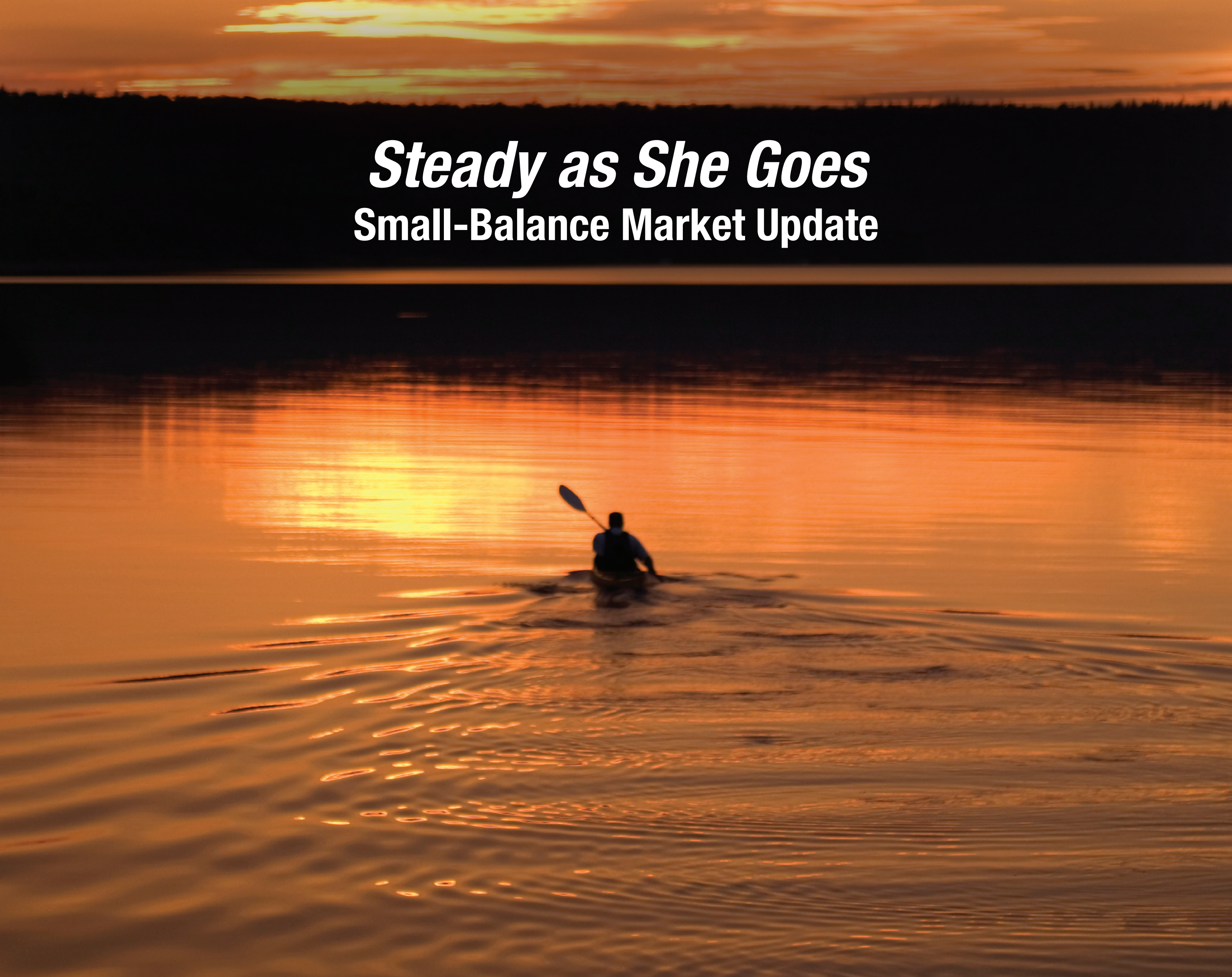

Steady as She Goes

Small-Balance Market Update

Survey of Small-Balance Lenders, Spring 2007

Sponsored by Boxwood Means, Inc. and Scotsman Guide

Prepared by Boxwood Means, Inc.

BOXWOOD MEANS, INC SCOTSMAN GUIDE

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Small-Balance Market Update • Survey of Small-Balance Lenders, Spring 2007

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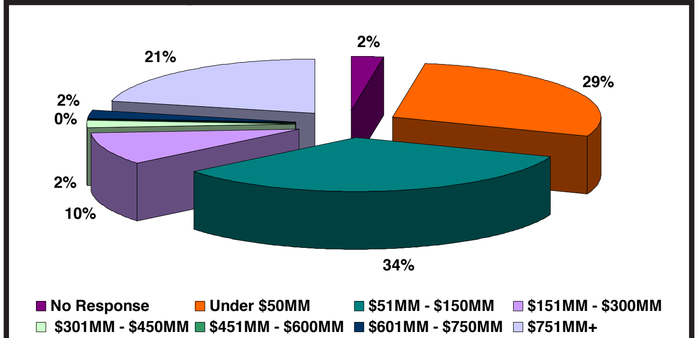
Introduction

Boxwood Means and *Scotsman Guide* sponsored a follow-up poll of small-balance commercial lenders this spring to gauge how the market may have changed since a similar and more extensive survey was undertaken last year (see www.scotsmanguide.com/report06 for details). The current briefing echoes much of the earlier report findings on the robust health of the market along with reported increases in competition, efforts to expand wholesale business and differing underwriting styles. There were also some new considerations such as the positive impact of residential brokers on production and a reported modest increase in delinquency rates. The *Methodology, Discussion of Findings* and *Conclusion* are described below.

Methodology

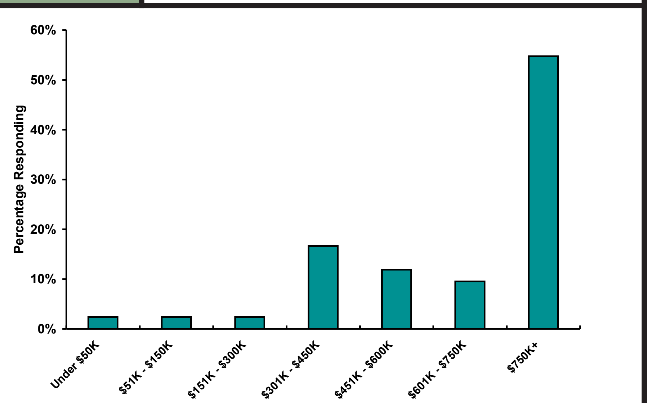
The lender survey was conducted online during March 2007 via *Scotsman Guide's* web site, scotsmanguide.com. Lenders were solicited exclusively via e-mail from separate lists of the sponsors. Respondents completed surveys voluntarily with the sole incentive that they would receive a personal copy of this report free of charge.

Figure 1 Lender Loan Volume - 2006



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

Figure 2 Average Loan Size



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

The survey effort yielded a total of 44 complete responses. The survey results are generally representative of the lender population at large, including a mix of lender types and sizes. However, the modest size of the sample presents some significant statistical limitations in analyzing groups within the survey. Hence, we omit cross-sectional analysis of the data since the relatively thin number of responses would render such findings unreliable. That said, we find that the responses and observed relationships fit well with expectations and are also consistent with our survey findings from last year.

> **"There were also some new considerations such as the positive impact of residential brokers on production and a reported modest increase in delinquency rates."**

Discussion of Findings

The findings are presented in two sections below, *Production and Marketing* and *Underwriting Practices.*

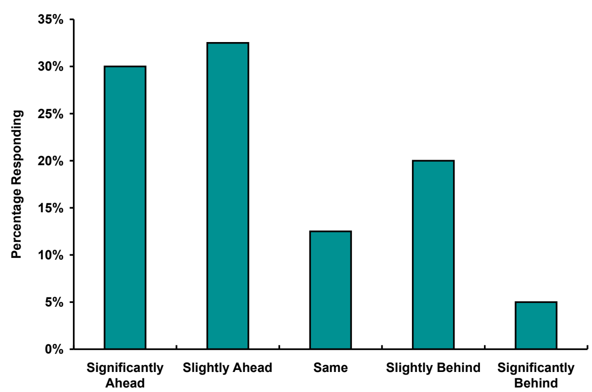
A. Production and Marketing

The survey respondents represented a mix of lender types as we might expect. This small-balance loan market under $5 million attracts both large and small lenders, conducting business at local, regional and national levels. A plurality (31%) classified themselves as specialty commercial finance firms, followed by national mortgage firms (19%), national/regional banks (14%), "other" (14%), local banks and savings institutions (12%) and local/regional mortgage banks (10%).

Across these lender groupings, the average annual origination volume in 2006 was $271 million. Yet, as shown in *Figure 1* the variation in output is indicative of the lenders' differing capabilities as well as the overall fragmentation of the market. Twenty-nine percent cited originations of less than $50 million per year, while another 33% claimed volumes between $50 million and $150 million. On the high end of the spectrum, 21% of the lenders reported originations exceeding $750 million per year. This distribution among lenders was equivalent to the percentages cited in our previous study.

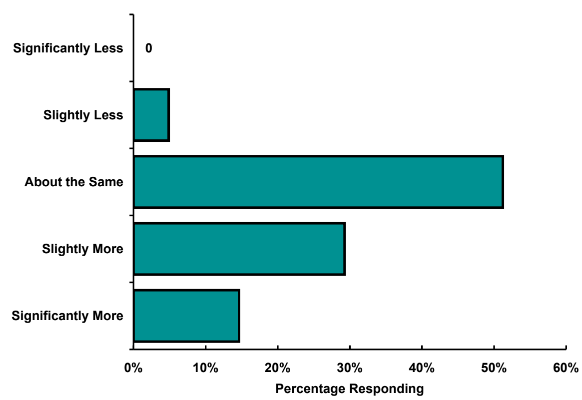
Average loan balance varied widely as well. As illustrated in *Figure 2*, the overall average of $690,000 was largely skewed by the 55% of lenders claiming an average loan of

Figure 3 **Ahead of Last Year's Pace**



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

Figure 4 **Competitiveness in the Wholesale Channel Last Six Months**



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

$750,000 or more. Meanwhile, 24% cited average loan sizes under $450,000.

Despite these differences, as illustrated in *Figure 3* the majority of lenders cited that production in the current year was ahead of last year's pace, with 30% reporting to be significantly ahead and another 33% slightly ahead. These responses are consistent with last year's with one exception: the one out of four lenders that indicated that production totals were lagging to some degree reflects a sizable increase of six percentage points since the last period.

We believe the slowdown experienced by some small-balance lenders signals a material change in the market. While the commercial real estate investment sales and mortgage markets were extremely favorable last year, Boxwood's proprietary research has previously indicated that small-balance mortgage originations began contracting during the latter part of last year, specifically in the lower range of loan sizes under $1.5 million. This phenomenon, correlated with the downturn in residential mortgage activity, explains why the sizable percentage of lenders indicated their production was trailing last year's pace.

Of course, increasing competition for loans represents another factor in lender output. We reported last time that the majority of lenders identified the wholesale channel as the primary driver for their originations. This heavy reliance on the wholesale channel for most of the lenders has generated keen competition for broker business. The most recent poll reaffirms this fact, as lenders claimed to source on average nearly 70% of their loans from the indirect channel. And, consistent with the last survey, nearly half of the lenders originate 80% or more of their volume through broker networks.

We recognize that local, regional and community banks have traditionally been the predominant retail lender to small-balance borrowers. As a result of their sheer numbers coast-to-coast, the banks are likely to be under-represented in this survey group. That said, we suggest that the wholesale platforms and flexible loan products of regional and national lenders have proven to be extremely effective competitors of late, resulting in market share shifts in favor of these more nimble players.

Clearly, though, competition is heating up in the space. As depicted in *Figure 4*, while 51% cited that the challenges to developing new business were about the same over the last six months fully 44% indicated that sourcing loans through broker networks had become either "significantly" or "slightly" more competitive.

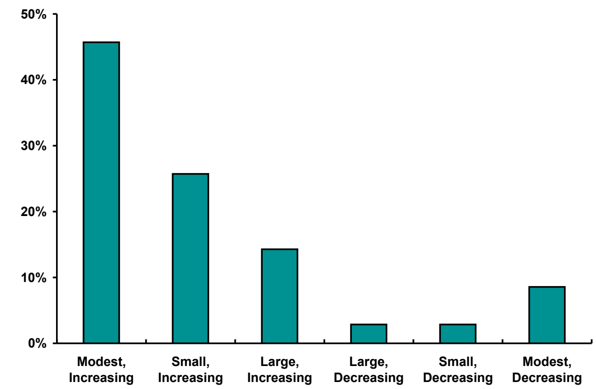
"We believe the slowdown experienced by some small-balance lenders signals a material change in the market."

Some lenders are implementing new marketing and outreach programs to gain market share in the wholesale channel. Others are developing retail platforms to counteract the growing logjam in these networks. Many, however, are attempting to tap into the reservoir of residential loan brokers whose mortgage production declined over the past year in lockstep with the housing sector's correction. Hence, we asked lenders about the contribution of residential brokers to their overall small-balance production over the last six months.

What was telling was the near unanimity of the responses.

Figure 5

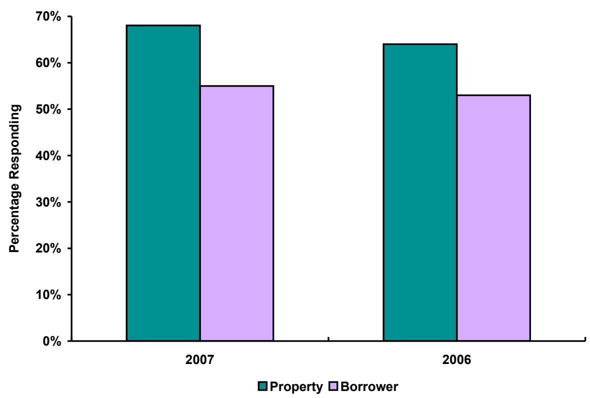
Residential Broker Contribution to Production Last Six Months



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

Figure 6

Increase in Full Documentation



SOURCE: Boxwood Means Inc.–Scotsman Guide Survey

As shown in *Figure 5*, over 85% of the respondents said their use of residential brokers was increasing in some fashion, with 14% indicating the brokers' contribution to origination was "large and increasing", 46% citing their role was "modest and increasing" and another 26% "small and increasing."

This is a significant turnaround in industry sentiment. Not long ago, many industry players claimed that residential brokers wouldn't be able to make the switch to the small-balance arena because of the added complexity of commercial deals. Yet, in last year's mortgage brokers survey, we documented the early and positive performance of residential brokers – and hybrid commercial/residential brokers in particular – that demonstrated the crossover potential of this broker group. And while questions may arise about the stability or permanence of their future contributions, especially once the residential housing market bounces back, it is apparent that most lenders today view residential mortgage brokers as a key asset in their business development efforts.

B. Underwriting Practices

The survey also investigated areas of property types and underwriting. The small-cap marketplace is typified by a wide array of primary and secondary property types, mixed-use and owner-occupied facilities. In fact, there is a relatively high concentration of 100% owner-occupied properties, which distinguishes this market segment and also influences underwriting styles. Of course, the lion's share of lending involves investment properties but, similar to the earlier survey, lenders reported that on average 37% of their originations involved these 100% owner-occupied facilities. Some lenders clearly specialize in this property type, too, as 26% of the lenders derived 60% or more of their loan volume from owner-occupied types of collateral.

"It is apparent that most lenders today view residential mortgage brokers as a key asset in their business development efforts."

Despite the heterogeneous mix of property types, a relative constant has been the loan-to-value ratios. The overall average LTV for acquisition and refinance loans, at 73% is conservative, and is actually 100 basis points less than the average ratio cited last year. Eighty-three percent of the respondents reported that their average LTVs were under 80% with the remainder (17%) citing averages above 85%. This latter percentage of seemingly high LTVs is consistent with last year's results and, furthermore, is corroborated by Boxwood's separate research on purchase mortgage transactions.

In last year's lender survey, we noted the incidence of alternative documentation in underwriting approaches. Of course, the predominant style reported was conventional or full underwriting of the collateral. And that bias persists, as 68% of all loans on average garnered full documentation, while 20% received light documentation and 12% no-doc (see *Figure 6*). In fact, as a sign of perhaps increased credit risk concerns the percentage of full-doc loans rose four percentage points since last year. Moreover, 47% of the lenders cited performing full documentation on 100% of their loans, up from 44% last time.

Similarly, full documentation on the borrower rose slightly to 55% of all loans (up two percentage points), while light and no documentation were reported on 27% and 18% of the loans, respectively.

Clearly, Alt-A or lower documentation approaches are making in-roads in the space. After all, the influx of residential loan brokers is certain to push underwriting approaches toward a lighter touch. And the fact that 45% of all loans on average received lower documentation on the borrower – down insignificantly from last year – suggests this bifurcation in underwriting styles may become a permanent and distinctive trait of the small-balance arena. To date, the rating agencies – the ultimate arbiters of acceptable underwriting methods – have demonstrated flexibility in analyzing securitizations from either camp.

> **"56% of the respondents indicated that they believed the nonprime situation would have either a "significantly negative" or "slightly negative" impact on credit."**

Solid underwriting produces healthy loan performance. While loan performance remains generally strong in the small-balance space, we note that more lenders reported an increase in delinquencies and defaults in this period compared with last time. For instance, for multifamily properties 81% of the lenders cited delinquencies (of 90 days or more) in the 0- to 50-basis point range – nearly double the number of lenders versus last year – with 10% reporting estimates of 51-100 basis points. Delinquencies also increased for commercial properties: 65% of the lenders indicated 0 to 50 basis points – almost 20 percentage points more than last year – with an additional 19% stating delinquencies of 51 to 100 basis points. More lenders reported that multifamily and commercial defaults of 0 to 50 basis points increased in the current period as well. While these figures might indicate some negative 'creep' in loan performance, it's conceivable that the results are influenced by sampling differences between this and the previous study (i.e., a plurality didn't have an answer on delinquencies last year).

On the subject of loan performance, we asked lenders how delinquency rates of 90 days or more had changed over the last six months. The majority (74%) claimed that delinquencies were the same, though 18% indicated that rates had increased moderately.

Lastly, we asked lenders their opinion of the impact the nonprime residential loan debacle would have on credit availability in the small-balance space. This survey question, which preceded the issuance of new CMBS underwriting guidelines that has since triggered significant re-pricing of debt, found that many lenders were generally circumspect: that is, 56% of the respondents indicated that they believed the nonprime situation would have either a "significantly negative" or "slightly negative" impact on credit. These lenders proved to be prescient given the recent widening of spreads in the capital markets.

Conclusion

Boxwood Means and *Scotsman Guide* conducted this follow-up poll of small-balance lenders to gauge trends in market conditions since our initial survey last year. The findings suggest that positive market momentum persists, with a majority of lenders ahead of last year's pace of originations. Notably, most lenders cite the increasing contribution of residential loan brokers to their production, whether their current engagement of this group is large or small. This trend will partially offset the increasing competition in the wholesale channel that lenders have reported. We also note that underwriting standards have turned slightly more conservative, anticipating the changing credit standards that have recently emerged in the marketplace. Finally, loan performance remains healthy though an increasing number of lenders indicate that delinquency rates are ticking up.

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Previous Small-Balance Reports

In late 2006, Boxwood Means, Inc. and Scotsman Guide produced two original research reports on the growing small-balance commercial mortgage market. The research reports were based on surveys of 260 brokers and 140 wholesale lenders involving a representative cross-section of industry players from small to large.

One research study covers the direct lender community and provides lenders with firsthand intelligence on origination activity, the use of the broker channel, underwriting practices, lending criteria, competition, securitization trends and more. The second research study covers the broker community and offers fresh brokers insights into the success of residential loan brokers crossing over into small-balance commercial lending, how brokers source business, the factors affecting which lenders they work with, and much more.

For information on how to purchase these reports, visit the following link: www.scotsmanguide.com/report06