

# The Real State<sup>®</sup>

The Real State of the Phoenix Commercial Real Estate Market



March 2020

## CRE, Post-COVID

While the impact of the COVID-19 pandemic has been sharp and dramatic for financial markets and residential real estate, commercial real estate tends to move more slowly during times of disruption. Notwithstanding, we are seeing some deals cancel due to concerns regarding the economy, and it is certainly getting more difficult to get deals financed. The commercial deals that seem to be “sticking” are owner-occupant office and industrial product. Investor deals seem to be frozen, with investors anxiously waiting to see how all of this shakes out, and downward pressure in almost every asset class.

The landscape seems to be shifting with every announcement by federal and state authorities, and each tick of the Dow. With that in mind, here are a few of our observations:

- Some market experts indicate we will see a trough in April, followed by a recovery soon after that. While we want to be optimistic, we also need to be realistic: Foreclosures will be stalled and rent payments will be deferred, and it will likely be July/August before the full state of the market is clear.
- Similarly, the most sanguine view of commercial real estate investment is that it is not as volatile as the stock market, and the lower cost of capital offers an opportunity to significantly increase your returns. Historically, periods of recession and stock market turmoil have also led investors into hard assets for predictable returns. That rosy view, however, needs to be balanced with the potential for price drops in assets and erosion of equity.
- The financing of transactions is in a difficult period, as lenders assess what’s in their pipeline, how to value properties in a declining market and what protections to put in place to ensure performance. Marginal borrowers are going to face some serious headwinds. Additionally, equity requirements are already increasing, along with additional assurances, including heavy interest and expense reserves.

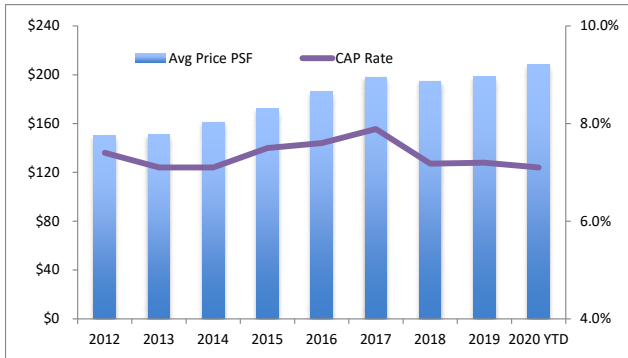
Several sectors are already experiencing significant changes/challenges:

- Multifamily: We have been cautious about multifamily in recent years, and there’s no way of sugarcoating the situation: It is going to be a problem if tenants can’t pay the rent. Additionally, it will be difficult for the Greater Phoenix area to digest existing inventory with unemployment increasing, and the 15,000+ units that are currently under construction (most of which is Class A product, with luxury amenities).
- Retail/Hotels: After several years of growth, retail (particularly restaurants) and hotels are getting hit particularly hard during their high season. Weaker operators will likely not survive, and this will be an opportunity to re-tool, for those who endure.
- Office: The nationwide experiment in working from home—and learning to Zoom on the fly—may have long-lasting effects on the office market. Based on early indications, we can anticipate a trend toward cohabitation and/or direct sublease. *Continued on page 3...*

### Stay Current

In light of the fast pace of changes in the commercial real estate space, we are going to be updating our LinkedIn page on a frequent basis with news and analysis. You can follow us here: [R.O.I. Properties – LinkedIn](#).

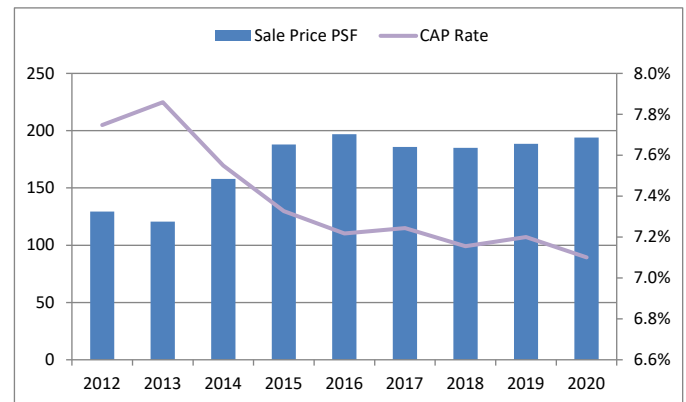
## Office



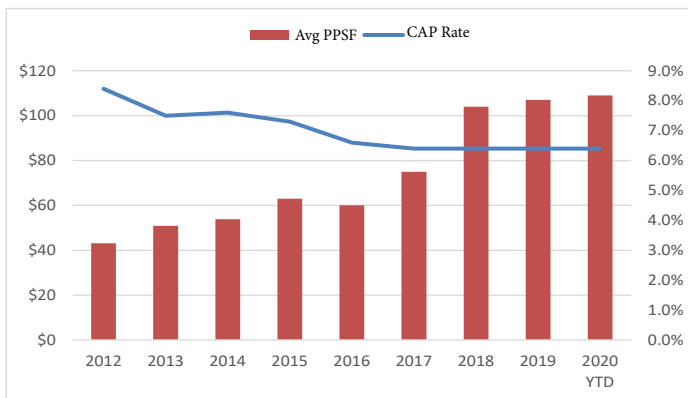
Before COVID-19, 2020 started off strong, with \$289.8M of office product sold year-to-date. At \$208/SF, the average price per SF represented a slight increase from the year prior. Likewise, so far in 2020, cap rates of 7.1% are slightly up compared to last year. Vacancy rates remain at 12.1%, but these numbers could change in upcoming months.

## Retail

Reporting indicates the average retail price per SF is currently \$188/SF. Cap rates for retail product have held steady around 7.2% for the past 4 years. Year to date, \$386.3M has been traded so far in 2020. Vacancy rates stood at 7% in the Phoenix metro prior to the impact of COVID-19.



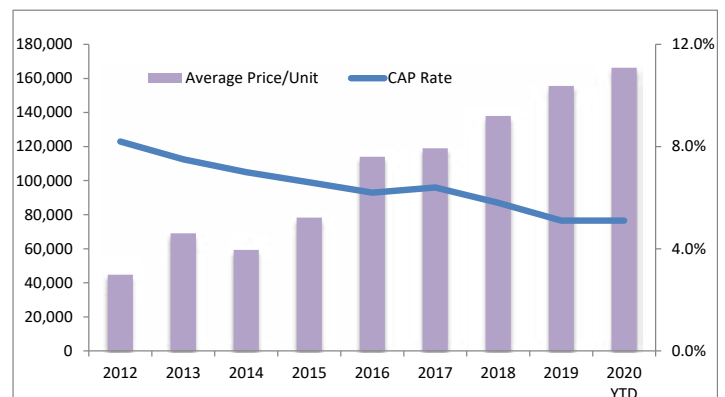
## Industrial



According to CoStar, over \$831.2M of industrial space has changed hands. The average price per SF has risen to \$109/SF in 2020, a record high in Phoenix. Cap rates have held steady around 6.4% the past three years, with vacancy rates at 7.3% prior to the virus outbreak.

## Multifamily

Multifamily was an investor favorite in 2019, with a reported \$6.83B in sales volume. So far in 2020, \$1.256B of multifamily product has been traded. At \$169,955/unit, average price per unit showed an 11% increase year over year. Cap rates are being reported at 5.0%, a cyclical low. With many investors growing wary of the market since COVID-19, we expect these numbers to slow drastically.



# Residential Snapshot

As is the case for commercial real estate, the financial effects of COVID-19 are creating a significant impact on the residential market. We are closely following key trends and metrics as the situation evolves, with the following items being top of mind:

- We believe that the market's best leading indicator is closed transactions (successful deals) and canceled transactions (deals that fell out of escrow, a byproduct of stress in the market)—and we're tracking those numbers daily. Since March 13, 2020, the average, per-day fall-through/cancellation volume is 80. When looking at that metric during the same period in 2019, the cancellation or fall-through rate was 1 per day. Still, there are deals being completed—almost exactly the same this year as last, around 350.
- Typical equilibrium in Arizona is around 22,000 units on market. We've been in a period where inventory has ranged around 8,000 and demand has been high. If you're looking for positive news, it's in the low supply, although that's climbed over 10,000 in the past week. The unanswered question at the moment is what happens to demand if it becomes more challenging to get financing or if unemployment numbers start to grow.
- With the announcement of the Federal Reserve dropping interest rates to zero earlier this month, logic would assume that bank mortgage rates would follow suit. That has not been the case, however; in fact, they have bumped up. We will be keeping a close eye on this.
- Multifamily is technically part of the commercial world, but it also impacts the residential market. As noted in our cover story, this has been an area R.O.I. has been cautious about for the past several years, because hot markets don't last forever. Here, we're watching the trends on rental payments and factors such as government actions.
- Even in rough markets, buying and selling property still goes on, but it requires a more thoughtful approach. At least for the time being, we're not going to see properties go on the market and sell the next day—although sellers who act sooner rather than later still have an advantage as far as relatively high comps and prices.

## Your Expert Commercial Real Estate Advisors Under All Market Conditions

At R.O.I. Properties, we know/understand the market, and are working hard to ensure that our clients thrive in every real estate market, and particularly as market conditions shift. If you would like objective, expert guidance on your individual circumstances, please know that we are here when you need us! Contact us at 602.319.1326.

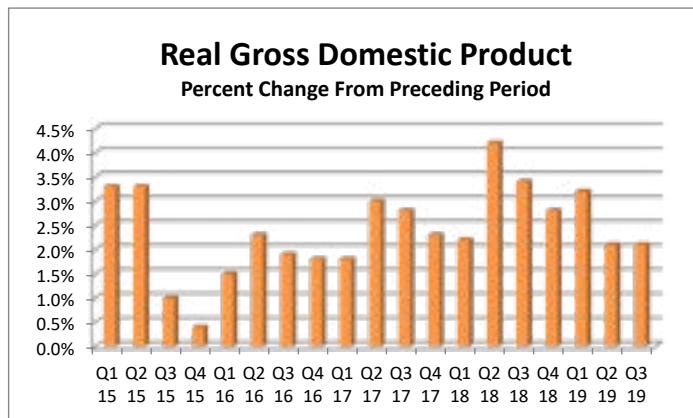
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- Net Lease: Investors' appetites for net-lease properties will be dependent on the financial stability of the tenant. Overall, we would anticipate cap rate increases and downward pressure on pricing.
- Industrial/Warehouse properties seem to be faring well, with continued and likely increased demand, with many of us ordering goods online instead of shopping. The supply chain can't rest, even as we work through this!
- Tech remains a bright spot, as well.
- On a positive note, the US Small Business Administration has announced that businesses within our region will be available to qualify for interim financing at extremely low interest rates. We've already been talking with clients about that, and hope it can serve as a lifeline for many of them.

Knowing the toll the coronavirus is taking on the nation's health and financial wellbeing, it can be a tough time to be optimistic and make big decisions. R.O.I. Properties is committed to providing stability for our clients during periods of uncertainty, anchored by our 17 years of service in the Greater Phoenix market.

We are here as advisors to assist you to meet the challenges you are having, or to create a strategy to position you for the coming years. Whether you need boots on the ground to do property checks, a broker opinion of value (BVO), or advice on the loan programs that are emerging, we are here for you. Please give us a call at 602.319.1326.

## Real GDP



Real gross domestic product (GDP) increased at an annual rate of 2.1% in the fourth quarter of 2019, according to the “third” estimate released by the Bureau of Economic Analysis. In the third quarter, real GDP also increased 2.1%.

The GDP estimate released today 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 also 2.1%. In the third estimate, an upward revision to personal consumption expenditures (PCE) was largely offset by downward revisions to federal government spending and nonresidential fixed investment.—*Bureau of Economic Analysis*

## Articles of Interest

### Phoenix Business Journal – March 24

[How the coronavirus is slowing Phoenix metro multifamily deal closures](#)

### CoStar News – March 23

[Coronavirus Concerns Spur Office Subleasing, Space Downsizing](#)

### DS News – March 23

[Is a Recession Already Here?](#)

### GlobeSt. – March 20

[As Unemployment Surges, Where Does Multifamily Stand?](#)

### GlobeSt. – March 23

[UCLA Forecasts Sharp Recession](#)

### GlobeSt. – March 23

[Some Landlords Are Using Force Majeure for Space Build-Outs](#)

### GlobeSt. – March 19

[Phoenix Cap Rates Tightened Last Year in Phoenix](#)

### Rose Law Group – March 19

[\(video featuring economist Elliott Pollack\) New \(Virtual\) Power Lunch...The New Economy](#)

### CoStar News – March 18

[Where the Brunt of the Coronavirus Impact Will Be Felt First in the Office Market](#)