Small Balance Advocate

QUARTERLY UPDATE FOR SMALL-CAP CRE INVESTORS

4th Quarter 2018

A Year of Living Cautiously By closing out fourth quarter on solid footing, small-cap CRE fundamentals offered encouragement for investors and lenders on the new year's prospect. Yet cracks in the foundation persist, raising some concern over the future durability of the market's expansion.

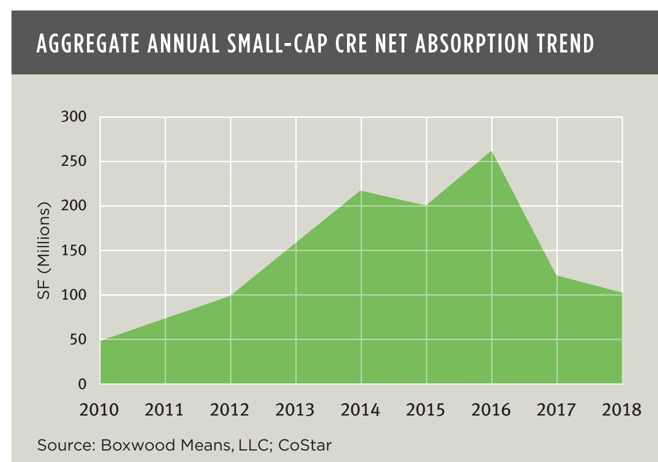
Space Market Fundamentals

The Q4 top-line numbers for Q4 and full-year 2018 were very favorable. National highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Growth in Occupier Demand Narrows.** The good news was that Q4 net absorption was positive for the 33rd consecutive quarter across office, industrial and retail sectors. More ambivalent was the news that the 26.1 million sq.ft. of aggregate occupancy gains represented a 40.1% YoY decline and the lowest Q4 total since the second year of the market's recovery in 2011. Furthermore, net absorption of 103.2 million sq.ft. for the full year, though commendable, was off by 20.7% compared with 2017 and the lowest annual amount in six years. See the graph below.

Each of the primary property types contributed to the pullback. The 7.0 million sq.ft. of Q4 industrial net absorption was a 52.9% cut YoY including a decrease of 22.3% in a full year over year comparison. Similarly, retail occupancy gains of 11.3 million sq.ft. reflected a 46.1% reduction in demand compared with the same quarter last year and a 17.7% decline for 2018. On the other hand, the office sector eked out a 1.4% gain YoY with 7.8 million sq.ft. absorbed in the quarter along with a more modest annual *decrease* of 4.1%.

AGGREGATE ANNUAL SMALL-CAP CRE NET ABSORPTION TREND



Source: Boxwood Means, LLC; CoStar

▸ **Downside to Tight Labor Markets.** Some market observers might conclude that the decelerating occupancy growth is much ado about nothing and, with a market bound by tight vacancies and sizable rent growth, fundamentals are sufficiently robust to maintain healthy market conditions and investment momentum. There's no disagreement here on the current solid state of the market, but we'd be remiss without addressing some undercurrents that may slowly be eroding that sturdy base.

The fact is that Main Street businesses are facing new challenges to sustained growth. The nation's very low unemployment levels have created the unintended, troublesome result that many small businesses are simply unable to find workers. Indeed, the NFIB claimed that owner reporting of unfilled job openings reached an all-time high in December. This trend, in turn, has slowed small business growth for the last two years including an accelerated pace of decline during last year according to the Paychex/IHS Markit Small Business Employment Index.

This taut labor market explains in part the pullback in occupier demand, i.e., the needs and plans for expansion space can diminish when some small businesses can't

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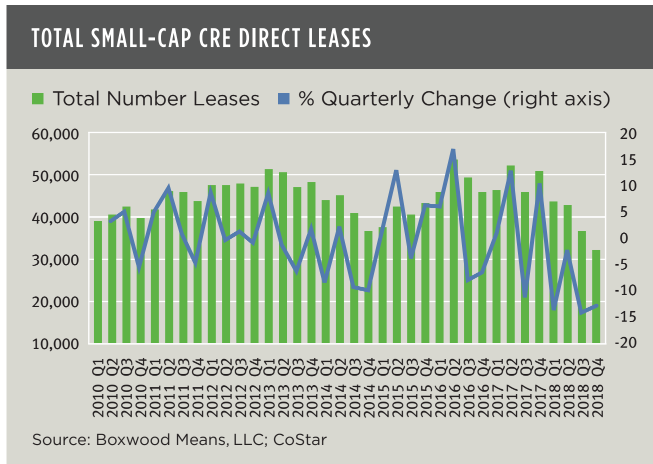
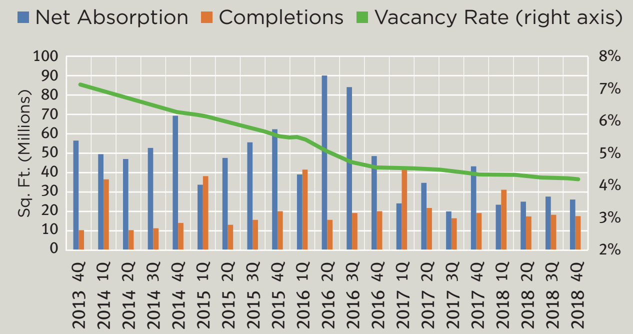
find/hire new workers. The declining total number of direct leases signed over time, including 20.7% fewer contracts YoY, is suggestive of a waning appetite for new facilities among small businesses. See the graph below. As noted below, a second possible cause for slackening demand is space scarcity.



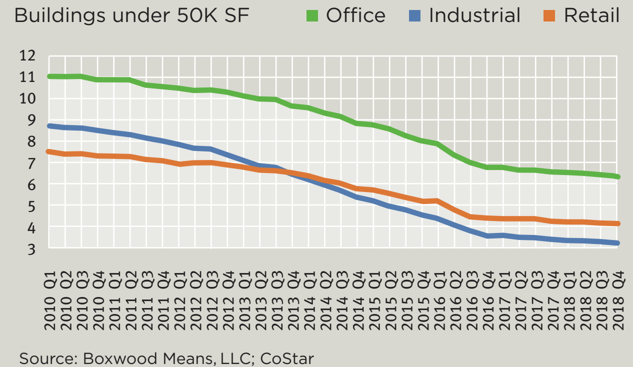
Source: Boxwood Means, LLC; CoStar

▶ **Low Vacancies Spell Another Problem.** A severe imbalance between demand and supply has created another challenge for expansion-minded small businesses. Completions have consistently trailed demand during the market's recovery, and the cumulative effect nine years into the market's expansion is that we have a state of disequilibrium in small-cap CRE. Annual supply across the three property types amounted to 85.4 million sq.ft., down 16.2% YoY, slightly ahead of the annual average over the last nine years but only about one-third of the average annual deliveries during the three years prior to the Great Recession. Industrial completions dropped by 6.0% YoY while construction put in place for both office and retail narrowed by 19%. As the next two graphs show, the net result of insistent demand meeting inadequate new supply is that vacancies have sunk to a bottom previously untouched, if not unthinkable.

Not surprisingly then we see a Q4 national small-cap industrial vacancy rate 280 basis points (bps) below the pre-recession low, averaging 3.2%, with retail and office vacancies each 170 bps lower than their previous 2006 nadir at a national average of 4.1% and 6.3%, respectively.



Source: Boxwood Means, LLC; CoStar



Source: Boxwood Means, LLC; CoStar

▶ **Rent Levels Hit New Highs.** Aside from historically low vacancy rates, the other telling sign of disequilibrium are soaring rents. By historical norms, rents skyrocketed last year. Sparked by high demand for small, in-fill warehouse locations among other light industrial and flex building uses, Q4 industrial rents jumped 2.5% and a whopping 10.2% over 12 months to a national average of $9.45 per sq.ft. In nominal terms, that's 22.0% greater than the previous high-water mark in 2008. Also, as testimony to the relevancy and staying power of small neighborhood retail and strip centers, retail rents, at $19.02 per sq.ft. on average, rose 1.7% sequentially and a record 6.7% YoY. Finally, Q4 office rents increased 1.2% along with a previously unmatched 4.6% YoY to reach an average level of $20.26 per sq.ft. See the graph on the following page.

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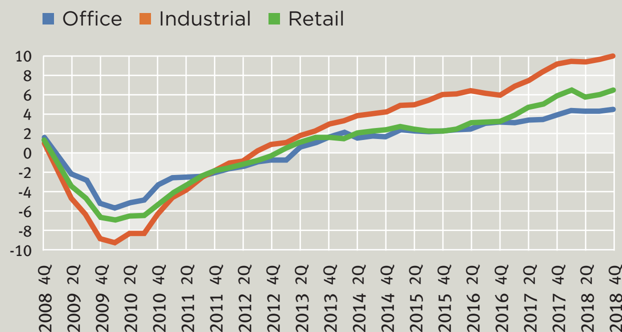
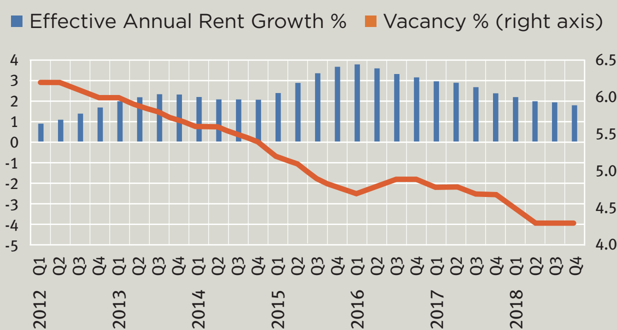
SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



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

▸ **Multifamily Market Plateaus.** Despite pervasive undersupply for affordable rental housing, rents and vacancies have flattened out of late in partial deference to the slim wage increases among mid-to lower-income working families. According to CoStar data encompassing nearly 300,000 Class B and C apartment buildings containing 5-40 units, Q4 effective rent growth eased 20 bps to a national average of $1,103 per unit. As such, small-cap rents grew by just 1.8% YoY – compared with average annual growth of 2.9% for the general multifamily market – continuing a slowing trend. Meanwhile vacancies flat-lined for the fourth consecutive quarter at a national average of 4.3%, the lowest level since at least 2008. (See the graph below.)

SMALL-CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

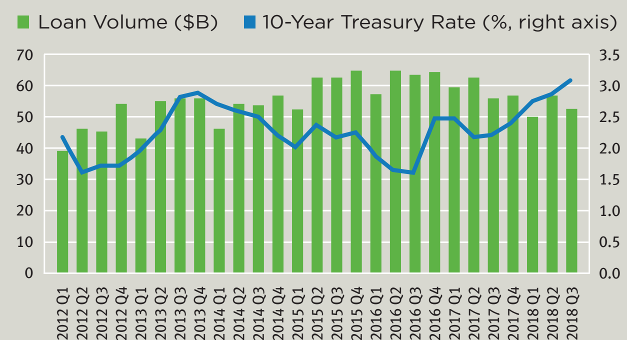
Even though unprecedented low small-cap CRE vacancies and soaring commercial rents may be exhilarating for small-balance lenders and investors, we must be mindful what the structural imbalance between supply and demand may fashion over time. Adequate supply is the space market's lubricant that keeps leasing activity humming. Like the increased friction on a car's pistons when the volume of motor oil is too low, the space markets will slowly grind down without an infusion of added inventory. As we've suggested, it already appears that supply scarcity may have played a role in a dip in small business growth and expansion.

Small-balance participants will likely find plenty of opportunities in 2019, but it is also a year to proceed with care and heightened risk management because Main Street businesses appear to be a little more cautious and a bit less optimistic then they were a year ago.

Investment Activity and Prices

▸ **Hefty SBL Originations Give Ground.** Headwinds in the form of higher interest rates and sky-high asset values modestly hurt small-balance loan (SBL) originations activity during Q3. Volume was robust at $52.5 billion – exceeding the $50 billion sum for the 17th quarter in a row – but the total represented a dip of 7.9% sequentially and 5.2% YoY for commercial and multifamily loans under $5 million. See the graph below. By all accounts, the $160.1 billion of close loans through Q3 will likely secure a sixth consecutive year of deal volume above $200 billion. But while refinance loans held their ground, purchase loans dropped a sizable 14.7% YoY as the velocity of sales transactions slowed (see below).

SBL ORIGINATIONS TREND



Source: Boxwood Means, LLC, FRB

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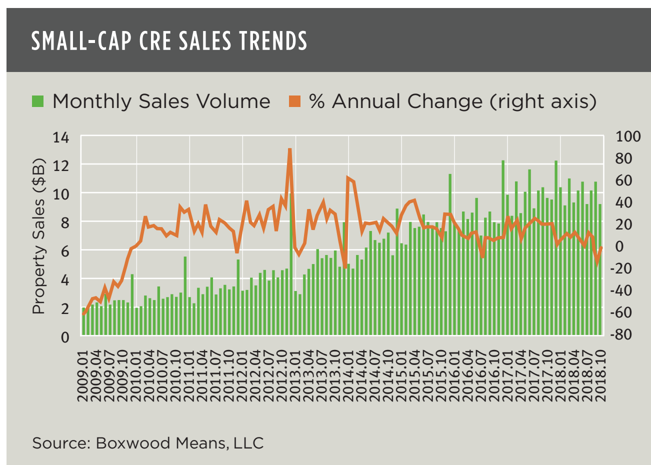
Consistent with the slowdown in overall purchase loans, the SBA reported that 504 loans, chiefly used by small businesses to acquire or upgrade facilities, declined 5.5% through September (and before the Federal government shutdown). Moreover, as discussed in this **blog piece** on Boxwood's web site, if SBL production follows a cyclical pattern and declines further, our historical research suggests that some percentage of principal SBL lenders will struggle to compete.

▸ **Sales on Trend for Another Banner Year.** October deal volume totaled $9.6 billion on a preliminary estimate basis, rebounding 8.8% from September's tally of $8.9 billion that was the lowest monthly sum of the year. YTD sales involving transactions under $5 million total $102.6 billion, comfortably ahead by roughly 5% versus last year's record pace that concluded with volume of $120.5 billion. This year-long frenzy of deal activity has persisted in the face of increasing challenges posed by the prolonged CRE cycle such as peak prices, historically low cap rates and increasing debt costs. But the cumulative impact of these factors is beginning to be felt as YoY changes in sales volume have slowed considerably as shown by the downward-sloping trend line in the graph below. Transaction data reported by Real Capital Analytics (RCA) separately confirms the slowdown as deal volume fell 15% YoY in October for single assets over $2.5 million in value.

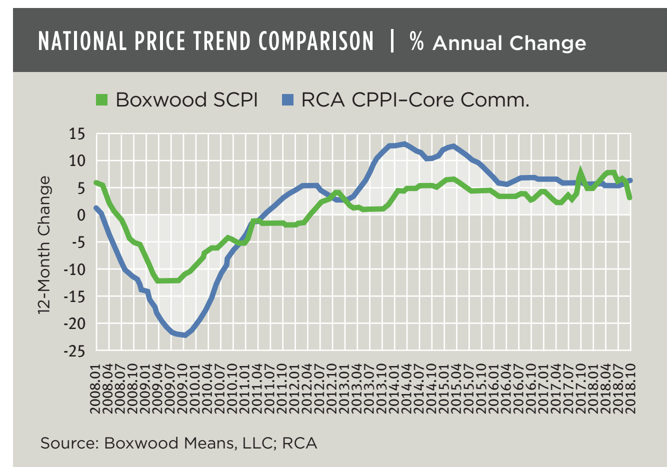
SMALL-CAP CRE SALES TRENDS



Source: Boxwood Means, LLC

▸ **Asset Prices Edge Higher.** Small-cap CRE prices rose modestly in October to another high-water mark. Boxwood's U.S. Small Commercial Price Index (SCPI) that tracks sales transactions under $5 million across 125 markets increased 0.2% on a preliminary estimate basis. As of this reading, with SCPI's 4.1% YTD gain, the Index had recovered more than 100% from its nadir and hovered 2.6% above its previous 2007 peak. However, the 2.6% YoY advance during the month was a significant drop – and the slowest annual growth rate in 14 months as show in the nearby graph. That trend line has recently under-performed the corresponding Commercial Component of RCA's CPPI in which institutionally-oriented commercial assets (excluding multifamily) in excess of $2.5 million gained 5.4% YTD and has advanced 7.4% above the previous peak.

NATIONAL PRICE TREND COMPARISON | % Annual Change



Source: Boxwood Means, LLC; RCA

By contrast, SCPI-6 inclusive of the six largest U.S. population centers rose 6.5% YTD and was 7.9% above its prior summit through October, underscoring the long-lasting attractiveness of small-cap CRE in these primary metros despite peak prices. Secondary and tertiary markets have retraced much of their losses during the financial crisis but have only gained 2.9% YoY and collectively remain 3.9% below the previous peak.

Clearly, both small- and large-cap CRE price trends reflect a normalization process over two years in the making as gravity finally holds sway over the prolonged market expansion.

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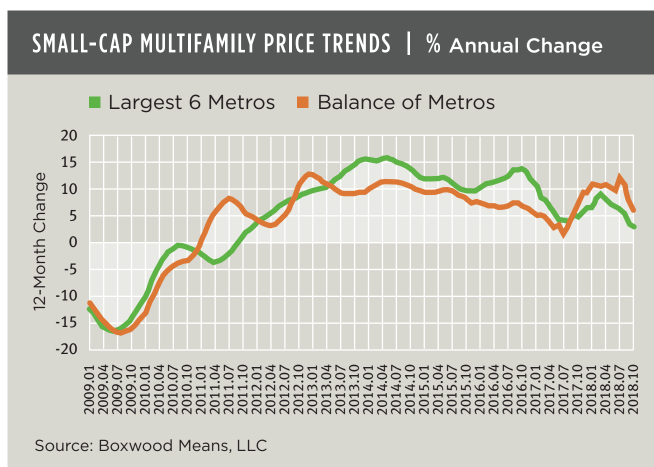
▸ **Multifamily Prices Take a Breather.** Small-cap multi-family prices unexpectedly ran out of steam during October, however temporarily it may turn out to be. Boxwood's Small Multifamily Price Index (SMPI) encompassing 45 markets eased just 0.1% on a prelim basis, but the 4.6% annual growth rate is a sizable pullback from prior months. As the graph below shows, the slower pace of price growth manifests itself in both the largest six markets and others comprising mostly smaller metro areas. The bigger markets posted a much slower 2.9% gain YoY while the remainder yielded 6.0%. Yet these SMPI metrics may foretell that small-cap multi-family asset values, which dwarf the pre-recession peak by a whopping 45.2%, may finally be causing a bit of heartburn for small-balance lenders and investors in an emerging era of higher debt costs.



No doubt the headline numbers for Q4 frame a narrative for another year of ambitious investment goals and continued success for small-balance lenders and investors. However, deal flow for loans and sales has been gradually decelerating for some time, perhaps foreshadowing a CRE market downshift. As the market slowly adjusts to different fiscal and economic inputs, as well as reduced demand from small business owners, it's incumbent upon lenders and investors to fine-tune their 2019 expectations and prepare for tougher sledding ahead.

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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