Current and Future Market Conditions Q1 2012

The Philadelphia Central Business District's (CBD) sea-saw of positive versus negative absorption trend from quarter to quarter continues in Q1 2012, with 68,000 square feet of positive absorption. This brings the total vacancy in the CBD to 5.5 M SF. Overall vacancy rates remain flat at 13.7%.

Leasing in the Trophy buildings located primarily on Market Street West remains strong through Q1 2012. Ballard Spahr recently announced they will relinquish two full floors and make a new 13-year lease commitment for 180,000 SF at Mellon Bank Center and Marsh McLennan consolidated offices from Two Logan Square into Three Logan Square where the insurance giant leased 108,000 SF and inked a new 12-year lease. As a result of the tightening in the trophy buildings located on West Market St., Class A landlords are seeing a much needed and anticipated flurry of activity. This activity will continue to strengthen Class A fundamentals and will most likely result in continued positive absorptions for the balance of 2012 throughout the market.

Cross Properties announced they will purchse1616 Walnut St. and convert the historic 232,863 SF building into multifamily housing. This announcement has created chaos in the Class B/C buildings located along South Broad St and the Chestnut/ Walnut St sub markets with small tenants looking for new homes. As a result of this conversion, the amount of available space in these submarkets will decrease, simultaneously decreasing the vacancy in the Class B market.

The lengthening of deal terms continues to be a common theme. As of late, tenants are taking advantage of the down economy. The abundance of available space enables them to secure lower base rents for longer periods of time during transaction negotiations. When possible, tenants continue to take full advantage of this opportunity to move into upgraded spaces without paying the historic premium between asset classes. This “flight to quality” still exists, but may be gone before you know it.

As the pipeline of existing and new business diminishes construction companies are pricing tenant’s fit-outs more aggressively. When space has residual value and existing conditions can be reused, pricing for build-outs can be astonishing. Unlike previous recessions, most build-outs today can be achieved with the landlord’s capital.

Justified or not; landlords are beginning to hedge their bets with all of the new activity and asking rates inched upward in Q1 2012 from $26.00 SF to $26.50 SF for Class A space, $23.00 SF to $23.25 SF for Class B space, and $19.00 SF to $19.50 SF for Class C space. The asking rates are the weighted average of the published rate from all vacant spaces per building class. Aggressively negotiated transactions continue to be discounted within the 80% to 85% asking range.

In summation, while small to mid-sized tenants are beginning to stabilize and often expand, the downward pressure the larger users (100, 000 SF+) of space are placing on the market by becoming more efficient and shedding unneeded space will continue to allow tenants to enjoy low occupancy costs with a variety of options. Meanwhile landlords, who own assets that are worth less than the debt, will continue to struggle to compete with institutional landlords and REITs who have the necessary capital to maintain their existing tenant rosters while simultaneously trying to entice and fund new transactions.

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