Current and Future Market Conditions Q4 2012

After a positive end to 2011, 2012 was a disappointment with 212,000 SF of negative absorption in the CBD. Vacancy has increased from 13.5% in Q 3, to 14.5% to conclude 2012. This brings the total vacancy in the CBD to 5.8 M SF. For comparison purposes, at the conclusion of 2011 vacancy was 13.7%, and the total vacancy in the CBD was 5.45 M SF. 2012's setbacks are due in large part to sizable tenants downsizing. At the peak of the market in 2007 vacancy was sub 10% and the total vacant space was just under 4M SF.

Perception vs. Reality:
The asking rates in the CBD are $25.50 SF for Class A space, $23.00 SF for Class B space and $19.00 SF for Class C space. The asking rates are the weighted average of the published rate from all vacant space per building class. **Aggressively negotiated transactions continue to be discounted in the 80% - 85% of asking range**.

Landlord Concessions:
Free rent is extremely prevalent in today's market with tenants receiving one month or more for every year of lease term. A once reluctant landlord community has slowly come to the realization that contraction, termination and expansion rights are essential to any new lease document. Tenant improvement allowances have ranged from $30/$35 SF in Class B buildings to $40/$50 SF in Class A buildings.

Renewal vs. Relocation:
The most attractive transaction to a landlord is a renewal. There is limited capital outlay, and virtually no downtime. Until the market is fully leveraged with viable relocation alternatives, renewals will continue to be high. In a market that is 14.5% vacant; tenants should continue to take advantage of the unstable economic climate and begin to address real estate relocations and renewals 15 to 18 months prior to their present lease expiration date. New opportunities continue to emerge daily. Relocation alternatives with **adequate leverage and time** will enable tenants to achieve similar economic concessions, regardless if you elect to relocate or renew.

Lease Securitization:
Due to a significant amount of capital being expended for new construction or improvements to existing space, today's landlords are much more focused on the credit-worthiness of tenants. Landlords will look to deposits and letters of credit for security. Lease securitization ranges from 20% to 40% of the transaction costs depending upon the credit-worthiness of the tenant. Lease security, like landlord concessions, free rent, and annual rent are highly contested and should be addressed early in the decision making process.

Landlord Capital:
As landlords want to be assured of their tenants' financial stability, tenants should also be comfortable that existing and future landlords are stable and able to fund transactions. Early in the process, tenants should be asking landlords to furnish documentation from their prospective lenders to provide proof they are in good standing and able to fund new transactions. Any lease document should insure a tenant's right to offset their base rent as a remedy in the event the landlord cannot perform services or fund tenant improvements.

Leasing activity among major tenants in 2012:

- Cozen O'Connor announced they would vacate 1900 Market Street after 31 years and relocate to One Liberty Place where they will occupy 202,000 SF.

- Morgan Lewis & Bockius renewed its lease at 1701 Market Street for 289,432 square feet.

- Ballard Spahr LLP relinquished two floors in Mellon Bank Center and signed a new 17 year lease commitment for 180,000 SF.

- Temple University renewed its lease for 120,000 SF in 1515 Market Street.

- ACE American Insurance Company downsized within Penn Mutual Towers and leased 141,000 SF for 10 years.

- Philadelphia Media (Inquire) relocated to 801 Market Street and leased 100,000 SF.

- Reed Smith announced they will be relocating from One Liberty Place in early 2014 to Three Logan Square where they leased 115,000 square feet.

- The Philadelphia Parking Authority will relocate from 60,000 SF at 3101 Market Street in University City and move into 80,000 square feet in 701 Market Street where they committed to a 50 year lease term.

- Drexel University expanded at Three Parkway from 40,000 SF to 150,000 SF and signed a new 10 year lease.

- Marsh McLennan consolidated its offices in Two Logan Square and Three Logan Square and signed a new long term lease within Three Logan Square for 110,000 SF.

- The Pew Charitable Trust downsized from 80,000 SF to 25,000 SF in One Commerce Square.

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Building comparison with the most vacancies:	2010	Vs	2011	2012
Mellon Bank Center	*297,116 RSF		*230,313 RSF	*231,108 RSF
2000 Market Street	*257,083 RSF		19,320 RSF	28,312 RSF
1717 Arch Street	461,367 RSF		245,817 RSF	142,675 RSF
Penn Mutual Tower	160,045 RSF		145,998 RSF	177,282 RSF
1818 Market Street	211,143 RSF		215,065 RSF	209,846 RSF
10 Penn Center	134,860 RSF		275,587 RSF	244,168 RSF
260 S Broad Street	155,077 RSF		177,910 RSF	172,120 RSF
1700 Market Street	202,006 RSF		137,038 RSF	137,780 RSF
One Commerce Square	122, 750 RSF		56,548 RSF	184,936 RSF
Two Commerce Square	143,666 RSF		222,730 RSF	189,960 RSF
1650 Arch Street	198,879 RSF		170,993 RSF	40,028 RSF
1500 Market Street West	459,426 RSF		425,575 RSF	423,208 RSF
1500 Market Street East	125,456 RSF		142,736 RSF	143, 736 RSF
100 Independence Mall West	161,896 RSF		161,896 RSF	161,896 RSF
Two Logan Square**	N/A		70,780 RSF	218,091 RSF
One Logan Square**	N/A		11,175 RSF	62,658 RSF

*Sublease/Direct
** New Addition

Trophy assets, such as the Mellon Bank Center and One Liberty Place have seen their vacancies drop into the single digits (6%) as a result of tenant's upgrading their space during this down cycle. The speed at which these buildings will continue to lease, however, is slowing greatly as rates begin to rise and the number of prime floors has decreased dramatically, particularly at Three Logan Square and One liberty Place.

Since the trophy assets have vacancy in the single digits and the vast majority of vacancy is still located in Class A assets, these landlords are willing to offer significant economic concessions to entice new tenants. When possible, tenants are taking full advantage of this opportunity to move into upgraded spaces without paying the historic premium between asset classes. This "flight to quality" will continue to result in more vacancy in the B/C Class office buildings while those landlords scramble to retain their existing tenants.

Given all of the above, a lackluster job growth environment, the competition for tenancy will remain heated in Center City for the foreseeable future. Tenants seeking long-term leases will continue to negotiate attractive base rent schedules, free rent concessions, and sizable construction allowances.