LOOK OUT BELOW

by Steve Brown

While certainly not as bad as getting hit by a piano dropped from a building, community bankers are beginning to see commercial real estate deterioration in the loan portfolio.

To be sure, the outlook for CRE is deteriorating. Spillover from consumer weakness, increasing job losses and other factors have led to a slowdown in property sales, higher vacancy rates, negative rent growth and declines in value. The good news is that in general, CRE was not as overbuilt as other sectors. For now, supply is outstripping demand, so while bankers still have some time to sort through problems, moving quickly is critical.

By sub-sector, the Federal Reserve has warned bankers to expect prices to fall by the highest amount nationwide in office, hotel, industrial, retail and finally, multifamily. Bankers should take note, however, that conditions in the retail sector are deteriorating quickly, so this list is very much in flux.

Reviewing the office sector by geography, we find areas that have seen the greatest strain over the past 12 months in order (per Federal Reserve reports) are Phoenix, Tampa, Honolulu, Salt Lake City, Orange County, Tucson, San Jose, Toledo, Dallas and Los Angeles. While Detroit still remains the hardest hit overall, Phoenix saw the largest annual decline (due to a sharp up-tick in new supply which exacerbated an already high vacancy rate). The office vacancy rate in Phoenix has reached nearly 18% and sizeable office space is still under construction, which will only serve to exacerbate the situation. Banks operating in these areas of the country or lending into them are urged to redouble underwriting efforts to ensure adequate analysis has been performed.

Moving to the industrial sector, we find the Fed reporting that demand for warehouse space has also been softening. While here again, Detroit remained the weakest overall region in the country, strain has been rising the most over the past year in Phoenix, Orlando, West Palm, Austin, Dallas, Tucson, Memphis, Riverside, San Francisco and Forth Worth.

The outlook for the hotel sector is also soft. That is no wonder, given a weak economy, bleak consumer confidence and a slowdown in business travel. Lower demand, increased supply and higher occupancy rates have some experts predicting the hotel space will see its worst performance in 20Ys. Profits for the industry are projected to decline by 8% and revenue per available room is projected to fall by 5% to 7%. Despite that doom and gloom, the good news for the sector is that there has been a 70% increase in the number of hotel projects abandoned or deferred over the past 12 months. As supply projections fall back in line, earnings should begin to stabilize.

Finally, we review the once stable multifamily sector. Here the hardest hit area isn't Detroit, but rather Houston, followed by Fort Worth, Phoenix, San Antonio and Jacksonville. As for areas that have been seeing significant weakening over the past 12 months, those that have experienced the greatest impact in order are San Diego, Miami, Tampa, Sacramento, Riverside, San Jose, Fort Worth, Kansas City, Dallas, Philadelphia and Chicago. As the data show, unsold homes on the market for rent and increasing supply are pushing rent growth down and vacancy rates higher in some areas. Despite this, the sector remains mostly balanced and fundamentals are decent.

Stay focused on credit underwriting fundamentals, monitor weakness by area and by sector/sub-sector and you are well on your way to avoid being hit by a falling piano. Oh yes, it also doesn't hurt now and again to look up and see what might be hurtling toward you at a high rate of speed.

BANK NEWS

Rates Offered

The FDIC is not only considering a risk-weighted deposit insurance premium on banks and thrifts below the capital regulatory requirements, but considering restricting the offering rates of these banks as well.

Treasury

Timothy Geithner was confirmed yesterday as the US Treasury secretary by the U.S. Senate.

FNMA

The GSE said it needs another $16B in emergency funding to cover losses in its mortgage portfolio. The move follows a similar one by FHLMC, who indicated previously they will need as much as $35B in assistance.

Freddie Fannie & FHLB

The Federal Housing Finance Agency is considering a proposal for new minimum capital requirements for theses government agencies.

Construction Activity

New home construction in 2008 fell to its lowest level in history (records go back to 1959).

Recession/Depression

For those trying to get a handle on whether we are in a recession or depression, know that GDP is projected to have fallen by as much as 3% to 5% in the 4Q (a depression is generally defined as a 10%+ decrease), which pales in comparison to the 27% drop the country experienced from 1929 to 1933.

Home Selling

High-end home builder Toll Brothers has launched a new program offering 30Y fixed rate loans at 3.99% for new home purchases. If that doesn't reduce inventory, we don't know what will.