Newmark Knight Frank

WASHINGTON METRO AREA ECONOMY AND OFFICE MARKET

OFFICE MARKET FUNDAMENTALS UNEVEN AS REGION MOVES GRADUALLY INTO RECOVERY

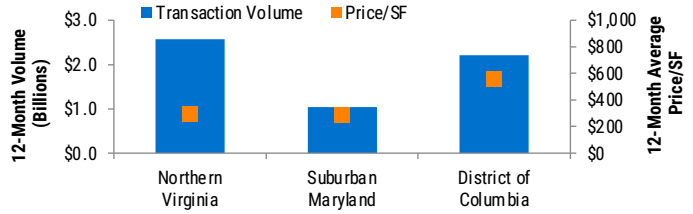
The Washington metro area's employment base increased gradually during the third quarter of 2020. For the 12 months ending in August 2020, the region lost 201,400 jobs; this compares with the metro area's 20-year average growth of 38,800 jobs per annum. While the region has sustained five straight months with negative trailing 12-month job change, employment is rising on a month-to-month basis. The unemployment rate measured 7.9% in July, 100 basis points higher than the rate's peak during the Great Recession and 460 basis points higher than the level in July 2019. The Fuller Institute's Leading Index, a predictor of the economy's performance over the next six to eight months, increased 0.45% for the 12 months ending in June, though this gain may be temporary as the rate of improvement for two of the indicator's components slowed more recently. The Fuller Institute notes that capacity constraints for businesses and any weakening in consumer demand in the coming months will likely result in a slower recovery.

Office space demand in the Washington metro area was negative overall during the third quarter and down from the previous quarter. Market activity remained slow due to limited movement during the ongoing pandemic, which forced many tenants to continue remote work; however, some tenants returned to offices, and jobs lost during the early months of the pandemic continued to come back. The third quarter saw negative 780,728 square feet of net absorption in the region, with all three substate areas registering negative totals, led by the District of Columbia with negative 518,401 square feet. Net absorption registered negative 219,117 square feet in Suburban Maryland and negative 43,210 square feet in Northern Virginia. At 16.6%, the region's overall vacancy rate was up 10 basis points from the previous quarter and up 50 basis points from the rate recorded one year ago. Based on current economic conditions and office market fundamentals, Newmark Knight Frank expects the region-wide office market vacancy rate to rise to approximately 18.2% by the end of third-quarter 2022.

The Washington region registered $5.8 billion in office sales volume for the 12 months ending in the third quarter of 2020. This marks a substantial decrease from the 12-month period ending in the third quarter of 2019, when volume was $8.6 billion. Transactions across the metro area averaged $337/SF over the past 12 months and regional cap rates averaged 6.6% over the past 12 months.

CAPITAL MARKETS

Office Investment Sales Volume and Price/SF 12 Months Ending 3Q 2020



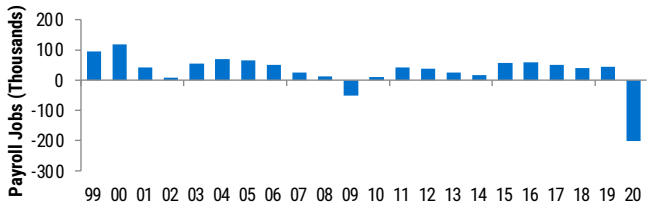
Source: Real Capital Analytics, NKF Research; September 2020

ECONOMY

- **Historical Job Change:** 201,400 jobs lost in the 12 months ending in August 2020 due to coronavirus shutdowns. The region has added an average of 38,800 jobs per annum over the past 20 years.
- **Projected Job Growth:** NKF forecasts the net loss of 124,000 jobs during 2020 before an average increase of 44,250 per annum from 2021 through 2024 once the economy stabilizes.
- **Unemployment Rate:** 7.9% in July 2020, an increase of 460 basis points over the rate of 3.3% at July 2019.

Source: Stephen S. Fuller Institute, U.S. Bureau of Labor Statistics, NKF Research; September 2020

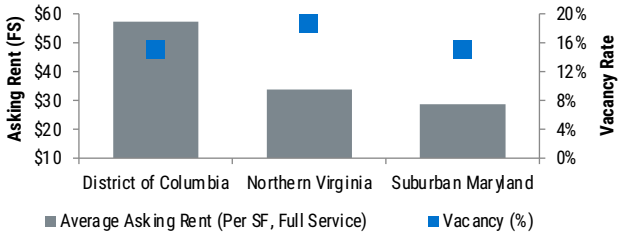
Washington Metro Payroll Job Change



Note: Totals reflect annual average net change; 2020 reflects 12 months ending in August
Source: U.S. Bureau of Labor Statistics, NKF Research; September 2020

MARKET ANALYSIS

Asking Rent and Vacancy Rate



MARKET SUMMARY

	District of Columbia	Northern Virginia	Suburban Maryland	Metro Area
Total Inventory (SF)	130.0 M	164.9 M	74.6 M	369.6 M
Vacancy Rate	15.0%	18.6%	15.0%	16.6%
Quarterly Net Absorption (SF)	-518,401	-43,210	-219,117	-780,728
Average Asking Rent (Per SF, Full Service)	$57.38	$33.80	$28.78	$40.75
Under Construction (SF)	2.4 M	2.2 M	2.2 M	6.8 M
YTD Deliveries (SF)	1.2 M	0.8 M	0.2 M	2.3 M

Note: Totals may not sum properly due to rounding

JOB MARKET BEGINS CLIMB OUT OF TROUGH

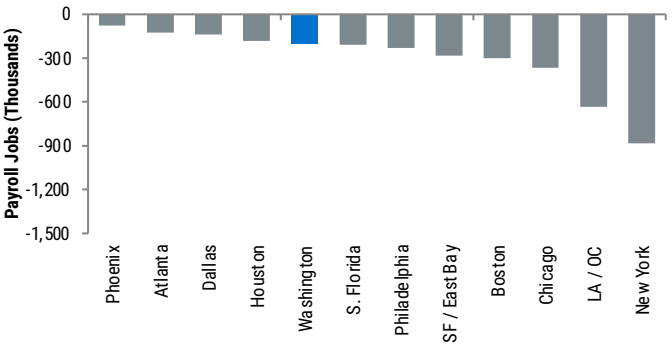
The Washington metro area economy is experiencing a gradual recovery. The employment market reached its trough in May. Since then, the market has been clawing jobs back as different portions of the economy reopen. Overall, the market lost 201,400 jobs in the 12 months ending in August; however, that figure was as low as 315,700 jobs lost in the 12 months ending in May. The region regained more than 100,000 jobs over the course of the summer, a trend that is expected to continue, albeit at a slower pace. Job losses, as expected, were greatest in the Leisure and Hospitality sector, which lost nearly 50% of total jobs region-wide at its lowest point. On the other hand, jobs in office-using sectors were lost at a much lower rate. For the 12 months ending in August of 2020, office-using sectors—which include the Information, Financial Activities, Professional and Business Services, Other Services, and Government sectors—have only seen a net job loss of 32,300 jobs, or 1.7% of all office-using jobs. These office using sectors make up approximately 60.0% of all metro area jobs, importantly helping to stabilize and insulate the region's employment. The unemployment rate peaked in the region at 9.8% in April, after hovering around 3.0% in the months leading into the pandemic. The consistency of Washington's office-using sectors has been important to the region; other gateway markets have seen steeper losses due to a different mix of sectors in their economies.

ELECTION LOOMS FOR REGION, BUT IMPACT MAY BE MILDER THAN WIDELY ASSUMED

In the midst of the election season, it is natural to wonder if the outcome of the 2020 election will have any direct impact on the region's commercial real estate market. Historically, political control of Congress and the Presidency has not produced a clear trend that shows one party having a significantly greater impact on the local commercial real estate market. While the perceived size of the federal government based on which political party has control of the White House and Capitol Hill (if there is single-party control) may produce some correlation with office and multifamily market fundamentals, it is important to note that public policy changes take time to implement, therefore diminishing any direct impact of political control on the market. There is no doubt that policy can impact the market, but to date, there is limited evidence that either party has a clear advantage in shaping market fundamentals. For more information on this topic, please see our forthcoming white paper, which will be available at the Insights section of our website at ngkf.com.

PAYROLL JOB CHANGE – LARGEST METRO AREAS

12 Months Ending August 2020



Source: U.S. Bureau of Labor Statistics, NKF Research; September 2020

FEDERAL GOVERNMENT A BOON FOR REGION

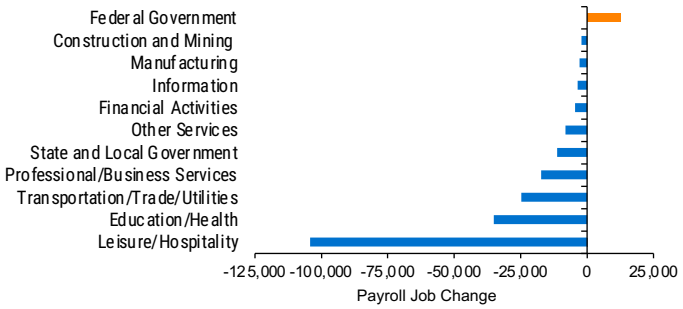
The presence of the federal government has long been beneficial to the regional office market and economy, and has helped to carry the metro area out of economic downturns in the past. While the pandemic has had a negative impact on most facets of the regional economy, the Washington metro area's economy has not been as adversely affected as those of most other gateway markets. In fact, the federal government's response to the pandemic has directly benefitted the region, as COVID-19 contracts totaling nearly $7.4 billion have been awarded in Maryland, Virginia and the District of Columbia since the onset of the pandemic. Led by Maryland, all three of the region's jurisdictions rank in the top four nationally. Additionally, the General Services Administration (GSA)—the federal government's real estate arm—has been one of the most active tenants in the market and has been signing leases during the pandemic. Deals inked by government tenants during the third quarter include the National Institutes of Health (NIH), Department of Health and Human Services (HHS), the Department of Homeland Security (DHS), United States Postal Service (USPS) and the Transportation Security Administration (TSA). The GSA also announced its plans to sell nearly $500 million worth of federally-owned property, which could help to kick-start the region's investment sales market.

SUBLEASE AVAILABILITY INCREASES

The sublease market in the Washington metro area has seen an uptick since the onset of the COVID-19 pandemic, as many tenants have been forced to work remotely and recalibrate their office space needs. The region's sublease availability rate—a measure of available sublease space as a proportion of total inventory—measured 1.5% at the beginning of the pandemic and has since risen 60 basis points, to 2.1%. The District of Columbia has the region's highest sublease availability rate at 2.4%, while both Suburban Maryland and Northern Virginia—the region's largest market by inventory—register rates of 1.9%. The region's sublease availability rate remains below the regional peak of 2.4%, which occurred at the zenith of the Great Recession in the third quarter of 2009. Importantly, the Washington metro area has the second-lowest sublease availability rate among peer metro areas, behind only South Florida. Other major markets, such as San Francisco, Boston, Dallas, New York, Los Angeles and Chicago, all face higher sublease availability rates and which are rising at a faster pace. The sublease availability rate in the Washington metro area is likely to rise further, as some companies make a decision to decrease their office footprints. Coworking firms are a tenant type to watch, with the possibility of contraction or consolidation in that segment of the office sector. In some cases, tenants may test the market by making sublease space available, but without a firm commitment to dispose of the space.

JOB CHANGE BY INDUSTRY

Washington Metro Area I 12 Months Ending August 2020



Source: U.S. Bureau of Labor Statistics, NKF Research; September 2020

3Q 2020 **WASHINGTON METRO ECONOMY AND OFFICE MARKET**

Newmark Knight Frank

REGION SEES NEGATIVE NET DEMAND

Office space demand in the Washington metro area was negative overall during the third quarter and down from the previous quarter. Market activity remained slow due to limited movement during the ongoing pandemic, which forced many tenants to continue remote work; however, some tenants returned to offices, and jobs lost during the early months of the pandemic continued to come back. The third quarter saw negative 780,728 square feet of net absorption in the region, with all three substate areas registering negative totals, led by the District of Columbia with negative 518,401 square feet. Net absorption registered negative 219,117 square feet in Suburban Maryland and negative 43,210 square feet in Northern Virginia. At 16.6%, the region's overall vacancy rate was up 10 basis points from the previous quarter and up 50 basis points from the rate recorded one year ago.

One notable project delivered in the Washington metro area during the third quarter: 909 Rose, a 212,000-square-foot property located at 909 Rose Avenue in the North Bethesda submarket. The property was approximately 31% pre-leased at delivery and counted workplace consultant OneDigital and the asset's developer, Federal Realty, as tenants at opening. There are three deliveries planned for the fourth quarter of 2020 totaling approximately 1.1 million square feet. The properties are pre-leased at a rate of 89.0%.

Despite the region's elevated vacancy rate, weighted average asking rents increased 2.8% over the past 12 months to $40.75/SF. This is largely the result of the outsized impact of new core product and renovated assets being delivered to the market. While asking rents rose on a trailing 12-month basis, they ticked down during the past three months, and tenants are being offered significant concession packages to incentivize a move or renewal. Effective rents are under downward pressure. Notably, 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. Flexible scheduling may modestly reduce overall net demand in the years ahead, but concerns surrounding corporate culture and talent retention are encouraging many tenants to reoccupy their office spaces as soon as it is practical to do so.

DEMAND FOR CLASS A SPACE MODESTLY POSITIVE DURING THE THIRD QUARTER

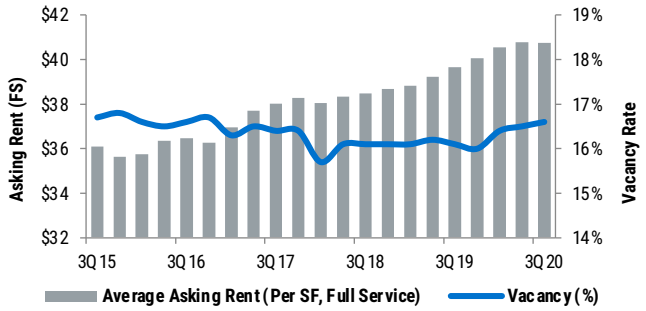
The region's Class A market registered 167,810 square feet of net absorption during the third quarter, with positive net demand of 164,446 square feet in Northern Virginia and 21,221 square feet in Suburban Maryland. The District of Columbia registered negative demand for Class A space, with net absorption registering negative 17,857 square feet. The Class A vacancy rate was 16.3% as of the third quarter, an increase of 60 basis points over one year ago, as new, top-quality product has continued to deliver to the market. Class A rents averaged $44.55/SF metro-wide as of the end of the third quarter, although demand for premier space lessened during the shutdown. Across all substate areas, trophy and Class A+ properties have continued to outperform commodity Class A space. The commodity Class A market will continue to be challenged, although renewals and short-term extensions by tenants looking to postpone space decisions during the pandemic could help to buoy the segment in the short term.

CURRENT CONDITIONS

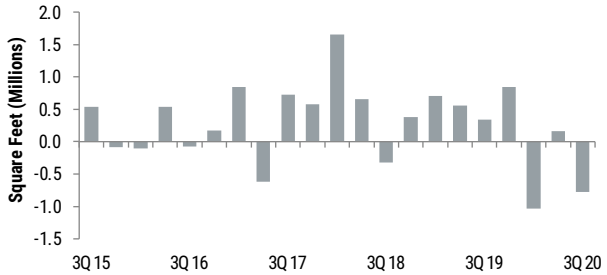
- The region registered negative 780,728 square feet of net absorption during the third quarter, with negative net demand in all three substate areas.
- Class A space tallied positive net absorption of 167,810 square feet during the third quarter. Class B and Class C space registered negative net demand during the quarter.
- Despite elevated vacancy, the average asking rent rose 2.8% over the past 12 months, reflecting the introduction of new and renovated product to the inventory. Asking rents are now beginning to tick down, however, and effective rents are under downward pressure.

MARKET ANALYSIS

Asking Rent and Vacancy Rate



Net Absorption



MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	369.6 M	369.7 M	367.1 M	↑
Vacancy Rate	16.6%	16.5%	16.1%	↑
Quarterly Net Absorption (SF)	-780,728	158,712	340,502	↑
Average Asking Rent (Per SF, Full Service)	$40.75	$40.78	$39.65	↑
Under Construction (SF)	6.8 M	6.9 M	8.9 M	↓
Deliveries (SF)	212,000	808,520	143,606	↑

WASHINGTON AREA ECONOMIC OUTLOOK

The Washington metro area's employment base increased gradually during the third quarter of 2020. For the 12 months ending in August 2020, the region lost 201,400 jobs; this compares with the metro area's 20-year average growth of 38,800 jobs per annum. While the region has sustained five straight months with negative trailing 12-month job change, employment is rising on a month-to-month basis. The unemployment rate measured 7.9% in July, 100 basis points higher than the rate's peak during the Great Recession and 460 basis points higher than the level in July 2019. The Fuller Institute's Leading Index, a predictor of the economy's performance over the next six to eight months, increased 0.45% for the 12 months ending in June, though this gain may be temporary as the rate of improvement for two of the indicator's components slowed more recently. The Fuller Institute notes that capacity constraints for businesses and any weakening in consumer demand in the coming months will likely result in a slower recovery.

Washington has likely already suffered most of its job losses due to the pandemic, barring a major resurgence of the virus that forces the economy back into a shutdown phase. Newmark Knight Frank forecasts region-wide job losses of 124,000 positions during calendar year 2020, followed by a modest but steady recovery averaging 44,250 jobs per annum over the four-year period from 2021 to 2024. This job forecast is a preliminary projection that is subject to change as conditions evolve. A majority of the job losses that occurred shortly after the onset of the pandemic were in the Retail; Education and Health; and Leisure and Hospitality sectors, while the region has experienced fewer job losses in office-using sectors, helping to insulate the region's office market to a degree. In fact, office-using sectors have lost only 32,300 jobs over the past 12 months, or 1.7%, compared to 6.0% for the market overall.

OFFICE MARKET OUTLOOK

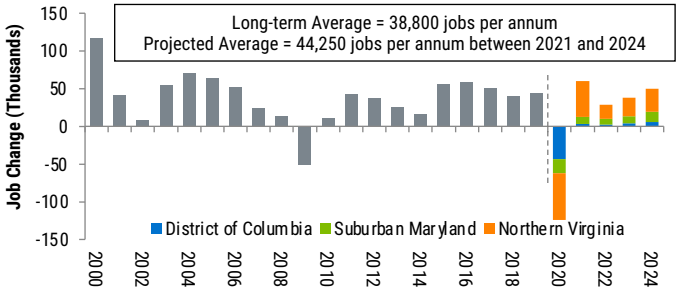
Over the next 12 to 24 months, the market faces a number of challenges that will impact absorption and rent growth, but opportunities also persist:

- 7.3 million square feet of new office space has delivered in the past two years. This increase in inventory has led to a continued rise in concession packages for both new and existing product. Both asset owners and tenants are taking a cautious approach that is slowing the market and softening rents. Based on current economic conditions and office market fundamentals, Newmark Knight Frank expects the region-wide office market vacancy rate to rise to approximately 18.2% by the end of third-quarter 2022 from 16.6% today.
- The Class A market faces supply headwinds from projects that are currently under construction in the region. Approximately 6.2 million square feet of Class A space will be delivered over the next 24 months, placing downward pressure on rents as competition increases.
- The pandemic has produced a range of possible outcomes for the future use of office space. While many office workers have adapted to a forced experiment over the past six months, many are finding that they prefer to be in the office, at least some or much of the time. In short, there is a difference between being *able* to work remotely, and *wanting* to work remotely. Partial remote work, whether that means weekly/monthly remote days or phased attendance, is likely to increase as tenants seek to control occupancy costs, modestly reducing overall net demand for office space in the long term. However, many employers are concerned about their ability to build a strong corporate culture and to attract/retain top talent while working remotely, underscoring the value of office space. Importantly, variables such as schools reopening for in-person learning and comfort with public transit will influence the speed at which tenants reoccupy office space.
- Job losses caused by the pandemic will likely impact construction starts in the intermediate-to-long term. 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; the current leasing environment may make filling the remaining spaces difficult before delivery, although new product is likely to be more appealing to tenants in the market than older product is.
- Jobs with the federal government have represented a declining share of the regional employment market over the past several years, but that trend has reversed as the government addresses the dual public health and economic crises. The federal government is presently the only sector of the regional economy that has positive 12-month net job change. Demand for office space from the federal government could potentially see an uptick across the region in the coming year.

For additional information on the District of Columbia, Northern Virginia, and Suburban Maryland office markets, please visit NKF's website: Mid-Atlantic Market Reports.

PAYROLL JOB GROWTH FORECAST

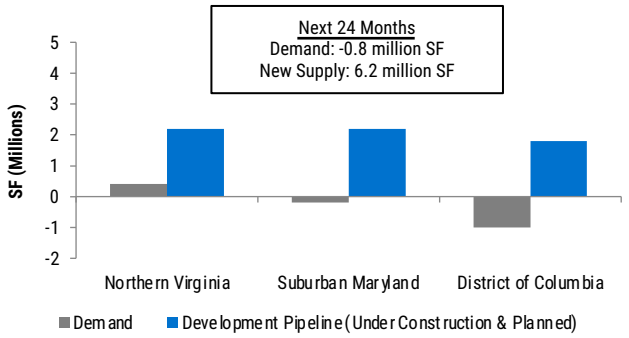
Washington Metro Area | 2020–2024



Source: U.S. Bureau of Labor Statistics; forecast developed by NKF Research with reference to data from the Stephen S. Fuller Institute and Moody's Analytics; Sep. 2020
Note: Previous projections have been revised due to the coronavirus pandemic and are subject to further revision as conditions change.

SUPPLY/DEMAND FORECAST

Washington Metro Area | 24 Months Ending September 2022



Source: Stephen S. Fuller Institute, NKF Research; September 2020

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. 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.

DISTRICT OF COLUMBIA OUTLOOK

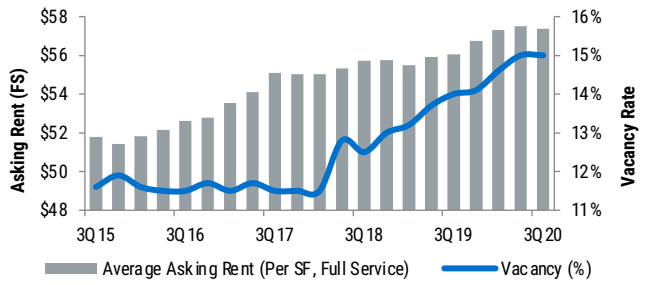
The District of Columbia's office market continues to face significant headwinds, with conditions likely to favor tenants over the next 12 months. Six months into an economic downturn, the market faces elevated vacancy rates and remains under a supply/demand imbalance rooted in the demand for new trophy office space. 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.

CURRENT CONDITIONS

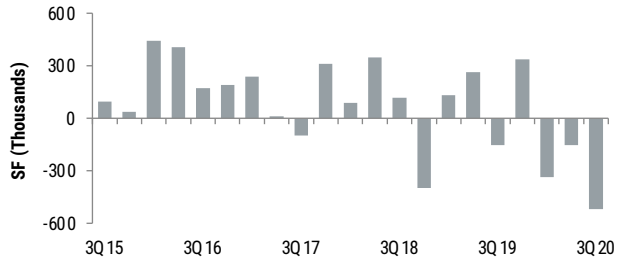
- The District of Columbia registered negative 518,401 square feet of net absorption during the third quarter of 2020.
- The vacancy rate has risen 100 basis points from a year ago to 15.0%, as a material amount of new space without significant pre-leasing has delivered in the past 12 months.
- Asking 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	↑

NORTHERN VIRGINIA MARKET FEELS EFFECTS OF COVID-19 BUT IS ELEVATED BY FEDERAL SPENDING

Demand had remained positive in the third quarter of 2020 despite the pandemic, but further effects on demand for office space in Northern Virginia became evident in the third quarter, as negative 43,210 square feet was absorbed. Gross leasing during this period also slowed, and a majority of new leases executed during the third quarter were comprised of renewals and extensions. The most significant lease of the quarter was by the United States Postal Service, which renewed 115,747 square feet at 1735 North Lynn Street in Rosslyn. Overall vacancy ended the third quarter at 18.6%, an increase of 10 basis points from the prior quarter and up 30 basis points from one year ago. Average overall asking rents increased 1.3% from one year ago to $33.80/SF. However, effective rents remain under downward pressure as concessions are elevated.

Office space under construction in Northern Virginia, excluding renovations and owner-occupied buildings, totaled 2.2 million square feet at the end of the third quarter. The overall pre-lease rate of the buildings under construction was 71.9%. Tenants that have preleased large blocks of space include ICF International (207,000 square feet), Fannie Mae (850,000 square feet), and the Transportation Security Administration (625,000 square feet). Reston continued to lead the way in new development, with 1.3 million square feet of office space under construction.

There were no ground breakings or deliveries in the third quarter of 2020. In terms of ground breakings, developers are trying to decide how to proceed and pausing until it is clearer what the need for space will be post-pandemic. Despite no deliveries in the third quarter there has still been 803,245 square feet of deliveries in 2020. Two major projects delivered in each of the first and second quarters: 4040 Wilson Boulevard and 14401 Penrose Place delivered in the first quarter, while 1750 Presidents Street and 1906 Reston Metro Plaza delivered in the second quarter. A combination of fewer deliveries and increased demand caused vacancy rates to decline throughout 2019. Vacancy has ticked up since one year ago as the impacts of the COVID-19 pandemic become more apparent. Weakened demand likely will continue into 2021, although the Northern Virginia office market remains fairly well positioned compared to its regional rivals and the nation overall.

NORTHERN VIRGINIA OUTLOOK

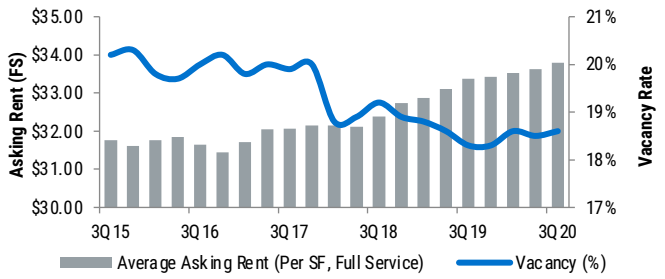
Northern Virginia's office market demand softened in the third quarter of 2020. Tenant movement and gross leasing activity declined significantly in the third quarter as the pandemic continued to impact the office market and the economy as a whole. Tenant movement is expected to continue to be slow through the end of the year as companies weigh when it is safe to bring employees back into the office and whether they should push pause until 2021. However, Northern Virginia is better positioned than many rivals because of its strengths in tech and contracting. Although asking rents are modestly higher than a year ago, gross leasing declined during the third quarter and absorption was negative. There was a slight uptick in vacancy. The duration of the pandemic and the degree of the resulting economic impact are still unknown, even after six months. It is certain that job losses in the private sector, especially in the service and retail industries, will continue to have an impact on Northern Virginia's economy; however, the Northern Virginia office market has been bolstered by its strength in technology and by its government contractors being well-positioned to capture COVID-related federal spending.

CURRENT CONDITIONS

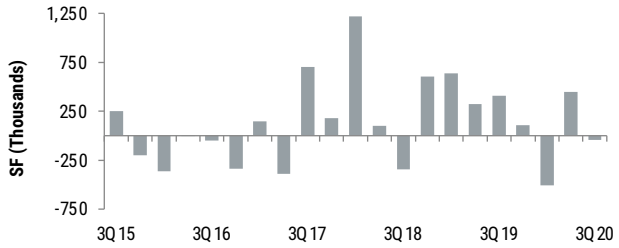
- Northern Virginia's construction pipeline remains robust at 2.2 million square feet.
- The largest lease of the quarter was signed by the United States Postal Service: a renewal for 115,747 square feet at 1735 N Lynn Street in Rosslyn.
- No buildings delivered or broke ground in the third quarter of 2020 after two buildings completed construction in the second quarter totaling 473,457 square feet.

MARKET ANALYSIS

Asking Rent and Vacancy Rate



Net Absorption



MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	164.9 M	164.9 M	164.5 M	↑
Vacancy Rate	18.6%	18.5%	18.3%	↑
Quarterly Net Absorption (SF)	-43,210	444,841	408,731	↑
Average Asking Rent (Per SF, Full Service)	$33.80	$33.63	$33.38	↔
Under Construction (SF)	2.2 M	2.2 M	2.7 M	↓
Deliveries (SF)	0	473,457	143,606	↑

MARKET ACTIVITY UNEVEN IN THIRD QUARTER AS COVID-19 DISRUPTION CONTINUES

Suburban Maryland's office demand continued to soften during the third quarter of 2020 with negative 219,117 square feet of quarterly absorption, bringing year-to-date net absorption to negative 540,798 square feet. As a continued result of disruption related to COVID-19, market activity was modest, with limited leasing activity and few notable tenant moves. The overall vacancy rate registered 15.0% at the end of the third quarter, an increase of 40 basis points from the previous quarter but level with a year ago. Asking rental rates ended the third quarter of 2020 at $28.78/SF, an increase of 2.5% from $28.09/SF in the third quarter of 2019. While it may seem counterintuitive that asking rents increased despite negative demand for space, market forces often take a while to adjust, and it is likely effective rents will be flat to declining over the next year as owners increase concessions to lure tenants in an environment of tepid demand.

As of third-quarter 2020, 2.2 million square feet of office space is under construction in Suburban Maryland in five projects, excluding renovations. The pipeline is approximately 76.9% preleased. While there were no office deliveries in the first or second quarter of 2020, 909 Rose Avenue in the North Bethesda submarket delivered during the third quarter. The property delivered approximately 31% pre-leased and counted workplace consultant OneDigital and the asset's developer, Federal Realty, as tenants at opening. Two projects are slated for delivery during the fourth quarter of the year. The Wilson at 7272 Wisconsin Avenue in the Bethesda submarket is 78.7% pre-leased to tenants including Enviva, WeWork, Fox 5 and ProShares. Additionally, 4600 River Road in the College Park submarket, a 139,095-square-foot property, will deliver during the fourth quarter of the year and is currently 39.9% pre-leased.

SUBURBAN MARYLAND OUTLOOK

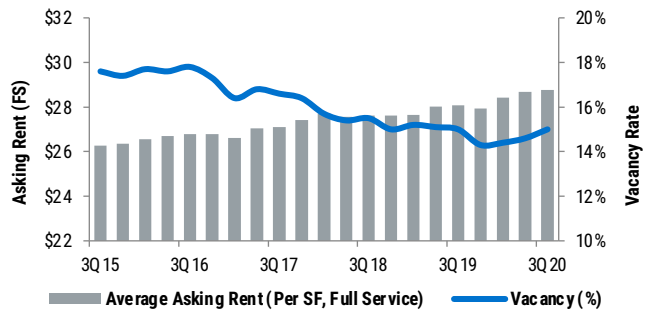
Office fundamentals in Suburban Maryland are likely to remain soft in the months ahead as leasing activity continues to be limited amidst uncertainty surrounding COVID-19. The recession caused by the global pandemic has led to job losses throughout the Washington region, although office-using jobs have seen fewer layoffs and furloughs than leisure/hospitality and retail positions, somewhat insulating the office market. The pipeline of office deliveries in Suburban Maryland over the next two years is substantial, although it is concentrated in Bethesda; overall vacancy will edge higher in the intermediate term. However, Suburban Maryland's office projects under construction are 68.9% preleased, which will help limit supply-side concerns. The potential for a second wave of the virus and the extent of the resulting economic whiplash is unknown at this point, but it is likely that job losses in some private sector industries will have an impact on Suburban Maryland office space demand. However, it is also likely the Suburban Maryland market will see necessary public investment and federal government growth in response to the pandemic over the next few months. Suburban Maryland's core sectors, including life sciences, technology and the federal government, will hasten the market's recovery. Once a treatment or vaccine for the virus emerges, the region could be poised for steady growth—perhaps even more than previously forecast, given the strengths of the area in science and medical research.

CURRENT CONDITIONS

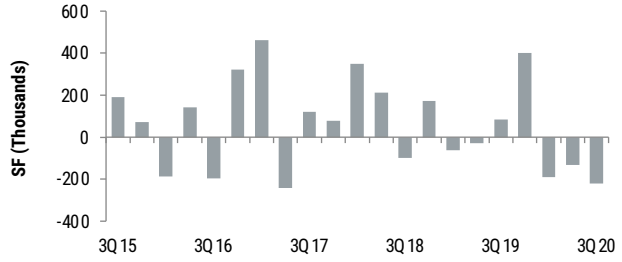
- Suburban Maryland registered negative 219,117 square feet of absorption during the third quarter of 2020. Year-to-date, absorption is negative 540,798 square feet.
- The vacancy rate is up 40 basis points from last quarter but level with one year ago at 15.0%. Demand has slowed materially in 2020.
- 2.2 million square feet is under construction, but groundbreakings are likely to slow given the nation's current economic challenges.

MARKET ANALYSIS

Asking Rent and Vacancy Rate



Net Absorption



MARKET SUMMARY

	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	74.6 M	74.5 M	74.2 M	↑
Vacancy Rate	15.0%	14.6%	15.0%	↑
Quarterly Net Absorption (SF)	-219,117	-132,886	84,724	↑
Average Asking Rent (Per SF, Full Service)	$28.78	$28.67	$28.09	↔
Under Construction (SF)	2.2 M	2.3 M	2.6 M	↓
Deliveries (SF)	212,000	0	0	↑

SUBMARKET STATISTICS — VACANCY AND ABSORPTION

	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)
Washington Metro Area	**369,574,143**	**15.6%**	**16.6%**	**1,531,170**	**2,367,437**	**2,447,616**	**-780,728**	**-1,652,533**
District of Columbia	130,035,406	13.8%	15.0%	463,758	152,721	577,020	-518,401	-1,008,432
Suburban Maryland	74,631,169	14.3%	15.0%	418,912	637,978	394,044	-219,117	-540,798
Northern Virginia	164,907,568	17.7%	18.6%	648,500	1,576,738	1,476,552	-43,210	-103,303

	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)
Washington Metro Area	**369,574,143**	**15.6%**	**16.6%**	**1,531,170**	**2,367,437**	**2,447,616**	**-780,728**	**-1,652,533**
Class A	224,198,701	15.3%	16.3%	2,945,116	3,132,885	2,496,853	167,810	95,183
Class B	108,563,656	16.5%	17.4%	-633,939	-719,470	183,064	-708,644	-1,133,124
Class C	36,811,786	15.6%	15.8%	-780,007	-45,978	-232,301	-239,894	-614,592

SUBMARKET STATISTICS — RENTS AND DEVELOPMENT

	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)
Washington Metro Area	**369,574,143**	**$44.55**	**$37.40**	**$40.75**	**212,000**	**2,263,391**	**6,818,497**
District of Columbia	130,035,406	$62.06	$50.46	$57.38	0	1,248,146	2,401,948
Suburban Maryland	74,631,169	$30.74	$27.63	$28.78	212,000	212,000	2,180,526
Northern Virginia	164,907,568	$36.40	$30.98	$33.80	0	803,245	2,236,023

	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)
Washington Metro Area	**369,574,143**	**$44.55**	**$37.40**	**$40.75**	**212,000**	**2,263,391**	**6,818,497**
Class A	224,198,701	$44.55	NA	$44.55	212,000	2,263,391	6,818,497
Class B	108,563,656	NA	$37.40	$37.40	0	0	0
Class C	36,811,786	NA	NA	$30.39	0	0	0

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

SALES VOLUME DECELERATES; REGION'S HISTORY OF STEADY RETURNS MAY SPUR Q4 ACTIVITY

The Washington region registered $5.8 billion in office sales volume for the 12 months ending in the third quarter of 2020. This marks a substantial decrease from the 12-month period ending in the third quarter of 2019, when volume was $8.6 billion. Transaction volume was muted during the third quarter of 2020 due to the COVID-19 global pandemic, as capital, both domestic and foreign, was scarce. Transactions across the metro area averaged $337/SF over the past 12 months. Regional cap rates averaged 6.6% over the past 12 months, up 20 basis points from the quarter prior but down 10 basis points compared with one year ago.

The largest transaction of the third quarter included a three-property portfolio in the North Rockville submarket. The buildings, part of the Danac Stiles Corporate Campus, are located at 9713-9717 Key West Avenue in Rockville, MD, and together they total 277,815 square feet. They sold for the combined price of $90 million, or $324/SF. Univest Management Company purchased the buildings, which were approximately 82% leased at the time of the sale, from Farallon Capital Management. The properties count Supernus Pharmaceuticals and American Gene Technologies as tenants.

THIRD QUARTER SALES VOLUME IS MUTED; REGION'S STRENGTHS AND PENDING ELECTION MAY BOOST VOLUME DURING FOURTH QUARTER

Following steady annual transaction volume over the past few years, third-quarter investment sales volume was $230.3 million, down significantly from the third quarter of 2019, when volume measured $3.0 billion. The first half of 2019 was unusually slow in terms of quantity and volume but accelerated significantly in the second half of the year. Prospects for a similar turnaround during the fourth quarter of 2020 are less likely due to the ongoing global health crisis, although an increase in sales volume is expected as the economy begins to normalize and as investors consider the potential impact of the November election. Nonetheless, the pandemic is likely to keep investment volume modest in the near term. There may be opportunities in the coming months for shrewd investors to buy low, or for institutional investors to purchase with long-term holding strategies. The Washington area's economic rebound has been stronger than that of most other gateway markets, making this region more appealing to investors.

OFFICE INVESTMENT SALES OUTLOOK

Although office transaction volume had been remarkably steady since reaching its cyclical high in 2015, overall transaction volume will likely be reduced for 2020. It is hard to gauge values at present, given the small sample of recent transactions. However, Washington's educated workforce and mix of industries give the region a boost relative to many of its peer markets. Importantly, the pace of the recovery in the American and global economies will impact buyers' ability to secure debt. However, the value of hard assets such as commercial real estate remains. Investors—domestic and foreign—will likely seek the safety of a primary market such as Washington. A second wave of the coronavirus over the balance of the year could create disruption, but that may further emphasize the relative value of Washington's history of stable returns.

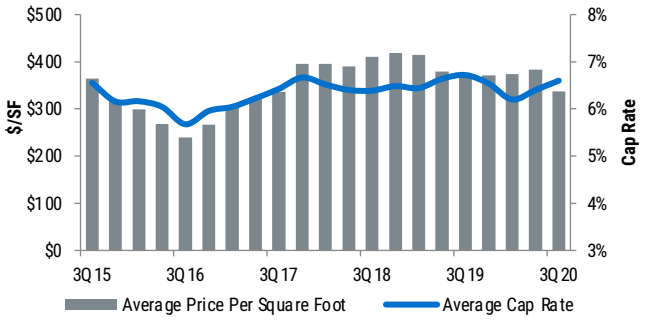
METRO AREA MARKET SUMMARY

	Metro Region
12-Month Transaction Volume at 3Q 2020	$5.8 B
12-Month Transaction Volume at 3Q 2019	$8.6 B
12-Month Trailing Average Price PSF at 3Q 2020	$337
12-Month Trailing Average Cap Rate at 3Q 2020	6.6%

Note: Averages are for trailing 12 months
Source: Real Capital Analytics, NKF Research

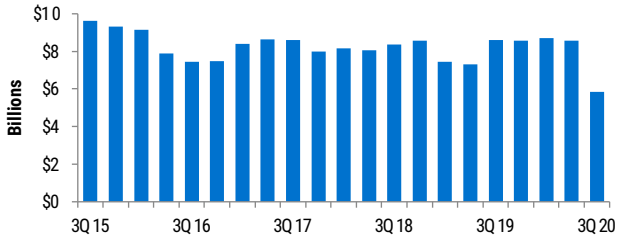
MARKET ANALYSIS

Average Office Cap Rate and Price Per Square Foot



Note: Values are trailing 12-month averages
Source: Real Capital Analytics, NKF Research

Trailing 12-Month Office Transaction Volume



Source: Real Capital Analytics, NKF Research

NOTABLE 2020 OFFICE SALES TRANSACTIONS

Address	Sale Price	Price/SF	Substate Area
1200 New Jersey Avenue SE	$760 M	$563	DC
399-499 Grove Street	$259 M	$514	VA
600 Maryland Avenue SW	$254 M	$362	DC
5454 Wisconsin Avenue	$160 M	$592	MD
2941 Fairview Park Drive	$117 M	$333	VA

Source: Real Capital Analytics, NKF Research

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.

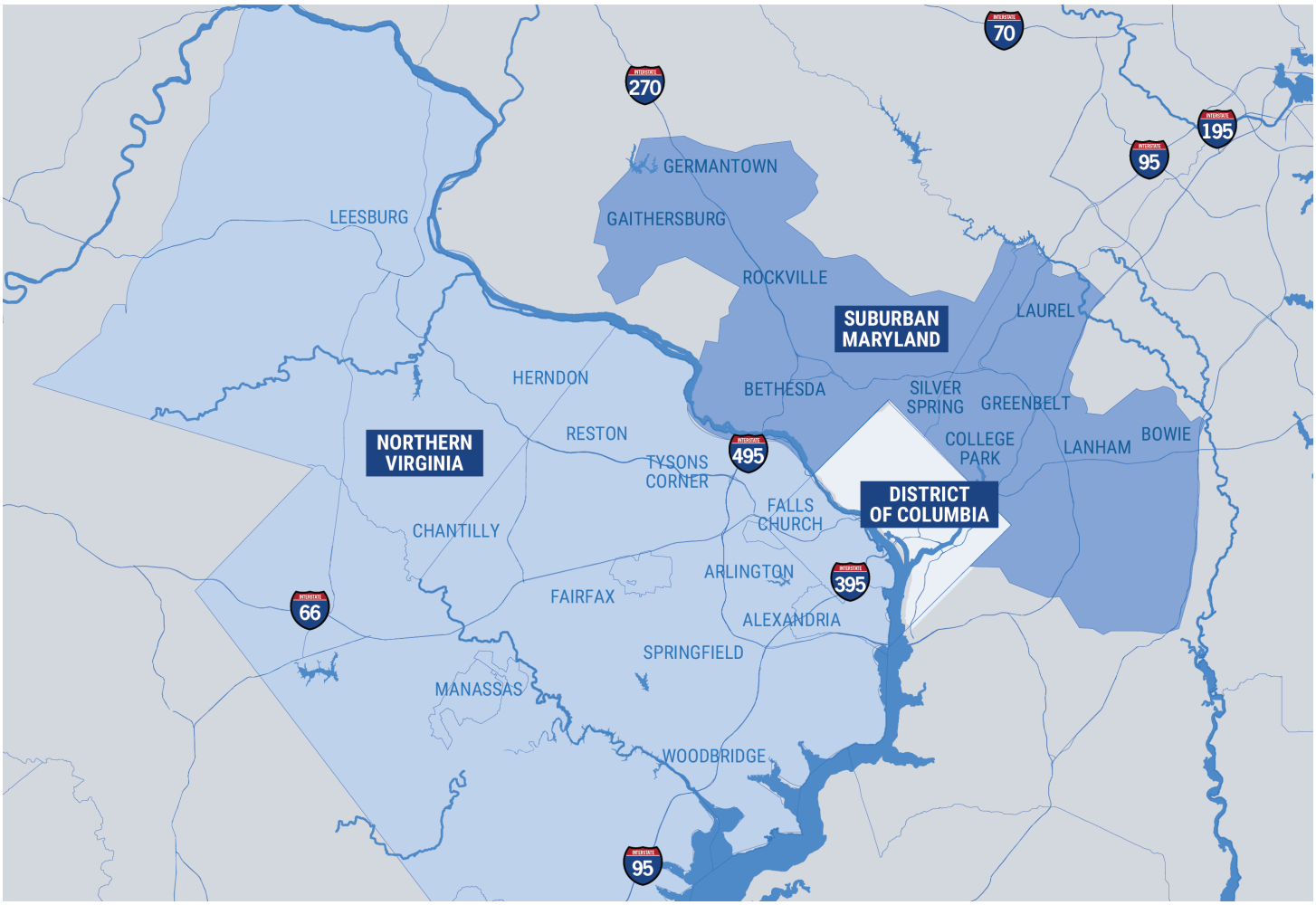
Transaction Volume: Total volume of office transactions $20 million and greater during a specific reporting period.

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.

WASHINGTON METRO AREA



Note: Major jurisdictions are labeled to provide orientation. This is not an exhaustive list of all covered submarkets. For detailed submarket maps for Northern Virginia, Suburban Maryland and the District of Columbia, please see each area's office market report.

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