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inside small-balance

By Randy Fuchs, principal and co-founder, Boxwood Means Inc.

Will the sun come out tomorrow?

It's difficult to sidestep the avalanche of bad news. Payrolls continue to contract, consumer expenditures are drying up, and housing prices appear as though they have yet to hit bottom.

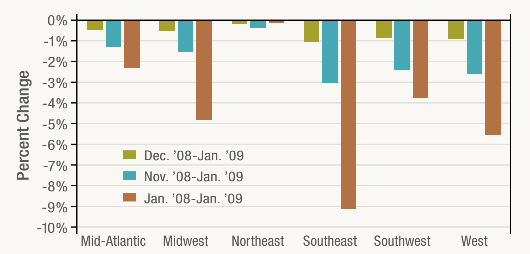
Less than a year ago, many observers considered commercial real estate invulnerable to the subprime (aka, nonprime) fallout. But now, considering the changes to the aforementioned indicators, the mortgage meltdown is taking its toll on property fundamentals. Neither the sector for large- nor small-balance commercial real estate loans has been spared.

Look no further than the small-cap-industrial sector. Nationally, asking rents have declined a sizable 7.8 percent since January 2008, with more than 40 percent of that loss occurring in just three months, from November '08 to January '09.

As shown in the nearby graph, most U.S. regions are taking it on the chin. For instance, the asking rents for small-cap-industrial properties in the Southeast are down 9.1 percent between January '08 and this past January, and the West dropped by 5.5 percent.

The pace of erosion appears to be quickening. The Southeast, Southwest and West have witnessed rent declines of nearly 1 percent this past January alone.

Small-Cap-Industrial Asking-Rent Trends



Sources: Boxwood Means Inc. and LoopNet Inc.

This negative reflex mirrors the severity of the manufacturing decline. The Institute of Supply Management's Purchase Managers' Index — which reflects a series of factory-related variables, including prices, production, delivery and employment — saw readings of 32.9 in December '08 and 35.6 this past January. These are its lowest readings since the early 1980s — when the nation suffered through its last deep recession.

These conditions invite some investors and lenders to batten down the hatches and ride out the storm. It's likely that rents and property values will continue to fall through at least the first half of this year. This means that the potential for opportunistic returns likely will only increase with time.

That said, there are a few rays of sunlight on the horizon in the form of low interest rates, low energy prices and the federal government's stimulus package. Experienced investors with a tolerance for uncertainty will increasingly find attractive asset pricing for industrial and other small-balance commercial property types.

Randy Fuchs, a principal and co-founder of real estate research and consulting firm Boxwood Means Inc., writes a monthly column on small-balance commercial loans for scotsmanguide.com. Boxwood provides lenders with strategic mortgage reports, direct-mail lists, portfolio analytics and other services based on its proprietary database of small-balance transactions. E-mail randy.fuchs@boxwoodmeans.com.

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