

Current and Future Market Conditions Q3 2020

Unlike Q2, which was stagnant as the majority of companies took the approach of “let’s wait and see,” where I debated over sending a report, this quarter, I feel that it is essential to get back to more traditional reporting and provide an update on the state of the CBD Office Market. Q3 produced 250,000/RSF of negative absorption, which has wiped clean Q1’s positive absorption. Today, the vacancy rate is back at 11% with 5M SF available.

The State of Things

The current climate is taking a true toll, particularly on small to medium-sized businesses and nonprofit organizations. These office space users have produced most of this quarter’s negative absorption. Corporate tenants, plaintiff firms, and larger users of space remain largely intact and are committed to their office space. Philadelphia is buffered with education, law, and healthcare. All these groups remain intact as well. For how long? I do not know, but let’s keep our fingers crossed that larger users of space do not begin to follow the same trend as the smaller users during Q3.

Philadelphia’s CBD has 45M SF of office space. On average there are presently 10% of occupants in their offices.

The Skies Are Ominous—Brace for a Sustained Storm

Lenders and landlords alike are nervous, of course, as small, and medium-sized companies are either going out of business or attempting to sublease. Businesses that were previously on the fence and were struggling pre Covid-19 have shuttered and closed their doors. Tenants are reluctant to commit to long-term leases. Landlords that have purchased their buildings in the past 5-7 years, refinanced their debt service, or done a combination of both, are particularly vulnerable. These landlords must retain their existing tenant rosters, fill vacancy, and meet their debt service—even if it means doing so and realizing less of a profit. Tenants with leases that are expiring within the next 12-24 months are addressing them—most are renewals that vary in length. Any tenant, specifically a tenant with solid credit that wants to take advantage of the current uncertainty, **can and should**. Covid-19 will inevitably result in longer uncertainty and will likely produce transaction terms that are far different than Pre-Covid, but I do not see this lasting once the Covid-19 Era is over. Ultimately, now is the time to negotiate more aggressively than what you were able to do prior to the pandemic.

Could There Be a Reduction in Rates?

Currently, construction pricing has not changed and while one would believe that general contractors might be inclined to bid more aggressively today, when compared to pre-Covid, especially since there are fewer projects, the reality is they are faced with a variety of issues that are well outside their realm of control. So, ultimately, pricing is largely existing in a holding pattern of sorts.

Below are the current quoted rental rates: The key word here is “quoted.” Please keep in mind that these numbers do not accurately reflect how landlords are currently addressing transactions:



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- Trophy Class space is priced at \$43.00/SF
- Class A space is priced at \$35.50/SF
- Class B space is priced at \$28.25/SF
- Class C space is priced at \$23.50/SF

I truly do not think there will be a big or sudden drop in office rents—vacancy is too low. If I were a betting man, I might say to expect a 5% reduction, with the exceptions noted above. To those who think that there might be a bunch of tenants that default, of course, that is a maybe—and if this does happen, evictions and defections are not immediate, they tend to take time. Commercial office space leasing lags the national economy by 24 months, and historically, Philadelphia follows other major markets by 6 months. My point is it will take years to feel the effects of tenant default. We are not going to see 2M-3M SF (5% +/-) of CBD office space tenants default in the next few months. For instance, in 2009-2011 the vacancy rate was 16%. For our market to reach those levels and once again become 16%, 5M SF of space would need to come back to the market.

Larger tenants that have the wherewithal to keep their employees out of the office continue to do so and may indefinitely or at least until there is a verifiable and deployable vaccine for Covid-19.

Conclusion

In my opinion, I believe there will be a vaccine at some point in Q1 of 2021, but even with that development, it won't become available to the everyday person until at least Summer 2021. I believe the employees of most businesses will begin to trickle back to their offices during the summer months, with most users returning in September 2021.

At the end of the day, no one, myself included, has a crystal ball and knows what the future holds. The best we can do is remain vigilant and aware of what is happening around us so that we are able to act and/or adapt when faced with any new developments.

So, in the meantime, stay safe, stay healthy, and let me know if you have any questions or if there is anything I can do for you.