A QUICK GUIDE TO CREDIT CONSIDERATIONS IN REAL ESTATE LENDING
This white paper discusses real estate credit risk considerations for the three most-researched real estate industries on eStatement Studies.

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COMMERCIAL LESSORS

CREDIT CONSIDERATIONS

Advantages
As the business sector improves, so too does demand for office, industrial, retail, and hospitality space. Currently, the commercial leasing industry is expanding, boosting occupancy and providing opportunities to increase rents. As operating revenue increases for commercial lessors, so too should property value. Volume and pricing for high-quality properties in the coastal markets have already increased, with an expected similar increase in some additional secondary markets.

Risks
Demand varies by property type. The demand for office space depends on office-related employment in the finance, insurance, technology, and real estate industries. If employment in these sectors increases locally, so too will the demand for retail space, which is also influenced by consumer spending. Consumer spending influences demand for hospitality spaces, which is also affected by local business activity, the cost of travel, and the strength of the U.S. dollar. Demand for industrial space tends to be influenced by proximity to a labor pool, transportation, local tax rates, and the presence of related industries.

Equally important in determining how this sector will fare is understanding how the national economy affects local conditions, which can vary widely from state to state and town to town. In addition, demand in metropolitan markets can also be influenced by demographics, tax burden, zoning, and utility infrastructure.

Funding Needs
Commercial lessors typically need funds for:

- Land acquisition
- Land preparation and construction
- Property acquisition
- Working capital for ongoing financing needs
CREDIT RISKS ISSUES TO CONSIDER

- What are the key candidate success factors that indicate a good credit risk?
- What critical external factors are likely to affect the industry?
- Which trends should you watch, i.e., which trends might have adverse effects on the industry?

COMMERCIAL AND INSTITUTIONAL BUILDERS

CREDIT CONSIDERATIONS

ADVANTAGES

As the nation’s economy rebounds, demand for new commercial and institutional building construction is growing at a steady pace. Office building construction has been on an upswing over the last few years, and institutional construction is expected to bounce back significantly after several years of a flat market, especially in the K-12 educational and public works sectors. In addition, the rising trend of consumer spending and subsequent demand for new retail and office space is expected to grow industry revenue.

RISKS

Commercial and institutional builders rely on steel (a commodity prone to some fluctuation) to construct a wide variety of structures. Builders who try to generate business by keeping customer prices low could see negative effects on their profits. Likewise, delays caused by labor disputes or supply chain problems can also affect profitability.

Several external and internal factors will determine how builders fare in this sector. Finding ways to offset rising building material costs, tracking trends in office vacancy rates and consumer spending, and taking advantage of opportunities in private nonresidential construction will be key. And, as always, commercial and institutional builders must maintain access to skilled workers and subcontractors, secure new contracts without compromising price margins, and explore the pros and cons of upgrading to higher-quality construction materials.
FUNDING NEEDS
Commercial and institutional builders typically need funds for:
- Land acquisition and development.
- Repositioning of underperforming properties.
- Equipment financing.
- Tract development.
- Construction labor and materials.
- Working capital for operating expenses.

CREDIT RISKS ISSUES TO CONSIDER
- How does consumer spending affects demand for commercial and institutional building construction?
- How do key external drivers influence profitability in this sector?
- Which sectors serve as major sources of demand and investments in this industry?
- How do interest rates affect operating expenses and profitability?
- Does local government spending indicate profitability in this sector?

RESIDENTIAL LESSORS

CREDIT CONSIDERATIONS
ADVANTAGES
Rising employment and income growth are enhancing the residential rental sector. For the past five years, young adults 18 to 34 years old contributed to a suppressed rental market by living with their parents. Now, those Millennials are ripe for starting their own households but, because of low savings and high education debt, most lean toward renting rather than home buying.
On the other end of the age spectrum, many Baby Boomers are testing for retirement by renting, particularly in coastal areas. Renting is also a very attractive option for professionals who are now part of a highly mobile workforce that wants to remain flexible and move quickly without the constraints of homeownership. Residential rental demand is expected to result in a rapid leasing pace which will push up occupancy and rent growth. As rental vacancy continues to fall, rent prices are expected to increase.

**Risks**
But demand varies by geographic sector, with just a handful of areas driving high national absorption rates. The greatest demand for residential rentals is in the Sun Belt and West Coast metropolitan areas along with the areas of Washington, DC, Chicago, and Boston. If employment in these areas slows, so too will the demand for residential rentals. In addition, a construction surge of multifamily housing in areas that are currently in demand can pose localized risk in this segment, driving down profitability. Likewise, if housing prices fall sharply and/or earnings growth improves, this could weigh heavily on the growth of the rental sector as homeownership becomes more affordable.

**Funding Needs**
Lessors of residential buildings and dwellings typically need funds for:

- Property renovations and repairs.
- Property acquisition.
- Land acquisition.
- Land preparation and construction.
- Working capital.

**Credit Risks Issues to Consider**

- What markets have the best potential to outperform?
- How do consumer habits affect demand?
- What questions should you ask candidates to help you determine risk?
- What trends should you monitor, i.e., which trends would indicate a change in the sector?
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Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

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RMA UNIVERSITY

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