

# Minnesota Lender Lunch

Hosted by SouthState Bank

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**Commercial Loan Credit &  
Pricing Trends  
For 2Q 2024**

# Data Source



- Pricing/risk data and risk-adjusted profitability data from Loan Command aggregates for 1Q to date through 5/01/24.
- Commercial real estate sector performance data from CoStar as of 3/31/24.
- C&I /owner-occupied probabilities of default and loss given default based on PayNet (Equifax) model using 1Q data.

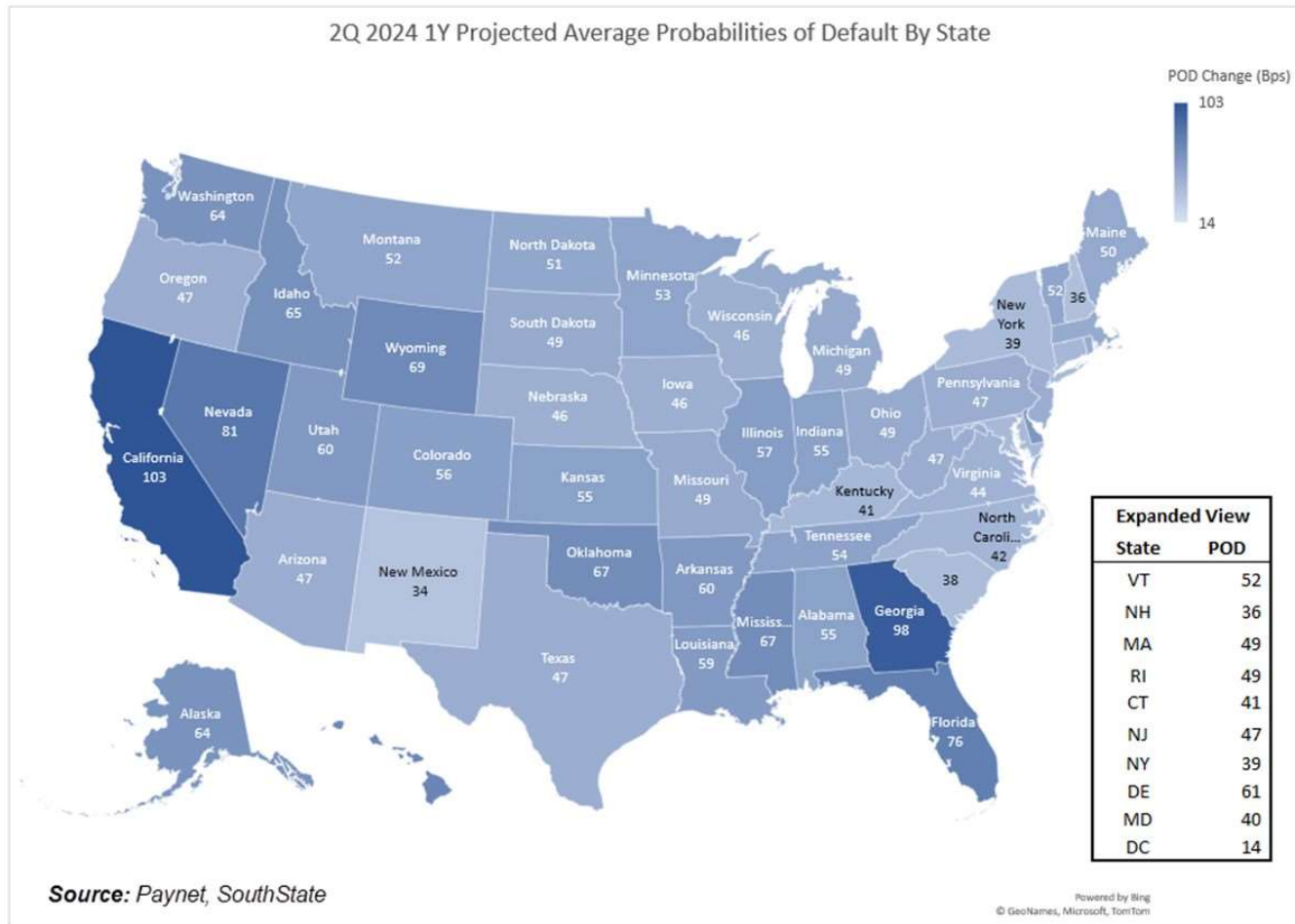


# Lending Trends

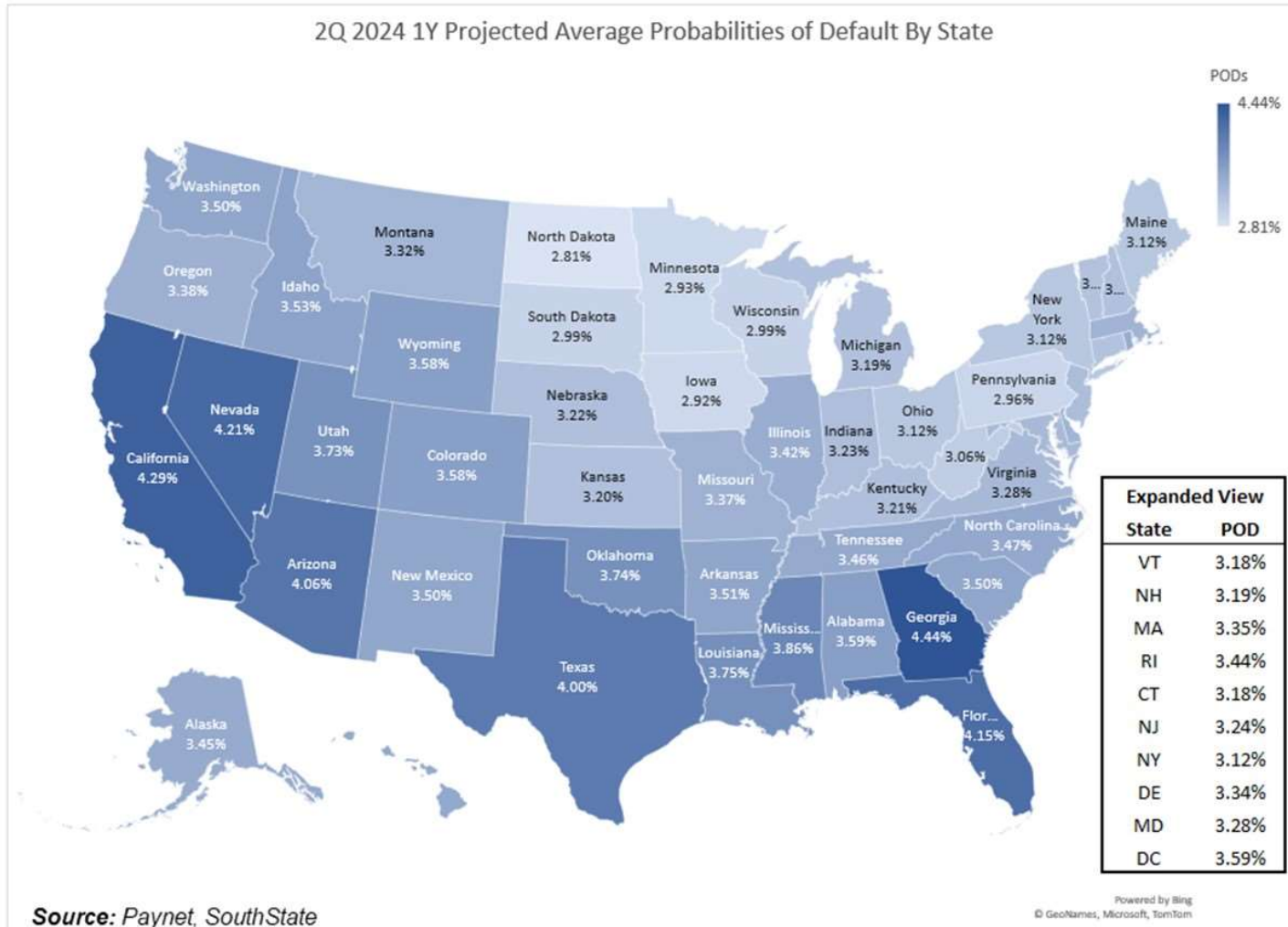


- Push out of recession and rate cuts – focus on inflation
- Slowing pace of Fed balance sheet runoff starting in June
- Office risk rising but could be OK
- Increasing cost of funds & credit risk dropping ROEs
- Investing in America stimulus loan (and deposit production)

# Geographical Credit Change



# Geographical Credit Conditions Forecast



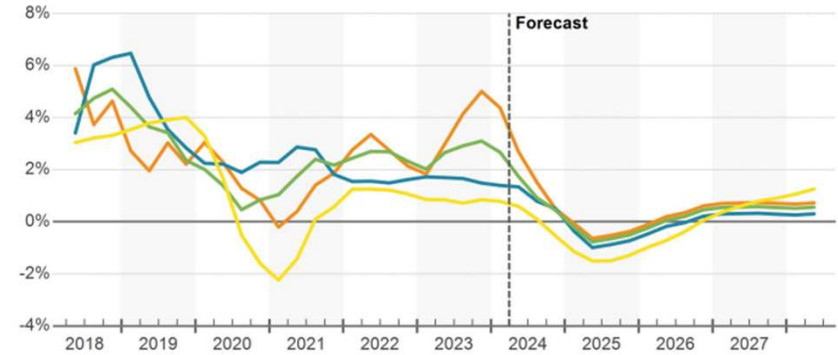
# Office



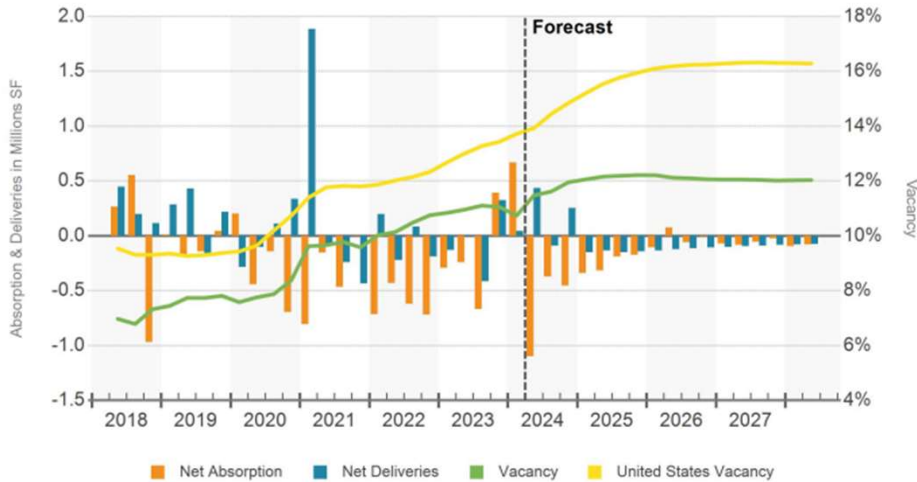
Despite the myriad of Fortune 500 headquarters in Minneapolis, the pattern of office spaces being vacated still plagues the city as is yet to return to the pre-pandemic leasing levels.

	Historic	Current	5Y Forecast
Rent Growth	2.0%	2.3%	0.3%
Vacancy Rate	8.5%	11.3%	12.0%

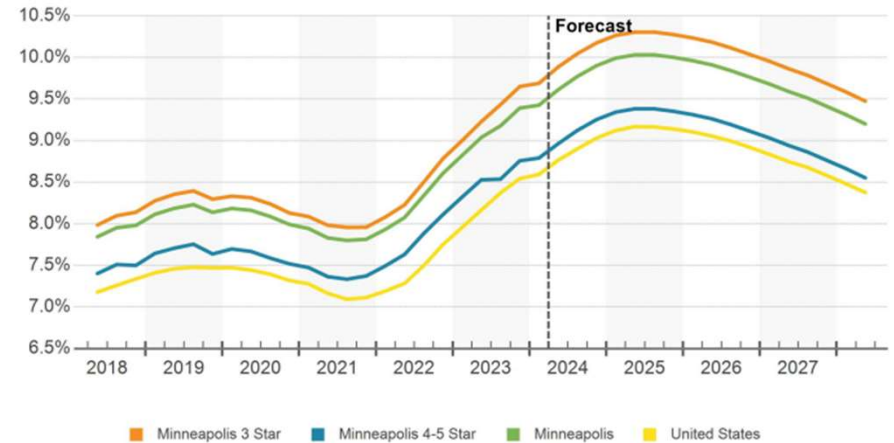
MARKET ASKING RENT GROWTH (YOY)



NET ABSORPTION, NET DELIVERIES & VACANCY



MARKET CAP RATE





- Looking at transit, cell phone and office control data, office usage has stabilized and even improved slightly over last year.
- However, usage is in the 40% to 65% range. Or about 50% of pre-pandemic levels.
- **45% of the office space has yet to come up for renewal**
- Forecasting the “peak day” syndrome
- LTV lower than last recession



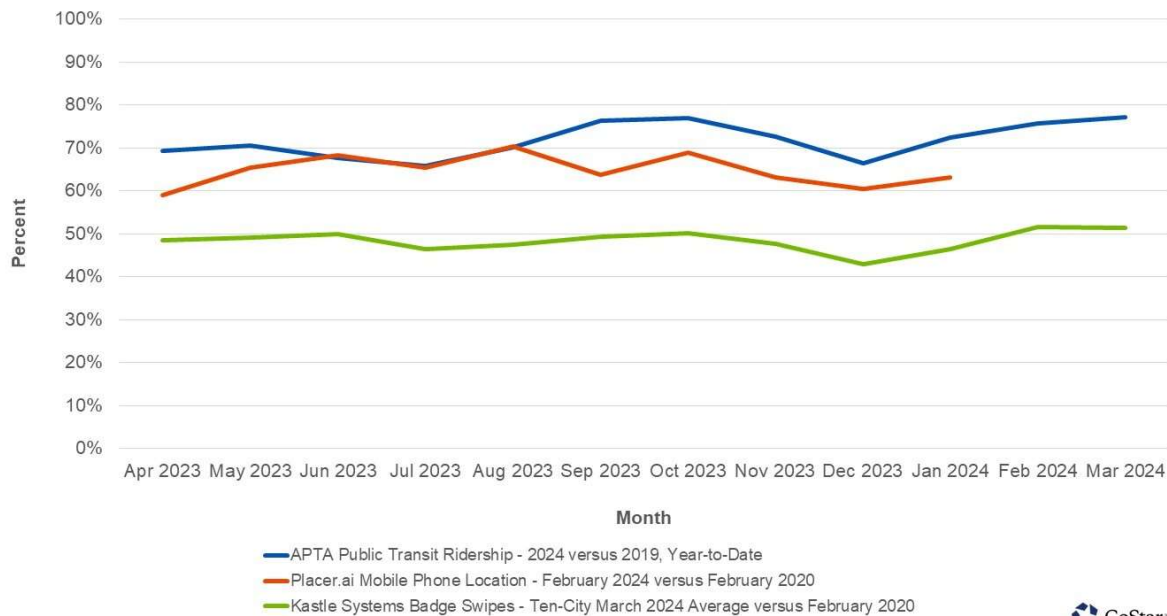
If at risk – Restructure NOW!!!



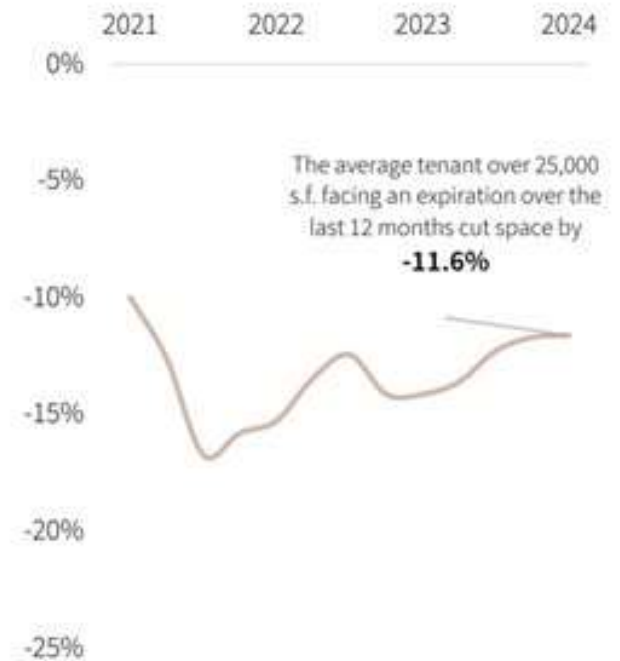


## Office Attendance Stabilizes

Office Attendance Indicators, 12-Month National Trend



## Downsizing rate for major tenants



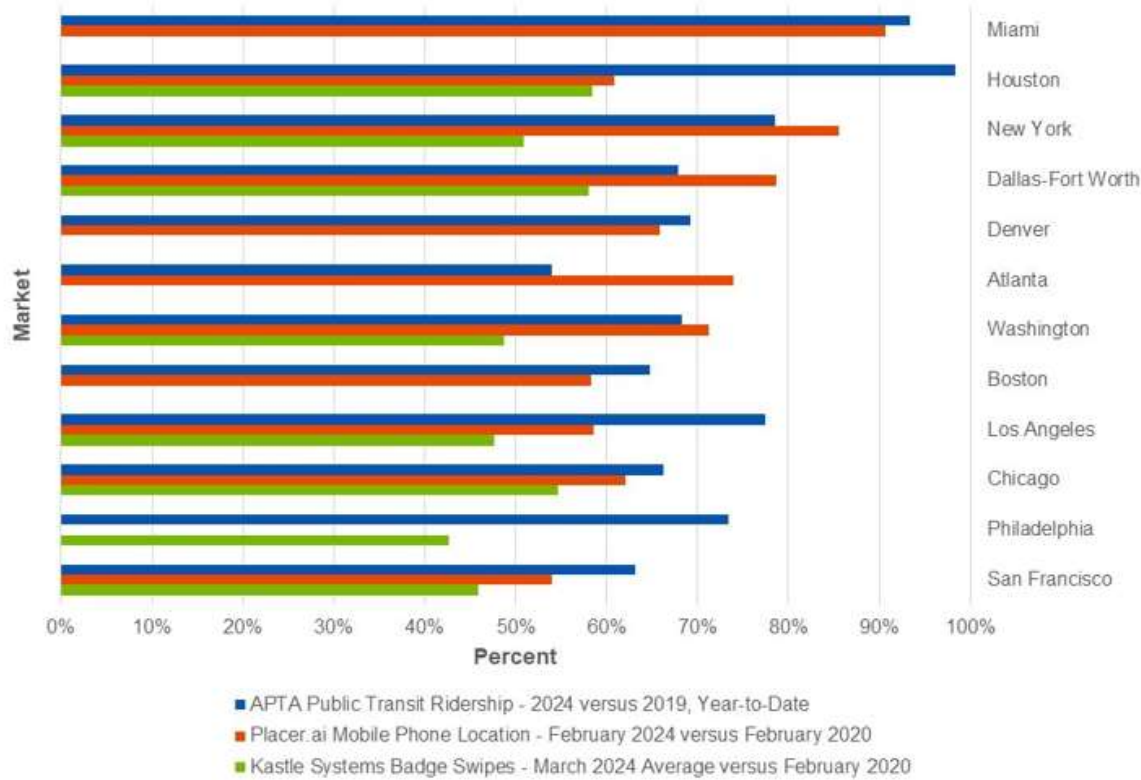
Source: JLL Research

Note: Includes tenants above 25,000 s.f. with a single office location in the market. Excludes tenants who downsized by more than 50% or expanded by more than 50%. N = 1,362

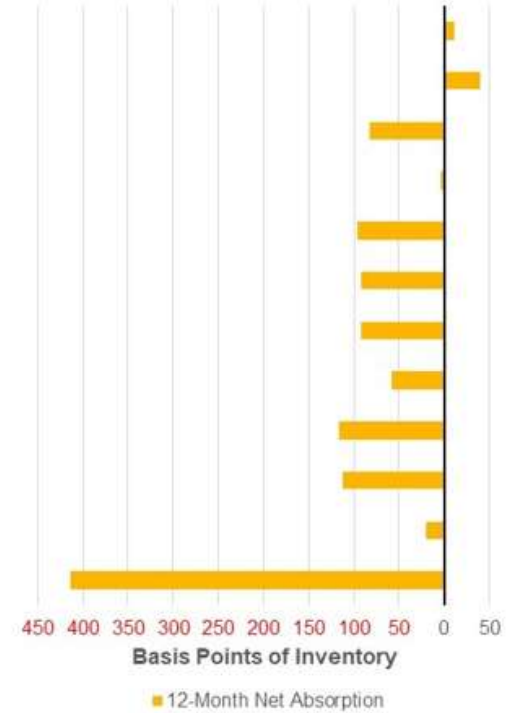




### Office Attendance Indicators



### Change in Office Demand, April 2023 to March 2024



Sources: American Public Transit Association (APTA), Placer.ai, Kastle Systems, CoStar, May 2024



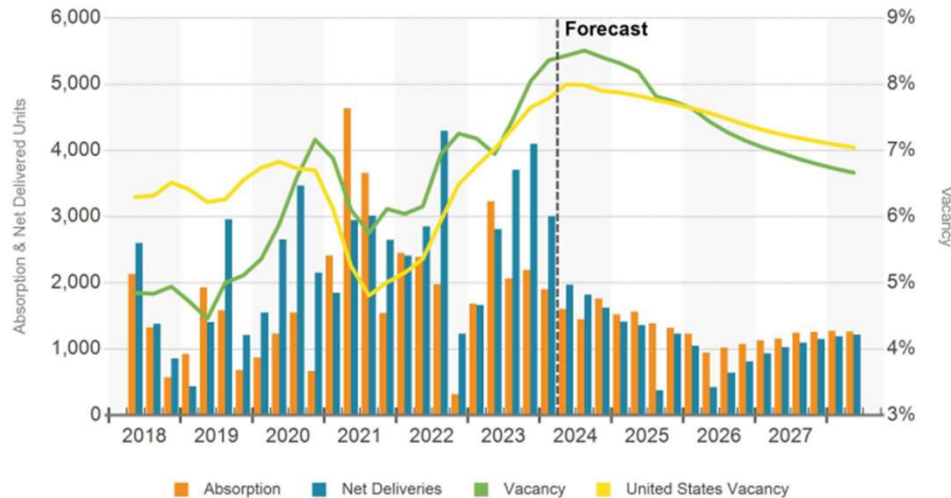
# Multi-Family



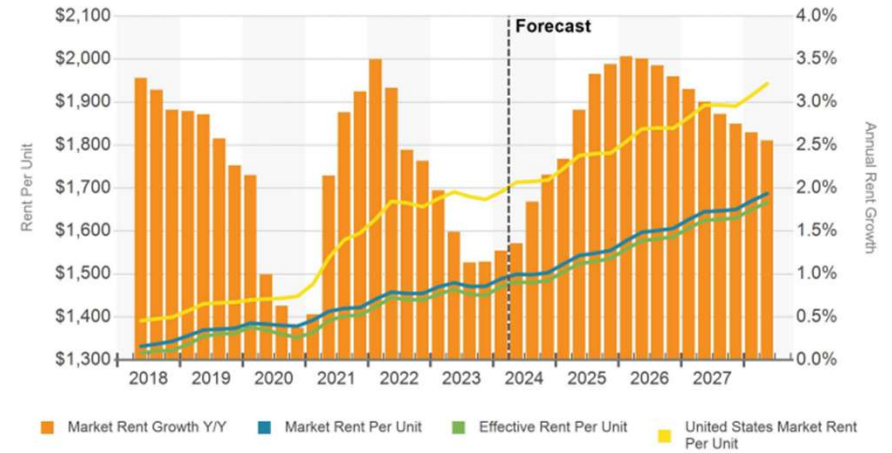
Despite being a consistently successful market, Minneapolis has seen a historic high in vacancy rates that may be accelerated by the high in development recently.

	Historic	Current	5Y Forecast
Rent Growth	1.7%	1.2%	2.8%
Vacancy Rate	5.6%	8.0%	7.4%

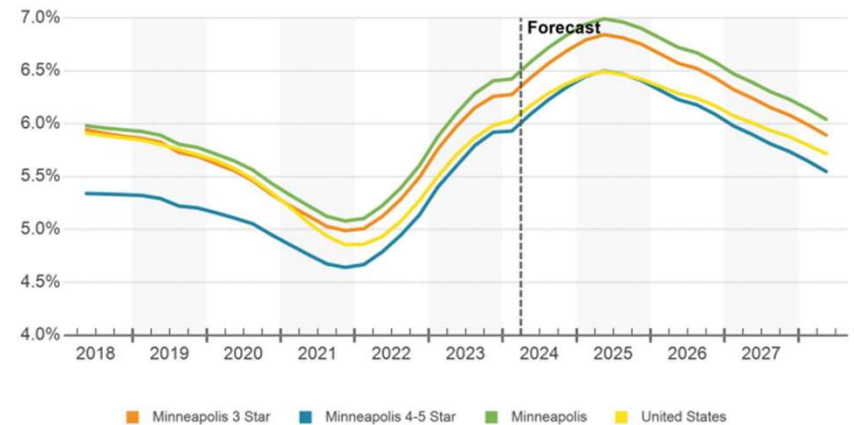
ABSORPTION, NET DELIVERIES & VACANCY



MARKET RENT PER UNIT & RENT GROWTH



MARKET CAP RATE



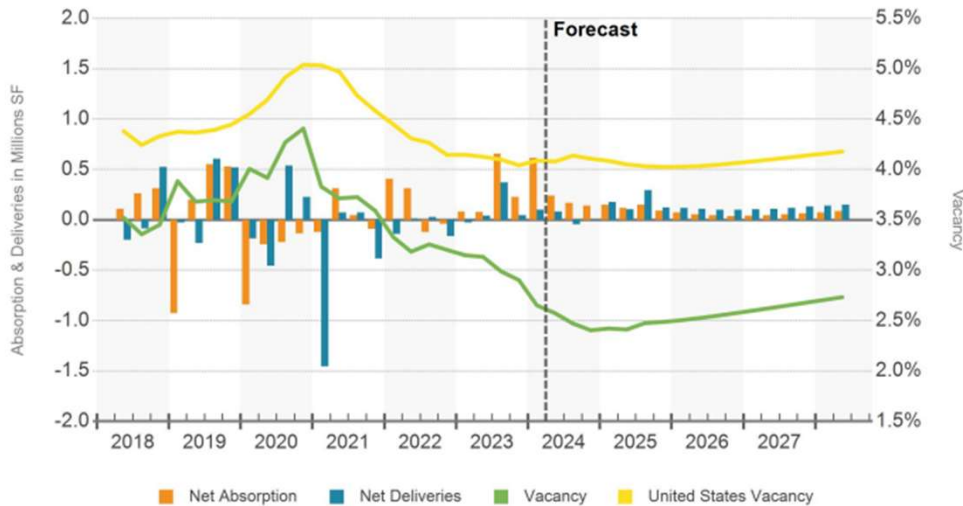
# Retail



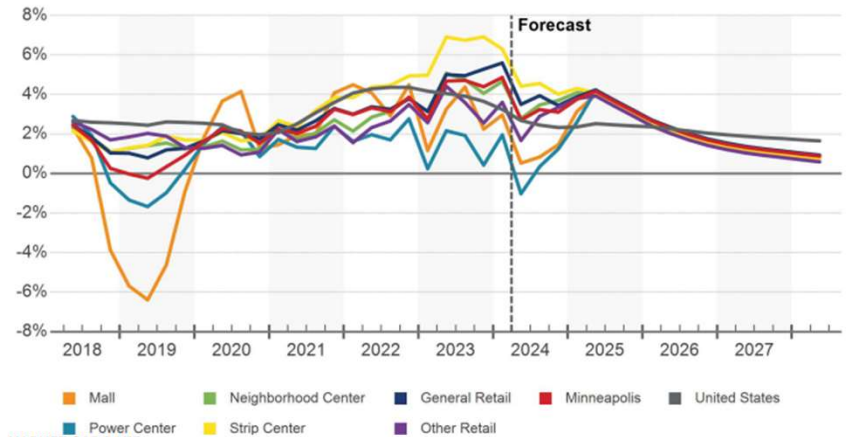
Due to a combination of tight development restrictions and the ever-constant demand for the market in Minneapolis, the retail market continues to have availability rates below the national average.

	Historic	Current	5Y Forecast
Rent Growth	0.7%	3.7%	2.1%
Vacancy Rate	4.0%	2.6%	2.6%

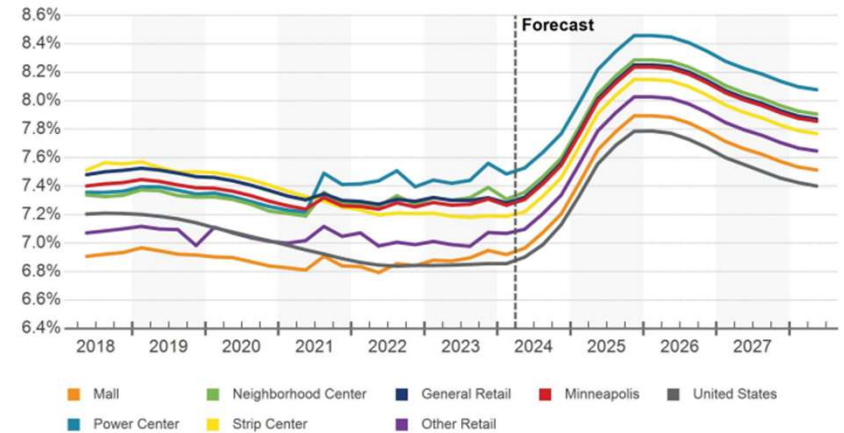
NET ABSORPTION, NET DELIVERIES & VACANCY



MARKET ASKING RENT GROWTH (YOY)



MARKET CAP RATE



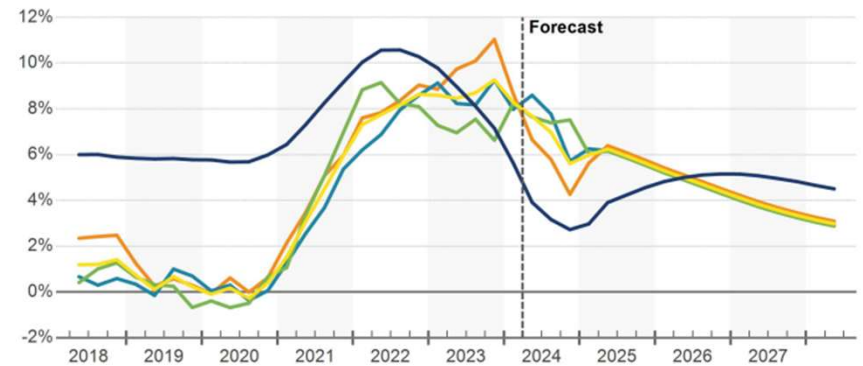
# Industrial



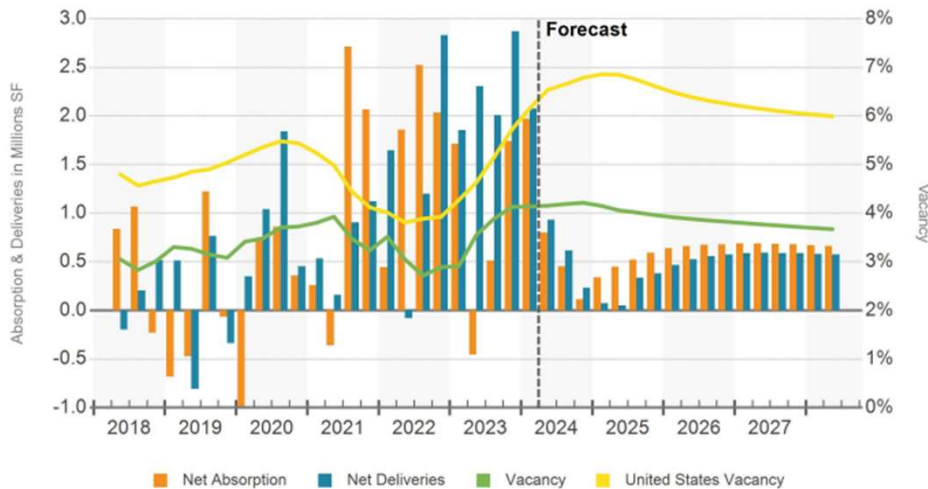
Due to a record speculative supply wave, the vacancy rate is at an 8-year high but remains lower than the national average. Growth from manufacturing tenants has fueled this struggling flame yet hope remains high due to the historic consistency.

	Historic	Current	5Y Forecast
Rent Growth	1.9%	7.8%	4.6%
Vacancy Rate	4.9%	4.1%	3.9%

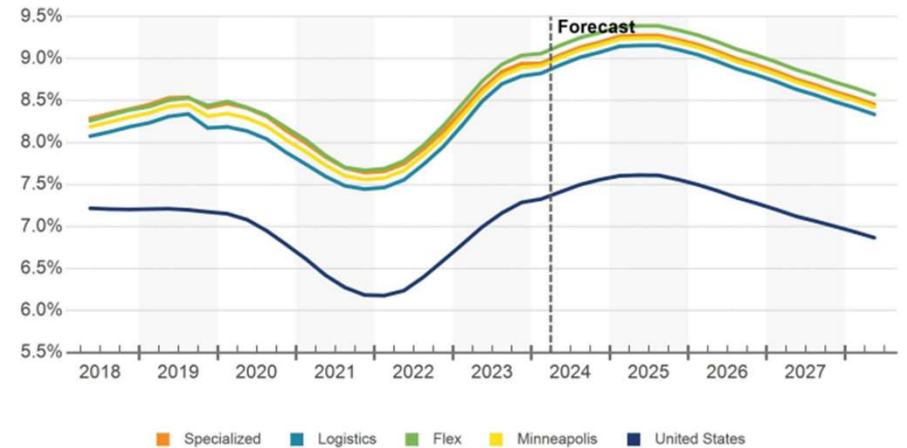
MARKET ASKING RENT GROWTH (YOY)



NET ABSORPTION, NET DELIVERIES & VACANCY



MARKET CAP RATE



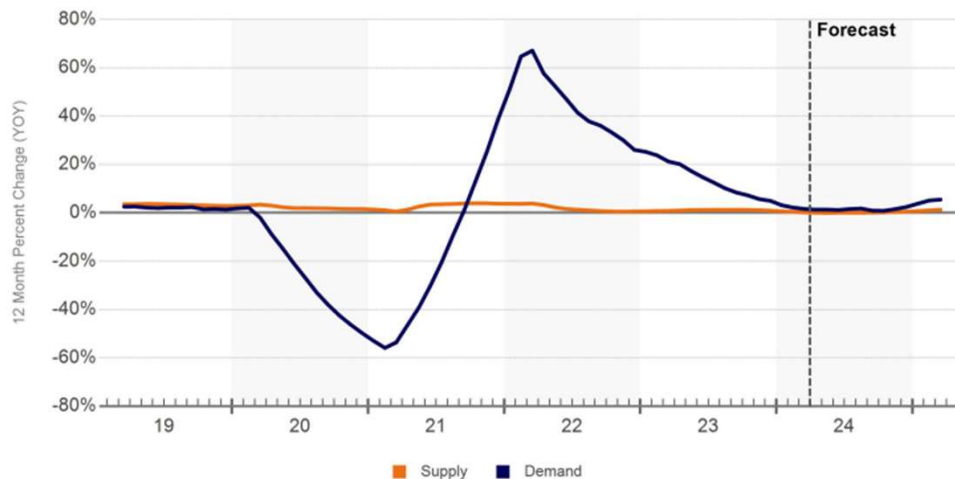
# Hospitality



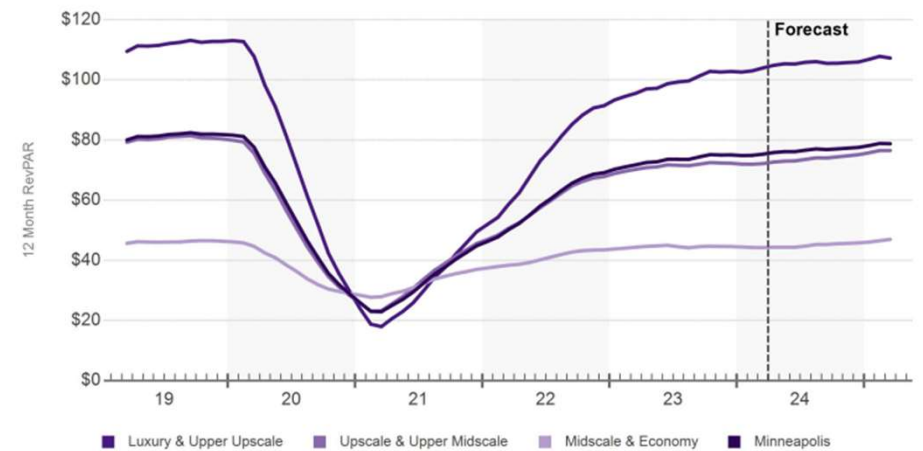
Increased travel and restricted supply allow for positive hospitality loan economics absent of a recession.

	Historic	Current	5Y Forecast
Occupancy	50.7%	57.3%	61.5%
RevPar Chg.	-1.2%	4.9%	4.9%

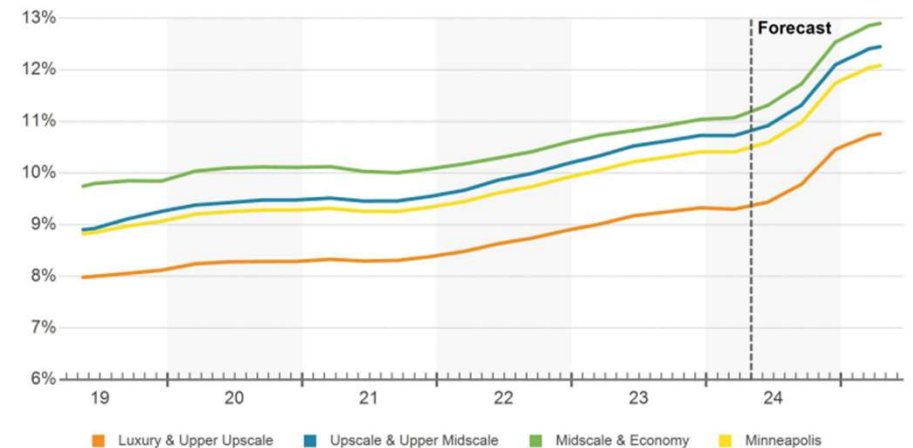
SUPPLY & DEMAND CHANGE



REVPAR BY CLASS



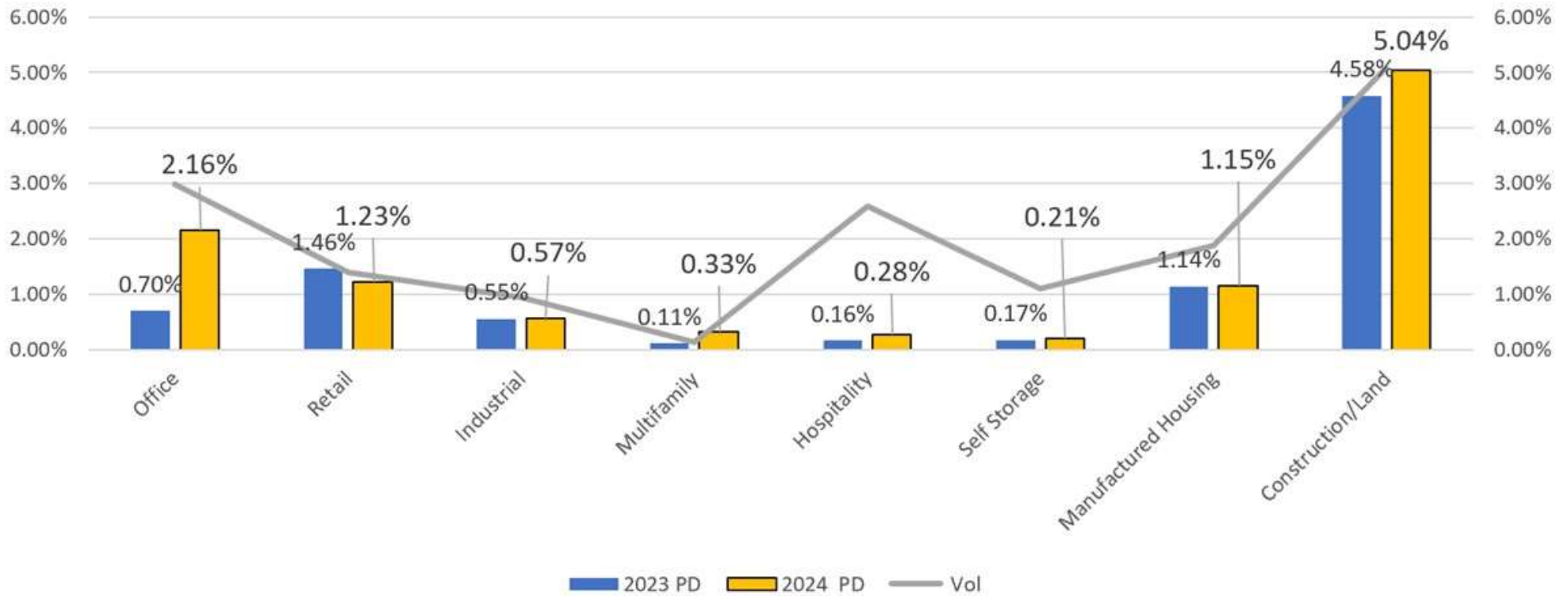
MARKET CAP RATE



# Industries That Are Decreasing in Credit Risk (1Q 2024)



Investor Owned CRE Probabilities of Default by Sector



# Industries That Are Increasing in Credit Risk (2Q 2024)



Minnesota - 30 Industries Where Their Credit Risk is the Highest 2Q 2024						
Rank	Industry	NAICS	APD	YOY bp Chg.		Vol
				In POD	In POD	
380	Other Pipeline Transportation	4869	4.58%	115	25%	1.74%
381	Other Transit and Ground Passenger Transportation	4859	4.87%	189	39%	1.77%
382	Water Transportation	483	4.85%	170	35%	1.79%
383	Inland Water Transportation	4832	4.87%	185	38%	1.81%
384	Scenic and Sightseeing Transportation	487	5.08%	149	29%	1.83%
385	Other Leather and Allied Product Manufacturing	3169	4.47%	128	29%	1.87%
386	Fabric Mills	3132	4.26%	173	41%	1.89%
387	Food Manufacturing	311	4.35%	148	34%	1.91%
388	Beverage Manufacturing	3121	4.42%	133	30%	1.91%
389	Beverage and Tobacco Product Manufacturing	312	4.42%	133	30%	1.91%
390	Couriers and Express Delivery Services	4921	6.03%	243	40%	1.91%
391	Scenic and Sightseeing Transportation, Land	4871	5.37%	174	32%	1.95%
392	Urban Transit Systems	4851	5.43%	212	39%	1.97%
393	Couriers and Messengers	492	6.10%	230	38%	1.99%
394	Support Activities for Transportation	488	5.67%	217	38%	2.06%
395	Other Food Manufacturing	3119	4.66%	146	31%	2.06%
396	Motor Vehicle Manufacturing	3361	4.90%	154	31%	2.08%
397	Apparel Manufacturing	315	4.85%	147	30%	2.11%
398	Local Messengers and Local Delivery	4922	6.28%	177	28%	2.19%
399	Bakeries and Tortilla Manufacturing	3118	5.25%	131	25%	2.26%
400	Transportation and Warehousing	48-49	6.49%	281	43%	2.31%
401	Fruit and Vegetable Preserving and Specialty Food Manufacturing	3114	5.30%	222	42%	2.41%
402	Electronic Shopping and Mail-Order Houses	4541	5.54%	221	40%	2.44%
403	Other Support Activities for Transportation	4889	7.87%	412	52%	2.71%
404	Freight Transportation Arrangement	4885	7.72%	320	41%	2.81%
405	Apparel Accessories and Other Apparel Manufacturing	3159	6.26%	217	35%	2.91%
406	General Freight Trucking	4841	8.28%	406	49%	2.94%
407	Truck Transportation	484	8.31%	407	49%	2.95%
408	Specialized Freight Trucking	4842	8.55%	416	49%	2.99%
409	Support Activities for Rail Transportation	4882	8.69%	517	59%	3.19%



# Industries That Are Decreasing in Credit Risk (2Q 2024)



Minnesota - Top 30 Industries Where Their Credit Risk is the Lowest 2Q 2024						
Rank	Industry	NAICS	APD	YOY bp Chg.		Vol
				In POD	POD	
1	Greenhouse, Nursery, and Floriculture Production	1114	1.05%	22	21%	0.27%
2	Aquaculture	1125	1.08%	17	16%	0.28%
3	Poultry and Egg Production	1123	1.11%	-2	-2%	0.28%
4	Oilseed and Grain Farming	1111	1.11%	14	13%	0.29%
5	Other Crop Farming	1119	1.13%	13	12%	0.30%
6	Crop Production	111	1.12%	13	12%	0.30%
7	Animal Production and Aquaculture	112	1.15%	16	14%	0.30%
8	Agriculture, Forestry, Fishing and Hunting	11	1.15%	15	13%	0.30%
9	Vegetable and Melon Farming	1112	1.17%	10	9%	0.30%
10	Sheep and Goat Farming	1124	1.16%	25	22%	0.30%
11	Cattle Ranching and Farming	1121	1.16%	16	14%	0.31%
12	Other Information Services	5191	2.05%	-34	-17%	0.31%
13	Other Information Services	519	2.05%	-34	-17%	0.31%
14	Hunting and Trapping	1142	1.24%	16	13%	0.31%
15	Hog and Pig Farming	1122	1.19%	13	11%	0.31%
16	Fishing, Hunting and Trapping	114	1.24%	16	13%	0.31%
17	Other Animal Production	1129	1.22%	20	16%	0.33%
18	Support Activities for Forestry	1153	1.31%	-4	-3%	0.35%
19	Support Activities for Animal Production	1152	1.38%	11	8%	0.36%
20	Support Activities for Agriculture and Forestry	115	1.44%	17	12%	0.38%
21	Support Activities for Crop Production	1151	1.48%	21	14%	0.39%
22	Fruit and Tree Nut Farming	1113	1.49%	40	27%	0.40%
23	Depository Credit Intermediation	5221	1.81%	5	3%	0.45%
24	Software Publishers	5112	2.04%	-67	-33%	0.46%
25	Gasoline Stations	4471	2.32%	-11	-5%	0.46%
26	Gasoline Stations	447	2.32%	-11	-5%	0.46%
27	Offices of Dentists	6212	1.82%	25	14%	0.47%
28	Justice, Public Order, and Safety Activities	9221	2.32%	33	14%	0.48%
29	Justice, Public Order, and Safety Activities	922	2.32%	33	14%	0.48%
30	Executive, Legislative, and Other General Government Support	9211	2.35%	28	12%	0.48%

# 2Q Pricing Trends - Summary



- Nominal spreads increased 2 bps due to lower credit supply, increased demand and deposit pressure. Average SOFR-equivalent credit spread for community banks is currently 2.55%.
- Target risk-adjusted ROE remained at 16%.
- Actual risk-adjusted ROE is 16.1% so far for the quarter.
- The average through-cycle probability of default (POD) is 0.49%, down 2 bps. from 1Q 2024. POD volatility is flat in 2Q and remains low at 0.27%.
- Expected loss given default increased 1.5% percentage points to 44.0% (due to higher cap rates).
- Average community bank portfolio expected loss increased 7bps to 0.28%, or well within bank reserve levels.
- Loan growth is projected at 7.7% in 2024, up from 7.1% from last year.

# Pricing by Grade and Loan Size



Credit Rating	Suggested Target Spread	Actual Spread (@ Booking)	Difference (Bps)	Difference %	Target ROE	Actual ROE (@ Pricing)	Difference	Difference %	Comments
1	1.91%	2.22%	0.31%	16%	16%	14%	⬇️ -3%	-16%	Spreads decreased by 2bp due to more competition for better collateralized loans (sub 50% LTV)
2	2.25%	2.43%	0.18%	8%	16%	15%	⬇️ -1%	-8%	Spreads increased by 3 bps QoQ.
3	2.55%	2.55%	0.00%	0%	16%	16%	⬇️ 0%	-1%	Spreads remained flat to 1Q
4+	2.65%	2.79%	0.14%	5%	16%	16%	⬇️ 0%	-1%	Spreads increased by 9 bps due to greater pricing power.

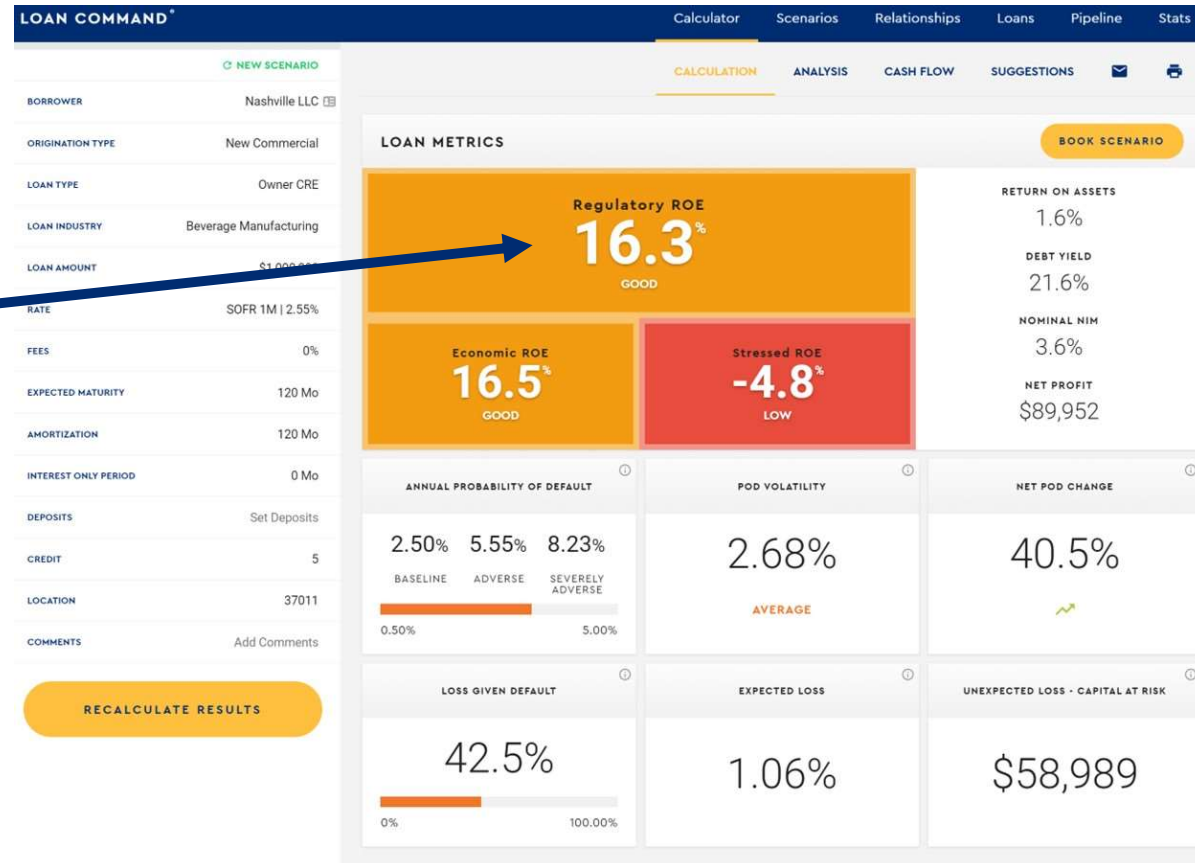
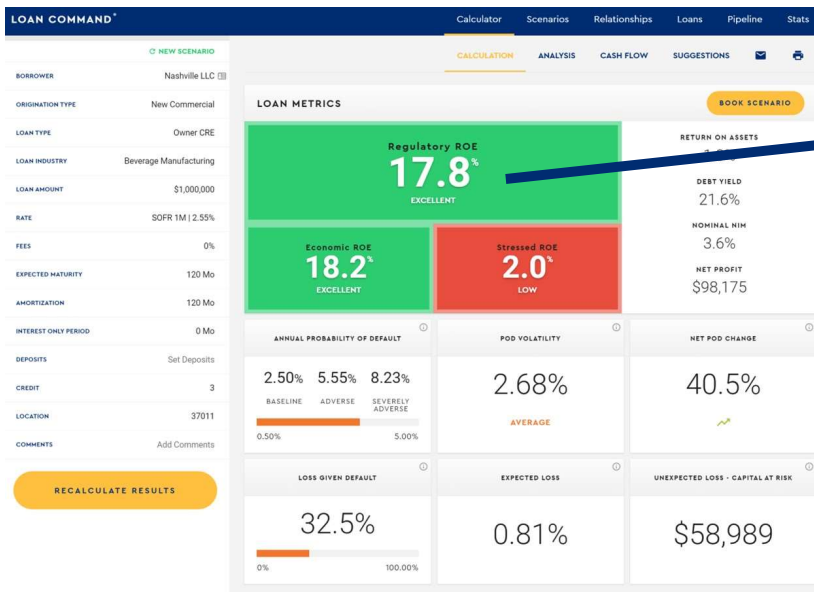
Loan Size	Suggested Target Spread	Actual Spread (@ Booking)	Difference (Bps)	Difference %	Target ROE	Actual ROE (@ Pricing)	Difference	Difference %	Comments
\$50k to \$500,000	3.25%	2.69%	-0.56%	-17%	16%	10%	⬇️ -6%	-39%	Industry is underpricing small loans
\$500,000	2.75%	2.69%	-0.06%	-2%	16%	14%	⬇️ -3%	-16%	Slightly underpriced
\$1,000,000	2.55%	2.67%	0.12%	5%	16%	17%	⬇️ 1%	3%	Increase of 16 bps
\$2,000,000	2.50%	2.56%	0.06%	2%	16%	16%	⬇️ 0%	1%	This remains the most competitive area but banks are showing discipline
\$3,000,000	2.43%	2.39%	-0.04%	-2%	16%	15%	⬇️ -1%	-7%	
\$4,000,000	2.40%	2.32%	-0.08%	-3%	16%	14%	⬇️ -2%	-10%	
\$5,000,000	2.38%	2.35%	-0.03%	-1%	16%	15%	⬇️ -1%	-5%	Decrease of 1 bps.
\$10,000,000	2.35%	2.48%	0.13%	6%	16%	18%	⬇️ 2%	13%	This area is down 4 bps from last quarter

# Pricing By Loan Type



	Target Spread	Actual Spread (@ Booking)	Difference (Bps)	Difference %	Target ROE	Actual ROE (@ Pricing)	Difference	Difference %	Comments
<b>NOOCRE</b>									
Office	2.65%	2.91%	0.26%	10%	16%	19%	▲ 3%	18%	Mostly all refinance volume. Spreads increased 5 bps over 1Q
Retail	2.80%	2.76%	-0.04%	-1%	16%	18%	▬ 2%	14%	Spreads decreased by 2 bps due to better credit outlook and firmer rents.
Hospitality	3.20%	3.14%	-0.06%	-2%	16%	22%	▲ 6%	38%	Hospitality pricing decreased 3 bps due to higher performance
Industrial	2.25%	2.19%	-0.06%	-3%	16%	17%	▬ 1%	6%	Spreads increased 4 bps
Multifamily	2.35%	2.18%	-0.17%	-7%	16%	13%	▬ -3%	-20%	Spreads increased 6 bps.
Other	2.50%	2.73%	0.23%	9%	16%	19%	▲ 3%	18%	Self-storage, MH, etc
<b>C&amp;I</b>									
General	2.45%	2.23%	-0.22%	-9%	16%	16%	▬ 0%	0%	Pricing increased 13 bps
Line of Credit	3.00%	2.80%	-0.20%	-7%	16%	12%	▬ -4%	-25%	Pricing remained largely unchanged from last quarter
Municipal	1.80%	1.81%	0.01%	1%	16%	13%	▬ -3%	-19%	Cost of muni deposits is hurting profitability. Pricing increased 3 bps from 1Q
Other	2.45%	1.80%	-0.62%	-25%	16%	13%	▬ -3%	-19%	Skewed towards higher quality and long term project finance
<b>OOCRE</b>									
Industrial	2.20%	2.38%	0.18%	8%	16%	16%	▬ 0%	-3%	Loans to manufacturing and distribution companies increased 6 bps
Office/Retail	2.55%	2.64%	0.09%	4%	16%	17%	▬ 1%	8%	Spreads increased by 6 bps
Medical	2.15%	2.19%	0.04%	2%	16%	14%	▬ -2%	-14%	Spreads increased by 5 bps
Church	2.90%	2.56%	-0.34%	-12%	16%	15%	▬ -1%	-6%	Underpriced given elevated risk. Spreads increased 10 bps.
Other	2.45%	3.06%	0.61%	25%	16%	21%	▲ 5%	33%	Restaurants, child care, etc. Spreads increased 4 bps
<b>Other</b>									
Other	2.45%	2.97%	0.52%	21%	16%	21%	▲ 5%	34%	Mostly ag loans. Spreads decreased 16 bps
Construction	3.25%	3.15%	-0.10%	-3%	16%	5%	▼ -11%	-66%	Elevated risk increased pricing by 8 bps

# ROE Targets ARE Reduced YOY



# Challenges and Opportunities

- **Community bank challenges**
  - **COF, Yield, Efficiency Ratio, Inverted Yield Curve**
- **Community bank opportunities**
  - **Loan size, loan term, relationship banking, loan hedging**
  - **How ARC can help**