FEDERAL CITY COUNCIL

A Catalyst for Progress in the Nation's Capital

202.223.4560
1310 L Street, NW Suite 325
Washington, DC 20005
www.federalcitycouncil.org

November 28, 2022

Glen Lee
Chief Financial Officer
District of Columbia
1350 Pennsylvania Ave., NW, Suite 203
Washington, DC 20004

Dear Mr. Lee,

In your critical role advising the city and its elected officials on the fiscal health of the District, we want to share our concerns with the very troubling situation for the District's office market.

With the dramatic and persistent decline in commuter activity, and flight out of high-cost employment centers precipitated by remote work, the office market in downtown DC is experiencing significant set-backs. To be clear, the years leading up to the pandemic saw deteriorating conditions in the DC office market. The pandemic and work from home have further eroded fundamentals and all indicators of the health of the District's office market point increased systemic risk and distress:

- **Increased vacancy**: Of the 733 large office buildings in the parts of the city with heavy office presence, 137 have vacancy rates that are over 25 percent; and if leasing activity does not increase, this number may go up to 238.[1] The office vacancy rate in the Central Business District now stands at 20.3 percent, up from 10.6 percent in the last quarter of 2019.[2]

- **Lackluster leasing activity:** Both private companies and the federal government have pulled back their leasing activity. Net absorption has been continuously negative in the Central Business District since 2019, and the average time to lease has increased to over two years.[3] The year-to-date net absorption in the CBD and East End submarkets was -174,763 and -391,485, respectively.[4]

- **Equity flight:** Institutional investor interest in D.C.—which kept the city strong during the 2007-08 global financial crisis—has declined significantly as secondary and tertiary cities have become far more important to institutional investors.[5] Many of the traditional D.C. institutional investors such as pension funds are bypassing the city for new investments and are selling (or attempting to sell) the properties they have.

- **Financing drought:** The rise in interest rates in an interest-rate sensitive sector have frozen the lending market for D.C. office properties. Institutional lenders (banks and insurance companies) are hesitant to lend on any D.C. office assets, and especially those assets with high levels of vacancy or those poised for development.

- **Increased distress and lack of sales:** There have been very few sales—a troubling sign—including a handful of distressed sales, which we expect to become more frequent. Some sales involve office to residential conversions, which is good news for downtown, but bad news for office market valuations. Nationally, office sales volumes are down 68.3 percent from 2018-2019 averages. [6]

Other markets in cities similar to the District are experiencing dramatic value losses. This month, the New York State Comptroller released a report on the New York City office market, showing that the market lost 17 percent of its value since the beginning of the pandemic.[7] A recent NBER working paper estimates that the decline in commercial property values in New York City was closer to 45 percent when one incorporates the increased risk premium (which would be captured in increased cap rates), and in the long term, even when some of these losses are reversed, the values would likely be 39 percent below pre-pandemic levels.[8] The Office of the Controller for the city of San Francisco projects that cap rates for office buildings in that city will remain at 7 percent to 8 percent (4 to 5 percent above the 10-year treasury yield) for the foreseeable future.[9]

Our interest in this matter is not about being overtaxed. We are primarily concerned about the future fiscal health of the city. For every decline of $100 million in commercial property tax assessments, annual property tax revenue falls by $2 million. It is vitally important for city officials to fully comprehend the difficult environment commercial office buildings are operating under and the risks to the future tax revenue.

We are glad to see the steps DC is taking to address these risks, including efforts to lure the federal workforce back to its District offices, planning for the economic recovery, and support for office-to-residential conversions. While conversions promise to inject energy and bustle into DC's commercial districts, conversions themselves are not a panacea. Conversions are only viable once the original office value falls to levels that can be as little as half or less of the historical value of a leased office building.

We are writing to ask your help in articulating these risks to the elected officials by including in your December revenue letter detailed information on the condition of the commercial office properties in D.C., and what risks you see that exist that can reshape assessments in the coming years. It will be tremendously helpful for the city's leaders to better understand (a) how the District's commercial office market is faring compared to markets like New York and San Francisco (both of which, unlike DC, do not have viable competitors directly across the street or river – further exacerbating the challenge); (b) how key variables that determine assessment values (vacancy rates, cap rates, rents) are determined and some of the challenges in developing these assessments in the post-pandemic era; and (c) how distressed sales and appeals impact assessed values.

We would welcome the opportunity to meet with you and your team to discuss this situation, its impending impacts, and potential means to address this enormous challenge. Our goal is to educate and be a source of assistance to the City's leadership.

The parties hereto have authorized and countersigned this letter.

Thank you.

Very truly yours,

Anthony A. Williams
CEO and Executive Director
Federal City Council

Deborah Ratner Salzberg
Chairman
Federal City Council

Oliver Carr
Carr Properties

Paul Dougherty
PRP Real Estate Investment

Doug Firstenberg
Stonebridge

Monty Hoffman
Hoffman & Associates

Matt Kelly
JBG SMITH

Matt Klein
Akridge

Richard Lake
Roadside

Jair Lynch
Jair Lynch Real Estate Partners

Peter Ottenji and Jake Stroman
Boston Properties

Gary D. Rappaport
Rappaport

Bobby Swennes
Brookfield

Chuck Watters
Hines

Adam Weers
Trammell Crow Company

Sandy Wilkes
The Wilkes Company

Cc: Mayor Muriel Bowser
Chairman Phil Mendelson
Councilmember Brianne K. Nadeau
Councilmember Brooke Pinto
Councilmember Mary M. Cheh
Councilmember Janeese Lewis George
Councilmember Keynan R. McDuffie
Councilmember Charles Allen
Councilmember Vincent C. Gray
Councilmember Trayon White, Sr.
Councilmember Anita Bonds
Councilmember Christina Henderson
Councilmember Elissa Silverman
Councilmember Robert C. White, Jr.
Deputy Mayor and Chief of Staff John Falcicchio
City Administrator Kevin Donahue

Endnotes

[1] D.C. Policy Center analysis of tax lots and Costar data.
[2] CBRE Q32022 Market Report.
[3] Costar data.
[4] JLL Q3 2022 Market Report.
[5] AFIRE International Investor Survey, 2022.
[6] US Office Insights Q3 2022 Avison Young
[7] https://www.osc.state.ny.us/files/reports/osdc/pdf/report-11-2022.pdf
[8] Gupta et. al. (2022). Work From Home and the Office Real Estate Apocalypse, NBER Working Paper 30526. Available at https://www.nber.org/papers/w30526
[9]https://sfcontroller.org/sites/default/files/Documents/Economic%20Analysis/Controller%20final%20reponse%20to%20Letter%20of%20Inquiry.pdf