Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

March 2016

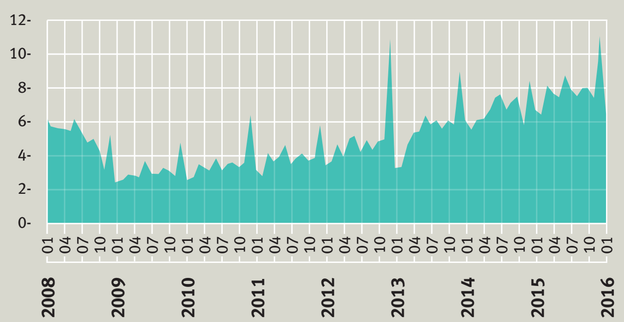
Market Expansion Gets Off to Slow Start Small balance loan originations peaked last year and helped boost property sales to another record high. In the aftermath, January's transaction volume dipped and prices flattened, but the small-cap CRE recovery remains largely intact.

Property Sales Activity

▸ **Transaction volume decelerated.** Sales of commercial and multifamily assets under $5 million declined 4.8% year over year to $6.4 billion in January on a preliminary estimate basis (see the nearby graphs). While the decline may suggest a bigger slowdown to come, we think small cap CRE investors are simply taking a breather rather than pulling back. After all, property sales during December hit a whopping $11.2 billion. Granted, December is typically the busiest month of the year, but last month's deal volume was the greatest since at least 2005. As a result, 2015's revised total sales of $95.4 billion was a landmark that blew out the previous year's record of $81.8 billion.

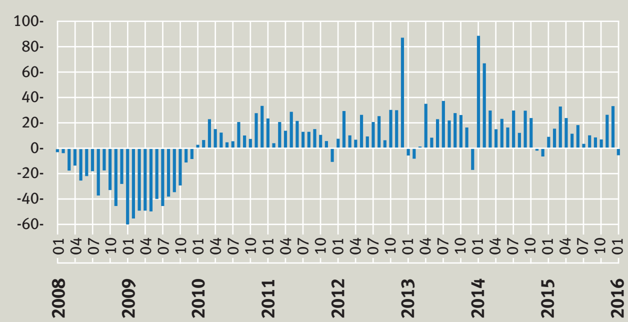
▸ **Broad sales momentum was still sustained.** Despite the slight dip in overall sales for the month, sales activity in the majority of markets remains buoyant. Across the 122 markets in which Boxwood tracks property sales, 84 cities posted sales gains year over year in January compared with only 70 from 12 months earlier. The best performers with a minimum of $50 million in monthly sales are displayed nearby. Unsurprisingly, a majority of

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



Source: Boxwood Means, LLC

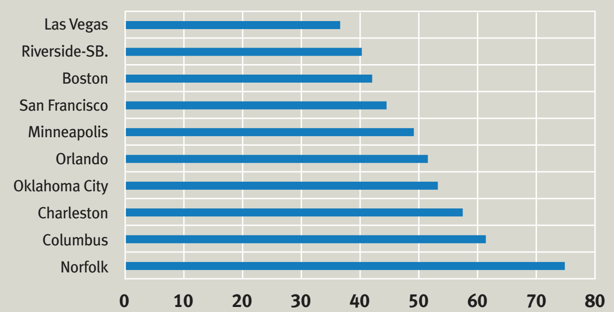
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, LLC

YOY SALES GROWTH LEADERS (%)

Minimum Monthly Sales >$50 Million



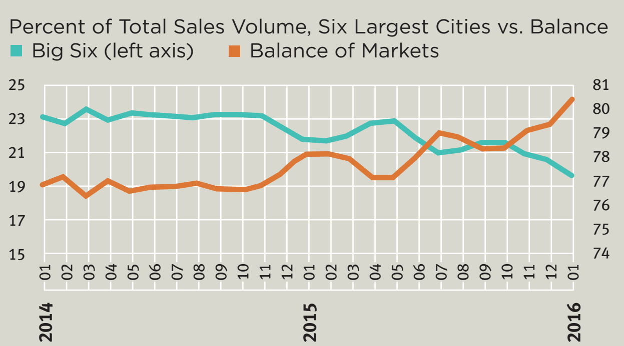
Source: Boxwood Means, LLC

the listed cities are also economic growth leaders in terms of jobs, aggregate wage income and gross metropolitan product.

▸ **Deal flow receded marginally in the larger CRE market.** Sales of significant properties greater than $2.5 million in value totaled $46.2 billion in January, down 3.2% compared with 12 months earlier but still the second highest level of deal volume for January over the previous 15 years according to Real Capital Analytics (RCA). This follows a mammoth December where sales activity peaked at $73.9 billion. RCA also reported that portfolio and entity-level transactions have been a key factor driving the continued growth in the investment market, advancing by 13% year over year and comprising 42% of total volume in January. By contrast, single-asset sales slid by 18% from 12 months earlier.

▸ **Sales make pronounced move to secondary markets.** Strengthening core fundamentals and the wide availability of financing for smaller assets have increased sales momentum in secondary and tertiary markets. The largest six U.S. population centers accounted for only 19.6% of total sales activity during January, off by 220 basis points compared with a year ago as more bountiful opportunities have surfaced in smaller markets. This trend, illustrated in the nearby graph that shows 80% of total deal volume now takes place in smaller markets, reflects increased buyer and lender confidence

TRENDS IN SMALL CAP CRE SALES ACTIVITY



Source: Boxwood Means, LLC

about the liquidity of these markets 6+ years into the CRE recovery. (Note in the graph the prominent shift in sales activity especially over the last couple of months.) The fact is that investment properties in many of these markets already produce stabilized income and, where that is not the case, many other borrowers are recapitalizing and repositioning assets via bridge financing to bring about stabilization and a possible future exit.

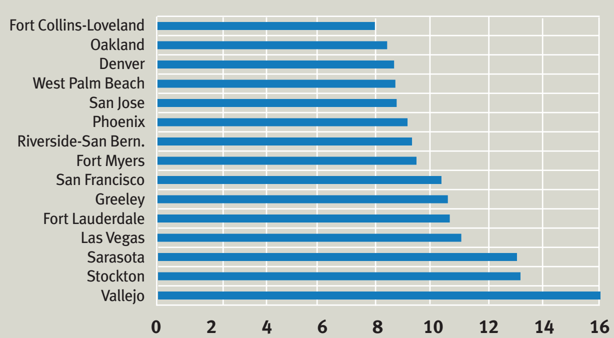
Volatility in the capital markets over the last couple of months raised some doubts about the durability of CRE's market expansion. While changes in financing costs, especially for CMBS, may alter the equation for some property buyers going forward, small balance borrowers still find a plethora of bank and non-bank financing options with relatively stable pricing, not to mention persistently strong space market fundamentals. As such, we expect to see continued healthy small cap sales activity in the months ahead.

Sales Prices

▸ **Slow start out the gate.** Small-cap CRE price gains were subdued during fourth quarter, and the trend continued in January as SCPI, Boxwood's national composite price index for small commercial (non-multifamily) properties under $5 million across 128 cities, rose only 0.1% on a preliminary estimate basis. SCPI's positive momentum has slowed to a 4.0% annualized gain, the weakest pace of growth in 24 months. SCPI has recovered 59.5% of its losses since hitting bottom exactly four years ago and is within 9.0% of its pre-recession peak in the fall of 2007.

▸ **Rocky Mountain high.** As previously reported, asset prices in selected California and Florida cities have rebounded strongly over the past year. Add some Colorado markets to the list, especially northern ones along the I-25 corridor which have been on a tear. A state's economy once overly reliant on "Coors, carbon and the Cold War" has transformed over 30 years into a highly diverse mix of financial, healthcare, aerospace and info-tech industries. Colorado's unemployment rate, at 3.2%, ranks among the lowest in the country. Along with this economic prosperity has come booming regional commercial and residential development. As the graph shows nearby, annualized price growth for small commercial assets in Greeley (10.6%), Denver (8.6%) and Fort Collins-Loveland (7.9%) rank among the top 15 U.S. metro areas. Colorado Springs (7.4%), in 18th place, is not far behind. Overall, the vast majority of U.S. cities are recovering, however modestly: i.e., 110 of the 128 cities recorded year-over-year price increases in January with 107 advancing over the last three months.

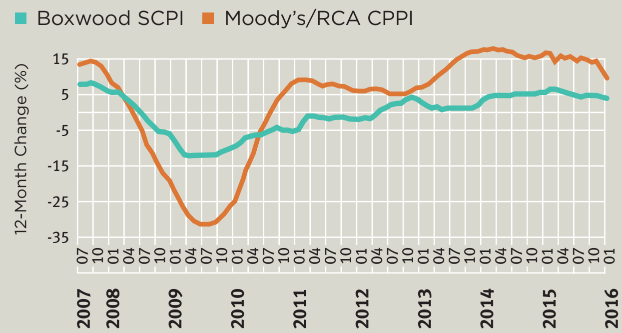
PRICE LEADERSHIP OVER LAST 12 MONTHS (%)



Source: Boxwood Means, LLC

▸ **Reversal for large caps.** The Core Commercial (CC) component of Moody's/RCA CPPI (that excludes multi-family and tracks sales transactions of investment-grade properties principally above $2.5 million) declined 0.8% in January following a 0.4% dip in December. What makes this noteworthy is that this is the first occurrence of consecutive monthly losses for the CC Index since the winter of 2009-2010. In particular, both Industrial and CBD Office prices showed marked decreases over one- and three-month periods. With this slowing of price momentum, the annual growth rate of the CC Index dropped to 9.7% in January and, though not at all shabby by historical standards, the rate happens to be in single digits for the first time in 33 months dating to early 2013. Moody's reported that the retreat in prices likely reflects a change in sentiment among institutional investors. See the nearby graph for a comparison of large and small cap price trends.

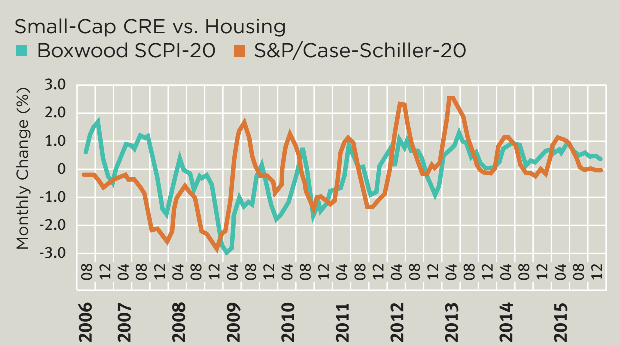
PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Moody's

▸ **Home prices flattened out.** While the 20-City Composite of the S&P/Case Shiller U.S. home price index rose to a 5.7% annual rate of growth – highest in 19 months – it's clear that price appreciation over recent months has fizzled out. For instance, home prices were unchanged during January as well as the latest three-month period. And eight of the Index's 20 metros lost ground during January after 10 posted losses in the previous month. The nearby graph shows the recently leveling off in month-over-month prices; it also illustrates two more

SALES PRICE TRENDS | 20 Cities



Source: Boxwood Means, LLC; S&P

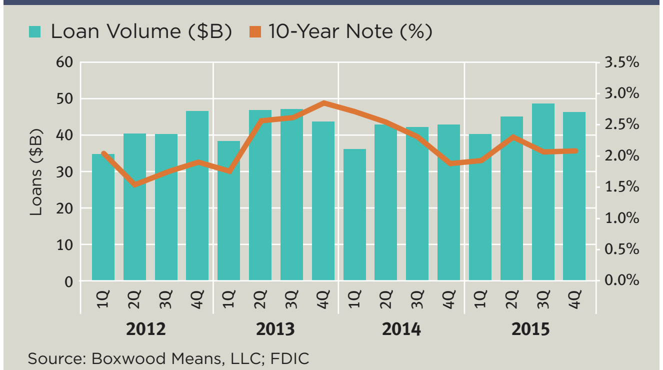
trends: that the amplitude of seasonal home price swings has strikingly diminished over the past two years; and, also, the historical lag in small cap CRE price changes has largely disappeared, i.e., housing and small commercial prices now move tightly together.

Recent commercial and residential housing price trends suggest we've entered into a period of moderating price growth, especially for institutional assets. Of course, gradual improvement has been the name of the game for small cap CRE prices during the post-crisis recovery. However, with fourth quarter U.S. GDP growth that exceeded expectations, strong national employment gains and a promising spring home buying season ahead, we expect small cap CRE price gains that are comparable to last year.

Small Balance Originations

▸ **Record high loan volume in 2015.** Against a backdrop of strong core fundamentals, cheap and plentiful debt and an improving U.S. economy, small balance lenders originated a massive $181.4 billion of loans under $5 million in value last year including $46.0 billion during fourth quarter. This annual total was the highest volume on record, advancing 10.1% compared with 2014 and eclipsing the previous peak of $176.2 billion in 2013. (See the graph below.)

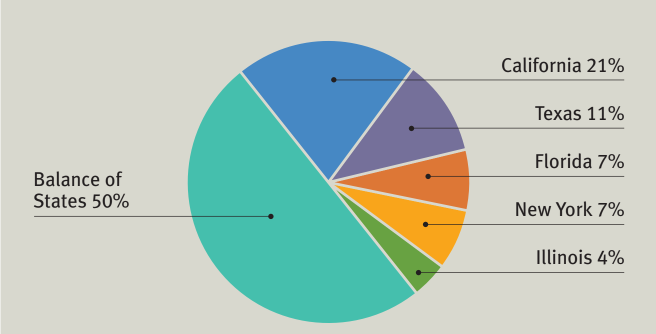
SMALL BALANCE ORIGINATIONS TREND | Loans under $5MM



Source: Boxwood Means, LLC; FDIC

▸ **Purchase loan share expanded.** Keeping pace with the burgeoning investment sales market, the national share of total originations due to purchase loans increased two percentage points during 2015 to 31%. The $57.0 billion of purchase loans represented a sizable 19.0% annual gain. By contrast, refinance loans increased by only 6.5% year over year (though commanding the lion's share of total volume). National lenders take note: as shown in the nearby graph, five states accounted for 50.0% of national purchase loan originations.

FIVE STATES | 50% of Total Purchase Loans 2015



Source: Boxwood Means, LLC

▸ **Smaller loans in great demand.** Loans under $1 million amassed $53.3 billion or just 29.4% of the total dollar volume last year, but this smaller loan category accounted for a whopping 71.6% of the more than 207,000 individual mortgages, spotlighting the breadth and depth of demand for smaller assets by private investors and small business real estate owners. The average loan amount across property types in this small loan tier was $279,000 and $291,000 for purchase and refinance loans, respectively.

▸ **Private lenders seize the opportunity.** The top 20 lenders increased their market share last year by 132 basis points to 23.4%. (See the table on the following page.) Private lenders grabbed a 1.4% share of the dollar volume – doubling their stake from 2014 – and advanced to fourth from 11th place. JP Morgan Chase, ranked #1, was the only other entity to post a material improvement with a year-over-year gain of 74 basis points for a 5.8% share. StanCorp Mortgage, ranked 20th, was the only life company among the bank-dominated league table.

TOP SMALL BALANCE COMMERCIAL LENDERS – 2015

Loans under $5 Million

Rank	Lender Name	Market Share	Avg. Loan Size ($)
1	JP Morgan Chase Bank	5.8%	1,413,808
2	Wells Fargo Bank	3.6%	1,014,830
3	Bank of America	1.5%	1,144,149
4	Private Lender/Individual	1.4%	599,226
5	New York Community Bank	1.3%	2,037,852
6	BB&T	1.1%	748,438
7	Signature Bank	1.1%	1,912,513
8	US Bank	0.9%	599,329
9	Bank of the West	0.8%	988,658
10	TD Bank	0.7%	931,802
11	Umpqua Bank	0.6%	1,383,852
12	M&T Bank	0.6%	999,385
13	First Citizens Bank	0.6%	685,091
14	PNC Bank	0.6%	749,947
15	East West Bank	0.6%	1,400,525
16	First Republic Bank	0.6%	1,630,882
17	Investors Bank	0.5%	1,689,388
18	Bank United	0.4%	1,825,117
19	Capital One	0.4%	1,389,383
20	StanCorp Mortgage	0.4%	1,912,841

The rise in private lending underscores the challenge that many small balance borrowers face securing conventional financing in certain parts of the country where asset values have yet to fully rebound. Obviously, continued recovery in small-cap CRE prices remains a key factor for those borrowers still underwater. With early signs that robust space market fundamentals persisted during first quarter, more borrowers will likely find that higher rents will help solve their financing needs. We turn to first quarter fundamentals in the next edition of this report.

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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