DENVER METROPOLITAN OFFICE COMMERCIAL REAL ESTATE UPDATE
Mid Year 2023

SHELDON • GOLD REALTY INC.
commercial real estate services

Denver currently ranks as the worst performing office market in the U.S.

Overview
With office demand remaining flat since the 2nd quarter of 2022, our opinion is the recession has already begun and the impact of this will mean a continued weakening demand for office space. Leasing activity has improved over the last two quarters increase by 11.6% in the 2nd quarter of 2023. However, this positive indicator is not enough to declare an official recovery, as average deal sizes continues to trend downward. The hybrid workplace environment is here to stay, and each company has its own interpretation of what remote access in office work looks like. Tenants currently in the market for office space are driving a flight to quality, with strong preference for newly delivered and under construction office buildings. Amenities are no longer an option, and the most important are connected to social interaction. Office property owners are focusing on common spaces, such as gyms, yoga studios, coffee shops, rooftop terraces, interactive golf simulators, wine/beer tasting bars and game lounges.

Vacancy & Lease Rates
Leasing activity has increased since the pandemic, but not enough to outpace tenant move outs. Annual absorption has remained in the red for 3 years now as companies reassess their office footprints. There is a continued emphasis on migration out of the CBD with office users favoring the Cherry Creek and Platt River submarkets. Denver's overall office vacancy at the end of 2nd quarter 2023 stands at 15.5%, up almost 1% from the beginning of 2023. Net absorption for 2nd quarter 2023 came in at a negative 512,000 square feet, a 30% increase from 1st quarter 2023. Cherry Creek is the only Denver submarket to maintain positive absorption and outperforming rents, due to a high concentration of class A assets with landlords capitalizing on the flight to quality. Office vacancies are concentrated in older vintage segment of the office market with offices built in the 1980's and 1990's mostly impacted. 60% of office vacancy is concentrated in 10% of existing office buildings and 90% of office vacancy is concentrated in only 30% of existing buildings. Tenants are downsizing footprints via densification and choosing properties with more efficient floor plates, enabling companies to take less space but in higher quality buildings. Denver's average lease size now stands at 3175 square feet, a 45% decrease from the average lease size at the peak in 2015. Average asking lease rates have remained flat since the end of 2022 and were at $29.19 per square foot on a full service gross lease at the end of 2nd quarter 2023. Lease terms remain in the favor of tenants with heavy concessions, such as significant free rent, generous tenant improvement allowances, moving and cabling allowances, and free parking. However, the tenants have to know what to ask for! Sublease space inventories are at historic record levels. Available office sublease space in Denver now totals 6.4 million square feet, slightly down from the end of 2022, most likely due to the leases ending rather than actually being subleased. The amount of sublease space on the market solidifies a continued trend of downsizing or eliminating the need for office space. The current availability rate of office space in Denver is 20.7%, up 0.7% at the end of 2022. 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. The difference between average asking lease rates for direct space versus sublease space has reached $9 per square foot, the widest delta on record. At the beginning of 2020 the difference was less than $2 per square foot.

2023 Metro Denver Office Market

↑	↑	↑	↓	↓	↑
Vacancy Rate: 15.5%	Available Rate: 20.7%	Average Lease Rate: $29.19/RSF/Year	Net Absorption: Negative 512,000 SF	Sublease Space Availability: 6.4 million SF	Under Construction: 4.1 million SF

Interesting Denver Office Market Statistics
- The Cherry Creek submarket has the lowest vacancy at 10%
- The Centennial/Meridian submarkets have the highest vacancy at 39% each
- The Platte River submarket has the highest average quoted gross lease rate at $47.33/RSF/Year
- The Centennial submarket has the lowest average quoted gross lease rate at $19.64/RSF/Year

Data source: CoStar

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
- Investment property CAP rates will rise
- Office vacancy spread between newer and older space will widen
- Smaller office spaces, under 15,000/sf will dominate leasing activity

New Construction and Outdated Buildings
Development remains active in Denver, as developers continue to take advantage of tenant's desire for quality office space. Currently, there are 26 properties totaling 4.1 million square feet of new office buildings underway. This is an increase from the 19 buildings and 2.1 million under construction at the end of 2022. Platt River is the most desirable area for office tenants in Denver and is on track to expand its office inventory by over 15%. 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. However, the opportunity to repurpose existing office properties into residential use is inconsequential. A very small percentage of office properties have the correct floor plate size and infrastructure for consideration, and the costs to convert are enormous. One study by COSTAR indicates that only about 6% of the office inventory in the U.S. would come off the market due to conversion to residential use. That would represent only a 2.5% increase (465,000 units) in the current residential inventory. This amount is dwarfed by the 1.1 million units of multifamily currently under construction in the U.S. and thus unlikely to impact or solve the housing shortage. It is agreed that we need to redesign our built environment, but the conversion of office to residential is not the answer. This leaves demolition and redevelopment as the final solution.

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Sales

Investment sale activity has taken a step back since the second half of 2022 due to the uncertainty of the future of office demand. The lack of sale transactions has stalled a much-needed reset in valuations. Vacant value add assets have fallen out of favor as office vacancies continue to climb to record levels. Market average CAP rates for Denver investment office properties came in at 8.1% since the beginning of 2023. A 1% increase in the last 6 months. Average sale price of office investment sales came in at $236 per square foot, a drop of 8.5% since the end of 2022. The Lodo and Cherry Creek submarkets are achieving the highest average sale prices at around $400 per square foot. Overall, office values have dropped by 25% in the past 12 months. Estimates show that work habit shifts have destroyed $413 billion of value in the overall U.S. office market, with a majority of that being in the central business districts. 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. Without a market expert consultant, the tenant has no clue what incentives they may be leaving on the table because they didn't know to ask. 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 significant time to accomplish space design, obtain construction permits, and complete construction of new space. For most tenants, starting the process 12 months in advance of your lease expiration is appropriate. For large tenants, starting 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.

The Sublease Space Flood!
Your Reward & Risk of Signing a Sublease

A total of 6.4 million SF of office sublease space is available, representing a record for the Denver market. Companies that do not have upcoming lease expirations are looking for options to offload space, due to a fundamental shift in where employees work. Deciding to take a sublease space offers both rewards and risks:

Rewards:
- Very attractive lease rates
- Quick move in times
- Sometimes, "plug and play" with furniture & equipment included
- Shorter term leases if that is what you are looking for

Risks:
- Don't like that tenant's lease? Don't take the space. You have to agree to everything in the lease that the tenant currently has.
- Don't like the carpet, colors or layout? You will have to reach into your pocket to change these. Typically, there is no tenant improvement allowance available from the tenant trying to sublease.
- Qualifying the tenant you are subleasing from is as important as them qualifying you! That tenant is your landlord and most likely, the rent you are paying them does not cover the full rent they are obligated to pay to the property owner. This means that the tenant must pay the deficiency each month. If they don't, YOU are evicted from the space!

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Lenders offering 100% SBA financing!
Stop buying a building for your landlord;
Start building equity for yourself!

Interest in ownership of one's own office or warehouse building/ condominium continues to increase. 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 adds a corresponding asset to the company balance sheet instead of just the liability of a lease.

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. **Ownership is the Future of Leasing!**

It's a tenants market!
Don't make these common leasing mistakes

Tenants typically make three major mistakes when renewal time comes around. The first is folding their cards by asking the landlord for a renewal proposal. By doing this your landlord believes that you are only considering a renewal and not exploring any competing space, with the assistance of a professional tenant representative, to educate you on the market. Once a landlord thinks that you are committed to staying, he will most likely make you an offer inconsistent with market rates and terms. The second common mistake made by tenants, is not allowing enough time for the relocation/renewal process. Too short of a time gives your landlord the advantage, as he knows you won't have the time you need to relocate. Tenants occupying less than 10,000 square feet should begin the process one year in advance, larger tenants up to two years. The third most common mistake tenants make, is not knowing what leasing incentives they should be asking for, thus, leaving a lot of money on the table!

All three of these pieces of leverage for the landlord can be mitigated by engaging a commercial real estate tenant representative. While a landlord may tell you this will raise the lease rate, this is simply incorrect, as brokerage fees are already factored into the lease rates and agreed to in advance with the landlords listing broker. Additionally, just advising your landlord that you have retained representation tells him to put his best foot forward or risk losing you as a tenant.
- What tenant improvement allowance, moving allowances and free rent should you be receiving on a lease renewal?
- What is fair for a tenant, in the current office market, with regards to operating expense costs, parking charges, holdover provisions, relocation clauses, options to renew, and your ability to sublease? You would never go to court without your attorney or through an IRS audit without your accountant. Don't make one of your company's top 3 financial commitments without having proper market knowledge and guidance. Eliminate the landlord leverage, protect your company's finances, all at no cost to you. Retain a commercial real estate tenant representative to be your advocate!

Celebrating Our 38th
Year in Commercial Real Estate
Over 143 Years Combined Experience