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Emerging Trends in Sacramento's Economy

2010 Economic Forecast

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

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Message from the Dean

Dear Friends,

I am delighted to share the 2010 market forecast by the *Sacramento Business Review* with you. Already recognized for its credibility and independence, the *Sacramento Business Review* provides the most thoughtful, intellectually sophisticated, and comprehensive analysis of the Sacramento economy – prepared by the region's very best financial analysts and researchers. To download your free copy please visit ***www.sacbusinessreview.com.***

As the world recovers from an economic collapse and the national economy is on the rebound, Sacramento unfortunately remains pressured with continued job losses and heightened uncertainty due to a growing state deficit. Unemployment will worsen beyond the already current record highs, housing and real estate will continue to drift in search of a bottom, bank credit will remain tight, and all of these will compound to weaken the regional economic health. On the bright side, our recession in Sacramento may end as early as the second quarter of 2010, and capital markets provide hope with stable local corporations and the SBR Index outperforming.

With this issue, we renew 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

Sanjay Varshney is Professor of Finance and Dean of the College of Business Administration at California State University, Sacramento. 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*.

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Emerging Trends in Sacramento's Economy

Sacramento's Labor Market & Regional Economy: 2010 Outlook

Brian M. Leu, CFA, Investment Officer, *CalPERS*
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"Given the magnitude of the job losses, we do not expect the number of jobs in Sacramento to return to pre-recession peak levels until at least 2013."

During this current recession, the unemployment rate for the Sacramento region has steadily climbed to 12.4% (as of November 2009) with a loss of nearly 83,000 wage and salary jobs since June 2007 and a loss of 43,800 jobs over the last 12 months. Furthermore, we estimate the "real" unemployment rate currently to be closer to 20%. Sacramento and the state of California were hit particularly hard by the downturn due to the high real estate exposure and state budget issues, and although economists have already declared the official end of the national recession, we believe that the Sacramento region will lag the rest of the country in the recovery.

We are reiterating our July 2009 forecast for the unemployment rate in the Sacramento region to reach 13.5% in early 2010, with an improvement in the employment picture unlikely before 4Q 2010. The good news is that Sacramento has likely already seen the worst of the job losses and the regional economy is starting to show early signs of improvement. The bad news is that the recovery, particularly as it relates to the employment picture, will likely be very gradual over the next several years, with the unemployment rate remaining near historically elevated levels.

Given the magnitude of the job losses, we do not expect the number of jobs in Sacramento to return to pre-recession peak levels until at least 2013. We expect businesses, especially small and medium-sized firms, will be very cautious in increasing their costs through hiring, leading to what we believe will be a prolonged U-shaped recovery for employment. In our view, several formidable headwinds will slow this local economic and employment expansion, including moderate corporate growth expectations, tight credit, excess capacity, an underemployment overhang, and consumers still looking to deleverage and rebuild wealth. In addition, we believe the state budget and real estate challenges will be the key risk factors to a Sacramento economic recovery, with government payrolls expected to decline about 2% this year. That said, business profitability and cash flow are improving after rounds of cost cutting and many firms have already begun hiring temporary workers (46,500 were added nationally in December 2009), which are the classic early signs of a recovery.

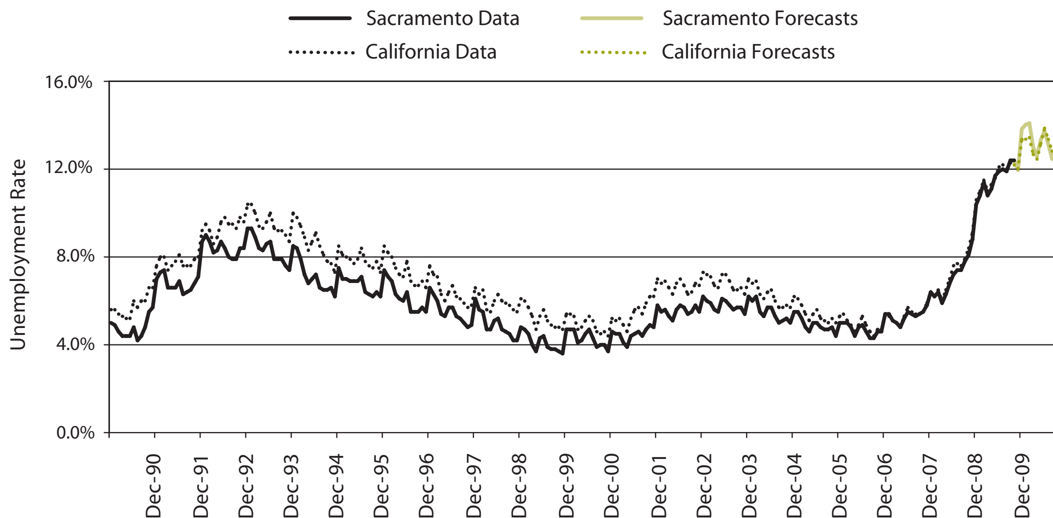
13%+ Sacramento Regional Unemployment Rate Still Likely in 2010

We are reiterating our forecast (from July 2009) for the regional unemployment rate to reach 13.5% by early 2010, representing a loss of about another 12,000 wage and salary jobs. Unfortunately, we view the strong likelihood of a "jobless recovery" to be a real concern, especially for those most directly impacted by local job losses. While timely production data is not as readily available for the local region as it is for the US, we believe that Sacramento will eventually follow the nation in emerging from the recession, with positive GDP growth, by 2Q or 3Q of 2010. That said, we believe most local residents will not "feel" that the economy is improving as unemployment remains elevated.

Historically, employment has shown the ability to recover within one or two quarters of the end of the recession (as it has prior to 1991); however the recoveries after March 1991 and March 2001 took 5 and 8 quarters, respectively, for the labor markets to improve (the commonly referenced "U-shaped" recoveries). We agree with most

Sacramento's Labor Market & Regional Economy: 2010 Outlook

Figure 1
Outlook for Sacramento and California Unemployment Rates



economists that at best a U-shaped recovery is likely coming out of this recession, suggesting the region will not return to previous employment levels until at least 2013. To help put this timeline in perspective, we note that the last time the Sacramento region added 83,000 jobs (the loss to date), it took approximately 3.5 years and was driven largely by the real estate boom. And the local job loss figure is likely to continue to climb well into 2010.

"Real" Sacramento unemployment rate likely closer to 20%

Although the 12.4% regional unemployment rate generally makes the headlines, this figure fails to fully reflect the underutilization of the labor force that usually occurs during an economic downturn. In response to the weak economic conditions, potential workers (1) have involuntarily taken on part-time work in lieu of full-time positions, (2) have been forced to work fewer hours, or (3) have simply ceased to actively look for a job, possibly discouraged from the tough labor market. Nationally, this so-called "under-employment" rate which includes such displaced workers stood at 17.3% as of December 2009 (see Figure 2), compared to a 10.0% stated unemployment rate, representing about 70% more affected workers and job-seekers. While the equivalent local data is not readily available, we estimate this under-employment rate to be approximately 20% in the Sacramento region, suggesting one out of every five potential workers has been unable to find adequate employment.

We note that in the last employment reading (November 2009) the local region witnessed a -1.8% year-over-year decline in the civilian labor force, the largest decline in the last two decades (where data is available), and we expect this downward trend to continue in 2010. We view this as further evidence that the under-employment rate has climbed significantly as discouraged and displaced workers have exited the "active" labor force. As the local economy and labor market improve, we believe this elevated under-employment rate will represent an overhang to potential reductions in the reported unemployment rate in 2010.

Headwinds for the Labor Market to Improve

While we are beginning to see very early signs of a broader recovery here locally, we believe that the Sacramento labor market will continue to face several headwinds through 2010, including (1) moderate GDP growth, (2) tight credit, (3) excess capacity, and (4) a general cautiousness towards hiring. As a result, we believe the regional unemployment rate will remain elevated in the 12.5-13.5% range for most of 2010.

Figure 2
US Under-employment Rate (U6 Unemployment rate)
Since 2000

Source: Bureau of Labor Statistics

Moderate GDP growth expected through 2010

Most economists expect a muted recovery from this recession, with US annual real GDP growth in 2010 expected in the +2% to +3% range, up from a -2.5% contraction in 2009, according to consensus estimates. Historically, the average US real GDP growth rate has been closer to 3.5%, and we believe these moderate growth expectations for 2010 will translate into moderate company revenue expectations as well.

Although US GDP was reported at a positive 2.2% for 3Q 2009, marking the official end of the national recession, we believe that economic growth in Sacramento has been relatively more modest for several reasons. First, federal government consumption and investment represented almost 30% of US GDP growth (most of which came from national defense), and we expect far less than that actually flowed through to the region. Secondly, Sacramento has felt the woes of the housing crash and unemployment worse than most cities, which has put additional pressure on consumption growth and will likely continue to do so through 2010. Finally, we believe state government spending cuts as a result of budget issues have been and will continue to be a drag on local economic growth.

As local companies prepare for a year of modest growth, we expect hiring and investment expenditures to recover slowly.

Credit to remain tight through 2010

As banks and credit card companies continue to deal with bad loans, delinquent credit card balances, write-offs, delinquent mortgages and commercial real-estate credit impairments, we believe credit will remain tight for both consumers and businesses through 2010. This relative unavailability of credit will likely continue to weigh on revenue growth, expansion, capital expenditures, consumer spending and hiring. That said, we believe this credit availability will improve moderately through 2010.

Excess capacity may delay widespread hiring

While US capacity utilization (see Figure 3) has increased in recent months to 71.3% in November, up from 70.6% in October, the figure is still well below the 1972-2008 average of 80.9% and suggests that there is plenty of idled production capacity in the market. In addition, the reported US average workweek of 33.2 hours in December is also still well below the 20-year average of 34.1 hours (see Figure 4). This data suggests that excess capacity still exists in the market (including Sacramento) and will allow businesses to increase production without having to significantly invest or increase labor costs. While there will undoubtedly be increased demand for labor as the local economy recovers, we believe that this excess slack and continuing productivity improvements will delay widespread full-time hiring.

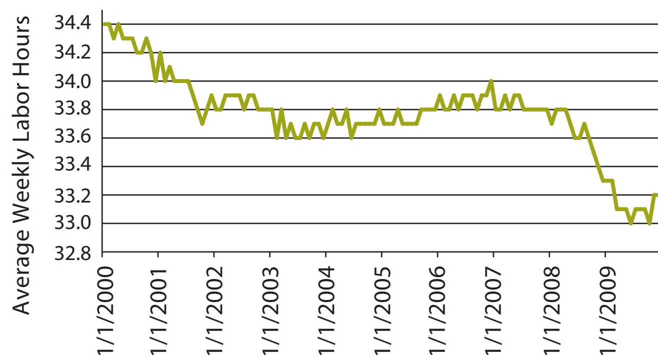
Businesses will show caution in rebuilding permanent workforces

In an environment with moderate GDP growth expectations, tight credit and excess capacity, we believe businesses, particularly small and medium-sized firms, will show caution in rebuilding their permanent workforces, especially given the general sense of uncertainty in the marketplace. Small

Figure 3
Industrial Capacity Utilization, Since 2000

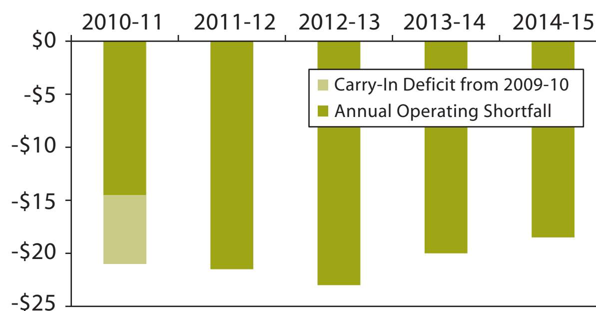
Source: Federal Reserve

Figure 4
Average Weekly Labor Hours, Since 2000



Source: Bureau of Labor Statistics

Figure 5
Projected California General Fund Operating Shortfalls
($ Billions)



Source: Legislative Analyst's Office

business bankruptcies were up 44% year-over-year in 3Q 2009, according to credit-reporting agency Equifax. In addition, two-thirds of small businesses are "concerned or extremely concerned about their firms' surviving for 2 years", according to a Toluna Research survey. While many businesses have managed to survive the downturn thus far through aggressive cost cutting and productivity improvements, we believe these data points are evidence that small businesses remain under a great deal of pressure in this environment and will be slow to again take on additional fixed costs through hiring.

State Budget and Real Estate Challenges Cloud Recovery Picture

As we described in detail in our inaugural issue a year ago, the Sacramento region is more highly exposed to the construction, real estate and government sectors of the economy than most other US and California local economies. While this exposure helped the region grow quickly during the real estate expansion, the subsequent collapse in the housing and real estate sector adversely impacted Sacramento more than most cities.

California budget imbalance will likely dampen local recovery

The government sector, which accounts for almost 3 out of every 10 jobs in the area and which has historically served as a stabilizing factor in the local economy, has experienced an unprecedented set of budget issues that has led to a daunting fiscal challenge for the state for the next several years. In its latest fiscal outlook, the nonpartisan Legislative Analyst's Office (LAO) estimated a $20.7 billion operating deficit over the next 18 months, including a $6.3 billion shortfall for the current fiscal year ending June 30. Furthermore, without dramatic corrective action, the budget woes are expected to continue well beyond 2011, with an average of $20 billion in annual shortfall over the next 5 years (see Figure 5). We should note that these predictions from the LAO assume no cost-of-living adjustments and that the state prevails in all outstanding budget-related court cases (including over 20 lawsuits challenging the state furlough policy), which suggests that significant additional downside risks exists for the state budget.

Unfortunately, we believe this operating shortfall will almost certainly necessitate additional government spending cuts, placing more pressure on an already fragile local economy. Unlike the budget balancing exercise from last summer, the upcoming fiscal year budget process will likely have less accounting flexibility and fewer one-time fixes available to fill the gap.

The governor has already called a fiscal emergency for California and another special session of the legislature to address this gap. While the upcoming months will certainly see different views over the potential budget remedies, the governor's latest proposal, along with other spending cuts, includes a potential directive to all state departments to cut payroll costs by 5% through layoffs, attrition or hiring people at lower salaries. Accordingly, in this recovery we expect the government sector to be a net drag on overall growth in the region, at least over the near-term.

Timing for real estate recovery still uncertain

Median home prices in Sacramento have dropped 20% over the last 18 months, according to the California Association

Realtors. Commercial vacancy rates, according to CB Richard Ellis, still hover at an average of 21% in the region, well above historical levels. While local median home prices have bottomed out, we believe most homeowners have not seen price stabilization, much less any price appreciation, in their homes. Until the local real estate market stabilizes, particularly in the residential sector, we believe it will prove difficult for a recovery to gain traction. We expect consumers, who are still deleveraging their balance sheets and rebuilding wealth lost from the housing and stock market crash, will be hard pressed to dramatically increase consumption until the housing market and job market stabilize.

The Consumer Will Shift the Tides

At about 70% of the economy, consumer spending, in our view, is the key to a sustained recovery from this recession, as it has been in most recoveries. We believe the consumer to be even more important for Sacramento's regional economy this time around, as two of the other main drivers of GDP – government and fixed investments (particularly residential and business construction) – are expected to be drags to economic growth in 2010. Furthermore, consumer spending has important "multiplier" effects that we believe will ultimately lead to the virtuous cycle necessary to sustain economic growth – stronger spending encourages businesses to invest and hire, which boosts income and employment, which leads to a stronger consumer spending outlook. Unfortunately, the outlook for consumer spending, while improving, is mixed.

> *"…when the job picture does visibly improve more broadly, the trends for the consumer and local economy will quickly shift to the positive."*

Household net worth slowly rebuilding, though at lower levels

With the rebound in the stock market since March 2009, households have seen their net worth recover at least partially from earlier lows, though admittedly to lower levels. Housing price declines have also begun to slow during 2009, as the residential housing market has showed signs that the worst may be behind us. In addition, through an increased savings rate, households continue to gradually deleverage their balance sheets by reducing outstanding debt levels. If household wealth continues to stabilize, we believe that this positive wealth effect will lead to increasing fundamental support for consumer spending.

But consumers are worried about jobs, income and credit

That said, despite some recovery in household wealth, we believe local consumer spending is currently dominated by persistent worries about job and income losses and the unavailability of credit. As discussed earlier, we believe the under-employment rate in Sacramento is about 20% and that this will represent a significant overhang for the recovery. In addition, two of the primary sources of consumer credit – home equity loans and credit cards – have dramatically contracted in availability. Furthermore, we believe wage growth will be moderate (1-2%) in 2010 as unemployment remains elevated.

Despite these challenges, we expect consumer spending to be up slightly in 2010 due to moderate personal income growth, helped late in 2010 by an improving jobs picture and an improvement in available credit. Business profitability and cash flow are improving after rounds of cost cutting and many firms have already begun hiring temporary workers to provide immediate help (46,500 were added nationally in December 2009), which are the early signs of a recovery. Given the close interdependency of employment and consumer spending, we believe that when the job picture does visibly improve more broadly, the trends for the consumer and local economy will quickly shift to the positive.

Sector-by-Sector Outlook

In our inaugural publication in January 2009, we analyzed in detail the different sector components of the Sacramento region labor market. While this sector composition has generally held consistent over the past year, we note that the government sector, which has been more resilient than most sectors, has actually grown slightly as a percentage of the local labor market (currently at 28%). The major sectors of the Sacramento economy are shown in Figure 6.

Government likely poised for additional cutbacks

Considering the fiscal challenges facing the state, county and local governments, we believe 2010 could be a very tough year for government employment. The primary question in

Figure 6
Sector Composition of the Sacramento Labor Market

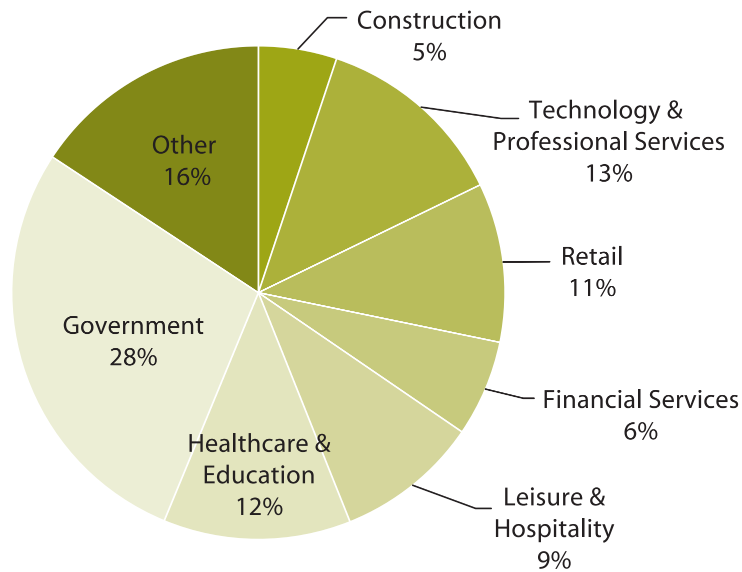


Figure 7
Government Employment Outlook

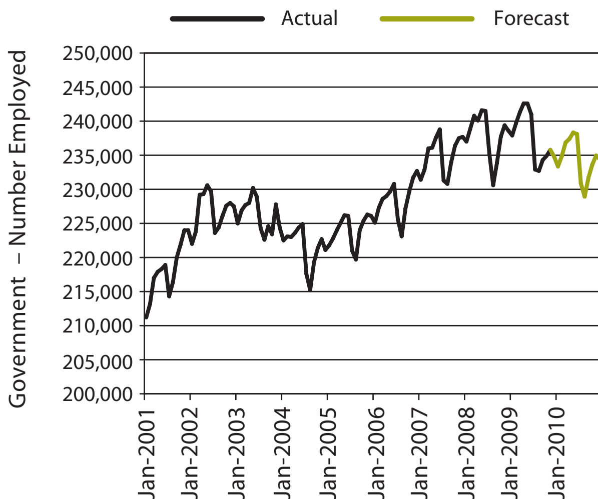
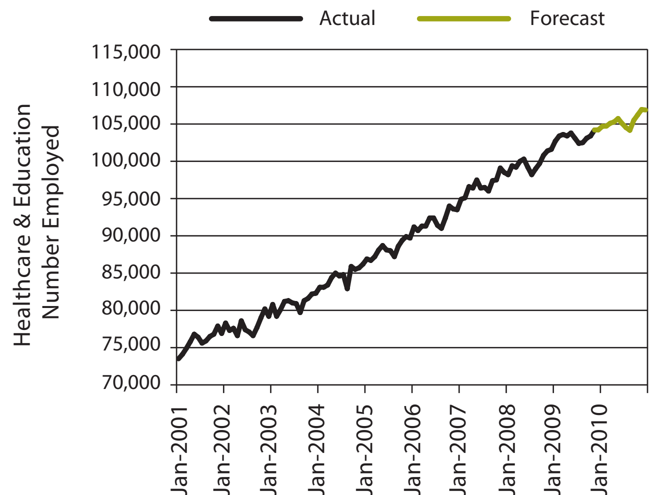


Figure 8
Healthcare & Education Employment Outlook



our view is "how long can the government hang on in the face of operating deficits without making additional staff reductions?" We believe the government sector will be a net drag on overall growth in the region and recognize the uncertainty surrounding this sector, including (1) outstanding court cases; (2) questions around federal aid packages; (3) looming health care reform; and (4) the timing and speed of an economic recovery. While government officials will undoubtedly work to avoid unnecessary layoffs, we believe the financial pressures will be too much in 2010 and at least some targeted additional cuts will be required, resulting in a net job loss of approximately 2% of government jobs this coming year.

Healthcare and Education still experiencing positive momentum

The healthcare and private education sectors have been the lone bright spot in the local labor market, adding 2,800 wage and salary jobs (+2.8% growth) over the last year when the region lost 43,800 jobs (-4.4% decline). These sectors continue to benefit from positive secular trends and demographic shifts. While we believe patient visits dropped slightly in 2009, we do not expect the growth in the healthcare sector to change significantly in 2010. Likewise, we believe the private education sector will continue to grow, benefiting from both favorable cyclical

and secular trends as more of the labor force seeks to enhance their skill sets. While private education expands locally, we expect the public education sector (included within the government sector), especially higher education, to experience continued pressure from the state budget imbalance.

Retail and Leisure & Hospitality face a wounded but healing consumer

While the average Sacramento consumer has been deleveraging and slowly rebuilding wealth over the past few quarters, we believe tight credit, housing price declines and persistent concerns about jobs and income will continue to weigh on spending. The latest US consumer confidence reading, which improved to 52.9 in December from 50.6 a month earlier, supports this picture of improving, yet still depressed, consumer spending expectations (see Figure 9).

US retail sales rose 1.3% in November and the initial look at December shows that holiday spending will likely be up from a terrible 2008 holiday season. While we expect retail hiring will still lag the recovery in consumer spending and retail sales, we believe Sacramento's retail employment will bottom in 2010 as consumer spending stabilizes and the retail workforce will be roughly flat year-over-year by December 2010. In addition, we expect to see the same pattern in the leisure & hospitality sector.

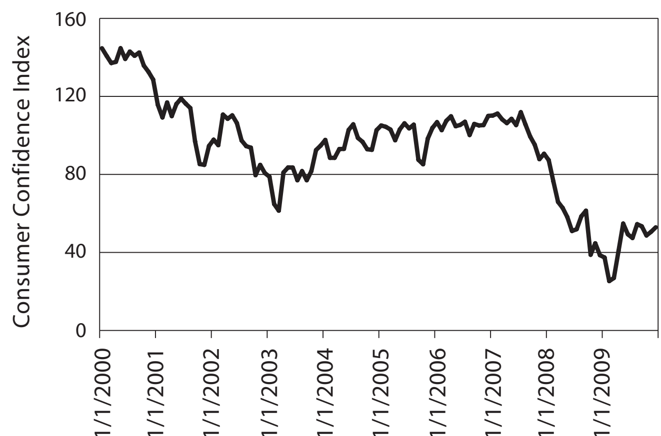
Construction and Financial Activities sectors still facing real estate headwinds

Since the peak of the housing boom in 2006, Sacramento's construction and financial industries have lost over 45,000 jobs. The construction and financial activities sectors are still struggling to recover from the housing collapse and the resulting market challenges that still plague the industry. While the state of the local banking community is discussed in detail in this broader publication, we will note here that we believe the financial sector may be one of the last industries to recover in the region and will likely not fully recover to its pre-recession peak for some time, as many of the jobs lost will not be replaced when the economy recovers.

While we expect the local construction sector to be aided by federal stimulus funding for a variety of local infrastructure and energy efficiency projects, we expect another down year for the construction labor market and are forecasting another 11-14% loss in the construction employment in 2010.

> *"...we believe tight credit, housing price declines and persistent concerns about jobs and income will continue to weigh on spending."*

Figure 9
US Consumer Confidence Index, Since 2000



Source: Conference Board

Figure 10
Retail Employment Outlook

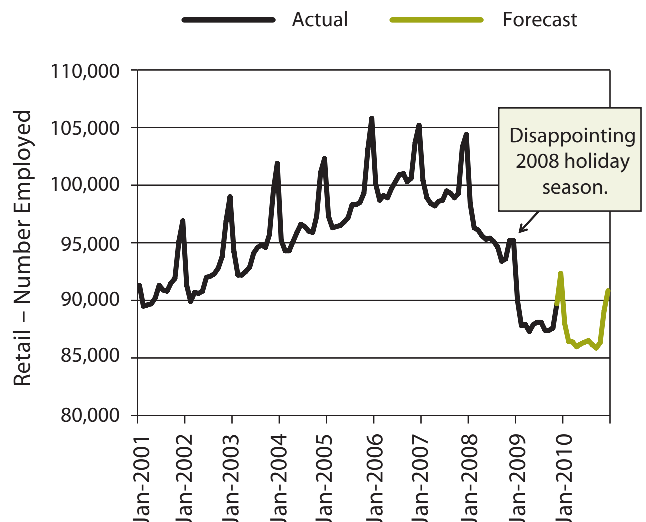


Figure 11
Leisure & Hospitality Employment Outlook

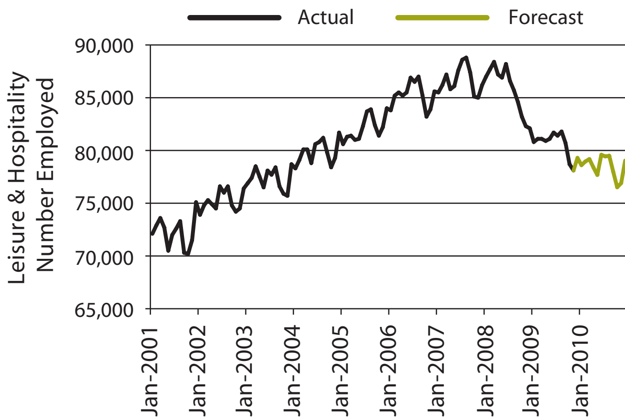


Figure 12
Financial Activities Employment Outlook

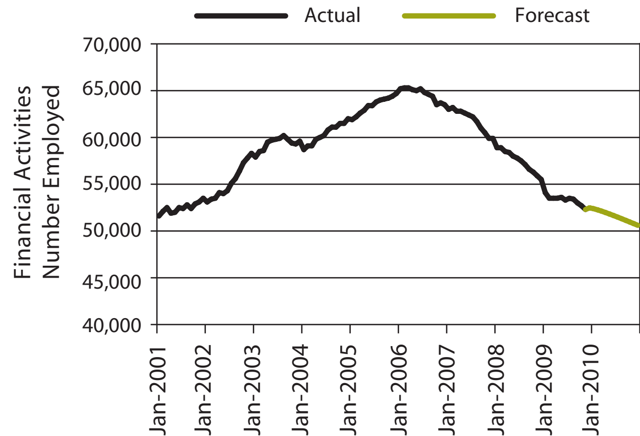


Figure 13
Construction Employment Outlook

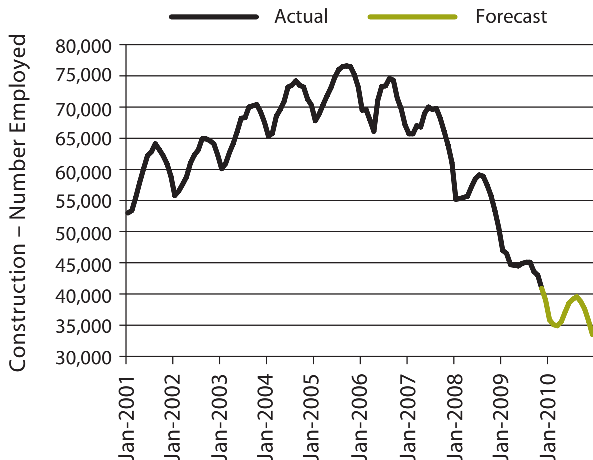
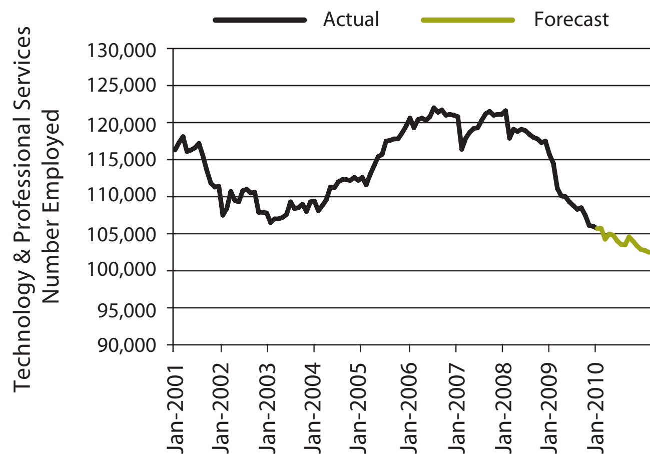


Figure 14
Technology & Professional Services Employment Outlook



Technology and Professional Services still in decline

The technology and professional services sector in the region has lost over 10,000 jobs over the last year as local companies struggled to manage cash flow and profitability through the extended economic downturn. While we have seen firms now operating at much higher productivity levels, we believe a degree of slack remains in the market. Still, even as the sector as a whole continues to decline, we note that employment services firms and temporary workers have actually rebounded in employment levels since 1Q 2009, and we view this as a positive sign that certain employers are again reaching back into the labor market to meet demand. We believe 2010 will again be a difficult year in general for this sector and expect the labor force to decline another 2% year-over-year.

Data Source: If not specifically labeled, the data is sourced from the Sacramento Metropolitan Statistical Area monthly employment data published by the Labor Market Information Division in the Employment Development Department of the State of California (available at http://www.labormarketinfo.edd.ca.gov). As of our publishing date, the most recent monthly unemployment rate reading was for November 2009. The Sacramento-Arden Arcade-Roseville Metropolitan Statistical Area (MSA) includes the counties of Sacramento, El Dorado, Yolo, and Placer. Since our analysis explicitly accounts for seasonality throughout the year, the employment figures in this paper are "unadjusted" figures.

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Real Estate Trends in the Sacramento Region

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

As 2009 ends many people have expressed a sense of relief that this very difficult year is over and now a part of the past, almost suggesting the end of the calendar year will somehow make the numerous challenges facing the Sacramento real estate market a part of the past as well.

2009 created deep battle scars – not just of the once-in-a-cycle kind, but of the once-in-a-lifetime kind (hopefully). Faced with the longest and deepest economic recession since the Great Depression and a credit market that refused to thaw, Sacramento's real estate market offered some memorable statistics:

- Fewest residential construction starts in decades – less than 3,000 as compared to over 17,000 during peak years
- Median home price fell to $190,000 – a whopping 55% drop from its peak in 2005
- Industrial market experienced negative net absorption for the first time
- Highest industrial vacancy since 1986
- Office vacancy exceeded 20% for the first time
- Retail rents fell 30% - 50% across the board
- Investment transactional volumes were down 80% from 2008

We saw several notable businesses declare bankruptcy and a few well-known and tenured developer/owners file for personal bankruptcy. We saw banks with several REO's or distressed loans in the region get seized by the FDIC or acquired by other banks. Signs of the current malaise were visible everywhere.

As fallout from the real estate bubble created unprecedented injury for many market participants, it's easy to see why most people are relieved to call 2009 history. But how excited should we be to begin 2010?

Those hopeful for a recovery will be disappointed. We do not see the residential real estate market stabilizing as long as income and employment levels continue to fall. Further, our sense is that stabilization, when it does occur, may not immediately presage a recovery.

The commercial real estate market will lag the residential market by several months as a housing recovery is necessary to spur job creation on a broad scale, which, in turn, will stimulate absorption of office, industrial, and retail projects that are currently suffering from chronic vacancy. Further, price stabilization in the residential market is also necessary before people start spending again – a critical component in the return of a healthy commercial market.

Highly anticipated to occur last year, banks will finally confront the painful write-downs, defaults, work-outs and foreclosures they were unwilling or unable to address in 2009. Distress-driven opportunities will become increasingly available, offering a golden opportunity for astute contrarians looking to amass real estate assets at cyclical lows. 2010 will offer investors an excellent opportunity to begin "loading up" for the next up-cycle.

Real Estate Trends in the Sacramento Region

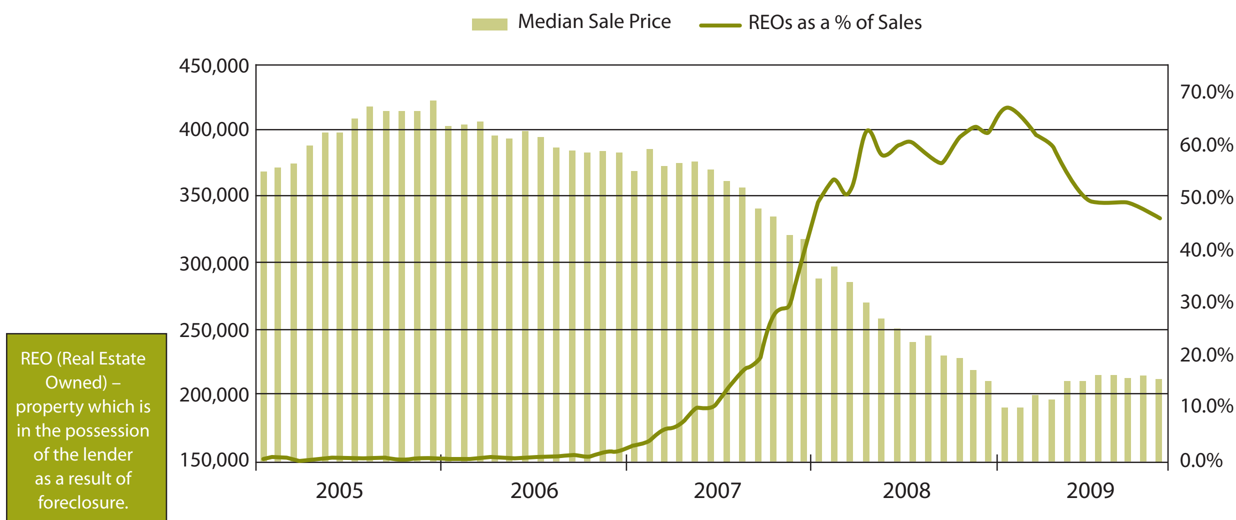
Residential

As we enter now the fifth year of a downturn in the Sacramento residential market, a turnaround remains elusive. Some have reported we reached a bottom in 2009, citing the trough in the median sale pricing that occurred in January/February, the temporary stabilization in sales volumes and land prices, and the downward trend of REOs as a percentage of sales, which suggest we're past the peak of the foreclosure glut. The New York Times even ran an article in May about Sacramento in which the first sentence posed the question, "Is this what a bottom looks like?". Unfortunately these "bright spots" are more the result of temporary government props and other factors than they are of any recovery in underlying market fundamentals.

The median price is impacted as much, if not more, by the types of homes sold as it is by an organic change in values. Many of the early foreclosures were of homes in the lower price ranges. As proportionately more homes in the higher price segments have sold the median price has risen, despite the lack of any price appreciation. In fact, there continues to be significant price erosion across several price segments, particularly in the upper ranges ($450,000 +). A growing number of the distressed sales, both short-sales and REOs, are coming from troubled prime loans in higher-end homes. What was originally a sub-prime problem fueled by irresponsible loans now includes the best of borrowers who have lost jobs or faced other financial hardships as a result of the recession.

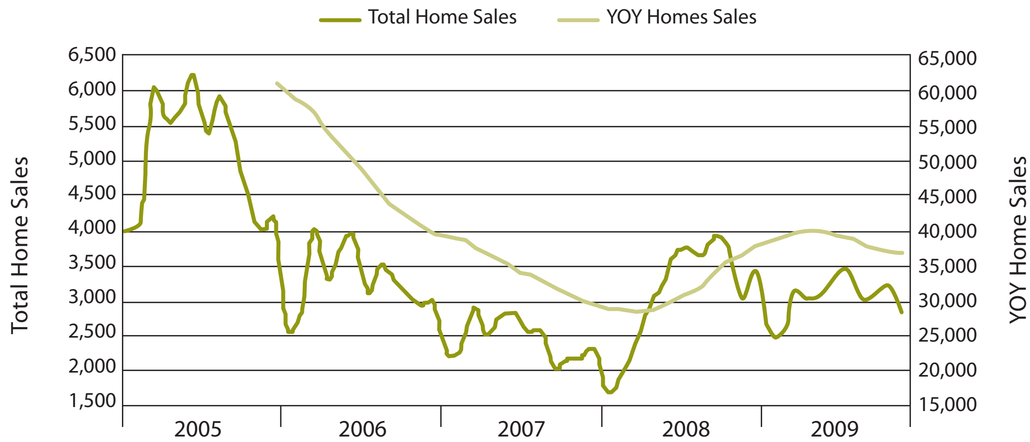
Finished residential land lots – those ready for vertical construction by home builders – fell to what may prove to be a temporary pricing floor of roughly $15,000 during 2009 due to a relative lack in supply. With the cost to "finish" a lot estimated to be roughly $45,000 to $55,000, which includes putting in the roads, gutter, sidewalks, utilities, and other backbone infrastructure necessary to make the lot ready for construction, investors and homebuilders are essentially buying the infrastructure for 30¢ on the dollar and the land and entitlements for free. While it may seem like land prices couldn't possibly get any cheaper, continued economic pressures in the region could heighten distress to new levels and soften prices even further.

Figure 1 – Residential
Median Sale Price (all homes) vs. REOs as a % of Sales | Sacramento MSA



Source: MDA DataQuick

Figure 2 – Residential
Total Sales (all homes) | Sacramento MSA



Source: MDA Data Quick

Probably the most misleading data from 2009 is the drop in the number of homes actually taken back by banks, and consequently, the drop in the number of REO sales as a percentage of total sales. Due in large part to a moratorium imposed on foreclosures and record bankruptcy filings which postpone the foreclosure process, banks were unable to respond to the growing number of delinquent mortgages. As shown in Figure 3, the percentage of mortgages over 90 days delinquent in the region grew at an alarming rate during 2009, rising from 7.64% to nearly 11% by October (the last month data is available). The momentum of casualties created by the economic downturn is growing.

Also shown in Figure 3 is the difference between the 90+ day delinquency rate and the foreclosure rate (defined here as the percentage of loans in some stage of foreclosure but not yet taken back by the bank as an REO). The rise in the difference between rates means that more and more people who have stopped paying their mortgages continue to live in their homes without the lender taking any action (e.g. filing a Notice of Default). What is going to happen to the growing overhang of failing loans in the region and what does that mean for the residential market in 2010?

While some of those loans may be modified, the results of the earliest modifications have been discouraging so far, as many have ended up back in default. We see the bulk of the failed loans becoming REOs or sold off in short-sales, creating more downward pressure on pricing and once again elevating the number of distressed sales as a percentage of the overall market.

Figure 3 – Foreclosure Activity
Sacramento | Arden | Arcade | Roseville | Woodland
California

Date	90+ Day Delinquency Rate	Foreclosure Rate	Difference
Oct-09	10.99%	3.73%	7.26%
Sep-09	10.51%	3.56%	6.95%
Aug-09	10.08%	3.44%	6.64%
Jul-09	9.51%	3.38%	6.13%
Jun-09	9.31%	3.40%	5.91%
May-09	9.01%	3.39%	5.62%
Apr-09	8.62%	3.22%	5.40%
Mar-09	8.16%	3.03%	5.13%
Feb-09	8.06%	2.59%	5.47%
Jan-09	7.64%	2.30%	5.34%

90+ Day Delinquency Rate: This measures the percentage of loans that are more than 90 days delinquent including those in foreclosure and REO (real estate owned).

Foreclosure Rate: This measures the percentage of loans in some stage of foreclosure including 90+ delinquencies through properties sold at auction.

This does not represent the number of new foreclosure fillings as provided by other data companies, but rather the current stock, or inventory, of loans in the foreclosure process which offers a comprehensive view of foreclosure trends.

Source: First American CoreLogic

Several temporary props are set to expire or have recently expired which will further challenge the residential market in 2010. A state tax credit worth up to $10,000 that helped encourage new home sales recently expired and it is still unclear whether or not that subsidy or something similar will get approved. Also, the Federal Reserve has taken a very active role in subsidizing mortgage rates by purchasing large amounts of mortgage debt, keeping rates at or below 5% for fixed loans. Their stated goal is to cease this activity by March 31st. It is estimated that interest rates could jump a full point if that were to occur, significantly impacting the prices people will be able to pay for homes.

However, the biggest challenge for the residential market is the ongoing economic distress in the region. As long as we continue to lose jobs and incomes are impaired (think furloughs, those compensated by commissions, etc.) the market will continue to suffer as well.

Retail

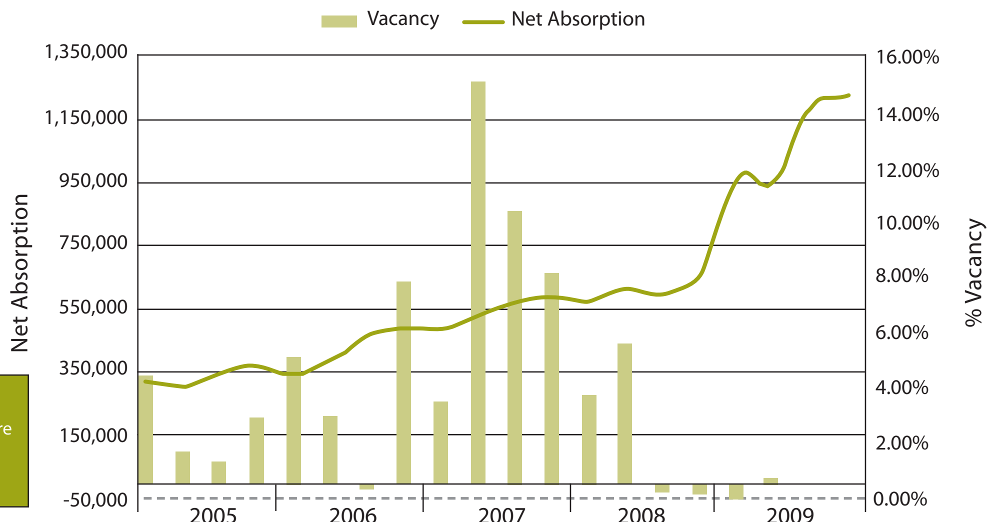
Strongly dependant on the flailing residential market, retail in Sacramento continued to suffer in 2009. Several "big box" stores were vacated, causing vacancy to jump from 8% to nearly 15% by year-end. More small shop spaces also went dark as many "mom & pop" stores struggling to stay afloat amid the drought in consumer spending finally succumbed. Continuing the trend started in 2008, some notable bankruptcies were announced, including Anchor Blue, Eddie Bauer and Gottschalks, while Borders narrowly escaped filing bankruptcy. Smith & Hawken also announced the closure of all their stores, including one in Roseville.

Contract rents fell 30% - 50% across the board as a lack in tenant activity made it very challenging for landlords to fill vacant space. With the difficulties associated with attracting new tenants, landlords took extreme measures to retain existing tenants, including reducing rent on existing leases. They also began to consider more non-traditional uses for their vacant space.

Although it is a very trying time in the retail market, it has become pretty exciting for those that know how to work it to their advantage. In a classic timing play, retailers based in the mid-west and elsewhere are beginning to look at expanding into the region. Betting on a recovery in 2011/2012, they see this as an opportunity to enter California at roughly half the cost of their predecessor in that space. Given the long start-up time associated with some of the larger retailers, which can be as much as 12 to 18 months, they are able to move forward ahead of a recovery and take advantage of the currently depressed rental rates.

Some smaller retailers are also taking advantage of the current market environment. With the difficulty today in obtaining financing for tenant improvements, smaller retailers are capitalizing on the abundance of vacant space available with preexisting improvements that can be modified for their use – e.g. the dentist going into old dentist space, or a restaurant going into space that already

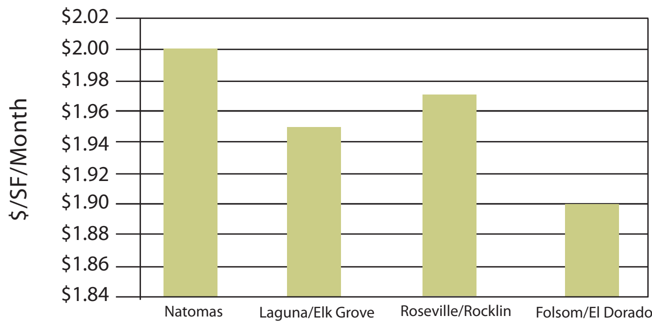
Figure 4 – Retail
Vacancy vs. Net Absorption | Sacramento MSA



Net Absorption: The change in occupied square feet from one period to the next.

Source: CBRE

Figure 5 – Retail
Suburban Asking Rents | 4th Quarter, 2009 | Sacramento MSA



Source: CBRE

has a grease trap and other very expensive improvements necessary for them to operate.

We do not anticipate a repeat of last year, with significant movements in rents and vacancy. However, the retail market will largely remain weak until the residential market rebounds.

Office

With the continued contraction in regional employment, the Sacramento office market experienced many casualties in 2009. We saw a few major developer/owners file bankruptcy in Opus West and Catlin Properties, and the largest locally based developer, Panattoni Development, undergo a significant layoff. We also saw continued deterioration in market fundamentals.

Regional vacancy jumped roughly 5% and remained over 20% for most of the year, ending at 21.4%. This is significant because it is the first time we've seen average vacancy exceed 20%. Projects that broke ground before the severity of the economic downturn was known contributed to the problem, bringing 1.5 million square feet of new office space, 1.2 million of which remains vacant. Submarkets hit the hardest include Elk Grove and Roseville/Rocklin, with vacancy rates of 39% and 34% respectively. By comparison, the downtown Class A market remains relatively healthy with a vacancy rate of less than 13%, despite the additions of two major buildings on Capitol Mall in 2008/2009.

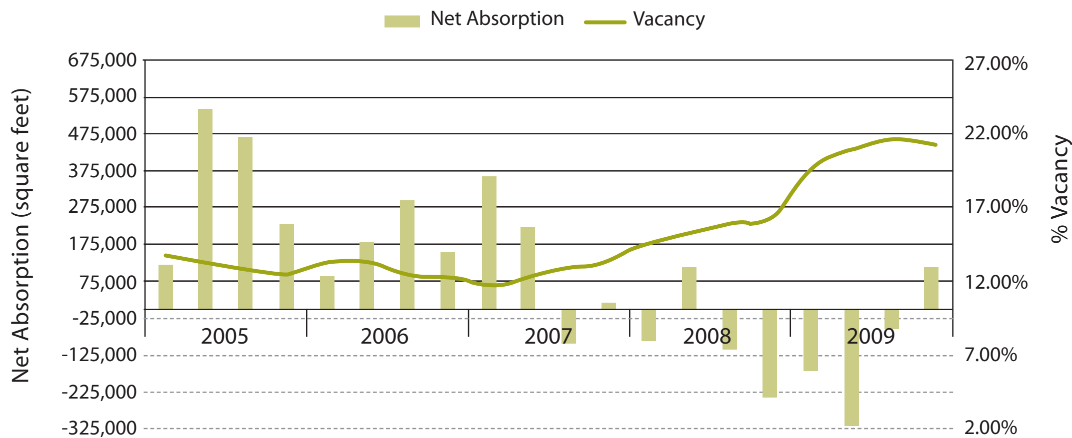
Although asking lease rates experienced only a small drop in 2009, effective rents which take into account concessions fell much more significantly. Concessions included free rent (as much as eighteen months on a five-year lease in some cases), generous tenant improvement packages, and favorable non-economic terms such as "right to cancel early clauses" and "expansion/contraction rights".

The State of California remains the most active tenant in the marketplace, as it continues to add to its overall square footage under lease. In 2009 the state 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 met with some success causing others to follow suit. However, the savings involved are nominal relative to the financial crisis the state faces.

Figure 6 – Office
Vacancy Rate vs. Asking Lease Rates | Sacramento MSA

Source: CBRE

Figure 7 – Office
Vacancy vs. Net Absorption | Sacramento MSA



Source: CBRE

With a budget shortfall estimated to be upwards of $38 billion dollars over the next three years, the State remains a significant wild card in the regional economy, and in turn, the office market. With the legality of the mandatory State employee furloughs undecided, there is an increasing likelihood of layoffs on the horizon which would "salt the wound". In order to cope with drying coffers, the State of California, which is the region's largest tenant, is also becoming the region's largest seller of commercial real estate assets. Local properties currently being offered for sale include the East End Complex, the Attorney General Building, the Franchise Tax Board Campus, the California Emergency Management Agency Building, and the Junipero Serra Building.

As with the retail market we do not see a repeat of 2009, with significant movement in rents and vacancy. There is some expectation of nominal private sector led-development by the end of 2010 in the areas of healthcare, engineering and technology. The State of California will remain active as well, though to a much lesser degree than it did in 2009. The State's focus will remain on cost cutting measures, likely delaying relocations and consolidations until the current fiscal crisis is addressed with more certainty.

Although we do not anticipate any increase in demand, the lack of any real new construction and a moderating pace of job losses should allow vacancy to remain relatively flat. Effective rental rates will also stay relatively flat, though with a continued bias downwards. Aggressive incentive packages will continue to be abundant, particularly for the most desirable tenants.

Industrial

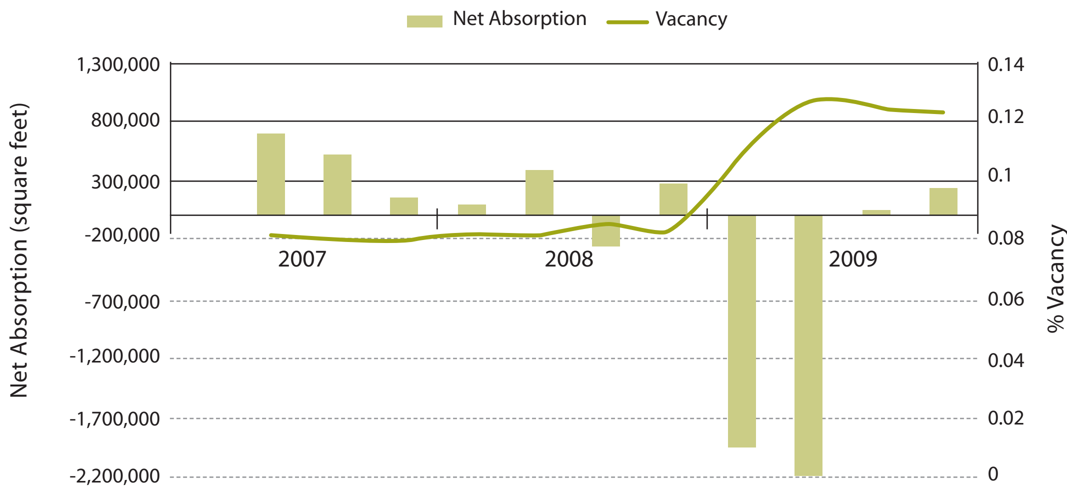
The economic turmoil took its toll on the historically resilient Sacramento industrial market. Vacancy rose from roughly 8% to over 12%, a 50% jump in one year. It was the first year on record the region posted negative net absorption - the change in occupied space from one period to the next - since CBRE began tracking it in 1991. We lost nearly 4 million square feet of occupancy in total, putting us back roughly to the level we were at in early 2006. Average asking lease rates also fell to early 2006 levels as landlords fought to keep vacancy in check.

However, most of the decline in market fundamentals occurred in the first half of 2009. After peaking in the second quarter at 12.7%, overall vacancy ended the year at 12.3%. Net absorption also improved the second half of the year by roughly 240,000 square feet. The leveling off of market indicators is encouraging after the free fall in fundamentals that occurred earlier in the year.

The biggest losses in occupancy for the year occurred in Roseville/Rocklin/Lincoln (-970,639 sf), Rancho Cordova/Hwy 50 (-684,671 sf), McClellan Park (-507,851 sf), and Woodland/Davis (-410,957 sf). There were only two submarkets that experienced year-over-year gains in occupancy, Folsom/El Dorado Hills (62,397 sf) and Downtown/Midtown/East Sac (21,950 sf).

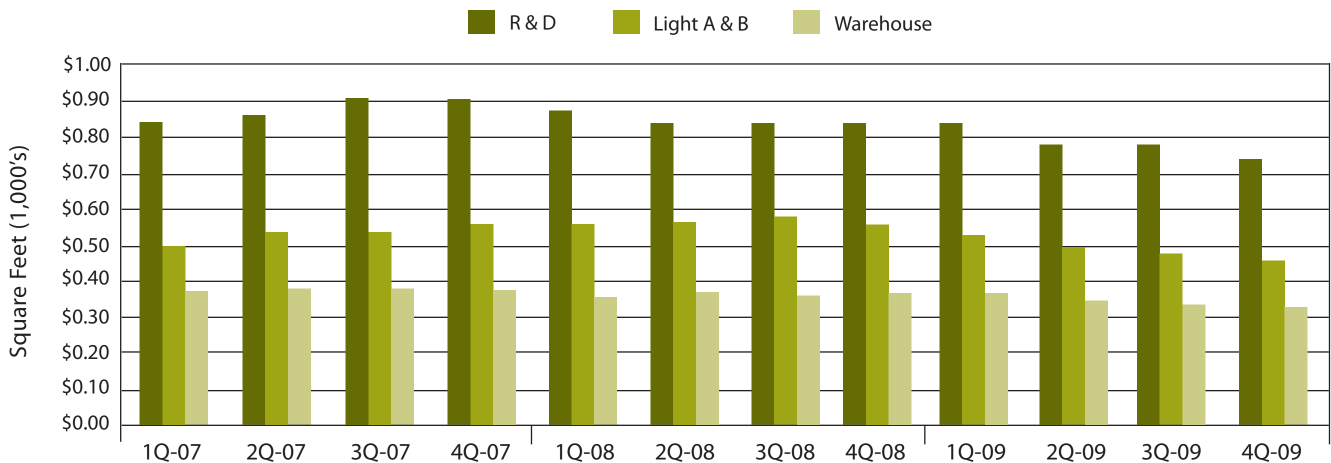
Rental rates fell throughout the year and other incentives such as free rent, tenant improvements, and increased broker incentives were prevalent in an effort to attract

Figure 8 – Industrial
Vacancy vs. Net Absorption | Sacramento MSA



Source: CBRE

Figure 9 – Industrial
Average Asking Lease Rents | Sacramento MSA



Source: CBRE

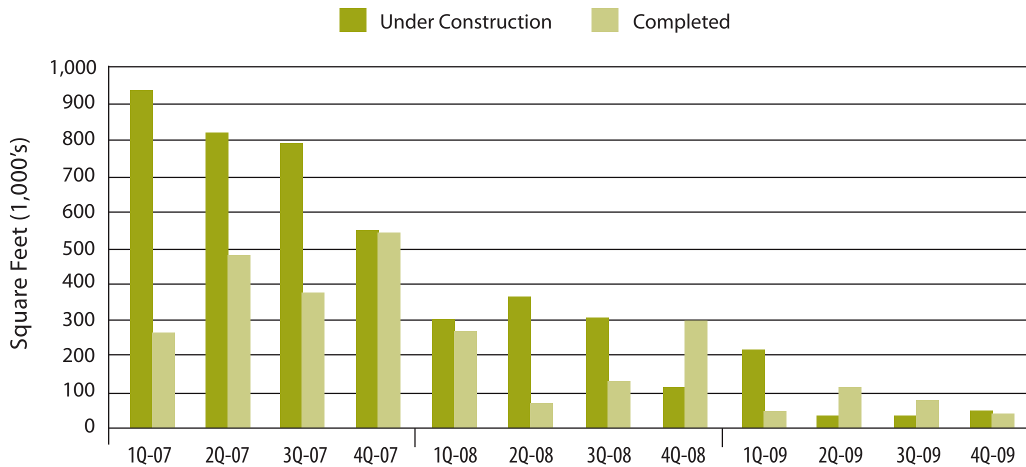
tenants. The most common leasing activity was lease renewals with shorter terms and, in many cases, early termination options as tenants remain highly cautious about the uncertain economic environment.

The most active users in the market were distributors of the "necessities". Multiple food and beverage distributors renewed their leases or even expanded their facilities in 2009. DBI Beverage is currently under construction on an expansion in West Sacramento. In contrast to the robust activity in this sector, those businesses closely tied to the home building industry were hit the hardest.

With the exception of a few build-to-suit requirements, construction activity in the industrial sector, like every other sector, was virtually non-existent. While there will likely be additional built-to-suit and expansion requirements in 2010, no speculative construction is currently underway or anticipated this year.

Overall we see the industrial market experiencing flat to positive activity in 2010. Positive net absorption will return and the vacancy rate should ease slightly. However, rents will continue to have downward pressure and concession levels will remain elevated.

Figure 10 – Industrial
Construction Activity | Sacramento MSA



Source: CBRE

Investments

Transactional volumes were down 80% in 2009 from the previous year, which itself was down from the year prior. To say this past year was a period of adjustment is accurate, but it does not begin to describe the swift and unforgiving manner in which the sales environment has ground to a virtual halt. There were a variety of reasons for this.

Sellers, to the extent they were engaged in the market voluntarily, were unwilling to accept prevailing price levels which in some cases were 30% - 50% lower than they were just a few years earlier. Banks, which were expected to churn out a healthy number of foreclosed properties, were unprepared for the wave of troubled loans and spent most of the year mobilizing. Many banks were also focused on trying to avoid seizure by the FDIC while others still were busy acquiring troubled banks and orchestrating the restructuring necessary to absorb them into their system. This created a dearth of properties being marketed that had high odds of trading.

"Taken together, the market dynamics in 2009 made it extremely difficult to transact."

Further, debt - the cardiovascular system of sorts for real estate investment - continued to be largely unavailable despite the multi-billion dollar infusion by Washington. And cash buyers generally had anxiety about overpaying or of being the "first one in" and often retreated at the first sign of an agreeable seller. Taken together, the market dynamics in 2009 made it extremely difficult to transact.

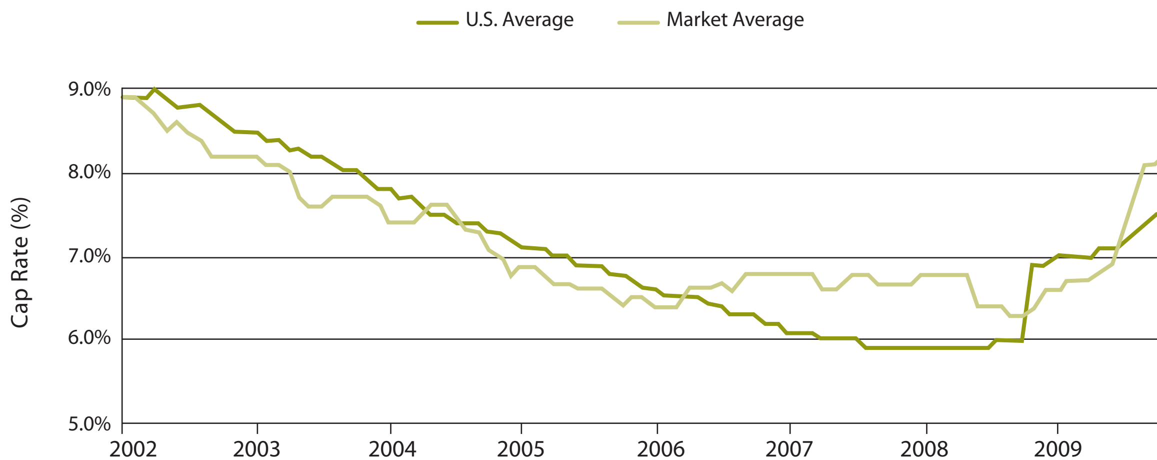
While the shortage of transactional activity made it difficult for market participants to predict closing prices of specific properties with any level of exactness, the general trend was clear. As shown in Figure 12, capitalization rates rose sharply this past year as values fell significantly (they have an inverse relationship).

Although the gap in pricing between quality classes (A, B, and C) was barely existent just a few years ago, it has become much more significant today as investors demand increasingly higher returns for the risk associated with age, functional obsolescence, impaired property condition, and challenging location characteristics. While the higher quality multi-housing and single-tenant, net leased (with credit tenants) properties still traded in the 7% - 8% cap rate range, properties trading at double-digit cap rates began to emerge.

Figure 11 – Investments
Market Volume through November 2009 (all property types) | Sacramento MSA

Source: Real Capital Analytics

Figure 12 – Investments
Cap Rate (%)/Sales through November 2009 (all property types) | Sacramento Region



Source: CBRE

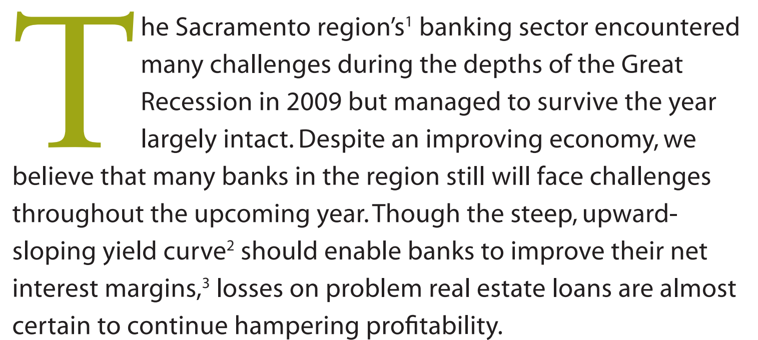
We see market activity increasing in 2010 with an increase in REO, short-sale and other distress driven offerings. Banks, now much more mobilized to act, will begin to dispose of their inventory of REOs. The State of California will also participate this year in a big way. It recently announced the sale-leaseback of eleven high-profile office assets across the state, including six in Sacramento. At more than 8.5 million square feet and a projected value of over $2 billion, it is currently the largest office portfolio available for sale in the nation. The increase in distress driven offerings will perpetuate the downward trend in pricing.

Investors, who were somewhat paralyzed in 2009 by the expectation that assets will become even cheaper, will be lured off the sidelines as the opportunity to buy at cyclical lows becomes compelling.

2010 Sacramento Banking Industry Forecast

Will the Capital Region's Banks Have Enough Capital?

> *"While we expect lending standards to continue easing and loan volumes to gradually improve, we are not confident that the region's banks will open the spigots for new loans in 2010."*



The Sacramento region's[1] banking sector encountered many challenges during the depths of the Great Recession in 2009 but managed to survive the year largely intact. Despite an improving economy, we believe that many banks in the region still will face challenges throughout the upcoming year. Though the steep, upward-sloping yield curve[2] should enable banks to improve their net interest margins,[3] losses on problem real estate loans are almost certain to continue hampering profitability.

Given the impending threat of higher loan losses, many banks will not have the financial capacity to provide an ample supply of much-needed credit to the region's small businesses and consumers. This lack of available credit is likely to temper the strength of the Sacramento area's economic recovery.

And while virtually all of Sacramento's banks have thus far survived the residential mortgage crisis, some may not be so fortunate in 2010 now that problems have migrated toward commercial real estate (CRE) loans. In this paper, we present our watch list of area banks that we deem at risk due to inadequate capitalization and heavy commercial real estate exposure. These institutions stand higher odds of getting shut down by regulators during the year ahead. We also present our list of banks that we consider the strongest financially.

In the midst of this difficult environment, profit opportunities still may abound for investors willing to buy, sell, or hold the Sacramento region's locally based, publicly traded bank stocks. We lay out our opinions for each at the conclusion of the paper.

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2010 Sacramento Banking Industry Forecast
Will the Capital Region's Banks Have Enough Capital?

Steep Yield Curve Good for Banks

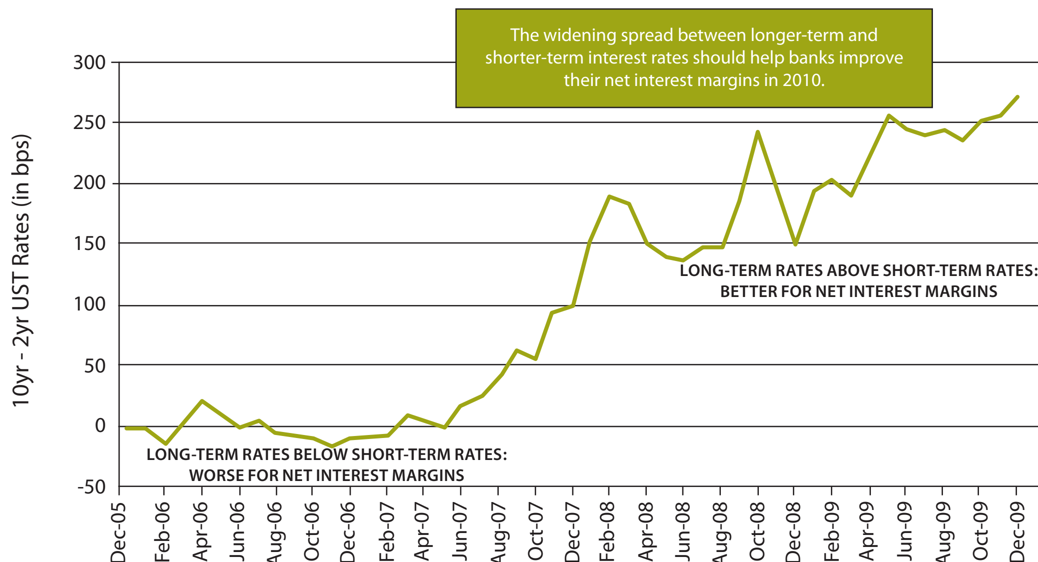
Since banks typically lend money at longer-term interest rates and pay depositors at short-term rates, the shape of the yield curve influences bank profitability. When the yield curve steepens and the differential between higher long-term rates and lower short-term rates widens, banks are usually able to improve their net interest margins.

After the U.S. Federal Reserve lowered the Fed-Funds target interest rate to virtually zero in late 2008, the yield curve steepened throughout 2009. Figure 1 shows how the spread between 10-year and 2-year Treasury rates increased from zero in mid-2007 to nearly 270 basis points (2.70%) by the end of 2009. Heading into 2010, this large differential should enable banks to improve their net interest margins.

What if the Fed Raises Rates?

One key issue that stands to impact bank profitability is whether the Fed will raise interest rates in the near future. Should it do so and should the yield curve start to "flatten" relative to its current shape (i.e., a narrowing in the spread between long-term and short-term rates), banks could see their net interest margins and profitability decline. Although we do not expect the Fed to actually raise rates during 2010, it is highly plausible that the yield curve could flatten anyway based on investor expectations of an increase. That said, we do not believe the degree of any potential yield-curve flattening would be significant enough to drive net interest margins materially lower.

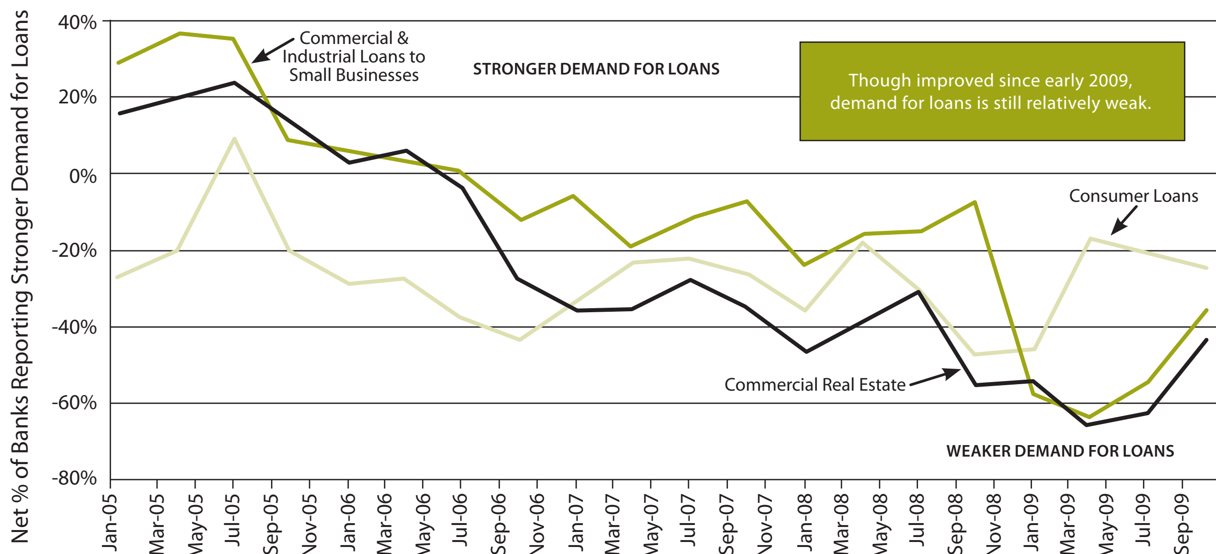
Figure 1
Differential Between 10-Year and 2-Year U.S. Treasuries: 2006-2009



Source: United States Treasury Department

Figure 1 shows the differential between 10-year and 2-year U.S. Treasury rates.

Figure 2
Small Business, Commercial Real Estate, and Consumer Loans
Net Percentage of Banks Reporting Stronger Loan Demand: 2005-2009



Source: Federal Reserve Senior Bank Officer Surveys

Figure 2 shows the net percentage of banks reporting stronger demand for loans.

Will Banks Be Able to Take Advantage?

While the steeper yield curve will provide banks with the opportunity to enhance their net interest margins, banks will be able to take full advantage only if they can increase their loan volumes. Should the region's banks be unable and/or unwilling to lend more, the wider interest-rate spreads may not necessarily translate into greater net interest income.

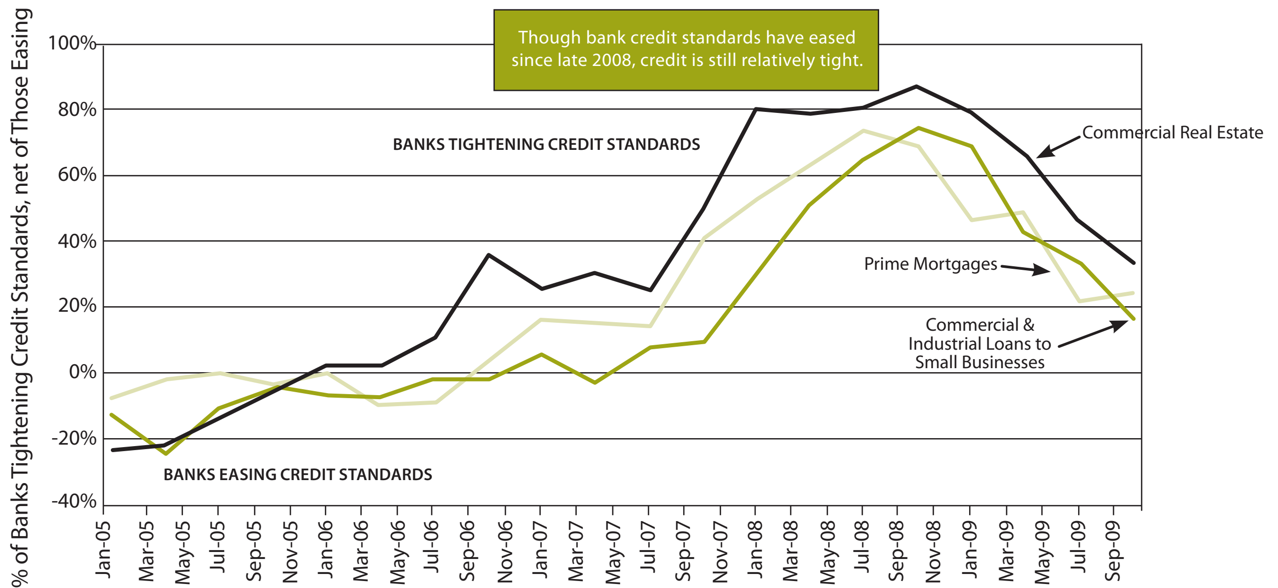
Due to the financial crisis and the Great Recession, aggregate loan volumes for FDIC-insured banks dropped 7.2% from 3Q 2008 to 3Q 2009.[4] And, according to the FDIC, the nearly three percent quarter-over-quarter drop in loan balances was the largest decline since insured institutions began reporting quarterly results in 1984. These declining loan balances have resulted primarily from two factors. First, loan demand from both businesses and consumers has fallen drastically and remains at relatively low levels (refer to Figure 2). At the same time, banks have tightened credit standards (refer to Figure 3) because of capital constraints caused by problem loans still on their books and/or concerns regarding the creditworthiness of borrowers.

As the economy shows more signs of stabilizing and slowly improving in 2010, we believe that credit standards will continue easing and that the region's banks will gradually start lending more, thereby taking advantage of the potential to increase both net interest margins and net interest income. More net interest income would help banks cushion the blow from loan losses, which we expect to remain at elevated levels throughout the upcoming year.

Impact on the Region's Economic Growth

A healthy economic recovery is almost always dependent on a banking sector willing and able to extend ample credit to both businesses and consumers. As Figure 4 shows, growth in U.S. private consumption, which comprises roughly two-thirds of economic output, has been highly correlated with bank lending standards to consumers for more than a decade.

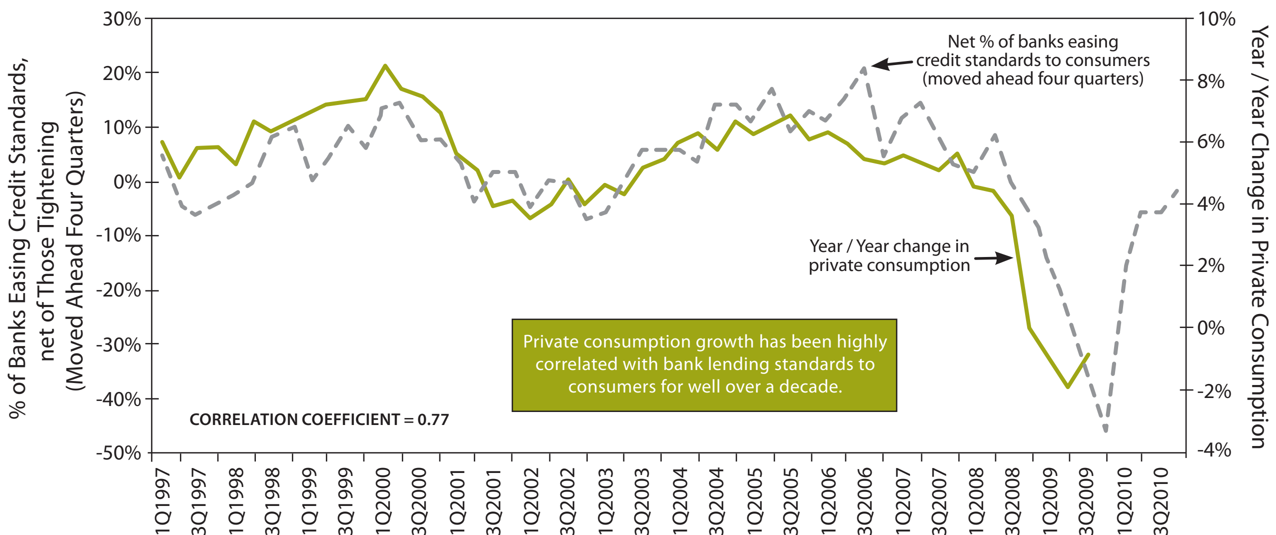
Figure 3
Credit Standards for Small Businesses, Commercial Real Estate, and Mortgages
Net Percentage of Banks Tightening Lending Standards: 2005-2009



Source: Federal Reserve Senior Bank Officer Surveys

Figure 3 shows the net percentage of banks tightening credit standards, net of those easing standards.

Figure 4
Bank Credit Standards to Consumers and Private Consumption Growth: 1997-2009



Sources: U.S. Bureau of Economic Analysis, Federal Reserve

Figure 4 shows the net percentage of banks easing lending standards to consumers in relation to year-over-year changes in private consumption.

While we expect lending standards to continue easing and loan volumes to gradually improve, we are not confident that the region's banks will open the spigots for new loans in 2010. Though the economy has stabilized, many banks are still dealing with problem loans, which adversely impact capital levels (and hence the ability to make new loans). We believe these fragile credit conditions will constrain the vitality of the Sacramento region's economic growth during the upcoming year.

Problem Loans Still an Issue

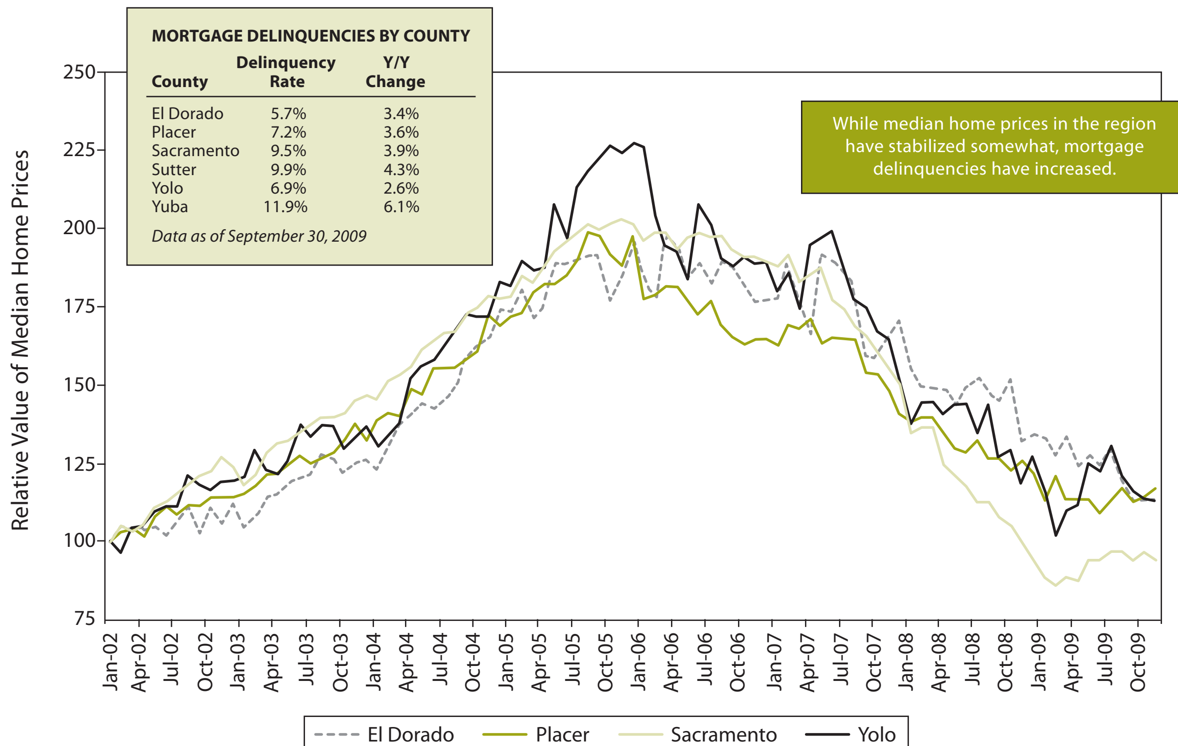
As noted previously, loan losses are likely to offset the benefits of higher net interest income throughout the upcoming year. While we expect residential mortgage loans to continue being problematic for some banks, we think the bigger issue in 2010 will be the severity of commercial real estate (CRE) loan losses, since many of the region's banks have considerable CRE loan exposure.

Continued Pressure from Residential Mortgages

Though median home prices in the Sacramento region stabilized during 2009, unemployment increased quite substantially, while wage growth remained relatively stagnant. As a result, mortgage delinquency rates rose from 2008 levels (refer to Figure 5) despite the more favorable pricing environment. By the end of September 2009, the percentage of mortgages more than 90 days delinquent ranged from 5.7% in El Dorado County to 11.9% in Yuba County.

Despite government efforts to stem the mortgage crisis (e.g., homebuyer tax credits, Fed purchases of mortgage-backed securities to artificially lower mortgage rates, moratoria on foreclosures, etc.), we expect problem mortgage loans to continue hampering bank balance sheets in 2010. With unemployment likely to remain

Figure 5
Relative Value of Median Home Prices, by County*: 2002-2009



MORTGAGE DELINQUENCIES BY COUNTY

County	Delinquency Rate	Y/Y Change
El Dorado	5.7%	3.4%
Placer	7.2%	3.6%
Sacramento	9.5%	3.9%
Sutter	9.9%	4.3%
Yolo	6.9%	2.6%
Yuba	11.9%	6.1%

Data as of September 30, 2009

** No median home price data is available for Sutter or Yuba counties.*

Sources: California Association of Realtors, New York Federal Reserve

Figure 5 shows the relative value of median home prices since 2002 and mortgage delinquency rates by county.

elevated and mortgage rates likely to increase (because we anticipate that the Fed will rein in mortgage-backed securities purchases by early to mid-2010), we are projecting mortgage delinquency and foreclosure rates to trend higher next year. The fact that option ARM[5] and Alt-A[6] mortgage interest-rate resets are scheduled to spike in 2010 and 2011[7] has fortified our opinion.

Bigger Issues with Commercial Real Estate (CRE)

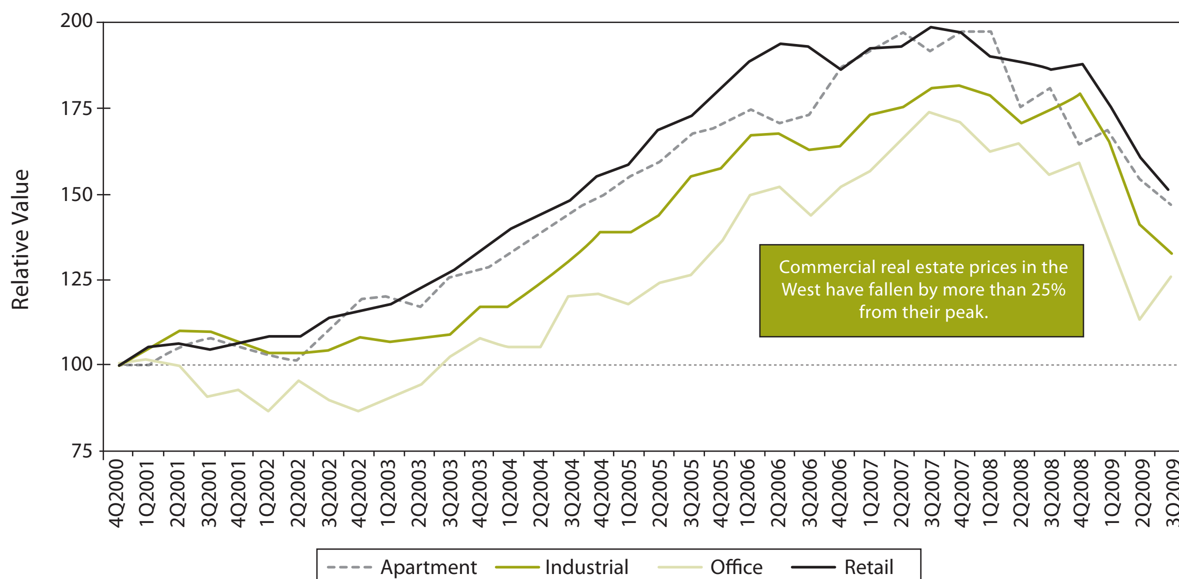
While residential mortgage problems have been prevalent for some time, the contagion has now spread to CRE loans. The phrase "waiting for the other shoe to drop" has become ubiquitous to describe the potential severity associated with construction and CRE loan defaults. When evaluating banks in the Sacramento region, one can understand why CRE loan losses should be taken very seriously. Of banks with more than $50 million of deposits in the region, residential mortgage loans comprise an average of 24% of total loans outstanding. Meanwhile, construction and CRE loans, in aggregate, make up nearly twice that figure (46%).

Figure 6 shows how commercial property prices in the Western United States have declined precipitously since the Great Recession began in late 2007. These declines followed a meteoric rise since the beginning of the decade. With many CRE loan-to-value ratios now far exceeding 100%, delinquencies and defaults have risen.

To provide a better understanding of how CRE loans are likely to impact bank balance sheets, the Federal Reserve included a special section regarding construction and CRE loans in its October 2009 *Senior Bank Officer Survey*. In the survey, a large majority of bankers reported that less than 10% of construction and CRE loans maturing between January and September 2009 were paid down, and less than 10% were refinanced. At the same time, less than 20% of loans (in aggregate) were delinquent or foreclosed. The key takeaway was that most loans were extended forward. *The survey results for CRE loans are detailed in Figure 7.*

We anticipate that many CRE borrowers will not have the financial capacity necessary to pay down their extended loans in 2010. Furthermore, with lower property prices impacting loan-to-value ratios, refinancing will remain

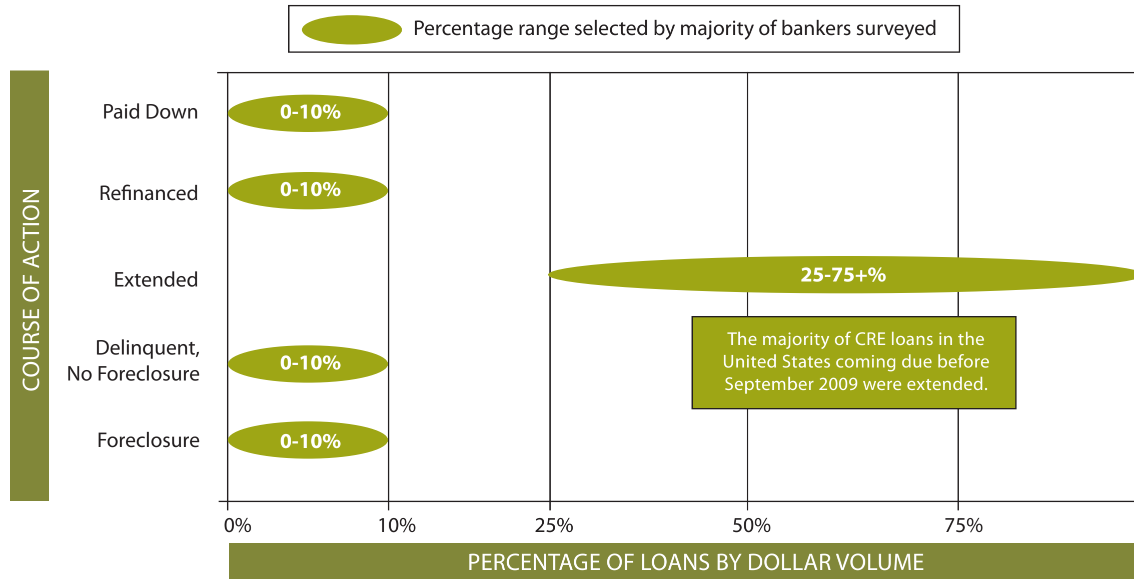
Figure 6
Relative Value of Moodys / REAL Western Region CRE Price Indices: 2000-2009



Source: MIT Center for Real Estate

Figure 6 shows the relative value of commercial real estate prices in the Western Region.

Figure 7
U.S. Senior Bank Officer Survey Data
Commercial Real Estate (CRE) Loans Maturing Between January–September 2009



Source: Federal Reserve October 2009 Senior Loan Officer Survey

Figure 7 shows the course of action for CRE loans maturing between January and September 2009 (by dollar volume of loans).

difficult. Given the large percentage of construction and CRE loans that were extended, the prospect of more foreclosures is likely to continue hanging over bank balance sheets during the upcoming year. We expect this overhang to constrain new lending and thus the vigor of the region's economic recovery.

Sacramento Banking Landscape

The main players in the Sacramento region's banking industry[8] are: i) larger, national banks headquartered outside Sacramento but with a large deposit base in the region, ii) regional banks based outside Sacramento, and iii) local banks that tend to be smaller in scale. Table 1 shows the market share of deposits for banks with more than $50 million of deposits in the six-county region. These banks comprised the group that we analyzed in the following sections.[9]

Which Banks are in the Best Financial Shape?

When determining our list of the strongest banks operating in the region, we chose to eliminate size bias and evaluate every bank on a "pound-for-pound" basis (i.e., we analyzed each bank's financial metrics relative to its asset size). In doing so, we acknowledge that many regard asset size as an indication of a financial institution's strength, especially considering the implicit guarantee provided by the Federal Reserve's "Too Big to Fail" policy, whereupon government capital would almost certainly be injected into the larger national banks during a crisis to prevent a financial system collapse.

To establish which banks (with more than $50 million of deposits in the region) should be considered the strongest financially, we started by evaluating how well each is capitalized. We did so by calculating every bank's Tangible Common Equity Ratio (TCE Ratio), which compares Common Equity capital, net of Preferred Stock and Intangible Assets,[10] as a percentage of Tangible Assets. All else being equal, banks with higher TCE Ratios are better capitalized. Of the nearly 40 banks that we analyzed, only 12 had double-digit TCE ratios as of September 30, 2009 (or afterwards for banks who issued new equity between September 30 and December 31, 2009).

Given the aforementioned concerns regarding CRE loan losses, we next compared each bank's loan-loss allowance

Table 1
Share of Deposits in the Sacramento Region | June 30, 2009

Bank	Headquarters	Deposits in Sacramento Region[1]	Market Share of Deposits	Adjusted Market Share of Deposits[2]
Citibank	New York, NY	$15,453[3]	33.1%	2.2%
Wells Fargo / Wachovia	San Francisco, CA	8,209	17.6%	25.7%
Bank of America	Charlotte, NC	6,712	14.4%	21.0%
U.S. Bank	Minneapolis, MN	4,101	8.8%	12.8%
JP Morgan Chase	New York, NY	2,333	5.0%	7.3%
Bank of the West[4]	San Francisco, CA	1,269	2.7%	4.0%
Umpqua Bank	Roseburg, OR	1,129	2.4%	3.5%
El Dorado Savings Bank	Placerville, CA	858	1.8%	2.7%
River City Bank	Sacramento, CA	852	1.8%	2.7%
Union Bank[5]	San Francisco, CA	807	1.7%	2.5%
First Northern Bank	Dixon, CA	420	0.9%	1.3%
Comerica Bank	Dallas, TX	407	0.9%	1.3%
Bank of Sacramento	Sacramento, CA	319	0.7%	1.0%
American River Bank	Rancho Cordova, CA	309	0.7%	1.0%
California Bank & Trust[6]	San Diego, CA	297	0.6%	0.9%
Tri Counties Bank	Chico, CA	292	0.6%	0.9%
Five Star Bank	Sacramento, CA	269	0.6%	0.8%
Westamerica Bank	San Rafael, CA	260	0.6%	0.8%
First Bank	St. Louis, MO	258	0.6%	0.8%
PremierWest Bank	Medford, OR	229	0.5%	0.7%
Guaranty Bank[7]	Austin, TX	200	0.4%	0.6%
Farmers & Merchants Bank	Lodi, CA	195	0.4%	0.6%
Redding Bank of Commerce	Redding, CA	151	0.3%	0.5%
Merchants Bank of Sacramento	Sacramento, CA	129	0.3%	0.4%
Granite Community Bank	Granite Bay, CA	121	0.3%	0.4%
Rabobank, N.A.[8]	El Centro, CA	114	0.2%	0.4%
Community 1st Bank	Roseville, CA	112	0.2%	0.4%
Mechanics Bank	Richmond, CA	107	0.2%	0.3%
United Commercial Bank[9]	San Francisco, CA	102	0.2%	0.3%
North Valley Bank	Redding, CA	95	0.2%	0.3%
Ironstone Bank	Fort Myers, FL	94	0.2%	0.3%
River Valley Community Bank	Yuba City, CA	84	0.2%	0.3%
Butte Community Bank	Chico, CA	79	0.2%	0.2%
Gold Country Bank	Marysville, CA	75	0.2%	0.2%
Sierra Vista Bank	Folsom, CA	73	0.2%	0.2%
Community Business Bank	West Sacramento, CA	71	0.2%	0.2%
Folsom Lake Bank	Folsom, CA	61	0.1%	0.2%
Sutter Community Bank	Yuba City, CA	54	0.1%	0.2%
		Total $46,701		

1) Aggregate deposits (in millions) for banks with more than $50 million of deposits in El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties
2) Adjusted share of deposits if Citibank's Alhambra branch office were excluded (see footnote 3 below).
3) Citibank's Alhambra branch holds $14.7 billion of deposits for the State of California.
4) Bank of the West is a subsidiary of BNP Paribas.
5) Union Bank is a subsidiary of Mitsubishi UFJ Financial Group.
6) California Bank & Trust is a subsidiary of Zions Bancorp.
7) Guaranty Bank was closed by the Office of Thrift Supervision on August 21, 2009. The bank reopened as part of BBVA Compass.
8) Rabobank, N.A. is a subsidiary of Netherlands-based Rabobank.
9) United Commercial Bank was closed by regulators on November 6, 2009 and was later taken over by East West Bank.

Source: FDIC

Table 2
The "Strongest" Banks Operating in the Sacramento Region*

Bank	Headquarters	TCE Ratio[1]	Allowance for Loan Losses as a % of Nonperforming Loans	CRE & Construction Loans as a % of Total Loans	Return on Equity[2]	Bankrate.com Rating[3]
El Dorado Savings Bank	Placerville	9.1%	267%	5%	7.68%	4
Farmers & Merchants Bank	Lodi	9.9%	204%	29%	12.42%	4
Merchants Bank of Sacramento	Sacramento	10.0%	N/A[4]	56%	10.00%	4
River Valley Community Bank	Yuba City	15.4%	120%	49%	3.50%	4

1) Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets

2) Return on Equity figures are for the first 9 months of 2009 and are annualized.

3) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated

4) Merchants Bank reported no nonperforming loans as of September 30, 2009.

* Banks were evaluated on a "pound-for-pound" basis, excluding asset size as a factor.

Financial Data from September 30, 2009, FDIC Call Reports

Table 3 *
The "Watch List"

Bank	Headquarters	Allowance for Loan Losses as a % of Nonperforming Loans	CRE & Construction Loans as a % of Total Loans	TCE Ratio[1]	Pro Forma TCE Ratio if 80% Loan Loss Allowance[2]	Bankrate.com Rating[3]
Butte Community Bank[4]	Chico, CA	39%	59%	7.6%	5.5%	1
First Bank[5]	St. Louis, MO	46%	48%	3.0%	1.0%	2
Granite Community Bank[6]	Granite Bay, CA	28%	58%	5.9%	0.8%	1
Guaranty Bank[7]	Austin, TX	33%	38%	7.4%	5.7%	2
North Valley Bank	Redding, CA	36%	64%	9.4%	6.9%	1
PremierWest Bank[8]	Medford, OR	38%	63%	3.9%	1.1%	2

1) Tangible Common Equity Ratio (TCE Ratio) calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.

2) This column shows the pro forma TCE Ratio if the bank were to increase its loan-loss allowance to 80% of nonperforming loans.

3) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated

4) On December 31, 2009, Butte Community Bank's parent company, Community Valley Bancorp, announced the conversion of $3.3 million of debt into Preferred Stock. Since the TCE Ratio excludes Preferred Stock, the offering would not affect Butte Community Bank's TCE Ratio.

5) First Bank data does not reflect the recent divestiture of assets and liabilities to FirstMerit Bank. These transactions would not change the TCE Ratio materially.

6) On November 16, 2009, Granite Community Bank sent a letter to shareholders requesting approval to increase shares of Common Stock and issue Preferred Stock. The bank also intends to raise $6.5 million of equity via a private placement. If this private placement were completed, the pro forma TCE Ratio would be 10.7% (6.1% at an 80% loan-loss allowance to nonperforming loans).

7) Guaranty Bank was closed by the Office of Thrift Supervision on August 21, 2009. The bank reopened as part of BBVA Compass, and the statistics listed in the chart are those of Compass Bank.

8) PremierWest Bank filed a registration statement for a $36 million stock offering on November 20, 2009. The pro forma TCE Ratio would be 5.9% (3.3% at an 80% loan-loss allowance to nonperforming loans) if the offering were completed.

Financial Data from September 30, 2009, FDIC Call Reports

* The "Watch List" (Table 3) has been updated. California Bank & Trust (CB&T) was previously included on this list because the authors included CB&T's portion of nonperforming loan balances acquired from two failed banks. After factoring in CB&T's proportion of nonperforming loans under new FDIC loss-sharing agreements, the authors determined that CB&T's allowance for loan losses as a percentage of its (adjusted) nonperforming loan balances was above the threshold on the aforementioned "Watch List".

as a percentage of nonperforming loans. According to our findings, only about one-third of the banks have reserved more than 100% of their 3Q 2009 nonperforming loan balances. Taking this analysis one step further, we calculated aggregate construction and CRE loan balances as a percentage of total loans outstanding[11] for every bank.

We also wanted to ensure that those making our list of strongest banks in the region were profitable even during this recent difficult operating environment. We therefore evaluated each bank's Return on Equity, which compares a bank's Net Income as a percentage of its Shareholders' Equity, for the year-to-date period ending September 30, 2009.

As a final litmus test, we checked every bank's rating from Bankrate.com, an independent bank research firm. Bankrate.com assigns ratings between 1 (Lowest Rated) and 5 (Superior).

Of the nearly 40 banks with more than $50 million of deposits in the region, we classified four as the strongest financially (on a relative basis, excluding asset size as a factor). Table 2 lists all four, each of which is based locally. Though El Dorado Savings Bank and Farmers & Merchants Bank have TCE Ratios below 10%, we deemed both worthy of inclusion because they have: i) reserved more than 200% of their nonperforming loan balances, ii) maintained low CRE loan exposure, and iii) managed to generate a solid Return on Equity in the midst of an adverse economic climate.

The "Watch List"

At the other end of the spectrum are banks that we believe have a higher risk of getting shut down by regulators during 2010. These banks have a combination of: i) low tangible capital, ii) inadequate loan-loss allowances, and iii) a sizable proportion of construction and CRE loans on their books. Table 3 shows the list of the 6 banks on our "watch list."

According to the FDIC, the number of problem U.S. banking institutions has risen more than tenfold since 2006, from 50 to 552 as of 3Q 2009. At the same time, the FDIC's Deposit Insurance Fund (DIF), which guarantees the safety of bank deposits (up to $250,000 per depositor per bank), has fallen from $52.4 billion in 2007 to an $8.2 billion deficit as of 3Q 2009, with the number of failed institutions increasing from 3 to 95 during this time frame. Though the FDIC announced in late September 2009 that it would be assessing insured banks (in aggregate) $45 billion of prepayment fees to restore the DIF, it is not unreasonable to expect this amount to get whittled completely away should 20% of today's 552 problem institutions fail. (The DIF fell by $60 billion from 2007 to 3Q 2009 when less than 100 banks failed). Depositors would therefore be wise to closely monitor the health of the banks holding their funds.

Publicly Traded Local Bank Recommendations

Within the six-county Sacramento region, 11 locally based banks are publicly traded on the OTC Bulletin Board. In this section, we present our recommendations for each. Readers should note that all of these stocks have very low liquidity, so investors should definitely consider market impact[12] when trading shares.

Outperform Recommendations[13]

First Northern Bank – Though Dixon-based First Northern Bank's Tangible Common Equity Ratio (TCE Ratio) is not the strongest and its CRE exposure is relatively high, the bank has already made healthy provisions for loan losses. As a result, Bankrate.com has given First Northern a 4-star (Sound) rating. With solid net interest margins and a stock trading at the peer group average Price-to-Tangible-Book Ratio (Price / TB Ratio), we think First Northern is likely to outperform its peers in 2010.

River Valley Community Bank – Yuba City-based River Valley, the only other local, publicly traded bank to receive a 4-star rating from Bankrate.com, was part of our list of the region's strongest banks. And while the stock trades at a premium to the peer group average (from a Price / TB Ratio standpoint), we still consider it worthy of an Outperform rating.

Market Perform Recommendations[14]

River City Bank – Even though Sacramento-based River City Bank trades at a discount to the peer average Price / TB Ratio, we are concerned that River City may need to set aside more in loan-loss provisions during 2010 (since its allowance for losses is less than 60% of its nonperforming loan balance).

Bank of Sacramento – Similar to River City, we are currently not compelled to give Bank of Sacramento an Outperform rating, despite its valuation discount to the peer average. With nearly 75% of its loans consisting of either construction or CRE loans, we remain worried that Bank of Sacramento's 60% loan-loss allowance to nonperforming loans may not be sufficient.

Table 4
Recommendations for Publicly Traded Banks Based in the Sacramento Region*
December 31, 2009

Bank (Ticker)[1]	Market Cap[2]	Price	2009 Total Return	Price / Tangible Book Value[3]	TCE Ratio[4]	Allowance for Loan Losses as a % of Nonperforming Loans	CRE & Construction Loans as a % of Total Loans	Net Interest Margin[5]	Return on Equity[6]	Bankrate.com Rating[7]
OUTPERFORM *(Stocks forecast to outperform peer group in 2010)*										
First Northern Bank of Dixon (FNRN)	$43.5	$4.85	-19.2%	0.7x	8.4%	139%	44%	4.70%	2.91%	4
River Valley Community Bank (RVVY)	15.8	$11.50	4.5%	1.0x	15.4%	120%	49%	3.88%	3.50%	4
MARKET PERFORM *(Stocks forecast to perform in line with peer group in 2010)*										
River City Bank (RCBC)	$40.9	$40.00	-32.7%	0.4x	9.0%	58%	49%	4.17%	-5.41%	2
Bank of Sacramento (GSCB)	15.4	$6.00	-37.2%	0.4x	9.9%	60%	73%	4.79%	3.04%	3
Folsom Lake Bank (FOLB)	11.9	$7.50	-16.7%	0.9x	13.8%	N/A[8]	80%	4.12%	-9.03%	3
Community Business Bank (CBBC)	6.0	$2.80	-34.1%	0.4x	11.0%	81%	52%	5.07%	-19.55%	2
Sutter Community Bank (SUTB)	2.9	$3.00	-15.5%	0.4x	10.8%	144%	35%	4.75%	1.04%	2
UNDERPERFORM *(Stocks forecast to underperform peer group in 2010)*										
American River Bank (AMRB)[9]	$77.4	$7.86	-19.1%	1.1x	11.9%	42%	67%	4.91%	2.99%	3
Sierra Vista Bank (SVBA)[10]	12.0	$7.29	3.4%	1.3x	10.0%	59%	60%	3.90%	-29.27%	1
Community 1st Bank (CFBN)	11.4	$6.50	-3.0%	0.8x	9.8%	62%	80%	4.06%	-1.77%	3
Granite Community Bank (GBSI)	2.4	$1.75	-67.6%	0.3x	5.9%	28%	58%	3.48%	-31.05%	1
			Peer Group Average:	0.7x						

1) Each of the stocks is traded on the OTC Bulletin Board.
2) Market capitalization as of December 31, 2009; Figures listed are in millions.
3) Tangible Book Value is determined by substracting Preferred Stock and Intangible Assets from Common Equity.
4) Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.
5) Net Interest Margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.
6) Return on Equity figures are for the first 9 months of 2009 and are annualized.
7) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated
8) Folsom Lake Bank reported no nonperforming loans as of September 30, 2009.
9) American River Bank's Price / Tangible Book Value Ratio and TCE Ratio are pro forma reflecting the company's $24 million equity offering in December 2009.
10) Sierra Vista's Market Cap, Price / Tangible Book Value Ratio and TCE Ratio are pro forma reflecting the company's $1.2 million equity offering in January 2010.

** The authors do not own shares in any of the banks listed in Table 4. The Sacramento Business Review cannot guarantee any of the forecasts made in this paper.*

Folsom Lake Bank – Upstart Folsom Lake Bank has been a solid operator since its 2007 inception, with no nonperforming loans on its books (as of September 30, 2009). However, given our concerns about construction and CRE loans, we would be less willing to pay the current premium to own Folsom Lake Bank because 80% of its loans are in these categories.

Community Business Bank – Community Business Bank, based in West Sacramento, appears well capitalized and has generated strong net interest margins. At 0.4 times Price / TB, the stock trades below the peer group average and would seem compelling. Nonetheless, our outlook for the stock has been tempered by the bank's poor returns on equity, Bankrate.com's 2-star (Below Peer Group) rating, and press regarding a high percentage of loans to bank directors.[15]

Sutter Community Bank – Like Community Business Bank, Yuba City-based Sutter Community Bank looks well capitalized and has produced solid net interest margins. It also trades at 0.4 times Price / TB, which is below the peer group average. But, the bank's 2-Star rating (Below Peer Group) from Bankrate.com makes us apprehensive to give the stock an Outperform rating.

Underperform Recommendations[16]

American River Bank – Though Rancho Cordova-based American River Bank was able to shore up its capital base recently with a $24 million equity offering, we think the bank could underperform its peers at current levels because it has only 42% of its nonperforming loan balance in loss reserves. With two-thirds of its loans in either construction or CRE, we would be reluctant to pay 1.1 times Price / TB for American River Bank when peers trade at an average of 0.7 times.

Community 1st Bank – Roseville-based Community 1st received a 3-star (Performing) rating from Bankrate.com. However, with 80% of its loans in the construction / CRE space and an allowance for loan losses at only 62% of nonperforming loans, we would not be willing to pay a premium for the stock right now (0.8 times Price / TB versus a 0.7 times peer average).

Sierra Vista Bank – Upstart Sierra Vista Bank, headquartered in Folsom, received only 1 star (Lowest Rated) from Bankrate.com. This rating may reflect the fact that 60% of Sierra Vista's loans are construction / CRE loans, and the bank has only a 59% loan-loss allowance relative to nonperforming loan balances. We therefore cannot explain how the stock trades at the richest Price / TB Ratio of all 11 publicly traded banks headquartered in the region.

Granite Community Bank – Granite Bay's Granite Community Bank was on our watch list given its inadequate capitalization. While we would argue that the bank's low valuation reflects many of its problems, we would recommend extreme caution because we think there is a high risk that Granite could get shut down by regulators. And though the bank is trying to issue more equity via a private placement, we are concerned that it could be too little too late.

We would like to give special thanks to Sharon Jou from Sacramento State College of Business Administration for her contributions to this paper.

Exhibit 1
Metrics for Banks with More Than $50 Million of Deposits in the Sacramento Region

Bank	Headquarters	Deposits in Sacramento Region[1]	Market Share of Deposits	Commercial & Industrial	Residential	Construction & CRE Loans	Other	TCE Ratio[2]	Allowance for Loan Losses as a % of Nonperforming Loans	Net Interest Margin[3]	Return on Assets[4]	Return on Equity[4]
				PERCENTAGE OF TOTAL LOANS								
Citibank[5]	New York, NY	$15,453[6]	33.1%	17.3%	38.1%	5.6%	38.9%	5.4%[7]	111%	3.17%	0.32%	-2.30%
Wells Fargo / Wachovia[8]	San Francisco, CA	8,209	17.6%	21.2%	42.1%	16.9%	19.8%	5.4%[9]	115%	4.27%	1.02%	11.32%
Bank of America[10]	Charlotte, NC	6,712	14.4%	28.8%	44.5%	7.9%	18.8%	5.8%[11]	112%	2.65%	0.35%	2.26%
U.S. Bank[12]	Minneapolis, MN	4,101	8.8%	19.0%	31.4%	16.2%	33.4%	5.4%	125%	3.62%	0.81%	7.70%
JP Morgan Chase[13]	New York, NY	2,333	5.0%	19.7%	51.9%	5.4%	23.1%	4.4%	174%	3.15%	0.56%	6.00%
Bank of the West[14]	San Francisco, CA	1,269	2.7%	13.0%	29.4%	21.5%	36.1%	7.9%	72%	3.15%	-0.67%	-4.89%
Umpqua Bank	Roseburg, OR	1,129	2.4%	18.6%	11.6%	68.3%	1.5%	8.8%	80%	4.26%	-1.92%	-10.92%
El Dorado Savings Bank	Placerville, CA	858	1.8%	0.0%	94.5%	5.1%	0.4%	9.1%	267%	2.97%	0.70%	7.68%
River City Bank	Sacramento, CA	852	1.8%	14.2%	29.8%	49.3%	6.7%	9.0%	58%	4.17%	-0.50%	-5.41%
Union Bank[15]	San Francisco, CA	807	1.7%	30.6%	47.1%	18.9%	3.5%	8.3%	93%	3.50%	-0.22%	-2.05%
First Northern Bank	Dixon, CA	420	0.9%	20.1%	23.6%	43.5%	12.7%	8.4%	139%	4.70%	0.31%	2.91%
Comerica Bank[16]	Dallas, TX	407	0.9%	51.7%	3.9%	32.7%	11.7%	8.0%	80%	2.65%	0.09%	-1.48%
Bank of Sacramento	Sacramento, CA	319	0.7%	15.0%	9.0%	73.3%	2.8%	9.9%	60%	4.79%	0.30%	3.04%
American River Bank	Rancho Cordova, CA	309	0.7%	14.9%	13.5%	67.3%	4.2%	11.9%[17]	42%	4.91%	0.34%	2.99%
California Bank & Trust[18]	San Diego, CA	297	0.6%	20.1%	20.6%	55.1%	4.1%	6.6%	33%	4.99%	0.27%	2.14%
Tri Counties Bank	Chico, CA	292	0.6%	7.5%	38.2%	42.4%	11.9%	10.7%	67%	4.96%	0.55%	4.80%
Five Star Bank	Sacramento, CA	269	0.6%	10.1%	9.6%	79.7%	0.6%	11.6%[19]	67%	4.10%	0.90%	8.88%
Westamerica Bank	San Rafael, CA	260	0.6%	14.3%	17.3%	38.4%	29.9%	6.6%[20]	38%	5.26%	2.81%	27.67%
First Bank	St. Louis, MO	258	0.6%	28.2%	20.6%	47.8%	3.4%	3.0%[21]	46%	3.29%	-3.26%	-33.83%
PremierWest Bank	Medford, OR	229	0.5%	19.9%	8.3%	62.9%	8.9%	3.9%[22]	38%	4.48%	-3.03%	-21.37%
Guaranty Bank[23]	Austin, TX	200	0.4%	21.4%	28.3%	38.1%	12.1%	7.4%	33%	3.84%	0.29%	1.35%
Farmers & Merchants Bank	Lodi, CA	195	0.4%	16.4%	15.0%	29.1%	39.5%	9.9%	204%	4.68%	1.22%	12.42%
Redding Bank of Commerce	Redding, CA	151	0.3%	22.5%	22.8%	52.2%	2.5%	7.3%	64%	3.98%	0.86%	9.00%
Merchants Bank of Sacramento	Sacramento, CA	129	0.3%	3.2%	39.2%	56.3%	1.3%	10.0%	N/A[24]	3.56%	1.04%	10.00%
Granite Community Bank	Granite Bay, CA	121	0.3%	17.0%	24.6%	58.0%	0.5%	5.9%[25]	28%	3.48%	-1.98%	-31.05%
Rabobank, N.A.[26]	El Centro, CA	114	0.2%	5.7%	14.3%	49.6%	30.4%	11.2%	42%	3.49%	0.33%	1.59%
Community 1st Bank	Roseville, CA	112	0.2%	12.5%	4.1%	80.0%	3.3%	9.8%	62%	4.06%	-0.22%	-1.77%
Mechanics Bank	Richmond, CA	107	0.2%	14.2%	15.1%	58.9%	11.8%	10.7%	55%	4.20%	0.59%	5.63%
United Commercial Bank[27]	San Francisco, CA	102	0.2%									
North Valley Bank	Redding, CA	95	0.2%	10.2%	21.1%	64.0%	4.6%	9.4%	36%	4.28%	-0.68%	-6.00%
Ironstone Bank	Fort Myers, FL	94	0.2%	19.0%	14.1%	64.9%	2.0%	11.3%	102%	3.20%	-0.89%	-8.07%
River Valley Community Bank	Yuba City, CA	84	0.2%	15.4%	17.4%	49.4%	17.8%	15.4%	120%	3.88%	0.51%	3.50%
Butte Community Bank	Chico, CA	79	0.2%	6.9%	22.3%	58.8%	12.1%	7.6%[28]	39%	4.29%	-1.05%	-12.87%
Gold Country Bank	Marysville, CA	75	0.2%	16.3%	11.8%	47.9%	24.0%	9.4%	36%	5.15%	-0.63%	-6.44%
Sierra Vista Bank	Folsom, CA	73	0.2%	31.3%	8.6%	59.6%	0.5%	10.0%[29]	59%	3.90%	-3.33%	-29.27%
Community Business Bank	West Sacramento, CA	71	0.2%	16.7%	14.3%	52.5%	16.5%	11.0%	81%	5.07%	-2.91%	-19.55%
Folsom Lake Bank	Folsom, CA	61	0.1%	10.2%	9.9%	79.7%	0.1%	13.8%	N/A[24]	4.12%	-1.55%	-9.03%
Sutter Community Bank	Yuba City, CA	54	0.1%	23.7%	10.2%	35.4%	30.8%	10.8%	144%	4.75%	0.11%	1.04%

Financial data from September 30, 2009, FDIC Call Reports and SEC filings when available

Footnotes to Exhibit 1

1) *Aggregate deposits (in millions) for banks with more than $50 million of deposits in El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties (as of June 30, 2009)*
2) *Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.*
3) *Net Interest Margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.*
4) *The Return on Assets and Return on Equity figures are for the first 9 months of 2009 and are annualized.*
5) *Data for Citibank are for the entire company (not just the bank holding company).*
6) *Citibank's Alhambra branch holds $14.7 billion of deposits for the State of California.*
7) *Citibank's TCE Ratio is pro forma reflecting the company's December 2009 equity offering and repayment of TARP funds.*
8) *Data for Wells Fargo is for the entire company (not just the bank holding company), including Wachovia, which was acquired at the end of 2008.*
9) *Wells Fargo's TCE Ratio is pro forma reflecting the company's December 2009 equity offering and repayment of TARP funds.*
10) *Data for Bank of America are for the entire company (not just the bank holding company).*
11) *Bank of America's TCE Ratio is pro forma reflecting the company's December 2009 equity offering and repayment of TARP funds.*
12) *Data for U.S. Bank are for the entire company (not just the bank holding company).*
13) *Data for JP Morgan Chase are for the entire company (not just the bank holding company).*
14) *Bank of the West is a subsidiary of BNP Paribas.*
15) *Union Bank is a subsidiary of Mitsubishi UFJ Financial Group.*
16) *Data for Comerica Bank are for the entire company (not just the bank holding company).*
17) *American River Bank's TCE Ratio is pro forma reflecting the company's $24 million equity offering in December 2009.*
18) *California Bank & Trust is a subsidiary of Zions Bancorp.*
19) *Five Star Bank's TCE Ratio is pro forma reflecting the company's $8 million equity offering in December 2009.*
20) *Westamerica's TCE Ratio is pro forma reflecting the company's November 2009 repayment of TARP funds.*
21) *First Bank data does not reflect the recent divestiture of assets and liabilities to FirstMerit Bank. These transactions would not change the TCE Ratio materially.*
22) *PremierWest Bank filed a registration statement for a $36 million stock offering on November 20, 2009. The pro forma TCE Ratio would be 5.9% if the offering were completed.*
23) *Guaranty Bank was closed by the Office of Thrift Supervision on August 21, 2009. The bank reopened as part of BBVA Compass, and the statistics listed in the chart are those of Compass Bank.*
24) *The bank reported no nonperforming loans as of September 30, 2009.*
25) *On November 16, 2009, Granite Community Bank sent a letter to shareholders requesting approval to increase shares of Common Stock and issue Preferred Stock. The bank also intends to raise $6.5 million of equity via a private placement. If this private placement were completed, the pro forma TCE Ratio would be 10.7%.*
26) *Rabobank, N.A. is a subsidiary of Netherlands-based Rabobank.*
27) *United Commercial Bank was closed by regulators on November 6, 2009 and was later taken over by East West Bank.*
28) *On December 31, 2009, Butte Community Bank's parent company, Community Valley Bancorp, announced the conversion of $3.3 million of debt into Preferred Stock. Since the TCE Ratio excludes Preferred Stock, the offering does not affect Butte Community Bank's TCE Ratio.*
29) *Sierra Vista Bank's TCE Ratio is pro forma reflecting the company's $1.2 million equity offering in January 2010.*

Endnotes

[1] We have defined the Sacramento region to include El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties.

[2] The yield curve measures the relationship between interest rates and maturities for U.S. Treasuries. An upward-sloping yield curve means that longer-term interest rates are greater than short-term rates.

[3] Net interest margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.

[4] Federal Deposit Insurance Corporation, *Quarterly Banking Profile* (3Q 2009), p. 4.

[5] An option ARM is an adjustable-rate mortgage where the interest rate resets after a certain number of years.

[6] An Alt-A mortgage is considered less risky than a subprime mortgage but more risky than a prime mortgage.

[7] T2 Partners LLC, *An Overview of the Housing/Credit Crisis And Why There is More Pain to Come* (December 18, 2008), p. 59.

[8] The scope of this paper deals exclusively with banks. Brokers and credit unions are excluded.

[9] Readers can refer to Exhibit 1 on page 38 for summary financial metrics for each bank with more than $50 million of deposits in the Sacramento region. The financial data was compiled from a combination of FDIC Call Reports and SEC filings when available.

[10] Intangible Assets are non-monetary assets that cannot be physically measured. Goodwill is the most common Intangible Asset for banks.

[11] The construction and CRE loan percentages do not reflect any off-balance-sheet and/or securitized loans.

[12] Market impact is the extent to which buying or selling a stock moves the price. Market impact is greater when stocks are more illiquid.

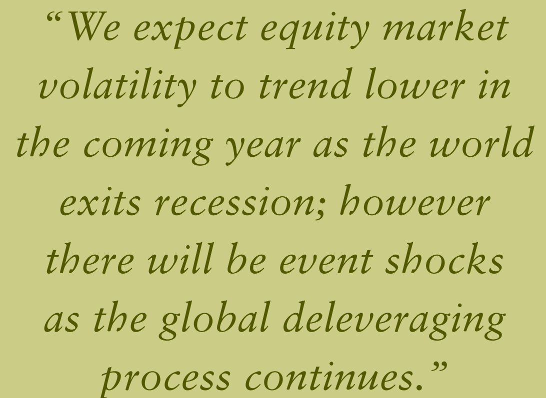
[13] The Outperform recommendations include banks that we expect to outperform the peer group of publicly traded banks based in the Sacramento region (during 2010). The authors cannot guarantee any of the forecasts made in this presentation.

[14] The Market Perform recommendations include banks that we expect to perform in line with the peer group of publicly traded banks based in the Sacramento region (during 2010). The authors cannot guarantee any of the forecasts made in this presentation.

[15] "Bailed-out bank's deals raise concerns," *Sacramento Bee*, 21 June 2009

[16] The Underperform recommendations include banks that we expect to underperform the peer group of publicly traded banks based in the Sacramento region (during 2010). The authors cannot guarantee any of the forecasts made in this presentation.

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



Pundits will claim that 2009 was one of the greatest investing opportunities in a generation, but most market participants remain rattled by the roller coaster ride they endured throughout the year. As for 2010, considerable but less uncertainty remains. Investors are faced with questions surrounding the sustainability of the economic recovery, fears of hyperinflation, near record unemployment and a troubled real estate market. We expect equity market volatility to trend lower in the coming year as the world exits recession; however there will be event shocks as the global deleveraging process continues. Even though nominal yields will rise, credit market volatility will be muted as spreads continue to trend lower.

A moderating continuation of last year's rally will likely characterize the first portion of the year, potentially setting up a corrective phase in the markets. Given the constituent weightings of the SBR Index, we expect it to perform in line with the major averages.

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

Equity Market Review and Analysis

Initial hopes that 2008 would contain the worst for the markets and that the New Year would usher in a return to normalcy were amplified with excitement surrounding a new Presidential administration. Hope soon reverted to fear as numerous press conferences and interviews that were long on posturing and rhetoric and short on details and specifics tempered the early optimism. Ensuing tough talk from Washington and open, hostile debate amongst legislators only served to exacerbate investor panic as the markets continued toward their nadir in early March that saw virtually any asset selling at any price.

Eventually recognizing the public's need for more information, a well-coordinated set of media appearances by the President, Treasury Secretary, FDIC and Fed Chairs helped to engender a more constructive tone of economic "green shoots" and the expected results of the strategies being undertaken. Definitive action steps such as lowering mortgage rates, limiting executive compensation and clarifying the process surrounding stress tests, the Troubled Asset Relief Plan (TARP), and the orderly disposition of bad loans ultimately broke the negative news cycle and helped the public psyche transition through the market bottom. Better than expected banking reports also helped to fuel the beginning of the 60%+ rally that ensued for the remainder of 2009.

"Significant improvements in global economic activity are broad based and prevalent in many important geographic areas."

Along the way, numerous economists, academics and prognosticators *du jour* encouraged investors to sell into the rally, hold cash and run for cover. Those bearish forecasts have proven costly as the global equity markets shrugged off minor consolidations in June and October and marched forward. As we now look into the New Year, the logical question is, "are the financial markets set for a double dip?"

Our answer, simply put, is no. We acknowledge that the markets will remain abnormally skittish and that spikes of fear will inevitably surface in 2010, however, there are a number of structural improvements that will prevent the equity and credit markets from giving investors a déjà vu of 2009:

- **Coordinated Stimulus** – in the past 18 months, over 750 policy initiatives have been enacted. By far, the amount of support and liquidity offered by the global central banks and governments is the largest on record. Historically, there is about a 12-18 month lag time before the effects of these policies are felt in an economic setting which suggests we are just starting to see the results of those initiatives.

- **Clarity in the Financial Sector** – though many challenges remain, one of the key differences in the coming year is that the banking sector is systemically stronger. Many large banking institutions have exited government support programs and are healing more quickly as they benefit from engineered low short rates and a dramatically steepened yield curve. A yield curve represents the interest rates that correspond with various maturities of debt instruments. When the curve is steep (i.e. long term rates are much higher than short term rates), banks can earn greater interest margins between their deposits and loans and generate profits more easily. The picture remains less rosy for smaller banks which generally have higher proportions of troubled commercial real estate loans relative to their asset base.

- **Economic Growth** – significant improvements in global economic activity are broad based and prevalent in many important geographic areas. Leading economic indicators such as new orders,

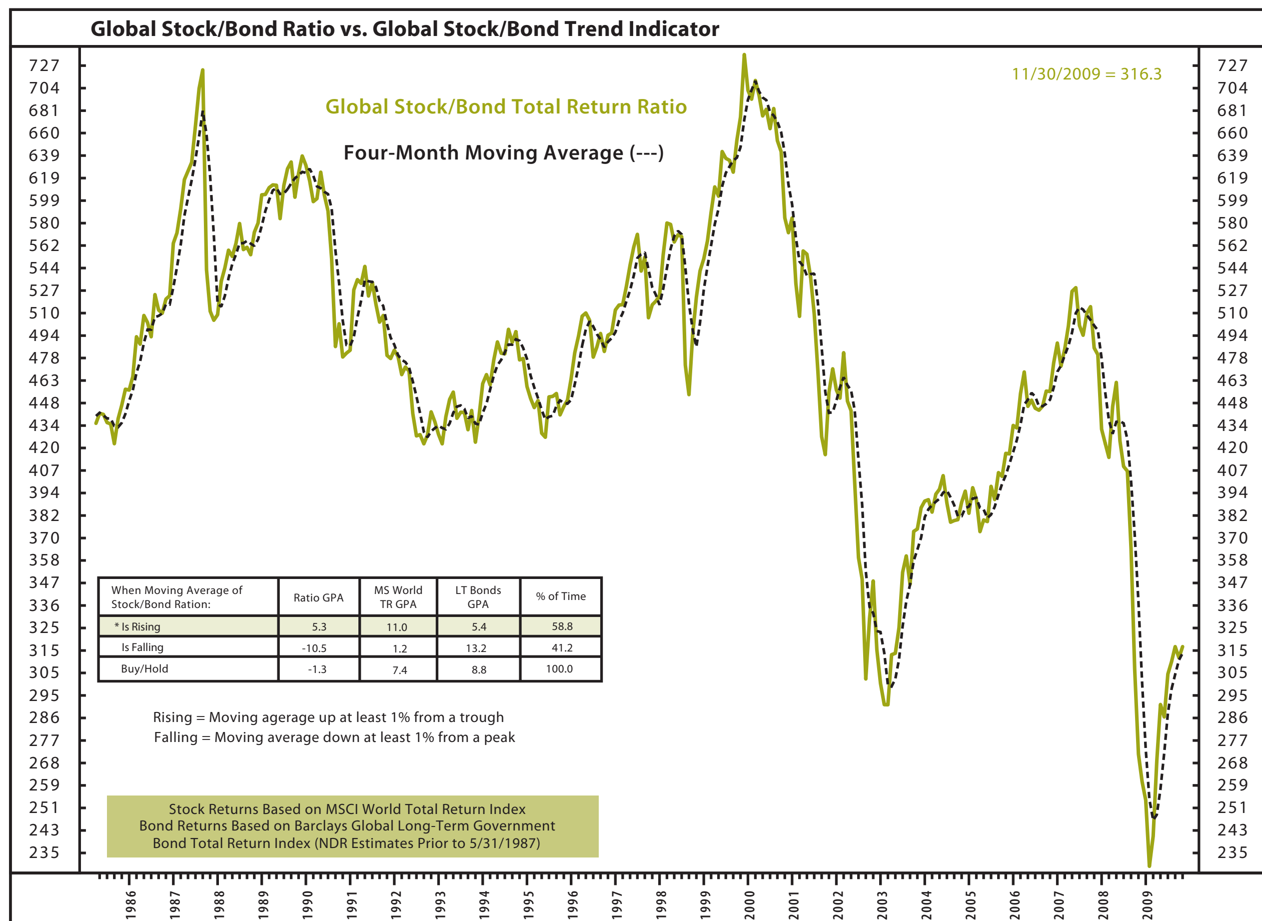
money supply and supplier deliveries have all rebounded sharply. Coincident indicators such as payrolls, personal income, manufacturing sales and industrial production provide insight to current economic improvement and indicate the recession is ending. Furthermore, lagging economic indicators such as duration of unemployment, inventories-to-sales ratios, and commercial and industrial loan growth are either improving or slowing their rate of decline.

- **Business Spending** – the recession and panic of 2008 not only affected investors, but also employers, who aggressively slashed labor costs, capital and operating expenses and delayed new initiatives. During this past year, manufacturing orders declined at an alarming rate and existing inventories were drawn down to minimal levels. Now that global demand is strengthening, employers will adjust to better conditions by expanding capital expenditures and rehiring employees.

- **Valuations** – a fair amount of debate exists regarding current equity valuations. Pessimists claim that certain measures, such as price-to-earnings or price-to-sales multiples are extended, given an outlook that doubts the sustainability of the economic recovery. Optimists claim that these multiples are based off trough levels and apply more normalized sales and earnings forecasts to support the case that equities are still undervalued. Our bias is towards the latter scenario, especially when considering equity valuations relative to bonds (Figure 1). We believe it is reasonable to expect corporate sales and profits to continue to improve as the world exits from recession. These conditions will be supportive of the current trend, allowing equity prices to continue to rise into the first portion of the New Year.

Figure 1: Global Equities Extended? Not When Compared to Bonds

Monthly Data 4/30/1985 –11/30/2009 (Log Scale)

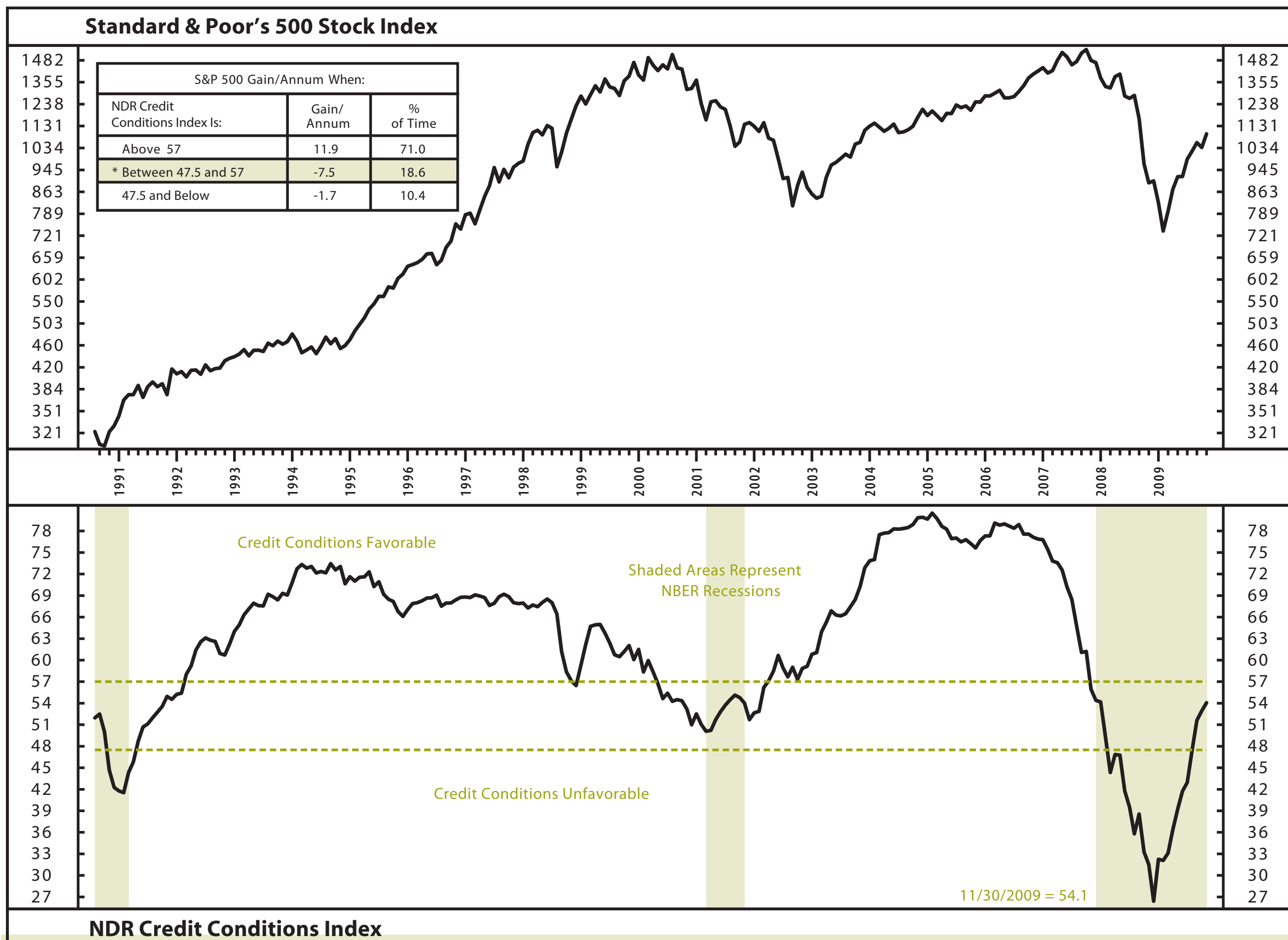


When Moving Average of Stock/Bond Ration:	Ratio GPA	MS World TR GPA	LT Bonds GPA	% of Time
* Is Rising	5.3	11.0	5.4	58.8
Is Falling	-10.5	1.2	13.2	41.2
Buy/Hold	-1.3	7.4	8.8	100.0

Source: Ned Davis Research Group | www.ndr.com

Figure 2: Improving Credit Conditions Historically Favor Equities

Monthly Data 8/31/1990 – 11/30/2009 (Log Scale)



NDR Credit Conditions Index Is:	Gain/ Annum	% of Time
Above 57	11.9	71.0
* Between 47.5 and 57	-7.5	18.6
47.5 and Below	-1.7	10.4

Source: Ned Davis Research Group | www.ndr.com

Equity Markets Outlook

We believe the first half of 2010 will bring higher returns in the equity markets even as the momentum from 2009 continues to slow. Though levels are still subdued, credit extension will be marginally better which historically has provided a constructive backdrop for equities (Figure 2). Sector rotation will be more pronounced as investors struggle to reconcile improving corporate profits in the face of global deleveraging and ongoing challenges in the banking sector and commercial real estate markets. 2010 will bring stronger revenue and earnings growth to cyclical sectors, a tightening of monetary policy and hints of inflation. Though runaway inflation will be well-debated amongst novices and experts alike, it will prove to be easily constrained by an excess supply of residential and commercial real estate, abnormally high unemployment, soft wage growth and slack economic capacity utilization. The second half of 2010 may very well set up for a short-term correction before resuming the cyclical recovery.

United States

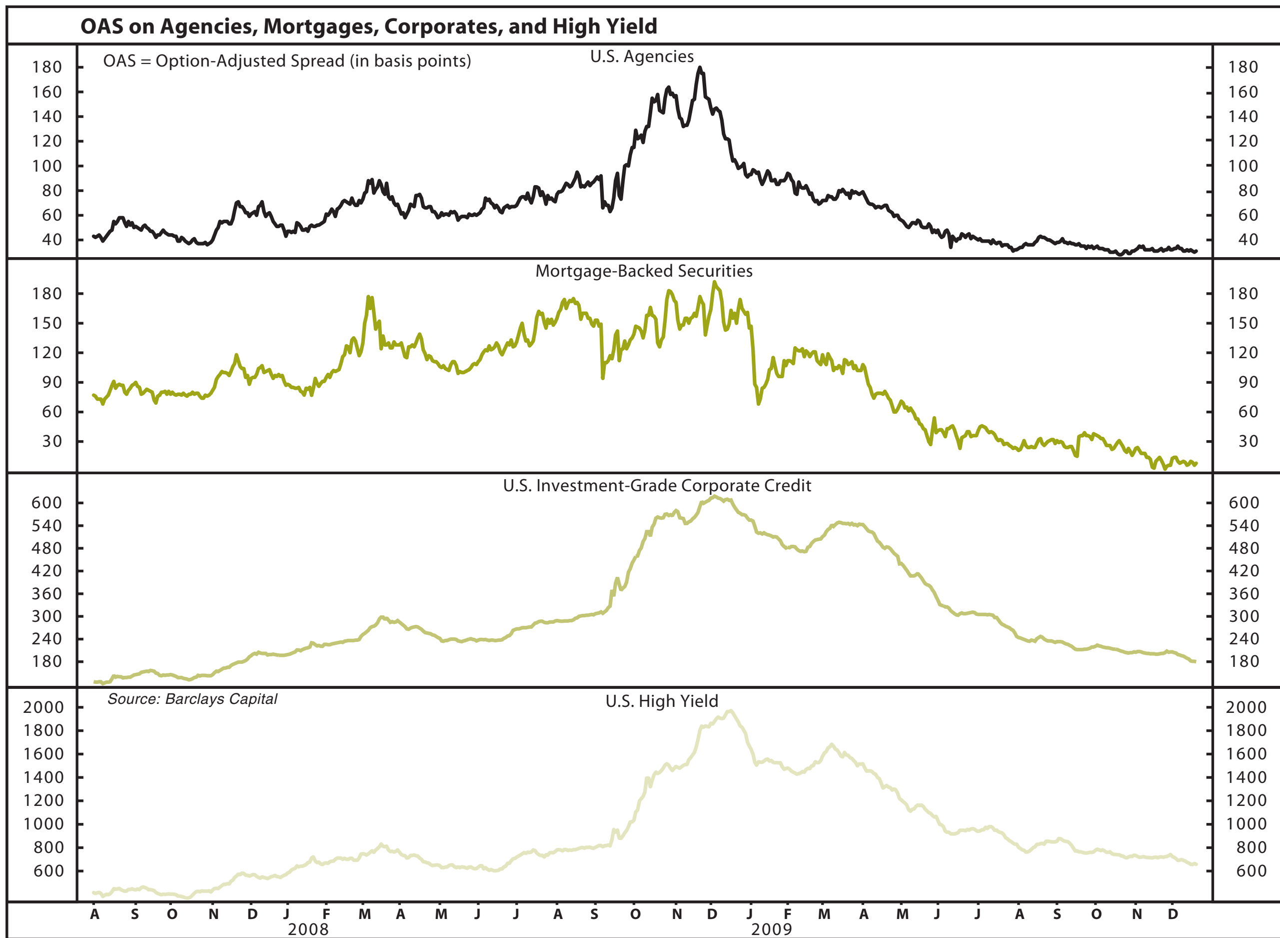
Early 2010 should see US large cap stocks outperform small caps as credit remains limited due to continued disruption in the financial sector. Risk aversion is ticking higher as the massive rally from 2009 is losing steam. There may be a resulting tactical opportunity in large caps as they remain the flight-to safety trade, and will be the most resilient if any shocks to the markets occur. Easier access to credit markets and international customer demand will also provide large caps a relative advantage to small caps. Sector rotation should favor later stage, business-driven cyclical sectors such as Industrials, Materials, and Energy relative to early cycle, consumer spending-driven stocks.

Developed International

Performance in the international markets should not materially differ from that of the US as advantages of stronger currency trends will be mitigated by relatively

Figure 3: Improving Confidence Reversed Trends in Credit Spreads

Monthly Data 8/01/2007 – 12/18/2009 (Log Scale)



Source: Ned Davis Research Group | www.ndr.com

lower GDP growth and higher unemployment. Compared to the US, continental Europe faces a more impacted banking system and also has a number of weaker constituent economies that will dilute the performance of its stronger nations. The exception to this seesaw dynamic will be the resource-based economies, such as Canada, South Africa and Australia, which should continue to enjoy strong relative equity market performance as their emerging economy customer base keeps demand brisk.

Emerging Markets

Emerging economies will continue to be the strongest performers of the global equity markets. More and more of these economies are reliant on self generated demand and are less exposed to many of the financial issues that the developed nations are facing. Of course, the emerging markets are not completely immune to credit issues and incidences such as the Dubai debacle will become more commonplace as the global deleveraging cycle continues. We suspect that these types of occurrences will be more limited in impact and not particularly indicative of any growing structural problems in the emerging economies.

Credit Markets Review and Analysis

Aggregate credit spreads began the year at historic highs as the debt markets struggled to unlock and function again. The first quarter of 2009 saw prices in virtually all subsets of the debt markets including agencies, mortgage backed securities, investment-grade corporate, and high-yield start to rise on the expectation that the new administration would be able to resolve the credit crisis in a prompt and orderly fashion. In mid-February, credit spreads temporarily widened reflecting disappointment with the regulators' initial responses to the banking crisis. However, by early April most fears were assuaged and spreads resumed their steady decline throughout the rest of the year (Figure 3).

As 2009 came to a close, agency and investment-grade corporate bond spreads were the lowest they had been since 2007, indicating solid investor confidence in those areas of the market. High yield spreads had declined back to average and commercial mortgage-backed spreads (CMBS) remained at elevated levels. The CMBS issue is likely caused by the recognition of the near term refinancing requirements for $1.2T of commercial real estate debt and questionable access to the credit markets.

Aside from rising default rates, the key issue affecting today's credit markets is the potential for excess inflation. At its roots, inflation is caused by too much money chasing too few goods. Many investors associate this economic cycle with prior ones and are concerned that recent injections of liquidity will result in skyrocketing inflation. We believe these concerns are overstated for the near term. Our view is that inflation will remain below long term trend averaging near a two percent figure over 2010. Current capacity utilization is near 71%, which is indicative of tremendous slack in the US economy. Excess supplies in the labor and real estate sectors, combined with structural deleveraging will also keep the CPI contained. We do expect to see fuel, utility and commodity prices rise as a result of the macro demand trends, but their contribution to aggregate domestic inflation will be minimal at best.

"...inflation will remain below long term trend averaging near a two percent figure over 2010."

Credit Markets Outlook

The coming year will exhibit less volatility in the credit markets. Higher yields across the government curve will result from Fed and other central bank activities as well as from investors moving toward more attractively-priced areas in the credit markets. Traditionally, falling unemployment and rising commodities prices have indicated a time to lower government bond exposure and we expect this scenario to play out again. The Federal Reserve will slowly start to soak up excess liquidity in the financial system by shrinking its balance sheet and phasing out its numerous special credit facilities long before it considers raising short term interest rates.

Treasuries

The outlook for US Treasury prices is still bearish as they remain overvalued (Figure 4). Benchmark ten-year yields rose nearly 70% in 2009 as fear subsided in the capital markets. Investors holding longer-term maturities bore the brunt of the price decline as the Treasury yield curve steepened dramatically throughout the year. 2010 will bring higher yields from two to thirty year instruments and corresponding price declines to those holding government bonds. If the Fed does decide to let its funds rate rise, a flattening of the yield curve is the most likely outcome and investors holding intermediate maturities will be the least impacted.

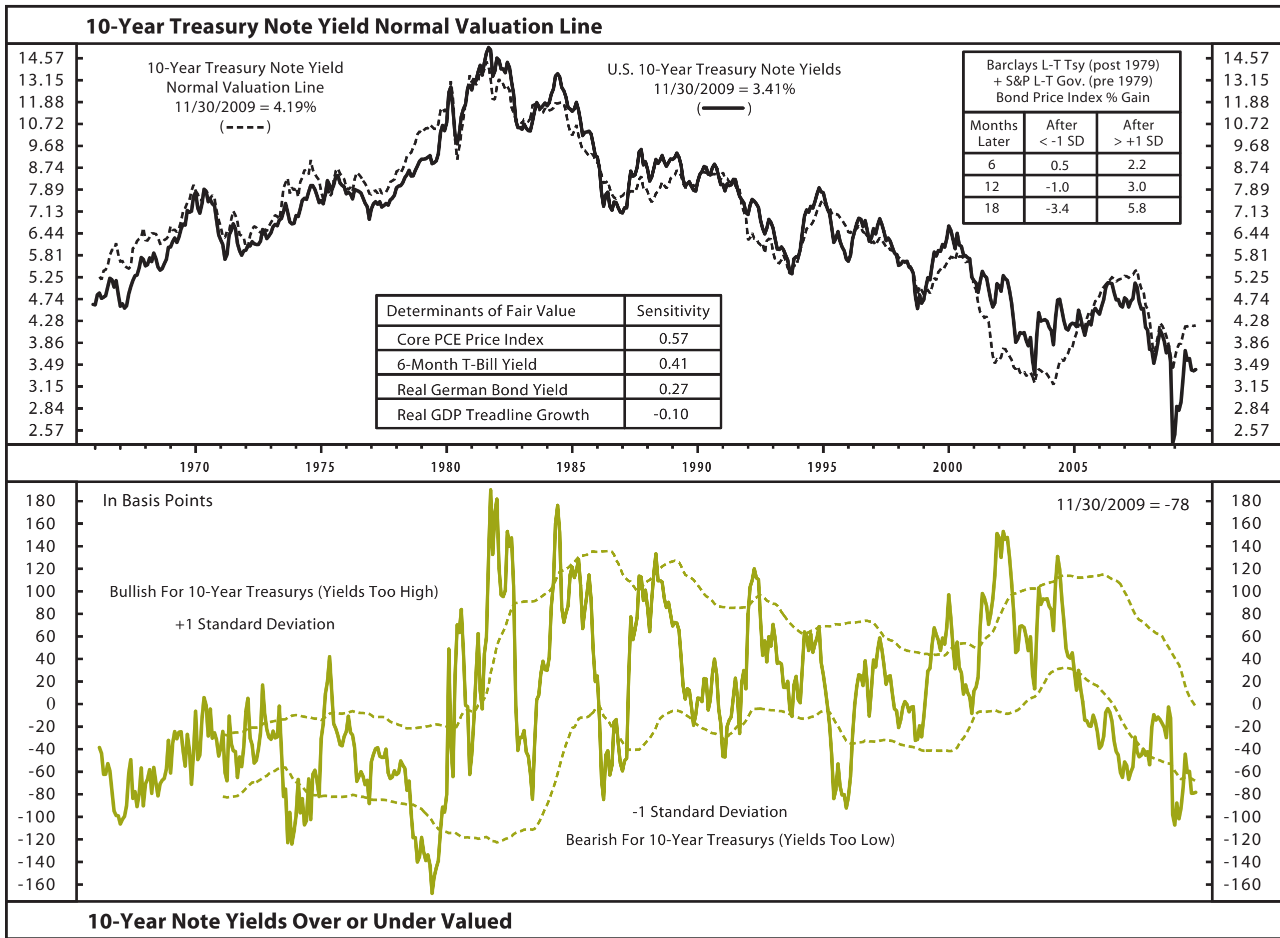
Corporate

In 2009, BAA corporate bond spreads declined by over 50% as investors realized that the debt issued by most non-financial companies was relatively immune to the tumult in the banking and real estate sectors. Stronger-than-expected earnings growth, higher free cash flow and lower amounts of debt on corporate balance sheets are now fostering a wave of ratings upgrades, which should continue to push corporate debt prices higher. Though selectivity is warranted, investment grade corporate bonds represent an attractive play during this part of the recovery cycle and will likely reward investors in the coming year.

Municipal

The State of California's finances remains a top concern amongst investors and analysts alike. Significant structural budget imbalances continue to challenge the California municipal bond market, but opportunities remain in this space. We expect a fair amount of volatility as the state works to correct its budget issues in 2010, but believe the New Year will present opportunities to buy California paper at more attractive prices. While often discussed, the probabilities for default on state debt are extremely remote: California boasts one of the largest economies in the world and has a large and diverse economic base to support its operations. Furthermore, bondholders are protected by state constitutional requirements which place debt service

Figure 4: Bearish Outlook for Treasury Prices
Monthly Data 12/31/1965 – 11/30/2009 (Log Scale)



Source: Ned Davis Research Group | www.ndr.com

obligations of the state second only to primary and secondary education expenses. The prospect of higher marginal tax rates should enhance the value of the tax-free income streams afforded to tax-sensitive investors.

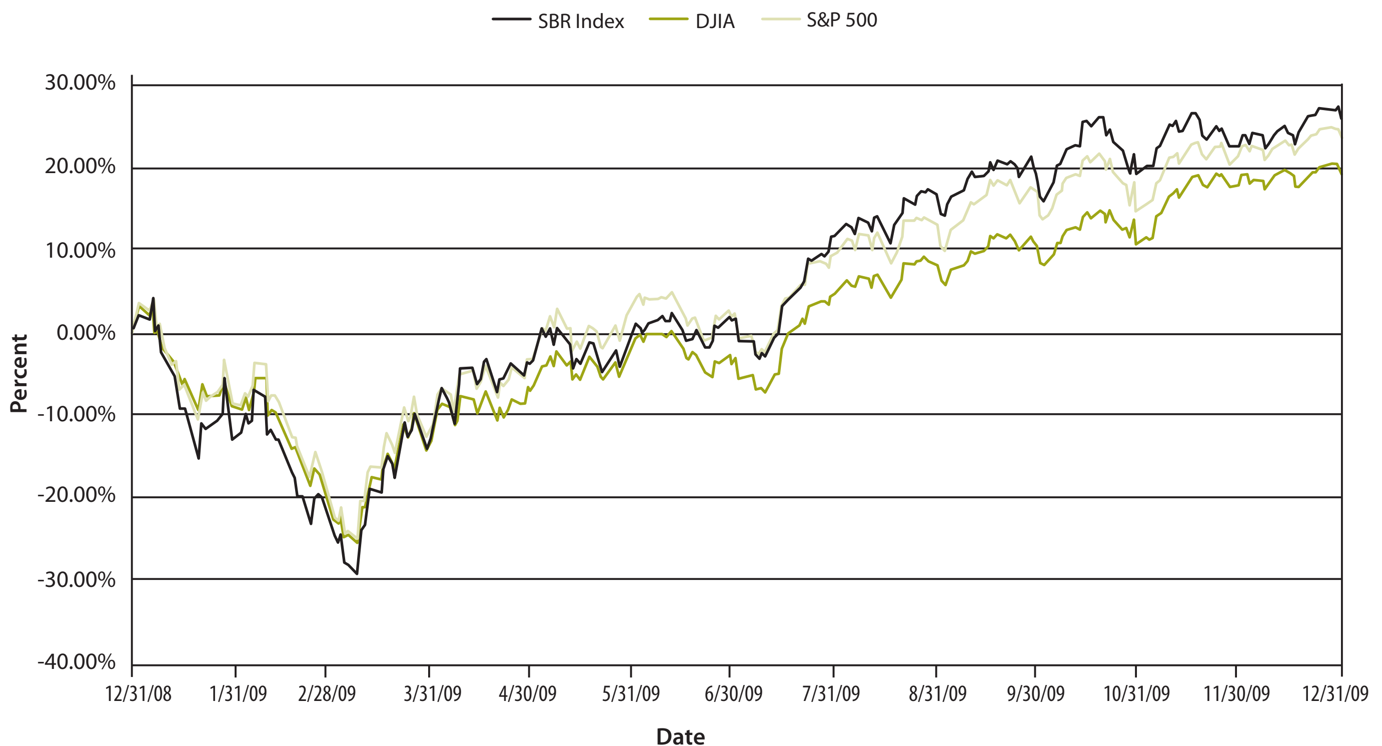
High Yield

The high yield to investment grade spread improved by nearly 70% as record yields reverted back toward longer-term averages. Volatility should be particularly notable in this space as the dynamics of an improving economic backdrop compete with rising default rates and global deleveraging, but the net effect should only be a marginal difference between 2010 year-end spreads from current levels.

> *"Global fixed income markets will exhibit pronounced differences in the New Year."*

Global

Global fixed income markets will exhibit pronounced differences in the New Year. Interest rate differentials will start to widen for commodity-producing nations and certain emerging economies as their need to contain inflation will drive them to raise rates faster than most other nations in the developed world. Weaker economies will be saddled with higher costs of funding as credit downgrades similar to the ones that affected Greece contribute to further disruption in the sovereign bond markets. Divergent views on economic policy will also lead the European Central Bank to alter its interest rate strategy and hike rates sooner than the US.



SBR Index: Recent Performance and Outlook

Despite a difficult start, the DJIA and the S&P 500 respectively gained 18.8% and 23.5% for the year. The SBR Index gained 25.7%, outperforming the DJIA by 6.9% and the S&P 500 by 2.2%.

The employment-weighted SBR Index is heavily influenced by the Technology, Consumer Discretionary and Financial sectors – sectors that have significantly outperformed the broad markets since the turn in March. In fact, the SBR Index has gained 77.8% from its lowest level on March 9th, comparing to the 59.3% gain for the DJIA and 64.8% for the S&P 500 (Figure 5).

The SBR Index continues to have a wide range of returns amongst its twenty constituents. New leaders and laggards of the index companies have emerged and 2009 returns range from +340% to -20%.

Outlook for Index Performance

As the SBR Index is largely dependent on the Technology, Financial and Consumer Discretionary sectors (Table 1), the outlook for 2010 is mixed. The Technology sector should continue to outperform the broad market for the first half of the year as business spending continues to strengthen. However relative strength in the Financial sector is weakening as many banks continue work through challenged loan portfolios. Also the Consumer Discretionary sector will face some headwinds as elevated unemployment and fashionable frugality curb consumer spending. With these competing dynamics in mind, our view is that the SBR Index will not significantly differ from the broader markets in 2010.

Sources:

Barron's, Bloomberg, CB Richard Ellis Investors, Franklin Templeton Investments, Goldman Sachs, International Monetary Fund, International Strategy and Investment, Ned Davis Research, Wells Fargo Private Bank, Wall Street Journal, Yahoo! Finance.

All charts reproduced with permission from Ned Davis Research.

Table 1: SBR Index Constituents and Weightings

No	Company	Symbol	Local Employment*	Revenue * ($ millions)	YTD Return ** (%)	Economic Sector	% of Index
Panel A: Incorporated Locally							
1	GenCorp Inc.	GY	1,587	754	90.2	Industrials	4.5%
2	The McClatchy Co	MNI	800	1,550	342.5	Consumer Discretionary	2.2%
3	SureWest Corp.	SURW	703	240	-12.8	Telecommunication Services	2.0%
4	Volcano Corp.	VOLC	490	206	15.9	Health Care	1.4%
5	Solar Power, Inc.	SOPW	290	50	161.7	Technology	0.8%
6	Waste Connections	WCN	284	1,140	5.6	Industrials	0.8%
7	American River Bank	AMRB	123	20	-19.5	Financials	0.3%
8	Pacific Ethanol	PEIX	95	389	61.4	Energy	0.3%
9	Unify Corp	UNFY	89	21	0.0	Information Technology	0.3%
10	ThermoGenesis Corp.	KOOL	87	20	34.9	Health Care	0.2%
Panel B: Incorporated Elsewhere							
11	Intel Corp	INTC	6,000	32,780	43.9	Information Technology	16.9%
12	AT&T California	T	5,389	123,240	4.7	Telecommunication Services	15.1%
13	Hewlett-Packard	HPQ	4,143	114,550	43.2	Information Technology	11.6%
14	Wells Fargo & Co	WFC	3,690	51,310	-6.2	Financials	10.4%
15	Target	TGT	3,482	64,740	42.5	Consumer Discretionary	9.8%
16	Safeway	SWY	2,469	41,970	-8.7	Consumer Staples	6.9%
17	Pacific Gas & Electric	PCG	2,169	13,500	20.2	Utilities	6.1%
18	Union Pacific Railroad	UNP	1,400	14,680	36.5	Industrials	3.9%
19	DST Output	DST	1,300	2,230	14.7	Information Technology	3.7%
20	Franklin Templeton	BEN	1,000	4,190	67.0	Financials	2.8%

** Employment data from Sacramento Business Journal Book of Lists 2009 and other estimates*
*** 12 month trailing revenue*
**** Returns through 12/31/09*

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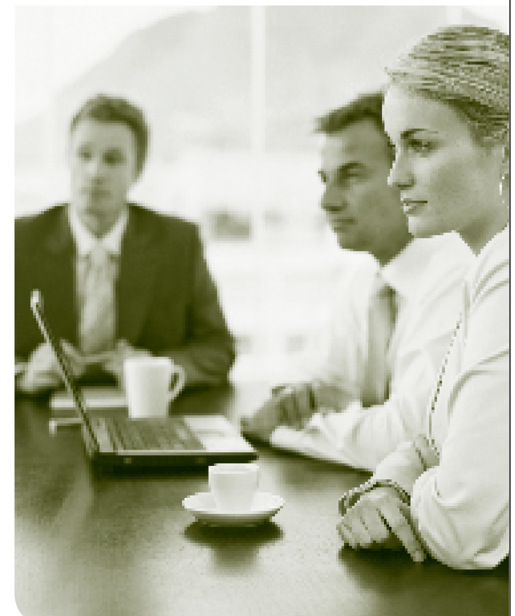

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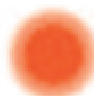

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