RESEARCH **2Q 2018**

Newmark Knight Frank

DISTRICT OF COLUMBIA OFFICE MARKET

VACANCY EDGES UP WITH A SPIKE IN DELIVERIES

Although the District saw its absorption in the second quarter of 2018 mirror its first-quarter absorption, the vacancy rate rose 150 basis points in the second quarter to 12.9%, largely due to the delivery of five projects totaling 2.1 million square feet:

- 2112 Pennsylvania Avenue NW delivered 250,000 square feet to the CBD submarket and was 56.6% pre-leased at completion.
- The Wharf at 1000 Maine Avenue SW delivered 267,560 square feet to the Southwest submarket and was 60.3% pre-leased at completion.
- 99 M Street SE delivered 234,000 square feet to the Capitol Riverfront submarket and was 37.2% pre-leased at completion.
- Fannie Mae's HQ at Midtown Center (1100 15th Street NW) delivered 875,000 square feet to the CBD submarket and was 91.4% pre-leased at completion.
- Capitol Crossing at 200 Massachusetts Avenue NW delivered 425,420 square feet to the Capitol Hill submarket and was 18.0% pre-leased at completion.

In addition to these construction deliveries, Alexander Court North at 2000 L Street NW completed its renovation and delivered 518,684 square feet to the CBD submarket. It was 66.0% leased at completion.

The District of Columbia registered 151,778 square feet of net absorption in the second quarter of 2018, comparable to the 160,763 square feet absorbed in the first quarter. The CBD topped District submarkets with 837,279 square feet of absorption, supported by Fannie Mae's occupancy of its new corporate headquarters at the recently delivered Midtown Center. However, this absorption was negated by 862,461 square feet in occupancy losses in the Uptown submarket, facilitated by the move-outs at five former Fannie Mae locations. The Capitol Riverfront and East End submarkets recorded the second and third-highest absorption totals in the District, measuring 151,030 square feet and 87,365 square feet, respectively. District absorption was largely driven by the following tenants:

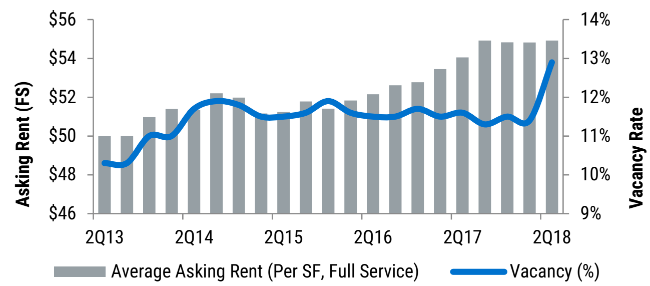
- The DC Department of Human Resources, which relocated from 77 P Street NE in NoMa and expanded by 31,214 square feet to a total of 86,214 square feet at 1015 Half Street SE in the Capitol Riverfront.
- WeWork, which continues to expand its presence within the District, occupying 54,000 square feet of net new space at 777 6th Street NW in the East End.
- The International Food Policy Institute, which relocated and expanded into 101,000 square feet at 1201 Eye Street NW in the East End from 52,000 square feet at 2033 K Street NW in the CBD.

CURRENT CONDITIONS

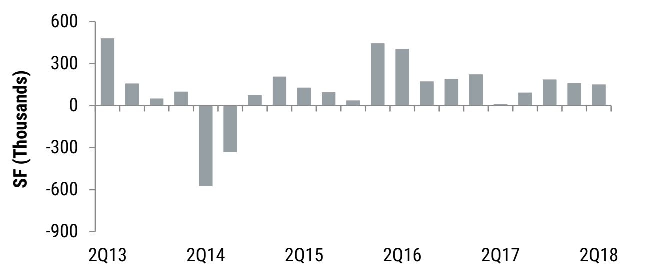
- The District of Columbia absorbed 151,778 square feet in the second quarter of 2018, supported by several tenant expansions.
- Five projects totaling 2.1 million square feet delivered during the second quarter—a ramp-up from 2017—when only 458,889 square feet came online during the entire year.
- The Class A market recorded 656,247 square feet of absorption in the second quarter as tenants continue their pursuit of quality space.

MARKET ANALYSIS

Asking Rent and Vacancy Rate



Net Absorption



MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	127.1 M	124.4 M	124.9 M	↑
Vacancy Rate	12.9%	11.4%	11.6%	↑
Quarterly Net Absorption (SF)	151,778	160,763	12,346	↑
Average Asking Rent (Per SF, Full Service)	$54.92	$54.82	$54.05	↑
Under Construction (SF)	4.0 M	6.0 M	4.8 M	↓
Deliveries (SF)	2.1 M	100,000	0	↓

Developers continue to bring new product to the market, encouraged by strong Class A market fundamentals. The construction pipeline remains substantial at 4.0 million square feet, excluding renovations. This is indicative of tenant preference for newer, well-located, and highly amenitized product. Asking rental rates increased by 1.6% from one year ago, to $54.92/SF. Asking rents continue to increase with the delivery of newer product, but substantial development places downward pressure on effective rents.

TENANT CONCESSION PACKAGES SIZEABLE

Competition for tenants is stiff, encouraging owners to offer sizeable concession packages. The average tenant improvement allowance per square foot for Class A office product rose rather steadily from 2008 and stands at $54.88/SF as of the first quarter of 2018. Some deals exceed $100/SF. The average number of months of free rent per year of lease term is 1.10 months and is trending upward. NKF expects concessions to remain elevated in 2018 and 2019, as more new product reaches the market.

TECH COMPANIES EXPANDING REACH FROM WEST COAST

Several tech firms have been expanding their reach from the West Coast and are growing their District footprint, helping to further diversify the local tenant base. Last quarter, Facebook and Yelp took occupancy at Terrell Place, contributing to 125,000 square feet of absorption in the East End submarket. World Wide Technology executed a lease at the same building during the first quarter and will take occupancy later this year. While an East Coast outpost is typically established as an effort to enhance government relations, Yelp's presence will be sales and marketing focused.

More recently, education technology firm EverFi announced plans to expand and relocate into 58,000 square feet at 2300 N Street NW in 2019 from its current lease of 23,000 square feet at 3299 K Street NW.

EMERGING MARKETS: ATTRACTIVE ALTERNATIVE TO THE URBAN CORE

Core office submarkets—the CBD and East End—command the highest asking rents in the District, with Class A product in those submarkets averaging $61.39/SF in the second quarter of 2018. For cost-conscious tenants priced out of high-end product in the urban core, emerging submarkets like Capitol Riverfront, NoMa, and Southwest are more affordable alternatives. Class A asking rents in emerging submarkets averaged $51.55/SF in the second quarter of 2018—19.1% less than for Class A product in the core. In 2017, emerging submarkets comprised an outsized share of net demand, which suggests tenant preferences may be shifting to these non-traditional locations where newer, amenity-rich space is being delivered at a discount.

FOREIGN INVESTMENT REMAINS CONSISTENT DESPITE SLUGGISH INVESTMENT VOLUME

The District of Columbia recorded $469.4 million in second-quarter sales volume, sluggish when compared with the $838.5 million recorded one year ago. Despite the deceleration in investment volume, international interest has not waned, owing to the District's reputation as an attractive gateway market for foreign capital, which has consistently accounted for 40 to 60% of total sales. This quarter, 40% of District investment sales were to foreign buyers of Class B properties in the East End. For more information on foreign investment in the District of Columbia, please read our latest white paper, Myths Vs. Reality: Evaluating Popular Misconceptions in Commercial Real Estate or visit the thought leadership page at ngkf.com.

2Q 2018 LEASE TRANSACTIONS

Tenant	Building	Submarket	Type	Square Feet
Carlyle Group	1001 Pennsylvania Avenue NW	East End	Renewal/Expansion	160,000
King & Spalding	1700 Pennsylvania Avenue NW	CBD	Renewal	120,000
WeWork	655 15th Street NW	East End	Expansion	107,726
Buckley Sandler	2001 M Street NW	CBD	Direct Lease	65,000
Spaces	1441 L Street NW	East End	Direct Lease	60,000

2Q 2018 SALES TRANSACTIONS

Building	Submarket	Sale Price	Price/SF	Square Feet
875 15th Street NW	East End	$139,000,000	$594	234,111
2000 Pennsylvania Avenue NW	CBD	$137,887,500	$341	403,817
1250 Eye Street NW	East End	$100,000,000	$562	178,000
1100 G Street NW	East End	$54,000,000	$491	109,959
950 L'Enfant Plaza SW	Southwest	$38,500,000	$138	279,681

Investors continue to flock to Class B properties, which comprised 60% of total office property sales. Investors employing a buy-and-hold strategy are conscious that quality Class B space is popular among value-conscious tenants. Simultaneously, Class B inventory is decreasing because of renovations and demolitions by owners looking to employ a value-add strategy and repurpose these buildings into competitive trophy projects.

The largest transaction of the quarter was the sale of the Bowen Building at 875 15th Street NW in the East End to J.P. Morgan. The 234,111-square-foot building sold for $139 million, or $594/SF, and was 86% occupied at time of sale.

DISTRICT OF COLUMBIA OUTLOOK

The District of Columbia will continue to favor tenants for the next 24 months, largely because of a robust development pipeline—18 buildings are 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 concession packages to incentivize a move or renewal. 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. Commodity Class A space—generally buildings that delivered 10 to 15 years ago—are oversupplied; this share of the market is stressed.

The District offers significant upside potential, including:

- LEED for Cities Platinum recognition, highlighting the high quality of its existing inventory
- Significant dry powder is available for investment. Commercial real estate presents an attractive option compared with stocks and bonds.
- Tech's growing presence in the region, including tenants such as EverFi, Global Technology, Facebook, and Yelp.
- The Federal omnibus spending bill funds the government through September 2018 and allocates 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.

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 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.

MARKET STATISTICS BY CLASS

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2015 Absorption (SF)	2016 Absorption (SF)	2017 Absorption (SF)	2Q 2018 Absorption (SF)	YTD 2018 Absorption (SF)
District of Columbia	**127,053,916**	**12.0%**	**12.9%**	**468,789**	**1,221,885**	**515,345**	**151,778**	**312,541**
Class A	81,689,481	12.6%	13.4%	-77,835	1,008,125	1,475,778	656,247	932,822
Class B	39,754,791	11.5%	12.5%	552,699	249,994	-910,254	-506,765	-588,404
Class C	5,609,644	6.7%	6.8%	-6,075	-36,234	-50,179	2,296	-31,877

MARKET STATISTICS BY CLASS

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	2Q18 Deliveries (SF)	YTD 2018 Deliveries (SF)	Under Construction (SF)
District of Columbia	**127,053,916**	**$58.80**	**$48.17**	**$54.92**	**2,051,980**	**2,151,980**	**3,961,688**
Class A	81,689,481	$58.80	NA	$58.80	2,051,980	2,151,980	3,961,688
Class B	39,754,791	NA	$48.17	$48.17	0	0	0
Class C	5,609,644	NA	NA	$43.16	0	0	0

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

SUBMARKET STATISTICS – ALL CLASSES

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2015 Absorption (SF)	2016 Absorption (SF)	2017 Absorption (SF)	2Q 2018 Absorption (SF)	YTD 2018 Absorption (SF)
District of Columbia	**127,053,916**	**12.0%**	**12.9%**	**468,789**	**1,221,885**	**515,345**	**151,778**	**312,541**
Capitol Hill	5,181,084	19.7%	20.0%	149,518	110,415	-74,404	5,081	18,268
Capitol Riverfront	3,919,480	7.5%	8.0%	241,453	27,229	109,832	151,030	186,828
Central Business District	40,274,865	9.5%	10.7%	545,344	792,925	-64,253	837,279	615,090
East End	41,252,294	12.4%	13.4%	-80,409	12,066	-320,212	87,365	385,913
Georgetown	2,851,274	5.5%	7.1%	58,942	4,518	-53,368	-27,201	-3,324
NoMa	10,993,269	9.0%	9.2%	145,735	34,494	524,131	-75,000	-27,269
Southwest	11,879,807	13.7%	14.1%	-284,704	291,181	312,976	36,500	-34,055
Uptown	7,177,338	26.6%	27.8%	-140,736	-92,515	-64,593	-862,461	-822,258
West End	3,524,505	8.2%	8.4%	-166,354	41,572	145,236	-815	-6,652

SUBMARKET STATISTICS – ALL CLASSES

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	2Q18 Deliveries (SF)	YTD 2018 Deliveries (SF)	Under Construction (SF)
District of Columbia	**127,053,916**	**$58.80**	**$48.17**	**$54.92**	**2,051,980**	**2,151,980**	**3,961,688**
Capitol Hill	5,181,084	$67.56	$47.34	$62.41	425,420	425,420	563,376
Capitol Riverfront	3,919,480	$53.25	NA	$53.25	234,000	234,000	0
Central Business District	40,274,865	$60.19	$47.55	$55.38	1,125,000	1,125,000	1,075,912
East End	41,252,294	$62.23	$51.26	$58.23	0	100,000	1,042,850
Georgetown	2,851,274	$59.38	$44.89	$46.62	0	0	0
NoMa	10,993,269	$51.92	$49.75	$51.27	0	0	1,067,550
Southwest	11,879,807	$50.74	$38.19	$47.99	267,560	267,560	212,000
Uptown	7,177,338	$44.93	$42.13	$43.60	0	0	0
West End	3,524,505	$55.90	$46.40	$53.68	0	0	0

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.

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.

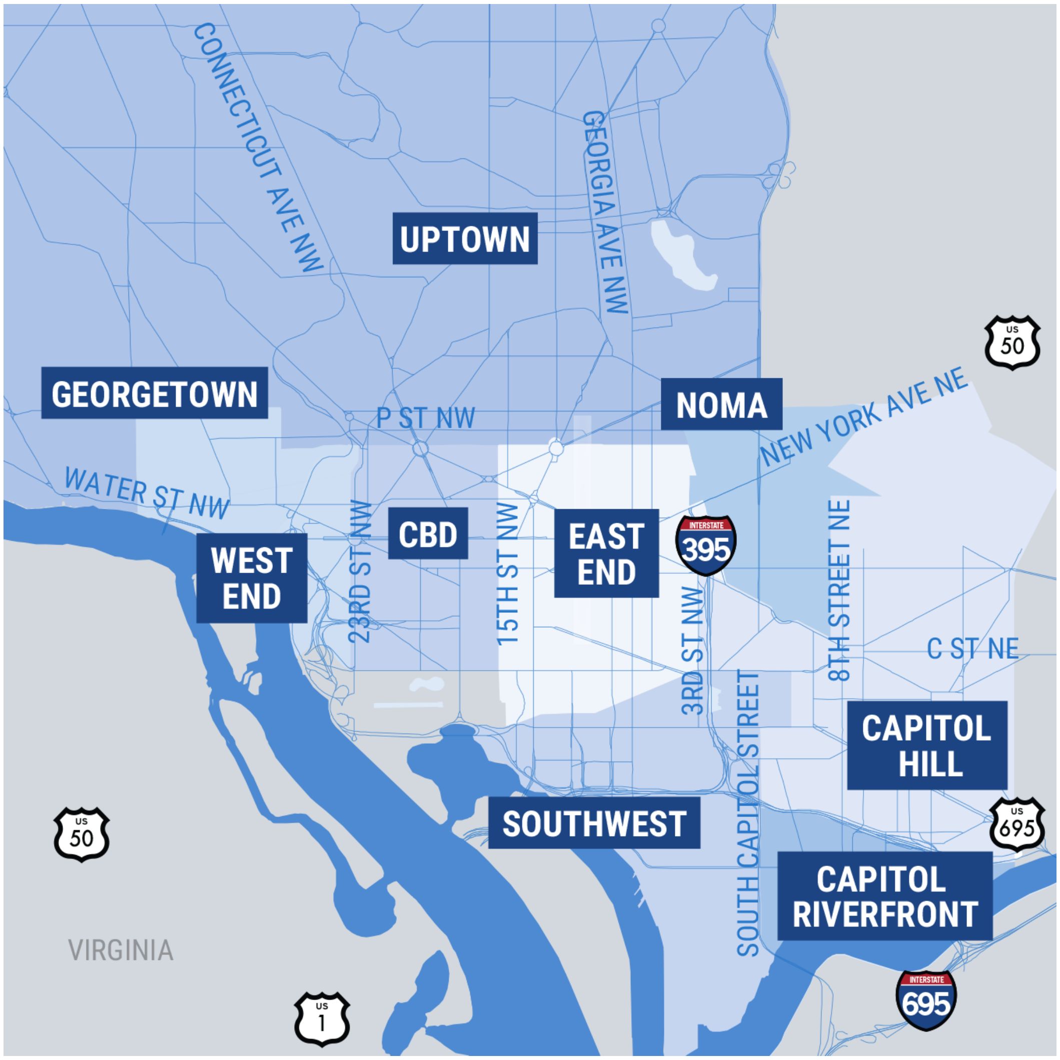
Sublease: Sublease space is offered and marketed as available by the current tenant, rather than directly from the owner.

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.

DISTRICT OF COLUMBIA OFFICE SUBMARKETS



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