Small Balance Advocate
QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS
1st Quarter 2017

Mixed Market Signals Materialize in New Year

Fundamentals posted another generally positive quarter to start out the year, but mixed space market conditions and sluggish price growth together serve notice.

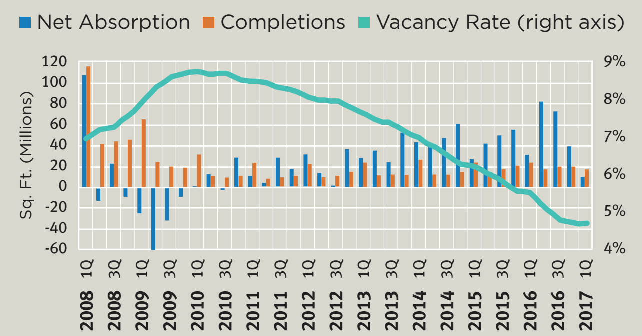
With this issue, the Small Balance Advocate moves to a quarterly publication schedule.

Space Market Fundamentals

Conditions in the small cap CRE space market were mixed during first quarter. Statistical highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Demand growth slows considerably.** Leasing activity across office, industrial and retail sectors slowed significantly from the breakneck pace of last year. Aggregate net absorption across the three property types totaled just 10.8 million sq.ft. during first quarter, a decline of 72.8% sequentially and 65.2% from the first quarter of 2016. The volume also represented the lowest quarterly demand increase in more than four years. See the graph below for aggregate leasing trends.

AGGREGATE SMALL CAP CRE LEASING TRENDS



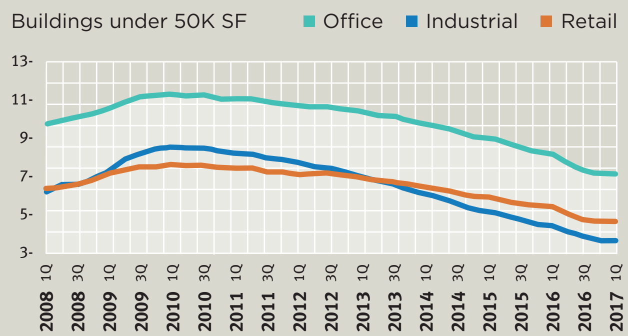
Source: Boxwood Means, LLC; CoStar Group, Inc

To illustrate the severity of the pullback, office demand plunged to 1.6 million sq.ft. from 6.3 million sq.ft. during first quarter 2016, or a loss of 74.2%. Similarly, industrial plummeted to 3.2 million sq.ft., or down 72.2%, from 11.4 million sq.ft. while retail occupancies dropped to 6.0 million (-54.7%) from 13.2 million in the corresponding quarter last year.

The pullback in overall occupancy growth comes after a mammoth record-setting year in 2016 with aggregate net absorption of 224.1 million sq.ft. that lapped 2015's sizable volume by 28.8% and also surpassed by 16.2% the previous high-water mark set in 2014. But U.S. employment growth was uneven during first quarter including a lower-than-expected 98,000 jobs in March, while retail spending declined for two months in a row for the first time in two years. That, coupled with the slow development of lower corporate tax rate and simplifications plans of the Trump administration, have created enough economic uncertainty to temper the appetite among businesses for more commercial space.

▸ **Vacancies level off.** Vacancy rates remain in uncharted (low) territory, but flattened out as tenant demand wavered. The national small cap office vacancy rate of 7.0% is extremely tight by historical norms, hovering 120 basis points (bps) beneath the previous 2006 low point after a 100 bps decline over the last 12 months. However, office vacancies were unchanged for two consecutive quarters for the first time since 2Q 2012 and narrowed by only 20 bps over the last three periods. Likewise, the national small cap industrial vacancy rate was flat at the record low of 3.6%, 250 bps below its previous nadir, while retail vacancies held steady at 4.6% for the third quarter in a row. See the graph below.

SMALL CAP CRE VACANCY TRENDS (%)

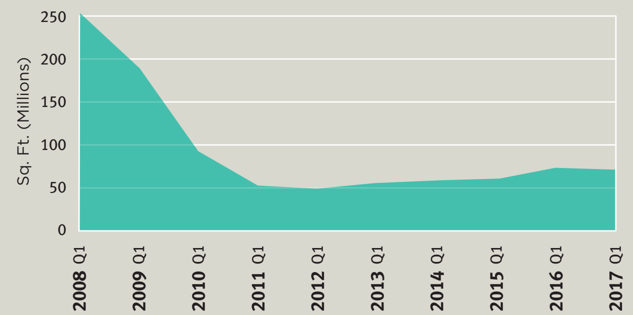


Source: Boxwood Means, LLC; CoStar Group, Inc.

▸ **Supply remains a no-show.** While flat vacancy rates at historic low levels may suggest market fatigue or even a turning point in the current real estate cycle, the fact is that small cap vacancies still face little upward pressure without a material upswing in new construction. Across the three property types, aggregate completions of 17.0 million sq.ft. during the latest quarter continued at a tepid pace, down 3.4% from fourth quarter and a sizable 28.7% decline from the same three months of last year. Total 2016 supply of 72.8 million sq.ft. was 1.1% lower than 2015 and, for comparison purposes, represented only about 25% of the average 271.8 million sq.ft. delivered between the years 2006-2008.

Office and retail deliveries each declined by roughly 30% from the corresponding quarter a year ago while industrial completions were off by 18.1%. See the graph below.

AGGREGATE SMALL CAP CONSTRUCTION COMPLETIONS

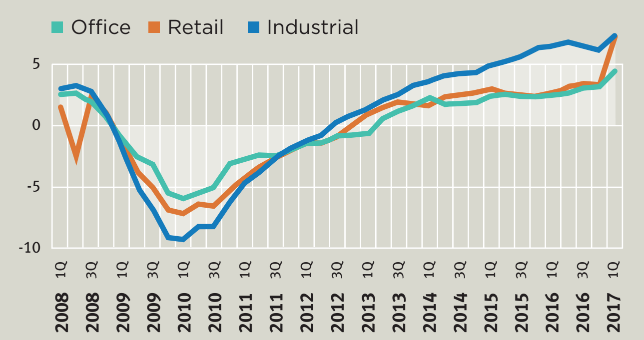


Source: Boxwood Means, LLC; CoStar Group, Inc

By contrast, supply in the general CRE market has turned up. Office deliveries were up 20.6% YOY, followed by industrial and retail at 11.5% and 3.0%, respectively. Furthermore, with the exception of retail which is facing a secular change in tenant demand (and store closings) by way of shopper disintermediation via the internet, office and industrial projects under construction (UC) have been mounting. The national pipeline of 206.8 million sq.ft. of industrial projects during first quarter is the fullest since at least 2005 (and only slightly below the level during the previous quarter) as internet commerce continues to drive the need for more warehouse and logistical space. Office projects of 133.0 million sq.ft., while about 15% short of the average UC inventory of the go-go years of 2005-2007, have substantially picked up over the last year.

▶ **Industrial rents reach new heights as all rental rates surge.** With historically low vacancies and little new construction for better than a year's time, it's not surprising that asking rents have finally kicked into a much higher gear. Industrial rents, including warehouse and flex properties, rose 2.7% over the first three months of this year and a whopping 7.3% compared with first quarter of 2016 to $8.25 per sq.ft. – the highest nominal rent in at least 12 years. Retail rents climbed an unprecedented 4.7% in the quarter and 7.2% year over year to $18.00 per sq.ft., the highest rental rate since Q3 2008. Office rents increased by 2.2% and 4.4% for this past period and four quarters earlier, respectively, as asking rents of $19.21 per sq.ft. recovered to their Q4 2008 level. See the graph below.

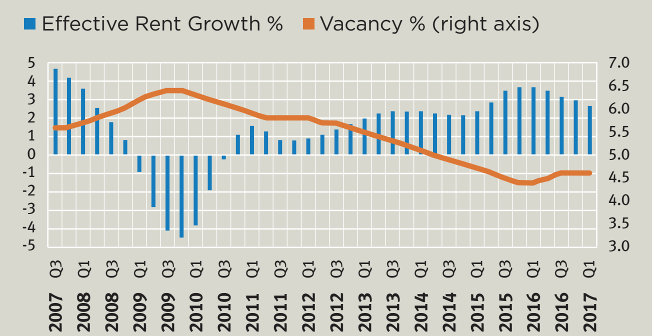
SMALL CAP RENT GROWTH TRENDS | Annual Percent Change (%)



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

▶ **Multifamily rent growth edges down; vacancies flat.** After seven consecutive quarters of 3% or better rent growth, effective rents for small multifamily properties rose a still hearty 2.7% during first quarter according to a Boxwood national analysis of Class B/C apartment buildings of 40 units or less. Effective rents declined 30 bps sequentially and 100 bps YOY. Asking rents rose 2.6% YOY to an average of $1,054 per unit and, as of March, were 10.5% above the previous peak in Q3 2008. Meanwhile, the national vacancy rate hovered at 4.6%, unchanged over the past three quarters and only 20 bps higher than first quarter 2016 when vacancies reached their lowest level since at least 2007. See the graph below.

SMALL CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

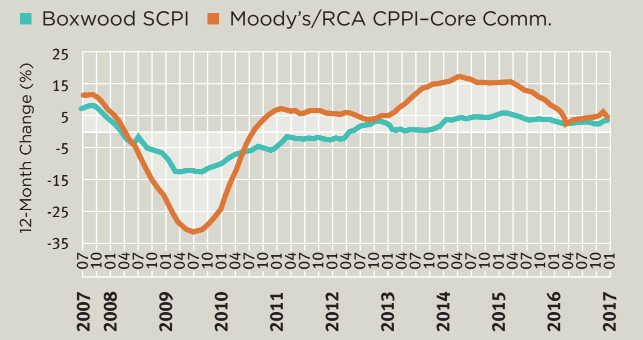
A commercial rent spike was predictable given how taut small cap space market fundamentals have been for so long. (Note, however, that the unprecedented magnitude of the rent increases frankly seems a bit questionable until confirmed again by CoStar next quarter.) In any case, this eventful rent boost raises some questions. If past is prologue (in terms of classic market cycle dynamics), the rent bump that returned nominal asking rates to pre-recession levels – if persistent – may spur a strong response from small building developers that may unsettle the market's poise in another year or so. But let's not forget that commercial occupancy growth dropped substantially across the board during first quarter as tenants took their cue from weaker economic conditions and stepped to the sidelines. Perhaps the pullback in commercial leasing demand will be temporary but if not, the upward trajectory in rents will not likely be long lasting.

Sales Prices

▸ **Prices edge higher.** Boxwood's small commercial price index (SCPI) for properties trading under $5 million across 127 cities rose 0.3% in January on a preliminary estimate basis for the third month in a row. Prices are up 4.0% YOY. With prices having increased steadily, if modestly since bottoming out in January, 2012, SCPI has recovered to within 5.3% of its previous 2007 peak.

▸ **Large cap prices soften.** 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) decreased by 0.7% in January as deal volume fell nearly 50% year over year according to Real Capital Analytics (RCA). The CBD-Office sub-index, which has soared over 150% since its nadir in the fall of 2009, plummeted in January by 2.3%. Clearly, buyer and seller expectations have increasingly diverged, and now with a prospective era of interest rate hikes that may increase future cap rates these combined factors and uncertainties have (at least temporarily) chilled the air: Annualized CC price growth, at 5.3% in January, has slowed to single digits for 14 consecutive months following three years of mid-teens annualized price growth. According to our analysis, the CC component index is 11.4% above its former peak level. See the nearby graph for a trend comparison between large and small cap prices.

PRICE TREND COMPARISON | Large vs. Small Cap CRE

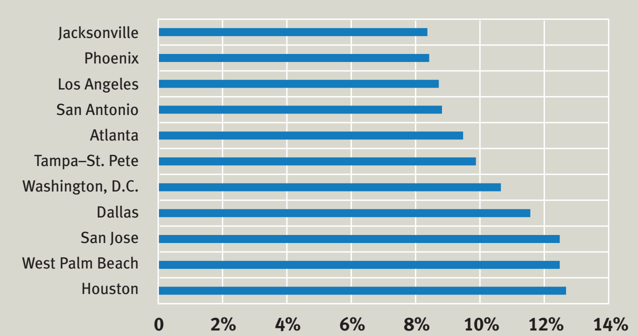


Source: Boxwood Means, LLC; Moody's

▸ **Small cap multifamily prices and sales decelerate.** Price growth ebbed in January with mere 0.1% growth on a preliminary estimate basis. Boxwood's Small Multifamily Price Index (SMPI) covering 48 metro areas actually declined slightly (-0.4%) over the last three months despite the continued strong capital support for affordable rental housing from Freddie Mac and Fannie Mae.

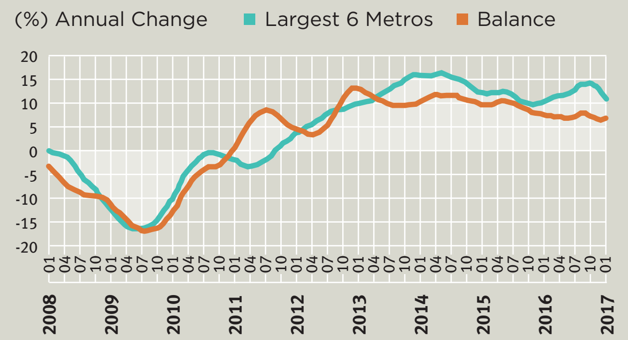
Further sedate pricing may be in the cards as Boxwood's analysis of national sales transaction data through March indicates that small multifamily sales volume dropped for three consecutive quarters and 24.4% YOY to the lowest quarterly volume in almost four years. That being said, as of January SMPI returned 8.5% over 12 months and is 28.1% above its prior 2006 peak, boosted by strong annualized price growth in Dallas (11.9%), West Palm Beach (11.8%) and Denver and San Jose (11.0%). See the graph of price leaders on the following page.

MULTIFAMILY PRICE LEADERS | Annualized Return



Source: Boxwood Means, LLC

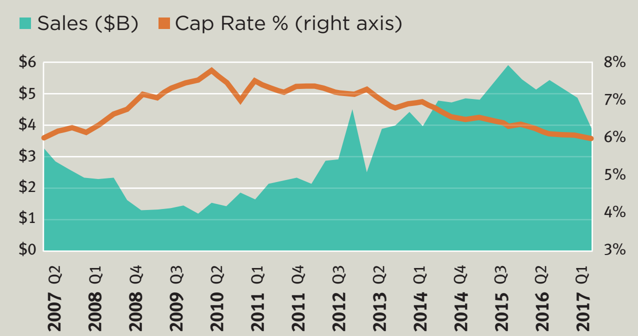
MULTIFAMILY PRICE TREND COMPARISON



Source: Boxwood Means, LLC

Also, total multifamily sales volume of $20.6 billion during 2016 was only 4.8% below the 2015 level – the highest volume since at least 2007 – and, therefore, may not have been sustainable at such high levels. Meanwhile, small multifamily cap rates remain steady. See the graph of sales and cap rate trends as well as another one showing SMPI trends nearby.

SMALL CAP MULTIFAMILY SALES AND CAP RATE TRENDS



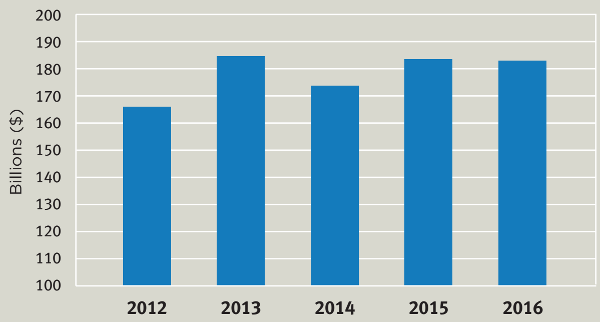
Source: Boxwood Means, LLC; CoStar Group, Inc

With some weakening in sales transactions, the likelihood of further interest rate hikes and some relatively new risks to the U.S. economic engine, it's still encouraging that small cap commercial and multifamily prices are holding up in this period of flux. Some continued price fluctuations may be expected as buyers adjust expectations for their income streams and sellers come to terms with less fervent deal activity. We might anticipate that small cap commercial prices will continue to edge higher with the return of solid job and GDP growth, but the era of double-digit price increases for a multitude of multifamily markets is likely behind us.

SBL Originations

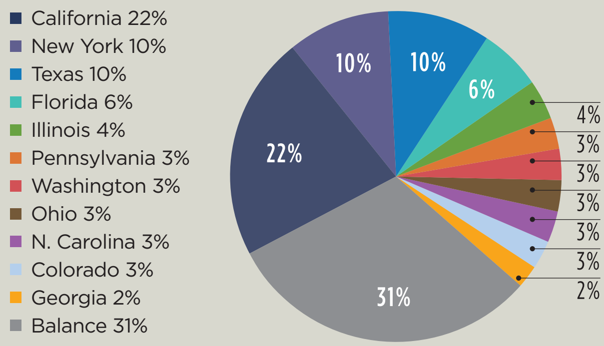
Small balance loan originations under $5 million closed out another massive year in 2016 with total volume of $183.2 billion. This total was flat compared with 2015 and only 1.1% below the previous high-water mark posted in 2013. Unsurprisingly, the top state SBL producers were led by California (21.7% share) followed by New York (10.3%) and Texas (10.2%). See the graphs on the following page.

SMALL BALANCE LOAN ORIGINATION TREND



Source: Boxwood Means, LLC

TOP STATES – 2016 SBL ORIGINATIONS



Source: Boxwood Means, LLC

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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