

# The Real State<sup>®</sup>

The Real State of the Phoenix Commercial Real Estate Market



JULY 2021

## The Strange, Short COVID Recession

One of the strangest aspects of the pandemic-caused recession was its brevity. In technical terms, a recession is defined by two consecutive quarters of negative GDP—conditions that the National Bureau of Economic Research recently concluded were met in the span from February 2020 to April 2020.

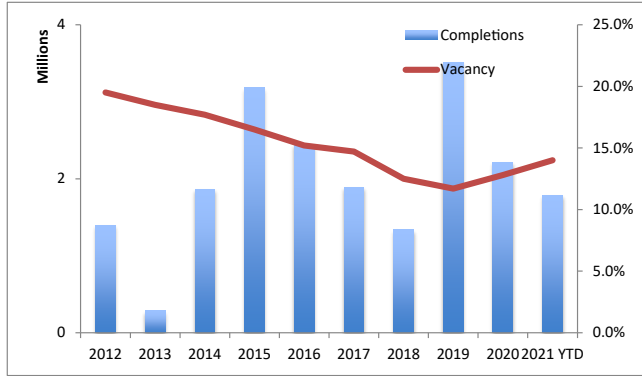
The COVID recession was the shortest in U.S. history, but also one of the deepest, plunging 31.4% in Q2 2020, only to experience a stimulus-fueled bounce of 33.4% in Q3. The fast recovery was a testimony to how much stronger the national and Arizona economies were compared to the Great Recession. Of course, the recession in commercial real estate went beyond the two-month technical definition, and not all sectors weathered it equally.

- **Industrial breaking records.** The pandemic forced an even greater shift to ecommerce and logistics management; Phoenix's appeal as a hub includes convenient transit access, cost advantages in land and labor, and fewer power and natural disaster issues than coastal locations. During the 2021 fiscal year, the Greater Phoenix Economic Council worked to bring nearly three dozen industrial users into the market, and is working with seven additional prospects. Industrial notched record-breaking construction in the first six months of 2021.
- **Retail in recovery mode.** Social restrictions had an outsized effect on retail, so it's a bright spot that sales volume and momentum have returned to pre-pandemic levels—although prices remain below the 2007 peak. Investment activity has been highest in the East Valley and high-income, dense areas of Scottsdale and North Phoenix, focused on 1031 exchanges and grocery-anchored retail centers, drive-thrus, and drug stores.
- **Multifamily experiencing low vacancies and soaring rents.** June saw another decrease in overall vacancy rates and increase in year-over-year asking rent growth and absorption in Greater Phoenix. Roughly 90% of units underway are Class A units, so affordable supply remains a looming concern. Despite rising prices and cap rates below 5%, sales volume in Q2 2021 hit the highest quarterly mark in the market's history. With high demand from a sales and rental perspective, now may be an optimal time for multifamily owners to consider selling.
- **Office tries to find its way.** Vacancies (including direct and sublet space) are at 14.2% according to CoStar, while other firms using different methodologies estimate the rate as high as 18.4%. From health concerns to employees seeking work-from-home options, there are no easy answers. If you are looking for glimmers of hope, there are a few. Transaction volume in the first half of 2021 was on pace with 2019's activity, net absorption was positive for Q2, and the pace of subleasing activity has slowed somewhat. We are seeing increasing activity in medical offices and net-leased single-tenant properties.

With a significant amount of investor capital wanting to come off the sidelines, low interest rates, and potential changes to 1031 exchanges, commercial real estate could be a beneficiary. While revenue and personal income growth are up, challenges in the Valley include housing affordability and unemployment, which ticked up to 6.8% in June.

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# Office



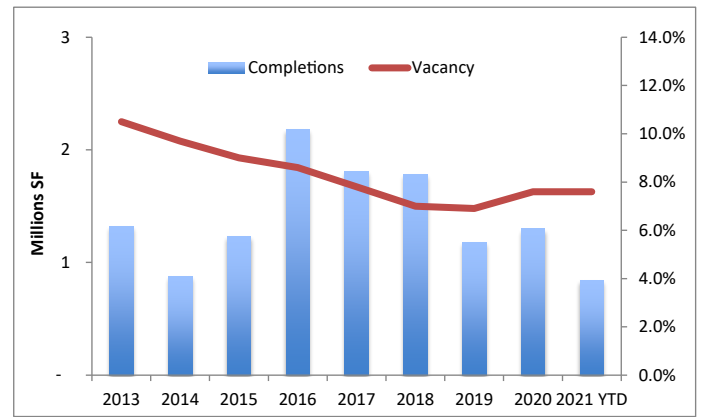
Rising confidence in the market has contributed to an increase in Phoenix investment activity over the past several months. Transaction volume in the first half of 2021 was on pace with 2019's activity.

Private and institutional investors have targeted single-tenant properties net leased by strong-credit tenants that offer stable cash flows and entail limited managerial oversight. Medical offices are also highly sought after.

Like many Tier II markets, Phoenix has garnered increased attention from national investors, though the buyer profile is relatively unchanged; private and some institutional interests drive the majority of transaction activity. Foreign investment, particularly from Canada and Asia, has picked up in recent years but still represents a small slice of the market.

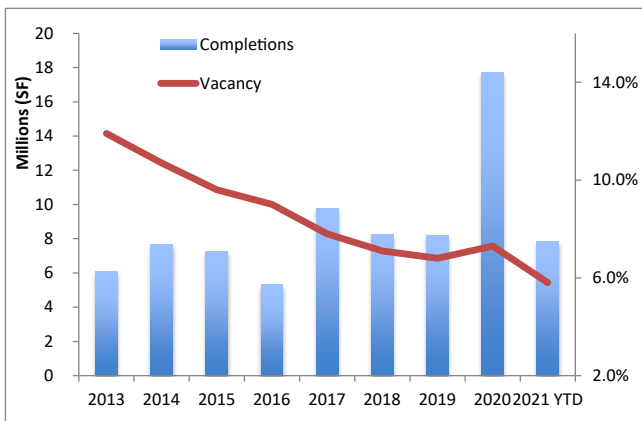
# Retail

Quarterly sales volume returned to pre-pandemic levels late last year, and that momentum has carried into the first half of 2021. Sales volume in the last quarter reached \$627 million as the Phoenix buyer pool expanded. Investors have been the most active in the fast-growing East Valley and in high-income and dense areas of Scottsdale and North Phoenix. Local and out-of-state investors, primarily from California, are the most active. Trades are driven by 1031 exchanges and demand for grocery-anchored retail centers, drive-thrus, and drug stores.



Before the spread of the virus, competition for well-located and quality assets bolstered transaction pricing to an average of \$200/SF. Yet, values have not returned to the 2007 peak. Despite price growth, Phoenix's average cap rate has hovered near 7% since 2015, mirroring the National Index.

# Industrial



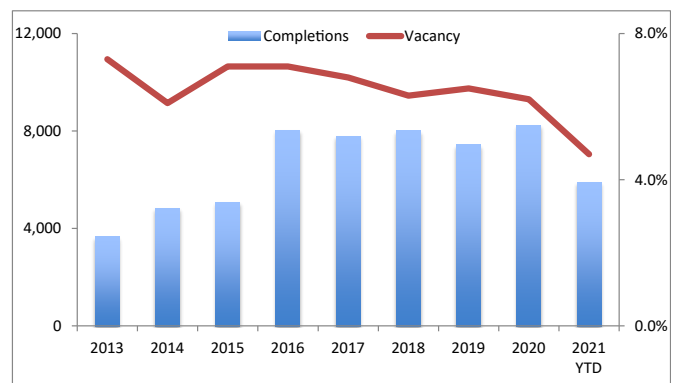
Investors are bullish on Phoenix, and the buyer pool is growing as more out-of-state buyers, especially from California, enter the market. In the second quarter, about 25% of the properties that traded sold to California-based investors. Local investors are still active, as well, but many are getting squeezed out of larger deals due to an intense bidding environment.

Sales volume entered by the end of the quarter reached \$600 million—setting a record for second quarter volume. Buyers are targeting last-mile facilities, and many deals are being driven by 1031 exchange deadlines.

In previous quarters, intense buyer competition had put consistent upward pressure on pricing. The average price of \$119/SF is 30% above the market's previous peak but below the National Index. Even with the rise in pricing, an average cap rate in the 6.5%-7% range remains attractive to investors.

# Multifamily

Completions exceeded 8,000 units for a third consecutive year in 2020, and the supply wave isn't over. Deliveries are expected to reach a peak this year. About 21,000 units are underway, and once completed, the market's inventory will expand by 6.3%.



Nearly one-quarter of the metro's construction total is in Downtown Phoenix, with more than 5,500 units underway in the submarket. The revitalization of Downtown Phoenix has made the submarket a top destination for millennials and multifamily development over the past few years. The new supply is concentrated near Roosevelt Row Art District. In 21Q2, Hubbard Street Group broke ground on another luxury high-rise: the Skye on 6th. The 26-story apartment complex will consist of 309 units, ranging from studio to two-bedroom units. Within a half-mile radius of the apartment complex, there are six other luxury apartment buildings, totaling 1,600 units, under construction.

## Residential Snapshot

Supply continues to rise, but at a faster rate over the past 7 weeks: up 11% over the course of April and May, and another 32% in June and July to date. Sellers can still benefit from relatively low inventory numbers and significant appreciation in recent months, but the clock appears to be ticking on those advantages—and could finally offer relief for buyers. If the current rate of decline were to continue, the Greater Phoenix housing market could see a balanced market by the end of 2021. Other key trends we're watching:

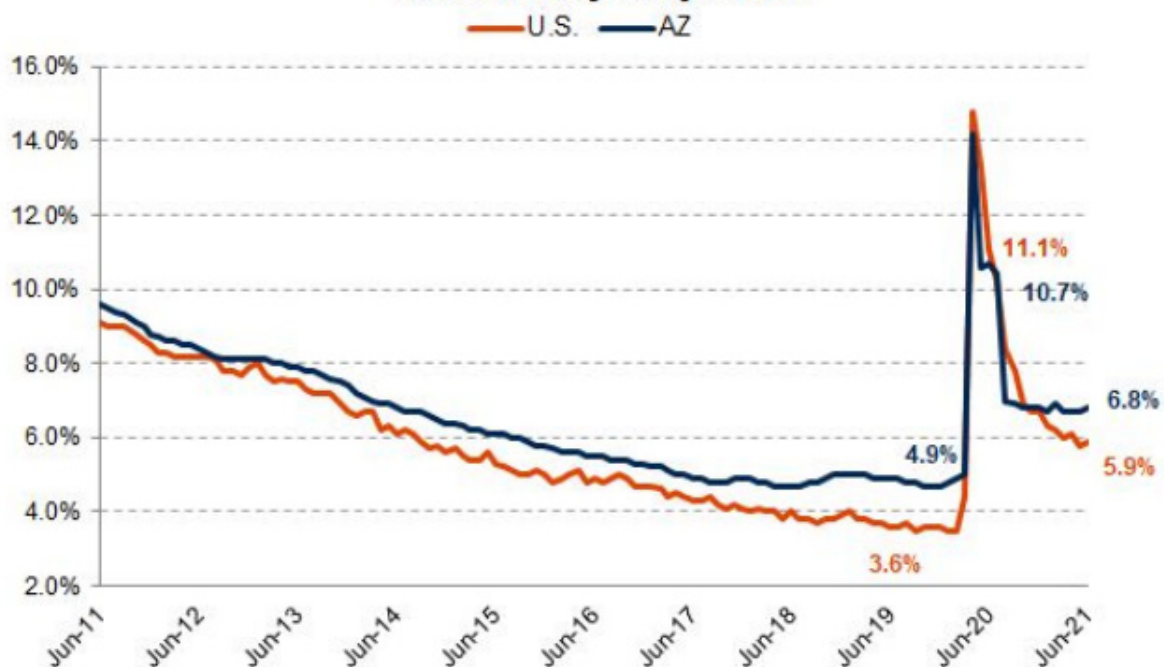
- Price reductions continue to respond to the increase in supply, especially between \$400K-\$800K, where price reductions are up from 100 per week to 422 per week.
- It's possible some of the supply increase is a result of some homeowners coming out of forbearances, since a large portion of them expired at the end of June.
- Sales through the Arizona Regional MLS so far are up 18% over 2020 in the first half of 2021 and up 25% from Q2 2020—but those numbers are a bit skewed given the unusual market conditions we experienced in 2020.
- While the sales price per square foot between \$250K-\$400K has been rising at an average of 3.5% per month over the past 5 months, so far between June and July, it's risen 1.2%; the overall median sales price is up just 0.1%, from \$400,000 to \$400,500.

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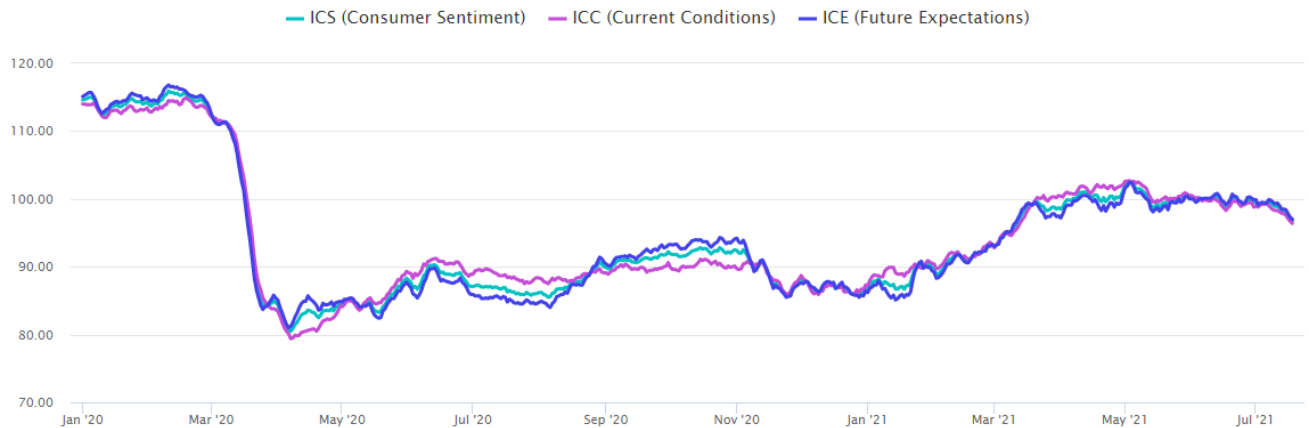
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## Unemployment

### Arizona & U.S. Unemployment Rate Seasonally Adjusted



## Consumer Confidence



Source: <https://morningconsult.com/form/consumer-confidence-dashboard/>

*“Normality is slowly returning. Job growth should be strong the rest of the year. The number of unemployed people who were prevented from looking for work because of the pandemic dropped to 1.6 million from 2.8 million two months ago. However, total employment is still 6.8 million below its prepandemic level. Many of these are likely to return to the labor force later, but some have permanently retired. The rise in the unemployment rate to 5.9% showed the tightness of the labor market, because it was the result of a higher quit rate and people coming back to look for work. Otherwise, the rate would have dipped to 5.7%.”*

—Kiplinger Economic Forecasts, July 2: [Jobs: Normality in Sight](#)

## Articles of Interest

### AZ Big Media – July 26

[Phoenix office market stabilizes as sublease additions slow](#)

### Phoenix Business Journal – July 14

[Single-tenant retail draws increased investor interest in Phoenix](#)

### CoStar – July 6

[Apartment Developers See Opportunity in Market Discount on Closed Hotels](#)

### TreppTalk – July 23

[Finding Opportunity: Rising NOI for Maturing Multifamily Loans Points to Looming Refinance or Sale Boom](#)

### AZ Big Media – July 26

[Here's why the West Valley is exploding with economic growth](#)