RESEARCH Q2 2022

District of Columbia Office Market

New Deliveries and Demand for Quality Steer Market Fundamentals

The District of Columbia's office market fundamentals showed signs of modest growth in the second quarter of 2022. Average asking rents increased for the first time in twelve months, and net absorption reached a two-year high. These improved fundamentals were partly supported by 1.2 million square feet of new construction deliveries. Although this inventory expansion boosted some market fundamentals, it also caused vacancy to rise to 18.2% due to net-new vacant space. Total square footage leased in the District modestly slowed for the second quarter in a row. Despite increased activity among small users, leasing among tenants larger than 50,000 square feet has been sluggish through the first half of 2022.

Demand remains strongest for the District's highest-quality assets. The pre-pandemic trend of downsizing and flight-to-quality continues to apply pressure on commodity-grade and Class B assets. This is particularly true as return-to-office momentum builds and firms begin re-engaging in real estate planning. Despite improved health conditions, the pace of office market recovery has been less aggressive. Recent return-to-office momentum has been largely supported by the federal government and its 194,200 District-based employees. Federal agencies were instructed to begin planning and scheduling the return of employees to offices, at least on a hybrid basis, beginning in the second quarter. The government's role as a leading employer should catalyze back-to-work momentum in the private sector in the coming months.

Current Conditions

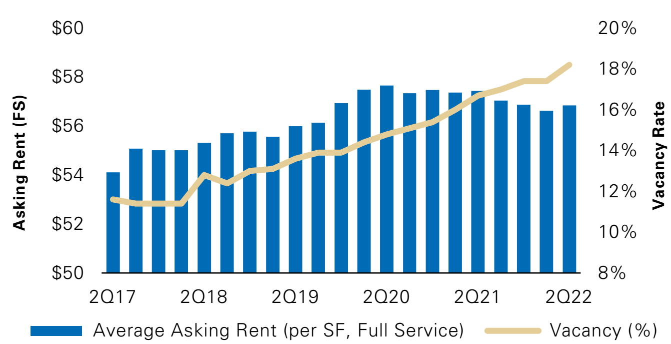
- The District of Columbia recorded 54,505 square feet of net absorption in the second quarter of 2022. Year-to-date net absorption measures negative 142,011 square feet, however two of the last three quarters have registered positive occupancy.
- The vacancy rate rose 80 basis points over the last quarter to 18.2%. The sudden increase in vacancy can be largely attributed to the 1.2 million square feet of new construction deliveries, which directly added 539,877 square feet of net-new vacant space to the market.
- Average asking rents measured $56.85/SF in the second quarter, marking the first quarter-over-quarter increase in a year. Newly-delivered office product is a factor in driving average asking rents, however rent compression is still common in lower-class and commodity-grade space.

Market Summary

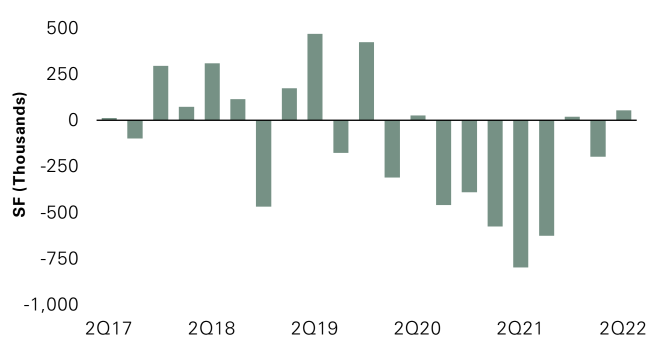
	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	132.1 M	131.2 M	130.8 M	→
Vacancy Rate	18.2%	17.4%	16.7%	→
Quarterly Net Absorption (SF)	54,505	-196,516	-797,568	→
Average Asking Rent/SF	$56.85	$56.63	$57.44	↑
Under Construction (SF)	580,083	1.4 M	2.0 M	→
Deliveries (SF)	1.2 M	0	0	↓

Market Analysis

ASKING RENT AND VACANCY RATE



NET ABSORPTION



Net absorption measured 54,505 square feet in the second quarter of 2022, marking a two-year high. Positive occupancy was supported by newly delivered office product in the Class A and Trophy segments. Class A net absorption measured 272,406 square feet, while Class B and C net absorption measured negative 217,901 square feet. Occupancy losses among lower-quality buildings were less severe than in prior quarters, however, tenant demand continues to be tilted to higher-quality assets. Over the last year, about 80.0% of all leases transacted greater than 10,000 square feet were in Class A buildings. In addition to flight-to-quality, many tenants are consolidating their footprints when moving to higher-quality buildings, resulting in net-negative occupancy on balance.

Quarterly vacancy measured 18.2%, up 80 basis points from first-quarter 2022 and up 150 basis points in the last year. Although net demand was positive, inventory expansion by way of new construction resulted in an increase in the District's overall vacancy. This rise in vacancy was anticipated due to the aligned schedules of several large deliveries, including Phase II of The Wharf and 2100 Pennsylvania Avenue. While these projects delivered over 1.2 million square feet of highly-demanded, top-quality space, they also applied a sizeable weight to supply. The District's vacancy rate is likely to remain elevated in the near term given the relatively slow leasing environment.

The District construction pipeline measured 580,083 square feet in the second quarter of 2022, marking its smallest pipeline in decades. Buildings currently under construction are 44.5% preleased and another 234,925 square feet is expected to deliver by year-end. A more modest construction pipeline will help to ease vacancy by steering leasing activity to existing assets. While the pandemic has presented unique short and long-term challenges to the office market, some alternate asset types have exhibited more upside. These fundamentals have increased investor and developer attention to consider the value of office conversions. Since 2021, 1.3 million square feet of underperforming and high-vacancy office space has been removed from inventory for conversion to alternate uses. Further, 2.4 million square feet of proposed conversions are planned in the District, which potentially could result in a reduction in vacancy measuring about 150 basis points as these buildings are formally converted to non-office uses.

Average asking rents in the second quarter of 2022 measured $56.85/SF, equating to a $0.22/SF increase from last quarter, but a $0.59/SF decrease from one year ago. Continued slow demand has caused downward pressure on asking rents, but there is optimism in the Class A market, which recorded quarter-over-quarter rent growth of 0.4%, a post-pandemic high. Effective rents remain under downward pressure, as elevated vacancy yields generous concessions for tenants looking for new space.

New Construction Deliveries Skew Market Trends

Quarterly deliveries measured over one million square feet for the first time in three years. This rapid influx of inventory boosted vacancy both through the delivery of new unoccupied space, and separately, vacant space left by tenants relocating to new construction. Buildings which delivered in the second quarter directly added 539,877 square feet of net-new vacant space to the market and indirectly contributed to 596,665 square feet of vacant space in older buildings through tenant relocations.

Among buildings which delivered in the second quarter, net absorption measured 665,693 square feet, due to the move-ins of Wilmer Hale at 2100 Pennsylvania Avenue, NW, Williams & Connolly at The Wharf, and the American Trucking Association at 80 M Street, SE. Though these tenants largely consolidated their footprints upon relocating, their contractions were relatively modest. Excluding the impact of these tenant relocations from the District's net absorption produces an adjusted second-quarter net absorption of negative 14,469 square feet.

Notable 2Q 2022 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
GSA – Department of Justice	555 4th Street, NW	East End	Direct Lease	331,000
Bank of America	1800 K Street, NW	CBD	Renewal/Expansion	117,874
Psychiatric Institute of Washington	4228 Wisconsin Avenue, NW	Uptown	Renewal	67,500
Blue Cross Blue Shield Association	750 9th Street, NW	East End	Direct Lease	63,782
Finsbury Glover Hering	1299 Pennsylvania Avenue, NW	East End	Direct Lease	60,904

Notable Recent Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
1900 N Street, NW	CBD	$265,000,000	$976	271,433
2300 N Street, NW	West End	$152,750,000	$546	280,000
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

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

Despite the construction-fueled rise in vacancy, net occupancy in buildings unaffected by new deliveries was effectively neutral. Overall leasing activity has been modest in recent quarters, which should temper expectations for large occupancy gains in the near term. Positively, large tenant give-backs have been less common and sublease availability has similarly been stable in the District.

Return-to-Office Decouples from Public Health

Public health conditions improved significantly in the second quarter, which was anticipated to cause the rapid repatriation of offices. The pandemic remains a threat, however vaccines and other measures have been proven to permit a safe environment for many office workers. The FDA's second-quarter approval of vaccines for children as young as six months will enable more working parents to comfortably return to offices. Despite encouraging public health conditions, return-to-office momentum has been slower than anticipated. Several non-health factors, including a tight labor market, poor public transit reliability, cost of fuel, and a proven track record of productivity while working remotely has tilted return-to-office leverage to employees.

Return-to-office momentum will be getting a boost from the public sector. Federal agencies received a directive to begin planning to recall workers to offices, at least in a hybrid capacity. As the region's largest employer, this is a meaningful development in steering the private sector to adopt a similar timeline. Though many firms remain cautious, various surveys indicate that the majority of workers want to return to offices, but for fewer than five days per week. Leaders must consider more than public health for return-to-office planning, as employee retention, culture, productivity, and financial objectives are important variables. Consideration of these factors can complicate reboarding efforts and is leading some noteworthy local firms to delay return-to-office plans until after the summer.

District of Columbia Outlook

Recovery of the District's office market was effectively neutral in the second quarter of 2022. The District's office market fundamentals were steered by the delivery of over 1.2 million square feet of newly constructed space. These deliveries contributed to both the District's modestly positive net absorption and its rise in vacancy. Given a relatively small construction pipeline moving forward, Newmark Research projects the vacancy rate to decrease to 17.9% by June 2024.

Newly constructed Trophy and high-Class A buildings are likely to perform well in a quality-focused demand environment. Lower-quality and commodity-grade assets are anticipated to remain challenged by the oversupply, elevated vacancy, and preference for top-quality space in the District. This bears out in the District's investment sales market, which has been exceptionally quiet for traditional multi-tenant assets. Though dry powder is available, most investors are focused on single tenancy, high WALT, and elite quality. Alternatively, conversion-focused investors are targeting the most challenged office assets seeking value pricing. In aggregate, the District's office investment pricing is down as the market continues to adjust to the challenged conditions.

Though some green chutes are emerging regionally, market fundamentals in the District are soft. Asking rents may continue to modestly appreciate, particularly in high-quality assets, but oversupply will ensure that tenants achieve generous concession packages in the period ahead. Landlord competition for tenancy will apply downward pressure on effective rent across most building classes.

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)	2Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**132,133,765**	**17.1%**	**18.2%**	**890,479**	**-1,131,361**	**-1,977,052**	**54,505**	**-142,011**
Class A	88,985,942	15.7%	16.8%	1,799,698	-41,565	-75,322	272,406	505,314
Class B	38,630,704	20.5%	21.8%	-628,279	-819,242	-1,725,051	-217,228	-649,115
Class C	4,517,119	14.6%	15.1%	-280,940	-270,554	-176,679	-673	1,790

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 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**132,133,765**	**$62.03**	**$48.27**	**$56.85**	**1,205,516**	**1,205,516**	**580,083**
Class A	88,985,942	$62.03	NA	$62.03	1,205,516	1,205,516	580,083
Class B	38,630,704	NA	$48.27	$48.27	0	0	0
Class C	4,517,119	NA	NA	$46.98	0	0	0

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

Submarket Statistics—All Classes

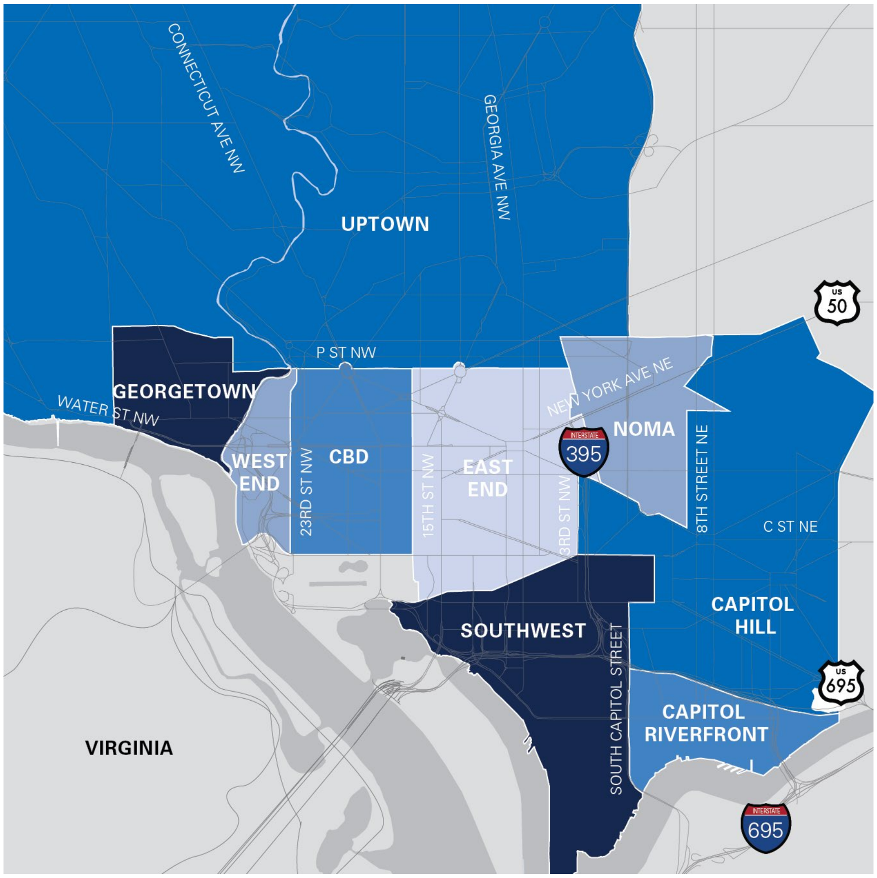
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2019 Absorption (SF)	2020 Absorption (SF)	2021 Absorption (SF)	2Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**132,133,765**	**17.1%**	**18.2%**	**890,479**	**-1,131,361**	**-1,977,052**	**54,505**	**-142,011**
Capitol Hill	5,394,334	23.0%	24.2%	5,188	169,977	-156,782	-81,399	-101,611
Capitol Riverfront	4,723,061	13.2%	16.3%	-835	93,635	88,926	94,406	110,905
Central Business District	41,886,106	19.5%	21.0%	-443,715	-738,606	-1,062,582	-89,402	-282,029
East End	42,827,344	18.6%	19.6%	-67,881	-557,417	-458,016	-44,451	111,607
Georgetown	2,851,274	16.7%	17.6%	-94,973	-7,392	-126,538	-12,397	-24,651
NoMa	11,860,648	8.00	8.5%	750,211	592,186	-366,110	-8,058	-143,180
Southwest	12,593,510	13.0%	13.2%	695,064	-568,116	373,321	231,711	172,063
Uptown	5,964,404	17.4%	18.0%	215,990	-34,521	-379,174	-9,965	38,115
West End	4,033,084	12.3%	12.6%	-168,570	-81,107	109,903	-25,940	-23,230

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 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**132,133,765**	**$62.03**	**$48.27**	**$56.85**	**1,205,516**	**1,205,516**	**580,083**
Capitol Hill	5,394,334	$72.81	$52.37	$63.86	0	0	178,324
Capitol Riverfront	4,723,061	$59.31	NA	$59.31	127,633	127,633	0
Central Business District	41,886,106	$62.79	$49.68	$57.36	438,180	438,180	336,289
East End	42,827,344	$64.18	$47.82	$58.84	0	0	0
Georgetown	2,851,274	$59.33	$44.84	$49.60	0	0	0
NoMa	11,860,648	$50.80	$49.01	$50.28	0	0	0
Southwest	12,593,510	$51.17	$46.46	$49.72	639,703	639,703	0
Uptown	5,964,404	$49.81	$40.16	$43.28	0	0	65,470
West End	4,033,084	$65.32	$51.10	$58.19	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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