Office observations

Metro DC Q4 2017

The Metro Washington office market posted 117,299 s.f. of occupancy losses in 2017, shifting occupancy close to a historical low (83%). The stagnancy in the market in 2017 is not new: the broader market has posted less than 1 m.s.f. of occupancy gains for seven years in a row and in nine of the past 10 years. Further, while supply held steady through 2014, levels have begun to pop recently: Q4 construction levels (12.4 m.s.f.) reached their highest point since 2008. The forecast broadly is not likely to shift greatly from today as slower demand caused by limited near-term lease expirations, limited economic diversification outside of the core government and contractor drivers and a dysfunctional Congress will keep supply-demand fundamentals relatively flat. This market environment will fuel limited rent growth and the continued escalation of concessions in the majority of locations and product types. Market segments that will go against the grain and cause challenges for tenants include the Bethesda-CBD, parts of Rockville Pike, the emerging eastern markets of DC and new construction along the Silver Line in Northern Virginia.

John Sikaitis

Managing Director, Research

A market of some winners and more losers

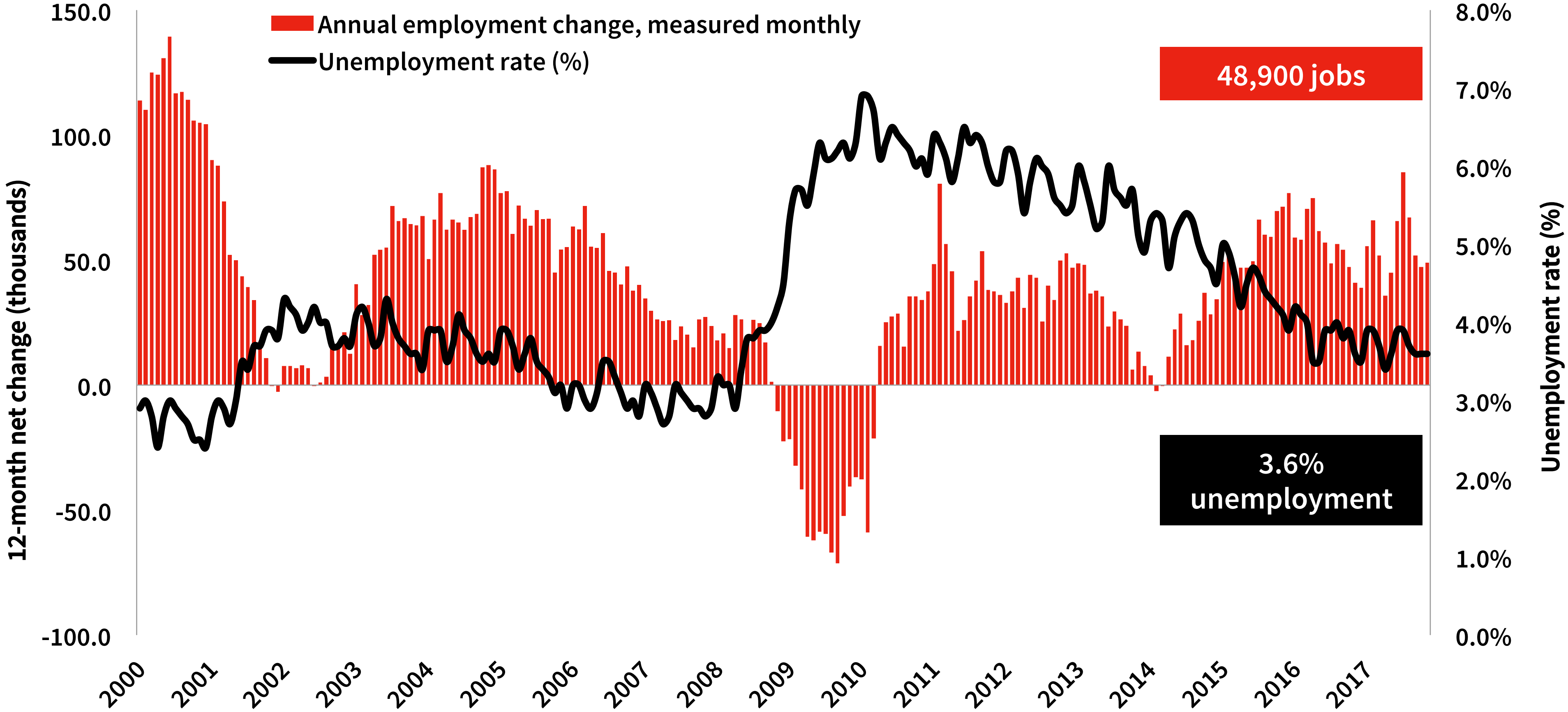
JLL

DC	Emerging market vacancy will drop below 10% in 2019; rents will grow as demand diversifies and the feds will face some rent sticker shock ahead	Vacant space within the Class B&C core market has dropped 20% since Q1 2014 and rents have jumped 9%; more of the same will follow in 2018	5.5 m.s.f. of core Trophy / A space is under development with preleasing of 46%. Rents will drop, but construction could continue as only 4 buildings have top-down availability	Vacancy in the core Trophy / A space heads to 20%, fueling continued record concessions, which are approaching the $150 p.s.f. TI mark with 20 months of abatement (15 yrs)
VA	Vacancy across the market hit a record high in Q4 at 20.9%; only two major submarkets (Old Town & Reston) posted vacancy below 15%, creating opportunity for nearly all tenants	Metro is king as Metro-accessible office space commands a 34% rent premium to non-Metro-accessible buildings. In Tysons, that rent premium is more than 47%	Absorption is likely to jump in Rosslyn in 2018 due to expected move-ins, yet, vacancy at the extremes of RB remain at 29%	Drive-up office park vacancy rates have increased from 4.9% in 2000 to 21.8% in 2017 with some of the most exposed markets approaching 35-45%
MD	The Bethesda construction pipeline just broke ground and already 40% of the space is preleased with rates approaching $70 p.s.f. FS	s Bethesda Trophy rents establish records, rent growth will trickle down to the B market, which along with traffic and parking, could fuel tenant move-outs	With NoBe vacancy levels along Rockville Pike approaching 25%, this market segment will benefit most from Bethesda-CBD migration	PGC vacancy has fallen 28% since Q2 2015. With emerging markets in DC establishing new pricing highs, look here as a release valve for the feds

Source: JLL Research

Metro DC employment and unemployment

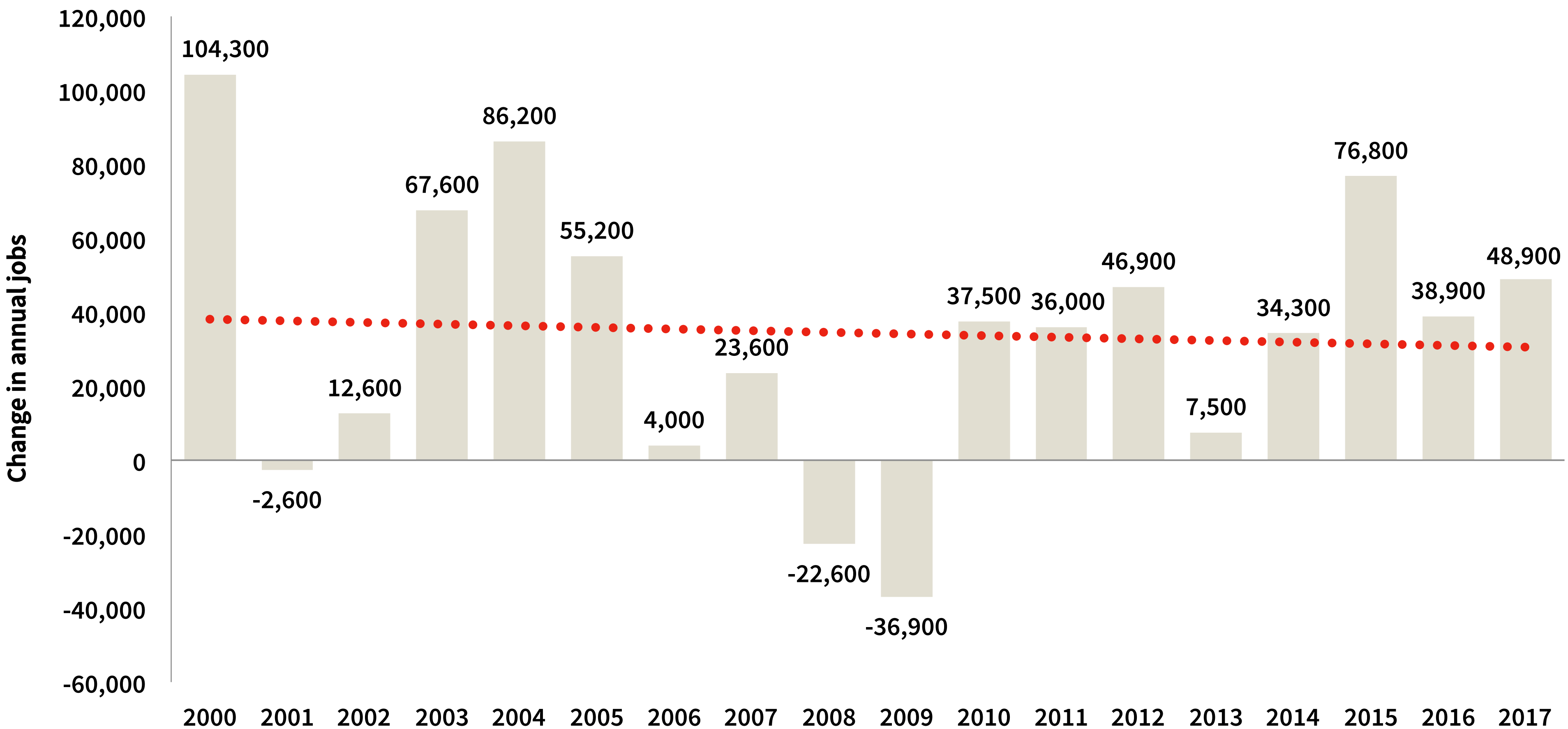
48,900 jobs were added over the past 12 months, 19% higher than the rate of growth in November 2016 and 14% higher than the average monthly job growth since January 2013



Source: JLL Research, U.S. Bureau of Labor Statistics

Metro DC change in annual employment

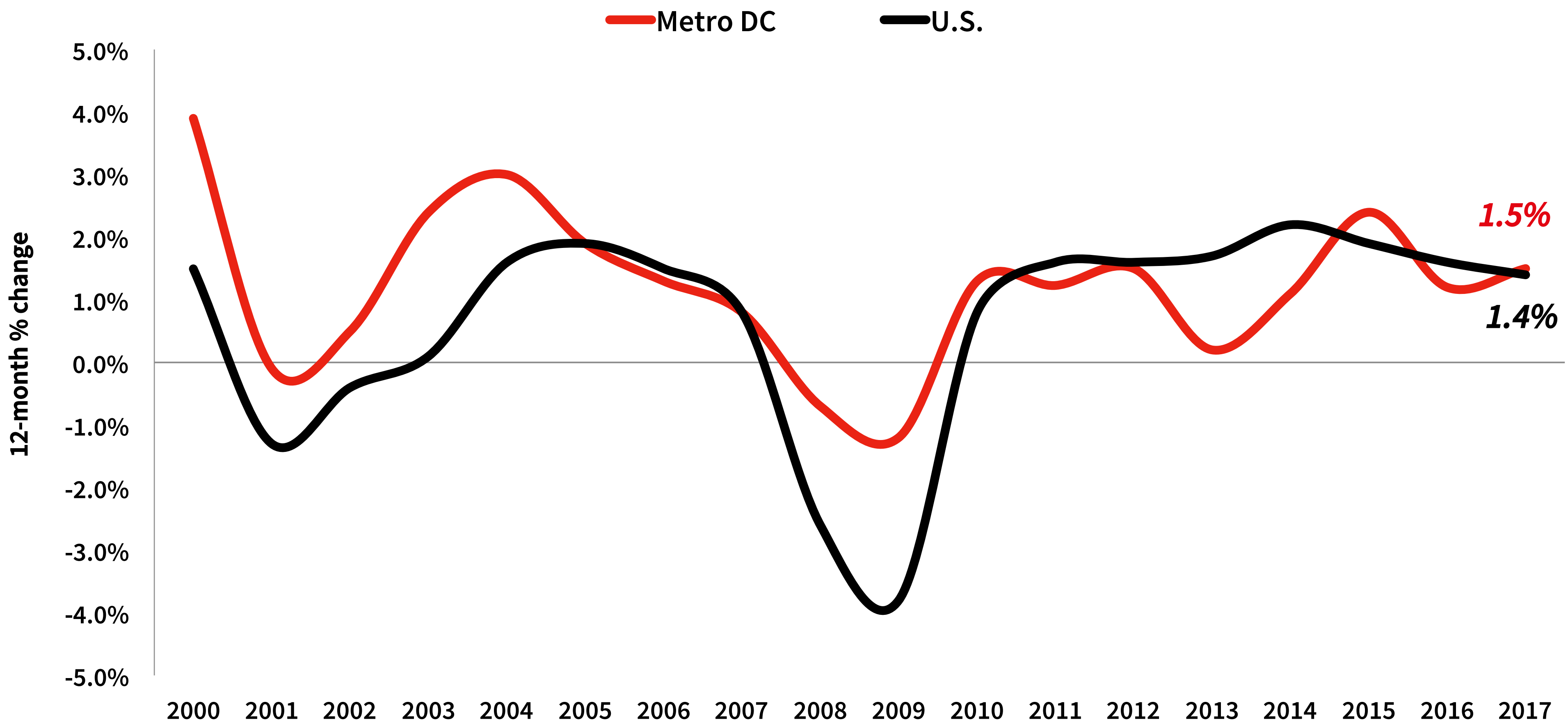
Current job growth is 43% higher than historical norms since 2000



Source: JLL Research, U.S. Bureau of Labor Statistics

Metro DC vs. U.S. employment change

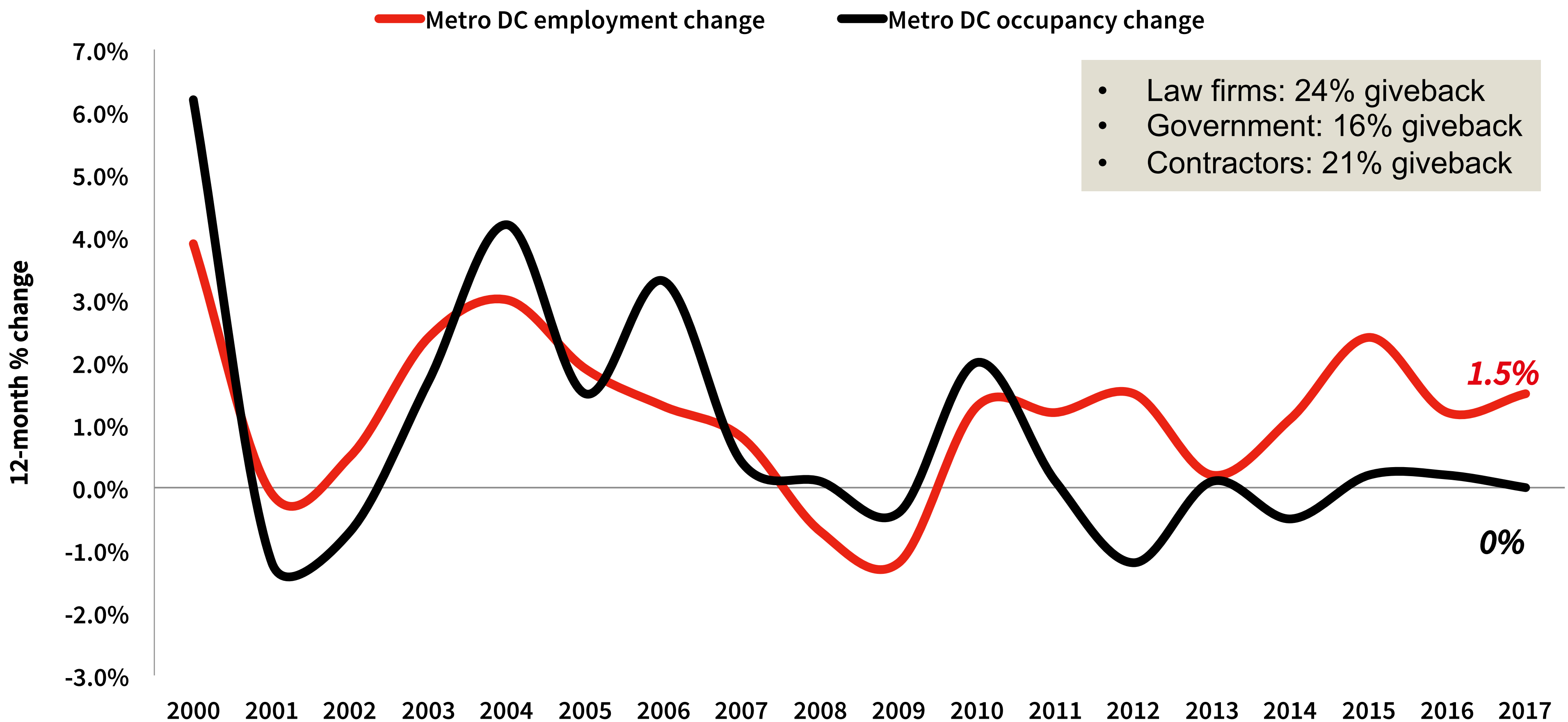
The rate of job creation in Metro DC is now slightly outpacing that of the U.S. overall, but lagging most coastal primary markets



Source: JLL Research, U.S. Bureau of Labor Statistics

Metro DC employment vs. office occupancy

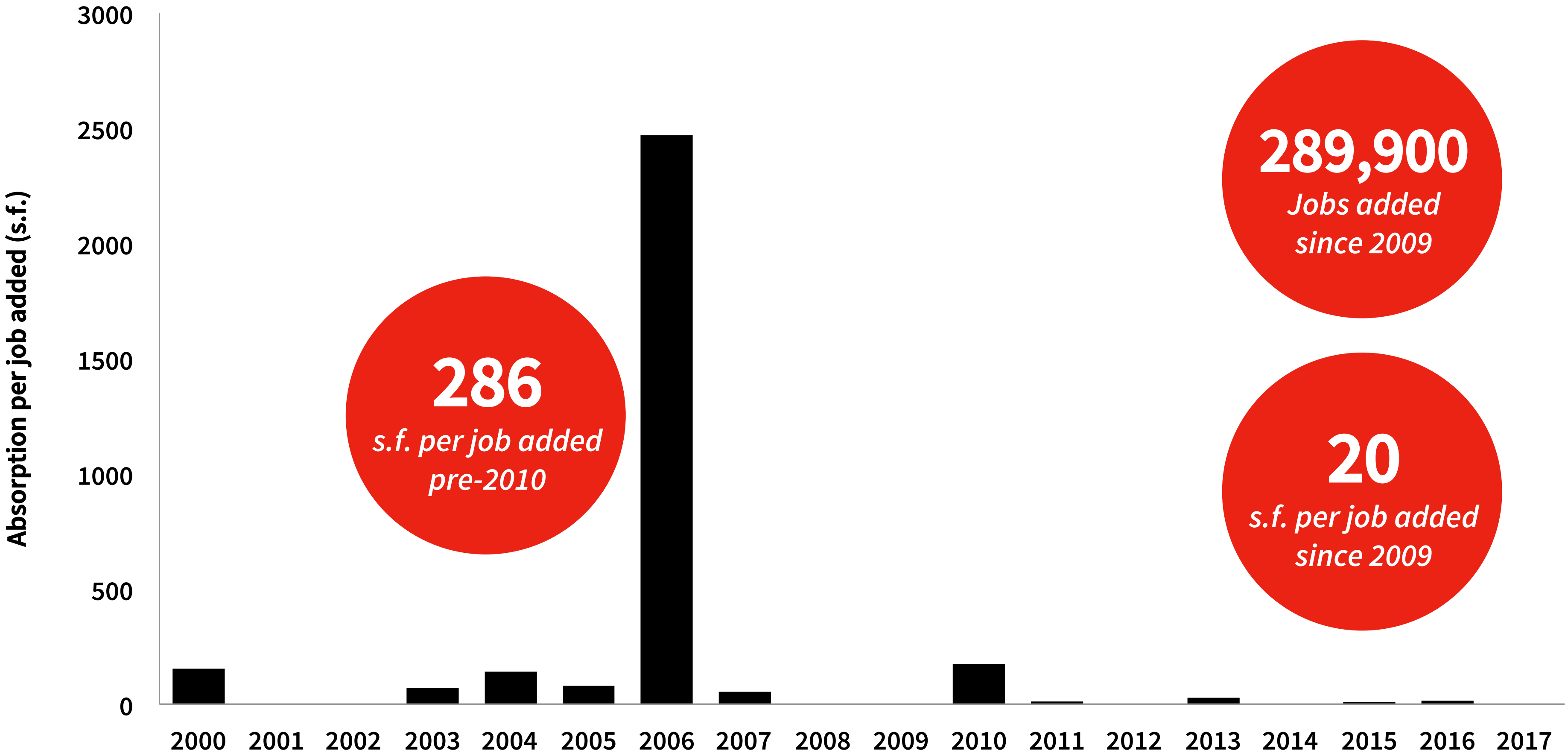
Despite 289,900 jobs added across the region since 2009, only 1.4 m.s.f. of occupancy gains have been realized, equating to 20 s.f. for every job added



Source: JLL Research, U.S. Bureau of Labor Statistics

Net absorption per job

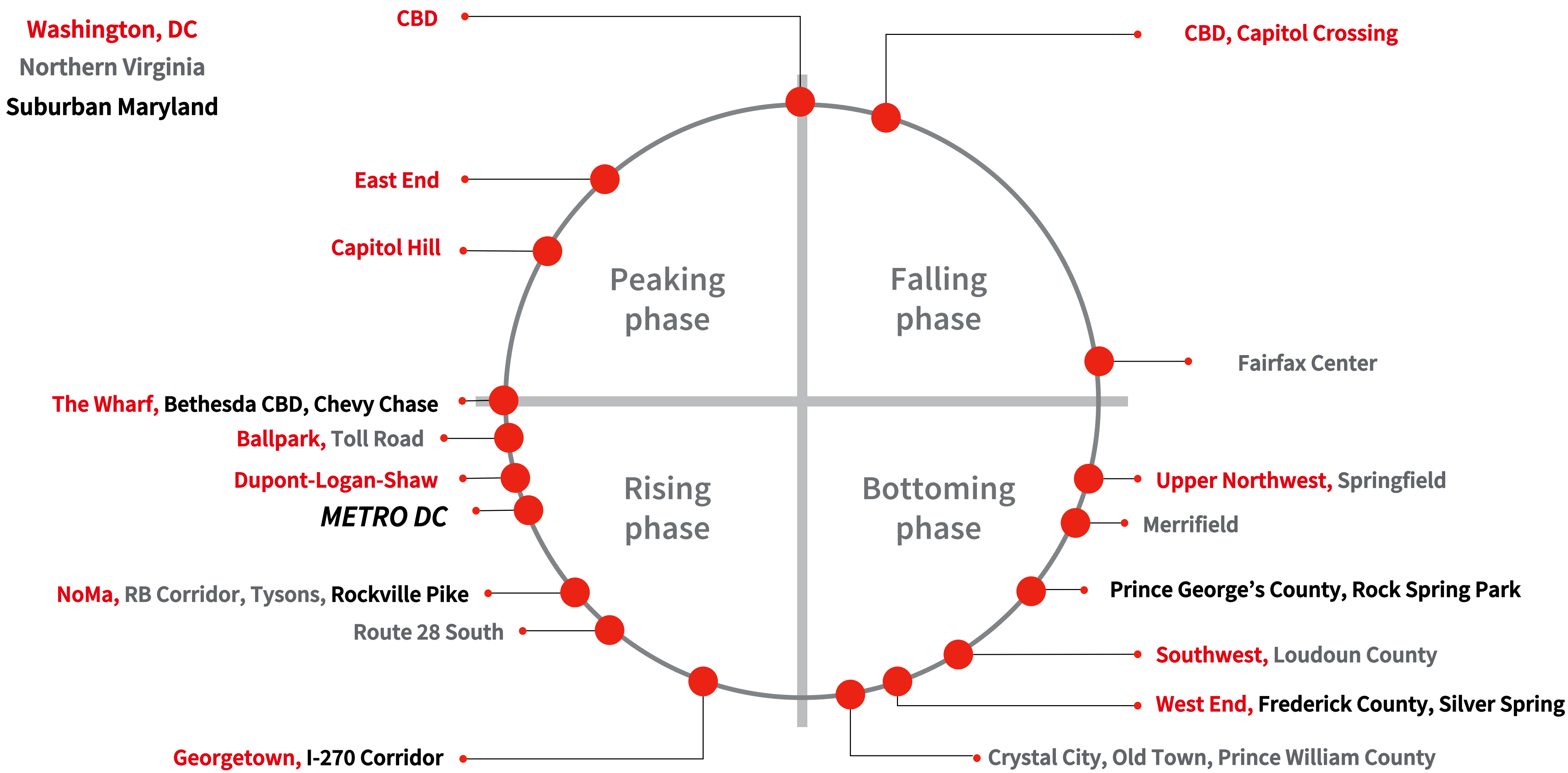
Despite moderate job creation, each new office job created in Metro DC today is generating minimal or no net absorption



Source: JLL Research, U.S. Bureau of Labor Statistics

Metro DC office clock – Q4 2017

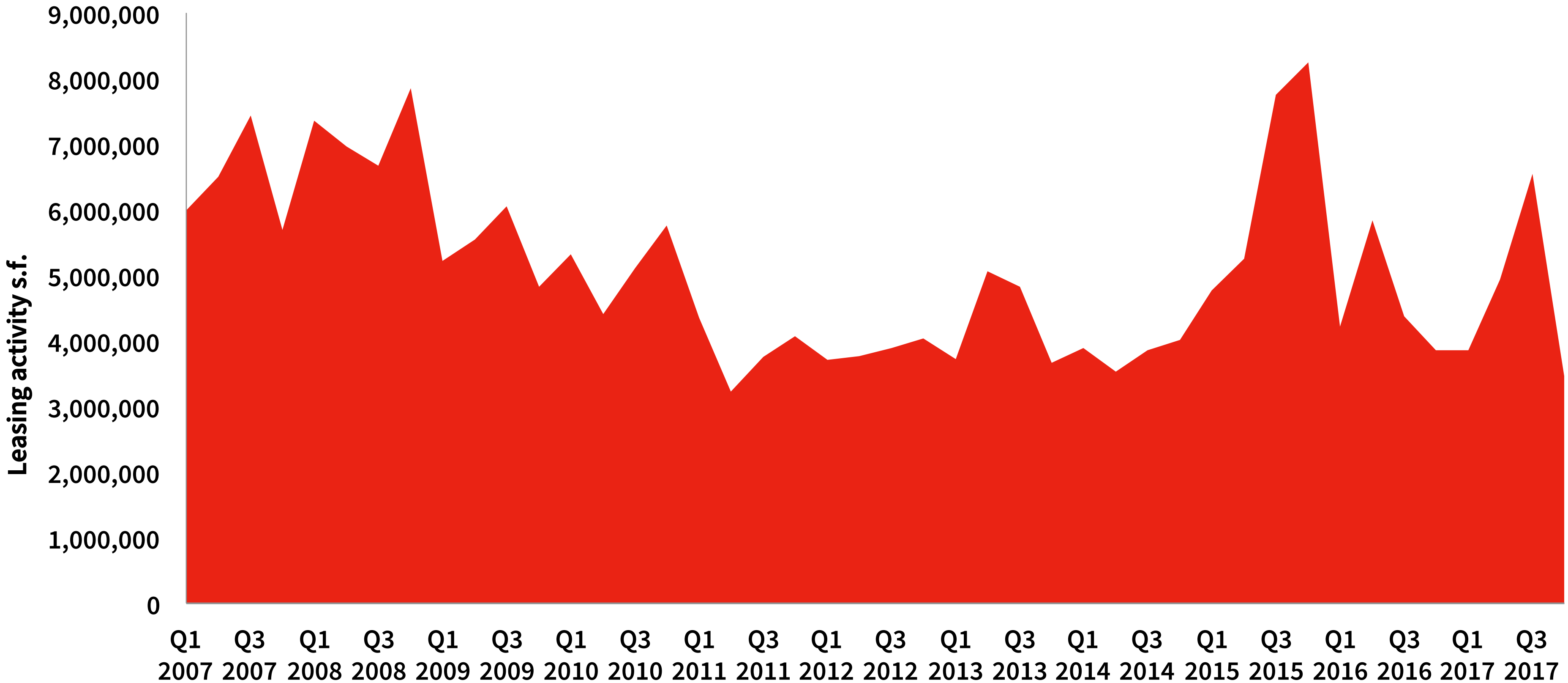
Downtown core markets are approaching peak due to oversupply; suburban transit-oriented markets are tightening and will see more development, while suburban off-transit markets are soft



Source: JLL Research

Metro DC office leasing (s.f.)

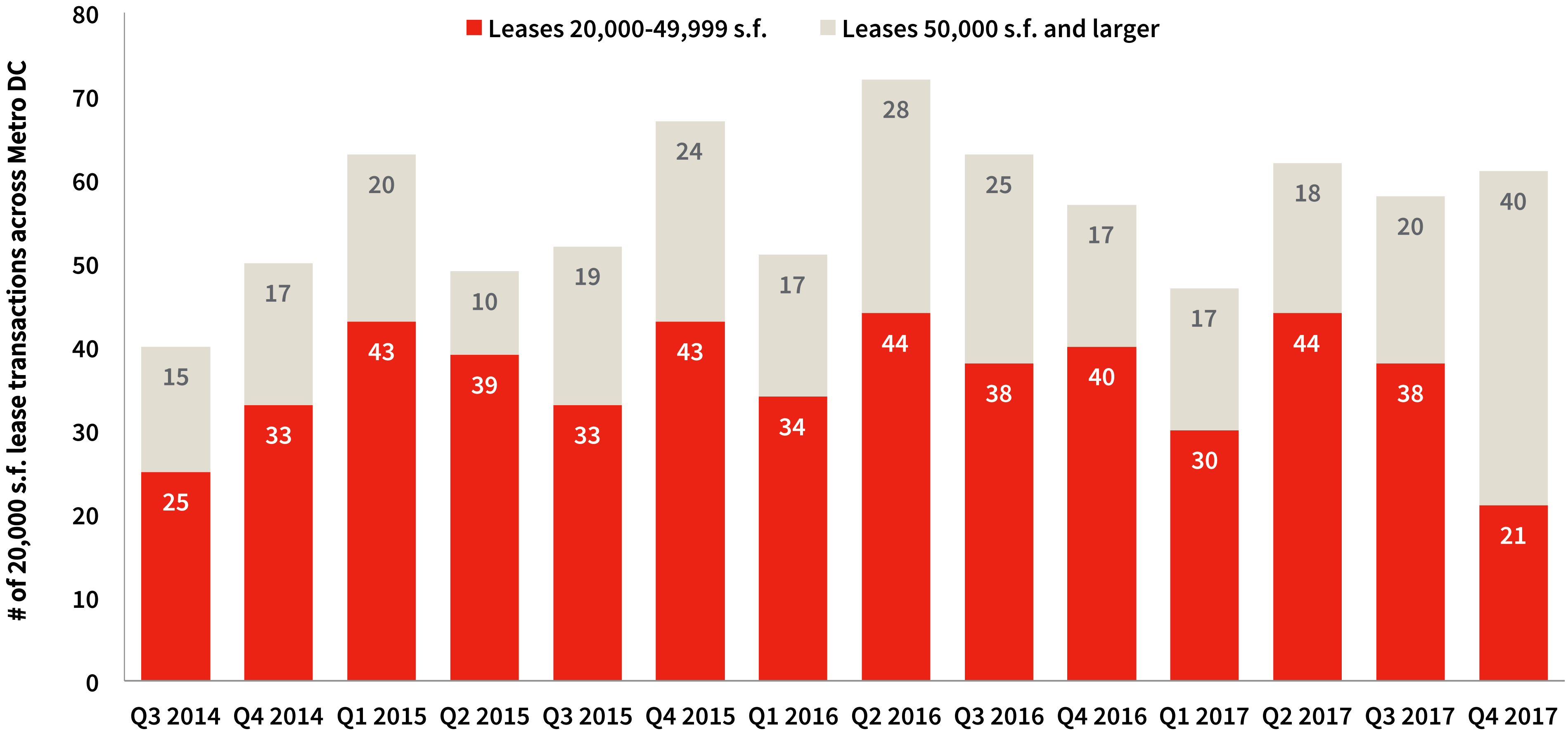
Leasing was down nearly 10% from Q4 2016 and more than 46% from Q3 2017



Source: JLL Research

Metro DC office leasing > 20,000 s.f. (#)

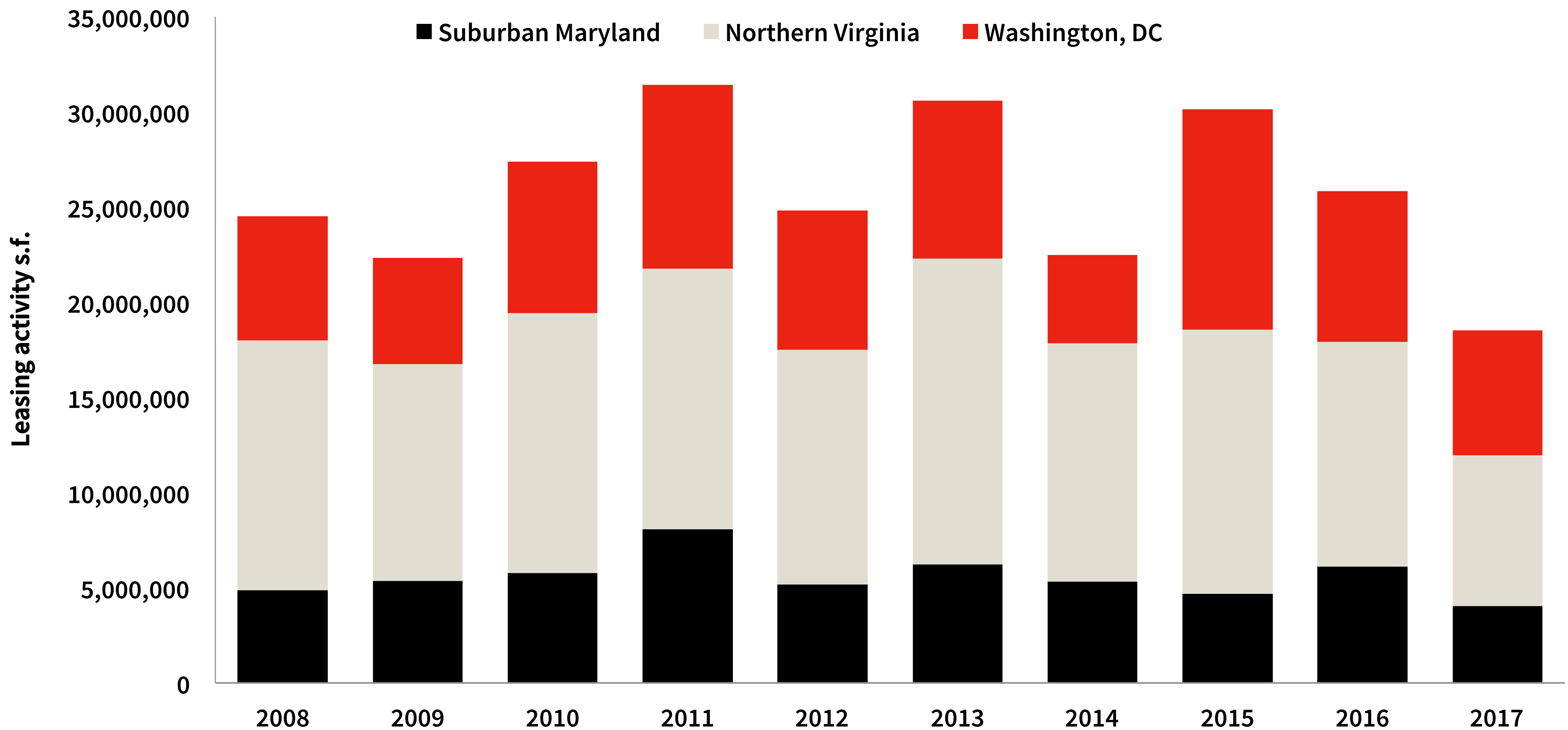
Leasing velocity in the sub-50,000-s.f. range reaches highest point in three years, but the lack of any leases > 400,000 s.f. pushed overall leasing levels down y-o-y and q-o-q



Source: JLL Research

Metro DC office leasing by area (s.f.)

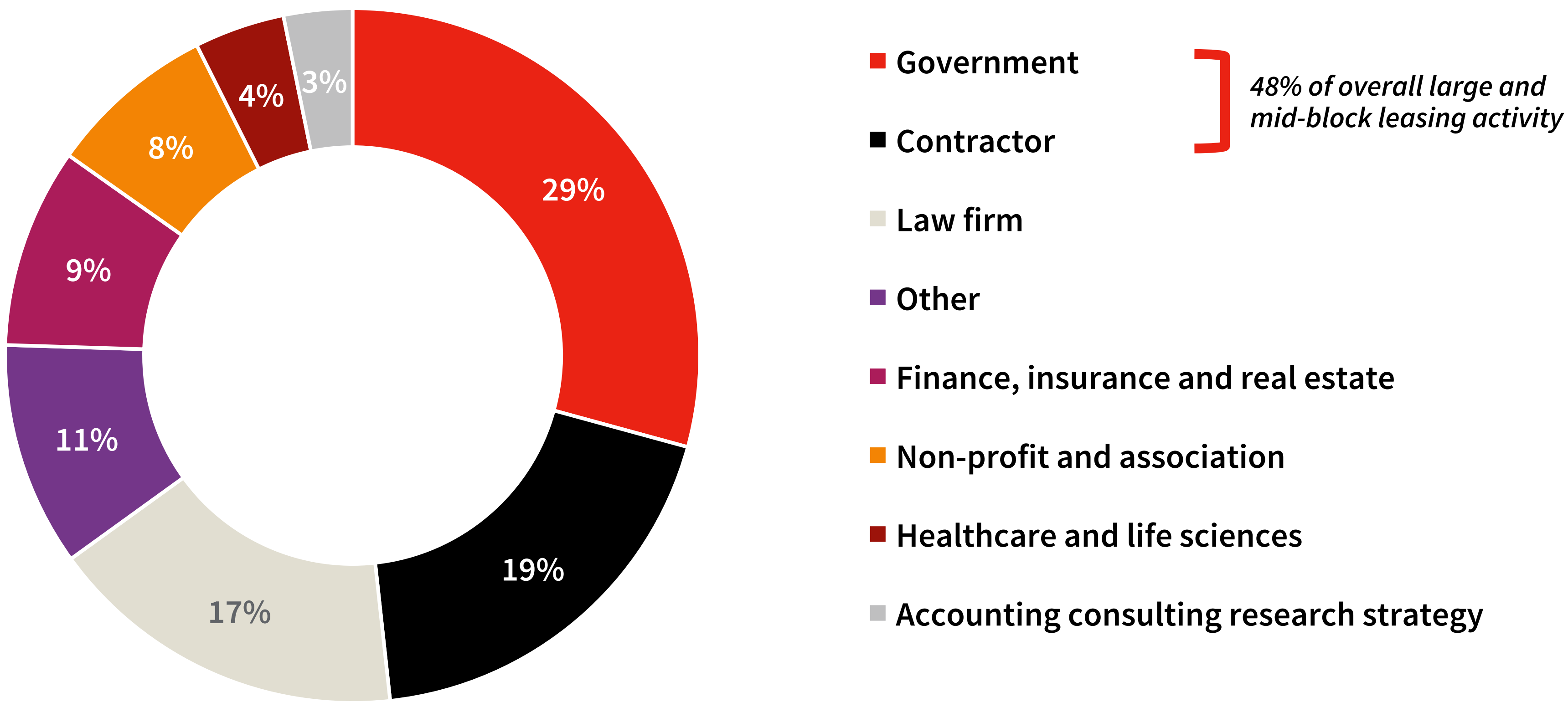
Leasing activity was down across the board, 33% y-o-y in the suburbs and 17% downtown; Northern Virginia experienced the least activity in more than a decade



Source: JLL Research

Metro DC office leasing by industry

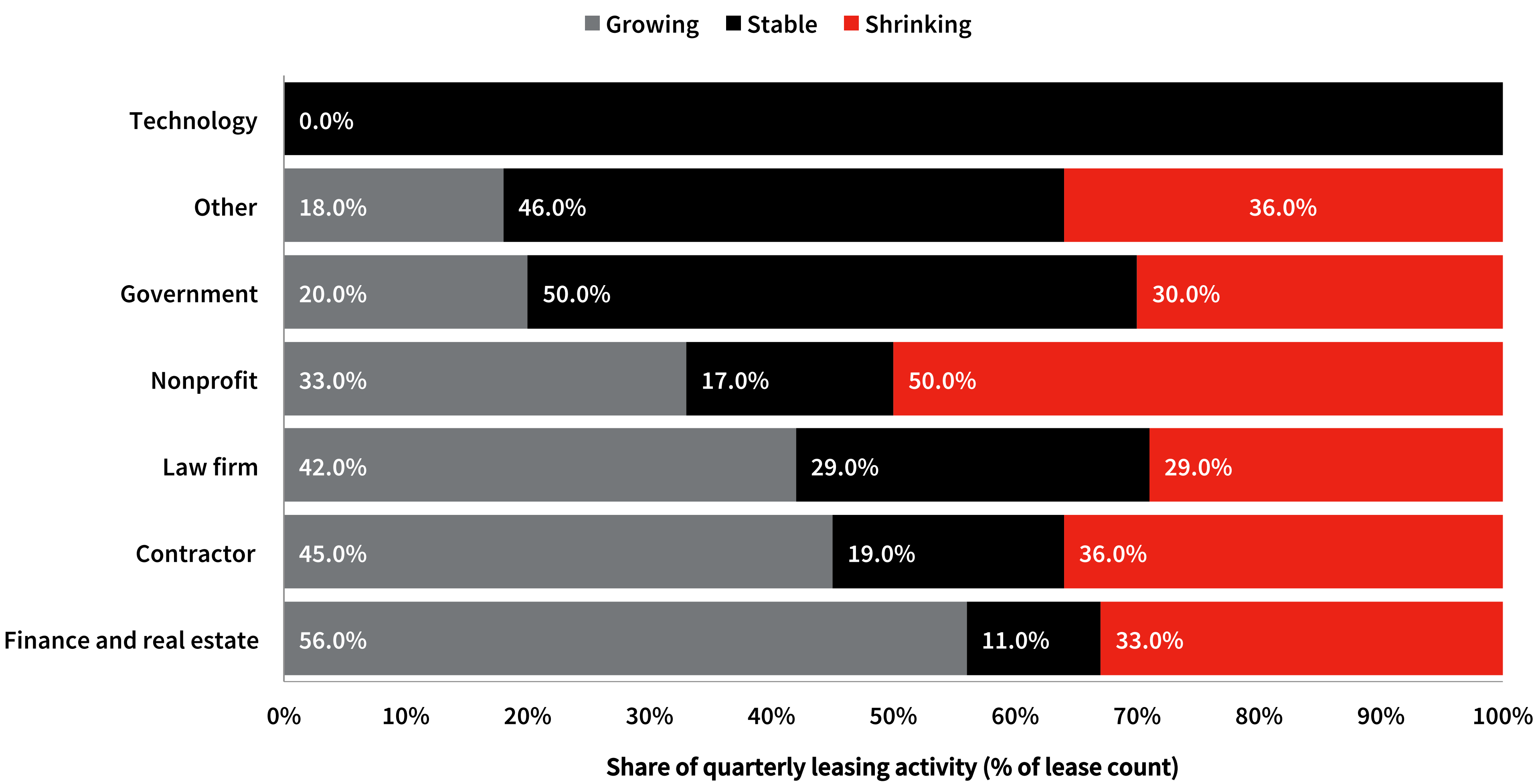
Government and contractors once again dominated mid-block and large-block leasing activity, accounting for 48% of overall leasing activity > 20,000 s.f. after comprising 58% last quarter and 54% in Q2 2017, demonstrating the market remains highly dependent on stagnant demand drivers



Source: JLL Research

Metro DC office leasing by footprint

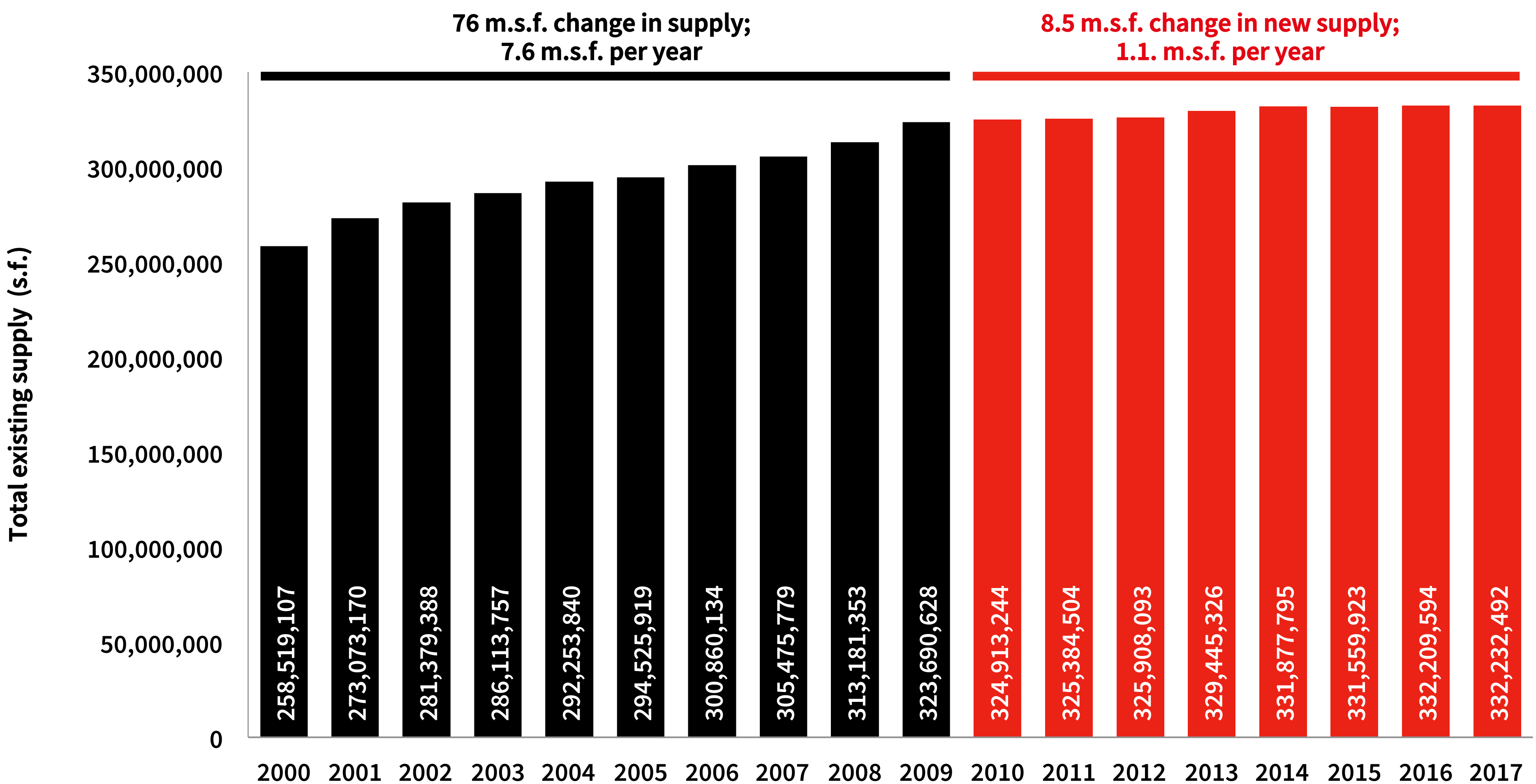
Despite increased frequency of expansions and growth in certain sectors, 1/3 of all leases involve contractions in Q4



Source: JLL Research

Metro DC office supply

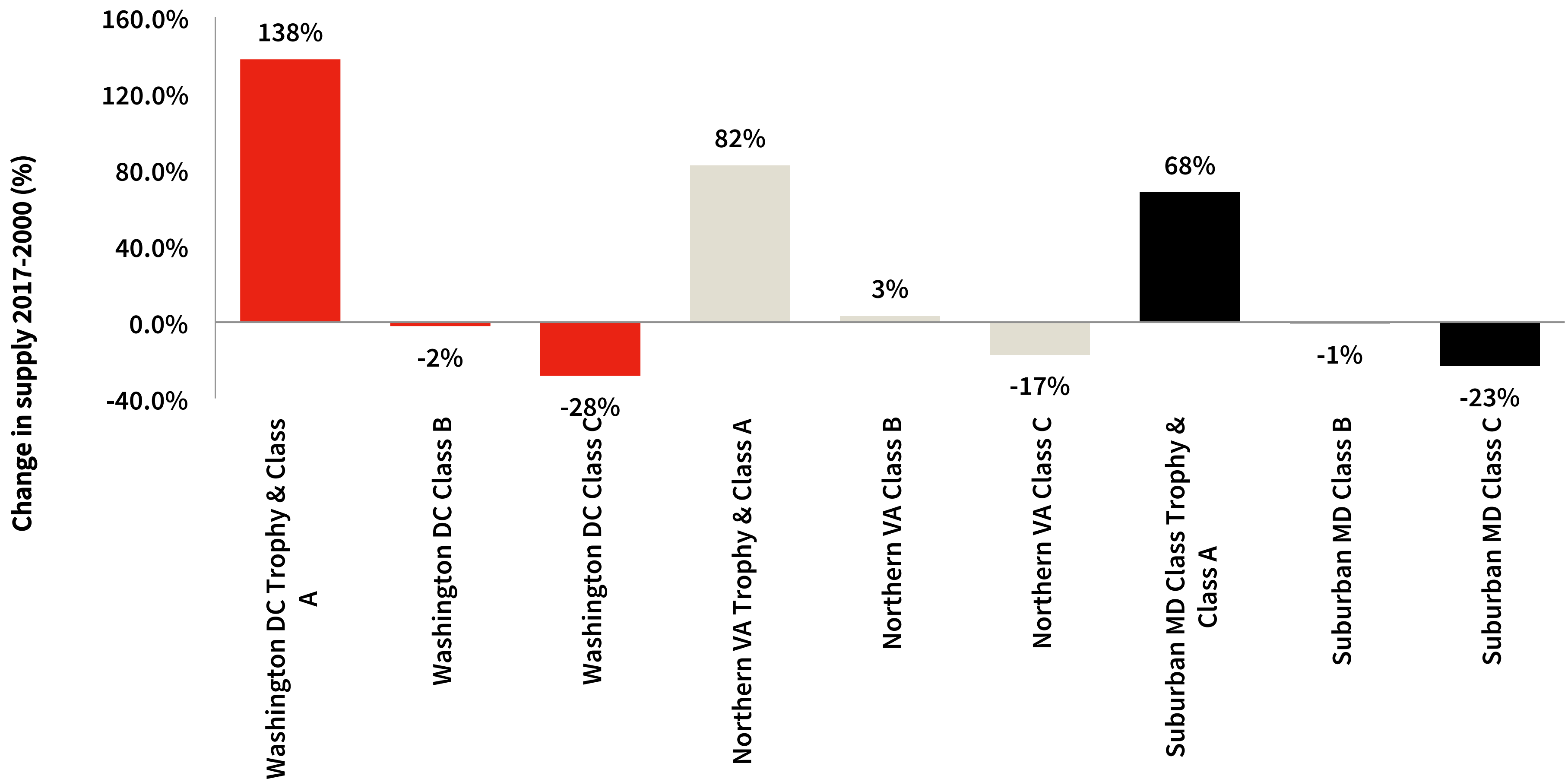
The change in annual supply levels have decreased more than 85% from 2010-2017 compared to 2000-2009



Source: JLL Research

Metro DC office supply by class and area

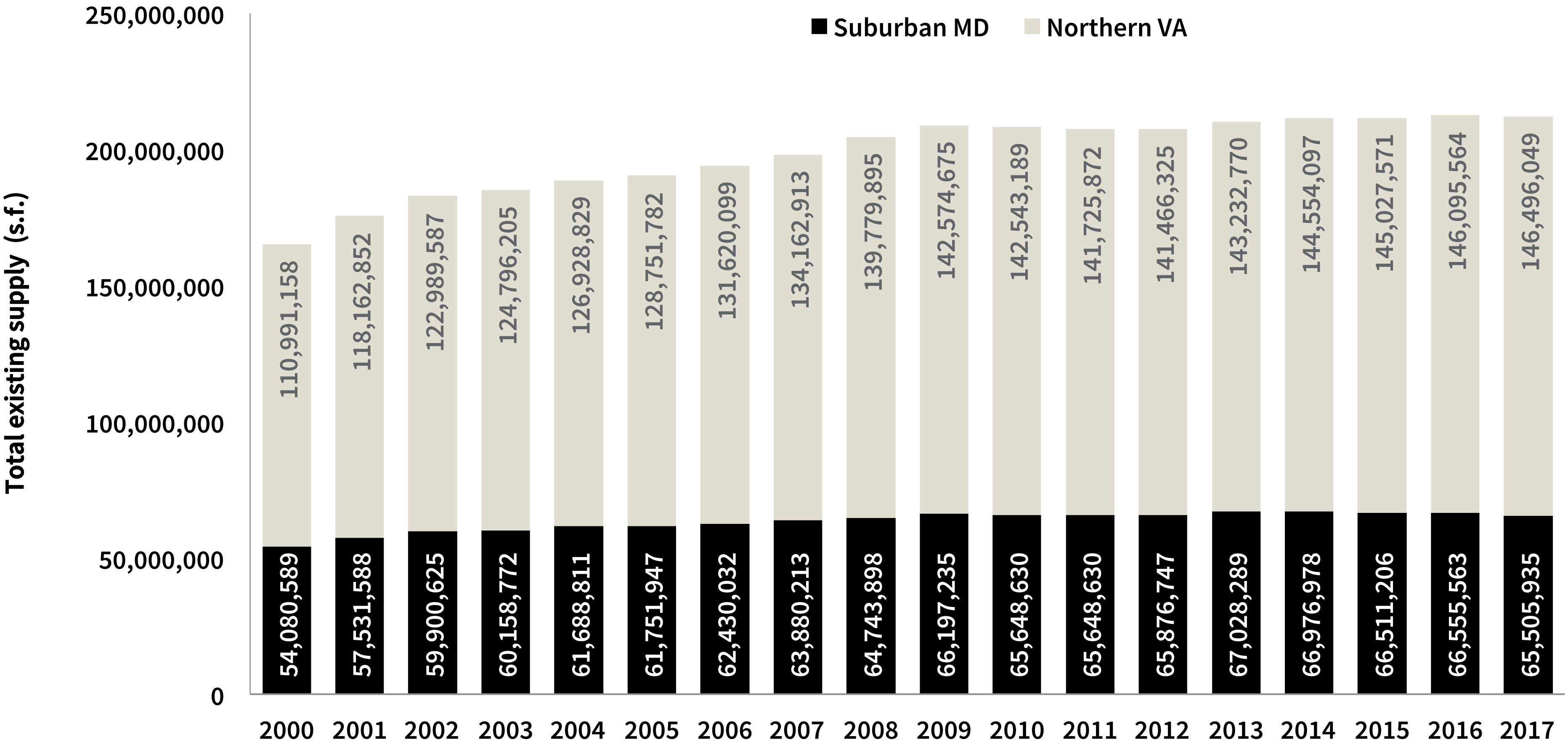
While Trophy and Class A supply levels have nearly doubled across each market, Class B and C supply levels have largely declined over time, presenting challenges for cost-conscious tenants



Source: JLL Research

Metro DC suburban office supply

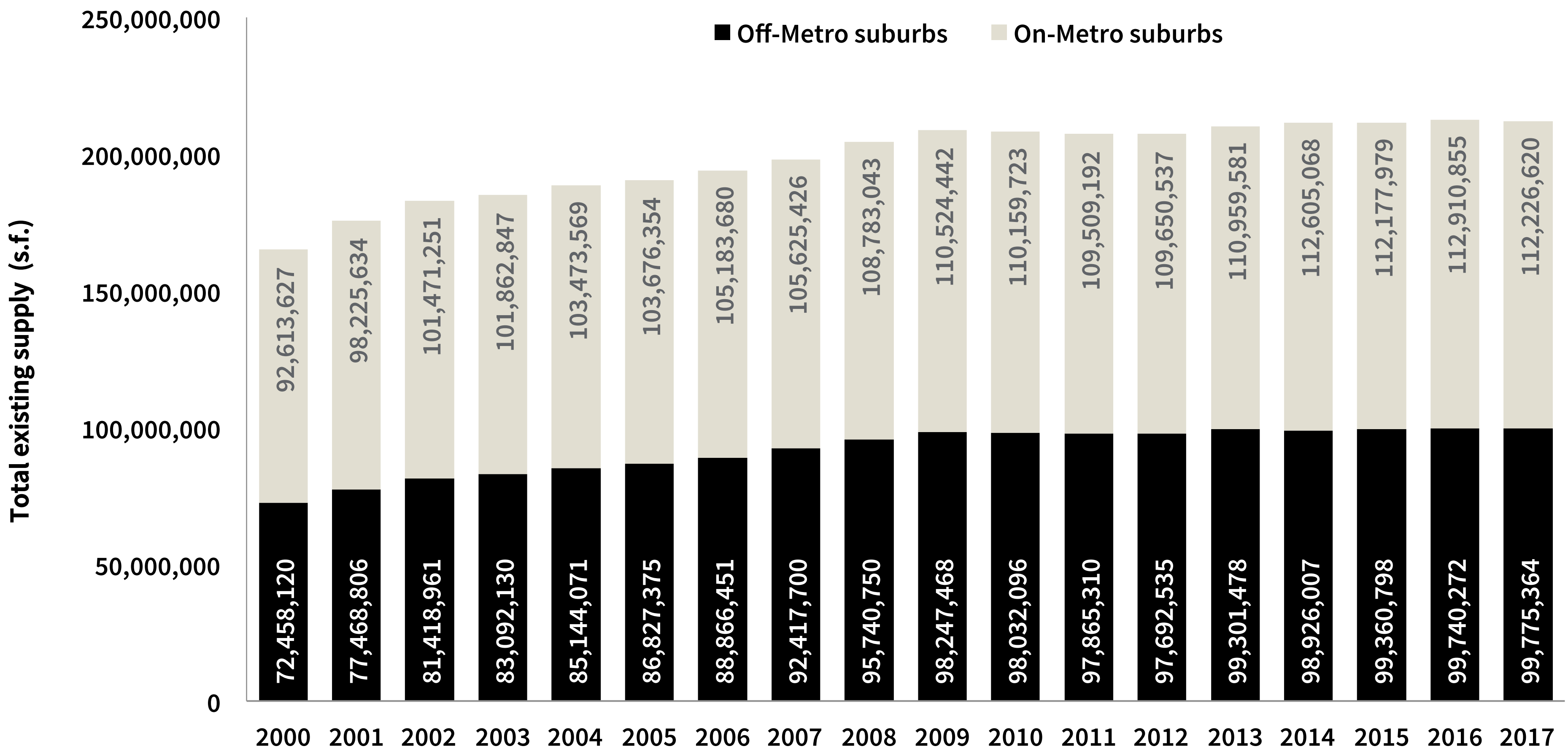
Recent conversion activity in the suburbs has stabilized supply levels with only 3.2 m.s.f. of new office supply delivering in the suburbs since the end of 2009 compared to 43.7 m.s.f. of net new suburban supply delivering from 2000-2009



Source: JLL Research

Metro DC suburban office supply

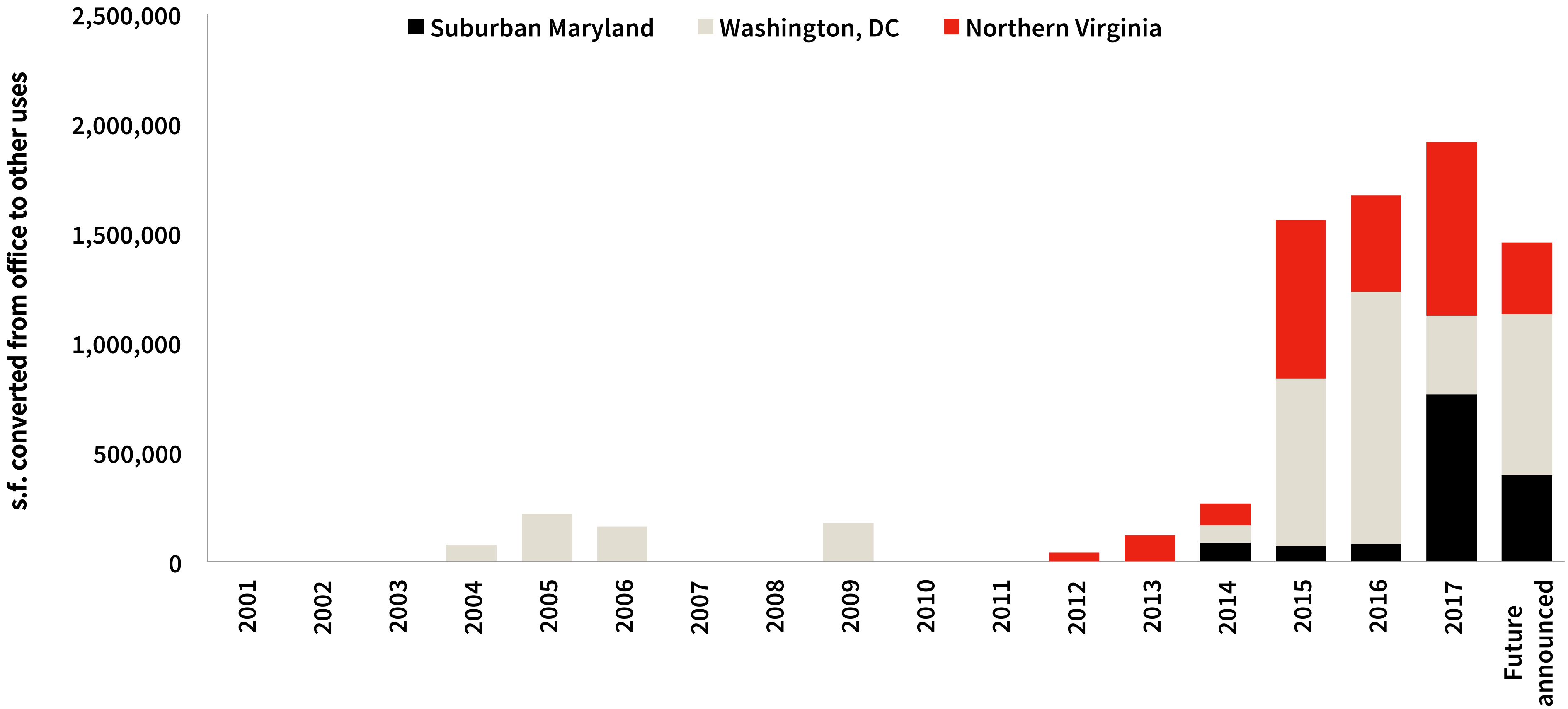
Surprisingly, off-Metro suburban supply (37.7% growth) has outpaced on-Metro suburban supply (21.1% growth) since 2000 and even in recent years, which is likely to reverse completely in the next few cycles



Source: JLL Research

Metro DC office conversions

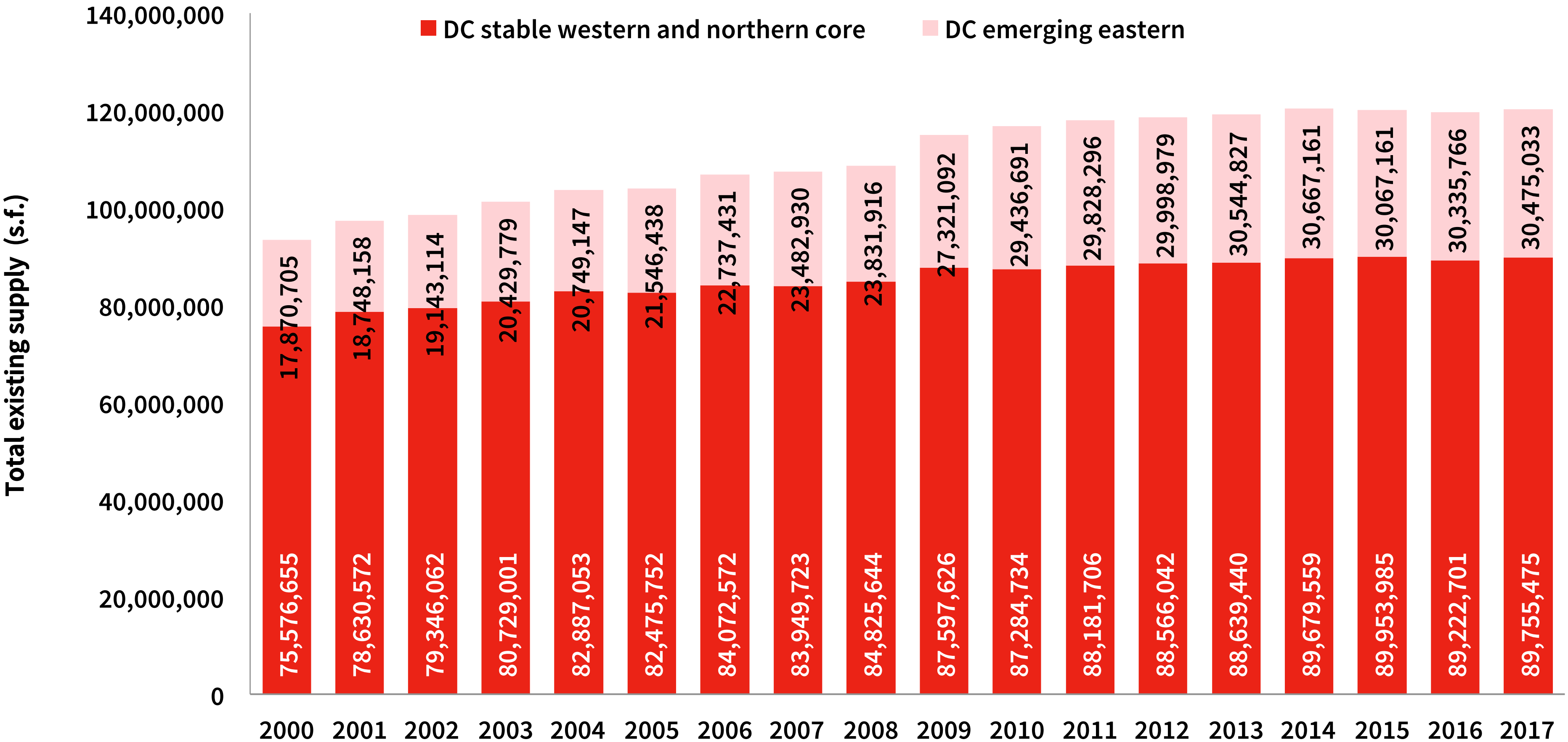
Over the past 2.5 years, more office product has been converted than in the prior 10 years combined; will the DC Council introduce a law that incentivizes conversions from office to MF?



Source: JLL Research

Washington, DC office supply

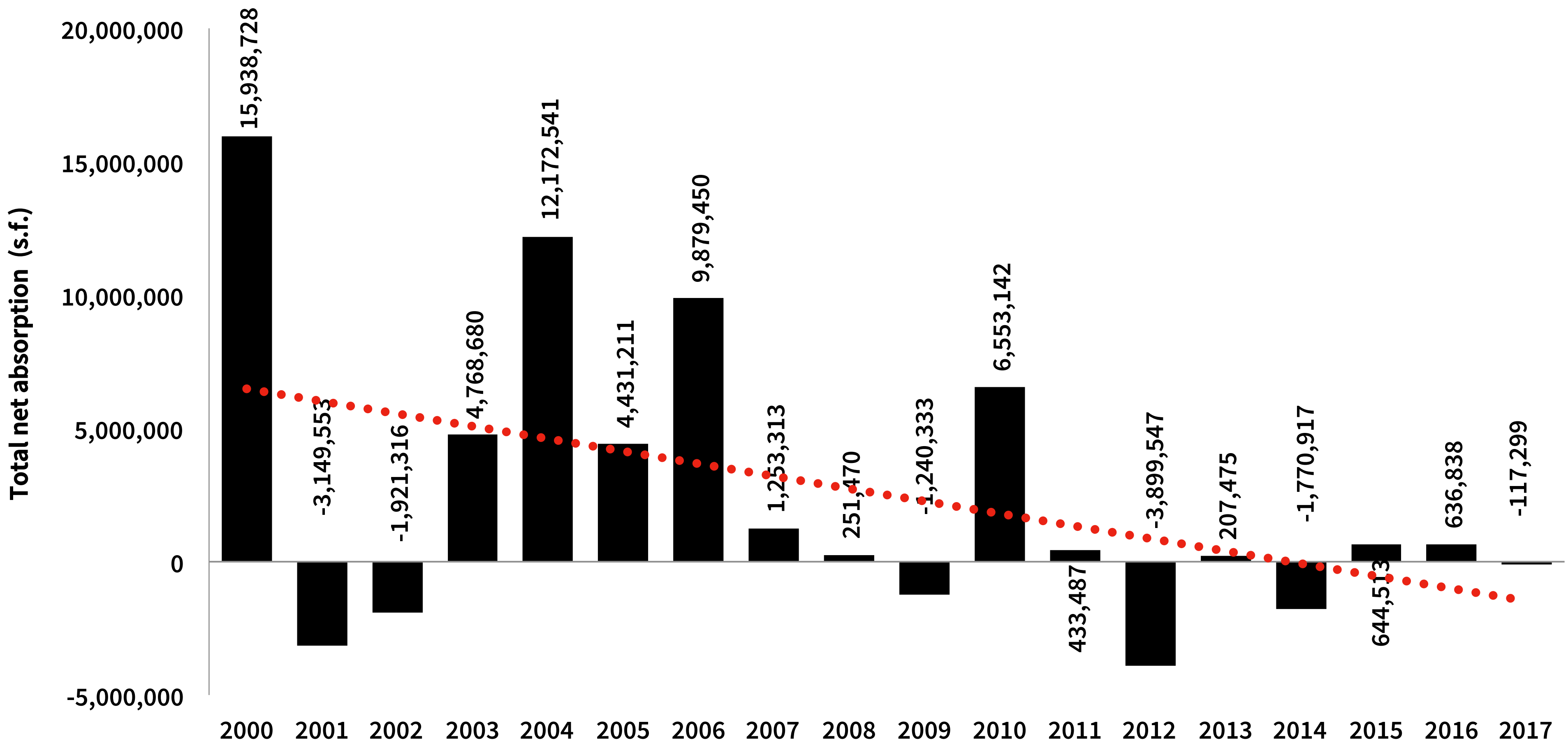
Inventory levels in the western and northern core and stable markets have grown by 18.8% since 2000, while emerging eastern market supply levels have grown almost four times that at 70.5%



Source: JLL Research

Metro DC office net absorption

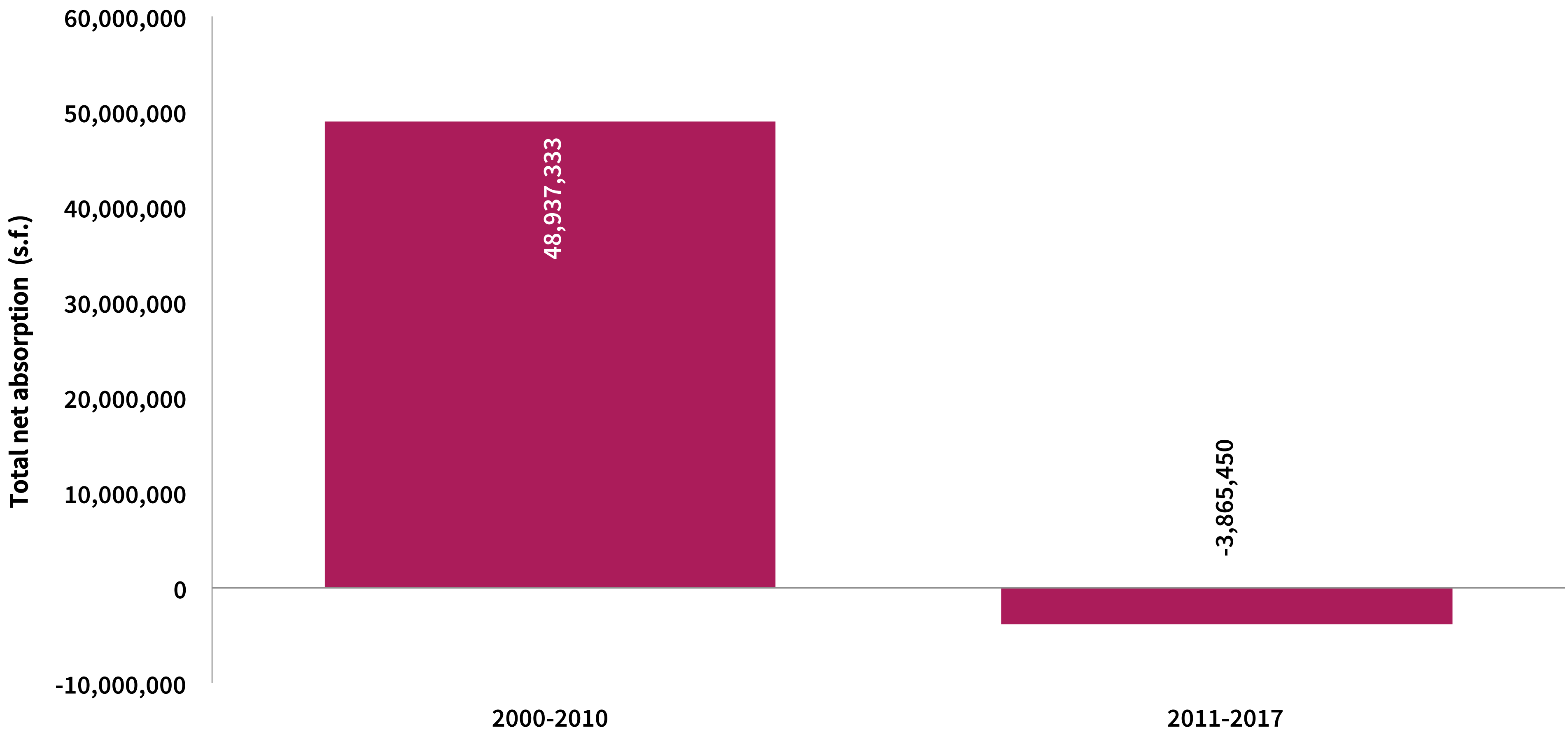
Since 2011, the market has posted 3.9 m.s.f. of total occupancy losses (552,000 s.f. annually) due to sequestration, BRAC, rightsizing, and most recently, conversion activity. Compare that to historical standards when annual net absorption levels averaged 4.4 m.s.f. prior to 2011



Source: JLL Research

Metro DC office net absorption

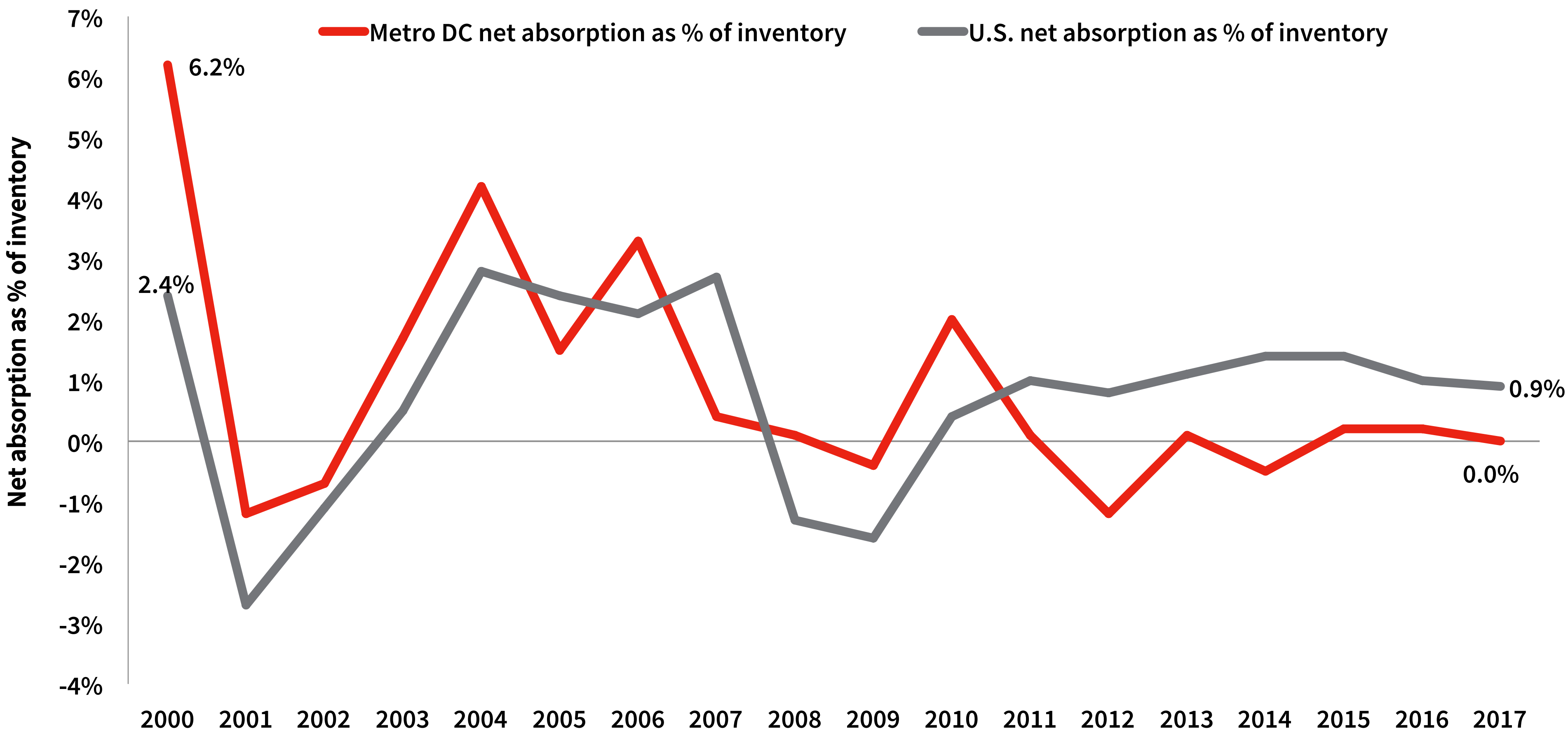
Not a s.f. of space has been absorbed in Metro DC the past seven years



Source: JLL Research

Office absorption as% of inventory

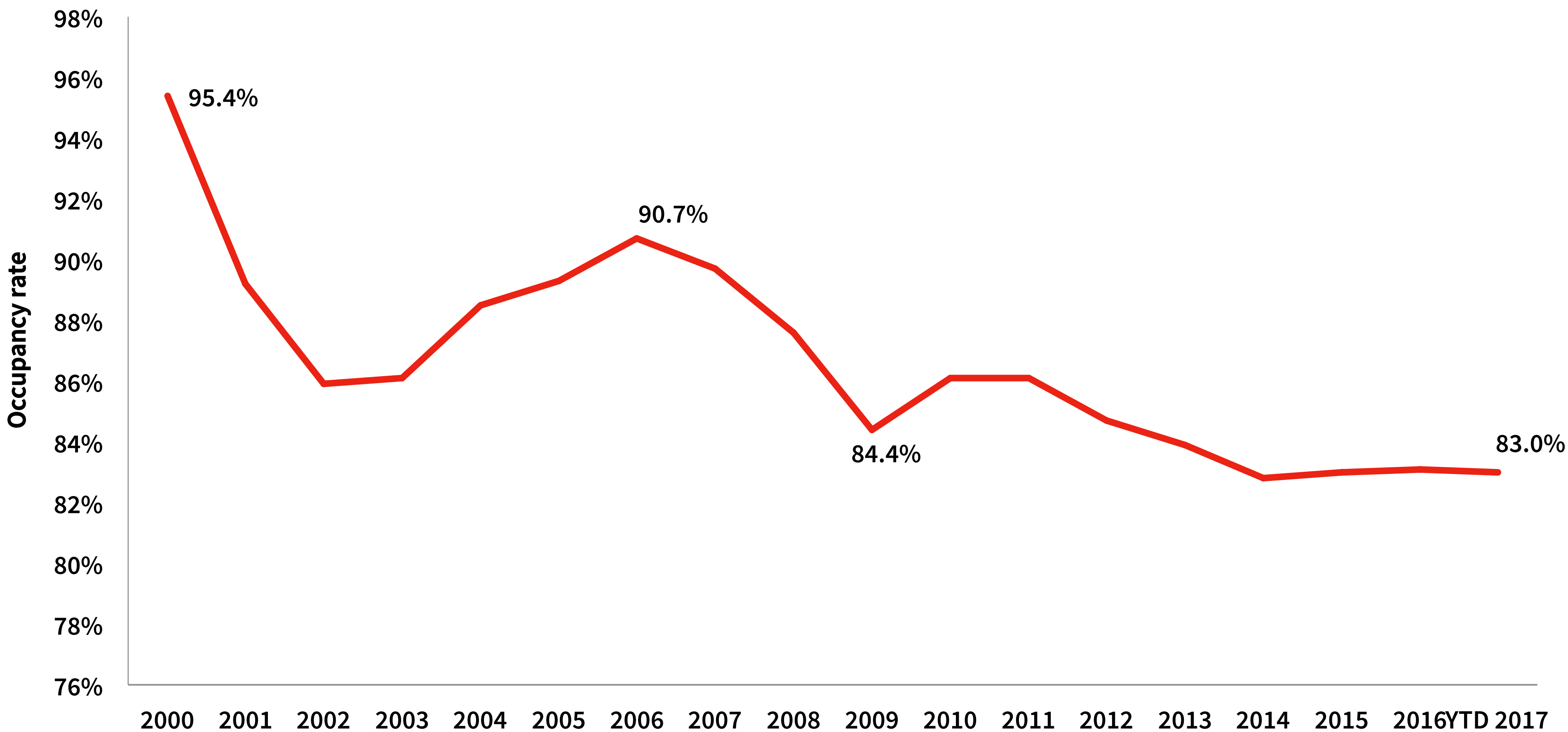
While the Metro DC office market consistently outpaced the U.S. office market from a demand perspective up until 2007, the tide has turned since 2011



Source: JLL Research

Metro DC office occupancy rate

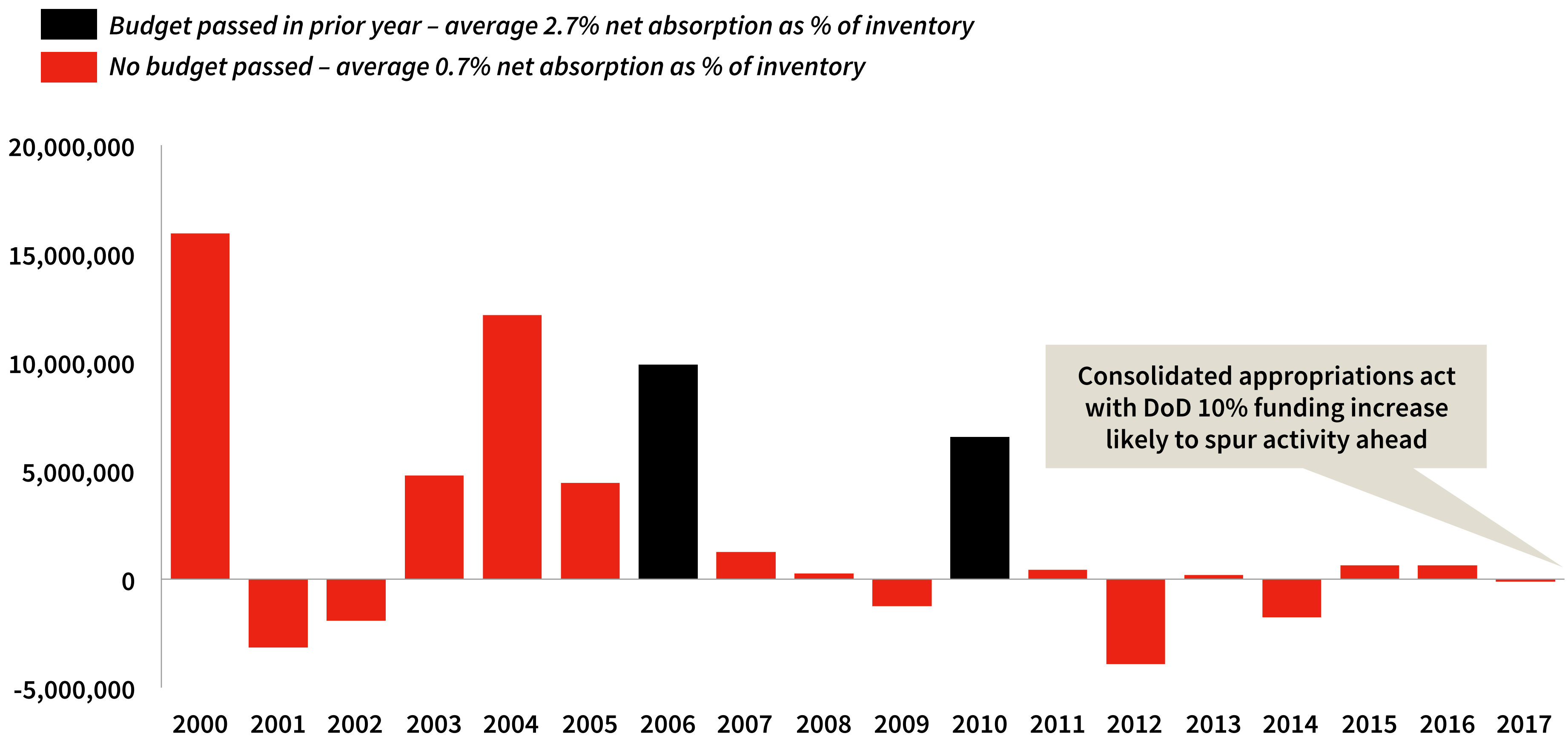
Occupancy across the regional office market has fallen by more than 700 basis points since peaking in 2006, dipping to one of its lowest points on record



Source: JLL Research

Budgets & Metro DC office net absorption

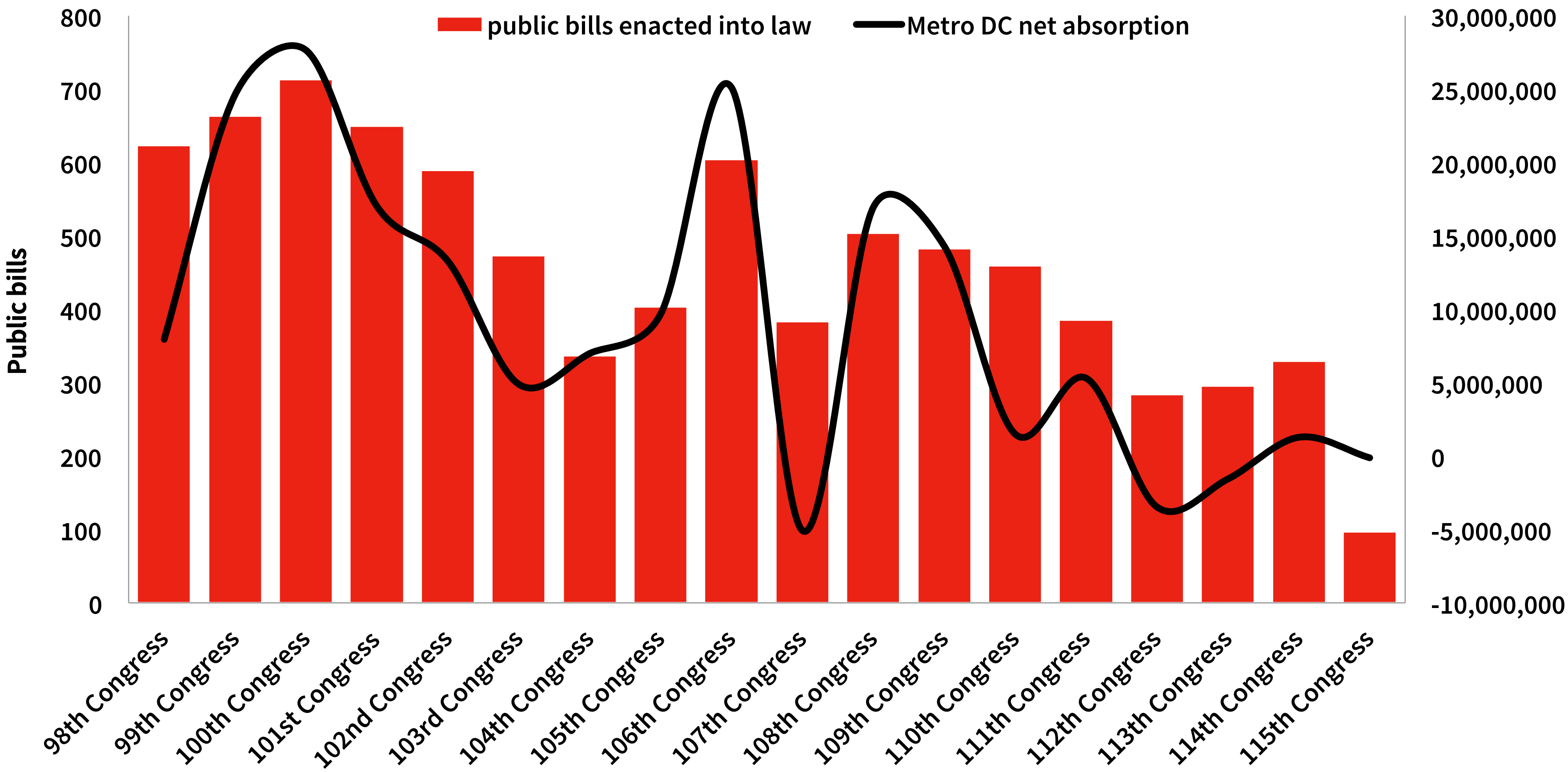
Budget approval in recent history is rare, but when a budget does pass, there is strong evidence that it fuels office demand; budgets are unlikely in the next few years based on political climate



Source: JLL Research

Legislation & Metro DC office net absorption

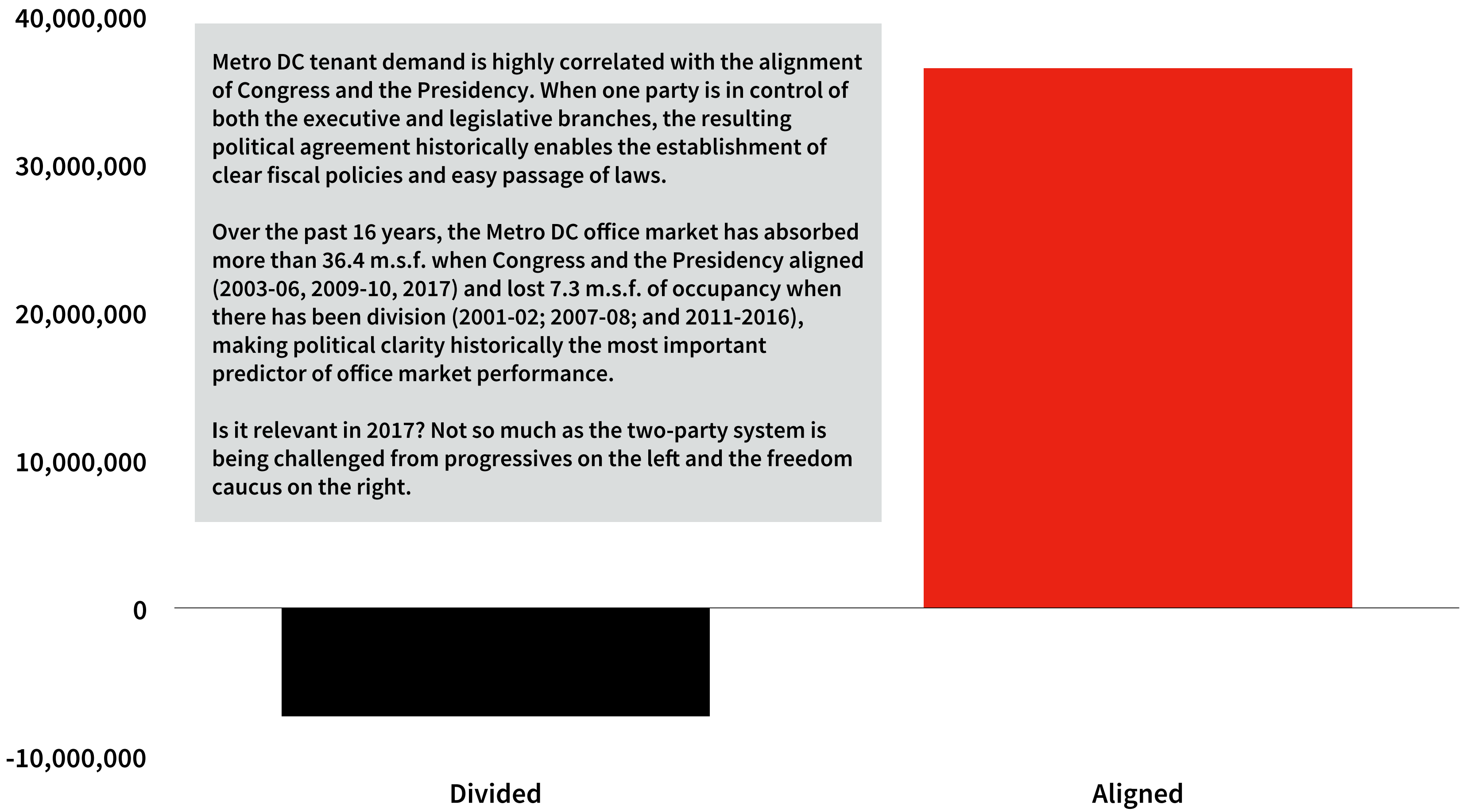
The 115th Congress is on historical pace to be the least effective in modern history, meaning this Congress is on track to pass the least legislation. Through the end of 2017, the 115th Congress has only enacted 97 bills into law



Source: JLL Research

Political alignment & office net absorption

Political alignment drives Metro DC office demand historically, but not as relevant in this cycle due to the 2-party system being challenged from the extremes of both political parties



Metro DC tenant demand is highly correlated with the alignment of Congress and the Presidency. When one party is in control of both the executive and legislative branches, the resulting political agreement historically enables the establishment of clear fiscal policies and easy passage of laws.

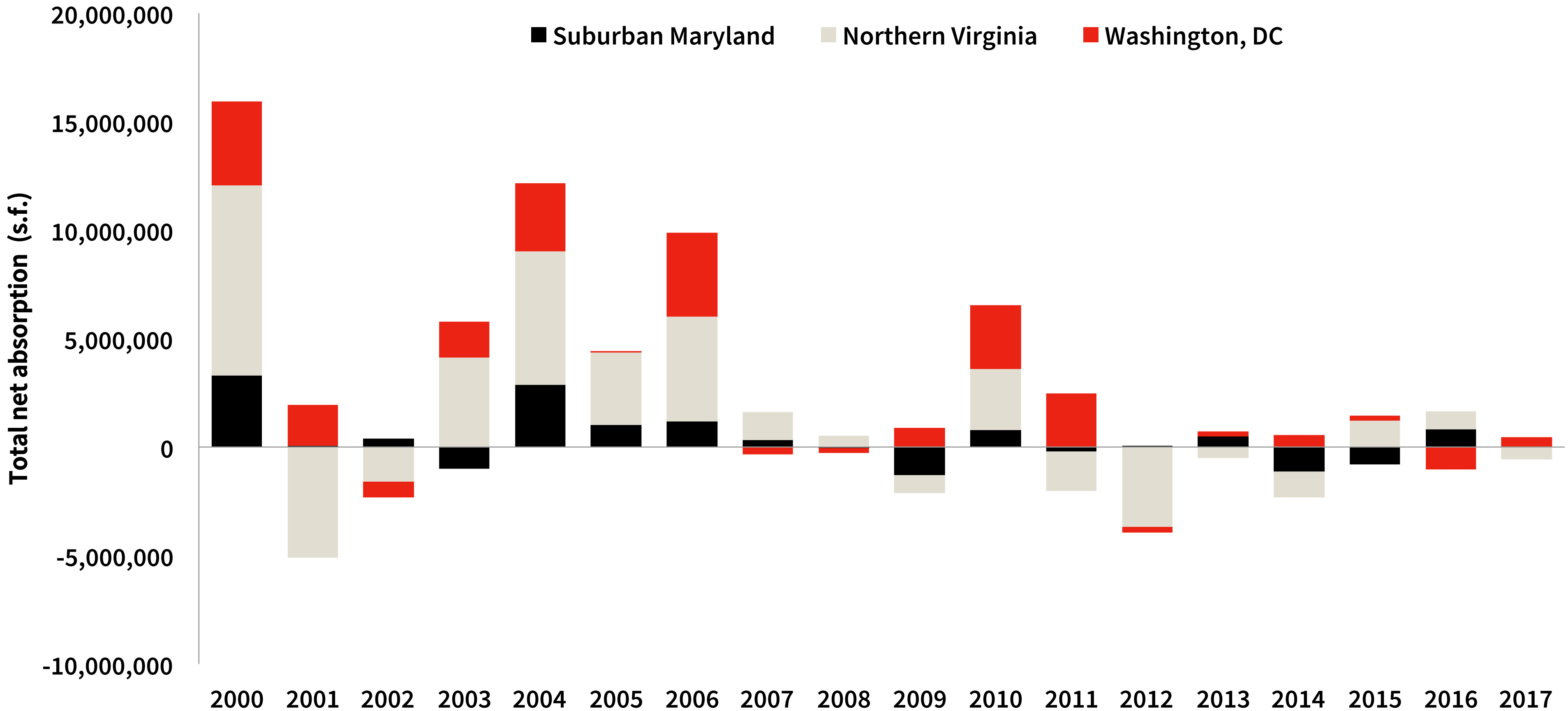
Over the past 16 years, the Metro DC office market has absorbed more than 36.4 m.s.f. when Congress and the Presidency aligned (2003-06, 2009-10, 2017) and lost 7.3 m.s.f. of occupancy when there has been division (2001-02; 2007-08; and 2011-2016), making political clarity historically the most important predictor of office market performance.

Is it relevant in 2017? Not so much as the two-party system is being challenged from progressives on the left and the freedom caucus on the right.

Source: JLL Research

Metro DC office net absorption by area

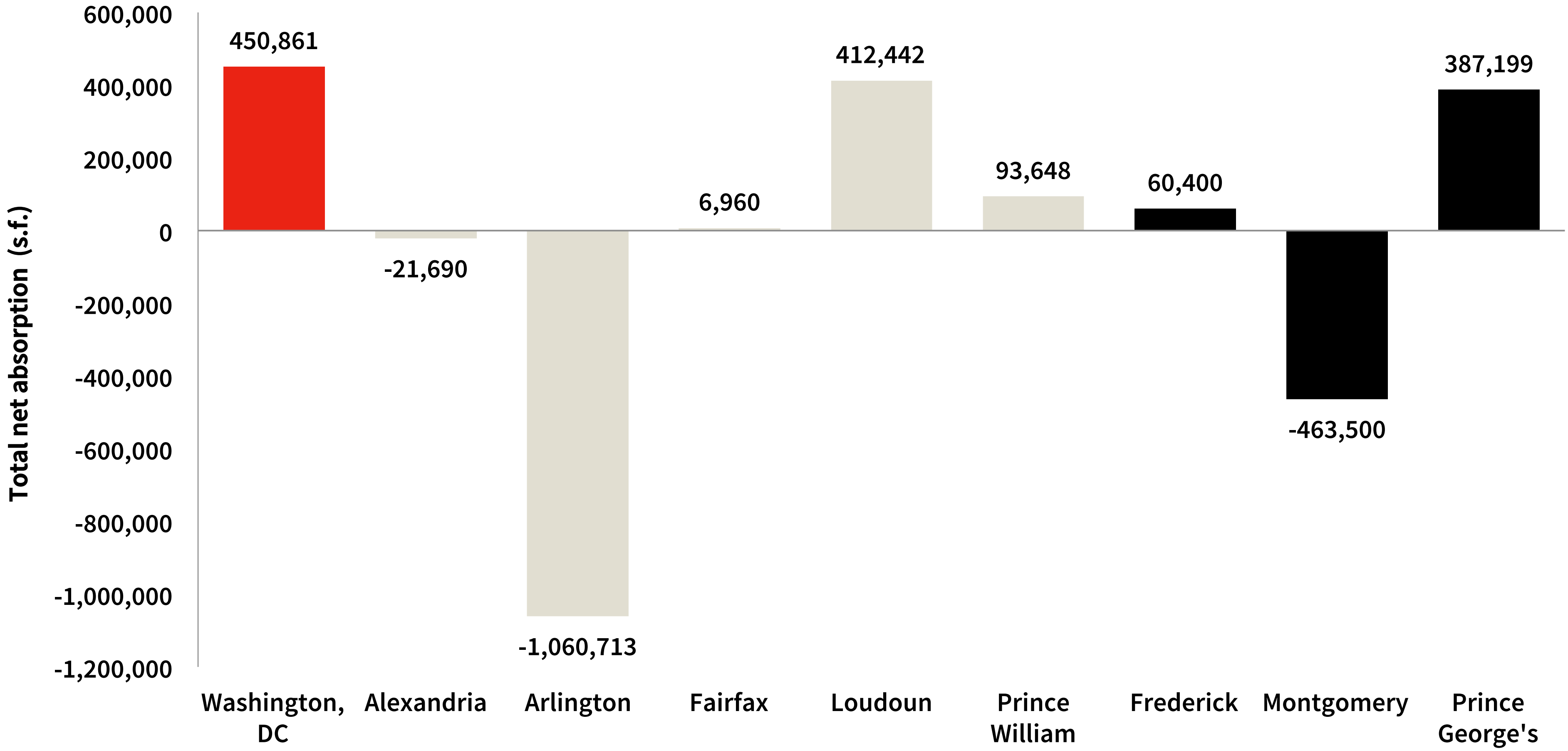
Broken down regionally by Suburban MD, Northern VA and Washington DC, none of the markets have been immune from the fundamental change in tenant demand patterns, but DC has experienced occupancy growth in seven of the past nine years



Source: JLL Research

2017 office net absorption by county

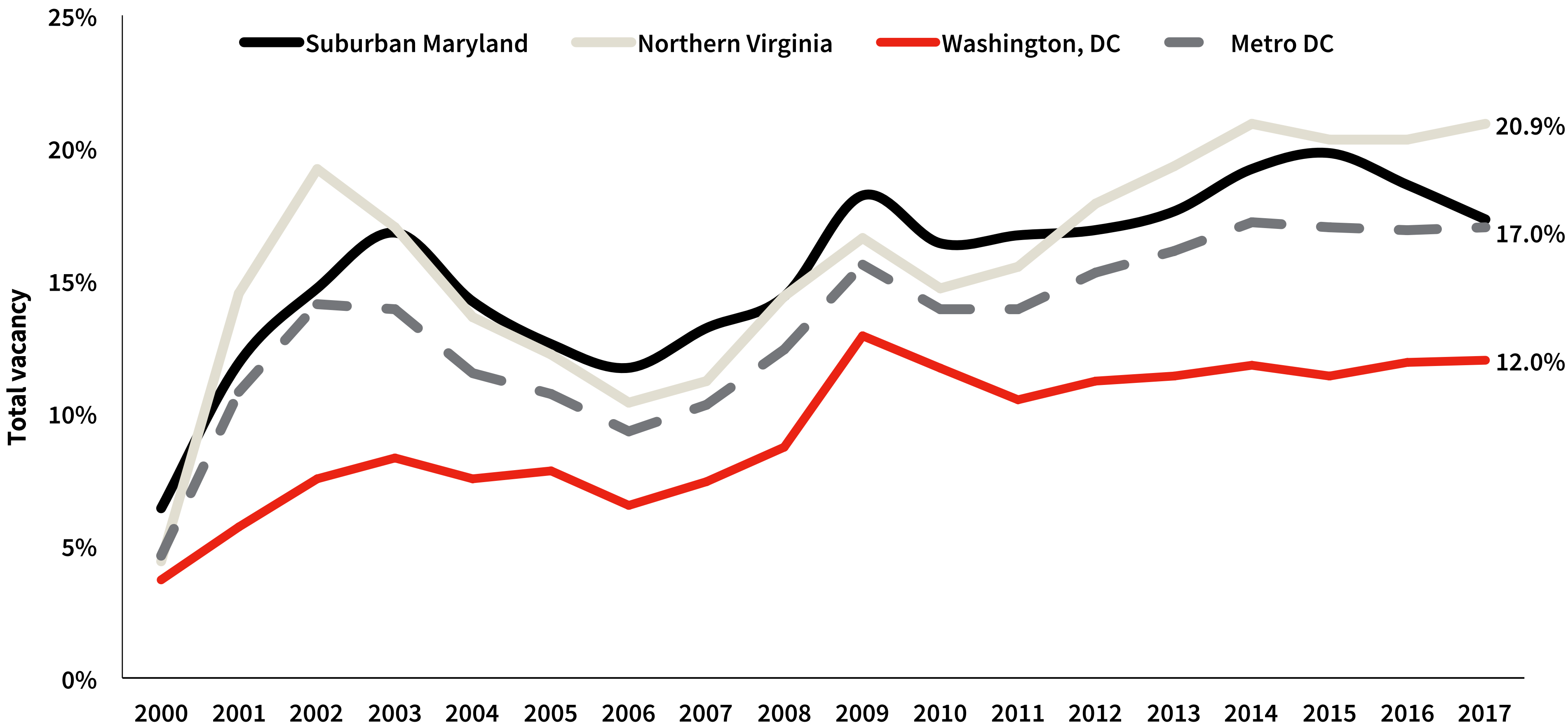
DC, Loudoun and Prince George's County drove the majority of office gains in 2017, while the inner suburbs of Montgomery and Arlington posted nearly 1.5 million s.f. of occupancy losses, mainly due to conversion activity, a positive sign for balancing the market



Source: JLL Research

Metro DC office total vacancy

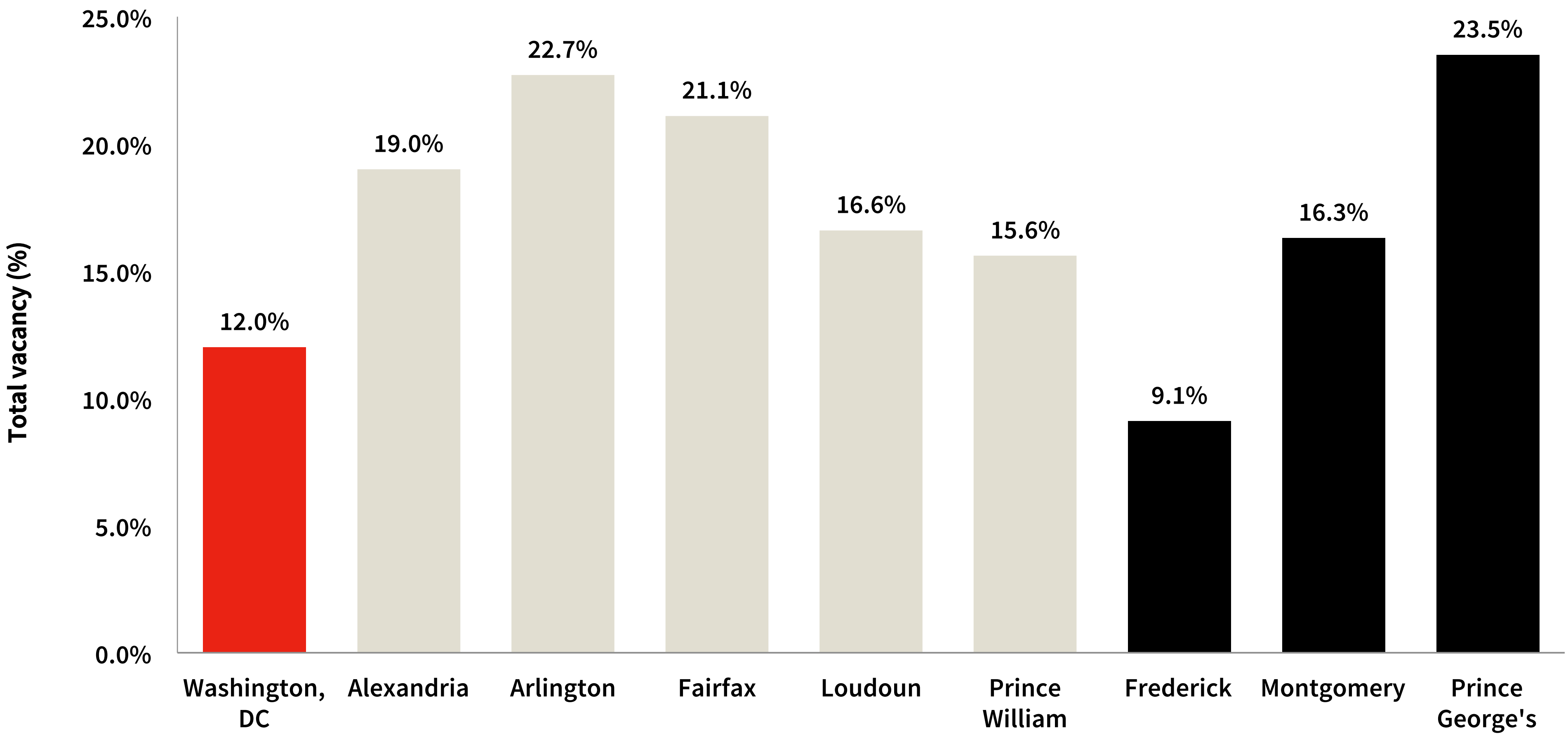
Only Suburban Maryland has seen a meaningful shift downward in vacancy the past 36 months; DC will see vacancy climb over the next 24 months due to its development pipeline



Source: JLL Research

2017 total vacancy by county

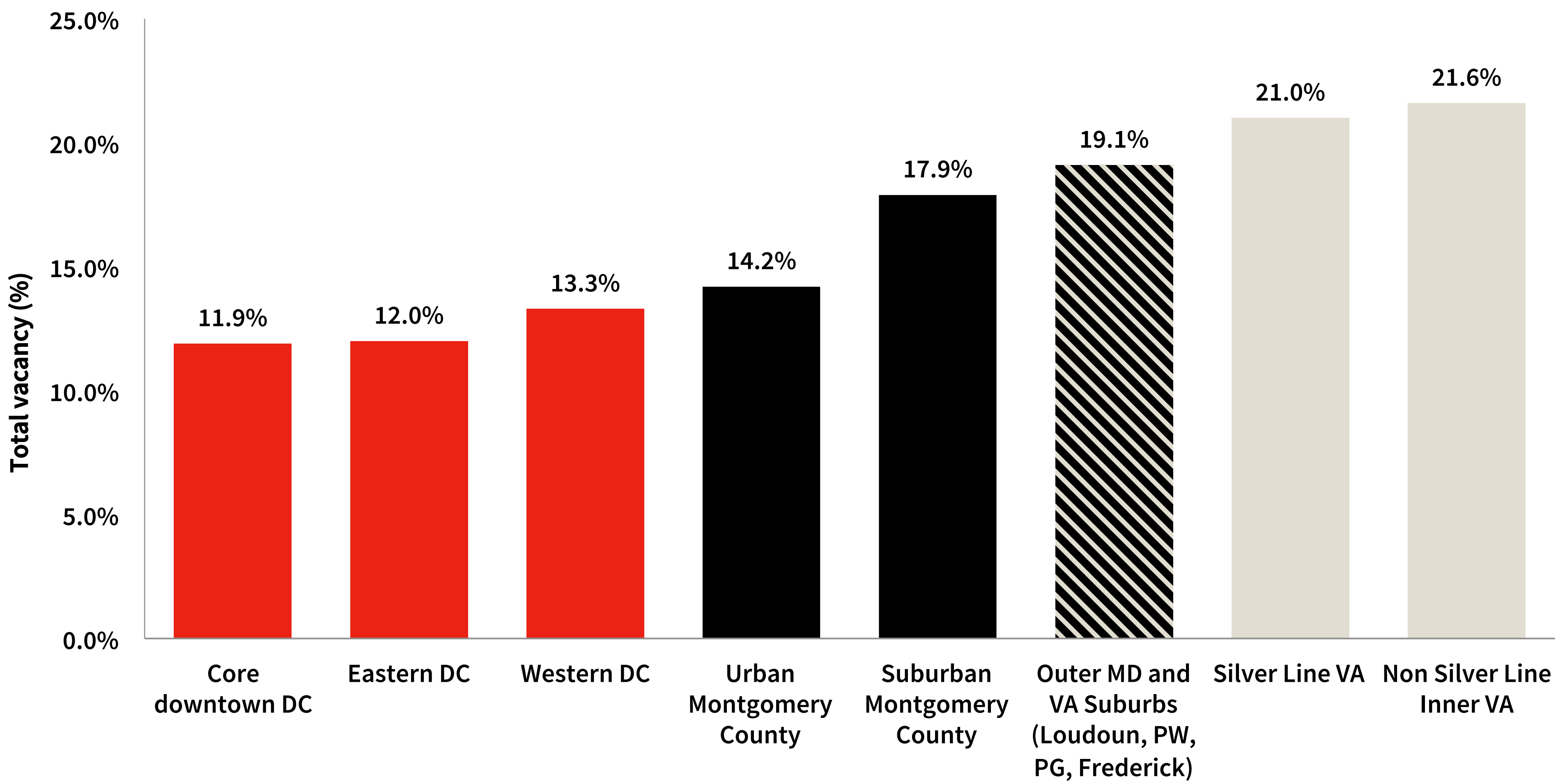
Only Frederick and Washington, DC posted vacancy rates below that of the overall U.S. vacancy rate of 15.0%



Source: JLL Research

2017 total vacancy by cluster

Supply-demand fundamentals are most aligned in Washington, DC and softest in Northern VA



Source: JLL Research

Metro vs. Non-Metro office fundamentals

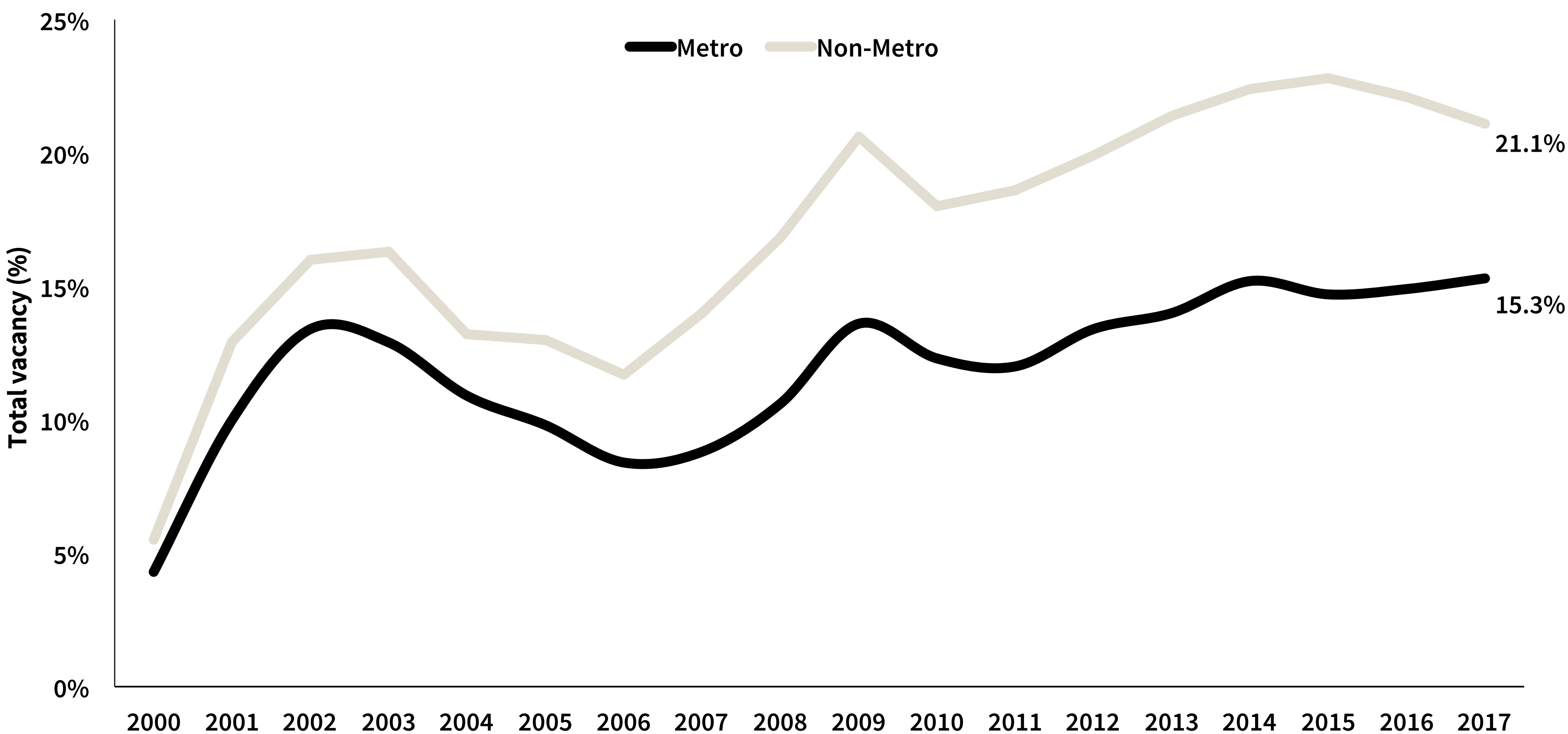
Metro-accessible locations dominate non-Metro-accessible locations from a performance standpoint

metro	Inventory 237 m.s.f.	Total vacancy 15.3%	Direct rent $47.73 p.s.f.	Under construction 11.1 m.s.f.
	71% of market	***-580 bps***	***73% premium***	***9x***
metro	Inventory 96 m.s.f.	Total vacancy 21.1%	Direct rent $27.55 p.s.f.	Under construction 1.2 m.s.f.

Source: JLL Research

Metro DC office total vacancy (Metro access)

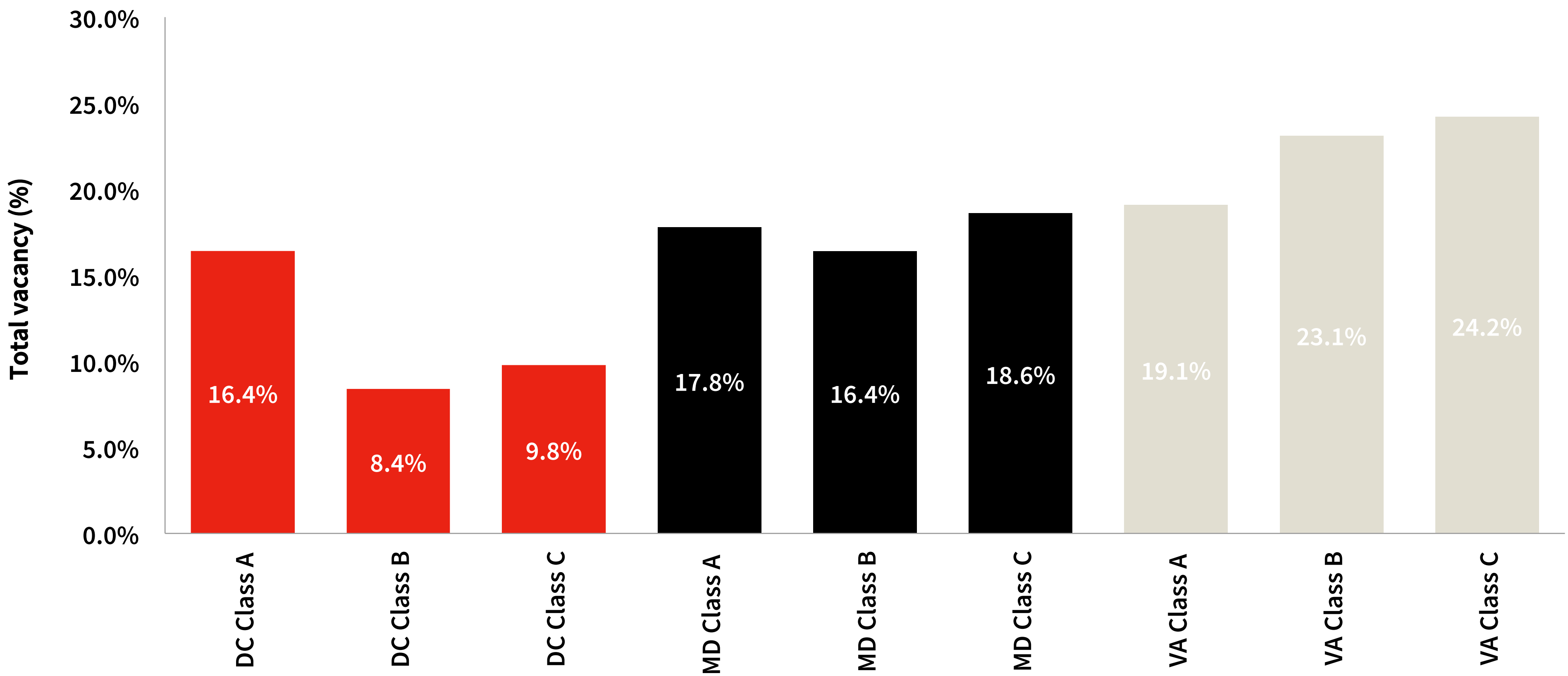
The vacancy gap between Metro and non-Metro locations continues to grow and the spread is now nearly 600 basis points compared to 120 basis points in 2000



Source: JLL Research

Metro DC office total vacancy by class

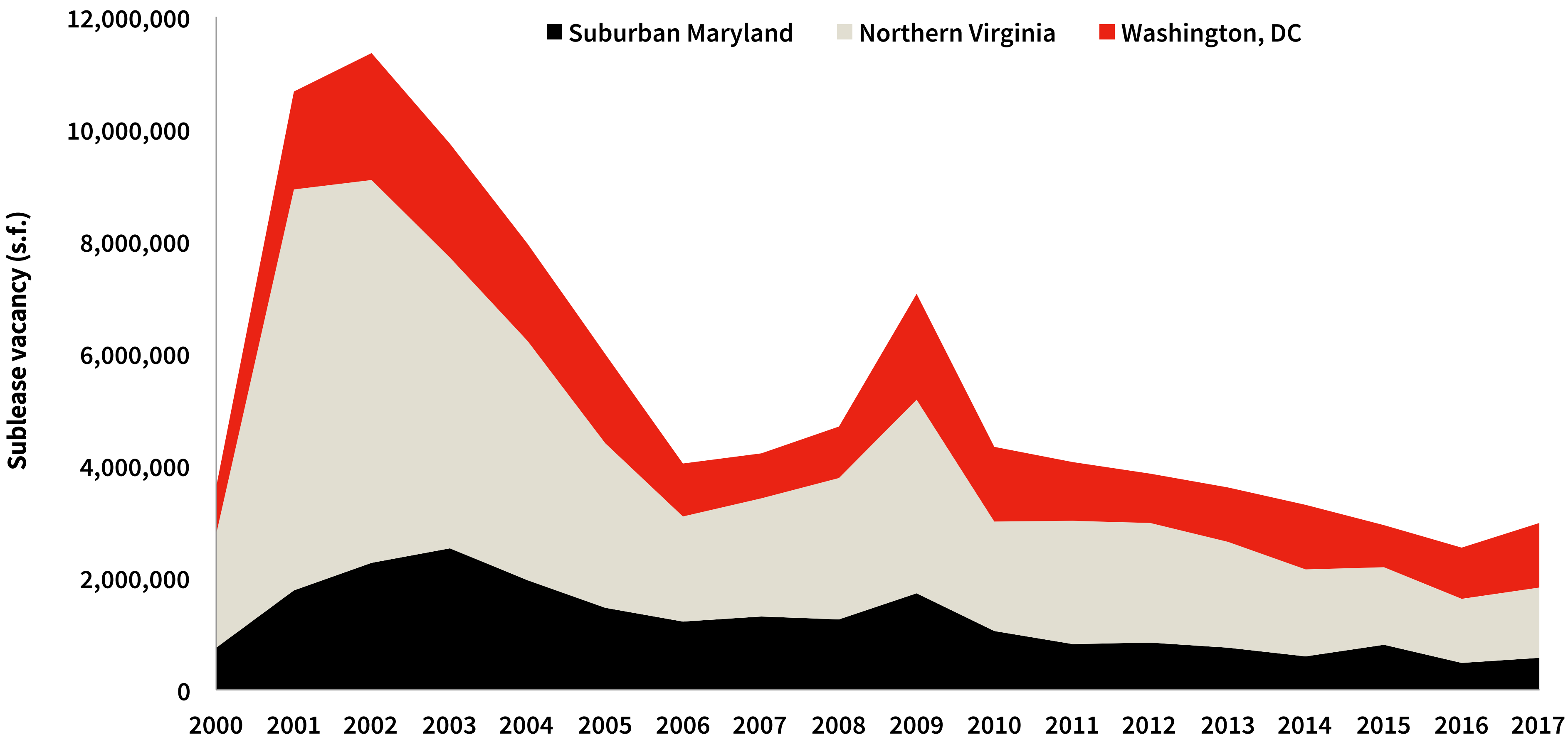
From a quality perspective, only the Class B and C markets downtown would be considered tight markets that benefit landlords more than tenants with respect to market leverage



Source: JLL Research

Metro DC office sublease space

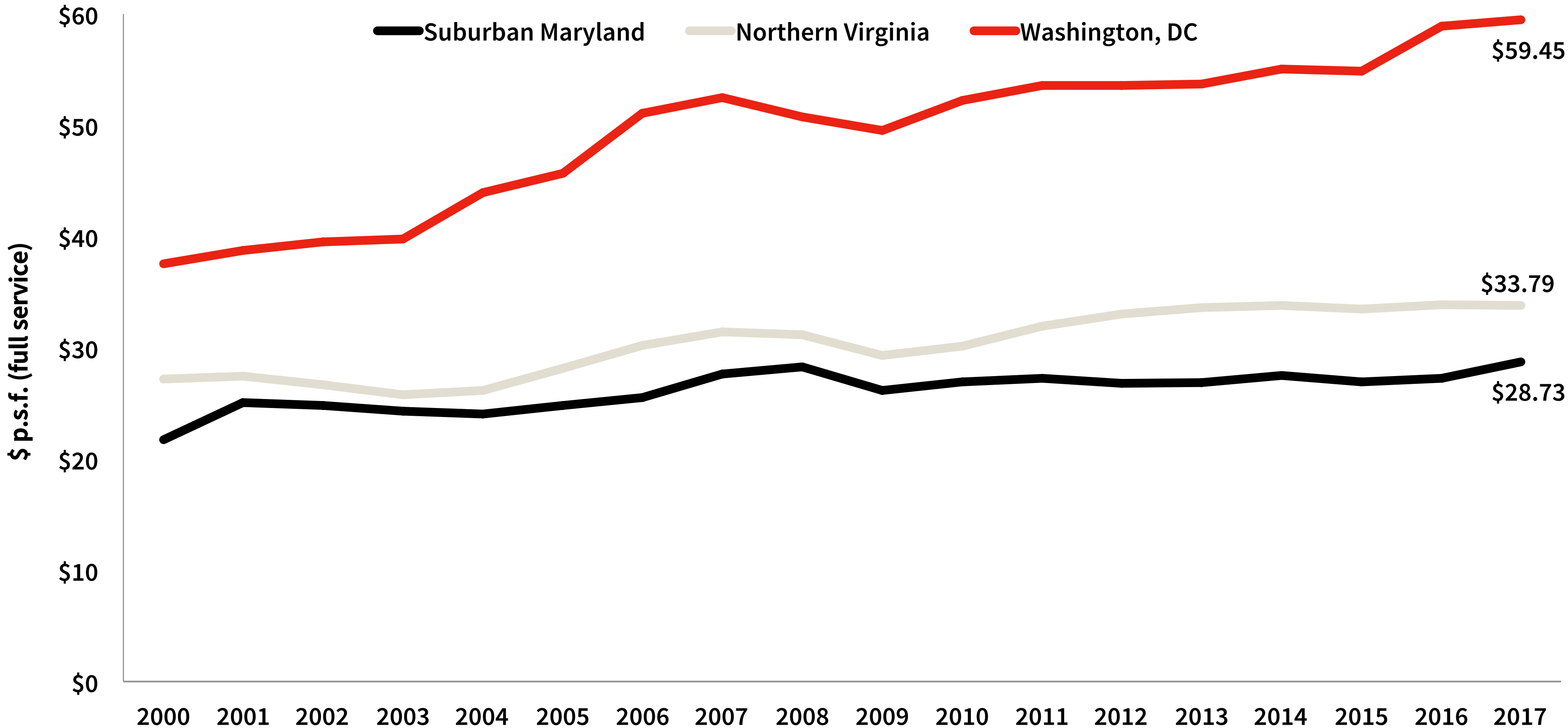
Sublease vacancy levels are 58% below peaks in 2009, but were up 17.5% in 2017 due to additional space coming on the market downtown and in the Bethesda-CBD



Source: JLL Research

Metro DC office direct average asking rents

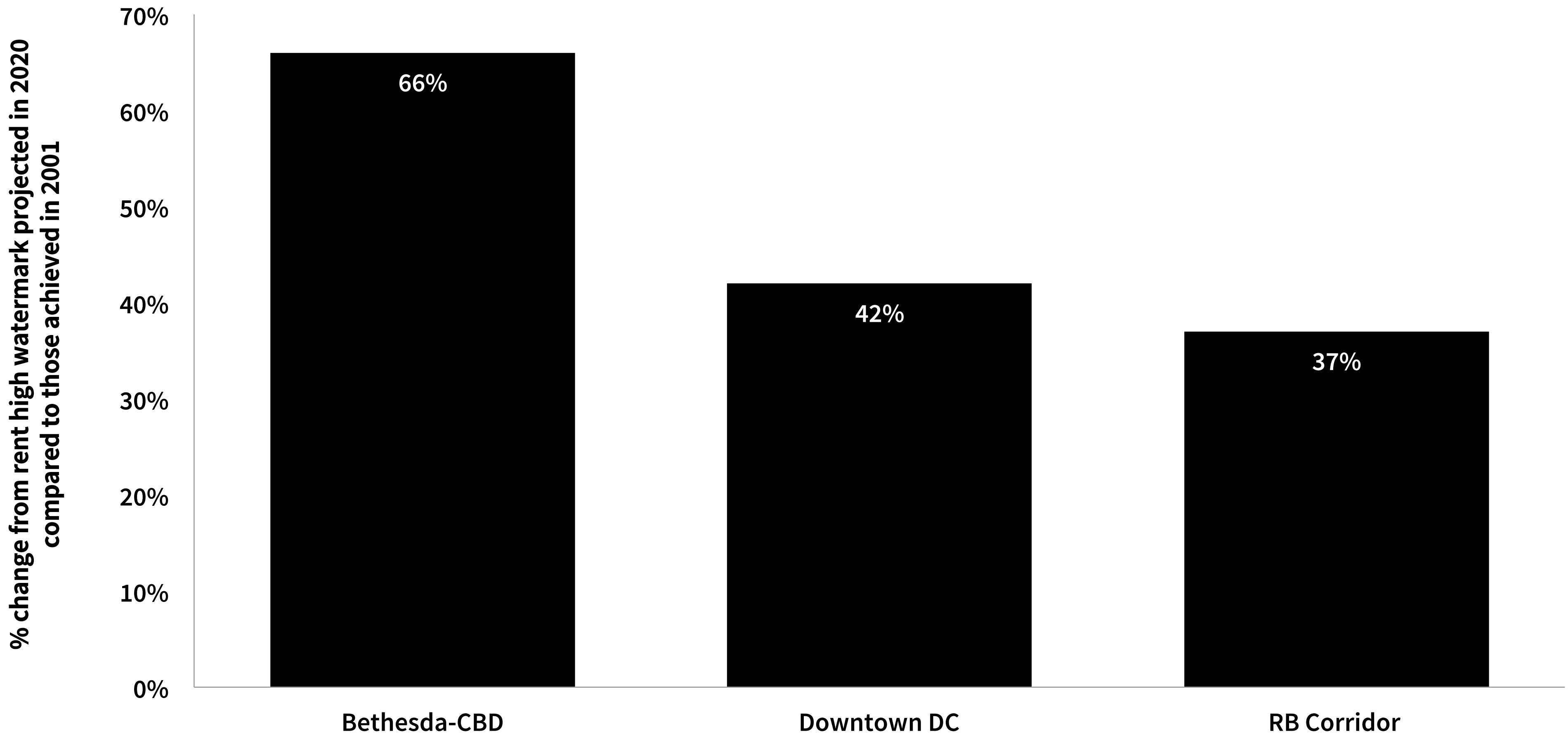
Suburban rents have largely remained flat over the past cycles whereas downtown rents have increased due to plethora of higher-priced new supply coming on the market and Class B market momentum



Source: JLL Research

Metro DC high watermark rents achieved

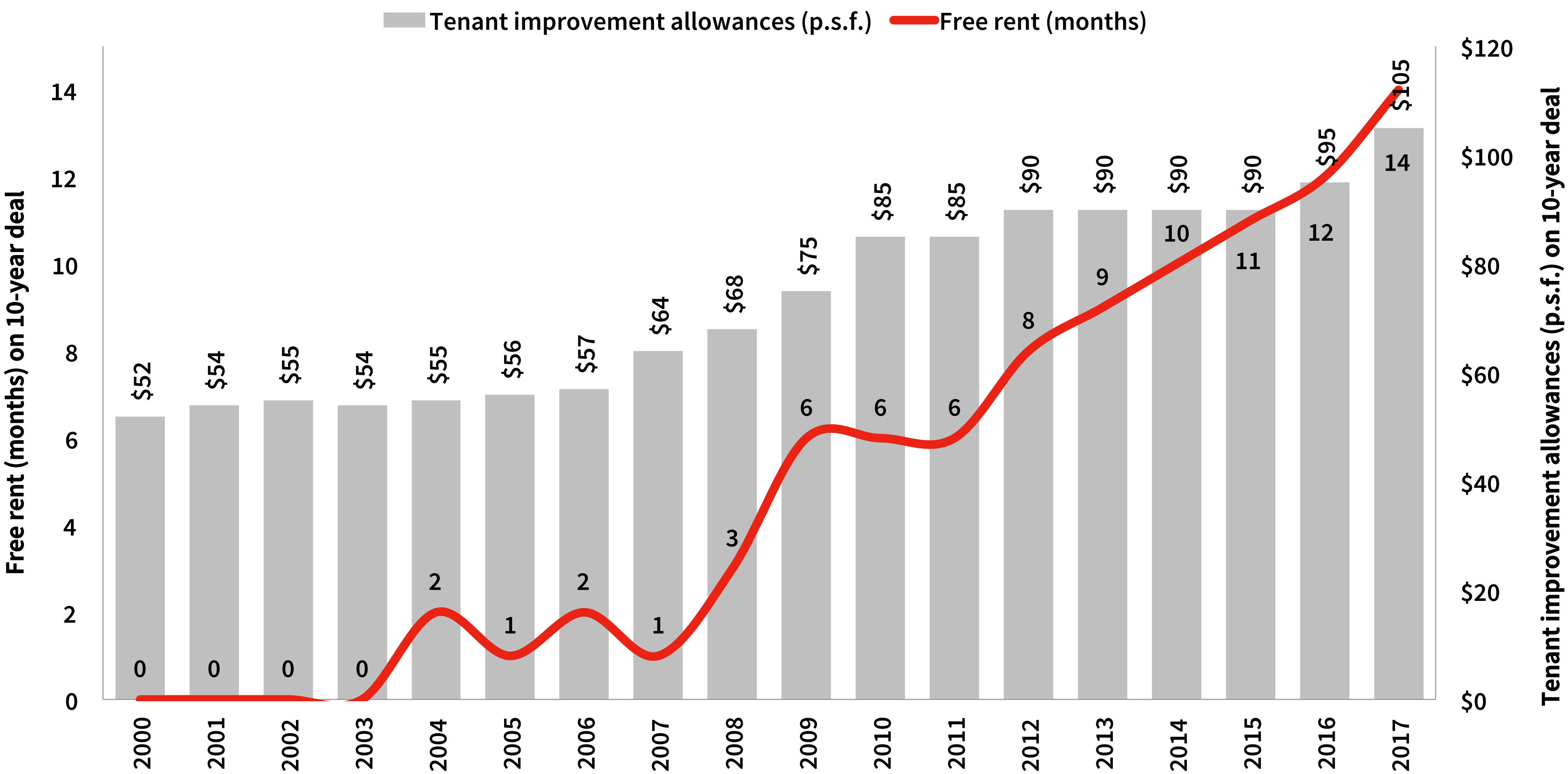
The change in high watermark rents in the Bethesda-CBD way outpaces that of the RB Corridor and Downtown DC, from projected rents in 2020 compared to those established in 2001



Source: JLL Research

Metro DC office concessions

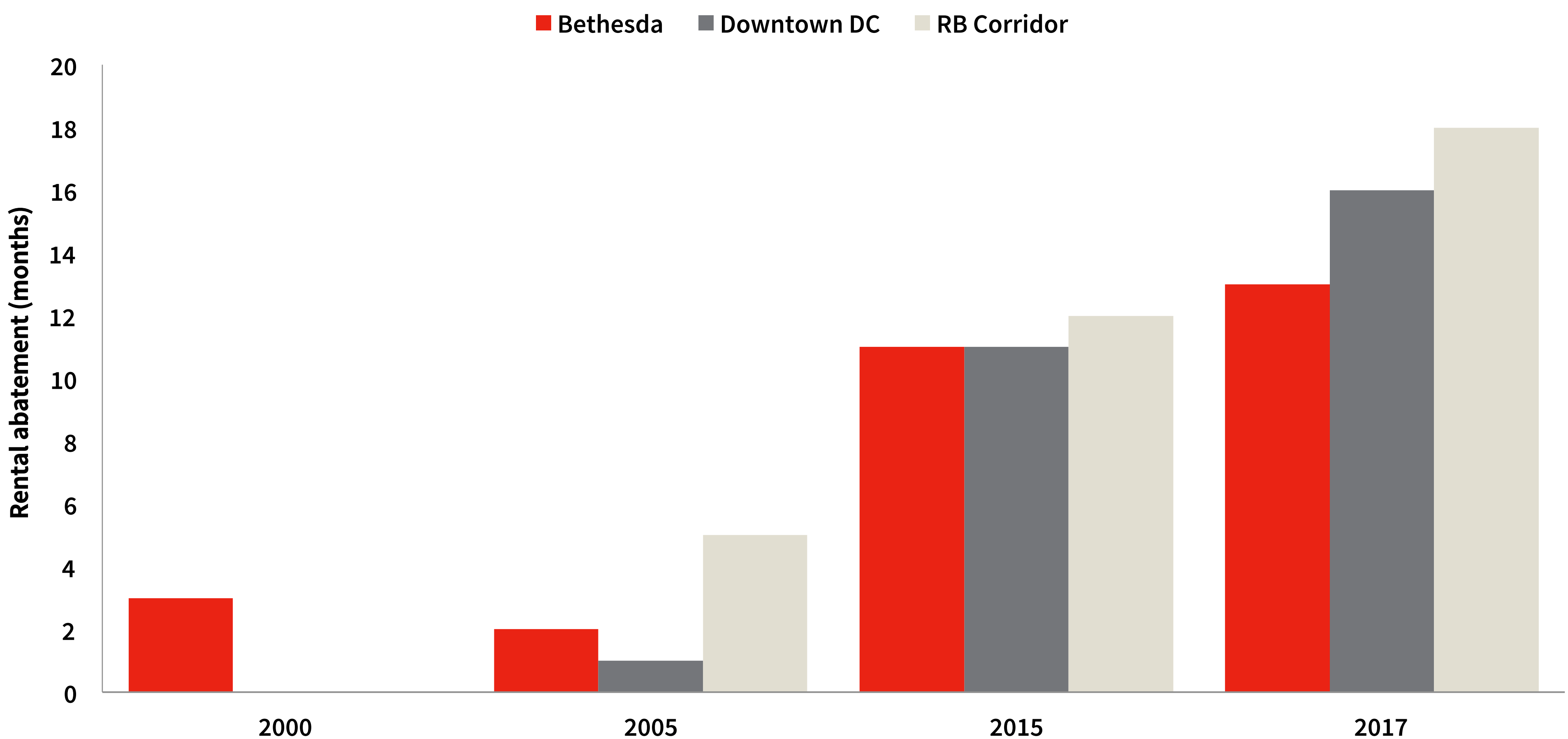
Concessions continue to rise as space options remain plentiful with new heights being established downtown, almost on a deal-by-deal basis



Source: JLL Research

Metro DC comparable office rent abatement

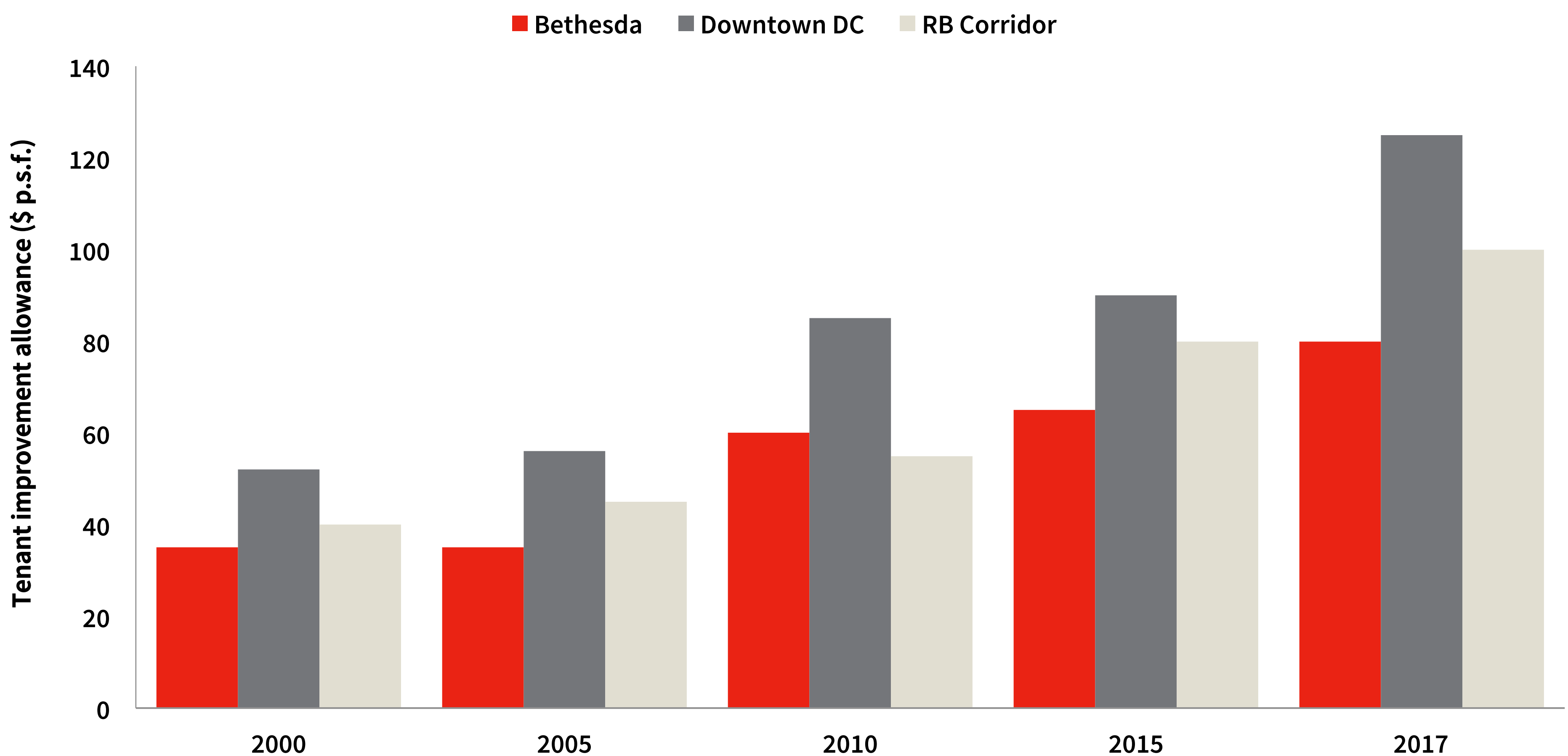
While rent abatement has increased market-wide across Metro DC, Bethesda-CBD landlords have not had to be as aggressive as those in peer markets



Source: JLL Research

Metro DC comparable office TI allowance

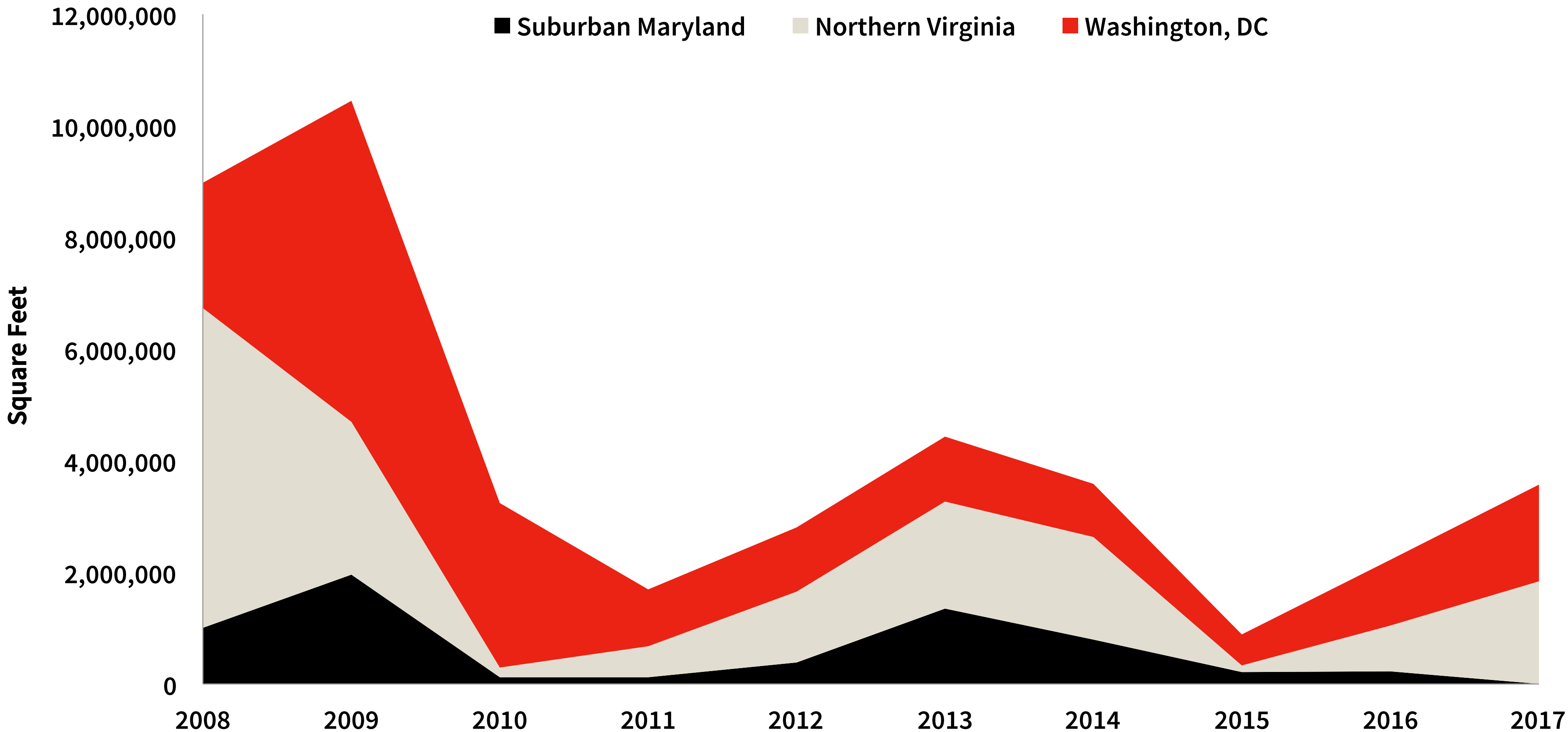
TI allowances have jumped 50% and 40% higher since 2001 in the RB Corridor and Downtown DC than they have in the Bethesda-CBD



Source: JLL Research

Metro DC office new deliveries

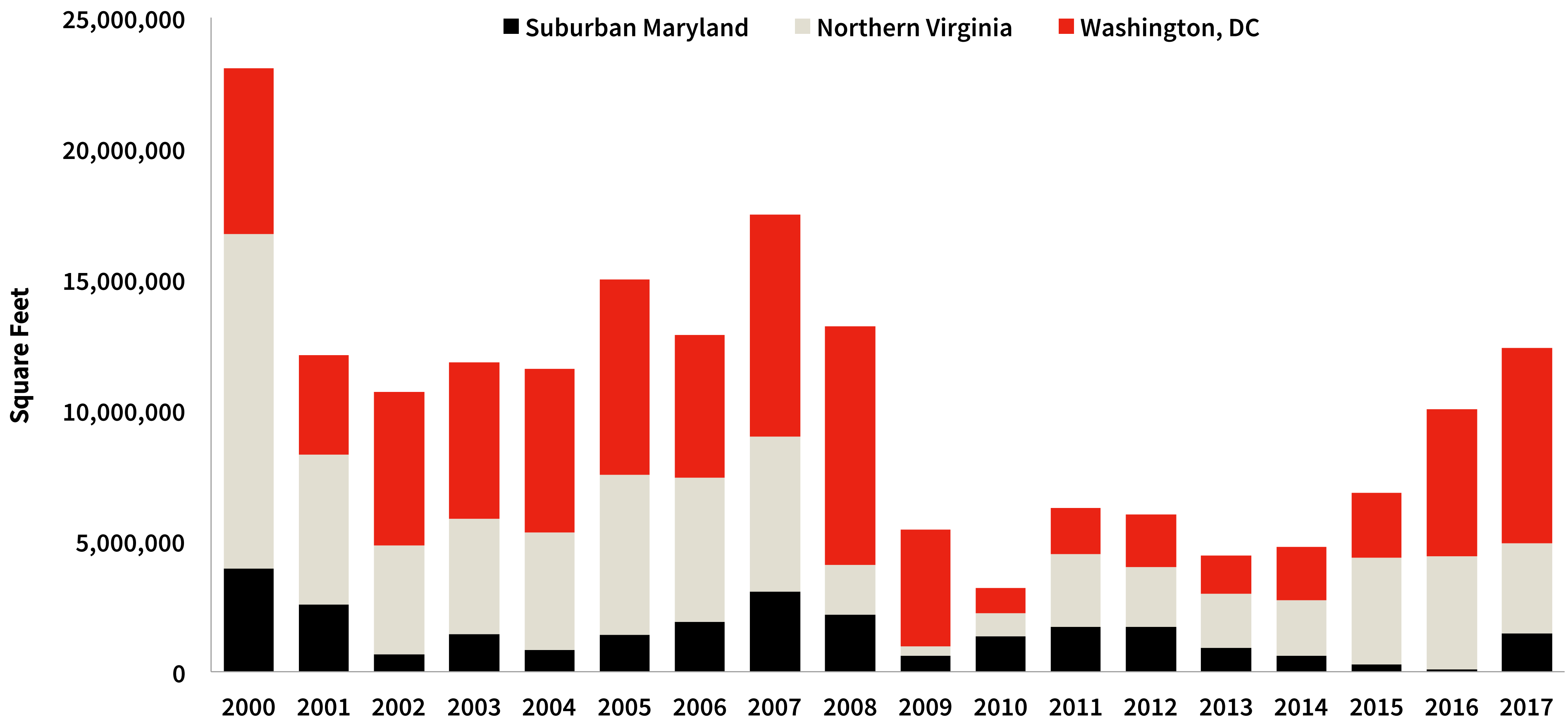
More than 3.5 m.s.f. of space has delivered in 2017, split between Northern Virginia and Washington, DC with DC's new developments just 50.3% preleased at delivery



Source: JLL Research

Metro DC office under construction

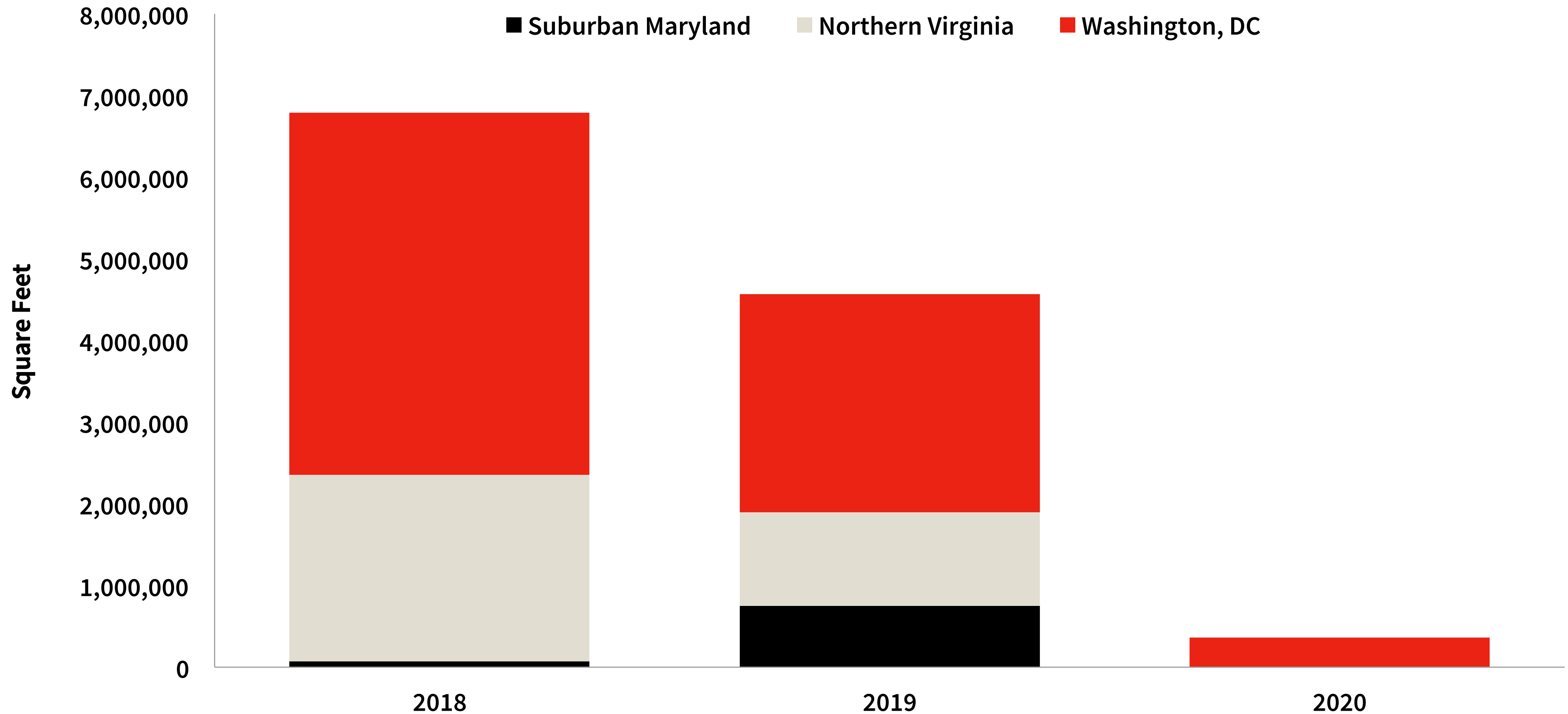
Construction levels reach their highest point since 2008: 12.4 m.s.f. is under construction across the region, representing a 159% increase from the end of 2014 levels



Source: JLL Research

Metro DC deliveries – under construction

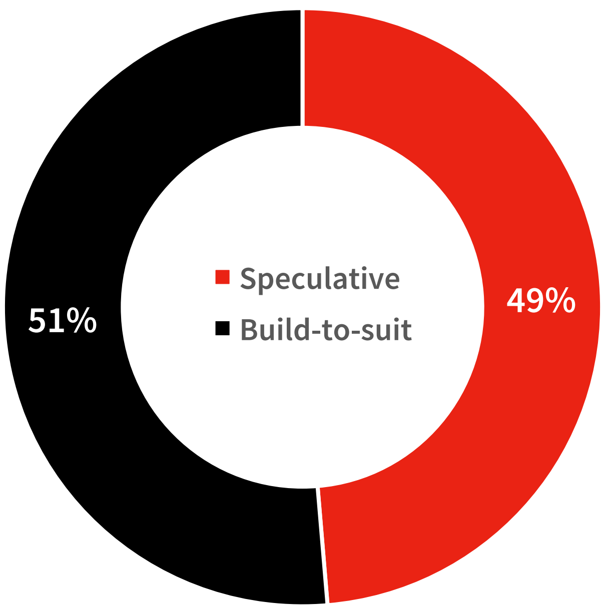
The development pipeline essentially ends in 2019 with very limited opportunity for many more groundbreakings based on disconnect between supply and demand; however, downtown could see more groundbreakings due to limited upper floor space available for anchor law firms



Source: JLL Research

Metro DC office construction spec vs. BTS

Suburban Maryland saw the biggest uptick in activity with USCIS project in Prince George's County break ground as well as two speculative projects in the Bethesda-CBD



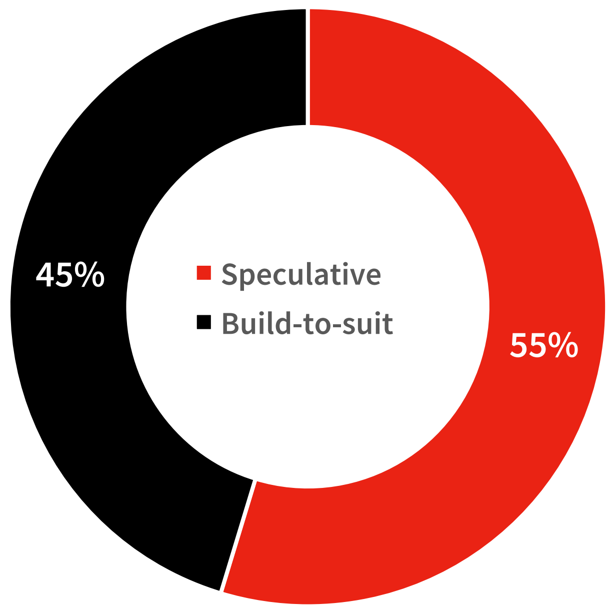
Suburban Maryland

751,000 s.f. BTS UC

712,000 s.f. spec UC

Overall preleased: 69%

Spec preleased: 36%



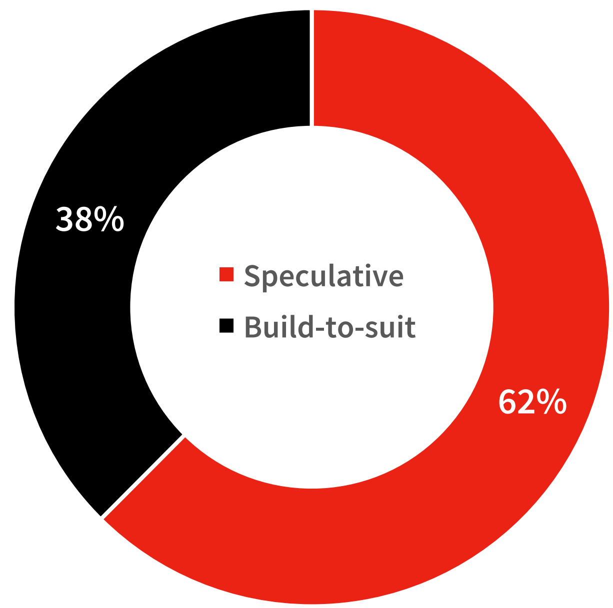
Northern Virginia

1.6 m.s.f. BTS UC

1.9 m.s.f. spec UC

Overall preleased: 63%

Spec preleased: 33%



Washington, DC

2.8 m.s.f. BTS UC

4.7 m.s.f. spec UC

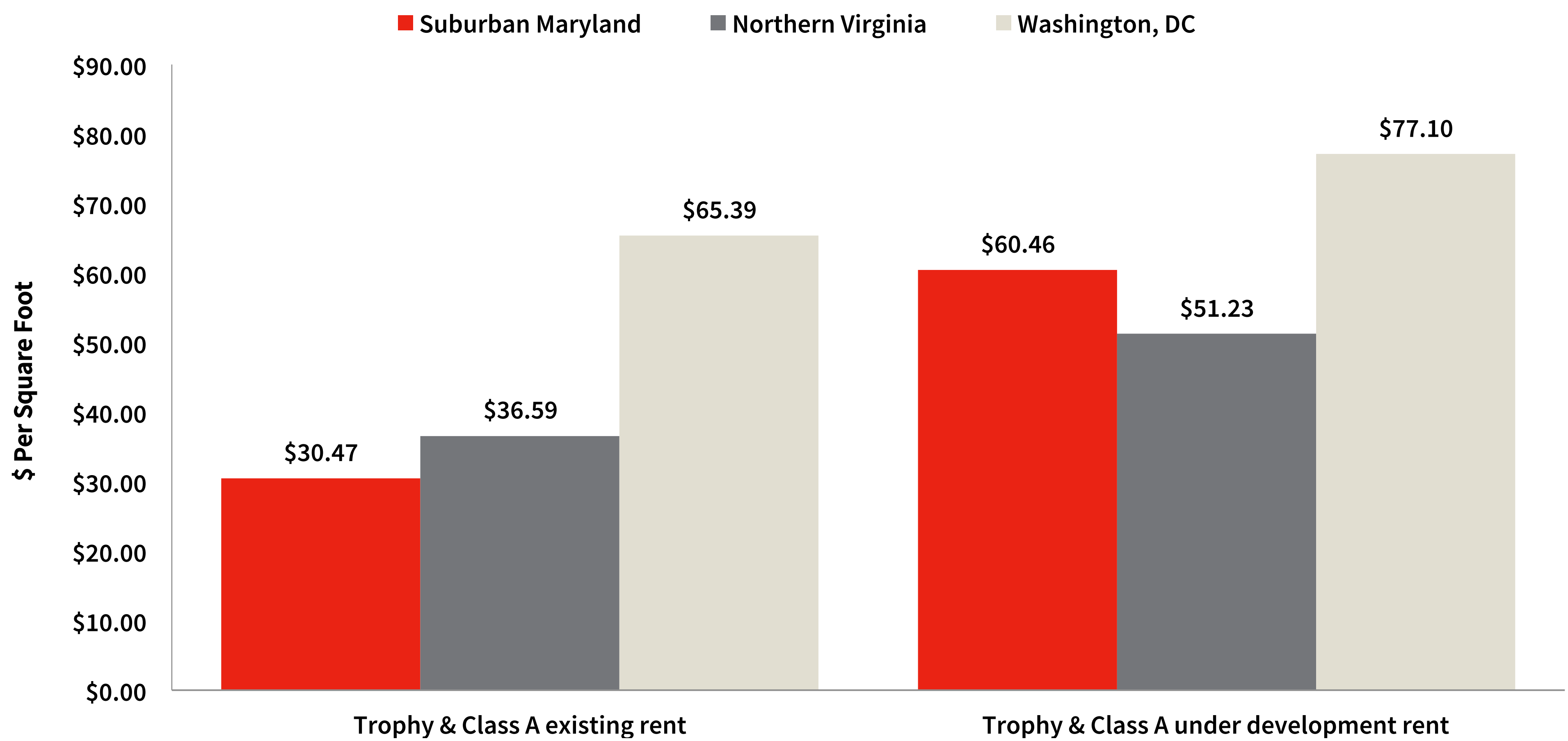
Overall preleased: 54%

Spec preleased: 34%

Source: JLL Research

Metro DC office under construction rents

Premiums for construction vary across markets, but the most substantial premium is found in Suburban Maryland driven by new Bethesda-CBD product commanding rents in the upper-$60s p.s.f. FS



Source: JLL Research

With minimal political legislation outside of tax reform implementation expected in 2018, growth in the market will mainly be limited to the life sciences market in upper Montgomery County; growing federal government new construction market in Prince George's County; flight to urban market in the Bethesda-CBD; high-growth residential markets of Ballpark, Wharf, Union Market and NoMa; affordable B+, B, B- and C+ market of the CBD and East End. And the biggest wild card? Northern Virginia. Not only will a 10% increase in FY 2018 defense spending spur additional leasing (has to come up as 2017 was one of the slowest leasing velocity markets in 20 years) but the market has the deepest pool of STEM talent regionally, which will spur organic growth from high-growth existing tenants, mainly on the Toll Road, and deeper consideration from companies outside the market that are challenged by talent in their hometown markets, mainly in the Arlington County and the Toll Road.

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