

Current and Future Market Conditions Q1 2020

The first two and a half months of the New Year picked up where 2019 ended—transaction velocity across the CBD remained robust and absorption was healthy with 150,000 absorbed. With two weeks left in the quarter, the global pandemic that we now know as COVID-19 brought the CBD and the rest of America to a screeching halt. In the end, the CBD's vacancy rate dropped to 10.7% with 4,850,000 SF available.

The COVID-19 global pandemic event combines significant financial deterioration, both on an individual level and a corporate level, with personal safety and health risks in the forefront. It is far too soon to know where this will settle, but it is safe to say that office users will be presented with an opportunity to recast the real estate cost structure. With the end of the longest economic expansion in generations, Philadelphia's CBD entered 2020 with extremely healthy, often landlord-favorable, fundamentals. As landlords and office users begin to realize the economic impact of the COVID-19 crisis to the economy, office tenants will be faced with pain but also with opportunity.

Reactions We Should Prepare For:

- The supply of direct and sublease space will increase, providing tenants an element of leverage to open discussions with their landlords to find cost-reduction opportunities. And landlords will likely be forced to cooperate, given their own challenges.
- Often overlooked are clauses such as: Default, Hold Over, Force Majeure, Substantial Completion, and how Rent Commencement is defined. Understanding these clauses are essential.
- Tenants with leases scheduled to expire and who have signed a new lease at an alternative location should look closely at the construction processes and hold-over provisions. A laser focus should be placed on force majeure issues and business interruption remedies and relief.
- Co-working space has had an enormous impact on Philadelphia's office market, with 1.5M SF absorbed the past 5-7 years. One wonders how these workspace phenomenon's will fare? Time will tell.

Items to Ponder:

- In general, a tenant is not released from its obligation to pay rent by reason of the tenant ceasing to use the premises. Under most office leases, damage to the premises by fire or other casualty (the term used in a typical lease) is an exception to this rule. If a particular premises happened to be contaminated by the COVID-19 virus, that might be considered a casualty, depending upon the language of the lease. Once the contamination is remedied the abatement would cease. If the premises are not

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contaminated and are vacated solely as a precaution (even a legally mandated precaution) then that would not be considered a casualty. An exception to this may be if a tenant is no longer able to occupy their space and it is caused by a failure of the landlord to provide access or services, then rent should be abated by way of the Interruption of Services section of your lease. Under the language of most leases, this exception only applies if the failure to provide access or services is the fault of the landlord and not force majeure.

- Tenants will be hard pressed to find rent relief with landlords—it's too soon. Simply going to your landlord and asking for rent relief without first having exhausted all government stimulus packages will result in pushback. If you have exhausted all stimulus packages and are still in need of relief from your landlord, be prepared to show proof of your applications for stimulus relief and to share your balance sheet and receivables. There are two scenarios that may be available to you: 1) Your landlord will forgive rent for a specific period of time, and when your agreed upon time is up your landlord will then take the value of your forgone rent and increase your rent accordingly going forward; or 2) in exchange for rent relief for a specific amount of time, likely 3-6 months, your landlord will request an extension of your lease. Some landlords may require both, forgone rent added back into your remaining lease obligation and a term extension.

Statistically speaking, rental rates saw new highs in three of four categories.

- 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

To Conclude

There will be considerable evolution within Philadelphia's office market, and it's likely going to be in favor of tenants. However, COVID-19 will also make less of an impact here when compared to other office markets. Why? Because of the high concentration within Philadelphia's office market of federal agencies as well as businesses that operate within education, healthcare, and law. I believe that all, save for the legal industry, will be insulated.

At the same time, while I believe there will be change, it is impossible to predict just how much change will transpire. I do not believe rental rates will plummet, or landlords will stop offering significant capital allowances and abated rent. Will office rents recede 5% +/-? Possibly. And likely.

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I believe the most significant changes will be with rental escalations that have increased annually to as much as 2.5%-3% of the preceding year. Furthermore, tenants will enjoy lease flexibility—with Contraction and Termination options becoming front and center and a part of every negotiation. If they aren't, well, let's just say that they should.

The largest unknown obstacle for both tenants and landlords will be the backlog of construction in Philadelphia. This could potentially have a ripple effect for everyone. It remains to be seen how this will pan out—because remember, any supply chain is only as efficient as its weakest link. It will be necessary to watch this closely as the days pass and new developments present.

In closing, this is a historic time for all us—not just here in Philadelphia, but the world over. There is not a single person who has ever faced what we are going through right now—and there is no sense in devoting time and energy to stressing and worrying about things and situations that are utterly beyond our individual control.

It is my wish that our lives will return to normal sooner, rather than later. But in the meantime, I truly hope that you and your loved ones stay healthy and well. Follow all precautions set forth by the CDC, the WHO, and other agencies, practice social distancing, and do your part in flattening the curve.

We are all in this together. Stay safe.

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