

AMAZON'S HQ2 DECISION: THE IMPACT ON THE WASHINGTON COMMERCIAL REAL ESTATE MARKET

Amazon's Split Decision on HQ2

After more than a year of deliberation, Amazon announced that the company has selected New York City and Arlington, Virginia, as the locations for its new headquarters. Long Island City and Crystal City will split the committed \$5 billion investment, including up to eight million square feet of office space needs, while creating more than 50,000 jobs between the two new headquarters locations.

The landmark decision to bring Amazon to the newly dubbed "National Landing" should provide a significant economic boost to Northern Virginia, with an estimated incremental tax revenue of \$3.2 billion over the next 20 years as a result of Amazon's investment and job creation. Additionally, the Commonwealth of Virginia has committed \$195 million toward infrastructure improvements, including upgrades to the Crystal City and Potomac Yard Metro stations and a pedestrian bridge connecting National Landing and Reagan National Airport.

In addition to an expected tightening of the Northern Virginia office market, we anticipate Amazon's arrival to have wide-ranging implications for the multihousing, retail, and hospitality markets in the Washington region. Long-term, Amazon's decision is likely to have a significant positive effect on the branding of the region, as well as its ability to attract new and transformational office tenants. These long-term benefits are likely to surpass the shorter-term impact of Amazon's direct job creation.

Current Office Market Conditions and the Short-Term Implications of Amazon's Decision

Amazon's arrival in Northern Virginia will provide a boost to the office market in National Landing, a newly-dubbed area that includes Crystal City, Pentagon City and North Potomac Yard in Alexandria. Although exact long-term year-to-year job projections are not public, Amazon expects to fill 400 jobs in 2019, followed by 1,180 in 2020. By 2030, that number should be a minimum of 25,000 in total, with the potential to expand to 37,850 by 2034.

Much of the space Amazon will occupy will be at the PenPlace and Metropolitan Park developments in Pentagon City and will be owned by the company, after sale transactions with JBG Smith are complete. Currently, plans allow for approximately four million developable square feet at these locations, but construction timelines have not yet been announced.

Amazon's initial requirement of 500,000 square feet will be met with leases covering space in three properties adjacent to the Crystal City Metro station. The properties at 241 18th Street S., 1800 S. Bell Street, and 1770 Crystal Drive will house Amazon's first National Landing employees.

Office market statistics in the Crystal City/Pentagon City submarket include an existing 12.4 million square feet of inventory, with a vacancy rate of 16.8%. Absorption in third-quarter 2018 was negative 26,440 square feet, but year-to-date absorption totals 163,185 square feet. Asking rents have risen gradually and sit at \$37.48/SF for the third quarter of 2018. Although exact move-in timelines are unknown, 500,000 square feet of newly-occupied leased space under current conditions would lower the vacancy rate in the submarket to approximately 12.8%.

Amazon's presence is likely to attract other like-minded companies and further diversify the area's economy away from dependence on the federal government, while activating the multihousing and retail sectors. It also may accelerate the redevelopment of obsolete office assets.

PROJECT'S PUBLIC COST AND INCENTIVES

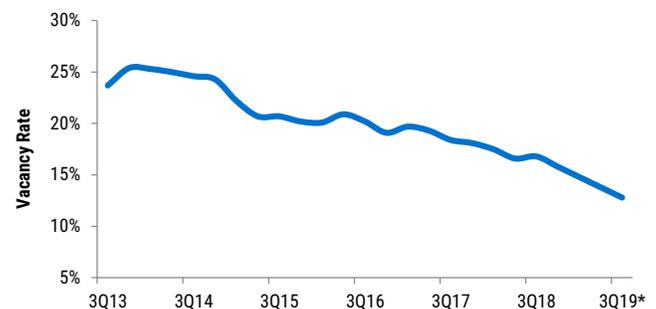
- Amazon will receive \$550 million in workforce cash grants from the Commonwealth of Virginia for the creation of 25,000 new jobs. Additionally, Amazon can receive up to \$200 million in grants if it delivers on an additional 12,850 jobs beyond the initial requirement.
- Amazon will receive a cash grant of \$23 million from Arlington County for the incremental growth of an existing local Transient Occupancy Tax over the next 15 years.
- The Commonwealth of Virginia has pledged \$250 million towards Virginia Tech's \$1 billion investment in a new campus proximate to Amazon's new headquarters, which will offer degrees in software engineering and computer science.
- The Commonwealth of Virginia will be investing \$195 million into infrastructure projects.

CRYSTAL CITY / PENTAGON CITY OFFICE SUBMARKET CONDITIONS

	3Q 2018
Total Inventory (SF)	12.4 million
Vacancy Rate	16.8%
Quarterly Net Absorption (SF)	-26,440
Average Asking Rent (\$/SF, full service)	\$37.43

CRYSTAL CITY / PENTAGON CITY OFFICE MARKET ANALYSIS

Projected Vacancy Rate



*Vacancy rate assumes 500,000 square feet of space will be leased space by Amazon

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National Landing's Multihousing and Retail Markets

Notwithstanding the new supply on the way, the area's multihousing and retail markets are likely to see rents rise over the next few years as demand for apartment units increases and more retailers are attracted to the market. Office development also is planned for the area.

Crystal Square

JBG Smith has approvals to redevelop a 15-acre area called Crystal Square. The project will include 100,000 square feet of retail including an Alamo Drafthouse and a yet to be announced small format grocery store. The project also will include a two-story freestanding retail building above the future new Crystal City Metro station entrance.

Metro Market Square

1750/1770 Crystal Drive will undergo renovations and a 22,000-square-foot expansion of the existing 250,000-square-foot office building. The project is projected to get underway during fourth quarter of 2019. Amazon is planning on occupying the entire building upon its completion.

Pentagon Centre

Kimco Realty is adding to the existing Pentagon Centre with 440 apartment units and 7,000 square feet of retail above the Pentagon City Metro station in phase one, which is set to deliver in the second quarter of 2019. Phase two includes 253 units of multihousing and 25,000 square feet of retail.

Potomac Yard (Arlington)

One million square feet of office space and 41,325 square feet of retail space are approved for development on land owned by Lidl and Meridian Group. Praedium Group is constructing a 342-unit apartment building, while Erkelitlan Development Co. is constructing a 360-unit apartment building.

Potomac Yard Center (Alexandria) Redevelopment

This site hosts a big-box shopping center that is slated to be redeveloped into 7.5 million square feet of mixed-use space. The first phase includes 732 multihousing units and 290,800 square feet of retail space. Phase one also would include either 115,000 square feet of office space or a 120-room hotel.

2351 Jefferson Davis Highway

Lowe Enterprises has approval for a 302-unit multihousing project with an additional 20,000 square feet of retail space. The building will be above the existing Buffalo Wild Wings restaurant.

Crystal House III

Mack-Cali's multihousing arm called Roseland Residential Trust gained approval for a third building with 252 apartment units. When completed, Crystal House will have more than 800 multihousing units.

1900 Crystal Drive

JBG Smith plans to start construction at 1900 Crystal Drive in 2019. The two-building multihousing project will total 750 units.

Altaire Phase II

LCOR recently purchased almost an acre of land adjacent to its recently completed Altaire project. Phase two will include 280 multihousing units at a lower price point than the 451-unit phase one building. LCOR plans to break ground in early 2020.

Pen Place and Metropolitan Park

Amazon is set to purchase land that was previously set aside for future developments called Pen Place and Metropolitan Park. The land has a potential density of up to 4.1 million square feet.

CRYSTAL CITY / PENTAGON CITY MULTIHOUSING MARKET CONDITIONS

3Q 2018	
Total Inventory (Units)	13,438
Occupancy Rate	96.2%
12-Month Effective Rent Change	-0.3%
Pipeline (Units)	2,952

CRYSTAL CITY / PENTAGON CITY RETAIL MARKET CONDITIONS

3Q 2018	
Total Inventory (SF)	2.83 million
Vacancy Rate	0.9%
Quarterly Net Absorption (SF)	48,501
Average Asking Rent (\$/SF, NNN)	\$55.00

CRYSTAL CITY / PENTAGON CITY HOTEL MARKET CONDITIONS

3Q 2018	
Total Inventory (Rooms)	5,900
Room-Nights	2,000,000
Amazon-Driven Seattle Room-Nights (in 2017)	330,000
Pipeline (Rooms)	470

Implications for the Local Hotel Market

Within National Landing, there are currently 17 hotels operating, totaling 5,900 rooms. Fifteen of the hotels exist in Crystal City and two are in Pentagon City. The North Potomac Yard portion of National Landing has two additional hotels planned among its 7.5 million square feet of planned development. Areas comprising National Landing make up the second-largest hotel district in the region outside of downtown Washington, DC, currently generating more than two million room-nights per year. A full 82% of the properties offer a service level of upscale or higher, with the Ritz-Carlton Pentagon City standing as the lone luxury option. The average age of the existing hotels is 34 years, although four properties are either undergoing renovation currently or have a renovation planned, including the Crystal Gateway Marriott, which is the largest hotel property in National Landing, with 701 rooms.

Occupancy within the market fluctuates between 50% during off-peak times up to 75% during the peak season. With the addition of Amazon to the submarket, these numbers likely will surge and seasonal differences may not be as pronounced. Amazon was responsible for approximately 300,000 room-nights in the Seattle metro area in 2017.

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Long-Term Implications of Amazon's Decision

Educational Programs to Enhance Tech Talent Pipeline

Amazon's decision to split HQ2 between the Washington and New York markets, though a surprise twist in the year-long search, likely was driven by the fact that although it liked the existing talent in both markets, there was concern that neither would generate enough computer science graduates to satisfy its needs. Both markets have highly educated workforces, but the share of tech workers may not have been enough to support the number of jobs Amazon plans to fill.

One reason for Amazon's decision to place a portion of HQ2 in Northern Virginia was the area's formal commitment to expand its higher education programs. Virginia Tech's \$1 billion investment in a new Innovation Campus proximate to HQ2 – supported in part by additional funds from the Commonwealth of Virginia – is a commitment that will benefit not just Amazon but the region's workforce and other employers in the long term. George Mason University also is making a \$250 million commitment to a new digital innovation program that will assist in creating a talent pipeline for the next generation.

These programs fill a hole in the local university landscape. The Washington area has excellent universities, but notwithstanding some good computer science programs, it does not have any comparable to those in other tech-heavy markets like the Bay Area (with Stanford and Berkeley), Pittsburgh (with Carnegie Mellon), or Boston (with MIT).

New graduates from these programs will not be hired only by Amazon; some will be hired by companies who lose workers to Amazon, and others will be hired by the federal government for mission-critical functions such as cybersecurity. Others will be hired by government contractors, while some will start their own companies. This will, in turn, generate a virtuous cycle of long-term job creation within high-wage fields, with a strong multiplier effect for the region's retail market. Further, while the area has received some criticism for offering incentives, Virginia's package was considerably less than the one New York used to close its deal with the company, and also less than other states offered. Virginia's incentives also are conditional on Amazon meeting its job creation requirements.

The Branding Value of Symbolism

Washington has long been known as a government town. As recently as 2010, the federal government accounted for nearly 40% of the regional economy. By 2017, this figure was down to approximately 31%. The economy is diversifying at a rapid rate, and Amazon's decision validates the region's appeal to tech firms, as well as to large companies in other industries that are seeking access to a highly educated workforce.

Many large companies are finding a need for a presence on the East Coast, and more specifically, tech companies are finding it increasingly necessary to establish a base near Capitol Hill for lobbying purposes. With an educated workforce, a high quality of life, and a cost of living comparable to or even lower than New York's and Silicon Valley's, the Washington region is appealing as a potential corporate home. Momentum in the region has been accelerating in recent years with large companies such as Nestle, Hilton, Northrop Grumman and Volkswagen all moving major operations to the area. Amazon is a culmination of those efforts and a springboard for the next generation of private-sector firms that will move to the region. It's particularly notable that Amazon is locating a headquarters in the region after already having experience in Northern Virginia through its Amazon Web Services (AWS) division, which leases 400,000 square feet of office space at One Dulles Tower in Herndon.

Due to the national and public nature of Amazon's search, and the early declaration by many that the region – Crystal City in particular – was a frontrunner for the massive project, there has been an enormous amount of free publicity for the region. Crystal City, and now National Landing, has been highlighted in the press for its proximity to the nation's capital, its accessibility via road and transit, and its supply of office space. This positive press benefits the entire Washington region, and has a chance to resonate beyond Amazon's decision. If Amazon is able to find a suitable workforce and culture in the Washington region – undoubtedly hiring some of its workers from the District of Columbia and Maryland as well as Virginia – so can other tech firms and large companies in other talent-starved industries.

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