The Real State®

The Real State of the Phoenix Commercial Real Estate Market

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ENHANCING REAL ESTATE ASSETS

December 2024

How Local CRE Is in Sync with National Trends

It continues to be an interesting period in the Greater Phoenix CRE market. There is money and demand in the marketplace, and deals are happening. As has been the case all year, cash is king: Financing is difficult to acquire, and high interest rates can make it a challenge for institutional and private investors to drive worthwhile returns. Because they are not reliant on leverage to make deals happen, cash buyers can focus on cash-on-cash returns rather than leveraged returns with high interest rates. Taking a broader national perspective, the current environment puts Phoenix right in step with two overall trends:

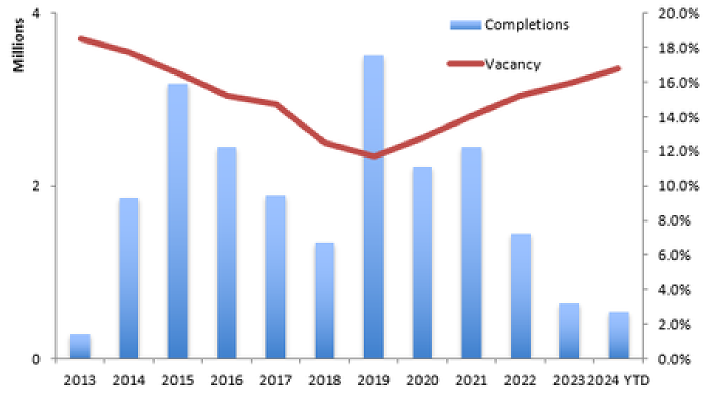
Trend #1: The Bifurcated Market
In the wake of the Fed's recent 25-basis point cut, Raj Aidasani, managing director at the CRE Finance Council, described the current commercial real estate market as bifurcated: "High-quality assets continue to attract capital while challenged properties face refinancing hurdles," he told *CoStar News*. "The Fed's likely pause after this cut suggests we're entering a period where property fundamentals, rather than monetary policy, will drive market activity." While he anticipates improvement in financing conditions for favored asset classes, the office segment will continue to be a challenge. His comments also fit the property owners in the Valley who would like to hold on to their assets but are struggling with the financing end as well.

Trend #2: Loans at Risk
While commercial mortgage-backed securities (CMBS) loans are generally larger than the types of loans that we see financed through our local commercial banks, Trepp's *November 2024 CMBS Delinquency Report* is instructive as far as what sectors are most at risk: The overall national delinquency rate increased 42 basis points to 6.40%, which is still well below the all-time high of 10.34% registered in July 2012 and the COVID-19 high of 10.32% in June 2020.

The report notes: "This month, the office, multifamily, and lodging property types all saw substantial increases in the sector-specific delinquency rates. The office delinquency rate surpassed 10% in November, increasing about 100 basis points to 10.38%. There were multiple large newly delinquent office loans that drove the office delinquency rate higher, with the office sector making up 60% of the net change in delinquent loan amount in November." While multifamily delinquencies are only at 4.18% nationally, that represents an increase from just 1.33% in April 2024.

In the Phoenix market, we are not seeing lenders necessarily declare default because that can trigger a series of actions that they might not be prepared to deal with, such as taking over and re-tenanting office buildings.

Office



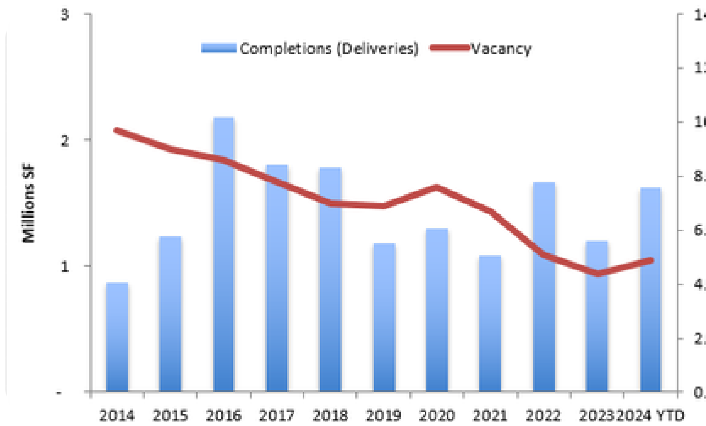
The steady rise in office vacancy remains unabated in Phoenix as the end of the year approaches. Many users are scrutinizing the effective use of their footprints, often resulting in space reductions or closures. Additionally, job growth has been sluggish in traditionally office-using employment sectors for over two years. This lowering of underlying space demand caused vacancy to climb more than 550 basis points since Q4 2019, and expectations are for further increases over the midterm as pre-pandemic leases expire.

The net amount of space vacated since the onset of COVID is nearing 5.5 million SF, well outpacing the total occupancy loss seen during the worst of the Great Recession. More than half of the space givebacks occurred in the past 18 months as weak tenant demand persists even four years after the pandemic's start. Empty space is accumulating more quickly in larger suites and single-tenant buildings than in smaller ones.

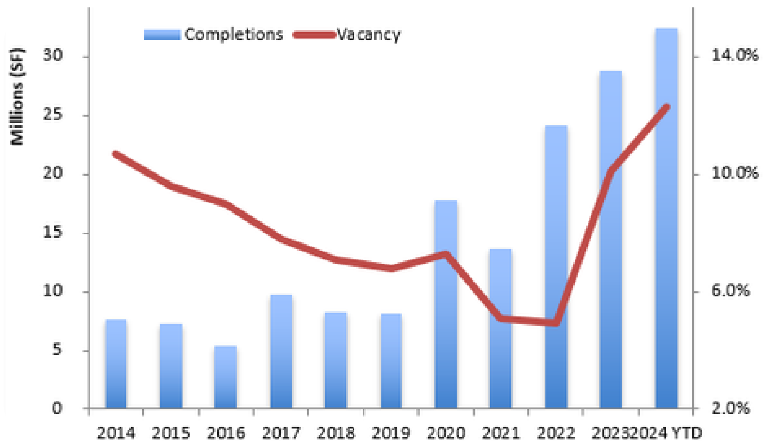
Retail

Though a pick-up in store closures caused net absorption to decelerate swiftly this year, fundamental tightness in the Phoenix retail market persists as 2024 nears its close. Strong demographics, continued income growth, and healthy job gains fuel robust underlying tenant demand. These stout demand drivers, coupled with the modest construction pipeline, have kept availability low and rent growth elevated.

The availability rate has risen to 4.8% thus far in 2024, up from 4.3% in late 2023. Bankruptcies by national brands, as well as the closure of some small-business tenants operating on thin profit margins, left several vacant spaces that have yet to be fully backfilled. Despite the modest increase, availability remains well below the low-8% range seen Q1 2020 as well as the previous cycle's low of about 5.8% in 2006. Additionally, local market participants report that competition for space is elevated and tenant retention is healthy.



Industrial



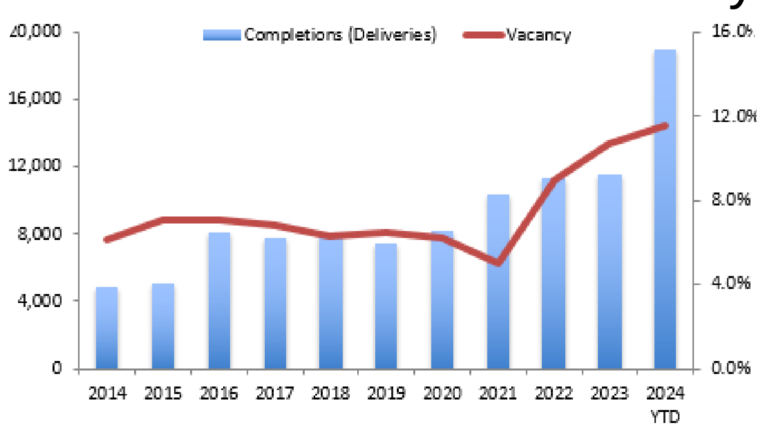
A deluge of new development completions continues to drive Phoenix's industrial vacancy rate higher, a condition that could persist well into 2025. Builders delivered an unprecedented 35.6 million SF of net new industrial space over the past 12 months, driving a normalization of market conditions. For comparison, Phoenix averaged 8 million SF of annual net deliveries in the three years leading up to the onset of the pandemic.

The wave of construction overshadows a resilient demand picture. While demand has eased from the frenetic pace seen in 2021 and 2022, leasing volume is 20% above 2019 levels as occupiers related to logistics, construction, and manufacturing continue to expand. For example, Logistics Plus and Amazon signed on for a total of 4.1 million SF at newly built industrial properties in the West Valley this year, reiterating the area's attractiveness as a logistics option. These factors, along with advanced manufacturing momentum, drove 13 million SF of net absorption over the past 12 months, the third most in the nation.

Multifamily

The Phoenix multifamily market took another step toward recovery in Q3 2024. Easing inflation and rising consumer confidence have unlocked renter household formation, driving a rebound in underlying tenant demand. Though new supply additions continue to outpace leasing activity, the rate of decline in occupancy has begun to flatten out, indicating that the start of a recovery in property performance could take place in the next year.

The Valley recorded 19,000 units of net absorption over the past 12 months, outpacing the pre-COVID five-year annual average of 7,200 units. Though the lease-up of newly delivered luxury complexes drove the bulk of activity, a turnaround among 3 Star properties has been the most notable trend. Midpriced communities saw 4,900 units of net absorption over the past 12 months, compared to thousands of units of negative net absorption the prior two years combined. These healthy demand figures caused metrowide vacancy to only rise modestly since the end of 2023, reaching 11.5% today.



Residential Snapshot

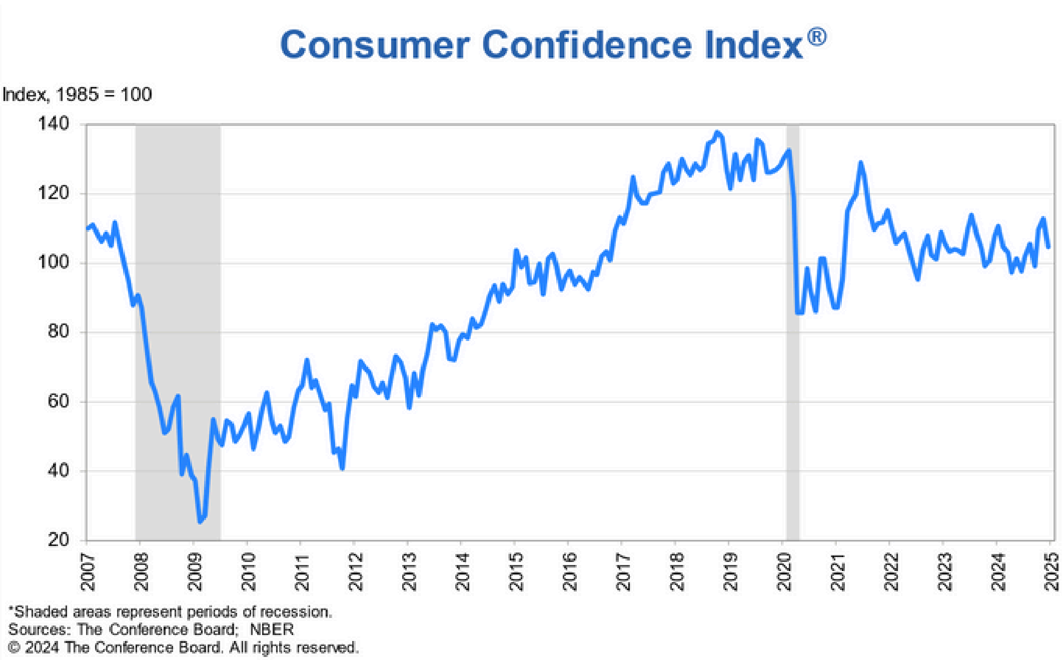
At the end of our second month of the 2024 buyer's market, the increase in inventory is beginning to impact pricing and deals. Although buyers technically have the upper hand, higher interest rates make it difficult to obtain affordable financing. Thinking back to 2021 and early 2022, rates were low enough that they were driving sales. That's not the case now, with mortgage rates exceeding 7% and defying the recent Fed rate decreases.

At the beginning of the year, we usually see an increase in inventory—people are done with the holidays and are ready to commit to a sale. The other piece of the puzzle: The original concerns from a supply standpoint were in the entry-level and move-up segments, because they are the most impacted by interest rates. Now we are seeing changes across the market, with more luxury inventory hitting and more high-end properties sitting on the market for longer. The luxury season kicks off in January, but there is already a lot of product out there to fulfill that need. If you start seeing signs springing up around your neighborhood, that means you have competition and need to manage your expectations—because supply and demand will eventually dictate lower pricing.

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

- Active listing counts this month are the highest Greater Phoenix has seen since 2015 and 2016, giving buyers a level of choice they haven't seen in 9-10 years. (2015 and 2016 were both mild seller's markets, because year-to-date sales were 19-23% higher than they are now.)
- All price ranges and property types increased in supply, but 75% of the supply increase is in condos/townhomes, mobile homes, and single family homes under $600K. This is good news for buyers in these markets.
- As of December 24, there have been 66,007 closed sales through the MLS this year, down 1.4% from last year through the same date. While 2024 has been a rough year for sales volume, closings to date are 26% higher than 2007 and 16% higher than 2008 when prices crashed.

CONSUMER CONFIDENCE



Source: Consumer Confidence

Present Situation

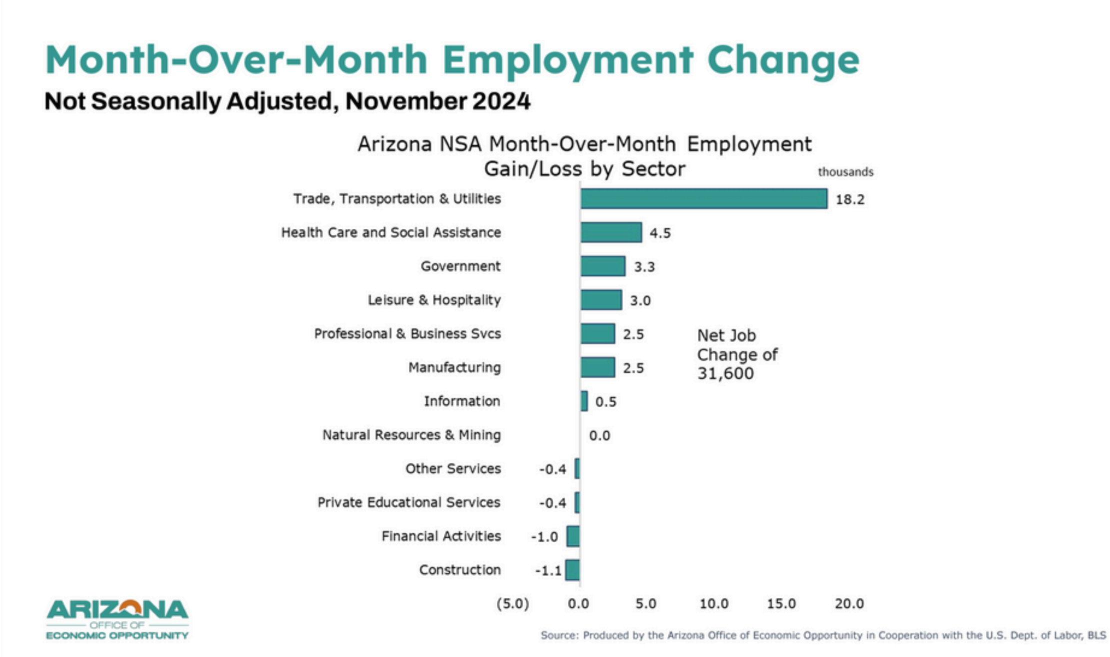
Consumers' assessments of current business conditions eroded somewhat in December.

- 19.1% of consumers said business conditions were "good," down from 21.6% in November.
- 16.7% said business conditions were "bad," up from 15.3%.

Consumers' appraisals of the labor market improved in December.

- 37.0% of consumers said jobs were "plentiful," up from 33.6% in November.
- 14.8% of consumers said jobs were "hard to get," down from 15.2%.

ARIZONA EMPLOYMENT REPORT – DEC. 19, 2024



Year-Over-Year Highlights for 2024

- Arizona NSA nonfarm employment increased by 59,800 jobs (1.8%)
- Arizona private sector employment increased by 50,700 jobs (1.8%), while government employment increased by 9,100 (2.1%)
- Nine of the 12 major sectors recorded job gains: The largest gains were recorded in Health Care and Social Assistance (26,200 jobs), Government (9,100 jobs), and Trade, Transportation & Utilities (8,800 jobs). The losses were recorded in Manufacturing (-600 jobs), Information (-700 jobs), and Construction (-900 jobs)
- All seven Arizona metro areas (MSAs) gained jobs

Source: Arizona Office of Economic Opportunity

Articles of Interest

Bisnow – Dec. 1
Beyond 'Retail-Curious,' Investors Are Ready For A Store Spending Spree

AZ Big Media – Dec. 27
San Francisco is most expensive office market; Where does Phoenix rank?

Phoenix Business Journal – Dec. 17
Peoria kickstarts plans for major development corridor near TSMC

GlobeSt. – Dec. 26
Nine of Top 10 Retail Metros Are in the Sun Belt, Says Study

Trepp Talk – Dec. 2
CMBS Delinquency Rate Soars Over 6% in November, Driven by Office, Multifamily and Lodging Sectors

CoStar – Dec. 18
Fed cuts interest rates again but signals slowdown on reductions in 2025