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Apartment Sector Soars - Banks Manage Expenses

Highlights & Observations from Select Reports

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The rental apartment market has roared back to life despite widespread weakness in the broader economy. Indeed, the sector has become the post crash darling as fundamentals strengthen. According to commercial real estate analytics firm Reis, the national vacancy rate is now at its lowest point in a decade having fallen 20 basis points in the second quarter to a current 4.7%. The market has tightened significantly and developers have moved off the sidelines. As might be expected, new development has also surged. Reis reported 10,000 new units came on line in just the second quarter. Their 2012 forecast is for 70,000 units followed by 150,000 new units in 2013. Demand will likely remain high for the next year or two. The greatest current demand appears to be in tech-concentrated metros. (San Francisco, Denver, Sacramento)

So far, new development has been constrained only by the availability of financing. Banks remain skittish as well they should be. The 60 day delinquency rate for commercial mortgage backed securities (CMBS) rose fractionally to 9.93% as $3.8 billion in newly delinquent CMBS loans entered special servicing. Despite a tight apartment market and strong fundamentals, the apartment sector still leads the way with a 14.09% delinquency rate. That is down from 15.13% a year ago but still higher than all other CRE sectors including hotel. Overall capitalization rates ("cap rates") for top tier space are once again showing signs of compression as they drop to 2006 levels in the five and six percent range. As more and more units come on line, fundamentals could, once again, become stressed.

Are we seeing an apartment bubble in the making? Not yet but time will tell. Builders are anxious to build and there is little demand to do so in any other CRE product sector. Migration to the apartment construction sector is inevitable. It is times like these in the apartment sector when circumstances become ripe for bubble inflation. So stay tuned and watch carefully for turning points. FOCUS continually monitors supply and demand relationships and turning points so check back frequently.

Bank Efficiency Ratios. All regulated financial institutions in the U.S. must file a *Report of Condition and Income,* known less formally as a "Call Report." The reports must be filed within 30 days of the end of a quarter. The information becomes public information and they yield a wealth of financial information about banks individually and collectively.

One indicator is the expense ratio, sometimes referred to as a bank's efficiency ratio. As might be expected, ratios vary significantly by bank size. Larger banks tend to be (but certainly not always) the most efficient. In the second quarter of 2012, the largest banks (those over $50 billion in assets experienced an average expense ratio of 59.8% while the smallest with less than $250 million in assets experienced the highest expense ratios at slightly over 70%. Other banks experienced expense ratios in between. As a percent of assets banks of most sizes, including the largest, experienced ratios in a tight percentage range of 2.5% to 2.9%. The smallest banks, (under $150 million in assets saw a higher ratio of 3.5% on average.

Smaller banks generally lack financial size, diversity and infrastructure to contain their expense ratio in the same way large banks can. Nevertheless, a bank's expense ratio should never be regarded as the sole indicator of its health. The old adage, *"it costs money to make money"* is true in banking. Often money must be spent even to exit unprofitable branches or lines of business. It is therefore prudent to evaluate expense ratios on a longer term stabilized basis.

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