Taking the Temperature of the Phoenix Office Market

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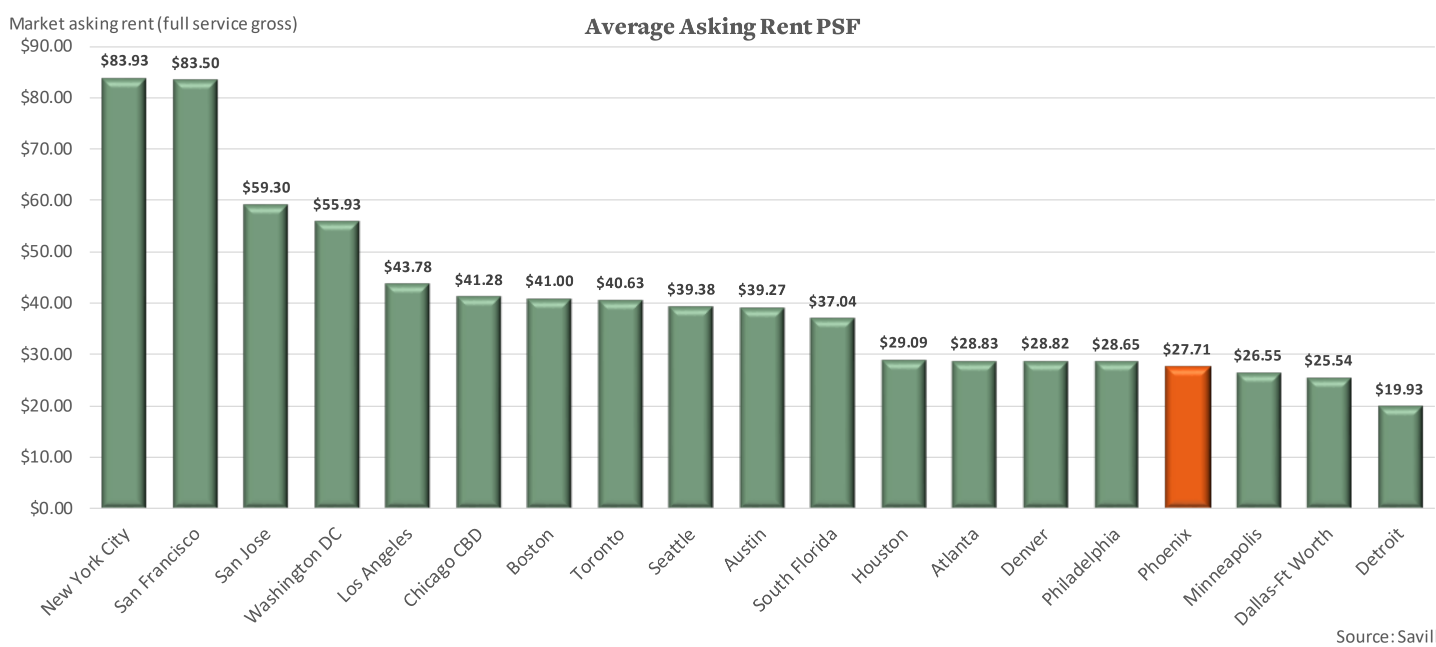
With the COVID-19 crisis and its after-effects top of mind, businesses and investors across the Phoenix metro area have rightfully been asking questions about the health and the direction of the office market. While it is impossible to predict the full impact of the pandemic, there is no question that COVID-19 will alter the local commercial real estate landscape.

Right now there are two divergent perspectives at play in the market: the generally optimistic view of the landlord community, contrasted with a tenant-driven perspective that anticipates and expects downward pressure on the office market. Each individual landlord naturally has their own take, but the general mood has been surprisingly optimistic despite the major economic disruption COVID-19 has caused statewide and nationally. Conversely, the businesses who occupy office space take the opposite view, expecting rates to have already dropped and concessions to have risen.

While we concur that Phoenix may not be impacted as severely as other major office markets, we do anticipate significant rate compression, heightened concession levels, and increasing availability rates. Below we examine the respective mindsets behind these two opposing views and suggest an analytic path forward we will use in the coming months to continue to monitor the market.

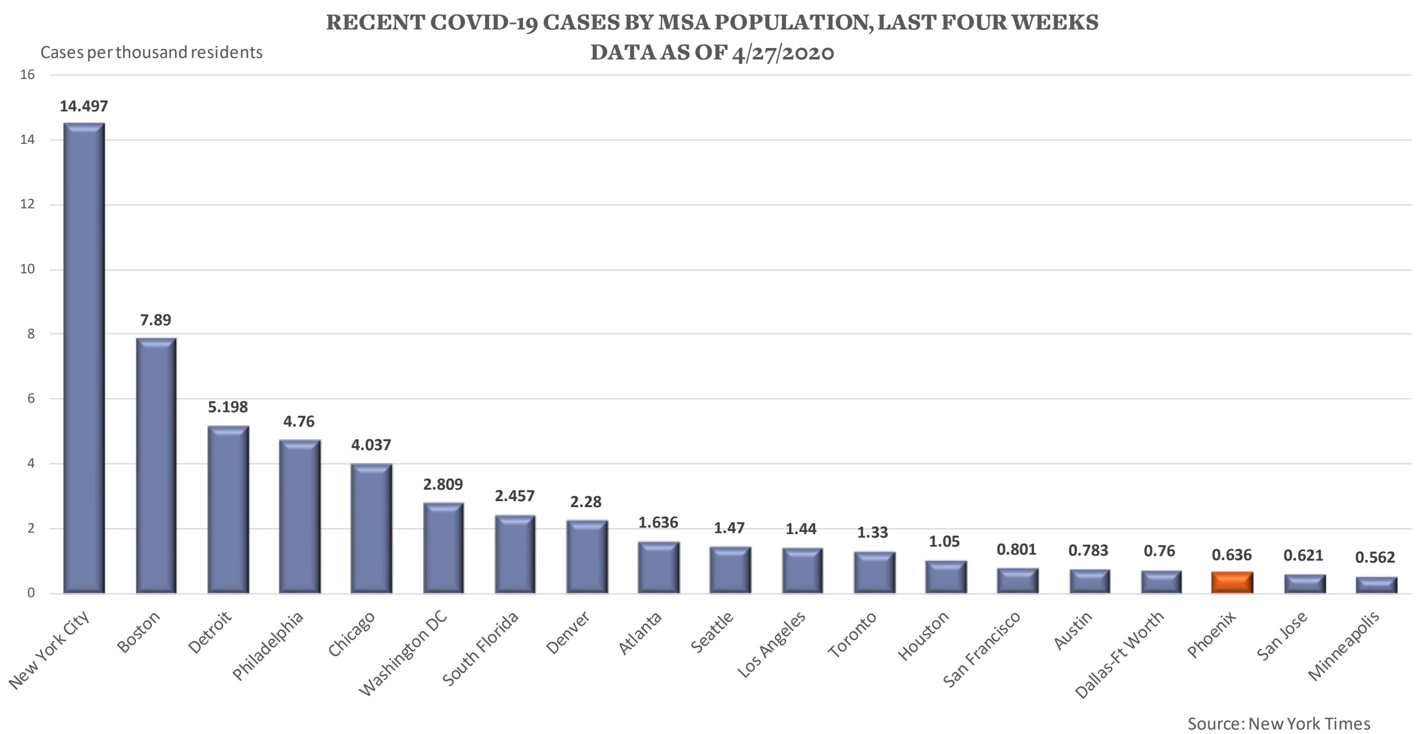
Phoenix Landlords Pause, But Remain Bullish

Phoenix has not been hit as hard as other major metropolitan areas, like New York City, and competitor markets, such as San Francisco and Denver. The Phoenix economy of the past several years has been strong, with steady population growth, an increasingly diversified business mix, a talented labor pool and a comparatively low cost of living.
For example, overall asking rents across Phoenix were $27.71/sf in Q1 2020, compared to an eye-popping $83.50/sf in San Francisco and a national average across major markets of $41.26/sf.



These qualities would hypothetically be attractive to a company post-COVID-19 looking to relocate to a market that is less dense and not highly dependent on public transportation. It is also worth noting that the amount of new construction underway is not only lower than the periods of past crises, but more of it is pre-leased than in prior downturns; today there are 2.4M sf of office space under construction, 48.2% of which is pre-leased, compared to Q4 2008 when 3.2M sf was under construction with only 14.0% pre-leased.

In terms of COVID-19, Phoenix nears the bottom of the list in terms of incidence of cases based on population density as of the end of April.



Perhaps as a result of the above, or simply because we are early in the economic dip, we have yet to see widespread price discovery in the market. As of now, major landlords have yet to drop published asking rents. Some have even gone so far as trying to avoid issuing any proposals in response to RFPs to see if they can buy time on active transactions. One notable exception is Renaissance Center (2 and 40 N. Central), a Class A asset in Downtown Phoenix whose owner Oaktree Capital Management dropped its asking rent on 61,000 sf of pre-built space from $34/sf to $26-$28/sf. This price drop was advertised widely in an aggressive marketing campaign, billed as temporary pricing through July 2020. The promotion seems designed to capture what immediate demand exists in the marketplace during a time when most requirements stood frozen.

Market and Economic Data Foretell a Different Story

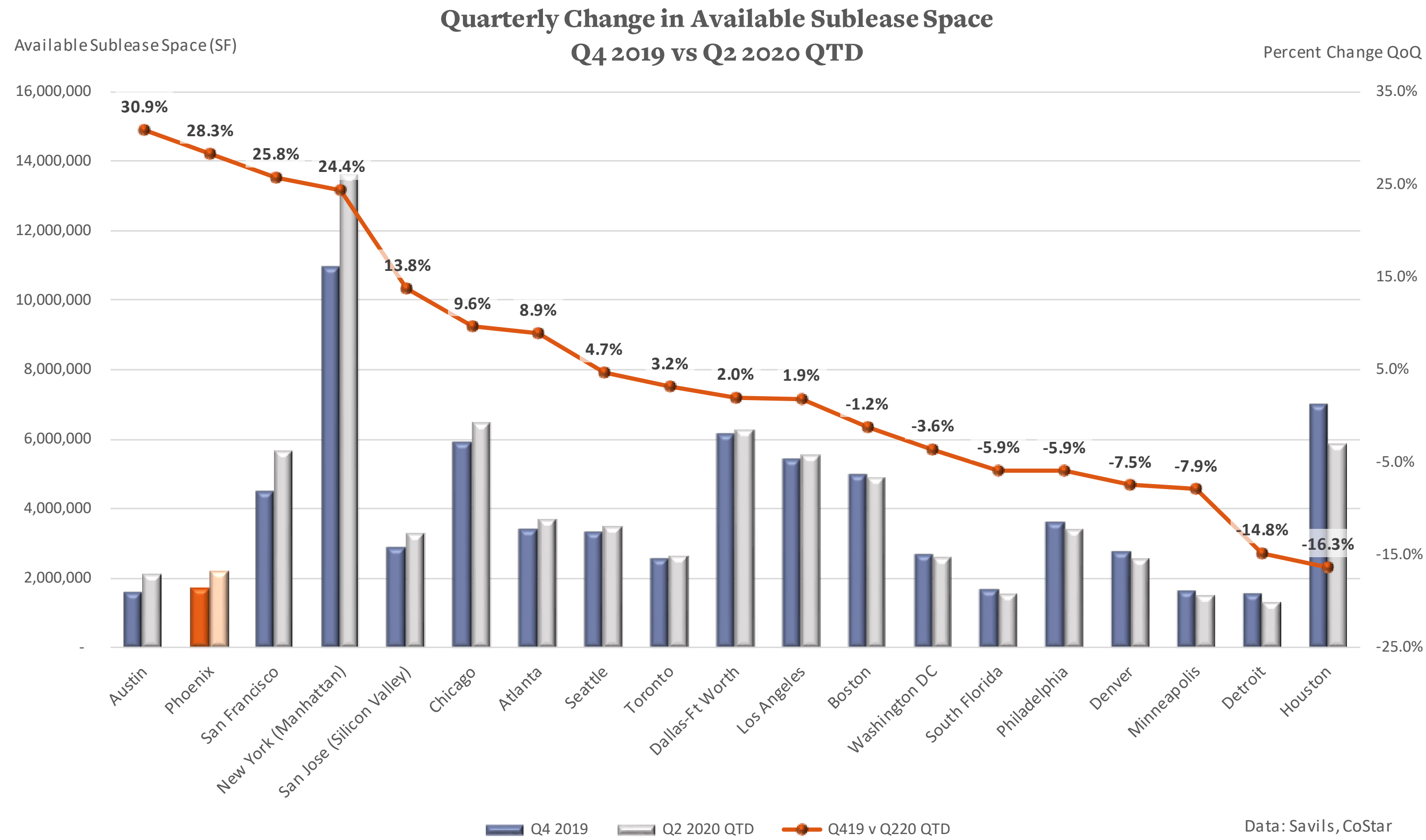
While Phoenix has been less affected than other markets, there are several considerations and scenarios that could alter that reality:

1. UNEMPLOYMENT

According to the Associated Press, since March 14 Arizona has processed 250,477 claims for unemployment, representing 8.7% of the state's total workforce eligible for the unemployment insurance program. This sharp spike represents an increase of 2,528.5% from the number of applications submitted the same week last year.

2. SUBLEASE INVENTORY

With a 28.3% increase from Q4 2019 to Q2 2020, Phoenix saw one of the largest early spikes in sublease inventory across major markets thus far.



Second only to the Austin market with its 28.3% increase over the same period, Phoenix has seen higher percentage levels of sublease inventory injected into the market than other competing cities. Given the recency of the crisis, we expect that the vast majority of sublease inventory has yet to be placed on the market.

> ***Submarket Snapshot: 44th Street Corridor***
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> *Healthcare company Care1st recently listed 81,306 square feet of space on the sublease market at Two Gateway (432 N. 44th Street). This one offering increased the submarket availability by 13.1% in a single day, demonstrating how one company's disposition decision can dramatically affect the fundaments of a submarket.*

3. HOSPITALITY & TOURISM

Arizona's economy relies heavily on the revenues from hospitality and tourism, two of the hardest hit sectors. According to the Arizona Office of Tourism's 2019 Industry Performance Report, Arizona tourism raked in $24.4 billion. With an uncertain outlook regarding how soon the population will get comfortable with hospitality environments, we anticipate this will continue to hamper the State's economy.

4. NON-HQ OPERATIONS

Generally speaking, corporate requirements in Phoenix tend to be more ancillary operations in comparison to headquarters functions. Call centers, shared service centers, onshore development hubs, and other types of similar requirements can be cycled out more easily than core operations as businesses shift and change. Major companies are always going to have a headquarters, but can always have fewer call centers if business needs shift.

5. GEOGRAPHIC COMPETITION

Many Phoenix requirements are "shopped," or competed against multiple markets. In these situations, Phoenix tends to compete on price, at least to some degree. To date, many top technology companies from California like Opendoor, Yelp, Square and Doordash have located operations in Phoenix because of its lower cost of doing business. Northern California as well as other markets like Denver that frequently come into play in this competitive landscape are predicted to be amongst the hardest hit, thus creating tenant-favorable pricing. For example, with San Francisco asking rates predicted to dip as much as 30%, Phoenix could lose some of its comparative sheen from a pricing perspective. Denver is another frequent competitor to Phoenix. Denver's dependence on the oil and gas industry opens it up to potentially huge price drops, as evidenced by the first energy bankruptcy of this cycle, Whiting Petroleum. If this cost delta between Phoenix and markets like San Francisco and Denver narrows, fewer companies could elect to come to Phoenix.

6. COWORKING & FLEXIBLE SPACE

The very public travails of WeWork may play a role in the Phoenix market. Though not one of the flexible office provider's largest markets, Phoenix hosts 200,000 square feet of WeWork space across three major submarkets: Tempe (one location), Camelback (one location) and Downtown Phoenix (two locations). In an article published March 2020, which specifically cited Phoenix as one of the cities where WeWork is experiencing thin attendance, Forbes said, "It's clear that workers are avoiding WeWork like, well, the plague." WeWork spaces are designed at 75 square feet per worker, including communal space. That was an aggressive utilization ratio even pre-COVID-19 but could now feel disconcertingly claustrophobic to corporate decision makers looking to create a safe environment to which they can bring employees back to work. If WeWork or other coworking companies return space to the market, either through bankruptcy or workout, they will be another source of increased supply.

7. TENANT PSYCHOLOGY

Few decisionmakers are willing to accept any landlord assertion that asking rates and concession levels have been unchanged, or only slightly affected, by the COVID-19 crisis. They know that their businesses have been adversely affected (as have their suppliers, customers and employees) and often perceive it as disingenuous when a landlord holds the line on pricing in this climate. Landlords should realize that some competitor, somewhere, will drop their pricing, and that by holding the line, they may wind up offending tenants during critical decision-making stages of their process.

Takeaway

While we wish the best for the local economy, we expect that the Phoenix office market will face struggles in the wake of the COVID-19 crisis. We anticipate the coming months will see more price discovery with proactive landlords responding to the dynamics described above. With Phoenix less affected than others, the market will see demand, but landlords should offer market-sensitive pricing and concessions in order to capture it and cement good long-term relations with tenants. We will continue to monitor and report availability rates, sublease inventories, asking and taking rates, and concession levels to identify opportunities for Phoenix tenants.