Small Balance Advocate

QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS

1st Quarter 2018

Market Watchwords: Get While the Gettin's Good Re-assuring signs of the market's durability from first quarter fundamentals offer hope to investors and lenders for a repeat of last year's exceptional transaction sales volume and SBL originations.

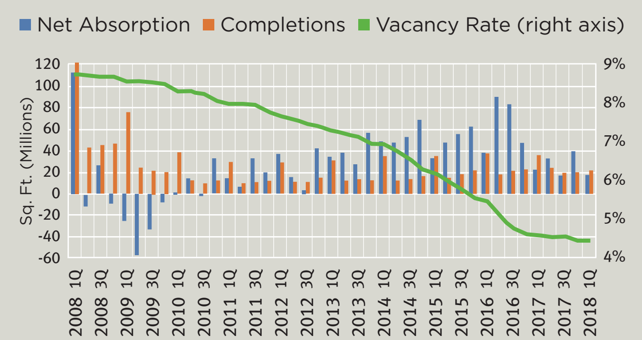
Space Market Fundamentals

Small-cap CRE occupier demand slowed considerably during first quarter, but tepid new supply kept vacant space in check while rents soared. National highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Net absorption tumbles.** Though aggregate demand advanced for the 30th consecutive quarter dating to the end of the financial crisis, its velocity weakened considerably. Net occupancies across office, industrial and retail sectors totaled just 16.2 million sq.ft. during Q1, down 57.8% from the earlier quarter and 27.0% YOY to the lowest quarterly volume in over five years (see the graph below).

All three sectors experienced demand compression of 50% or more. Net occupancies for industrial and flex space dropped most significantly, by 68.6% sequentially and 29.7% YOY to 4.2 million sq.ft. to the lowest quarterly level since Q3 2012. Office demand dropped to only 3.0 million sq.ft., contracting by 55.2% and 37.2% quarter-over-quarter and YOY, respectively. Net absorption for retail space totaled 9.0 million sq.ft. with a pullback of 50.8% compared with fourth quarter and 21.4% versus 12 months earlier.

AGGREGATE SMALL-CAP CRE LEASING TRENDS



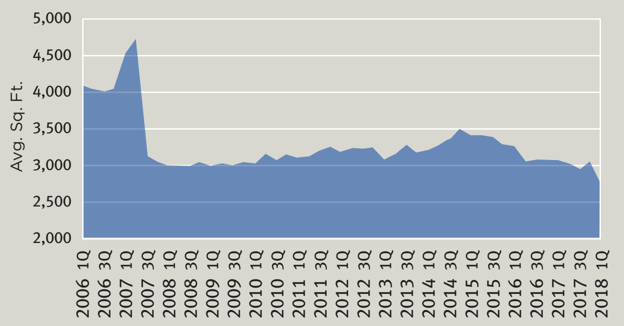
Source: Boxwood Means, LLC; CoStar Group, Inc

▸ **Direct lease activity tells a better story.** While net absorption fell significantly, the 40,600 total direct leases signed during Q1 represented a much smaller decline. In fact, while aggregate demand has downshifted of late – dropping by 57.2% in square footage terms over the last four quarters compared with the same rolling four quarters during the preceding year – the total number of direct leases fell by only 3.5%. Hence, by this metric leasing activity has held fairly steady.

The weak correspondence between direct leases signed and total space absorbed underscores general CRE workplace trends emphasizing more efficient use or re-tooling of existing space by tenants, the rise of co-working environments as well as home offices, and an increase in service-related jobs that simply don't require as much individual space for employees. These shifts may explain why the total square footage per direct lease signed has consistently tapered over time (see the graph on the following page). Indeed, Q1's national average of 2,760 sq.ft. per lease across the three sectors was the lowest in the available historical record and one-third less than the average-sized lease at the beginning of 2006. Not surprisingly, the average unit size of small-cap office leases, at -36.0%, contracted the most over this time frame while retail (-19.1%) suffered the least.

BOXWOOD MEANS
Know the value of Main Street

TREND IN SMALL-CAP CRE DIRECT LEASES



Source: Boxwood Means, LLC; CoStar Group, Inc

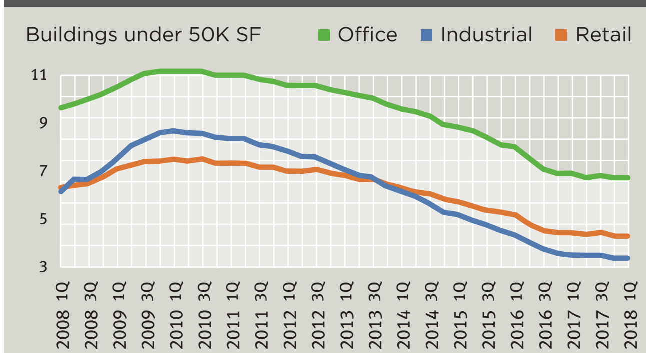
▸ **New supply continues to sputter.** Deliveries across the three property types rose a modest 4.1% quarter over quarter to an aggregate 20.1 million sq.ft., but the overall construction trend for buildings under 50,000 sq.ft. remains soft. Total completions were down 42.0% YOY and decreased 13.7% over the last four quarters versus the previous four.

That being said, industrial small-cap CRE deliveries jumped 26.2% during Q1 to 5.8 million sq.ft. -- the highest volume in five quarters – an important and positive sign for a sector where demand has routinely outstripped supply for new warehouse and other industrial facilities ranging from manufacturing to distribution and supply chain-related urban and infill locations. Even so, concerns linger that as occupier requirements continue to mount, industrial demand may be choked off by the lack of sufficient facilities. The recent flagging small-cap industrial demand, evidenced by an unusual 60.2% drop during the last four quarters compared with the corresponding four from a year earlier, may be a signal of such structural imbalance.

Meanwhile, deliveries for the other sectors continued their tepid pace, with office completions off 12.5% sequentially and 40.3% YOY while retail deliveries increased 1.7% during Q1 but plummeted 46.4% YOY. As suggested last time, a new normal envelopes this late stage of the cycle where the incidence of hyper-supply is absent and the market expansion rolls on because, among other factors, federal rules have crimped construction financing from banks, and developers have been disciplined and cautious even though rents have now more than fully recovered.

▸ **Record low vacancies prevail.** Certainly the slow-down in net absorption stirs up fresh concerns about the future of the market's eight-year expansion. But if there's one hallmark of this bull market's health and durability it is the temperament of small-cap CRE vacancy rates – seemingly suspended in time at record-low levels. The aggregate national vacancy rate was affixed below 5% for the seventh consecutive quarter and, at 4.4%, rests 190 basis points (bps) below the pre-recession low (see the graph on Page 1). All three sectors have achieved record lows: Industrial vacancies averaged 3.4%, unchanged in Q1 and down 20 bps YOY, and perched at a seeming rock-bottom level 260 bps below the previous cyclical low; at 4.3%, the average retail vacancy rate was also unchanged during the quarter, down 10 bps YOY and, because of the continued viability of small-cap grocery-anchored community and local strip centers serving everyday consumer needs, average retail vacancies comfortably sits 150 bps below the previous low point during 2006; and the national office vacancy rate averaged 6.7%, unchanged for four consecutive quarters and 140 bps beneath its previous low before the Great Recession. See the graph below.

SMALL CAP CRE VACANCY TRENDS (%)

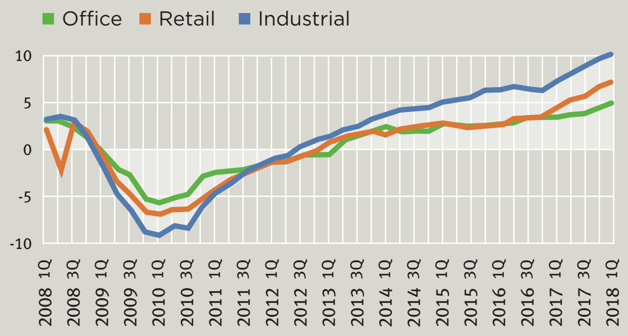


Source: Boxwood Means, LLC; CoStar Group, Inc.

▸ **Rents jump to new highs.** Extremely low space availabilities continue to drive rents higher to the delight of small-time investors. Simply put, the level of rent inflation is unprecedented for our times. Since 2006, the average annual increase in industrial rents, for example, was 1.5%. Yet small-cap industrial rents have consistently exceeded 2% rent growth for each of the last five *quarters*, soaring an extraordinary 2.9% over three months ending March. Strong U.S. industrial production and growing e-commerce activity – complemented by consistent job growth in manufacturing and warehousing/transportation jobs – have placed all types of manufacturing, light industrial and warehouse space at a rent premium. At $8.85 per sq.ft. on average, industrial rents have jumped 9.9% over 12 months to 14.1% above the pre-recession peak.

As previously mentioned, the average square footage of small office leases is under relatively more pressure from workforce shifts and efficiency initiatives than the other two property types. Add to that a tight labor market, and there are reasons for concern about the future of office-using demand. Even so, small-cap office rents are killing it rising 1.5% during first quarter and 4.7% YOY – with both percentages representing new highs. At $19.71 per sq.ft. on average, small-cap office rents sit 2.7% above the previous cyclical peak. And despite the controversies over the sustainability of retail as we know it, retail rents also hit a new apex with unparalleled quarterly and annual growth of 2.2% and 7.0%, respectively. Small-cap retail rents are now 3.0% above their pre-recession high. See the nearby graph for rent growth trends.

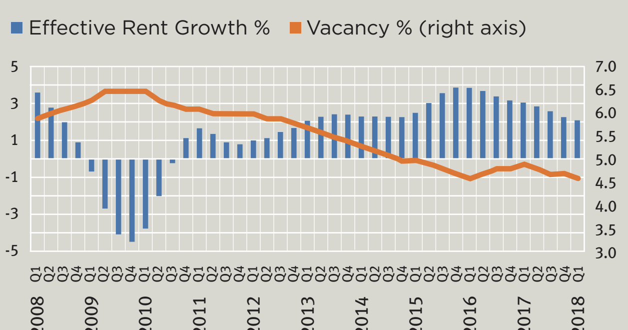
SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



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

▸ **Multifamily rent growth continues to slow.** Though amply exceeding a long-term annual growth rate of 1.4%, affordable multifamily housing rents have slowed considerably according to Boxwood's latest analysis of CoStar data encompassing nearly 300,000 Class B and C apartment buildings containing 5-40 units. At $1,091 per unit on average during first quarter, annual effective rent gains eased to 2.1% down from 3.1% a year earlier and a peak rate of 3.9% two years ago. This moderation in rent growth is likely associated with the continued challenges to housing affordability among middle-income workers whose wage increases have trailed rent growth since at least the financial crisis. Meanwhile, small-cap multifamily vacancies narrowed by 10 bps to 4.6% on average during last quarter and 30 bps year over year to 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

The size of the Q1 pullback in demand was conspicuous and concerning because the scarcity of new supply, coupled with a very tight labor market, may indeed conspire to further suppress small tenant leasing activity this year. Skyrocketing, if not inflationary-style rents may also become a deterrent. Some tenants will likely stay put rather than expand while others may vacate older Class B and C buildings and trade up for better infrastructure and amenities in more modern facilities. This may pose a possible threat to small-cap CRE lenders and investors of older office, flex and warehouse buildings. That being said, strong U.S. economic growth against a backdrop of generally low non-residential building construction will keep vacancy rates near record lows for the foreseeable future.

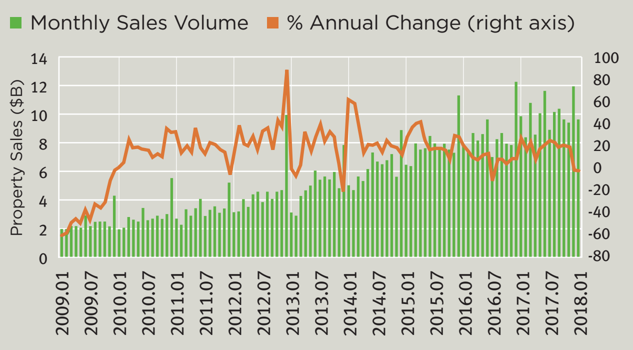
Investment Activity and Prices

▸ **Property sales get off to a decent start.** Transaction volume involving assets under $5 million totaled $9.6 billion in January after the typical year-end rush when December's volume reached $11.9 billion. Though January's total declined by only 2.5% compared with 12 months earlier – and is comfortably above monthly average totals over the last three years – the annual monthly rate of change shows a clear pattern of slowing (see the graph below). That being said, this sales market remains bullish and very liquid: Last year's $119.3 billion worth of investment sales was 17.5% greater than the previous year and the highest recorded total since at least 2006.

The still elevated transaction activity in the small-cap domain contrasts sharply with the institutionally-oriented sales marketplace where Real Capital Analytics (RCA) reported that deal volume for assets above $2.5 million in value declined by 7% overall in 2017, reduced in large part by a 12% decline in megadeal activity. By contrast, single-asset institutional sales fell by only 5% as RCA suggested that buyers and sellers of smaller properties found relatively more agreement on pricing. In January, entity-level or portfolio-related sales bolstered total transaction volume of $34.3 billion, off only 3% YOY, though individual asset sales tapered by 13%.

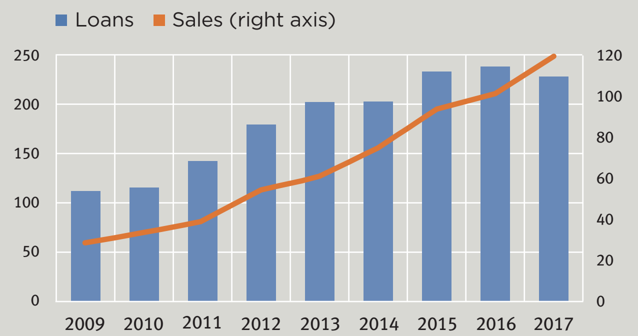
▸ **SBL originations are boosted by acquisition activity.** Small-balance loan originations totaled a robust $228.8 billion last year, down a modest 4.2% compared with 2016 but still the third highest total on record. Vast and diverse sources of interim and longer-term credit continued to flow into the space for loans under $5 million as real estate debt looks increasingly more attractive than bonds for investors. Purchase loans representing 41.2% of total volume – the second highest percentage all-time – clearly helped to spur the small-cap sales of nearly $120 billion last year (see the graph below).

SMALL-CAP CRE SALES TRENDS



Source: Boxwood Means, LLC

SBL ORIGINATION AND SALES TRENDS ($B)



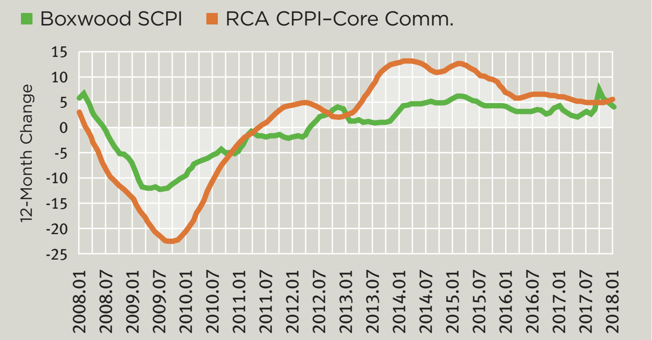
Source: Boxwood Means, LLC

Last year's SBL volume also revealed some other noteworthy trends: Commercial banks' dominion over the SBL space continued to erode, i.e., the top 15 lenders commanded a collective market share of 19%, down from the mid-twenties several years ago; and, moreover, two non-bank lenders have cracked this leader board: CBRE Capital Markets (ranked 3rd) and Greystone (12th). CBRE Capital Markets generated the largest market share increase YOY rising by 25 bps. See the complete list of top lenders in this **blog piece**.

▸ **Prices lose a bit of steam.** Small-cap CRE prices dipped for the third month in a row but are still higher than any time since March, 2008. Boxwood's national Small Commercial Price Index (SCPI) for properties trading under $5 million across 125 cities rose 4.3% YOY after easing 0.5% during January. The best performers over 12 months include San Antonio (6.3%), Charlotte (5.6%), Los Angeles and Columbia -GA (5.5%), and Fort Lauderdale (5.4%). Overall, SCPI has recovered 95.5% of its post-crisis losses and, notably, closed within 1.0% of its previous cyclical peak.

▸ **Large-cap prices re-awaken.** After succumbing to pedestrian-like annual price growth of 5% for four consecutive months, institutional prices of late have displayed more spunk. The Core Commercial (CC) component of the RCA CPPI (that excludes multifamily and tracks sales transactions above $2.5 million) rose 0.5% in January and increased 5.5% YOY which is the best 12-month gain in 10 months. Commercial prices were buoyed by the industrial sector's outperformance with 1.0% and 8.9% gains for January and 12 months, respectively. By contrast, large-cap office and retail prices appear constrained to less than 4% annual growth as each of these sectors faces separate challenges, the former cyclical and the latter structural. See the nearby graph for trend comparisons between large- and small-cap CRE prices.

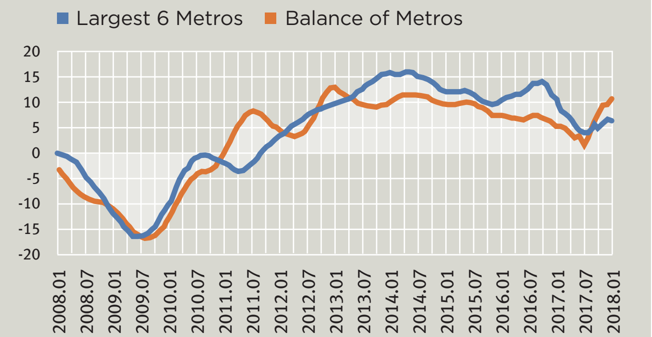
NATIONAL PRICE TREND COMPARISON | % Annual Change



Source: Boxwood Means, LLC; RCA

▸ **Smaller multifamily markets shine brighter.** It continues to be an outstanding run for the small-cap multifamily sector at large. Boxwood's national Small Multifamily Price Index (SMPI) advanced 1.5% over the last three months and a sizable 9.2% YOY. SMPI has risen 257.2% since hitting bottom in 2010 and, as of January, was a remarkable 40.1% above its previous peak level. As the graph below shows, the price trajectory for two principal market groupings has recently transformed. The five- year average annual growth rate of 11.3% for the largest six population centers has handily beat the long-term average for the balance of metros (8.5%). However, multifamily price increases in the biggest markets have slowed of late with a 12-month return of just 6.4%, as the dearth of new workforce housing supply has pushed acquisition prices up and yields down to

SMALL-CAP MULTIFAMILY PRICE TRENDS | % Annual Change

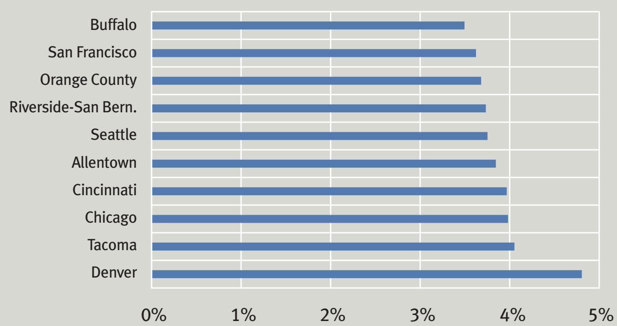


Source: Boxwood Means, LLC

levels that have given small investors pause. On the other hand, the comparatively better values presented by small apartment assets in secondary and tertiary markets is no longer a secret, and prices have inflated quickly. Indeed, Boxwood's index of prices for the balance of metros jumped 3.0% over three months and 10.6% YOY to the highest annual growth rate since the fall of 2014.

In fact, the ubiquity of healthy price gains underscores the current strength of the small-cap multifamily sector. As of January, 41/45 multifamily markets tracked by Boxwood posted positive annual returns led by Long Island (16.8%), Allentown (12.6%) and Las Vegas (12.4%). Moreover, this positive trend shows no sign of abatement as all 45 markets recorded increases over three months, including 21 that posted outsized gains of 3% or more led by Denver (4.8%), Tacoma (4.1%) and Chicago (4.0%). (See the graph below.)

TOP MULTIFAMILY MARKETS | Three-Month Price Gains



Source: Boxwood Means, LLC

Clearly, so far this year small investors and lenders remain very enthusiastic about this sector and for good reason – apartment rents are at record-high levels and rising, and vacancies remain stuck at historic lows.

The first glimpse into 2018 generally indicates that small-cap space fundamentals and the investment sales market – the entire CRE domain for that matter – continue to offer participants opportunities, albeit with a requirement for greater geographical scope, and more asset selectivity and due diligence. Of course, all is good until it's not; so it's imperative that investors and lenders acknowledge the changing risk-reward dynamics at play during this market's protracted run and maintain discipline that can mitigate the downside associated with the market's eventual reversal of fortune.

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.

Boxwood deems that our data sources are reliable. Some areas of the country offer more complete information than others. This report is presented on an "as is, as available" basis. Boxwood makes no warranties, expressed or implied, without limitation, to the information provided, nor are we responsible for any errors or omissions.

Boxwood Means, LLC is a leading national provider of property valuations and data analytics in the small commercial property and loan markets. Our technology-driven solutions, featuring a full range of commercial evaluation products complemented by appraisals, CRE price indices and market research, support the investment and risk management needs of 200 banks, non-bank lenders and investors nationwide.