Looking Forward Through 2012 — Ups and Downs of Apartment and Office Markets

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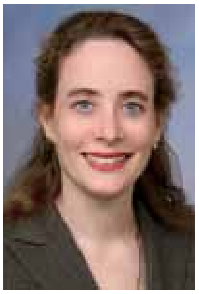

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In the fall of 2008 and in most of 2009, the financial markets were in free fall. Fannie Mae. Freddie Mac. Lehman Brothers. AIG. General Motors. Washington Mutual.

Real estate was no different. The values of single family residential and condominiums plummeted throughout the United States. Commercial real estate values collapsed in most areas of the country.

Washington, particularly inside the Beltway, was different. As Doug Bibby, President of the National Multi Housing Council notes, "Washington, DC has been one of the best performing multifamily markets for several years, including during the single-family meltdown of 2008-2009. There is a lot of capital interested in investing here, both from domestic and international sources. There have [however] been some recent rumblings about the possibility of too much capital chasing too few opportunities and speculation that we may be over-building apartments in the metro area. But I am not convinced that this market is anywhere near a bubble because it is one of the most desired places to live and work in the US."

By 2010, the real estate market in Washington DC had begun to rebound and the financial collapse was a distant memory. Perhaps not even a memory, as purchasers and lenders fought for the right to buy and finance core properties in the DC metro area driving prices well above the peaks we had seen in 2006 and 2007. The Palatine apartment complex in Arlington may be a classic example. This "failed" apartment project was sold at auction on the courthouse steps during a February 2010 snowstorm by sellers foreclosing on the construction loan. The building had been completed by Monument Realty in August 2008 and converted from a proposed condominium project to rental and leased up prior to the auction. The auction orchestrated by the DC office of Holliday Fenoglio Fowler fetched a price of \$450,000 per unit and a cap rate of 4.75% and was purchased by a Miami developer, Crescent Heights. Slightly more than a year later, HFF was called upon to sell the Pallatin again and this time the project was sold for more than \$540,000 per unit to TIAA-CREF.

Commercial real estate enjoyed similar success. According to Cassidy Turley, office sales in 2011 reached \$7.2 billion in the DC metro area. Market Square sold for a record breaking \$904 per square foot and the owners of the Evening Star (227,000 sf) building and 1225 Connecticut Avenue (240,000 sf) did not fare badly either. Their buildings sold, respectively, for \$838 per square foot and \$897 per square foot.

The Rosslyn, Virginia commercial market provides a good example of the 2011 optimism. Goldman Sachs replaced Lehman Brothers as Monday Properties' financial partner so that allowing the developer to proceed with its 580,000 spec office building on North Moore Street. In addition, The JBG Companies broke ground in January, 2011 on a 474 apartment unit and 25 townhome complex at 1510-1530 Clarendon Blvd.

While the first half of 2011 saw much activity, sales and lending appeared to grind to a halt during the second half of the year. Among the reasons given for the slowdown was the European financial crisis leading European lenders and buyers to pull back from the US commercial market. The European downturn also caused spreads to widen and that, coupled with concerns about new regulations, resulted in a virtual shut down of CMBS lending. In addition, life companies and other non-CMBS lenders which filled a good deal but not all of the void left by the quiescent CMBS market reached their lending quotas and slowed down or ceased lending.

There is much to be optimistic about as we enter 2012. There is no question that DC is considered one of the top four markets in the world (along with New York, San Francisco, and London) and will continue to attract international investors. Interest rates are at an all time low and should remain low for the foreseeable future. Consumer confidence is spiking and holiday sales at stores and on the internet well exceeded projections. Money is available to buyers for equity. The life companies have increased their lending targets in 2012 and the CMBS market may be poised to restart and compete for quality product. Apartment rents have climbed in the DC metro area and office rents seem to be increasing for quality projects.

We have asked some of the leading individuals in the multi-family residential arena for their prognosis on the 2012 market. They all share the optimism expressed earlier in this article by Doug Bibby. Bill Roohan of CBRE (providing his own views and not

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that of his company) predicts a sales volume in the Mid Atlantic (NoVa, DC and MD suburbs) of at least $5 billion and possibly closer to $6 billion. He notes that in the first 40 days of the year, there were $1.3 billion of sales under contract. Bill expects cap rates on the best Class A projects to be in the range of 3.9% to 4.5% for high rises and 4.5% to 5.25% for garden apartments, based on 90 days trailing income and the past 12 months of expenses. He expects interest rates to stay very low through at least the middle of 2012, ranging from 3.3% to 4.5% for 10 year money, depending on the asset quality, sponsor, and location, noting that the buyer of the Jefferson at Thomas Circle secured a 5-year interest only loan at 2.99%. Bill believes that there is only a 40% chance of a sale topping the price per apartment of the Palatine and could not venture a guess on the best submarket or the worst. He does think that a story which might unfold in 2013 is at least one DC submarket being overbuilt.

Al Cissel of Jones Lang LaSalle (providing his views and not that of his company) believes that 2012 will be a very strong year, with sales volume in the range of $5 to $6 billion for the DC metro market, including Baltimore. He sees significant global demand for this product and the ability to borrow seven year money, with interest only for two years, in the range of 3.8% to 4.2% range, depending on various factors. Al thinks that it is possible that a trophy product, located very near Metro, in a site with high barriers to entry, could top the Palatine sales price per unit. Cap rates will remain below 5%, based on the prior year's operations. The best market in the area may be DC proper, with areas such as the U Street corridor, very hot. Al does not see any particular submarket as a poor performer in 2012, although some areas may be slower to lease up new product resulting in increased rent concessions.

We also spoke to Dave Nachison and Alan Davis of Holiday Fenoglio Fowler (who provided their views and not those of the company). Dave and Alan feel this is an historic opportunity to borrow debt capital and are advising their clients to consume as much debt capital as possible while rates are low and the government sponsored entities (GSE's), life insurance companies and banks compete to finance this asset type. If the US economy continues to show signs of growth as the recent drop in unemployment suggests, they expect to see upward pressure on rates as our economy improves despite the Federal Reserve's position to maintain current rates through 2014. Dave and Alan also note that there is widespread investor enthusiasm and plenty of investment capital available for multi-housing assets and thus they expect 2012 transaction volume to meet or exceed the $5.4 billion generated throughout the greater Washington/Baltimore region in 2011. They expect to see premium pricing continue and see the likelihood of a new pricing benchmark topping the sale of the Palatine as being strong should a similar type core asset come to market in 2012. The best submarkets will be close-in, urban and transit-oriented like the 14th Street corridor in northwest DC, the Rosslyn – Ballston corridor in Northern Virginia and Chevy Chase/Bethesda market in Maryland because these submarkets attract the most affluent and educated demographic of "renters by choice" who pay market leading rents to live in high quality product with minimal commuting time to work and an eclectic and convenient choice of entertainment, shopping and cultural venues. The tougher submarkets can be characterized as those with significant imminent construction and additional planned development by well capitalized sponsors that collectively may result soon in excess supply.

A more pessimistic note is struck in Delta Associates 2012 Trendlines. Delta notes that by the 4th quarter of 2011, construction had started on 6,207 units — the largest number in almost two decades which may result quickly in an overbuilt market. Delta also predicts a slight uptick in Class A vacancy from 5.0% to 5.4% by year end 2014 and that Class A rents will face downward pressure in 2012 in the DC metro area due to the large slate of scheduled deliveries compared to likely demand levels.

There may also be strong headwinds facing our commercial real estate market, particularly the office market in the metropolitan DC area. Will the CMBS market truly re-emerge? Projections for CMBS lending volume in 2011 were grossly overestimated and Credit Suisse has already abandoned its platform. 2007 vintage loans which were made at the height of the market and structured as five year interest only loans will be maturing this year but may lack adequate value for refinancing. However, what really gives us pause is what has always been a key driver of real estate fundamentals in Washington DC — the Federal Government. A recent article in the Washington Business Journal, "When the Ax Falls," by Jill R. Altoro (Dec. 9-15, 2011) suggests that" if federal budget cuts take hold next year, an estimated 192,000 workers could be out of jobs." The article quotes Stephen Fuller stating "as many as 30,000 federal jobs could disappear — and quite quickly." And, he estimates that an additional 162,000 jobs will be lost in the region in areas that rely on the Federal Government such as federal contracting, defense and aerospace, as well as retail and real estate. Fuller's conclusion is that these layoffs will result in slower growth, rather than a downward dip in the economy.

Boston Properties, in discussing its 4th quarter 2011 results, appears to share this pessimism. In DC, it notes that "the impacts of the deficit negotiations and spending reductions and the Presidential election are going to mute any significant improvement in overall market conditions. In the District, we really don't see the government expanding in 2012." The discussion also notes that law firm consolidations have lead to additional large blocks of space coming on the market and, in the short term, Boston Properties sees private sector leasing as slow. Ted Lerner of Lerner Enterprises which owns and manages office buildings throughout the DC metropolitan area echoes these sentiments. Ted sees a large inventory of potential office development sites creating an overhang on the market. With GSA not leasing and with CEOs of major companies and large law firms reluctant to part with capital or borrow to finance moves to new buildings, Ted forecasts a challenging 2012 for office developers.

As Delta's 2011 Trendlines noted, net absorption of office space in the DC metro area totaled 1.1 million square feet in 2011, compared to 6.4 million in 2010 (which was very close to the 15 year average of 6.2 million square feet).

We share these views. The Federal Government, which as noted above, traditionally has been a driver of leasing activity in the DC metropolitan area (both as a result of federally occupied space and space occupied by government contractors), has had a mixed record in recent years. Between growth of federal agencies, a large uptick in GSA appropriations and a directive from the top ranks at GSA to solve what had become a significant holdover issue for GSA tenancies, 2009 and 2010 saw significant GSA leasing activity in this region. Some of that continued into 2011 with, for example, awards for leases for the Department of Health and Human Services and for the National Institute of Allergy and Infectious Diseases in Rockville and the just before year end award of a 463,000 square foot lease for the State Department on 19th Street.

But 2011 was also marked by Congress' increasingly vocal criticism of federal leasing activity. Inked in 2010, the Security and Trade Commission's 900,000 square foot lease at Constitution Center in Southwest (from which the SEC eventually extricated itself) brought much attention (including several hearings) and scathing criticism from Congress throughout 2011. Congressional disapproval was not aimed solely at the SEC, however. All federal leasing activity received increased scrutiny as Congress and the Executive branch focused on lowering federal space costs by, among other things, increasing space utilization rates and reducing agency footprints. In this environment, Congress let prospectus-level leases languish without needed Congressional approval.

The picture looks no rosier for 2012. Congress' attention has been focused on the Civilian Property Realignment Act and the shedding of excess federal properties. Meanwhile, the combination of agency budget cuts, the directives to agencies to rethink and reduce their space use, and the continued backlog of Congressional lease approvals, will result in little federal leasing activity. The public sector, including large law firms, does not appear ready to pick up this slack, as there is

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reluctance to spend the capital needed to move to new quarters. Both the private and public sectors use of space has been affected by telecommuting and the significant downsizing in the amount of office space needed per employee.

But, although 2012 may be a difficult year for the office market in the DC region, the lack of activity in 2012 should bring with it further need and demand. A significant number of GSA leases expire between 2012 and 2014 including, for example, leases for the National Science Foundation and Federal Trade Commission. Absent action by the Federal Government, the gains made in reducing holdovers before 2010 will quickly be swept away. Ironically given concerns about federal spending, Congress' hold on GSA activity may expose the government to potentially greater leasing costs to the extent the government is forced to pay market rents during holdovers. The impact though will be felt outside of GSA and its tenant agencies too as landlords will find it difficult to refinance or sell their properties so long as the Federal Government is failing to act. Given these pressures, though, it is likely that the current holding pattern will be limited. As one GSA observer noted recently (and hopefully), "the floodgates will open in 2013".

In summary, a consensus seems to be emerging that 2012 will be a very strong year for the multi-family residential market in the DC metropolitan area. The pendulum may, however, swing back in late 2013 and 2014 as the euphoria driving multi-family residential will lead to significantly more construction and likely overbuilding in certain submarkets. The reverse appears to be true for the office market. 2012 figures to be a difficult year, with no appetite in the government for increased leasing of space, few law firm tenants actively looking to move, and most large corporate users of space unwilling to deploy their capital to upgrade their offices in new quarters. There are, however, signs of pent up demand for office space which suggest that by late 2013 and in subsequent years, demand should outstrip supply. And in all events, as we look at much of the rest of the country where the financial collapse remains a living reality, we should be thankful to be working in the DC real estate market, even with all of its ups and downs. ▲