Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

CRE Market Conditions in the West: Steady but not Spectacular

Overview: Commercial real estate markets have returned to good health. With all CRE sectors now in the upward trajectory of the real estate cycle, anecdotal reports suggest that banks are beginning to provide loans to less creditworthy developers who are basing their valuations on non-fundamental demand. Although such lending is not yet prevalent, the current improving CRE environment could reverse if rents and net absorption needed to meet pro forma projections outpace actual demand.

Additionally, healthy growth has not been uniform. Supply side investors have relied on upscale properties to post gains, leaving the middle to lag behind. Now that upscale subsectors are becoming saturated, more eyes are looking at lower tier properties. The success of “express” localized retail stores and B/C class office spaces will be important factors behind the continued rate of growth for these sectors. Growth in all sectors will also depend on the trajectory of interest rates since increased rates are generally accompanied by rising cap rates and decreasing property values.

In the 12th District, technology continues to drive space demand. Benefits of this are seen in coastal areas like Seattle and San Francisco, but do not spillover into inland areas like Phoenix and Las Vegas, which still struggle.

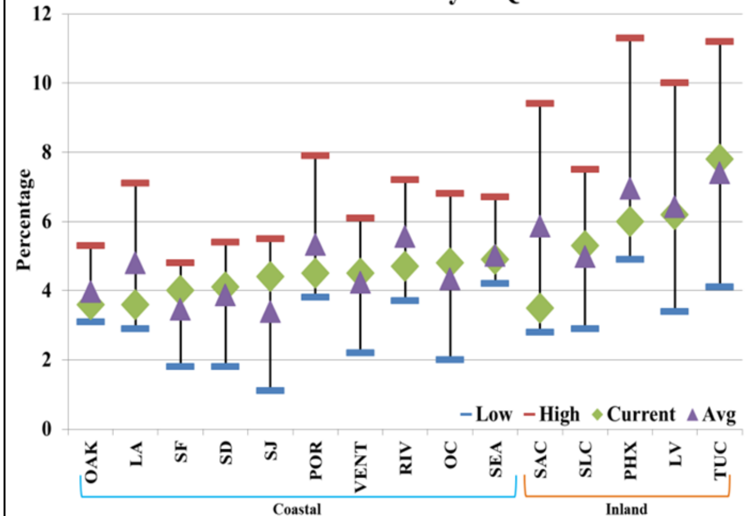
Apartments—Big Booms Can Sometimes End Up in Busts: The Apartment sector remains robust with a national vacancy rate between 4-5%. Seven of the top eleven markets ranked by lowest vacancy rate are located in California and, overall, the 12th District average vacancy rate is only 70 bps above its pre-crisis low. While demand is forecast to continue growing, it’s unlikely to keep pace with record breaking supply growth. For 2015, Reis expects 240,000 units to be completed nationally, a level never seen in the 30 years the company has been tracking the sector. Of this, three of the top ten cities with the most construction are in the District (Seattle, San Francisco, and Los Angeles) and roughly 20% of the total dollar value generated by the construction activity will flow into the District.

As banks increase construction loans, underwriting standards are relaxing. In the April 2015 Senior Loan Officers Opinion Survey on Bank Lending Practices, more respondents replied that standards had eased on construction, land development, and multifamily property loans compared to prior years. While average LTV ratios at banks remain below 80%, underwriting standards will likely continue to ease as loan officers face aggressive competition from nonbank lenders who are often willing to take on more risk.

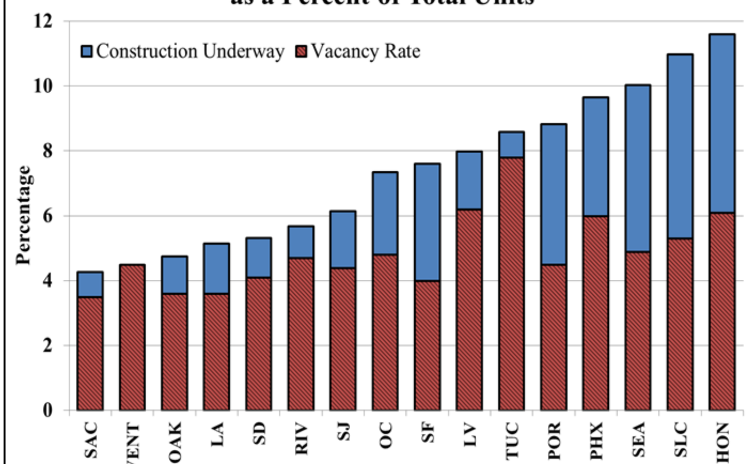
Retail—Don’t Expect Anything but Escargot: While retail vacancy rates have declined in the past year, they have done so at a snail’s pace—30 basis points. The 12th District sits at an 8.8% vacancy rate, 330 points higher than its pre-crisis low but 110 points lower than last year.

Coastal regions benefit from continued job growth in the technology sector. Compared to MSAs across the nation, San Jose and San Francisco posted stronger absorption rates and rent growth while…

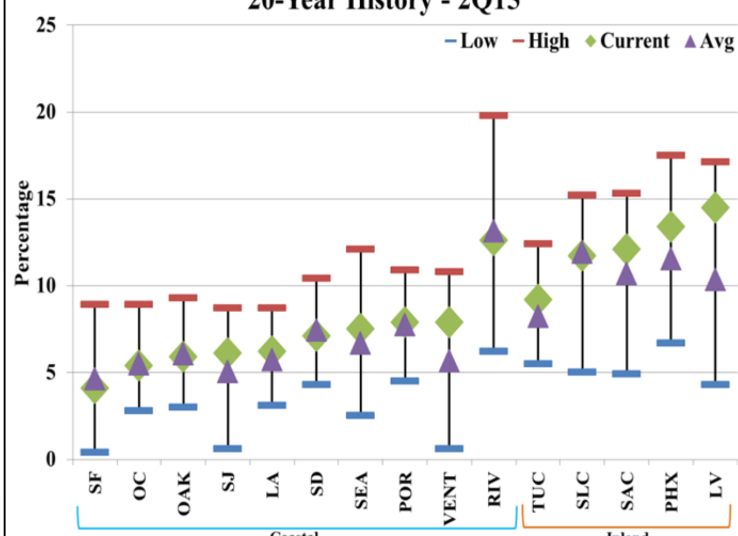
Apartment Vacancy Rates Compared to Metro Area 20-Year History - 2Q15



Potential Increase in Apartment Availability - Current Vacancies Plus Construction Underway as a Percent of Total Units



Retail Vacancy Rates Compared to Metro Area 20-Year History - 2Q15



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12th Federal Reserve District

…Seattle, Portland, and San Diego all recorded the steepest annual declines in vacancy rates. Salt Lake City, Riverside, Phoenix, and Las Vegas, however, continue to struggle due to the severe downturn these markets experienced during the recession.

Given the robust domestic labor data and the stabilization of oil prices at low levels, it may be tempting to forecast higher retail demand. However, three factors are likely to mute this theme: 1) Predictions of consumer spending can tend to overshoot the reality; 2) E-commerce will absorb a larger share of whatever increase in spending occurs (E-commerce sales grew by 14.5% YOY compared with 1.6% in total physical retail); and, 3) when interest rates rise, it will be more expensive for consumers to spend on credit.

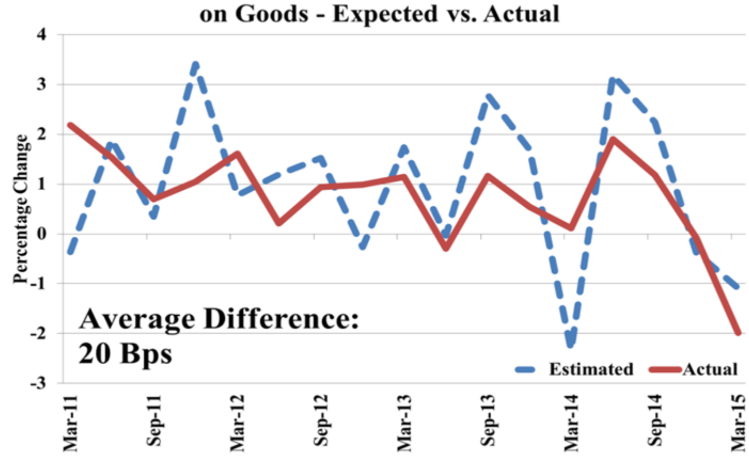
Office—Fundamentals look good, but speculators see more: In the 12th District, coastal regions are enjoying high levels of Office sector growth. Among MSAs nationally, San Francisco, San Jose and Seattle are three of the top five cities with the highest expected rent growth for 2015. In the suburban subsector, five of the top six markets are in the 12th District—San Jose, San Francisco, Los Angeles, Seattle, and Phoenix. However, Las Vegas and Phoenix vacancy rates still hover above 20%, levels that, before the recession, they last saw in the 1980s. While high end properties have done well even in weaker markets, poor lower end absorption is holding down growth. With the exception of Salt Lake City, only the strongest MSAs have seen robust declines in B/C class vacancy rates. Elsewhere, B/C rate declines trail A class rate declines by a mean of 200 basis points.

The District's coasts are boosted not only by the boom in technology, but also by increased foreign investment in downtown office real estate. While this foreign interest has pushed up asset values in markets like San Francisco, it should raise some red flags since property value gains from speculative growth can quickly deflate. Should headwinds in the Chinese equity markets continue to create unrest, Chinese investors may pull back on further FDI.

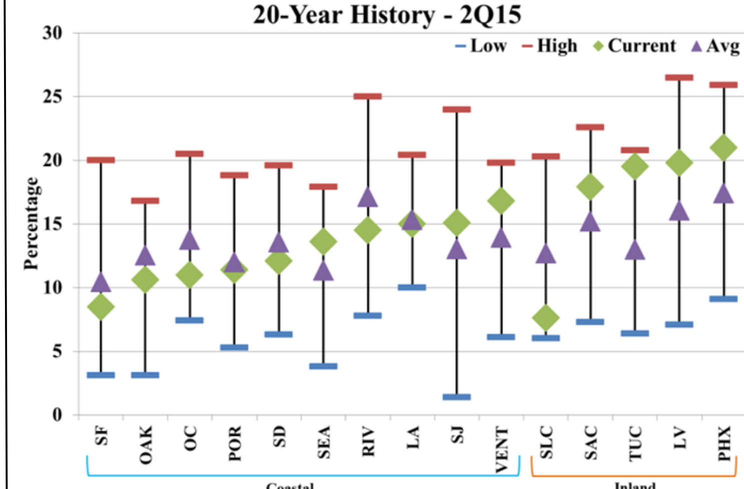
Given the elevated prices of downtown office assets, some investors are turning to suburban properties. In the first half of 2015, suburban YOY growth outpaced downtown growth, 50% vs 20%. In this subsector too, there is reason for caution. CBRE-EA reports that "opportunistic developers" are building properties based on bets that they can lure tenants out of their current spaces. Whether their bets win or not, the final outcome will leave some landlords without tenants. Thus, while overall office growth continues to climb, the portion of growth fuelled by more than fundamentals in either subsector can quickly cool down.

Sources: Vacancy rates and construction underway calculated using data from CBRE-EA. Consumer spending data provided by Haver Analytics/Macroeconomic Advisers. Office subsector rates provided by Haver Analytics/CB Richard Ellis. Additional market data provided by CBRE-EA, Reis, and Real Capital Analytics.

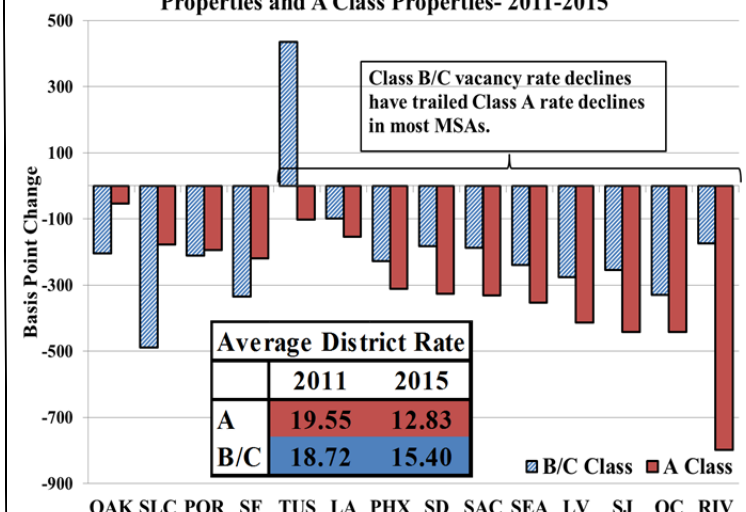
Percent Change in National Consumer Spending on Goods - Expected vs. Actual



Office Vacancy Rates Compared to Metro Area 20-Year History - 2Q15



Average Office Vacancy Rate Declines Between B/C Class Properties and A Class Properties- 2011-2015



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