



# Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

## CRE Market Conditions in the West: Slow but Steady Improvement

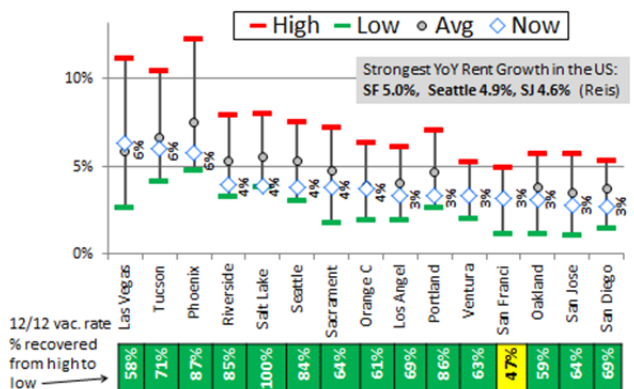
**Figure 1:** Among the main commercial real estate (CRE) sectors, apartments remain the healthiest. Vacancy rates have dropped across markets in the West, and many are at or below their long term averages. Las Vegas, Tucson, and Phoenix are the only 12<sup>th</sup> District markets with apartment vacancy rates above 6%, but these are well down from peaks. Construction activity is on the rise but has not yet caught up with demand which is now more a product of job growth than the single family housing crisis. However, annual net absorption is slowing and is forecast to slow further in 2013 as competition from demand for single family housing increases. Per forecasts, previously strong rent growth will reflect these headwinds and continue in 2013, but at a more moderate pace.

**Figure 2:** The overall improvement in office vacancy rates has been slow, along with the pace of job growth. Financial and business services job growth has been particularly weak. But some tech markets like San Francisco and San Jose are booming and vacancy rates have plummeted. Construction remains subdued except for Salt Lake City which added 2.8% to existing stock in 2012 and San Jose, which CBRE-EA forecasts will add 3.8% to its stock in 2013. Much of this construction is single tenant office space (e.g. new Yahoo! headquarters). With subdued construction and slowly increasing demand, rent growth resumed in 2011 and is expected to continue to improve.

**Figure 3:** The recovery in the industrial sector picked up momentum in 2H12 with the absorption rate almost twice the 1H12 rate. Weakness in Europe has less impact on 12th District industrial space than has Asia which continued to see strong growth. The trade imbalance with Asia favors 12th District warehouse properties because imports require more space than exports. Among industrial property types (warehouse, R&D, manufacturing) warehouse vacancy rates fell the fastest, again benefiting the 12th District which has more warehouse distribution space relative to manufacturing. The lack of significant new construction has also helped vacancy rates fall. CBRE-EA forecasts construction below long term averages through 2014. But even this will not revive Sacramento's industrial sector, which missed out on two large distribution centers that Amazon will open south of Sacramento in Patterson and Tracy, or Las Vegas, which had negative net absorption of over 800 thousand sq/ft in 2012. Vacancies in these markets are expected to remain high and rents to continue to fall, even as rents in other 12th District markets rise.

### 1) Apartment Vacancy Rates Compared to 20-Year History of Each Metro Area - 4Q12

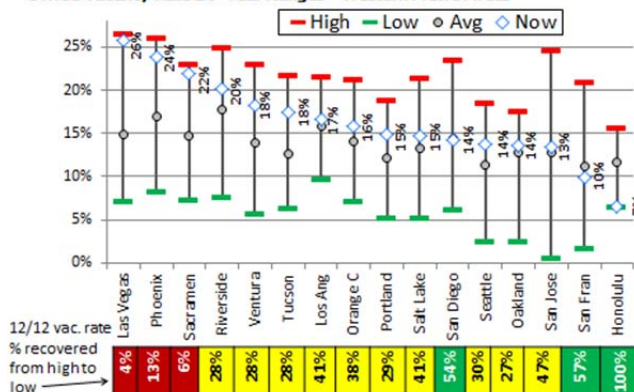
Apt. Vacancy Rate 20-Year Ranges - Western U.S. Metro Areas



Source: Reis, FRBSF

### 2) Office Vacancy Rates Compared to 20-Year History of Each Metro Area - 4Q12

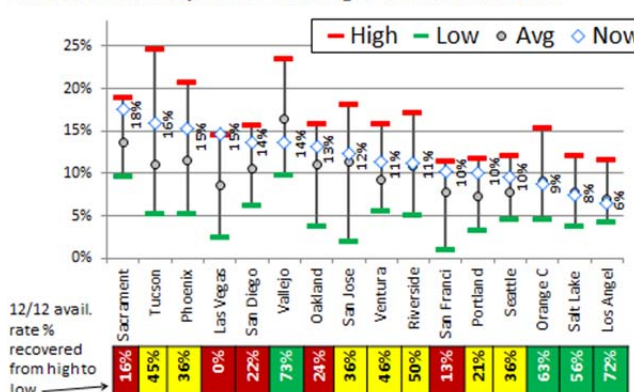
Office Vacancy Rate 20-Year Ranges - Western Metro Areas



Source: CBRE Econometric Advisors, FRBSF

### 3) Industrial Availability Rates Compared to 20-Year History of Each Metro Area - 4Q12

Industrial Availability Rate 20-Year Ranges - Western Metro Areas



Source: CBRE Econometric Advisors, FRBSF



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12<sup>th</sup> Federal Reserve District



**Figure 4:** Retail availability rates in all 12th District markets are above historical averages and most are near 20-year highs. Major retailers including Best Buy, Sears, and JC Penney are shedding space as they struggle financially. The merger of Office Depot with OfficeMax will also result in reductions of occupied space. But despite these challenges, the sector is finally showing a bottom. The aggregate 12th District availability rate has held flat at 11.5% for the last three quarters and is forecast to decline to 10.7% by the end of 2013. However, not all markets will improve. Per CBRE-EA, availability rates in Bakersfield will increase, and will stay flat in Oakland and Sacramento. With so much excess existing space and tepid demand, construction activity in the retail sector is the lowest among the four main property sectors. Activity will pick up slightly in 2014 but should remain well below historical averages. Rent growth will continue to be a challenge, with Oakland, Phoenix, Sacramento, San Jose, Seattle, Tucson, and Ventura forecast to end 2013 with lower market rents.

**Figure 5:** Construction activity remains well below pre-financial crisis levels. Only the apartment sector has seen significant construction, but at an overall moderate level. Modest industrial sector construction is propelled by the need to replace obsolete facilities, but not much new demand yet. Low construction rate forecasts in the office and retail sectors are in line with significant surplus space, and forecasts for generally slow economic growth.

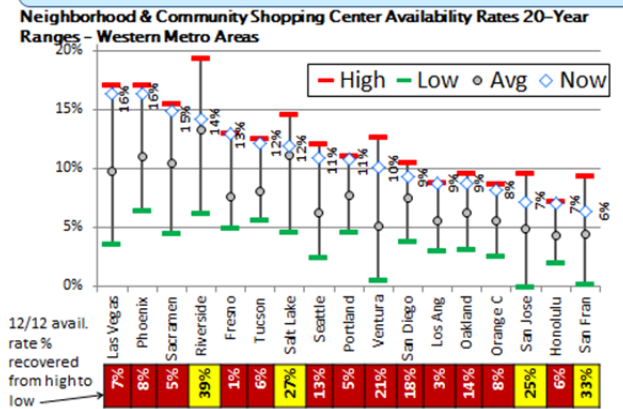
**Figure 6:** The continuing general improvement in CRE fundamentals that started in 2011 is mirrored by the increasing volume of CRE loan originations. As banks are feeling more confident in the CRE recovery, lending is picking up speed. Also, the surge in property transactions in 4Q12 as sellers pushed to close deals before rising tax rates also contributed to rising loan originations.

## CRE Lending Risks: A Summary

With the exception of retail centers, overall CRE market conditions are improving and continue to benefit from the favorable interest rate environment.

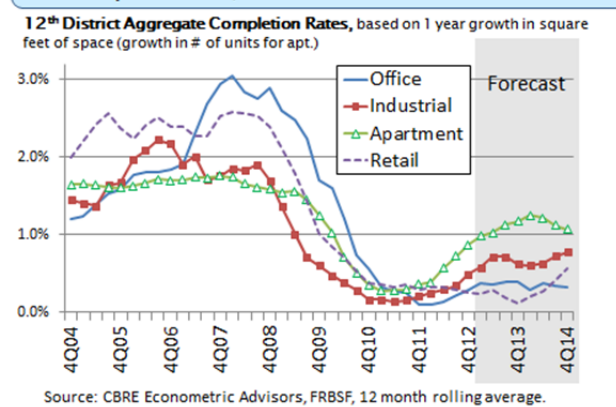
However, heightened attention is still needed on CRE loans originated near market peaks of 2005-2008. The pace of improvement in core CRE market sectors has been, in many cases, too slow to repair the damage done to market peak credits -- declines in values, rents and occupancy -- experienced during the Great Recession. When market interest rates rise, this will help banks improve yields on floating rate loans, but it could also prove challenging for troubled credits.

### 4) Retail Availability Rates Compared to 20-Year History of Each Metro Area - 4Q12



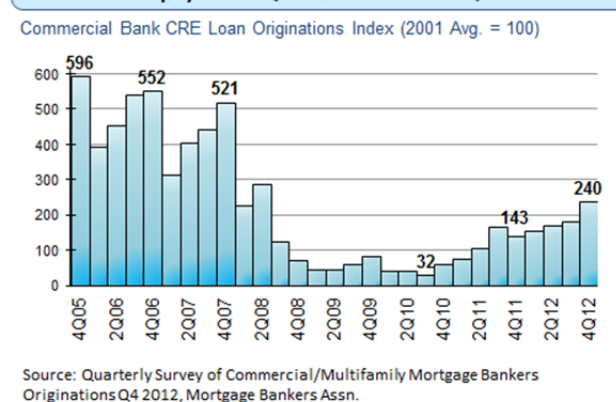
Source: CBRE Econometric Advisors, FRBSF

### 5) Completion Rates Remain Low, But Rising in Apartment, Industrial & Office Sectors



Source: CBRE Econometric Advisors, FRBSF, 12 month rolling average.

### 6) Banks Increased CRE Loan Originations Sharply in 4Q12 (national survey data)



Source: Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations Q4 2012, Mortgage Bankers Assn.

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