Small Balance Advocate

QUARTERLY UPDATE FOR SMALL CAP CRE INVESTORS

4th Quarter 2017

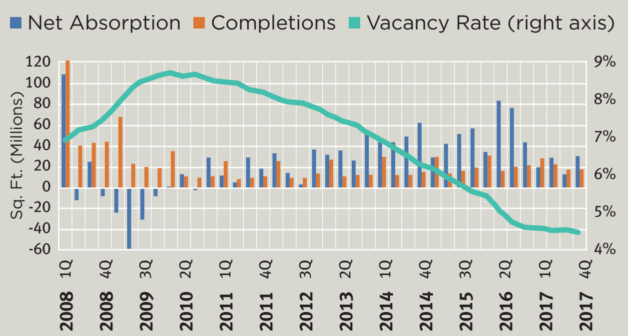
Solid Q4 Results Fuel Optimism for 2018 Rejuvenated small business growth has supported a trifecta of vigorous small-cap property fundamentals, peak sales and robust loan originations that shows few signs of abating soon.

Space Market Fundamentals

Leasing activity rebounded smartly during fourth quarter though overall demand for the year came up short in comparison with 2016. Meanwhile, asking rents soared above pre-recession peak levels. Statistical highlights drawn from CoStar data solely involving commercial properties under 50,000 sq.ft. are outlined below.

▸ **Demand ends year on high note.** After a lackluster Q3, net absorption more than doubled during the final quarter to 30.2 million sq.ft. across small-cap office, industrial and retail sectors as the U.S. economy expanded at a healthy 2.6% quarterly clip and business investment increased by a robust 11.4% (see the graph below). Yet a strong close out to the year couldn't overcome the relatively weak annual activity defined by the 30.9% YOY decline in demand that was also the lowest annual net absorption since 2012. That being said, tenants remained active, if not confident over their business prospects as 170,000+ new small-cap direct leases were signed across the three sectors during 2017 representing only a 9.5% decline compared with the year earlier.

AGGREGATE SMALL CAP CRE LEASING TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

Industrial net absorption posted its best quarterly increase of the year, jumping 164.2% to 10.5 million sq.ft. Still, it's notable that total annual demand of 26.9 million sq.ft. was less than half the 79.4 million recorded one year earlier. Similarly, Q4 office occupancies rose a hefty 112.9% to 4.9 million sq.ft., but total net occupancies of 19.8 million sq.ft. during 2017 was just one-third of the total gain of the previous year. The retail sector also recorded more than a 100% sequential increase with 14.8 million sq.ft. of net absorption – also the best quarterly increase all year – but it wasn't sufficient to offset the overall 54.1% decline in retail net occupancies YOY.

Small businesses may have been short on confidence about the economy around mid-year, but vibrant GDP growth during the second half dispelled much of the cautiousness or fear. As a result, the Q4 surge in occupier demand that jumped to 30 million sq.ft. rivaled the average increases posted each quarter since the end of the financial crisis.

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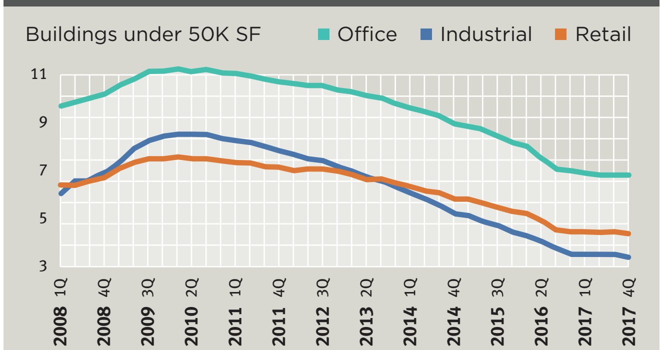
▶ **Vacancies hit new lows.** Once again small-cap commercial vacancy rates plumbed new depths. The aggregate commercial vacancy rate dipped 0.1% (10 bps) to 4.5% by year end after flat-lining for the four previous quarters (see the same graph). Total vacancies for each of the three sectors edged further into uncharted territory. The national industrial vacancy rate declined by 10 bps to an average of 3.4% in Q4, a sizable 270 bps below its pre-recession nadir during 2006 that reflects the sector's multi-year shift into overdrive with high demand for flex, light manufacturing and especially warehouse/logistical properties fueled by e-commerce activity. Total retail vacancies also decreased by 10 bps reaching the same bottom found earlier this year that is 160 bps below the previous record low before the Great Recession. As discussed last time, retail is a diverse asset class, and small strip and neighborhood centers, and small retail stores catering to everyday consumer needs have performed well in the post-crisis era. As the trajectory of its national vacancy rate suggests, small-cap retail has significantly out-performed many large or institutional retail assets. The national office vacancy rate, down 10 bps to 6.7% finished the year 140 bps below its previous low. See the graph below.

SMALL CAP CRE VACANCY TRENDS (%)

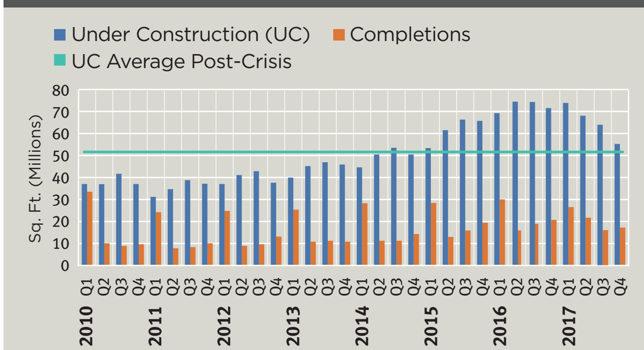


Source: Boxwood Means, LLC; CoStar Group, Inc.

▶ **General CRE trends follow suit.** Similar healthy fundamentals persisted in the general CRE space markets. Net occupancy growth rebounded for the quarter, but similarly the annual demand retreated in the YOY comparison, down by 14.7% for the general industrial sector, 24.2% for office and 33.6% for the retail sector according to CoStar data. Nevertheless, total vacancies dropped to historic lows in each sector as well, though it's notable that average vacancy rates in the small-cap CRE space are all tighter than observed in the general market.

▶ **A new normal for supply.** Classic real estate cycles produce a crescendo of new construction activity to meet the rise in demand, especially as rents inflate and help projects pencil out for developers. Supply of new buildings under 50,000 sq.ft. have certainly increased since the end of the financial crisis, averaging 16.9 million sq.ft. of project deliveries in the aggregate per quarter, but this level is nowhere near the same zip-code for completions in the run-up to the recession which averaged a whopping 137.3 million sq.ft. per quarter between 2006-2009, i.e., 8X the current average level. As the nearby graph shows, Q4 deliveries rose slightly above the post-crisis average to 17.2 million sq.ft., but supply across the three sectors for the full

SMALL-CAP CONSTRUCTION TRENDS



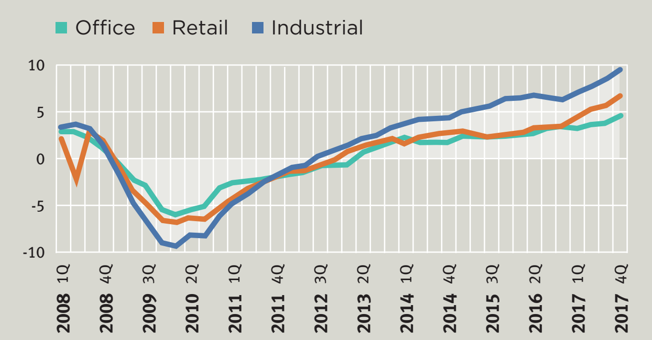
Source: Boxwood Means, LLC; CoStar Group, Inc year (82.1 million) was off 4.8% YOY. This pullback was entirely due to the 11.5% YOY decrease in retail supply, as YOY project deliveries in the industrial and office sectors rose modestly by 6.4% and 2.1%, respectively.

Meanwhile, future supply risk appears low. In fact, as illustrated by the same graph the build-up in aggregate under construction (UC) projects seems to have presently peaked, as pipeline projects across the three sectors declined 22.9% YOY to 55.4 million sq.ft., the lowest level of UC projects in 11 quarters.

The fact is that construction financing has been hampered by higher borrower equity demands and banks' larger capital reserve requirements imposed by federal HVCRE regulations since the financial crisis. Granted, non-bank lenders have stepped up their construction lending a lot, but that activity is largely concentrated in bridge financing for existing assets, less so ground-up projects. As a result, a new normal for the real estate cycle has emerged. In the eighth year of the market's expansion that most observers believe is near peak, demand continues to exceed supply – and the climatic phase of hyper-supply (with some local exceptions) is nowhere to be seen. It's apparent that the agencies' regulatory regime, whether inadvertently or not, has played a major role in prolonging the duration of the overall market expansion through its singular purpose of tamping down bank exposure to riskier construction loans. Supply is thus at a fraction of long-term averages. As such, these regulations may also have a hand in facilitating a softer landing sometime in the future.

▸ **Rents reach 12-year highs.** The languid pace of new construction has stoked the pricing power of property owners. With unprecedented rent growth during the year, average small-cap asking rents reached their highest levels since at least 2006. Reflecting the outsized demand for warehousing facilities of various types, Q4 industrial rents jumped 2.2% with blistering growth of 9.3% for the full year. By historical comparison, industrial's average annual gain was only 1.9% since the end of the financial crisis. Nominal industrial asking rents of $8.74 per sq.ft. on average are now 11.3% above their pre-recession peak. Office rents gained 1.2% sequentially – the best quarterly performance in at least the last 48 quarters – and the 4.4% increase YOY also topped any previously recorded annual figure. National office rents, at an average of $19.59 per sq.ft., are 1.2% above the previous high-water mark in 2008. At an average of $18.21, retail rents advanced by 1.5% sequentially and 6.5% YOY, also outsized gains that pulled office asking rent levels 1.2% over the pre-recession peak. See the graph below for rent growth trends.

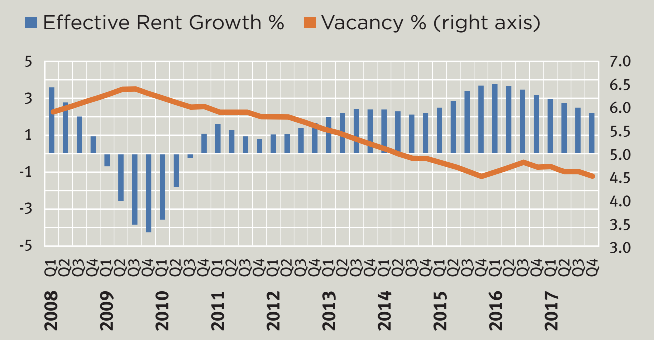
SMALL-CAP RENT GROWTH TRENDS | Annual Percent Change



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

▸ **Multifamily rents normalize even as vacancies hit bottom.** Persistently strong demand for affordable rental housing sustains the favorability of the apartment sector. The average small-cap vacancy rate dipped 10 bps to 4.5% during Q4, thereby matching the lowest rate previously achieved (Q1-2016) over at least 10 years according to Boxwood's analysis of CoStar data encompassing nearly 300,000 Class B and C apartment buildings of 5-40 units. Effective rents, at $1,073 per unit, continued to climb albeit at a slower pace, up 2.2% YOY but down from an annual 2.5% rate last quarter and 3.2% from a year earlier. See the graph below.

SMALL CAP MULTIFAMILY RENT AND VACANCY TRENDS



Source: Boxwood Means, LLC; CoStar Group, Inc

We suggested last time that the CRE market's Q3 slowdown appeared to be out of sync with promising news about the U.S. economy, an observation that was validated as small-cap space market fundamentals rebounded smartly over the last three months of this year. It's conceivable that the "Trump bump" was finally manifest by the strong growth in Q4 business spending as well as leasing activity, all of which – and more – may be extended by the corporate tax cuts signed into law in December. Clearly, the message is getting through to small business owners whose improved earnings and lower taxes are supporting higher capital expenditures and has triggered their highest level of business optimism since 1983 according to the January Small Business Optimism Index from the National Federation of Independent Business.

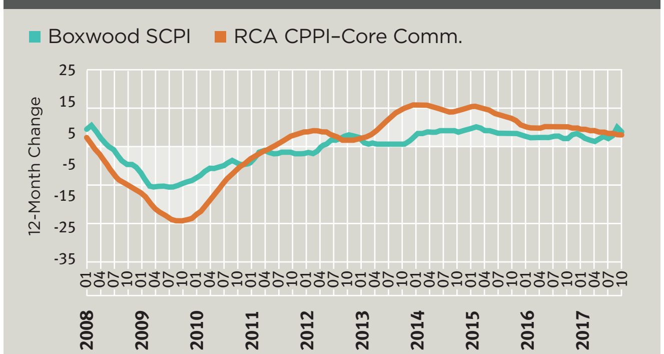
As the New Year unfolds, what remains to be seen is whether the tax cuts produce an even faster pace of growth with little downside or, on the other hand invite unintended consequences, e.g., better economic growth with higher-than-expected inflation and more frequent interest rate bumps that could possibly crimp CRE's bull market run.

Investment Prices and Sales

▶ **Prices rise despite November dip.** Boxwood's national Small Commercial Price Index (SCPI) for properties trading under $5 million across 125 cities dropped a sizable 1.4% in November on a preliminary basis, but the year's trend is more positive. Asset prices are up 3.7% year to date and 4.7% YOY which, with the exception of the previous month, represents the highest annual return in over two years. SCPI has recovered 90.5% of its losses and closed within 2.1% of its pre-crisis peak.

▶ **Price growth slows for large-cap CRE.** Prices for institutional-grade commercial assets have normalized this year, with the month-to-month double-digit annual returns of 2014-15 now a distant memory. The Core Commercial (CC) component of the RCA CPPI (that excludes multifamily and tracks sales transactions above $2.5 million) increased 3.7% through November and just 4.0% from a year earlier. This 12-month return is the lowest increase since March, 2013. The CPPI's growth has benefited from pricing power in the industrial sector, up 7.0% YOY, but constrained by subpar 12-month yields in retail (1.0%) and office (3.2%). RCA reported that pricing dynamics are reflecting buyers' re-assessment of the opportunities at hand which no doubt are influenced by a more conservative outlook caused by near-peak conditions as well as recent trends in interest rates and cap rates. See the graph below for trend comparisons between large- and small-cap CRE prices.

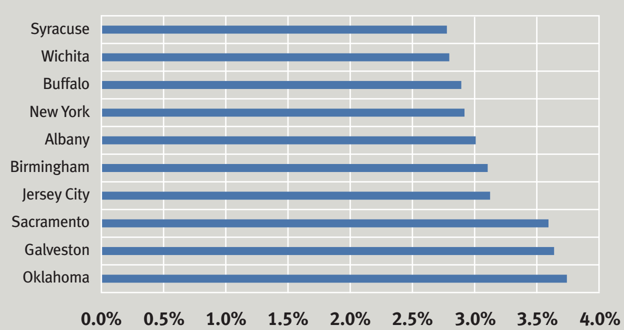
NATIONAL PRICE TREND COMPARISON | % Annual Change



Source: Boxwood Means, LLC; RCA

▸ **Prices perk up in most metros.** The national SCPI rose a healthy 2.1% over the last three months as 92 of the 125 metros posted price gains in the period. Over 50 metros recorded increases of at least 1% led by Oklahoma City (3.7%), Galveston and Sacramento (3.6%) and Jersey City (3.1%). By contrast, only 62 metro areas produced price gains over 12 months suggesting price momentum has picked up of late in many areas. See the graph below of recent out-performers.

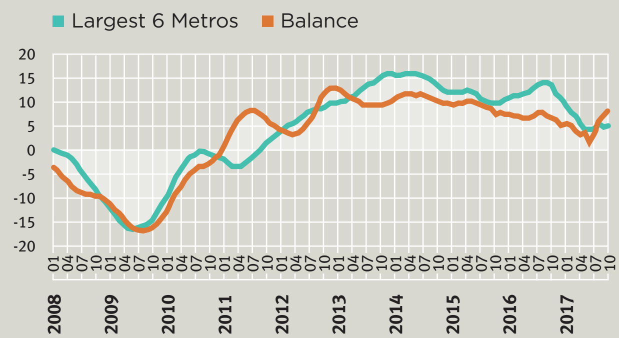
BEST METRO PRICE GAINS | Last Three Months



Source: Boxwood Means, LLC

▸ **Multifamily sector spreads the wealth.** Small-cap multifamily prices continued on a tear as demand for affordable rentals exceeds the meager supply, and highly successful Agency small balance lending programs continue to boost the sector. Despite no change on a preliminary basis during November, Boxwood's national Small Multifamily Price Index (SMPI) advanced by a hearty 2.6% over the previous three months, thereby charging up the YTD return to 8.3% and YOY to 7.7%. The latter is the best 12-month increase since January. Moreover, as shown in the nearby graph, secondary and tertiary markets have produced a late-cycle move and, with a formidable 8.2% annual gain as a group, have overtaken the combined performance of the six largest population centers. Overall, 38/45 metro areas posted annual price increases led by Long Island (11.2%) and followed by Las Vegas (9.8%), Syracuse (9.1%), Boston (8.4%) and Allentown (8.3%). Because small-cap multifamily has delivered such sustained and now widespread price appreciation, SMPI has recovered 249.4% since hitting bottom in 2010 and, at 38.3%, sits way above its previous peak perch.

NATIONAL PRICE TREND COMPARISON | % Annual Change

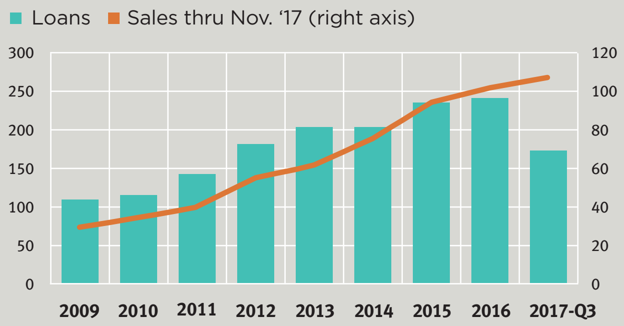


Source: Boxwood Means, LLC

▸ **Investment sales rocket ahead.** The slowdown in deal volume in the large-cap CRE domain is well documented. According to Real Capital Analytics, sales involving assets above $2.5 million declined in 2017 by 7% as institutionally-oriented buyers grew more selective as the market neared peak. Yet sales activity in the small-cap CRE domain has run counter to this trend. We've recorded $106.3 billion of transactions under $5 million through November, 2017 – already topping 2016's full year total by 19.1% and reflecting the highest level in at least the past 11 years.

This sales trend has boosted small balance loan originations which hit a post-crisis peak at $240.2 billion during 2016 as purchase loans rose to the highest percentage (42%) of total originations since at least 2009. The linkage between sales and originations is shown in the graph on the following page.

SBL ORIGINATION AND SALES TREND ($B)



Source: Boxwood Means, LLC

Clearly, all elements of the small-cap CRE space encompassing property fundamentals, investment sales and loan originations are hitting on all cylinders, keying off a U.S. small business economy that has re-asserted itself after years of tempered growth and profitability. With owner expectations for further improvement in small business performance in 2018 at near record high levels, we are cautiously optimistic that Main Street will again be a principal driver of dynamic growth this year in the small commercial property and loan markets.

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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