

## PHOENIX

## MARKET

## HIGHLIGHT

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Despite talk of a residential slowdown, the Phoenix market forges ahead, posting strong absorption and development numbers. Vacancy figures have remained healthy while investors have remained focused on the burgeoning metro area.

### Office

The metro Phoenix office market posted its strongest net absorption in history at the close of 2006. Nearly 3.5 million square feet of office space were absorbed last year, reflecting the area's nationally recognized job growth and expanding population.

An estimated 115,000 new jobs were created in metro Phoenix in 2005. Since that time, new job growth has decreased slightly to 95,000 jobs in 2006 and projections for 2007 indicate 56,000 new jobs.

The metro Phoenix office market has experienced an impressive surge of activity in the past few years. During 2006, the market added approximately 2.5 million new square feet of office space to its inventory, and the direct vacancy rate was a very healthy 11.2 percent.

Investors have purchased metro Phoenix office buildings at a remarkable pace and for record-breaking prices. This investor interest, combined with higher construction and land costs and stronger demand for space, has fueled dramatic increases in rental rates. Office buildings in the prestigious Scottsdale area that commanded \$22 to \$23 per square foot 10 years ago are now quoting prices in the \$30 to \$35 per square foot range. It is not uncommon to see some developers construct buildings and sell them vacant upon completion.

With that said, the realities of the market are beginning to show through. Rates certainly have increased, but tenants are starting to push back on that escalation. Although contract rental rates are much higher, there is discounting in the form of free rent for strong credit tenants. Phoenix is no longer in a pure landlords' market, and negotiations are taking place. Class A tenants are investigating their options and many have chosen to relocate to Class B structures.

Experts are mindful of some fundamental issues facing the city. Job growth is slowing at a time when there is more than 4.8 million square feet of office space under construction. In order to maintain a healthy market and vacancy rate, net absorption in 2007 must equal or exceed the nearly 3.5 million square feet absorbed in 2006.

The slowdown in home building has resulted in cutbacks for many office users, such as homebuilders, title companies, civil engineering firms, mortgage lenders and brokerage firms. The market has not yet seen a significant increase in sublease space as a result, however.

Most of the new office space being created falls within the Class A category. It begs the question, "How deep is our Class A market?" Phoenix has become a hub of large, regional facilities and service centers, and is not a haven for corporate headquarters. The labor pool, favorable weather and relatively low cost of locating a business here have all contributed to the market's growth. Phoenix still looks very favorable when compared to Southern California or Chicago. However, as rental rates have increased, the market is now experiencing stiff competition from other western cities such as Denver, Salt Lake City and Dallas.

The expansion of Phoenix's biotech industry and the relocation of more significant corporate regional centers help in the effort to lure more higher-paying jobs to the city. As service centers continue to be sent overseas and technology enables more telecommuting, it is imperative that Phoenix solidify its place as a sophisticated, metropolitan area that can provide high-quality, educated labor for the skilled, professional jobs wanted here.

— Mike Beall is senior director of Cushman & Wakefield of Arizona Inc.

### Industrial

Phoenix has grown up, and industrial users throughout the nation have taken notice of this booming metropolis. The city absorbed more than 6 million square feet of industrial space in 2006, and more than 6.5 million square feet are currently under construction.

During the past 12 months, metropolitan Phoenix has experienced some significant shifts in its industrial real estate market. These changes are strong indicators of the area's maturation. Phoenix's population passed the 3 million mark, further underscoring the need for a significant industrial base just to service the city's own consumer needs.

Warehouse/distribution space has been the cornerstone of Phoenix industrial absorption for more than 20 years, and it continues to serve that role. However, as the city has grown, so has the size of its transactions; Phoenix now regularly attracts users with requirements exceeding 250,000 square feet. Acquisition transactions have grown in size, too, while cap rates have been compressed. Phoenix investors are anxious to purchase product, both leased and vacant.

Most submarkets now have moderate to high barriers to entry, a change that's taken place during the past 5 years. Demand has outpaced supply by such a margin that tenants are now pre-leasing facilities, a completely new trend in Phoenix. Developers have struggled to keep up with demand because the lease comparables simply have not supported the escalating costs of purchasing property and constructing new space. Land prices continue to rise, but people are optimistic that construction cost inflation will level off.

Recently, The Home Depot pre-leased 376,000 square feet of space on the west side of Phoenix. Transactions like this indicate that Phoenix will post net absorption of more than 1 million square feet in first quarter 2007 in the west Phoenix area alone. Existing tenants are expanding at a noteworthy rate. In addition, impressive in-migration has been evident. For example, Federated just recently purchased 50 acres in Goodyear, Arizona, with plans for a build-to-suit facility totaling approximately 600,000 square feet.

User demand completely outpaced supply in 2006, which resulted in lower levels of net absorption than anticipated. More than 6 million square feet were absorbed in 2006, compared to more than 9 million square feet in 2005. This was remarkable because the decrease was completely attributable to a lack of available supply. Several users wanted to relocate to Phoenix, but were forced to competing markets because their requirements could not be satisfied here.

The direct vacancy rate for industrial space hit a very low 5.2 percent at year-end 2006. Every submarket within the Phoenix area posted vacancy levels well below 10 percent. About half of the more than 6.5 million square feet under construction right now is being built in the southwest Phoenix submarket. In addition, more than 7.1 million square feet of space are proposed for development in the near future.

— *Pat Harlan is director of Cushman & Wakefield of Arizona Inc.*

## **Multifamily**

Low vacancies and high investor interest remain the hallmarks of the Phoenix multifamily market. Fueled by strong job creation and even stronger population growth, the market continues to be popular among buyers, sellers and renters, even amid ongoing corrections in the single-family and condo-conversion arenas.

Multifamily vacancy hovers around 7 percent, the lowest level in 6 years. With very little apartment construction, increasing interest rates and a steady influx of new people to the metro Phoenix area every day, the market's robust health is no mystery.

About 6,500 new units — 2 percent of the market's overall inventory — are expected to be delivered this year, on par with 2005's performance. The availability of land, as well as fierce competition for prime parcels from condo developers and other land speculators, will continue to restrict product supply, which, under other circumstances, would be around 15,000 units.

The few new projects that have emerged in recent months follow in the wake of the valley's light-rail construction and freeway expansion along the Loops 101 and 102 in the West Valley and Southeast Valley, respectively. Among the metro area's most exciting projects is Gray Development's Grigio, a 523-unit complex on the north shore of Tempe Town Lake. The development, which in February began welcoming tenants willing to pay as much as \$5,000 per month in rent, is billed as the valley's most expensive luxury apartment community.

Meanwhile, rising occupancies have had a positive effect on the elimination of concessions, which have all but disappeared in most areas. Shadow inventory, caused by failed condo-conversion units returning to the rental pool, has created a slight overhang in product, but nothing too concerning. At most, the additional inventory has prevented concessions from disappearing altogether.

Rising occupancy also has had a positive effect on the average rental rate, which, according to Real Data, was \$775 per month in 2006, up 6.8 percent from 2005. Similar growth is in store for this calendar year.

Rising land and construction costs, coupled with the aforementioned lack of site availability, have hampered new construction to the point where investors have resorted to scouring the market for value-add opportunities. Phoenix's abundant supply of product built in the 1980s and 1990s is in hot demand for its potential to garner \$75 to \$150 per unit in additional rent following interior renovations that range from upgraded flooring, lighting and kitchens to exterior painting, landscaping and amenities. A typical project might find an investor spending around \$85 or \$95 a door, plus an additional \$10,000 per unit in upgrades, a price tag still significantly below that of new construction.

Overall, look for value-add deals to replace new construction in Phoenix's infill locations. Investors with deep pockets remain sold on the metro area's growth potential and will continue to prowl the market in search of outstanding

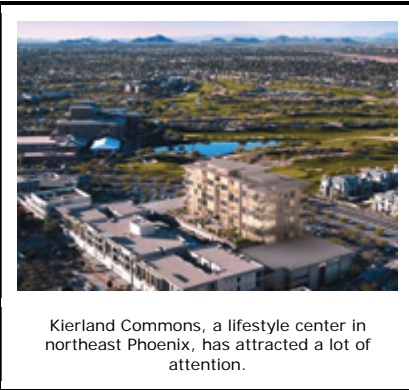
opportunities. Sellers will go on benefiting from the large amount of capital that remains heavily allocated to Phoenix. Although contending with significant future rent gains, tenants will find relative affordability compared to other western markets.

— Tyler Anderson is vice chairman at CB Richard Ellis in Phoenix.

**Retail**

Predictions of a slowdown in both the local housing market and the economy have not appeared to put the brakes on metro Phoenix's red-hot retail market, where nearly 10 million square feet in product is presently under construction.

Projects ranging from lifestyle centers to mixed-use developments are popping up all over the Valley of the Sun, sustained primarily by aggressive freeway construction and residential expansion to the outer fringes. The west/southwest Phoenix submarket led the area for new construction in 2006, with 1.3 million square feet of new retail space delivered. The Mesa/Chandler/Gilbert submarket followed with 1 million square feet completed last year. Approximately 36.5 million square feet of retail space is presently on the drawing board, with delivery scheduled during the next several years.



Kierland Commons, a lifestyle center in northeast Phoenix, has attracted a lot of attention.

In one of the most significant developments of the last few months, United Kingdom grocery giant Tesco PLC announced its expansion into the United States in 2007. Reports call for 50 stores in the valley, including locations in El Mirage, Queen Creek, Gilbert Mesa and Chandler. Tesco's announcement comes at an opportune time when traditional grocers, other than Wal-Mart, appear to be progressively scaling back.

Other newcomers to the area include Barney's New York, which announced plans to open a flagship store at Westcor's Scottsdale Fashion Square in 2009, and Dick's Clothing and Sporting Goods, which intends to break ground within the year on its first Arizona store, to be located near IKEA in Tempe.

The introduction of millions of square feet of new retail space has barely put a dent in the market's vacancy rate, which checked in at 5.14 percent at the end of 2006, 11 basis points lower than the same time the year prior. Rents also have been unaffected, with rates ranging from the mid-teens for big box space to a high of \$45 to \$70 per square foot in at least one upscale mixed-use development.

On the investment front, private capital investors and 1031-exchange buyers are beating the bushes for shadow anchor centers and core retail properties with top-flight locations, new construction and major tenants. Unfortunately, supply is tight as many owners are reluctant to sell, citing reasons ranging from market volatility to fear of being unable to find a trade that would generate attractive returns. In short, while demand for these core assets remains strong, the buying frenzy of the past 3 years for Class B and C assets is over, at least for now.

As for the future, investors and developers continue to keep an eye on the housing market, which economists predict will undergo a correction for all of 2007 and possibly into 2008. According to experts, an overabundance of housing inventory and continued affordability issues will place a drag on the market until supply and demand reach equilibrium. However, low unemployment rates, a solid job growth forecast and strong population growth continue to underscore the need for new retail development throughout the region.

— Bob Pearlstein is a senior vice president for CB Richard Ellis in Phoenix.

| <b>Phoenix</b>                                  |                 |                      |
|---|-----------------|----------------------|
| <b>4Q 2006 -- Class A Effective Rent per SF</b> |                 |                      |
| <b>SECTOR</b>                                   | <b>Rent PSF</b> | <b>ANNUAL CHANGE</b> |
| CBD Office                                      | \$24.01         | 9.3%                 |
| Suburban Office                                 | \$23.98         | 9.1%                 |
| Warehouse                                       | \$6.29          | 9.6%                 |
| Retail  | \$17.97         | 6.1%                 |
| Class A Apts                                    | \$11.55         | 7.9%                 |
| Class B Apts                                    | \$9.46          | 8.2%                 |

*Global Real Analytics, LLC (GRA) is an investment management firm that has published the National Real Estate Index commercial real estate market reports for over 20 years. A variety of local and national reports are updated quarterly. For more information, call (415) 733-5351 or visit www.graglobal.*