RESEARCH **2Q 2020**

Newmark Knight Frank

DISTRICT OF COLUMBIA **OFFICE MARKET**

CORONAVIRUS IMPACTS DISTRICT OFFICE MARKET

The District of Columbia experienced uneven office leasing metrics during the second quarter of 2020, with modestly negative net absorption and slightly lower asking rents. The COVID-19 pandemic had a significant impact on the economy and office market during the quarter, as many employees were forced to work from home, slowing market activity considerably. Vacancy ticked up as well, a result of slow leasing velocity, delayed move-ins and 335,063 square feet of new office space that delivered during the quarter. Two notable new construction projects that delivered were: 1050 17th Street NW, a 154,413-square-foot office building in the Central Business District submarket. The property delivered entirely vacant. Additionally, 2100 L Street NW, a 180,650-square-foot office property in the Central Business District submarket. The building was 53% pre-leased at time of completion, with Morrison & Foerster expected to move into 81,000 square feet during the second half of the year.

The District of Columbia registered negative 27,933 square feet of net absorption during the second quarter of 2020. The downturn created by the COVID-19 pandemic impacted the District of Columbia office market in many ways, perhaps most visibly in terms of the lack of absorption by coworking companies, as the model itself came under pressure due to heightened worries over physical proximity and open and shared office space. Coworking has represented a significant share of the District's positive net absorption over the past three years. Although that was expected to moderate even before the COVID-19 pandemic hit, as leasing activity had slowed in the wake of WeWork's turmoil, the industry faces new headwinds due to the public health crisis.

Vacancy continues to tick up, registering 15.0% at the end of second-quarter 2020. This is largely due to a robust construction pipeline; 3.4 million square feet has delivered in the District of Columbia since the start of second-quarter 2019. Leasing activity likely will remain slow in the near term. As tenants wait to reoccupy their offices, many are also examining their space needs, as remote work has become more realistic for many companies. However, social and physical distance guidelines may result in a reversal of the recent densification trend, with each employee present in the office occupying more space. This will partially offset a loss of occupancy due to more remote work.

Average asking rents ticked down during the second quarter to $57.05/SF, although this was an increase of 2.0% 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.

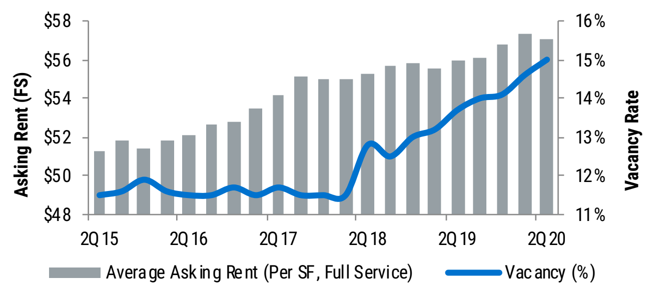
The District's construction pipeline remains active at 2.4 million square feet, excluding renovations, as developers sought to capitalize on strong trophy market fundamentals in recent years. The COVID-19 outbreak has not led to any significant delays to current office construction projects thus far, including nearly 600,000 square feet long projected to deliver in the District over the next 12 months. However, the economic outlook may alter construction plans over the next few years, as developers seek to determine the best timing or whether a different property type might result in a better return.

CURRENT CONDITIONS

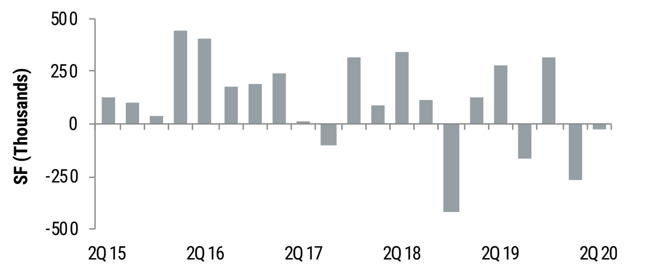
- The District of Columbia registered negative 27,933 square feet of net absorption during the second quarter of 2020.
- The vacancy rate has risen 130 basis points from a year ago to 15.0%, as a large amount of new space without significant pre-leasing has delivered in the past 12 months.
- Asking rents were down during the second quarter to $57.05/SF, although this is still an increase of 2.0% 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)	130.2 M	129.5 M	127.8 M	↑
Vacancy Rate	15.0%	14.6%	13.7%	↑
Quarterly Net Absorption (SF)	-27,933	-271,352	281,363	↓
Average Asking Rent (Per SF, Full Service)	$57.05	$57.29	$55.92	↔
Under Construction (SF)	2.4 M	2.7 M	3.6 M	↓
Deliveries (SF)	335,063	913,083	1.3 M	↓

LEASING VELOCITY SLOWS DURING DOWNTURN

Lease transaction volume slowed during the second quarter of 2020, as asset owners were unable to show their properties and many tenants put off making decisions regarding office leasing. As of this writing, most companies have not yet re-entered their workplaces, although some have begun to welcome workers back on a phased or partial basis. Overall, asset owners and tenants alike have a cautious attitude that may postpone meaningful acceleration in the market until 2021. Of the deals that were signed during the second quarter, renewals and short-term extensions were popular as both sides see the benefit of remaining in place until the health and economic crises are contained and begin to reverse. Anecdotally, at least one tenant has determined that if it is unable to find a new space or come to an agreement on an extension or renewal, it will allow its lease term to end and keep its employees working remotely until a new space is found—the firm remains in the market but with less urgency.

The two largest lease transactions of the quarter both included the General Services Administration inking deals to remain in place. The Department of Education signed a 290,000-square-foot renewal at 550 12th Street SW in the Southwest submarket, while the Department of Homeland Security and Customs and Immigration Service signed an extension on its 287,000-square-foot space at 111 Massachusetts Avenue NW in NoMa.

CLASS A FUNDAMENTALS UNEVEN

The District of Columbia's Class A market saw 215,129 square feet of net absorption during the second quarter of 2020, pacing the market overall. However, Class A asking rental rates were down 0.9% quarter-over-quarter, while the vacancy rate was up 30 basis points from the previous quarter, to 14.6%, and up 90 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.

DISTRICT IN GOOD POSITION TO REBOUND MORE QUICKLY THAN PEER MARKETS

The District of Columbia is uniquely positioned to withstand the pandemic-induced economic downturn due to the nature of the highly-educated, office-using employment landscape that exists. Of course, the existence and footprint of the federal government is advantageous in times of downturn, specifically one that is uniquely not caused by financial indicators, but rather by a government-enforced quarantine. Although the region's dependence on the federal government has been shrinking in recent years, the District of Columbia itself continues to depend on and benefit from its presence. Pandemic-related leasing has been slow, but office-using sectors that are prevalent in the District are likely to see jobs return first. While the market has seen other property types suffer, including hospitality and retail, the office market recovery will help to drive the recovery in other property types and sectors as well.

DISTRICT INVESTMENT SALES VOLUME DOWN

Investment sales volume in the District of Columbia was down significantly in the second quarter of 2020 due to the global pandemic. Some deals that were close to finalized before the outbreak were able to close, but overall activity was down and remains largely on hold. Sales volume in the District of Columbia reached $153.0 million for the quarter, which is down significantly from $329.8 million during the second quarter of 2019. The global nature of the COVID-19 outbreak has slowed foreign investment and the economic downturn has likely forced changes in valuations. However, the District of Columbia is likely to be a target for international and domestic capital as the economy begins to reopen. This is due to its history of steady employment growth and stable office market returns—thanks to the employment base and stock of properties with federal government or government-related tenants. Distressed and core assets are likely to lead the way out of the slowdown in the District as investors will see these properties as solid investments in the near term.

NOTABLE 2Q 2020 LEASE TRANSACTIONS

Tenant	Building	Submarket	Type	Square Feet
Department of Education	550 12th Street SW	Southwest	Lease Renewal	290,000
Customs and Immigration Service	111 Massachusetts Avenue NW	NoMa	Lease Extension	287,000
Palantir Technologies	1025 Thomas Jefferson Street NW	Georgetown	Lease Renewal	104,777
National Endowment for Democracy	1201 Pennsylvania Avenue NW	East End	Direct Lease	82,329
Berkeley Research Group	1800 M Street NW	CBD	Lease Renewal	86,216

NOTABLE 2Q 2020 SALES TRANSACTIONS

Building	Submarket	Sale Price	Price/SF	Square Feet
2001 Wisconsin Avenue NW	Uptown	$85,000,000	$353	240,475
1307 New York Avenue NW	East End	$41,500,000	$391	106,060
1509 16th Street NW	Uptown	$26,500,000	$830	31,920

DISTRICT OF COLUMBIA OUTLOOK

The District of Columbia's office market faces significant headwinds, with conditions likely to favor tenants over the next 12 months. The market entered an economic downturn with elevated vacancy rates and 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 the full impact of the coronavirus on the region's office market remains unclear, the current deceleration in demand is likely to linger, as short-term economic growth has slowed dramatically in the midst of sustained reduced consumer spending and continued unemployment, which reached 11.1% in the District in April 2020. Office projects currently underway have not faced significant delays, as the local and federal governments have determined construction to be essential. Still, the speed with which a recovery occurs will likely lead to changes for some proposed or planned projects that have not yet broken ground. A smaller office supply pipeline may help soften increasing vacancy levels as demand in the market eventually catches up to supply.

Asking rents in the District are up 2.0% from one year ago, but effective rents have remained under downward pressure. Tenants being offered significant concession packages to incentivize a move or renewal will continue, though 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 adjust or ascertain best practices moving forward. The flight to quality persists, as tenants have been seeking well-located, highly-amenitized space. Well-located trophy and Metrorail-proximate properties have outperformed the market in general over the past several years. However, near-term concerns over the use of public transportation due to an increased chance of disease transmission in compact public spaces could impact decision makers' view of mass transit as an amenity in the long term. Physical in-building amenities will remain valuable but what is prized may change, with rooftop decks and other outdoor spaces increasingly valuable.

Recently, densification within the District of Columbia's office market had been plateauing, as employers placed greater emphasis on workplace strategy to attract and retain top talent, although consolidations and downsizing in the legal sector persisted. Now, there is a range of possible outcomes as it relates to densification. The longevity and breadth of remote work is uncertain. If employers find that remote work capabilities are sufficient for their business model, smaller office footprints could become the norm. Still, remote work has been possible for years, and some companies that chose to try it have since brought those employees back to the office due to declining efficiency and productivity, plus a loss of corporate culture. Further complicating matters, uncertainties remain about office layouts and worker preferences regarding social distancing within the office. Partial remote work or shifts in office attendance will also affect the demand for office space in the period ahead.

The District of Columbia is likely to remain a target for international capital, owing to the District's reputation for consistent and sturdy returns, particularly as long-term investors seek hard assets during this period of increased global volatility. Although investment volume has been modest during the downturn, the market's history of stability likely will be a reason it stands as one of the nation's leaders out of recession. Despite its challenges, the District offers significant upside for investors. As the seat of the federal government, the District is likely to experience an increase in economic activity as the government continues spending to combat fallout from the coronavirus outbreak. 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)	2Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**130,235,407**	**13.9%**	**15.0%**	**463,758**	**136,619**	**555,500**	**-27,933**	**-299,465**
Class A	85,234,552	13.5%	14.6%	1,398,208	1,351,409	1,432,505	215,129	213,581
Class B	39,451,963	14.5%	15.8%	-884,271	-1,216,895	-561,358	-75,991	-307,993
Class C	5,548,892	15.8%	16.3%	-50,179	2,105	-315,647	-167,071	-205,053

MARKET STATISTICS BY CLASS

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	2Q 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**130,235,407**	**$61.42**	**$50.59**	**$57.05**	**335,063**	**1,248,146**	**2,401,948**
Class A	85,234,552	$61.42	NA	$61.42	335,063	1,248,146	2,401,948
Class B	39,451,963	NA	$50.59	$50.59	0	0	0
Class C	5,548,892	NA	NA	$46.09	0	0	0

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

2Q 2020 **DISTRICT OF COLUMBIA OFFICE MARKET**

SUBMARKET STATISTICS – ALL CLASSES

	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2017 Absorption (SF)	2018 Absorption (SF)	2019 Absorption (SF)	2Q 2020 Absorption (SF)	YTD 2020 Absorption (SF)
District of Columbia	**130,235,407**	**13.9%**	**15.0%**	**463,758**	**136,619**	**555,500**	**-27,933**	**-299,465**
Capitol Hill	5,667,247	22.1%	22.4%	-73,918	141,019	-7,500	12,887	105,516
Capitol Riverfront	4,037,480	5.3%	7.0%	109,832	242,861	-72,366	8,634	49,452
Central Business District	41,255,920	14.0%	15.4%	19,869	500,872	-377,874	-86,297	-329,472
East End	42,549,896	16.9%	18.1%	-320,212	-112,233	-260,447	8,162	-172,564
Georgetown	2,851,274	9.9%	11.8%	-53,368	-107,899	-76,437	-19,757	-14,132
NoMa	12,167,195	10.8%	11.0%	387,936	19,628	726,243	35,432	50,103
Southwest	11,953,807	9.5%	9.7%	312,976	203,963	583,289	22,648	1,760
Uptown	6,152,404	10.1%	11.8%	-64,593	-754,646	209,162	841	9,320
West End	3,600,184	11.0%	13.3%	145,236	3,054	-168,570	-10,483	552

SUBMARKET STATISTICS – ALL CLASSES

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	2Q 2020 Deliveries (SF)	YTD 2020 Deliveries (SF)	Under Construction (SF)
District of Columbia	**130,235,407**	**$61.42**	**$50.59**	**$57.05**	**335,063**	**1,248,146**	**2,401,948**
Capitol Hill	5,667,247	$70.52	$50.76	$59.64	0	32,083	509,300
Capitol Riverfront	4,037,480	$52.71	NA	$52.71	0	0	557,948
Central Business District	41,255,920	$61.99	$52.17	$57.82	335,063	671,063	452,000
East End	42,549,896	$63.95	$52.15	$59.52	0	0	137,797
Georgetown	2,851,274	$57.65	$43.32	$45.44	0	0	0
NoMa	12,167,195	$51.44	$49.25	$50.64	0	545,000	0
Southwest	11,953,807	$47.82	$41.68	$46.62	0	0	639,703
Uptown	6,152,404	$51.05	$42.73	$44.64	0	0	105,200
West End	3,600,184	$68.29	$49.49	$63.95	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.

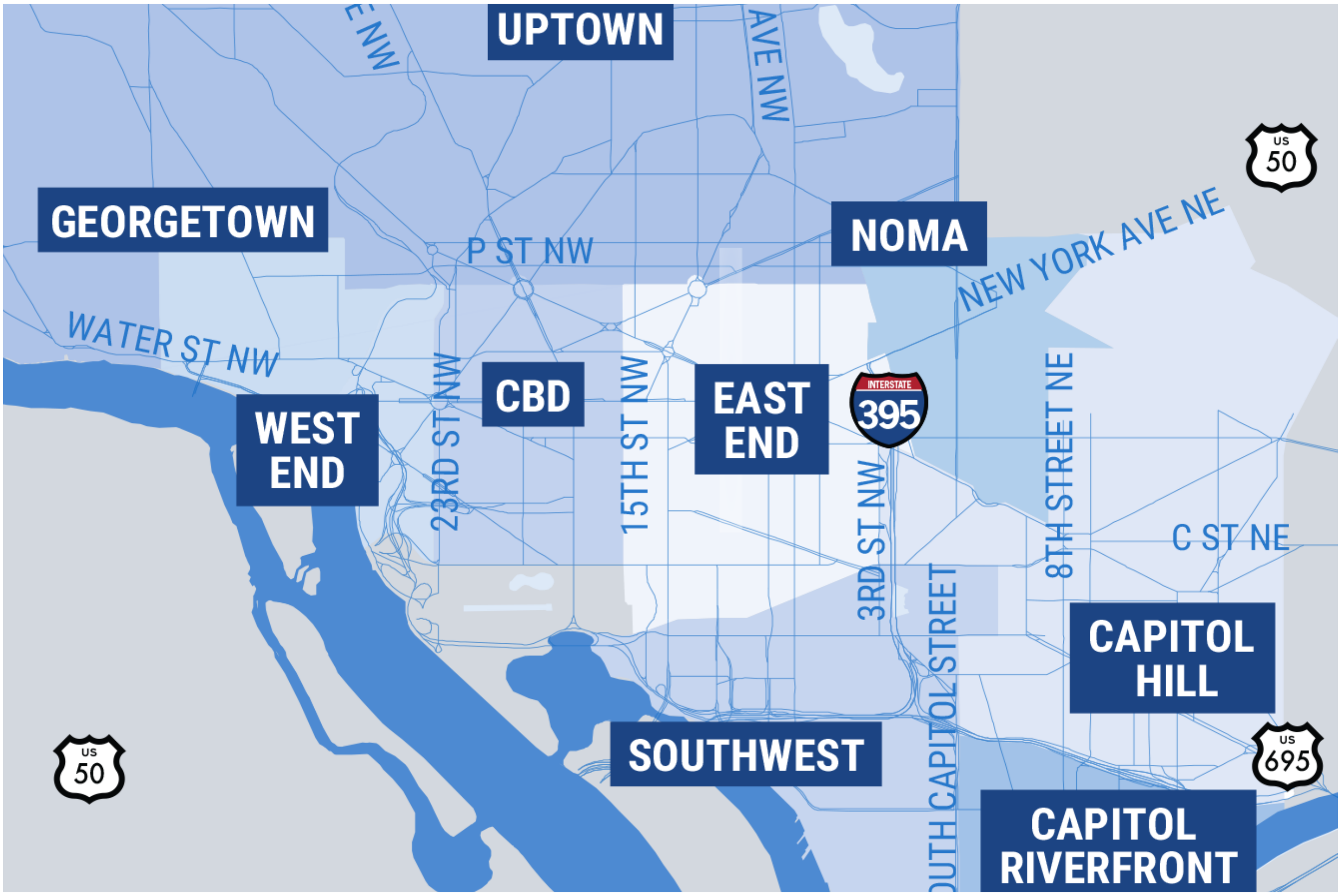
Sublease: Sublease space is offered and marketed as available by the current tenant, rather than directly from the owner.

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



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Newmark Knight Frank has implemented a proprietary database and our tracking methodology has been revised. With this expansion and refinement in our data, there may be adjustments in historical statistics including availability, asking rents, absorption and effective rents. Newmark Knight Frank Research Reports are available at www.ngkf.com/research