BENT BUT NOT BROKEN: SMALL-CAP CRE PRICES PROVE RESILIENT

Boxwood's New Property Sales Indices Spotlight Unique Market Performance

August, 2010

INTRODUCTION

The differences in market fundamentals between small and large commercial real estate properties are under-appreciated because of the predominance of bigger, investment-grade assets in industry market research and the press. Has the CRE "market" actually fallen roughly 40% peak to trough as Moody's Investors Service and conventional opinion assert, or does this judgment apply primarily to the major-asset segment of the market?

With this month's introduction of small commercial property price indices, Boxwood adds a powerful measure to its data and analytics that charts a divergent market trajectory for small-cap CRE sales. Reflecting property investment at the grassroots level, these indices may act as a counterweight to the general assessment about the overall CRE market.

Greater sales price transparency in the small-cap CRE arena is helpful to diverse groups including commercial bank lenders, investors and government oversight agencies that are all striving under challenging conditions to evaluate local market and collateral valuation risks.

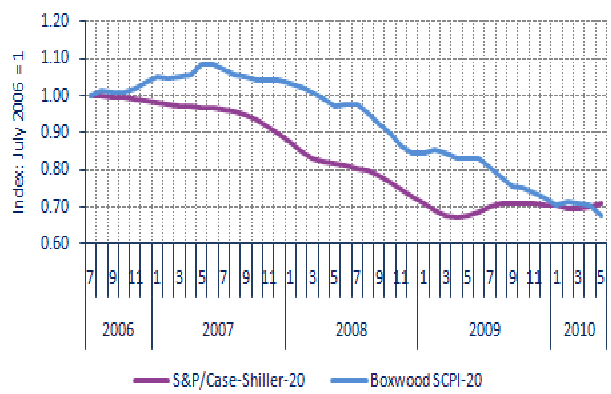
BOXWOOD'S INDICES

We constructed two proprietary small-cap CRE indices: the *Boxwood Small-Cap Property Index* ("SCPI") tracks aggregated U.S. price trends from 90 diverse metropolitan areas involving property sales under $5 million. The SCPI contrasts with the Moody's/REAL Commercial Property Price Index, or CPPI, which comprises primarily sales of large-cap CRE assets. The Boxwood SCPI-20 Index is a composite of the nation's 20 largest metro areas – the same markets in the S&P/Case-Shiller Home Price Index of residential housing.

Boxwood's indices mirror the diversity of the small CRE market by tracking closed sales for various small commercial property types. The indices include conventional multi-tenant office, industrial and retail property types that characterize large CRE sector indices, but they also include assorted secondary types of assets that frequently befit owner-users and single tenants. Secondary property types include, for example, street retail stores, mixed use, light industrial, and free-standing buildings.

Figure 1

20 Largest Metros: Price Trends for Small-cap CRE vs. Housing



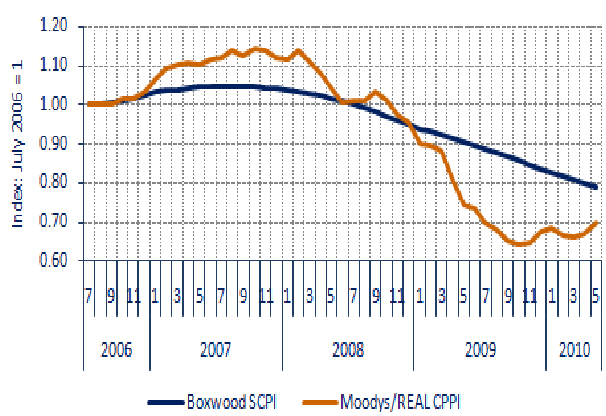
The SCPI's inclusive definition of property types reflects the CRE mortgage portfolios of many commercial banks, where non-farm, non-residential loans involving owner-occupied commercial uses account for nearly 50% of the aggregate loan balance.

RESEARCH HIGHLIGHTS

Boxwood's small CRE sales price trends are illustrated in the first three graphs along with other industry indices updated through May, 2010. Boxwood's sales price trends include the following highlights:

- ***Strong linkage between small-cap CRE markets and local economic and housing conditions***. The health of small commercial properties is tied to local economic and business conditions to a greater degree than major, institutional-grade assets which tend to be buffeted by regional-national economic and CRE market trends. Small assets are predominately purchased by local owner-users, small private investors and one-off “mom and pops”. Thus, small CRE dwells in a neighborhood-based ecology of housing, business and economic interactions. For example, small CRE sales trends are highly correlated with metro-level unemployment (r= -.46), i.e., sales prices decline as unemployment rises. There is an even stronger relationship between small-cap CRE and residential housing prices (r= .62).

Figure 2
National Price Trend Comparison



The linkage between housing and small CRE markets is illustrated in *Figure 1. T*he SCPI-20 comprising Boxwood’s large-sized markets has decreased 37.6% peak to current trough while housing prices for the S&P/Case-Shiller Index dropped by 32.6%. With the help of federal tax credit relief, housing prices have stabilized, up 4.6% over 12 months ending May. However, in the absence of stable economic growth – or government stimulus for that matter – small commercial property prices continue to decline as described further below.

- ***Small assets produce less price volatility***. The national aggregate Moody’s/REAL Commercial Property Price Index (CPPI), representing CRE sales transactions with a heavy concentration of closed sales over $5 million, plummeted 43.7% from its high-water mark in 2007. By comparison, Boxwood’s SCPI, encompassing 90 primary and secondary metros, has shed 24.7% peak to current trough. As shown in *Figure 2*, these trend lines reveal a sizable 918 basis-point spread in price depreciation as of May, and an even wider 1,900 basis-point gap from respective peak values. The spread underlines the fundamentally higher cyclical volatility of the large CRE sector comprising major, high-quality assets.

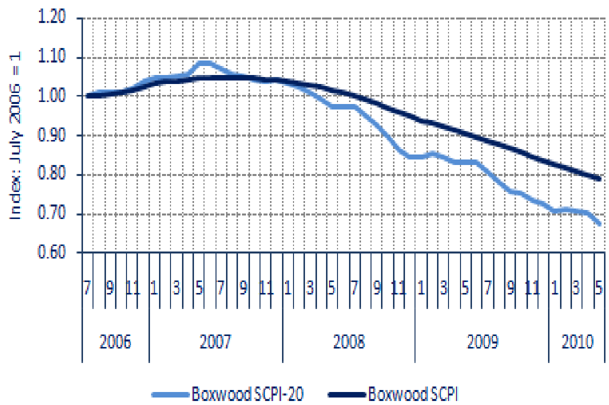
  This disparity derives in part from the former’s substantial and uneven capital flows. The variability in price trends also simply reflects the more heterogeneous profile of properties represented in Boxwood’s indices. As mentioned, Boxwood’s measures comprise primary and secondary property types involving both income-producing as well as owner-occupied buildings. The owner-occupied slice is less sensitive to the ups and downs of the CRE market cycle and more responsive to the local economy and creditors’ business performance. In the aggregate then, small CRE markets exhibit relatively more price stability.

- ***Smaller CRE markets: neither too hot nor cold***. As depicted in *Figure 3*, small-cap CRE price volatility is less severe for the aggregate U.S. compared with the 20 largest metro areas. Boxwood’s national aggregate SCPI declined 24.7% from its apex while the SCPI-20 segment lost 37.6%, or 1,290 basis points more. Furthermore, exclude the 20 largest geographical metros from the aggregate SCPI and the sales price decline for the remaining 70 markets is even less harsh: down 17.2% from peak.

This underscores the sizable performance gap between large- and small-sized CRE markets, the greater insulation from regional and national shocks that smaller metro areas enjoy and, as a result, their tendency through the cycle to demonstrate more price resilience.

Figure 3

Comparative Price Trends: Large Metros vs. Nation



- ***Performance varies widely across U.S. metros.*** We have described how prices have depreciated less for small assets compared with larger ones nationwide, as well as for smaller- versus larger-sized geographic markets. Yet, the variation in small-cap CRE price performance market-by-market is striking. The diagram of *Figure 4*, which plots 90 metro areas on sale price changes along two time periods, illustrates a positive, linear correlation: i.e., metro areas that fended off deep losses in property value from peak levels tend to have also posted modest price *gains* over the last three months (upper right quadrant); on the other hand, metros that have suffered the largest losses through the cycle also remain quite weak (lower left quadrant). Some of the most troubled areas, including Ft. Pierce, Sarasota, and Phoenix, have witnessed losses in value ranging from 40% to nearly 70% since 2007.

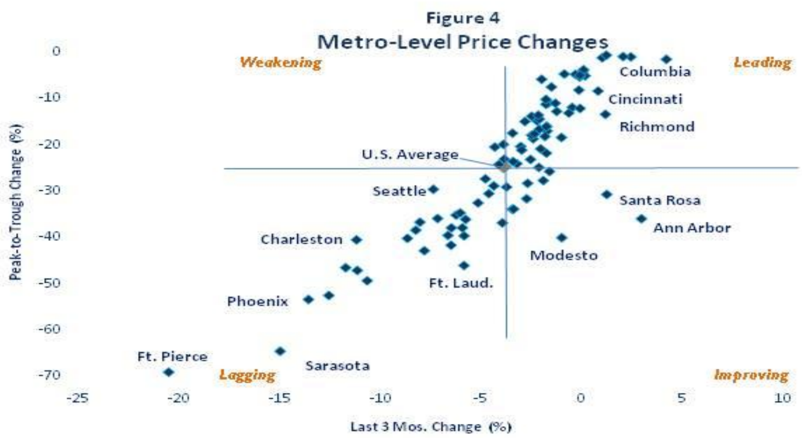
- ***Small-cap CRE prices remain vulnerable.*** The Moody's/REAL CPPI decreased only 6.3% over 12 months ending May as trophy property transactions in top markets buttressed sales prices and investor sentiment. (As of this writing, the CPPI reversed course and lost 4% in June.) Year-on-year performance in the small-cap CRE arena has yet to stabilize: indeed, the SCPI and SCPI-20 have declined sharply over this period, down 12.9% and 18.6%, respectively, including losses of 1.2% and 3.8% during May.

The persistent losses in values is troubling though not unexpected for a number of reasons including: (1) Small commercial space market fundamentals, though modestly improving according to a separate Boxwood report, still lack conviction; (2) Small firms, which tend to house or own operations in smaller facilities, still face basic challenges to obtaining credit that is often used for building expansion and investment; and (3) An increasing volume of distressed small-balance loan and property sales is exerting further downward pressure on prices.

CONCLUSIONS

Despite fundamental differences, the sales price variations between Boxwood's SCPI and Moody's/REAL CPPI indices are instructive. Our vocabulary for the U.S. commercial real estate market is needlessly one-dimensional, and leads us to characterize market performance in monolithic terms like "CRE is down 40% from the peak." Lumping small and large commercial property performance together may be necessary when quality data is lacking, but it tends to misinform the public and may compromise vital collateral valuation efforts of commercial banks and other industry participants on the front lines of appraisal, credit policy, and market risk assessment.

The fact is that there are two distinct CRE markets and, in the aggregate, the small-cap segment to date has out-performed the large-cap or major-asset sector. That being said, small commercial property markets are brittle and, with sale prices retreating at a fast clip, a floor on property values may remain elusive.



Small CRE's recent out-performance as well as its current precariousness are important considerations when we recognize that the majority of the $1.5 trillion of CRE mortgage assets in bank portfolios is composed of small-balance commercial and business real estate loans.

Thus, Boxwood's indices have a bearing on some of the pressing CRE lending issues of the moment such as: (a) calculations for projected loan losses and recoveries; (b) estimates of the size of the equity-refinance gap; (c) the overall outlook on market recovery; and (d) government policies, programs and corrective plans.

NOTES ON INDEX CONSTRUCTION

Boxwood's price indices are derived from arms-length sales transactions of small CRE properties under $5 million including primary and secondary commercial property types. Boxwood culls this data from public records which comprise the most comprehensive collection of small commercial property sales available. The transactions include distressed sales. Foreclosures and multi-family transactions are not included in Boxwood's indices.

Conventional valuation techniques warrant that nearby sales comparables be "adjusted" in order to accurately reflect a subject property's attributes. The same basic framework is followed in the construction of Boxwood's indices and is enhanced on a more sophisticated and expanded scale. Robust multivariate hedonic models are employed, metro by metro, to estimate the affects of location, vintage, property use, construction type, and other factors upon sales prices. Once estimated, these factors are then eliminated from the sales prices to produce a population of transactions that are as comparable as possible across time within each metro. This technique leverages the information from a large number of small-cap property transactions to create a population of closed sales that is reflective of the broad small CRE market and also comparable over time. Price movements are computed month by month, metro by metro, and smoothed into over-time trends. Metro trends are then aggregated to the national level.

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