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

R·O·I PROPERTIES® ENHANCING REAL ESTATE ASSETS

MAY 2021

Office Properties: More Questions than Answers

While many commercial asset classes were hit early and hard by the pandemic through closures and shutdowns, most seem well on the road to recovery in the Greater Phoenix Area. The near-term and long-term outlooks for offices, however, remain foggy. As the haze begins to clear, these are some of the trends that we're watching—and questions that we're asking:

- **What is the true vacancy rate?** According to CoStar, office space availability (which includes vacant and sublease space), is 18.2% for Class A properties and 14.2% overall. These statistics are changing quickly due to the volatility in this asset class, lease renewal rates and the amount of space that is under lease, but put on market as sublease space due to tenants occupying space differently now, versus pre-pandemic.
- **How and when do employees get back to work?** Employers are pushing to get workers back into the office, but it is not as simple as hanging out an "open for business" sign. Companies understandably want the benefits of in-person collaboration, even as simple as having people go to lunch together or chatting in the breakroom. Many employees, however, want the flexibility and efficiency of working from home (WFH) or working from anywhere (WFA).
- **Will sublease and direct lease space keep growing?** Phoenix sublease and direct availability have been increasing dramatically. The most recent numbers indicate 4.2M SF of sublease space is now on the market, and 35.4M SF of direct space is available. We believe direct space will continue to grow, as leases come up for renewal. Some businesses have been taking an aggressive (and proactive) stance, by bringing unnecessary office space to market as sublease space, where they may have short- or long-term lease commitments. We are seeing numerous financial service and legal firms seek to shrink their office footprint, by planning for an "office hotel"/"guest office" concept, enabling employees to have office space when they need it, but without specifically designating offices for permanent use by specific employees.
- **Is it a landlord's market or a tenant's market?** In most cases, tenants still have the upper hand in negotiations, including pandemic, force majeure and impossibility clauses. Notwithstanding, many landlords are holding firm, for now, with respect to rental rates, but are offering some concessions such as free rent, more tenant improvement (TI) allowances, etc. We believe that once lease renewals really hit, tenants will have even more negotiability.
- **Is it a buyer's market or a seller's market?** National investors perceive Phoenix as still offering relative value. Office cap rates have held stable, hovering near 7% over the past few years, and at 150-200 basis points above California markets, Golden State buyers looking for higher returns accounted for nearly one-quarter of deals over the past year. There have, however, been very few office investment transactions that have closed post-pandemic in the Greater Phoenix Area. Owner-occupant buyers are experiencing tough competition for now, as many owners have not made decisions as to how they will occupy their buildings, going forward. As a result, the inventory level for smaller, owner-occupied buildings is low, and these buildings are still commanding high prices.

To sum it all up, the office asset class, as landlord, tenant, owner or buyer, will continue to be difficult to navigate for the foreseeable future. The number of impending lease expirations in the coming months will also impact what happens, and valuations. R.O.I. believes that the distress this sector ultimately experiences remains the biggest question of all commercial asset classes.

For expert guidance in buying, selling or leasing commercial real estate, contact the team at R.O.I. Properties: info@roiproperties.com or 602-319-1326.

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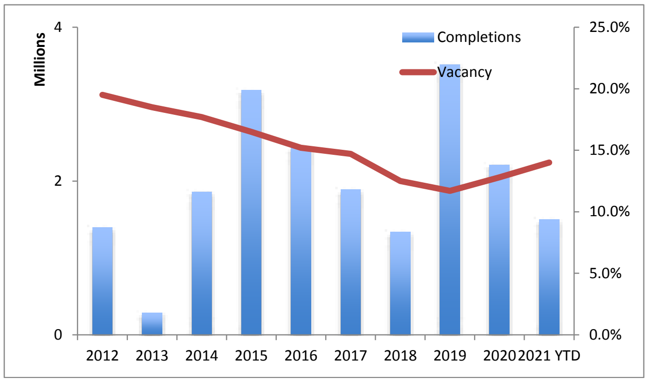
Office



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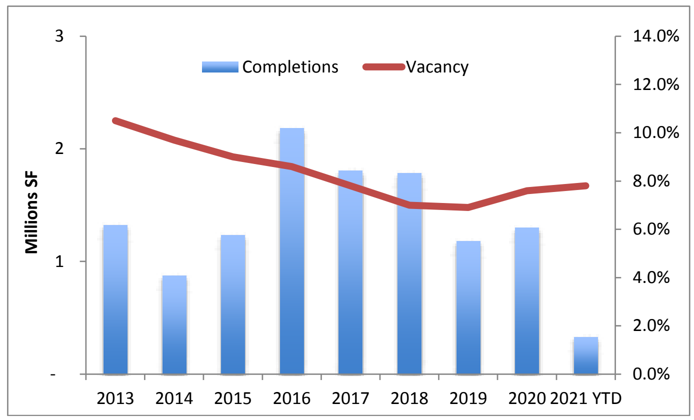
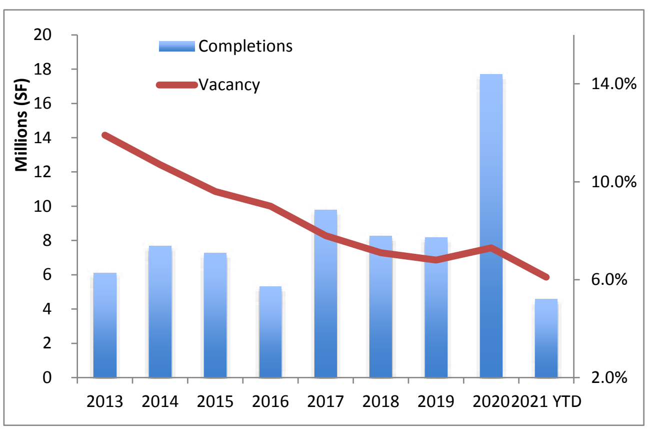
Retail

Retail rent growth has slowed since the onset of the pandemic, following a long stretch of gains. Annual rent growth grew by an average of 2.9% from 2017–19, outpacing the National Index. Over the past 12 months, same-store rents changed by 1.9%.

Strip mall and neighborhood centers have realized the strongest rent growth, though still modest over the past few quarters. Larger malls continue to struggle; the segment has recorded measurable rent reductions over the past few quarters. Malls that have diversified their tenant bases to include more "internet-resistant" tenants such as theaters, restaurants, and even office space have fared better than malls whose main composition is apparel retailers. However, the pandemic hit many of those internet-resistant retailers the hardest due to social distancing.



Industrial

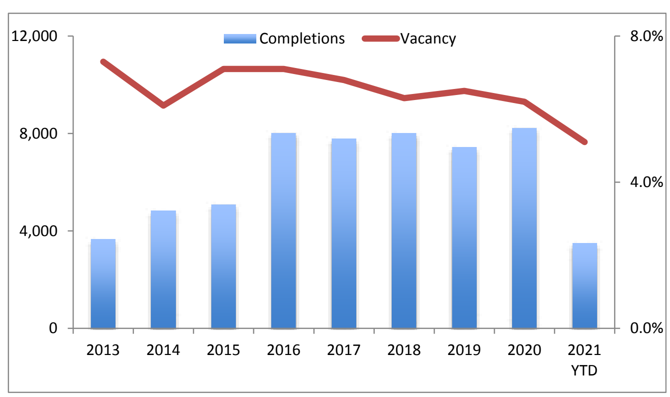


Industrial tenants are searching for more space in the Phoenix market than they ever have, following a historic year for both net absorption and supply additions. In Q1 2021, leasing volume climbed to more than 6 million SF—a new market high. The increased consumer dependence on online ordering throughout the pandemic has fueled demand for warehouse and distribution space. Amazon alone has penned 12 leases from January 2020 through May 2021 and has also completed ground-up construction. Its leases range in size from a massive 1.1 million-SF distribution and fulfillment center to a 100,000-SF last-mile facility. The e-commerce giant planted its largest stake in the market late last year upon the delivery of its two-story 2.3 million-SF robotics fulfillment facility in Goodyear. It's not just Amazon that is driving demand. The largest occupancies in recent months represent a variety of industries, including e-commerce, advanced manufacturing, food and beverage suppliers, pharmaceuticals, and data centers.

Multifamily

Multifamily rents continue to climb, and Phoenix remains one of the top markets in the country for rent growth. Despite rent gains that have consistently outstripped the U.S. average over the past five years, Phoenix has maintained its place as an affordable market in the Western region. Rents are below the national average and account for about 20% of the metro's median household income. That rent-to-income ratio is much more favorable than Los Angeles, San Francisco, San Jose, and Seattle—all of which are markets that recorded negative year-over-year rent growth in 2020.

Rents in Phoenix recovered from the COVID-19 dip faster than most large markets. A key reason for the impressive local performance was that stimulus payments went a longer way in Phoenix than they did in pricier metros.



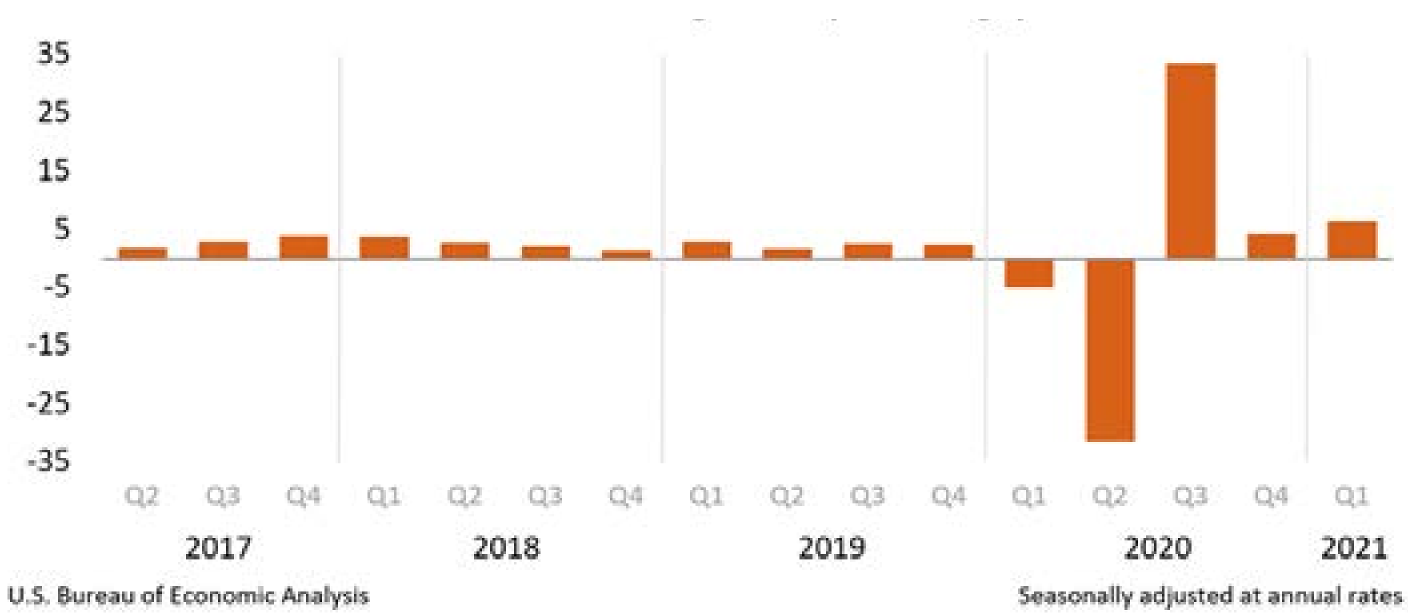
Residential Snapshot

This month's decline in the overall supply-demand index resulted from a gradual rise in supply and not falling demand, as was previously the case. Pricing going forward will be dependent upon supply levels—and unless there is a dramatic increase in supply, values will likely just stabilize. Here are a few of the other key statistics shaping the Greater Phoenix residential market:

- Supply remains extremely low, down 59% from this week last year. Since mid-February, however, it stopped dropping and now has shown a rise of 14.5%.
- The price range with the highest percentage gain in supply is $400K–$800K, up 45%. The $800K-$1.5M range saw an increase of 30% in the same time frame; over $1.5M only rose 4%.
- Since the supply rise began in mid-February, the weekly number of list price reductions in the $600K–$800K price range have more than tripled, despite the time on market remaining low and stable. All other price points have little to no discernable change in price reductions for now.
- Sales over asking price comprise 58% of all May sales to date through the Arizona Regional MLS.
- The average sales price per square foot is currently $251.83, up 39.7% over last May and 2.6% higher than last month.
- Over the past 6 months, the median cost for a 1,500–2,000 SF home in Greater Phoenix has risen $55K from $320K to $375K, up 17%.

Real GDP

Real gross domestic product (GDP) increased at an annual rate of 6.4% in the first quarter of 2021, reflecting the continued economic recovery, reopening of establishments, and continued government response related to the COVID-19 pandemic. In the first quarter, government assistance payments, such as direct economic impact payments, expanded unemployment benefits, and Paycheck Protection Program loans, were distributed to households and businesses through the Coronavirus Response and Relief Supplemental Appropriations Act and the American Rescue Plan Act. In the fourth quarter of 2020, real GDP increased 4.3%.



Consumer Confidence

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

"GDP will likely grow by 6.6% or more this year because of the additional fiscal stimulus passed by Congress. The stimulus checks last month boosted personal disposable income by 67.7% at a yearly rate, which led to a 11.3% gain in consumer spending in the first quarter. The quarterly savings rate jumped to 21%, far above the normal level of 7.5%, indicating that more spending is on tap later in the year... Strong GDP growth of 6.4% in the first quarter will be typical for the rest of the year. Consumers bought big-ticket items and other retail goods freely. Spending on dining out and recreation services surged, and is only beginning a strong upward trend. Travel will be picking up, as well."—Kiplinger Economic Forecasts, GDP: Strong First Quarter, More Gains to Come

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Articles of Interest

Globe St. – May 25
Office Vacancies Are High But Investors Don't Seem To Care

Phoenix Business Journal – May 14
Zoom rooms. Lockers. Office hoteling. Here's how the hybrid model is shaping office design

Phoenix Business Journal – May 10
International investors likely to increase Phoenix real estate holdings this year, report says

Trepp – May 27
Pendulum Swing in the Office Sector: Where Will the Market be in January 2022?

AZ Big Media – May 27
Phoenix retail vacancy drops as leasing activity accelerates