Small Balance Advocate
MONTHLY UPDATE FOR SMALL CAP CRE INVESTORS
November 2015

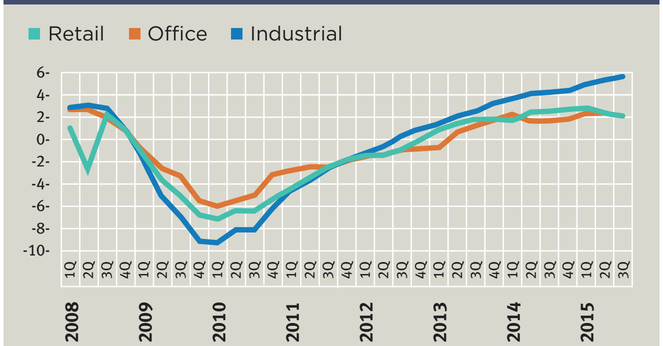
Asset Purchases Get a Boost from Rents With rents showing some solid momentum, small cap CRE investors have pulled out all stops on asset purchases. Strength in residential housing markets offers further reassurance for investors.

Space Market Fundamentals

As discussed last month, record-low vacancies and recurring gains in leasing demand assure another solid year for space market fundamentals. To complete the picture for third quarter, highlights of supply and rents based on an extract of CoStar data involving properties solely under 50,000 sq.ft. include the following:

▸ **Industrial rents steal the show.** With a bottom-hugging 5% national vacancy rate, rents for small cap warehouse and flex buildings are on fire (see the nearby graph). Third quarter rents rose a lavish 1.3% to an average of $7.44 per sq.ft. Year over year, rents appreciated by 5.6% – the highest annual rate of growth over 39 quarters dating to 2006 as the U.S. economy continued to expand modestly led by strong inventory growth that favorably affects warehousing needs. Industrial rents have recovered 13.7% from the previous cyclical low and rest 5.7% below the pre-recession peak.

SMALL CAP RENT GROWTH TRENDS | Annual Percent Change (%)



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

▸ **Office and retail rents are perking up.** Small cap office rents rose 2.2% year over year including a slight gain of 0.3% in the latest quarter to a national average of $18.10 per sq.ft. While modest in comparison with industrial rent growth, eight years have passed since annual growth in office rents improved by 2% or more. With the high velocity of leasing demand reported in last month's report, coupled with continued strong U.S. employment growth, it's likely that office rents will accelerate through year end. Office rents remain 6.8% below the pre-recession peak at a level commensurate with the final quarter of 2009.

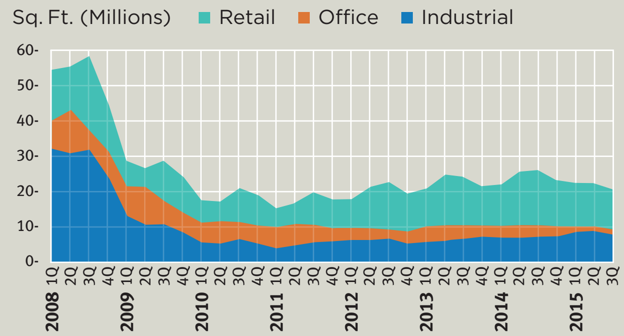
Retail rents increased at a reduced rate. Rents eked out a 0.2% gain to an average of $16.50 per sq.ft. The 2.0% year-over-year increase, though reminiscent of some 2%+ gains witnessed before the recession, represents a slowing in annual rent growth achieved earlier this year. Nevertheless, retail net absorption levels have substantially out-performed sequentially as well as year over year causing vacancies to plummet. In addition, residential housing markets, on which street retail and strip centers especially depend, continue to improve. So retail owners are likely to find an accommodative environment to keep pressing for rent increases. Retail rents remain 8.7% below the pre-recession high point.

► **Rents fared even better in the general market.** Office and retail rents in the overall CRE market are proving more elastic. General retail market rents, at the national average rate of $17.32 per sq.ft., rose 0.7% during third quarter and a hefty 4.5% year over year according to CoStar. Office rents, at $24.98 on average, also posted healthy growth – up 0.8% in the period and 3.4% from a year earlier. Industrial rents averaging $6.19 per sq.ft., predictably out-performed by jumping 1.1% and 4.7% respectively. Note, however, that unlike the other two sectors small-cap industrial rents have appreciated at a faster rate than the general industrial market because of significant supply growth.

► **Industrial supply turns the corner.** Supply of small cap industrial projects has ticked up after years of dormancy, though not close to the rate of growth in the general market. Developers have begun to fill the project pipeline as industrial rents have increased steadily, reaching mid-2009 levels. Construction of smaller facilities totaled 7.8 million sq.ft. during the latest period and, though the level fell 12.6% compared with second quarter, the year-to-date total exceeds the first three quarters of last year by a notable 19.2%.

► **Retail and office supply continues to lag.** Despite the revival in industrial new construction, aggregate commercial supply remains at extremely low levels (see the nearby graph). Small cap CRE construction averaged 146 million sq.ft. across industrial, office and retail sectors during the 14 quarters between 2006 and the recession's end (3rd quarter, 2009). By contrast, the average quarterly total has shrunk to 38.9 million sq.ft. over the subsequent 25 quarters. Enthusiasm for development by industry participants continues to be curbed by insufficient rents and the somewhat indeterminate course of the nation's economic recovery.

SMALL CAP CRE NEW CONSTRUCTION TRENDS



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

The retail sector generated over 50% of the aggregate volume of new construction projects with 20.7 million sq.ft. during the latest quarter. Even so, this sum represented a decline of 7.7% compared with second quarter and a 21.4% decrease year over year. Office projects accounted for 9.2 million sq.ft. but here, too, the total compared unfavorably with last quarter and the previous 12 months, down 8.7% and 12.0% respectively.

The industrial spigot opened in classic fashion this year in response to extraordinary space market fundamentals that reflected economic demands for factory output, trade and transportation. Strong industrial rent growth is likely to persist as long as the demand-supply gap persists. The national outlook for small cap office and retail sectors is a bit less clear, but very low vacancies and promising job growth in service-related industries augur further rent gains.

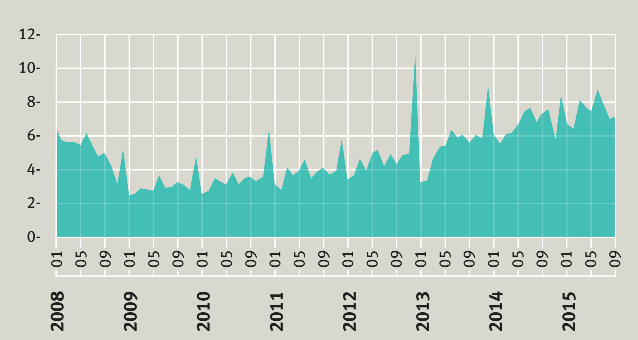
Property Sales Activity

Property sales rose in September. Highlights involving commercial and multifamily assets under $5 million include:

► **Property sales steamed ahead.** After a seasonal dip in August, sales transactions climbed higher. September's preliminary volume estimate of $7.1 billion rose 0.7%

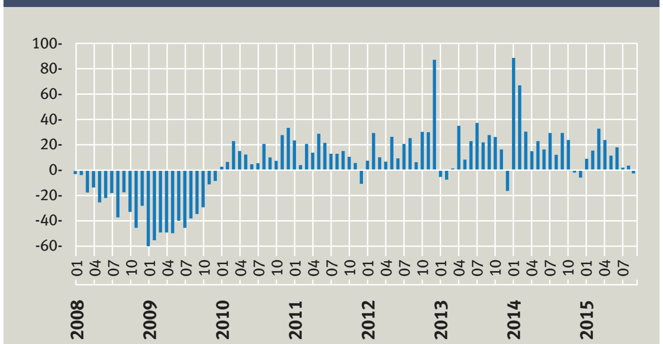
from the previous month after a hefty $1.2 billion upward revision. September's transaction total, though down 2.7% compared with September 2014, with near certainty will set a new record for the month with the next sales revision (see the nearby graphs). With total year-to-date sales of $67.4 billion eclipsing last year's record pace by 12.3%, 2015 is shaping up as the best year ever for investment sales. This comes as no surprise given the strength of small cap CRE market fundamentals noted in the section above, as well as the ongoing and competitive chase for yield among private investors.

SMALL CAP CRE SALES VOLUME TREND | Property Sales ($B)



Source: Boxwood Means, LLC

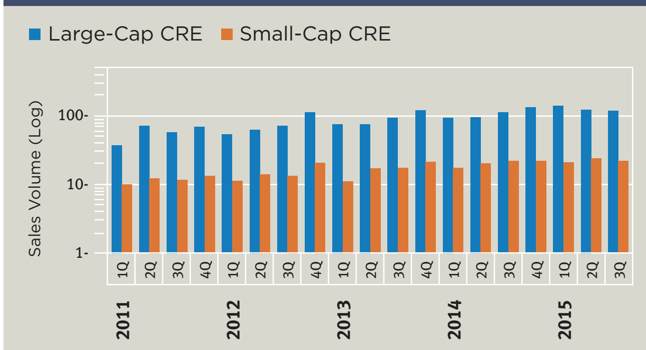
ANNUAL CHANGE IN SALES VOLUME (%)



Source: Boxwood Means, LLC

► **Transactions of larger properties continue to diminish.** Sales of significant properties greater than $2.5 million in value totaled $37.3 billion in September according to Real Capital Analytics (RCA), dipping 2.2% from the previous month and 5.7% from a year earlier. RCA suggested that this past summer's turmoil in the financial market, associated with the Fed's uncertainty on rates, devaluation of the Yuan and volatility in equity stock prices, slowed transaction activity and especially portfolio-entity deals. Despite the last quarter's contraction, the $378.7 billion in cumulative large cap CRE sales through September surpasses by 25.7% the total volume for the corresponding three quarters of last year. See the sales trend comparison in the nearby graph.

SALES VOLUME TRENDS COMPARISON

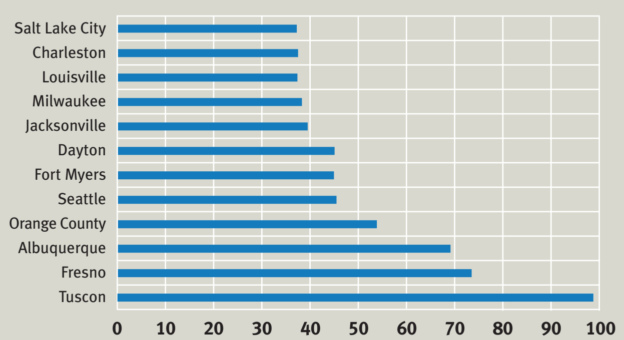


Source: Boxwood Means, LLC; RCA

► **Aggregate deal flow continues to slow in the largest cities.** The Big-Six population centers captured 21.6% of total sales, but trades have been slowing most likely because quality assets are in shorter supply. Four of the six cities posted annual sales declines led by Houston (-23.3%) where diminishing sales are a byproduct of energy market disruptions, and followed by Chicago (-12.8%), Los Angeles (-5.5%) and Phoenix (-4.9%). Sales in Philadelphia and New York grew by 37.7% and 1.1%, respectively. The strong revival of Center City, both commercially and demographically, appears to be a catalyst behind Philadelphia's surge. Aggregate volume for the Big-Six decreased 4.2% year over year; by comparison, sales in secondary and tertiary markets gained 5.6%.

▸ **Secondary cities shine bright.** Overall, of the 122 cities for which Boxwood tracks property sales, 88 recorded sales increases over the first nine months compared with last year. Among cities with at least $200 million in year-to-date sales as shown in the nearby graph, the percentage gain leaders are predominately secondary and tertiary markets led by Tucson (98.7%), Fresno (72.8%) and Albuquerque (69.4%). At this phase of the CRE market expansion, buyers find the income of assets in many smaller cities more durable than earlier and thus more appealing.

SALES VOLUME LEADERS (%) | Minimum of $200MM YTD Sales



Source: Boxwood Means, LLC

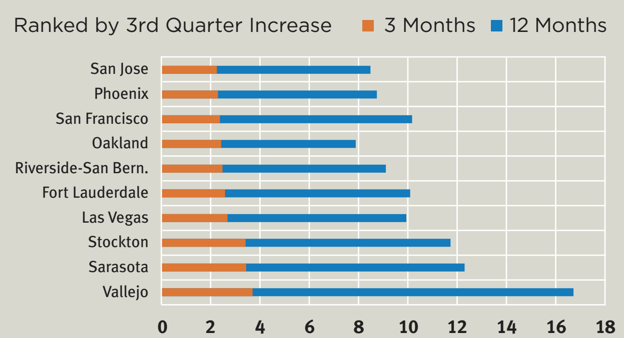
An unusual intersection of capital and market conditions has unleashed this year's torrent of investment sales. Low interest rates, ample financing and lower returns on alternative asset classes are major factors encouraging investment in higher-yielding CRE assets in both primary and secondary markets. Yet we think that the current and expected performance of the property markets, i.e., rising rents and small cap property income, is the ultimate driver for the sales surge.

Sales Prices

Small cap CRE prices rose modestly in September for commercial assets trading under $5 million (excluding multifamily). Notable results include:

▸ **Prices lifted in most cities.** During third quarter, 99 of the 117 markets in Boxwood's national population of cities posted price increases, and 59 of them recorded healthy gains of 1.0% or more. This is a significant achievement where small cap CRE asset appreciation tends to be sluggish, measured – the tortoise to the large cap's hare. As shown in the nearby graph, six of the top 10 cities are located in California led by outsized gains over three months in Vallejo (3.7%), Sarasota (3.5%) and Stockton (3.4%). Note that the 10 cities shown have out-performed almost all other comers in terms of 12-month gains as well. Overall, Boxwood's composite national index, or SCPI-117, increased 0.3% on a preliminary basis in September, 4.5% year over year and is 9.7% below the Index's pre-recession peak.

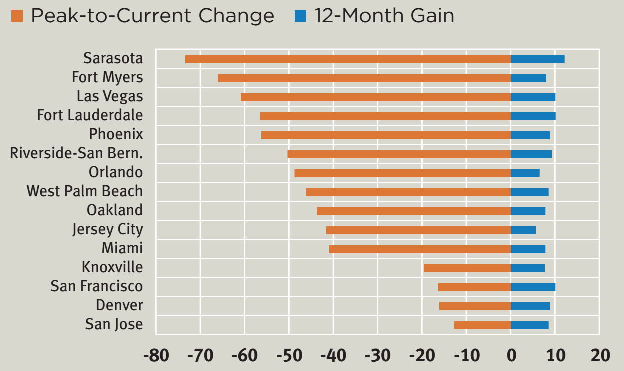
CITIES WITH HIGHEST PRICE GROWTH (%)



Source: Boxwood Means, LLC

▸ **Late-recovering Florida cities are pulling ahead, too.** Annual returns for selected Florida cities are among the best in the land including Sarasota (12.3%) and Fort Lauderdale (10.1%). Yet as shown in the graph on the following page, the Florida markets as others are, in sports-related parlance, playing from behind, i.e., recent price gains are overshadowed by a legacy of precipitous losses during the recession. Given these circumstances, lenders and investors may still find attractively priced assets in some of these markets.

PRICE RECOVERY FOR SELECTED CITIES (%)

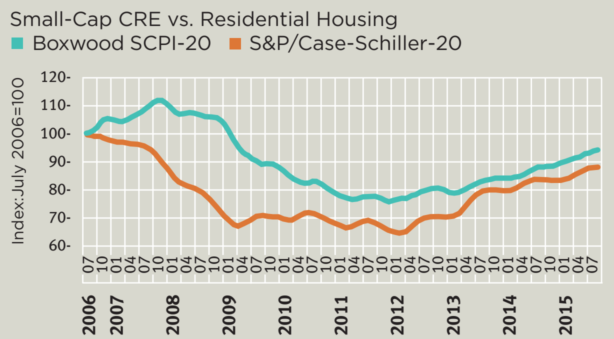


Source: Boxwood Means, LLC

▸ **Housing and small CRE markets continue to move in lockstep.** Residential housing prices have ticked up of late, increasing 1.3% during third quarter and 5.5% since last September according to the S&P/Case-Shiller Home Price Index. This was the best annual return in 13 months and included robust year-over-year price gains by San Francisco (11.2%), Denver (10.9%) and Portland (10.1%). The Home Price Index remains 11.4% below its previous peak level. Meanwhile, Boxwood's SCPI-20 comprising the same 20 metro areas rose 1.7% during third quarter and 6.9% year over year. As Small Balance Advocate readers know, SCPI-20 has out-performed all other Boxwood indices because of its potent combination of fast-recovering, tech-oriented and late-blooming cities. Yet because of its inherent volatility, SCPI-20 remains 15.8% below its previous apex.

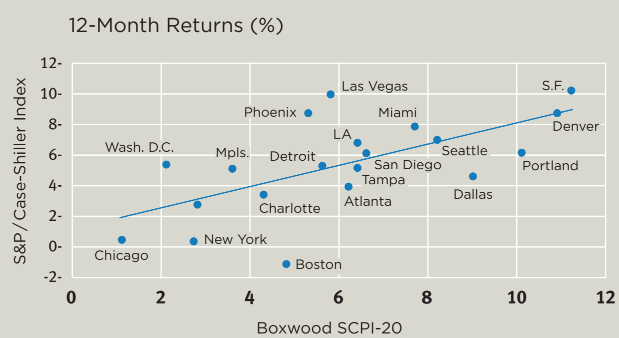
As the nearby graph shows, aggregate housing and small-cap trends track closely. In the down years prior to 2012, small cap CRE prices lagged housing prices by roughly six months. Since then, however, the lag has disappeared and 12-month returns show a strong correlation (.64). See the other nearby graph depicting the relationships at the metro level. The implication for lenders and investors is that residential housing prices are a strong indicator for the health of small cap CRE.

COMPARATIVE SALES PRICE TRENDS | 20 Metros



Source: Boxwood Means, LLC; S&P

SELECTED HOUSING AND SMALL CAP MARKETS



Source: Boxwood Means, LLC; S&P

▸ **The ceiling on large cap CRE prices keeps rising.** The Core Commercial (CC) component of Moody's/RCA CPPI (that excludes multifamily and tracks sales transactions of investment-grade properties principally above $2.5 million) rose 0.8% in September after an extremely bullish 2.2% gain in the previous month. The CC Index's 2.9% gain during third quarter, though impressive, slightly clipped the wings on the annual return to 15.7%, down 40 basis points from 12 months ending in August. Core commercial property prices have recovered 122.8% of their losses and hover 9.3% above peak.

Note: A recent Boxwood report on substantial differences in CRE prices among major and non-major market groupings is located **here**.

Moody's large cap CRE price trends imply that institutional investors have adjusted to higher asset prices and associated lower returns, particularly in major markets. No doubt, buyers have long-term expectations that higher cash flows associated with more economic growth will prop up values and offer some protection against rising interest rates. But large cap CRE prices in secondary and tertiary markets have now fully mended, too, according to Moody's, and this suggests that some investors and lenders are pursuing higher-risk strategies since property fundamentals in non-major markets have not recovered nearly as much relative to major markets. Small-cap CRE investors face similar opportunities and risks in local markets, but the lower prices on which many of these assets still trade hands may offset some capital growth expectations that may not be met.

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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