



NAI Horizon

1st Quarter
2019
Office
Market Report

Q1 2019

OFFICE MARKET METRO PHOENIX

Phoenix Market Snapshot

THE ECONOMY

The Phoenix economy remains robust in the two key areas of job growth and population growth, which are the primary drivers for office absorption. The Bureau of Labor Statistics ranked Maricopa County as the second leading county nationally in 2018 for job growth with 86,800 jobs last year, a 4.2% increase.

These new job opportunities in turn led to dramatic population growth. Maricopa County was ranked number one in population growth nationwide for the third straight year, according to the US Census Bureau. An influx of 81,244 people migrated to the Phoenix market during the 12 month period ending July 2018, and many of these new Phoenicians came from California. The US Census Bureau reported that 59,233 people moved to Phoenix from California during 2017 and 2018.

ABSORPTION & DEVELOPMENT

The Metro Phoenix office market posted net absorption of 925,016 square feet in the first quarter this year, marking the 16th consecutive quarter for positive absorption going back to 2Q15. To add perspective, during the past four quarters the market absorbed over 3.7 million square feet of office space, making this quarter's performance consistent with absorption numbers in 2018.

Q1 2019 saw 944,184 square feet of new office product delivered, which was nearly identical to the amount of absorption-indicating a balanced market.

By comparison, there was 402,265 square feet delivered in Q1 2018, more than double the delivered product in each of the past 7 quarters.

This statistic could be concerning on the surface; however, recent years have shown a positive supply/demand relationship with net absorption exceeding deliveries every year since 2010. Deliveries since 2010 are 13.9 million square feet with net absorption of 22.0 million square feet—an improvement of 8.1 million square feet.

Currently there are 24 office buildings under construction totaling more than 2.7 million square feet – or approximately an 18-month supply. In the past six quarters, 2,657,172 square feet of office space was positively net absorbed in the Phoenix area.

VACANCY & RENTAL RATES

The Phoenix office market continued to tighten with the vacancy rate ending the first quarter at 13.2 percent. This was down 10 basis points from 4Q2018 and 130 basis points from a year ago, when the 2018 first quarter vacancy rate was 14.6 percent. The current vacancy is the lowest it has been since pre-recession and is considerably down from its peak of 21.6% posted in mid-year 2011. The pace of improvement in the downward trajectory of vacancy has actually increased each year since 2015 when it posted a 60bps improvement to more than double that pace over the past 12 month period. With the Phoenix economy still expanding, we believe there remains room for continued growth in the office market and further declines in vacancy.

With many of the opinion that market equilibrium for office space is a vacancy rate in the 13 to 15 percent range, we've reached that point and more speculative office development is occurring, albeit at a measured pace. Lack of labor and rising costs for materials has moderated office deliveries to levels the market has been able to comfortably absorb.

As a result of declining vacancies rental rates have escalated, reaching an overall average of \$26.31, Full Service Gross (FSG), in the first quarter of 2019. That compares with \$25.24 in 1Q18 an increase of 4.2%, and a staggering

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VACANCY & RENTAL RATES CONTINUED

increase of 36.4% from the \$19.29 per square foot in 1Q2013 – the year when the Phoenix economy began to rise from the ashes of the Great Recession. However, falling vacancy rates are emboldening landlords who are reducing the free rent offered to tenants. Because these incentives don't show up in reported rental rates the effective rental rates are actually higher than the numbers currently reveal.

At the end of their current lease term many office tenants face sticker shock. Average asking rents for tenants with an expiring 3 year lease could be facing an increase in their rent of 17% and for a 5 year lease as much as a 30% increase. At mid-year 2018 we discussed the “flight to affordability” for tenants and to some degree that is still happening, having a further positive impact on Class B buildings.

Rental rate increases are clearly evident – they spiked 39 cents in the most recent quarter, compared with 68 cents for all of 2018. Our strong growth in rental rates, and predicted continued increases, should push our average asking rental rates beyond pre-recession highs.

TRENDS

Tempe and Chandler are the hottest submarkets for office space and have the greatest demand. There is approximately 2 million square feet of new office under construction in Tempe and Chandler alone. While this is a significant amount of new space, the Tempe and Chandler submarkets absorbed 518,309 SF during the first quarter of this year and 1,739,076 SF during 2018, which should indicate an appetite adequate to satiate this new supply.

Co-working continues to expand, with WeWork being the latest entrant in the Phoenix market. They are the largest national co-working company and had been conspicuously absent until 1Q19 when they signed 3 leases for a total of 176,061 square feet in 3 locations: The Esplanade, US Bank Center (downtown), and the under construction Watermark (Tempe). They will add to the other collaborative workplace operators already established in our market, such as Spaces by Regus, Industrious Serendipity Labs and Workuity.

Rapidly rising tenant improvement costs are causing landlords to push for longer term leases in order to allow time to achieve a more sustained return on their additional investment. This is in opposition to the desires of many tenants who would prefer shorter term leases for better timing with future market corrections which many feel may come before a longer term lease may expire. Also tenants with significant amounts of space nationally or regionally, especially public companies, are driven towards shorter lease terms due to the revision in the tax laws requiring they show lease obligations on their balance sheets.

OUTLOOK

Our projected ongoing strong job growth, and many companies making long term hiring commitments, will create strong demand for office space going forward that will result in additional absorption in coming years. The industry categories with the highest absorption are; business services, insurance, health care, technology, and education.

State Farm's recent significant commitment to Phoenix is accompanied by many other national companies announcing significant long term hiring commitments. Many of these pledges are linked to incentives provided that dictate future hiring targets, and salary thresholds. Over the past year these include:

- Deloitte committed to hiring 2,500 employees with an average salary of \$95,000 and has established its first location, leasing 102,434 SF at Rivulon in Gilbert in the first quarter this year.

Phoenix Market Snapshot

OUTLOOK CONTINUED

- Voya Financial, had a smaller presence in the Phoenix area, received a hiring incentive package from the City of Gilbert for agreeing to employ 1,100 workers, and they will receive additional incentives for new hires with salaries in excess of \$46,000. They have leased 151,000 square feet in Allred's Park Place South-Bldg 16 currently under construction in Chandler.
- PNB Parabas/Bank of the West committed to hiring 500 people by June 2018 and an additional 500 by June 2021 at a minimum salary threshold of \$75,000 annually. They will be housed in the two Fountainhead Plaza office buildings in Tempe. The agreement provided tax and training incentives and required a minimum salary threshold for employees of \$75,000.
- Nationwide, who already has a strong presence in Phoenix, recently acquired 134 acres in North Scottsdale for \$950 million to build a campus to be called Cavasson. It will eventually be home to 2,200 employees with room to expand
- Allstate, based near Northbrook, IL, has plans to employ about 2,500 people locally recently leased 100,622 square feet in Allred's Park Place Central-Bldg 4 and 117,000 square feet in Van Trust's One Chandler Corporate Center, both in Chandler.

With Arizona's business-friendly environment, quality of life and reasonably affordable housing, we expect companies to continue to find Phoenix a desirable option for expansion or relocation and will provide strong drivers for future demand for office space.

OFFICE TRENDS

VACANCY
RATE



AVERAGE
ASKING RATE



NET
ABSORPTION



ECONOMIC TRENDS

CONSUMER
PRICE INDEX



30-YR FIXED
MORTGAGE



PHOENIX
METRO
UNEMPLOYMENT



Q1 2019

OFFICE MARKET METRO PHOENIX

Phoenix Market Snapshot

Market Overview

	Total RBA	Vacant SF	Vacant %	Net Absorption	RBA Delivered	RBA Under Construction	Average Rental Rate
CLASS A	52,963,456 SF	7,032,077 SF	13.3%	788,745 SF	669,224 SF	2,137,490 SF	\$30.43/SF
CLASS B	90,850,768 SF	13,031,035 SF	14.3%	119,059 SF	274,960 SF	567,614 SF	\$23.86/SF
CLASS C	15,555,467 SF	1,434,895 SF	9.2%	74,177 SF	-	-	\$18.55/SF
TOTAL	159,369,691 SF	21,498,007 SF	13.5%	981,981 SF	944,184 SF	2,705,104 SF	\$26.31/SF
Q4 2018	158,424,008 SF	21,089,181 SF	13.3%	103,418 SF	368,886 SF	368,886 SF	\$25.92/SF
Q3 2018	158,078,636 SF	20,847,227 SF	13.2%	1,350,461 SF	409,108 SF	199,756 SF	\$25.68/SF

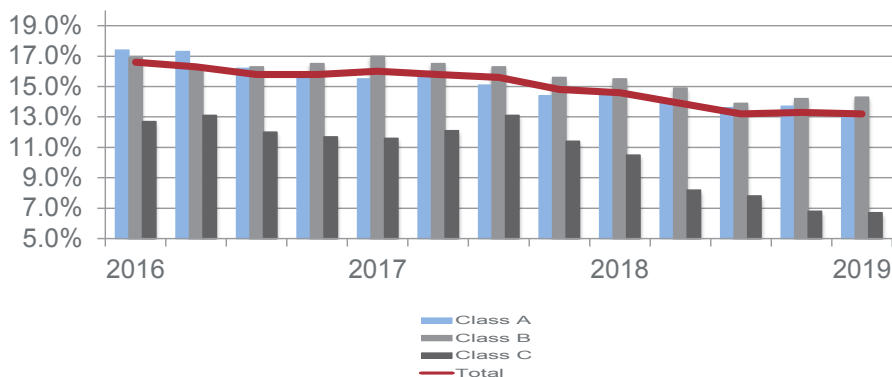
Significant Lease Transactions

Address	Tenant	Size	Class	Type
410 N Scottsdale Rd	WeWork	68,968 SF	A	New Lease
2390 E Camelback Rd	Turo	30,090	A	New Lease
350 W Washington	Caris Life Sciences	28,640 SF	A	New Lease
9165 W Thunderbird Rd	Banner Medical Group	26,116	B	New Lease
4645 E Cotton Center Blvd	23 and Me	25,719 SF	A	New Lease

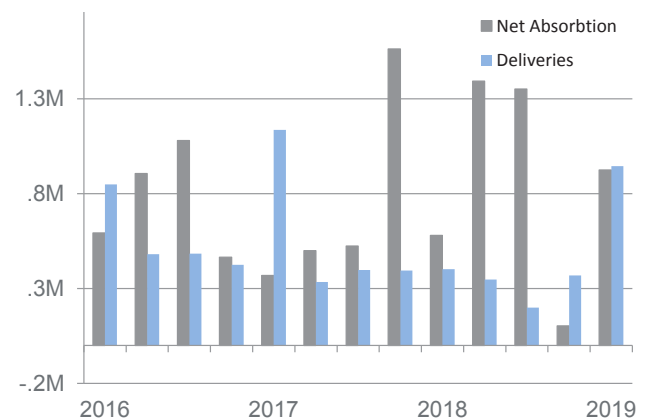
Significant Sale Transactions

Address	Date	Size	Class	Price
The Alameda	02/20/2019	485,687 SF	B	\$80.7M (\$166.16/SF)
Phoenix Corporate Tower	03/14/2019	457,893 SF	A	\$42.3M (\$92.47/SF)
2020 On Central	03/17/2019	247,645 SF	A	\$23.89M (\$96.46/SF)

Office Vacancy Rates



Absorption & Deliveries



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OFFICE MARKET METRO PHOENIX

Submarket Snapshot

	RBA		Vacant SF		Vacant %		Net Absorption		Deliveries		Under Construction		Avg FSG Rate
44th Street Corridor	3,786,930	—	432,608	▼	11.4%	—	3,200	▲	-	—	-	—	\$26.43
Airport Area	9,322,359	▲	1,488,936	▲	16.0%	▼	263,866	▲	82,951	▲	160,910	▼	\$23.68
Arrowhead	2,925,021	—	439,097	▲	15.0%	▲	(30,218)	▼	22,700	▼	25,401	▲	\$26.34
Camelback Corridor	9,148,002	—	1,532,375	▼	16.8%	▼	108,781	▲	-	▼	118,500	—	\$31.34
Central Scottsdale	7,641,437	▲	956,922	▲	12.5%	▲	14,171	▲	3,597	▲	-	▼	\$26.31
Chandler	9,765,020	▲	1,350,004	▲	13.8%	▲	164,774	▲	246,144	▲	748,721	▼	\$27.04
Deer Valley/Airport	11,161,287	—	1,211,467	▲	10.9%	▲	281,031	▲	-	—	14,500	▲	\$24.38
Downtown	10,140,979	▲	1,325,149	▲	13.1%	▲	(117,193)	▼	-	—	228,402	▼	\$31.63
Gateway Airport/Loop 202	1,372,180	—	161,545	▲	11.8%	▲	(7,196)	▼	-	—	185,600	—	\$25.90
Glendale	2,942,231	—	397,182	▲	13.5%	▲	9,623	▲	64,152	▲	195,000	▼	\$26.50
Loop 303/ Surprise	1,929,109	—	166,302	▼	8.6%	▼	7,586	▼	-	—	-	—	\$22.36
Mesa Downtown	924,621	—	58,918	▲	6.4%	▲	(24,322)	▼	-	—	-	—	\$18.81
Mesa East	2,029,877	—	149,314	▲	7.4%	▲	(44,106)	▼	-	—	-	—	\$18.41
Midtown	12,059,386	—	2,395,287	▲	19.9%	▲	(53,421)	▼	-	—	-	—	\$23.34
Midtown/Central Phoenix	4,881,995	—	414,721	▲	8.5%	▲	(24,138)	▼	-	—	-	—	\$20.84
N Phoenix/Cave Creek	81,281	—	3,000	▲	3.7%	▲	(600)	▼	-	—	-	—	\$19.31
N Scottsdale/Carefree	1,080,339	—	185,107	▼	17.1%	▼	(1,582)	▼	-	—	-	—	\$25.22
North I-17	510,640	—	93,884	▼	18.4%	▼	1,275	▼	-	—	23,000	—	\$25.09
Northwest Phoenix	8,757,809	—	2,115,710	▲	24.2%	▲	(188,133)	▼	-	—	-	—	\$19.19
Paradise Valley	3,738,342	—	504,281	▼	13.5%	▼	43,348	▲	-	—	-	—	\$25.17
Piestewa Peak Corridor	3,119,582	—	526,206	▼	16.9%	▼	19,061	▲	-	—	-	—	\$23.95
Pinal County	816,637	—	71,272	▲	8.7%	▲	(2,869)	▼	-	—	-	—	\$19.43
Scottsdale Airpark	12,473,213	—	1,664,914	▲	13.3%	▲	(20,027)	▼	-	—	48,514	▲	\$27.78
Scottsdale South	5,701,576	—	763,571	▲	13.4%	▲	(23,350)	▼	-	▼	274,338	—	\$30.99
South Tempe/Ahwatukee	7,093,306	▲	799,846	▼	11.3%	▼	353,535	▲	220,000	▲	-	▼	\$23.47
Southwest Phoenix	4,346,420	—	246,024	▼	5.7%	▼	16,844	▲	-	—	-	—	\$27.34
Superstition Corridor	4,771,638	—	463,003	▼	9.7%	▼	24,191	▲	-	—	-	—	\$21.25
Tempe	14,725,016	▲	932,598	▼	6.3%	▼	388,576	▲	213,500	▲	961,628	▼	\$31.90
West I-10	2,121,959	—	259,106	▲	12.2%	▲	(7,863)	▲	-	—	-	—	\$25.12

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

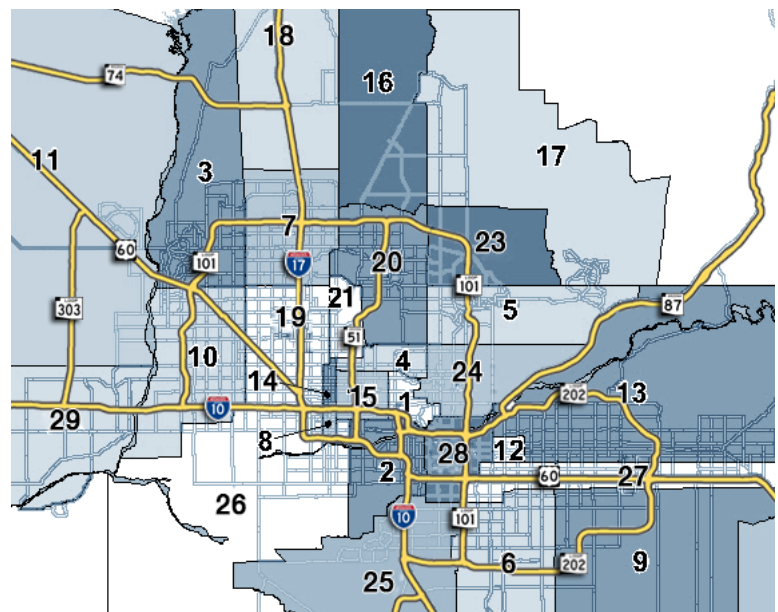
The status of a building that is in the process of being developed, assembled, built or constructed. A building is considered to be under construction after it has begun construction and until it receives a certificate of occupancy.

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. 44th St Corridor
2. Airport Area
3. Arrowhead
4. Camelback Corridor
5. Central Scottsdale
6. Chandler
7. Deer Valley/Airport
8. Downtown
9. Gateway Airport/Loop 202
10. Glendale
11. Loop 303/ Surprise
12. Mesa Downtown
13. Mesa East
14. Midtown
15. Midtown/Central Phoenix
16. N Phoenix/Cave Creek
17. N Scottsdale/Carefree
18. North I-17
19. Northwest Phoenix
20. Paradise Valley
21. Piestewa Peak Corridor
22. Pinal County
23. Scottsdale Airpark
24. Scottsdale South
25. South Tempe
26. Southwest Phoenix
27. Superstition Corridor
28. Tempe
29. West I-10

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NAI Horizon knows commercial real estate. With over 26 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 55 other countries, with more than 400 offices and more than 7,000 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 challenges.

www.naihorizon.com

Office Specialists



Thomas Bean, CCIM
Vice President
thomas.bean@naihorizon.com



Logan Crum
Associate
logan.crum@naihorizon.com



Troy Giammarco
Vice President
troy.giammarco@naihorizon.com



Kevin Higgins
Vice President
kevin.higgins@naihorizon.com



Lori Kahn, MBA
Associate
lori.kahn@naihorizon.com



Laurel Lewis
Senior Vice President
laurel.lewis@naihorizon.com



Lane Neville
Senior Vice President
lane.neville@naihorizon.com



Stan Matzinger
Associate
stan.matzinger@naihorizon.com



Jay Mininberg, J.D.
Associate
jay.mininberg@naihorizon.com



Don Morrow
Senior Vice President
don.morrow@naihorizon.com



John Toben
Associate
john.toben@naihorizon.com



Dylan Whitwer
Associate
dylan.whitwer@naihorizon.com



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NAIHorizon

2944 N 44th Street, Suite 200
Phoenix, Arizona 85018
tel +1 602 955 4000
www.naihorizon.com