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 Zillow Rated 5 ★★★★★*

The Skarphol Rapport[©]

Q2 - 2023

**A QUARTERLY MARKET
 UPDATE - FOR BUYERS,
 SELLERS, AND INVESTORS**



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*As Temps & Prices
 Soar...
 Cash Buyers steady!
 But...
 Borrowing Buyers
 Chill!*



*“When I feel the heat, I see
 the light.”*

Everett Dirksen

EXECUTIVE SUMMARY – RESIDENTIAL REAL ESTATE MARKET IN 60 SECONDS

The real estate market remains HOT...literally and figuratively! All area markets and price points remain favorable to sellers. However, inventory remains constrained with no significant increase in supply on the horizon.

Interest rate fluctuations and predictions dominate the headlines in discussions about the housing market. The FED focusing on manipulating the rates is applying a short-term solution to a long-term problem. For most, real estate is a long-term investment, so I believe national policy should focus on stabilizing and incentivizing the supply side of the equation versus using rates to whipsaw the market to the brink of recession. It takes years to add supply to the inventory, making stability and certainty critical to a successful robust supply chain. If there is a recession, it should be short, and the good news is that mortgage rates always decline in response to a declared recession.

Although it may take time to correct, economists are becoming vocal about recognizing a serious flaw in how the housing component is calculated and incorporated into the CPI and PCE index calculations. This flaw results in an over-weighting of the impact of housing appreciation in the CPI and PCE. In fact, if the housing component is removed from these indexes the actual rate of inflation is under 1%. Unfortunately, change will be slow and difficult, so bracing for the FED to manipulate rates is just treating a symptom and not resolving the underlying cause. The good news is the local economy is robust, inflation is slowing, and national unemployment remains at a record low.

LUXURY MARKET: All segments of the luxury market are appreciating and remain advantaged for sellers. Corporate profits have declined, the stock market is recovering and Q3 is typically slower as summer temperatures cool demand. Appreciation above \$2M has been 9.5% since December, so it is still a good time to sell and an even better time to invest as appreciation remains solid into the foreseeable future. Cash sales make up over 52% of this market and typically enable buyers to negotiate on price. There is also a steady supply of new high quality spec luxury homes featuring world class design, materials, and all the in-demand bells and whistles!

BUYERS (under \$1M): Increasing the FHA limit to \$530,150 and decreasing the PMI rate created opportunities for buyers resulting in a healthy increase in the percentage of sales to owner occupants to a level above 75%. Battered iBuyers focused on selling inventory so their competitive pressure facing owner occupants has diminished significantly. That said, volatile interest rates peaking above 7% have put a chill on potential buyers looking to enter the market.

Price appreciation has slowed to less than 3% since December, so the opportunity for buyers to secure a property during this lull in appreciation is a smart move. Inventory remains low but buyers can expect sellers to provide \$7,500 - \$10,000 in concessions and quality properties are still available.

Further, consider buying now with the expectation that the opportunity to refinance will present itself in the next 1-3 years and the property appreciation will more than offset the higher interest paid. Finally, the home mortgage interest is tax deductible on loans up to \$750,000.

SELLERS (under \$1M): Not a great time for flippers hoping for a quick turn as high interest rates have tempered buyer demand and purchasing power. Appreciation is also slowing to the rate of inflation increasing and making days on market more pronounced where homes are priced above the prevailing market. Most sellers that purchased 3 or more years ago still have substantial equity appreciation, so if the objective is to sell, then I recommend collaborating with a qualified buyer, making reasonable concessions to complete the sale as soon as practical. A surge in supply is not likely, but iBuyers may discount more heavily to cap losses which could result in price reductions in areas of concentrated iBuyer inventory. Market conditions are challenging, but I think if the strategy is to move-up or downsize, using specialized loan offerings from Knock for example, allow sellers to use their equity to purchase a new home, move into the new property and then allow up to 6 months to complete the sale. The cost is reasonable, usually 1.5% of the purchase price. Call for additional details if this might be of interest.

RENTALS: A disappointing short-term rental season during the recent Superbowl and increased regulation of short-term rentals has resulted in a surge of rentals to hit the market, especially in Scottsdale. Owners are adjusting by moving to a 12-month rental model so I expect rates to stabilize, and substantial reductions may precipitate as landlords adjust to cap monthly operating losses from holding a vacant property. High interest rates will keep some tenants in place, but new tenants will express demands for concessions and possibly free rent in the months ahead.

ADU's: GREAT NEWS AND BIG OPPORTUNITY FOR PHOENIX HOMEOWNERS AND BUYERS! Expanding the use of Accessory dwelling units (ADU's) or casitas through revisions to the zoning ordinance are on the City of Phoenix City Council Consent Agenda for September 6. Targeting expansion of options to preserve and expand affordable housing by 50,000 units, this change in the ordinance has the potential to be a windfall for savvy Phoenix homeowners and homebuyers. Adding a rental unit provides cash flow or provides living space for multi-generational living. In either case, the numbers make sense when adding square footage can increase the fair market value by \$275 - \$800 per sq. ft. based on comparables while the cost to add the square footage can be accomplished at 50% - 80% of the value added. Also, cost effective modular units are widely available online with even Costco and Home Depot offering solutions.

The bottom line for Phoenix homeowners is to invest in maintaining and improving the home incrementally versus deferring key maintenance. Next, invest in adding a casita for current utility and future rental. This advice works for homeowners as well as buyers looking for a property in Phoenix. Buying something that may need some fix-up and adding a casita is a smart way to work through a high interest period while adding value to enhance the outcome on a cash-out refinance when rates are lower. Call if you have questions or further interest in this strategy.

LAND OPPORTUNITIES: Lots are available at all price points, but due diligence is key as access, restrictions, water, and other utilities all impact the value and ultimately the ability to build on the lot. Paradise Valley is setting new records for land prices as the luxury market blazes on to satiate the seemingly unlimited demand for mega-mansions and properties in the \$2M - \$30M range. No cooling on the horizon!

KEY STATISTICS – Single-family homes:

Active Listings: **11,899 – up 3.7% YOY (Well below 25K average).** Listings Under Contract: **8,950 – down 10.9% YOY.**
Sales: **69,278 – lowest level in a decade** Sales Volume: **\$21B Q2 2023 versus \$28.6B Q2 2022 (INVENTORY IMPACTING)**

EXECUTIVE SUMMARY – COMMERCIAL REAL ESTATE MARKET IN 60 SECONDS

Multi-family: This segment was dramatically impacted by the rapid increase in interest rates. Resales at \$854M was an 85% decrease YOY. High rates also caused: a decline of 6.8% YOY in sales price per unit, a 13.6% decline in sales price per sq. ft., rents remained unchanged, and the vacancy rate increased to about 7%. All these data points portend a correction is in process that will bring some foreclosures on leveraged properties and probably soften rents in response to stabilizing vacancies. Despite these conditions, there are still 44,000 units under construction and another 31,000 planned. I expect cap rates to rise to a point greater than the prevailing interest rate, an inversion, which will ultimately reverse the negative trend.

Office: Substantial negative absorption of 1.6M sq. ft., rents remained unchanged, increased sublease activity, and no substantial new construction underway are evidence of a significant market correction underway in the office segment. High interest rates have added to the burden as companies and landlords seek a new normal for office workers. Vacancies remain high at nearly 27% with only the Camelback Corridor and Scottsdale Airpark submarkets showing a positive recovery.

Adding to the market disruption was the roll-out of 5G technology for high-speed internet access which emboldens the remote workforce movement. Also, the recent infrastructure bill passed by Congress is bringing almost \$1B in Federal funds to expand broadband access to rural, tribal, and other underserved areas of the State which will work to expand remote work employment opportunities.

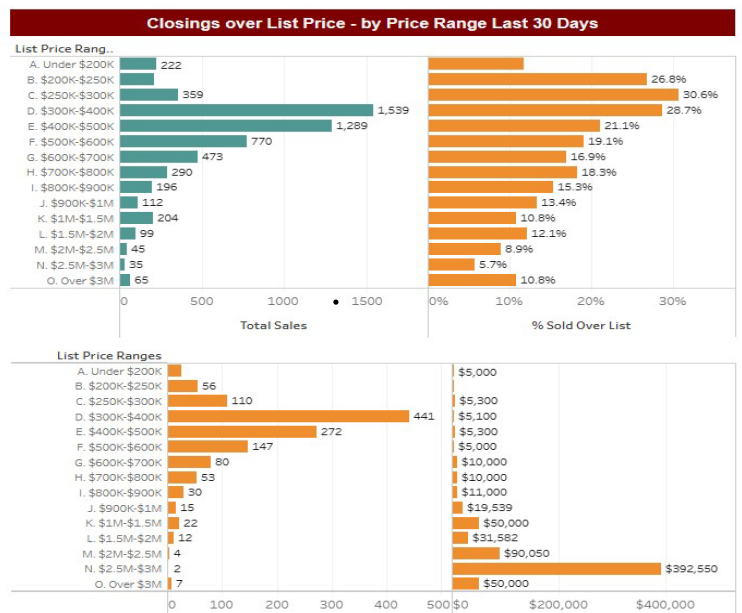
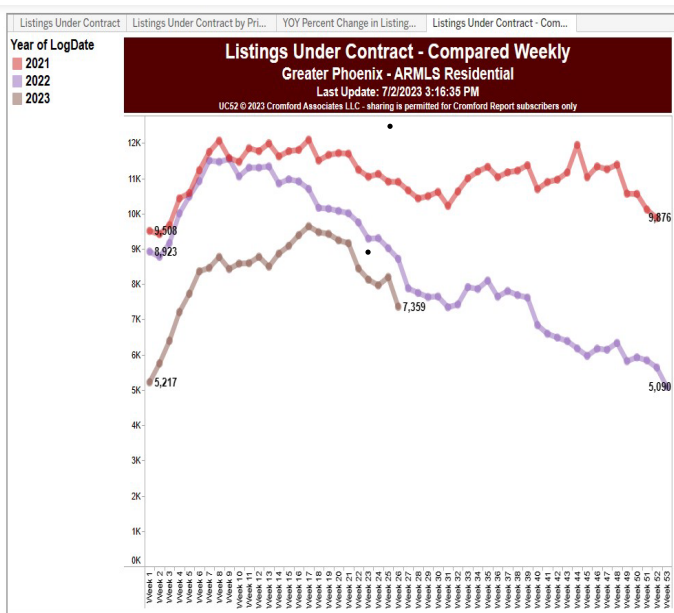
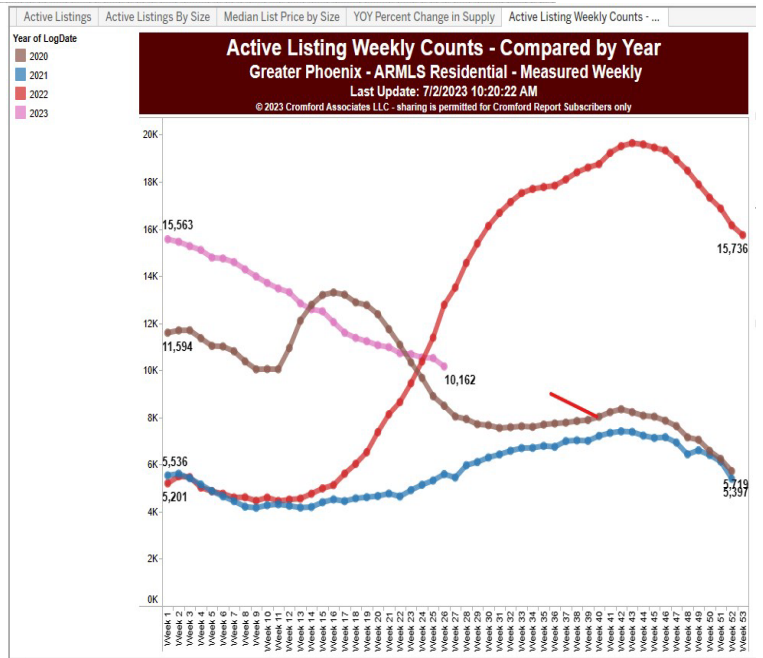
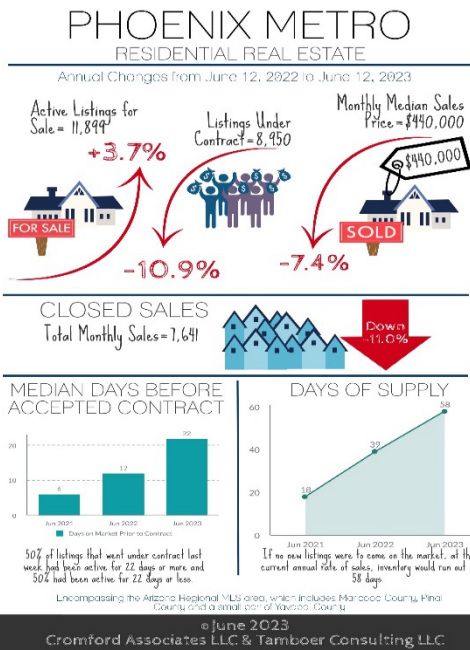
I expect this asset class to continue to decline in the foreseeable future given the negative market conditions and interest rate headwinds. Innovation and adaptive reuse can accelerate the turn-around with several office-to-residential conversions completing or in process with new projects in planning stages. This is very similar to the apartment-to-condo conversion adaptive reuse paradigm that occurred in the valley.

Medical Office: Rents increased over 7.5% year-to-date showing the continuing strength and expansion of this market segment. Seven medical office building projects are under construction of which 75% are pre-leased. In addition, two of the projects represent over \$100M in construction value for over 177,000 sq. ft. The segment has also experienced significant M & A activity with HonorHealth making a \$300M acquisition of 26 FastMED urgent care centers in the valley.

Industrial: Warehouse and distribution space construction, delivery, and leasing continues at a fiery pace. Over 54M sq. ft. are under construction currently with 10M sq. ft. that commenced construction in Q2. Net absorption is 5.5M sq. ft. year-to-date with a market vacancy rate remaining at 3.4% which is evidence of the continuing strong demand for industrial space. Rental rates remained steady at an average rate of \$1.11 per sq. ft. over all types of available industrial space. This segment is a good indicator of the underlying strength of the local economy. Currently over 200 companies are actively looking in the market to secure space with more than 100 companies requiring over 100,000 sq. ft. This sector brings new high paying manufacturing jobs and continues to expand the breadth and depth of industries served by the local supply chain.

Retail: Retail continues to recover with vacancies declining, rental rates improving, and adaptive re-use or redevelopment efforts rapidly adjusting the inventory. High interest rates will likely precipitate some foreclosures on marginal properties, but continued job growth has shored-up the retail demand. Metro Center and Paradise Valley Malls are both undergoing billion-dollar rebuilding projects that represent regional revitalization bringing jobs, new retail, and new housing opportunities to those sub-markets.

Land: This segment continues to show a robust underlying economy as thousands of acres are acquired, planned, and put into production for industrial and residential uses. Major expansion of the I-10 corridor towards Tucson foretells the creation of a Megalopolis forming between Maricopa, Pinal, and Pima counties. Significant investment in Pinal County related to the EV segment is anchored by Lucid and Nikola. Also, substantial acquisitions for supply chain vendors related to the TMS fab facilities and battery segment have been announced. Residential acquisitions in the southwest and southeast markets continue as water supply issues were resolved.



SOURCES: Michael Orr, The Cromford Report, The Information Market, Phoenix Business Journal, The Rose Law Group/Belfiore – Dealmaker
 ARMLS - the most accurate and comprehensive Arizona Real Estate Statistics and Data available

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