

MARKET FEASIBILITY STUDY

CREEKSIDE MEMORIAL PARK
7000 CAMINO TASSAJARA
CONTRA COSTA COUNTY, CA

AS OF AUGUST 14, 2015
AGI FILE NO.: 15-06-039

PREPARED FOR

BOARD OF SUPERVISORS AND
DEPARTMENT OF CONSERVATION AND DEVELOPMENT
CONTRA COSTA COUNTY

PREPARED BY

AGI VALUATIONS

AGI VALUATIONS

A.G.I.

VALUATIONS

August 14, 2015

Department of Conservation and Development
30 Muir Road
Martinez, CA 94553

Attention: Telma Moreira

Re: Feasibility Study – Creekside Memorial Park Cemetery
AGI File No.: 15-06-039

Ladies and Gentlemen:

In accordance with your request, we have conducted the required investigation, gathered the necessary data, and made certain analyses that have enabled us to form an opinion of the market feasibility of the above-proposed cemetery development.

This feasibility analysis is prepared in compliance with the Uniform Standards of Professional Appraisal Practice adopted by the Appraisal Standards Board of the Appraisal Foundation. According to the 2014-2015 USPAP, a feasibility analysis is defined as the study of the cost-benefit relationship of an economic endeavor.

The conclusions of the feasibility study set forth in the Executive Summary are based on our understanding of the proposed development of Creekside Memorial Park as represented to us by the client and/or the client's representatives and professional consultants, as well as other available sources. We direct your attention to the "Introduction" and "Project Description" sections of this feasibility study. It is your responsibility to read the report and inform the consultant of any errors or omissions you are aware of prior to utilizing it.

Based on an inspection of the property and investigation and analyses undertaken, we have formed a series of opinions relative to the feasibility of this project that are set forth in the Executive Summary which follows this letter of transmittal.

Respectfully submitted,

AGI VALUATIONS



Arthur E. Gimmy, MAI
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EXECUTIVE SUMMARY

Market Analysis

1. Creekside Memorial Park is a proposed cemetery/memorial park on a site of approximately 212 acres located at 7000 Camino Tassajara in Contra Costa County, CA.
2. The project is proposed to be developed in phases with a total of about 100,000 entombments comprising indoor and outdoor mausoleum crypts and niches and ground plots at an initial investment of approximately \$22,000,000, which does not include the land or operating capital.
3. The market for this project is defined as a 15-mile radius, which contains a population of approximately 977,000 persons with a median household income of \$95,600 and an average household income of \$123,600.
4. There are 19 cemeteries in the 15-mile radius, of which there are none in the 5-mile radius, six in the 5-10 mile zone, seven in the 10-15 mile zone and five are just outside the 15-mile radius.
5. Within the market area, these cemeteries account for about 950 cases per year, whereas the market supports a potential number of interments of about 2,680.
6. The market analysis indicates that there is unsatisfied demand of 1,730 cases and that the proposed Creekside project could capture about 900 cases per year on a stabilized performance basis.

Financial Feasibility

7. Current average unit or per case revenue is estimated at \$17,000, comprised of a weighted average price per case for indoor crypts, indoor niches, outdoor crypts, outdoor niches, and ground plots, plus an allowance for other services that include scattering of cremated remains, opening and closing graves, sales of urns, memorials, flowers, etc., sealing crypts, interments and inurnments, and memorial services, etc. estimated at 25% as the average weighted price of crypts, niches and plots.
8. Estimated operating expenses are 80% of revenues based on actual data from projects we have appraised, published data and current operating costs of publicly traded deathcare industry businesses.
9. An Endowment care Cemetery is discussed on page 76 of this report. The statutory endowment fund for this cemetery is estimated at \$110,000 per year. However, the developers of the cemetery have agreed to fund \$165,000 (a figure 50% greater than the required amount). These funds will be set aside in an investment fund to accumulate interest and eventually be available for maintenance of the cemetery when it is at capacity. At a very safe rate of 2.5% per year, this fund would have a balance of about \$16,500,000 in 50 years..
10. Annual net operating income is estimated at \$2,895,000, which is a reasonable return on investment in the project. This amount is more than sufficient to finance the project through a conventional construction and take out loan process. Debt service on a \$22,000,000 loan would be about one-half of the \$2,895,000.

INTRODUCTION

Creekside Memorial Park Project

The proposed Creekside Memorial Park project is situated on the west side of Camino Tassajara, approximately 2,600 feet south of Highland Road, in unincorporated Contra Costa County.

The project sponsor proposes development of a cemetery with associated buildings, structures, roads, parking, landscaping and infrastructure. The subject site encompasses 212.24 acres, and has extensive frontage along Camino Tassajara. The site is generally rectangular, with relatively level grassland areas along Camino Tassajara and moderate to steeply sloping hills to the west. Elevations range from 528 feet along the road frontage to approximately 980 feet. Tassajara Creek crosses the southeastern corner of the site, and there are two additional small tributaries that traverse the eastern and southern borders of the site.

The developed portion of Creekside Memorial Park will be limited to approximately 58.7 acres of the 212.24-acre site, and will include two primary areas - the Lower Gardens, comprised of 45.5 acres closest to Camino Tassajara, which is proposed for the main cemetery buildings and structures; and, the Upper Gardens, consisting of approximately 13.2 acres in the hills to the west. The remaining area of approximately 153.54 acres will remain in its primarily natural state.

Property Identification

The subject property is comprised of Assessor's Parcel No. (APN) 223-020-005 and a portion of APN 223-020-007. The Project will include a variance for a lot line adjustment for APN 223-020-007 to establish 9± acres as a separate parcel, with the remaining acreage combined into parcel APN 223-020-005 (a 212.24-acre parcel).

Property Ownership and History

Title to assessor's parcel 223-020-022 is in the name of 7000 CMP LLC, a California limited liability company. Title to parcel 223-020-007 is currently in the name of Timothy F. Clancy, with a 23.82 acre portion under option, to be acquired by Sidney Corrie subject to approval of a zoning variance and lot line adjustment to create two parcels. Corrie had traded parcel 223-020-007 (previously parcel 206-160-010) to Clancy in April 2000, but retained a 20 year option to reacquire this 23.82 acre portion.

Intended Use and Users of the Report

The intended users of this feasibility study are the Board of Supervisors of Contra Costa County and Corrie Development Corporation, and the intended use is for County staff to aid the Planning Commission and the Board of Supervisors in making decisions regarding the property.

Type of Report

A feasibility analysis is defined by USPAP as “the study of the cost-benefit relationship of an economic endeavor.”

A financial feasibility study is defined in the *Dictionary of Real Estate* as “the ability of a property to generate sufficient income to support the use for which it was designed.”

Date of Report

The date of the report and conclusions is August 14, 2015.

Scope of the Assignment

The scope of this assignment is to inspect the subject property and its surrounding environment, analyze project documents and costs, collect and analyze market data, estimate the net revenue or cash flow potential of the project, and prepare a financial feasibility study.

In preparing this study, we did the following:

- Inspected the subject real property and its environment;
- Provided an overview of the deathcare industry;
- Gathered information on the cemetery competition and market conditions;
- Analyzed demand associated with the projected revenue categories;
- Analyzed market data and trends to estimate sales prices and absorption / market share for the subject project;
- Applied a seven-step methodology to form an opinion of the financial feasibility of the proposed project. The seven steps, which encompass nine chapters, are described below:

Step One: Definition of Creekside Memorial Park – This includes project overview, summary of acreage and land uses, description of proposed infrastructure, description of proposed buildings and structures, proposed Phase I inventory and proposed project phasing and timing. It assumes that the development is fully entitled and ready for construction.

Step Two: Market Delineation – This includes a definition of the market, which is defined as a 15-mile radius primary market. The primary market includes the Tri-Valley area and extends north to Walnut Creek and west to Hayward beyond the Pleasanton Ridge.

Step Three: Supply Analysis – Includes all cemeteries or memorial parks within the 15-mile primary market area with a wide range of facilities, including historical, district and non-denominational facilities which vary in their age and quality and in their interment options. Older facilities tend to have less open space than newer cemeteries. The primary competitive market survey indicates five existing cemeteries within the Tri-Valley area – two in Livermore and one each in Pleasanton, Dublin and Alamo. In terms of current competitive inventory, these facilities are limited. Roselawn Memorial Park and Dublin Pioneer Cemetery are at capacity, while Alamo Cemetery is a district cemetery and is use-restricted to those within district boundaries, although there are exceptions. The Alamo Cemetery is at capacity for in-ground burials, with only niches available. Notable competitive cemeteries would include Lone Tree Cemetery, Chapel of the Chimes, and Mt. Eden Cemetery, all situated in the Hayward area, and Oakmont Memorial in Lafayette. We have concentrated on these facilities and endeavored to obtain operational data.

Step Four: Demand Analysis – Demand segmentation includes the identification of characteristics of the most probable user (consumer profile), analysis of historical growth and absorption data for competitive cemeteries, and detailed analysis of population, demographic, and death rate trends.

Step Five: Analyze the Interaction of Supply and Demand – The intersection of the demand analysis and supply analysis indicates the unsatisfied demand within an underserved market. Based upon the competitive characteristics of Creekside Memorial Park, estimates of sales rates of burial plots, niches, mausoleum spaces, and lawn crypts can be developed.

Step Six: Estimate of revenue per case can indicate the possible gross revenue that a project can achieve within a reasonable marketing period. Development and operating costs are front-loaded and operating expenses (fixed and variable) will vary during the ramp-up period. These estimates are derived from actual, reported costs and revenues.

Step Seven: Financial feasibility of the Creekside Memorial Park is shown by its ability “to generate sufficient income to support the use for which it was designed.”

General Assumptions and Limiting Conditions

This study has been made with the following general assumptions:

- No responsibility is assumed for the legal description provided or for matters pertaining to legal or title considerations. Title to the property is assumed to be good and marketable unless otherwise stated.

- The property is assumed to be free and clear of any or all liens or encumbrances unless otherwise stated.
- Responsible ownership and competent business management are assumed.
- The information furnished by others is believed to be reliable, but no warranty is given for its accuracy.
- All engineering studies are assumed to be correct. The plot plans and illustrative material in this report are included only to help the reader visualize the property.
- It is assumed that there are no hidden or unapparent conditions of the property, subsoil, or structures that render it more or less valuable. No responsibility is assumed for such conditions or for obtaining the engineering studies that may be required to discover them.
- It is assumed that the property is in full compliance with all applicable federal, state and local environmental regulations and laws unless the lack of compliance is stated, described, and considered in the appraisal report.
- It is assumed that all required licenses, certificates of occupancy, consents and other legislative or administrative authority from any local, state or national government or private entity or organization have been or can be obtained or renewed for any use on which the opinion of feasibility contained in this report is based.
- It is assumed that the use of the land and improvements is confined within the boundaries or property lines of the property described and that there is no encroachment or trespass unless noted in this report.
- Unless otherwise stated in this report, the existence of hazardous materials which may or may not be present on the property, was not observed by the analyst. The analyst has no knowledge of the existence of such materials on or in the property. The analyst, however, is not qualified to detect such substances. The presence of substances such as asbestos, urea-formaldehyde foam insulation and other potentially hazardous materials may affect the value of the property. The report conclusions are predicated on the assumption that there is no such material on or in the property that would cause a loss in value. No responsibility is assumed for such conditions or for any expertise or engineering knowledge required to discover them. The intended user is urged to retain an expert in this field, if desired.
- The forecasts, projections, or operating estimates contained herein are based on local market conditions, anticipated short-term supply and demand factors, and a continued stable economy. These forecasts are, therefore, subject to changes in the future.

This report has been made with the following general limiting conditions:

- Possession of this report, or a copy thereof, does not carry with it the right of publication or dissemination to the public.
- The analyst, by reason of this study, is not required to give further consultation or testimony or to be in attendance in court or at hearings with reference to the project in question unless arrangements have been previously made. The fee for this assignment does not include payment for conferences or the taking of expert testimony.
- Neither all nor any part of the contents of this report (especially any conclusions as to feasibility, the identity of the analyst, or the firm with which the analyst is connected or any reference to the Appraisal Institute, or to the MAI or SRA designations) shall be disseminated to the public through advertising, public relations, news, sales, or other media without the prior written consent and approval of the analyst.
- This report and all information contained herein was prepared for the sole and exclusive benefit of the clients, as specified herein, and is intended for their use only. No one except the clients and the intended users specified herein may rely on this report for any purpose. Any person or entity who obtained or reads this report, or a copy thereof, other than the clients specified herein, expressly assumes all the risk of damages to himself or third persons arising out of reliance thereon of use thereof and waives the right to bring any action based on the conclusions, directly or indirectly, and the analyst shall have no liability to any such person or entity.

Extraordinary Assumptions

An extraordinary assumption is defined by the Appraisal Institute as:

“An assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser’s opinions or conclusions. Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal or economic characteristics of the subject property; or about conditions external to the property such as market conditions or trends; or about the integrity of data used in an analysis. An extraordinary assumption may be used in an assignment only if:

- It is required to properly develop credible opinions and conclusions;
- The appraiser has a reasonable basis for the extraordinary assumption;
- Use of the extraordinary assumption results in a credible analysis; and
- The appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.”

It is an assumption of this study that a zoning ordinance and lot line adjustment have been granted in a timely manner to allow for the current option to be exercised for the 23.82-acre

portion of adjoining parcel 223-020-007, which is proposed to comprise a portion of the subject site.

Hypothetical Conditions

A hypothetical condition is defined by the Appraisal Institute as:

“That which is contrary to what exists but is supposed for the purpose of analysis. Hypothetical conditions assume conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. A hypothetical condition may be used in an assignment only if:

- Use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;
- Use of the hypothetical condition results in a credible analysis; and
- The appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions.”

We are analyzing the subject project under a hypothetical condition, assuming Phase I of The Creekside Memorial Park Project has been entitled and is completed, and that cash flows from preneed cemetery contracts are presented at the full contract price as operating cash flows.

References

- Wells Fargo Bank for California & Regional Outlook;
- Wikipedia.org for Contra Costa County, and Blackhawk Data;
- IBISWorld for Overview of the Deathcare Industry;
- Numerous articles from sources such as Forbes and blog archives;
- 10Q's for publicly traded stocks;
- EIR for Creekside Memorial Park;
- MarketsDaily;
- Nasdaq;
- The Street Ratings;
- Risk Management Association Annual Statement Studies;
- California Department of Public Health – County Health Status Profiles;
- Contra Costa County Health Data Profile;
- Alameda County Health Data Profile;
- ESRI Demographic and Income Profile, Age 50+ Profile, Disposable Income Profile, ACS Population Summary;
- Cemetery Management Solutions, Inc.;
- *The Complete PreNeed Perspective* by Dan Iserd;
- Technical Memorandums of Contra Costa County;
- Appraisal files of Arthur Gimmy International;
- Funeral Home Software Info;

- HyperStrategy;
- Marshall Valuation Services; and
- *PWC Real Estate Investor Survey*

Glossary

The following terms are common to the deathcare industry and have the following meanings:

Atneed – Funeral and cemetery arrangements sold once death has occurred.

Burial Vaults – A reinforced container intended to inhibit the subsidence of the earth and house the casket after it is placed in the ground, also known as outer burial containers.

Cancellation – Termination of a preneed funeral or cemetery contract, which relieves one of the obligation to provide the goods and services included in the contract. Cancellations may be requested by the customer or be initiated for failure to comply with the contractual terms for payment. State laws govern the amount of refund, if any, owed to the customer.

Care Trust Corpus – The deposits and net realized capital gains and losses included in a perpetual care trust that cannot be withdrawn.

Case – The sale of a crypt, niche or plot. Case revenue also includes an allowance for other services.

Cemetery Perpetual Care or Endowment Care Fund (ECF) – A trust fund established for the purpose of maintaining cemetery grounds and property into perpetuity, also referred to as a perpetual care trust. Where allowable by state law, capital gains can be distributed to and recognized as cemetery revenues in the period earned. However, in certain states, capital gains within the perpetual care trusts are generally not distributable, so they are not included in revenue. Capital gains which cannot be distributed in those states instead increase the investable perpetual care trust assets and trust corpus, increasing the potential for higher ordinary investment income in the future.

Cemetery Property – Developed lots, lawn crypts, mausoleum spaces, cremation niches, and cremation memorialization property available for sale as interment rights and undeveloped land intended for future development.

Cemetery Property Revenue – Recognized sales of cemetery property interment rights when a minimum of 10% of the sales price has been collected and the property has been constructed and is available for interment.

Cemetery Merchandise and Services – Stone and bronze memorials, markers, merchandise installations, and burial openings and closings.

Cremation – The reduction of human remains to bone fragments by intense heat.

Cremation Memorialization – Products specifically designed to commemorate and honor the life of an individual that has been cremated. These products include funeral merchandise and cemetery property types that provide for the disposition of cremated remains such as benches, boulders, statues, ossuaries, and reefs. They also include memorial walls and books where the name of the individual is inscribed, but the remains have been scattered or kept by the family.

Interment – The burial or final placement of human remains in the ground, in mausoleums, in cremation niches, or cremation memorialization property.

Lawn Crypt – An underground outer burial receptacle constructed of concrete and reinforced steel, which is usually pre-installed in predetermined designated areas.

Marker – A method of identifying a deceased person in a particular burial space, crypt, niche, or cremation memorialization property. Permanent burial markers are usually made of bronze or stone.

Maturity – When the underlying contracted merchandise is delivered or service is performed, typically at death. This is the point at which preneed contracts are converted to atneed contracts (note -delivery of certain merchandise and services can occur prior to death).

Mausoleum – An above ground structure that is designed to house caskets and cremation urns.

Merchandise and Service Trust – A trust account established in accordance with state law into which is deposited the required percentage of customers' payments for preneed funeral or cemetery merchandise and services. The amounts deposited can be withdrawn only after obligations under the preneed contract have been met or the cancellation of the contract.

Preneed – Purchase of cemetery property interment rights and funeral and cemetery merchandise and services prior to a death occurring. Sometimes referred to as advance need.

Preneed Backlog – Future revenues from unfulfilled preneed funeral and cemetery contractual arrangements.

Preneed Cemetery Production – Sales of preneed or atneed cemetery contracts. These sales are recorded in Deferred preneed cemetery revenues until the merchandise is delivered, the service is performed, or when a minimum of 10% of the sales price has been collected and the property has been constructed and is available for interment.

Sales Average – Average revenue per service performed, excluding the impact of recognized preneed revenue, general agencies revenue, and certain other revenues.

Trust Fund Income – Recognized investment earnings from merchandise and services and from perpetual care trust investments.

Privacy Policy

This is a required disclosure. AGI Valuations is committed to protecting our clients' personal and financial information. This privacy statement addresses what nonpublic personal information we collect, what we do with it, and how we protect it. AGI Valuations may collect and maintain several types of personal information in the course of providing you with appraisal services, such as: information we receive from you on letters of engagement, correspondence, or conversations, including, but not limited to, your name, address, phone number, information about your transactions with us, our affiliates or others, including but not limited to, payment history, parties to transactions and other financial information; and information we receive from a consumer-reporting agency such as a credit history. We may disclose the nonpublic personal information about you described above, primarily to provide you with the appraisal services you seek from us. We do not disclose nonpublic personal information about clients or former clients except as required or permitted by law.

Experience of Consultants

Our qualifications for this study include the analysis and valuation of numerous cemeteries or memorial parks throughout Northern California. They include some of the most prestigious projects such as Skylawn Memorial Park and Chapel of the Chimes in Oakland and Hayward. Arthur E. Gimmy, MAI is the author of the only article published by the Appraisal Institute dealing with this type of subject matter, *Valuation of Cemeteries and Mortuaries*, published in the 2008 Fall Edition of *The Appraisal Journal*.

Qualifications of Arthur E. Gimmy, MAI are included in the Addendum of this report.

OVERVIEW OF THE DEATHCARE INDUSTRY

Background

The term "deathcare industry" refers to the array of providers of funeral and burial goods and services, such as funeral directors, cemeterians, and third-party sellers. This chapter provides an overview of the changing deathcare industry.

The deathcare industry is currently undergoing a major transformation. Historically, it has been fragmented, with limited overlap among various segments of the funeral and burial industries. Funeral homes and funeral directors sold funeral merchandise and services. Cemeterians sold burial merchandise and services. Cemeterians and monument/memorial dealers sold monuments and memorials. A funeral home or cemetery generally arranged cremation services, and independent florists sold flowers.

Today, such distinctions are diminishing. The industry is consolidating. Large chains, such as Service Corporation International (28.6% of the market) and Stonemor Partners (5.3% of the market) are buying and managing locally owned funeral homes and cemeteries. Many nonprofit cemeteries are now owned by, managed by, or otherwise affiliated with for-profit chains.

The growth of preneed sales has been a catalyst for much of the change that has occurred in recent decades. In the past, nearly all funerals and burials were arranged upon death and survivors went to their local funeral homes and cemeteries at the time of need and little competition existed within the industry. Today, a growing number of consumers who purchase funeral and burial goods and services have shopped around in advance at casket stores or over the Internet, particularly for expensive items such as caskets. According to an AARP survey, 18% of persons who had planned or arranged for a funeral had contacted more than one funeral home.

The Industry Today

Currently, in the United States, there are:

- About 21,000 funeral homes;
- About 6,800 active cemeteries.

The nation's cemeteries represent a \$3.6 billion industry, performing nearly two million funerals and burials per year. The average cost of a funeral, burial and monument is over \$10,000.

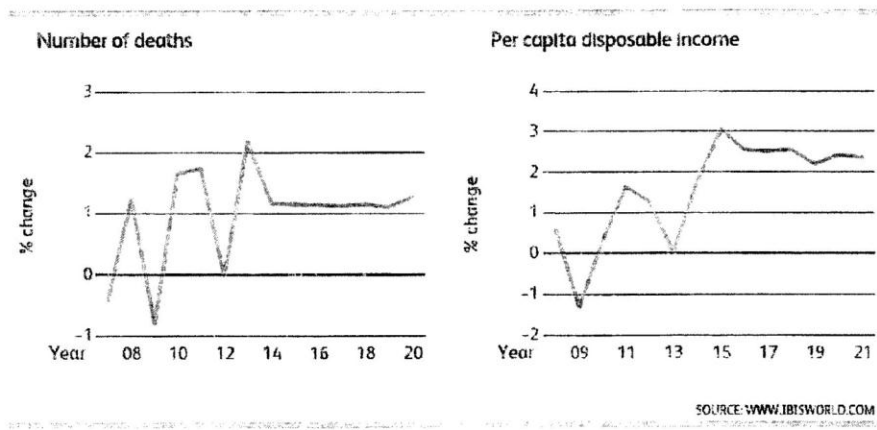
Increasingly, funeral directors provide goods and services once exclusive to cemeterians. Similarly, cemeterians sell items that were once exclusive to the funeral industry. It is estimated that there are approximately 1,000 combination funeral home/cemetery operations in the deathcare industry. The number of casket sellers is increasing, although the increase is limited to those states that allow individuals other than funeral directors and cemeterians to sell caskets.

Key External Drivers

Number of Deaths – The number of US deaths has a significant positive correlation to industry revenue. The number of deaths is related to the age structure of the population, infant mortality rates, natural disasters, and deaths from accident, suicide, and other causes. Advances in medical treatments, interventions, and procedures in general improvements to the health of the population will increase average life expectancy, thereby slowing the prevailing mortality rate relative to the US birth rate. The number of deaths is expected to increase slightly during 2015.

Per Capita Disposable Income – Changes in per capita disposable income have a direct effect on family preferences for cremations and burial services. When per capita disposable income is high, families are more likely to purchase additional merchandise and services, which favorably affects revenue. Per capita disposable income is expected to increase during 2015, which is a potential opportunity for the industry.

Number of Cremations – The Cemetery Services industry provides burials and cremations. Cremations typically cost significantly less than burial services. Demand for cremations has increased over the past five years due to cost considerations, environmental reasons, religious considerations, and changing consumer preferences. Because cremations bring in significantly less revenue and profit for cemeteries, rising demand for cremations has adversely affected the industry. The number of cremations is expected to increase during 2015, posing a potential threat to the industry.

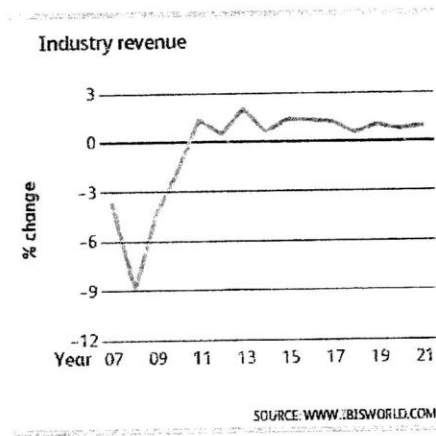


Number of Adults Aged 65 and Older – The proportion of the population older than 65 is a positive indicator of demand for cemetery services. This age segment of the population accounts for the majority of all deaths; therefore, this driver is positively correlated to industry performance. Individuals in this age bracket also commonly purchase industry programs in

advance, thereby helping the industry revenue. The number of adults aged 65 and older is expected to increase during 2015.

Current Performance

The cemetery services industry has exhibited consistent growth over the five years to 2015, stemming from the economic recovery and increasing sales of value-added services and products. Over the 5-year period, industry revenue is estimated to increase at an average annual rate of 1.2% largely due to recovering per capita disposable income, which has enabled the gradually aging US population to purchase industry products and services that once suffered due to cash-strapped consumers during the recession. Prior to the five years to 2015, families were far more likely to choose relatively inexpensive cremations rather than seek out costly grave plots and caskets; the number of cremations has continued to boom in the past five years, growing at an annualized rate of 5.0% to an estimated 1.2 million orders in 2015. However, with the economic recovery boosting the industry, operators have successfully increased sales of products that yield traditionally higher profit margins. As a result, industry revenue turned the corner in 2011 with a 1.4% revenue increase, its first year of growth in several years. In 2015, total revenue is projected to grow to \$3.6 billion.



The industry includes companies that operate cemeteries and crematories. It does not include funeral homes that operate in conjunction with cemeteries. The industry's main source of revenue comes from the sale of gravesites, niches and spaces in mausoleums and columbaria. Collectively, these sales make up the largest portion of the industry's revenue. In addition to burial services, the industry also provides direct cremations and inters ashes within columbaria. With direct cremation, the remains are simply returned to the family members, who typically organize their own private ceremony to scatter the ashes or place them in a special urn.

Aging Population Increases Demand – The number of US deaths is the predominate driver in this industry. In the five years to 2015, the number of deaths is estimated to increase at an annual rate of 1.2%. The rising number of US deaths is partly due to the changing age structure of the population, which is becoming increasingly concentrated with elderly citizens. Over the five years to 2015, the number of adults aged 65 and older was estimated to increase an annualized 3.4% to 47.8 million people, about 15.0% of the US population. According to the latest data released by the Center for Disease Control, life expectancy in 2014 was estimated at 78.8 years and will likely continue to trend upward as medical technologies and access to medical care continue to improve. As the baby-boomer generation continues to near retirement, the elderly population will play an increasingly substantial role in the industry's anticipated revenue growth.

The Rising Popularity of Cremations – Industry revenue has experienced intermittent declines during the past decade, largely led by the increasing tendency toward cremation services rather than traditional burials. Typically, cremations, exclusive of services, are less than one-third the cost of burials, so declining disposable income during the recession exacerbated this trend, as families were more likely to choose inexpensive options and forego purchasing any additional industry merchandise. According to the Cremation Association of North America (CANA), the cost for cremation, funeral and memorial services is often more than half the cost of a traditional funeral. Furthermore, profit margins for direct cremations are much lower because they do not require families to purchase lucrative niches within columbaria. However, in 2011, industry revenue began to recover from the recession, growing 1.4% as improving economic conditions allowed families to increase spending on higher-priced industry options. Over the five years from 2015, per capita disposable income is estimated to grow at an annualized rate of 1.5%, which will likely make consumers more capable of affording traditional burial options.

The cemetery services industry generally has high profit margins, and the industry is estimated to have earned a 17.3% profit (before a deduction for depreciation) in 2014 according to RMA. This figure represents a major increase compared with three years prior, when the typical operator generated an average profit margin of 10.8%. Profit margins have been aided by improving sales of additional merchandise and value-added services, such as burial vaults, flowers, limousine services and other high-value products. The industry has also undergone a period of intense acquisition activity among its largest operators, the upfront costs of which have contributed to temporarily subdued profit margins.

Industry Consolidation – Establishments in the industry have decreased marginally; over the five years to 2015, the number of cemetery service locations is estimated to have dropped at an annualized rate of 0.6% to about 8,220 establishments, some of which are not considered as active. Alongside this trend has been steady consolidation among the industry's largest operators during the past decade, partially led by increasing merger and acquisition activity. Major companies such as Service Corporation International and Stonemor Partners have exhibited strong merger and acquisition activity and have routinely purchased several small industry cemetery service providers every years during the five years to 2015. In 2013, industry leader Service Corporation International made major news when it acquired Stewart Enterprises, the industry's second largest operator for \$1.4 billion.

Other prominent acquisitions includes Service Corporation's purchase of the fifth-largest funeral home and cemetery operator, Keystone North America. Service Corporation purchased Keystone for \$288.9 million, which expanded its network by 15 cemeteries. Stonemor Partners, on the other hand, has acquired mainly regional operators in the US, including 67 cemeteries and 43 funeral homes over the five years to 2015. As a result of continued merger activity, the total number of industry employees has fallen. Over the five years to 2015, the total number of industry employees was estimated to have declined at an annualized 2.9% to about 32,500 workers.

Industry Outlook

During the next five years to 2020, the cemetery services industry will continue to benefit from a growing base of consumers aged 65 and older. In this period, revenue is forecast to increase at an average annual rate of at least 1.0% to reach \$3.8 billion. Operators will also likely benefit from improving per capita disposable income, which will enable more families to spend more on value-added burial vaults, specialized urns, limousine services and flowers, among others. As a result, it is projected that industry revenue will increase 1.4% in 2016.

The changing age structure of the US population should provide steady revenue growth for the industry, although the nature of the industry has made it historically rare for cemeteries to experience very significant revenue growth. According to the US Census Bureau, the number of adults older than 65 is expected to accelerate, rising at an annualized rate of 3.2% over the five years to 2020. Adults within this age bracket are targeted for both advance and as-needed burial services. The number of deaths in the US is also forecast to increase at an average annual rate of 1.2% during the next five years, mainly due to the baby boomer generation entering the upper-age bracket.

Per capita disposable income remains a key driver of industry growth; per capita disposable income is forecast to rise at an average annual rate of 2.4% over the period, as improving economic conditions typically result in lower unemployment rates and increases in average wages. With greater disposable incomes, families are more likely to purchase specialized merchandise for burial services and forego cremation services, which, in many cases are purchased due to families' inability to afford costlier cemetery products and services. As families increasingly opt for these high-margin products, and their concerns over price wane slightly, industry profitability is expected to improve. Profit margins or EBITDA as a percentage of revenue are forecast to remain essentially the same as they were in 2014 at 17.3%.

Trend Towards Cremation – Although people will have more money to spend on burials, cremations will likely continue to become more prevalent during the five years to 2020. In 2014, an estimated 42.0% of consumers chose cremations instead of burials. According to the latest forecast from the Cremation Association of North America, 44.4% of consumers are expected to choose cremations instead of burials by the end of 2015.

In order to combat this challenge to revenue, cemetery operators are likely to offer more specialized products and services associated with cremations, such as customized urns and stationery. Cemetery operators are also likely to direct marketing efforts toward burial services, following cremations, and niches in columbaria, which have higher profit margins.

A Changing Landscape – Increased acquisition activity is anticipated during the period. As the trend towards cremations threatens to limit revenue gains, major companies in the industry have increasingly acquired regional operators in order to increase their customer base. This trend is expected to continue, and as a result, industry market share concentration will likely increase over the five years to 2020.

The industry is likely to face external competition from the proliferation of combination operations, which are funeral homes that are affiliated with an adjoining cemetery. Combination operations are expected to become more popular in the five years to 2020 because they typically have higher profit margins and families are more likely to choose these locations because of their integrated services. External competition for cemetery operators is expected to increase, and the number of industry establishments is projected to grow only minimally over the next five years as a result. In the five years to 2020, the number of establishments in the industry is expected to increase, while total industry employment improves at a similar 0.3% annualized rate to an anticipated 33,000 workers.

Industry Life Cycle – The cemetery services industry is in the mature phase of its industry life cycle. Indicators of its mature life cycle include the industry's well-established products and services, widespread industry acquisition activity and limited changes in overall demand for industry services. Although the recession curtailed demand for more lucrative burial and merchandise sales, demand for industry services has remained stable given the nature of the industry. Revenue for industry operators rarely experiences major volatility. It grew from \$3.169 billion in 2012 to its current level at \$3.6 billion.

The cemetery services industry has witnessed increased merger and acquisition activity during the five years to 2015, which is characteristic of a mature industry. During this period, major companies in the industry have started acquiring both regional and national competitors, including the purchase of prominent industry cemetery service provider Stewart Enterprises by Service Corporation International in 2013. Overall, the number of companies in the industry is projected to fall at a slim annualized rate of 0.4% from 2010 to 2020, largely due to increased merger and acquisition activity among the largest cemetery service providers in the industry.

Products and Services

Sale of Graves, Plots and Other Spaces – The cemetery services industry derives the majority of its revenue from the sale of plots, graves, or spaces in mausoleums. These sales are estimated to generate 39% of the industry's revenue. Typically a funeral home will negotiate the purchase of burial plots, though consumers can do this on an individual basis as well. In certain states cemetery plots can be purchased from a cemetery broker rather than a funeral home director. The cost of a burial plot is typically more than \$4,000. Individuals may also purchase niches within columbarium walls. Columbarium walls have become a common feature of many cemeteries, reflecting the increasing popularity of cremations as opposed to burials.

Interment – Interment services are estimated to account for about 22% of industry revenue in 2015. These services include digging graves, preparing gravesites for services or burial and sealing graves. Interment services also include placing ashes in niches and mausoleums and other similar facilities. Natural, or green burials, in which a body is returned to the earth to decompose naturally, have become popular in the past two decades. Typically, however, bodies are wrapped in a shroud or placed in a coffin prior to burial. In the United States, a burial liner or a burial vault usually covers a coffin to prevent the coffin from collapsing. Interment services also include exhumation. Exhumation is typically done for repatriation reasons, reinterment in

another section of the cemetery, relocation to a different cemetery, to scattered interred ashes or to conduct forensic investigations.

Merchandise Sales – Merchandise sales are another large source of revenue and estimated to account for approximately 19% of revenue in 2015. Cemeteries will typically offer sales of caskets, urns, and other memorial markers such as headstones, commemorative plaques, mausoleums, vaults and liners. Cemetery operators may also sell apparel, books, cards, videos, photographs, and other memorial items, and these products typically have high profit margins attached to them. Merchandise sales have been a growing product line for the industry, and companies have increasingly expanded their merchandise offerings to increase margins on cremation services, which generate less revenue to cemetery operators.

Cremations – There are two basic types of cremation that can be chosen: direct cremation and traditional cremation. Direct cremation involves transporting the deceased to the cemetery, cremating the body and then returning the remains to the family. Direct cremation is performed at crematories and is included in this industry. Traditional cremation, however, can be as elaborate as a traditional burial service, and can include a visitation service prior to the cremation, funeral or memorial service. Traditional cremation services are typically performed by funeral home operators, which have attached crematories and are not included in this industry. Cremation services have been steadily gaining in popularity during the five years to 2015, as they are less than one-third the cost of a burial service. Therefore, because of low discretionary income during the recession and its recovery, more individuals have opted for direct cremations.

Along with price considerations, cremations are gaining in popularity because of environmental concerns and a growing preference for simple services. Environmental concerns generally stem from the use of chemicals, such as formaldehyde, during the embalming process, as well as chemicals for making caskets. Religious considerations also play a role, as some religions either mandate or prohibit cremations. Furthermore, cremations have been gaining popularity because of a growing preference among families for simple ceremonies. Cremation, consequently, has been growing as a share of industry revenue. In response to growing demand, during the past five years, the average cost of a cremation has increased. In 2015, cremations are estimated to account for 13% of the industry's revenue.

Cremation Maintenance Service – Cemetery maintenance services are estimated to generate 4% of the industry's revenue in 2015. These include allocating land for burial, digging graves, and maintaining the grounds and landscaping. Typically, the construction and maintenance of headstones is the responsibility of family members of the deceased and burial costs do not include these maintenance fees.

Pre-Burial Services – Pre-burial services vary depending on whether the end service is a burial or a cremation. If relatives or the deceased have chosen a burial, the body is typically washed and disinfected prior to burial. Other pre-burial services that are performed include transporting remains to the ceremony; this may include transporting remains from a crematory to the cemetery grounds. In 2015, pre-burial services are estimated to make up 3% of industry revenue.

Demand Determinants

The main determinant of demand for this industry is the number of deaths in the United States. According to the latest preliminary available data from the Centers for Disease Control and Prevention, the number of deaths in the US was about 2.6 million in 2014, or 8.1 persons per 1,000 population. The number of deaths is partly related to the age structure of the population; when the age structure has a higher percentage of the population older than 75 years old, demand for industry services rises. The percentage of the population older than 75 years old has been expanding in recent years, and the aging of the population is likely to expand sales for at-need and preneed burial and cremation services. Demand for industry services also rises with an increase in the infant mortality rate, suicides, disease-related mortality and drug-related deaths. In general, with continued improvement in medical diagnosis and procedures, the average life expectancy has been increasing, reducing demand for industry services.

Demand for industry services is also affected by consumer preferences and trends in disposable income. Some consumers are increasingly opting for home funerals and direct cremations because of their increased simplicity and lower cost. Because direct cremations are less expensive relative to traditional funeral services, during the recession an increased number of consumers opted for direct cremations. As cremations, particularly direct cremations, are much less expensive than traditional burials, this consumer trend may decrease revenue for cemetery operators. Although cremations do bring in less revenue than other industry services, cremations do have high profit margins/

There is some seasonality in industry demand. In general, there are more deaths recorded during cold winter months due to the increased incidence of major illnesses and car-related accidents caused by severe weather conditions. There tend to be fewer deaths recorded during the warmer summer months.

Major Markets

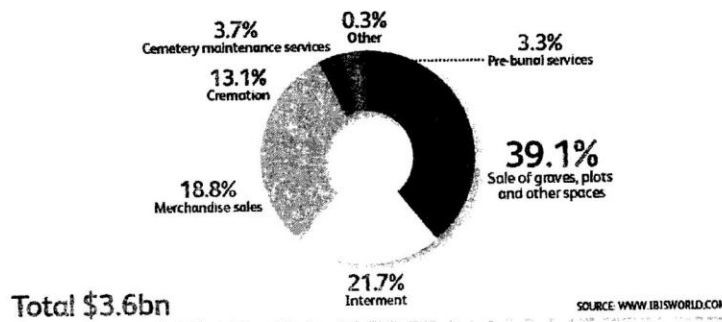
The major markets for this industry's services are categorized according to the age of the consumer. According to the latest data from the Center for Disease Control and Prevention (CDC), there were an estimated 2,515,000 deaths in 2011. People older than 75 years old make up a greater share of the population, a trend that is expected to continue during the next decade, increasing demand for cemetery services. People aged older than 75 years make up the majority of the market, accounting for 56.3% of industry revenue in 2015. Heart disease and cancer are the leading causes of death for people older than 75 years old.

On the other hand, life expectancy has increased gradually. According to the CDC's latest data, the average US citizen was expected to live to 78.7 years in 2011. Life expectancy increases are largely due to improving consumer health and enhanced access to medical care. Longer life expectancy lowers demand for industry services, negatively impacting revenue. In 2015, life expectancy is projected to rise to 78.9 years.

The second largest consumer market is composed of adults between 55 and 74 years old, who are estimated to make up about 29.4% of the total market in 2015. Heart disease and cancer are also

the leading causes of death for this age group. Industry operators increasingly target this consumer market for at-need and preneed cemetery arrangements. Preneed sales represent an opportunity for operator expansion because the target market is larger. Furthermore, as preneed sales are available through installment plans, consumers may find expensive traditional cremation and burial services a more viable option because they can pay over a longer period of time. As the baby-boomer generation moves into retirement age, this age segment increasingly makes up a greater share of the overall US population.

Products and services segmentation (2015)



Adults between 35 and 64 make up the third-largest market for the industry. People within this age group make up 10.1% of all deaths in the US. Car accidents, cancer and heart disease are the leading causes of death for this segment. Although rare, some consumers within this age group purchase preneed cemetery arrangements, expanding the target market for industry operators.

Persons between 15 and 34 make up the fourth-largest market for cemetery services. Car accidents, suicides and cancer are the leading causes of death among this age group. This group is targeted for at-need sales more than preneed sales. The smallest market for cemetery services is people under 14 years old, who made up for an estimated 1.3% of all deaths in 2014. Leading causes of death include birth defects for those under one-year old as well as accidental causes, which most often stem from car accidents and drowning within this age group.

Key Success Factors

- *Complying with Government Regulations* – Complying with all government regulations is a necessity for industry operators.
- *Proximity to Key Markets* – Establishments that are located close to or within a major city or town will gain a competitive advantage.
- *Access to Multiskilled and Flexible Workforce* – Companies with access to a multiskilled and trained staff who can provide services across a broad range of areas within the operation can save on labor costs and raise productivity.
- *Consistent Maintenance* – Aesthetic appeal is one of the primary factors that individuals consider when choosing a cemetery.

- *Upstream Vertical Integration (Ownership Links)* – Cemetery or crematory operations that have links to funeral homes will experience more stable demand.
- *Economy of Scale* – Given the high capital costs inherent to owning a cemetery or crematory, companies with economies of sale will hold a competitive advantage.

Cost Structure Benchmarks

Profit – The cemetery services industry is fairly profitable, given the relatively high markups assigned to most of the services and products that are provided, such as the cost of reserving a specific plot and reselling monuments from stone masons. Profit, measured as earnings before interests and taxes (EBITDA), is estimated at 17.3% for the average industry company. Profit margins have increased in the past five years due to the expanding sales of high-margin products for cremations, which do not require profit-eroding costs such as acquiring markers, vaults, flowers and regular maintenance. Individuals have increasingly chosen cremations as opposed to burials, which bring in significantly less revenue for industry operators. Countering this trend is the rising price of cremations as industry operators have expanded the level of customization options available to consumers. Because all prepaid cemetery contracts have to be deposited in trust funds until required, they are exposed to the volatility of the financial market. During the financial crisis, significant negative financial returns and losses forced operators to make up shortfalls related to the cost of performing agreed-upon burial services.

Wages – Wages are the most significant cost for this industry. Labor expenses are estimated to be 31.6% of revenue for industry operators in 2015. This share reflects a decline compared to 2010, when wages accounted for 39.8% of revenue. Average industry wages have declined over the past five years, partly as a result of the industry's slight increase in capital expenditures in comparison to wage expenses over the period.

Purchases – Purchases are expected to account for 12.4% of revenue for cemetery operators in 2015. Typically, cemeteries and crematories purchase lawn crypts, markers, burial vaults, flowers and grounds maintenance supplies. Purchase costs have remained relatively constant for industry operators during the past five years.

Depreciation – Depreciation expenses make up about 4.1% of revenue for cemeteries and crematories in 2015. Newer cemeteries have higher fixed costs related to building columbaria and setting up crematories, neither of which had incurred significant purchases for local cemeteries in previous years. Furthermore, cemetery and crematory operators must invest in cemetery property and maintenance equipment, which represent other significant depreciable costs for the industry.

Rent and Utilities – The cost of utilities has increased slightly in the past five years due to escalating commodity prices. The prices of electricity, natural gas, and crude oil are prone to significant volatility on a daily basis. Utilities are estimated to account for 3.1% of industry revenue in 2015, while rental costs average about 2.6% and include the cost of leased facilities and equipment.

Other – Miscellaneous expenses, which represent a smaller percentage of industry revenue, include sales and administrative expenses, restructuring, marketing, legal goodwill adjustments and others. Many state governments have enacted preservation funds that collect contributions that may be used to ensure that the upkeep of cemeteries and the interred are respected and maintained even after the cemeteries' revenue-generating years have passed. Contributions to these funds are typically made by the cemetery, the cost of which may be passed along to the consumer in the form of preservation fund fees. Other expenses, as a percentage of industry revenue, have increased slightly during the past five years due to a greater emphasis on advertising and increased restructuring among industry operators.

Basis of Compensation

Competition within the industry is high but steady, as there are many companies operating with a small share of the market. Competition is particularly intense in the Mid-Atlantic and Southeast regions, as nearly half of the industry's establishments are located in the two areas. Barriers to entry are at a moderate level in parts of the country, but very high in California, and there is a low level of market share concentration. The industry faces some external competition from funeral homes, which own cemeteries and are not included in this industry. These combination operations typically have higher profit margins because they share overhead expenses.

Internal Competition – Competition with other industry operators is mainly based on competitive pricing, reputation and location. The appearance of the cemetery, including well-maintained grounds and favorable views, are important components of competition for industry operators. Pricing has become increasingly important as a basis of competition because during the recession, cash-strapped consumers were less able to pay the high costs associated with burials and increasingly shopped around at other cemeteries. Consequently, more consumers turned to direct cremations rather than burials because they are significantly less expensive.

A cemetery's location is also important as industry operators typically serve customers that live within a 10- to 15-mile radius from the property's location. Industry operators will also hold a significant advantage if a potential customer's family members are already buried in that same cemetery. Moreover, cemeteries or crematories located near large metropolitan areas with a higher share of the population that is older than 65 years old will also hold a competitive advantage. California, Florida and Texas are some of the top states with populations in this age group, and as expected, they have a high proportion of industry establishments. A cemetery's reputation and heritage are also significant sources of competition. Older and more well-known cemeteries hold a competitive advantage over new operators.

Another basis of competition is having an established preneed program, which allows industry operators to expand their target market. This can also give consumers a more viable form of financing costly burial services. Some smaller operators do not have a preneed program. Finally, offering a greater array of personalized memorial services and merchandise for traditional burials and cremations is important so that operators can distinguish themselves from other competitors.

External Competition – The industry faces external competition from funeral homes, which operate cemeteries. These companies are referred to as combination operations. They are more

cost competitive and generally have higher profit margins, compared to independent cemeteries, given that they are able to share high fixed costs. Cemeteries also compete with internet retailers and other non-traditional providers who sell low-cost caskets, burial vaults, liners, urns, and other goods.

CALIFORNIA AND REGIONAL ECONOMIC OUTLOOK: FEBRUARY 2015

California's economy continues to power forward, with many of the Golden State's largest and most important industries gaining momentum over the course of 2014. High-tech employers have shown no sign of slowing their hiring. Employment in professional, scientific and technical services, the industry with the largest number of tech-related workers, grew 4.3% in 2014. San Francisco, San Jose and San Diego are all benefitting from the strong growth in this major industry group. Health services are also expanding rapidly and appear to have adjusted to the rollout of the Affordable Care Act with only minimal disruption. Construction has picked up to keep pace with the rapidly expanding economy and demand for apartments, warehouse and office space is rising solidly. Home sales remain sluggish but the trend seems to be somewhat more positive than what we have seen nationwide. Home price appreciation continues to run ahead of the national average, reflecting both stronger economic gains and a scarcity of developable land.

Although we expect California's economy to continue to grow, the state is not without its challenges. Growth has moderated recently, and the huge surge in tech-related hiring and associated construction projects is unlikely to be sustained longer term. Retailers and financial services firms are still posting only modest gains. In addition, labor disputes at West Coast ports could push importers to make more permanent adjustments to their supply chains away from Los Angeles and Long Beach. Lower oil prices are weighing on the energy producers in Kern County, and a lack of water remains a challenge for farmers and residents alike. In addition, the state's high costs of living, combined with sluggish wage and salary growth for middle-income households, has exacerbated the out-migration of residents. Few of these problems are truly new, however, and California seems to continuously prove that none of them are insurmountable.

Figure 1

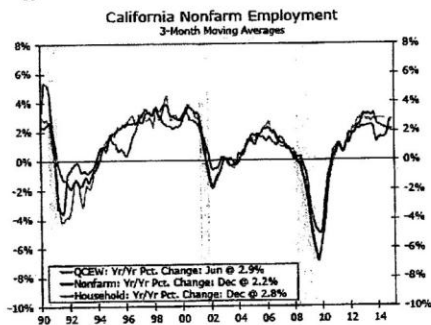
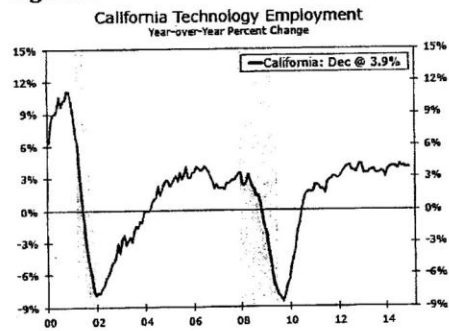


Figure 2



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

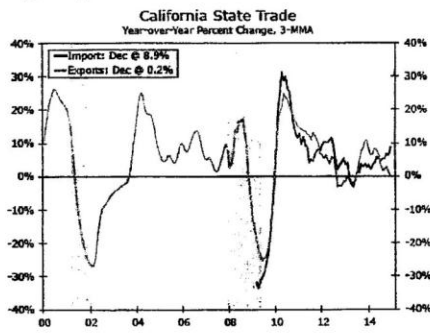
Facing Headwinds Head On

So far, the state seems to be weathering its challenges rather gracefully. The port dispute at the Port of Los Angeles and Port of Long Beach created some real hardship for businesses in southern California. While some of the total loss figures bandied about may be over the top, the losses for individual businesses are quite meaningful. Despite the ongoing dispute, which has left a flotilla of ships at sea waiting to unload, activity at Port of Los Angeles through the end of 2014 was actually 6.0% higher than the prior year and the Port of Long Beach also showed growth. Despite any bottlenecks that have occurred, those ports are busier than last year, though activity would certainly have been stronger had there been no disruptions.

Estimating the impact from the work stoppage is difficult. Some traffic is being diverted to other ports and some firms had built precautionary stockpiles in anticipation of some sort of supply shock. Most firms, however, operate with extremely lean inventories and cuts in production at manufacturing facilities along the West Coast and elsewhere are expected. In addition, businesses involved with perishables, including seafood and produce, likely suffered some sizable losses. Moreover, the dispute makes it more likely that businesses in the Midwest and Northeast will look to alternative ports for future shipping needs as West Coast ports look less reliable.

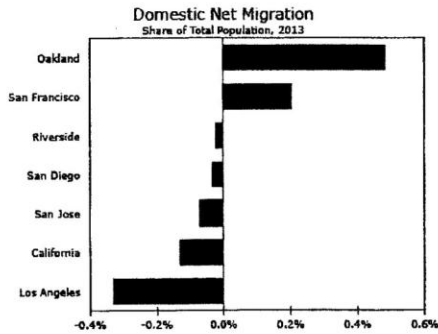
Drought is a major long-term challenge for California. Farmers have suffered as a result, but higher prices of key crops are partially offsetting low yields and farmers are moving toward more water-efficient crops. Almond and grape prices received in 2014 in California were both well above their year-ago levels. In addition, the scarcity of fresh water has spurred investment in much needed infrastructure improvements, including the desalination plant in Carlsbad and numerous smaller water storage and water treatment projects around the state.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Figure 4



Another major challenge for the state is that more U.S. residents move out of California each year than move in. This domestic outmigration has long been a cause for concern and is frequently blamed on the state's high housing costs. San Francisco and Oakland, however,

actually have positive domestic net migration, which is somewhat surprising given how expensive the Bay Area is. Domestic net migration is strongest in Oakland, which offers relatively affordable housing when compared to San Francisco. A booming labor market is helping to draw more people to the area. Despite high housing costs, relatively few households spend more than 30% of their income on housing. In the San Francisco metro area, 39.3% of households spent 30 percent or more of their income on housing costs, while that share was 43.4% statewide and 52.8% in Los Angeles. Although these numbers are above the national average, they show there is more flexibility in the housing market than first appears. In addition, California does benefit from positive total net migration, thanks to international migrants.

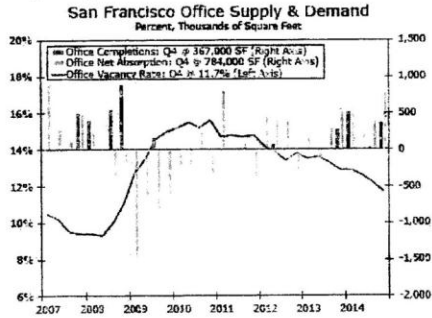
Office Market Holds Strong in the Bay Area

The office market in the state continues to flourish. Employment in the construction of nonresidential buildings is up a whopping 9.6% from a year ago. The office market is tightest in San Francisco where the vacancy rate is just 11.7%, considerably lower than the nation's 16.7%. Demand remains strong in the San Francisco market, as the tech sector continues to snap up large swathes of space, with notable leases from Salesforce, Uber, Yelp and Pinterest. In addition to high rents, another threat to the San Francisco office market is Prop M, which limits the amount of office space that can be built in the city. There appears to be some ways to temporarily work around this cap, but the pace of building has been strong and the current limit of 875,000-square-feet per year is unlikely to allow for supply to keep up with demand and could push rents even higher and drive new construction toward Oakland and San Jose.

With an office vacancy rate of 17.7%, San Jose has more supply than the markets along the Peninsula. Activity in Silicon Valley, however, is still quite high. About 3 million square feet of space is under construction in Santa Clara-Sunnyvale and another 1 million square feet in Cupertino. The new supply is doing little to alleviate demand. The vacancy rate has come down considerably from recent highs over the past couple of years. Although we remain constructive on the metro area, demand slipped some in the fourth quarter, which may point to some of the competition Silicon Valley is facing from San Francisco and elsewhere.

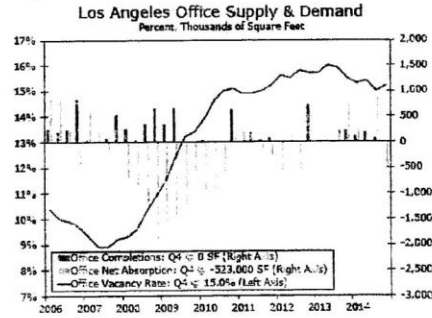
Demand for office space in southern California has been considerably softer. Los Angeles has only recently started to improve. Although there are some sizable projects under construction, including about 500,000 square feet in downtown and another 300,000 square feet in LAX/El Segundo and Long Beach. Los Angeles's broader economic recovery has been more modest than in other parts of the state. While more modest than the Bay Area, the creative sector has been vibrant throughout southern California, particularly companies producing digital entertainment content. Some of that work is beginning to come downtown. The office vacancy rate in Los Angeles is slightly below the national average and rents are increasing, which could help spur some more construction. Moreover, there has been a great deal of activity in the hotel and apartment sectors. Similarly, San Diego's office market is holding its own, with very little space currently under construction. Leasing remains steady and rents and resale prices continue to rise, benefitting from a lack of new supply and low interest rates. Considerably more projects are in the planning phases, however, though the physical construction still appears to be a ways off.

Figure 5



Source: Reis, Inc. and Wells Fargo Securities, LLC

Figure 6



Home Sales Growth Struggles

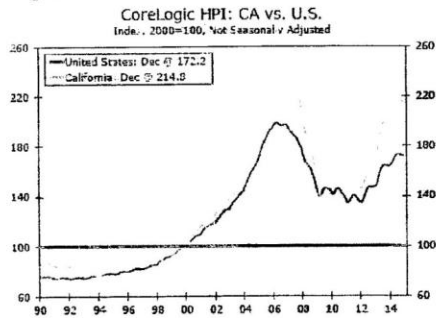
Home sales improved only modestly in 2014, with the single-family market up just 0.6% over the year and the condo and townhome market rising a paltry 0.2%. In the first month of 2015, however, sales worsened considerably, pushing single-family sales down 2.7 percent from a year earlier and condo and townhomes 4.6% lower over the same period. Some of the largest year-ago declines were felt in the Bay Area, which likely has more to do with the slim inventories than a lack of underlying demand in the rapidly improving economy. Indeed, San Francisco homes spend very little time on the market before being sold. The upshot is that weaker sales in the first month of the year means more inventory to lure potential buyers into the market. The pace of single-family construction has leveled off at fairly low levels but is showing signs of reviving in a handful of areas. The strongest markets have few developed lots available for single-family construction.

Figure 7



Source: U.S. Department of Commerce, CoreLogic and Wells Fargo Securities, LLC

Figure 8



The multifamily sector continues to strengthen, which comes somewhat in contrast to the slowdown we have seen nationwide. The apartment market is exceptionally strong in the Bay Area and San Diego. Vacancy rates in San Jose, San Diego, Los Angeles and San Francisco are all below the national average, which is encouraging more growth in those markets. Although home prices have moderated recently, they remain 7.0% higher than a year ago. Thanks to the faster-than-average appreciation, home prices are just 15.2% below their prerecession peak, not much further than the national average of 13.4%.

Conclusions and Outlook

California's economy will continue to outperform the national average. The surge in technology-related industries has had huge spillover effects in the Bay Area and San Diego, with construction projects cropping up to meet rising demand. The state has proved to be much more than a one-trick pony, however, with gains seen in most industries. Life and health sciences also appear to be strengthening, while transportation & warehousing continue to pick up. The housing market continues to show improvement and rising home prices should help boost consumption in a state where numerous homeowners had seen sizable wealth declines during the housing bust. The state faces its fair share of challenges, but by most measures, they appear to be abating. Drought has plagued the state's farmers and although water levels remain below normal, they have improved relative to a year ago. Furthermore, the port dispute has now been resolved, with workers rapidly removing the backlog of goods, which should provide a boost to the Inland Empire. The longer-run prospects for the state are also favorable, as California is home to some of the most highly-skilled workers in the world, a key driver of growth that is unlikely to change any time soon. Despite the high-cost environment, more people move into the state than move out of it, further reflecting the robust labor market and the abundance of high-paying jobs.

California Economic Outlook								
	2009	2010	Actual			Forecast		
			2011	2012	2013	2014	2015	2016
Real Gross Domestic Product, Billions *	1,906,376	1,924,438	1,957,114	2,009,936	2,080,284	2,148,933	2,215,550	2,284,732
Annual Rate	(4.1)	0.9	1.7	2.7	3.5	3.3	3.1	3.1
Normal Personal Income, Billions	1,517,095	1,578,553	1,685,635	1,805,194	1,856,614	1,953,155	2,076,348	2,194,568
Percent Change	(3.7)	2.7	6.8	7.1	2.8	5.2	6.0	6.0
Population, Thousands	36,961	37,336	37,702	38,053	38,431	38,803	39,178	39,544
Change, Thousands	357	375	366	361	369	371	375	370
Households, Thousands*	12,215	12,406	12,469	12,553	12,675	12,800	12,935	13,065
Change, Thousands	38	192	62	84	122	125	135	150
Nonfarm Employment, Thousands	14,370	14,210	14,399	14,705	15,153	15,566	15,961	16,336
Change, Thousands	(872)	(160)	189	347	447	412	396	374
Unemployment Rate, Annual Average	11.4	12.4	11.8	10.4	8.9	7.6	6.6	6.6
Total Housing Permits	35,099	43,716	45,471	58,549	80,742	82,925	98,030	105,000
Single-Family Permits	25,525	25,693	21,705	27,736	37,034	38,599	46,000	51,000
Multifamily Permits	9,564	18,023	23,766	30,813	43,708	44,326	52,030	54,000
Existing Single-Family Home Sales, Thousands	277	306	288	321	408	448	475	498
CoreLogic Home Price Index, Percent Change	(2.6)	(2.4)	(4.7)	13.5	20.6	7.0	4.7	4.5

* Values in 2013 include expected revisions
Sources: CoreLogic, California Association of Realtors, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC
Forecasts as of February 24, 2015