Current and Future Market Conditions Q4 2023

To put it plainly, conditions are worsening. In Q4 of 2023, there was a negative absorption of 450,000 rentable square feet, mainly due to the CBD's vacancy rate reaching 16.5%, with 7.1M square feet available.

As we conclude the fourth year of the ongoing global pandemic, its impact remains significant.

Construction costs remain at record highs, leading landlords to prioritize the creditworthiness of tenants due to substantial capital requirements for new transactions. Security measures include deposits and letters of credit, with lease securitization ranging from 10% to 20% based on tenant creditworthiness.

To ensure tenants' financial stability, landlords seek assurance, and tenants should verify landlords' stability and transaction funding capability. Early in the process, tenants should request documentation from landlords' potential lenders as proof of financial standing. Lease agreements should include provisions allowing tenants to offset base rent if the landlord fails to fund tenant improvements.

Is it a Tenant or Landlord-Friendly Market?

Typically, a tenant or landlord-friendly market is defined by the vacancy rate. Ten percent is a fair equilibrium. Anything less favors tenants—and anything more favors landlords. Determining whether the Philadelphia CBD market favors tenants or landlords falls somewhere in between, and is contingent on factors like the landlord's situation, building vacancy, cash flow, and debt service.

Despite a 16.5% vacancy rate, which would signal a very strong tenant market, it's not a distinctly tenant-friendly market. Why? Because as the number of buildings facing financial distress increase, healthy, viable options available to tenants continues to decrease.

Trophy buildings, especially those with scenic views, are thriving due to tenants downsizing from existing footprints in lower value buildings and seeking quality assurance from financially stable landlords capable of funding improvements. Ultimately, they are leasing less space in these high-quality buildings at higher rates, but they are not increasing their bottom-line leasing costs.

Class A buildings, particularly west of Market Street, face challenges as tenants flock to trophy assets, creating difficulties in debt restructuring amid high interest rates. Many of these landlords are struggling to stay afloat, specifically anyone who purchased a building in the previous 8-12 years.

Class B buildings, occupied by locally owned small-medium size tenants, remain status quo, with a preference for short-term renewals and a reluctance towards relocations or long-term leases. Most of these tenants do not require significant capital outlay from the landlord either.

Tenants situated in trophy buildings or Class B assets should anticipate market concessions and a premium in rental costs. Conversely, tenants in Class A buildings or those seeking space in such establishments can anticipate landlords actively pursuing their tenancy, with high demand for their occupancy. It is essential to note that these dynamics pertain to *healthy assets* and do not apply to buildings undergoing special servicing or facing challenges related to debt service and cash flow.

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Current Quoted Rental Rates

Promptly evident is the decrease in asking rates exclusively observed in the Class A space.

- Trophy Class space is priced at $43.50 SF
- Class A space is priced at $33.00 SF
- Class B space is priced at $28.00 SF
- Class C space is priced at $23.50 SF

It's Wise to Be Wary

Vigilance is advised regarding operating expense escalations above the base year, as a notable number of buildings in the CBD raise concerns, signaling an impending challenge for tenants. Despite a 50% occupancy rate, some buildings experience alarming year-over-year increases in operating expenses, contrary to the expected decrease with lower usage.

In the two decades preceding the pandemic, operating expenses typically rose by 2%-3% annually. However, recent examples highlight an alarming trend, with some experiencing increases as high as 5%-7% annually. Tenants facing these issues should consider negotiating a full-service lease inclusive of electricity and operating expenses or impose a cap of 2%-3% on controllable expenses. Additionally, tenants should secure the right to audit the landlord's books annually.

Looking Back at 2023—and Peeking Ahead to 2024

Reflecting on Philadelphia's office market in 2023, the year can be characterized as disappointing, concerning, and frightening. Looking forward, prospects don't seem significantly brighter. I anticipate the current downturn and the resetting of office market fundamentals to persist for another 2-3 years. Predicting the office market's appearance in the latter part of the decade remains uncertain, but it is expected to remain a market divided between the haves and have-nots.

As 2023 concluded, the lender overseeing MRP Realty's 2016 acquisition of 325 Chestnut St, 400 Market St, 401 Rannstead, and the Bourse Building has assumed control of these assets.

To conclude, just because the market waters are murky, it does not mean that well-represented tenants cannot drive incredibly aggressive, tenant-friendly deals. However, the key term there is "well-represented." Simply raising your hand and asking for the best deal is not the answer, it is necessary to leverage all viable and healthy options.

The typical timeline to address a lease is 12-15 months in advance of lease expiration. Today, however, considering everything that must be navigated in this process, it would be most prudent to begin the process 18-24 months in advance of lease expiration.

I welcome the chance to discuss this information with you one on one. Do not hesitate to reach out

Best,

Ken

KCR
Ken Clyman Realty
"Specializing in tenant representation services"

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