Small Balance Advocate

QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS

2nd Quarter 2017

Market Advances at a Slower Pace While small cap CRE market and investment conditions improved during second quarter, a growing body of evidence suggests the market is nearing a peak.

Space Market Fundamentals

Leasing fundamentals improved during second quarter. Statistical highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below..

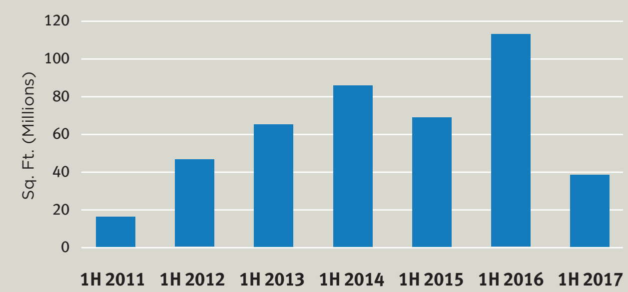
▸ **Demand growth slows considerably.** Demand rebounded smartly. After sluggish Q1 tenant activity resulted in the lowest quarterly demand in nearly five years, aggregate demand across office, industrial and retail sectors jumped 32.1% sequentially during last quarter to 21.9 million sq.ft. Office demand rose the most on a percentage basis, by 110.9% including 6.5 million sq.ft., followed by industrial at 31.6% that absorbed 5.9 million sq.ft. and retail with a modest gain of 5.4% and 9.5 million sq.ft.

That being said, the improvements in Q2 occupancies mask evidence of a continuing slowdown at this late stage in the market's expansion. Aggregate demand declined a whopping 73.1% from Q2 2016 and, more concerning as the nearby graph shows, a net occupancy gain of 38.5 million sq.ft. during the first half of 2017 was the lowest sum since 2011 with sizable pullbacks across all sectors. See a second graph nearby showing the longer-term trend.

The fact is that signals from the U.S. economy haven't offered much encouragement for businesses that might otherwise consider leasing more commercial space. Job growth, at an average of 180,000 per month so far this year, is slightly below last year's average monthly gain of 187,000. Also, first-half GDP has averaged just 1.9%. Furthermore, the National Federation of Independent Businesses indicated that its index of small business optimism faded during June to its lowest level since hitting a five-year high in January on expectations of a combination of stronger economic growth, and tax and regulatory relief from Washington.

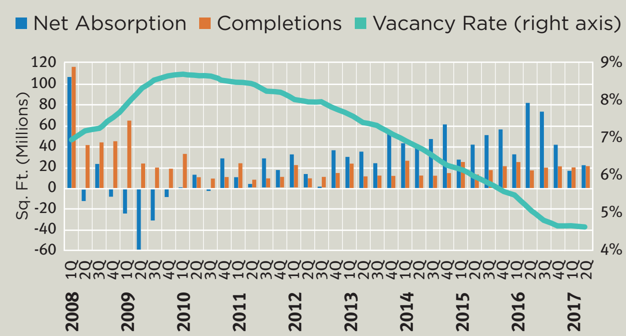
SLOWDOWN IN AGGREGATE DEMAND

Combined Office, Industrial & Retail



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

AGGREGATE SMALL CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

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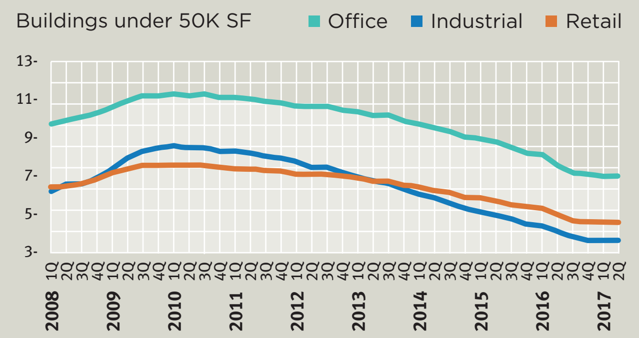
▶ **Sector vacancies are tight as a drum.** The aggregate small cap CRE national vacancy rate of 4.6% is in record-low territory, down 50 basis points (bps) YOY and 190 bps below the previous low-water mark of 6.9% established nearly 11 years ago. All sectors have registered new lows: the industrial vacancy rate, averaging a remarkably low 3.5% nationally, is 250 bps below its pre-recession low; the national office vacancy rate of 6.9% is 130 bps beneath its previous nadir; and average retail vacancies, at 4.5%, are 150 bps lower. See the graph below.

SMALL CAP CRE VACANCY TRENDS (%)

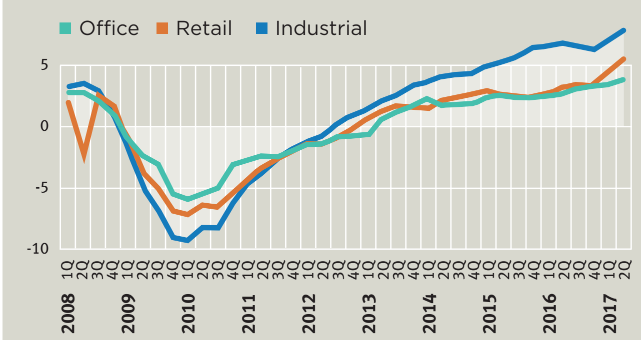


Source: Boxwood Means, LLC; CoStar Group, Inc.

▶ **New construction activity shows a pulse.** As we've noted throughout the market's expansion phase, the proximate reason for the rock-bottom small cap vacancies has been the subdued level of commercial building. Whereas construction completions averaged 68.0 million sq.ft. over 12 quarters from 2006-2008 during the peak of the last cycle, quarterly deliveries since the end of the financial crisis have averaged less than one fourth of that amount, or 16.2 million. This soft trend has persisted as the first-half 2017 total of 40.4 million showed a decrease of 2.8% compared with the same period last year. That being said, it appears that supply may be on the uptick as Q2 aggregate deliveries rose 25.8% YOY. Sector-wise, industrial completions rose 51.8% YOY— not surprising given this property type's prized fundamentals— as office deliveries increased 41.7% over 12 months and retail by 11.4%.

▶ **Rent surge repeats.** After a strong showing in Q1, asking rents jumped again in what appears to be a classic late-stage phenomenon. Small cap industrial rents gained an unprecedented 2.4% for a second period in a row resulting in growth of 7.7% YOY. Industrial's average rent of $8.41 per sq.ft. is 6.8% above the pre-recession peak and represents the highest nominal rent in at least 12 years. Office rents rose 1.2% in Q2—the largest increase in 45 quarters dating to 2006—on top of a robust gain of 1.1% during the first three months of the year. With a 3.8% rent jump YOY, office rents of $19.21 per sq.ft. are nominally within 0.6% of the previous peak in 2008. Retail rents, too, posted very strong results with a quarterly gain of 2.2% and a robust 5.5% leap over 12 months. Average retail rents of $17.85 per sq.ft. remain nominally 1.1% below the previous cyclical peak. See the graph below.

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

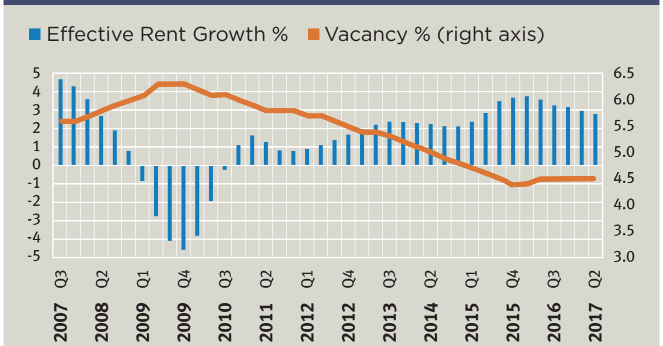


Source: Boxwood Means, LLC; CoStar Group, Inc.

As noted, with the exception of the industrial sector, small cap rents remain below former peak levels. That may partially explain why builders have stood on the sidelines despite the persistently tight leasing conditions and record-low vacancies. We would argue that the inherently low visibility of the small cap CRE market and highly fragmented nature of demand for new construction by small business owners also contribute to the inelasticity of supply. Again, the less than bullish sentiment about the outlook for U.S. economic growth overshadows the market and diminishes the appetite for capital outlays and new facilities. Yet as the latest construction figures indicate, the compelling space market fundamentals may finally be overcoming these obstacles.

▸ **Multifamily rent growth has likely peaked.** Quarterly increases in small cap multifamily rents likely topped out at an extraordinary—and unsustainable—3.8% during Q1 2016. As of Q2, rent appreciation has slowed, but the 2.8% advance is still arresting for small balance lenders and investors despite the fact that it is the first sub-3% quarterly increase in over two years. National asking rents equate to an average of $1,070 per unit according to Boxwood's national analysis of Class B/C apartment buildings of 40 units or less derived from CoStar surveys. Consistent with this rent deceleration is the leveling off of the small cap multifamily vacancy rate. The national average remains fixed at 4.5% for five consecutive quarters and hovers near the lowest level in more than 10 years. See the graph below.

SMALL CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

With little change to the dynamics of this market, including chronic under-supply that perpetuates substantial shortages of affordable rental housing, small balance multifamily lenders and investors maintain a favorable outlook for the sector's performance. Capital sources remain abundant, and SBL funding programs at Freddie Mac and Fannie Mae continue to be wildly successful.

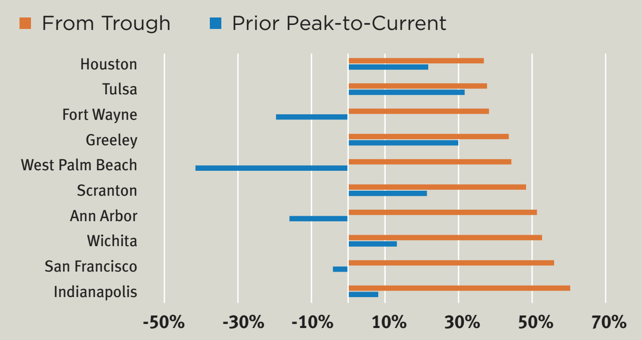
But an overarching question is how far to read into the slowdown in commercial occupancy growth witnessed over the first half of this year. Granted last year's level of aggregate demand, at 299.1 million sq.ft. over the course of the entire year, was unprecedented and thus represents a challenging benchmark. Yet as indicated earlier, the 1H 2017 net absorption total is the smallest first half sum since 2011. So the pullback in leasing demand likely reflects a fundamental reset in expansion plans and business sentiment among small business owners and tenants about the outlook for the U.S. economy. Certainly there is sustained strength and vigor in many individual CRE markets but, increasingly, overall small cap space market fundamentals seem to be imitating classic late-stage trends where rents and supply increase while demand wanes.

Investment Activity and Prices

▸ **April sees a bounce in prices.** Boxwood's national small commercial price index (SCPI) for properties trading under $5 million across 125 cities rose 1.0% in April, the best monthly performance of the year. SCPI has increased 3.5% YOY and has crept back within 5.2% of its pre-recession peak to the highest level since September, 2008.

▸ **Prices outperform in booming cities.** Despite the modest price performance in the aggregate that also includes an average 16.0% recovery from the trough since the financial crisis, prices in selected cities are stand-outs and have recorded sizable gains during the market's recovery. As shown in the graph on the following page, a number of oil and gas-related markets (Houston, Tulsa, Scranton and Greeley) have bounced off the mat by as much as 50% and others, including tech-intensive San Francisco and also Indianapolis (ranked fifth in a recent report for the most tech employment gains over the last two years), rebounded by an even greater degree. Furthermore, as shown by blue bars in the graph property values in six of these 10 markets are above their pre-recession peak led by Tulsa (31.9%).

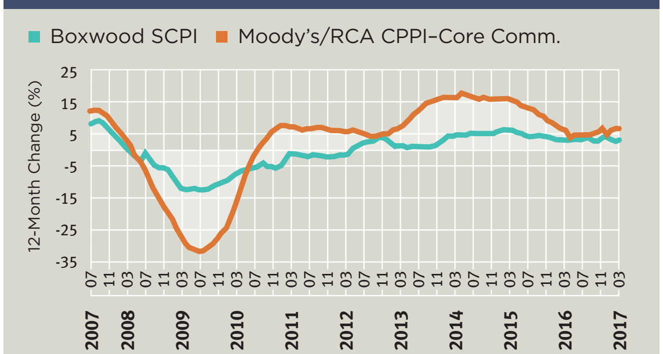
BIGGEST REBOUNDS FROM THE BOTTOM



Source: Boxwood Means, LLC

▸ **Large cap CRE prices stay earthbound.** Prices of investment-grade assets gained 0.5% in April but continue to move in a narrow range so far this year. The Core Commercial (CC) component of the RCA CPPI (that excludes multifamily and tracks sales transactions above $2.5 million) is flat year to date and has posted an annualized return of just 4.7%, as RCA reported that investment sales volume contracted by 25% YOY. Following a slightly lower 12-month price increase during the previous month, April's annualized return is the third lowest since 2012 and signals an increasing divide on asset valuations between institutional buyers and sellers, as well as concerns about interest rates and property fundamentals. RCA's CC Index has recovered 129.4% of its pre-recession losses and stands 11.9% above the previous peak. See the graph below for a trend comparison between large and small cap prices.

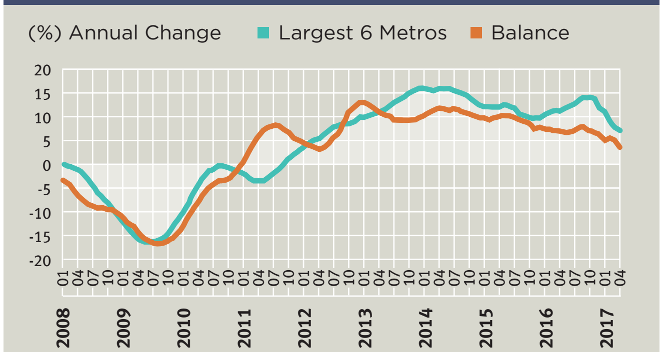
PRICE TREND COMPARISON | Large vs. Small Cap CRE



Source: Boxwood Means, LLC; Real Capital Analytics

▸ **Small cap multifamily prices rally.** Asset values in the sector regained some momentum with a strong 0.8% increase in April. Boxwood's national Small Multifamily Price Index (SMPI) covering 48 metro areas increased by only 1.2% through four months, and the annualized return of 6.5%, though attractive, has declined for six months in a row and represents the smallest 12-month yield since mid-year 2012 (see the graph below). Still, as testimony to the formidable run by—and prominence of—this sector, SMPI has recovered 214.3% since its nadir and is 29.3% above the prior peak.

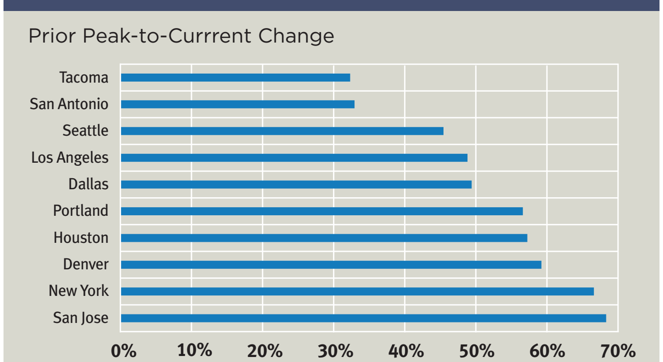
MULTIFAMILY PRICE TREND COMPARISON



Source: Boxwood Means, LLC

To further heighten some dimensions of this sector, see the next graph nearby that highlights multifamily markets that have posted steep price growth above and beyond former peak levels led by San Jose (68.4%), New York (66.5%) and Denver (59.1%). The hi-tech orientation of a number of these cities does not go un-noticed.

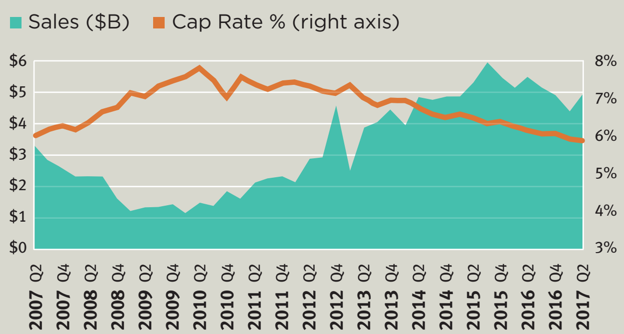
BOLD MULTIFAMILY PRICE RECOVERIES



Source: Boxwood Means, LLC

▸ **Multifamily sales volume recovers.** Small cap multifamily turned back up during Q2. The incremental rise in the 10-Year Treasury rate and the Federal Reserve's earlier announcement of an increase in the fed funds rate likely hindered buyers and led to a sizable drop in sales activity during Q1. Boxwood's analysis of CoStar multifamily sales data indicates deal volume during the first six months of this year decreased 11.6% compared with the corresponding period during 2016. But the sales market returned to trend during Q2 with a 12.7% sequential jump in volume to $5.0 billion that may reflect buyers' re-commitment to prevailing investment conditions despite the new interest rate environment. Meanwhile, the Q2 cap rate of 5.89% narrowed to its lowest level since at least 2007. See the graph below.

SMALL CAP MF SALES AND CAP RATE TRENDS



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

With cooperating capital market and economic conditions, the small cap CRE market remains on solid ground. But take a step back, and second quarter results offer growing evidence that the market is reaching a peak. Growth in asset prices is shrinking, commercial leasing demand is lower and, beyond the choppy deal volume for smaller multifamily assets, investment activity in the general CRE market is down substantially compared with last year. These factors impose fundamental concerns, risks and uncertainty about future market performance that will require small balance lenders and investors to increase their due diligence on deals during the second half of the year.

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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