QUESTIONING POLAR BEARS AND CRE

by Steve Brown

Those little penguins running around with those puppy-looking polar bears are just too cute to be believed. In fact, despite many pictures to the contrary, penguins and polar bears live on opposite continents and are never seen together except in zoos. Unfortunately, we have come to believe in a great many facts in this world just because we fail to challenge them. In like manner, few banks have challenged how their commercial real estate loans may perform in an economic downturn. While shocking a property's cash flows should be standard procedure when analyzing the credit on a loan, we are embarrassed to say that this is still not done by a majority of banks. If it was, banks that are looking at August data may find the start of a negative trend. Alternatively, banks that use our Loan Pricing Model or subscribe to our Credit Stress Analyzer will see the results of where the market is heading. This is because for the first time since 2001, both the future estimated probabilities of default and loss given default rates are increasing. One reason is a softening in asset prices in many markets. Problems in housing are starting to spill over to the general economy. Furniture sales, a metric that we closely watch, are down some 24% for the last two months. Homebuilder and mortgage layoffs are now affecting employment and the cost of financing has increased the carrying cost of many investment properties - making them unprofitable. Investors in July bought the fewest commercial properties in the last year. From a sampling of property sales data for July and August, apartment building acquisition is down 50% from just a quarter earlier and asset prices across the board will most likely fall at an annualized rate of 3% for 3Q. If real estate prices continue to track the general economy (as they have in the past) and employment continues to deteriorate (as the numbers last Friday portend), then commercial real estate prices are projected to be down some 7%. Capitalization rates, or a property's net operating income divided by the purchase price, were trending at 6.6% for community bank loans for the last 12 months up to 1Q. Now, these rates are moving up and may march back to the 9.15% rate that community banks saw during the last downturn in 2001. While real estate is regional in nature and not all CRE subsectors will perform the same, we can tell you that the underlying cash flow fundamentals are either slowing or turning negative in each of the 168 markets we track. This is also the case for almost all sectors, with maybe the exception of multifamily. While things are not looking too rosy for bank's existing portfolios, the good news is that pricing has recently increased to compensate for much of the cash flow variability risk. However, this assumes banks have the ability to quantify, track and monitor such changes to make proper risk/reward adjustments. Our advice right now is to question everything. Polar bears do not live on a steady diet of Coca Cola and a rock-solid CRE portfolio may not perform as it did in 2004 through 2006. CRE loans should be closely scrutinized - from appraised value to cash flow assumptions. If this takes place, banks will be in a better position to understand how deterioration in CRE may affect future earnings and capital.

BANK NEWS

M&A

National Penn Bancshares ($5.6B, PA) will acquire the HC for Keystone Nazareth Bank and Trust ($2.9B, PA), for $464.6mm or about 1.4x book.

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Canadaigua National Bank & Trust ($1.2B, NY) will acquire Genesee Valley Trust (NY) for an undisclosed sum.

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Farmers & Merchants State Bank ($720mm, OH) will acquire Knisely Bank ($46mm, IN) for an undisclosed sum.

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The HC of First Niagara Bank ($8.0B, NY) will acquire the HC of Greater Buffalo Savings Bank ($892mm, NY) for $153mm or approximately 1.1x book.

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Nara Bancorp ($2.2B, CA) said it has a deal to acquire a branch in Brick Township, NJ, from an undisclosed New Jersey bank. The purchase will allow Nara, which has 4 branches in the NY metropolitan area, to expand its East Coast footprint.

Layoffs Continue

Countrywide Financial Corp announced Friday that it will cut as many as 12k jobs over the next 3 months and it expects loan originations to decline by 25% in '08. Separately, IndyMac Bancorp will eliminate 1k jobs, or about 10% of its workforce, over the next few months.

Mortgage Lenders Cutoff

Citigroup has suspended lending to mortgage companies, saying its First Collateral Services unit will no longer accept new clients for "warehouse" lines of credit. First Collateral provided lines of credit, ranging from $2mm to $250mm to mortgage banks, so they could fund home purchases and refinancings.

Financial Ed

A new FDIC study shows banks can build retail relationships and improve performance by providing financial education to customers. The report outlines the many ways banks can get involved, including providing basic finance for students or immigrants; mortgage counseling; or debt reduction strategies. See the latest FDIC Quarterly.