SummerStreetAdvisors

Construction debt casts long shadow over Banks' CRE portfolios

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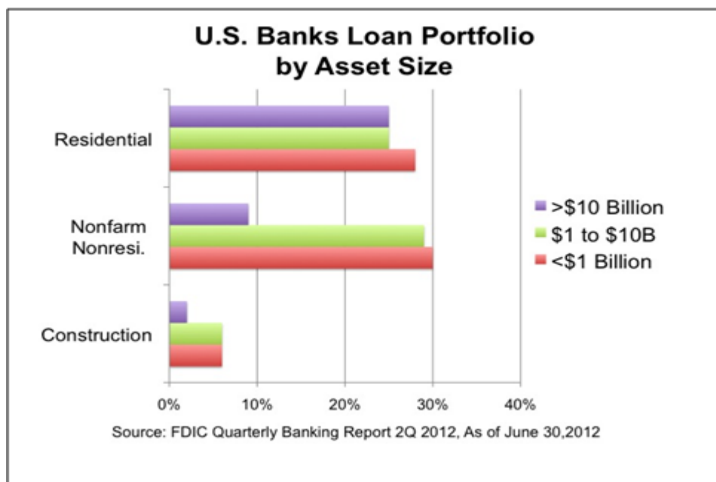
As 2012 comes to a close, the complexity of America's real estate crash in the banking sector continues to unfold. Looking at the big picture, FDIC data for the nation's 7,246 banks and federally chartered thrifts showed commercial real estate (CRE) asset quality indicators continued to improve in the first half of 2012. One important milestone was reached as total delinquent CRE loans and foreclosed properties fell below $100 billion, down almost 28% from a year ago.

Despite slow but positive progress, closer scrutiny on underlying asset classes in banks' loan portfolios reveals the rocky road to recovery continues, particularly for smaller banks. The nation's community banks, defined as having assets less than $1 billion, and mid-sized banks with assets of $1-$10 billion, continue to be vulnerable to disproportionate CRE exposure. While CRE loans comprise 14% of the $700 billion in banks' aggregate portfolios, mid-sized banks have 29% and community banks 30% exposure, compared to 9% for banks with assets over $10 billion.

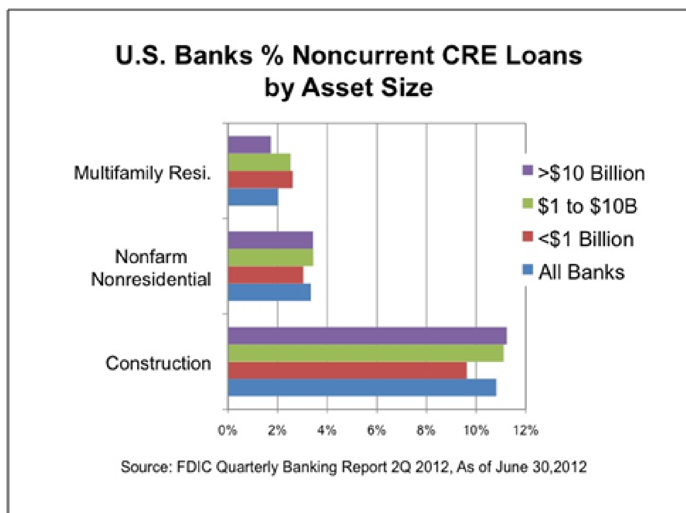
Even more challenging for the sector is the concentration of construction and development (C&D) loans: $51.9 billion (6%) at mid-sized banks and another $55.1 billion (6%) at community banks. At mid-year, the combined $107 billion in C&D loans is almost equal to the $110.3 billion (2%) on the books of large banks with assets over $10 billion.



Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

Construction loans produce shaky foundation

Across the board, the delinquency rate at the end of June was highest for construction loans. Noncurrent C&D loans exceeded 11% for mid-size and large banks, running 9.6% for community banks.



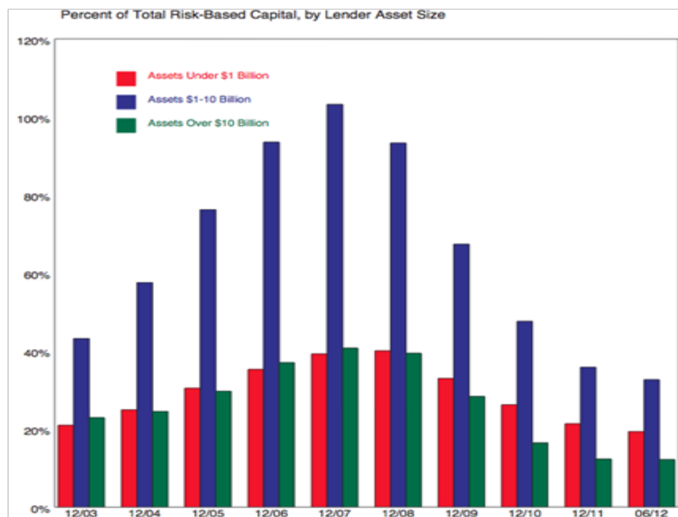
Mid-year REO statistics also tell a sobering story. The FDIC reported a total $41.8 billion in REO at the end of June, of which $14.3 billion (34.2%) falls in the C&D category. Community and mid-sized banks hold the lion's share, $5.8 billion and $4.7 billion, respectively, $10.5 billion combined – 74% of all construction and development REO.

"Acquisition, construction and development loans (ADC) can be relatively high-risk, even in a boom economy. Many of the 407 banks that failed since 2007, and those that remain in serious trouble today, did not fully appreciate the concentration risk of construction and land development exposures in a down market," says Jack Mullen, Founder and Managing Director of Summer Street Advisors, LLC (SSA).

Portfolios of small and regional banks are more heavily weighted to secondary and tertiary markets, where pricing has been slow to recover. Refinancing in these markets remains difficult, even for properties with stable cash flow.

Even before the sector crash, mid-sized banks had significantly higher concentrations of ADC loans than community banks and large banks. At the end of June 2012, mid-sized banks still held almost 40% of risk-based capital in construction and development loans, more than double the exposure of small and large lenders. This situation highlights the severe risk of CRE losses that many banks still face.

Chart 1: Median Construction and Development Loan Concentrations by Lender Asset Size: 2003 - 2012



Sobering, but enlightening, statistics

Mullen believes banks that hunker down to conduct detailed analyses of their CRE loan transactions may find some surprises.

"Based on our experience at SSA, a significant portion of commercial real estate loans is secured by owner-occupied properties. If so, these loans are essentially commercial or business loans and ADC exposure is likely understated, particularly for smaller banks," says Mullen.

Portfolio analyses undertaken by SSA for banking and CRE investor clients have turned up "misclassified" loans for residential lots, spec homes, built-to-suit industrial space for builders and building companies.

"Many times, loans are written where primary or secondary residences of business owner-borrowers serve as additional collateral to CRE loans. We also see single-tenant office/industrial with little marketable value," Mullen continues.

Loan classification distinctions are important for accurate structuring, as well as reporting. A loan backed by an income-producing property relies on the performance of that property for the repayment of the loan. The loan is underwritten based on the ability of future property revenues (in the form of rent and lease payments) to cover both future property expenses and the debt service of the loan. On the other hand, a loan backed by an owner-occupied property is essentially a business loan with additional collateral (the property) pledged as credit support. In this case, the loan is

underwritten based on the ability of future business revenues to cover both business expenses and the debt service on the loan.

"Five years after the crash, many banks still haven't come to grips with how to deal with distressed construction projects. The reasons banks are having difficulty revolving around three issues: First, there may be no expertise to complete the project, especially if the owner has walked away; Second, there's no capital available because the money has run out; Third, in many cases, market conditions do not support the real estate as underwritten. All three conditions create a perfect storm for banks stuck with these loans," says Mullen.

Slow-growth economic recovery extends banks' pain

Although fundamental economic health is necessary for real CRE sector recovery, most economic growth measures are only weakly positive. Still, as 2012 closes, traditional drivers of CRE rent growth and demand have begun to track stronger than the broad market (and magnitude of CRE distressed debt) would suggest. Also, corporate balance sheets are showing increased strength.

Another bright spot, U.S. home prices climbed 1.6% in July from a year earlier, the fifth consecutive increase, as reported by S&P Case Shiller Index. Improvement in the residential market may also boost commercial property, as a strong housing market helps increase consumer spending.

"Once residential prices improve, pricing clarity will provide much more certainty for investors looking to purchase distressed loans, or banks attempting to work them out," says Mullen.

Ultimately, community and mid-sized banks likely will face more difficulty than their large counterparts, as the entire banking system deals with unprecedented pressure.

Summer Street Advisors LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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