

RESEARCHING THE RIGHT STUFF

Guiding Principles for Analyzing Small Commercial Properties

CRE research supports numerous investment decisions about a commercial real estate loan as it passes through various life stages. Market data reduces the friction along these decision points as well as in the loan's transfer from one lender department to another.

With multiple views of the loan over time, it makes sense that lenders and analysts should exercise caution in applying market data – or researching the right stuff – when it comes to decisions about small-balance loan collateral and markets. In gathering and employing various data sources, we believe two issues or guiding principles come into play: Relevancy and Restraint.



Principle #1: Relevancy

Market data is relevant when it's a good fit for the subject property. Relevance has two requirements: (a) that the performance attributes of the subject property conform to the characteristics of the market at large; and (b) that the physical characteristics, type and class of the subject property are clearly reflected in the composition of the market's building stock. Put another way, the analyst who can confirm that the subject property is *competitive* with the majority of buildings sourced by the market data increases the reliability of his/her conclusions about collateral valuation and the market segment's performance.

This task is easier with large commercial properties, e.g., over 50,000 square feet in size or above \$10 million in value. These assets comprise the typical building stock and "market" tracked by CRE data vendors. By contrast, the smaller, non-institutional grade properties – despite their numerical dominance across the U.S. landscape – languish under the radar screen of most vendor market surveys. As a result, researchers often get 'tripped up by typology' and end up mixing the proverbial apples with oranges when conducting market data assessments for small-balance commercial loan collateral.

Rent Example

Here's an illustration that highlights the challenges and potential risk in market assessment. Let's say the analyst is seeking office rents in Dallas in order to underwrite net operating income for a small-cap office property. One source, Grubb & Ellis, a respected brokerage firm that publishes its market research on the Internet, reported that Dallas rents in the third quarter of 2010 averaged \$23.17 psf and \$17.85 psf for Class A and Class B office properties, respectively. Is the analyst's task complete? Well,

with Boxwood's specific small-cap office rents at \$14.43 psf in Dallas during the same time period, employing Grubb & Ellis' general market numbers would inflate rents by roughly \$3-\$9 psf depending on which building class was chosen. Layer on differences between the sources regarding recent historical rent trends that often support pro forma rent growth assumptions, and the error or risk is only further magnified.

Vacancy Rate Example

In addition, published market vacancy figures introduce similar problems. Vacancy rates are the market's total vacant stock (square footage) as a percentage of total building inventory. That ratio immediately introduces a couple of methodological hazards because, as suggested above, vendor surveys don't cover the entire building stock, and their results also tend to be biased towards the larger buildings.

With this in mind, Grubb & Ellis pegs 3Q Dallas office vacancy at 23.2%. Is this a good number to use for our hypothetical small-cap office property? That's unlikely given the above caveats. Instead, we have an alternative Dallas vacancy figure: i.e., 15.3%. It's not property-type specific; in fact, this statistic is a composite vacancy rate of all Dallas commercial properties. More specifically, Boxwood's vacancy rate tracks all commercial business addresses that have been vacant for 90+ days, down to the neighborhood level.

Why might Boxwood's vacancy rate be relevant – or, for that matter, a better vacancy statistic – than conventional property-specific ones? As mentioned, small-cap vacancies aren't typically represented or captured by mainstream data sources. But here's a more affirmative answer: Roughly 70% of the 25 million business addresses nationwide reflected in our database relate to firms with 20 or fewer employees. The lion's share of these small firms, in turn, typically inhabits small multi-tenant and owner-occupied buildings. By tracking the vacancies primarily of these small businesses then, we assert that our business vacancy figure captures an important, if not more relevant dimension of small-cap market leasing conditions.

Principle #2: Restraint

The second guiding principle for CRE research is one of restraint. Our instinct is often to gather as much market information as possible based on the presumption that more is better. But in addition to the litmus test of relevancy discussed above, the market data must have a direct bearing on decision-making whether related to loan investments, sales prices, etc. Restraint is thus a form of analyst discipline to compile only the data points that have an impact on the current and prospective performance of the subject asset and its immediate environment. Anything more is simply overkill.

A classic example of overkill is compiling reams of demographic data that typically appear in the last pages



of the investment file or market report. Clearly, items such as population growth, median family income and ethnicity, for instance, are associated with absolute property value. Yet, their relationship to the stability of cash-flows from an income-producing property or likely tenure of an owner-occupied facility is more tenuous. (The relationship between demographic variables and multi-family and retail property/loan investments are exceptions to this proposition.)

Questionable, too, in the context of small-balance loan collateral is the importance of conventional CRE market fundamentals involving net absorption and new construction figures. Clearly, these factors have a bearing on leasing demand for the market comprising investment grade or large-cap properties that are tracked by data vendors. But what direct influence do these macro supply and demand trends have on smaller commercial properties like the 2,500 square foot free-standing retail store, office building or light manufacturing facility? Not much. That said, at the bottom of a real estate cycle as recently endured it's conceivable that the narrowing of rent spreads among different building classes on the heels of massive surpluses of leasable space may incent some small tenants to trade up to higher quality facilities.

And, so, given the widening pool of attractive properties under these market circumstances, the call for supply and demand indicators may be invigorated. Yet, the prevailing, sizable gap in rent levels between conventional small- and large-cap properties (e.g., see the Dallas office disparities above) is likely to prevent widespread tenant mobility of this type. As a result, these factors are usually dispensable for loan decision-making in the small-balance world.

The fact is that Boxwood's research indicates that small-cap and large-cap markets move in separate orbits, with somewhat different gravitational forces at play. By adopting a discriminating perspective, analysts are more apt to be surgical in their uses of market data, and less likely to err in their market and collateral assessments.