

Current and Future Market Conditions Q1 2021

Q1 brought 300,000 SF of negative absorption. Looking back, year over year, there has been 1M SF of negative absorption since the pandemic began. The CBD's vacancy rate rose to 12.2% with 5.5M SF available.

Twenty-five percent of Q1's negative absorption is attributed to subleases. Regarding how many of these availabilities are real—or if firms are testing the market—I do not know. Leasing activity is well below historic levels, and if 2021 proves to be anything like 2020, some firms may have little choice but to remain in their space or wait until activity picks up to jettison excess space.

How Things Look

- Office towers remain empty. On any given day, 10% of a building's capacity is occupied.
- Direct and sublet space are becoming increasingly prevalent.
- Tenants are rethinking office space standards.
- The concept of "Hoteling," an office layout where employees do not have assigned seats and use whatever desks are available to them when they arrive to work, has become the new norm as workers begin returning to the office.

The Return of the Receiver

Similar to the financial crisis of 2008-2009 when landlords were faced with defaulting on their debt service and Court-Appointed Receivers were tasked with managing office buildings, I fully expect to see the "Return of the Receiver" as we move into the summer months and round out the year. Landlords that have purchased their buildings in the past 5-7 years, refinanced their debt service, or engaged in a combination of both, are particularly vulnerable.

Simply put, a receivership takes control of the property's management and out of the hands of an owner/borrower. Per the direction of the court, control is given to a neutral third party, also known as the Receiver. The Receiver operates all aspects of the property and attempts to increase the value so that the lender can recoup as much as possible from the borrower's default. This change will not affect the building's office tenants or prospective tenants but creates an opportunity for those individuals who are addressing office requirements and in buildings that have Court-Appointed Receivers.

Construction Woes

With \$1M SF of negative absorption, you may be curious as to why asking rates have not plummeted?

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Let me explain so you have a better understanding.

The CBD's average asking rent in 2010 was \$27.00 SF; today the average is \$32.50 SF. A 20% increase in rent has not been able to keep pace with a 150% increase in the cost of construction. Fit-outs that were once \$40 SF are now \$100 SF. Landlords are able to justify enormous capital allowances by signing long-term leases with moderately (or at least comparatively) increased rents.

The reason asking rents have not been impacted as much as one would think is because materials such as wood, millwork, and doors are on back-order and are scarce. Beginning Q-2, the cost of sheet metal, structural steel, and drywall are expected to increase 25% with wood being slated to increase 35%. And if that is not enough, carpenter union raises go into effect on May 1st.

Materials associated with construction have kept the costs of fit-outs at unmerciful levels. Landlords must provide sufficient capital—especially to attract new tenants. However, they unfortunately cannot afford to lower rents too much if they want to continue offering concession packages to keep pace with the cost of materials and construction, which is a vital component to secure new tenants.

The most profitable transaction for all landlords has always been renewals. Why? It's simple really. There is limited capital outlay and zero downtime without revenue. Should a tenant that is renewing a lease for a specific period of time receive the same concession package as a new tenant? Of course, but that is a different topic for a different day.

Moving forward I would expect landlords to aggressively pursue new tenant opportunities with large capital and abated rent packages, while offering a slight decrease, if any, in base rent. Expect landlord returns to be less for new transactions because of the concession packages being offered. However, if you are a tenant looking to renew, I urge you to be cautious. Landlords will be looking to make up for their lack of return on new transactions with renewals.

Below are the current quoted rental rates:

- 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



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The Path Forward

As vaccines continue to become readily available for those who want them, the CBD will gradually see an increase in traffic and a return of office space users. Business will slowly reopen—with employees trickling back into their offices. In the coming months, employers will likely allow employees and staff members to slowly become reacclimated to working and collaborating from an office.

However, it must be stated that at some point in the not-so-distant future, employers will be tasked with setting a firm date for their employees to return to in-person work. Will it be after Labor Day, or will it be January 2022? My guess is after Labor Day, but only time will tell.

At the end of the day, quality office space and an attractive work location brings people together, drives collaboration, inspires mentoring and innovation, and enhances business development initiatives. And this, frankly, outweighs any cost savings that companies may experience from encouraging remote work in the long term or dramatically reducing headcount. The in-office culture, ultimately, matters to an organization—and creating a productive work environment helps in building and retaining a deep bench of talent.

For now, tenants, landlords, and lenders have obligations. As a tenant, when your lease is scheduled to expire, my best advice is to begin negotiations early—at least 18-30 months in advance of your lease expiration. This ensures the process you must go through isn't rushed and your needs are met.

In closing, it is my wish that your life is beginning—on some level—to achieve some level of “normalcy.” On a personal note, I certainly feel as if there is light at the end of the tunnel as I have been able to get fully vaccinated and am eager to have a better summer than last. Frankly speaking, I am ready to live life again—professionally and personally.

I truly hope that you and yours are coming out of this feeling hopeful and happier. I know it has been a challenging and frustrating year for everyone—and while we have all been in the same storm, I know we haven't all been in the same boat. Good thoughts are headed your way. I am looking forward to *moving forward* in 2021. Be well.



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