PANDEMIC

THE PATH FORWARD IN THE WASHINGTON COMMERCIAL REAL ESTATE MARKET

RESEARCH SPOTLIGHT | APRIL 2020

Newmark Knight Frank

During these challenging times, Newmark Knight Frank remains committed to providing our clients with the latest market information and data-driven, actionable intelligence. We are here to support your business activities during and after the coronavirus pandemic.

As of early April, here is an assessment of the effect of COVID-19 on the Washington metro area's major commercial real estate property types, as well as potential action steps and opportunities for investors and tenants to consider.

THE REGIONAL ECONOMY AND WASHINGTON'S COMPARATIVE ADVANTAGES

The longest business expansion on record has ended, as the coronavirus pandemic spreads throughout the world and consumer spending slows dramatically. Although a robust data set confirming the economic toll is still a few weeks away, forecasting firm IHS projects that the national economy will contract 12.6% during the second quarter of 2020 before rebounding steadily during the third quarter and then expanding 6.0% during the fourth quarter (see adjacent graph). The Stephen S. Fuller Institute at George Mason University forecasts that the Washington region's economy will contract by 0.8% in 2020 (in the aggregate).

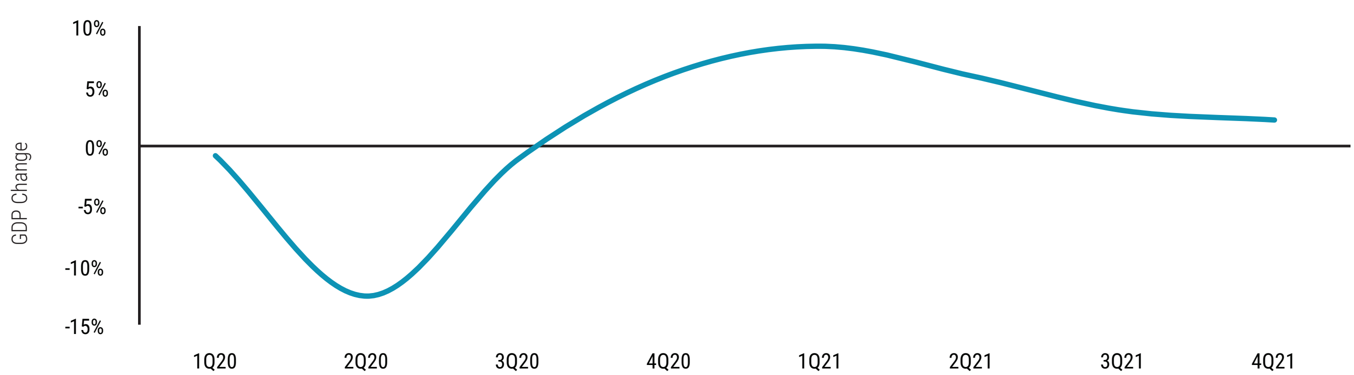
Government-mandated measures keeping citizens at home for a prolonged period have already affected many industries and will continue to have an impact until the virus is contained. The Washington region is less insulated from recessions than it has been in previous downturns due to federal job cuts and a pivoting of the region's economy toward the private sector. However, the area remains better insulated than do many peer cities. Service-related industries such as hospitality, lodging, retail and restaurants are being disproportionately impacted, and the region's normally strong tourism sector has been temporarily shuttered. The full scope of the outbreak and its local economic impact cannot be fully evaluated yet, particularly since stay-at-home orders covering the entire region were only implemented on March 30.

However, the Federal Reserve and the federal government have taken steps to try to shore up the economy, and lawmakers continue to introduce legislation to provide financial assistance to companies and individuals. The most notable example so far is the CARES Act (Coronavirus Aid, Relief and Economic Security Act), which was approved by Congress and signed into law by President Trump on March 27.

The duration of the outbreak and the degree of the resulting economic decline will lead to private sector job losses across all three of the region's substate areas. However, the Washington metro area's economy is likely to benefit from public investment and other federal government activity over the next few months in response to the pandemic. This spending will likely lessen the duration of the impact on the local economy and office market. The region's core sectors—including life sciences, the technology sector, and the federal government and its contractors—will help it bounce back from recession. According to a study by Chmura, the Washington metro area scores below the national average on economic vulnerability—meaning the region has less downside exposure than the average U.S. market during a crisis of this nature. The study looked at the impact the coronavirus threat may have on employment based on a region's mix of major industries, and the District of Columbia and its suburbs are expected to suffer job losses that are well below the national average.

QUARTERLY CHANGE IN UNITED STATES GDP

PROJECTED FOR 1Q 2020–4Q 2021 | SEASONALLY ADJUSTED ANNUAL RATES

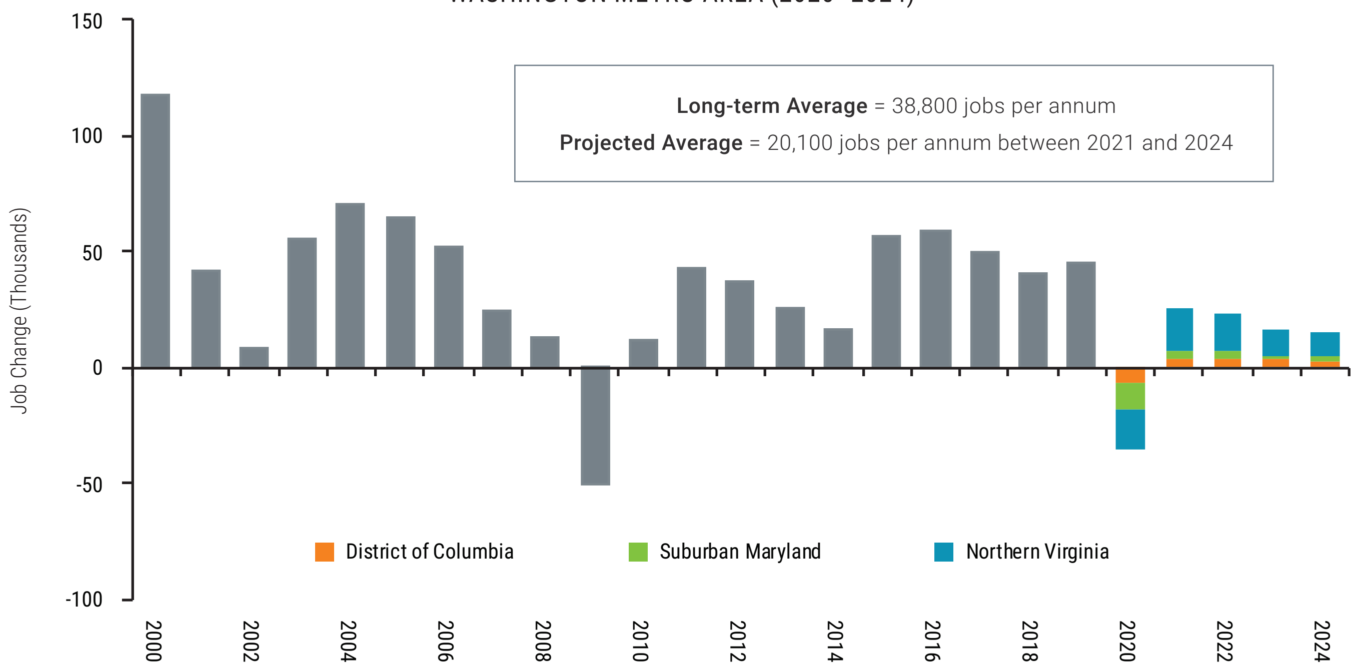


Source: IHS Markit, The Stephen S. Fuller Institute at the Schar School, GMU; Analysis: NKF Research; April 2020
Note: The quarterly seasonally adjusted annual rate (SAAR) estimates the change from the prior quarter after accounting for seasonal patterns. This is not equivalent to the quarterly over-the-year change so the average SAAR for the year does not equal the annual change.

THE REGIONAL ECONOMY AND WASHINGTON'S COMPARATIVE ADVANTAGES (CONTINUED)

Even considering the region's comparative advantages, NKF projects a net regional loss of at least 36,000 jobs in 2020—likely more than that in the near term, but with some rehiring occurring during the second half of the year, particularly in the fourth quarter. We expect modest, positive employment growth in 2021, although conditions continue to evolve rapidly; we will update our projection throughout 2020 as evidence warrants. Once economic conditions begin to normalize, the region should return to a path of steady growth, given its highly educated workforce.

PAYROLL JOB CHANGE 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; April 2020
Note: Projections are subject to revision as conditions change.

CAPITAL MARKETS

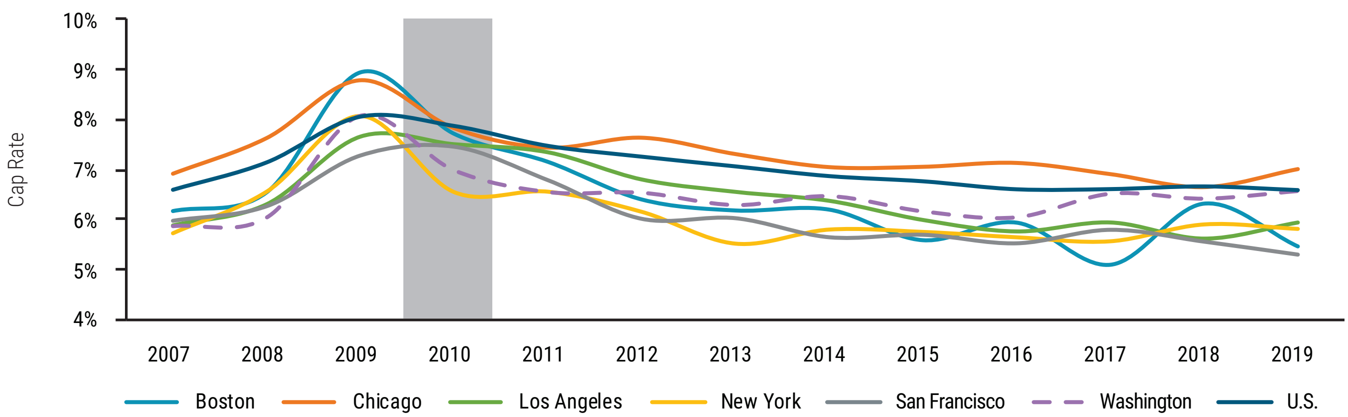
Regional investment sales volume across all major property types in 2019 approximated the previous cyclical peak from 2015; multifamily and industrial transactions boosted last year's volume. In 2020, the impact of the coronavirus on the office investment sales market could be significant, as the global economy suffers and job losses mount, potentially affecting the investment-worthiness of some assets. However, hard assets like real estate have generally been a strong alternative during downturns in the economy, particularly for investors seeking a hedge against the volatility of the stock market. The Washington market has been a magnet for capital during recessions and their immediate aftermath due to its stable economic performance and the federal government's presence, which serves as a ballast. See the cap rate and total return graphs on pages 5 and 6 for more detail regarding the Washington market's outperformance in 2010, as capital began to flow again following the Great Recession.

CAPITAL MARKETS (CONTINUED)

In the Americas, January/February 2020 transaction volume was up over the same period in 2019, as the coronavirus outbreak had not escalated to the same degree as it had in Asia and Europe, where volume was off. This suggests that a material decline in volume will likely be recognized in the second quarter of 2020. While the pandemic may shrink the amount of capital available in the near term, some of that sales activity will be pushed into the second half of the year, potentially serving as a catalyst for the third and fourth quarters.

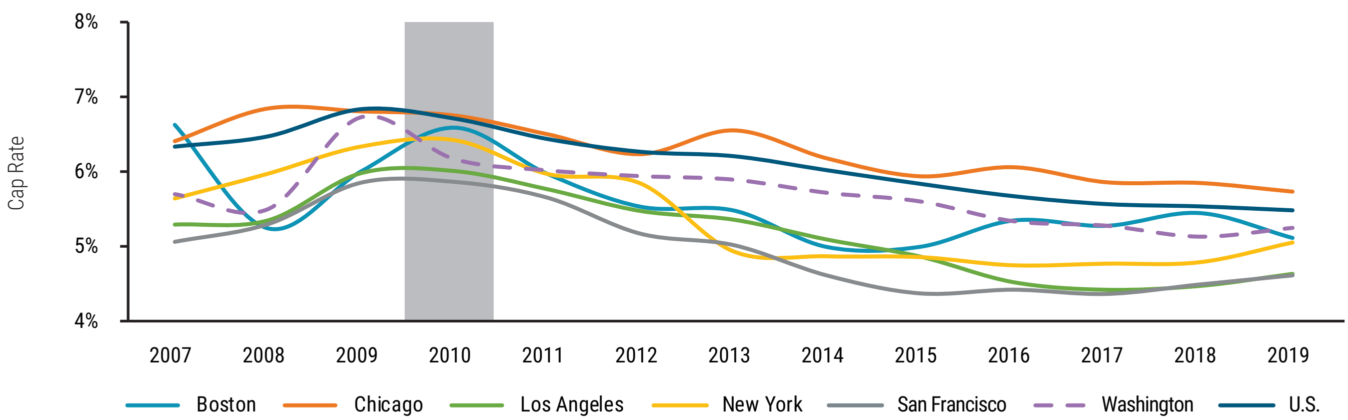
Our professionals report that there is still a substantial amount of liquidity and dry powder on the sidelines, evaluating opportunities. Further, investors are better capitalized than during the 2008–2009 recession, with generally lower debt levels. Lenders are being very careful with new deals, but the recent actions of the Federal Reserve, Fannie Mae, and Freddie Mac have bolstered overall confidence in the investment markets.

OFFICE INVESTMENT SALES: AVERAGE ANNUAL CAP RATES
GATEWAY MARKETS (2007–2019)



Source: NKF Research, Real Capital Analytics; April 2020
Note: Gray bar represents immediate aftermath of Great Recession

MULTIFAMILY INVESTMENT SALES: AVERAGE ANNUAL CAP RATES
GATEWAY MARKETS (2007–2019)



Source: NKF Research, Real Capital Analytics; April 2020
Note: Gray bar represents immediate aftermath of Great Recession

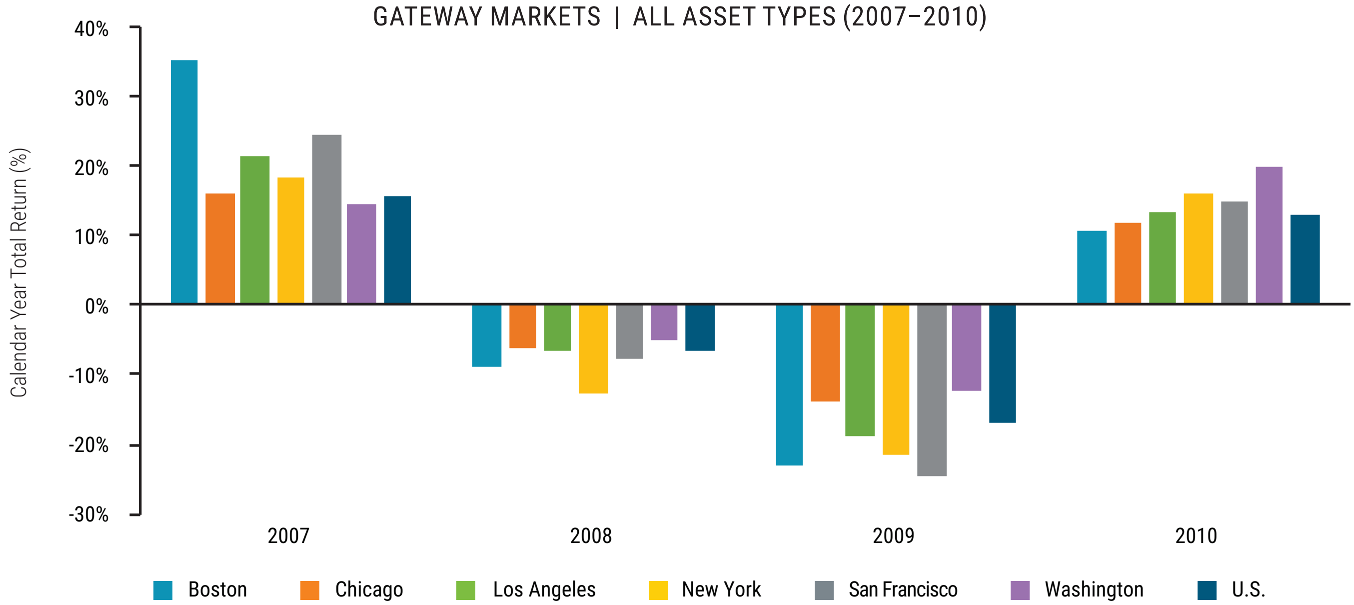
CAPITAL MARKETS (CONTINUED)

ACTION STEPS AND OPPORTUNITIES: Opportunities to buy office assets at a discount have been available for some time in commodity Class A product, where leasing demand is soft, although not many have actually sold during the past few years; well-capitalized investors with long-term time horizons could reposition those obsolete assets, and may find those that are Metrorail-adjacent especially attractive. **Well-located Class B office product will continue to present a strong buying opportunity in the District** because of long-term demand from associations and non-profits. There may be opportunities in the coming months for shrewd investors to buy low on other product types, or for institutional investors to purchase with long-term hold strategies; **trophy product with leasing risk** stands out as a strategy with notable upside for a more aggressive investor. **Multifamily and industrial assets are likely to be in greatest demand,** with multifamily often serving as a safe haven during times of crisis, and with e-commerce especially important during the pandemic and likely to further accelerate demand for logistics and distribution space, even in the longer term as consumers move more of their routine shopping online.

The possible movement of some supply chain activities back to the U.S. creates additional investment opportunity in the industrial market, particularly in Suburban Maryland and the Baltimore-Washington Corridor with regard to **life sciences opportunities.** Similarly, due to the increased demand for data services and the ongoing migration toward cloud computing, **Northern Virginia's data center and industrial markets** present additional investment opportunities. Please see the property type analyses that follow for more information.

On balance, ongoing volatility in the American and global economies will continue to underscore the value of commercial real estate. **Investors—domestic and foreign—will likely seek the safety of a primary market such as Washington,** which has an established reputation for resilience. Early indications are that Middle Eastern investors in particular are very interested in U.S. assets for their stability, given the uncertainty of global oil prices. Notably, sellers who can execute high-quality virtual tours, particularly of office assets, may be able to attract outsized attention during a time when travel is limited.

CALENDAR YEAR TOTAL RETURNS
GATEWAY MARKETS | ALL ASSET TYPES (2007–2010)



Source: NCREIF, NKF Research; April 2020

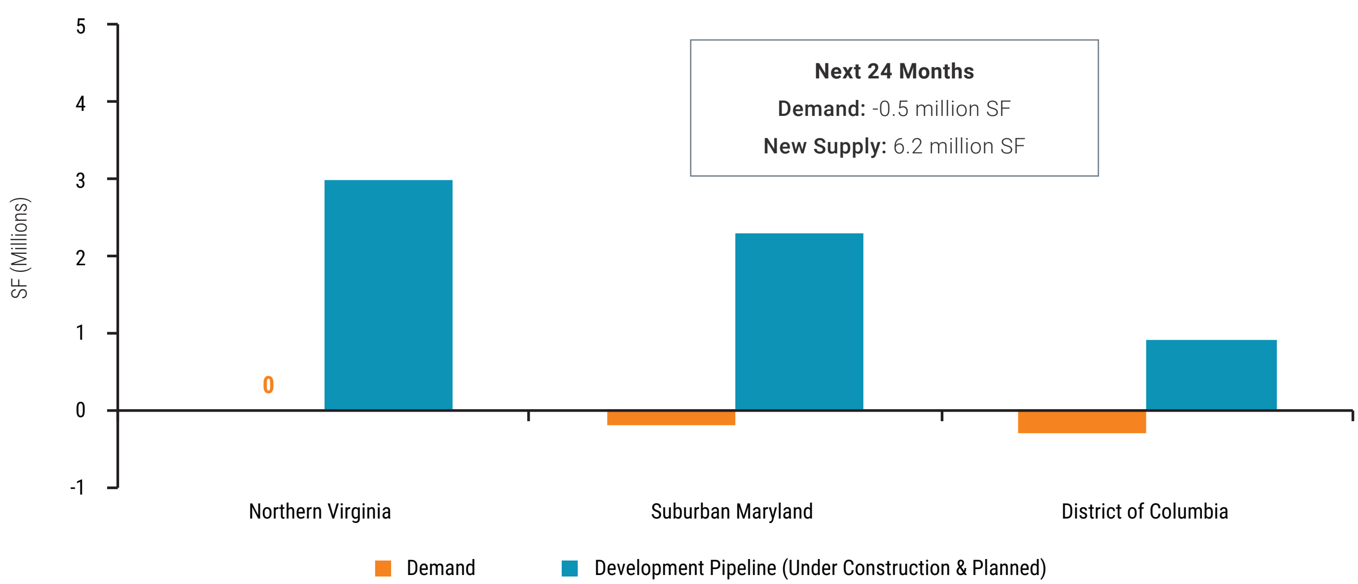
OFFICE

Office fundamentals in the Washington metro area are likely to soften in the months ahead, not solely because of a reduction in leasing demand due to the coronavirus pandemic, but also because of the region's outsized volume of recent and forthcoming deliveries (see adjacent graph). The District of Columbia is likely to see the greatest overhang of new supply when recent deliveries are considered. Projects that are already underway will likely still deliver, though possibly later than planned. Additional projects in the pipeline that have not yet broken ground may stall in the short-term until the full impact of the coronavirus comes into focus. Absorption across the substate areas is likely to decline in the short term, yielding higher vacancy rates, especially when considering upcoming deliveries. However, a potential halt to construction may result in a spreading out of delivery dates once construction resumes, somewhat easing the immediate oversupply concerns.

The coworking sector could be disproportionately impacted by sustained remote work and greater competition from asset owners looking to attract tenants as the economy recovers; in fact, WeWork is seeking up to a 30% reduction in its lease liabilities, which may affect those who lease to it in the District. However, the Washington market is fairly well insulated from a downturn in the coworking sector; as of April 2020, only 2.1% of the District's office inventory was occupied by coworking operators, compared with more than 4.0% in Manhattan and San Francisco. Wide-open office configurations, which were already seeing pushback from workers, may see further decline in popularity due to their congested nature—potentially weakening demand further for open coworking spaces. However, **a move away from the open floor plan,** combined with the persistent sense of isolation some are feeling while working remotely during this pandemic, **may help to soften or reverse the market's push for densification**. Also, for those tenants that still want a coworking-style suite that is amenity-rich, asset owners have become increasingly adept at creating those suites in-house and leasing them directly to occupiers.

Vacancy levels in the District of Columbia have been on the rise, reaching cyclical highs, while Northern Virginia and Suburban Maryland have seen vacancy decline over the past few quarters. While vacancy is

SUPPLY/DEMAND FORECAST
WASHINGTON METRO AREA OFFICE MARKET | 24 MONTHS ENDING MARCH 2022



Source: NKF Research; April 2020

OFFICE (CONTINUED)

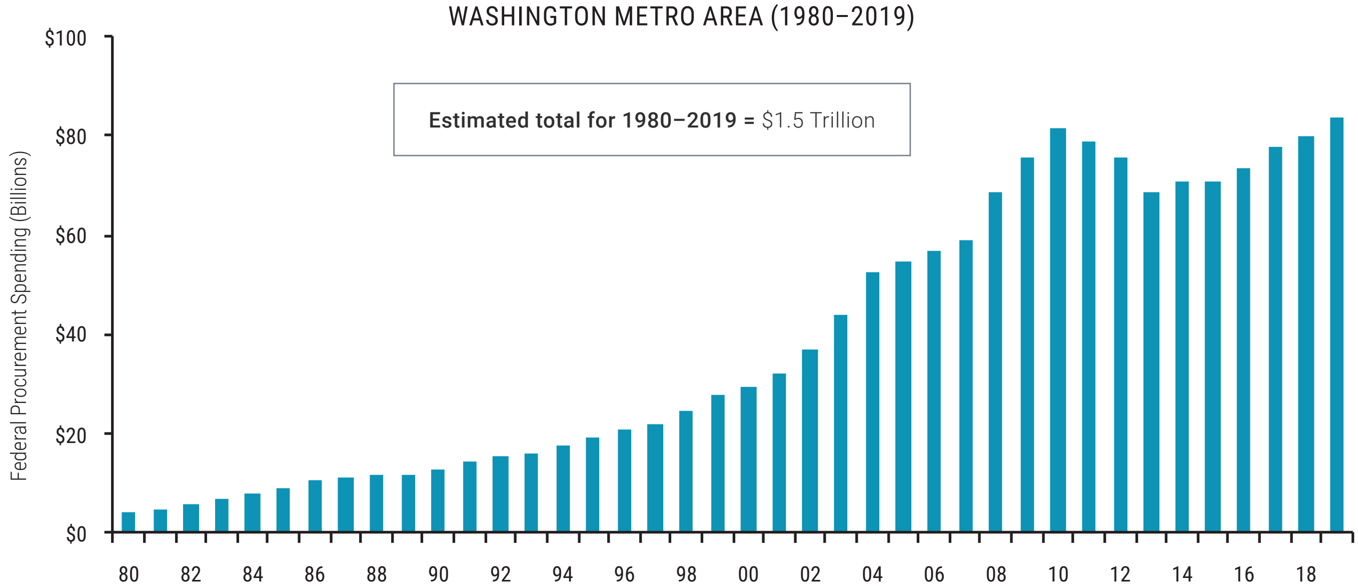
expected to rise across all substate areas during the balance of 2020, **the federal government's response may bolster the Northern Virginia office market** due to its prevalence of federal contractors, who may be called on to provide more services. (See the adjacent graph on the recent growth of federal procurement spending in the region, which disproportionately benefits Northern Virginia's office market and reached an all-time high in 2019.) **The Suburban Maryland market (in particular, the I-270 Technology Corridor) also may benefit in the longer term due to the presence of the National Institutes of Health and its subsidiaries,** as greater investment in medicine and bioscience is likely in an effort to control the current pandemic and stop future pandemics from developing.

ACTION STEPS AND OPPORTUNITIES: Some office lease deals are moving forward, particularly if the tenant has an inflexible lease expiration date. However, if the requirement is not driven by a near-term lease expiration, the deal is likely either on hold or progressing slowly. Our professionals report that in many cases, asset owners are coordinating with tenants on rent abatements or deferrals, sometimes with near-term obligations deferred until later in 2020 or amortized across a portion of 2021. In other cases, tenants that had planned to relocate are requesting extensions of 12–24 months.

Provisions of the CARES Act that allow small business loans to be used for lease payments may serve as a ballast for the office market nationally and locally. **Submarkets and assets that were poised to perform well before COVID-19, including National Landing and transit-adjacent properties in the Rosslyn-Ballston Corridor, will likely lead the market's rebound.**

In the years ahead, **larger tenants in smaller buildings may be more inclined to consider full-building leases** with better control of their environment, including public spaces, garages, and food service facilities. In the short-term, asset owners and tenants likely have already reviewed their lease obligations, including penalties for non-compliance. Longer term, once offices reopen, a space re-evaluation and updated workplace strategy would benefit many tenants, who will have considerable space options but may choose to stay in place with a redesign of their suite.

FEDERAL PROCUREMENT SPENDING
WASHINGTON METRO AREA (1980–2019)



Source: Consolidated Federal Funds Report, NKF Research, The Stephen S. Fuller Institute, USAspending.gov, U.S. Census Bureau; April 2020

MULTIFAMILY

The region's multifamily investors face challenges, as the economic hardship that many renters are enduring may affect the cash flow from certain assets in the short term. However, eviction and unemployment protections are built into the CARES Act, which should help renters who are impacted by layoffs or business closures; similarly, direct payments to individuals under certain income thresholds will assist with rental payments. Although those provisions do not directly help asset owners, renters having more cash to fulfill their obligations and stay in their homes is best for both parties in the long run.

Early data has shown that despite expected employment disruptions and economic uncertainty from the COVID-19 pandemic, renters are renewing existing leases early. This may be partially due to some large owners and operators offering renewals with no increases, but the economic circumstances may limit relocations and could lead to some recoupling of renters into roommate situations. This is a dramatic shift from recent trends, as uncoupling has bolstered apartment absorption and occupancy rates around the metro area as millennials moved into the next phases of their personal lives and careers. That said, **Class B assets likely are lifted by the prospect of a downturn.** Further, the Washington market traditionally has led the nation out of recessions, as it did in 2010 when absorption was a robust 14,000 units, **thus enhancing the resilience of local apartment assets** and attracting potential renters from other metro areas. Regional occupancy, at approximately 96%, has been comparable to the national rate over the past several years; it likely will remain at or above the national level during the balance of the year. **Parts of the region best insulated from job losses, including the healthcare corridor in Montgomery County and the technology corridor connecting Arlington, Tysons and Reston, are likely to feature the best multifamily investment opportunities in the period ahead.**

As with the region's office market, development projects that were already underway will likely deliver, perhaps with some of the 40,000 units delayed; however, projects that are yet to break ground may be stalled or scrapped altogether in an uncertain economic climate. Delivery of new units while fewer tenants are able to move or afford the luxury product in the pipeline could extend lease-up periods. The new supply may also force asset owners to increase concession packages, lowering effective rents. Still, the safe harbor of the multifamily market relative to other asset classes and investment vehicles will buoy values in this property type during the volatility of the months ahead.

The brightest spot in the multifamily capital markets sector is the continued availability of debt provided through Fannie Mae and Freddie Mac. While both lenders are currently requiring operating reserve escrows at closing, there is ample liquidity in the market with the Federal Government continuing to purchase mortgage securities. Loans are still being quoted at sub-4% interest rates with special consideration being given to assets providing workforce or affordable housing.

ACTION STEPS AND OPPORTUNITIES: Ongoing economic uncertainty may push some potential homebuyers back into the rental market, making up for some losses and helping the multifamily market remain an attractive investment option. As operators closely track rental collections and renewals, the Washington metro area could offer more potential transaction opportunities compared with the region's peer markets, considering this area's better insulated employment base, which is bolstered by federal spending.

RETAIL

In a metro area that typically features high levels of income and discretionary spending, a shutdown of physical retail locations such as malls and theaters is a major hurdle for business owners of all sizes. With an unprecedented increase in unemployment claims in late March and again in early April, consumer spending will be impacted significantly, although e-commerce likely will get a boost as residents continue to practice social distancing. Federal relief checks sent directly to consumers will help spur spending, but the duration of the negative impact on the retail industry depends on how long it takes to contain the virus. Because the Washington market is among the nation's wealthiest—it has the nation's second-highest average household income—the local retail market may be less affected than many others, but the short-term damage remains significant.

The CARES Act provides a sizable business loan program, which could help small businesses remain open and continue to pay employees, or at least provide jobs for people to come back to once a sense of normalcy returns. Still, the region's retail industry likely will see the largest share of job losses, especially among hourly and tipped workers. However, centers featuring grocery stores, pharmacies, and other essential businesses have performed well throughout this cycle and are likely to remain appealing long-term investments.

Partially alleviating the damage to the region's retail market is the federal government's guidance to lenders, which has encouraged them to cooperate with borrowers on payment plans, such as deferring payments and amortizing them across the months and years ahead. Lenders have generally been moving quickly and have been flexible; this collaborative approach will help retail centers stay afloat until the area's household income is once again able to support the local retail landscape.

Certain areas with a high concentration of national brands and flagship stores of credit tenants—such as Georgetown, City Center, National Harbor and Tysons—may be better equipped to handle a longer downturn due to the nature of their tenancy, while areas such as Bethesda, Old Town Alexandria, and Barracks Row may face stronger headwinds due to a higher concentration of independent retailers. (Many national brands are still asking asset owners for rent relief, either because they urgently need it or because they have the leverage to obtain it.) As the economy normalizes, the businesses that were able to survive the downturn may see a rapid bounce back as customers are eager to get out of their homes to eat and shop, but reduced levels of disposable income will remain a challenge for the balance of the year and into 2021.

ACTION STEPS AND OPPORTUNITIES: It may behoove investors and asset owners to do everything possible to help existing tenants weather this storm through measures such as temporary rent forgiveness or allowing for delayed payments, as it may be difficult to fill these spaces immediately after the shock of a downturn, no matter the length of the pandemic. In the longer term, **a focus on essential businesses such as groceries, pharmacies and urgent care locations may become an even more popular investment path.** Multifamily and office asset owners may also wish to collaborate with their ground-floor retail tenants, since those stores are an amenity that can help attract and retain renters and office tenants. Rent abatements and deferrals are the most likely strategy, but retail asset owners may wish to tie any forbearance to the level of relief the tenant can expect from federal programs. The early application of security deposits with a deferred obligation to replenish, or an extension of term in exchange for rent deferral, are other potential options.

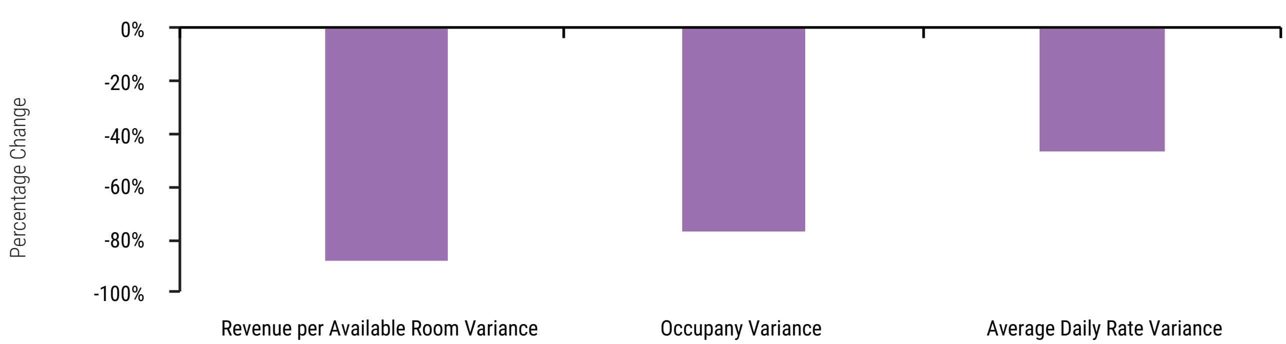
HOSPITALITY

The leisure and hospitality industry, one of the largest employers in the region with more than 330,000 direct employees, has been the hardest hit during this pandemic in terms of economic output. With many open hotels now experiencing occupancy rates in the high-single digits, many owners have temporarily closed their hotels, with more than 50 known hotel closures in the District of Columbia. Occupancy, average daily rate (ADR) and revenue per available room (RevPAR) are all down substantially over the past few weeks (see adjacent graph), and this trend is likely to continue beyond the end of social distancing. Travel expenditures (both business and leisure) are likely to remain reduced for some time due to the economic implications of the outbreak and the expected slower ramp-up of cancelled group business.

The District of Columbia saw $7.8 billion in tourism spending in 2018—the most recent complete data set available—with 27% of that coming from international visitors, leading to $851 million in tax revenue. The significant disruption in transient travel will have a meaningful impact on the region's hospitality market. To help mitigate the damage, the hotel industry will have access to $350 billion of potentially forgivable loans through the small-business rescue program in the CARES Act. Hotels are eligible for loans of up to $10 million, which can be used to pay for salaries and benefits, mortgage or rent, utilities and existing debt. Additionally, the airline industry, which services the domestic and international tourism the region relies on, will see $25 billion in grants to be used exclusively to pay employees' salaries, wages and benefits. There is also an additional $25 billion in loans available. **At the local level, the District of Columbia's Office of Tax and Revenue has deferred the payment deadline for real property taxes covering the first half of 2020** for hotels and motels from March 31 to June 30. This deferment gives local lodging establishments greater flexibility to weather a cash crunch.

ACTION STEPS AND OPPORTUNITIES: Although hotels are enduring substantial disruption to their business—especially in markets such as Washington that are major tourist and convention draws—lodging is likely to experience a material bounce in demand once the outbreak has been contained. Economic uncertainty may slow the return of leisure travel in the mid-scale sector, but **business travel may return sooner as executives seek to reconnect with their clients.** Additionally, there has been a gradual resumption of economic activity and hotel market recovery following the containment of the coronavirus in China. Mainland China's daily hotel occupancy reached an absolute level of 31.8% on March 28, up from a low of 7.4% during the first week of February. Smith Travel Research now shows that 87% of the hotels in its Mainland China sample are open for business after a majority of properties had closed over the previous two months.

HOTEL MARKET METRICS: WASHINGTON METRO AREA
PERCENTAGE CHANGE FROM COMPARABLE WEEK THE YEAR PRIOR | WEEK OF MARCH 22–28, 2020



Source: NKF Research, STR; April 2020

HOSPITALITY (CONTINUED)

Similar to multifamily asset owners, hotel owners may seek to update hotel design and shared amenity spaces to better withstand future illness outbreaks or major economic disruptions. If capital is available, this period may also present an opportunity for renovation while occupancy is low; **portions of the region that are proximate to economic drivers but have substantial outdated inventory, such as National Landing, may be especially well served to renovate during this period.** While the equity markets are reacting daily to a highly distressed operating environment, the private markets are flush with capital and poised to take advantage of the dislocation. For those who have the enviable position of liquid balance sheets and access to capital, opportunities will emerge within their own portfolios via loan buybacks and discounted payoffs (DPOs) as select lenders look for liquidity. **We expect a flight to quality by international investors into major U.S. markets like Washington, especially if at a discount to previous pricing levels.** Moreover, the slowing of traditional asset sale marketing processes will allow offshore investors to be more responsive. Equally important, their reliance on domestic operating partners will increase given the ongoing travel restrictions.

INDUSTRIAL

Although Washington's commercial real estate market is not as reliant on its industrial sector as are major metros with large ports, the region's commercial real estate industry places a value premium on certain segments of the industrial market. Northern Virginia, and specifically its Dulles Corridor—famously referred to as data center alley—is home to server farms that support some of the world's largest companies. The coronavirus pandemic, through its displacement of American office workers, has put a strain on networks across the country. **Open space on which to build in Northern Virginia creates an opportunity to expand data center complexes,** making the area even more attractive to that segment of the market. There is little data center land remaining in Loudoun County, but exurban areas offer more opportunity. The Baltimore-Washington Corridor and I-95 Corridor cater to the more common functions of the industrial sector. Access to major interstates, rail lines and airports make those corridors logisitics, warehouse and distribution hubs.

Nearly 10 million people call the greater Baltimore-Washington metropolitan area home, making distribution space vital. Quick access to other major metros, both north and south of the region, make **Baltimore-Washington industrial assets an integral element of the nation's supply chains.**

ACTION STEPS AND OPPORTUNITIES: E-commerce, already an indispensable resource, has become even more vital to the American consumer. Quick delivery of essential goods is now even more necessary due to stay-at-home orders during the pandemic. However, even after the coronavirus is contained, **it is likely that some new online shopping habits will persist, enhancing further the value of close-in distribution space.** Greater demand for this space may make industrial warehouses, particularly those with **cold-storage capability, a valuable commodity on the investment sales market.** The technology sector may see even more value in expanding network and data center capacity as some office-using firms extend their remote work programs into a more normal function of the employee experience, even after the pandemic has ended. Finally, the CARES Act specifically provides $16 billion for the strategic national stockpile of pharmaceutical and medical supplies. While some of this supply will likely come from foreign sources, there has been renewed national interest in harnessing domestic production to produce the most essential medical supplies and drugs. **Investors in Suburban Maryland and the Baltimore-Washington Corridor are particularly well positioned to take advantage of such an increase in production.**

LOOKING **FORWARD**

Newmark Knight Frank's professionals stand ready to advise our clients on how COVID-19 may affect their business activities. We invite our clients to call on us for guidance and to visit our **NKF COVID-19 Perspectives** page and our **NKF Washington Metro Area Market Reports** page for more commercial real estate market information and actionable intelligence. We wish you and your families the best of health.

Sources: AFIRE, *Bisnow*, Bloomberg, Chmura, Cooley LLP, CoStar, Destination DC, JD Supra, NKF Research, Real Capital Analytics, Stephen S. Fuller Institute, STR, *The Wall Street Journal*, *Washington Business Journal*, *The Washington Post*, *USA Today*

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