Newmark Knight Frank

THOUGHT LEADERSHIP SERIES

THE RISE OF SPEC SUITES:

AN ANALYSIS OF SPECULATIVE OFFICE SPACES IN THE WASHINGTON METRO AREA

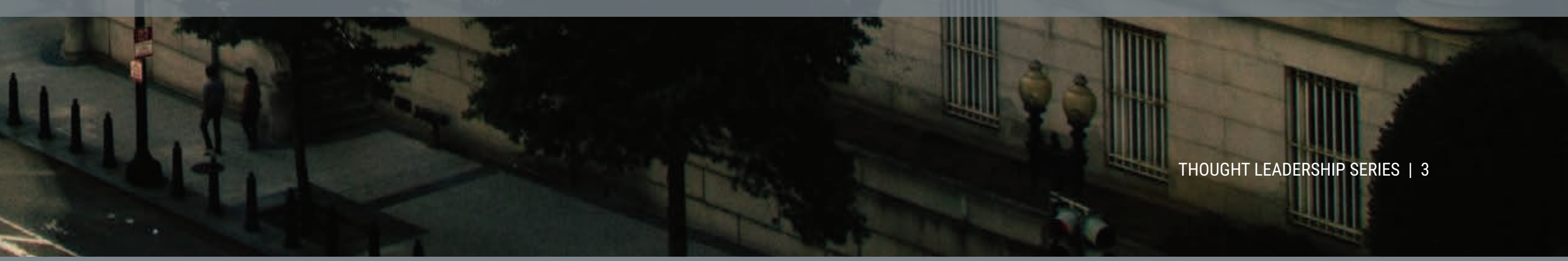
OCTOBER 2018

MET SQUARE • WASHINGTON, DC

TABLE OF CONTENTS

KEY FINDINGS

- Speculative office suites—move-in-ready office spaces that are built-out and designed by the property owner in advance of a tenant signing a lease—have become increasingly popular in the Washington metro area and other markets. Notably, the number of spec suites available in the CBD and East End submarkets of the District of Columbia has more than doubled in the past 18 months.
- Spec suites are beneficial for both owners and tenants as they allow owners to market space more efficiently and allow tenants to move in right away, potentially with more flexible lease terms. Tenants do not have to endure the process of securing permits and supervising a build-out.
- Spec suites lease up considerably more quickly than space that is not built-out: 3.4 months on average compared with 16.5 months for customized space.
- The added flexibility and shorter lease terms that come with spec suites allows owners to charge a premium, with average achieved rents 10-20% higher for spec suites than for customized space.
- The build-out costs for spec suites and customized space are essentially the same, since the hard and soft costs for an owner to build a spec suite—$80-$120 per square foot in the District of Columbia and $50-$70 per square foot in the suburbs—are comparable to the average tenant improvement allowances in those markets.



MET SQUARE • WASHINGTON, DC

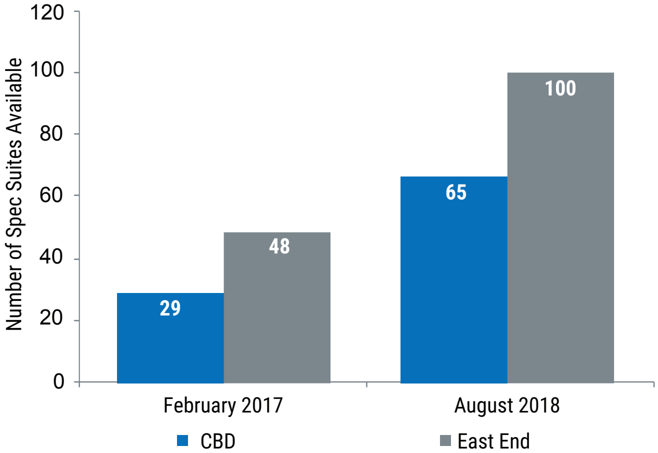
I. THE RISE OF SPEC SUITES

Speculative office suites, or spec suites, are move-in-ready office spaces that are built-out and designed by the property owner in advance of a tenant signing a lease. This is in contrast to the more traditional arrangement whereby a tenant tours a space in shell (unimproved) condition and then designs the space to its specifications once a lease is negotiated. When the practice of building spec suites started in the commercial real estate industry, it was a strategy used to make small, less appealing office spaces more marketable. However, in the past several years, the competitive office environment in the region has allowed spec suites to become a standard practice.

The office vacancy rate in the Washington metro area registered 16.2% at the second quarter of 2018—270 basis points above the national rate of 13.5%—and vacancy has been elevated across the Washington metro region for the past several years. As a result, tenants have a breadth of options when seeking office space, so building owners are seeking ways to stand out from the competition. At the same time, the region's sublease vacancy rate stands at only 0.8%, meaning tenants seeking move-in-ready space—and who may normally consider subleases—have fewer options to consider.

These factors combine to make spec suites an increasingly popular option for both owners and tenants. Over the past 18 months, there has been a marked increase in the number of spec suites available in the Washington metro area, particularly in the core submarkets. For example, as shown in the adjacent chart, between February 2017 and August 2018, the number of spec suites available in the CBD and East End submarkets of the District of Columbia increased by 124% and 108%, respectively.

INCREASE IN SPEC SUITE AVAILABILITY
SPEC SUITES AVAILABLE IN CBD AND EAST END FEBRUARY 2017 VS. AUGUST 2018



Source: CoStar, NKF Research; October 2018

In the Washington metro area, and particularly in Northern Virginia, government contractors are finding spec suites to be an especially appealing option since contract awards, contract duration and staffing totals are often in flux. Washington Real Estate Investment Trust (WashREIT) recently launched a spec suite concept called Space+, which aims to compete with coworking space. The program offers flexible lease terms and move-in turnaround time as short as 24 hours. WashREIT sees government contractors as a prime target for this program, since it can offer near-immediate space availability and more privacy than coworking space.

Traditionally, spec suites have often been on the lower floors of a building and have been smaller in square footage, topping out at about 5,000 square feet. Recently, however, owners have been expanding spec suites to larger blocks of space and even full floors to capitalize on their growing appeal. Boston Properties recently launched a full-scale renovation of the 670,000-square-foot 655 15th Street NW (Metropolitan Square) which includes several spec suites, some as large as 19,000 square feet.

MET SQUARE • WASHINGTON, DC

Spec suites are a mutually beneficial arrangement for tenants and owners. Fully built-out space can be more marketable since owners can choose which part of the space to highlight, potentially by using appealing lighting or finishes, and which parts to minimize, like less-than-ideal views or window lines. Tenants benefit because they can tour the space without having to visualize a layout that does not yet exist, and can move in more quickly, often with more flexible lease terms.

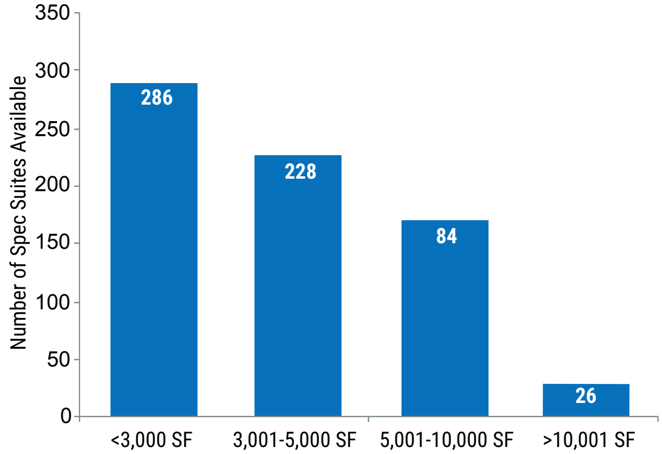
Spec suites appeal to a wide variety of tenants. The faster move-in process and more flexible lease terms are a fit for growing companies that have uncertainty regarding future expansion or contraction of their staffs. In particular, spec suites appeal to rapidly growing companies that have outgrown coworking space and need additional space and privacy, yet are not ready to commit to a long-term lease. Spec suites are a natural fit for these tenants as they provide the flexibility and immediate turnaround needed while still offering the look and amenities that the expanding younger workforce is seeking. Locally, MRP Realty recently instituted a practice of building several smaller spec suites around a shared amenity space. This replicates the appeal of coworking while offering tenants more privacy and customization.

225 REINEKERS • ALEXANDRIA, VA

II. AVAILABILITY OF SPEC SUITES IN THE WASHINGTON METRO AREA

As of August 2018, there are approximately 624 spec suites available in the Washington metro area. While some owners are offering larger suites to meet the growing needs of a variety of tenants, smaller spec suites are still the norm. The majority of available spec suites are between 1,000 and 5,000 square feet, with an average size of 3,679 square feet. As shown in the adjacent chart, 514 spec suites, or 82%, are 5,000 square feet or less, and 286, or 46%, are 3,000 square feet or less. A robust construction pipeline has created stiff competition in the Washington metro area office market and made it more difficult for some existing properties to sign larger tenants, many of whom have already signed leases for newly constructed space—even with their current lease expirations as far as five years away. As a result, owners have found spec suites to be an effective way to target smaller office tenants who find the flexible lease terms and move-in-ready suites appealing—and who are still in the market for their next homes.

SPEC SUITE SIZE RANGE
WASHINGTON METRO AREA
AUGUST 2018



Source: CoStar, NKF Research; October 2018

The number of available spec suites in each jurisdiction in the Washington metro area generally aligns in relative proportion to the size of each office market. Northern Virginia, with an office

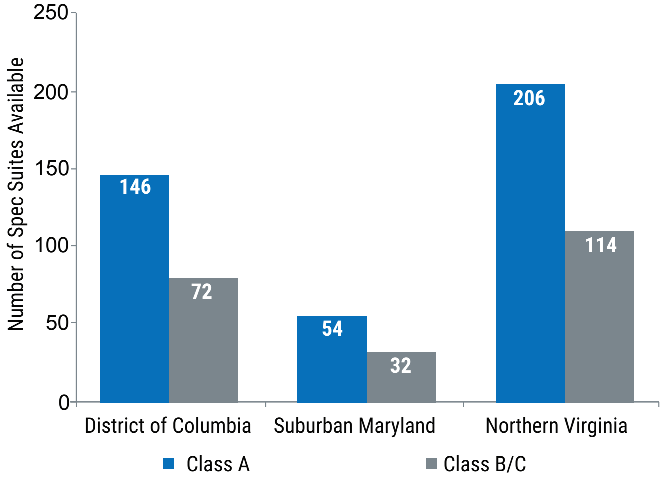
MET SQUARE • WASHINGTON, DC

inventory of 164 million square feet, has the greatest number of available spec suites at 320. The District of Columbia, with an office inventory of 127 million square feet has 218 available spec suites. Suburban Maryland, a smaller market with only 75 million square feet of office space, has 86 available spec suites. With increased funding for defense in the latest federal budget, an uptick in office space demand from government contractors is likely, further adding to the growing demand for spec suites. As a result, the region is likely to see more spec suites in the coming years aiming to capture this demand, particularly in the 8,000-square-foot and greater range, compared with today's more common 5,000-square-foot or smaller range.

The Washington metro area's office market continues to reflect a flight to quality, as tenants are seeking well-located, highly amenitized space. This trend holds true with regard to spec suites, as spec suite availability in Class A space outnumbers Class B/C space at a nearly 2-to-1 ratio across all three jurisdictions.

MET SQUARE • WASHINGTON, DC

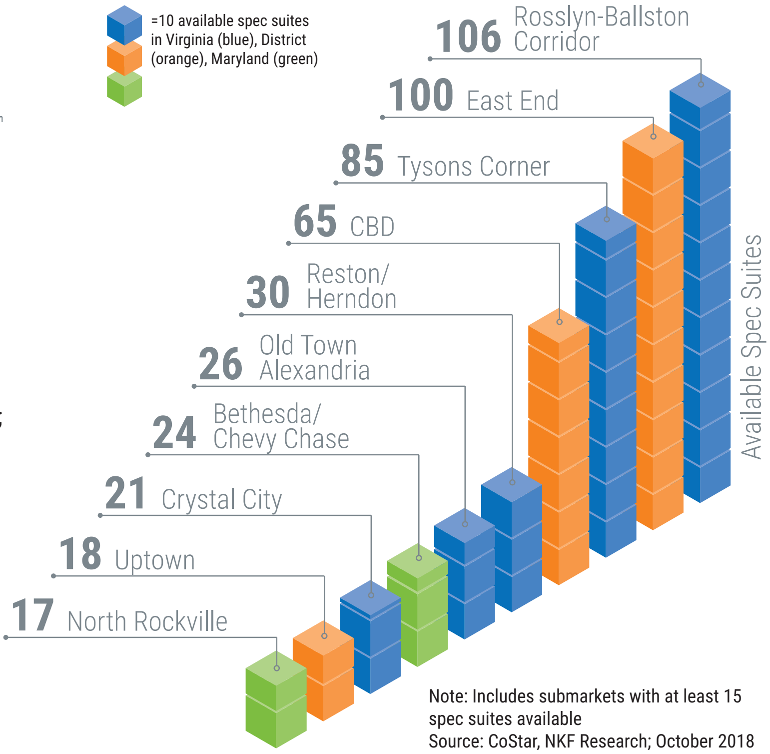
SPEC SUITE AVAILABILITY BY CLASS
WASHINGTON METRO AREA
AUGUST 2018



Source: CoStar, NKF Research; October 2018

Spec suites tend to be most heavily concentrated in the largest core submarkets within each jurisdiction. Notably, 62% of all available spec suites in the Washington metropolitan area are located within just five submarkets: The Rosslyn/Ballston Corridor, Tysons Corner, and Reston/Herndon in Northern Virginia; and the East End and Central Business District in the District of Columbia. These core submarkets lead the region in recent development and demand, and thus represent the greatest opportunity to successfully market spec suites.

SPEC SUITE AVAILABILITY BY SUBMARKET
WASHINGTON METRO AREA
AUGUST 2018



Note: Includes submarkets with at least 15 spec suites available
Source: CoStar, NKF Research; October 2018

WILLOW OAKS • MERRIFIELD, VA

III. FINANCIAL CONSIDERATIONS: COST COMPARISON OF SPEC SUITES VERSUS CUSTOMIZED SPACE

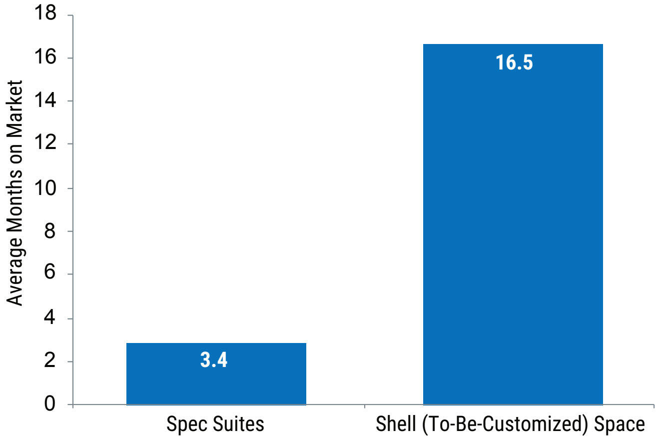
Spec suites are becoming increasingly popular in the Washington metro area's office market, but how do their construction costs compare with tenant-directed build-out of shell space? We quantified the differences between spec suite construction and shell space build-out to address these questions:

- *Do spec suites lease faster than shell (to-be-customized) space?*
- *Can owners get a premium for spec suites?*
- *How do build-out costs compare?*

An analysis comparing District of Columbia spec suites to similarly sized shell spaces—the best data available for such a comparison—found the average time to lease-up is much faster for spec suites. Spec suites were on the market for an average of 3.4 months before being leased, while shell spaces smaller than 7,500 square feet took 16.5 months on average to lease. Of note, some spec suite spaces were on the market as shell space or with a relet build-out before the space—and the listing—was converted to a spec suite.

For owners, the difference in time on market is evidence that spec suites eliminate much of the downtime involved in getting a tenant in place. Many tenants have a difficult time visualizing what an office space will look like once it is built-out, thus making spec suites more marketable. Additionally, many tenants in today's downtown market are looking for space that is move-in-ready, and do not have the six months to a year that may be required to build-out office space. In some local jurisdictions, it can take as long as 90 days to get a permit for an interior build-out, a timeframe that does not line up with many tenants' business needs.

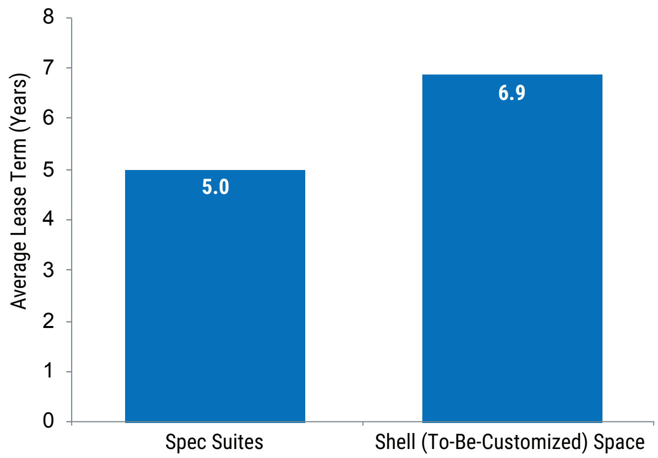
TIME ON MARKET COMPARISON
DISTRICT OF COLUMBIA OFFICE SPACES 7,500 SF AND SMALLER | 2015 - 2018



Source: CoStar, NKF Research; October 2018

Many of today's tenants also are seeking greater flexibility, including shorter lease terms, which is something many spec suite owners offer. An analysis of spec suite leases in the Washington metro area compared to customized space leases in a similar size range found that spec suite deals averaged a 5.0-year lease term compared with a 6.9-year average lease term for customized space transactions.

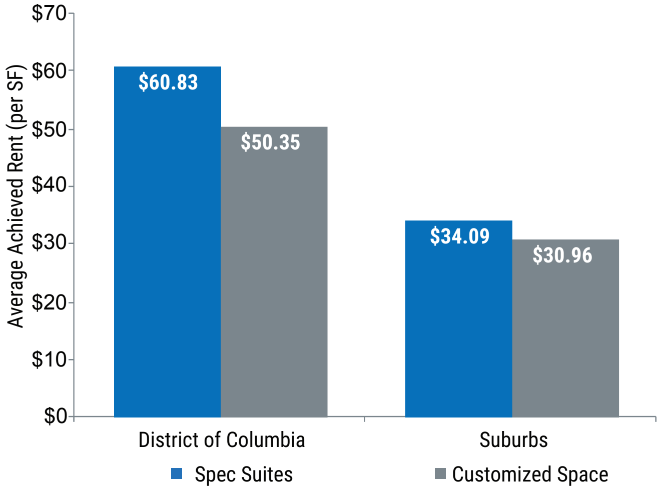
LEASE TERM COMPARISON
WASHINGTON METRO OFFICE SPACES 7,500 SF AND SMALLER | 2015 - 2018



Source: CoStar, NKF Research; October 2018

The additional flexibility and shorter lease terms for spec suites mean property owners often can charge a rent premium. Since rents vary significantly between downtown and the suburbs, we compared rents between spec suites and customized space separately for the two jurisdictions. For leases in the District of Columbia, spec suites achieved markedly higher rents than customized space. While customized space transactions smaller than 7,500 square feet had an average achieved rent of $50.35 per square foot, spec suite transactions averaged a $60.83 per square foot achieved rent, 20.8% higher. The trend for suburban space was similar. In an analysis of deals in Suburban Maryland and Northern Virginia, spec suites averaged a $34.09 per square foot achieved rent, 10.1% higher than customized space, which averaged a $30.96 per square foot achieved rent.

ACHIEVED RENT COMPARISON
WASHINGTON METRO OFFICE LEASES 7,500 SF AND SMALLER | 2015 - 2018



Source: CoStar, NKF Research; October 2018

When comparing the build-out costs between spec suites and customized space, the differences are negligible. Local market experts estimate the total build-out costs for spec suites—including design, wiring, cabling, furniture, and basic upgrades like a flat screen TV in the conference room—range from $80.00-$120.00 per square foot in the District of Columbia and $50.00-$70.00 per square foot in the suburbs. These costs are comparable to the average tenant improvement allowances in these jurisdictions, making the build-out costs for owners essentially the same whether they do a spec deal or lease shell space for customization. The main difference between the two types of deals is the average lease term. Many owners are hesitant to lease customized space with a term of less than five years because it is difficult for them to recoup the costs of building out the space in such a short timeframe. If the space is a spec suite, on the other hand, it is less customized to a particular tenant and the landlord is often able to make a quick upgrade when the tenant moves out, such as painting and re-carpeting the space. In turn, the space is positioned to re-lease faster.

In summary, build-out costs for an office owner tend to be similar between spec suites and customized space, but since rents are higher and time on market is shorter, it makes sense from an owner's perspective to build spec suites. Owners do bear some risk in building out spec suites, however, as the upfront costs will not be recouped if the space never leases. Meanwhile, spec suites are a great option for tenants who need move-in-ready space and are willing to pay a premium for shorter, more flexible lease terms.

IV. IMPLICATIONS FOR OWNERS AND TENANTS

The findings in this study have implications for both office property owners and tenants. Which actions might they take to best advantage themselves in the spec suite market?

Implications for Owners:

- Spec suites can help market the least desirable space within a building, since built-out space allows a landlord to accentuate the positives of the space, like high quality finishes, and minimize the negatives, such as limited window lines.

- Many of today's tenants are seeking shorter, more flexible lease terms, and are willing to pay a premium to get them. Spec suites are a way to provide the flexibility today's tenants are seeking while still leasing space in a way that make sense financially for the property owner.

- The upfront costs of building a spec suite create some risk for owners, but those costs are comparable to what tenants are likely to demand in improvement allowances should the space be leased in shell condition. As a result, the risk/reward proposition is more favorable to owners than it seems at first glance, especially if they are able to reduce the concession package (rent abatement) on the shorter lease term.

- Because of the considerable new supply now under construction in the Washington area, more owners are considering spec build-outs in some of their assets in order to differentiate their properties and appeal to a new segment of the market—making the spec landscape more competitive. In particular, building out larger spec suites to address the potential increase in demand for turnkey space from government contractors could be a practical strategy, considering the coming increase in federal defense spending in the Washington area. Government contractors have few options for quick move-ins once they receive an award, as the region's sublease rate is 0.8 percent, near the cyclical low.

WATERGATE • WASHINGTON, DC

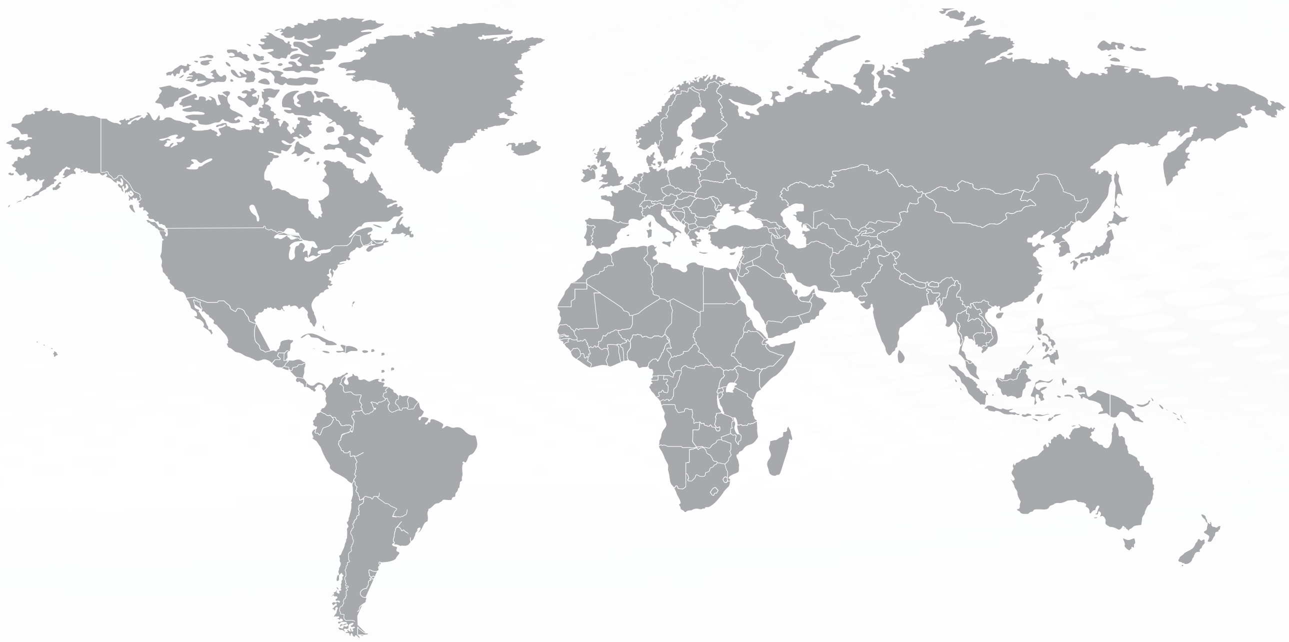
Implications for Tenants:

- Spec suites are a good option for tenants who need space that is turnkey and that comes with flexible lease terms. Leases for spec suites, on average, are nearly two years shorter than leases for customized space.
- However, tenants should be aware that this flexibility comes at a premium, with spec suite rents 10-21% higher than rents for customized space.
- Tenants who are less interested in—or who do not have the time or resources to navigate—design details of their space may find spec suites to be a good alternative. However, spec suites are not right for every tenant. Those seeking a customized look and functionality likely will prefer traditional shell space, rather than the open landscape and open plenum builds of most spec suites.
- Tenants who lease spec space may wish to view a short-term lease as a trial period in a certain property, with the potential to expand if the building proves to be a good fit for their business needs.

SOURCES:

In addition to consulting with local market experts and Newmark Knight Frank's proprietary database of lease comparables and building data, sources include:

- ***BISNOW***
- ***BUILDING DESIGN+CONSTRUCTION***
- **COSTAR**
- ***WASHINGTON BUSINESS JOURNAL***



Washington, DC
1899 Pennsylvania Ave NW
Suite 300
Washington, DC 20006
202.331.7000

Tysons
1410 Spring Hill Road
Suite 600
McLean, VA 21202
410.625.4200

Gregory H. Leisch, CRE
Senior Managing Director,
Market Research
gleisch@ngkf.com

Alexander (Sandy) Paul, CRE, LAI
Senior Managing Director,
National Research
apaul@ngkf.com

Bethany Schneider
Associate Director
bschneider@ngkf.com

Nick Schlanger
Senior Research Analyst
nick.schlanger@ngkf.com

Jordan Schott
Senior Research Analyst
jordan.schott@ngkf.com

Kevin Sweeney
Senior Research Analyst
kevin.sweeney@ngkf.com

North America
Canada
United States

Latin America
Argentina
Brazil
Chile
Colombia
Costa Rica
Dominican Republic
Mexico
Peru
Puerto Rico

Asia Pacific
Australia
Cambodia
China
India
Indonesia
Japan
Malaysia
New Zealand
Philippines
Singapore
South Korea
Taiwan
Thailand

Europe
Austria
Belgium
Czech Republic
France
Germany
Ireland
Italy
Netherlands
Poland
Portugal
Romania
Russia
Spain
Switzerland
United Kingdom

Africa
Botswana
Kenya
Malawi
Nigeria
South Africa
Tanzania
Uganda
Zambia
Zimbabwe

Middle East
Saudi Arabia
United Arab Emirates