Office Insight

Washington, DC | Q1 2014

Urbanization trend takes hold in Metro DC as downtown properties drastically outperform the suburbs

Economy

Competing themes impacted the Metro DC economy in early 2014. The regional unemployment rate ticked up modestly to 5.0 percent, but remained the lowest among primary U.S. cities. Growth of creative and high-tech sectors clashed with falling payrolls within the federal government. Law firm profits rose 4.6 percent year-over-year, but a major DC-based firm continued to wrestle with partner defection. A federal budget was passed, yet agencies grappled with how to implement spending cuts and modernize their workplaces.

In essence, the Metro DC economy followed a "two steps forward, one step back" path. As the first market to emerge from the downturn in 2009, the area experienced a rapid recovery in 2010, yet languished in recent years as political gridlock and calls to rein in government spending softened tenant demand. Longer term, the area's increasingly diversified economy, strong population growth, affluent consumer base and top-notch workforce demographic raise hopes that the market will regain momentum, but the near-term challenges remain an impediment to progress.

Market conditions

Demand within Metro DC was bifurcated between urban and suburban markets in early 2014. Positive net absorption in downtown DC contrasted with occupancy losses in Suburban Maryland and Northern Virginia. Most lease transactions continued to emphasize cost-containment and efficiency, particularly deals involving a federal tenant and federal contractors.

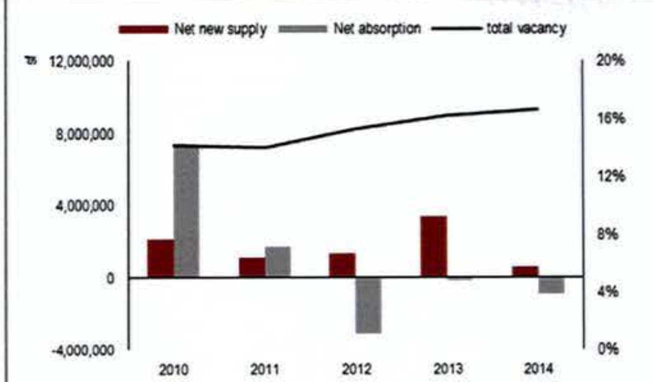
Growth of small and mid-size tenants helped drive occupancy gains in downtown Washington, DC. The appeal of walkable, amenity-rich enclaves of the city was clear, as niche tenants grew their footprints in micromarkets such as Gallery Place, Dupont Circle and Shaw. Meanwhile, contractor rightsizing and consolidations by federal agencies in Northern Virginia and Suburban Maryland accounted for the majority of negative net absorption in those markets.

Outlook

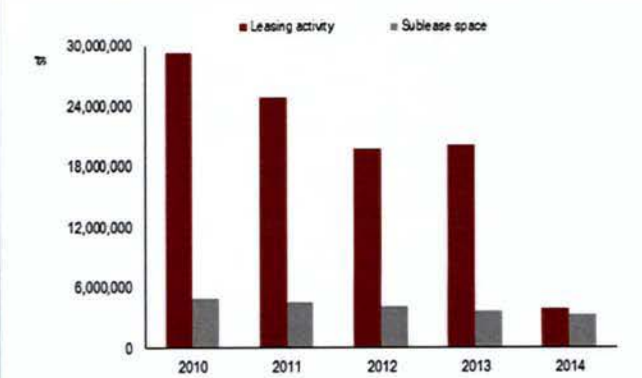
Although near-term tenant demand remains limited, the pullback in new construction will have a meaningful impact on the Metro DC office market over the next 24 months. Vacancy across the region is becoming concentrated in Commodity Class A and Class B assets – buildings that are not particularly appealing to today's efficiency-minded tenants. The result of this trend is that large tenants with pending lease expirations must start their search process early to preserve the option of anchoring a new development or risk being confined to less-desirable second-generation space. That confining supply-demand dynamic is likely to signal a peak in concession packages and a gradual shift in negotiating leverage from tenants' favor to more balanced conditions by year-end 2014.

	Key market indicators	12-month forecast	
Supply	Supply	↑	330,266,655 sf
	Direct vacancy rate	↓	15.5%
	Total vacancy rate	↓	16.6%
	Under construction (% preleased)	↓	4.0 msf (51.6%)
Demand	Leasing activity 12 mo. % change	↑	-26.9%
	YTD net absorption	↑	-877,239 sf
Pricing	12-month overall rent % change	→	1.7%
	Class A overall asking rent	→	$39.79 psf
	Class B overall asking rent	→	$32.99 psf

Net new supply, net absorption and total vacancy



Leasing activity vs. sublease vacant space



Sublease space only includes vacant space

~~ZONING COMMISSION~~
District of Columbia
CASE NO.03-12S/03-13S
EXHIBIT NO.1F

Tenant perspective

Within Washington, DC's urban core, large blocks of new and efficient space have become increasingly scarce. Although obtaining these quality blocks at a reasonable price point is a challenge for many large tenants, smaller groups willing to compromise on quality or location are able to receive big bargains at Commodity A buildings.

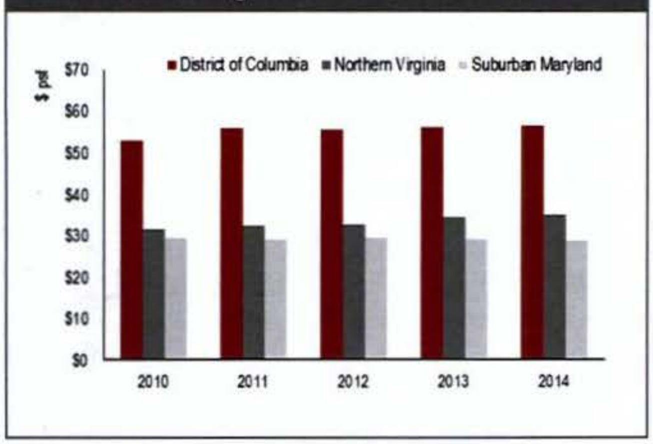
Given demand for new space in the urban core, and a general lack of modern Trophy product, many tenants have entered the market years ahead of their lease expirations to evaluate potential build-to-suits. Meanwhile, several new construction projects along the city's periphery in NoMa and Southeast, and in the close-in suburbs of Rosslyn-Ballston and Bethesda-CBD, continue to await their first commitments. Leasing prospects in these secondary markets are thin and tenants hold strong negotiating leverage. Some owners of second-generation assets in these submarkets – such as Vornado in Crystal City – have responded by aggressively slashing base rents and offering record-high concessions to attract new tenants.

Landlord perspective

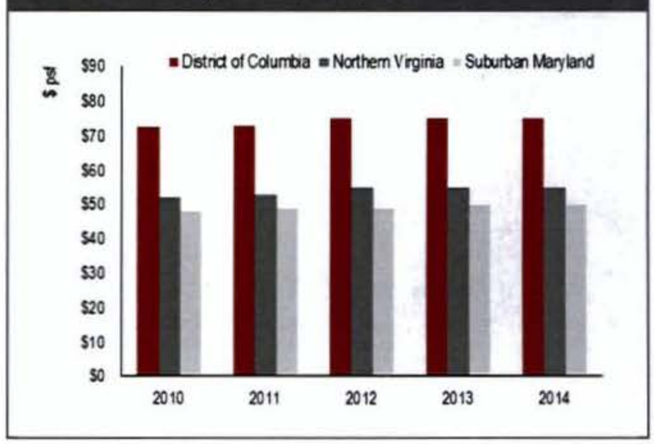
Given limited space requirements and stubbornly high vacancy rates in many tranches of the market, attracting new prospects and retaining existing tenants has required aggressive action. Renovations to add new amenities, such as rooftop terraces and fitness facilities, have been common among many second-generation buildings and owners across the board continue to offer record levels of concessions to appeal to cost-conscious tenants.

Supply constraints have emerged within the top segment of the market, but overall vacancy remains high. Speculative construction has slowed and sublease inventory has fallen from recent peaks. Competition is most intense within the commodity segment, where finite space requirements and plentiful small to mid-sized blocks of space define the environment. Older buildings with deep floor plates, inefficient layouts and punched windows will likely require creative renovations, as tenants' preferences for efficient floor plates, open space plans and abundant natural light remain clear.

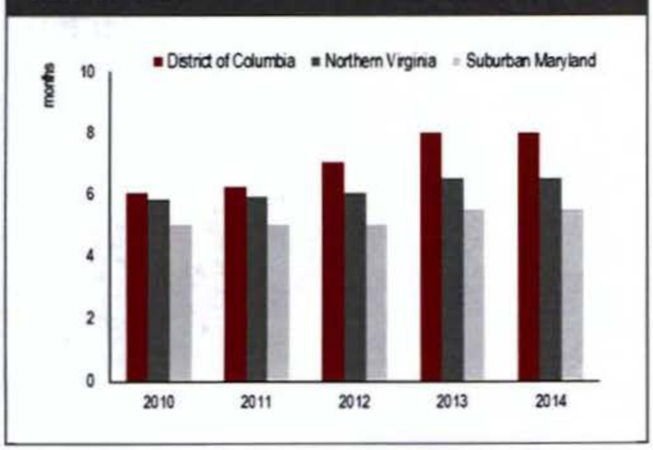
Class A overall asking rents



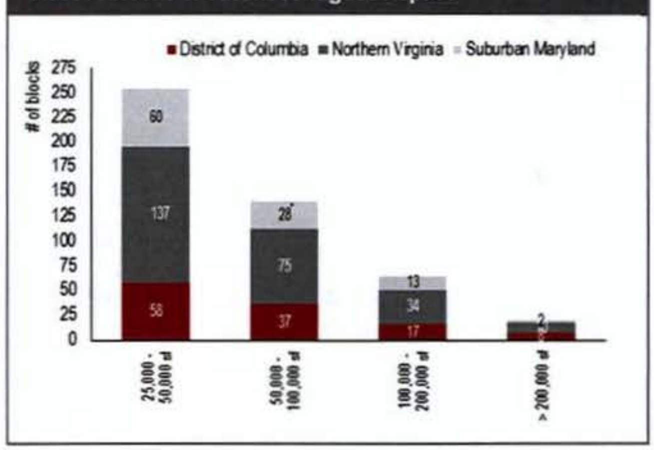
Class A tenant improvement allowance



Class A free rent

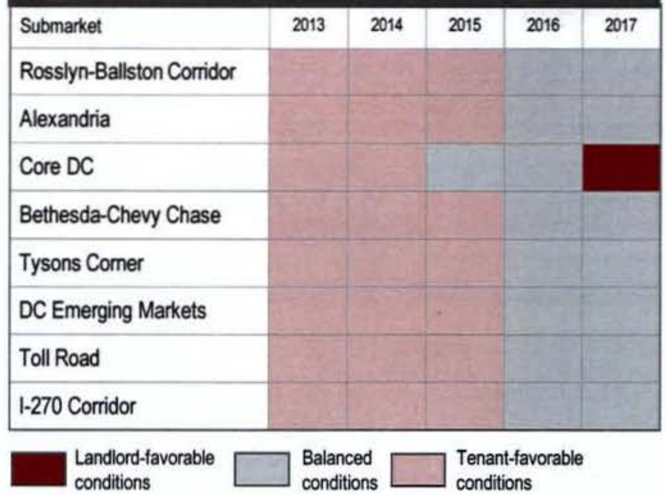


Class A blocks of vacant contiguous space



Property clock – current market conditions

Submarket leverage – market history and forecast



Completed lease transactions

Tenant	Address	Submarket	sf	Type
Argon ST	12701 Fair Lakes Circle	Fairfax Center	165,000	Renewal
U.S. National Labor Relations Board	1015 Half Street, SE	Southeast	143,116	Relocation
DRS Technologies	1 Milestone Center Court	Germantown	133,140	Relocation
Microsoft	5404 Wisconsin Avenue	Chevy Chase	106,000	Renewal
U.S. Centers for Disease Control and Prevention	3311 Toledo Road	College Park	104,000	Renewal
U.S. Millennium Challenge Corporation	1099 14th Street, NW	East End	96,894	Relocation
Marymount University	4040 N Fairfax Drive	Ballston	87,000	Relocation
U.S. Minerals Management Service	45600 Woodland Road	Route 28 North	80,000	Renewal

Completed sale transactions

Property	Submarket	Buyer / Seller	sf	$ psf
700 13th Street, NW	East End	Fosterlane / Beacon Capital Partners	258,695	$822
2550 M Street, NW	West End	Mirae Asset Global Investment Group / Tishman Speyer	207,081	$753
555 12th Street, NW	East End	MetLife and Norges / Manulife	781,423	$635
1110 Vermont Avenue, NW	East End	Epic UK / Tishman Speyer	306,600	$530
90 K Street NE	NoMa	Utah Retirement System / Trammell Crow	412,661	$475

Washington, DC methodology: Inventory includes all Class A, B, & C office properties > 30,000 square feet, excluding all condo, medical and government owned buildings, and owner occupied buildings

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