



Phoenix's Resilience to Foreclosures and Immigration Battles

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By Erika Schnitzer, Managing Editor



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The Phoenix commercial real estate market appears to be on the rebound, at least according to the fourth quarter 2010 Arizona State University-Repeat Sales Index. While home prices continue to decline, commercial prices appear to have remained stable throughout 2010. Though commercial prices declined at an annual rate of nearly 40 percent during 2009, prices rebounded to almost a 13 percent annual rate in 2010 (compared to an annual rate of 28 percent in 2006).

Population flows, however, have slowed dramatically, says Elliott Pollack, CEO of Scottsdale, Ariz.-based Elliott D. Pollack and Co., an economic and real estate consulting firm. Whether this can be attributed to Arizona's stringent immigration law, SB1070, remains to be seen.

At the same time, the industry seems unsure about the effect that the law has had, and will continue to have, on multi-housing. Bill Hahn, senior vice president of multifamily properties in Colliers International's Phoenix office, believes that it has driven people out of the state.

"It's hard to measure how many people have left, because they weren't counted in the first place," he notes, "but by extrapolating school enrollment figures, it looks like about 100,000 to 200,000 have left Arizona."

But Pollack doesn't think the law really had that much of an impact. "It would have been a big deal had the economy not cratered," he says. "But it cratered, not because of the immigration law, but because of the overall economic situation the country went through from mid-2007 on."

The population outflows that Phoenix experienced in 2009 and 2010—which, Pollack notes, were the first in the area's history—were due to the bad national economy; the inability of people to sell

their homes, particularly in Michigan and California, before retiring to Phoenix; and the lack of jobs, he says.

“The immigration law is a big deal only for one reason,” says Pollack. “Many construction and service workers are Hispanic. The reason they left might have been the immigration law, but overwhelmingly it was because they couldn’t get jobs.”

In fact, the Phoenix-Mesa-Glendale unemployment rate has dropped 190 bps from its peak of 10 percent in Jan. 2010. The latest numbers from the U.S. Bureau of Labor Statistics indicate that unemployment was 8.1 percent as of April 2011, a 60-bp decline from the month prior.

“In Greater Phoenix,” Pollack points out, “we went from 63,000 units being permitted in 2005 to 6,800 units being permitted in 2010, and virtually no commercial construction. That, combined with the inability of people to move here, combined with the national recession, really affected us.”

The latest preliminary numbers for April 2011 indicate that construction jobs are still off year-over-year; the 12-month change registered -2.8 percent.

Fortunately, some jobs are—slowly—beginning to return to the market. Manufacturing, trade, transportation and utilities, professional and business services, education and health services, and leisure and hospitality all registered small gains over the past year.

Unfortunately, construction, financial activities and government continued to show declines in employment over that period, according to a recent “Monday Morning Quarterback,” a weekly economic report put out by Pollack’s firm.

While the state gained about 84,000 jobs in the last 12 months, it lost 65,000 jobs in the 12 months prior and 140,000 jobs in the 12 months before that, Pollack reports. “You can see things are getting better because we’re not losing jobs,” he says, though he calls the job growth “anemic.”

But, he adds, he expects the recently passed jobs bill, which includes a 2 percent drop in the corporate income tax rate—commercial property taxes will decrease beginning in 2013, according to the *Arizona Capitol Times*—and incentives for new business, to have a dramatic impact over the long term. Some companies have already announced expansions in Phoenix; for example, Amazon.com recently announced an expansion of a fulfillment center in Phoenix, which is expected to create hundreds of new jobs, including management positions.

Despite this, though, the market is all about construction jobs. “You can’t have a boom in this economy without construction, and construction is still several years off,” says Pollack. The good news for multifamily, however, notes Pollack, is that “there will probably be demand for apartments next year and the year after,” he says, “because vacancy rates are coming down quickly, and I expect demand to pick up.”

Apartment fundamentals

While the shadow market’s impact on apartments has not been measured, it remains fairly significant, particularly from vacant single-family homes. “A lot of the single-family home business here was speculative in nature,” recalls Hahn. “Now, all of a sudden, all these houses are going through foreclosure. They are being bought by a new wave of investors, at half the price they were selling for before, so they’re being thrown back on the rental market at much lower rents than in 2006-2007. We have about 100,000 vacant single-family homes in the marketplace, and that’s impacted multifamily.”

Zillow's Home Value Index in metro Phoenix stood at \$103,400, as of May 1, a year-over-year decline of 13.6 percent. (The estimate has declined every month since February 2006, when the home value estimate was \$281,400.) The rate of decline, however, appears to be slowing, points out Pollack.

While such a high number of foreclosures (one in every 180 housing units in Phoenix received a foreclosure filing in April 2011, according to RealtyTrac, and Phoenix ranked No. 4 in the company's 2010 Year-End Metropolitan Foreclosure Market Report, with a 7.27 percent foreclosure rate) comes with the expectation that people will flood the apartment market, Pollack notes that only a relatively small percentage of these people have, in actuality, moved to multifamily housing.

"The average household size for an apartment dweller is 2.2 people, and the average household size for a single-family rental is 3.7 people," he points out. "That means mom and dad and two kids and a dog are not going to an apartment; they are going to [rent] a single-family home, probably in the same school district or neighborhood where they lost their house."

Still, apartment vacancies are trending downward, according to Colliers International's first quarter Phoenix Research & Forecast Report, which indicates that vacancy stood at 9.3 percent as of the end of the first quarter, compared to 10.4 percent at the end of 2010 and 12.1 percent one year prior. And, the report notes, the first quarter of 2011 marked the ninth consecutive quarter of positive net absorption. Hahn expects no more than 1,000 units to be delivered into the market this year—a significant drop off from years past.

"The A Class assets are outperforming the Bs and the Cs," observes Mark Schilling, CPM, senior vice president and director of operations, MEB Management Services, a third-party manager that oversees approximately 12,000 units in the Phoenix metro area.

"In addition to that, you have East Valley submarkets that are much stronger than the West Valley. [Occupancy rates in] suburbs like Gilbert, Scottsdale and Fountain Hills are much stronger than when you go west and get into Glendale, Avondale or Surprise," he says.

"Newer buildings were primarily built on the East Side," Schilling adds, "so you have some of the A - and B-Class assets more heavily defining the East Side. In addition, some of the real surge in home-building took place on the West Side, so you had an overbuilding of single-family homes—and now, consequently, you have an overabundance of single-family home foreclosures."

Concessions, meanwhile, are starting to burn off; they continue to run, on average, between 4 percent and 5 percent across most asset classes and submarkets, Schilling observes. "But in the A-quality assets you don't see concessions at all, and when you get into the East Valley, there's no or very little concession being offered. When you get into B- and C-quality assets, and particularly when you get into the West Valley, you can give as much as 8 percent concession."

At the same time, Schilling reports that the market has seen seven consecutive months of increased net effective rents.

Investor interest, meanwhile, seems to have returned to the market, mostly from private capital buyers, notes Hahn, who reports that prices have fallen off between 40 percent and 70 percent. And when a property is listed, he notes, there are anywhere from 10 to 25 cash offers.

"There is strong interest because people perceive that this market over-corrected price-wise and it's time to bounce back," he says, pointing out that many of those interested in Phoenix are new to the

market, having started looking here about two years ago. "It's different than who was buying here from 2002 to 2007," he recalls.

"We're seeing a lot of our clients that have renewed interested in investing," says Schilling, "but we are also seeing clients from California and the East Coast, and we're seeing Canadian investors coming into the Phoenix market."

According to Colliers' report, average prices are \$48,400 per unit, with cap rates in the mid-6 percent range. Of course, this varies by asset quality and location, notes Hahn, who says that a highly distressed building in a distressed part of town is selling for under \$20,000 per unit, with B buildings trading between \$30,000 and \$40,000 per unit. Class A buildings—of which very few have traded—are priced between \$70,000 and \$110,000 per unit.

Unanswered questions

The greatest bright spots for Phoenix continue to be the weather and its laid-back lifestyle, but the future holds many questions for the market.

As far as a setback, Pollack believes the national economy would have to double dip for Arizona to double dip. However, Hahn notes that there has been some discussion of a potential double dip in single-family home prices, as a number of foreclosures have not yet been completed. While he doesn't predict anything like that for multifamily, it remains to be seen whether these homes are purchased by investors or end users.

There haven't been many large-scale job growth situations in Phoenix, notes Hahn, with the exception of Tempe-based First Solar, which recently announced it will be building a \$300 million factory in Mesa that could ultimately create up to 4,800 jobs. The first phase, however, is only expected to create between 400 and 500 jobs, which, Hahn points out, is certainly not a game-changer.

What will impact the unemployment rate is a return to construction, says Schilling. "Single-family home-building is probably going to be very, very slow for the next couple of years, so I don't think the Phoenix economic engine will be at full strength until a lot of the single-family homes are absorbed," he notes. "Then the home-builders can get back in there and begin building new homes, and that will create a lot of jobs. It's going to be very slow and steady," he predicts.

The resolution of the immigration law also remains a big question, and Pollack believes there could be a problem if it "is not resolved by 2014 or so when construction begins again in earnest—because that was a big part of the construction labor force."

If the Supreme Court keeps the law on the books, Pollack hopes, and expects, that other states will adopt similar laws so that Arizona doesn't "stick out like a sore thumb," adding that if the law is not thrown out, "maybe then the administration will deal with the immigration problem." But, he adds, "I expect it to be dealt with [either way] by the time it will be a factor."

However, he points out that Arizona has a history of surviving scandal during tough times and believes this will be no exception. During the recession of the early 1990s, he notes, Arizona survived the impeachment of Governor Evan Mecham, whose decision to rescind the observation of Martin Luther King Jr. Day directly impacted the NFL's vote not to award Super Bowl XXVII to Arizona, and, of course, the Keating Five fiasco (of which two Senators were from Arizona and considered Charles Keating Jr. their constituent).

Despite all this, even during a time when the economy was in shambles, Pollack notes, “the long-term effect was zero—and I do believe that will be the effect of the immigration [law] in the long-run.”

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