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

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ENHANCING REAL ESTATE ASSETS

March 2022

Overcoming Office Space Obsolescence

The pitfalls of aging office buildings are not new, but the COVID-19 pandemic put concerns about obsolescence front and center. The acceleration of work from home (WFH) and work from anywhere (WFA) trends has led businesses owners to reassess how much space they truly need to operate efficiently. With tenants who can afford to be selective, plus a focus on healthy spaces and stricter environmental regulations, office assets may be sailing into a perfect storm of challenges.

Current office leases are renewing, but for shorter terms until businesses figure out how their employees will really use offices when they come back. In order to secure longer leases, office building owners will need to significantly invest to overcome obsolescence. Tenants are increasingly showing a preference for newer buildings with more flexibility and modern amenities such as fitness rooms and food courts. At the same time, more-stringent government green standards are forcing building owners' hands.

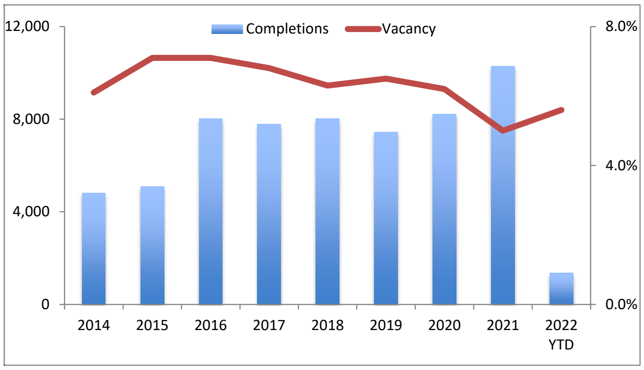
A new economic analysis by Zisler Capital Associates details some of the implications. (See pg. 4, "Articles of Interest" for the full story.) Nationally, prices for newer, amenity-rich offices are up about 15%, while smaller, older properties are down 20%. The Zisler report concludes that "as much as 70% of the total inventory faces an alarming period of repricing due to fast-paced obsolescence" and "for 30% of the existing office stock, retrofitting and upgrades may be economically unfeasible." As GlobeSt. notes, the potential impacts may extend to financing, valuations, and loan covenants.

By the Numbers: Greater Phoenix Office Space

- The vacancy rate is estimated to be in the 14.5% to 15.5% range by different market observers, close to the national average. In Class A properties, the vacancy rate is higher, in the 20% range. Phoenix is faring better than some secondary markets; Atlanta, for example, is estimated at over 22%.
- Tenants who experienced good performance by remote workers during the pandemic are relinquishing unused office space. As a result, sublease availabilities have surged from about 1.7 million SF in Q4 2019 to a record high of more than 5 million SF.
- Development has slowed in the past 12 months, partly due to the uncertainty of office demand moving forward. The amount of office space under construction is at its lowest level since 2017, reducing supply-side risk in the near term. Marketwide, about 1.6 million SF is under construction, half of which is available for lease. Construction is concentrated in Tempe and Scottsdale Airpark, high-demand urban submarkets with a large and high-quality talent pool.

Whether you are located in Arizona, out of state, or in another country, we welcome the opportunity to discuss the best available options for buying and selling commercial real estate investment properties. The team at R.O.I. Properties 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



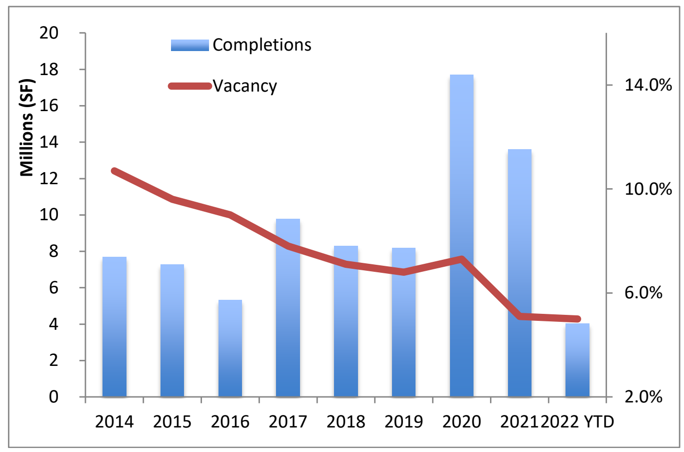
Rents in Phoenix's office market have rebounded stronger than most major metros. Annual rent growth currently registers at 3.0%, compared to the national average of 0.3%.

Rents are still facing downward pressure in key submarkets, however, due to a rise in sublease space availabilities. Downtown Phoenix offers some of the highest discounts due to its more than 20% availability rate. At One North Central, for example, sublet space was discounted from $34/SF to $24/SF.

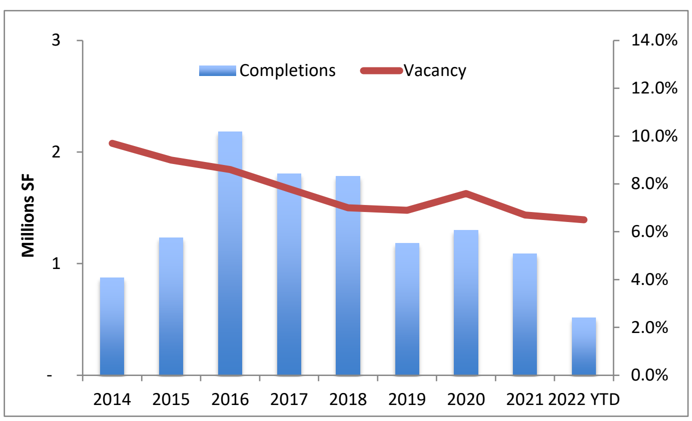
Retail

Phoenix retail construction has maintained a manageable level since the global financial crisis. The market recovered slowly from a supply-induced spike in vacancies since 30 million SF of retail delivered from 2006–08. But over the past decade, retail deliveries have moderated to an average of 1.2 million SF annually.

About 1.0 million SF of retail space is under construction, which accounts for about 0.4% of the existing inventory, a small share by historical standards. Less than 15% of the space under construction is available for lease, creating little supply risk.



Industrial



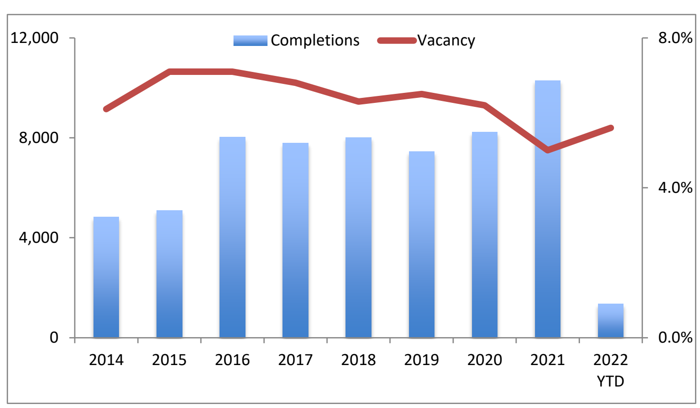
Deliveries are projected to hit an all-time high in 2022. Construction activity has surged in recent quarters, and most of the space is being built without a tenant in place. This rise in speculative construction demonstrates the high level of confidence among developers and lenders that the new product will attract a tenant.

About 40.1 million SF is underway. Once that space is completed, the market's inventory will expand by 10.2%. That share ranks Phoenix second in the nation for construction as a percent of inventory.

Multifamily

Completions exceeded 8,000 units for a fourth consecutive year in 2021, and the supply waves will continue. Deliveries are expected to reach a peak in 2022. About 28,000 units are underway, and once completed, the market's inventory will expand by about 8.2%.

Nearly one-quarter of the metro's construction total is in Downtown Phoenix. 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.

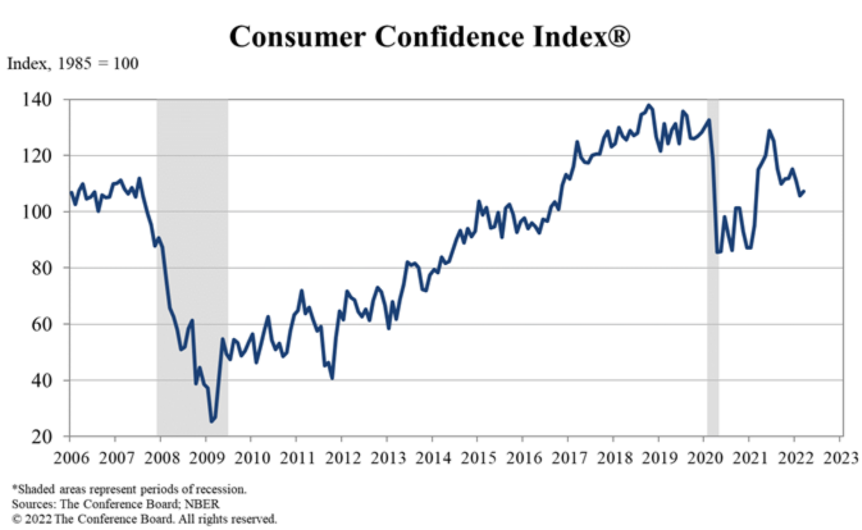


Residential Snapshot

From February to March 2022, the supply-demand index dropped from 471.8 to 458.9, with the demand index returning to the cusp of normal range for the first time since summer of 2021. Last month, we noted the potential impact of interest rate and price increases on the residential market's health. This month's cautionary note comes with a rise in available rental properties at decreasing rental rates—currently being experienced in single-family rentals and likely carrying over into multifamily as new inventory is completed. If rental supply really starts increasing, this will signal changes ahead for the housing market in general. Here are some of the other trends R.O.I. Properties is watching in the Phoenix residential market:

- Supply continues to hover slightly above last year's measure, sitting 6.2% higher than this point in 2021. Last year, supply counts started to increase at a faster rate after May. This was believed to be caused by a segment of homeowners settling with their lenders, exiting forbearance, and selling their homes after appreciating an incredible 39% in just a year. At the same time, affordability measures had dipped below normal for the first time since 2018, causing household formation to retract. The result was a rise in supply, but not enough to reach pre-pandemic levels. While supply measures in 2022 are following a similar path, the circumstances are different and it's unclear if they will rise in a similar manner.
- While sales volume is slightly below last year to date, the MLS has closed the second highest number of homes ever. Mortgage rates reached an average of 4.1%, the sharpest rise since the 1980s; the impact of inflation is causing many to wonder when the effects will be seen in housing prices.
- Over the course of the past year, asking monthly rents on vacant rentals in the MLS rose from a median of $1,995 in March 2021 to a peak of $2,395 by September. During the same time frame, closed rent prices stopped rising and stagnated at $2,100 after mid-July. By September, the supply of rentals in the MLS began to accumulate, then exploded at the beginning of 2022—especially in Maricopa, Queen Creek, Gilbert, Laveen and Buckeye.

CONSUMER CONFIDENCE



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

Present Situation

Consumers' appraisal of **current business conditions** improved in March.

- 19.6% of consumers said business conditions were "good," up from 17.6%.
- 22.1% of consumers said business conditions were "bad," down from 25.1%.

Consumers' assessment of the **labor market** also improved.

- 57.2% of consumers said jobs were "plentiful," up from 53.5%, a new historical high.
- 9.8% of consumers said jobs are "hard to get," down from 12.0%.

2022 BLUE CHIP FORECAST

NONFARM EMPLOYMENT
February 2022 - Seasonally Adjusted

3,034,000
Total Nonfarm Employment

Year-over-Year Change

130,200 (Numeric) | +4.5% (Percentage)

Employment Details ›

EMPLOYMENT BY SECTOR
February 2022 - Seasonally Adjusted

Total Nonfarm Payroll Em

3,034,000
Employment Level

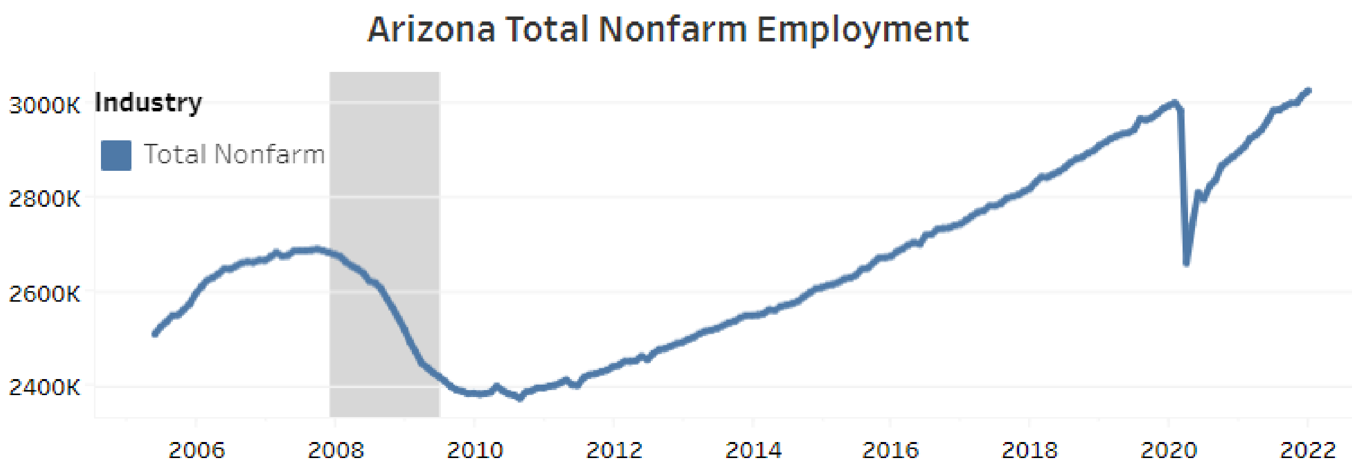
Year-over-Year Change

130,200 (Numeric) | +4.5% (Percentage)

ANNUAL AVERAGE WEEKLY WAGES IN ARIZONA (2020)

$1,124 Total, All Industries

Industry Category	Weekly Wage
Goods-producing	$1,367
Natural resources and mining	$1,063
Construction	$1,211
Manufacturing	$1,584
Service-providing	$1,084
Trade, transportation, and utilities	$1,008



Source: https://www.azcommerce.com/oeo/labor-market/industry-employment/

Articles of Interest

Globe St. – March 10
Obsolescence Could Trigger a Massive Downward Repricing in Office Space

Phoenix Business Journal – March 21
High-profile Valley office buildings drive new leasing activity

Phoenix Business Journal – March 17
Major industrial moves in the Phoenix metro; plus more than a dozen other real estate deals to know

AZ Big Media – March 30
Phoenix ranks No. 3 in U.S. for data center leasing activity

AZ Big Media – March 29
Here’s how Phoenix malls are being revamped and redeveloped