

inside small-balance

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

Markets continue to soften

It's been more than a year since the nonprime-loan market imploded, triggering the credit crisis that has affected the residential and commercial sectors. While commercial property markets so far have been largely unaffected, investor sentiment has soured.

As noted previously (*Inside Small-Balance, Scotsman Guide commercial edition, February 2008*), investors' retrenchment in the small-balance sector began in mid-2006 in lockstep with the downturn in residential housing sales.

By contrast, the investment cycle lasted much longer — well into a record-setting 2007 — before the large-cap market slowed. That market has now turned bearish: First-quarter 2008 data from Real Capital Analytics indicate that overall sales volume contracted 64 percent year-to-year for industrial, multifamily, office and retail properties valued at more than \$5 million.

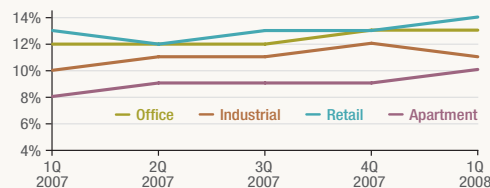
Clearly, the feeding frenzy is behind us. Factors such as the economic climate, differing buyer-seller expectations about cap-rate inflation and scarcity of mortgage financing have all conspired to break the pace of transactions.

But the property market is showing little signs of systematic distress in contrast with the capital markets. Although price discovery is more problematic, property values remain relatively stable. Prices of large-cap office



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Asking-Price Vs. Sales-Price Spreads



Source: Boxwood Means Inc. and LoopNet Inc.

properties — which attracted heavy buyer activity in the past few years — have dropped the most, down 11.3 percent since first quarter 2007, according to Real Capital Analytics. Industrial prices were basically flat, declining 0.5 percent, while retail gained 9.9 percent and apartment gained 2.5 percent, representing relative bright spots.

What about small-cap sales prices? Of course, small-balance properties of less than \$5 million trade at a discount relative to larger commercial properties. But small-cap-price trends show a similar pattern. Small-balance office values declined 6.8 percent year-to-year, according to the latest data, while apartment values eased 2.5 percent and industrial values by 1.8 percent. Small-balance retail, however, posted a gain of 18.8 percent, propped up in part by continued investor interest in street retail.

While we don't know exactly what's in store for the investment market, the spread between asking and sales prices may offer a clue. As the above graph shows, the trend has increased modestly across the board of late. This suggests further softening as the market continues to correct and as sellers adjust to a more-sober reality.

Small-balance originators who keep abreast of these pricing dynamics can better manage their clients' expectations about asset values and loan proceeds.