RetailResearch

MARKET OVERVIEW

Marcus & Millichap

Phoenix Metro Area *Second Quarter 2012*

Resurgent Economy Bodes Well for Retail Performance

As the economic recovery gains steam, the Phoenix retail market will continue to strengthen this year. Over the past 12 months, the metro has been one of the top-performing job markets in the country. Additionally, after years of setbacks, the housing market recorded six consecutive months of price increases through March. As these trends unfold, retailers that shuttered during the housing crisis will be encouraged to expand in densely populated areas of the metro. Most of the submarkets will post positive absorption this year as new supply remains limited and national tenants, including Sprouts, Hobby Lobby, and Dollar General, capitalize on the available space and low rents. However, store closures by Borders, Circuit City and, more recently, Best Buy has left more than 8.5 million square feet of empty big-box space on the market. Operators sitting on large blocks of space in established areas will have to offer lucrative concessions to backfill the space, while properties in less-desirable neighborhoods will struggle to attract tenants. In the East Valley, a few owners will reconfigure layouts and offer smaller footprints to broaden their potential tenant roster, while others may redevelop the property into another commercial use.

As CMBS loans mature, more distressed properties will hit the market this year, attracting private investors seeking steep discounts. A bulk of the multi-tenant deals that traded in the last year involved bank-owned strip centers, a trend that will continue for the remainder of 2012 as banks foreclose on overleveraged owners. In hard-hit areas of Mesa, Chandler, and Gilbert, where population growth did not meet prior expectations, buyers will be able to purchase highly vacant strip centers for below $60 per square foot. Well-capitalized local and California investors who waited on the sidelines will pay cash for troubled assets. The owner will renovate the property and adapt the use toward the changing demographics in the area. The new configuration, along with favorable leasing terms, will help the operator backfill the space over several quarters. After holding the asset for three to five years, the owner may list the stabilized strip center at a cap rate around 9 percent, depending on interest rates.

2012 Annual Retail Forecast

2.0% increase in total employment

Employment: By year end, total employment will expand by 2 percent as companies generate 35,000 new jobs. The increase represents a modest uptick from last year, when employers hired 28,600 workers.

600,000 square feet will be completed

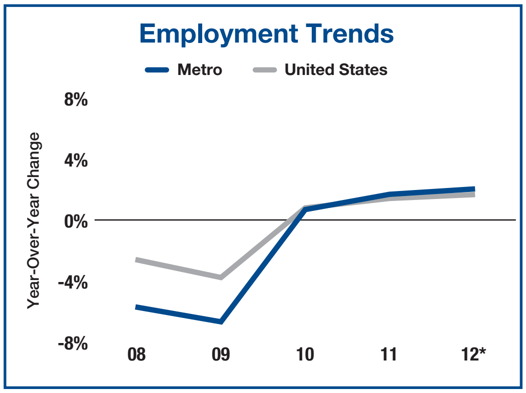
Construction: In 2012, projects totaling 600,000 square feet of retail space will be completed in Phoenix, expanding supply levels by 0.4 percent. In the previous year, construction output fell to the lowest level on record as builders delivered a mere 391,000 square feet.

70 basis point decrease in vacancy

Vacancy: As the economic recovery gains traction this year, retailers will continue to expand in the metro. Vacancy will finish 2012 at 11.2 percent, marking a 70-basis point improvement from a year earlier as tenants occupy 1.5 million square feet. In 2011, vacancy fell 30 basis points.

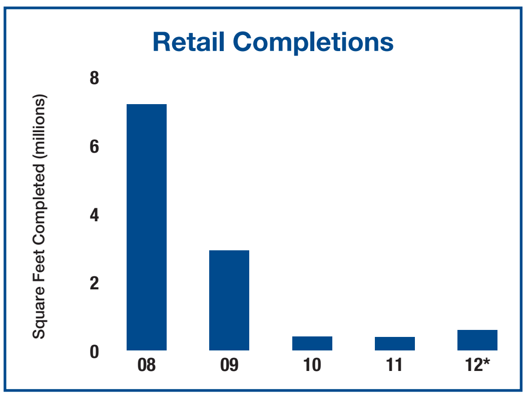
0.5% increase in asking rents

Rents: Asking rents will show a 0.5 percent increase this year to $18.18 per square foot, while effective rents will rise 0.6 percent to $15.26 per square foot. In 2011, owners trimmed asking rents 0.6 percent as effective rents retreated 0.5 percent.



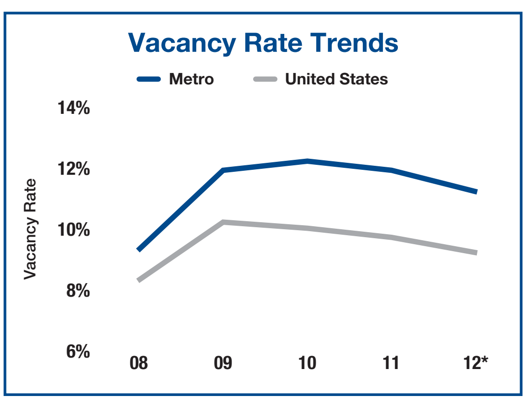
Economy

- Year over year, Phoenix ranked fourth in the nation in terms of absolute job growth after gaining 45,100 new positions, which included 23,300 jobs in the first quarter of 2012. In the previous year, 17,800 employees were hired.
- A modest construction boom is taking place in Phoenix after four straight years of job losses in the industry. The surge in activity can be attributed to multiple factors such as the development of the $5 billion Intel plant, thousands of apartment units currently under way, and investors revamping foreclosed single-family homes. As a result, the construction sector has gained 4,500 jobs in the last year.
- As every employment sector added jobs in the past year, the unemployment rate tightened 110 basis points to the mid-8 percent range. As a result, the median household income grew 2.3 percent in that time to $52,200 per year, which supported a 4.6 percent increase in retail sales.
- **Outlook:** By year end, total employment will expand by 2 percent as companies generate 35,000 new jobs.



Construction

- Year over year, developers completed 444,000 square feet of retail space, which consisted mostly of single-tenant formats. The new supply expanded the metro's inventory by 0.3 percent. In the prior year, 306,000 square feet came online.
- After multiple years of delays, builders are currently working on more than 900,000 square feet of retail space, which will come online over the next few years. Similarly, the economic downturn put the brakes on planned projects as the pipeline is now overflowing with 12.3 million square feet.
- Construction recently started on the Phoenix Premium Outlets, a 360,000-square foot outlet mall slated for the Gila River Indian Community by 2013. The project will contain 90 stores, and be anchored by Saks Fifth Avenue Off 5th. Further, the 330,000-square foot Tanger Factory Outlet Center is also under way, and is expected to come online in Glendale in the fourth quarter of this year.
- **Outlook:** In 2012, projects totaling 600,000 square feet of retail space will be completed in Phoenix, expanding supply levels by 0.4 percent.



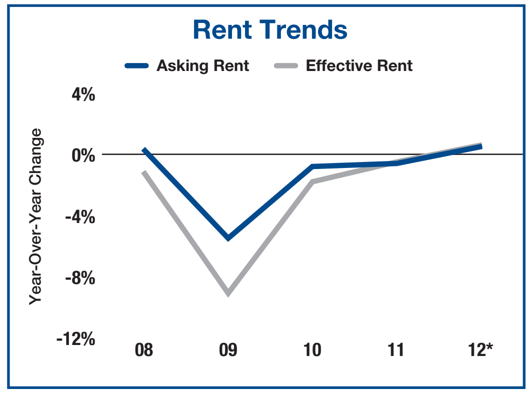
* Forecast

Vacancy

- Operations improved in most submarkets during the past year as favorable lease terms and a positive economic outlook encouraged retailers to expand in Phoenix. As such, vacancy dipped 80 basis points to 11.7 percent, including a decrease of 20 basis points in the first quarter.
- After increasing for three consecutive years, vacancy at community centers leveled off in the last four quarters at 10.4 percent. Operations at neighborhood centers, meanwhile, showed signs of improvement in the last year as vacancy contracted 50 basis points to 12.6 percent.
- In the last 12 months, limited new supply and positive net absorption of 172,000 square feet reduced vacancy at power centers 80 basis points to 7.6 percent.
- **Outlook:** As the economic recovery gains traction this year, retailers will continue to expand in the metro. Vacancy will finish 2012 at 11.2 percent, marking a 70-basis point improvement from a year earlier.

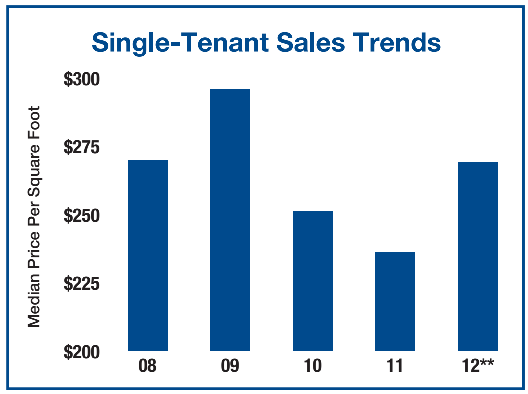
Rents

- In the first quarter of 2012, landlords raised asking rents 0.2 percent to $18.13 per square foot, however, the growth was not enough to offset the 0.3 percent decrease in the last year.
- Effective rents also grew 0.2 percent in the first three months to $15.20 per square foot, which is the first quarterly increase since 2008. Nonetheless, effective rents slipped 0.1 percent in the last year after a 1 percent drop in the prior 12 months.
- In order to sustain tenant demand, operators kept concessions at peak levels, finishing the first quarter at 16.2 percent of asking rents. Meanwhile, as occupancy posted solid gains, revenues edged up 0.8 percent in the last year.
- **Outlook:** Asking rents will show a 0.5 percent increase this year to $18.18 per square foot, while effective rents will rise 0.6 percent to $15.26 per square foot.



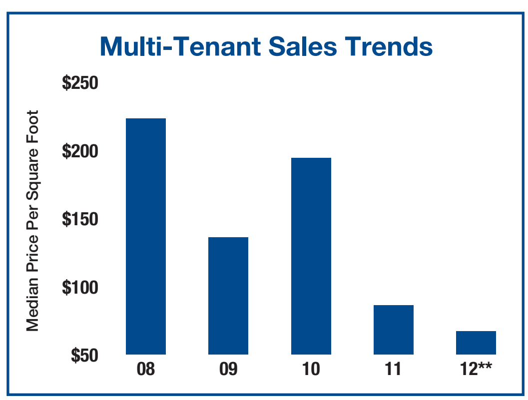
Single-Tenant Sales Trends**

- Single-tenant sales accelerated by 20 percent in the past 12 months as owners capitalized on cap rate compression and listed high-quality assets. Velocity for drugstores and fast-food restaurants net leased to a creditworthy tenant surged by 50 percent in the last year.
- As demand intensified for quality single-tenant properties, the median price jumped 12 percent over the past year to $269 per square foot. Assets occupied by an investment-grade tenant commanded more than $360 per square foot.
- Cap rates for all single-tenant assets averaged just below 8 percent in the past 12 months, while fast-food restaurants secured by a franchisee traded around 7.5 percent. Drugstores occupied by Walgreens or CVS with full-term leases traded at first-year returns in the mid-6 percent range, while older drugstores with shorter-term leases in place fetched up to 100 basis points higher.
- **Outlook:** The improving economy and higher yields will continue to draw coastal capital to the metro. With cap rates for single-tenant assets net leased to a nationally recognized chain averaging around 7 percent, investors will capture a 50- to 100-basis point premium compared with primary markets.



Multi-Tenant Sales Trends**

- As banks looked to shore up balance sheets, a number of reclaimed multi-tenant properties flooded the market. Value-add buyers emerged to capitalize on the discounts, which supported a twofold increase in sales velocity during the past year.
- With a bulk of the transactions taking place in the past year involving distressed assets, the median price decreased by 22 percent to $67 per square foot, which is 60 percent below pre-recession levels.
- Multi-tenant initial yields significantly tightened in the last year to the high-8 percent range, while strip centers in outlying areas changed hands at returns in the double-digit territory. Grocery-anchored shopping centers in established areas sold for first-year returns in the high-7 percent range.
- **Outlook:** Institutions and REITs will target discounted Class A shopping centers in prime retail corridors. Most of these buyers are seeking centers anchored by a highly rated tenant and trading at cap rates hovering near 8 percent.



* Forecast
** Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics

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Capital Markets

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

- The yield on the 10-year Treasury hovers below 2 percent as political uncertainty in the eurozone has investors flocking to the safety of U.S. bonds. In response, lenders have pushed out loan spreads by approximately 250 basis points to 300 basis points, with CMBS lenders pushing wider.

- Mortgage originations were up 46 percent in the second half of 2011 when compared with the same period the previous year, driven by higher activity among commercial banks and life insurance companies.

- Funding for single-tenant assets with credit tenants will remain plentiful this year. All-in lending rates for drugstore assets currently fall in the high-4 to mid-5 percent range, while loans for fast-food and restaurant properties price 50 to 100 basis points higher. In the multi-tenant sector, lenders are loosening criteria on anchored Class B centers and Class A strip centers.

- Deals under $10 million will be dominated by local and regional banks, which offer three- to seven-year, fixed-rate recourse loans. In the $10 million to $20 million range, CMBS lenders and finance companies step into the picture, while deals over $20 million typically have access to a full spectrum of sources. On average, debt yields will hover in the 9.5 to 10.5 percent range, translating into LTVs of 65 percent to as high as 75 percent.

Submarket Overview

- The 800,000-square foot Prasada, which is slated for Surprise, is in the design phase as developers wait for the economy and retail market to fully recover before starting construction. The $1.6 billion regional mall has been delayed multiple times due to the financial crisis, but a start date has been set for 2014.

- The Mesa/Chandler/Gilbert submarket remains the most sought-after area for investors chasing distressed assets with a value-add component. Closings accelerated by 40 percent over the past year, with a bulk of the deals involving high-vacancy REO strip centers, which traded well below replacement costs.

- Hobby Lobby continued to expand late last year, opening two new stores. The company leased 55,000 square feet at the Pavilions at Talking Stick in the North Scottsdale/Paradise Valley submarket in the last year. The retailer also moved into 55,000 square feet at the Chandler Gateway power center around the same time.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Central/NE Phoenix/S. Scottsdale	8.4%	-30	$16.80	0.7%
2	Tempe/South Phoenix	9.3%	-120	$15.75	-0.9%
3	West Phoenix/Southwest Valley	11.8%	70	$11.47	0.5%
4	N. Scottsdale/Paradise Valley	12.1%	-80	$19.47	-0.3%
5	Northwest Phoenix/Glendale	12.5%	-80	$13.67	-0.9%
6	Mesa/Chandler/Gilbert	12.9%	-140	$14.15	0.5%