Optimism or Opportunity: Landlords and Tenants See Different Futures.

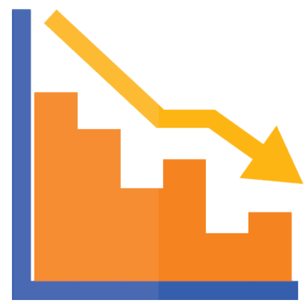
Everyone is talking about it. The impacts of COVID-19 on our economy have been far reaching. Some industries continue to struggle while others are bouncing back, and a few have benefitted. Residential real estate, for example, has experienced a boom with interest rates at all-time lows and people wanting to be more comfortable at home. Industrial real estate has seen unprecedented leasing as retailers look to take advantage of the demand for online shopping. The office market has, understandably, gone the other way, as companies reconsider the size of their office footprint due to the surge in remote work.

This article will look at the Philadelphia Suburban Office market and examine the impact of the pandemic on this segment of real estate. This market, while not capturing headlines, has quietly and quickly transformed into more of a tenant's market. 2018 and 2019 were heady times for owners of office space. Rents moved to an all-time high, activity was brisk, and tenants were expanding. 2019 saw a record high of 5.2M SF of space leased over 916 transactions. **Similarly, 2020 began on a promising note, looking even better than 2019 and then Covid hit.** In the year since that date in Mid-March when all non-essential businesses were ordered to work from home the market recorded 539 transactions, a drop of 41%. Is this a blip or a long-term trend?

The headlines say we are recovering and many on the ownership side believe widespread vaccinations will help fuel a quick rebound, but even the most optimistic projections suggest this may not happen. Is it fair to say that with only 12.3M SF of direct vacancy in a market of 107M SF - things could be worse? Maybe so. 11.5% percent of direct vacancy would be manageable if nothing else changed. One thing is certain, there will be change. There is no shortage of theories as to where we are headed, and these are often colored by where you sit in the real estate ecosystem. This article provides a look into key metrics for the market, some context for what they mean as well as what we are hearing and seeing from all sides.

What is Cresa seeing?

- Companies want to return to the office to maintain culture and engagement despite the convenience of video conferencing technologies.
- Most occupiers are discussing needing less space due to work from home and unassigned seating.
- Vacancies have increased and will continue to increase as sublease spaces turn direct in the next 24 months. There is over 680,000 SF of sublease space set to expire by the end of 2022.
- Even the most optimistic absorption scenarios will not backfill Covid vacancies to 2019 levels any time soon.
- Expanded concession packages and aggressive rents in negotiations are a sign that landlords are open to stretching due to a lack of demand.



What are landlords seeing?

- Landlords of office buildings have not directly absorbed significant financial pain from the pandemic as very few tenants have defaulted.
- Landlords believe that a V-shaped recovery is possible and there will be significant leasing activity from pent up demand.
- Landlord brokers are seeing little tenant interest for their direct space, so the "asking rate" isn't changing – why change if there are no deals to make?
- Institutional investors are better suited to weather these unfavorable circumstances and in some cases are taking advantage of unoccupied real estate to make improvements.
- Vaccinations will be a leading catalyst for return to office.

With landlords and tenants looking at the market from different perspectives and drawing different conclusions how do you know what is really going to happen. We've looked deep inside the numbers to try and answer this question. Based on the data, here is a look at the market over the next 24 months.

Three critical statistics that measure where a market is headed are:

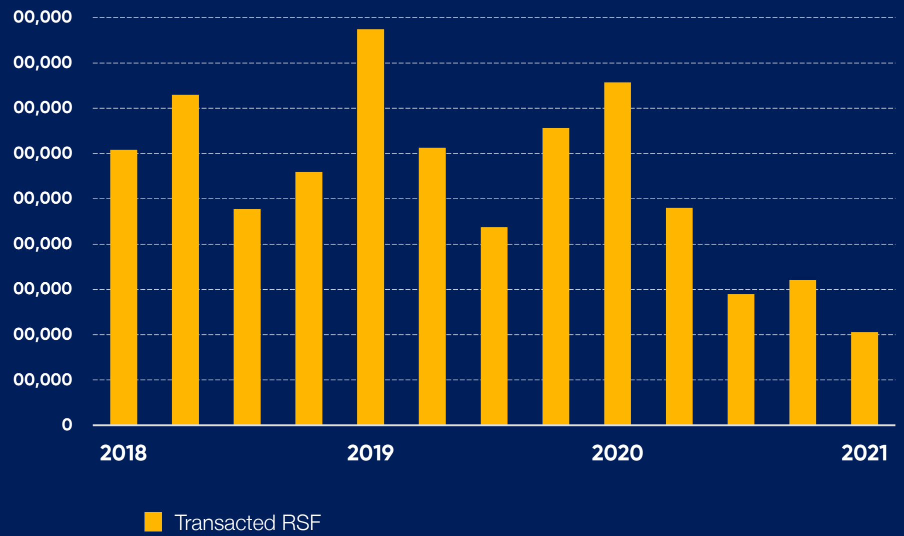
- *Leasing Activity*
- *Net Absorption*
- *Vacancy Rate*

Leasing Activity

Leasing activity measures the square footage of transactions that occur which is a more meaningful figure than the sheer number of transactions.

2019 was the recent high-water mark for leasing activity as the suburbs recorded 5.2M SF of transactions. Q1 2020 showed signs of beating that figure with 1.5M SF in transactions however the pandemic impacted this figure significantly and the year finished at 3.7M SF. Real estate is a lagging economic indicator due to the time needed to complete a transaction so the true impact of the pandemic will be felt long after we were ordered to work from home. Twelve months after the onset of the pandemic, **Q1 2021 had leasing activity at 382,793 SF which is the lowest level in the past 23 years.** This is indicative of the impact of the pandemic as tenants assessed their true space needs. These numbers don't reflect the fact that many tenants in this period have done short-term extensions (1-2 years) of their leases. This boosted the leasing activity figures but essentially tenants were buying time to try and figure out what their space needs are really going to be moving forward.

Total Leasing Activity



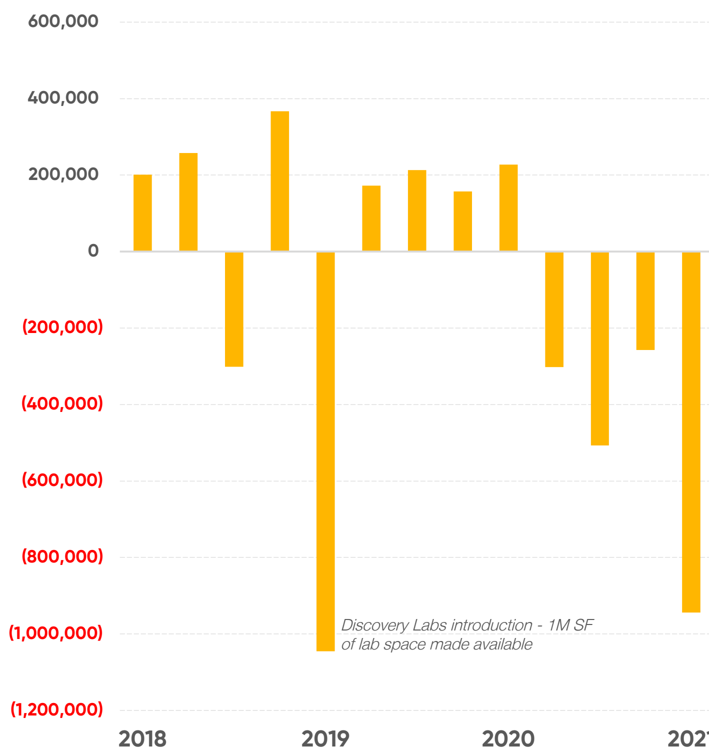
Net Absorption

Net Absorption is the difference between space entering the market (available) and space leaving the market (leased). This figure can be either positive (more leased than available) or negative (more available than leased).

The Philadelphia Suburbs had been riding a 9-year run of positive absorption except for 2019 when we saw a negative 472,000 SF. This 2019 result was singularly due to the introduction of 1M SF of space entering the market at Discovery Labs. Removing this from the figures we would have realized 529,000 SF of positive absorption which is right in line with the 536,000 SF in 2018.

Q1 2020 saw 220,000 SF of positive absorption but we finished the year at (847,000) SF of negative absorption, undoing all positive absorption accumulated in 2018 and 2019. Specifically, absorption took a nosedive as leasing activity declined dramatically at the onset of the pandemic. Perhaps more importantly, **Q1 2021 showed (944,761) SF of negative absorption alone or more than the entirety of 2020 with a projection of more to come.**

Total Net Absorption



Vacancy Rate

In the Philadelphia Suburbs the vacancy rate went from 9.8% (10.2M SF) at the end of 2018 to 12.6% (13.5M SF) and the end of Q1 2021. In context this additional 2.3M SF of vacancy is the equivalent of 9 buildings the size of the new Hamilton Lane Building in Conshohocken. At an absorption rate of 530,000 SF per year (2018 and 2019 normalized) this equates to 4.3 years of supply just to get us back to the end of 2019.

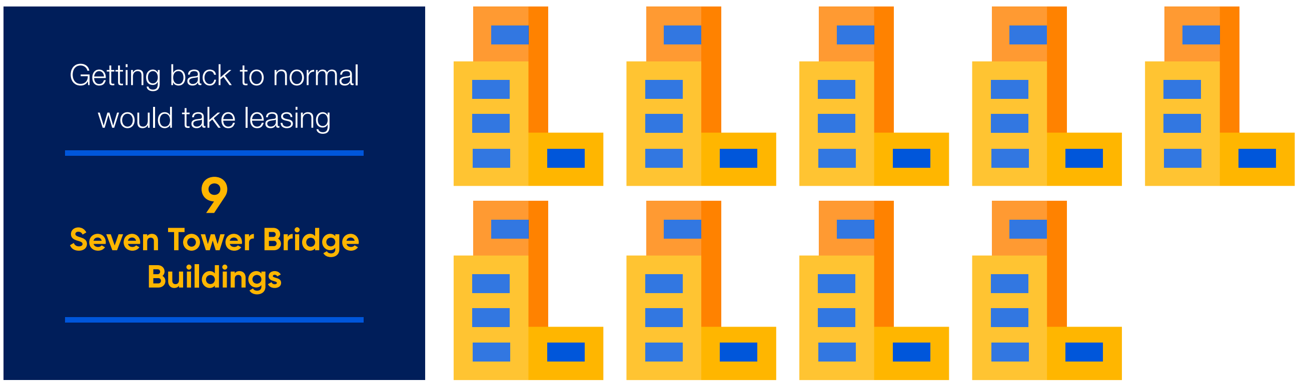
Vacancy Rate - Including Sublease Space

Sublease space has always been a factor in the market and more so in difficult times when companies seek to cut costs. While not technically a part of Vacancy Rate, as it is leased, it certainly has an impact on the market as it is available to lease and often at a significant discount to space a landlord is offering.

As the pandemic dragged on, many companies have realized they would not need either all or a portion of their space and have made the decision to list their space for sublease. More have come to the same conclusion but have determined that the economic benefit does not justify the cost to sublease and will simply address their space needs upon lease expiration. Others have yet to determine what their exact space needs will be moving forward and of these few, if any, are expressing a need for more space.

The net result of these conditions is that sublet space in the **Philadelphia Suburbs has increased from a low in Q1 2018 of 1.1M SF to a high of 2.5M SF in Q1 2021.** This increase of 1.4M SF of available sublease space has put further downward pressure on rents in the market.

With the addition of sublease space, the market has 13.4M SF of vacancy but that is only a portion of the story. When we consider sublease space that is expiring by the end of 2022 and space landlords are marketing for direct lease this figure increases to 19M SF available or 15.9%. Typically, tenants look for space 1-2 years ahead of their lease expiration so the forecast for the end of 2022 is the current reality. Basic supply and demand economics suggest an even steeper vacancy cliff is looming.



Markets are seeing a shift in demand as tenants rethink space needs and the Philadelphia suburbs are no exception. With changes in workplace strategies to accommodate varying degrees of agile work, many tenants can utilize less space and landlords can expect to get this space back upon lease expiration. These factors will create a lack of substantial demand for office space and, combined with the current space available, present opportunities for tenants.

Can occupiers navigate the current market to create value for themselves? If so, it's a great time to be a tenant.

Cresa is the world's only global commercial real estate advisory firm that exclusively represents occupiers and specializes in the delivery of fully integrated real estate solutions. Our purpose is to think beyond space, strengthening those we serve and enhancing the quality of life for our clients. Delivered across every industry, With over 1000 employees in more than 80 offices globally, Cresa partners with occupiers everywhere. For more information, please visit cresa.com.

About the Authors- Matt Feeney is a Managing Principal in the Cresa Philadelphia office and former Chairman of Cresa. Matt Hirshman is an Advisor in the Cresa Philadelphia office.