SHELDON • GOLD REALTY INC.
commercial real estate services

DENVER METROPOLITAN OFFICE COMMERCIAL REAL ESTATE UPDATE
July 2022

Return of Office Demand, Strongest since 2019, But it's a Marathon, not a Sprint

Overview

The Denver office market is showing early signs of recovery, as leasing volume resembles 2019 levels. However, Denver is still a tenant's office market. Risks in the office market are clearly evident for both the short and long term, as many companies are settling on the type of work environment, in office, hybrid work model, or fully remote. Office designs are changing rapidly to "we" spaces instead of "me" space, with heavy influence on multiple types of shared and hotel space options. Tenants currently in the market for office space are reluctant to renew leases in older buildings, driving a flight to quality, with strong preference for newly delivered and under construction office buildings. These companies are able to afford the higher quality office properties by shrinking their leased footprint due to remote work environments. Tenants with larger office space requirements are demanding their buildings be healthy environments, with building sustainability ratings and top-notch amenities, such as fitness centers, food service, outdoor spaces, meeting areas, rooftop terraces, bike storage, golf simulators, game rooms, mountain views, and access to transportation, which are now considered necessities instead of optional.

Vacancy & Lease Rates

Leasing activity has rebounded to pre-pandemic levels, but there is an emphasis on migration out of the CBD. The rapid rise in vacancy that the market experienced in 2020 has subsided, but vacancies still continue to rise. For offices outside the CBD, vacancy rates have dropped considerably from pandemic level highs. Denver's overall office vacancy at the end of 2nd quarter 2022 increased to 14.5%, up 1/10th of a percent from the end of 2020. Net absorption in the prior 12 months came in at a positive 114,000 square feet, much better than the negative 1.8 million square feet in 2020. Sublease space inventories have begun to rise once again. Available office sublease space in Denver now totals 5.1 million square feet, breaking the highest record previously set in first quarter of 2021. The current availability rate of office space in Denver is 18.8%, up from 18.1% at the end of 2020. The difference between the vacancy rate and the availability rate is the sublease space, which is currently not vacant, but is being marketed as available. The effects of the sublease space are largely felt in the Downtown Denver submarket, where the vast amount of sublease space is listed. Sublease space puts downward pressure on overall lease rates, as these spaces are typically offered at a deep discount relative to direct lease space. Average asking lease rates at the end of second quarter 2022 for office space increased to $29.12 per square foot from $28.60 per square foot at the end of 2020. Year over year rent growth in Denver is now at 1.9%. The DTC, Greenwood Village, and East Hampden submarkets have seen the highest annual rent growth. Pricing still remains in the favor of tenants by commanding heavy concessions, such as generous tenant improvement allowances, moving and cabling allowances, free parking, and free rent. However, the tenants have to know what to ask for!

New Construction, Tenant Finish & Outdated Buildings

Denver's office construction pipeline remains thin, with only 1.7 million square feet of new office buildings currently underway, a decrease of more than 50% from the previous year. Tenants, working on leasing new office space, continue to see significant time delays in occupancy dates due to challenges with long construction permit times, rising tenant finish costs, supply chain issues, and labor shortages. ***See update page 2***

2nd Quarter 2022 Metro Denver Office Market

↑	↑	↑	↑	↑
Vacancy Rate: 14.5%	Average Lease Rate: $28.12/RSF/Year	Net Absorption: Negative 114,000 SF	Sublease Space Availability: 5.1 million SF	Under Construction: 1.7 million SF

Interesting Denver Office Market Statistics

- The Northeast Denver submarket has the lowest vacancy at 2.8%
- The CBD submarket has the highest vacancy at 25%
- The Platte River submarket has the highest average quoted gross lease rate at $44.67/RSF/Year
- The East Hampden submarket has the lowest average quoted gross lease rate at $21.33/RSF/Year

Data source: CoStar

Tenants turn to ownership with 100% SBA financing! Stop buying a building for your landlord; Start building equity for yourself!

The interest in ownership of one's own office or warehouse building/ condominium has increased tremendously. In 2021, our company sold over 30 commercial user buildings to companies that were looking to control their environment and have their monthly rent go to equity in a property they owned. In most situations, you can own your office space for the same or less than the cost of leasing. The incentives to ownership offer a tenant the ability to fix their occupancy costs long term and no longer be subjected to supply and demand pricing every time their lease renews. Ownership allows the tenant to build equity with their monthly payments instead of helping their landlord purchase a building for themselves. Owning your own property also provides stability and control over the costs of your occupancy and adds a corresponding asset to the company balance sheet instead of just the liability of a lease.

Financing for the purchase of commercial owner user properties is very easy to obtain. Both SBA and Conventional loans are readily available now with ZERO down payment on some SBA loans and with as little as a 20% down payment requirement on conventional owner occupied loans. Tenants as small as 600 square feet have the ability to purchase and own the office space they need. It takes forethought, knowledge, and fast decision making to purchase a property, and the company's credit, size fluctuations, and the potential risk of the purchase all need to be considered. The purchase, once under contract can take 2 to 6 months depending on the type of financing the buyer wants to achieve. Owner user commercial properties are in high demand, and thus, you should start your property search about one year in advance of when you want to be in the space. Make sure you discuss purchase options with your commercial real estate consultant and find out what so many other tenants already know: **Ownership is the Future of Leasing!**

update from page 1

The pandemic has spelled the end for office properties that were already on their last legs. Finding new uses for these structures will become the focus for obsolete older office buildings. Many cities and ownerships are looking at conversion of these properties, through adaptive reuse, into industrial, storage, or affordable housing. Denver is no different, with currently four applications into the city from property owners looking for permits to convert large CBD office buildings to residential use. The Platte River submarket has emerged as a highly desirable area for office tenants and new construction development has increased to staggering levels in this submarket in the last year.

Sales

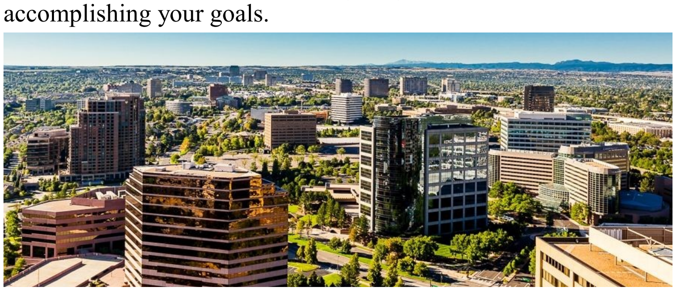
Investors have returned to the Denver market after retreating in 2020, following the initial outbreak of the Coronavirus. $3.4 billion in office sale transactions closed since July 2021. However, quarter or quarter sales volume has been steadily declining since 3rd quarter 2021. Over the past decade, Denver has become a destination for both corporate relocations and small startup expansions, due in part to the city's relatively lower prices, diversified economy, and educated workforce. While the long-term impact of the pandemic on Denver's office sector remains uncertain, the uptick in sales volume and investor interest signals that the office sector is starting to normalize from a capital markets perspective. Investors also continue to target assets located in Denver's suburban submarkets as well. The market CAP rate for leased office investments was averaging around 6.91% the first half of 2022, and the average sale price per square foot was around $253, up from $240 per square foot in the prior year.

Summary

Market trends we are watching:

- Space reallocation: downsizing
- Location migration: to the suburbs
- Lease terms: short and flexible
- Work environment: flight to quality and amenities

Tenants of all sizes who desire to lease space should be able to command significant incentives that have not been seen in decades. Property owners will be looking closer at tenant credit and ability to withstand another round of a COVID variant. Tenants with lease renewal options should make sure they have expert advice on market lease rates and not just accept a lease renewal rate proposed by their landlord. With the office market in the tenants favor, don't be fooled into thinking you can secure a lease space on short notice! You will need significantly more time than in the past to accomplish space design, obtain construction permits and complete construction of new space. For most tenants, starting the process 12 to 15 months in advance of your lease expiration is appropriate. For large tenants, starting 18 months to 2 years in advance is necessary. Identifying upcoming space options and gaining market knowledge on other tenants negotiated lease rates and incentives is necessary to achieve the best economics on your lease decision. Retaining an experienced commercial real estate consultant to represent your company is imperative to navigating our "new normal" and accomplishing your goals.



Denver Technological Center

Office property investors are still buying, but the market is changing.

Office property investors are still on the hunt for value add office investment opportunities; however, the disparity between the seller's asking price and buyers purchase price is growing. Office real estate investors that we have represented still believe there is a strong demand for small office space for companies to lease. In the last 12 months, our company has sold a number of value add office buildings totaling over 269,000 square feet and valued at close to $30 million dollars. The average sale price of these buildings was $109 per square foot, which is well below replacement costs. All of the properties gave the investor the ability to add value through lease up of vacant space, updating the property, or increasing rents to market prices on expiring leases.

Investment trends we are seeing:

- Foreclosures have started. We have seen a number of office properties go into receivership and then foreclosure, mostly in the central business district, but still some in the suburban market.
- CMBS (Commercial mortgage back security) loan problems are on the horizon across the U.S. as many of these loans come due in the next 12-18 months. Problem loans in Colorado are expected to be less than 1% of all Colorado CMBS loans compared to some East coast cities where up to 30% of the CMBS loan are expected to potentially default.
- Older office properties in the CBD have moved past their useful life. Four property owners in the CBD have already applied for permits to convert their high-rise office towers to residential use. We expect to see a lot more of this.
- Borrowing interest rates for both owner users and investors have climbed quickly and are expected to continue to climb. Higher interest rates will force an increase in CAP rates that investors find acceptable. Higher CAP rates mean lower property values.