

BUILDING

*Several Factors Distinguish Commercial Development
in Washington, D.C., From Other Real Estate Markets*

BY CHARLES GERENA



In Uncle Sam's Backyard

During the 1990s, commercial development reshaped the Washington, D.C., metropolitan area. The expansion of telecommunications, Internet services, and other high-tech sectors fueled demand for office and retail space in suburban Virginia and Maryland.

One look at data from Julien J. Studley Inc., a New York-based commercial real estate firm, tells the tale. By the end of 2000, the availability rate — the percentage of office space on the market for lease or sublease — was just 5.1 percent for the northern Virginia counties of Arlington, Fairfax, Loudoun, and Prince William, and the city of Alexandria. The rate was only 7.1 percent for Montgomery and Prince George's Counties in suburban Maryland. In comparison, the average availability rate was 11 percent for the 13 major metropolitan markets tracked by Studley.

Then, the tech boom went bust and the effects of a national economic slowdown reached metro Washington. Between the fourth quarter of 2000 and the second quarter of 2003, availability rates more than tripled in northern Virginia and almost doubled in southern Maryland. Meanwhile, average rental rates either fell or didn't grow much.

Back in the nation's capital, the commercial real estate market looks quite different. The availability rate in Washington rose from 5 percent in the fourth quarter of 2000 to only 7 percent in the second quarter of 2003, the lowest rate among metro markets

that Studley monitors. Although the city's lease rates have fallen, they are much higher than the suburbs.

Why does Washington's commercial real estate market look so good compared to the suburbs? "There's only one answer — the federal government. It's more than half of the economy in the city," says Stephen Fuller, a public policy professor at George Mason University (GMU) who tracks the regional economy. "The federal government spent \$33.5 billion in Washington last year, up \$2.6 billion from the year before."

In fact, the presence of the federal government is just one of the factors driving the market for commercial real estate in Washington, D.C. These factors have limited both the overall supply of commercial property and the demand for retail space, but they have also kept demand for office space from dropping as quickly as it has in other markets.

Looking for Land in All the Wrong Places

The pace of commercial construction in Washington was sluggish during the last decade. Although this created a supply imbalance in the real estate market, it helped vacancy rates and rents hold up better in the new millennium.

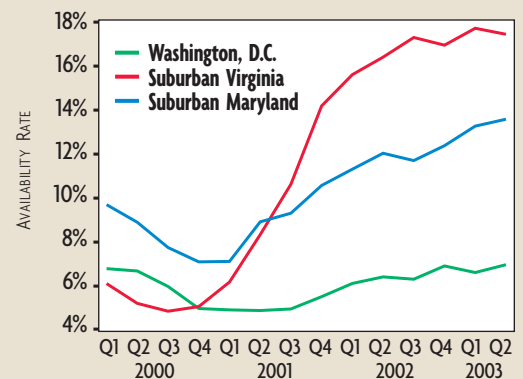
Cranes and steam shovels started moving steel and dirt in Washington again only within the last few years. More than 13 million square feet of new and renovated non-residential property has been added to Washington's total inventory since 2000, according to offi-

cialists with the Downtown D.C. Business Improvement District (BID). Another 11 million square feet was under construction as of March 2003. Total rentable office space in the city exceeds 100 million square feet.

The majority of commercial development has been in areas northwest of the Capitol, including the central business district near the White House and neighborhoods like Shaw and Logan

City vs. Suburbs

Since 2001, consistent demand from the federal government and relatively less commercial development in Washington, D.C., have kept the city's availability rate from climbing as quickly as the rates in suburban Virginia and Maryland.



NOTES: The availability rate is the percentage of all office space being marketed for lease or sublease. In addition to unoccupied space, it accounts for space that is occupied but due to be vacated in the near future. Suburban Virginia includes the counties of Arlington, Fairfax, Loudoun, and Prince William, and the city of Alexandria. Suburban Maryland includes the counties of Prince George's and Montgomery.

SOURCE: Julien J. Studley Inc.

Circle north of downtown. Development also has occurred in the southwest quadrant, including new headquarters for the Federal Aviation Administration (FAA) and the Federal Communications Commission.

Washington's eastern quadrants have been quieter, mostly because they are dominated by residential neighborhoods. But there have been pockets of commercial activity there, including

the development of the Southeast Federal Center on M Street near South Capitol Street.

What held up commercial development in Washington until now? Leasing agent Geoff Kieffer says business people didn't trust the local government. "There was a lack of confidence that for every dollar of taxes you'd get a dollar's worth of services back," explains Kieffer, president of Wash-

ington-based Woodmark Commercial Services LLC. "And public safety was an issue. We were labeled the murder capital of the world."

During the mid-1990s, in particular, the city was in the throes of a fiscal crisis. An October 2002 Brookings Institution paper noted that "the city was effectively bankrupt and unable to pay its bills, collect taxes, access the credit markets, or deliver adequate services to its citizens."

These issues made investors and developers unwilling to bear the cost of building in the nation's capital.

Like any mature metropolis, Washington has physical limitations that make it expensive to expand existing buildings and construct new projects. "You have to tear stuff down to build new buildings, and some of the stuff you'd like to tear down has to be saved because it has historical value," notes Fuller. "A lot of the central city office construction involves renovation of existing structures." Such endeavors aren't cheap, partly because "the regulatory process is lengthy."

Unlike most cities, however, Washington has other constraints that make it even harder to build or expand. The Building Height Act, passed by Congress in 1910 and codified in the city's zoning ordinances, restricts a building's stature to the width of the fronting street plus 20 feet. Typically, structures on commercial corridors can be no taller than 130 feet.

As a result, the boundaries of downtown have extended into Washington's fringes. This has caused some commercial development to push against residential neighborhoods.

Combined with uncertainties about Washington's business climate, these high barriers to entry sent real estate investors and commercial developers into northern Virginia and suburban Maryland during the 1990s. But after the U.S. economy ran out of gas in 2001 and demand for office space evaporated, vacancies didn't increase in Washington as much as they did in the suburbs.

"The District of Columbia does better than the outlying areas because it doesn't build up as big a surplus when there is a lot of building," says Anthony

Creating A Capital City

More than two centuries ago, a special federal district was carved out of Virginia and Maryland to serve as the young nation's permanent capital. Both states agreed to donate the remote 10-mile square on the Potomac River that Congress chose for the new district.

Washington, D.C., isn't the only national capital planned in this manner. During the 20th century, the cities of Brasilia and Canberra were created within separate federal districts to serve as the seats of government for Brazil and Australia, respectively. Common threads weave through the unique histories of these city-states.

Scott Campbell, assistant professor of urban planning at the University of Michigan, likens a capital city to a corporate headquarters. Workers scattered across the country produce its goods and services, but the primary decisionmakers are still concentrated in one place. Accordingly, a substantial amount of economic activity in capital cities continues to come from the national government, both directly and indirectly.

"Firms seek proximity and access to government offices and bring in more jobs, construction, and tax revenues," wrote Campbell in an April 2000 research paper. "Other firms set up in the capital to serve government offices with legal, financial, communication, and administrative services. Lobbyists for corporations, trade unions, nonprofits, and other interest groups cluster in the capital."

Since a capital city is the seat of government, federal officials usually want it to symbolize their nation's economic and social status. Therefore, development of sufficient public infrastructure and architecturally grand amenities is carefully planned and often subsidized.

At the same time, planners usually design capital cities to be efficient, functional centers of government administration. As a result, these cities are sometimes derided as socially and culturally drab. Washington has made strides in encouraging the development of restaurants and entertainment offerings, but Stephen Fuller at George Mason University notes that most tourists stick to seeing the sights on the Mall and don't stroll around downtown.

The economies of Washington, Brasilia, and Canberra could be considered one-dimensional as well. In each capital, the national government is the single largest employer. The manufacturing base is also small, but there is some variety of service industries. Each city has taken steps to increase private employment so that the impact of government budget cutbacks on the local economy is minimized.

As much as these cities have in common, there are some differences.

While Washington and Canberra are near population centers, Brasilia is not. Washington was centered on the eastern seaboard to provide equal access for the industrial North and the agricultural South. Canberra came into existence between two major Australian cities, Melbourne and Sydney, in 1913 to avoid the political fallout of choosing either one as the capital. But Brasilia was built hundreds of miles inland in 1960 because the government wanted to relieve overcrowding in Brazil's populous coastline and encourage economic growth in the center of the country.

For the most part, only residential growth has been stimulated beyond the borders of Brasilia. In fact, most of the people who work in Brasilia and Washington commute from elsewhere. However, most workers in Canberra live in the city.

—CHARLES GERENA



By providing large blocks of contiguous space for retailers, it is hoped that Gallery Place will attract suburban shoppers to downtown Washington.

Downs, an economist with the Brookings Institution and a real estate expert. “...It’s much easier to build more space in the suburbs, so the supply is likely to rise faster in the suburban locations than downtown.” In other words, Washington’s commercial real estate market can’t expand its supply rapidly, so it doesn’t have as far to contract during downturns in demand.

Richard Bradley, executive director of the Downtown D.C. BID, thinks that’s a good thing because “it creates a sense of predictability. It’s one of the reasons why Washington is considered to be the most desirable location for commercial office investment internationally,” according to a recent survey by the Association of Foreign Investors in Real Estate. “It’s ahead of London, Paris, and New York.”

Indeed, investors are taking a second look at Washington’s commercial real estate market. “A ton of money has fled out of the stock market,” notes Downs. “There are investors looking for well-occupied properties with leases that aren’t going to roll over. That kind of property, which is a lot of downtown Washington, has gone up in price in spite of the fact that vacancies have risen.”

In addition to the relative stability of Washington’s commercial real estate market, the city’s fiscal situation has

improved. The local government has balanced the budget for five years in a row, boosted its credit rating, and improved services. Under Mayor Anthony Williams, “the government is being run like a business,” notes Geoff Kieffer.

Real estate investors also have been attracted to the city’s comparatively healthy economy. For example, the unemployment rate of 6.4 percent in Washington was about the same as Charlotte, N.C., in 2002, but it increased less than one point from 2000 while Charlotte’s rate more than doubled over the same period.

With more capital available, developers are better able to finance the high cost of commercial development in Washington. Also, building owners are able to garner higher sale prices in the market, especially those with high-occupancy and high-profile properties.

However, lease rates haven’t responded to market conditions as much as they have in other cities. For one thing, tenants in Washington can escape to the suburbs more cheaply and easily than tenants in places like New York City, where landlords were able to jack up rents for several years due to the higher cost of exiting the market.

Second, many Washington businesses are unable to bear substantial rent increases. “Big law firms tend to

pay the highest prices for the prettiest and newest buildings, [but] halfway through 2002 most of them redid their business plans and downsized their revenue expectations,” explains Kieffer. Washington’s foundations and institutes tend to be well-funded, but non-profit trade groups and associations also have been under pressure to reduce costs. “There has been no business sector that is doing well, so the money going to [these groups] has been off.”

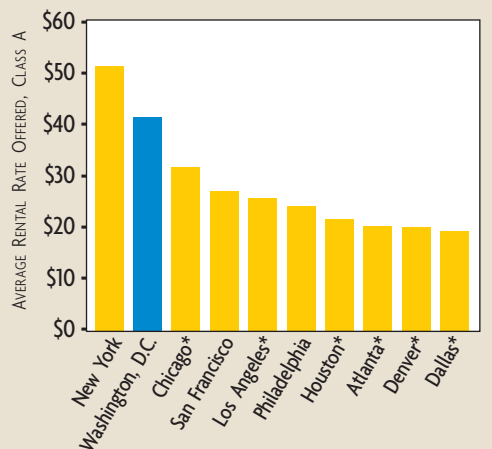
Still, rents remained higher in Washington than in the suburbs for the second quarter of 2003, according to data compiled by Julien J. Studley Inc. Class A properties — buildings that are relatively new, are in an excellent location, and have high-quality tenants — leased for about \$41 per square foot. In contrast, the average asking price for Class A space was about \$25 per square foot in suburban Virginia and Maryland. (See graph below for comparisons of Washington to other major commercial markets.)

God Bless the U.S. Government

So who has been willing to buy or lease property in Washington when there is lots of cheaper space in the suburbs?

It’s All Relative

Despite stagnant growth in rental rates for office space in Washington, D.C., Class A properties managed to get more money per square foot than many major markets in the second quarter of 2003.



*Includes properties only in the city’s downtown or Central Business District

SOURCE: Julien J. Studley Inc.

A Helping Hand

In an appropriations bill passed by Congress in February 2003, Washington, D.C., officials received a variety of federal payments to cover local expenses. Here are a few examples:

- \$15 million to reimburse the costs of emergency planning and security measures
- \$10 million to support bioterrorism preparedness
- \$161.9 million to cover the salaries and expenses of the local court system
- \$17 million for public charter schools
- \$50 million to implement the Combined Sewer Overflow Long-Term Plan

SOURCE: Consolidated Appropriations Resolution, 2003

The city's huge government sector is responsible for much of this demand, both directly and indirectly.

GMU's Stephen Fuller says there was 139 million square feet of office space in Washington in 2002. The federal government owned or used about 50 million square feet of that space. "The federal work force decreased by about 55,000 employees [since 1992], but their space utilization went up 17 million square feet," observes Fuller. That's because government activity shifted onto the shoulders of private contractors, who send scores of employees to work side-by-side with federal agencies in their buildings.

Then, there are the businesses and organizations that want to be near the seat of the U.S. government regardless of the cost. They range from attorneys and lobbyists to think tanks and providers of international financial services.

Uncle Sam's presence may bring businesses to Washington, but Rich Bradley of the Downtown D.C. BID argues that

they remain because the city has a critical mass of private-sector customers. For example, law firms initially provide expertise on federal regulation and taxation, then they diversify their offerings to serve local businesses like information technology companies, which need to protect their intellectual property rights.

Some federal agencies have a greater effect on the commercial real estate market than others, says Kieffer. For example, many buildings in southwest Washington are filled with companies that want to be next door to the FAA's new headquarters. Other agencies that have a large pool of contractors include the Department of Energy and the National Aeronautics and Space Administration. In contrast, less technical agencies like the Small Business Administration and the Peace Corps pull in few contractors.

Even when a federal agency is experiencing growth and looks to hire a significant amount of outside help, sometimes it can take longer than

Changing Factory Fundamentals Affect Industrial Market

Not much factory work takes place in the nation's capital. Manufacturers are more active in other parts of the Fifth District, but market forces ranging from increased imports to automation have led to work force reductions. At the same time, the requirements for industrial space have evolved.

These fundamental changes have affected the amount of industrial real estate utilized in the region. "There has definitely been a contraction of industrial space needs based on the manufacturing pullback that we have experienced in the last several years," says David Williams, senior vice president at Harrison and Bates, a commercial real estate firm in Richmond, Va.

Real estate analysts say that industrial developers usually react quickly to changes in the market. Still, as manufacturers shed workers, a lot of factory space ended up vacant.

According to Torto Wheaton Research, a subsidiary of CB Richard Ellis, availability rates for industrial space in the United States increased from 7.0 percent in 1999 to 11.3 percent in 2002. Net absorption—the change in occupied square feet from one period to the

next—went from 125 million square feet to minus 33 million square feet during the three-year period.

By these measures, the Baltimore, Washington, D.C., and Charlotte regional industrial markets have fared worse. "Overall, the mid-Atlantic area does have more available space than the national average, indicating that the area has suffered more than the nation in regard to the 2001-2002 recession," says Laura Stone, vice president and research economist at Torto Wheaton, a Boston-based firm.

Manufacturers have reoccupied some vacant industrial facilities. For example, a Pakistani company plans to use a former textile plant in Ranlo, N.C., to manufacture and distribute bedding. Other facilities have been subdivided for smaller tenants or converted for storage and distribution use.

But older plants can have physical characteristics that make them obsolete for industrial use, according to realtors in the Fifth District. They may have ceilings that are too low and floors that aren't strong enough to accommodate modern manufacturing equipment. Or their fire suppression equipment and electrical wiring

may not meet current building codes.

In addition, the plant's location may no longer be suitable. "It might be too far from a manufacturer's customer base," describes Williams. "It might be a property with inadequate access for tractor trailers [or] be in an area that has declined and is no longer considered safe."

For industrial facilities that are inadequate for modern-day manufacturers, developers have had to be more creative. A variety of properties have been transformed into retail stores, offices, or residential units, or a combination of all three. Examples abound in the Fifth District, from the high-priced apartments carved out of tobacco warehouses in Richmond to the retail complex created from a former power plant in Baltimore.

But not just any plant can be successfully redeveloped in this manner. John Moore Jr., president of the Society of Industrial and Office Realtors' Carolinas Chapter, thinks the facility must be near a population center. As development spreads into rural areas, plants in those areas may become candidates for residential or retail redevelopment in the future.

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Franklin Square North is just one of Northwest D.C.'s new office buildings.

expected for Congress to fund the space requirements of agencies and their contractors. For example, the demand for office space from homeland security-related agencies didn't materialize last year as expected.

Michael Goodwin, a lawyer at Arnold & Porter who represents real estate owners and developers in Washington, believes this is more of an issue in the city's periphery where there is little other business activity. "In those areas, you have sites that sit there patiently waiting for a number of years for the public-sector procurement process to run its course. On K Street or elsewhere in the heart of downtown, a building can compete equally for private-sector and public-sector tenants."

Don't Forget the Private Sector

Believe it or not, some demand for office space in Washington is purely private-sector driven. Rather than build in the middle of nowhere, businesses are rethinking being in an urban environment where there is a concentration of workers and better transportation access. Gerry Widdicombe, director of economic development at the Downtown D.C. BID, adds that communica-

tions firms like XM Satellite Radio Inc. and Atlantic Video Inc. have located in Washington, as well as a few high-tech firms, because of the city's rising "creative class."

There has been some hotel development as well, responding to demand from both tourists and people visiting government agencies and local businesses. A San Francisco-based hotel developer has renovated five properties in northwest Washington in the last few years, including the luxury Hotel Monaco near the MCI Center.

However, retail development in downtown Washington has been abysmal. While several restaurants and clothing stores have opened recently, the customer base isn't there for mass merchandisers because most of Washington's workers spend their salaries in the suburbs where they live. "You are not going to buy a new car or a suit at lunch time; you'll go to the mall," notes Fuller. Also, many workers don't go out for lunch because their buildings have cafeterias.

As for the city's resident population, Fuller says it peaked in the 1950s and has been declining ever since. From 1990 to 2000, the population dropped 5.7 percent to 572,000 people.

This exodus may be slowing down — Washington's estimated population rose 0.3 percent from 2000 to 2001 and fell only 0.5 percent in 2002. This could be due to renewed interest in urban living and a backlash against suburban sprawl. Residential developers seem to have responded to this trend — housing under construction in the Downtown D.C. BID region rose from 174 units as of Sept. 30, 2000, to 1,800 units two years later.

At the same time, Rich Bradley believes Washington needs to provide large amounts of contiguous property in order for retailers to locate near each other, which they can do in a mall or a shopping center. Currently, most retail space downtown is within buildings and not on street level, but that's beginning to change with projects like Gallery Place and the redevelopment of the old convention center.

Meanwhile, Home Depot, Target, and other retailers have moved into residential areas in and near downtown

Washington. Companies have already located stores in the "easiest" locations in the suburbs and want additional access to the thousands of high-income people who live in the region.

In order to encourage private-sector development, local officials removed some impediments and created new incentives. A higher tax rate for vacant property was eliminated in 1999 and wasn't reenacted until last year. The New Economy Transformation Act created incentives for high-tech companies in 2000.

The city also enacted a tax increment financing (TIF) program in 1998 to fund commercial development. This program enables developers to fund their projects with government bonds, which are repaid from the projects' future tax revenues. So far, the daunting application process has resulted in only a few TIF projects being approved, including Gallery Place and the Mandarin Oriental Hotel.

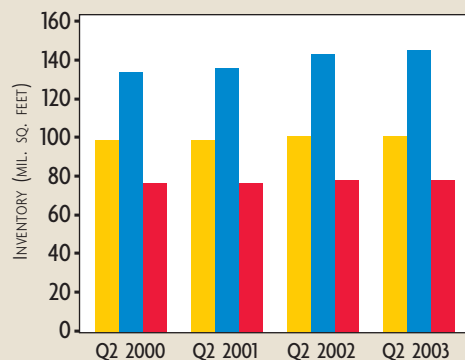
Bridging the Gap

In addition to relying on incentives, Washington may need to spend more on its schools, roads, and other munic-

A Bounty Of Space

Northern Virginia had the largest growth in office space among the commercial real estate markets in the Washington, D.C., metro area. This reflects the rapid pace of development in the region spurred by the high-tech boom.

■ Washington, D.C. ■ Virginia Suburbs ■ Maryland Suburbs



NOTES: Inventory refers to total square footage of office space. Suburban Virginia includes the counties of Arlington, Fairfax, Loudoun, and Prince William, and the city of Alexandria. Suburban Maryland includes the counties of Prince George's and Montgomery.

SOURCE: Julien J. Studley Inc.



JANELLA REISER, DOWNTOWN D.C. BID

A mixture of redevelopment and new construction is transforming the east side of Seventh Street between E and F Streets NW.

ipal infrastructure to create an attractive environment for businesses.

Such expenditures have been deferred for decades due to budget issues. But part of the problem could lie with Washington's long-term "structural imbalance," the gap between what a local government can raise in revenue, on average, and what it needs to finance an average level of basic services.

A May 2003 report by the U.S. General Accounting Office (GAO) confirmed the existence of a structural imbalance. "...The cost of providing an average level of public services exceeds the amount of revenue [the District of Columbia] could raise by applying average tax rates," noted the report. "Consequently, even though the District's tax burden is among the highest in the nation, the resulting revenues plus federal grants are only sufficient to fund an average level of public services, if those services were delivered with average efficiency."

The GAO's report placed part of the blame for Washington's structural imbalance on a higher per-capita cost of delivering services "due to factors such as high poverty, crime, and a high cost of living." In addition, "the District's significant management problems in key programs waste resources

and make it difficult to provide even an average level of services." Local government provides special services for Uncle Sam, such as added security, but it receives federal funds to help defray these costs. (See sidebar on page 16.)

The report also pointed to a basic dilemma faced by the nation's capital. The dominance of the federal government as a user of office space has resulted in lost property tax revenue. Land owned by federal agencies — as well as embassies, churches, and various non-profit organizations — are all tax-exempt, yet the organizations that operate on these properties use city services.

In addition to losing property tax revenue, Washington cannot tax incomes earned in the city by commuters. Since most workers commute, this results in a large population that utilizes municipal services but doesn't pay for them. A federal bill was introduced last year that would redirect 2 percent of federal income taxes paid by commuters into a special infrastructure fund.

Fuller disagrees that Washington has insufficient infrastructure. "The city has the best sewer system in the country — Fairfax and Arlington ship their sewage across the river to be treated," he notes. "There is plenty of ... water and lots of roads."

What Washington really lacks, asserts Fuller, is land in private hands for development. About half of the city's 61 square miles are owned by Uncle Sam or tax-exempt organizations.

With more than five million square feet in office, hotel, and retail space under construction or renovation at the end of the first quarter of 2003, developers are doing their best to boost the available supply of commercial property in Washington, D.C.

Will that be the right amount to satisfy future demand for commercial space? Real estate analysts think vacancies may increase in the short term if tenants continue to put their growth plans on the back burner until the economy improves. But the new commercial space could be gobbled up several years from now as leases expire and tenants from law firms to federal agencies hunt for space.

"There is a certain core of tenants downtown that are always going to be there," says Kieffer. **RF**

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