FUTURE EXECUTION IN COMMERCIAL REAL ESTATE

by Steve Brown

Sometimes a strategy can be right but the execution can be improved upon. Take the Trojan Horse for instance. While a solid plan for getting the Greeks inside Troy, Odysseus failed on the medical front, when he had Greek solders consume large amounts of raw carrots to "bind the bowels" and hold nature's call at bay. Unfortunately, carrots, with their high insoluble fiber content, had the opposite effect and soldiers couldn't wait to get out. In similar vein, banks that are eager to book CRE loans should also monitor future expectations. While many banks are good at deducing credit risk, few combine and rank sectors with pricing to understand optimal allocations within each sector. We took a look a look at the performance of about 35k properties (data as of the end of 2011) with loans on them, covering 90 metro markets. We then looked at current pricing, leverage requirements, projected effective rents, vacancies, building permits, absorption and demographics (data as of the end of June). Today, we give an overview of which CRE sub-sectors might perform the best in the next 5Ys based on this data, to help you in the future. Office lending comes out on top as one of the best risk- adjusted areas for community banks. Year-over-year cash flow growth has been a negative 2%, but it has stabilized. That allows banks to garner loan pricing in excess of a projected 16% ROE (all ROE is risk-adjusted) over the next 5Ys. Effective rents have grown by 0.3%, slightly slower than last year's 0.5% pace. While vacancy rates are averaging 17.2%, that is down 30bp from last year and vacancies have been largely stable for the past 2 quarters. Given this sub-sector's sensitivity to vacancy rates and the fact that occupancy is improving (coupled with limited supply coming on line), the future of office lending looks like it will be the best risk-reward trade off of any of the major community bank CRE sub-sectors. Looking at a combination of pricing, vacancies, effective rents and future supply/demand, lower-risk markets include San Francisco, NY, D.C. and Birmingham. The best risk- reward profile can be found in Austin, Nashville and Houston. Next in the value chain is multifamily. Here, banks can expect to obtain an 11% ROE over the next 5Ys. While the risk is lower than office, pricing is back to the tightest levels we have seen in the last 10Ys, thus hurting this sub-sector when risk is compared to return. Properties we reviewed saw cash flow up 6.2%, the 2nd consecutive year of growth. The current economic slowdown, combined with a projected decline in homeownership rates, has multifamily improving almost faster than loan pricing is compressing. Vacancy rates declined 20bp in 2Q and are currently at 4.7%. Rents are up about 3% on a YOY basis and are projected to continue to rise, as new supply is just starting to ramp up. Supply looks like it will catch up to demand by 2016, but by that time, much of the lending risk could be mitigated by better cash flow. Lower-risk markets are NY, Portland, Seattle and Central Jersey, while the best risk-reward trade off can be found in Austin, Nashville, Fort Worth and Houston. Retail is projected to deliver the next best return with a 0.8% increase in property cash flow and flat future fundamentals. Record low new construction is finally stabilizing retail economics, but online purchase growth continues to hurt physical stores. The national vacancy rate is 10.8%, down 10bp from last year. The good news here is that effective rents have risen 0.2% from last quarter, the 3rd consecutive increase. Only regional and some community malls have shown an increase in demand, while most neighborhood centers and stand alone properties remain flat to negative. While we still see loan quality deteriorating, pricing spreads remain wide and a well priced loan should be able to garner a 6% ROE over the next 5Ys. One area of note is hospitality. This one would have a high risk- adjusted position, but because of its high correlation to the global economy, this sub-sector remains hard to forecast (so we give it a special mention). However, cash flow is up 11% and occupancy is up 20% in some markets. If the economy can continue to grow, hospitality lending could eclipse all other CRE areas in terms of risk-adjusted performance. Finally, we mention negative sectors that industrial, self-storage and specialty properties. These are all still deteriorating and/or lack enough data to make an accurate projection of the future. Limit exposure to these sectors until the economy improves.

BANK NEWS

Earnings

Citigroup beat estimates, but produced earnings down 12% $2.9B, as asset quality is still an issue, margins are reduced and earning assets have decreased some 28%.

GDP Weakness

The IMF cut expectations for world growth to 3.5% this year (from 3.6% prior), marking the lowest level since 2009. In addition, 2013 global growth expectations were reduced by nearly 5% (to 3.9%). Meanwhile, the U.S. is forecast to grow 2.0% this year and 2.3% in 2013 (also down from prior estimates). These economic growth downgrades unfortunately mean loans will be even harder to originate.

No More Fees

Ohio will no longer allow U.S. Bank (as the prepaid debit card provider the state uses for unemployment compensation) to charge fees for overdrafts on the card.

Pre M&A Filing

The Fed introduced a new process for comment that allows banks to garner feedback on potential acquisitions or business changes before formally submitting them. Pertinent documents such as letters of intent, business plans, new product analysis and others can be electronically submitted through the E-Apps system. Turnaround time is targeted at 60 days or less for comments on filings.