Savills Studley Report
Phoenix office sector

Q4 2016

SUMMARY

Market Highlights

ASKING RENT RISES

Phoenix's overall average asking rent rose by 1.0% to $23.43 during the final quarter of the year and has jumped by 5.9% year-on-year. The Class A rate, $27.97, was essentially flat, but has increased by 5.0% from year-end 2015.

AVAILABILITY RATE UNCHANGED

The overall availability rate,* 21.4%, inched down by seven basis points. The Class A availability rate jumped by 40 basis points to 20.3%, but posted a 30 basis point decline to 21.8% in Class B and C buildings.

LEASING BELOW AVERAGE

Tenants have leased 8.4 msf in the last four quarters, well under the long-term average of 10.9 msf.

SALES HAVE SLOWED

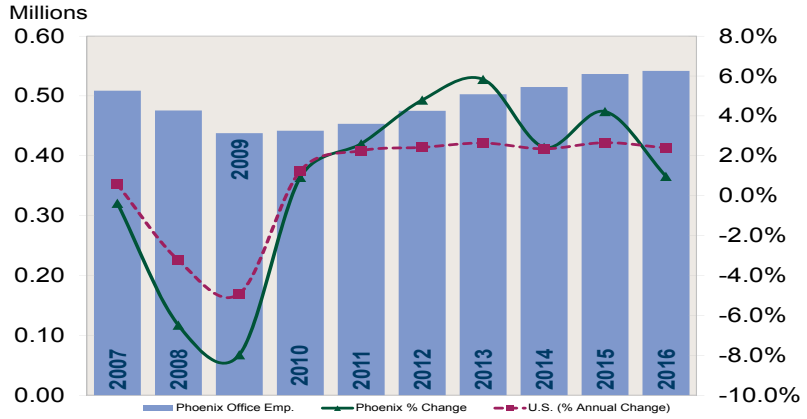
Office property sales totaled $1.4 billion the first 10 months of 2016, a 38.1% decline from the same period in 2015.

*Availability includes all vacant space as well as space marketed for lease with future occupancy in existing properties as well as those under construction.

"Sustained demand from larger corporate tenants seeking bigger blocks of quality space is supporting development activity in a handful of Phoenix locations. Although select areas have tightened, this new construction is adding to what is still a relatively deep set of space options across most of the market."

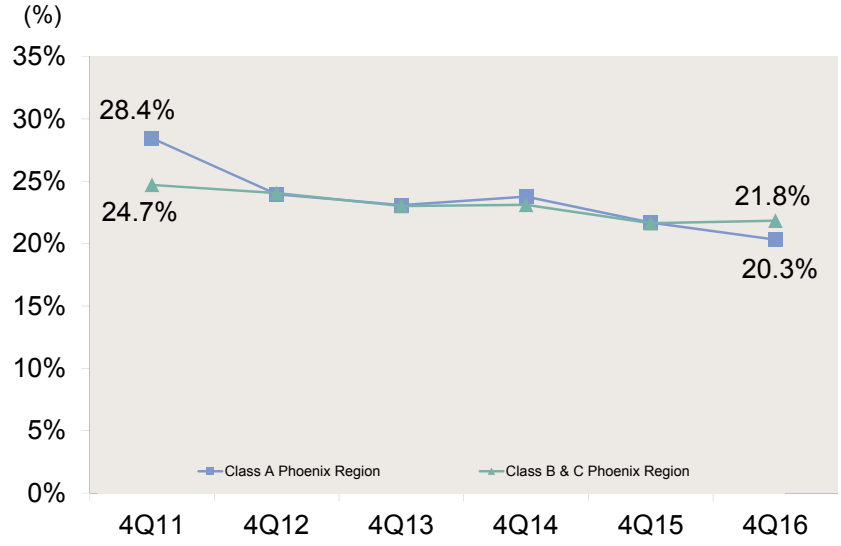
Michael White, Senior Managing Director

Office-Using Employment Trends

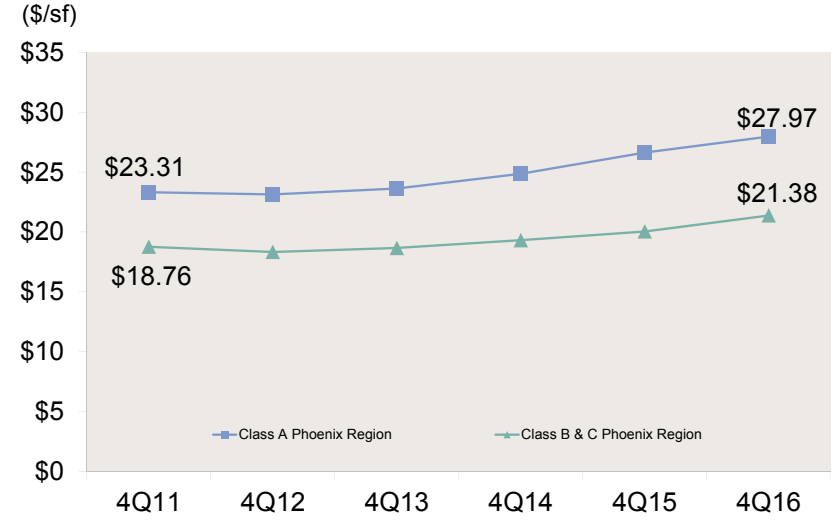


Source: Bureau of Labor Statistics

Availability Rate Trends



Asking Rent Trends



Cost Arbitrage to Sustain Demand in 2017

A healthy combination of steady corporate relocation activity and growth among local firms continues to keep demand for office space brisk in Phoenix. Rent in a handful of the most coveted submarkets is reaching $40.00/sf, making new construction activity viable for developers in select areas. Companies moving from Los Angeles, Chicago or other high-cost metros will not flinch at these new historically high rents in Phoenix. Despite rental rate growth in the last 12 months, the differential in rent between the top U.S. metros and Phoenix remains very wide. Companies would easily pay $60.00/sf in West Los Angeles, while businesses in San Francisco and Manhattan are currently leasing Class A space for $70.00/sf to $80.00/sf. Lower corporate and personal taxes, reasonable salaries and other operating costs, combined with a dramatically reduced cost of living add to the discount between Phoenix and other high cost major markets. These savings, coupled with the region's "pro-business climate" will surely attract more companies in 2017.

Internal Rent & Quality Segmentation Intensifies

In addition to this inter-market gap, Phoenix is experiencing more separation in terms of costs within its own borders. Tenants have depleted the range of options in Old Scottsdale and Downtown Tempe, with vacancies hitting single digits in Class A space. Space in these areas has been at a premium for quite some time, with rent surging to between $35.00 and $40.00/sf. More companies have been turning to new projects in Southeast Valley submarkets, including South Tempe, Chandler, Mesa and Gilbert. Class A rent in these submarkets ranges between $26.00 and $33.00/SF, while Class B back office space averages between $23.00 and $26.00/SF.

At the other end of the scale, conditions lag in several submarkets North and West of Downtown Phoenix. Buildings in these areas constructed in the 1980s or 1990s are still struggling to overcome systemic problems with outdated space layouts, tired or minimal amenities, crime issues, nominal access to quality employees and long commute times. Availability in the Metrocenter, North I-17,West Phoenix and Northwest Phoenix submarkets ended 2016 hovering between 25.0% and 30.0%. The average full service asking rents in these markets sets the floor for the Phoenix market, running as low as $17.00/sf up to $23.00/sf. There are very

few, if any, real Class A structures in these submarkets.

Hidden Costs Loom

From the perspective of other markets, costs in Phoenix seem like a bargain. Local market participants who have experienced the last few cycles recognize, though, that some areas of the region have attained occupancy levels considered unimaginable a few years ago. Additionally, owners in Phoenix are concerned about the impact of rising interest rates and inflation. Interest rates remain very low, even after the Federal Reserve's recent hike, but as rates increase, cap rates will push higher and yields on commercial real estate investments may lose some of their edge compared to low-yield fixed investments or equities. Additional increases in interest rates will also dampen development financing. Construction and permanent lenders are expected to be more conservative in this cycle and will probably keep loan-to-value requirements elevated along with other loan metrics.

Inflation also is starting to enter discussions. Core inflation, like interest rates, has been subdued for an extended period. Inflation measures often fail to fully capture escalating pricing such as construction costs. Construction costs are in record territory in many markets, including Phoenix, with Class A multi-story structures estimated at between $225.00 to $250.00/SF to construct, including land and parking structures. Costs for tenant improvements are $45.00-$65.00/SF, depending on the type of tenant. Much of the skilled labor left the region or retired after 2008. A portion of the construction workforce returned recently, this should hopefully attenuate some of the shortages.

Phoenix's long list of major capital improvement projects and the multi-family development boom have exacerbated the construction labor shortage. Rising construction costs also push the break-even point for rent higher. Landlords constructing new Class A properties will need to achieve rents between $35-45/sf, depending on the submarket and their land pricing. Firms that paid a sub-$30.00 rent five years ago are having a tough time digesting the record rent levels.

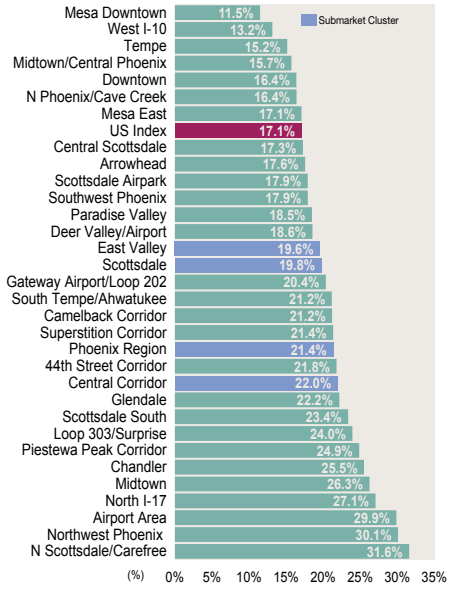
Sustained Leasing Expected in 2017

Leasing fell slightly in the second half of 2016, but 2017 is shaping up to be a strong year for demand. The flow of businesses from high-cost markets could intensify in the next few quarters. Tech, life sciences, law and entertainment may maintain some or all operations in San Francisco, Silicon Valley, Los Angeles and Manhattan – despite exponentially higher costs of living and doing business. That leaves a wide range of other sectors from wealth management and mortgage lenders, to insurance and health care that are still able to capitalize on the savings associated from siting a new location in Phoenix.

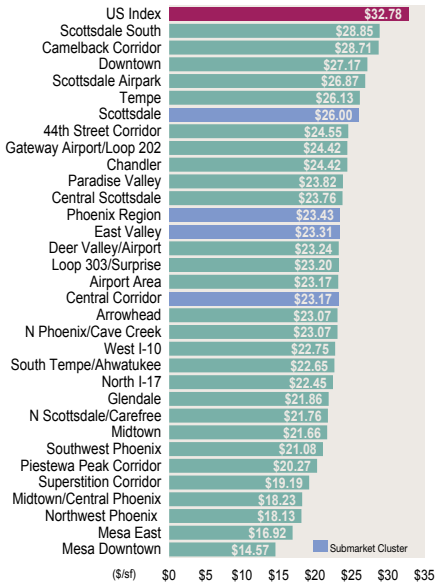
The motivation for migration to Arizona is not limited to corporate users. Entrepreneurs are inspired to consider and make the decision to relocate to Phoenix based on many factors, including quality of life issues (crime, traffic, education, culture and basic challenges of big city living), The amazing variance in costs of real estate, labor and taxes are enormous driving motivators. A business owner can capture substantial gains by selling their residential and commercial properties in a myriad of higher-cost states, and then redeploy of fraction of these proceeds to purchase quality assets in Phoenix. Additionally labor cost variances and personal income tax savings have long been a major driver of movement to Phoenix.

It is often difficult to pinpoint which factor – talent, cost, demographics, incentives, culture, politics or the preferences of the C-Suite – was the determining factor in a site selection. Companies have often cited onerous regulation as a reason for relocation, but this is generally after a long drawn out multi-year process. It is rare to see a company pack up a division overnight and relocate. Uber, however; dramatically packed up its self-driving Volvo XC90 Suvs and shipped them from its home base in San Francisco to Arizona in December. The move came after the State of California revoked the rights of the company to test the vehicles until it secured a $150 permit for each of the 16 vehicles. Of note, 20 other companies are abiding by the registration requirements and are testing about 130 vehicles in California.

Availability Rate Comparison



Overall Rental Rate Comparison



Major Transactions

Tenant	Sq Feet	Address	Market Area
ADP	225,000	111 W Rio Salado Pky	Tempe
State of Arizona Attorney General	67,650	2005 N Central Ave	Downtown
Orbital Sciences	46,225	1233 S Spectrum Blvd	Chandler
Dibble Engineering	29,540	7878 N 16th St	Piestewa Peak Corridor
Western Governors University	28,376	432 N 44th St	44th Street Corridor
Mindbody	28,229	1355 N Scottsdale Rd	Scottsdale South
Lifewell Behavioral Wellness	16,300	2715 N 3rd St	Midtown
Brightcove	13,000	1355 N Scottsdale Rd	Scottsdale South
Parchment Inc.	12,965	7001 N Scottsdale Rd	Central Scottsdale
Insight Global, Inc.	12,460	2325 E Camelback Rd	Camelback Corridor
Sum of Top Leases	**479,745**		

Submarket	Total	Net Absorption & Leasing Volume		Available SF			Availability Rate			Asking Rents Per SF		
	Inventory SF (1000's)	Net Abs. (Last 12 months)	Leasing (Last 12 months)	This Quarter	% Change from Last Qtr.	Year Ago	This Quarter	pp Change from Last Qtr. (1)	Year Ago	This Quarter	% Change from Last Qtr.	Year Ago
Airport Area	9,160	-273	367	2,737	-1.9%	2,262	29.9%	-0.6%	24.5%	$23.17	2.4%	$21.15
Airport Area - Class A	1,642	-53	0	466	0.2%	430	28.4%	0.0%	26.2%	$26.26	0.1%	$24.80
South Tempe/Ahwatukee	6,260	77	566	1,325	-2.7%	1,195	21.2%	-0.6%	19.1%	$22.65	0.8%	$20.83
South Tempe/Ahwatukee - Class A	776	83	222	34	34.3%	107	4.3%	1.1%	13.8%	$25.43	2.8%	$24.51
Downtown	8,732	41	199	1,432	1.2%	1,444	16.4%	0.2%	16.5%	$27.17	-0.9%	$25.37
Downtown - Class A	4,809	51	124	913	4.9%	896	19.0%	0.9%	18.6%	$28.54	0.5%	$27.39
Midtown	11,354	3	471	2,982	-0.5%	2,810	26.3%	-0.1%	24.7%	$21.66	1.7%	$21.00
Midtown - Class A	4,576	0	169	1,245	5.6%	1,142	27.2%	1.4%	25.0%	$24.50	2.9%	$23.07
44th Street Corridor	3,149	-102	287	687	2.2%	780	21.8%	0.5%	24.8%	$24.55	3.4%	$22.99
44th Street Corridor - Class A	1,715	-134	203	376	-7.5%	508	21.9%	-1.8%	29.6%	$26.44	1.1%	$25.70
Camelback Corridor	8,667	102	722	1,839	-1.3%	2,049	21.2%	-0.3%	23.6%	$28.71	-2.8%	$27.50
Camelback Corridor - A	4,805	-16	463	1,084	-1.6%	1,181	22.6%	-0.4%	24.6%	$33.21	-1.4%	$31.72
Midtown/Central Phoenix	3,590	40	214	565	-9.6%	629	15.7%	-1.7%	17.5%	$18.23	2.2%	$17.44
Midtown/Central Phoenix - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Chandler	7,279	209	532	1,858	2.9%	1,742	25.5%	0.7%	24.7%	$24.42	0.7%	$23.86
Chandler - Class A	2,109	70	0	378	16.8%	398	17.9%	2.6%	20.9%	$27.02	-2.7%	$28.08
Gateway Airport/Loop 202	1,597	52	69	325	-0.8%	346	20.4%	-0.2%	21.7%	$24.42	-0.4%	$24.32
Gateway Airport/Loop 202 - Class A	47	0	0	12	0.0%	12	26.5%	0.0%	26.5%	$27.36	0.0%	$27.36
Mesa Downtown	973	24	23	112	-10.4%	118	11.5%	-1.3%	12.2%	$14.57	1.5%	$13.97
Mesa Downtown - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Mesa East	1,702	80	97	291	-6.0%	378	17.1%	-1.1%	22.2%	$16.92	0.8%	$17.21
Mesa East - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Superstition Corridor	4,996	197	325	1,067	0.4%	1,066	21.4%	0.1%	21.3%	$19.19	-0.3%	$19.01
Superstition Corridor - Class A	664	32	41	154	1.5%	147	23.2%	0.3%	22.1%	$23.28	0.1%	$23.08
Tempe	9,297	1,323	843	1,409	-18.5%	1,477	15.2%	-3.4%	18.4%	$26.13	1.0%	$22.74
Tempe - Class A	4,845	1,177	476	569	-35.0%	714	11.7%	-6.3%	19.9%	$32.40	2.3%	$27.26
N Phoenix/Cave Creek	83	0	0	14	10.5%	15	16.4%	1.6%	18.5%	$23.07	10.1%	$21.96
N Phoenix/Cave Creek - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Paradise Valley	3,877	145	274	717	-6.7%	848	18.5%	-1.3%	21.9%	$23.82	3.4%	$22.12
Paradise Valley- Class A	1,532	67	146	338	-1.5%	377	22.0%	-0.3%	24.6%	$27.18	0.4%	$25.34
Piestewa Peak Corridor	2,451	47	208	610	1.2%	615	24.9%	0.3%	24.9%	$20.27	1.8%	$18.73
Piestewa Peak Corridor - Class A	409	-9	11	105	74.3%	15	25.6%	10.9%	3.7%	$27.11	-10.1%	$23.42
Northwest Phoenix	8,423	21	284	2,536	5.3%	2,418	30.1%	1.5%	28.7%	$18.13	4.1%	$17.24
Northwest Phoenix - Class A	1,160	20	3	334	0.9%	340	28.8%	0.3%	29.3%	$22.30	1.6%	$21.78
Arrowhead	3,420	148	234	601	-5.5%	655	17.6%	-1.0%	19.5%	$23.07	0.9%	$21.64
Arrowhead - Class A	81	0	0	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Deer Valley/Airport	8,788	141	321	1,632	-2.5%	1,806	18.6%	-0.4%	20.8%	$23.24	0.3%	$22.21
Deer Valley/Airport - Class A	2,111	38	108	327	-1.2%	380	15.5%	-0.2%	19.4%	$26.23	-0.8%	$25.13
North I-17	541	42	29	147	-14.2%	181	27.1%	-4.5%	33.4%	$22.45	-0.6%	$21.75
North I-17 - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Central Scottsdale	7,616	214	474	1,316	-3.5%	1,464	17.3%	-0.6%	19.2%	$23.76	0.6%	$22.64
Central Scottsdale - Class A	2,507	75	129	430	6.2%	373	17.1%	1.0%	14.9%	$26.07	-0.2%	$25.04
N Scottsdale/Carefree	1,543	62	109	488	-1.0%	545	31.6%	-0.3%	35.3%	$21.76	-1.7%	$20.73
N Scottsdale/Carefree - A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Scottsdale Airpark	10,695	491	1,082	1,917	15.4%	2,132	17.9%	2.4%	20.0%	$26.87	2.1%	$25.35
Scottsdale Airpark- Class A	5,840	443	695	1,273	25.2%	1,369	21.8%	4.4%	23.6%	$28.98	1.2%	$27.51
Scottsdale South	5,649	-149	355	1,321	24.4%	835	23.4%	4.1%	15.2%	$28.85	1.7%	$25.22
Scottsdale South - Class A	2,132	-40	129	507	10.0%	327	23.8%	0.6%	16.5%	$30.40	0.0%	$29.58
Glendale	2,429	141	78	539	-2.0%	566	22.2%	-1.0%	23.9%	$21.86	-0.5%	$22.31
Glendale - Class A	521	35	0	38	0.0%	68	7.3%	0.0%	13.1%	$29.14	1.7%	$27.20
Loop 303/Surprise	1,377	31	69	330	-3.3%	351	24.0%	-0.8%	25.6%	$23.20	0.6%	$22.92
Loop 303/Surprise - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Southwest Phoenix	1,862	19	37	334	-7.5%	359	17.9%	-1.5%	19.3%	$21.08	4.2%	$20.81
Southwest Phoenix - Class A	917	1	19	174	0.0%	194	19.0%	0.0%	21.2%	$23.00	0.0%	$23.00
West I-10	1,335	8	73	176	-9.2%	205	13.2%	-1.3%	15.4%	$22.75	-0.7%	$21.88
West I-10 - Class A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Central Corridor	**20,086**	**44**	**670**	**4,414**	**-4.5%**	**4,254**	**22.0%**	**0.0%**	**21.1%**	**$23.17**	**1.4%**	**$22.30**
Central Corridor - Class A	**9,385**	**51**	**293**	**5,062**	**-5.5%**	**5,129**	**23.0%**	**1.2%**	**21.7%**	**$25.94**	**2.2%**	**$24.69**
East Valley	**25,844**	**1,885**	**1,891**	**5,062**	**-18.3%**	**5,129**	**19.6%**	**-1.2%**	**21.1%**	**$23.31**	**1.0%**	**$21.82**
East Valley - Class A	**7,665**	**1,280**	**517**	**3,949**	**-1.2%**	**3,858**	**14.5%**	**-3.3%**	**20.5%**	**$29.22**	**-0.6%**	**$26.97**
Scottsdale	**25,503**	**605**	**2,020**	**5,042**	**10.1%**	**4,976**	**19.8%**	**1.7%**	**19.7%**	**$26.00**	**1.4%**	**$24.13**
Scottsdale - Class A	**10,479**	**618**	**954**	**2,210**	**17.4%**	**2,070**	**21.1%**	**2.9%**	**20.1%**	**$29.49**	**1.2%**	**$27.42**
Phoenix Region	**138,087**	**3,044**	**8,422**	**29,503**	**-0.2%**	**29,521**	**21.4%**	**-0.1%**	**21.7%**	**$23.43**	**1.0%**	**$22.12**
Phoenix Region - Class A	**43,200**	**1,840**	**3,083**	**8,779**	**2.4%**	**8,980**	**20.3%**	**0.4%**	**21.7%**	**$27.97**	**-0.3%**	**$26.63**

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(1) Percentage point change for availability rates.
Unless otherwise noted, all rents quoted throughout this report are average asking gross (full service) rents psf.
Statistics are calculated using both direct and sublease information.

The information in this report is obtained from sources deemed reliable, but no representation is made as to the accuracy thereof. Statistics compiled with the support of The CoStar Group.
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