

METRO PHOENIX
Office

NAIHorizon

VACANCY ▲

CONSTRUCTION ▼

FSG RATE ▲

1st Quarter
2023
OFFICE
Market Report

1st Quarter Office Market Report

Nationwide, the office market is beginning to look as grim as it did 13 years ago, in April of 2010 – arguably the low point of the Great Financial Crisis’ impact on commercial real estate. Back then, the U.S. office vacancy rate hit 17.2%, a level not seen in 16 years, or 1994, another dark period for the industry.

The current vacancy rate culprit is companies letting go of excess space as they (primarily, though not exclusively) downsize their respective office footprints.

As the first quarter of this year concluded, the national office vacancy rate settled at 16.5%, according to CommercialEdge.

There’s a big difference between this economy and the economy of 2010, or 1994 for that matter, with the latter two periods suffering from high unemployment, which classically leads to higher-than-average vacancy rates. While many of the big tech firms have announced layoffs, and others have too, such as RH, formerly known as Restoration Hardware, employment, especially office-based work, remains very high in the U.S. The current vacancy rate culprit is companies letting go of excess space as they (primarily, though not exclusively) downsize their respective office footprints.

Since the pandemic, we’ve devoted considerable print space in these reports to remote and hybrid work, debated its durability and permanence, and most considered it for what it was – an experiment in surviving a health crisis and getting work done. While the debate continues, there is no question now that the proven ability of companies to allow employees to work productively from home is negatively impacting office occupancy rates in the U.S. and major metro markets around the globe.

It’s also begun spurring defaults on commercial office mortgages and deeply discounted valuations and sales when they do occur.

In February, at the NAI Global annual convention in Las Vegas, one of the speakers, Lonnie Hendry from Trepp, presented a data-loaded Overview of the Office Market, among which was a slide of the top 10 office markets to watch for (trouble) in the coming years—called The Top 10 Office Watchlist because of the number of office properties that are threatened by default or potentially going into special servicing due to loan maturities in 2023 and 2024. The Top Ten list included Phoenix, Kansas City, Detroit, Stanford, Bridgeport, and others. Hendry said being on the list

Q1 2023

OFFICE MARKET METRO PHOENIX

Q1 AT A GLANCE:

VACANCY: 15.0% ▲

SF CONSTRUCTION: 1.3M SF ▼

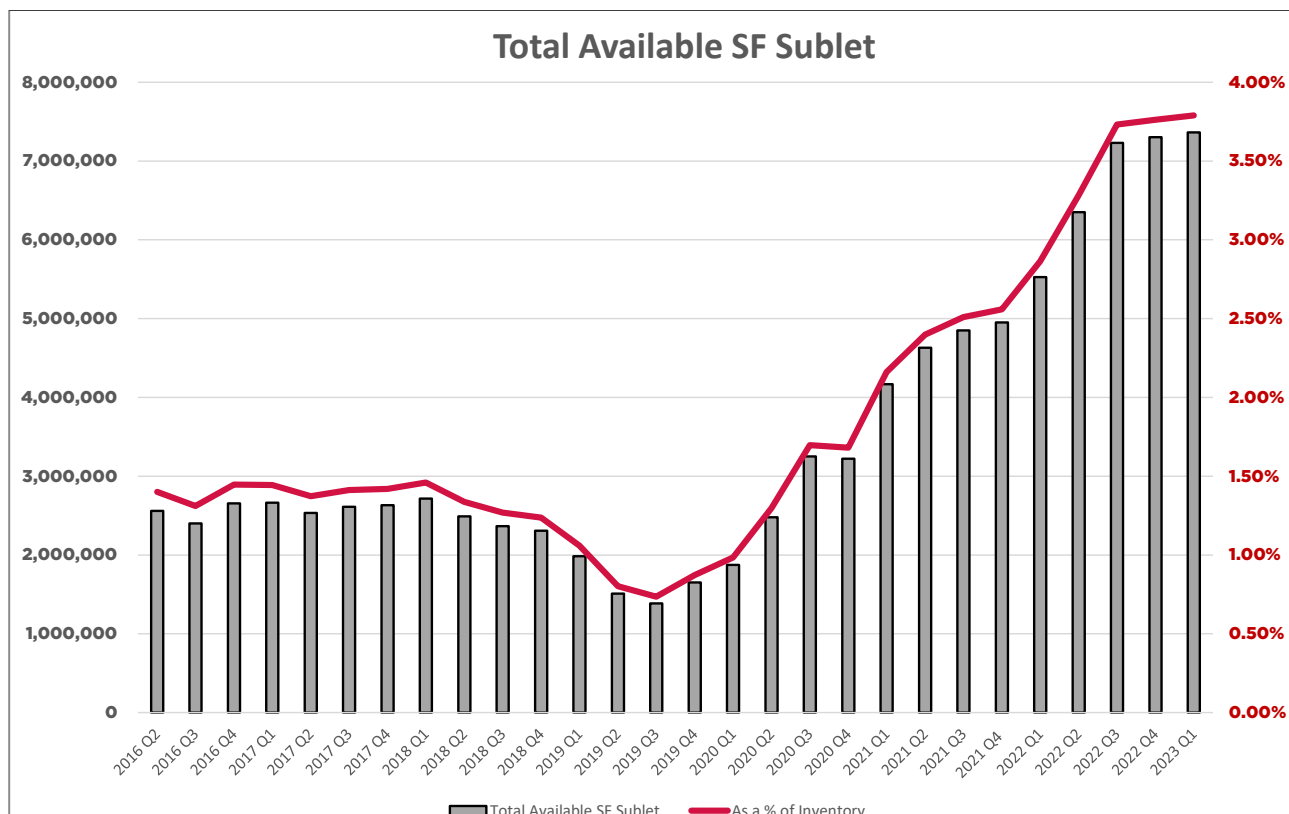
AVG FSG RATE: \$28.83 ▲

doesn't mean the owners of buildings in those cities have missed payments, but rather, there is something the lender doesn't like regarding market conditions. Foremost among the warning signs are:

- High levels of sublease space
- Lease rates trending lower, in some cases substantially
- Falling occupancy
- Capitalization rates doubling

...there is no question now that the proven ability of companies to allow employees to work productively from home is negatively impacting office occupancy rates in the U.S. and major metro markets around the globe.

Total Available SF Sublet



“We’ve had 12 years of what should have been a 7-year cycle and subsequently experienced a deep dive in valuations from 2016 to the present,” Hendry said.

The combination of factors is changing the ballgame for investors.

“Over the last 20-25 years, institutional investors had a model that worked. They took out 10-year, interest-only loans and, at maturity, would either sell the property for hefty capital gains or refinance the loan, take equity out from a decade of appreciation, and distribute that to investors and shareholders,” he said.

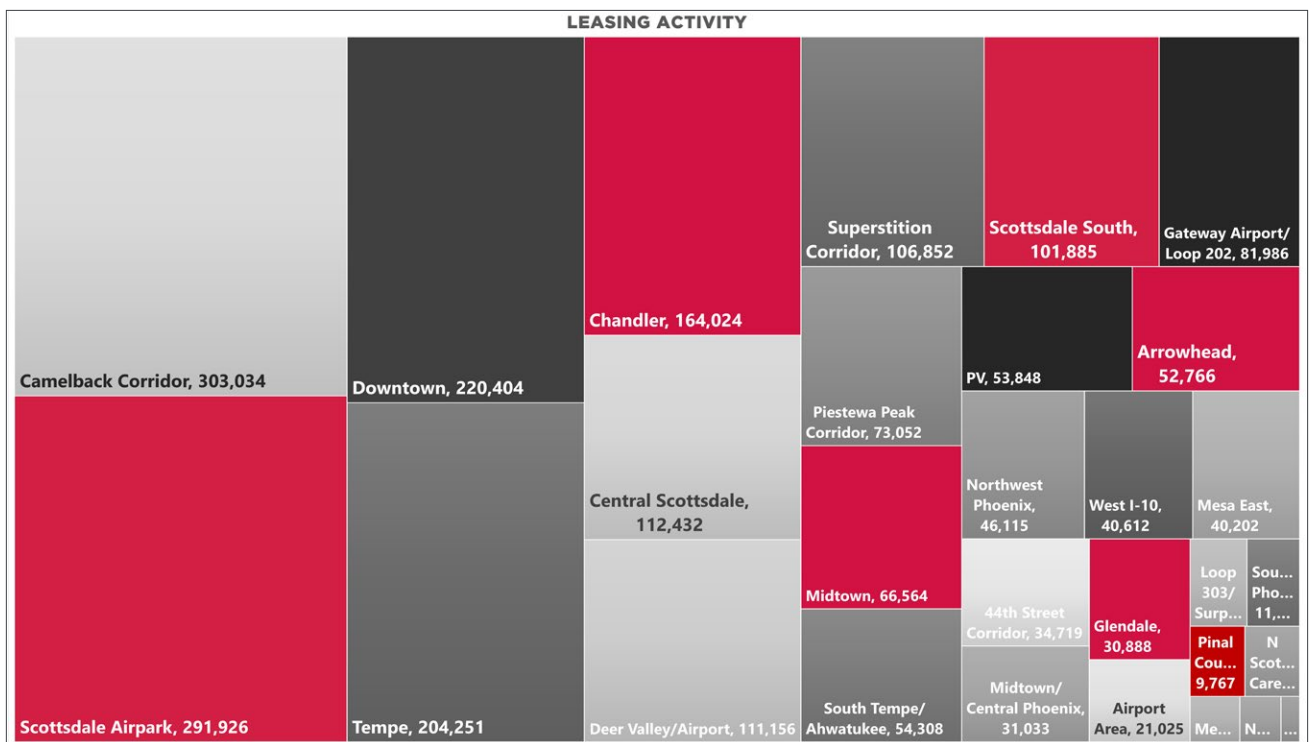
Now, investors are facing capital calls when loan maturities come due. He provided an example of an asset that peaked in value in 2017 at \$485 million, in which the owners had a very low interest rate on the building. With new rates floating between 6.75% and 7.25% (at the time of his speech), the owners had to contribute \$160 million to maintain their current net operating income and get a new loan. That situation

contradicts the investment model of owning and operating commercial real estate assets.

Where we go from here is shaping up to be turbulent times for office property owners, mortgage holders and lenders, and related stakeholders, with many expecting that 2024 will be the year when more significant levels of distress hit the office property markets across the U.S. There was a saying in CRE during the recession of 1990 and the early part of that decade, which was “stay alive to ‘95.” Don’t be surprised if it is resurrected, as “stay alive to ‘25.”

First Quarter 2023 Phoenix Market

The vacancy rate in the downtown office submarket reached 19.1% at the end of the first quarter and has been on an upward trajectory since the first quarter of 2020 when it was 11.8%. By comparison, the downtown vacancy rate was 16% at the close of the first quarter in 2010 – the peak following the GFC.



Q1 2023

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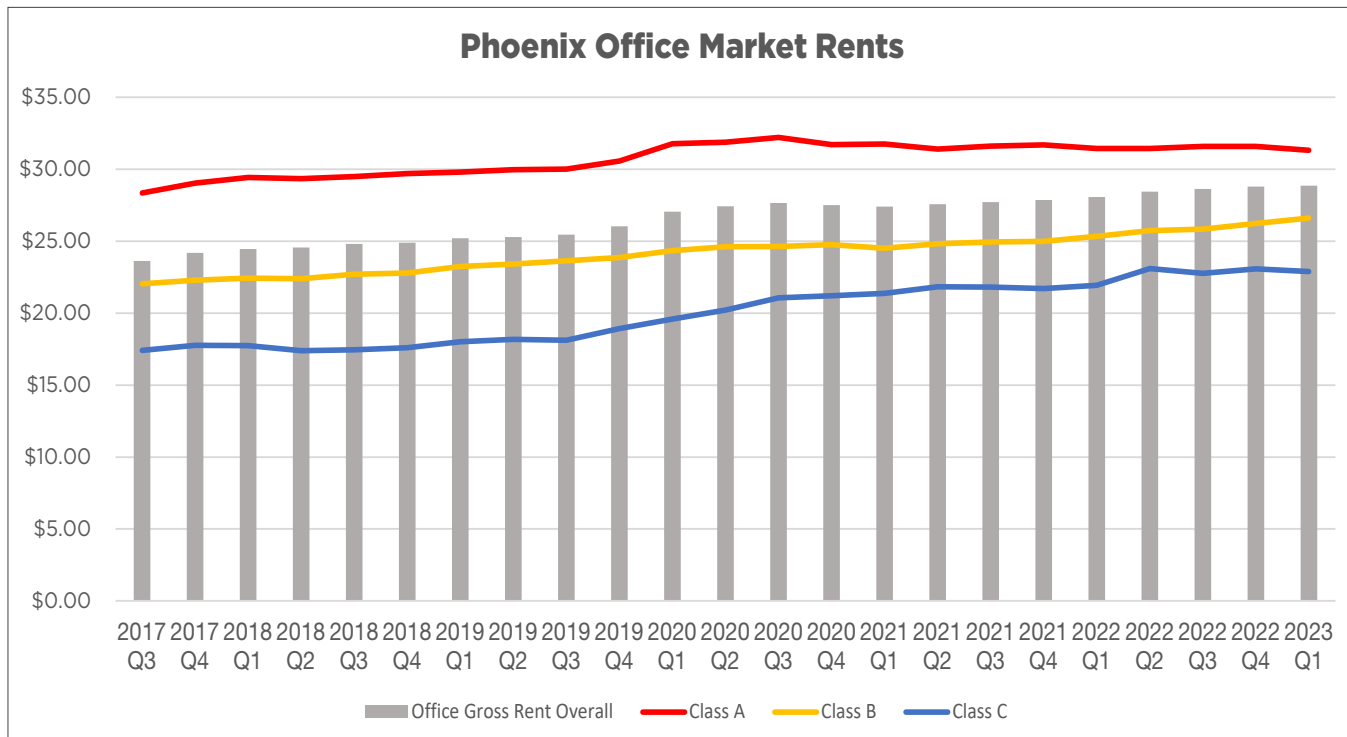
By 2012, it had settled at 10.3% and then ranged between 10.3% and 12% until early 2021. Most experts agree that a vacancy rate of 10% to 11% is equilibrium and doesn't favor either landlords or tenants.

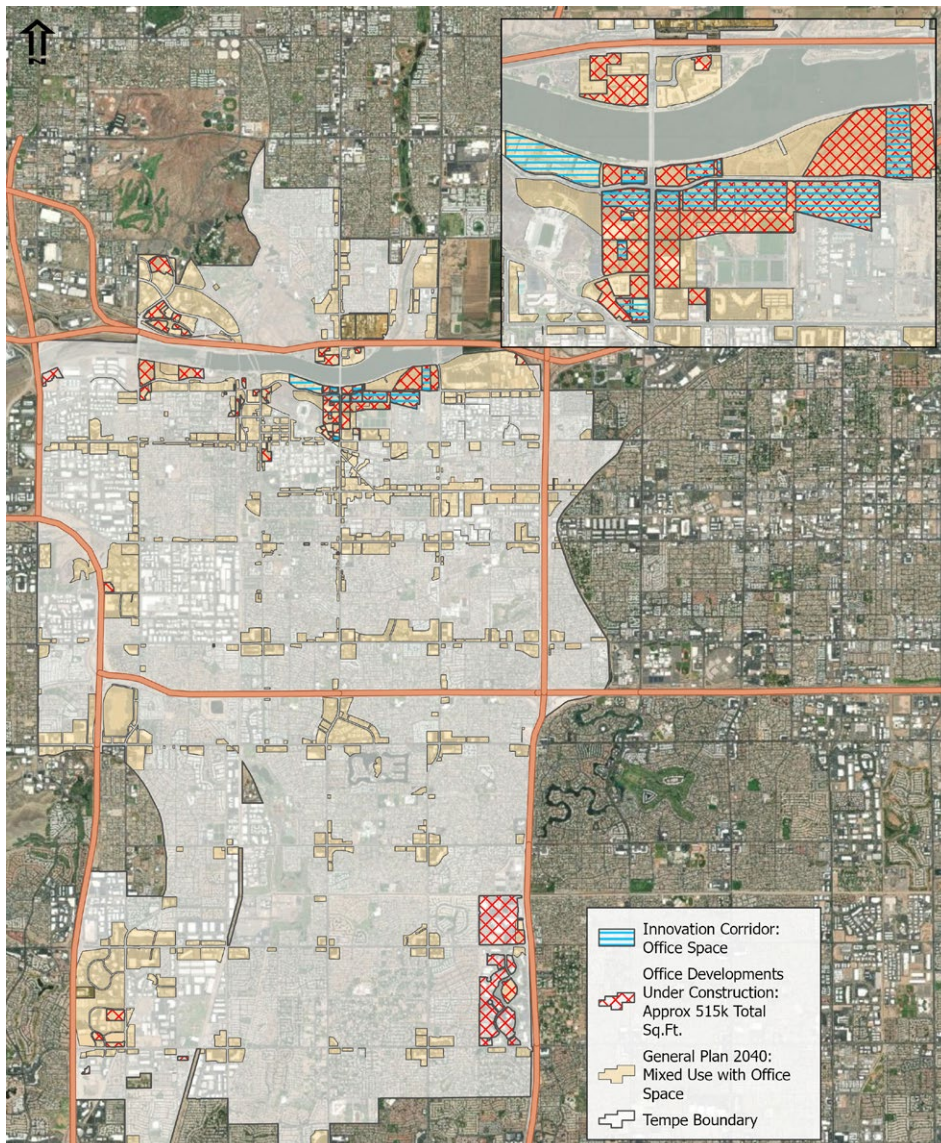
Valley-wide, the Class A sector of the office market is showing an overall vacancy rate of 23.6%, also a high-water mark for the past dozen years. Of the 14+ million square feet of vacant Class A inventory (from a total of nearly 61 million square feet of that product type), 5.2%, or 3.15 million square feet of the market's best office space, is for sublease. Before the pandemic – after 4Q2019, sublease space accounted for 1.7% of vacant Class A space, which is about average when reviewing 24 years of data starting with 1999.

Companies that have put up sizeable blocks of sublease space include Carvana, GoDaddy, PayPal, Peloton, DoorDash, and Opendoor.

For the entire valley and its 29 submarkets and across all office property classes, the first quarter this year ended with a 15.1% vacancy rate, or over 34 million square feet of available

Valley-wide, the Class A sector of the office market is showing an overall vacancy rate of 23.6%, also a high-water mark for the past dozen years.





space in a market with total inventory north of 194 million square feet. Absorption was negative for the period, at -188,672 square feet. Office net absorption was negative in 10 of the last 11 quarters.

Despite the less-than-rosy figures, deals are still getting done, as leasing activity was reasonably robust for the first quarter of the year, with 605 total lease transactions. That's up from 583 in the fourth quarter last year and about average for the past few years. In the first quarter, one lease was signed at over 100,000

square feet at Riverwalk Arizona in the Central Scottsdale submarket (123,952 sf), one completed for over 50,000 square feet, two at more than 40,000 square feet, and several closed transactions over 20,000 square feet.

Seven new office buildings came online in the quarter, adding 166,842 square feet to the office inventory. There is approximately 1.3 million square feet of office space under construction, the majority of which is in Tempe, the largest submarket in the valley and the only one with more than 20 million square feet of office space. Nearly 70% of the 515,000 square feet being built in Tempe is pre-leased.

Rents continued their resilience, rising to \$26.51 for the overall asking rent. That's up from \$25.89 a year ago, though we suspect that effective rents are less than published asking rates, given the vacancy rate and volume of sublease space on the market.

Sales

Approximately \$2.3 billion of office assets have been sold in the Phoenix

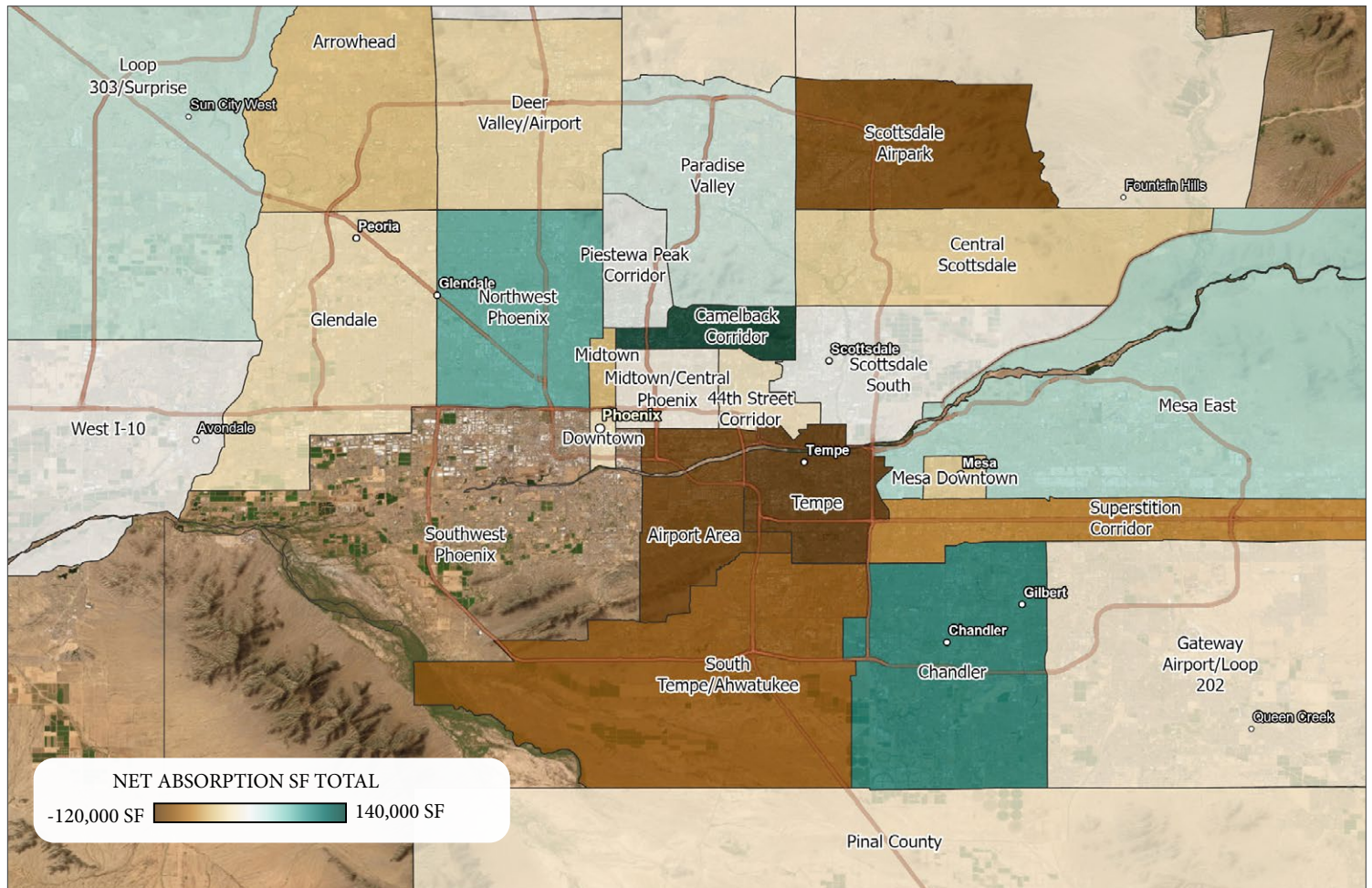
metro area in the past 12 months, slightly less than the five-year annual average of \$2.8 billion. At \$240-per-square-foot, pricing remains below the national average of \$330 a foot for office property sales. The capitalization rate based on recent trades in the last 12 months equaled 6.3% and is expected to rise as transaction volume declines due to the suspended activity in capital markets trading and the bid-to-ask spread. There were no significant office building sales in the first quarter.

Phoenix Market Snapshot

Market Overview

	Total RBA		Vacant SF		Vacant %		Net Absorption		Deliveries		Under Construction		Average Rental	
Class A	60,817,765	▲	14,349,676	▲	23.6%	▼	75,398	▲	70,000	▲	649,000	▼	\$31.32	▲
Class B	106,781,555	▼	14,112,046	▲	13.2%	▲	(288,148)	▲	64,788	▼	578,363	▲	\$26.60	▲
Class C	26,633,941	-	948,568	▼	3.6%	▼	69,129	▼	-	-	-	-	\$22.89	▲
All Submarkets	194,265,315	▲	29,410,290	▼	15.1%	▲	(188,672)	▲	166,842	▼	1,195,309	▼	\$28.85	▲
2022 Q4	194,104,120	▲	29,092,477	▲	15.0%	▲	(45,477)	▲	369,900	▼	1,229,616	▲	\$28.80	▲
2022 Q3	193,772,746	▲	28,691,626	▲	14.8%	▲	(861,606)	▼	457,154	▲	1,185,911	▼	\$28.62	▼
2022 Q2	193,415,026	▲	27,472,300	▲	14.2%	▲	300,014	▼	425,222	▼	1,203,065	▼	\$28.43	▲

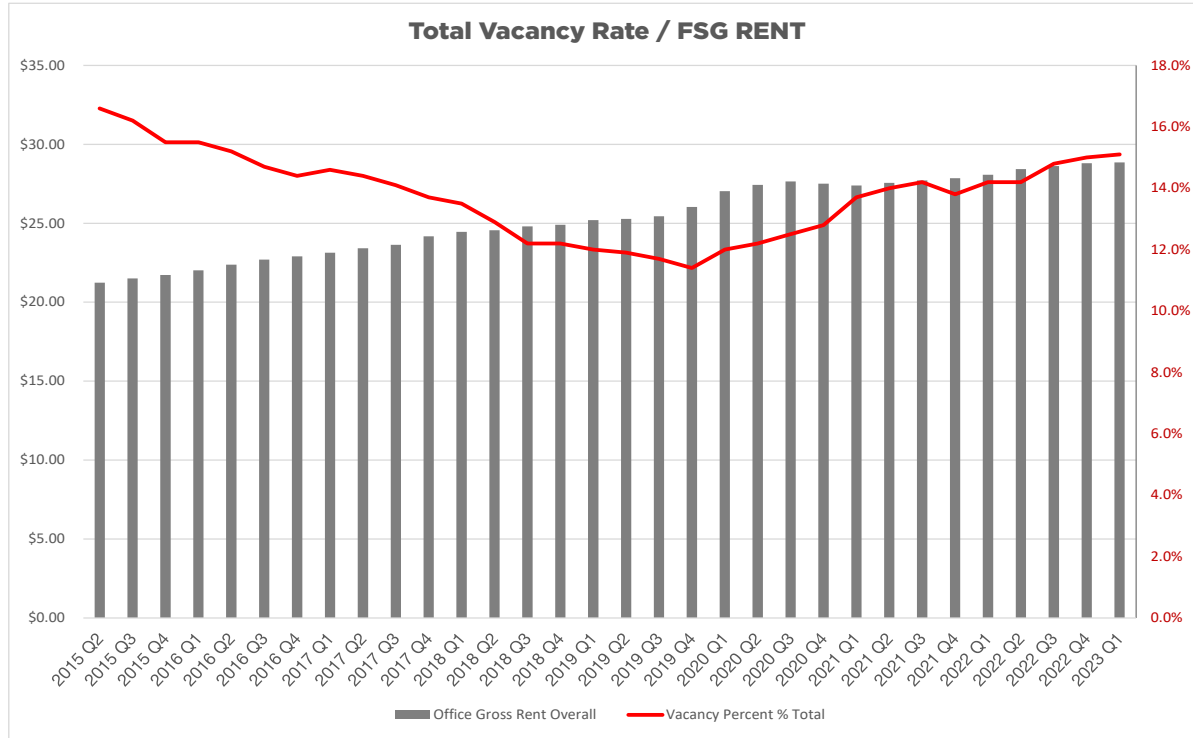
Net Absorption Map Office Q1 2023



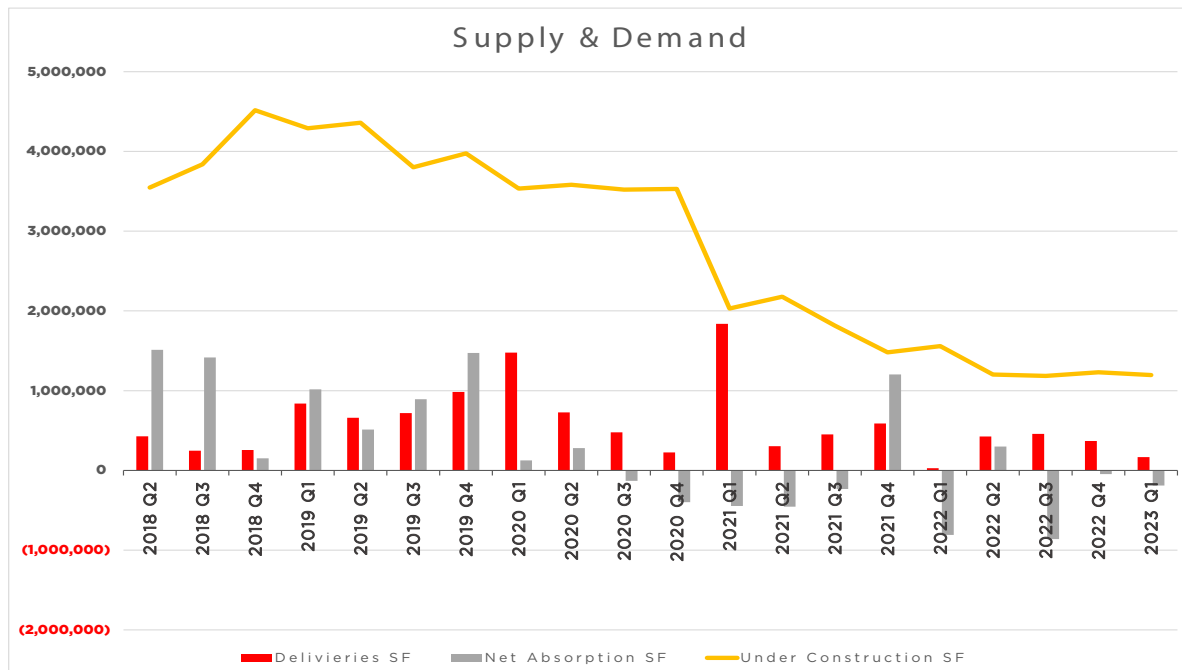
Q1 2023

OFFICE MARKET METRO PHOENIX

Office Vacancy Rates



Supply, Demand & Under Construction



Q1 2023

OFFICE MARKET METRO PHOENIX

Submarket Snapshot

	RBA	Vacant SF	Vacant %	Net Absorption	Deliveries	Under Construction	Avg FSG Rate
41st Street Corridor	3,983,571	- 672,607	▼ 16.9%	▼ (9,698)	▲	- - -	\$27.43 ▲
Airport Area	5,548,055	- 1,241,057	▼ 22.4%	▼ (108,386)	▲	- - -	\$20.97 ▼
Arrowhead	4,779,253	- 454,664	▼ 9.5%	▼ (36,162)	▼	- ▼ -	\$29.70 ▲
Camelback Corridor	9,361,459	- 1,478,582	▲ 15.8%	▲ 138,849	▼	70,000 ▲ 40,000	\$35.45 ▲
Central Scottsdale	9,094,028	- 1,272,532	▼ 14.0%	▼ (25,535)	▲	- - -	\$28.69 ▲
Chandler	12,896,213	▲ 1,900,429	▲ 14.7%	▲ 99,810	▲	13,156 ▲ 84,759	\$28.71 ▲
Deer Valley/Airport	11,924,613	▲ 2,534,115	▼ 21.3%	▼ (21,024)	▲	- ▲ -	\$26.08 ▲
Downtown	11,395,151	- 2,175,299	▲ 19.1%	▲ (12,763)	▼	- ▲ -	\$31.71 ▼
Gateway Airport/Loop 202	2,915,311	▲ 164,480	▼ 5.6%	▼ (2,282)	▼	11,202 ▲ 112,032	\$33.08 ▼
Glendale	3,667,356	- 408,702	▲ 11.1%	▲ (15,673)	▼	- ▼ 103,935	\$30.39 ▲
Loop 303/Surprise	2,648,079	- 182,003	▼ 6.9%	▼ 37,888	▲	- - 18,984	\$32.05 ▲
Mesa Downtown	1,507,892	- 196,736	▼ 13.0%	▼ (27,487)	▼	- - -	\$21.76 ▼
Mesa East	4,922,886	- 514,548	▲ 10.5%	▲ 45,032	▼	36,000 - -	\$23.48 ▼
Midtown	13,301,057	- 2,648,361	▲ 19.9%	▲ (40,882)	▼	- - 18,984	\$25.08 ▼
Midtown/Central Phoenix	5,980,511	- 424,949	▲ 7.1%	▼ 4,797	▼	- - 90,000	\$23.82 ▼
N Phoenix/Cave Creek	148,013	- 4,699	- 3.2%	- (3,369)	▲	- - -	\$24.25 ▲
N Scottsdale/Carefree	1,906,233	- 207,748	▼ 10.9%	▼ (2,115)	▲	- - -	\$25.12 ▼
North I-17	906,306	- 123,965	▼ 13.7%	▼ 14,337	▲	- - -	\$25.12 ▲
Northwest Phoenix	11,048,233	- 1,889,829	▲ 17.1%	▲ 75,592	▼	- - -	\$22.16 ▲
Paradise Valley	5,445,883	- 601,529	▼ 11.0%	▼ 32,104	▲	- - 130,000	\$31.45 ▼
Piestewa Peak Corridor	3,452,961	- 325,838	▼ 9.4%	▼ 20,246	▼	- - -	\$26.23 -
Pinal County	1,771,328	▲ 43,938	▼ 2.5%	▼ (5,714)	▲	4,430 - 5,826	\$15.00 ▲
Scottsdale Airpark	13,967,673	- 2,077,005	▼ 14.9%	▼ (101,398)	▲	- ▲ 32,054	\$32.92 ▼
Scottsdale South	7,987,626	- 1,306,593	▼ 16.4%	▼ 13,452	▲	- - -	\$35.61 ▲
South Tempe/Ahwatukee	7,671,459	- 1,630,246	▼ 21.3%	▼ (91,249)	▲	- - -	\$28.80 ▼
Southwest Phoenix	4,990,560	- 154,221	▼ 3.1%	-	▼	- - -	\$27.54 ▼
Superstition Corridor	6,997,448	- 717,443	▼ 10.3%	▼ (64,279)	▲	- ▼ -	\$26.76 ▲
Tempe	20,829,018	- 3,856,112	▲ 18.5%	▲ (116,321)	▼	- - 515,000	\$31.79 ▲
West I-10	2,743,333	- 201,060	▼ 7.3%	▼ 14,558	▲	- ▼ 94,773	\$32.05 ▲
Total Valley	194,265,315	▲ 29,410,290	▲ 15.1%	▲ (188,672)	▲	166,842 ▼ 1,195,309 ▼	\$28.85 ▲
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Methodology | Definitions | Submarket Map

Class A

A classification used to describe buildings that generally qualify as extremely desirable, investment-grade properties and command the highest rents or sale prices compared to other buildings in the same market.

Class B

A classification used to describe buildings that generally qualify as a more speculative investment, and as such, command lower rents or sale prices compared to Class A properties.

Class C

A classification used to describe buildings that generally qualify as no-frills, older buildings that offer basic space and command lower rents or sale prices compared to other buildings in the same market.

Deliveries

Buildings that complete construction during a specified period of time. In order for space to be considered delivered, a certificate of occupancy must have been issued for the property.

Full Service Gross (FSG) Rental Rate

Rental rates that include all operating expenses such as utilities, electricity, janitorial services, taxes and insurance.

Leasing Activity

The volume of square footage that is committed to and signed under a lease obligation for a specific building or market in a given period of time. It includes direct leases, subleases and renewals of existing leases. It also includes any pre-leasing activity in planned, under construction, or under renovation buildings.

Net Absorption

The net change in occupied space over a given period of time. Unless otherwise noted, Net Absorption includes direct and sublease space.

Rentable Building Area (RBA)

The total square footage of a building that can be occupied by, or assigned to a tenant for the purpose of determining a tenant's rental obligation. Generally RBA includes a percentage of common areas including all hallways, main lobbies, bathrooms, and telephone closets.

Submarkets

Specific geographic boundaries that serve to delineate a core group of buildings that are competitive with each other and constitute a generally accepted primary competitive set, or peer group. Submarkets are building type specific (office, industrial, retail, etc.), with distinct boundaries dependent on different factors relevant to each building type.

Under Construction

The status of a building that is in the process of being developed, assembled, built or constructed. A building is considered to be under construction after it has begun construction and until it receives a certificate of occupancy.

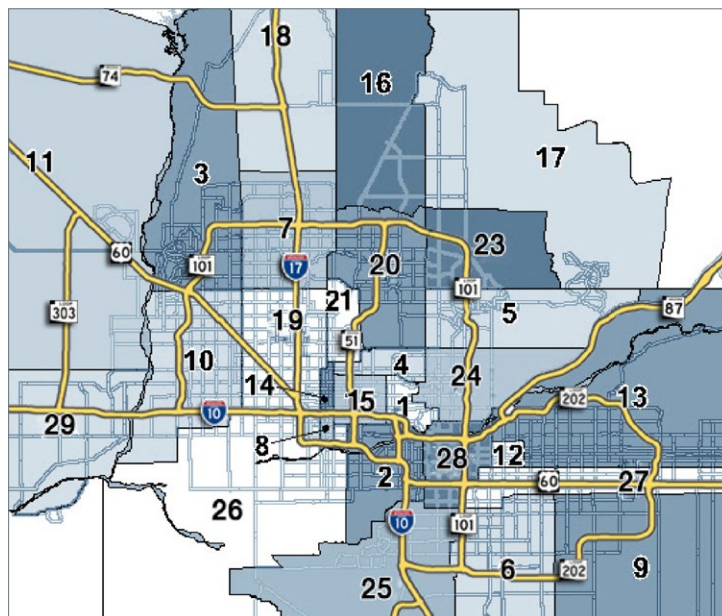
Vacancy Rate

A measurement expressed as a percentage of the total amount of physically vacant space divided by the total amount of existing

inventory space. Under construction space generally is not included in vacancy calculations.

Vacant Space

Space that is not currently occupied by a tenant, regardless of any lease obligation that may be on the space. Vacant space could be space that is either available or not available.



PHOENIX OFFICE SUBMARKETS

- | | |
|-----------------------------|----------------------------|
| 1. 41st St Corridor | 16. N Phoenix/Cave Creek |
| 2. Airport Area | 17. N Scottsdale/Carefree |
| 3. Arrowhead | 18. North I-17 |
| 4. Camelback Corridor | 19. Northwest Phoenix |
| 5. Central Scottsdale | 20. Paradise Valley |
| 6. Chandler | 21. Piestewa Peak Corridor |
| 7. Deer Valley/Airport | 22. Pinal County |
| 8. Downtown | 23. Scottsdale Airpark |
| 9. Gateway Airport/Loop 202 | 24. Scottsdale South |
| 10. Glendale | 25. South Tempe |
| 11. Loop 303/Surprise | 26. Southwest Phoenix |
| 12. Mesa Downtown | 27. Superstition Corridor |
| 13. Mesa East | 28. Tempe |
| 14. Midtown | 29. West I-10 |
| 15. Midtown/Central Phoenix | |

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NAI Horizon knows commercial real estate. With over 30 years in the Valley, NAI Horizon's extensive market insight allows us to match client needs with the right solutions. NAI Global member firms span the U.S. and 42 other countries, with more than 300 offices and more than 5,100 local market experts on the ground. Supported by the central resources of the NAI Global organization, member firms deliver market-leading services locally, and combine their in-market strengths to form a powerful bond of insights and execution for clients with multi-market interests.

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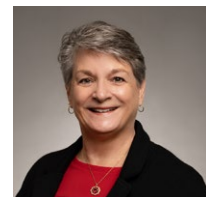
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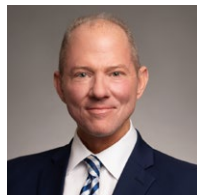
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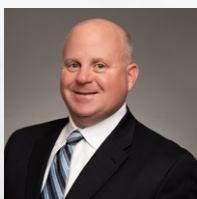
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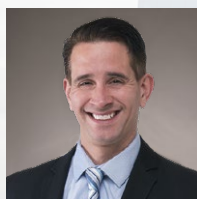
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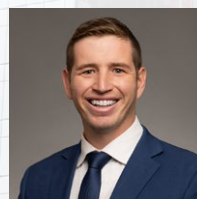
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