

Not One-Size-Fits-All

BY RANDY FUCHS AND MICHAELL TAYLOR

Smaller commercial properties in secondary and tertiary markets proved far less volatile in the downturn than much pricier real estate. Smaller and less-expensive properties actually may carry less risk than many assume.

Big trophy deals capture the imagination of many real estate professionals, not unlike Santiago's fixation with the big fish in Ernest Hemingway's *The Old Man and the Sea*. This fascination with large commercial real estate (CRE) assets also permeates industry market research, trade publications and the business press. ■ The net result is that public discourse on the ups and downs of the investment-grade class tends unduly to influence assessments of the CRE market *en masse*. This homogenizing effect was most recently on display during the slump in

the sales transaction market triggered by the Great Recession. Sales of investment-grade properties valued at \$5 million and above totaled roughly 7,500 transactions during 2010, based on data from Real Capital Analytics LLC (RCA), New York. By contrast, Boxwood Means catalogued nearly 100,000 sales transactions, or more than 13 times the total number of larger deals, by focusing exclusively on what we term “small-cap” CRE assets below the \$5 million threshold amount.

Despite these disproportionate numbers, consideration of the small-cap segment’s performance is effectively eclipsed by the large-deal activity. In fact, the industry’s final assessment and familiar refrain—devoid of the contribution of smaller transactions—avers that the CRE “market” fell by 40 percent from its cyclical high in 2007.

A closer look at the small-cap CRE arena produces a different picture of market performance. Our research shows that the small-cap CRE market is not only distinctive, but it also handily outperformed the large-cap CRE market segment during the recent down cycle.

At the end of Hemingway’s story, villagers extolled Santiago’s trophy marlin catch. Yet as we suggest in this article, when it comes to the small-cap CRE market, the plentiful harvest of small fish by local fishermen cannot be denied.

Boxwood’s indexes

Boxwood Means constructed two proprietary indexes to assess small-cap CRE performance. The Boxwood Small-Cap Price Index (SCPI-100) is a broad measure of sales transactions under \$5 million across 103 metropolitan areas.

The Boxwood SCPI-20 Index is a similar index of some of the nation’s 20 biggest metro areas that also comprise the Standard & Poor’s (S&P)/Case-Shiller Home Price Index for residential housing.

Boxwood’s indexes mirror the diversity of the small-cap CRE market by combining and tracking closed sales among various small commercial property types. The indexes include conventional office, industrial and retail property types that characterize the Moody’s/REAL Commercial Property Price Index (CPPI). However, our metrics also include assorted secondary types of assets often associated with owner-users and single tenants—such as free-

standing buildings, street retail, mixed use, light industrial, restaurant buildings, commercial condos and more.

Our inclusive definition of property types is meant to reflect the CRE mortgage portfolios of many commercial bank lenders, in which non-farm, non-residential loans total an estimated \$1.5 trillion, and owner-occupied commercial uses account for nearly 50 percent of the aggregate loan balance.

Boxwood produces monthly updates of its aggregate indexes and 103 individual metro areas based on a two-month lag. This article describes price trends through December 2010 and how they highlight the unique nature of the small-cap CRE market.

Small-cap CRE markets are linked to local conditions

Small commercial properties are acquired predominantly by local owners and users, small private investors and one-off “mom and pops.” The health of these small assets is tightly bound to local economic and business conditions.

In effect, small-cap CRE dwells in a neighborhood-based ecology of housing, business and local economic interactions. Hence, it comes as no surprise that Boxwood’s research indicates that small commercial property sales trends are highly correlated with metro-level unemployment—i.e., sales prices decline as local unemployment rises.

There is an even stronger relationship between small-cap CRE and residential housing prices. This linkage is illustrated in Figure 1.

The parallel trajectory of the price trends—and tendency for small-cap CRE to trail housing market movements—is striking. The SCPI-20, comprising larger-sized markets, decreased 29.9 percent peak to trough through December 2010 while housing prices for the same residential markets tracked by the S&P/Case-Shiller Index dropped by 32.6 percent.

The national housing market’s plunge that began in the summer of 2006 preceded the small-cap CRE market’s decline by 17 months. Later, the bottoming out of house prices in spring 2009—abetted by government tax incentives—also heralded by 15 months the initial stabilization of SCPI-20 prices witnessed last summer.

The housing price index for the major metro areas

dropped 3.9 percent during the last quarter of 2010 and, as a result, was dipping toward its 2009 trough. Meanwhile, the SCPI-20 declined by 5.4 percent in the fourth quarter and set a new low.

The impact of housing on the health of the economy cannot be underestimated. Residential investment and related housing services combined typically contribute as much as 18 percent of the nation's gross domestic product (GDP), with shares varying slightly depending on the phase of the business cycle.

Given the fact that housing is a key economic driver and is highly correlated with small-cap CRE, persistent housing market challenges are likely to be a damper on the small commercial property market's resurgence, to a greater degree than for the larger commercial real estate market.

Small CRE assets produce less price volatility

The national aggregate Moody's/REAL CPPI representing CRE sales transactions heavily weighted by deals valued at \$5 million or more plummeted 45.1 percent from its high-water mark in 2007. By comparison, Boxwood's SCPI-100 shed only 21.9 percent from peak to year-end trough, or

less than one-half of the loss incurred by the larger commercial property market.

This sizable spread is depicted in Figure 2. Note, however, that the segments have further parted ways in the waning months of last year. While the SCPI-100 dropped by 3.4 percent during the fourth quarter of 2010 and 7.6 percent for the full year, the performance of Moody's/REAL CPPI seemingly turned the corner with a 1.1 percent gain during the last three months and a loss of only 2.1 percent over 12 months.

The CPPI rose 5.5 percent since bottoming out last August, while the SCPI-100 was unable to sustain its two-month increase ending September and resumed its slow descent.

The CPPI's historical trend—inclusive of the upturn in the second half of the year—underscores the fundamentally higher cyclical volatility of the large CRE sector comprising major, high-quality assets.

To a large degree, the variability between the commercial price trends reflects the more heterogeneous profile of properties represented in Boxwood's indexes. The CPPI comprises the four major property types, but SCPI measures comprise primary as well as secondary property

Figure 1 Price Trends: Small-Cap Commercial Real Estate (CRE) vs. Housing

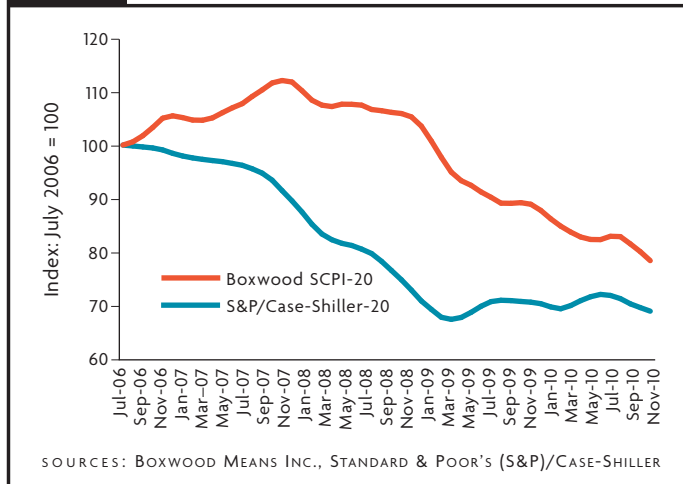


Figure 3 Sales-Price Trends: Primary vs. Secondary Markets

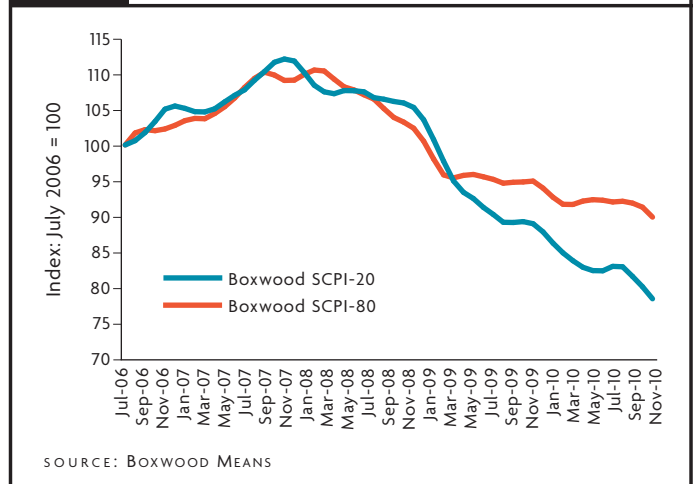


Figure 2 National CRE Sales-Price Trend Comparison

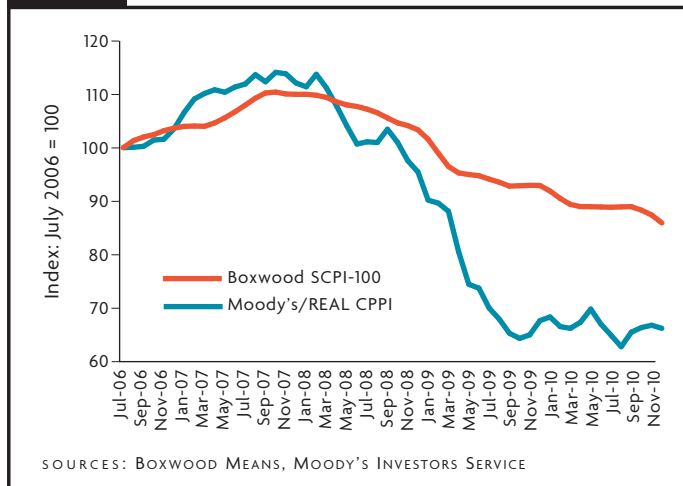
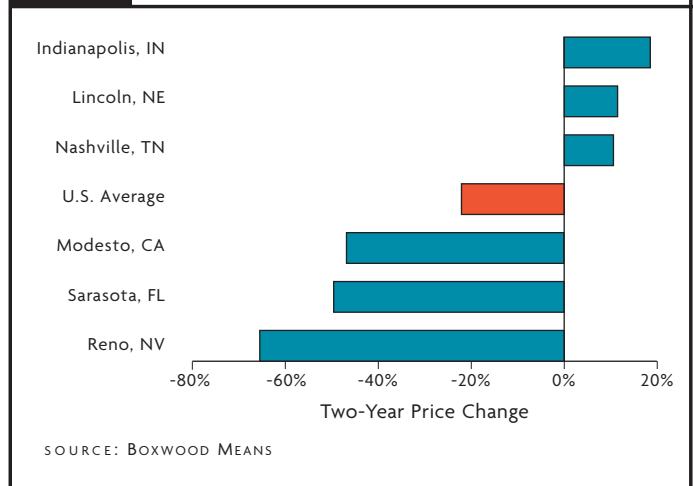


Figure 4 Small-Cap Sales-Price Change for Selected Metros



Small-cap CRE markets are not invincible—*far from it.*

types, including a heavy dose of owner-occupied facilities that typically populate the small-cap CRE landscape.

The owner-occupied slice is a major determinant of the more placid small-cap sales trends because it has less exposure than income-producing properties to the ups and downs of the CRE market cycle. Instead, the performance of owner-occupied assets is more responsive to the local economy and creditor business circumstances. Hence, the diversity of the small-cap universe delivers more price stability.

With small-business owners forming a cornerstone of the small CRE property market, the SCPI-100's relative underperformance during 2010 reflects in part the financial well-being of the small-business economy. It is well known that lending was effectively closed off to Main Street firms during the Great Recession. What is less apparent is that capital availability continued to contract in the post-recession period. In fact, outstanding small-business CRE loans under \$1 million held by U.S. commercial banks fell last year to the lowest level since 2006.

By contrast, credit expansion and strong capital flows lie at the heart of the large-cap CRE revival as well as this segment's greater volatility. For instance, RCA reported that significant property sales of \$5 million and above jumped to \$134.1 billion in 2010—more than double the volume of the previous year and, remarkably, less than 30 percent of the deal flow produced in 2007.

Moreover, Boxwood calculated that a sizable concentration, or 52 percent, of that 2010 investment capital traded hands solely in the 20 metros comprising our SCPI-20. As these large sums of capital chase a limited number of investment-grade assets during good times, or disappear in bad, price movements of large assets are accentuated.

Smaller metro areas prove more resilient

Prices of the broad SCPI-100 declined less than the larger markets of the SCPI-20 by evidence of the latter's price spread of 792 basis points over the peak-to-trough period. The lower volatility of smaller geographical markets was much more pronounced when we subtracted the 20 big metros from SCPI-100 and derived a group for the remainder, i.e., SCPI-80.

As shown in Figure 3, this collection of chiefly secondary and tertiary markets was the most resilient with a decline of only 18.5 percent from the apex, including a 5.3 percent loss for 2010. By comparison, SCPI-20 fell 11.9 percent last year, reflecting the higher sensitivity of large, top-tier cities to market dynamics.

Conventional wisdom has it that secondary and tertiary markets are a greater investment risk than top-tier markets. The presumption is that the thinner or less diverse industrial base of small cities renders them more

economically vulnerable and, by extension, more illiquid.

It may very well be that assets trade hands less often in small cities. But that doesn't necessarily prove that secondary markets are more risky.

And with regard to the industrial diversity question, it is too easy to get carried away with the argument that small markets are more susceptible to economic shocks. After all, Houston's diverse economy still fluctuates to some degree with the price of oil, as does Detroit with autos and New York with finance.

In fact, we suggest that the sales-price decline among smaller markets over the last couple of years was muted precisely because they are relatively less economically vulnerable. Secondary markets are only loosely tied to macro and regional economic factors that exert much greater influence on bigger markets. Hence, small CRE markets typically neither boom nor bust.

Also, as mentioned earlier, what contributes, paradoxically, to the price risk among major markets is the considerable sums of capital that are funneled into (and out of) top-tier markets rather than subordinate ones over time. While small-cap assets are not typically the beneficiaries of this largesse, it is conceivable that a spillover effect accounts for some of the higher volatility reflected in the SCPI-20.

Performance varies widely across U.S. metros

We have described how sales prices for small-cap CRE assets depreciated less than large caps and, also, that price movements have been generally more stable in smaller geographical markets over recent times. Nevertheless, the variation in small-cap CRE price performance across the United States has been substantial.

Price changes for selected metros are shown in Figure 4. There have been only a handful of cities, such as Indianapolis; Lincoln, Nebraska; and Nashville, Tennessee, that produced price increases over the last two years.

By far, the majority of metros large and small suffered losses of some degree, with places like Reno, Nevada; Sarasota, Florida; and Modesto, California, plummeting by as much as 40 percent to 60 percent—or more.

Such analyses easily isolate winners and losers, but sometimes conceal from us core strengths and weaknesses. Clearly, the nexus between small-cap markets and residential housing is underscored by the capitulation among the bottom sample of markets that were severely overbuilt earlier in the decade. What is less transparent is the economic stability and stronger housing markets of other communities that have fared better (and appear at the top of Figure 4).

Small-cap CRE markets are not invincible—far from it. However, as a large collection or portfolio of small assets distributed extensively across the national landscape, this

Note on INDEX CONSTRUCTION

Boxwood Means' price indexes are derived from publicly recorded, arm's-length sales transactions of small commercial real estate (CRE) properties under \$5 million, including primary and secondary commercial property types. The database of transactions includes distressed sales but excludes foreclosures/real estate-owned (REO) and all multifamily transactions.

Customary valuation techniques warrant that nearby sales comparables be "adjusted" in order to accurately reflect a subject property's attributes. We follow a similar framework in the construction of Boxwood's indexes.

Robust multivariate hedonic models are employed, metro by metro, to estimate the effects of location, vintage, property use, construction type and other factors upon property sales prices. Once estimated, these factors are then statistically removed from the sales prices to produce a population of transactions that are comparable across time within each metro.

This technique leverages information from tens of thousands of annual small-cap property transactions to create a population of closed sales that is reflective of the broad small-cap CRE market and also comparable over time. Price movements are computed month by month, metro by metro, and smoothed into over-time trends. The metro trends are then aggregated to the national level in the form of the Boxwood Small-Cap Price Index (SCPI) measures.

market appears sufficiently idiosyncratic to have earned a separate place in the sun.

Forget the one-dimensional picture of CRE

Our vocabulary for the CRE market is deficient, one-dimensional and yields perfunctory declarations about real estate market conditions such as "CRE plummeted 40 percent." By and large, the generalizations are an outgrowth of the industry's "follow-the-money" mentality that venerates and primarily targets investment-grade assets and top-tier markets.

Our research offers a more bifurcated view: two distinct CRE markets moving in complementary orbits but with different gravitational forces at play. The upshot is that small-cap CRE markets tend to oscillate less intensely over time than the large-cap arena.

While this outcome may confound some real estate observers, it may invigorate others to re-evaluate the riskiness of investments in various small-cap CRE markets. Moreover, the research may guide industry participants along the front lines of collateral valuation and market risk assessment. After all, this pluralistic vision has a bearing on some vital and lingering CRE lending questions, including projected loan losses and recoveries, the size of the equity-refinance gap and the overall outlook for the market's recovery. **MB**

Randy Fuchs and Michael Taylor are principals and co-owners of Boxwood Means Inc. in Stamford, Connecticut. They can be reached at randy.fuchs@boxwoodmeans.com and michael.taylor@boxwoodmeans.com.

REPRINTED WITH PERMISSION FROM THE MORTGAGE BANKERS ASSOCIATION (MBA)