In Q2 of 2024, there was a negative absorption of 100,000 rentable square feet (RSF), with the CBD's vacancy rate reaching 16.3%--meaning there is a whopping 7.4M square feet available.

Studs and Duds

Suburban Station has slowly undergone a transformation. Once known as a low-cost alternative Class B building located west of City Hall, it had a reputation for being a dark and dingy property. However, today it has evolved and re-emerged as a solid building with a plethora of amenities for its tenants. For instance, one will immediately notice that the lobby has been enhanced and features new, modern lighting. The building is historic, and coupled with its natural artwork, truly stands out because of this new lighting.

Furthermore, the building is committed to making its tenants' experiences in the building more enjoyable. Management at Suburban Station is accomplishing this by introducing a multi-purpose common area conference room that is available to tenants. The building has a dedicated space where its tenants can come and relax and have refreshments. Simultaneously, common area space for conference rooms, including video-focused conference rooms, is located on the 17th floor. Suburban Station's ownership is hands-on, and its management team is on-site, proactive, and recognized as one of the best in the business. At its price point, which is $29.00/RSF and inclusive of electricity, it is the best bang for the buck in our market today.

At the same time, 1801 Market Street has always been a difficult building for tenants as it offers limited views, and the depth-to-core ratio makes it inefficient for a lot of users. With 275,000/RSF vacant, 1801 Market Street has fallen on hard times in recent years. A sizable portion of their tenant base has left the building for one reason or another. Morgan Lewis is the building's anchor tenant, leasing 100,000 RSF, which will be relocated to their new headquarters at 22nd and Market Street next year when their lease expires. The building was thrown a lifeline in 2020 when Septa temporarily leased 100,000 RSF while their space at 30th Street Station is completed. However, Septa will vacate in 2025. Frankly, I do not see how it will be possible for the current ownership structure to maintain their debt service after all of these sizable defections. Of course, I hope I am wrong.

A Noteworthy Development

- In May, the city of Philadelphia mandated that all employees had to be back at the office five days a week, effective July 15th. Blue Cross Blue Shield, Comcast, and Vanguard have all called workers back to the office as well for at least three days each week.

Emerging From the Rubble

Prior to the pandemic in 2019, it was common for tenants to enter 10 to 15-year lease commitments. From 2019 through 2023, essentially during the pandemic, one-to-two-year lease term extensions were common. Tenants are slowly becoming more comfortable with a three-to-four-day workweek and are also beginning to commit to longer term leases.

This is important for several reasons. Firstly, construction costs remain at merciless levels, and to build any new space, tenants must make longer term lease commitments in order to have new construction built without having to come up with out-of-pocket capital.

Secondly, it means the market is more active, which it is. The trophy market is doing well, with One Liberty Place and Mellon Bank Center leading the charge. And the Class B market is robust with activity.

Unfortunately, the Class A market, specifically west of City Hall, remains stuck in its own way, with issues ranging from receivership (bankruptcy), the inability to meet debt service (loan), failures to fund capital, and a mass exodus of tenants. Some landlords do not have the capital needed to fund transactions.

Any new tenant considering space today in buildings that are facing these issues should seek to have their tenant improvement allowance placed into escrow within 30 days of a mutually executed lease. If the funds are not placed into escrow, then the lease automatically terminates. If the funds are placed into escrow, these funds can be drawn down at their discretion during construction.

Summer is approaching and the Philadelphia office market is positioned positively. The pandemic days of tenants "kicking the can down the road" seems to be behind us. Businesses are realizing they need office space, and that life is going on after COVID.

Now, yes, space requirements have changed, but at the end of the day, office space is still needed. Tenants are slowly becoming more comfortable extending leases 5-10 years again.

Does this mean the CBD's course correction is over? Of course not. It still has another four or five years for the 10-year-cycle to be complete. Regardless, what it does mean is that businesses are healthy, and life is going on.

Rental Rates

As noted, Trophy buildings are thriving. Brandywine Realty Trust, specifically, has asking rates rising in instances of more than $50 per square feet. Along with Trophy buildings, ASI Real Estate Investments and Relex Capital are boosting rates in Class B buildings located along JFK Boulevard.

But Class A assets continue to decline. The reasons, as stated during Q1, are because they are undercapitalized, not able to meet debt service, being monitored by a special servicer, or are already in receivership.

Current Quoted Rental Rates

- Trophy Class space is priced at $45.50/SF
- Class A space is priced at $33.00/SF
- Class B space is priced at $28.50/SF
- Class C space is priced at $23.50/SF

Timeline

Before the pandemic, it was normal to address a pending office lease requirement 15-18 months in advance.

Today, as we "emerge from the rubble," it is evident that 18-24 months is required. Everything is taking longer to do. Why? The simple answer is we live in a world where a 3-day work week is acceptable and the norm.

A real estate transaction process typically involves owners, brokers, architects, contractors, and attorneys from both sides of the transaction to be successful and come to fruition.
Ultimately, it is similar to the spokes on a bicycle. If one of those spokes is missing or broken, the wheel stops until it is repaired. As such, if one of the essential components to the transaction process is sick, out of the office, or on vacation, the transaction comes to a halt and is delayed until that component returns.

When all of this must happen over a 3-day workweek, a significant toll is taken on the time required to properly leverage and negotiate transaction parameters.

My advice? Give yourself as much time as possible. Delays and mistakes are inevitable; you don't want to find yourself in a situation where you need to pay union labor to complete your project on time. If that happens, it will cost you as a tenant significantly.

As we look ahead, let's keep hoping office markets continue to naturally course correct. In the interim, enjoy your summer and the time you spend with your families and friends.

Ken

Current and Future Market Conditions Q2 2024