January 2013

sacramento BUSINESS REVIEW

Volume 5 Issue 1 | www.cba.csus.edu

Emerging Trends in Sacramento's Economy

Your Best Guide to Sacramento's Economy

2013 Economic Forecast

CFA Society Sacramento

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JANUARY
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Message from the Dean

Dear Friends,

I am pleased to share the ninth edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For more than four years, our team has accurately forecasted the economic and business climate and has provided thoughtful predictions. With 14 of Sacramento's very best financial analysts and researchers combining their skills and talent, the *Sacramento Business Review* (SBR) has become the most credible source of independent thinking, insights, and research not found elsewhere in the region.

I am delighted by your overwhelmingly positive response, as you have embraced the publication and have used it as your regional guide. Last year, we made countless presentations of our work in the community, and I received hundreds of emails and phone calls complimenting the great work. I want you to know that none of the analysts who produce the SBR forecast receive any monetary benefit or compensation; they do this work entirely as a public service to the region.

For 2012, we predicted that the regional unemployment rate would drop to the 10-11.5% range with improving prospects for spending and job growth, the real estate market would be healthier today than a year ago, many of the banks would find it more difficult to improve their bottom line, our **Small Business Confidence Index** would show greater optimism with credit conditions improving, and policy, not investment fundamentals, would determine the course of the markets in 2012. Overall, we were more optimistic about 2012. **We were right.**

For 2013, we are much more optimistic that real estate markets will see recovery, unemployment will decrease to a high single digit, local banks will continue to improve their financial health, the local government sector will stabilize, and equities will remain the favored asset class with lower systematic risk. However, the region still faces headwinds with unemployment higher than the national average, banks struggling with load demand to increase their top line revenue, and small businesses facing tough choices in the face of the fiscal cliff and Affordable Care Act implications. Overall, 2013 promises to bring better news and a stronger economy; and both consumers and businesses share this optimism.

We are committed to delivering 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. To download your free copy, please visit **www.sacbusinessreview.com.**

Warm regards,

Sanjay Varshney

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Contents 2013 Economic Forecast

- We expect the unemployment rate to fluctuate between 9.0% and 10.5%, as positive overall job growth is partially offset by an improvement in the labor participation rate.
- Our updated sector-by-sector outlook for the local labor market calls for a rebound in job growth in construction and financials in 2013.
- We are optimistic that government spending may at least be stabilizing, if not marginally increasing this year.
- Consumer spending is expected to grow but still faces headwinds, especially in the first half of 2013, including a series of mini-cliffs and payroll tax increases.

- Owners continued to contend with an improving but still challenging leasing environment across all commercial asset classes, but especially in the office category, where vacancies proved to be both vexing and chronic.
- Capital in general and institutional capital in particular was still generally ambivalent about deploying funds to the Sacramento region for commercial properties despite the higher capitalization rates being offered relative to other parts of California, although this is changing.
- The multi-housing market remained healthy and experienced a doubling of sales activity spurred by elevated interest in this lower-risk property type and an anticipated increase in the capital gains tax rate(s) in 2013.
- Sacramento's housing market turned a corner in 2012, with increases in both home prices and sales volume during the past year. A dearth of existing homes for sale has caused renewed but moderate interest in new homes, prompting some major homebuilders to buy inventory of finished lots.

- Banks in the Sacramento region[1] and those nationwide may continue to face challenges increasing their top-line net interest income unless borrowing accelerates toward pre-financial crisis levels.
- While some experts are predicting more robust loan demand this year, the SBR banking team believes credit growth for local banks will remain fairly constrained. Based upon historical precedent, the team expects additional post-crisis deleveraging for at least another several years.
- Given a healthier economic backdrop, banks should be able to increase their bottom-line profitability in 2013 by further reducing loan loss provisions. However, looking longer-term, there is only so much juice that can be squeezed from this lemon.
- Despite the fact that merger-and-acquisition (M&A) activity has failed to materialize locally, we still think M&A is inevitable considering the industry's structural growth obstacles.

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

- Small businesses will face tough choices due to changes in tax and health care laws.
- The Small Business Confidence Index shows very high optimism for 2013.
- In spite of challenges, the expectations of Small and medium-sized enterprises (SMEs) for the near-term economic outlook and local supportiveness surge across all different sectors for the first time since January 2011.
- Small Business Administration lending activity declines 25% for regional firms – a sign of continued tight credit.
- The manufacturing sector in the region turns sharply optimistic.

- The capital markets are still subject to elevated policy error risk amid persistent deleveraging.
- However, systemic risk is much lower than last year.
- Equities remain our favored asset class – international stocks are now more attractive than domestic.
- The yield curve looks set to steepen considerably this year.
- The SBR Index shows strong improvement in regional economic health.

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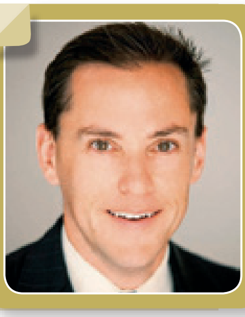

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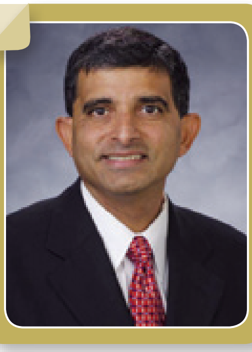

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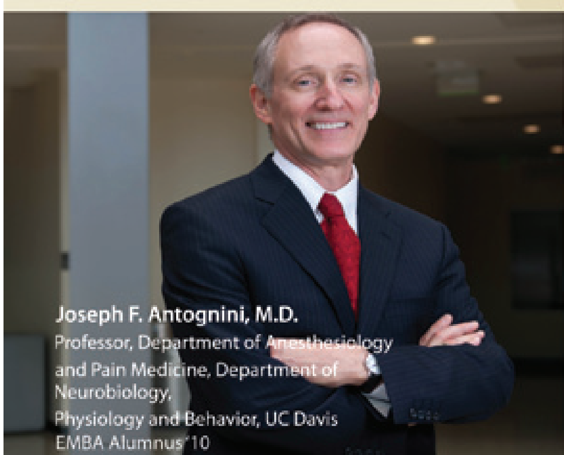

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Professor, Department of Anesthesiology and Pain Medicine, Department of Neurobiology, Physiology and Behavior, UC Davis
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Sacramento's Labor Market & Regional Economy: *2013 Outlook*

Key Points

- We expect the unemployment rate to fluctuate between 9.0% and 10.5%, as positive overall job growth is partially offset by an improvement in the labor participation rate.
- Our updated sector-by-sector outlook for the local labor market calls for a rebound in job growth in construction and financials in 2013.
- We are optimistic that government spending may at least be stabilizing, if not marginally increasing this year.
- Consumer spending is expected to grow but still faces headwinds, especially in the first half of 2013, including a series of mini-cliffs and payroll tax increases.

> *"More than two years into the local recovery, the Sacramento economic outlook continues to improve, albeit at a moderate pace, as expected."*

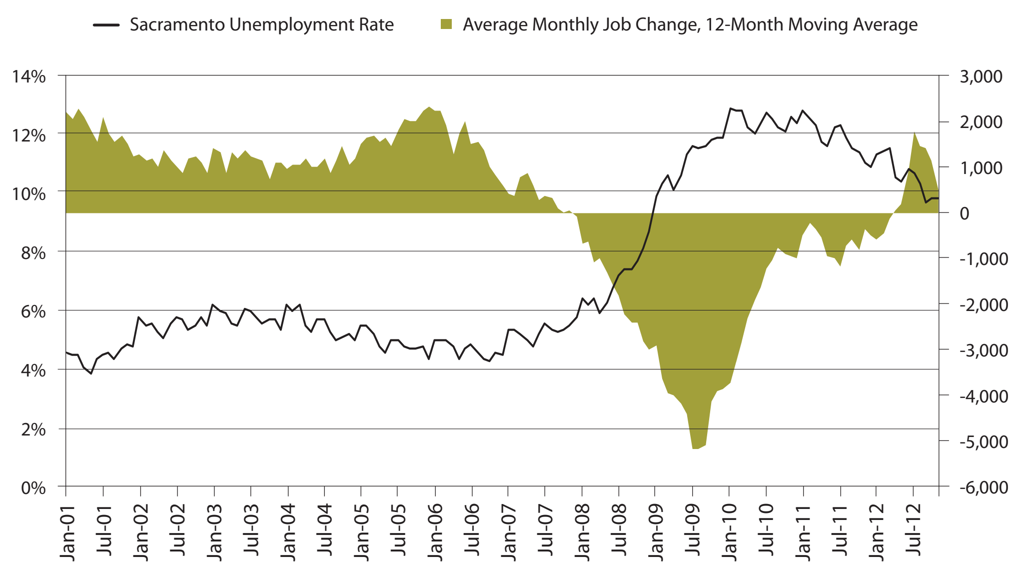
Our 2013 outlook for the Sacramento region's labor market and economy is incrementally more positive than last year, as the economic recovery continues to progress at a moderate pace. We are still far from pre-recession levels by most metrics; but, for 2013, we expect at least some positive growth across every sector – including construction, financials and government – three of the hardest hit parts of the economy. While consumers and businesses must continue to deal with a high level of uncertainty, including upcoming negotiations in Washington, we believe the near-term risk of another recession is low. Conversely, we see an increasing likelihood of a positive feedback loop in the local economy.

Sacramento Job Growth Still Sluggish as the Labor Participation Rate Declines

More than two years into the local recovery, the Sacramento economic outlook continues to improve, albeit at a moderate pace, as expected. The regional unemployment rate improved to 9.8% in the latest reading (November 2012), down from 11% a year ago (Figure 1). This compares to 9.6% for California and 7.4% for the United States (unadjusted). This drop in the local unemployment rate has come through both a gain in nonfarm payrolls and a shrinking of the labor force.

To illustrate, we point out that the region has added just 8,900 net payroll jobs since the unemployment rate peaked at 12.9% in January 2010 – this compares to the 97,000 jobs that would still need to be added before the region reaches pre-recession peak employment levels. Since that unemployment peak in January 2010, the region has also lost more than 19,000 workers from the local labor force, which helps explain the sharp drop in the unemployment rate. We believe the falling labor participation rate is due to both discouraged workers leaving the workforce and an aging population that includes baby boomers entering retirement. So, while the declining local unemployment rate does signal an improving labor market, subpar net new job creation in the Sacramento region suggests the economy is still in the early stages of recovery.

Figure 1
Despite a Falling Unemployment Rate, Broader Job Growth Remains Tepid



Data Source: California Employment Development Department

Figure 2
Most Sectors Are Still Struggling to Recover Jobs Post-Recession

Data Source: California Employment Development Department

> "Our updated sector-by-sector outlook for the local labor market calls for a rebound in job growth in Construction and Financials in 2013."

For 2013, we expect the unemployment rate to fluctuate between 9.0% and 10.5%, as positive overall job growth is partially offset by an improvement in the labor participation rate.

Not All Sectors Experiencing a Local Job Recovery

The employment growth in the region, though sluggish overall, has come largely from improved hiring in the retail and business services sectors, with continued growth in education and health care (Figure 2). Figure 2 shows the number of jobs lost or added from the month the overall local unemployment rate bottomed out (October 2006) until the month it peaked (January 2010) compared with the change in jobs since that January 2010 unemployment peak. As expected, the construction, leisure, financial and manufacturing sectors, which were some of the hardest hit by the housing bubble's collapse, have been the most challenged in recovering lost jobs after the recession, which is reflected by negligible or negative job growth since the beginning of 2010. More recently, while job growth in the second half of 2012 was largely consistent with our last sector-by-sector outlook, we were somewhat surprised by the job loss in the leisure and hospitality sector of the local economy (particularly in restaurants), especially given the gains in the retail segment.

Our updated sector-by-sector outlook for the local labor market calls for a rebound in job growth in construction and financials in 2013, stemming largely from an improvement in the housing market (Table 1). As we have stated in previous reports, the Sacramento region has historically been heavily reliant on the government and housing/construction sectors of the economy. While these were two of the hardest hit parts of the economy, the region may finally be able to expect more stable growth in these two areas this year.

Table 1
Sector-by-Sector 2013 Growth Outlook for Sacramento Labor Market

Key Sectors	% of Local Economy	Expected Average % Change Y/Y	Change vs. Last Forecast	Comments
Government	27.4%	flat to +1%	↑	Forecasts for budget surpluses and increased spending should finally lead to a more positive outlook, though any meaningful hiring may not occur until 2014.
Education & Health Care	13.2%	+2% to +3%	↓	Health care should benefit from Obama's re-election, and fundamentals remain very positive.
Business Services	12.8%	+1% to +2%	↑	Corporate spending will be muted near-term given uncertain policy outlook, but expect activity to increase once the political dust settles.
Retail	12.0%	+2% to +3%	↑	More positive outlook (especially in the second half of the year) as payroll tax hike and weak income growth are more than offset by improved balance sheets, positive wealth effects and a lower savings rate.
Leisure	9.2%	flat to +1%	–	Consumer spending growth should help offset recent weakness in restaurant job growth; improving consumer confidence and wealth effects should be positive.
Financials	5.9%	+1% to +2%	↑	Growth is accelerating from the economic recovery, and an improving housing market should be a tailwind; lending is expected to grow, albeit at a moderate pace.
Construction	4.5%	+1% to +2%	↑	Residential construction will maintain a steady pace; however, hiring will be constrained by high vacancy rates in commercial real estate.
Manufacturing	4.1%	flat to +1%	↑	Incrementally more positive outlook as mini-cliffs and uncertainty abate, and capital spending is expected to increase despite weak foreign growth.

↑ = We expect **higher** employment growth in 2013 vs. our 2012 mid-year forecast.
↓ = We expect **lower** employment growth in 2013 vs. our 2012 mid-year forecast.

Government Spending Should Finally Stabilize in 2013

The government sector, even after shrinking through spending cuts and layoffs in recent years, still accounts for nearly 28% of the local labor market. While government spending stayed largely intact during the early days of the economic slowdown, the eventual sharp tax revenue decline and fiscal shortfall made spending cuts inevitable, leading the government sector to shed the most jobs of all the major sectors post-recession (Figure 2).

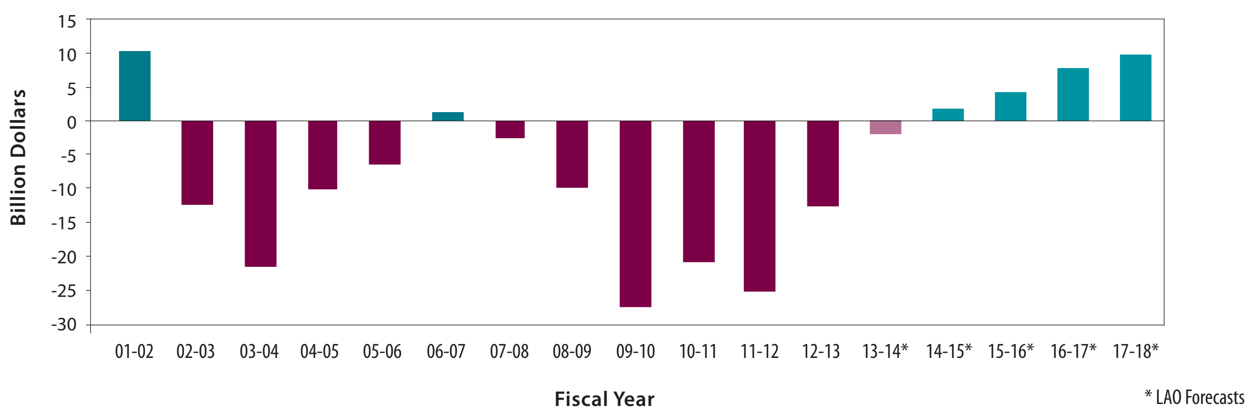
As 2013 begins, we are optimistic that government spending may at least be stabilizing, if not marginally increasing. With California's economic recovery under way, prior budget cuts, and the temporary taxes created by Proposition 30, the state may finally be on the verge of not only a smaller budget shortfall this year but also potential surpluses during the next several years (see Figure 3). This would be a dramatic shift from the fiscal woes of the past decade and would relieve the pressure for more waves of spending cuts, similar to those in recent years. In addition, we believe local city and county government budgets may begin to improve this year with higher assessed property values and tax receipts. While we believe this is all incrementally positive for the region, we caution against high expectations for 2013. As we have stated earlier, the economic recovery is progressing slowly and remains relatively fragile. Even higher tax revenues will take their time to materialize and work their way through the system to job growth.

"As 2013 begins, we are optimistic that government spending may at least be stabilizing, if not marginally increasing."

Consumer Spending and Housing Will Help Lift the Economy

The consumer is coming out of 2012 stronger than he went into the year. This has largely been driven by the housing market as prices have bounced off lows to increase 14% year-over-year (Y-o-Y) in the Sacramento region in September 2012, according to the Freddie Mac House Price Index. This bottoming in housing prices has helped consumer

Figure 3
California Budget Balances Since 2001



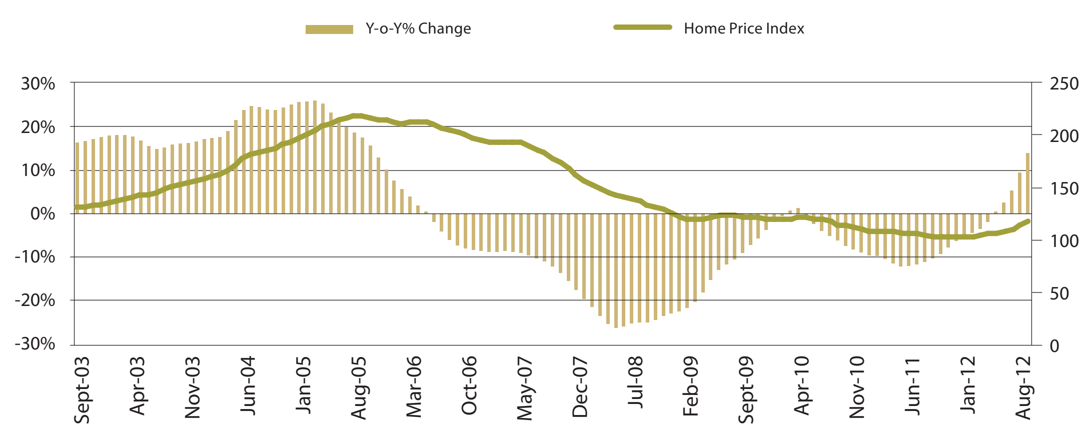
Data Source: California Legislative Analyst's Office confidence rebound from near all-time lows in 2011; and, in combination with waning negative wealth effects, the consumer has felt more confident to increase spending – reflected in domestic auto sales, which have climbed to near pre-crisis levels. We expect the consumer overall to continue to increase spending in 2013 as the economic outlook and balance sheets improve. That said, there are still headwinds facing the consumer, especially in the first half of 2013 – including the impact of the fiscal cliff or what is now a series of mini-cliffs. Near-term partisan bickering over the debt ceiling and the approaching sequester cuts are likely to leave plenty of uncertainty in spending. In addition, with the expiration of the payroll tax holiday, consumers are finding their paychecks to be slightly smaller in 2013.

Despite the recent rise in housing prices, we still have yet to see meaningful employment growth in the construction sector, apart from seasonal swings. With household formation increasing for the first time since the financial crisis and a dwindling supply of homes on the market, we expect new home construction to continue at a steady pace once the seasonal effects fade in the beginning of the second quarter. On the commercial side, Sacramento vacancy rates in office and retail are off their highs; however, they still sit at 20% and 12%, respectively, according to REIS, Inc. We expect the increase in residential construction to boost job growth in the sector, though the large supply of available commercial real estate will limit the upside potential in 2013.

In last year's forecast, we also discussed the impacts of uncertainty on the economy. Unfortunately, as another year has passed, uncertainty is still playing a major role in the economic recovery process. The headwinds of uncertainty facing businesses are similar to those facing the consumer. The recent fiscal cliff "resolutions" did provide some clarity in regards to taxes; however, the upcoming debt ceiling debate and the negotiations around the sequester spending cuts will likely keep business spending restrained in the first half of the year. While we believe this time around the negative impact from the debt ceiling negotiations will be less severe than before, we are reminded that the 2011 debt ceiling debate brought the economy to a crawl. With the assumption that agreements will be reached in Washington that will extend the perceived fiscal stability further than just a couple of months, we expect corporate and consumer spending to increase in the second half of 2013.

SOURCES: Sacramento Metropolitan Statistical Area monthly employment data published by the California Employment Development Department, U.S. Bureau of Labor Statistics, Federal Reserve, Barclays Capital, Bank of America Merrill Lynch, and JP Morgan. As of our publishing date, the most recent monthly unemployment rate reading for Sacramento was for November 2012. The Sacramento-Arden Arcade-Roseville Metropolitan Statistical Area (MSA) is made up of the counties of Sacramento, El Dorado, Yolo, and Placer. Since our analysis explicitly accounts for seasonality throughout the year, the employment figures in this article are "unadjusted" figures.

Figure 4
Sacramento Home Prices Rising



Source: Freddie Mac Home Price Index for Sacramento MSA

Real Estate Trends *in the* Sacramento Region

Key Points

- **Owners continued to contend with an improving but still challenging leasing environment across all commercial asset classes, but especially in the office category, where vacancies proved to be both vexing and chronic.**
- **Capital in general and institutional capital in particular was still generally ambivalent about deploying funds to the Sacramento region for commercial properties despite the higher capitalization rates being offered relative to other parts of California, although this is changing.**
- **The multi-housing market remained healthy and experienced a doubling of sales activity spurred by elevated interest in this lower-risk property type and an anticipated increase in the capital gains tax rate(s) in 2013.**
- **Sacramento's housing market turned a corner in 2012, with increases in both home prices and sales volume during the past year. A dearth of existing homes for sale has caused renewed but moderate interest in new homes, prompting some major homebuilders to buy inventory of finished lots.**

As anticipated, the real estate markets in Sacramento are healthier than a year ago with varying paces of improvement experienced across property sectors. Businesses moved into more space than they vacated in 2012; and vacancy rates for office, retail, and industrial properties have dropped, albeit slightly, compared to a year ago. The residential market also showed measured signs of improvement, officially marking the end of a six-year downturn. Despite these positive occurrences, however, every sector will remain in recovery mode for some time (the office sector for several years) with the exception of the multi-housing market, which we expect to cross into the expansion phase of the real estate cycle within the next 12-18 months – defined as exceeding the prior peak in revenue achievement.

"2012 marked another year of improvement overall with more than a half million square feet of positive absorption and the average vacancy down to 11.3% from a high of 15% in 2010."

Office

- Statistically, 2012 was the best year since the start of the downturn but we cannot yet say a meaningful recovery is under way in this sector.
- With four consecutive quarters of positive net absorption for the first time since 2007, vacancy fell modestly to 23% (still critically high) while rental rates continued to fall, particularly at lower-end properties.
- The majority of leasing activity occurred in higher-quality buildings within core submarkets (Downtown, Highway 50, Folsom, and Roseville), which continued to attract tenants taking advantage of historically low rents and the opportunity to upgrade and optimize their workplaces.
- The most notable new leases in 2012 were signed by health care providers: Sutter Health leased 295,000 square feet at the former HP facility in South Placer County in addition to 100,000 square feet at Mather Business Park along the Highway 50 corridor. Dignity Health also leased a 100,000 square foot call center along Highway 50. The state of California contributed little new leasing activity.
- While no speculative construction occurred in 2012, one significant build-to-suit project in Elk Grove was completed – a 275,000 square foot building for the California Prison Health Care Services.

2013 Outlook: Expect something similar to 2012 with a continued lack of energy. The market moves slowly at this point in the cycle with improvement evident only after looking back several months. We will see more flight to quality by tenants, and leasing activity caused by positive economic growth will still represent a minority. Real-estate-related companies (title, mortgage, etc.) may become an active market segment again, and there is hope that a much more vibrant office market in the Bay Area will cause companies to begin to explore our region, though it is unlikely to provide an impact in 2013.

Retail

- 2012 marked another year of improvement overall with more than a half million square feet of positive absorption and the average vacancy down to 11.3% from a high of 15% in 2010.
- Leasing activity was strong at Class A centers, causing rental rates at some properties to increase as they approach full occupancy. This has also spurred increased activity at Class B centers, though rents remain flat in this segment. Class C centers had little draw for new tenant activity regardless of rental rates.
- National tenants were active in 2012 with several expanding into our region, including Hobby Lobby, Total Wine and More, and Walmart Neighborhood Grocery. Local tenant activity, while still quiet, showed a slight improvement over 2011. Mom and pop retailers remained cautious, with limited access to capital.
- Relocating was a continued theme as some national tenants upgraded their locations to sites that normally would not be available to them. Examples of 2012 relocations include Bed Bath & Beyond, Ulta, and Old Navy.
- Sacramento experienced a decrease in store closures throughout the region as the economic downturn already "weeded out" the least successful operators in prior years.

2013 Outlook: Retail will continue its recovery with marked improvement in shop leasing, especially in shopping centers that have recently backfilled their anchor spaces. The stabilization of rents will continue and become incrementally more widespread. The average vacancy rate will continue to drop, possibly reaching single digits by year's end. Look for announcements of some new projects, whether they are redevelopments or ground up, as some developers will come off the sidelines to position themselves for the future.

Industrial

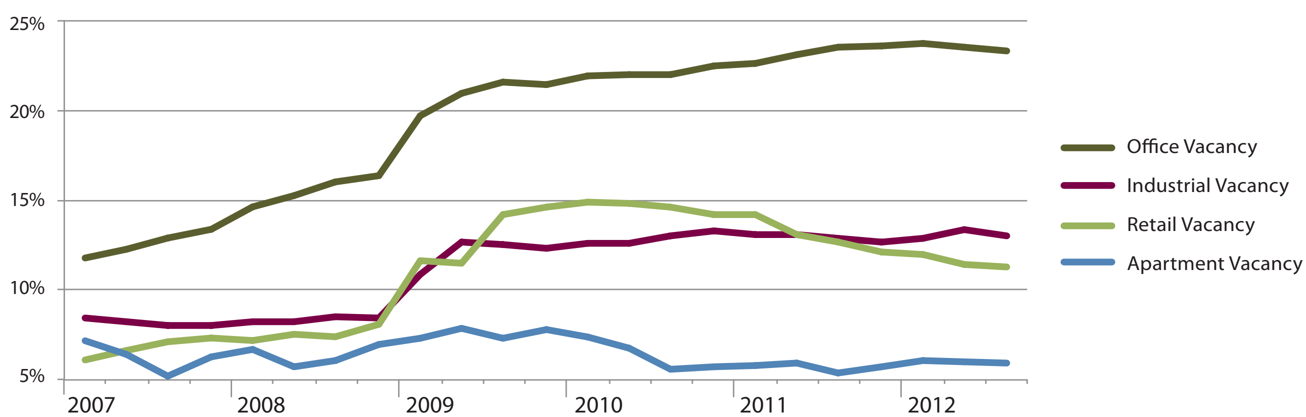
- After incurring big losses early in 2012, the market ended the year with more than half a million square feet of positive absorption and the vacancy rate down slightly from a year ago.
- Rental rates have largely stabilized while the level of concessions has generally decreased, together causing effective rents to trend modestly upward. Owners of newer buildings with modern amenities, particularly those with larger footprints (75,000 – 200,000 square feet) received more tenant interest and experienced greater increases in effective rents.
- Although the volume of distressed asset sales – most of which are former owner-user properties – has diminished, they still represent a drag on the market.
- Owner-user activity increased in 2012 as cyclically low pricing and historically low interest rates have in many cases made owning more advantageous than leasing again.
- New construction was limited to tenant-driven facilities including Mori Seki (200,000 square feet) in Woodland, and Saladino's (131,211 square feet) and Nippon Shokken (70,000 square feet) in West Sacramento.

2013 Outlook: The Industrial market will continue to become healthier, although measured improvement in indicators such as absorption, vacancy, and effective rents will likely be choppy, much like this past year.

Investments

- Sales volume increased in 2012 compared to the prior year due to tax-deferred exchanges, acquisitions of value-added assets and purchases of stabilized properties offering better returns than were available via alternative asset classes.
- We did not see what we expected might be a meaningful spike in distressed commercial property offerings. Instead, special servicers and lenders determined that it made more sense for them to hold properties, generate fees, and hope for a market recovery. If that were to happen, it would be a win. If not, they can say they tried and can always sell the asset down the road.
- Owners continued to contend with an improving but still challenging leasing environment across all commercial asset classes, but especially in the office category, where vacancies proved to be both vexing and chronic. Many owners were obligated to triage portfolios to halt onerous cash outflows and ensure long-term personal viability.
- Capital in general and institutional capital in particular was still ambivalent about deploying funds to the Sacramento region for commercial properties despite the higher returns being offered compared with other parts of California.
- The multi-housing sector remained healthy, again distinguishing itself from the commercial sectors as the most luminescent bright spot of the overall recovery. Sales activity doubled in 2012 spurred by an elevated interest in this lower-risk property type and an anticipated increase in the capital gains tax rate(s) in 2013.

Figure 1
Sacramento MSA Vacancy Trends



Source: CBRE, Inc.

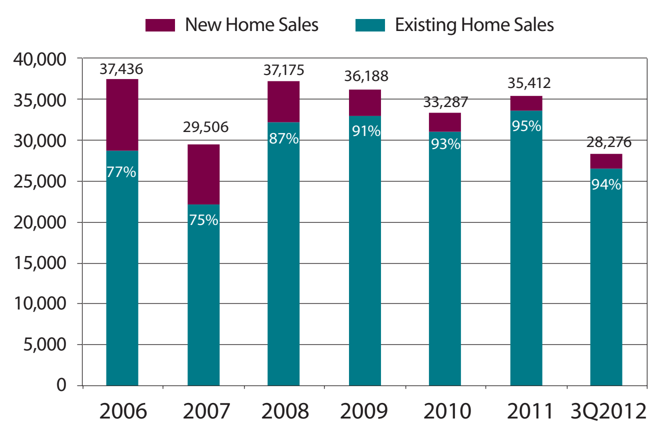
2013 Outlook: Our outlook is more guarded than we thought would be the case this far into the recovery, but look for a step up in commercial sales activity in 2013 as more buyers acknowledge a market improvement and give themselves permission to buy here. Current and prospective market conditions suggest that Sacramento will enjoy an increasingly compelling transactional environment during the next several years, which will prove attractive to the full array of local, regional, and national capital sources.

Residential

- Sacramento's housing market turned a corner in 2012, with increases in both home prices and sales volume during the past year.
- After stabilizing in the first quarter of 2011 and averaging approximately $185,000 for the next year and a half, the median home price reached $206,750 in the third quarter of 2012. While this represents an 11.2% increase year-over-year (compared to roughly a 4% increase nationally), the median sales price remains approximately 50% off the 2005 peak. Part of the price increase can be attributed to the mix of homes that sold, with proportionately more higher-priced homes having traded recently. The price per square foot in the Sacramento region increased by 6.5%, with the largest increases observed in Placer and Sacramento counties (8.4% and 6.9%, respectively).
- Existing home sales increased modestly (5%) in the first three quarters of 2012 over the same period in 2011, from 25,209 to 26,520.
- After falling to its lowest level in 20 years in 2011 (1,933), new home sales in the Sacramento region are once again on the rise, on pace to reach 2,800 in 2012. To keep perspective, this equals less than 20% of the peak levels reached in 2003-2005. Still, the increase in new home sales has prompted some major homebuilders to buy finished lots in the region again, including Taylor Morrison, Meritage Homes, and Lennar.
- After representing more than 40% of all sales in 2011, the proportion of REO (Real Estate Owned by lenders) sales fell to 22% of all home sales.

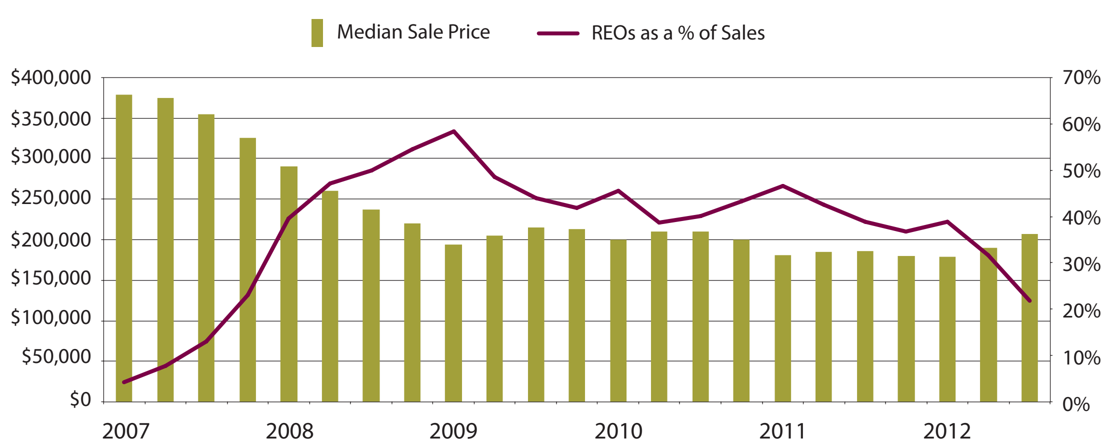
2013 Outlook: As the economy improves, demand for owner-occupied housing should continue to rise, particularly if mortgage rates remain accommodating as expected. Both home prices and sales activity should increase modestly again in 2013 barring a setback in employment growth.

Figure 3 – Residential
New Home Sales vs. Existing Home Sales | Sacramento MSA



Source: MDA DataQuick

Figure 2 – Residential
Median Sale Price (All Homes) vs. REOs as a % of Sales | Sacramento MSA



Source: MDA DataQuick

2013 Sacramento Banking Industry Forecast

Will Loan Growth Now Start to Materialize?

Key Points

- Banks in the Sacramento region[1] and those nationwide may continue to face challenges increasing their top-line net interest income unless borrowing accelerates toward pre-financial crisis levels.

- While some experts are predicting more robust loan demand this year, the SBR banking team believes credit growth for local banks will remain fairly constrained. Based upon historical precedent, the team expects additional post-crisis deleveraging for at least another several years.

- Given a healthier economic backdrop, banks should be able to increase their bottom-line profitability in 2013 by further reducing loan loss provisions. However, looking longer-term, there is only so much juice that can be squeezed from this lemon.

- Despite the fact that merger-and-acquisition (M&A) activity has failed to materialize locally, we still think M&A is inevitable considering the industry's structural growth obstacles.

> *"Heading into 2013, perhaps the biggest question facing the banking industry is whether customers will start borrowing again at a more rapid pace."*

In 2012, the SBR banking industry analysts correctly predicted that the Sacramento region banks[2] would have a difficult time substantially improving their top lines (Table 1) due to a lack of loan demand from creditworthy borrowers. Heading into 2013, perhaps the biggest question facing the banking industry is whether customers will start borrowing again at a more rapid pace.

With policy uncertainty now reduced following the November 2011 election and the year-end fiscal cliff, and with the Federal Reserve taking unprecedented measures to reduce longer-term interest rates, some experts are optimistic that Americans will again start borrowing money from banks. Should bank lending increase at a healthy pace, the thought is that the economic recovery will finally achieve "escape velocity" nearly five years after the 2008 global financial crisis.

Though hopeful that the aforementioned experts prove to be prescient, the SBR banking industry team is not so sanguine and believes that loan growth this year will remain tepid throughout the region. As a result, banks are likely to still have trouble growing their top-line net interest income substantially. While local players should again be able to improve their bottom lines due to lower loan-loss provisions (in what is now a healthier economic backdrop), there is only so much juice that can be squeezed from this lemon. Thus, the SBR banking team members expect many local bank management teams to contemplate strategic alternatives before year-end. Although M&A activity has failed to materialize as forecasted during the past two years, the SBR team is holding steadfast to this prediction.

Are Sacramentans Through Deleveraging?

As the SBR banking team has discussed in previous reports, empirical data from prior financial crises shows that borrowers typically "deleverage" (i.e., reduce their debt levels) for a period of six to seven years following the crisis. Because only four years have passed since the devastating 2008 global financial crisis, history would dictate that most Americans remain more focused on reducing debt as opposed to ramping up borrowing again.

Table 1
Net Interest Income Growth*

	2011	2012
Sacramento Region Banks	0.0%	2.3%
All Banks Nationwide	-2.3%	0.3%

** Figures represent the changes in year-to-date net interest income through Sept. 30.*

Data Source: FDIC

Despite this historical context, a number of experts have recently made the case that the post-crisis deleveraging period has largely ended. To support their case, they point to the U.S. debt service ratio, which measures the ratio of debt payments to income. Debt service coverage has fallen back to 1980 levels (Figure 1), from where the stock of debt in the United States went on to increase nearly *tenfold* during the ensuing three decades.

Analyzing the data in more detail, it quickly becomes clear that the reason for the better debt service ratios has more to do with the Federal Reserve's unprecedented policy of reducing longer-term interest rates than with borrowers substantially cutting debt levels. The stocks of consumer, mortgage, business, and finance debt as a percentage of gross domestic product (GDP) in the United States have indeed fallen from their pre-crisis highs (Figure 2). However, the debt levels are still at or well above those from a decade ago.

Since the SBR banking team believes that this deleveraging cycle will not end until the debt-to-GDP ratios fall further, the team is more inclined to side with historical precedent. Thus, we do not expect Sacramentans to notably ramp up borrowing for at least another few years.

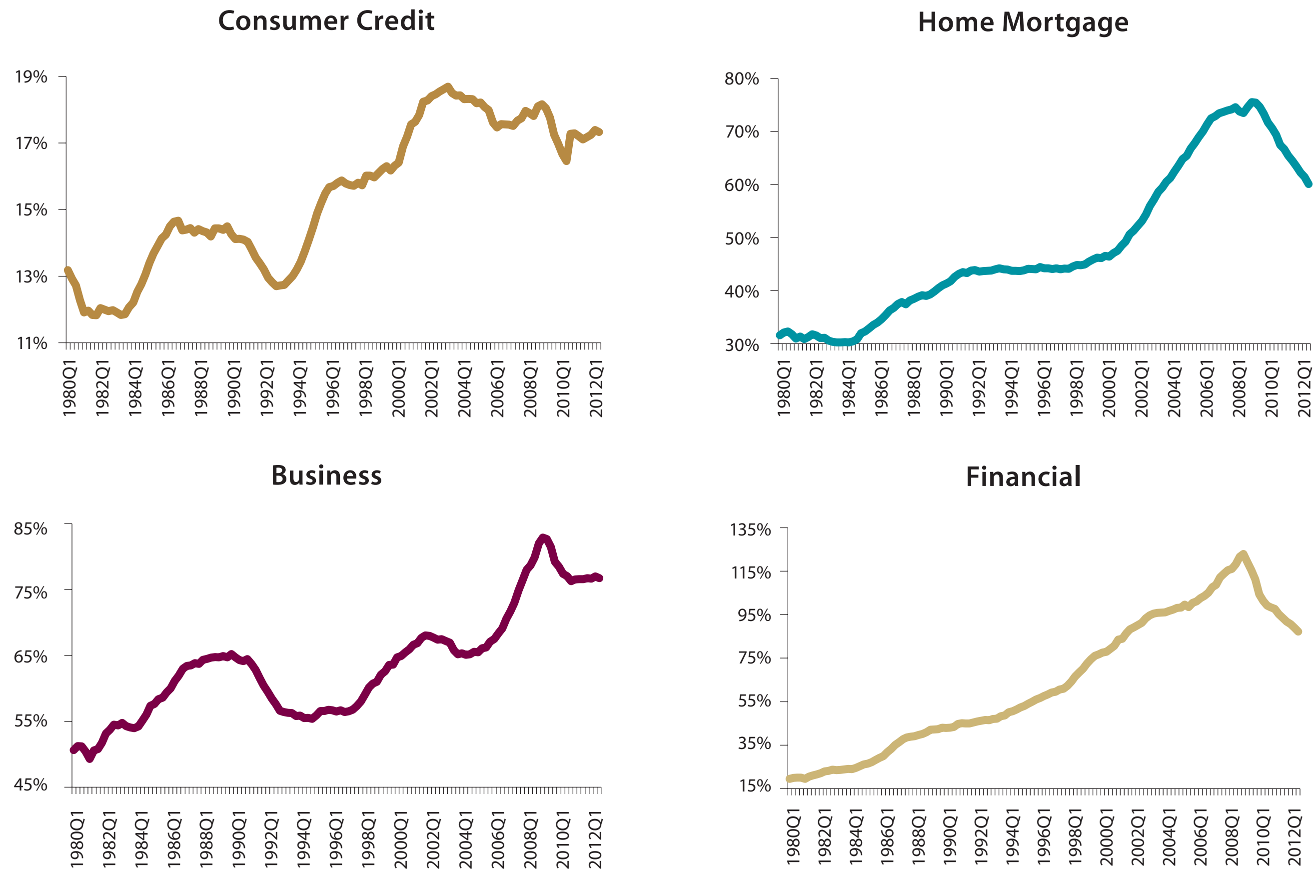
Those making the case for an increase in borrowing also point to the recent improvement in real estate prices, which would support greater loan-to-value ratios. Without question, residential and commercial real estate (CRE) prices have bounced off their lows. However, residential prices remain well below their pre-crisis highs (Figure 3). CRE prices exhibit a similar pattern. As a result, many borrowers still do not have enough equity to lever up further. The SBR team is therefore not convinced that the recent price action will spur a wave of new lending.

Analyzing the loan figures both locally and nationwide (Table 2), one can observe that the more recent real estate price recovery has yet to spur robust commercial and residential real estate loan growth. Table 2 shows how loan growth nationally has been driven largely by commercial and industrial loans, as opposed to real estate lending. Considering that real estate makes up roughly three quarters of the loan balances for the Sacramento region banks in aggregate, the SBR banking team is not expecting strong overall loan growth this year.

Figure 1
U.S. Debt Service Ratio: 1980-Present

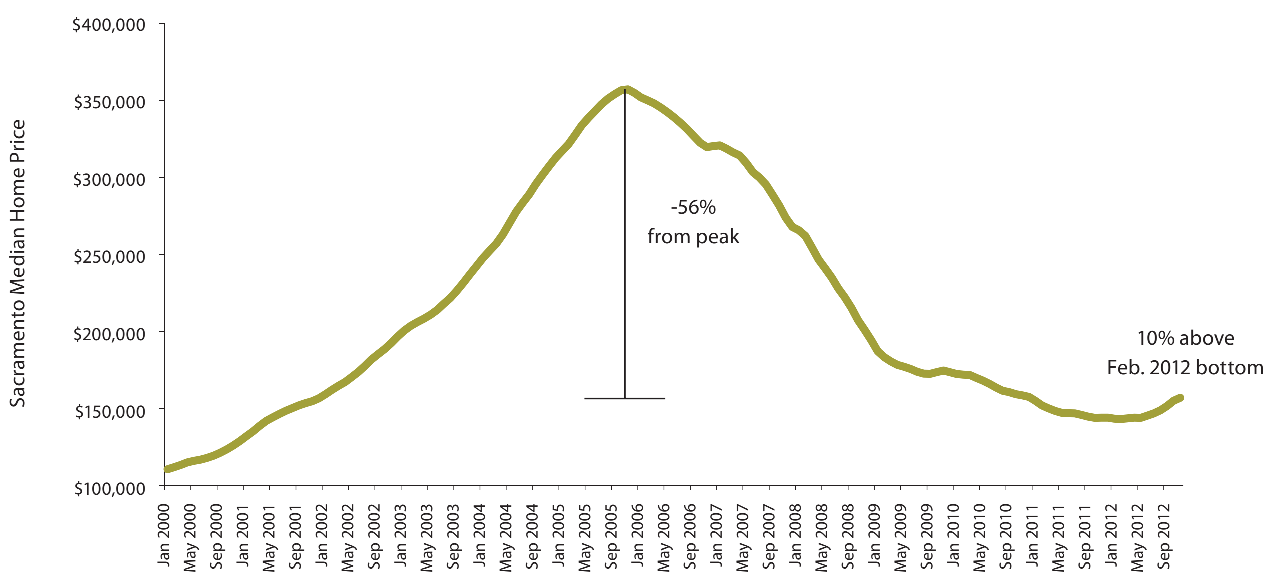
Data Source: Federal Reserve

Figure 2
Debt to GDP Levels: 1980 to Present



Data Source: Federal Reserve

Figure 3
Zillow Home Price Index for Sacramento: 2000 to Present



Data Source: Zillow

Table 2
2012 Loan Growth

	Percentage of Total Loans		Year/Year Loan Growth	
	Sacramento Region Banks	All Banks Nationwide	Sacramento Region Banks	All Banks Nationwide
Commercial Real Estate	42.1%	14.0%	2.3%	0.2%
Residential	27.1%	24.9%	2.5%	1.8%
Commercial & Industrial	11.4%	19.2%	-1.8%	13.5%
Farm Loans	4.7%	0.9%	-10.1%	9.4%
Multifamily Residential	3.6%	3.0%	10.1%	5.0%
Construction Loans	3.4%	2.8%	-6.7%	-17.4%
Loans to Individuals	0.9%	17.1%	-19.4%	0.8%
Other	6.8%	18.2%	10.6%	3.5%
Total	**100.0%**	**100.0%**	**1.4%**	**3.2%**

Data Source: FDIC

Solid Profit Growth Still Possible This Year

Despite the industry's potential top-line growth challenges, the good news is that many of the local banks should still be able to increase their bottom-line net income this year. With a healthier economic backdrop (relative to the past several years) and with most banks now more than adequately reserved for loan losses, virtually all of the Sacramento region banks will almost certainly take fewer loss provisions in 2013. Declining provisions have helped the banks increase their net profits in recent years. We expect more of the same during 2013.

Although most local banks appear to have a window in which they can generate solid profit growth due to falling loss provisions, management teams must not lose sight of the longer-term obstacles facing the industry. First, taking lower loss provisions has a finite zero-bound, and there is only so much juice that can be squeezed from this lemon. If loan growth fails to materialize soon and the tailwind from lower provisions ceases, it will be incredibly challenging to increase profits, especially since operating expenses are on the rise due to the Dodd-Frank act and other regulatory measures. It is therefore not surprising to observe announced cost-cutting measures (branch consolidation, etc.) among some local players in recent months.

Sticking With the M&A Call

For the past two years, the SBR banking team has predicted that Sacramento would begin to see an increase in M&A activity among local banks. These predictions were based upon the culmination of several factors: 1) continued difficulty generating higher loan volumes due to weak credit demand, and 2) increasing compliance costs resulting from the voluminous Dodd-Frank act.

Through the end of 2012, no M&A transactions involving the local banks have taken place. With the local banks still able to significantly increase profits via lower loan loss provisions, bank management teams may not have felt enough pressure to seriously explore strategic alternatives. Moreover, since a merger transaction entails marking to market the loans on the seller's balance sheet, some potential acquirers may have been gun-shy about certain implications of a takeover. Finally, many merger targets are trading well below book value, and management teams could feel the need to hold out until valuations improve.

Despite these conditions, the SBR banking team remains steadfast in its belief that local bank M&A activity is more a matter of when, and not if, it will occur. The most-likely M&A candidates are the smaller banks and these players may end up either merging with other banks of similar size or being purchased by mid-sized regional financial institutions.

Publicly Traded Local Bank Stock Ratings

Within the six-county Sacramento region, 13 locally based banks are publicly traded on the OTC Bulletin Board. In Table 3, 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[3] when trading shares.

Table 3
Stock Ratings for Publicly Traded Sacramento Region Banks | Dec. 31, 2012

Bank	Ticker	Stock Price	Market Cap ($ in millions)	2012 Total Return	Price / Tangible Book Value[1]	TCE Ratio[2]	NPAs[3] as a % of Total Assets	Return on Equity[4]	Bankrate.com Rating[5]
OUTPERFORM									
River City Bank	RCBC	$70.50	$87.4	15.0%	0.7x	10.9%	1.2%	8.66%	4
American River Bank	AMRB	$6.91	64.4	51.9%	0.8x	13.6%	6.3%	3.79%	4
Community Business Bank	CBBC	$6.12	13.0	40.7%	0.7x	12.8%	4.4%	9.03%	4
MARKET PERFORM									
Farmers & Merchants Bank	FMCB	$405.00	$315.0	15.9%	1.5x	11.5%	0.5%	11.76%	4
North Valley Bancorp	NOVB	$14.24	97.3	48.2%	1.0x	10.5%	3.8%	9.93%	3
First Northern Bank of Dixon	FNRN	$5.20	48.1	13.0%	0.8x	7.8%	1.8%	5.59%	4
Bank of Sacramento	GSCB	$15.90	41.4	59.0%	1.0x	9.9%	1.1%	7.03%	4
River Valley Community Bank	RVVY	$15.00	25.8	24.4%	1.3x	13.7%	0.7%	7.68%	5
Folsom Lake Bank	FOLB	$6.81	10.9	-9.2%	0.8x	10.5%	6.9%	4.00%	3
Community 1st Bank	CFBN	$3.00	16.4	50.0%	0.9x	9.4%	2.4%	3.03%	2
Sutter Community Bank	SUTB	$6.00	5.7	1.7%	0.7x	12.4%	7.0%	5.70%	4
Sierra Vista Bank	SVBA	$1.55	5.0	-6.1%	0.5x	12.5%	5.5%	-8.50%	1
UNDERPERFORM									
Tri Counties Bank	TCBK	$16.75	$267.9	20.3%	1.3x	8.1%	5.3%	7.75%	3
				Peer Group Average:	**0.9x**				

1) Price to Tangible Book Value (TBV) ratios use market prices as of Dec. 31, 2012, and TBVs as of Sept. 30, 2012. TBV is determined by substracting preferred stock and intangible assets from total equity capital.
2) The Tangible Common Equity Ratio (TCE Ratio) is calculated by taking total equity capital, net of preferred stock and intangible assets, as a percentage of tangible assets.
3) Nonperforming Assets (NPAs) used in this calculation include noncurrent loans, restructured loans, and other real estate owned.
4) Return on Equity figures are for the first nine months of 2012 and are annualized.
5) Bankrate.com ratings are as follows: 5 = superior, 4 = sound, 3 = performing, 2 = below peer group, 1 = lowest rated

Data Source: FDIC

The authors do not own shares of any of the banks listed in Table 3. The Sacramento Business Review cannot guarantee any of the forecasts made in this article.

Endnotes

1 We have defined the Sacramento region as El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties.

2 The Sacramento region banks are American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, Farmers & Merchants Bank, First Northern Bank, Five Star Bank, Folsom Lake Bank, Gold Country Bank, Merchants Bank of Sacramento, North Valley Bank, Redding Bank of Commerce, River City Bank, River Valley Community Bank, Sierra Vista Bank, Sutter Community Bank, and Tri Counties Bank.

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

The Small Business *Economy*

Key Points

- Small businesses will face tough choices due to changes in tax and health care laws.
- The Small Business Confidence Index shows very high optimism for 2013.
- In spite of challenges, the expectations of Small and medium-sized enterprises (SMEs) for the near-term economic outlook and local supportiveness surge across all different sectors for the first time since January 2011.
- Small Business Administration (SBA) lending activity declines 25% for regional firms – a sign of continued tight credit.
- The manufacturing sector in the region turns sharply optimistic.

Small Businesses Face Tough Choices From Cliff Deal

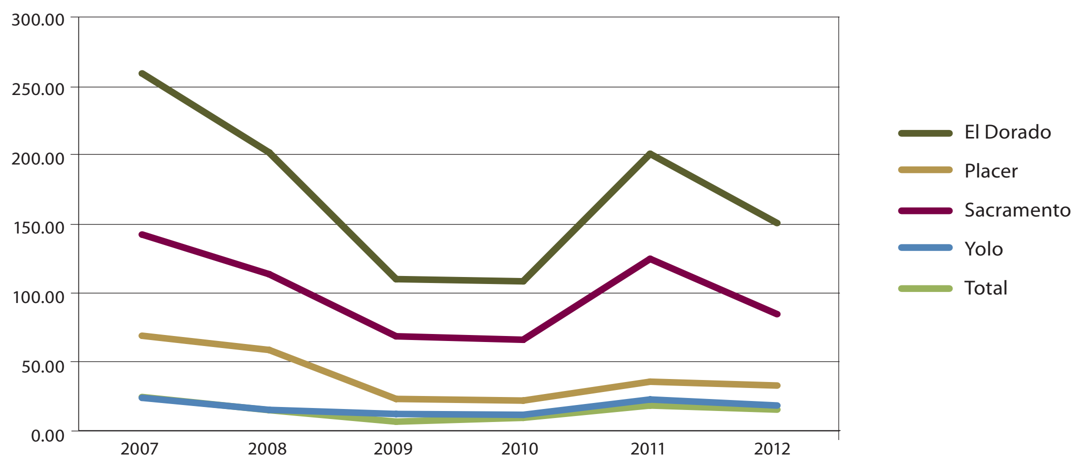
While last-minute negotiations helped avert falling off the fiscal cliff, small businesses will face some tough decisions for 2013. Many of them – organized as S corporations, partnerships, or other small entities – pay taxes on profits from the business at their personal marginal tax rates, which will now be at 39.6% for those exceeding $400,000 as single or $450,000 filing jointly (compared with 35%). This will likely have an impact on their appetite for new hires, new investments, or capital reinvestments.

Switching to the more attractive C corporation for tax purposes, incorporating or moving their headquarters to tax havens such as the Cayman Islands, or adjusting their operations to reflect the higher costs is neither easy nor inexpensive. On top of this dilemma, small businesses that have more than 50 employees will be required to comply with the provisions of the health care law requiring them to offer employees health insurance by 2014 or face penalties.

"On the bright side, in 2012 the economy grew, unemployment declined, revenues were stronger, and access to credit improved."

On the bright side, in 2012 the economy grew, unemployment declined, revenues were stronger, and access to credit improved. Alternate forms of borrowing from banks are becoming increasingly popular, allowing small businesses to reduce their reliance on traditional forms of bank financing. The JOBS Act will further loosen financing restrictions for small firms and start-ups.

Figure 1
Total Dollar Amount of SBA Loans Approved in Sacramento MSA (in Millions)



Data Source: U.S. Small Business Administration

Small Business Confidence Index Optimistic

While the fiscal cliff resolution leaves a good deal of uncertainty and difficult decision making for small business owners, the local small business community foresees much better economic times and local supportiveness for the next six months. Despite the declining SBA lending and credit accessibility, SMEs still remain optimistic regarding prospects for future business revenues and new hires. While unemployment is often a lagging indicator of the economy, we believe this optimism regarding future revenues and job growth may signal business intent to begin reinvesting once the clouds of uncertainty dissipate.

SBA Lending and Bank Credit Remain Tight

During the first eight months of 2012, the total dollar volume of SBA loans approved in the Sacramento MSA decreased by approximately 37% from the previous year. However, a steady recovery during the second half of 2012 helped end the year with only a 25% decline compared to that of 2011 (Figure 1). Banks continue to stay conservative, and lenders appear to chase a small and declining portfolio of high-quality borrowers. While the first half of 2012 has brought a sharp decline in lending activity, small businesses can take small comfort in the fact that lending levels remain 40% higher than those in 2010.

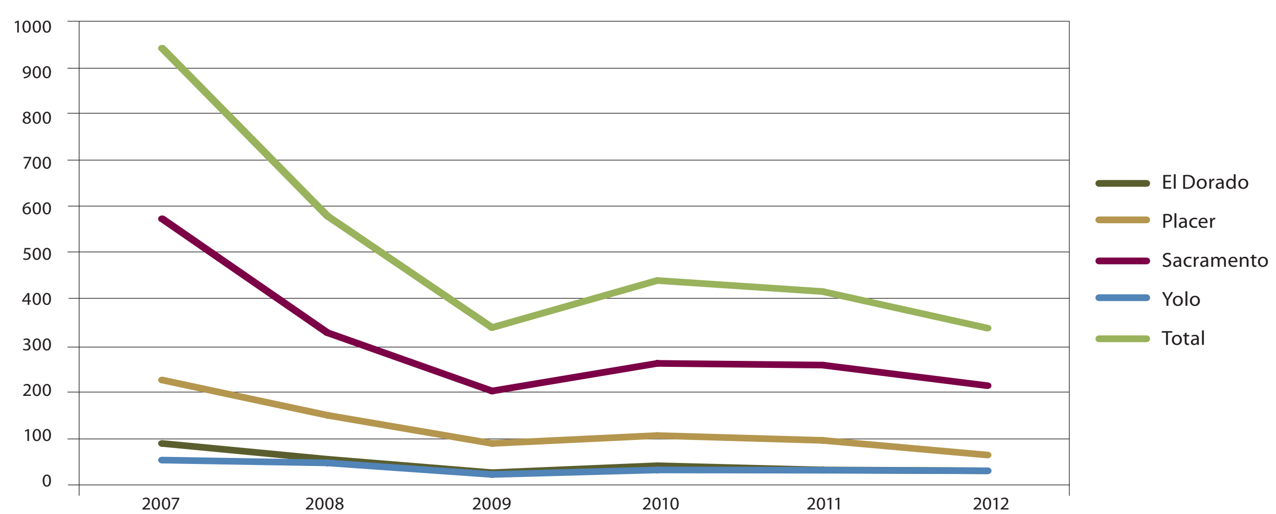
Economic Outlook Positive

In spite of challenges, SMEs' expectations of the near-term economic outlook and local supportiveness surge across all different sectors for the first time since January 2011. This restored confidence is much needed to move the economy forward. SMEs remain optimistic regarding prospects for future business revenues and new hires, especially in the manufacturing and others sectors. This continued optimism ahead signals the sustainability of the slow regional economic recovery.

Manufacturing Sector VERY Optimistic

After two continuous disappointing declines in the past year, the manufacturing sector sees an enormous jump in its optimism regarding the future economic outlook and local supportiveness. The Small Business Confidence Index surged almost 35 and 5 times, respectively. The manufacturing sector is also very optimistic on its credit accessibility, future revenue, and new hires. The others sector, which includes agriculture, health care, waste management and recycling – also shows its best improvement in all areas of expectations since our survey started.

Figure 2
Total Number of SBA Loans Approved in Sacramento MSA



Data Source: U.S. Small Business Administration

Figure 3
Small Business Confidence Index Trends: July 2011 - January 2013

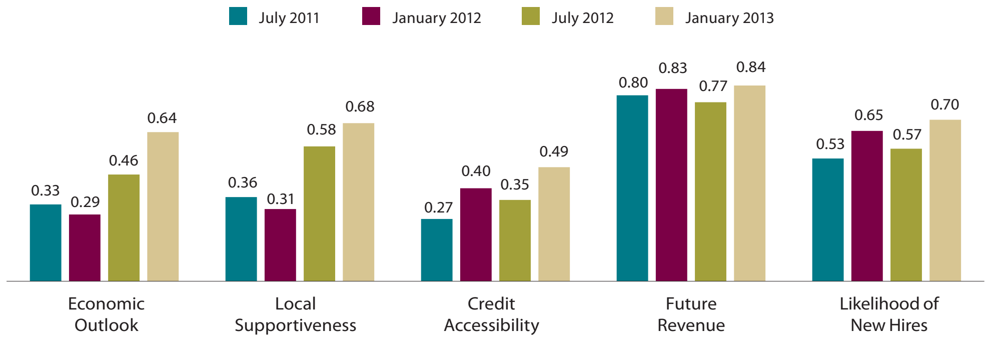


Figure 4
Small Business Confidence Index Trends in the Manufacturing Sector

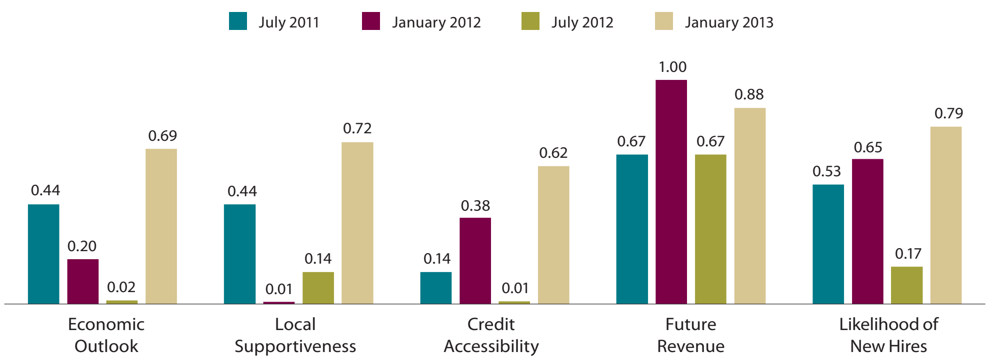


Figure 5
Small Business Confidence Index Trends in the Service Sector

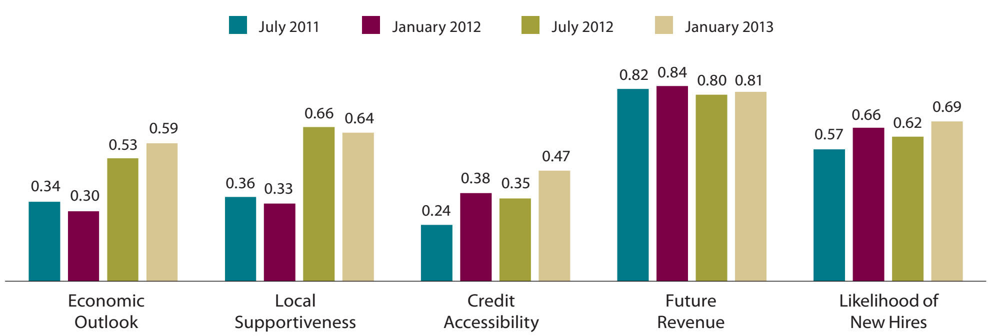
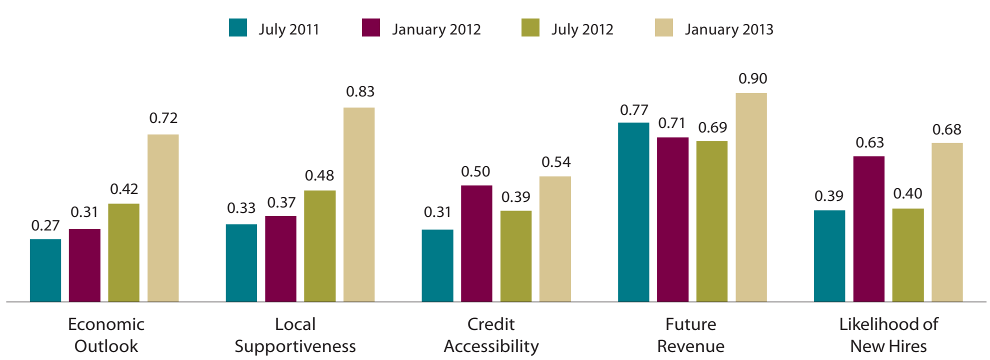


Figure 6
Small Business Confidence Index Trends in the Others Sector



2013 Capital Markets *Outlook*

Key Points

- The capital markets are still subject to elevated policy error risk amid persistent deleveraging.
- However, systemic risk is much lower than last year.
- Equities remain our favored asset class – international stocks are now more attractive than domestic.
- The yield curve looks set to steepen considerably this year.
- The SBR Index shows strong improvement in regional economic health.

"2013 presents us with much lower systemic risk than we faced last year."

What a difference a year makes. We entered 2012 as a full-blown banking crisis was unfolding in Europe that threatened the very existence of one of the world's most important currencies and economic blocs. Looming questions surrounded leadership transitions in the United States, China, and Japan. The impending fiscal cliff appeared certain to shove the U.S. economy back into recession through a combination of massive tax increases and spending cuts.

Fast forward twelve months as we witnessed European leaders backstop their banking system through their own version of the Troubled Asset Relief Program, address sovereign debt issues through quantitative easing, and proclaim a firm commitment to the Euro. Leadership changes in the United States and Asia occurred smoothly, and in perfectly dramatic fashion, the fiscal cliff was avoided with a literal last-minute deal among Washington lawmakers.

Last January, our view was that the capital markets would be primarily influenced by political brinksmanship that hinged on policy decisions during the midst of a multi-year deleveraging cycle. Though we find ourselves at a better starting point this year, we believe that those same key themes will remain with us in 2013. We present our summary outlook on the right.

Market	Viewpoint	Comment
Economy		
Global Growth	Moderate	Emerging market growth outweighs Eurozone recession
U.S. Growth	Moderate	Increased fiscal policy clarity, housing now a tailwind
Inflation	Subdued	Output gap keeps inflationary pressures in check
Stocks	Moderately bullish	Valuations reasonable, earnings stable, relatively attractive to bonds
Regions	International	Tired S&P 500 leadership likely lags global equities
Sectors	U.S. financials, energy	Steepening yield curve and uptick in commodity demand
Bonds	Lean bearish	Better economic conditions erode bond prices
Regions	Euro-periphery, emerging markets	Fundamentals improving, European Central Bank backstop
Sectors	U.S. non-government	Credit risk abating, relatively attractive yields
Commodities	Trading range	Emerging market growth will battle strong dollar dynamics
Sectors	Oil, gold	Geopolitical risk, growth and quantitative easing supports prices

Macro Themes

2013 presents us with much lower systemic risk than we faced last year. In Europe, leaders made significant progress as they adroitly dealt with both their banking liquidity and sovereign debt crises, buying necessary time for their institutions to heal themselves. Importantly, crucial players have personally guaranteed their commitment to the Euro, quelling existential questions about the currency for the time being.

Concerns in Asia have settled as well. A smooth leadership transition and the resumption of pro-growth policies appear to have helped China avoid the dreaded hard landing that plagued investor confidence in 2012. Aside from mid-year disputes with China over the Senkaku Islands, even Japan appears to have made important progress as new leadership has initiated a stronger pro-growth agenda and has begun devaluing the yen.

Finally, the U.S. economy continues to grind higher; and we now have more clarity regarding monetary, fiscal, and tax policy. Looming debates regarding the U.S. budget cuts may prove to be the likeliest catalyst for any sort of destabilizing force this year.

The reduction in global risk led to a sharp rally in equity prices last year and has removed key points of uncertainty for now. We believe the macro environment will be even less turbulent this year as we further distance ourselves from the calamitous events of the past.

Still, the problem remains that there simply is too much debt in the world, which ultimately hampers growth and increases vulnerability to future fiscal shocks. Risk from policy errors will remain elevated as leaders struggle to manage their way through the current deleveraging cycle.

Economic Backdrop

With macro risks remaining contained in the New Year, the attention quickly returns to global and domestic GDP growth prospects. Once again, we find ourselves in a dichotomy between debt-saddled developed economies and creditor emerging economies, with the former growing at a fraction of the rate of the latter. A mild Eurozone recession and reacceleration of China's growth remains our base case for the year. The International Monetary Fund aggregate estimates do not forecast significantly different growth patterns from last year either, with developed nations growing about 1.5% and emerging nations growing near a 5.6% pace.

Though the U.S. economy barely avoided the worst of the fiscal cliff, the last-minute deal will still reduce domestic economic growth by roughly 1%. Aggregate consumption and investment continue to improve and offset drag from the overleveraged government sector. Much of the U.S. economy's trajectory hinges upon the outcomes of the impending budget and debt ceiling debates later in the year, but our best estimate at this point is for the slow, halting recovery to continue.

Monetary policy should remain accommodative throughout the world as the economic recovery is still too fragile to sustain any sort of tightening. Lastly, the output gap remains too large to spur any legitimate concerns for inflation in developed markets, though emerging economies continually have a more delicate balancing act.

Equity Markets

Equities remain our favored asset class as we head into 2013. The environment of generally improving economic fundamentals; slow, but steady growth; low inflation; and a lower frequency of macro shocks should continue to support the relative performance of stock prices. Valuations appear reasonable even considering our expectations for moderate sales growth and flat profit margins. Our contrarian side notes that soft corporate guidance has pulled analysts' earnings expectations down, resulting in fairly pessimistic sentiment towards equities – traditionally a good sign.

We are adjusting our regional equity view this year. The combination of very attractive valuations and substantive progress in the Eurozone as well as China's resumption of its easing cycle, leads us to conclude that the relative leadership of the S&P 500 is near an end. We believe international markets, both developed and emerging, should outperform the domestic markets in 2013.

A steepening yield curve and slowly improving credit demand should help the U.S. financial sector lead most other areas of the domestic market. Additionally, recovering global growth as well as increasing capital expenditures should help commodity-related sectors such as energy and materials outperform.

Credit Markets

Improving economic performance and less frequent shocks to the financial system will also likely cause slow, steady erosion to bond prices throughout the year. We expect central bankers to keep short-term rates exceedingly low; however, they will be unable to contain market forces, which should push longer-term rates higher as the year progresses. In short, we expect the yield curve to steepen considerably in 2013.

Absolute valuations remain unattractive; however, investors' insatiable search for yield and limited net new debt supply will provide more support for prices than otherwise warranted. We continue to favor bonds outside of developed governments, namely corporate, emerging market, municipal, and high-yield obligations.

Commodity Markets

Commodity performance was largely range-bound in 2012 as the strong dollar and tepid demand offset lower levels of risk-aversion. Commodities remain a proxy for China's growth this year, just like they have been in years prior. Our expectation is that the Chinese easing cycle will push prices meaningfully higher; however, this outcome is contingent upon its leaders being able to contain food price inflation as well as spur money supply growth.

Our favored spots in the commodity complex remain oil and gold as the combination of geopolitical risk, increasing global growth, and continued central bank money-printing activity should support those asset price levels.

SOURCES:

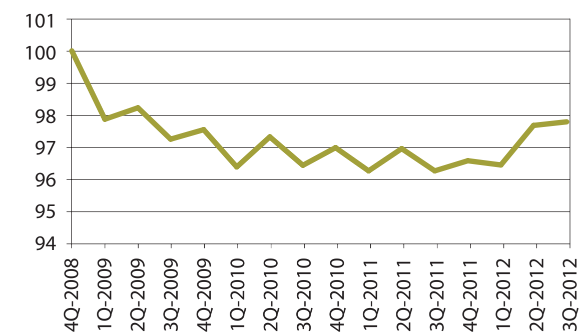
1 BCA Research, *Outlook 2013*, January 2013
2 Ned Davis Research, *2013 Outlook*, December 2012
3 Wells Fargo Private Bank, *Asset Allocation and Strategy Report*, December 2012
4 International Strategy and Investment, *Capital Markets Chronicle*, January 4, 2013

Sacramento Business Review Financial Conditions Index • January 2013

Our proprietary SBR Index incorporates portions from all of the areas of our SBR team's research. This unique combination of local employment, real estate, small business financing activity, banking, and capital market performance data illustrates the general economic conditions that influence the Sacramento region. Below is a brief description of each component of the index:

- **Employment** – the change in total private and government sector employment levels
- **Real estate** – quarterly median home sale prices and quarterly total home sales
- **Small business** – average growth in credit extension from regional SBA data
- **Banking** – gross credit extension from the 14 local banks[1] in the surrounding six counties[2]
- **Capital markets** – share price levels of the 10 largest local publicly traded employers[3]

Last year's January report showed that the Sacramento region had found the bottom in 2011; this year's report shows a strong improvement in our regional economic health. The local housing sector, a recovery in the banking industry, and strong capital market performance all contributed to the positive change in the index. Though private-sector employment has also been slowly improving, government-sector employment is still on the decline. We are cautiously optimistic that the pace of government employment declines may slow given the improving state fiscal conditions.



DATA SOURCES:

Employment Development Department
MDA DataQuick
Federal Deposit Insurance Corporation
Sacramento Business Journal Book of Lists
Dow Jones
U.S. Small Business Administration

NOTES:

1 American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, First Northern Bank of Dixon, Five Star Bank, Folsom Lake Bank, Gold Country Bank, Merchants Bank of Sacramento, River City Bank, River Valley Community Bank, Sierra Vista Bank, and Sutter Community Bank.

2 El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba.

3 Intel Corp., AT&T California, Hewlett-Packard, Target, Wells Fargo & Co, Safeway, Pacific Gas & Electric, Union Pacific Railroad, Franklin Templeton, and DST Output.

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