Bucking the Trend:

Comparing Washington D.C., Rents and the S&P 500 Index

May 18, 2020

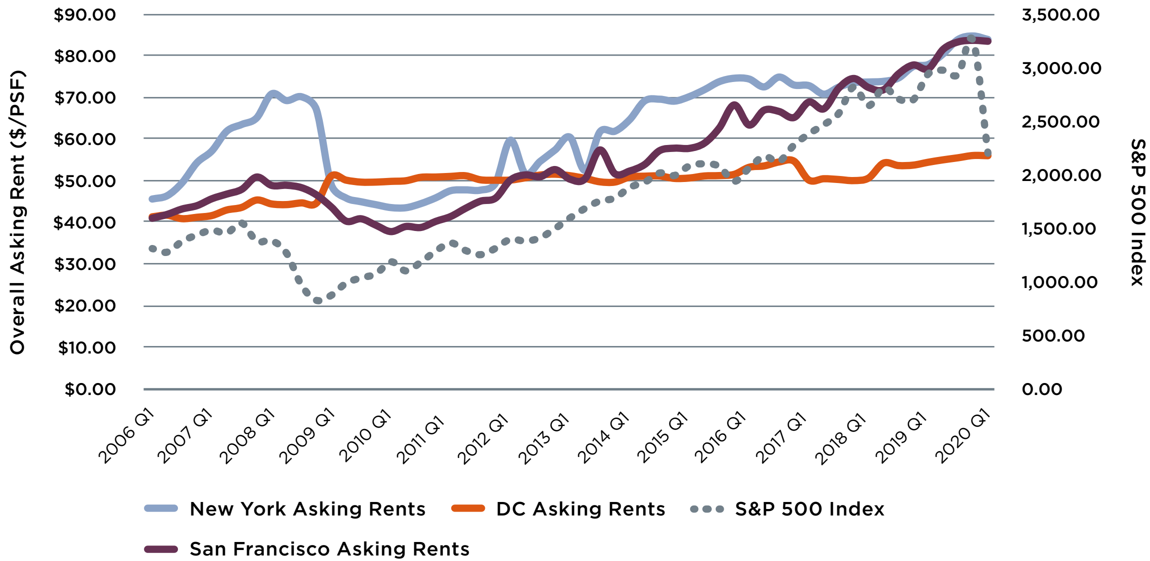
Like the rest of the world, Washington, D.C., is experiencing an unprecedented shutdown of daily life in response to the COVID-19 pandemic. The trajectory of this global disruption, and ultimate fallout, are impossible to foresee. Still, historic trends and underlying strengths or weaknesses of an office market can provide some insight into what could be expected when the country returns to a "new normal."

The S&P 500 Index often serves as a proxy for the health of the U.S. stock market and the overall economy. Commercial office markets in many Tier One cities closely follow the index's trendline. Overlaying the S&P 500 with average office asking (advertised) rents for other gateway markets, including New York and San Francisco, shows a coincidence and likely correlation between previous economic downturns and a decline in rents. The D.C. market, however, is an outlier in that it has not responded to severe downturns in the economy with a similar downward trend.

During the Dot-Com Bubble crash and the aftermath of the September 11th terrorist attacks in 2001, the S&P 500 Index fell 41.1% from peak to bottom. In tandem, Manhattan asking rents fell 29.0%, and San Francisco's fell 49.6%. D.C.'s rents, however, continued to push upwards despite the economy floundering. Similarly, during the Global Financial Crisis and Great Recession (2008-2009), the S&P 500 Index fell 40.4% peak-to-bottom, while Manhattan asking rents dropped 38.4% and San Francisco's dropped 25.0%. Again, D.C.'s asking rents hardly budged from a gradual upward trajectory with only a 2.5% dip.

Glossary of Terms	
Asking Rent	The landlord's advertised pricing on space
Base Rent	The final negotiated base rent for the starting year of the lease term
Concessions	Incentives provided to the tenant by the landlord as part of lease commitment, typically include improvement allowance (for build out) and free rent (in months)
Tenant Effective Rent	The net rate paid by tenant under final negotiated terms, factoring in concessions (base rent minus value of concessions)

Average Asking Rents and the S&P 500 Index (Major Market Comparison)
Includes all class types

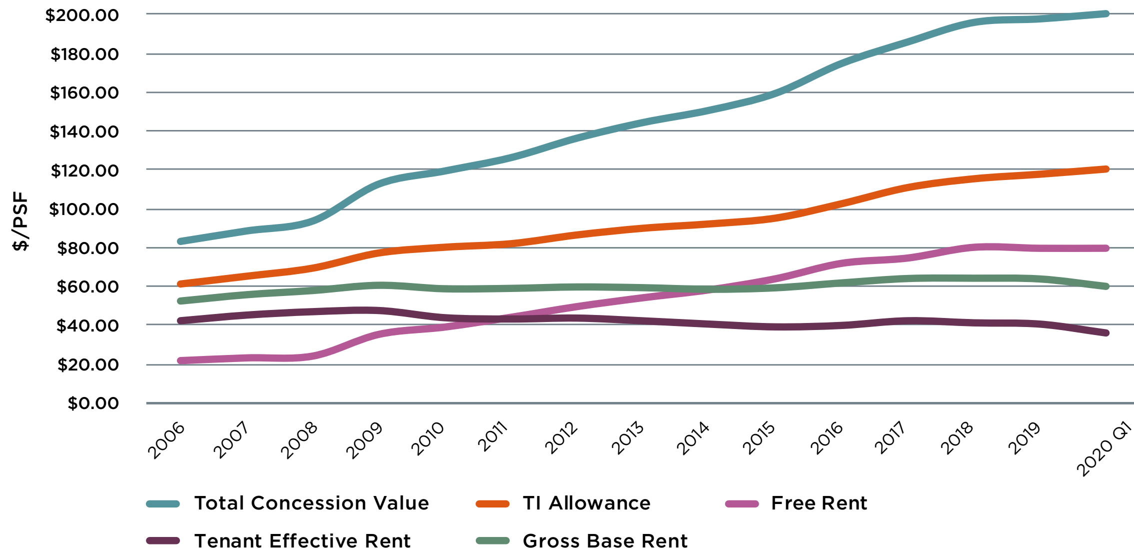


Source: Savills Research, CoStar

This correlation, or lack thereof, brings into question whether asking rents are the correct metric to use in analyzing the Washington office market. In a market that has been tenant-favorable for more than a decade, studying landlord-provided concessions and tenant effective rents is a more logical metric. In D.C., even when availability has swelled, owners have been hesitant to reduce asking rents to fill space, instead raising cash incentives ("concessions"), including free rent and tenant improvement (TI) allowance. Concessions have steadily increased over the past 14 years to become the highest on record of any major U.S. office market. In fact, concessions have more than doubled since 2008. As a result, tenant effective rents, which factor in concessions to show the net impact to tenants, have declined 9.9% since 2006 (when Savills began recording them), while asking rents increased 2.4% over the same period. The pace of this gradual decline has remained steady, even as the stock market has ascended to new highs over the past decade.

When the S&P 500 Index plunged in 2008, D.C. concessions responded with a sharp 27.7% increase in total concession value (free rent plus TI allowance) from 2008 to 2010. Tenant effective rents dropped 6.3% as a result of these increased concessions for the same two-year period. Meanwhile, base rents, which are the negotiated first year rental payment, rose 1.6%. The decrease in tenant effective rents, despite an increase in base rents, exemplifies why base rents alone do not accurately reflect the D.C. market.

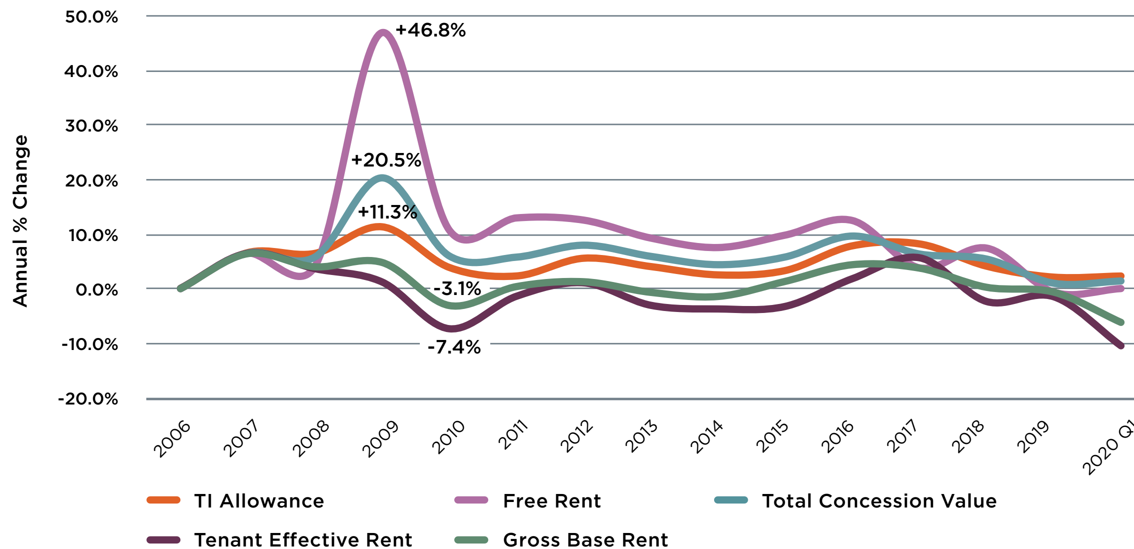
Historical Changes in D.C. Tenant Concessions and Rent
Includes class A, long-term (10 years+), new leases



Source: Savills Research

Expressed in terms of annual percentage changes, the values of free rent and tenant improvement allowances have both increased every single year, with the exception of free rent in 2019. Overall concessions have seen positive increases every single year.

Annual Percentage Changes in D.C. Tenant Concessions
Includes class A, long-term (10 years+), new leases



Source: Savills Research

Why does D.C. deviate from other markets?

Washington is unlike other Tier One office markets in that its core tenant base of government, legal, trade association, nonprofit and related sectors has not experienced the rapid boom and bust that financial services, technology or FinTech sectors have – the sectors that have driven growth on both coasts. The Great Recession led tenants to aggressively seek ways to use real estate more efficiently. D.C.'s office-intensive tenant base had plenty of opportunity to become more efficient, while there were no rapidly expanding sectors to fill the vacancy left behind.

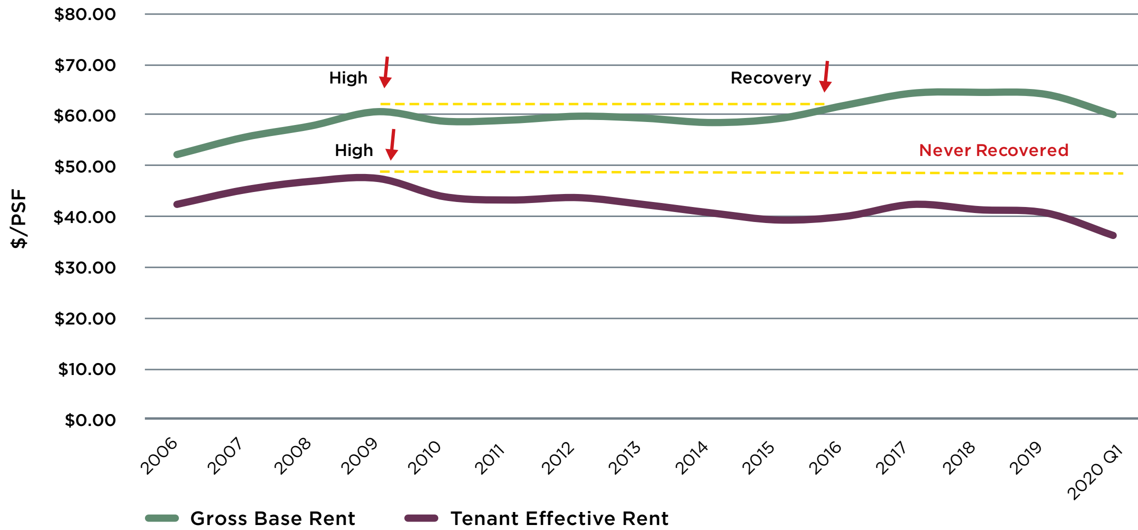
Although there is likely no direct correlation, total concessions are the indicator that seems to track the S&P 500 Index closest in the D.C. market. This may have to do with the fact that as the stock market boomed, cash flooded the real estate investment market and investors competed for leased assets. Developers and owners found it necessary to offer increasingly larger concessions to secure the base rents necessary to take full advantage of plunging cap rates and record multiples on each dollar of rent. In other words, the cost of selling at the top of the market rose alongside the stock market. As the S&P 500 has dropped again with the current COVID-19 crisis, concessions will not drop, but instead will continue to increase as competition between landlords continues, unless landlords are unable to access capital required to fund concessions. If this is the case, then market conditions will be reflected directly in base rents. Landlords will not chase multiples, but will aim to secure their share of a weakened – and likely shrunken – tenant base.

D.C. Concessions, Rents and the S&P 500 Index
Includes class A, long-term (10 years+), new leases

Source: Savills Research

Analyzing the increasing disparity between base rents and tenant effective rents demonstrates how D.C. has become progressively more tenant favorable since the last recession. In 2009, base rents reached a high, topping $60.00 per square foot, and tenant effective rents similarly peaked that year. Following the Great Recession, base rents fell, but fully recovered by 2016, while tenant effective rents have never recovered and continue to sink. Tenant effective rents are lower today than they were over 10 years ago.

Rent Recovery Comparison
Includes class A, long-term (10 years+), new leases



Source: Savills Research

What does this mean for the post-COVID-19 office market?

Prior to the onset of COVID-19, Savills predicted that the tenant-favorable market would continue for the foreseeable future. Tenants continue to become more efficient with each relocation, and flight to quality has been enabled by declining size requirements. Paired with a robust new development pipeline, an increasing amount of commodity space is being left vacant without a market sector poised for explosive growth to fill the void.

After the impact of COVID-19, we expect these trends will accelerate. While it is true that social distancing, and the associated de-densification, may provide some offset to increased levels of remote work – preventing a dramatic drop in office footprint – many tenants will be hyper-focused on their bottom lines, and thus the size of their real estate obligations. Overall, it is likely the market will see a continued increase in availability and erosion of effective rents. If the past is any indicator of the future, we'd expect the tenant-favorable market conditions in Washington, DC to continue and even accelerate for the foreseeable future.

It's too early to tell how rents will trend after the shock of the COVID-19 pandemic, of course, but it is certain that the landlord-favoring metric of asking rent will only become less relevant than they have been over the past decade.

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