Brokers Forum Report

September 24, 2015

Forecast for October 2015 – March 2016

The Center for Real Estate Theory and Practice

W. P. CAREY SCHOOL of BUSINESS

ARIZONA STATE UNIVERSITY

ASU Commercial Brokers Forum Survey
Forecast for October 2015 – March 2016

Introduction

The market is better – and getting better, but it is still shaky in some products areas and submarkets. I think we can see the sunlight. When you look at the trends and read the comments the conclusion is clear that we are on pretty solid ground once again and expanding. Although panelists feel expansion is again occurring, concerns still exist and the geography of the expansion is not uniform – some products and submarkets are doing much better than others but sufficient demand exists to push opportunity for expansion to submarkets that have been slower to recover.

Background

On September 24th, a group of some of the Valley's most successful commercial real estate brokers were brought together by the W. P. Carey School of Business and the 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 held every six (6) months by the Center for Real Estate Theory and Practice in order to track the perceptions, insights and trends in the Phoenix commercial real estate market.

The purpose of this forum is to seek informed opinion and hopefully achieve 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 Pete Bolton, managing director of Newmark Grubb Knight Frank. The forum was conducted as an open discussion about what is happening "on the street" in 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 from the group. This report is a summary of their opinions. Each session builds on the previous ones and the information gathered is synthesized chronologically to provide an indication of trends.

This is the sixth report of the Commercial Real Estate Broker Survey which addresses what the panelists believe will happen between October 2015 and March 2016. The following charts indicate the answers to the associated questions asked of the panel. Preceding each chart are consensus statements made by panelists about the question asked. The responses are anonymous. 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 are as close as possible to being verbatim. This is not a refined analysis of market conditions.

In our last report we felt comfortable saying that there will be little change in performance in all segments of the metro Phoenix real estate market for the next six months. It is clear from the results of this edition of the forum that those who know this market best are feeling good about where we are and confident we will continue to expand. We still feel certain saying 2015 will be better than 2014 and little change will occur before the end of Q1 2016.

Many of the same systemic problems that have persisted for the past several years still exist, such as attracting more high-wage earning jobs but our economic development is improving, construction labor shortages are still a problem but construction hiring is increasing and tight lending is still making anything other than institutional grade borrowing tough and continues to keep a governor on new home construction in addition to tight supply. Again 100 percent of those surveyed said the Phoenix market is moving upwards. When asked the question "Where are we in the cycle?" 90 percent said “Expansion” - this is up from 58% six months ago. Our respondents are feeling good about where we are. They all wished for more activity in most segments, but they see the progress. How we are growing is different and continues to reflect a maturing metro development pattern. These are the forward-looking opinions of the professionals who are in the market every day. These survey results are their opinions based upon their experience.

Mark Stapp
Executive Director, Master of Real Estate Development
Fred E. Taylor Professor of Real Estate

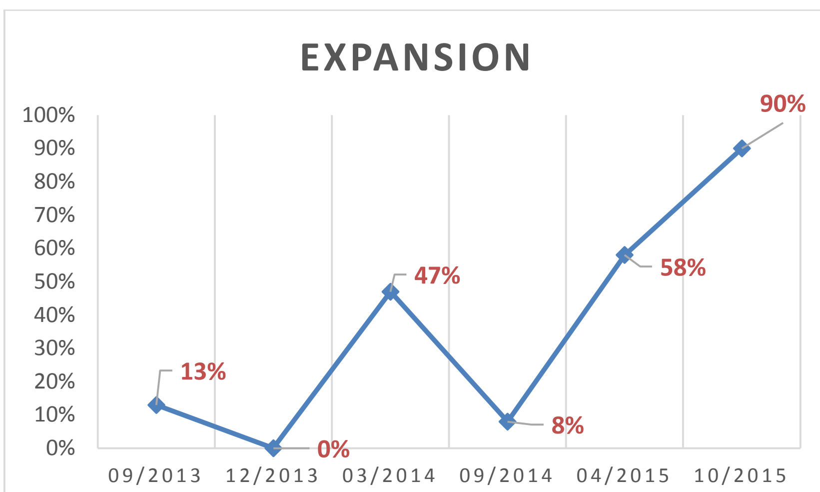
Below are consensus statements made by the panel and charts that show responses to questions asked of the panel. For most questions, panel members could choose "Up", "Down" or "Stationary". For simplicity sake, we chose to only show % of respondents selecting "Up" but believe this adequately show trends.

Questions regarding the overall metro Phoenix real estate market

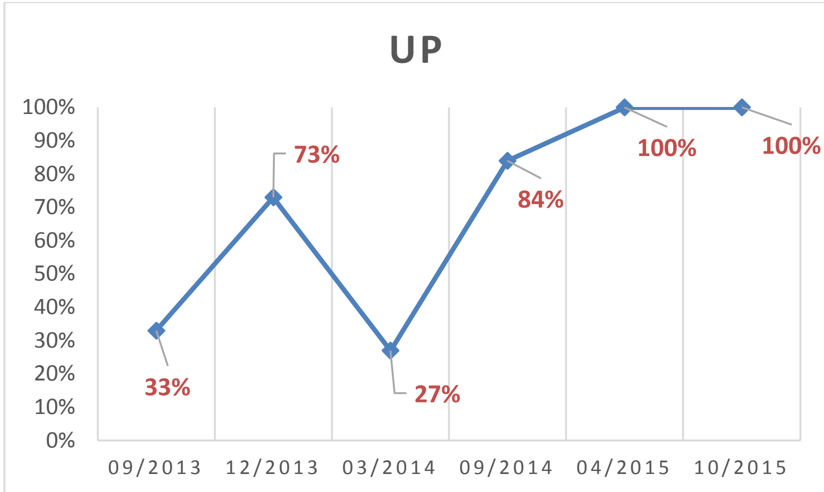
CONSENSUS STATEMENTS:

- [Last year] in September 2014, 92% of respondents believed unemployment or job searching was going to affect the commercial real estate market. The fact of the matter is we aren't seeing unemployment as an issue in this market at this point.
- I think we can say with confidence that we have moved beyond recovery and are expanding – but it's still a little tenuous.
- We just keep feeling better about the market and we can see slight improvement in submarkets that have been unchanged to date.
- Labor production as a factor of GDP has been declining, which is a concern.
- How people work and how they earn a living has changed.
- Hope burns eternal.

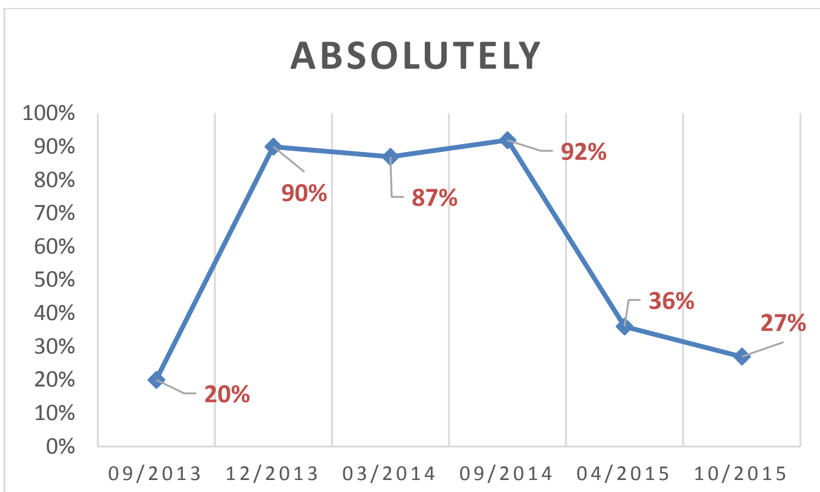
Where are we in the cycle?



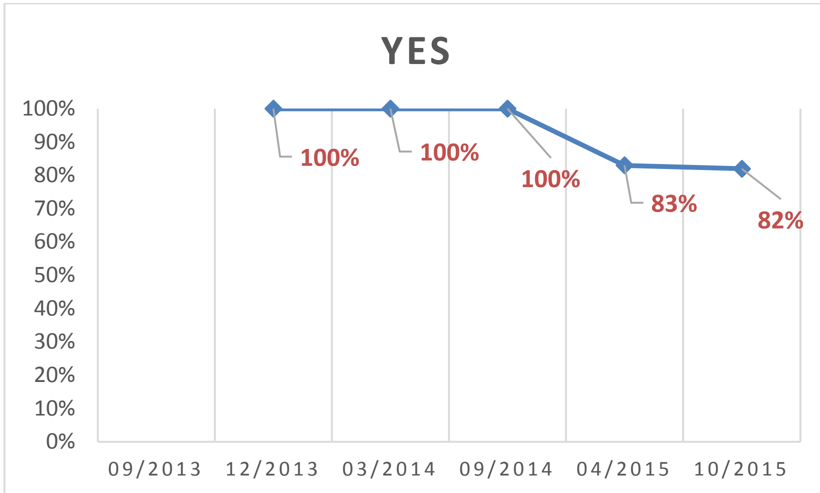
In what direction is the metro Phoenix market moving?



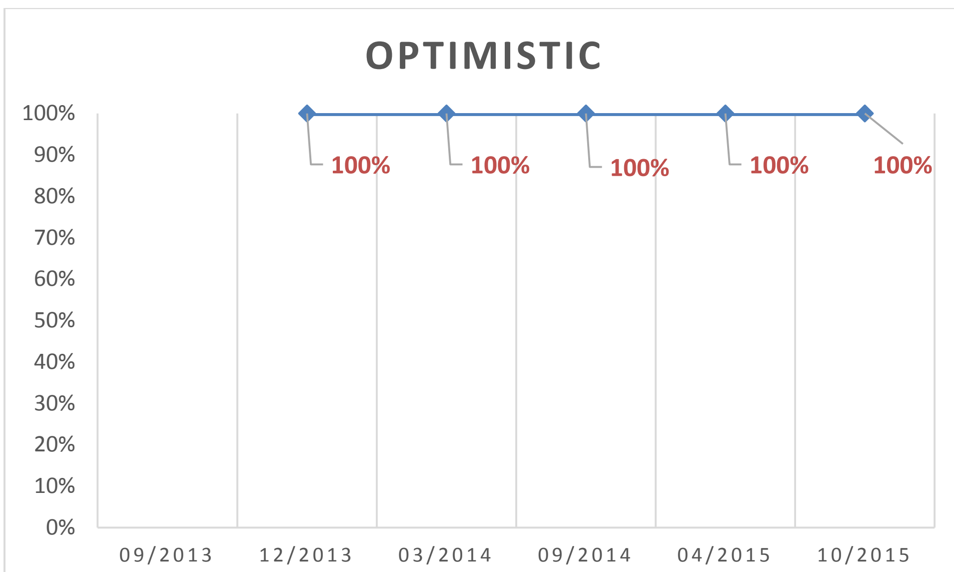
Will the number of people who have stopped working or stopped looking for work affect commercial real estate markets?



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



What is the overall feeling about the metro Phoenix commercial real estate market?

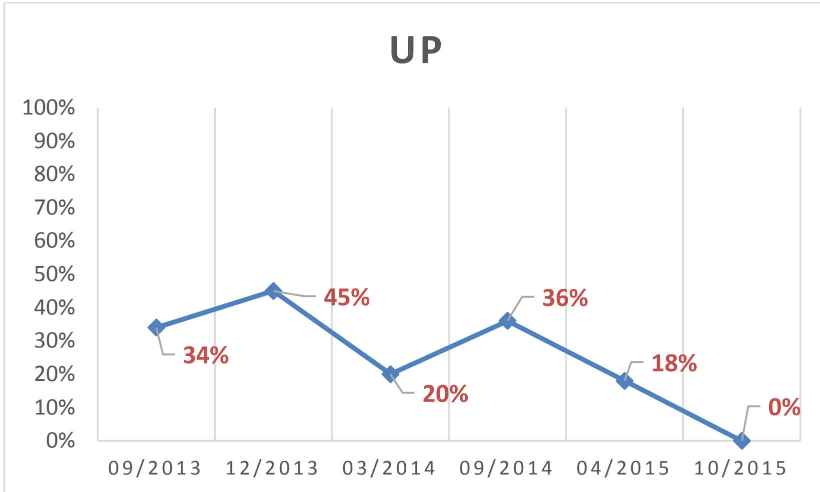


Questions regarding the <u>metro Phoenix Multi-family real estate market</u>

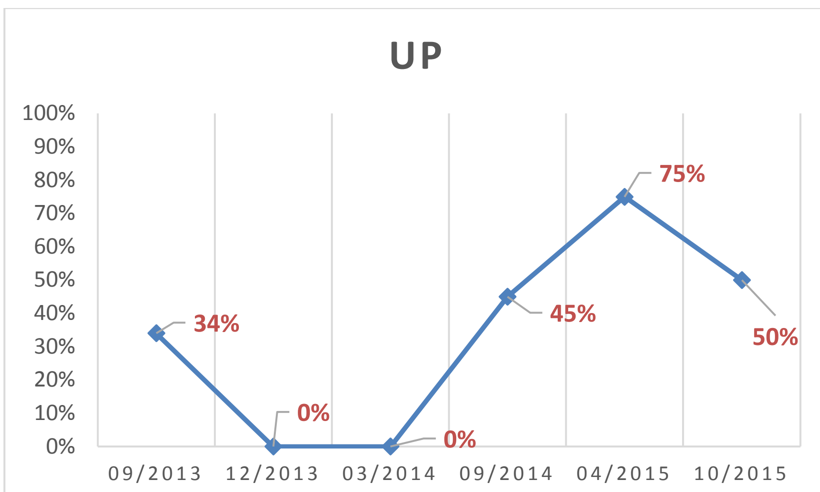
CONSENSUS STATEMENTS:

- Everyone is trying to keep units around 96% occupied.
- Vacancy this last quarter was at 4.3%. A year ago we were at 7%.
- People still aren't buying homes. Central Phoenix with millennials is hot. Luxury apartments are getting soft but C product is on FIRE.
- We are testing the market to see what people will pay until we figure out the ceiling. We're pretty stationary when you look at the overall market.
- Single family has not come back yet. This cycle we haven't overbuilt single family units. We had a shortage supply of going into the downturn. The vacancy problem happened when the immigration laws changed. That is now finally being absorbed. The west side and north phoenix have held out the longest.
- Single level apartments are going to be a hot market. Location driven, want to be with the cool restaurants and retail. It's an unlimited market.
- Home builders are searching for what to do and the single family rental neighborhood can be an answer for that, but it's hard to find affordable land.
- Last year we did 5,400 new units. Right now we are at 7,900 units year to date. We're seeing a crack in A+. The trajectory on rent is running up. A+ is getting soft. They're pushing rents until they go too far.
- Proposed new units is 13,000 next year. There are no B and C units being built. Construction costs are definitely a factor.
- The recovery started in the San Tan Valley. It feels like North Scottsdale was last cycle. It isn't underserved; it's about balance.
- It feels like the southeast valley is becoming an equivalent market to Scottsdale, and the job market is phenomenal in the southeast valley. The land comps in the southeast valley are comparable to north Scottsdale.
- The employment market is now catching up and in tandem with that, there are clients in the west valley redoing buildings. That renter is now willing and able to pay more for nicer, safer communities.

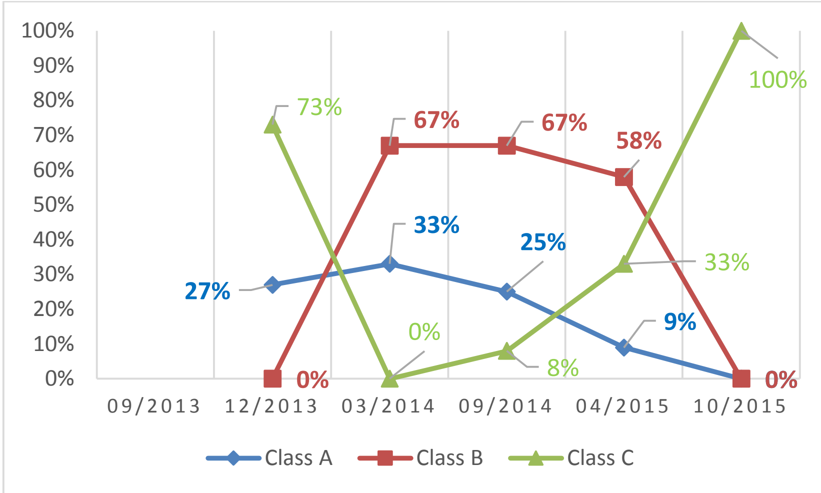
Where are apartment vacancy rates headed in the next six months (October 2015 – March 2016)?



Where are apartment rents headed in the next six months (October 2015 – March 2016)?



Which multifamily property class will realize the greatest rent growth over the next six months (October 2015 – March 2016)?

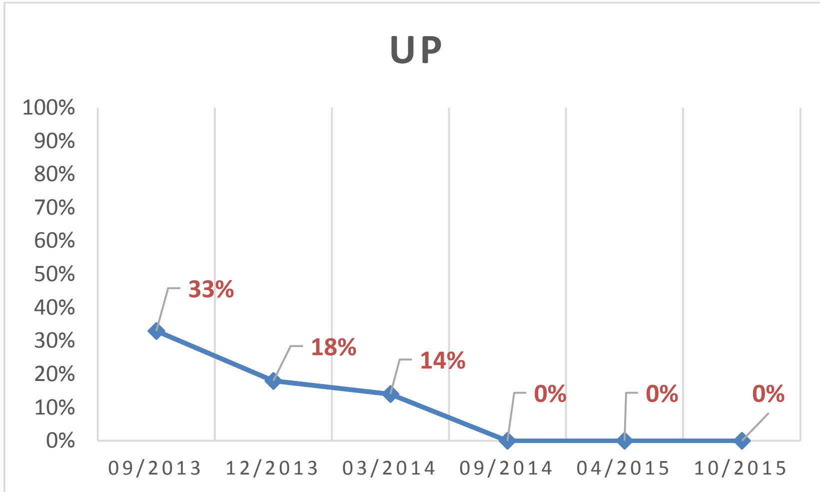


Questions regarding the metro Phoenix Industrial real estate market

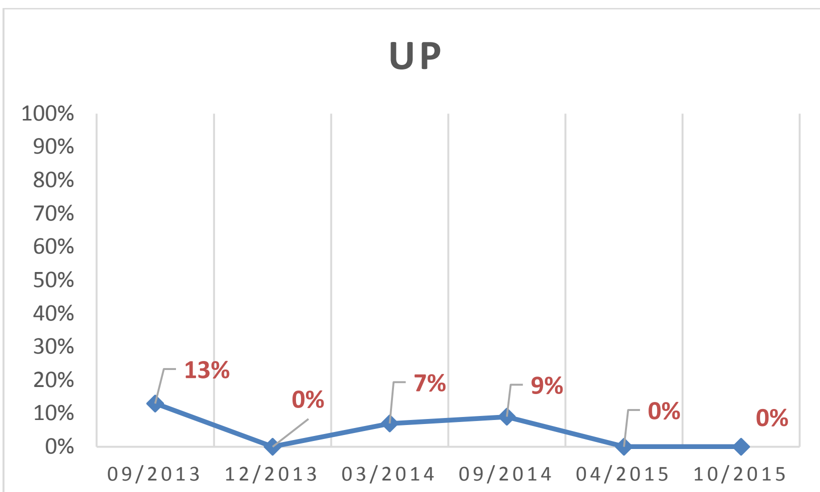
CONSENSUS STATEMENTS:

- Big box industrial has been soft for some time. It has been a long haul but very recently we have seen an uptick in big box commitments and we're optimistic. Out of market employers are now touring facilities; it will be plateauing in terms of demand.
- Overall industrial vacancy is 10%. If we take large blocks of big box space (notably in the SW Valley) out of the calculation, vacancy would be down considerably.
- Amazon is doing so many things but their new, smaller units are part of their fresh food aspect. Back when Amazon was taking space, they were task driven but now it's about the population. How close can they get to the households?
- Amazon is in many businesses and their use of robots now affects employment and therefore affects the building usage.
- They can't all be in West Phoenix and deliver well [so we are likely see space taken in other submarkets].
- There is a continued sentiment that the market is becoming less tenant driven. Vacancies are slowly coming down.
- Most new construction is almost exclusively industrial which creates a tenant market, and those rents are 15% above 2nd generation markets.

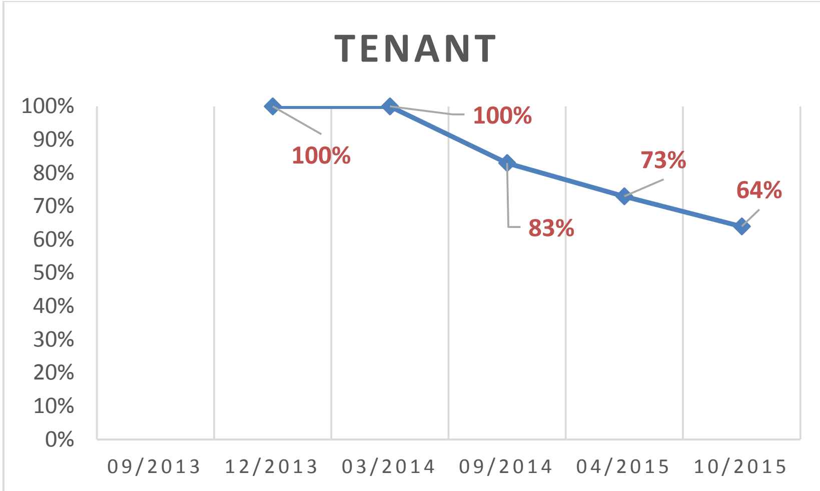
Where are big box industrial vacancy rates headed in the next six months (October 2015 – March 2016)?



Where are big box industrial rents headed in the next six months (October 2015 – March 2016)?



Is this a tenant or landlord industrial market?

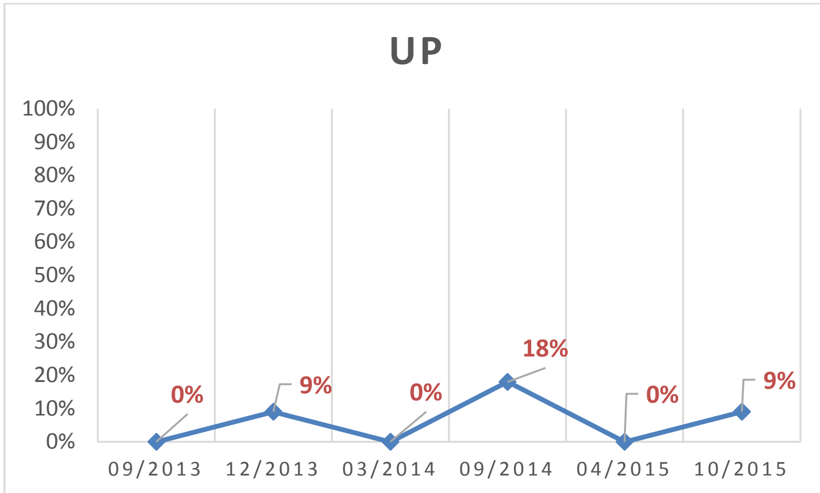


Questions regarding the metro Phoenix Office real estate market

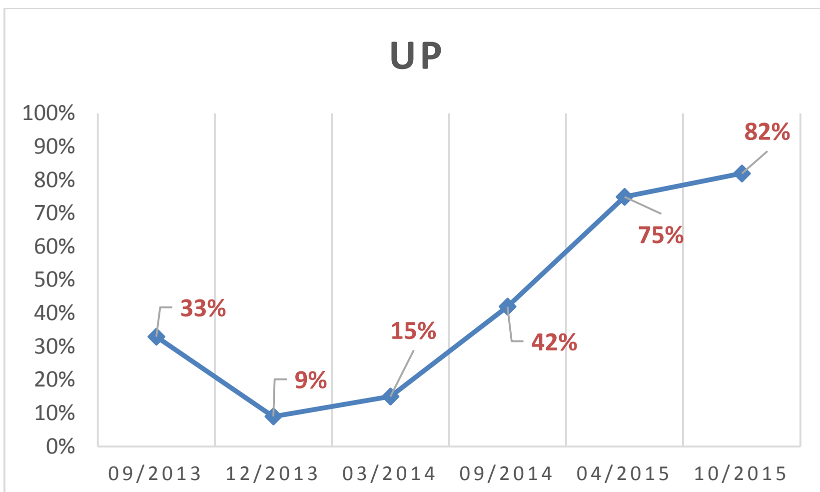
CONSENSUS STATEMENTS:

- Employers are putting more people in less space (which mandates more parking, not the opposite as some thought it would). It used to be that the real estate guy would come in and say "This will work for the business." Now they say "How will this work for the employees?"
- Dealing with the HR Department is now required when even considering renovating a space.
- Medical office condos: They're in great demand because there has been no construction. The highest price per square foot right now is $233. In 06-07 the price per square feet was $320 for build. When the crash happened price per square foot hit below $130.
- For newer buildings vacancy is down. Some older class C buildings are becoming obsolete and need to be repurposed. We're seeing physicians looking for revenue streams. It's cheaper for them to build what they need. Vacancy in medical office is stagnant.
- For medical, if you are close to a hospital the landlords can ask for top of the market rates.
- For the most part institutions are back. [People ask] Why won't our vacancy go down? The answer is because class C product doesn't lease so overall vacancy looks high. These buildings will more likely sell to apartments or retail developers.
- Other than Downtown Tempe (which is a landlord market), office is still a tenant market. For the most part tenants still get concessions and have their fair share of options.

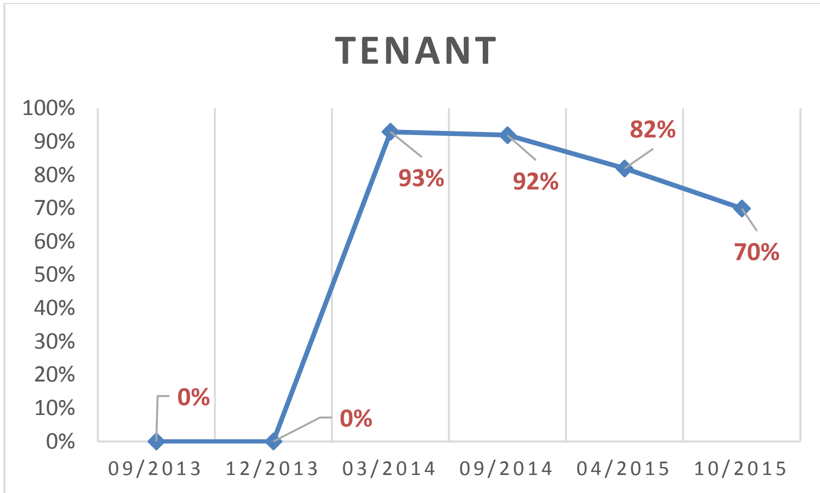
Where are office vacancy rates headed in the next six months (October 2015 – March 2016)?



Where are office rents headed in the next six months (October 2015 – March 2016)?



Is this a tenant or landlord office market?



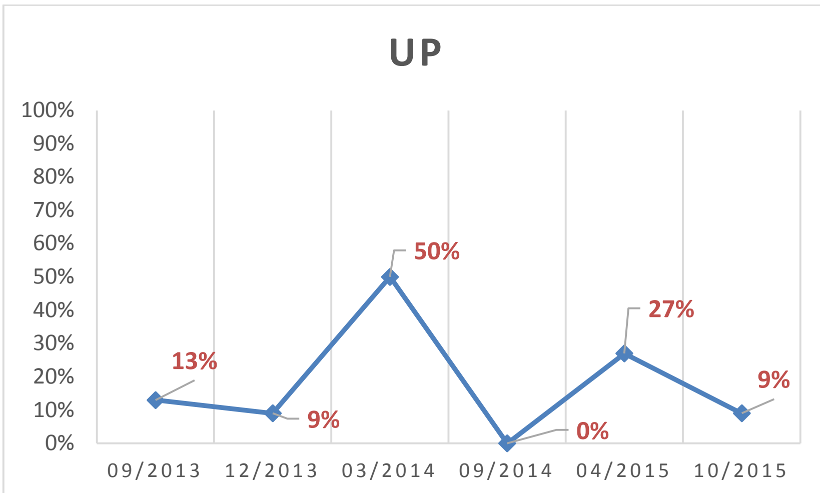
Questions regarding the metro Phoenix Retail real estate market

CONSENSUS STATEMENTS:

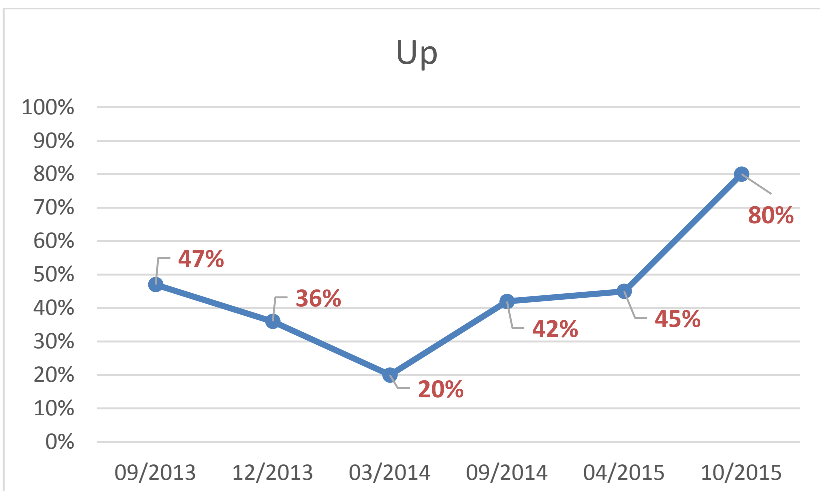
- There are still a lot of big boxes to fill.
- High-end submarkets are doing very well and are being leased up.
- Landlords close to Kierland are taking advantage of the high demand. Tenants don’t want to pay Scottsdale Quarter prices but they want to be near it.
- Certain areas are really hot; all of the restaurants opening have driven rates upward.
- For the first time transaction privilege tax collection is greater for restaurants than grocery stores. Locally owned restaurants have greater collections than national chains.
- The local, foodie thing is huge. It’s a different world than it was at beginning of the recession.
- Big-box’s are being remade into children’s entertainment, jump houses, gymnastic venues, churches, and local furniture stores. Big-box’s that can’t be re-leased or converted are being torn down and converted to apartments.
- It is not easy to convert empty big box stores – there are many restrictions in power and grocery anchored centers prevent repurposing. It’s more than just having the size; the universe of users is getting smaller.
- If you look at the baby boomers and you combine them with the millennials, they are not cooking at home as much as they used to. They would rather eat out, but they still go to the grocery store. However, food is the least profitable part of any grocery store, the retail items make the money.
- Are chain restaurants freaking out? No, if they have a good location, they’re loving it. They may just close one area of the country and flourish elsewhere.

- Small shop space and restaurant rents are going up fast. In Arrowhead, North Scottsdale, and Gilbert rents are over $50 per square foot – it is mostly the food users who are willing to pay.

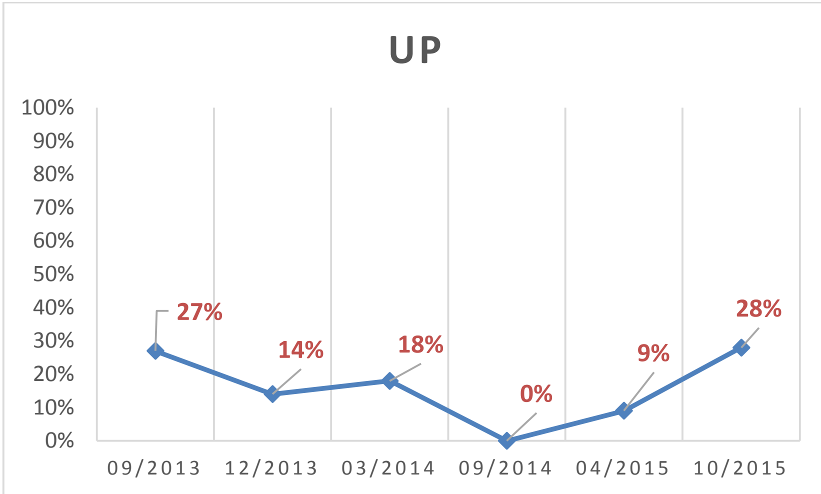
Where are retail vacancy rates headed in the next six months (October 2015 – March 2016)?



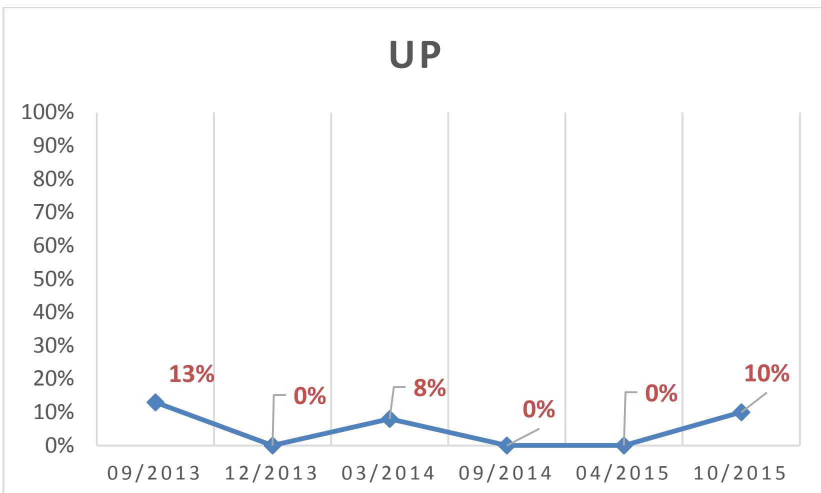
Where are retail — anchored center rents headed in the next six months (October 2015 – March 2016)?



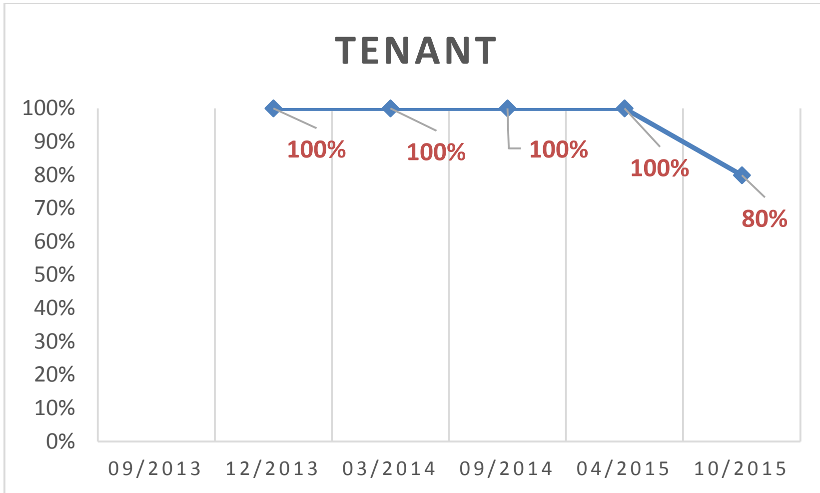
Where are retail - unanchored center rents headed in the next six months (October 2015 – March 2016)?



Where are retail — big box (over 25K square feet) Rents headed in the next 6 months (October 2015 – March 2016)?



Is this a tenant or landlord retail market?

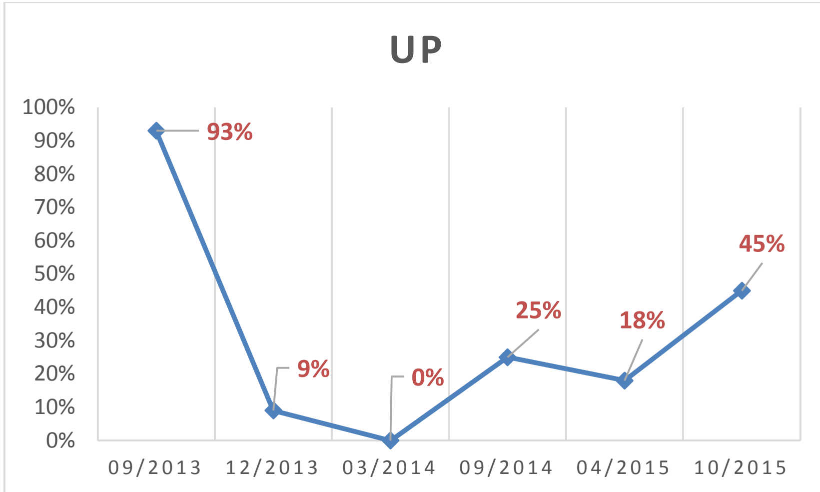


Questions regarding the metro Phoenix Capital markets

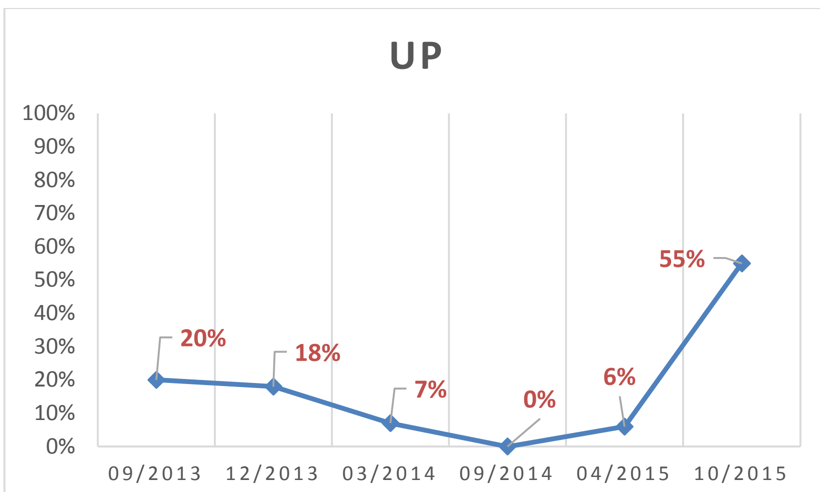
CONSENSUS STATEMENTS:

- Interest rates for commercial loans are stationary – for years we have been thinking they will go up but they haven't yet.
- We will likely see increases in single tenant investment CAP rates.
- In first tier markets (coastal cities), CAP rates are in the 3's. CAP rates in the Phoenix market look very attractive compared to these areas so investors are looking here.
- Corporate users don't like uncertainty. It has a lot to do with the Fed and rising interest rates.

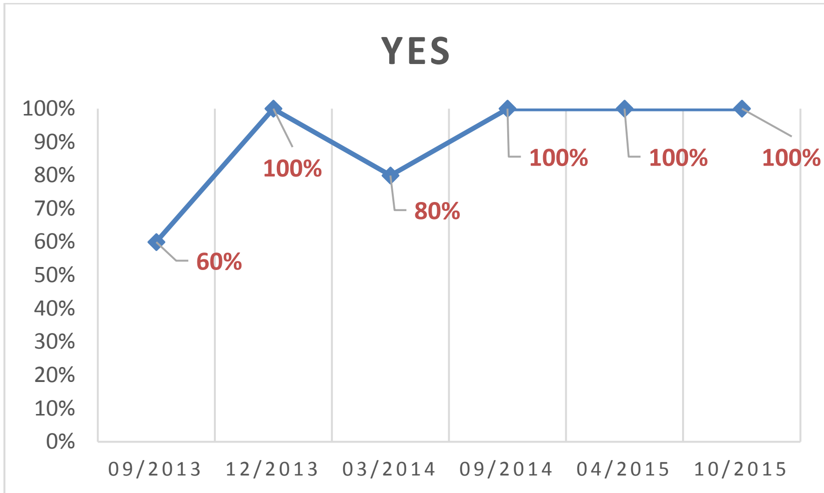
Where are interest rates for commercial loans headed in the next six months (October 2015 – March 2016)?



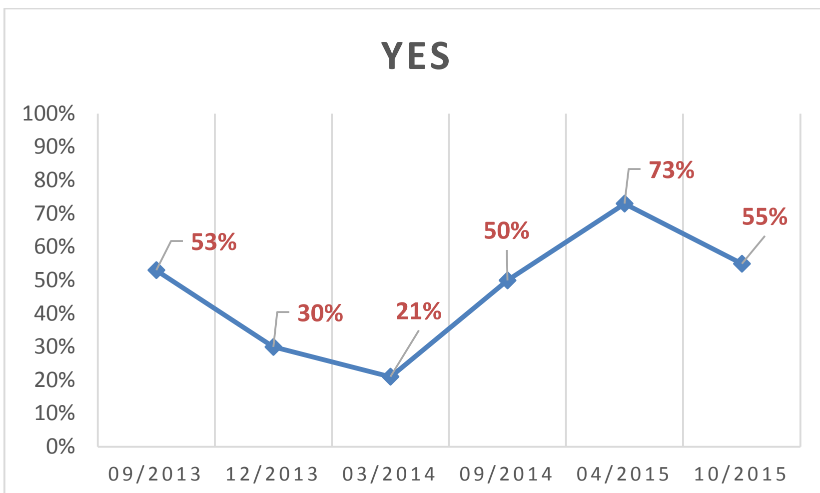
Where are investor returns headed in the next six months (October 2015 – March 2016)?



Has cap rate compression helped effect gains in core real estate values over the past six months (October 2014 – March 2015)?



Will cap rate compression continue in the next 6 months (October 2015 – March 2016)?

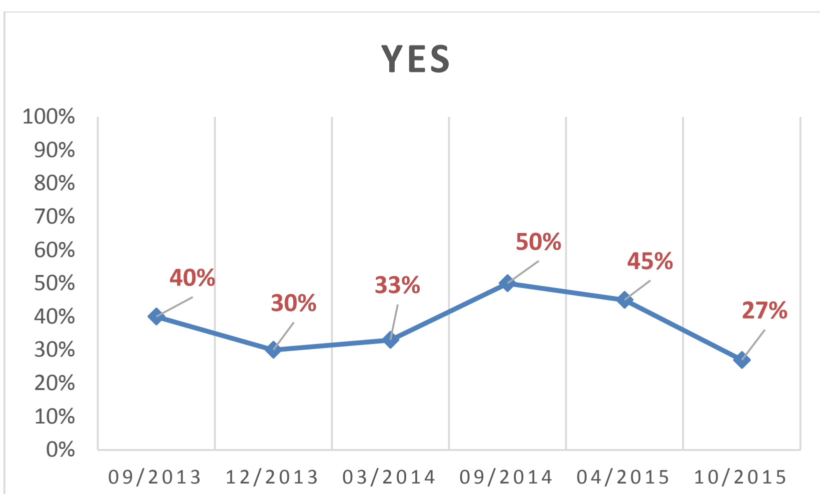


Questions regarding the metro Phoenix Land and Home real estate market

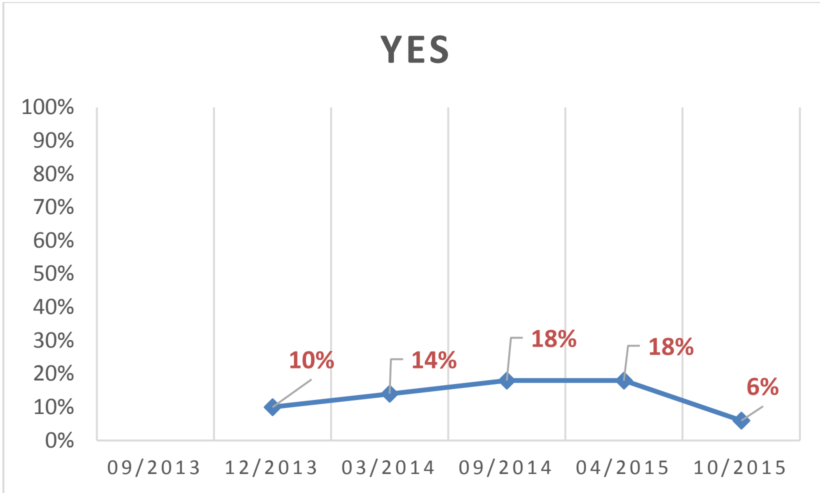
CONSENSUS STATEMENTS:

- The market is slowly improving, permits are up 40% year to date – good news.
- There is a big push to provide more affordable housing because the first time home buyer is starting to wake up.
- We see a couple home builders marketing to apartment renters to pull them out of renting and into home ownership, similar to time shares. A new marketing concept has started touting the purchase of a home as a monthly payment instead of the details of the house or full purchase price. "You won't pay more than $700/month for your mortgage." This is an interesting strategy for entry level sales. It won't affect rent and vacancies because the locations aren't ideal (City of Maricopa, South Phoenix, east of San Tan, etc.), but it shows how builders are getting creative.
- Labor is the biggest problem to building homes. What used to take four months to build is now taking six months or longer.
- Home builders have moved into the multifamily market and are doing it marginally.
- Lower level guys will source the opportunities but the C-suite guys kill the deals when it gets down to the wire.
- Inventory levels will be down in the next two years as there is little new inventory coming on line.

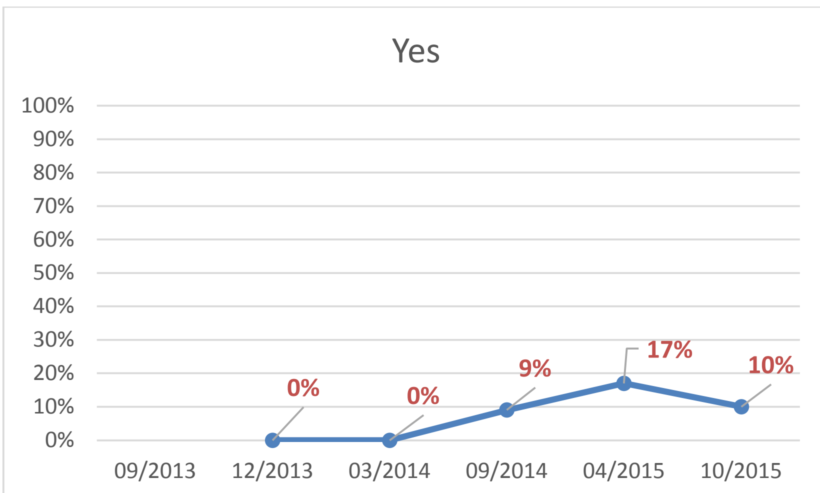
Is the tight inventory for homes on the market affecting the commercial side at all?



Have land prices reached their peak?



Have homebuilders stopped buying land?



Are homebuilders backing out of land deals?