Looking back and moving forward

NAIOP-AZ leaders discuss the past, present and future of Arizona's commercial real estate industry

By DAVID MCGLOTHLIN

Often times in order to progress, one must first reflect back on how they got there, which is what board members of NAIOP-AZ did for this year's annual roundtable.

Despite being hard hit by the Great Recession, Arizona's commercial real estate industry continues to make a slow and steady recover that has most people optimistic the state is headed down the right track into the future.

With a combined 112-plus years of CRE experience and knowledge between them, this collection of NAIOP board members represent a diverse cross-section of disciplines and specialties in the industry.

DS: ***What is different in our local commercial real estate industry since last year?***

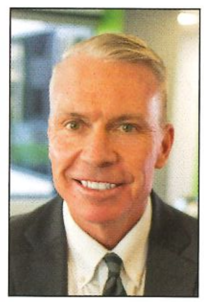
RK: A year ago, Phoenix was still recovering from the Great Recession. That remains true today, but our road to recovery has been very strategic. In that time, we've stabilized our growth, diversified our industries and worked toward a more sustainable future. Furthermore, our vacancy rate has fallen below eight percent for the first time since 2006 and we have experienced robust positive net absorption totaling nearly 4.79-million square feet YTD 2017. The effects of the recovery can also be seen in the number of new businesses and influx of people that now call the Valley home.

MM: For the most part, I think we are seeing more of the same trends that we have seen this cycle: diversification of our jobs base, particularly financial services and tech, as well as an urban appetite for office, multifamily and retail. The one thing that stands out to me compared to last year is the build-to-suit activity we've seen on the office side. Companies like McKesson, Centene and Freedom Financial choosing to wait on a new build in the East Valley when our overall Phoenix market office vacancy remains as high as it is, is another validation on the importance of specific submarkets.

DP: We are experiencing increased interest from national retailers who

Danny Swancey
Executive vice president at ViaWest Group
Moderator DS

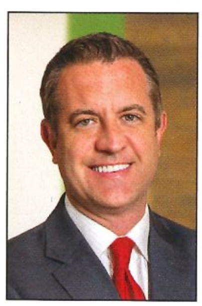
Andrew Cheney
Principal at Lee & Associates
AC



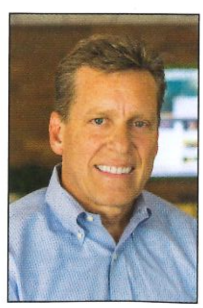
Keith Earnest
Executive vice president at VanTrust Real Estate
KE

Rusty Kennedy
First vice president at CBRE
RK

Matt Mooney
Senior vice president, managing director at Cousins Properties
MM



Darren Pitts
Executive vice president at Velocity Retail Group
DP



Lawrence Pobuda
Senior vice president, general manager at The Opus Group
LP

Molly Ryan Carson
Vice president of real estate development at Ryan Companies US, Inc.
MC

had previously put their expansion plans on "pause" during the recession. Nearly every category of retailers, restaurants and grocers who currently have a presence in Arizona are actively pursuing new sites to grow their store presence in emerging trade areas as well as reposition in more established areas, which includes relocating to a better location or a more optimal size. In addition, Phoenix is once again seeing activity from retailers that are new to the market. Expect to see more announcements later this year and into 2018. Phoenix came out of the Great Recession very slowly but clearly has turned the corner in the last 12 to 24 months.

KE: We are currently more active in other markets than in Phoenix. We still plan on approximately $60 million in construction starts at two local projects, Chandler Corporate Center for 115,000 SF and a 600,000 SF spec-industrial building in Buckeye, but have constructed over three-million SF of space in North Las Vegas in the past 18 months. Many of the e-commerce transactions that we made in Las Vegas were looking at multiple markets, but selected Southern Nevada for its streamlined entitlement process and affordable labor. We have seen Phoenix win several of the most recent "multi-market search" deals, so we are very encouraged by that trend and believe it will continue.

DS: How would you compare our Metro Phoenix commercial real estate market to other major markets throughout the nation and specifically the Western U.S.?

DP: I would say that Phoenix is becoming the "bargain of the West." All of the coastal markets — Seattle, Portland, San Francisco, Los Angeles, San Diego — remain phenomenally expensive, additionally, the inland markets of Las Vegas and Denver are becoming very expensive places to live too. The cost of living bundled with a high-quality of life and a pro-business political environment make Phoenix a very attractive alternative for business expansion today. Our state's leadership has done a good job but needs to continue to support infrastructure expansion as well as improve the overall education system in Arizona to remain a competitive market for business.

RK: It's no secret why Phoenix continues to be on any tenant's or investor's shortlist. While we're still very much a young metro area, we have an exceptional business-friendly environment as a right-to-work state, a growing educated workforce and an incredible, affordable quality of life. In 2017, employment is projected to grow 3.1 percent, more than any other Western U.S. metro. Combine that with competitive costs for electricity for users and housing for employees, and it's easy to see why Phoenix remains attractive for both tenants and investors.

LP: Overall, very healthy, yet very young. Metro Phoenix is evolving and in many ways represents a pleasant surprise for folks who might have other preconceived ideas. This seems to be especially true of Silicon Valley technology companies that might initially invest in Phoenix for backroom/support functions, but they find the talent pool is capable of much more than back office work. As compared to other west coast markets, we are not Seattle or San Francisco, yet we are carving our own unique path. I believe that one of the unique calling cards for Phoenix will be its strategic geographic location. Sharing borders with California and Mexico – the 8th and 13th largest economies in the world, respectively – makes for endless possibilities.

MC: Arizona's recovery lagged behind the good majority of other markets. Phoenix's office market remains steady; positive absorption, vacancy continues to decline and rents continue to rise, albeit modestly.

METRO PHOENIX BY THE NUMBERS:

4.4 million population (2017)

5.5 million population (by 2027)

35.4 median age

3rd largest labor pool in the West

5th largest metro

6th largest concentration of data centers

top **20** nationally for tech job growth

COMPARING METRO PHOENIX:

59k+ median household income ($58,216 nationally)

17% projected employment growth over the next decade (11% nationally)

6.19% projected manufacturing employment growth over the next decade (1.53% nationally)

40% cheaper operating costs than in California

20% more competitive labor costs on average than leading California markets, including Los Angles, San Francisco and San Jose

77% cheaper cost of living on average than leading California markets

Source: Greater Phoenix Economic Council; Marcus & Millichap Q2 2017 Market Research Reports

DS: ***Where does Arizona stand in its economic development plans?***

MM: Without question we are headed in the right direction. I think Governor Ducey is doing a great job, and I think businesses and investors nationally are continuing to learn how different Arizona is today than it was 10 years ago. The theme I'm continuing to hear that we've got to remain focused on is K-12 education. Prospective employers and headquarters evaluate that component of our state a lot more closely than many people realize.

LP: The focus on education is spot on – it's been Arizona's Achilles heel for far too long and we need to solve it. This is one of the most important elements in any economic development strategy – an educated and well-trained workforce. We are planting education seeds today that will take a long time to germinate. In addition to education, the focus on infill development is exciting – people moving into the city to take advantage of neighborhood restaurants, cultural amenities and transit choices. Roosevelt Row and Downtown Tempe are two great examples.

MC: We are on the right track. We have done a very good job attracting and expanding a variety of business segments from startups to corporate headquarters, from technology to medical components, financial institutions, etc. For example, Gov. Ducey with the help of GPEC, the ACA, our universities and economic development departments throughout the Valley, have come together to strengthen our brand, attract dozens of new firms to our state and help local companies grow.

DS: ***What do you think has the biggest chance of derailing the positive trajectory of Phoenix's CRE market?***

MM: I think our biggest concern is the same as every other city and that's just an economic downturn nationally. That said, it is important that we continue to make the right moves politically to grow our state as well. There are a lot of people that would argue we are still feeling the ramifications of a bill like SB1070 that passed 10 years ago. We've got to maintain a business-friendly message nationally to continue to win corporate expansions and relocations.

RK: Since the end of the Great Recession, we've made great strides in being better prepared to handle national and regional economic challenges. As always, we need to be mindful of staying competitive from a business-friendly perspective. If you look at our history, we've been hard to fall and fast to rise. But more than any other city in the Western U.S., I believe Phoenix will experience an incredible 25–30 years ahead.

AC: Higher taxes and any legislation that doesn't support Arizona's pro-business environment. If we keep those two areas in check, we will continue to beat out California and Texas on a lot of company relocations. The state is in an enviable position in many ways. We are excited about the future.

POSITIVE SIGNS FOR AZ:

#1 nationally for entrepreneurial activity

#1 nationally for projected annual job growth

#1 nationally for high education degree opportunities

#2 nationally for workforce quality and availability

Source: Arizona Commerce Authority

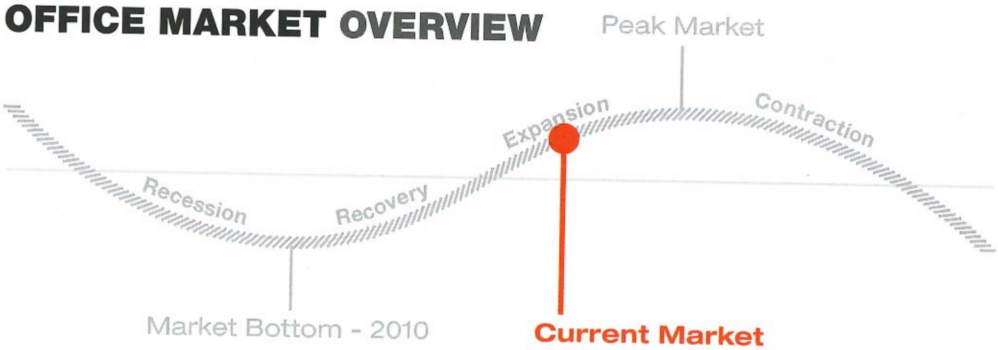
DS: ***We now have a number of years of consistent expansion of the national economy. Are we overdue for a national recession? If so, how will Arizona fare in comparison to Great Recession? If not, how many good years do you see before the next cyclical downturn?***

AC: Metro Phoenix was late in recovering, so to many it feels like it's been long enough since our last recession so it must be time for another. I agree to an extent and feel like we have a few good years before a recession hits. But, I believe it will be a relatively small one. We haven't overbuilt product and a lot of the real estate related tenants that got us into trouble last time have grown at a healthier pace this time. In other words, I think the next recession will be a soft landing for us.

MM: There is certainly no shortage of people saying we are overdue for a recession, but generally their reasoning is just the length of this cycle versus glaring areas of the economy that are overheated. I think that makes it a lot more difficult to predict. Fortunately, Arizona is in a dramatically different spot than it was during the Great Recession. Yes, our jobs base is more diverse, but more importantly we just haven't seen anywhere near the same levels of construction – particularly in office and single-family housing. In essence, we just have much less further to fall this time if we do get a pull back.

KE: I believe the landscape is different in this cycle in that the conservative underwriting and conservative lending principals practiced over the past several years will keep us out of a significant recession. Interest rates are rising as are equity requirements for new deals so all of those factors should keep development in line with demand. With vacancies continuing to fall, we should see a nice bump in rent growth over the next few years, which makes everyone happy.

OFFICE MARKET OVERVIEW



Overall vacancy
15.0% ▼

RENTAL RATES

Northwest Phoenix	Airport area	Central Corridor	East Phoenix
$20.72/SF ▲	$23.30/SF ▲	$23.17/SF ▲	$25.33/SF ▲
West Valley	**East Valley**	**North Phoenix**	**Scottsdale**
$22.14/SF ▼	$23.13/SF ▲	$21.69/SF ▼	$25.84/SF ▲

Source: CoStar, Cresa

DS: ***Has Downtown Phoenix finally turned the corner? Do you believe a viable downtown is essential to our city's success?***

MM: I think Downtown Phoenix is making tremendous progress. ASU and TGEN deserve a lot of credit as its downtown campuses put a lot more people down there and now that momentum has spurred a tremendous amount of multifamily and retail. A move like Quicken Loans going from North Scottsdale to Downtown Phoenix for 150,000 SF is a big validation, along with the growth of Uber, Galvanize and others. That said, I don't think our overall Phoenix Metro's success is disproportionately tied to Downtown Phoenix. In my opinion, Phoenix grows a lot more like Los Angeles, Houston or Atlanta where you have multiple urban nodes — Downtown Phoenix, Downtown Tempe, Old Town Scottsdale, etc. — and there is nothing wrong with people having options.

LP: I'm not sure I think of it in terms of "turning a corner" as much as I think of it as analogous to moving from adolescence to adulthood, and yes, I think we're all happy to be moving into this next phase. The City of Phoenix has been smart to focus on economic development initiatives that center on making downtown more livable and inviting – for businesses and residents, alike. Is a viable downtown essential to our city's success? Is a strong core essential to an overall fitness plan? Strong arms and legs don't go with a weak core – a strong core is essential.

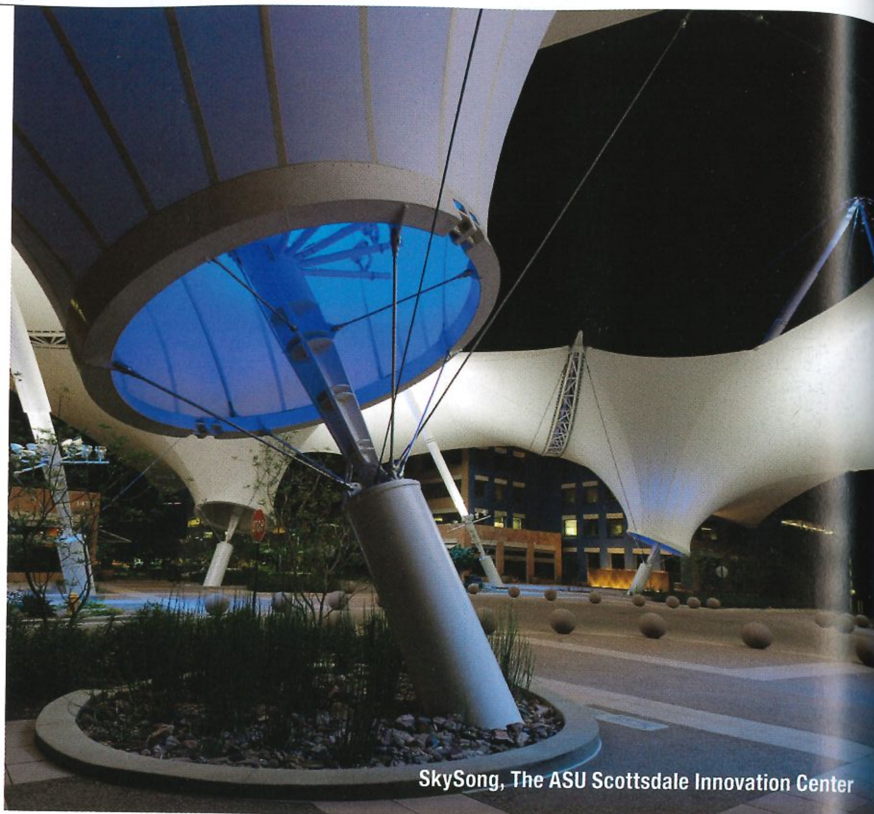
KE: Downtown has certainly turned the corner and the addition of the grocery store with Block 23 will be a real game changer. I'm encouraged by all of the residential development in Downtown Phoenix and am pleased with the variety of residential options that now exist. From two-story lofts, to converted office buildings, to high-rise penthouses, residents now have several choices when renting or buying in downtown. It took time and vision from developers like Trammel Crow, Opus, Ryan and RED to set the table for the transformation, but when you see the Super Bowl NFL Experience, Football National Championship and the Final Four all have their main events in Downtown, it's well worth the wait. I just hope the Suns, Diamondbacks and Coyotes are also part of the mix going forward.

AC: 25 years and now Downtown is an overnight success? Yes, we are now reaping all the investments we made. Have you heard all the leasing that's been done downtown? Quicken Loans, Credify, and Upgrade are just some of the 250,000 SF deals that have been done this year. I do think a downtown with impressive infrastructure and a healthy buzz is key for a city's success.

DS: ***Is the Phoenix market still ripe for speculative building? If so, where and what type of buildings?***

AC: Yes, in most submarkets. If you build spec in Tempe or Scottsdale, where companies love to recruit the most, it will be leased. There has been tremendous success with multi-story class A office product at signature projects like SkySong and the Grand at Papago as well - recently inking their Union Bank deal. We have done an internal study that shows over 80-percent of builders who have gone spec, have been at stabilized occupancy within one-year of building delivery.

RK: From an industrial viewpoint, there's still a need for speculative building. Since 2008, there have been very few, if any, functional multi-tenant buildings built in the Southwest Valley that cater to the 5,000–45,000 SF tenant. These tenants have historically been key to our market's success and will continue to be in the decades to come. However, with high construction costs, these kinds of buildings are not cheap to build. Any developer that can work through these challenges will certainly succeed.

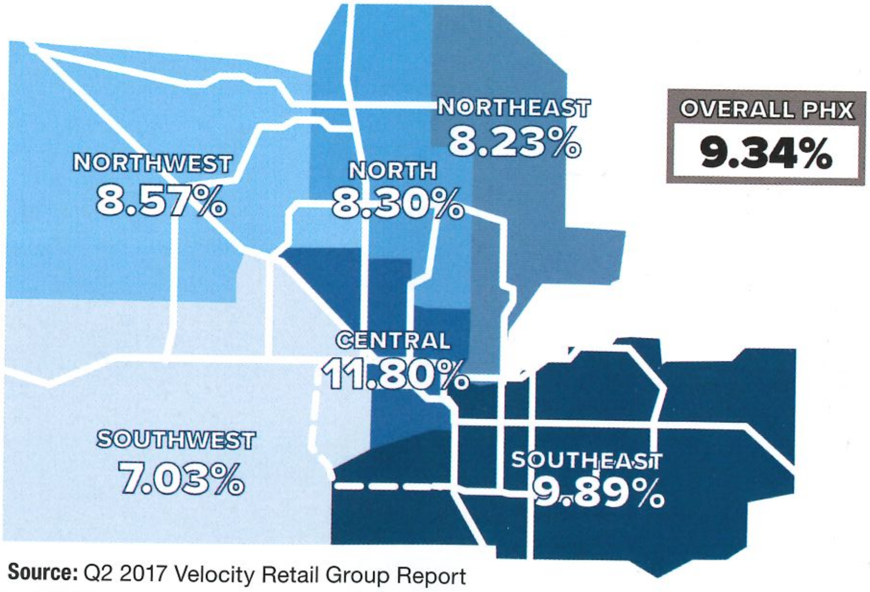


SkySong, The ASU Scottsdale Innovation Center

KE: Phoenix is ripe for spec industrial buildings. The success of Wentworth, Opus and First Industrial proves that if you build it, they will come, or buy it empty for a good price.

LP: Yes, selectively, with strong consideration for the best locations with the most compelling points of difference. Spec development by its very nature is risky, and any spec development decision is predicated on demographics, location factors, workforce analysis, capital markets, investor interest, tenant demand, etc. Overall, I think Phoenix will continue to see spec development in the coming year in both the industrial and office sectors.

RETAIL VACANCY ANALYSIS REPORT



Source: Q2 2017 Velocity Retail Group Report

DS: ***What is the current state of our Metro Phoenix retail market? What is the biggest risk for Phoenix retail?***

DP: I would suggest the term "steady improvement." Vacancy, leasing activity and construction are all recording positive signs that the retail market is continuing its slow and steady improvement. The current vacancy rate is 9.3 percent, which is two percentage points less than it was 24 months ago. Current leasing activity (absorption) is currently 900,000 SF and is on track to be close to two-million SF by year end, surpassing the last three years. New construction will be just over one-million SF, with very little being speculative in nature. Biggest risk to retail would be retailers that don't embrace and adapt to the systemic change involving technology and online commerce.

DS: ***Where is the hottest submarket right now and where will be the next?***

AC: Tempe, then South Scottsdale, then Downtown Phoenix. These three areas are attracting tech tenants, and have the most office space job creation.

RK: My bets are all on the Southwest Valley. The area is now home to distribution centers for major companies such as UPS, REI and SubZero. Aldi will soon be opening a new distribution center for the Southwestern U.S. in addition to Huhtamäki, who recently purchased a 753,000 SF building. This momentum isn't stopping any time soon as the area continues to fare well with large distributors and e-commerce companies. As for the next hottest submarket, I'd keep an eye out for the 59th Avenue corridor along the new Loop 202, as it promises to deliver some exciting success stories.

LP: Depends on what product type you are talking about, yet the best news is that there is increasing strength Valley-wide, which is different from a few years back. The multifamily explosion was largely centered in the East Valley but that is changing. Other commercial development that has been more East Valley centric is starting to shine in the West Valley, too. And at the heart of it, is a strengthening Phoenix with success in all areas – industrial, office, multifamily and healthcare.

MC: From an office perspective, Tempe and Central Scottsdale continue to lead, South Scottsdale and Chandler are not far behind in activity and becoming a coveted location for office tenants of all sizes and business segments.

DS: ***Do you feel the Trump presidency has been net positive, negative or neutral to-date? Do you feel CRE will fare well under President Trump?***

KE: It's too early to tell the impact of the Trump presidency on the Phoenix real estate market, but the stock market and the NASDAQ seem to like what he is doing so hopefully that translates to our industry as well. We remain very optimistic that our market, and those of our bordering states, will continue on an upward trend. Arizona is fortunate to have the leadership of Gov. Ducey who is making headway in attracting new business while focusing on education and job growth.


Tempe, Arizona