INSTITUTIONAL INVESTMENT IN WASHINGTON, D.C.

by Anthony Reynolds, CRE

As a Counselor of Real Estate (CRE) in Washington, D.C., my assignments are varied, rewarding and enjoyable. Many of my clients are from the local area, but not so for institutional investors, who can be dispersed nationwide. Apparently, the subject of Washington real estate can crop up at anytime in a client's conversation with a CRE.

While the substance of this article is opinion and not necessarily conventional wisdom, the material presented here represents my insights regarding Washington, D.C. and its investment real estate together with pertinent counseling tips.

Political Washington

Of the 3.6 million people who live within the commuting area of the nation's capital and whose livelihood is linked here on a day-to-day basis, 84 percent live in Maryland or Virginia and only 16 percent live in the District of Columbia. These three jurisdictions compete for economic success. The local Council of Governments (representing counties and cities in the three jurisdictions) is analogous to the United Nations in that its representatives are relatively low-level officials who notionally support cooperation. They tend to adopt joint recommendations without any authority for their implementation.

For example, Montgomery County, Maryland, for 30 years immediately following World War II, was the dominant suburban jurisdiction principally because it was an hour closer drive to New York City, and its residents enjoyed the benefits of astute county and state governments. The completion of the Capital Beltway and the balance of the interstate highway system removed the driving time advantage. Other factors working together have resulted in suburban Virginia surpassing suburban Maryland as the economic leader. Why? The Pentagon presence in Virginia enables that state to benefit from defense contracting. Also, both airports for the Washington metropolitan area are in Virginia. National is very close to the center city and the much larger Dulles is popular, growing and provides development synergy. Suburban Virginia's population is noticeably more physiocratic and more cohesive than suburban Maryland's. In 1994, however, both Maryland counties (Prince George's and Montgomery) adjacent to Washington elected responsible governments but both must work within limited financial resources.

Washington's long-term population decline has depleted its middle class. A revealing statistic is that 67 percent of the municipal employees live out

Anthony Reynolds, CRE, practices with the Washington, D.C. valuer/counselor firm of Mitten & Reynolds, Inc.

of the municipality, mostly in Maryland. City officials operate an unsuccessful public school system and tolerate a high level of street crime in the poorer neighborhoods.

The city has no port access, no factory, no large bank and a weak retail core, but it does have a large collection of thriving private office buildings, a disproportionately high employment relative to population, lots of entertainment (including entertainment shopping), an adequate number of successful hotels, an excellent subway system, six universities, tourism-conducive attractions and weather, and superior print and radio/tv outlets.

Because of the high proportion of Washington real estate owned by international agencies, foreign governments and the United States itself, the city cannot be self-supporting. The U.S. Congress subsidizes Washington's budget and supervises its administration. For the next decade, Congressional supervision will be more direct in reaction to profligate and deceptive municipal practices of the past ten years.

Institutional real estate investments in downtown office buildings and hotels are as resilient to economic cyclical fluctuation and as protected from potential casualty loss as this real estate would be in other communities. To put this into perspective, in 1995 the most expensive office building transaction sold for $119 million or $348 per full-floor rentable square foot of finished space.

Architectural Washington

There are no canyons of steel here. Generally, Washington's streets are relatively wide and its building heights limited. The original District of Columbia included Alexandria, Virginia and Georgetown, Maryland, but the portion of the federal district that was the subject of the original but enduring city planning for the city was farmland. There have been successive comprehensive plans but each respected L'Enfant's original city plan. Federal agencies and congressional committees monitor land use in Washington. However, that the federal government itself is immune to the city's zoning and planning requirements is evidenced by the recent closing of the 1500 and 1600 blocks of Pennsylvania Avenue, N.W. to automobile traffic.

The owner of the local hockey and basketball teams is developing a new arena for music concerts, sports and other events at the Chinatown edge of downtown. The new arena is also expected to benefit hoteliers. It is generally thought that a new and much larger convention center could be successful, but funds for its development have yet to be identified. The Washington Opera intends to leave the Kennedy Center and presently is seeking a downtown site with the assistance of a major private donor.

Zoning Codes

Within various areas of the Central Employment District, building heights are limited to 90 feet, 110 feet, 130 feet and 160 feet. Those height limits correspond to 8 stories, 10 stories, 12 stories and 15 stories, respectively, and to floor area to land area ratios (FAR) of 6.5, 8.5, 10.0 and 12.0, respectively. The ease in which development can proceed within these various constraints indicates (for example, a 12-story building within a 130-foot-height limit to a density of 10.0 times the land area): 1. that almost all construction downtown is of reinforced concrete rather than steel frame and 2. first floors are built with relatively high ceiling heights for retail use and are on grade with adjacent sidewalks. Office suites occupying the top floors command premium rents as do buildings that are closest to the White House, front on mid-town park squares (for the less valuable easterly locations), or provide prominent views of the Capitol's dome. Automobile parking is the primary use of multiple cellars located under all buildings developed since 1970 and a few built earlier. Buildings that are developed to the maximum permitted zoning density (most post-1950 structures) with adequate parking, are not completely demolished as they age; rather their slabs and columns are retained during any major rebuilding.

Before the popularization of central air conditioning, office building floor plates in Washington were designed to maximize fenestration. As a result, both the density and the efficiency of older buildings, within any given height limit, are obsolete, and over the years many have been replaced with buildings of modern design. Washington now has a rather strict and rather strictly enforced preservation law which has resulted in the forced retention of buildings that are economic only if priced below the value of their underlying sites.

In general, Washington has an extremely complicated zoning code: the Central Employment District includes seven distinct Euclidean zones together with provision for the densities of each to be enhanced by predevelopment zoning-proffer negotiations. Furthermore, part of downtown is subject to various zoning map overlays that require mandatory but uneconomic partial-building uses: office development may require inclusion of apartments, theatres, art galleries, retail stores, etc. in locations that are not economically conducive to such uses. The result is either above-market rent subsidizing the uneconomic uses or (since often that is not possible) sites left vacant. Historic preservation further complicates the zoning code by limiting development of on-site density and permitting restricted transfer of development rights to other sites.

Changes to land use requirements are made by the Zoning Commission. Exceptions to existing requirements are granted by the Board of Zoning Adjustment. Neither group has veto power over the other; appeals are heard in the municipal court system. Exceptions to the preservation ordinance are heard and occasionally granted by yet a different board from which administrative appeal is possible.

Real estate counselors should advise their clients not to enter into purchase contracts for real estate in downtown Washington until the clients fully understand which uses are permitted and what the probable costs associated with seeking relief will be, as well as the risks involved when relief is denied. And all of that must be weighed against the risks and costs associated with trying to amend purchase contracts by inserting contingency clauses.

Office Buildings

Starting in the 1980s, office buildings developed in Washington were significantly more expensive than those developed in the preceding 25 years. This increase in capital was commensurate with a run-up in land value. It was noticeable not only in facades but also in entrance lobbies, elevator lobbies, corridors and toilet rooms and in HVAC equipment, elevators and fire/smoke safety systems. For the most part, tenants negotiated more opulent building material finishes and installed more expensive furnishings in the newer, better-designed and better-built buildings.

Economic Washington

Office Space

The United States, of course, is the largest owner of office space in Washington and is, by far, the largest tenant. Although government leases specify a net usable measurement, all negotiations are conducted on a commercial gross rentable basis. Several federal agencies have independent negotiating authority, although most rely on the General Service Administration (GSA). In either case, rents are paid monthly, in arrears, for which the usual adjustment is an increase of 1 percent in the rental rate. Full-service government leases are typical, although utilities will be paid directly by the tenant if the agency occupies all or nearly all the office space in the building or needs unusual computer rooms or large meeting rooms. Landlord-provided services following the base lease year will be indexed to the national urban Consumer Price Index (CPI); for private tenants, leases require passing through the actual increases. The two systems would probably be equivalent on a long-term basis, but government leases only tend to be three to five years in duration or ten years for entire buildings.

Appropriations and oversight committees of Congress and the Executive Branch's Office of Management and Budget (OMB) are united in suggesting shorter and shorter terms. If the agency likes the building and has a continuing need for the same amount of space, it might renew for decades, but the renewal risk attendant on a short-term lease, especially for a large block of space, has slight appeal to institutional investors. This is particularly true if the building occupies a secondary location, as do many large government-leased buildings, because there is minimal private multi-tenant demand in such locations. Government leases often include tenant options to renew, but a decision to stay usually results in renegotiation rather than an exercise of the option. Leases for large blocks of space to private tenants often provide for options to lease adjacent suites or floors. If negotiations to renew an entire building should fail, the United States, as tenant, may well condemn the use-and-occupancy rights for a one-year period. That, of course, could be inconvenient and expensive for the landlord.

A more prevalent problem has been the government's inability to quit the premises on schedule. In this instance an eminent domain action is substituted that amounts to an indeterminate number of daily takings for use and occupancy, i.e., a taking for an undetermined time. The usual cause for such an action is that the building in which the agency intends to relocate is behind in its construction or renovation schedule. In such cases, when the tenant eventually moves out of the condemned building, it is on a gradual, perhaps one-floor-at-a-time basis. Sometimes the just compensation awards have recognized compensable damages related to the landlord's reliance on the original lease expiration date when contracting with another tenant, with a purchaser or with a remodeling-construction contractor. Othertimes, a jury may award compensation equal to the difference between available rents at the end of the government's holdover occupancy as compared with available rents on the original lease termination date. If the government does not formally file an eminent domain proceeding, the landlord may pursue an inverse-take action in the United States Court of Federal Claims.

Government rental occupancy of entire buildings generally results in the landlord's being compelled to lead the market regarding such safety considerations as asbestos-free space and modifications to accommodate disabled Americans. Some agencies require elaborate anti-terrorist protection of pedestrian and vehicle access.

Office Tenants

Law Firms

In Washington, many government offices, and even more private offices, are staffed with lawyers. Most large law firms, nationwide, maintain a Washington office in order to represent their clients who wish to influence legislation and the wording of regulations or to represent clients in adversarial hearings before administrative law judges. These judges have the authority to grant exceptions to the regulations and extract penalties for violations of foreign and domestic commerce regulations. Other law firms specialize in constitutional law, admiralty law, the law of intellectual property and the law regarding civil and criminal fraud. Almost always, large law firms rent rather than build or buy. The last recession strengthened some Washington law firms and closed others.

Trade Associations And Labor Unions

Washington includes hundreds of trade associations, many of which have enormous staffs, although recently almost every organization has reduced duplicative layers of management. The largest trade associations tend to own their buildings. The city also has quite a few large think-tank associations employing intellectuals both on a career basis and as a respite between government appointments. Such organizations favor the best locations. National labor unions often own monumental buildings, and those who rent tend to seek the best. The huge press corps representing news organizations from all over the world is a major component of office occupancy in Washington.

Leasing Considerations

It is customary for both tenant and landlord to be represented separately by real estate professionals for lease negotiations. Leasing agents tend not to be in property management or in real estate sales, although their colleagues in the same firm might perform such functions. Some leasing agents represent tenants exclusively.

Major private tenants typically negotiate 10-year leases with expansion and renewal options. Also typically, they negotiate concessions to provide for 1. outfitting their own suites and 2. occupancy for a substantial early part of the lease while incurring no obligation to pay rent. The cash- and free-rent concessions result in an above-market rental rate until the rent commences and is subsequently paid. A sixth-year base rent increase (a "bump") is customary in a private 10-year lease. The recent recession has reduced both effective market rents and the higher paid rents ("face" rents) and has reduced the disparity between them.

Meanwhile, most of Washington's best multiple-tenant buildings are occupied by tenants paying concession-reflective and pre-recession-negotiated rents that are well above the current market rent level, i.e., well above the rent that would be available today for the same space. The tenant's predicament in such cases is exacerbated by the pass-through lease provisions for services and real estate taxes that tend to increase over time. Most tenants are aware that they are paying above-market rents. Some have commenced negotiating lease extensions at reduced rents; others are merely waiting to do so when their lease terms expire. By and large, in the future such buildings will have lower incomes as leases turn.

For clients interested in acquiring Washington real estate, a CRE (designation awarded to members of The Counselors of Real Estate) should conduct some analysis of the total dollars paid under each extant lease relative to the likely rent for each at its respective rollover. If analyzing the price vis-à-vis capitalization rates, consider the use of a K factor or some other device if the income being capitalized is, in fact, a declining annuity as measured in constant dollars.

Organized Labor

Washington is not a strong labor town. The construction trades have unions, but hourly rates on union jobs and non-union jobs are identical. Until last year, the largest union construction company and the largest non-union construction company were owned and managed by the same holding company. Some clients require that construction proceed with organized labor.

Office building char forces are supplied by cleaning contractors rather than by management staff employees. Most of the cleaning companies maintain open shops, but a labor union exists and is engaged in a multi-year process of what appears to be a well-funded membership drive.

Generally, the top hotels in Washington employ union labor. Marriott chooses, and is apparently able, to avoid union labor while operating the city's largest downtown hotel along with two other downtown hotels.

D.C.'s Real Estate Overview

Most wholesale and distribution centers, most research and development facilities, most office parks and most modern motels are located outside of Washington in suburban Maryland and Virginia, typically at Beltway interchanges with other major roads. Some suburban neighborhoods have significant collections of office towers. This is particularly true in Northern Virginia because of 1. the proximity of Arlington (which was formerly part of the District of Columbia), 2. the location of the two Virginia airports, and 3. the success of Tysons Corner, near McLean.

Retail

With the metropolitan area's population overwhelmingly suburban, major shopping is almost entirely a suburban enterprise. However, the municipality has forced the retention of department store use for part of the now defunct downtown retail sites. Meanwhile, adjacent to the Pentagon in nearby Arlington, a new Galleria-like, multi-level, and multi-department store mall, with an attached Ritz Carlton Hotel and an integral subway station, is highly successful.

The Friendship Heights neighborhood, which spans the Washington-Maryland boundary, has a concentration of successful department stores, hotels, offices and apartments. There is no enclosed shopping mall at that location, although one is contemplated.

The best retail properties in the metropolitan area tend not to be institutionally owned but held by local or retail developers. Generally, the retail centers are burdened with great institutional debt. Much of downtown Washington's office inventory, too, was put in place by successful local developers. Some of the largest of these did not weather the last recession and their properties were acquired by institutional investors or securitized as real estate investment trusts. Some mixed-use facilities remain in local hands, but L'Enfant Plaza, which includes a large shopping component, a major hotel and four office buildings, is mostly owned by a United Kingdom pension scheme.

Washington's choice hotel properties are owned primarily by foreigners or by hotel interests and business partnerships which cheerfully outbid the institutions. Washington hotels are constructed, furnished and staffed to compete in a category somewhere between the expensive and luxury levels. Out-of-town Counselors should recognize that Washington hotels sell at high prices with capitalization rates that recognize room rates can be adjusted almost instantly for either competitive reasons or in reaction to inflation. Also, while the prices represent relatively high price earning ratios, they are still below the level of cost required to develop which precludes new construction.

Conclusion

Institutional investors are attracted to Washington real estate. While wealthy individuals may choose investments on an ad hoc basis, institutions do so only within a certain context and after careful study. Institutions seek real estate investments that are characterized by significant magnitude, acceptable income, potential gain, observable prestige and manageable risk. For all these reasons, investment in Washington is desirable. Also, institutions tend to be reassured when faced with competition, and the amount of quality real estate in the Washington area is sufficient to attract broad competition. The demand for real estate here, both domestic and foreign, also is balanced by a steady growth in a population which tends to be well educated and increasingly cosmopolitan.

The nation's government has withstood many and varied tests and remains strong, stable and democratic. It provides extensive liberties to its citizenry and a reliable currency for the globe. The federal government closely monitors its immeasurable investment in the Capital City. Washington continues to attract tourists because of its monumental and natural beauty and its usually agreeable climate. The CRE Designation is respected by the local legal and real estate communities. Thus, real estate counselors should consider the investment opportunities prevalent in Washington D.C.