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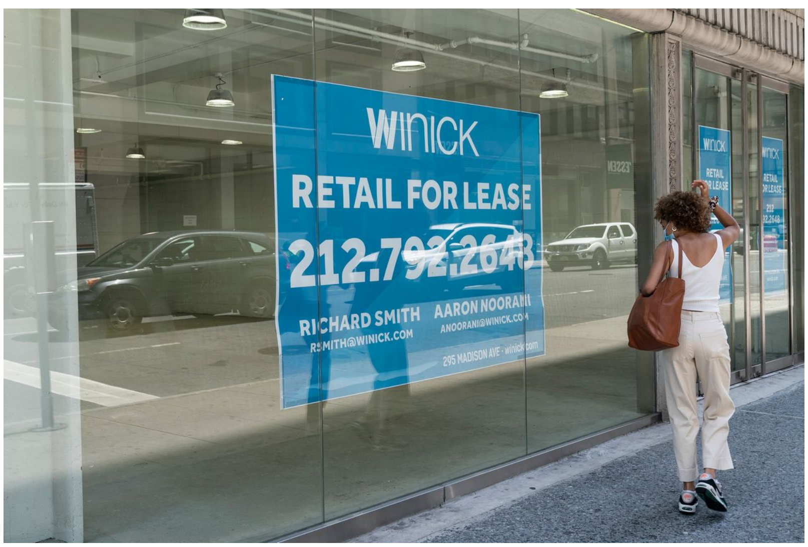
OPINION | COMMENTARY

A Reckoning Looms for Commercial Real Estate—and Its Lenders

The composition of their portfolios makes small community banks especially vulnerable.

By Brian Graham
Dec. 14, 2020 6:37 pm ET



A commercial space is available for lease in New York, July 13.
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Even as Covid-19 cases surge world-wide, the arrival of viable vaccines holds the promise of a return to something resembling normality by the middle of next year. But the commercial real-estate sector may never get back to normal, and that could spell trouble for banks.

Many banks are concentrated in and dependent on commercial property lending. Banks hold half of all commercial real-estate loans. The 5,000 or so U.S. community banks, with about a third of total assets, are two to three times as concentrated in commercial real-estate lending as the approximately 30 larger banks.

Problems in commercial real estate can hurt banks in two ways. Losses on existing loans can damage earnings directly, and a correction can reduce future lending volumes, impairing an important driver of earnings. Based on what we know now, things don't look good.

Neiman Marcus and at least 28 other major retailers have filed for bankruptcy. Hotel occupancy is down 32%. The Journal reported last month that world-wide airline capacity in October was down 58% from 2019. Apartment rent levels have collapsed 15% to 25% in large cities including New York, San Francisco, Boston and Seattle. Suburban shopping malls have been devastated.

A recent Citigroup report on 400 properties in the retail and hotel sectors found an average decline in value of 27%. The stock prices of real-estate investment trusts, companies that own equity in commercial properties, are down 42% for retail properties since the most recent valuation prior to the pandemic onset in March. Office-property REITs are down 36% and lodging property REITs are down 50%—all despite the recent stock-market rally on vaccine news.

Some of the pressure on commercial real estate is undoubtedly temporary. Recreational and business travel is likely to recover gradually, aiding travel industries. Recent college graduates who have been living and working from their parents' homes will eventually move out, boosting the recovery of apartment rental markets. With a vaccine distributed, patrons likely will flock back to restaurants and bars.

But some more-permanent shifts in the commercial real-estate market are only beginning to emerge, driven by the acceleration of pre-existing trends. The decadeslong shift to online retail went to warp speed this year, with severe implications for traditional retail properties. Many companies are looking hard at their office space and concluding they need much less of it. Similarly, banks are reducing their branch networks as the pandemic sweeps away their customers' concerns about mobile banking. "What's clear is consumer behavior has changed, and my belief is, in a lot of ways, it's changed permanently with this adoption to digital," said William S. Demchak, chairman and CEO of PNC Financial Services. "We'll have to adjust the way we serve our clients, and it is likely that will mean less physical space."

It isn't all bad news. Businesses like Amazon have prospered, boosting demand for warehouse and distribution space. Stock prices for data-center REITs are up 23% this year, and industrial REITs are up 9%. But those types of properties command much lower rents than office and retail. And strong performance of one type of property is modest comfort for a lender facing losses on retail, office or lodging properties.

For properties financed with typical debt levels of 75% to 80%, even a 30% drop in value—if sustained—is more than enough to push the property underwater. Receding temporary factors may improve this picture, but the emerging long-term factors will make it worse for many properties. If the downdrafts for a specific piece of real estate are entirely temporary in nature and the property owners have the resources to stay afloat (or get them through future government aid), perhaps even underwater properties won't become total losses. But how many retail, office and lodging properties will be so well-positioned in the end?

Today, banks are in good shape and their large commercial real-estate exposure is not yet a problem. Hopefully that continues, but the available facts suggest a challenging few years lay ahead. Many, including community banks, will weather this storm in solid shape due to some combination of loan diversification, careful underwriting and good fortune. Unfortunately, not all will be so lucky.

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Appeared in the December 15, 2020, print edition.