The Real State®

The Real State of the Phoenix Commercial Real Estate Market

R·O·I PROPERTIES®
ENHANCING REAL ESTATE ASSETS

February 2024

Let's Talk about Trends

Concerns about potential defaults on the multifamily side have been lingering for months, and we are finally seeing notices of trustee sales. We are closer to the beginning of the trend than the end, however, with a significant quantity of undelivered inventory under construction that's on peoples' minds—including lenders. About 33,000 units are in planning and/or under construction.

While the in-the-pipeline development has been dominated by class A properties in recent years, we are starting to see more affordable product emerge. Public-private partnerships, sometimes known as P3, foster development via nonprofit organizations funded with bonds, public funds or government monies through the state or city. P3 initiatives are prominent in the West Valley and we are seeing a proliferation of affordable builders and nonprofits that are focused on Low Income Housing Tax Credit (LIHTC) projects. The trend also dovetails with Gov. Katie Hobbs' focus on affordable housing, and the $49 million commitment to affordable housing developers announced in January by the Arizona Department of Housing.

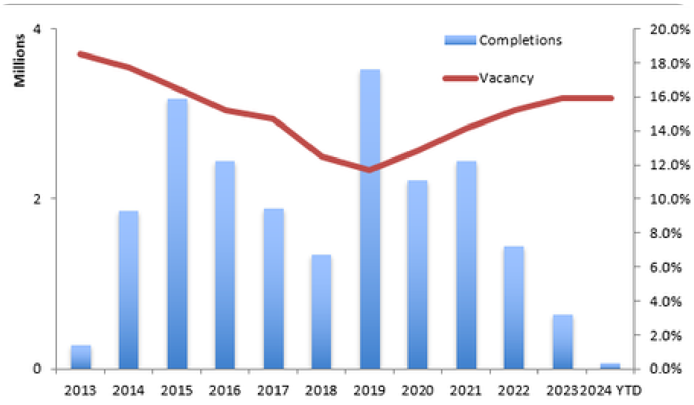
An additional trend we are seeing involves more deals structured as ground leases. As our community matures, there are fewer available key parcels located at major cross streets or with desirable frontage. With a ground lease, the owner of a property might lease the undeveloped commercial land to a third-party investor, while retaining the fee interest. Then, the investor may work with a build-to-suit developer to build a Chick-fil-A, Walgreens, or Raising Cane's. While many corporate owners used to require full fee ownership of the real property, many are now compromising and settling on long-term land lease interests, to secure the location.

Historically, there had been very little investor appetite for that type of transaction, since you're only getting a slice of interest in the property rather than the whole thing. But as well-located land becomes harder to come by, it requires creativity. Similarly, it takes a mindset change on the part of a landowner: Rather than selling a property outright, a ground lease offers the potential for a long-term annuity income stream.

Want to Learn More about the Potential of Ground Leases?

Ground leases require a mix of creative planning and thinking along with legal knowledge to create a structure that maximizes the value of your real estate assets. Contact the R.O.I. Properties team to learn more about this increasingly popular trend: info@roiproperties.com or 602-319-1326.

Office



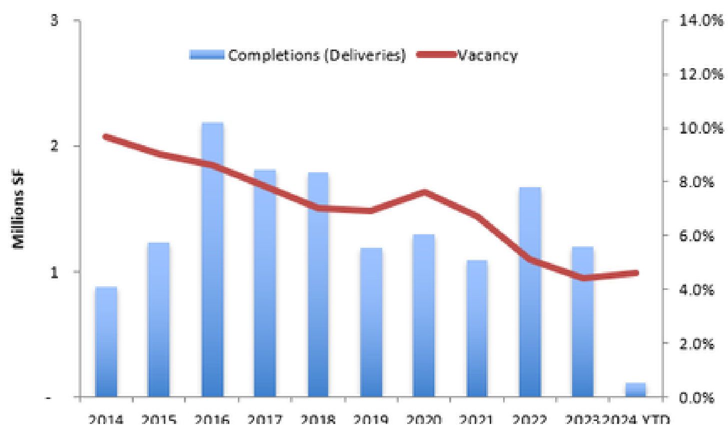
Supply-side pressure remains modest in the Phoenix office market as 2024 kicks off. Just 310,000 SF of net new office space was completed over the past 12 months, representing a meaningful slowdown from the nearly 2.5 million SF that was added per year from 2015 to 2017. Weaker underlying tenant demand, 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 as developers take a more cautious approach. New groundbreakings were down 60% in 2023 compared to the pre-pandemic five-year average. The bulk of the current pipeline is composed of smaller properties and medical office space, two segments of the market that have shown more resiliency. About 940,000 SF is currently underway, representing just 0.5% of total inventory.

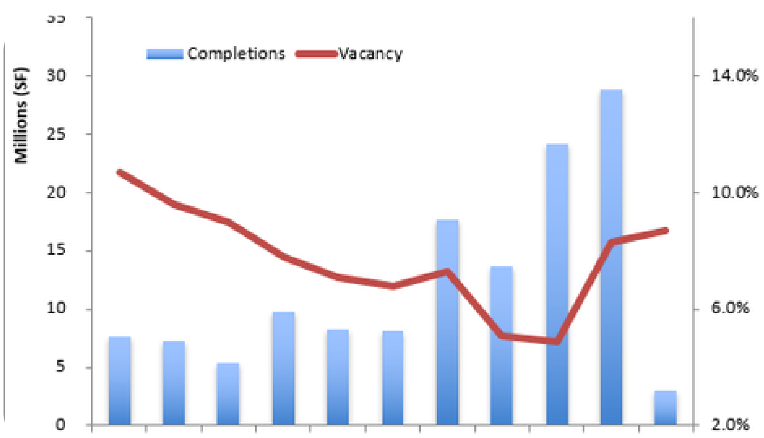
Retail

The Phoenix retail market is firing on cylinders in early 2024, with vacancy, space availability, and rent growth at multi-decade bests. Powerful demographics, healthy consumption growth, and the expanding local economy underpin robust retail demand. Additionally, a lack of construction and limited store closures further contribute to tight market conditions. These dynamics are expected to continue over the near term, setting Phoenix up for another year of outperformance.

The Valley recorded 3.6 million SF of net absorption in 2023, trailing only Chicago in terms of absolute demand. Grocers, gyms, and pickleball-related tenants are taking space in larger format boxes while quick-service restaurants, beverage shops, and service tenants fill smaller blocks. Geographically, the Valley's rapidly growing suburbs boast the strongest demand figures, tracing household formation and available land for retail developments.



Industrial



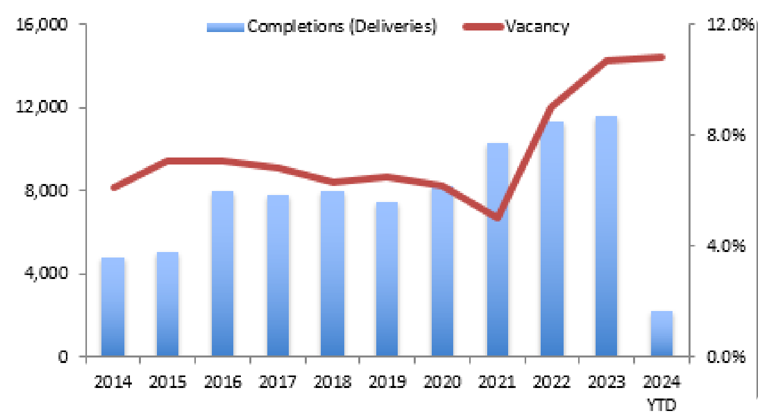
The Phoenix industrial market is facing one of the most aggressive construction pipelines in the nation. Developers delivered a record 23 million SF in the final two quarters of 2023, on pace with the completion total from 2017 to 2019.

The wave of supply is expected to continue over the near term with 43.9 million SF currently underway, the most of any U.S. market. That amount represents 9.7% of existing inventory, more than triple the 2.2% share for the national level. With two-thirds of development occurring without a tenant in place, the delivery of speculative buildings is expected to put further upward pressure on vacancy in the coming quarters. Supply-side pressure is most acute among big box space with about 60% of the total square footage in the pipeline comprised of buildings 250,000 SF or greater. The availability rate among properties of this size built since 2020 is over 25% and jumps to nearly 40% when including those currently underway.

Multifamily

Though renter demand rebounded in 2023, Phoenix's aggressive delivery schedule overwhelmed sturdy leasing activity, causing market conditions to weaken for back-to-back years. Vacancy has been on a steady upward trend over the past eight quarters and now stands at the highest level in over a decade at 10.8% as of early 2024. Amid increased competition, local operators have shifted their focus to maintaining occupancy at the expense of revenue gains, keeping rent growth decidedly negative at -1.8% and concession usage elevated. This persistent imbalance between supply and demand is expected to continue in the coming quarters as the full effect of the construction pipeline is felt.

The Valley recorded 10,000 units of positive net absorption over the past 12 months, the sixth most in the country and more than 35% above the pre-pandemic five-year average. High inflation and economic uncertainty, which were the primary culprits for weak demand in 2022, both improved last year, helping unlock renter household formation.



Residential Snapshot

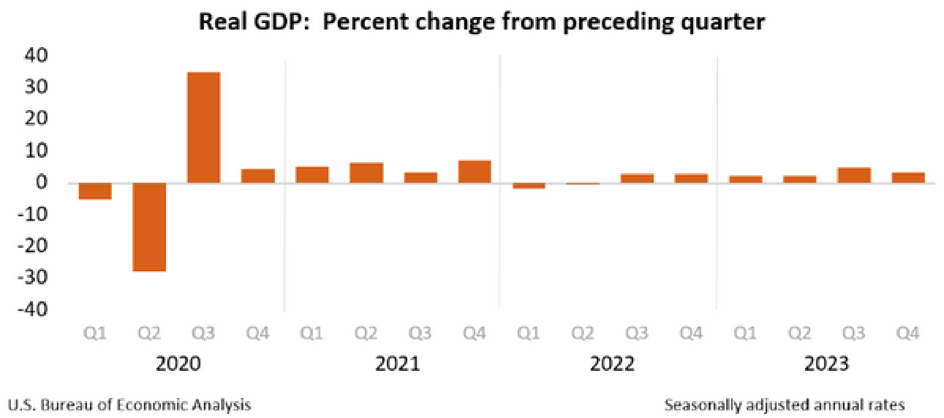
Perhaps it's appropriate for a month that starts with Groundhog Day: Like the Bill Murray movie, we're stuck in a loop without much real day-to-day change in the market. In the past few weeks, interest rates bumped above 7% once again, while inventory held relatively steady. Contract activity, which typically rises sharply from January through March, stagnated after rates increased and has been underperforming in comparison to 2023. Technically, we're in a slight seller's market, but buyers are seeing more negotiability and opportunity in some areas.

The market isn't going to change overnight. The majority of would-be sellers remain locked in, without the ability to move up or down due to interest rates. On the demand side, potential buyers are dealing with interest rate levels and the appreciated pricing we've experienced over the past four years.

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

- New listings for January exceeded last year by 16% and were the highest counts for January since 2020. While an improvement, this January was still the fourth lowest in 24 years for Greater Phoenix.
- Overall, supply has risen 10% over the past 6 weeks but is not rising evenly across the board. Condo/townhome listings are up 17%, mobile home listings are up 15%, and single family are up just 8%. All listings over $1M are up 21% while listings between $300K-$600K are up just 5%.
- Demand, which includes both listings under contract and closed sales, is running 22% below normal. That's an improvement over the past two months; December 2023 measured 31% below normal, which was the lowest demand index recorded since April 2008.
- 44% of February closings have involved seller-paid closing costs, including mortgage rate buydowns.

REAL GROSS DOMESTIC PRODUCT



Real gross domestic product (GDP) increased at an annual rate of 3.2 percent in the fourth quarter of 2023, according to the "second" estimate released by the Bureau of Economic Analysis. In the third quarter, real GDP increased 4.9 percent. The GDP estimate released today is based on more complete source data than were available for the "advance" estimate issued last month. In the advance estimate, the increase in real GDP was 3.3 percent. The update primarily reflected a downward revision to private inventory investment that was partly offset by upward revisions to state and local government spending and consumer spending.

Source: https://www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-second-estimate

GREATER PHOENIX BLUE CHIP ECONOMIC FORECAST

2023 ANNUAL PERCENTAGE CHANGE	Population	Personal Income	Retail Sales	Wage & Salary Employment	Manufacturing Employment	Construction Employment
ASU Economic Outlook Center	1.5%	5.9%	2.5%	2.1%	2.0%	4.5%
EconLit LLC	1.7%	4.5%	7.2%	3.4%	3.5%	3.2%
Elliott D. Pollack & Co.	1.7%	6.6%	2.9%	2.2%	1.4%	4.3%
Hoyle Cohen	1.5%	5.0%	5.5%	3.5%	2.8%	3.1%
Joint Legislative Budget Committee	1.7%	5.5%	5.1%	2.8%	3.5%	3.0%
Rounds Consulting	1.9%	5.5%	6.5%	2.5%	3.5%	3.0%
Southwest Growth Partners	1.8%	4.2%	6.8%	4.6%	4.0%	3.2%
The Maguire Company	1.7%	5.0%	6.0%	4.0%	4.0%	2.2%
University of Arizona Eller College	1.6%	6.4%	3.2%	2.4%	1.7%	5.2%
CONSENSUS	**1.7%**	**5.4%**	**5.1%**	**3.1%**	**2.9%**	**3.5%**

Source: https://seidmaninstitute.com/wp-content/uploads/2024/01/GPBC-2023-Qtr-4.pdf

Articles of Interest

Kiplinger – Feb. 13
January CPI Report: What the Experts Are Saying About Inflation

Phoenix Business Journal – Feb. 9
West Valley economic leaders align on development potential of key highway corridor

AZ Big Media - Feb. 27
High retailer demand fuels Phoenix retail market

AZ Big Media – Feb. 27
$500,000 grant supports preservation of affordable rents and mortgages

TreppTalk – Feb. 23
National Office Vacancy Rate Climbed in 2023 to Record 19.7%

Arizona Capitol Times – Feb. 8
Bill would allow commercial buildings refurbished into housing

Inside Tucson Business – Feb. 26
E-commerce is boosting the commercial real estate market