

# PHILADELPHIA OFFICE MARKET

## LARGE DEALS TAKE CENTER STAGE IN THE CBD

### Philadelphia Central Business District (CBD)

There was an increase in large-deal activity during 2018, driven by users looking to utilize space more efficiently. Macquarie Group announced it will reduce its footprint from 150,000 square feet at One Commerce Square to 140,000 square feet at One Hundred Independence in the third quarter of 2020. Wells Fargo will consolidate its three offices located at 123 South Broad Street, One South Broad Street and Centre Square into 84,558 square feet at Two Logan Square. In the second quarter of 2020, Towers Watson will reduce its space envelope from 209,000 square feet at Centre Square – East Tower to 97,448 square feet at 1735 Market Street. Reliance Standard Insurance Company committed to lease slightly more space as part of its deal to relocate in the first quarter of 2021, from 140,000 square feet at Two Commerce Square to 152,000 square feet at 1700 Market Street.

The choice many tenants are making to reduce their space footprint or consolidate offices can be attributed to the efficiency of new workplace strategies rather than a slowing CBD economy. According to the Bureau of Labor Statistics, between October 2017 and October 2018, 19,300 nonfarm jobs were added in the city of Philadelphia. Of that total, there were increases in employment for the office-using industries of finance (1,000 jobs), educational and health (9,100 jobs) and government (3,200 jobs).

There was also a significant increase in leasing activity during 2018, some of which came from tenants new to the CBD market. During this period, 950,000 square feet of deals were executed, 700,000 square feet more than in 2017. During the first quarter of 2018, Neumann Finance, a newly created equipment leasing firm in partnership with Beneficial Bank, leased 21,695 square feet at 123 South Broad Street. In the third quarter, Entercom Communications finalized plans to relocate from Bala Cynwyd to 67,000 square feet at 2400 Market Street. Fittler Club also leased 107,000 square feet at this property. Coworking facilities accounted for 13.7% of new tenancy in the city.

Three new properties were added to the CBD's inventory in 2018. The largest was the 1.3 million-square foot Comcast Technology Center, which completed construction in the second quarter; Comcast is the sole occupant of this property. During the fourth quarter, 2400 Market Street (615,481 square feet) delivered with Aramark secured as the anchor tenant, measuring 300,000 square feet. Another delivery in the fourth quarter was 3675 Market Street (350,000 square feet). Leasing

## CURRENT CONDITIONS

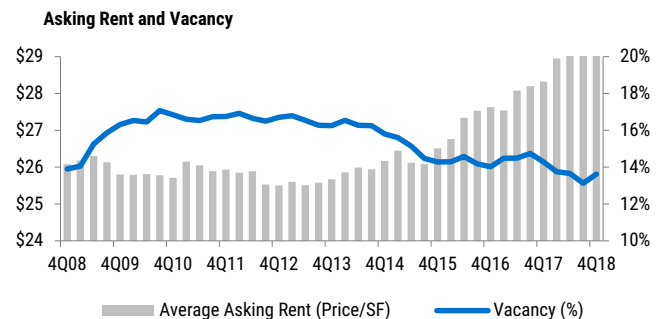
The trend towards downsizing is occurring in both the CBD and suburbs.

AmeriHealth Caritas's new headquarters is under construction.

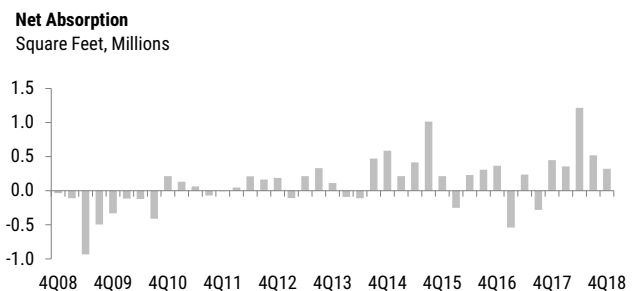
The investment market is saturated with dry powder ready to be invested.

## MARKET ANALYSIS

### Asking Rent and Availability



### Net Absorption (SF, Millions)



## MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	12 Month Forecast
Total Inventory	111 MSF	110 MSF	108 MSF	↑
Vacancy Rate	13.6%	13.1%	14.2%	↓
Quarterly Net Absorption	0.3MSF	0.5 MSF	426,670 SF	↓
Average Asking Rent	\$29.08	\$28.74	\$27.83	↑
Under Construction	0.4 MSF	1.0MSF	2.3 MSF	↑
Deliveries	1.0 MSF	0.0 MSF	0.0 MSF	↑

commitments at this building included Cambridge Innovation Center, which made its Philadelphia debut by leasing 127,000 square feet, and the Science Center, which relocated from 30,000 square feet at 3711 Market Street to 50,000 square feet. Lastly, Drexel University committed to 50,560 square feet.

Year-over-year, the overall vacancy rate decreased 20 basis points to 13.0%. The CBD recorded a total of 1.8 million square feet of positive absorption for 2018, which can mostly be attributed to the delivery and occupancy of the Comcast Technology Center. Class A vacancy increased 70 basis points to 13.1%, as large blocks of space became available at both Two Commerce Square and Centre Square - East Tower as the result of headquarter relocations. Class B vacancy fell 90 basis points from the fourth quarter of 2017 to 12.0%. This decline was due to increased leasing activity from creative and technology firms.

Both Class A and Class B direct rental rates rose from one year ago. At \$35.05/SF, the Class A average direct rental rate increased \$2.43/SF from the fourth quarter of 2017; for the second consecutive quarter, rental rates reached record-high levels north of \$35.00/SF. Class B asking rental rates also reached record highs, increasing \$0.36/SF year-over-year to \$29.33/SF.

## Southeastern Pennsylvania

Tenants are utilizing space more efficiently, so they require a smaller envelope of space for their operations. Technology allows all of this to happen, but the degree to which users are affected depends upon individual circumstances. Some have abandoned the concept of private offices and have converted entirely to an open floor concept. There has also been increased hiring of remote or contract workers, who do not require a permanent spot in an office to work. Outsourcing, consolidations, mergers and acquisitions are ongoing facts of life that are contributing to both the elimination of jobs and the decreasing need for space.

The local market has many examples of tenants that have shrunk their space requirements. For instance, in the second quarter, Transamerica relocated from 90,300 square feet at 300 Eagleview Boulevard in the Exton/Malvern submarket to 9,500 square feet at neighboring 350 Eagleview Boulevard. The firm required less space when certain service line jobs were outsourced. During the third quarter, Unirest vacated 2,607 square feet, while Air Wisconsin vacated 5,613 square feet at 300 Stevens Road (Central/Southern Delaware). The former chose to have its employees work from home, while the latter closed operations when it ceased service in Philadelphia. In the fourth quarter, Teva vacated 60,000 square feet at 2 West Liberty Boulevard (Exton/Malvern submarket) and offered the space to the market for sublease as part of a company-wide restructuring plan.

Some existing tenants expanded or relocated from outside the suburbs in 2018. During the first quarter, Keystone Sports & Entertainment expanded by 23,000 square feet, while Power Home Remodeling took another 40,000 square feet at 2501 Seaport Drive. In the third quarter, Crown Holdings relocated from Philadelphia to 50,000 square feet at 770 Township Line Road in the Bucks County submarket. The National Comprehensive Cancer Network expanded its footprint when it moved at the end of the year from 17,000 square feet at 275 Commerce Drive in Fort Washington to 65,000 square feet at 3025 Chemical Road in the Blue Bell/Plymouth Meeting submarket.

Southeastern Pennsylvania recorded its ninth consecutive year of positive absorption in 2018, posting 651,480 square feet of additional occupancy. Year-over-year, vacancy fell 90 basis points to 14.1%. Vacancy was tight in submarkets close to Philadelphia, such as Bala Cynwyd and Conshohocken. However, the King of Prussia submarket recorded 177,654 square feet of positive annual absorption, with the amenity-rich Swedesford Road corridor accounting for 42,889 square feet of that total.

The overall average direct asking rental rate increased by \$1.02/SF from year-end 2017 to \$27.18/SF. The Class A rate, at \$30.02/SF, was up \$0.19/SF year-over-year, while the Class B average increased by \$1.00/SF to \$25.31/SF.

There were some exciting announcements concerning future construction in Southeastern Pennsylvania. AmerisourceBergen committed to a new, 400,000-square-foot headquarters at the future SORA West development in Conshohocken. In the fourth quarter, AmeriHealth Caritas announced it would move its headquarters near the Philadelphia International Airport to a 378,000-square-foot built-to-suit at Ellis Preserve, located in Newtown Square. Lastly, a new speculative project will break ground in Southeastern Pennsylvania in 2019. Equus will construct a 145,000-square-foot office building at 675 East Swedesford Road. Newmark Knight Frank is marketing the property on behalf of Equus.

## Investment Sales

There is still a great amount of dry powder floating around the investment market. Over the past year, institutional buyers have turned to secondary and tertiary markets like the Philadelphia CBD, with a growing interest in opportunity zones. These new investors were active during 2018, and overall sale activity in the CBD was brisk. Three high-profile assets traded in the west Market Street submarket. These included 2000 Market Street, a 665,649-square-foot property that was purchased by Goldman Sachs and NAHLA Capital for \$126.4 million, and 1600 Market Street, an 862,370-square-foot value-add property with an in-place cap rate in the low 5's, which sold to AREP for \$160.0 million. Lastly, 1650 Arch Street, a 553,349-square-foot value-add sale wherein a lease for 55% of the building's total was set

to expire in 2020, was acquired by ASI for \$81.9 million. If the latest activity is any guide, then 2019 is on track to be another strong year for investment sale activity in the CBD.

Institutional investors have continued to shy away from suburban assets, leaving that market to private buyers, some of which are coming from overpriced markets. For example, in the third quarter, the 136,919-square-foot 1001 Adams Avenue in the King of Prussia submarket traded to Blue Stone Capital LLC out of New York for \$19.5 million, or \$142/SF. The seller was Regional Real Estate Investment Corporation. In the fourth quarter, Barings Real Estate Advisers sold the 346,659-square-foot Eight Tower Bridge located in Conshohocken to American Real Estate Partners based in Herndon, Virginia for \$108.0 million, or \$312/SF.

There was one notable exception. Equus Capital Partners and USAA Real Estate Company purchased the 222,058-square-foot Five Tower Bridge for \$75.65 million, or \$341/SF, from a joint venture between The Davis Companies, MIM-Hayden Real Estate Funds and Miller Investment Management.

Newmark Knight Frank expects regional sales volume in 2019 to meet levels realized in 2018, with office cap rates remaining stable for part of the year because of the amount of capital yet to be invested. Multifamily and industrial assets will remain hot among investors.

## Outlook

Although Philadelphia lost the contest to house Amazon's future East Coast headquarters, it could still reap some benefits. Philadelphia's proximity to the winning cities, Long Island City, New York, and Crystal City, Virginia, makes it a desirable location for Amazon clients requiring easy access to both locations. In addition, the detailed marketing package put together by the city is a good tool for wooing other companies to Philadelphia.

A minimum of 470,000 square feet of requirements are actively pursuing space in the CBD market. Tenants eager to attract younger workers will seek out those buildings that offer superior amenities, while suburban-based companies will set up "outposts" in the CBD to recruit the best talent. The next 12 months should see the remaining blocks of Class A space steadily lease and Class A rents continue to rise.

Market conditions in the Southeastern Pennsylvania suburbs will remain healthy going into 2019. A look at combined employment numbers for office-using sectors within Bucks County, Montgomery County, Chester County and Delaware County show steady hiring over the past two years with no expectations of slowing down. Like city tenants, suburban users will likely plan more densely and continue to seek buildings with attractive lifestyle features. Tenant flight to quality will put upward pressure on Class A rents, and the delta between Class A and Class B rents is likely to rise. In addition, more owners will renovate older inventory to remain competitive and raise rents in order to recoup construction costs.

## Philadelphia CBD Lease/User Transactions

Tenant	Building	Submarket	Type	Square Feet
American Board of Internal Medicine	510 Walnut Street	Independence Square	Renewal	97,946
GSA-HUD	801 Market Street	East Market	Direct	50,104
Lubert-Adler	2400 Market Street	West Market	Direct	35,000
United Healthcare	1818 Market Street	West Market	Direct	30,000
MakeOffices	111 S Independence Mall East	Independence Square	Direct	27,400

### Southeastern Pennsylvania Lease/User Transactions

Tenant	Building	Submarket	Type	Square Feet
AmeriHealth Caritas	West Chester Pike	Central/South Delaware	Direct	375,000
Unisys	801 Lakeview	Blue Bell/Plymouth Meeting	Extension	156,331
Gamry Instruments	730 Lewis Drive	Bucks County	Renewal	18,000
M3 USA	501 Office Center Drive	Fort Washington	Renewal	18,000
Worthington Armstrong Venture	101 Lindenwood Drive	Exton/Malvern	Renewal/Expansion	17,552

### Southeastern Pennsylvania Sales Transactions

Building	Submarket	Sales Price	Price/SF	Square Feet
Liberty Property Trust Portfolio	Exton/Malvern	\$173,100,000	\$304	568,658
Eight Tower Bridge	Conshohocken	\$108,000,000	\$312	346,659
1400 Atwater Drive	Exton/Malvern	\$71,250,000	\$238	299,809
Five Tower Bridge	Conshohocken	\$75,650,000	\$341	222,058

## 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	-	12.5%	(6,425)	(199,046)	\$33.34	\$28.35	\$30.72
Independence Square	5,337,684	-	12.2%	(73,225)	226,716	\$29.75	\$30.10	\$30.47
University City	3,218,880	-	11.8%	292,002	225,239	\$38.30	\$45.65	\$39.70
Walnut/South Broad	3,890,064	-	18.8%	(200,664)	(187,858)	\$32.00	\$29.35	\$28.73
West Market	27,731,953	-	12.6%	332,989	1,749,393	\$35.20	\$28.01	\$33.84
<b>CBD Total</b>	<b>46,709,665</b>	<b>-</b>	<b>13.0%</b>	<b>344,677</b>	<b>1,814,444</b>	<b>\$35.05</b>	<b>\$29.33</b>	<b>\$32.74</b>
Bala Cynwyd	2,971,802	-	9.5%	5,295	3,847	\$36.01	\$33.60	\$33.75
Blue Bell/Plymouth Meeting	8,318,267	-	18.9%	83,864	272,523	\$28.70	\$25.24	\$27.98
Bucks County	8,261,004	-	17.3%	53,877	84,577	\$28.20	\$22.76	\$23.97
Central/S Delaware County	5,358,937	378,000	12.8%	(84,584)	(7,736)	\$28.58	\$24.88	\$26.41
Conshohocken	3,181,518	-	8.4%	(854)	6,086	\$39.05	\$30.38	\$36.84
Exton/Malvern	8,292,524	-	11.0%	(102,091)	37,290	\$27.11	\$26.65	\$26.79
Fort Washington	3,548,964	-	13.1%	(13,405)	113,546	\$27.78	\$23.79	\$25.84
Horsham/Willow Grove	4,607,314	-	19.0%	24,888	(30,431)	\$27.98	\$24.18	\$24.72
Jenkintown	1,081,401	-	16.5%	(7,116)	(25,965)	\$23.98	\$22.86	\$23.42
King of Prussia	13,367,948	-	14.2%	24,499	177,654	\$31.33	\$26.04	\$27.71
Radnor/Main Line	2,635,337	-	10.0%	(14,728)	43,519	\$39.58	\$24.18	\$38.49
Southern 202 Corridor	2,506,915	-	8.2%	6,867	(23,430)	\$27.82	\$25.35	\$26.31
<b>Suburban Total</b>	<b>64,131,931</b>	<b>378,000</b>	<b>14.1%</b>	<b>(23,588)</b>	<b>651,480</b>	<b>\$30.02</b>	<b>\$25.31</b>	<b>\$27.20</b>
<b>Market Totals</b>	<b>110,841,596</b>	<b>378,000</b>	<b>13.6%</b>	<b>321,089</b>	<b>2,465,924</b>	<b>32.20</b>	<b>\$26.24</b>	<b>\$29.08</b>

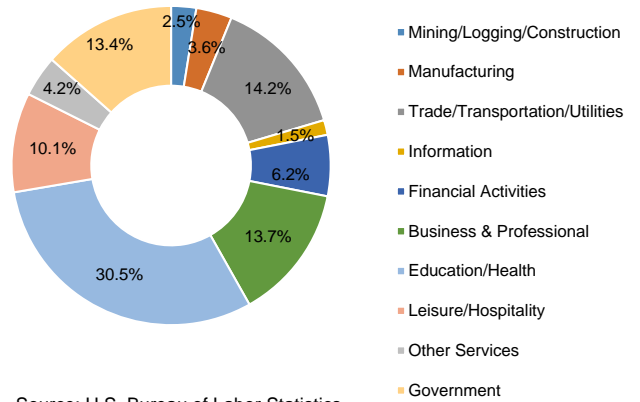
## ECONOMIC OVERVIEW

A strong economy put downward pressure on unemployment in the Philadelphia Metropolitan Division. In October, the Bureau of Labor Statistics reported an unemployment rate of 4.1%, 60 basis points lower than at the beginning of year. There were employment gains in the mining, logging and construction sectors, followed by leisure and hospitality, and education and health services.

On the national front, the last few months of the year have been tough on the stock market, as concerns about technology companies, a trade war between the United States and China and the fallout from BREXIT are making investors nervous. However, incomes have slowly started to rise, and hiring is steady.

## EMPLOYMENT BY INDUSTRY

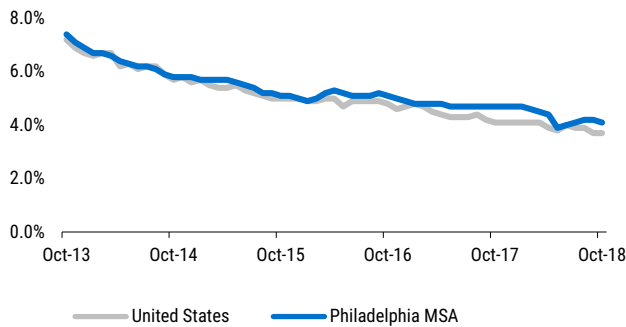
Philadelphia Metropolitan Division, 2017 Annual Average



Source: U.S. Bureau of Labor Statistics

## UNEMPLOYMENT RATE

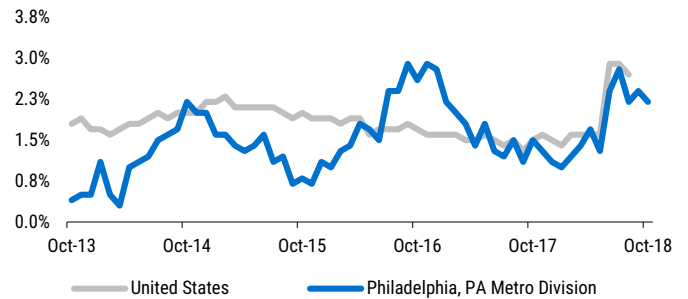
Not Seasonally Adjusted



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

## PAYROLL EMPLOYMENT

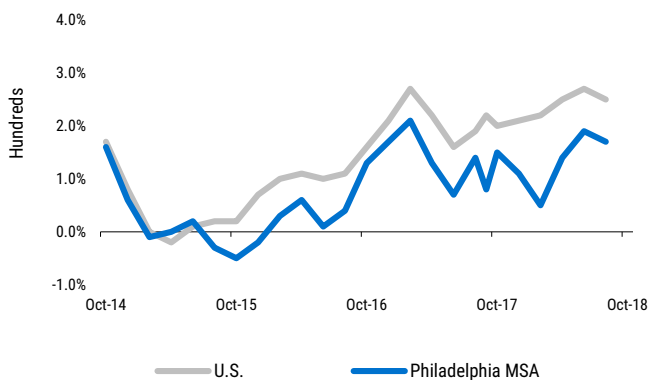
Total Nonfarm, Not Seasonally Adjusted, 12-Month % Change



Source: U.S. Bureau of Labor Statistics

## CONSUMER PRICE INDEX (CPI)

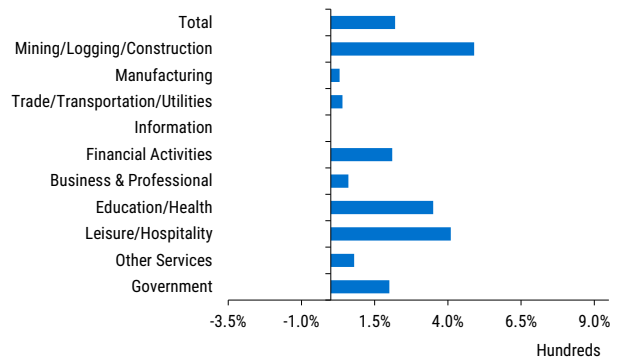
All Items, 12-Month % Change, Not Seasonally Adjusted,



Source: U.S. Bureau of Labor Statistics

## EMPLOYMENT GROWTH BY INDUSTRY

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



Source: U.S. Bureau of Labor Statistics



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