In Q1 of 2024, there was a negative absorption of 200,000 rentable square feet (RSF), with the CBD's vacancy rate reaching 16.2%--meaning there is a whopping 7.3M square feet available.

The market is scary, I'm not going to lie. And I have *very* serious concerns about how transactions will get funded for tenant buildouts. While there is an abundance of space, there are only a handful of buildings with a low debt service… and that are flush with cash and able to fund deals. For the sake of this update, let's call these buildings "the haves."

Over time, Philadelphia has avoided the highs and lows experienced by other office markets. There are a few reasons behind this. These reasons include: 1) the Philadelphia CBD is small in comparison to New York City and Washington D.C. Both of these areas are a 90-minute train ride from Philadelphia. Plus, the market comprises 45M SF of office space; and 2) the Philadelphia office market is buffered by the large presence of Education, Healthcare, and Law Firm users. Traditionally, these users have been stable and steady as she goes. However, times are changing. Below you will find a glimpse into how these sectors have fared.

The Legal Sector

Because of technology, law firms have been contracting space since the Great Recession of 2009. For example, the need for paper storage and filing has been replaced by digital scanning and cloud-based technology. The ratio of attorneys to support staff has changed dramatically as well. What was once 1:1 became 4:1. When COVID-19 disrupted our lives, the ratio spiked to as high as 8:1. Younger, tech savvy millennials are more comfortable doing work themselves, and do not rely on secretarial or paralegal support. Combine these changes with the reality of "work from home" and we have the perfect storm. The need for office space by law firms will always be there, but in today's world that need has diminished. Most, if not all law firms, are requiring and taking up less space. A few of the larger examples are:

- Stradley, Ronon, Stevens & Young exercised a contraction option and relinquished 25% of its space in One Commerce Square.
- Blank Rome exercised a contraction option and gave back 45% of its 195,000/RSF footprint at One Logan Square to only occupy 130,000/RSF.
- Morgan, Lewis & Bockius recently relocated 305,000/RSF to 2222 Market Street. In doing so, they reduced their space usage by 28%.
- Post & Schell will leave 70,000/RSF at Four Penn Center to occupy 40,000/RSF at Three Logan Square, reducing its space by almost 43%.
- Fox Rothschild will relinquish 135,000 square feet at 2000 Market Street to 80,000 square feet at Commerce Square, a 41% reduction in space.
- Rawle & Henderson subleased 35,000/RSF at Centre Square after leaving behind 70,000 square feet at the Widener Building, a 50% reduction in space.
- Dechert gave back 55% of its 240,000 square feet at Cira Centre when it agreed to a lease extension for 110,000/RSF.
- Baker Hostetler leased 45,000/RSF at Mellon Bank Center when it left 80,000 square feet at Cira Centre, a 44% reduction in space.

- Saul Ewing has agreed to lease 65,000/RSF at Mellon Bank Center when it vacates 110,000/RSF at Centre Square, a 45% reduction in space.

These are just a few examples of some of the larger law firm space users in the CBD. This does not account for most, if not all, small-medium sized tenants doing the same thing.

The Healthcare Sector

- Penn healthcare leases 300,000/RSF at Centre Square and will lease 75,000/RSF when it occupies new space at 3535 Market Street next year. This 75% reduction in space is the tip of the iceberg in healthcare.
- Jefferson Healthcare agreed to lease 230,000/RSF at 1101 Market Street, and with an additional 120,000/RSF of expansion space to be occupied at a later date. Jefferson is rumored to already no longer require that 120,000/RSF of committed expansion space and is left pondering what to do.

The Education Sector

Education continues to thrive—and the University of Pennysylvania and Drexel are leading the way.

What Happens When the Market Resets?

Personally, I believe the current cycle of course correction will persist for another five years, which will ultimately mark a full decade since COVID-19 emerged and changed our lives and our work environment forever.

Why the pessimism, you ask?

The average office lease term pre-2019 was 6-8 years—with the largest users of space having entered 12–15-year leases. A full decade should allow the market to course correct and for Philadelphia to evolve into a “new norm.”

This will leave enough time for all users of space to identify and adjust their space needs accordingly.

What will be left, then?

I believe well capitalized and low debt Trophy landlords… the “haves” that I previously mentioned… will thrive and will also likely enjoy 90%+ occupancy.

I further believe that under-capitalized, Class A landlords—specifically west of City Hall—that were purchased in the previous ten years are in for difficult times. I think these buildings will be 50%-60% occupied.

Class B landlords will survive and have an uptick in occupancy, rates, and value. Most of the users in these buildings are smaller, locally owned companies. They enjoy short-term, low-capital, landlord-

friendly renewals. Coupled with the fact that some of these older buildings are being converted to residential use, the tenants in those buildings presently will need to relocate. In turn, they will seek similar rent in other Class B assets.

Current Quoted Rental Rates

Promptly evident is the increase in asking rates exclusive to Trophy space, and the decrease in asking rates exclusively observed in Class A space.

- Trophy Class space is priced at $45.50/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…

I cannot stress this next piece enough.

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

In the two decades preceding the pandemic, operating expenses typically rose approximately 2%-3% annually. However, recent examples highlight an alarming trend, with some buildings 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.

In Conclusion

Despite the growing pressure for employees to return to office spaces and a resurgence in urban foot traffic in the CBD, the relentless momentum of the market reset appears not only inevitable… but unstoppable. I truly expect this to persist for at least another five years.

I wish I was the bearer of better news, but simply put, this is the reality and the world that we presently live in.

Of course, as always, I welcome your feedback as well as the opportunity to have a one-on-one discussion.

Best,
Ken

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Current and Future Market Conditions Q1 2024