14TH ANNUAL KENTUCKY COMMERCIAL REAL ESTATE CONFERENCE: PANEL DISCUSSION: COMMERCIAL LEASING 2024

LOUISVILLE, KENTUCKY

WEDNESDAY, NOVEMBER 6, 2024

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CURRENT TRENDS/MARKET DEMANDS

- Impact of interest rate changes on different asset classes
- Office building delinquencies, receivership [survivors vs. non-survivors]
- Permanent change in office occupancy – never 100% ‘5 days’ again
- Seller financing
- Ground lease structure [layers of owners/debt]
- Flight to quality
- Growth in rental properties [senior living, student housing]
- Retail evolution/repurposing of shopping malls
- Industrial remains strong
- Store-in-a-Store (retail)

Recent Court Decisions Regarding Commercial Leasing Issues

- *Cummins Properties, LLC v. Hines*, 201 N. E. 3d 295 (Mass. 2022)
- *Sourcing Unlimited, Inc. v. Cummins Properties, LLC,* No. 21-P-1054 (Mass. 2023)
- *Cody Real Est., LLC, v. G&H Catering, Inc.,* 219 Conn. App. 773 (2023)
- *Brandywine Dev. Grp., L.L.C. vs. Brinker Rest. Corp.* (Del. Super. Ct. May 16, 2023)
- *CM Com. Realty, Inc. v. Alpha Trust Real Est., LLC* (2023 Del.)
- *NCO Fin. Sys. V. Montgomery Park, LLC.,*40 F. 4th 123 (4th Cir. 2022)
- *Garrison Southfield Park L.L.C. v. Aspen Specialty Ins. Co.,* 2022-OH-709 (Ct. App.)
- *Pioneer Plaza of Georgetown, LLC v. Georgetown Apothecary, PLLC* (Ky. Ct. App. April 1, 2022)
- *Dika-Homewood, L.L.C. v. Office Max, Inc.* (N.D. Ill. 2023)
- *Eighty Hundred Clayton Corp. v. Lake Forest Dev. Corp,.*2022 Mo. App. LEXIS 472 (App. Ct. July 26, 2022)

Changes in Office Leasing

- Debt markets and the impact of office product
- Loan maturity and refinancing issues
- Operating in a building under receivership
- Pitfalls for the City of buildings going into default/receivership now and the City's/State's potential roll to avoid the long-term impacts
- Conversion of existing office produce to hotel or residential
- Cost, demand

CHANGES IN OFFICE LEASING

- Code issues, existing floor plate obstacles, plumbing
- Return to office/Office Redesigns to encourage employees back to the office
- Nearly half of employees express dissatisfaction with their personal comfort and overall experience at the office
- A shift toward people first design is reshaping workplaces, with an emphasis on creating spaces that support both remote and on-site collaboration and focus
- Hybrid workers value workplaces that support collaboration and socialization. While the social side of the office is important, so are private workstations, acoustics and other factors that support desk-based work. Employers need to understand which factors boost performance and identify shortcomings in existing offices

Key office sector themes

By the numbers

4.8 billion
Existing inventory (s.f.)

51 million
Under construction (s.f.)

19.1%
Direct vacancy

22.1%
Total vacancy

-28.0 million
YTD net absorption (s.f.)

195 million
Sublease available (s.f.)

1 Tenant demand recovering

- Leasing activity surged 15% in Q2, reaching the highest quarterly total since the onset of the pandemic, buoyed by a return of large transactions
- Active space requirements remained consistent despite the large uptick in deals closing in Q2

2 Sublease market continues to stabilize

- Sublease additions declined YoY and backfill activity has been brisk for high-quality, pre-built spaces
- Many sublease listings are reaching their expiration dates and converting to direct vacant space, which has offset any potential decline in total vacancy

3 Tenants gravitating to new buildings, but fewer remain

- Slowing deliveries are reducing the occupancy gains for new construction and stabilizing occupancy losses elsewhere
- While newer product remains, the only segment generating occupancy gain, negative net absorption for historic assets and second-generation construction is stabilizing

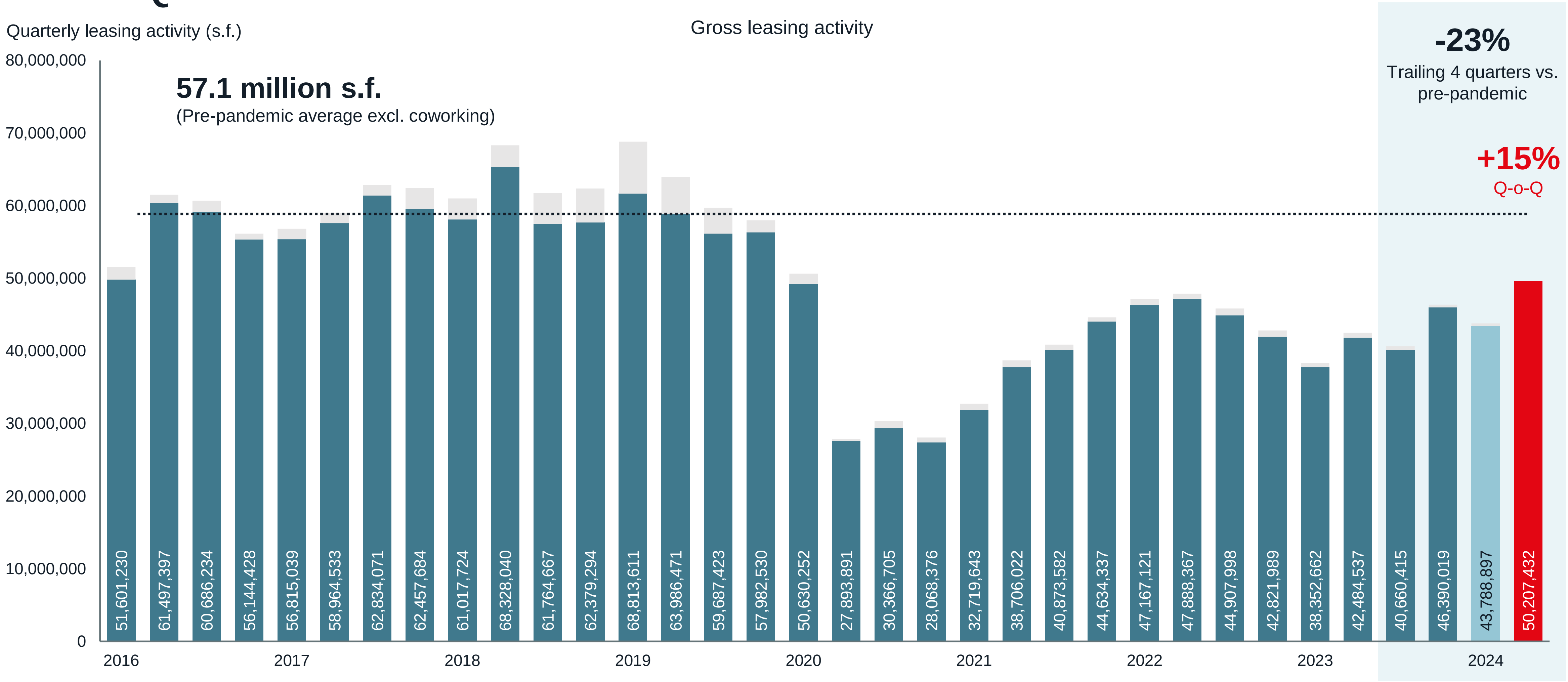
4 Capital avoidance driving leasing

- Renewal probabilities are rising as tenants seek to avoid out-of-pocket buildout costs and landlords grapple with capital constraints
- Pre-built spaces – including spec suites and high-quality sublease listings – are seeing greater attention and leasing more quickly

5 Falling office inventory

- Groundbreakings remain near historic lows, and more than two-thirds of projects that broke ground is preleased
- Overall inventory has declined marginally for two consecutive quarters as deliveries slow and removals accelerate

Leasing volume jumps in Q2, reaching highest quarterly total since Q1 2020



Source: JLL Research
Note: Tan bars represent leasing volume by coworking providers and are excluded from pre-pandemic average.

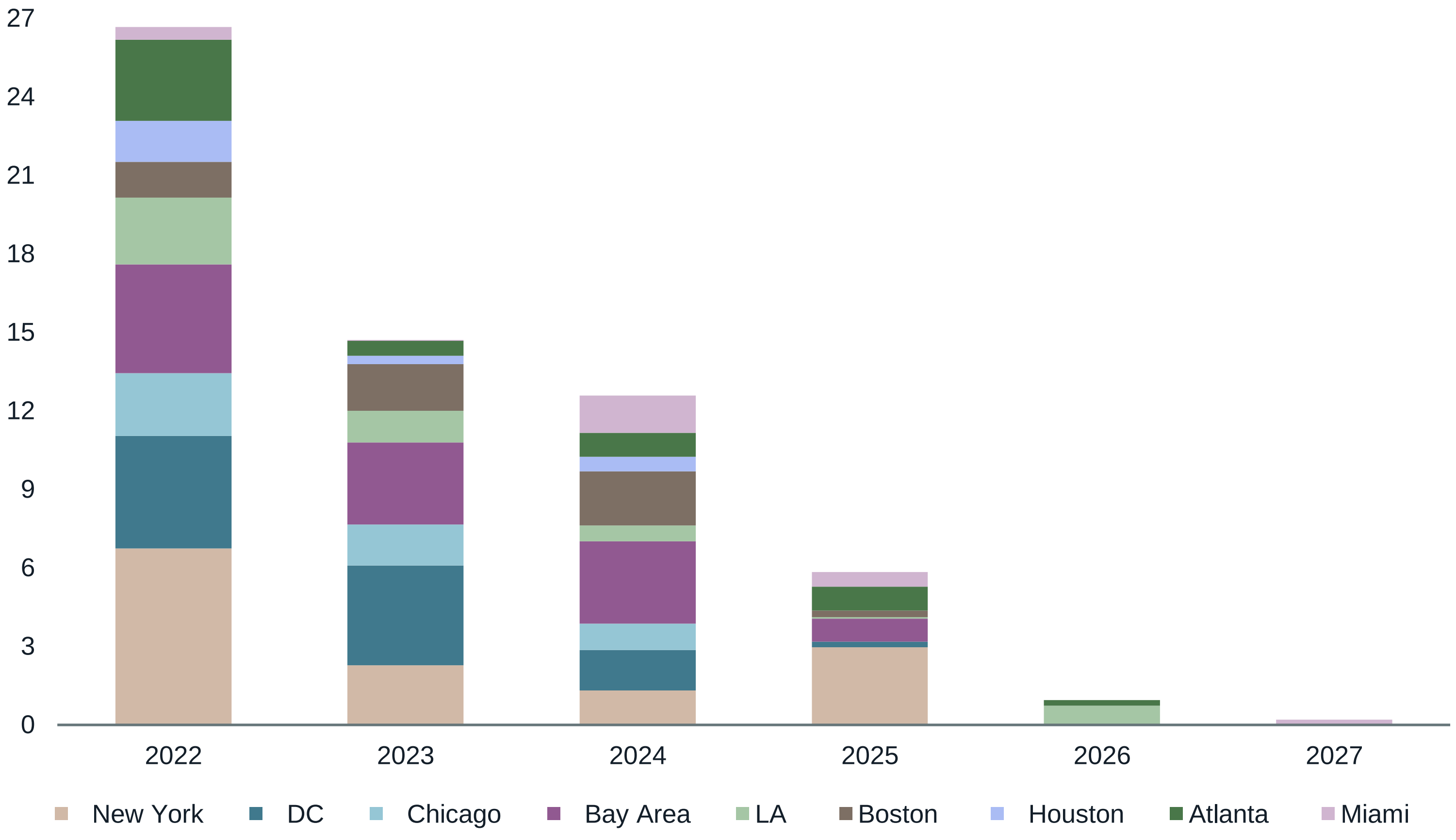
U.S. office inventory shrank for the first time on record as conversions and redevelopments began to overtake dwindling new office constructions.

In Q1 2024, the U.S. office inventory shrank for the first time on record (by 1.6 million s.f.), due to conversion and redevelopment activity outpacing new office construction.

- In 2023, 28 million s.f. of existing office product was removed from the inventory because of conversions, redevelopments and demolitions, while only 10.8 million s.f. of new office development broke ground.
- In Q1 2024, virtually no new office projects broke ground, but another 10.5 million s.f. was removed from the inventory.

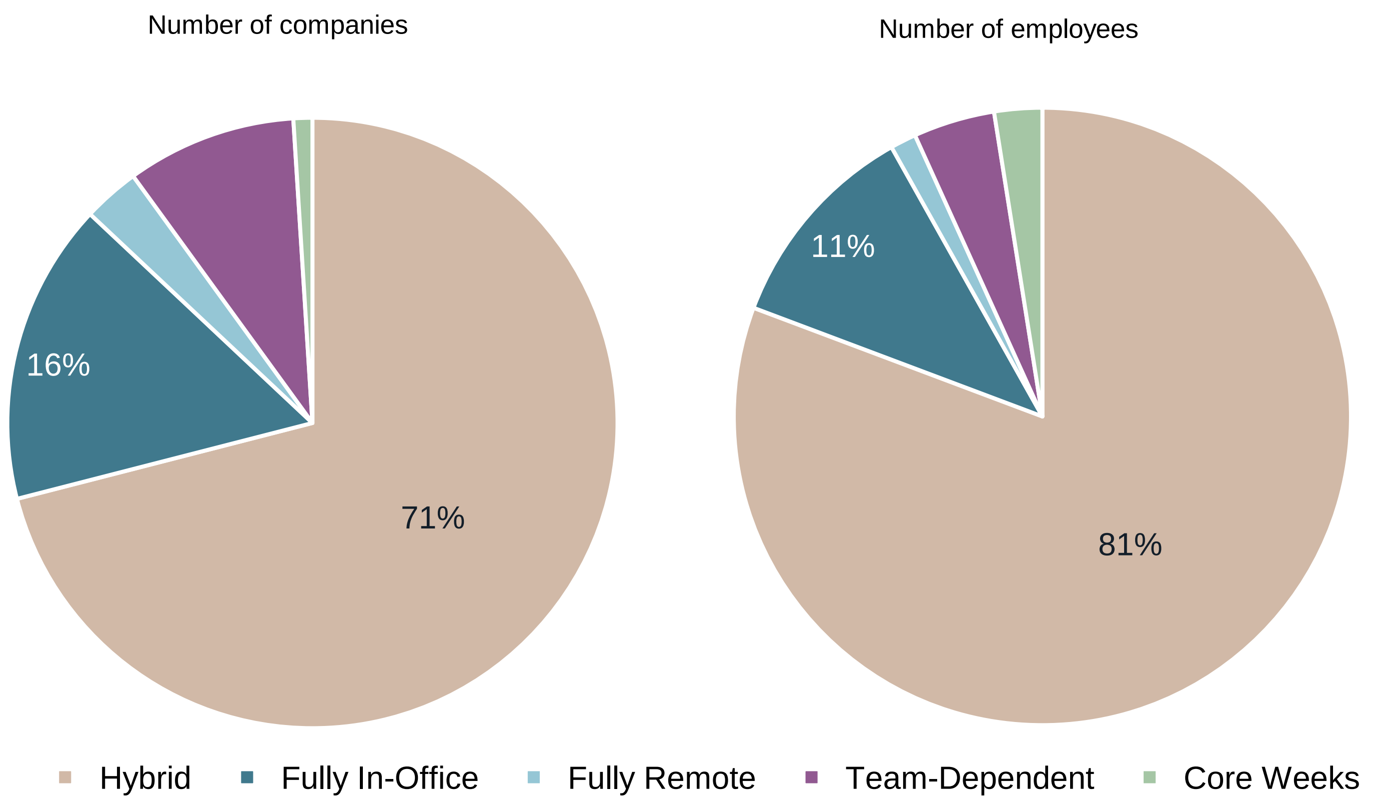
As one of the largest consumers of new construction product, law firms will face heightened competition for quality large blocks. Some larger firms are beginning their search process five or more years in advance of their lease expiration. While the overall office market remains soft with extremely tenant-favorable conditions, persistent supply constraints at the top of the market will result in upward pressure on rents among well-positioned, newer vintage buildings.

New office completions (million s.f.)



Remote-first companies have become a rarity; most pre-pandemic office employees returning to regular office attendance

Fortune 100 Office Attendance Policies



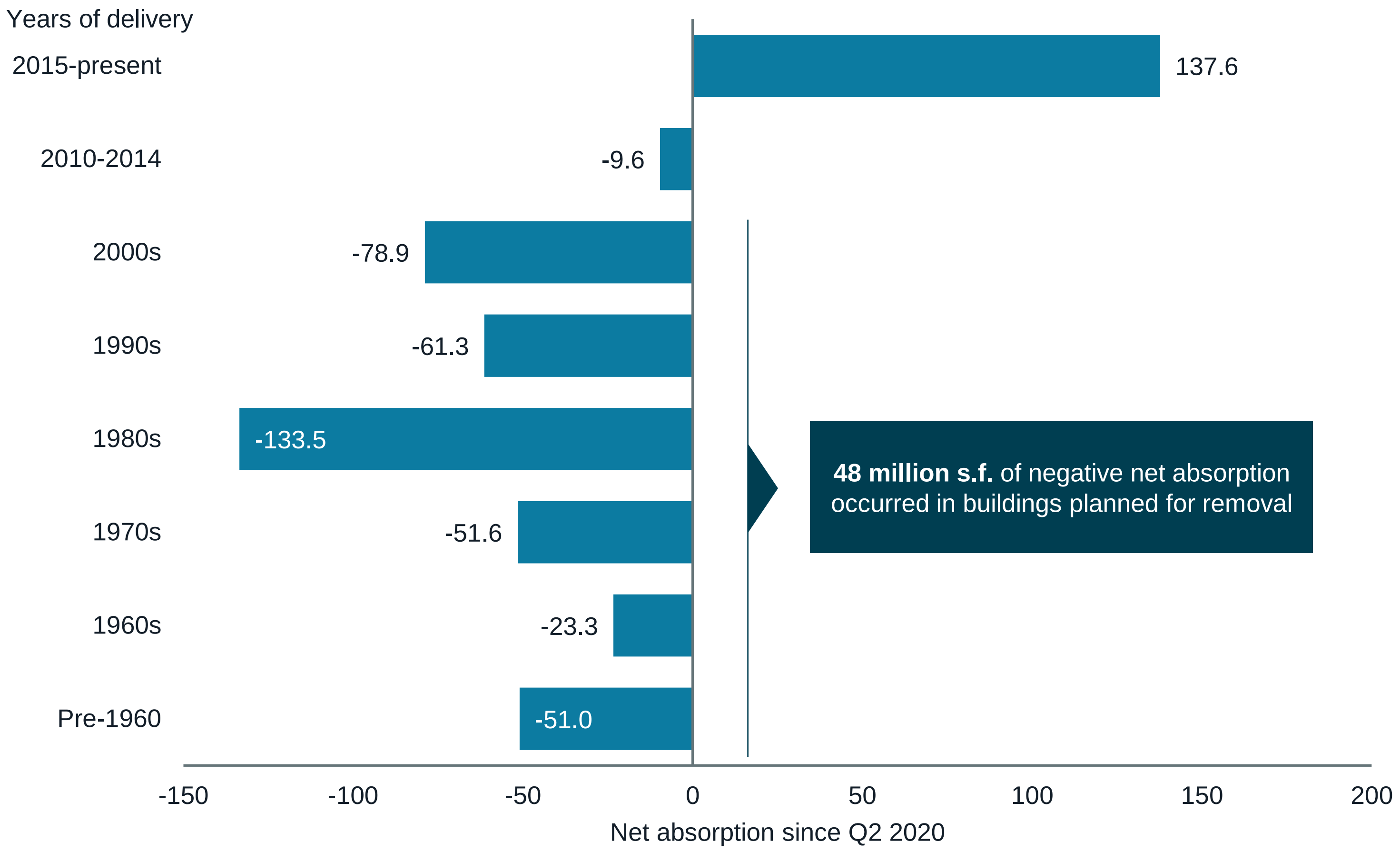
Source: JLL Research

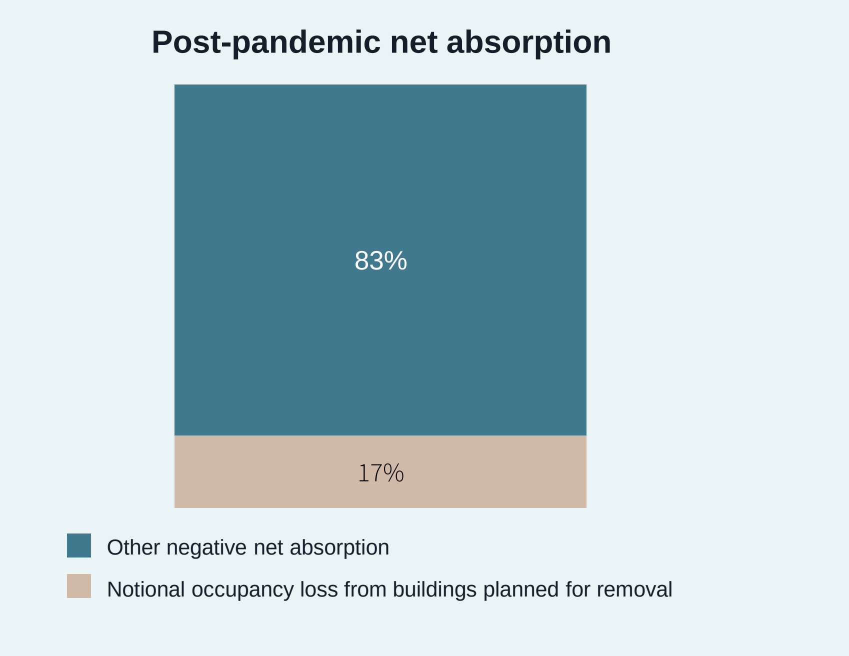
3.11 days

Average weekly attendance requirement for Fortune 100 employers

Flight to quality continues to drive occupancy gains in newer product; negative net absorption in older product elevated by notional occupancy loss

Net absorption by building vintage





Construction costs stabilizing

Reduction in new construction starts has stabilized price increases and shortened lead times for materials. However, costs will remain at a relatively high floor due to persistent labor shortages and competitive wages.

$

2024 pricing outlook →

+2 to 6%

Material costs

Slowing private-sector construction starts will keep supply chain pressure manageable, but the current pipeline and increase in public-funded developments will prevent price regression.

+3 to 5%

Labor wages

Limited labor availability is expected to persist for the long term, setting a price floor above historical compensation growth rates. Advancements in AI and robotics may help offset falling productivity levels.

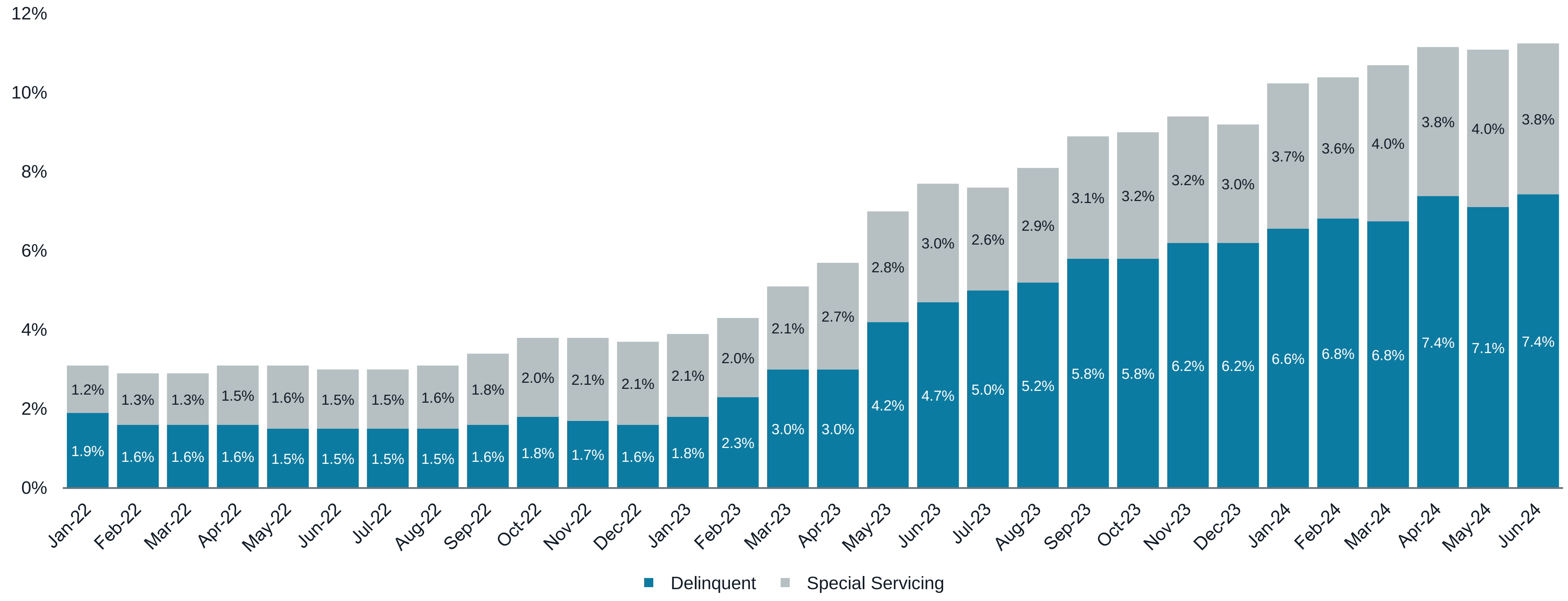
+2 to 4%

Total costs

Overall inflation in construction costs is falling toward historical averages after years of extraordinary growth. Rapidly evolving design choices that push the office to do more in less space will continue to affect fit-out prices.

Distress levels continue to rise as debt markets await material improvement

Delinquency and special servicing rates on office CMBS debt



Why default rates among office landlords is increasing

01

Rising interest rates:

The Federal Reserve has raised rates at 10 consecutive meetings, hovering between 5% and 5.25%

02

Loan maturities

More than 25% of commercial loans will be due within the next year landlords may have negative equity and opt to hand the keys back to the lender.

03

Regulatory changes

Banks are scaling back their exposure to commercial real estate, limiting refinancing options for landlords.

04

Volatile market conditions

The hybrid and remote work trend are causing demand for office space in low quality buildings to fall.

05

Flight to Quality

Many companies are rightsizing their office footprint, opting for less square footage but in higher quality buildings that offer modern amenities, employee perks, and are more conducive to a modern work environment

06

Low space utilization

A building may host several long-term leaseholders; however, if the utilization is low, a lender may be more hesitant to offer a loan.

Consider this: Nearly 350 U.S. office properties are on the CMBS watchlist, meaning they are being monitored for potential default. Characteristics of watchlist properties include:

- Lack of amenities
- Lack of submarket leasing
- Commodity product
- Near-term expiration of large leases
- Average loan maturity date: 3.6 years

Receivership and loan default pose several risks to tenants

1 Disruption of improvement projects:

Due to lack of capital, tenants may not receive promised tenant improvement (TI) allowances or other concessions

2 Building operations:

Lenders may foreclose on properties and sell them, causing interruptions to ongoing building operations and renovation projects

3 Challenging lease negotiations:

Lease negotiations may be lengthier and more complex, and the risk of rental rate increases exist

How you can mitigate risk if a landlord defaults on a loan

- SNDA
- Right to Remedy
- Work with a trusted advisor

Technology trends to watch in 2024

1 Rightsizing real estate portfolios

- Companies continue to evaluate their footprints, many adjusting after a roller coaster of growth in 2020 and 2021, then cuts in 2022 and 2023.
- Tech companies look to find a balance between conserving cash and providing a compelling reason to make the commute to the office.

2 Walking the talent tightrope

- Specific skillsets will remain in high demand, despite layoffs, and wages will rise for rare expertise.
- Companies walk a tightrope between pushing employees to return to the office to increase productivity and allowing flexibility to recruit and retain employees and maintain talent diversity.

3 Creating wholistic, human-centered workplaces

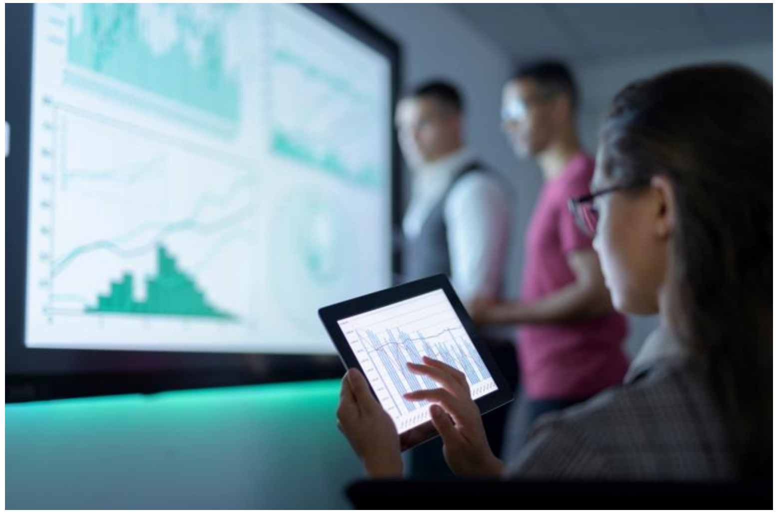
- Technology companies will strategically upgrade workplaces in 2024 frugally; cautious about capital spend and taking advantage of increased sublease availability in core technology markets.
- Growing landlord competition means tenants increasingly have amenities in common space, allowing mid-sized tech companies to provide campus-like amenities.

4 Reshoring technology manufacturing

- Deglobalization stemming from increased supply chain and geopolitical shocks will continue, pushing countries to provide incentives to boost domestic manufacturing especially for crucial components like semiconductors.

5 Rise in Artificial Intelligence

- Chat-based large language models democratized generative artificial intelligence (AI) in 2023. In 2024, CIOs will focus on balancing data security and resource intensity with strategic implementation to take advantage of AI’s huge potential for boosting productivity.
- Because AI requires intensive resources and specialized talent, large well-capitalized tech companies lead the charge; innovation will concentrate in gateway markets.



How is real estate transforming in a hybrid world?

Hybrid

Hybrid programs continue to be key driver of change

Utilization

Utilization data is unlocking value in context of weekly fluctuations

Individual & focus space

Individual seating is evolving toward agility

Spectrum of space types

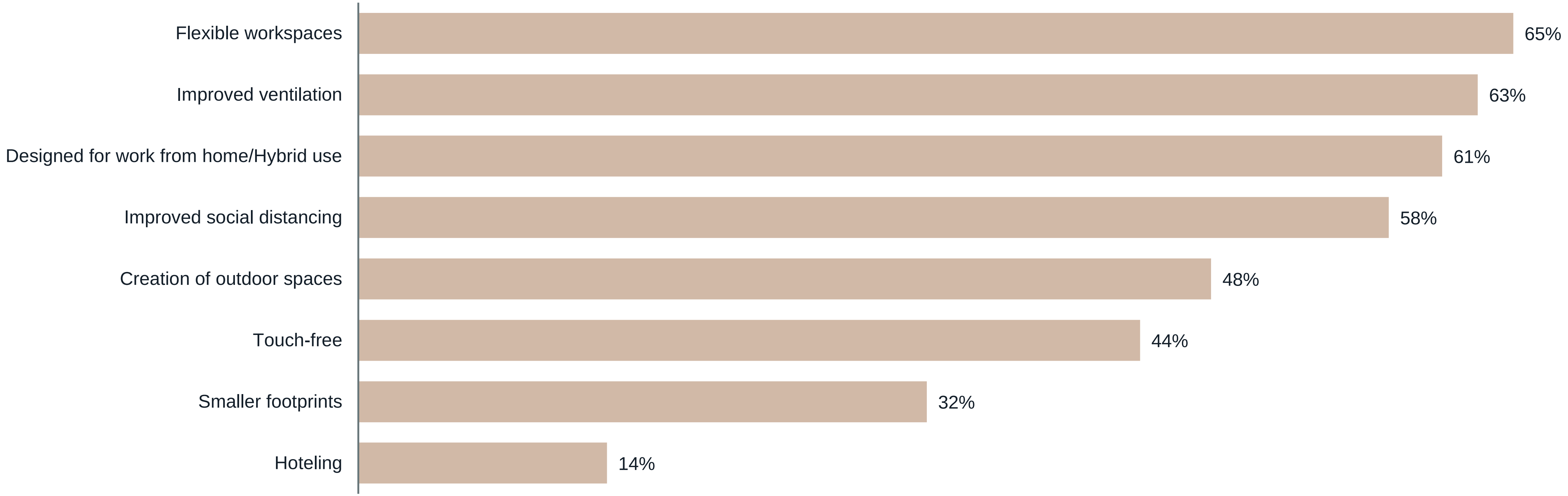
The spectrum of space types is expanding

Technology

Insights are being driven by technology and visualization platforms

The office design of the near-future will support flexibility and wellness

Changes expected in office building design over next 5 years (%)



Note: Survey of 151 commercial architects, commercial builders, and commercial property owners and managers
Source: JLL Research, US Chamber of Commerce “Future of the Office Survey’, S&P Global

Office market forecast

Tenant demand

Q2 was the strongest quarter of leasing activity since the onset of the pandemic, and tenant requirements remain stable despite the spike in transaction volume.

New deliveries

Office construction has come to an abrupt halt and new deliveries will be scarce through at least 2027. The majority of current development pipeline has already been preleased.

Vacancy rates

While expiring tenants are still downsizing their footprints, the removal of obsolete buildings through redevelopment and conversions will help vacancy increases taper off towards year-end.

Rental rates

Rents are expected to hold steady as demand targets limited high-end supply. New owners' ability to cut rents when acquiring offices at a lower basis may be undermined by elevated debt costs.

Sales volume

Sales activity is expected to trend upward throughout the year as distressed transactions are brought to market and liquidity improves amid potential rate cuts in the second half of the year.

Economic growth

Inflation indicators have been improving and unemployment remains low. Job growth has softened slightly in office-using sectors but remains generally healthy.

Source: JLL Research

Law firm trends

Major U.S. Markets

Key findings

Law firm leasing rebounds

U.S. law firm leasing demand closed 2023 strong, totaling 9 million s.f. of signed leases in the nine reported markets which reached 92% of the historical leasing volume, up from 78% in 2020 and 2021. We have visibility into another 8.2 million s.f. of currently active law firm space requirements.

Larger firms continue to densify

Larger law firms in the market remain focused on space efficiency, as 79% of active requirements with a current footprint of 100,000+ s.f. are seeking space reductions (by an average of 31%). In contrast, smaller firms show a mixed trend with as many looking to expand as ones looking to contract.

Law firm lease rollovers peak in 2027

Over the next five years (with a peak in 2027), more than 30 million s.f. of law firm leases are expiring in the nine reported markets that have not committed to a new lease. These firms will face a significantly diminished development pipeline and limited options of high-quality large-block availabilities.

U.S. office inventory shrinks

In Q1 2024, the U.S. office inventory shrank for the first time on record (by 1.6 million s.f.), as conversion and redevelopment activity has outpaced new construction. Supply constraints at the top of the market will result in upward pressure on rents among well-positioned Class A buildings built or renovated post 2015.

Workplace design on a sliding scale

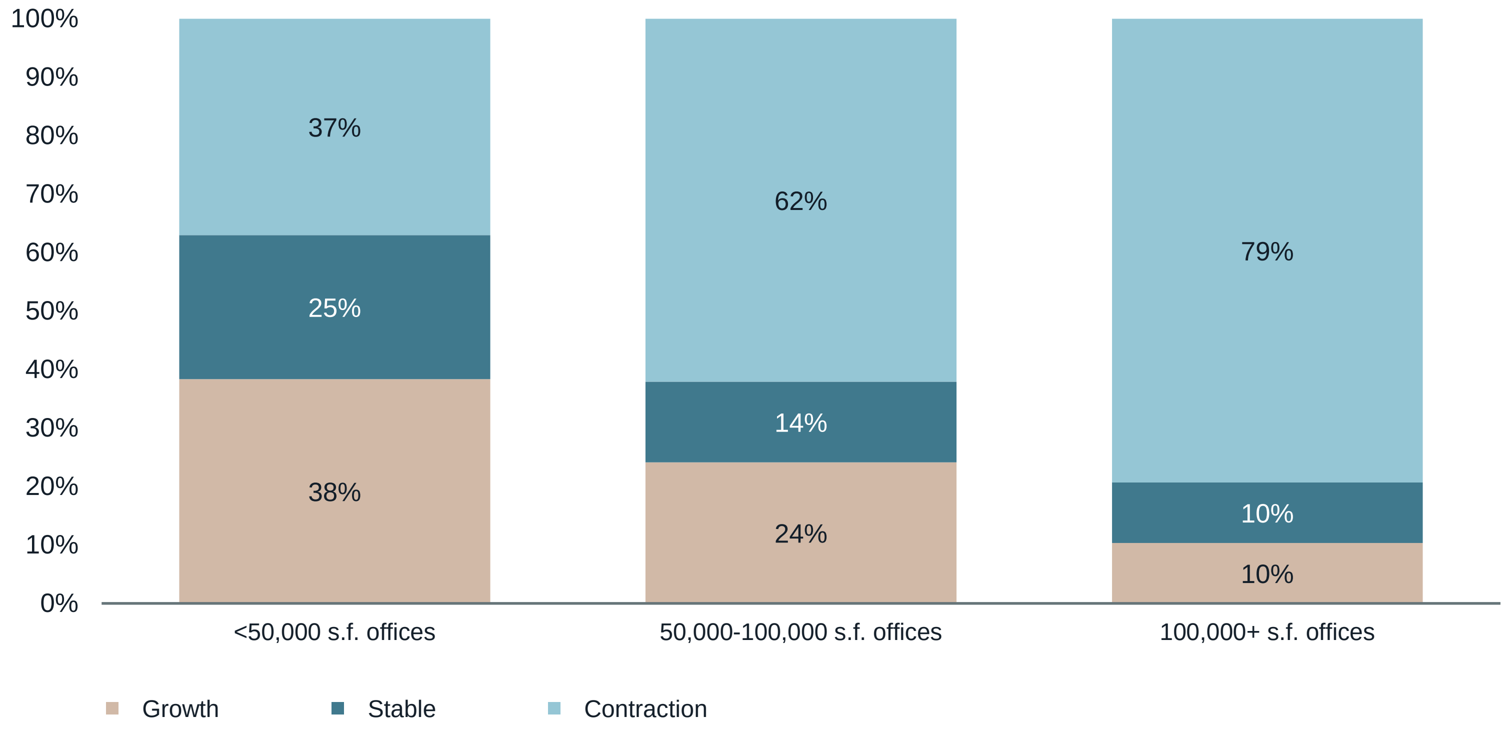
Law firms are evaluating workplace design decisions on a sliding scale and exploring more progressive strategies such as hoteling, while continuing to implement baseline industry standard practices such as single-sized offices.

Construction costs stabilizing

Reduction in new construction starts has stabilized price increases and shortened lead times for materials. However, costs will remain elevated due to labor shortages and competitive wages. Rapidly evolving design choices that push each office to do more with less space will continue to affect fit-out prices.

Larger law firms in the market are mostly focused on space efficiency gains, while smaller firms are remaining stable in overall office needs

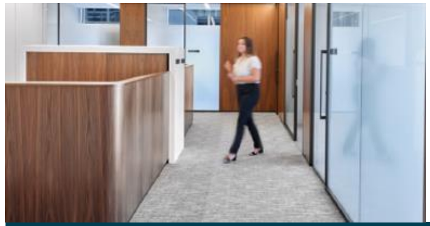
Target footprint change among active law firm space requirements

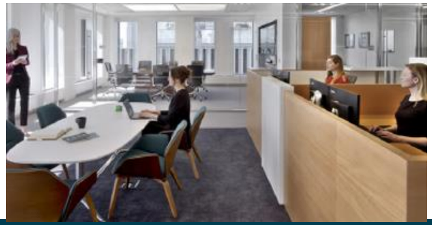


Densification remains the prevailing theme within the immediate leasing pipeline. Of the 150 active law firm space requirements (10,000+ s.f.) we are currently tracking, a little more than half of the firms **(52%)** are looking to reduce their office footprint, **29%** are looking to expand, and **19%** are looking to maintain their current size. However, trends diverge among firms with large, mid-sized, and smaller offices.

- Large law firm offices are mostly focused on space reductions. Of all active law firm requirements with a current footprint of 100,000+ s.f., **79%** are seeking less space than they currently occupy, with an aggregate target contraction rate of **31%**.
- Among smaller law firm offices under 50,000 s.f., there are as many firms **(38%)** looking to grow as ones looking to reduce space **(37%).** In aggregate, tenants in this size range are expected to stay flat in net office demand.

Law firms are approaching workplace design decisions on a sliding scale.





	Baseline Strategies that are considered market and industry standard	**Stretch** Strategies that push industry standard and have not been previously adapted by the firm	**Progressive** New strategies that borrow from other industries and have not been done previously
Attorney offices	• Single-sized offices 150 to 165 s.f. • Most attorneys on the perimeter • Junior attorneys on the interior • 1-to-1 assignment • 3 to 4 days in the office	• Single-sized offices 135 to 150 s.f. • More attorneys on the interior • Shared offices for junior attorneys • Smaller offices for hybrid attorneys • Moderate hybrid-work policy	• Open plan or hoteling offices • Assigned offices for some attorneys • Shared offices, coworking or hoteling for hybrid attorneys • Progressive hybrid-work policy
Legal assistants & professionals	• Higher attorney-to-secretary ratio • Fewer workstations but distributed evenly on work floor	• Secretary pool on work floor in centralized location • May be located on window line	• Minimum onsite staff • Offsite or remote support
Administrative staff	• Interior offices	• Smaller interior offices	• Shared interior offices, coworking, or offsite
Collaboration	• More collaboration spaces to accommodate hybrid meetings	• Dedicated corner areas as meeting spaces	• Smaller rooms that integrate more advanced technology to create better hybrid experience

*Source: HYL Architecture

Case study

Global IP law firm utilizing hybrid work technology

Finnegan

- **50%** reduction in office space by implementing a hybrid work model with limited dedicated offices
- Standardized office module with shared window offices for associates (typically only occupied by one attorney at a time)
- Centralized meeting/hub area for hosting internal lunches, gatherings, and events
- Implementation of office hoteling software to reserve all spaces (individual offices, conferencing, etc.)

Changes in Retail Leasing

MARKET ACTIVITY:

- Publix
- Grocery Activity: Kroger, Hyvee, BJs, Publix
- Others Active & New
    - Wawa
    - Banks
    - Restaurants
- Closings/Bankruptcy

Market Activity

CBRE

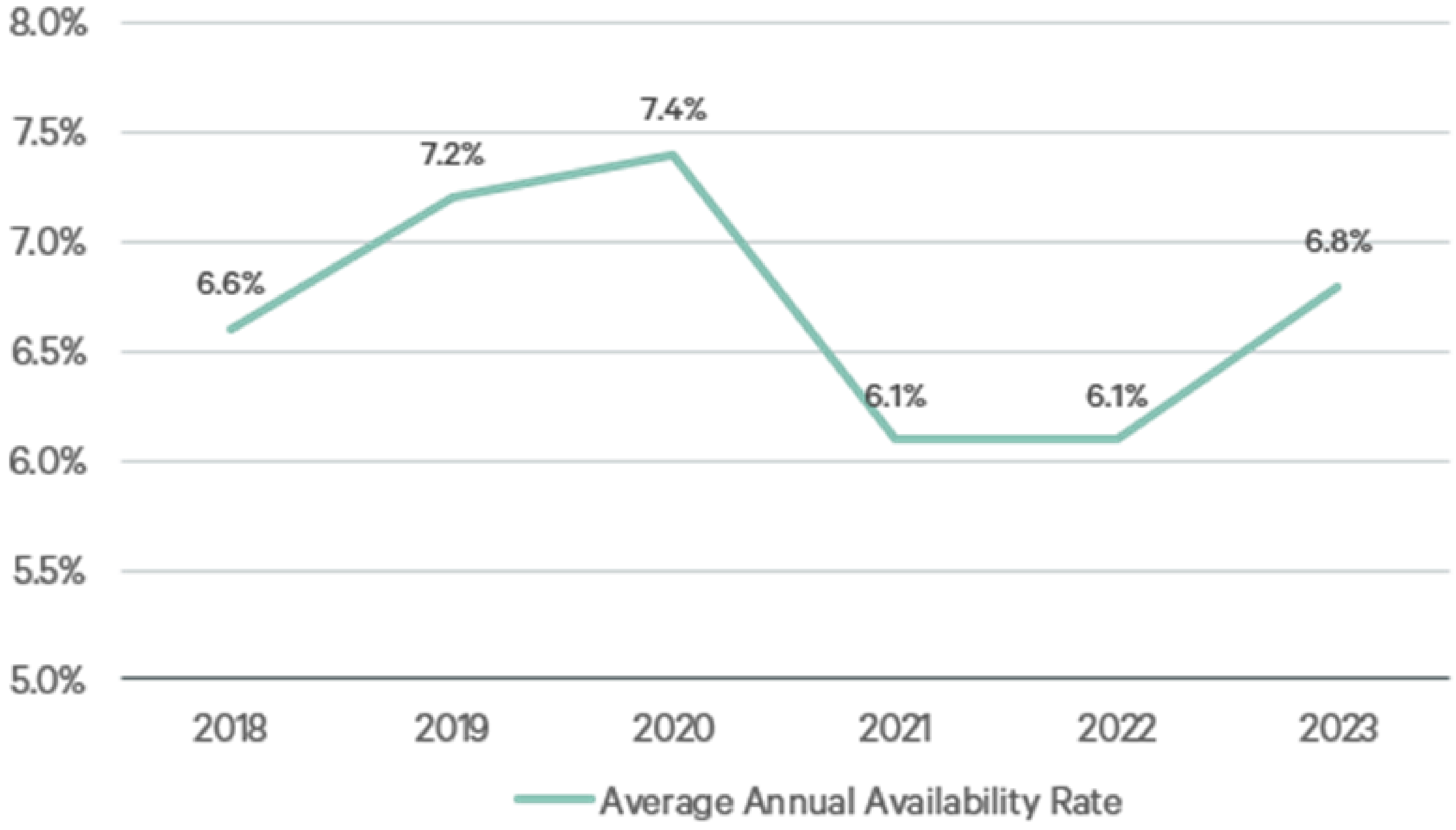
Retail Closings & Bankruptcies

Retail Space Availability

By % Available

6.8%

Year End 2023



Retail Average Asking Lease Rate

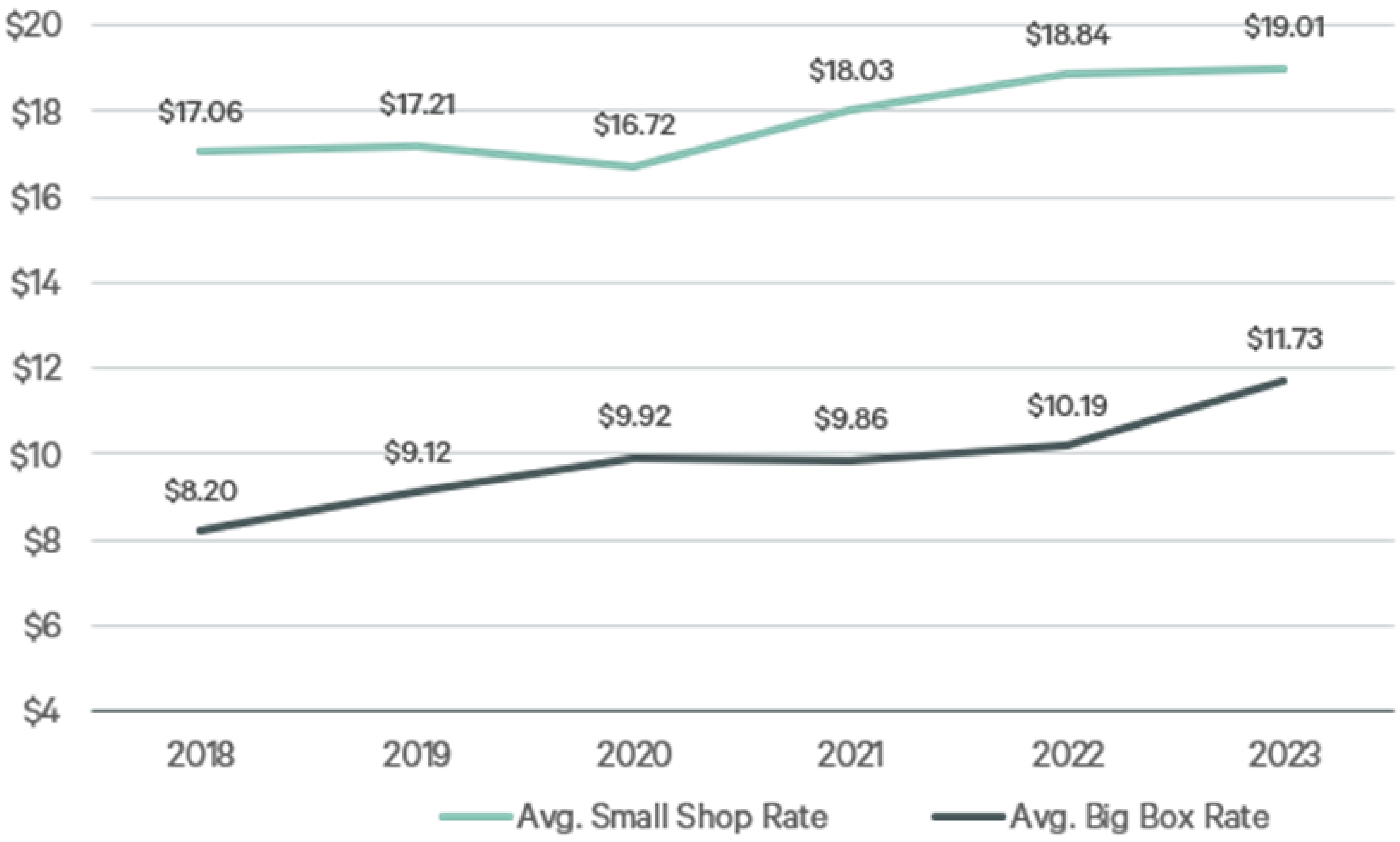
Big Box & Small Shop

$11.73/SF

Big Box Space

$19.01/SF

Small Shop Space



Retail Cap Rates

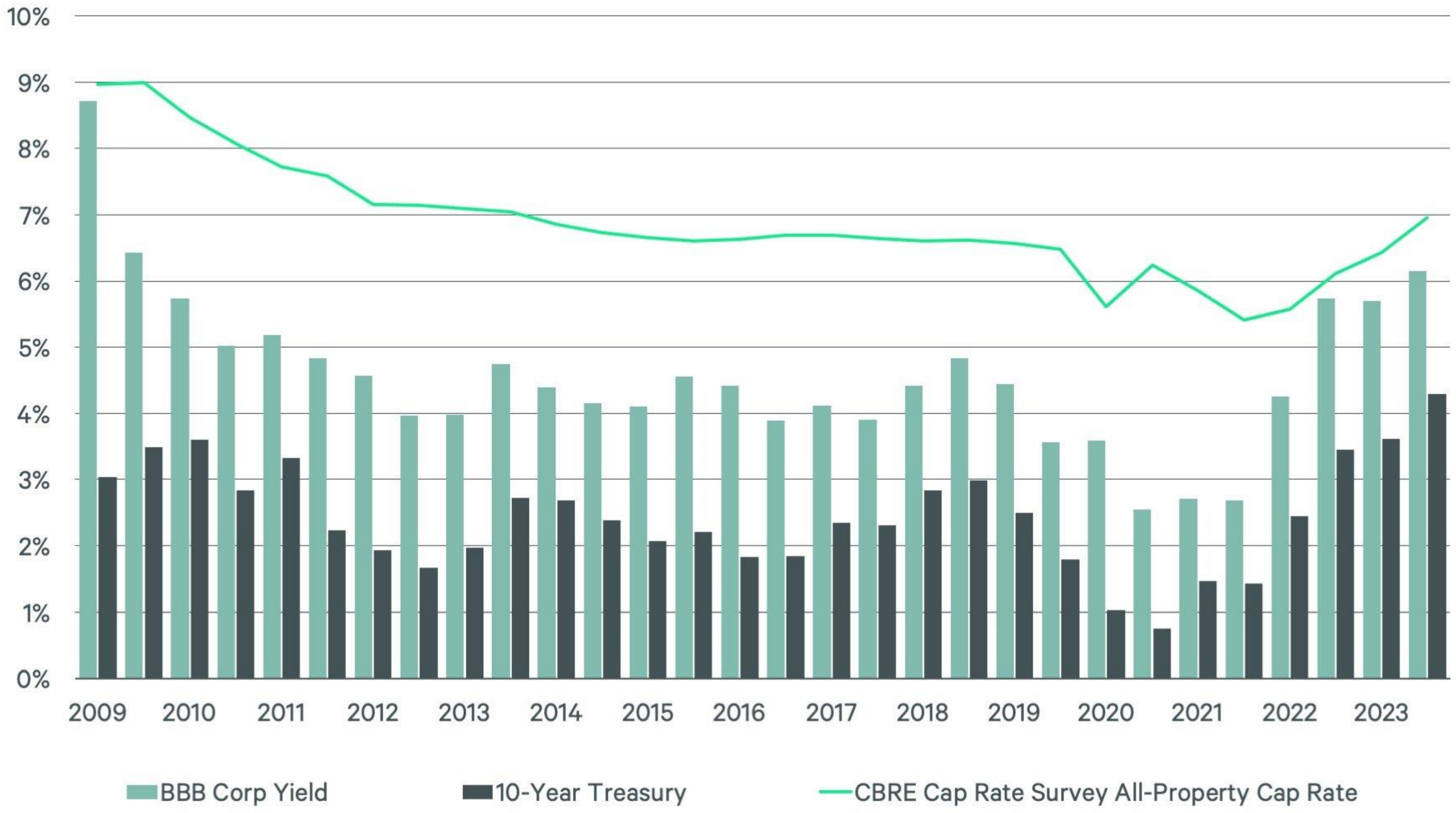
Investment Market

CBRE

Cap Rates Trended Upward in H2 2023 as Bond Yields Stalled

- H2 2023 was a volatile period for bond markets with yields peaking at 5% in October 2023 before falling back below 4% by year-end.
- This rise in bond yields was a headwind to deal flow and caused cap rate expansion to accelerate relative to H1 2023. The average cap rate increased from 6.4% to 7% in H2 2023, with expansion across multiple property types.
- In the final weeks of H2 2023 signals from the broader capital markets and the CRS suggest higher yields may not last. CBRE Econometric Advisors expects that yields are near a peak level, although offices may face further upward pressure.

Real Estate Cap Rate and Bond Yields, Period Average (%)



Retail Trends

- Availability: 6.8%
- Cost of construction
- City approvals/zoning/development corridors
- NNN – expenses
- Growth outside of traditional city: Louisville & Lexington growth areas
- Store model of the future

What's Next/Questions