

Current and Future Market Conditions Q4 2019

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Transaction velocity across the CBD increased during Q4. Overall, 100,000 SF of positive absorption was recorded, which brought the year-to-date net absorption to 300,000 SF. Inbound demand and organic growth continue to fuel the CBD’s rental rate growth to new heights. For example, Hana—another co-working operator—inked a new 15-year lease on 55,000/RSF spanning two floors at 1818 Market Street. Atlanta-based Fisher & Phillips, a leading labor and employment law firm, announced they would relocate 20,000 SF from Radnor to Two Logan Square, representing a significant shift in their demographic target base. These small yet subtle shifts in location by suburban tenants have further solidified that Philadelphia is the place to be when it comes to working, living, and playing. For employers, it is a talent hotbed with a deep bench that allows for considerable choice. In the end, the CBD’s vacancy rate closed the year at 11% with 5,000,000 SF available.

Ultimately, transaction components that comprise a successful lease transaction are much different today than they were 10 years ago. Therefore, let’s take a quick examination of the past decade.

A Decade in Review

Transaction Components	2009	2019
Lease Term:		
Renewals:	3-5 Years	7-10 Years
New Transactions:	7-10 Years	13-15 Years
Base Rent:		
Trophy:	\$35.00/RSF	\$43.50/RSF
Class A:	\$27.50/RSF	\$36.50/RSF
Class B:	\$21.00/RSF	\$29.00/RSF
Class C:	\$19.00/RSF	\$23.50/RSF
Annual Escalations:	\$0.50	2.5%
Tenant Improvement Allowances:	\$4.00/RSF-\$5.00/RSF per year of lease term	\$6.00/RSF \$7.00/RSF per year of lease term
Abated Rent:	1 month per year of lease term	½ month per year of lease term
Lease Security:	15%-20% of the transaction value	2-3 Months of Base Rent
Termination Options:	Standard Operating Procedure	Difficult to Obtain
Renewal Options with Meaningful Terms:	Standard Operating Procedure	Non-Existent
Expansion Options:	Standard Operating Procedure	Non-Existent to Difficult to Achieve
Contraction Options:	Common to Difficult to Achieve	Non-Existent



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Buildout & Move Related Expenses	2009	2019
Construction Buildout	\$35.00/RSF-\$50.00/RSF	\$80.00/RSF-\$100.00/RSF
Soft Costs:		\$3.00/RSF
Cable & Wire:	\$3.00/RSF	\$4.00/RSF
Architect & Engineer:	\$2.00/RSF-\$3.00/RSF	\$5.00/RSF
Physical Relocation:	\$3.00/RSF	\$2.00/RSF
Construction Management Fee:	0%-2%	2%-3%

Notable Success Stories

Kudos to 1818 Market Street—the building is currently 92% occupied, ownership has retained its largest tenants, and they have also attracted credit worthy tenants who will be sustained well into the next decade. Additionally, ownership has leased most of the vacant space in the building. In 2015, 1818 Market Street was purchased by Shorenstein Properties from Daymark Realty for approximately \$185,000,000 or \$185/RSF. Today, Shorenstein is actively seeking to sell the building for more than \$300,000,000 or \$300/RSF. When this happens—and it will—the sale price will set a new highwater mark for Class A office buildings in Center City. As a result, any new owner will seek a premium over today’s rates, which are currently at an all-time high.

Pertinent Developments

American Realty Partners, owner of 1600 Market Street, is seeking to mimic the playbook that has made 1818 Market Street’s lease up so successful. The building’s lobby and street exposure are in the process of being enhanced. What’s more is that the building is also offering a new restaurant with outdoor seating, constructing a new tenant-only gym, and building common area space for tenants to congregate and work. These upgrades will justify higher-than-market average rents, which allows them to simultaneously offer significant capital improvement allowances, and thus will inevitably lead to long-term lease stability. I expect this trend to continue; for example, Centre Square, in an effort to lease 250,000 SF of vacancy, has begun their revitalization by embarking on a transformative renovation to the ground floor of the complex, which includes the exterior plaza, Market Street retail, interior lobby, and concourse level. I expect Centre Square to follow the same path as 1600 Market Street and 1818 Market Street. Today, it’s true that rates are well below market averages; however, I believe that will change during 2020 as the building showcases their renovations and embarks on a successful lease up. If you are a landlord and your building is weathered, it doesn’t offer tenants modern-day amenities, and you are not well capitalized, let me inform you that you are operating at a disadvantage. If a tenant in any of these buildings desires new space or a significant renovation, it will be difficult for them to be retained, especially if they are well represented.

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Future Predictions

Historically speaking, Philadelphia's office market has lagged other major metropolitan office markets by 18-24 months and the national economy by 24-30 months. With few signs that either are slowing down, I believe Philadelphia's office market will remain healthy for the foreseeable future. Additionally, "Shadow Space" (space that is occupied but will become vacant in the future) totaling more than 750,000/RSF will reach the market in 2020. Although this new vacancy is second generation space, possesses little to no residual value, and will require new construction by any tenant who chooses it as their own, I believe it will impede the CBD's rental rate growth in 2020. Tenants will have more options and competition for tenancy is set to become increasingly more heated than landlords are accustomed to, particularly for larger users of space. Therefore, I am forecasting healthy absorption for 2020. I anticipate that the CBD's rental rate growth will begin to stabilize and transaction parameters, including rates, will hover at current levels.

In closing, I hope you find considerable value and benefit to this report. This information is compiled and penned by me on a quarterly basis—and not by a corporate marketing department. I send this report to my clients and prospects with the hope that it offers you some considerable flavor and insight into the CBD's office market. Please do not hesitate to reach out to me with any additional comment or questions that may arise while reading. Thank you!

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