

PHILADELPHIA OFFICE MARKET

HEADQUARTER MUSICAL CHAIRS IN THE CBD

Philadelphia Central Business District (CBD)

As discussed in detail below, the overall performance of the market during the third quarter was positive with healthy net absorption and a noteworthy reduction in vacancy. Asking rents remained at or near all-time highs resulting from sustained demand, higher construction costs and influence from owners of newly acquired properties, who have lender mandates to meet pro forma. One suburban user has made the commitment to move its headquarters to Philadelphia, while several existing CBD users announced decisions to relocate within the market area. In line with national trends, many of these users will maintain or increase employee headcount, but nearly all will choose to utilize their space more efficiently and reduce their footprint.

Overall vacancy fell 80 basis points during the quarter to 12.1%, with 416,354 square feet of positive net absorption—a healthy sum. Class A vacancy remained nearly flat at 12.3%. Small occupancy gains were countered by downsizing tenants. Class B vacancy declined 250 basis points to 10.5%.

Quarter-over-quarter, the overall average direct asking rental rate increased by \$0.61 to \$32.73/SF. Class A average asking rents grew by \$0.90/SF to \$35.64/SF.

The cost of fitting out space continues to climb, which is affecting lease transaction dynamics in a meaningful way. No longer can tenants expect to gut and refit space within the standard improvement allowance offered by landlords. Some well-capitalized tenants choose to pay the difference out-of-pocket. Other tenants ask the landlord to absorb the expense and in exchange agree to pay higher rent or add term to the deal. Still others compromise and make use of previous occupants' existing space conditions.

Entercom Communications announced that it would relocate from Bala Cynwyd to 67,000 square feet at 2400 Market Street. Also, several existing tenants relocated their headquarters within the CBD. Reliance Standard Insurance Company announced it would vacate 140,000 square feet in the first quarter of 2021 at Two Commerce Square for 152,000 square feet at 1700 Market Street; Reliance plans to add over 120 jobs in the next three years. In the third quarter of 2020, Macquarie Group will move from 150,000 square feet at One Commerce Square to 140,000 square feet at One Hundred Independence. The office property

CURRENT CONDITIONS

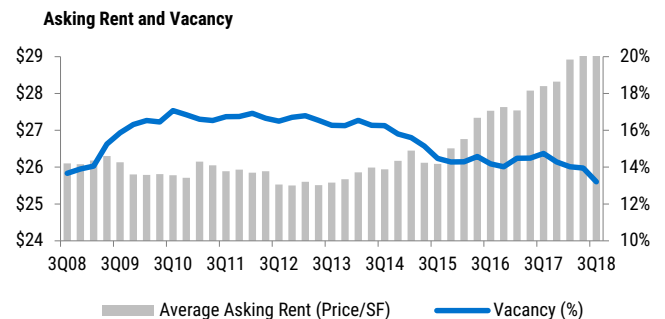
A number of high-profile Philadelphia CBD companies relocated their headquarters within the market.

Construction costs increased across the region.

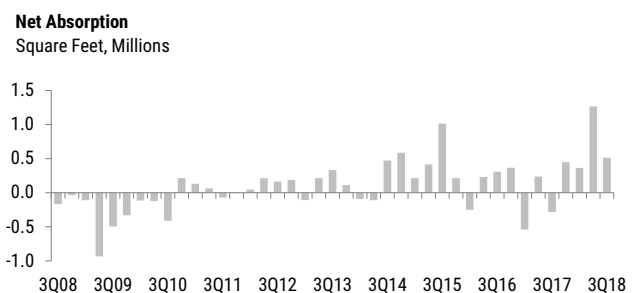
Tenants are downsizing but continue to hire at a swift pace.

MARKET ANALYSIS

Asking Rent and Availability



Net Absorption (SF, Millions)



MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	12 Month Forecast
Total Inventory	110 MSF	110 MSF	109 MSF	↑
Vacancy Rate	13.2%	13.6%	14.6%	↑
Quarterly Net Absorption	0.5 MSF	1.3 MSF	-0.3 MSF	↓
Average Asking Rent	\$28.76	\$28.66	\$27.71	↑
Under Construction	1.0 MSF	1.0 MSF	2.3 MSF	↑
Deliveries	0 MSF	1.3 MSF	0.2 MSF	↑

located at 2400 Market Street in West Market is on track to finish lease-up by year's end. It is 84.0% pre-leased as of the end of the quarter thanks to the Entercom Communications deal. In addition, 3675 Market Street in University City will soon deliver. Its largest tenant, The Cambridge Innovation Center, is scheduled to open its doors in November.

The delivery of the Comcast Technology Center, located in the West Market submarket, has not yet attracted many new users to the market in support of Comcast's expanded initiatives. Separately, at the close of the quarter, 16 companies covering multiple industries were considering a move into the CBD, which could absorb 254,000 square feet of space.

The national and local economies are going strong. According to the United States Bureau of Labor Statistics, as of August 2018, there were 68,000 more nonfarm jobs in the city of Philadelphia than at the start of the economic recovery in June 2009. Meanwhile, tenants continue to surrender walled offices for open plan design. When leases roll, it is common to see tenants accommodate the same number of employees in less space. To a degree, this trend has a slowing effect on overall net absorption.

Southeastern Pennsylvania

The overall market in the third quarter of 2018 remains healthy. A steady stream of new jobs created in the region has contributed to gains in occupied space and, with almost no new space under construction, vacancy is decreasing. The availability of space generally remains in balance. However, Class A space across the market is limited, and steep rent increases for this quality space have occurred. Rents are particularly high in the most desirable submarkets, where every class of space is scarce, and further increases in the coming year are likely. The cost of constructing space has increased sharply from a year ago, and tenants are most often required to absorb the difference.

Local companies continued their hiring spree, buoyed by the strong local economy. According to the United States Bureau of Labor Statistics, the combined nonfarm payroll employment for Montgomery, Bucks and Chester counties grew by 8,900 jobs between August 2017 and August 2018. Within this same geographic area, a total of 679,000 square feet of office space was absorbed in the third quarter of 2018 alone. This far exceeds the 562,000 square feet of new occupancy recorded for all of 2017.

Overall vacancy fell 20 basis points during the quarter to 13.9%. Radnor/Main Line remained the tightest submarket with only 6.3% of the inventory available for lease; space is particularly tight around the Radnor train station.

The trend toward open floor plan design is very strong among users. Tenants often experience sticker shock when they learn that fit-out for this kind of space now costs \$50.00/SF, and the landlord is only willing to offer half that amount as a fit out allowance for a five-year lease commitment. Either the tenant directly pays the delta to the contractor, or the landlord fronts the money and the tenant agrees to pay higher rent and/or add to the term of its lease commitment.

Premier office space with amenities remains desirable to tenants eager to attract a younger workforce. This demand led to the Class A average direct asking rental rate reaching a record high of \$30.00/SF in the third quarter. In addition, strong activity among Class B assets caused its average to climb \$0.54/SF over the past 12 months to \$24.92/SF.

On the construction front, AmerisourceBergen received board approval to move forward with leasing the 400,000-square-foot tower at the future SORA West campus in Conshohocken. Keystone Crossing Centers I and II (a total of 80,000 square feet) will be demolished to make way for this new campus.

Investment Sales

There is continued demand for value-add and opportunistic assets with investors focused on secondary and tertiary markets rather than gateway cities. Across the country, opportunity zones are peaking investor interest. Investors have plenty of cash to spend, and lenders are pushing aggressive debt terms to win deals.

Many transactions are being completed with equity partners that have substantial capital to place. A local example of this trend is the purchase of 2000 Market Street, located in the Philadelphia CBD, by a joint venture between Goldman Sachs and Nahla Capital. This 665,649-square-foot property traded in July for \$126.4 million at an 7.5% cap rate.

Industrial and multifamily cap rates continue to compress, but office cap rates remain flat. The bid-ask spread between buyers and sellers continues to widen. Investors are bullish but not carefree and focus more on leasing costs in stabilized assets. A significant percentage of suburban office and retail properties taken to market do not trade because of the widening bid-ask dilemma.

Outlook

Expect good overall performance from the CBD during the fourth quarter of 2018, with asking rents likely to remain at or near current levels. However, fewer large tenants will make space commitments than in the third quarter, and there might be some overall negative net absorption as a result of Willis Towers Watson downsizing by approximately 150,000 square feet in its relocation to 1735 Market

Street. Lastly, several owners of less-than-prime office buildings are likely to announce the conversion of their properties to multifamily use—as others have done in 2018—thereby eliminating difficult-to-lease space from the inventory.

The Southeastern Pennsylvania submarket should remain positive through the end of the year. Class A space will tighten further in all

areas of the market, as the flight to quality continues. Rent should increase for all quality space, especially Class A space. The cost of constructing space will continue to rise, with tenants bearing those increases. We also see increased activity on the part of small-to-mid-size companies with additional cash to spend seeking to become owners rather than lease.

Philadelphia CBD Lease/User Transactions

Tenant	Building	Submarket	Type	Square Feet
Reliance Standard Insurance Company	1700 Market Street	West Market	New	152,000
Macquarie Group	One Hundred Independence	Independence Square	New	140,000
Sungard Availability Services	1500 Spring Garden Street	West Market	Renewal	123,456
Willis Towers Watson	1735 Market Street	West Market	New	97,448
Entercom Communications	2400 Market Street	West Market	New	67,031

Philadelphia CBD Sales Transactions

Building	Submarket	Sales Price	Price/SF	Square Feet
2000 Market Street	West Market	\$126,400,000	\$190	665,649
1421 & 1425 Walnut Street	Walnut/South Broad	\$16,500,000	\$695	23,748

Southeastern Pennsylvania Lease/User Transactions

Tenant	Building	Submarket	Type	Square Feet
Confidential Tenant	980 Jolly Road	Blue Bell/Plymouth Meeting	New	55,185
Ostroff Injury Law PC	518 Township Line Road	Blue Bell/Plymouth Meeting	New	9,612
BTB Security	Three Bala Plaza	Bala Cynwyd	Renewal/Expansion	7,000
Communications Graphics	VEVA, Building #16	Blue Bell/Plymouth Meeting	Renewal	4,692
MiWon North America	100 Arrandale Boulevard	Exton/Malvern	New	4,500

Southeastern Pennsylvania Sales Transactions

Building	Submarket	Sales Price	Price/SF	Square Feet
AIG portfolio sale	Lower Bucks	\$85,000,000	\$182	467,000
Highview I & II	King of Prussia	\$32,000,000	\$175	183,342
Cassford Corporate Center	Southern 202 Corridor	\$9,233,333	\$70	131,509
1230 American Boulevard	Southern 202 Corridor	\$4,000,000	\$144	27,800

SUBMARKET STATISTICS

	Total Inventory (SF)	Under Construction (SF)	Total Vacancy Rate	Qtr Absorption (SF)	YTD Absorption (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Total Asking Rent (Price/SF)
East Market	6,531,084	-	12.4%	5,153	(192,621)	\$33.45	\$27.89	\$28.67
Independence Square	5,337,684	-	10.9%	259,093	299,941	\$29.77	\$29.87	\$30.45
University City	2,868,880	350,000	10.3%	40,767	(41,674)	\$38.21	\$48.05	\$40.62
Walnut/South Broad	3,890,064	-	13.6%	(19,731)	12,806	\$29.39	\$28.98	\$27.96
West Market	27,116,472	618,481	12.3%	131,072	1,369,246	\$35.91	\$28.08	\$34.30
CBD Total	45,744,184	968,481	12.1%	416,354	1,447,698	\$35.64	\$29.41	\$32.73
Bala Cynwyd	2,971,802	-	9.7%	(14,127)	(1,448)	\$35.74	\$33.42	\$33.56
Blue Bell/Plymouth Meeting	8,298,682	19,585	19.9%	56,319	200,534	\$28.53	\$24.63	\$27.11
Bucks County	8,261,004	-	17.4%	44,967	76,026	\$28.04	\$22.676	\$23.69
Central/S Delaware County	5,358,937	-	11.6%	5,258	(27,783)	\$27.76	\$24.75	\$26.04
Conshohocken	3,305,942	-	10.5%	(32,211)	(31,793)	\$38.83	\$30.78	\$36.55
Exton/Malvern	8,292,524	-	9.8%	(9,306)	139,381	\$26.67	\$26.37	\$26.39
Fort Washington	3,605,418	-	14.5%	(21,226)	111,220	\$27.75	\$24.19	\$25.74
Horsham/Willow Grove	4,657,314	-	20.0%	(10,920)	(50,739)	\$27.81	\$24.42	\$24.80
Jenkintown	1,081,401	-	15.9%	875	(18,849)	\$24.05	\$22.63	\$23.39
King of Prussia	13,172,366	-	13.4%	81,889	182,552	\$30.85	\$25.18	\$26.76
Radnor/Main Line	2,823,417	-	6.3%	(7,115)	130,139	\$39.20	\$27.25	\$38.92
Southern 202 Corridor	2,506,915	-	8.5%	3,216	(30,297)	\$28.04	\$24.33	\$25.87
Suburban Total	64,335,722	19,585	13.9%	97,619	678,943	\$30.00	\$24.92	\$26.73
Market Totals	110,079,906	988,066	13.2%	513,973	2,126,641	\$32.54	\$25.90	\$28.76

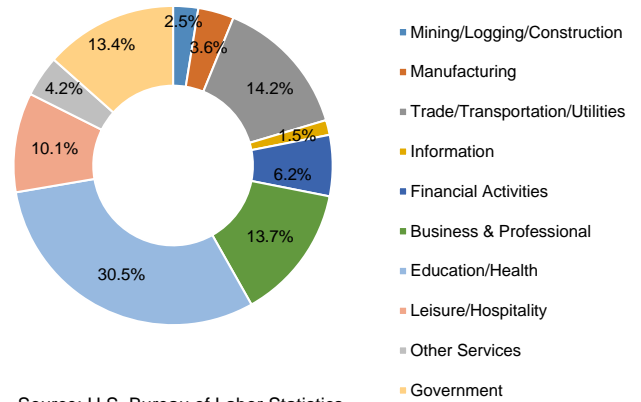
ECONOMIC OVERVIEW

The national economy is moving full steam ahead with no sign of negative effects from the trade war. At 3.9%, the unemployment rate remained flat between July and August but was down 20 basis points from the beginning of the year. According to the U.S. Bureau of Labor Statistics, 35 states had year-over-year increases in nonfarm payroll employment.

The Philadelphia metropolitan statistical area reported a 4.1% unemployment rate in July. While slightly higher than in June, the rate was down 60 basis points from one year ago. Business and professional services, education and health and leisure and hospitality remain the main drivers of employment in the region.

EMPLOYMENT BY INDUSTRY

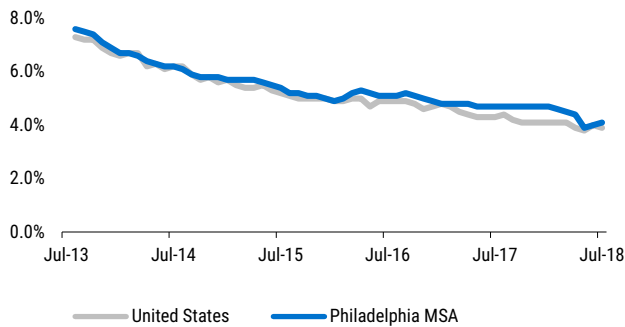
Philadelphia Metropolitan Division, 2017 Annual Average



Source: U.S. Bureau of Labor Statistics

UNEMPLOYMENT RATE

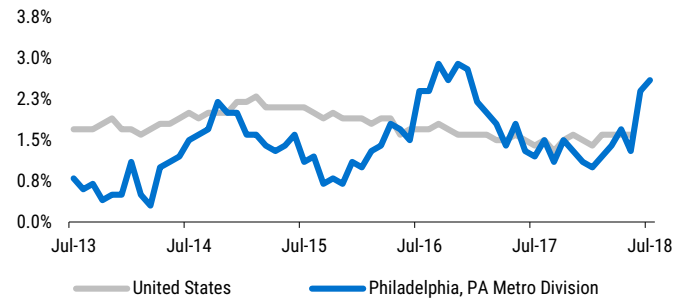
Not Seasonally Adjusted



Source: U.S. Bureau of Labor Statistics, Philadelphia Federal Reserve Bank

PAYROLL EMPLOYMENT

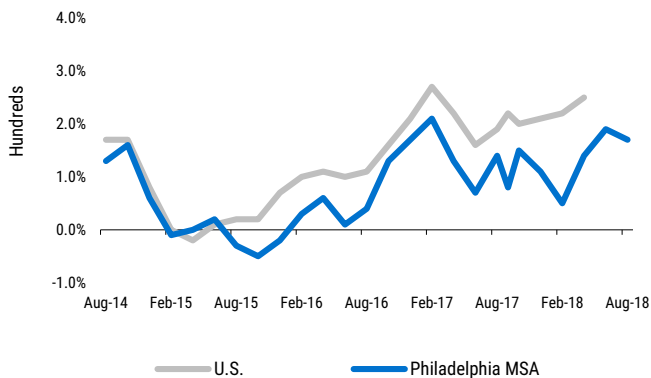
Total Nonfarm, Not Seasonally Adjusted, 12-Month % Change



Source: U.S. Bureau of Labor Statistics

CONSUMER PRICE INDEX (CPI)

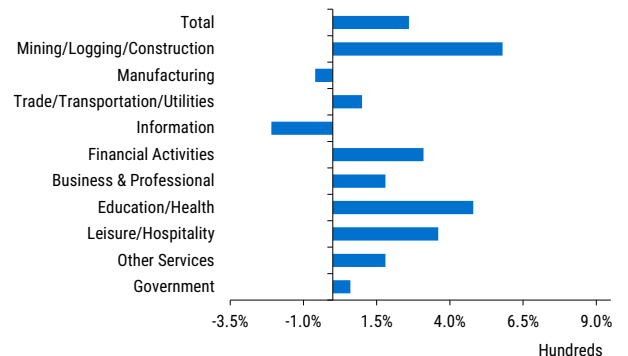
All Items, 12-Month % Change, Not Seasonally Adjusted,



Source: U.S. Bureau of Labor Statistics

EMPLOYMENT GROWTH BY INDUSTRY

Philadelphia Metropolitan Division, July 2018, 12-Month % Change, Not Seasonally Adj.



Source: U.S. Bureau of Labor Statistics



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