

MARKETBEAT

WASHINGTON, D.C. OFFICE REPORT

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION



4Q09

ECONOMY

The U.S. economy has turned a corner. The economy expanded for the first time in over a year in the third quarter, and gained further traction in the fourth quarter. Moreover, the unemployment rate slipped to 10.0% in November as job losses dropped to their lowest level since the recession began. Despite signs of a turnaround, there are still reminders that the economy remains very weak. The unemployment rate in the District of Columbia remained high at 11.9% in November; it was only at 5.8% upon the onset of the national recession in December 2007. For office-using employment, the professional and business services sector posted the steepest job losses. The only substantive source of employment growth in the District continues to be the government sector which has added nearly 5,000 jobs over past the 12 months ending November and in turn, helped offset the general weakness among other office-using sectors.

OVERVIEW

While economic conditions continue to slowly improve, the Washington, D.C. office market is still struggling. The overall vacancy rate climbed to a 12-year high of 14.3% at year-end as more new supply was added than absorbed. Non-core markets* posted the highest vacancy rate, which jumped to an all-time high of 20.1%. The heavy pace of construction continued to take a toll, particularly on the Southwest, Capitol Hill/NoMa, and Capitol Riverfront submarkets. The mammoth Constitution Center (Old Nassif Building) at 400 7th Street in Southwest delivered empty in December, adding 1.4 million square feet (msf) to vacant space and bringing total completions in non-core markets to 3.7 msf for all of 2009. Not surprisingly, vacant space was concentrated in new buildings. Nearly 60% of all availabilities (or 4.0 msf) were in buildings that were constructed since 2006. The biggest upside surprise was an uptick in leasing activity in the fourth quarter, thanks to a growing federal government. Notably, the General Services Administration (GSA) signed three leases totaling nearly 800,000 square feet (sf) in top-quality new buildings in non-core markets. Those large deals were a bright spot in an otherwise sluggish leasing market. Owners of new construction in non-core markets have been the most accommodating, offering generous work allowances, historically high free rent, and competitive rates. As such, the GSA was able to trade up to class A buildings, paying effective rental rates in the low to mid \$30s, full service, a far cry from previous pro forma full-service rates of low-\$50s for those new buildings.

Conditions have also remained challenging for core markets, the traditional mainstays, but at the least, they are deteriorating at a slower rate. The overall vacancy rate reached close to its all-time high (11.4%) at year-end after steadily rising since the third quarter of 2008 with the ongoing slowdown in demand. Leasing activity level is the lowest on record, with new leases totaling 2.3 msf for all of 2009 compared with the historic average of 5.0 msf. Compounding the dearth of leasing opportunities, landlords face competition from their own tenants subleasing their surplus space. As a result, sublets abound the most in core markets, accounting for nearly 20% of current availabilities, with the bulk (700,000 sf) coming from downsizing law firms. While no new project came online in the fourth quarter, completions totaled 1.6 msf this year of which 1.0 msf remained available through year-end. Such a surge in availabilities, particularly for top-grade space, continues to depress rents. So far, landlords have been slow to lower asking rents; rates are down only 3.0%-5.0% from a year ago. However, the effective rents at which deals are being signed have declined by another 10.0% to 20.0% from 2008. Consequently, tenants (such as Vorys Sater, Widmeyer Communications, Feldesman Tucker, Fried Frank and Vinson & Elkins) are beginning to take advantage of aggressive relocation options and not just simply renewing.

* **Core Markets:** Central Business District (CBD), East End; **Non-Core Markets:** Capitol Hill/NoMa, West End/Georgetown, Uptown, Southwest, and Capitol Riverfront

BEAT ON THE STREET



"Despite a negative net absorption level of 1.5 msf, overall optimism improved in the fourth quarter due to the jump in leasing activity led by GSA. Several large potential relocations including Fried Frank, Vinson & Elkins and IBM should help keep leasing momentum positive. Unfortunately, the commencement dates are not until 2011."


- Susan Thomas, Senior Director


ECONOMIC INDICATORS


| National | 2008 | 2009F | 2010F |
|-------------------|------|-------|-------|
| GDP Growth | 0.4% | -2.5% | 2.3% |
| CPI Growth | 3.8% | -0.4% | 1.7% |
| Regional | | | |
| Unemployment | 6.7% | 10.6% | 11.6% |
| Employment Growth | 0.1% | -5.3% | -1.2% |

Source: Moody's/Economy.com

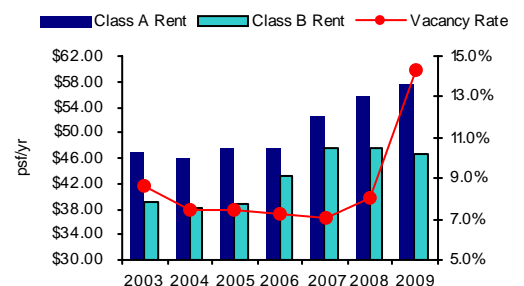
MARKET FORECAST

LEASING ACTIVITY will gradually pick up as the turnaround in labor market conditions gains traction in 2010. A growing federal sector – thanks to stimulus measures – will continue to fuel job creation. However, a sustained expansion in leasing activity will also require a rebound in private-sector employment. 

RENTAL RATE pressures will intensify in 2010 with continuing high levels of availabilities. While face rent declines will remain relatively modest, landlords will continue to offer significant concession packages particularly in non-core markets. This, in turn, will also compel other landlords to remain aggressive on renewals. 

CONSTRUCTION starts will effectively shut down in 2010. Lower rents and occupancies, combined with restrained financing, will keep new development on hold until 2011. Even so, the construction pipeline will remain substantial through 2010, with 1.2 msf under way in core markets and 2.2 msf in non-core markets. 

OVERALL RENTAL VS. VACANCY RATES



On the investment front, after a modest rally in the third quarter, investment activity retreated again in the fourth quarter, making 2009 the slowest year on record. Sales volume dipped to \$870 million in 2009, with property values falling 20.0%-30.0% from their 2007 peaks. While credit markets have started to heal, the borrowing climate is far from normal and continues to constrain activity. Moreover, the lack of product for sale and sagging property fundamentals contributed to the sales pullback.

FORECAST

With the worst of the economic slump presumably over, the outlook for 2010 has the potential for improvement from 2009 but is far from certain or robust. Cushman & Wakefield (C&W) expects the recovery process to continue in 2010, provided that overall demand continues to stabilize, businesses restock their inventories, and financial conditions improve. Of course, the key to a lasting recovery will be a return to job growth that will support consumer incomes and spending. Washington, D.C. is expected to lead the way out of the recession. Various fiscal stimulus measures will play a pivotal role in stoking the area's economy in 2010, and that should create enough initial momentum to fuel a job recovery. As such, C&W expects a mild recovery in leasing activity in 2010. Current government initiatives to toughen financial oversight, accelerate spending, and create more jobs before the midterm elections next November all invoke the expansion of federal agencies over the next 5-10 years, and with it the potential for positive net new absorption going forward. The number of leases already submitted to Congress for approval is on the rise. In October alone, about 2.5 msf worth of prospectus sized deals for 2010 were submitted to Congress.

2010 will see a continued softening of office market fundamentals even if the economy mounts a sustained rebound.

- *First*, absorption has the potential for a gradual improvement in 2010 but the pace will remain below trend. Two key factors underlie this forecast. The expected job growth will be slow to bring the unemployment rate in the District of Columbia back to its pre-crisis level of 5.0%-6.0%. It is therefore critical that the private sector fill the breach as the impetus from government programs diminishes in order to sustain any meaningful growth in office-using employment, and thus, absorption. Moreover, tenants are likely to remain extremely cautious and will continue to minimize their capital expenditures. Consequently, they will be more prone to utilize their current space more efficiently rather than inking new lease commitments.
- *Second*, the onslaught of more new supply remains the “Achilles Heel” in the office market recovery. The District has 11 projects under way totaling nearly 3.4 msf, of which the bulk is slated for completion in 2010. Notably, 46 buildings have already come online since 2006, with 6.3 msf of vacancies in these properties through year-end 2009.
- *Third*, landlords will continue to lower rates and step up concession packages as vacancies mount. Landlords will also be aggressive on lease renewals as rates on new leases are further

discounted. Consequently, 2010 will mark another year of rent decompression for landlords in the District, particularly, in recently delivered class A building and existing trophy space.

- *Lastly*, landlords have to work out those balance sheet stresses. Highly leveraged owners are starting to lose deals due to their inability to secure lender approval. With credit conditions expected to remain stringent in 2010, tenants will tend to gravitate towards well-capitalized and stable owners and thus avoid the perils associated with troubled ownership such as losing the allowance for tenant improvements.

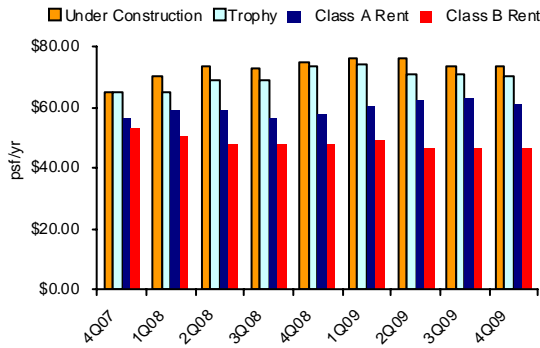
Space opportunities will abound for an extended period even in traditional core market hot spots. The explosive growth since 2006 has pushed up class A vacancies in the East End and CBD to their all-time highs of 13.6% and 22.1%, respectively. While new construction has dwindled to 1.2 msf at year-end 2009 (its lowest level since 1998), and concentrated in the CBD, the additional supply is expected to boost the overall vacancy rate in core markets by at least another percentage point in 2010. It is therefore likely that rents will continue their downtrend in order for landlords to get their inventory under control. By conservative estimates, effective rents for top-grade space are expected to fall by another 4.0%-5.0% in 2010, bringing the cumulative decline to 15.0%-20.0% from the 2007 peak. Such attractive rates among top-tier properties will continue to spur a “flight to quality” and could help class A rates to stabilize towards the end of 2010. Therefore, vacancies are likely to surge in class B and C buildings in the market as tenants upgrade. The outlook brightens after 2010, with supply/demand returning close to equilibrium for the East End in 2011 and the CBD in 2012.

Available options will remain the highest in non-core markets. The addition of 2.2 msf in 2010 will exacerbate the supply overhang, and subsequently cause vacancies to surpass their peaks of 30.0% for class A and 20.0% overall at year-end 2009. Since absorption is bound to be slowest in non-core markets, vacancies for top-tier properties are expected to rise another 7.0-8.0 percentage points in 2010 due to pending deliveries. Such abundance of availabilities will continue to pressure landlords to offer deeper rent discounts and more inducements to fuel leasing activity. As such, effective rents for class A space in non-core markets are expected to slide at least another 5.0% in 2010, for a total decline of 20.0%-25.0% since hitting their highs in 2007. With increased competition from traditional strong markets in the District, non-core markets will remain hard pressed to eke out demand gains of any significance even after 2010. Supply will be slow to absorb until options in core markets are back to normal levels. Thus, expect overall vacancies to remain elevated (20.0%+) through 2012.

Shaky investment market conditions will create buying opportunities in 2010. We expect to see the first wave of significant loan maturities (from three year paper that was generated at the height of the old market—2007) hit in 2010. Nonetheless, mere maturity and other covenant defaults have not triggered much resolution activity in the Washington, D.C. market and that may be true again in 2010. With investment fundamentals improving, cap rates and pricing on a per square foot basis holding up, low interest rates and underwriting terms settling out in a new “normal” that begins to see the cup at least a quarter of the way filled rather than empty and draining. Expect much of the debt on Washington D.C. properties will be successfully refinanced next year.

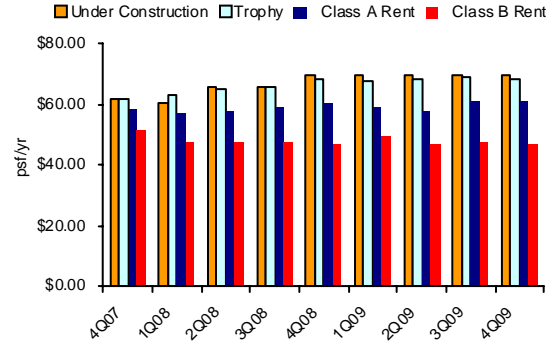
CENTRAL BUSINESS DISTRICT

ASKING RENTAL RATE



EAST END

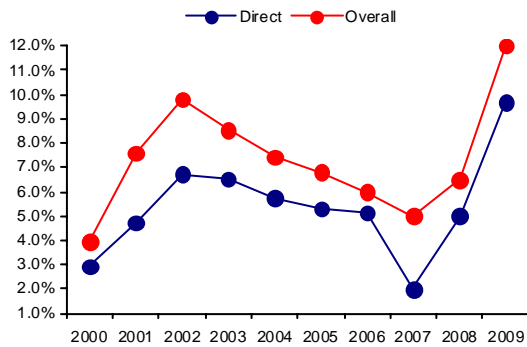
ASKING RENTAL RATE



- Direct average asking rents in the CBD showed a 3.0% drop for the first time in the fourth quarter since the downturn began over a year ago. This decline reveals that in addition to offering step-up concession packages to keep/attract tenants to their buildings, landlords are continuing to grapple with the current economic cycle and are starting to reduce asking rents for mid-size to large blocks (25,000 sf-plus) on the market to attract new tenants.
- It is worthy to note that while asking rents show only a 3.0% drop, net effective rents have fallen 10.0% to 15.0% since the start of the year. The higher drop in effective rents is due largely to increases in tenant allowances and rent abatements currently being offered by landlords to secure a deal. Even trophy buildings in the CBD did not go unscathed – their effective rates show a 6.0% drop in 2009.

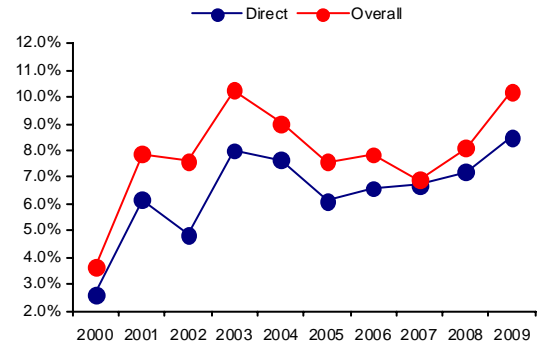
- Class A direct asking rents in the East End remained above the \$60.00 per square foot (psf) mark however, overall asking rents have declined 18.0% from \$59.39 psf in the first quarter of 2009 to \$50.33 psf at year-end. The steep fall in overall rates can be ascribed to the increase in sublease space in the East End as most law firms returned excess space to the market. Sublease space in the East End constitutes 42.0% of total sublet space on the market in the District.
- The deterioration in overall rents can be attributed to much lower rates being offered for built-out sublease space in prominent class A buildings, mostly from law firms. Some of the buildings with sublease spaces in excess of 20,000 sf include Columbia Square, 601 Pennsylvania, 801 Pennsylvania, 401 9th Street, 1201 F Street, 1101 New York, Metropolitan Square and 901 New York Avenue.

DIRECT VS. OVERALL VACANCY RATES



- Vacancy rates inched up almost six percentage points from year-end 2008 to end 2009 with a double-digit vacancy rate at 12.0%. The increase can be attributed to a string of new deliveries in 2009 totaling 1.1 msf that added over 700,000 sf of available space amid the current slowdown in tenant demand.
- Expect rates to remain high through 2012 as three more projects are slated for delivery at 800 17th Street, 1000 Connecticut and 2200 Pennsylvania Avenue that will add 590,000 sf to vacant space.

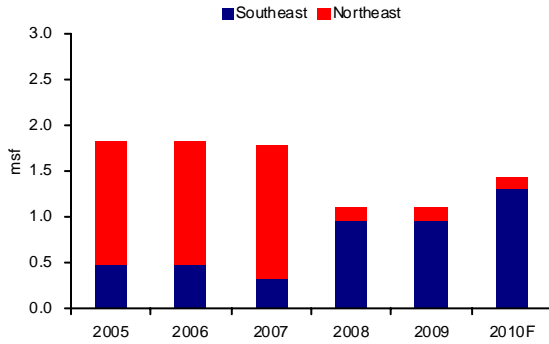
DIRECT VS. OVERALL VACANCY RATES



- Vacancy rates in the East End remain elevated at 10.8% but are surprisingly the lowest of the seven submarkets in the District. Having delivered at least one building three quarters out of four per year since 1999, the East End has added 23 buildings totaling 5.2 msf since 2005. Of this, 1.6 msf remain available with large blocks in excess of 100,000 sf still available at 1101 K Street, Columbia Square and 901 K Street that continues to keep supply levels high.

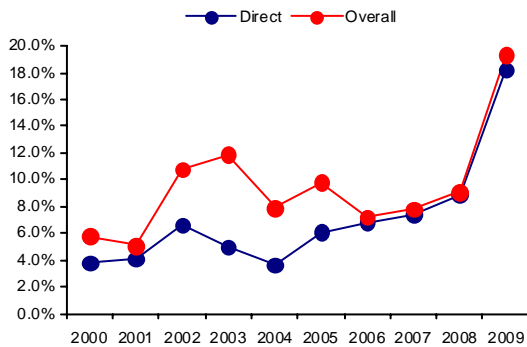
SOUTHEAST/NORTHEAST†

CONSTRUCTION PIPELINE



- The emerging markets North of Massachusetts (NoMa), northeast of Capitol Hill, and Capitol Riverfront in Southeast have become “hot beds” for large private and government sector leases in 2009 due to below market rents. Together, these two markets captured close to 45.0% of large lease transactions in excess of 75,000 sf in the District. Tenants include Bureau of Land Management at 20 M Street, Kaiser Permanente at 700 2nd Street and GSA at 1275 First Street.
- Since 2004, developers have added 11.5 msf of new developments to the Southeast and Northeast quadrants, which commenced with the construction of the Southeast Federal Center in 2004 to accommodate Department of Transportation employees and the Securities and Exchange Commission’s move to Station Place I and II in 2005.

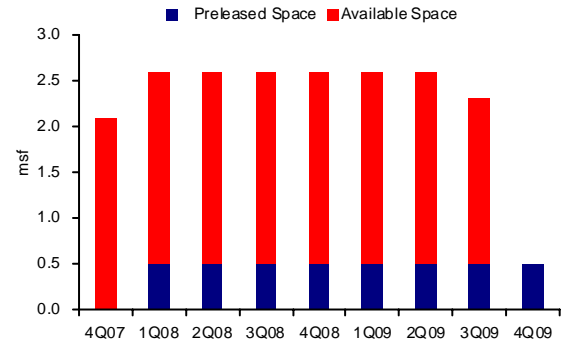
DIRECT vs. OVERALL VACANCY RATES



- With an unprecedented amount of space on the market from new deliveries coupled with the ongoing slowdown in tenant demand, both taking and effective rentals rates have taken a plunge (almost 15.0% to 35.0% decline) as owners have increased concession packages to lure tenants to this part of the District with little amenities.
- The relocation of Department of Justice to the area in 2010 will be a boost. Expect a chunk of this space to be leased in the next 12 to 18 months as contractors move to locate close to the agency. Also, no new deliveries are expected before 2011.

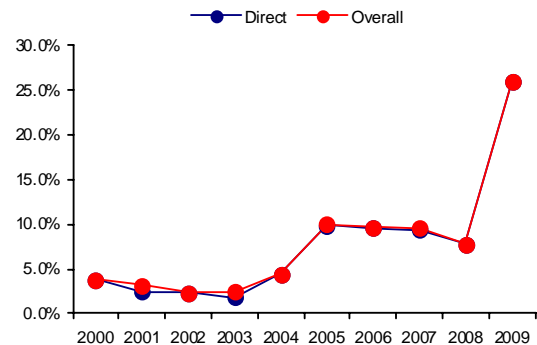
SOUTHWEST

CONSTRUCTION PIPELINE



- The speculative development pipeline is finally empty in Southwest with the delivery of 400 7th Street, Patriots Plaza II and III in the second half of 2009. Year-to-date, this submarket has added 2.1 msf with only a 15.0% pre-lease commitment signed by the Department of Agriculture at 355 E Street. This lease will relocate employees from multiple locations in the District including 1800 M Street and the Portals with a late 2010 lease commencement date.
- The largest delivery in the District for 2009 is 400 7th Street with 1.4 msf of rentable space designed with security setbacks required for federal tenants. With close to 2.0 msf of federal lease requirements pending, 400 7th Street will likely be one of the recipients.

DIRECT vs. OVERALL VACANCY RATES



- Year-to-date leasing activity without the Department of Agriculture lease is a paltry 91,355 sf for Southwest – the lowest ever recorded. This showing, even after landlords have increased concessions packages that caused effective rents to fall almost 15.0% to 20.0% from start of the year for class A space. Landlords are starting to lower asking rents for class A as some deals are being done in the low \$40.00-psf range in addition to generous concession packages for tenant work even on renewals.
- Expect fundamentals to remain soft through 2010 even as landlords continue to lure large tenants with as much as 20 months of free rent.

† Combination of Capitol Hill/NOMA and Capitol Riverfront Submarkets

MARKET/SUBMARKET STATISTICS

| MARKET/ SUBMARKET | INVENTORY | NO. OF BLDGS. | OVERALL VACANCY RATE | DIRECT VACANCY RATE | YTD LEASING ACTIVITY | UNDER CONSTRUCTION/ RENOVATION | YTD CONSTRUCTION COMPLETIONS** | YTD OVERALL ABSORPTION | DIRECT WTD. AVG. GROSS RENTAL RATE* |
|-------------------------|--------------------|---------------|----------------------|---------------------|----------------------|--------------------------------|--------------------------------|------------------------|-------------------------------------|
| Capitol Hill/Noma | 10,770,589 | 41 | 20.4% | 19.1% | 1,012,107 | 1,634,377 | 1,109,875 | (155,517) | \$48.13 |
| East End | 35,642,768 | 152 | 10.8% | 8.7% | 953,559 | 363,041 | 778,791 | (463,944) | \$55.86 |
| CBD | 31,635,846 | 182 | 12.0% | 9.7% | 1,323,159 | 1,204,639 | 1,106,136 | (679,416) | \$51.54 |
| West End/Georgetown | 5,225,062 | 34 | 15.4% | 13.4% | 268,808 | 0 | 0 | (129,497) | \$43.73 |
| Uptown | 3,528,736 | 31 | 13.0% | 11.3% | 63,370 | 0 | 0 | (164,898) | \$39.22 |
| Southwest | 10,539,982 | 32 | 25.9% | 25.9% | 716,311 | 626,000 | 2,106,606 | 39,865 | \$53.78 |
| Capitol Riverfront | 4,282,403 | 11 | 16.6% | 15.8% | 148,741 | 0 | 505,290 | 109,960 | \$47.67 |
| Washington, D.C. | 101,625,386 | 483 | 14.3% | 12.5% | 4,486,055 | 3,828,057 | 5,606,698 | (1,443,447) | \$51.54 |
| Class A | | | | | | | | | |
| Capitol Hill/Noma | 4,155,829 | 12 | 42.7% | 41.4% | 915,910 | 1,634,377 | 1,109,875 | 82,042 | \$56.23 |
| East End | 20,164,740 | 67 | 13.6% | 11.2% | 586,358 | 363,041 | 778,791 | (157,267) | \$61.24 |
| CBD | 9,065,380 | 35 | 22.1% | 17.5% | 361,672 | 1,204,639 | 1,106,136 | (123,378) | \$61.03 |
| West End/Georgetown | 1,437,437 | 7 | 7.2% | 6.4% | 10,646 | 0 | 0 | (54,394) | \$54.78 |
| Uptown | 365,367 | 2 | 30.3% | 29.9% | 16,580 | 0 | 0 | (74,062) | \$47.78 |
| Southwest | 7,300,977 | 16 | 36.0% | 36.0% | 678,153 | 626,000 | 2,106,606 | 101,507 | \$55.40 |
| Capitol Riverfront | 3,204,841 | 9 | 19.4% | 18.4% | 148,741 | 0 | 505,290 | 109,960 | \$49.35 |
| Washington, D.C. | 45,694,571 | 148 | 21.8% | 19.7% | 2,718,060 | 3,828,057 | 5,606,698 | (115,592) | \$57.73 |

* Rental rates reflect \$psf/year

** Includes renovations

MARKET HIGHLIGHTS

SIGNIFICANT 2009 NEW LEASE TRANSACTIONS

| BUILDING | SUBMARKET | TENANT | SQUARE FEET | BLDG CLASS |
|----------------------|-------------------|---------------------------------|-------------|------------|
| 355 E Street SW | Southwest | GSA - Department of Agriculture | 332,665 | A |
| 1275 First Street NE | Capitol Hill/NoMa | General Services Administration | 288,255 | A |
| 1200 1st Street NE | Capitol Hill/NoMa | DC Government Public Schools | 200,000 | A |
| 700 2nd Street NE | Capitol Hill/NoMa | Kaiser Permanente | 200,000 | A |
| 77 K Street NE | Capitol Hill/NoMa | GSA - IRS | 166,770 | A |

SIGNIFICANT 2009 SALE TRANSACTIONS

| BUILDING | SUBMARKET | BUYER | SQUARE FEET | PURCHASE PRICE* |
|-------------------------|-----------|-----------------|-------------|-----------------|
| 1999 K Street NW | CBD | Deka | 249,000 | \$207,800,000 |
| 1615 L Street NW | CBD | Bernard Spitzer | 414,195 | \$180,000,000 |
| 500 12th Street SW | Southwest | Invesco | 497,196 | \$155,000,000 |
| 1099 New York Avenue NW | East End | Credit Suisse | 177,506 | \$90,500,000 |

SIGNIFICANT 2009 CONSTRUCTION COMPLETIONS

| BUILDING | SUBMARKET | MAJOR TENANT | SQUARE FEET | COMPLETION DATE |
|------------------------|-------------------|----------------------------|-------------|-----------------|
| 400 7th Street SW | Southwest | N/A | 1,400,000 | 12/09 |
| Patriot Plaza II & III | Southwest | Department of Agriculture | 706,606 | 9 & 10/09 |
| Station Place II | Capitol Hill/NoMa | American Chemistry Council | 508,313 | 5/09 |
| 1100 First Street NE | Capitol Hill/NoMa | N/A | 345,871 | 5/09 |

SIGNIFICANT PROJECTS UNDER CONSTRUCTION/RENOVATION

| BUILDING | SUBMARKET | MAJOR TENANT | SQUARE FEET | COMPLETION DATE |
|-----------------------------|-------------------|-------------------|-------------|-----------------|
| Constitution Square | Capitol Hill/NoMa | GSA - DoJ | 589,916 | 6/10 |
| 2200 Pennsylvania Avenue NW | CBD | Hunton & Williams | 434,965 | 12/10 |
| 90 K Street NW | East End | N/A | 412,661 | 4/10 |
| 1000 Connecticut Avenue NW | CBD | Arent Fox | 374,145 | 12/12 |



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*Market terms & definitions based on BOMA and NAIOP standards.

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