Phoenix Office Insight Report

Q3 2021

AVANT by AVISON YOUNG

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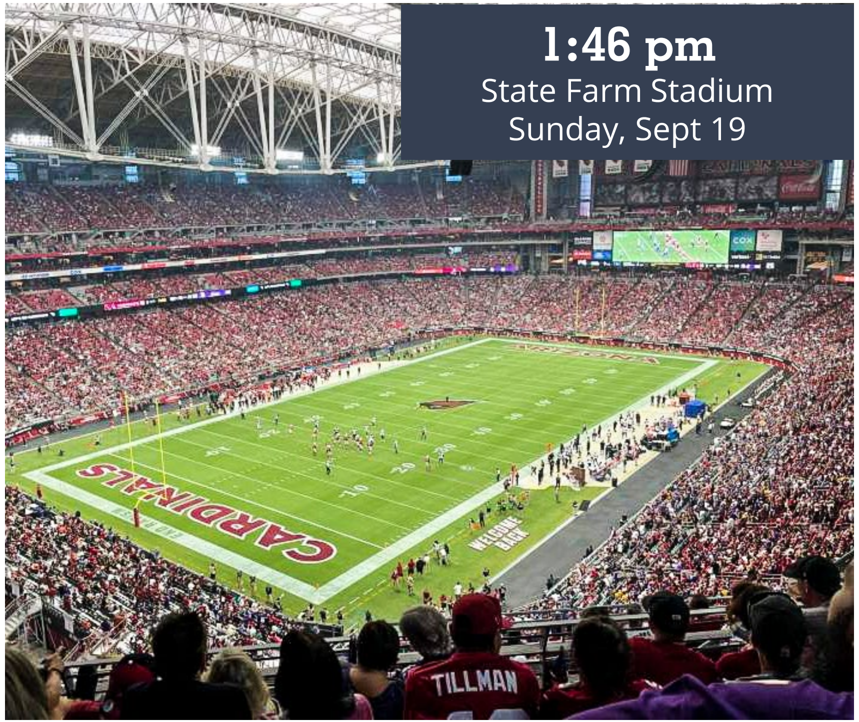
12:42 pm
Camelback Corridor
Thursday, Sept 30

1:14 pm
Midtown Phoenix
Saturday, Sept 25

4:33 pm
University & Mill Avenues
Tuesday, Sept 28

4:47 pm
College Avenue
Tuesday, Sept 28



1:46 pm
State Farm Stadium
Sunday, Sept 19

12:39 pm
Biltmore
Thursday, Sept 30

Key takeaways

Economic conditions

- Reopening efforts have enabled the Phoenix unemployment rate to rebound from a high of 13.5 percent in April 2020 to **5.7 percent** in July 2021.
- Post-COVID office-using job losses totaled **4.2 percent** compared with leisure and hospitality job losses that totaled 13.2 percent, underscoring the disproportionate impact the pandemic had on the discretionary segments of the local economy.

Recovery rate

- Numerous economists and business leaders believe that Phoenix is on pace to recover quicker than the national average. Minimal COVID-19 restrictions since the end of Q1, relatively low cost of living expenses, and an influx of new residents and corporations are a few commonly cited reasons for the positive outlook.
- In July, Phoenix surpassed the pre-pandemic employment high with just over **2.45 million workers** currently employed.

Office demand

- Leasing activity has slowed compared with pre-COVID levels as office workers gradually return and the economy begins to reopen. Post-pandemic leasing activity has decreased by **22.9 percent** compared with the prior 20-year annual level.
- Two notable leases signed in the quarter come from health and fitness related companies. Banner Health signed a new **70,000 sf** lease, while Peloton signed a new sublease for their member support team totaling just under **45,000 sf**.

Key takeaways

Office supply

- Direct and sublease vacancy totaled **19.3 percent** in Q3 2021. While elevated compared with historical levels, the aftermath of the Global Financial Crisis caused the Phoenix vacancy to surpass 24.4 percent from 2010 and 2011.
- The sublease market accounts for **2.2 msf** of vacant space.
- Approximately **9.0 msf** of office space is currently proposed or under construction. The development pipeline is largely comprised of speculative projects, rather than build-to-suits, potentially applying pressure on future supply risk.

Pricing trends

- Base rents continued to rise, increasing by **1.7 percent** through the first three quarters of 2021. Price increases can largely be attributed to competition for the highest quality office spaces on the market.
- Concessions have remained above their historical average since the start of the pandemic as landlords provide incentives to induce tenant commitments.

Capital markets

- Deal volume is moving closer to pre-COVID levels. Nearly **$1.6B** of Phoenix offices have been sold since the beginning of 2021, just $93M less than the total level of deals made in 2020 with the typically active fourth quarter upcoming.
- Asset pricing has increased by **18.6 percent** from September 2020 to Q3 2021, driven in part by higher demand from investors that were less active in 2020.

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01.

Economic and demographic trends

The Phoenix economy saw marginal improvements in Q3 2021, but the impact of pandemic continues to linger.

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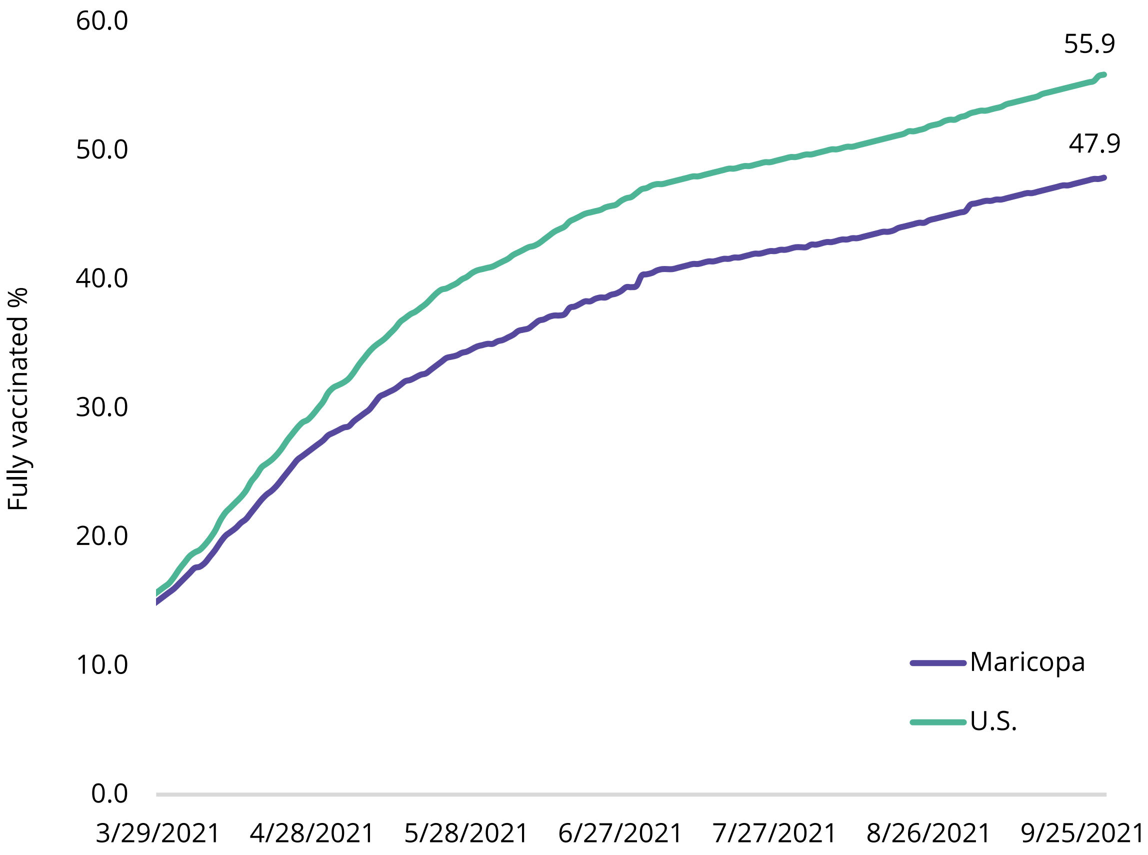
Vaccination rates

47.9%

Share of the total Phoenix population that is fully vaccinated

Phoenix's vaccinated population continues to trail the U.S. average; however, it has shown a marked increase in the past couple months. Arizona's greater reopening efforts have kept the economy moving in the right direction.



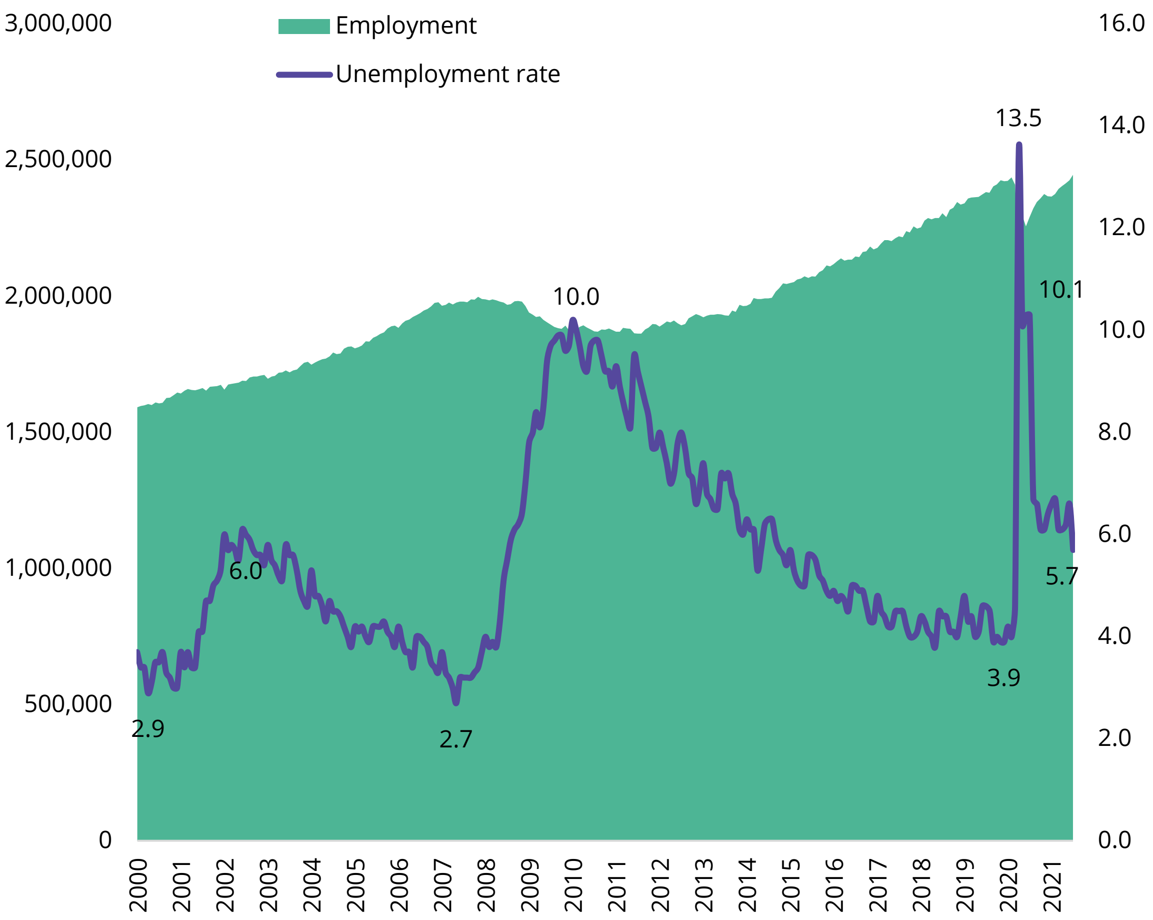
Source: CDC

Employment and unemployment rate

5.7%

Phoenix unemployment rate as of July 2021

The employment rate of 5.7% as of July 2021 has approached the post-2000 average of 5.6%. The pandemic temporarily eliminated 288,000 jobs between February 2020 and May 2020. Since reopening, the local labor market recovered 263,000 jobs from May 2020 to July 2021.



Note: Not seasonally adjusted data.
Source: Bureau of Labor Statistics

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Office-using job gains and losses

-4.2%

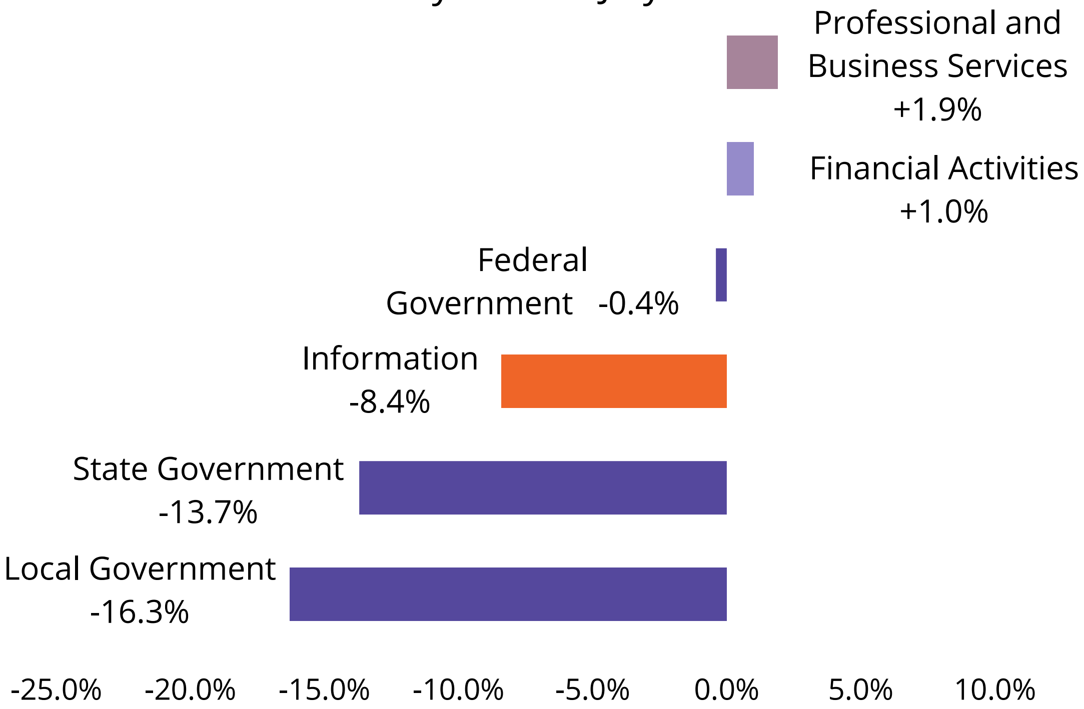
Change in office-using employment during the pandemic

Phoenix MSA job losses amounted to 2.2% since the pandemic's start, while office-using jobs have contracted by 4.2%. However, the current recession's impact on the office labor market has been much less severe than the Global Financial Crisis, when total office employment shrunk by 13.3%.

VIEW DASHBOARD

Total change in Phoenix MSA* job gains/(losses)

February 2020 to July 2021



Note: Not seasonally adjusted data. Metropolitan statistical area.
Source: Bureau of Labor Statistics

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Office occupier conditions

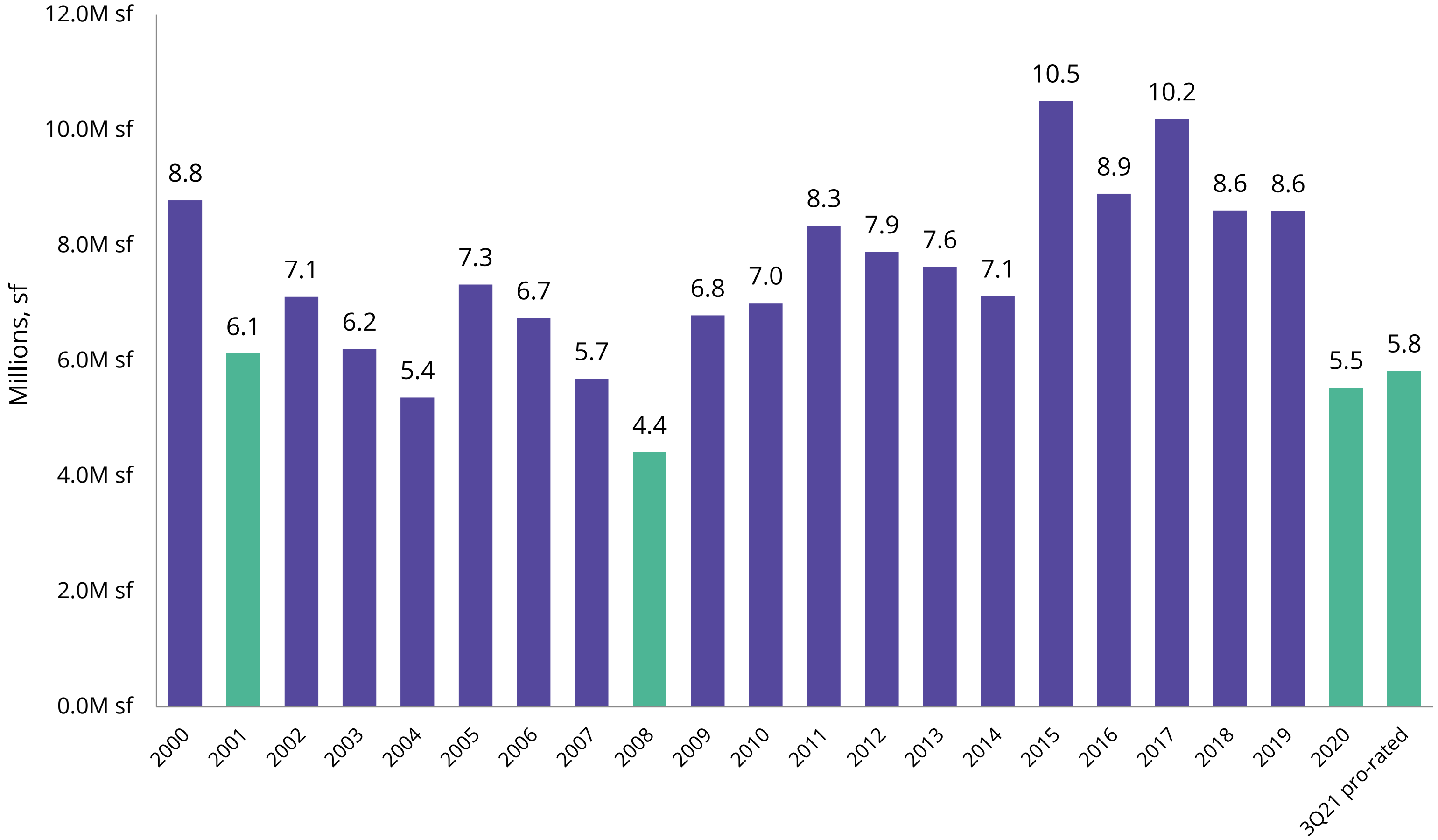
Office leasing activity incrementally increases but does not achieve pre-COVID levels due to unprecedented market conditions and continued uncertainty relating to return-to-office strategies.

Office leasing activity

-22.9%

2020 to pro-rated 2021 vs. prior 20-year annual average leasing activity

Leasing activity in Phoenix has not been this slow outside of the Global Financial Crisis, though the pace accelerated during Q3. The impact of the 2020 recession and work-from-home trends softened throughout the quarter.



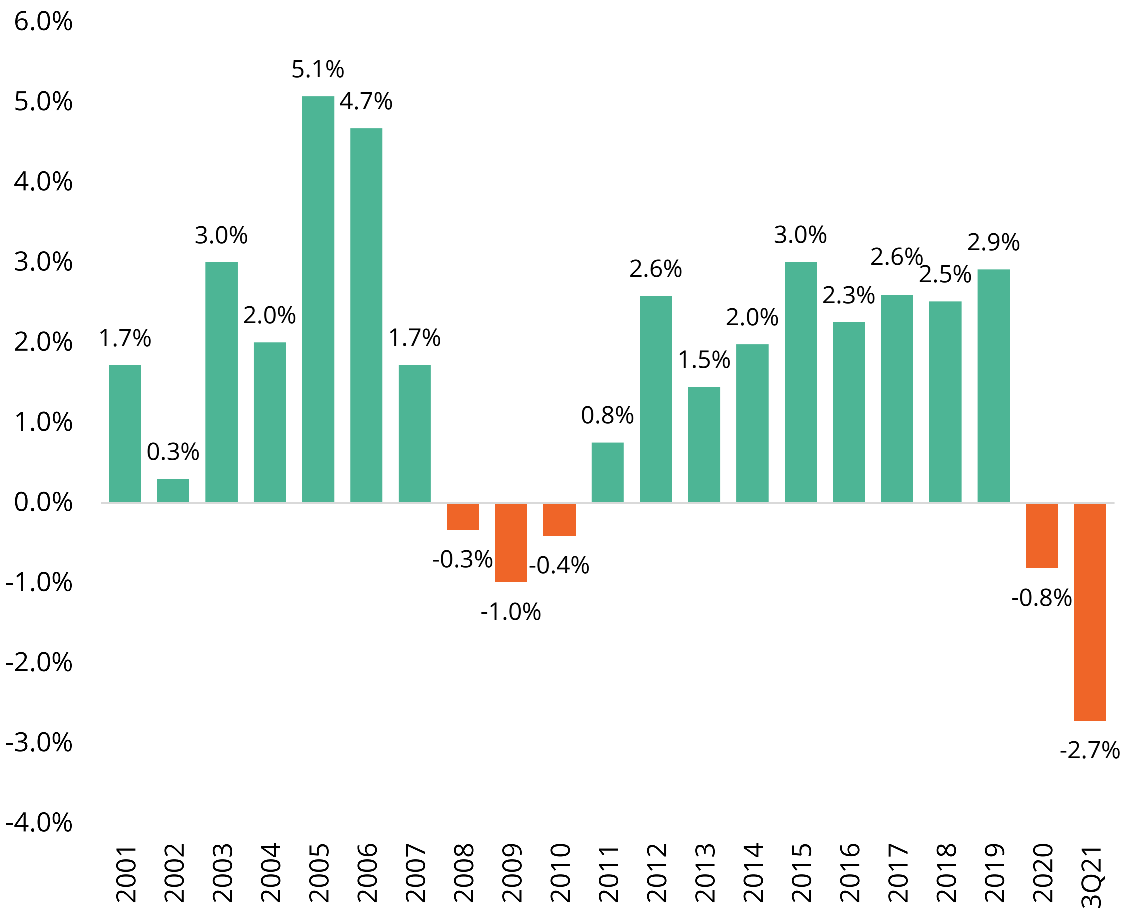
Source: AVANT by Avison Young

Absorption

-3.5%

Net absorption as a percentage of inventory, 2020 through Q3 2021

Negative absorption from 2020 to Q3 2021 has totaled 3.7 million sf, representing -3.5% of the existing inventory. This negative absorption surpasses the depths of the Global Financial Crisis (-1.7%).



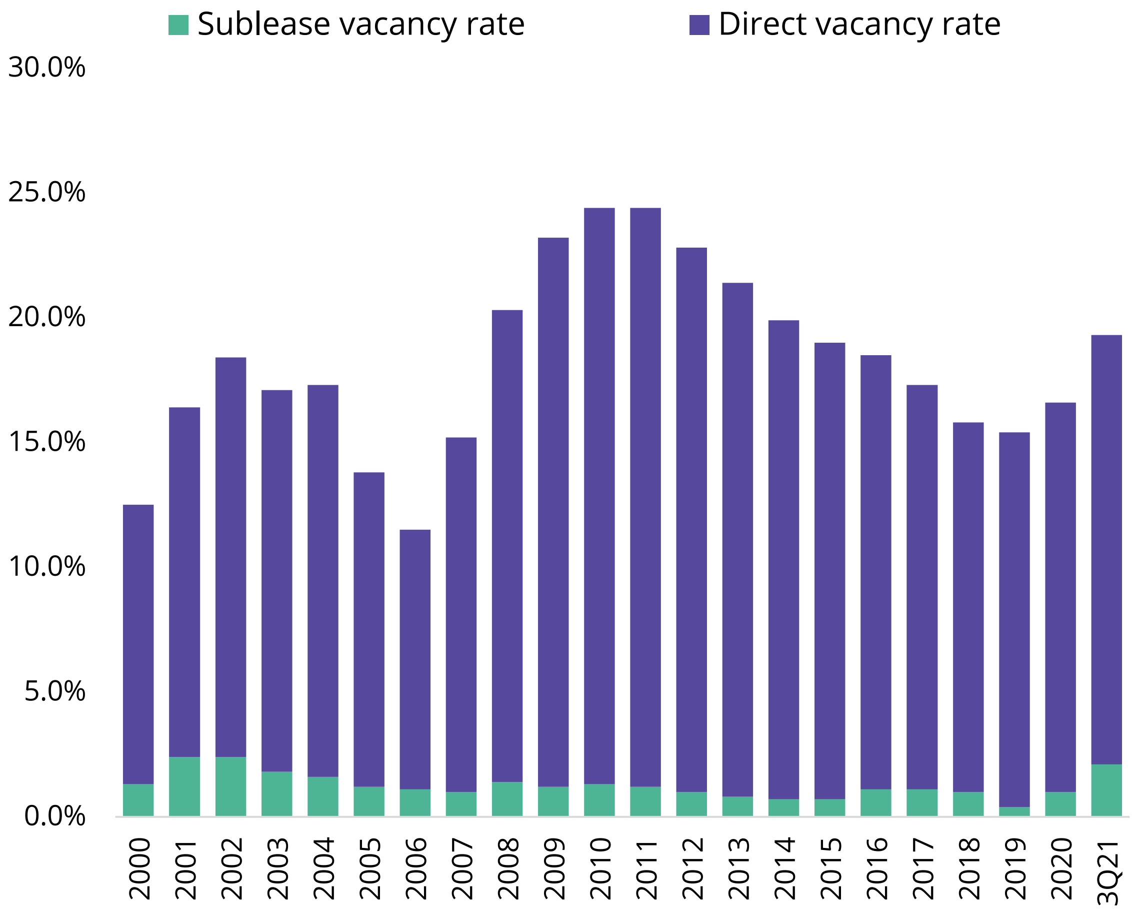
Source: AVANT by Avison Young

Vacancy rate

19.3%

Phoenix vacancy as of Q3 2021

The Q3 2021 total vacancy rate experienced some improvement, declining by 60bp quarter-over-quarter. The vacancy rate should continue to decline if the spread of the virus subsidies and companies continue to relocate to Phoenix for its cost-efficient operating environment and to access its diverse talent pool.



Source: AVANT by Avison Young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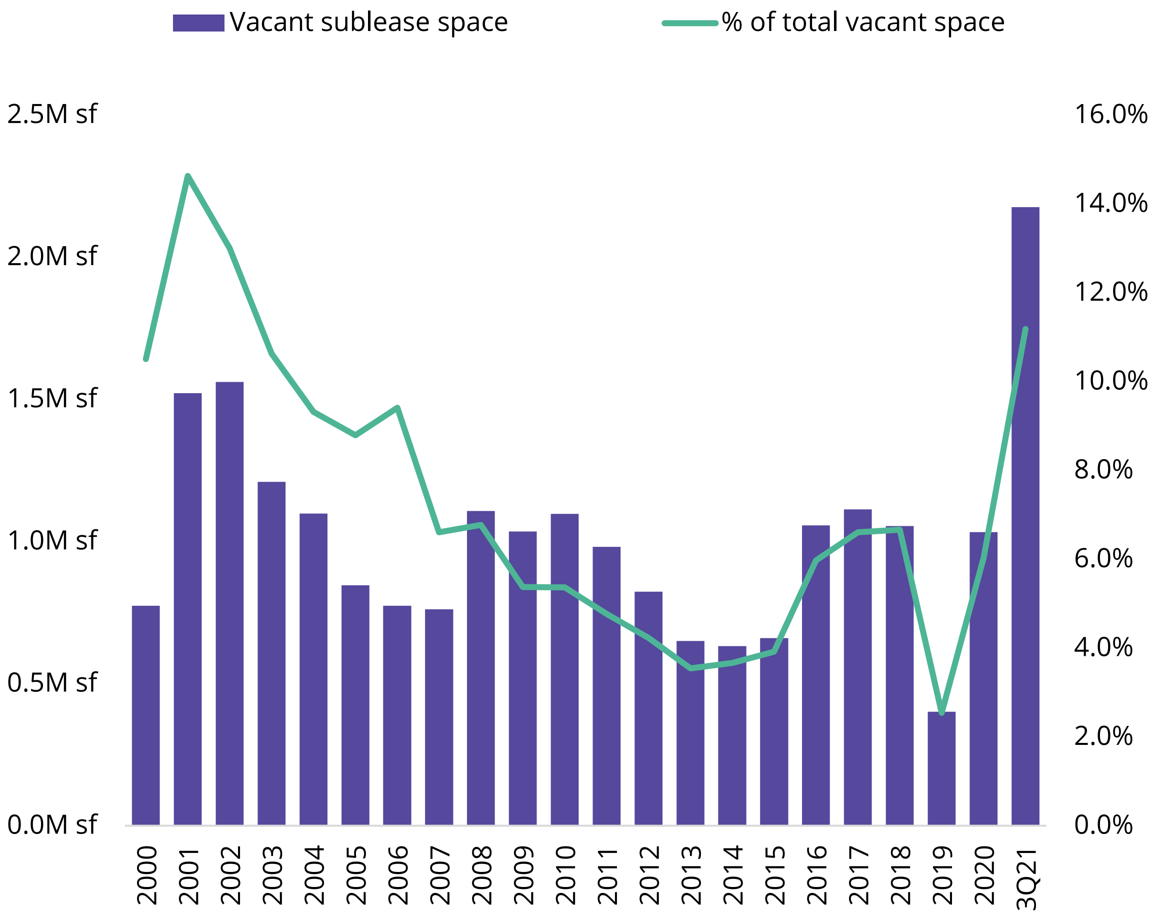
Vacant sublease space

2.2 msf

Elevated levels of sublease vacant space

The share of sublease-to-total vacant space of 11.2% has surpassed the peak of 6.8% from the Global Financial Crisis but remains below the Dot-com Recession peak of 14.6%. Despite some workers returning to the office in Q3, vacant sublease space remains at an unprecedented level as many continue to work from home.



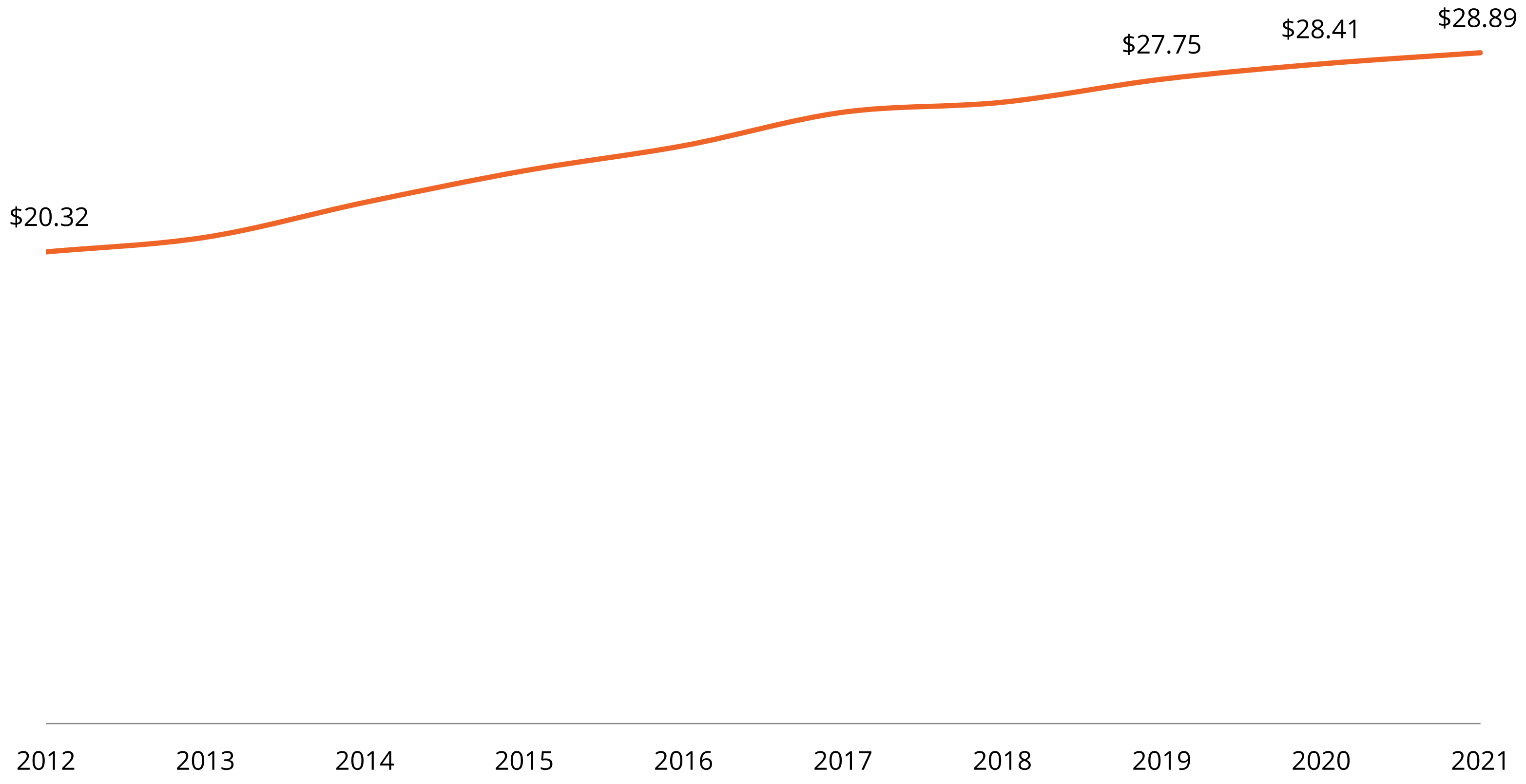
Source: AVANT by Avison Young

Base rents

+1.7%

Year-to-date change in Phoenix annual FS base rents

Base rents have grown by a modest 1.7% year-to-date, or an increase of $0.48 psf. Since 2012, base rents have increased by an average of 4.0% annually. This slower growth rate indicates a market that favors tenants more than it has historically.



Source: AVANT by Avison Young, CoStar

Phoenix office development pipeline

55 properties

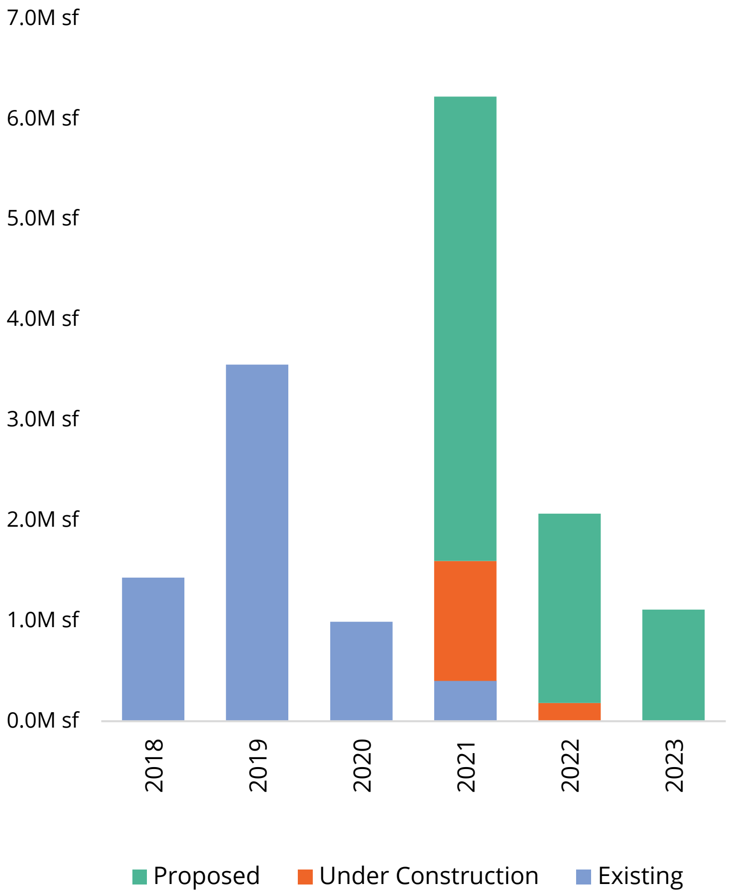
proposed or under construction

9.0 msf

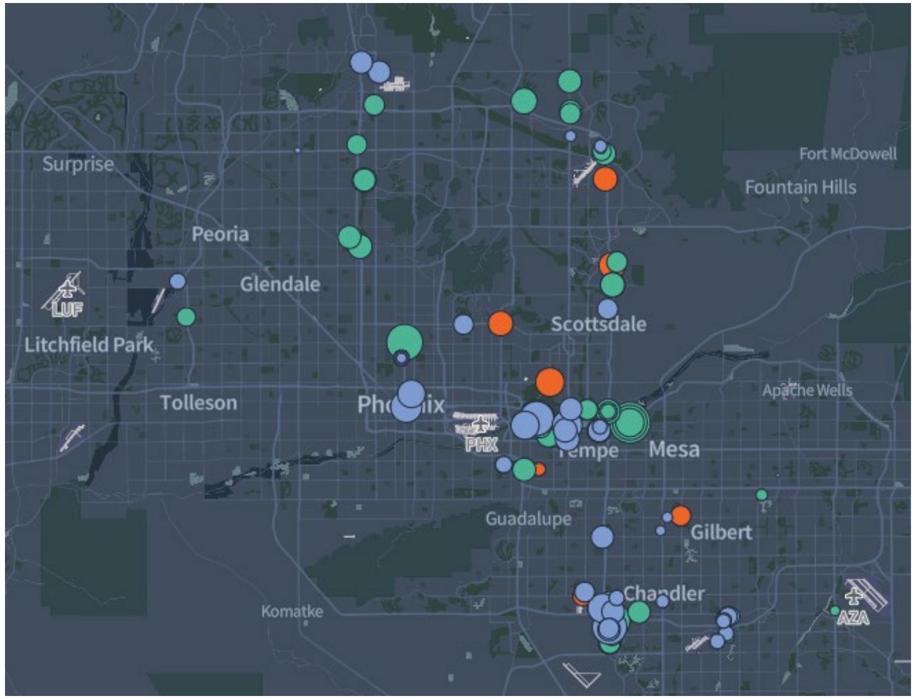
proposed or under construction

8.3%

share of office inventory



Source: AVANT by Avison Young



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Capital market conditions

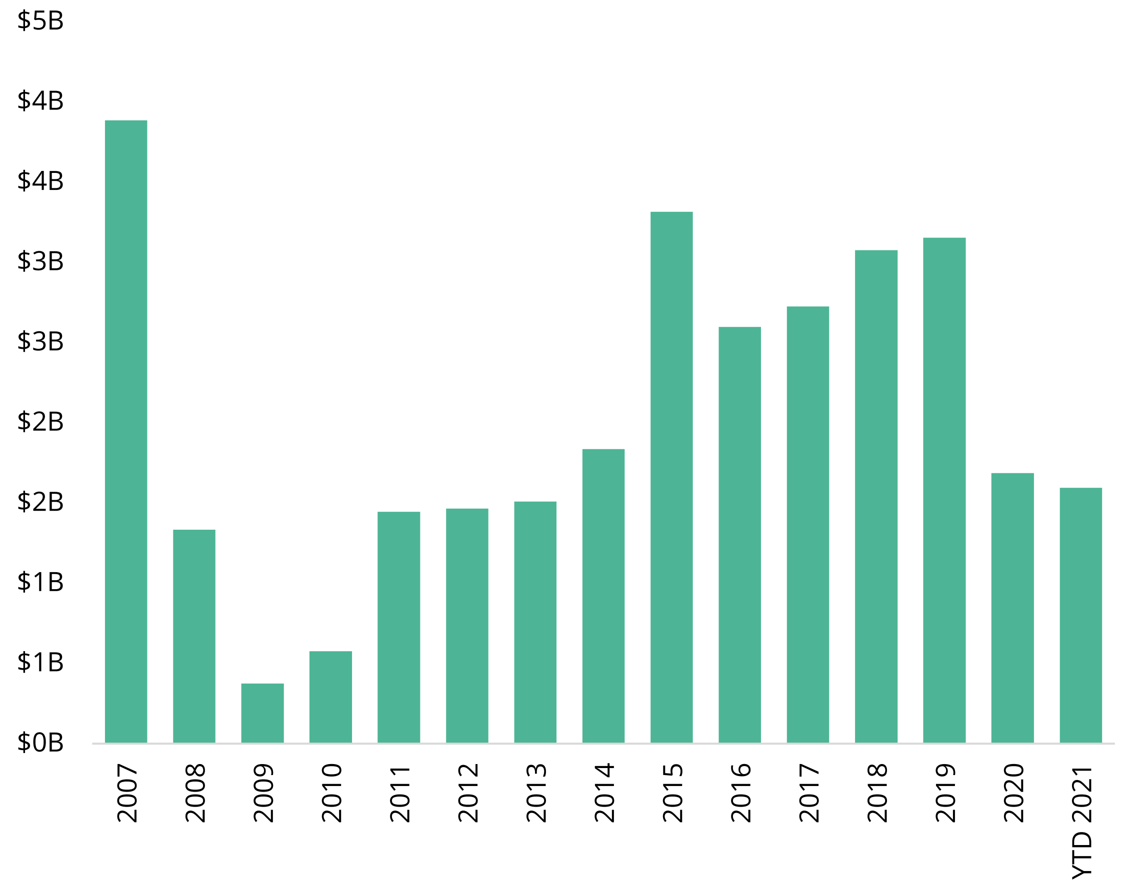
Investor demand continued to outperform 2020 levels as more acquisitions were executed in the quarter.

Office investment dollar volume

$3.3B

Phoenix office dollar volume 2020 to present

Post-COVID annualized sales volume remains 35.9% below the prior five-year average but is on pace to dramatically surpass the $1.7B in total sales recorded in 2020.



Source: AVANT by Avison Young, Costar, RCA

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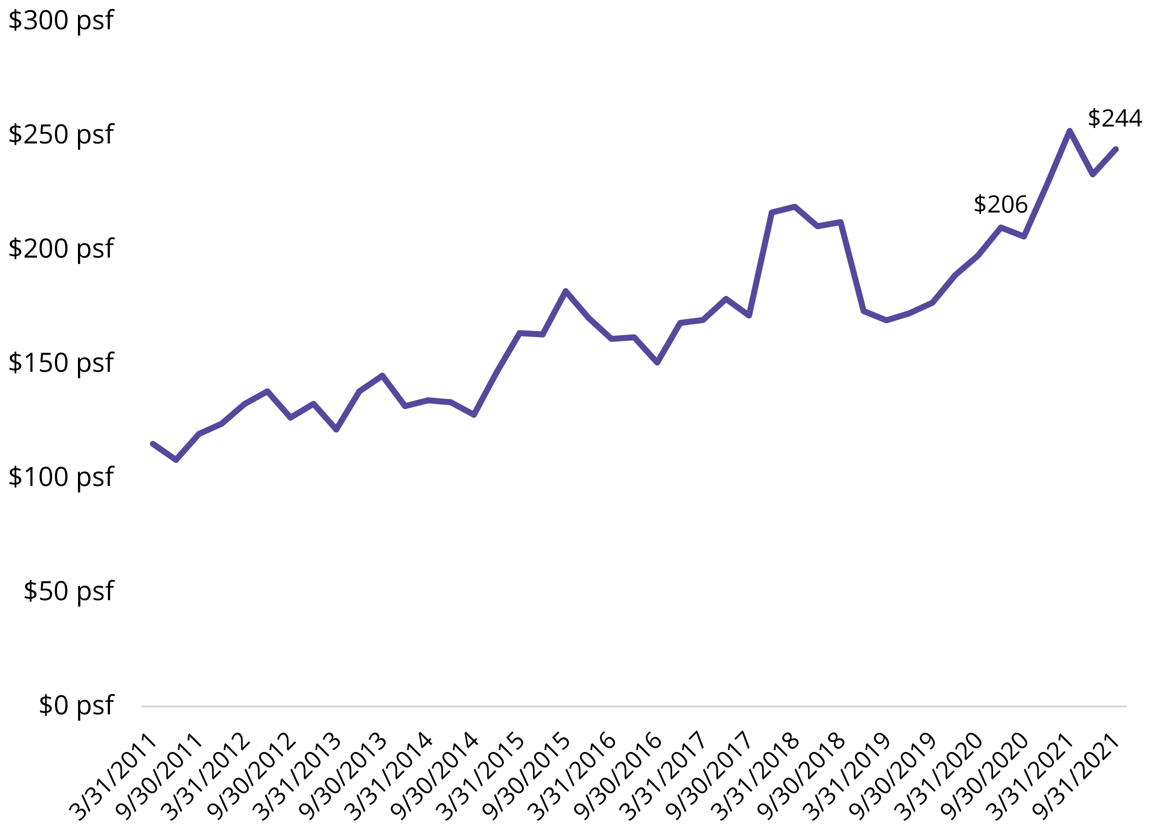
Office asset pricing

+18.6%

Phoenix office pricing from September 2020 to present

Asset pricing has experienced a steady rate of growth throughout the pandemic as investors have been actively pursuing acquisitions. In recent quarters, there has been a flight to quality which has contributed to the rising asset prices. Pricing was also impacted by a $132-million sale completed in Q3, the largest office transaction in the Valley since the start of the year.



Source: AVANT by Avison Young, RCA

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Looking forward

Here’s what we can expect

- Maricopa County **employment is projected to increase by 5.5% annually through 2022** per the Office of Economic Opportunity, underscoring strengthening economic fundamentals.
- **Companies continue to enter or expand their presence in the Phoenix MSA via new office leases.** Peloton signed a new office lease in Tempe for their customer support staff in July. Banner Health and SmartRent were two notable Arizona-based companies to sign an office lease during Q3.
- Despite some companies returning to in-person workspaces, there is still a **high level of uncertainty regarding the outlook for traditional office space.**
- **Asset pricing is positioned to remain elevated but should stabilize** as investors have focused their attention on acquiring Trophy and Class A properties but have adopted more conservative underwriting assumptions.
- Office demand is in the process of inching closer to pre-COVID levels. However, **vacancy should remain high, with more companies shifting to less rigid requirements for where work is done.**

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Let's talk