The Unforgiving Commercial Real Estate Cycle

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Pity commercial real estate lenders. They can hardly enjoy the good times. Or at least maybe they shouldn't enjoy them too much, because just when times seem brightest, history says the worst is soon to come.

This dynamic is important to the southeastern economy. Real estate lending remains the predominant business of banks in the Southeast.

Indeed, one of the big questions looming over the Atlanta Fed's recent Banking Outlook Conference was whether the peak of the post-financial crisis commercial real estate (CRE) cycle is at hand. The answer: nobody knows. It's impossible to identify the "inflection point" in real time, according to Sam Chandan, an economist at the University of Pennsylvania's Wharton School and commercial real estate consultant, who spoke at the conference.

Take the apartment business. Brian Bailey, a senior financial and policy analyst in the Atlanta Fed's Supervision and Regulation department, figured apartment rental revenue had crested by 2013 after three to four years of strong escalations. Bailey's analysis led him to conclude that the rapid growth in effective rental revenue was due to level off and slow down. Growth rates slackened in 2013. But growth rates turned right back up the next two years.

Loans made today could mature in totally different economy

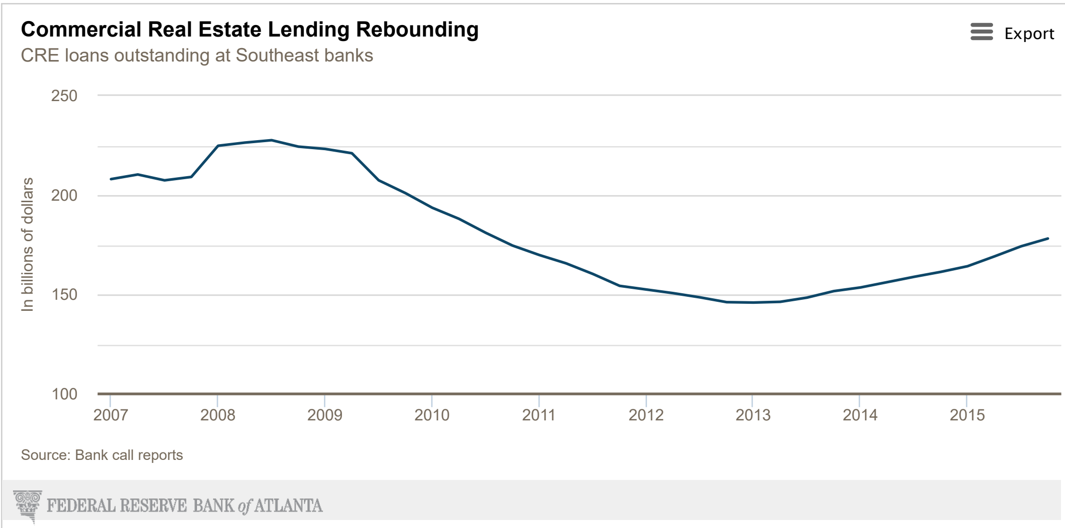
Right now, vital signs in property markets are generally strong. Delinquency and default rates of CRE loans and building vacancy rates are the lowest since the financial crisis, Chandan pointed out. Nominal prices for office buildings and other commercial properties are at historic highs in major markets, in part fueled by an influx of overseas capital. Apartment rents, as Bailey noted, keep climbing faster than personal incomes across the country.

Times seem flush. And that's exactly why Chandan advised caution. He noted that loans made today will likely mature amid economic conditions different from those of today.

Using history as a guide, he said: "It is at this point in the cycle that we ultimately make the loans that will one day prove to introduce the greatest stresses to our balance sheets."

CRE loan volume steadily climbing

Since a nadir in late 2012, the volume of commercial real estate loans on the books of southeastern banks has climbed to about $160 billion at the end of the 2015 third quarter, according to the latest data from bank call reports. That's below the 2008 peak of more than $200 billion. (See the chart.)



Nationally, bank CRE loans outstanding during the third quarter of 2015 ascended back to the highs of 2008, at about $1.6 trillion. And the dollar volume of transactions—mortgage-financed apartment and commercial property sales—has reached record levels, according to Chandan, hitting $470 billion in 2015, from a trough of $83 billion in 2009.

The enterprise of lending money to property developers, builders, and property owners has become increasingly complex. Newer international investors from China, especially, have different time horizons and motivations than do longer-standing foreign investors from Canada and Europe, Chandan noted.

Many players, regulated and unregulated, compete to make real estate loans. Consequently, the market and not individual lenders sets market lending rates and terms, Chandan and Bailey pointed out. So the bank that refuses to bend its underwriting standards can watch customers walk away.

Community banks and regional banks in particular can face a stark choice: "Either compete on terms set by the market or not be in the market at all," Chandan said.

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