OfficeResearch
MARKET OVERVIEW
Marcus & Millichap
Phoenix Metro Area *Second Quarter 2015*

Startups Leave Coastal Areas, Seek Desert Office Space

A vacancy freefall is on the horizon for Phoenix-area office buildings as startups and financial services firms commit to large local expansions. California tech companies are moving beyond the coast, seeking the Valley's educated workforce and affordable office rents, while a lower cost of living and sunny climate will attract additional employees. These establishments include ride-hailing company Uber, which has officially opened a national support center in the Bank of America tower downtown and will add 300 local jobs by year end. Meanwhile, east of downtown, online HR firm Zenefits and Northern Trust Bank will hire a combined 2,300 employees in the next three years and lease floor plates in excess of 100,000 square feet. To prepare for corporate and demand growth, office developers have pushed a number of projects through the planning pipeline and are ramping up completions to a six-year high in 2015. Approximately 1 million square feet of construction is pre-leased in State Farm's Marina Heights Building D, the Wells Fargo Ocotillo Campus Phase II and Liberty Center at Rio Salado Building 2. With half of the space in new projects already under contract, competition for well-located available space near well-known brands and business hubs will push rents higher this year.

Office property owners are active again, motivated to list as buyer competition heats up due to recent performance gains and a looming interest rate hike. More investors are confident in the durability of operational improvements and are willing to consider the metro's value-add opportunities, as indicated by rising sales in the Class B/C segment. Transaction velocity for these buildings continues to rise, applying upward pressure on prices. Last year, initial returns for office assets rose 50 basis points to near 8 percent as more value-add assets traded. Out-of-state buyers were willing to pay a 50 percent premium on this property class while also accepting cap rates up to 150 basis points lower than local buyers. Investors will continue to look for renovation and lease-up potential this year, focusing on the east and northwest areas of the metro, next to new corporate expansions.

2015 Annual Office Forecast

3.1% increase in total employment

Employment: Companies will lift employment by 59,000 jobs or 3.1 percent in 2015, an acceleration from the 2.7 percent increase last year. A variety of firms are growing, generating new jobs in the office-using professional and business services sector.

2 million square feet will be completed

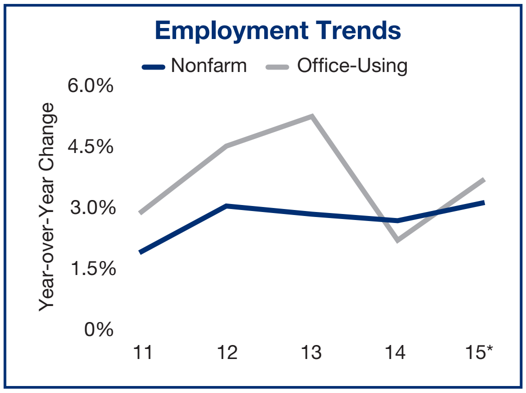
Construction: Developers will deliver 2 million square feet this year after 1.4 million square feet was finished in 2014. Companies are enlarging their footprints in the Phoenix metro, motivated by an educated employment base and the availability of land for development.

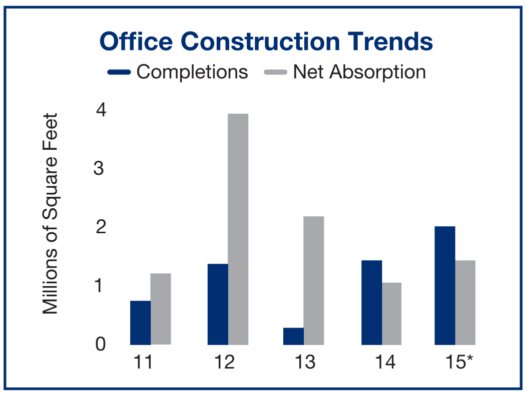
10 basis point increase in vacancy

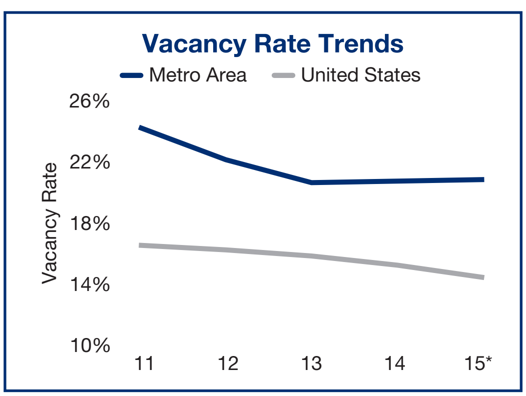
Vacancy: In 2015, vacancy will tack on 10 basis points to end at 20.9 percent as the highest amount of supply in six years is added to the market. While demand will fall metrowide, properties in areas to the northwest and east of the metro will experience stronger demand.

3.7% increase in asking rents

Rents: Average rent will reach $22.10 per square foot, a 3.7 percent rise, this year, after advancing 3.5 percent in 2014. Strong demand pushed up rents across all tiers in the first quarter, though the marketwide level remains approximately 12 percent lower than the prior peak.







*Forecast
Source: CoStar Group, Inc.

Economy

- Phoenix metro employment advanced 3.0 percent, or by 55,300 positions, in the 12 months ending in the first quarter. Employers created 42,300 jobs a year earlier.
- Office-using employment grew 3.2 percent in the year ending in March, led by 10,300 new hires in the professional and business services sector. Financial and business services, and the information sectors rounded out the remainder with 5,500 positions combined.
- Corporate growth compressed unemployment by 60 basis points to 5.4 percent as more residents collected paychecks. This is an acceleration from the 50-basis-point slide last year and a fifth consecutive year of reduction, yet the rate is still 200 basis points above the pre-recession level.
- **Outlook:** Expansions will boost employment by 59,000 jobs or 3.1 percent in 2015, an acceleration from the 2.7 percent increase last year.

Construction

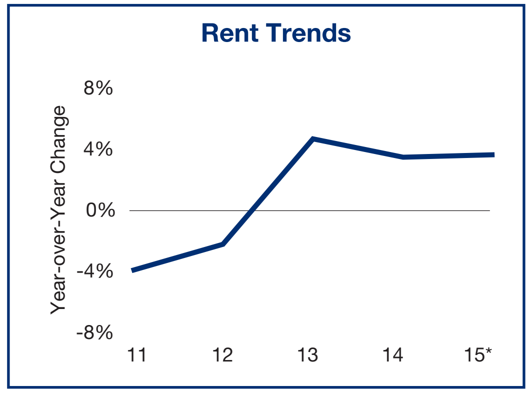
- Builders completed 1.7 million square feet of space in the past 12 months, boosting inventory by 1.3 percent. This is the strongest gain since the first quarter of 2010.
- Approximately 4.3 million square feet of office buildings is under construction with delivery dates through 2017. The total includes 3.3 million square feet in the East Valley submarket, which has projects such as Marina Heights, Isagenix Headquarters and Hayden Ferry Lakeside.
- Although a majority of office projects have proceeded through the planning pipeline, developers have proposed an additional 1.6 million square feet with completion dates set through 2017 and these projects are concentrated in East Valley and Scottsdale ZIP codes.
- **Outlook:** Developers will deliver 2 million square feet this year, expanding office inventory by 1.5 percent. Companies are enlarging their footprints in the Phoenix metro, motivated by an educated employment base and the availability of land for development.

Vacancy

- Phoenix metro vacancy was flat during the past four quarters, ending the first quarter at 20.7 percent as 1.4 million square feet of office space was absorbed in the period.
- Demand remained strong for Class A space in the past four quarters as businesses upgraded to higher-quality layouts. As a result, top-tier vacancy tumbled 50 basis points to 20 percent, adding to last year's 100-basis-point fall.
- Class B/C assets in the Northwest Phoenix and East Phoenix submarkets had vacancy rates above the metro level in the first quarter at 27 and 22 percent, respectively. These two areas account for a third of the metro's office product. The metro-low rate of 13.2 percent was in Pinal County, which has the market's smallest inventory of office buildings.
- **Outlook:** In 2015, vacancy will increase 10 basis points to 20.9 percent as significant new supply is added to the market.

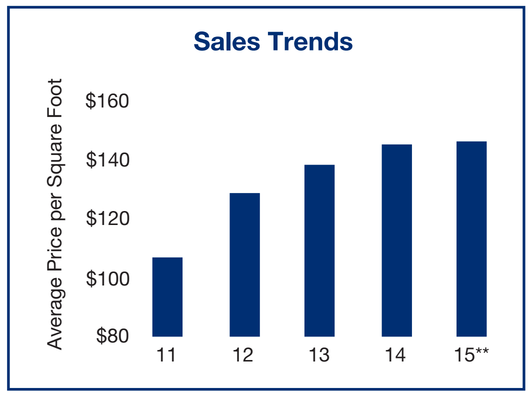
Rents

- Average rent grew 3.2 percent to $21.41 per square foot in the 12 months ending in March, marking a third year of improvement. The average rent is still 15 percent below the 2007 level.
- Demand growth in this year's opening period lifted the Class A rent to $25.38 per square foot, up 2.3 percent from a year ago. An 8.2 percent jump was recorded in the prior year.
- The rent for Class B/C office buildings advanced 3.6 percent over the past year to $19.62 per square foot in the first quarter. Strengthening demand for space in mid-tier properties pushed up the average rent by 4.6 percent in both the East Valley and East Phoenix submarkets.
- **Outlook:** Average rent will reach $22.10 per square foot, a 3.7 percent rise this year, after advancing 3.5 percent in 2014.



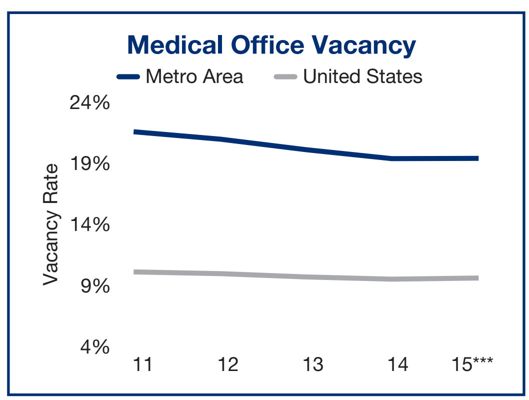
Sales Trends**

- The search for strong tenant rosters and affordable prices drove investors to Phoenix-area office assets, boosting transactions by 10 percent in the past four quarters after 14 percent growth in the preceding year.
- Competition for well-placed properties pushed up the average price 5 percent to $146 per square foot, surpassing gains in other Southwest metros. An identical gain in the average price occurred in 2014.
- The average cap rate ticked 30 basis points lower to the low-7 percent area. Top-tier assets traded 100 basis points lower, while Class B/C properties traded 50 to 100 basis points above average.
- **Outlook:** Eastern areas of the metro, including the Scottsdale and the East Phoenix submarkets, will continue to draw interest from office investors. Northwest Phoenix assets will also trade frequently.



Medical Office

- No new medical office properties were delivered in the past 12 months. In the prior year 33,000 square feet were completed in two properties to the east and west of the urban core.
- Vacancy plummeted 190 basis points year over year to 19.5 percent in the first quarter, as slow construction shifted demand to existing spaces. This marks a third consecutive quarter of receding vacancy in the medical office segment.
- Average asking rents dipped 2.0 percent over the last 12 months to $22.62 per square foot, following a 2.8 percent rise one year earlier. The decline was due to the absorption of higher-tier space, leaving more Class B/C spaces available.
- Medical office trades were flat in the period, matching the five-year high last year when transaction velocity jumped more than 50 percent. Motivated investors were willing to bid on value-add opportunities, which comprised the majority of transactions in the period. Bidding competition pushed up the average price per square foot by 9 percent. Cap rates for medical office properties ticked up 50 basis points to the low-8 percent area.



* Forecast ** Trailing 12-month period through first quarter *** 1Q15
Sources: CoStar Group, Inc.; Real Capital Analytics

Marcus & Millichap

NATIONAL OFFICE AND INDUSTRIAL PROPERTIES GROUP

Alan L. Pontius
Senior Vice President, National Director
National Office and Industrial Properties Group
Tel: (415) 963-3000
apontius@marcusmillichap.com

Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- Although volatility and speculation about the first rate hike since 2006 have ramped up considerably in recent weeks, the yield on the 10-year U.S. Treasury has traded near 2.4 percent, mostly due to recent issues in the eurozone involving Greece. Economic data is improving since the weak print in first quarter GDP, proving the Federal Reserve's thesis of seasonal factors and transitory conditions as the culprits behind soft GDP. Market participants are now positioning for the September meeting as the most likely starting point for an interest rate hike, while the latest comments from Federal Reserve Chairwoman Janet Yellen indicate that the exact moment is still data-dependent.

- The Federal Open Market Committee has committed to a policy of "lower for longer" as it assuages fears that the first interest rate increase will disrupt the recovery that is underway. The first policy rate change is expected to be just 25 basis points, with measures remaining accommodative for some time as the Federal Reserve seeks to move past crisis-era policies nearly six years into the current cycle.

- Interest rate volatility has moved over to the commercial loan markets and 10-year fixed-rates are now pricing between 4 and 4.6 percent with LTVs from 55 to 75 percent for office properties, depending on location, as underwriters have become more competitive in an effort to do business. Floating bridge loans for stabilized assets will require LTVs of 65 percent and price with a spread between 250 and 400 basis points over LIBOR, while re-positionings will be underwritten at 80 percent LTV with a 300- to 475-basis-point spread.

- Total CMBS issuance is expected to top 2014 levels this year as $100 billion to $125 billion is underwritten, driven largely by growth in office property originations. A wave of pre-crisis loans will start to come due over the next few years, prompting refinancing as current owners renegotiate the capital structure of their assets. Through April, $35.8 billion in CMBS has been originated, underscoring the availability of credit as credit unions, insurance companies and alternative asset managers expand their offerings. Meanwhile, traditional commercial banks have backed off due to higher capital reserve requirements and intensifying regulation.

Local Highlights

- Growth at headquarters and administrative operations supported a gain of 10,000 professional and business services jobs in the past 12 months. Future corporate expansions of hundreds of employees are planned at State Farm, Discover and Revana Tech. The largest national call center is located in Phoenix, with more than 5,000 American Express employees.

- Apple has plans for an East Valley command center that will create up to 500 jobs, including 150 executive-level positions. The 1.2 million-square-foot data center will be led by Silicon Valley executives and will hire the remaining staff locally.

- DriveTime is completing a 96,000-square-foot corporate headquarters at the Liberty Center development at Rio Salado, a 1.2 million-square-foot mixed-use project that includes office, retail, industrial space and a hotel. This will be the third of five Class A office buildings at the center.

Marcus & Millichap

Prepared and edited by
Mridul Nanda
Research Associate
Research Services

For information on national office trends, contact
John Chang
First Vice President, Research Services
Tel: (602) 687-6700
john.chang@marcusmillichap.com

Phoenix Office:
Don Morrow
Regional Manager
don.morrow@marcusmillichap.com
2398 E. Camelback Road
Suite 550
Phoenix, Arizona 85016

Tel: (602) 687-6700
Fax: (602) 687-6710

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