A MARKET ANALYSIS OF THE TUCSON OFFICE REAL ESTATE MARKET

FOR

THE PIMA COUNTY REAL ESTATE RESEARCH COUNCIL

COMPLETED BY

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Presented here is the office market study requested by The Pima County Real Estate Research Council. The goal of this study is to understand and evaluate the environment and opportunity for the office market in the Tucson market. This study reviews the historical, current, and projected market conditions to understand the office market and looks at both supply and demand factors.

The last few years have seen changes and uncertainty in much of the office market. The onset of Covid-19 led to a rapid increase in the number of office employees working from home. While many people have gone back to the office over the last couple of years, many remain working from home or are on a hybrid schedule. This has changed demand for office properties. Many office users have found they do not need office space or need significantly less office space. The office vacancy rate remains high for many properties. While there remains demand and limited supply for small office spaces, due to these recent changes in employment and office trends, there is much less demand for larger spaces of 10,000 square feet or more. There is significant uncertainty in the market about how many employees will return to the office.

Many market participants use phrases such as “uncertain” or “treading water” about the office market. Market conditions also vary widely based upon what type of office product is being discussed. Demand and outlook for medical office or a small office building is very different than a 100,000 square foot multi-tenant office building on the east side. Tucson has many vacant spaces or larger vacant buildings, and there remains uncertainty in the market about what will increase demand enough to bring down vacancy rates, or how what to do with the large vacant or low-occupancy multi-tenant buildings. Vacancy rates are considered higher than the statistics indicate, and will likely to continue to increase in the next few years as tenants who have been paying rent but not occupying or fully occupying the space reach the end of their lease terms and give up the space. But while the office market remains slow, it is not all doom and gloom. There remains considerable demand for small spaces, with a lack of supply. The medical office market remains strong, with limited supply. There are uncertainties and some difficult times ahead, but market participants feel that the market will eventually slowly improve.

Baker, Peterson, Baker & Associates would like to thank the following market participants who agreed to be interviewed or provided other support for this study:

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<u>Office Supply</u>

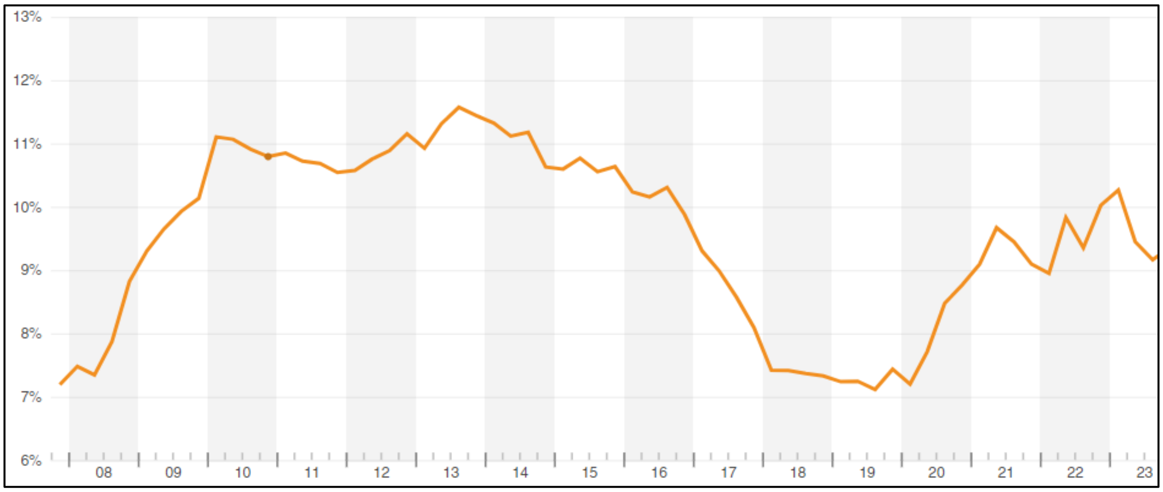
Existing Inventory

The first step in analyzing the office real estate market is to consider the existing inventory. The following chart provides the inventory and net absorption from 2014 through the first three quarters of 2023 for all office buildings, according to CoStar. This data indicates that at the end of third quarter of 2023, there were 2,634 office buildings containing 28,966,290 square feet of office space. The number of buildings has slowly grown over the last few years. Overall, the office market saw net positive absorption from 2014 through 2019. With changes to office demand due to Covid-19 in 2020, there was net negative absorption. After slight positive absorption in 2021, there was net negative absorption again in 2022. So far in 2023, there is net positive absorption.

Year	No. of Buildings	Total Sq. Ft.	Net Absorption
2014	2,593	27,700,767	737,779
2015	2,595	27,731,624	25,693
2016	2,602	27,861,476	327,181
2017	2,605	27,906,730	539,354
2018	2,607	27,849,284	160,673
2019	2,617	28,404,339	484,096
2020	2,623	28,533,368	(263,751)
2021	2,625	28,695,853	57,088
2022	2,627	28,905,949	(78,358)
2023	2,634	28,966,290	283,528

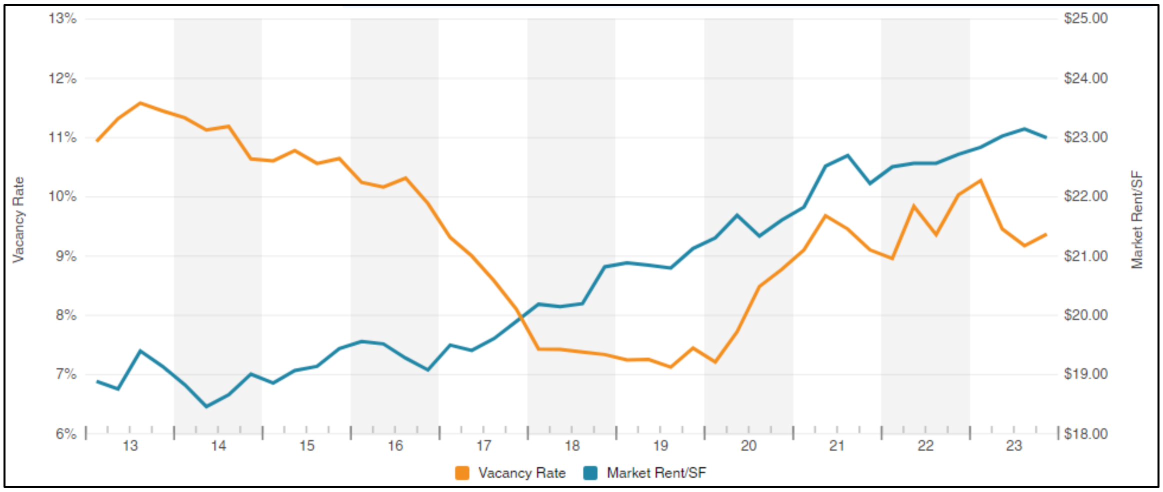
Tucson Office Statistics

The following is the vacancy rate for all office properties in the Tucson market, per CoStar. The vacancy rate peaked in mid-2013 and then gradually declined through 2017. Starting in second quarter 2020, the vacancy rate then increased through mid-2021. After slight variations, the vacancy rate has declined slightly in the second and third quarters of 2023 and was 9.2% in third quarter of 2023. It is noted that market participants believe the actual vacancy rate is higher than indicated here, which is discussed further later in this report.

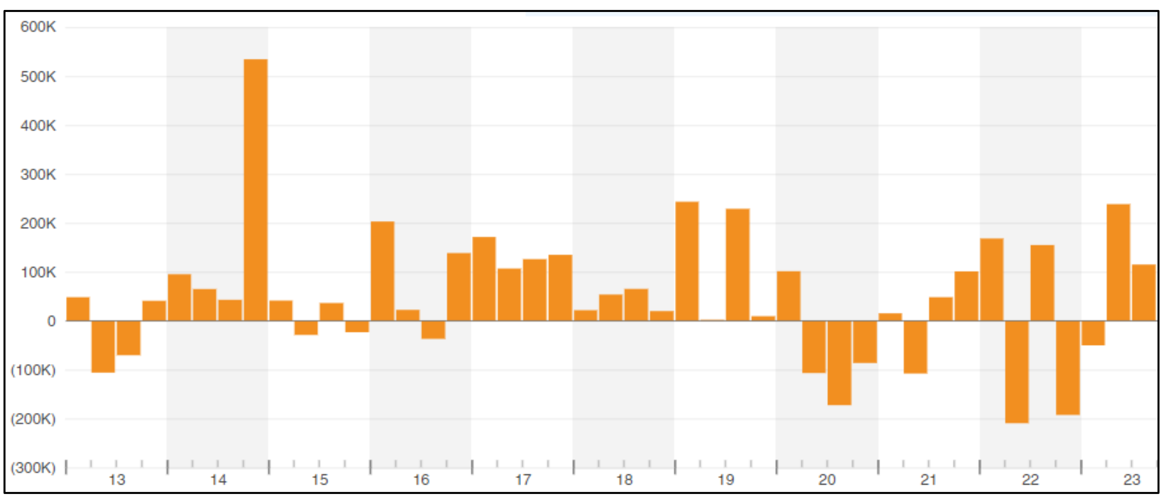


The following is the average asking rental rate for office properties in the Tucson market, per CoStar. This indicates that after remaining mostly level, the average asking rental rate has increased since 2020. The average asking rental rate was $22.78 per square foot in the third quarter 2023. It is noted that while CoStar indicates asking rental rates are generally increasing, rental rates vary significantly by product type. Rental rates are reportedly not increasing for many office products such as older offices in areas with significant available space, although they can be increasing for higher end space, smaller spaces with limited inventory, and medical office space.

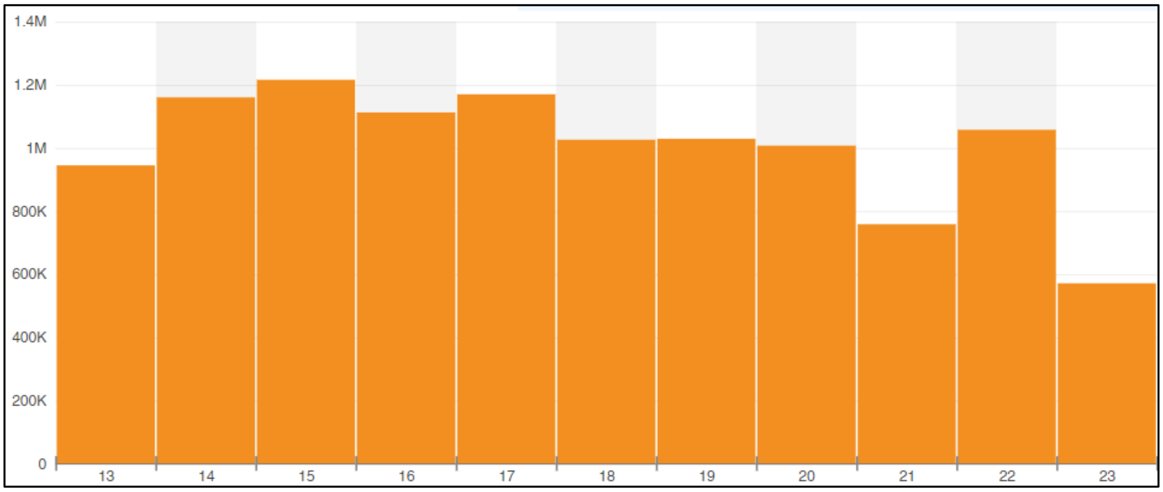
The following is the vacancy and market rental rates for all office properties, per CoStar. This indicates that as vacancy rates gradually declined, the market rental rate gradually increased, with this being the expected relationship between rents and vacancy rates. However, in the last couple of years, both the vacancy rate and market rental rates have both generally increased.



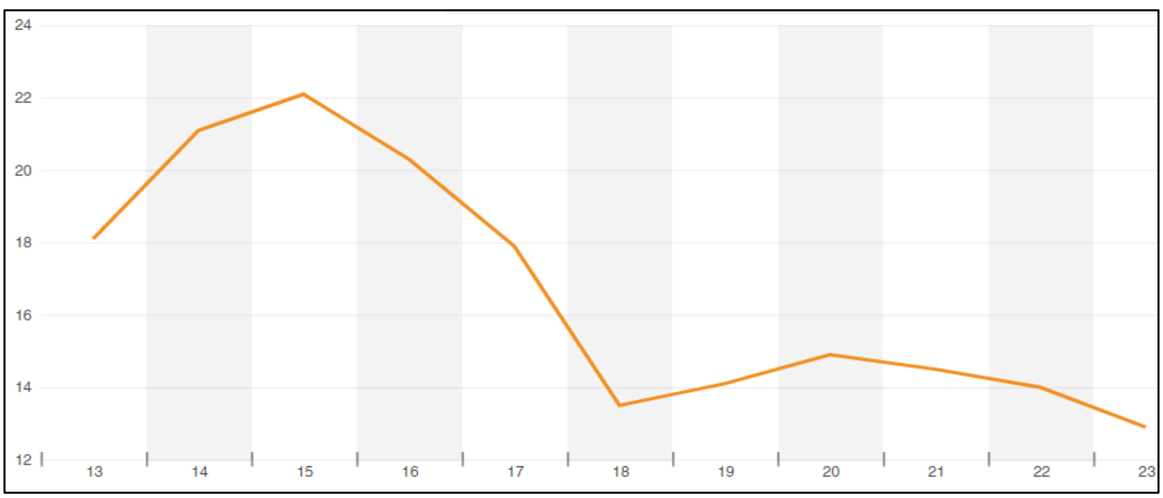
The following is the quarterly net absorption for office properties in the Tucson market, per CoStar. From the start of 2016, there was mostly net positive absorption through 2019. There was net negative absorption in the last three quarters of 2020 as unemployment increased and more people worked from home. There was a mix of net positive and net negative absorption in 2021 and 2022. Most recently, there was net positive absorption in the second and third quarters of 2023, with net positive absorption so far for the year. This is likely due limited new construction adding to vacancy while more square footage is absorbed in 2023.



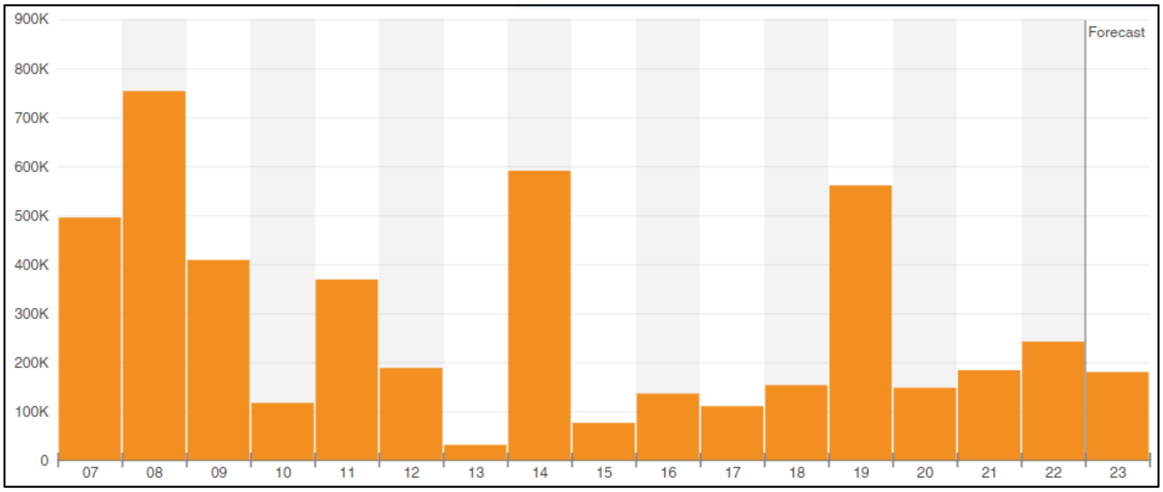
The following is leasing activity for office properties in the Tucson market, per CoStar. The leasing activity had been generally stable but declined in 2021 but increased in 2022. However, there was a decrease in leasing activity again in 2023.



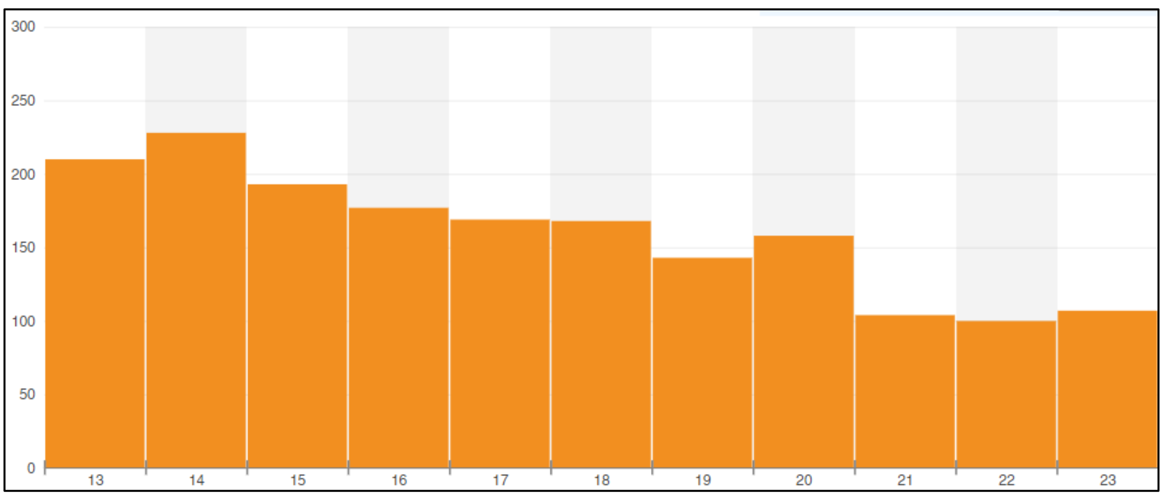
The following is the median months on market for office properties in the Tucson market, per CoStar. The median months on market declined from 2015 through 2018 as overall market conditions improved. After increasing slightly, the median months on market declined slightly since 2020.



The following is new office construction deliveries in the Tucson market, per CoStar. The following indicates that after 2008, there was limited new construction with the exception of 2014 and 2019. These years were impacted by the construction of large buildings. While new office construction remained low, it had increased slightly in 2021 and 2022. The 2023 deliveries are forecast for the entire year.



The following is the number of office listings for sale in the Tucson market, per CoStar. This indicates that the number of properties listed remained mostly level from 2016 through 2018. The number of properties listed declined slightly in 2021 and remained mostly stable from 2022 and 2023. The number of listings remains limited as inventory is low.



The following is the office direct, sublease, and total vacancy rates in the Tucson market.

Year	Vacant Direct	Vacant Sublease	Vacant Total	Available Total
2015	10.6%	0.1%	10.7%	10.2%
2016	9.8%	0.1%	9.9%	12.3%
2017	8.0%	0.1%	8.1%	10.2%
2018	7.2%	0.2%	7.3%	10.3%
2019	7.3%	0.1%	7.4%	10.1%
2020	8.5%	0.2%	8.8%	10.9%
2021	8.2%	0.9%	9.1%	10.3%
2022	9.0%	1.0%	10.0%	11.2%
2023	8.2%	1.1%	9.2%	10.4%

The above chart shows that both the direct and total vacancy rates gradually declined through 2019 before starting to increase in 2020. The amount of office space available for sublease was relatively limited and stable through 2020. However, it increased from around 0.1-0.2% to around 1% starting in 2021 as more space became available for sublease. This is due to an increase in the amount of leased but functionally vacant space. This is space that is currently leased, but the tenant is not occupying the property and therefore attempts to sublease their space until their lease ends. This increases the amount of space available in the market for sublease.

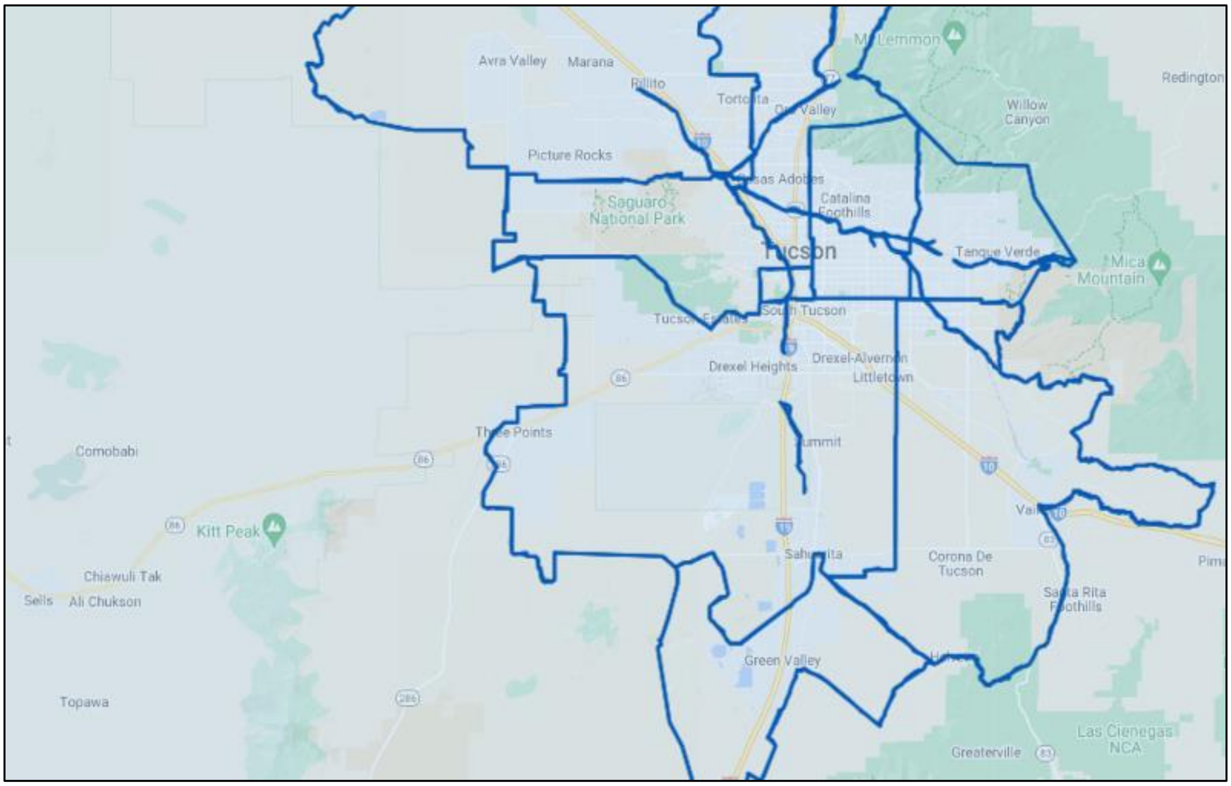
CoStar indicates that the overall office vacancy rate is 9.2%. It is noted that CoStar's 9.2% office vacancy rate is for all office properties in the Tucson market, which includes general office properties as well as medical offices, and owner-user properties as well as investment properties. The vacancy rate can vary based upon specific property types, with smaller properties and medical offices having a lower vacancy rate than larger multi-tenant properties. For example, CBRE's office market report indicates that the office vacancy rate was 14.5% in the second quarter of 2023. However, this vacancy rate looks at only investment buildings that contain 10,000 square feet or more of building area.

The vacancy rate of all office properties 10,000 square feet and larger is significantly higher than the overall vacancy rate of 9.2%, and is currently at 11% according to CoStar. This is because currently there is strongest demand for smaller office properties, with strongest demand for those office properties under 10,000 square feet, particularly for 2,000 to 5,000 square foot spaces. There is a limited availability of these small offices for sale and for lease, with some brokers reported that it can be difficult to find a small building available for lease or for sale. There is limited demand for properties 10,000 square feet and larger due to fewer users for properties of this larger size.

While CoStar indicates the overall vacancy rate for all office properties is 9.2%, it is noted that market participants believe the actual vacancy rate is higher than this. Most market participants believe that the current true vacancy rate in the market, including shadow vacant space, is probably in the range of 10-18%, with around 12-15% considered most likely by some market participants. One factor mentioned by market participants who believe that the vacancy rate is higher than 9.2% is that CoStar may not have accurate information on all buildings to fully account for all vacant spaces, so the actual vacancy rate is likely higher than the 9.2% recognized by CoStar.

Another factor supporting the assertion that the actual vacancy rate is higher than 9.2% is the recent increase in “shadow” vacant space that is not measured in vacancy rate statistics. Many market participants discussed a shadow vacancy from the leased but unoccupied or underoccupied space in our market. There are many ongoing leases signed before 2020 and the increase in work-from-home trends that started that year in which the tenants continue to pay rent but do not actually occupy the space, or significantly underutilize the space. These tenants may attempt to sublease the space until their lease expires, but will continue to pay until the end of the lease term. At the end of the lease term, these tenants will then give up the space, and perhaps lease a smaller space that better fits their current needs, or have no office if they are entirely remote. It is unknown exactly how much shadow vacant space is in the market that is leased and unoccupied or underoccupied, but market participants indicate that this space could add a couple percent to the vacancy rate. As these leases expire, these spaces will be given up. Due to this, some market participants believe there is a potential for the vacancy rate to increase in the next couple of years as this space is gradually vacated. Unless there is a strong increase in demand and new leases, we may see a slight increase in vacancy in the next couple of years.

Sub-Market Demand
The following is the office submarkets utilized by CoStar.



The following is the office statistics for the various office submarkets, as defined by CoStar.

Office Sub-Market Statistics

Sector	Bldgs.	Inventory Sq. Ft.	Vacant Sq. Ft.	Vacancy Rate	YTD Net Absorption	Asking Rates
Ajo/ W. Outlying	9	104,583	-	-	-	-
Central	1,124	10,343,668	1,246,890	12.1%	(13,835)	$23.36
Downtown	340	6,319,305	148,211	2.3%	48,733	$21.53
East	138	1,312,182	264,937	20.2%	38,502	$15.00
Foothills	100	1,411,429	128,258	9.1%	(8,906)	$28.47
Green Valley/South	50	381,669	21,825	5.7%	(722)	$22.50
North/Oro Valley	362	3,898,042	301,892	7.7%	95,486	$24.47
Northwest	57	554,528	13,798	2.5%	22,601	$19.25
Southeast	41	720,360	125,830	17.5%	57,569	$17.50
Southwest	189	2,402,338	75,783	3.2%	22,667	$28.10
West	223	1,510,782	330,897	21.9%	21,433	$17.95
Total	**2,634**	**28,966,290**	**2,658,321**	**9.2%**	**283,528**	**$22.78**

It is noted that the Green Valley/south, northwest, and southeast sectors have the lowest inventory, with the low inventory potentially impacting the statistics in these sectors. It is also noted that based upon the number of buildings compared to square footage, the average building size is smaller in the central sector, with more small buildings in this sector, while the downtown submarket has a larger average building size, with more multi-story office buildings in this sector.

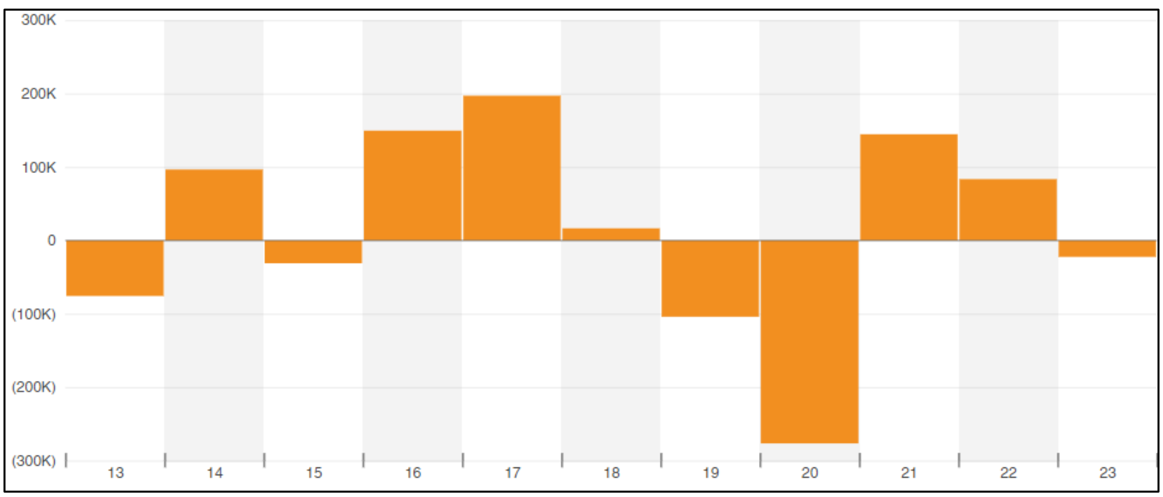
While the overall Tucson office vacancy rate was 9.2%, the vacancy rate varied significantly by sub-market. The submarkets with the highest vacancy rates are the west with 21.9% and east with 20.2%. The southeast also has a higher vacancy rate of 17.5%. Per Costar, the submarkets with the lowest vacancy rates are downtown with 2.3%, northwest with 2.5%, and southwest with 3.2%. It is noted that the downtown market was impacted by work from home trends in 2020 and that the actual and shadow vacancy rate in this sector is likely higher than CoStar is reporting. It is also noted that there is government-occupied office space in this sector.

The majority of the sectors have seen net positive absorption in the first three quarters of 2023, with total net positive absorption of 283,528 square feet for the total Tucson market. While none of the sectors have had significant net positive absorption, the North/Oro Valley sector had the most absorption with 95,486 square feet. The southeast, downtown, and east sectors also had more positive absorption than other sectors. The central, foothills, and Green Valley/south sectors have had net negative absorption for the year, although the amount of net negative absorption was low for all three sectors.

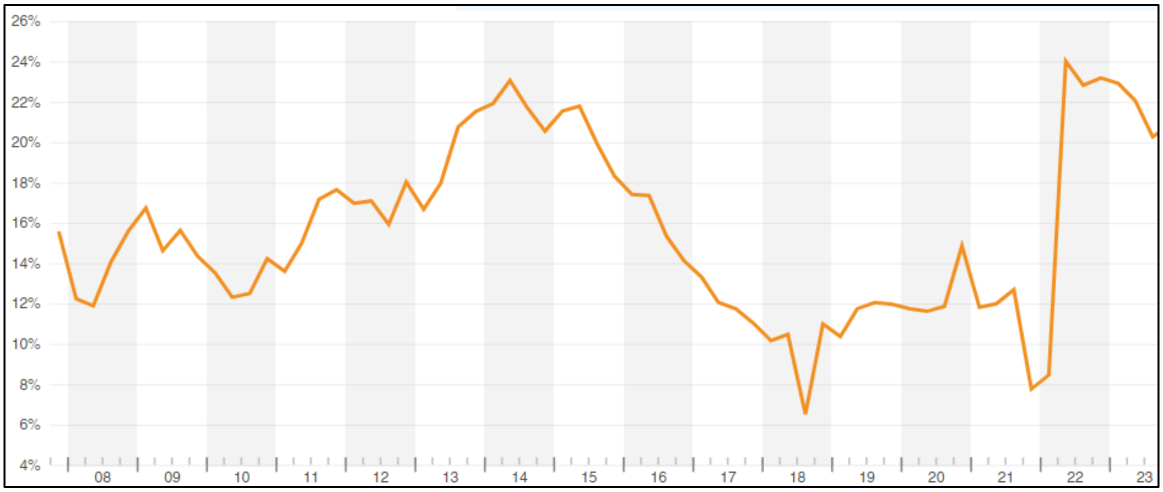
Average asking rental rates varies significantly. The east sector had the lowest asking rates with $15.00 per square foot, with the southeast having an average asking rental rate at $17.50 and the west at $17.95 per square foot. The foothills has the highest average asking rate at $28.47 per square foot, with southwest at $28.10 and north/Oro Valley at $24.47 per square foot.

The following is the vacancy rates for office properties in the central sector, per CoStar. This indicates that the vacancy rate in this sector peaked in mid-2013 and then gradually declined through 2017. After remaining mostly level at about 10% for two years, the vacancy rate increased rapidly in 2020. The vacancy rate has declined slightly since that time but remains elevated in the east sector.

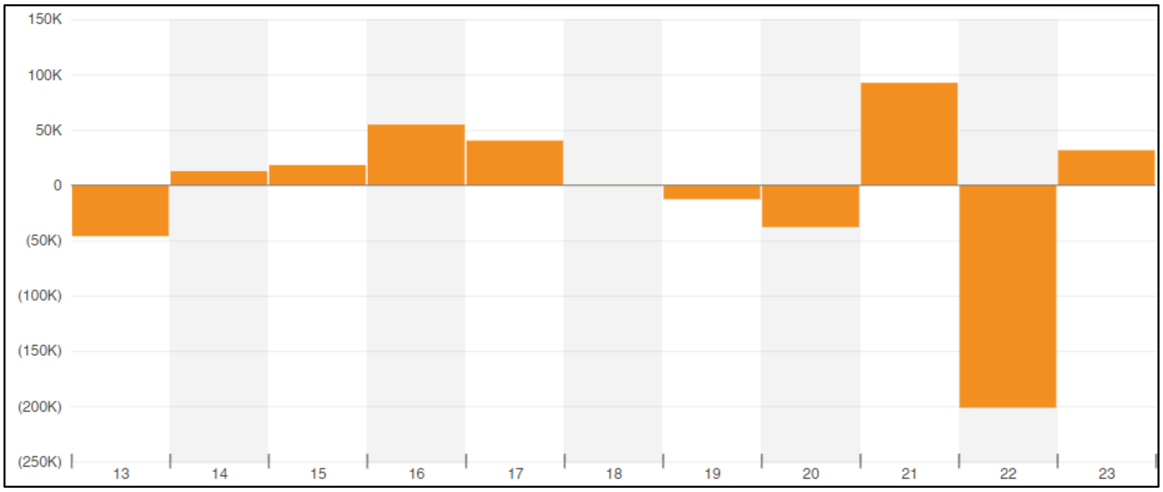
The following is the net absorption for office properties in the central sector, per CoStar. This indicates that there was net negative in the sector in 2019 and then significant net absorption of over 275,000 square feet in 2020. After net positive absorption in 2020 and 2021, there was net negative absorption in 2023.



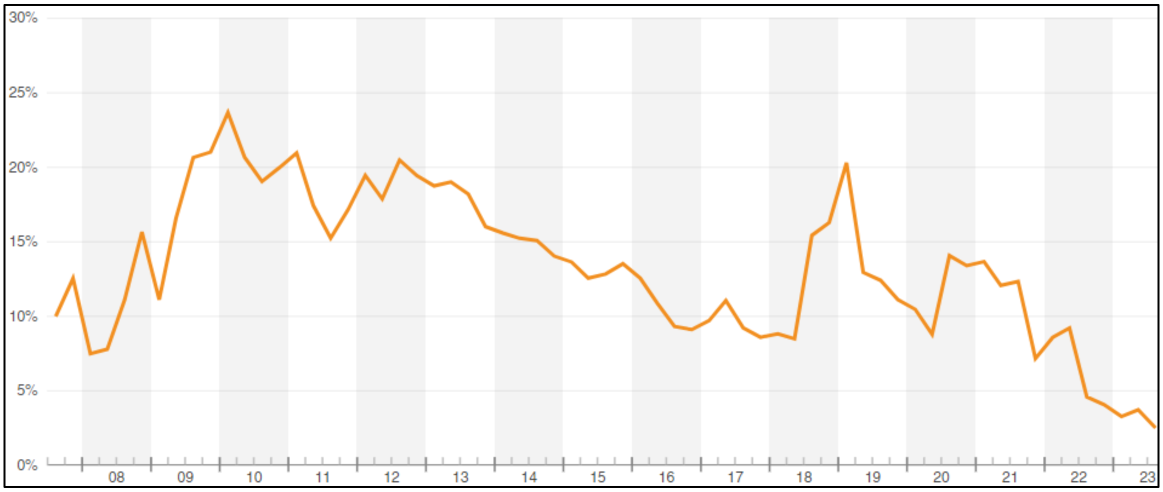
The following is the vacancy rate in the east sector, per CoStar. After peaking in 2014, the vacancy rate in the sector then declined. There was a significant increase in the vacancy rate in 2022, with the vacancy rate declining slightly in 2023 but remaining high at 20.2%.



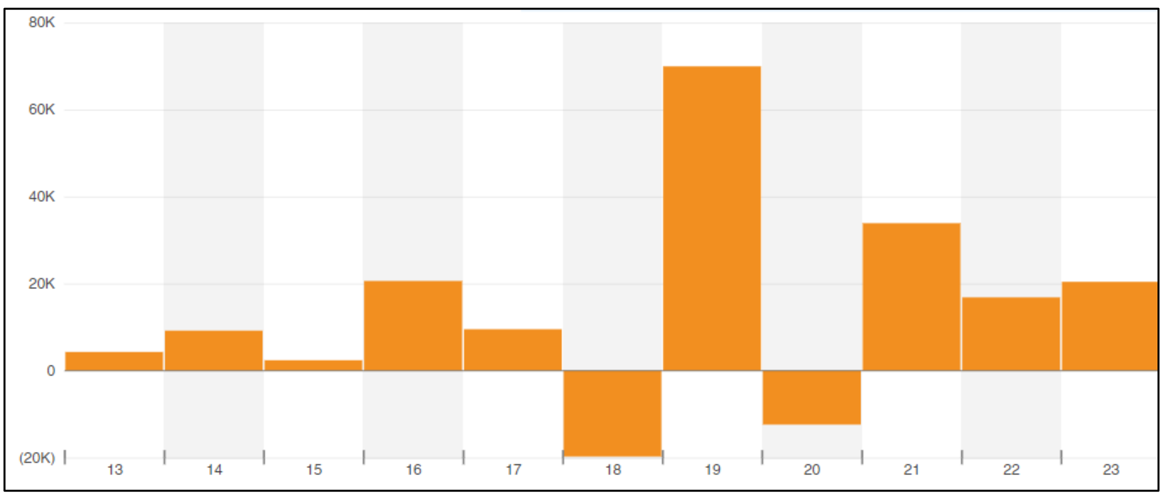
The following is the net absorption for the office properties in the east sector, per CoStar. After net positive absorption for several years, there was net negative absorption in 2019 and 2020. There was significant net negative absorption in 2022 with slight net positive absorption in 2023.



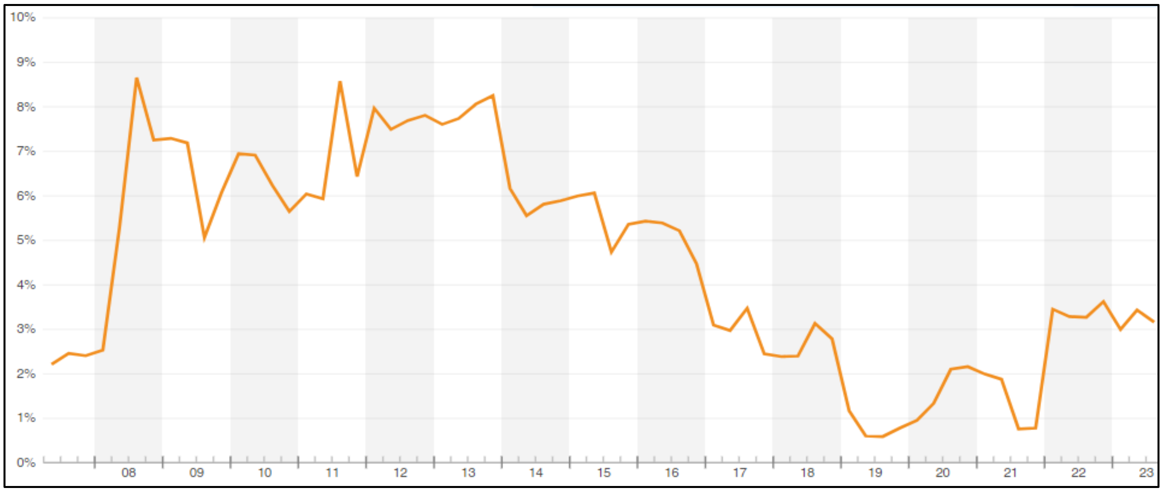
The following is the vacancy rate for office properties in the northwest sector, per CoStar. The vacancy rate peaked in 2010 and then gradually declined. After increasing in 2018 and early 2019, the vacancy rate gradually declined, despite a brief increase in 2020, and is one of the lowest vacancy rates in the Tucson market



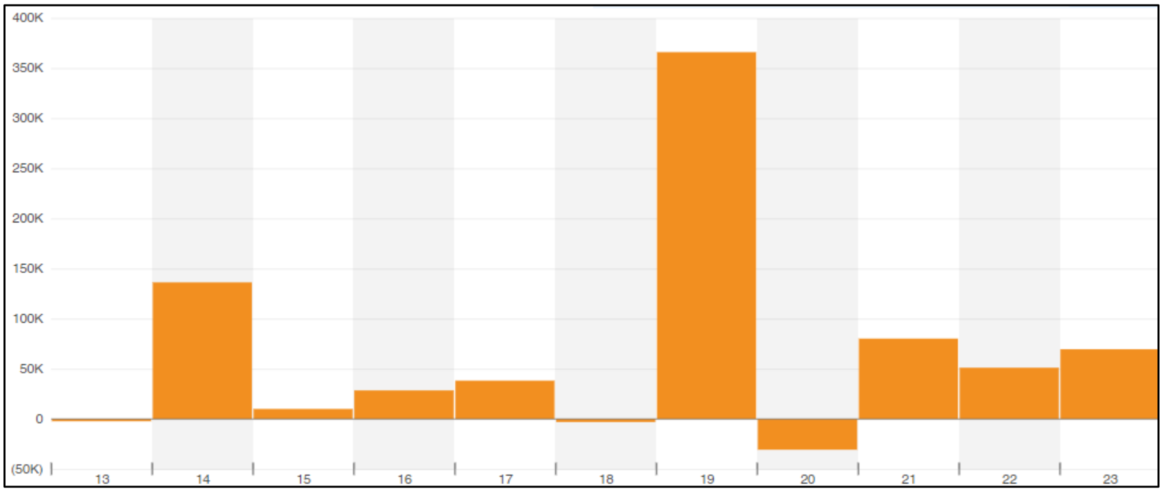
The following is the net absorption for office properties in the northwest sector, per CoStar. After net negative absorption in the sector in 2018, there was significant net positive absorption in 2019. There has been net positive absorption in 2021 through the first three quarters of 2023.



The following is the vacancy rate in the southwest sector, per CoStar. The vacancy rate in the sector remained elevated but lower than many other sectors from 2008 through 2013 and then declined through 2019. The vacancy rate increased in 2022 and has remained mostly stable.

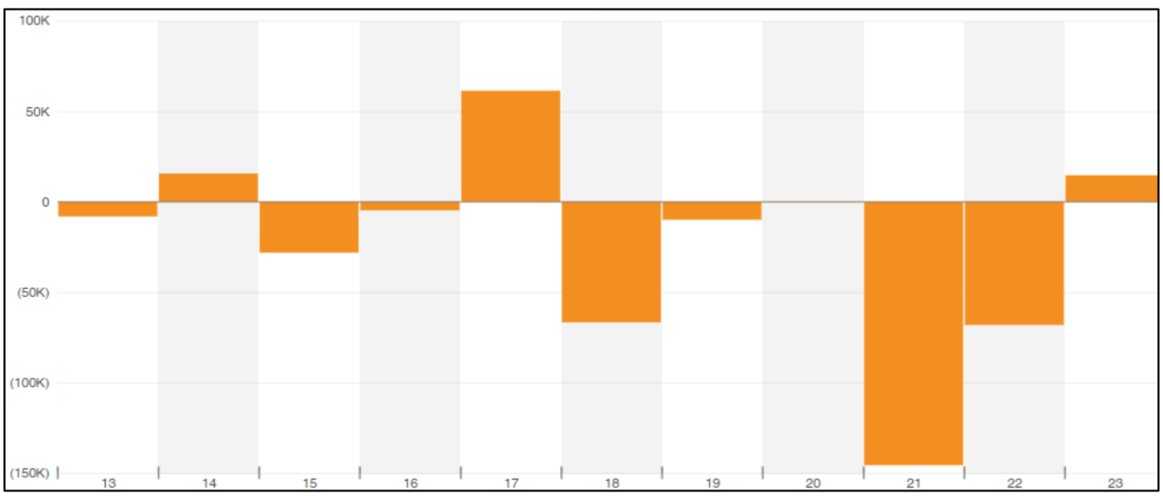


The following is the net absorption in the southwest sector, per CoStar. After significant net positive absorption in 2019, there was net negative absorption in 2010. There has been net positive in 2021 through 2023.



The following is the vacancy rate for office properties in the west sector, per CoStar. The vacancy rate remained relatively stable through 2020 and then increased steadily through early 2023.

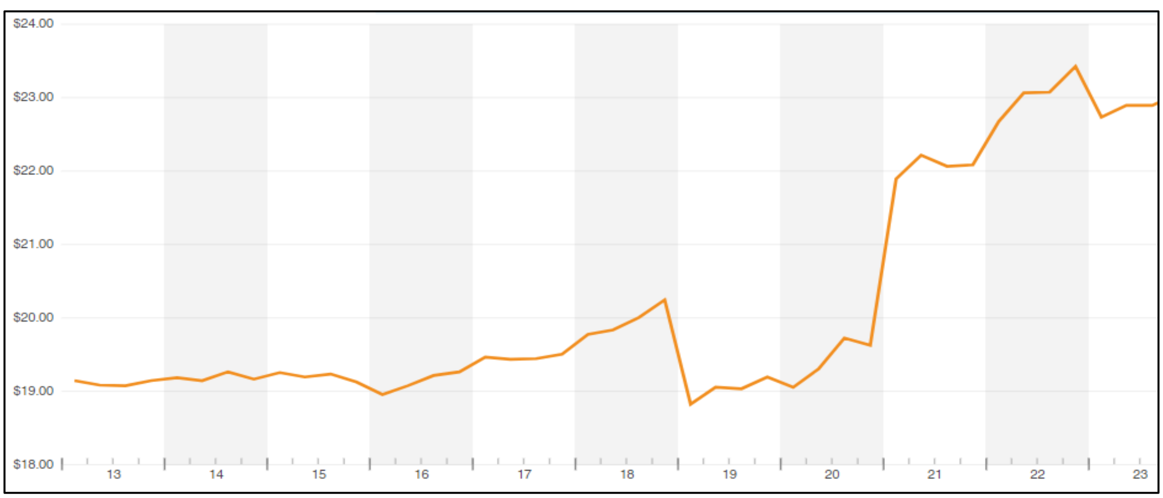
The following is the net absorption for office properties in the west sector, per CoStar. After a mix of slight net positive and net negative absorption for several years, there was more significant net negative absorption in 2021 and 2022, with slight net positive absorption in 2023 through third quarter.



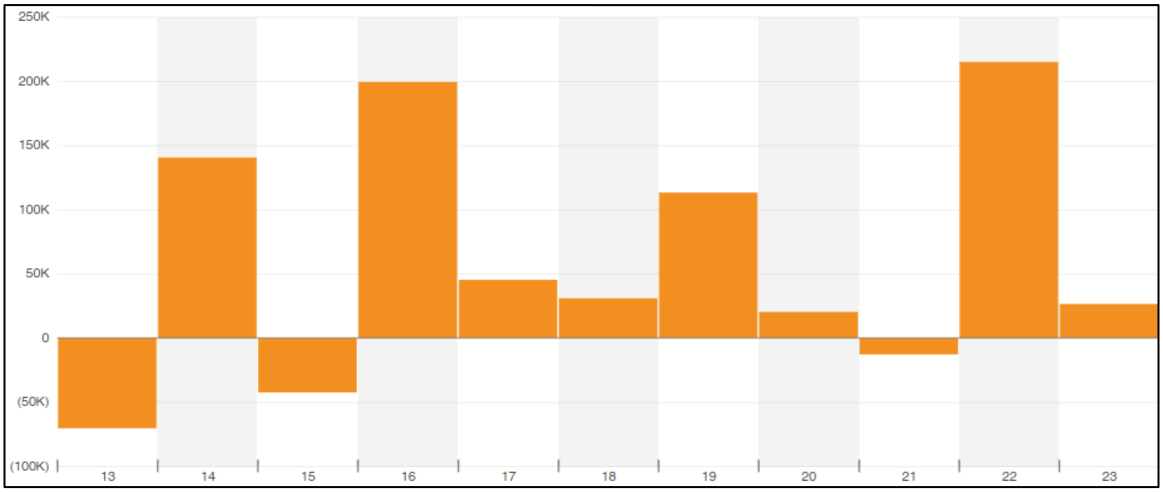
Medical Office Statistics

The following is the vacancy rate for medical office properties in the Tucson market, per CoStar. While the vacancy rate increased in 2020 and early 2021, the medical office has gradually declined since that time. Market participants indicate there is currently strong demand for most medical office uses, except for older obsolete medical uses.

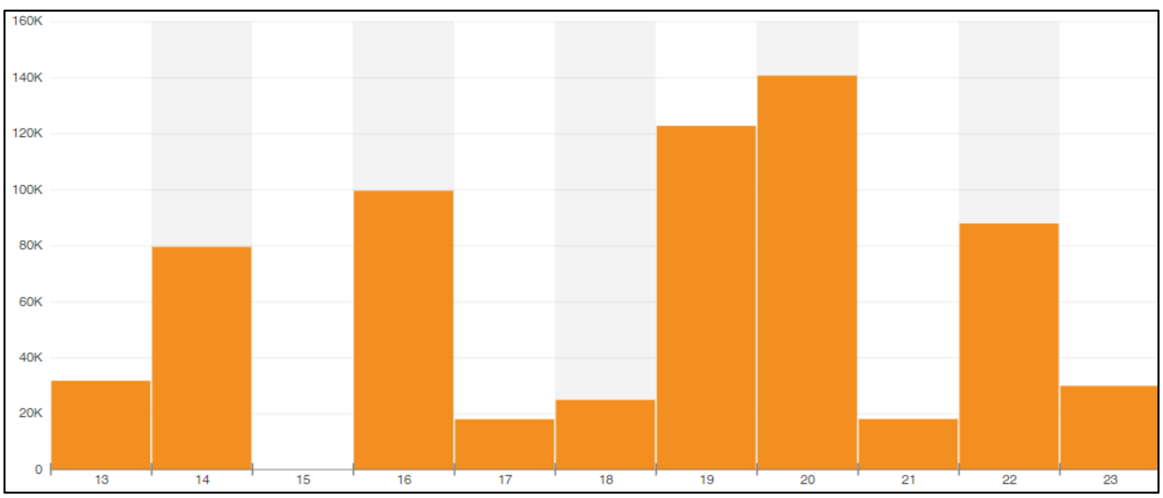
The following is the average asking rental rate for medical office properties in the Tucson market, per CoStar. After remaining mostly level, the average asking rental rate increased in 2021 and again in 2022. The average asking rental rate was mostly level in the first three quarters of 2023.



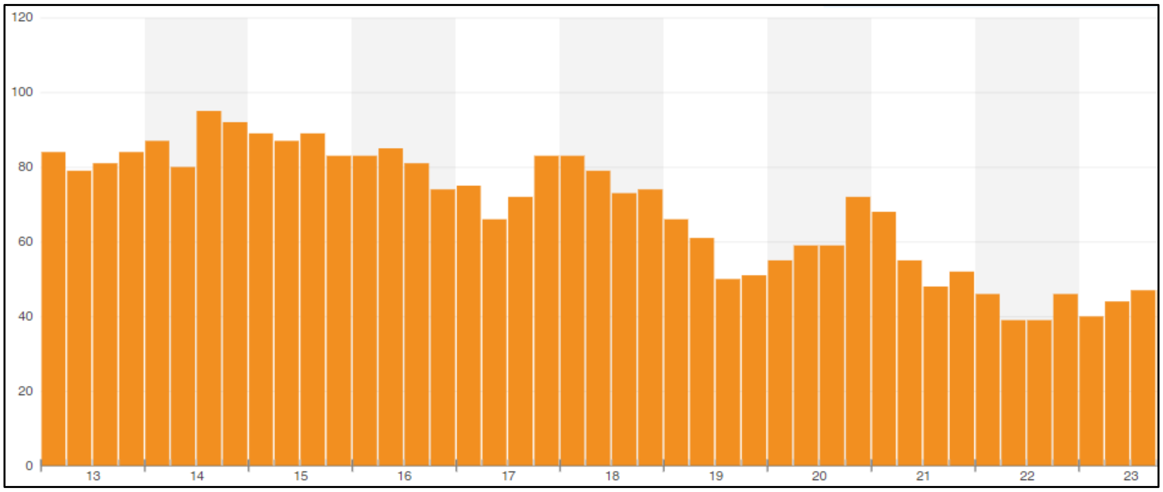
The following is the net absorption for medical office properties in the Tucson market, per CoStar. Since 2016 there was net positive absorption for medical office properties. After slight net negative absorption in 2021, there was significant net positive absorption in 2022. In the first three quarters of 2023, there was some net positive absorption. Overall, there was stronger absorption of medical uses in the last couple of years compared to absorption of general office uses.



The following is the new construction deliveries for medical office uses in the Tucson market, per CoStar. There has been some limited medical construction since 2016. This is primarily due to medical users who cannot find an existing building that meets their needs in the location they desire, and therefore construct or lease a new constructed building.

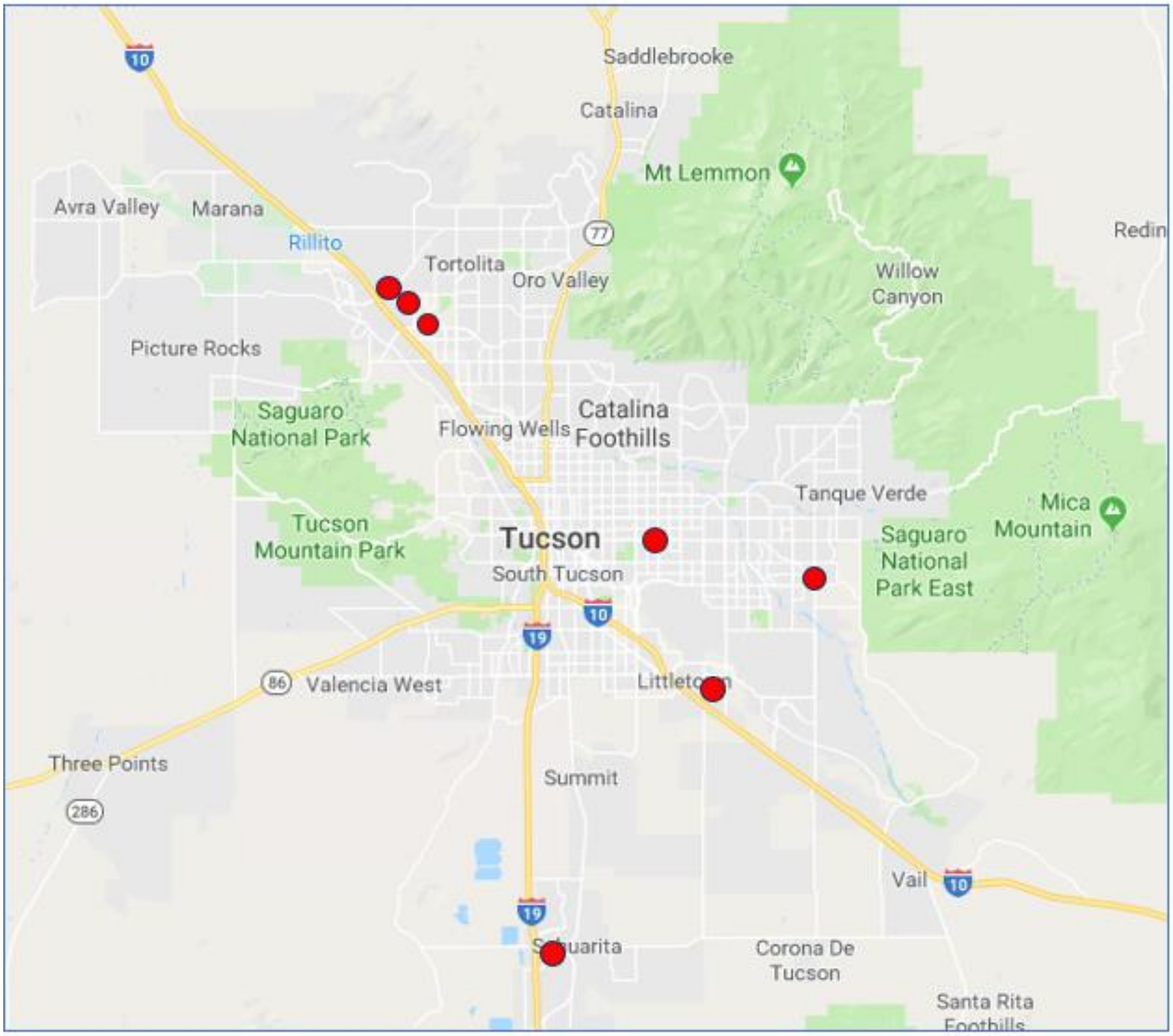


The following is the number of medical properties listed for sale in the Tucson market, per CoStar. The number of listings declined from late 2020 through early 2022 and has remained generally since that time. There is limited availability of medical office properties for sale in the current market.



Market participants indicate that in the current market, there is strong demand for medical office uses than general office uses. Medical office users are less impacted from work from home trends than the general office uses, and medical office users continue to need space for their businesses. There is outdated/obsolete older medical space that sits vacant or will require modernization. These are second or third generation medical office spaces that have not received significant updating and do not meet current medical office preferences in layout, medical finishes, or overall finishes. These buildings would need to be modernized in layout and finishes in order to have continued medical use by most medical users who would prefer modern features that meet current medical office needs. If not updated, the buildings may no longer be utilized by medical users in the future but may be purchased by general office or other users with no value given to the outdated medical finishes. In the market, there is strong demand for modern medical space that does not require significant renovation. There is limited supply of available medical space for sale or lease in areas of strongest demand, which includes the northwest, southeast, and certain areas in the central part of Tucson such as by TMC or Banner-UMC. There has been some recent construction for medical users who need a building but cannot find one that meets their specifications. Medical users are a source of continued new office construction as medical users will convert or build a new building if they cannot find an existing building.

One recent trend in the medical office market is demand for small freestanding hospitals or emergency rooms. These are primarily in areas outside of the Tucson core, in areas of recent new residential construction, in order to serve residents in these areas. Below are several that have been built or are planned within the last few years.



These locations include:

- 7401 S. Wilmot – Carondelet St. Raphael's
- 5620 W. Cortaro – Carondelet Marana
- 2200 S. Houghton Road – Northwest Medical Center Houghton
- 4547 E. Broadway – Tucson ER & Hospital
- 16260 S. Rancho Sahuarita Blvd – Northwest Medical Center Sahuarita
- 6350 Marana Center Drive – Northwest Emergency Center
- Twin Peaks and Linda Vista – TMC planned location

Office Transactions

The number of office sales has remained limited in the last few years. The following is a list of notable improved sales. This is not a complete list of all sales in recent years, but provides an example of the type of office buildings that have sold.

Notable Sales					
Sale Date	**Location**	**Use**	**Sale Price**	**Size**	**Price/SF**
01/22	7890 N. Cortaro Road	Medical	$3,319,000	6,850	$484.53
04/22	1055 La Canada Drive	Medical	$3,880,000	23,905	$162.31
04/22	5140 E. Glenn	Medical	$4,028,000	8,304	$485.07
04/22	4892 N. Stone Avenue	Medical	$7,129,000	19,202	$371.26
04/22	5620 W. Cortaro Farms Road	Medical	$20,444,000	31,245	$654.31
05/22	6969 E. Sunrise Drive	Office	$2,600,000	9,340	$278.37
06/22	6401 N. Campbell	Office	$5,800,000	6,048	$958.99
06/22	2404 E. River Road	Medical	$6,149,000	23,746	$390.00
07/22	180 W. Magee Road	Office	$4,600,000	24,098	$190.89
08/22	850 N. Kolb Road	Medical	$2,000,000	11,750	$170.21
09/22	1100 N. Wilmot	Office	$2,250,000	11,379	$197.73
09/22	2626 E. River Road	Medical	$7,500,000	15,084	$497.22
10/22	6390 E. Broadway	Office	$2,200,000	21,820	$100.82
11/22	2210 E. Fort Lowell	Office	$2,400,000	14,500	$165.52
11/22	10140 N. Oracle Road	Office	$957,500	5,955	$160.79
11/22	4582 N. 1st Avenue	Medical	$1,100,000	4,531	$242.77
01/23	4001 E. Sunrise Drive	Medical	$9,000,000	21,449	$419.60
03/23	2122/2224 N. Craycroft	Office	$2,575,000	26,280	$97.99
03/23	3104 N. Swan	Office	$1,075,000	5,000	$215.00
04/23	2202 N. Forbes	Office	$8,200,000	58,367	$140.49
06/23	4640 E. Sunrise Drive	Office	$3,150,000	15,702	$200.61
06/23	5670 N. Professional Park Drive	Medical	$6,600,000	14,035	$470.25
08/23	7552 N. La Cholla	Medical	$1,450,000	5,092	$284.76
08/23	4745 E. Camp Lowell	Medical	$3,525,000	12,937	$272.47
08/23	3838 N. Campell	Medical	$134,000,000	281,497	$476.03

While the last five years have seen the sale of some high-vacancy, large multi-tenant office buildings that were purchased to lease up, there have been limited sales of this type of property in the last year or two. There is limited demand for larger buildings, particularly by investors for large multi-tenant properties as leasing remains slow for this type of property. On the investment side, recent sales have been more likely to be properties with strong tenants and good lease terms, as opposed to vacant or partially vacant buildings that need to be leased. One example of a notable recent sale is the August 2023 sale of the University of Arizona Cancer Center and North Clinic Campus with parking that sold as a sale-leaseback for $134 million. There has also been some demand by owner-users. The property at 2202 N. Forbes was purchased by the State of Arizona to be utilized as an owner-user. Market participants confirm that there is good demand in the market for office properties. The above list has larger sales, but overall, market participants indicate that strongest demand in the market is for sales of properties under 10,000 square feet, particularly 5,000 square feet or smaller.

There is also strong demand for purchase of medical uses, with demand by owner-users as well as investors with properties that are leased with strong tenants and longer lease terms. Many of the above sales are medical properties, including general medical as well as specialty uses including a free-standing hospital at 5620 West Cortaro Farms Road. Medical users are continuing to purchase properties when needed. However, market participants indicate that Tucson also has available older second or third generation medical office spaces that is significantly obsolete. These medical spaces have much less demand than more modern facilities. They either require renovation, or the medical finishes have no value and they may be converted to a non-medical use.

The following is a sample of capitalization rates for office properties in Tucson. As discussed, there have been more limited sales of properties by investors in the last year or two. The strongest demand has been for properties with strong tenants and longer terms, which have the lowest capitalization rates. There is also demand for medical properties in particular. Market participants indicate that capitalization rates may have increased slightly since early to mid-2022 due to increases in interest rates and a slower market. They indicate that properties that may have sold based on a capitalization rate in the low 5% range a couple of years ago could be closer to a low 6% now, although particularly strong leases or tenants could still allow for a capitalization rate in the mid 5% range. The capitalization rate is likely to be 6%-7% for many medical or certain office properties with strong tenants, and 8% or higher for many general office properties. Capitalization rates can be much higher for older properties or properties that need lease-up. Market participants indicate that there actually are not enough investment sales of this type of property to fully gauge capitalization rate due to lack of investor purchases, but rates could be 8% to 10% or even higher.

The below list also includes several listings of investment properties. These properties may eventually sell below the list price, indicating the capitalization could be lower than that provided by the list price.

Notable Capitalization Rates				
Sale Date	**Location**	**Use**	**Sale Price**	**Cap Rate**
01/22	7890 N. Cortaro Road	Medical	$3,319,000	5.75%
03/22	2850 N. Swan Road	Office	$602,000	7.37%
04/22	5140 E. Glenn Road	Medical (Pima Heart)	$4,028,000	5.36%
05/22	2761 N. Country Club	Office	$938,328	8%
06/22	2104 E. River Road	Medical (Pima Heart)	$9,261,000	5%
09/22	2626 R. River Road	Medical (Banner)	$7,500,000	5.25%
11/22	401 W. Cool Drive	Dental	$960,000	6.68%
02/23	2122-2224 N. Craycroft	Medical	$2,575,000	6.6%
06/23	5670 N. Professional Park	Medical (AZ Urology)	$6,600,000	6.45%
List	10195 N. Oracle	Multi-tenant	$6,195,533	6.15%
List	10569 N. Oracle	Medical	$5,659,762	5.25%

List	1161-1181 N. El Dorado	Office	$4,251,823	7.86%
List	6740 N. Oracle	Office	$4,100,000	6.10%
List	1011 N. Craycroft	Multi-tenant	$2,995,000	9.0%
List	1575 E. River	Office	$2,975,000	7.3%
List	7485 E. Tanque Verde	Medical office	$1,877,000	5.75%
List	1640 E. River Road	Office	$675,000	7.0%

There are a variety of office properties listed for sale. The following is a small sample of current listings. It is probable that most if not all of the properties will sell for below the current list price. These show that properties for a variety of properties are available in the market. There are some multi-tenant properties available for sale in the market. There are also a few properties that are entirely or mostly vacant, such as the former call centers at 1401 S. Pantano and 4690 N. Oracle. However, some properties listed are office or medical space that is owner-user or is leased as an investment. Most of the highest priced sales are for properties that are leased or are high-end and/or specialty buildouts. Some properties are available for sale but without a list price. It is noted that some of these properties with the least demand have been on the market for extended listing periods, some over 500 or 1,000 days due to a lack of demand for the property. Some properties may eventually sell at a much lower sale price. Again, it was noted that the strongest demand in the market is for properties under 10,000 square feet, particularly under around 5,000 square feet. There is limited properties of this size available in many submarkets, particularly for small spaces without significant depreciation.

Notable Listings				
Location	**Use**	**List Price**	**Size**	**Price/SF**
6420 E. Broadway	Medical/Office	$8,000,000	34,997	$228.59
7454 E. Broadway	Office	$2,800,000	12,123	$230.97
1011 N. Craycroft	Office	$2,995,000	27,072	$110.63
1161-1181 N. El Dorado	Medical office	$4,251,823	22,850	$186.08
1650 E. Fort Lowell	Office	$3,696,000	21,141	$174.83
1350 N. Kolb Road	Office	$4,250,000	24,821	$171.23
10569 N. Oracle	Medical office	$5,695,762	6,869	$823.96
6740 N. Oracle	Office	$4,100,000	12,720	$322.33
10195 N. Oracle	Multi-tenant office	$6,195,533	21,190	$292.38
1401 S. Pantano	Call center	$5,950,000	47,531	$125.18
655 E. River Road	Office	$2,730,000	14,000	$195.000
1575 E. River Road	Office	$2,975,000	10,000	$297.50
1775 E. Skyline Road	Medical	$3,703,700	8,140	$455.00
800 E. Wetmore	Office	$5,195,000	38,464	$135.06
6130 N. La Cholla	Office	N/A	58,122	N/A
3131 N. Country Club	Office	N/A	61,855	N/A
3350 E. Hemisphere Loop	Office	N/A	141,501	N/A
5860 N. La Cholla	Medical	N/A	10,105	N/A
4690 N. Oracle	Office/Call center	N/A	211,152	N/A
326 S. Wilmot	Office	N/A	24,829	N/A
13101 N. Oracle	Medical/Office	N/A	50,500	N/A

The leasing market remains slow but stable, with net positive absorption for the year. As with sales, demand is greatest for smaller spaces, particularly under 5,000 square feet. There is limited spaces available in the smaller sizes that does not have significant depreciation or need modernization. There is significant office space available for lease in the market, particularly in large or multi-story buildings. A sample of larger buildings available for lease is listed below. This is not all properties available for lease but gives a sample of the larger properties with more space available.

Lease Availability				
Location	**Use**	**Total Size**	**Total Available**	**Asking**
6261 N. La Cholla	Medical	55,372	14,977 – sublease 21,663 – total	N/A
1707 W. St. Marys	Medical	55,000	16,919	$24/NNN
100-150 N. Tucson	Office	50,000	16,972	$14.50/Full
250 S. Craycroft	Office	44,385	10,301 – sublease 25,075 – total	$14.50/Full
1010 N. Finance Center	Office/Call center	48,673	48,673 – sublease	$11/NNN
6261 N. La Cholla	Office/Medical	55,372	21,633 – sublease	N/A
9060 S. Rita Road	Office/lab	115,632	57,816 – sublease	$10/NNN
7202 E. Rosewood	Office	48,830	18,300 – sublease 31,323 – total	$12/Full
345 E. Toole	Office	24,260	24,260 -sublease	$15/NNN
335 N. Wilmot	Office	286,164	27,176 – sublease	$16/Full
630 N. Alvernon	Office	110,414	64,566	$27/Full
4801 E. Broadway	Office	88,394	27,174	$22/Full
5055 E. Broadway	Office	34,551	16,017	$19.50/Full
5151 E. Broadway	Office	270,763	100,030	$24-$27/F
6420 E. Broadway	Medical	34,997	34,997	$22/NNN
6565 E. Carondelet	Office/Medical	91,460	27,310	$27/Full
930-950 N. Finance Center	Office	130,716	130,716	$18/Mod
1600 E. Idea Lane	Office	120,000	53,255	$29.25/Full
1350 N. Kolb Road	Office	24,821	24,821	$20/Mod
5320 N. La Cholla	Office	53,210	53,210	$24/Mod
11100 N. Oracle	Office	131,928	53,838	N/A
13101 N. Oracle	Medical	50,500	50,500	$9.50/NNN
9072 S. Rita Road	Office	57,816	57,816	N/A
155 N. Rosemont	Office	51,404	25,000	N/A
333 E. Wetmore	Office	142,148	64,648	N/A
800 E. Wetmore	Office	38,464	25,998	$22.50
5431 E. Williams Circle	Office	47,706	47,706	N/A
5210 E. Williams Circle	Office	168,655	64,958	N/A
250 S. Williams	Office	128,000	128,000	$28/Full
4690 N. Oracle	Call center	211,152	345,708	$14/NNN

Many buildings are mostly or even entirely vacant. It is uncertain how the market will absorb this vacancy, particularly in the high-vacancy properties. Market participants were in agreement that call center buildings will not be occupied by new call centers as call centers now operate with remote workers and they will not be returning to the office. These buildings will no longer be call centers but must be converted to other uses. Some were former industrial uses that were converted to call centers; these buildings have been or will be converted back to industrial uses. Other buildings may be more easily converted to industrial uses. However, other buildings are not easily converted. Many cannot easily be converted to another use due to the building characteristics or their location. These properties will take more creativity to repurpose.

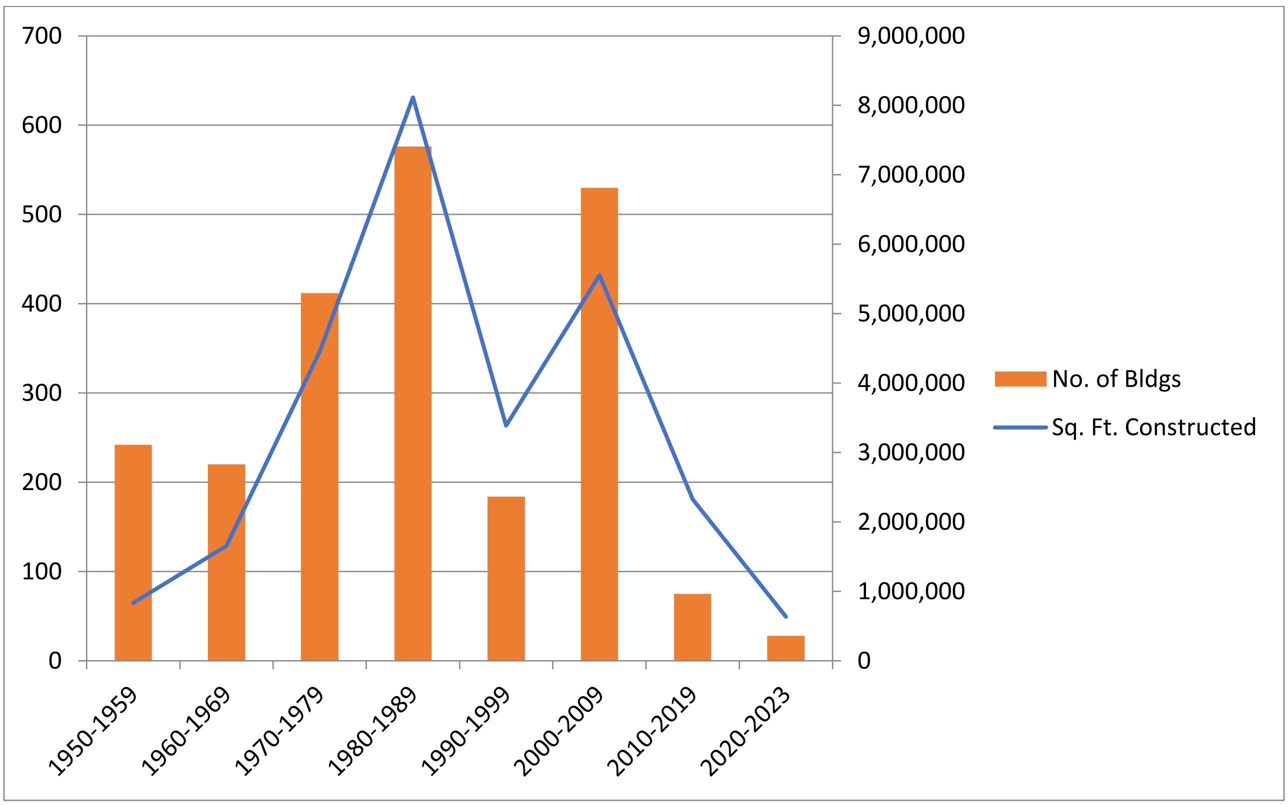
Market participants indicate that these large high vacancy properties have an uncertain future. As will be discussed more later, market participants generally feel there is unlikely to be a change that will significantly increase demand for general office space or increase office employment here, meaning that office absorption will continue to improve gradually and not rapidly. As buildings sit vacant, demand will be slow to increase, meaning that there may need to be creative solutions to utilize these buildings or redevelop them.

Rental rates for office properties can vary significantly. For older general office space in areas with less demand, rental rates can be around $10 per square foot on a triple net basis. For multi-story general office buildings, which tend to be rented on a full service or modified gross basis, rental rates can range from $15 to $30 per square foot. Medical space can rent from around $15 to $23 per square foot triple net for average space and around $25 for nice, modern medical office space. For new or Class A office or medical space, rental rates can be $25 to $35 per square foot, with higher rental rates for the newest space in the best locations or specialty medical space.

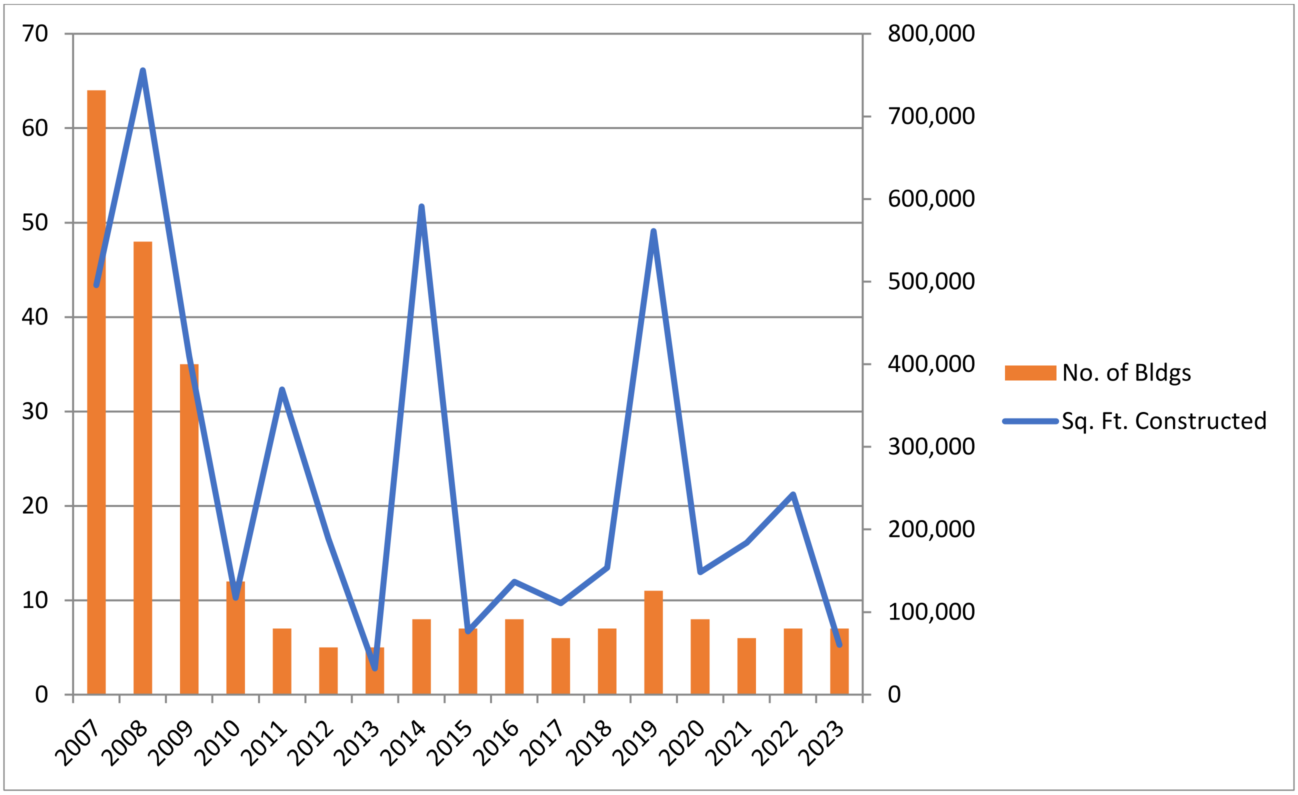
Tucson Office Historic Construction

As previous discussed, there has been limited new office construction since 2009. There has been an extended period with limited new construction compared to earlier time periods. After the recession ended, there has remained limited demand for new construction.

The following chart shows office supply by construction decade, according to CoStar. It analyzes both the number of buildings constructed and the square footage constructed. This chart indicates that the number of buildings and the square footage increased from the 1960s, with the number of buildings and square footage constructed peaking in the 1980s. This was followed by a large decline in the 1990s. There was an increase in number of buildings and square footage constructed in the 2000s. One market participant indicated that Tucson had success with back office and "workhorse" type office properties in the 1990s and 2000s. However, there has been limited construction since 2010. This indicates that the majority of office buildings were constructed before 1990, with many 1980s era buildings, although there is also a supply of buildings constructed in the 2000s. Comparing the number of buildings constructed to the square footage constructed demonstrates that the buildings constructed since the 1990s have generally been larger than those constructed prior to 1980.



The following chart indicates new office construction since 2007, according to CoStar, looking again at both the number of buildings constructed and the square footage constructed. This indicates that the number of buildings has declined since 2007, with fewer than 10 new office buildings constructed each year since 2010 except for 2019, which was slightly over 10 new buildings. The square footage varies as some years saw the construction of larger buildings. In 2014 and 2019 the square footage was much higher due to the construction of large buildings in those years. There has been limited office construction since 2020 by both number of buildings and square footage.



Due to the slow demand for office as well as high construction costs, there is less new construction, with more people choosing to purchase and renovate an existing building. However, some owner-users or tenants cannot find a building that meets their needs and construct a new building. This is most likely to occur with larger or more unique buildings. As discussed, there has been slow growth in demand for general office uses, with more demand for medical office uses. Many people worked from home since 2020, leading to a decline in demand for office uses in 2020 and slow recovery since that time. Additionally, construction costs for all property types have increased rapidly since 2020. This has increased the cost of new office construction. Recent interest rate increases have also increased construction costs of new properties as well, indicating it is not financially feasible for many office uses to be constructed. The combination of slow demand and high construction costs is expected to continue to limited demand for new office construction in the immediate near future. Due to these factors, there has been limited demand for new office construction. The majority of new construction has been for users unable to find a suitable building in their preferred location.

Due to the significant construction in the 1980s and earlier, Tucson has many older office buildings. The buildings constructed in the 2000s are now also aging if they have not yet had significant renovations. This includes both general office and medical office uses. While some older buildings are remodeled and find a new life, many other office buildings have significant depreciation. This stock of older office space remains readily available, and asking rents and sale prices can be quite low for these buildings. There are many older buildings that are functionally obsolete. These buildings have lower affordable rents and sale prices. With lower rents for these buildings as well as high construction costs for renovations, there is limited rent potential and incentive to renovate these buildings, as the owners may not be able to get back the cost of renovations. Some buildings have been renovated, but many others have not. Some older medical buildings are obsolete and the medical fixtures may not be used by a new tenant or owner. Many of the older obsolete buildings may also need extensive repairs and maintenance as well as general modernization and updating. This can be particularly costly for the large multi-tenant buildings.

New Construction
The following is a small sample of office buildings constructed in recent years. Due to the number of new buildings, this is not meant to be a comprehensive list of newly constructed buildings, but to give an overview of the types of uses constructed within the last several years.

Address	**User/Use**	**Size**	**Year**
40 E. Congress	Multi-Use	65,062	2017
7890 N. Cortaro Road	Northwest Healthcare	6,850	2017
1358 W. Orange Grove	Medical office	9,907	2018
5620 W. Cortaro Farms Road	Carondelet Marana Hospital	31,245	2019
875 W. Cushing	Caterpillar	150,000	2019
1230 S. Cherrybell Stravenue	El Rio	50,000	2019
3600 E. Hemisphere Loop	Office	30,300	2019
3050 S. Martin Luther King Jr. Way	Geico	200,000	2019
7374 N. La Cholla	Office	3,500	2020
3300 S. Park Avenue	JTed	50,000	2020
6442 E. Speedway	Medical	14,000	2020
1707 W. St Marys	Medical	55,000	2020
3925 E. Fort Lowell	Medical office	8,064	2021
1600 E. Idea Lane	The Refinery	120,000	2022
2300 S. Houghton Road	Northwest Medical Center	45,000	2022
10569 N. Oracle	Northwest Urgent and Medical	6,869	2023

As discussed earlier in this report, there has been limited new construction in recent years, with fewer than ten new office buildings constructed most years in the last decade. Most new construction has been for users who cannot find an existing building to meet their needs in the location they desire. There have been several large office buildings constructed, including the Caterpillar building and the Geico building; however, these are owner user buildings constructed for their particular office needs. There have also been several medical buildings constructed in recent years, including free-standing hospitals and other general or medical specialty uses. These buildings are being constructed for specific users, with no demand for speculative office construction due to lack of demand and existing supply. Some smaller office or medical suites have also been constructed within new multi-tenant retail and office buildings, in areas of strong retail demand. These allow users such as financial services, urgent care, or dental users to be located in areas with other commercial uses. There are some additional medical or office uses developed, such as those uses at the northeast corner of Alvernon and Fort Lowell or at the Pima Medical Campus on the west side of Craycroft Road, south of Grant Road.

Construction costs for all property types have increased significantly in the last few years. New construction has seen a dramatic increase in costs compared to 2019. In mid-2020, supply chain issues caused a dramatic increase in the cost of many materials. This had a significant impact on construction hard costs for all property types, including office. There was strong demand for new construction for many property types, particularly residential (multifamily and single-family) as well as industrial properties. This strong demand increased demand for materials and labor, which led to higher prices. Construction costs had increased significantly faster than normal from

2020 through 2022, making new construction more expensive to build and less likely to be financially feasible to construct. In addition to materials, there was also an increase in labor costs. There was and continues to be a labor shortage, combined with increased demand for construction, that led to a further increase in construction costs. Overall, both hard and soft costs increased substantially between mid-2020 and mid-2022. Construction prices increased further starting in mid-2022 with interest rate rises as construction loan costs increased. Market participants indicated that although new projects have slowed, construction costs remain high. While costs for many materials has declined from the peak, costs have remained high for other materials. Additionally, labor costs remain high with a lack of adequate contractors and subcontractors. While there continues to be construction primarily from projects planned and started before the slowdown, new projects will likely slow as market conditions continue to remain slow. It is expected that some market participants or users will continue to construct new medical or general office buildings if they cannot find a building to meet their requirements and office construction is expected to continue to remain slow over the next couple of years. Construction costs may remain stable or decline slightly in the near term, but are currently not projected to decrease significantly.

Some market participants gave indications of current construction costs. It was noted that costs vary widely by factors such as size, buildout, and finishes. Smaller properties can have significantly higher costs on a price per square foot basis compared to much larger buildings. One market participant indicated that construction costs for an office building could be $300 per square foot, with about $175 for the shell building, $100 to finish out the building, with the remainder for permits and other costs. Construction costs would be higher for a medical building or building with more buildout or nicer finishes. Another market participant indicated that a shell building could cost $150 to $175 per square foot, with finishes of $200 to $250 for a medical building. Another market participant indicated that a shell building around 10,000 square feet could cost $145 to $160 per square foot. Finishes for a building could be around $150 per square foot for a general office building, and $180 to $250 for a medical office buildout, with costs significantly higher for nicer medical finishes or more buildout, and with specialty buildout costing even more to finish out. Costs do vary with smaller buildings being higher on a price per square foot. It was estimated it could cost $300 to $350 per square foot above shell cost to finish out a surgery center, for example. It is noted this is only construction costs for a building and does not include land costs.

Several market participants also indicated that in addition to the increase in new construction costs, tenant improvements costs were also up significantly. Whereas new paint and basic flooring may have previously cost $5 per square foot, this may now cost $10 to $15 per square foot, and can go higher for nicer flooring. Minor changes may cost a minimum of $20 per square foot and more significant changes such as air conditioning and/or minor floorplan changes may cost $50 to $150 per square foot, depending on changes and quality of finishes, and can be higher for nicer finishes or more significant floorplan changes. Many older buildings have depreciation and may require renovations to lease, while other spaces are more modern and can rent in the as-is condition. However, significant tenant improvement costs can be high enough that landlords may not get enough rent to justify the tenant improvements and thus deals in which tenants request high tenant improvements may not occur. Some potential tenants are asking for significant tenant improvements but the rents are not adequate to justify these improvements. Some market participants felt that investing in building improvements helped increase rents or bring in new interest enough to make renovations worthwhile, while in other buildings there was not adequate demand or rents to pay for needed improvements. Overall, as buildings continue to age, more renovations will be needed.

Some market participants noted that not only are tenant improvement costs increasing, but operating expenses are also increasing. Like other costs, operating expenses have been continuing to rise over the last several years. With vacancy rates high, for many properties rents are not increasing at the same pace as costs, and leaving landlords feeling more squeezed with expenses rising faster than rents. This also contributes to making it more difficult to work out office leases.

Feasibility Analysis

Several market participants indicated that in the current market, it is highly unlikely that a speculative office building would be constructed. Most recent construction has been for specific users who were not able to find an existing building to meet their needs in the location they wanted. There is significant existing supply of buildings, lack of office rental rate growth, limited new office demand, high construction costs, and limited financing for this type of office project. Due to these factors, while some build-to-suit office or medical construction is likely to continue, it is not projected that speculative office construction will occur. However, a feasibility analysis is provided below. It is noted that due to the significant variance in construction costs (both hard and soft costs) in recent years, the uncertainty of how construction costs will be changing in the near-future, the changes in interest rates that increases costs, and inflation, estimated construction costs are likely to continue to change in the near future. The following costs are based upon information provided by various market participants. This analysis is done on a price per square foot basis, assuming a building size of 10,000 square feet for a general office use.

Class A Office Development Costs and Required Rents

Shell Building	$150	$150
Buildout	$125	$125
Site Costs	$25	$25
Land Costs	$100	$100
Total Cost Per Square Foot	$400	$400
Total Cost, @10,000 Square Feet	$4,000,000	$4,000,000
Times Rate of Return:	x 0.09	x 0.08
Feasibility Income:	$360,000	$320,000
Divided by Square Footage:	10,000	$10,000
Feasibility Annual Rent	$36	$32

The above analysis indicated that if the rate of return was 9%, they would need to obtain rents of $36 per square foot on a triple net basis for a project to be financially feasible. A rate of return of 8% would necessitate rents of $32 per square foot. This is much higher than is typical for most general office uses. While some specialty office users or office users with higher quality finishes may pay this much or more for rent, they likely have higher construction costs for the buildout and/or higher cost in the land. Most typical offices spaces are renting for significantly less than this amount. For this reason, many new construction projects are not financially feasible at this moment and speculative office construction is not likely to occur. It is noted that certain costs or expenses may vary significantly depending on the features and location of a project, and this is only one example. It may be that some build-to-suit projects are currently financially feasible because the project is being constructed for a known user who has agreed to the terms before construction starts. This occurs when a user is seeking a desired location. However, speculative office projects not are financially feasible in the current market. Multiple market participants indicated that is unlikely that speculative office construction would occur in the current market.

Land

As previously discussed, there has been more limited new construction in recent years in the Tucson market. Due to the lack of significant new office construction, there was limited demand for purchases of vacant office land during this time.

Land sales purchased for office development may have zoning that allows for other uses, such as retail uses. Therefore, purchasers of land for office buildings in these areas must be competitive with other users. Many of the recent land purchases have been for development of medical office uses, including general medical office or medical uses such as freestanding hospitals. Many of these purchases are located in areas of strong residential growth, with medical uses in particular locating in areas of residential growth to serve new residents. This includes the northwest and southeast market areas of Tucson where Tucson has experienced the greatest population growth. The following are a sample of land sales purchased for office development.

Notable Land Sales					
Sale Date	**Location**	**Use**	**Sale Price**	**Size**	**Price/SF**
09/19	Wrapping around the southwest corner Houghton and Old Spanish Trail	Northwest Hospital	$7,042,162	858,132	$8.21
05/20	North side of Linda Vista, west of Thornydale	VA office	$2,007,000	165,712	$12.11
08/20	18779 S. Nogales Hwy	Medical/Dental	$750,000	35,129	$21.35
10/21	South of Old Vail, west of Houghton	Medical office	$525,000	38,247	$13.73
07/22	6394 W. Linda Vista	TMC Hospital	$16,040,555	1,630,374	$9.84
07/22	10568 N. Oracle	Medical office	$1,225,000	45,674	$26.82

These sales show that there have been sales of land for specific users in a variety of areas. For smaller sites of under 50,000 square feet, prices can be over $20 if located in shopping centers or on major roadways, in areas with land competing against retail pad users. For larger sites, prices are lower but vary by location, frontage, and utility. Some small pads in developments may be purchased on a price per square foot of building area, which can generally range from $70 to $125 per building square foot.

There is land available for office uses throughout the Tucson market. This includes land zoned for office, as well as land located within newer commercial centers such as The Bridges or Irvington and I-19, where office or retail uses could be developed. There are also numerous office pads available in the Tucson market. Previously, many general or medical uses were developed in office parks, such as on Swan Lee Offices or off of La Cholla. There was also fairly recent development at the northeast corner of Fort Lowell and Alvernon. Most of these developments are built out, although some may have a limited number of pads remaining. One exception is at the Innovation Park area, which still has several parcels available for development. However, many medical users are no longer building offices in office parks, and are building outside of parks, including in larger commercial centers. This trend of building within large retail or mixed-use developments is expected to continue

There is some land available for development that is planned and available for development now. While much of this land could be developed with office uses, land may be developed with other uses when zoning and demand allows due to the limited office demand.

It is also noted that there are several proposed office and medical buildings available throughout the Tucson market. The vacant land is not for sale, but the properties could be developed with a medical or office building on a build-to-suit basis. This includes numerous potential offices at Innovation Corporate Center off Innovation Park Drive. Other opportunities include Swan Lee Offices, Houghton Crossings, Palisades Corporate Center, Oracle Vista Center, and La Cholla Corporate Center. Office or medical buildings are approved for pads in these areas and could be developed at any time in the future.

Redevelopment
As discussed, Tucson contains a large number of older office buildings that have significant depreciation and do not meet the modern standards of today's office users. The market also contains numerous large, high vacancy office buildings that are located outside of the areas of strongest demand for office uses. Areas for lower office demand include east, parts of central, by the airport, and parts of downtown. Many of these buildings have high vacancy rates. One question being asked is what will happen with these large, high vacancy buildings?

Some buildings were purchased in before or early in the pandemic, with plans for renovations and lease-up. However, this has proven to be difficult. In the current market, most large properties are being purchased by owner-users and not investors.

One example includes 2202 North Forbes. This 58,367 square foot office property was purchased in September 2019 for $2,800,000, or $44.55 per square foot, with the intention to lease up the property. The buyer made improvements to the property after this sale. In April 2023, the property resold for $8,200,000, or $140.49 per square foot. The property was about 25% occupied at that time, with low occupancy. However, the property was purchased by the State of Arizona to be fully occupied as an owner-user property, with an owner-user willing to pay more for the property than an investor.

The office complex at 7810-7840 East Broadway sold in September 2020 for $2,005,500, or $20.69 per square foot. This property consisted of three large office buildings and one smaller single-story office building. The property had an occupancy rate of about 30% at the time of sale; however, this was a short term lease due to expire in less than a year. The new buyer sold off the smaller building. However, the three large buildings were not leased out but were later traded to the City of Tucson.

In February 2020, the office building at 800 East Wetmore was purchased for investment purposes for $2,457,500, or $63.89 per square foot. It was approximately 10% occupied at the time of sale, with a total size of 38,464 square feet of building area. The buyer intended to lease the building. As of this writing, the property has 25,998 square feet of building area available for lease.

In January 2021, the 39,339 square foot office property at 655 East River Road was purchased for $2,045,000, or $51.98 per square foot. The buyer intended to lease the property, which was vacant at the time of sale. As of this writing, the property has had some success but a portion remains available for lease.

The office building at 5411 East Williams Boulevard was vacant and listed for sale or lease. The building contains 125,000 square feet of building area and is in the Williams Centre office park. The property could accommodate a single or multi-tenant office use with 25,000 square foot floorplates and two stories. The property was available on the market with no list price and offers due by a specified date. The property is currently in escrow at an undisclosed sale price with the buyer being an investor. It is unknown if the buyer plans to lease out the property or to convert all or part to another use.

Prior to 2020, Tucson contained numerous call centers, with many located in larger buildings. During 2020, call center workers began to work from home, and technology exists to support these employees to work efficiently remotely. Call center workers have not returned to the office, and many former call center buildings are now vacant. Market participants agree that call center workers will not be returning to the office, new call center leases are not being signed. There are not sufficient new tenants to use the former call centers in the current configurations. So how can the former call centers be utilized? Buildings that can easily be converted to other uses will be converted, and this has already begun. Some call centers were former industrial buildings such as warehouses. These buildings are being or will be returned to industrial uses. However, not all call center properties can easily be converted, particularly if they are not located in an area of strong demand or do not have physical characteristics that would allow for easy conversion. Buildings located outside of industrial areas or not property set up for industrial uses would not be converted to this use. Other former call centers remain vacant, with many vacant for several years. It will take creative solutions that will have to be found for each building, and this may take an extended period of time.

Tucson also has numerous large high vacancy building, with some being mid or high-rise towers. Many people have raised the possibility of converting these buildings to a multi-family residential use. Most market participants believe that converting office buildings to multifamily apartment buildings is unlikely to be a significant factor in the Tucson market, although it may happen more in other larger markets. Most office buildings cannot be easily converted to apartment use, as the floorplates are not easily divisible for this use, and the utilities are also not set up for this use. Other difficulties in conversion to multifamily include zoning and parking. Conversion to apartment use would be extremely expensive and difficult in most cases. While this may have been economically feasible when apartment rents were rapidly increasing, rental rate growth for apartments has slowed significantly. The conversion costs would be extremely high and not all offices have floorplates that would allow for easy conversion, with more difficult conversions adding to costs. In order to justify these high conversion costs, rents would need to be higher than would realistically be achieved in most cases, and it is unlikely to be economically viable to convert most office buildings here in Tucson to apartment use. While we may see limited conversion to apartment uses, market participants felt that this type of conversion would be limited in this market due to high conversion costs and inability to obtain high enough rents for conversion to be financially feasible. This might have been more likely when apartment rents were increasing rapidly but did not occur significantly in the Tucson market. One example of a possible exception is the sale of 1150 North 7th Avenue, which contains 24,412 square feet of building area and sold in November 2021 for $1,575,000, or $64.52 per square foot. The buyer has now obtained approval to convert the property to 35 residential units.

Government and zoning regulations can be modified to help with these conversions. Rezoning for higher density or high-rise development could allow conversion to occur in areas such as around Park Mall. Several market participants indicated that governments could do more to help with repurposing or redevelopment. This would include allowing more rezoning. Another potential idea is government entities helping with subsidizing construction costs or rents to allow conversion to multifamily uses. As conversion to multi-family uses is cost-prohibitive for many offices, government assistance with financing might help more of these conversions become financially feasible and increase rental property availability.

So, what will happen to these large high vacancy buildings if they aren't converted to apartments? Most market participants felt that some would struggle along as high vacancy office properties for a while. Some of these properties may eventually be given back to the bank and some properties will eventually sell at a substantially lower price. With a lower basis in the property, a new owner would be able to make renovations that would enable them to lease the properties. Many high vacancy properties are unlikely to be have substantial investments in the property until there is a new owner who has a lower basis in the property by purchasing at a lower price point. However, some market participants felt that Tucson is unlikely to see as many large office buildings turned over to the lender as will be seen in many large cities with higher vacancy rates. Market participants also agreed that some of these high vacancy properties will eventually be converted to other types of uses. These potential future uses will be dependent upon the property characteristics including size, floorplates, parking, utilities, location, and zoning, as well as conversion cost. Effective use of these properties will take creativity and may include uses such as assisted living or other uses not immediately considered.

Some buildings may be demolished for future uses. Many market participants indicated that many office buildings would ideally be demolished but this may not be financially feasible and so will not occur in a significant manner. Demolition is unlikely to occur for most office buildings unless the building is located in a prime location for a new use as the land value must be higher than the value of the property as improved to justify demolition and redevelopment. This is less likely to occur in mid or high rise properties with smaller land parcels for the large building size. While some of the office buildings with high vacancy are located in areas with limited office demand, there may not be strong demand for other types of uses in these locations either. The land value may not be adequate to justify demolition of many of these buildings. Overall, market participants agree that there is no easy solution to the problem of large, high vacancy office buildings, and these will continue to be an ongoing source of office vacancy in the future.

It is noted that some smaller office buildings are being demolished for redevelopment. The office property at 6403-6421 East Grant Road was purchased in 2023. The buyer demolished the existing office use and a new Super Star Car Wash is under construction on the 36,030 square foot site.

Another office building at 6565 East Grant Road was purchased in March 2021. The building was demolished with a new Popeye's constructed on the site.

Adjacent to this, an office property at 6601 East Grant Road was demolished with a new multi-tenant retail building currently under construction on the site. It is noted that all three of these properties are located on Grant Road between Kolb/Tanque Verde and Wilmot, with other recent redevelopment in the area and many other retail uses in the immediate area. These redevelopments would not be possible in all locations.

Factors Influencing Demand

One of the major factors influencing office demand in recent years is work-from-home trends. In 2020, during early Covid-19, many office workers began to work from home. Three years later in 2023, many of those office workers continue to work from home. While many companies have had employees return to the office full time, many others continue to work from home on a full time or part-time hybrid schedule. In many companies, employees are reluctant to return to the office full time, and employers attempting to bring workers back full time to the office have had various levels of success. However, more employers nationwide are indicating they intend to bring employees back to the office at least part time. Many employers feel that productivity and a sense of culture have declined during work-from home, and feel that returning to the office increases productivity.

Do local market participants feel that employers will succeed in bring employees back to the office full time? Market participants are a bit mixed on this question. Some market participants feel that most office employees will end up back in the office full time in the next few years. Others felt that while some would return to the office, many workers would remain working from home full time or on a hybrid schedule. Overall, the market is uncertain on how much of the office workforce will remain working from home.

How does working from home impact office demand? With employees working from home, many employees have office space that is leased and is sitting vacant or is considerably underoccupied. As leases end, the tenants give up these spaces. They may find that they need less office space and lease a smaller space, or have no lease at all if they have gone fully virtual. As was discussed earlier in this report, market participants indicated that this is considered "shadow" vacant space, and that when this shadow vacant space is considered, the actual vacancy rate may be up to a few percentage points higher than the reported vacancy rate. They also indicated that the vacancy rate may actually increase or at a minimum is unlikely to substantially decrease in the next couple of years as more leases end and are not renewed. While some of these leased but vacant properties are available for sublease, many others are not and sit vacant or underutilized by only a few employees. Owners should be aware that these leases will not be renewed when they end.

What other factors have we seen influencing office demand? One is the strong demand for medical offices. Some market participants discussed the ongoing demand, and felt that medical office has been substantially stronger than the general office market. There is a trend of small medical practitioners consolidating into larger practices for many years, and this continues with hospital associated practice groups continuing to grow. While this has impacted demand for the smallest spaces that might be used by one or two practitioners, these consolidated practitioners continue to need medical space. Some medical office users will pay a substantial amount of money to buy or construct a medical office building that meets their needs. As the population ages, there will continue to be demand for medical services. Medical usage has also seen an increase in specialty medical buildings, such as free-standing surgical centers, imaging facilities, or free-standing hospitals. These uses will continue to grow. Many of these buildings are constructed new at a substantial cost.

There has also been a continuation of the trend of office and medical/wellness uses locating within retail or shopping centers. Medical office uses, including dental offices and even vet offices, are locating in strip centers and shopping centers around town, often in spaces that would previously have been leased by a retailer. In pad strip centers, there are tenants who want the visibility from a strong location, and these tenants will often pay high rents to be in new buildings in strong locations. These users include dental users, physical therapy, and general medical users. Urgent Care clinics are frequently locating in shopping centers as well. Doctor practices may locate in a larger shopping center, as these users do not depend upon the direct street visibility and can be located in large centers without direct frontage on a major roadway. Office and medical uses are locating in mixed-use developments with greater demand from office users for this type of location. This is both more attractive to employees who prefer to work in walkable mixed-use areas as well as attractive to customers who may prefer to have retail and office uses in the same location. Financial services users have been locating in the foothills area, particularly around Skyline. Medical uses are increasing being developed in areas of residential growth, such as the southeast and the northwest market areas of Tucson.

One factor mentioned by several market participant is amenities. Strong amenities can increase demand for a property. While some buildings are being developed with amenities such as gyms and coffee bars, others found that these factors may not be enough to bring back tenants, especially if not well done. Well finished out lobbies and common areas are also a positive amenity as well as providing an inviting office space. Some common amenities mentioned include walkability and location within a mixed-use environment. There is a demand for office properties located in a mixed-use location with other uses such as retail, coffee, and restaurants located within walking distance. This is one reason why some office uses are locating within larger retail or mixed-use developments as this amenity is a strong positive factor for many tenants. This helps them attract and retain employees who enjoy working in this type of location. Overall, mixed-use development or nodes with amenities and uses where people who want to come together, and live with a variety of retail, office, and entertainment uses are planned for the future.

Another amenity mentioned by some market participants is safety and security. Employees want to work in areas in which they feel a sense of safety and with lower crime rates. This may mean additional fencing or on-site security. Cleanliness of the area is also a positive factor. Some market participants indicated that a lack of feeling of safety and cleanliness is one factor leading to lower demand in parts of the downtown market. Adequate windows and decent views are other positive amenities as well as adequate power and fiber for tech-oriented office users. One market participant indicated that fundamentals and not gimmicks are important to tenants. Good quality amenities are more important than gimmicks and quality of construction is important.

Financing is currently limited for office properties. Many banks have limited interest in lending for investment office properties due to the uncertainties in the office market. It is difficult to obtain new financing for office properties, so many are being purchased with all cash transactions. If new financing can be obtained, it is more likely to be for owner-users or for medical office properties, with many banks not looking to finance new general office properties for investment purposes. If new financing is considered, it would need to be with a credit tenant and a long-term lease, and all details would be thoroughly investigated by the lending institution.

For existing loans, financial institutions are in regular contact with borrowers, looking at the status of all tenants and leases in order to determine any risk factors. Interest rates have risen in the last year. Market participants indicate it is possible there will one more quarter point interest rate increase this year. It is uncertain what will happen in 2024, as interest rates may be held steady, or there may be one or two more rate hikes. It is also unknown if there will be a recession, which would impact financing and real estate demand. Overall, it is much more difficult to obtain financing for an office property, and that financing is more expensive with higher rates. Many banks are more focused on existing loans and clients rather than obtaining new office loans. As financing obtained earlier at lower rates eventually matures over the next few years, owners will have to make determinations as to how to proceed with their properties, and more properties could be sold in the future.

Market participants generally agreed that demand for general office is sluggish, and is expected to remain this way in the near future. What would help increase demand for office uses and help absorb that vacant space? One factor would be an increase in population. However, as this data from Eller's Economic and Business Research Center indicates, Tucson's population is growing at a slower rate than the overall state, and compared to Phoenix. Population growth is projected to continue to be slower here than in Phoenix, and is unlikely to rapidly increase.

Population - U.S., Arizona and AZ Metros - July 1st Estimates	2017	2018	2019	2020	2021	2022
U.S. Census Bureau						
United States	326,860	328,794	330,513	331,788	332,351	333,595
% Chg from Year Ago	0.69%	0.59%	0.52%	0.39%	0.17%	0.37%
Office of Economic Opportunity, Arizona Commerce Authority						
Arizona	6,884,547.21	6,982,246.2	7,082,092.57	7,176,401	7,285,370	7,409,189
% Chg from Year Ago	1.29%	1.42%	1.43%	1.33%	1.52%	1.70%
Flagstaff MSA (Coconino County)	143,553	144,982	146,611	145,697	147,434	149,647
% Chg from Year Ago	0.49%	1.00%	1.12%	-0.62%	1.19%	1.50%
Lake Havasu City-Kingman MSA (Mohave County)	205,846	208,393	211,782	213,985	216,527	221,105
% Chg from Year Ago	0.93%	1.24%	1.63%	1.04%	1.19%	2.11%
Phoenix-Mesa-Glendale MSA	4,622,153.22	4,703,295.52	4,786,297.03	4,864,924	4,946,547	5,040,355
% Chg from Year Ago	1.64%	1.76%	1.76%	1.64%	1.68%	1.90%
Prescott MSA (Yavapai County)	225,918	229,607	233,104	237,073	241,173	245,389.22
% Chg from Year Ago	1.78%	1.63%	1.52%	1.70%	1.73%	1.75%
Sierra Vista-Douglas MSA (Cochise County)	124,094	125,374	125,253	125,718	126,463	126,648
% Chg from Year Ago	-1.05%	1.03%	-0.10%	0.37%	0.59%	0.15%
Tucson MSA (Pima County)	1,021,153	1,028,511	1,038,205	1,045,589	1,058,318	1,072,298
% Chg from Year Ago	0.78%	0.72%	0.94%	0.71%	1.22%	1.32%
Yuma MSA (Yuma County)	200,595	201,032	202,457	204,722	207,318	209,920
% Chg from Year Ago	0.01%	0.22%	0.71%	1.12%	1.27%	1.26%

Published by Economic and Business Research Center.

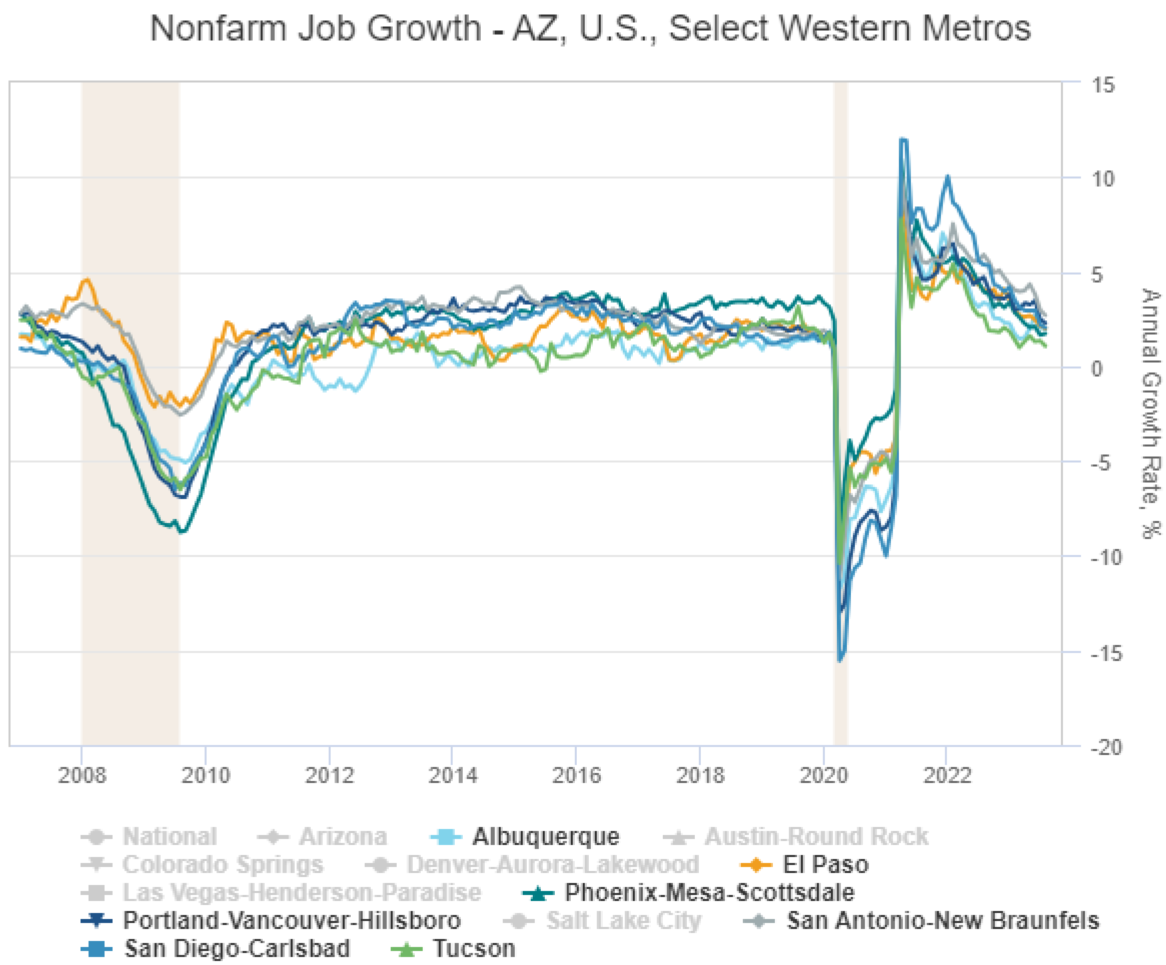
Looking at growth within the Tucson community, Eller's Economic and Business Research Center supports that growth is focused in the Marana and Sahuarita communities. As discussed earlier, many medical users are locating in the southeast and northwest areas as medical users wanted to be located within the communities with strongest residential growth.

Population - Tucson MSA (Pima Co.), AZ	2017	2018	2019	2020	2021	2022
July 1st Estimates, Employment and Population Statistics, Arizona Department of Administration						
Total Population	1,021,153	1,028,511	1,038,205	1,045,589	1,058,318	1,072,298
% Chg from Year Ago	0.78%	0.72%	0.94%	0.71%	1.22%	1.32%
Marana	46,103	48,064	50,313	52,643	55,174	56,758
% Chg from Year Ago	3.48%	4.25%	4.68%	4.63%	4.81%	2.87%
Oro Valley	45,151	45,909	46,721	47,208	48,222	48,906
% Chg from Year Ago	1.73%	1.68%	1.77%	1.04%	2.15%	1.42%
Sahuarita	30,451	32,254	33,389	34,378	35,588	36,179
% Chg from Year Ago	2.39%	5.92%	3.52%	2.96%	3.52%	1.66%
South Tucson	4,859	4,767	4,690	4,615	4,603	4,599
% Chg from Year Ago	-2.02%	-1.89%	-1.62%	-1.60%	-0.26%	-0.09%
City of Tucson	533,694	538,883	541,288	543,136	546,061	554,021
% Chg from Year Ago	0.90%	0.97%	0.45%	0.34%	0.54%	1.46%
Unincorporated	360,895	358,634	361,803	363,609	368,670	371,835
% Chg from Year Ago	0.05%	-0.63%	0.88%	0.50%	1.39%	0.86%

Published by Economic and Business Research Center.

How is employment growth in Tucson? Could that be a source of growth for office demand? The following is Tucson's unemployment rate, per the U.S. Bureau of Labor Statistics. Overall, Tucson unemployment remained low in early 2023, and was 3.2% for the first several months of the year. More recently, unemployment has increased slightly to 4.6% in July 2023 due to a combination of factors including increased interest rates, slowing and uncertain economy, inflation, and higher labor costs. Employment is growing in Tucson but is unlikely to grow at a rate that would rapidly increase demand for office uses.

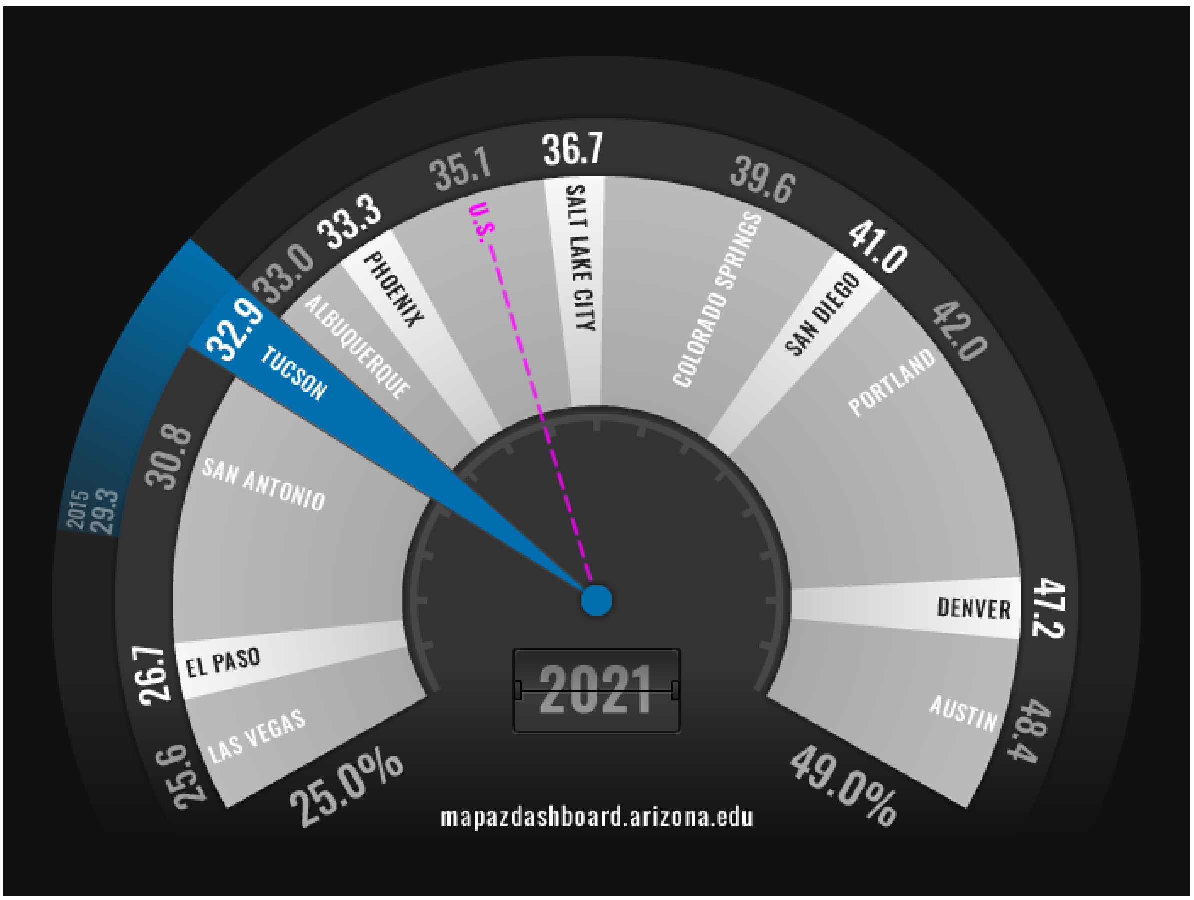
How does our employment growth compare to other western metro areas? Per U.S. Bureau of Labor Statistics data as charted by Eller's Economic and Business Center, the data below shows non-farm job growth in Tucson compared to other western metros including Alburquerque, El Paso, Phoenix, Portland, San Antonio, and San Diego. Tucson's unemployment growth is currently lower than all of these other metro areas, indicating they are seeing stronger job growth than Tucson.



One factor that would increase office demand in Tucson is the location of major national office tenants or more headquarters constructed in the Tucson market. More national tenants locating or headquartering here would increase demand for large office spaces and attract more attention from other tenants. However, market participants generally thought this was unlikely to occur in any substantial way. While we may occasionally get a new large office tenant or headquarters, this is not likely to occur in a significant number or to significantly increase office demand. There are many other western cities with much stronger demand for this type of user, such as Denver and Phoenix. These national tenants are likely already located in one of these locations, or would locate there over Tucson. Market participants mentioned several factors that impact Tucson's ability to attract national tenants in general, not just for office users. This includes a lack of direct flights to many cities, poor road conditions, and governments that are not business friendly. Some market participants indicated that local governments are not business friendly, and that it is not easy or cheap to get approval to construct a new building. These market participants felt that more flexibility and streamlining of processes by local government would help demand here. Some also felt that more regulations that allowed for flexibility of zoning and parking requirements would help with potential conversion of outdated or vacant office buildings to other uses.

Another factor mentioned was a lack of college educated employees to work in more tech-oriented offices. Many college graduates leave Tucson, and the lack of these employees is considered a negative factor for businesses considering locating in Tucson. Below is the four-year college attainment rate for the working age population from the MAP dashboard. This indicates that Tucson has a lower college attainment rate compared to Phoenix, the US, and many other western metro areas.

Four-Year College Attainment Rate for the Working Age Population (2021)



How does Tucson's office market compare to other western Metro areas? The following data is from CoStar and compares Tucson's office market statistics to other western metro areas. Overall, Tucson's office market is better than some metro areas while others have a healthier market area. Phoenix, Las Vegas, and Denver all have significantly more office space compared to Tucson. One market participant noted that some of these cities have a higher office space per capita compared to Tucson. This market participant noted that this is because these cities have stronger demand for office users, particularly for larger, national tenants and many have headquarters or a large presence in these cities. However, it is also noted that some of these cities may be struggling with this larger office supply per person when office demand drops. Currently, Tucson's vacancy rate is higher than some markets, such as Albuquerque and El Paso, similar to Las Vegas, and much lower than Phoenix, which has a vacancy rate of 16.1% and Denver with a vacancy rate of 16.2%. It is noted that most if not all of these metro areas may have a higher actual vacancy rate than is reported here if "shadow" vacancy is included, similar to Tucson. The Phoenix, El Paso, Las Vegas, and Denver metro areas all have net negative absorption in the year-to-date, with only Tucson and Albuquerque having net positive absorption. Phoenix, Las Vegas, and Denver all have higher rents. One market participant noted that previously, Tucson's office market might appeal to smaller tenants who did not want to pay the higher rents of the Phoenix market. However, due to the high vacancy currently in the Phoenix office market, while Phoenix rents remain higher than in Tucson, there are now some lower rents available in the Phoenix office market and more office lease deals available. Some potential tenants may choose to stay in Phoenix, even if rents are slightly higher there, in order to be in their preferred market, whereas before they may have moved to Tucson in order to have a much lower rent in Tucson. The lowering of some office rents in Phoenix will keep Tucson from being as competitive as it previously was with certain tenants. It is also noted that Phoenix has a bigger supply of space, with Tucson having a shortage of certain product types such as smaller spaces.

Office Statistics Comparison

Location	# Bldgs	Inventory	YTD Deliveries	Vacancy Rate	YTD Net Absorption	Asking Rates
Tucson	2,634	28,966,290	60,341	9.2%	283,528	$22.78
Phoenix	9,074	197,547,839	873,388	16.1%	-2,029,857	$29.40
Albuquerque	3,134	39,486,470	109,409	4.9%	104,830	$19.75
El Paso	2,567	25,348,150	24,634	5.6%	-62,668	$21.64
Las Vegas	4,143	69,398,321	297,884	10.5%	-456,083	$30.93
Denver	5,644	195,061,256	466,096	16.2%	-2,577,276	$30.81

Conclusion

Overall, Tucson's office market is hard to summarize in one word or phrase. While much of the general office market might be summarized as "sluggish" or "treading water", some parts of the market are doing well. The medical market remains a bright spot within the office category, with continued demand. There will likely to continue to be sales and new construction of medical office buildings, particularly in areas of greatest population growth.

Covid-19 led to many office employees working from home. Offices sat vacant. While many employees are back in the office full time, others work fully from home or on a hybrid schedule. While employers indicate they would like employees back in the office, it remains to be seen how many will go back full time. Office tenants may have given up their office space, or are going to smaller spaces. There is shadow vacant space that is leased but sits empty or minimally utilized. As more leases end and are not renewed, vacancy is expected to remain high, or even increase in the next couple of years. Work from home and hybrid schedules are likely to continue to some degree in the immediate future. This will continue to impact tenant needs.

Like much of our real estate, Tucson has many older office buildings that will require updating and modernization, with limited recent construction. Some owners struggle to achieve enough rent to make the needed improvements. Tucson has many high vacancy large office buildings. While some will be converted to other uses, others will sit vacant for long periods of time. Conversion to multi-family apartment uses will remain limited due to high construction costs but may occasionally occur. Conversion to other uses is also possible. It will take creativity to imagine new uses for some of these buildings, but conversion and new uses are possible for many. Government and zoning regulations can be modified to help with these conversions. Rezoning for higher density or high-rise development could allow conversion to occur in areas such as around Park Mall. Several market participants indicated that governments could do more to help with repurposing or redevelopment. This would include allowing more rezoning. Another potential idea that was raised is government helping with subsidizing construction costs or rents to allow conversion to multifamily uses. As conversion to multi-family uses is cost-prohibitive for many offices, government assistance with financing might help more of these conversions become financially feasible and increase rental availability.

Some of the older or high vacancy properties are being sold, or will be sold, at lower prices. A new owner with a lower basis in the property will be able to complete renovations and lease at an affordable rate. We will likely see more of these buildings selling at lower prices in the next few years.

Offices need to locate in areas with walkable amenities. Offices that do well have onsite amenities as well as the ability to walk to other amenities such as retail and restaurants. There will continue to be demand for offices in these walkable locations. Mixed-use development and offices locating within retail centers will continue to grow.

Overall, the office market has not imploded but remains slow. There is more pain to come for those involved in the office market, and there are no easy solutions to increase demand. Things will remain slow for the foreseeable future. But there is light at the end of the tunnel, and the office market will improve and grow again in the future.