MULTIFAMILY LENDING UPDATE

by Steve Brown

We have uploaded the latest independent bank default data for January into our Loan Pricing Model. While there is little change in either the probability of default ("PD") or recovery information, the one notable exception is multifamily underwriting. The PD on loans to apartment buildings across the nation has increased by 11bp since December to approximately 2.12% annualized. After almost 12 months of increasing rents, monthly prices for apartments have started to come down over the last 3 months. This drop in rents is a result of lower demand, caused by home affordability remaining at high levels and greater supply (driven by increased building). Net absorption has decreased while vacancy has increased. After hitting a near term low in early 2002 (of 2.3%), as of January 2007, independent bank multifamily vacancy rates came in at 6.1%. Keep in mind that the 1Q almost always wreaks havoc with independent bank rental unit statistics (as the first 3 months of the year are usually slow for lease up and net absorption usually turns negative until mid-March). One factor that is also affecting the multifamily market is condo conversions. Slower condo sales have resulted in more supply of rental units available in the marketplace. This has led many owners of these units to try renting them instead. These afore-mentioned factors not only affect cash flow, but also loss given default ("LGD") as the valuation for multifamily units is also dropping in many markets. In the last 3 months, capitalization rates for low, medium and high rise buildings have all increased, as have garden-style apartments. One year ago, we reported that capitalization rates were outrageously low. We pointed out that we believed it was only investor speculation (instead of cash flow) that was driving valuation. This has since abated a bit and regions where we saw 4.1% capitalization rates (in places like Sacramento and Portland), are now seeing rates back to the 6% level. Given all of this, however, the multifamily sector outlook remains strong. We are simply attempting to point out that the multifamily sector has become a little more risky (as lending risk reverts back to the mean). Our model shows stabilization of credit at its current level, with the exception of some key areas likely to deteriorate further, due to supply and demand imbalances. While many of these areas are in Florida (Orlando, Palm Beach, Miami, Broward to name a few), we also project credit weakness in Las Vegas and Seattle. Additionally, look for some further weakness in Los Angeles, Washington D.C./Maryland and Phoenix. For banks looking to maintain their risk-adjusted ROE and don't have access to our Loan Pricing Model, credit spreads should increase an average of 6bp in February in order to compensate for the higher projected PD and lower recovery rates. The average bank multifamily loan garnered banks an estimated 22.3% risk-adjusted ROE for the month of January and we look for that number to decrease slightly due to a weaker credit profile.

BANK NEWS

No Checks

The Fed announced that it will reduce by 20% its nightly air transport service of checks by May. In addition, the Fed is expected to announce the closing of more check processing sites later this year with the goal of eliminating their involvement in paper checks by 2010. For banks that continue to rely on paper, they will continue to see their availability of funds to decrease.

Hiring

According to the American Banker, staffing levels at commercial banks are at 1.34mm, or the highest they have been since mid-1991.

USDA

The Bush Administration is trying to push through a dramatic increase (doubling in some cases) in the maximum loan amount to ranchers and farmers that need operating loans.

Airport Branches

M&T announced that it will open a branch at the Baltimore/Washington Int'l airport. We have looked into this for independent banks and while having an airport branch is great advertising, the locations are rarely profitable. If any reader has evidence to the contrary, we would love to hear about it.

Interest Rates

Experts point out that since 1990, capital inflows from other countries have been rising at nearly an 11% annual rate (after adjusting for inflation and exchange rates). That kind of globalization has created lots of liquidity, which is being invested for the most part in the U.S., keeping yields low.

Cheap Money

Spreads on junk bonds have ground down to 470bp over Treasuries, the lowest level in history (compared to the previous record of 520bp reached in 1997). Overseas investors anxious for yield are the primary reasons according to credit rating agency analysts.

Rich Customers

A study finds the number of households with at least $1mm in liquid assets has climbed 56% over the past 3Y, to 5.4mm. Meanwhile, the number of households with $5mm or more in liquid wealth has grown to 755,000, an increase of 47% over the same period of time.