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*commercial real estate services*

# DENVER METROPOLITAN OFFICE COMMERCIAL REAL ESTATE UPDATE
## Mid Year 2021

## The COVID office shakeup is just getting started Record 5 consecutive quarters of negative office space absorption

We are 18 months into the post COVID pandemic commercial real estate market, and the good news is that office leasing activity is back to 70% of normal instead of the 50% it was 6 months ago. However, tenants are not making long-term decisions in our uncertain environment. Estimating future demand for office space is complicated, as we experience the largest global work-from-home effort in modern history. Its positives and negatives are still being assessed, but the consensus is the office will remain a critical part of a hybrid work model, as 59% of businesses expect to reduce their office space requirements, and 69% of companies say the typical 9-5 workday schedule is a thing of the past. The recovery of the office market is going to be a slow process, with some predicting the market will be unbalanced until 2025. As employees return to the office, companies will begin to embrace low-rise buildings, (recently coined as “groundscrapers”), with the ability to reach offices via stairs rather than elevators and a shift to multiple smaller suburban locations closer to where their employees live. It is highly possible that lower floors of office properties will become more valuable than the top floors with mountain views.

In the meantime, office vacancies continue to rise, and the quantity of office sublease space on the market has hit an all-time record high in Denver recorded history. Metro Denver ended second quarter 2021 with 4.7 million square feet of available office sublease space. Denver's overall office vacancy at the end of second quarter 2021 increased to 14.4%, up 3.7% from one year ago. Net absorption in the prior 12 months came in at a negative 4.8 million square feet, where the historical average is a positive 1.3 million square feet. The current availability rate of office space is 19.2%. The difference is the sublease space, which is currently not vacant but is available. Denver’s sublease space now represents 18% of all the office space currently offered on the market. With this quantity of sublease space on the market, most of it will not be absorbed before the term of the lease expires, at which time, the space will be returned to the property owner and then counted in the market as vacant. Office sublet space poses more of a competitive threat than initially thought and is expected to slow the office market recovery. The effects will largely be 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. If this were not enough, a wave of over 2.2 million square feet of speculative office space construction is expected to deliver in the next 12 months, further pushing office vacancies up. Some good news for tenants: average lease rates are now sitting at $28.67 per square foot on a full service lease, a 1.71% decrease from one year ago. As the market swings to the tenants favor, landlords are also boosting leasing concessions such as free rent, tenant improvements, and moving allowances.

Tenants of all sizes who desire to lease space should be able to command lower lease rates and significant incentives such that have not been seen since the 1980’s. 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. With the office

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### 2nd Quarter Metro Denver Office Market

| ↑ | ↓ | ↓ | ↑ |
|---|---|---|---|
| Vacancy Rates 14.4% | Average Lease Rates $28.67/RSF/Year | Net Absorption Negative 4.8 million SF | Sublease Space Availability 4.7 million SF |

### Interesting Denver Office Market Tidbits

- The Northeast Denver submarket has the lowest vacancy at 3.1%
- The Centennial submarket has the highest vacancy at 21.5%
- The Platte River submarket has the highest average quoted gross lease rate at $42.65/RSF/Year
- The East Hampden submarket has the lowest average quoted gross lease rate at $20.15/RSF/Year

**Denver’s average change in direct asking lease rates between End of 2nd Quarter 2020 and End of 2nd Quarter 2021**

**Class A 2.7% increase**
**Class B 4.2% increase**
**Class C 4.5% decrease**

***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!**

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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, all due to supply chain issues and construction labor shortages. 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", 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 only asking the landlord for a renewal proposal. By doing this your make your landlord believe 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 free rent and moving allowance 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 lease decision!



Eric Greg Mary Jo George Jason

## Market Comparisons
## Average Quoted Direct Gross Lease Rate Per Square Foot Per Year

| | End 2nd Quarter 2020 | | | End 2nd Quarter 2021 | | |
|---|---|---|---|---|---|---|
| **Class** | **A** | **B** | **C** | **A** | **B** | **C** |
| CBD | $37.31 | $28.56 | $22.84 | $38.46 | $30.36 | $23.40 |
| Aurora | $23.15 | $19.84 | $13.10 | $24.82 | $20.48 | $12.65 |
| CO Blvd. | $30.66 | $23.88 | $21.92 | $30.60 | $24.11 | $21.52 |
| SE | $30.07 | $23.70 | $19.95 | $31.22 | $23.93 | $20.02 |
| NE | $27.85 | $26.20 | $25.95 | $28.40 | $24.88 | $20.93 |
| North | $26.14 | $23.63 | $15.99 | $25.69 | $25.78 | $16.42 |
| West | $27.58 | $24.02 | $15.54 | $27.92 | $24.16 | $15.81 |
| SW | $30.09 | $18.42 | $16.67 | $24.55 | $20.62 | $16.58 |
| NW | $27.85 | $20.59 | $17.42 | $28.40 | $21.51 | $18.21 |

## Vacancy Rates

| | End 2nd Quarter 2020 | End 2nd Quarter 2021 |
|---|---|---|
| CBD | 17.9% | 26.0% |
| Aurora | 18.0% | 23.0% |
| Colorado Blvd. | 13.3% | 23.6% |
| Southeast | 18.2% | 26.5% |
| Northeast | 16.5% | 13.4% |
| North | 19.2% | 22.4% |
| West | 16.7% | 23.0% |
| Southwest | 16.7% | 22.6% |
| Northwest | 14.1% | 20.8% |

***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.
- Rise of the hybrid model which is a combination of working from home and the office during the week. Typically achieved using a "hoteling" approach to office space where employees don't have a permanent desk location.
- Significant delays to complete office space renovations, even something as simple as new carpet and paint. Supply chain issues have created a construction supply shortage, there is an labor shortage of construction workers and government entities are very delayed in issuing permits.

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

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 as important as they are going to qualify you! That tenant is your landlord and most likely, the rent you are paying them does not fully cover the 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!