Favorable Expectations For 2014 Voiced By Experts In First Survey

SMALL BALANCE COMMERCIAL MARKET OUTLOOK | February 2014

Overview

After generating robust small-balance loan volume last year at historically low interest rates, the question arises as to how the small commercial lending landscape is shaping up for 2014. An inaugural survey by Boxwood Means declares: notwithstanding all-too-real prospects of rising interest rates, look for another strong year.

While some are more optimistic than others, on average the small-balance commercial (SBC) finance professionals participating in Boxwood Means' first annual Small Balance Commercial Market Outlook survey expect 2014 originations volume for loans under $5 million to end up pretty close to last year's total, preliminarily estimated by Boxwood at $160 billion. The mean originations estimate came in a bit under $155 billion, trailing 2012 and 2013 volumes only slightly – and in fact still within striking distance of 2006's peak of $166 billion.

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Meanwhile even if higher rates end up cutting into potential SBC loan refinance activity, the consensus among most survey participants is that small-cap investment sales activity appears destined to increase – perhaps even by double-digits.

And many are expecting small-cap property price appreciation to generally outpace 2013's modest gains – even with the more dour respondents projecting stable pricing. Nor does there appear to be much sentiment that rising interest rates will nudge small-cap investment capitalization rates upward – at least not this year.

Boxwood conducted the 2014 survey among a select number of SBC senior executives during the New Year's first couple of weeks. Questions touched on: expected SBC national originations volume; refinance-driven to purchase-mortgage ratios; movement in mortgage rates and loan-to-value ratios; the roster of active SBC lenders; property values and cap rates; preferences by property type; and activity in secondary and tertiary markets.

The survey results are described in two sections below. A discussion about SBC originations comes first followed by the topic of property sales and prices.

Originations Steady Amid Likely Higher Rates

As Janet Yellen takes over the Federal Reserve chairmanship from Ben Bernanke, survey participants appear all-too aware that interest rates will be the key wild card – especially for refinance activity in the SBC space. Roughly half the respondents expect small-balance mortgage coupon rates to rise 50 basis points or more during 2014 – with pretty much all the others anticipating more moderate increases.

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Many acknowledge that refinance activity – which accounted for more than three-fourths of SBC originations last year according to Boxwood's research – is more threatened by higher rates than new purchase-mortgage originations. But the extent to which ever-improving space market fundamentals might compensate for declines in refis, through heftier investment funding, is a matter of debate.

"A material increase in rates will cause the refinance markets to slow down," cautions Steve Skolnik, CEO of ReadyCap Commercial LLC. In fact Skolnik wouldn't be surprised if SBC originations fall a full 20 percent, to the neighborhood of $120 billion.

But again given the survey's average estimate that volume will likely end up within 5 percent of last year's originations, or roughly $160 billion, Skolnik's pessimism appears to be a minority sentiment. Indeed participant projections ranged up to $175 billion.

President/CEO Keith Van Arsdale at BMC Capital LP considers pending maturities and investment opportunities – and projects increases in both refinance-driven and purchase-based SBC originations.

"Based on the data we have, maturing loans in 2014 loans will be beyond 2013 levels by 25 to 35 percent," Van Arsdale specifies. He also notes that even some owners not facing maturities may well "get off the fence" and try to lock in attractive rates if debt costs head north.

But likewise Van Arsdale acknowledges that were SBC mortgage rates to rise by 100 basis points or more, demand for small-balance debt would be less robust than if the marketplace maintains prevailing rates.

Participants expressed particular optimism about growth in purchase-mortgage originations. They note that improving market fundamentals are attracting more investor capital along with a deeper and broader base of lenders willing to fund transactions – including additional non-bank private lenders joining commercial banks, select life companies, some of the Wall Street CMBS conduits and (in the apartment sector) the government-sponsored enterprises.

Indeed a lot of owners that have stabilized previously struggling assets are now looking for profitable exits – and the increasingly competitive SBC purchase-lending arena will produce plenty of debt-backed buyers looking to build (and rebuild) portfolios, relates Gary Bechtel, chief lending officer with credit union lending agent Business Partners LLC.

Van Arsdale and others note that commercial banks returning to financial health are becoming more comfortable financing new small-cap investment transactions. Others suggest that lenders most willing to offering forward rate locks in a rising-rate environment – namely life companies – would logically attract plenty of business if rates do move up.

But as Centerline Capital managing director (and small-loan official) Rick Warren points out, questions remain about how new Volcker Rule interpretations and BASEL III regulations will impact banks' SBC lending activities.

Warren also noted, as others did, the entry (or re-entry) of new, mostly non-bank lenders into the SBC lending space. "Small-balance commercial lending is still an under-served space and an inefficient and fragmented market that is catching the attention of numerous organizations."

One key question in Warren's mind going into the New Year is whether most of new and returning non-bank participants will pursue higher margins by funding "non-bankable" transactions, or look to go head-to-head with banks on more standard lending opportunities.

Amid the expected heightened competition for deals, some survey respondents think certain lenders will become more aggressive with leverage limits – although those expecting more of the same outnumber those anticipating considerable boosts to allowed LTV ratios.

Van Arsdale is in the latter camp, anticipating that many lenders financing purchases will offer proceeds factoring to 80 percent of value. But most others suggest proceeds will continue maxing out closer to 70 percent.

Investment Sales, Property Values Looking Up

Even if higher mortgage rates do end up cutting into some potential refinance activity, the majority of survey participants expect small-cap investors to follow up a brisk 2013 with even more investment activity over the coming year. A sizable portion of the experts even see sales increasing as much as 10 percent or more beyond last year's roughly $70 billion in transactions – which would approximate 2013's growth rate over the previous year's $62 billion.

Those anticipating flat sales activity are clearly in the minority – and that holds for investment in lower-leverage/higher-cap-rate secondary and tertiary markets along with heavily competitive top-tier metros.

The respondents appear similarly optimistic about dynamics in small-cap property values over the course of 2014. With the retail property sector expected to lead the way, some are projecting average price gains well into double-digits – spurred by even lower cap rates along with operating-income improvements.

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After all, it's the improving general economy that has convinced the U.S. central bank to allow long-term rates to begin fluctuating by reducing the amount of its monthly bond purchases. Hence the expectation that improvements in property-level incomes, due to strengthening tenant demand, should continue boosting sales prices this year. [See Boxwood's January edition of the *Small Balance Advocate* report for a separate discussion about the impact of recent small-cap market fundamentals on prices.]

While a minority of cautious participants believe small-cap commercial and apartment property values are more likely to remain flat than book any gains this year, predictions of value declines were pretty much non-existent. The more optimistic foresee non-residential commercial prices gaining as much as 15 percent, with projected apartment gains topping out at 10 percent.

The average predicted price increase is in the mid-single-digits for non-residential commercial properties, with low-single-digits for apartments. For context, national small-cap prices for commercial (non-residential) assets under $5 million had cumulatively increased only 3.1% through November of 2013 according to Boxwood.

And the apparent consensus among survey participants is that any hikes in market interest rates this year are unlikely to put upward pressure on cap rates. On the contrary, the most pessimistic among the respondents expect prevailing cap rates to hold firm, with the majority projecting that caps on non-residential small-cap trades will decline 20 to 25 basis points.

Respondents are generally less optimistic about cap rate reduction in the small-cap apartment sector, with a majority expecting no change ahead. No doubt this prognosis reflects some concern or restraint about an apartment market that has experienced intense investor demand and price appreciation over the last several years. But at least a few are still bullish on the thriving category, with the most dramatic predictions indicating apartment caps will fall as much as 50 basis points.

That being said, survey participants ranked the retail property sector as the clear favorite for posting the strongest price appreciation this year. This may well turn out to be prophetic since space market fundamentals for small-cap retail properties, which have trailed the other major property types during the recovery, are beginning to perk up according to Boxwood's research. Small-cap office and industrial properties follow about neck and neck, with apartments again generally trailing the pack.

Even retail properties requiring some value-adding improvements should attract a lot of investor interest among optimistic opportunists this year, Van Arsdale observes. Bridge-type lenders are offering attractive financing programs for decently located (if financially struggling) small centers, augmenting the number of likely bidders, he adds.

He and others also point to net-leased retail properties as a preferred property profile among a lot of private real estate investors looking for relatively no-fuss and bond-like investment yields.

A large segment of respondents also identified self-storage as a small-cap income-property category likely to be in strong favor among real estate investors in 2014. As Warren notes, availability of debt financing for this niche should attract more and more equity into mini-warehouse properties.

Other specialty categories garnering some mention include hospitality and manufactured-housing.

Participants also generally agree that an increasingly competitive SBC lending environment should generate more quotes – and in turn somewhat higher transaction volume generally – in secondary (especially) and tertiary markets in 2014. Still, borrowers will logically need more cash equity than were they to pursue comparable investments in the significantly more liquid major metros.

Given the general direction of the economy and market fundamentals, Van Arsdale for one expects modest investment growth in non-premier markets. Of course second-tier markets demonstrating the strongest employment and population growth will logically see the most investment activity, he and others point out.

Several respondents appear particularly bullish about activity in the secondary markets of the Southeast and Southwest regions – including Van Arsdale's booming home state (Texas), along with Arizona, Nevada, Georgia and Florida. And Skolnik for his part sees the most promising "rebound"-related opportunities spawning transaction growth in mostly Midwest "Rust Belt" secondary markets.

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Nevertheless investors scouting around the riskier tertiary markets are bound to encounter lender "reluctance" to fund transactions, and will consequently need lots of cash to close deals, as Van Arsdale puts it. But while that paucity of financing options is bound to limit small-cap investment volume in these cities, it can also translate into some favorable going-in investment yields for those willing to take the risk.

Postscript

Boxwood expresses its gratitude to all of the finance professionals who participated in this survey, some of whom agreed to allow their comments to be on the record while others requested anonymity.

The survey included less than 20 closed- and open-ended questions that participants completed using a fillable PDF form. We welcome readers to nominate qualified participants for next year's survey. You can submit names at Info@Boxwoodmeans.com.

To receive notification of next year's report on survey findings, or to keep abreast of Boxwood's small commercial property and loan research on a monthly basis via our *Small Balance Advocate* report, sign up for the SmallBalance.com newsletter here.

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