RESEARCH Q4 2021

District of Columbia Office Market

Late-Year Market Recovery Accelerates; New Deliveries Drive Occupancy

The District of Columbia's office market continued to show signs of modest recovery from the pandemic's worst effects. For the first time since the second quarter of 2020, the District recorded positive net occupancy. Although the move-ins have outweighed the move-outs over the last quarter, other market fundamentals remain pressured by the pandemic. Asking rents have contracted for the last two quarters and a wave of new deliveries increased vacant space in the market, causing the vacancy rate to rise 40 basis points on the quarter, despite occupancy growth.

Public health concerns remain a barrier for firms' return-to-office plans. Several factors have suppressed the pace of office reboarding in the fourth quarter; including variant spread and MetroRail's extended service reductions which began in October. Conversely, reasons for optimism have also risen throughout the quarter due to increased vaccination rates, approved vaccines for children and booster shot availability. Additionally, the District lifted its indoor mask mandate in November, but uncontrolled viral spread led to its temporarily reinstatement in late December. Office market recovery will be dependent on how and when firms return to offices, which remains uncertain. Given the District's concentration of federal and federally-related employees, the GSA's formal return-to-office guidance will be a catalyst for the market's reboarding timeline. As of the writing of this report, formal federal guidance has not been issued.

Current Conditions

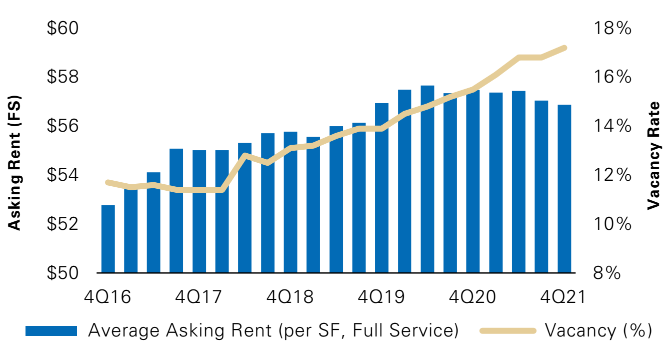
- The District of Columbia recorded 44,848 square feet of net absorption during the fourth quarter of 2021. This marks the first quarter of positive occupancy growth since second-quarter 2020.
- Annual net absorption in 2021 was negative 1,516,412, which exceeds that of 2020 year-end net absorption. Despite modest recovery in the second half of the year, the District recorded exceptionally large occupancy losses in the first half of 2021.
- The vacancy rate has risen 170 basis points from a year ago to 17.2%. Vacancy increased by 40 basis points from third-quarter due in part to net-new vacant space in newly-delivered buildings.
- Asking rents fell for the second consecutive quarter to $56.88/SF, as the prolonged pressure of the pandemic suppressed asking rents.

Market Summary

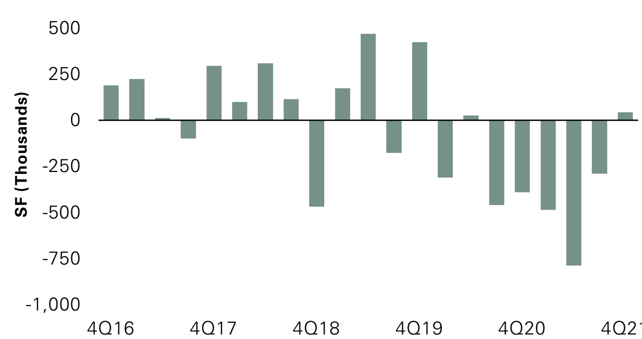
	Current Quarter	Prior Quarter	Year Ago Period	24-Month Forecast
Total Inventory (SF)	131.5 M	130.7 M	130.5 M	↑
Vacancy Rate	17.2%	16.8%	15.5%	→
Quarterly Net Absorption (SF)	44,848	-288,806	-389,812	↑
Average Asking Rent/SF	$56.88	$57.04	$57.48	→
Under Construction (SF)	1.4 M	2.1 M	2.2 M	↓
Deliveries (SF)	688,373	38,191	0	↓

Market Analysis

ASKING RENT AND VACANCY RATE



NET ABSORPTION



NEWMARK

Net absorption registered 44,848 square feet in the fourth quarter, bringing the year-end absorption to negative 1,516,412 square feet. Despite the modestly positive quarterly gain, year-end losses were over 25% greater than 2020. Marginally positive net absorption in the fourth quarter continues the trend of recovery; however, improved net absorption is largely supported by fewer move-outs, as opposed to more move-ins. Gross absorption has decreased in each of the last three quarters due to limited leasing activity, while on the other side of the net absorption equation, significantly less space has been "given back" by tenants over the last six months. While further consolidations are expected as firms reassess their office needs, space "give backs" made in reaction to the direct impacts of the pandemic appear to be dissipating

Vacancy increased in the fourth quarter, reaching 17.2%, up 40 basis points from third-quarter 2021 and 170 basis points from one year ago. Although net demand was positive on the quarter, several construction deliveries caused vacancy to rise. There were three deliveries in the quarter, which added 688,373 square feet to inventory and 447,417 square feet to vacancy. The District's construction pipeline currently measures 1.4 million square feet, excluding renovations, and is 48.1% pre-leased. This marks the District's smallest construction pipeline since late 2014. No new construction projects broke ground on the quarter.

Average asking rents fell in the fourth quarter to $56.88/SF, measuring $0.60/SF below year-ago rents. After holding steady for much of the pandemic, asking rents have begun to follow the softening market over the last six months. Effective rents remain under downward pressure, as elevated vacancy yields generous concession packages for tenants in the market for new space.

Demand for Quality Drives Late-Year Recovery

The District's Class A market continues to outperform Class B and support the market's recovery. Class A net absorption was 242,085 square feet in the fourth quarter, strongly supported by the delivery of Chemonics' new headquarters at 1275 New Jersey Avenue, SE. Quarterly net absorption of existing Class A assets was net-neutral, but some noteworthy gains were measured at 1025 F Street, NW (Morning Consult) and 400 Virginia Avenue SW (D.C. Government).

Both Class A and B markets have recorded improved demand growth over the last six months; however, the Class A has attracted a larger share of this demand. Over the last six months, Class A net absorption measured 49,185 square feet and Class B recorded negative187,394 square feet. Though Class B occupancy losses have softened, lower-quality buildings have struggled to compete for several years predating the pandemic, exhibited by Class B vacancy, which has risen from 8.0% to 19.6% over the last five years. Given tenant demand for high quality, competition among commodity-grade assets, and anticipated continued slow demand, Class B asset owners may want to consider their asset's strategic position, investment potential and alternative uses. Extracting peak value from inefficient buildings comes at a cost to both the developer and to Class B market fundamentals. Additionally, inflationary pressures created by supply chain constraints have made major construction endeavors increasingly costly and risky.

Construction Slows but Deliveries Pressure Vacancy

The District's construction cycle had been anticipated to wane in the early 2020s, even before the pandemic began. With the onset of the pandemic, limited demand and uncertainty led to a more rapid decline in new construction starts. Over the last 12 months, only two projects have broken ground, totaling 305,957 square feet. In the 10 years before the pandemic, new groundbreakings exceeded 1.0 million square feet annually in all but three years.

Although high-quality and recently constructed/renovated buildings command much of the current demand, developers remain cautious in undertaking new projects. Oversupply and competition are leading causes of the slowdown in new construction activity. Of the projects completed in fourth-quarter 2021, both Signal House at 350 Morse Street, NE and 699 14th Street, NW delivered 100% vacant. Signal House secured a 50,000-square-foot lease agreement with TikTok in the fourth quarter, but the space has not been occupied and the balance of the 214,501-square-foot building remains unleased.

Notable 4Q 2021 Lease Transactions

Tenant	Building	Submarket	Type	Square Feet
District of Columbia Government	1100 & 1104 4th Street, SW	Southwest	Renewal	543,798
Office of Justice Programs	810 7th Street, NW	East End	Extension	251,795
GSA – Department of Veterans' Affairs	425 Eye Street, NW	East End	Renewal	241398
Kaiser Permanente	700 2nd Street, NE	NoMa	Renewal	206,875
Gibson Dunn	1700 M Street, NW	CBD	Direct Lease	163,750

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*
Midtown Center - Partial Interest 49%	East End	$455,102,041	$1,070	425,150*
Sentinel Square III	NoMa	$305,000,000	$560	545,000
1015 Half Street SE	Capitol Riverfront	$220,750,000	$556	396,000

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

There are likely to be very few speculative (spec) ground breakings in the District in the coming quarters due to continued slow market conditions, performance of recently-delivered spec buildings, and current variability in construction pricing. Build-to-suit and preleased developments are much more likely to break ground due to their predictable future cash flows. In the fourth quarter, Gibson and Dunn announced a 163,750-square-foot build-to-suit prelease at 1700 M Street, NW and the SEC announced plans to relocate to a proposed development at 60 New York Avenue, NE. Both of these projects could reasonably break ground in 2022.

While market conditions are dampening developer appetite for traditional office buildings, some owners are looking to creatively redevelop or reposition office assets for a new or higher-value use. In 2021, 20 Massachusetts Avenue, NW and 4000 Wisconsin Avenue, NW, underwent conversions to become, respectively, a hotel and a large multi-family building. Additionally, the former office building at 515 22nd Street, NW was converted and delivered in the fourth quarter as a 153-unit multi-family building. This trend has caught the attention of the District Government, which launched an initiative to explore the impact of an incentive program aimed at encouraging owners of office assets to convert to multifamily. Conversion activity is likely to remain high as oversupply pressures asset pricing for outdated or less desirable office buildings, while other product types, like multi-family, provide higher potential value.

Office investment sales volume fell in the fourth quarter, measuring $623.6 million. The largest transaction of significance was a partial interest sale (49.0%) at 655 New York Avenue, NW. Brookfield and Douglas Development sold minority stake in the building to Rockwood Capital on behalf of Mertiz Alternative Investment Management for roughly $388.7 million, valuing the building at $1,033/SF. Although investment sales activity has been relatively quiet in 2021, assets that have transacted have been above-average in quality and pricing, which has helped to support the District's average price per square-foot rates. The District remains a long-term target for institutional capital due to its reputation for consistent and sturdy returns.

District of Columbia Outlook

The District of Columbia's office market inched further in its recovery in the fourth quarter. The Delta variant slowed the pace of recovery for much of the fall but did not result in significant degradation of quarterly market fundamentals. However, Delta did have an impact on slowing firms' return-to-office plans, a trend that may be prolonged due to the increase in infection rates in December and the emergence of the Omicron variant. While the true threat of Omicron is not known at the writing of this report, office occupiers are still likely to take a more cautious approach to re-boarding in early 2022.

Although the re-occupancy of many offices remains delayed, some pent-up demand has loosened in the quarter and boosted leasing activity. Office market fundamentals such as absorption and vacancy are lagging indicators however and therefore are expected to remain challenged, despite the improved leasing activity. Vacancy will additionally be pressured by space consolidations (particularly among federal and legal tenants), new deliveries/inventory expansion, and the greater prevalence of remote working. Newmark Research projects that the vacancy rate will reach 18.5% by December 2023. Given the supply-demand imbalance, asking rents are expected to remain under pressure through at least the first half of 2022. Average asking rents had held face value for much of the pandemic but began to marginally contract beginning mid-2021. While significant rent contraction is not anticipated, particularly in higher-quality Class A assets, the surplus of available supply will ensure that tenants maintain considerable leverage in lease negotiations. Effective rents will remain under downward pressure, a result of generous landlord concession packages, well into 2022.

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	2018 Absorption (SF)	2019 Absorption (SF)	2020 Absorption (SF)	4Q 2021 Absorption (SF)	YTD 2021 Absorption (SF)
District of Columbia	**131,450,091**	**16.0%**	**17.2%**	**56,303**	**890,479**	**-1,131,361**	**44,848**	**-1,516,412**
Class A	87,644,628	15.0%	16.3%	1,325,024	1,799,698	-41,565	242,085	29,320
Class B	39,258,344	18.2%	19.6%	-1,270,826	-628,279	-819,242	-132,935	-1,369,053
Class C	4,547,119	14.4%	15.1%	2,105	-280,940	-270,554	-64,302	-176,679

Market Statistics By Class

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	4Q 2021 Deliveries (SF)	YTD 2021 Deliveries (SF)	Under Construction (SF)
District of Columbia	**131,450,091**	**$62.10**	**$48.64**	**$56.88**	**688,373**	**954,512**	**1,445,742**
Class A	87,644,628	$62.10	NA	$62.10	688,373	954,512	1,445,742
Class B	39,258,344	NA	$48.64	$48.64	0	0	0
Class C	4,547,119	NA	NA	$47.05	0	0	0

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

Submarket Statistics—All Classes

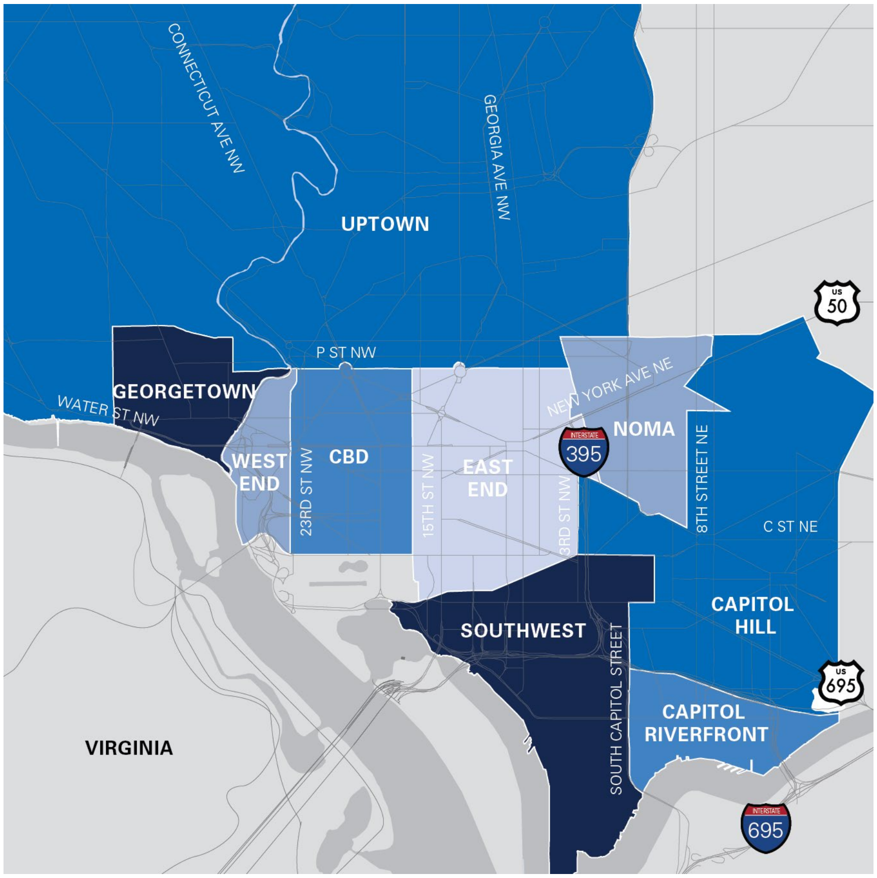
	Total Inventory (SF)	Direct Vacancy Rate	Overall Vacancy Rate	2018 Absorption (SF)	2019 Absorption (SF)	2020 Absorption (SF)	4Q 2021 Absorption (SF)	YTD 2021 Absorption (SF)
District of Columbia	**131,450,091**	**16.0%**	**17.2%**	**56,303**	**890,479**	**-1,131,361**	**44,848**	**-1,516,412**
Capitol Hill	5,430,603	21.1%	22.2%	141,019	5,188	169,977	13,843	-156,782
Capitol Riverfront	4,595,428	13.8%	16.4%	242,861	-835	93,635	212,914	88,926
Central Business District	41,666,876	17.8%	19.3%	494,740	-443,715	-738,606	-266,414	-1,062,582
East End	42,827,344	17.7%	19.2%	-170,534	-67,881	-557,417	123,924	2,624
Georgetown	2,851,274	15.0%	16.7%	-107,899	-94,973	-7,392	-9,351	-126,538
NoMa	12,127,271	8.7%	9.2%	39,048	750,211	592,186	-8,764	-366,110
Southwest	11,953,807	9.8%	10.0%	164,964	695,064	-568,116	59,005	373,321
Uptown	5,964,404	18.1%	18.6%	-750,950	215,990	-34,521	-100,208	-379,174
West End	4,033,084	10.7%	12.0%	3,054	-168,570	-81,107	19,899	109,903

Submarket Statistics—All Classes

	Total Inventory (SF)	Class A Asking Rent (Price/SF)	Class B Asking Rent (Price/SF)	Overall Asking Rent (Price/SF)	4Q 2021 Deliveries (SF)	YTD 2021 Deliveries (SF)	Under Construction (SF)
District of Columbia	**131,450,091**	**$62.10**	**$48.64**	**$56.88**	**688,373**	**954,512**	**1,445,742**
Capitol Hill	5,430,603	$71.26	$52.30	$62.85	214,501	214,501	178,324
Capitol Riverfront	4,595,428	$58.05	NA	$58.05	330,000	557,948	127,633
Central Business District	41,666,876	$62.96	$49.76	$57.51	0	0	438,180
East End	42,827,344	$64.45	$48.61	$59.34	143,872	143,872	0
Georgetown	2,851,274	$58.56	$44.46	$48.56	0	0	0
NoMa	12,127,271	$50.91	$50.26	$50.65	0	38,191	0
Southwest	11,953,807	$50.55	$46.11	$49.18	0	0	639,703
Uptown	5,964,404	$49.82	$44.09	$45.03	0	0	61,902
West End	4,033,084	$67.18	$52.08	$60.36	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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