Small Balance Advocate

QUARTERLY UPDATE FOR SMALL-CAP CRE INVESTORS

1st Quarter 2019

Supply Scarcity Cramps Industrial Sector Demand Stresses on the occupier market were exposed during first quarter as supply's long-standing deficit finally exacted its price in terms of curbed demand generally and negative net absorption specifically in the industrial sector. Similar cooling has emerged in the investment market.

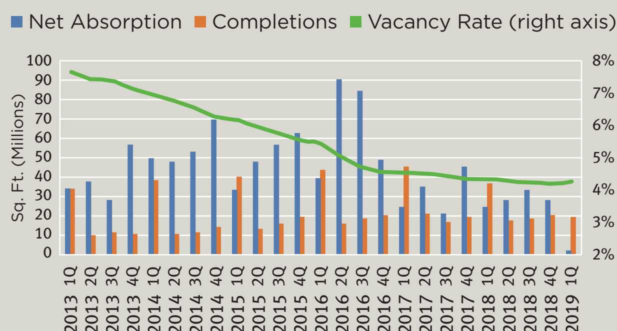
Space Market Fundamentals

Low demand overshadowed an otherwise solid first quarter. National highlights from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Demand for Space Plummets.** Aggregate small-cap CRE demand across office, industrial and retail sectors retreated to a meager 1.9 million sq.ft. during Q1, roughly a 90% drop from the previous quarter as well as during the same period in 2018. It was the lowest combined net absorption over the last 34 quarters dating back to Q3 2010. See the graph below.

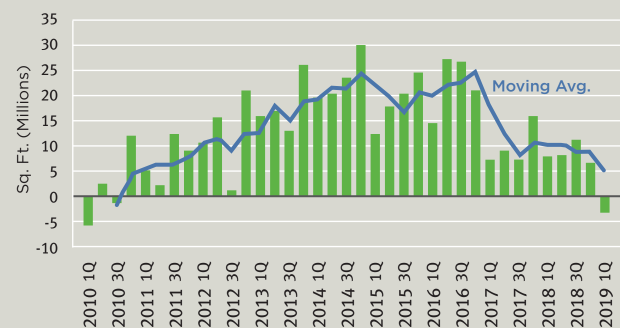
The tumbling trend in demand will not be a surprise event for Small Balance Advocate readers, since we have repeatedly raised the caution flag about it. Still, a Q1 collapse in industrial demand is particularly striking: i.e., net negative absorption of 3.3 million sq.ft. translating to huge net occupancy losses of 151.3% sequentially and 144.4% YoY, and the first negative turn since 2010 when CRE was struggling to gain a footing after the financial crisis. See the nearby graph. Industrial's occupancy slide is a direct result of supply scarcity – the absence of adequate leasing options and expansion opportunities for users particularly of small warehouses, light industrial and flex facilities and underscored by an historic low national vacancy rate.

AGGREGATE SMALL-CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar

SMALL-CAP INDUSTRIAL DEMAND TREND



Source: Boxwood Means, LLC; CoStar

Demand took a skid in the office and retail sectors, too. The office sector eked out a net occupancy gain of 1.3 million sq.ft. while dropping 84.6% from Q4 and 71.4% YoY to the smallest quarterly amount in over six years. Retail didn't fare much better with roughly 70% declines in positive net absorption for both the quarter and YoY while adding just 3.8 million sq.ft.

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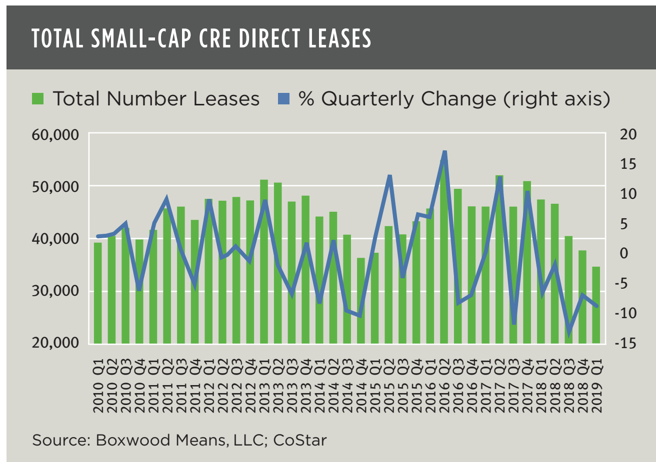
The general contraction in small-cap demand is perhaps best illustrated by the trend in aggregate signed direct leases which, as the graph below shows, has fallen for five consecutive quarters including a sizable 27.0% decline YoY.

TOTAL SMALL-CAP CRE DIRECT LEASES

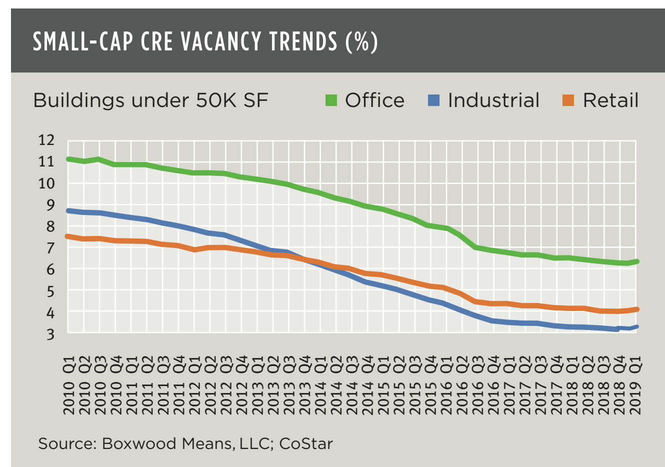


Source: Boxwood Means, LLC; CoStar

A nearsighted view might dismiss this latest swoon in tenant occupancies as the adverse consequence of January's federal government shutdown and bad weather. But we suggest there's a more fundamental or structural change afoot. The market's persistent, inelastic supply represents the ultimate paradox of this cycle where history shows that expansions typically climax with an over-production of new inventory that swamps elevated levels of demand. So this development – or non-development – is a bit puzzling. The best explanation seems to be that the current CRE market expansion has departed from the traditional pattern such that the historic relationship between supply and demand no longer applies – or at least doesn't apply in this instance. The fact is that even as digital communications have reduced the barriers of physical space in this era, commercial tenants increasingly prefer the social, organizational and cultural benefits of tight-knit urban locations that have spurred the back-to-the-city movement. But as near all-time low vacancies denote, CBD leasing availabilities and in-fill development locations for small business owners and tenants have grown increasingly rare.

▸ **Weak Deliveries Keep a Lid on Vacancies.** Developers remain sidelined by the few and costly small-building construction opportunities in many metro areas. Aggregate deliveries across the three property types totaled 19.2 million sq.ft., down 5.4% sequentially and a substantial 48.4% decline YoY but roughly on par with 20.0 million sq.ft. of new construction put in place on average each quarter since 2010. Yet as the long-term vacancy trend has shown, this relatively consistent volume has been insufficient to fill the gap from excess demand. That is, until now: in the face of the notable slide in positive net absorption, Q1 national vacancy rates edged up 10 basis points across the board (see the graph below). As negligible as that may be, these directional changes nonetheless mark the first quarterly reversal in sector vacancy rates in over eight years.

SMALL-CAP CRE VACANCY TRENDS (%)



Source: Boxwood Means, LLC; CoStar

When we couple this supply scarcity with a national unemployment rate of 3.6% – a 50-year low – it's understandable that demand might also be faltering because small businesses cannot find qualified new workers to fuel growth or expansion. Granted, small business employment is rising, but it's against a rising shortage of job applicants. As the graph on the following page shows, 54% of small business owners (and 90% of those in hiring mode) reported few or no qualified workers for open positions according to the March NFIB Small Business Economic Trends report. Moreover, 39% of all owners, equal to the record high set last December, claimed they could not fill job openings in the latest period.

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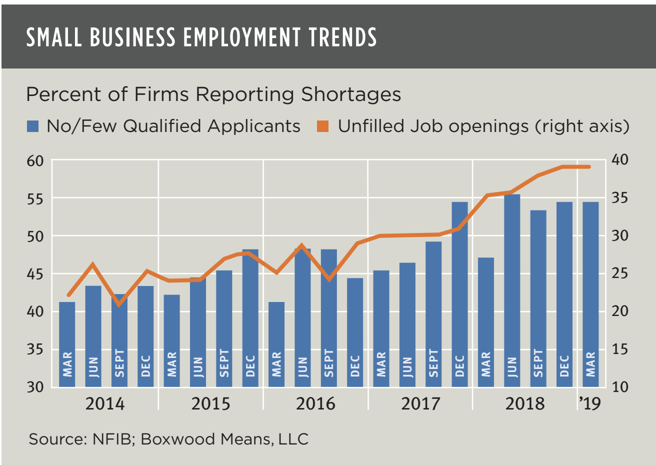
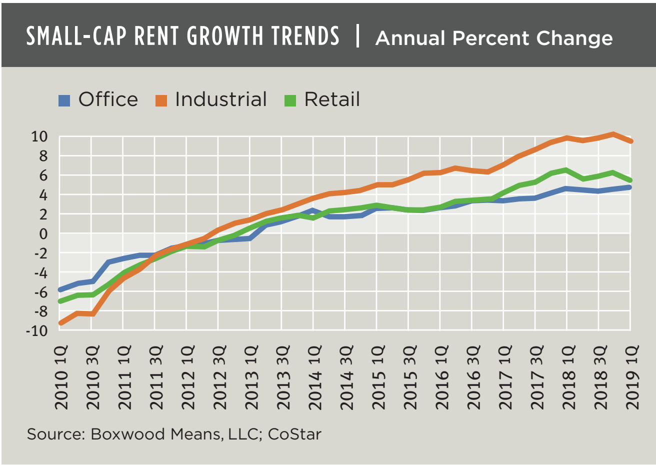


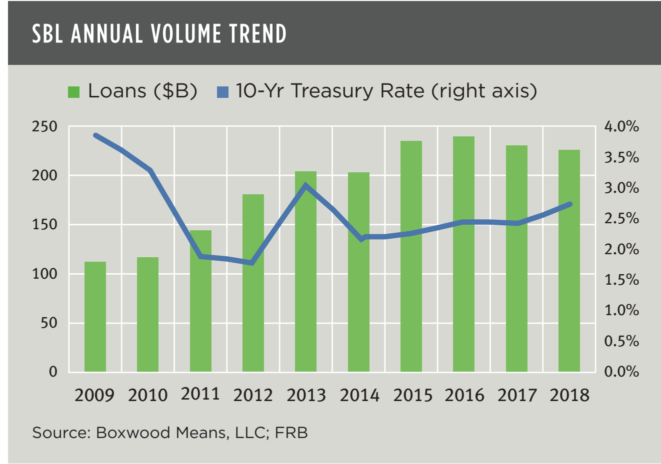
▸ **Rent Surge Continues.** With severely tight fundamentals, landlords maintained the upper hand on small-cap rents. With an all-time best 1.5% advance during the quarter as well as 4.5% gain YoY, office rents soared to a national average of $20.52 per sq.ft. On a nominal basis, that rent level is 7.0% above the previous cyclical peak. Retail rents posted a healthy 1.2% sequential increase contributing to a 5.3% gain YoY, and the average rental rate of $19.13 per sq.ft. is 7.7% over its previous apex. At $9.64 per sq.ft. on average, industrial rents scored a record ninth consecutive quarterly increase of 2% or more that propelled a 9.4% gain over 12 months and nominal rents that exceed its former 2008 peak by a whopping 24.6%. See the graph below.



It's well established that demand for city office space and in-fill warehouse and distribution facilities supporting urban consumers has accelerated as talented workers and high-paying jobs move back to the urban core. It's also well known that there's an ongoing revolution in the way we shop that has produced retrenchment in retail. At the intersection between these divergent trends are the next-generation types of urban land use redevelopments typified by projects such as: WeWork's purchase of Lord & Taylor's flagship NYC store; the repurposing of the Arcade Providence in Rhode Island from downtown shopping mall to apartments and small businesses; and multiple, multi-story warehouse facilities, both ground-up and retrofits, in places like Brooklyn, Seattle, LA and elsewhere. This transformation of anachronistic retail and other aged facilities into updated pieces of a revitalized ecosystem is not a panacea for the demand stressors within CRE, but it is creating new and productive assets that help stabilize our communities.

Investment Activity and Prices

▸ **Annual SBL Originations Top $200 Billion Again.** With over 260,000 closed loans, small-balance commercial originations under $5 million totaled $225.0 billion in 2018 and extended to six years the streak of annual volume above $200 billion. See the nearby graph. Not surprisingly, Los Angeles led all U.S. counties with a 7.3% share of total dollar volume, while the top 15 counties accounted for 28.5%. As testimony to an expansive market of available SBL capital, the balance of nearly 1,800 U.S. counties witnessed a 54.6% YoY increase in closed loans.



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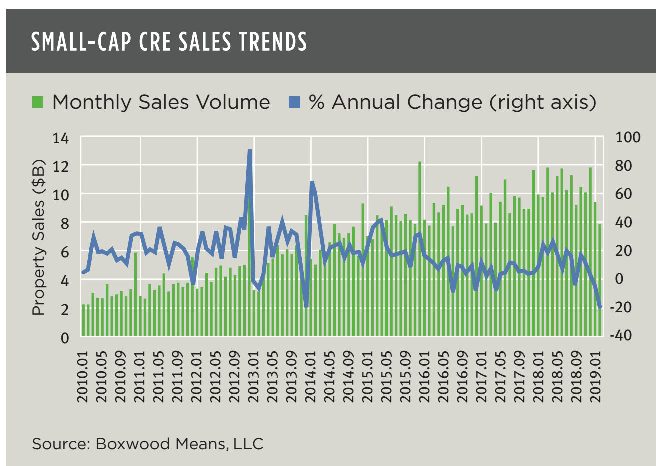
Commercial banks continue to dominate the leader board with JP Morgan Chase (4.7%) and Wells Fargo (2.5%) again taking the top two spots. But banks continued to lose some of their collective grip as the market share of the top 15 lenders eased 6.9 basis points YoY to 19.1%. Moreover, Arbor Commercial Mortgage (and affiliates) and CBRE Capital Markets ranked third and fourth with nearly 2% shares, respectively, that highlight the growing influence and impact that nonbank lenders are having in the space. Boxwood's complimentary national SBL report is available for download **here**.

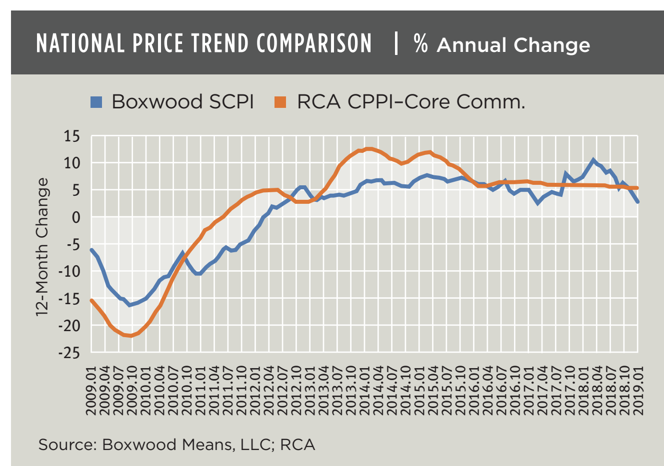
► **2018 Property Sales Hit Another Milestone.** With an abundance of capital sources fueling deal activity, small-cap assets trading under $5 million rose 12.7% to $126.9 billion during 2018, exceeding $100 billion for the fourth year in a row. Yet February's preliminary sales figure of $7.8 billion was off 19.5% YoY and, as shown in the nearby graph, the overall velocity of sales transactions has been slipping for several months. Single-asset sales for large-cap CRE (valued above $2.5 million) rose last year, too, though advancing only by 3% YoY to $387.5 billion according to Real Capital Analytics. In a similar pattern to the small-cap trend, RCA noted that deal activity softened during Q4, and this weakness extended through February of this year with a 12% YoY decline in single-asset deal volume.

Financial turbulence during Q4 may explain some of the slide in property sales. But it's also quite ambitious to expect buyers and sellers to sustain the elevated pace of transactions over the last couple of years since, at this advanced state of the cycle, investors face peak prices, stubbornly low cap rates and higher financing costs.



► **Asset Prices Weaken.** With the marked slowdown in deal flow so far this year, small-cap CRE prices have given ground. Boxwood's U.S. Small Commercial Price Index (SCPI) that tracks sales transactions under $5 million across 125 markets decreased 0.6% on a preliminary estimate basis during February for a cumulative 1.2% loss since the beginning of the year. SCPI's annualized return dropped to 2.5%, less than half the rate this past December and the lowest 12-month increase in nearly two years. SCPI remains 1.5% above its previous cyclical peak. By contrast, stronger buyer demand for relatively safer assets in the six biggest population centers has preserved richer pricing in these metros underscored by a peak-to-current change of 5.6% in the most recent period.

Prices in the large-cap CRE arena have fared better. RCA reported a 0.4% gain for February and a 5.2% YoY increase that positioned the Commercial Component of RCA's CPPI at a healthy 7.3% above the prior cyclical peak. That said, February's YoY increase was the lowest annualized return in nearly six years, and RCA noted that the deceleration in annual price growth was affected by slackening deal activity. See the comparative price index trends in the graph below.



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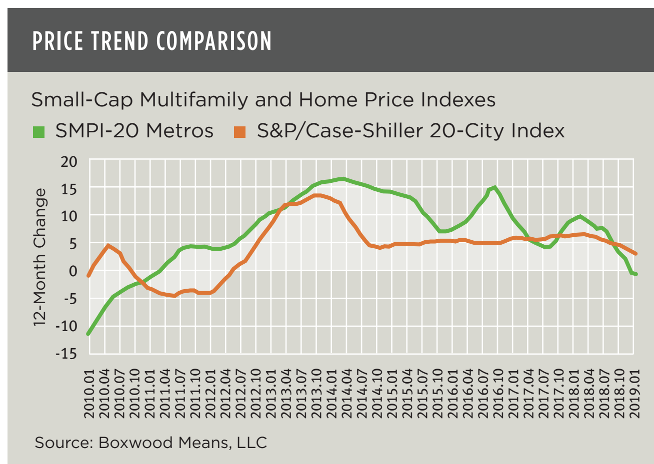
▶ **Multifamily Price Growth Decelerates.** The pace of small-cap multifamily price increases has also slowed considerably over the last several months. Though Boxwood's Small Multifamily Price Index (SMPI) that tracks 45 markets rose a modest 0.1% on a preliminary estimate basis in February, the Index has declined 1.8% over three months as it appears that interest rate volatility and higher debt costs straddling the new year took a toll on asset valuations. The National SMPI rose only 0.9% YoY in February which pales in comparison with the annualized 10.9% return posted 12 months earlier. Still, multifamily prices are greatly elevated at 40.1% above the previous 2006 peak and, at this level, is likely another factor creating some price resistance from buyers.

The pullback in small-cap multifamily prices echoes the recent trend in residential housing. As the nearby graph of the same 20 metros for each asset class shows, home prices dropped from double-digit annualized increases between 2013-2014 to just a 3.0% growth rate in February – the lowest 12-month gain since the fall of 2012. S&P noted that trends in new home sales, housing starts and residential investment similarly weakened over the last year.



Solid U.S. jobs and GDP growth would appear to clear the runway for a sustained CRE market expansion this year, if not add more fuel to it. While slowing asset sales and prices, and the supply-demand gap that has notably curbed net absorption during Q1 may not pose major threats or disruption to the market's present stability, the weight of these factors is real and will likely create more friction over time. Small-balance lenders and investors that temper economic bullishness with a dose of vigilance about these CRE market trends will be prepared to make the most sensible and secure deals.

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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