BANKING & FINANCE

# Surveying Current Trends in Commercial Real Estate

November 5, 2015

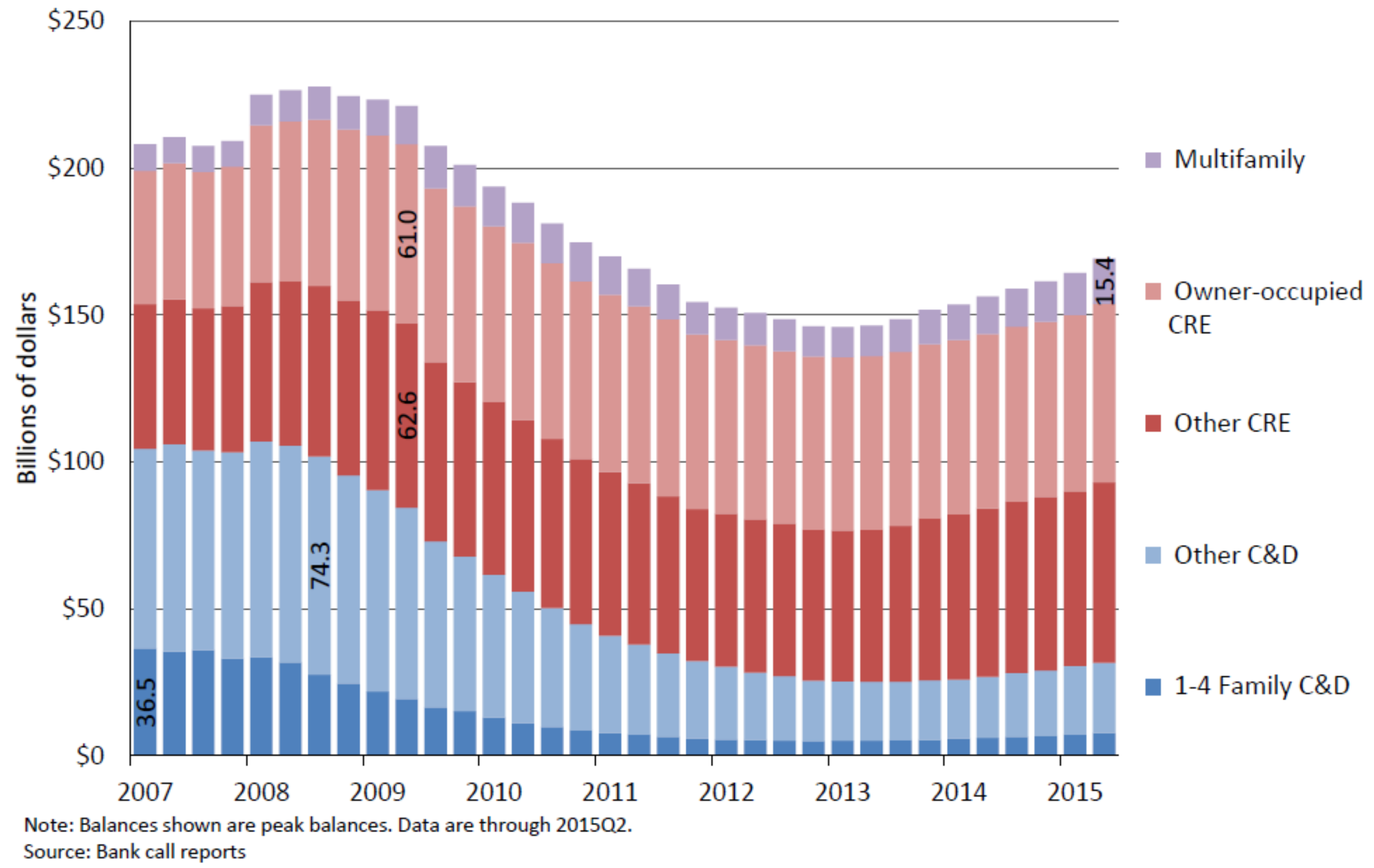
In the Southeast, in particular, commercial real estate giveth and commercial real estate taketh away—repeatedly. When times have been good, they have been really, really good, and when bad…well, we know the story. So where are we now?

As underlying economic fundamentals have improved, commercial real estate (CRE) has slowly rebounded, although specific performance varies depending on the market, submarket, location, and product. And with growth comes risk. As risk reemerges, questions about the future of the market arise. So how should we respond to the emerging risks in CRE? What should we be watching for, and what is the appropriate risk management strategy in the current environment? Let's take a look.

## Exposing the exposures

First, a word about exposures: CRE is growing—finally. During the crisis and subsequent recovery, as problem loans were liquidated and CRE originations fell, overall CRE balances steadily decreased. Following a five-year decline, CRE balances increased for the first time in 2013 (see chart 1).

**Chart 1: CRE Loans Outstanding at Sixth District Banks**

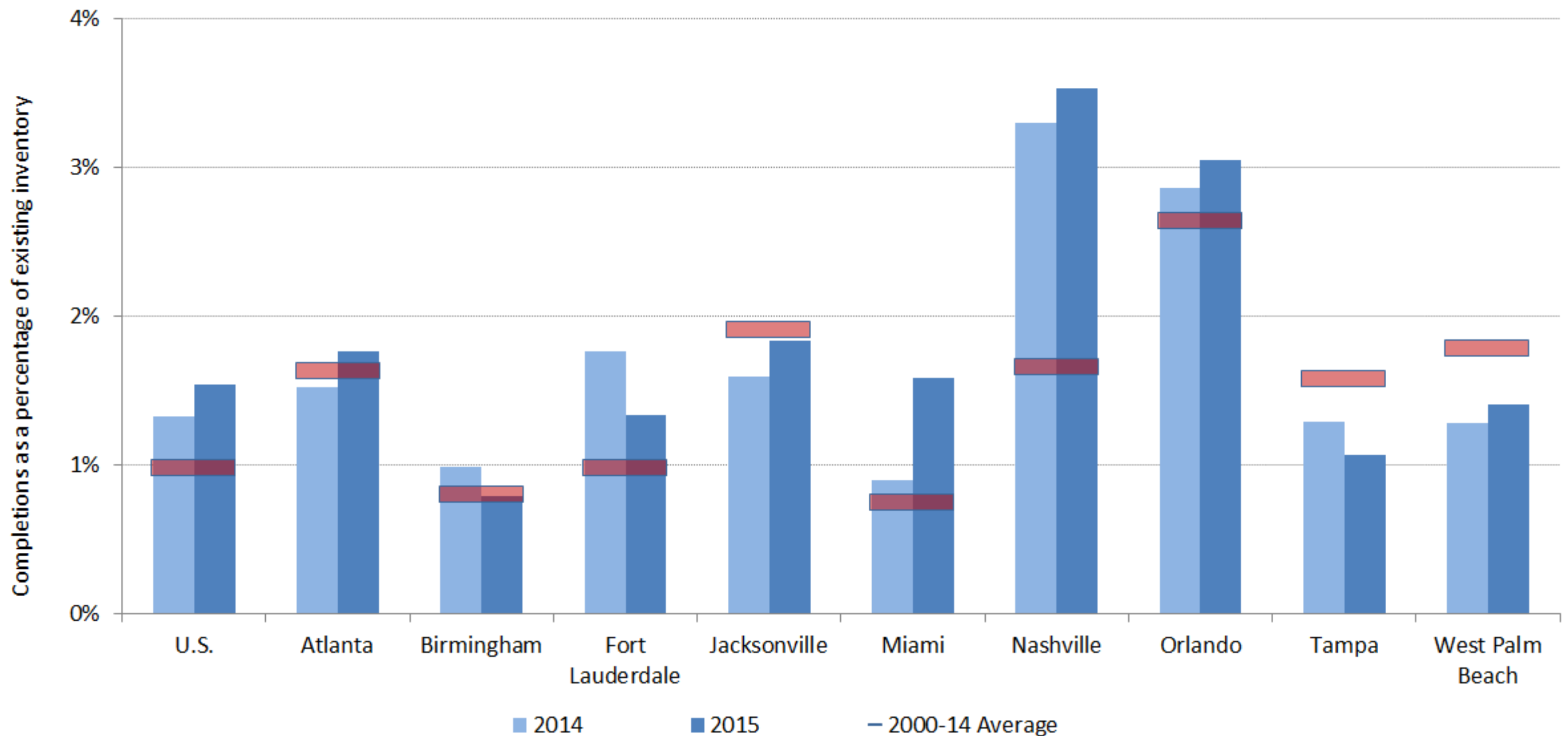



Note: Balances shown are peak balances. Data are through 2015Q2.
Source: Bank call reports

Since CRE activity began to pick up in 2013, multifamily construction has led the way. Nationally, the multifamily apartment sector has benefited from the aftereffects of the mortgage crisis. Economic uncertainty and trends in residential real estate markets kept many buyers on the sidelines. As a result, occupancies and rents in the multifamily sector have climbed sharply, and fundamentals have improved significantly during the last five years. According to Axiometrics, from June 2010 through June 2015, rents increased by more than 33 percent.

As surplus units were absorbed, new construction returned. In fact, nationally, the pace of 2015 multifamily building exceeds the 2000–14 average by 56 percent. Chart 2 indicates that in the Southeast, markets such as Atlanta, Fort Lauderdale, Miami, Nashville, and Orlando are also currently building more units than the average during the last 15 years. As institutions expand their presence in the multifamily lending space, bank loan balances are growing. Growth is good; however, at this point in the cycle, it is appropriate to step back and consider the sustainability of apartment fundamentals and the implications of the robust supply dynamics. Greater diligence is required on the part of lenders as more units are constructed and more renters graduate to become homebuyers in the next few years, as many analysts expect.

**Chart 2: Apartment Construction Supply Comparisons**



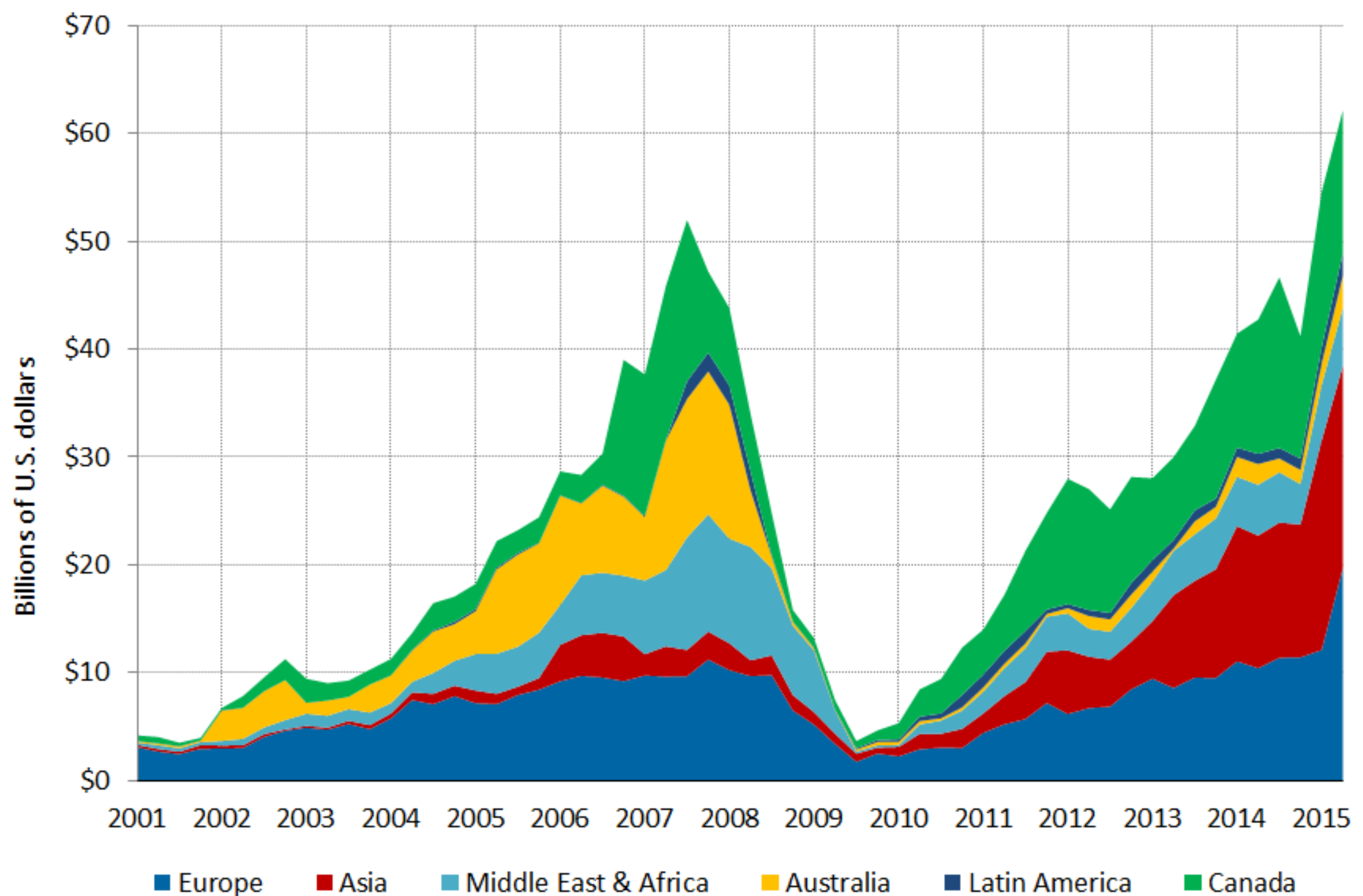

Note: 2015 data include year-to-date completions and current construction with an expected 2015 completion date.
Source: CBRE-Econometric Advisors, Risk Analysis Unit/Federal Reserve Bank of Atlanta

Although multifamily lending has driven CRE growth on banks' balance sheets, 1-4 family acquisition, construction, and development (ACD) has lagged. In the period following the downturn, housing demand fell as potential buyers deleveraged and repaired their credit. The Federal Reserve's summary of household debt service and financial obligations ratios fell from a high of 18.1 percent in the fourth quarter of 2007 to a trough of 14.9 percent in the fourth quarter of 2012. Many first-time buyers likely

continued renting as a result of economic uncertainty and misconceptions about the availability of financing. Negative equity levels limited other homeowners' mobility. Now, however, pent-up demand is driving price increases in the most desirable markets. Continued economic improvement will further increase demand and put more pressure on prices. Builders are rapidly depleting their existing lot supplies. As a result, demand for ACD lending is expected to improve. Already, the trend in ACD loans showed a clear inflection point in mid-2014. The sector finally moved from liquidation to stabilization and, in the second half of the year, a bounce off the bottom.

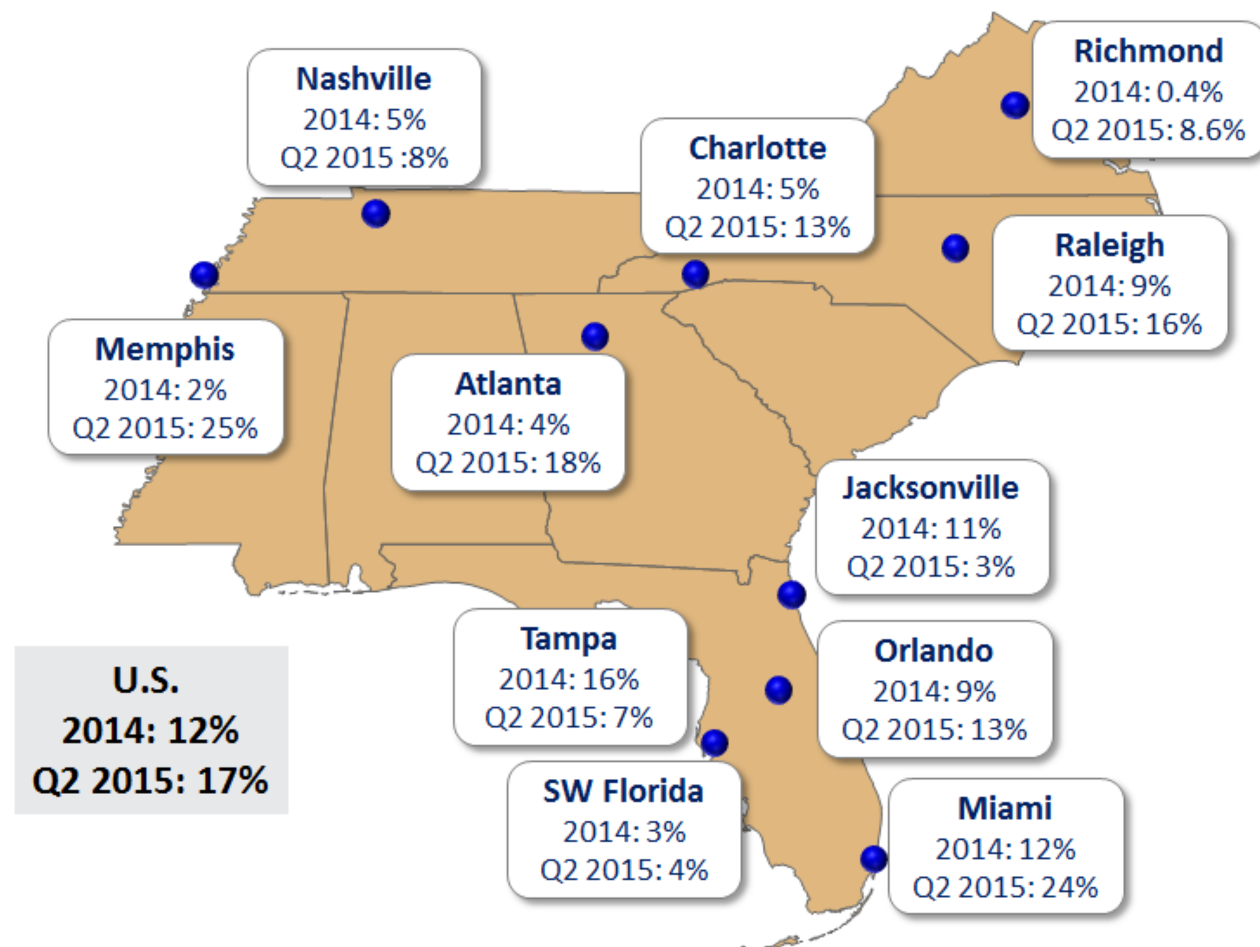
## Foreign investment continues flowing

One development emerging in this CRE cycle is the level of foreign investment in real estate outside traditional "gateway" markets. Foreign investment in CRE has risen significantly, amounting to almost $50 billion in 2014, a record high but an amount already surpassed this year (see chart 3). In the past, foreign investment in U.S. CRE has been associated with the gateway markets such as San Francisco and Boston. As the focus of foreign investors broadens to include secondary and tertiary markets, a number of southeastern areas—including Atlanta, Miami, Nashville, and Orlando—are experiencing an inflow of foreign investment.




For example, in 2014, foreign investors made roughly 4 percent of CRE purchases in the Atlanta market. As of August 17, 2015, year-to-date foreign investment had ballooned to 18 percent, as the map below shows.

## Foreign Capital Invested in Southeastern CRE

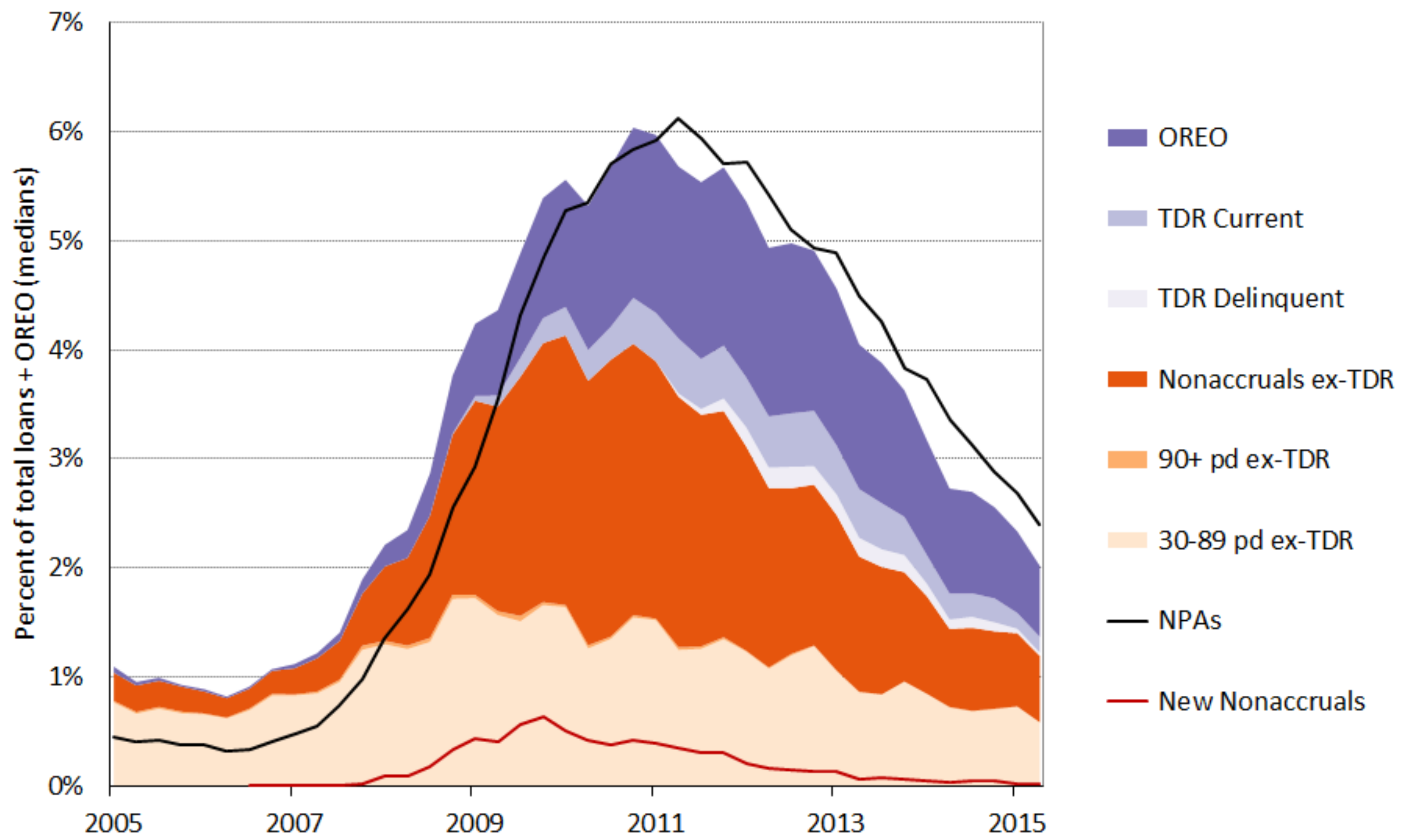



Note: Data are through 2015Q2 and indicate encompassed sales of $2.5 million and greater.
Source: Real Capital Analytics, Risk Analysis Unit/Federal Reserve Bank of Atlanta

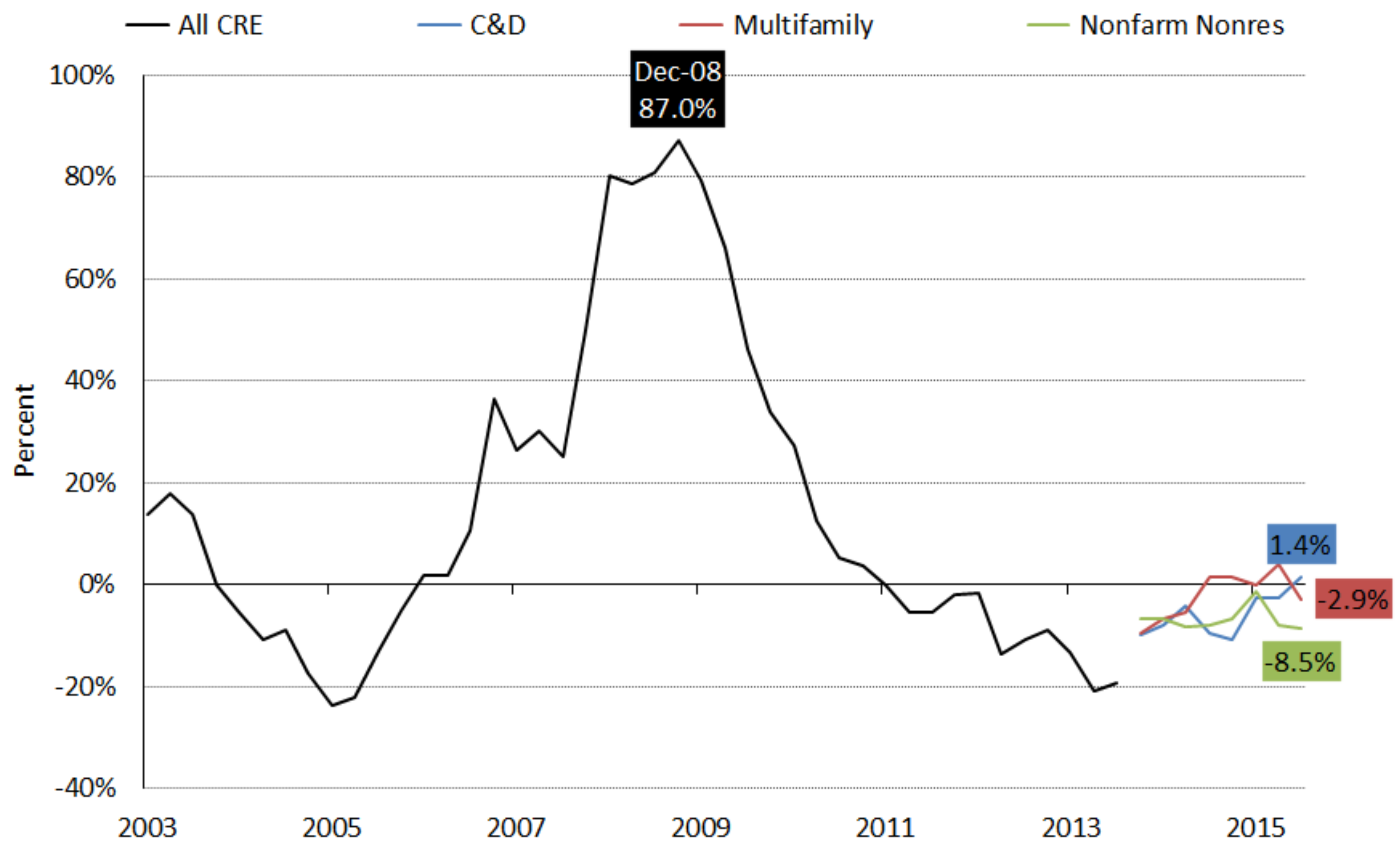
In some cases, foreign investors are paying substantially more than market value for properties, and that is having a significant effect on cap rates and associated CRE prices. Anecdotal reports from bankers across the country suggest that increased foreign investment is distorting property values and introducing additional risk to the marketplace. Foreign capital presents a challenge to determining accurate market values. In addition to accelerating price increases, rapid expansion and contraction of factors such as foreign capital, which can occur during periods of economic uncertainty, can also cause disruptions. Given this, trends in foreign investment in U.S. CRE should be monitored closely and carefully considered in underwriting.

## Asset quality moves in the right direction

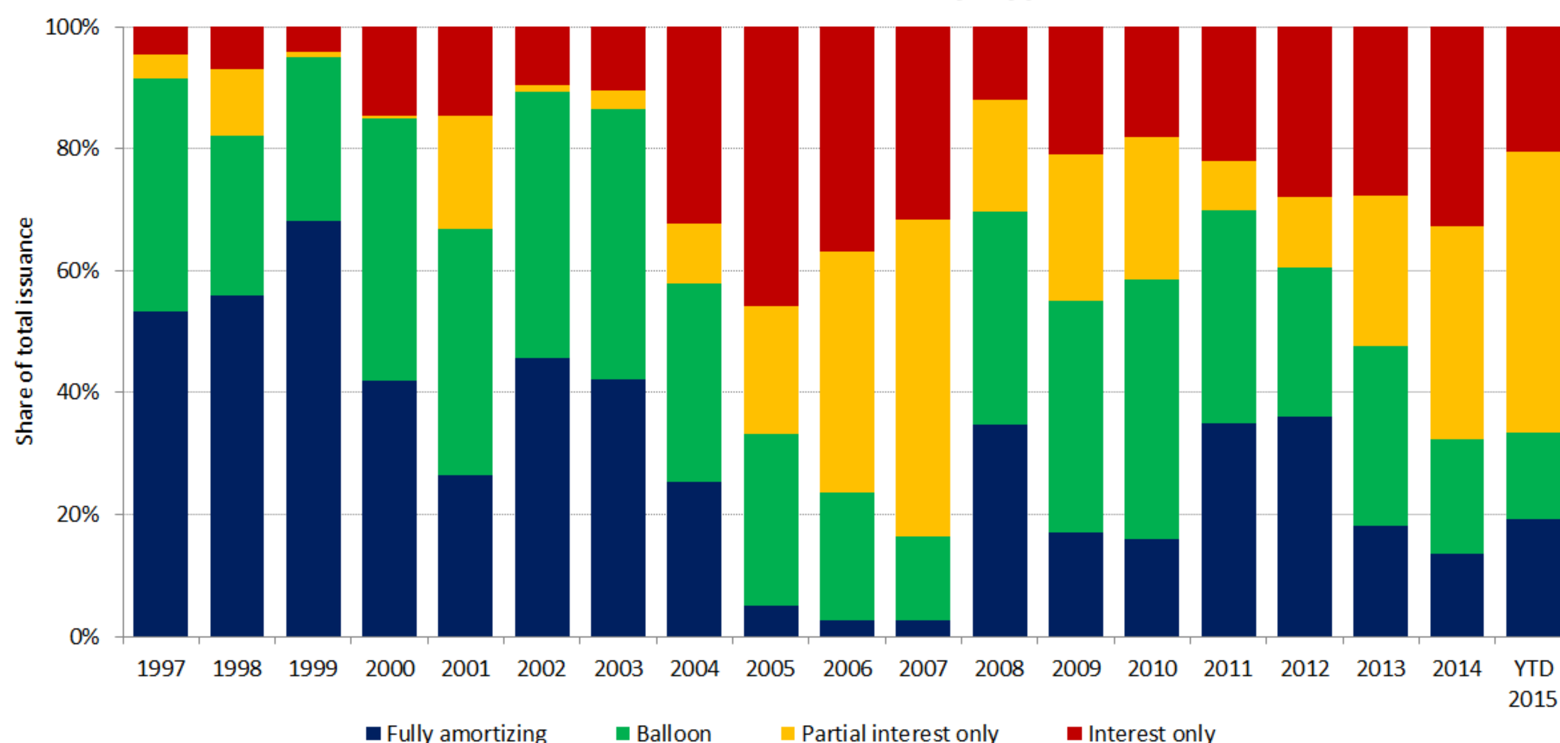
One key, though lagging, indicator in the market cycle is asset quality. Based on current metrics, asset quality continues to trend in a positive direction (see chart 4). Problem loan levels are back in line with or, in some cases, have fallen below precrisis levels. Noncurrent loans (as a percentage of total loans) and net charge-offs have returned to precrisis levels. Other real estate owned (OREO) as a percentage of total loans, on a median basis, is now on par with the first quarter of 2009, when balances first started to increase.




However, although asset quality has improved, surveys such as the Federal Reserve's *Senior Loan Officer Opinion Survey on Bank Lending Practices* show that underwriting standards for CRE continue to ease (see chart 5). According to the July 2015 survey, “Regarding the level of standards for CRE loans, domestic banks reported that the current level of standards on loans secured by multifamily properties and loans secured by nonfarm, nonresidential (NFNR) properties were generally easier than or near the midpoints of their ranges.”




In addition, recent data indicate an easing in commercial mortgage-backed securities (CMBS) underwriting (see chart 6). So although asset quality appears healthy, the trend toward looser credit standards at the local level and on Wall Street is noteworthy.




## Market concerns persist

As stated, CRE continues to experience improvement. However, recent trends are indicative of potential risk in certain sectors and markets. Multifamily properties in some areas are being built at rates exceeding their 15-year average, which may lead to an oversupply in the future and a resulting drop in prices. Supply constraints in residential real estate are pushing prices higher. As a result, residential-dependent CRE is finally taking off and may have an impact on the demand for multifamily. Foreign investment in CRE in the United States is at a record high and is already causing distortion in some markets.

From a lending perspective, historically low interest rates, modest growth in the gross domestic product, new requirements for consumer lending and risk retention, and higher regulatory capital requirements may prove difficult to navigate simultaneously. Median return on assets and net interest margins rank well below their precrisis levels, in large part because of persistently low interest rates, leaving less room for error in lending decisions.

## Lessons learned enhance future analysis

Throughout the financial crisis and subsequent recovery, data points were gathered on a case-by-case basis by supervisors, bankers, and industry analysts. On the ground level, bank supervisors reviewed numerous strategic plans and evaluated countless CRE loans. At a higher level, a significant amount of market information surfaced as the crisis unfolded. This information informed supervisors of fundamental imbalances that were emerging in one CRE-related market (subprime mortgages) and then spreading to other market segments. As a result of the lessons learned during the crisis, risk management guidance and data analysis capabilities have improved.

In 2012, the Board of Governors issued SR 12-17, "Consolidated Supervision Framework for Large Financial Institutions." SR 12-17 directs boards of directors to use the lessons and insights from the crisis to establish a governance framework that will maintain the strength and resiliency of their firms across a broad range of economic and operational stresses. Risk managers must look beyond the valuations determined by standard appraisal approaches. The board and management must ensure that underwriting is based on the likely source of repayment and not make decisions solely based on rising values. Potential market disruptors must be assessed before putting the capital—and future resiliency of their firms—at risk. This approach can include rigorous stress testing.

Bank supervisors have also significantly enhanced their data analysis capabilities. Through the use of expanded data collection and increased technical expertise, supervisors are developing a horizontal view of industry risk. When this data analysis is combined with lessons learned from the crisis, current supervisory observations, and old-fashioned examiner judgment, valuable insight into the fundamentals needed to support a healthy CRE market emerges. Using this knowledge, emerging risks in national markets and at the local level may become apparent. Once these risks are identified, risk management strategies, based on lessons learned, can be refined to address changes in the market.

## Taking the next steps

So, how should we respond to the emerging risks in CRE? The proper response is vigilance. Although CRE metrics are positive in many markets, the recovery is still uneven across sectors and geographies. Potentially disruptive trends in multifamily, residential dependent CRE ACD lending and foreign investment are emerging. Additionally, surveys note an easing of CRE credit standards.

As in the last crisis, when demand and value trends appear to separate from the underlying market fundamentals, banks must be cautious. The underwriting and approval of individual credits must be backed by due diligence that considers whether market fundamentals support the feasibility and value of a proposed project. Remembering this lesson is particularly important in the current climate. It is also a good time to remain mindful of the CRE concentration guidance (SR 07-1) and the importance of sound risk management practices.

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