

# CRE: Certain Uncertainty ??

May 19, 2022

Brian Bailey, CCIM, CRE



# PLEASE BE HEARD

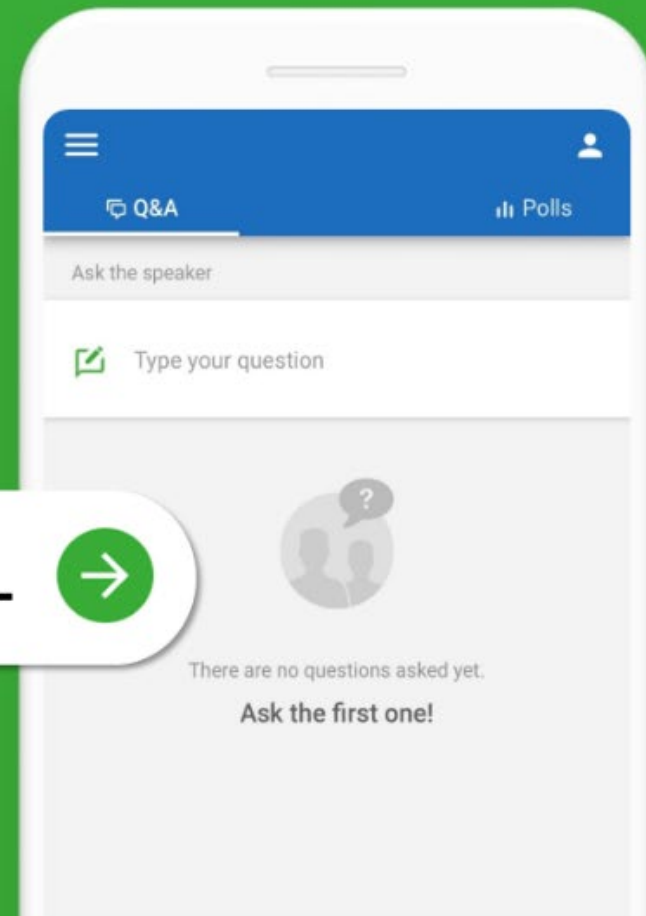
## Questions & CPE

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# Polling Question

What is your main area of business?

A) Academia

B) Lender, Bank

C) Lender, Non-bank (Debt Fund, Hedge funds, Insurance, Pension, Private Equity, Structured (CMBS & CLO))

D) Owner/Operator

E) Public/Regulator

F) Trade Association

G) Third Party Service (appraiser, brokerage, due diligence, environmental, legal, etc.)

H) Other

The views expressed in this document are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Atlanta, the Federal Reserve Board of Governors, or the Federal Reserve System.



# Brian Bailey

Subject Matter Expert & Senior Policy Advisor, CRE  
Atlanta Federal Reserve

## Experience:

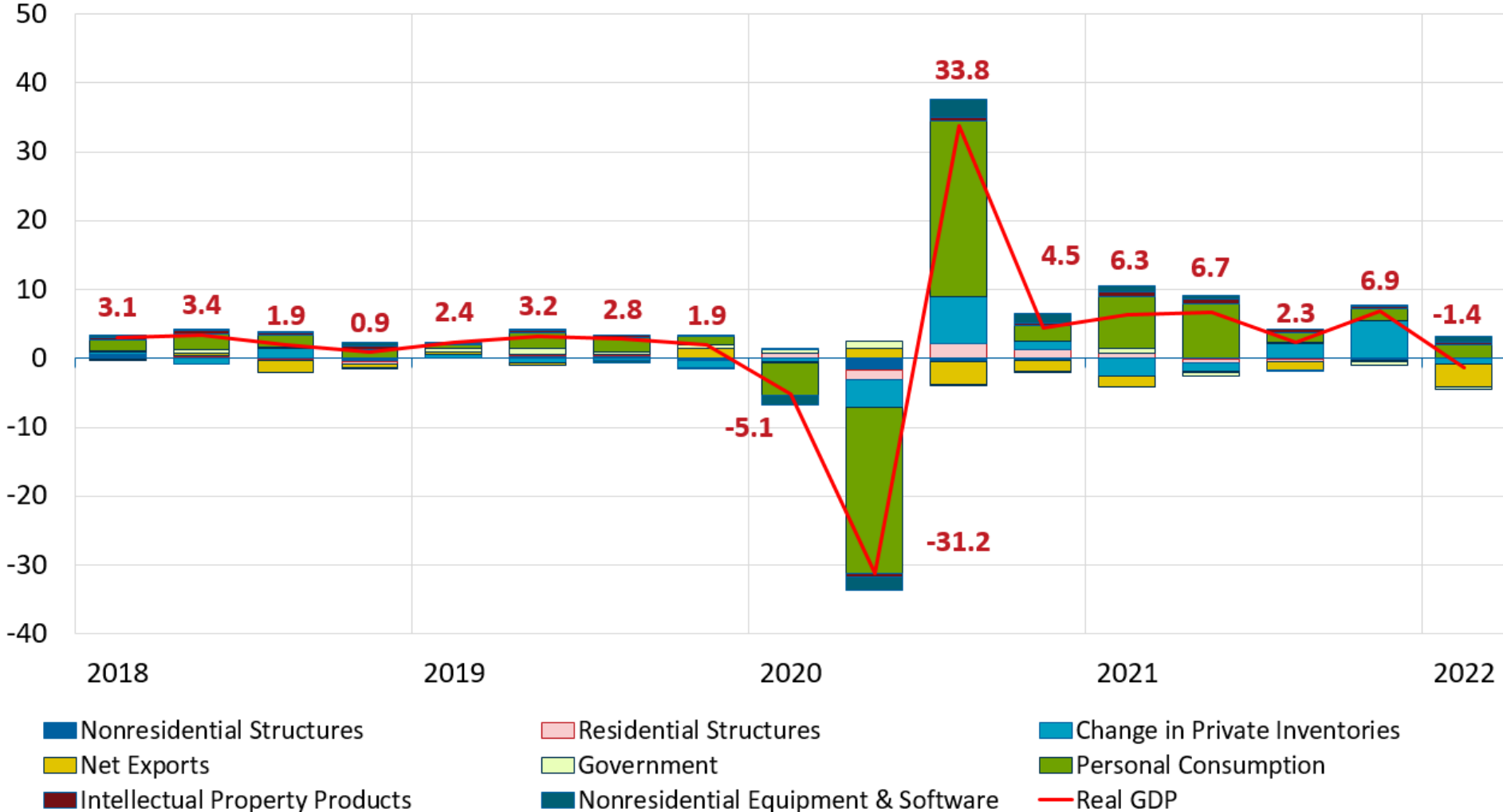
- Federal Reserve Bank of Atlanta (11 years)
- Private Industry (15+ years)
  - Tavistock Group
  - Flagler Development
  - EY

# Agenda

- Economic Conditions
- Market Trends
- CRE Conditions
- Risks
  - Eroding Net Operating
  - Declining CRE Value

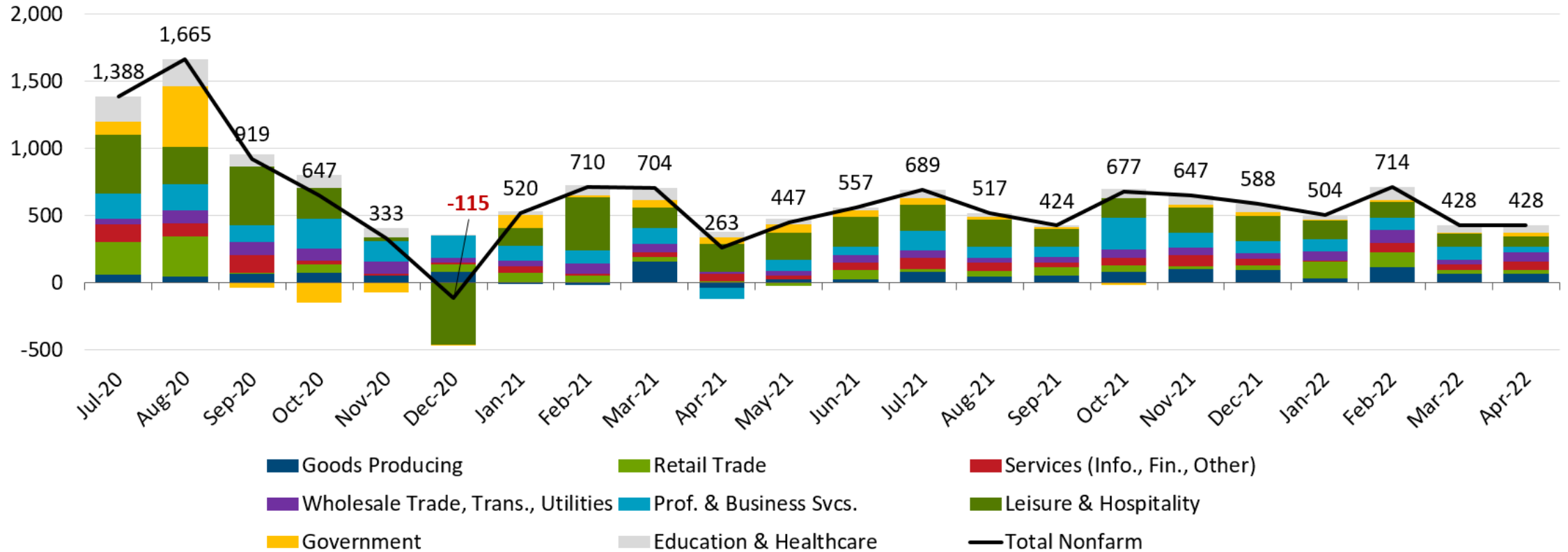
# Contributions to Real GDP

Note: Quarterly, percent, annualized rate  
 Source: Bureau of Economic Analysis; Risk Analysis Unit/Federal Reserve Bank of Atlanta



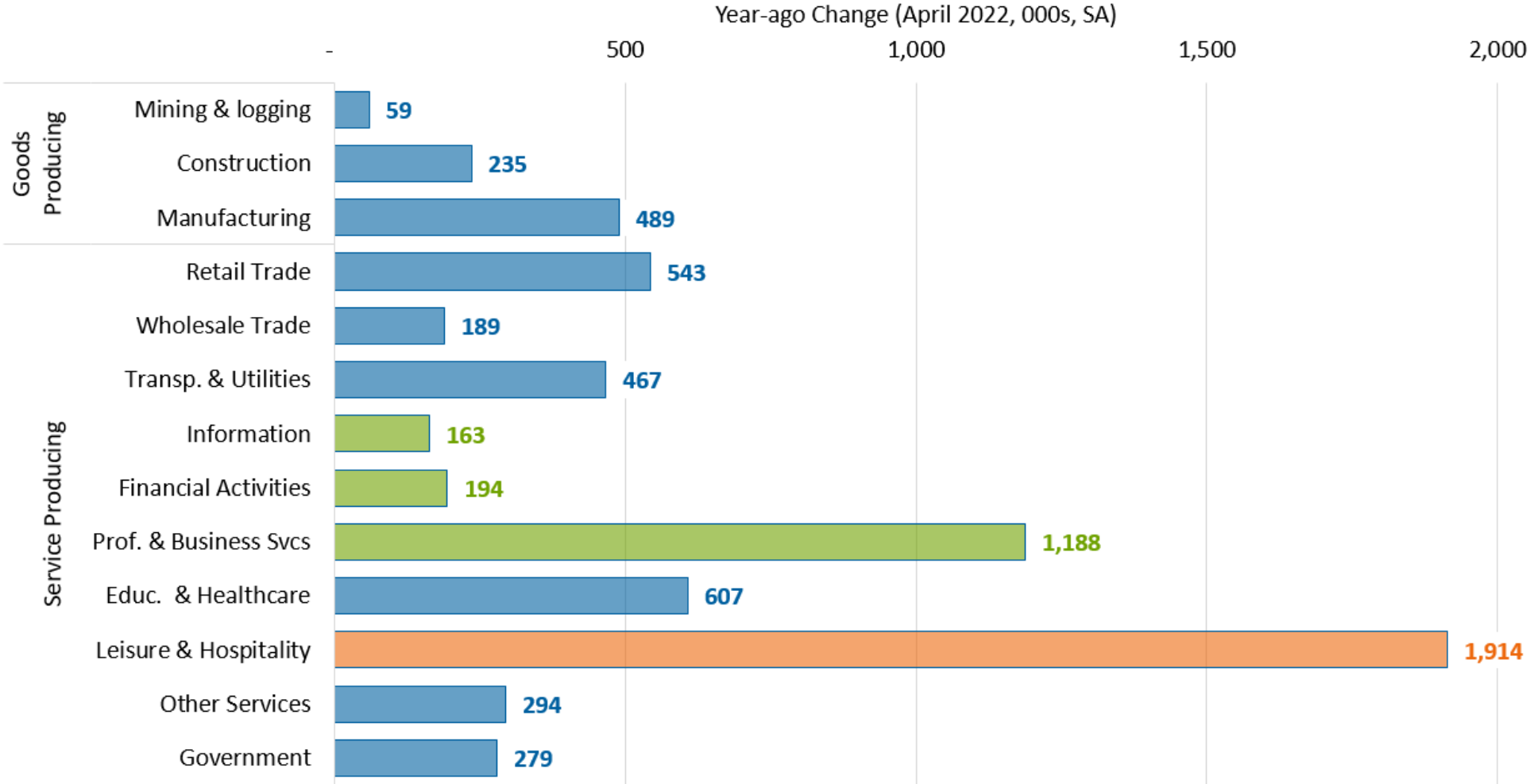
# Monthly Job Gains

**Nonfarm Payroll Employment  
(000s, SA)**





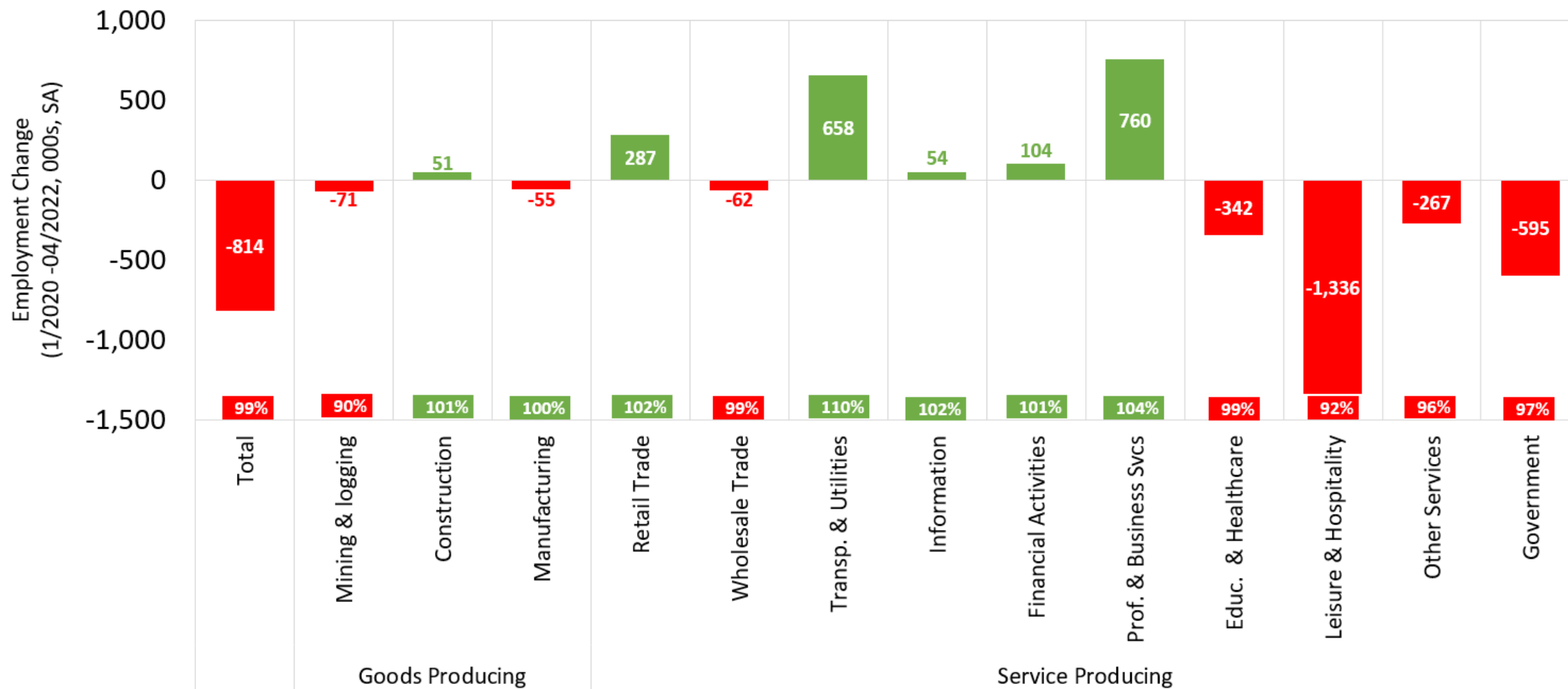
# U.S. Job Creation by Sector



Source: BLS, Risk Analysis Unit/Federal Reserve Bank of Atlanta

# Employment by Sector

Pre-pandemic vs. April 2022



# Population Migration

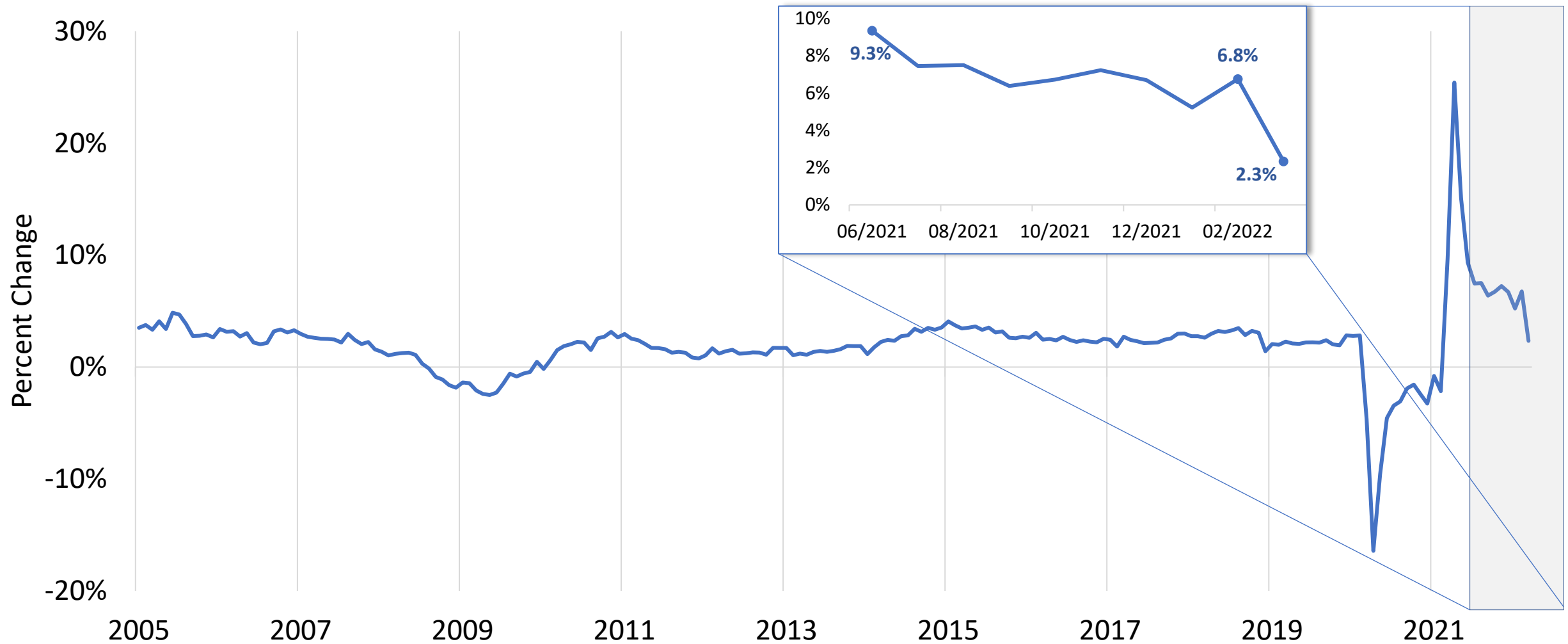


A wave of outmigration from high density markets was necessitated by the onset of the pandemic.

A follow up wave of migration will be driven by outmigration from higher to lower cost markets.

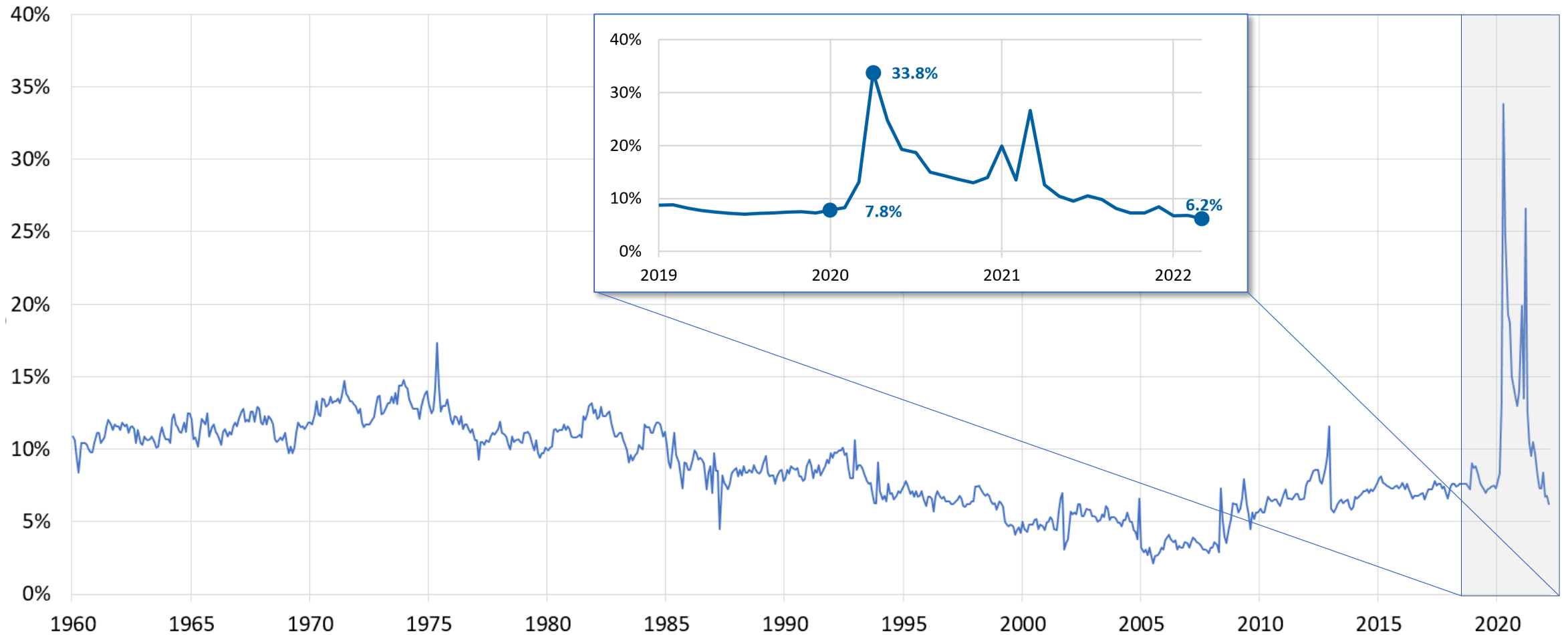
# Real Consumer Spending

Year-over-year percent change

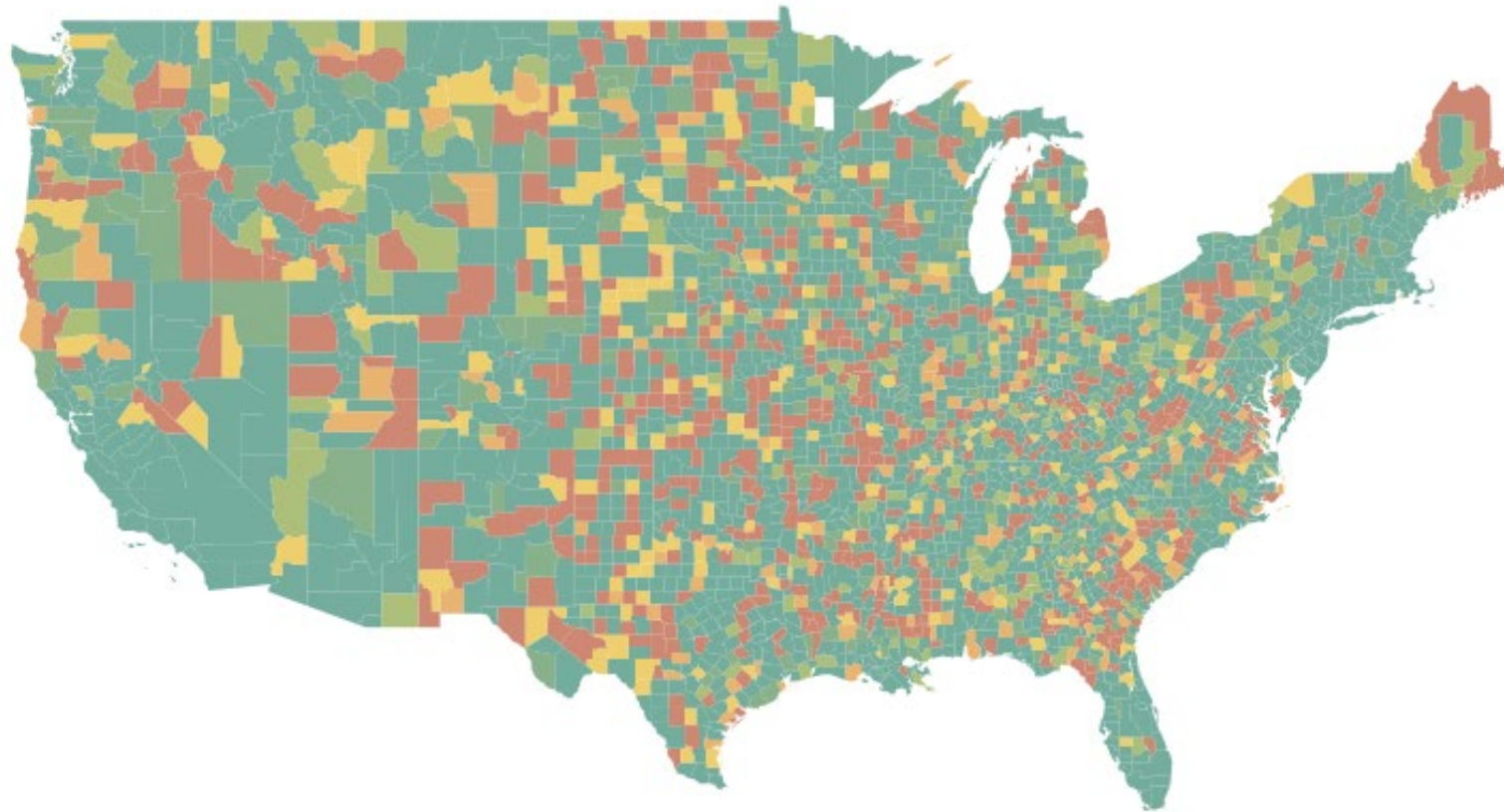


# Personal Savings Rate

Savings rates decline in conjunction with the economic reopening



# Year-Ago Change in Delinquencies: March 2022



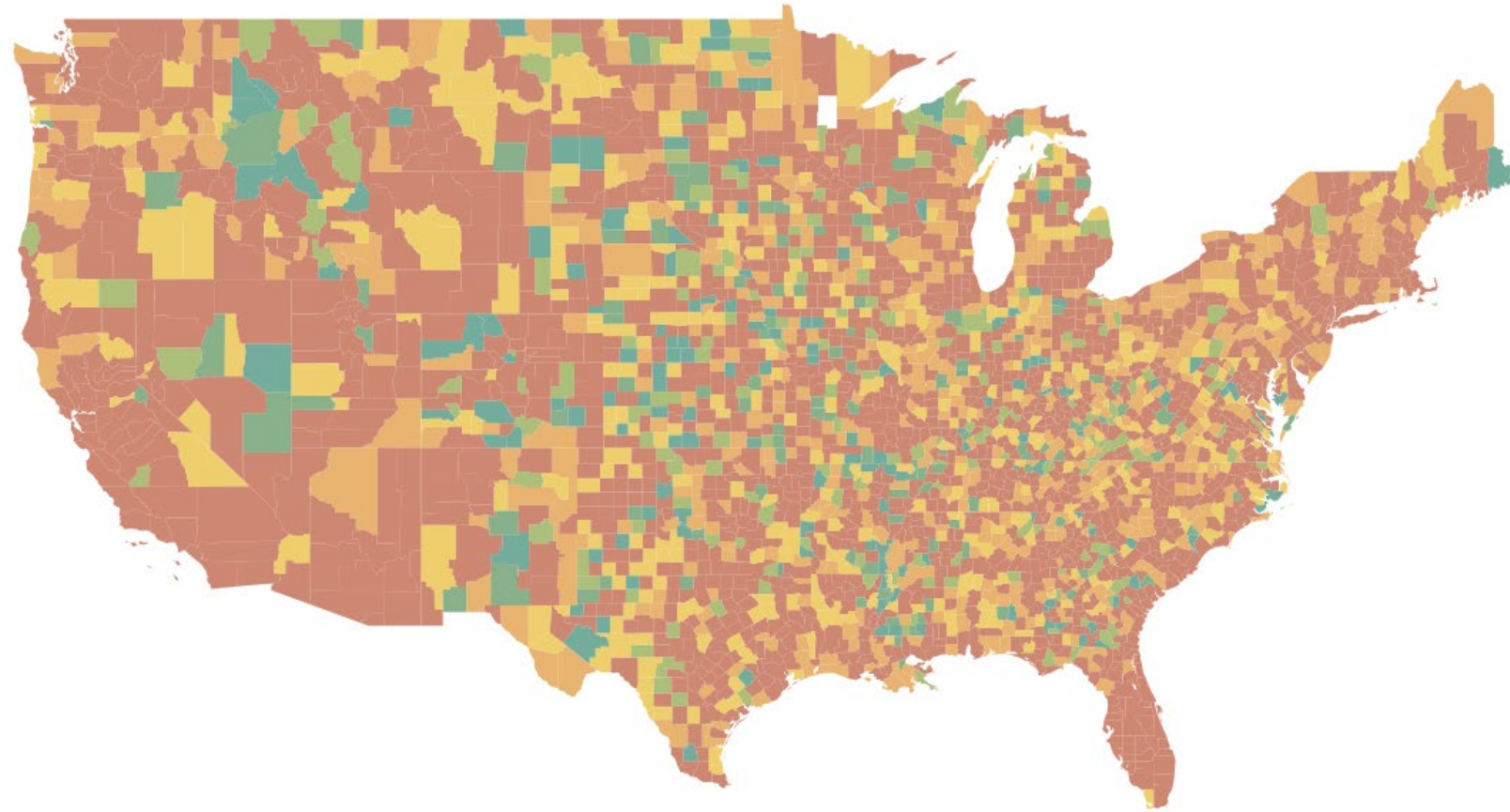
Basis Point Change

-100



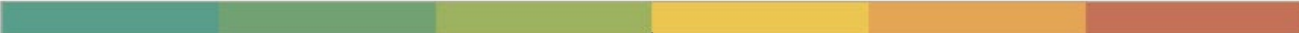
100

# Year-Ago Percent Change in Debt Balances: March 2022



Growth

-10%



10%

# Consumer Price Inflation

Supply chain driven...Yes and No.

Date		Core	All Items	Food	Energy	Home-ownership	Rent	Other Utilities	Educ. & Comm.	Medical Care	New Vehicles	Used Vehicles	Recreation	Transp.	Lodging	Furniture	Apparel	Other Services	Alcohol
2022	Apr	6.1	8.2	9.4	30.2	4.8	4.8	13.0	1.0	3.2	13.2	22.7	4.3	19.8	19.7	9.9	5.4	3.2	3.9
	Mar	6.4	8.6	8.8	32.2	4.5	4.4	12.5	1.6	2.9	12.5	35.3	4.8	22.5	25.1	10.1	6.8	3.2	3.7
	Feb	6.4	7.9	7.9	25.7	4.3	4.2	11.0	1.6	2.4	12.4	41.2	4.9	21.1	25.1	9.7	6.6	3.4	3.5
	Jan	6.0	7.5	7.0	27.0	4.1	3.8	11.9	1.7	2.5	12.2	40.5	4.8	20.9	20.5	9.0	5.3	3.3	2.7
2021	Dec	5.5	7.1	6.3	29.4	3.8	3.3	9.4	1.6	2.2	11.8	37.3	3.3	21.3	24.2	7.4	5.7	2.6	2.3
	Nov	5.0	6.8	6.1	33.1	3.5	3.0	9.8	1.7	1.7	11.1	31.4	3.2	21.1	22.2	6.4	5.0	2.5	1.9
	Oct	4.6	6.2	5.3	29.8	3.1	2.7	10.4	1.8	1.3	9.8	26.4	3.8	18.7	22.5	6.2	4.5	2.7	2.3
	Sep	4.0	5.4	4.6	24.9	2.9	2.4	8.3	1.7	0.4	8.7	24.4	3.5	16.5	17.5	5.1	3.4	2.5	2.8
	Aug	4.0	5.2	3.7	25.1	2.6	2.1	8.1	1.2	0.4	7.6	31.9	3.4	17.6	17.1	4.0	4.1	2.3	2.6
	Jul	4.2	5.3	3.4	23.8	2.4	1.9	7.2	1.1	0.3	6.3	41.6	3.5	19.1	21.0	3.7	4.1	2.3	2.4
	Jun	4.4	5.3	2.4	24.5	2.3	1.9	6.6	2.1	0.4	5.3	45.3	2.4	21.4	15.0	4.1	4.9	2.2	1.9
	May	3.8	4.9	2.1	28.0	2.1	1.8	6.4	1.9	0.9	3.4	29.8	1.6	19.8	9.2	4.6	5.7	1.8	1.6
	Apr	3.0	4.2	2.4	24.9	2.0	1.8	5.6	1.7	1.5	2.0	21.0	2.2	14.9	7.5	3.5	2.1	2.1	1.9
	Mar	1.7	2.7	3.5	13.3	2.0	1.8	4.4	1.5	1.8	1.5	9.4	1.1	6.0	-6.3	3.2	-2.5	1.9	2.0
	Feb	1.3	1.7	3.6	2.3	2.0	2.0	3.4	1.7	2.0	1.2	9.4	0.8	0.6	-15.0	2.7	-3.7	1.8	2.0
	Jan	1.4	1.4	3.8	-3.9	2.0	2.1	2.1	1.7	2.0	1.5	10.0	0.1	-1.4	-11.5	2.9	-2.8	1.5	2.4
2020	Dec	1.6	1.3	3.9	-7.3	2.2	2.3	2.1	2.0	1.8	1.9	10.0	0.9	-2.6	-9.7	3.1	-4.2	2.2	2.8
	Nov	1.6	1.1	3.7	-9.7	2.3	2.5	1.6	1.9	2.4	1.6	10.8	1.3	-3.4	-11.0	2.7	-5.1	2.5	3.0
	Oct	1.6	1.2	3.9	-9.3	2.5	2.7	1.0	2.1	2.9	1.5	11.5	1.3	-3.5	-13.5	2.0	-5.4	2.7	2.3
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	Aug	1.7	1.3	4.1	-8.9	2.7	3.0	0.3	2.3	4.4	0.6	4.0	1.3	-4.1	-11.5	2.5	-6.0	2.7	1.7
	Jul	1.5	1.0	4.1	-10.8	2.8	3.1	0.1	2.3	5.0	0.5	-0.9	1.0	-5.8	-13.5	1.5	-6.4	2.7	1.5
	Jun	1.2	0.7	4.5	-12.2	2.8	3.2	0.2	1.4	5.1	-0.2	-2.7	1.6	-7.9	-14.0	1.4	-7.2	2.5	2.2
	May	1.3	0.2	4.0	-18.3	3.0	3.5	-0.4	1.5	4.9	-0.3	-0.3	2.1	-10.7	-14.9	1.7	-7.7	2.8	2.2
	Apr	1.5	0.4	3.5	-17.5	3.1	3.5	-0.5	1.6	4.8	-0.5	-0.8	1.0	-9.4	-13.9	1.3	-5.5	2.3	1.8
	Mar	2.1	1.5	1.9	-5.8	3.2	3.7	-0.2	1.5	4.7	-0.4	0.1	1.3	-2.4	-6.2	0.7	-1.6	2.3	1.4
	Feb	2.4	2.3	1.8	2.6	3.3	3.8	0.5	1.5	4.6	0.4	-1.2	1.5	1.7	1.0	0.8	-1.2	2.2	0.9
	Jan	2.3	2.5	1.8	6.0	3.4	3.8	0.5	1.5	4.5	0.1	-2.0	1.4	2.7	-0.1	0.7	-1.6	2.4	0.8





# Jerome Powell

Chair, Federal Reserve

**“Inflation is much too high, and we understand the hardship it is causing. We’re moving expeditiously to bring it back down.”**

**“We’ve seen some evidence that core PCE inflation is perhaps either reaching a peak or flattening out.”**

**“...assuming that economic and financial conditions evolve in ways that are consistent with our expectations, there’s a broad sense on the committee that additional 50 basis point increases should be on the table for the next couple of meetings. So we’re going to make those decisions at the meetings.”**

FOMC Conference 5.4.2022

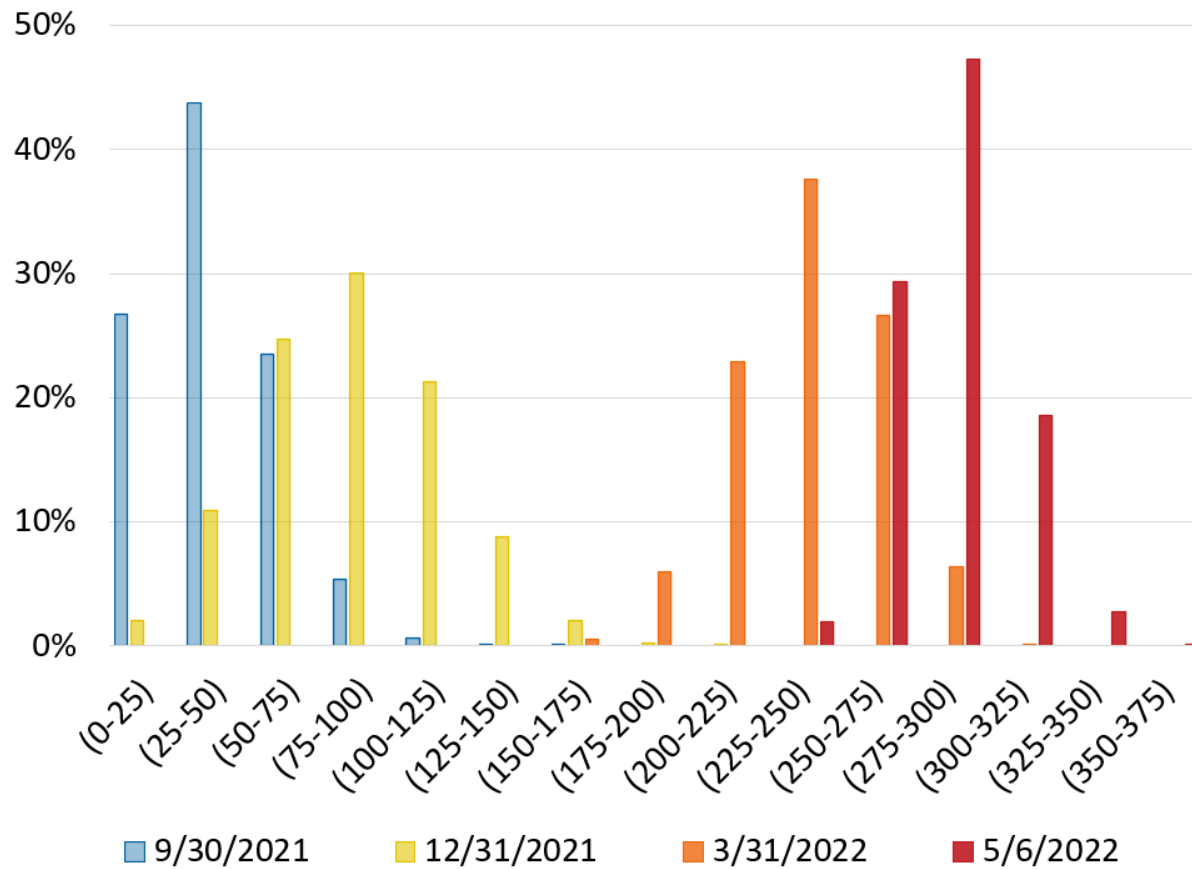
**“This is not a time for tremendously nuanced readings of inflation,...we need to see inflation coming down in a convincing way. Until we do, we’ll keep going.”**

WSJ 5.17.2022

# Fed Funds Futures

December 2022 estimate of Fed Funds

### Target Rate Probability for FOMC Meeting on Dec-14



### March 2022 Dot Plot





# Esther George

President and CEO, Kansas City Federal Reserve

**“We do see the structural change that are taking place right now where maybe fewer people are going into offices and in some cases where businesses have decided they may not return to some of those offices.”**

**“Real estate markets are quite sensitive to interest rates and how those move.”**

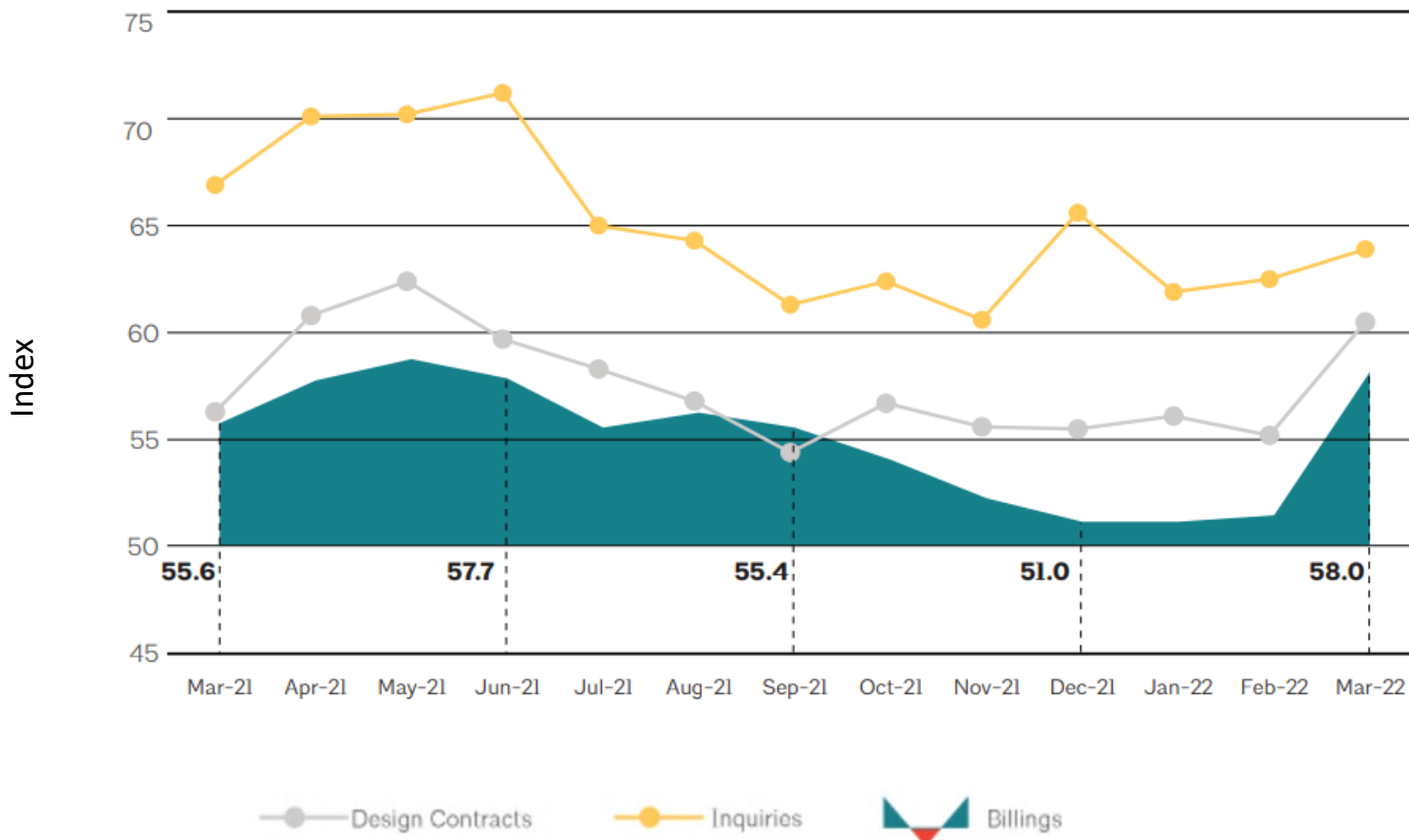
**“Given that we’ve come through this period of very highly accommodative policy, (we are) watching how that translates into market values. In addition to this idea, now society is making changes, people are thinking differently about how they want to work, how those things will come together for that adjustment process.”**

# Polling Question; Near-Term CRE Risk

In your opinion, what property segment has the most near-term risk?

- a. Apartment
- b. Hotels
- c. Industrial
- d. Office
- e. Retail
- f. Other

# Architectural Billings



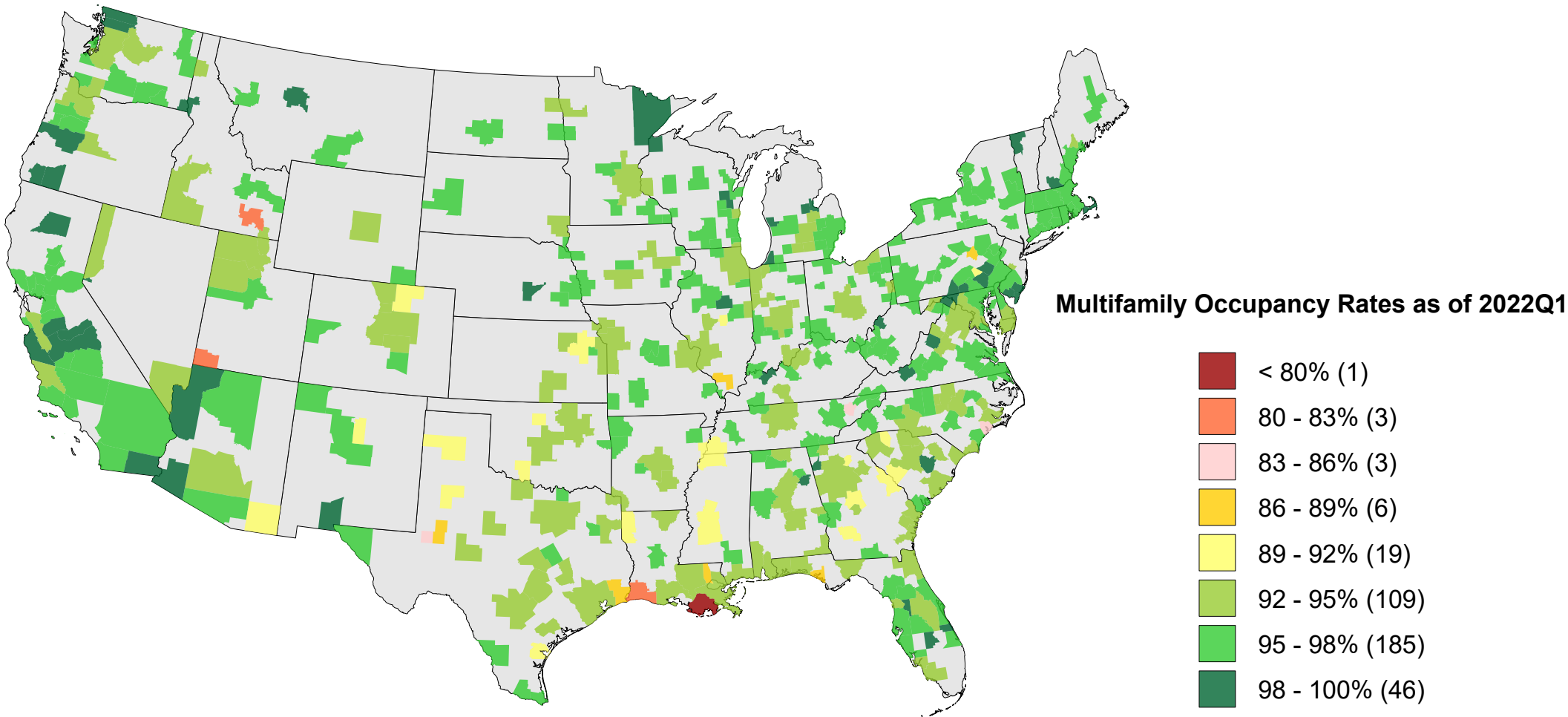
- A result below 50 indicates activity is contracting, while above 50 represents an expansion.
- Inquiries are expanding which indicate improved prospects for future activity
- Activity associated with Design Contracts and Billings turned positive, signaling that activity levels may have reached a point of inflection.

# Polling Question; Future CRE Risk

In your opinion, what property segment has the most longer-term risk?

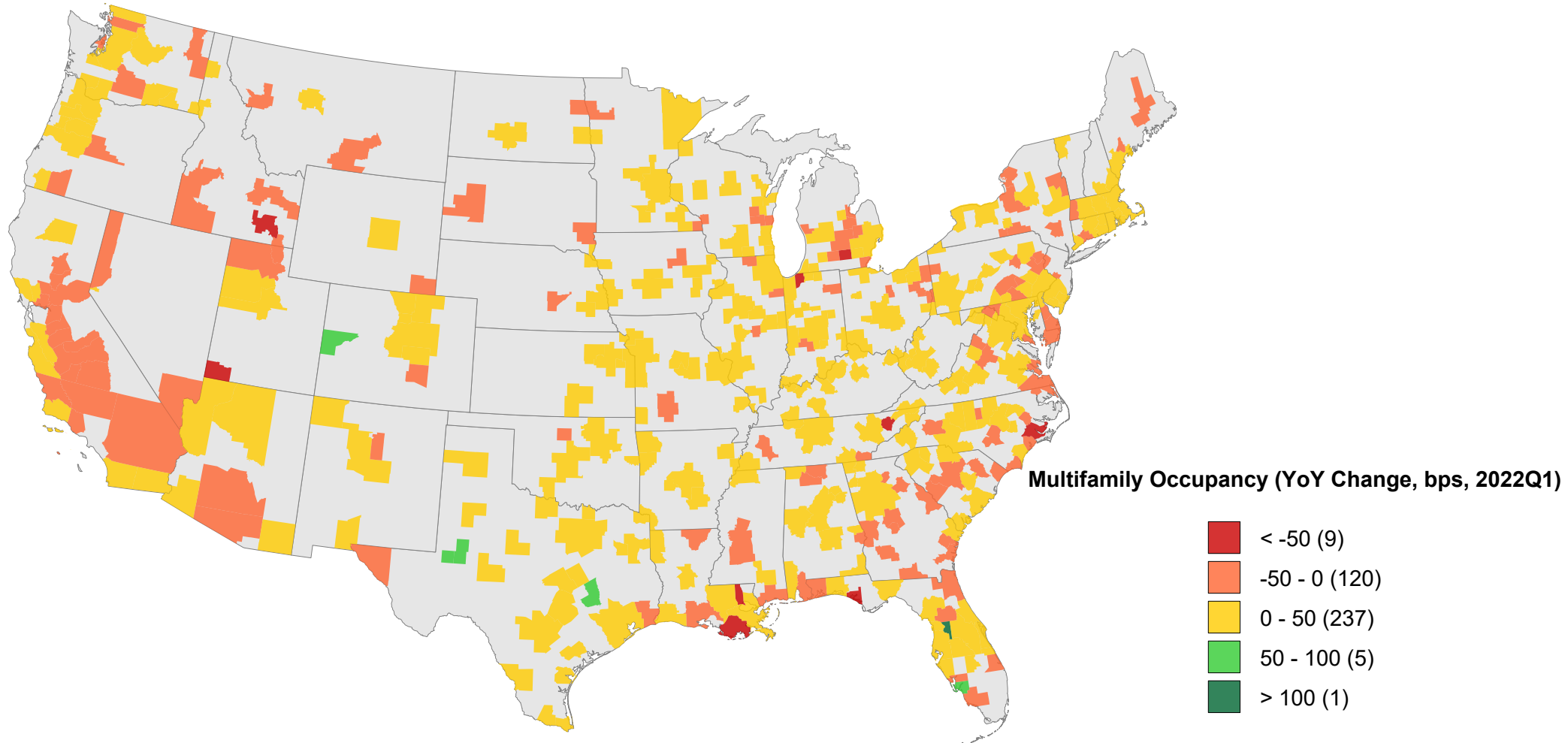
- a. Apartment
- b. Hotels
- c. Industrial
- d. Office
- e. Retail
- f. Other

# Multifamily Occupancy Rates as of 2022Q1



Source: CoStar, Risk Analysis Unit/Federal Reserve Bank of Atlanta

# Year-Ago Basis Point Change in Multifamily Occupancy: 2022Q1



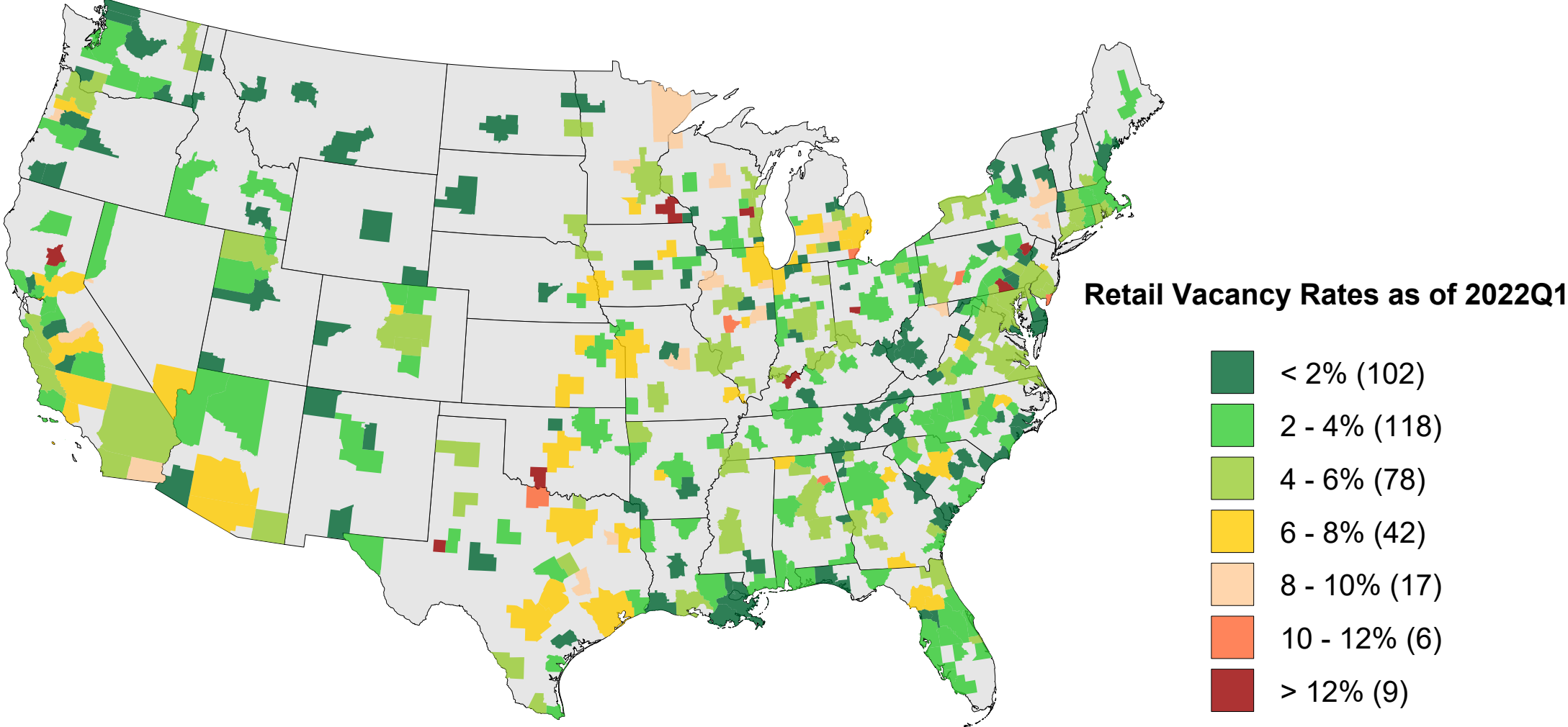


# Multifamily Occupancy

Property Class Occupancy

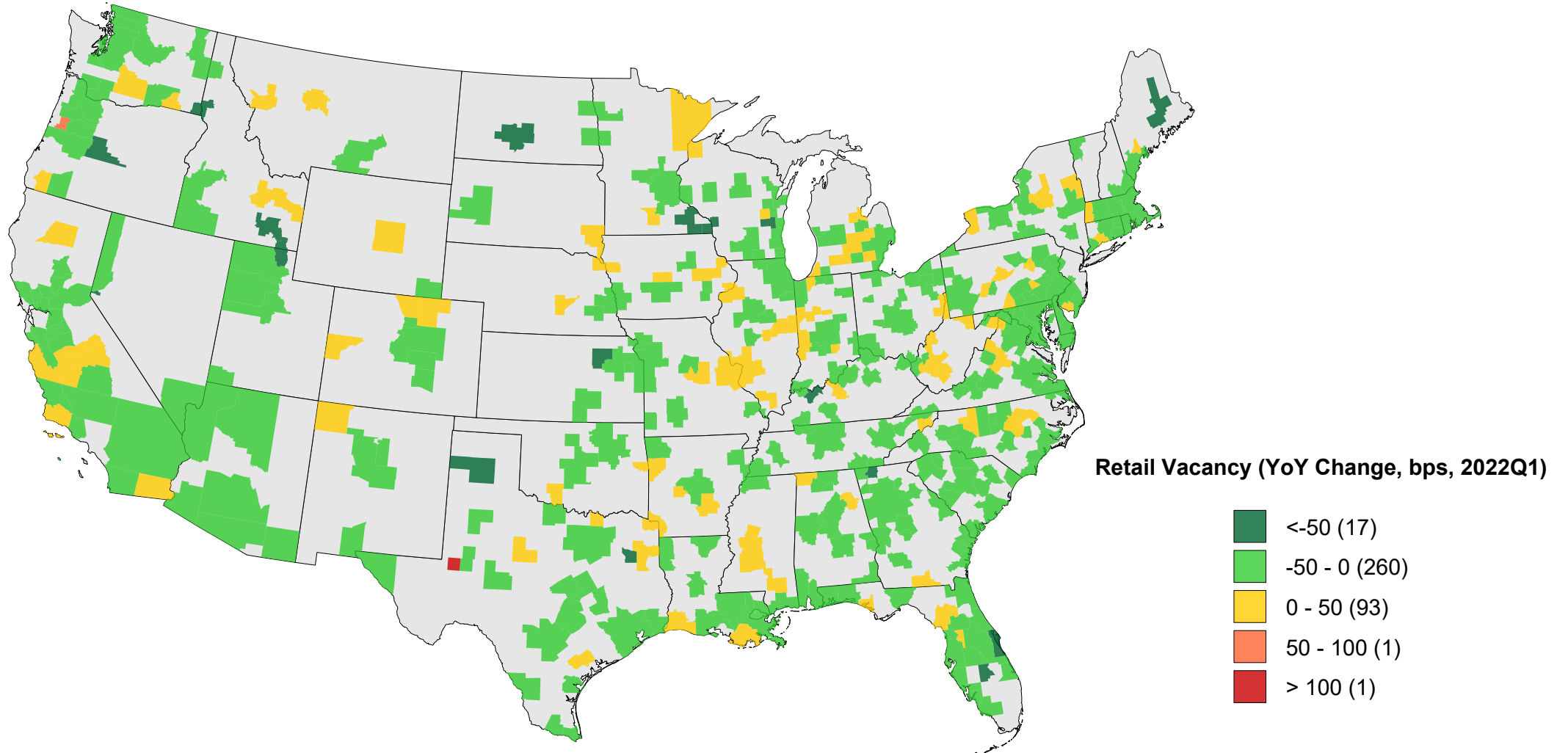


# Retail Vacancy Rates as of 2022Q1



Source: CoStar, Risk Analysis Unit/Federal Reserve Bank of Atlanta

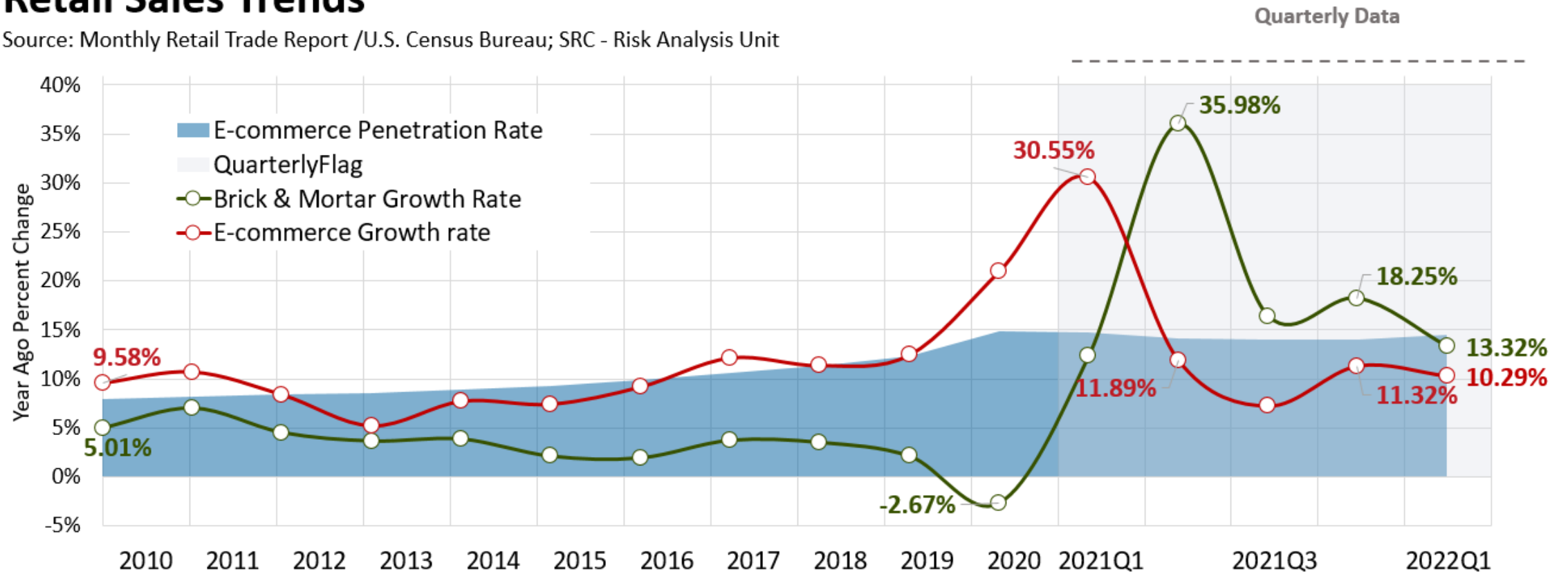
# Year-Ago Basis Point Change in Retail Vacancy: 2022Q1



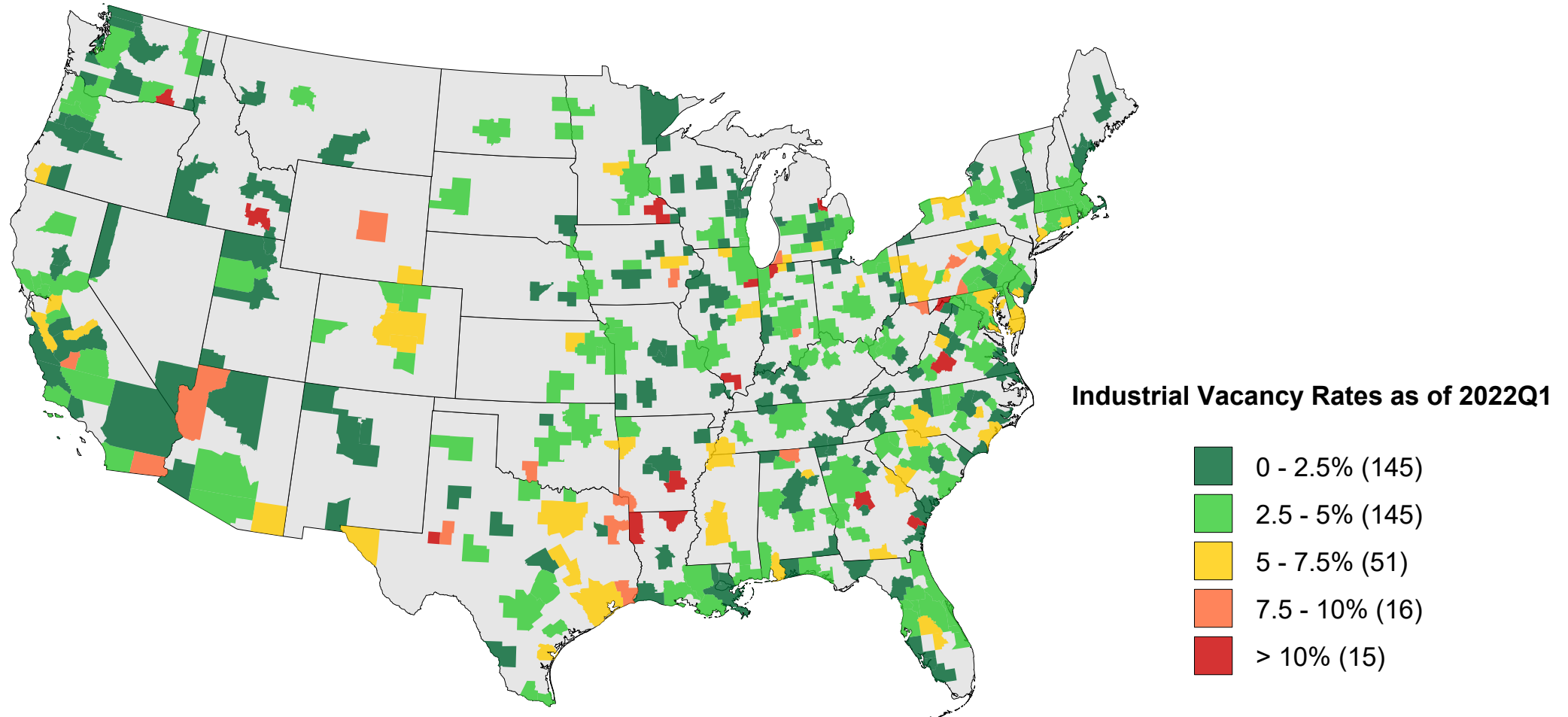
# Retail Sales Trends

## Retail Sales Trends

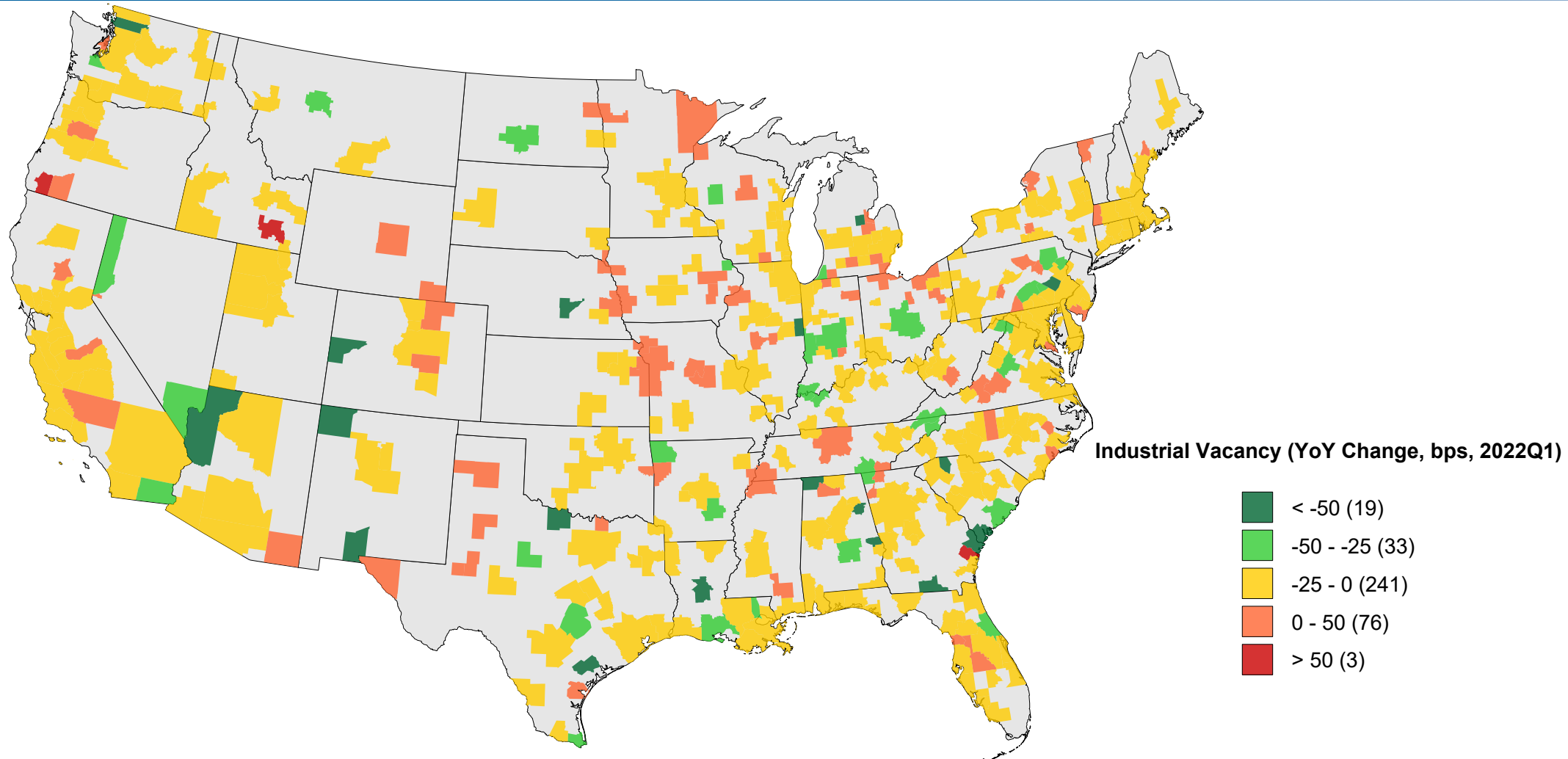
Source: Monthly Retail Trade Report /U.S. Census Bureau; SRC - Risk Analysis Unit



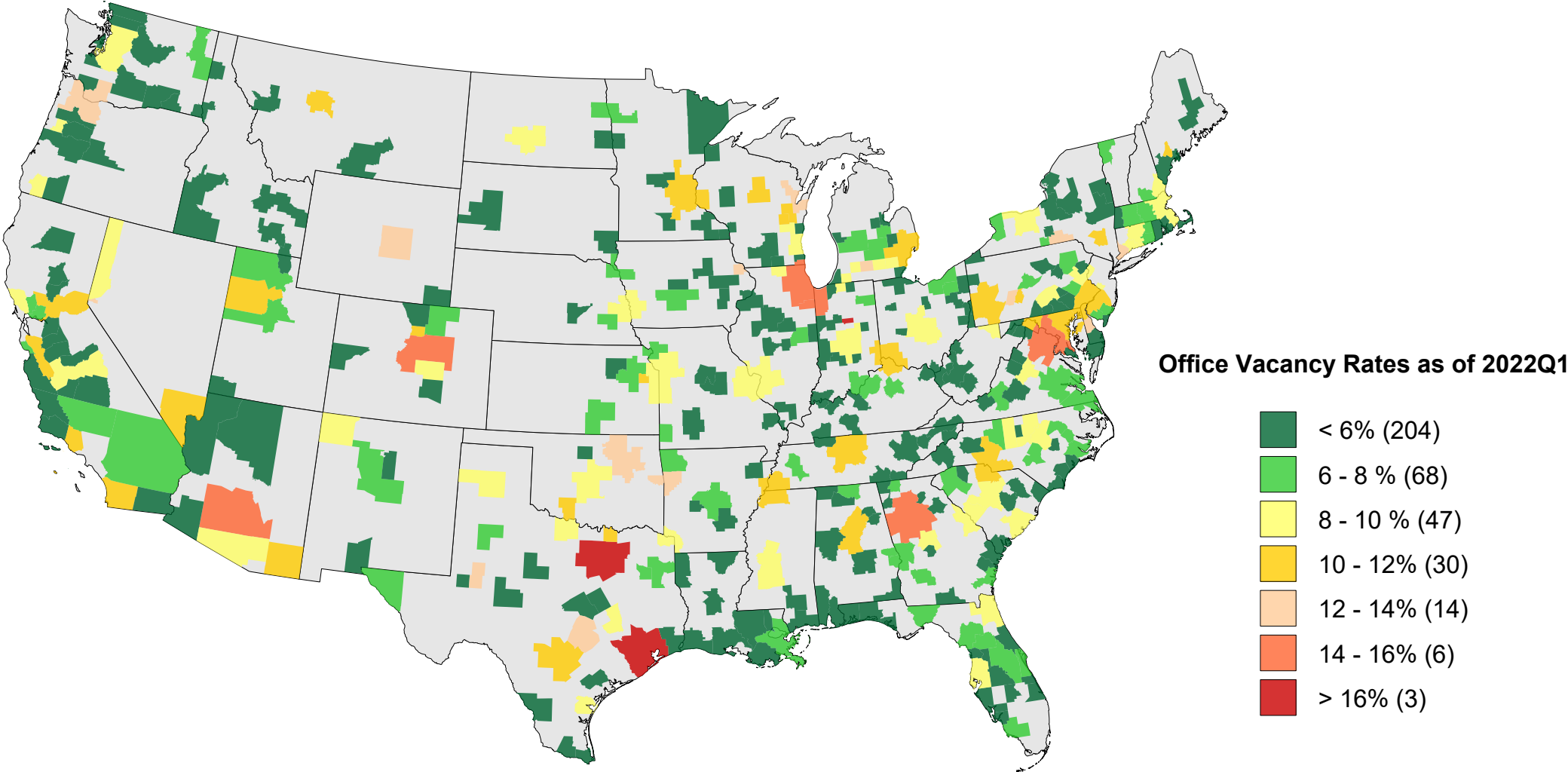
# Industrial Vacancy Rates as of 2022Q1



# Year-Ago Basis Point Change in Industrial Vacancy: 2022Q1



# Office Vacancy Rates as of 2022Q1



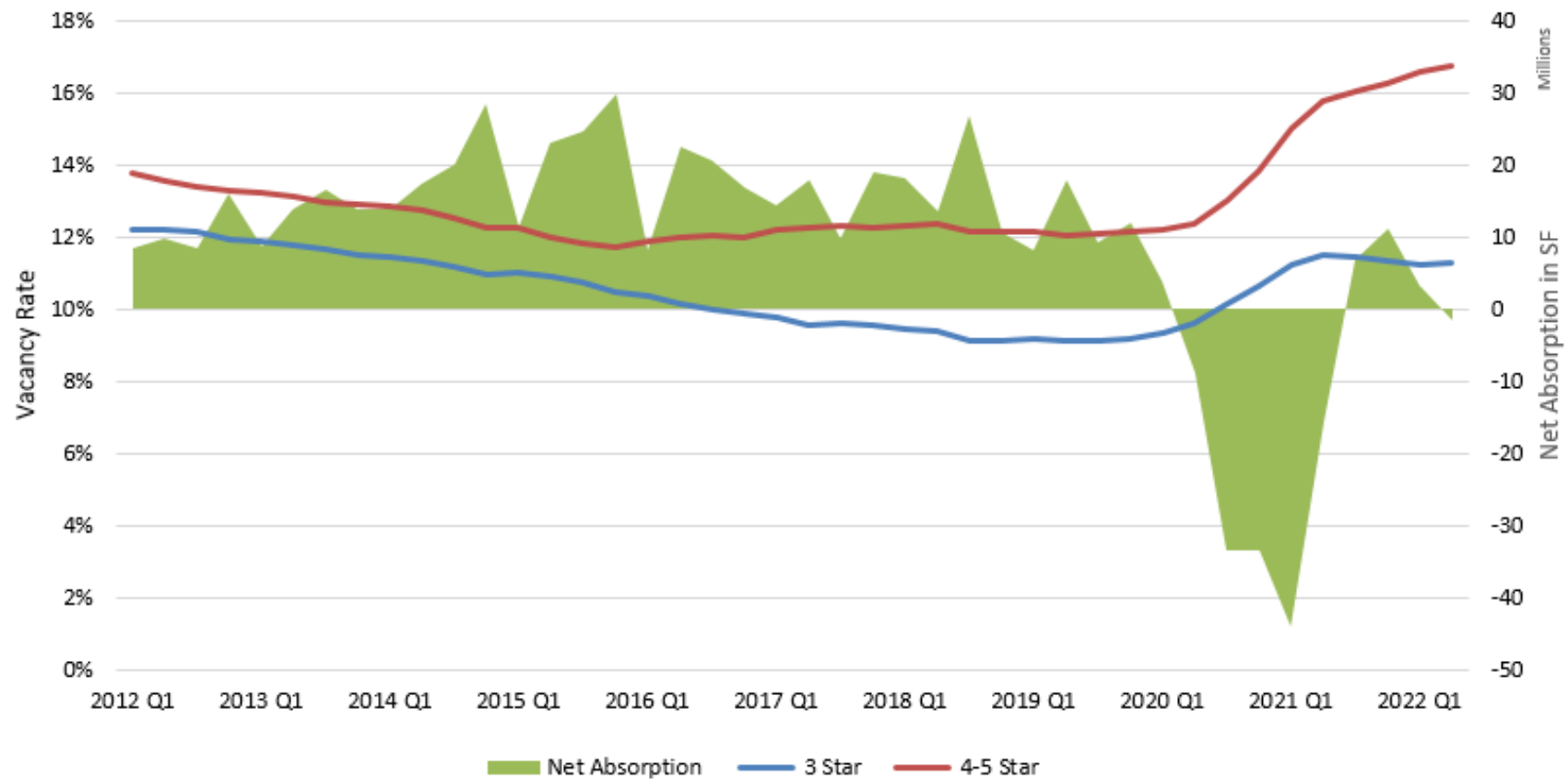
Source: CoStar, Risk Analysis Unit/Federal Reserve Bank of Atlanta

# Office Vacancy per class

Rise in sublease pushed vacancy upward in higher tier properties

## United States Office Vacancy Rate and Net Absorption

Source: CoStar; Risk Analysis Unit



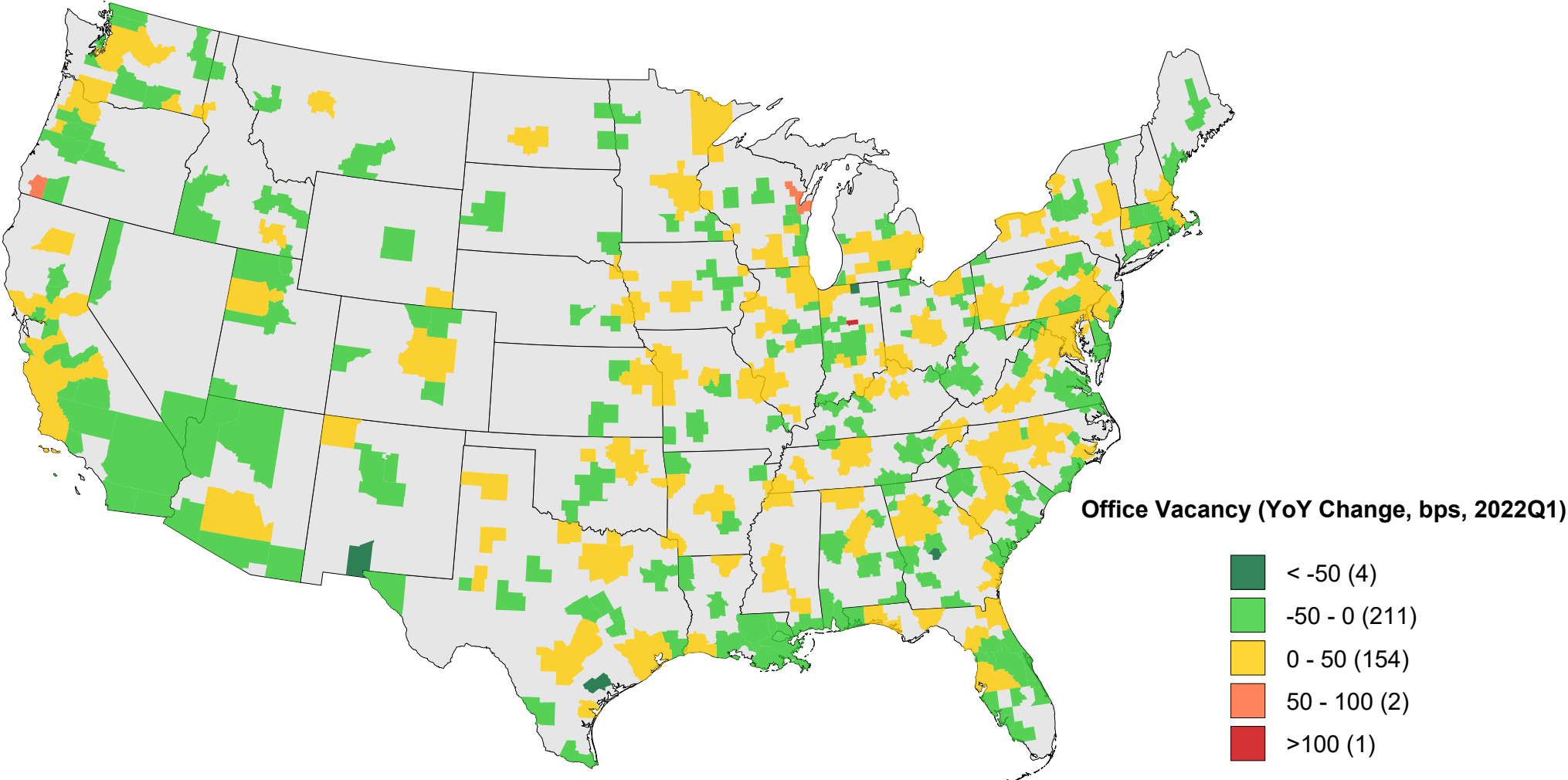


# Polling Question – Return to the Office

How many full-time days, each week, are you expecting to work in the office in 2022?

- a. 0
- b. 1
- c. 2
- d. 3
- e. 4
- f. 5 or more

# Year-Ago Basis Point Change in Office Vacancy: 2022Q1

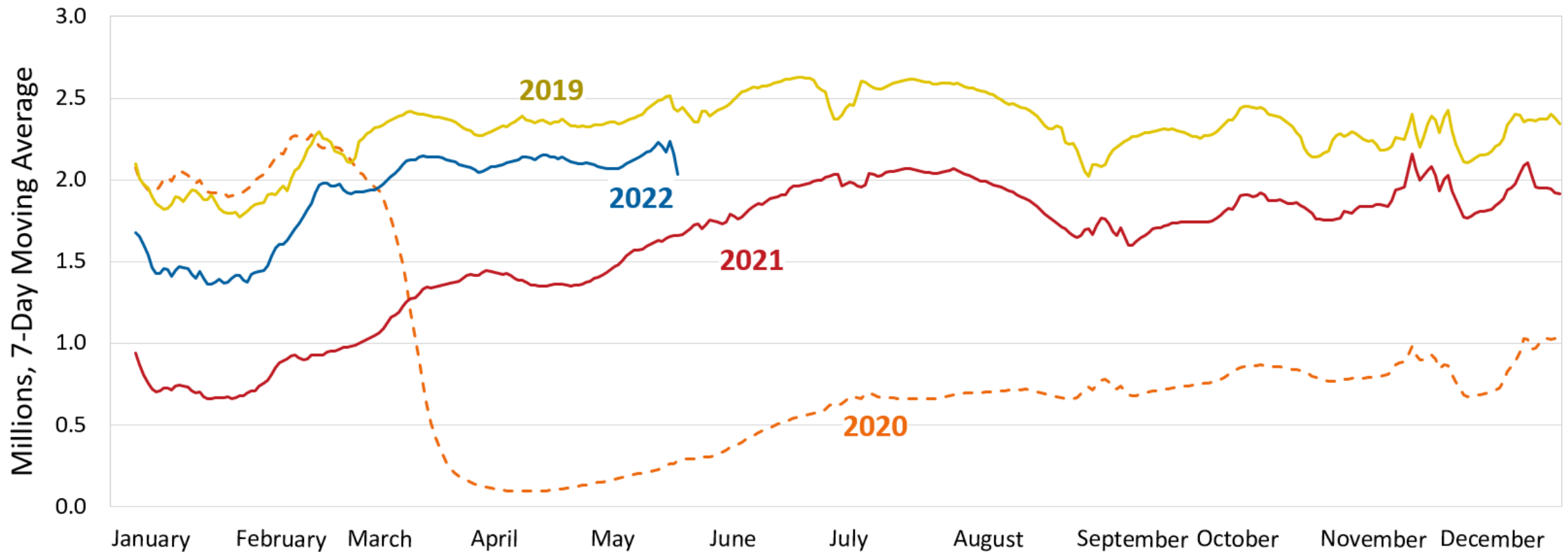


Source: CoStar, Risk Analysis Unit/Federal Reserve Bank of Atlanta

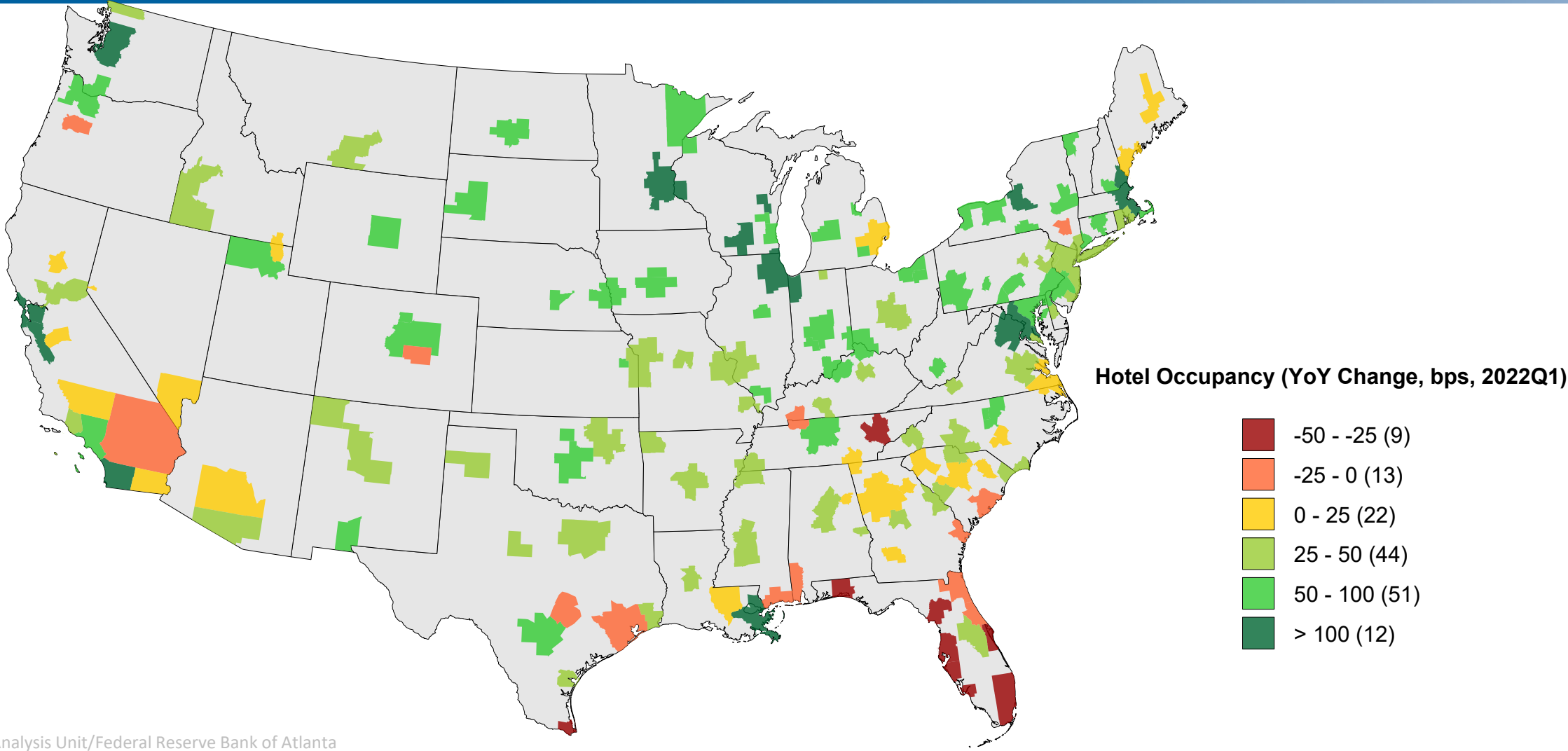
# Travel is Back

## TSA Checkpoint Travel Numbers

Source: Transportation Security Administration; Risk Analysis Unit/Federal Reserve Bank of Atlanta



# Year-Ago Basis Point Change in Hotel Occupancy: 2022Q1



Source: CoStar, Risk Analysis Unit/Federal Reserve Bank of Atlanta

# Polling Question – 2022 OPEX

What are your expectations for Operating Expense growth in 2022?

- a. Less than 3%
- b. 3-4%
- c. 4-5%
- d. 5-6%
- e. More than 6%

# Increasing Risk to Net Operating Income



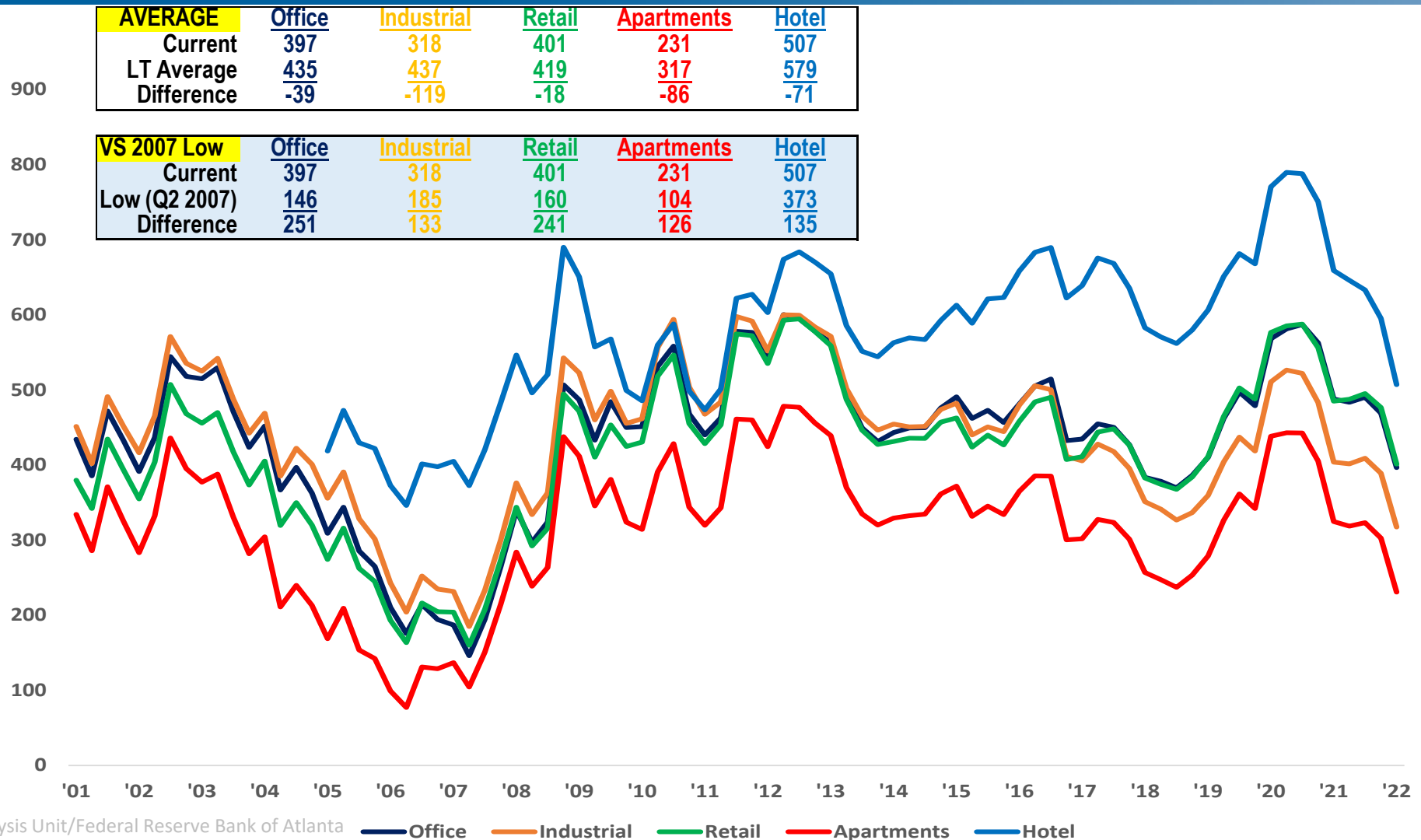
Higher inflation could cause operating costs to rise faster than rents

If operating at less than capacity, retailers and restaurants, which often have percentage rent lease clauses, may generate less rent.

In the longer run, the inability to open to full capacity may cause businesses to adjust fixed expenses, which could translate into lease leasing and possibly lower rates.

# Spread Compression

10 UST: 2.13%



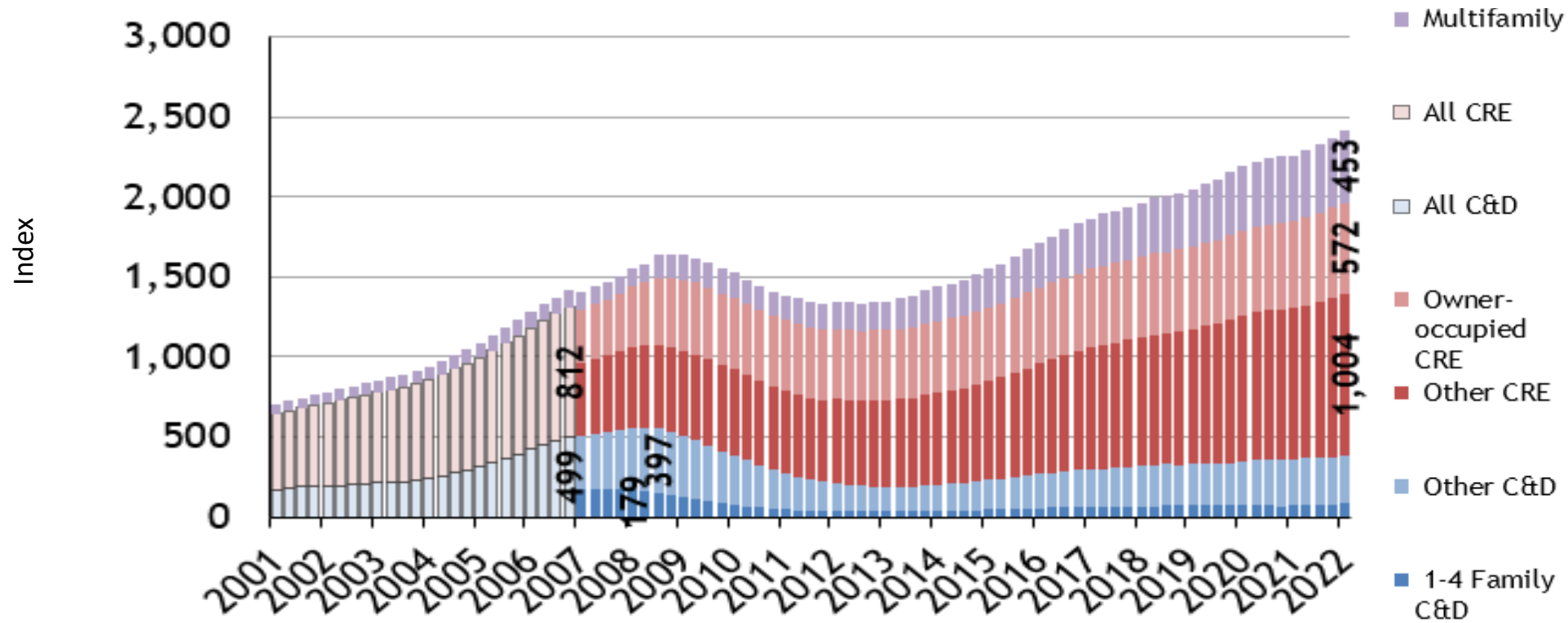
# Commercial Property Prices

Price declines...already?

	<u>2022 YTD</u>	<u>YOY</u>	<u>MoM</u>	<u>Peak to Through</u>	<u>Peak to Current</u>
<u>ALL</u>					
Major Markets (All)	1.6%	12.7%	0.4%	-29.6%	67.8%
National All Property	1.1%	17.4%	-0.4%	-35.1%	61.9%
Non-Major Markets (All)	1.4%	18.8%	-0.4%	-38.2%	57.4%
Apartment	4.2%	22.4%	1.1%	-30.8%	140.0%
Industrial	6.5%	30.1%	1.9%	-32.6%	86.3%
Office CBD	1.7%	7.5%	0.5%	-34.4%	44.2%
Office	0.8%	10.3%	0.2%	-39.3%	21.9%
Office Suburban	0.0%	9.3%	-0.2%	-40.8%	15.6%
Retail	0.4%	16.3%	-0.7%	-36.4%	9.9%



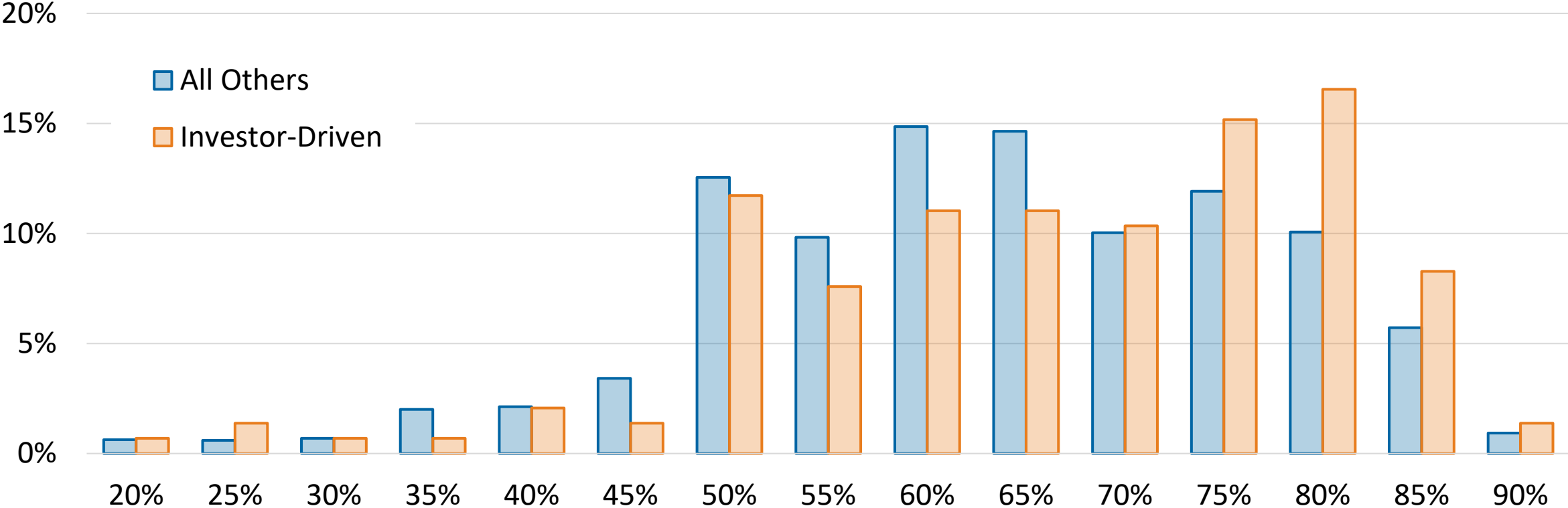
# CRE Loans Outstanding at Banks



# Return of Risk?

## Higher LTV Loans in 2021

Percent of Loans



Source: Real Capital Analytics, Risk Analysis Unit/Federal Reserve Bank of Atlanta

# Increasing Cap Rates and Greater Loan Risk

65% LTV @ Origination; with Future Cap Rate Increase

		Cap Rates @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
Cap Rate	0.5	73%	72%	72%	71%	70%	70%	70%
Increase	1.0	81%	79%	78%	77%	76%	75%	74%
	1.5	89%	87%	85%	83%	81%	80%	79%
	2.0	98%	94%	91%	89%	87%	85%	84%

75% LTV @ Origination; with Future Cap Rate Increase

		Cap Rates @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
Cap Rate	0.5	84%	83%	83%	82%	81%	81%	80%
Increase	1.0	94%	92%	90%	89%	88%	87%	86%
	1.5	103%	100%	98%	95%	94%	92%	91%
	2.0	113%	108%	105%	102%	100%	98%	96%

85% LTV @ Origination; with Future Cap Rate Increase

		Cap Rates @ Origination						
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
Cap Rate	0.5	96%	94%	94%	93%	92%	92%	91%
Increase	1.0	106%	104%	102%	100%	99%	98%	97%
	1.5	117%	113%	111%	108%	106%	105%	103%
	2.0	128%	123%	119%	116%	113%	111%	109%

Any move in cap rates in the 85% LTV scenario creates much greater default risk for the lender.

Loans with LTVs greater than 75% may need to be closely monitored, due to the increased risk.

In the future, non-“Green” properties could be penalized by the industry, by increased cap rates of 100-200bps.

# Closing

1. Economic activity has improved since the early stages of COVID; however, headwinds and uncertainty are growing.
2. As the economic circumstances and situation in CRE evolve, risk will also pivot. Lenders need to pivot also!
3. The most sizeable fundamental risk is in the Office sector. It may continue to emerge in the short/mid-term as leases expire and more employers right-size their office footprint.
4. Accelerated operating expense growth has the potential to erode Net Operating Income. Due to the implications for negative value change, Owners/Lenders should closely monitor changes in NOI.
5. Lenders with heightened loan risk (LTV, Covenant Lite, etc.) need to be considering strategies to identify and mitigate potential risk.

# Raphael Bostic

President and CEO, Atlanta Federal Reserve

“We at the Fed will do all in our power to meet our mandate and make sure that elevated inflation does not become entrenched in the economy for years to come.”

National Association for Business Economics Annual Policy Conference,  
March 21, 2022



# Thank You!



Federal Reserve  
Bank of Atlanta

