RESEARCH **3Q 2020**

Newmark Knight Frank

DISTRICT OF COLUMBIA OFFICE MARKET

IMPACT OF CORONAVIRUS ON DISTRICT'S OFFICE MARKET ACCELERATES

The District of Columbia experienced weakening office leasing metrics during the third quarter of 2020, with negative net absorption and lower asking rents. The impact of the COVID-19 pandemic on the economy and office market remained significant as many tenants paused their searches for office space, slowing market activity considerably. Vacancy remained even with last quarter, a result of slow leasing velocity and delayed move-ins but helped by the fact that there was no new office space that delivered during the quarter. Two notable construction projects will deliver over the next few months. One is 250 M Street SW, a 227,948-square-foot office building in the Capitol Riverfront submarket. The property is 100.0% pre-leased to the District Department of Transportation and will deliver in the first quarter of 2021. Additionally, 699 14th Street NW, a 137,797-square-foot office property in the East End submarket, will be completed. The building is currently 0.0% pre-leased and will also deliver during the first quarter of 2021.

The District of Columbia registered negative 518,041 square feet of net absorption during the third quarter of 2020. The downturn created by the COVID-19 pandemic has impacted the District of Columbia office market in many ways, including the continued lack of absorption by coworking operators. Coworking has represented a significant share of the District's positive net absorption over the past three years, but the model itself faces unique issues in the face of the pandemic. Additionally, questions about the future scale of remote work and what that means for companies' space requirements remained a challenge for the market.

Vacancy continues at near record-high levels, registering 15.0% at the end of third-quarter 2020—level with last quarter, but up 100 basis points over the past year. Although there were no new deliveries during the third quarter, the construction pipeline warrants close observation, especially as tenants reconsider their office space needs. 2.1 million square feet has delivered in the District of Columbia over the past year, and with an additional 1.8 million square feet expected to deliver over the next 24 months and leasing activity likely to remain slow in the near term, vacancy is likely to rise further.

The average asking rent ticked down during the third quarter to $57.38/SF, although this was an increase of 2.4% from one year ago. Although current office leasing conditions are expected to remain slow in the short term, asking rents are likely to remain at current levels or potentially tick up with new construction set to deliver. Effective rents remain under downward pressure, as concessions remain high.

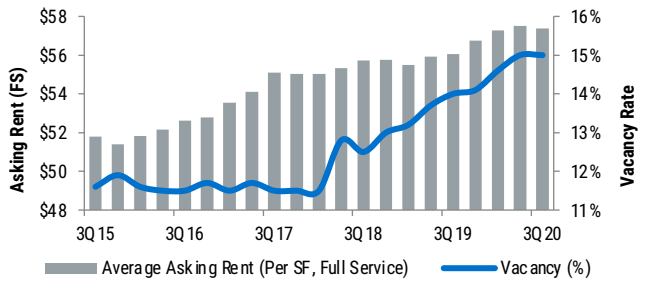
The District's construction pipeline remains active at 2.4 million square feet, excluding renovations, as developers sought to capitalize on strong trophy market fundamentals in recent years. The COVID-19 outbreak has not led to any significant delays to current office construction projects thus far, including nearly 600,000 square feet long projected to deliver in the District over the next 12 months. However, the prolonged nature of remote work that has occurred has taken a toll on the economic outlook of the District of Columbia. Downtown, Metrorail-focused submarkets have been hit especially hard, which may alter construction plans over the next few years, as developers seek to determine their best timing or whether a different property type might result in a better return.

CURRENT CONDITIONS

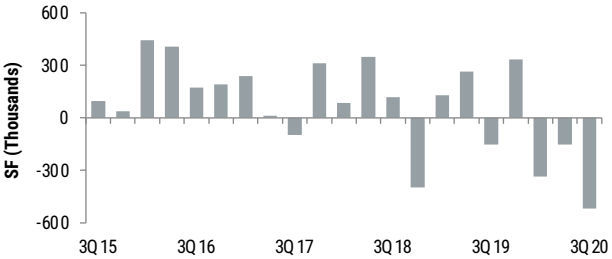
- The District of Columbia registered negative 518,401 square feet of net absorption during the third quarter of 2020.
- The vacancy rate has risen 100 basis points from a year ago to 15.0%, as a material amount of new space without significant pre-leasing has delivered in the past 12 months.
- Asking rents were down during the third quarter to $57.38/SF, although this is still an increase of 2.4% from 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)	130.0 M	130.3 M	128.4 M	↑
Vacancy Rate	15.0%	15.0%	14.0%	↑
Quarterly Net Absorption (SF)	-518,401	-153,243	-152,953	↑
Average Asking Rent (Per SF, Full Service)	$57.38	$57.52	$56.04	↔
Under Construction (SF)	2.4 M	2.4 M	3.7 M	↓
Deliveries (SF)	0	335,063	0	↑

LEASING VELOCITY REMAINS SLOW

Lease transaction volume remained slow during the third quarter of 2020, as asset owners' ability to show their properties remained limited and many tenants put off making decisions regarding office leasing. According to the DowntownDC BID, only 5.0% of office workers were in their office at the end of July and downtown economic activity was down nearly 90% compared to the same time last year. As of this writing, most companies have still not yet re-entered their workplaces, although some have begun to welcome workers back on a phased or partial basis. Many trends that appeared during the previous quarter persisted. Of the deals that were signed during the third quarter, renewals and short-term extensions were again popular, as tenants and their landlords valued maintaining the status quo until the health and economic crises are contained and begin to reverse. Few large leases were signed during the quarter, as tenants seeking large blocks of space are more likely to take some extra time to assess their office needs before signing their next deal.

The two largest lease transactions of the quarter both included government tenants. The District of Columbia Department of General Services signed a 239,800-square-foot lease to occupy the entirety of the not-yet under construction project slated for 3924 Minnesota Avenue NE in the Capitol Hill submarket. Additionally, the U.S. Secret Service renewed its 74,234-square-foot lease at 1111 18th Street NW in the Central Business District submarket.

CLASS A METRICS EXPERIENCE SOME EROSION

The District of Columbia's Class A market saw negative 17,857 square feet of net absorption during the third quarter of 2020, pacing the market overall. However, Class A asking rental rates were down 0.2% quarter-over-quarter, while the vacancy rate was up 10 basis points from the previous quarter, to 14.7%, and up 100 basis points over the past year. Stress among Class A properties is high due to an abundance of competitive supply. A continued lack of coworking leases in the coming months may lead to softened Class A fundamentals. Although rumors exist about coworking companies such as WeWork seeking to restructure or terminate lease deals, nothing material has come to pass thus far. The Class A market faces headwinds from projects that are currently under construction in the District. Approximately 2.4 million square feet will be delivered by the end of 2022, placing additional downward pressure on fundamentals as competition increases.

TRANSIT ISSUES ARE AFFECTING THE DISTRICT OF COLUMBIA OFFICE MARKET AND ECONOMY

The District of Columbia, more so than its neighbors in Suburban Maryland and Northern Virginia, is heavily reliant on the region's mass transit systems. Office workers and consumers alike are accustomed to using the Metrorail and MetroBus systems to commute and traverse the city to entertainment and retail districts, both for convenience and because of a dearth of parking options. In previous economic downturns, the District of Columbia helped to lead the nation into recovery thanks to the outsized share of the economy that is occupied by the federal government. In many ways, this is likely to happen again, thanks to the federal procurement spending that occurs in the region's private sector. However, this specific downturn impacts the District uniquely as it relates to the rest of the metro area. Although the city is well-positioned to withstand some of the pandemic-induced economic downturn due to the nature of the highly-educated, office-using employment landscape that exists, the comfort level of the region's residents regarding the use of public transportation will likely extend the timeline for recovery for many of the District's core submarkets. So far, there is little evidence of a material shift of office occupancy to the suburbs, but in the short term, the downtown economy will suffer as fewer office workers present will lead to the closure of many commuter-dependent businesses and restaurants.

Additionally, a major trend over the past few years has been the uptick in marketing of transit proximity as an amenity for existing properties and new developments. Property values of Metrorail-adjacent assets may decline in the short term, not just in the District but also in Manhattan, Boston and Chicago. Metrorail ridership in the Washington region was down 80-90% over the summer months compared to the prior summer, and although service has been gradually restored, many riders have not yet returned.

While leasing has been slow since March, the office-using sectors that are prevalent in the District are likely to see jobs return first and endured fewer furloughs and layoffs. While the market has seen other property types suffer, including hospitality and retail, the office market's recovery will help to drive the recovery of other property types as well. A return of commuters to public transportation will play a significant role in accelerating the recovery.

NOTABLE 3Q 2020 LEASE TRANSACTIONS

Tenant	Building	Submarket	Type	Square Feet
DC Department of General Services	3924 Minnesota Avenue NE	Capitol Hill	Direct Lease	239,800
United States Secret Service	1111 18th Street NW	CBD	Lease Renewal	74,234
Microsoft	901 K Street NW	East End	Lease Renewal	57,363
Mintz Levin	555 12th Street NW	East End	Direct Lease	57,000
Altria Client Services	101 Constitution Avenue NW	Capitol Hill	Lease Renewal	36,460

NOTABLE 2020 SALES TRANSACTIONS

Building	Submarket	Sale Price	Price/SF	Square Feet
1200 New Jersey Avenue SE	Capitol Riverfront	$760,000,000	$563	1,350,000
600 Maryland Avenue SW	Southwest	$253,675,000	$362	700,505
2001 Wisconsin Avenue NW	Uptown	$85,000,000	$353	240,475

DISTRICT OF COLUMBIA OUTLOOK

The District of Columbia's office market continues to face significant headwinds, with conditions likely to favor tenants over the next 12 months. Six months into an economic downturn, the market faces elevated vacancy rates and remains under a supply/demand imbalance rooted in the demand for new trophy office space, which encouraged developers to bring a significant amount of new product to the market despite abnormally high overall vacancy rates. Although jobs have begun to return, and some offices are starting to reopen, the full impact of the coronavirus on the region's office market remains undetermined, and the current deceleration in demand is likely to linger, as short-term economic growth has slowed dramatically in the midst of a sustained reduction in consumer spending. The unemployment rate, which reached a peak of 11.7% in the District in April, declined to 8.5% in August 2020, though it remains elevated compared with a low of 5.1% measured in February, before the onset of the pandemic. Office-using sectors have experienced fewer job losses than other sectors; however, current office usage rates are still very low. Office construction has seen few delays, as the local and federal governments determined construction to be essential. The pace of a potential recovery will likely lead to updates for some proposed or planned projects that have not yet broken ground. Office projects currently under construction are approximately 60.0% pre-leased, and the current environment may make filling the remaining spaces difficult. A smaller office supply pipeline may help keep vacancy in check as the market eventually catches up to supply.

The average asking rent in the District is up 2.4% from one year ago, but effective rents have remained under downward pressure. Tenants will continue to be offered significant concession packages to incentivize a move or renewal, although the trend may lessen to a degree as asset owners and tenants may find short-term extensions or renewals mutually beneficial, as they allow for additional time to ascertain best practices moving forward—whether that includes reduced footprints, altered layouts or adjusted in-house employee counts.

The pandemic has produced a range of possible outcomes regarding the use of office space. It is likely that many employers will incorporate more flexible schedules into their operating plans, but this does not necessarily mean a significant reduction in the long-term demand for office space. Notably, over the past six months, while many office occupiers have been able to function remotely, there is a significant difference between being able to work remotely and wanting to work remotely. Long-term functions such as hiring, mentoring staff, and retaining and attracting top talent are very challenging if colleagues rarely or never see one another in person.

Productivity is a metric that companies will watch closely, especially as a school year based around distance learning progresses and the holiday season approaches. Schools reopening for in-person learning, comfort with public transit, and the timing of a coronavirus vaccine all will shape the office market's recovery.

While investment sales volume in the District of Columbia has been modest recently, the District is likely to remain a target for international capital in the medium-to-long term due to the market's reputation for consistent and sturdy returns. Despite its present challenges, the District offers significant upside for investors. In past national crises, such as the Great Recession, the Washington region saw a lesser economic decline compared with other major U.S. metro areas due to its ability to capture federal dollars.

For additional information on the Washington metro area's economy and its office market outlook, please visit the Mid-Atlantic Market Reports page at ngkf.com.

MARKET STATISTICS BY CLASS

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2017 Absorption (SF)	2018 Absorption (SF)	2019 Absorption (SF)	3Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**130,035,406**	**13.8%**	**15.0%**	**463,758**	**152,721**	**577,020**	**-518,401**	**-1,008,432**
Class A	85,234,552	13.4%	14.7%	1,398,208	1,367,511	1,427,761	-17,857	11,756
Class B	39,251,962	14.1%	15.5%	-884,271	-1,216,895	-535,094	-463,926	-778,517
Class C	5,548,892	16.5%	17.0%	-50,179	2,105	-315,647	-36,618	-241,671

MARKET STATISTICS BY CLASS

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	3Q 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**130,035,406**	**$62.06**	**$50.46**	**$57.38**	**0**	**1,248,146**	**2,401,948**
Class A	85,234,552	$62.06	NA	$62.06	0	1,248,146	2,401,948
Class B	39,251,962	NA	$50.46	$50.46	0	0	0
Class C	5,548,892	NA	NA	$49.97	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	2017 Absorption (SF)	2018 Absorption (SF)	2019 Absorption (SF)	3Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**130,035,406**	**13.8%**	**15.0%**	**463,758**	**152,721**	**577,020**	**-518,401**	**-1,008,432**
Capitol Hill	5,667,247	21.1%	21.4%	-73,918	141,019	-7,500	38,787	158,533
Capitol Riverfront	4,037,480	5.3%	7.0%	109,832	242,861	-72,366	-340	49,112
Central Business District	41,055,919	13.5%	15.4%	19,869	516,974	-365,388	-397,892	-824,176
East End	42,549,896	17.4%	18.7%	-320,212	-112,233	-260,447	-146,749	-432,701
Georgetown	2,851,274	6.7%	7.0%	-53,368	-107,899	-77,883	-253	-40,582
NoMa	12,167,195	10.9%	11.0%	387,936	19,628	726,243	2,400	52,503
Southwest	11,953,807	8.1%	8.2%	312,976	203,963	593,769	13,063	78,253
Uptown	6,152,404	10.0%	11.6%	-64,593	-754,646	209,162	11,322	-3,282
West End	3,600,184	12.1%	14.6%	145,236	3,054	-168,570	-38,739	-46,092

SUBMARKET STATISTICS — ALL CLASSES

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	3Q 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**130,035,406**	**$62.06**	**$50.46**	**$57.38**	**0**	**1,248,146**	**2,401,948**
Capitol Hill	5,667,247	$69.36	$50.35	$59.48	0	32,083	509,300
Capitol Riverfront	4,037,480	$52.16	NA	$52.16	0	0	557,948
Central Business District	41,055,919	$64.00	$52.39	$59.11	0	671,063	452,000
East End	42,549,896	$63.94	$51.95	$59.46	0	0	137,797
Georgetown	2,851,274	$59.20	$42.63	$44.66	0	0	0
NoMa	12,167,195	$51.61	$49.27	$50.76	0	545,000	0
Southwest	11,953,807	$48.83	$46.53	$47.95	0	0	639,703
Uptown	6,152,404	$50.75	$42.89	$44.92	0	0	105,200
West End	3,600,184	$68.47	$49.61	$64.19	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.

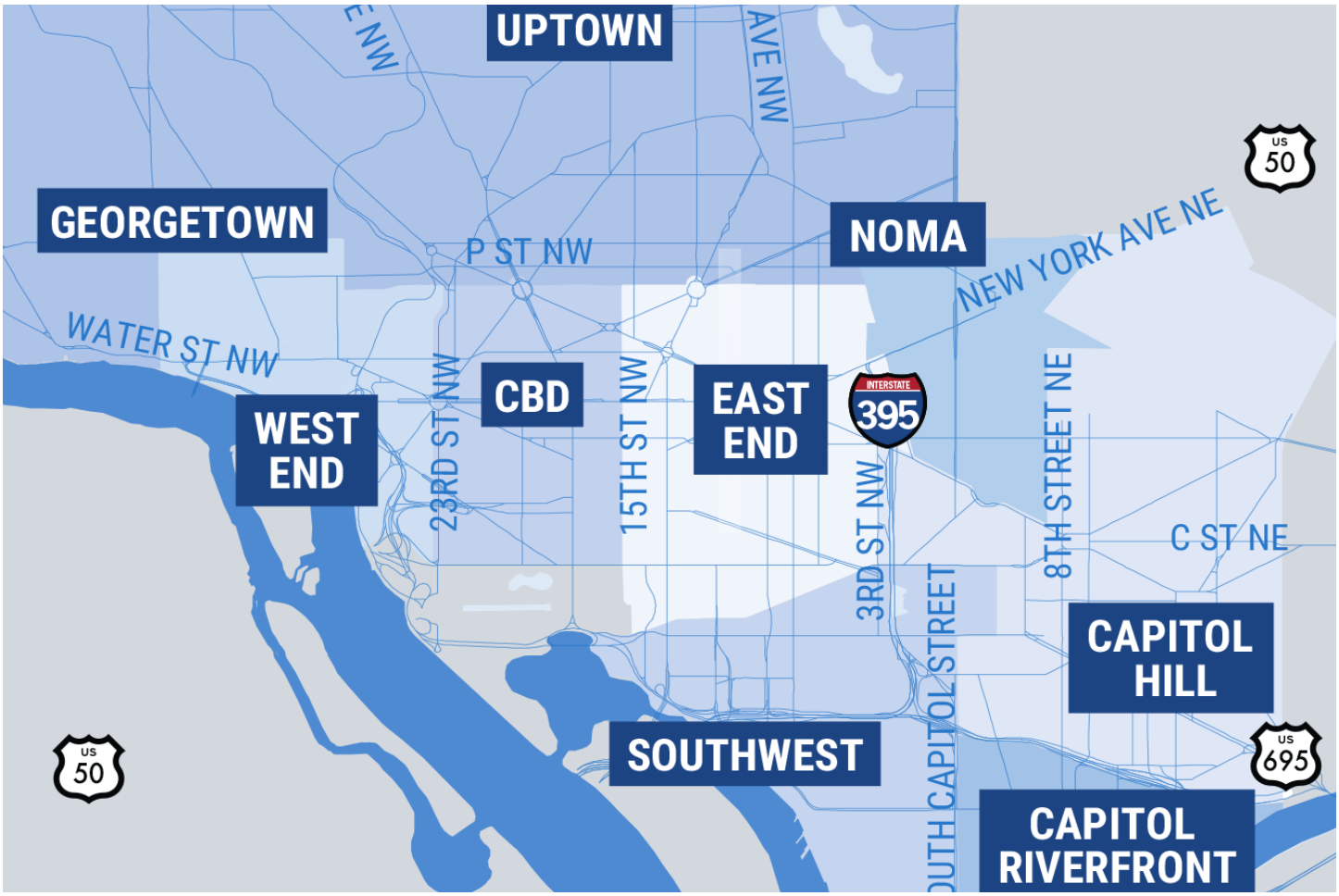
Sublease: Sublease space is offered and marketed as available by the current tenant, rather than directly from the owner.

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



WASHINGTON, DC
1899 Pennsylvania Avenue NW
Suite 300
Washington, DC 20006
202.331.7000

ALEXANDER (SANDY) PAUL, CRE, LAI
Senior Managing Director
202.312.5783
apaul@ngkf.com

JORDAN SCHOTT
Senior Research Analyst
202.664.5902
jordan.schott@ngkf.com

KEVIN SWEENEY
Senior Research Analyst
202.312.5763
kevin.sweeney@ngkf.com