Inside Small-Balance

Small-balance vs. CMBS

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

Mortgage originations in the small-balance commercial arena totaled $130.2 billion in 2006, close to the record volume of $134.2 billion set in 2005. This total represented a modest 3-percent decline from 2005 — providing fresh evidence that the market for loans of less than $5 million is growing at a more modest pace than the commercial-mortgage-backed-securities (CMBS) market.

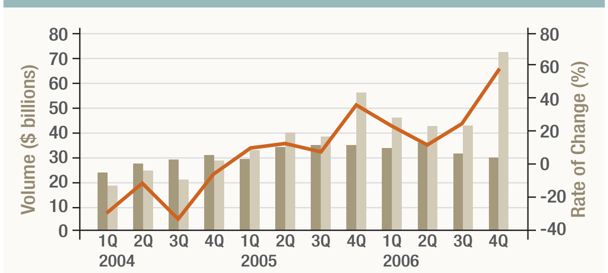
Why? The small-balance sector is more closely influenced by residential-market trends. For instance, smaller commercial mortgages of less than $1.5 million — and particularly those of less than $500,000 — contracted in 2006 as residential mortgage production tumbled. In contrast, larger small-balance loans for as much as $5 million more closely matched increases in the CMBS market.

With the restraint imposed by the residential market, overall small-balance loan volume declined modestly in each period following the second quarter of 2006. Nonetheless, each quarter of the year still saw at least $30 billion in activity, reflecting a favorable refinancing environment and a robust purchase market. Indeed, in this huge commercial real estate investment market, 2006 property sales totaled $142 billion, encompassing more than 160,000 transactions.

As noted in the graph below, the trend in small-balance volume does lack the explosiveness of the CMBS market. Demand for CMBS from the institutional and investor markets has triggered massive inflows of capital that have bolstered this sector's growth in the last two years. As recently as 2004, however, quarterly small-balance production actually exceeded totals for CMBS — before the flood of money pushed CMBS volumes to record heights.

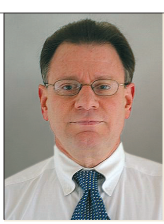
This capital-markets effect, realized through the availability of securitized CMBS product, likely will be replicated in the small-balance world, as well. Only a handful of players are involved with securitizations of small-balance products. Potential participants on the originations and securitization sides of the business have noticed the growth potential, however.

Origination Trends



In the past six months, several large lenders have jumped into the small-balance market, leveraging existing residential and/or commercial broker platforms. And a few Wall Street banks are planning to launch securitization programs.

The arrival of these new players, coupled with expectations for another solid year for production in 2007, could mean that small will be the new big in commercial mortgages.



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 *Scotsman Guide*. 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.

Reprinted From *Scotsman Guide* Commercial Edition and scotsmanguide.com, July 2007