NAIOP (COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION)

2014 NAIOP-AZ ROUNDTABLE

It's an exciting time for commercial real estate. With technological advances and a new generation entering the workforce, office space is undergoing a significant paradigm shift. NAIOP Arizona's members discuss the state's reputation and role in the market — its strengths, weaknesses and promising statistics — as well as what companies need to do to keep that trajectory on the up-and-up.

Moderator:
Megan Creecy-Herman, Liberty Property Trust

Participants:
Anthony Lydon, Jones Lang LaSalle
Bob Mulhern, Colliers International
Chuck Vogel, American Realty Capital Properties, Inc.
Keaton Merrell, Legacy Capital Advisors
Molly Ryan Carson, Ryan Companies US, Inc.
Steven Schwarz, ViaWest Group
Tom Johnston, Voit Real Estate Services

Megan Creecy-Herman (MCH): What is different in July 2014 in our local commercial real estate industry than a year ago?

Tom Johnston (TJ): Although the economy is growing slowly, it just feels better. Vacancy rates are dropping and rates are increasing in all product categories. Job growth is improving year over year, and it is great to see office and industrial projects under construction again.

Bob Mulhern (BM): The most distinct difference in the local commercial real estate market today from a year ago is increased momentum. In the first half of last year, the office and industrial markets were impacted by tepid employment growth and economic uncertainty at the national and local levels. As such, net absorption was minimal in the first half of 2013. The pace of absorption accelerated in the second half of last year and that trend has carried over into 2014. In the first half of 2014, net absorption of office space totaled more than 1MSF, compared to approximately 150KSF in the first half of 2013. In the industrial market, net absorption in the first half of this year topped 4.6MSF, up from approximately 1.5MSF in the first half of last year. The other noteworthy change in the market is sustained rent growth in the office market. A year ago at this time, rent trends were mixed. Today, office rents are clearly trending higher and, with absorption likely to remain positive, rent should continue to rise.

Chuck Vogel (CV): The local economy has continued to gather momentum. Job growth is running 50 percent faster than the national pace and unemployment is lower. A stronger local economy and a pickup in regional and national distribution activity is fueling more demand, especially in the office space (industrial recovered earlier). Rent growth has accelerated, from nearly zero a year ago to about 2 percent annually today.

Construction has resurfaced. Office deliveries in 2014 will be more than double that of the last two years combined, although at under 800KSF it will remain low. Industrial construction is nearly back to pre-crisis levels: nearly 2.5MSF is expected to complete in 2014, split 50/50 between speculative and build-to-suit projects.

Steven Schwarz (SS): The market has shifted very quickly in the past year. A year ago, we were very busy buying distressed properties. Those deals are now few and far between. Capital is extremely active now pursuing both development projects and stabilized assets in certain submarkets. As well, the 1031 Exchange buyer is back because they now feel comfortable selling the assets that they have been sitting on for the past seven-plus years. We have sold three projects in the last few months to 1031 buyers. Corporate America has continued to lease space at a moderate pace and we have seen a return, albeit very gradually, of some of the local tenants becoming more comfortable expanding and leasing space.

MCH: There are several things that are different and I would say the vast majority of them are positive. Two differences that stand out are the increased speculative development in the office sector, specifically in Tempe, and now even some proposed ground up development in the retail sector. These are good signs as the market continues to recover and I am optimistic that the recovery will become more broad-based across the Phoenix Metropolitan area over the next 12 months.

Keaton Merrell (KM): From a financing perspective, there is more and more money in the market chasing deals and it continues to get more and more aggressive on LTV and rates.

MCH: How would you compare our Metro Phoenix commercial real estate market to other major markets throughout the nation and specifically the western U.S.?

Anthony Lydon (AL): We believe Phoenix is like many other national markets who are experiencing two types of recovery. Value-add, high technology submarkets (i.e., San Francisco Bay Area; Phoenix's east Valley and Deer Valley) are experiencing a higher level of user demand and good capital flow related to employment. Lower tech submarkets like California/Inland Empire and Phoenix/southwest Valley are seeing an inconsistent, staccato recovery. While the national employment has risen to pre-recession times most of the new jobs are part-time and/or lower wage. This reality has muted U.S. and Metro Phoenix recovery.

BM: The Metro Phoenix commercial real estate market is noteworthy among competing markets nationally and in the Western region for both elevated vacancy and healthy tenant demand. With office vacancy near 20 percent and industrial vacancy in the 12 to 13 percent range, Metro Phoenix is at the high end of the vacancy spectrum. Despite elevated vacancy, tenant demand for commercial real estate is healthy. Final second quarter data is not quite available yet, but in the first quarter, net absorption of office space in Phoenix outpaced all other Western region markets. Tenant demand is sufficient to spark some spec office construction due to tight conditions–particularly for large blocks of Class A space–in a handful of popular submarkets such as Tempe and Chandler. Local industrial properties are further along in the cycle, and spec developments began to deliver in mid-2013. To date, much of the spec industrial space that has been delivered has yet to lease, but the improving national and local economies should ultimately fuel absorption in these buildings.

CV: Phoenix has among the best growth stories in the nation. Population growth is running at 2-3 times the national pace. That means more office workers, more shoppers and more goods circulating through the metro's warehouses. People and

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businesses are attracted to the metro's low living and business costs (especially relative to California), amenable climate, and strong transportation infrastructure.

Although commercial real estate prices have picked up, cap rates remain very competitive relative to those in the top six coastal metros (New York, Boston, DC, LA, San Francisco, and Chicago), which have seen an influx of foreign capital. Expect prices to increase and cap rates to fall further as more investors look beyond the top markets to places like Phoenix for yield.

SS: Generally speaking, our vacancies are far worse than other western major markets but it doesn't appear that the capital cares. Most California markets have recovered fully. Denver and Salt Lake City have surpassed peak values in nearly all product types and vacancies are tight across the board. The capital believes, and I agree, that Phoenix will continue to be a national leader in annual job growth and population growth and is therefore positioning accordingly, but we have a ways to go before our fundamentals are as strong as most other Western markets.

MCH: Where does Arizona stand in its economic development plans? Are we headed in the right direction or leave anything for the asking? Is the furor over SB 1062 still creating an image problem for the state?

AL: Arizona has a terrific story! We can further enhance our brand by passing "thoughtful" legislation supporting our communities, families and businesses. We need to continue to invest in education, increase the state's job closing fund and maintain lower costs of business. SB 1062 is an extreme example of a well-funded, smaller minority that can negatively impact all of us. Just as Seattle recently "jumped" in front of the minimum wage issue, Arizona needs to be a perceived thought leader on issues like thoughtful immigration, sustainable energy, educational reform, minimum wage, etc.

MCH: What kind of business practices came out of the recession that many professionals should keep well past the recovery?

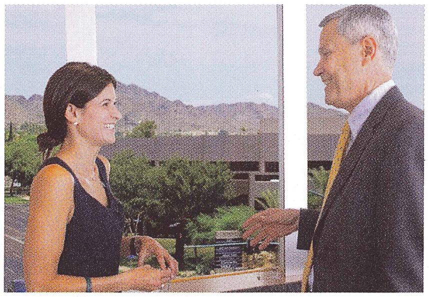
TJ: Learning to do more with less man power. From the pursuit of new business opportunities to operational efficiencies, a lot of creativity came about because of the recession.

MCH: I would hope that an overall prudence in lending with an increased focus on the quality of the borrower and their track record is one of the best practices that we all keep in mind moving forward, specifically when it comes to development. I would also hope that real estate fundamentals are the driving factor behind the corresponding financing decisions, as opposed to the availability of capital driving irresponsible development.

MCH: What has been most surprising about Arizona's commercial real estate recovery?

TJ: How slow it has been compared to past recoveries. What is encouraging is seeing our healthcare and high-tech sectors expanding.

CV: Warehouse construction is also surprising. Warehouse development has accelerated dramatically, to 2.8MSF in 2013. As a result, even though demand is robust, vacancies actually



Molly Ryan Carson and Bob Mulhern

increased over the past year. The hope is that demand will continue to expand to meet this supply. Retailers (Amazon, TJX Companies, Macy's) and third-party logistics firms are gobbling up millions of square feet, attracted to Phoenix's affordable land, strong transportation network, proximity to southern California ports, and growing local economy.

SS: When the recovery started, I did not expect such a pronounced and extreme gap in values and rental rates when comparing quality, well-located office buildings and less desirable properties. The flight to quality was expected but the ability for landlords to push rates on class-A product as much as they have while class-B buildings remain stagnant has been surprising. This is partially attributable to the need for higher parking ratios and other functional issues rendering many older buildings somewhat functionally obsolete. As well, the recovery has been led by corporate America rather than small business so the class-A buildings have experienced much greater demand. With corporate America's strong activity there is now a shortage of large blocks of space leading to new development much more quickly in the recovery than anticipated. Each submarket is experiencing a very different recovery than others so real estate operators are evaluating opportunities on a micro-geographic and property-type level. For example, new office and industrial buildings have gone up in Chandler while the overall metro market still had over 20 percent vacancy in office and 12 percent vacancy in industrial. As well, we bought an office complex in 2012 in west Phoenix although overall vacancy in that part of town was over 30 percent. The reality is that the vacancy out there was in specialized buildings – medical, office condos, Westgate, while the service office buildings had an extremely tight vacancy. Lastly, the amount and aggressiveness of the capital has been surprising. There is an enormous amount of capital seeking alternative assets.

MCH: What is the current state of our Metro Phoenix office market and what needs to happen to push the office sector into continued recovery?

BM: The Phoenix office market is in a recovery stage, with vacancy ending the second quarter in the mid-18 percent range, 200 basis points lower than one year ago. Net absorption has been positive in each of the past nine quarters, and market rents have increased in each of the past five quarters. Tenant demand growth is being fueled by job growth in office-using sectors, particularly among financial services

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companies. Over the past 12 months, financial employers have added nearly 8,500 workers. These positions have accounted for more than 20 percent of total job growth in Metro Phoenix in that time. There are a few things that need to happen for the Phoenix office market to move into a more sustained recovery. The first is continued strength in the financial sector. Phoenix is attracting large, corporate users looking to operate in our market. This trend needs to continue to backfill vacant space and support new development. Second, the housing market will need to gain some momentum. The housing market has stabilized, with foreclosures having largely been worked through the system and prices ticking higher. While those trends are positive, new home construction is down approximately 80 percent from peak levels and builders are behaving with extreme caution bringing new homes to market. Housing is a huge employment driver in our market and growth in this sector is essential to long-term economic expansion. While a return to the peak levels recorded at the height of the housing frenzy would be a recipe for another "boom and bust" market, current construction levels are hindering a natural pace of economic growth. The final hurdle to clear for sustained recovery in the office market is the need to move to a more diversified mix of industries. Attracting companies from California will be a significant source of economic expansion in the coming years.

SS: Phoenix still hasn't recovered all the jobs it lost during the recession. Considering this, our office market is doing pretty darn well. There is a shortage of class-A product and large-floor plates in a number of submarkets presently. The class-B and -C product and less desirable areas just need more bodies in more homes and more job growth. It is steadily getting there, but the market is much better than the headline vacancy makes it appear. Phoenix is still a young city and therefore redevelopment of old, functionally obsolete buildings hasn't taken a stronghold, but as the market tightens and the city matures this will start taking place more. Time, jobs, people and removal of obsolete space are the answers. It's in process. Slow and steady isn't necessarily a bad thing for this historical boom-bust market.

CV: The Phoenix office market, like the national office market, is recovering gradually. Job growth is creating some demand, but companies are still soaking up "shadow space" (space under lease but not being used) left over from the recession. Technology (firms do not need the libraries and filing space that they did in the past) may have also dampened demand. Construction is rising modestly but is primarily limited to build-to-suit facilities. Vacancies are high at 25 percent, but they are down 90 bps from last year, and rents are rising by about 2 percent year over year. We expect that the recovery will accelerate over the next few years. Much of the "shadow space" has likely been absorbed. Provided that construction stays in check, vacancies should fall substantially.

Molly Carson (MC): In order to push the office sector into continued recovery, we need to continue to focus on strengthening Arizona's brand to best position our market to be the first choice for companies looking to relocate – with specific focus toward corporate and regional headquarters. This cannot be done by one organization, rather a collective, unified effort by the private and public sector on the city and state levels. We have a wonderful opportunity at hand to capture a number of new, relocating or expanding firms from other markets with California being our low-hanging fruit. This takes a strong positive message illustrating the advantages our cities and state have to offer. I think this is one of the most important things the real estate business segment can put efforts toward now and in the coming years.

MCH: Why does the Tempe submarket appear to be so hot right now?

MC: Tempe has done a wonderful job of positioning itself for success within the development realm. The abundance of amenities (restaurants, the Tempe Center for the Arts, Tempe Town Lake) within this walkable community are desirable from

Steven Schwarz, Megan Creecy-Herman, Tom Johnston and Keaton Merrell

a work-and-live standpoint. Arizona State University remains a valuable draw from an employment standpoint. Simply put, Tempe has done an impeccable job of building a strong foundation and was ready to take advantage of the uptick in the market.

TJ: The confluence of our freeway system and the center of Metro Phoenix is in Tempe. Proximity to ASU, the airport and light rail make it advantageous for employers. It has become a real urban core where you can live, work and play.

CV: Tech companies want to locate in areas that are attractive to younger, tech-savvy workers. Arizona State University and recreational, cultural and retail amenities are draws for this cohort as is easy access via the Loops 101 and 202, Highway 60 and Interstate 10. Somewhat central locations (are ideal), especially for the east Valley and the nearby Phoenix Sky Harbor.

MCH: Tempe doesn't "appear to be hot" ... it is hot. There are numerous reasons why tenants want to be in Tempe, one of which is its central location and the fact that it allows employers to pull talent from across the metro-plex considering that 60 percent of Phoenix Metro residents live within a 20-minute commute of Tempe. Also, its proximity and access to Sky Harbor Airport and proximity to the largest public university in the United States are substantial contributing factors.

MCH: There's a lot of buzz around adaptive reuse and redevelopment of downtown spaces, particularly in Phoenix. What significance does this development have to the industry? What have been some of the most important projects?

TJ: As someone who grew up here and now lives downtown, it is refreshing to see all the redevelopment in our central core. As evidenced by housing price increases in central Phoenix, people want to be in an urban environment. They no longer want to drive 30 to 45 minutes to get somewhere. We have seen tremendous success with retail (particularly restaurants) and multi-family redevelopment. There is a lot of opportunity with infill sites for office redevelopment as well. Important projects include 7th Avenue and McDowell Road, 7th Street and Osborn Road, Central Avenue and Colter Street, and the Roosevelt Arts District.

Metro Phoenix typically absorbs

+/-3.5MSF to 4MSF

SF of space annually

Metro Phoenix has almost

3 MSF

of industrial facilities currently under construction

BM: Phoenix is in the early stages of the adaptive reuse and redevelopment phase, in part because Phoenix is a newer city and in part because the area does not have as developed a downtown as some other markets. That is not to say that the city does not have opportunities for adaptive reuse, either with outdated inventory in the downtown/midtown area or some large blocks of vacant retail space. Education has been a driver of redevelopment in the downtown portion of Phoenix, and further expansion by Arizona State University and University of Arizona could be a source of future activity.

The pace of population growth is the wild card for adaptive reuse downtown. First, a larger residential presence would fuel development of retail properties to serve the population. Chef-driven restaurants, where properties are purchased, rehabbed and then re-opened would be an example of this. Also, an increase in the local population would make transit oriented development increasingly feasible and alleviate some of the strain associated with office parking ratios that are lower than the current market standard.

MCH: What is the current state of our Metro Phoenix industrial market?

AL: Metro Phoenix typically absorbs 3.5MSF to 4MSF of space annually. As we move through Q2 Metro Phoenix's industrial market remains in flux. Larger, national/regional employers like Living Spaces, Winco Foods, Pepsi and others have selected Metro Phoenix to be their "West Coast solution" through the design-build process. These requirements tend to be larger and/or sophisticated "process" facilities that mandate signature construction. In fact, Metro Phoenix has almost 3MSF of industrial facilities currently under construction. In fact, almost two-thirds of "net" absorption is due to corporate design-build projects.

Conversely, the smaller (less than 50KSF) and larger (more than 200KSF) "existing building stock has yet to see a clear, sustained level of occupant demand." The mid-sized (75KSF to 200KSF) market does show significant activity with several leases and user sales pending. Leading vertical sectors include high-technology, food and beverage, e-commerce and regional retail fulfillment. With a metro industrial vacancy rate at +/-12 percent versus the national average at 8 percent, the Valley has significant product runway to accommodate most occupant requirements.

CV: The Phoenix industrial market is very strong. Demand has been booming, fueled by e-commerce (Amazon), as well as traditional retailers and third-part logistics firms attracted by the area's low costs, proximity to southern California ports and expanding local economy. Construction has picked up more quickly than we would have expected and led to an increase in warehouse vacancies last year despite robust demand. It is expected that demand will continue to accelerate, putting vacancies back on a downward path.

MCH: NAIOP conducted the industry's first in depth look at e-commerce and its effect on industrial. Where does Arizona stand in preparedness for this shift, in existing and future developments?

AL: Due to the lack of sales tax consistency nationally, Metro Phoenix was an early winner in attracting e-commerce operations. In fact, Arizona contains almost 10MSF of e-commerce space with operators like Amazon, Target, Home Depot and others. Moving forward, facilities will provide a multichannel service: internet, store replenishment, catalog, etc. Older industrial properties will be hard-pressed to compete with higher clear heights, larger electrical services, higher auto parking needs, super flat floors and other building/site enhancements mandated by e-commerce employers.

MCH: What role does our proximity to the Inland Empire increasingly play in industrial development?

AL: Metro Phoenix offers an excellent location option for energy-centric, higher head count employers who seek a 25 to 40 percent operational cost saving while enjoying a deep,

Anthony Lydon and Chuck Vogel

qualified workforce population at +/-4.5M. The +/-300MSF Inland Empire lies an hour from the ports of Long Beach and LA and is comprised of "West IE" and "East IE." IE West has significant geographic and economic development barriers to entry. The IE East lies further from ports while being susceptible to California's perceived over-regulated and cost environments. Accordingly, Metro Phoenix's west Valley provides same-day access within the federal truck driving rules and regulations.

BM: In the short- to intermediate-term, proximity to the Inland Empire will play a minimal role in the Greater Phoenix industrial market. The Inland Empire's status as a premier big-box industrial market is well-deserved, with approximately 70 percent of the market space in buildings of 100KSF and greater and 88 percent of its space built in the past 20 years. Current vacancy in the region is approximately 4 percent, which at first glance would suggest an opportunity to attract tenants that are unable to secure space in the Inland Empire, but developers have more than 15MSF of space under way to meet current and future demand. Tenant demand in Metro Phoenix is forecast to be fairly steady in 2014 and 2015, but tenant activity will likely stem from organic growth rather than spillover from the Inland Empire.

MCH: Is the Phoenix market ripe now for spec building? If so, where and what type of building?

MC: Yes, for responsible spec building. Tempe's sub-5 percent, class-A vacancy and overall 10 percent office vacancy combined with very healthy activity in the class-B+ office product make for a market ripe for spec class-A office. The construction of Hayden Ferry Lakeside phase III allows Tempe to remain squarely competitive (with other markets such as Denver, Austin and California in general).

KM: For the right submarket and project, banks will finance spec buildings in the 60 to 65 percent of cost range.

MCH: There's a lot of capital coming into the market right now. Where is this best invested? How is financing trending?

MC: Core assets in solid locations within primary and tertiary markets. The discipline to invest in core assets through upturns and downturns is almost always rewarded. As for financing, we are seeing institutions continue to be competing to invest/purchase/lend for the type of assets mentioned above. Lending for land is still challenging.

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10MSF

of e-commerce space with operators like Amazon, Target, Home Depot and others

SS: Since we are selling a decent amount of office product right now, I would say that the best investments are in stabilized office. The reality is that there are certain office markets (certain pockets of north Scottsdale, like Chauncey, Tempe and Chandler) where rents are beginning to really move in a positive direction. We have sold some assets at sub-6 percent caps, but if full-service rents move from $20 to $25 that is really a 40 percent increase in net rents. That cap rate becomes an 8.3 percent, which is a pretty nice return on investment when interest rates are 4 to 5 percent. One of our strategies that applies to the local market is a focus on acquiring and developing general industrial in tightening markets. This asset type can take advantage of the current historically low interest rate environment, upside potential in rents and being bought at below replacement cost.

CV: There is no shortage of available debt and equity capital. Senior secured lenders still remain modestly levered. Projects with 30 to 40 percent equity work because there is plenty of capital available. If the 10-year treasuries tick up, there will be pressure for the senior secured lenders to take a bigger part of the capital stack if cap rates remain low.

KM: Financing is getting very aggressive. CMBS is back and quoting interest only for up to half of the loan term at 75 percent loan to value. Banks are getting aggressive as well.

MCH: What new trends are coming to our industry?

SS: In the short-term, the "densification" of office space and focus on creative space will continue. I love these companies saying they want their office to be a "home away from home." If that's the case, why are they cramming eight people in 400 SF? I doubt most people are sharing their bedroom with seven other people! The corporate world has realized that density saves the company money, so they have offset that negative by making the space fun and cool so people aren't bothered by their lack of space. There are a lot of studies going on right now about productivity and morale related to office space. It's still early, so I'm not sure anyone has the true answers at this point. Obviously, the continued adoption of technology such as the internet, smartphones and 3-D printing will change the supply chain and use of industrial space, as will the shifting energy landscape and globalization. These items will have a profound impact on the office environment on a rapid and constant basis for many years to come.

AL: The newest industrial trends include 3-D printing, robotics and open source hardware. 3-D printing deposits thin layers of plastics or metals atop the other fabricating a component part and/or finished good. This will have a profound impact on how companies manage their supply chains. For instance, half of typical pharmacy stock can be 3-D printed on-site. The cost of robotic equipment has dropped from +/-$250,000 per machine to $25,000 per machine. Amazon hopes to increase its pick-pack-ship robotics from 1,300 to 10,000 by end of 2014. Finally, open source hardware found in mechanical systems and networking equipment is available to all without reverse engineering need. This will compress the prototyping cycle time and move machine tools to the production line sooner, quicker and faster.

CV: It is becoming easier for the small investor to invest in institutional quality real estate through non-traded and exchange traded REITs. More investment products are coming available for investors that may offer liquidity and yield in the product types they are looking for. I expect you will see these kinds of investment vehicles continuing to grow. There is also an increasing disparity between credit and non-credit cap rates as the investor appetite continues to grow for credit opportunities, which is keeping the credit cap rates low.