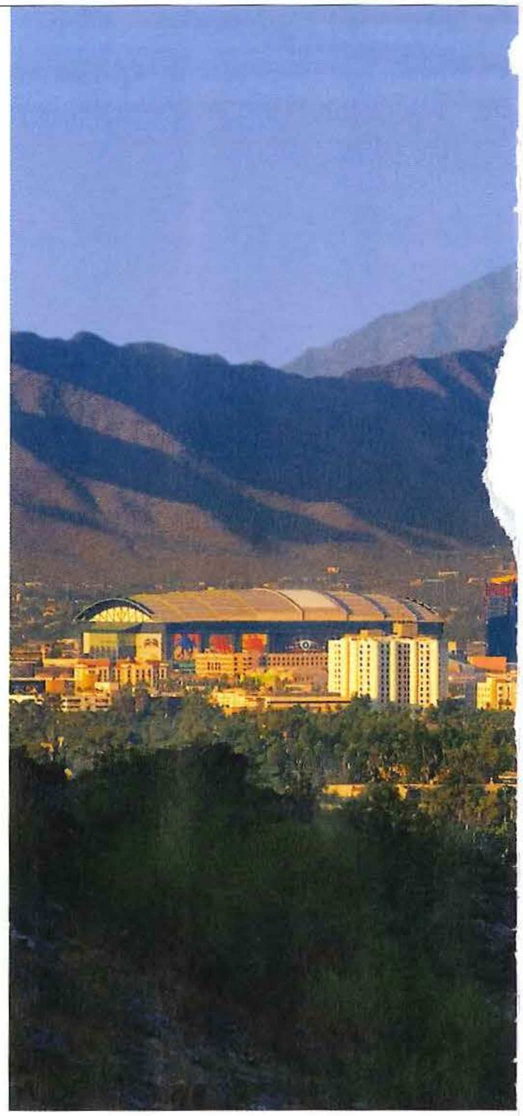
THE 2015 OUTLOOK

Ready, set...go or no?

By AMANDA VENTURA



The recovery has thrown down the gauntlet. There are billions of dollars in capital looking to be invested in commercial real estate, and housing researchers are pointing to a potential rise in first-time homebuyers with the dropping 3 percent downpayment mortgage rate offered by the FHA.

The race is on.

Texas, California and Colorado are currently leading the pack with six of the Top 10 U.S. markets to watch, according to Urban Land Institute's "Emerging Trends in Real Estate 2015" report released in December. Phoenix clocked in at No. 26.

With vacancies weighing down a handful of submarkets in the Phoenix Metro area, the region may come across a little out of shape. Newmark Grubb Knight Frank managing director Pete Bolton notes Texas and California has business development funds that utterly dwarf Arizona's. But, there's also the issue of pacing.

Economists are reporting Arizona about 35 percent behind the country, overall, in reclaiming its pre-recession job levels.

Elliott D. Pollack, CEO of his eponymous economic consulting firm, believes the Valley won't see any significant office construction – except in select submarkets like Tempe – until at least 2017, according to his points at the 51st annual Economic Forecast Luncheon, co-sponsored by Arizona State University's W. P. Carey School of Business and JPMorgan Chase.

This has kept Sunbelt Holdings President John Graham cautious. Graham says he will continue to develop with restraint until he sees an improvement of higher-wage employment and an uptick in housing, which may be on the horizon as a quarter of buyers locked out by former foreclosures or short-selling their homes qualify to re-enter the market. The key until then is to not overcommit while anticipating the recovery, he says.

It's ready, set, wait.

This is how AZRE's interview begins with Marty Hedlund, senior vice president and Southwest district manager at Sundt Construction.

There are "lots of medium-sized ideas, not many triggers pulled," he says. Some of the reason the industry may be shooting blanks is banks' required equity levels are "not conducive to development," Hedlund says.

"Alternate sources of funding like REITs or nontraditional investment funds can only fill so much need," Hedlund says. These obstacles will linger for a year or longer, he says, adding, "Corporate capital investment — in their own real estate needs — will likely help us get out of this office doldrums, and projects 'on the drawing board' at this point appear promising."

Sundt construction broke ground on the $125M Wells Fargo Chandler Campus expansion (technically, doubling its size) last January, with construction on the 410KSF campus expected to wrap up this summer.

Ryan Companies US, Inc., which is co-developing the largest office development in Arizona with Sunbelt Holdings, Marina Heights, for insurance company State Farm's new campus, agrees with matching the slow and steady pace of the market.

"I believe 'slow and steady wins the race,'" says Molly Ryan Carson, vice president of development for Ryan Companies. By now, she says, the industry understands the peaks and valleys of the Arizona market are more frequent than in other states. It's about pacing.

"A great deal of our work nationally in 2015 is single-tenant office development and construction," Carson adds. "The office market, although

not booming by any stretch, a steady requirement continues."

Cautious developers, she says, will consider

- Sticking to the fundamentals
- Increased multi-state competition for office and industrial company attraction
- Increase in the cost of finance
- Adequate skilled construction and engineering work base

The latter point has become a concern as construction job growth dwindles in Arizona. The state lost 2,400 construction jobs between October 2013 and October 2014, according to the Associated General Contractors.

"Though it has not slowed our development and I do not foresee it doing so, it is something we have national efforts working on," Carson

ZACK AULICK

DAVE CHEATHAM

ANDREW CHENEY

MARTY HEDLUND

CRAIG HENIG

TIM THIELKE

PHILIP WEDDLE

NICHOLAS WILSON

says. "Partnering with top universities and construction organizations that are working to grow interest and participation in construction and engineering fields is something we've always done, [but] it is needed now more than ever."

Craig Henig, senior managing director and market leader at CBRE, says Arizona's pace is actually going to work to the state's advantage.

"For commercial real estate investment purposes, the fact that the employment recovery in the local market has lagged behind the national recovery is a positive because it means that Phoenix has a longer runway compared with markets whose economic recoveries took form earlier," he says.

INFILLING THE HOLES

Through the downturn, the various sectors of the industry began communicating more, says Tim Thielke, LEED AP at PHArchitecture.

"The RFPs have gotten better in more accurately describing not only what the clients needs but also what they want. Some of the earlier RFPs we were getting really seemed to be written in a way that encouraged teams to respond with a solution based solely on pricing and some minimal user requirements. I think there's been a lot of communication between developers, architects and brokers and the result has been an evolution of the process that provides a more comprehensive look at the identity of the user. This adaptation allows for responses that are directed more toward current and future trends in the office environment like additional flexibility, newer technologies, open environments, collaborative spaces and also providing an image of their company to attract the right type of workforce."

The Scheduling Institute will soon give new purpose to a vacant bar and restaurant space. Courtesy PHArchitecture

This has kept the architectural firms busy with addressing the Generation X effect on office, leading to a more flexible working lifestyle being reflected in office development and redevelopment of obsolete spaces.

"As the way work is done changes, employers are wanting to create environments that can evolve with their workforce."

PHArchitecture's new office space reflects such changes with exposed ceilings, open as well as private workspaces and a break room kitchen equipped with a beer tap (though it's not always in use).

Prior to the downturn, Thielke says, PHArchitecture's workload didn't include of a lot of infill or adaptive reuse and renovation projects. One such project, he says, is The Scheduling Institute, a vacant bar and restaurant

CRANE'S EYE VIEW

John Graham

President, Sunbelt Holdings

Major projects: Marina Heights, Portland on the Park, PV|303 and management of ASU Research Park

Industry prediction: Commercial and residential markets will see improvement in latter half of 2015

Open for discussion: I said this a couple years ago, but I think we should continue to focus on the quality of infrastructure, long-lead items, such as water and sewer but also roadways and telecommunications. At some point, we're going to burn through what we built. One of [Arizona's] greatest strengths has been the high quality of infrastructure.

Mood: Cautiously optimistic

Molly Ryan Carson

Vice president of development, Ryan Companies US, Inc.

Major projects: Marina Heights, Amkor Corporate Headquarters, ASU Research Park, Hayden Ferry Lakeside, others not ready for publication

Industry prediction: Steady improvement in the Southwest market's commercial development and construction, without a boom or bust, and significant absorption in the industrial sector and continued apartment growth

Open for discussion: Nationally, the future of retail and industrial distribution logistics further merging; Statewide, the continuance of our state's great efforts in attracting new businesses

Brian Ellis

President and COO, Nationwide Realty Investors

Major projects (in Arizona): Rivulon, renovations of Gainey Ranch Corporate Center

Industry prediction: I believe the Phoenix market is going to do what it has demonstrated in the past which is rapid growth. I think the next few years it will be time for growth in all sectors. We've been invested in the Phoenix market for more than 25 years and the next few [years] will be strong.

Mood: I feel very optimistic. We had a good year and a lot of activity in 2014 and solid improvement over the last year and [are] expecting that trend to continue…in the Phoenix market, Southeast Valley and Gilbert.

located at the southwest corner of Third and Jackson streets in downtown Phoenix. It's being transformed into a training facility for dentists.

"While we are seeing less activity as opportunities have become less attractive due to the rising costs of existing properties, we still believe this type of work will be ongoing for several years and continue to bring obsolete product up to current market standards," Thielke says.

Philip Weddle, FAIA and principal at WEDDLE GILMORE black rock studio, notes more public-private partnership (P3) projects than he remembers in years past.

"Public-private partnerships certainly aren't new, but as public agencies continue to struggle with tight budgets, we've seen this type of partnership as the way to get things done," says Weddle, whose studio is involved in a "handful" of larger public projects.

"It does seem like there has been an increase in the number of public RFQs, however, some of them only have funding for design phase services and do not have construction funding secured at this time. For public work to return to pre-recession levels will require the continued improvement of the regional economy to the point where more public entities can successfully pass bond issues for capital improvement projects."

Sunbelt Holdings' Graham agrees — there's a lot of talk, but no action on P3 projects.

Tempe — hottest submarket in the Metro — however, announced a notable P3 project that will move forward in 2015 — Arizona State University's 300-acre University Athletic Facilities District. Tempe is seeing millions of square feet of new development as well as its share of infill, from The Yard in Farmer's Arts District to Postino at The Annex.

"A healthy community should have both," says Mayor Mark Mitchell. "[Adaptive reuse] is an increasingly popular option that reflects the progressive, innovative, funky, sustainable character for which Tempe is known."

The mayor's top priority, he says, is to move forward with the longstanding vision of a hotel-conference center.

The city is already en route with the USA Place plans, and two recently announced historic preservation projects. The Hayden Flour Mill on Mill Avenue and Rio Salado Parkway will be redeveloped by Baum Development, Sundt Construction and SmithGroupJJR into a boutique hotel and outdoor amphitheater. Across the street, the parcel of land that includes the old Hayden House and Monti's La Casa Vieja will transform into class-A office, a Kimpton hotel and retail/dining.

According to Nicholas Wilson, managing director at Douglas Wilson Companies, one of three developers of Hayden House Tempe LLC that will handle the Mill & Rio Salado project, his company has been eyeing the project for nearly a decade. Many Douglas Wilson Companies' projects have a historic element to them, but Wilson says it really came down to Tempe being a true urban core the Valley didn't seem to have at the time.

"We love quality, good projects. We saw Tempe could use one," says Wilson, who says he has spent nearly every week of the last two years in the city.

"I feel pretty confident in what Tempe is," he says. " It has a lot of charm and character and a good base of building blocks for being vibrant for Millennials. It has all those items people are attracted to."

As for the project's new neighbors across the street — Wilson says he thinks they balance out and may have

TUCSON TAKES OFF

A lot of economists are pointing at 2017 as a full recovery year. How will 2015 compare to last year?

We feel optimistic about 2015. The last six months of 2014 have seen a big increase in our pipeline of companies interested in Tucson, and we have had several major announcements with more coming in the first quarter of 2015. We are tracking ahead of our goals for TREO's fiscal year.

How is Tucson looking next to comparable metropolitan areas?

In our targeted industry focus on aerospace and defense, transportation and logistics, and bioscience/diagnostics – we are doing well. We have the fifth highest concentration of A&D workers in the country and that attracts other companies to the talent base we have. The state and local infrastructure plans for the future (I-11, Sonoran Parkway and the Aerospace, Defense & Technology Research Park) are generating buzz among companies in these targeted industries, as the right priorities for the future. Our diagnostics sector is still emerging but gaining strength and recognition with the presence of Roche, Sanofi and other growing bio start-ups.

– Laura Shaw, senior vice president, Tucson Regional Economic Opportunities, Inc.

The 250-acre Rivulon project consists of a 150KSF class-A office build-to-suit for Isagenix in its $70M first phase.

more to reveal in coming months about that topic.

"At the end of the day, business development is a hugely important catalyst for establishing quality of life in a community, but it's not the only thing," says Mitchell. "We want to keep improving as a well-rounded place to be – one that is diverse, has great public spaces, reliable transportation, enriching arts experiences, terrific schools and so much more."

It sounds a lot like the sentiments of Brian Ellis, president and COO at Nationwide Realty Investors, who is developing the $750M mixed-use Rivulon project (that's also a P3) in Gilbert.

"I didn't know Gilbert was the hay capital of Arizona," he says. "I saw it as the fastest-growing community in the country...The city leaders wanted to increase their in-town employment and build an area where there were lots of high-paying jobs in Gilbert."

The 250-acre project consists of a 150KSF class-A office build-to-suit for Isagenix and spec office as well as some retail in its $70M first phase.

The built-to-suits are a big deal, says NGKF's Bolton.

"There are still billions of dollars out there looking for assets to purchase in real estate. It's still a hot commodity. You can't buy an industrial building in Phoenix, and if one goes online that is 80 percent leased, everyone will be all over that."

How will Arizona get out of this hole?

"One shovel at a time," Bolton says. "I mean that. That's what we're doing."

UPSWING AND A MISS

Phoenix's office market saw some notable success in 2014, according to Arizona brokerage experts.

Some markets in Phoenix Metro broke through the 20 percent office vacancy ceiling in 2014, propelling it among the Top 10 markets in demand of office space, says Cassidy Turley Director of Research Zach Aulick. The market's office sector saw 2.5MSF of net absorption, adds Lee & Associates Principal Andrew Cheney. This is the area's 25-year average, he notes, but it's still an optimistic blip in recent years. This was the first year, Aulick says, that the Valley had multiple speculative projects announced to start construction. SkySong 3 was also 95 percent pre-leased in August 2014 — another notable achievement Cheney mentions.

"Pre-leasing in Phoenix is incredibly difficult and is a testament to [SkySong] and the improving market. This improved leasing activity has increased leasing rates in select submarkets and helped drive sales activity across the Valley, particularly in class-A properties," he says, adding that pre-leasing will still be an obstacle in 2015. "Signing a 10-year lease for a new property will be a challenge for businesses that are constantly changing due to technology and growth projections."

Class-A properties are difficult to find and sell, Cheney says, as buyers will continue to compete for core properties.

The industrial market — the other hot sector for leasing in 2014 — continued to see more small- and mid-sized users looking for 10KSF to 150KSF, Aulick says.

"What is most surprising is that the increase in industrial leasing velocity has taken place without a big push by the housing market, which in the past has greatly influenced the demand for industrial space," Aulick says.

When it came to sales, "Metropolitan Phoenix was on nearly every investor's radar screen in 2014 with robust investment sales occurring for every product type," says Aulick. "Buyers view the Valley as a great value compared with global gateway markets. Buyers who purchased assets in other markets that rebounded quicker are now trading out of those areas and looking to Metro Phoenix as their next target market. The Valley has not reached peak pricing set in 2007. There is still a lot of upside for Metro Phoenix real estate values as both pricing and rents increase."

Another factor to consider, says Dave Cheatham, president, Velocity Retail Group, LLC, is that home building, one of Arizona's main industries is on the sidelines and is still not back to pre-recession levels.

"It is encouraging to note that the Arizona economy is still creating new jobs, and is in the top in the U.S. even without home building as a driver for jobs. The best is in front of us for 2015 and 2016 as the Phoenix area will continue to grow stronger in all areas of the economy," he says.

CBRE's Henig notes that employment change in Phoenix is forecasted at 2.9 percent.

"Overall, Arizona is growing, both from a GDP standpoint and a population standpoint, which is something that a lot of states cannot say," Henig says. "ASU is driving Phoenix's future as knowledge-based employers are attracted to the large supply of talent that is coming out of the university."

With brains, brawn and an easy-to-follow gait, Arizona may just win this race if it can keep the momentum through 2017.

BROKERAGE OUTLOOK: WHAT'S THE DEAL?

INDUSTRIAL

"Though the trend of large industrial users opting for build-to-suit over existing space may continue, Phoenix's small- to mid-size tenants are ready, willing and able to fill the absorption gap. In the past 12 months, users taking down up to 100KSF drove the market, often committing to new construction before it was completed. We expect more of the same in 2015, as a result creating a more balanced market and a definite uptick in absorption and rental rates. All of Greater Phoenix will benefit from this activity, particularly the strong-performing Airport and Southeast Valley submarkets, where insiders are not at all worried about the 2.2MSF of spec industrial space scheduled to deliver in the next 12 months."

– Steve Larsen, vice president of industrial/supply chain & logistics solutions group, JLL

OFFICE

"You really can't look at the market as a whole anymore. [The overall 23 percent market vacancy] is a misnomer; There are some submarkets doing a lot better (and worse)...The good news is the architects, engineers and contractors are staying busy with the build-to-suits. We'll see more of those. It doesn't do much for brokerage...the place to focus is business expansion."

– Pete Bolton, Executive vice president and managing director, Newmark Grubb Knight Frank

MEDICAL OFFICE

There are four major trends to look out for in 2015:

1. More physicians to become employed by hospitals or other corporate healthcare networks due to the increase in the costs of running a medical office while physician's insurance reimbursements are decreasing. They will move out of their medical office suite and into hospital owned or leased clinics.

2. Larger suites to be leased by healthcare practices. The former norm of doctor's office sizes of 1,500 to 2,500 SF is changing to 5KSF 15KSF to accommodate larger practices/clinics, with few smaller practices to replace them.

3. Hospitals and other corporate healthcare networks will continue to build new large health centers and outpatient clinics in highly visible, easily accessible residential communities to provide primary care, and to create a wellness environment for their patients.

4. Branding and visibility will continue to be important to healthcare practices and they will continue to lease space in retail projects that provide these opportunities; they will be located in proximity to the populations they serve and they will be focused on a consumer-centric experience for optimum patient satisfaction.

– Julie Johnson, CCIM, Executive vice president, GPE

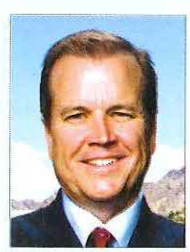
MULTIFAMILY

"Greater Phoenix will see 155 to 120 transactions (in the 100+ unit market) in 2014. In 2013, it was 103. From a total volume standpoint, the metro area was $2.35B and will be close to $2.5B. It's up 6 percent in total dollar value. We saw more trade in 2014 of B and C product. The first half (of 2015) will be similar to 2014 but the second half will have more merchant build (immediately reselling) recorded than we have seen before...The trend we're watching is second-generation asset sales next year. From January 2010 to 2015, 51 percent of overall stock were traded."

–Cliff David, Vice president of investments, Marcus & Millichap

RETAIL

"Each quarter during 2014, the Phoenix area vacancy rates have shown a clear path to becoming healthier, which is evidenced by the majority of our regional areas working down into the single digits. What I think is even more interesting, is that our vacancy is improving despite a glut of more than 250 vacant big boxes, and without a healthy lending environment for small business. Looking forward, as banking starts to allow more lending to the smaller entrepreneurs, which will allow mom and pop business owners to lease retail space, we are going to see more rapidly declining vacancy rates."



– Dave Cheatham, president, Velocity Retail Group, LLC