COMPARING CRE VS. C&I

by Steve Brown

Yesterday's BID we discussed the merits of C&I lending. One reason why community banks do not add more C&I to their balance sheet is that they often have much higher underwriting standards when it comes to this asset sector. As we pointed out yesterday, the probability of default is often lower on C&I than it is on CRE despite holding real estate as collateral. As such, it is ironic that banks that believe they are lowering risk, are actually exacerbating it.

One issue is that most community banks fail to utilize a risk-adjusted pricing model. Because of this, most underwriters have a difficult time comparing the two classes when it comes to risk, pricing and structure and so prefer CRE because it feels safer. This situation manifests itself by large banks gaining an outsized marketshare in C&I. At larger banks, C&I and CRE loans make up approximately 22% and 24%, respectively, of total loan portfolio - a close to optimal diversification. At smaller banks, however, that same ratio is 17% and 42%. Furthermore, community banks have recently been losing market share in C&I credits. This has been partly a reflection of certain larger banks abandoning CRE relationships.

We believe that there are additional specifc reasons why community banks have lost C&I market share. First, CRE loans are perceived to be less risky because of the tangible security. Real estate security may be better collateral, but there is a very high inverse correlation between default and collateral value - the value of collateral declines at precisely the time it is most needed. Second, scale allows CRE loans to be more bankable. CRE loans tend to be larger and less complex to underwrite and monitor. The smaller size and perceived complexity of C&I loan structure requires that lenders develop a level of knowledge and specialization that is outside the area of expertise of most real estate underwriters (an area of expertise at most community banks). Third, there is a perception that CRE loans have inherently more cash flow cushion in the event of economic downturn.

It is the last sentence that we wish to address. Larger C&I loans, and those that do not require asset-based draw calculations, are generally underwritten to three financial covenants: debt-to-EBITDA, debt service coverage, and interest coverage. While the last two ratios are common to CRE transactions, the debt-to-EBITDA (DTE) ratio is not. The closest CRE example of DTE is loan amount divided by NOI. C&I loans are generally underwritten to a maximum DTE based on perceived stability of future cash flow. Stable industries, such as utilities, may be underwritten to 8X DTE. However, less stable cash flow businesses, such as technology, will be underwritten to approximately 2X DTE. While every transaction is different, the amount of permitted leverage should correspond to the future expected stability of the borrower's cash flow.

What interested us was the DTE that the typical community bank feels comfortable underwriting for CRE categories in today's environment. We were surprised at the results. For example, at 70% LTV, 9% cap rate, 6.00% coupon on 30-year amortization, the CRE loan exhibits a DTE of 7.78X. A significant amount of leverage on what has been recently declining collateral value and unstable cash flow (especially for office, multifamily and hospitality). Only at 54% LTV does the CRE loan exhibit acceptable DTE of 6X. Few lenders have the ability to generate such low leverage and much less at 9% cap rates.

For community banks that want to survive and flourish, developing an expertise and marketing strategy for C&I loan generation is crucial. If you do not utilize our Loan Pricing Model, but would like to compare general underwriting parameters, we have developed a simple model that will help evaluate C&I with CRE loans on the above mentioned ratios. This model is free and available to any community bank. If you would like a copy, please email cnichols@bancinvestment.com and we will email the file to you.

BANK NEWS

Overdraft

The FRB announced yesterday new restrictions effective July 10th, barring banks from charging overdraft fees from ATMs and debit-cards without consumer consent. Consumers must be provided notice outlining services (fees and options) prior to opting in.

ABS

The FDIC approved an extension for transitional safe harboring of debt securitized by consumer loans and new bonds issued before the end of March 2010. Even in the event of the institution failing or filing for bankruptcy, the FDIC cannot seize the assets backing these securities.

Bills

A study by Experian Simmons finds online bill pay has risen 40% since 2007 and nearly 15% "always" pay their bills online.

Construction Lending

Analysis by Foresight Analytics indicates 16.3% of all construction loans held by US banks were delinquent, a number projected to rise to 18.2% when the 3Q data is finalized in coming weeks.

Big Bucks

As of the 2Q, the 500 largest nonfinancial companies in the country held 9.8% of their assets in cash - the highest level in 40Ys.