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Small-Cap Market Gets Hit Hard in 1Q, Before Coronavirus Lockdown

Commercial Real Estate Direct Staff Report

The small-capitalization commercial property market, which had started softening last year largely because of demographic issues, got walloped during the first quarter. And that was largely before the coronavirus pandemic hit.

Tenants vacated space by the droves, as office, industrial and retail properties in the small-cap market suffered 13.8 million square feet of negative net absorption during the quarter, according to Boxwood Means. That means 13.8 million sf that previously had been leased became vacant during the period. It was the first time since the third quarter of 2009 that the small-cap market witnessed negative absorption.

Surprisingly, industrial properties suffered the most, with 10 million sf of negative absorption; office properties suffered nearly 3 million sf; and retail had just less than 900,000 sf of negative absorption.

Small-cap industrial properties suffered because of the slowing economy heading into the coronavirus lockdown and growing global trade tensions, explained Randy Fuchs, principal and co-founder of Boxwood Means, a Stamford, Conn., provider of valuations, research and analytics on the small-cap property market. The company relies on a database that tracks some 600,000 buildings, of 50,000 sf or less each, that have a total of 9 billion sf.

While the broader industrial market has benefited widely from growing e-commerce trends, "small warehouse operators face different stresses," Fuchs said, adding that many small industrial properties are used for manufacturing, as opposed to last-mile distribution, which have seen fundamentals balloon. Those manufacturers were squeezed by growing trade tensions.

Given that small businesses have borne the brunt of the impact of the near nationwide shutdowns stemming from the pandemic, property fundamentals likely have weakened further. The first-quarter results reflect only two weeks of the shutdowns.

"Many small businesses are failing," Fuchs said. "The challenges facing small businesses have flipped on their head."

The small-cap market had been on a tear since the Global Financial Crisis as businesses of all sizes expanded. The sector enjoyed nearly non-stop growth in absorption, as well as a spike in rents. That started slowing about a year ago, but not because of a lack of tenant demand.

Instead, small businesses were having difficulties orchestrating their growth strategies as the economy enjoyed seemingly full employment, making it challenging to find qualified workers. A year ago, more than one-third of all business owners said they couldn't fill open job positions

At the same time, developers weren't building new space. So, companies seeking to expand simply couldn't, pressuring fundamentals

The volume of space available for sublease increased by 11.5 percent to 31.1 million sf, the most since the third quarter of 2010. And roughly one-third of that was comprised of industrial space.

Each of the three sectors tracked by Boxwood Means saw an increase in vacancy. The office and industrial sectors both saw increases of 10 basis points, to 6.3 percent and 3.5 percent, respectively. The retail rate was up 20 bps to 4.3 percent.

Asking rents for office space, however, continued to increase and were up 9.3 percent from last year, to $22.38/sf. For retail, they were up 3.8 percent to $19.61/sf, and for industrial they were up 4.4 percent to $9.98/sf. That's the smallest rate of increase since 2014. Asking rents don't take concessions like free rent and tenant improvements into account, so they might overstate actual rents.

What was a supply issue has become a demand issue. Many small businesses likely have been permanently shuttered as a result of the lockdown. How many of those are replaced by new small businesses will provide clarity on how the small-cap property market fares.

"We're really in a weird place right now," Fuchs said.

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