District of Columbia Office Market

Overall Recovery Moderates; Class A Supports Demand Growth

The District of Columbia's office market softened modestly in the first quarter of 2022, exhibited by asking rent compression and net occupancy losses. The office market has improved from its position one year ago, but the momentum achieved in the fourth quarter of 2021 has slowed. Although quarterly occupancy was negative, inventory contraction resulted in a stabilized vacancy rate, measuring 17.4%. Leasing activity decelerated modestly in the quarter, particularly among the largest footprint tenants. No leases in excess of 100,000 square feet were signed in the first quarter. Relatively low demand continues to apply downward pressure to asking rents, particularly for commodity-grade and Class B assets.

The moderating of recovery momentum in the first quarter may reflect cyclical seasonality; however, public health conditions related to the pandemic were particularly volatile as well. The rate of transmission of the Omicron variant broke records in early January and just as rapidly contracted in February. The District lifted its proof of vaccination requirement for restaurants and other private businesses on February 14th and its indoor mask mandate was lifted on March 1st. This development will make returning to offices more feasible for employers and approachable for employees. Despite the headwinds of the pandemic in early 2022, several return-to-office metrics indicate a slow but steady return of workers to offices, at least on a part-time basis.

Current Conditions

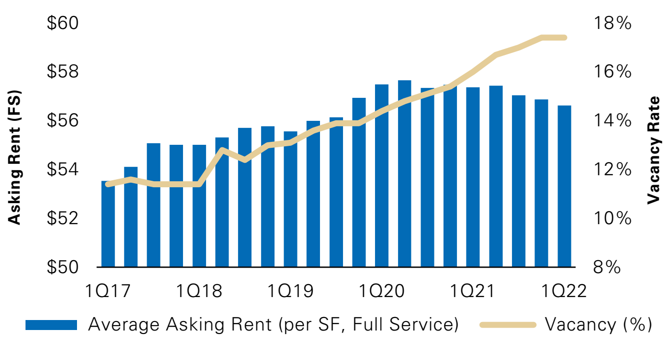
- The District of Columbia recorded negative 178,966 square feet of net absorption in the first quarter of 2022. This is a reversal of the trend toward positive occupancy recorded over the preceding 6 months.
- Tenant movement has been increasing in recent months, though most relocations involve downsizing and consolidations, which are resulting in net-negative occupancy shifts for most office occupiers.
- The vacancy rate has risen 140 basis points from a year ago to 17.4%. Vacancy has been steady since the fourth quarter, due in part to inventory contraction by way of conversion and owner-user sales.
- Asking rents fell for the third consecutive quarter to $56.63/SF, as the prolonged nature of the pandemic pressures landlords to reduce asking rents.

Market Summary

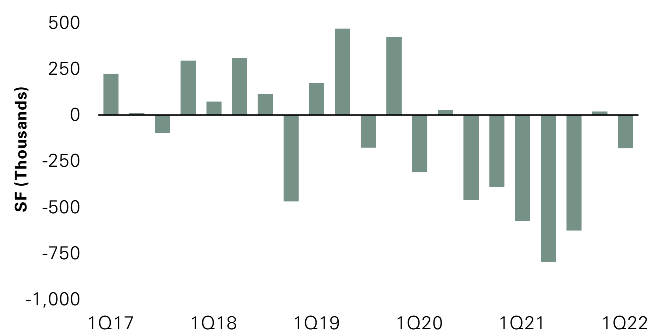
	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	131.2 M	131.4 M	130.8 M	↑
Vacancy Rate	17.4%	17.4%	16.0%	→
Quarterly Net Absorption (SF)	-178,966	20,450	-574,792	↑
Average Asking Rent/SF	$56.63	$56.88	$57.37	→
Under Construction (SF)	1.4 M	1.4 M	2.0 M	↓
Deliveries (SF)	0	688,373	227,948	↑

Market Analysis

ASKING RENT AND VACANCY RATE



NET ABSORPTION



Net absorption was negative 178,966 square feet in the first quarter. This marks a slowing of the occupancy momentum gained in late 2021; however, net occupancy was bifurcated in the first quarter. Consistent with the long-term trend of flight to quality, most occupancy losses were in lower-class assets. Net absorption in Class B/C buildings measured negative 408,178 square feet, compared to Class A buildings, where net absorption was 250,458 square feet. In addition to flight to quality, many tenants are consolidating their footprint when moving to higher-quality buildings, resulting in net-negative occupancy on balance.

The largest relocation of the quarter was Wiley Rein, which contracted by 150,000 square feet in moving from two buildings on K Street to 2050 M Street. The IRS and PwC also underwent large consolidations. Although some tenants may see the period ahead as an opportunity to reduce space, others have grown and are demanding more space. Morning Consult, a decision analytics firm, has grown from less than 10,000 square feet to over 50,000 square feet in its recent relocation to 1025 F Street, NW.

Vacancy measured 17.4% in the first quarter; steady from last quarter, but up 140 basis points from one year ago. Although net demand was negative, inventory contraction resulted in stable vacancy. Office inventory can contract in several ways, including when a building is purchased by an owner-user. The sale of 111 Massachusetts Avenue, NW to Georgetown University resulted in its removal from inventory. While owner-occupied acquisitions are uncommon, office conversions may also cause inventory contraction, particularly in period ahead. 111 Massachusetts Avenue is also expected to undergo a conversion for academic uses. The District's proposed office conversion pipeline measures 1.6 million square feet and developers remain active in the market, seeking additional candidates for conversion.

No construction projects delivered this quarter. The District's construction pipeline measures 1.4 million square feet, all of which is anticipated to deliver by year-end. The District's construction pipeline is 63.7% preleased. Additionally, no new projects broke ground in the first quarter. It is anticipated that 1700 M Street, NW will break ground in 2022, marking the District's first ground-up office building to commence construction since late 2019.

Average asking rents fell in the first quarter to $56.63/SF, measuring $0.74/SF below year-ago rents. After holding steady for much of the pandemic, asking rents have begun to wear under the prolonged stress of the low-demand market. Effective rents are also under downward pressure, as elevated vacancy yields generous concessions for tenants looking for new space.

Return to Office Momentum Grows

For many office occupiers with plans to return to the office in early 2022, the emergence of the Omicron variant resulted in delayed reboarding plans. Although infection rates reached a peak in January, community spread moderated by late February, which permitted the elimination of most pandemic-related restrictions in the region. The District lifted its proof of vaccination requirement for restaurants and other private businesses on February 14th and its indoor mask mandate was lifted on March 1st.

Companies with plans to institute a required return-to-office have faced major hurdles over the last six months, despite the improved public health conditions. With fewer logistical challenges in 2022, employers may view returning to the office as more feasible and employees may find it more approachable. However, for most firms, a hybrid schedule is likely, which will require employees in the office less than five days a week. A growing number of large and noteworthy firms have begun to publicly disclose return-to-work policies and timelines. The region's largest tenant, the federal government, has also begun preparing employees for a return to the office. In his State of the Union address, President Bident highlighted the federal government's commitment to be a leader in bringing workers back to offices nationwide.

Notable 1Q 2022 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
Foley & Lardner	3000 K Street, NW	Georgetown	Renewal	95,000
PhRMA	670 Maine Avenue, SW	Southwest	Direct Lease	76,470
Investment Committee Institute	1401 H Street, NW	East End	Renewal	62,580
Booz Allen Hamilton	20 M Street, SE	Capitol Riverfront	Renewal	60,219
Milbank	1850 K Street, NW	CBD	Renewal	53,860

Notable Recent Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
655 New York - Partial Interest 49%	East End	$388,738,560	$1,033	376,320*
Sentinel Square III	NoMa	$305,000,000	$560	545,000
1015 Half Street SE	Capitol Riverfront	$220,750,000	$556	396,000
77 P Street NE	NoMa	$201,750,000	$589	342,411

*Square footage representative of the share of interest purchased in building

Each federal agency will dictate its own return-to-office plans, but like private firms, many government entities are expected to permit more lenient hybrid and telework arrangements based on employee need and function. For some agencies, like the Drug Enforcement Administration and the Department of Agriculture, a phased recall of employees began this quarter. Other departments should soon follow suit but are likely to give employees at least one month of advance notice.

Space Flexibility Drives Demand in Dynamic Climate

Given the expected uncertainty in office space needs, tenants returning to real estate planning are prioritizing flexibility. Prior to COVID-19, coworking was a major growth sector for the District's office market. However, its growth and financial stability was disrupted by the pandemic, due in part to the short-term nature of its membership plans. Some asset owners anticipated the post-pandemic desirability of coworking and supported the industry by establishing management agreements and constructing landlord-operated coworking and spec suite complexes with shared common areas.

In the first quarter, Industrious announced the planned opening of three locations, totaling over 105,000 square feet, and Venture X announced a new 36,217 square-foot location in the East End. Given the lack of leasing activity among coworking providers over the last two years, these announcements show optimism for new demand, particularly among small tenants. The greater acceptance of remote work could be additionally advantageous for coworking providers looking to capture a broader cross section of members. In late 2021, the GSA approved five coworking providers that can be contracted by federal agencies for flexible work needs. This indicates the GSA's willingness to embrace a decentralized workforce, but it could also accelerate the government's long-term trend of portfolio densification.

District of Columbia Outlook

Recovery of the District's office market slowed in the first quarter but resisted significant softening. Despite the emergence of Omicron, conditions improved by February and allowed the removal of the District's mask and vaccine mandates. These restrictions had been significant hurdles for firms looking to reboard employees. Assuming no major regression in public health conditions, more firms are expected to begin reboarding employees in the coming months. The federal government's large share of local employment will ensure that federal agencies are viewed as market leaders in dictating return-to-office plans.

Leasing activity modestly slowed in the first quarter, but pent-up demand has been loosening. Bifurcated market conditions are expected in the future, as flight to quality draws occupancy from Class B to Class A assets. Consolidations and hybrid work are likely to result in net-negative occupancy. Vacancy will be further challenged by the 1.6 million square feet of new construction expected to deliver in 2022. The pipeline is 63.7% preleased, but most tenants relocating to these buildings will largely be consolidating from elsewhere in the District. Newmark Research projects that the vacancy rate will reach 18.0% by March 2024. Given the supply-demand imbalance, asking rents are expected to remain under pressure. Average rents have been falling since mid-2021, due to the prolonged duration of the pandemic and slow leasing conditions. While large rent contraction is not anticipated, particularly in high-quality assets, the surplus of supply will ensure that tenants maintain considerable leverage in lease negotiations. Effective rents will stay under downward pressure, caused by generous landlord concession packages.

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	2019 Absorption (SF)	2020 Absorption (SF)	2021 Absorption (SF)	1Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**131,150,033**	**16.2%**	**17.4%**	**890,479**	**-1,131,361**	**-1,977,052**	**-178,966**	**-178,966**
Class A	87,780,426	14.7%	15.9%	1,799,698	-41,565	-75,322	250,458	250,458
Class B	38,852,488	19.8%	21.1%	-628,279	-819,242	-1,725,051	-431,887	-431,887
Class C	4,517,119	14.4%	15.1%	-280,940	-270,554	-176,679	2,463	2,463

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	1Q 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**131,150,033**	**$61.76**	**$48.48**	**$56.63**	**0**	**0**	**1,445,742**
Class A	87,780,426	$61.76	NA	$61.76	0	0	1,445,742
Class B	38,852,488	NA	$48.48	$48.48	0	0	0
Class C	4,517,119	NA	NA	$47.55	0	0	0

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

Submarket Statistics—All Classes

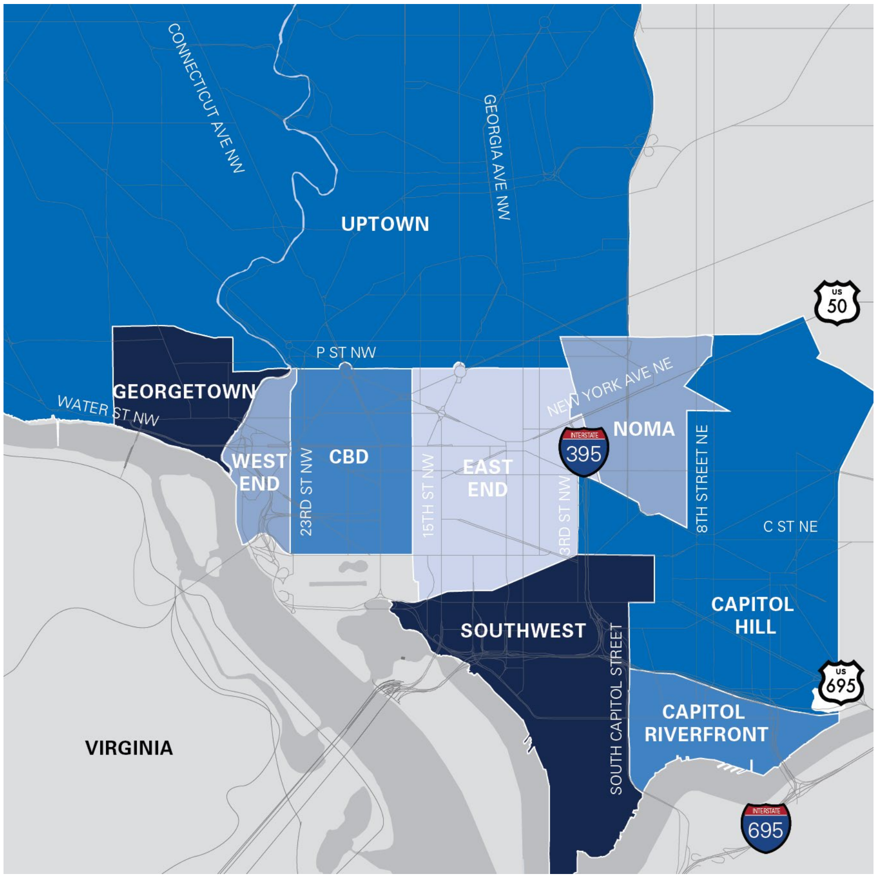
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2019 Absorption (SF)	2020 Absorption (SF)	2021 Absorption (SF)	1Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**131,150,033**	**16.2%**	**17.4%**	**890,479**	**-1,131,361**	**-1,977,052**	**-178,966**	**-178,966**
Capitol Hill	5,430,603	21.7%	22.6%	5,188	169,977	-156,782	-72,369	-72,369
Capitol Riverfront	4,595,428	13.4%	16.0%	-835	93,635	88,926	16,499	16,499
Central Business District	41,633,441	18.4%	19.9%	-443,715	-738,606	-1,062,582	-218,089	-218,089
East End	42,827,344	18.0%	19.3%	-67,881	-557,417	-458,016	251,227	251,227
Georgetown	2,851,274	15.5%	17.2%	-94,973	-7,392	-126,538	-12,254	-12,254
NoMa	11,860,648	7.8%	8.4%	750,211	592,186	-366,110	-135,122	-135,122
Southwest	11,953,807	10.2%	10.5%	695,064	-568,116	373,321	-59,648	-59,648
Uptown	5,964,404	17.4%	17.8%	215,990	-34,521	-379,174	48,080	48,080
West End	4,033,084	11.0%	12.0%	-168,570	-81,107	109,903	2,710	2,710

Submarket Statistics—All Classes

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	1Q 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**131,150,033**	**$61.76**	**$48.48**	**$56.63**	**0**	**0**	**1,445,742**
Capitol Hill	5,430,603	$70.63	$52.37	$62.51	0	0	178,324
Capitol Riverfront	4,595,428	$58.67	NA	$58.67	0	0	127,633
Central Business District	41,633,441	$62.71	$49.59	$57.22	0	0	438,180
East End	42,827,344	$64.11	$48.67	$59.01	0	0	0
Georgetown	2,851,274	$59.27	$44.63	$49.96	0	0	0
NoMa	11,860,648	$50.69	$48.79	$50.06	0	0	0
Southwest	11,953,807	$50.51	$46.11	$49.16	0	0	639,703
Uptown	5,964,404	$49.71	$43.23	$44.65	0	0	61,902
West End	4,033,084	$65.34	$51.48	$58.61	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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