THOUGHT LEADERSHIP SERIES

WASHINGTON METRO AREA COMMERCIAL REAL ESTATE MEGATRENDS

2017 UPDATE

Newmark Grubb Knight Frank

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INTRODUCTION

At our BenchMarks DC event in November 2016, we presented three MegaTrends that will shape the future of the Washington metro area's regional economy and commercial real estate market. With a new presidential administration now in place, we are updating our clients with new information on the MegaTrends we identified in November (the first three listed at left), plus two additional trends that are shaping our market.

THE REGIONAL ECONOMY CONTINUES TO EXPAND, EVEN AS 2017 MARKS THE EIGHTH CONSECUTIVE YEAR OF RECOVERY AND ECONOMISTS HAVE PREDICTED A DECELERATION IN GROWTH.

Washington's regional economy has continued to expand in early 2017, even as a controversial presidential administration has taken office and the current economic cycle has reached its eighth consecutive year of growth. We predict that growth will continue but at a decelerating rate compared with the 2010-2016 recovery from the Great Recession. The consensus of both national and regional economists is that the next significant economic downturn will take place in 2018 or 2019. With that prediction in mind, 2017 should remain a time of consistent economic growth in the Washington metro area.

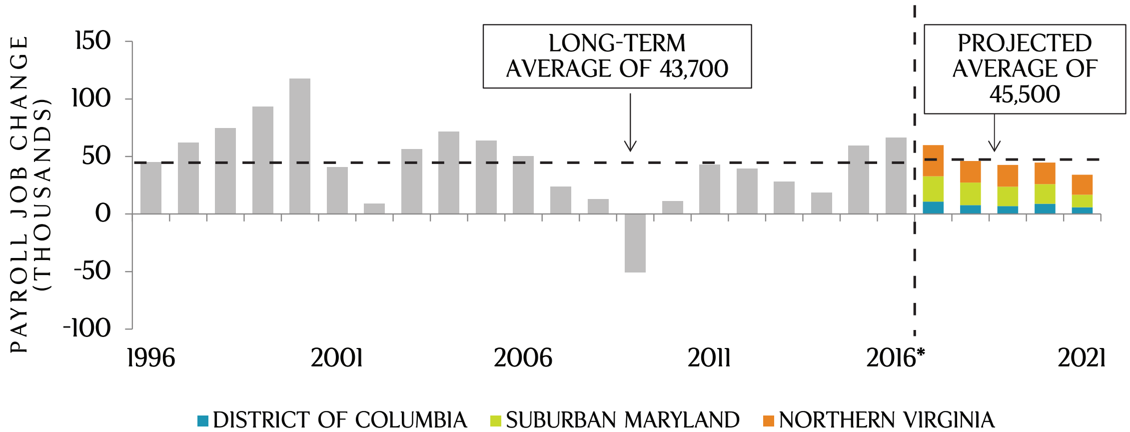
Since the post-war period began in 1945, national economic recoveries following a recession have lasted an average of 58 months. The most recent economic expansion, beginning after the Great Recession of 2008-09, has lasted 92 months. If the consensus of economists is correct – that a national recession will occur in the 2018-2019 timeframe – then the current expansion period will last well over 100 months. However, the Washington metro area tends to be somewhat insulated from national economic cycles due to the steadying effect of the federal establishment and its educated and diverse regional employment base. This has meant that previous recessions have resulted in fewer local jobs lost and a quicker recovery when compared to other major U.S. metropolitan areas.

We are forecasting job growth greater than the long-term average of 43,700 jobs (dating back to 1996). In the five-year period between 2017 and 2021, we expect the region to add an annual average of 45,500 payroll jobs. In consultation with Dr. Stephen Fuller of George Mason University, we expect Northern Virginia to host the greatest share of new jobs in this region. As shown in the adjacent graph, the Washington area's job growth rate exceeded the U.S.'s rate in 2016, something it had not done since 2011.

More new positions in the region are being created in the professional/business services sector than in any other sector, which will support demand for office space and – given the high wages of such positions – Class A apartments and retail.

PAYROLL JOB CHANGE

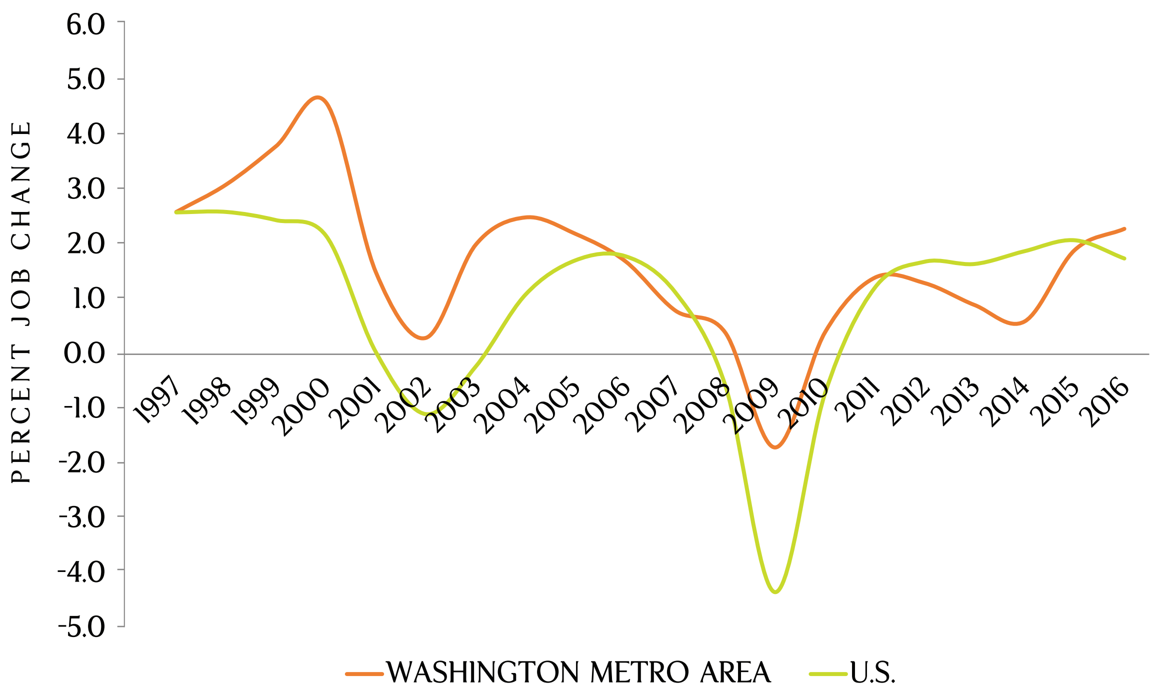
WASHINGTON METRO AREA: 1996 – 2016 AND FORECAST FOR 2017 – 2021



*2016 reflects 12 months ending December 2016; other years reflect annual averages
Source: U.S. Bureau of Labor Statistics, Dr. Stephen Fuller, NGKF Research; March 2017

ANNUAL AVERAGE 12-MONTH PERCENT JOB CHANGE

WASHINGTON METRO AREA VS. U.S. | 1997 – 2016



Source: U.S. Bureau of Labor Statistics, NGKF Research; March 2017

MEGATREND #2: INFLUX OF FOREIGN CAPITAL CONTINUES

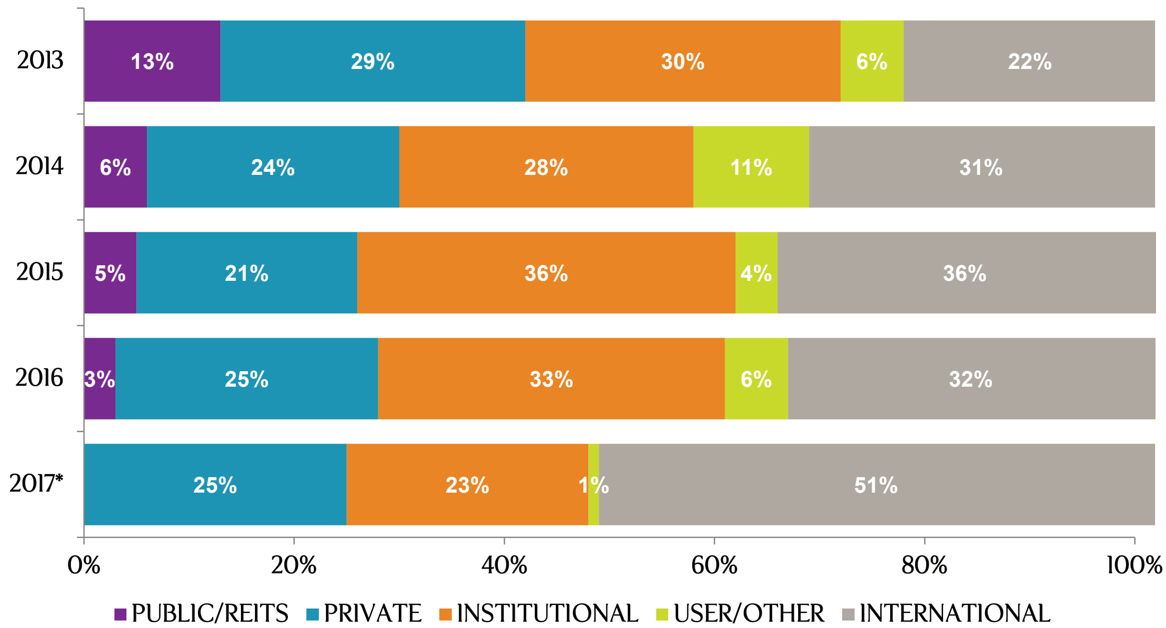
INVESTMENT CAPITAL IS GROWING MORE CAUTIOUS ON A NATIONAL LEVEL, BUT THERE IS A CONTINUED FOCUS ON GATEWAY CITIES FOR INVESTMENT, AND WASHINGTON HAS REMAINED A TARGET.

Over the past several years, foreign investors have sought out properties within the Washington metro area, frequently purchasing trophy office properties for top dollar. Between 2013 and 2016, foreign capital purchases rose from 22% to 32% of total transaction volume. Data for 2017 year-to-date shows an even greater increase in foreign capital investments locally, with foreign investors contributing over half of all transaction volume through February (though in a small sample of transactions). Japanese REIT Unizo Holdings spent close to $800 million on Washington area real estate in 2016 alone, and a recent office purchase in February brings it close to $1 billion. But for how long will the consistent flow of foreign capital last? The answer may be shaped in part by politics. What effect might the Trump Administration's "America first" foreign policy have on the influx of foreign capital to the Washington metro area?

Having already attempted to implement a travel ban on nationals from seven Muslim-majority nations, some asset owners are concerned that foreign investors looking to purchase investment-grade properties – particularly Middle Eastern firms – may turn their attention to countries that offer a more welcoming message. For now, investors remain bullish on the Washington area and continue to place capital here due to the market's long-term safety and the stability of returns. It is an important sign for current owners that foreign investors continue to view Washington positively. Even with the shift in foreign policy implemented by the Trump Administration, Washington remains an attractive gateway market for foreign and international investors to park their capital. We anticipate that this trend will continue through the end of 2017 even as interest rates rise modestly. Compared with stocks and bonds, commercial real estate represents an attractive opportunity for institutional investors seeking consistent returns and a way to rebalance their portfolios.

OFFICE BUYER DISTRIBUTION BY TRANSACTION VOLUME

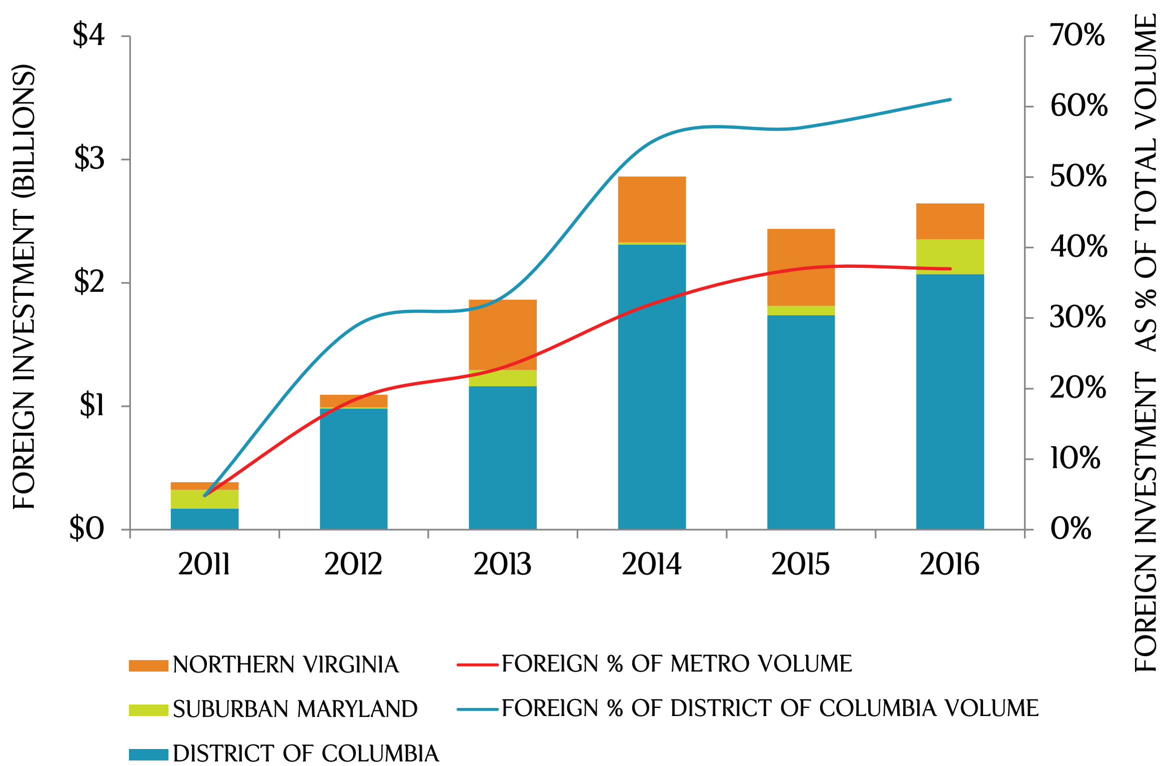
WASHINGTON METRO AREA | 2013 – 2017



*Through February 2017
Source: Real Capital Analytics, NGKF Research; March 2017

FOREIGN CAPITAL PLACED INTO OFFICE ASSETS

WASHINGTON METRO AREA | 2011 – 2016



Source: Real Capital Analytics, NGKF Research; March 2017

MEGATREND #3: SHARING ECONOMY SHAPES MARKET

THE SHARING ECONOMY BOTH BENEFITS AND DISRUPTS OUR MARKETPLACE.

One of the most publicized trends in real estate over the past few years has been the rising popularity of the sharing economy and its effect on the industry. With companies like Airbnb reshaping the hospitality industry, and WeWork expanding its footprint both worldwide and in the Washington metro area in particular, the sharing economy has impacted commercial real estate. Many investors wonder whether it will continue to upend traditional aspects of the commercial real estate industry or, instead, emerge as a complementary option for tenants.

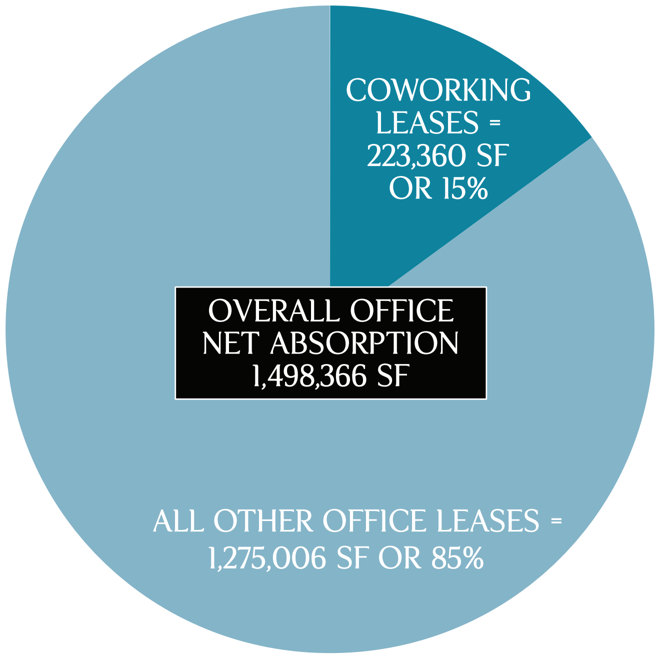
Locally, the sharing economy's effect on the hospitality industry is apparent through the well-known Airbnb platform. A major player in Washington area real estate recently made use of an Airbnb-type platform when it wanted to temporarily fill vacant apartments. In 2016, Vornado Realty Trust completed construction on the Bartlett apartments in Pentagon City, a 700-unit, 23-story project anchored by a Whole Foods Market on the ground floor. Several months after the project opened to tenants, more than 150 units remained vacant. Vornado decided on a short-term, "pop-up" hotel to temporarily fill the units, known as the WhyHotel. Vornado decided to introduce the concept at the Bartlett due to its proximity to Crystal City, where a surplus of vacant, outdated office space has encouraged owners to lease space to startups like 1776 and sharing economy pioneers like WeWork. In fact, WeWork introduced the first non-New York location of its co-living concept, WeLive, to Crystal City in May 2016. The concept blends the collaborative, shared-space atmosphere found in WeWork locations with a structure resembling that of a dormitory, with shared laundry and kitchen facilities for residents to use.

WeLive Crystal City is emblematic of the positive effect the sharing economy has had on Washington's commercial real estate market. Crystal City has been one of the Washington metro area's hardest-hit submarkets due to the obsolescence of the office stock, military base consolidations that caused leased space to be vacated, and an overall downsizing among federal agencies that were headquartered in the area. A building constructed in 1964 would be a tough sell to a traditional office tenant looking for quality space, but the space was a good fit for a creative tenant like WeWork, which tends to seek obsolete, overlooked space that can be improved through significant buildout. By bringing a tenant like WeLive into Crystal City, Vornado has brought new energy into an oversupplied submarket and has boosted the submarket's local popularity.

With regard to Washington's office market, the popularity of coworking space has affected the market largely in a positive manner. While at first the idea of tenants filling WeWork's coworking spaces instead of signing traditional long-term leases may seem detrimental to property owners, WeWork and its peers have been prospectively taking a substantial amount of vacant space off the market. Tenant demand for space is modest overall, and has been since 2010. However, a significant portion of the recent demand has been from coworking firms. As shown in the adjacent graph, coworking leases constituted 223,360 square feet of net new demand in 2016, approximately 15% of the Washington area's overall net absorption. As of February 2017, more than 700,000 square feet of Washington area office space is under lease to coworking firms, and approximately one-third of that space was leased in 2016.

OFFICE SPACE ABSORPTION

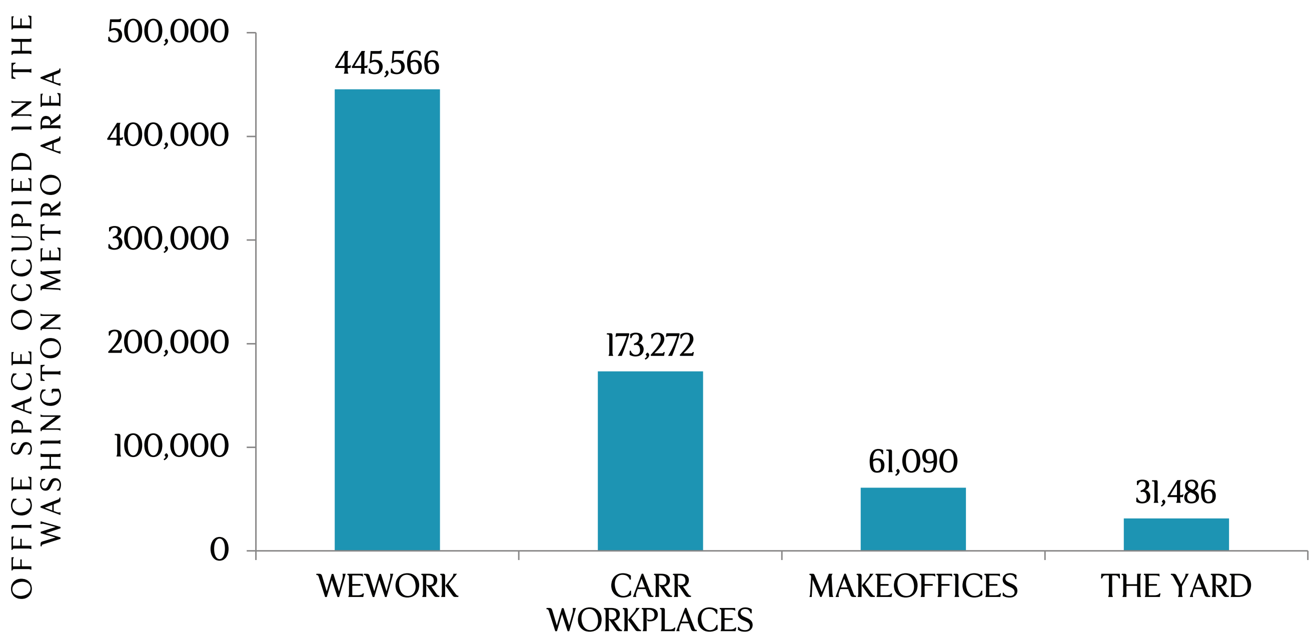
WASHINGTON METRO AREA | 2016



Source: CoStar, NGKF Research; March 2017

OFFICE SPACE OCCUPIED BY COWORKING CONCEPTS

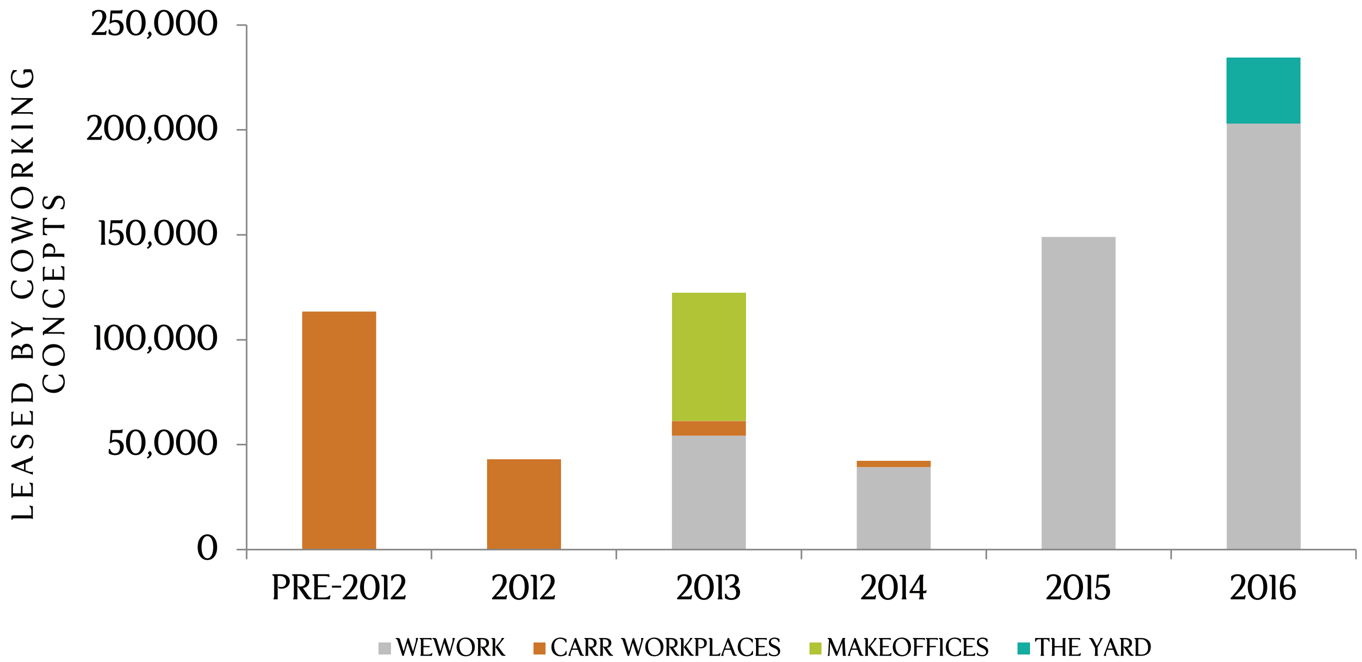
WASHINGTON METRO AREA | AS OF FEBRUARY 2017



Source: CoStar, NGKF Research; March 2017

OFFICE SPACE LEASED BY COWORKING CONCEPTS

WASHINGTON METRO AREA | THROUGH 2016



Source: CoStar, NGKF Research; March 2017


WITH THE
JIMMIES
OPEN LAND

MEGATREND #4: NEW ADMINISTRATION HAS LIMITED IMPACT

THE TRUMP ADMINISTRATION'S POLICIES HAVE HAD A MODEST EFFECT ON WASHINGTON AREA COMMERCIAL REAL ESTATE – SO FAR.

Since President Donald Trump took office in January 2017, the attention of the world has fixated upon Washington, as many wonder what effect President Trump and his administration's policies will have on both the United States and the world. Regarding Washington, the President's rhetoric on policy issues ranging from immigration to infrastructure funding on a national scale has thus far resulted in regulatory confusion. The well-publicized travel ban on seven Muslim-majority nations was overturned by a federal judge who determined it to be unconstitutional; a revised order was issued weeks later. The Trump Administration's full slate of regulatory proposals has yet to be issued, but judging by the impact so far, a fair amount of uncertainty is to be expected for the foreseeable future.

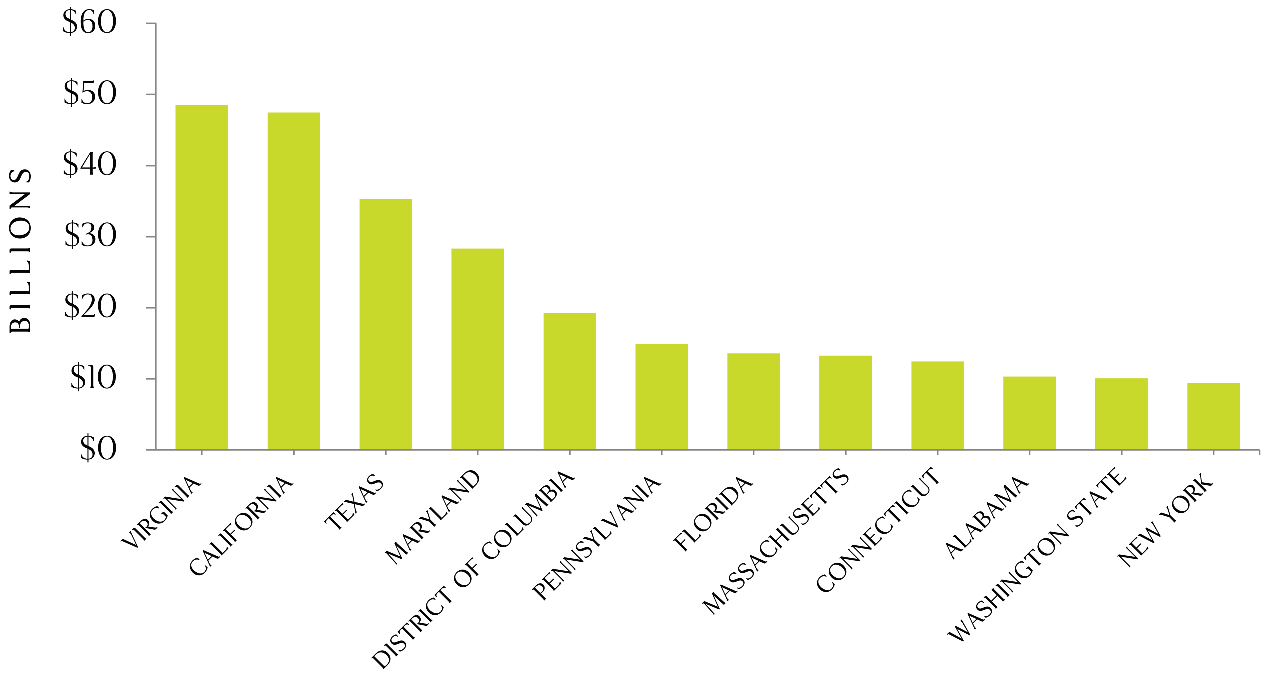
However, when it comes to the Washington metro area's office market, history has shown that political control of the federal establishment does not have as direct an impact on office demand as one might expect. The Trump Administration's policies are likely to have a modest impact on the office market just as prior administrations' policies have had – for more information on the reasons behind this dichotomy, please see our 2016 white paper titled *Political Control*. In short, exogenous events such as recessions and terrorism have a much stronger relationship to office absorption in the Washington area than does party control of the White House and Congress. *Correlation* between party control and absorption is often confused for *causation*.

With that analysis as background, the consensus coming from industry leaders and local market analysts has been that the Trump Administration may have a modestly positive impact on the Washington office market overall, yet the largest gains will be seen in specific jurisdictions that are home to industries which will benefit from the new administration's proposed policies. One particular example is government contracting, especially relating to the defense industry. Northern Virginia has long been the preferred location for industry leaders like Northrop Grumman and General Dynamics, along with related subcontractors seeking federal procurement contracts. These firms value proximity to the Pentagon. In fact, for the fiscal year 2015, Virginia ranked first nationally in terms of federal procurement dollars captured. The Washington metro area overall is closely tied to government contracting – Maryland ranks fourth on the list, with the District fifth.

President Trump has pledged reform across all sectors of government, some of which are closely tied to the private sector. Tax reform, especially relating to the middle-class and high-end tax brackets, could spur growth among the District's lobbying and law firms. Some analysts have suggested that potential healthcare reform, in terms of the president's pledge to repeal and replace Obamacare, will have a positive effect on Suburban Maryland's life sciences corridor and substantial biomedical research tenant base. Yet even while the defense contracting and biomedical tenant bases may see growth under the Trump administration, a Republican-controlled legislature is likely to favor reduced spending for domestic social programs, along with their related agencies. Notable examples include the Environmental Protection Agency, which President Trump has pledged to defund. When examining the new administration's planned policies as a whole, it seems likely that there will be clear winners and losers, with the projected gains in local employment for certain sectors offset by proposed spending and personnel cuts in other sectors.

FEDERAL GOVERNMENT CONTRACT FUNDS BY STATE

FISCAL YEAR 2015



Source: USA Spending, NGKF Research; March 2017

MEGATREND #5: OFFICE DEMAND IS BIFURCATED

COMMODITY CLASS A OFFICE SPACE WILL REMAIN OVERSUPPLIED FOR SEVERAL MORE YEARS.

Class B office space within the District's CBD and East End submarkets is experiencing a rise in popularity among value-conscious tenants who wish to retain a presence in the District. This has coincided with a trend toward older Class B office buildings being renovated into Class A or torn down and rebuilt into trophy assets. As available inventory declines and tenant interest grows, Class B rents have risen over the past several quarters. The average Class B rent in the CBD and East End is $45.73 per square foot, an increase of 4.5% since the second quarter of 2014. As shown in the adjacent graph, during that same period, the Class B inventory has declined by 400,000 square feet due to renovations and demolitions.

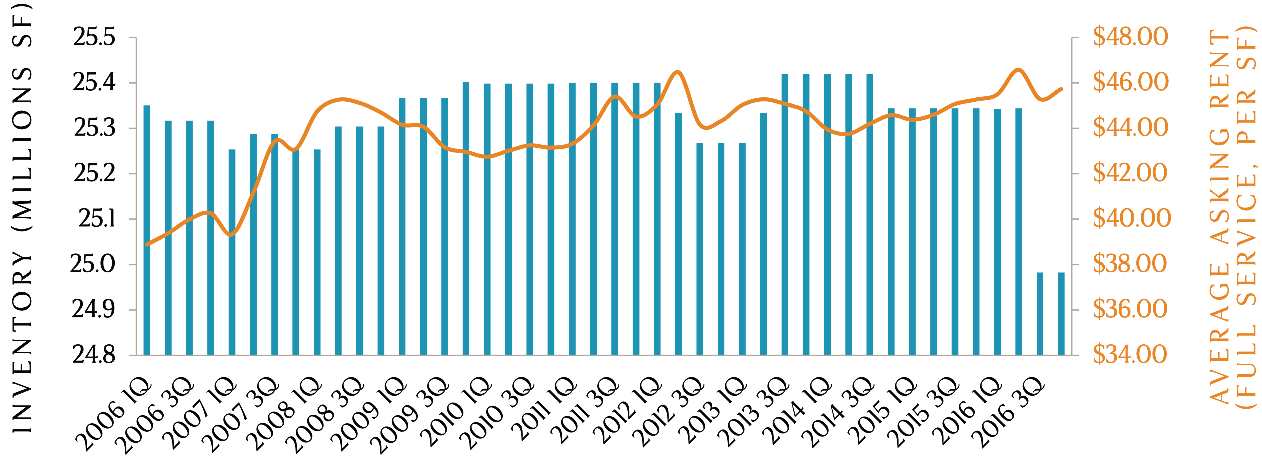
There is bifurcated demand in the Washington office market – a widening chasm between the two most popular classes of office space within the District. On one extreme is top-quality trophy space, which commands the highest rents in the market. Down the spectrum is mid-level Class B space, which often is located in desirable submarkets but within older, poorly amenitized buildings. In between is commodity Class A space, generally in buildings delivered 10-15 years ago. Many tenants within these commodity buildings were the initial anchor tenants when the buildings delivered and have leases expiring within the next 2-5 years. Many of these tenants are large law firms that tend to seek new trophy space and are unlikely to renew in place. This leaves a significant amount of commodity Class A space coming available over the next two years; we estimate that figure at more than eight million square feet between now and the end of 2018 in the core CBD and East End submarkets (see the adjacent graph). This space is generally leasing in the range of $55-$75 per square foot, full service, with competition particularly intense in the $65-$75 per square foot range. Since many of the anchor tenants in these buildings signed their leases 10-15 years ago, their rents have escalated to a number far higher than what these buildings are now able to achieve for vacant space, particularly with the amount of competition in the market.

Therefore, owners are presented with a difficult situation regarding the future use of their Class A properties. One option is to dramatically renovate the structure, involving either an addition (like Rockrose Development and Spitzer Enterprises' Alexander Court), a re-skin/new façade (such as Tishman Speyer's 900 19th Street NW), or other significant improvements in order to elevate the structure to Class A+/trophy status. This requires a significant up-front capital outlay (often $100 million or more) that some ownership structures will be unwilling or unable to provide. A second option is to target value-conscious tenants who are looking for centrally located space but who are unwilling to pay trophy rents. However, this strategy has the side effect of lowering the overall value of commodity Class A space as a whole, since it will no longer be able to command Class A-level rents.

Ultimately, owners of 10- to 15-year-old Class A- office assets – what we call commodity Class A product – will have to (1) renovate to trophy/near-trophy status; (2) repurpose the asset; or (3) with limited modernization accept Class B+ status and re-rent space at rates below expiring, escalated rental rates. The years 2017-2018 are a pivotal time for these owners to determine their next steps.

INVENTORY AND AVERAGE ASKING RENT FOR CLASS B OFFICE SPACE

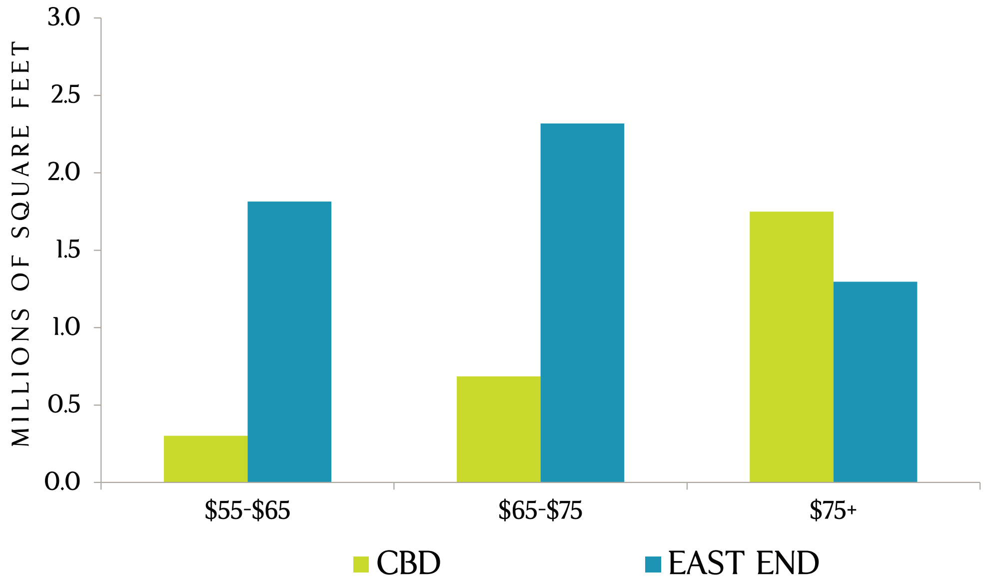
DISTRICT OF COLUMBIA'S CBD AND EAST END SUBMARKETS | 2006 – 2016



Source: NGKF Research; March 2017

AVAILABILITY BY ACHEIVABLE RENT (DOLLARS PER SF, FULL SERVICE)

DISTRICT'S CBD AND EAST END SUBMARKETS | SPACE BECOMING AVAILABLE BY DECEMBER 2018



Source: NGKF Research; March 2017

CONCLUSION

For the commercial real estate developer, investor, and service provider the Washington region offers better prospects for economic prosperity over the next five years than does the nation as a whole. While we believe the peak of this investment cycle likely is behind us, the region is a better bet than most gateway markets through the end of this decade due to continuing office-using job growth and an ongoing influx of foreign capital. The prudent operator will be a disruptor in the sharing economy – finding creative ways to use and market space – rather than being disrupted. The verdict is still out on the impact of the Trump administration on the Washington region; we believe there will be clear winners and losers, with defense contractors requiring more office space while some federal agencies downsize. Finally, we observe that there will be significant competition within the District of Columbia's downtown commodity Class A office market. Within that challenged segment of the market, opportunities are most ripe at the edges of spiffy Class B+ space (at $45 to $55 per square foot, full service) and Class A+/trophy space (at $75 per square foot or greater, full service).

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