Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

June 2016

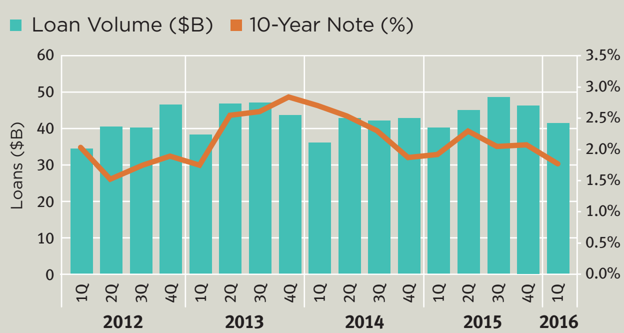
Momentum in Investment Property Sales and Prices Slows

Chalk it up to market uncertainties and/or investor fatigue, but the dynamic pace of growth in the CRE investment market has hit a speed bump.

Small Balance Originations

▸ **Solid loan growth out of the gate.** With favorable underpinnings of strong economic and real estate fundamentals, small balance loan volume totaled $41.5 billion during first quarter, down 10.8% from fourth quarter but an increase of 3.1% YOY. The gain over first quarter 2015 is noteworthy as last year produced a record $181. 3 billion of loan originations under $5 million. (See the graph below.)

SMALL BALANCE ORIGINATIONS TREND | Loans under $5MM



Source: Boxwood Means, LLC; FDIC

▸ **Smaller loans predominate.** While loans under $1 million accounted for only 30% of the total volume during first quarter (unchanged from last year), this smaller loan tier represented 72.1% of the roughly 48,200 individual deals under $5 million completed during the period. Average loan sizes for these smaller commercial and multifamily mortgages increased slightly from last year, to an average of $286,000 and $296,000 for purchase and refinance loans, respectively.

▸ **Private lenders ratchet up share.** The top 20 small balance lenders commanded 22.9% of total origination volume during first quarter, down 50 basis points YOY as competition intensified. Particularly noteworthy is the trend in private lending: Private lenders grabbed 2.0% of the market – the most on record since Boxwood began tracking small balance originations in 2005 – and as a group rose to #3 in the rankings right behind JP Morgan Chase and Wells Fargo (see the table below).

TOP SMALL BALANCE COMMERCIAL LENDERS – 1ST QUARTER 2016

Loans under $5 Million

Rank	Lender Name	Market Share	Avg. Loan Size ($)
1	JP Morgan Chase Bank	5.7%	1,361,000
2	Wells Fargo Bank	3.5%	1,067,000
3	**Private Lender**	**2.0%**	**656,000**
4	Bank of America	1.4%	1,008,000
5	Signature Bank	1.2%	1,842,000
6	US Bank	1.0%	671,000
7	NY Community Bank	1.0%	2,012,000
8	BB&T	0.9%	740,000
9	Bank of the West	0.8%	1,010,000
10	TD Bank	0.6%	987,000
11	FCB-NC	0.6%	693,000
12	M&T Bank	0.6%	1,028,000
13	Umpqua Bank	0.5%	1,302,000
14	First Republic Bank	0.5%	1,487,000
15	MUFG Union Bank	0.4%	1,713,000
16	StanCorp Mortgage	0.4%	1,773,000
17	Arbor Commercial Mortgage	0.4%	1,876,000
18	East West Bank	0.4%	1,476,000
19	BBCN Bank	0.4%	1,353,000
20	PNC Bank	0.4%	719,000
Total		22.9%	

Source: Boxwood Means, LLC

Not surprisingly, the average loan size placed by private lenders is the smallest among these 20 leaders, as these deals tend to fund more modest-sized acquisitions in secondary and tertiary markets, along with recapitalizations and interim/bridge financings.

▸ **Market fragmentation warrants second look.** While the top 75 lenders account for only 37% of the national market and leave bountiful opportunities for other lenders, the level of competition for deals at the local level is known to be fierce. Boxwood's recent **blog piece** on SmallBalance.com, "Siren Call of Small Balance Lending," quantifies how much more concentrated small balance lending happens to be among lenders at the state level and suggests that national lenders in particular be more selective in picking their markets in which to operate.

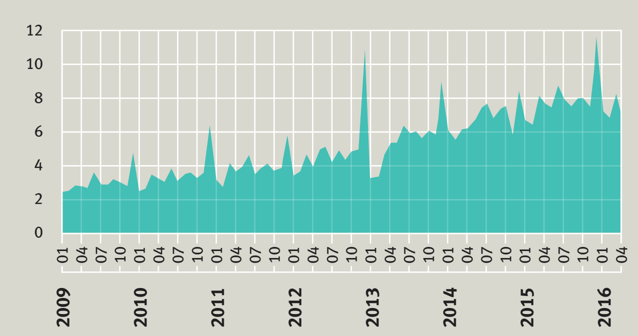
The compression in bank market share coupled with an uptick in private lending over the past two years reveals a slowly shifting landscape for conventional CRE mortgage lending. The fact is that federal regulations have increasingly raised the bar for capital risk mitigation which, in turn, is forcing commercial banks to dial back their loan appetite principally by elevating CRE underwriting standards and also by pruning loan portfolios. Since commercial banks have traditionally been predominant in the small balance lending space, any further and material retreat by banks from the market will likely have substantial rippling effects on small cap CRE borrowers and investments.

Nevertheless, the mood among the roughly 250 attendees at the Mortgage Bankers Association's inaugural Small Balance Lending conference last month was demonstrably upbeat. With early reports indicating a robust second quarter for space market fundamentals, we expect that small cap CRE rents and property income will still be rising, paving the way for solid loan origination volume during the second half of the year. We will turn to second quarter fundamentals in the next edition of this report.

Property Sales Activity

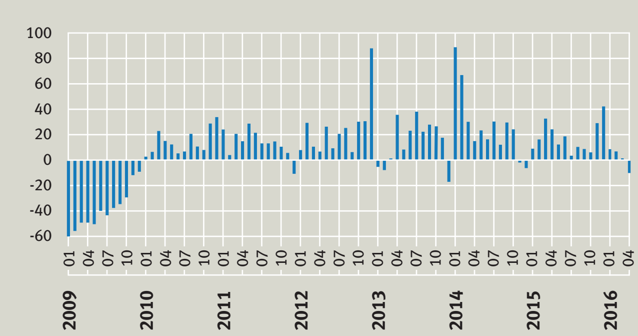
▸ **Deal volume wavers.** After first quarter's record pace, sales of commercial and multifamily assets under $5 million slowed during April. Monthly transaction volume declined 9.7% YOY to $6.9 billion on a preliminary estimate basis as the investment market may be normalizing after two record-setting years in a row. (See the graphs below.) Nevertheless, total sales of $29.5 billion through the first four months of the year are slightly ahead of last year by 1.6%.

SMALL CAP CRE SALES VOLUME TREND | Property Sales ($B)



Source: Boxwood Means, LLC

ANNUAL CHANGE IN SALES VOLUME (%)

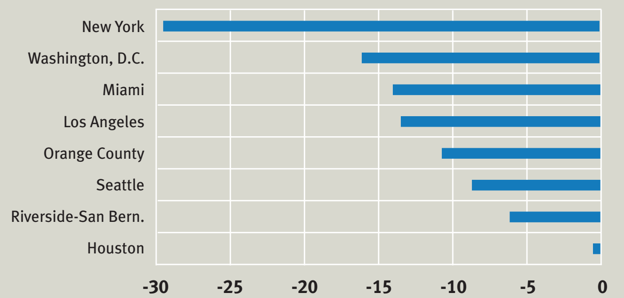


Source: Boxwood Means, LLC

▸ **Hot markets have cooled off.** Sales in some of the most active markets last year have retreated. As the nearby graph shows, YTD sales volume through April is off by sizable amounts in some major, typically high-volume metro areas compared with last year led by New York (-29.5%), Washington, DC (-16.1%), Miami (-14.0%) and Los Angeles (-13.5%). Moreover, the general slowdown among the 122 metro areas in Boxwood's sales coverage as noted last month also persists: i.e., our Advance-Decline Ratio, as illustrated in the nearby graph, indicates that a greater proportion of cities have witnessed YOY sales decreases, dropping to the lowest level in two years. Specifically, only 55 markets posted YOY sales gains during April, down from 66 last month and 99 from 12 months earlier.

METRO AREAS WITH LARGEST YTD SALES DECLINES (%)

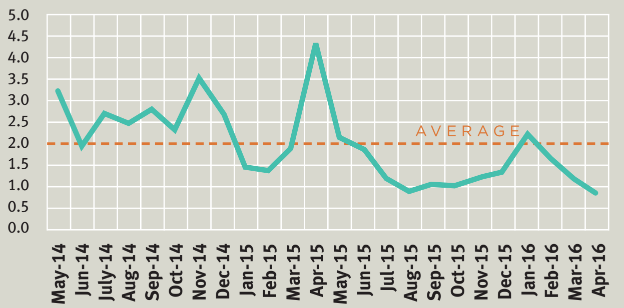
Minimum Total Sales of 400MM



Source: Boxwood Means, LLC

ADVANCE-DECLINE RATIO

YOY Sales Activity for 122 Metros



Source: Boxwood Means, LLC

▶ **Large cap sales suffer, but only by comparison.** The headline isn't good news as sales of significant properties greater than $2.5 million in value declined 34.0% YOY to $21.9 billion during April according to data from Real Capital Analytics (RCA). Moreover, sales were off 21.3% over the first four months of 2016 compared with last year. Yet as noted last time, this year's institutional sales activity is compromised by reference to 2015 when RCA reported that megadeal volume peaked during first quarter and aggregate sales for the year represented the second highest transaction volume since at least 2001. So while this year's sales have softened with declines in both portfolio/entity and single-asset deals, the fact remains that activity through April of this year, totaling $134.9 billion, is still the third highest level in RCA's historical series.

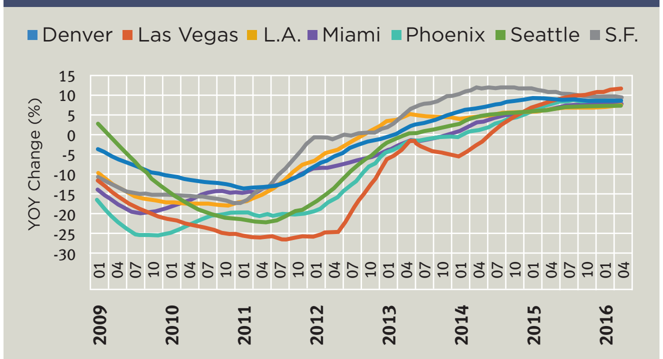
Reference points aside, large and small cap CRE sales have clearly softened, and the only question is whether the pullback will accelerate as the year proceeds. The weaker trend may be more likely on the institutional side, where the investment sales market faces more asset price resistance than the smaller domain as well as greater financing hurdles related to volatility of CMBS pricing. Even so, U.S. CRE markets continue to be a safe haven for global capital and these inflows may offset to a degree the slowing domestic appetite for institutional CRE assets. Small cap CRE buyers face fewer headwinds and asset prices lingering below peak, but they are not oblivious either to the uncertainties and yellow caution flags flying over the general investment market.

Sales Prices

▶ **Prices stay flat.** Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities was unchanged in April on a preliminary estimate basis with only slight YTD gains of 0.3%. The annualized 2.9% return is only one-half the rate of appreciation posted 12 months ago and continues a string of six consecutive months of slowing annualized price increases. It's likely that the pullback in investment sales activity is a primary driver behind the stalled national prices but, as mentioned below, slowly normalizing property values in frontrunner cities is also a contributing factor.

▶ **Primary cities fare a bit better.** Boxwood's index for the top six U.S. population centers is still gaining ground, though also at a decelerating rate. SCPI-6 rose 0.4% preliminarily in April to produce a 1.5% YTD gain and a respectable 4.1% increase over 12 months led by Phoenix (9.0%) and L.A. (7.3%). Yet SCPI-6's annualized increase has eased from 6.5% in April of last year and from over 9% annualized during the second-half of 2014, as softer sales are taking a toll in these biggest of cities as well. The nearby graph illustrates the slowing price trend among selected bigger cities, including a couple of conventional boom-bust towns where prices have drifted below double-digit price gains attained earlier. Note in particular that Las Vegas, a visible member of the boom-bust cadre, leads with a 11.8% gain over 12 months (though Sin City also claims the dubious distinction of fielding current prices that are 58.5% below its former pre-recession peak level – the deepest spread among primary and larger secondary markets.)

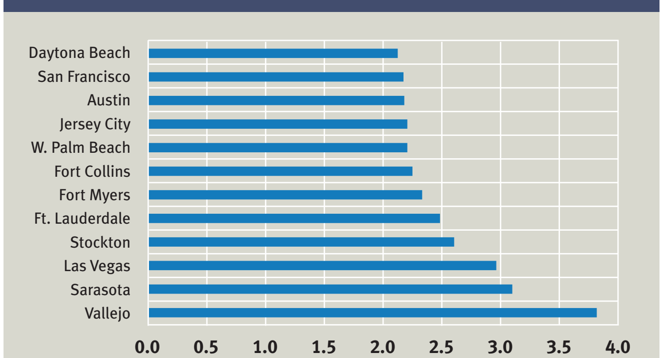
SLOWING PRICE GROWTH IN SELECTED LARGER CITIES



Source: Boxwood Means, Inc.

▸ **Florida markets are still playing catch up.** Of course, some big variations in price growth persist, especially of late. For example, 35 metro areas recorded healthy price gains of 1.5% or more over the most recent three-month period, and prices advanced generally in 109 of the 127 total markets in the same period. As shown in the graph nearby, Florida commands five of the top performers led by outsized gains in Sarasota (3.1%) and Ft. Lauderdale (2.5%).

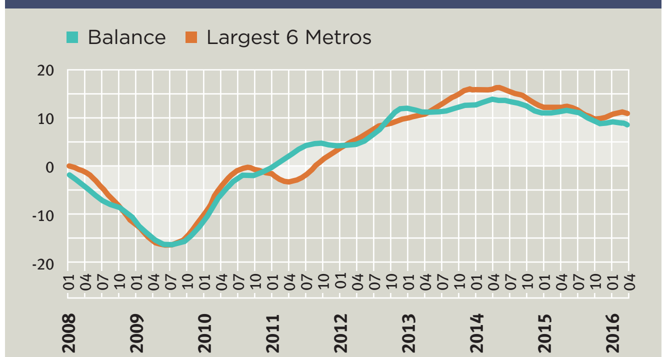
PRICE MOMENTUM LEADERS | Three-Month Gain (%)



Source: Boxwood Means, LLC

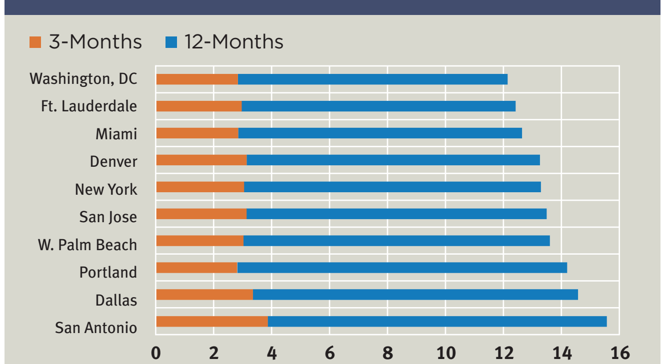
▸ **Multifamily prices outperform.** Multifamily investments continue to generate the best returns with gains of 0.7% and 2.9% for April and YTD, respectively, on a preliminary estimate basis according to Boxwood's Small Multifamily Price Index for 48 markets. Here, too though, a slowdown is evident as the 8.0% annualized return is 280 basis points lower than the yield 12 months earlier and down from nearly 16% annual gains in the corresponding period two years ago (see the nearby graph). However, powerful demographic and economic forces along with steadfast debt support from Agency lenders keep investor demand and prices elevated. As a result, prices in 45 of the 48 small cap multifamily markets advanced over 12 months led by hefty gains in San Antonio (15.6%), Dallas (14.6%) and Portland (14.2%), among others (see the nearby graph).

MULTIFAMILY PRICE TREND COMPARISON | Annual Change (%)



Source: Boxwood Means, LLC

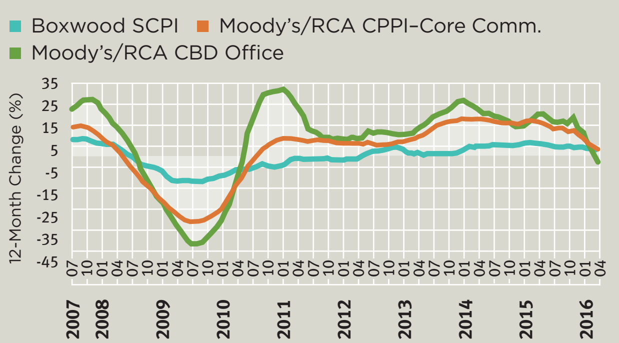
TOP 15 MULTIFAMILY PRICE LEADERS (%)



Source: Boxwood Means, LLC

▸ **Prices peel back for large cap commercial.** We've been saying for months that institutional CRE prices were normalizing at best and correcting at worst, and recent trends only buttress that contention. The Core Commercial (CC) component of Moody's/RCA CPPI (that excludes multifamily and tracks sales transactions of investment-grade properties principally above $2.5 million) declined for the fifth consecutive month. The CC Index dipped 0.4% in April, and though YTD losses amount to only 2.0%, the annualized return has plummeted to 3.0% from percentage annual gains in the mid-teens from 12 months earlier. Moody's reported that losses in the core commercial segment have been largely tied to softening prices in the CBD Office segment that have skidded 6.8% over just the last three months. (See the nearby graph for a comparison of rolling 12-month returns for CBD Office, and large and small cap prices.)

PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Moody's

The price vicissitudes of the CBD Office segment, annualized gains for which conspicuously turned negative in April (-3.0%) for the first time in six years, and have fallen from 20.0% just 12 months ago, underscore not only the advanced state of the price appreciation cycle but also fatigue among institutional investors for chasing a diminishing pool of trophy assets at often challenging (i.e., lower) yields. Clearly, too, challenges within the CMBS market (e.g., volatile pricing and upcoming risk-retention rules) play a role here. The lingering question is not whether institutional commercial prices will decline further but only at what speed. For their part, small cap CRE investors are not facing an asset pricing bubble and, if history is any guide, any correction in the large cap sector will be relatively muted in the small cap domain. We don't see any hazardous market conditions on the near horizon, but it may still be prudent for small balance lenders and investors to consider the historical price volatility of specific metro areas when it comes to setting LTVs, cap rates or expected asset price appreciation on current deals.

Note to Readers: Boxwood's reported sale price indices are preliminary estimates based on sales transactions received from county assessor offices for the latest available month. As a result of lags in sales transaction reporting, both current month sales volume and price estimates are subject to modest revision in the subsequent three periods.

Boxwood deems that our data sources are reliable. Some areas of the country offer more complete information than others. This report is presented on an "as is, as available" basis. Boxwood makes no warranties, expressed or implied, without limitation, to the information provided, nor are we responsible for any errors or omissions.

Boxwood Means, LLC is a leading national provider of property valuations and data analytics in the small commercial property and loan markets. Boxwood owns and operates SmallBalance.com, where commercial banks, non-bank lenders and investors find technology-driven solutions for their investment and risk management needs including appraisals, commercial evaluations, CRE price indices and market research.