MID-YEAR 2023 ECONOMIC FORECAST ▪ EMERGING TRENDS IN SACRAMENTO'S ECONOMY

sacramento BUSINESS REVIEW

MID-YEAR 2023

Volume 15 Issue 2 » sacbusinessreview.com

Recession looms, while housing still booms.

Labor Market & Regional Economy
SBR/SAFE Credit Union Consumer Sentiment Survey
The Small Business Economy
Real Estate
Capital Markets & Banking Forecast
Human Capital Trends
Healthcare Industry Conditions
Tourism & Hospitality

MID-YEAR 2023

sacramento BUSINESS REVIEW

MISSION

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

LABOR MARKET & REGIONAL ECONOMY

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

THE SMALL BUSINESS ECONOMY

REAL ESTATE

CAPITAL MARKETS & BANKING FORECAST

HUMAN CAPITAL TRENDS

HEALTHCARE INDUSTRY CONDITIONS

TOURISM & HOSPITALITY

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MESSAGE FROM THE CHIEF ECONOMIST

Dear Friends,

The Fed's efforts to slow down the economy are working. In January I predicted: "While a recession is widely feared, we might see a soft landing in 2023." This is exactly where we are currently.

The first 6 months has surprised most pessimists, with the economy staying resilient in the face of 11 interest rate hikes, a slowing labor market, and tired consumers who are exhausted from the high inflation of last year. The Atlanta Fed is now predicting the U.S. economy to grow closer to 6% next quarter — a far cry from a recession. Perhaps the most glaring outcome has been the rapid and significant decline in headline inflation — now at 3.2% — defying skeptics who continue to insist inflation is sticky and still a problem. The stock market, a leading indicator, has reversed much of the losses from 2022, with technology firms making a strong comeback on the promise of higher productivity, especially driven by AI.

I cannot help but feel optimistic about the coming months, so long as the labor market does not deteriorate too much as we continue to bring inflation down by slowing the economy through higher rates. While I never agreed with those screaming that recession was imminent, I feel vindicated in my views regarding inflation, which I do believe will continue its downward trajectory due to global deflationary pressures. China just entered deflation this past quarter. The leading economic indicators have declined the past 11 months in a row. The Federal Reserve should pause here, as any further rate hikes will likely push our economy — which is still growing — into a sure recession. The Fed has a great track record of doing exactly that by making decisions driven more by ego and less by economic sense. As we enter election season for next year, I feel more encouraged that the Fed will not want to rock the boat too much. In fact, the stock market is already pricing in a couple of rate cuts in 2024, not rate hikes.

I do feel quite pessimistic when I see the several socio-economic challenges confronting Sacramento: housing unaffordability, a wide skills gap, rising homelessness and crime, destructive policies that impact safety and office occupancy, and of course the continuously rising state budget deficit — now projected at closer to $50 billion.

The worst is behind us, and I do a expect a soft landing as the most likely scenario, unless policy — which is the highest risk — changes that.

Warm regards,

Sanjay Varshney

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FEATURES

KEY POINTS

LABOR MARKETS & REGIONAL ECONOMY

- As of May 2023, the unemployment rate in the Sacramento region remained low, hovering around 4%, just as we had predicted in our previous issue.
- Among the local economic sectors, the Education and Healthcare Services sector experienced significant job gains, with nearly 13,000 jobs added over the past 12 months.
- The Construction sector performed the worst, experiencing a decline of more than 3,000 jobs locally over the past year due to the completion of some large construction projects.

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

- Regional and national consumer sentiment are up since our annual release in January 2023.
- Regional sentiment remains slightly higher than national sentiment overall.
- Since our annual release in January 2023, national sentiment has increased more than regional sentiment on all three indices.

SMALL BUSINESS ECONOMY

- The health of the Small Business Economy has improved relative to the beginning of 2023. Sentiment results are 4% higher than at the beginning of the year.
- Four of the five categories of the Small Business Confidence Index – *Economic Outlook*, *Business Conditions*, *New Hires*, and *Future Revenue Outlook* scored above their 18-month moving averages. Credit Access was the only category plotting below its 18-month moving average.
- Total loan volume activity is on pace to reach 2022 levels. Sacramento County and El Dorado County are up 2% and 33% versus this time last year. Placer and Yolo are down 23% and 38%. Sacramento continues making up the largest share of the volume, capturing 60% of the activity. These levels have already surpassed 2019 volume and 5-year pre-pandemic averages.
- The number of business listings declined versus last quarter, but transactions slightly increased. Multiples in closed transactions are not as expensive relative to historical numbers.

REAL ESTATE

- **Residential Market:** The Sacramento housing market has held up surprisingly well in the first half of 2023, despite the negative sentiment at the end of 2022. Home prices have recently been trending up, helped by very low supply and typical seasonal spring uptick in demand. This trend is expected to reverse, however, given recent increases in mortgage rates and the upcoming seasonally slower summer months.
- **Office Market:** This segment is showing more signs of weakness, but is still better positioned than most of the state. Large availabilities are hampering metrics and driving the vacancy rate to a seven-year high. Property values have been particularly hard hit, with no clear solution for occupancy issues happening alongside higher interest rates.
- **Industrial Market:** The industrial market is the best positioned in Sacramento. The risk of oversupply is growing as developers continue to bring large buildings to market while tenant requirements shrink. However, fundamentals remain strong and internal market risk is limited.
- **Retail Market:** The retail market is in good standing considering the last few years. Availability is near the lowest it's been since the great financial crisis of 2008, and demand remains for the region's big box spaces. However, rising interest rates continue to hamper sales activity and property values.

CAPITAL MARKETS & BANKING FORECAST

- **H1 2023 Capital Market:** High inflation and recession fears continue, with three banks failing and one voluntary liquidation. A relief rally was observed in equity markets, notably in IT firms like Tesla and NVIDIA.
- **Inflation and Interest Rates:** The economy is resilient, with slow growth, consumer spending, and low unemployment despite increased interest rates. Inflation dipped, owing to lower energy costs, resolved supply chain problems, and higher interest rates.
- **Regional Banking:** Regional credit unions and banks have experienced four quarters of increasing net charge-offs. Despite growth in deposits in Q1 2023, lending slowed due to liquidity and deposit strength worries, affecting profitability.
- **Financial Conditions:** Slight drop in the SBR Financial Conditions Index in Q1 2023 due to decreased private employment, home sales, and median sales price.

HUMAN CAPITAL TRENDS

- Organizations are concerned with the talent management landscape in 2023 — still hoping for a "return to normalcy."
- The talent market in Sacramento continues to face worker shortages. Promoting and hiring continue to increase for Fall and Winter, suggesting slight job growth.
- Post-pandemic work expectations are still not hammered out, contributing to ongoing burnout among workers.
- The skills gap leads to decreased productivity; increased recruitment challenges; higher employee turnover; competitiveness challenges; increased investment in training programs; and operational inefficiencies.

HEALTHCARE

- The new statewide CalAIM program is designed to reduce high-utilizing patients in emergency departments.
- Healthcare systems are under pressure to provide consumers with "omnichannel care" and expanded technology.
- The fiscal health of hospitals remains just out of reach due to high inflation and a burned-out labor market.

TOURISM & HOSPITALITY

- Post-COVID recovery in the Sacramento hotel industry continues, but revenues per available room have not achieved pre-COVID levels yet.
- The hotel occupancy rates are slowly increasing, but are still substantially lower than during pre-COVID times.
- Average daily rates substantially increased in the first five months of 2023 and achieved record high levels, exceeding the same period of 2019, which was the previous record year.
- Among Sacramento areas, in the first five months of 2023, Downtown demonstrated the most substantial growth in terms of occupancy rates, while Natomas experienced modest growth and two other zones (Point West and Outlying) had stable or declining occupancy rates.

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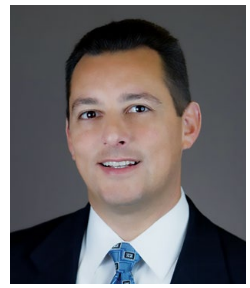

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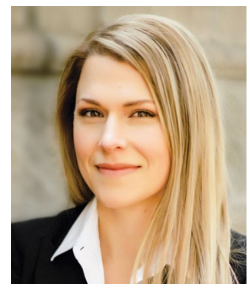

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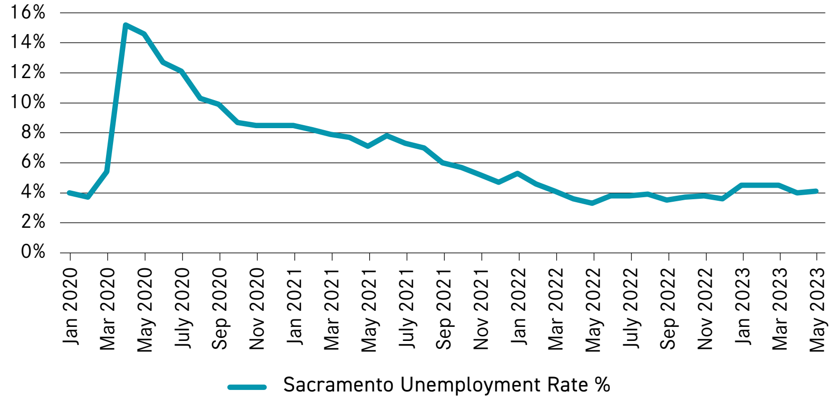
SCAN ME

Labor Markets
& Regional Economy

As of May 2023, the unemployment rate in the Sacramento region remained low, hovering around 4%, just as we had predicted in our previous issue. Simultaneously, labor force participation in the region has remained strong, with approximately 15,000 new entrants into the labor force in the last year.

AS OF MAY 2023, THE UNEMPLOYMENT RATE IN THE SACRAMENTO REGION REMAINS LOW, HOVERING AROUND 4%.

Figure 1
Sacramento Local Unemployment Rate Since the Pandemic



Data Source: California EDD

Overall, we anticipate that the labor market demand in the service sectors of Sacramento will continue to be robust, ensuring that the local unemployment rate remains below 4.5% over the next 6-12 months.

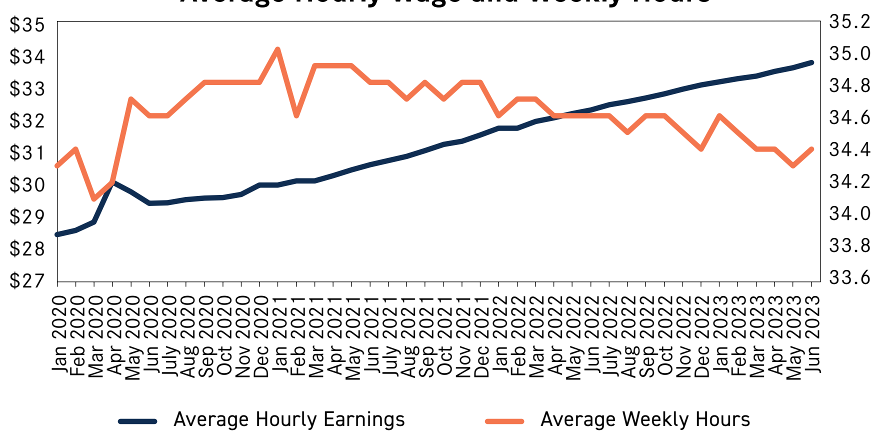
Average weekly hours declined slightly from 34.6 hours in January 2022 to 34.4 hours in June 2022. The average hourly wages have been rising since the peak of the pandemic. June hourly earnings increased 4.4% compared to the June 2022 figures, with the average weekly earnings at $1,155.8, a 3.8% increase from last year's levels. With inflation showing signs of cooling, the recent hourly wage growth figures have been positive news. June was the first month with the year-over-year wage figures surpassing inflation. The labor markets continue to show resilience, although there are some early signs of a soft landing.

Among the local economic sectors, the Education and Healthcare Services sector has experienced significant job gains, with nearly 13,000 jobs added over the past 12 months. Healthcare alone contributed over 12,000 of those jobs. Additionally, the Government sector witnessed an increase of over 7,700 jobs. Other sectors — such as Leisure and Hospitality, Professional and Business Services, and Trade, Transportation, and Utilities — have also contributed positively to job creation. However, Construction experienced a decline of more than 3,000 jobs locally over the past year due to the completion of some large construction projects. The Financial Services sector also saw a loss of nearly 1,000 jobs during the same period. Overall, we anticipate that the labor market demand in the service sectors of Sacramento will continue to be robust, ensuring that the local unemployment rate remains below 4.5% over the next 6-12 months.

Table 1 • Local Labor Market

Sacramento Local Industrial Sector	# of Jobs (as of May 2023)	Year-over-year % Change in Jobs
Total Nonfarm	1,093,900	+2.7%
Government	257,000	+3.1%
Private Education and Health Services	187,500	+7.4%
Trade, Transportation, and Utilities	170,000	+1.3%
Professional and Business Services	150,700	+2.2%
Leisure and Hospitality	112,500	+4.4%
Construction	75,000	-4.5%
Financial Activities	51,200	-1.9%
Manufacturing	40,300	+0.5%
Data Source: California EDD		

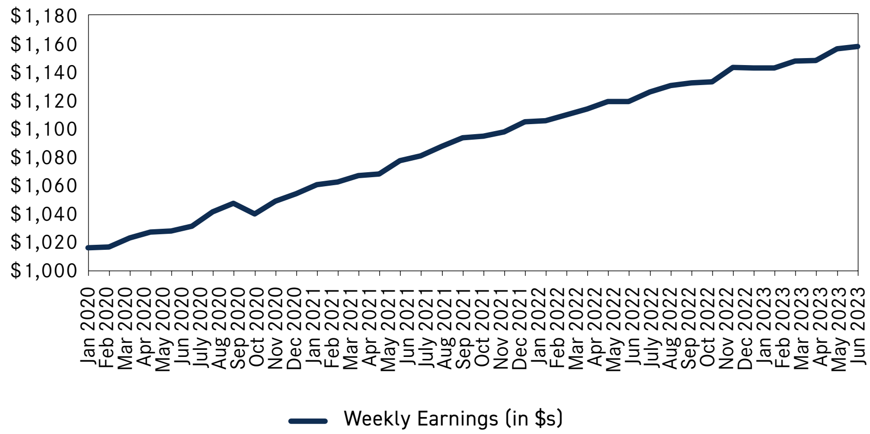
Figure 2
Average Hourly Wage and Weekly Hours

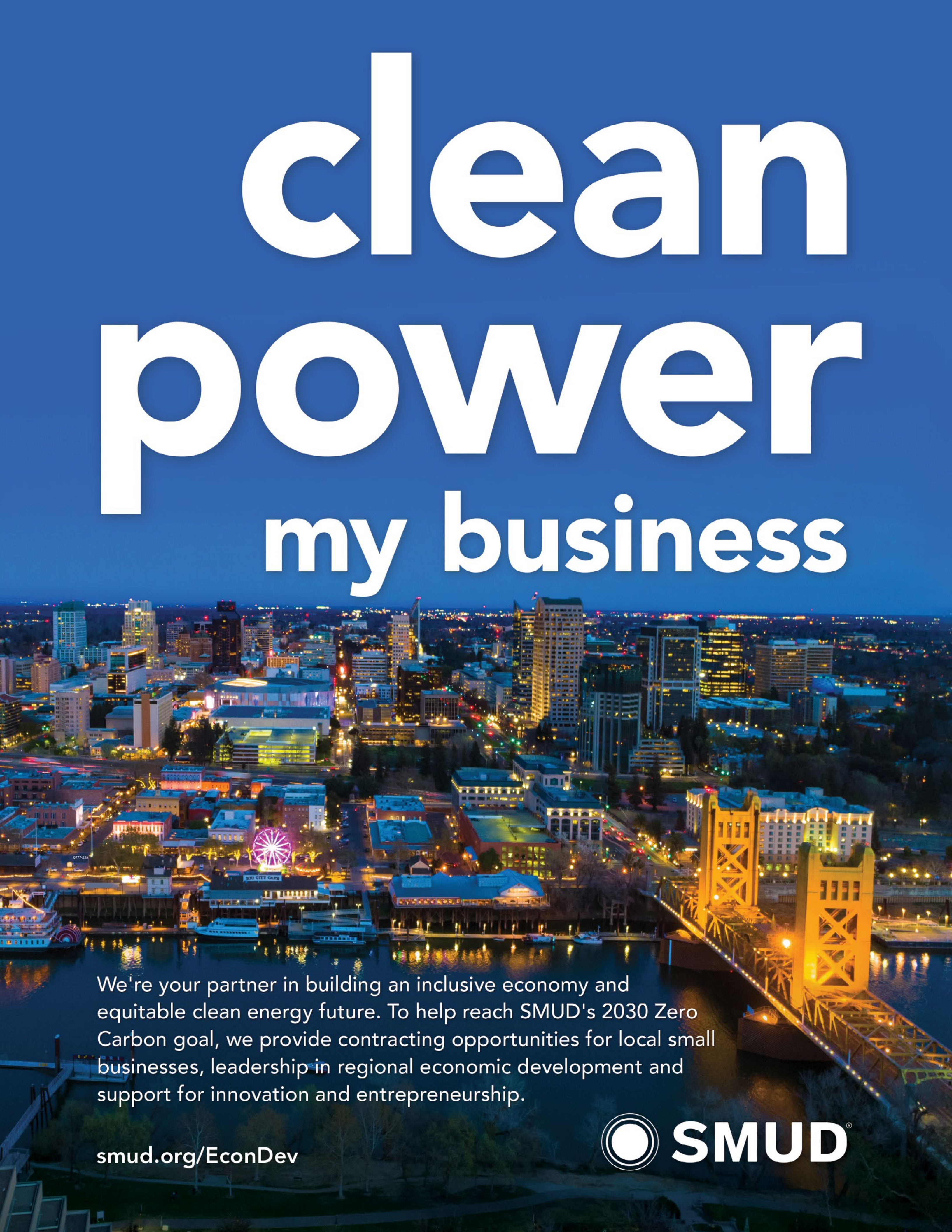


Given the strength of the labor market, we maintain our expectation that both the national and local economy will avoid recession in 2023. However, we anticipate a potential slowdown in economic growth during 2024 due to prevailing headwinds. Although the supply-chain-related inflation, as previously discussed, has dissipated, the robust labor market carries the risk of wage inflation. This, in turn, will escalate production costs and consumer prices, consequently driving up inflation further. While some households may have accumulated additional savings during the pandemic period, which positively contributes to economic growth, it also adds to inflationary pressures. In response to sustained inflation, the Federal Reserve may adopt a more aggressive approach to interest rate hikes. Furthermore, federal, state, and local governments are expected to curtail spending in the coming year.

Ongoing geopolitical tensions remain a significant risk factor, prompting businesses to urgently restructure their supply chains to enhance global market resilience, albeit at a higher cost. Financial institutions exercise caution when trading government bonds due to heightened volatility in the global financial markets, and emerging markets face restrictions on accessing capital flows. Banking crises are also emerging domestically and globally. A slowdown in global economic growth will have adverse effects on the U.S. economy in the near future, leading us to anticipate a flat economic growth in 2024.

Figure 3
Average Weekly Earnings

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Consumer Sentiment *Survey*

For the mid-year update, the Sacramento Business Review (SBR), in partnership with SAFE Credit Union, conducted another round of our regional consumer sentiment survey. The survey included measures of personal and regional economic conditions along with purchasing and credit utilization.

Regional vs. National Sentiment

The SBR team once again compared regional sentiment with national sentiment measures with the results shown in Table 1. To measure sentiment, we utilized questions from the University of Michigan Consumer Sentiment© survey that were adapted to specifically address the Sacramento region. Per methods used by the University of Michigan survey, we calculated the following three indices for the region and compared them to the national data.

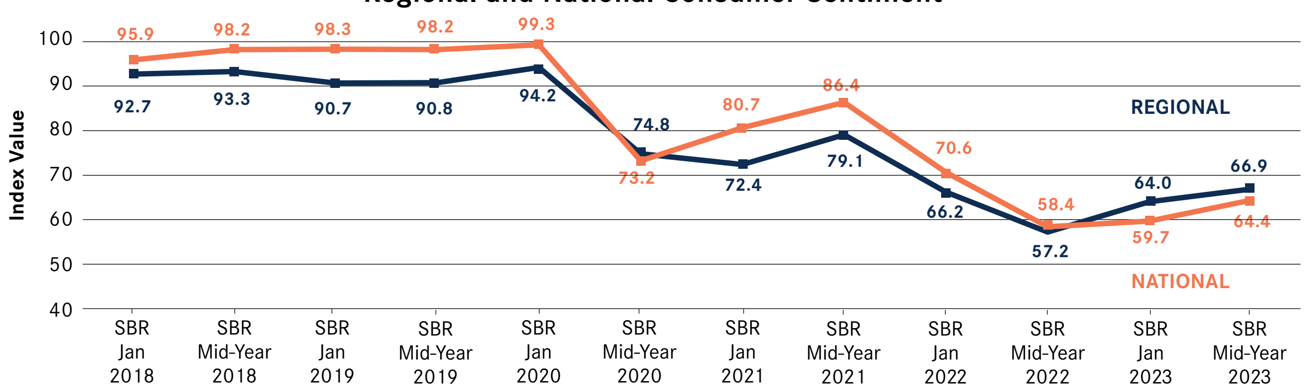
(1) Index of Consumer Sentiment: An overall measure of how consumers assess their own personal economic prospects and broader regional or national economic conditions.

(2) Index of Current Economic Conditions: A measure of how consumers assess their own personal economic prospects compared to a year ago, along with perceptions about the current market for making major household purchases.

(3) Index of Consumer Expectations: A measure of what consumers expect to happen in the future for their own finances and the regional or national economy.

Both regional and national sentiment continue to move upward. After being at the lowest point since the inception of our survey in our annual 2022 release, regional sentiment

Figure 1
Regional and National Consumer Sentiment



Notes: National data obtained from the University of Michigan Consumer Sentiment Survey, available at: https://data.sca.isr.umich.edu/. Indices calculated using the methods specified at: https://data.sca.isr.umich.edu/fetchdoc.php?docid=24770.

BOTH REGIONAL AND NATIONAL SENTIMENT CONTINUE TO MOVE UPWARD.

has rebounded almost 10 points; from 57.2 in January 2022 to 66.9 currently. (See Figure 1.) National sentiment has similarly bounced back; however, both measures remain well below where they were just a few years ago.

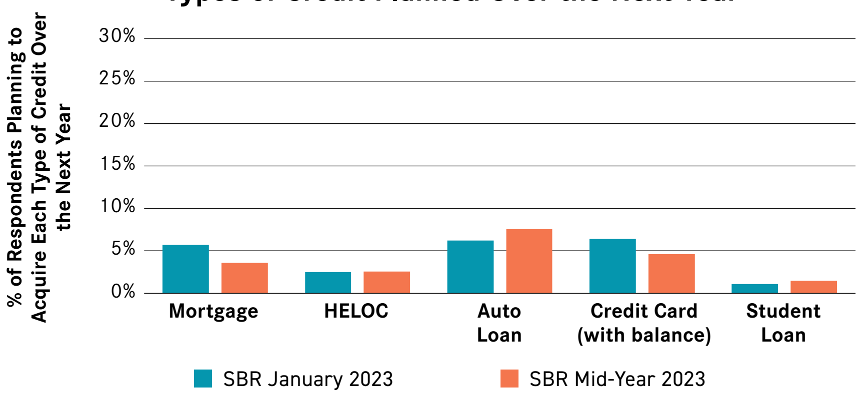
In absolute terms, regional sentiment is slightly higher than national sentiment; however, national sentiment has increased more than regional sentiment in the six months since our annual release in January 2023. Consumers nationally perceive current economic conditions as being better than regional consumers, while regional consumers exhibit more optimism for the future compared to the national data. (See Table 1.)

Table 1 • Regional vs. National

	Regional Index Score		National Index Score	
	Mid-Year Update	Change Since January 2023	Mid-Year Update	Change Since January 2023
Index of Consumer Sentiment	66.9	+2.9	64.4	+4.7
Index of Current Economic Conditions	61.8	+5.7	69.0	+9.6
Index of Consumer Expectations	70.2	+1.1	61.5	+1.6

Notes: National data obtained from the University of Michigan Consumer Sentiment Survey June 2023 Final Data, available at: https://data.sca.isr.umich.edu/. Indices calculated using the methods specified at: https://data.sca.isr.umich.edu/fetchdoc.php?docid=24770.

Figure 2
Types of Credit Planned Over the Next Year



Consumers nationally perceive current economic conditions as being better than regional consumers, while regional consumers exhibit more optimism for the future compared to the national data.

A pullback in plans to acquire mortgages could reflect cooling in the housing market and the effect of higher interest rates.

Purchasing and Credit

Compared to our annual release in January 2023, the mid-year data suggest a potential slowdown in regional consumers' plans to acquire mortgages and credit cards (with a balance). (See Figure 2 on page 15.) A pullback in plans to acquire mortgages could reflect cooling in the housing market and the effect of higher interest rates. Additionally, despite the persistence of higher interest rates, the mid-year data show an uptick in regional consumers' plans to acquire auto loans. This could be attributed to many factors, including growth in electric vehicle adoption and rebounding consumer sentiment.

Summary

Regional and national consumer sentiment continue to rebound over the past year. While still lower in absolute terms than just a few years ago, the data suggest consumers may be adjusting to the effects of higher inflation and interest rates and are beginning to feel more optimistic about their future economic prospects.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The Small Business *Economy*

Most of the data points and indicators tracked by the Sacramento Business Review (SBR) team saw a modest to sharp reversal vis-à-vis the beginning of 2023. Those indicators are the Small Business Confidence Index (SBCI), loan volume in the region, and business transactions. At first glance, the data appears to be turning the corner and moving in the right direction, but financial conditions are still tight. Tighter access to credit across sectors is still showing up in the results and is no different than national conditions.

The Small Business Confidence Index started to show a reversal in the Overall Sentiment across most categories. The *Economic Outlook* had the largest change, increasing 22% relative to the January 2023 update. Access to Credit deteriorated by 25% and continues to be challenged. The other three categories — *Local Supportiveness*, *Future Revenue Prospects*, and *New Hires* — improved by 18%, 13%, and 13%, respectively. The data is encouraging and moving in the right direction, but remains below pre-pandemic levels. Related to credit, recent figures from the *National Federation of Independent Business* (NFIB), shows that the average rate paid on short-term loans was 9.2%, nearly doubling from 12 months

Figure 1 • Overall Sentiment
(January 2011 - July 2023)

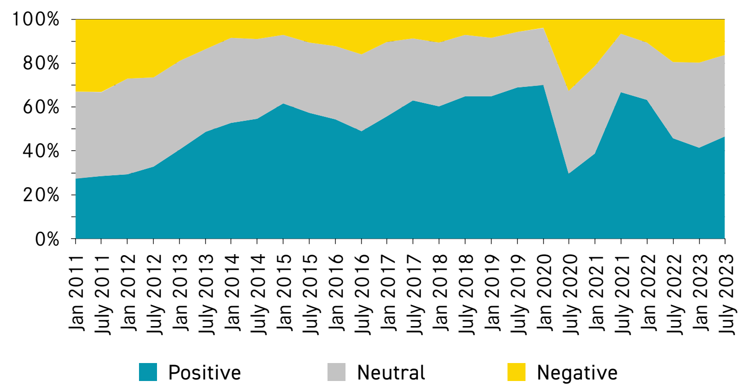
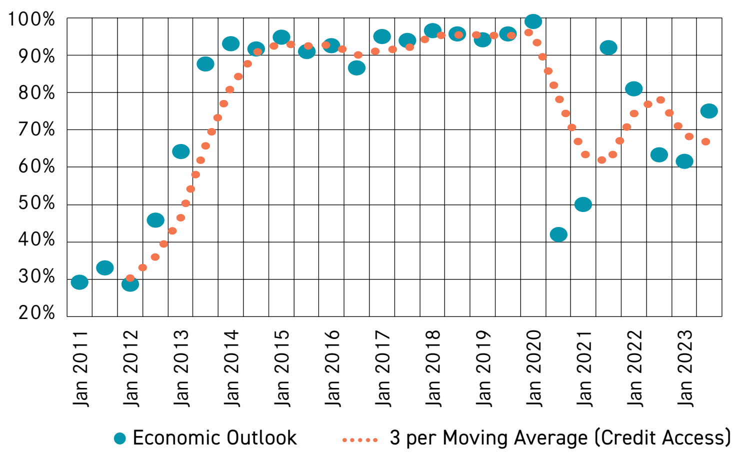


Figure 2 • SBCI Total: Economic Outlook
(18-month Moving Average)



> *Most of the data points and indicators tracked by the Sacramento Business Review (SBR) team saw a modest to sharp reversal vis-à-vis the beginning of 2023.*

ago. Respondents to this survey also indicated harder credit conditions during the next 3 months. In general, the *Economic Outlook*, *Future Revenue*, and *Likelihood of New Hires*, are moving in the same direction as national trends.

Four of the five categories — *Economic Outlook*, *Business Conditions*, *New Hires*, and *Future Revenue Outlook* came in well above their 18-month moving averages — only Credit Access came in below the 18-month moving average.

Loan volume activity data through mid-year is closely tracking last year's levels, with only a 5% decline in activity. The biggest decliners are coming from Yolo and Placer counties, dropping 38% and 23%, respectively. Sacramento and El Dorado counties are up 2% and 33% versus this time last year. The total volume so far is over $311 million, already surpassing 2019 levels as well as 5-year pre-pandemic averages. At this pace, loan volume might very well exceed last year's volume of $375 million. Sacramento is making up 60% of the volume, with Placer making up the second

Figure 3 • SBCI Total: Future Revenue Outlook
(18-month Moving Average)

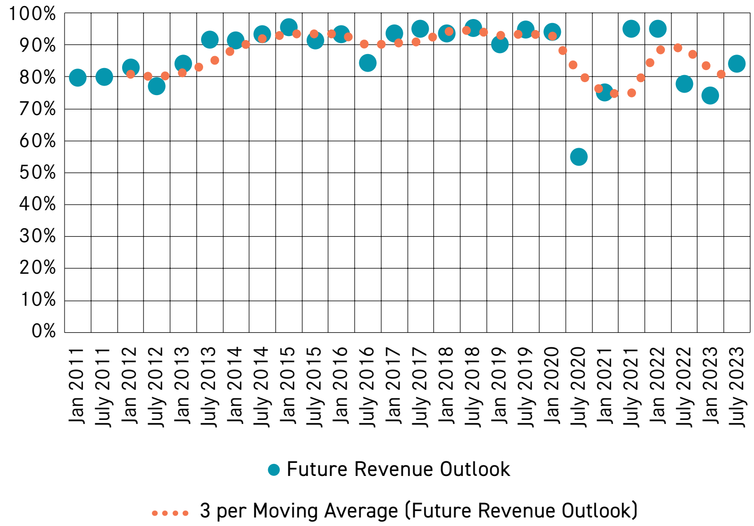


Figure 4 • SBCI Total: Credit Access
(18-month Moving Average)

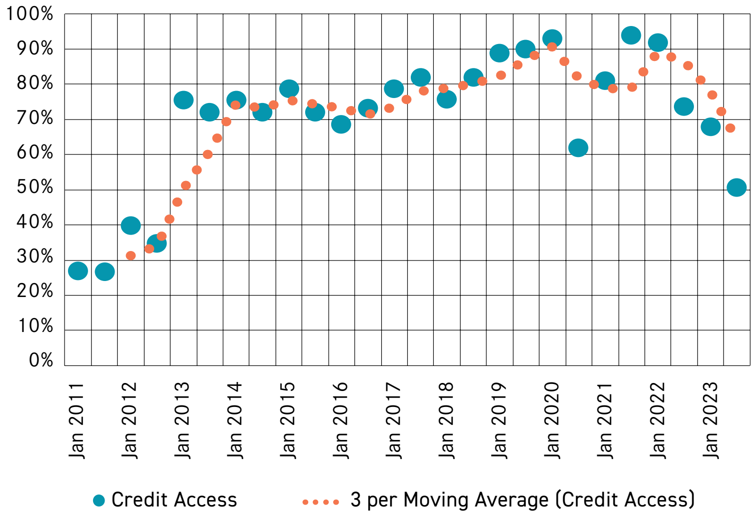
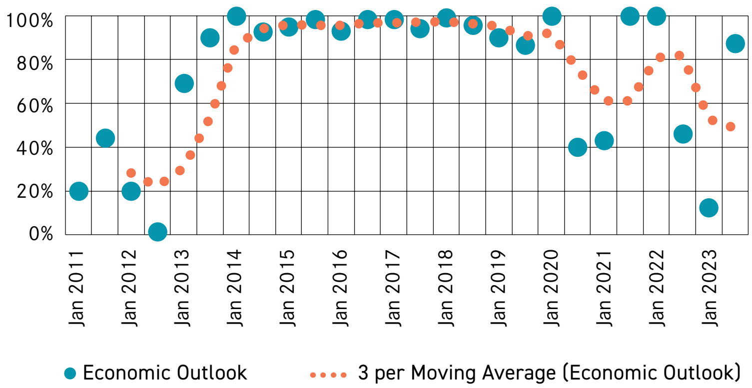


Figure 5 • SBCI Manufacturing: Economic Outlook
(18-month Moving Average)



largest share at 20%. Respondents to our survey are negative on credit, likely due to the higher costs of borrowing.

The total number of business listings slightly increased versus last quarter, but they are down 6% versus the average of last year. Transactions are up versus last quarter, and increased 4% versus the average of last year. Despite transactions stabilizing, Revenue and Cash Flow multiples are not expensive versus historical multiples.

LOAN VOLUME ACTIVITY DATA THROUGH MID-YEAR IS CLOSELY TRACKING LAST YEAR'S LEVELS, WITH ONLY A 5% DECLINE IN ACTIVITY.

Figure 6 • SBCI Service: Economic Outlook
(18-month Moving Average)

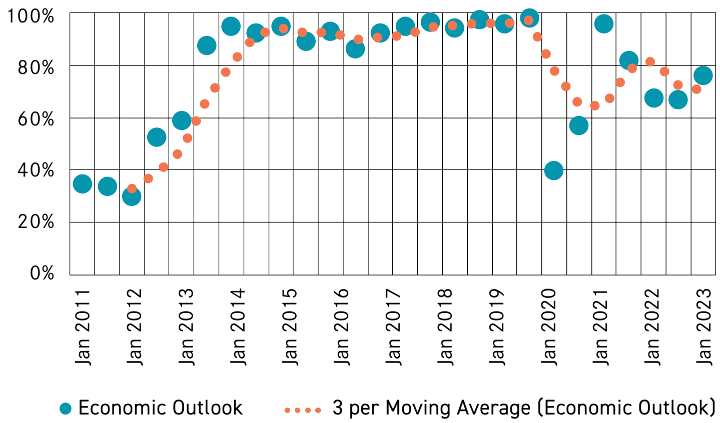


Figure 7 • SBCI Other: Economic Outlook
(18-month Moving Average)

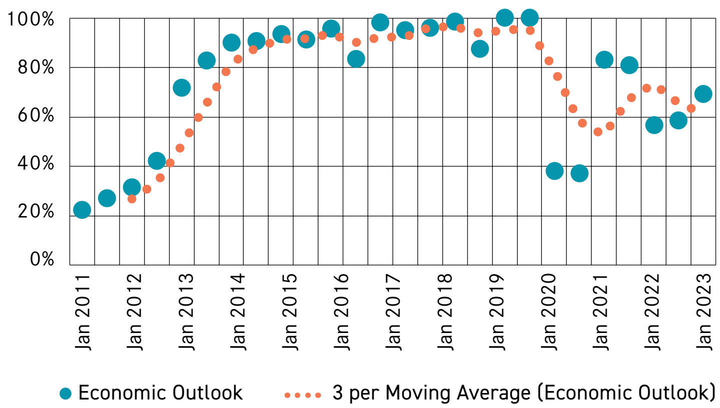
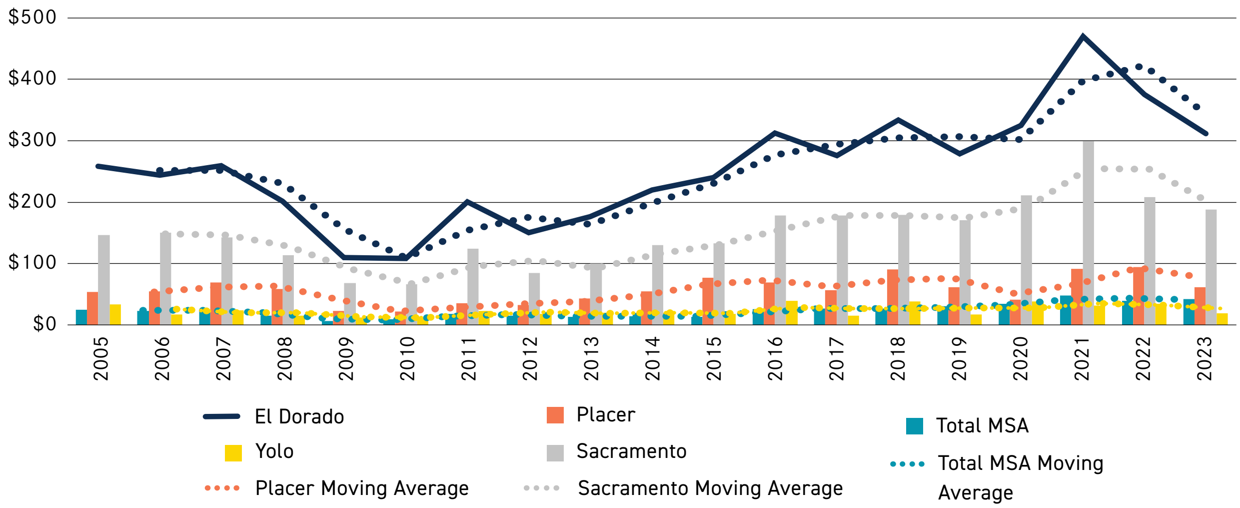


Figure 8 • Total SBA Loan Approvals By County
(in millions, 2-Year Moving Average)

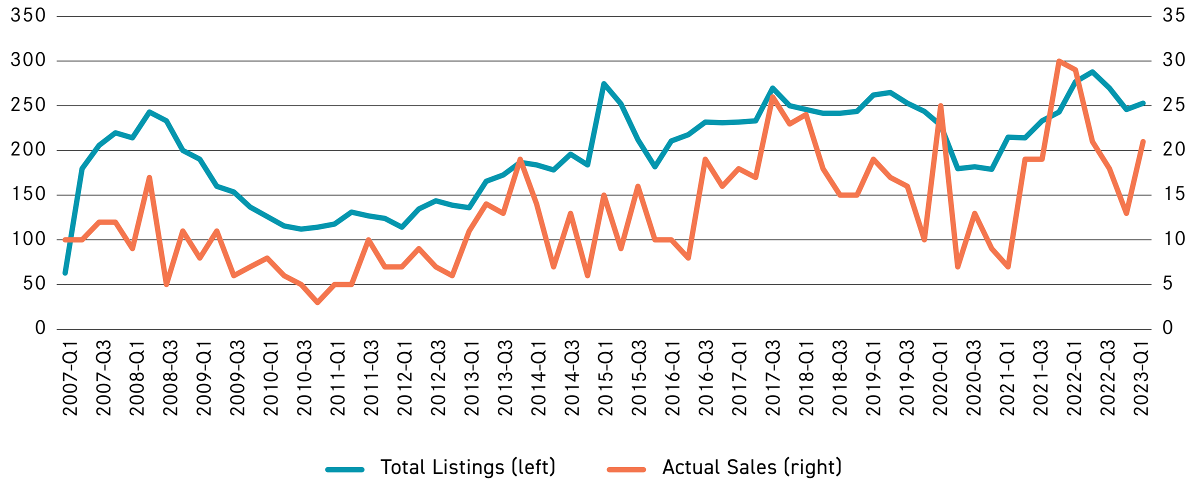


Moving Average is average of two previous data points.

Data Source: BizBuySell

The total number of business listings slightly increased versus last quarter, but they are down 6% versus the average of last year.

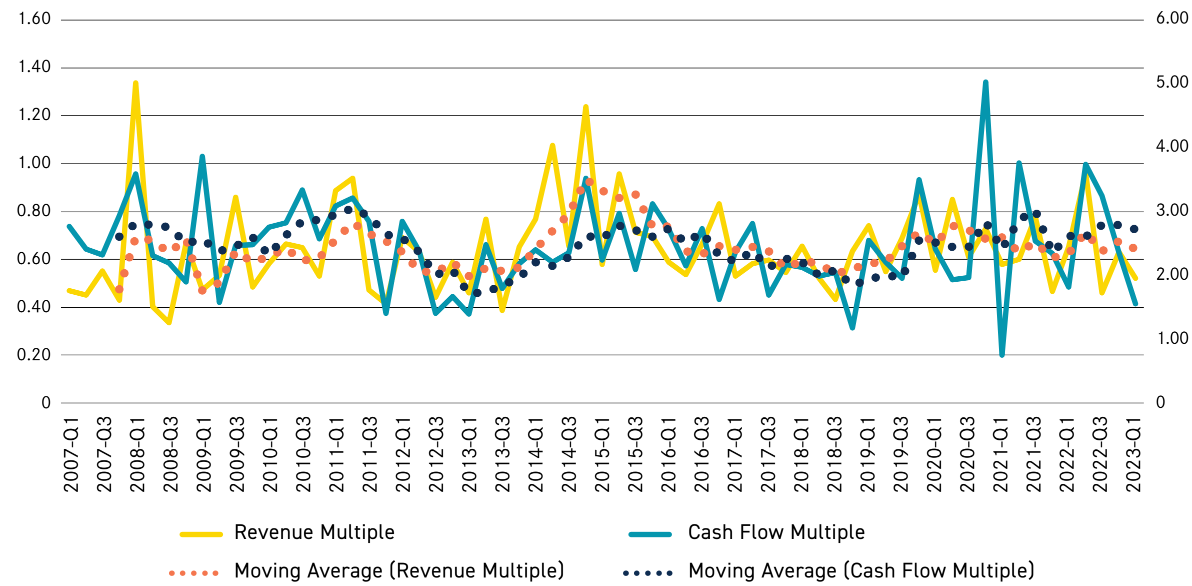
Figure 9 • Total Listings vs. Actual Sales (Quarterly)



Data Source: BizBuySell

Figure 10 • Revenue and Cash Flow Multiples (Quarterly)

(2-year Moving Average)



Data Source: BizBuySell

SMALL BUSINESS

THE MEDIAN EXISTING HOME PRICE AS OF MAY 2023 IS $544K, A 30% INCREASE FROM THE SAME TIME IN 2019.

Real Estate

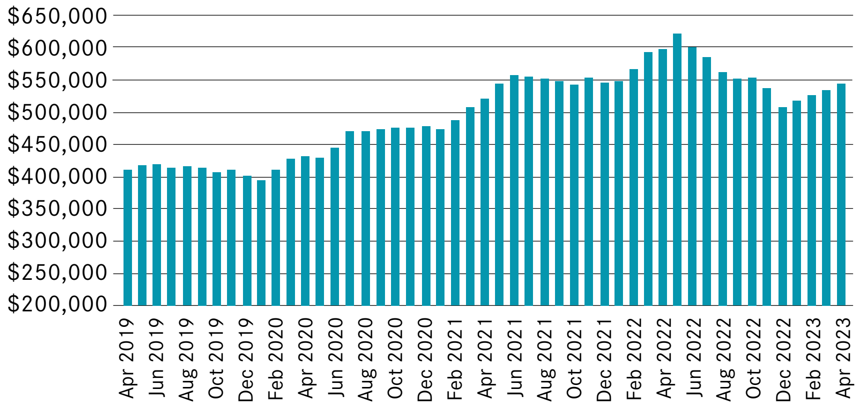
Residential

Towards the end of 2022, inflation hit a 40-year high and surging mortgage rates priced many buyers out of the market, leading to pessimism as we entered 2023. Despite the negative sentiment, the national housing market has been surprisingly resilient in 2023. The Sacramento market is no exception, and demand has held up for the first half of the year.

Many would-be sellers are unwilling to relinquish their record low mortgage rates in their current homes, creating a lock-in effect. This has led to extremely low resale supply. As of May 2023, there is currently only 1.2 months of supply in the Sacramento MSA. Home builders are successfully stepping into the supply void, adding communities and drawing buyers to the new home market. New home communities in the South Placer County submarket continue to report solid sales. Even new home communities in Rancho Cordova, a clearly oversupplied submarket, are selling adequately.

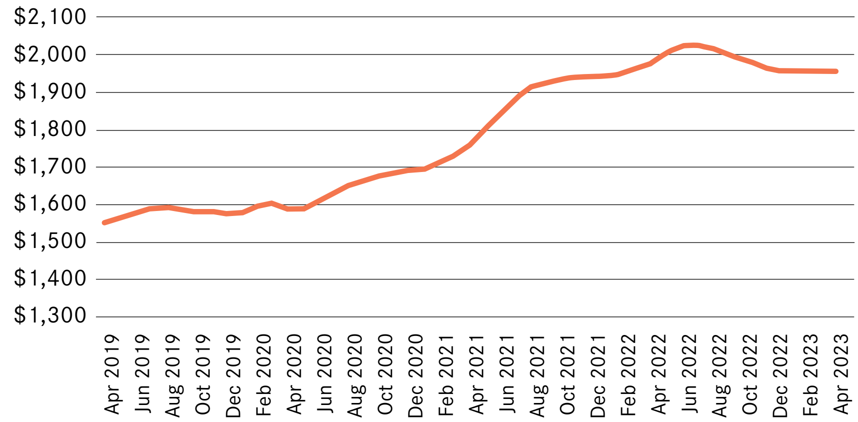
The Sacramento region has historically attracted people from more expensive markets, such as those in the Bay Area, seeking more bang for their buck.

Figure 1
Sacramento MSA Median Existing Home Price



Source: John Burns Research and Consulting Analysis of Public Records

Figure 2
Sacramento MSA Burns Apartment Rent Index™



Source: John Burns Research and Consulting

John Burns Research and Consulting's aggregation of migration data provided by Melissa found that the pandemic put this trend into overdrive. However, many large employers are now requiring employees to return to the office at least part time, and Sacramento is not commutable to job centers in the Bay Area. This will likely moderate the elevated levels of in-migration seen in recent years.

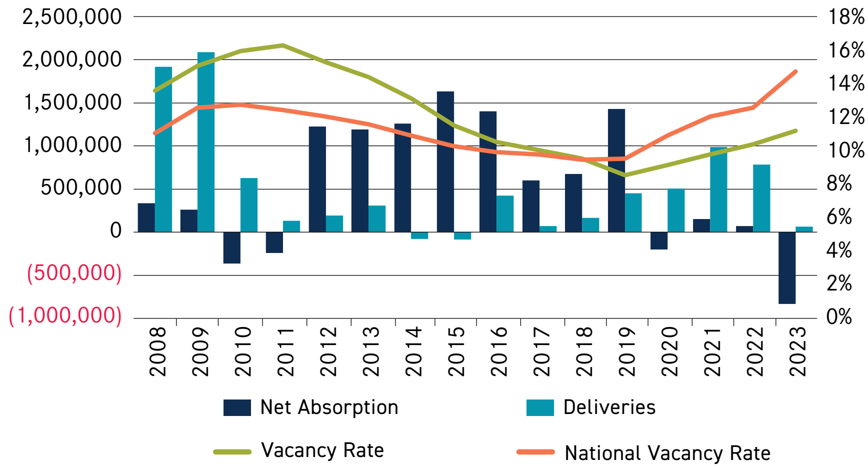
The recent influx of new residents has contributed to substantially rising housing costs, which are challenging affordability. The median existing home price as of May 2023 is $544K, a 30% increase from the same time in 2019. Builders are bridging the affordability gap through a combination of pricing and financing sales tools (namely rate buydowns). Builders commonly leverage rate-buydowns, a practice that is uncommon in the resale market. Apartment rents, however, have begun to cool. John Burns Research and Consulting's Burns Apartment Rent Index™ indicates that apartment rents in Sacramento ($1,958 in April) are down -1.1% YOY.

The Sacramento new home market has recently begun to moderate marginally, in line with the typically slower summer months. Mortgage rates recently hit 7% again, which may also impact buyer demand.

Office

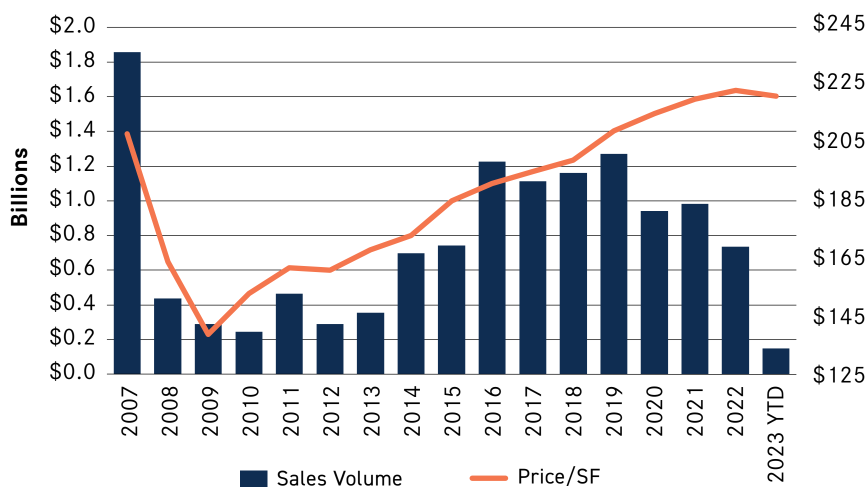
Sacramento remains one of the most stable office markets in California, but it is showing more signs of weakness. Tenants are downsizing as they seek space in newer, better located, and highly amenitized buildings, resulting in more vacant space on the market. At the same time, large blocks of sublease space continue to enter the market. For example, Centene never fully occupied

Figure 3
Office Market Activity • 2008-2023



Source: CoStar

Figure 4
Office Sales Volume & Price/Square Foot



Source: CoStar

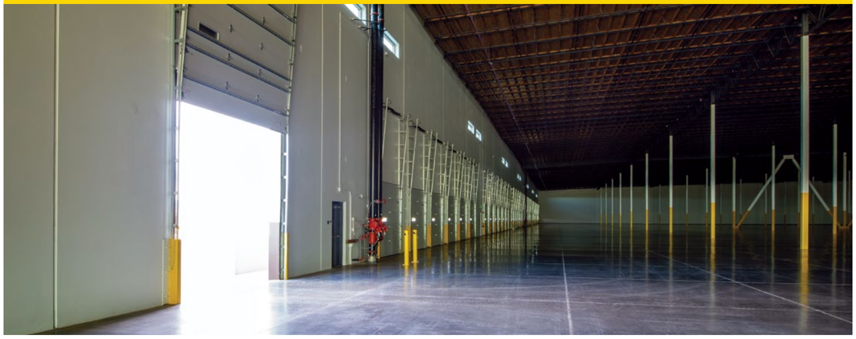
REAL ESTATE

their 500,000 square feet campus in North Natomas, and it recently announced that the two buildings were being marketed for sublease. This pushes the overall market availability rate to 14%, the highest point since 2016, but below the national average of 16.5%.

Shrinking occupier footprints are likely to continue through the end of 2024, as five-year leases signed in 2019 have yet to expire. Many office users are looking to diminish their footprint by 20-30%, while leveraging increased vacancy in the market into concessions such as free rent, lower lease rates, and increased landlord-tenant improvement contributions.

Lower occupancy levels and higher interest rates are wreaking havoc with office property values, especially in over-supplied submarkets such as the Highway 50 Corridor. One of the most salient examples is the recent sale of 2868 Prospect Park in Rancho Cordova. The building sold in April for $12.7 million. The property sold in 2019 for $25 million, a 49% reduction in value as it fell from 85% to 43% occupied. While there have only been a handful of building sales with similar loss in value, more office buildings are expected to trade at decreased prices as loan maturities approach. Total activity in the near future is expected to be similar to the low levels seen in 2009 and 2010. High interest rates, increasing vacancy rates, and a tightened lending environment are the main factors contributing to investors lack of interest in office product and decreased sales prices.

While the rest of the commercial sectors face hardship, the industrial sector continues to perform well, but is not immune to a slowing economy.

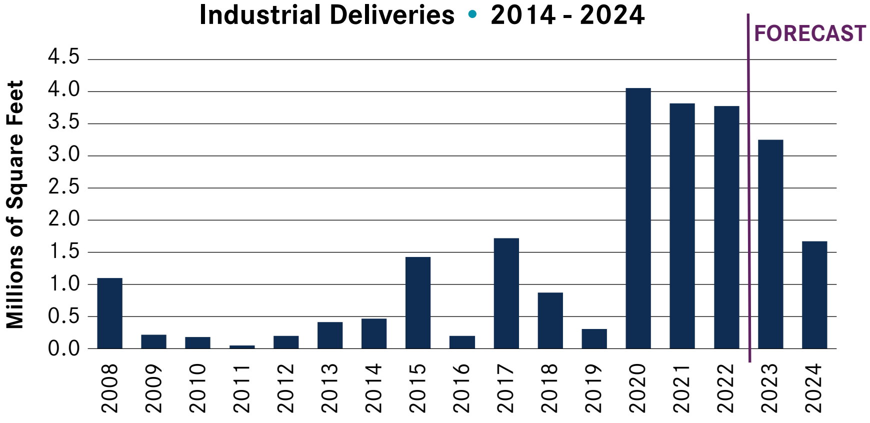


Industrial

While the rest of the commercial sectors face hardship, the industrial sector continues to perform well, but is not immune to a slowing economy. Demand for large distribution buildings has evaporated as the ecommerce boom that accompanied the pandemic has waned. At the same time, development totaling 2.6 million square feet remains — 66% of which is in buildings of 200,000 square feet or more.

The influx of new supply leads to some oversupply risk in the market, as much of the new inventory does not align with Sacramento's traditional tenant base of 50,000 to 100,000 square feet. This user base has been underserved by recent development, but will not be able to absorb such large blocks of space without considerable investment from landlords in creating individual units.

Figure 5
Industrial Deliveries • 2014 - 2024



Source: CoStar

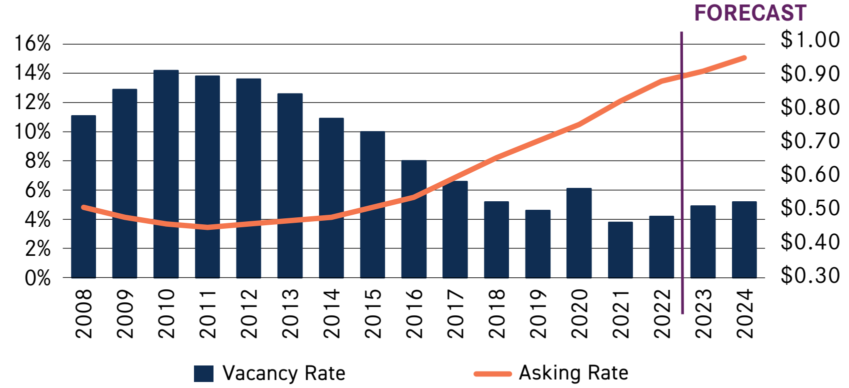
Even if these new properties linger on the market, Sacramento is still well positioned. The mid-year vacancy rate of 4.3% is below the national average, and net absorption has been positive since the fourth quarter of 2020, averaging 3 million square feet annually. The market will likely end the year very close to that number, as more than 1.3 million square feet has been absorbed so far.

Consistent demand has allowed for continued rent growth, despite increasing supply. Rent growth is up more than 7% year-over-year and ahead of the pace of inflation, but slower than the national average of 9%. The industrial market has not softened like the office sector, and tenants do not have the leverage to command similar concessions. However, there is some indication that property owners are more willing to offer something to attract tenants, especially compared to 12 to 18 months ago.

While leasing has remained strong, the sales aspect has slowed. Volume through the first half of 2023 is only $300 million, compared to $575 million in 2022. Some of the smaller figures can be traced to a transition point in the market. Buyers and sellers are still unsure as to property value in a higher cost lending environment. Additionally, the strong rent growth gives property owners options, and they may be able to refinance their properties rather than being forced to sell when loans mature. Regardless, sales will likely remain lackluster for the balance of 2023 and possibly into early 2024.

Figure 6

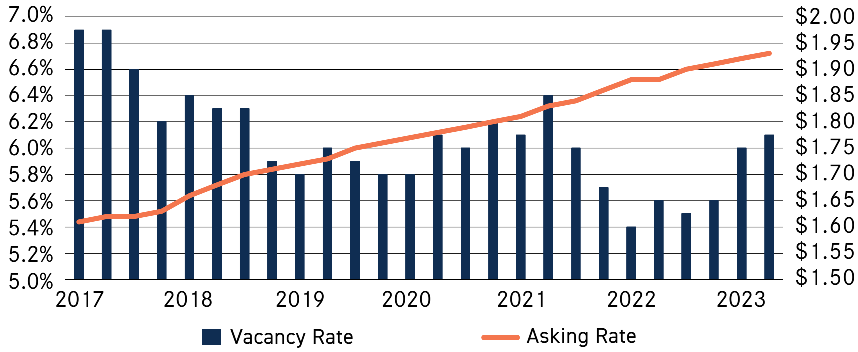
Vacancy & Average Asking Lease Rate • 2008 - 2024



Source: CoStar

Figure 7

Vacancy & Average Asking Lease Rate • 2017 - 2023



Source: CoStar

Retail

The retail sector remains on solid footing and leasing activity remains strong. The market has benefited from the lack of construction in recent years, helping to keep the availability rate low. Current levels are some of the lowest since the great financial crisis and are not expected to increase significantly in the coming months.

Net absorption was negative through the first half of 2023, totaling -344,000 square feet. Most of that negative figure comes from the Sunrise Mall, as that property prepares to be redeveloped. Strong interest remains for Sacramento's big box spaces, especially from fitness users and discount retailers, two tenant types that have been active in the market for some time. Additionally, a number of new restaurants have opened throughout the region, especially in Roseville, Folsom, and Downtown.

Like the rest of the market, retail sales activity has slowed with the increase in interest rates. Fortunately, the underlying market fundamentals are strong, helping some deals to close. Grocery-anchored retail in particular has been resilient and continues to see demand from investors, as those properties are insulated from online competition and have been some of the best performing retail shopping centers.

REAL ESTATE

Capital Markets & Banking *Forecast*

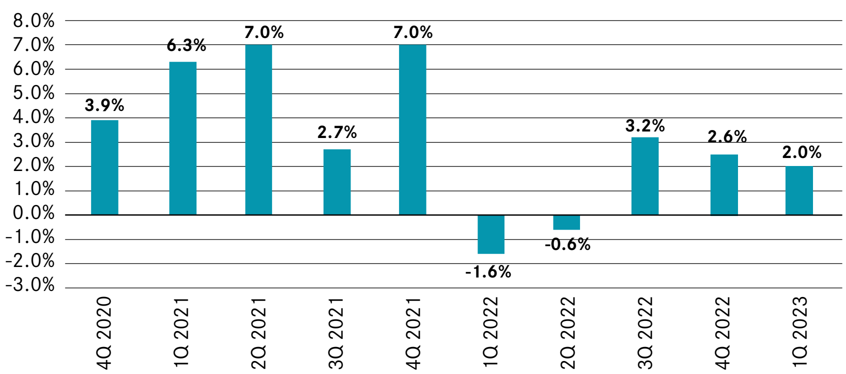
> *In the first half of 2023, the economic environment was marked by continued high inflation, tightening monetary policy, and concerns about a potential recession.*

Overview of Capital Market Events

In the first half of 2023, the economic environment was marked by continued high inflation, tightening monetary policy, and concerns about a potential recession. This period witnessed the failure of three regional banks; Silicon Valley Bank, Signature Bank, and First Republic Bank. Additionally, Silvergate Bank opted for voluntary liquidation.

Despite these headwinds, investors experienced a needed relief rally to start 2023 after 2022, which was one of the worst years in history for both equity and fixed-income markets. Equity markets, in particular, benefited from moderated inflation numbers and the Federal Reserve's indication that peak interest rates were approaching. Despite higher interest rates, the economy demonstrated resilience, with continued growth (albeit at a slow pace), consumer spending, and low unemployment.

Figure 1 • Real GDP Growth (year-over-year, quarterly)



Source: Bureau of Economic Analysis. Real GDP Growth, year-over-year, quarterly.

In terms of sector performance, the Information Technology sector played a significant role in driving equity gains. This was evident in the notable divergence between the year-to-date performance of the NASDAQ and S&P 500 indices. The gains were concentrated in a few specific companies. Tesla experienced a relief rally after a significant decline the previous year, and NVIDIA — which is viewed as the primary beneficiary of the burgeoning Artificial Intelligence market — increased significantly. Although initial public offering (IPO) activity remained sluggish, the combination of higher equity valuations and pent-up demand could lead to a surge in IPO issuance in the coming quarters. Conversely, the Energy sector was the worst performer, as declining oil and natural gas prices weighed on stocks in that space.

Looking ahead, equity market participants are closely monitoring declining corporate profit margins to determine the sustainability of the current rally. The trade-off between a potential recession and a soft landing will be actively debated, as the Federal Reserve considers its next set of interest rate decisions. In the fixed income market, the yield curve has remained inverted for over a year. Within the credit sector, higher interest rates have made refinancing more challenging, especially for smaller companies. Leveraged loans have experienced the highest default levels in over two years and are projected to continue rising.

On the equity front, the recent rally has overextended valuations. Coupled with weakening earnings and macroeconomic headwinds, we are forecasting negative returns for the S&P 500 in the low single digits for the second half of 2023. For the fixed income sector, the SBR team thinks the Fed may push short-term rates to the 5.75% range by year-end. Longer term rates are likely to remain near current levels, i.e., 3.75% to 4.00% for the 10-year UST, with demand offset by Fed balance sheet run-off.

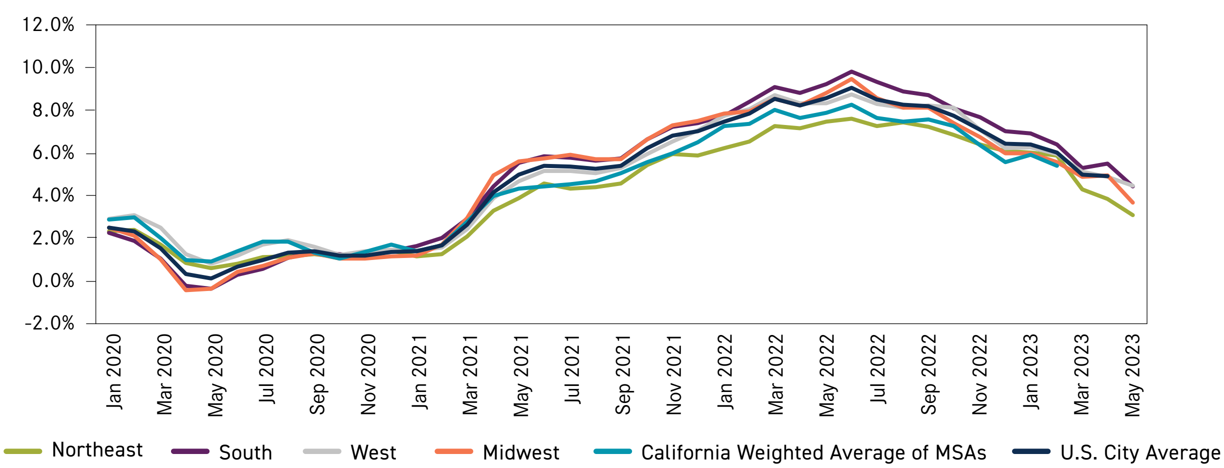
The trade-off between a potential recession and a soft landing will be actively debated as the Federal Reserve considers its next set of interest rate decisions.

Inflation

In May 2023, the Labor Department reported a year-on-year surge of 4.0% in the Consumer Price Index (CPI), marking a deceleration from the previous month's figure of 4.9%. The contraction in the inflation rate is primarily attributable to a reduction in energy prices, relief in supply chain tensions, and increasing interest rates, reflecting tangible progress in the Federal Reserve's ongoing battle against inflation. The Consumer Price Index (CPI) trends for California's urban consumers have been closely aligned with the broader U.S. CPI trends.

The Federal Reserve Bank of Chicago reports that the differential inflation rates across U.S. regions from January 2019 to January 2023 were predominantly driven by disparities in the housing sector. It is worth noting that the Midwest demonstrates a significantly lower housing budget when compared to the Northeast or West, which consequently results in subdued inflation within the Midwest. Additionally, regions with comprehensive public transportation infrastructure were less impacted by the surge in used car market prices or fluctuations in energy costs.

Figure 2 • Regional CPI (year-over-year, for the period ending May 2023)



CAPITAL MARKETS & BANKING

AMERICAN CONSUMERS HAVE SIGNIFICANTLY INCREASED THEIR RELIANCE ON CREDIT CARDS.

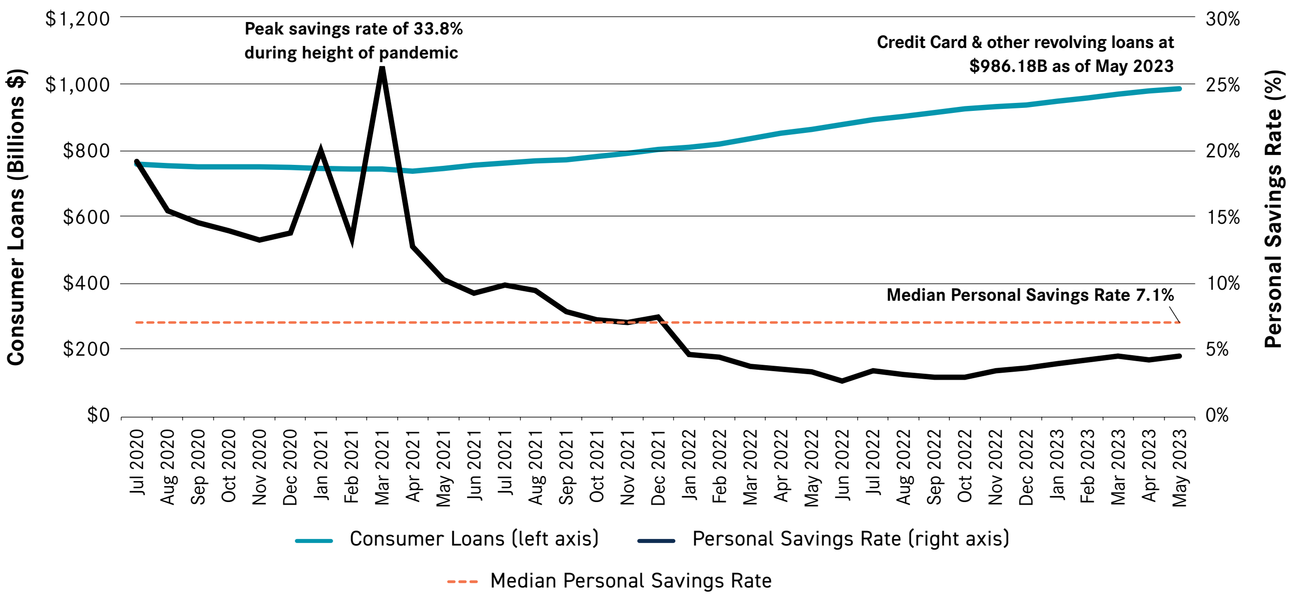
Consumer Credit Trends

In response to the ongoing inflationary pressures, American consumers have significantly increased their reliance on credit cards, causing the collective outstanding debt to rise to approximately $986 billion as of May 2023, as reported by the Federal Reserve Bank of New York. This figure represents a substantial 15% increase in credit card debt from the previous year.

An anomalous trend has been observed for the first time in nearly two decades, as credit card balances did not decline in Q1 2023, following the typical increase during Q4 for holiday expenses. Instead, balances remained steady, suggesting an elevated reliance on credit cards to manage monthly expenses.

Despite a modest uptick in consumer confidence, real consumer spending has contracted, causing some market observers to question the sustainability of current spending behaviors. Specifically, April 2023 saw a decline in real spending of over 3% compared to the same period in the previous year, marking the second consecutive month of decline. Furthermore, a decline in real spending growth has been seen across all demographic groups, irrespective of age and income, signaling widespread economic challenges. With signs of inflation continuing to show cooling, it makes sense that we would start seeing consumer health deteriorating, especially since consumers have been bearing most of the weight of these increased prices for the past 18 months. Nationally, credit card and all consumer loan net charge-offs are up quarter-over-quarter.

Figure 3 • Consumer Loans and Personal Savings Rate By Date



Regional Banking Trends

Regional credit union and regional bank net charge-offs are up 2 basis points and 1 basis point, respectively. Net charge-offs have risen for four consecutive quarters for regional credit unions. In Q4 2022, most large banks increased their provisions for loan losses, and we have seen that trickle into the regional banking system and increase even further in Q1 2023. Regional credit unions increased their allowance for credit losses by 65%, with regional banks increasing their allowance by 5%. Net charge-offs as a function of total loan loss provisions has also increased for regional banks and credit unions.

Regional banks and credit unions alike both experienced deposit growth for the first quarter of 2023. With liquidity and deposits strength continuing to be a concern for financial institutions, it appears they are slowing down loan growth. Many regional financial institutions have historically seen a funding advantage relative to other borrowing indications, but with the cost of funds significantly rising and the deep inversion of the curve, many institutions are seeing this funding advantage dissipate quickly.

From a loan growth perspective, many regional financial institutions appeared to be overly aggressive in the past couple of years, and as a result, competition drove margins in these products lower and lower. With liquidity still a major concern and profitability declining generally in these loan products, we are seeing regional financial institutions dial back on their loan growth so it can more closely match the deposit growth.

Figure 4 • Regional Credit Union Net Charge-Offs and National Credit Card/Consumer Loan Net Charge-Offs (%)

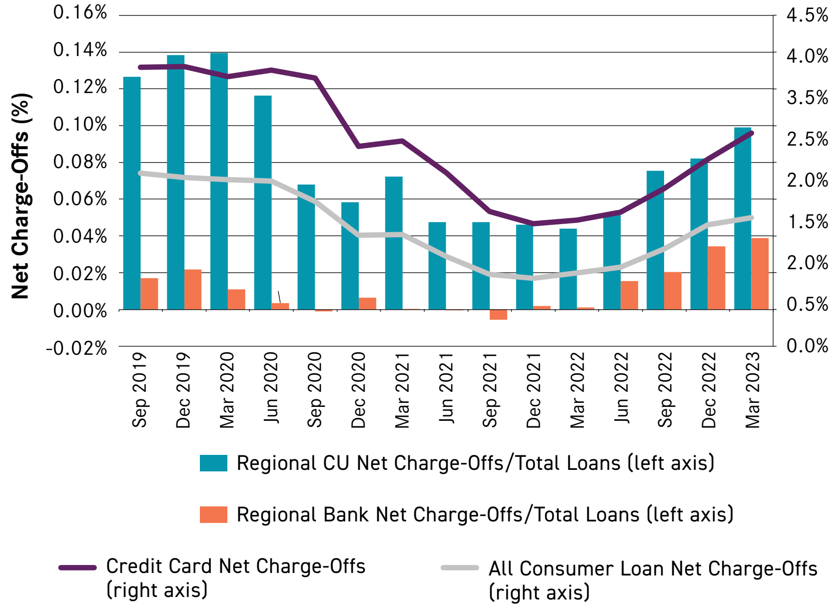


Figure 5 • QoQ Loan & Deposit Growth – Regional Credit Unions

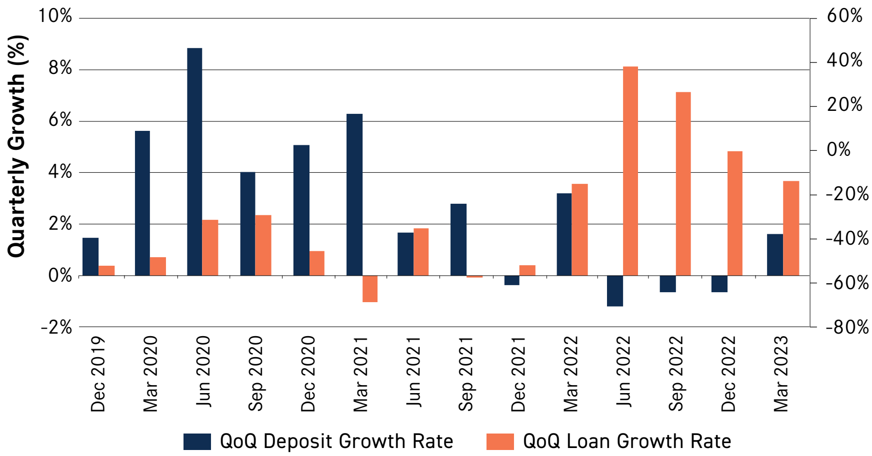
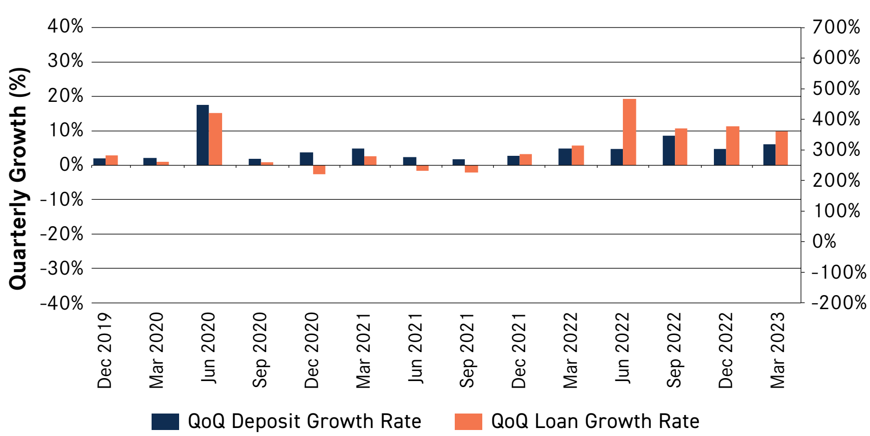


Figure 6 • QoQ Loan & Deposit Growth – Regional Banks

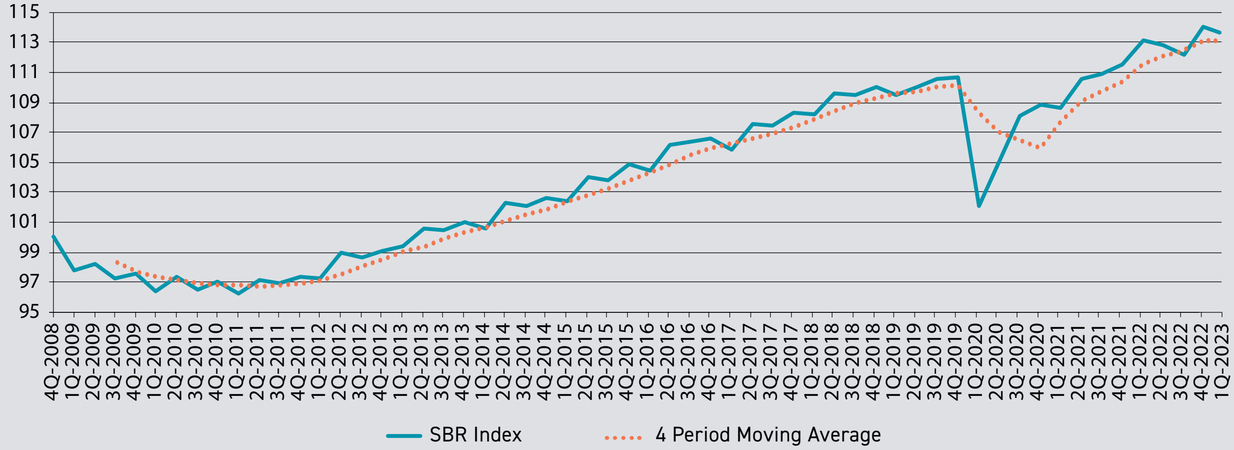


CAPITAL MARKETS & BANKING

Capital Markets & Banking *Forecast*

Sacramento Business Review Financial Conditions Index (with 2-year moving average)

The SBR Financial Conditions index slightly declined from Q4 2022 to Q1 2023 (-0.34%). Private employment, which represents a weight of 30% in the index, fell a little over 1% quarter-over-quarter. In addition to this driver, total home sales and the median sales price for a home both fell quarter-over-quarter, 13.4% and 2.6%, respectively.* These three components were the largest drivers for the SBR Financial Conditions Index declining over first quarter of 2023.



*Source: John Burns Research and Consulting aggregation of public records data

REGIONAL CREDIT UNION AND REGIONAL BANK NET CHARGE-OFFS ARE UP 2 BASIS POINTS AND 1 BASIS POINT, RESPECTIVELY.

MID-YEAR UPDATE

Human Capital Trends

ORGANIZATIONS ARE STILL FOCUSED ON UPSKILLING AND RESKILLING EFFORTS, BUT POSITIONS OFTEN REMAIN UNFILLED FOR MONTHS.

The persistent skills gaps and talent management challenges are becoming a recurring theme. Organizations are still focused on upskilling and reskilling efforts, but positions often remain unfilled for months. Employees express a strong need for further training and development, as organizations are not adequately prepared to meet these needs. Alongside the lack of training, workers feel that their employers are failing to provide fulfillment and growth opportunities, leading them to either stagnate within the organization or leave altogether.

The skills gap has several significant effects as described below:

1. **Reduced productivity:** When there is a mismatch between the skills required for a job and the skills possessed by the available workforce, organizations experience decreased productivity. Employees struggle to perform their tasks efficiently and effectively, leading to delays, errors, and subpar outcomes.

2. **Increased recruitment challenges:** Organizations are having difficulties finding qualified candidates for open positions. There are longer recruitment cycles, higher recruitment costs, and increased competition for skilled talent. This can delay important projects and hinder growth.

3. **Higher employee turnover:** When employees feel that their skills are not adequately utilized or developed, they seek opportunities elsewhere. This turnover is costly for organizations in terms of recruitment, onboarding, and lost institutional knowledge. It also disrupts team dynamics and leads to decreased morale among remaining employees.

4. **Hindered innovation and competitiveness:** The skills gap hampers an organization's ability to stay competitive. Lack of specialized skills and knowledge limits an organization's capacity to adopt new technologies, implement new strategies, and respond to evolving market demands.

5. **Increased reliance on training and development:** Organizations need to invest more in training and development programs to bridge the skills gap. This can strain resources and budgets, requiring careful planning and allocation of resources to address the specific skill needs of employees.

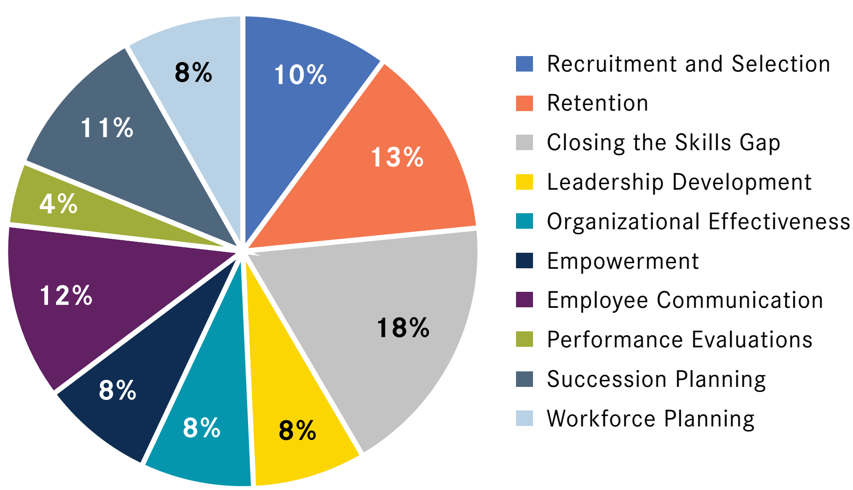
6. **Inefficiencies in operations:** When employees lack the necessary skills to perform their roles optimally, it can lead to inefficiencies in daily operations. This, in turn, can result in increased errors, rework, and delays, which negatively impact customer satisfaction and overall business performance.

To mitigate the impact of the skills gap, Sacramento enterprises are looking at implementing strategies such as upskilling and reskilling programs, partnering with educational institutions, fostering a learning culture, and offering competitive compensation and benefits to attract and retain skilled talent.

The key performance indicators (KPIs) expected to impact business performance include retention as a top concern, followed by hiring, training and development, and succession planning. Employee communication remains crucial as we continue to move through uncertain circumstances (see Figure 1).

The key performance indicators (KPIs) expected to impact business performance include retention as a top concern, followed by hiring, training and development, and succession planning.

Figure 1
Areas of Focus Q3 and Q4



Healthcare *Industry Conditions*

> ACCORDING TO THE CALIFORNIA HEALTH CARE FOUNDATION, ABOUT 1 IN 3 CALIFORNIANS DEPEND ON MEDI-CAL FOR THEIR HEALTHCARE BENEFITS.

Note: Medi-Cal provides healthcare benefits to approximately one in three Californians, including: seniors, children, and families living in poverty; people living with disabilities; homeless people; children with complex medical conditions and those in foster care; and people transitioning from incarceration.

Progress and New Programs but Uncertain Financial Health

The biggest change to California's healthcare landscape this year has been the introduction of the Department of Health Care Services' California Advancing and Innovating Medi-Cal (CalAIM) program on January 1, 2023. CalAIM is an ambitious 5-year state-funded plan designed to significantly improve services and outcomes for the state's most vulnerable citizens. According to the California Health Care Foundation, about one in three Californians depend on Medi-Cal for their healthcare benefits. Hospitals stand to benefit greatly if CalAIM can help reduce the enormous cost incurred from treating those who visit emergency rooms most. Communities stand to benefit from the decreased financial and societal toll associated with unmet health and social needs.

As the region slowly recovers from the fiscal downturn brought about by the pandemic, adaptation to new norms — particularly telehealth — is part of the economic recovery. According to McKinsey & Company, telehealth utilization has stabilized at levels at least 38 times higher than before the pandemic. *Fortune Business Insights* estimates that the telemedicine market size will grow at a compound annual growth rate (CAGR) of 19.7% from 2022 to 2030.

Most providers welcome virtual care as long as financial parity is met by the payer. Cyberattacks and data breaches remain the largest threats to the telemedicine market, with the potential for huge financial losses for hospitals and healthcare systems, forcing these entities to invest heavily in cyber protection.

The response to innovation in healthcare is strong. Healthcare leaders are searching for ways to differentiate themselves, increase revenue through streamlined operations, and improve the health of their customer base using technology, particularly Artificial Intelligence (AI). There is a growing recognition that consumers want to engage in preventive health. This has resulted in a strong and competitive market for health and wellness apps, predictive analysis, RPM (remote patient monitoring), and technology platforms that can use AI to mine the massive amount of data generated by wearables. Healthcare systems face increasing pressure to engage in *"omnichannel healthcare"* — an array of channels used to communicate and interact with healthcare consumers.

NURSES REMAIN AT RISK OF BURNOUT AND EXHAUSTION EVEN WHILE TECHNOLOGY SOLUTIONS IMPROVE HEALTHCARE

Healthcare systems face increasing pressure to engage in "omnichannel healthcare" — an array of channels used to communicate and interact with healthcare consumers.

Figure 1
Telemedicine Market Size, 2020 to 2030 (USD Billion)

Source: precedenceresearch.blogspot.com/2021/12/telemedicine-market.html

The 2023 healthcare industry faces challenging conditions, largely tied to continued high inflation rates and labor costs. Provider burnout remains a high priority for healthcare leaders. One in three nurses said they are likely to leave their career, even as the public health emergency was declared over.

The fiscal health of hospitals in the Sacramento region reflects that of the state: High inflation continues to eat away at the slow recovery of many facilities that have not even regained pre-pandemic revenue streams. According to the California Hospital Association, one in five hospitals throughout the state are at risk of closure, and more than half of them are operating at a loss (*Sacramento Business Journal*, May 2023).

Governor Newsom announced a $150 million loan fund to help hospitals at risk of closure to stay afloat, but industry leaders say that it is insufficient. In the Sacramento region, operating losses were announced publicly by Eskaton Senior Living facilities and Adventist Health, while Sutter Health made a positive turnaround from the last two years after suffering significant operating losses. Other local healthcare systems appear to be stabilizing, and UC Davis, Sutter Davis, and Kaiser are moving forward with plans for expansion.

MID-YEAR UPDATE

Tourism & Hospitality

> *The occupancy rates have shown a consistently positive trend since 2020, but they still remain significantly lower compared to the pre-COVID period.*

THE AVERAGE DAILY RATE FOR SACRAMENTO HOTELS SIGNIFICANTLY INCREASED IN 2023.

Sacramento Hotels' Revenues

The estimates provided below for the first five months of 2023 are based on summary statistics for four zones (Downtown, Point West, Natomas, and Outlying hotels) as provided by the Sacramento Convention & Visitors Bureau through the end of May 2023.

The trend of increasing revenues for Sacramento hotels and the recovery after the impact of COVID, as reported in the previous issue of SBR, continued during the first five months of 2023. If this trend persists throughout the year, there is expected to be a relatively substantial growth (more than 20%) in Sacramento hotels' revenues compared to 2022, and a growth of more than 60% compared to 2021. However, it is still anticipated that the revenues will not yet surpass the record high of 2019.

Hotels' Occupancy Rates

The occupancy rates have shown a consistently positive trend since 2020, but they still remain significantly lower compared to the pre-COVID period. When comparing the first five months of 2018 through 2023, the highest level of occupancy achieved was in January-May of 2019 (78.1%), which remains the peak during this timeframe. Following a decline to 52.8% in January-May of 2020, there has been moderate growth in each subsequent year. In the first five months of 2023, Sacramento hotels reached an occupancy rate of 66.7%, which is still considerably lower than the peak level in 2019.

The occupancy rate dynamics varied among the three segments of hotel guests: transient, group, and, contract travelers. The transient travelers segment made the largest contribution and showed the most significant growth. In the first five months of 2023, this segment occupied 49.7% of available hotel space, compared to 46.6% and 48.5% in the same period of 2022 and 2021, respectively. The group segment remained at a much lower occupancy level than before COVID, although the share of available rooms occupied by this segment slightly increased (reaching 12.4% in the first five months of 2023, compared to 11.5% and 3.6% in the same periods of 2022 and 2021, respectively). The share of contract travelers continued to decline, accounting for 4.7% of available hotel rooms in January-May of 2023, compared to 5.0% and 8.2% in the same period of 2022 and 2021, respectively.

Pricing Trends

The Average Daily Rate (ADR) for Sacramento hotels significantly increased in 2023, reaching $142.9 in January-May compared to $125.4 in the same period of 2022. This marks the highest amount in recorded history for the first five months of the year, surpassing the previous record of $132.5, which was established in 2019.

Revenues from Hotel Tourism

The Revenue Per Available Room (RevPAR) indicator demonstrates a growth trend similar to the average daily rate (ADR) when compared to previous years. However, unlike ADR, RevPAR has not yet reached a record high and still remains below the pre-COVID level of 2019. In the first five months of 2023, there was a noticeable increase in RevPAR compared to 2022 and the COVID-impacted years. The RevPAR for January-May of 2023 was $96.4, whereas it was $79.3, $58.9, and $58.6 in the same period of 2022, 2021, and 2020, respectively. However, when comparing it to 2019, there is still a decline, as the RevPAR for January-May of that year was $103.6.

Geographic Segmentation of Sacramento Hotels

The aforementioned trends had varying impacts on the four geographic segments of the Sacramento market: Downtown, Point West, Natomas, and Outlying. Among these zones, Downtown (Zone 1, as per the Sacramento Convention and Visitors Bureau) demonstrated the most significant growth in the first five months of 2023 when compared to the same period in 2022: an 8.7% increase in occupancy rates, a 15.3% increase in ADR, and a 25.4% increase in RevPAR. The second segment with notable growth was Natomas (Zone 3), which experienced a 1.4% increase in occupancy rates, a 10.6% increase in ADR, and a 12.2% increase in RevPAR.

Figure 1

Sacramento Hotels • Occupancy Rates (January-May)

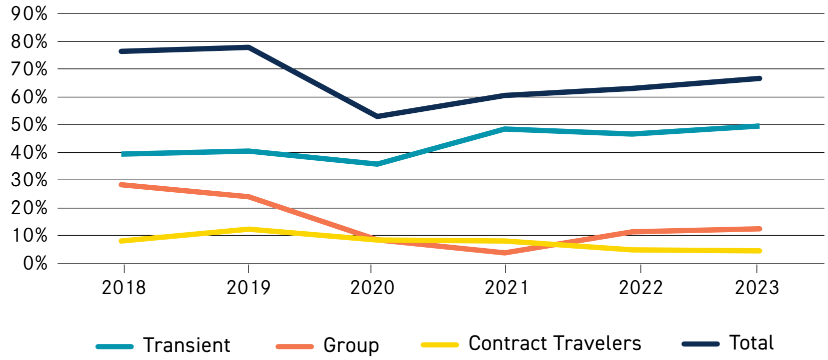


Figure 2

Sacramento Hotels • Average Daily Rates (January-May)

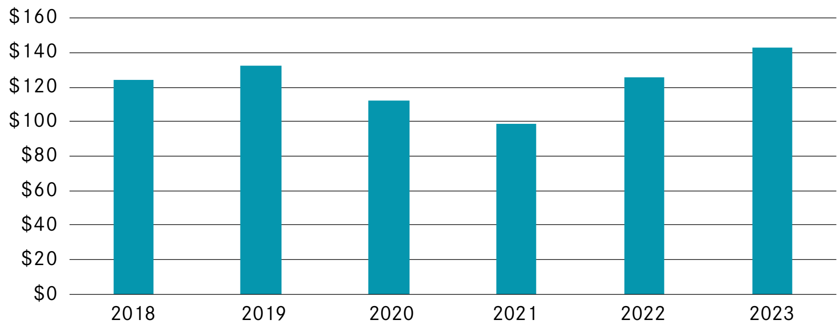
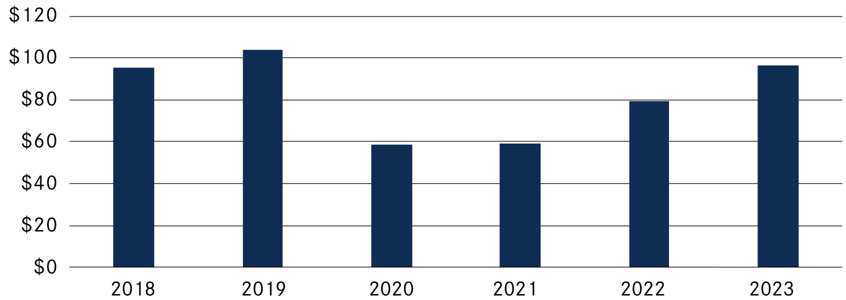


Figure 3

Sacramento Hotels • Revenue Per Available Room (January-May)



The other two segments of the Sacramento market, Point West (Zone 2) and Outlying (Zone 4), either had similar or declining occupancy rates compared to the first five months of 2022. Point West saw a slight 0.6% increase in occupancy rates, while Outlying experienced a 1.9% decrease. However, due to higher rates, both segments witnessed an increase in average revenue per room: Point West had a 6.6% growth in ADR, and Outlying had a 4.7% growth. Consequently, the average per room revenue increased in both cases in the first five months of 2023 compared to the same period in 2022, with a 7.2% increase for Point West and a 2.7% increase for Outlying.

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