INTERVIEW
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Credit Unions and the Future of CRE Lending: A Chat with Moody's Analytics Experts

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The commercial real estate asset class has proven to be resilient throughout the COVID-19 pandemic. Certain sectors like multifamily and warehouse/distribution/logistics have arguably even benefited from the economic and demographic uncertainty during this volatile period. How can credit unions take advantage of these opportunities in CRE, while carefully managing the associated risks?

Moody's Analytics' Robby Holditch, Director, Risk and Accounting, and Victor Calanog, Ph.D., Head of CRE Economics, recently participated in a webinar hosted by the Credit Union Journal on the topic of "Credit Unions and the Future of CRE Lending." We sat down with Victor and Robby to get their perspectives on the latest trends and outlook for commercial real estate lending, and how credit unions can best grow and protect their portfolios.

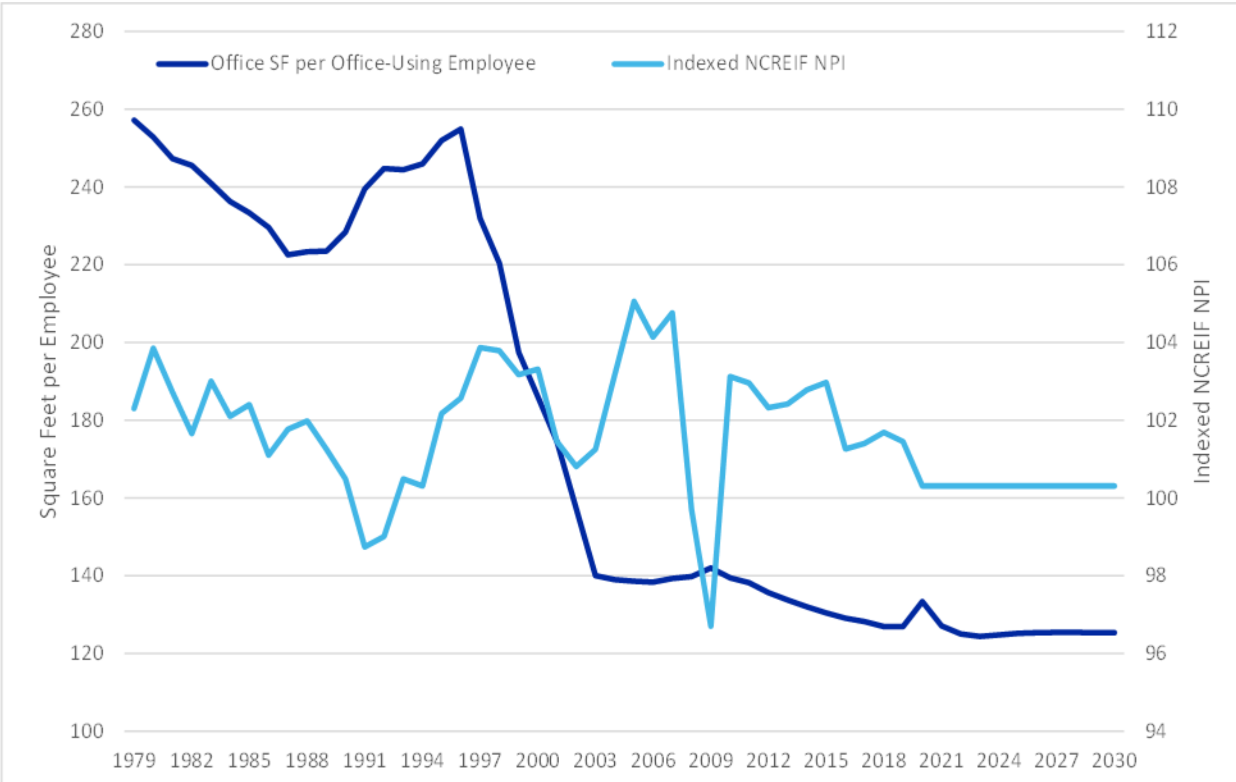
Q: It's been a volatile few years in commercial lending. Which CRE sectors have struggled the most during COVID-19?

Victor Calanog: The pandemic really put significant pressure on travel overall, and performance metrics for the national hotel market suffered significantly. But we saw average daily room rates increase by 23% nationally in the second quarter of 2021, and occupancies also hit 60% in the same period. These are really good signs for how the hospitality sector has been recovering from the crisis.

Based on our tracking of Transportation Security Administration (TSA) screening data, leisure travelers returned to airports more quickly than expected in July, and people seemed to be taking vacations right through August. But given the ongoing concerns with the Delta variant, we'll have to see if that's sustainable as we move into fall.

Office space has also been a well-publicized soft spot during the pandemic, and indeed, the death of office space has been heralded for many years. But what's interesting is that in our analysis, although office space as measured by square footage per employee using an office has declined precipitously since the mid-1990s, the indexed values of office properties have remained roughly stable over that same period.

Figure 1 The Death of Office Space?



Telecommuting rates have dropped since March of this year, but began flatlining more recently, most likely due to a combination of employees taking vacation and concerns with the Delta variant. It will be interesting to see how many workers return to the office over the coming months.

Q: Construction projects have been heavily delayed during the pandemic. How should credit unions adjust to work with their borrowers?

Robby Holditch: What I'm hearing from credit unions is that construction materials are still in short supply, and there aren't enough contractors available to complete projects on time. This is extending average construction periods out past the typical 12 months, by up to 25 or 50%, which is forcing lenders to extend the amortization period on these loans. These impacts are particularly being felt on larger, more complex commercial projects, especially those with detailed finishings.

Until these supply chain issues are resolved, credit unions should look to adjust their product mix, and work with their borrowers to allow for extended construction periods before converting to permanent financing.

Q: Which opportunities should credit unions focus their efforts in CRE lending?

VC: The hottest markets we're tracking right now include multifamily, warehouse/distribution/logistics, and self-storage.

Within multifamily, affordable housing has performed above par during the pandemic, with lower vacancy rates and stronger rent growth than market rate properties. In the top 5 affordable housing markets across the U.S., which includes metro areas like Pittsburgh, Nashville and Omaha, rent growth has outperformed market rate rentals by anywhere from 50 to 300 basis points in the second quarter of 2021.

Figure 2 Top Five Affordable Housing Markets by 2021 Q2 Rent Growth

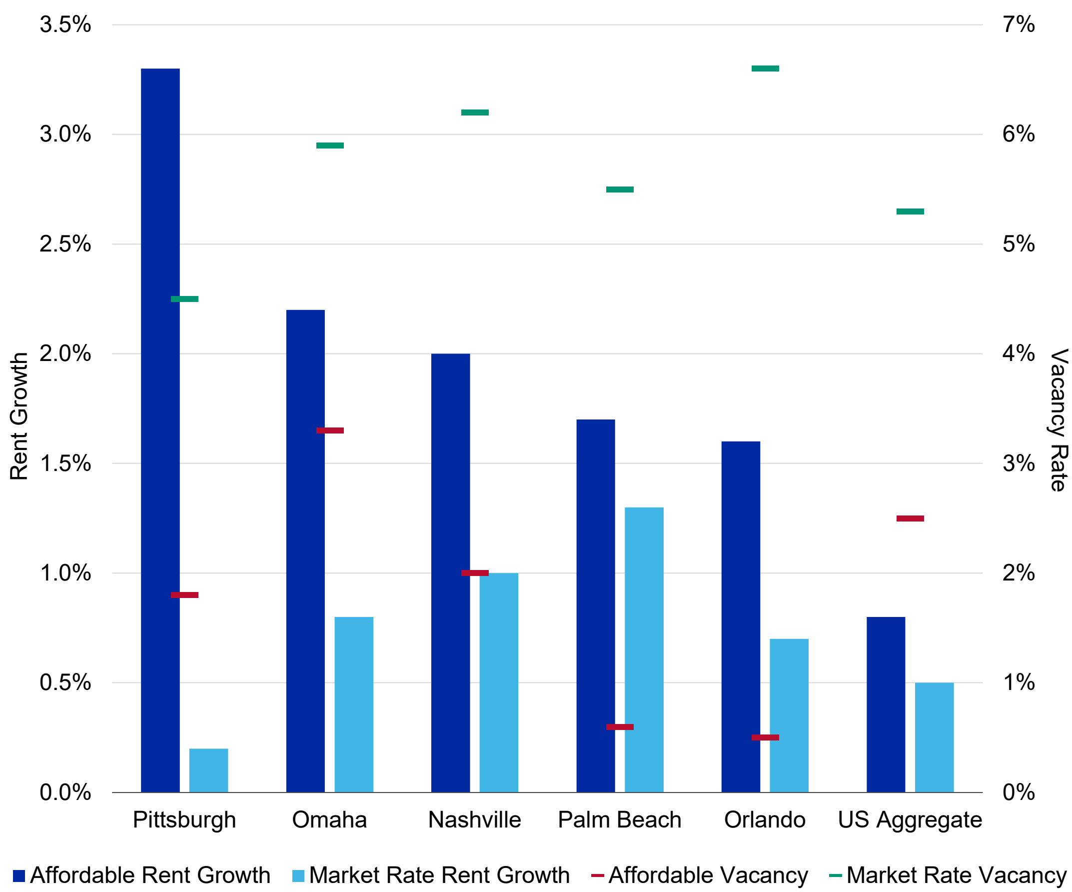
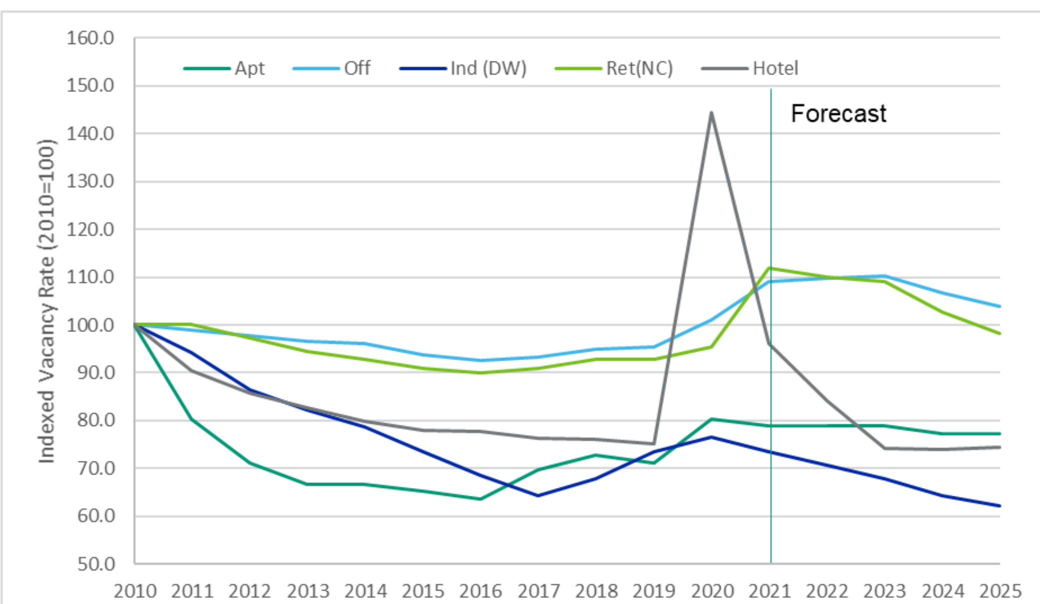


Figure 3 Vacancy Trends Across Property Types



Meanwhile, the warehouse/distribution/logistics market experienced no decline in rents throughout 2020, although there were some short-term dips in occupancy at the height of the pandemic. The sector has welcomed over 200 million square feet of new warehouse space in single or multi-tenant market rate rentals over the past year, a figure that excludes the recent explosion in owner-occupied Amazon distribution centers. This trend is certainly consistent to the dramatic acceleration of the shift toward eCommerce we have seen during COVID.

Lastly, self-storage units are another bright spot. Occupancies improved by 160 basis points to end the period at 88%, the strongest second quarter improvement in five years. Rent growth for the most popular 10 foot by 10 foot storage units also posted a quarterly record, with 79 out of 125 markets posting increases for climate-controlled 10X10 unit rents of 3.0% or higher.

Figure 4 Self-storage Occupancy Rates

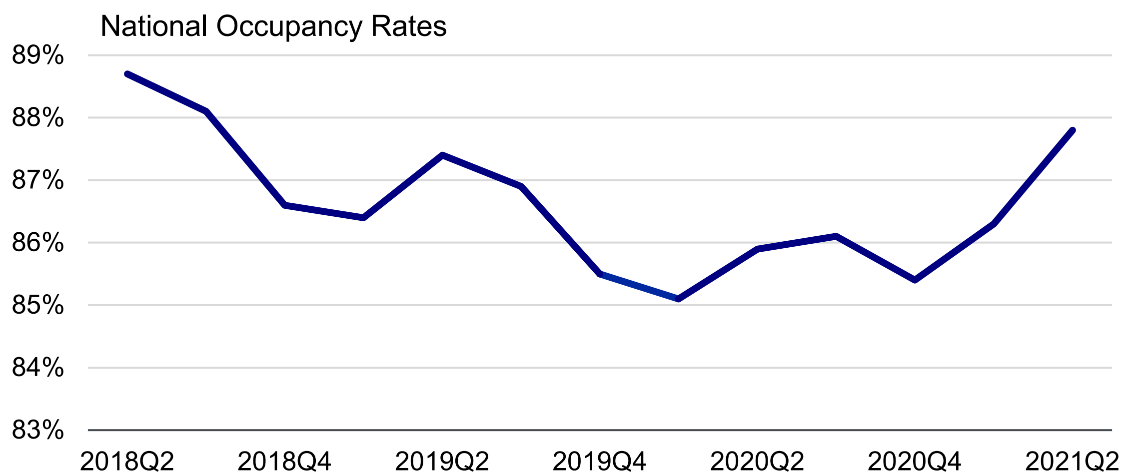
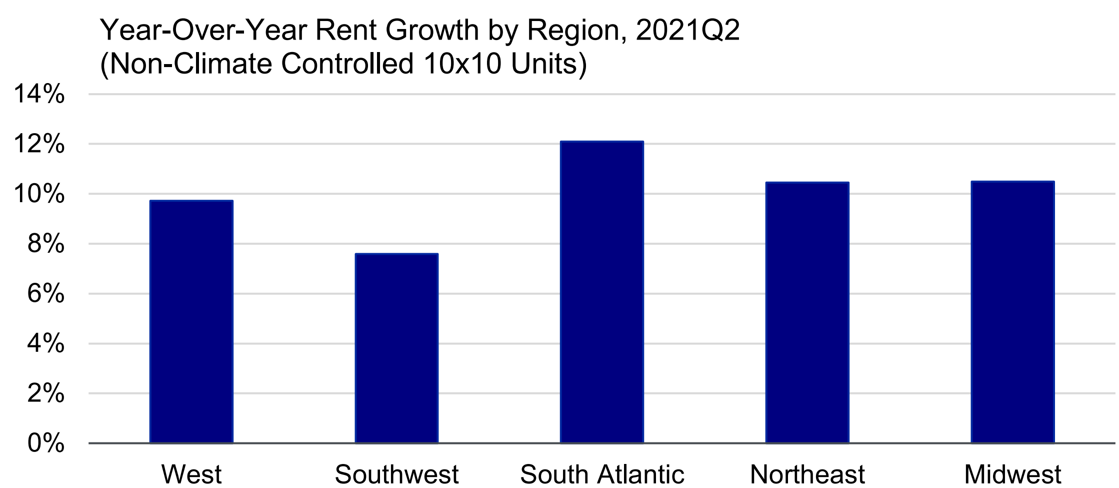


Figure 5 Self-storage Rent Growth by Region



Q: How strong is credit unions' appetite for CRE loans right now?

RH: Credit unions are a resilient bunch. According to the participant poll we took during our recent webinar, 78.8% of respondents are actively attempting to increase the size of their commercial book. And this doesn't surprise me at all. As I traveled around the country recently, the credit unions I'm talking with are looking to increase not only CRE, but their commercial & industrial (C&I) portfolios as well. A lot of them are investing in the retail space, which has been greatly discounted due to risk and higher vacancies. Now borrowers are putting their money to work, buying retail properties like strip centers. For credit unions, this translates to excellent margins, which they can return in the form of distributions to their members.

VC: Robby, did I hear you right? Are credit unions actually lending to investors in retail strip centers?

RH: Yes, Victor. Based on my conversations, many credit unions are originating in that space, taking advantage of the new phased rollout of the CECL standard that went live in January 2020 for public filers. Because of CECL's requirement to use incurred loss estimates, those banks that are already on the standard have to reserve more capital for riskier deals and thus are looking to get some of these CRE loans off their books. The result has been an influx of fintechs and credit unions to the market, as they are able to offer better rates to borrowers than publicly-filing institutions.

Q: Should credit unions reposition their CRE lending strategies post-pandemic?

VC: Credit union lenders should ask themselves whether it's too late to jump into some of these hot markets, and if over-exuberance will lead to a decline of traditional underwriting standards. But the good news is that we haven't seen any evidence of credit unions relaxing their underwriting standards to pick up deals. Debt service coverage ratios averaged a very strong 2.4X, and LTVs were around 50% prior to the pandemic. With the record government support in 2020, there has been a relative lack of distressed deals, both on the transaction and debt sides.

Credit unions have done a good job in helping their borrowers through this difficult period, while lending appropriately and with strong risk management practices. It's a great story all around, and credit unions should continue to stick to the script!