Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

August 2016

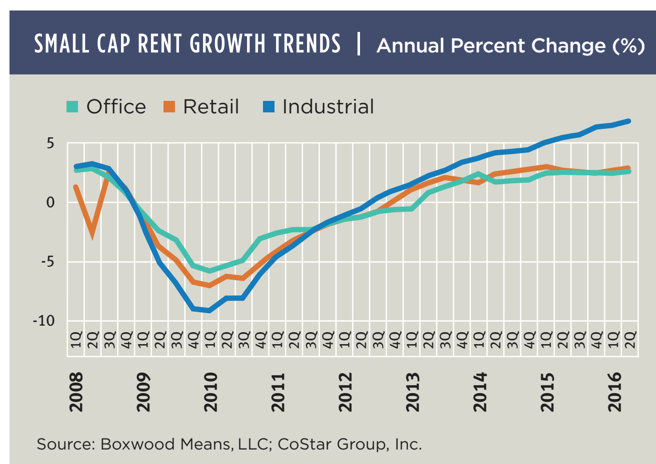
Investment Trends Signal Heated Second Half for 2016 Improved stability in financial markets has bolstered investor sentiment; so, too, have core fundamentals underscored by a surge in rents. As a result, small balance investors have gained a collective second wind and are driving asset sales and prices higher.

Space Market Fundamentals

Following last month's discussion of second-quarter demand and vacancies, below are statistical highlights for small cap CRE rents and supply drawn from CoStar data solely involving commercial properties under 50,000 sq. ft.

▸ **Rents surge with tightest markets in over a decade.** The velocity of rent growth reached new heights as strong demand for space drove small cap CRE commercial vacancy rates to record lows (see the graph below). Industrial rents rose a massive 1.9% during second quarter and 6.8% YOY, and the national average of $7.84 per sq. ft. is now within 0.7% of its pre-recession high. Both the quarter and annual percentage change figures represent the highest rates of industrial rent growth since at least 2006 and affirm the general vibrancy of the small cap CRE industrial-manufacturing and warehousing sector – a segment of the market that tends to slip under the radar of much of the business and CRE industry press. Indeed, since as much as three-quarters of the 252,000 firms in the U.S. manufacturing sector employ less than 20 workers according to the National Association of Manufacturers, the contributions of these smaller firms to overall U.S. manufacturing output and the health of the general industrial real estate market cannot be understated.

SMALL CAP RENT GROWTH TRENDS | Annual Percent Change (%)



Source: Boxwood Means, LLC; CoStar Group, Inc.

Meanwhile, retail and office rent growth also soared. Retail rents, at an average of $16.94 per sq. ft., jumped 0.9% for the second quarter in a row, producing the best back-to-back quarterly gains since 2006. Coupled with near-peak annualized rent growth of 2.7%, it appears the sector is running on all cylinders. So reports of the sector's demise may be a bit premature with a growing tenant base, record-low vacancies and virtually no substitute for neighborhood shopping centers that consumers depend on for everyday shopping needs. Small cap office rents rose a healthy 0.7% during second quarter to a national average of $18.52 per sq. ft. The 2.5% YOY increase, the biggest annualized jump in over 30 quarters dating to 2008, underscores the uptick in office-using employment particularly in professional and business services. Office rents are now within 4.8% of the previous cyclical high.

▸ **Industrial supply sustains modest uptrend.** Given the upsurge in industrial rents and rock-bottom vacancies, it comes as no surprise that developers have delivered more industrial product. Though supply declined during second quarter, small cap industrial completions rose 22.1% YOY to 3.2 million sq. ft., and total deliveries at mid-year were also 12.7% ahead of the first six months

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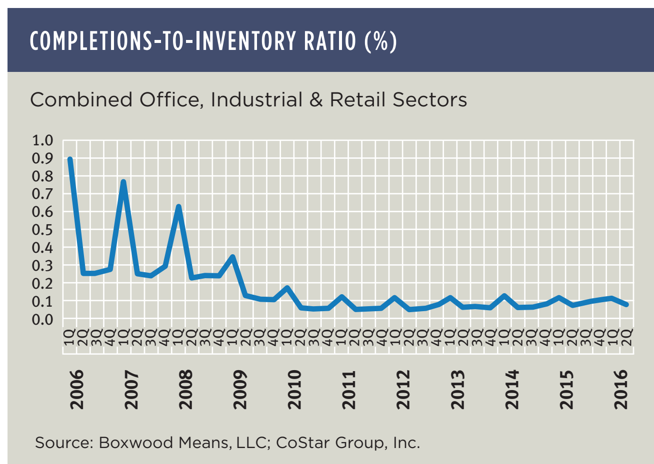
of last year. That being said, this level of supply is only a fraction of the projects brought on line during the previous peak years when completions averaged 19.4 million sq.ft. per quarter. So supply at this point in the market's expansion poses little threat to the durability of the industrial sector.

Office and retail deliveries are also a non-factor. Office supply shrunk during second quarter and declined 1.5% YOY to 2.9 million sq.ft., but the sector eked out a 2.1% gain over the first six months of the year compared with 2015. Retail completions were down a sizable amount in second quarter to 7.9 million sq.ft. which resulted in a 4.9% decrease at mid-year.

The nearby graph of the completions-to-inventory ratio illustrates the halting growth in supply since the beginning of the recession. The slow recovery in retail and office rents – where average rents today have yet to erase the negative spread to historical levels – is a key factor discouraging greater supply in these sectors.

COMPLETIONS-TO-INVENTORY RATIO (%)



Source: Boxwood Means, LLC; CoStar Group, Inc.

▸ **Construction pipeline is loaded in general CRE market.** Elsewhere, supply is vigorous and signals a possible future shift in market dynamics. The high demand for new and bigger industrial facilities in the general market, primarily warehouse projects serving logistic uses for e-commerce businesses, have triggered a wave of development projects underscored by the 18.1% jump in first-half completions compared with 2015 according to CoStar data. On the other hand, office and retail deliveries have been tepid, declining by 10.7% and 6.9%, respectively over the same time periods. However, the more revealing story relates to what's coming on line, and it's portentous: industrial projects under construction (UC) total 162.1 million sq.ft. as of second quarter which is more than double the average UC inventory over the five years (2010-2014) preceding the recent run-up in pipeline supply. Office and retail UC inventories have expanded as well, by 69.3% and 26.0%, respectively over the same corresponding time frame. As a result, UC inventories are nearing pre-recession peak levels: i.e., office projects underway are within 14.1% of their previous high-water mark in 2007 while industrial (-18.9%) and retail (-32.8%) are not far behind. In stark contrast, aggregate UC inventory in the small cap CRE domain is subdued and 78.8% below the 2006 peak level.

Higher rents are driving the resurgence in commercial projects under construction in the general CRE market-place. General industrial and office lease rates are nominally 2-3% above the previous cyclical high while retail rents are 1.3% short of the previous peak. As mentioned above, with the exception of the industrial sector small cap CRE rents are still lagging. But aside from the difference in domain rent growth, it's unclear why UC inventory build-up in the small cap CRE province trails the general market by such a wide margin. It's conceivable though that new banking regulations have played a part. Since last year all banks face increased capital requirements for acquisition, development and construction loans stemming from the Basel III Capital Accords. These capital reforms invoked a new class of "High Volatility Commercial Real Estate" (HVCRE) that forces banks to retain more capital against HVCRE loans (such as new construction), unless the borrower-developer can satisfy more stringent financial standards. The net result may be that many modest-sized projects have been sidelined because smaller and relatively under-capitalized borrowers lack the bigger equity commitment that is necessary and/or balk at higher bank fees for the HVCRE loans.

In any event, the sizable pipeline of construction projects in the general CRE market will inevitably alter the space market dynamics consistent with late-stage expansions that include higher leasing availabilities and slower rent growth. As discussed, those winds of change do not currently loom on the small cap CRE horizon where supply has proven to be more restrained.

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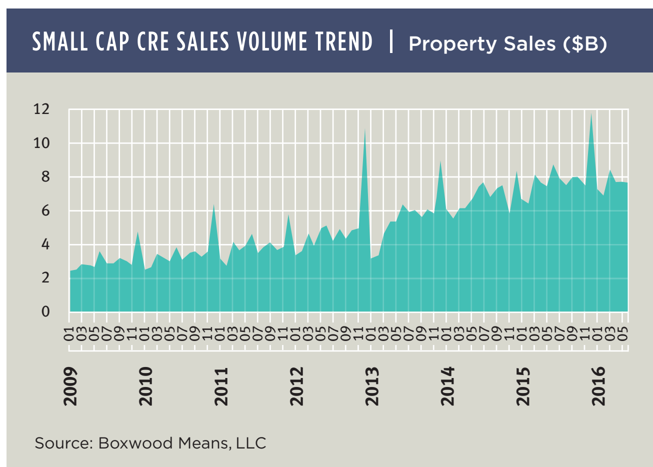
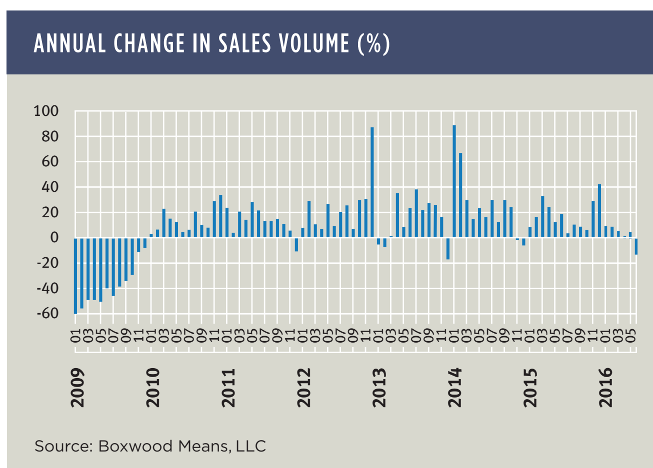
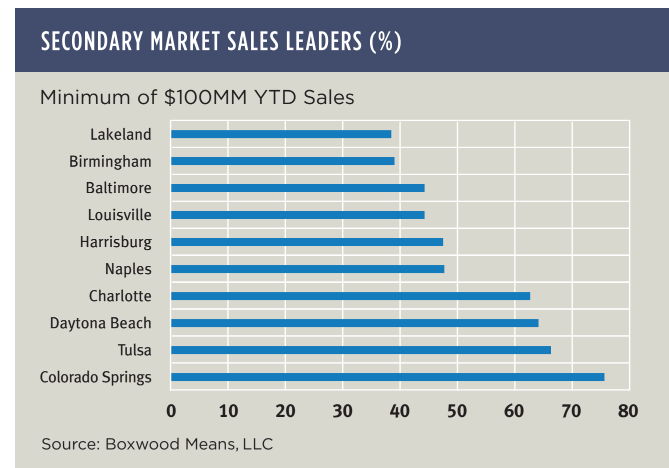
Property Sales Activity

▶ **Sales keep pace.** Sales volume for commercial and multifamily assets under $5 million dipped negligibly by 1.7% to $7.7 billion in June on a preliminary estimate basis, but the overall trajectory is strong. Cumulative sales through the first half of the year totaled $46.1 billion, 1.6% ahead of last year's sum and on pace to challenge 2015's record sales volume. (See the graphs below.)





▶ **Secondary markets are hot.** Sales activity continues to tilt in favor of secondary and tertiary markets that increasingly present solid investment opportunities for local players. The six biggest population centers garnered 20.7% of total deal volume during June, down 90 basis points (bps) from June of last year and off a notable 250 bps from 2014. Also, while first-half sales activity rose in Phoenix and Philadelphia by 53.6% and 14.4%, respectively, transactions were flat in Chicago and tailed off in the other three largest metros including New York (-14.8%), Los Angeles (-6.3%) and Houston (-4.2%) . On the other hand, 30 smaller cities with at least $100 million in cumulative sales through June posted year-to-date sales gains of 30% or more, led by Colorado Springs (75.7%), Tulsa (66.3%) and Daytona Beach (64.2%). (See the graph below). Overall, 73 of the 122 markets that we track generated first-half sales that exceeded their volume from the same six months of last year.



▶ **Large cap sales decline with increasing risk aversion.** Deal activity in the large cap arena of significant properties greater than $2.5 million cooled during the first half of the year as investors shied away from portfolio and entity-level transactions as well as the smaller markets. Total sales volume through June totaled $219.2 billion, down 15.8% compared with last year as megadeals dropped by 39.1% according to data from Real Capital Analytics (RCA). (Single asset transactions fell by only 4.1%.) RCA reported that first-half financial market uncertainties led institutional buyers towards core and stabilized assets in major markets where returns are typically less vulnerable to economic shocks and, thereby, pushed volume in this segment up 17% YOY. By contrast, a perception of greater downside risks resulted in a 17% drop in value-add transactions YOY among institutional/equity investors. For similar reasons deal activity in smaller markets narrowed by 12% YOY. Yet RCA said that general sales volume trends recovered in June. See the graph on the following page for comparative large and small cap CRE sales trends.

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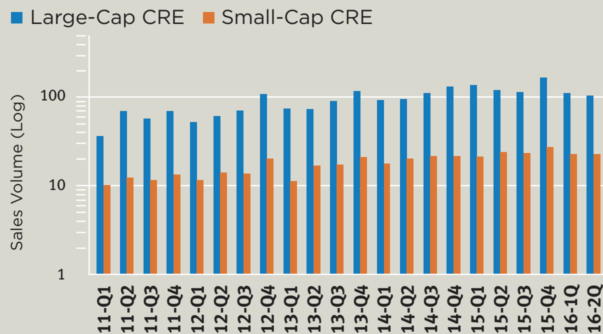
SALES VOLUME TRENDS COMPARISON



Source: Boxwood Means, LLC; RCA

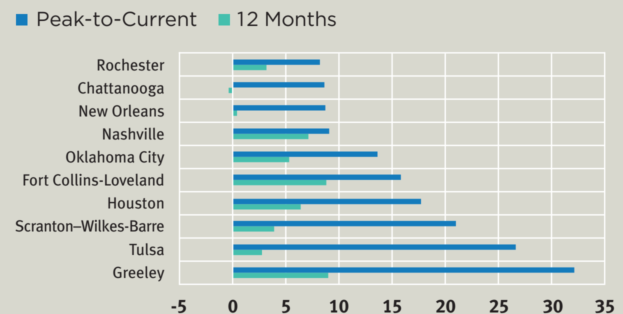
Plainly, the risk appetite among investors in the large cap arena waned during the first half as the financial markets took an early hit in 2016 and, also, prevailing asset prices confronted buyers with less attractive yields. Whether the January-June correction in large cap CRE deal volume persists into the second half of the year is unclear. Nevertheless, the CRE asset class is still very tempting with an accommodating U.S. monetary policy that has diminished yields on fixed-income alternatives. Couple the lack of investment alternatives with CRE's low vacancies and climbing rents, and there is every reason to believe that both small and large cap investors alike will sustain a strong pace of asset purchases in the year's second half.

Sales Prices

▸ **Prices gather steam.** Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities displayed some consistent momentum in June, increasing 0.4% on a preliminary estimate basis for the third month in a row. The second quarter gain of 1.2% is the best three-month gain since August of last year. Across the 127 markets, 50 posted quarterly price gains of 1.5% or better led by Vallejo (3.6%), Sarasota (3.3%), Stockton (2.8%) and Las Vegas (2.7%), along with positive gains in 106 total cities.

▸ **Energy-focused cities top recovery list.** Even though SCPI-127 is within 7.7% of its pre-recession peak, the small cap CRE price recovery has been far from uniform. Prices in roughly 30 cities are still 40% or more below their former cyclical peak with concentrations in some Florida, California and Southwestern markets that were pummeled during the recession and its aftermath. Not surprisingly, with a reboot to local economies many of these cities rank among the top price leaders of late. With their resurgence, some of these late recovery markets are in fact attractive nominees for investor momentum picks. However, the strongest – and persistent – recoveries so far are dominated by metros in the oil and gas industries. As shown in the nearby graph, 5 of the top 10 markets with the highest cumulative return since the recession are energy-focused. Overall, 21 of the 127 markets have surpassed their pre-2009 peak price levels.

MARKETS WITH GREATEST PRICE RECOVERY (%)



Source: Boxwood Means, LLC

▸ **Multifamily prices accelerate.** Returns on small cap multifamily assets ratcheted up in June, jumping 1.2% on a preliminary basis for the third month in a row according to Boxwood's Small Multifamily Price Index (SMPI) covering 48 markets (see the graph on the following page). SMPI's 3.7% increase during second quarter was the best three-month return in 2½ years and suggests that, given very favorable demographics as well as abundant sources of debt, small cap investors still find affordable rental housing to be an irresistible lure. The SMPI rose a vibrant 6.1% in the first half of the year and 9.3% YOY.

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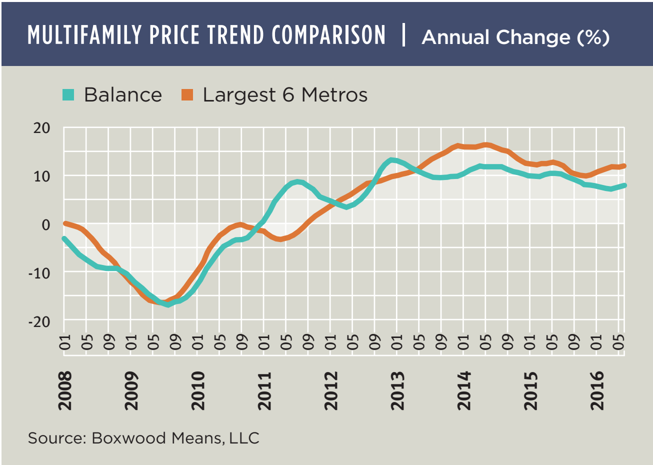
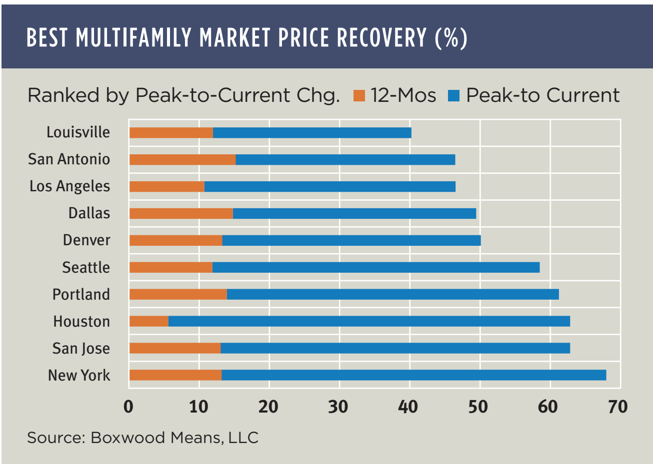
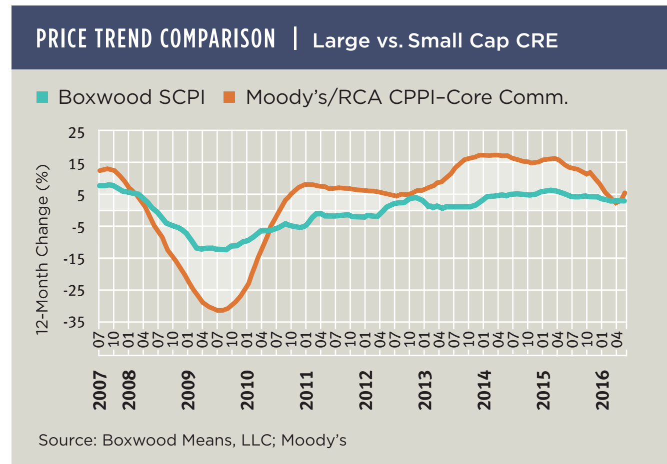


▸ Tech-oriented multifamily markets out-perform. Overall, prices in 42 of the 48 small cap multifamily markets advanced during second quarter as well as over the previous 12 months. The best annualized returns were posted by San Antonio (15.2%), Dallas (14.8%) and West Palm Beach (14.3%). However as shown in the nearby graph, some of the highest and most protracted gains have been recorded by tech-friendly cities. In all, prices in 30/48 markets exceed their previous peak level, but the hottest, peak-to-current leaders among them include New York (68.0%), San Jose and Houston (62.9%), and Portland (61.3%). In the aggregate, SMPI is a hefty 24.4% above its former cyclical peak.



▸ Office acquisitions rejuvenate large cap prices. The Core Commercial (CC) component of Moody's/RCA CPPI (that excludes multifamily and tracks sales transactions of investment-grade properties principally above $2.5 million) jumped 2.7% in June propelled by a whopping 6.8% gain in the CBD Office segment and a 4.0% increase generally in the Office component. The CC Index rebounded for the third consecutive month after the dissipation of first quarter's financial market turmoil and increased at an annual pace of 6.1% in June. With the weaker deal activity as noted in the previous section of this report, the sharp uptrend in recent prices suggest that many institutional investors have rotated to a risk-off stance with more core asset purchases in safer Major Markets (MM) and fewer in Non-Major Markets (NMM). So while the NMM tier has returned 8.7% YOY versus only an 8.0% gain for the MM tier, prices in the primary markets bounced by 4.7% during second quarter compared with only 2.8% for the secondary metros. (See the graph below for a comparison of rolling 12-month returns for large and small cap prices.)



▸ Tight inventories keep housing prices aloft. Strong sales amidst tight supply drove housing prices higher. The S&P CoreLogic Case-Shiller 20-city home price index rose a healthy 0.8% in June and 5.1% over 12 months. Though the YOY return is the lowest since last August, the Index has gained 4.1% over just the first half of this year as the pace of existing home sales rose 1.1% in June to the highest level in over nine years. Also, new home

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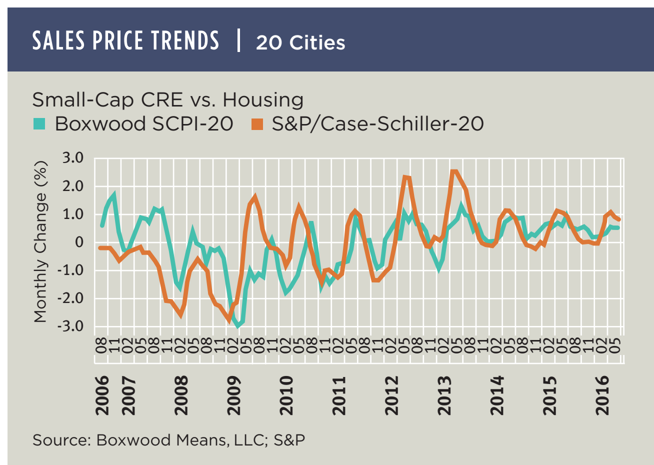
sales rose 3.5% in June to a fresh post-recession high-water mark. Home supply shortages and lower housing affordability hinder an even more robust recovery. That being said, single-family starts and completions are rebounding, and the annual pace of residential investment increased by 9.6%. Such favorable residential housing conditions bode well for small cap CRE markets given the strong price correlation between the two domains (see the graph below).



Large and small cap CRE prices are accelerating though it's uncertain whether the recent spike in the larger domain is sustainable. If concerns about downside risks precipitate a wholesale shift by investors to core assets in major markets, it's feasible that asset values for a dwindling supply of prime assets will continue to spiral upwards as a result of crowded trades during the second half of the year. But if recent history is any guide, such lofty asset prices may, in turn, be vulnerable once again to any sudden change in financial market conditions that alters investor sentiment.

The second-half outlook for small cap commercial prices seems durable and perhaps even more favorable as the volume of transaction activity remains elevated, and the pick-up in residential sales will have a knock-on effect as well. As noted, small multifamily asset prices have been on fire. They will likely remain so since personal income growth is generally lagging housing price increases – especially in major metros and tech-focused cities in the West and Southwest – all of which will keep demand for affordable rental housing high.

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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