Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

January 2016

Property Sales Advance to New High as Fundamentals Shine Annual sales volume set a new record in November by capitalizing on exceptional trends in space market fundamentals.

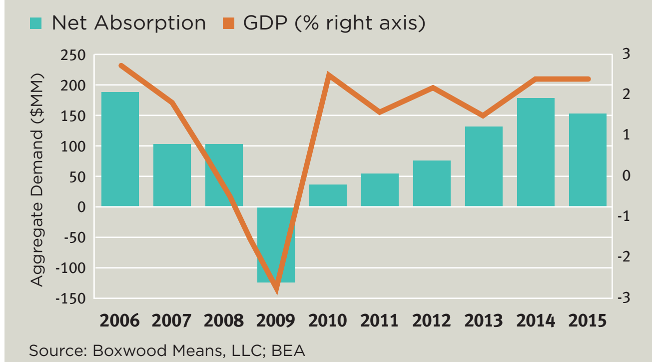
Space Market Fundamentals

Statistical highlights about small cap CRE demand and vacancy trends drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below. A discussion of rents and supply will follow next month.

▸ **Demand ends year on high note.** Bolstered by stable, if not improving U.S. economic growth, aggregate net absorption across industrial, office and retail sectors totaled 153.3 million sq.ft. during 2015 – the third highest annual total over the last 10 years. Demand rose 4.4% sequentially during fourth quarter as the 48.0 million sq. ft. of net occupancies represented the highest quarterly total of the year.

▸ **Questions arise about future leasing momentum.** Despite the elevated year-end demand figures, annual demand trailed the high-water mark set in 2014 during the post financial crisis era. Fourth quarter commercial net absorption declined 12.2% year over year, and the overall 2015 sum amounted to a 12.7% annual decrease. Industrial, CRE's blockbuster sector for several year's running, showed the most vulnerability with annual demand falling a sizable 24.7%. Retail demand was off 6.7% compared with 2014 while the office sector eked out an annual occupancy gain of 2.2%. The fact is that the U.S. economy grew at an annualized rate of only 0.7% during fourth quarter and, without some further acceleration in economic growth in the months ahead, the slower leasing velocity of the past year may foreshadow further slowing ahead. See the nearby graph showing the relationship between GDP and small cap CRE demand.

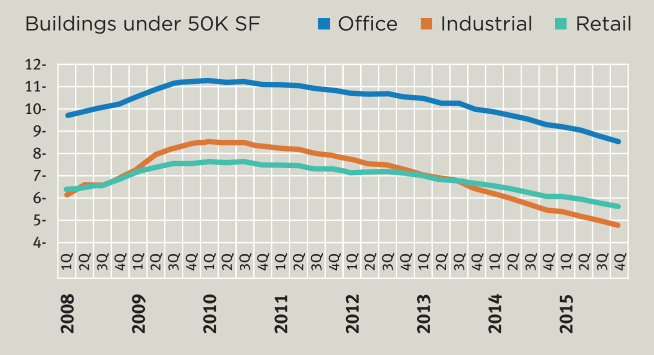
GDP AND AGGREGATE DEMAND TRENDS



Source: Boxwood Means, LLC; BEA

▸ **Vacancy rates set new lows.** Thirteen consecutive quarters of positive net absorption have pushed vacancies into record-low territory. The small cap industrial vacancy rate narrowed by 20 basis points (bps) in the last quarter and 70 bps year over year to an average of 4.7% – 130 bps below the level attained at the market peak in 2006. The national retail vacancy closed out the year at 5.6%, down 50 bps year over year and 30 bps from its pre-recession nadir. Only the national office vacancy rate at 8.5%, down 20 bps during fourth quarter and 70 bps year over year, remains above its 2006 low point, albeit by only 30 bps. Perhaps most noteworthy is the fresh impact that sustained tenant demand and rock-bottom vacancy rates have produced on new construction activity, to be discussed next month. See the graph on the following page for sector vacancy trends.

NATIONAL SMALL CAP CRE VACANCY TRENDS (%)



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

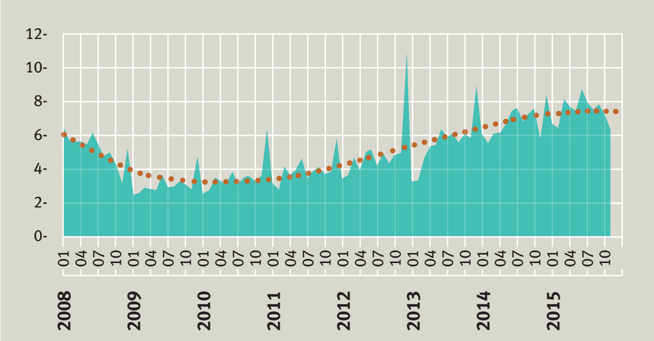
▸ **General CRE market vacancies also tightened.** The general industrial vacancy rate declined a sector-best 70 bps year over year to an average of 6.4% at year's end, 160 bps beneath the previous cyclical low in 2006. At 11.0%, the national office vacancy rate improved by 50 bps but remains 50 bps above the low set in 2006. Total retail vacancy rates narrowed by 40 bps year over year to an average of 5.7%, 30 bps below the pre-recession level. These vacancy trends underscore the vitality and durability of overall CRE market fundamentals heading into 2016.

Expectations are that growth in the U.S. economy will rebound in the first quarter with stronger contributions from consumer and investment expenditures. That will spell good news for the durability of the CRE market upcycle and another favorable year for small balance lenders and investors.

Property Sales Activity

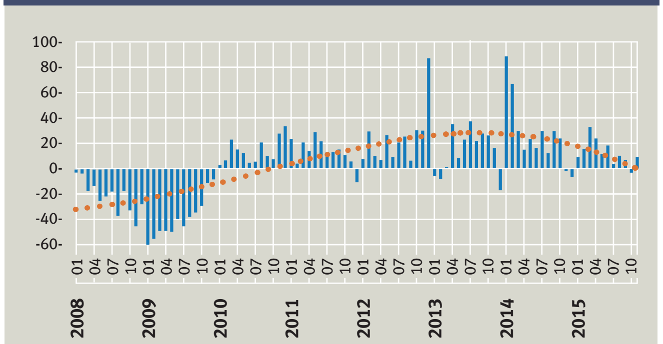
▸ **Asset sales reach new peak.** Sales of commercial and multifamily assets under $5 million rose 9.7% year over year to $6.4 billion during November. This preliminary monthly estimate elevated the year-to-date total to $82.4 billion, thereby eclipsing 2014's record annual total ($81.8 billion) even before the strong sales push typically posted during December. Though there is some evidence that sales momentum has slowed a bit since mid-summer (when some volatility in interest rates emerged and a rate hike became imminent), transactions on a month-to-month basis are still way above the historical norm. See the nearby graphs.

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



Source: Boxwood Means, LLC

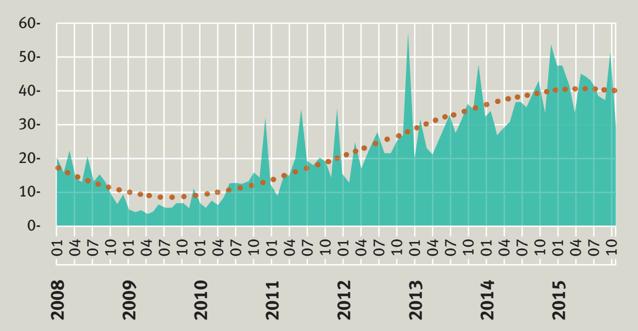
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, LLC

▸ **Similar story with large property sales.** Sales of significant properties greater than $2.5 million in value totaled just $28.3 billion in November, down 45.5% sequentially and off 15.2% year over year according to data supplied by Real Capital Analytics (RCA). RCA reported that transaction volume slowed in the fall, and that individual property sales (versus entity and portfolio sales) have declined on a year-over-year basis. (See the graph on the following page.) Nevertheless, through November large cap property sales totaled a whopping $460.3 billion, 6.4% ahead of 2014 annual volume and trailing only the mark of $575.0 billion attained in 2007.

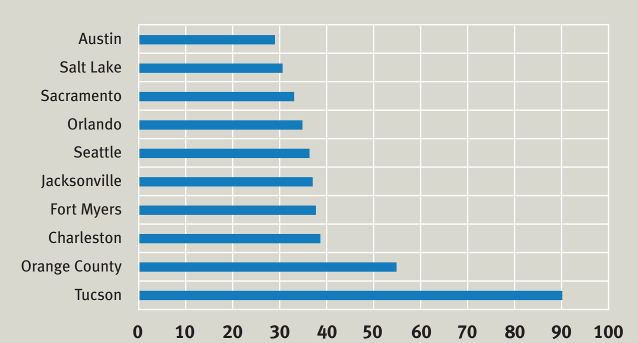
LARGE CAP CRE SALES VOLUME TREND | ($ Billions)



Source: Boxwood Means, LLC; RCA

▸ **Secondary markets lead the pack.** Robust sales volume in secondary and tertiary markets is one of the leading story lines of the year. Of the 122 markets for which Boxwood tracks small cap sales, 91 cities posted year-to-date sales increases through November compared with 2014 – up from 86 in October and dominated by the likes of Tucson (90.0%), Orange County (55.0%), Charleston (38.9%) and Fort Myers (37.8%) among cities with a minimum of $500 million in year-to-date sales (see the nearby graph). Many of these smaller cities have pulled off strong economic revivals but are appealing to private investors because low asset values still offer strong risk-adjusted returns.

SALES GROWTH LEADERS (%) | Minimum of $500MM YTD Sales



Source: Boxwood Means, LLC

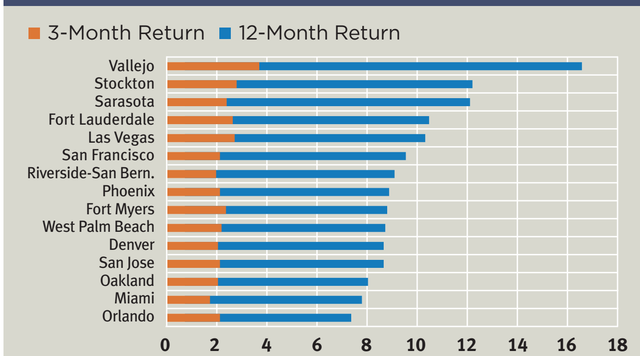
It's apparent that investors in both small and large cap CRE segments recently eased off the gas pedal in light of interest rate uncertainties as well as global concerns primarily about China. Both domains are coasting to annual record or near-record high volumes nonetheless and, at these heights, some investor temperance that offsets the market's general exuberance is probably a good thing.

Sales Prices

▸ **Prices improved in more markets.** While SCPI-117 representing Boxwood's national composite index of small cap commercial (non-multifamily) prices for 117 cities increased modestly by 0.3% preliminarily in November, price growth is nevertheless building across an ever broader number of cities. Ninety-eight cities posted annual price gains in the latest month, up from 82 metro areas 12 months earlier. With 104 cities showing price increases over the latest three-month period, SCPI-117 has recovered to within 9.2% of its pre-recession era peak.

▸ **Florida and California markets dominate the leader board.** These two states account for 12 of the top 15 metro areas for best annual returns (see the nearby graph). Despite this recent strength, these cities still face a long path to full recovery having retraced on average only 21.3 % of their recession-period losses. Clearly with so many asset values meaningfully below peak levels of 10 years ago, coupled with lower market

PRICE LEADERS OVER 12 MONTHS (%)



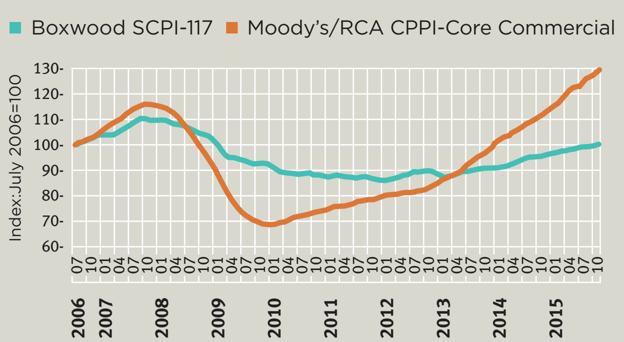
Source: Boxwood Means, LLC

rents, bridge and mezzanine lenders will especially be busy for another year helping small balance borrowers refinance their debt.

- **Large cap CRE prices rocket ahead.** 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 1.7% in November after two relatively sedate months. The CC Index rose 15.8% year over year and extended its run of double-digit annualized gains to 31 months. As a consequence, the CC Index is 11.7% above its former peak in January, 2008. Institutional prices have been heavily influenced by asset purchases in the Major Markets (MM) group (Boston, Chicago, L.A., N.Y., S.F. and Washington, DC) with outsized gains of 20.3% over the last 12 months compared with 9.7% for the balance, or Non-Major Markets (NMM). Institutional appetite for assets in secondary and tertiary markets may be inchoate – but is so far less fervent – as prices in the NMM grew by only 0.9% over the last three months compared with a robust 4.6% gain in the MM segment. The NMM Index was 0.5% above its previous pre-crisis peak in November while the MM Index has exceeded the previous high by a massive 39.2%. See the nearby graph for a comparison of large and small cap price trends.

While small cap asset prices in many cities have been slow to recover, with some exceptions average rent growth has turned out to be even more sluggish. Small cap fundamentals have substantially improved over the last three years during the market's expansion phase and, with national vacancies at or near historic lows, we expect that rent growth will become more dynamic. Rent and income growth will be particularly important for boosting asset values in the small cap CRE space which remains relatively untouched by the tremendous sums of global capital that are sustaining upward pressure on large cap prices.

NATIONAL CRE SALES PRICE TREND COMPARISON



Source: Boxwood Means, LLC; Moody's

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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