Small Balance Advocate

QUARTERLY UPDATE FOR SMALL-CAP CRE INVESTORS

3rd Quarter 2018

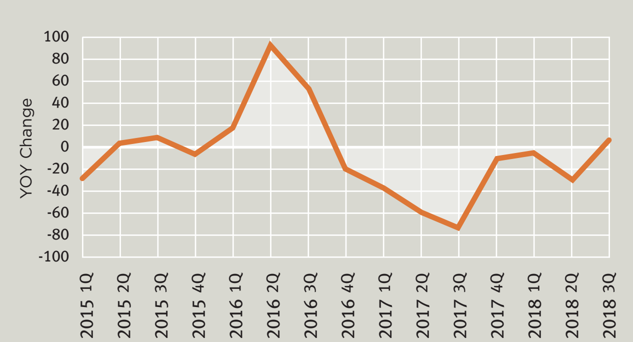
Fundamentals Advance, Extending Investment Opportunities Solid third quarter fundamentals combined with strong optimism among Main Street businesses sustain a thriving small-cap CRE market.

Space Market Fundamentals

The market's overall demeanor remained very positive, but Q3 demand statistics were once again cause for some unease. National highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Occupier demand grew at a much slower pace.** Based on the demand trend of late, it's fitting to ask if the glass is half empty or half full. On the positive side, net occupancies across office, industrial and retail sectors totaled 20.4 million sq.ft. during Q3 extending the streak of positive net absorption to 32 consecutive quarters. Yet the slackening demand trend cannot be dismissed: aside from the modest 4.9% increase from the same quarter one year ago, aggregate net absorption has declined in seven of the last eight quarters and represents the lowest quarterly volume since 2012 when the market expansion first gained steam. See the graph below depicting the recent trajectory of aggregate space demand.

AGGREGATE NET ABSORPTION TREND



Source: Boxwood Means, LLC; CoStar Group, Inc

On a sector by sector basis, net occupancy gains for the small-cap office sector decreased 43.7% sequentially to 4.1 million sq.ft., a sum that was only one-half the average absorption level over the last eight quarters. Industrial demand receded by 9.2% in the quarter to 5.5 million sq.ft.—the smallest quantity in 24 quarters—and also roughly 50% of the average rate of absorption since Q3 2016. Only the retail sector showed positive momentum, adding 10.8 million sq.ft. of net occupancies, or 11.1% from the previous quarter and reflecting only about a third of a reduction in demand compared with quarterly averages over the same two-year period.

As we suggested last time, it's increasingly likely that the pullback in demand is a reflection of the severe imbalance between market supply and demand rather than some underlying weakness or conservative bias among Main Street businesses. Indeed, U.S. small businesses are hitting on all cylinders according to various polls and research. For example, NFIB's Small Business Optimism Index posted its third highest reading for September in the survey's 45-year history with a sizable increase reported in capital spending and strong employment activity. This robust pace of capital investment was echoed in Thomson Reuters/Paynet Small Business Lending Index (SBLI) which indicated that commercial lending to private companies reached its second-highest level on record during August with a 16% YoY gain. The leading industry component of the SBLI's increase was Transportation and Warehousing (+20.4% YoY), which is not surprising given the outsized demand among import/export and light assembly users as well as suppliers in need of "last mile" and infill facilities in close proximity to large retail distributors.

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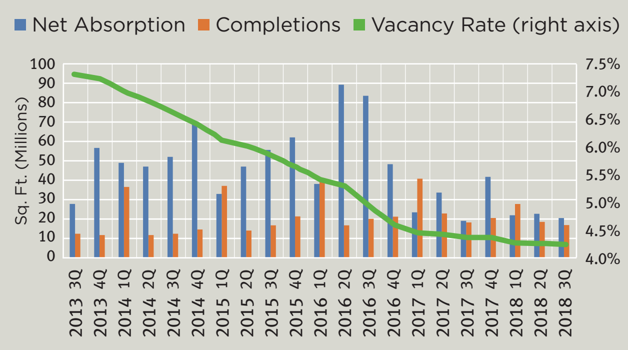
So these signals point to conditions favorable to opportunity and growth for Main Street firms—not a retreat as the trending numbers for small-cap space demand might otherwise suggest. Yet as indicated below, the supply situation represents an unprecedented and irregular constraint on the market's continued vigor which, and though challenging for expansion-minded small tenants, is an absolute windfall for building landlords.

▸ **The vacancy trend spells disequilibrium.** Among many notable trends associated with this extended market cycle is the persistent misalignment between supply and demand. As the nearby graph shows, the composite small-cap national vacancy rate has contracted to an historic low (4.3%) as net absorption has consistently surpassed project completions over the last five years. Granted, aggregate small-cap deliveries of 100.0 million sq.ft. during 2017 was the highest volume in eight years, but even that uptick was feeble compared with historical norms and has failed to relieve the pressure on space scarcity or mute rent increases. This imbalance continues as the 61.3 million sq.ft. of completions YTD is 23.7% less than last year's total over the corresponding three quarters.

AGGREGATE SMALL-CAP CRE LEASING TRENDS

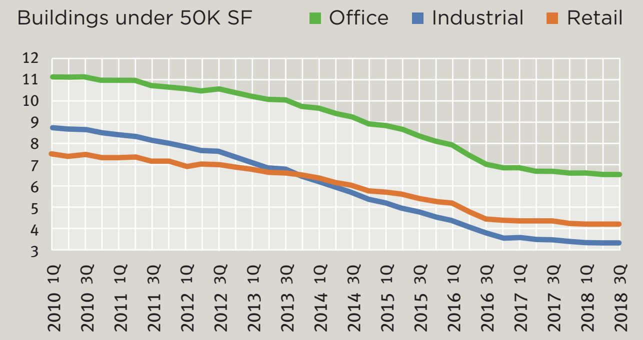


Source: Boxwood Means, LLC; CoStar Group, Inc

It seems inconceivable but true that the Q3 small-cap U.S. industrial vacancy rate is a meager 3.3%, a sizable 270 basis points (bps) below the previous cyclical low achieved 12 years ago. Also, let's not forget that figure is a *national* average, and our analysis of CoStar data indicates that some small-cap industrial markets are way tighter like Columbus (1.9%), Orange County (2.4%), and Seattle and Miami (2.6%).

Similarly constrained is the national retail vacancy rate that averages only 4.2%, 160 bps below the previous nadir while office vacancies average just 6.5% or 150 bps less than the previous low during 2006. As the nearby graph illustrates, for a year or more these sector vacancy rates have basically flat-lined at near bottom because of the under-supply of modest-sized facilities to which smaller tenants typically lay claim.

SMALL-CAP CRE VACANCY TRENDS (%)



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

We have previously suggested that this state of market imbalance likely represents a new normal that deviates sharply from the traditional pattern of CRE cycles that routinely have produced hyper-supply after an extended period of excessive demand, narrowing vacancies and surging rents. Yet if we assume a recession-free and solid U.S. economy for another year or so, it's plausible that this period of record-low vacancies can persist. After all, the new construction pipeline, at an aggregate 67.5 million sq.ft., represents the lowest volume of projects in two years.

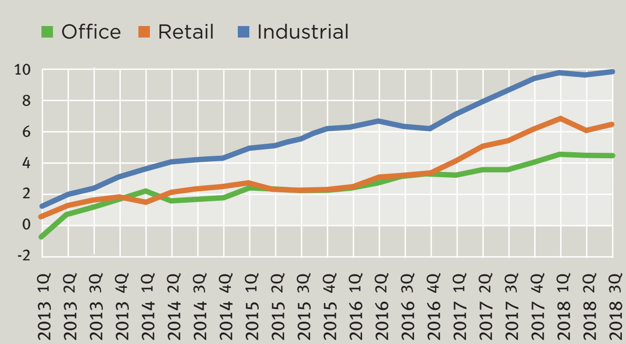
It's also conceivable that without more abundant small-cap leasing opportunities we might see more small companies shift towards other alternatives including: acquiring buildings for their own use (especially as rents continue to soar); converting or co-developing facilities with local sponsors; relocating at a distance; or trading-up to larger, multi-tenant Class B and C buildings where available.

▸ **Rent surge continues.** In the wake of historic low vacancy rates, property owners continue to raise rents with impunity. Small-cap industrial asking rents, at a national average of $9.22 per sq.ft. rose a whopping 2.2% in Q3—the seventh quarter in a row of 2% growth or better—to an annualized growth rate of 9.7% that matched the previous record high posted during Q1. To best appreciate the magnitude of these recent gains, keep in mind that industrial's average annual rent growth at the market's previous peak was between only 3%-4%. Similarly, office rents, at the U.S. average of $20.03 per sq.ft., increased at an average annual rate between 2%-3% during the market's apex last time but have now nearly doubled to 4.4% YoY while exceeding 4% growth for four consecutive quarters.

Perhaps the biggest surprise relates to retail's overall performance, and rents in particular. Many observers presume rents have compressed with the rising disintermediation of brick and mortar stores by the Internet. Yet that's simply not the case with many small retail properties like strip and neighborhood centers, and street retail that are often in strong or densely populated areas and serve everyday-type consumer needs. As one investor quipped, "The Internet isn't going to replace the nail salon." Small-cap retail rents, at $18.77 per sq.ft. on average, have thus topped 6% for the last four quarters including 6.4% during Q3.

On a nominal basis, rents for the three property types are now all above previous peak levels during 2006-2007 led by industrial (18.9%), retail (5.5%) and office (4.4%). See the rent trends in the graph below.

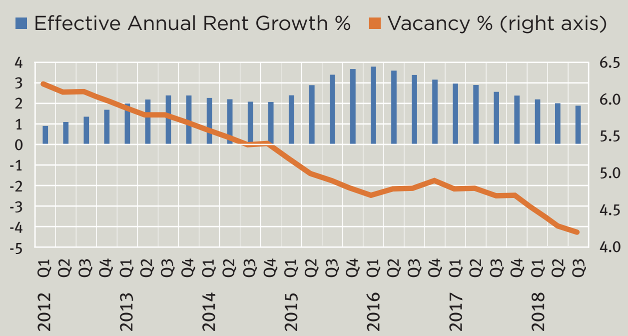
SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



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

▸ **Multifamily rent growth decelerates further.** While multifamily rents generally have perked up with waves of new luxury apartments spilling onto the market, small-cap rent increases are slowing considerably. Costar reported that average annual multifamily rents in the general market rose by 3.1% during Q3, but small-cap rents narrowed to an annualized growth rate of just 1.9%—a big step back from the 3.8% annual increase posted in early 2016. According to CoStar data encompassing nearly 300,000 Class B and C apartment buildings containing 5-40 units, effective rent growth eased 30 bps in Q3 to a national average of $1,095 per unit. As the nearby graph shows, small-cap rent increases have declined over the past 10 quarters, with a reset, temporarily or otherwise, to a rate last witnessed six years ago.

SMALL-CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

Meanwhile, the national vacancy rate for small multifamily housing decreased by 10 bps in the quarter and 50 bps YoY to 4.2%, or the lowest level since at least 2008. While tight vacancies typically engender ever-increasing rents, it seems that many small multifamily property owners got the memo on the need for restraint since many working families have been priced out of markets where affordable housing supply is scarce. Also, further help for the affordable housing crisis may yet arise from Freddie Mac's recent Workforce Housing and Targeted Mezzanine Loan program that offers low-cost pricing and additional debt to property owners that agree to limit workforce housing rents over the term of the loan in communities across the U.S.

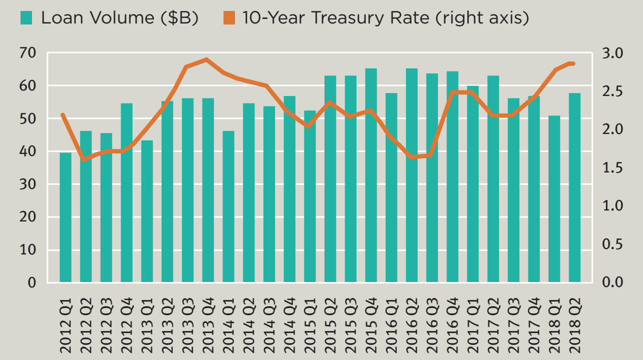
On balance, small-cap space market fundamentals remain healthy nine years into the market's recovery and expansion. Yet small-balance lenders and investors should be mindful that overall leasing demand trends, though still on positive ground, have weakened considerably for nearly two years because of what we believe are chiefly supply shortages. Though some commercial banks have modestly increased their exposure to construction loans of late, and also non-banks and debt funds have taken up some of the slack, bank ADC (acquisition, development and construction) lending has been shrinking for several years. And while recent legislation to more narrowly define the scope and capital requirements of high volatility commercial real estate (HVCRE) would likely make these construction loans more attractive to banks as well as developers, it may turn out to be too little too late to re-balance the space markets given the protracted state of the current bank credit cycle.

So in a potentially radical departure from tradition, these trends may augur some modest correction in the small-cap CRE market not caused by increasing oversupply but, instead, as a function of supply scarcity that overtly suppresses levels of demand.

Investment Activity and Prices

▸ **SBL originations bounce back.** Small-balance commercial loan originations rose by 12.6% during Q2 (the latest period available) to $57.0 billion as small-cap CRE investors and operators continued to take advantage of a favorable lending climate resulting from strong operating and investment fundamentals, and a surplus of debt capital. See the nearby graph. Though Q2's total was the best in the four previous quarters, the cumulative mid-year total of $107.6 billion trailed last year's robust pace by 11.3%. Even so, this massive lending space for loans under $5 million is shaping up to exceed $200 billion for the sixth year in a row chiefly supported by refinance activity that accounted for 62% of total originations in this last period.

SBL ORIGINATIONS TREND

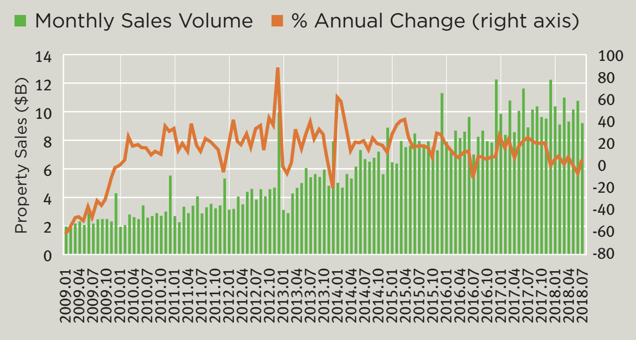


Source: Boxwood Means, LLC, FRB

The top commercial banks have recently upped their game in the SBL space by commanding 18.7% market share during Q2, up 6.8% sequentially and 3.9% YoY, and led by JP Morgan Chase (5.3%) and Wells Fargo (2.6%). CBRE Capital Markets (1.9%), ranked #3, was the only non-bank among the top 15 lenders, as the firm also posted the largest increase in market share from 12 months earlier.

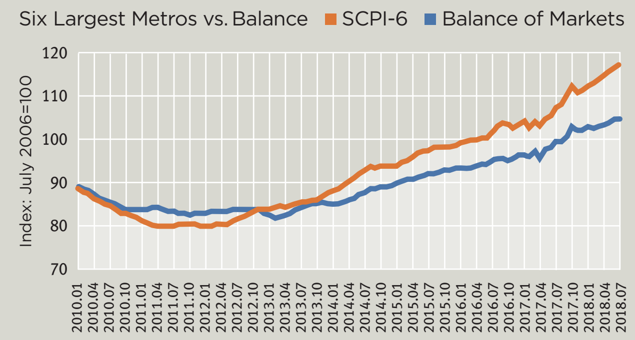
▸ **Sales Trend Higher.** Despite month-to-month choppiness, small-cap property deal volume remains elevated. July's sales totaling $9.2 billion dipped 14.8% on a preliminary estimate basis, but the $69.7 billion in YTD sales involving transactions under $5 million exceeded last year's record pace through July by 2.6%. However as the graph on the following page shows, most of the upward momentum has largely dissipated with 12-month percentage increases reduced to single digits. The fact is that growth in deal volume during the market's expansion has been breathtaking, doubling in annual volume to $120 billion from only four years prior. So some degree of reversion makes absolute sense at this stage of the cycle especially since investment headwinds in the form of higher interest rates, peak prices and stubbornly low cap rates prevail. Institutionally-oriented transactions have also moderated. Real Capital Analytics (RCA) reported that July deal volume for principal assets over $2.5 million fell 4% YoY as deal activity for individual assets shrank for the third month in a row.

SMALL-CAP CRE SALES TRENDS



Source: Boxwood Means, LLC

SMALL-CAP COMMERCIAL PRICE TRENDS

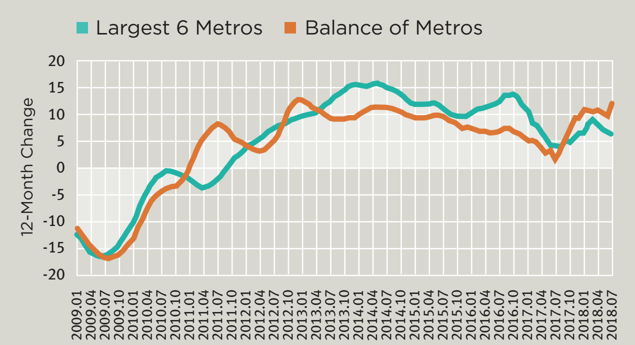


Source: Boxwood Means, LLC

▸ **Asset prices reach new summit.** Small-cap CRE prices edged up in July to a new market peak. Boxwood's U.S. Small Commercial Price Index (SCPI) that tracks sales transactions under $5 million across 125 markets increased 0.2% on a preliminary estimate basis and 6.4% YoY. Though a healthy 12-month increase, July's reading reversed the string of record annual returns over the previous three months. Nevertheless, SCPI-125's mark in July which, eclipsed the previous 2007 peak level by 2.1%, heralds this market's full price recovery. Meanwhile, SCPI-6 for the six largest U.S. population centers gained a sizable 9.1% over 12 months pushing this sub-index 6.9% above the prior apex as robust economic and CRE conditions in these primary markets continue to charm small, private investors despite the strong run-up in values. While secondary and tertiary markets have also fared well, unsurprisingly their recovery has lagged and falls short by comparison: i.e., SCPI-119 generated a 12-month gain of 5.1% that finds the sub-index 3.6% *below* the previous cyclical peak. (See the nearby graph.) The silver lining to this inferior price performance is that small-balance lenders and investors will likely find more favorable risk-adjusted returns in these smaller but now healthy markets.

▸ **Secondary multifamily markets are hot.** In contrast with the lagging prices of commercial assets in smaller metros cited above, multifamily prices have rebounded smartly in these areas. While Boxwood's national Small Multifamily Price Index (SMPI) encompassing 45 markets turned in a strong performance in July with an 8.1% gain YoY, it's the secondary and tertiary markets that have rocketed ahead: i.e., recording a 12.2% annual return that is the highest yield since the beginning of 2013. Also noteworthy is that these smaller markets have also trended far better of late versus the biggest six U.S. metros (see the graph below). Overall, Boxwood's national SMPI in July was a massive 42.8% above the previous peak.

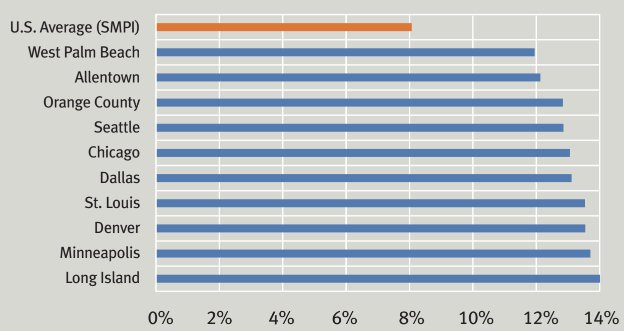
SMALL-CAP MULTIFAMILY PRICE TRENDS | % Annual Change



Source: Boxwood Means, LLC

Clearly, investors are captivated by the favorable investment climate for small-cap apartments as the local economy in many of these smaller markets has stiffened while inventories of affordable rental housing remain highly constrained. It's not surprising then that small-cap multifamily prices in many of these small metros have been bid up—including 19 of the 22 markets where hefty annual returns of 10% or more were posted in July led by Long Island (14.0%), Minneapolis (13.7%), and Denver and St. Louis (13.6%). See the graph below showing the top multifamily market performers.

TOP SMALL-CAP MULTIFAMILY MARKETS | 12-Month Returns



Source: Boxwood Means, LLC

As individual CRE markets and property types flow in and out of favor over time, generally speaking the underlying investment fundamentals and trends across the board are extraordinary for our times. Though thinning net absorption trends and supply scarcity on the leasing side are concerning, they are unlikely to trigger a reversal of the market's continued growth. Solid opportunities for discriminating small-balance lenders and investors thus prevail. However, what will be more determinative and always warrants a cautious eye are external conditions—especially the housing market. Housing tends to be the first sector to be adversely affected by higher interest rates and, given that sales are now retreating at a fast clip in the face of eroding affordability, the housing market may already be past peak in the current cycle and raising a red flag.

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.

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