FDIC PODCAST

The Future of Commercial Real Estate

BRIAN SULLIVAN: Welcome to a very special edition of the FDIC Podcast, webcasting live to the Community Banking in the 21st Century Research and Policy Conference. I'm Brian Sullivan with the Federal Deposit Insurance Corporation and today we're going to break out our crystal balls and look to the future of commercial real estate.

You know, the last year and a half has turned so much of our lives upside down. And while the banking sector has generally proven to be quite resilient in the face of so much uncertainty, there are still unanswered questions about the possible lasting impacts of this pandemic on our community banks.

Well, joining us today to talk about what they're seeing in commercial real estate, are four people on the front lines of this sector. For a national perspective, Bob DiChiara joins me in studio. Bob manages the FDIC's Regional Research Division in New York City. And we have a number, of community bankers from around the country who will give us a sense of how commercial real estate is trending where they are.

- **John Buran** is president and chief executive officer of Flushing Bank in Uniondale, New York.
- **Jim Edwards** joins us from Griffin, Georgia, where he serves as chief executive of United Bank. And by the way, Jim is also the current sitting chairman of the American Bankers Association.
- And out on the west coast, **Joanne Kim** is the president and CEO of Commonwealth Business Bank, a minority depository institution based in Los Angeles.

Well, hello to you all. Thank you so much for joining with us and Bob, you're sitting next to me, let's begin with you…set the table for us. Where is commercial real estate today and where might it be headed?

BOB DiCHIARA Well, thank you very much, Brian, and happy to be with you here today. So you're right. It's been quite a year and a half on many fronts and particularly for our commercial real estate. We like to look at commercial real estate through the lens of the five property types, right? It's not a monolithic industry, there's many different facets to it, but you know, these five broad areas were impacted very differently. We have multi-family, which is known as apartments. We have industrial, retail, hotel and office.

Now the first two, multi-family and industrial, have been pretty resilient, particularly industrial. Industrial really is a function of how much we're shopping online, shipping needs, storage and logistics. And as, as you can imagine, there's been quite a demand for that as we shopped online much more during the pandemic than we ever have before.

The next two, retail and hotel, were challenged severely in the pandemic. You think about hotels, the normal occupancy rate nationally hovers around 70% in normal times. That dropped to less than 25% and at the luxury property, which typically will cater to the business traveler during the week, those occupancy rates dropped to single digits. So it was a tough go of it for many of the hotels. A lot of those occupancy rates have come back, particularly in the, you know, the mid-scale properties. We're seeing a little bit of a lag in the luxury properties, as I mentioned, I think that's a function of, you know, the slow return back to business travel and that may take some time.

And retail it's most of the stress really that's been durable has been in the mall space. There are certainly vacancies throughout some of the strip malls and other areas like that. But there's a divergence between urban areas that require a public transportation and so forth versus maybe some of the suburban areas that are doing a little bit better.

And then the last area office, arguably, is the one area that probably has the most uncertainty ahead when we look forward to possibly changes in how we work and where we work.

BRIAN SULLIVAN: Let's focus on that for just a little bit. It's great to define all these property types, but on the office space sector it seems like what we've just been through this past year and a half is redefining what the office even means and what it means to go to work. I would wager to say that a fair number of us have been working from home. And so what does this mean for that particular sector?

BOB DiCHIARA Yeah, certainly. I would say with the office sector there's, in my opinion, likely a transformational aspect of this pandemic. There are certain companies that have said we're going full back. It's a real range. Some are going full back, some have said we're permanently remote. And then there's those in the middle that are the hybrid.

Nationally the pre-pandemic, the vacancy rate was about 10% when you compile all the markets nationally it went up to about 12 now it's expected to be about 14 and another year or so. So there's some rising vacancies ahead. And I would argue, you know, many companies may not have to make a decision right away. It takes time for office leases, which are typically, you know, five-to-10 years. So they may have people working remotely now, but they're still paying the rent and they don't have to decide for another two years.

BRIAN SULLIVAN: Right.

BOB DiCHIARA What that's going to be?

BRIAN SULLIVAN: So adjustments might happen in the years to come?

BOB DiCHIARA Yea, I think we have some time for this to play out.

BRIAN SULLIVAN: Okay. Well, let's go around the country now and survey our bankers. John Buran of Flushing Bank in Uniondale, New York…John, by some measures, you do business in the number one commercial real estate market in the country. What are you seeing where you are and maybe what do you expect to see?

JOHN BURAN: So, a lot of what Bob had mentioned, I think there was a clearly the weak link at this point in time continues to be office, which and I'll even make a distinction there though. I think there's a differential between Midtown office space that requires public transportation and more suburban locations where people can get to work without you know, without public transportation or limited public transportation. So I think that's clearly a factor and it builds upon this whole idea that was just spoken about with respect to commercial real estate not being a monolith.

And I think you go from place-to-place certainly in office space and even in the hotel sector…one that did have some substantial pull back as we as we entered the pandemic. Now we're seeing more local hotels that cater to local business people or also people coming in for special events like weddings. Obviously a lot of pent up demand for people to do you know, to do weddings that were delayed, let's say during the pandemic. So we're seeing those smaller hotels that are not in the center of urban areas or high a demand tourist areas actually doing quite well.

You know, that said, I think the retail space is the next one I think that had some significant softness to it. But then again, along the theme of it not being a monolith, when you look at these small strip centers in suburban markets or even in some of the urban markets, the neighborhoods where the retail is central to the day-to-day lives of the area residents. You have people in walking communities that have to go to the food store, they have to go to the nail place, you have to go to the pizza parlor, et cetera, et cetera. So these types of retail, this retail was among the quickest to come back.

BRIAN SULLIVAN: Thank you for that, now from the New York Metro Area, let's head south to Griffin, Georgia, about an hour outside of Atlanta where Jim Edwards of United Bank joins us. Jim are you experiencing anything like what John just described down your way? And do you feel comfortable maybe forecasting what might lay ahead in commercial real estate?

JIM EDWARDS: So we're a little bit different bank obviously. In Griffin, Georgia, we're located about an hour south the world's busiest airport in Atlanta, Georgia. But where our bank is chartered in Zebulon, Georgia, just south of my office here, there's still just two stoplights in the entire county. Have a nice mix, really being able to lend money in the Atlanta suburbs as well as some of the more rural areas as we stretch to the southern part of the state.

What we're seeing in our part of the world it's really impressive in terms of the turnaround that we've seen since the beginning of the pandemic. Where we sort of used the phrase, we didn't know where the bottom of the pool was there for a couple of months. A lot of our customers did not either, but we have really seen, from a real estate standpoint, those markets come back very nicely.

You know our biggest challenges right now, frankly, are for our builders in this market…it's talking about supply chain issues right now, as opposed to lack of demand, which we were so worried about there at the earliest stages of the pandemic. But I totally agree with John, you can't look at commercial lending and the future of commercial lending is one monolith here you have to break it apart and obviously we all know how critical location is to real estate and so that's very important to consider as well.

But talking about some of the specific areas there, you know, I think we are seeing some of the lowest levels of past dues now that we have seen really in, in my entire career. You know, problem assets are way, way down. As I said, when we talked to customers about issues, it's not about problem loans right now. It's supply chain issues when they're trying to do their next…build their next project here really.

But specifically we were very concerned about the hospitality and hotel industry early on. That's where we saw the most stress early on, obviously. And I would say that's come back nicely. There are still some lingering challenges there as I think John mentioned as well we're seeing that in the Metro Atlanta area also, but overall not seeing a lot of problems there.

Retail similarly, I think we've seen for the most part, our retail commercial loan customers do just fine right now. They did come in, we had a number of them came in and asked for deferments early on, but everybody's back and where they're amortizing their loans as originally agreed right now. So that's working out very well.

We don't do a lot of multifamily, but that market is strong in our area. Again, with housing prices increasing dramatically I'm sure they are and the other bankers' area we're seeing strong demand for multifamily stock, just because of the more affordable nature of that product offering there.

And single-family construction for one-to-four family homes is really, really strong. Maybe the strongest I've ever seen it.

If I had a concern, I would be worried a little bit about the fact that there is so much money that is still sloshing around the system here. And I'm not sure we really know that we can trust our traditional banker instruments if you will just yet. So, I think we've got to let a little more time go by to see how things shake out here. But in our part of the world we're excited about the market that we're seeing. And we're so grateful that that, you know, so many of our customers have seemed to have survived this pandemic scare very well.

BRIAN SULLIVAN: Well, it is true time heals all wounds, but okay, now we've touched a base in the Northeast and a bit down South. Let's head out West now to Los Angeles where Joanne Kim joins us. Joanne, I wonder, along with all the potential impacts of this pandemic that we've been talking about, you also have to deal with a chronic affordability problem out your way. Land values, development costs very high in Southern California, statewide in fact. How is all this affecting commercial real estate in Southern California?

JOANNE KIM: Sure. Thank you, Brian. We are about $1.8 billion business bank serving various ethnic business communities here. And commercial real estate is our key product and our bread and butter. About 80% of our loans are in commercial real estate, whether it's owner user or investment properties. And majority of our commercial real estate borrowers are doing very well.

As far as the, I know that I will talk about the affordability just a little bit. Prices have gone up so much! Let me give you an example, about 10 somewhat years ago, I financed a property, it's a commercial property, originally an office building, AT&T building in our area converted to a grocery market. But it has some big lots. And I remember my financing amount was less than $5 million. That property was sold to over $45 million in about 2018, I think.

BRIAN SULLIVAN: I don't know don't know if that's irrational exuberance or what have you, but wow!

JOANNE KIM: It's amazing!

BRIAN SULLIVAN: Well, very good. You know now that we've surveyed our bankers and got a general sense of what about what's happening where they are. Let's open it up among us all, if you will. Bob, I'll begin with you though, but please feel free any of you to jump in on this. As we got going, I was thinking, are we seeing something transitory here with the impact of this pandemic? Or is there some seismic shift taking place? Bob what are your impressions?

BOB DiCHIARA Yeah, sure. We think about that question also through the lens of the property types. And the one that sticks out to me is, you know, when you say is it durable, is it transformative or transient you know, it matters is this going to, does this affect how people want to live or work or behave in some way? And the one that keeps sticking out to me constantly is the work. Where do people want to do the work? And I think there's a lot of revisiting to that going on, whether you're on well, you know, all the way on one side or the other, I think it's undeniable where work is conducted is going to change.

BRIAN SULLIVAN: So, I think we all want to be back to where we used to be. Generally speaking, I think we can all agree there. We want to go to the restaurants we used to go to, we want to go to the movies…but it's the work thing that's is that still the big sticky wicket here?

BOB DiCHIARA To me, that seems to be the case. And I think Joanne is probably a good person to ask this question and maybe the opposite story might be in retail, where even before the pandemic, retail was going under sort of a transformation. So I'd like to ask Joanne, because I know you're in this space quite a bit. When you talk about mixed use and retail, would you say it's the experiential retail where you actually have to physically go to the property to experience something like a restaurant or have something dry cleaned or, you know, we talked about nail salons earlier.

Are those that the types of retail that will probably be more long lasting and perhaps the places that, where you have to go buy something where possibly an online retailer could do better, they might suffer a little bit more?

JOANNE KIM: There's a distinction between large malls versus a small neighborhood community shopping center. There's two different things and I will be focusing on smaller shopping centers that I see in our area. Surprisingly, they are filled, the businesses are opening and open to public. And then people are walking around and having you know, they eat in the restaurants and all that. So it's almost business as usual to pre-pandemic level. So I am very happy to see that. As far as the larger malls are concerned, I see a lot of vacancies, close-out sale signs, and dark storefronts, it's very sad to see it.

BRIAN SULLIVAN: Jim? John?

JOHN BURAN: So, just as we were anticipating the demise of Manhattan office space, in walks Google and pays a $2.1 billion for a for a New York office building. I do agree with Joanne wholeheartedly again about the retail space. I think there are certain types of retail that is an internet proof, if you will…where they may be a high degree of touch involved, a high degree of service involved. And those are the things that are going to underpin strong retail, a retail growth, I think big box retailers I think they're going to be problematic. I think malls, as Joanne mentioned again, problematic, but people need to do certain activities or make certain purchases in a much more intimate type of a relationship then online.

BRIAN SULLIVAN: Jim, how about you?

JIM EDWARDS: Right I'd agree with what John said there. I think we're all trying to figure this out. We've been trying to figure this out in our work environment for our respective banks, I'm sure. I know we are here at United Bank. I think office, you know, your workplace and the office, what that the composition of that is going to change, it is changing and what we're seeing is I think one trend is you're seeing less square footage needed per employee. And so while I don't think office, you know, commercial office space is certainly going to evaporate for all the reasons we've talked about. There, there are a number of things that you need to do that you need to be face-to-face with people for. But I do think we are seeing more of a trend that employees are not required to be in the office every single day. And that is having a spillover effect in our part of the world being an hour outside of Atlanta. If you roll back three or four years, there was a trend where we were not losing population, but we had some customers that were saying, I just can't deal with the traffic driving to Atlanta an hour-and-a-half each way and doing that five days a week and what we've seen since the pandemic though, is a reversal where we're seeing employees going, gosh, I'd rather be a little further outside of the city, I can buy a bigger house, I can have a nice yard. Maybe they're ready to have a family, whatever, but they're moving into our area and they're saying, you know, I still will be going into Atlanta a couple of days a week, but I can do that. But I'm not going to have to go in, my boss has told me I'm not going to have to go in five days a week for the foreseeable future here and really long-term.

BRIAN SULLIVAN: But I do want to pivot just a bit, one of the things the pandemic has really seemed to reinforce for everybody is that Dorothy was right after all, there is *no* place like home. And in many parts the country, we're seeing just a huge demand for housing and low supply. And I should think that all of this suggests there's room for growth in construction lending and on the multi-family side in particular, let's just turn to you, John Buran…just outside of New York, you have a lot of experience in the multi-family residential space, right? So, what do you see?

JOHN BURAN: Yes. We have probably about over $2 billion of multi-family, real estate and you know it's not a multi-family real estate it's not as simple story in New York either. Just prior to the pandemic, New York had gone through a pretty significant increase in multi-family construction activity. And I'm not seeing much weakening in that market and it clearly is it's weaker than the than the rent regulated market. But I'm not seeing a disaster even though in the market rate environment. So I think the eventual absorption and the desire, or the desire to work in New York City still has a great deal of appeal to young people. And I think that is going to certainly support even market rate multi-family going forward.

BRIAN SULLIVAN: Okay. Well, Jim Edwards down in Georgia your bank's footprint is largely in a suburban and rural setting. What's the impact of the single family residential construction market?

JIM EDWARDS: We're seeing extremely strong demand. I will say though, that I think one of the things that's different is that we're seeing, in my opinion, much better qualified buyers across the board here. You know, folks are sticking to their underwriting guns from a development standpoint, in terms of developers have real money in these projects. Maybe I'm certainly not, that was not as much the case back in the run-up to the Great Recession. I think that bankers are being careful about that and are making sure that they're being conservative with that because they realize how quickly things can turn in that sort of acquisition and development market there.

But, you know, it's just that the Georgia has, or the Metro Atlanta Area is a very strong economy right now. And that is causing a strong demand growth in jobs in the area, and with that comes a significant housing demand. And so you know, we're working hard to try to fill that need there. And it it's, people seem to be really responding to that.

We've not seen quite the price appreciation that you heard Joanne talk about, but it's very strong.

BRIAN SULLIVAN: Okay. Well, we have to we're reaching our time here and as we wrap things up, I'm just going to go around the horn here and ask each of our community bankers if you're bullish or bearish, just generally speaking on the commercial real estate sector and John let's begin with you.

JOHN BURAN: I'd have to say bullish. I think things are coming back. New York has really only been open since May, I think that we'll see more and more activity.

BRIAN SULLIVAN: Okay. How about you, Jim?

JIM EDWARDS: Yeah, so I'm certainly bullish too. I would at the risk of sounding like I'm talking out of both sides of my mouth though I do know that I made this comment the other day to somebody that, bad loans get made in good times and we're in what appear to be very good times right now. And so I think it's important, we're trying in our bank, I know to be certainly open to new ideas from our customers and assisting them in what they want to do and be great partners, but also just be careful right now but I think good times are ahead, but all bankers need to be cautious.

BRIAN SULLIVAN: Amen to that. Joanne?

JOANNE KIM: I would say cautiously bullish because there are still some unanswered questions.

BRIAN SULLIVAN: Right. Okay, well Bob give you the last word here. I know that you'll be following the CRE market very closely into the future, but where did all the indicators point?

BOB DiCHIARA Yeah, absolutely. So I'll avoid the bull-bear answer coming from the regulator, if that's all right. But I will say, you know, that our community banks are very important to this sector. You know, they have only a small share in total of the total assets of FDIC-insured institutions. They account for about 10%...community banks as a group, but they account for 30% of the commercial real estate loans. So they're active in the space they're a group that serves small communities across the country in this space. And it's an asset class it's important to us, it's important to them and it's something we're going to watch closely going forward.

BRIAN SULLIVAN: Okay. Well, I want to thank Bob you, of course, for joining us, but also our community bankers around the country, John Buran and Jim Edwards, Joanne Kim, thank you all for joining us today for a really great sort of across the board look at our commercial real estate market. I do appreciate that, thank you!