

DISTRICT OF COLUMBIA 4Q17 OFFICE MARKET

DISTRICT DEMAND STRONG WITH BANNER FOURTH QUARTER PERFORMANCE

The District of Columbia ended 2017 on a positive note with 800,623 square feet of annual net absorption, its second-strongest performance of the last five years. Annual absorption was bolstered by strong fourth-quarter figures, as 463,590 square feet was absorbed. Absorption was concentrated in the NoMa, Southwest and West End submarkets and was partly attributable to tenants relocating their headquarters from the suburbs.

During the fourth quarter:

- Silver Spring-based Macfadden & Associates moved into 177,000 square feet at 555 12th Street NW in the East End, canceling out some of the vacancy created by Arnold & Porter Kaye Scholer LLP's 483,000-square-foot move-out in 2015.
- The Federal Election Commission moved into 164,000 square feet, relocating from the East End to NoMa.
- The Aspen Institute's 91,000-square-foot lease and relocation from the CBD to the West End brought year-to-date absorption for the West End submarket to 145,236 square feet.
- The headquarters relocation of the Virginia-based American Psychiatric Association saw 63,000 square feet of Southwest space occupied.

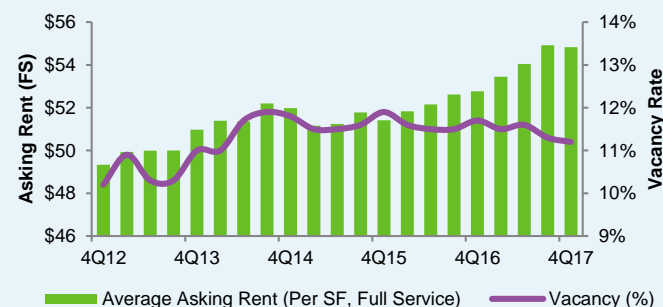
The uptick in fourth quarter demand compared with the relatively tepid performance of the first three quarters of the year saw the vacancy rate decline 50 basis points to 11.2%, from 11.7% one year ago, while asking rental rates rose 3.9% from last year, to \$54.83/SF. Core submarkets such as the CBD and East End – as well as Capitol Hill – continue to command the highest rents in the District. Effective rents remain under downward pressure due to a substantial development pipeline yet continue to increase with the delivery of newer product. Emerging markets such as NoMa and Southwest, where Class A rents are at least \$8.00/SF lower than in core submarkets, comprise an outsized share of annual net demand. Year-to-date net absorption totaled 864,937 square feet in the NoMa and Southwest submarkets alone, which helped to offset negative 411,589 square feet of annual net absorption in Capitol Hill, East End, Georgetown and Uptown.

Current Conditions

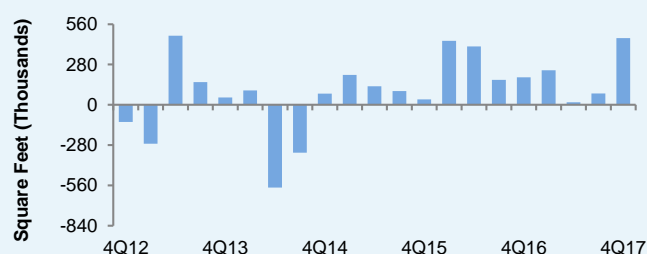
- The District of Columbia closed 2017 with 800,623 square feet of annual net absorption, bolstered by a strong-fourth quarter performance in which 463,590 square feet was absorbed—the strongest quarterly performance since the second quarter of 2013.
- The Class A market recorded 1.6 million square feet of absorption for the year, outpacing the 1.0 million square feet of Class A absorption in 2016.
- The vacancy rate edged down 50 basis points to 11.2%, from 11.7% one year ago.

Market Analysis

Asking Rent and Vacancy Rate



Net Absorption



Market Summary

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	124.3 M	124.1 M	124.3 M	↑
Vacancy Rate	11.2%	11.3%	11.7%	↑
Quarterly Net Absorption (SF)	463,590	79,178	190,573	↔
Average Asking Rent (Per SF, Full Service)	\$54.83	\$54.92	\$52.77	↑
Under Construction (SF)	6.1 M	5.3 M	4.2 M	↑
Deliveries (SF)	458,889	0	739,827	↑

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Repositioning Commodity Class A Office Assets to Stay Competitive

There is a significant rent difference between the two most popular classes of office space in the District: top-quality trophy space, which commands the highest rents in the market, and Class B space, which is more affordable and often located in desirable submarkets, albeit within older, poorly amenitized buildings. In between is commodity Class A space, generally located in buildings delivered 10 to 15 years ago. The market has shown minimal demand for this latter of space at a time when a significant amount of it is becoming available. Many tenants in these commodity buildings were the initial anchor tenants when the buildings delivered and have leases expiring within the next two to five years. Among these tenants are a good number of large law firms, which tend to seek new trophy space and are less likely to renew in place.

Of the major law firm transactions (50,000 square feet and larger) signed over the past 10 years, less than half opted to renew in their current building. As a result, Newmark Knight Frank estimates that more than 10 million square feet of Class A space in the core CBD and East End submarkets will become available over the next few years. In order to stay competitive, owners have the option of targeting value-conscious tenants that are looking for centrally located space but are unwilling to pay trophy rents. Another option is to dramatically renovate the structure, involving either an addition, a re-skin/new façade, or other significant improvements in order to elevate the structure to Class A+/trophy status. This requires a significant up-front capital outlay (often \$200/SF or more).

At-A-Glance: Major Law Firms Relocating and Densifying

Year-to-date, seven of eight major law firms occupying more than 50,000 square feet have chosen to relocate to new, well-located and amenity-rich space. The cumulative lease transactions of Akin Gump, Bates White, Baker Botts, Goodwin Procter, Morrison Foerster, Paul Hastings and Wilmer Hale total 1.3 million square feet. These combined deals represent a 25% 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. One of the fourth quarter's most notable lease transactions was Wilmer Hale's 288,000-square-foot deal at 2100 Pennsylvania Ave NW, a 45% reduction in occupancy from its current lease at 1875 Pennsylvania Avenue NW. The only renewal of the year was K&L Gates' 126,910-square-foot lease at 1601 K Street NW.

Capitol Hill and Southwest Lead District in Year-to-Date Deliveries

Two projects totaling 458,889 square feet delivered during the fourth quarter:

- Phase I of the Wharf Development at 800 Maine Avenue SW in the Southwest submarket, which was 73% pre-leased at time of completion.
- 700 Pennsylvania Avenue SE in the Capitol Hill submarket, which was 21% pre-leased at time of completion.

The District of Columbia has a robust development pipeline with 25 construction and renovation projects underway totaling 7.9 million square feet, of which 6.1 million square feet is new construction. At the

4Q 2017 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
Wilmer Hale	2100 Pennsylvania Avenue NW	CBD	Direct Lease	288,000
GSA—Peace Corps	1275 First Street NE	NoMa	Direct Lease	173,000
Baker Botts	700 K Street NW	East End	Direct Lease	150,000
K&L Gates	1601 K Street NW	CBD	Renewal	126,910
Department of Homeland Security	500 12 th Street SW	Southwest	Renewal	99,150

4Q 2017 Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
1800 M Street NW	CBD	\$421,000,000	\$725	580,930
370 L'Enfant Plaza SW	Southwest	\$126,680,000	\$311	407,248
1133 15 th Street NW	East End	\$100,500,000	\$489	205,319
Union Center Plaza I	NoMa	\$64,250,000	\$338	190,119

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time of this writing, two developments totaling 973,721 square feet are expected to deliver by year-end but are not factored into fourth quarter statistics:

- Mount Vernon Place, 901 4th Street NW, East End, 105,000 SF
- Midtown Center (Fannie Mae headquarters), 1100 15th Street NW, CBD, 868,721 SF

District Sales Volume Outpaces 2016's Figures

As of mid-December, the District of Columbia registered \$1.8 billion in sales volume in the second half of the year, a slowdown compared with the first half of 2017 and the second half of 2016, when sales volume reached \$2.5 billion and \$2.4 billion, respectively. Still, year-to-date sales volume totals \$4.3 billion, outpacing 2016's sales volume of \$3.3 billion. Foreign investors continue to view District assets favorably: Their capital constitutes a 68% share of 2017 sales volume, or \$3.0 billion. The largest transaction of the fourth quarter and the year to date was the sale of 1800 M Street NW to Columbia Property Trust. The 580,930-square-foot building sold for \$421.0 million, or \$725/SF, and was 94% leased at time of sale.

District of Columbia Outlook

The District of Columbia is a tenant's market and will continue to favor tenants for the next 12 to 24 months, largely because of densification, a robust development pipeline (with 24 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 high asking rents, effective rents remain under downward pressure, as tenants are being offered free rent and high TI's to incentivize them to move. A 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 renovated 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, as developers work to repurpose these buildings.

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 Yelp's deal for 52,000 square feet at Terrell Place. 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 the Washington metro report for a more detailed discussion. 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	2014 Absorption (SF)	2015 Absorption (SF)	2016 Absorption (SF)	4Q 2017 Absorption (SF)	YTD 2017 Absorption (SF)
Class A	78,904,194	10.9%	11.8%	498,653	-77,835	1,008,125	957,235	1,646,275
Class B	39,805,808	9.7%	10.7%	-1,124,055	552,699	249,994	-458,517	-795,473
Class C	5,609,644	6.2%	6.5%	-106,377	-6,075	-36,234	-35,128	-50,179
District of Columbia	124,319,646	10.3%	11.2%	-731,779	468,789	1,221,885	463,590	800,623

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	4Q17 Deliveries (SF)	YTD 2017 Deliveries (SF)	Under Construction (SF)
Class A	78,904,194	\$57.93	NA	\$57.93	458,889	458,889	6,113,668
Class B	39,805,808	NA	\$48.79	\$48.79	0	0	0
Class C	5,609,644	NA	NA	\$43.11	0	0	0
District of Columbia	124,319,646	\$57.93	\$48.79	\$54.83	458,889	458,889	6,113,668

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	2014 Absorption (SF)	2015 Absorption (SF)	2016 Absorption (SF)	4Q 2017 Absorption (SF)	YTD 2017 Absorption (SF)
Capitol Hill	4,755,664	12.4%	13.0%	-226,956	149,518	110,415	32,398	-74,404
Capitol Riverfront	3,685,480	6.6%	7.3%	45,862	241,453	27,229	19,631	109,832
Central Business District	38,667,014	7.4%	8.4%	54,400	545,344	792,925	33,759	92,207
East End	40,886,223	13.1%	14.3%	467,574	-80,409	12,066	-57,108	-246,918
Georgetown	2,851,274	4.0%	5.4%	59,086	58,942	4,518	-3,385	-42,003
NoMa	11,099,645	8.6%	9.0%	11,446	145,735	34,494	133,829	516,977
Southwest	11,612,247	11.4%	11.7%	-591,767	-284,704	291,181	198,822	347,960
Uptown	7,237,594	15.0%	16.1%	-440,911	-140,736	-92,515	16,312	-48,264
West End	3,524,505	8.1%	8.2%	-110,513	-166,354	41,572	89,332	145,236
DC - District of Columbia	124,319,646	10.3%	11.2%	-731,779	468,789	1,221,885	463,590	800,623

Submarket Statistics – All Classes

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	4Q 2017 Deliveries (SF)	YTD 2017 Deliveries (SF)	Under Construction (SF)
Capitol Hill	4,755,664	\$63.38	\$49.48	\$53.60	234,920	234,920	988,796
Capitol Riverfront	3,685,480	\$48.18	NA	\$48.18	0	0	234,000
Central Business District	38,667,014	\$61.58	\$49.85	\$56.98	0	0	2,200,912
East End	40,886,223	\$60.37	\$50.85	\$57.38	0	0	1,142,850
Georgetown	2,851,274	\$56.46	\$45.91	\$47.59	0	0	0
NoMa	11,099,645	\$51.98	\$49.78	\$51.50	0	0	1,067,550
Southwest	11,612,247	\$49.88	\$38.74	\$46.83	223,969	223,969	479,560
Uptown	7,237,594	\$44.31	\$40.48	\$42.78	0	0	0
West End	3,524,505	\$57.27	\$46.87	\$55.57	0	0	0
DC - District of Columbia	124,319,646	\$57.93	\$48.79	\$54.83	458,889	458,889	6,113,668

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.

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

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