Small Balance Advocate
MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS
December 2014

The 2014 Trifecta: Accelerating Asset Sales, Values and Loan Originations

A record-setting volume of property sales is growing more likely for 2014, pushing small cap CRE asset prices to new highs and promoting a second consecutive year of robust small balance loan originations.

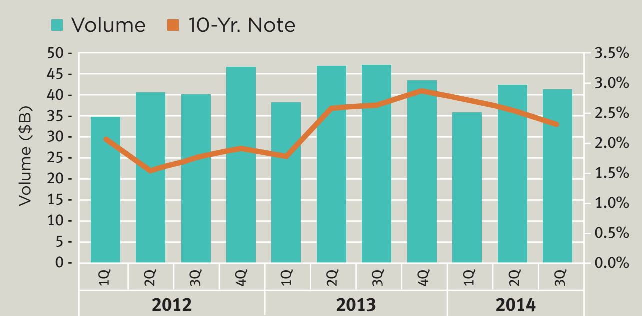
Small Balance Loan Originations

We discuss below third quarter 2014 results for small balance loan originations under $5 million. In the opening section of next month's report, we will return to small-cap CRE space market fundamentals updated for fourth quarter.

Small balance commercial (SBC) loan originations were stable during third quarter, 2014. Highlights of the period include:

- Loan originations were steady during third quarter at a total of $41.3 billion. While total volume was 2.6% lower than second quarter volume and represented a decline of 12.7% from third quarter of 2013, the latest period's total was on par with average loan production over the past 10 quarters (see the nearby graph).

SMALL BALANCE ORIGINATIONS TREND



Source: Boxwood Means, Inc.

- Originations through third quarter totaled $119.7 billion, compared with $132.5 billion in the corresponding period during 2013 when yearly loan originations hit an all-time high.
- Purchase volume continued to increase relative to refinance loans. Purchase loans, reflecting the strong pace of small cap property sales, rose by 1.9% sequentially to $12.7 billion and grabbed 31% of the total market, up from a 24% share during third quarter of 2013 and the highest ratio since at least 2006. Refinance loans dipped 4.4% from the previous quarter to $28.7 billion.
- In contrast, commercial mortgage originations in the overall market are rising. The Mortgage Bankers Association survey of commercial lenders reported an 18% jump in volume during third quarter as well as a 16% increase year over year. The lion's share of the increase derived from CMBS lenders who pumped up nearly 50% more volume compared with third quarter of 2013.
- Tarrant County joined Dallas and Harris counties in Texas to make the list of the 15 most active counties for SBC loans during third quarter. Both California and New York were represented by four counties, and Chicago (Cook County), Miami (Miami-Dade), Phoenix (Maricopa) and Seattle (King) were also among the front-runners.

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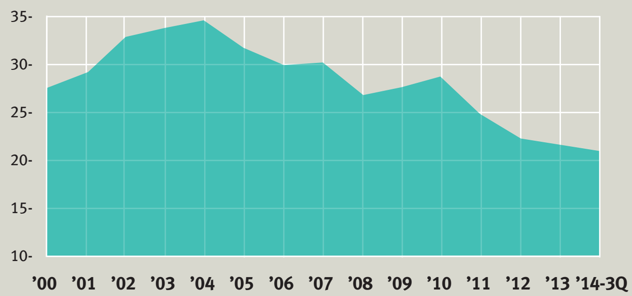
▸ The market share of the top 15 SBC lenders (all banks) bounced back during the quarter, rising 110 basis points to 20.7% of total originations as national and regional banks loosened underwriting guidelines to grab more business. Nevertheless, the banks' collective market share has yet to recover from levels achieved before the financial crisis.

▸ Indeed, the longer term trend suggests that commercial banks are less effective at capturing the smaller loans. While commercial bank portfolios of CRE loans in the aggregate have expanded by 6.6% year over year to $1.65 trillion according to the FDIC, bank loan balances of small business real estate loans (under $1MM) have dropped considerably, from 35% of all CRE loans outstanding in 2004 to only 21% (and $291.4 billion) as of third quarter, 2014 (see the nearby graph). Of course, overall demand for property loans by small business owners greatly diminished during the recession and its aftermath, but it is also apparent that small businesses have increasingly leaned on alternative, non-bank capital sources for modest-sized CRE loans.

SMALL BUSINESS REAL ESTATE LOANS (<$1MM)

Percentage of Bank CRE Loans Outstanding



Source: Boxwood Means, Inc.; FDIC

We anticipate total 2014 originations in the range of $160-$165 billion which will result in one of the best annual performances since Boxwood began tracking SBC originations eight years ago. A number of factors support this projection: (a) With the 10-Year Treasury Note at 2.3% at the end of September – the lowest rate since first quarter, 2013 – mortgage rates remain extremely attractive; (b) The lineup of non-bank SBC lenders with veteran leadership and national platforms has recently expanded with the likes of ReadyCap Commercial, Cherrywood Commercial Lending, PennyMac Commercial Real Estate Finance and Sabal CRE Term Lending. Between them these entrants offer a broad array of loan products that are likely to meet the varying needs of smaller borrowers; and (c) As described below, small cap property sales and asset values show no signs of retreating and will only further stoke loan production during the remainder of the year.

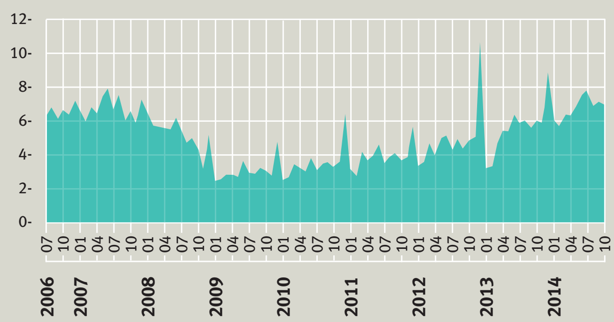
Property Sales Activity

Sales continued at a frenzied pace as fourth quarter got underway. Sales highlights involving commercial and multifamily assets trading under $5 million include:

▸ Sales transactions totaled a robust $7.0 billion in October on a preliminary estimate basis, down 2.1% from September's total that included a hefty $800 million upward revision. October's volume, which represented a 15.0% jump over total sales from a year ago, will likely post the highest one-month tally over the first 10 months of 2014 once the revision estimate is available.

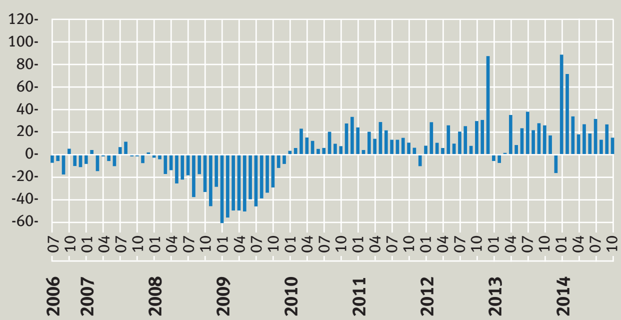
▸ Year to date, transaction volume reached $67.8 billion in October, exceeding 2013's 10-month sales total by 30.0% and, what is more, eclipsing 2013's entire year sum by 1.2% (see the nearby graphs).

SALES VOLUME TREND | **Property Sales ($B)**



Source: Boxwood Means, Inc.

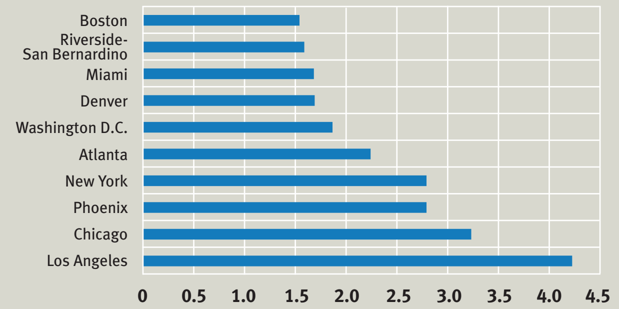
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, Inc.

▸ Fifteen metros have recorded transaction flows in excess of $1 billion through October (see the nearby graph). But more noteworthy is the breadth of the sales surge, where 112 of the 122 markets for which Boxwood tracks sales trends posted greater sales volume year to date compared with 2013. A sizable number of these cities (32) has witnessed year-to-date sales gains of 50% or more, with a total of 72 metros posting increases of 25% or more. Percentage gainers with at least $500 million in sales to date are dominated by secondary cities such as Nashville (92.1%), Oklahoma City (81.2%), Cleveland (57.5%), Denver (57.2%) and Norfolk (50.2%).

PROPERTY SALES LEADERS | **Cumulative 10-Month Sales ($B)**



Source: Boxwood Means, Inc.

▸ Investment sales in the larger CRE market parallel the small cap trend. October's $41.6 billion of sales for properties valued at $2.5 million or more rose 6.1% sequentially and 14.9% year over year, according to data provided by Real Capital Analytics (RCA). The strength of this market is underscored by the fact that the cumulative sales total of $338.1 billion through October is within 6% of 2013's full-year total of $361.3 billion. RCA reported that the pipeline of pending deals indicated a strong conclusion to 2014 and that a record level of individual property transactions is possible.

Small cap investment sales are on track to rival the peak level recorded in 2007. For now, it's about as good as it gets for private investors who enjoy a sizable risk premium with low interest rates, operate with strong leasing fundamentals and find asset prices that are still in a recovery phase.

Sales Prices

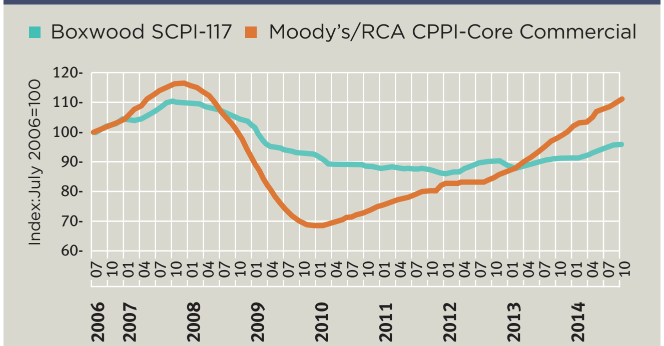
Small cap CRE prices rose for the ninth consecutive month. Notable results for October include:

▸ Boxwood's national composite price index of commercial properties trading under $5 million across 117 metro areas, or SCPI-117, rose a modest 0.4% in October on a preliminary estimate basis. Year to date the Index, which excludes multifamily transactions, has increased by 5.3%, while the 12-month return of 5.6% represents the highest annual growth rate since the beginning of 2008. SCPI-117 has recovered 41.9% since its low point and remains 13.0% below the pre-crisis peak level.

▸ The strongest price growth continues to be centered in the larger metro areas. SCPI-6, representing the six largest cities by population, rose 0.7% preliminarily in October and has posted a healthy 10.5% annual return. SCPI-6 has recovered 50.7% of its post-crisis losses and is 13.5% below its previous high-water mark. Similarly 20 of the largest cities, or SCPI-20, gained 0.8% in the current month and has generated a second-best Index performance with a 6.8% increase year over year led by San Francisco (11.9%) and Denver (8.5%).

▸ Major markets continued their hot streak in the large cap CRE investment market. Overall, the Core Commercial component of Moody's/RCA CPPI (that excludes apartments and tracks sales transactions of investment-grade properties principally above $2.5 million) rose a stout 1.5% in October and 13.4% over 12 months. Despite this strong national price trend which, as shown in the nearby graph substantially beats SCPI-117, the CPPI Major Market segment (Boston, Chicago, LA, NY, San Francisco and Washington, DC) has turned in the most vigorous performance. The Major Markets group

NATIONAL CRE SALES PRICE TREND COMPARISON



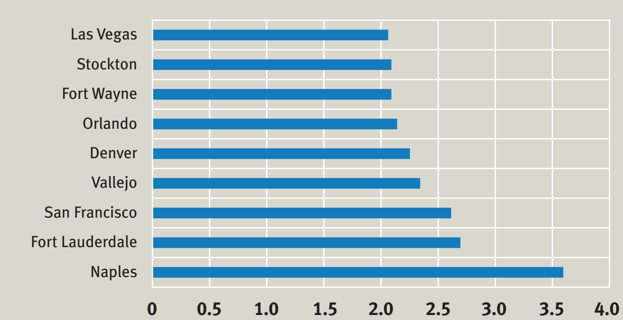
Source: Boxwood Means, Inc.; Moody's

jumped 2.2% in October, 5.4% over three months and 16.6% year over year. Of note, Moody's reported that Major-market prices now surpass the November 2007 pre-crisis peak by roughly 15%. By contrast, the Non-major Markets gained only 0.8% over three months, 12.0% over 12 and are about 10% below the pre-crisis peak. As of October, the Core Commercial CPPI is within 4.3% of its October, 2007 peak level.

▸ Smaller markets represented by Boxwood's SCPI-97 are recovering but at a relatively slow pace. SCPI-97 increased 0.2% on a preliminary estimate basis during October along with a 4.8% gain year over year. Nevertheless, the annual return is the highest since November, 2008 and reflects the much improved, risk-adjusted opportunities for investments in secondary and tertiary markets.

▸ Indeed, 81 of the 117 markets for which Boxwood tracks prices generated positive annual returns and are dominated by secondary markets including San Francisco (11.9%), El Paso (10.3%), Rockford-IL (9.6%) and West Palm Beach (8.6%). Meanwhile, 86 markets posted price gains over three months and, in so doing, demonstrate forward price momentum again concentrated among smaller markets (see the nearby graph).

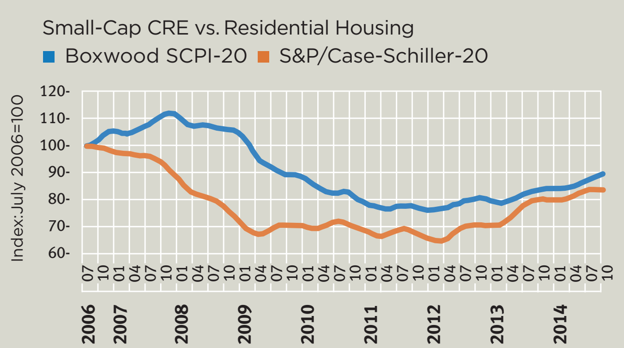
METROS WITH BEST THREE-MONTH PRICE CHANGE (%)



Source: Boxwood Means, Inc.

▸ Growth in home prices has slowed considerably. The S&P/Case-Shiller 20-City Composite Index declined 0.1% in October for the second consecutive month as 13 of the 18 constituent cities posted monthly losses. The annual return of 4.4%, down from 4.8% in September, represents a precipitous decline from double-digit growth earlier this year and marks the lowest annual increase in two years. However, as we suggested earlier this year there's a silver lining to the slowdown: that is, the more reasonable pace of growth expands the population of potential buyers of affordable homes, especially among first-time purchasers who have largely sat on the sidelines during the price run up. The slower pace may also secure a more durable national recovery as prices gain further support from accelerating job growth and rising incomes. Meanwhile as shown in the nearby graph, the price trajectories of housing and small cap CRE in the identical 20 cities have diverged as the market fundamentals and momentum behind CRE asset prices has only grown stronger.

COMPARATIVE SALES PRICE TRENDS – 20 METROS



Source: Boxwood Means, Inc.; S&P

The liquidity of CRE markets evidenced by the year's sizable amount of loan originations highlights the general confidence that investors and lenders have in the U.S. economy and the interest rate outlook among other considerations. This liquidity, in turn, has accelerated asset prices above the pre-crisis peak specifically for larger assets in selected major or core markets, thus placing the onus squarely on future operating income growth to blunt the prospect of some localized price bubbles. On the other hand, asset prices have appreciated at a more modest pace in most small cap CRE markets – a pattern consistent with the past – and offer private investors and lenders what is likely to be a sustainable path of price growth going forward.

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.

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