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The Real State of the Phoenix Commercial Real Estate Market

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JULY 2024

A Closer Look at Price Discovery in CRE

Phoenix is not alone in experiencing challenges in its CRE markets. Office assets are troubled nationwide, with prices down, subleases up, and investors and banks sitting on the sidelines. Multifamily, which was the CRE industry darling for years, is experiencing a price decline in many parts of the US, including the Valley.

As a result, it's a time of price discovery across all asset classes, particularly in the office and multifamily markets. Comparing previous sales to the most recent sale price is one way to get a handle on what we might expect going forward.

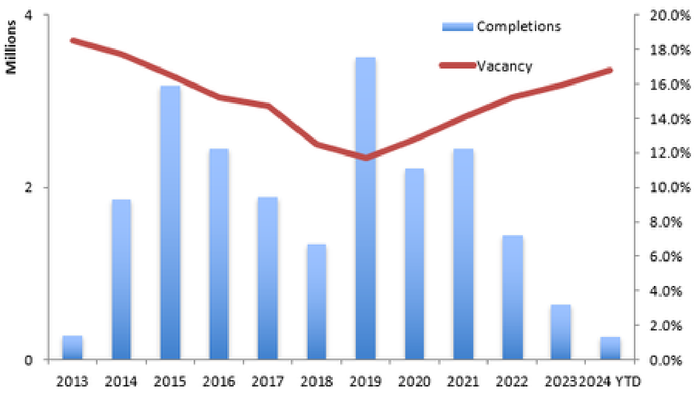
Even prime office assets, located in the most coveted submarket in Phoenix (Camelback Corridor) and that have been able to increase their lease rates, are seeing price declines. For example, 2375 E. Camelback Rd. (308,827 SF) sold for $100 million in June 2018, and sold for $86 million in April this year—a 14% decrease. Some areas are being hit even harder, such as the Central Ave. Corridor: 3200 N. Central Ave. sold for $49 million in November 2016, and sold for $24.5 million at the end of May—a 50% drop. In a less prominent corridor, 4801 E. Washington experienced a 47% decrease from November 2018 to this June. And, these are just a sampling of the deals that have sold. With very few transactions closed, we are just beginning to see what the market is telling us about price discovery.

CFOs and CEOs are experiencing resistance as they ask employees to get back to work. Multi-tenant offices are a difficult asset to work with, even if they get repositioned or repurposed. Owners need to wait for leases to term out (or for tenants to accept a buyout), or to bring in new tenants, usually with discounts. Meanwhile, the capital markets are not offering financing on many opportunities because of the risks and high vacancy rates; deals that are being done are all cash. While default rates increase, lenders are working with their borrowers/office owners, as these assets are complicated to manage through to repurposing.

While office has been experiencing turbulence ever since the pandemic, multifamily's market peak occurred more recently, in the range of late 2021 to early 2022. During the past 12 months, developers delivered 20,000 net new units—nearly triple the pre-Covid average—putting pressure on the market and pushing vacancies to 11%. What has price discovery looked like in the multifamily market? Recent sales have included 3213 E. Flower St. in Phoenix, a 20-unit property that fell from $15 million to $10.5 million in just under a year; 15501 N. Dial Blvd. (285 units), which sold for $117 million in May, a 10% drop since July 2021; and 15509 N. Scottsdale Rd. (240 units), which fell almost 34%—$145 million to $96 million—from May 2022 to March 2024.

While we have clearly fallen from the peak, we do not know if this is a bottom. What we do know is that there is value in the marketplace—and that there are property owners who acquired at the peak and do not ... *continued on page 4...*

Office

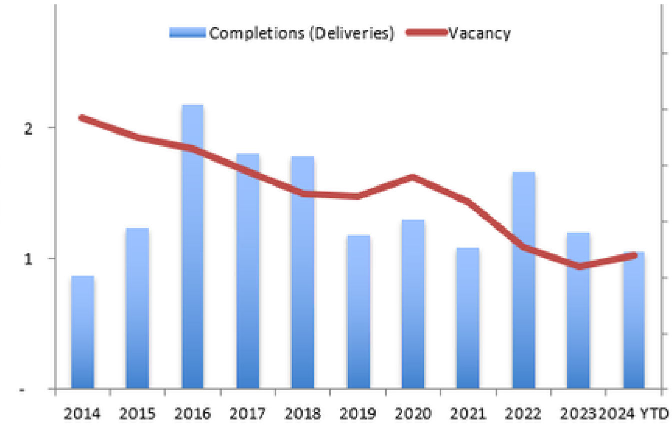


Supply-side pressure remains modest in the Phoenix office market. Just 480,000 SF of net new office space was completed over the past 12 months, representing a meaningful slowdown from the 2.3 million SF added per year from 2015 to 2019. Weaker underlying tenant demand, coupled with higher development costs and limited availability of construction financing, has made it difficult for builders to break ground.

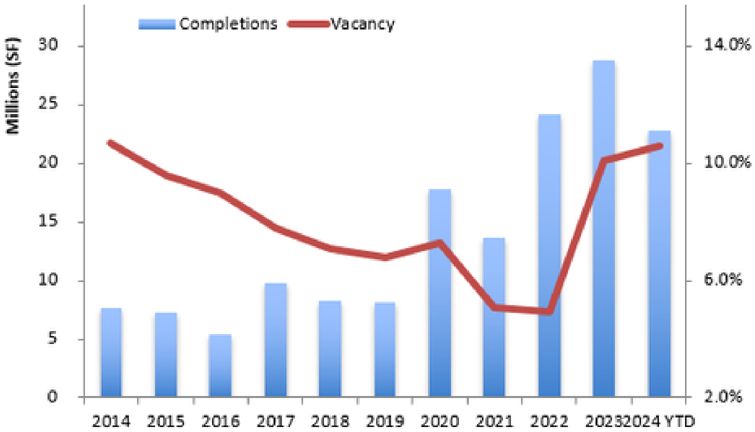
As a result, construction starts have slowed considerably as developers take a more cautious approach. New groundbreakings are down more than 60% compared to the pre-pandemic five-year average, leaving just 960,000 SF currently underway. That share represents about 0.5% of total inventory, lagging the 1.0% share seen at the national level.

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. Removing obsolete stock is another critical factor in helping return balance to the market. About 5.3 million SF was demolished over the past decade, primarily consisting of pre-1980s suburban product and department store closings.



Industrial



The Phoenix industrial market is contending with one of the most aggressive development pipelines in the country. Builders completed a record 43.6 million SF over the past 12 months, outpacing the cumulative completion total from 2014 to 2019.

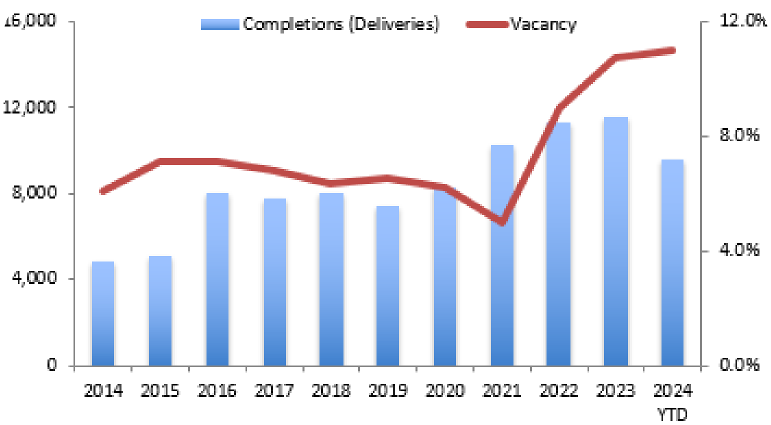
The wave of supply is expected to continue over the near term. Phoenix is now the nation's top construction market with 29.9 million SF currently underway. That amount represents 6.3% of existing inventory, tripling the 1.8% share for the national level. With more than 60% of development occurring without a tenant in place, the delivery of speculative space 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.

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 20,000 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 8.3% 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.



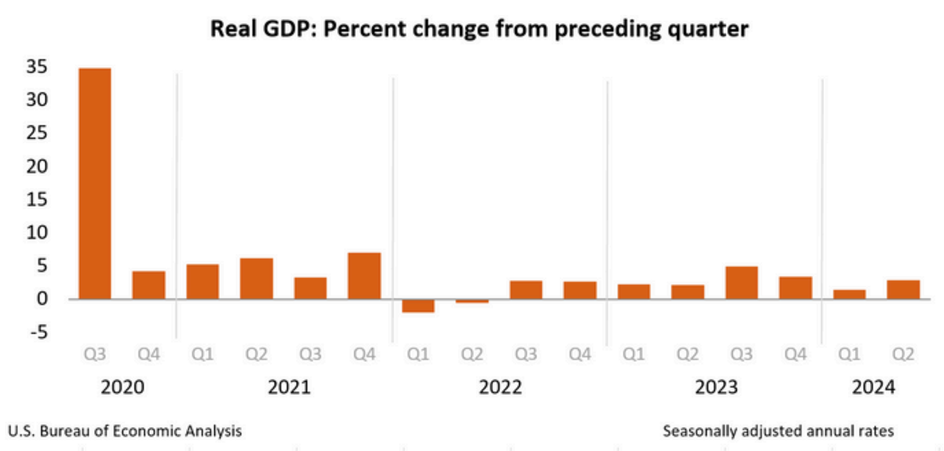
Residential Snapshot

Phoenix remains in an inventory-driven market, staying mostly stable with pockets of increased new listings in some areas. In neighborhoods with low inventory and high demand, buyers remain willing to step up and make a deal happen. From a seasonal perspective, we are close enough to the start of the school year that families are getting settled in rather than thinking about making a move; meanwhile, the luxury buyer base will not become active again till October rolls around. Once interest rates decrease sufficiently—and they will at some point—we can expect more inventory to hit the market, particularly from homeowners who have been locked in, unable to make a move up or laterally.

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

- Supply is up 61% over last year now but has remained stagnant for 10 weeks.
- The average list price per square foot has declined 9.5% since the start of May and price reductions are up 91% over last year. However, when listings over $1 million are removed, the measure changes to just 0.5% lower than the start of May.
- Demand is struggling this year, but even a mild decline in rates could make a difference during the remainder of summer. For example, the unseasonal bumps in contracts in August 2021 and 2022 were both fueled by brief declines in mortgage rates. Recent rate history indicates that demand could see a mild increase if rates declined just below 6.5%, less than a 0.4% difference from where they are now.
- Buyers with a contingent home sale, those utilizing downpayment assistance, low- or no-downpayment loans, or wishing to assume an existing sub-5% FHA or VA mortgage are finding more sellers willing to consider their offers—whereas a year ago they would've been rejected outright. Sales with seller concessions had 51% market share of all sales in both June and July, up from 43% last year, with a median contribution to the buyer of $9,600.

GROSS DOMESTIC PRODUCT (ADVANCE ESTIMATE) SECOND QUARTER 2024



Real gross domestic product (GDP) increased at an annual rate of 2.8 percent in the second quarter of 2024, according to the "advance" estimate released by the U.S. Bureau of Economic Analysis. In the first quarter, real GDP increased 1.4 percent.

The GDP estimate released today is based on source data that are incomplete or subject to further revision by the source agency. The "second" estimate for the second quarter, based on more complete source data, will be released on August 29, 2024.

Source: https://www.bea.gov/news/2024/gross-domestic-product-second-quarter-2024-advance-estimate

UNEMPLOYMENT - ARIZONA

UNEMPLOYMENT RATE
June 2024 - Seasonally Adjusted

3.3%

--0.5% Year-over-Year

4.1% US

+0.5% Year-over-Year

UNEMPLOYMENT RATE BY AGE
2022

5.3%

Total (16 years and above)

16.4%	8.1%	5.6%
16-19 Years	20-24 Years	25-34 Years
4.0%	3.6%	4.5%
35-54 Years	55-64 Years	65 Years+

UNEMPLOYMENT RATE BY EDUCATIONAL ATTAINMENT (2022)*

5.3% Total population

Educational Category	Rate
Less than a high school diploma	undefined%
High school graduates	undefined%
Some college or associate degree	undefined%
Bachelor's degree or higher	undefined%

*Minimum education as defined by BLS

Source: https://oeo.az.gov/labor-market/unemployment

A Closer Look at Price Discovery in CRE...*continued from page 1...* have equity at this point. Institutional interest has waned. More common buyers are private equity funds that are doing value-add deals for cash or more entrepreneurial well-capitalized private owners.

Why are owners willing to take such a significant haircut, rather than wait out the market? There can be a number of reasons, particularly for institutional investors—and they may not always be obvious. They may prefer to have a property off their balance sheet than to have to continue to throw dollars at a building that could require years of heavy lifting. Institutional investors may also be more influenced by what the market is telling them, or by what their investors are demanding, as opposed to the finances of a given property. What might look odd to the casual observer could be a result of rebalancing their portfolio or taking a different look at their asset load.

The positive news? While the big players may be steering away from various assets, entrepreneurial investors with a value mindset and cash may fare better in today's market. With pricing coming down, there will be unique opportunities to buy well-positioned assets that will generate income and appreciate in value over time.

Articles of Interest

Axios Phoenix – July 25
1 big thing: Office space conundrum

GlobeSt. – July 10
Distressed Properties See 43% Average Valuation Drop From Issuance

Phoenix Business Journal – July 30
Valley office tenant activity sees Q2 uptick despite more space being vacated

Phoenix Business Journal – July 18
Why Maricopa County was ranked No. 1 for economic development

Commercial Property Executive – July 29
$2B Phoenix Project Lands CHIPS Act Funding

AZ Big Media – July 30
The state of commercial real estate in Arizona and what to expect in the future