Small Balance Advocate

QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS

3rd Quarter 2017

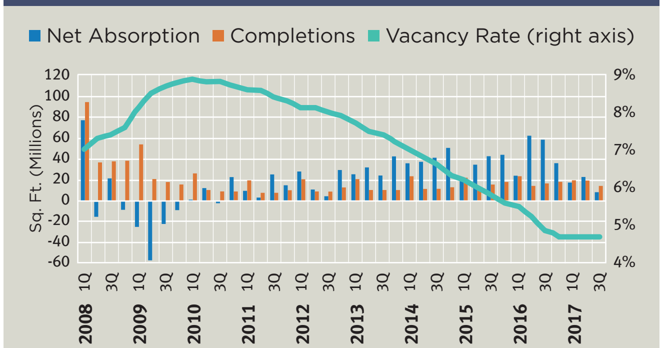
Leasing Velocity Retreats as Cycle Grinds On Space demand advanced at a markedly slower pace during the most recent quarter. Yet rent growth hit new highs and small cap CRE prices were re-invigorated.

Space Market Fundamentals

Leasing velocity slowed considerably during third quarter. Statistical highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Demand ebbs.** Despite the solid uptick in net absorption during the previous quarter, tenant leasing activity faded during Q3 and resumed the weakening trend reported last time. (See the nearby graph.) Aggregate demand across office, industrial and retail sectors plummeted 64.5% sequentially and a whopping 86.5% YOY to a total of just 7.8 million sq.ft. This was the lowest quarterly advance in five years and supports the narrative that the CRE market may be reaching its limit after a bull run lasting eight years. As further evidence, the combined 46.1 million sq.ft. of net absorption for the three quarters of this year is only one-third of the aggregate demand for the corresponding nine months of 2016.

AGGREGATE SMALL CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

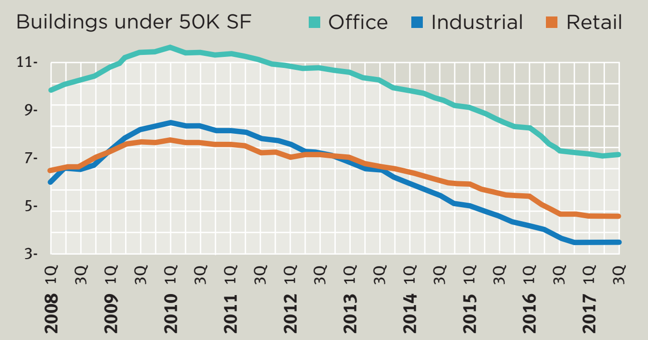
All three sectors suffered a pullback. Small cap office demand declined by 84.8% during the quarter and 93.8% YOY to only 952,000 sq.ft. with the number of direct leases falling to the lowest total in 10 quarters. Net occupancies in the industrial sector, at 1.9 million sq.ft., dropped by 66.2% and 89.4% for the quarter and YOY, respectively—the lowest quarterly volume since the same period in 2012. This softer industrial leasing activity stands in sharp contrast with the longer-term, quarterly average of 9.9 million sq.ft. following the end of the financial crisis. Notably, the total of 8,100 direct industrial leases signed during Q3 was the smallest number in eight years.

Similarly, retail net absorption decreased by 50.6% sequentially and 79.7% YOY to 4.9 million sq.ft. Though by historical norms retail's 2017 occupancy gains have also been modest, it's important to note that small retail tenants—many located in convenient strip centers serving neighborhood residents—and catering to consumers' everyday needs (e.g., food and gourmet markets, liquor stores, nail salons, cleaners, etc.) have proven to be resistant to the fallout from online sales relative to many big-box retailers and department stores.

▸ **Vacancies flatten out at historic lows.** With the deceleration in occupier demand, sector vacancies have flattened out. The aggregate commercial vacancy rate remained fixed at 4.7% for a fourth quarter in a row (see the same graph), including a 20-basis point (bps) drop from the level of a year ago and compressing it 420 bps below its post-crisis high. And, lest we forget, the rate represents the lowest figure since at least 2006.

National vacancies for small cap office averaged 7.2% in Q3, up 10 bps, and remain a comfortable 240 bps below the pre-recession low. The industrial vacancy rate, hovering at 3.5% for four consecutive quarters, is still in prominent territory way below the previous nadir of 6.0% recorded in early 2008. Retail vacancies were unchanged at 4.6% for a third period in a row and remain 320 bps beneath the previous low-water mark posted in 2006. See the nearby graph.

SMALL CAP CRE VACANCY TRENDS (%)



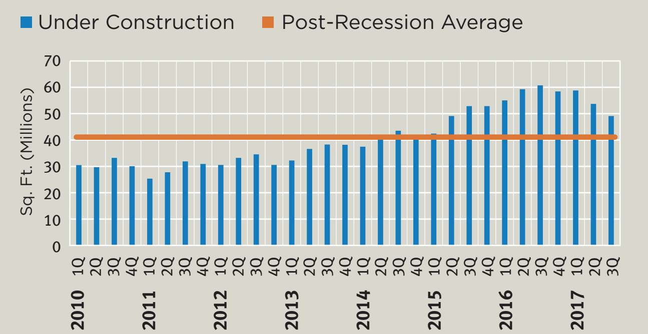
Source: Boxwood Means, LLC; CoStar Group, Inc.

▸ **Completions down, starts on the upswing.** As mentioned in previous reports, the persistent, low supply growth of small commercial projects during the market's expansion has helped to keep the lid on vacancy rates and has enabled rents to recover. Aggregate Q3 completions of 13.5 million sq.ft. reflect more of the same trend including a combined 25.4% decrease from the previous quarter and 13.4% decline YOY. Only industrial completions, buoyed in part by outsized rent growth (see below), produced a 6.4% gain in volume YOY and a 17.6% increase over the last three quarters versus the same nine months of last year.

In contrast with this overall tepid increase in supply, completions in the general CRE market are modestly higher across the board for industrial, office and retail sectors year to date compared with 2016.

And, while construction starts in the small cap domain are also lower relative to last quarter and last year, the broader trend is elevated (see the nearby graph). Aggregate projects under construction have averaged 54.1 million sq.ft. for the last three quarters, or a gain of 31.7% over the average quarterly start volume since the end of the financial crisis. Again, the industrial sector was the most active sector with a sizable 57.8% increase in projects under construction through Q3 compared with the same three quarters of last year. This uptrend in small industrial development mirrors a similar pattern exhibited in the general industrial market where large warehouse and logistical facilities serving e-commerce requirements have been in high demand.

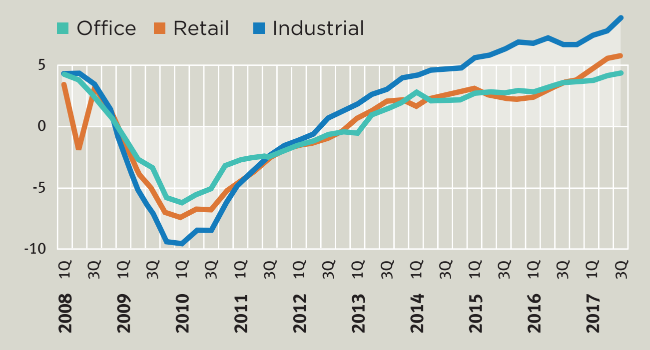
AGGREGATE NEW CONSTRUCTION TREND



Source: Boxwood Means, LLC; CoStar Group, Inc

▸ **Rent growth accelerates.** Low supply has pushed small cap rents higher across all sectors (see the graph on the following page.) Industrial rents rose a hefty 2.2% during Q3 to an average of $8.95 per sq.ft. after an unprecedented 2.4% gain in the previous period. With small industrial space in high demand from various light manufacturing, warehousing and urban in-fill uses, rents have surged 8.7% over 12 months—the highest annualized rent growth in at least 11 years and far exceeding the former 5% record-high gains during

SMALL CAP RENT GROWTH TRENDS | Annualized Percent Change



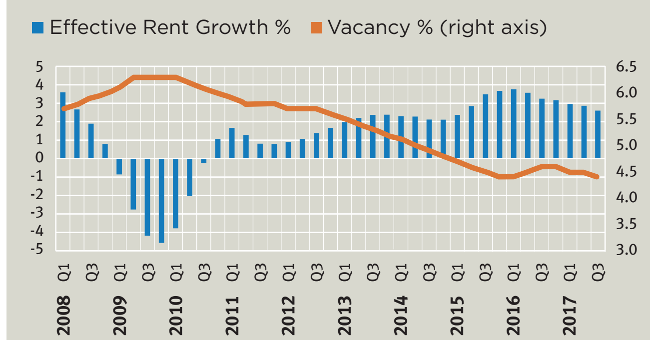
Source: Boxwood Means, LLC; CoStar Group, Inc.

the peak years of 2006-2007. Industrial rents are now nominally 10.6% above the pre-recession high.

Office rents are nominally 1.6% above the former peak level at $20.46 per sq.ft. on average after a 1.1% quarterly increase. The 12-month gain of 4.2% represents the best annualized rent growth since late 2007. Meanwhile, as noted above small cap retail continues to be resilient in the face of e-commerce threats as rents rose 1.2% sequentially and an exceptional 5.7% YOY to $18.77 per sq.ft.—the highest annualized rent growth since 2007. On a nominal basis, average retail rents are effectively flat (+0.1%) compared with the pre-recession high mark.

▸ **No stop signs for multifamily.** The chronic undersupply of affordable rental housing combined with a demographic tidal wave of renter households assures small balance lenders and investors of favorable prospects for current and future investment in the sector. Nine million new renter households were added over the last decade which is the biggest 10-year boost on record according to Freddie Mac. The impact on operating fundamentals is telling: small cap effective rents rose by 2.6% on an annualized basis to an average of $1,074 per unit during Q3 according to Boxwood's national analysis of Class B and C apartment buildings of 40 units or less derived from CoStar surveys. Though this rent figure was down 30 bps sequentially and 70 bps YOY, this rate of appreciation substantially exceeds the average annual 1.9% growth since the end of the financial crisis. Moreover, the average vacancy rate hit a new low at 4.4%, down 10 bps over three months and 20 bps YOY. See the graph below.

SMALL CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

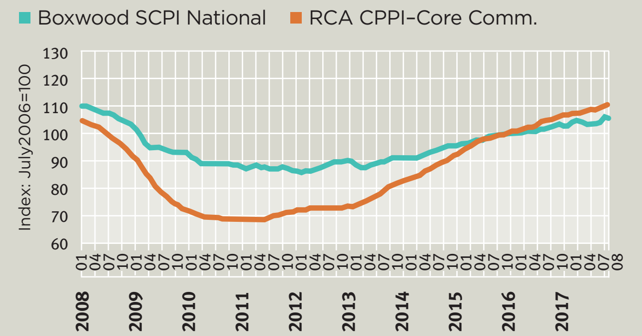
Clearly, low supply growth in both multifamily and commercial sectors has protected occupier markets and has also underpinned the current regime of stiff rental gains. As we have previously suggested, this market cycle looks different than previous ones because of the relatively inelastic supply of new construction. While the slowing trend in commercial leasing may be consistent with a maturing CRE cycle, compounded further by fears of future interest rate increases and fading expectations for a "Trump bump," the pullback in demand seems a bit out of sync with recent, upbeat reports on the U.S. economy. For example, GDP growth has increased, job gains are solid, business spending has improved and positive Wall Street earnings continue to propel the equity markets, among other positive indicators. This upward momentum may very well re-energize small business tenants and owners, and sustain the CRE bull market deep into next year.

Investment Activity and Prices

▸ **Recent small cap CRE prices show renewed strength.** Boxwood's national Small Commercial Price Index (SCPI) for properties trading under $5 million across 125 cities dipped 0.1% in August, but recent prices are on the upswing. Property values rose a much improved 2.1% over the last three months after a slight retreat (-0.6%) over the first five months of 2017. Year over year, SCPI is up 2.6% and, as of August, has recovered 81.3% of its losses to close within 4.2% of its peak before the financial crisis.

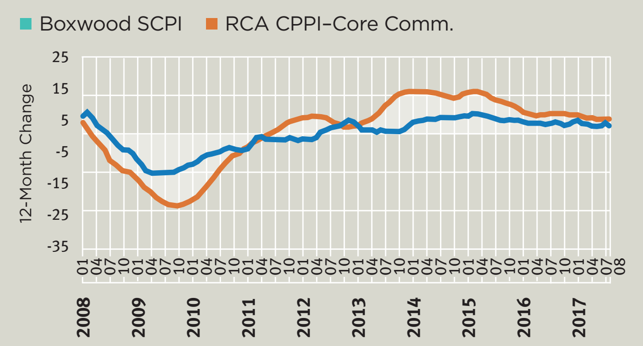
▸ **Large cap commercial prices advance at a modest clip.** Prices of investment-grade commercial assets gained 0.5% in August to sustain an upward trend. The Core Commercial (CC) component of the RCA CPPI (that excludes multifamily and tracks sales transactions above $2.5 million) increased by 1.6% over the last three months after just a 1.7% gain through May. The CC component Index has gained 4.8% over 12 months as RCA reported that deal volume dropped 9% year-over-year. August's 12-month return is only slightly better than the previous month—the lowest annualized growth in nearly six years—and continues a streak of 23 consecutive months of single-digit, year-over-year price gains. This trend thus underscores that even institutional property prices cannot defy gravity forever. The CC component of CPPI has recovered 105.0% of its cyclical losses and is 1.8% above the previous peak. See the two related graphs nearby for trend comparisons between large and small cap CRE prices.

NATIONAL PRICE INDEX TREND COMPARISON



Source: Boxwood Means, LLC; RCA

NATIONAL PRICE TREND COMPARISON | Annual Change



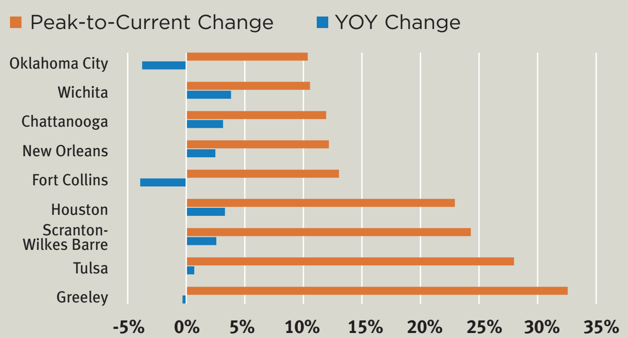
Source: Boxwood Means, LLC; RCA

Note on RCA CPPI: This summer RCA modified and expanded its CPPI price indices. We observed that the revisions in index methodology affected some historical data values that, in turn, impacted (i.e., tamped down) the amplification of historical trends. Our readers may recall commentary on the wide performance gap between the CPPI Core Commercial (CC) and Boxwood's SCPI during the market's expansion. This divergence was illustrated in part by the CPPI CC's peak to current change well in excess of 10% while the post-crisis recovery level for SCPI remained in negative territory (as it still does). That CPPI history has now been revised and, though the past price volatility of the CC Index is still unique and very much apparent, the current trajectory for, and performance variation between institutional and small commercial real estate prices are much closer in line.

▸ **Price increases run more broad than deep.** Only a handful of metros show strong double-digit price gains from 12 months ago, which isn't unexpected since the overall market's recovery and expansion did not lift all secondary and tertiary cities alike. Price appreciation is very uneven, and asset values in many smaller markets remain below peak. Nevertheless, 66/125 metros posted increases YOY, and price momentum is evidently widespread as 100 cities recorded positive monthly gains.

▸ **Oil and gas markets buck CRE industry sentiment.** Over the past two years or more, many institutions curtailed small balance lending in oil and gas markets because of the shakeout in commodity prices. However, with this year's rebound in oil and gas prices and increased drilling activity, a majority of the best performing markets since the end of the financial crisis have been energy based, with peak-to-current price changes led by Greeley (32.6%), Tulsa (28.0%) and Scranton-Wilkes Barre-Hazleton (24.4%). See the graph below.

TOP 10 MARKETS ABOVE PEAK

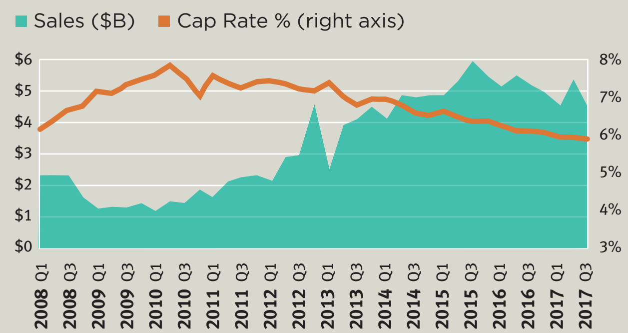


Source: Boxwood Means, LLC

▸ **Multifamily sales take a breather.** Small cap multi-family sales fell 16.1% to $4.5 billion during Q3 after a previously solid quarter. Sales through the first three quarters are off by 8.8% compared with the corresponding period last year according to our analysis of CoStar data. This decline mirrors the same YTD drop-off for large cap multifamily sales reported by RCA; and it reflects buyers' concerns with peak prices and record-low cap rates combined with tightening financial conditions as the Fed ends its quantitative easing campaign and looks to raise its benchmark interest rate once again during Q4.

Speaking of cap rates, they continue to taper as the graph below shows. Small multifamily cap rates closed out the quarter at 5.88% -- the lowest level since at least 2008—and a decrease from 5.93% during second quarter and 6.08% from a year ago.

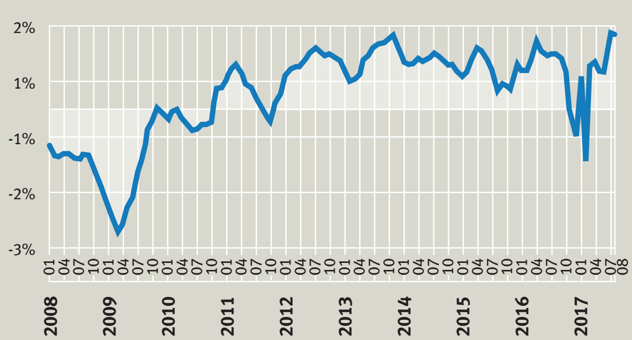
SMALL CAP MULTIFAMILY SALES AND CAP RATE TRENDS



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

▸ **Multifamily prices accelerate.** Though fewer multi-family properties may be trading hands, prices continue to escalate. Boxwood's national Small Multifamily Price Index (SMPI) soared 1.4% in August for the second month in a row to the highest month-to-month rate increase in at least nine years. See the graph below.

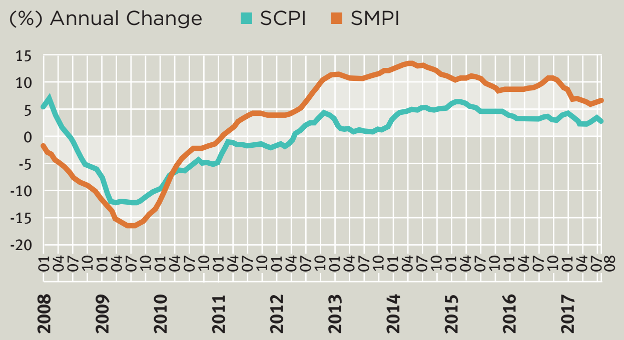
SMALL CAP MULTIFAMILY PRICE TREND | Monthly Change



Source: Boxwood Means, LLC

Asset values soared 3.4% over three months as 44 of 45 markets advanced during this period led by outsized gains in Dallas and Palm Beach (4.5%), Miami (4.4%) and Chicago (4.1%). SMPI has returned 6.5% YOY to elevate the Index to a massive 34.7% above its prior peak level. The persistent outperformance of the small cap multi-family sector versus commercial is illustrated in the next graph.

SMALL CAP COMMERCIAL AND MULTIFAMILY PRICE TRENDS



Source: Boxwood Means, LLC

The old adage is that bull markets don't simply die of old age. But investment activity naturally tends to diminish late in the cycle as investors retreat from sky-high market prices that appear close to a tipping point. At the moment, such market risk appears more prevalent in the large cap CRE domain rather than the smaller one where assets in many markets remain below peak valuations. Which suggests that small balance lenders and investors can more freely navigate the twin beacons of opportunity and risk at this advanced stage of the market's expansion.

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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