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

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MAY 2024

Monitoring the Market Signals in Multifamily

In the February issue of *The Real State*, we observed that notices of trustees sales began to hit the market, following many months of speculation about inevitable distress. The newest data points from Real Capital Analytics confirm the reasons for concern: US apartment transactions have hit their lowest level since the pandemic. "Nearly 1,040 apartment properties changed hands at a value of $20.6 billion during 1st quarter 2024. The overall sales volume during the quarter was down 25% from 1st quarter 2023, while the number of properties trading hands was down 26% during the same period."

Obviously, those are national figures, and Phoenix has its own dynamic. Our local observations are that properties are selling at a reasonable if slow pace, but at a 19-20% discount from where they were in late 2021 or early 2022, including Class A, B and C properties.

Like all commercial classes, multifamily is also suffering some drag from persistently high interest rates. Higher rates not only increase what investors are paying on loans, they make it more difficult to generate cash flow and overall returns and can exert downward pressure on valuations. The Federal Reserve's benchmark rate remains at a 23-year high—and the earlier statements of multiple rate decreases now appear overly optimistic, given that we remain well above the Fed's 2% inflation target.

For multifamily investors seeking a silver lining, the current environment in the Valley presents an interesting time to buy quality assets—with the knowledge that we are likely not done with distress on the multifamily side.

On a related note, Starwood Real Estate Income Trust recently announced that it would be limiting investors' monthly withdrawals to 0.33% of net asset value. About 48% of the REIT's holdings are in market rate apartments—which is part of their reason for a "cash crunch." In a shareholder letter, the company said, "We cannot recommend being an aggressive seller of real estate assets today given what we believe to be a near-bottom market with limited transaction volumes, and our belief that the real estate markets will improve." Contractually, Starwood can put specific parameters on when and how much an investor can withdraw. Above all, it is an interesting signal that a significant number of investors would be unwilling to stick it out at the current point in time—and it will be instructive to see if other multifamily-heavy REITs follow suit.

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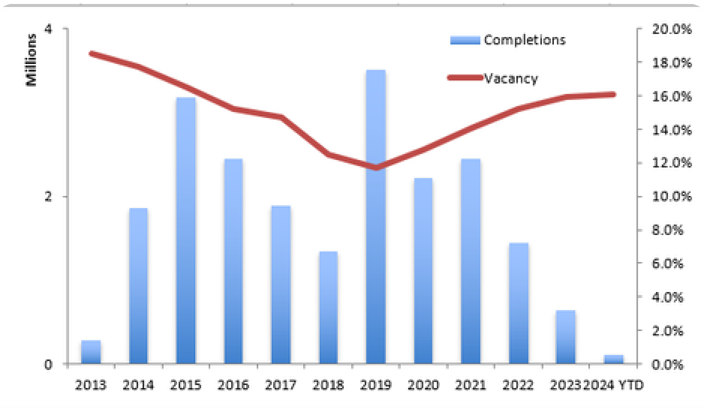
Office



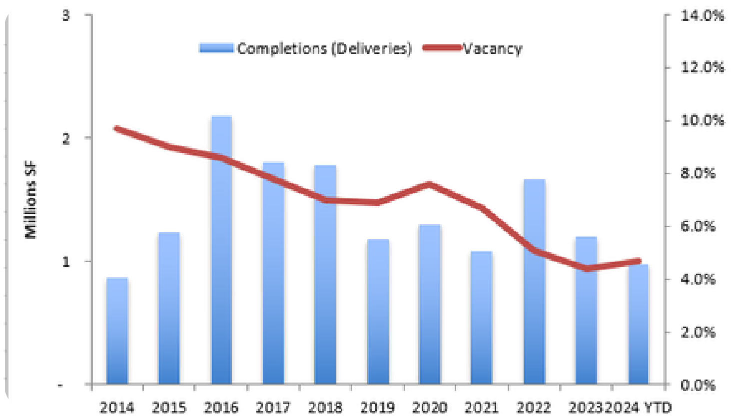
Supply-side pressure remains modest in the Phoenix office market. Just 490,000 SF of net new office space was completed over the past 12 months, representing a meaningful slowdown from the 2.3 million SF added per year from 2015 to 2019. Weaker underlying tenant demand, coupled with higher development costs and limited availability of construction financing, has made it difficult for builders to break ground.

As a result, construction starts have slowed considerably as developers take a more cautious approach. New groundbreakings are down more than 60% compared to the pre-pandemic five-year average, leaving just 1.1 million SF currently underway. That share represents about 0.5% of total inventory, lagging the 1.1% share seen at the national level. The bulk of the current pipeline comprises smaller properties and medical office buildings, two market segments that have shown greater resiliency.

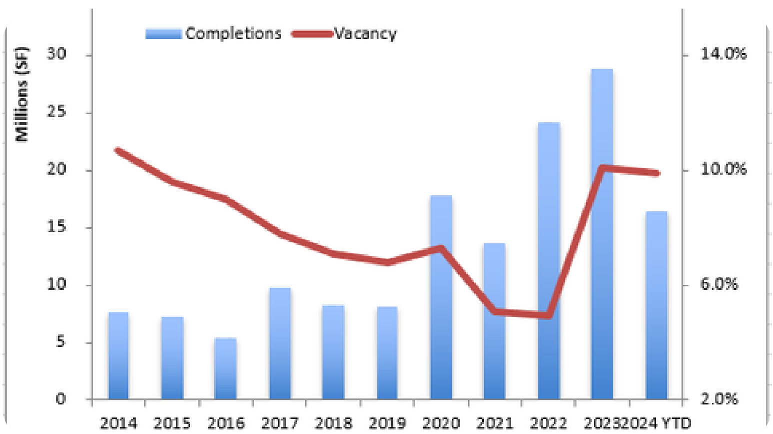
Retail

New construction has 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 Great Recession have left developers and lenders much more disciplined this time around, keeping supply-side pressure 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 ten years.

About 5.5 million SF was demolished over the past decade, primarily driven by pre-1980s suburban product and department store closings. Headlining this transformation has been the redevelopment of several enclosed shopping malls. PV Mall, Fiesta Mall, and Metrocenter Mall are all in various stages of reinvention. Final plans often feature more bar, restaurant, and entertainment space, as well as a residential or hotel component. This ongoing refinement of Phoenix's retail inventory has resulted in the existing stock featuring a greater concentration of quality space, with poor-performing properties often getting replaced by other uses.



Industrial



The Phoenix industrial market faces one of the nation's most aggressive construction pipelines. Developers delivered a record 42.4 million SF over the past 12 months, on pace with the completion total from 2014 to 2019.

The wave of supply is expected to continue over the near term with 32.8 million SF currently underway, the most of any U.S. market. That amount represents 7.0% of existing inventory, tripling the 1.9% 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.

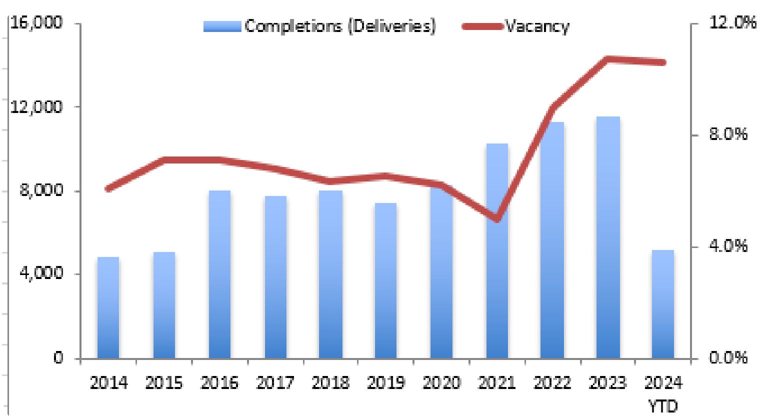
Supply-side pressure is most acute among big box space, with about 60% of the total square footage in the pipeline comprised of buildings 250,000 SF or greater. The availability rate among properties of this size built since 2020 is over 25% and jumps to nearly 35% when including those currently underway. For comparison, availability among properties smaller than 50,000 SF built since 2020 is less than 15%, and a fraction of the development is in this size tranche.

Multifamily

Supply-side challenges plague the Phoenix multifamily market as a wave of deliveries overshadows rebounding rental demand. Over the past 12 months, apartment builders delivered a staggering 18,000 net new units, outpacing the pre-COVID five-year average of about 7,100 units per year. The surge in construction activity has caused vacancies to rise quickly since mid-2021 and turned rent growth negative.

The effect of the construction pipeline will be felt through 2024 and could linger into 2025. About 33,000 units are under construction, representing 8.4% 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 also extended to class B properties.

Over the past few quarters, construction starts have begun to ease from 2021 and 2022's record levels. Lower rent growth projections, rising expenses, and higher exit cap rates have made it difficult for developers to break ground profitably.



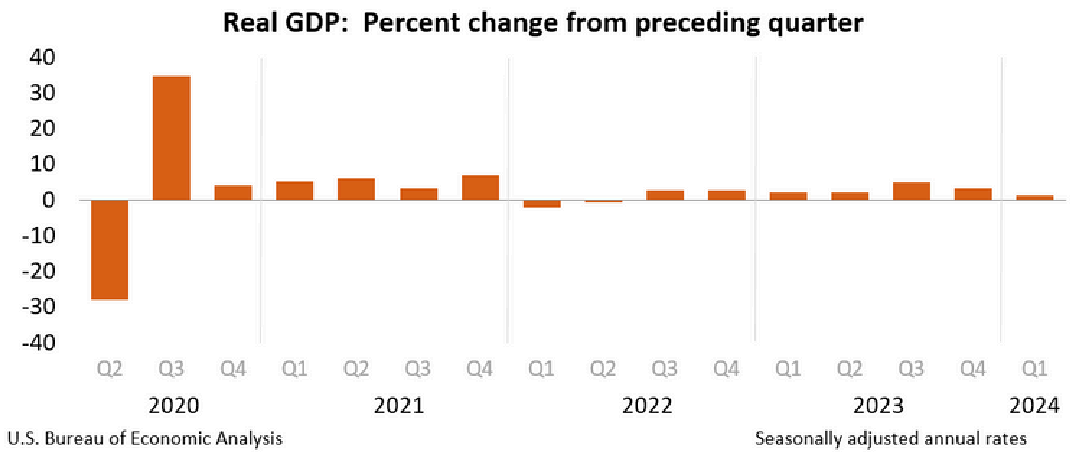
Residential Snapshot

For the third time in two years, the Greater Phoenix housing market has shifted into balance. April to May 2024, the supply-demand index dropped from 111.1 to 108.7, with supply up and demand essentially flat. The most affected properties in this type of market are the fixer-uppers: homes with extensive wear and tear, deferred maintenance, or in outdated condition. In Q1 2022, the market was so hot that these homes would fly off the market with little to no effort by the seller. By 2023 the market had cooled, so these homes would still sell, but their owners would take hits on price, repairs, and concessions to the buyer. In May 2024, buyers are gaining the advantage as supply continues to rise. Fixer-uppers should be priced to sell to investors, or have all necessary repairs and updates done prior to being listed—not to achieve a higher price but just to sell at all.

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

- Supply is up 48% over this time last year and continues to rise.
- There have been 41,207 total new listings year-to-date, up 16.6% over last year, but still the second lowest count historically going back to 2001; second only to last year, 2023.
- Historically in May, the median number of marketing days prior to contract has been approximately 3 weeks. Last year, it was 22 days and this year it's 27 days, the highest count for May since 2015. While an extra 5 days may not seem like much, it has led to a 67% increase in price reductions and the highest level of listing cancellations since 2016.
- Total sales year-to-date are down 4.3% from last year and this May is 13.8% lower than last May. This makes 2024 the third lowest year in both year-to-date and May-to-date sales volume since 2003 so far. (#1 and #2 were 2008 and 2007.)
- In the luxury market over $1.5M, however, Greater Phoenix is having the best April and May ever for sales volume: up 30% over last year and up 3% over the previous high of 2021.
- As the supply-demand index moves into a balanced market, we expect the annual appreciation rate to move closer to the rate of inflation, which is currently 3.4% for the US and 2.6% for the Greater Phoenix area.

REAL GDP - Q1 2024

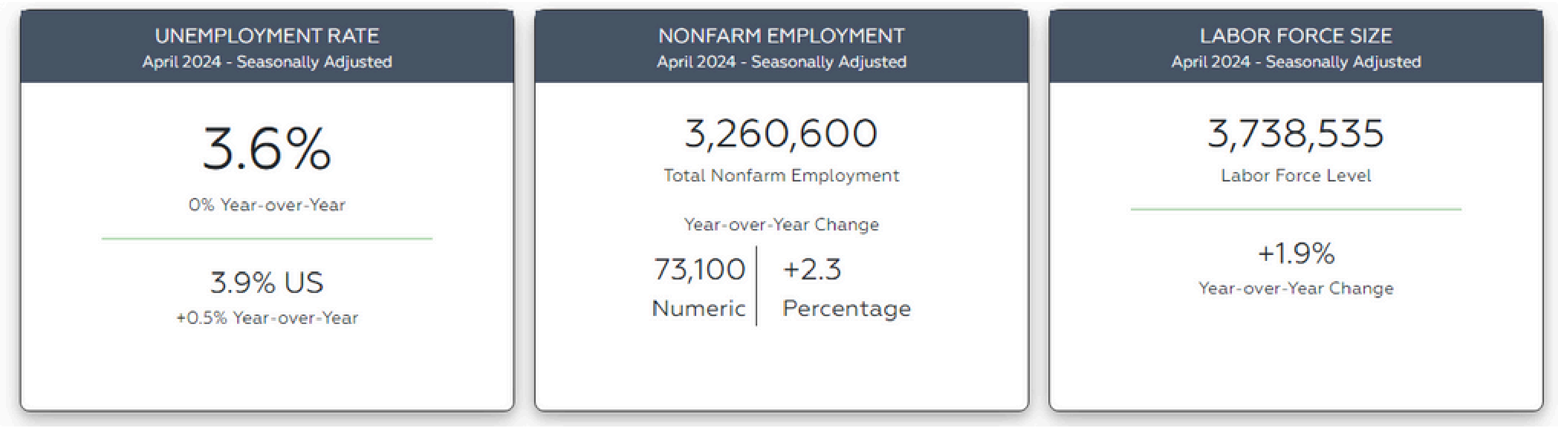


Real gross domestic product (GDP) increased at an annual rate of 1.3% in the first quarter of 2024, according to the "second" estimate released by the Bureau of Economic Analysis. In the fourth quarter of 2023, real GDP increased 3.4%.

The second estimate 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 1.6%. The update primarily reflected a downward revision to consumer spending.

Source: https://www.bea.gov/news/2024/gross-domestic-product-first-quarter-2024-second-estimate-and-corporate-profits

ARIZONA UNEMPLOYMENT DATA



The Arizona seasonally adjusted (SA) unemployment rate decreased to 3.6% in April 2024 from 3.8% in March 2024. The U.S. SA unemployment rate increased to 3.9% in April 2024 from 3.8% in March 2024. Month over month, Arizona's SA labor force increased by 2,971 individuals, or 0.1%. Year over year, the SA labor force increased by 68,041 individuals, or 1.9%. Month over month, Arizona not-seasonally adjusted (NSA) total nonfarm employment increased by 12,900 jobs. Year over year, NSA total nonfarm employment increased by 64,600 jobs, or 2%. Arizona SA total nonfarm employment increased by 9,800 individuals, or 0.3%, month over month.

Source: Arizona Office of Economic Opportunity

Articles of Interest

TreppTalk – May 17
TreppWire Week in Review: Uncovering the Latest Office Sector Developments

AZ Big Media – May 30
Here's how the office-to-apartment conversion trend impacts Phoenix

GlobeSt. – May 24
Starwood Further Limits Withdrawals

Phoenix Business Journal – May 30
SIGNS OF LIFE? Four years after Covid-19, Valley brokers and tenants cautiously see a new way forward

GlobeSt. – May 22
Fed Worries If Current Rates Are Enough to Tame Inflation

RealPage Analytics Blog – May 22
U.S. Apartment Transactions Slump to Lowest Level Since Pandemic

AZ Central May 29
Land auctioned near TSMC in Phoenix could see $7B in development, bring 50K jobs