

inside small-balance

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

Property prices and cap rates

Amid the nonprime debacle and contraction in capital-markets liquidity, most industry analysts cite healthy commercial real estate property fundamentals to differentiate the commercial market's prospects from the beleaguered residential market.

Indeed, as of press time, most commercial market data suggest that the coast is clear. Vacancies are low, rents are still increasing and loan performance shows little sign of weakness. That said, there are hints that the small-cap market for loans of less than \$5 million might be fatigued and more vulnerable to a pullback than larger commercial loans.

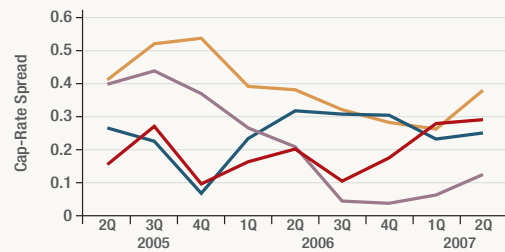
As I've mentioned in previous columns, research indicates the small-balance world is more tied to changes in residential loan cycles. This is because of the types of investors in small-balance. Origination volume for modest-sized small-balance commercial loans declined in 2006. Now, there's some air seeping from sales prices and capitalization rates.

For instance, small-cap sales prices may be topping out for some property types. Although property prices have continued to increase each year nationwide, as of second quarter 2007, growth has slowed to single digits for retail properties (median sales price of \$583,000) and office properties (\$701,000), according to Boxwood Means' research. Price appreciation for apartment

(\$1,094,000) and industrial properties (\$818,000) remain relatively strong.

Trends in cap-rate spreads amplify these property dynamics. As noted in the table below, there's some volatility in these numbers.

Cap-Rate Spreads: Small-Cap vs. Large Cap Properties



Source: Real Capital Analytics

But note the upward trend of late — particularly with apartment, office and retail properties. These growing gaps are associated entirely with cap-rate increases in the small-cap sector. By contrast, cap rates for larger commercial loans remain relatively immune.

It makes sense that cap rates in the small-balance space, which reflect the sector's relatively lower-quality assets and sponsorship compared to larger loans, might experience more upward pressure with the turmoil in the credit markets. The upward trend could be a short-term phenomenon. Then again, the outlook for commercial real estate in general likely will be driven more by macroeconomic trends — such as employment and the gross domestic product — than by the nonprime residential market alone.



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

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