



Real Estate Lending Risks Monitor – Special Edition

Federal Reserve Bank of San Francisco – Division of Banking Supervision & Regulation

CRE Market Conditions & Outlook *

Executive Summary

- **Market fundamentals and outlook:** The outlook for commercial real estate (defined in this report as income property) is deteriorating due to the slowing economy, the ongoing paralysis in credit markets, wide CMBS spreads, and more costly financing for CRE transactions and projects.
- CRE property sales transactions have dropped off dramatically with financing more difficult to obtain and more costly. Vacancy rates are rising and rent growth is slowing as the economy slows.
- CRE markets will continue to weaken but should avoid the kind of collapse seen in residential real estate.
 - CRE markets are not overbuilt as they were in the late 1980s. For example, the office completion rate (as a percentage of existing stock) was a minimal 1.4% in 2006 and 1.7% in 2007, compared to an average yearly rate of nearly 6% in the 1980s.
 - Supply and demand remain reasonably balanced with vacancy rates expected to increase moderately as tenant demand softens over the next year, but only to levels below those of 2001-2002 period.
 - Rent growth should remain positive in most local markets as rents rollover from those set in 2002-2003.

* “CRE lending” traditionally includes mortgage lending to finance income properties (e.g. an apartment complex), as well as acquisition, development & construction (AD&C) lending for both commercial and residential purposes. In the current environment, residential AD&C lending is suffering from rapid price deflation and meager absorption rates for homes and lots in many areas of the country. This report does not address these issues. Instead, the focus of this report is on traditional income-producing CRE, and spillovers of the current housing and credit conditions into CRE.

Note: This report is based on statistics and forecasts that predate credit and stock market events of the past few weeks.

Risks: The severity and duration of the economic downturn and current credit crisis will dictate the severity of CRE market weakness.

- Property values have been overly inflated by excess liquidity over the past few years and are vulnerable to further correction
- If the current situation deteriorates into a severe recession, CRE would falter with vacancy rates rising more sharply than anticipated, property owners not able to roll over leases at current rates may have to offer concessions. Cash flows could weaken as a result.

Outlook for CRE Credit Quality: Given that market fundamentals remain generally in balance, most CRE property owners should continue to generate adequate cash flows to service their debt.

- Bank-held CRE loans generally have been underwritten conservatively such that credit loss rates should climb only moderately to more “normal levels”, compared to the last 10 years of exceptionally low loss rates.
- Loss or net charge-off (NCO) rates for CRE loans have remained negligible thus far. The annualized aggregate NCO rates for nonfarm nonresidential-secured loans and for multi-family-secured loans were 0.2% and 0.3% respectively for the first half of 2008. Those same NCO rates averaged 1.3% and 1.5% per year in 1991 – 1993.
- Moody’s Commercial Mortgage Metrics model suggest that CRE NCO rates may not climb materially from current levels in most areas of the country. The current low interest rate environment will help reduce credit risk somewhat via improved debt service coverage, at least for loans not already priced near interest rate floors.
- Nevertheless, there is considerable refinancing risk on maturing CRE loans, particularly those underwritten under more liberal CMBS underwriting standards. Refinancing, when available, is not likely to be at the same terms as the original loans, with property owners expected to contribute more equity and likely to pay considerably higher rates. Fortunately, CRE loans tend to be longer term (e.g. seven or ten years), and many property owners locked in long term funding during 2006/2007, so the amount maturing over the next year or two is relatively limited.
- Loans to property owners who bought at the top of the market or financed with short term debt have higher credit risk. Within the CMBS market, the highest risk segment appears to be CRE CDOs which often include transitional credits such as land and construction loans, as well as mezzanine credits, often financed aggressively and for relatively short terms. Many first-loss CRE CDO tranches are facing significant losses.

About This Report

This special edition of the RE Lending Risks Monitor was prepared by the San Francisco Fed's Banking Supervision Department to help understand the conditions and credit quality outlook related to the office, industrial, multi-Housing, and retail sectors. The report highlights sector performance by MSA based on the internally developed **CRE Market Vitality model**. This model utilizes market data and forecasts from Torto Wheaton Research and other sources to provide an assessment of the current and near term strength of the major CRE sectors. The Model attempts to differentiate markets by indicators of CRE credit risk with each MSA/CRE sector receiving a Vitality Score to represent its strength and near-term outlook. Vitality Scores fall can range from strong (green) to weak or vulnerable (red). A score of 50 indicates performance and outlook that approximate the long term (20+ years) performance of all markets within a sector. A score above 50 indicates a stronger market and a score below 50 is a weaker market.

Key Vitality Model Variables (each variable is translated into percentile rankings based on up to 20 years of historic performance within each property sector; percentile rankings are averaged for the final Vitality Scores)

- Property value change (pct growth rate over the past 5 years' avg.)
- Employment growth rate (2-yr) relative to the given property sector
- Current vacancy (or availability) rate
- Forecast vacancy (or availability) rate 1-year from now
- Recent rent growth (pct growth rate over the past 5 years' avg.)
- Forecast rent growth over next year (pct growth rate)
- Recent supply growth (2 yr pct growth in square footage)
- Forecast supply growth over next year (forecast completions in sq feet as % of existing stock)
- Forecast absorption rate over next year (forecast absorption in sq feet as % of existing stock)
- Pct of construction projects abandoned or deferred - past two years

10/24/08 Update: New Forecasts, Post-Intensified Credit Crisis

This report makes significant use of the Fall 2008 market data and analysis from Torto Wheaton Research (TWR), a premier provider of CRE data and forecasts. Today, TWR economists provided insight into how the recent credit market events will impact their Winter 2009 forecasts. Overall, forecast vacancy rates will be moderately higher than previous forecasts with peaks approaching 2002 levels. However TWR still believes that the performance of income producing CRE will remain solid. Despite rising vacancy rates and property value declines, rent roll-ups will continue to boost to net operating income due to the longer term nature of most leases while rents have generally risen. The massive Federal interventions to boost credit markets also will help. With just moderate changes in property forecasts, the analysis and conclusions contained in this report should still hold.

Disclaimer: The data, models, forecasts, and opinions referenced in this report are those developed by outside vendors and the authors and do not represent official views of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

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CRE Market Conditions and Outlook

CRE Market Vitality Model – High Level Results

FRBSF's CRE Market Vitality Model (data and forecasts as of 6/30/08) signals continuing deterioration in CRE sectors. Average scores for all four CRE sectors were down year-over-year (YOY). The office, industrial, and multi-housing sectors are now worse than their long run (20 year) averages. The industrial sector had the steepest drop at 6.4 points, followed by office down 4.3, multi-housing down 2.5, and retail down 1.3. Thirty-one MSAs had at least one or more weak or vulnerable "red" sector; this compares to only 12 MSAs six months ago.

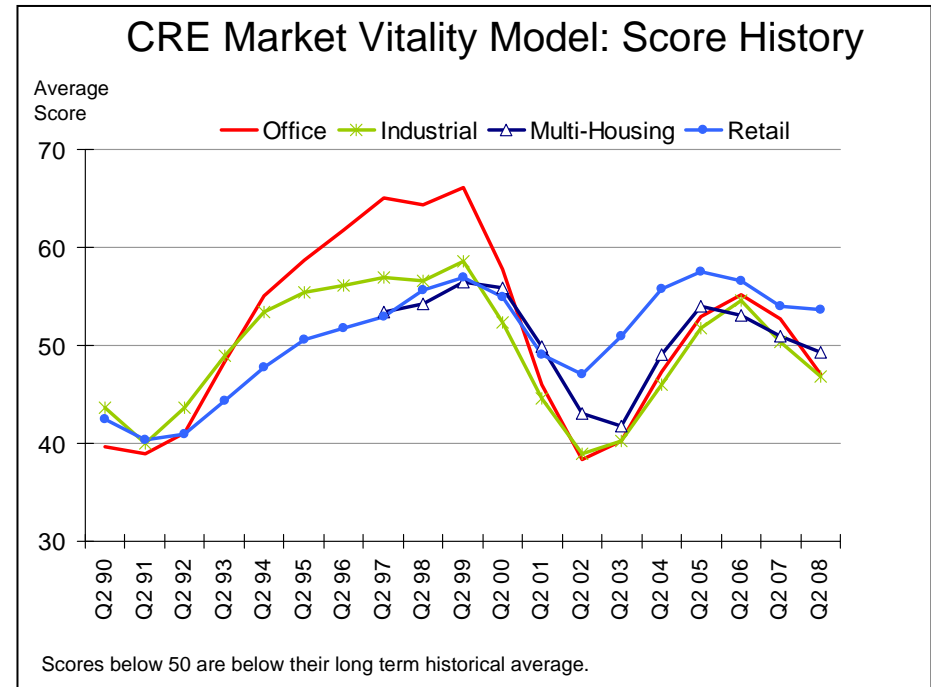
Fall 2008 Average CRE Market Vitality Scores - Nationwide				
	Office	Industrial	Multi-Housing	Retail
Average Score	47.1	46.8	49.3	51.6
YOY Change	-4.3	-6.4	-2.5	-1.3

Note: a score of 50.0 would reflect an average performance over the past 20 years.

Commercial real estate is under stress from a number of factors including weakness in the consumer sector, manufacturing, financial and real estate job losses, high oil prices, and a persistent credit crisis. This has led to rising vacancy rates, slowing rent growth, and modest declines in property sales.

Vitality Scores have seen consecutive quarterly declines in all four CRE sectors. With an increasing likelihood that the economy is (or will soon be) in recession, Vitality scores are likely to fall further over the next few quarters and could test the lows from prior recessions.

However, CRE markets appear in better overall balance today compared to prior recessions – in recent years, CRE has not had the level of speculative overbuilding that occurred in the late '80s, nor the level of speculative over-leasing that occurred leading up to 2001. A factor



distinguishing CRE from residential real estate is lower leverage. Leverage levels on commercial transactions have generally remained well below typical residential mortgage levels, which often exceeded 90% combined LTV financing.

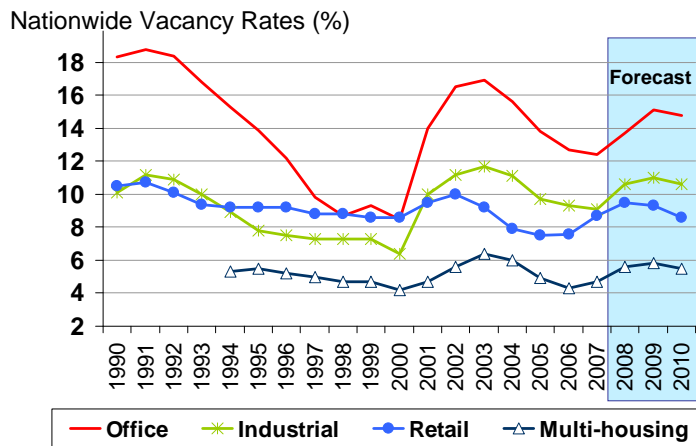
Vacancy Rates and Rents

Another important consideration benefiting the CRE market is rent growth. While slowing, rent growth should remain positive in most MSAs as leases signed near the lows of 2002 and 2003 roll over at higher lease rates.

Key variables in the Vitality model are current and forecast vacancy rates and rents. As the charts below show, vacancy rates have been rising while rent growth has slowed. Forecasts call for the weakening trends in both these metrics to be only moderate, which if proven correct – that is, if the economy can avoid protracted recession -- CRE should escape a deep contraction, and CRE credit risk should remain moderate.

Vacancy rates generally should rise modestly in the near term

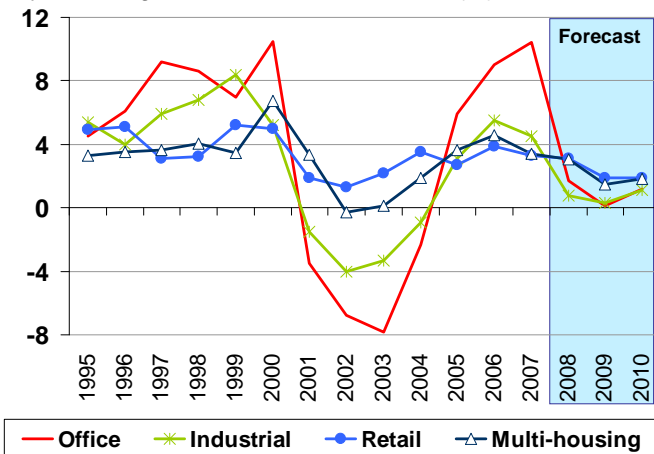
(due to higher completions & slowing pace of absorption)



Source: Torto Wheaton Research; all sectors based on Spring 2008 Outlook reports.

Rent growth rates are slowing from high rates, but should remain positive

Year-over-year change in nationwide rent indices (%)

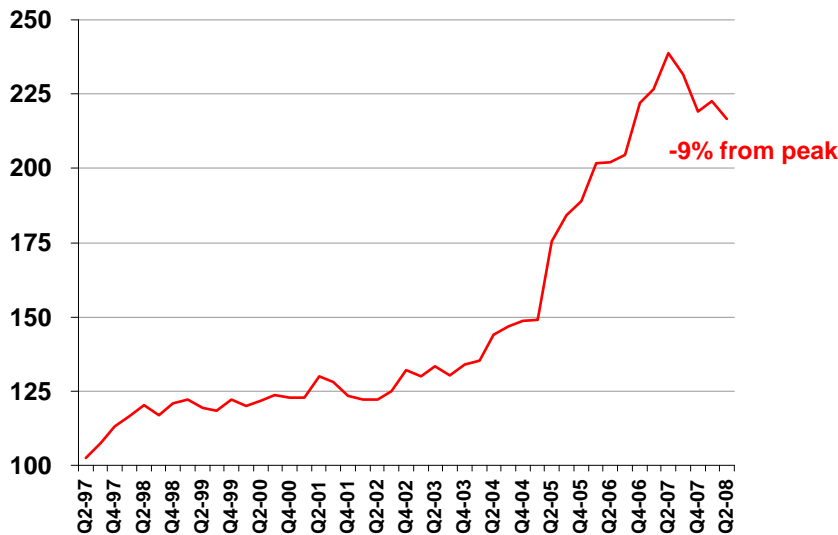


Source: Torto Wheaton Research; all sectors based on Fall 2008 Outlook reports.

CRE Property Values

Recent changes in property values are another important component in the Vitality model. According to the Moody's/MIT/REAL Commercial Property Price Indices (CPPI), CRE prices have slipped 9% from their 2Q2007 peak after a tremendous run-up from 2003-2007. Torto Wheaton Research expects that the ultimate peak-to-trough decline in property values will be modest, ranging from a 6% decline for the multi-family properties to 14% for office and full-service hotel sectors.

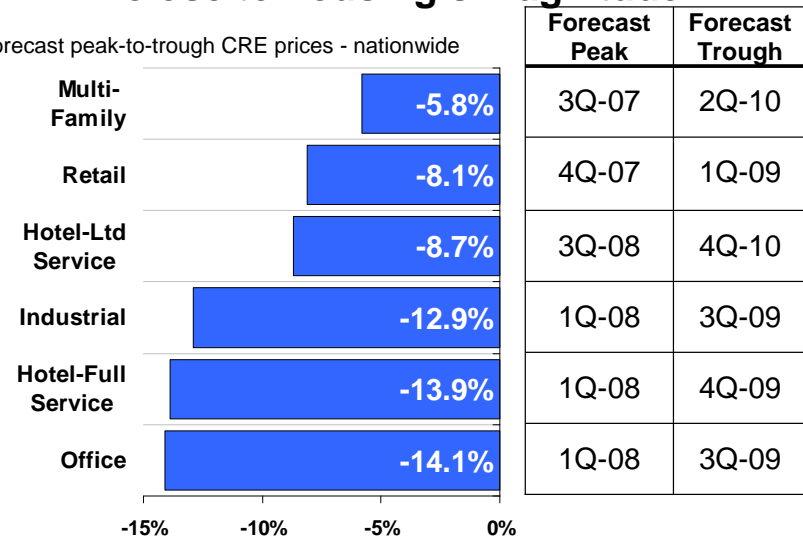
Commercial Property Price Index - Nation



Source: Moody's/Real/MIT CPPI -- MIT Center for Real Estate / Haver Analytics

CRE prices expected to weaken, but not close to housing's magnitude

Forecast peak-to-trough CRE prices - nationwide



Source: Derived from Torto Wheaton Research, Summer 2008 Investment Fundamentals

Moody's CMM

Moody's Commercial Mortgage Metrics, a CRE default risk model, also points to manageable loss rates. For a portfolio of prototypical CRE loans originated three years ago with generally conservative underwriting across the country, the cumulative expected loss rates are very low. CMM finds that the retail sector has the greatest credit risk with a cumulative expected loss rate of 1.6% over the 7-year period until maturity for our prototypical set of loans across the country. This translates to an average expected loss rate of 0.22% per year, a very manageable level. With the weakening in CRE market fundamentals in the past year, the CMM model produces moderately higher (but still relatively low) expected loss rates today compared to what it produced a year ago, as shown in the following table.

YOY Change in National Cumulative Expected Loss Rates			
	Fall 2007	Fall 2008	YOY Change
Office	0.96%	1.25%	+0.29
Industrial	0.62%	0.77%	+0.15
Multi-Housing	0.69%	0.81%	+0.12
Retail	1.41%	1.56%	+0.15
Cumulative expected loss rate on a 10 year loan, LTV:75, DSCR:1.3, 3 years into the loan.			

Regional Concerns: Weakest / Most Vulnerable MSAs

Among the MSAs with at least three CRE sectors covered, **Detroit** remains clearly the weakest with continued job losses, very high vacancy rates and generally declining rents and property values. **Phoenix** is now the second worst MSA per the Vitality Model, but for different reasons – Phoenix scores low largely due to forecast variables in the model (e.g. forecast vacancy rates, forecast absorption and completion rates, and forecast rent growth rates) while Detroit scores low due to current and recent-change variables like current vacancy rates, recent changes in employment, rents and property values). Rounding out the top five weak CRE markets are **Memphis, Trenton, and St. Louis**.

Regional Concerns: Most Deterioration Among MSAs

Some of the MSAs with the sharpest housing decline also saw their Vitality Scores drop the most over the past year. Arizona markets had the greatest deterioration. **Phoenix's** an average cross-sector score dropped 17.9 points YOY, and **Tucson** was down 16.3 points. Phoenix had a considerable amount of construction activity, and oversupply is now a driver of lower scores, and combined with a weaker economic outlook, this caused the forecast variables to compare poorly to other MSAs.

Tucson deteriorated in all sectors from fairly strong performance a year ago due to the slowing Arizona economy. Yet only the retail sector dropped to the “red zone” with a score below 40. The Retail sector dropped 25.3 points YOY as housing related employment slowed and a significant number of projects were abandoned or deferred. This was the largest YOY decline among the markets and sectors covered.

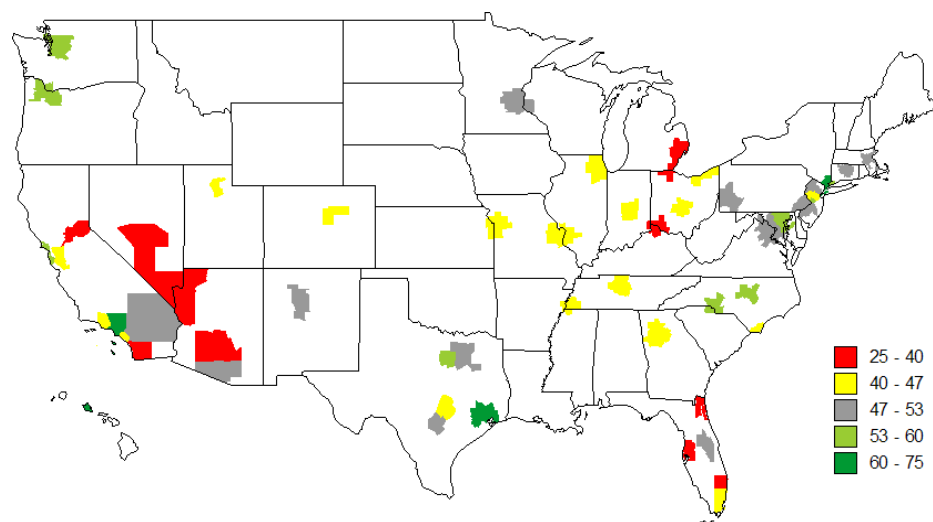
YOY Change in Average CRE Vitality Scores			
	Fall 2007 Avg	Fall 2008 Avg	YOY Change
Phoenix	53.5	35.6	-17.9
Tucson	67.1	50.8	-16.3
Orlando	60.9	47.7	-13.2
Tampa	56.8	44.5	-12.4

Much like Tucson, **Orlando** had Vitality Scores for most sectors at or near the strong category just a year ago. Double digit declines across all four CRE sectors have significantly reduced these scores, although none dropped into the red category. Vacancy rates particularly in the Orlando industrial sector are increasing sharply. The Orlando multi-housing sector is also struggling with higher current and forecast vacancies as it competes with single family rentals for tenants.

OFFICE

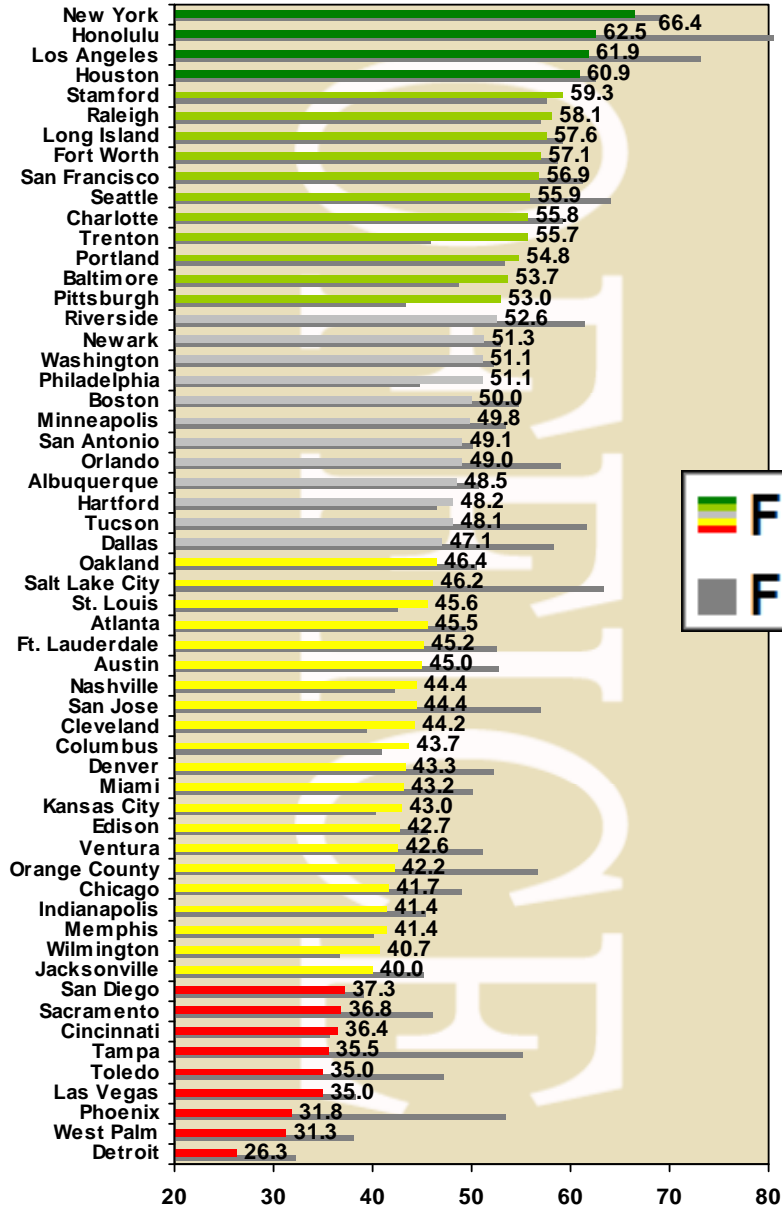
Office sector average scores were down 4.3 points YOY, as tumult has persisted in the financial and housing sectors, and the overall economy has continued to be anemic. Negative employment growth and slow forecast absorption rates reduced Vitality scores in many markets. Performance continues to be particularly weak (red or yellow) in markets impacted by the housing and credit bust. As a result, weakness spread geographically outside previously soft Midwest markets. **Detroit** remained the weakest market, driven by multiple factors including loss of jobs, declining rents and very high current and forecast vacancy rates. **Phoenix** declined 21.8 points YOY as new supply added to an already elevated vacancy rate. This was the largest YOY decline in the office sector, as is shown in the chart on the following page. The challenges confronting the office sector are not contained to the worst performing markets. All of the markets considered strong (green) had lower YOY scores. There were also 9% fewer markets in the dark green range than one year ago.

CRE Market Vitality Scores – Office (56 MSAs)

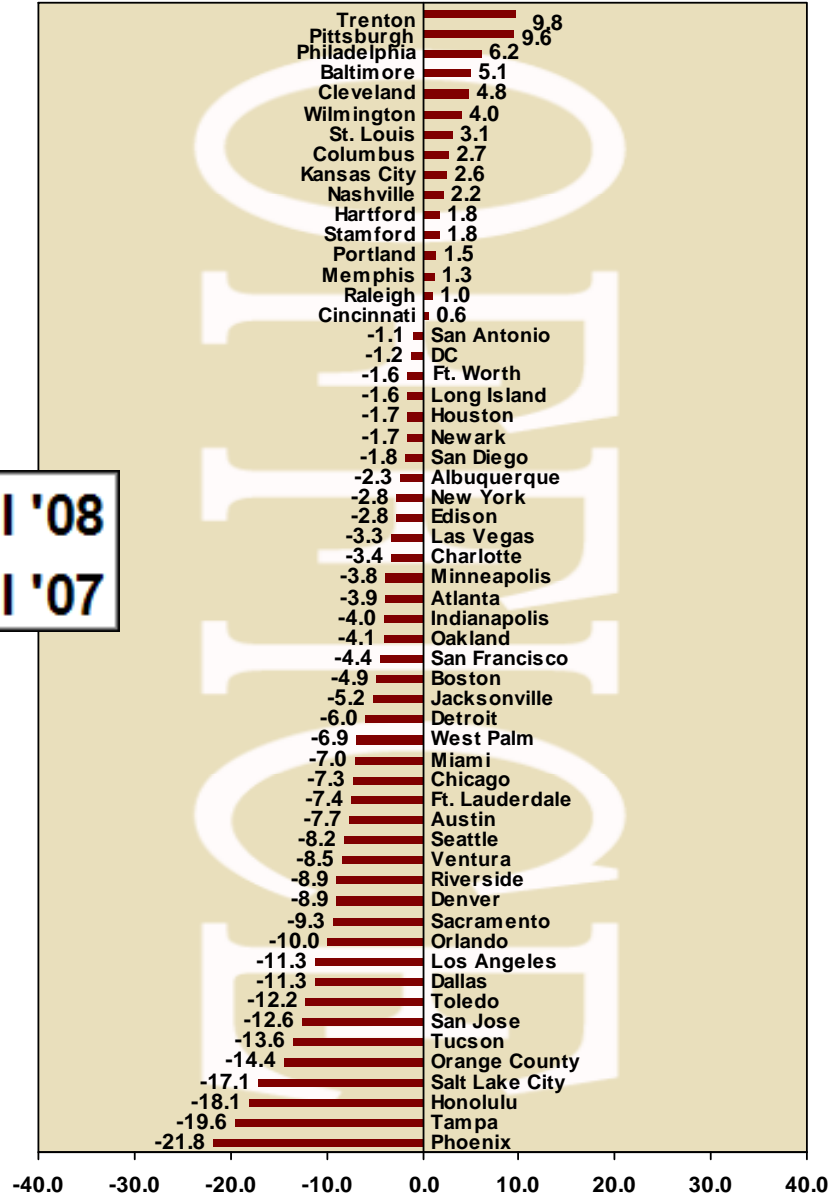




Vitality Scores fall into a range of categories from strong (dark green) to weak (red).

CREMV Model Office Scores



1 Year Change in Office Scores

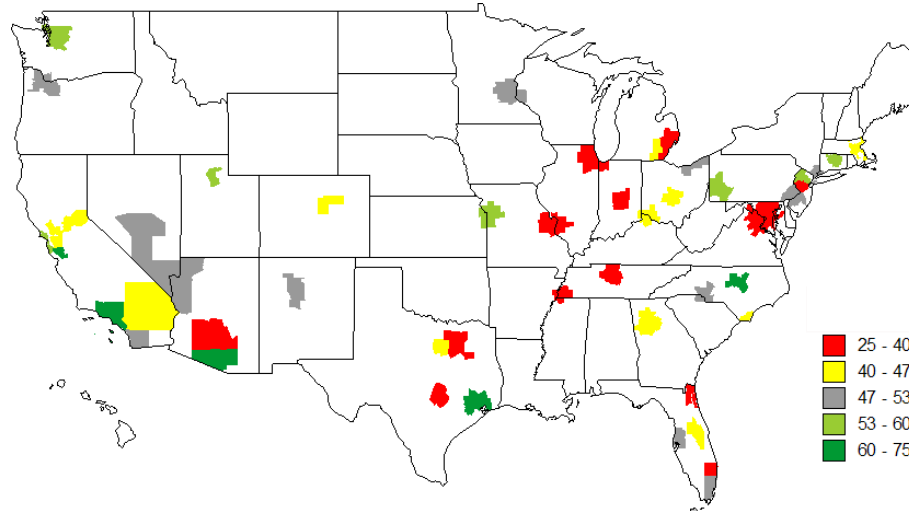


 Fall '08
 Fall '07

INDUSTRIAL

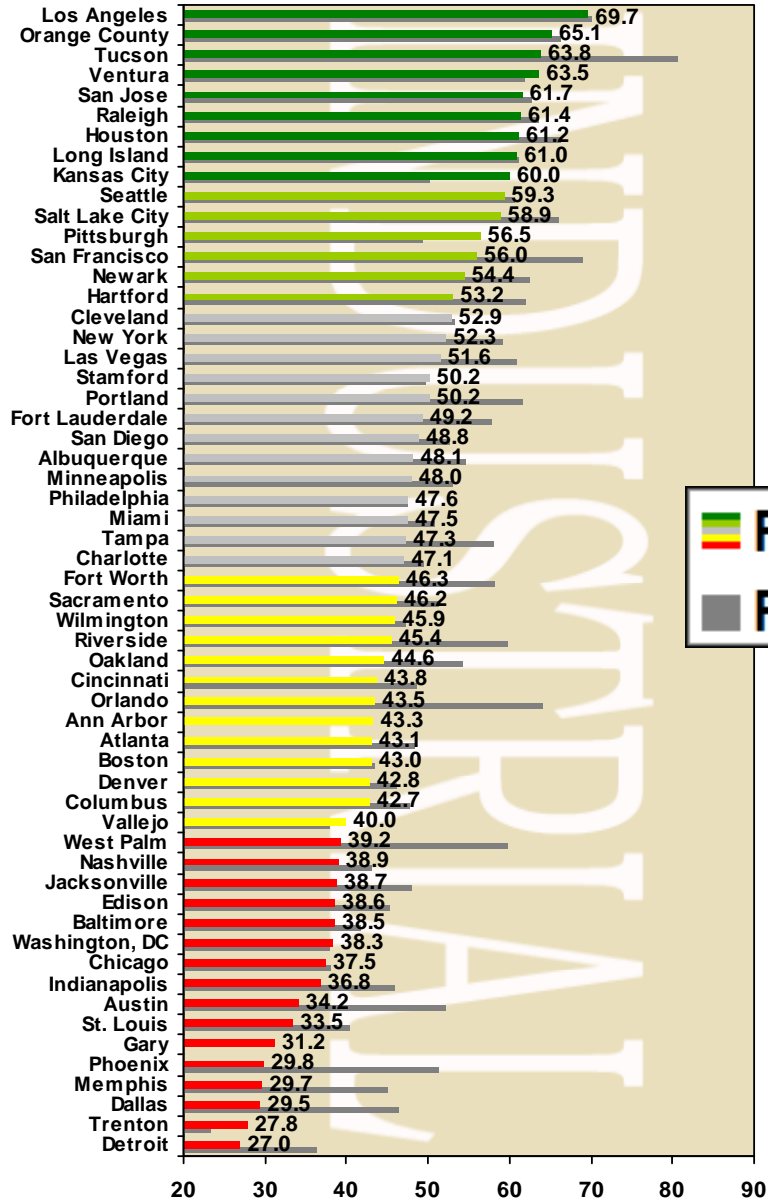
The industrial sector declined 6.4 points YOY with low or negative forecast absorption the key variable driving down Vitality Scores. Waning consumer confidence and the inability of consumers to maintain prior levels of spending have placed downward pressure on the demand for imports. Consequently, the demand for warehouse space is suffering. Markets with the most severe housing troubles saw the largest Vitality Score declines, as the drop in residential construction further decreased demand for warehouse space. YOY **Phoenix** was down 21.6, **Orlando** was down 20.6, and **West Palm Beach** down 20.5 points. Although lack of demand is the predominant issue in the industrial sector, significant oversupply in **Riverside** drove that market down 14.4 points YOY.

CRE Market Vitality Scores – Industrial (54 MSAs)

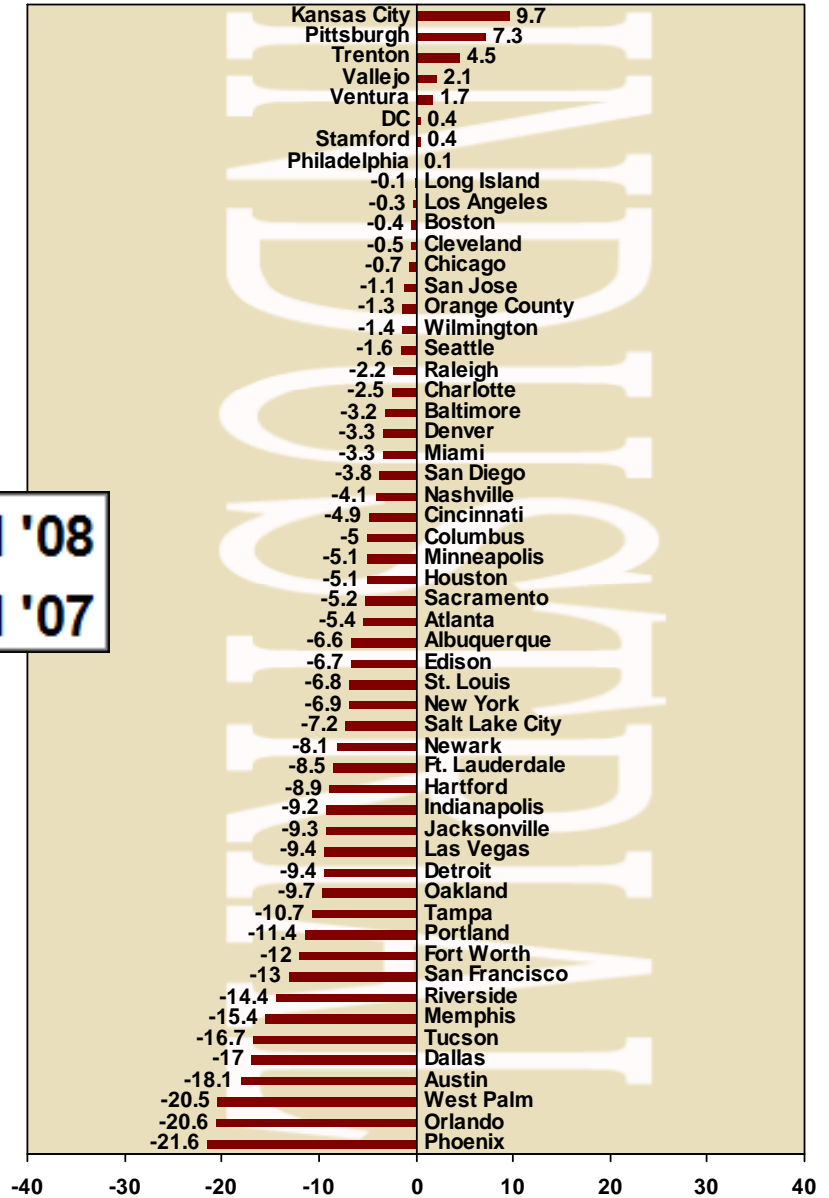




Vitality Scores fall into a range of categories from strong (dark green) to weak (red).

CREMV Model Industrial Scores



1 Year Change in Industrial Scores

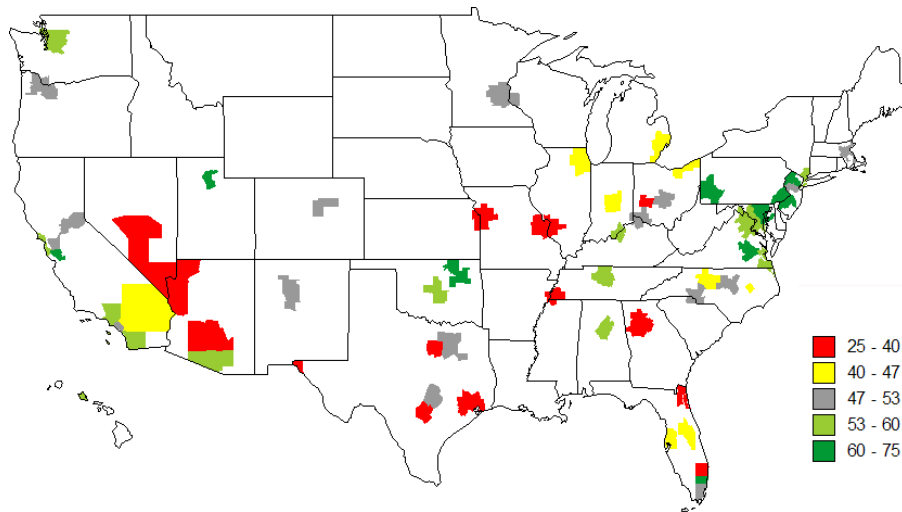


 Fall '08
 Fall '07

MULTI-HOUSING

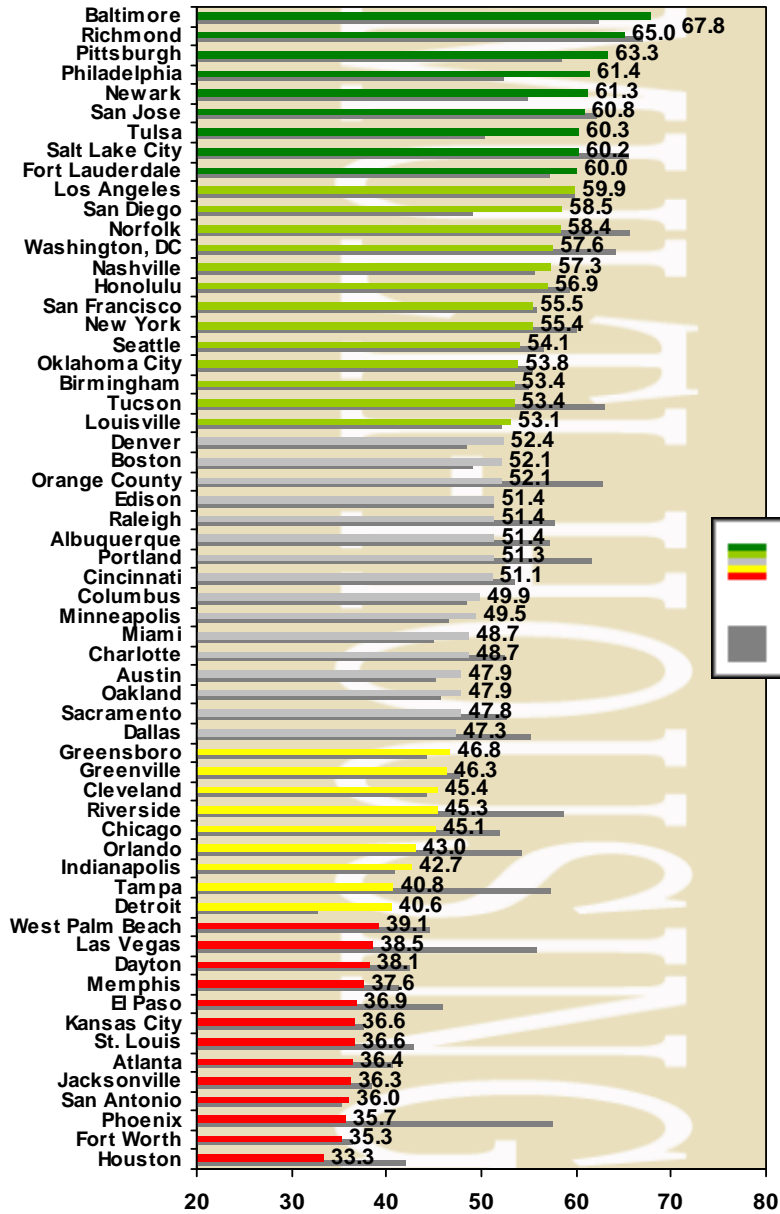
Multi-housing has been caught in a tug-of-war with condominiums reverting back to rentals increasing supply and problems in the housing sector pushing previous home owners into the rental marker. As a result, fundamentals are mostly balanced and the sector finished down only 2.5 points YOY. The sector is showing strength in markets where supply has been constrained such as **Tulsa**, up 9.9 YOY, **Philadelphia** up 9.1 and **Baltimore** up 5.4. **Phoenix** continued to perform poorly and was down 22 points, the most out of any market, due to negative forecast rent growth and high current and forecast vacancy rates. Texas markets also look weak as a result of high forecast completions. All are below their long term historical averages.

CRE Market Vitality Scores – Multi-housing (60 MSAs)

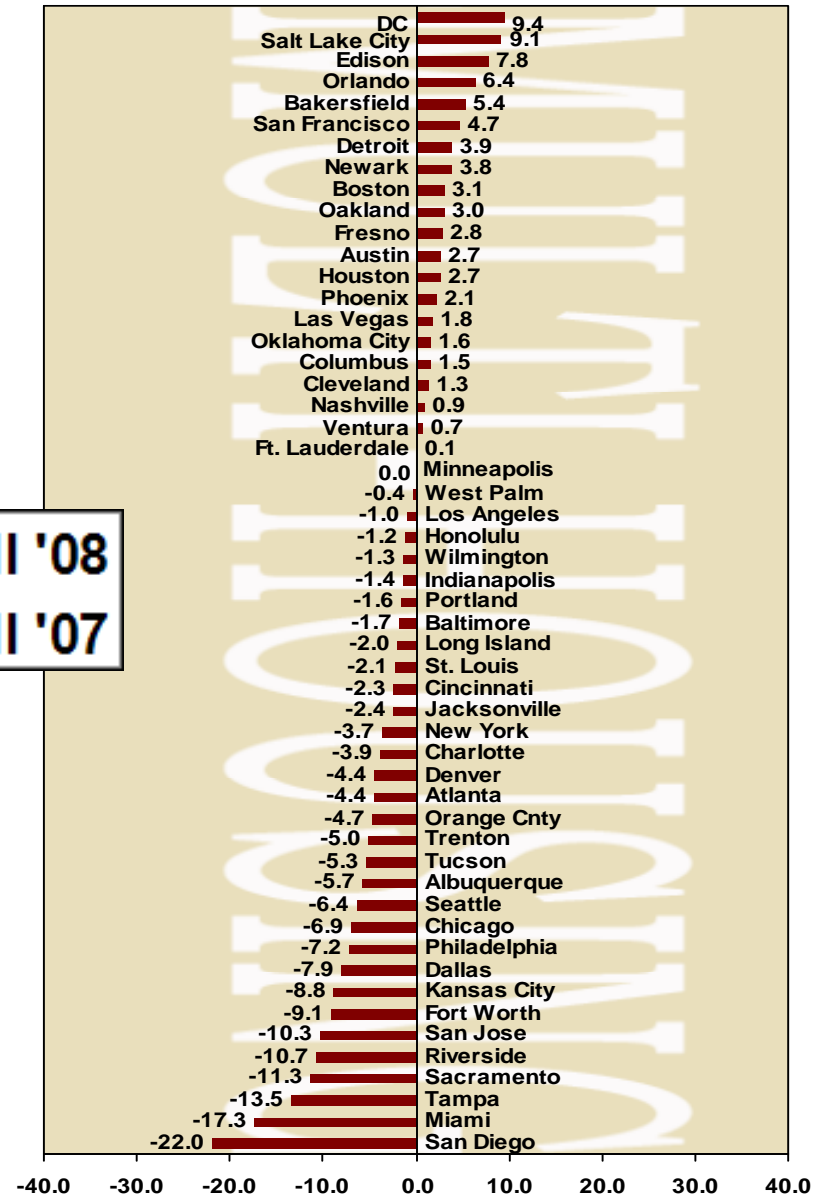


Vitality Scores fall into a range of categories from strong (dark green) to weak (red).

CREMV Model Multi-Housing Scores



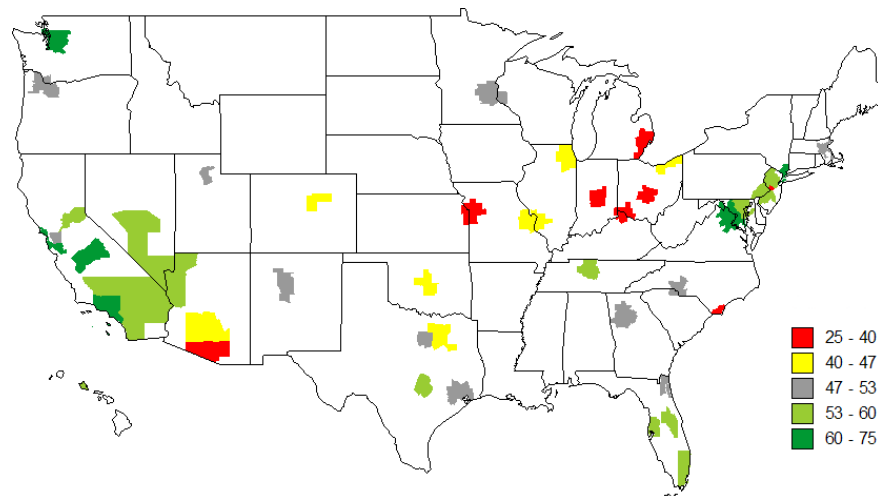
1 Year Change in Multi-Housing Scores



RETAIL

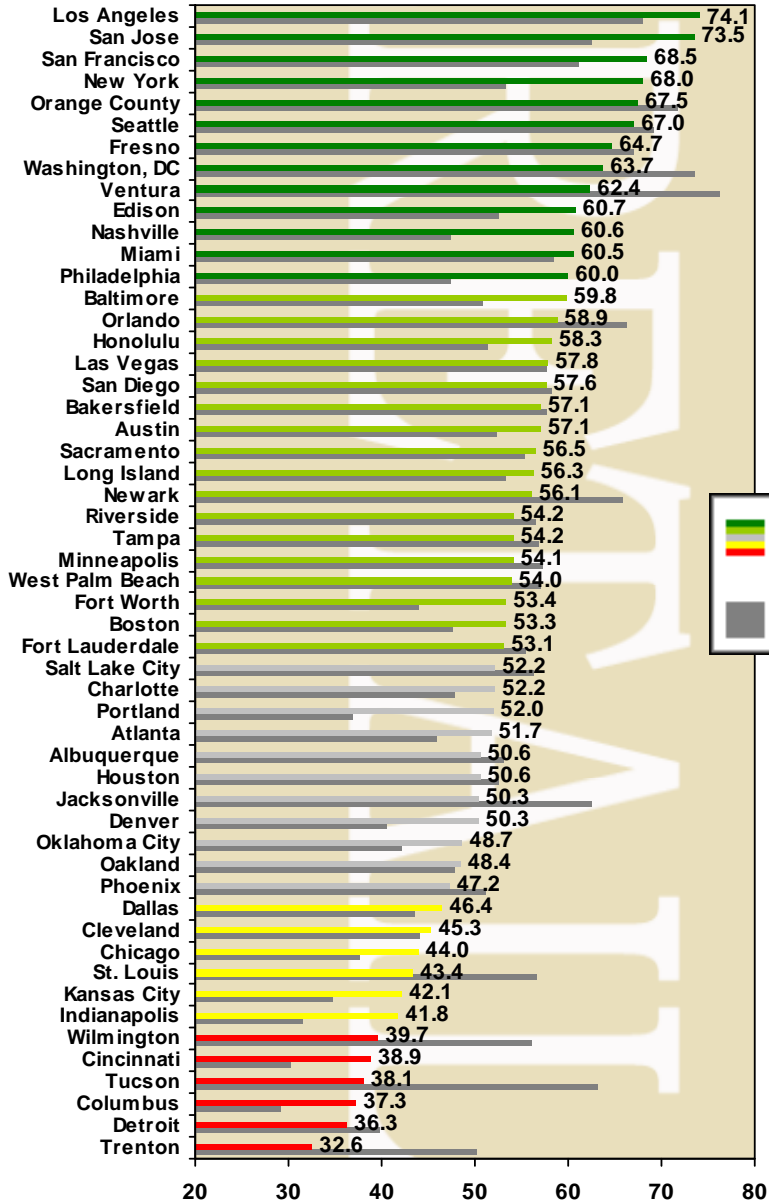
The retail sector continues to hold up reasonably well considering the pressure consumers are under. In fact, although slowing noticeably, sales growth at the major retail center tenants remains positive according to TWR. Consequently the retail sector average fell only 1.3 points YOY. Primary markets such as **San Francisco**, **New York** and **Los Angeles** continue to perform well due to minimal new supply. They also benefit from their status as shopping destinations. Slow forecast absorption is a negative driver in most markets but particularly in secondary and tertiary markets such as **Wilmington**, **Trenton**, **Columbus**, and **Indianapolis**. These markets are among the poorer performers. With absorption not expected to improve until the economy picks up, these markets are likely to languish near the bottom for some time. Other markets in the Midwest including **Kansas City** and **Cincinnati** also had weak scores due to slow absorption and poor rent growth.

CRE Market Vitality Scores – Retail (64 MSAs)

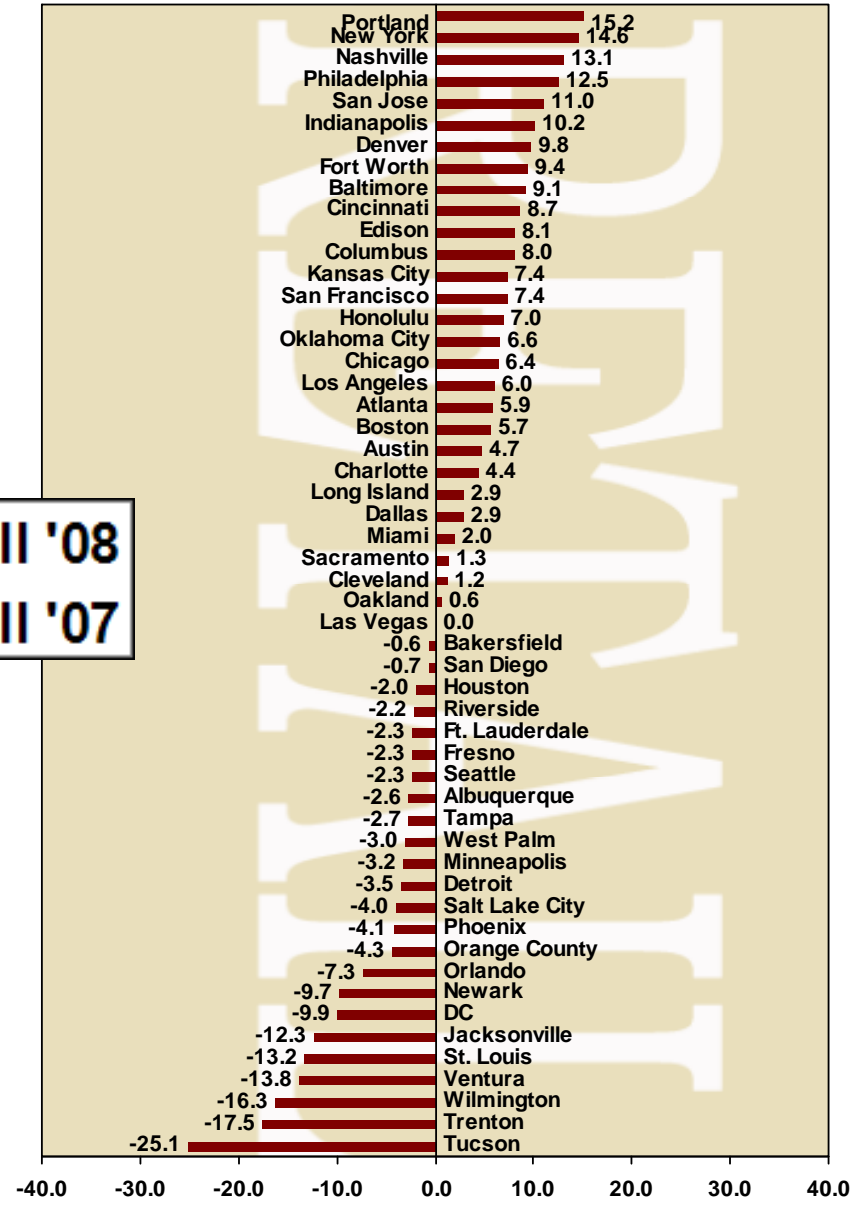




Vitality Scores fall into a range of categories from strong (dark green) to weak (red).

CREMV Model Retail Scores



1 Year Change in Retail Scores



 Fall '08
 Fall '07