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Local Economic Report Series

Tourism Industry

2002



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Tourism is a strong economic driver in Sonoma County [SON], employing approximately 20,000 people, and representing an important career ladder for Sonoma County residents.

Although both positive and negative trends are found in the Sonoma County hospitality sector report for 2002, the long-term outlook predicts growing profitability within the industry. Highlights from the report include:

- ◆ The hotel occupancy rates in Sonoma County are higher in July 2002 compared to July 2001
- ◆ The nationwide shift towards shorter vacations within driving distance protected the Sonoma County tourism sector
- ◆ The pricing power of the industry has the possibility of increasing through promoting all available tourism activities, including beaches, specialty foods and golfing
- ◆ The industry has stabilized more quickly than statewide and nationwide tourism industries signaling strong underlying demand in Sonoma County

The report complements the survey on the tourism sector produced by the EDB earlier this year, which can be found at www.sonoma-county.org/edb/Reports.htm; the report is listed as the “Tourism Report 2002”.

Economy.com produces the Local Economic Report Series for the EDB with the cooperation of the local Workforce Investment Board (WIB). This year, the WIB is focusing on enhancing the workforce for tourism as one of six priorities in its work program.

Thank you for your continuing interest in the local economy.

Yours sincerely,

Ben Stone
Director

Sonoma County Tourism

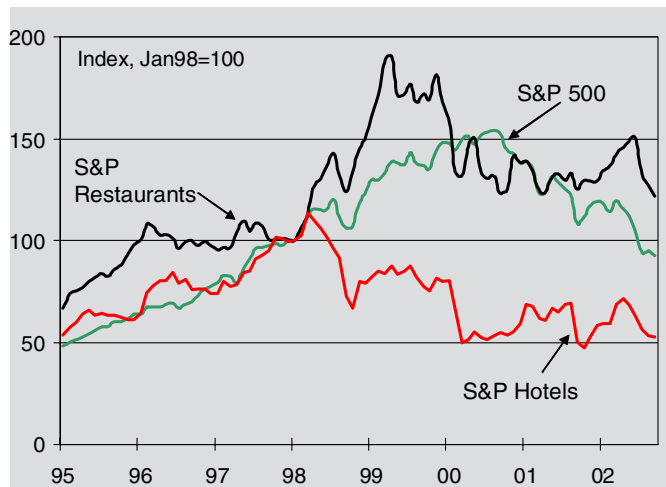
Recent Trends. The Sonoma tourism industry has begun to recover, despite challenging economic conditions in its key feeder markets. According to PKF Consulting, after sagging through the early part of the year, hotel occupancy in Sonoma and Napa Counties moved ahead of year-ago rates in July. Hotel room rates are also holding up strongly: rates for Sonoma and Napa Counties are even with a year ago but down 3% nationwide and down almost 5% in California. Labor markets show positive signs. The county's unemployment rate has fallen below 4% once again after rising through the first quarter, and payrolls in retail trade – the cluster that accounts for the largest share of SON's gross output behind high-tech manufacturing - continue to expand.

Indeed, SON's tourism recovery is particularly impressive given the Bay Area's painfully slow march through recession. Over 40% of overnight visits to SON originate in the Bay Area, and an additional 30% of visitors come from other parts of California. That SON has performed solidly even amid weak conditions in the Bay Area and statewide is a harbinger of solid gains for the county once a broader California-wide recovery takes hold.

California's economy indeed has stalled. It came to an abrupt halt in January 2001 and has gone nowhere since. There is no sign of a turnaround yet, and it will be next year's second quarter before any significant upturn is seen. Tech-related industries have likely seen the nadir of demand, but payroll cutbacks are still in the offing, and airline industry consolidation poses some risk here as well.

The Bay Area remains mired in recession. Payroll employment in the Bay Area has contracted for five consecutive quarters, and the pace of contraction has eased only slightly. Employment remains down 1.8% on a year-ago basis, and while the dot com bust has long passed, the risks of further job cuts in transportation, and financial and business services remains high.

Redoubling the impact of the Bay Area's slowdown on SON tourism has been the distribution of job losses among industries. Business services payrolls - including programmers, IT consulting, engineering services, etc. - fell by 141,000 during 2001, and payrolls have slipped by an additional



9,000 this year. Average annual earnings for the Bay Area in this industry were over two times the national average in 2000. Financial services employment, where average earnings were nearly 50% higher than the U.S. level in 2000, has also suffered steep declines. Payrolls dropped by over 2,000 in 2001 and have fallen another 1,000, this year.

A nationwide shift towards shorter vacations within driving distance, however, has buffered the downturn for SON. Residual fear of flying due to 9/11/01 combined with reluctance to take more costly vacations has conspired to favor drive-to destinations like SON over larger fly-to markets.

More broadly, however, the floundering of the U.S. recovery is hampering a more robust rebound in SON tourism. While Tourism Program data indicate the majority (69%) of SON visitors are from in-state, out-of-state domestic visitors account for over a quarter of the total, and as the bulk of them fly in, these visitors stay longer and spend more, on average, than their in-state counterparts.

Despite these constraints, tourism in SON is mounting a steady recovery. While investment in new lodging and winery projects has cooled this year due to weaker revenues, winery and hotel operators continue to invest in enhancements and additions, and a handful of notable hotel projects recently points to a still-healthy level of optimism. The county's geographic endowments, name recognition and strong tourism infrastructure should help the tourism industry finish the year even with, or slightly ahead of, 2001.

Macro Drivers. The macroeconomic recovery is listing, with the nation's economy expanding at a very tepid pace. An ongoing slide in business investment and sharp erosion

in the nation's trade balance are largely offsetting continued gains in consumer and government spending. Although labor market conditions are not deteriorating as rapidly as they were at the start of the year, the pace of job creation remains anemic. The jobless rate could well move above 6% by year's end given the threat of further layoffs in transportation, manufacturing and financial services.

The soft labor market is not the only factor hampering a robust recovery in leisure tourism demand. The ongoing slide in equity markets

is also a factor. Some \$7 trillion in stockholder wealth, equal to over 40%, has evaporated since the bear market began in early 2000. Current stock wealth is back close to where it was over five years ago.

Spending on travel in the U.S. remains depressed. Consumer expenditures on intercity travel was down 7% from 2001 during the second quarter, and foreigners spent over 10% less this year on travel in the U.S. than in 2001Q2. While year-ago declines have been diminishing since the fourth quarter 2001, the fundamental drivers of travel demand will continue to hamper a return to pre-9/11/01 volume for the near term.

Personal income is on track to finish the year at its slowest growth rate in over four decades, and payroll employment in 2002 will likely finish the year below where it started for only the third time since 1991. However, due to tax cuts, disposable income growth should finish the year up markedly from 2001, close to 5%. Disposable income growth will fall to a more pedestrian pace in 2003, but should still come in well above 2001's pace.

Industry Drivers. Tourism industry investment in SON experienced a brief lull following 9/11/01, but it has picked up in 2002 and will be unaffected by the attacks longer term. Modest hotel room supply growth in recent years, widening name recognition and a shift to drive-to destinations are all helping the local market.

Hotel construction looks to accelerate over the next several years for two reasons. First, trends in room revenue, occupancy rates and pricing power in SON have all outshone surrounding areas in the Wine Country. Performance has snapped back in 2002 more quickly than statewide and

nationwide, signaling a market with robust underlying demand. Occupancy rates in Sonoma and Napa counties were slightly ahead of a year ago in July, while they continued to play catch up in the rest of the country. Second, nearly three-fourths of visitors to SON are leisure travelers, saving the area from the business-travel implosion that continues to plague metro areas like San Francisco and Boston.

However, while SON itself is not host to a large volume of business travel, it is vulnerable to slowdowns in business travel in the Bay Area because out of state visitors frequently take day trips from the Bay Area to visit SON.

Going forward, the business travel market presents potentially fruitful avenue for investment, and lodging developers are looking increasingly toward catering to business travel demands. Groundbreaking on a new 125-room eSuites hotel is slated for the first quarter of 2003. Rooms are to include a PC, a fax-printer-copier unit, digital cable TV and DVD players and an in-hotel e-mail account. The newly opened 183-room Sheraton Petaluma offers a similar array of high-tech equipment for guests.

These hotels, while larger than the county's upscale boutique hotels and bed and breakfasts, will carry high costs and charge upscale room rates, further solidifying SON's reliance on upper-income travelers. The Hotel Healdsburg, which opened in October 2001 is a recent 55-room addition to the county's high-end product, with rates on some rooms topping \$600/night. Furthermore, the opening of Santa Rosa's \$36 million Vineyard Creek Hotel, Spa and Conference Center, and renovation activity at the DoubleTree Hotel, Sonoma County Wine Country, and the Mark West Lodge in Santa Rosa also underscore healthy demand expectations.

Demand drivers for tourism activity in SON will remain strong through the forecast horizon. Winery tourism is still growing more quickly than more established types of vacationing. And among wine growing regions, SON should command a strong share of the travel market on the strength of the popularity of its wine labels. And located within one of the most highly productive labor markets in the country, SON can expect continued expansion in its upper-income tourist base in and around the Bay Area.

Pricing. While the faltering labor market recovery will put downward pressure on hotel and restaurant prices in the near term, hotel room rates, at least, have caught up to year-ago levels in recent months.

The wine making industry faces an increasingly competitive pricing environment. While the weakening in the dollar this year will favor domestic producers and give some support to prices of SON labels, an abundant grape harvest statewide, and an increasing volume of lower priced imports will militate against price rises.

More broadly, tourism industry pricing will remain under pressure in coming quarters. Nationwide, hoteliers have been forced to slash rates to get occupancy back near year-ago rates. Facing a falloff in business travel, upscale hotels have reduced room rates in a bid to induce lower-budget vacationers to trade up. As SON caters to higher income travelers primarily, its hotel market is vulnerable to the price-cutting going on at other destinations across the country.

Pricing power over the longer term depends primarily on the county's ability to differentiate its tourism product from surrounding destinations. This can be accomplished best by developing not just a single activity like winemaking, but all of SON's tourism assets, including beaches, wineries, specialty foods and golfing into a unique basket of activities. Maximizing the attraction of multiple types of vacation activities will not only broaden the tourist base, it will enhance SON's pricing power by giving the county a unique product to offer travelers.

Operating Expenses. Tight labor markets remain the number one input cost concern for the tourism industry. The county's jobless rate has averaged 1.5 percentage points below the national average for the last five years. A shortage of both skilled and unskilled labor plagues the region, putting upward pressure on wages. Low housing affordability (the median-priced home in SON is roughly half as affordable for SON residents as the national average) is one factor keeping the availability of labor low.

Marketing expenses will also rise as competition in the wine and tourism markets intensifies. With the Internet making travelers increasingly price sensitive, the county risks the defection of existing visitors as well as the loss of potential first-time visitors, if it does not seek out target markets aggressively through multiple channels.

Higher energy prices are a downside risk to the outlook. California's energy supply has not kept up with the pace of population growth and supply remains volatile. Electricity costs have a major impact on the bottom line of large

hotels, especially when hotels choose to maintain high occupancy via lower room rates.

Profitability. With its foot in a growing niche of the tourism industry, and with significant name recognition and pricing power among upper-income travelers, the outlook for profitability is positive. Erosion in pricing power due to competition from other upscale resorts in California however, poses a clear threat to bottom lines. And an expanding supply of hotels and restaurants within SON will drive profits downward over time.

Longer-term risks include county building restrictions that help keep the cost of housing (and thus labor) high, and an unexpected erosion of market share for Sonoma wines that leads to a falloff in the popularity of traveling to SON wineries.

As the state and national economies recover more strongly in 2003, however, and as SON's array of lodging and winery offerings grows richer, longer visitor stays and higher per visitor spending should bolster profits.

Long-Term Outlook. The industry's long-term outlook calls for healthy, measured expansion on the strength of the county's geographic endowments, name recognition and proven ability to attract investment. That said, an emerging challenge for the county will be to account for changing demographics in the U.S. population. Population growth in the 35-54 age cohort, from which SON draws nearly 60% of its visitors, is decelerating and is expected to drop below zero by roughly 2007. Over the same time period, the 55 and over age group will swell at an accelerating pace. Growth is forecast to average 2.6% annually for the next decade.

Upside Risks. A brisker than anticipated expansion in the domestic wine-drinking population would boost tourism industry growth above baseline expectations. An increase in housing affordability, a quicker than expected rebound in the Bay Area, and a slow onset of competition from nearby counties would all bring about better than expected performance.

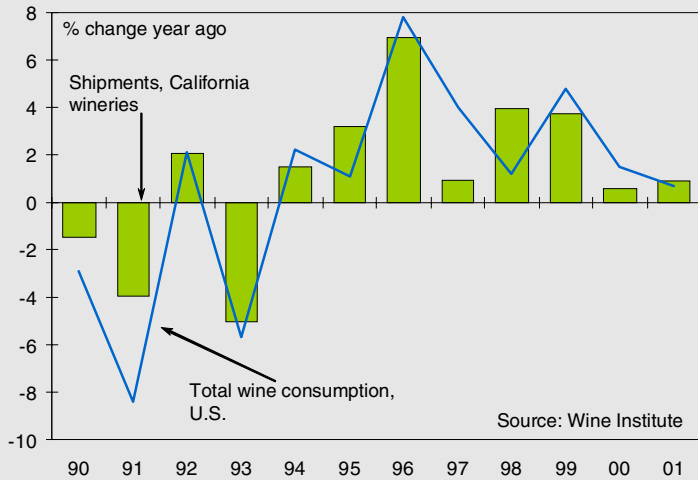
Downside Risks. The most significant near-term risk to the outlook is the potential for the U.S. economy to slip back into recession. While this is still an unlikely event, the risks are rising. A longer term downside risk is a shift in consumer preferences away from wine consumption and winery tourism.

David Givens

September 2002

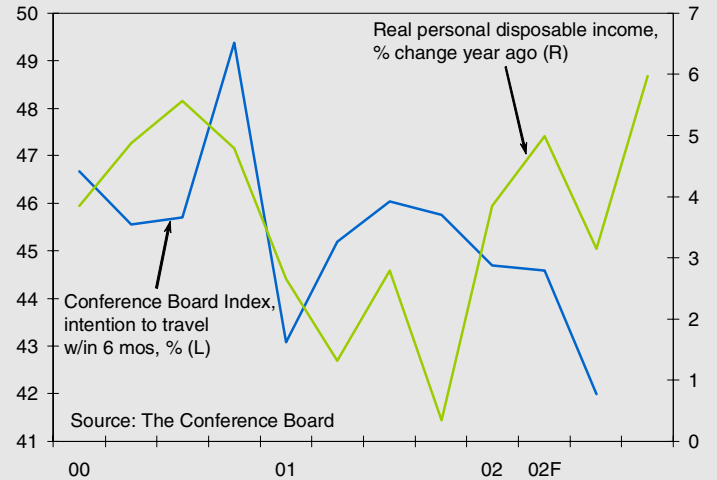
Sonoma County Tourism

Faltering U.S. Demand Will Hurt Vintners and Winery Tourism



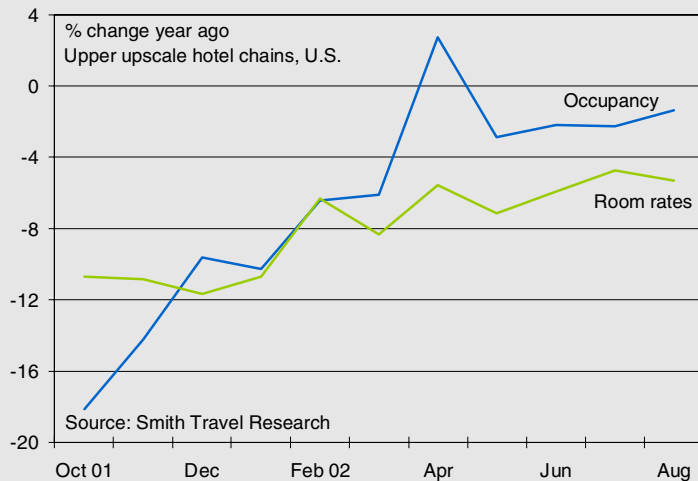
Growth in wine consumption in the U.S. is decelerating. Furthermore, increased import competition, a growing number of domestic wineries, a fall in disposable income and reduced leisure and business travel have are weighing on sales of SON labels in particular. Slower growth in sales of SON wines will likely restrain growth in first-time visitors to the county's wineries.

Stronger Incomes Will Fuel Recovery in Travel



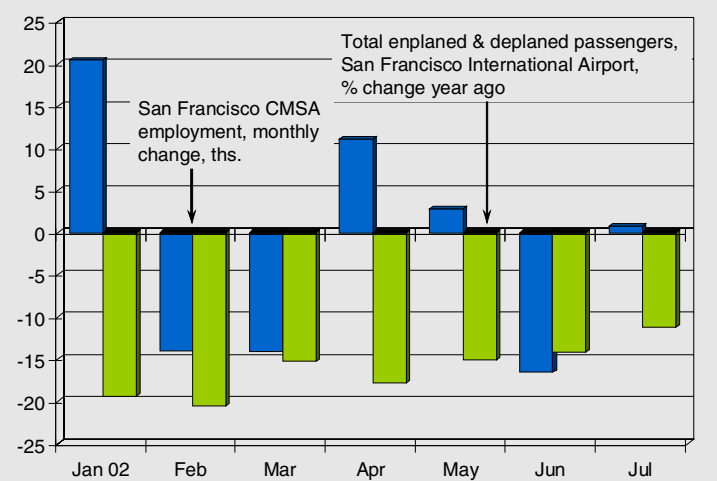
The U.S. economy's lackluster recovery, depressed equity markets and lingering travel fears from 9/11/01 continue to weigh on consumers' appetite for travel. According to the Conference Board, intention to take a vacation within the next six months is at its lowest level in over two decades. However, as labor markets revive, disposable income growth will accelerate, fueling increased discretionary spending on the part of households.

Low Room Rates Bolstering Occupancy at The High End



The high end of the hotel market continues to suffer weak pricing power. Demand has come back close to year-ago levels, but this is only thanks to lower room rates. While in SON occupancy is up and room rates flat compared to a year ago, the national trend illustrates the intensity of price competition in the upscale lodging market. Price competition remains a downside risk to profitability for SON tourism, especially as its lodging supply grows.

Bay Area's Economy Is Still in Recession.



According to the Sonoma County Tourism Program, the Bay Area is the source of more than 40% of overnight visitors to the county. The steep decline in the Bay Area's job market and the dropoff in fly-in visitors have dampened the flow of upper income visitors to the county for two reasons. Bay area residents themselves are taking fewer trips, and the falloff in business travel has cut down on day trips by out of state visitors.