

Road to Recovery in Tucson Real Estate

Are we there yet? Probably not, in my opinion. All sectors of commercial real estate remain in flux during the first half of 2010. As we work our way through the lows of residential real estate values, we still see foreclosures and their impacts on valuations of all classes of real estate. We predict that while we still are experiencing a small decrease in value, many people will look back at this present era as the best time in recent memory to buy a residential property. While this is good news for the residential market and brokers that sell residential real estate, there is some cause for concern for owners of commercial real estate in the future. We feel that commercial properties values peaked in mid 2008 and values held their own for a brief period. 2009 was a different story. Particularly hard hit was the retail sector. Those projects recently built with forecasts of rising rents and advancing roof tops tanked. These projects were in the planning stages way before the crash of residential real estate and they were completed. We refer to them as "see thrus". Once the project was completed, there was no activity and improvements stopped. Bankers took action. Cap rates accelerated upward and pro formas did not come to fruition. We see this trend continuing in all but several smaller and more well located projects in still growing sub markets such as Vail and Vistoso, both at opposite ends of Tucson. Many of these smaller market areas are still underserved and opportunity for leasing remains moderately active. We will see weak retail sales growth continue through 2010 and into 2011. If the national economy can shake the blues, this will certainly help the local retail sector.

Industrial activity remains slow but most brokers maintain that activity has increased recently. While the incubator market has been hardest hit, activity picked up in the late Spring. Rates and deals are out there. Most tenants are confused with too many options to pick from. Our advice to tenants is to try and secure long term leases and take advantage of long term cost savings. Our advice to Landlords is try and shorten lease terms as we predict a turn in decreasing lease rates in late 2011. While rates have decreased during the last 12 months, there has been some strong activity in the Palo Verde corridor indicating that rates may have bottomed out. Building prices remain in the decline with users possible but more stringent lending in tandem with the ability of lenders to indiscriminately reduce current appraisals by as much as ten percent just are not making many purchases possible. Only the financially strongest borrowers can qualify. Building values have declined by about 20-25% in the past 12-18 months. New construction is non-existent and we do not see any new product in the works for the next 18-20 months. There are a number of larger opportunities for tenants in the airport area and rents are running in the .35-.45/SF NNN for newer large warehouse projects near the airport. We anticipate a rebound in 2012. If you think about it, this will be about 5 years after the peak of the housing market. Typically, the industrial sector trails the residential market by about 24-36 months.

The following bits of information were recently printed in the January/February issue of Commercial Investment Management magazine which is a publication by the national CCIM organization. In the retail sector, local shopping malls where people buy their local items will perform best and have the highest occupancy. Cap rates will continue to

increase. Rates are still on a downward trend nationally. Multi-family pricing is weakest in the east coast and west coast markets although one would have to argue that apartment value trends in the Phoenix market have to be some of the lowest in the US. The proliferation of over building and the impacts of cracking down on illegal immigration continue to spell higher vacancy rates which include lower rents and rising cap rates. We don't see those things changing soon for our friends in Phoenix. However, once again, well located project in the Tucson market have attracted some national buyers who recognize value with well positioned projects and demographics that still predict in migration albeit in quite different than what it was during the past ten years. According to the recent article, Multi-family real estate product was given the highest investment rating for different types of real estate. The second highest rated product was industrial.

Industrial real estate will be and is tied directly to the national economy. Fewer retail sales ultimately mean less manufacturing and less warehousing. Until we see some significant change in people's perspectives in the economy, the industrial sector will be hum hum. What will ultimately mean the most to this sector will be the ability of capital for refinancing shorter term loans that will come due during a weak economic period for the national economy. There has been negative net absorption for seven quarters according to the article. The average price per SF was \$60.00 nationally which represents a 15% decline from a year earlier. Rates have declined on average about 15% for institutional type product which is close to Tucson market conditions.

Office property types are some of the hardest hit as national companies have reduced their overall needs on a national basis. Values have declined to an average SF value at around \$181.00/SF nationally. Once again, this value mirrors the Tucson market. Lower values are in order for class B and C properties in the Tucson market. Cap rates for this property type are lower in the east and west coast markets are the lowest. We see the trend of increasing office cap rates and decreasing valuations until the local economy begins a turn around.

In conclusion, we hope this information is useful and the article in Commercial Investment Management was written by Kenneth Riggs, Jr., CCIM, CRE, MAI, CEO of Real Estate Research Corporation.