



Q&A

Randy Fuchs
PRINCIPAL AND CO-FOUNDER
BOXWOOD MEANS INC.

BY KURT STEPHAN

THE SMALL-BALANCE MARKET IS ON A ROLL.

The small-balance, or small-cap, commercial real estate market is a vital sector that has surged in recent years, but is sometimes overlooked by mortgage originators. Generally defined as commercial and multifamily properties under 50,000 square feet and \$10 million in value, this space reached an all-time high in originations this past year, approaching \$180 billion, an 8.4 percent increase over 2012. We spoke with Randy Fuchs, principal and co-founder of research/consulting company Boxwood Means Inc., about the current state of small-cap commercial market and where it's headed.

This past year was a record-setter for small-balance originations in terms of loan volume. How does this year compare to 2013?

First, small-cap commercial real estate space-market fundamentals are quite strong. Second, the sales-transaction market has been on a tear, hitting nearly \$75 billion in sales last year — the highest since the prerecession peak in 2007 — and even accelerating into the early months of 2014. Third, small-cap commercial real estate prices, which have lagged behind the general market, are finally advancing at a better clip, by much as double digits year-over-year in some markets. These conditions are changing investor sentiment about the space. We expect a broader and greater number of private owners and investors to exploit the opportunities this year.

The purchase-loan market should be strong because of the improvements in market conditions. Our research indicates that refinance activity, which traditionally accounts for 75 percent to 80 percent of total small-balance originations, declined during the first quarter as interest rates ticked up. We think refinances will recover, but it won't be another record-setting year. We project \$140 billion to \$145 billion for 2014, which is on par with the long-term average.

What are the strong fundamentals in the small-cap commercial space?

There have been six consecutive quarters of positive net absorption across office, industrial and retail sectors on the national level, which, coupled with no material increase in new construction activity, has driven vacancy rates down to levels last seen six years ago. As a result, average industrial rents have risen over 3 percent year over year, and office and retail rents between 1 percent and 2 percent.

Why has this sector been relatively slow to recover, even as asset sales have increased sharply?

In areas like space-market fundamentals, it hasn't been slower. It's outperforming the general market in some respects. This space typically doesn't rebound as fast through a cycle as the larger, more institutionally oriented market, and the lion's share of distress in the wake of the recession was concentrated among smaller assets. Although a lot of that distress has been rung out of the market, small-cap commercial real estate is largely viewed as a riskier asset class, demanding higher yields and lower prices, hence the slower recovery. But the sustained high level of asset sales — evidenced by the fact that 106 of the 122 markets for which Boxwood tracks small-cap sales produced year-over-year sales gains — suggests that there's a lot of local money out there making smart, risk-adjusted investments while the getting is still good.

What are the greatest threats to the small-balance market's upward growth?

One is possible refinance risk as significant numbers of small-balance commercial loans mature over the next couple of years. Will small-cap prices have recovered sufficiently by then? Boxwood's Small-Commercial Price Index indicates national prices are 17 percent below the prerecession peak level on average, but some areas of the country have legacy losses that are two and three times worse than that. Also, the sector itself is hot again, with new entrants appearing almost every month, and lest history repeat itself, we need to try to keep underwriting criteria on a reasonable keel.

What should mortgage originators and lenders know to capitalize on the current small-cap market and to prepare for the future?

It's a unique asset class and the types of collateral can be challenging. Be realistic about prices and loan-to-value rates. Bridge-lending sources continue to be an important arrow in the quiver and likely will be for years to come. A couple of national players are starting to offer small-balance securitizations, which would be great for the market, [providing] a lot more liquidity and attracting more investors.

Kurt Stephan is an editor at *Scotsman Guide*. Reach him at (800) 297-6061 or kurts@scotsmanguide.com.

In the Past Month

NEWS FROM THE INDUSTRY AND ABROAD

NAR expects modest gains in commercial sectors

All major commercial real estate sectors are expected to make modest gains over the next year as credit eases and the economy adds jobs, reported the National Association of Realtors (NAR).

"The multifamily sector continues to be the top performer in commercial real estate, with the lowest vacancy rates," said Lawrence Yun, NAR's chief economist. "However, tight availability — despite new construction — is causing rents to currently rise near 4 percent annually in many markets. Many renters who are getting squeezed may begin to view homeownership as a more favorable long-term option."

NAR is forecasting that vacancy rates will remain essentially flat through the second quarter of 2015 in all major sectors. Rents are predicted to rise between 2 percent and 4 percent for each of the next two years depending on the sector. Yun said the outlook for commercial real estate depends on solid economic growth and investment.

Multifamily sector drives surge in home construction

Multifamily construction, particularly apartments, drove a surge in new-home construction this past April, according to the U.S. Census Bureau.

Building permits for homes of five units or more jumped 21.8 percent month over month to a seasonally adjusted rate of 453,000 units.

"It really says what is happening in the marketplace," said David Crowe, chief economist for the National Association of Home Builders, in an interview with MarketWatch. "There are a lot of renters there, relatively young people who are forming their first household and going directly into rental, and very few additional people coming into the homebuying market."

MarketWatch reported that the share of multifamily housing starts was 39 percent, the highest total since 1974.

U.S. office market cools in first quarter

Demand for U.S. office space slowed this past first quarter, CBRE reported, but a lack of new office buildings still pushed up leasing prices — particularly in the downtown cores.

The extreme winter probably did not cast the chill on the sector after a strong end to 2013, according to CBRE. "It is more likely a result of excess capacity in both the office and labor market, a volatile — and vexing — trend that has resulted in a slow and uneven recovery," its report said.

Net absorption totaled 5 million square feet across the United States, the highest first-quarter total since 2007, CBRE reported.

— VICTOR WHITMAN

Have you heard of Scotsman Guide News?

We bring you daily news updates on our website. Stay on top of mortgage news and trends at ScotsmanGuide.com/News
Contact Chief Reporter Victor Whitman at (425) 984-6017 or victorw@scotsmanguide.com.

