

The Pinkard Fund

Investor Update

January 2019

Market Update

For Q4 2018

The fourth quarter began on a high note for the Washington region's business community as Amazon finally announced its decision to establish a major East Coast presence in Arlington, Virginia. In addition to the drama leading up to the announcement, there was the surprising disclosure that HQ2 would be split between Northern Virginia and Long Island City. Under any set of circumstances, the resulting 25,000 jobs is a significant economic development win for the region. Another surprise was the announcement that Virginia Tech will receive \$250 million from the Commonwealth of Virginia in addition to its own matching contribution to launch a one million square foot Tech Innovation Campus near Amazon HQ2. In conjunction with these announcements, JBG Smith rolled out the rebranding of Crystal City, parts of Pentagon City and Potomac Yard to the new name, "National Landing". There is a lot to unpack here.

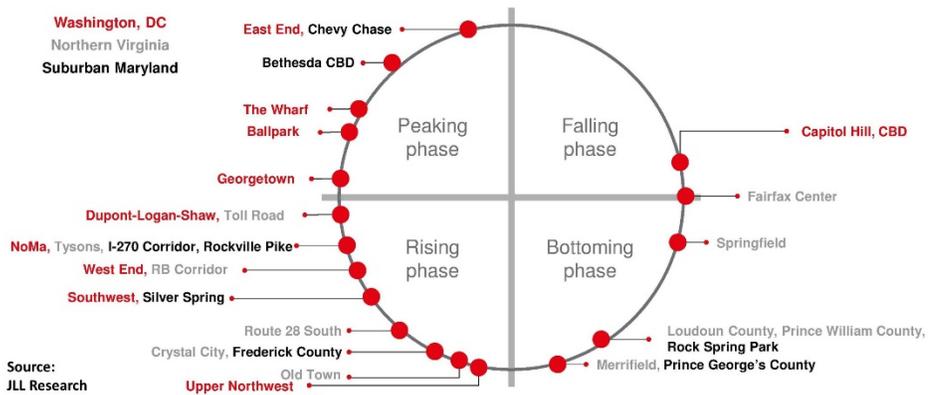
The quarter ended on a much less buoyant note as the government shut down and thousands of local employees were told not to come to work and others were required to come to work but not get paid. This government shutdown was the longest in history. The Fuller Institute estimates that 145,000 federal employees did not receive paychecks and another 112,500 contractor employees were not working. While the federal employees will be paid, the contractors likely will not. The longer-term economic effect of the shutdown on the local economy is relatively minor. If there is a concern, it is the headline risk of Washington being viewed across the country and the world as a place of disfunction.

Let's take a closer look at the impact of Amazon. It is immediately leasing 500,000 square feet at National Landing and is purchasing sites to allow for several million more square feet of office development. The company is rumored to be leasing approximately 90,000 square feet from WeWork in Rosslyn. The plan is to build out the campus over the next 10 years with plans for as much as 8 million square feet in total. Estimates of Amazon's impact on the job market show it spurring the growth of approximately 25,000 jobs at other companies over the next ten years. Although the significance of the Virginia Tech Innovation Campus has been overshadowed by the much-awaited Amazon announcement, it too will have a significant impact on the tech ecosystem in the region. As a "global center of technology excellence and talent production," the campus will deliver programs in computer science and software engineering, technology policy and artificial intelligence. The synergy with Amazon is readily apparent. The most compelling

impact may be the jumpstart Amazon and Virginia Tech provide in moving Washington’s burgeoning entrepreneurial and tech market forward as a global center of technology excellence.

While prospects for Northern Virginia seem bright, the same cannot be said for DC (See the chart below). With a current vacancy rate above 14% (the highest level in some years) and over 4 million square feet of Class A and trophy space under construction, it will be a tenant’s market for the next several years. A secular change to the DC market that presents a further challenge to owners is the emergence of new submarkets which compete for A tenants, as witnessed by the Williams & Connolly

Metro DC clock



Source: JLL Research

commitment to move to The Wharf, Washington’s hottest new development. Previously, the CBD and East End captured virtually all the major law firms. That is not the case anymore. Another anomalous trend in DC is how tight the Class B market is. The Class B vacancy rate has traditionally been higher than the Class A vacancy rate. That is not the case today. This market, which includes older buildings and secondary locations, has historically been the only place that many non-profits could afford to lease space in DC. One of the reasons for the currently tight market conditions is that multiple B buildings are undergoing major renovations to compete in the A market. While this strategy may have made sense to individual owners at the time, a number of these projects will be delivering into the teeth of the broader A market oversupply.

The positive momentum from the Amazon announcement, plus 2018’s net absorption of 2.4 million square feet of office space regionwide (the most since 2010) and the slowing in the reduction of the federal government footprint as the rightsizing (reduction in space per employee) effort of the last six years is coming to an end, all bode well for the office market in general. However, the benefits will not be evenly spread. While we have been looking hard for the right investments in DC, we are happy that our current portfolio is overweight Northern Virginia.