

Commercial Mortgage Insight[®]

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Mortgage Brokers Still Control The Distribution Of Small Commercial Loans

In a fragmented small-balance world, accessing loans through the wholesale channel remains the best game plan.

BY W. JOSEPH CATON

Even though the barriers to entering the small-balance commercial real estate finance business are quite low, lenders have conceded access to the borrower to their brokers and deal intermediary correspondents.

And lenders have done so for very good reasons. Among them is the difficulty of competing with local retail branch/banking offices and commercial mortgage brokers who already have the best possible handle on local or regional markets, as well as an intimate understanding of their borrowers.

The concept of creating an extensive marketing program to this segment of borrowers simply does not appeal to many lenders, particularly because of the fragmented nature of the marketplace. And even the largest of commercial banks have made little progress in snagging a major piece of the national small-balance commercial mortgage market.

In fact, recent research conducted by Stamford, Conn.-based Boxwood Means, Inc. - a research and consulting firm focused on the small-balance commercial lending arena - suggests that the top 10 small-balance commercial and multifamily lenders accounted for just about 15% of all the loans originated in the previous year. And among these top 10 lenders are the major commercial banking shops, including household names like

Washington Mutual, Bank of America and Wells Fargo.

"These numbers were stunning to



us," commented Randy Fuchs, Boxwood Means' president, while addressing a group of mortgage brokers and correspondent lenders at a recent industry meeting sponsored in part by CMI. "If we are reading the tea leaves correctly here, it means that the wholesale channel is still the overwhelming choice for placing these loans and that mortgage brokers, spread across the country, are still the dominant force that's driving the small-balance bus."

Fuchs' comments validate what many market participants - particularly the lenders that source small commercial loans on a national level - have maintained for some time now. And with the bold new entrance into the

business by well-known residential players like Pasadena, Calif.-based IndyMac Bank and C-BASS, a New York-headquartered investor and securities issuer that focuses on buying subperforming residential mortgage portfolios, many capital providers are taking aim at this fragmented market and seeking to bring a new level of underwriting discipline and efficiency to it.

High-touch loan origination

To no one's surprise, many of these lending and investment players are focusing on the wholesale channel because the origination of small commercial mortgages also generally requires a significant amount of touch from loan officers.

Brokers dominate that aspect of lending because not only do they have a financial stake in getting deals done to the satisfaction of capital providers and the investors who ultimately buy these loans, but



Randy Fuchs

they also own an important piece of the pie - local face-to-face access to borrowers. And to be sure, the cost of launching a retail-based marketing program to a broad range of real estate investors is an additional barrier pre-

venting many lenders from circumventing the wholesale channel.

"We have seen brokers take more of a lead on evaluating small commercial mortgages across many markets," said John Bauer, a senior director in the Sacramento, Calif., office of Tremont Realty Capital, an origination firm that serves as both deal intermediary and direct lender. "And when you think about it, these brokers have to take that lead, because there are a lot of hungry originators out there who are eager to build their volume of business."

Bauer believes that brokers are making a greater effort today to be more of a deal origination partner with correspondent lenders than they did in the recent past. He told the meeting's attendees that rather than simply referring deals to lenders, he sees brokers becoming more educated about the loan underwriting process, and by doing so, they make themselves a more valuable asset in correspondent relationships.

It is no secret that brokers and loan officers who work with small commercial real estate owners and operators have developed insight into how these borrowers think and operate their business. In many cases, small commercial mortgages are written to small business owners, as well as to operators who often occupy the property being financed.



John Bauer

For these reasons, many lenders have determined that they are prepared to give more of the deal evaluation and initial underwriting responsibilities to brokers, choosing instead to focus on other aspects of the business such as watching for geographical and asset type concentrations in their portfolios.

Bauer pointed out that property owners and investors also tend to have more of a relationship with brokers. He said many of these borrowers are comfortable with their local mortgage representative and tend to take more advice from a neighborhood loan officer than a lender located "halfway across the country."

Bauer also believes that as brokers further hone their deal origination skills, they are likely to further solidify their place in the small-balance world, and lenders will surely be taking notice.

Capital markets effects

Given the high level of interest that capital markets players have in the small-balance commercial world, the availability of unrestricted capital for funding these deals continues to have a great impact on the roles of mortgage brokers.

When lenders come to market with funds they have raised through private equity sources and high-yield real estate investment funds, they provide brokers with ammunition to delve deeper into the stories of individual deals. Perhaps this is why capital markets lenders have been taking aim at unconventional deals, such as repositioning, rehabilitation and other short-term financing programs. They also hope to eventually turn these short-term deals into permanent financing for their conduit and securitization platforms.

Because conduit players today can underwrite risky deals at rates that are more aggressive than what many traditional portfolio players (including local banks) can offer, they court brokers very effectively. Brokers are attracted to the wide range of financing products that capital markets lenders provide, and best of all, the origination of deals does not necessarily depend on a broker's ability to structure deals based on a lender's capital stack requirements.

Kenneth Gaiten, executive vice president in the Irvine, Calif., office of Johnson Capital Express, the small-balance arm of Johnson Capital - a commercial mortgage broker, banker and sometimes capital provider - sees structured deals as the key to the success of capital markets players. He noted to attendees that Johnson Capital has a flourishing conduit program and that it is driven in large part by the structured financing concept.

"Brokers and the borrowers they serve do not necessarily get down into the details of how a loan is broken up in the capital stack after that loan is made," said Gaiten, who sees further evidence of heightened capital markets investors' interest in structured small-balance deals.

"All you see as broker or borrower at the closing table is the blended rate of interest, and you don't get much further into the 65-percent leverage of the senior piece or the 25-percent



Wells Fargo recently funded a \$5 million, 10-year loan secured by Pottery Barn-Winter Park, a standalone retail center in Winter Park, Fla. The asset consists of one two-story neighborhood retail center containing 13,102 square feet.

leverage of the mezzanine piece," he commented.

Gaiten also told the meeting's attendees that because small commercial loans still have some level of inefficiency in them, both borrowers and brokers expect the rates to be somewhat higher than those of larger deals. He believes that the entrance of so many new players into small deals will only serve to weed out some of these inefficiencies and eventually bring the pricing structure of small deals closer in line with some of their larger counterparts.

Furthermore, the advent of the commercial real estate collateralized debt obligation (CDO) marketplace is also



The Minneapolis office of NorthMarq Capital Inc., a mortgage broker/banker firm, recently arranged a small-balance permanent financing for phase two of Sierra Ridge Apartments in Bismarck, N.D. The \$3.7 million deal was arranged for the borrowers, Goldmark Real Estate Investors, through Freddie Mac.

aiming to take a bite out of the small-balance space and its pricing inefficiencies. Because many new lenders and investors are willing to take on additional risk and employ loan exit strategies through the issuance of commercial mortgage-backed securities (CMBS) that include CDOs, there is further appetite from the capital markets for small loans and the healthy interest rates they generally carry.



Mike Boggiano

With thriving small-balance securitization programs now in place for well-known players such as GE Real Estate, Bayview Financial, Lehman Brothers and CBA Commercial, brokering small loans to capital markets lenders is quite an easy feat for brokers. And this growing market is a boon for borrowers, who often rely on the favorable terms that capital markets players can offer.

Additionally, Bauer noted that his shop focuses a fair amount of its efforts on helping brokers better understand the constraints that come attached to conduit loans. He believes that once brokers become more informed about how these loans work, they are likely to become greater contributors to the deal aggregation efforts of capital markets players.

Low concentrations persist

However, according to Fuchs' research, there is little by way of market control and concentration from any particular groups of players, and as formative as capital markets lenders and their investors are, they had little influence over how small-balance deals were distributed in the previous year. The \$134 billion market continues to be driven, in large part, by independent brokers and loan officers who maintain strong local and regional relationships with small-balance borrowers.

"With some 200,000 loans originat-

ed in the small-balance space last year alone, this market segment is potentially bordering on becoming a rival product to even the current domestic CMBS market," Fuchs concluded. "And over the next year or so, we will finally begin to see the true effect that big Wall Street money can and will have on this still fragmented space."

Perhaps the fact that the field for doing small commercial loans remains open explains the entrance of residential brokers in droves. Many lenders have been cranking up the marketing machine to residential brokers, who have seen significant declines in their business volumes because of the housing slump. And because many analysts believe that this slump still has some course to run, the lack of concentration in the small-balance commercial space will continue to attract these new brokers.



NorthMarq Capital also secured financing of \$4.4 million for The Arbors, a multifamily complex located in Sioux City, Neb. The small-balance deal was arranged through Freddie Mac on behalf of the borrower, IRET.

The migration of residential brokers into small-balance commercial is a natural one, according to Mike Boggiano, senior vice president and national wholesale manager for Coral Gables, Fla.-based Silver Hill Financial LLC, a small-balance commercial lender that heavily courts residential brokers in its marketing efforts.

"When you think about how much contact residential brokers have with the ideal candidates for small commercial loans, they can't help but be serious contenders for these loans," he said.

Boggiano, whose firm was a co-host of the meeting, told the audience that he has yet to meet a residential broker to whom small-balance commercial loans make no sense. He especially pointed to the ability of a broker to earn as much as over two points on a

deal through his lending platform and said that the numbers are just too compelling for residential brokers to not get involved in doing these loans.

"And if a lender can bring a residential style of loan origination to the small commercial space, that makes the learning curve much easier for a residential broker," Boggiano said. "After all, if I can give a residential broker two-plus points on a \$450,000 deal, and all he or she has to do is learn a few different deal origination steps, I can't see how that won't make sense to that broker."

The true winners

Finally, the low barriers to a small-balance commercial loan brokering program make the business most compelling to both lenders and brokers. As lenders are content to negotiate with brokers over what level of participation the broker occupies in getting deals done, the field opens even further for parties of interest.

In fact, based on a broker's level of experience - including the capability to service small loans after closing - there is an ample field of real estate fund investors who are willing to ride on the ability and experience of that broker.

Lenders, however, bring much more robust platforms to the table for both funding and servicing loans. And those platforms are what drives the exit strategies that many real estate fund investors employ - issuing securities against these portfolios.

The great incentive for brokers here is to quickly move up to the level of mortgage banker, where they can acquire the capabilities of servicing the small commercial loans they help to originate. Many of these brokers see this migration as the next logical step in creating more value in their correspondent relationships.

The brokering of small loans is a great business to be in at this point of the real estate cycle. The true winners, though, will be determined based on which brokers can develop a banking shop and continue to dominate the distribution of profitable deals. ●

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