Small Balance Advocate

MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS

May 2016

Investors Turn Bullish At Quarter Close

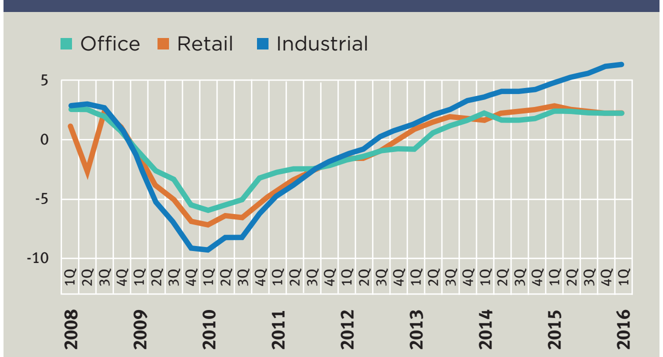
Small cap CRE investors returned to the market-place in force, elevating property sales to a first-quarter high as core fundamentals shine.

Space Market Fundamentals

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

▸ **Rents rise at fastest pace in years.** Small cap rents surged during first quarter as landlords in many parts of the country are realizing the bounty of an extremely tight marketplace (see the nearby graph). Industrial rent growth was unparalleled jumping 1.6% during first quarter and 6.4% year over year –the highest growth rates for these respective periods since at least 2007. Nominal industrial rents, at a national average of $7.69 per sq.ft., are 2.7% below the pre-recession peak and are equivalent to levels at the beginning of 2009 just as the CRE market began to deteriorate.

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

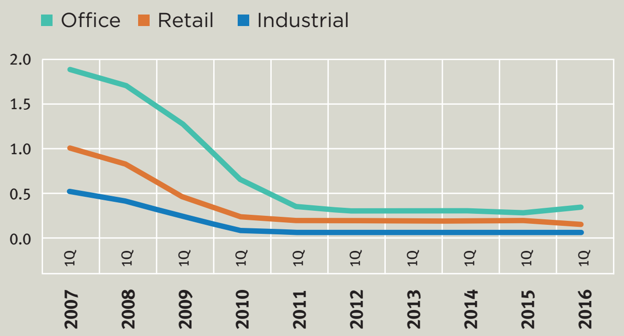


Source: Boxwood Means, LLC; CoStar Group, Inc.

Office rents rose 0.9% and 2.3% during first quarter and year over year, respectively, as the office sector responded to the ramp up in office-producing jobs. The recent movement is noteworthy: over the past 41 quarters, there have been only three other periods that posted similar increases. Also, the 12-month gain was the third highest rate of growth dating to 2006. That said, office rents averaging $18.38 per sq.ft. are still 5.5% below the pre-recession peak and are roughly on par with the third quarter, 2009 level. Retail rents also performed well, increasing by 0.7% during the quarter – an increase that ranked among the highest quarterly retail growth rates over the past 10 years. Rents rose 2.3% over 12 months to $16.76 per sq.ft. – still 7.2% below the pre-recession high and comparable with rents during four quarter, 2009.

▸ **Modest pick-up in industrial and office supply continues.** Industrial and office project completions rose 7.4% and 4.7% year over year, respectively, as small cap deliveries in these two sectors maintained a positive trend from fourth quarter of last year. However, total completions across the three major property types, at 17.8 million sq.ft., translated to a 7.9% decrease from 12 months earlier as retail projects contracted by a hefty 16.4% during first quarter. The general sluggish construction trend is highlighted in the graph on the following page where the completions-to-inventory ratio for the three property types has long-since normal-ized at levels far below the crest of the last cycle. Even

CONSTRAINED SUPPLY | Completions-Inventory Ratio (%)



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

so, the recent trend is worth watching for two reasons: the combined deliveries of 36.7 million sq.ft. over the two most recent quarters was the highest figure for consecutive quarters in six years; and aggregate projects under construction, at 205.7 million sq.ft. over the last four quarters, represented the greatest sum since first quarter 2009.

▸ **Industrial rents in the general CRE market continue to surge.** Strong fundamentals have also bolstered rents in the general marketplace, led by booming demand for warehouse and logistic uses in major hubs that support swift delivery of e-commerce purchases. National average industrial rents soared 1.8% to $6.36 per sq.ft. during first quarter according to CoStar data. The latest 12-month gain of 5.7% topped last year's sharp 5.3% increase and is the highest annual growth rate since at least 2005. Industrial rents are now 0.9% above the former peak level in 2008.

Meanwhile, general office rents rose slightly by 0.2% in first quarter and a more favorable 3.3% year over year. At a national average of $15.93 per sq.ft., office rents are 1.2% above the pre-recession peak recorded eight years ago. Retail rents across all subtypes rose 0.2% during first quarter and 2.2% over 12 months to $15.93 per sq.ft. Though annualized rents have increased at or better than 2% for the last three quarters, these rents remain 8.1% below the pre-recession high. By contrast general retail, which CoStar typically defines as single-tenant freestanding buildings (and roughly accounts for 50% of total retail gross leasing square footage), has fared much better: national rents increased by 0.7% and 3.5% during first quarter and over 12 months, respectively. And at an average of $17.60 per sq.ft., general retail rents have surpassed the 2008 peak level by 4.2%.

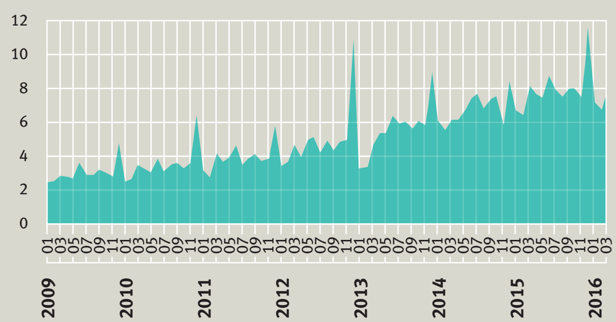
It's notable that small cap rent growth lags the level of rent appreciation in the general CRE market; and moreover, that small commercial rents have yet to fully recover or exceed pre-recession rent levels as have the larger property markets. Of course, leases in smaller properties (under 50,000 sq.ft.) typically have a shorter duration (e.g., three years) than lease terms in bigger properties and, hence, are marked to market relatively more often with smaller rent increases. By contrast, during an upcycle renewal leases in bigger, more institutional-type properties are subject to heftier rent bumps after typical 5-10-year terms expire. As a result, it's predictable that larger rent increases prevail in today's vigorous, general CRE marketplace. (But on the flip side we'll also see bigger rent discounts in this domain after the market reverses course.)

It's also apparent that the recent rent surge in the general CRE market has triggered a sizable reaction in new construction activity which, if past is prelude, will eventually have a diminishing effect on general rent increases for new and renewal leases as the market expansion further matures. But as mentioned above, supply pressure is quite modest in the small cap arena and, with persistently strong positive net absorption, vacancies are tighter than at any time over the last decade. Combined with recent favorable reports on consumer spending, salary and payroll growth, and housing sales, we can expect small cap space fundamentals to remain quite strong even as supply continues to modestly expand.

Property Sales Activity

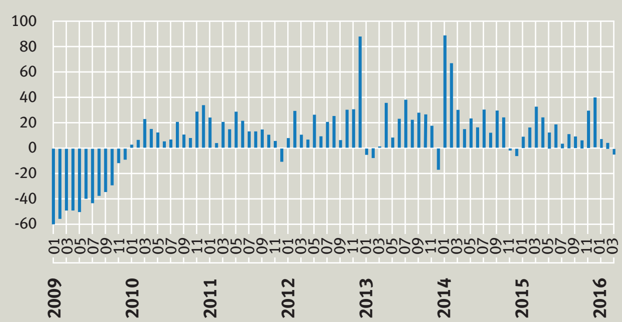
▸ **Deal volume bounces back.** With renewed stability in financing costs, sales of commercial and multifamily assets under $5 million rebounded strongly during March. Transaction volume jumped 15.3% from February to $7.8 billion on a preliminary estimate basis. As a result, first quarter sales of $21.7 billion exceed last year's record pace by 1.8%. See the nearby graphs.

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



Source: Boxwood Means, LLC

ANNUAL CHANGE IN SALES VOLUME (%)

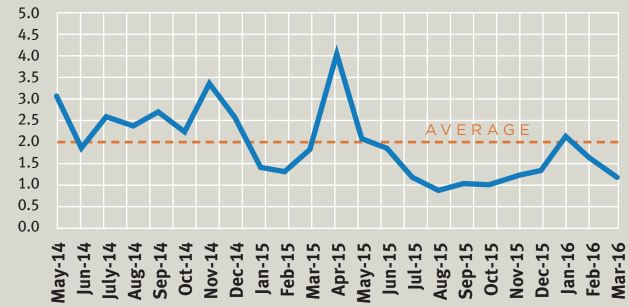


Source: Boxwood Means, LLC

▸ **Fewer cities participate in sales boom.** Despite the rebound in national sales across 122 metro areas, the recent investment trend suggests that widespread buying activity has begun to narrow among an increasing number of cities. See the nearby graph that shows

SALES ADVANCE-DECLINE RATIO

YOY Sales Activity for 122 Metros

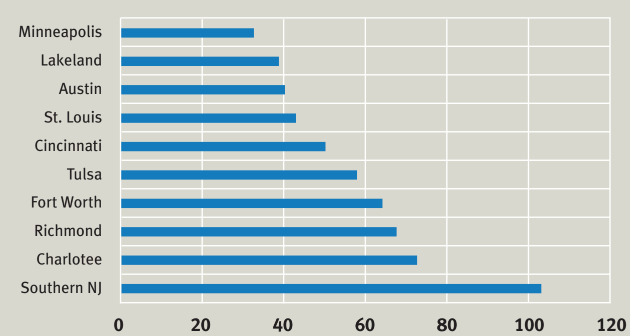


Source: Boxwood Means, LLC

that our Advance-Decline Ratio has dropped below the two-year average on a fairly consistent basis. For example, 66 markets posted sales gains year over year during March, down from 84 cities in January and 80 from March of last year. The recent Advance-Decline trend may be interpreted as somewhat of a bearish signal for the overall small cap CRE investment sales market, but it's doubtful that it foreshadows a significant sales pullback. In that vein, also let's not forget that 2015 was extraordinary with a record $95.4 billion of sales which creates a tough comparison year.

The top 10 cities for sales activity with a minimum of $100 million in 2016 year-to-date sales are charted below.

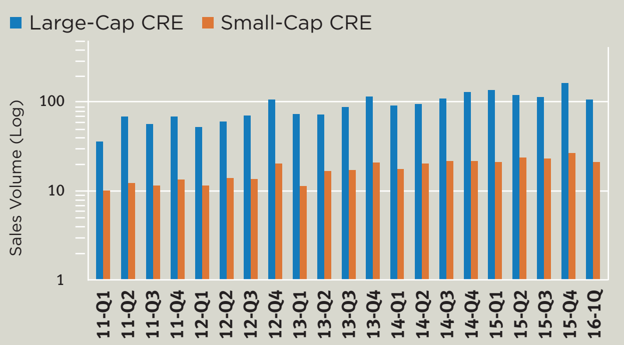
TOP 10 METROS FOR YTD SALES (%)



Source: Boxwood Means, LLC

▸ **Sales in larger CRE market stage a comeback.** Sales of significant properties greater than $2.5 million in value mounted a comeback in March with an 18.1% sales gain versus February to $34.6 billion according to data from Real Capital Analytics (RCA). Moreover, even though the first quarter tally of $112.9 billion may have painted a dim picture with an 18.2% decline compared with the corresponding three months of 2015, the figure is a bit deceiving: that is, total deal activity through March still represented the second-highest first quarter volume since 2007 and, as RCA reported, first quarter 2015 was punctuated by heavy transaction flow in both portfolio/entity deals and single-asset sales. RCA also cited the uncertainty of CMBS financing (that is more apt to fund larger-sized deals) and record-low cap rates for producing additional friction for deal-making during first quarter. See the nearby graph for a comparison of large and small cap sales volume trends.

SALES VOLUME TRENDS COMPARISON



Source: Boxwood Means, LLC; RCA

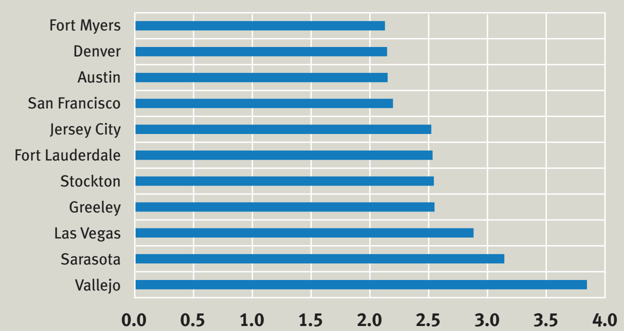
As we anticipated last time, normalization of debt costs and persistently dynamic space market fundamentals ended up pulling small investors from the sidelines and back into the fray by quarter close. Price resistance may be a bit of a drag on investment sales in the large cap domain going forward, but with the slower run-up in small cap CRE prices this is likely to be less of a factor for smaller commercial property sales.

Sales Prices

▸ **Price appreciation stalls.** Though property sales volume picked up at quarter close, it appears that small cap CRE buyers may have regained some control over sellers. Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities was flat in March on a preliminary estimate basis and up only 0.2% during first quarter. Until March, SCPI had generated positive monthly increases for 26 consecutive periods, and the annualized 3.1% return also happens to be the lowest since December, 2013. The Index remained unchanged at 8.9% below its pre-recession peak.

▸ **Prices in some locations are undeterred.** Even though national prices appear to be stabilizing, some cities continue on a tear. Nineteen metro areas generated robust price growth of 2% or more during first quarter led by Vallejo (3.8%), Sarasota (3.1%), Las Vegas (2.9%) and Greeley (2.6%). (See the nearby graph showing the top 10 quarterly winners.) Overall, 111 of 127 cities advanced over three months, but positive national momentum has clearly slackened as more than 50% of the metros generated gains of less than 1% during the three-month period.

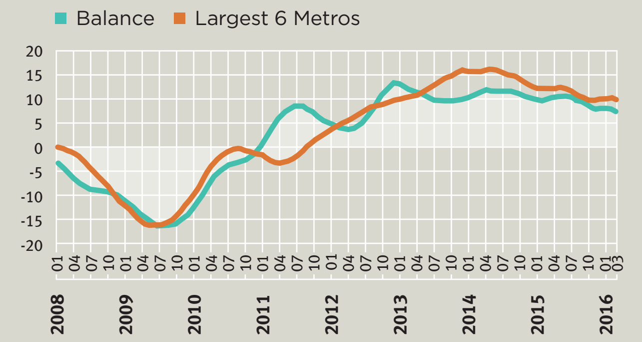
FIRST QUARTER PRICE GROWTH LEADERS (%)



Source: Boxwood Means, LLC

▸ **Multifamily price gains are steady.** Demographics and deep sources of financing for affordable rental housing have stoked the widespread appeal for small multifamily assets among investors. While Boxwood's Small Multifamily Index for 48 markets indicates that the annualized return eased to 8.0% as of March – the lowest rolling 12-month gain in 3½ years – the multifamily sector continues on an amazing run. Prices gained 0.5% preliminarily in March, the same amount as February, resulting in a solid 1.8% increase over three months. And in contrast with the modest price gains generated by small commercial assets, Boxwood's Small Multifamily Price Index has recovered 175.2% of its post-financial crisis losses and sits 19.3% above its previous peak in August, 2008. The nearby graph plots the small multifamily price trend comparison between the top six population centers and the balance of markets.

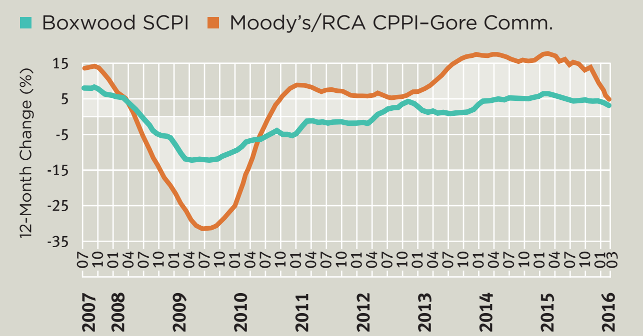
MULTIFAMILY PRICE TREND COMPARISON | Annual Change (%)



Source: Boxwood Means, LLC

▸ **General CRE prices retreat further.** 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) declined for the fourth month in a row, albeit by the smallest amount (-0.1%) during this time period. We've been saying for some time (most recently in our MarketBeat Notes blog **here**) that large cap prices were ripe for a correction, and it appears that lingering uncertainties about debt costs and shifting buyer sentiment took a toll since the end of last year. The CC Index is down 1.7% year to date, and the annualized return has tumbled to a more plebeian 4.7% as of March – a precipitous fall from 17.6% only 12 months earlier. (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

The recent trajectory of CBD Office prices perhaps best underscores the substantial pullback witnessed in the institutional arena. Twelve months earlier (March 2015), the annualized return for trophy assets in primary cities was a whopping 22.6%. But with losses of 2.3% and 6.3% for the month and first quarter, respectively, CBD Office's rolling 12-month gain had tapered to a meager 0.8%. As of March, this bellwether Index is a sizable 9.9% below the recent cyclical peak reached in November of last year. Among the major property types, only the Apartment sector has sustained positive momentum, up 0.9% during March and 10.7% year over year.

Some bifurcation in the overall investment market has emerged early this year with a retreat in prices and choppy deal volume in the large cap arena, juxtaposed against the smaller domain's resumption of robust sales and steadier prices. Small cap CRE investors still find core space market fundamentals, asset prices and overall U.S. economic conditions compelling. On the other hand, institutional real estate players appear to have been spooked by sky-high prices and dwindling CRE investment returns, as well as gyrations in the bond market that disproportionately affect financing for large CRE deals. The silver lining to the recent pullback in institutional CRE prices is perhaps that big-time investors will be less likely to overpay and, also, narrow their focus more so on property income and cash flows instead of capital appreciation.

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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