Current and Future Market Conditions Q3 2012

The Philadelphia Central Business District's (CBD) sea-saw of positive versus negative absorption trend from quarter to quarter continued in Q3 2012 with 128,112 square feet of positive absorption. This brings the total vacancy in the CBD to 5.4 M SF. The overall vacancy rate remains flat at 13.5%.

Despite The Pew Charitable Trust downsizing from 80,000 square to 25,000 SF in One Commerce Square leasing in the trophy buildings located primarily on Market Street West remains strong through Q3 2012. After 31 years, Cozen O Conner recently announced they will vacate 1900 Market Street to lease 202,000 SF of trophy space located in One Liberty Place. Morgan Lewis & Bockius announced they will renew 300,000 SF at 1701 Market Street. Reed Smith announced they will relocate from One Liberty Place to Three Logan Square where they will occupy 121,000 SF and signed a long-term lease. Janney Montgomery Scott relocated 146,000 SF from 10 Penn Center to Three Logan Square. As a result of the tightening in the trophy buildings located on West Market Street we find vacancy in trophy assets to be 6.2%, and an abundance of vacancy in Class A buildings.

Investor interest in value-added opportunities continues to drive tightening of Class B product. Spurred by the first quarter sale of 1616 Walnut Street, small tenants with less than 5,000 square feet have inundated the market. Class B buildings located on South Broad Street and in the Chestnut Street / Walnut Street submarket have been the benefactors.

The lengthening of deal terms continues to be a common theme. Tenants continue to take advantage of the down economy. The abundance of available space enables Tenants 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” is very prevalent and will continue for the foreseeable future, or at least until the CBD enjoys positive absorption in the neighborhood of 1,000,000 SF.

Unlike previous recessions, most build-outs today can be achieved with the landlord’s capital.

Lease flexibility is a relatively new concept that has emerged during this down cycle. Properly leveraged transactions enable tenants to enjoy the right to expand, contract or terminate their leasehold at specific times throughout their lease term. These options typically de-value an asset, but whether landlords like it or not, these accordion-style leases that give tenants contraction and termination options remain key components to any new lease.

Justified or not, asking rates remained relatively flat in Q3 2012 at $26.50 SF for Class A space, $23.25 SF for Class B space, and $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.

While there have been both positive and negative shifts to the CBD thus far this year, we can expect to continue to enjoy a very tenant friendly office environment for Class B tenants looking to upgrade their space and Class A tenants looking to leverage their tenancy for aggressive long term transactions with plenty of lease flexibility. For those who believe the tightening of the trophy assets and flurry of activity Class A landlords have enjoyed, means we are approaching the end of our down cycle, they are wrong. The flurry of activity will result in either 1) tenants’ playing musical chairs, or 2) aggressively leveraged renewal transactions with lower base rents, and even greater tenant concessions. The good news for landlords is that tenant’s occupying trophy space will be hard pressed to find alternative space and renewals will come at a premium

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