Current and Future Market Conditions Q2 2021

Q2 brought 400,000 SF of negative absorption. This negative absorption brings the year—to date—to 700,000 SF. The CBD's vacancy rate rose to 13.1% with 5.9M SF available.

Since the inception of tenant representation in the early 80's, landlords have enjoyed low vacancy markets—and tenants have equally benefitted from high vacancy markets. Historically speaking, 10% vacancy has been considered a fair vacancy equilibrium. With the conversion of Class B/C buildings to residential use in the early to mid-2000's (not counting single-building users like Independence Blue Cross and Comcast, which represent 11% of the CBD's office inventory), coupled with today's efficiency trends, the new standard for fair vacancy equilibrium is likely closer to 15%. With 13.1% vacancy, Philadelphia's CBD is considered a tenant-favorable market. Landlords are feverishly chasing new transactions and this behavior solidifies a new norm.

Sub-lease space continues to flood the CBD office market, and it outpaces direct availability by 2/1 during Q2. This brings the total amount of sub-lease space to 1.5M SF. I do not expect this trend to change, as I am aware that a 160,000 SF user of space placed their suite on the market during the first few days of Q3 (I'll speak more on this in Q3's report).
There certainly has been an uptick in traffic in the CBD and building occupancy has risen to 30%-40%. Most, if not all, of the business leaders I have spoken to will be encouraging their employees to return to their offices this summer and will be requiring them to return in September while mandating vaccinations.

How Will Offices Change in a Post-Pandemic World?

My prediction? Likely not much, if anything, actually changes. New approaches will be tested, of course, programs will be modified, and revisions will be made, but tenants will still require office space and the bells and whistles of the 21st Century will be employed to get work done, i.e., collaboration, technology, and efficiency.

As a tenant representative, I have been preaching lease flexibility for 20 years. Tenants should have the right to expand, contract, and terminate their lease—consider it an accordion-style lease, if you will—and these leases will feature fair market, tenant-favorable penalties. I expect landlords to be more understanding and willing to add these lease options today when compared to pre-pandemic times, especially for smaller office space users. Owners that are not willing to accommodate these options will operate at a disadvantage. I expect tenants to place a greater emphasis on these terms and seek out partnerships with buildings that are more flexible.

Below are the current quoted rental rates:

- Trophy Class space is priced at $43.50 SF
- Class A space is priced at $36.00 SF
- Class B space is priced at $28.00 SF
- Class C space is priced at $23.50 SF

Moving forward, I would expect landlords to aggressively pursue new tenant opportunities with large capital and abated rent packages. I also anticipate the offering of the potential of a slight decrease in base rent. Existing landlords will try to maintain their asking rent, but if they are faced with the real possibility of losing a tenant, will be spurred to become more aggressive. This wake-up call sometimes comes too late, and the tenant has already mentally prepared themselves for a relocation to a new building and new space. Therefore, I would advise landlords to not wait for the other shoe to drop. Be aggressive and come to the negotiating table as soon as possible. Additionally, it is fair to expect landlord returns to be less for new transactions primarily because of the concession packages that are going to be offered. However, if you are a tenant considering a renewal, I urge you to be cautious. Landlords will be looking to make up for their lack of return on new transactions with renewals.

When a tenant vacates space, landlords are faced with an uncertain amount of downtime related to the now-empty space while also dealing with demolition costs and capital expenditures associated with new buildout. Let me be clear: Landlords want to avoid this at all costs. The only way to achieve optimal results is to address your pending office lease requirement 18-24 months prior to the current lease expiration date, have viable relocation options, and leverage this to yield a tenant-favorable transaction. Anything less will not be sufficient. If your lease expires in 2022, or during the first half of 2023, now is the time to address your office lease needs.

I hope that all of you are beginning to feel like life is returning to normal. I know that I certainly am, and it is refreshing to put the bleakness of the past 15 months or so behind us—hopefully for good. It has been exciting to reconnect with family and friends (in person no less!) and begin to see, do, and experience all that the world has to offer once again.

In closing, I also hope that you continue to stay safe and get vaccinated, while also having some well-deserved fun. Cheers to summertime!