Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

July 2016

Space Markets Provide a Lift For Investments

After the recent pullback in investment sales and prices, impressive second quarter space market fundamentals re-assure small balance lenders and investors that there's plenty of gas left in the tank.

Space Market Fundamentals

Small cap CRE fundamentals strengthened further during the second quarter of this year. Statistical highlights on demand and vacancy trends drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

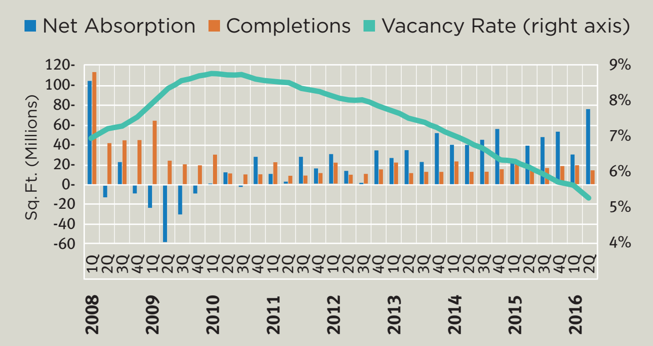
▸ **Demand soars to post-recession high.** Second quarter marked 23 consecutive quarters of positive demand topped off by a whopping 76.1 million sq.ft. of net absorption across office, industrial and retail sectors – a gain of nearly 90% YOY and the second highest total since the 104.4 million during fourth quarter, 2007. Also, remarkably the 106.3 million sq.ft. of aggregate demand through the first half of the year exceeded the net absorption total for the first six months of last year by 62.8% and represents the highest mid-year total since at least 2006.

Though preliminary second quarter GDP was under-whelming at 1.2%, the U.S. economy added 2.5 million jobs this past year – the second best year for job gains since 1999 – and June's surge in job growth dispelled most fears that the economy was stalling seven years into the recovery. Also, wages are modestly increasing, job openings are at a record high and consumer spending is robust. These are primary factors behind the dazzling demand levels for commercial space that, in turn, are perpetuating the small cap CRE market expansion.

▸ **All sectors feel the burn.** Office net absorption jumped 223.7% sequentially and 119.7% YOY to 21.0 million sq.ft., the highest quarterly demand figure since at least 2006. At mid-year, office demand was 86.1% ahead of the same six months during 2015.

Similarly, quarterly and YOY demand in the retail sector climbed 156.2% and 105.6%, respectively, with a mid-year total that surpassed last year's first six months by 68.8%. The 31.9 million sq.ft. of retail net absorption is the highest quarterly figure since the record net occupancy gains of 41.8 million generated during fourth quarter, 2006. Industrial demand, which has been robust for three year's running, also turned in a stellar quarter, rising 107.2% over first quarter and 54.4% YOY to 23.3 million sq.ft. Net occupancy levels at mid-year were 42.1% ahead of last year's pace. See the graph below for leasing trends.

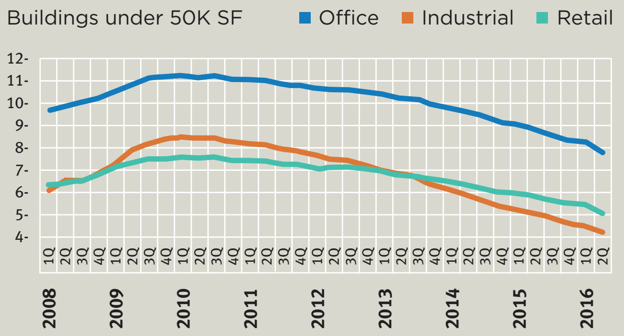
AGGREGATE SMALL CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

▸ **Vacancy rate trifecta.** Each of the three main property types plumbed new depths. The national small cap industrial vacancy rate decreased 30 basis points (bps) to an average of 4.2% during second quarter – 190 bps below the pre-recession low attained in 2006. Office vacancies narrowed by a sizable 50 bps to a national average of 7.8% that is 50 bps below the pre-recession nadir of 8.2%. Retail vacancies declined by 40 bps to 5.0% in the quarter, besting the previous low of 5.9% achieved in June of 2006. See the graph below.

NATIONAL SMALL CAP CRE VACANCY TRENDS (%)



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

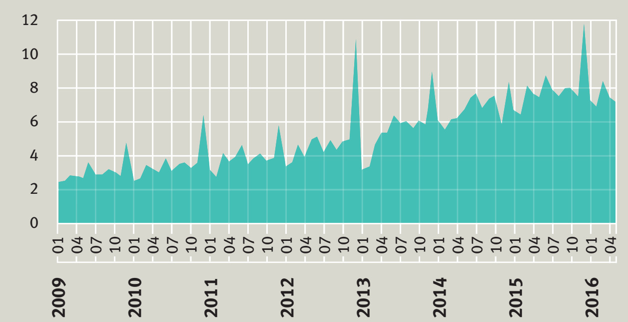
▸ **General CRE vacancies dip further.** The national vacancy rate for the general industrial market edged down 10 bps to 6.0% and 210 bps beneath the previous low in 2006. This quarter's decline occurred despite accelerating supply that totaled roughly 87 million sq.ft. over the first six months of this year – an 18% increase in deliveries over the first half of last year – that underscores the level of pent-up demand for new and larger regional distribution centers and infill properties. Demand in the general office market nearly doubled up on the level of new deliveries in the quarter, causing the national vacancy rate to narrow by 20 bps to 10.7% -- a level within 20 bps of its pre-recession low point. The net occupancy total for general retail (across all subtypes) was also two times the amount of supply, pushing the national vacancy rate to a new low at 5.3%, down 20 bps during the quarter and a level substantially below than the previous low of 6.6% posted in 2008.

The small cap CRE demand and vacancy trends offer convincing evidence that the Main Street USA economy is healthy and expanding: i.e., that small office-using firms are hiring; that the utility of smaller warehouse/distribution and flex buildings is largely undiminished by big supply chain and logistic facilities; and, similarly, despite formidable online sales trends, neighborhood shopping and strip centers still satisfy important needs for everyday items like groceries and personal care products and services. We will discuss small cap supply and rents in next month's report.

Property Sales Activity

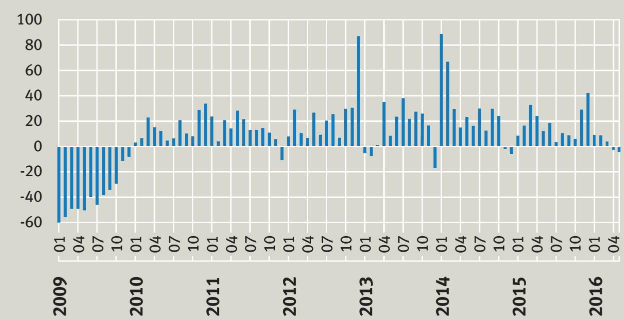
▸ **Slowing trend continues.** Deal volume for commercial and multifamily assets under $5 million eased 4.3% preliminarily in May and 4.6% YOY. Of course, last year's record $96.4 billion in sales must be taken into consideration when making comparisons here. Nevertheless, this year's cumulative sales of $37.4 million through May remain slightly ahead of last year's pace by 2.5%. (See the graphs below.)

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



Source: Boxwood Means, LLC

ANNUAL CHANGE IN SALES VOLUME (%)

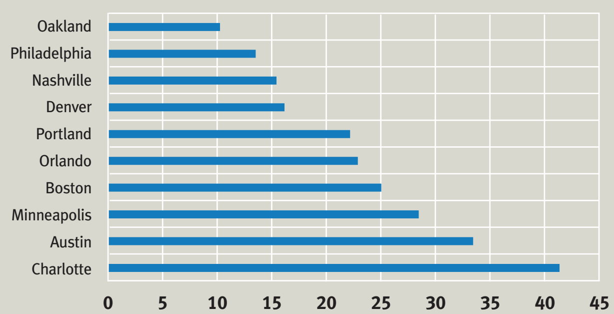


Source: Boxwood Means, LLC

▶ **Secondary markets pick up the slack.** While transaction volume has slowed dramatically in some primary markets this year, sales in some smaller markets are booming. So, e.g., while YTD sales are trailing last year's volume in core cities like San Francisco (-33.1%), New York (-20.8%), Washington DC (-15.1%) and Los Angeles (-10.1%) among others, some secondary markets have taken the lead. As shown in the graph nearby, winners with a minimum of YTD sales exceeding $500 million include Charlotte (41.4%), Austin (33.5%), Minneapolis (28.5%) and Boston (25.1%). Secondary and tertiary markets also led a modest rebound in Boxwood's Advance-Decline Ratio during May as 68 markets posted positive YOY sales growth among the 122 markets in our coverage universe, up from only 55 cities in April. (See the graph below.)

SECONDARY MARKET SALES LEADERS (%)

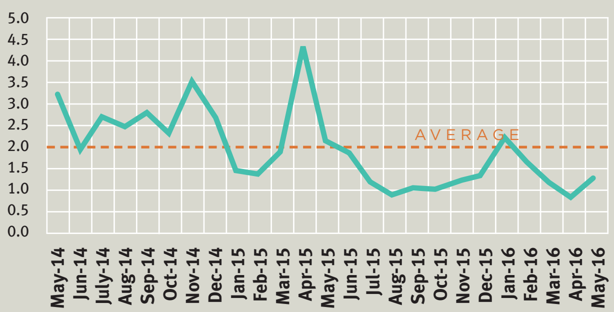
Minimum of $500MM YTD Sales



Source: Boxwood Means, LLC

ADVANCE-DECLINE RATIO

YOY Sales Activity for 122 Metros



Source: Boxwood Means, LLC

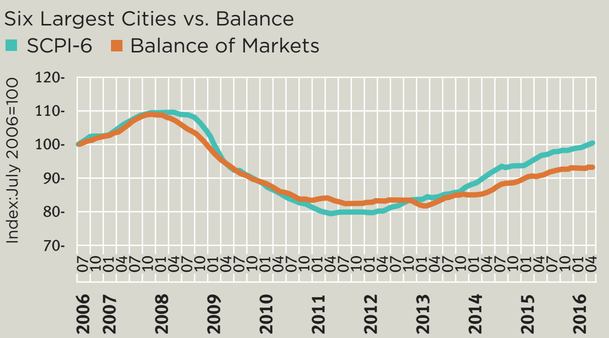
▶ **Large cap sales down, but not out.** Limited portfolio and entity deals was the primary factor in the sales decline of significant properties greater than $2.5 million in value so far this year. According to data from Real Capital Analytics (RCA), YTD large cap deal volume of $169.0 billion was off 21.8% compared with the same five months of last year as portfolio/entity deals shrunk by a sizable 37.5%. By contrast, single-asset sales declined by 13.5% in that period. RCA noted deal volume has slowed so far this year because cap rates stopped contracting, debt (especially CMBS) was less easy to come by and the financial markets suffered a bout of interest rate volatility. However, May's numbers may signal some normalization in the general CRE investment market: overall deal volume increased 7.5% from the previous month including a 30.0% increase in portfolio/entity deals and 2.3% growth in single-asset sales.

Clearly fears about the macro-economy and the extended length of the current CRE cycle weigh heavily on investors, especially institutional buyers confronted with peak pricing for assets in major markets. Many have pulled chips off the table because of increasing perceptions of economic and market risks that, in the event of a downturn, may adversely affect property values. Out of similar concerns, lenders are underwriting loans more conservatively which is producing more challenges for borrowers. But the underlying strength of, and seeming discipline generally exhibited by the space markets – when coupled with still favorable cap rate spreads and returns compared with alternative investments – provide some measure of re-assurance for CRE lenders and investors. In the absence of any further shocks to the financial markets, we expect both small and large cap investment sales to further pick up the pace.

Sales Prices

▶ **Prices edge up.** Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities rose marginally by 0.1% in May on a preliminary estimate basis. The modest gain of 0.5% YTD, as well as the 2.7% YOY increase, reflect in part the slowdown in commercial investment sales in numerous primary markets. Yet even with the sales slowdown, the six largest U.S. population centers collectively show better price momentum as SCPI-6 increased by 0.4% in May and 3.9% YOY. See the nearby graph for a trend comparison between the big-six cities and the balance of markets.

COMPARATIVE SALES PRICE TRENDS

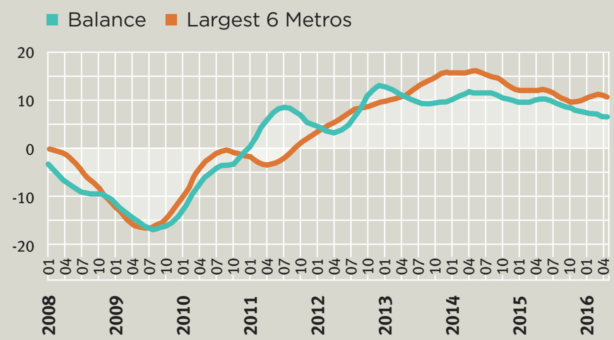


Source: Boxwood Means, LLC; S&P

Though the news headline is that commercial price gains are decelerating, a majority of markets are still posting results in the plus column. Across the 127 markets, prices in 109 markets advanced over the last three months including 37 with gains of 1.5% or more led by Vallejo (4.3%), Las Vegas (2.7%) and San Francisco, Stockton and Jersey City (2.6%). Moreover, prices rose in 112 (88%) metro areas YOY compared with 94 cities from 12 months earlier, underscoring the inherent stability of the small cap CRE price recovery. As of May, SCPI-127 was 8.6% below the pre-recession peak.

▸ **Multifamily prices still buoyant.** Returns on small cap multifamily assets continue to outshine the commercial sector, with a healthy 0.9% gain on a preliminary basis during May according to Boxwood's Small Multifamily Price Index (SMPI) covering 48 markets (see the nearby graph). And while the annualized rate of return has steadily diminished since 2014, SMPI's yield of 8.2% YOY

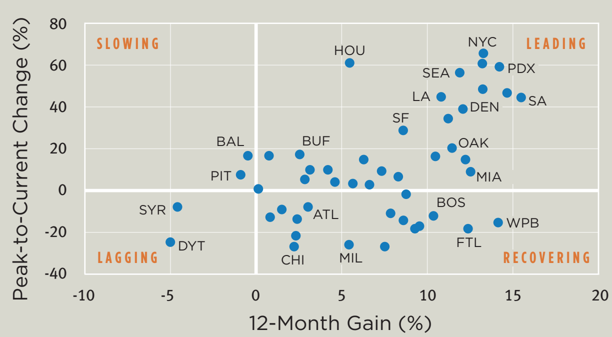
MULTIFAMILY PRICE TREND COMPARISON | Annual Change (%)



Source: Boxwood Means, LLC

is still extremely attractive to private and small balance investors who find prevailing economic and demographic forces supportive of continued high levels of demand for affordable rental housing. As a result, it comes as no surprise that 44/48 markets posted annualized price gains in May, led by outsized returns in San Antonio (15.4%), Dallas (14.7%), Portland (14.2%) and West Palm Beach (14.1%). The widespread vigor of small cap multifamily markets is illustrated in the scattergraph below where the vast majority of cities are located in the "leading" and "recovering" quadrants.

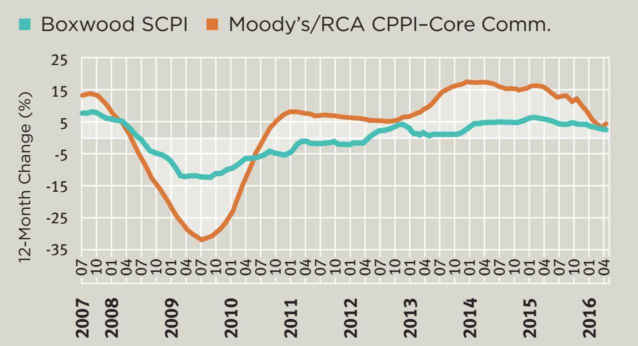
MULTIFAMILY METRO PRICE MOMENTUM



Source: Boxwood Means, LLC

▶ **Large cap prices rebound.** By jumping 1.8% in May, 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) ended a skid in commercial prices that started last December. Prices were boosted by strong monthly gains in Industrial (3.6%) and Office CBD (2.1%) which roughly correspond with the robust supply-demand fundamentals displayed by these sectors during second quarter. The CC Index showed a 4.7% annualized return in May – an improvement over the 3.1% gain in April – but a far cry from the 15.3% yield from May, 2015. (See the graph below for a comparison of rolling 12-month returns for large and small cap prices.)

PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Moody's

May's rebound in institutional CRE prices may augur a new stint of rising property values after what amounted to a modest five-month pullback. However, the possibility of an asset bubble still looms as the commercial component of CPPI is less than 1% below its November, 2015 peak and, according to RCA, deal activity from institutional/equity investors is alive and well with a particular emphasis on stabilized assets in core markets. There is equivalent enthusiasm for assets in the small cap CRE domain but, with the exception of the multifamily sector, prices are moving at a relatively moderate pace of growth. The more stable price movements in this domain will likely continue to temper price expectations of small cap CRE buyers and sellers in most markets, thereby preserving reasonable bid-ask spreads and furthering high levels of transaction activity. The same may not hold for institutional players if CRE price volatility resurfaces in that arena.

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.

Boxwood Means, LLC is a leading national provider of property valuations and data analytics in the small commercial property and loan markets. Boxwood owns and operates SmallBalance.com, where commercial banks, non-bank lenders and investors find technology-driven solutions for their investment and risk management needs including appraisals, commercial evaluations, CRE price indices and market research.