MARKETBEAT

WASHINGTON, D.C. OFFICE REPORT

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION

CUSHMAN & WAKEFIELD® Global Real Estate Solutions℠

2Q10

ECONOMY

The recovery of the U.S. economy appears to be proceeding with modest gains in consumer spending and business investment. The job market continues to improve, with the unemployment rate declining in 37 states as well as the District of Columbia; in fact, the unemployment rate in the District fell to 10.4% in May, a fourth consecutive monthly decline after peaking at 12.0% in January. However, employment has yet to return to pre-recession levels, when unemployment rate hovered around 5.0%-6.0%. Most of the gains in office-using employment continue to be concentrated in the government and professional and business services sectors.

OVERVIEW

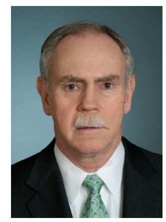
There were several signs of improvement in the Washington, D.C. office market in the second quarter of this year against the backdrop of better economic fundamentals and strong government support in the region. After reaching a 12-year high of 14.6% at year-end 2009, the overall vacancy rate slipped for a second consecutive quarter to 14.3%. Much of the improvement reflects a rebound in leasing activity that began in the second half of last year. The volume of new leases climbed off their record lows in 2009, rising to 2.4 million square feet (msf) year-to-date, which is close to the historic average of 2.5 msf. While rental rates have yet to firm, even there, the news has been encouraging. Concession packages remain high but are beginning to level off.

The news is even more encouraging in non-core markets[1]; they have been recovering at a faster-than-expected pace. The overall vacancy rate fell modestly from 19.8% in the first quarter to 19.5% in the second. Supporting leasing activity has been the growing federal sector, which has been pivotal in this notable turn. During the quarter, the Securities and Exchange Commission (SEC) expanded its headquarters, leasing the remaining 200,216 square feet (sf) of available space at Station Place III in the Capitol Hill/NoMa submarket. The SEC already occupies Station Place I and II, and this latest lease brings this office complex to full occupancy. The General Services Administration (GSA) inked a 10-year lease for 85,000 sf on behalf of the U.S. Customs and Border Protection at the newly-constructed 90 K Street NE in NoMA. The GSA also signed a five-year lease on behalf of the Department of Health and Human Services for 58,143 sf at Patriots Plaza II in Southwest. Year-to-date, the GSA has leased nearly 600,000 sf in non-core markets; this comes on the heels of 1.2 msf of new leases the agency inked for all of 2009. The University of the District of Columbia's (UDC) 88,200-sf lease at 801 N Capitol Street in NoMa is another welcome development during the quarter. UDC plans to open its new campus in the third quarter of this year.

Meanwhile, speculative construction, though still abundant, has benefited from the measurable uptick in demand. All five speculative projects totaling 2.0 msf that were completed during the second quarter were substantially leased upon their delivery – thus, boosting absorption in non-core markets this year. However, four projects totaling 1.1 msf that are currently under construction or renovation remain largely available, with pre-leasing of only 15.0%. Moreover, another speculative project is on the way: Boston Properties and Clark Construction divulged their intent to redevelop 181,000 sf at 500 N Capitol Street upon the departure of the Internal

[1] **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



"Just as we had predicted, rental rates slipped in D.C., but not by double-digit percentages seen across the country. It might be another 10 to 18 months, but I do foresee an upside swing out of the capitulation stage of our "mini-trough."

- Gene Kenney, Senior Director

ECONOMIC INDICATORS

National	2009	2010F	2011F
GDP Growth	-2.4%	3.1%	3.9%
CPI Growth	-0.3%	1.8%	2.1%
Regional			
Unemployment	10.8%	12.1%	11.6%
Employment Growth	-5.1%	0.1%	0.3%

Source: Moodys|Economy.com

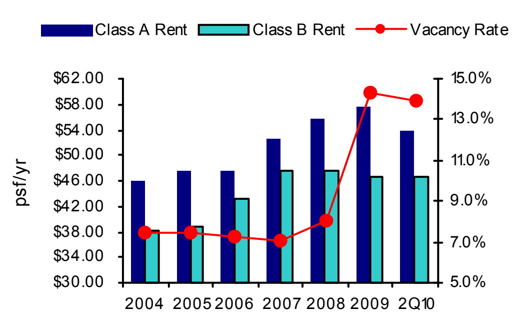
MARKET FORECAST

LEASING ACTIVITY will continue its uptrend, though a large bounce-back is highly unlikely. Of course, if job growth does surprise on the upside, leasing could see a more robust recovery. GSA will remain the catalyst for transaction activity over the next 6-12 months.

EFFECTIVE RENTAL RATES will continue to stabilize as concessions bottom out this year. If job creation allows for a sustained upturn in leasing, rental rates in core markets could continue to eke out increases particularly for high-grade space where vacancies will continue to tighten most quickly.

CONSTRUCTION starts will remain constrained by relatively prohibitive credit conditions. Even so, the pipeline will remain active in the near-term, with ten projects totaling 2.9 msf under construction and renovation.

OVERALL RENTAL VS. VACANCY RATES



Revenue Service, the location's anchor tenant which will relocate to 77 K Street NE this fall.

Core markets appear to be on the cusp of recovery as well. The overall vacancy rate was almost unchanged from the first quarter at 11.5%. Moreover, the volume of sublet space coming back to the market continued to abate; sublet availability actually dipped in the second quarter – to 1.3 msf – after peaking at 1.5 msf at year-end 2009. From a historical perspective, that remains well below the 1.8 msf of sublease space that hit the market in the 2002-2003 downturn. The economic stimulus program also had a noticeable impact on core markets. In May, the GSA signed a 285,434-sf lease at 425 Eye Street NW in the East End on behalf of the Department of Veterans Affairs (VA). The 10-year lease will serve as swing space for the VA while its current home at the Lafayette Building undergoes a $105 million renovation as part of stimulus construction work.

Tenants continued to gravitate towards brand-new class A/trophy buildings in core markets. Case in point is the most notable law firm transaction this quarter: Squire, Sanders & Dempsey LLP is moving from 1201 Pennsylvania Avenue NW and relocating to 1200 19th Street NW. The law firm of Vinson and Elkins, currently at the Willard Building at 1455 Pennsylvania Avenue NW in the East End, is also negotiating to lease 90,000 sf at the trophy building under construction at 2200 Pennsylvania Avenue NW, while law firm McDermott, Will & Emery is in discussions to lease approximately 200,000 sf at PNC Place. All three of the aforementioned buildings are located in the CBD submarket. This trend is chipping away at class A vacancies, which declined from 15.9% in the first quarter to 14.1% in the second, and is setting the stage for steady rents. The top-grade buildings are logging significant blue-chip company renewals as well. Global public relations firm Fleishman-Hillard renewed its 65,000-sf lease for another 10 years at 1615 L Street NW in the CBD, while the investment firm of Carlyle Group renewed for another 16 years its 129,724-sf lease at 1001 Pennsylvania Avenue NW in the East End.

Office acquisitions have also been on the rise this year. This backdrop of stabilizing market fundamentals is stoking investor optimism, and in turn, increasing the investment flow in Washington, D.C. There were several high-profile transactions that closed during the second quarter. Northwestern Mutual Life Insurance Company has closed on a deal to buy the newly constructed quarters of the Department of Justice at Two Constitution Square in NOMA for $305 million. MRP Realty and Rockpoint Group acquired Washington Harbour, a two-building office and retail complex in Georgetown, for $240 million. TIAA-CREF also completed its purchase of the Evening Star building at 1101 Pennsylvania Avenue NW in the East End submarket for $180 million or nearly $800 per square foot (psf) – which is the second-highest price fetched for a trophy building in Washington, D.C.; 1999 K Street NW commanded a price of $830 psf in 2009. Year-to-date, sales volume of properties (valued at $10 million or more each) totals $1.1 billion, already surpassing the $870 million in office sales reported for all of 2009.

FORECAST

Cushman & Wakefield maintains a cautiously positive outlook for Washington, D.C. The U.S. economy will continue to move ahead on its recovery road, although its pace will be modest; consequently jobs will be slow to return in the region. However, some risks could weigh on the outlook. The growing push for fiscal retrenchment could slow economic growth, and potentially upend the primary job growth driver of the Washington, D.C. office market. Hence, for the office market recovery to take root, the region must be able to develop a more sustained impetus from the private sector. Moreover, President Obama's call for a reduction in federal space requirements could affect lease procurements currently in the market and thus poses as a long-term risk. Even so, some optimism is warranted. We believe that the $787 billion economic stimulus package will continue to fuel GSA demand for swing space. In addition, government efforts to strengthen financial regulations this year will be a growth catalyst and help lift the outlook for the Washington, D.C. office market.

Office fundamentals in core markets are poised to improve through the remainder of 2010. The "flight to quality" trend, coupled with constrained construction activity, should continue to fuel a decline in class A vacancies, and eventually lead to rising rental rates. Moreover, the lack of shovel-ready projects could keep construction starts muted in core markets, and that should help put them back on track. Hence, the window of opportunity for landing "good deals" in core markets may dissipate soon. Meanwhile, leasing activity in non-core markets should continue to firm up until year-end as they remain a government hotspot. However, the uptick in absorption is likely to trail new supply. Notably, two projects are slated to be completed in non-core markets in the second half of 2010 with nearly 500,000 sf of available space. If these projects deliver with no new tenants in place, overall vacancies are likely to remain elevated by year-end. Longer term, non-core markets will also draw government contractors and thus support increasing occupancies.

This gradually improving leasing environment, and the area's core strengths in employment and demographics, will continue to position Washington, D.C. as a magnet of acquisition opportunities for investors. We expect 2011 and 2012 to be particularly active years, when better economic and office market fundamentals whet lender and investor risk appetites.

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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 DIRECT ABSORPTION	YTD OVERALL ABSORPTION	DIRECT WTD. AVG. DIRECT GROSS RENTAL RATE*
Capitol Hill/Noma	11,713,718	43	19.9%	19.7%	476,549	749,072	1,497,577	1,198,790	1,301,525	$52.09
East End	35,740,858	152	11.9%	10.0%	673,928	532,079	0	(170,950)	(112,560)	$53.65
CBD	31,615,626	181	11.2%	9.2%	736,546	1,249,320	34,594**	236,139	385,895	$51.25
West End/Georgetown	5,226,557	33	14.0%	11.2%	77,513	0	0	92,603	57,105	$38.29
Uptown	3,531,201	31	13.7%	11.5%	19,437	0	0	(23,327)	(42,881)	$38.29
Southwest	11,115,786	33	26.0%	26.0%	350,134	0	626,000	433,964	432,464	$49.49
Capital Riverfront	4,282,403	11	13.1%	12.8%	29,995	391,923	0	133,021	154,092	$47.30
Washington, D.C.	103,226,149	484	14.3%	12.8%	2,364,102	2,922,394	2,158,171	1,900,240	2,175,640	$50.56
Class A										
Capitol Hill/Noma	5,653,406	16	34.4%	34.3%	385,875	136,800	1,497,577	1,220,125	1,269,642	$54.19
East End	19,974,021	67	12.5%	10.5%	525,749	532,079	0	384,173	441,933	$58.02
CBD	9,670,142	40	17.3%	14.4%	460,482	1,170,045	34,594	210,604	387,265	$60.35
West End/Georgetown	1,437,437	7	9.5%	5.6%	7,493	0	0	11,875	(32,825)	$56.16
Uptown	367,832	2	25.5%	25.3%	11,129	0	0	16,762	16,952	$44.00
Southwest	7,926,977	18	36.0%	36.0%	326,065	0	626,000	417,176	415,676	$49.55
Capital Riverfront	3,204,841	9	14.8%	14.4%	29,995	391,923	0	133,021	154,092	$47.30
Washington, D.C.	48,234,656	159	20.1%	18.5%	1,746,788	2,230,847	2,158,171	2,393,736	2,652,735	$53.89

* Rental rates reflect $psf/year.
** Expansion completion of 2175 K Street NW; total building office RBA is 156,850 sf.

MARKET HIGHLIGHTS

SIGNIFICANT 2Q10 NEW LEASE TRANSACTIONS				
BUILDING	SUBMARKET	TENANT	SQUARE FEET	BLDG CLASS
425 Eye Street NW	East End	GSA - Dept. of Veterans Affairs	285,434	A
700 2nd Street NE	Capitol Hill/NoMa	GSA - Securities and Exchange Commission	200,216	A
801 North Capitol Street NE	Capitol Hill/NoMa	University of the District of Columbia	88,200	C
1200 19th Street NW	CBD	Squire, Sanders & Dempsey LLP	78,032	A

SIGNIFICANT 2Q10 SALE TRANSACTIONS				
BUILDING	SUBMARKET	Buyer	SQUARE FEET	PURCHASE PRICE
Two Constitution Square	Capitol Hill/NoMa	Northwestern Mutual	589,916	$305,000,000
Washington Harbour	West End/Georgetown	MRP Realty	536,000	$240,100,000
1101 Pennsylvania Avenue NW	East End	TIAA-CREF	219,627	$180,000,000

SIGNIFICANT 2Q10 CONSTRUCTION COMPLETIONS				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
Two Constitution Square	Capitol Hill/NoMa	United States Department of Justice	589,916	5/10
90 K Street NE	Capitol Hill/NoMa	U.S. Customs and Border Protection	412,661	4/10
One Constitution Square	Capitol Hill/NoMa	General Services Administration	330,000	5/10

SIGNIFICANT PROJECTS UNDER CONSTRUCTION/RENOVATION				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
2200 Pennsylvania Avenue NW	CBD	Hunton & Williams	430,900	2/11
1000 Connecticut Avenue NW	CBD	Arent Fox	374,145	5/12
800 17th Street NW	CBD	PNC Bank	365,000	7/10

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

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