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

R·O·I PROPERTIES®
ENHANCING REAL ESTATE ASSETS

December 2023

Lost in Syndication

After a few years as the asset class of investor choice, multifamily continues to experience headwinds. The latest indication of weakness are properties selling at a loss, facing foreclosure, watch-listed or in work out.

In many instances, these properties are owned by funds, bringing together investors, through syndication. Many of these funds are facing loan maturity, at significantly higher rates than existing loans, with lower rent rolls and net operating income than when the loans were put in place. As a result, some funds are in the midst of workout discussions with lenders and/or proactively selling properties at a loss prior to loan maturity.

For additional insights on this trend, please see “Syndicators Are Sinking. Who’ll Make It Out Alive?” in the Articles of Interest section on page 4 of this month’s newsletter. The bottom line: The problem is compounded by syndicators who overpaid for assets, failed to complete renovations, haven’t been able to raise rents, and are inexperienced in negotiating workouts.

A Look at the Broader Market

Banks continue to work with borrowers and are doing whatever they can to avoid taking office and other management intensive properties into their portfolios. They are in the business of lending, not owning. We are starting to see some deals trade at low pricing in office buildings in Central Phoenix, particularly Central Avenue, as many of those properties need to be completely renovated with new amenities. The One Camelback saga continues to evolve, after being converted from offices to apartments, contractor bankruptcy, then lender foreclosure. The latest news is that the lender, which has an asset management and development arm, is going to complete the project.

In contrast, retail has moved into a highly sought after asset class, likely overtaking industrial, shortly. As it turns out, all of the pandemic doomsaying was overblown and people do really want to go to the store, and to touch and feel merchandise. Strip centers and mixed-use properties in particular are in favor; earlier this month, the *Wall Street Journal* noted increased institutional interest in grocery stores and other recession-resilient stores.

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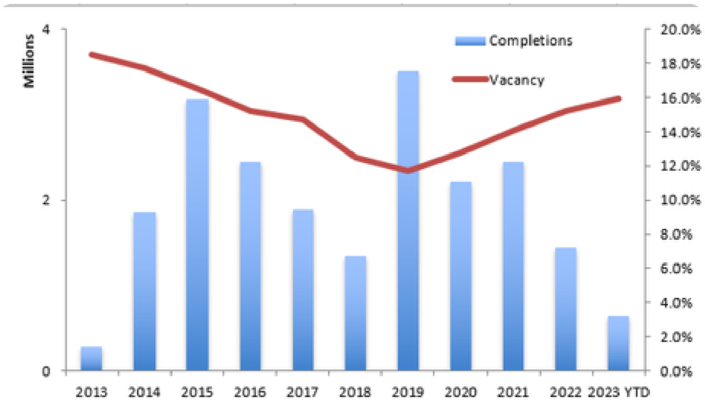
Office

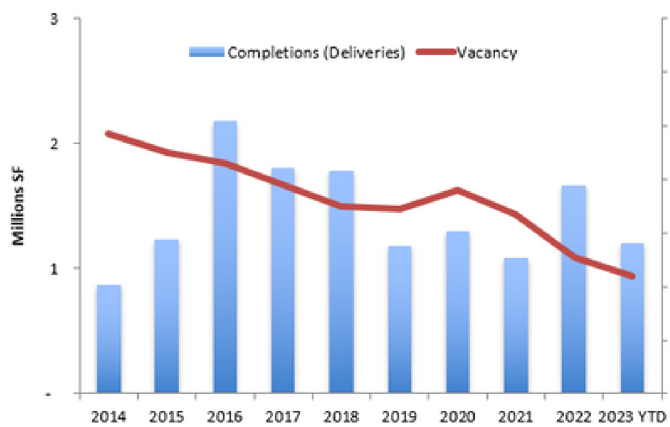


Supply-side pressure remains modest in the Phoenix office market. Just 760,000 SF of net new office space was completed over the past 12 months, representing a meaningful slowdown from the nearly 2.5 million SF that was added per year from 2015 to 2017. Weaker underlying tenant demand, coupled with higher development costs and limited availability of construction financing, has made it difficult for builders to profitably break ground. As a result, construction starts have slowed to the lowest level in over a decade with the bulk of the current pipeline composed of smaller properties and medical office space, two segments of the market that have shown more resiliency. About 1.1 million SF is currently underway, representing just 0.6% of total inventory.

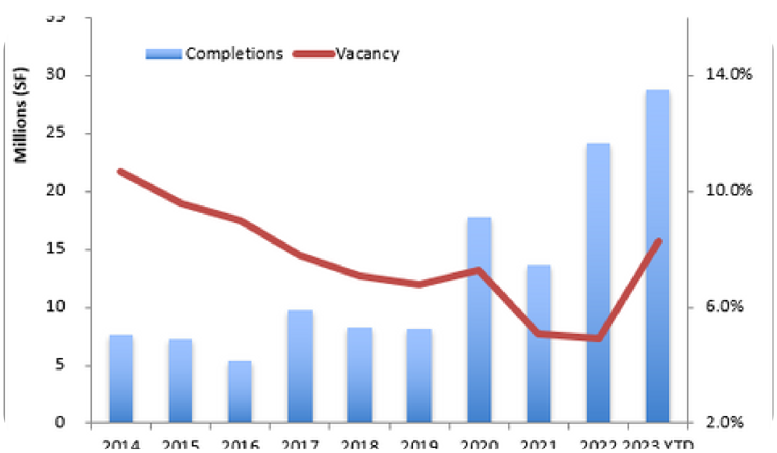
Retail

New supply additions have been modest during the most recent expansion cycle, supporting over a decade of steady improvement in the Phoenix retail market. Harsh lessons learned during the global financial crisis have left developers and lenders much more disciplined this time around, keeping supply-side pressure largely at bay. In the sector's heyday, from 2006 to 2008, builders delivered over 10 million SF per year, a far cry from the 1.4 million SF per year completed on average over the past 10 years.

Another key factor helping return balance to supply and demand has been the removal of older, obsolete stock. About 6.1 million SF of retail space was demolished over the past decade, largely driven by pre-1980s suburban product and department store closings.



Industrial



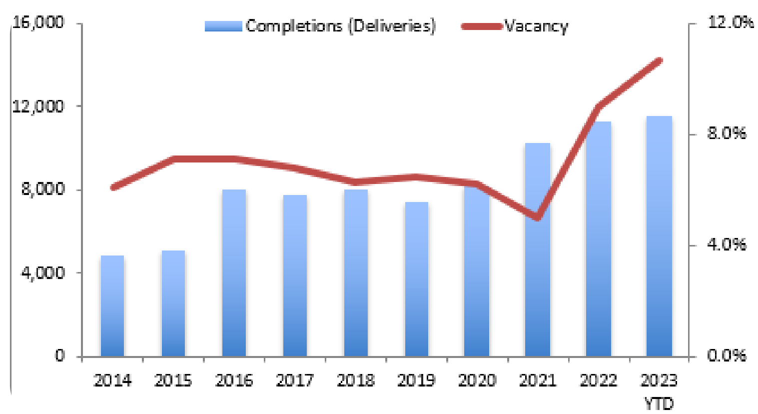
Conditions are shifting in the Phoenix industrial market as a wave of new construction overwhelms sturdy leasing activity. Developers completed a record 14.4 million SF in Q3 2023, outpacing the second-strongest quarter for gross deliveries on record by several millions of SF. The surge caused vacancy to spike to 8.3% today, erasing most of the occupancy gains made during the pandemic era.

While leasing volume has shown some signs of moderating, particularly for spaces larger than 350,000 SF, the substantial supply pipeline remains the primary driver of higher vacancies. A total of 40.8 million SF is currently under construction, which equates to 9.1% of the market's current existing total square footage. About two-thirds of space now under construction remains unleased.

Multifamily

Supply-side challenges plague the Phoenix multifamily market as a wave of deliveries overshadows rental demand. Over the past 12 months, apartment builders delivered 17,000 net new units, outpacing the pre-COVID five-year average of about 7,100 units per year. The surge in construction activity has kept vacancies on an upward trajectory since mid-2021 and turned rent growth negative.

The effect of the construction pipeline will be felt through 2024 and could linger into early 2025. About 35,000 units are under construction—9.4% of existing inventory. That figure ranks Phoenix as one of the most aggressively built markets in the country. With much of the development activity focused on luxury properties, supply pressure has been most acute in the Class A segment, though weakness has extended to Class B properties, as well.



Residential Snapshot

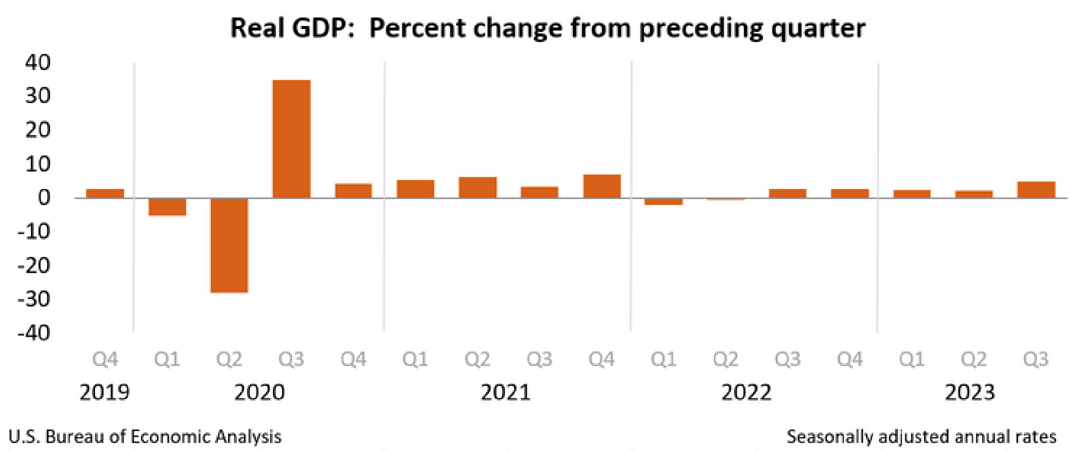
On December 13 the Federal Reserve held the Federal Funds Rate at its current level and indicated plans for three rate decreases in 2024. Mortgage rates responded with a drop from 7.1% to 6.6% within 2 days, where they have stabilized—down about 1.4% since October's 8.0% peak. On a $400,000 loan, that's $380 off the monthly payment.

From the vantagepoint of the annual holiday lull, it's a bit difficult to project how lower rates will affect supply, demand, and overall activity going forward. Theoretically, they may create more market demand and favorably impact sales volumes for homes under $1 million. More affordable rates might finally create opportunities for sellers who have been locked in for the past few years and free up their properties. On the buyer side, they could enable buyers to move up or get out of the rental market.

Other market factors that R.O.I. Properties is tracking include:

- The last 2 weeks of December are typically a "dead zone" for new listings as most sellers decide to wait until the new year. Of all the new listings added to the Arizona Regional MLS since the year 2000, January and March are the top months for listing a home.
- While buyer activity is expected to increase in 2024, it's uncertain how much new inventory will offset it. If the lower mortgage rates pull some sellers off the fence, then the market could stay in balance with unremarkable price appreciation. If sellers decide to stay put, then we could see a mild seller's market emerge once again, which would resume an upward pressure on price.
- The current state of pricing, as of December 22, is up 8.1% year-over-year and flat from November to December. The upward pressure on the overall average is due to luxury appreciation over $1M.

REAL GDP – Q3 2023

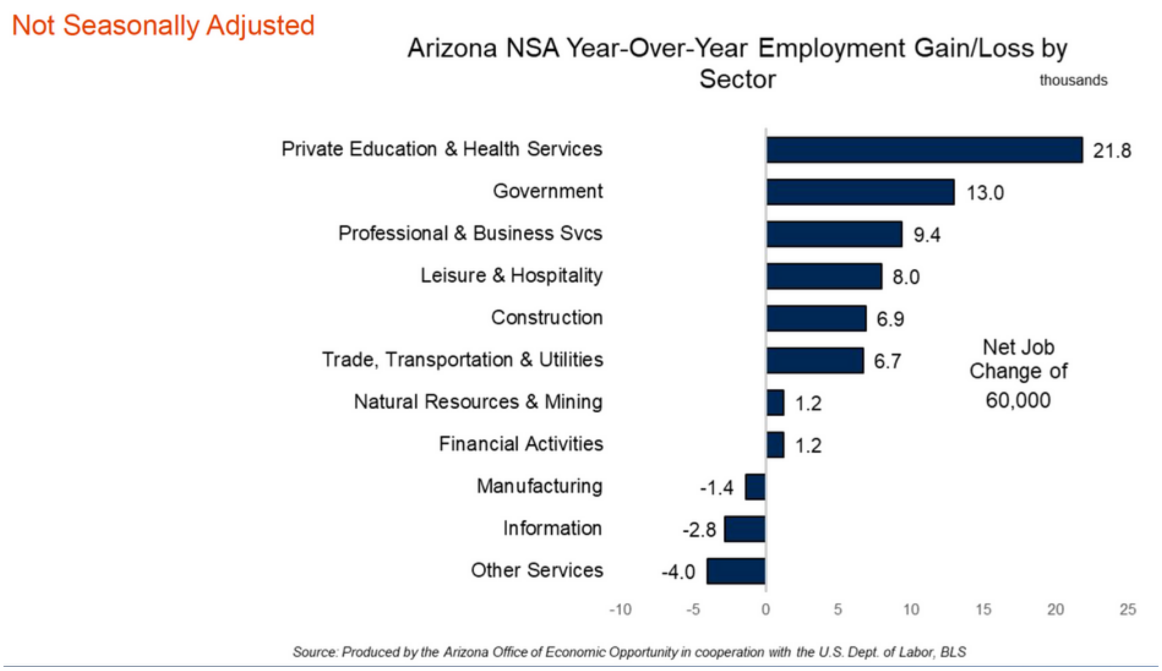


Source: Bureau of Economic Analysis

Real gross domestic product (GDP) increased at an annual rate of 4.9 percent in the third quarter of 2023, according to the "third" estimate released by the Bureau of Economic Analysis. In the second quarter, real GDP increased 2.1 percent.

The GDP estimate released on Dec. 21 is based on more complete source data than were available for the "second" estimate issued last month. In the second estimate, the increase in real GDP was 5.2 percent. The update primarily reflected a downward revision to consumer spending. Imports, which are a subtraction in the calculation of GDP, were revised down.

YEAR-OVER-YEAR EMPLOYMENT CHANGE



Source: Arizona Office of Economic Opportunity

- Arizona NSA nonfarm employment increased by 60,000 jobs (1.9%)
- Private sector employment increased by 47,000 jobs (1.7%), while government employment increased by 13,000 jobs (3.0%)
- Eight of the 11 major sectors recorded job gains. The largest gains were recorded in Private Education and Health Services (21,800 jobs) and Government (13,000 jobs). Losses were recorded in Other Services (-4,000 jobs), Information (-2,800 jobs), and Manufacturing (-1,400 jobs)
- Six of the seven Arizona metro areas (MSAs) gained jobs. The largest percentage gains were recorded in Yuma MSA (2.0%) and Phoenix-Mesa-Scottsdale MSA (1.9%)
- Losses were recorded in Lake Havasu City-Kingman MSA (-0.7%)

Articles of Interest

The Real Deal - Dec. 4
Syndicators are sinking. Who'll make it out alive?

MSN – Dec. 23
The Great American Warehouse Building Boom Is Over

GlobeSt. – Dec. 28
CRE Prices Continue to Decline

Phoenix Business Journal – Dec. 21
Mechanic's liens pile up at X Phoenix project, including $25M by general contractor

Wall St. Journal – Dec. 19
Investor Appetite for Retail Real Estate Is Heating Up Again

Phoenix Business Journal – Dec. 22
Camelback Corridor building sale is Phoenix's top office deal of the year

CoStar – Dec. 18
Manulife US REIT Sells Its Best-Performing Office Property