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commercial real estate services

# DENVER METROPOLITAN OFFICE COMMERCIAL REAL ESTATE UPDATE January 2021



## 2020 Year End Metro Denver Office Market

↑	↑	↓	↑
Vacancy Rates	Average Lease Rates	Negative Net Absorption	Sublease Space Availability
13.1%	\$28.43/RSF/Year	4.4 million SF	4.6 million SF

### Don't Expect the COVID-19 Vaccine Rush Back to the Office & Make Way for the Groundscraper!

The new post COVID pandemic real estate market is now a year in the making, and office space leasing activity has been reduced in half. With 50% of the leasing activity lost, vacancies are rising, and the quantity of sublease space for lease on the market has grown exponentially, which puts downward pressure on direct lease rates. Property owners are taking longer than we might like to adjust lease rates while they figure out the extent of the coronavirus damage, and at the same time, they are just starting to realize the battle they are in to retain the tenants they have, especially at the pre COVID lease rates they were achieving. The pandemic is only part of the reason for negative absorption. Absorption rates were already in decline due to companies having fewer square feet per employee. Now, with the pandemic, this trend has reversed. Companies are now focusing on de-densification; modifying their workplaces to accommodate social distancing for those employees that will be in the office. Working from home does provide for reduced real estate costs, but those savings will be lost to companies having to create more distance between the employees in the office.

The impact of work from home trends will continue to slow the office market, but the use of office space will play an important role in the recovery of the economy. The recovery of the office market is going to be a slow process, with some predicting the market will be unbalanced until 2025. The period between now and then will be especially murky for office real estate. There will be a large reversal of the work from home trend. It may not be 5 days in the office, but will be substantially more than it is today. Office space does provide benefits that are difficult to replicate or keep in place when all or most of your work force is remote, such as face-to-face contact, which is important for collaboration and creativity. Employees have begun to feel lonely and depressed working from home full time on zoom meetings and feel they have lost their connections. As employees return to the office, companies will begin to embrace low-rise buildings with the ability to reach offices via stairs rather than elevators and a shift to smaller suburban locations closer to where their employees live. It is highly possible that lower floors of office properties will become more valuable. Investors, who have been sitting on the sidelines with tons of cash, are all fired up and ready to pick up distressed commercial real estate at bargain prices in the very near future.

Denver's office vacancy at the end of 2020 increased to 12.63% up from 9.96% one year ago. Net absorption was over negative 3.6 million square feet, where a year ago it was just over positive 1.7 million square feet. Average asking lease rates for all metro Denver office space continued to increase to \$28.43 per rentable square foot on a full service lease at the end of 2020. Available sublease space in the Denver market now exceeds 4.6 million square feet, which represents an 80% increase from one year ago. This is a record breaker for the Denver office market, as sublease space now represents over 20% of all the office space currently offered on the market. 2020 ended with Denver having approximately 2.6 million square feet of office space under construction, compared with 3.1 million square feet one year ago.

Office use is not going away. It will just look a bit different from before, and will still play a major part in corporate culture. Employees will begin to push back against remote work policies as they recognize they have been shouldering expenses and costs that

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### Vacancy Rates

	Year End 2019	Year End 2020
CBD	14.5%	16.3%
Aurora	17.3%	22.6%
Colorado Blvd.	11.9%	15.1%
Southeast	16.7%	24.2%
Northeast	19.6%	19.1%
North	15.1%	16.3%
West	16.9%	18.7%
Southwest	15.4%	19.4%
Northwest	8.1%	17.6%

### Denver's average change in asking lease rates between Year End 2019 and Year End 2020

Class A	3.7% increase
Class B	1.0% increase
Class C	10.8% increase

Data source: CoStar

### Commercial Real Estate Trends to Watch

- Space design that offers greater dedication, privacy and separation from others, "de-densifying". Covid-19 is the final straw for recently trending open office, benching and shared space concepts. As we reevaluate our physical proximity to others, the focus will be on personal space and creating distancing between people.
- Hyper focus on health and safety could include: restroom designs without doors, touch surfaces, such as door knobs and faucets, replaced with anti-microbial surfaces.
- More square footage for spacing, less employees in the office.
- Highly amenitized class A properties with conferencing centers, delis, health facilities, showers/lockers, covered parking, ground and rooftop public areas, and game rooms may find an exodus of companies moving to class B and C locations to reduce occupancy costs. With employees only being in the office 50% of the time on average, and little interest in using publicly accessible facilities, companies may find they can forgo the more expensive lease rates in the market.
- Lengthier lease documents. Force majeure to the center stage! Events such as our COVID 19 pandemic have both landlords and tenants negotiating for exceptions and contingencies to prevent defaults of lease obligations in such circumstances.
- Evictions and foreclosures. The next 12 months will prove to be the most damaging, as we see tenants who are in default finally being evicted, and property owners who had a high percentage of tenants lost due to COVID 19, hand the keys back to the bank or have the property foreclosed on.

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ordinarily would have been paid by their employers. Expectations are for the office market to move more strongly to a tenants market, with office lease asking rates contracting in 2021 and 2022 by 10% to 20%. Tenants of all sizes should be able to command lower lease rates and significant incentives, including some we have not seen since the 1980's; more free rent, increased tenant finish allowances, moving and cabling allowances, and discounted or free covered parking are just some. Property owners will be looking closer at tenant credit and ability to withstand another round of stay at home orders. 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. For companies that wish to relocate or build out new space, significant time will be needed to accomplish design, obtain construction permits and complete construction. For most tenants, starting the process 9 to 12 months in advance of your lease expiration is appropriate. For large tenants, starting 1 to 2 years in advance is necessary. Identifying upcoming space options, gaining market knowledge on other tenants negotiated lease rates and the incentives other tenants received, is necessary to achieve the best economics on your next lease decision. Retaining an experienced commercial real estate consultant to represent your company is imperative to navigating our "new normal", accomplishing your goals, and keeping your companies occupancy costs as low as possible.

**Hidden Costs of Signing a Lease Renewal**

Tenants typically make two 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.

Both of these pieces of leverage for the landlord can be eliminated 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 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 companies top 3 financial commitments without having proper market knowledge and guidance. Eliminate the landlord leverage, protect your companies finances, all at no cost to you. Retain a commercial real estate tenant representative to represent you in your office lease decisions!



Denver Technological Center

**Market Comparisons  
Average Quoted Gross Lease Rate  
Per Square Foot Per Year**

Class	Year End 2019			Year End 2020		
	A	B	C	A	B	C
CBD	\$36.07	\$29.34	\$22.33	\$37.50	\$28.73	\$23.20
Aurora	\$22.26	\$19.16	\$13.16	\$23.16	\$19.85	\$14.62
CO Blvd.	\$30.61	\$23.82	\$20.94	\$30.28	\$23.19	\$23.63
SE	\$30.00	\$23.91	\$17.07	\$31.15	\$23.86	\$18.92
NE	\$21.50	\$23.08	\$19.69	\$21.82	\$24.65	\$27.13
North	\$26.28	\$24.25	\$15.70	\$25.87	\$24.41	\$16.30
West	\$28.38	\$23.30	\$18.13	\$28.10	\$23.93	\$15.60
SW	\$28.64	\$18.11	\$17.38	\$25.66	\$20.56	\$16.17
NW	\$27.56	\$19.95	\$16.35	\$28.30	\$20.23	\$16.35

**Interesting Denver Office Market Tidbits**

- Based on historical data since 2000, Denver's office market has never had three consecutive quarters of negative absorption. That streak was broken in 2020 as the market experienced major tenant move-outs.
- Sublease space availability is at an all-time record! 4.6 million square feet representing 2.5% of the entire metro Denver office inventory.
- The Northeast Denver submarket has the lowest vacancy at 3.6%
- The Highlands Ranch submarket has the highest vacancy at 31.7%
- The Platte River submarket has the highest average quoted lease rate at \$42.18/RSF/Year
- The Southwest Denver submarket has the lowest average quoted lease rate at \$20.95/RSF/Year

**Data source: CoStar**

**Demand for office ownership increases!  
Control your entrance, control your social distancing & control your occupancy costs!**

With the advent of the pandemic, the interest in ownership of one's own office building or condominium has increased tremendously. Many companies are making the move from large office buildings with elevators, large common lobbies and many people, to a property they can control the entrance and avoid the use of elevators. Loan interest rates for owner occupied properties are at record lows!

In most situations, you can own your office space for 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. Loans for the purchase of commercial owner user properties are very easy to obtain. Both SBA and Conventional loans are readily available and with as little as a 10% down payment requirement. 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 company's credit, size fluctuations, and the potential risk of the purchase all need to be considered. The purchase process takes about four months longer than a lease. Thus, if you are going to consider a purchase, you

should start 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!**

## Lease Rate Is Only Part Of A Tenant's Occupancy Costs

Too many office tenants get wrapped up in lease rates when it comes time to renew or relocate. It may sound ridiculous to overemphasize the fiscal impact of square footage rates over a three- or five-year lease period, but tenants routinely do. They perceive the rental rate as the end-all without considering what other elements might be involved in the cost to occupy space, and there are always other elements. Here are six to look out for when reviewing the lease:

### 1) Building Operating Expenses

It costs landlords big dollars to operate and maintain their buildings. There are scores of recurring costs that factor into their profit models other than rent. Any one of these costs could be handed down in some part to tenants. These "pass throughs" can include taxes, insurance, landscaping, snow removal, security and utilities, among many others. Most landlords limit their financial liability by employing "expense stops." This is when the landlord agrees to pay an operating cost up to a specified threshold where it then passes all additional costs on to the tenant. The tenant better know at the front end exactly who is responsible for those costs.

### 2) Tenant Finish Allowance

This is usually a dollar per square foot amount used to improve the tenant's lease space. Tenant improvements can include construction, design and engineering costs, carpet, paint, millwork, doors, and hardware. The landlord already has an allowance built into its budget, regardless of whether or not the tenant asks for any of it. So for the tenant, it is a "use it or lose it" proposition. Every tenant should take full advantage of whatever the current market will bear when it comes to improvement dollars. And that includes renewing tenants as well.

### 3) Space Measurement

It is astounding how few tenants actually know how the space they rent is defined and measured. "Usable square footage," in essence, is the amount of space on which the tenant can set its furniture and equipment, and where people work each day. "Rentable square footage" is the usable square footage plus the tenant's pro rate share of common elements of the building, like lobbies, hallways and restrooms. Rentable square footage is specifically what tenants pay for each month. There are other methods of measurement that apply to full-floor and multi-floor tenants, and it can get complicated. Tenants should always know who is doing the measuring and what standard they are using. In fact, tenants would be wise to hire their own interior architect or other qualified expert to verify the landlord's documented square footage.

### 4) Holdover Provisions

What happens to the tenant if they stay in their space after the lease period expires? In some cases, the landlord will allow for a month-to-month lease period to commence, but at dramatically inflated rates. This provision will also state how much notice the landlord will offer the tenant before eviction.

### 5) Right of Relocation

Any given lease may stipulate that the landlord can relocate a tenant to another space within the same building. This might not seem like an overwhelming inconvenience on the surface, but consider all of the hassles even a small tenant must endure during the relocation process. The disruption of an unintended move to another space, even within the same building, could be crippling to a tenant, not to mention the associated expenses.

### 6) Subleasing Provisions

Any given tenant's space requirements can change dramatically during the lease period. Sometimes subleasing becomes a fiscally attractive option, if the landlord will allow it. Can the tenant move out altogether and sublet its entire space, or will it be in default of the lease? Can it sublease just some of the space to another tenant? What would the rates be? What kinds of restrictions on the type of sublease tenant might be stipulated? How long is the approval process?

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

A total of 4.6 million SF of sublease space is available, representing a record for the Denver market. The sublease space on the market represents 2.5% of the entire office inventory in the Denver metro area. Companies that do not have upcoming lease expirations are looking for options to offload space, due to either financial distress, consolidation, or a permanent work-from-home policy. The significant rise in sublease space is expected to slow the office market's recovery and hinder near-term rent growth. The effects will largely be felt in Downtown Denver, where the vast amount of space is listed. The pace of sublease space coming to market has not slowed, and sublease levels are expected to rise into 2<sup>nd</sup> quarter 2021.

Sublease space may not be the largest contributor to office vacancies. Oil price volatility and lack of demand have caused oil and gas companies to vacate their office space just as fast as they have been declaring bankruptcy. Over 43 oil and gas companies declared bankruptcy in 2020 and 5 of these were headquartered in Denver. Oil and gas companies currently occupy about 14.5% of all the office space in the Denver market and Denver County has one of the nation's highest concentrations of jobs in the oil and gas industry.

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 all furniture and 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 money available from the tenant trying to sublease.
- Qualifying the tenant you are subleasing from is important as they are going to qualify you! That tenant is your landlord and most likely, the rent you are paying them does not cover the full rent they pay to the property owner. This means that tenant is supposed to pay the deficiency each month. If they don't, YOU are evicted from the space!

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