Small Balance Advocate

QUARTERLY UPDATE FOR SMALL-CAP CRE INVESTORS

3rd Quarter 2019

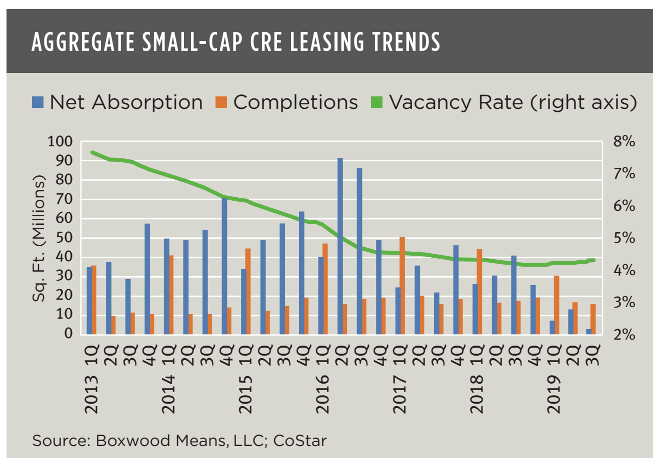
More Doubts Infect a Late-Stage Market Main Street occupier and investment market fundamentals were steady through three quarters of the year. But the economic underpinnings of the long CRE bull market ride have loosened and frayed, and small business owners and small-cap investors have taken notice.

Space Market Fundamentals

Continued weakness in demand heightened uncertainty about the direction of the small-cap CRE market. National highlights from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Positive Net Absorption Shrinks Again.** Space demand is far weaker than any year following the financial crisis, and Q3 only amplified the flagging trend. Aggregate small-cap CRE net absorption across office, industrial and retail sectors totaled a mere 3.3 million sq.ft., a 76.1% decline from the previous quarter and a washout of 92.0% versus the same period last year. The YTD story doesn't improve matters either: aggregate demand was just 24.3 million sq.ft. through September of this year, a drop of 75.1% compared with the 97.3 million sq.ft over the corresponding three quarters of 2018. See the graph below.

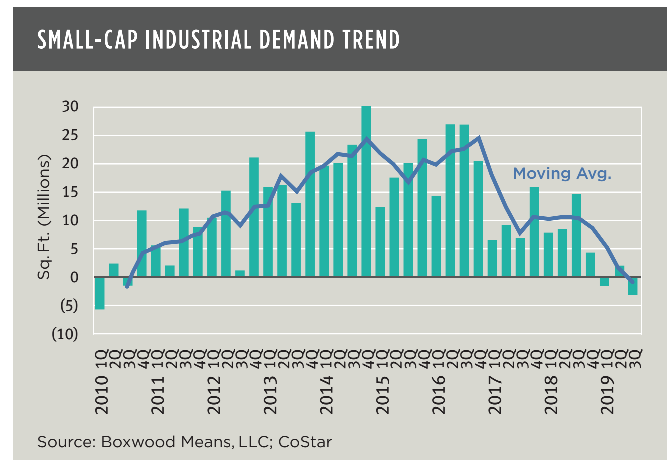
AGGREGATE SMALL-CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar

Quarterly industrial demand was most troublesome. As the nearby graph shows, net absorption for small industrial facilities turned negative for a second time this year – and notably the first such occurrence in nine years. Q3 occupancy losses of 2.9 million sq.ft. were a whopping 224.9% lower sequentially and 119.8% YoY.

SMALL-CAP INDUSTRIAL DEMAND TREND



Source: Boxwood Means, LLC; CoStar

This setback may seem contradictory to many observers and industry participants familiar with the impact of e-commerce on the booming demand for large-scale industrial buildings, logistics sites and fulfillment centers across the U.S. The big-box industrial juggernaut of the past decade has been supported by the construction of new distribution centers, as well as conversion of outdated regional malls, near arterial highways on the outskirts of metropolitan areas to further bridge the gap between online sales inventory and customers. Instead, the supply-demand dynamics of the small industrial

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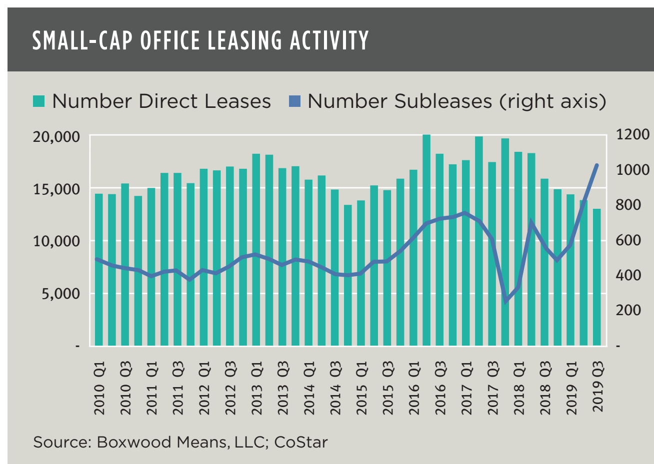
domain are far less pliant with few expansion opportunities for small industrial users especially near the urban core. There, small warehouse and light industrial uses must compete with retail, office and apartment land uses that typically capture higher rents. Hence, and as we've previously suggested, this supply scarcity is likely one factor suppressing small-cap industrial demand.

Meanwhile, space absorption hasn't fared much better for the small-cap office and retail sectors. Net gains in office occupancies were barely positive at 317,000 sq.ft. representing more than a 90% decline versus Q2 as well as 12 months earlier. Over three quarters ending September, the office sector's modest 7.3 million sq.ft. of net positive absorption was 65.3% less than the YTD amount last year.

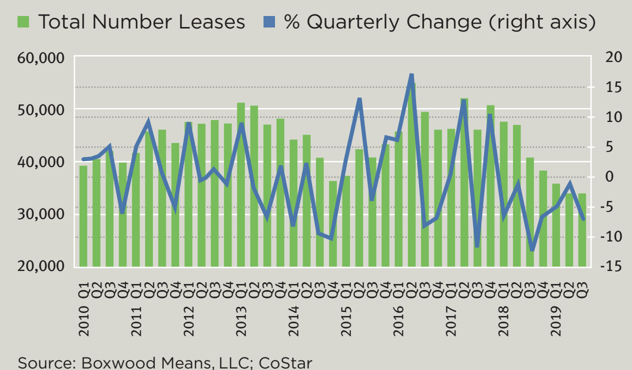
As the next graph shows, the slowing trend in office occupancies is underscored by the contraction in the number of direct signed leases. At the same time, though, note the elevated trend in office subleases. In fact, office subleases jumped 83.2% YoY while direct leases decreased by 18.1%. It's plausible that the nation's extremely tight job market partially explains the pullback in new, direct office leases, as does growing business uncertainties that have caused other small tenants to shift to short-term and often cheaper sublease options. But it's most likely that the swelling sublease trend reflects the growing popularity and disruptive force of WeWork and other entities furnishing alternative, coworking space for startups, independent professionals and freelancers, and specialized corporate groups, among



Source: Boxwood Means, LLC; CoStar

others. The square footage of office subleases grew to 6% of the sector's total small-office leasing activity in Q3 – the highest level since at least 2006 – helping to push small-office direct leases down to the lowest level since 2009.

Retail, including street-level stores and small strip or neighborhood centers, posted better results than the other commercial sectors with Q3 occupancy gains of 5.9 million sq.ft. Strong consumer spending, which remains a bright spot for the economy, has bolstered this sector. Still, these absorption figures were off 12.4% and 68.4% sequentially and YoY, respectively, largely mirroring the softer demand trends in the other sectors. Faltering small-cap CRE demand across all three sectors is captured in the graph below that highlights the aggregate decline in direct leases.



Source: Boxwood Means, LLC; CoStar

► **Low Vacancy Rates Comfort Investors.** This year's ebb in demand has exacted only a modest price so far this year in terms of higher national small-cap CRE vacancy rates. Aggregate vacancies across all three sectors edged up 10 basis points (bps) to 4.3% during Q3 – level with its rate in June 2018 – as modest sums of construction completions topped demand for the last three consecutive quarters (see the previous graph of aggregate leasing trends). Sector-wise, the national industrial vacancy rate rose 10 bps for the third quarter in a row to 3.4% while office and retail vacancy rates were flat at 6.2% and 4.1%, respectively, for the last couple of periods. As the graph on the following page shows, these near-record low vacancy rates offer small-balance lenders and investors

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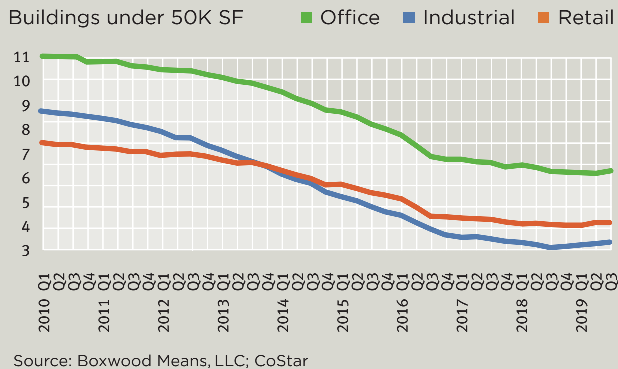
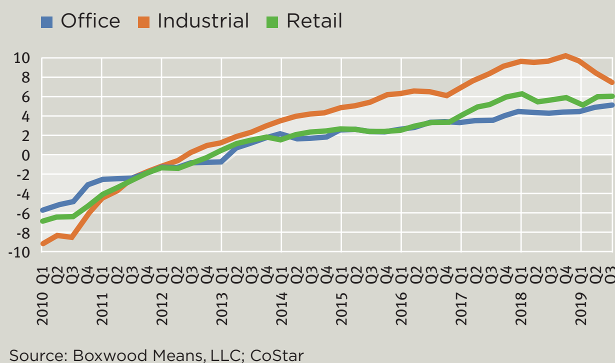
SMALL-CAP CRE VACANCY TRENDS (%)



some reassurance of the market's health and a green-light for sustained deal-making at this juncture. As the trends indicate, though, it's highly likely that average vacancy rates will only rise from here.

▸ **Rent Growth Is Healthy but Slowing.** Historically speaking, there's nothing shabby about 1% quarterly rent growth or better. And all three sectors exceeded that rate in the most recent quarter. Small-cap industrial rent growth, which has surged far higher than the other two sectors, posted a 1.7% gain to a national average of $9.87 per sq.ft. Retail rents increased by 1.3% to $19.66 per sq.ft. while office rents added 1.0% to $20.94. Yet as the graph below illustrates, annual rent growth has lost steam at this late stage in the cycle. Industrial rents are nominally 28.3% above the pre-crisis peak. Retail rents are 10.6% higher while office rents are 9.2% greater.

SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



Let's be clear: This year's substantial downshift in demand is worrisome and isn't contained to Main Street businesses alone; i.e., a similar pattern has emerged among users in the broad or general CRE market. For example, net absorption for both the large-cap office and industrial sectors fell roughly 50% YoY. While supply scarcity is less of a factor in the general market, tenants and owner-users in both domains have reduced their capital investment and expansion plans due to domestic and global economic uncertainties, trade tensions, as well as growing concerns about a coming recession. After all, the advance estimate of the 3Q GDP increased at 1.9%, or about half the actual annual rate of 3.4% during the same quarter last year. Similarly, the ISM manufacturing purchasing managers index recorded the lowest reading in more than 10 years as exports plummeted amid the trade war. Moreover, small business optimism has receded per the NFIB's Index, along with small business owners' six-month outlook for general business conditions. Such sentiments, in turn, produced lower actual capital expenditures by small businesses as reported by NFIB.

Granted, with overall vacancy rates near historical lows small-balance lenders and investors might naturally conclude that CRE market conditions are stable, if not hunky-dory. And, indeed, that assessment would be on target for some humming economies such as Austin, Boston, New York City, Pittsburgh, Raleigh, San Francisco and Southern California among others that have big concentrations of STEM workers in high-tech industries. But there's no escaping the fact that other areas, e.g., Midwestern economies largely dependent on manufacturing, are soft, vulnerable and living on borrowed time. Prudent small-balance participants will recognize the reality of rising market risk and its eventual impact on collateral values, and rachet-up market selectivity and investment due diligence accordingly.

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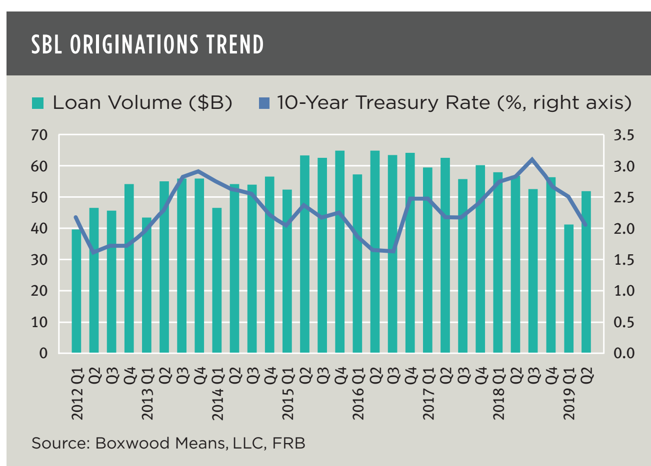
Investment Activity and Prices

▸ **SBL Originations Bounce Back.** With the Fed's policy reversal to cut interest rates, U.S. small-balance loan originations rebounded sharply in Q2 (the latest period of data availability). SBL volume for loans under $5 million jumped 26% from the previous quarter to $51.1 billion. Purchase loans jumped 31% and accounted for 37% of total originations while refinance loans rose by 23%, or 63% of all closed loans. That said, the quarter's overall sum was 10% lower YoY. See the graph below.

SBL ORIGINATIONS TREND



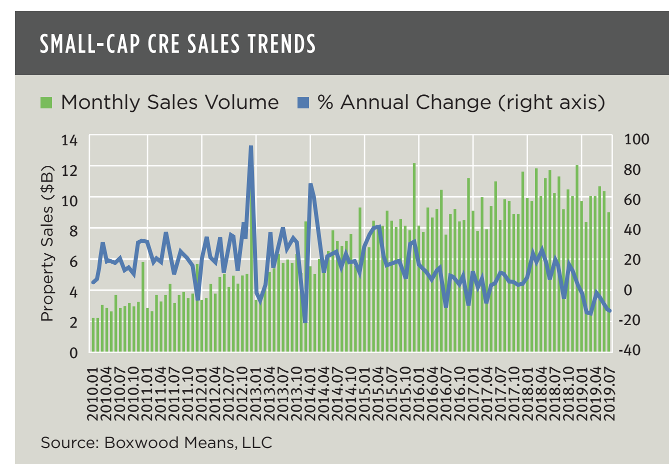
The top 15 lenders together grabbed a national market share of 19.5%, basically unchanged for the quarter and YoY. JP Morgan Chase again topped the leader board with a market share of 5.5% followed by Wells Fargo (2.3%), while CBRE Capital Markets and Arbor Commercial Mortgage (1.8%) tied for third place.

With fierce competition for new loans in major metros, lenders focused more on smaller markets. The top 15 U.S. counties netted 29% of total volume in the quarter, a decline of 13% YoY. By contrast, originations in the balance of the counties ramped up by a whopping 57%.

Nevertheless, midyear's total SBL originations of $91.9 billion will require a heavy lift – and continued low financing rates – over the second half to overcome a soft Q1 and, thereby, extend the streak of annual volume above $200 billion for a seventh consecutive year. You can obtain Boxwood's complimentary Q2 National SBL report **here.**

▸ **Investor Caution Blunts Property Sales.** Deal volume continued to slide through July, the latest period of available data. Sales of assets under $5 million totaled $8.9 billion on a preliminary estimate basis, down 12.9% YoY and 8.8% lower in a YTD comparison with last year's record total. As many small investors step to the sidelines over growing economic uncertainty and record-high prices, sales activity has fallen on a year-over-year basis in every month of 2019 (see the graph below). Transaction volume also pulled back in the large-cap CRE domain. Principal deals above $2.5 million fell by a sizable 21% to $32.8 billion in July – the greatest YoY plunge in volume so far this year according to Real Capital Analytics (RCA).

SMALL-CAP CRE SALES TRENDS



▸ **Prices Continue Uptick.** Despite slowing deal activity, small-cap CRE prices have perked up since a slow start to the year. Boxwood's U.S. Small Commercial Price Index (SCPI), a hedonic pricing model that tracks commercial property sales transactions under $5 million across 125 markets, advanced by a robust 0.8% on a preliminary estimate basis in July. By dint of five monthly increases in a row, SCPI has risen 2.8% YTD and 3.6% YoY to a level that is 5.5% above the previous pre-recession peak. Meanwhile, SCPI-6 comprising the six largest metros by U.S. population posted even healthier 4.5% YTD and YoY growth and sports a cumulative price recovery that is 11.7% above the previous apex. The balance of markets (SCPI-119), heavily represented by riskier secondary and tertiary markets, has underperformed with gains

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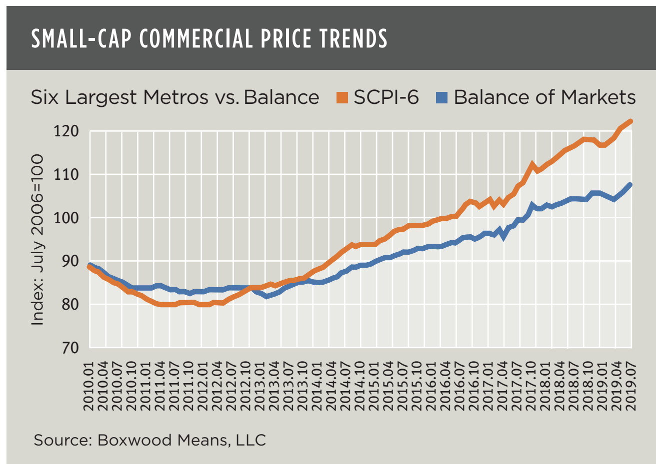
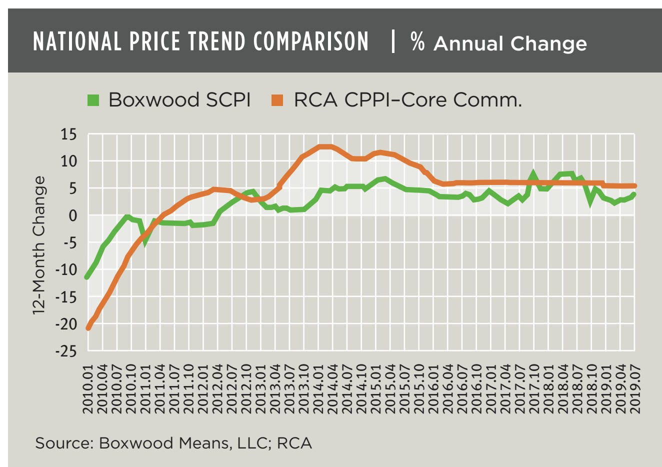
of 1.9% and 3.1% YTD and YoY, respectively, and a prior peak-to-current ratio that has fallen below par at -1.7%. (See the trend comparison graph below.) Nevertheless, 102/125 metro areas have recorded 12-month price gains led by San Jose (13.2%) along with other smaller markets including Lakeland-Winter Haven (12.7%), Vallejo-Fairfield-Napa (12.4%), Lansing-East Lansing (12.2%) and Richmond-Petersburg (11.1%).

SMALL-CAP COMMERCIAL PRICE TRENDS



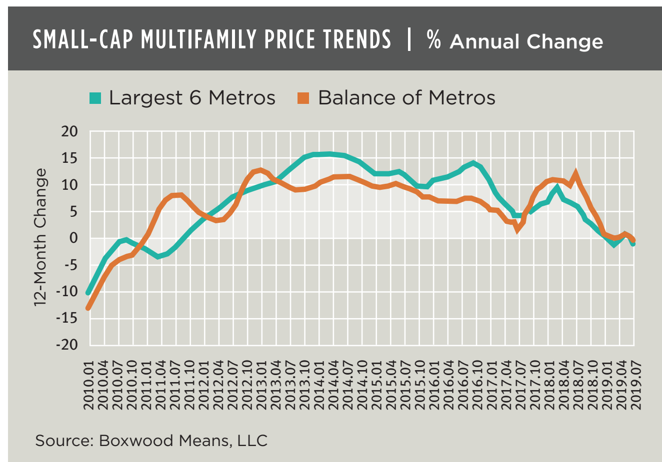
Large-cap CRE prices have advanced, too, though at a moderating pace of late. RCA reported that the Commercial Component of its CPPI, which is analogous to SCPI and tracks non-multifamily transactions above $2.5 million, rose 0.5% in July elevating the Index to gains of 3.1% YTD and 5.1% YoY. Note that this annual rate is the lowest 12-month rate of return in over six years, thereby underlining the marked slowdown in price appreciation among these more institutionally oriented assets. (See the comparative price index trends in the nearby graph.) RCA suggested that record-high prices, hovering 9.5% above the pre-crisis peak by our calculation, have stymied buyers.

NATIONAL PRICE TREND COMPARISON | % Annual Change



▸ **Multifamily Price Growth Slows to a Crawl.** Despite the sustained and broad appeal of apartments among private, small-time investors, small multifamily asset prices moved sideways. Boxwood's Small Multifamily Price Index (SMPI) that tracks 45 markets is flat this year and relatively unchanged YoY, too. As shown in the graph below, this slowdown has equally affected both large and small metros. Meanwhile, SMPI posted a one-month gain of 0.5% on a preliminary estimate basis in July, raising the possibility that interest-rate sensitive, small buyers re-entered the fray as lower funding costs gradually took hold by midyear. Still, the fact that SMPI indicates small multifamily prices are a hefty 40.1% above prior peak will likely cause continued friction between buyers and sellers going forward.

SMALL-CAP MULTIFAMILY PRICE TRENDS | % Annual Change



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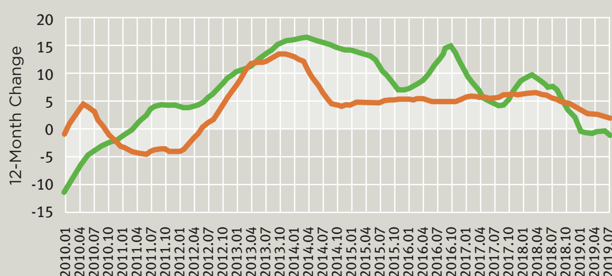
This decelerating trend in small-cap multifamily prices resonates in the single-family residential (SFR) housing sphere, not surprisingly since prices for small-cap CRE and SFR assets tend to be correlated over time. The 20-City Composite Home Price Index from S&P Corelogic/Case-Shiller, which mirrors the same 20 cities in Boxwood's SMPI-20 Index, indicates that SFR prices have slowed to an annual growth rate of 2.0%, or the lowest 12-month increase since August 2012. But whereas the historically high volatility of small multifamily prices has boosted asset values way above the pre-crisis peak, the Case-Shiller data indicate a decidedly slower pace to SFR price gains that translates to a level just 5.5% above the former peak. (See the trend comparison in the graph below.) No doubt this year's lower price appreciation has improved affordability for many would-be buyers especially when combined with reduced mortgage rates and rising wages. Yet these favorable factors will have limited impact in offsetting rising home prices particularly in cities with low SFR inventories that continue to attract millennials with high-paying tech jobs.

PRICE TREND COMPARISON

Small-Cap Multifamily and Home Price Indexes



Source: Boxwood Means, LLC

The CRE market has taken a lofty ride with a tailwind from 10 years of economic expansion. Clearly, the U.S. economy has now moderated, and real estate market participants have taken the hint: leasing demand from small businesses has fallen off significantly, small-cap property trades have retreated from last year's record pace and asset prices, though still marginally growing, are reflecting buyers' less bullish view framed by the double jeopardy of peak prices and mounting recessionary fears.

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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