RESEARCH

Newmark Grubb Knight Frank

DISTRICT OF COLUMBIA
1Q17 OFFICE MARKET

STRONG ABSORPTION PLUS AN UPTICK IN OCCUPANCY AND RENTS FOR THE DISTRICT OF COLUMBIA

Absorption was positive in the District of Columbia in the first quarter of 2017, supported by two large move-ins by Venable and the Department of Justice, whose combined footprint accounted for a total of 586,869 square feet. Vacancy declined by 40 basis points from the prior quarter, aided by a lack of deliveries. The quarter ended with net absorption totaling 623,224 square feet, a jump compared with the first quarter of 2016, when the District recorded only 291,162 square feet of net absorption. Asking rental rates rose by 3.2% over the past year to $53.51/SF, with most gains attributable to Class A assets. Despite this, Class A vacancies will remain elevated, as redevelopment, renovation and new construction of office space continue at robust levels.

While Trump Administration Brings Uncertainty, the District's Office Market Appears to Be Only Moderately Impacted So Far

Since President Donald Trump took office in January 2017, the world's attention has been focused on Washington, as many wonder what effect President Trump and his administration's policies will have on both the United States and the world. However, when it comes to the Washington metro area's office market, history has shown that political control of the federal establishment has had little direct impact on office demand. The Trump administration's policies, like those of prior administrations, are likely to have a modest impact on the office market. For more information on the reasons behind this dichotomy, please see our 2016 white paper *Political Control*. In short, exogenous events such as recessions and terrorism have a much stronger relationship to office absorption in the Washington area than does party control of the White House and Congress. *Correlation* between party control and absorption is often confused for *causation*.

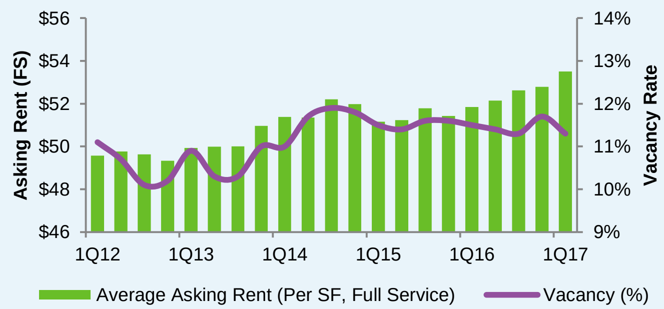
With that analysis as background, there appears to be no consensus coming from industry leaders and local market analysts regarding what impact the president's proposed budget would have on the Washington office market. Trump's proposed budget, including its major cuts to the federal workforce, is just that – proposed. It is unlikely to gain approval from Congress without significant revisions. For those agencies that do get scaled down, much of their work will likely be outsourced to the private sector, leading to increased office demand from government contractors. Proposed increases in defense and homeland security spending would benefit not just Northern Virginia and its contractor community but portions of the District as well. We believe that, by the time Congress passes spending authorization bills, they will likely have a limited negative impact on the region overall, but with some submarket winners and losers.

Current Conditions

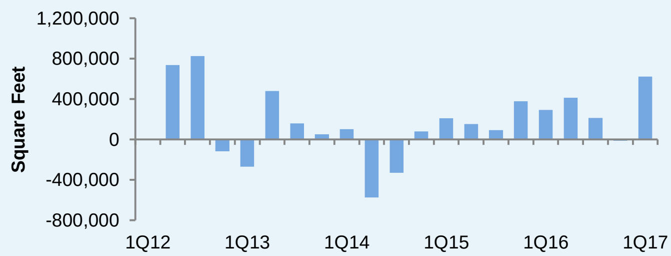
- The District of Columbia began 2017 with 623,224 square feet of net absorption and an overall vacancy rate of 11.3%, down 40 basis points from the previous quarter.
- The Class A market posted strong quarterly absorption of 504,079 square feet, but its vacancy rate of 12.4% is still elevated compared with the Class B rate of 9.6%.
- Investment sales activity registered $948.3 million in first-quarter 2017

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	124.4 M	124.0 M	↑
Vacancy Rate	11.3%	11.7%	11.5%	↑
Quarterly Net Absorption (SF)	623,224	-13,373	291,162	↓
Average Asking Rent (Per SF, Full Service)	$53.51	$52.79	$51.84	←→
Under Construction (SF)	4.2 M	4.2 M	3.1 M	←→
Deliveries (SF)	0	739,827	263,623	↑

The Emergence of Class B Space

Class B office space within the District's CBD and East End submarkets is increasing in popularity among value-conscious tenants that wish to retain a presence in the District. This has coincided with a trend toward older Class B office buildings being renovated into Class A or torn down and rebuilt into trophy assets. As available inventory declines and tenant interest grows, Class B rents have risen over the past several quarters. The average Class B rent in the CBD and East End is $45.73/SF, an increase of 4.5% since the second quarter of 2014. During that same period, the Class B inventory has declined by 400,000 square feet due to renovations and demolitions.

There is a bifurcated office market in Washington. On the one extreme is top-quality trophy space, which commands the highest rents in the market. At the other end of the spectrum is renovated Class B space, which often is located in desirable submarkets. In between is commodity Class A space, generally in buildings delivered 10-15 years ago, which is struggling to find tenants. These buildings often have leases expiring within the next two to five years. This space is generally leasing in the range of $60/SF to $75/SF, full service, with competition particularly intense in the $65/SF to $75/SF range. Since many of the anchor tenants in these buildings signed their leases 10 to 15 years ago, their rents have escalated to a number often higher than what these buildings are now able to achieve for vacant space, particularly with the amount of competition in the market.

Therefore, owners of commodity Class A buildings are presented with a dilemma. One option is to dramatically renovate the structure, involving either an addition (like Rockrose Development and Spitzer Enterprises' Alexander Court), a re-skin/new façade (such as Tishman Speyer's 900 19th Street NW), or other significant improvements in order to elevate the structure to Class A+/trophy status. A second option is to target value-conscious tenants who are looking for centrally located space but who are unwilling to pay trophy rents. Ultimately, owners of 10- to 15-year-old Class A- office assets – what we call commodity Class A product – will have to (1) renovate to trophy/near-trophy status; (2) repurpose the asset; or (3) with limited modernization accept Class B+ status and re-rent space at rates below expiring, escalated rental rates.

CLASS B OFFICE SPACE WITHIN THE DISTRICT'S CBD AND EAST END SUBMARKETS IS INCREASING IN POPULARITY AMONG VALUE-CONSCIOUS TENANTS

Consolidation Driving Down Demand

Office consolidation and densification – a reduction in the square footage occupied per employee -- will continue to negatively impact demand and contribute to a rise in vacancy over the next 12 to 24 months. This trend has been especially pronounced for law firms and the federal government, two sectors that occupy a significant amount of office space

Recent Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
DC Government	1200 1st Street NE	NoMa	Direct Lease	199,822
Akin Gump	2001 K Street NW	CBD	Direct Lease	189,268
Urban Institute	500 L'Enfant Plaza SW	Southwest	Direct Lease	115,000
Paul Hastings	2050 M Street NW	CBD	Direct Lease	97,000
Quinn Emanuel	1300 Eye Street NW	East End	Direct Lease	71,931

Recent Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
1120 20th, 1133 & 1155 21st Street NW	CBD	$415,000,000	$526	789,235
64 New York Ave NE	NoMa	$187,000,000	$527	355,034
425 3rd Street SW	Southwest	$148,000,000	$669	221,066
500 D Street SW	Southwest	$93,000,000	$273	341,281
1901 L Street NW	CBD	$75,000,000	$583	128,672

in the District of Columbia. However, we see some evidence that the densification process is beginning to plateau. As a result, there will be a more direct correlation between added office-using jobs and demand for office space. Most recently, GSA sold the Cotton Annex building at 300 12th Street SW in the Southwest submarket to reduce the government's footprint. The GSA put the building up for auction in order to achieve the greatest value for taxpayers. These factors, in conjunction with a significant amount of office space expected to come online within the next three years, have made the District of Columbia a tenant-friendly market.

CBD and East End Lead the District with the Most Construction

As of the first quarter, the District of Columbia registered a total of 4.2 million square feet of construction of Class A assets. The CBD and East End submarkets dominated construction in the District, accounting for roughly 53%, or a combined 2.3 million square feet, of total activity in the first quarter. Outside of the core submarkets, two projects totaling 342,000 square feet began construction this quarter. One M in the Capitol Riverfront submarket will deliver toward the end of third-quarter 2018, and 500 L'Enfant Plaza in the Southwest submarket will deliver in December 2019.

Foreign Investment Continues to Drive Sales Activity

Since January, six major office properties traded hands in the District of Columbia for a total of $948.3 million. Foreign buyers remain interested in District assets. For example, Singapore's sovereign wealth fund, GIC, purchased One, Two & Three Lafayette Centre in the CBD submarket for $415 million, or $526/SF, from Beacon Capital Partners. The acquisition represented the largest transaction for the quarter and traded at a 5.5% cap rate. In an effort to consolidate, the GSA sold the GSA Cotton Annex at 300 12th Street SW in the Southwest submarket for $30.3 million, or $381/SF, to Douglas Development.

District of Columbia Outlook

The District of Columbia's office market will remain in the tenant's favor over the next 24 months due in large part to an elevated level of deliveries. Absorption is expected to remain in the 1.0 to 1.2 million square feet per annum range, while deliveries (excluding renovations) are expected to total 3.8 million square feet over the next 24 months. During this period, we expect property owners to offer robust concessions, free rent periods and flexible lease rates to fill space. Notwithstanding the competitive nature of the office leasing market in general, well-located trophy and renovated Class B properties will continue to outperform the market.

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	Total Vacancy Rate	2014 Absorption (SF)	2015 Absorption (SF)	2016 Absorption (SF)	1Q 2017 Absorption (SF)	YTD 2017 Absorption (SF)
Class A	77,825,080	11.8%	12.4%	498,653	283,047	964,776	504,079	504,079
Class B	40,406,764	9.1%	9.6%	-1,124,055	547,630	-24,594	132,058	132,058
Class C	6,163,644	8.7%	8.8%	-106,377	-6,075	-36,234	-12,913	-12,913
District of Columbia	**124,395,488**	**10.8%**	**11.3%**	**-731,779**	**824,602**	**903,948**	**623,224**	**623,224**

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	1Q17 Deliveries (SF)	YTD 2017 Deliveries (SF)	Under Construction (SF)
Class A	77,825,080	$57.81	NA	$57.81	0	0	4,239,299
Class B	40,406,764	NA	$46.53	$46.53	0	0	0
Class C	6,163,644	NA	NA	$40.32	0	0	0
District of Columbia	**124,395,488**	**$57.81**	**$46.53**	**$53.51**	**0**	**0**	**4,239,299**

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

Submarket Statistics – All Classes

	Total Inventory (SF)	Direct Vacancy Rate	Total Vacancy Rate	2014 Absorption (SF)	2015 Absorption (SF)	2016 Absorption (SF)	1Q 2017 Absorption (SF)	YTD 2017 Absorption (SF)
Capitol Hill	4,520,744	5.9%	6.5%	-226,956	149,518	110,415	17,455	17,455
Capitol Riverfront	3,685,480	9.1%	9.1%	45,862	241,453	27,229	42,251	42,251
Central Business District	38,561,652	7.6%	8.3%	54,400	545,344	776,925	116,996	116,996
East End	41,304,315	13.6%	14.2%	467,574	-63,081	-159,112	32,081	32,081
Georgetown	2,851,274	3.9%	4.7%	59,086	58,942	4,518	-11,402	-11,402
NoMa	11,099,645	10.0%	10.3%	11,446	145,735	56,907	353,064	353,064
Southwest	11,487,235	13.3%	13.5%	-591,767	53,781	138,009	1,171	1,171
Uptown	7,360,638	14.9%	15.4%	-440,911	-140,736	-92,515	44,863	44,863
West End	3,524,505	11.6%	11.6%	-110,513	-166,354	41,572	26,745	26,745
DC - District of Columbia	**124,395,488**	**10.8%**	**11.3%**	**-731,779**	**824,602**	**903,948**	**623,224**	**623,224**

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 2017 Deliveries (SF)	YTD 2017 Deliveries (SF)	Under Construction (SF)
Capitol Hill	4,520,744	$62.80	$50.89	$56.97	0	0	769,920
Capitol Riverfront	3,685,480	$45.84	NA	$45.84	0	0	235,000
Central Business District	38,561,652	$60.46	$47.44	$55.17	0	0	1,125,000
East End	41,304,315	$61.49	$48.43	$57.17	0	0	1,142,850
Georgetown	2,851,274	$59.75	$43.08	$49.33	0	0	0
NoMa	11,099,645	$52.77	$44.25	$50.96	0	0	475,000
Southwest	11,487,235	$49.62	$39.76	$43.94	0	0	491,529
Uptown	7,360,638	$43.06	$39.30	$41.56	0	0	0
West End	3,524,505	$56.63	$47.20	$54.16	0	0	0
DC - District of Columbia	**124,395,488**	**$57.81**	**$46.53**	**$53.51**	**0**	**0**	**4,239,299**

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

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District of Columbia Office Submarkets

Newmark Grubb 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.

Newmark Grubb Knight Frank Research Reports are also available at www.ngkf.com/research