



OFFICE CONDO CAPITAL

As Phoenix creates jobs at a healthy clip, small businesses increasingly want to own their real estate.

By Steve Bergsman

A real healthy employment market typically fuels office development, but in the Phoenix area an entirely new phenomenon has occurred. While general office construction has been in the doldrums, strong job growth has led to a boom in office condo construction.

In a healthy economy, most new jobs are created in small firms striving to be big firms, and in the Phoenix market, office condos are increasingly becoming the first choice of space for these entrepreneurial outfits. In fact, a 2005 year-end report by Grubb & Ellis touts the city as the office condo capital of the nation with 73 office complexes recently completed in the Phoenix metro area and 20 more under construction.

Office condos have been “selling like hot cakes,” observes Robert Kammrath of Kammrath & Associates, a real estate analysis firm. In this property type, buyers own the space within the walls and share ownership of common areas. CB Richard Ellis estimates that from the late 1990s through 2005, 8 million sq. ft. of office condo space was constructed in Phoenix with at least 500,000 sq. ft. more space coming on line in 2006.

At the end of November 2005, the unemployment rate for Phoenix-Mesa-Scottsdale stood at just 4% compared with the national average of 5.1%, according to the federal Bureau of Labor Statistics.

The office condo concept has strongly taken hold in Phoenix due to a number of converging factors: a sprawling office market with a small CBD, rapid growth in job and business creation, relatively low interest rates and a passion for real estate investing.

Additionally, from 1995 to 2004, the greater Phoenix population has increased by 39% compared with the nationwide rate of just 12%.

Genesis of a boom

Another reason the office condo market has been so robust is that there has been a dearth of general office construction in the Phoenix metro area over the past five years. The trend line for office condo development remains strong in the near term, but after this year the future becomes cloudy. In select markets such as Scottsdale, prime locations are disappearing. Meanwhile, general office construction is finally picking up, especially in suburban locations such as Scottsdale and Tempe.

Considering office condos are relatively small in size — most no larger than 15,000 sq. ft. — 8 million sq. ft. of development is considerable. It's also a remarkable number considering that annual office construction in metro Phoenix totaled 2 million sq. ft. or less from 2001 to 2005, according to GVA Daum, a commercial brokerage in Phoenix. In fact, office construction activity dipped below 1 million sq. ft. in 2002. (Office condos aren't included in general office data compiled by the big brokerage firms.)

ENVIABLE ECONOMY:

With an unemployment rate of 4%, well below the national average, Phoenix is growing by leaps and bounds. Small businesses are the driving force behind the office condo building boom.

**“Probably 40% of the office condo buyers are users,
25% owner/investors and 35% pure investors.”**

—Colleen McPherson, CB Richard Ellis

Still, the lack of new construction for larger office buildings should not be taken as a sign of weakness in the Phoenix economy. In a 2006 real estate report, Grubb & Ellis placed Phoenix as a top 10 city for returns on investment in the office, industrial, retail and multifamily sectors. Grubb & Ellis notes that metro Phoenix is one of the tightest office markets nationally that will find little relief until building starts again.

For its part, CB Richard Ellis estimates the office vacancy rate for downtown Phoenix by mid-year 2006 will be less than 3% with an estimated new construction supply of zero.

Small business appeal

While there is some question at the national level of whether office condos have staying power, the property type does sport a few convincing selling points for small companies.

“The scenario I often paint when I’m talking to a doctor group or a small service company is that when they retire, it is often planned around the expiration date of the office they lease,” says Brad Logan, co-owner of Cavan Commercial, a Scottsdale company that provides services to office condo developers and owners, in addition to developing its own office condos. Logan notes that when the owners retire, because they own the building, they have the option of leasing it to a younger generation of themselves.

Logan began selling office condos in metro Phoenix in 1997 when he was a broker with CB Richard Ellis. He wasn’t very familiar with the real estate type, nonetheless he successfully brokered the sale of an office condo property in the Scottsdale, Ariz., anyway. It was around that time when the new craze for office condos in the greater Phoenix market began, Logan recalls.

His new company, Cavan Commercial, is currently involved in numerous ground-up developments and the conversion of a 49,000 sq. ft., three-story office building into office-condos. Most of the company’s projects have been in the western suburbs of Phoenix, in cities like Glendale, Peoria and Surprise. However, the hottest markets have been in the more established suburban cities of Mesa, Chandler and Gilbert, southeast of Phoenix, and in North Scottsdale.

Another busy company taking advantage of the demand for small office space in the southeast metro area is UTAZ Development Corp., based in Gilbert. It mostly builds office condos in its hometown and surrounding cities of Mesa and Chandler. Over the past eight years, it has completed 26 developments in that wide market and currently has another four under construction. “We have nine more to announce this year,” says Craig Willett, UTAZ’s president and CEO.

The company targets general medical, real estate sales, mortgage and title companies, insurance firms and financial planners. “Demand is there,” Willett says. “By the time we go vertical [during construction], we are typically 50% sold.”

The other hot local area for office condos is Scottsdale. Lee & Associates Arizona office has been busily working that submarket. Robert Kling, a principal with Lee & Associates, says his firm is currently brokering and managing four projects in North Scottsdale. Tracking developments in that particular submarket, Kling estimates 330,000 sq. ft. to 400,000 sq. ft. of office condo space has either closed or is under contract.

On the flip side

There is a downside to all the good news, however. If the North Scottsdale market absorbs 350,000 sq. ft. of space in 2006 and the same in 2007, that will probably be it for the market “because there is no more land to build,” says Kling.

There is also the problem of speculators. “Probably 40% of the office condo buyers are users, 25% owner/investors and 35% pure investors,” says Colleen McPherson, an office condo specialist with CBRE.

McPherson worked with a client who bought a 10-building, garden-office complex in North Scottsdale, which was converted into office condos. “Most of the owners are passive investors from states stretching from California to Nebraska,” she says. “We even got a buyer from Australia.”

Since there is not a lot of history in regard to office condos, there is still some question whether they appreciate in value. “The market is now about 7 years old and we are just starting to see them turn over,” McPherson says. In Scottsdale, an office condo shell used to sell for \$170 a sq. ft., says McPherson, and with \$50 per sq. ft. in improvements, the new owner ends up with a \$220 per sq. ft. investment. “We are selling those for \$320 per sq. ft. built out,” she says.

Where has big gone?

There are at least 30 office condo projects under construction, says Kamrath. By his count, that could mean 1 million sq. ft. of new office condo space coming on line, which could indicate that the market is overheating.

Phoenix, like nearly all real estate markets, is cyclical. In the last big building boom of 1997 through 2002, almost all the construction was with bigger buildings of 100,000 sq. ft. or more. "No one wanted the little guy," says Kamrath, "and some developers cleverly perceived that."

While the office condo market will continue to "rip along," at least until lenders stop lending money to the sector, Kamrath says, the cycle for larger office building construction appears to have started once again.

A solid economy and slow office construction has changed the face of the greater Phoenix office market. In 2005, Phoenix turned back into a landlord's market, says Mark Seale, a senior vice president with CBRE. The vacancy rate, which topped off at 18.8% in 2002, dropped to 12.6% at the end of 2005, he says.

That kind of progress could only mean that absorption has been strong. Indeed, Seale adds, the market was so healthy that 3.1 million sq. ft. was absorbed — very close to the record year of 1999 when space users gobbled up 3.6 million sq. ft.

Hayden Ferry Lakeside has been one of the few high-visibility office projects to open in the past few years. Built by Phoenix-based SunCor Development Co. on the banks of the Tempe town lake, the first mid-rise of a three-building office complex opened in July 2002. With eight stories and 209,000 sq. ft., today it is 97% leased, says Randy Levin, senior project manager with SunCor.

The second building, a 12-story, 300,000 sq. ft. structure, is now underway with an opening target date of February 2007. It is almost 70% pre-leased, Levin adds, and architects have begun the drawings for the third tower, a 10-story, 250,000 sq. ft. building.

"In hindsight, we should have started phase two sooner because I'm sitting here with phase one fully leased," Levin says. "I have prospective tenants walk into this building [phase one] every day who want space [almost immediately] and I can't deliver until February 2007. That's not a good position to be in."

Actually, SunCor is in an extremely favorable position. About a mile to the west of Hayden Ferry Lakeside, the company is also developing the Rio West Business Park that will consist of five office-flex buildings totaling 300,000 sq. ft. In between sits the headquarters for America West Airlines, which recently merged with USAir to become US Airways.

The Tempe-based company needed more space and took 148,000 sq. ft. at Rio West. The first three buildings in that park have been leased, says Levin, and they will soon be breaking ground on the last two structures.

Busy in the burbs

Tempe is widely considered to be a relatively small submarket, and is often lumped into the wider East Valley submarket, which includes the other high-density suburban cities of Mesa, Chandler and Gilbert.

As the fifth largest office submarket in the metro Phoenix area behind the Phoenix Central Corridor, East Phoenix, NW Phoenix and Scottsdale, Tempe has been one of the three very busiest submarkets in terms of new construction with 493,880 sq. ft. going up as of the fourth quarter of 2005, reports CBRE. Tempe pales when compared to the busiest submarket, Scottsdale, with 1.7 million sq. ft. under construction out of a total 2.9 million sq. ft. under development in the metro Phoenix area.

Since net absorption remains strong, CBRE reports the vacancy rate in the Scottsdale office sector stands at 10.4%, the best of the submarkets. Rental rates in the Scottsdale area for Class-A properties range from \$22 to \$36, says GVA Daum senior associate Laura Becker, adding that in 2005, the average asking rate for rents was higher in Scottsdale than any other submarket.

"The main thing that has been fueling Scottsdale over the last several years was the completion of the 101 Outer Loop [the northern section of beltway around the metro area], and the availability of real estate as the state periodically auctions off land," says James Watkins, a broker with Lee & Associates.

North Scottsdale has all the critical factors in place, says Watkins, including strong middle- and high-income housing. Outside of Scottsdale and a couple of select submarkets, the other main office corridors are starving for supply.

With Scottsdale and downtown Phoenix vacancy so low, space users are looking at other submarkets, says Becker, including the central corridor-uptown, which with a fourth-quarter 2005 vacancy rate of 19.4%, was the only cool spot in a "hot" town.

Steve Bergsman is a Phoenix-based writer.

PHOENIX - BY THE NUMBERS

POPULATION OF METRO AREA: 3.5 million

Source: City of Phoenix

UNEMPLOYMENT RATE: 4%

Source: Bureau of Labor Statistics

LARGEST EMPLOYERS:

- 1 Wal-Mart Stores: 17,500 employees
- 2 Honeywell: 16,000 employees
- 3 Motorola: 15,100 employees
- 4 Banner Health Systems: 14,000 employees

Source: The Business Journal

METRO AREA VACANCY RATES

Office:

12.6% vacancy, 4Q 2005
16.4% vacancy, 4Q 2004
\$20.17 rent per sq. ft., 4Q 2005
\$19.28 rent per sq. ft., 4Q 2004
Source: CB Richard Ellis

Industrial:

8.5% vacancy, 4Q 2005
10.7% vacancy, 4Q 2004
\$0.55 monthly per sq. ft., 4Q 2005
\$0.50 monthly per sq. ft., 4Q 2004
Sources: GVA Daum

Multifamily:

7% vacancy, 4Q 2005
8.5% vacancy, 4Q 2004
\$648 avg. effective rent, 4Q 2005
\$629 avg. effective rent, 4Q 2004
Source: Reis

Hotel:

67% occupancy, 4Q 2005
63.7% occupancy, 4Q 2004
\$102.69 average daily rate, 2005
\$95.93 average daily rate, 2004
Source: Smith Travel Research

Retail:

7.1% vacancy, 4Q 2005
7.5% vacancy, 4Q 2004
\$16.93 asking rent, 2005
\$16.32 asking rent, 2004
Source: Reis

MAJOR PROJECTS:

Scottsdale Waterfront

Mixed-use development at the edge of Scottsdale's urban core. The project features retail, office, restaurant, and two, 13-story condominium towers.

Cost: \$250 million

Developer: Starwood Capital Group, International Development Management and Golub & Co.

Completion: end of 2006

The Pinnacle in Kierland IV

The six-story, 210,000 sq. ft. office building will be the tallest structure in the Kierland master-planned development located in the North Scottsdale area.

Cost: \$45 million

Developer: Furst Properties

Completion: March 2007

Power Ranch Professional Village

One of the largest office condo projects in the bustling Southeast Valley with 95,000 sq. ft. under development.

Cost: \$16 million

Developer: UTAZ Development

Completion: Spring 2007