The Center for Real Estate Theory and Practice

On Dec. 11, 2013, a group of the Valley’s most successful brokers were brought together by the Arizona State University’s W. P. Carey School of Business and its Center for Real Estate Theory and Practice to provide meaningful, insightful and relevant input on the commercial real estate market in Phoenix. These brokers came from a variety of sectors and specializations, as well as a cross-section of the many brokerage houses in the Valley. This discussion is part of a series of forums being held by the Center for Real Estate Theory and Practice on a quarterly basis, in order to track the perceptions, insights and trends in the Phoenix commercial real estate market.

The purpose of this forum was to seek consensus on forward-looking key indicators of the commercial real estate market in the Phoenix metropolitan area. The forum was organized with the help of and moderated by Pete Bolton, executive vice president and managing director of Newmark Grubb Knight Frank (NGKF). The forum was conducted as an open discussion centered around what is truly happening “on the street” in terms of commercial real estate. The intention of this gathering was to detect current trends; discover similarities and differences among various sectors and submarkets; and document anecdotal evidence, opinions and insights of the group. As the moderator Bolton said, “Nobody knows this market better than the brokers, period, the end.” This is a summary of their opinions.

At the end of each session, a consensus report is generated and available on the W. P. Carey School of Business website at http://www.wpcarey.asu.edu/realtyreports. Each quarterly session builds on the previous ones, and the information gathered will be synthesized chronologically.

This is the second report of the Commercial Real Estate Broker Survey, which addresses what the panelists believe will happen in the 1st Quarter 2014 timeframe. The following charts indicate the answers to the associated questions asked of the panel. Following each chart are comments made by panelists in response to the question asked. The responses are anonymous, and no quote is attributable to any one person. Reading the comments will give readers a sense of what these important players in the commercial markets are thinking. Readers should note that the comments are those of the brokers and as close as possible to verbatim. This is not a refined analysis of market conditions.

Bolton summarized the recent forum by stating, “2014: More of the same, but better!”

Mark Stapp, executive director of the Master of Real Estate Development program and Fred E. Taylor Professor of Real Estate at the W. P. Carey School of Business, who manages the forum, said, “The opinions and comments of the participants reflect the facts that underlying economic fundamentals that drive real estate are too weak and market participants are too uncertain to cause a significant acceleration in growth. It will take more economic healing before significant growth occurs locally, and that will not be quarter 1 of 2014 and probably not in quarters 2 or 3 either. Imagine a year ago, and the situation we were in. Now consider where we are. Look at how things are different, yet somehow everything is still in some way the same. This will continue.”

The overall consensus of the commercial real estate roundtable is: At a minimum, the first quarter will be similar to all of 2013 in its lack of excitement. The commercial real estate market is definitely recovering from the doldrums of the past five years, but because of governmental uncertainty, the retreat of the housing market, and overall lack of confidence in government, corporate America’s relatively weak appetite to expand/manufacturer/explore new areas is going to continue to affect every aspect of our recovery. Here are the participants’ comments for each specialty group of the commercial real estate market:
Where are we in the Cycle?

- I don’t think we can bring ourselves to think of another year like last year
- It’s kind of easy to [say], “We’re still recovering,” which, according to everything I read, we are.
- It’s not gangbusters, but we’re still making some positive gains, except for employment.
- It’s just it’s not the hockey stick recovery. It’s just going to be this long, steady recovery. It’s positive.
- Baring some global, cataclysmic event, it’s not like I think that we’re going to all of a sudden turn down, in 2014, 2015. It’s just this trudging—choppy recovery.
- It’s like there is no velocity.
- My rose-colored glasses are through the office market. What is recovery? Well, it’s irrefutable that we’re on our third year of recovery in the office market. What does that mean? Well, 2010 was slightly positive, but let’s just say that 2010 was the year that we hit zero, and 2011, 2012, and 2013 have all been recovery years, with very little new construction. Every year has posted more than historical normal net absorption numbers. We’re in recovery. I mean it’s irrefutable for the office market.
- The majority of the office absorption has been a lot of big users. When you look at the numbers this year, there are six big users that make up a lot of the numbers.
- Some markets are terrible, and then there is the Southeast Valley and you land 100 or 200 thousand square foot deal, and you feel great.
- I think it’s segmented, to say the least. I don’t think Obamacare’s is going to help next year. Especially office employment.
- On the industrial side, in the last few years prior to 2013, it was the huge deals that were having the impact. The smaller to mid-sized users were in paralysis mode. Now, I’d say the big transactions, the Amazons and the Gaps of the world, and so forth, have pulled back significantly. The larger deals were built to suit, but the smaller to mid-sized user seems to have a lot more confidence. That’s probably tied to housing, to our housing recovery.
- The way I look at it, it’s a tale of two cities. I think the technology sector, from product type in the Southeast Valley and from a geographic standpoint are leading the recovery. I think the
The low-tech in West Valley are a year or two behind. This is playing out in other parts of the country.

- You can’t get a broad stroke comment when somebody asks you about the industrial marketplace. It’s what sector? What part of town? What sub-market and what size? There are so many variables that are coming into play. The technology sector’s very, very active.
- From the office and industrial ownership side, they’re going like crazy, because the interest rates are low, and they want to snatch it up while they can, because they know they’re going to go up.
- In a way, we are in recovery, but it’s shadowed by the fact that we’re still correcting a lot of stuff.
- The thing is we’re not far enough along in that recovery to attract the true, core investor that’s underwriting A to Z. It’ll come back, but it’s still in the future.
- Again, this goes back to what we said. It’s just limping along, but it’s not going backwards.

In what direction is the Metro Phoenix Market moving?

- [Relating to] the general market, this has more to do with feeling, than it has to do with anything else.
- On the investment side, there is so much money sitting there chasing so few deals.
- You have to define the capital that is on the sidelines, because it’s very, very fickle.
- For deals that we call value-add (those that are 65 to 75 percent occupied), where there’s something to do, there’s meat on the bone we will get all kinds of activity. For deals that are stabilized, what we will call more core plus and, by definition, core plus is a leveraged five year internal rate of return from a 13 to a 15, there’s very little capital. There is no depth in bidding, where we might have five or six offers, compared to 20 on a value-add deal.
- For the private REITs, if you have a minimum of 10 years of lease term, preferably 12 on up, and annual increases of 2 and a half to 3 percent, you can name your cap rate. That’s probably six and a half to seven. Anything inside of that, you might as well be multi-tenant in an office, industrial with risk, because it’s very binary. They either want it, or they don’t.
- We’re up two percent on the year for new home permits. As far as the bumpiness goes, it’s the low replacement costs, and the periphery, and back to B pricing in Chandler, and Gilbert, and
the rest. The homebuilders are all complaining because most of the market (60 something percent) is coming out of the Southeast Valley. The West Valley is relatively dead for sales.

- There is a lot of shuffling around, and that goes back to the REITs. Some of those guys have to spend some money. They don’t have inventory. It’s just a different game, with a different name. Overall, the homebuilders aren’t selling homes. They’re lowing prices, and it’s not a rosy picture.
- We are going to see some bad numbers out of the homebuilders this fourth quarter. Homes aren’t selling. There has been a lot of activity with the homebuilders, less closings because the homebuilders are either dropping deals, and then another homebuilder will come in. They’re pushing off closings, and now they’re closing in final plats, as opposed to preliminary plats, and they’re just kind of pushing, and pushing, and pushing.
- The fact of the matter is that there’s no traffic through these subdivisions right now. It’s got them all pretty nervous. They’re just not turning houses.
- There are so many different dynamics in trying to analyze what’s going on in the home, and the land market. Because there’s good news on some fronts, and then there’s terrible news on other fronts. It is mostly just indecision, and uncertainty. That’s the biggest problem in the market. Everybody’s going, “We don’t know what to do.”
- One of the things we’re seeing in the healthcare leasing market is that doctors won’t make a decision. If you were a doctor, would you sign a lease? You don’t know who your patients are. You don’t know if you’re going to get reimbursed. On the other side of that is homeowners, or potential homeowners, who would take on a new mortgage when the price of your healthcare is the price of your mortgage?
- There’s still a massive hangover from the credit issues. That’s why the West Valley’s not doing much. It’s because somebody goes in there, wants to buy a house, potentially has the money, and then they decide to buy a car. Two weeks before they are closing, and they just ruin the whole thing. Now they’re completely out of it, and they can’t do anything for nine months.
- Caveat to that, though, is it’s always a pretty crappy time for homebuilders, from summer on. Some of that is typical. Everybody’s really posturing for ’14 to actually see a run up. If the homebuilders are buying today, it’s because they think 2015 is when we’re actually going to have some recovery.
Where are Apartment Vacancy Rates headed in the next three months?

- A marketplace for multi-family where there’s rent growth is five percent vacancy factor. Despite that movement in the vacancy factor, we’ve increased rents 10 to 12 percent, or about 3 to 5 percent a year, for the last three years. The big concern now, going forward, is we just delivered to the market 3,200 units in the last two quarters. The first and second quarters of next year we’ll deliver another 3,500. That’s Scottsdale, Phoenix, Tempe, and the East Valley. Nothing west of the I-17 corridor.

- We have interviewed the top six management companies in town that manage anywhere from—the aggregate is 75 to 10 thousand units. Foot traffic is flat. They’re concerned. This is the time when they see peak leasing in the marketplace. Third or fourth quarter, and first quarter of the year, and they’re very concerned.

- I think if these deliveries happen, which will trigger concessions in the marketplace, such as, free rent, you could see a 50 bases point to 100 bases point increase in vacancy. I think rents are flat for the next 12 months, potentially. Unless we see massive job growth, and then we factor Obama Care in, and that could be a deal killer as well.

- Everyone is whispering, “We hope it’s going to be the same. We hope it’s not going to be flat.” I think it could go backwards. Because, again, the concern is you bring—Scottsdale’s going to see 1,200 units in the first quarter. You’re going to see Phoenix only 600, Tempe 800, and East Valley 1,300, but you saw 32 come to market the last quarter. You’ve got 6,000 units that come to the market in a 6 month period of time. They could drop the marketplace from a stability standpoint,—and now the turnover in the properties is huge. You get past that 75 percent point on an annualized basis. That will add to vacancy

- When you add this many multi-family units to the marketplace, you create this location. Renters say, “I’m going to go find another deal, or a better deal somewhere else.” Either they’re moving up or moving down in the marketplace.

- It’s not absorption, it’s just a wash.
- For first quarter absorption is 3,500. Then it trails off significantly. Most of the lenders I’ve spoken to, most of the construction lenders, said “we’re done. We’ve done our run.” They’d love to do more, but the problem is prime locations for multi-family are extremely expensive now. The construction costs have gone up, and they’re struggling to pencil in $1.25 to $1.50 rents to make the deal pencil on a class A project. Nobody wants to build B and C.
- The biggest thing is that the cities now are willing to give up the C2 zoning for any type of housing, because they’re starting to understand that there will never be a shopping center on that property. It’s taken a long time. Gilbert, Chandler, everybody, they won’t even talk to you about downzoning something. Today, they’re actually doing it. That is a statement of the retail world. They’re accepting the fact that you cannot have a shopping center on every corner in the entire market, which is what everything was zoned for.

Where are Apartment Rents headed in the next three months?*

*Total does not equal 100% due to some participants not responding.

- From an owner’s perspective it is really going to be down, because if we see concessions come back in the marketplace, the market rate to their effective rate, they’re getting less money. We’re 6 to 12 months into a marketplace; we just got out of a 3 to 4 year run of concessions.
- From an ownership standpoint, it’s (rent) down. From a market rate standpoint, it’ll be flat.
Where are Big Box Industrial Vacancy Rates headed in the next three months?

- Our industrial vacancy rate’s about 12%, so about 50 percent higher than the national average. The big box existing space has been one of the more anemic product types in terms of demand over the last 18 months. We’re cautiously optimistic we’re going to see an uptick in demand early to mid-next year.
- Most of the activity recently, we’ve had 5 1/2, almost 6 million feet of corporate design built projects over the last 36 months, and that pace continues. They tend to be specialized, food/beverage, or scalable.
- We’re talking big box here but the mid-sized, smaller guys are, again, very inconsistent. Two steps forward, one step back.
- We had so much big box spec from 2008, 2009, and then 2010, 2011, and 2012, every one of them except one was absorbed of the new speculative development.
- There have been a couple second generation buildings come back on line. There was a pause from the capital sources to go start putting a shovel in the ground again. We finally had that happen in 2011 or 2013—from 300,000 feet and above—finally came out and really only one of those buildings now has had activity on it.
- We have a couple of these out-of-market employers who have told us, “We want to come back for a second or third time and look at the market again.”
- I think they’re going to stay flat for the next six to nine months. I mean it’s all about jobs. Again, we’ve got 170,000 jobs that we’ve got to get back. That’s 170,000 families in our marketplace. It’s pretty simple. Once we see a sustained recovery of jobs, which that’s 2016 at least, then we can start thinking about spec and building more boxes.
Where are **Big Box Industrial Rents** headed in the next three months?

- It’s good to be a tenant. I don’t see any industrial rent growth in the near future.
- Well, there were per formas done on a bunch of these buildings, and I think those owners are going to sit for a little while, but it is competitive now. There are options again.

Which **Multifamily** property class will realize the greatest rent growth in the next three months?

- This was the first part of the leg of the recovery. We saw almost 12 percent in the first year from 2010 to 2011, rent growth in A. Now you’re seeing the C do 5 percent in the last 12 months, and our marketplace—the biggest growth of the classes.
- One of the interesting things about all this stuff are the guys that come in and grab these Cs, basically kick everybody out, put a million dollars into rehabbing it, and turn it around.
- What the real smart money is finding is that if they go into tougher C pockets and they make a little bit nicer unit—because in the C pockets there is no B plus, A buildings. You find certain
parts of the community, who are hardworking, who have dual income, that are probably bringing in five to six hundred dollars each, per week. They’re making three to four thousand dollars a month. They’re glad to pay $50.00 to $75.00 more a month for an upgraded unit. New cabinets, nice countertops, good finishes, safe community. They’ll pay for that. The smart money has gone in that direction. They’re getting good yields.

What is the level of interest for the Multifamily investor and lender?

- High, but starting to wane a little bit.
- We are seeing a lack of product, concern with pricing, concern with yields. The pro formas aren’t being realized, three years ago. They’re saying, “Wait a minute, we thought we’d see 15 to 20 percent rent growth, we saw 10.” They’re not hitting their hurdles.
- It’s still chasing to see added value, B plus stabilized is a little bit more quasi-institutional. The REITs have been on a buying spree that we’ve never seen before. As we saw, the REITs returns are very anemic for the last 12 months.

Is this a Tenant or Landlord Industrial market?

- 100% Tenant
I think they’re going to go down a little bit, but not much. We’re going to see probably a million square feet of net absorption which, on 82 million square feet, is about a point.

We are estimating a million for the year 2013. Last year two million. That’s one basis point on 82 million square feet. It’s not a lot. We’re kind of just kicking along.

I think the big question is what happens in 2015, 2016 from an office standpoint in Tempe and some of these other markets? What happens with State Farm and US Airways? Are they really going to keep the presence here? You’ve got new product coming online.

Our net absorption numbers will be good. I think there will be stories, though, that you’ll continue to see some of our more traditional office buildings slowly make recoveries. However, it’s not going to be an equally opportunity recovery. There are parts of Phoenix that are forever going to see plus 30 percent vacancy. As this market continues to grow and become a freeway sort of office market, areas like Mesa and Metro Center are going to post 30 plus percent vacancies.

There is a spike development in Chandler. We have a pipeline right now of new inventory. Inevitably, we’re going to see vacancies decline.

Over the last ten years you can go through a corporate list of the tenants that are pulling out of these markets. Whereas 10 or 11 percent vacancy would’ve been a number to go and build for Phoenix ten years ago, I think 15 or 16 percent probably will be a number you that can go.

There is a new directive now, and for each person with a cubicle, their cubicle now goes down from 15 square feet down to 8.

We’re going to 100 square feet per person. We’re probably higher than that, where it used to be 250. It’s going to 100. It’s probably 150, maybe 200 now. The trend is going down.

Using Cloud now is taking away all the storage space.

It’s the same in every market. Every tenant has about 20 percent too much space. They say the trend in law firms is that they’re still way, way, way too inefficient. Every law firm’s space is too big, and so the next renewal cycle of law firms are probably all downsizing again, because they still have way too much space per person. Each attorney’s more efficient because of technology. They need less space, less support.

We’re going to go through the cycle where people bail out of downtown to go to the seven per thousand part building, where they used to go out to the Scottsdale Airport. Then, all of a
sudden, you’re going, “I can get that really nice, class A, high-rise downtown. That’d be great for 14 bucks again.” How am I going to park it?

Where are Office Rents headed in the next three months?

- Well, overall, everyone’s going to follow the pack leaders. I think rents are increasing. For the first time, we see our fourth best office sub-markets with asking rents over $30.00 a foot again. Certain buildings would’ve been doing $19.00 and $20.00 deals a year ago, is asking $24 to $25. Old Town Scottsdale has gone from $20, to $24, to $25. Where people want to be, the rents are increasing.

Is this a Tenant or Landlord Office market?

Where are Retail Vacancy Rates headed in the next three months?
- We haven’t had any construction for six years, so that’s helped. They’re going down, but where people want to be, there’s really no vacancy in a lot of the major power centers.
- I think it’s going to go down, but we’re still going to have 40 percent of the big boxes that are available right now, will never be retail again. It becomes a charter school, or it gets blown down for apartments.

Where are Retail - Anchored Center Rents headed in the next three months?

- The rents are definitely going up. Oddly enough, some of our triple nets are going down, which is not in projects like the Casa Paloma, or Scottsdale Quarter, but in a lot of the traditional centers, the triple nets are going down somewhat.
Where are Retail - Unanchored Center Rents headed in the next three months?

- I would say definitely down.
- Even some of the anchored is going down, depending on where it is.

* Total does not equal 100% due to some participants not responding

Where are Retail - Big Box (over 25K square feet) Rents headed in the next three months?

- Everybody is still reeling with internet sales, and trying to figure that out. 40 percent of Macy’s sales is now doing internet fulfillment, instead of selling product.
- The other thing is the downsizing of the Staples and OfficeMax, some of the retailers are just not going to be 28,000 anymore, so that means we’re going to get those back or cut in half.
- The other thing is what Best Buy did which is to basically sublease; they have Samsung in there now. They’re doing little sections that they are subleasing to other retailers.
Scottsdale Road and Acoma, there was an industrial building with that World of Rugs that was going out of business for like the last ten years. Someone bought the building, and they’re going to lop off the L to the east, and they’re turning into retail space. Here is a deal for Firehouse subs for like $40.00 a foot. They had 30 offers for a building that’s 16,000 square feet. That’s why it’s strange. Everybody wants to be there.

Even if the Fed increases the rate, you’re going to see spreads in contracts to be competitive in the marketplace.
Where are Investor Returns headed in the next three months?

- They’re flattening. I think IRR’s are coming in inside of 15%, on a 5 year, 7 year loan.
- Not in our world. We are already seeing the yields that are priced in. We are seeing cap rates that are 50 to 75 to 100 basis points up of where they thought they would be.
- The investors that came in—the stress, the true value-add investors have added the value. They’ve stabilized them. I’m not sure they thought that when they purchased a value investment that the exit would be so thin, as of 2013.
- It all depends on the sub-market and the specific deals and transactions. It’s one of those giant, “It all depends.”
- There are no developer deals in land. The land values are just too high. The makeup of the owners of the land is just different now. They’re investors that have been hanging on for a long time and they aren’t willing to take their hit. It is just tough. There is no speculative land market.
- Whatever little land deals are being done right now, they’re all user deals or homebuilder deals. There’s just no spec land stuff, because there’s just no room in the deal.
- There’s no market for the retail buyer. The numbers aren’t where they thought they’d be. It’s a three to five year hold. It is typical if they went to New York for money; those guys want to see their return because they’re burning their internal rate of return the longer they hold it.
How do you see Medical Office users affecting the absorption of office space in the next three months?

- Medical Office is taking a lot of space that’s been vacant now for a couple years.
- They’re taking it in non-traditional medical space. When you look at how much retail’s been converted to medical now, how do you even track medical space? Banner buys retail centers, and they’re planning to convert those to office. You can’t really track it like you used to. Yet you go to any of the hospitals, you’ll find all this empty space around the hospital.
- They’re just moving out. They’re moving out to the communities, and building little ambulatory centers, or renting ambulatory centers, which is non-traditional in our minds. It’s not the medical office building that we all thought.
- It’s flat. It’s just moving to a different area.

Has Cap Rate Compression helped effect gains in core real estate values over the 4th Quarter of 2013?

- 100% Yes
- 0% No
It all depends; this is the one area where you cannot generalize, even remotely. It is location and sector-specific.

Take the single tenant net lease investment rate credit, right? That’s the closest thing that trades like a bond. Annual bonds. I’m not seeing further cap rate compression. Because why would I pay a six cap for an office in Phoenix when I can buy West LA for six cap? Or north Scottsdale.

We hear that frequently. There’s a point at which I don’t know that you’re going to see further cap rate compression. I think if there’s any kind of a blip in interest rates, then those guys are going to hold their return. To hold that return, that means they have to pay a lower price, which means cap rate goes up.

Will Cap Rate Compression continue in the First Quarter of 2014?

- Depends, as well. Just don’t capitalize it.

Is the tight inventory for homes on the market affecting the commercial side at all?

- We are probably looking at no effect for first quarter. Just a thought.
Will the number of people who have stopped working or stopped looking for work affect commercial real estate/industrial/office/retail/multifamily?

- It is affecting it dramatically
- White collar millennials have a lifestyle completely different than ours.
- They have less furniture. They have iPads. They just live a much smaller and more compact lifestyle. They want to live in a cool place; they want to be close to cool bars and restaurants. It’s all about lifestyle.
- When they want to have a family, they’re going to go out and buy a single-family detached home.
- Again, it’s going to be smaller. Their footprint is going to be much smaller than our footprint was.
- The units are tiny. Most of them are one bedroom. They’re like 650 square feet.
- It is a highly amenitized project. It’s going to be like living in a hotel with towel service at the pool and stuff like that. The rent is 18 or 2,000 bucks a month. It is really, really small. Apparently that’s the trend in these super high-end things.
- Or retirees that want to lock and leave. They want to live in an exclusive location.
Have land prices reached their peak?

- Absolutely not, not in some of the sub-markets. It’s still land barely trading, and if it is, it is lots you can get below replacement costs in a lot of submarkets.
- Those deals that were in escrow in the peak, at 300 plus in Chandler fell apart because the market went to hell. The home prices—the homes were never built, so now we’ve got homebuilders basically paying those same prices back then, and we’ve yet to see where that pricing points us to.
- Because there’s just a huge chasm between the good (A) properties and the not (B) properties.
- Technically, all of the state land stuff will be peak values because they are required to wait on the state land until it reaches that value.
- If you throw out the A markets, everything still has plenty of room to rise. Even some of the B, for that matter.

Have homebuilders stopped buying land?

- 100% No
Sixty percent of the lots, so far this year, were purchased in the West Valley. The supply’s gone. Then it’s just pushing further and further out. You are seeing a move to the West Valley. We still need the jobs to come back to make them be able to afford now a $250,000 house.

Are homebuilders backing out of land deals?

- 90% Yes
- 10% No

Is uncertainty in the Federal Government affecting the commercial real estate market and hindering our local growth potential?

- 100% Yes
- 0% No
What is the overall feeling about the Metro Phoenix commercial real estate market?

- Guardedly optimistic.