BY PETER MADRID

PRIMED FOR A REBOUND

Market conditions including absorption rates and private sector jobs driving a favorable office outlook

Liberty Property Trust's build-to-suit Aetna office buildings at Cotton Center

When it comes to the office market in Metro Phoenix, so far 2013 has been significantly more active on the lease and transaction front than what it's been the past two or three years.

This is very much expected, says John DiVall, senior vice president/city manager for Liberty Property Trust for a couple of reasons:

>> Absorption has totaled nearly 700,000 SF year to date, higher than this time last year and capital activity has been fairly robust;

>> Private sector job gains have played the largest part in the absorption activity, along with some pent up demand.

"The demand for office space is rebounding," DiVall says. "Companies are growing and we've had some nice job announcements that are fueling this, along with the fact that many companies have delayed making decisions on space needs during the uncertainty of the past three years and now they have to make some decisions."

DiVall adds that larger companies are taking advantage of market conditions to consolidate into one facility for greater efficiencies in a more modern facility. He points out a Liberty Property Trust project — the Aetna build-to-suit in the Cotton Center.

"I'm of the strong belief that centrally located, high-quality properties will continue to out-perform," he says. "For example, North Tempe is the only submarket with single digit vacancy rates. Around the Valley, large blocks of vacant or contiguous space are rapidly dwindling."

Two to three years ago the focus was doing everything necessary to keep existing tenants and to fill space at whatever minimum rent and terms you could in order to meet debt covenants and maintain occupancy, says Steven Schwarz, principal at the ViaWest Group.

"In the past six to nine months, we have begun pushing rents (as much as 15% to 20%) in the Southeast Valley and parts of Scottsdale," Schwarz says. "Corporate America re-entered the picture two years ago and began taking down larger chunks of space. In the past nine months, we have seen a strong resurgence of activity by the 2,000 to 10,000 SF tenants.

"The combined dynamic of corporate America and smaller tenants bodes well for the well-located, quality assets. Class B and Class C buildings will continue to have a more difficult time until the better assets are near full occupancy and begin pushing rents further."

On the investment side, Schwarz says, there is a significant amount of capital looking for opportunities and the process has become very competitive with prices increasing very quickly. Tenant demand is very dependent upon location and quality of building.

"That being said, we have been extremely pleased with the leasing activity in our buildings," Schwarz adds. "We have bought more than $70M of assets in the past six months anticipating continued strength in the office market. Shadow space seems to be a thing of the past. Our tenants are running at near full capacity and many are in need of expansion space."

While industry experts agree the office market is healthier now than it has been over the past two to three years, there is still room for improvement.

There is a tangible sense of improving conditions, says Andrew Cheney, a principal at Lee & Associates because of increasing values due to cap rate compression for Class A properties, ➜

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some positive net absorption (job growth), and more consistent deal velocity.

"Office space pricing for tenants remains on sale, but landlords are now developing a sense of confidence that rents will soon stabilize," Cheney says. "While values and rental rates vary widely depending on product type, they are no longer dropping in any particular class. It's important to put things in perspective though; our overall vacancy was nearly 27% in 2011 and as of Q2 2013 we stand at 23.7%. Until we drop below 16% to 18%, there will be not be strong upward pressure on rents in all but a handful of buildings."

Cheney also agrees that office demand is coming back — it's just a matter of how fast it will keep coming, he says.

"Keep in mind that we still have some tenants giving back space (Medicis, University of Phoenix, Lewis & Roca). We also have some exciting news for large blocks of space leading with the incredible State Farm transaction followed up with General Motors, OnTrac, and many more in the queue.

"However, if you look at the past three years overall we had a mediocre year of demand in 2011. This past year (2012) was a historically average year at 1.8 MSF of net absorption. This year we are on track to be mediocre again."

Notable trends, according to Cheney:

>> More employers want to pack their employees into quality, open, collaborative spaces;

>> Real estate companies are back and cautiously optimistic. Many are only willing to take on 3-year commitments with wait-and-see attitudes;

>> California companies are not necessarily leaving California, but they are expanding here in Phoenix (Silicon Valley Bank, Union Bank);

>> Tenants, regardless of industry, are trying to tie their leases to specific contracts they hold. Landlords with existing, functional space are the ones landing these users who will often stay well past their initial expiration.

"Office space demand is closely linked to job growth," says Jim Achen, senior vice president at Brokerage: Office, at Transwestern. "Concurrent with the positive net absorption we have seen for the past five quarters and the new, substantial requirements we are seeing come to Phoenix, we are now experiencing a lack of large, Class A blocks of office space. As a result, build-to-suit activity is picking up significantly and lease rates on existing product are starting to increase and will continue to do so."

While the past few years have seen steady leasing activity, but with vacancy rates still hovering around 23% to 25%, there is still a ways to go before it can labeled a recovery, says Keith Earnest, vice president of development at RED Development. Several of the highest performing markets — Camelback corridor, Downtown Phoenix and Tempe — are experiencing a higher volume on larger deals and most of the big blocks of vacant space have been leased.

"We are starting to see a shift from a completely 'tenant favorable' market to one that is more balanced," Earnest says. "Tenants still have the upper hand, but that will be changing by 2014 when there will be a significant drop in vacancy rates and some speculative buildings under construction. The past 12 months have been highlighted by several large transactions including State Farm, GoDaddy, Fennemore Craig, Aetna and Lewis & Roca. In order for the market to fully recover, we will need to see more growth from small businesses and services companies. Small business growth is the catalyst for a healthy and sustainable market."

Earnest cites several trends that are impacting the market. Law firms, he says, are becoming even more efficient with their space resulting in lower occupancy costs and higher parking ratios. Another significant trend is the evolution of mixed use projects, he says. Building owners and developers are more focused on providing "experiential" spaces for tenants and visitors. Whether it's open, shaded plazas, water features, or fast casual restaurant amenities, both old and new buildings are finding it a key component in attracting prospective tenants.

"These three elements — job growth, absorption and new projects for large users — are indeed some of the key ingredients for a more robust commercial real estate market," Earnest says. "We are seeing how these positive economic trends are definitely lifting the office sector. We hope this is a long-term phenomenon, but so many factors are at play as this sector has faced some unique challenges in recent years. Right now, things look very positive and there is reason to believe we are headed for continual upswing in overall demand and lease rates in the coming years."

ANDREW CHENEY

JIM ACHEN

JOHN DIVALL

KEITH EARNEST

STEVEN SCHWARZ