Small Balance Advocate

QUARTERLY UPDATE FOR SMALL-CAP CRE INVESTORS

2nd Quarter 2019

A Market Poised for a Late Stage Course Adjustment The most favorable reading of second quarter results was that market stability prevailed. But there is no denying that small-cap CRE space market and investment trends have flattened out and appear vulnerable.

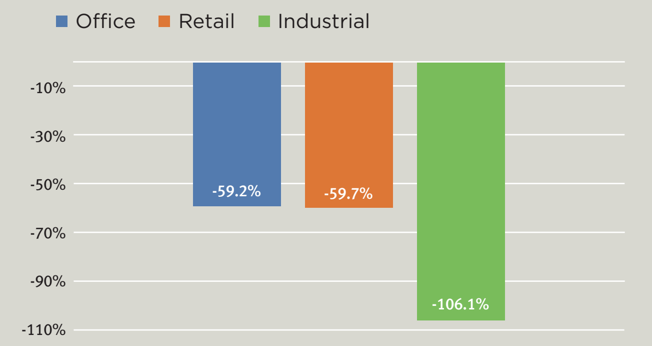
Space Market Fundamentals

Space demand rebounded modestly during second quarter but was insufficient to offset the sustained slowing trend. National highlights from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

► **Demand Charts a Sloping Path.** The slowing trend continued during Q2. Aggregate small-cap CRE net absorption across office, industrial and retail sectors doubled in volume to 9.8 million sq.ft. from an upwardly revised Q1 figure of 4.9 million that alone represented the lowest quarterly total since Q3 2012. Still, Q2's sum was off 66.4% YoY and, more reflective of the softening trend, the first half sum of 14.7 million sq.ft. declined 73.0% compared with the 54.5 million sq.ft. of aggregate occupancy gains achieved in the same six-month period in 2018. See the two nearby graphs.

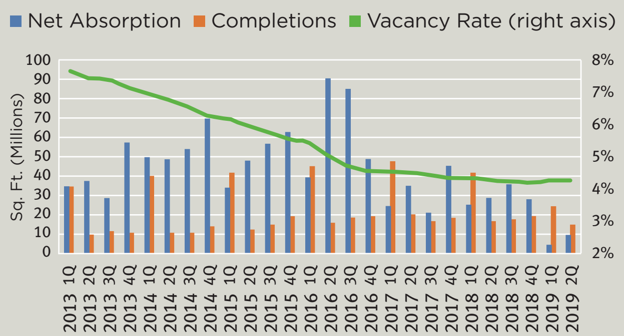
Industrial demand barely reversed the negative net absorption of the previous quarter – the first of its kind in 34 consecutive quarters –that had served as a wake-up call to small-cap investors and lenders about this sector's seeming invincibility. After that negative turn earlier this year, industrial occupancy gains of just 1.1 million sq.ft. during Q2, down 86.3% YoY and 106.1% at mid-year, is far from reassuring. See the graph.below.

SMALL-CAP NET ABSORPTION CHANGE | 1H 2019 vs. 1H 2018



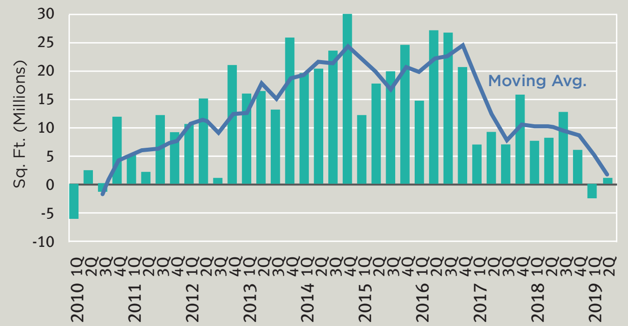
Source: Boxwood Means, LLC; CoStar

AGGREGATE SMALL-CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar

SMALL-CAP INDUSTRIAL DEMAND TREND



Source: Boxwood Means, LLC; CoStar

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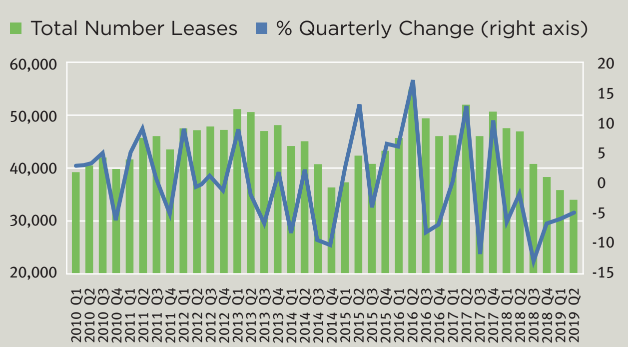
As we have previously suggested, historically low vacancy rates in many metro areas have restricted many industrial users of small warehouses, light industrial and flex buildings from finding opportunities for facility expansions especially in areas close to the market's urban core. This supply scarcity, coupled with recent economic and trade war uncertainties, largely explains the pullback in national demand. Note, too, that flagging demand has afflicted the general industrial market as well: i.e., net absorption plummeted 56.9% to just 50.9 million sq.ft. nationally over the first six months of 2019 versus 2018 according to CoStar.

Separately, office demand expanded by over 100% to 3.8 million sq.ft. in the most recent quarter after meager output of 1.7 million during the first three months of the year. But here, too, leasing velocity has slowed considerably: total net absorption of 5.5 million sq.ft. through June decreased by 59.2% compared with the same period last year. Similarly, retail demand softened with a 59.7% decline over the first six months YoY with total net absorption of only 10.2 million sq.ft.

Flagging small-cap CRE demand across these three sectors is underscored in the graph below showing that the total number of signed, small direct leases has narrowed for six quarters in a row to the lowest quarterly sum since Q1 2009 amid the Great Recession.

TOTAL SMALL-CAP CRE DIRECT LEASES

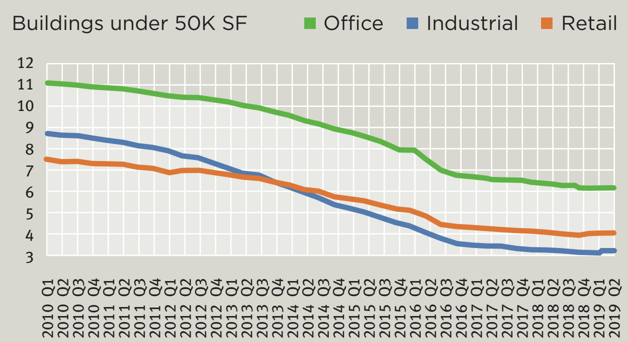


Source: Boxwood Means, LLC; CoStar

▸ **Vacancies Have Likely Bottomed Out.** Small-cap commercial vacancies are ticking up as the strong pullback in space demand meets relatively consistent, albeit modest new construction put in place. In fact, construction deliveries exceeded demand for the second consecutive quarter and just the seventh such occurrence over the past 26 quarters dating to Q1 2013. Aggregate new supply between 2016-2018, which surpassed the long-term national average produced during the entire current cycle, might otherwise provide some needed lubrication for the small-cap space markets if construction deliveries were to maintain the pace. Yet that doesn't appear to be the case, with volume having declined by 32.3% at the midpoint of 2019 compared with the corresponding period last year.

Vacancies are thus in flux. Aggregate vacancies across all three sectors were flat at 4.1% during the quarter, though up 10 basis points since December. Individually, the national office vacancy rate of 6.0% was unchanged for the third quarter in a row; the retail average was unchanged at 4.1% for a second consecutive quarter but above its recent 4.0% low; and the industrial sector posted a 10-basis point increase to 3.3%. See the graph below.

SMALL-CAP CRE VACANCY TRENDS (%)



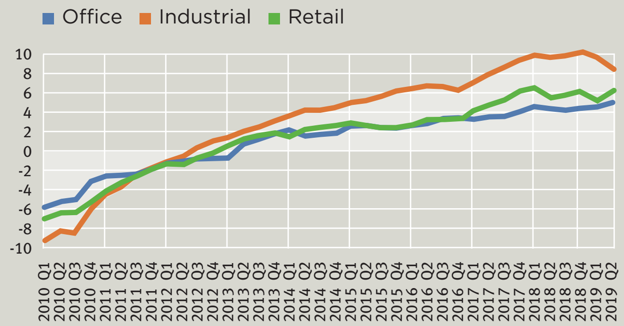
Source: Boxwood Means, LLC; CoStar

▸ **Industrial Rent Growth Cools Down.** Red-hot industrial rents increased at a rate of nearly 2% in every quarter over the last four years. But as industrial demand has sharply declined, small-cap rent growth has followed suit and posted a 1.1% gain during Q2 – the smallest increase in 18 quarters dating to Q4 2014. Softer U.S. economic conditions have conspired with tight space market conditions to limit landlord leverage on rents. GDP growth rose at only a 2.1% annual rate in Q2 as nonresidential fixed investment fell sharply compared with the previous quarter. Also, the ISM Manufacturing PMI that tracks factory activity across 18 manufacturing industries declined in June for the third consecutive month to the weakest pace of expansion since October 2016. It makes sense then that annualized rent growth at 8.2%, though still elevated by historical norms, is considerably lower than the stratospheric 9%-10% appreciation YoY recorded over the past six quarters. Still, average asking rents ended the quarter at $9.73 per sq.ft., or 26.4% above the pre-recession peak level in nominal terms.

Meanwhile, Q2 **office rents** grew by a healthy 1.2% to $20.75 per sq.ft. that is 8.2% above the previous peak in 2008. With office vacancies at historic lows, annualized rent growth of 4.8% is the highest 12-month increase since at least 2006.

Similarly, small-cap **retail rents** continued to rise and, in so doing, most likely exceed some performance expectations from industry pundits. While the number of retail stores slated to go dark this year already tops last year's total according to Coresight Research, most of these closures are occurring in older enclosed malls that are outmoded and lack ease of access. Also, while news headlines routinely claim that Amazon increasingly dominates the retail market, the fact is that most consumer purchases are still made in stores. Indeed, convenient neighborhood centers and strip retail locations that offer a healthy mix of internet-resistant retailers and service-oriented tenants are generally doing just fine, thank you. Moreover, over the past several years these outlets have grown increasingly popular with new tenants such as fitness retailers, urgent care medical offices, and financial services and insurance firms, among others. As a result, small-cap retail rents, at $19.47 per sq.ft. on average, rose 2.1% during Q2 – the biggest three-month increase on record. Along with the robust 6.2% gain YoY, retail rents nominally exceed the previous peak by 9.5%. See the nearby graph for rent trends.

SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



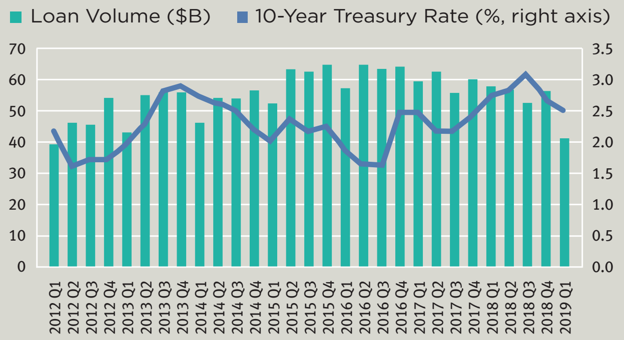
Source: Boxwood Means, LLC; CoStar

It would be a miscalculation to think the weakening leasing trends have come about only because of slowing global demand, trade tensions and tariffs, a stronger dollar and overall softer domestic business spending. Beyond these legitimate concerns, we continue to assert that structural factors are a root cause for the decline in small business demand for space, especially in the industrial and office sectors. First, the ever-modest supply of new commercial facilities has hand-cuffed the space market over the entire cycle, and the resulting historic low vacancies have severely impaired tenant and user mobility and expansion. Second, as the national unemployment rate also hovers near historic lows, small businesses are unable to find qualified workers for open positions. These two factors may indeed conspire with the above economic conditions to choke off the market's continued expansion. (See a recent Boxwood Blog piece on job and space scarcity ***here***.)

Investment Activity and Prices

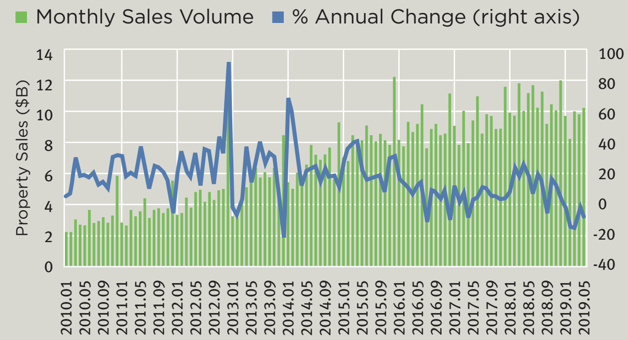
▸ **Weak Start for SBL Originations.** Small-balance loan originations dropped sharply during Q1 amidst much market uncertainty. The volume of loans under $5 million fell 27.5% from the previous quarter and 29.2% YoY to $40.7 billion – the lowest quarterly total in eight years. (See the graph on the following page). Deal volume suffered because of broad doubts about the economy and, more specifically, the steady rise in treasury rates during the latter part of 2018 that produced a delayed

SBL ORIGINATIONS TREND



Source: Boxwood Means, LLC, FRB

SMALL-CAP CRE SALES TRENDS



Source: Boxwood Means, LLC

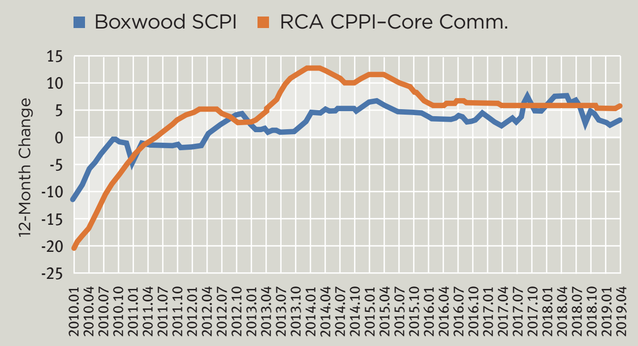
and adverse impact on financing activity in the early part of 2019. Indeed, commercial mortgage rates jumped during Q1 in reaction to the 2018 upward 10-Year rate move. So, it's not surprising that Q1 SBL purchase loans plunged by 43.2% YoY while refinance loans also fell though by the lesser rate of 17.9%. Thus, some Boxwood bank clients that told at the outset of the year that lending was slow may find a bit of consolation in these broadly lower, national figures. Meanwhile, the 10-Year rate substantially declined this year and augurs improved growth in SBL originations for Q2. You can obtain our complimentary National Q2 SBL report **here**.

▸ **Property Sales Continue to Soften.** Sales transaction activity has dipped so far this year after record sales volume in 2018. Deal volume for assets under $5 million totaled $10.2 billion on a preliminary estimate basis during May. Though that figure showed a 4.4% gain over the previous month, the total was down 8.2% YoY and produced a fifth consecutive monthly decline in annualized volume. (See the nearby graph.) Also, the year-to-date total of $48.0 billion was off by 8.5% versus the January-May period last year. Transaction volume is lower in the large-cap CRE arena as well, off 8.1% YoY during May and 8.8% below 2018's YTD total according to data from Real Capital Analytics. Yet while sales velocity is down relative to last year in both large- and small-cap domains, investment activity has been surprisingly resilient given the market and economic uncertainties that soured investor sentiment referenced earlier.

▸ **Asset Prices Show Improved Strength.** Small-cap CRE prices have rebounded of late. Though increasing only modestly by 3.0% YoY, Boxwood's U.S. Small Commercial Price Index (SCPI) that tracks sales transactions under $5 million across 125 markets rose smartly by 0.9% on a preliminary estimate basis in May and 2.0% over the last three months alone. That said, there's no doubt that asset prices, which were 4.1% above the pre-recession peak during May, have cooled down when compared, e.g., to the annualized 6%-7% growth from 12 months earlier. Unsettling national economic conditions have played a role here, too, which only further complicate investment decisions at this mature stage of the real estate cycle. Meanwhile, small-cap property prices in the six biggest U.S. population centers are still buoyant. SCPI-6, propelled by a robust monthly increase of 1.3% and a 5.1% gain YoY, stands 10.6% above the previous peak level. As testimony to the healthy status of small-cap markets broadly, 101 of 123 metro areas posted twelve-month price increases led by smaller places including Vallejo (16.0%), Lansing (15.0%), Lakeland-FL (14.4%), Fayetteville (13.6%) and San Jose (12.4%).

Large-cap CRE prices are on a modest upward trajectory as well. RCA reported that the Commercial Component of its CPPI, which is analogous to SCPI and tracks non-multifamily transactions above $2.5 million, gained 0.6% during May with a 5.4% YoY increase, but the year-to-date change is subdued at only 2.4%. The Commercial Component sub index was 7.3% above the previous peak. See the comparative price index trends in the graph on the following page.

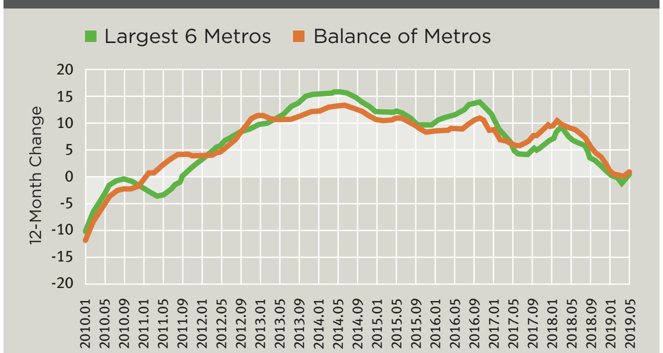
NATIONAL PRICE TREND COMPARISON | % Annual Change



Source: Boxwood Means, LLC; RCA

▸ **Multifamily Prices Get a Slight Lift.** Like small-cap commercial prices, small multifamily asset prices have recovered a tad after a slow start. Boxwood's Small Multifamily Price Index (SMPI) that tracks 45 markets rose a modest 0.2% on a prelim basis in May, but prices remained in the red for the first five months of the year, at -0.6%. Again, it appears that interest rate volatility and higher debt costs that straddled the new year stalled the momentum behind multifamily (and commercial) property valuations. With SMPI values still a sizable 40.1% above the previous 2006 peak, a slowdown in price growth – that better aligns with rental income growth rather than capital market effects – may better support the investment thesis for this sector for the remainder of this year. See the nearby graph showing a similar pattern of price changes in the six largest markets versus the remainder of the metros.

SMALL-CAP MULTIFAMILY PRICE TRENDS | % Annual Change



Source: Boxwood Means, LLC

It's challenging to assess the downside risk to a mature market like this one when the conventional markers of a late cycle such as hyper-supply, mounting vacancies and growing cap rates among other signals are missing. Yet, the escalation in trade tensions and tariffs that has already taken a bite out of U.S. GDP, compounded by the profound small-cap CRE space and job scarcity, have shaken business confidence, and limited expansion and investment plans. At minimum, it appears we're poised for a late-stage course adjustment. At the worst, continued economic turmoil will tip the scales downward for an already tenuous small-cap CRE market.

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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