RESEARCH Q3 2022

District of Columbia Office Market

Slow Leasing Drives Negative Occupancy; Rent Contraction Moderates

The District of Columbia's office market fundamentals continued to soften through the third quarter of 2022. Slow leasing activity in recent quarters resulted in net absorption returning to contractionary levels in the third quarter and persistent upward pressure on vacancy. Average asking rents have held relatively steady in 2022, marking a divergence from the downward trend set in 2021. Asking rent stability is encouraging, given the District's shrinking construction pipeline, which is limiting the influence of high-priced, net-new inventory on overall rents. Still, leasing activity remained low in the third quarter, and additional rent contraction may be common in some Class B and commodity-grade buildings. Furthermore, landlord competition remains high, leading to sustained downward pressure on effective rents by way of elevated concession packages.

Office recovery remained slow for much of the third quarter; however, many firms set Labor Day as the date on which employees would begin to return to offices, at least in a hybrid capacity. This trend bears out in Kastle Systems data, which shows DC's occupancy averaging 38.1% of pre-pandemic occupancy in July and August but rising to 45.5% in the week after Labor Day. As firms re-occupy offices, decision makers will collect more data points from which to assess future workplace needs and begin reengaging in real estate planning. The federal government, DC's largest employer, has not been cohesive in its efforts to recall employees, though non-essential federal workers have been slowly returning throughout the summer.

Current Conditions

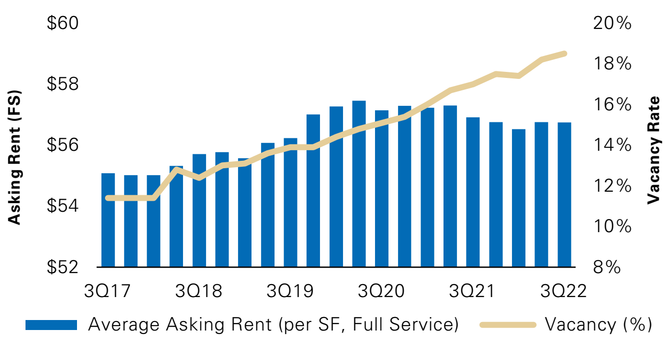
- The District of Columbia recorded negative 252,305 square feet of net absorption in the third quarter of 2022. Year-to-date net absorption measures negative 290,774 square feet. Sustained low leasing volume is likely to suppress absorption gains over the next six months
- The vacancy rate rose 150 basis points over the last year to 18.5%. This is reflective of steady occupancy contraction; however, DC's construction pipeline has fallen to just 580,083 square feet, which will reduce the effect of inventory expansion on rising vacancy.
- Average asking rents measured $56.74/SF in the third quarter and have been relatively stable in 2022. This seemingly breaks the downward trend in asking rents experienced through 2021. Still, low leasing activity is driving rent compression in lower-class and commodity-grade spaces, and effective rents are similarly under downward pressure.

Market Summary

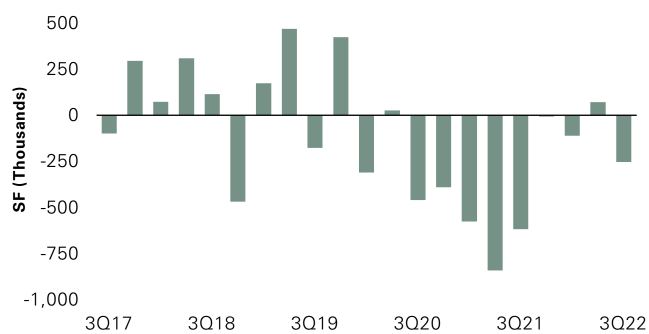
	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	132.0 M	132.1 M	130.7 M	→
Vacancy Rate	18.5%	18.3%	17.0%	→
Quarterly Net Absorption (SF)	-252,305	71,191	-616,797	↑
Average Asking Rent/SF	$56.74	$56.76	$56.91	→
Under Construction (SF)	580,083	580,083	2.1 M	→
Deliveries YTD (SF)	1.2 M	1.2 M	266,139	↑

Market Analysis

ASKING RENT AND VACANCY RATE



NET ABSORPTION



NEWMARK

Net absorption measured negative 252,305 square feet in the third quarter of 2022, its most negative level since third-quarter 2021. Absorption had been supported by new deliveries from late 2021 to mid-2022; however, as the construction pipeline has slowed, its positive influence on occupancy has lessened. Flight-to-quality trends continue to benefit Class A occupancy. In the third quarter, Class A net absorption measured 126,911 square feet, while Class B and C net absorption measured negative 379,216 square feet. This trend is also consistent with year-to-date net absorption, as Class A absorption measured positive 815,767 square feet and Class B and C measured negative 1,106,541 square feet.

Quarterly vacancy measured 18.5%, up 20 basis points from second-quarter 2022 and up 150 basis points in the last year. Class A vacancy, aided by noteworthy positive net absorption, decreased by 10 basis points on the quarter, measuring 16.7%. Given consistently low demand over the last two years, even modest contraction in vacancy is encouraging. Conversely, Class B vacancy has risen by 110 basis points over the last quarter. Class B vacancy remains elevated through the third quarter, though growing developer interest in office conversions could help moderate Class B fundamentals. Over the last 12 months, 1.7 million square feet of Class B assets have sold in the District with the intent of non-office conversion or redevelopment. However, none of these properties have commenced construction, and therefore remain a weight on Class B office fundamentals. Should all these properties commence conversion, their removal from office inventory could result in up to a 350 basis-point reduction in the District's Class B vacancy rate.

The District's construction pipeline, which excludes renovations and owner-occupied developments, measured 580,083 square feet in the third quarter, unchanged from the second quarter and at its lowest level in decades. Buildings currently under construction are 56.1% preleased, and 113,126 square feet is expected to deliver by year-end. The only office project to deliver in the quarter was the renovated headquarters of the International Baccalaureate Organization (IBO) at 3950 Wisconsin Avenue, NW. This former headquarters to Fannie Mae underwent a significant renovation as part of the City Ridge redevelopment project. Although the building formally delivered in the third quarter, IBO will not occupy until the fourth quarter.

Average asking rents in the third quarter of 2022 measured $56.74/SF, a $0.02 decrease from last quarter and a $0.17 decrease from one year ago. Continued slow demand has caused downward pressure on asking rents since the onset of the pandemic, but overall asking rent contraction has moderated in 2022. Additionally, there is optimism in the Class A market, which recorded year-over-year rent growth of 0.3%, an 18-month high. Still, effective rents remain under downward pressure, as elevated vacancy and overall low demand yields generous concessions for tenants looking for new space.

Shrinking Construction Pipeline Tightens Availability for Largest Occupiers

Construction activity in the District has reached its lowest level in decades, due to decreased demand and, more recently, increased cost of construction. This reduction in the supply of net-new inventory will assist in slowing vacancy growth and encourage tenants in the market to consider existing availabilities. However, the market's largest and most influential occupiers have long relied on new construction to satisfy their significant footprints when relocating. The contracting pipeline of active and planned construction projects could pose a challenge for large occupiers in the period ahead. Although overall availability is plentiful, given DC's 22.6% availability rate, occupiers looking for large blocks of space are faced with much tighter conditions. At the close of the third quarter, there were only 13 existing buildings in the District that could accommodate a 150,000 square-foot tenant.

Notable 3Q 2022 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
FINRA	1700 K Street, NW	CBD	Direct Lease	68,030
Van Ness Feldman	2000 Pennsylvania Avenue, NW	CBD	Direct Lease	44,649
Industrious	853 New Jersey Avenue, SE	Capitol Riverfront	Direct Lease	41,245
Mortgage Bankers Association	1919 M Street, NW	CBD	Renewal	34,560
AT&T	1120 20th Street, NW	CBD	Renewal	33,272

Notable Recent Sales Transactions

Building	Submarket	Sale Price	Price/SF	Square Feet
601 Massachusetts Avenue, NW	East End	$531,000,000	$1,109	478,883
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
1900 N Street, NW	CBD	$265,000,000	$976	271,433

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

During periods of market uncertainty, DC has been buoyed by large federal leasing requirements. This was particularly true in the years following the global financial crisis, during which large federal agencies played a significant role in spurring development in emerging submarkets like NoMa and the Capitol Riverfront. Currently, there are very few large federal requirements in the District, and while the market is lacking in large block availabilities to house such requirements, the government's reputation as a backstop for leasing during periods of uncertainty is less reliable than in prior recovery periods.

Access to Capital Tightens; Foreign Buyers Support Investment Sales

Rising inflation has led to significant economic uncertainty in 2022. In addition to rising prices, real estate investors have been affected by high interest rates and increased cost of capital. Further, some lenders are less certain about the value of office assets. This has created more hurdles for owners looking to refinance and elevate the quality of their assets to compete in the current market.

Although financial market conditions have affected many owners, foreign investors have been active locally. The District's three largest office acquisitions over the last year have involved foreign equity. Most recently, Mori Trust, a Japanese developer, acquired 601 Massachusetts Ave, NW, for $531.0 million, or $1,109/SF. This marks the District's largest sale of the year, exceeding 1900 N St, NW, which sold in June for $265.0 million to Commerz Real AG, a German firm. Real estate investment markets tend to benefit from periods of high inflation, and the District has a reputation for steady returns in periods of uncertainty. As inflation remains elevated and the U.S. dollar strengthens relative to other global currencies, safety-minded investors from abroad may seek the stability of DC's highest-quality office assets.

District of Columbia Outlook

The District's office market softened in the third quarter as market fundamentals continue to be heavily steered by the slow leasing environment. Growing economic headwinds have dampened activity among both investors and occupiers. Despite market uncertainty, Newmark Research projects modest tightening over the next 24 months, resulting in the vacancy rate decreasing to 18.4% by September 2024.

Flight to quality will remain the strongest market driver and newly constructed Trophy and high-end Class A buildings are likely to attract much of the demand in the period ahead. The impact of oversupply and pricing competition will present challenges to commodity-grade and Class B assets. Yet, low-quality Class A buildings may face more lasting threats, given the popularity of Class B conversions. Contracting Class B inventory could tighten fundamentals for the most cost-effective buildings. Continued slow leasing in the third quarter should temper expectations for strong occupancy gains in the coming quarters. Asking rents may modestly appreciate in high-quality assets, but low demand will ensure that generous concession packages remain common.

Like occupiers, investors have similarly exhibited an imbalanced appetite for office space. Office sales volume is heavily concentrated in top-quality assets, which generally feature large footprint tenants and high WALT. Uncertainty in financial markets will likely slow investment activity in the near term, particularly for value-add investments. Although headwinds persist, the District of Columbia's reputation as a strong investment market has supported noteworthy inbound foreign capital over the last year.

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)	3Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**132,031,725**	**17.2%**	**18.5%**	**890,479**	**-1,131,361**	**-2,037,381**	**-252,305**	**-290,774**
Class A	88,985,942	15.6%	16.7%	1,799,698	-41,565	-135,651	126,911	815,767
Class B	38,528,664	21.3%	23.1%	-628,279	-819,242	-1,725,051	-376,949	-1,106,064
Class C	4,517,119	14.6%	15.2%	-280,940	-270,554	-176,679	-2,267	-477

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	3Q 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**132,031,725**	**$62.01**	**$48.32**	**$56.74**	**0**	**1,077,883**	**580,083**
Class A	88,985,942	$62.01	NA	$62.01	0	1,077,883	580,083
Class B	38,528,664	NA	$48.32	$48.32	0	0	0
Class C	4,517,119	NA	NA	$46.88	0	0	0

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

Submarket Statistics—All Classes

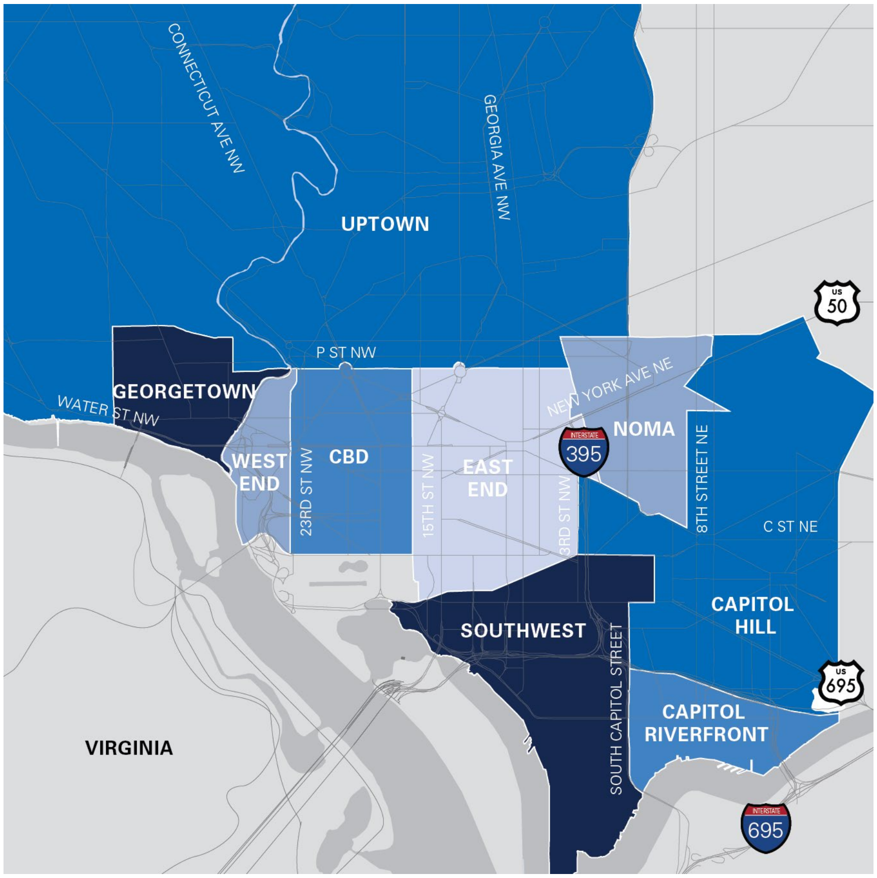
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2019 Absorption (SF)	2020 Absorption (SF)	2021 Absorption (SF)	3Q 2022 Absorption (SF)	YTD 2022 Absorption (SF)
District of Columbia	**132,031,725**	**17.2%**	**18.5%**	**890,479**	**-1,131,361**	**-2,037,381**	**-252,305**	**-290,774**
Capitol Hill	5,394,334	22.3%	23.4%	5,188	169,977	-156,782	44,599	-57,012
Capitol Riverfront	4,723,061	14.0%	16.1%	-835	93,635	88,926	38,043	245,634
Central Business District	41,784,066	19.2%	21.3%	-443,715	-738,606	-1,062,582	-34,919	-316,948
East End	42,827,344	19.3%	20.3%	-67,881	-557,417	-518,345	-227,674	-109,211
Georgetown	2,851,274	17.4%	17.8%	-94,973	-7,392	-126,538	-4,569	-29,220
NoMa	11,860,648	8.2%	8.9%	750,211	592,186	-366,110	-47,763	-190,943
Southwest	12,593,510	12.8%	12.9%	695,064	-568,116	373,321	27,903	199,966
Uptown	5,964,404	17.0%	17.6%	215,990	-34,521	-379,174	24,466	62,581
West End	4,033,084	10.7%	14.4%	-168,570	-81,107	109,903	-72,391	-95,621

Submarket Statistics—All Classes

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	3Q 2022 Deliveries (SF)	YTD 2022 Deliveries (SF)	Under Construction (SF)
District of Columbia	**132,031,725**	**$62.01**	**$48.32**	**$56.74**	**0**	**1,077,883**	**580,083**
Capitol Hill	5,394,334	$73.38	$53.19	$63.56	0	0	178,324
Capitol Riverfront	4,723,061	$59.54	NA	$59.54	0	0	0
Central Business District	41,784,066	$62.63	$49.77	$57.19	0	438,180	336,289
East End	42,827,344	$64.79	$47.62	$59.01	0	0	0
Georgetown	2,851,274	$58.63	$44.78	$50.08	0	0	0
NoMa	11,860,648	$50.88	$48.83	$50.29	0	0	0
Southwest	12,593,510	$51.12	$46.31	$49.66	0	639,703	0
Uptown	5,964,404	$50.28	$40.13	$43.49	0	0	65,470
West End	4,033,084	$57.22	$51.07	$53.96	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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