RESEARCH Q4 2020

District of Columbia Office Market

Office Occupancy Contracts for Fourth Consecutive Quarter as Leasing Market Remains Quiet

The District of Columbia's office market continued to weaken in the fourth quarter under the persistent pressure of the pandemic. Market activity was considerably below average in the fourth quarter, as many tenants remained paused in their search for office space. Limited demand over the last nine months has contributed to occupancy losses and increasing vacancy. The District of Columbia did not deliver any office buildings in the fourth quarter; however, the pipeline of deliveries in 2021 is likely to put upward pressure on vacancy rates as some buildings deliver with large blocks of unoccupied space.

Net absorption registered -311,036 square feet during the fourth quarter of 2020. Net absorption for all of 2020 measured -1.3 million square feet. Slow leasing activity throughout the year has limited the opportunities for occupancy gains. As tenants continue to delay long-term real estate decisions, pent-up demand is likely building; however, leasing activity will remain quiet until office re-boarding is deemed safe. The approval and distribution of coronavirus vaccines, which began in December, will boost confidence that 2021 will be an inflection point in the return to normalcy of commercial markets.

Vacancy continues to rise steadily, reaching 15.3% in the fourth quarter, a 30-basis-point increase from the third quarter and a 120-basis-point increase from last year. The District of Columbia's development pipeline, which measures 2.1 million square feet excluding renovations, will apply upward pressure on vacancy rates as unoccupied space delivers. Office construction activity is expected to contract in the coming quarters as supply-and-demand conditions have slowed ground breakings.

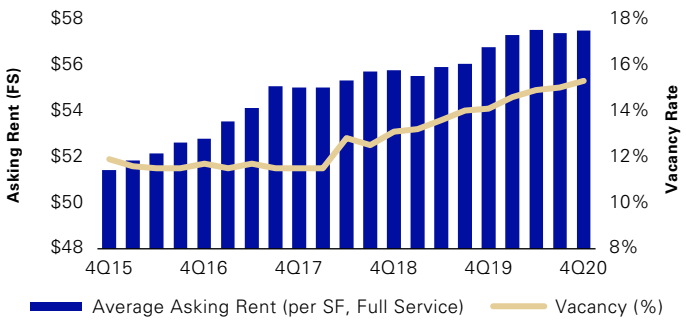
Asking rents rose in the fourth quarter to $57.49/SF, which nearly offset the 15-cent rent reduction experienced in the third quarter. Although current leasing conditions are expected to remain slow in the coming months, asking rents are likely to hold steady or modestly increase with new construction set to deliver. Conversely, effective rents will be under downward pressure, as high vacancy and oversupply ensure generous concession packages for tenants in the market for new space.

Current Conditions

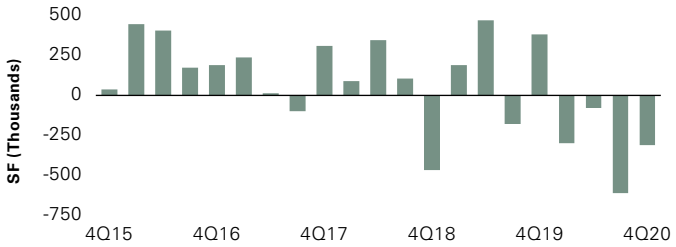
- The District of Columbia recorded -311,036 square feet of net absorption during the fourth quarter of 2020.
- The vacancy rate has risen 120 basis points from a year ago to 15.3%, as a material amount of new construction delivered in early 2020 and the continued pressure of COVID-19 have inflated the balance of vacant space.
- Asking rents rose modestly in the fourth quarter but effective rents remain 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)	129.9M	130.0M	129.0M	↑
Vacancy Rate	15.3%	15.0%	14.1%	↑
Quarterly Net Absorption (SF)	-311,036	-612,197	364,034	↑
Average Asking Rent/SF	$57.49	$57.37	$56.77	→
Under Construction (SF)	2.1M	2.1M	3.3M	↓
Deliveries (SF)	0	0	890,067	↑

NEWMARK

Class A New Supply Steadily Outweighing Demand

Class A vacancy, which measured 14.8% in the fourth quarter of 2020, has been steadily rising over the last two years. While the coronavirus certainly contributed to rising vacancy in 2020, Class A market softening was evident prior to the pandemic. Since 2019, Class A vacancy rates have increased by an average of 20 basis points quarterly. The recent construction cycle supported healthy net absorption levels within the Class A market; however, new buildings also drew some tenants out of older Class A product. As Class A supply expanded, demand for high-cost space slowed, leading to upward pressure on vacancy. Despite the growing imbalance between new supply and demand, the average Class A asking rent appreciated throughout 2020, reaching $62.14/SF in the fourth quarter as top-of-the-market new product pushed the average higher.

While Class A buildings hold a strong competitive advantage in quality, efficiency and amenities, the pandemic has caused many tenants to reconsider the utility of their office space. According to a recent national space use survey conducted by BOMA, Yardi and Brightline Strategies, a relationship exists between a tenant's likelihood to reassess its space use and the cost of the tenant's current space. As a tenants' real estate costs increase, so too does the likelihood of a tenant to reassess their space use. While there is a range of possible outcomes regarding how tenants may change space utilization after the pandemic, the threat of more vacancy in an oversupplied Class A market could strengthen the downward pressure on effective rents.

Coworking Facilities Face Challenges and Opportunities

The COVID-19 pandemic has impacted the District of Columbia's office market in many ways, but it has proven particularly difficult for companies operating in the shared economy. Coworking providers, which have supported a large share of the District's leasing and occupancy growth in recent years, have seen demand and office utilization fall in 2020. Some of the core benefits of coworking facilities, including shared amenities, have become less desirable during the pandemic. MIXER Work & Lounge, a new coworking provider to the market, has given back its 30,247-square-foot space at 600 Massachusetts Avenue, NW before even moving in. Other shared workspace tenant losses during the fourth quarter include WeWork, which moved out of three locations, contracting the firm's District footprint by about 105,000 square feet. With demand for space low, WeWork has also begun considering traditional brokerage providers to assist the operator in filling vacancies across its local portfolio.

Though challenges exist, the flexibility of coworking in a post-pandemic market could be appealing to tenants. Expediting "time to occupancy" could be important for tenants that have delayed real estate decisions throughout 2020. While coworking may serve as a viable option for fast and flexible office space post-pandemic, members occupying space within coworking facilities will not impact office market indicators such as net absorption or vacancy since the operator is the tenant. On balance, while flexible space is likely to be very appealing in the period ahead, traditional coworking operators are likely to remain challenged.

Federal Government Demand Pipeline May Slow in Coming Years

The federal government has been an anchor for leasing activity for the District of Columbia throughout the pandemic. Though most of the GSA's activity has been in the form of renewals, it has been a welcomed support to an otherwise quiet market.

The GSA's role as a backstop for the District of Columbia's office market has been shrinking in recent years. Over the last decade, the GSA's collective leased footprint in the District has contracted by 13.4%, or 3.1 million square feet. Federal leasing activity should remain relatively strong for the next two years, based on upcoming lease expirations; however, continued consolidation among agencies will remain common and erode some of the GSA's weight in the District of Columbia's office market.

Notable 4Q 2020 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
GSA—U.S. Small Business Association	409 3rd Street SW	Southwest	Lease Extension	266,193
Skadden, Arps, Slate, Meagher & Flom LLP	1440 New York Avenue NW	East End	Lease Extension	199,902
GSA—Department of Veterans Affairs	1800 G Street NW	CBD	Lease Renewal	95,444
Morning Consult	1025 F Street NW	East End	Direct Lease	49,108
AARP	620 F Street NW	East End	Lease Renewal	46,372

Notable Recent Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
1000 F Street NW	East End	$105,865,000	$1,118	94,655
1899 Pennsylvania Avenue NW	CBD	$92,196,364	$479	192,481
499 South Capitol Street SW	Southwest	$86,430,000	$424	204,000

Of the GSA's total leased office portfolio in the District of Columbia, 40.7%, or 8.0 million square feet, is set to expire in the 24 months beginning October 2020. Though many of these leases will result in net-negative occupancy due to consolidations, the influence on total leasing activity is important during this period of slow recovery. Anticipated GSA leasing activity may slow substantially beginning in 2023, as only 1.6 million square feet of GSA leases are set to expire between 2023 and 2024. One of those expirations is the Department of Justice (DOJ) at 450 5th Street, NW, which announced plans to consolidate from 477,473 square feet to 331,000 square feet (30.7% contraction) at the conclusion of its lease in 2023.

District of Columbia Outlook

The District of Columbia's office market will continue to face significant headwinds due to the impacts of the pandemic, with conditions likely to favor tenants for at least the next 12 months. The office market's imbalanced supply and demand will continue to put upward pressure on vacancy. Office buildings under construction and scheduled to deliver in 2021 total approximately 675,000 square feet and are roughly 60.0% pre-leased. Although the 2021 delivery pipeline is about half the size of 2020's, any net-new vacancy will add pressure to already elevated rates.

Average asking rent growth has been decelerating in 2020. Although face rents are expected to at least remain steady in the coming quarters, market forces will apply downward pressure on effective rents. This months-long period of low demand is likely to result in significant concession packages aimed at incentivizing tenant activity. It has yet to be seen how the coronavirus will impact office space utilization in the future, but a range of outcomes is possible. Space efficiencies may be achieved if firms permit more remote work and flexible employee schedules.

Conversely, data has begun to show that full-time remote work is not preferred by employees and that physical offices are critical for achieving corporate goals such as effective hiring, mentoring, and retention.

The approval and distribution of the first coronavirus vaccine in late fourth quarter is encouraging for office markets. While it will require months for inoculations to become ubiquitous, this advancement will start to bring normalcy to commercial activities, such the return of tenants to their office spaces.

Labor markets struggled in the fourth quarter to maintain the pace of recovery achieved in the summer. District unemployment is slowly trending down and was 8.2% in October 2020, which is up 290 basis points from a year earlier. Employment growth and job recovery slowed in the fourth quarter. Federal stimulus funds from the CARES Act have been exhausted. Despite a second stimulus package passed in late December, the tepid pace of Congressional negotiations has slowed economic recovery nationally and locally.

Investment sales volume in the District of Columbia was modest in 2020; however, velocity did increase late in the fourth quarter with several notable transactions. Although activity has been slow on the year, the District is likely to remain a long-term target for institutional capital due to its reputation for consistent and sturdy returns. Given the nature of the pandemic, many investors have been reluctant to deploy capital, particularly in office assets. As dry powder builds, the District's reputation of stability and its position as a global seat of power will likely reattract investors.

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

Market Statistics By Class

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2017 Absorption (SF)	2018 Absorption (SF)	2019 Absorption (SF)	4Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**129,931,614**	**13.9%**	**15.3%**	**450,492**	**36,883**	**844,360**	**-311,036**	**-1,303,468**
Class A	85,234,552	13.4%	14.8%	1,398,208	1,289,417	1,725,466	-183,421	-126,659
Class B	39,148,170	14.7%	16.1%	-897,537	-1,254,639	-587,272	-104,002	-906,255
Class C	5,548,892	16.3%	17.1%	-50,179	2,105	-293,834	-23,613	-270,554

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	4Q 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**129,931,614**	**$62.14**	**$50.27**	**$57.49**	**0**	**1,248,146**	**2,105,616**
Class A	85,234,552	$62.14	NA	$62.14	0	1,248,146	2,105,616
Class B	39,148,170	NA	$50.27	$50.27	0	0	0
Class C	5,548,892	NA	NA	$49.39	0	0	0

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

Submarket Statistics—All Classes

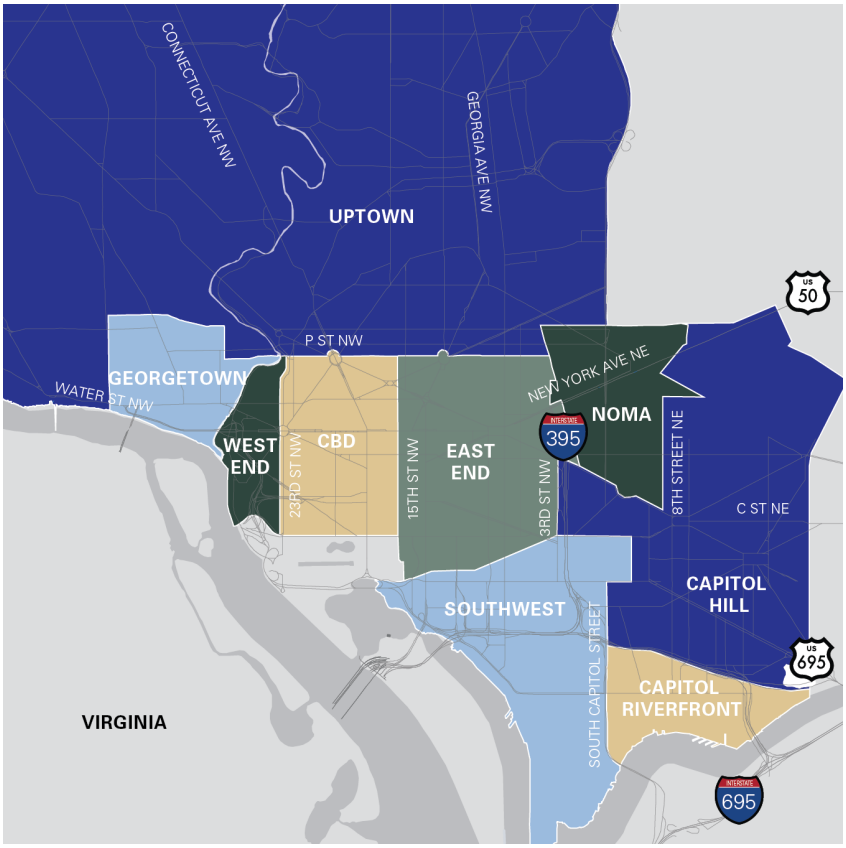
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2017 Absorption (SF)	2018 Absorption (SF)	2019 Absorption (SF)	4Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**129,931,614**	**13.9%**	**15.3%**	**450,492**	**36,883**	**844,360**	**-311,036**	**-1,303,468**
Capitol Hill	5,667,247	21.1%	21.5%	-73,918	141,019	5,188	-5,545	169,977
Capitol Riverfront	4,037,480	6.5%	7.0%	109,832	242,861	-835	11,884	93,635
Central Business District	41,003,919	14.0%	15.8%	19,869	494,824	-422,644	-64,136	-912,296
East End	42,549,896	17.0%	18.6%	-333,478	-166,922	-121,365	-147,620	-473,355
Georgetown	2,851,274	6.8%	7.2%	-53,368	-107,899	-77,883	-5,007	-45,589
NoMa	12,167,195	6.8%	7.0%	387,936	19,628	726,243	13,108	546,020
Southwest	11,953,807	12.8%	13.1%	312,976	164,964	695,064	-49,350	-568,116
Uptown	6,152,404	10.3%	12.1%	-64,593	-754,646	209,162	-29,355	-32,637
West End	3,548,392	14.0%	15.8%	145,236	3,054	-168,570	-35,015	-81,107

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 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**129,931,614**	**$62.14**	**$50.27**	**$57.49**	**0**	**1,248,146**	**2,105,616**
Capitol Hill	5,667,247	$69.25	$52.31	$59.53	0	32,083	212,000
Capitol Riverfront	4,037,480	$51.95	NA	$51.95	0	0	557,948
Central Business District	41,003,919	$63.96	$52.19	$59.06	0	671,063	452,000
East End	42,549,896	$64.59	$51.23	$59.84	0	0	143,872
Georgetown	2,851,274	$59.39	$42.89	$44.76	0	0	0
NoMa	12,167,195	$51.92	$49.60	$51.15	0	545,000	38,191
Southwest	11,953,807	$50.49	$46.55	$49.42	0	0	639,703
Uptown	6,152,404	$52.10	$42.63	$45.26	0	0	61,902
West End	3,548,392	$68.33	$50.24	$63.11	0	0	0

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

District of Columbia Office Submarkets



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.

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