Small Balance Advocate
MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS
February 2016

Small Caps End Year on High Note Deal volume topped $90 billion in 2015 for the first time as rents and asset prices strengthened in most markets.

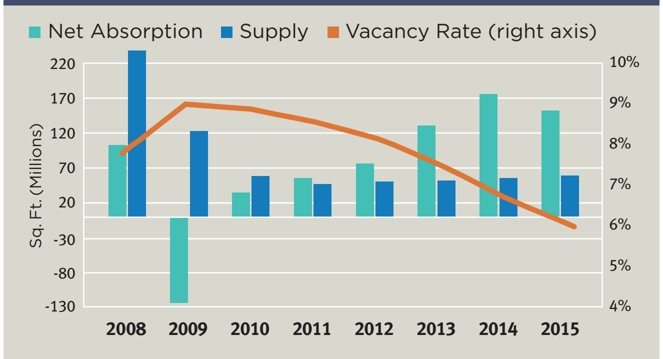
Space Market Fundamentals

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

▸ **The supply spigot finally opened up.** With 1,282 new office, industrial and retail buildings, the aggregate number of commercial deliveries was the highest total in eight quarters. This 16.6 million sq.ft. of new inventory represented an 8.7% increase over third quarter and a ramp up of 20.3% year over year. Total completions for 2015, at 61.4 million sq.ft., amounted to a 7.9% increase over 2014 and the largest sum since 124.4 million was brought on line during 2009. Industrial projects increased by 79.6% for the year (albeit off a low comparative base), office deliveries rose by 22.3% and retail by 4.4%. However as shown in the nearby graph, the fresh supply – still a fraction of historical norms prior to the financial crisis – has yet to dent the trends of bottom-hugging vacancies and strong net absorption.

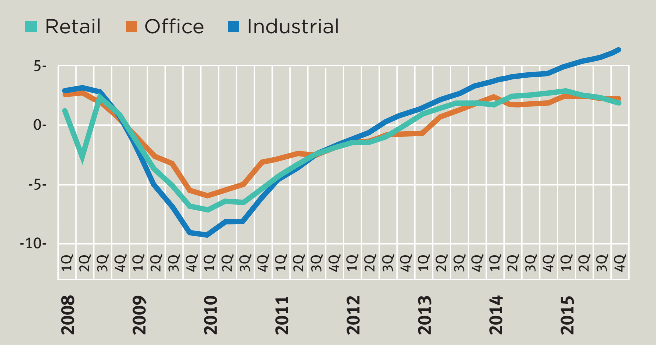
▸ **Industrial rents were a show-stopper.** With national industrial vacancies plunging 130 basis points (bps) below its pre-recession low, it's no wonder that industrial rents have soared (see the nearby graph). Small cap rents, at $7.57 per sq.ft., jumped 1.7% during fourth quarter, the highest quarterly growth rate in at least 39 quarters. For the full year, rents climbed a whopping 6.3% – also the best annual performance since at least 2006 – so that rent levels are within 4.1% of the pre-recession high. To place these operating metrics in further context, even during the peak years of roughly a decade ago when rent growth topped out at 3-4% per year average annual project completions reached outsized proportions of 77.3 million sq.ft. – or nearly six times the 2015 total.

AGGREGATE SMALL CAP CRE LEASING TRENDS



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

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



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

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▸ **Office and retail rents on the rise.** Small cap office rents rose 0.4% during the quarter and 2.2% for the entire year as national demand for office space, totaling 36.9 million sq.ft., was the highest yearly amount since at least 2006. With strong growth of late in office-using jobs, annualized rent increases have now exceeded 2% for four consecutive quarters, the best performance during the cycle so far. Small cap office rents, at $18.20 per sq.ft., are 6.4% below the pre-recession peak.

While retail net absorption during 2015 was the highest in seven years, rent increases have been held in check by a traditionally strong flow of project deliveries. Small cap retail rents increased 0.2% during fourth quarter and 1.9% for the year. At an average of $16.58 per sq.ft., rents are 8.2% below the previous cyclical peak.

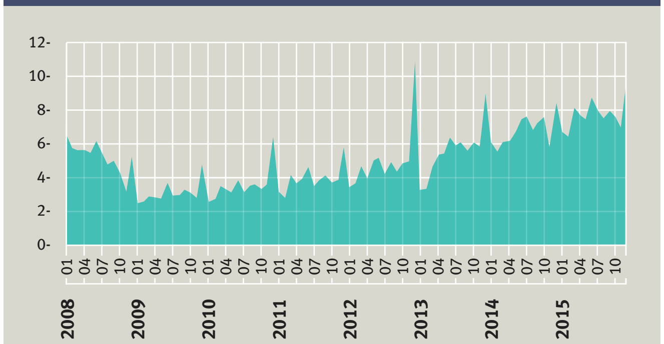
▸ **Rents in the general CRE market tracked higher.** With the exception of the industrial sector, retail and office rents in the general market are out-performing rents in the small cap arena. National office rents rose 3.6% in 2015 to an average of $25.29 per sq.ft. according to CoStar despite a 30% annual jump in rentable building area supply. General retail market rents rose 3.8% to $17.37 per sq.ft., but the rate of growth slowed by more than a percentage point compared with 2014. Industrial rents jumped by 5.4% to $6.26 per sq.ft. on average, nearly doubling the growth rate for 2014 and representing this sector's best performance since at least 2006.

Without doubt 2015 was a landmark year for the small cap industrial market, along with healthy progress in office and retail sectors. However as mentioned last time, there are some lingering questions about the sustainability of commercial demand during 2016: Net absorption across all three sectors declined nearly 13% compared with 2014 as industrial demand alone contracted by a sizable 25% in lockstep with fourth quarter's sluggish U.S. economic growth. That being said, core CRE fundamentals are performing exceptionally well at this stage of the cycle. As long as U.S. economic output and jobs maintain their moderate pace of growth, we can expect that rent and property income appreciation will continue during 2016. That outcome would certainly please small balance lenders and investors.

Property Sales Activity

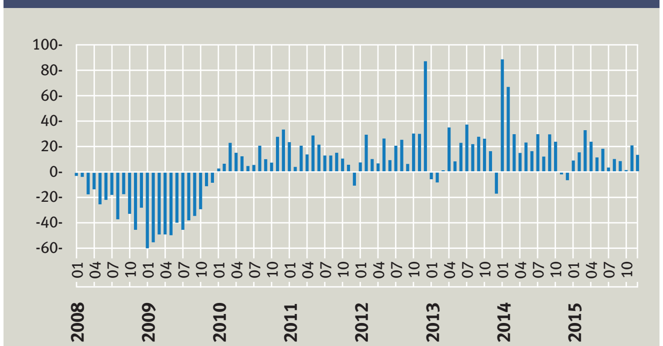
▸ **Annual sales top $90 billion for first time.** Sales of commercial and multifamily assets under $5 million reached $93.2 billion during 2015, besting last year's previous record high by 13.9% (see the nearby graphs). Deal volume during fourth quarter rose 11.7% year over year. In a persistently favorable investment climate, property sales averaged nearly $8 billion per month and topped out at $9.6 billion in December on a preliminary estimate basis.

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



Source: Boxwood Means, LLC

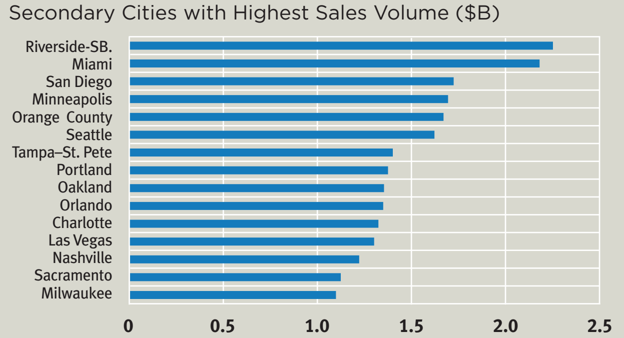
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, LLC

▸ **Billion-dollar club grew.** The number of cities with $1+ billion sales rose to 30 from 24 during 2014 as deal flow increased in some of the larger secondary locations (see the nearby graph). For example, sales volume jumped a massive 49.9% in Orange County, followed by Seattle (39.1%), Orlando (37.9%) and Sacramento (34.5%). All told, 11 of the 30 cities with a billion or more in sales were located in California and Florida.

2015 BILLION-DOLLAR CLUB

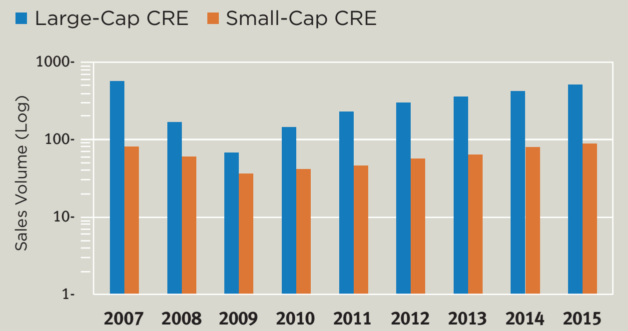


Source: Boxwood Means, LLC

▸ **Softness surfaced in some energy and Midwest markets.** Despite the huge top-line sales figure, areas of weakness emerged as 93 cities posted advances in annual sales compared with 112 during 2014. Sales declined in a number of the oil patch markets including but not limited to Shreveport (-39.8%), New Orleans (-16.0%) and Tulsa (-10.8%) and also modestly in a fair number of Rust Belt cities such as Akron (-12.1%), Pittsburgh (-8.7%), Detroit (-2.7%) and Cleveland (-1.6%).

▸ **Large asset sales soared as well.** Sales of significant properties greater than $2.5 million in value totaled $533.6 billion last year, 23.4% higher than 2014 and only 6.9% below the record volume of $573.3 billion set in 2007 according to Real Capital Analytics (RCA). RCA reported that portfolio and entity-level transactions accounted for 32% of total transaction volume and 45% of the overall growth in sales dollars. Single asset trades rose 15% compared with 2014 and achieved the highest level of investment volume on record for this segment. See the graph below for a sales trend comparison.

SALES VOLUME TREND COMPARISON



Source: Boxwood Means, LLC; RCA

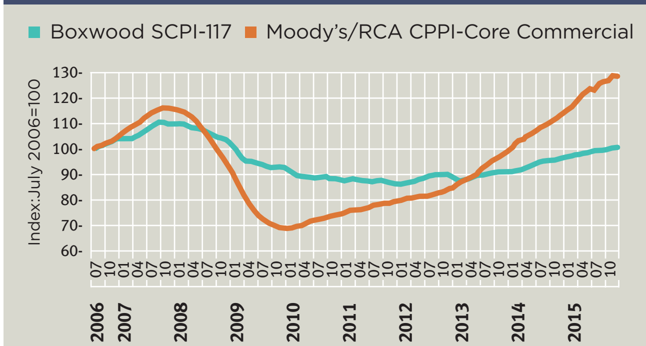
After bottoming out at $36.9 billion in 2009, small cap CRE sales have climbed relentlessly with each ensuing year of the market's recovery. Now deep into the market's expansion phase with record-high deal volume, market sentiment about 2016 is mixed with uncertainties about interest rates, cap rates and the direction of asset prices. These are just some of the unknowns, but we think the combination of stable core fundamentals and relatively attractive yields can sustain the favorable small cap CRE investment market this year.

Sales Prices

▸ **Modest gains for the year.** SCPI-117 representing Boxwood's national composite index of small cap commercial (non-multifamily) prices for 117 cities rose 0.3% in December on a preliminary estimate basis and 4.5% during 2015. While this price growth is modest compared with the large cap market (see below), the rate of appreciation is roughly equivalent to the 5.4% annual gain in the U.S. national housing market with which the small cap CRE market is tightly linked. Small cap prices in the majority of the country are on the mend with 97 metros posting annual price gains for the year along with 101 advances during fourth quarter. As a result, SCPI-1117 has recovered to within 8.9% of its pre-crisis peak of October, 2007.

▸ **Large cap asset prices decline.** The Core Commercial component of Moody's/RCA CPPI (that excludes multi-family and tracks sales transactions of investment-grade properties principally above $2.5 million) eased 0.3% in December – conspicuous not so much for the level of loss but for the fact it represents the lowest monthly return since January, 2010. In addition, the 12.6% annual gain for the year, though sizable, is more than 300 basis points lower than 2014's total return and the lowest annualized increase in 30 consecutive months. Moody's confirmed the price deceleration in both their Major Markets and Non-Major Markets components. Overall, as of December the Core Commercial segment had recovered 125.5% of its financial crisis losses and was 10.4% above its previous peak. See the nearby graph for a comparison of large and small cap price trends.

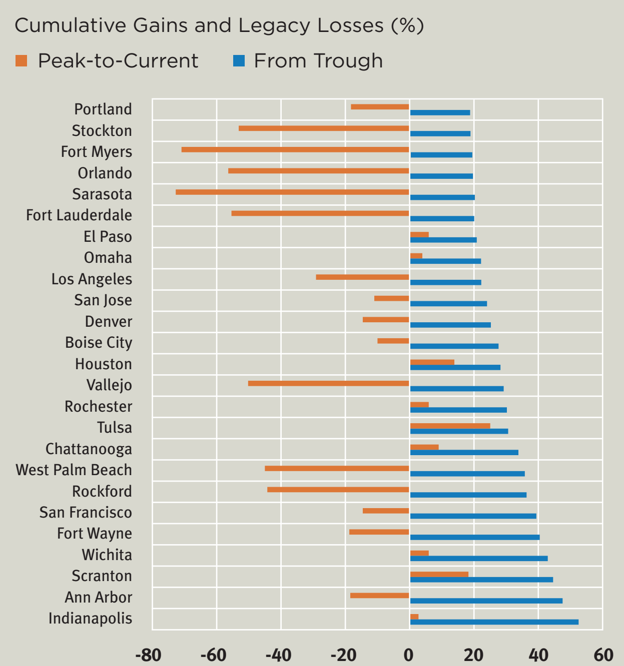
NATIONAL CRE SALES PRICE TREND COMPARISON



Source: Boxwood Means, LLC; Moody's

▸ **Legacy losses mask some big gains.** Many metros have staged strong price comebacks since hitting bottom after the financial crisis, even though the majority remain in negative territory compared with their previous peak levels. The nearby graph shows those cities with the strongest cumulative gains ranging from 20% to 50%, along with their still sizable peak-to-current losses. Stockton, Fort Myers, Orlando, Sarasota and others are prominent in that respect, and their losses may very well not be fully recovered during this cycle.

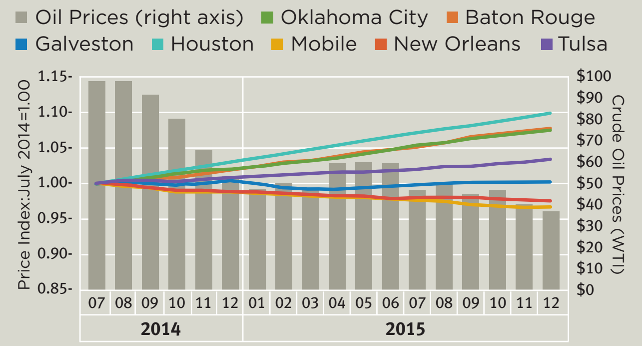
BEST PRICE RECOVERY: TOP 25 METROS



Source: Boxwood Means, LLC

▸ **Mixed bag in the oil patch.** Oil prices have fallen from roughly $100/barrel to $33/barrel in the past 12 months, and the question arises as to the impact on asset prices in markets dependent on the oil and gas industries. The smaller oil patch cities in our coverage universe have tracked more annual losses than gains including Mobile (-2.3%), New Orleans (-1.4%) and Galveston (-0.2%). Annual returns were positive in mostly the larger metros led by Houston (6.7%), Baton Rouge (5.7%) and Oklahoma City (5.3%). See the graph below as well as our blog piece on the topic **here**.

SMALL CAP CRE PRICES IN SELECTED OIL PATCH MARKETS



Source: Boxwood Means, LLC; FRED

We've suggested for some time that the prices for institutional assets may be overheating, and the latest figures from Moody's now indicate that some of the hot air may finally be escaping from the large cap domain. RCA also reported that cap rate compression slowed during 2015 compared with previous years. These conditions may cause some buyers to step to the sidelines and usher in, at least temporarily, more moderate price growth. Of course, small cap CRE prices in most markets have yet to fully recover, but all signs indicate national prices will increase by 5-6% during 2016.

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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