MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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Bank Watch

ARTICLE

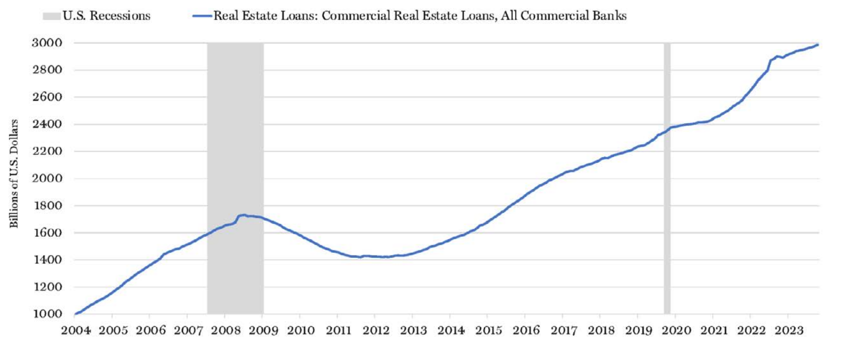
Economic Pressure on Commercial Real Estate Sector

In This Issue

Economic Pressure on Commercial Real Estate Sector

Commercial real estate loans totaled ~$3 trillion across all U.S. commercial banks as of March 2024, which represents a 0.34% increase from February of 2024 and a 3% increase from March of 2023. As seen in the graph below, U.S. banks have continued to expand their CRE loan portfolio over the last ~20 years.

Figure 1: Real Estate Loans: Commercial Real Estate Loans, All Commercial Banks



Source: Board of Governors of the Federal Reserve System (US)

Due to the slowing economy as well as strong preferences for remote and hybrid-working schedules, U.S. commercial property prices decreased by 7% in the past year and 21% since their peak in March of 2022, per Green Street's Commercial Property Price Index. The increasing number of delinquent loans surrounding commercial properties continues to be a concern for banks, increasing from $11.2 billion in 2022 to $24.3 billion in 2023. Additionally, data from MSCI notes that over $38 billion of U.S. office buildings are pressured by potential defaults and foreclosures, which represents the largest amount since the fourth quarter of 2012.

Six of the largest U.S. banks (JPMorgan Chases, Bank of America, Wells Fargo, Citigroup, Goldman Sachs, and Morgan Stanley) have experienced increases in delinquent CRE loans ($9.3 billion in 2023). **CRE loans make up ~11%** of the average loan portfolio at large U.S. banks, so most large banks have set aside reserves for this sector. Smaller banks, on the other hand, are further exposed as CRE loans account for ~22% of their average loan portfolios.

CRE has long been a hot topic of conversation and CRE regulatory guidance to address elevated concentrations of CRE loans and help institutions manage risk accordingly was released all the way back in 2006. Investors and potential acquirers increasingly focus on CRE concentration levels in assessing valuation and potential riskiness of an institution in today's environment. For example, an article on **S&P Cap IQ** noted that investors are increasingly focused on CRE concentrations and those public banks with higher CRE concentrations (those whose CRE loan balances exceeded the 2006 CRE regulatory guidance threshold and had CRE loans above 300% of risk based capital) are experiencing lower returns and pricing multiples relative to their peers in the current environment despite having higher profitability (as measured by ROAA and ROAE and NIMs).

CRE Stress Test – Severely Adverse Scenario

For those banks with a CRE concentration, stress testing can be an important piece of risk management, and the results from the U.S. Federal Reserve's **stress test** of the 31 largest U.S. banks in June of 2024 could be of interest. The stress test aimed to assess the exposure levels of large U.S. lenders during a post-pandemic era of record-high vacancy rates in commercial properties (~20%). Balance sheets of these large banks were tested with severe economic scenarios that included the following economic variables : ~36% decrease in U.S. home prices, ~55% decrease in equity prices, a ~40% decline in CRE prices, and a 10% peak unemployment rate.

On June 26, 2024, the Fed released its stress test results examining banks' ability to continue lending to both businesses and households should a severe global recession occur. The 2024 stress test showed that the 31 largest banks in the U.S. had sufficient capital to absorb **~$685 billion** in losses and continue lending to households and business under stressful conditions. **These results** helped to soothe many qualms surrounding the financial health of the banking industry in relation to CRE loans. While the post-stress CET1 capital ratios remained above required minimum regulatory levels throughout the projection horizon—both in the aggregate and for each bank tested—the aggregate maximum decline in the stressed CET1 capital ratio was 2.8%. This was larger than the decline in 2023 (2.5%) but within the range observed between 2018 and 2022.

For CRE loans, the projected aggregate loan losses under the severely adverse scenario for the three year stressed forecast period (2024-2026) was 8.8% of average loan balances (~2.9% annually). This was above the projected loss rate for the total loan portfolio of 7.1% (~2.4% annually) but comparable to the aggregate loan loss rate for the CRE segment in the 2023 **stress test** of the largest banks (which was also 8.8%).

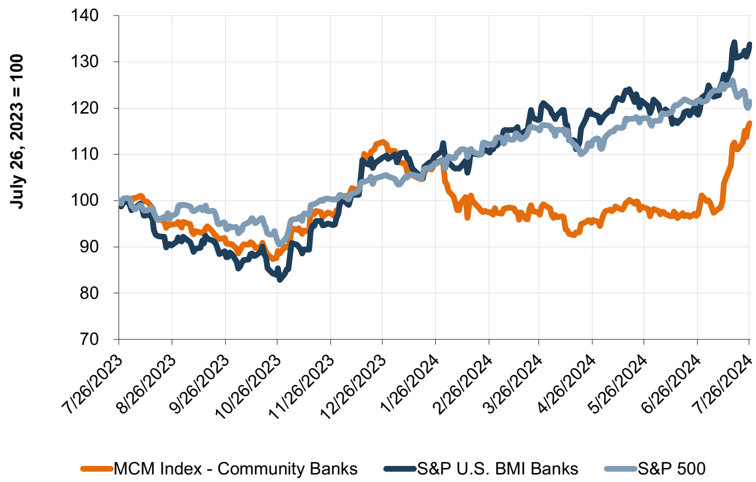
Conclusion

It is important when performing a valuation or a stress test of a CRE portfolio to understand that CRE is a diverse asset class that ranges from office to multifamily to retail to hotel/hospitality and industrial/warehouse loans and the potential risk of loss can vary markedly from one type of CRE loan to another. Many factors such as a bank's underwriting criteria, the property's type and location, owner and nonowner occupied, guarantor support, historical loan performance, vintage, and occupancy rates can be important. For example, the size of the underlying property alone can impact the expected default rate of an office loan significantly. An article from the Kansas City Fed noted that expected default rates on a sample of office loans in Q4 2023 were ~25% for the largest office properties (those with more than 500,000 square feet) versus under 5% for those with less than 50,000 square feet. Thus, diligence must be taken when performing a valuation or stress test of a bank or its CRE loan portfolio.

Valuing financial institutions and stress testing can be a complex exercise, particularly for those financial institutions with a relatively high proportion of commercial real estate in their loan mix. At Mercer Capital, we have over 40 years of experience in valuing financial institutions through a variety of market and economic cycles. Please call if we can be of assistance in providing valuation or stress testing services to your financial institution.

Vincent R. Baumer
(469) 904-6714 | baumerv@mercercapital.com

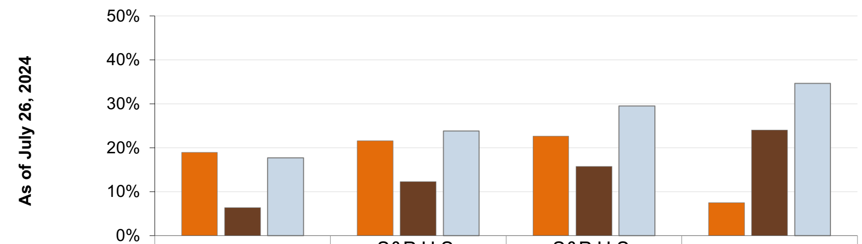
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	S&P U.S. Banks Market Cap Under $250 Million	S&P U.S. Banks Market Cap Between $250 Million - $1 Billion	S&P U.S. Banks Market Cap Between $1 Billion - $5 Billion	S&P U.S. Banks Market Cap Over $5 Billion
Month-to-Date	18.99%	21.65%	22.64%	7.54%
Year-to-Date	6.39%	12.31%	15.75%	24.07%
Last 12 Months	17.75%	23.83%	29.51%	34.65%

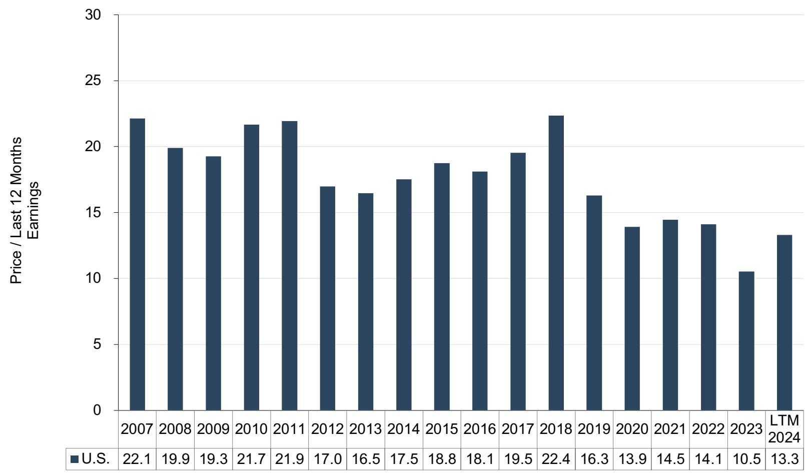
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of July 26, 2024					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2024 (E) EPS	Price / 2025 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	17.7%	1.4%	9.7%	12.3x	13.8x	10.7x	102%	117%	2.9%
Midwest Index	10.8%	14.1%	21.8%	10.1x	11.0x	10.7x	90%	106%	3.4%
Northeast Index	17.1%	4.2%	16.1%	11.0x	11.4x	10.6x	101%	122%	3.3%
Southeast Index	13.6%	9.6%	30.6%	12.3x	11.6x	9.7x	99%	119%	2.9%
West Index	15.2%	3.0%	17.7%	11.8x	12.8x	11.3x	104%	112%	3.0%
Community Bank Index	15.4%	5.3%	16.7%	11.5x	12.0x	10.7x	100%	112%	3.0%
S&P U.S. BMI Banks	9.4%	22.7%	33.8%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

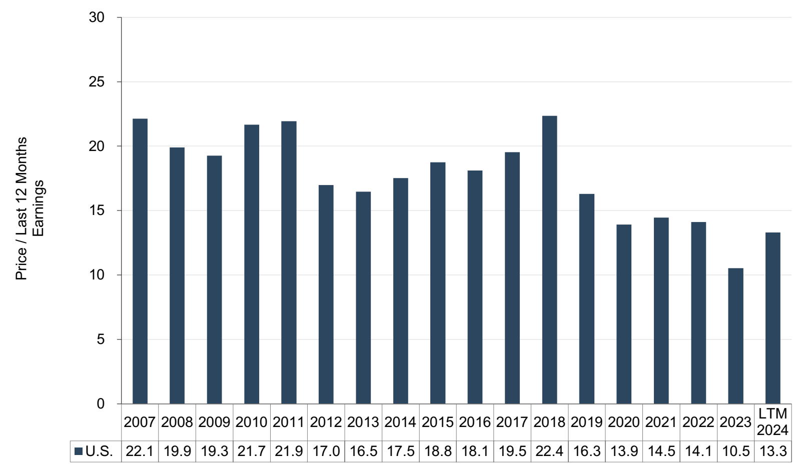
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

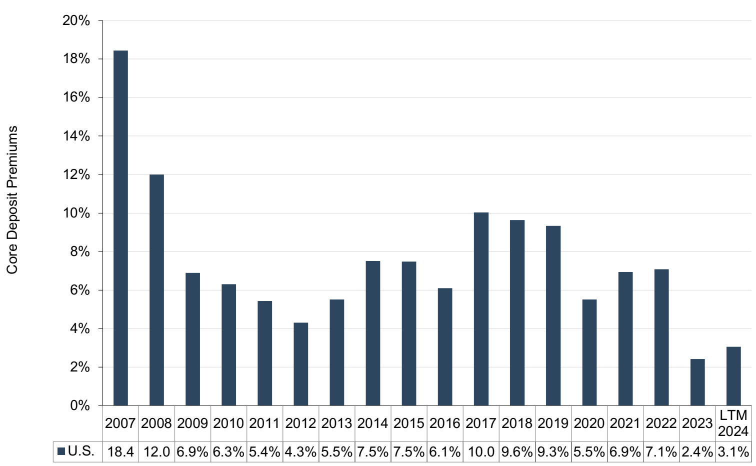
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

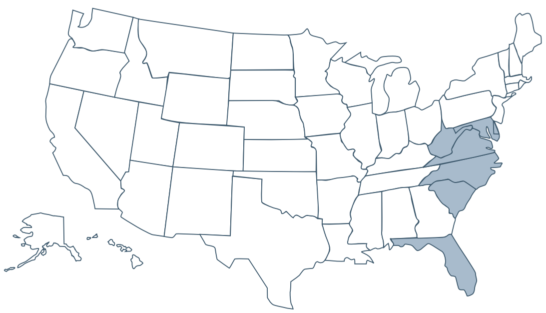
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended July 29, 2024

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	8.5x	112%	1.6%	4	63.6	616,112	11.8%
Midwest	13.7x	143%	4.6%	4	134.0	1,299,632	12.0%
Northeast	12.2x	121%	1.7%	4	107.6	1,360,231	10.7%
Southeast	9.8x	128%	4.5%	7	73.4	701,819	9.6%
West	17.1x	154%	6.0%	8	70.5	884,149	9.0%
National Community Banks	13.3x	128%	3.1%	27	77.0	727,792	9.9%

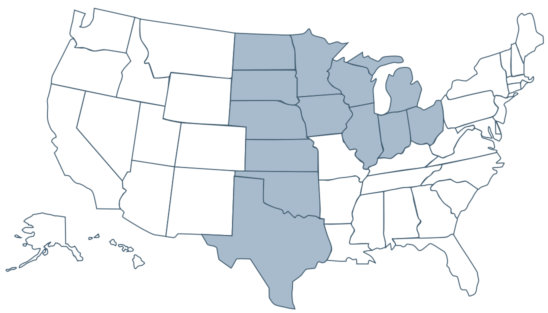
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

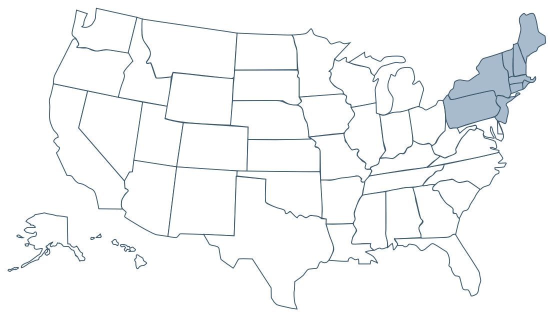
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



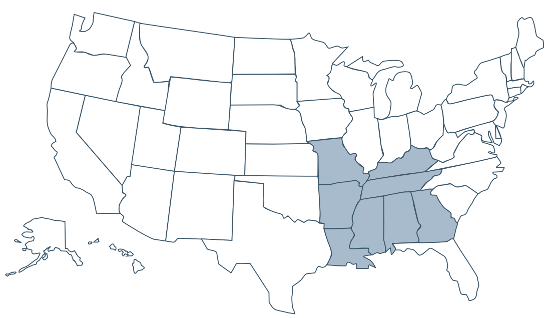
Atlantic Coast



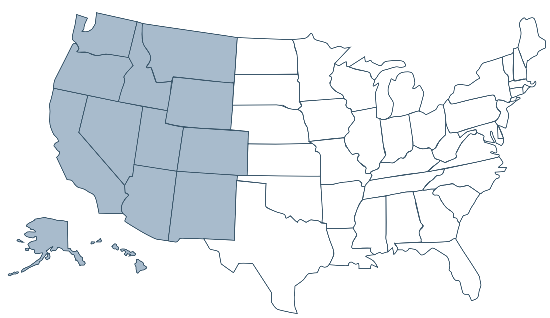
Midwest



Northeast



Southeast



West

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Depository Institutions Services

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

- Bank valuation
- Financial reporting for banks
- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

Depository Institutions Team

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
901.322.9726
gibbsa@mercercapital.com

Eden G. Stanton, CFA, ASA
901.270.7250
stantone@mercercapital.com

Jay D. Wilson, Jr., CFA, ASA, CBA
469.778.5860
wilsonj@mercercapital.com

Mary Grace Arehart, CFA
901.322.9720
arehartm@mercercapital.com

Heath A. Hamby, CFA
615.457.8723
hambyh@mercercapital.com

Vincent R. Baumer
269.904.6714
baumerv@mercercapital.com

Luke Tanner
901.322.9722
tannerl@mercercapital.com

www.mercercapital.com

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