Sizing Up The Small-Loan Market

The market for loans on small commercial properties of less than $5 million is under-reported and poorly understood. The lack of attention flows partially from a paucity of data on this market but, more important, from a lack of understanding about its size, character and impact. $ Or put another way, it may be that scant data are tolerated as long as observers assume the small-balance lending space is indeed small or insignificant, and that it mirrors trends in the larger institutional market. $ Employing a national database of small commercial property and mortgage transactions provided by the Santa Ana, California–based First American Corporation, Boxwood Means Inc., Stamford, Connecticut, demonstrates these assumptions to be untrue. With $64 billion in originations in the first half of 2005, following $127 billion in the previous full year, the small-loan market is anything but small. $ If you're still not convinced, consider this: The 2004 small-balance origination total exceeded the total issuance of domestic commercial mortgage-backed securities (CMBS) in the same period. $ As we lift the veil on this marketplace, we also see evidence that the small market differs substantially from the institutional market in degrees of leverage, loan terms and investment trends. Borrowers and owners appear to be chiefly buy-and-hold investors, which may account for the relatively stable, bubble-less flows of capital into this space. Moreover, despite its size and unique characteristics (or perhaps because of them),

There may be a significant untapped market for commercial mortgage lenders in the small-balance real estate loan sector. Here are some facts and figures to help size up the opportunity.

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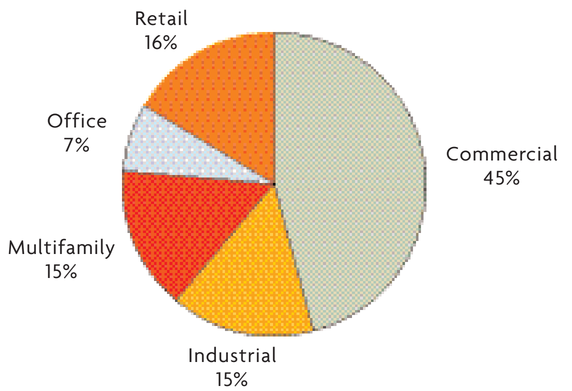
the small commercial loan market is extremely fragmented. Even the largest players maintain a trivial market share.

This conclusion has implications not only for lenders that could better exploit the new intelligence on this market, but also for small-property investors and small-business owners. The fact is the small-loan market caters particularly to small businesses, classically understood to be a major growth engine for the economy and job creation. As a result, fostering better market information about this sector could produce extensive private, as well as public, benefits.

Figure **1** **First American–Boxwood Means Small Commercial Property Database**



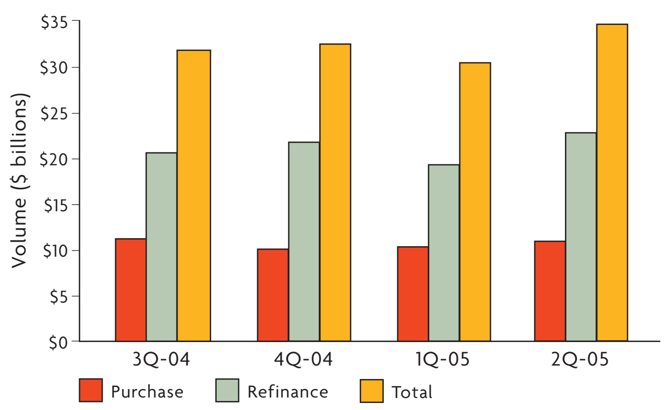
SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

Figure **2** **Top Five Small-Balance Commercial Property Lenders**

Lender	Market Share
Private Party	4%
Washington Mutual	4%
Bank of America	3%
Wells Fargo	2%
Wachovia	2%

SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

Figure **3** **Small-Loan Origination Trend**



SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

Data availability

Boxwood Means maintains a substantial database on small properties nationwide on behalf of its joint-venture partner, First American Commercial Real Estate Services Inc., Dallas, a division of the First American Corporation. This database, encompassing more than 3 million commercial properties of less than $5 million in value, archives all U.S. property sales and mortgage transactions as recorded in county tax assessor offices nationwide. Boxwood also maintains a similar database of transactions on larger properties.

There is no doubt that small-balance lending is big business for participants.

The First American–Boxwood database reflects an ongoing effort to quantify the size and activity levels of this small-property market principally for the benefit of lenders. Therefore, though we catalog property sales and loan transactions for more than 200 property categories, we focus on the major property types that are typically financed by commercial real estate lenders and small-business bankers.

Many of these small-balance loans are secured by owner-occupied properties, single-tenant facilities or buildings run by individuals as a single investment. The building types include office, industrial, retail and multifamily, plus a generic commercial land-use type. The commercial category, which includes hotels, motels, medical buildings and public storage facilities, is also the designated classification for more conventional office, retail or industrial properties in a minority of U.S. counties and states. The dominance of the generic commercial sector is depicted in the database categories shown in Figure 1.

Reasons for anonymity

There is no doubt that small-balance lending is big business for participants. Nevertheless, the small-loan market has been difficult to quantify and, thus, has remained in relative obscurity. Perhaps the major reason is that, unlike mainstream markets for commercial and multifamily mortgages, small loans lack a secondary market for loan packaging and purchases. Also, small-loan securitization programs to date have been slow to develop. Such arrangements would increase visibility. However, the challenges to an efficient secondary market for small loans (including a lack of correspondence between underwriting costs and the value of the properties that can support those costs) are sizable and well-recognized within the industry.

A second reason for low visibility is the significant fragmentation of the market. Despite the extensive geographical footprint of many national lenders, small-loan lending still remains a very local and relationship-oriented business characterized by thousands of individual commercial banks, thrifts, savings and loans, and mortgage bankers and brokers. Lender concentration is simply not a factor in this marketplace.

As shown in Figure 2, the top-ranking lenders command only low single-digit market shares. Note also in Figure 2 that "private party" heads the list. This reliance on private individuals and seller financing is a widespread pattern across the country, reinforcing the fragmented state of the marketplace while further hindering a consolidated view.

A final reason for the scarcity of mortgage-market intelligence is that lenders generally have not demanded it. Granted, for their part, third-party vendors have been tardy in stepping up to the plate because of various data challenges in processing and synthesizing public loan data. Nonetheless, one might assume that in a marketplace this large—equivalent to the size of the $100 billion U.S. consumer electronics market or, alternatively, total annual domestic pharmaceutical sales—more lenders would be motivated to capitalize on market-research resources as participants in other significant industries routinely do.

Such actions are likely to lead to more profitable lending, and the formulation and delivery of new financial products and services to borrowers along with it. Next we would like to discuss a number of the traits and trends of the small-loan market that illustrate its depth, distinctiveness and potential.

Market attributes and activity

The small commercial real estate property market is extensive. Boxwood Means and First American Commercial Real Estate Services tracked $64 billion of commercial real estate originations during the first half of 2005, comprising small commercial mortgages and business real estate loans at less than $5 million apiece. In 2004, the most recent period for which full-year figures are available, total production was $127 billion. By contrast, total domestic issuance of CMBS issued in the same period was $94 billion as recorded by the Commercial Mortgage Securities Association (CMSA), New York. Clearly, the small-balance market is big business, and the capital flows reported here expose a vigorous pulse of retail investor and small-business real estate activity.

Pumping up the volume

Originations in the small-loan space are routinely heavy. There have been five consecutive quarters of production exceeding $30 billion. As shown in Figure 3, the growth has been quite stable.

The $64 billion of originations in the first half of 2005 is 2.6 percent higher than production totals in the similar period last year. Volume in the second quarter of 2005 alone was nearly 14 percent greater than the previous quarter. In this latest period, refinance loans increased by 20.5 percent, while purchase mortgages rose 2.7 percent. Overall, refinance activity, at 67 percent of total production, swamped total originations in the latest quarter as property owners successfully monetized their investments in what has been a favorable interest-rate environment.

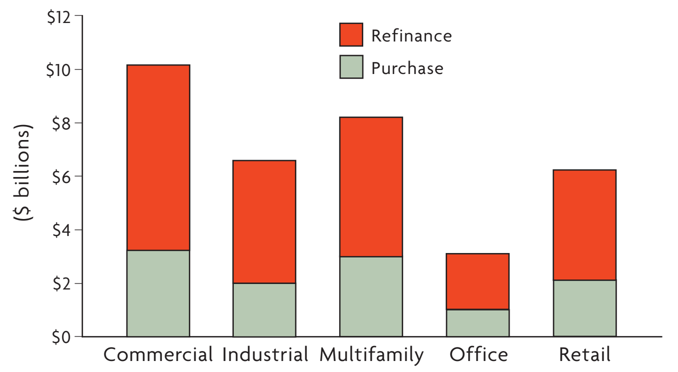
The stable year-over-year origination figures are unlikely to invoke comparisons with the frothy conditions that occasionally accompany discussions about the larger commercial mortgage market. Yet, this smaller market has not attracted the same degree of institutional interest associated with the larger commercial market. The proverbial "wall of money" that has inundated the real estate capital markets has not as yet disrupted the dynamics of the small-loan marketplace. Instead, the strong volume appears simply to bear witness to the very robust, albeit provincial or internal, demand generated by small-property investors and small-business owners.

As shown in Figure 4, the generic commercial category accounted for the highest volume in the second quarter at $10.1 billion, or nearly 30 percent of the total loan production. Multifamily followed at 24 percent, industrial and retail at 19 percent and 18 percent, respectively, and then office at 9 percent of total volume. Note from the figure that heavy refinance activity was uniform across all property types.

While origination volumes have been stable over the last several quarters, the size of the average loan has been steadily growing (see Figure 5). Overall, the mean small-balance loan size was $740,000 in the second quarter of 2005, up 8.5 percent year-over-year. The value of refinance loans increased more, by 11 percent to $836,000, while average purchase mortgages climbed 4.9 percent to $599,000.

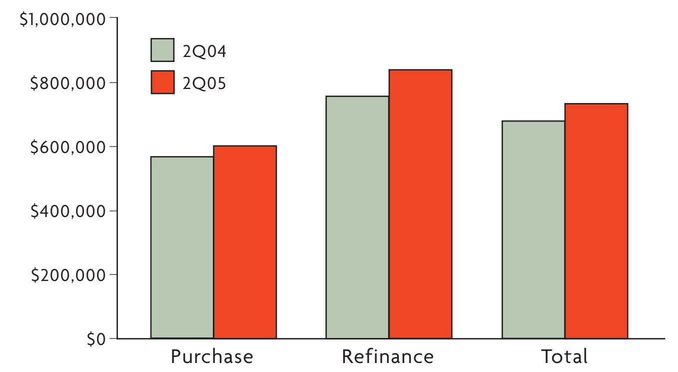
As noted earlier, the small-loan space is typified by thousands of lenders without significant market-share. However, there do exist unambiguous top geographical markets for originations. In fact, the top 10 U.S. counties account for almost 30 percent of total production. Not surprisingly, these counties encompass some of the largest metropolitan areas in the country. The top five counties for loan volume, including three in California, are depicted in Figure 6.

Figure **4** **Purchase and Refinance Activity, 2Q 2005**



SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

Figure **5** **Average Loan Size**



SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

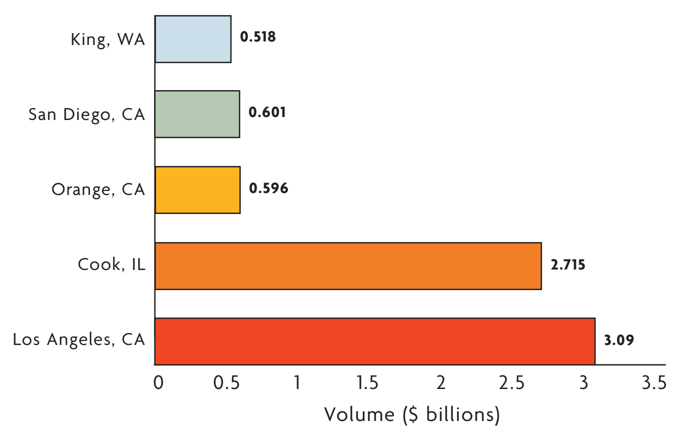
It may seem obvious that lenders should have a presence in such top-ranking markets for small loan originations. Yet, employing proprietary metrics to produce a "Market Attractiveness Index," Boxwood suggests that any lender's market potential is a function not only of a market's annual origination yield, but also a number of other important factors. These other factors include local lender concentration, the composition of the industrial and employer base, and other economic, demographic and real estate considerations. Such an index is useful to lenders in setting production goals in existing territories as well as formulating expectations before entry into new markets.

Property sales proliferate

Based on the robust finance market, it comes as no surprise that property sales activity among small-retail investors and owner-occupants is also extensive. In 2004, more than 75,000 commercial and multifamily transactions accounted for $53 billion in sales. Through the first half of 2005, sales volume was slightly ahead of that pace, with roughly $27 billion of properties trading hands and prices on the rise (see Figure 7).

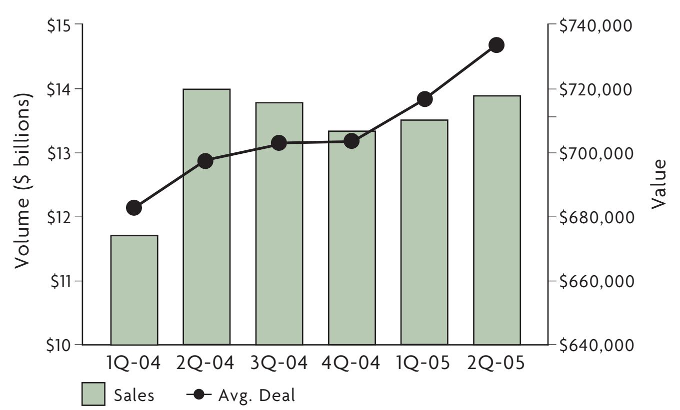
This sales activity is estimated to represent only 20 percent of annual dollar volume in the larger ($5 million–plus) market based on third-quarter 2005 figures compiled by Real Capital Analytics Inc., New York. However, the massive flow of modest-sized transactions underscores the vitality of commercial real estate on Main Street, as well as its peculiar focus on the discrete business and investment needs primarily of individuals and modest-sized firms.

Figure **6** **Top Five Most Active U.S. Counties**



SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

Figure **7** **Investment Property Sales Trends**



SOURCES: BOXWOOD MEANS INC., FIRST AMERICAN CORP.

The active transaction volume also confirms the common perception that many individual investors and "mom-and-pops," like their counterparts in the institutional realm, have converged on this asset class as an alternative investment to relatively low-yielding stocks and bonds. Multifamily properties, which tend to be especially attractive to new or part-time real estate investors, accounted for the largest percentage of sales at 29 percent.

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Clearly, the market of small investors plays to a different set of needs and wants than the institutional segment. For instance, institutional investors aggressively bought office properties in 2005 as market fundamentals slowly improved. In contrast, the small commercial property market tends to be less focused on more complex or management-intensive office properties, and more on multifamily and other categories such as single-tenant properties popularized through tenant-in-common and tax-deferred real estate exchange programs.

Financing gap

In the wake of strong property sales, the level of purchase financing is instructive. As noted, private individuals and seller financing are quite prevalent in this market. What is perhaps more surprising is that across all property types, only 78 percent of small-property sales included debt.

We might expect that low sales prices relative to the institutional market, as well as tax considerations, might induce many all-equity deals. However, other issues such as access to financial information on the property or borrower, general credit availability, borrowing costs and specific building uses appear to be key factors limiting the mortgage penetration rate.

This sizable mismatch between property sales and financing signifies market inefficiencies that astute lenders likely will want to further ferret out and exploit.

Loan composition

The degree of leverage on small loans is also distinctive. Overall, 70 percent of purchase loans in aggregate were originated with loan-to-value ratios (LTVs) of 75 percent or more in the second quarter, with 28 percent of originations with LTVs exceeding 85 percent. Borrowers of commercial and industrial properties obtained the highest leverage on average, while multifamily and retail properties received the lowest.

The fact that small-loan originators frequently rely on the personal credit strength of the principals, often obtain full personal recourse and, like the institutional market, are blessed with extremely low loss rates, are additional factors supporting this degree of leverage. Having said that, these leverage levels are shifting downward, even as the small space remains heated. Overall, leverage in the highest bracket (LTVs at or above 85 percent) has decreased four percentage points since the second quarter of 2004, with commensurate increases in the share of LTVs at lower ranges of debt levels.

As we know, leverage in the institutional market is even greater than what we see in this small-loan market. In addition, whereas the large mortgage market heavily relies on floating-rate and other adjustable-type loans, fixed-rate loans predominate in the small market at 71 percent of all deals. Borrowers with a long-term mentality have perhaps been the exception in the institutional market, but for the small-property investor, fixed-rate terms are still the rule. It points once again to the fact that the small-property market attracts a different type of player—often the single investor or small-business owner—who typically operates with a buy-and-hold strategy.

Final thoughts

The research on small commercial properties by Boxwood Means and First American Commercial Real Estate Services has uncovered a vast, and heretofore unplumbed, marketplace of sales and loan transactions. With its exposure, we glimpse not only its broad expanse, but also the inefficiencies, fragmentation and disparities in lending practices compared with the larger institutional market.

The idiosyncrasies of the small-property market have implications for market participants as well as the general public. For lenders, we can anticipate that these players will continue to expand their outreach to small investors and small-business real estate owners, create new capital market initiatives and strive further to wring out existing market inefficiencies. In these efforts, benefits will accrue to the public at large because small commercial properties tend to house small businesses and owner-occupants that have proven to be a primary driver of U.S. employment growth.

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Continued research on small-loan activity can increase market transparency and support the role of lenders in financing small-property investors and small-business owners' real estate needs. MB

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