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Emerging Trends in Sacramento's Economy

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Real Estate Trends in the Sacramento Region page 14

2015 Economic Forecast

Your Best Guide to Sacramento's Economy

CFA Society Sacramento

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

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MISSION

To educate consumers on the economic and financial health of the Sacramento region.

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Founded in 1991, the CFA Society Sacramento operates as a member Society of CFA Institute. Our membership consists of more than 180 regional investment professionals and academics; and our mission is to utilize our collective investment knowledge, expertise, and global network in order to function as a valuable resource to our members and to benefit our regional community.

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The College of Business Administration at California State University, Sacramento, is the capital region's educational institution of diversity that provides a strong foundation in business knowledge, skills, and values through collaboration among faculty, staff, and students in order to enrich their respective communities.

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The Center for Small Business provides free management assistance to small businesses operating in and around the Sacramento area. Consulting services are provided in virtually all facets of business except for taxation, law, and loan packaging. Each year the Center works with approximately 100 small-business owners to help solve management problems. The quality of the program can best be illustrated by the 600% increase in requests in recent years, and the awards for outstanding performance from the Small Business Administration. Established in the spring of 1969, this program is one of the oldest in the western United States and has grown to be one of the largest and most successful.

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Message From the Director

Dear Friends,

I am pleased to share the 13th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For more than seven 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) is now the most credible source of independent thinking, insights, and research not found elsewhere in the region.

I am both pleased and grateful for 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 to 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.

Last year, our forecast for 2014 was optimistic. We predicted that real estate markets would see continued recovery with declining vacancy rates and improved asking rents, unemployment would decrease further to a mid to high single digit, local banks would experience meaningful loan growth and see some M&A activity, the local government sector would stabilize and might expand somewhat, and equities would remain the favored asset class with lower systematic risk. We were absolutely right – no surprise – given the consistently strong market analysis by our analysts!

While the region has made a strong recovery to near pre-recession levels, job growth at the low end of the wage distribution and absence of major private sector announcements regarding new job creation at the high end remain as headwinds. We will likely see some sectors lag as low affordability strains on the housing market. Our Small Business Confidence Index shows continued high optimism for the next year in spite of a softening in the small-business sales market. We expect local banks to continue to consolidate through mergers and acquisitions and loan growth to remain positive. The residential real estate market that experienced a noticeable cooling off will remain stable, as will other sectors of real estate. Our SBR Index has shown sustained stability and predicts continued improving conditions for the region. While job growth remains moderate, the unemployment rate for the region will continue to drop. The construction and financial sectors are yet to reach pre-recession levels and will be the sectors to watch closely. The positive psychology and momentum will be sustained through new efforts to build and diversify the regional economy. Sacramento is currently sitting at a unique crossroad at which the region may be creating an exciting future.

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 **sacbusinessreview.com**.

Warm regards,

Sanjay Varshney

Sanjay Varshney, PhD, CFA

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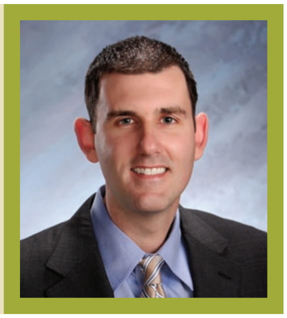

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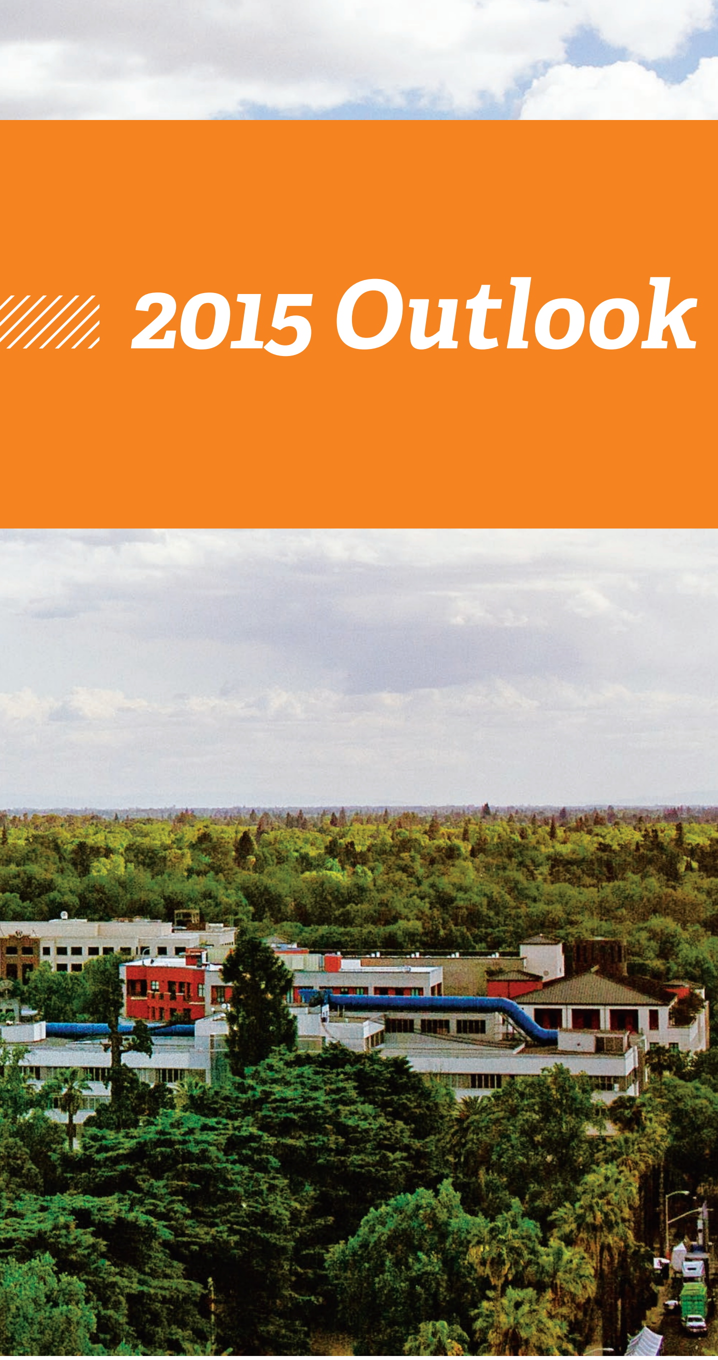
Sacramento's Labor Market & Regional Economy

Key Points

- The Sacramento region's labor market has nearly recovered from the 2008-2009 recession.
- The region has added 85,000 jobs since 2011 causing the unemployment rate to decline, but the labor force participation rate remains low.
- The health care and business and professional services sectors have been the region's leading job creators.
- Construction and financial services sector jobs remain well below their 2007 levels.



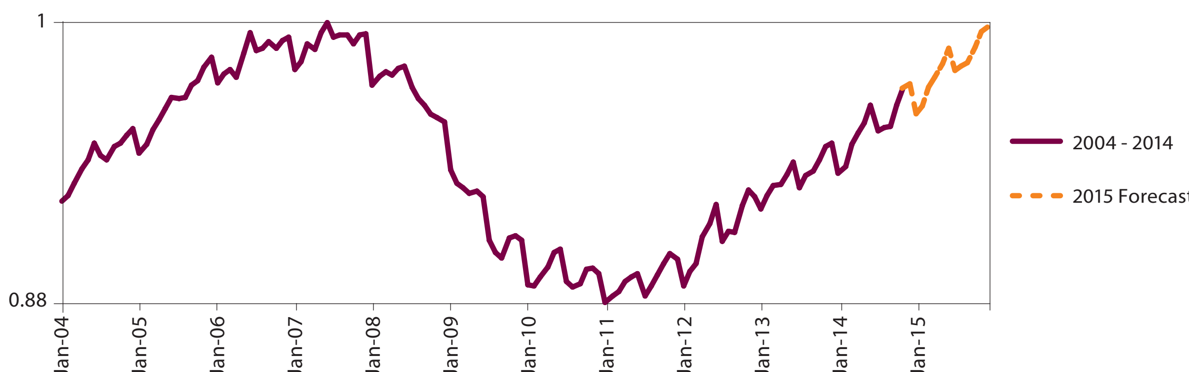
2015 Outlook

We are almost there.

The key to economic recovery is job recovery as Sacramento lost 12% of its nonfarm jobs during the last great recession. Last year we asked the question: "Are we there yet?" This was in reference to the fact that the labor market in the Sacramento region had not fully recovered from the recession. The pace of job growth was steady over the last three years. This year we can say that we are almost there, as Sacramento nonfarm jobs have recovered close to the 2007 peak level, and hopefully we can finally claim a full job recovery for the Sacramento region in 2016.

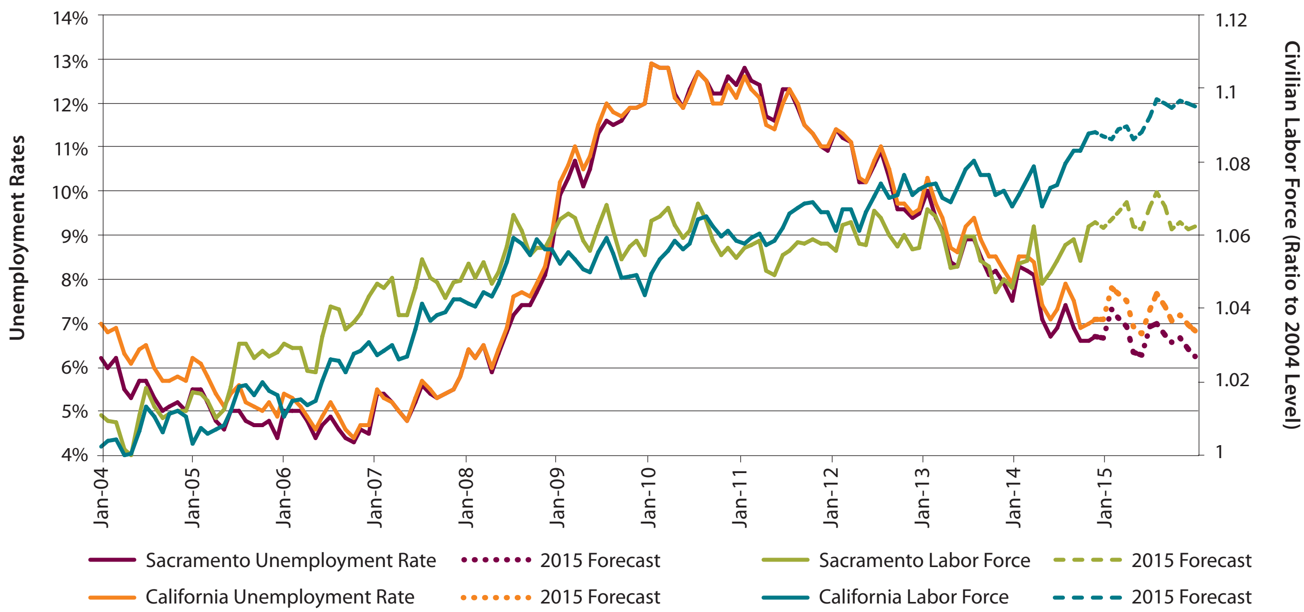
In the process, the region's unemployment rate has continued to decline as the number of jobs has increased by about 85,000 since the 2011 low. However, it is necessary to understand that the unemployment rate is not the perfect indicator of where we are in the recovery process. The official unemployment rate masks a large number of workers who are counted toward employment but are working part-time or have dropped out of the labor force altogether. Sacramento has outpaced California in terms of the improvement in the unemployment rate; however over the last five years the Sacramento region's labor force (the denominator) has flattened while the state's labor force has increased. This is why although California overall has regained all its jobs lost during the last recession, we cannot yet make the same claim here in Sacramento. The improvement of the unemployment rate in Sacramento is expected to slow down in 2015 as part-timers find full-time jobs and dropouts come back to the labor force. We expect to continue to see the local unemployment rate ranging from 6% to 7% in 2015.

Figure 1
Sacramento Job Recovery » Sacramento Total Nonfarm Jobs (Ratio to 2007 Peak Level)



Data Source: EDD

Figure 2
Unemployment Rates



Data Source: EDD

The Economy Has Room to Run

The good news is that as the national economy grows strong, the local economy has a lot of room to grow. With workers still underemployed and the inflation rate below the Fed's target, we expect the economic recovery to continue, and to continue to improve.

Most recently the low oil price has contributed to stronger consumer confidence, and the financial market has continued to show its optimism. If the economic recovery is nearly completed and the economic growth is about to slow down, then financial market optimism may be misplaced. As the economy is still on its path of recovery and there is a lot of growth potential, we believe the financial market is right to be optimistic. Inflation is still low, and we have not seen upward pressure on wages and prices that is often considered by economists as the true signal of a full economic recovery. We should expect continued economic growth for the next few years.

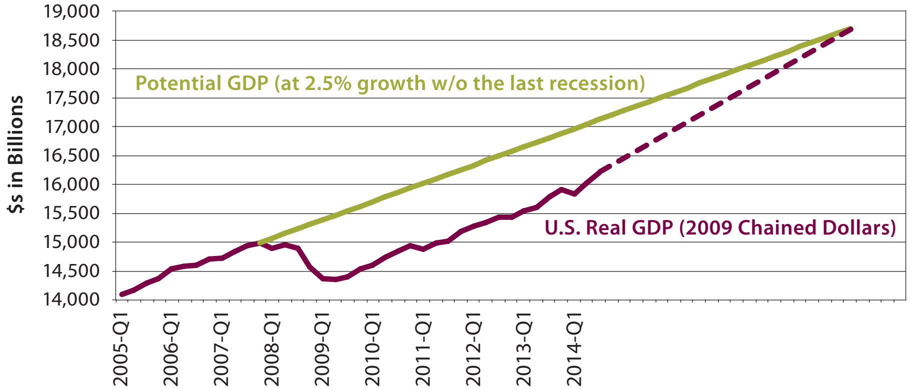
The health care industry has been the region's leader when it comes to job creation over the past seven years.

A Region Transformed

While the region's labor market has recovered close to its previous highs, it has undergone a major transformation in the past seven years. There have been winners and losers as some industries have thrived, adding jobs and becoming a larger portion of the region's labor market, while others have struggled, shedding jobs and becoming a smaller portion of the regional labor market.

The winners: The health care industry has been the region's leader when it comes to job creation over the past seven years. The number of the region's health care jobs has increased by over 22,000, an average annual increase greater than 3.5%. As a result, the health care sector increased its share of the Sacramento region's labor market from 10.6% in 2007 to 13.4% today. Within the health care sector, the subcategory of ambulatory health care services (outpatient care) has done most of the heavy lifting having added 10,000 jobs, a 28% increase, during the same period while hospitals (inpatient care) added 3,000 jobs, a 15% increase.

Figure 3
The Economy Has Room to Improve



Data Source: BEA

Figure 4
Changes in Sacramento Labor Sectors » 2007-2014

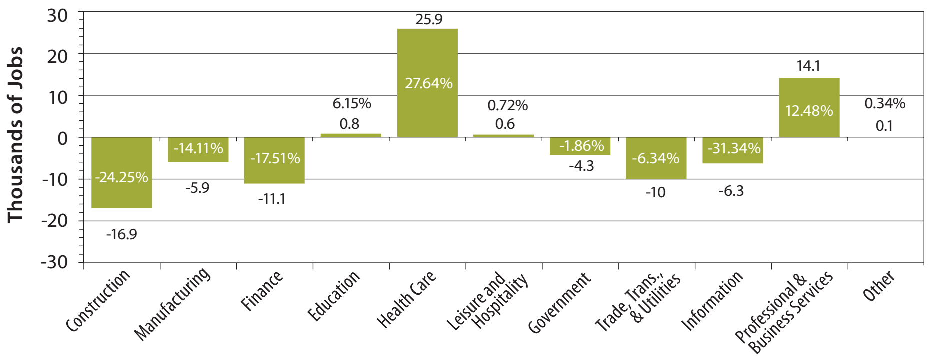


Figure 5
Sacramento Job Market Changes » 2007-2014

Sector	2007 Jobs	2007 as % of Economy	2014 Jobs	2014 as % of Economy	Changes
Government	238,800	25.8%	228,100	25.4%	–
Trade, Retail, Transportation & Utilities	152,200	16.5%	149,600	16.6%	–
Professional & Business Services	112,300	12.1%	123,000	13.7%	↑
Health Care	97,700	10.6%	120,300	13.4%	↑
Leisure & Hospitality	87,600	9.5%	85,300	9.5%	–
Financial Services	62,100	6.7%	51,400	5.7%	↓
Construction	70,000	7.6%	47,600	5.3%	↓
Manufacturing	41,300	4.5%	34,700	3.9%	↓
Education	12,600	1.4%	14,400	1.6%	–
Information	20,000	2.2%	14,200	1.6%	↓
Other	29,900	3.2%	29,900	3.3%	–

Data Source (Figures 4 & 5): EDD

Second only to health care, the professional & business services sector posted strong job gains over the past seven years, too. In total, the sector added over 10,000 jobs, a more than 12% increase from pre-recession levels. These job gains have caused the sector's share of the region's total employment to increase from 12.1% to 13.7% since 2007. However, the gains within this sector are concentrated in two areas: management of companies and enterprises and employment services. Management of companies and enterprises, which overall represents approximately 1% of the region's labor, increased by 2,500 jobs, or 30%, over the past seven years. Meanwhile, those working for employment services, which include part-time staffing, increased by 7,300, nearly 40% from the pre-recession level.

The losers: While health care has led the region's labor market recovery, the construction sector has lagged. In the past seven years, the region has lost about 22,000 constructions jobs, or over 30% of the pre-recession total. In the process, the construction sector fell from the region's fifth-largest nongovernment employment sector with 7.6% of the labor market to the seventh with just 5.3% today. Within the construction sector, those engaged in building construction took the hardest hit, losing 5,100 jobs (33% of the pre-recession total). The least hit were building equipment contractors, however this segment still lost 2,700 jobs (18.5% of the pre-recession total).

Figure 6
Health Care Jobs Outlook

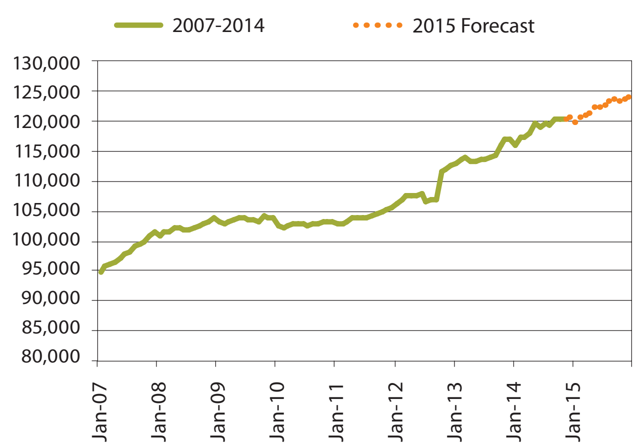


Figure 7
Professional & Business Services Outlook

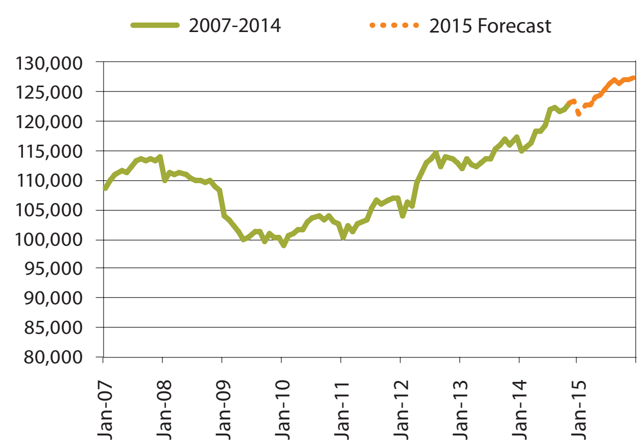


Figure 8
Construction Jobs Outlook

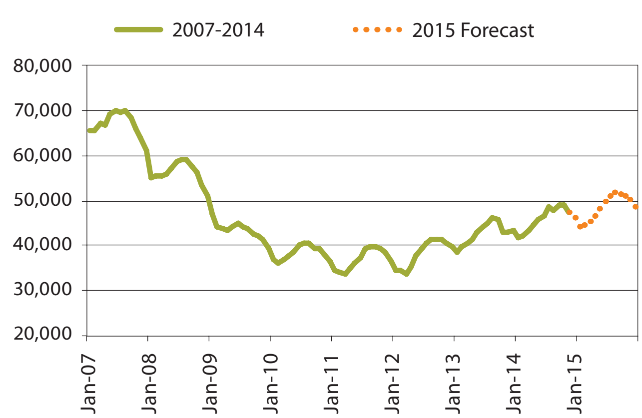
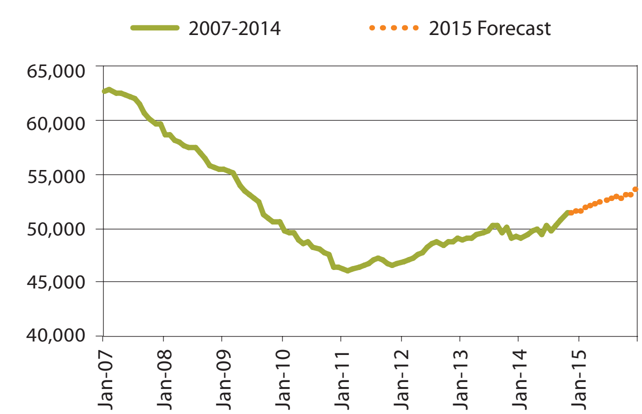


Figure 9
Financial Jobs Outlook



Data Source (Figures 6-9): EDD

Next to the construction sector, the financial services sector was the biggest loser both in terms of the number of jobs lost (over 10,000) and the percentage decline (17.2%). Within the financial sector, both the insurance and real estate subsectors reported a 2,000 to 3,000 reduction in jobs representing a decline of between 12% and 13% from pre-recession highs. However, it was credit intermediation that showed the largest decline, losing 6,500 jobs, a 33% reduction since 2007.

Nonetheless, we expect to see continued economic recovery and job growth in most sectors in Sacramento in this coming year.

Nonetheless, we expect to see continued economic recovery and job growth in most sectors in Sacramento in this coming year. In 2015 we expect another 3,000- to 4,000-job gain in both the health care and professional & business services sectors that have been leading our regional job recovery, and roughly 2,000 jobs added in the retail industry. Government, education, leisure and hospitality, and manufacturing jobs should remain stable or show moderate growth in the coming year. We can even expect to see a moderate job growth in both the financial services and construction sectors. Although we did not see an increase in building permits issued in Sacramento over the last year and the housing sector will not add a significant number of construction jobs, the railyards, the arena and other potential downtown development projects should provide a steady growth of construction work in the near future.

Real Estate Trends *in the* Sacramento Region

Expanding rental rates and falling vacancy have fueled new construction of multifamily, retail, and industrial properties.

The Rivermark » West Sacramento

Key Points

- Real estate fundamentals improved across the board as vacancy rates declined and lease rates generally increased across all major property types.
- Attracted by incrementally higher returns and a more promising economic upside compared with many other markets that are three or four years further into their economic and rental recovery/expansion, investors from outside the region have turned their focus toward Sacramento.
- Expanding rental rates and falling vacancy have fueled new construction of multifamily, retail, and industrial properties.
- Sacramento's housing market was lackluster in 2014 with a decline in sales and a modest increase in the median sale price. A healthy employment outlook, coupled with new programs allowing first-time home buyers the ability to purchase a home with as little as 3% down, portends a better 2015 for the region's housing market.

Last year brought continued good news for Sacramento's commercial real estate markets as occupancy increased across all sectors. While the office market remains furthest still from equilibrium, particularly in the suburbs, developers surfaced from hibernation this past year to build new multifamily, industrial, and retail projects. Given our region's position in the early innings of a real estate upcycle, we see this trend of recovery and/or expansion continuing for some time and even gaining momentum as employment expands. Of course, nowhere in the region do you see more optimism than in the urban core, where significant capital has and will continue to be invested around the new entertainment and sports complex.

As more tenants moved into office space the vacancy rate fell below 19% by the end of 2014.

Unfortunately, while the residential market continues to make incremental improvements, it has yet to take off with as much vigor as widely anticipated in recent years.

Office

2014 was another encouraging year for the Sacramento office market, which enjoyed positive net absorption of 518,534 SF. Although this represents less than half of 2013's net absorption, occupancy ended the year the highest it's been in six years.

As more tenants moved into office space, the vacancy rate fell below 19% by the end of 2014, a 1.4% decline year-over-year. However, vacancy remains elevated above the 13-15% "equilibrium" rate, and average asking lease rates remained essentially flat at $1.69 per SF per month.

No new construction projects commenced in 2014, and none are on the immediate horizon. However, with the likely mid-year repeal of the building moratorium in Natomas and the surge in demand in the urban core, it's likely we will see some new development projects announced in 2015.

We saw healthy investment sales activity, with at least one sale greater than 110,000 SF in each quarter of 2014. Perhaps an even greater signal of the growing interest in the office market locally was the number of out-of-town investors that purchased properties in the Sacramento region.

2015 Outlook: The Sacramento office sector remains saddled with excess vacancy and unremarkable tenant activity in the suburbs. However, it's trending positively, and we expect leasing momentum to increase in 2015. In particular, demand for office space in the Downtown submarket will continue to rise due to the expected completion of the Kings' arena in 2016.

Retail

2014 was an active year as all four quarters ended with more occupied retail space than they started with, providing nearly 500,000 SF of net absorption for the year. While closures of The Fresh Market, Staples, OSH, and Kmart made headlines, net demand for big box space increased steadily with several retailers expanding, including Smart & Final, Sportsman's Warehouse, and Total Wine & More.

The vacancy rate for retail properties continued to decline. Despite the addition of some new retail space due to construction, the year ended with a vacancy rate of 10.5%, which is a 0.3% decline from the fourth quarter of 2013. Asking lease rates were $1.49 per SF per month in the fourth quarter of 2014, which is $0.05 higher than the same period in 2013.

Construction of almost 400,000 SF of retail space was completed in 2014, which is 20,000 SF more than in 2013 and represents the highest new building activity since 2007.

A defining feature of 2014 was increased institutional investment in Sacramento area retail centers.

2015 Outlook: Expect steady absorption, flat or slightly declining vacancy rates, and stable lease rates. We expect to see healthy leasing activity return to smaller retail spaces and construction activity to continue, particularly development of big-box and high-quality shopping centers. As retail jobs increase and consumers enjoy higher disposable incomes (in part due to lower gas prices), Sacramento retail properties will continue to attract increasing numbers of private and institutional investors.

Industrial

The Sacramento Industrial market continued its ascent in 2014 with net absorption of just over 4,100,000 SF – a level not seen in nearly a decade – and vacancy falling below 10%. Nearly half of the net gain in occupied space occurred in West Sacramento and Woodland.

Expect steady absorption, vacancy rates to remain in the single digits, and a healthy increase in lease rates.

Leasing activity was robust in 2014, with 15 transactions over 100,000 SF. While the food and beverage industries contributed, the bulk of market activity was driven by retail distribution users. While lease rates generally held steady this past year, we expect to see them move upward more meaningfully in 2015.

Declining vacancy and stable rents made construction of new industrial properties attractive in 2014. We saw the return of construction and the announcement of several projects – both build-to-suit and speculative – that have elevated the amount of space currently under construction to just over 1,100,000 SF.

Investment activity was strong in 2014, as multiple properties larger than 300,000 SF changed ownership and investors saw value in Sacramento's improving market fundamentals.

2015 Outlook: Expect steady absorption, vacancy rates to remain in the single digits, and a healthy increase in lease rates. Both build-to-suit and speculative construction will continue, particularly for high-quality Class A buildings. Investment from outside the region, both from private and institutional investors, will remain strong.

Residential

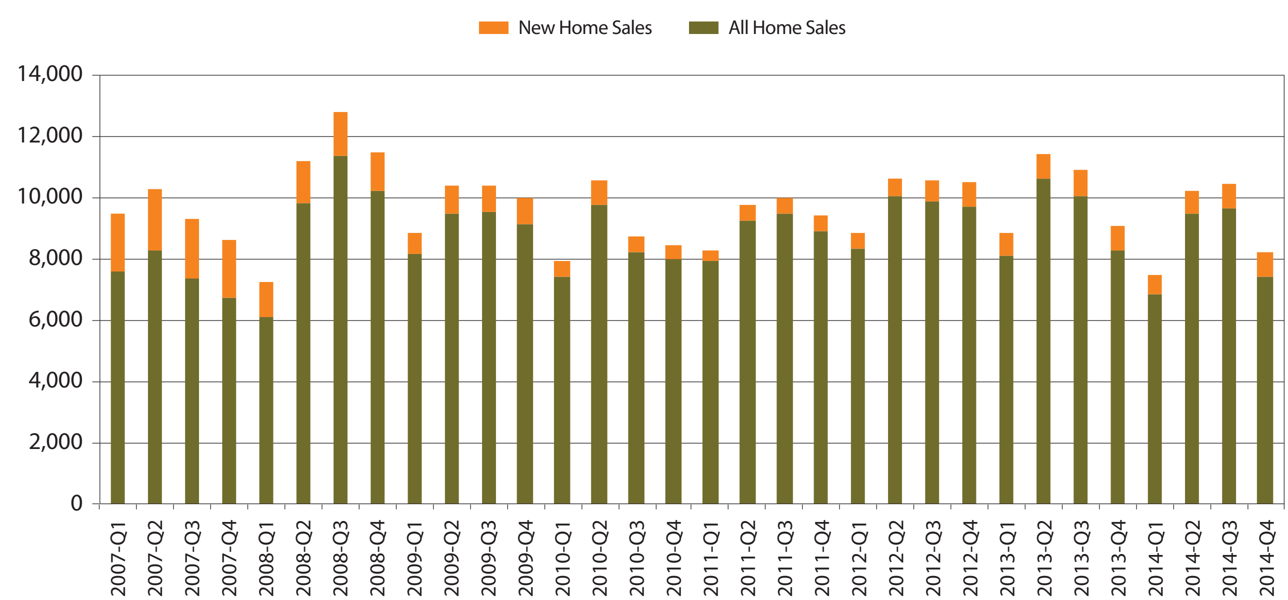
The Sacramento region is making a concerted effort in establishing a trajectory of economic normalcy. This is supported by declining unemployment, (moderately) escalating home prices, and increasing construction activities. However, for this moderate improvement to evolve into a robust economic expansion, the region's housing market will need to lead the way as had been expected the past couple years.

The Sacramento region saw the median sale price rise during the past year and a half but finish 2014 with a nominal drop. The median sale price rose 8% year-over-year to $295,000 but remains 29% below the 2005 peak. Part of the price increase can be attributed to the type of homes sold – a larger proportion of luxury homes traded hands. The price per square foot for single family homes in the Sacramento MSA increased by 7%, with the largest increase observed in Placer and Sacramento counties (7.8% and 6.7%, respectively).

In 2014, the sales volume of all types of homes (new homes, resale homes, and condominiums) in the Sacramento MSA dropped 10.4%. While new home sales essentially remained flat, contributing a paltry total of less than 3,000 homes, the drop came mostly from existing home sales and was concentrated in properties valued below $200,000. Sales within this pricing segment alone dropped by more than 7%. However, sales of homes valued at more than $400,000 picked up 19% in 2014.

Several new residential projects made advancements this past year in the Sacramento region such as the Curtis Park Village plan for 286 single family homes, the Creamery infill project plan for 117 homes, and almost 425 homes to be built in the Vineyard planning area. The last set of projects is split among three builders: Lennar Homes will build 296 single family homes in the Florin road area, Taylor Morrison will build 66 single family homes at the corner of Bradshaw and

Figure 1
New Home Sales vs. All Home Sales | Sacramento MSA



Data Source: Data Quick

Real Estate Trends
in the Sacramento Region

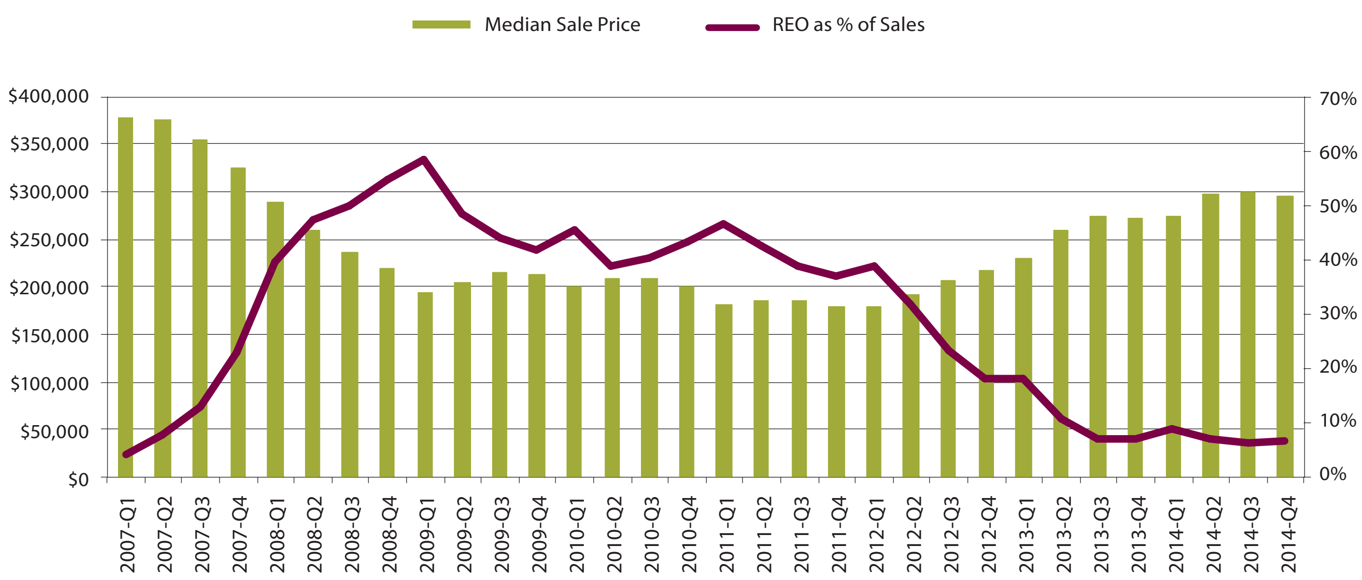
Calvine Road, and Taylor/Village Partners will construct 63 single family homes on Bradshaw Road. In recent years, the south Placer County and the Elk Grove/Vineyard planning regions have become residential growth centers.

Foreclosure activity in the Sacramento MSA declined by 25% in the fourth quarter of 2014 relative to the same period last year. This is corroborated by the fact that notices of default, which are non-payment of mortgages due for three months, declined from 1,357 in the fourth quarter of 2013 to 1,011 during the same period in 2014. This trend can be explained by rising home values and a strengthening job market. Further, the proportion of REOs (Real Estate Owned by Lenders), which represented a little more than 41% during 2011, dropped to 10.4% and 7.1% during 2013 and 2014 respectively (ending with 6.7% during fourth quarter of 2014).

Inventory shortages coupled with the end of the Federal Reserve bond buying program should escalate home prices and the demand for homes during 2015.

2015 Outlook: As the state and local economies become more resilient and the labor market improves, the demand for single family homes will continue to rise. Low interest rates and the unveiling of a new policy by Fannie Mae and Freddie Mac to accept mortgage down payments as low as 3% for first-time homebuyers will prod improvement in homeownership rates. Inventory shortages coupled with the end of the Federal Reserve bond buying program should escalate home prices and the demand for homes during 2015.

Figure 2
Median Sales Price (All Homes) vs. REO as a % of Sales: Sacramento MSA



Data Source: Data Quick

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2015 Sacramento Banking Industry Forecast

Higher loan volumes could not come at a better time for local banking industry profitability.

Key Points

- The Sacramento Business Review (SBR) banking team expects loan volumes in the Sacramento region[1] to continue growing at a healthy pace throughout 2015.
- Higher loan volumes could not come at a better time for local banking industry profitability, as the tailwind from lower loan loss provisions has ended.
- The Sacramento Region Banks[2] should be able to increase their top-line net interest income at a mid- to high-single-digit pace this year, despite the modest drag from slightly lower net interest margins[3].
- Unless loan growth turns out to be much higher than anticipated, the banks will still need to maintain a tight lid on operating expenses should they endeavor to increase their bottom lines at a solid clip.
- Given less scalability in a more stringent regulatory climate, many smaller banks will almost certainly struggle to maintain competitive cost structures. As such, the team expects the nascent trend of merger-and-acquisition activity among the local banks to continue during the year ahead.

Last January, the SBR banking industry analysts questioned whether the stronger pace of loan growth witnessed during the latter half of 2013 would accelerate in 2014. Despite signs of more ample lending and borrowing capacity more than five years after the global financial crisis had passed, the team remained skeptical that the post-crisis "deleveraging" period had concluded. Heading into 2015, however, the weight of the evidence appears to indicate that lenders are enabling healthier borrowers to re-leverage in earnest (Figure 1).

Table 1 shows how the aggregate loan balances for the Sacramento Region Banks increased by more than 10% last year. The banking team expects this trend to continue throughout the upcoming year.

Figure 1
Aggregate Loan Balances
Sacramento Region Banks » 2009-2014

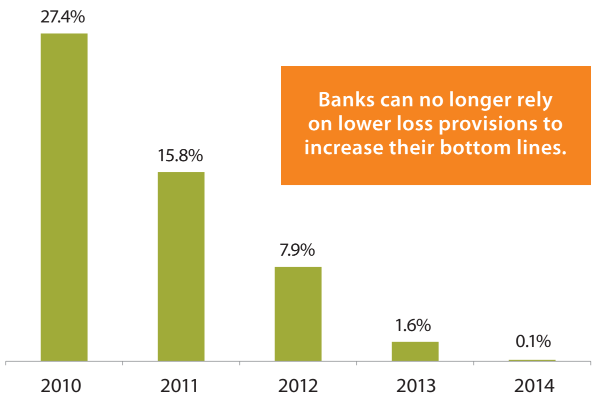
Table 1
Loans by Segment
Sacramento Region Banks » Last 12 Months (through 9/30/14)

$ in millions	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014	Year/Year % Change Since 3Q 2013
Commercial Real Estate	$3,113.0	$3,172.5	$3,204.8	$3,281.8	$3,397.1	9.1%
Residential	1,900.7	1,893.9	1,881.3	1,885.8	1,895.8	-0.3%
Commercial & Industrial	779.7	802.7	803.9	864.8	841.9	8.0%
Multifamily	288.7	359.3	364.8	364.6	402.7	39.5%
Construction Loans	218.5	256.1	283.9	307.7	305.7	39.9%
Other Loans & Leases	919.1	971.6	926.3	1,027.9	1,102.8	20.0%
Total	**$7,219.7**	**$7,456.1**	**$7,465.0**	**$7,732.6**	**$7,946.0**	**10.1%**

Data Source: FDIC

Higher loan volumes could not come at a better time for the banking industry. This report has noted for several years how, despite tepid top-line growth, the local banks were still able to increase their bottom-line net profits by reducing loan-loss provisions as the economy recovered (Figure 2). Entering 2015, it is obvious that all of the juice has been squeezed from that lemon. Therefore, it is imperative that the banks grow their top lines in order to produce solid profit growth this year. Increasing loan balances would move them closer to that goal.

Figure 2
Provisions for Loan Losses as a % of Net Interest Income
Sacramento Region » 2010-2014



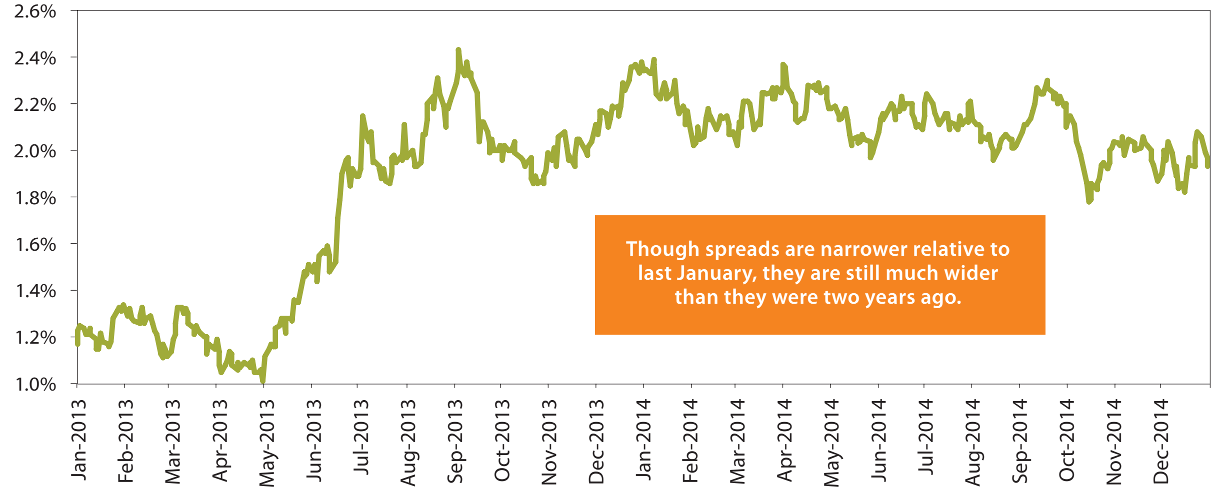
If high-single-digit loan growth materializes as expected, the team believes that the Sacramento Region Banks should be able to collectively increase their top-line at a 5%-7% rate. The differential between the forecasted pace of loan growth and that of net interest income growth is due to a slight drag from lower projected net interest margins. These are expected to occur due to a narrowing spread between longer-term interest rates at which banks lend and shorter-term rates at which banks pay depositors (Figure 3). Furthermore, assuming the Federal Reserve moves forward with its stated intention to raise the Fed-Funds interest rate later this year, margins are likely to narrow further.

Expense Control Still Necessary

Unless loan growth turns out to be much higher than anticipated, the banks will still need to maintain a tight lid on operating expenses should they endeavor to increase their bottom lines at a healthy rate, especially considering that they can no longer rely on the tailwind from lower loan-loss provisions.

Given less scalability in a more stringent regulatory climate, many smaller banks will almost certainly struggle to maintain costs and keep their Efficiency Ratios[4] competitive. Thus, these institutions may face challenges to becoming more profitable in 2015. As such, the team expects the nascent trend of merger-and-acquisition (M&A) activity among the local banks to continue during the year ahead.

Figure 3
Differential Between 7-Year and 3-Month U.S. Treasury Rates » 2013-2014



Data Source: United States Treasury Department

M&A Finally Occurs!

For the past four years, the SBR banking analysts have expected to see M&A activity among the smaller local banks. These predictions were based upon the culmination of several factors: 1) continued difficulty generating top-line net interest income growth due to weak loan demand, 2) the diminishing benefits from lower loan-loss provisions, and 3) a lack of scale in a more challenging regulatory and security environment.

Through the end of 2013, no M&A transactions involving the local banks had taken place. Nonetheless, the team remained steadfast in its prediction, even in the face of ridicule from local journalists. Fortunately for the SBR team, it did not need to wait long after the 2014 banking forecast was released to finally see the M&A prediction come to fruition. Last January, Tri Counties Bank purchased North Valley Bank in a $178 million all-stock transaction. And then last fall, Bank of Sacramento announced that it was being acquired by American West out of Spokane, Washington.

As indicated previously, the team believes that local bank M&A activity will continue this year. The leading M&A candidates are still the smaller banks, and these players are likely to either merge with other banks of similar size or to be purchased by mid-sized regional financial institutions.

Table 2
Stock Ratings for Publicly Traded Sacramento Region Banks » December 31, 2014

Bank	Ticker	Stock Price	Market Cap ($ in millions)	2014 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									
First Northern Bank of Dixon	FNRN	$7.92	$77.6	10.0%	1.0x	7.9%	1.3%	6.89%	4
American River Bank	AMRB	$9.42	76.2	-0.3%	1.1x	12.0%	2.6%	5.23%	4
Community Business Bank	CBBC	$9.15	19.6	2.8%	0.9x	10.8%	1.3%	9.11%	5
Folsom Lake Bank	FOLB	$7.20	11.5	1.4%	0.8x	9.9%	4.7%	6.89%	4
MARKET PERFORM									
Farmers & Merchants Bank	FMCB	$463.00	$360.2	12.5%	1.6x	10.3%	0.5%	11.30%	4
River City Bank	RCBC	$120.00	146.4	20.6%	1.2x	10.8%	1.6%	7.74%	4
River Valley Community Bank	RVVY	$14.50	25.5	-12.6%	1.3x	10.3%	0.0%	5.19%	4
Community 1st Bank	CFBN	$3.57	19.6	-10.8%	1.2x	8.7%	2.2%	2.65%	3
Sutter Community Bank	SUTB	$5.60	5.3	-2.6%	0.6x	13.8%	8.7%	2.18%	2
UNDERPERFORM									
Tri Counties Bank	TCBK	$24.70	$561.1	-11.4%	2.3x	8.8%	2.9%	9.97%	4
Sierra Vista Bank	SVBA	$4.50	20.3	77.9%	1.2x	13.4%	1.6%	3.26%	5
				Peer Group Average:	**1.2x**				

1) Price to Tangible Book Value (TBV) ratios use market prices as of 12/31/14 and TBVs as of 9/30/14. TBV is determined by subtracting 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 9 months of 2014 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 1. The Sacramento Business Review cannot guarantee any of the forecasts made in this article.

Publicly Traded Local Bank Stock Ratings

Within the six-county Sacramento region, 13 locally based banks are publicly traded on the OTC Bulletin Board. However, two of them (Bank of Sacramento and North Valley Bank) are in the process of being acquired. In Table 2 (on previous page), the SBR banking team presents its recommendations for the 11 remaining local bank stocks. Readers should note that all of these stocks have very low liquidity, so investors should consider market impact[5] when trading shares.

2014 Local Bank Stock Performance Review

In what was a relatively uneventful year for regional bank stocks nationwide, the SBR Bank Index[1] (4.4% total return) outpaced the benchmark KBW Regional Bank Index (1.8% total return) by a fairly wide margin during 2014. As in previous periods, those basing their trading strategies on the SBR bank stock ratings last year would have fared reasonably well. For example, two of the banks rated as Outperform in January 2014, Sierra Vista Bank and River City Bank, generated returns of 78% and 21%, respectively.

We would be remiss if we neglected to mention some of our erroneous calls, which included Bank of Sacramento (up 41% while rated just Market Perform) and North Valley Bancorp (up nearly 15% while rated Underperform).

1) The SBR Bank Index tracks the performance of all publicly traded Sacramento Region Banks on a capitalization-weighted basis (i.e., a weighted average of returns by market capitalization).

Table 3
2014 Local Bank Stock Performance Review

Bank	2014 Total Return	January 2014 Rating
Sierra Vista Bank	77.9%	Outperform
Bank of Sacramento	41.4%	Market Perform
River City Bank	20.6%	Outperform
North Valley Bancorp	14.6%	Underperform
Farmers & Merchants Bank	12.5%	Market Perform
First Northern Bank of Dixon	10.0%	Market Perform
Community Business Bank	2.8%	Outperform
Folsom Lake Bank	1.4%	Market Perform
American River Bank	-0.3%	Market Perform
Sutter Community Bank	-2.6%	Outperform
Community 1st Bank	-10.8%	Market Perform
Tri Counties Bank	-11.4%	Underperform
River Valley Community Bank	-12.6%	Market Perform
SBR Bank Index	**4.4%**	
KBW Regional Bank Index	**1.8%**	

Endnotes

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

2 The Sacramento Region Banks include 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 The 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 Efficiency Ratio is a commonly used metric to measure a bank's operating expenses. It is calculated by taking noninterest expenses as a percentage of a bank's interest and noninterest income (combined).

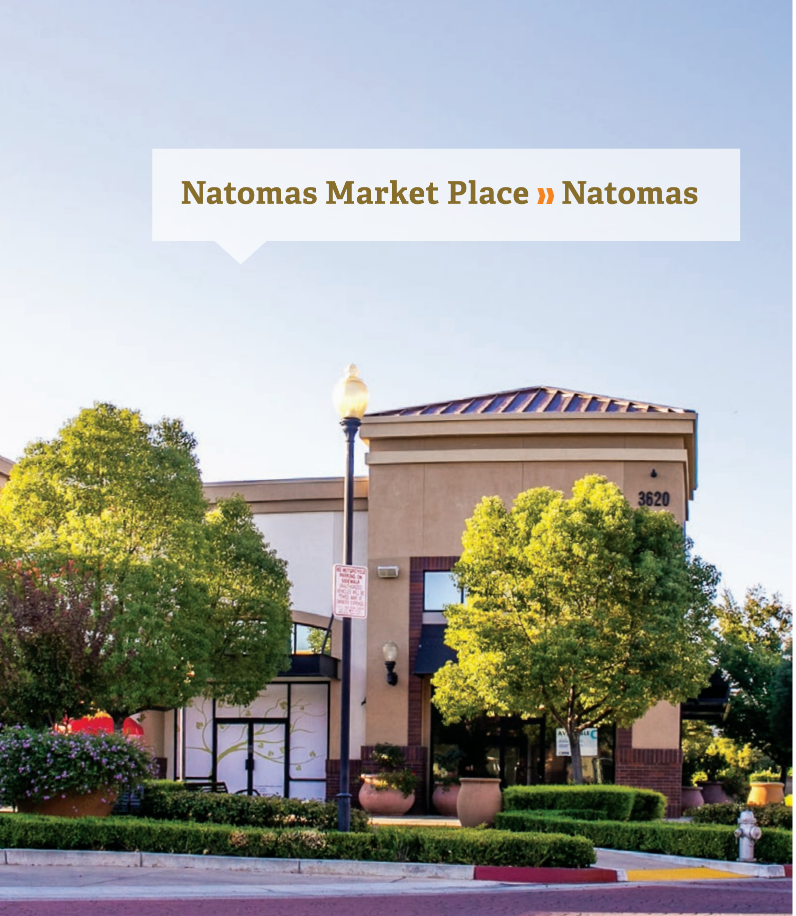
5 Market impact is the extent to which buying or selling a stock moves the price. Market impact is greater when stocks are less liquid.

> The region has shown a steady and healthy improvement in the last couple of years.

The Small Business Economy

Key Points

- Our key metric of small-business health – total dollar volume of SBA loans approved in the region – increased by 24%.
- Overall, small-business confidence improved across the board for all sectors compared with last year's levels, with significant improvements in access to credit.
- Small businesses remain very upbeat regarding business prospects for 2015 with noticeable improvements in the manufacturing sector regarding prospects for new hires.
- Even though the market for small-business sales has softened, we believe the small-business economy will continue to show sustained improvements in 2015.



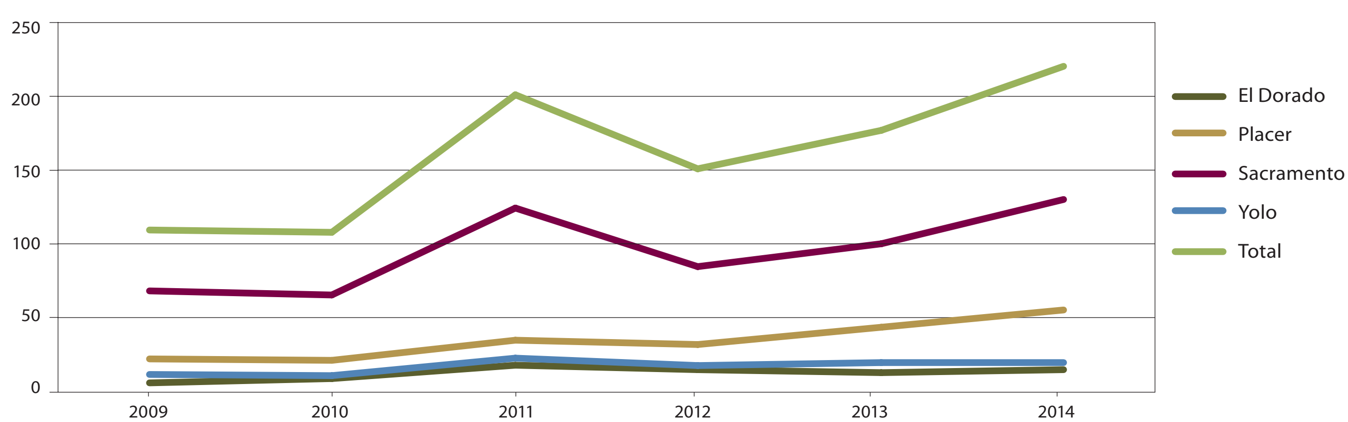
Natomas Market Place » Natomas

SBA lending serves as the key leading indicator for the small-business economy and has shown a steady and healthy improvement in the past two years. In 2014, the total dollar volume of SBA loans approved for the Sacramento MSA increased by 24%. Sacramento County, the largest county in the region, led with the largest increase at 30%, followed by Placer County at 27%. Essentially, the overall loan volume in the four-county region has doubled since 2009. The region's small-business economy appears on track for a full recovery to pre-recession levels in 2015.

Overall, small-business confidence has improved across the board compared with similar measures from last year.

Overall, small-business confidence has improved across the board compared with similar measures from last year. The most notable improvement is in the measure of credit accessibility, which increased by 9.3% during the past six months. The service sector's access to credit improved by 21%, in sharp contrast to a decline in the previous six-month period. This is significant given that the Greater Sacramento economy is driven primarily by the service sector. The manufacturing and

Figure 1
Total Dollar Amount of SBA Loans Approved in Sacramento MSA - January 2015 (in Millions)



Data Source: U.S. Small Business Administration "other" sectors also sustained high levels of confidence regarding credit conditions. All of this is consistent with increased SBA loan activity and further proof of a substantially improved local small-business economy.

We see more positive news in our Small Business Confidence Index with a 7.5% increase in the overall likelihood of new hires compared with six months ago. The manufacturing sector promises to be the best performer with a 24.4% increase in likelihood followed by the service sector with a 9.6% increase – bringing these measures to record levels of optimism.

Small businesses across the various sectors remain very upbeat regarding business prospects in 2015.

Small businesses across the various sectors remain very upbeat regarding business prospects in 2015. This measure of confidence is currently either at peak or near historic peak levels for all industries, suggesting

Figure 2
Small Business Confidence Index Trends: July 2013 – January 2015

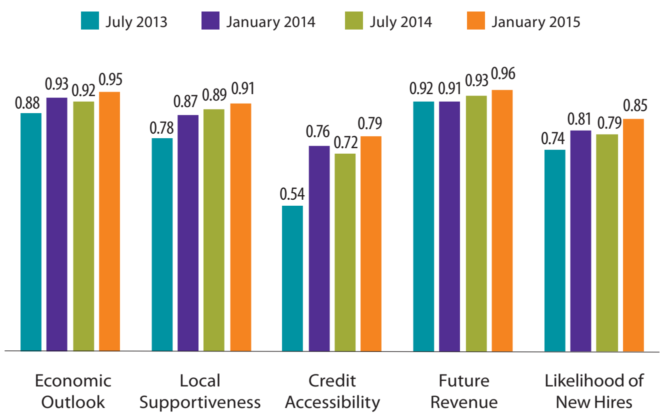


Figure 3
SBCI Trends in the Manufacturing Sector

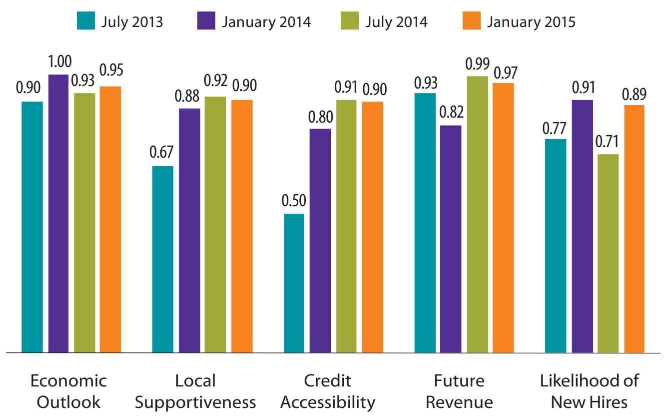


Figure 4
SBCI Trends in the Service Sector

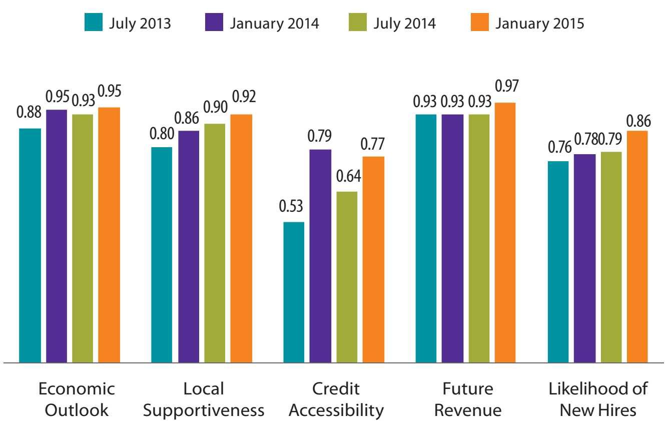
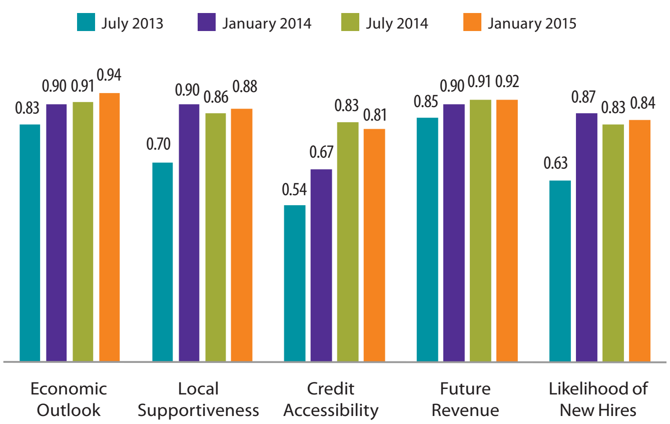


Figure 5
SBCI Trends in Others Sector



Data Source (Figures 2-5): U.S. Small Business Administration high optimism regarding future business growth and continued improvement in the small-business economy.

The number of businesses listed for sale in the Sacramento region – another key metric of small-business economic health – increased in 2014 to 742. While still below peak levels, this is 58.5% higher than in 2010. The number of actual closed sales in 2014 was 40, down from 57 in 2013.

The median revenue and cash flows of the sold businesses were $272,700 and $67,225 respectively, also lower than in 2013. The median closed sales price was 22.6% higher at $190,000 than a year earlier. We have seen some softening in the small-business listings and sales in the latter half of last year. The most recent quarter, 2014-Q4, saw a dip in the number of total transactions, median sales price, and, in particular, the median revenue and cash flows of closed sales.

Small Business Sales

Figure 6
Numbers of Listing vs. Actual Sales (Quarterly)

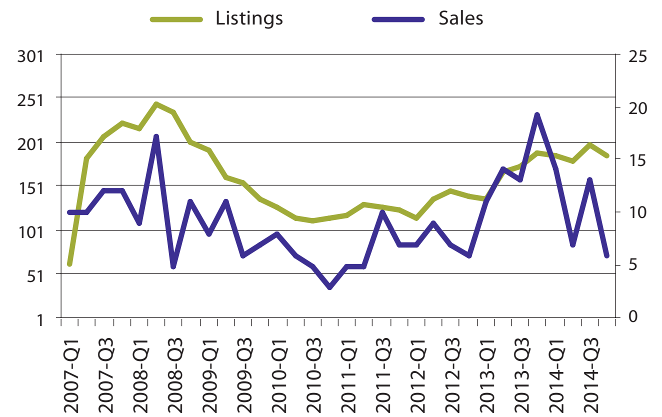


Figure 7
Median Closed Sales Price (Quarterly)

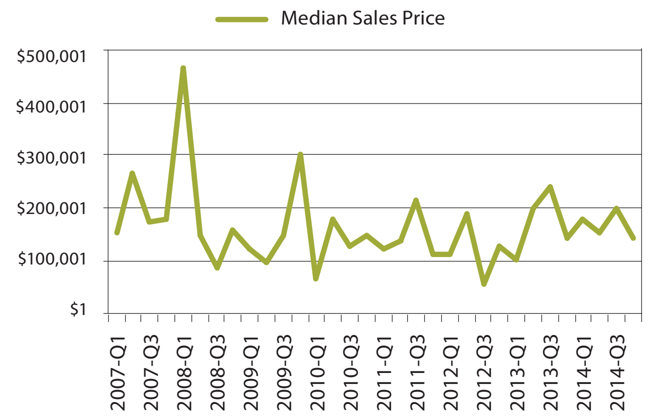


Figure 8
Median Revenue of Closed Sales (Quarterly)

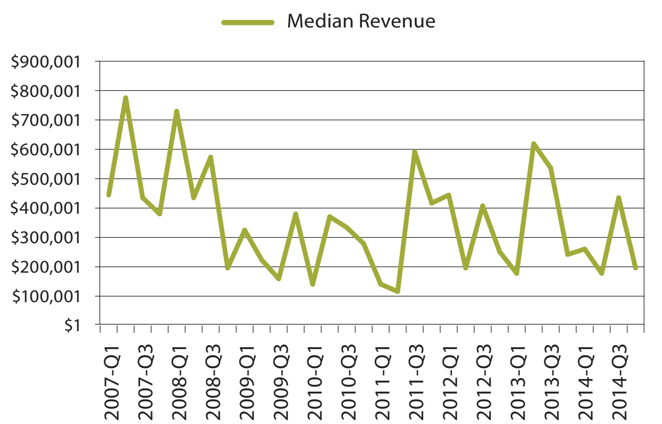
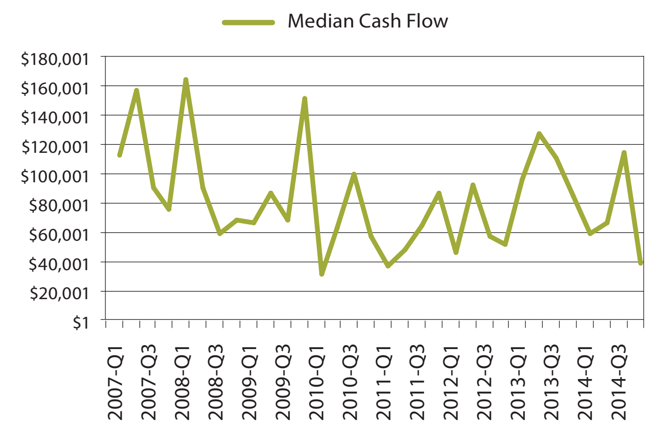


Figure 9
Median Cash Flow of Closed Sales (Quarterly)



Data Source (Figures 6-9): BizBuySell

2015 Capital Markets *Outlook*

Key Points

- Given our expectations for capital markets, companies whose revenue is driven by domestic consumption should outperform stocks of firms that rely heavily on exports.
- Inflation is not likely to be a concern for U.S. markets given the strong dollar and weak growth abroad, so the long end of the treasury yield curve should continue to experience pressure downward while the short end should see upward pressure given expectations of a Fed rate hike toward the later part of the year.
- Domestic and foreign energy producers will ultimately find an equilibrium point that fits the prevailing weak global energy demand, and emerging market economies should find relief once this point is found.
- The SBR Financial Conditions index shows positive signs as we begin 2015. Private employment, home prices, and credit demand trended upward for 2014.

The U.S. capital markets saw another solid year in 2014, one in which both treasury bonds and the stock market posted double-digit returns. In fact, 2014 was the first year since 1998 in which long-term treasuries beat stocks by more than 10%, returning 25% versus 11% for the S&P 500. However, things were not quite as rosy beyond the U.S. border. Developed economies and emerging markets struggled in 2014 and saw little growth. As the end of the year approached, central bank intervention in the Eurozone became more likely, Japan slipped back into recession, and China's real GDP was trending below its stated growth target of 7.5%. Perhaps most shockingly, crude oil prices plunged, falling below $50 per barrel by the first week of the New Year.

Our belief is that much of the gain in U.S. asset prices resulted from a "flight to safety" behavior by global investors

Our belief is that much of the gain in U.S. asset prices resulted from a "flight to safety" behavior by global investors, and we expect this trend to continue well into 2015. The evidence to support this view is compelling: Commodity prices have declined significantly due to weak global growth, and disinflation appears to be morphing into deflation in major economic regions such as China and Europe. The appetite for the relative safety of U.S. assets has already been quite evident for the first part of 2015 with the 10-year treasury yield falling below 2%. This year should be interesting given the bifurcation of economic prospects facing the U.S. and the rest of the world – will the U.S. markets be able to maintain their global leadership positions?

As for last year, we present the key macro-economic themes that we see as the most influential for capital markets in 2015.

Market	Outlook	Comment/Update
Economy	↗	Wages have room for growth, consistent GDP of 2.7%-3.0%
Global Growth	↔	U.S. growth to be offset by weakness abroad
U.S. Growth	↗	Low inflation + confident consumer = continued strength
Eurozone	↔	Stimulus measures to stave off disinflation
Emerging	↔	Reduced oil production to allow for rebound of EM currencies
Global Inflation	↔	Central bank actions to halt the downward spiral
Stocks	↗	Cont. earnings strength; Bogey looms in debt ceiling debate
Regions	U.S. > Rest of World	DM ex US = low inflation, weak to modest growth EM = high inflation, weaker growth
Sectors	Consumer	Stronger but need to see wage growth
Bonds	↔	Downward pressure on the long end with upward pressure on the short end; it is difficult to justify tightening into a flat yield curve
Regions	Eurozone	Another year of low inflation and slow growth = accommodative ECB
Sectors	Corp/Floating Rate	Remains more attractive than government debt; same holds true this year
Commodities	↘	Weak growth abroad + strong dollar = more price declines
Sectors	Agriculture	Chinese meat demand + low beef supply = best relative space in commodities sector

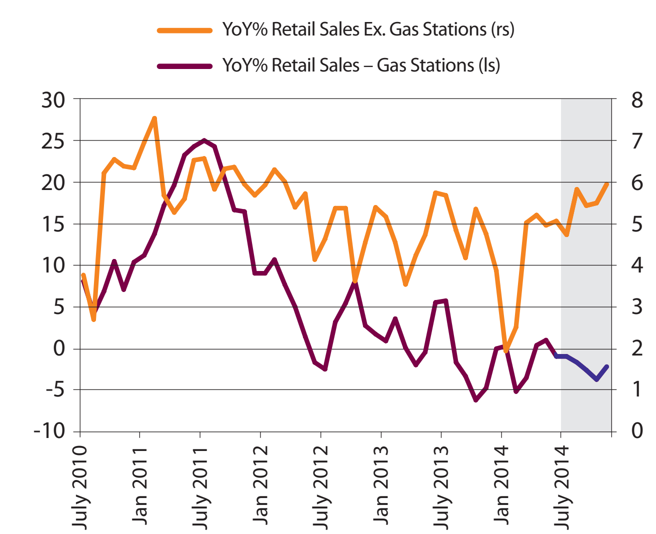
A Game of Chicken With Oil Prices

As we discussed last year, America's ability to innovate on the oil fields has put the country well on the path to energy independence with growth in oil and gas exports continuing to rise. However, this boom in domestic production coupled with weak demand and growth prospects abroad has resulted in a sudden oversupply of these resources. While American energy producers have been trying to adjust to the sharp decline in crude prices; OPEC appears dead set on maintaining current production levels.

Many suspect this is a strategic move by OPEC to curb supply by forcing higher-cost American drillers to reduce production via depressed prices. Although Saudi Arabia and other OPEC countries have denied such allegations, the fact of the matter is that in order for prices to rise, global oil demand has to increase or crude production has to fall. Given the muted global growth conditions, oil demand appears unlikely to change course any time soon. Neither OPEC nor the U.S. appears to be willing to reduce production, leading us to believe that a near-term rebound in oil prices is unlikely.

In the U.S., where economic growth is on the rise, lower oil prices have been a welcome sign to the consumer as shown by multi-year highs in consumer confidence and retail spending toward the end of 2014.

Figure 1
Gasoline Sales vs. Retail Spending



Source: Bloomberg & U.S. Dept. of Commerce

However, as OPEC may be hoping, lower prices have put significant pressure on many energy producers, particularly those who have issued substantial amounts of debt and equity capital to finance the increased levels of production. With sharp stock price declines for many producers and debt service requirements that must be kept, the market has expressed concerns regarding the ability of these producers to stay the course.

The major threats to capital markets from the low oil prices appear to come from two fronts. First, while the energy finance concentrations of the early 1980s do not appear to have found their way to 2015, the default of any sizeable producer may be enough to rattle markets and curb the steady growth that we have seen throughout the recovery. Second, energy-dependent sovereigns such as Russia and Venezuela are finding it difficult to obtain the U.S. dollars necessary to pay their debts since the oil markets still require settlement in greenbacks. As we saw in 1998, a sovereign default does have the potential to wreak havoc on capital markets globally.

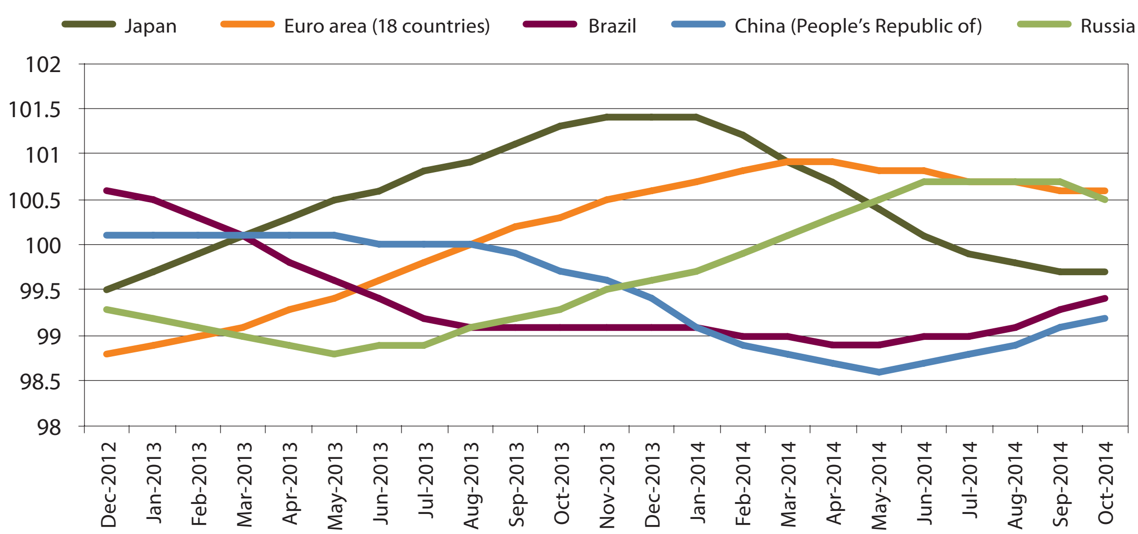
Weak Global Growth

As mentioned above, tepid growth abroad will ultimately impact U.S. capital markets in a negative manner. Although U.S. dollar strength gained from weak growth elsewhere does

initially lead to increased exports, as we saw in the third quarter, our foreign trading partners' inability to continue purchasing similar quantities of U.S. goods at high prices eventually makes its way through corporate earnings and to domestic capital markets. The strong dollar should eventually contribute to domestic GDP coming back down from its lofty 5% third-quarter reading to the range of 2.5% to 3%.

It is not all doom and gloom for capital markets abroad, however, as the Organisation for Economic Co-operation and Development's leading composite economic indicators have either turned positive or leveled off from recent declines for the countries responsible for the bulk of the economic activity abroad. Stimulus measures that are either underway or imminent for both Europe and Asia should hold the line on disinflation in the first half of 2015 with modest growth making a comeback for the second half of the year.

Figure 2
Leading Composite Indicators for Major Global Growth Drivers



Source: Organisation for Economic Co-operation and Development

The Fed Still Has a Dual Mandate … Right?

With the end of quantitative easing this last October and the Fed providing more and more hints of tightening in the later part of this year, unemployment must be on the decline and inflation must be on the rise … at least that is what the Fed's dual mandate would have us believe.

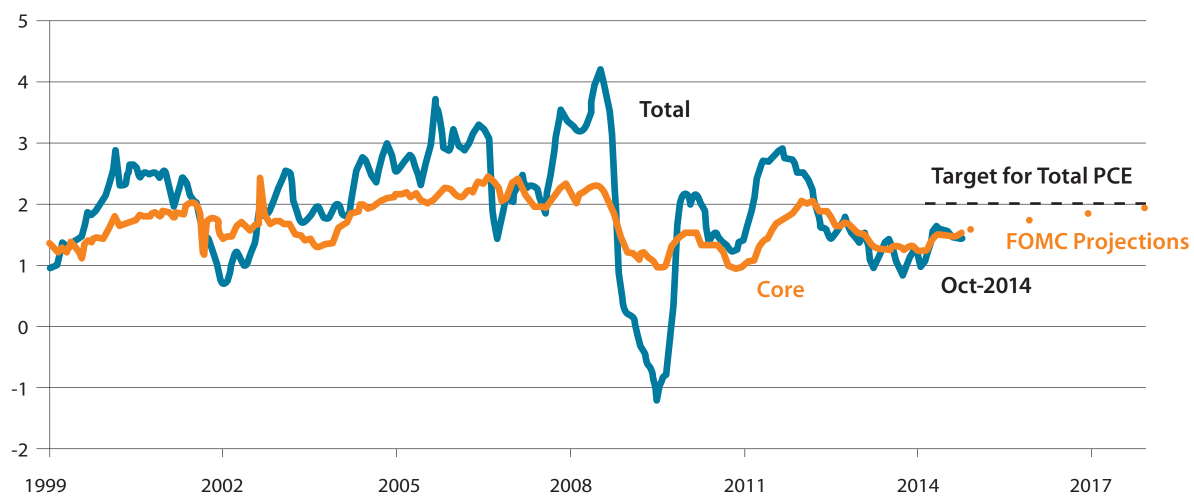
Unemployment has been on a steady downward trend with an average monthly payroll gain of 241,000 jobs through November leading to an unemployment rate of 5.8%. This positive employment trend has many thinking the Fed will soon move to tighten. What many fail to realize is that the underutilized workforce (Bureau of Labor Statistics category U6) is still above 11%, indicating there is more improvement to be had in the labor markets.

More importantly, the Fed's other key objective, to control inflation, does not appear to be in jeopardy any time in the near future.

More importantly, the Fed's other key objective, to control inflation, does not appear to be in jeopardy in the near future. As shown in the next figure, the Fed does not expect to reach target inflation of 2% until sometime after 2017. The lack of concern regarding inflation coupled with global investors' "flight to safety" behavior has been pulling down the long end of the yield curve with real returns for long-term bonds looking attractive. On the opposite end of the curve, however, rates have been inching upward in anticipation of what most believe will be a rate hike in the second quarter.

We maintain the view that the Fed will hold tight to its dual mandate and delay any rate hike until the later part of the year when unemployment and the overall economy have demonstrated some persistence in their recent, positive trends. Our expectation is for another positive year for stocks with returns in the range of 5% to 10%, and we see long-term treasuries ending the year 0.25% to 0.5% higher than where they began 2015.

Figure 3
Consumer Inflation » 12-month percent change in the price index for personal consumption expenditures



Federal Open Market Committee projections are the midpoint of the central tendency of projections from September 2014.
Source: Haver Analytics and Economic Projections of the Federal Reserve Board Members and Bank Presidents.

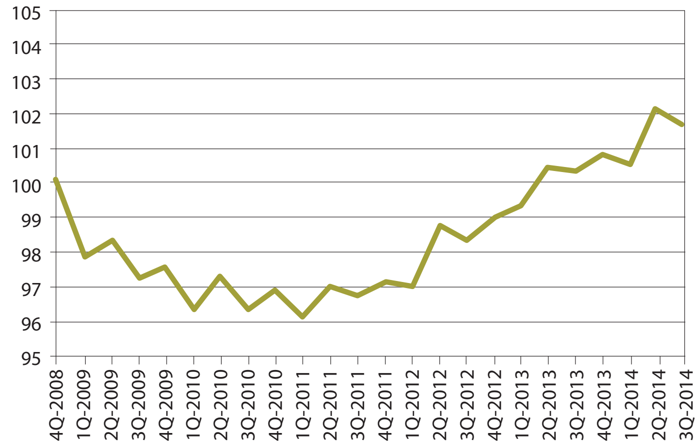
Source: Federal Reserve Bank of Chicago

Sacramento Business Review Financial Conditions Index

Our latest reading of our proprietary SBR Financial Conditions Index confirms that the region continued to grow. Our data show that the Sacramento region experienced stable private sector employment, improved home sale prices, as well as an increased demand for credit, both in volume and size of loans. Public sector employment declined slightly, which may indicate seasonal trends.

SOURCES:

Rabobank Financial Markets Research, "Oil Outlook," December 23, 2014
Wells Fargo Economics Group, "2015 Economic Outlook," December 10, 2014
Ned Davis Research, "2014 Benchmark Review," January 2, 2015
Ned Davis Research, "2015 Global Outlook," December 4, 2014
Ned Davis Research, "2015 U.S. Outlook," December 11, 2014



Thank You

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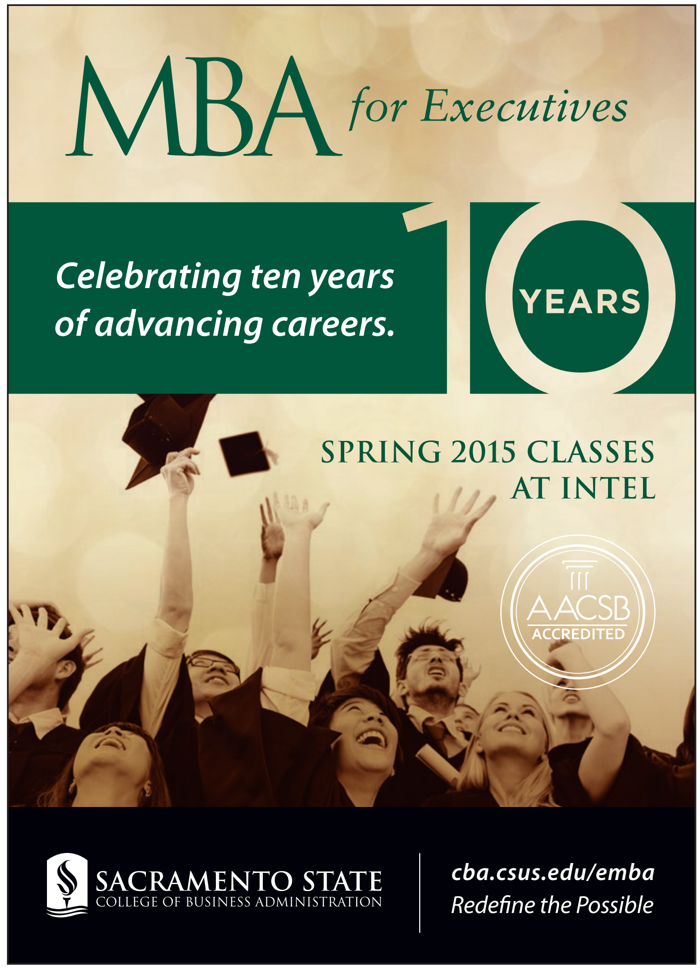
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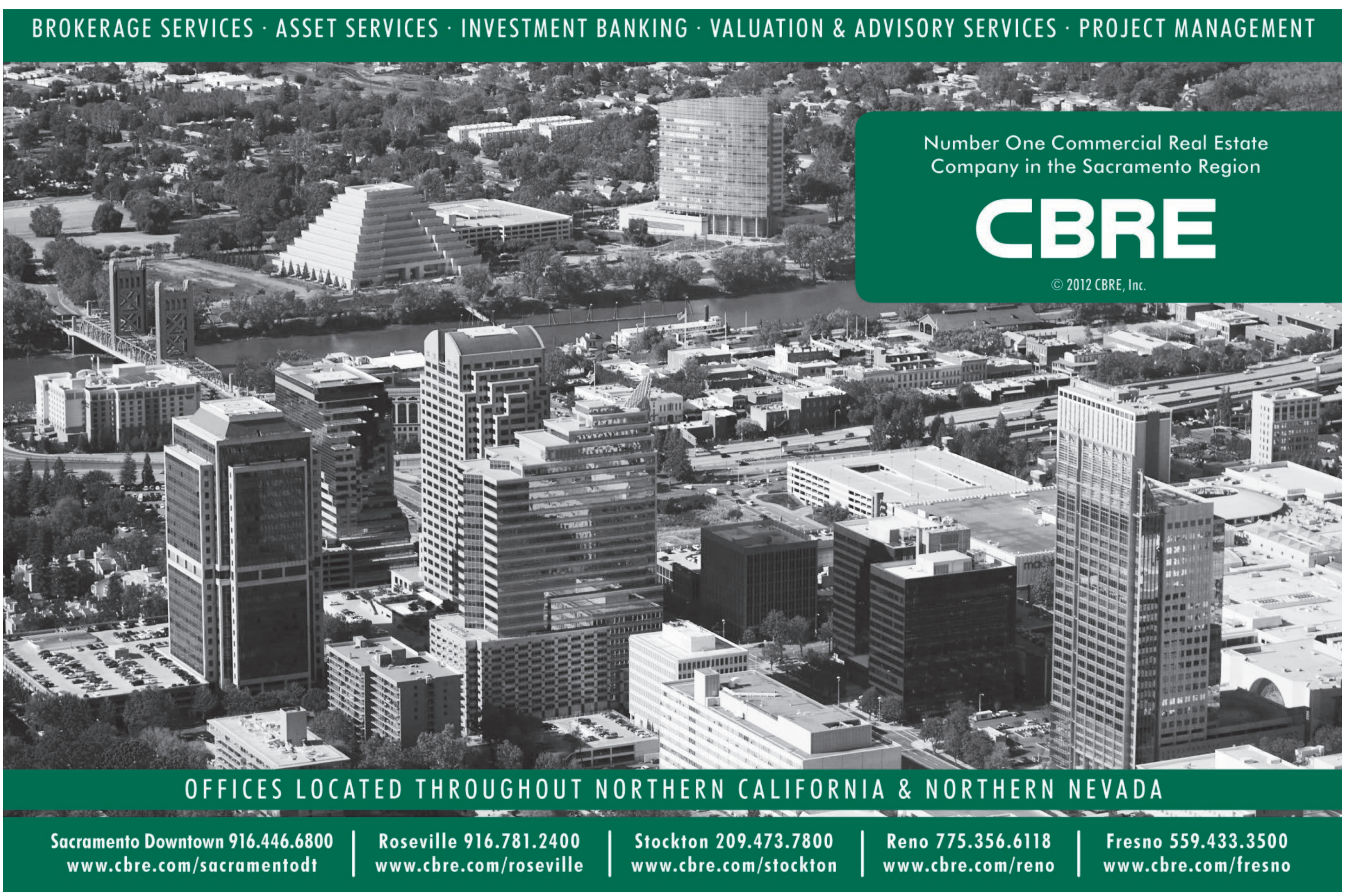
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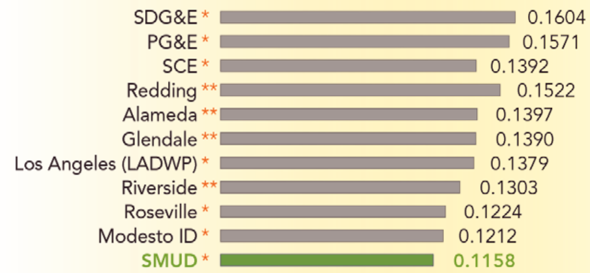

* *Data from 2013 EIA Form 826 at www.eia.gov/electricity/data/eia861/*
** *Weighted average using 2012 EIA 861 data and average rates from CMRG Survey dated April 2014.*

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