Office Conversion Activity Accelerates in the Washington Metro Area

Transition in Office Market Pushes Investors to Repurpose Assets

The Washington metro area has been experiencing a period of significant economic diversification and expansion in recent decades, resulting in a dynamic and evolving real estate market. COVID-19 presented challenges to the region's real estate markets; however, headwinds were not consistent across all asset types and quality levels.

Overall, the region's office market has exhibited significant softening, noted by the widening imbalance between supply and demand. Although the pandemic had a strong influence in reducing leasing activity, real estate consolidation efforts were underway among key office-using industries for many years. Given soft office market conditions and underlying tenant preference for quality, Class A assets have commanded a significant share of leasing activity over the last two years. Conversely, the Class B market has softened more aggressively due to its lack of competitiveness and minimal tenant demand.

Some Class B office asset owners are reacting to these trends by elevating the quality of their buildings through major capital investments; however, owners of the most demand-challenged office buildings have begun to consider the value proposition of their assets for non-office use.

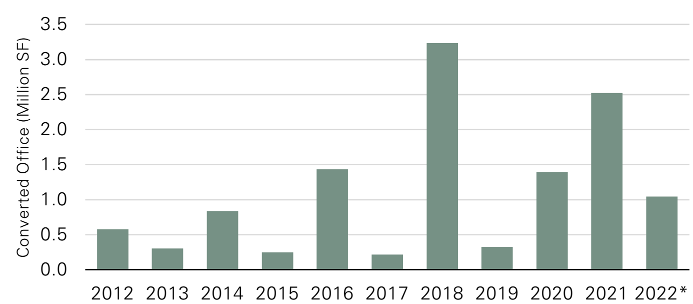
While converting the use of an existing office building is not new, current market forces are encouraging owners to consider repositioning buildings to achieve a higher-value use. Since 2018, 8.5 million square feet of office space has been either converted or demolished and replaced by a non-office redevelopment. The pipeline of proposed conversions measures 6.7 million square feet, or 1.8% of the region's overall inventory, in the third quarter of 2022.

Key Market Trends

- Office leasing demand has been slowing in the Washington metro area for several years, led by real estate consolidations in the federal government and legal industry. Office demand has been further suppressed by the COVID-19 pandemic, adding to the region's oversupply of office space.
- Softened office conditions have encouraged some owners to maximize the utility of their assets by repositioning their use. Office-to-residential conversions have gained popularity due to strong housing demand and regional undersupply.

Office Repositioning Activity

OFFICE INVENTORY REPOSITIONED TO ALTERNATE USE



*Through third quarter 2022

Repositioned Office Assets

Office Square Footage Repositioned/Converted Since 2018

	District of Columbia	Northern Virginia	Suburban Maryland	Metro Area
Conversion (SF)	2,523,197	2,557,741	785,959	**5,866,897**
Demo and Redevelopment (SF)	107,337	1,683,032	863,817	**2,654,186**
% Conversion	95.9%	60.3%	47.6%	**68.9%**

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Repositioning Office Buildings to Alternative Uses

Since 2018, over 8.5 million square feet of office space in the Washington metro area has been removed from inventory due to a change in use; however, it is important to distinguish that office assets can be repositioned in one of two ways: a building conversion or a building demolition and redevelopment.

Office Conversions

Office conversions are projects in which the original structure is retained, and the new use is configured largely within the former structure's footprint. Office conversions may involve the addition of some square footage to maximize the density, but the structure of the former office building must be retained. Office conversions can be cost-effective for well-positioned buildings that boast structural advantages, including sufficient underground parking. Features such as these can save significant time and reduce excavation costs that ground-up developers are likely to undertake.

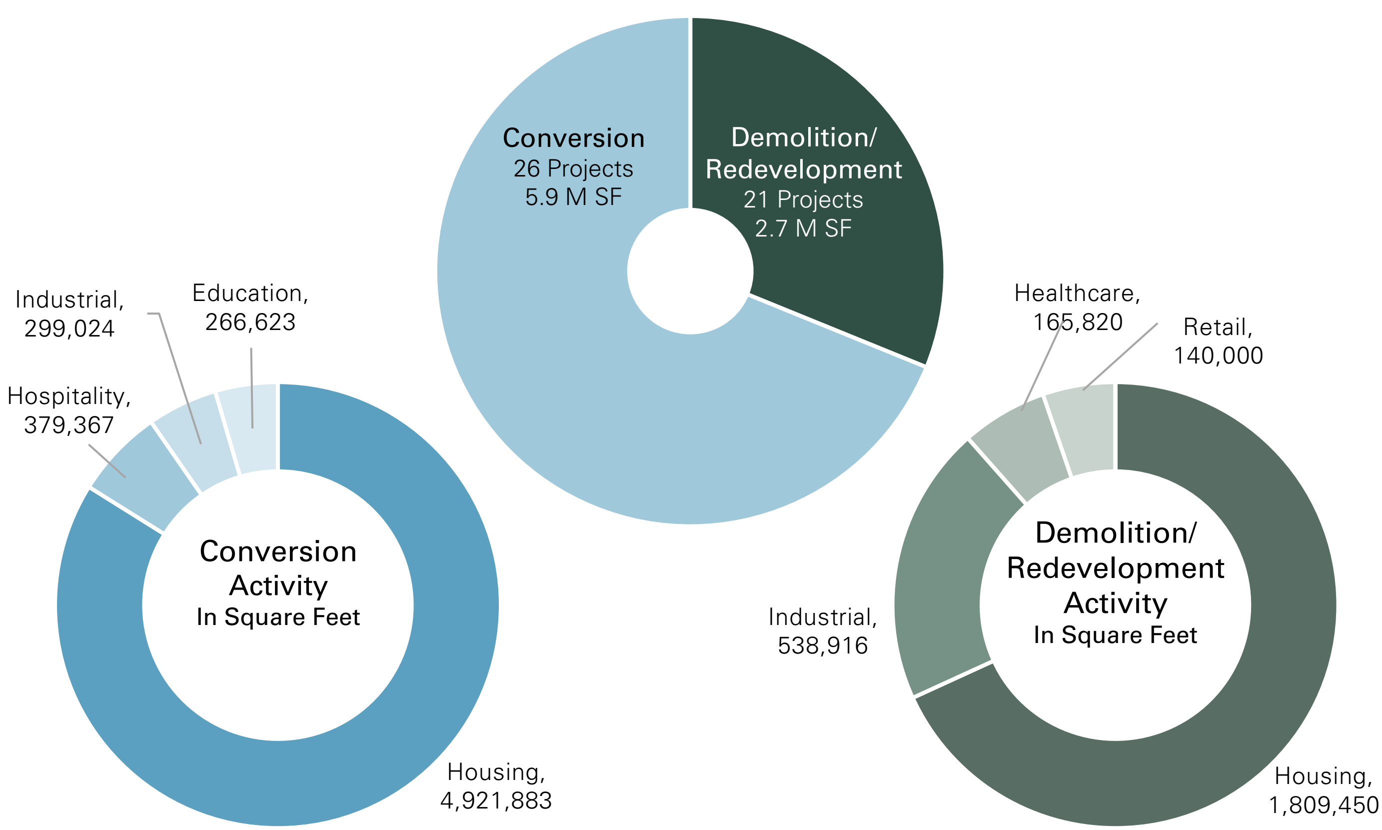
Despite financial challenges, office conversions can be appealing for real estate investors and developers who prioritize environmental sensitivity and ESG goals. Conversion projects produce relatively low levels of construction waste and can help investors reach climate benchmarks within their portfolios.

Office Demolitions and Redevelopments

Office demolitions and redevelopments are a construction method in which the original office building is substantially demolished, and a new, nonoffice structure is developed in its place. This method is generally most common in suburban markets, where the cost spread between challenged office assets and developable land is narrow. While these redevelopments do not result in the conversion of the structure's use, they still lead to the net loss of office square footage due to the repositioning of the property's primary use.

Office Repositioning Activity

OFFICE PRODUCT REPOSITIONED TO AN ALTERNATIVE USE | WASHINGTON METRO AREA | 2018 TO CURRENT



Source: Newmark Research

Repositioning Activity Driven by Suburban Markets

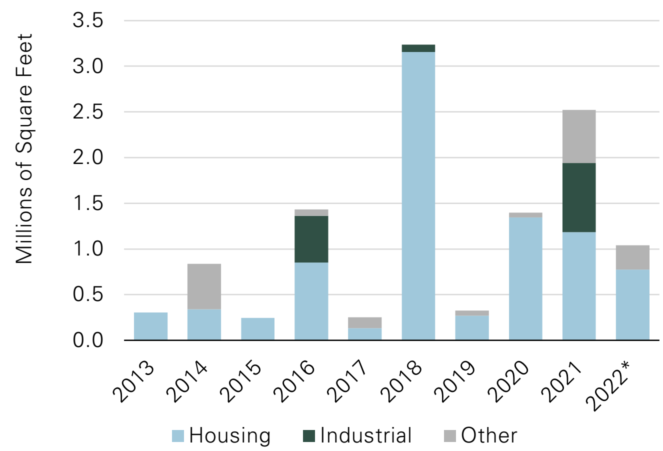
The last two decades of economic expansion has also supported population growth, which has increased 31.8% since 2000. To accommodate new residents and diversified economic activities, land use in both the urban core and suburbs has needed to adapt. Suburban densification has awarded property owners the opportunity to maximize asset values. Outdated and low-density suburban office complexes have attracted new developer interest, particularly among those considering demolition. Prime candidates for ground-up redevelopments often exhibit high vacancy and are located near dynamic demand drivers, like mixed-use town centers and transit hubs.

Recent office repositioning activity has been strongest in Northern Virginia. In the last two years, 2.5 million square feet of Northern Virginia's office inventory has been repositioned to an alternate use, much of which has been redeveloped from the ground up. Of the 47 office repositioning projects to break ground since 2018, demolitions and redevelopments represent about 44.7% of the projects; however, nearly all are in Northern Virginia or Suburban Maryland. Demolitions offer more development flexibility then conversions; subsequently, the suburbs boast a more diverse mix of replacement property uses, which can include data centers, education facilities and self-storage, in addition to multifamily and residential.

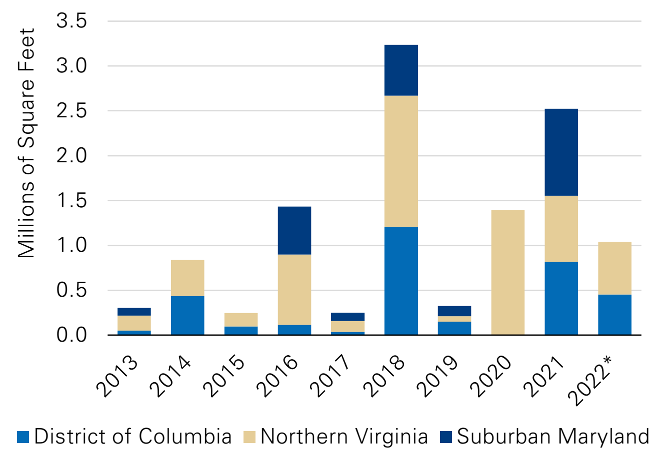
Conversion projects have been more common in dense urban markets, like the District of Columbia, due to elevated asset pricing and less flexibility for new space use. Since 2018, only one of the District's 10 office repositioning projects to commence was a demolition and redevelopment. The District's conversion pipeline is relatively homogeneous, with residential representing the majority of projects to begin construction in recent years.

Repositioning Activity By Ground Break Year

OFFICE RBA REPOSITIONED BY ALTERNATIVE USE



OFFICE RBA REPOSITIONED BY SUBSTATE



Source: Newmark Research

Noteworthy Completed Office Conversions

	1701 N Beauregard Arlington, Virginia	200 Stovall St Alexandria, Virginia	515 22nd St, NW District of Columbia	1764 Old Meadow Rd McLean, Virginia	5600 Columbia Pike Falls Church, Virginia
New Use	Elementary School	Multifamily	Multifamily	Self Storage	Multifamily
Previous Office RBA	119,088 SF	615,939 SF	95,995 SF	79,833 SF	172,000 SF
Year Completed	2018	2020	2021	2019	2020

Photo Credit: Loopnet, Costar

Multifamily Demand Fuels Office-to-Residential Conversions

For many years, the Washington metro area has faced a housing shortage. In 2019, the Metropolitan Washington Council of Governments reported that the region would need to construct at least 320,000 new residential units by 2030 to accommodate projected demand. This measures about 75,000 more units than were forecasted to be constructed during that period.

In the third quarter of 2022, the Washington metro area's multifamily occupancy rate measured 95.9%. Although this rate has contracted following a steady flow of new deliveries in the last two years, the imbalance in multifamily supply and demand remains strong. Developers have looked to capitalize on these market conditions, fueling a robust construction pipeline, including new construction and repositioned office properties. Of the 6,471 multifamily units under construction in the Washington metro area, 2,415 are in converted office buildings and 4,056 are in demolished and redeveloped office properties.

Multifamily units delivered in former office properties have increased since 2017. Partly attributed to growth in repositioning projects undertaken, this also represents increased appetite among developers to achieve greater developable density. Additionally, economic sprawl has shifted the utility of suburban real estate and has supported office repositioning activity, particularly in Northern Virginia. Regional office-to-multifamily unit deliveries are anticipated to reach a new peak in 2022, measuring 1,737 units delivered by year-end. Through the third quarter of 2022, 1,326 units have delivered, nearly all in Northern Virginia.

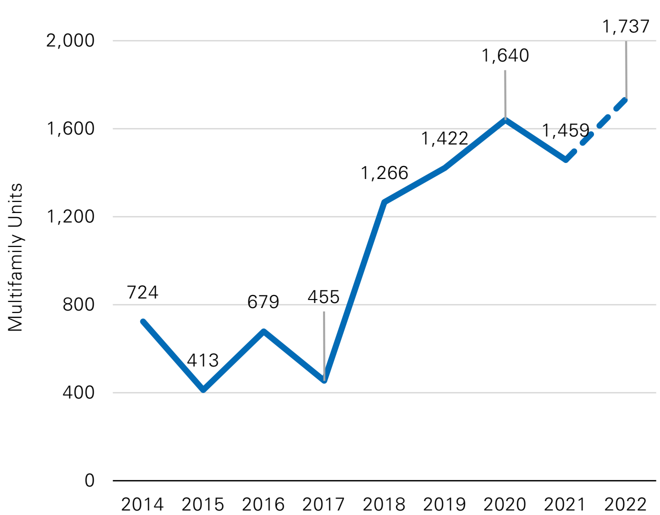
Challenges to Sustained Growth in Office Repositioning Activity

Although office conversion activity has been growing in popularity, the repositioning of assets can be a financial challenge. First, the cost to reposition an asset is high. In addition to the expected costs of conversion, such as redesigned infrastructure and new utility systems, these projects can also be hampered by structural deficiencies, including incompatible window lines, poor floor plate sizing, and limited or non-existent parking. Some office buildings require significant and costly structural alterations to accommodate noncommercial uses.

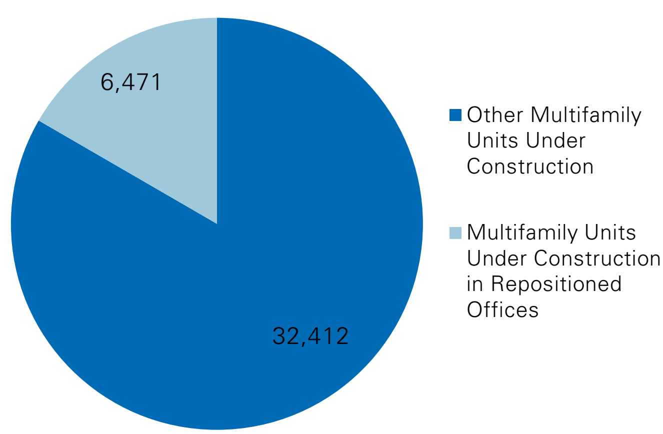
Office demolition and redevelopment projects face different cost challenges to conversion projects. Acquisition pricing must be comparable to the cost of land, as the existing structures provide no value to the buyer. Also, developers looking to build ground-up multifamily developments are presented with other cost-effective options, including entitled pad sites or cleared land. Location is paramount, so office demolitions and redevelopments will remain enticing for properties with high vacancy and available density potential in emerging commercial nodes.

Office Repositioning Activity by Ground Break Year

MULTIFAMILY UNITS DELIVERED BY YEAR



MULTIFAMILY UNITS UNDER CONSTRUCTION



Source: Newmark Research

Also important to owners considering conversion is the net operating income potential. Viewed as a long-term investment, owners should consider the impact of repositioning on the asset's long-term value. In urban settings, commercial buildings tend to carry a premium over multifamily, due to higher earnings potential. Given the higher asset value and long-term net operating income potential of a commercial property, many office owners may absorb temporary losses to protect future earnings.

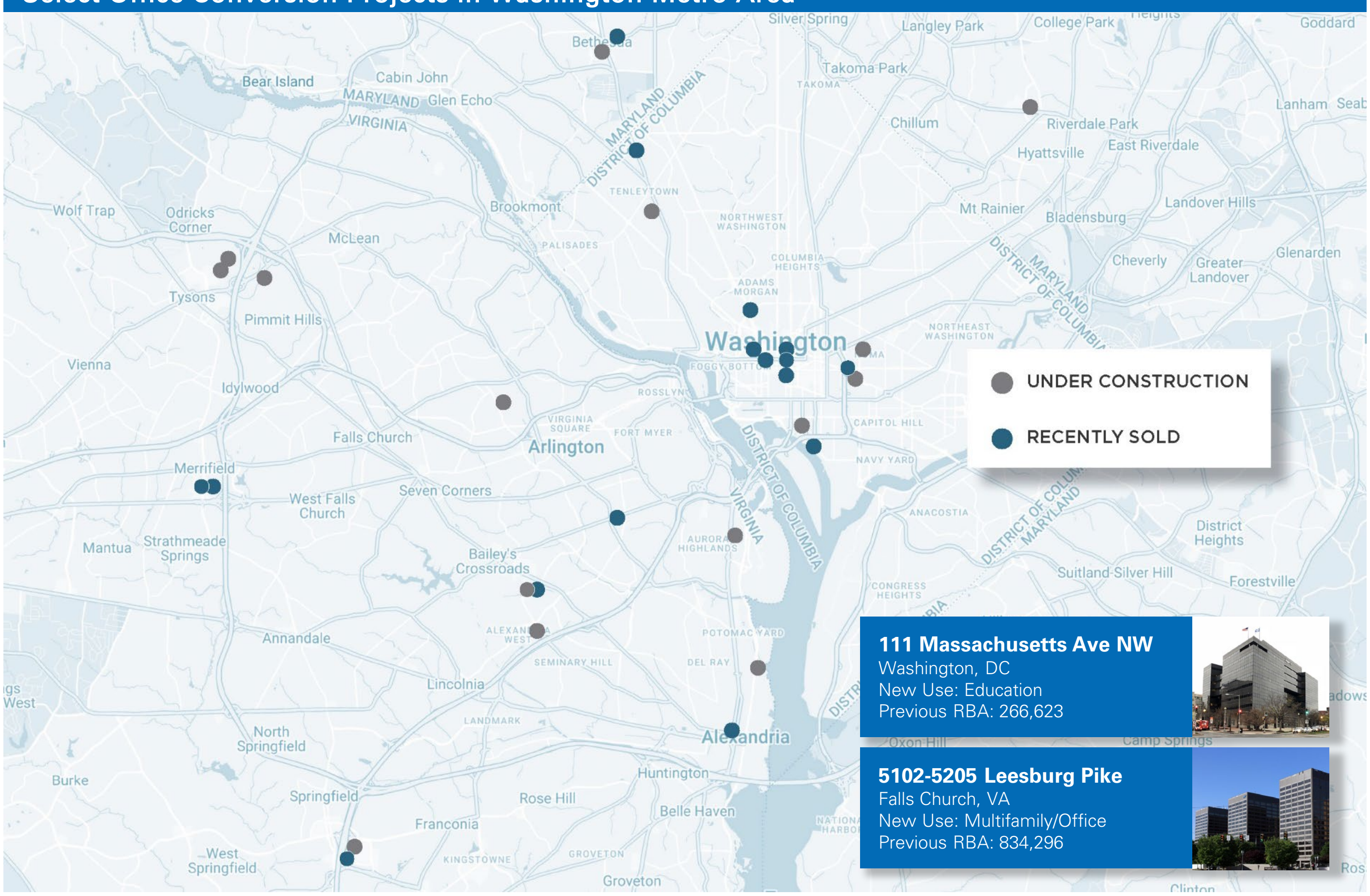
Also important, the cost of construction has been increasing in 2022, due to a combination of hampered supply chains and global inflation. Unpredictability in construction pricing and economic headwinds are starting to temper development enthusiasm, as the threat of a recession simmers. Despite downward pressure on office asset pricing, uncertainty in construction costs will further challenge to the risky nature of repositioning office assets. Current volatility in both economic and pricing markets could measurably cool momentum for office repositioning projects.

Tax Abatements to Incentivize Office-to-Residential Development in the District of Columbia

The District's FY2023 approved budget includes a new 20-year property tax abatement program aimed at incentivizing office-to-housing conversion projects. The program seeks to diversify the composition of Downtown's office-heavy market and use financial incentives to encourage the development of up to 800 residential units, of which 60 are to be designated affordable. The program has made $2.5 million in annual tax abatements available from fiscal year 2024 through 2026.

When seeking to encourage specific development activity, the District historically awards additional development density to sites, partly to accommodate new site requirements, like affordable housing. However, the Downtown core is already zoned for District's maximum density and tax abatements are therefore one of the only financial "levers" at the District's disposal to encourage residential redevelopment activity.

Select Office Conversion Projects in Washington Metro Area



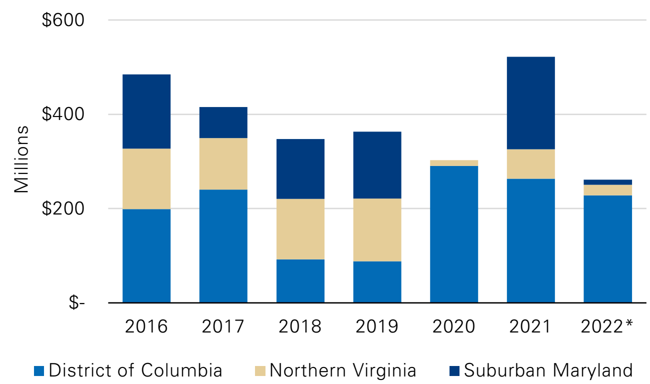
Investment Activity Builds for Conversions

In 2021, the Washington metro area recorded an increase in investment activity for office assets purchased with the intent of repositioning. Activity was supported by the relative market strength of nonoffice assets and the pandemic's influence in reducing office pricing. This was particularly evident in the urban core and among lower-quality assets. This pricing "reset," and soft office market fundamentals energized conversion-driven investors seeking to optimize property utility.

In 2021, $522.0 million was invested regionally in office assets, with the intent to reposition to an alternative use. Through the third quarter of 2022, $261.3 million has been invested. Regional economic diversity has helped to provide investors with repositioning options. In Suburban Maryland, two office properties sold in 2021, with plans for life science/lab conversion. Still, office-to-multifamily remains most popular, representing 59.3% of repositioning investment volume since 2021.

Investment Sales Activity

INVESTMENT VOLUME WITH INTENT ON REPOSITIONING



*Data through third quarter
Source: Real Capital Analytics, Newmark Research

Although investments in office repositioning have been increasing, a critical component which has encouraged these sales has been depressed pricing among challenged office assets. Lowered acquisition costs have given investors greater financial opportunities to undertake higher risk projects; however, headwinds are increasing in financial and investment markets. Increased cost of construction, inflation and the rapidly constrained access to debt financing will challenge some projects. Additionally, developers are cognizant that conversions do not necessarily improve an asset's long-term value potential.

The Future of Office Repositioning

The Washington region's office market is expected to remain oversupplied in the near term and conditions will continue to encourage competition among owners, and support office repositioning. The pipeline of proposed repositioning projects is healthy, but given headwinds, expectations for the growth potential of this trend and its impact on office market fundamentals should be moderated.

Not all office properties are well suited for conversion.
Some office buildings may be incompatible for conversion due to a variety of structural limitations. Nonoffice construction often requires new building requirements, which could be unsuitable or costly to retrofit within the existing structure. Some owners could consider demolition and redevelopment, dependent on financial standing of both the owner and the property.

Office demand is recovering in higher quality office buildings.
Long term financial returns of well-leased office assets exceeds that of most alternative real estate investments. In some cases, owners will be better suited investing in their existing office asset to increase its competitive position for quality-focused tenants. Though attracting demand may remain a challenge, well-leased office assets provide greater financial upside, despite current challenges.

Office inventory removed due to repositioning will have a modest effect on the region's supply and demand imbalance.
Since 2018, 8.5 million square feet of office space has been removed from inventory due to repositioning. While this is noteworthy, the market's overall office inventory measured 373.5 million square feet in third-quarter 2022. Removing high vacancy office assets from the market will help to reduce vacancy, but the impact will not completely shift the region's oversupply imbalance.

Office Repositioning Activity by Substate

	Office Space Repositioned by Groundbreaking Year (Sq. Ft.)					Office Repositioning Projects	
	2018	2019	2020	2021	2022 YTD	Under Const. (Sq. Ft.) / Perc. Conversion	Proposed (Sq. Ft.)
Washington Metro Area	**3,235,210**	**324,984**	**1,397,125**	**2,522,261**	**1,041,503**	**3,833,482 / 56.1%**	**6,684,998**
District of Columbia	1,209,827	149,217	0	818,145	453,345	1,004,867 / 89.3%	2,365,350
Northern Virginia	1,458,615	60,767	1,397,125	736,108	588,158	2,127,698 / 54.5%	2,757,453
Suburban Maryland	566,768	115,000	0	968,008	0	700,917 / 13.1%	1,562,195

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Education	0	0	0	0	266,623	0 / 0.0%	539,030
Healthcare	3,155,377	271,762	1,345,019	1,184,295	774,880	165,820 / 0.0%	0
Hospitality	79,833	0	0	758,107	0	326,145 / 100.0%	177,732
Housing	0	0	52,106	113,714	0	2,710,501 / 63.9%	7,979,310
Industrial	0	53,222	0	326,145	0	631,016 / 14.6%	1,086,051
Retail	0	0	0	140,000	0	0 / 0.0%	0

Recently Sold Office Assets with Intent for Repositioning

Project	Market	Proposed Use	Existing Square Feet	Sale Date	Sale Price	Sale Price Per SF	Buyer	Seller
1010 Vermont Avenue, NW	DC – CBD	Conversion: Multifamily	63,291	4Q 2022	$16.0	$253	Pembroke	Altus Realty Partners
1825 & 1875 Connecticut Avenue, NW	DC – Uptown	Conversion/ Redevelop: Multifamily	762,000	2Q 2022	$228.0 M	$299	Post Brothers	JBG Smith
1125 15th Street, NW	DC – CBD	Conversion: Multifamily	263,020	4Q 2021	$82.0 M	$312	Lincoln Property Co.	SC Herman & Associates
1425 New York Avenue, NW	DC – East End	Conversion: Multifamily	287,042	4Q 2021	$56.0 M	$195	Foulger-Pratt	Ares Management/ Monument Realty
West Gude Labs	MD – North Rockville	Conversion: Life Science	209,101	4Q 2021	$45.0 M	$215	Thor Equities	Brookfield
5151 Wisconsin Avenue, NW	DC – Uptown	Conversion: Multifamily	105,000	4Q 2021	$18.0 M	$171	Donohoe Companies	Louisa C. Heider

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