

DISTRICT OF COLUMBIA 1Q18 OFFICE MARKET

FIRST QUARTER ABSORPTION MAINTAINS 2017 PACE

The District of Columbia registered 122,277 square feet of annual net absorption in the first quarter of 2018, maintaining a pace comparable to that of 2017, when net absorption averaged 149,000 square feet per quarter. In a reversal from last year's performance, absorption was strongest in the East End, with the submarket registering 271,921 square feet of net absorption.

During the first quarter, some of the District's largest moves were attributable to the following tenants:

- Facebook and Yelp, in an effort to expand their East Coast presence, moved into 73,000 square feet and 52,000 square feet, respectively, at Terrell Place (575 7th Street NW) in the East End.
- The DC Bar, which moved into 65,000 square feet of owned space at its recently delivered headquarters at Mount Vernon Place in the East End, vacating 52,000 square feet at 1101 K Street NW in the East End.
- Coworking firm, Mindspace, which entered the U.S. market with 30,000 square feet of space at 1301 K Street NW in the East End.

The largest vacancies occurred in the Southwest and the CBD:

- GSA reduced its footprint at 400 C Street SW in the Southwest submarket, giving back 84,000 square feet of space.
- The Consumer Financial Protection Bureau vacated 68,000 square feet of space at 1625 Eye Street NW in the CBD submarket and moved back into owned space at 1700 G Street NW in the CBD. The building has undergone more than \$100.0 million in renovations over the past two years. The move-in is not reflected in NKF absorption, as owner-occupied buildings are not counted among competitive inventory.

Even with delivery of 100,000 square feet of new construction, the vacancy rate remained flat at 11.4%, aided by strong pre-leasing figures at Mount Vernon Place, which was 77.8% pre-leased at completion. Asking rental rates rose 2.6% from one year ago, to \$54.82/SF.

Core submarkets such as the CBD and East End – as well as Capitol Hill – continue to command the highest rents in the District. The substantial development pipeline continues to place downward pressure on effective rents, yet asking rents continue to increase with the delivery of newer product.

Current Conditions

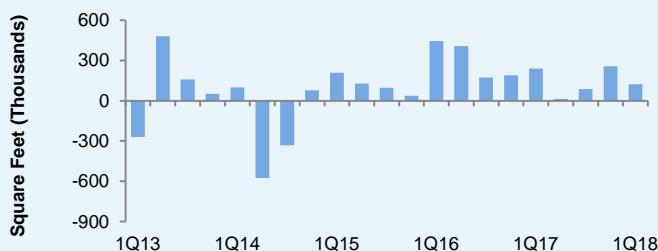
- The District of Columbia demand was sturdy in the first quarter with 122,277 square feet of absorption. In a reversal from last year's performance, the East End submarket led the District with 271,921 square feet of absorption.
- The Class A market recorded 224,295 square feet of absorption in the first quarter as tenants continue their pursuit of quality space.
- The vacancy rate remained flat at 11.4%, despite the delivery of 100,000 square feet of new construction during the first quarter.

Market Analysis

Asking Rent and Vacancy Rate



Net Absorption



Market Summary

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	124.4 M	124.3 M	124.3 M	↑
Vacancy Rate	11.4%	11.4%	11.5%	↑
Quarterly Net Absorption (SF)	122,277	257,446	240,095	↑
Average Asking Rent (Per SF, Full Service)	\$54.82	\$54.83	\$53.45	↑
Under Construction (SF)	6.0 M	6.1 M	4.8 M	↔
Deliveries (SF)	100,000	458,889	0	↑

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Still a Tenant's Market

Competition for tenants is stiff, as a growing array of attractive options is pushing owners to offer sizeable concession packages. The average tenant improvement allowance per square foot for Class A office product rose rather steadily from 2008 through 2015 but edged down in 2016 and 2017. The average number of months of free rent per year of a lease term was 0.95 months during 2017 and is trending upward. NKF expects concessions to remain elevated in 2018 and 2019, as more new product reaches the market. However, demand for office space is gaining traction, which will moderate any increase in concessions.

Anchor Tenants Taking Top Floors of Trophy Assets

A flight to quality among District of Columbia office tenants has been occurring for years, with newer, amenity-rich space in demand. Consequently, developers have continued to deliver new product to the market. For assets delivered from 2015 through 2017, 88.0% of the space on the top floors of new trophy buildings was leased as of January 2018, whereas just 45.0% of the lower floors was leased. This disparity demonstrates the attractiveness of the highest floors in new properties, which in turn makes leasing the less prestigious lower floors more of a challenge for owners.

Flight to Quality Evident Among Major Law Firms

In 2017, six of seven major law firms occupying more than 50,000 square feet chose to relocate to new, well-located and amenity-rich space. Continuing this trend year-to-date, Baker Botts expanded into 150,000-square-feet at Anthem Row (700 K Street NW), from its original lease of 135,000 square feet at 1299 Pennsylvania Avenue NW.

In the last year, the cumulative lease transactions of Akin Gump, Bates White, Goodwin Procter, Morrison Foerster, Paul Hastings, and Wilmer Hale have totaled 813,948 square feet. Notably, these combined deals represent a 37.0% reduction in occupancy from existing leases in place to trophy buildings that are currently under construction or renovation, illustrating the persistent flight to quality and densification underway in the District. The only major law firm to buck this trend last year was K&L Gates, which renewed its 126,910-square-foot lease at 1601 K Street NW.

Investment Sales Down Slightly from Last Year

As of mid-March, the District of Columbia has registered \$903.9 million in sales volume, just 4.7% lower than one year ago, when the District recorded \$948.3 million. Notably, 42.9% of District investment sales were to foreign buyers of Class A properties located in the East End, compared with 36.4% in the first quarter of 2017. The balance of properties sold was spread among buildings located in the CBD, NoMa, Southwest, and West End submarkets. The largest transaction of the first quarter was the sale of 1440 New York Avenue NW to a joint venture between EastBanc and Munich RE. The 214,093-square-foot building sold for \$250.0 million, or \$1,168/SF, and was 100% occupied at time of sale. The only other property to top \$1,000/SF this quarter was 900 G Street NW, which was sold to Spain's Masaveu Inmobiliaria S.A. This acquisition represents the second most expensive per-square foot transaction in District history, behind the Abu Dhabi Investment Authority's record-setting 2016 purchase of 2020 M Street NW in the CBD for \$57.5 million, or \$1,768/SF.

1Q 2018 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
GSA—USAID	500 D Street SW	Southwest	Renewal	348,173
Baker Botts	700 K Street NW	East End	Direct Lease	103,317
NBC News	400-444 N. Capitol Street NW	Capitol Hill	Renewal/Expansion	72,351
WeWork	777 6 th Street NW	East End	Direct Lease	70,000
GSA—Safety Transportation Board	395 E Street SW	Southwest	Renewal	63,825

1Q 2018 Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
1440 New York Avenue NW	East End	\$250,000,000	\$1,168	214,093
1255 23 rd Street NW	West End	\$166,200,000	\$493	337,000
1401 New York Avenue NW	East End	\$166,000,000	\$785	211,474
900 G Street NW	East End	\$144,000,000	\$1,278	112,635

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District of Columbia Outlook

The District of Columbia will continue to favor tenants for the next 24 months, largely because of densification, a robust development pipeline (with 23 buildings expected to deliver in this timeframe) and GSA consolidations. The District faces a supply-demand imbalance exacerbated by tenants that have locked in long-term leases to relocate as their current leases approach expiration. These forward-looking leases capitalize on the current “tenant’s market”, prompting landlords to offer sizeable concession packages. Despite rising asking rents, effective rents remain under downward pressure, as tenants are being offered sizable free rent and tenant improvement packages to incentivize a move. The flight to quality persists, as tenants are seeking well-located, highly amenitized space. Notwithstanding the competitive nature of the office leasing market in general, well-located trophy and cleaned-up Class B properties have outperformed the market and will likely continue to do so. However, the amount of available and affordable Class B product is declining at premier locations.

The District offers significant upside potential, with its LEED for Cities Platinum recognition highlighting the high quality of its existing inventory and tech’s growing presence in the region, including Facebook and Yelp’s deals at Terrell Place.

On March 23rd, the president signed the federal omnibus spending bill, funding the government through September 2018 and allocating military and defense spending during the next two years. The new budget

includes a significant uptick in defense spending, that will likely benefit some parts of the District. Still pending, GSA’s proposal to reconstruct a new FBI headquarters at its current downtown address rather than relocate to the suburbs as was originally proposed.

Additionally, the Washington metro region is considered to have many competitive advantages in Amazon’s search for an additional headquarters that place it among the top two or three metro regions competing for HQ2. Please see our Washington metro report for a more detailed discussion of these regional topics. For additional information on the Washington metropolitan area economy and office market outlook, please visit the [Washington, DC Market Reports](#) page at NGKF.com.

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Market Statistics By Class								
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2015 Absorption (SF)	2016 Absorption (SF)	2017 Absorption (SF)	1Q 2018 Absorption (SF)	YTD 2018 Absorption (SF)
Class A	79,004,194	11.0%	11.8%	-77,835	1,008,125	1,534,169	224,295	224,295
Class B	39,815,047	10.2%	11.1%	552,699	249,994	-887,771	-67,845	-67,845
Class C	5,609,644	6.6%	6.9%	-6,075	-36,234	-50,179	-34,173	-34,173
District of Columbia	124,428,885	10.6%	11.4%	468,789	1,221,885	596,219	122,277	122,277

Market Statistics By Class							
	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	1Q18 Deliveries (SF)	YTD 2018 Deliveries (SF)	Under Construction (SF)
Class A	79,004,194	\$58.58	NA	\$58.58	100,000	100,000	6,013,668
Class B	39,815,047	NA	\$47.84	\$47.84	0	0	0
Class C	5,609,644	NA	NA	\$43.21	0	0	0
District of Columbia	124,428,885	\$58.58	\$47.84	\$54.82	100,000	100,000	6,013,668

Note: Asking rents are quoted on a full service basis.

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Submarket Statistics – All Classes

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2015 Absorption (SF)	2016 Absorption (SF)	2017 Absorption (SF)	1Q 2018 Absorption (SF)	YTD 2018 Absorption (SF)
Capitol Hill	4,755,664	12.7%	12.9%	149,518	110,415	-74,404	13,187	13,187
Capitol Riverfront	3,685,480	5.6%	6.3%	241,453	27,229	109,832	35,798	35,798
Central Business District	38,631,181	8.3%	9.3%	545,344	792,925	-51,731	-209,278	-209,278
East End	41,137,671	12.7%	13.8%	-80,409	12,066	-268,189	271,921	271,921
Georgetown	2,851,274	4.7%	6.2%	58,942	4,518	-53,368	23,877	23,877
NoMa	10,993,269	8.5%	8.6%	145,735	34,494	524,131	47,731	47,731
Southwest	11,612,247	12.4%	12.6%	-284,704	291,181	312,976	-95,325	-95,325
Uptown	7,237,594	15.0%	15.4%	-140,736	-92,515	-48,264	40,203	40,203
West End	3,524,505	8.2%	8.4%	-166,354	41,572	145,236	-5,837	-5,837
DC - District of Columbia	124,428,885	10.6%	11.4%	468,789	1,221,885	596,219	122,277	122,277

Submarket Statistics – All Classes

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	1Q 2018 Deliveries (SF)	YTD 2018 Deliveries (SF)	Under Construction (SF)
Capitol Hill	4,755,664	\$63.27	\$47.95	\$53.00	0	0	988,796
Capitol Riverfront	3,685,480	\$49.75	NA	\$49.75	0	0	234,000
Central Business District	38,631,181	\$61.12	\$47.50	\$55.90	0	0	2,200,912
East End	41,137,671	\$61.31	\$50.32	\$57.65	100,000	100,000	1,042,850
Georgetown	2,851,274	\$56.54	\$44.30	\$46.55	0	0	0
NoMa	10,993,269	\$51.91	\$49.60	\$51.21	0	0	1,067,550
Southwest	11,612,247	\$50.87	\$38.50	\$47.76	0	0	479,560
Uptown	7,237,594	\$44.56	\$40.79	\$42.95	0	0	0
West End	3,524,505	\$57.41	\$44.27	\$56.26	0	0	0
DC - District of Columbia	124,428,885	\$58.58	\$47.84	\$54.82	100,000	100,000	6,013,668

Note: Asking rents are quoted on a full service basis.

METHODOLOGY

Market statistics are calculated from a base building inventory of office properties 20,000 SF and larger that are deemed to be competitive in the Washington Metro Area office market. Properties that are more than 75% owner-occupied and federally owned buildings are generally excluded from inventory.

GLOSSARY

Asking Rental Rate: The dollar amount asked by landlords for direct available space (not sublease), expressed in dollars per square foot per year. Average asking rents are calculated on a weighted average basis, weighted by the amount of available space. Asking rents are quoted on a full service basis, meaning all costs of operation are paid by the landlord up to a base year or expense stop.

Cap Rate: The ratio of Net Operating Income (NOI) to property asset value.

Class A: The most prestigious buildings competing for premier office users with rents above average for the area. Class A buildings have high-quality standard finishes, state-of-the-art systems, exceptional accessibility and a definite market presence.

Class B: Buildings competing for a wide range of users with rents in the average range for the area. Class B building finishes are fair to good for the area and systems are adequate, but the building cannot compete with Class A at the same price.

Class C: Buildings competing for tenants requiring functional space at rents below the area average.

Deliveries: Projects that have completed construction and received a certificate of occupancy.

Net Absorption: The net change in physically occupied space from one quarter to the next. **Year-to-Date (YTD) Net Absorption** is the net change in physically occupied space from the start of the calendar year to the current quarter. Net absorption is counted upon physical occupancy, not upon execution of a lease.

Price Per Square Foot: Transaction value divided by total square footage of the property.

Sublease: Sublease space is offered and marketed as available by the current tenant, rather than directly from the owner.

Transaction Volume: Total volume of office transactions \$20 million and greater during a specific reporting period.

Under Construction: Properties undergoing ground-up construction in which work has begun on the foundation. Properties that have only undergone grading or other site work are not included as under construction.

Under Renovation: Properties undergoing significant renovations that require all tenants to be out of the building. These properties are removed from inventory during the renovation period and delivered back to inventory upon completion of the renovations. These properties are not included in under construction totals.

Vacancy Rate: The amount of space that is physically vacant, expressed as a percentage of inventory. (Space that is being marketed as available for lease but is largely occupied is not included in the vacancy rate.) The **Overall Vacancy Rate** includes all physically vacant space, both direct and sublease while the **Direct Vacancy Rate** includes only direct space.

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District of Columbia Office Submarkets



Newmark Knight Frank has implemented a proprietary database and our tracking methodology has been revised. With this expansion and refinement in our data, there may be adjustments in historical statistics including availability, asking rents, absorption and effective rents.

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