PICKING LEMONS TO MAKE SOME LEMONADE

by Steve Brown

As the old saying goes, "when life gives you lemons, make lemonade." Many community bankers have been feeling kinda' down as of late. That isn't surprising, when you consider so many are facing softness in the economy and struggling with increasing credit issues, more competition and tighter margins.

In such an environment, it is critical to stay positive and alert. We say that because out of such enormous pressure comes opportunities that can arise quickly.

Consider the retail sector. If you have been watching the news lately, you probably heard Linens 'n Things will close 120 stores and file for bankruptcy. That announcement was preceded by similar ones from Children's Place, Sharper Image, Bombay, Wilson's Leather and many others. It is clear that retailers are under stress and many are aggressively shuttering unprofitable stores. Some of the most notable ones include Disney (100 stores), Ann Taylor (117), Foot Locker (274), Zales (100), Pacific Sunwear (154) and CompUSA (103).

All told, the number of reported store closings in the 1Q of 2008 has already surpassed some totals for the first 6 month period of many prior years. Things are getting so dicey that experts now project an estimated 7,000 stores could close this year, a 25% increase from 2007 and a level not seen since 1991.

As if that weren't enough to deal with, the retail construction boom that really took off in January 2004 (2Ys after the boom in residential construction) is adding even more stress and capacity to the sector.

During the 4Q of 2007 alone, some 12mm square feet of neighborhood shopping centers were completed - the highest quarterly total in 3Ys.

In addition, this year we will see an additional 130mm square feet of retail space come online. That is on top of 143mm from last year and well above the 100mm square foot average of the prior 10Ys. All of that additional space is putting pressure on the vacancy rate, which is projected to rise as high as 10% to 12% by the end of the year (vacancies are currently averaging 7% to 8% in many markets). Vacancy rates are likely to increase in areas most affected by the housing downturn; which include Las Vegas, Phoenix and most of Florida.

No matter how you slice things, a drop in consumer spending, less funding availability and extreme competition in the retail sector are all taking a toll on these businesses.

Those are the lemons, but where is the lemonade? Well, retail is one sector where location matters a lot. Stresses will give bankers opportunity to widen out credit spreads. Conduits have sharply decreased lending, large banks seem disinterested in all but the biggest deals and lending opportunities abound.

Given so much uncertainty in the market, what is the opportunity? For the first time in quite awhile, community banks are finding more opportunities to lend on higher quality projects. Those that do their research, monitor credit migration and stay on top of regional trends in consumer spending have an opportunity to lock the best of these customers in for a long time.

Geographic areas in retail that community bankers might want to consider lending into include New York, Orange County, Los Angeles, Maryland, Northern Virginia, Atlanta, San Francisco, Seattle and San Diego. Meanwhile, areas that are getting worse include Kansas City, Phoenix and San Antonio.

While retail net absorption this year is projected to reach only 3.7mm square feet (compared to 60mm last year), opportunities are everywhere if you are careful.

Community bankers may be drinking a lot of lemonade in 2008, but that is the market right now. To help pick the right lemons, we'll continue to surface some lending sectors bankers may also want to carefully consider during such difficult times.

BANK NEWS

FNMA

The probability of default for bank owned debentures jumped 6bp to 48bp (however, FHLMC is similar), as the GSE posted a larger than expected 1Q loss of $2.2B. This level is greater than many loans community banks make and represents a growing credit/liquidity risk. Spreads are 5bp wider. In related news, Fannie said it would cut its dividend and raise $6B in capital.

UBS

After announcing a $17B 1Q loss, the bank said it would fire 7% of its workforce (primarily securities and wealth management divisions). More important to community banks, the firm announced it will withdraw from the municipal underwriting business, reducing a needed source of liquidity.

Target Credit Cards

Retail store Target said credit card performance has been deteriorating over the past few months. The company reported 30 day credit card delinquencies have now reached their highest rate in 7Ys. Target is the 2nd largest discount chain behind Wal-Mart. In other related news, JP Morgan Chase has agreed to purchase a 47% stake in Target's credit card receivables and operations. The complicated deal is 5Ys in length and can be extended. In other words, this is more like a perfected loan than an outright sale. However, JP Morgan is expecting a 9%+ return, while Target gets approximately $3.6B of liquidity.