Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

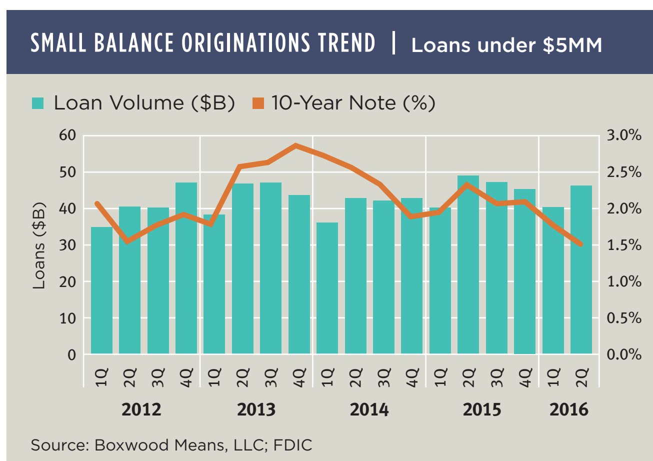
September 2016

Investment Domains Begin to Bifurcate Sales volume dropped in July for both large and small cap CRE domains, but the similarities end there. Transaction activity in the large cap arena is in a prolonged drought abetted by unstable asset prices. Small cap trends have been more favorable.

Small Balance Originations

▸ **Rock-bottom rates boost originations.** Loan production accelerated during the second quarter as the 10-year Treasury note dropped to 1.47% at the end of June, its lowest level in four years. Loan originations under $5 million totaled $46.4 billion, a robust gain of 15.4% from the previous quarter (see the nearby graph). The SBL market's vigor is apparent: e.g., mid-year total originations of $86.6 billion are only 2.9% behind the record-setting pace of last year. Meanwhile, the Mortgage Bankers Association reported that total commercial and multifamily debt outstanding grew 6.8% YOY and is on target to exceed its 2008 peak by the end of third quarter.

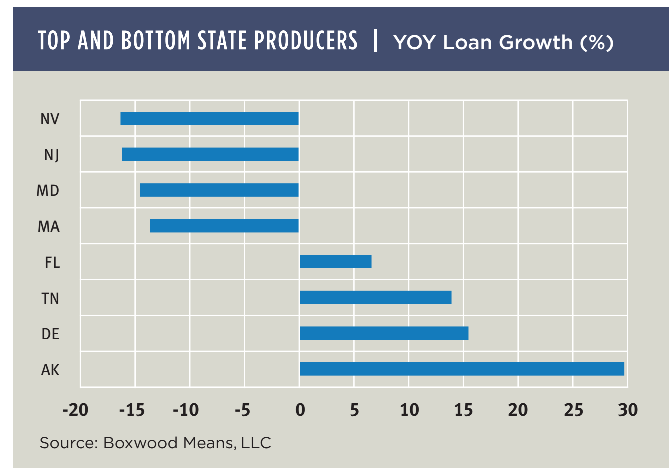
SMALL BALANCE ORIGINATIONS TREND | Loans under $5MM



Source: Boxwood Means, LLC; FDIC

▸ **Loan growth slowed for a majority of states.** Overall, total loan volume dipped 5.0% in the second quarter compared with the same period last year. Among the 37 states for which Boxwood tracks originations, 12 posted positive loan growth YOY while volume shrunk for the balance of states. As shown in the nearby graph, the top performers over 12 months included Alaska (29.8%), Delaware (15.6%) and Tennessee (14.0%), and the biggest losers were Nevada (-16.4%), New Jersey (-16.2%) and Maryland (-14.6%).

TOP AND BOTTOM STATE PRODUCERS | YOY Loan Growth (%)



Source: Boxwood Means, LLC

▸ **Banks hold their ground.** Despite increasing regulatory and compliance pressures, commercial banks produced a strong quarter of loan activity. The top 20 lenders – 19 of which were banks – accounted for 23.0% of total 2Q origination volume, up 10 basis points sequentially and

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led by JP Morgan Chase with a market share of 6.5% and followed by Wells Fargo (3.2%), and Private Lenders and Bank of America (1.5%). Notably, Private Lender share narrowed by 50 basis points as overall competition stiffened.

▸ **The sweet spot remains loans below $1 million.** The needs of private buyers and small business real estate owners for smaller loans is always the key driver of this loan space. While loans under $1 million contributed only 29.4% of total dollar volume during the latest quarter, this small loan tier accounted for a sizable 71.3% of the roughly 53,000 individual deals under $5 million. This total number of smaller loans represents a 9% gain over first quarter and underscores the sustained demand by borrowers with modest-sized property acquisition and recapitalization needs. To wit, the average loan size of $660,000 produced by Private Lenders is nearly one-half the average size of $1.3 million for the other 19 leading lenders.

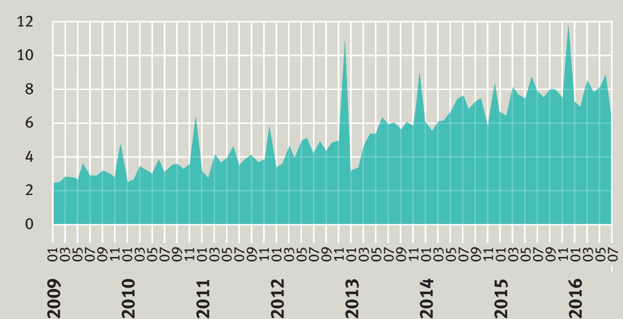
Small balance lenders, brokers and investors have every reason to be upbeat as vigorous CRE space market conditions remain buoyed by the modest pace of growth in the U.S. economy. While improved labor markets, personal income growth and business investment have again turned the conversation towards an increase in the federal funds rate towards year end, a modest increase in interest rates is unlikely to deter most borrowers who enjoy low loan coupons and still-rising property incomes. Banks' strong lending activity and stable market share during second quarter is encouraging given growing industry concerns over a pullback due to reported tightening in underwriting standards and greater regulatory intervention. In fact, a majority of banks remain optimistic about loan demand going forward, especially regarding CRE loan growth, according to a recent survey of 200+ institutions by Promontory Financial. That being said, banks are showing restraint and seem to be heading into a credit tightening cycle at this late stage of the market expansion. That will help keep the market from further over-heating and will also likely shift some of the loan demand further towards non-banks, specialty finance and marketplace lenders.

For additional national small balance loan statistics and trends, see our 2Q Small Balance Originations Brief **here**.

Property Sales Activity

▸ **Sales take a dive.** Investment sales of commercial and multifamily assets under $5 million plummeted in July as investors seemingly took stock of the heated pace of acquisition activity during the first half of the year. July's preliminary sales total estimate of $6.1 billion declined a sizable 32.3% from June and 24.2% YOY (see the nearby graphs). Even with an expected bump of roughly ½ billion dollars with the revision next month, the July drop-off will still be notable as monthly sales volume hasn't fallen below $7 billion for 17 consecutive months. Though a seasonal pattern of July doldrums isn't apparent from the long-term trend, sales in July 2015 – which increased at the lowest monthly rate for the entire year – may offer a clue. Despite the slowdown, total deal volume of $46.7 billion through July is level with 2015's record pace.

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



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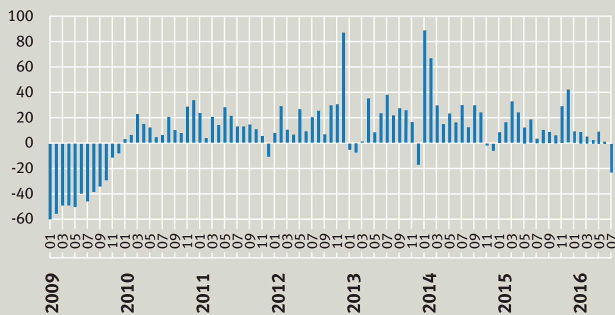
ANNUAL CHANGE IN SALES VOLUME (%)

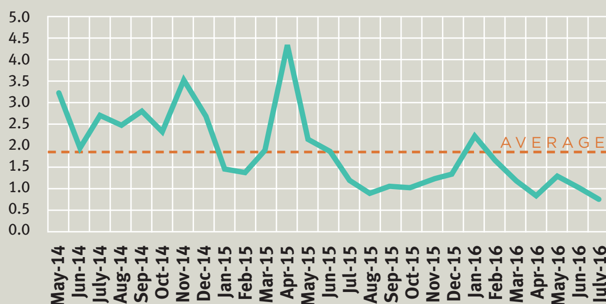


Source: Boxwood Means, LLC

▶ **Metro sales may be topping out in leading cities.** While the headline U.S. sales figure remains high, many metro areas seem to be running low on fuel to stay aloft. As shown in Boxwood's Advance-Decline Ratio graph nearby, the number of cities with persisting YOY sales increases has slowed considerably compared against the two-year average. Only 51 of the 122 markets posted YOY sales gains during July, down from 84 in January and 66 from a year earlier. Sales in the six largest population centers dropped 16.4% YOY with substantial pullbacks in Chicago (-37.6%) New York (-20.9%) and Philadelphia (-18.4%). The balance of 116 markets eased by only 3.3%. The year-to-date figures

ADVANCE-DECLINE RATIO

YOY Sales Activity for 122 Metros



Source: Boxwood Means, LLC

tell a similar story: 66 cities recorded sales gains over the first seven months of the year versus last year, down from 73 in June and 88 during the previous July. Granted, 2015 is a tough comparison year with its record sales of $96 billion. But these latest figures reveal that sales have cooled off in a host of former frontrunner cities such as San Francisco (-28.8% YOY), San Jose (-26.4%), New York (-22.8%) and Jacksonville (-19.2%) and may be signaling more than just a mid-year hiatus. Instead, perhaps it's a cautionary flag that small cap investors are growing less enthusiastic about chasing declining yields in over-heated markets.

▶ **Large cap investment activity downshifts further.** Transaction volume in the large cap arena of significant properties greater than $2.5 million also fell considerably during July. Sales volume totaled $30.1 billion according to Real Capital Analytics (RCA), down 32.4% from June and 25.0% YOY. Cumulative annual sales through July totaled $254.3 billion, a decline of 15.4% compared with the same period last year as portfolio and entity-related deals plummeted 38.4%. The silver lining is that single-asset deals that accounted for 76.2% of the total dollar volume year to date are off by only 4.1%. RCA noted that investors are generally showing more caution in their acquisition activity, leaning heavily towards the relative market stability of core markets rather than smaller cities. RCA also suggested that the recent lull in deal activity is unassociated with elevated asset prices, reporting that the cap rate spread to mortgage rates, currently at 327 basis points, is far wider than the long-term average, also wider than during the last peak period and, as a result, provides ample cushion for eventual rate increases.

It's too early to know if the investment sales market has peaked, particularly in the large cap arena. The fact that megadeals are down substantially might suggest that

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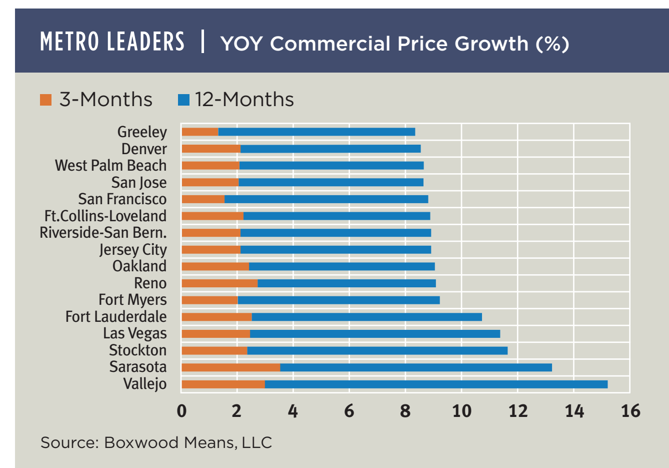
the smart money is less confident about the direction of the current CRE and economic cycles. Also, large cap property prices that dipped earlier this year have recently reclaimed a new high (see below) and, though cap rates are steady, few would suggest today that institutional assets are a bargain. But while many industry participants lament that the ballgame is in its late innings or the market is "long in the tooth," bull markets don't just die of old age as they say on Wall Street. A period of greater selectivity and elevated risk management among lenders and investors is upon us, but the investment sales market is unlikely to suffer terribly as long as core fundamentals remain strong.

Sales Prices

▸ **Prices edge higher.** Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities rose 0.3% in July on a preliminary estimate basis for the third month in a row. Asset values are up 3.0% YOY. With prices having increased steadily, if modestly for 41 consecutive months, the Index has recovered to its December, 2008 level and is only 7.6% below its former peak of late 2007.

▸ **Sunbelt cities extend their lead.** Metro areas in Florida, Nevada, and California have outperformed in lockstep with their late-recovering, but now booming economies. As shown in the nearby graph, cities with the best 12-month returns begin with Vallejo-Fairfield-Napa (15.2%), Sarasota (13.2%), Stockton (11.7%) and Las Vegas (11.4%) and also encompass other Sunbelt locations. Despite these impressive price recoveries, which range between 25-40% from their respective troughs, readers of this publication know that asset values in most of these markets remain substantially below their former peak levels. And while current prices in places like Reno, For Myers and Sarasota among others may appear attractive relative to the former boom period, it's important that small balance lenders and investors make reasonable assumptions about pro forma rent growth and terminal values because the odds are very good that asset values during the present market expansion will top out well below their former 2007 peak. Overall, 112 of the 127 markets posted YOY price gains in a broad display of market strengthening.



▸ **League of their own: Multifamily.** Small cap multi-family prices powered forward during July rising a robust 0.9% and 9.2% YOY on a preliminary basis as debt capital continued to flow freely to investors in small affordable rental housing projects. Low home ownership rates due in part to low affordability, low single-family inventories and changing housing preferences among other factors have driven rental vacancies way down and rents straight up – music to the ears of small balance lenders and investors who also find that competitive supply tilts heavily towards luxury apartment projects and not affordable ones. As shown in the nearby graph, asset prices in the six largest population centers accelerated even further, increasing a heady 1.6% in July and 12.8% from a year earlier. Boxwood's Small Multi-family Price Index for 48 markets has recovered 197.7% from its September, 2010 trough and hovers 25.1% above its previous 2006 peak.

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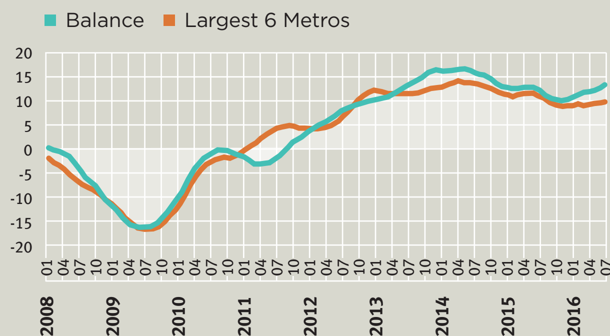
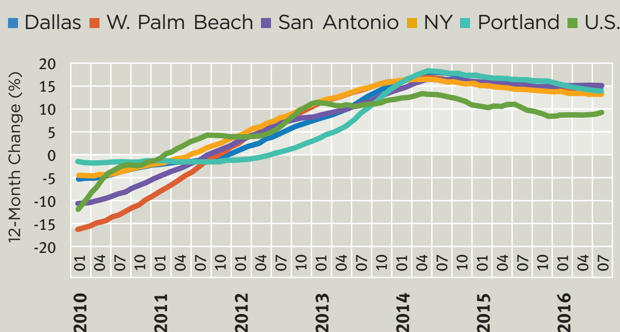
MULTIFAMILY PRICE TREND COMPARISON | Annual Change (%)



Source: Boxwood Means, LLC

▶ **Diverse group posts outsized multifamily gains.** The multifamily price surge is broad-based as asset values in 42 of 48 small cap multifamily markets advanced on an annualized basis during July. Moreover, a sizable number – 16 cities – have been on fire with annual returns exceeding 10% and led by San Antonio (15.0%), Dallas (14.7%), West Palm Beach (14.1%), Portland (13.3%) and New York (13.1%). This subset of markets also averages a (former) peak-to-current change of 32.9% that underscores the outperformance of this group compared with the balance of markets. See the graph below.

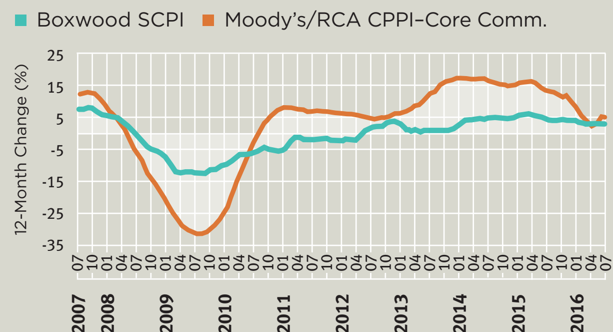
MULTIFAMILY MARKETS WITH HIGHEST YOY RETURNS



Source: Boxwood Means, Inc.

▶ **Large cap prices stay volatile.** 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) rose 0.5% in July to the highest level since the Index's origin in 2001. The CC Index is now 9.8% above its late 2007 peak. However, as shown in the nearby graph, commercial asset prices have been somewhat erratic of late as many institutional investors, facing peak prices, having curtailed their appetite for subprime markets and riskier types of CRE assets. In fact, the CC's 12-month return of 5.3% is roughly half the annualized rate from last December and has increased by only 1.7% through July as both CBD and suburban office property prices have declined nationwide. The industrial sector is the only sector to materially bolster the CC Index with a 10.0% YOY gain.

PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Moody's

The recent price volatility for large cap CRE assets is a bit concerning. Investors are recalibrating their expectations for future income streams in a looming era of increasing interest rates and also find it increasingly challenging to acquire assets at reasonable entry points. Core fundamentals have been rock-solid to date, but the market's long-lived expansion now comes with some uncertainties, likely clipping deal activity and

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causing some rotation in the types of asset acquisitions. In particular, changes in the dynamics of the large cap multifamily sector loom: i.e., as research provider Reis, Inc. and others recently reported, national multifamily rent growth has slowed for a number of quarters and, in some expensive cities, rents have actually slipped as new luxury apartments have flooded many CBD locations.

That being said, we see no short-term, negative spillover effect on the small cap multifamily sector since supply and demand of affordable rental housing appear to be better balanced. In addition, with small cap commercial prices showing sustained durability and growth, any possible connection between lower transaction activity and asset prices is clearly less pronounced.

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.

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