The Real State®
The Real State of the Phoenix Commercial Real Estate Market

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ENHANCING REAL ESTATE ASSETS

June 2022

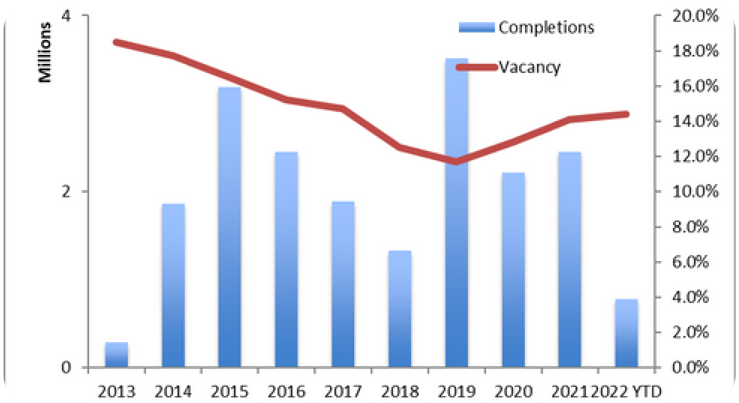
Midyear Checkup: Greater Phoenix CRE

In the May issue of *The Real State*, we discussed the overall potential impact of interest rates on commercial real estate, including increased building and borrowing costs, heightened competition to deploy capital, and cap rates. The caveat is that inflation also affects investor returns, which requires keeping an eye on which asset classes may offer the best safe-haven opportunities—regardless of what the Federal Reserve does with rates. As we close out the first half of 2022, here's an overview of the current performance and outlook in the Greater Phoenix market:

- **Multifamily** has been overbuilt for a considerable time, but it has not been impacted as much as anticipated. Sales volumes and prices have remained strong, and many smart multifamily owners are selling and achieving excellent returns even after owning less than a year. We are starting to see some cracks, however, with more properties hitting the market this year and an even larger influx of deliveries in the first half of 2022. (Just under 38,000 units are under construction, and over 26,000 are in some stage of planning.) The multifamily market has benefited from higher interest rates keeping people in the rental pool. While many ex-California homebuyers have ample cash, that's not necessarily the case for everyone moving into Arizona. Multifamily developers are counting on that in-migration to absorb the extra units.
- **Office** reported vacancies are lower than anticipated, at about 20%, but a walk through many office buildings with professional and financial service tenants might yield a physical occupation rate significantly lower/higher physical vacancy. Business owners are still bound by their leases—even if they're not sure what to do with the space. Last year, employers/tenants kicked the can down the road with 1-year extensions, and landlords accommodated them in lieu of an outright termination. This year, at lease renewal time, many will be seeking to shrink their footprint—especially with the possibility of recession. That is likely to lead to the repurposing of office spaces, and we're already seeing a trend towards smaller office spaces, in better locations with more highly amenitized buildings, a.k.a., the "flight to quality." Building owners are retrofitting to get their tenants to renew, while employers will do whatever it takes to get employees back to the office.
- **Industrial** has eclipsed multifamily as the favored investor asset. While demand continues to be strong, plus major initiatives for Arizona as a logistics hub, there is a considerable amount of new space being built. About 36.5 million SF is under construction, representing about 9.2% of total inventory, and a significant amount is speculative. While the market has had no trouble as yet absorbing industrial property, it will be interesting to see how the influx plays out.
- **Retail** was among the most troubled asset classes during the pandemic, so it's good to see a bit of a revival. In particular, investor interest has increased in neighborhood retail/multitenant retail centers. Pricing has increased and cap rates have remained low, which creates a lot of good opportunity. It's important to note the major shift on what's successful: tenants providing services versus products—so-called internet-resistant tenants.

Given today's challenging market conditions, R.O.I. Properties welcomes the opportunity to discuss the best available options for buying and selling commercial real estate investment properties with you. Our team is ready to help you formulate a strategy for success that aligns perfectly with your business goals. Please contact us at: info@roiproperties.com or 602-319-1326.

Office



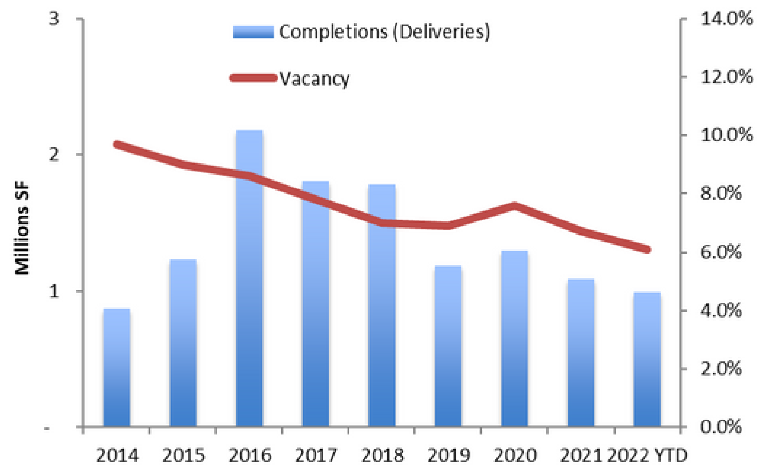
Despite a steady stream of new office deliveries since 2015, the pace of completion has moderated from the building boom in the early 2000s. From 2000–08, the market's stock grew by an average of 6.2 million SF each year, but the annual level has slowed to 1.9 million SF over the past five years.

Marketwide, 1.9 million SF is under construction, and about half of the space is available for lease. Construction is concentrated in Tempe and Scottsdale Airpark, high-demand urban submarkets with a large and high-quality talent pool.

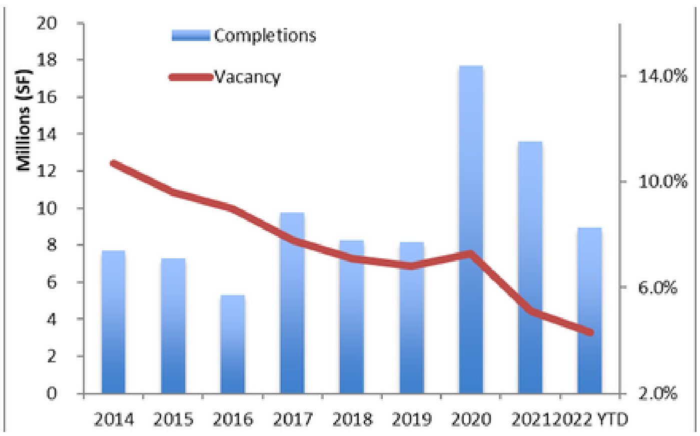
Retail

The resilient local economy coupled with robust job and population growth has stabilized Phoenix's retail market. Leasing volume is on the rise and new investors are searching for quality assets in Phoenix. Over the past dozen years, Phoenix consistently ranks among those metros with the highest vacancy rates, partially due to the acute impact of the Great Financial Crisis.

Elevated vacancy has not slowed year-over-year rent growth, which clocks in at 6.3% versus the national average of 4.4%. While many tenants closed during the pandemic, even more have opened up shop in the past 18 months.



Industrial



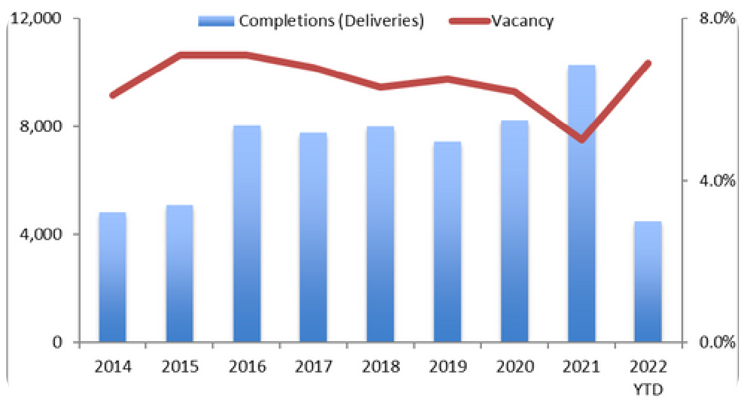
Industrial deliveries are projected to hit an all-time high in 2022. Construction activity has surged in recent quarters, and most of the space is being built without a tenant in place. This rise in speculative construction demonstrates the high level of confidence among developers and lenders that "if you build it, they will come."

About 35.6 million SF is underway. Once that space is completed, the market's inventory will expand by 8.9%. That share ranks Phoenix second in the nation for construction as a percent of inventory.

Multifamily

Demand, rents, and supply have climbed to unprecedented levels in the Phoenix apartment market. Before the coronavirus, fundamentals were solid and supported by some of the country's strongest employment and household growth that fueled demand and low levels of single-family inventory.

A record-high 3,700 units were absorbed in the past year versus 11,000 delivered units, also a record high. With supply outpacing demand, the vacancy rate is now at 6.9%. Landlords will need to brace for a wave of deliveries over the next few quarters.



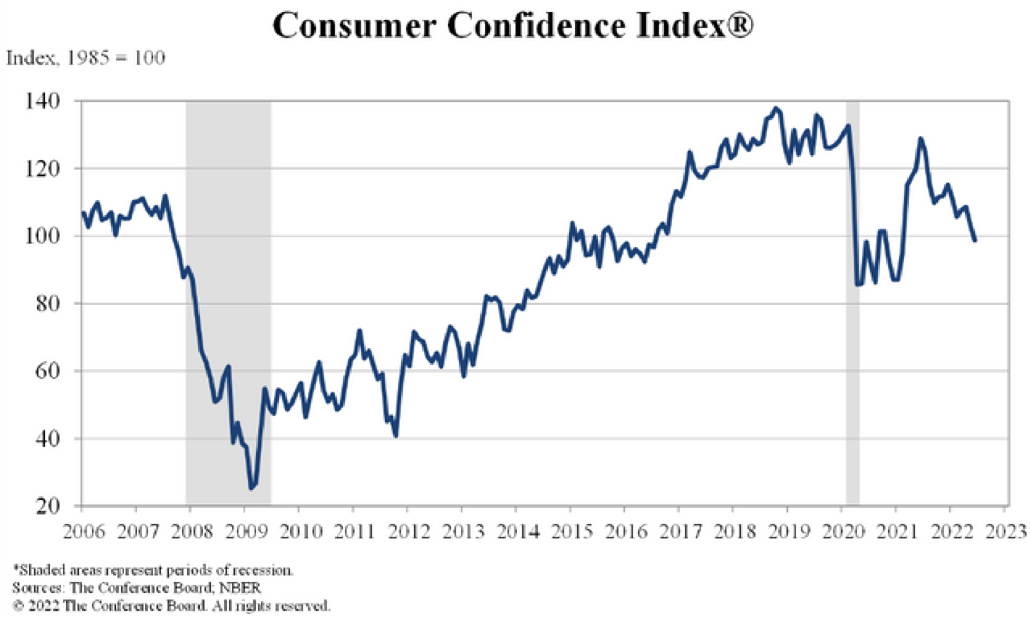
Residential Snapshot

What was anticipated to be a general stabilization is turning into a more sudden market decline, and it's getting more difficult to get deals to stick. Turnkey properties are faring better for sellers, while those that need a lot of work are lingering on market a lot longer. It's more important than ever that a property looks good and clean and presents in a market-ready state. For buyers, the major hurdle is that financing is significantly more expensive than it was two months ago. On the positive side for home-hunters, there's a lot more choice and negotiability in the market—particularly for all-cash deals that waive the inspection. From May to June 2022, the supply-demand index dropped from 315.0 to 190.9, a level not seen since pre-COVID and it's declining rapidly. At this pace, Greater Phoenix could be in a balanced state by August and a buyer's market by September. Whether the Federal Reserve raises rates by 50 or 75 basis points in August, it will likely be painful.

A few other market factors that R.O.I. Properties is tracking include:

- Supply counts continue to soar every week with little signs of slowing down at this stage, a dramatic trend that started about 13 weeks ago with interest rates passing 4.4% in March 2022.
- Demand under $400K has been diving, while supply over $400K has been skyrocketing as sellers rush to put their homes on the market before the good times end. Major components of current active supply increases include iBuyers OpenDoor and OfferPad (12%), LLCs (10%) and builders (13%).
- Demand is officially below normal for this time of year. As the supply-demand index races towards a balanced market , many institutional buyers have decided to sit on the sidelines for now.
- The sale price/list price ratio is currently 100.1%, down from last month's measure of 101.7%, and is expected to fall to a normal range of 97-98%. The percentage of sales over list price in June is 46%, down from 56% last month.
- Seller concessions are expected to rise significantly over the next 4-6 weeks, signifying the final stage of shifting out of an aggressive seller's market and into a near-balanced market.

CONSUMER CONFIDENCE



Source: https://www.conference-board.org/topics/consumer-confidence/

The Conference Board Consumer Confidence Index again decreased in June, following a decline in May. The Index fell to 98.7 (1985=100)—down 4.5 points from 103.2 in May—and now stands at its lowest level since February 2021. The Present Situation Index—based on consumers' assessment of current business and labor market conditions—declined marginally to 147.1 from 147.4 last month. The Expectations Index—based on consumers' short-term outlook for income, business, and labor market conditions—decreased sharply to 66.4 from 73.7 and is at its lowest level since March 2013.

Western Blue Chip Current Update

Net Domestic Migration	
Metro Area	**Net Migration**
Phoenix	66,850
Dallas	54,319
Tampa	42,089
Austin	40,264
Riverside	34,859
Sarasota	29,186
Fort Myers	25,864
San Antonio	25,660
Lakeland	24,939
Jacksonville	24,815

Source: https://seidmaninstitute.com/wbc-update/

PHOENIX, DALLAS MOST POPULAR METRO MIGRATION DESTINATIONS

One approach to determining the best places to live is the proposition that people "vote with their feet," stated as a testable hypothesis by noted regional economist Charles Tiebout in a 1956 Journal of Political Economy research paper. The adjacent table compiled by *U.S. News & World Report* lists the top metro destinations for domestic migration as reported by the U.S. Census Bureau for 2021, with Phoenix in the #1 spot.

Phoenix ranked 67th on the U.S. News annual metro area rankings of Best Places to Live. The rankings are derived from an index based on desirability, labor markets, quality of life, and other factors including costs.

"Expect another 0.75% rate hike at the Fed's next meeting on July 27, 0.5% on Sept. 21, and then four more 0.25% increases at meetings after that. That would bring the rate to 3.25% by the end of the year, and 3.75% early next year."
—Kiplinger, Interest Rates: The Fed Ups the Ante

Articles of Interest

Globe St. – June 29
Can Retail Survive Another Recession?

TreppTalk – June 22
CREFC Confidential: Rising Interest Rates; Widening Spreads; Uptick in Loan Defaults

Phoenix Business Journal – June 29
Here's why CRE deal volume may not see dramatic slowdown in second half of 2022

Phoenix Business Journal – June 23
Valley build-to-rent communities sell, New York-style pizzeria opens; 6 other real estate deals to know

AZ Big Media – June 29
How increased renter interest is reshaping post-pandemic office market