

Washington, DC Office Outlook Q1 2010

Quarter in review

The federal government continued its robust expansion during the first quarter of 2010, adding space across the District and helping offset continued weakness in the private sector. The majority of government growth materialized in the outlying markets of NoMa and Southwest, which chipped away at the city's oversupply predicament. Rents flattened and the construction cycle began winding down, indicating that more balanced market conditions were likely on the horizon.

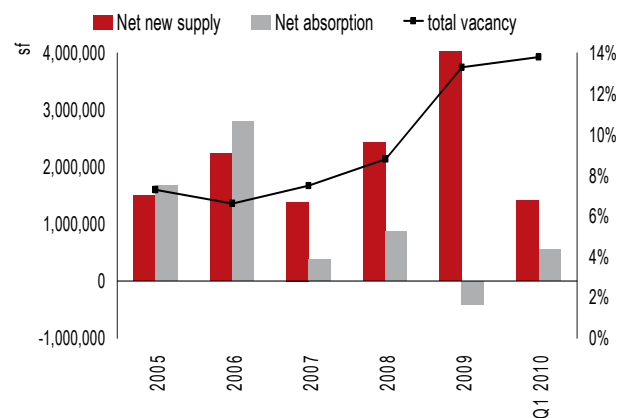
Many stimulus-funded initiatives helped drive new federal requirements in Washington, DC during the first quarter. With spending appropriated for retrofits and renovations of old federal office buildings, various agencies swung from owned space to leased space while their outdated facilities received overhauls. The General Services Administration headquarters at 1800 F Street, NW and the FBI headquarters at the Hoover building were two of the most notable examples of this trend.

The FBI, Federal Courts and Secret Service were all net new federal leases signed in the first quarter, totalling 273,553 square feet. However, since these agencies have not yet taken occupancy of their space, the transactions have yet to affect market statistics and did not contribute to the 552,171 square feet of positive net absorption recorded in DC during the first quarter. Occupancy gains were largely a result of the Department of Justice moving into 521,000 square feet at newly-delivered 145 N Street, NE. Most of the space DOJ vacated across various East End and CBD buildings was backfilled by other government agencies related to financial crime and security.

As the public sector drove demand, the private sector continued to exhibit a preference for renewals. A handful of tenants took advantage of low rents at new developments and locked in deals at rental rates well below 2008 levels. On a case by case basis, tenants with a confident business plan opted to take advantage of favorable conditions and depressed rents. For example, firms such as Fried Frank and Squire Sanders relocated from second generation product on Pennsylvania Avenue, NW in the East End to new developments, 801 17th Street, NW and 1200 19th Street, NW, in the CBD. Conversely, other firms kept waiting out the commercial real estate recession and decided to remain in place by signing lease renewals. Law firm Wiley Rein was a prime example of this, signing a 355,240 square foot renewal at two buildings, 1776 K Street, NW and 1750 K Street, NW for the next 10 years. Despite restrained private sector activity, more leases were signed in the first quarter compared to the fourth quarter of 2009.

| Key market indicators | | | 12-month forecast |
|-----------------------|----------------------------------|-----------------|-------------------|
| Supply | Supply | 111,278,525 sf | ▲ |
| | Direct vacancy rate | 12.1% | ▲ |
| | Total vacancy rate | 13.8% | ▲ |
| | Under construction (% preleased) | 3.1 msf (28.6%) | ▼ |
| Demand | Leasing activity 12 mo. % change | -23.2% | ▶ |
| | YTD net absorption | 552,171 sf | ▲ |
| Pricing | 12-month overall rent % change | -6.5% | ▲ |
| | Class A overall asking rent | \$47.22 psf | ▶ |
| | Class B overall asking rent | \$39.47 psf | ▶ |

Net new supply, net absorption and total vacancy



Class A vs. B overall asking rents



Development activity

Following two years of speculative construction, which delivered 8.0 million square feet in the District and caused the current supply imbalance, new construction starts have halted. The financial crisis, resulting credit shortage and stricter lending standards have made speculative construction financing unattainable. Even for developers rich with cash, the soft market conditions made additional supply unpalatable. Market fundamentals will likely not justify speculative construction activity for several years, and no new construction projects are expected to break ground in the foreseeable future without significant preleasing to cover financial and leasing risks.

At the end of the first quarter there was a total of 3.5 million square feet under construction, 28.6 percent of which was preleased. While preleasing rates have increased compared to 2008-2009 levels, there still remained five projects in the pipeline with no preleasing to date. These projects, 90 K Street, NE, 425 Eye Street, NW, 1015 Half Street, NW, 733 10th Street, NW and 440 First Street, NW, will likely mark the end of the current speculative construction cycle in Washington, DC.

Out of the five buildings that delivered in the first quarter, three were fully leased. The Department of Justice preleased 145 N Street, NE, which totals 575,790 square feet and the DC Government leased both 1100 4th Street, SW and 1101 4th Street, SW, totalling 626,000 square feet. Two other projects delivered in the first quarter, 20 F Street, NW, located on Capitol Hill, and 2175 K Street, NW. 20 F Street, NW is owned by the American College of Surgeons, which will occupy 18,000 square feet in the building. In addition lobbying firm, the National Business Group on Health, which preleased 13,947 square feet, and the National Farmers Union Property and Casualty Company, which preleased 6,600 square feet, will occupy 20 F Street, NW. The other project, 2175 K Street, NW, located in the CBD, added three floors to the building totaling 47,577 square feet. The addition was preleased to the Delegation of the European Union.

Demand

The main driver of growth in the DC market remains the federal government, which has cushioned the DC market from a further increase in vacancy throughout most of the recession and into the recovery. Increased stimulus funding has caused agencies such as the Federal Bureau of Investigation, General Services Administration, Secret Service, Veterans Affairs and many more agencies to occupy more office space in the District. In addition, there remained several requirements in the market that total approximately 2.0 million square feet. The American Reinvestment and Recovery Act (stimulus bill), increased regulation of the financial and energy sectors, and potential growth associated with the new healthcare bill will all drive office demand in the region.

On the other hand, the private sector has shown very limited signs of growth. Law firm Troutman Sanders grew by 36,000 square feet, which was the result of a merger with Ross Dixon; Cozen O'Connor expanded by 13,000 square feet; and Slevin & Hart grew by 7,414 square feet. Considering the reluctance of the private sector to hire more workers, demand is expected to remain weak through mid-year 2010. Many tenants are rightsizing their office needs and using their space more efficiently. In addition, shadow space, which is estimated around 9.0 percent of leased space, will further hinder demand. Even once firms begin hiring again, they likely already have space to accommodate the first wave of growth, suggesting that the office market has a distance to go before private sector firms enter expansion mode.

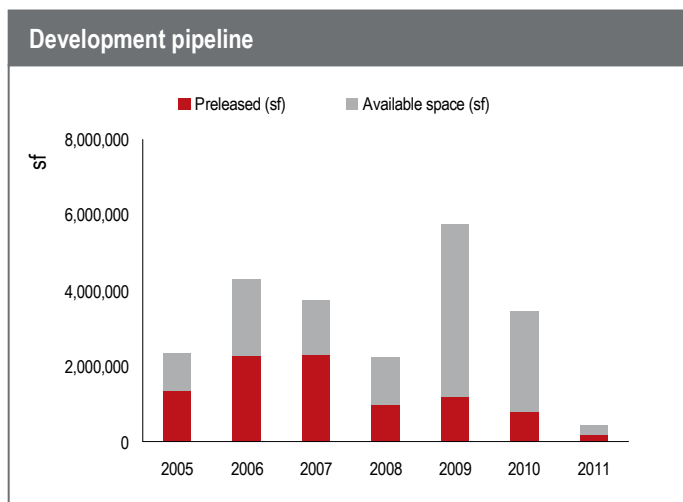
Rental rates

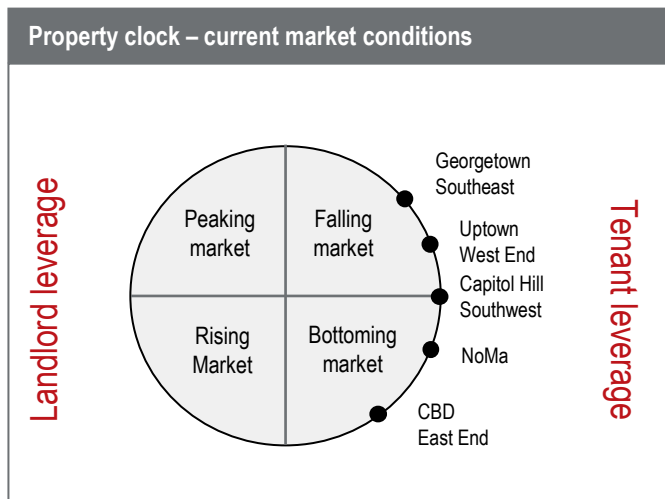
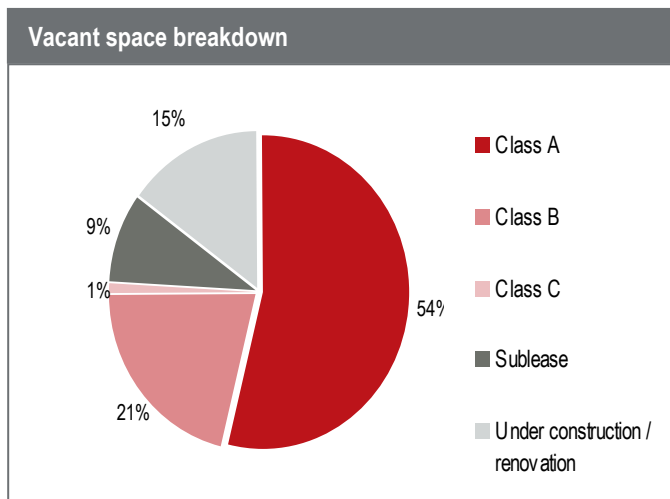
Asking rents have remained flat for the second consecutive quarter, and elevated vacancy will likely keep rates depressed well into 2010. Until vacancy decreases, tenants will still have the upper hand in negotiating leases. In the core markets of DC, where rent decreases have not been as severe as the outlying markets, rents are still expected to remain flat due to weak private sector demand and a multitude of space options. The private sector will retain bargaining power in lease agreements as landlords fight to keep their buildings leased.

The outlying markets of DC (NoMa, Southeast and Southwest) continued to see very aggressive deals with extremely low rates. Two factors pushed rents down in these markets: desperation among landlords who are struggling for occupancy and the superior credit and stability of federal government tenancies. The massive speculative development activity in these markets has increased competition for the recent uptick in federal requirements. The public sector has taken advantage of tenant-favorable conditions, pushing rents lower and often laying claim to 10-year terms with additional extension options at aggressive rates.

Looking ahead

The federal government will continue to drive demand and slowly remove some of the large blocks of space on the market. The outlying markets of DC will be the main beneficiary of federal activity, while the private sector is expected to see modest growth, if any, throughout the year. Significant job gains will be needed to reduce the 15.5 million square feet of vacant inventory and additional shadow space that continues to weigh on the market.





Vacant space – existing buildings

| Building | Submarket | Owner | RBA | sf |
|----------------------------------|-----------|-------------------------|-----------|-----------|
| 400 7 th Street, SW | Southwest | David Nassif Associates | 1,400,000 | 1,400,000 |
| 1100 1 st Street, NE | NoMa | Tishman Speyer | 347,608 | 317,415 |
| 1201 Maryland Avenue, SW | Southwest | Republic Property Trust | 506,600 | 317,143 |
| 1030 15 th Street, NW | CBD | Invesco | 332,022 | 255,378 |
| 55 M Street, SE | Southeast | Monument | 266,566 | 246,909 |

Completed lease transactions

| Tenant | Address | Submarket | sf | Type |
|---|-------------------------------------|--------------|---------|------------|
| Wiley Rein | 1776 K Street, NW/1750 K Street, NW | CBD | 335,240 | Renewal |
| U.S. Securities and Exchange Commission | 700 2 nd Street, NE | NoMa | 200,216 | Relocation |
| U.S. Dept. of Health and Human Services | 370 L'Enfant Promenade, SW | Southwest | 186,880 | Renewal |
| U.S. Federal Bureau of Investigation | 375 E Street, SW | Southwest | 180,000 | Relocation |
| U.S. Internal Revenue Service | 500 North Capitol Street, NW | Capitol Hill | 140,000 | Renewal |

Completed sale transactions

| Address | Submarket | Buyer / seller | sf | \$ psf |
|---------------------|-----------|---|---------|--------|
| 1625 Eye Street, NW | East End | EDGE Fund Advisors / Brookfield | 384,259 | \$529 |
| 1331 L Street, NW | East End | CoStar Group / Mortgage Bankers Association | 169,429 | \$243 |



Real value in a changing world

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