Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

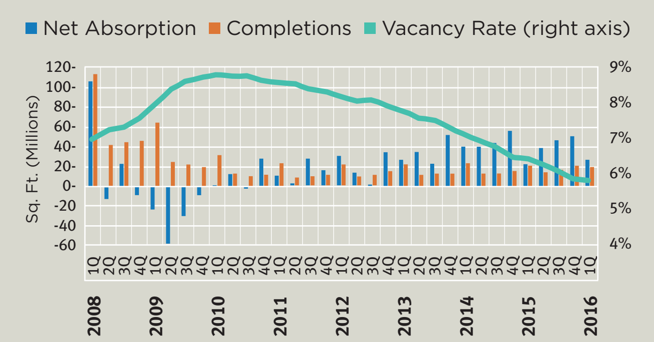
April 2016

Investor Wariness Trumps Strong Fundamentals Small cap space market fundamentals turned in a solid first quarter, but investment activity waned as investors were largely focused elsewhere, i.e., on choppy financial markets.

Space Market Fundamentals

► **Demand is off to a strong start.** Even with last year's very high net absorption totals, hefty first quarter demand relieved most doubts that the last chapter in this market's expansion had been written. Aggregate demand across office, industrial and retail sectors rose 19.2% year over year to a combined 26.7 million sq. ft., supported in part by employment gains averaging a healthy 209,000 per month during first quarter and totaling two million new jobs over the past five months. Small cap office demand was the top performer jumping 32.8% over 12 months to 6.0 million sq. ft., the second highest, first-quarter total since the recovery got underway in 2010. Net occupancies in the industrial sector rose 17.5% to 9.6 million sq. ft. while retail demand increased by 14.4% to 11.1 million. See the nearby graph for leasing trends.

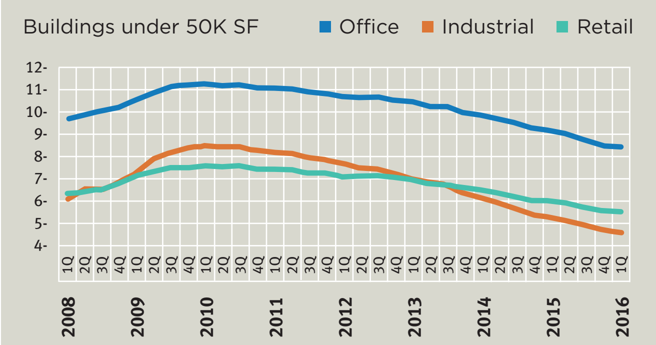
AGGREGATE SMALL CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

► **Vacancy rates sink further.** With supply of new commercial space a non-factor, the tightness of the small cap CRE space markets once again pushed national vacancy rates to new lows. The industrial vacancy rate ended first quarter at 4.6%, down 10 basis points (bps) sequentially and 70 bps year over year. Notably, the rate has recovered 390 bps since the financial crisis and is 150 bps beneath its lowest point in 2006. The national retail vacancy rate has also descended to a new low. The 5.5% rate was negligibly lower compared with fourth quarter but declined 50 bps year over year to 30 bps below its pre-recession nadir. Office vacancies, at 8.4%, eased 10 bps from the previous quarter and 70 bps from 12 months ago. The office national vacancy rate remains 20 bps above its pre-recession low point. See the nearby graph.

NATIONAL SMALL CAP CRE VACANCY TRENDS (%)



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

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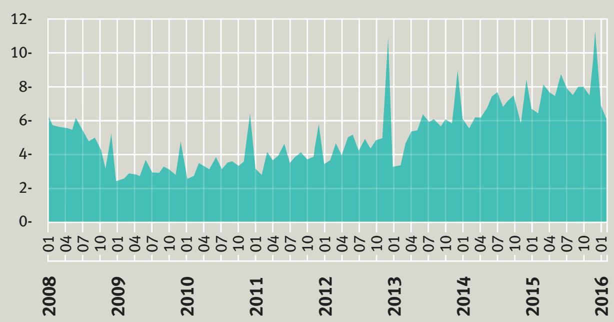
▶ **General CRE vacancies also ratchet down.** With persistently high level of demand, vacancies in the general CRE market also plumbed a fresh bottom. The national industrial vacancy rate dipped 10 bps to 6.2%, 180 bps below its previous 2007 level according to Costar data. However, general industrial supply popped during first quarter with deliveries of 42.1 million sq. ft., a massive 40.8% increase year over year as developers rushed to satisfy requirements for large regional distribution centers as well as smaller urban infill properties. Meanwhile, the national office vacancy rate was unchanged at 11.0%, 50 bps above its previous bottom, as building deliveries exceeded net absorption. Retail vacancies (across all subtypes) declined 10 bps to 5.6%, 40 bps lower than its previous cyclical low as demand has outstripped supply for four quarters running.

While sluggish global trade and weak business spending have been a drag on the U.S. economy of late, a strong labor market and increased housing sales and residential investment are positives that have helped bolster small cap CRE core fundamentals. The first quarter uptick in general CRE market supply, if it persists, may impede occupancy and rent gains ahead, but evidence of similar pressure on the small cap CRE domain remains non-existent. We will discuss small cap supply and rents in more detail with next month's report.

Property Sales Activity

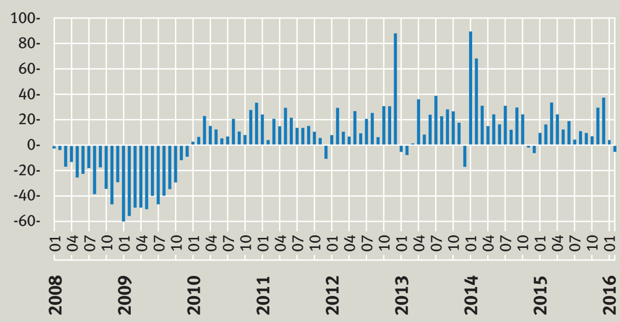
▶ **Slowdown continues.** Sales of commercial and multifamily assets under $5 million declined 12.1% in February to $6.1 billion on a preliminary estimate basis as investors dialed back their hunger for asset purchases (see the nearby graphs). Also, sales were off 5.3% compared with 12 months earlier. No doubt sales volume has taken a hit from a hike in CRE financing costs that reflected the upheaval in the corporate debt market that persisted into January.

SMALL CAP CRE SALES VOLUME TREND | Property Sales ($B)



Source: Boxwood Means, LLC

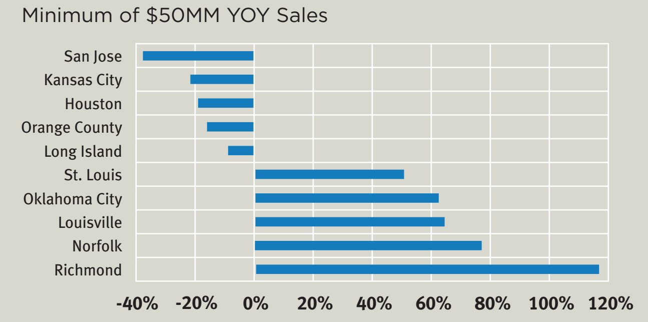
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, LLC

▶ **Sales were broadly lower.** A growing number of metros witnessed flagging investment sales activity. Across the 122 metro areas in Boxwood's sales coverage, 76 markets posted sales gains year over year in February, down from 84 in the previous month. Winners and losers with a minimum of $50 million in sales year over year are shown in the graph on the next page.

YOY SALES VOLUME WINNERS AND LOSERS



Source: Boxwood Means, LLC

▸ **Broader CRE market retrenched big time.** Sales of significant properties greater than $2.5 million in value plummeted in February generating volume of only $25.8 billion, down roughly 45% both sequentially and year over year according to data from Real Capital Analytics (RCA). Monthly volume has not been that low since May, 2013 and, moreover, RCA reported that the last time deal flow dropped so drastically was early 2008 just before the CRE market tanked. Portfolio and entity-level transactions fell 70% in February from 12 months earlier and single-asset deals declined by 26%. RCA suggested higher pricing specifically for CMBS debt, which often tends to back larger property loans, created significant dislocations in the market and deterred sales.

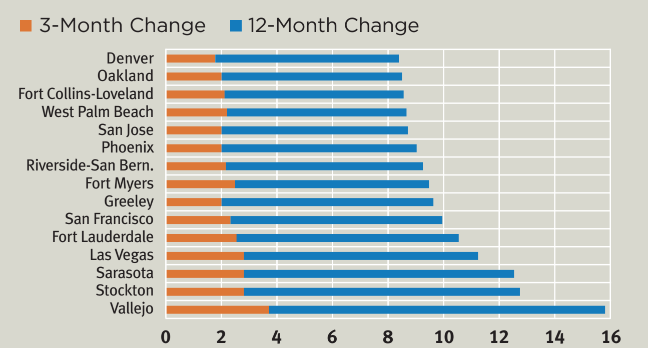
Though the drop-off in transaction volume was ubiquitous, small cap sales activity was less affected than the larger CRE investment market by financing uncertainties in the current quarter. It's also likely that large cap deal activity was singularly hurt by growing resistance among institutional investors to paying astronomical prices for trophy assets. As small cap CRE investors adjust to higher debt costs and re-affirm the unflinching, solid prospects of the space markets, we think the odds are good that small cap CRE deal-making will rebound over the next couple of months.

Sales Prices

▸ **Price growth ebbs.** Increases in Boxwood's national composite price index for small commercial (non-multi-family) properties under $5 million across 127 cities slowed to a crawl with a mere 0.1% increase in February on a preliminary estimate basis. Price growth slowed to just 0.4% over the last three months and 3.6% year over year – the lowest annualized gain since January, 2013 as differences in market sentiment between buyers and sellers have magnified and curbed deal-making. SCPI has recovered 60.3% of its losses since bottoming out and remains 8.9% below its pre-recession peak.

▸ **Top 15 markets concentrated in three states.** Prices are still charging ahead in selected metro areas of Florida, California and Colorado that occupy 13 of the top 15 spots with the highest price appreciation over 12 months (see the nearby chart). With the exception of Fort Collins-Loveland where prices are 12.5% above the previous peak, prices in the majority of these markets are still substantially below their respective high-water mark before the recession. Nevertheless, price momentum is evident in these markets by the healthy 2-3% increases over three months. Overall, 111 of the 127 markets recorded year-over-year price increases in February (one more than during January) with 113 advancing over the last three months (versus 107).

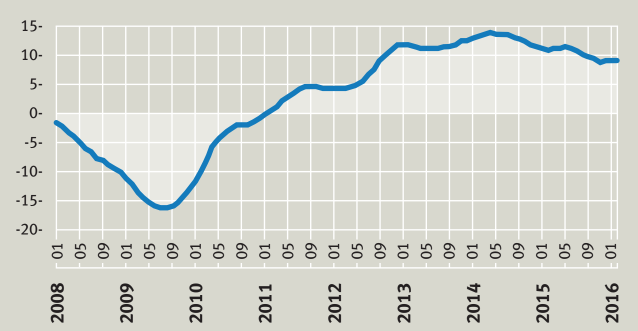
TOP 15 MARKETS FOR CRE PRICE GROWTH (%)



Source: Boxwood Means, LLC

▸ **Run-up in small multifamily asset prices decelerates.** A confluence of factors including robust core multifamily fundamentals, favorable demographics, abundant capital sources and shortages of affordable single-family housing options promoted double-digit annual price increases for small rental housing properties over 33 consecutive months beginning in late 2012. Indeed, Boxwood's recently introduced Small Multifamily Price Index (based on the aggregate performance of 48 markets) shows that national prices recovered a whopping 174.2% since bottoming out in April, 2011 and, as of February, were 19.0% above the previous peak level. However, that extraordinary price growth appears to have run its course – or at minimum been temporarily impeded by recent rising interest rates – yielding lower, single-digit gains since last August (see the nearby graph). That being said, small multifamily properties continue to be prized by investors, and February's 8.8% price gain over 12 months attests to that zeal, aided by plentiful funding by the GSEs and other lenders.

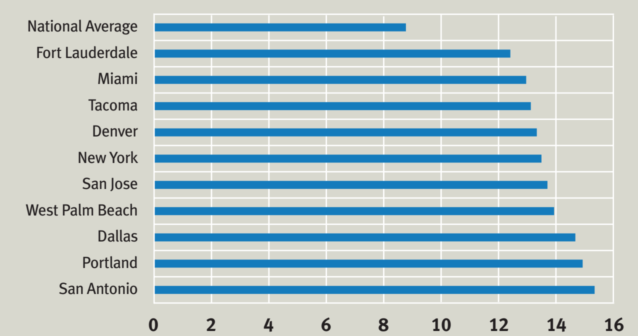
MULTIFAMILY PRICE TREND | Annual Change (%)



Source: Boxwood Means, LLC

In fact, prices are still growing at a fast clip in a diverse subset of these markets, with 18 of the 48 multifamily metro areas posting double-digit price growth over 12 months led by San Antonio (15.4%), Portland (15.0%), Dallas (14.7%) and West Palm Beach (14.0%). See the nearby graph. Overall, 44 of the 48 markets posted gains year over year.

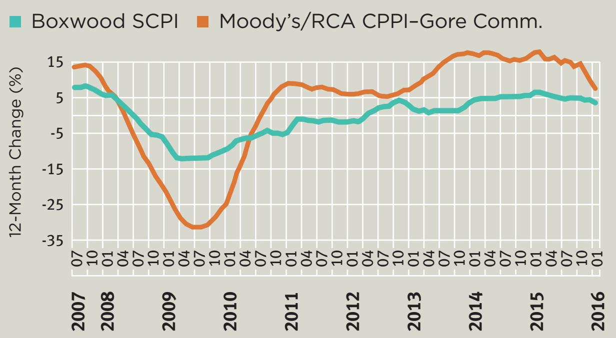
MULTIFAMILY OUTPERFORMERS | 12-Month Price Change (%)



Source: Boxwood Means, LLC

▸ **Large caps may be correcting.** 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) slipped for the third month in a row, off 0.6% in February and 1.8% since December. The last time the CC Index posted three consecutive months of negative returns was January, 2010 just before the recovery got underway. Again, we can point to the recent tumult in the debt markets as a primary driver behind the setback in prices, but it's also conceivable that selected sectors of the investment market are correcting. Take, for instance, CBD Office, the perennial darling of institutional investors that outperformed all other commercial property types with a cumulative 95.8% gain over five years according to Moody's. Yet the tables have now turned for this sector, where prices declined notably by 1.7% in February and 5.2% over three months. A similar pattern has emerged for Industrial: i.e., a 48.8% cumulative return over five years, but losses of 0.9% and 2.7% for the most recent one- and three-month periods, respectively. Overall, the CC Index increased 7.3% over 12 months – healthy no doubt – but down precipitously from annualized price appreciation in the mid-teens as late as last summer. See the nearby graph for a comparison of large and small cap price trends.

PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Moody's

Clearly, we've crossed a threshold into a period, temporary or otherwise, of normalizing property prices. It was ushered in by volatility and fear in the financial markets a couple of months ago as crude oil dropped below $30 per barrel, high-yield bond markets deteriorated and the stock market swooned by 10%. Financial investors grew concerned about a stock market downturn or even recession and, seemingly on cue, many real estate investors headed for the sidelines. These are some of the proximate causes for the slowdown in CRE investment activity and prices.

However, psychology may be playing a role here, too. Many investors, particularly in the institutional domain, were for months wondering out loud about the sustainability of the CRE market's surge and whether prices had topped out after the extended, multi-year run. Those cautious views have a way of traveling far and fast in the industry, and we might argue that those sentiments or expectations became a self-fulfilling prophecy, by infiltrating investor behavior and ultimately bringing about softer prices that investors were concerned about in the first place.

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.

Boxwood deems that our data sources are reliable. Some areas of the country offer more complete information than others. This report is presented on an "as is, as available" basis. Boxwood makes no warranties, expressed or implied, without limitation, to the information provided, nor are we responsible for any errors or omissions.

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