



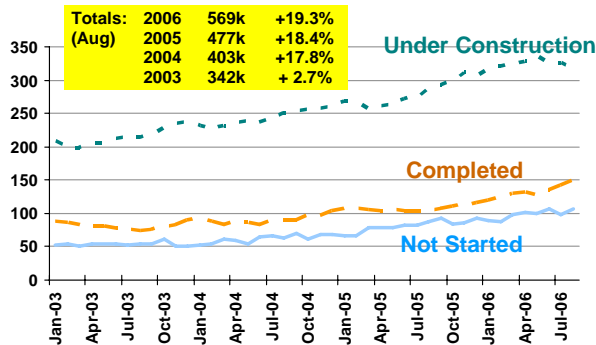
# 12<sup>th</sup> District Commercial Real Estate Lending Risks

## I. Residential Real Estate

**Figures 1 & 2:** A significant slowdown is underway in the housing market. Inventories of new homes for sale are at all-time highs, and this number is expected to grow as homes under construction come onto the market amidst cancellations and slowing sales. Prices are softening and mortgage delinquencies are rising in many areas of the West. The impact of the slowdown is being felt as job growth slows, driven by a contraction of California construction jobs in 2006 year-to-date. Homebuilders are offering incentives and lowering their sales outlook. Some are experiencing serious problems, including a major New Jersey builder that recently filed for bankruptcy, reportedly with outstanding loans from eight commercial banks. There is no consensus yet on whether we are facing a mild/short-lived housing correction or a more substantial/protracted downturn. If the rest of the economy holds up reasonably well, the former is more likely.

### 1) Record levels of home construction

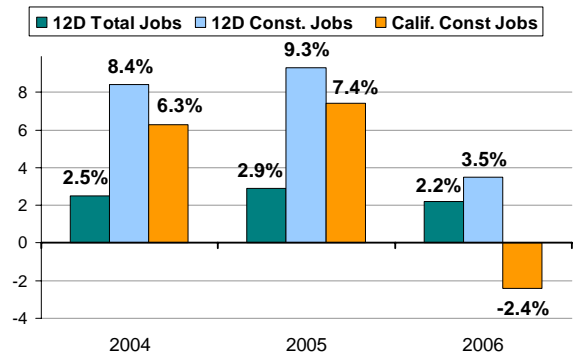
Inventory of New Single-Family Homes - Nation



Source: U.S. Census Bureau; Data in 000s  
Not started = Permitted but not yet started

### 2) Housing slowdown is now apparent in the construction employment numbers

Annual % Growth in Jobs



Source: BLS. Annual data except 2006 which is nine months annualized.  
12D = Twelfth Federal Reserve District (9 Western states)

**Figures 3 & 4:** While financing single-family construction is becoming riskier in areas where market conditions are softening, financing of condominium projects in these areas may be even riskier, especially if enough units are not pre-sold before construction begins. Once construction is underway, all the units in a building must be built, with the developer carrying the entire cost. In the second quarter 2006, condominium price appreciation slowed sharply from last year. Some previously high-flying markets such as San Diego saw prices decline. By September, median condo prices were down over 12% in the West. Despite these trends, the number of condos under construction keeps reaching new record highs, even before considering conversions. These new units will add to an already escalating supply and may depress prices further.

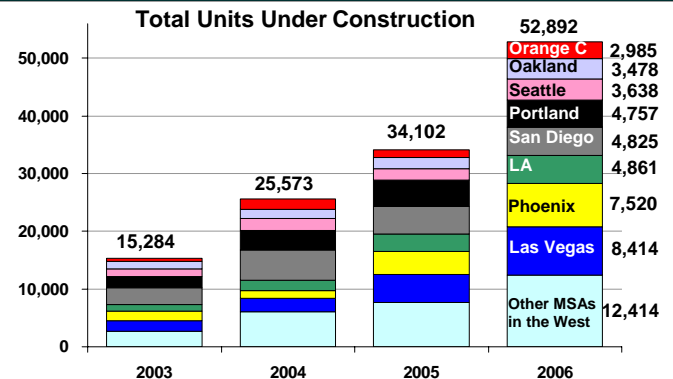
### 3) After slowing through 2Q06 condo prices are now on the decline

September 2006 YOY Price Change: National: -2.8% West\*: -12.4%

Qtrly MSA Condo Price Data Through June 2006 (Sept. data not yet available)			
	% Chg 2Q04- 2Q05	% Chg 2Q05 - 2Q06	Pctg Pt Chg
Phoenix	34.6%	25.3%	-9.3
Honolulu	26.4%	18.7%	-7.7
Riverside	27.8%	18.4%	-9.4
Portland	19.2%	15.9%	-3.3
Tucson	25.7%	10.7%	-15.0
Las Vegas	27.4%	7.7%	-19.7
Los Angeles	19.8%	6.3%	-13.5
San Francisco	26.7%	4.0%	-22.7
Sacramento	27.1%	0.5%	-26.6
San Diego	5.5%	-3.4%	-8.9
Reno	76.8%	-8.9%	-85.7
National	14.9%	-0.3%	-15.2

Source: National Association of Realtors. Median prices for existing condos  
\* West = Montana, Wyoming, Colorado, New Mexico and states to the west

### 4) Despite soft prices, condo construction in full force



Source: TWR / Dodge Pipeline; projects underway as of July or August in each year (does not include apartment-to-condo conversions)

# 12<sup>TH</sup> District CRE Lending Risks – page 2



## II. Commercial Real Estate

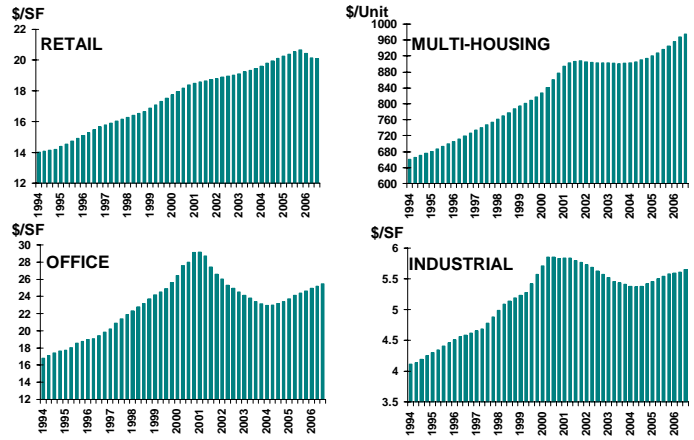
**Figures 5 & 6:** District CRE market fundamentals continue to strengthen. Vacancy and availability rates continue to improve while loan delinquencies and charge-offs are near historic lows. Rents have rebounded from recent lows in every sector except retail, where they are just now beginning to slip. Forecasts call for continuing strong rent growth particularly in the office and industrial sectors. But retail could be somewhat riskier in the short-term as the slowing housing market, heavy debt burdens, and higher short term interest rates may cause consumer spending to slow. Retail space being developed alongside new residential communities may present an area of risk if the growth plans in those communities fail to materialize. Fortunately, with forecasts of solid population, income, and job growth in the West, softening in the retail sector is likely to be short term. However, a sharper than expected contraction in housing would negatively impact all commercial property sectors.

**Figure 7:** Another positive for lenders is the continued rise of commercial property prices, which has enhanced collateral values. This run-up in commercial property prices resembles the recent run-up in residential real estate, leading some to consider if commercial real estate is overpriced. Maybe not. Solid rent growth, strong corporate balance sheets and a continuous flow of capital into CRE from investors attracted by above-average returns may continue to bolster the market. Additionally, increased transparency in CRE markets has reduced the risk premium and is likely to be an ongoing factor. Barring significantly higher interest rates or a sharper downturn in the economy than is currently forecast, prices should continue holding their own, at least in the near-term.

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### 5) Despite recent weakness in retail, commercial rents are trending upwards



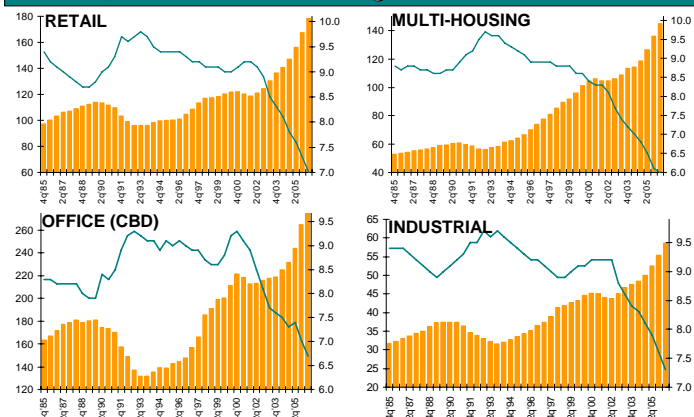
Source: Torto Wheaton Research 3Q06 History & Forecast. National.

### 6) Near-term rent outlook is strongest in select office and industrial markets

District MSAs With The Strongest Forecast Rent Growth		
MSA	Property Sector	Projected Annual Rent Growth - Next 2 Years (%)
San Jose	Industrial	14.8
Tucson	Industrial	10.2
San Francisco	Industrial	10.2
Orange County	Office	9.8
Honolulu	Office	8.7
Seattle	Office	7.3
Honolulu	Retail	7.1
San Francisco	Office	6.8
Phoenix	Office	6.7
Salt Lake City	Office	6.3

Source: Torto Wheaton Research Outlook XL Fall 2006

### 7) Nationwide property values up, capitalization rates down, but for how much longer?



Source: National Real Estate Index. Through 2Q06. Prices(\$/SF): Bars - Left Scale. Cap Rates (%): Line - Right Scale.