ACADEMY SECURITIES
MISSION DRIVEN

Securitized Products Special Topics

Small Balance Commercial: Periphery Locations and "Weak" Sponsors May Prove Supportive

SBC Deals Poised for Stable Performance Amid Broader CRE Distress

Stav Gaon
+1 (646) 768-9173
sgaon@academysecurities.com

Headquarters Address:
Academy Securities, Inc.
622 Third Avenue, 12th Fl
New York, NY 10017

Several features of small balance commercial (SBC) loans that traditionally were thought to be weaknesses of the sector should now support performance, especially compared to the distress of some large-cap CRE loans, and major, institutionally owned properties. For example, we see non-CBD, suburban properties, that typically characterize small-cap CRE, as better positioned to address secular trends that hobble sectors such as office and multifamily.[1] Top loans in recent SBC deals were backed by industrial or unanchored retail properties in places such as Woods Cross, UT, Lawrenceville, GA, or Templeton, CA.

In turn, SBC loan borrowers/sponsors are usually perceived as "weak". This characterization reflects the generally less sophisticated nature of small balance borrowers, according to rating agencies. Presales categorize >90%, and in several cases 100% of loan sponsors as weak. While such assessment of small-cap CRE sponsors may still hold true, we don't necessarily see it as telegraphing loan performance in the current environment. Recent notable cases of large, sophisticated institutional sponsors walking away from properties such as 1740 Broadway in Manhattan, or Gas Company Tower in Los Angeles, underscore how sponsor's strength or sophistication is not necessarily positively correlated with sponsor's commitment to the property in distress.[2] In fact, individual owners, that have their personal income tied to a neighborhood retail property or a small rental building behind SBC loans, may be reluctant to risk foreclosure and lose title on the heels of non-performance.

Less Urgency for Redevelopment

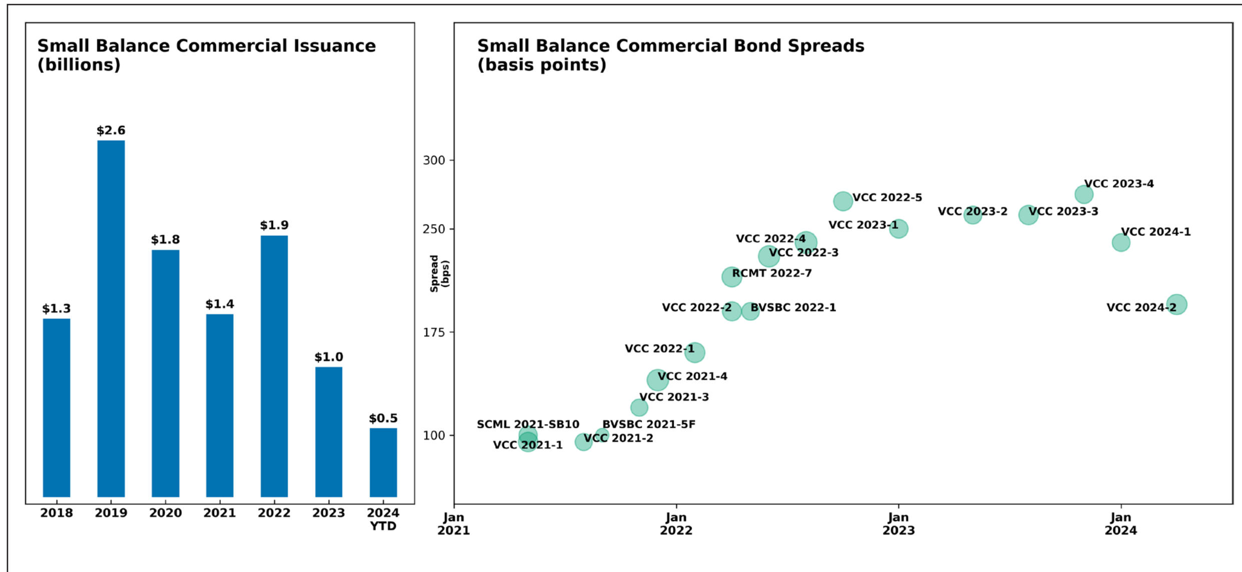
We expect SBC deals, that feature concentrated exposure to small-cap CRE, to see more stable collateral performance amid the broader CRE distress (Figure 1). Such deals also feature a residential, "investor" loans component, that should reflect the dynamics and value we discussed in a recent report on the segment.[3]

1 See "Office Modifications: 285 Madison Could Offer a Blueprint for More to Come," CMBS Credit Focus, Academy Securities, October 27, 2022, and "Small Balance Multifamily: Value in Concentrated Exposure Ahead of Slower Prepays," Securitized Products Special Topics, Academy Securities, September 13, 2022

2 "Credit 2024: Workout Nuances Come to the Fore," CMBS Credit Focus, Academy Securities, December 11, 2023

3 "Investor Non-QM: Pockets of Value as Underwriting Tightens," Securitized Products Special Topics, Academy Securities, January 22, 2024

Figure 1. Small Balance Commercial Securitization Issuance and Spreads



Source: Bloomberg and Academy Securities

We identify a couple other aspects that highlight the unique characteristics of small-cap CRE:

- **Property redevelopment/repositioning.** In the small-cap CRE domain we see less pressure for redeveloping properties, and the attendant capital expenditures, compared to larger properties, especially office and retail. Class B/C CBD office buildings, or older regional malls, cannot remain competitive unless they go through major renovations. Loan modifications of large CMBS properties now routinely include renovation components that both sponsors and servicers view as critical for the property's future performance. Smaller, suburban properties may be in less dire need of such renovations. Employees may value the shorter commute times suburban office offers, and nearby amenities (or proximity to home). Satellite or flex office spaces should similarly face less pressure to introduce lavish amenity offerings that trophy CBD office now regularly features.

- **Contrasting dynamics in challenged CRE sectors.** Small office and retail properties have shown fairly stable performance in recent months, defying the challenging broader environment. For example, small-cap office demand ended 2023 with two consecutive quarters of net positive absorption, according to analysis from Boxwood Means. The small-cap office vacancy rate stood at 6.5%, less than half of the total vacancy rate for the sector, based on Boxwood, using CoStar data. Small retail also showed robust performance, with small-cap retail vacancy rate finishing 2023 at a record low of 3.4%. In contrast, small-cap industrial showed some stress in 2023, highlighting the unique dynamics of small-cap CRE across different sectors. Retail, industrial, and office represented some of the top exposures in the SBC components of deals priced in recent months (Figure 2). The deals also had high exposure to mixed-use properties.

Figure 2. Small Balance Commercial Pool Characteristics

	VCC 2024-1	VCC 2023-4	VCC 2023-3	VCC 2022-4	VCC 2022-3
Balance ($MM)	221.1	229.5	263.5	333.5	315.2
# of Loans	530	652	774	782	682
Property Type					
Investor 1-4 (%)	61.8	65.7	65.9	51.9	43.7
Mixed-use (%)	10.1	7.9	6.4	13.6	13.3
Retail (%)	7.5	5.3	8.0	9.1	12.8
Multifamily (%)	3.4	4.3	4.4	7.4	14.2
Industrial (%)	7.1	6.7	7.6	7.9	5.9
Other (%)	10.1	10.1	7.6	10.1	10.2
Market Tier					
Primary (%)	48.3	46.9	45.8	50.2	54.6
Secondary (%)	37.9	40.3	41.6	39.9	33.9
Tertiary (%)	13.8	12.8	12.7	9.9	11.5

Source: Deal Documents, Ratings Agencies, and Academy Securities

If the aspects we discuss above indeed prove to be supportive of SBC performance, it will mark some departure from the historical experience of small- and large-cap loans. SBC loans have exhibited higher delinquency rates relative to CMBS, as rating agencies note. For example, 60+ day delinquency rate on KBRA-rated SBC deals stood at 12.5%, on average, as of March 2024. This compares to a 4.50% rate on CMBS deals the agency rates. Agencies also allude to higher resolution expenses on smaller balance loans compared to larger assets. Such historical estimates may not directly carry forward. Large commercial loans now experience elevated delinquencies and losses, the latter sometimes driven by high liquidation expenses or servicer decisions.[4]

4 See "Crossgates Liquidation: Holdbacks Complicate Severity Projections," CMBS Credit Focus, Academy Securities, September 11, 2023

Academy Securitized Products Research Recent Reports

Securitized Products Special Topics:

Recovery Bonds: Deal Reporting Shows True-Up Adjustments Potency

Data Centers: Performance Wrinkles to Test Operators' Role

Recovery Bonds: Diversifying Exposure Moves Beyond Disasters

Investor Non-QM: Pockets of Value as Underwriting Tightens

Multifamily Prepays: Becoming Less Common, as Property Sales Drop

Device Payment ABS: Expect Stable Performance as Collateral Evolves

CRE CLO Mods: Rising Volume Not Immediately Telegraphing Distress

Aircraft ABS: Waterfalls Playing Catch-Up as Fundamentals Recover

Data Centers: Teakeaways from 2023-Vintage Deals

Litigation ABS: Tailwinds in Place for an Uncorrelated Segment

Agency Floaters: Adjusting Interest Rate Cap Escrows

Equipment ABS: Pick Your Spots Amid Diverging Collateral Trends

Commercial Solar ABS: Emergent Segment to Alleviate Headline Risks

Multifamily CRT: Limited Credit Risk on Synthetic Exposures

OC Triggers: Subtle Thresholds Come to the Fore As Collateral Stress Builds Up

Cell Towers: Lender-Friendly Features Dovetail with Secular Tailwinds

Timeshare ABS: Exposure to Favorable Hospitality Segments

Self Storage: Aspects to Watch as Performance Decelerates

Transitional Multifamily: Collateral Migration Away from CRE CLO Offers Different Deal Profile

Recovery Bonds: No Need to Closely Watch the Fed or the Economy Here

Affordable Mortgages: Fee Elimination Spotlights Convexity Profile

Investor Non-QM: Rental Exposure with Some Structural Twists

Data Centers: A Strong Segment Juggles ABS and CMBS

Small Balance Multifamily: Value Ahead of Slow Prepays

Future Funding: Potential Key Performance Driver as CRE CLO Pipeline Builds Up

Multifamily Prepays: Property Sales Trigger Paydowns

Manufactured Housing: Resilient Segment Amid Potential Multifamily Softness

Tender Offers: Expect More to Come, Though Not on a Predictable Schedule

NYC Multifamily: Rent Increases to Support Cashflows Amid Regulatory Restrictions

Housing at a Crossroads: Single-family and Multifamily Exposures

Senior Housing: Focus on Segment Selection Amid Pandemic Impact

Disaster Performance: Pandemic Forbearance Resolutions Bode Well for Future Stresses

Russian Sanctions Impact: Lease Terminations and Forced Property Sales

CMBS Credit Focus:

Forward Forbearances: One Market Plaza Introduces a Twist to Mods

Loan Assumptions: Watch Waterfalls as New Borrowers Redevelop

Holdbacks: RENT in the Limelight, as Other Cases Brewing

Blanket NRAs: Shutting Down Advances Upends Credit IO Trades

Credit 2024: Workout Nuances Come to the Fore

Recovering the Non-Recoverable: Liquidation Nuance Bolsters Paydowns

Special Servicer Replacements: 1740 Broadway Crystalizes Implications

Crossgates Liquidation: Holdbacks Complicate Severity Projections

WODRA: Bond Cashflows Under Stress in Post-Mod Advance Recovery

Securitized Mezz: Workout Dynamics in Public Display

Dark Triggers: Nuances in Focus as Tenant Departures and Subleasing Pick Up

Upping Appraisals: Recovering Valuations Reverse Shortfalls

Non-Recoverable Advances: Unveiling a Rationale for a Key Decision

Excess Cash Allocations: Probing Advances on Positive Cashflowing Loans

Release Prices: Cherry Picking Across Office Portfolios, Sometimes at a Discount

Mezz Loan Sales: A Potential Headache for CMBS Workouts

Equity Pledges: Hotel Bossert Spotlights Dual Collateralized Loans

The Road to Conversion: Consider Office Ground Leases and ARD Loans

Credit 2023: Advancing and Workout Approaches to Play a Central Role

Hotel Receiverships: Palmer House Hilton Spotlights Stabilization Efforts

Office Modifications: 285 Madison May Offer a Blueprint for More to Come

Triple-A Shortfalls: Destiny Spotlights Delayed ASERs Impact

Inflation-Resistant Leases: Rent Steps Offer Some Revenue Protection, though Not Much

Industrial Delinquencies: Don't Happen Often, but Watch Closely When They Do

Hotel Reserves: Key Performance Driver after Pandemic-Driven Depletion

Government Tenants: Short Termination Notices and Specialized Properties

Mall Foreclosures: What to Track as Servicers May Shift Away from Modifications

Disclaimer

Although certain information has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness. We have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public sources.

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by Academy Securities for any purpose including buying, selling, or holding any security. Views and opinions are current as of the date of this presentation and may be subject to change, they should not be construed as investment advice.

This information discusses general market activity, industry or sector trends, or other broad-based business, economic, market or political conditions and should not be construed as operational, research or investment advice. This material has been prepared by Academy Securities and is not financial research nor a product of Academy Securities. It was not prepared in compliance with applicable provisions of law designed to promote the independence of financial analysis and is not subject to a prohibition on trading following the distribution of financial research. The views and opinions expressed may differ from those of Academy Securities. Investors are urged to consult with their financial advisors before buying or selling any securities. This information may not be current and Academy Securities has no obligation to provide any updates or changes.

Economic and market forecasts presented herein reflect a series of assumptions and judgments as of the date of this presentation and are subject to change without notice. These forecasts do not take into account the specific investment objectives, restrictions, tax and financial situation or other needs of any specific client. Actual data will vary and may not be reflected here. These forecasts are subject to high levels of uncertainty that may affect actual performance. Accordingly, these forecasts should be viewed as merely representative of a broad range of possible outcomes. These forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change. Academy Securities has no obligation to provide updates or changes to these forecasts. Case studies and examples are for illustrative purposes only.

Index Benchmarks

Indices are unmanaged. The figures for the index reflect the reinvestment of all income or dividends, as applicable, but do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices.

The indices referenced herein have been selected because they are well known, easily recognized by investors, and reflect those indices that the Investment Manager believes, in part based on industry practice, provide a suitable benchmark against which to evaluate the investment or broader market described herein. The exclusion of "failed" or closed hedge funds may mean that each index overstates the performance of hedge funds generally.

THIS MATERIAL DOES NOT CONSTITUTE AN OFFER OR SOLICITATION IN ANY JURISDICTION WHERE OR TO ANY PERSON TO WHOM IT WOULD BE UNAUTHORIZED OR UNLAWFUL TO DO SO.

©Academy Securities, Inc.