



# Financial, Real Estate & Creative Industries Insider

**2011**  
SONOMA  
COUNTY

# Financial, Real Estate & Creative Industries Insider

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March 2011

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2011 Financial, Real Estate & Creative Industries Insider. Our research partner, Moody's Analytics, provided the research for this report. Creative industries include creative arts, technology services, and related professional services. Some components of the cluster are science and engineering, architecture and design, management and finance, arts, music, and entertainment.

Highlights of the 2011 Financial, Real Estate & Creative Industries Insider include:

- Job losses have finally eased in formerly hard-hit industries such as construction, reflecting overall improvement in the labor market from the depths of the recession.
- Consumer credit conditions are improving. Delinquency rates for all types of credit remain below the state level, although mortgage delinquencies remain at elevated levels.
- The pace of economic recovery in Sonoma County and the U.S. will be assisted by strong growth in developing Asia in 2011 and 2012. This will help to offset the weaker near-term outlooks for Europe and Japan.
- Stronger job growth in office-using industries will help to lower office vacancies in 2011. The vacancy rate will fall below 20% by 2012 as Sonoma County transitions into a full economic expansion. However, the existing oversupply of space will hinder demand for new construction in the short-term.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit [www.sonomaedb.org](http://www.sonomaedb.org).

Sincerely,



Ben Stone  
Executive Director

**MOODY'S**  
ANALYTICS

SONOMA COUNTY  
**WORKFORCE**  
INVESTMENT BOARD

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SONOMA COUNTY  
ECONOMIC DEVELOPMENT BOARD

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# Sonoma County: Financial, Real Estate & Creative Industries

## Recent Performance

Sonoma County's recovery is regaining momentum. Though modest, recent improvements are spread throughout the tech, tourism and wine industries. Small employment gains and a stabilizing labor force have pushed the unemployment rate lower, to just above 10%, down by nearly a percentage point from the peak in March 2010. Professional, scientific and technical services and financial services are slowly beginning to add workers. Job losses have finally eased in formerly hard-hit industries such as construction, reflecting overall improvement in the labor market from the depths of the recession.

Consumer credit conditions in the county are improving. Delinquency rates for all types of credit remain below the state level, although mortgage delinquencies remain at elevated levels.

Housing is cooling, with both prices and sales falling after the end of federal and state housing tax credits. The decline in construction permit issuance is finally easing after a four-year decline, although permits are only at 20% of their 2004 peak.

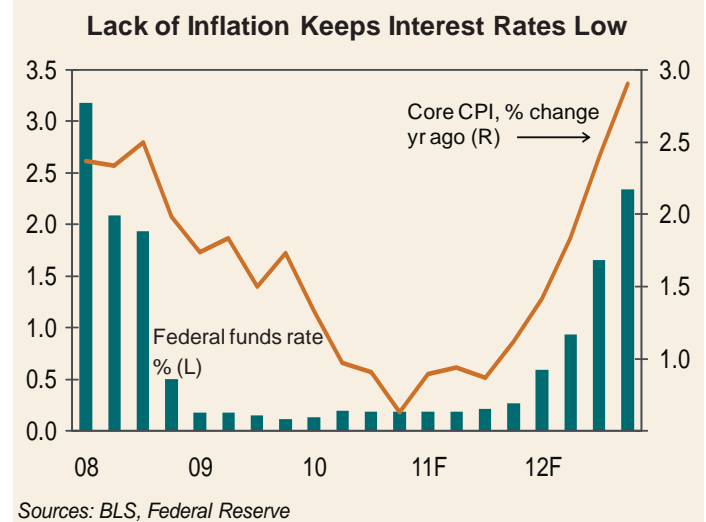
## Macro Drivers

The U.S. economy is gaining traction. U.S. GDP grew 2.8% both in the fourth quarter of 2010 and for the entire year, following a contraction of 2.6% in 2009. Growth in the fourth quarter was the fastest since the first quarter of 2010. Retail, vehicle and even home sales have firmed in recent months; business investment remains strong, and export gains are sturdy.

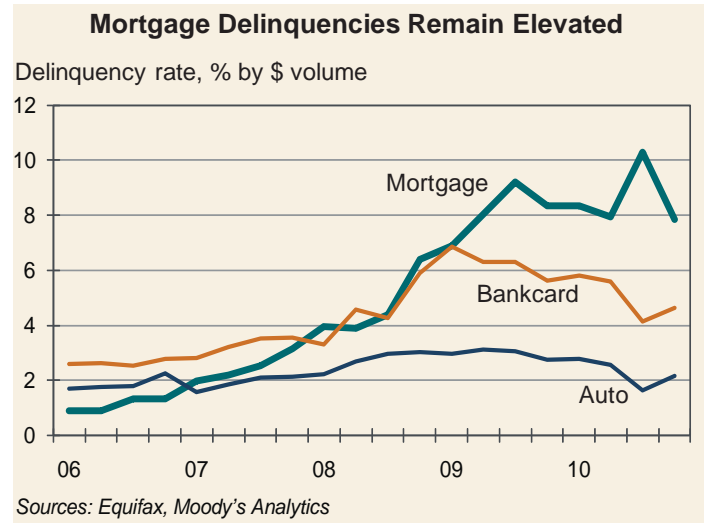
December's deal between President Obama and congressional Republican leaders to extend the Bush-era tax cuts and reduce payroll taxes for all workers was instrumental in improving the U.S. economic outlook for 2011. This latest round of stimulus will push forward some growth from 2012 to this year—U.S. real GDP will grow 3.7% this year and 4% in 2012, when the economy will fully transition into expansion.

The pace of improvements in the labor market will be slower. After approaching 10%, the unemployment rate has recently fallen largely because of the contracting labor force. The jobless rate will tick upward briefly as formerly discouraged workers re-enter the workforce, partly masking the improved pace of job creation before falling below 9% by the end of the year. Private sector payroll growth will be more than double its 2010 pace, adding approximately 2.7 million net new jobs—up from 1.1 million in 2010.

The pace of economic recovery in Sonoma County and the U.S. will be assisted by strong growth in developing Asia in 2011 and 2012. This will help to offset the weaker near-term outlooks for Europe and Japan. Europe, in particular, is bogged down by the specter of a renewed sovereign debt crisis and budget tightening by governments. Export growth slowed in the second half of 2010 but remained strong for tech products. The pace of export growth will increase in the second half of 2011 and will strengthen through the middle of 2012.



The Federal Reserve will keep interest rates at their low levels until inflationary pressures begin to build by the end of 2011. To date, core consumer price inflation has been weak as a result of spare capacity in labor markets and elsewhere in the economy. As the recovery regains momentum and the pace of hiring strengthens, firms will begin to exhaust productivity gains and face increased input costs, labor in particular. Dwindling productivity will also diminish firms' ability to avoid passing along rising agricultural and energy prices to consumers.



Mortgage credit quality will remain a lingering near-term concern for Sonoma County's financial services and other real estate-related industries. While the county's mortgage delinquency rate remains below the California rate, it has exceeded the U.S. rate since the beginning of 2009, reflecting the sharp losses in both employment and house prices during the recession. The high level of delinquencies threatens to set off another round of foreclosures and ultimately more distress sales, which would extend house price declines further into 2011 and 2012.

# Moody's Analytics Financial, Real Estate & Creative Industries

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## Financial Services

U.S. financial conditions will strengthen amid improving macroeconomic conditions. Amid expectations of stronger growth, banks are easing lending standards for large companies, and companies are increasing their demand for money, according to the Federal Reserve's most recent survey of senior bank loan officials. Low levels of inflation will allow the Fed to keep its zero interest rate policy through at least the middle of this year before beginning to raise the federal funds rate.

Sonoma County's small and midsize banks will grapple with problematic commercial real estate mortgage and construction loans in the near term. In August, the FDIC closed Sonoma Valley Bank—the fifth nationwide recipient of TARP funds to be shuttered by regulators. The county's two other TARP recipients have yet to repay their outstanding capital injections, limiting their ability to expand lending to local businesses until the quality of their loan portfolios improves. Local household and business balance sheets will generally improve in 2011. Business and personal bankruptcy filings in the county rose in 2010, although business filings did edge down at the end of the year. The strengthening pace of recovery will push down business filings further in 2011, but more moderate improvements in the labor market will keep personal filings at elevated levels until 2012. More encouraging, delinquency rates of consumer and mortgage loans have peaked and will move downward in 2011.

Sonoma County remains attractive for financial services in the long run. Demographic trends have improved, with population growth close to 1% for a third consecutive year in 2010, according to the California Department of Finance. In addition, per capita income is growing again amid a rebound in high-value-added tech-producing industries located in the county, and it remains well above the state and U.S. averages.

## Real Estate

The housing market in Sonoma County will reach its true bottom in 2011. With the expiration of federal and state incentives for home purchases and a renewed increase in foreclosure filings following the voluntary moratorium by major lenders, house prices will decline through the middle of this year as the number of distress sales increases. The total peak-to-trough decline in the median house price will be nearly 45%—17 percentage points larger than the U.S. decline but close to the state's 47% drop. The county's foreclosure rates and price declines will be smaller than in the hard-hit housing markets in the Central Valley but more severe than in the coastal housing markets in the Bay Area. By the end of this year, housing affordability will reach a record high in Sonoma County, a positive outcome of further price declines for homebuyers.

The issuance of residential construction permits will begin to strengthen this year as house prices near a bottom and pent-up demand for housing is unleashed. Permitting will accelerate in 2012 and will peak in 2013 at only slightly more than half the previous peak level reached at the end of 2004. The looming, albeit moderate, recovery in residential construction will cause construction employment to increase in 2011 after falling 45% since 2006.

Stronger job growth in office-using industries will help to lower office vacancies in 2011. Professional services registered moderate jobs gains last year, and according to Keegan & Coppin Company, the office vacancy rate was 22.3% in the fourth quarter of 2010—a decline of 2.5 percentage points from the peak at the end of 2009. The vacancy rate will fall below 20% by 2012 as Sonoma County transitions into a full economic expansion. However, the existing oversupply of space will hinder demand for new construction in the near term.

Industrial markets will similarly improve further in the near term amid a strengthening regional and U.S. recovery. After peaking at 15.6% in the first quarter of 2010, according to Keegan & Coppin Company, the industrial vacancy rate fell to 13.9% in the fourth quarter. Demand for industrial space has been boosted by growth among technology manufacturers. After laying off 300 workers in 2009, Agilent Technologies' Santa Rosa-based electronic measurement division is boosting employment and production in 2011. Renewed demand and a dwindling inventory of new industrial sites—no construction permits for industrial space were issued in the county last year—will support new construction in the near term.

The retail space market will slowly improve in the near term. The vacancy rate fell to 8.5% in the fourth quarter, after peaking at 9.2% at the end of 2009, but is still more than double the prerecession rate. Retail employment will begin to increase in 2011 after falling more than 14% since 2007—more than double the decline for the U.S. Despite the slowdown in construction of new commercial space (issued construction permits fell to their lowest level last year in several decades), the availability of sites vacated by national and regional retailers will suppress demand for new construction.

## Insurance

Rising costs and new regulations will squeeze the profits of insurers operating in Sonoma County. Health insurers have already faced surging costs prior to the implementation of the federal healthcare reform law. Hospital costs jumped 150% from 2000 to 2009, according to the California Office of Statewide Health Planning and Development, outpacing the 50% nationwide increase in medical care during the same period. In early 2011, the state's largest health insurers agreed to temporarily delay significant rate increases at the request of the California Department of Insurance.

In light of tighter profit margins, insurers are reducing operating costs. In November, State Farm Insurance—one of the county's largest private sector employers—announced that it will be closing its Rohnert Park office as part of a statewide consolidation resulting in the loss of nearly 500 jobs. Insurance companies are also introducing new products in California that reward safer behavior and reduce insurance payouts such as mileage-based automobile auto insurance policies.

## Creative Cluster

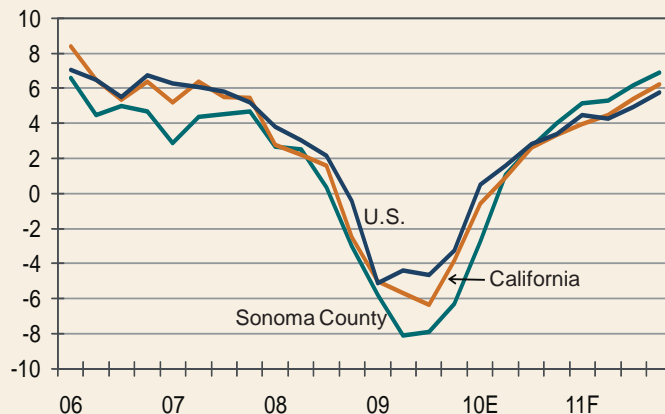
The outlook for Sonoma County's creative cluster of industries, which includes creative arts, technology services, and related professional services, will improve in 2011. After declining 25% from its 2008 employment peak, more than double the decline in other industries, the cluster began to moderately add jobs in the second half of last year. The cluster's components of science and engineering, architecture and design, management and finance, education, and arts, music and entertainment have fallen to 6% of total county employment. This is below the California average of 9% but slightly above the U.S. share.

The technology-related industries will be the cluster's primary near-term drivers. Electric measurement, biotech and broadband equipment are among the products designed in the county whose demand will grow as a result of federal and private investment in healthcare, electronic medical records, and high-speed internet. The improving economic outlook will be a boost for business services such as architecture, which shed jobs and reduced output in 2010 amid cost cutting by businesses.

The outlook for recovering venture capital investments, the lifeblood for several components of the economy's creative cluster, is also positive. A potential downside risk to investments was averted when a proposal to tax venture capitalists' profits at ordinary income tax rates rather than lower capital gains rates was not included in the federal tax deal. Silicon Valley venture capital placements rose in 2010 but remain below their 2008 peak. Placements for electronics and instrumentation—including clean energy equipment—were the largest contributors to growth. This will help to wean clean energy firms from their dependence on federal grants, loans and financial guarantees.

## Tech Will Lift Income Levels in Sonoma County

Wage and salary income, % change yr ago

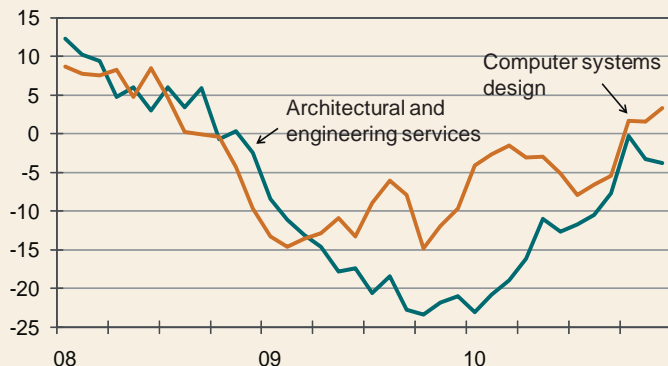


Sources: BEA, Moody's Analytics

Expansion within technology industries will boost Sonoma County's personal incomes, providing a near-term lift for FIRE industries. Construction and other real estate-related industries contributed the most to declining personal incomes and gross metro product during the recession and the subsequent weak recovery. Rising demand for the tech products and services designed and produced in the county is boosting incomes as firms expand payrolls and production. This is a positive for financial services and the cluster of creative service providers such as business services.

## Tech Outpaces Rest of Creative Cluster

Employment, % change yr ago



Source: BLS

Within the cluster of creative industries, most nontech firms will lag tech-related firms in the near term amid continued business cost containment. During the recession, businesses slashed spending on architecture, engineering and other services and have been slow to renew spending. Music and other performing arts organizations have faced a decline in both business and personal charitable contributions, putting stress on already-tight budgets. In contrast, cuts to state higher education funding have increased demand for private colleges.

# Moody's Analytics Financial, Real Estate & Creative Industries

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## Long-Term Outlook

Financial services, real estate, insurance and the creative cluster will benefit as the county's economy transitions from recovery to expansion. However, long-term growth will be modest relative to the high rate of growth experienced during the tech boom a decade ago and the period prior to the recent recession. The slower rate of growth will be more in line with Sonoma County's projection of moderate population gains in the long term.

The creative cluster maintains the brightest long-term outlook, given its inherent strengths and its position in the larger California creative economy. Sonoma County's climate, quality of life, proximity to Bay Area urban centers, proximity to nearby technology centers and universities, and abundant recreational opportunities will contribute to the area's ability to attract a highly educated and innovative workforce, as well as new investments, once the U.S. economy enters into a period of stronger economic growth. Biotechnology and energy-related technology offer particularly good potential for the future.

## Upside Risks

Strong growth in developing Asia—China and India in particular—represents a major upside risk for the county's finance, insurance and real estate industries. As more citizens of developing economies enter the middle class and as firms in these countries seek IT and other capital equipment, demand for the tech products designed and manufactured in Sonoma County will rise. This will boost demand for new tech-related office and industrial space in addition to further bolstering the strongest component of Sonoma County's creative cluster.

The recovery and structural change of the county's high-value and high-profile wine industry is an upside risk for industrial real estate and tech companies catering to internet based retail. Increased production will boost demand for new space for the manufacture and storage of wines. As more states remove the remaining restrictions on the interstate shipment of wine and other alcoholic beverages, demand will increase for firms that create and manage web-based wine retail and shipping operations.

## Downside Risks

The moderate drop in house prices in the first half of this year could give way to extended price declines in the second half of 2011 if foreclosures are greater than forecast and employment gains are anemic. This would bode ill for the county's financial services and real estate industries in that it would further exacerbate banks' already-troubled loan portfolios, seizing up lending for small and medium-size businesses and reinforcing expectations of further price declines.

The county's industrial real estate market faces some downside risk in the form of potential outsourcing of tech production. The crash of the Irish economy and the slowdown among Eastern European economies have lowered wages and other manufacturing costs in these countries, which have large amounts of skilled workers, thus increasing their attractiveness to producers of medical devices and other high-value-added items. In 2009, Medtronic shifted some of its manufacturing operations to Ireland, eliminating 240 jobs in the county.

WITH ACKNOWLEDGMENT AND APPRECIATION TO LOCAL KEY BUSINESSES  
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