



## **Why the Washington DC Market is not where the smart money should be investing.**

### **“Bad Business Decisions are often made during good times”**

How often have we heard that the DC commercial real estate market is impervious to any downturn in the real estate cycle, and how the local economy can not be affected by a national economic slowdown? It has been said repeatedly, that the Federal Government primes the proverbial economic pump...just look at the ever expanding line-up of defense contractors and all the collateral impact they have. Take a look at the upcoming BRACS (BASE REALIGNMENT AND CLOSURE) situation, in which it is predicted 40,000-60,000 new jobs will be created in the DC/Baltimore Corridor area. Look at the low unemployment rate for the area and couple that with the some of the lowest office vacancy rates in the Nation, and you can certainly understand the exuberance many investors feel towards this market.

This is why REITS and institutional investors are willing to pay record high per square foot prices for the office assets at historically low cap rates. Their bet is that the market can only get better and therefore so will the returns on their investments, meaning the office market is poised for a spike (greater than 10% increase) in rental rates.

So why should investors not invest in the DC/Metro I-95 Corridor office market any longer?

Commercial real estate people are an interesting group in that they have very short memories. If another old adage can be used “those that forget history are doomed to repeat it” is what is going on now here in the DC marketplace. The area commercial real estate folks have already forgotten the devastation to the Northern Virginia Market after the Tech bubble burst in the late 1990’s into 2000. I can’t blame brokers for trying to sell when the market is hot, it’s just the buyers need to understand the real dynamics and have an **exit strategy** and tune out all the hype the brokers love to promote. Real estate investment is not for the short sighted investor even though there have been some sellers doing just that on re-sales after only a few short years. It will become a game of musical chairs and who ever is left standing will pay a deep price.

First let's analyze the premise as presented above.

1. Federal Government: The Federal budget deficit is at an all time high. Most economists and the Federal Reserve have said this must be reduced substantially. The War in Iraq is adding to this and the American public have emphatically told the current administration to wind this down and get out by virtue of the results of the November 2006 election. There have already been cut backs on defense contracts which have not been widely broadcasted. There will be another administration in power in just a few short years, and the early bet is it will be a Democrat. There has been no Democratic President since LBJ that has been defense spending happy. There will be a reallocation of money, most likely towards social programs and those agencies that support them. However, that will not compare to the amounts spent on expensive defense systems and programs. Therefore the Federal Government is NOT this never ending source of economic stimulus as evidenced by past markets that have not historically fared that well. If you look at the Washington Business Journal's (March 9<sup>th</sup> 2007 issue) list of the top leasing deals in the area, the top 4 were government agencies. The total for those top 4 transactions was 2 million square feet. It also points out the reliance on the Federal Government to keep the market propped up. Without those leases where would the market be?
2. BRACS: This event is 2-3 years away from starting. It is supposed to be completed by 2011. The so called experts are predicting the generation of between 40,000-60,000 new jobs. This from initial estimates of 20,000-30,000 new openings. The real question is how this will even be possible in light of the area's low unemployment. Currently the unemployment rate is around 4% area wide, lower in some places such as Montgomery County MD. How can an area create jobs when it is at what most employment experts would admit is full employment? This leads to the next question of where then will the people come from? Will employees currently working for those companies that support the bases in the areas that will be closing move with their employers? The answer is probably nowhere near the scale that will be needed to fill those positions. Secondly, the United States is restricting immigration more since 9/11/2001. A recent news blurb reported that many Hi-Tech companies are lobbying Congress to have the work visas for the type of workers they need be less restrictive. (US Hi-Tech News - <http://hi-tech.infonews.us> 3/9/07)

They are saying their companies will become hurt by the lack of high technology employees and will lose out to other countries. These Hi-Tech workers come mostly from India, Pakistan, and Asia. So again the question is where are all those 40,000-60,000 workers coming from? If they come from local companies, then there will a cannibalization of the workforce and many companies will be hurt by that process. What will most likely happen are those companies who have to do business with those base functions that relocate, will not move. There is no need to move. In this day and age, there is no reason when you can easily communicate and transfer information and data over the Internet. Look at how many companies "outsource" many

functions half way around the world. This leads to the next reason why the demand for office space will not dramatically increase.

3. The networked global business environment is why companies won't need to expand their office especially into high rent districts. The ultimate goal as reported in the recent white paper produced by CoreNet, is cost reduction is the most important thing a corporation can do, and since real estate is a major component of their overhead, companies are looking for all different ways to reduce their operating expenses. With the networked global environment, you no longer need workers sitting at a company location. There is a big push, especially in the DC/Metro area by the Federal Government as well as the local and state governments around the DC area, to promote telecommuting and flex time. The main reason is traffic congestion and quality of life issues. Many workers especially knowledge workers who are on the high end of the salary range for most companies, can easily work from their homes. High speed Internet connectivity is commonplace today unlike 10 years ago. Couple these factors as well as the high cost of commercial real estate along with the high cost of residential real estate and ask why would a company want or need to be in this area unless it was an absolute necessity? And even if it was, why couldn't they just have an office which provides them with a "presence" in the area.

Another interesting result of the outsourcing mentality of corporate America is to move basic functions, back office and the like to economically hard pressed American communities. There is a commercial real estate company that provides research on the commercial mortgage market, principally the CMBS portion of the industry. The company is planning to move an entire back office research function to a rural North Carolina town. The town had recently lost a major manufacturer and the President of the company who is moving this workforce had grown up there. He's trying to give something back as well as keep jobs here in the United States. He will train and educate those qualified workers they hire. Companies will come to a quick realization that the networked environment can help reduce overhead, as well find other suitable locations with ample labor especially in less expensive office markets. Companies such as Oracle and others like them have reduced the per square foot area allotted to their workers down to a paltry 90 square feet. Traditionally the rule of thumb is 250 square feet per office worker.

Many in this market like to compare it to New York City. New York City is a unique place, and no other place on the planet should try to compare itself. New York City is a 24/7 environment, and it attracts the young highly educated knowledge worker who is looking for more than just a job, but a social environment as well. Washington DC proper is not a 24/7 place and many of the workers are suburbanites who commute into the city. Take a look at the Beltway and I-95 on any given business day to know where most of the DC workers come from. Look at the roster of the largest tenants in DC. They are composed mostly of Federal agencies, large law firms, large lobbying firms, and non-profit organizations. DC is not a financial center as New York City is. And in case you missed this, Google has leased 500,000 sq. ft in New York City. The reason is that they determined NYC has many skilled young Hi-Tech workers that want to live and work in a 24/7 environment. You did not see

the DC/Metro area make the cut. You have not seen new Class "A" office space rent for \$100 psf in DC, but New York has had several hit that high water mark and they were large law firms. New York City has a vastly better public transportation system vs. the DC area and that has a dampening affect on the commercial real estate market in DC. With the restrictions on building heights within the DC city limits, and the recent slow growth attitude of the DC area's government an argument can be made that exiting and soon to be completed office buildings will be that much more valuable and able to generate the forecasted rent spikes everyone is anticipating. However, that is begging the question as to why companies need to be here. What is the overwhelming reason a company has to be in the DC/Metro area? For a while the bio-tech industry was thought to be the Holy Grail mostly in Montgomery County MD. But as the bio-techs have not made a profit, the investor sentiment has greatly cooled and those companies are scrambling to reinvent themselves. Take a look at Human Genome which recently completed a huge office complex in Rockville MD. They have already subleased 55,000 sq. ft. to a close relative of the company that will share some of their research etc. If you are counting on the return of Hi-Tech companies, Thomas Wolfe said it best, "You can't come home again".

4. Lastly, is investing in a supposedly secure market such as DC a better investment decision than buying in a less robust market? The answer is it depends on what basis the investment was purchased. Therefore, if you buy a real estate investment based on a 5.5% to 6% return, which has been the case for the last 2 years, you have more of a downside risk than the other way around. And this is how it can happen.

Say you bought a property at a 5.5% return that was 100% leased up. Say you lose a tenant for whatever reason, which equates to no greater than 5% of the building's occupancy. That investment has just become breakeven. If that building loses another tenant, the return becomes negative. If the property was purchased with mortgage financing (debt) you will be under water in no time. Even those institutional investors, who bought with all cash and no debt, will be in a negative return situation if they lose just a small fraction of their tenant base within the building. If they bought at a higher rate of return they could withstand losing a small fraction of their tenants and still have a positive return, but not at the yields they have been paying in the last 2-3 years.

When Equity Office Properties decided to sell their REIT, that should be the bell weather the commercial real estate market is due for its correction. EOP was created out of the ashes of the early 1990's real estate debacle and had thrived ever since in most markets. Sam Zell would not be selling the entire portfolio if for one moment he thought the anticipated rent spikes were a moment away. EOP's basis for many of their holdings are low, which means the returns they would get for the spike in rents would be better than selling now. Sam Zell has answered the question with this sale. You buy at the bottom or near bottom and sell at the peak or near peak of any market cycle.

The commercial real estate market is not an industry island unto itself. It is dependent on Corporate America. This whole low cap rate environment was

brought about by the Federal Reserve's taking interest rates to historical lows to bring the Country out of its post tech bubble and 9-11 trauma.

This low interest period spurred investors to buy commercial real estate as opposed to buying into the equity markets which had been performing poorly or the bond markets which were in lockstep with the mortgage interest rates. What happened is asset inflation, meaning so much capital chasing a particular asset class. This created the competitive climate that brought about the low cap rates that were being achieved. Investors thought and modeled their financial analyses on leveraging a better return.

It worked in the early stages of the investment market; however, as interest rates were brought back up the selling community did not react to this new direction nor have the buyers. How can an investor rationalize paying for an investment property whose return is less than their borrowing cost?

This circumstance has driven the leveraged buyer out of the market for the DC/Metro office product.

This turn of events has left only the big institutional investor to buy at these low cap rates. The fact to be watching out for is the institutional investors who have poured so much capital into buying these high priced assets, will they be able to meet the demands of their investors who can easily buy government bonds at the same or better returns without the attached risk of owning overpriced real estate. And please, do not suggest their returns are better because the IRS gives depreciation and interest deductions which in turn can help on PAPER the perceived return on investment. The last time investors made that mistake was in the late 1980's and we all know what happened then. If you don't think the party is almost over, just look at the Federal Reserve recently released new guidance for commercial real estate bank lenders. There are many within the mortgage banking industry that will say this will not be a repeat of the 1980's-early 1990's commercial real estate disaster. The reason is Wall St. and the securitized mortgage market. That may be true as the fundamentals are totally different, whereby there is not a tremendous over supply of real estate with vacancy. However, the thin returns that investors have bought this round are directly related to the fact it will not take much vacancy to get them into trouble.

You'd be better off investing in perceived worse markets, as you will be buying at a greater rates of return and the upside potential is far greater than the downside risk. Lastly, those investors that have bought recently into the DC myth who want to sell their assets, at what price or rate of return do they think they will be able to sell. If they don't get the rent spikes they had forecasted there is no way they will be able to sell those properties for what they even paid for them. There are constant statements from those investors who bought recently that they will "need" to get higher rents. When does "need" have any coloration to market? It doesn't and its surprising that those statements are even being made. Couple the recent high prices investors have paid for the office asset, with the pending new construction and in a real estate instant there will be double digit vacancy rates.

The new construction will invariably be way more expensive due to the 30% increase overall in construction costs. If the tenants that are coming up for renewal understand this new approaching market dynamic, they will not only have the upper hand but possibly pay even less rent than what they are presently paying if they are willing to be open minded about where they can conduct their business. In conclusion, buying investment real estate in this market carries far more risk than buying in other less sexy markets. Stay tuned.