

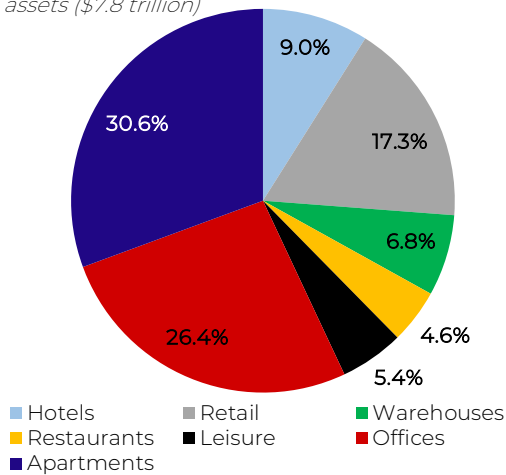
US COMMERCIAL PROPERTY ACCIDENTS AHEAD

Suttle Economics Notes #131

- The COVID-19 crisis has dampened the demand for commercial property in the short-run
- Hotels and retail have been hardest hit; apartments and offices face long-term uncertainty
- Banks (especially smaller banks) are heavily exposed to CRE
- CMBS spreads have widened to high-yield reflecting fundamentals and less Fed support

Chart 1
US commercial real estate by sector

2018 shares, current cost net stock of fixed assets (\$7.8 trillion)

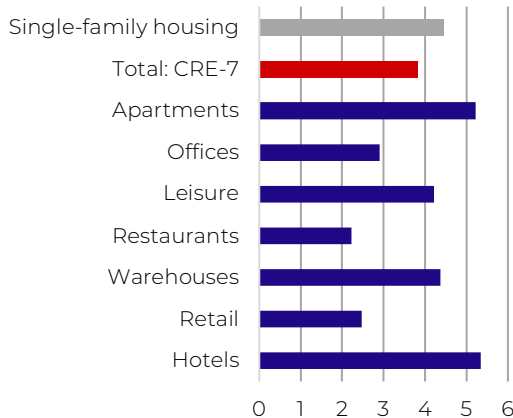


The COVID-19 (C-19) crisis is having a significant negative impact on the commercial real estate (CRE) sector around the world. In this note, I focus on the United States, where the C-19 crisis is most persistent and where the CRE sector is large. The main concern is what the C-19 crisis will do to the demand for commercial property over both the short-and-medium-term. This will affect growth both directly (by lowering some important components of construction activity) as well as indirectly through a possible rise in bad property loans. Many small US banks are heavily exposed to commercial real estate, often in a geographically-concentrated fashion. The extent of damage to the CRE sector will be dependent on how quickly a credible vaccine or treatment is developed, as this will shape the nature of the long-run behavioral response.

The CRE sectors most vulnerable to the C-19 downturn are likely to vary over time. Hotels and leisure developments have been most immediately affected and credit problems there could develop quite quickly. The retail sector was already under pressure from industry shifts underway before the crisis, and these trends have accelerated post-crisis. In the longer-term, however, the two largest sectors of the CRE market—apartments and office developments—could come under pressure (Chart 1). The last time this occurred was in the late 1980s, when the interaction of poor policies and excess market leverage combined to produce a serious crisis among smaller depository institutions.

Chart 2
CRE capital stock growth by sector

annual average change 2010-18



The CRE sector pre-and during-crisis

In this note, I focus on a subset of 7 of the main components of the CRE sector. I exclude industry, religious structures, healthcare, energy, education and transportation—many of which are could well also be hurt by the CRE downturn. The property capital stock of these 7 subsectors was \$7.8 trillion at the end of 2018, which accounts for just over half the stock of non-residential structures.

Chart 3
Commercial construction spending

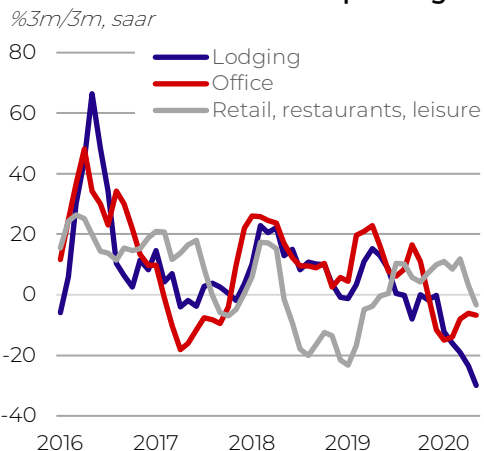


Chart 4
Hotel occupancy rates

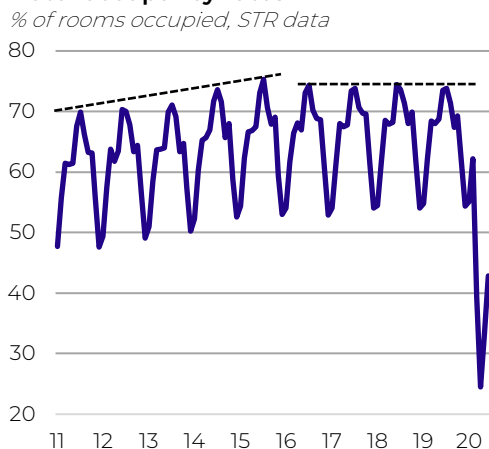
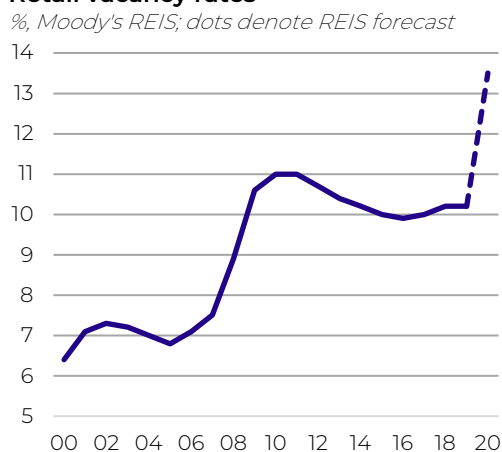


Chart 5
Retail vacancy rates



The growth in these components of CRE was not obviously excessive through the last expansion (Chart 2). In aggregate, the net fixed assets of the group grew at an annual average rate of 3.8%, well below the 7.3% annual average of the ill-fated 1980s boom (1983-1990). Office and retail developments were notable laggards: in the 1980s, these grew at annual averages of 9.6% and 8.4%, respectively. The most rapidly growing components in the last expansion were hotels and multi-family apartment buildings.

In terms of new construction activity, the sector had shown signs of weakness in recent months (Chart 3). Since January, hotel construction spending through May was down 27.5%, saar; retail and restaurant development by 9.3%, saar; and office development by 7.1%, saar. Given the long-life of many of these projects most of this decline will have reflected work interruptions. The more fundamental construction spending adjustment to a (probable) post C-19 world of lower demand for the structures lies mainly ahead.

Plenty of room at the inn

The lockdowns associated with the effort to control the spread of the virus have led to a sharp decline in the demand for many types of commercial property. Lodging is the CRE sector where this demand shortfall has been most immediate and serious (Chart 4). The room occupancy rate is typically highly seasonal, hitting a low in February before improving in the spring to peak in July. This year, occupancy rates slumped in March and April to average 39%-points below the average in those months for 2015-19. In May, the shortfall improved a little more, to down 30.7%-points versus the 5-year average. With the peak months of the summer looming, recent flare-ups in infections will not help a return of visitors.

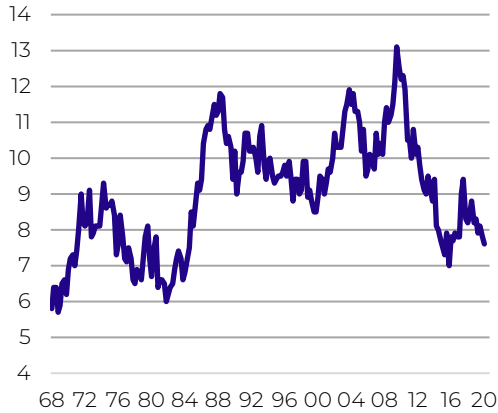
The retail shake-out will accelerate

The retail sector has also been visibly rattled by the C-19 crisis, with store and mall closures accelerating the shift to online retail (this development provides an important boost to the warehousing sector, thus underlining some winners as well as losers). The retail CRE sector has been struggling throughout the current expansion, as reflected in a persistently high vacancy rate, which is expected to move sharply higher in 2020 (Chart 5). There have been several high-profile bankruptcies in recent weeks (Neiman Marcus, JC Penney, Brooks Brothers and J Crew) and more are sure to follow. Many smaller shops and restaurants are also very likely to fold, especially as PPP-related funding runs out.

Uncertainties for the apartment and office sectors

Problems facing the apartment and office sectors have been less immediate, although could well end up being more serious (from a macro perspective),

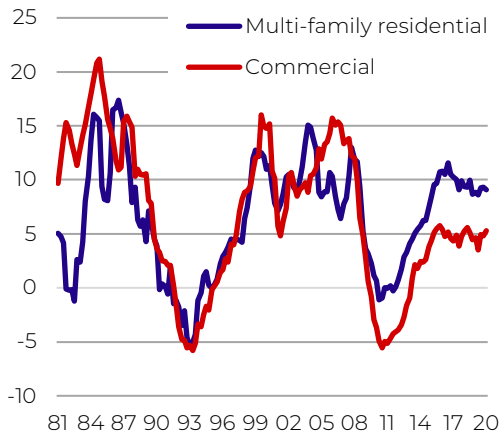
Chart 6
Apartment vacancy rates
% , properties with 5 or more units



given the relative size of the sectors. In both cases, there is considerable uncertainty over the degree of structural change in demand that C-19 will produce.

The apartment sector did relatively well in the last expansion. It benefitted from a structural shift in favor of renting in urban areas, especially by millennials. Buying in suburbia has been the main factor behind the housing boom of the 2000s. Aside from shifting preferences, the sharp tightening in mortgage lending conditions after 2010 meant that many millennials could not qualify for a mortgage, adding to the demand for rental properties. Despite relatively rapid growth in apartment supply, apartment vacancy rates have been quite low in recent years and were falling in early 2020 (Chart 6). In a post C-19 world, however, it is plausible that more will look to live further out and in larger structures, especially if remote working persists.

Chart 7
Commercial mortgage growth
%oya



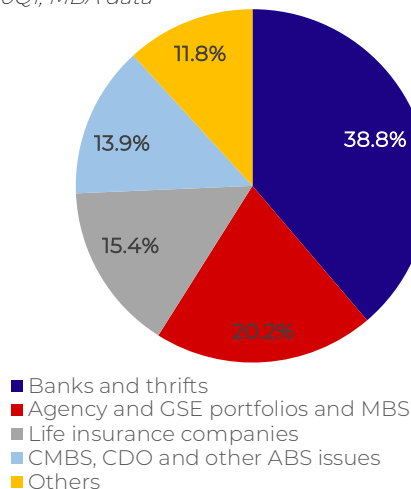
The future of working practices is the biggest cloud hanging over the office sector, raising concerns about lease renewals and the outlook for rents, especially in some major urban areas (this is also a concern for global cities such as London). According to Moody's REIS, the office vacancy rate has been very steady in recent years, edging up to 17% in 2020Q1.

Worries over the financial fall-out

With the demand for commercial property lower, a key issue is what the financial fallout will be, both in terms of lower asset prices and—even more importantly—mortgage defaults.

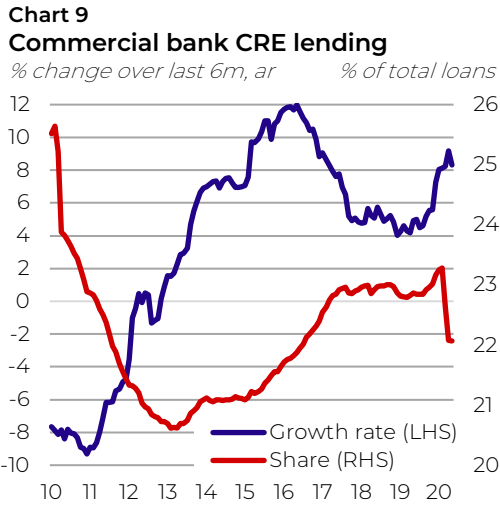
Commercial mortgage lending had been quite robust through the last expansion, especially to finance apartment development (Chart 7). Through 20Q1, default rates had been low and stable for about 4 years. Signs of financial stress have emerged in Q2.

Chart 8
Commercial mortgage debt
2020Q1, MBA data



For the past 9 weeks, the Commerce Department has been collecting a survey of about 70,000 renters. The share that did not pay last month's rent due has been edging up and was 18.3% of the total in the week ending June 30th. The share answering that there is no or only a slight chance of making next month's rent has risen to 32.3%. These shares could rise further if, as seems likely, Federal support programs are scaled back in August. In the commercial mortgage backed securities (CMBS) market, Moody's REIS has observed that mortgage servicers of hotel CMBS have mentioned C-19 problems on 35.6% of the outstanding. Of this problem group, about 37% are still current, but 63% are late or delinquent (more than 30 days overdue on payments).

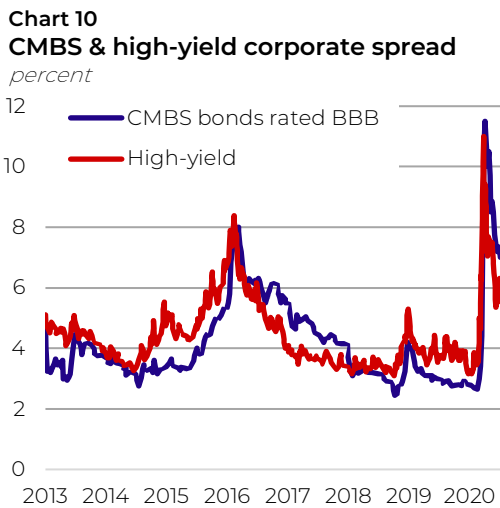
The commercial property market is less dependent on securitization than the residential market. The stock of mortgages on residential property was \$11.2 billion at the end of 20Q1, of which about \$9 trillion



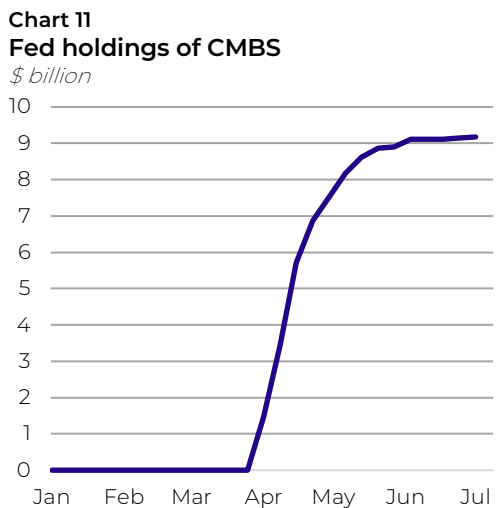
was securitized (mainly through the GSEs). The stock of mortgages on commercial property (including apartments) was about \$3.75 trillion, of which only about \$550 billion was securitized.

Importantly, banks hold about 39% of commercial mortgage debt, according to the Mortgage Bankers' Association (MBA; Chart 8). The role of banks in the commercial property lending process is even more significant than these data suggest. Fed H.8 data show that US commercial bank loans to CRE borrowers were \$2.39 trillion at the end of June. This is equivalent to 64% of commercial mortgage debt. Bank lending to CRE borrowers has been very robust in recent years and accelerated through 2019 into early 2020 (Chart 9).

The aggressiveness of this lending was enough to attract significant concern from a number of Fed officials, most notably Boston Fed President Rosengren, whose district had been one of those ravaged by the bank and thrift commercial lending excesses of the late 1980s. CRE lending rose to 23.3% of bank loans in February. The decline in the share since reflects the surge in other bank lending, especially loans to commercial and industrial (C&I) companies. It is quite likely, in my view, that mounting CRE defaults could lead a renewed wave of small bank failures and renewed concentration. At the peak of the last CRE debt crisis in 1989, 534 banks failed (in the GFC peak, in 2010, it was just 157).



Although the CMBS market is relatively small, it provides useful signals on market perception of CRE risk (Chart 10). Spreads on (notionally better-quality) BBB-rated CMBS traded an average of 80bp tighter than high-yield corporate debt through 2019. Since March 20th, however, they have traded about 180bp wider. This differential seems to reflect two factors.



First, the fundamental picture for commercial real estate has deteriorated more than for the corporate sector as a whole. Second, the Fed has been a less active supporter of the CMBS market than other segments of the private debt market (Chart 11). It bought about \$9 billion of CMBS in April and May but has bought little since the beginning of June.

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Important Information

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