

MARKETBEAT

WASHINGTON, DC OFFICE REPORT

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION



4Q08

ECONOMY

The U.S. economy has officially been in recession for a year. The unemployment rate surged to 6.7% in November 2008 – its highest level in 15 years – as a broad range of companies continued to slash payrolls in response to a sinking economy. In the District of Columbia, the unemployment rate has been following the steady increase in the national U.S. jobless rate, and jumped to 7.4% in November 2008, its highest level since 2004. Remarkably, office-using employment in the District has been holding up. Most of the sectors including government and professional/business services– which make up the vast majority of office-using employment – continued to hire throughout the year, and thus more than offset the protracted job losses in finance and information sectors. Another sign of economic strength is the District’s relatively low mortgage delinquency rate. The rate of home foreclosures through the third quarter 2008 remained well below the national average – only 3 in every 100 mortgage holders were behind in their payments or had their homes in foreclosure compared to 7 in every 100 nationally.

OVERVIEW

The Washington, D.C. office market remained one of the few bright spots in the U.S. throughout 2008, maintaining its stature as one of the healthiest markets. Through the fourth quarter, the area posted one of the lowest vacancy rates (7.0% direct, 8.0% overall) among all office markets and was one of the few markets in the U.S. where rental rates were holding up. Core markets including the East End and the Central Business District (CBD) remained the best performing, as overall vacancies in these submarkets were the lowest and rental rates the highest for the area. However, concessions have been on the rise outside core markets where availabilities have been on an uptrend this year. As enticements, owners have been offering free rent periods up to 16 months and as much as \$80.00 per square foot (psf) in tenant improvements.

The federal government remains the area’s economic buffer, fueling much of the leasing activity in this tumultuous period. GSA signed close to 1.8 million square feet (msf) of transactions greater than 30,000 square feet (sf) this year. The Departments of Justice and Homeland Security were the most active government agencies, inking new leases totaling over 830,000 sf while the Treasury Department took an initial 80,000 sf to house the newly created office for the Troubled Assets Relief Program (TARP). Adding to the stability, Washington, D.C.’s exposure to the financial turmoil has been minimal, limiting downward pressure. The area’s finance and insurance industries also remain relatively small, only accounting for 6.0% of office-using jobs. By comparison, other major CBDs such as Manhattan, NY, Boston, Chicago, and San Francisco are major hubs of financial and insurance companies, which constitute 20.0% to 30.0% of their office-using employment.

Development activity continues to move forward in Washington, D.C., even at a time when the credit squeeze is taking a toll on new construction across the U.S. Two new projects came online in the fourth quarter – 1050 K Street in the East End and 1225 Connecticut Avenue in the CBD – bringing total completions for the year up to 1.6 msf. The World Bank leased the entire office space at 1225 Connecticut Avenue for 10 years, making it as the most active non-government tenant during the year. The institution also renewed its lease at 1776 G Street for another five and a half years last April.

Even so, signs of strain from the ongoing contraction in the national and global economies have become increasingly apparent. New leasing activity in the District declined to its lowest level in a decade (5.2 msf) as the volume of lease renewals picked up during the year. But the impact has been most profound among law firms – which, together with the federal government, has been the cornerstone for tenant demand in

BEAT ON THE STREET



“The barrier to new construction in the prime core locations of downtown D.C. will help to minimize the overall deterioration of market fundamentals brought on by construction deliveries in Washington D.C.’s secondary markets. However, downward trends will present tremendous opportunity for creditworthy tenants who are positioned to move in the next 18 to 24 months”.

– Mark Minich, Executive Vice-President

ECONOMIC INDICATORS

National	2007	2008	2009F
GDP Growth	2.0%	1.2%	-1.5%
CPI Growth	2.9%	4.2%	0.9%
Regional (District of Columbia)			
Unemployment	5.7%	6.8%	8.7%
Employment Growth	2.0%	0.5%	-1.2%

Source: Moody’s | Economy.com

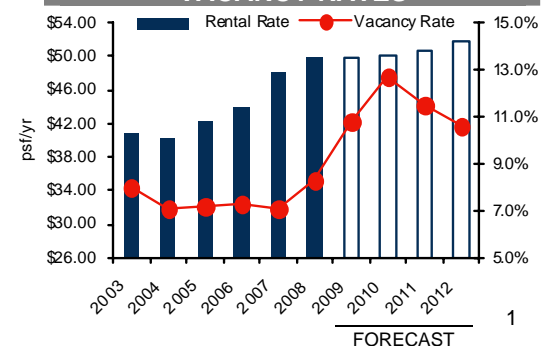
MARKET FORECAST

LEASING ACTIVITY will remain moderate until concrete signs of economic stability emerge. Tenants are likely to ink more short-term renewals through 2009. ↓

CONSTRUCTION pipeline will remain high, but should taper off as a restrictive credit environment continues to depress starts. Completions are estimated at 4.8 msf in 2009 and 3.8 msf in 2010. ↓

ASKING RENTAL RATES should hold steady but expect increased concessions, particularly in non-core markets. There could also be a potential shift back to full service leases from triple net structures. ↓

OVERALL RENTAL VS. OVERALL VACANCY RATES



Washington, D.C. for over a decade. While law firms signed more than ten leases greater than 20,000 sf in 2008, two national law firms in the area, Thelen Reid & Priest and Heller Ehrman, dissolved, and each put over 80,000 sf up for sublease in the fourth quarter. The rapid economic decline has also triggered a wave of contractions and layoffs among law firms resulting in a rise in sublease availabilities since fall of 2007 and are expected to mount in 2009.

Though investment sales volume plummeted and prices have begun to moderate with deteriorating credit markets in Washington, D.C., as they have nationwide, the city is still a preferred investment destination. The area ranked third in office sales nationally; approximately \$1.9 billion in office properties valued at \$10 million or more were sold in 2008.

FORECAST

Recession risks dominate the outlook at least until the second half of 2009. An economic recovery can only begin when the housing market stabilizes and stops eroding the value of banks' mortgage-related assets, and consumer and business confidence is restored. Fortunately, massive policy efforts are underway which could eventually stem the damage and possibly lay the foundation for modest economic growth late in 2009. However, *don't expect any quick rebound in employment.* In the District of Columbia, Cushman & Wakefield (C&W) expects office-using employment to level off through 2010 after a decade of expanding. Still, this is a positive development compared with the retrenchment that will continue just about everywhere else in the U.S. As such, we expect the Washington, D.C. office market to be better positioned than other major CBDs in the U.S. to ride out the economic storm.

Of course, tenant demand will not escape the wave of contraction occurring across all markets. No significant rebound in absorption will occur until after 2010, and even then it will be modest in comparison to the growth witnessed after the 2001 recession. Nonetheless, there are several factors that provide an upside potential to our demand forecast:

- *First*, the presence of the federal government will continue to provide stability in office-using employment and cushion the area from a protracted housing and financial crisis. We estimate that new GSA requirements could range as high as 1.0 msf through 2010. Moreover, plans for increased public spending and increased investments in sectors such as health care and alternative energy will drive employment among government agencies administering these programs.
- *Second*, there are a number of large private users who are active within the marketplace and thus could potentially act as growth catalysts in the near term. Based on C&W's latest tenants-in-the-market survey, the requirement of firms looking for at least 100,000 sf in the District totals 1.5 to 2.0 msf.
- *Lastly*, the federal government's stakes in finance and insurance industries highlight the likelihood of increased oversight. We believe that regulators will push for an overhaul of the financial regulatory system to manage these massive investments. That bodes well for the office market in

the long term. In the wake of the formation of the Resolution Trust Corporation which was tasked to divest assets that failed during the savings and loan crisis in the 1990s, over 4,000 net new jobs were created. Hence, if history is a gauge, it is reasonable to expect some job creation and a subsequent increase in office space requirements from the passage of the Emergency Economic Stabilization Act of 2008 (commonly referred to as the "TARP"). This law authorizes the U.S. Secretary of Treasury to spend up to US \$700 billion to purchase distressed assets and make capital injections into banks. While estimating GSA demand levels is clearly a conjecture at this point in time, we could reasonably expect some modest growth over the next three to five years in the U.S. Treasury (Office of Financial Stability) as well as other government agencies, such as the Congressional Budget Office, Office of Thrift Supervision, Office of the Comptroller of the Currency, Office of Federal Housing Enterprise Oversight, and Securities Exchange Commission as well as their affiliates that are located within the District.

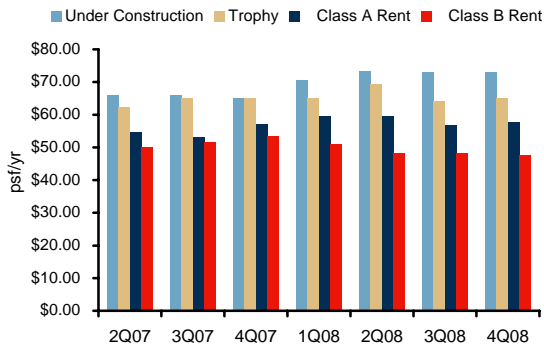
Sublease space has been on an uptrend – but the risks are not as great compared to other major CBDs. Tenants have put over 700,000 sf up for sublease since the credit crisis began in the second quarter of 2007. However, the sublease volume in the District (1.0 msf) remains well below the peak of 3.0 to 4.0 msf during previous downturns in the beginning of the decade and early 1990s. Moreover, even though contracting sectors (finance, insurance and legal services) continue to shed space as the financial crisis extends into 2009 and will likely return at least another 500,000 sf, this will hardly cause a material impact on overall vacancies in Washington, D.C.

Nonetheless, the Washington D.C. office market faces some obstacles in the near term. Indeed, the greatest risk in the outlook will come from robust construction. The development pipeline totaling 8.9 msf is the highest in the nation, and remains largely available. However, the impact will likely be most pronounced for non-core markets including Capitol Hill/NoMa, Southwest and Ball Park/Navy Yard, where nearly 80.0% of the speculative projects are located. Through the fourth quarter, only 20.0% of these new projects have been pre-leased. In a worst-case scenario in which the rest of those projects deliver empty, the vacancy rate for non-core markets (9.3% as of year-end 2008) stands to double over the next two years. In contrast, the addition of another 2.0 msf in the CBD and East End is less likely to pose a serious threat to those markets, though only 30% have been committed to private sector tenants. If pre-leasing remains tepid through completion date of these projects, the vacancy rate could rise by 2.0 to 3.0 percentage points but still hover close to market equilibrium (10%).

As more space hits the market, effective rental rates are poised to fall moderately. Though face rates are likely to hold steady, tenants willing to relocate will be able to take advantage of great opportunities as owners continue to offer generous tenant improvement packages and rent abatements in this challenging economic environment. Of course, greater enticements will be available in submarkets that have more abundant space.

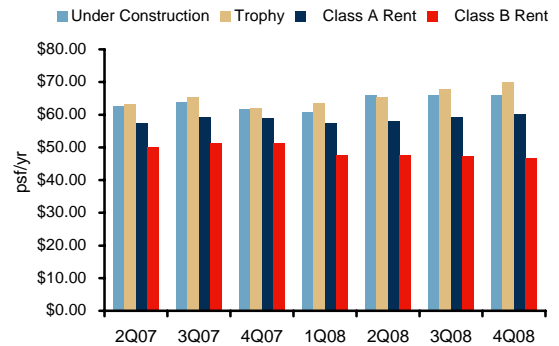
CBD

RENTAL RATE COMPARISON



EAST END

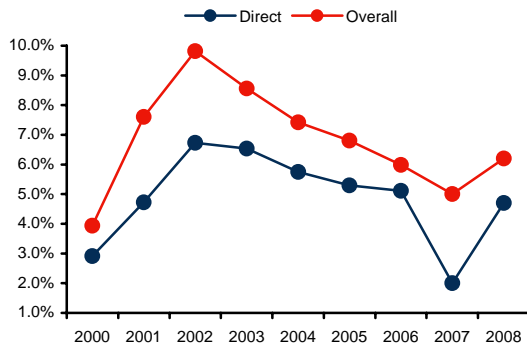
RENTAL RATE COMPARISON



- There are currently three trophy projects under construction that may alleviate the scarcity of trophy availabilities, starting with the delivery of 801 17th Street in the first quarter of 2009. With no pre-lease tenant, this project will add 230,000 sf at delivery and may increase trophy vacancy rates to 12.0%.
- The other two buildings under construction are 800 17th Street (340,000 sf, 30.0% pre-leased) slated for delivery by mid-year 2010 and 2200 Pennsylvania Avenue (434,965 sf 56.3% pre-leased) scheduled to deliver in the first quarter of 2011. They will have close to 500,000 sf available at delivery.

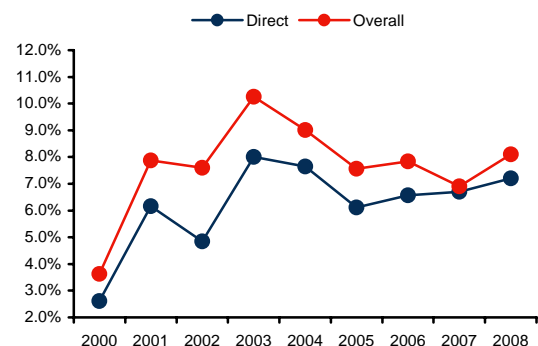
- Construction activity continues to decline from its historic high of 2.8 msf three years ago. No new product is proposed to start in 2009, but there are four projects (884,344 sf) in the pipeline slated for delivery in 2009 and 2010 with 647,328 sf available for lease.
- However, the future of 733 10th Street, NW hangs in the balance as construction has been halted until further notice due to the ongoing credit freeze. With completion scheduled for 2010, it is hopeful they will secure further pre-leasing to proceed.

DIRECT vs. OVERALL VACANCY RATES



- Overall vacancy rates in the CBD remain the lowest in the District even though rates have edged up 1.5 percentage points from year-end 2007. This increase is due primarily to space returned at 1717 Rhode Avenue, NW by the dissolution of Heller Erhman in October.
- Despite the ongoing slowdown in the national economy, large tenants remained active in the CBD with three leases over 100,000 sf signed by the World Bank and the law firms of Arent Fox and Hunton & Williams.

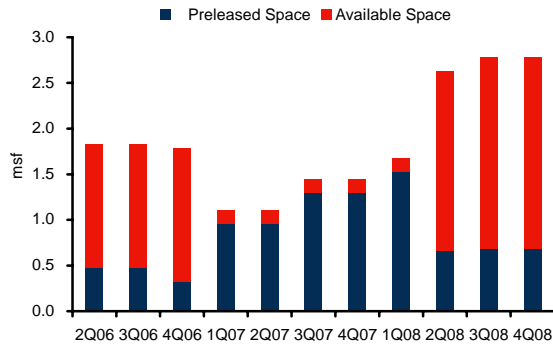
DIRECT vs. OVERALL VACANCY RATES



- Vacancy rates in the East End inched up 1.2 percentage points for direct and 3.3 percentage points overall from year-end 2007 levels. This increase is due largely to five new deliveries totaling 1.0 msf in 2008, of which 25.0% was pre-leased, and a rise in sublease availabilities.
- Even though leasing activity is down 36.5% from year-end 2007, the market still garnered close to 1.5 msf in new transactions in 2008 and 547,992 sf of absorption. Expect fundamentals to be softer in 2009, as sublet space in trophy buildings becomes more abundant due to law firms cutting back on expenditure and returning space to the market.

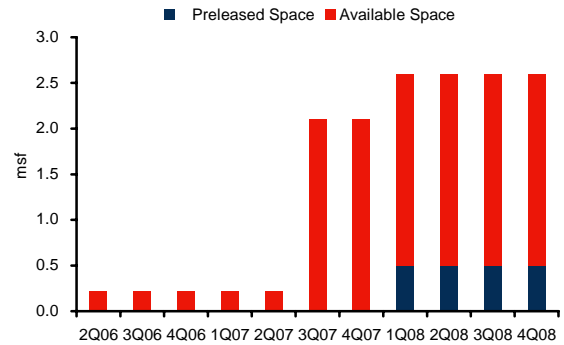
CAPITOL HILL/NOMA

CONSTRUCTION PIPELINE



SOUTHWEST

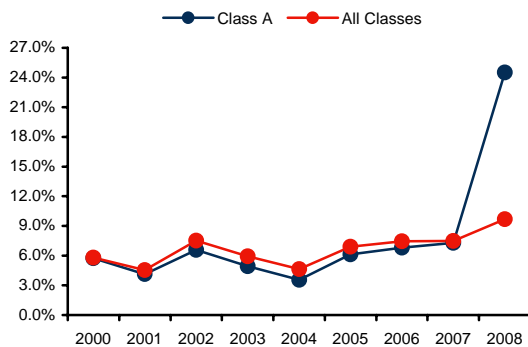
CONSTRUCTION PIPELINE



- The NoMa neighborhood continues to benefit from the federal government and trade group/associations activity. In 2008, the federal government signed two leases greater than 50,000 sf totaling 580,353 sf for DoJ and the E.E.O.C while the American Chemistry Council, currently based in Rosslyn, signed a 90,000-sf lease at Station Place III to relocate its offices back to the District.
- Two buildings are set to deliver in the submarket in the first quarter of 2009: Jones Day's headquarters expansion at 300 New Jersey Avenue, NW (255,000 sf) and Tishman Speyer's NoMa project at 1100 1st Street, NE (345,871 sf).

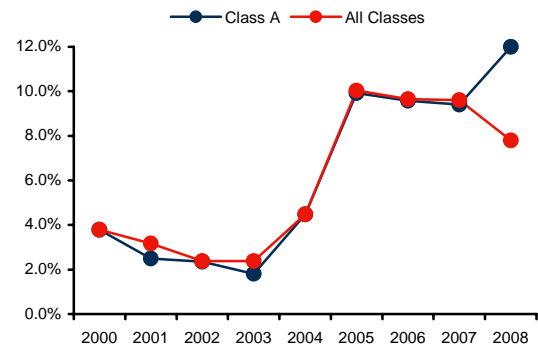
- The Southwest anticipates adding 1.2 msf to its inventory in 2009 with Patriots Plaza II & III (707,606 sf) and the DC Government's build-to-suit projects at the Waterside mall (500,000 sf) delivering throughout the year.
- Clark Construction's building at 425 3rd Street, SW may finally have a tenant after delivering in August of 2007. The American Association of Railroads is expected to lease 30,000 sf in the first quarter of 2009 for a 15-year term.

CLASS A vs. OVERALL DIRECT VACANCY RATES



- The CareFirst building at 840 1st Street, NE, is under contract by Behringer Harvard from Stephen A. Goldberg for \$108 million or \$442 per square foot (psf). Closing was postponed to first quarter 2009 due to financing constraints.
- Like the rest of the country, the D.C. market has not been immune to the overall economic woes. The National Public Radio, the area's newest key tenant, announced in the fourth quarter they would be cutting back on programs and jobs.

CLASS A vs. OVERALL DIRECT VACANCY RATES



- An undisclosed government agency took 65,168 sf at Douglas Development's building, 1900 Half Street, the largest new lease of the fourth quarter. Next door, at 2100 2nd Street, SW, the Coast Guard renewed for almost 600,000 sf for 10 years making it the largest GSA renewal in D.C. in five years.
- With the major tenant make-up being the government, the submarket hopes that its largest future vacancy at Patriots Plaza will be the lucky recipient of the 330,000-sf Department of Agriculture requirement to be awarded in 2009.

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. DIRECT GROSS RENTAL RATE*
Capitol Hill / Noma	9,660,914	38	9.7%	9.4%	720,896	2,285,835	335,462	80,143	\$48.35
East End	34,863,977	148	8.1%	7.2%	1,477,275	884,344	1,004,916	540,673	\$55.51
CBD	30,617,710	179	6.5%	5.0%	2,276,004	1,871,365	227,356	150,763	\$50.82
West End / Georgetown	5,225,062	34	12.9%	11.8%	235,212	0	0	9,111	\$46.49
Uptown	3,528,736	31	8.3%	5.4%	58,205	0	0	(154,973)	\$36.41
Southwest	9,511,032	31	7.8%	7.8%	353,468	2,671,606	0	113,694	\$49.28
Ball Park / Navy Yard	2,699,551	7	7.2%	7.0%	54,790	897,213	0	14,270	\$46.50
Washington, D.C.	96,106,982	468	8.0%	7.0%	5,175,850	8,610,363	1,567,734	753,681	\$51.14

Class A									
Capitol Hill / Noma	3,045,954	9	24.5%	24.5%	585,622	2,285,835	335,462	62,901	\$49.67
East End	19,561,732	64	9.6%	8.6%	789,065	884,344	1,004,916	523,837	\$60.31
CBD	7,750,024	30	10.1%	7.2%	952,575	1,871,365	227,356	492,448	\$58.01
West End / Georgetown	1,437,437	7	3.4%	3.4%	89,607	0	0	126,992	\$59.78
Uptown	365,367	2	10.0%	6.9%	2,683	0	0	(14,637)	\$43.08
Southwest	5,194,465	13	12.0%	12.0%	97,762	2,671,606	0	19,999	\$51.61
Ball Park / Navy Yard	2,699,551	7	7.2%	7.0%	54,790	897,213	0	14,270	\$46.50
Washington, D.C.	40,054,530	132	10.8%	9.7%	2,572,104	8,610,363	1,567,734	1,225,810	\$55.74

* Rental rates reflect \$psf/year

** Includes Renovation completions

MARKET HIGHLIGHTS

SIGNIFICANT 2008 NEW LEASE TRANSACTIONS				
BUILDING	SUBMARKET	TENANT	SQUARE FEET	BLDG CLASS
145 N Street, NE	Capitol Hill/NoMa	GSA - DoJ	521,000	A
1000 Connecticut Avenue, NW	Central Business District	Arent Fox	254,475	A
1225 Connecticut Avenue, NW	Central Business District	World Bank	227,356	A
2200 Pennsylvania Avenue, NW	Central Business District	Hunton & Williams	190,000	A
SIGNIFICANT 2008 SALE TRANSACTIONS				
BUILDING	SUBMARKET	Buyer	SQUARE FEET	PURCHASE PRICE
300 New Jersey / 51 Louisiana	Capitol Hill/NoMa	Ralph Dweck	461,261	\$375,000,000
2445 M Street, NW	West End/Georgetown	WRIT	290,142	\$181,400,000
1030 15th Street, NW	East End	Invesco	328,218	\$181,200,000
2099 Pennsylvania Avenue	Central Business District	Vico Capital	199,520	\$172,500,000
SIGNIFICANT 2008 CONSTRUCTION COMPLETIONS				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
77 K Street, NE	Capitol Hill/NoMa	N/A	335,462	8/08
1030 15th Street, NW	East End	Wenderoth, Lind, & Ponack	311,466	4/08
455 Massachusetts Avenue, NW	East End	Reno & Cavanaugh	234,050	2/08
1099 New York Avenue, NW	East End	Jenner & Block	166,000	4/08
SIGNIFICANT PROJECTS UNDER CONSTRUCTION/RENOVATION				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
400 7th Street, SW	Southwest	N/A	1,400,000	4/10
145 N Street, NE	Capitol Hill/NoMa	GSA - DoJ	589,916	6/10
700 2nd Street, NE	Capitol Hill/NoMa	American Chemistry Council	508,313	6/09
2200 Pennsylvania Avenue, NW	Central Business District	Hunton & Williams	434,965	2/11



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

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