Late-Cycle Considerations for Small-Balance CRE Bank Lenders

By Randy Fuchs, principal and co-founder of Boxwood Means, LLC

The U.S. commercial real estate market (CRE) has been boosted to new heights after experiencing tailwinds from 10 years of a U.S. economic expansion. National vacancy rates for office, industrial, retail and multifamily sectors, all hovering near historical lows, have escalated rent growth to newer, higher altitudes. And yet, while news of economic and CRE vitality spreads in places like Austin, Nashville, Seattle, Pittsburgh, Raleigh and San Francisco, among others locales, there is no escaping the fact that many other cities around the country have yet to fully recover — including many in our own Northeast backyard.

Proprietary research from Boxwood confirms that soft market conditions prevail in various metropolitan areas in terms of sales price trends for small commercial office, industrial and retail assets under $5 million in value which comprise the lion's share of collateral within bank commercial mortgage portfolios. The Northeast's aggregate small-cap CRE prices, for example, rose at a compound average of only 1.1 percent since the Great Recession, which was about half the national average and lowest among the six U.S. regions (see the accompanying graph).

The Midwest, largely dependent on traditional manufacturing and factory employment, is often characterized as the poster child for lagging regional economies. But it is the Northeast's sluggish employment growth, including the two metro areas encompassing Hartford and New Haven-Bridgeport-Stamford, that has hindered the region's potential for economic and CRE resurgence. As of last month, Connecticut metro area commercial vacancies were above national norms and rent growth was relatively weak.

That said, there is some good news. We can also report signs of a turnaround that emerged late last year. Small-cap CRE prices rose a healthy 6 percent year-over-year in the Northeast (on a preliminary estimate basis as of November data) and, better yet, Hartford's prices gained a whopping 17 percent year-over-year, representing one of the highest annual increases in the country. Meanwhile, prices in the New Haven-Bridgeport-Stamford area also increased with a healthy 7 percent increase from 12 months earlier.

Still, these price gains arrive at a somewhat tenuous time for small-balance lenders and investors. It is late in the cycle and, though stability currently reigns, small-cap CRE space market fundamentals are more fragile than at any other time over the past 10 years, and some of the economic underpinnings of the long CRE bull market ride have also loosened a bit.

Fortunately, many bank lenders have recognized these changing dynamics at a time that asset prices are also peaking; and so there is no time like the present for bank lenders to take measures to scale up internal processes to assure that CRE property valuations — and basic loan metrics such as LTVs and DSCRs — are underwritten very conservatively.

Also, small-cap CRE lenders should heighten surveillance of key economic and demographic factors and trends that we find are strongly correlated with changes in small-cap CRE values, such as home prices, small business establishment growth, and trends in middle-age population and blue-collar employment.

Such measures will help lenders navigate a smooth balance between ambitious loan production goals and increasing market and collateral risks posed by late-cycle loan originations. Then, despite any turbulence or possible bumps in our regional economy, lenders can still manage a smooth landing.

Randy Fuchs is principal and co-founder of Boxwood Means, LLC, the Stamford, Connecticut-based national provider of property valuations and data analytics in the small-balance commercial loan market.

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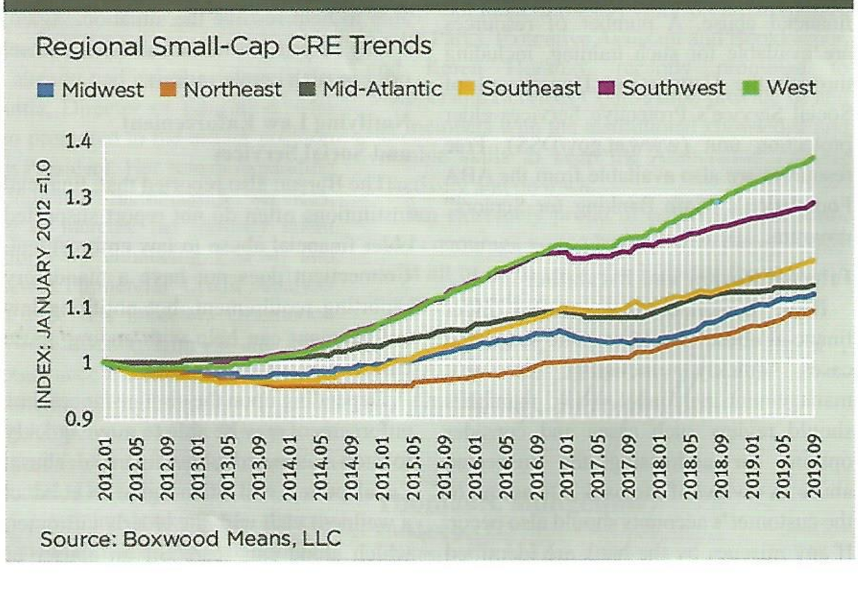

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