



## *Industry Report Series*

# 2006 Financial, Real Estate, and Creative Industries

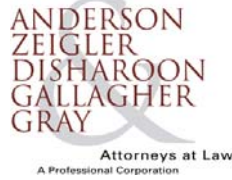


*Presented by the Sonoma County Economic Development Board, in partnership with the Sonoma County Workforce Investment Board*



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# 2006 Financial, Real Estate, and Creative Industries Report

November 2006

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2006 Financial, Real Estate, and Creative Industries Report. Our research partner, Moody's Economy.com, produced this report for the EDB.

Highlights from the 2006 Financial, Real Estate, and Creative Industries Report include:

- **Despite near-term turbulence for banks, real estate firms, and insurance companies, the financial services industry in Sonoma County has a positive long-term outlook.** Interest rate hikes may cause some short-term fluctuations, but Sonoma County has many comparative advantages to attract more financial services business, including above-average per capita income, good quality of life factors, favorable climate, and proximity to San Francisco.
- **Sonoma County's real estate market will be significantly cooler in the coming months than it has been in recent years.** Residential building permits have moderated throughout the year, but still remain elevated. Existing home sales, however, have declined quite steeply and are near a 10-year low, while real estate firms have already begun to trim their payrolls.
- **Sonoma will continue to attract the biotech industry, which will be an important asset to the area over the long run.** Once current lagging venture capital investment returns to traditional drivers, including electronics and software, creative employment should experience a marked improvement.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have any questions, please feel free to contact us at (707) 565 - 7170.

Sincerely,



Ben Stone  
Executive Director

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# Financial, Real Estate and Creative Industries - Sonoma County

**Recent Performance.** Sonoma County's economy is expanding, albeit with some volatility. Yet, payrolls in the financial services industry have fallen for the past three years and have regressed to their 1998 level. The downturn among insurance carriers has lasted even longer, with employment at a 15-year low, but it has leveled off over the past year. Meanwhile, residential real estate is entering a period of adjustment to higher interest rates and slower construction and sales. Nevertheless, household finances in the county remain healthy. Consumer loan delinquency rates edged upward in the first half of 2006 according to CreditForecast.com, but not nearly to the degree they did statewide and across the nation. Credit conditions are bolstered by Sonoma County's unemployment rate of around 4%, its lowest rate since 2001.

**Macro Drivers.** The changing macroeconomic climate will pose significant challenges for the broader financial services industry. As the business cycle winds down, the economy is now showing signs of below-potential performance. National employment growth has been below expectations throughout the year, and real GDP growth expectations for the coming 12 months are less than 3%. Business confidence is slipping among construction and real estate firms. Business investment spending plans remain a bit sturdier, but are indeed easing. Banks are facing higher interest rates, as the Federal Reserve has ratcheted up its target rate in order to contain rising inflationary pressures. Similarly, higher mortgage rates and a national decline of the housing market are weighing heavily on the real estate sector.

Record low mortgage rates sparked a frenzy over the past two years in housing markets not only on the West Coast but in Florida and the Northeast. In the past few months, however, a period of readjusting has set in. Nationally, home sales are down 10% over last year, construction is down, and prices have flattened. However, through the summer months, the cooling housing market has not imposed a disproportionate burden on the U.S. economy outside of housing-related industries.

**Financial Services.** Sonoma County's financial service industries face a more challenging environment than they did two years ago when short-term interest rates were at record lows. Over the near term, the outlook for employment growth in the industry

remains weak. Financial institutions must readjust to higher, but not yet restrictive, interest rates after 17 consecutive rounds of tightening by the Federal Reserve. Although short-term interest rates have increased, longer-term rates have not yet risen substantially, and thus the yield curve, which traces interest paid on Treasury notes of different durations, is currently inverted. Small regional banks depend heavily on a positive interest rate spread, paying lower rates for short-term deposits and charging higher rates on longer-term loans; thus they are impacted by a flat or inverted yield curve. Meanwhile, larger banks have also been squeezed, but have had more success in maintaining their profits with their more diversified sources of revenue and strong activity in consumer and industrial lending. However, a decline of business confidence may rein in demand for business lending over the coming year.

Offsetting the negative trends in interest rates and the housing market has been the continuation of solid credit quality that has reduced the number of charge-offs by banks. The personal bankruptcy filing rate in Sonoma County has been falling back toward its trend rate this year following a one-time spike late last year when bankruptcy law was reformed. Additionally, delinquency rates in Sonoma County for credit cards, mortgages, and most other forms of consumer debt have held nearly steady this year despite an upward trend nationwide.

The wealth and credit quality of Sonoma County make it attractive over the long term to financial service providers and a wide variety of personal services. However, the industry is outpacing the county's declining demographic trends, creating a much more competitive environment. Net migration has turned negative over the past four years, owing largely to an extremely high cost of living. Sonoma County's quality of life will continue to draw high income households into the area, but its high cost structure will be a major impediment to the continued growth of both population and business in the county.

**Real Estate.** Sonoma County's residential real estate market will be significantly cooler in the coming months than it has been in recent years. Residential building permits have moderated throughout the year, but still remain elevated. Existing home sales, however, have declined quite steeply and are near a ten-year low, while real estate firms have already begun to trim

their payrolls. According to the California Association of Realtors, the median existing price in the North Bay region has fallen roughly 6% from its peak in January and is now about \$620,000. The housing market is oversupplied and overpriced, and with merely average personal income growth, prices have risen far beyond what the market can bear. Moody's Economy.com estimates that in the second quarter of 2006, the median income-earning household in Sonoma County could only afford to buy a house priced at 46% of the median sales price, which is nearly a record low rate of affordability. Prices have been heavily influenced by investor demand for homes, which has driven prices beyond affordability for the local market. Speculative buying is quickly fading away, however, with higher mortgage rates and declining prices. An expanding economy will still generate demand within the local market and demographic trends will support longer-term demand for retirement or vacation homes, helping to stabilize the market in the years ahead.

The commercial real estate market is showing much more promise. Office space-using employment recently rebounded, and demand for commercial real estate appears to be stronger than at any time since the 2001 recession. Although office vacancy rates hover around 20% in Sonoma County, according to Keegan & Coppin Co., much of this vacant space is concentrated in the Rohnert Park submarket. Agilent Technologies abandoned its 700,000 sf campus in Rohnert Park, single-handedly reversing Sonoma County's otherwise improving absorption rates. Therefore, with this one exception, demand for office space should be moderate but positive over the coming year, with asking rents and new construction picking up.

Industrial markets are even stronger. Keegan & Coppin estimates a 6.1% industrial vacancy rate as of the first quarter of 2006, down from 8.5% a year earlier and a peak rate of 11% in mid-2004. Given that a number of small firms are garnering venture capital and other sources of capital infusion, the outlook for industrial space demand is reasonably good, although it will likely be absorbed in small increments. Moreover, construction permit issuance has been slow for new industrial space.

Finally, Sonoma County's retail market continues to exhibit the strongest performance. The vacancy rate for retail space has

remained at or below 4% over the past several years. New construction of retail space continues unabated, and most buildings have tenants lined up before completion. The Petaluma submarket is leading the way, followed closely by the Santa Rosa submarket. Large national chains are responsible for most of the leasing activity, and are putting upward pressure on asking rents. Retail real estate markets are expected to remain solid in Sonoma County, but consumer spending is expected to moderate nationally over the near term, creating some risk for retailing.

**Insurance.** The insurance industry has also faced its share of difficulties recently. Nationally, Hurricane Katrina was the costliest disaster for insurers in U.S. history and the industry has not yet fully recovered. Of course Katrina did not directly affect Sonoma County's local insurers, but national carriers were widely affected. State Farm is the largest insurance company by employment in Sonoma County, and it also incurred the greatest losses of any national insurance company. State Farm lost between \$8 and \$9 billion from Katrina, a record amount for an insurer from a single storm.

Insurance companies are also struggling with increasingly challenging economic conditions, including the maturing business cycle and higher interest rates. These factors have generated volatility in financial markets and eroded insurance companies' return on investments. Meanwhile, automobile and home sales, two of the industry's main drivers, are declining nationally. As one of the most overpriced housing markets in the country, Sonoma County, in particular, will see slower home sales, and thus, slower demand growth for homeowners' insurance. That said, Sonoma County's high house prices will still allow insurers to charge top premiums. Furthermore, Sonoma County's high level of household income will buoy auto sales in the area, even as rising interest rates and fuel costs hurt sales nationwide.

Meanwhile, the state legislature is currently working on a bill that would create a state-run public health insurance system for all Californians. While the proposal is not supported by the governor, it is indicative of the measures the state may consider in its effort to reform insurance. Such a measure would reshape the state and local insurance markets, but at least Sonoma County's largest insurance industry employer, State

Farm, is not highly concentrated in lines of health insurance.

**Creative Cluster.** The creative cluster is a group of industries that, at their core, employs persons in the fields of science and engineering, architecture and design, management and finance, education, arts, music and entertainment who create new ideas, new technology or new creative content. In Sonoma County, these occupations employ roughly 30% of the local workforce, approximately two percentage points above the national share.

Creative industries represent a significant portion of the local industrial base. Several major tech segments, including telecom and navigational/electromedical equipment, utilize the creative cluster of workers to generate new or improved products for long-term growth. These are industries, despite travails of the past several years, with growth potential for employment with above average wages and salaries, and they can be used to lure further high-tech investment to the county. Other drivers of the local economy, including wine and tourism, also rely on creative clusters to thrive.

In the near term, creative cluster employment growth will lag that of other industries. Creative clusters often depend on investment spending and venture capital to support research and fuel product development. While venture capital flows have improved, the major industry funded in the Bay Area has been biotech, an industry with a relatively small but growing presence in Sonoma County. Medtronic is by far the largest biotech firm in Sonoma County, but there are several smaller companies that are drawn to the North Bay area by its large share of professionals with technical, scientific, or biomedical backgrounds. Sonoma County will continue to attract the biotech industry, which will be an important asset to the area over the long run. Once current lagging venture capital investment returns to traditional drivers, including electronics and software, creative employment should experience a marked improvement.

**Long-Term Outlook.** Despite near-term turbulence for banks, real estate firms, and insurance companies, the financial services industry in Sonoma County has a positive long-term outlook. Interest rate hikes may cause some short-term fluctuations, but Sonoma County has many comparative

advantages to attract more financial services business, including above average per capita income, good quality of life factors, favorable climate, and proximity to San Francisco. These factors will also encourage development in Sonoma's creative cluster, which will be an increasingly important driver of the economy in generating long-term comparative advantage for the area's basic industries.

**Upside Risks.** Despite its generally weak migration trends, Sonoma County does consistently lure new residents away from the neighboring San Francisco area. Furthermore, these in-migrants have a well above average level of median income, bolstering Sonoma County's already strong income trends. This pattern is expected to continue as the economies in San Francisco and Oakland improve. This will help Sonoma County's financial services industries by stimulating demand for both private borrowing and business investment. Additionally, as home to several high-tech manufacturers, the area could see an increase in federal funding as the government looks to upgrade its systems and electronic intelligence capabilities.

**Downside Risks.** A correction in the housing market remains the primary negative risk for Sonoma County. The county is a highly desirable residential location, but speculation and investment in second homes have driven prices far beyond sustainable levels. Price appreciation has already halted in the county and Moody's Economy.com estimates that it faces a significant negative risk of overall price declines. This would have widespread effects on the area's economy, particularly the financial services sector. Declining prices would threaten homeowner credit quality, curtail demand for consumer borrowing, and reduce the pace of real estate transactions.

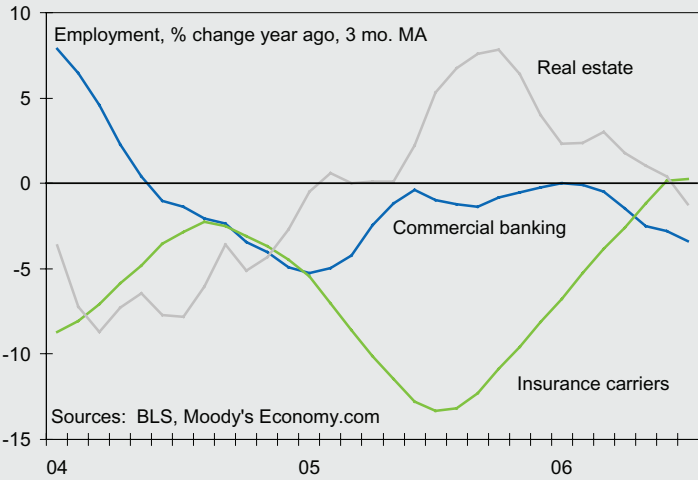
Over the long term, problems with housing affordability or greater reluctance among venture capital investors could cause creative class workers to seek more inviting locations, thus limiting the generation of new ideas, products and, ultimately, new industries.

Furthermore, higher interest rates could precipitate a decline in business investment, which would hurt both Sonoma County's financial institutions and its base of high-tech equipment manufacturers.

*Sean Maher  
November 2006*

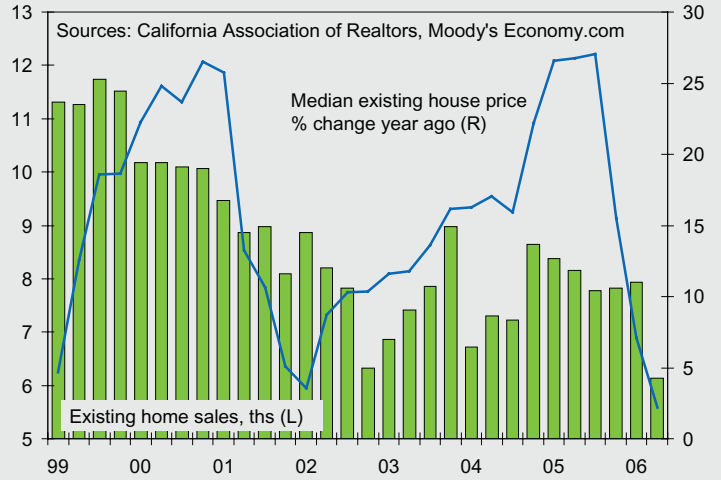
# Financial, Real Estate and Creative Industries - Sonoma County

## Financial Services Struggle in Sonoma County



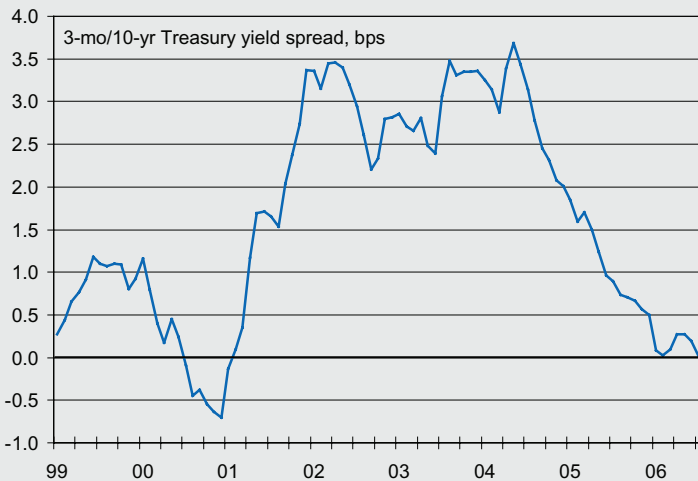
Sonoma County's financial services have been unable to gain any traction since 2001. In recent years, real estate has offered some support to Sonoma County's financial services industry, but the cooling housing market has put an end to its expansion. Although a maturing business cycle and higher interest rates make the near-term outlook for financial services dim, the industry is expected to recover in the long run due to Sonoma County's exceptional wealth, credit quality, and labor force quality.

## Homebuyers Gain the Upper Hand in Sonoma County



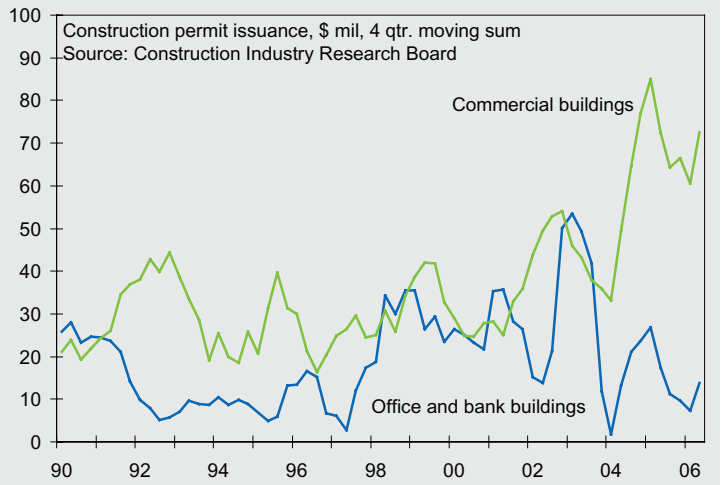
Sonoma County's housing market has become a buyers' market. Sales have declined to their lowest level in ten years, inventories of unsold homes stand at record highs, and prices in the county have recently begun to fall. Many home sellers will soon be forced to either take their homes off the market or reduce their asking price. Others are undertaking additional repairs and upgrades to get their homes sold. These added incentives are not reflected in the market price, but they reduce the effective price received by home sellers.

## Flat Yield Curve Eats Into Bank Profits



Yields on long-term Treasuries are below yields on shorter-term issues, a condition that is known as an inverted yield curve and often precedes economic downturns. Strong global demand for long-term Treasuries has suppressed long-term rates, but this demand has moderated and the continued inversion of the yield curve is now more cause for concern. It indicates an elevated risk of a recession, and has squeezed banks' profit margins as the interest they earn on long-term loans is not enough to cover payments on short-term deposits.

## Non-Residential Real Estate Conditions Are Mixed



Sonoma County's office vacancy rate remains near 20%, and demand for new office space is low. After improving in 2005, employment in office-using industries has since declined, erasing much of the previous year's gain. However, several large concentrations of vacant space, such as the Rohnert Park campus, are responsible for the county's high vacancy rate. Meanwhile, retail space continues to move at an overly brisk pace, driving vacancies down and rental rates very high. This cycle may be at its peak, however, as consumer confidence deteriorates.