Despite an increase in foot traffic and a boost in occupancy, Philadelphia's office market remained in the negative during Q2 with 500,000 SF of negative absorption. In the past, absorption trends have been known to change on a quarterly basis. In this case, it is my personal belief that negative absorption will continue for the foreseeable future. The CBD's vacancy rate surged to 14%, with 6.5 million SF available.

During Q2, Guy Carpenter inked a new 20,000/RSF expansion at United Plaza, adding to the 40,000/RSF that was already existing in the building by JMT Insurance—a company they acquired. Guy Carpenter will vacate 106,000/RSF at Three Logan Square. This defection is 106,000/RSF of negative absorption for Brandywine Realty Trust and is considered as net absorption to the CBD's inventory of 85,000/RSF. In addition, Comcast, Willis Towers Watson, and Marsh McClennan gave back more than 300,000 RSF.

The Reality of Landlord Concessions

CBD office tenants have enjoyed enormous amounts of capital as well as generous abated rent packages by landlords. However, capital contributions on behalf of landlords are showing signs of slowing, in specific buildings.

Landlords who purchased their buildings in 2015+ are beginning to ask themselves "do we really want to invest capital when our building is worth 30% to 40% less than it was when we purchased it?"

Well-capitalized REITS, such as Brandywine Reality—and owners with little to no debt service—have a significant advantage over their competitors. Their buildings are not underwater, and they are able to provide enough capital to fund existing tenant needs and buildouts for new prospects.

Ultimately, there is a big divide between the have and have nots. The haves have capital, along with a lower debt service, and the have nots have a higher debt service and purchased their buildings in 2015+.

Landlord Capital Is Important, Too

Just as landlords want to be assured of their tenants' financial stability, tenants should also be comfortable knowing that their 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 financial standing and able to fund new transactions. Any lease document should ensure a tenant's right to offset their base rent as a remedy in the event the landlord cannot perform services or fund tenant improvements.

Speaking of capital and tenant fit out, I must touch on a very concerning trend. Namely, that general contractors have enjoyed a 150% increase in build-out costs over the previous decade but now are seeing their pipelines begin to show signs of slowing. Preliminary estimates are most often over exaggerated; however, this is an issue for tenants and landlords alike.

For example, the delta between the lowest budget and the highest budget can sometimes range as much as $20/RSF, which is significant. All tenants must vet each budget thoroughly prior to accepting a tenant improvement allowance.

Additionally, as a tenant I would suggest transitioning the burden away from yourself and placing it squarely on the landlord by asking for turnkey transactions. Hopefully, as the pipeline of existing and new business diminishes, construction companies will begin pricing tenant's fit-outs more accurately and aggressively.

Other Key Considerations

- **Renewals:** Now more than ever, existing landlords are holding firm on their rental rate and concessions—and are daring tenants to leave. As such, those tenants that take the time to educate themselves and leverage the market will inevitably prevail. Discounted rent can be as much as 20% off the asking rate.

- **Relocations:** There are still significant concessions (tenant improvement packages) to be had, but tenants need to be strategic in where they look for options.

- **Subleases:** Nothing new to the CBD, of course; however, it is important to examine what are the types of subleases being offered. Large blocks of space with significant amounts of lease term remain. Plus, existing conditions are modern and efficient—and most often high-end furniture is available for free. These spaces are considered plug-and-play and can be found at a significant discount. Moreover, these blocks of space are in direct competition to landlords seeking to lease existing vacancy. Simply put, they are a tenant's best friend.

Below are the current ***inflated*** asking rents for the Philadelphia CBD. The good news for tenants is that during Q2 landlords began to realize that these quoted rents are not attainable and recognize the need to get aggressive with ***new*** transactions. Oftentimes, quoted rents can come at a 15% to 20% discount.

1650 Market Street 36th Floor Philadelphia, PA 19103 215.640.8800

Current Quoted Rental Rates:

- Trophy Class space is priced at $44.50/RSF
- Class A space is priced at $36.00/RSF
- Class B space is priced at $28.00/RSF
- Class C space is priced at $23.50/RSF

In Conclusion, Trends:

It is quite clear that the CBD office market has moved west and there is not much—if any—interest in the east side of town. South Broad Street has some small-to-medium sized users of space that remain, but for the most part this area is now an arts and cultural district. On top of it, there is a heavy residential influence, with many old commercial office buildings being converted to residential use.

I do not expect this to change.

It's my opinion that buildings like 2000 Market Street and One and Two Commerce will one day be considered the center of town, just like City Hall was 25 years ago.

Ultimately, the moral of the story at this point in the game is landlords who allow their tenants to walk into the market when it can be avoided are one of life's great mysteries. The sheer nature of this is absolutely mind boggling to me.

Of course, I welcome the opportunity to discuss these developments. With any comments and questions, I invite you to reach out.

Current and Future Market Conditions Q2 2023

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