JULY 09

UPDATE

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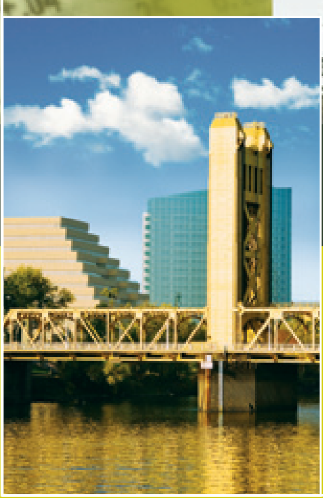
Emerging Trends in Sacramento's Economy



Mid-Year Update

2009 Economic Forecast

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JULY 09

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Message from the Dean

Dear Friends,

I am delighted to share the mid-year update of the *Sacramento Business Review* with you. Already the most widely recognized for its credibility and independence, the *Sacramento Business Review* provides the most thoughtful, intellectually sophisticated, and comprehensive analysis of the Sacramento economy. To download your free copy please visit ***www.sacbusinessreview.com***.

In this issue, we update our report in detail on emerging trends and also make bold predictions for 2009-10. In the current economic downturn and worst financial market performance since the Great Depression, you will find the *Sacramento Business Review* your best guide to the economy, various sectors and industries in the region, real estate market, the energy outlook, capital markets including the stock market, corporate performance in Sacramento, and employment. We will be providing periodic updates as our commitment to deliver the very best economic and financial research to the region. I invite your feedback. Please do not hesitate to let me know how we may improve future issues or if you wish to be a supporting sponsor.

Warm regards,

Sanjay Varshney

Sanjay Varshney, Ph.D., CFA
Dean, College of Business Administration
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SACRAMENTO STATE COLLEGE OF BUSINESS ADMINISTRATION

Sacramento's Key Industry Sectors: Trends and Forecasts

2009 Mid-Year Update

Brian Leu, CFA, Associate, DCA Capital Partners | Yang Sun, Ph.D., Professor, College of Business Administration, Sacramento State

Brian Leu, CFA

Yang Sun, Ph.D.

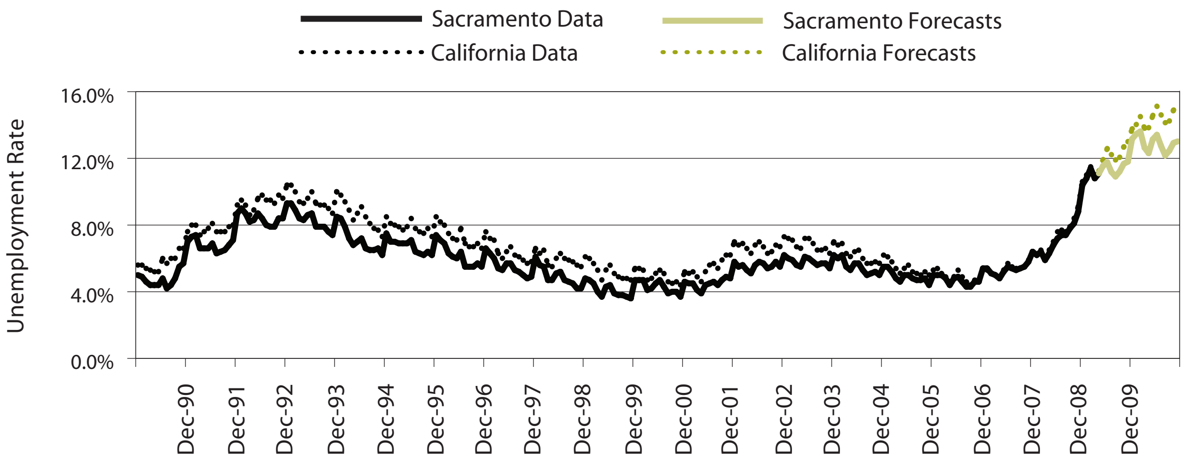
At the time of our last release in January 2009, the Sacramento regional unemployment rate was 8.1% (November 2008 reading) which we were forecasting would eventually exceed 10% in early 2009. Since then, the unemployment rate has climbed to 11.1% (May 2009), with a loss of nearly 40,000 jobs during the six-month period, as the local economic downturn progressed deeper than expected. While we expect the national economy to officially exit this recession later this year, we expect job losses to continue in the Sacramento region well into 2010, even after the local economic climate begins to stabilize. Indeed, we view the much-discussed "jobless recovery" to be a real possibility locally, as businesses and the state and local governments take time to reestablish financial stability before expanding their workforces.

13%+ Sacramento Regional Unemployment Rate Likely in 2010

We are forecasting for the unemployment rate in the Sacramento region to exceed 13% in early 2010, representing a loss of about another 20,000 wage and salary jobs. While the stock market has recently rebounded sharply from its March 2009 lows, the Sacramento regional employment picture will not likely begin to recover until the second half of 2010 due primarily to (1) weak consumer spending, (2) continuing headwinds on small business profitability in the region, (3) limited access to credit, and (4) reduced government spending and potential government layoffs. We expect a 13.5% local unemployment rate in early 2010 to roughly correspond to a 14.5% and 11% unemployment rate in California and the U.S., respectively.

We believe that increased consumer spending, which will ultimately support the recovery, continues to face immense challenges in the near-term. Declining home prices, while slowing, continue to negatively impact consumer wealth. Consumer debt (as measured by the ratio of US household debt to disposable income) is still at elevated levels, while access to consumer credit remains limited. The US personal savings rate has climbed to 6.9% in May 2009, a 15-year high, and will likely rise as households work to reduce spending and repair their balance sheets. Furthermore, we believe wages will continue to come under pressure, with few pay increases and a decline in working hours expected. In addition, while the unemployment rate is expected to rise, this measure does not fully capture reduced hours, more part-time labor, and the increasing number of people dropping out of the labor force. All of these factors were reflected

Figure 1
Local Unemployment Rate



in the Conference Board consumer confidence index, which remains historically low at 49.3 in June, down from 54.8 in May. (An index level of 90 would indicate a "solid" economy.)

Continued Job Losses in the Region Expected to be Widespread

The Education (private) and Healthcare sectors are the only industries that are expected to grow over the next 12 months, driven by displaced workers seeking further education and positive secular healthcare trends. The Construction and Financial sectors will continue to show weakness until the housing sector further stabilizes and shows signs of recovery. The Retail and Leisure & Hospitality sectors will continue to experience job losses with consumer spending still depressed, and we expect this holiday season will again be rough for local retailers. Likewise, we do not see the business environment improving materially in 2009, suggesting the Technology sector, which includes Professional Services, will continue to lose jobs at least until the middle of 2010.

Potential Impact of Government Budget Cuts and Employment

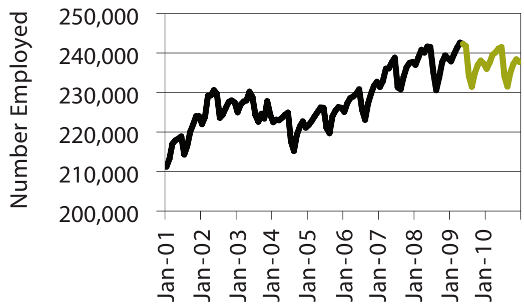
We believe the most important potential swing factor locally is the level of cutbacks in state and local government spending. Government jobs represent almost three out of every ten wage and salary jobs in the Sacramento region. Consistent with our January forecast, the Government sector has largely maintained its employment levels over the last year, insulating the regional economy from a potentially higher level of job losses. However, the current $26 billion state deficit represents approximately 28% of the state's general-fund budget, and while we expect cuts to come through a combination of furloughs, layoffs and other spending cuts, just a 5% reduction in the state and local government workforce would add an additional 1.1% to the current regional unemployment rate. While cuts to date have been made primarily through salary reductions (a three-day-per-month mandatory furlough represents about a 14% salary reduction), there are increasing signs that more widespread government layoffs are a distinct possibility. We believe such developments could drive the regional unemployment rate as high as 15%. Given the current challenges and uncertainties surrounding the California budget deficit, potential changes in the government employment situation pose the largest downside risk to the Sacramento regional economy.

> *"We believe the most important potential swing factor locally is the level of cutbacks in state and local government spending."*

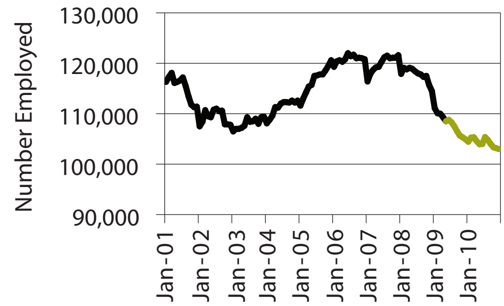
Actual Data

Forecasts

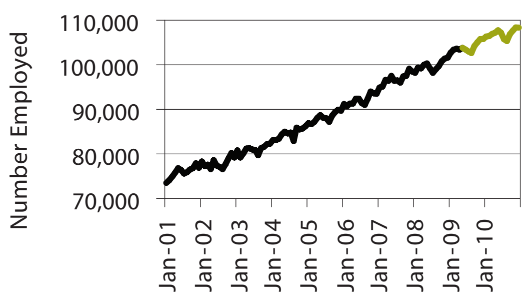
Government



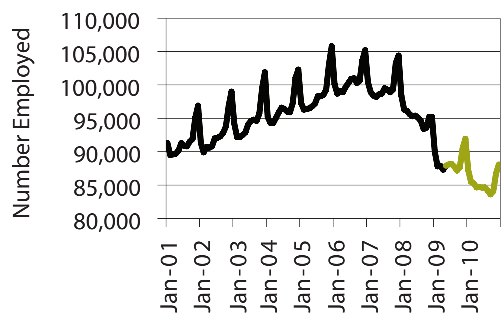
Technology & Professional Services



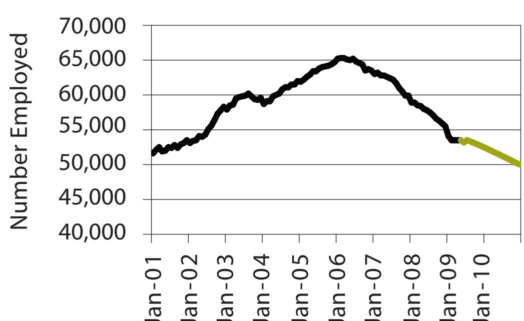
Healthcare & Education



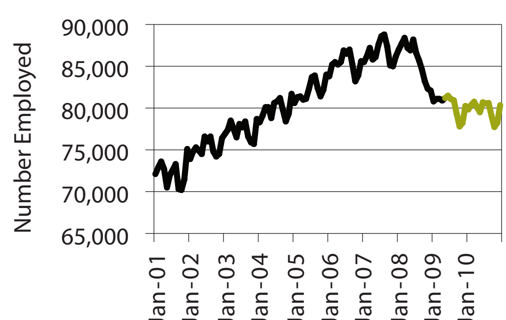
Retail



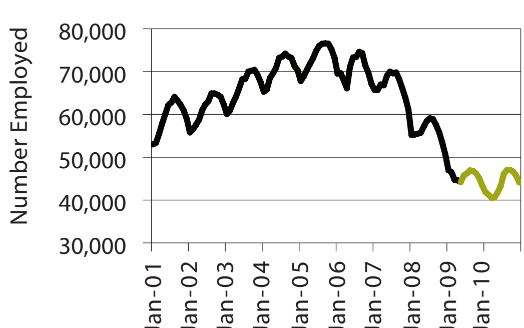
Financial Activities



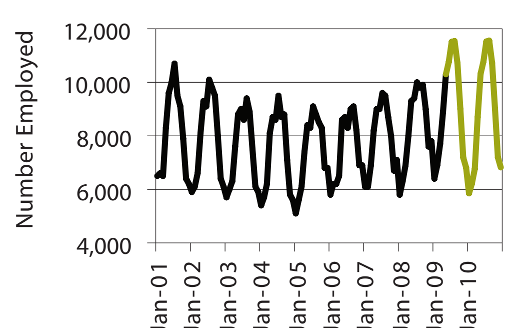
Leisure & Hospitality



Construction



Farm



(The quantitative analysis is based on data published by the Employment Development Department of the State of California as well as the U.S. Bureau of Labor Statistics.)

Real Estate Trends in the Sacramento Region

2009 Mid-Year Update

Marc Ross, CFA, Real Estate Investment Broker, CB Richard Ellis
Sudhir K. Thakur, Ph.D., Professor, College of Business Administration, Sacramento State


Marc Ross, CFA


Sudhir Thakur, Ph.D.

Mid-way through 2009, the Sacramento commercial real estate market continues to struggle. With the economic recession about to become the longest and deepest on record since the Great Depression, and its primary cause - the residential market - continuing to flounder in search of a bottom, the commercial sectors show no signs of healing soon.

Retail

- Contract rents in the retail sector declined dramatically during the first half of the year, dropping 30% - 50% across the board. With a major lack in tenant activity, especially from national retailers, landlords are going to extreme measures to retain tenants, including reducing the rent on existing leases.
- A few notable bankruptcies were announced during the first half of the year, including Anchor Blue, Eddie Bauer, and Gottschalks, while Borders narrowly escaped filing bankruptcy. Smith & Hawken also recently announced the closure of all 56 of their stores nationally, including one in Roseville. We anticipate a few additional high-profile bankruptcies will occur during the second half of the year.
- Discount stores continue to do well in this economic environment. Wal-Mart opened a new Supercenter at the Florin Towne Centre (formerly the Florin Mall) in June, and The Goodwill Store, Ross Dress for Less and Winco Foods continue to plan for expansion. PetCo and CVS are also actively looking in the market for space.
- We have seen an increase in anchor and junior anchor space come available with the demise of Gottschalk's, Mervyn's, Linens & Things, Circuit City, Shoe Pavilion, Office Depot and a few others. Landlords are now considering less traditional types of tenants to backfill these spaces, including churches, trade schools, temporary or seasonal users, and thrift stores.

Office

- Regional vacancy increased from 16% to 21% since the beginning of the year, which is significant because it is the first time in Sacramento's history that office vacancy has exceeded 20%. The submarkets hit the hardest are the "new growth" areas of Elk Grove and Roseville/Rocklin with vacancy rates of 39% and 34% respectively.
- The state of California remains the most active tenant in the marketplace, as it continues to add to its overall square footage under lease. Additionally, the state recently initiated an effort with landlords to renegotiate all but its most recent leases, offering to extend them for a reduction in rent. Known as "blend & extending," this cost-cutting effort has met with some early success.
- Leasing activity in the private sector is down substantially over 2008 levels. The most common leasing activity continues to be lease renewals with shorter terms (12-24 months) and, in many cases, early termination options as tenants remain highly cautious about the uncertain economic environment.

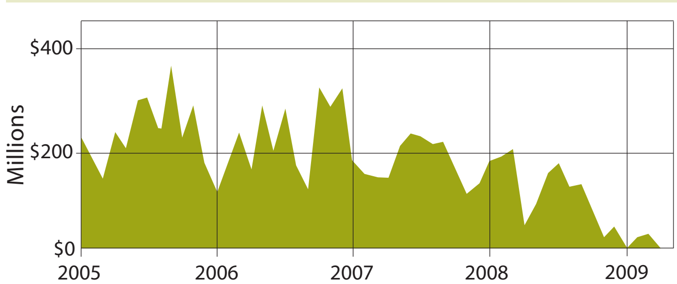
Industrial

- The most resilient real estate sector to date in the current economic crisis has finally seen its rental fundamentals deteriorate considerably during the first half of 2009, as regional vacancy increased from 8.4% to 11.6%. The most challenged submarkets are McClellan Park (33.1%), Woodland/Davis (17.5%), Northgate/Natomas (15.3%), and Roseville/Rocklin/Lincoln (15.2%).
- Net absorption – the change in occupied square feet from one period to the next – has been significantly negative during the first two quarters, with 4.1 million fewer square feet occupied today than at the beginning of the year. If this pace continues through the second half of 2009, it will take several years for this sector to recover.
- The most common leasing activity continues to be lease renewals with shorter terms, as industrial tenants also remain highly cautious in the current economic environment.

Investments

- Investment sales activity slowed to a crawl during the first half of 2009. While buyer capital is plentiful and there is great anticipation of some fantastic investment opportunities on the horizon, many would-be buyers believe the market will continue to degrade, keeping them on the sidelines with the expectation that assets will become even cheaper.
- Commercial REO (real estate owned by banks) activity is just now beginning to occur and, together with other types of distressed assets, will represent a large portion of the sales activity going forward. However, banks are having difficulty understanding the assets they have and what to do with them, which is prolonging the REO process. As a result, it is taking longer for distressed assets to become available for sale, pushing out the correction by several months. Although we will see REO offerings during the second half of this year, we expect the bulk of REO sales across all commercial sectors will occur in 2010.
- With the exception of the multi-housing sector, which benefits from the availability of loans from Fannie Mae and Freddie Mac, credit options for commercial real estate remain limited.

Figure 1 – Investments
Sales in Dollars Per Month through May 2009
(all property types)

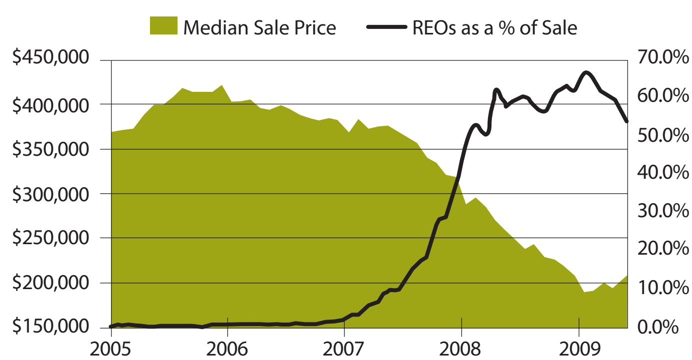


Note: Monthly, reported closed. Source: Real Capital Analytics

Residential

The federal government's bailout of the banking industry appears to be prolonging the down-cycle as banks, bolstered by government capital, are better able to hold REO inventory and delay taking ownership of homes on which they are not receiving payments. Banks are doing this for a variety of reasons, ranging from inadequate staffing to a strategic plan to avoid selling at the depressed prices that would result if they flooded the market with homes. They are also making a more aggressive attempt to workout and/or modify loans where possible. To the extent that their modification efforts are successful, it will benefit the market. However, many of the early loan modifications, which took place last year, have ended up back in the REO pipeline. Lender "shadow" REO inventory, along with an indefinite supply of future REOs as the region continues to shed jobs, is the real wild card in the timing of a recovery. Until lenders sell a large portion of their REO assets, and the pipeline of new REOs begins to dry up, it will be difficult to gauge when the market will bottom out.

Figure 2 – Median Sale Price (all Homes) vs REOs as a % Sacramento MSA



REO (Real Estate Owned) - property which is in the possession of the lender as a result of foreclosure.

Source: MDA DataQuick

- California recently stopped accepting applications for its new-home tax credit worth up to $10,000, which had helped encouraged new home sales. The building industry is lobbying for an extension of the tax credit, but it is unclear whether this effort will be successful.
- The median sale price in the Sacramento MSA has stabilized over the past few months, due to a change in the composition of sales. We are beginning to see more expensive homes sold as REOs, which may actually raise the median sale price during the second half of the year despite the lack of any price appreciation.
- REOs continue to represent the bulk of the sales in the region and will continue to play a significant role in the sales market through 2010.
- Foreclosure notices, including a Notice of Default, Notice of Trustee's Sale, or Notice of Transfer has risen substantially during the first half of 2009. We expect this trend to continue and that foreclosure notices will remain at elevated levels well into 2010.

Capital Markets Review: The Global Markets and Their Impact on Sacramento

2009 Mid-Year Update

Jason Bell, CFA, Senior Investment Manager, Wells Fargo Private Bank
Hao Lin, Ph.D., CFA, Professor, College of Business Administration, Sacramento State


Jason Bell, CFA


Hao Lin, Ph.D., CFA

The capital markets are continuing their wild roller-coaster ride as investors grapple with the implications of a flurry of policy changes stemming from Washington, the fallout of stress-testing the U.S. banking system, and the failure of GM and Chrysler. Most recently, strained state budgets have served to reignite fears, causing many to question the sustainability of the market's recent recovery.

Closer inspection reveals that there has been marked improvement since January. The financial crisis is largely over as interbank lending has resumed and money and commercial paper rates have returned to levels prior to the Lehman Brothers collapse.[1] Also, the peak strength of the recession appears to be behind us – global manufacturing levels are surging, commodity prices have firmed, export-economy GDP levels have snapped back and global leading economic indicators are turning positive.[2]

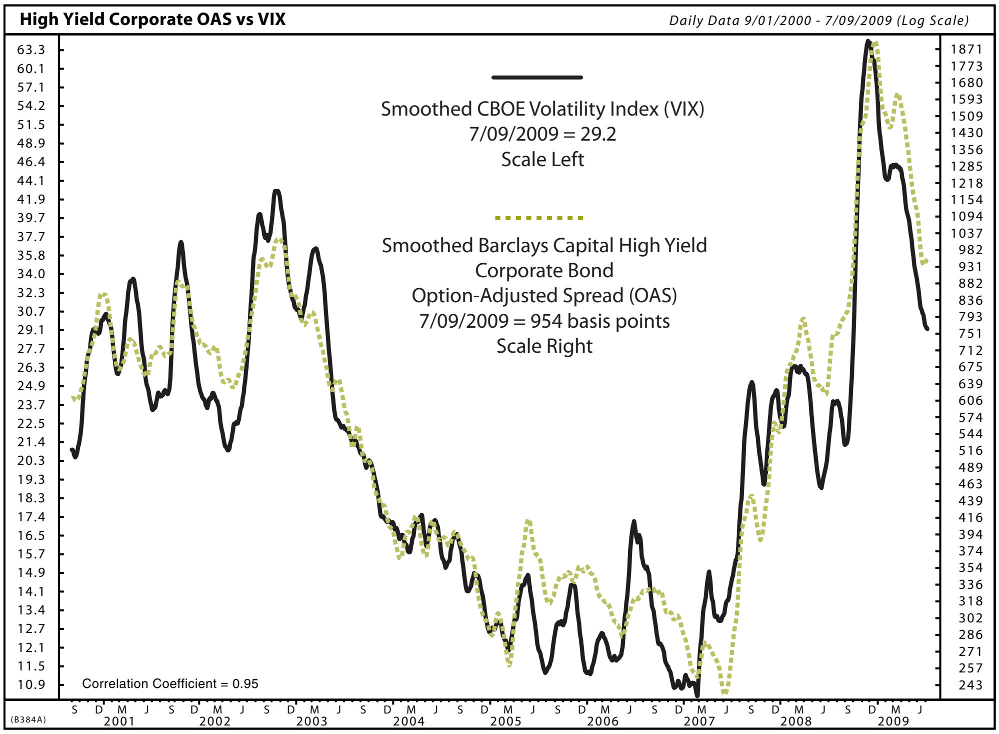
Concerns are brewing about hyperinflation and the monetization of our national debt. Despite the increasing amount of criticism, we believe the Fed and other regulatory bodies will remain accommodative for the rest of 2009. The economy simply remains too fragile for any sort of tightening cycle to begin. Inflation is not a near term threat, but may become a longer-term one if the authorities ultimately wait too long to wean the limping U.S. economy off of their monetary largesse.

Regarding our January forecasts, we see that most are playing out according to our expectations. We review them below:

1) **Continued elevated volatility in the financial markets** – this has largely proved accurate as both equity and credit market volatility (respectively measured by the Chicago Board Options Exchange Volatility index (VIX), and option-adjusted spreads (OAS)) remain well above levels not seen since 2004 (see Figure 1). Fortunately, both measurements are trending lower, and this development bodes well for an eventual return to normalcy in the marketplace.

2) **A bottom will be made within 2009** – it is becoming more likely that this call will prove correct as the equity market bottom looks to have been put in place on March 9th. Economic and sentiment indicators have dramatically improved since then. These confirming pieces of data have provided significant support for the enormous rally off the lows and have reduced the risk of a major retest. Credit spreads, the markets' pricing mechanism for

Figure 1: Measures of Market Volatility



credit risk, have massively contracted across the agency, mortgage and asset-backed yield curves and have compressed by more than 70% in some cases.[3]

3) **Favored sub-asset classes** – in the equity markets, our bias leaned towards large cap domestic and emerging markets versus developed international and small cap domestic. Our equity calls are performing as expected with the exception that developed international is slightly outperforming large cap domestic. We are now adjusting our view, as it looks probable that small cap domestic will outperform large cap for the rest of 2009 due to risk aversion fading from the markets.

   Our credit market outlook favored high-quality municipal, corporate and global sovereign debt versus Treasuries. These calls are performing as expected, as virtually all credit market indexes have outperformed the Treasury market. We have no adjustments to our credit market outlook at this time.

4) **The employment-weighted Sac-CFA index will outperform the S&P 500** – to date this is not performing to our expectations. Our view was that the Sac-CFA index's exposure to technology, consumer discretionary and financial sectors would help it rebound more quickly than the S&P 500. While the technology and consumer discretionary sectors have significantly outpaced the broad market so far, the financial sector continues to lag. Furthermore, half of our publicly-traded index constituents have outperformed the market, while the other half have underperformed, resulting in a slight underperformance of the Sac-CFA index.

Sources:

[1] Ned Davis Research, *30 Day Nonfinancial Paper Rates (B0124)*, June 25, 2009

[2] International Strategy and Investment, *Daily Economic Commentary*, June 29, 2009

[3] Ned Davis Research, *OAS on Agencies, MBS, CMBS, and ABS (B384C)*, June 25, 2009

"Green Shoots" for Green-Energy Firms?

2009 Mid-Year Update

Jonathan E. Lederer, CFA, President, Lederer Private Wealth Management, LLC
Denver H. Travis, Ph.D., Professor, College of Business Administration, Sacramento State

First-Half Review

Jonathan Lederer, CFA

Denver Travis, Ph.D.

In January's inaugural edition of the *Sacramento Business Review* (SBR), we predicted that the clean technology (cleantech) industry would face substantial challenges due to the combination of: i) lower fossil-fuel prices (which would make cleantech less competitive from a cost standpoint), and ii) highly constrained capital markets (which would make it difficult for cleantech firms to access new funding). We also indicated that the most positive cleantech catalyst would be the incoming Obama administration's commitment to green technologies, though we expressed concern that government support could wane in light of sizable budget deficits.

While several of the Sacramento region's more prominent cleantech companies did not survive the first half of 2009, the industry's prospects did appear to improve toward mid-year. Steadfast government support, coupled with the "green shoots" of a broader economic recovery, drove cleantech stock indexes higher in the face of less-than-accommodative capital markets and lower fossil-fuel prices (relative to their 2008 highs). Now, with the debt and equity markets seemingly in better shape than they were in early 2009, our outlook for the cleantech industry has become more positive.

Year-to-Date Performance

After experiencing sizable declines last year, cleantech stocks performed well during the first six months of 2009. In particular, the Renewable Electricity and Solar PurePlay Indices, created and tracked by Sacramento-based Camino Energy[1], generated first-half gains of 26% and 15%, respectively (see Figure 1). Cleantech stocks managed to produce these gains despite the fact that fossil fuels remained well below their 2008 highs and the capital markets continued to be largely inaccessible for cleantech firms.

Fossil Fuels

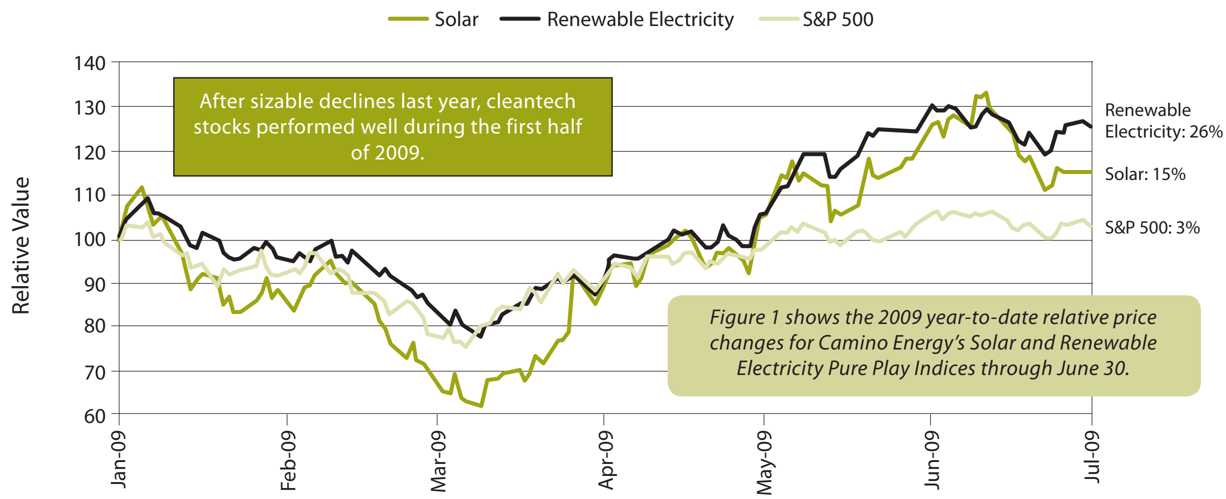
As we predicted in January's SBR, fossil-fuel prices have not approached their 2008 highs this year (see Figure 2). While crude oil did manage to rise nearly 60% during the first half of 2009, thanks primarily to the anticipated impact of Chinese stimulus, U.S. coal and natural gas prices continued to decline, making many clean technologies more costly on a relative basis.

Capital Markets

Credit Markets

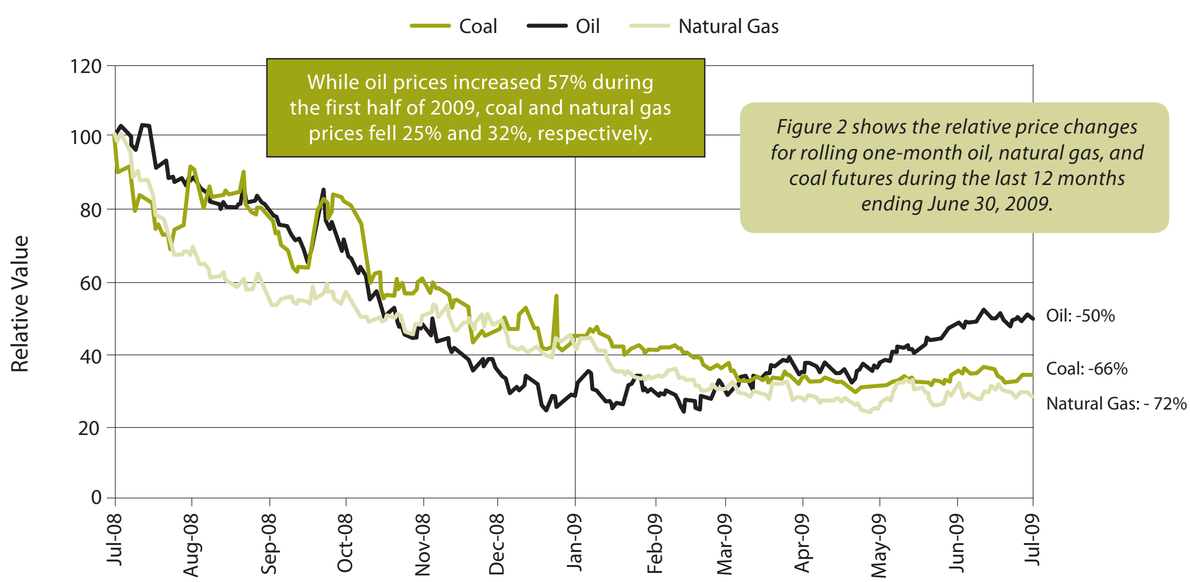
Back in January, it was virtually impossible for cleantech firms to access the debt markets. While conditions remained difficult throughout the first half of 2009, some encouraging signs started to emerge. For example, Wells Fargo announced in late June that it would provide up to $100 million in financing (through power purchase agreements) for commercial-scale solar power systems developed by San Jose-based SunPower.[2]

Figure 1
2009 YTD Performance: Cleantech Stock Indices



Source: Camino Energy

Figure 2
Last-12-Month Price Changes: Oil, Natural Gas, and Coal



Source: U.S. Energy Information Administration

In addition, credit spreads on Clean Renewable Energy Bonds (CREBs) narrowed substantially since January, making this form of financing more affordable for smaller electric cooperatives and public power systems. On June 30, 10-year CREBs were yielding roughly 300 basis points (3.00%) more than the 10-year Treasury rate, down from 520 basis points (5.20%) in January 2009.[3]

Equity Financing

As we predicted in January, there were no public cleantech equity offerings during the first half of 2009. We also expected the level of venture-capital and private-equity funding to drop during 2009. According to The Cleantech Group, a San-Francisco-based research firm, global cleantech venture investments totaled $1.2 billion during the second quarter of 2009.[4] This figure was down significantly from the record $2.6 billion in the third quarter of 2008. However, second-quarter funding levels did increase by 12% relative to the first quarter of 2009.

Government's Role

Given the obstacles that cleantech firms faced earlier this year due to constrained capital markets and lower fossil-fuel prices, we believed that government support represented the primary positive catalyst for cleantech firms. Through the first half of 2009, two landmark pieces of legislation were drafted, and both promise to benefit the cleantech industry.

On February 13, Congress passed the "American Recovery and Reinvestment Act of 2009," a $787-billion stimulus bill that included more than $60 billion of clean-energy investments. Of this $60 billion, more than $6 billion was intended for state and local renewable-energy and energy-efficiency efforts.[5]

Then, on June 26, the United States House of Representatives approved the "American Clean Energy and Security Act," a bill mandating that 15% of the nation's electricity come from renewable sources by 2020.[6] At the time this *SBR* update went to press, the House's "cap-and-trade" bill had yet to be approved by the Senate.

While we expressed concern in January that the federal government could scale back support of cleantech given massive budget deficits and lower fossil-fuel prices, it appears thus far that President Barack Obama and the United States Congress are dedicated toward moving forward with their green-energy agendas.

Local Cleantech Firms

Based on our outlook in January's *SBR* that the cleantech industry would face sizable obstacles, we were concerned that a number of local cleantech firms would not survive 2009. These concerns proved valid in late March when OptiSolar announced that it was suspending solar manufacturing operations at both its McClellan Park plant and Hayward headquarters.7 Less than two months later, Sacramento-based Pacific Ethanol declared bankruptcy.[8]

With regard to the other publicly traded, local cleantech firms featured in January's SBR, Solar Power, Inc., announced several new solar deals in recent months. While we remain concerned about the company's liquidity situation, Solar Power, Inc.'s stock price more than doubled during the first half of 2009, indicating that stock holders have become more confident about the company's prospects. Meanwhile, El Dorado Hills-based Premier Power, who we concluded was in the best financial shape relative to the other local publicly traded cleantech firms, experienced a 3% first-half stock-price decline. We were surprised when the company used nearly $3 million of cash during Q1 2009 (after using only $758,000 of cash from operations and investments during the 12 months ending September 30, 2008).

Second-Half Outlook

With the capital markets ostensibly on the mend and government support remaining steadfast, our cleantech industry outlook has become more positive since January. That said, the industry continues to face the same headwinds (e.g., lower fossil-fuel prices and diminished funding sources), but now seemingly to a lesser degree.

As with many industries today, the cleantech industry's success would appear to hinge on the "green shoots" of an economic recovery turning into something more substantive later this year. A recovery would increase global energy demand and would almost certainly drive fossil-fuel prices higher, making clean technologies more cost competitive. Furthermore, stronger evidence of a second-half recovery would undoubtedly benefit the capital markets, improving the ability of cleantech firms to access much-needed debt and equity funding. Such a development will likely be vital toward ensuring survival for many of the Sacramento region's cleantech companies.

Sources:

1 Information about Camino Energy's PurePlay Indices can be accessed at www.caminoenergy.com.
2 "SunPower, Wells Fargo in $100M solar deal," *Sacramento Business Journal*, 29 June 2009
3 United States Treasury, Clean Renewable Energy Bond Rates, https://www.treasurydirect.gov/SZ/SPESRates?type=CREBS, (June 2009)
4 "Cleantech venture investing jumped in Q2," *Boston Business Journal*, 1 July 2009
5 *Energy & Environment*, http://www.whitehouse.gov/issues/energy_and_environment/ (July 2009)
6 "House Passes Climate Bill," *The Wall Street Journal*, 27 June 2009
7 "Solar panel maker OptiSolar powers down," *Sacramento Business Journal*, 27 March 2009
8 "Pacific Ethanol units file bankruptcy," *Sacramento Business Journal*, 18 May 2009

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Sanjay Varshney is Professor of Finance and Dean of the College of Business Administration at California State University, Sacramento. He previously served as the Dean of the Business School at State University of New York in Utica for five years. At age 31 he became one of the youngest deans in the country to lead a business school. His prior experience includes working at University of San Francisco, Citigroup, Arthur Anderson, and as a portfolio manager. He earned an undergraduate degree in Accounting and Financial Management from Bombay University, a Master's degree in Economics from the University of Cincinnati, and a Ph.D. in Finance from Louisiana State University in Baton Rouge. He also holds the Chartered Financial Analyst (CFA) designation. Dr. Varshney serves as the chief economist for the Sacramento Business Review.

Jason Bell, CFA

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Brian Leu, CFA

Brian Leu joined DCA Partners in 2007 and supports the Firm's investment banking business and private equity investment effort through DCA Capital. Prior to joining DCA, he was a member of the Equity Research team at Deutsche Bank Securities. Mr. Leu was previously an investment analyst at Bayes Capital, a long-short hedge fund and earlier began his career at AT&T within Corporate Finance. Mr. Leu earned his MBA from NYU and holds an Economics degree from Duke University.

Hao Lin, Ph.D., CFA

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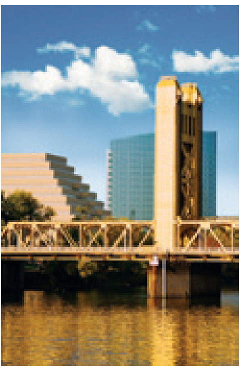

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