

inside small-balance

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

Impacts of a recession

These are interesting, if not challenging, times in the commercial real estate and debt markets.

Evidence is mounting that our toes are dipping into recession. Nonfarm payrolls shrunk by 80,000 jobs this past March, according to the U.S. Department of Labor, and the unemployment rate increased from 4.8 percent in February to 5.1 percent in March.

Jobs are a key driver for office and apartment consumption, and the likely consequences of this weak employment report are a slowdown in leasing and more pressure on property values.

Indeed, in the larger commercial property arena, cap rates are increasing across the board.

The slowing economy and reduction in property values are two factors keeping a tight grip on the capital spigot. That, in turn, has hurt mortgage originations.

Conduits, for instance, which had issued more than \$60 billion of commercial-mortgage-backed securities (CMBS) in the first quarter of 2007, according to the Mortgage Bankers Association, saw their volume reduced to less than one-tenth that figure in the first quarter of this year.

Originations in the larger property market have shifted away from the conduits and investment banks to portfolio lenders and insurance firms.



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These capital dislocations are affecting small-balance commercial loans, or those of less than \$5 million.

Lenders willing to take on these loans are scarce, and pricing isn't as favorable as in 2007.

These are prime reasons why small-balance originations are down this year, too, though Boxwood Means' early data on first-quarter volume, at roughly \$10 billion, already have surpassed final CMBS totals for the same period.

The small-balance sector's reliance on portfolio lenders, rather than on conduits, has minimized execution risk. This has kept some financing avenues reasonably fluid.

Of late, other investors, including private-money lenders and investment funds, also have stepped up their participation in the space.

There may be more job losses and deleveraging ahead, but I think indications of a soft landing in commercial real estate are afoot. The Federal Reserve and U.S. Department of Treasury have taken aggressive steps to bolster confidence.

The positive sentiment, in turn, is beginning to have a favorable influence on debt pricing. The spreads on the tradable CMBX — indices for CMBSs — for example, have markedly declined.

Thus, there is hope that the worst is over for the financial sector, and we may well see improvements in small-balance origination markets later this year.