A Deprived CBD?

The COVID-19 pandemic, which has been ongoing since the spring of 2020, continues to take a toll on the CBD. And it has specifically shown how deprived **NEW tenant demand** is in the Philadelphia office market. Landlords who are competing for **NEW TENANTS** are reaching further and higher than ever before. And frankly speaking, landlords who insist on living in the days of years' past are not able to keep pace. Those landlords who believe it's a landlord favorable market, or those hanging their hat on the idea that the "market will turn around," are being left behind, ultimately scratching their heads and wondering why they are losing out on ***NEW tenant transactions.***

Commercial office space in the CBD has clearly shifted to a tenant-friendly market, and it will remain this way for the foreseeable future. Over the next 3-4 years tenants will continue to shed excess space, choose to work remotely, or simply relocate to the suburbs—it is inevitable.

There is also an abundance of phantom space (such as leased space that is not occupied, but not contributing to the overall vacancy until the lease expires—these tenants are simply waiting for their leases to expire to be able to give back a portion or all of the space).

In times' past, I recommended that tenants begin addressing their pending requirements 12-24 months in advance of their lease expiration date—while also considering variables such as size, location, need, etc. In today's market, I suggest beginning 18-36 months in advance. Tenants that signed leases at the peak of the market in 2017-2020 are well-positioned for an early lease restructure. There are just too many variables today to consider, including size, location, need, above market rent, and excess space, not to mention landlords who are in desperate need to meet their debt service. In addition, everything is taking longer to do—this includes construction, permitting, budgeting, lease negotiations, etc. Tenants with leases that are expiring in the next 12-36 months are well positioned, but again, should address them 18-36 months in advance if they want to maximize their leverage and have optimal results.

An Issue We've Never Experienced Before

I want to touch on a subject that is increasingly becoming an issue in today's CBD office environment. Ultimately, landlords hire agents to represent their interests, just as tenants do. However, these landlord agents, unlike the majority of tenant-only agents, sometimes play their hand in representing tenants, too. Setting aside the natural conflict of interest a landlord agent has while representing both their landlord and a tenant, another significant disadvantage that is often overlooked—and has become a major issue—is that these landlord agents are not actively in the trenches of the market the way tenant agents are. In turn, this results in a significant lack of market knowledge—they simply don't understand the true reality. As a result, landlords that have already inflated expectations are being given inaccurate market data and now also lack the knowledge of market norms and thresholds from the very people they have hired to lease space in their buildings. Oftentimes, this presents a significant cost, not to mention, a potential **NEW TENANT**, too.

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The reality is, there are not many tenants in the market that are seeking relocation. Therefore, if landlords hope to attract a tenant and win a transaction they need to make drastic changes to their pro forma as well as their expectations. Otherwise, they should be content sitting on the sidelines for 3-4 years with the hope that the market will change, and their existing tenants remain in place.

Tenants seeking relocation should be prepared to commit to a long-term lease of 12-15 years. A long-term commitment is necessary because construction pricing remains at unmerciful levels. Without a long-term commitment, there is little hope of extracting enough capital from the landlord to build space out without an out-of-pocket expense. Tenants remaining in their existing space have more control over the term commitment they enter.

In closing, my year end Tenant Road map:

Tenant Roadmap

1. Abated Rent: One month of abated rent per year of lease term commitment.
2. Tenant Improvement Allowance: $7-$8/RSF per year of lease term commitment in Class A space and $6-$7/RSF per year of lease term in Class B space.
3. Asking Rents are artificially inflated, sometimes as much as 10-15%.
4. Annual Rent Escalations: 2.25%-2.5%
5. Lease Security: 2-3 months of base rent, with a reduction in the amount of lease security over time to one month as lease security.
6. Termination Options: These are essential to any new lease, but the language that makes up the termination options is just as important, if not more important than the options themselves. Ideal language comprises a 12-month notice period and an “exit payment” (payable on the effective date of the termination) in an amount not to exceed brokerage commissions and tenant improvement allowance using an interest rate of 6%. Anything else is cumbersome and makes the option virtually exercisable.

The above roadmap is only made possible with options, and leverage is derived from time spent negotiating. Landlords will argue that a renewal transaction should yield less capital and abated rent than a new transaction but that’s hogwash. Why should a new tenant receive more capital and abated rent than an existing tenant? The answer is simple. They shouldn’t

However, a lot of existing tenants do not take the time to evaluate market alternatives. Regardless of if you are a new tenant, or a tenant renewing your existing office lease, you are entitled to what the market will yield. If you are an existing tenant, it will require more work and time. However, through due diligence, options and leverage will come—and it will be worth it.

Of course, with any questions or comments, I invite you to reach out to me directly.

Best,
Ken

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