Current and Future Market Conditions Q3 2014

The Philadelphia Central Business District ("CBD") made huge strides in Q3 with 350,000 SF of positive absorption, bringing the year-to-date absorption to 492,000 SF. 5.2 million SF remain available, and the CBD's vacancy rate dropped to 12%. For comparison purposes, at the peak of the market in 2007, vacancy was below 10%, and the total vacant space was just under 4 million SF.

Q3 saw inbound demand and organic growth. Hill International, a South Jersey-based construction company, announced that it would relocate its global headquarters from South Jersey to One Commerce Square, where they have leased 60,000 SF for 12 years on floors 16 and 17. vXchnge, a data center service company, entered the CBD this quarter with a 10 year lease of 70,000 SF at 1500 Spring Garden Street. The University of Pennsylvania Health Systems renewed its lease in Centre Square through 2021 and leased an additional 56,000 SF. The healthcare giant now has a total of 234,000 SF in the building.

Cigna Corporation continues its search for 300,000 SF, a substantial 150,000 SF reduction from its current footprint of 450,000 SF in Two Liberty Place. The Radian Group has entered the market and is seeking 150,000 SF. Obermayer Rebmann Maxwell & Hippel, LLP, a long-standing tenant occupying approximately 86,000 SF of the top three floors of Suburban Station, is seeking 50,000-60,000 SF. Accounting firm EisnerAmper, based in Jenkintown, is seeking 50,000 SF. Mellon Bank is still looking for 60,000 SF. Lastly, Comcast Corp may be leasing an additional 75,000 SF from Brandywine Realty Trust's Two Logan Square.

Despite all this inbound demand and positive growth, those storm clouds mentioned last quarter are coming to fruition. Major upcoming losses spread out over the next two years threaten to offset the current healthy market. Sunoco exercised their termination option and will leave 200,000 SF in Mellon Bank Center in September of 2015. ExcelleRx is vacating 125,000 SF in Three Parkway. The American College of Radiology lost its funding and will be vacating 45,000 SF on the 15th and 16th floors of 1818 Market. And, lest we forget, Comcast will be occupying its own building, the Innovation and Technology Center, when that is completed in two years. That will leave the CBD spiraling to backfill nearly 400,000 SF of former Comcast space spread out over several buildings.

Another indicative trend is the flurry of buildings for sale in the CBD. There is an unusual amount of Class A and B buildings for sale, including 1515 Market Street, 1650 Arch Street, 30 S. 17th Street (United Plaza), 1760 Market Street, 1818 Market Street, and 1835 Market Street. 1601 Market Street is undergoing a recapitalization, and the newly converted condominiums at 1616 Walnut Street are for sale as well. It will be interesting to see who acquires these assets; I'm curious to see what external investors think of Philadelphia's real estate and how such acquisitions will impact future rates.

Statistically, rental rates remained flat, with Trophy Class Buildings at $37.00/SF, Class A space at $27.25/SF, Class B space at $23.50/SF, and Class C space at $20.00/SF. The asking rates are the weighted average of the published rates from all vacant spaces per building class. While tenants still command a fair amount of leverage, many landlords are making fewer concessions, particularly for renewals. Also, annual percentage increases in rent, as opposed to fixed bumps of $.50, are creeping back into the market.

At the present time, the CBD is trending in a healthy positive direction, but the surprising number of buildings for sale and the skyrocketing amount of space that will become available in the next two years is disheartening. There is another foreboding sign; Brandywine Realty Trust, the city's largest landlord, has been towing the upper limits of rental rates and becoming more and more vested in the CBD. They are pushing prices up, and most, if not all of the CBD's landlords are following suit. As a result, rates in Class A and B buildings have risen 10-15% over the past 5-7 years.

In Q2, there was an abundance of vacancies in select buildings in the market. These holes still exist, but they are quickly diminishing thanks to inbound demand and the growth of small to medium-sized law firms, financial services firms, consulting firms, and the ever-expanding education and healthcare sectors. Tenants with leases expiring in 2015-2016 should begin to address their pending real estate requirements 15-18 months prior to their lease expiration date. This will allow sufficient time to establish the leverage needed for optimal economic results in a market on the brink of changing tides.