Small Balance Advocate

QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS

2nd Quarter 2018

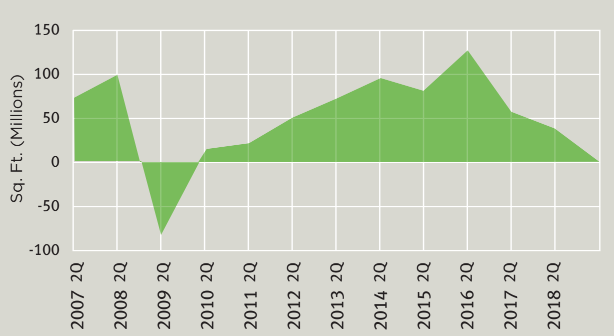
Crosswinds Emerge at Mid-Year Generally, favorable small-cap space market and investment fundamentals progressed through second quarter. Yet the occupier demand trend may create headwinds for future growth.

Space Market Fundamentals

Occupier demand stayed in positive territory during Q2 but erosion continued. That didn't deter asking rents which again grew at a healthy clip. National highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Demand trend weakens further.** It's too early to raise the warning flag, but the recent deceleration in aggregate small-cap net absorption is nonetheless concerning. Net occupancies across office, industrial and retail sectors during Q2 totaled 17.9 million sq.ft., declining 8.3% versus the previous quarter and a sizable 45.7% YoY. Not only is the Q2 increase the lowest in 24 consecutive quarters, the 37.4 million sq.ft. of total occupancy gains for the first-half of 2018 represents the weakest mid-year performance since 2011 when the CRE market began expanding with conviction (see the graph below).

AGGREGATE MID-YEAR NET ABSORPTION TREND



Source: Boxwood Means, LLC; CoStar Group, Inc

Only the office sector witnessed an increase in Q2 demand, jumping 72.5% to 6.0 million sq.ft., but that was frankly a rebound off an abnormally low Q1 base figure. The fact is that office demand is waning like the other sectors, off 37.4% YoY, and by a similar rate of decrease during the first half of the year. Despite its unflagging and near universal popularity, the industrial sector is experiencing a similar fate. Clearly, small-time investors and lenders have been attracted by the outsized demand for small (and large) industrial properties triggered by robust user needs for manufacturing and warehousing space that ultimately produced net occupancy gains averaging 20 million sq.ft. per quarter between 2014-2016. However, the 4.0 million sq.ft. of Q2 net absorption was paltry by comparison, and industrial's lax demand was further underlined by ebbing 24.8% sequentially and 53.1% YoY to the lowest quarterly positive volume since 2012. Similarly, retail demand abated as the addition of 7.9 million sq.ft. was 26.5% lower than Q1 and 46.9% less than the same period last year.

What to make of this softening trend? Clearly, recent occupancy trends appear to be running counter to a bullish U.S. economy that generated Q2 GDP at a robust 4.1% clip. In addition, NFIB's Small Business Optimism Index established its sixth highest reading ever in June as high levels of sales and profits were sustained by small firms. But this survey also reveals a finding that likely correlates to some degree with the noted suppression in small-cap space demand. That is, 55% of small business owners reported a shortage of qualified applicants for open positions, and 36% indicated that they were unsuc-

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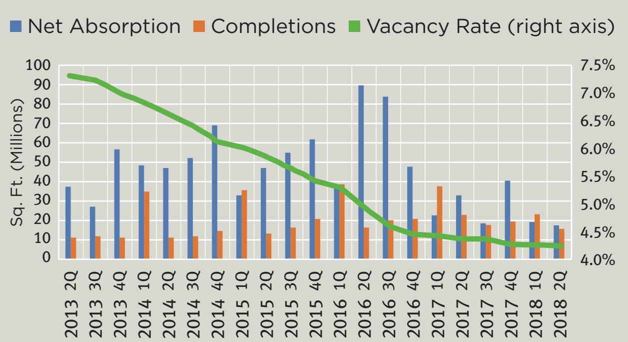
cessful in filling job openings – matching a survey high point. Furthermore, 21% of small business owners identified this labor challenge as their most important business issue. Hence, low unemployment rates as well as related anecdotal evidence suggest that labor shortages in some regions of the country are restraining Main Street businesses from desired expansions. As reported below, vacancy and supply fundamentals may also be restricting tenant demand.

▸ **Low vacancy rates are double-edged.** Most analysts perceive low vacancies as a good thing, clearing the market of excess space while satisfying tenant demand. And in this mature CRE market, we should anticipate that very low vacancies invite new inventory that would temper scarcity and bring supply and demand fundamentals back into better balance. But when record low vacancy rates fail to engender an adequate supply of new construction projects, tenants seeking relocations or expansion space will likely be frustrated in that endeavor and also discouraged by soaring rents. This is a telltale sign that markets have fallen into disequilibrium.

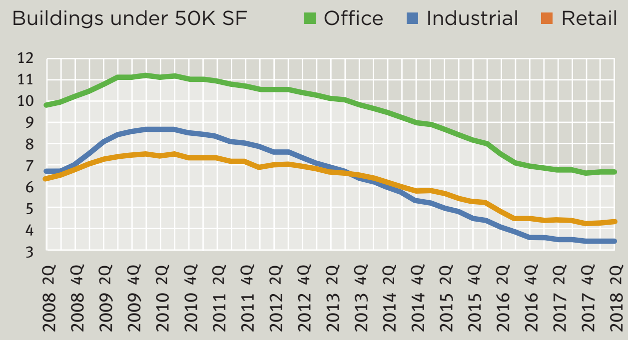
As the nearby graph shows, the aggregate small-cap national vacancy rate, at 4.4%, has dropped precipitously to an historic low point as demand has routinely exceeded supply. As of Q2, the composite average vacancy rate was markedly 200 basis points (bps) below its pre-recession nadir in 2006. Vacancies for all three primary property types are at record low levels and, with seemingly no place to go, sector rates have been flat for a couple of quarters. Industrial's 3.3% average rate was down 20 bps YoY; retail vacancies edged down 10 bps YoY to 4.2%; and office rates were also down 10 bps from 12 months earlier to 6.6%. (See the graph below.)

AGGREGATE SMALL-CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

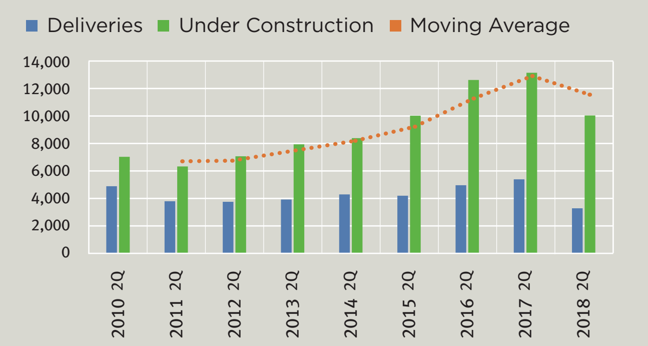
SMALL CAP CRE VACANCY TRENDS (%)



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

▸ **It's the (lack of) supply, stupid.** While the graph on the following page indicates that supply has been on the rise, it's obviously not been enough. Quarterly aggregate deliveries of 15.4 million sq.ft. were down by 33.5% during Q2 and by a similar percentage YoY. Also, aggregate square footage under construction was off 3.7% and 18.5% for the quarter and YoY, respectively. Moreover, on a project basis the *number* of deliveries today are roughly 40% below the long-term average dating to 2006, and pipeline projects are about one-third less than the historic average. On a sector basis, office, retail and industrial delivery volume (SF) uniformly declined by about 30% YoY and by at least 20% respectively over the last four quarters compared with the previous same four periods. With the exception of certain local markets, supply has proven to be substantially inelastic to demand. And without adequate new supply, the market's current disequilibrium will continue to disrupt the normal cyclical pattern. More critically, as mentioned this severe imbalance may ultimately extinguish some amount of that demand – which may already be manifest especially in the booming industrial sphere – and, in so doing, upend future small business health and growth.

SUPPLY TRENDS | Number of Projects



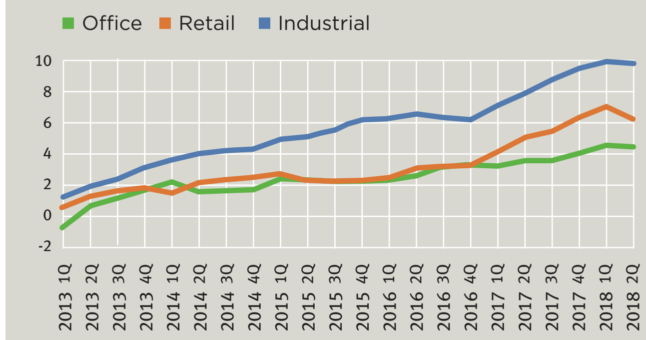
Source: Boxwood Means, LLC; CoStar Group, Inc

▸ **Rents grow at slower rate.** In the face of persistent under-supply, building owners have maintained the upper hand with rents. That's actually an understatement. Small-cap asking rent growth has been nearly boundless to date with unprecedented increases: national industrial rents, fueled by gains in both manufacturing and warehousing, jumped 2.3% on average during Q2 to an average of $9.05 per sq.ft., slower than the historic 2.9% rate posted in the previous quarter but still far above the long-term quarterly average. At the annualized rate of 9.7%, industrial rents grew at the fastest clip on record with the exception of first quarter's 9.8% rate. With this exceptional growth, nominal industrial rents have surpassed the pre-recession peak by 16.8%.

Office and retail rents are buoyant as well. Office rents, at an average of $19.88 per sq.ft., rose 1.1% for the third consecutive quarter and matched the record annual rate of 4.5% growth posted in the last quarter. Nominal office rents are 3.6% above the pre-recession apex. Retail rents grew by 1.2% to $18.53 per sq.ft. --- the sixth quarter in a row with increases of 1.0% or more – and a robust 6.2% from the same period a year earlier. Nominal retail rents are 4.1% above their previous high in 2008.

However as the nearby graph shows, rents in all three sectors conceded some growth as 12-month increases slowed a bit for the first time in a couple of years. It's too early to tell, but it may signal that landlords are taking their foot off the pedal on rents as tenants have dialed back their appetite for leasing more space.

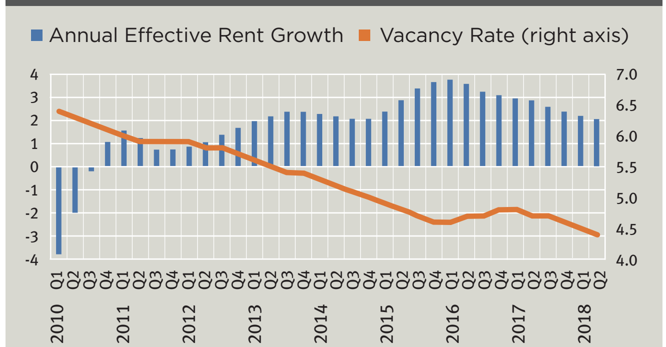
SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



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

▸ **Multifamily vacancies reach a new low.** The national vacancy rate for small, affordable multifamily housing declined 10 bps during Q2 and 30 bps YoY to 4.4% that is the lowest level since at least 2008 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, effective rent growth eased 10 bps to an annualized rate of 2.1%, down from 2.9% a year earlier and a peak rate of 3.8% two years ago (see the graph below). The slowing rental trend is a good thing for middle-income workers since there is a limited supply of small, affordable rental buildings as a result of perpetually rising land and construction costs that favor building larger developments with economies of scale. Fortunately, agency-sponsored small-balance lending programs have bolstered the affordable housing market over the last couple of years by supplying needed capital to maintain small apartment buildings and forestall obsolescence.

SMALL-CAP MULTIFAMILY RENT AND VACANCY TRENDS %



Source: Boxwood Means, LLC; CoStar Group, Inc

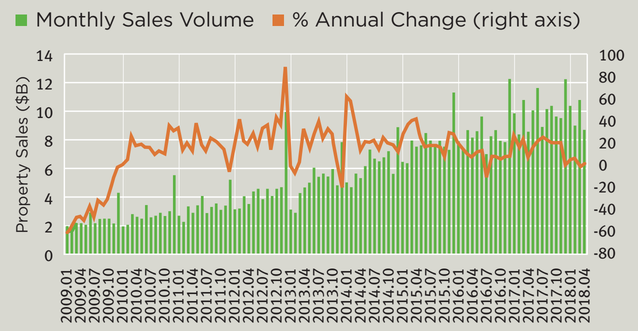
Let's be clear about the structural imbalance between commercial supply and demand discussed above. This disequilibrium is unique to the small-cap CRE arena. The industrial sector is a case in point: the shift from traditional shopping to e-commerce that has been God's gift to the industrial market in the form of hyper demand has, in turn, successfully generated a sizable amount of new supply especially for big warehouse and logistical facilities. Our analysis of Q2 CoStar data indicates that there were ample, bigger industrial projects under construction as well as project deliveries that in the aggregate are keeping pace with levels of demand. Larger office deliveries, too, have met tenant demands underscored by an average national office vacancy rate that has been stable for at least the last eight quarters. Of course, there are certain local market conditions that defy this generality with larger disparities between supply and demand.

But as noted shortages in labor and space availabilities for small businesses and user-tenants are imposing unusual strains on small-cap CRE space fundamentals. Obviously, it's all good for owners and investors. However, this trend might have a chilling effect on the market's continued expansion if some of the pressure isn't released.

Investment Activity and Prices

▸ **Another record sales pace.** Though April's transaction volume involving assets under $5 million dropped 19.0% versus March to a total of $8.7 billion, small-cap CRE sales are still on a record pace this year. Deal volume reached $38.7 billion through April, outpacing by 3.1% the total amount posted during the first four months of last year when property sales hit an annual record high. That being said, as mentioned in the last report the velocity of small-cap sales is clearly braking with annual growth rates dropping to the low single digits compared with average annual growth of nearly 19% over 12 months of last year (see the nearby graph). A recent run-up in asset prices (see below) and increases in the 10-Year Treasury rate that rose beyond 3% in April have likely begun to hinder some deal-making activity. Meanwhile, a pullback in sales of institutional assets is even more conspicuous: deal volume for principal assets above $2.5 million in value declined by 23% YoY during April and were down 1% over the first four months from a year earlier as both megadeals and single-asset sales suffered, according to Real Capital Analytics.

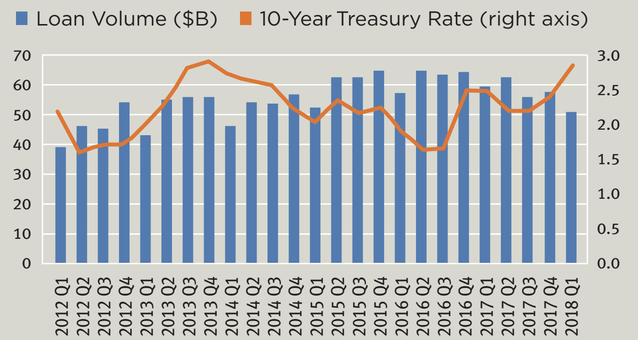
SMALL-CAP CRE SALES TRENDS



Source: Boxwood Means, LLC

▸ **SBL originations dip.** Small-balance loan volume of $50.6 billion in Q1 sets the table for another robust year of $200 billion in total production for loans under $5 million, but a recent softening trend cannot be ignored. Total quarterly originations were the lowest in four years and declined sequentially and YoY by 9.7% and 14.4%, respectively (see the graph below). As discussed in our recent **blog** piece, the slowdown in SBL volume arises as a consequence of higher interest rates, a sizable contraction of 25.6% YoY in purchase loans and perhaps an associated tilt towards more cash deals.

SBL ORIGINATIONS TREND



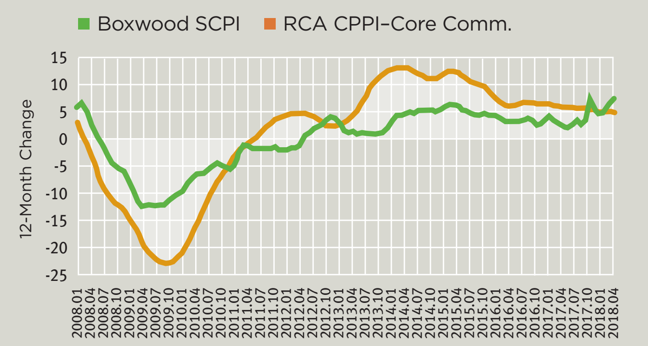
Source: Boxwood Means, LLC, FRB

Beyond these headline SBL numbers, a shift in small-balance lender composition continues. While commercial banks still dominate the leader board, their collective market share plunged to 18.0% in Q1, down 34 bps YoY and a decrease from roughly 23% a couple of years ago as competition from alternative and non-bank lenders progresses. (For more trends and statistics, see our latest SBL National Report **here**.) It comes as no surprise that a rising tide of alternative lenders have made their presence felt since overall SBL competition naturally surges with a maturing CRE and credit cycle – as last witnessed at the market's 2007-2008 peak. If the softening trend in SBL originations persists, it's likely that the staying power of some of these non-banks will be tested.

▸ **Asset prices hit a high-water mark.** Four strong months of sales activity have ignited small-cap CRE prices. Boxwood's U.S. Small Commercial Price Index (SCPI) that tracks sales transactions under $5 million across 125 markets increased 2.3% over the first four months and 7.7% YoY – the highest annual return on record. Also, it took nearly 11 years to make the round trip, but as of April SCPI hovered 1.0% above its previous peak in October, 2007. Not surprisingly, investors have pushed up prices for smaller properties at a greater rate in the six largest population centers (NY, LA, Chicago, Philadelphia, Phoenix and Houston), collectively by 11.4% YoY and to a level 4.4% above the pre-recession peak.

▸ **Large-cap commercial prices rise at a slower rate.** Prices for institutionally-oriented assets have stabilized. The Core Commercial (CC) component of the RCA CPPI (that excludes multifamily and tracks sales transactions above $2.5 million) rose just 1.0% over four months ending in April and 4.8% YoY with annualized gains stuck around 5% for the past six months. The pullback in transaction volume coupled with a diminishing number of deals in major metros from reluctant buyers fronting persistently low cap rates have likely stemmed greater overall price appreciation. In fact, price growth in RCA's non-major metros have outpaced their major metros by 60 bps YoY. As a result of this recent flat price growth, notably small-cap CRE has performed more favorably than large caps (see the nearby graph).

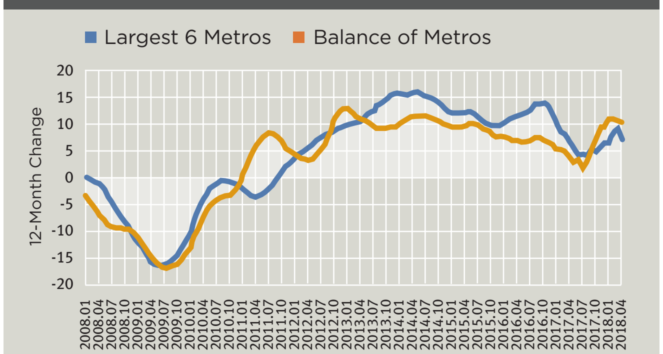
NATIONAL PRICE TREND COMPARISON | % Annual Change



Source: Boxwood Means, LLC; RCA

▸ **Small multifamily prices keep buzzing.** Investors continue to bid up prices for small apartment properties, and why not? Low supply in the face of stagnant wages for middle-income workers and the proclivity among millennials to rent versus buy have, among other factors, conspired to inflate prices to record-high levels. Boxwood's national Small Multifamily Price Index (SMPI) advanced a robust 9.4% over 12 months ending April reaching a point 40.8% above the previous apex in 2006. Similarly, RCA reported that large-cap apartment prices have also soared, up 12.1% YoY. As previously mentioned, buyers are shifting their attention to secondary and tertiary markets as yields diminish in primary metros. This is also the case with small multifamily properties where prices for SMPI-6 (denoting the six biggest markets) slowed to a 7.1% annual return in April while the balance of markets posted a gain of 10.3% YoY with 10% annual increases in every previous month this year as well (see the graph below). In fact, 27/47 multifamily markets

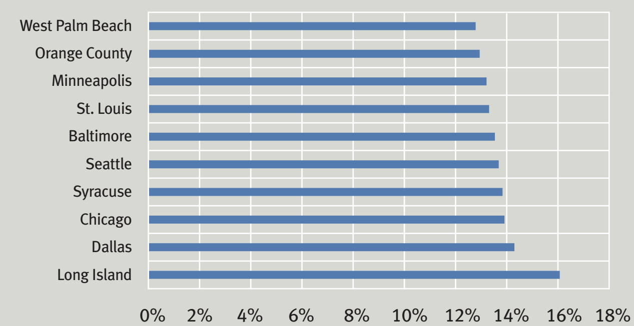
SMALL-CAP MULTIFAMILY PRICE TRENDS | % Annual Change



Source: Boxwood Means, LLC

recorded annual returns that exceeded 10% led by Long Island (16.1%), Dallas (14.3%), Chicago (14.0%) and Syracuse (13.9%). See the graph below.

LEADING SMALL-CAP MF MARKETS | Annual Price Change



Source: Boxwood Means, LLC

While small- and large-cap apartment prices are similarly at record-level prices, market dynamics suggest that the better bet for ongoing, strong price growth this year will reside in the smaller domain because of the scarcity of small, affordable rental apartments compared with sizable and growing new Class A apartment supply. Meanwhile, as deal activity and price momentum march on for small-cap CRE in general, these same trends are moving sideways if not retreating a bit in the large-cap arena. These bifurcating trends – and relative degree of market liquidity – can be partially explained by the outperformance of space market fundamentals in the smaller arena, where the severe imbalance between supply and demand, and surging rents (along with property income) are plain as day for small-time investors to see. Yet it's an emergent threat to the market's durability if tenants and small businesses are largely choked off from fulfilling new facility needs, and demand subsequently caves.

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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