Report

An Assessment of the Economic Health and Prospects for Class B and Class C Office Buildings in Montgomery County, Maryland

Prepared by:

Research and Technology Center
Montgomery County Department of Park and Planning

for Transmittal to Montgomery County Council

September 1997

Report

An Assessment of the Economic Health and Prospects for Class B and Class C Office Buildings in Montgomery County, Maryland

Prepared by:

Research and Technology Center
Montgomery County Department of Park and Planning

for Transmittal to Montgomery County Council

September 1997

THE MARYLAND-NATIONAL CAPITAL PARK AND PLANNING COMMISSION

The Maryland-National Capital Park and Planning Commission is a bi-county agency created by the General Assembly of Maryland in 1927. The Commission's geographic authority extends to most of Montgomery and Prince George's Counties. The Commission's planning jurisdiction, the Maryland-Washington Regional District (M-NCPPC planning jurisdiction), comprises 1,001 square miles; its parks jurisdiction, the Metropolitan District, comprises 919 square miles.

The Commission has three major functions:

(1) The preparation, adoption, and, from time to time, amendment or extension of *The General Plan (On Wedges and Corridors) for the Physical Development of the Maryland-Washington Regional District within Montgomery and Prince George's Counties.*

(2) The acquisition, development, operation, and maintenance of a public park system.

(3) In Prince George's County only, the operation of the entire County public recreation program.

The Commission operates in each county through a Planning Board appointed by and responsible to the county government. The Planning Boards are responsible for preparation of all local master plans, recommendations on zoning amendments, administration of subdivision regulations, and general administration of parks.

The Maryland-National Capital Park and Planning Commission encourages the involvement and participation of individuals with disabilities, and its facilities are accessible. For assistance with special needs (i.e., large print materials, assistive listening devices, sign language interpretation, etc.), please contact the Community Relations Office, (301) 495-4600 or TDD (301) 495-1331.

ELECTED AND APPOINTED OFFICIALS

COUNTY COUNCIL

Marilyn J. Praisner, *President*
Isiah Leggett, *Vice President*
Derick P. Berlage
Nancy Dacek
Gail Ewing
William E. Hanna, Jr.
Betty Ann Krahnke
Neal Potter
Michael L. Subin

COUNTY EXECUTIVE

Douglas M. Duncan

THE MARYLAND-NATIONAL CAPITAL PARK AND PLANNING COMMISSION

William H. Hussmann, *Chairman*
Elizabeth M. Hewlett, *Vice Chair*

COMMISSIONERS

Montgomery County Planning Board

William H. Hussmann, *Chairman*
Davis M. Richardson, *Vice Chairman*
Patricia S. Baptiste
Arthur Holmes, Jr.

Prince George's County Planning Board

Elizabeth M. Hewlett, *Chairman*
Roy I. Dabney, Jr., *Vice Chairman*
Zola E. Boone
James M. Brown
Regina J. McNeill

TABLE OF CONTENTS

Acknowledgments 1

Scope and Purpose 3

Executive Summary 5

Part I: Report

I. Definition of Class A, B, and C Buildings 11

II. Real Estate Market Cycles 13

III. Factors Affecting the Viability of Class B and C Office Buildings 19

IV. Recent Montgomery County Experience 24

V. Analysis and Recommendations 28

Part II: Renovation and Conversion Dynamics

I. The Process of Complete Renovation 37

II. Conversion to Residential Use 41

III. Demolition 46

IV. Renovation Assistance Programs 47

Appendix A - Survey of Class B & C Office Space Initiatives: Other Jurisdictions

Appendix B - Article entitled, “Understanding Real Estate’s Physical and Financial Market Cycles,” by Glenn R. Mueller, Ph.D.

Appendix C - Profiles of Office Market Areas in Montgomery County

Appendix D - Inventory of Renovated Class B & C Office Buildings

ACKNOWLEDGMENTS

This report was prepared and authored by Frederick R. Peacock, Research Coordinator, Research and Technology Center, Department of Park and Planning, M-NCPPC. Mr. Peacock was assisted in this effort by Mr. Lembit Jõgi, Planner/Market Analyst, and other members of the Research and Technology Center as well as Ms. Tonia Bleecher, AICP, Assistant to the Director, Department of Park and Planning. However, the material and conclusion included in the report are solely the responsibility of the author.

Industry Advisory Committee

An Industry Advisory Committee was formed in 1997 to assist in identifying the critical issues concerning B and C office space condition and serve as a technical resource for staff. The Committee members attended meetings, answered phone questions, and agreed to be interviewed in person. They were very generous with their time and knowledge and immensely helpful in assisting the staff in understanding the office space industry, the real estate market cycle, and the particular characteristics of same in Montgomery County.

The members of the Committee were:

Mr. Edmund B. Cronin, Jr.
President and CEO
Washington Real Estate Investment Trust

Mr. Marc Dubick
Vice President
Lowe Enterprises

Mr. Chuck Duda
Chief Operating Officer
Citizens Savings Bank

Mr. Stephen Heidenberger
President
Heidenberger Construction Company

Mr. Michael E. Hickok, A.I.A.
Hickok, Warner and Fox

Mr. Douglas Jemal
President
Douglas Development Corporation

Mr. Phil McCarthy
Vice President
Carey Winston Company

Mr. Matt McDevitt
Senior Vice President
Smithey Braden ONCOR International

Mr. Tom Miller
President
Miller Properties of Bethesda

Mr. Jay Olshonsky
Vice President
C.B. Commercial Real Estate

Mr. Lawrence Thau
Managing Director
Barnes, Morris, Pardoe & Foster, Inc.

Survey of Other Jurisdictions

The survey, entitled "Class B and C Office Space Initiatives: Other Jurisdictions," was prepared as a resource for this study and the County Council on B and C office space initiatives in similar jurisdictions. It is included in this report as Attachment B and was prepared by Ms. Tonia Bleecher, AICP, Assistant to the Director, Department of Park and Planning.

Real Estate Market Cycle Description

This study was assisted greatly by an analysis of the real estate market cycles described in an article, entitled "Understanding Real Estate's Physical and Financial Market Cycles," by Glenn R. Mueller, Ph.D., of Legg Mason Wood Walker, Inc. Real Estate Research Group, in Baltimore, Maryland. Dr. Mueller is also a faculty member of the Berman Real Estate Institute at Johns Hopkins University. The article is included in this report as Appendix B.

Intergovernmental Cooperation

Appreciation is expressed to the Department of Housing and Community Affairs for their assistance in providing data and sharing information concerning B and C office buildings in Montgomery County. Particular thanks to Elizabeth Davison, Director, Department of Housing and Community Affairs, and Andrea Eaton, Assistant to the Director, Department of Housing and Community Affairs.

Other Assistance

The author would also like to thank Ms. Frankie Blackburn, Vice President, Montgomery Housing Partnership, Inc. for sharing information on the Phillips Building; John Becker of Kimel Company, Inc. for discussion of the Silver Spring office market; and, James Darcy of Lowe Enterprises. The following agencies were also helpful in responding to questions: Silver Spring Redevelopment Office, Montgomery County Fire Marshal, and the Department of Permitting Services.

SCOPE AND PURPOSE

This report presents an examination of the office space market in Montgomery County, Maryland, and its prospects for the immediate future. It also involves a review of the advisability of assisted conversion of Class C office space to housing and an analysis of the desirability/feasibility of public sector intervention in the market to assist or support the economic health and future viability of Class B and C office space.

This study was prepared as a "derivative" of the Research and Technology Center examination of the health of Montgomery County's economy, entitled "The Economy Study - Phase I," completed in the Fall of 1996. The results from that examination indicated vacancy rates and market reabsorption of B and C office space occurring at a pace slower than anticipated, particularly in the down County market areas, which led to the impetus to further analyze how and under what terms greater market absorption should/could be catalyzed. The ability of Class B & C space to absorb part of the anticipated excess demand for Class A space was also an object of evaluation.

The report has been prepared for the Montgomery County Planning Board, the Montgomery County Council, and the Montgomery County Executive as a resource to assess the condition of B and C office space and the need for further public sector actions to encourage its health and sustainability as a positive economic factor in Montgomery County.

EXECUTIVE SUMMARY

This report examines the economic health and prospects for Class B and Class C office buildings in Montgomery County. Class B and Class C office buildings are an important component of the economy, serving thousands of small businesses in the County that cannot afford, or do not need, the higher quality and more costly Class A office space. Part I of this report defines Class A, B, and C buildings; describes real estate market cycles and factors affecting the viability of Class B and C buildings; examines Montgomery County's experience with this tier of buildings; and finally, analyzes and makes recommendations for maintaining this vital sector of the County's office stock. Part II of this report discusses in detail the process of renovation; the potential for conversion to residential use; options for demolition of obsolete buildings; and renovation assistance programs currently in place for Class B and C buildings in Montgomery County. The report establishes that there is always a market for Class B and C office buildings at below Class A rents and, in healthy markets, the regular investments required to keep these older buildings well maintained and competitive are financially feasible.

Class B and C office buildings suffered dramatic vacancy rates commencing in the late 80's and continuing until the past year due to a combination of overbuilding and a severe recession. Tenants who normally would locate in Class B or C buildings were able to afford the discounted rental rates of Class A buildings, which arose due to the oversupply of Class A space. Rental rates were further suppressed for Class B and C office buildings.

In the past twelve months, however, the County office market is beginning to recover and many submarkets are absorbing supply. The County has experienced significant absorption of its Class A space with subsequent spillover into B space. Rental rates are rising close to the rate that will support new construction and several older buildings have undergone extensive renovations. This recovery has occurred and will continue to occur without significant public subsidies or intervention. As of early July 1997, the overall vacancy rate for the County stood at 5.9 percent -- very close to the 5 percent vacancy rate considered indicative of a healthy office market.

Overall, the economic health and prospects for Class B and C office buildings in the County reveals a strong and positive outlook. The significant vacancy rates, resulting from the recession of the early 1990's, are well on their way to being absorbed through the natural forces of the real estate market cycle and increased demand for office space as economic development efforts are strengthened in the County. A portion of the projected Class A market demand will be absorbed over the short term by vacancies in Class B space; however, increased demand for Class A space cannot be satisfied through the Class B market over the mid to long term.

However, there is a submarket that will pose a challenge to the County in the immediate future. The Silver Spring submarket has one Class B and six Class C buildings totaling 778,000 square feet, that are presently vacant, have been so for more than one year, and are "effectively" out of the real estate market. These buildings require significant renovations if they are to be able to

reenter the market. The pro formas for renovation as office space, or conversion to housing, indicate large gaps between revenues and expenditures. Given the relatively low rental rates existent in the Silver Spring submarket at this time, there is little incentive to invest in renovation or conversion of these structures.

This report recommends the solution to this problem will be found in improving the general investment climate and market perception of Silver Spring, rather than direct financial subsidies for the properties. A concerted public and stakeholder effort to increase the market demand and investment climate in the market area is the most effective way to address this submarket problem. Otherwise, public sector investment will simply increase supply in a constant demand situation, thereby creating the possibility of further affecting rental rates in the downward fashion.

This report identifies several initiatives that the County and stakeholders could consider to facilitate this heightened investor interest and investment climate for CBD revitalization:

1. Creation of a public/private partnership, such as the Downtown Baltimore Partnership or the Phoenix Community Alliance, to meld public sector and CBD stakeholder interests into an advocacy, promotion, and business recruitment effort for the Silver Spring CBD;

2. A clear indication from the public sector of a investment commitment to the Silver Spring CBD, expressed through a coordinated capital projects agenda among the County Government, The Maryland-National Capital Park and Planning Commission, the Washington Suburban Sanitary Commission, the Housing Opportunities Commission, and other agencies affecting the revitalization prospects process in the area;

3. A utilization of constructive demolition, including financial incentive and retention of existing FAR, to catalyze the demolition of functionally obsolete buildings;

4. In Montgomery County, the job capacity of vacant office buildings is counted in the Annual Growth Policy as if the buildings were occupied. Allowing the sale of this job capacity to others wishing to develop within the policy area would be a possible incentive in Silver Spring and help leverage either demolition or conversion to housing. Under certain circumstances the County may wish to purchase the capacity to encourage the removal of the buildings from the office market inventory;

5. For the South Silver Spring area, consider performance zoning as a tool to encourage consolidation of parcels, innovative building designs, transfer of development rights within the area and, generally, more economically feasible project plans. The economics of a more fluid approach to development proposals in the area could lead to heightened investor interest, elimination of functionally obsolete properties and their replacement with more functionally adequate developments.

In conclusion, analysis of the health and prospects for the B and C office market in the County, in general, reveals a strong positive outlook. The Class B and C problem in the Silver Spring submarket needs to be addressed through a concerted vision and strategic public sector commitment to improve the investment climate and the revitalization climate in that sector of the market. If that commitment occurs, which is in many instances coalescing as this point (i.e. the Montgomery College expansion and the Transit Hub), the B and C office market in the County should maintain a strong and healthy position which will contribute to the overall health of Montgomery County.

PART I

REPORT

REPORT

I. Definition of Class A, B, and C Office Buildings

Office buildings are classified according to a combination of location and physical characteristics. Class B and Class C buildings are always defined in reference to the qualities of Class A buildings. There is no formula by which buildings can be placed into classes; judgment is always involved. A fair number of the Class C office spaces in the inventory are not truly office buildings but rather walk-up office spaces above retail or service businesses. They are nevertheless included in this study because they are part of the office leasing market.

The Urban Land Institute, a noted authority on commercial land uses, says the following about these classifications in its *Office Development Handbook*.

> Class A space can be characterized as buildings that have excellent location and access, attract high quality tenants, and are managed professionally. Building materials are high quality and rents are competitive with other new buildings. Class B buildings have good locations, management, and construction, and tenant standards are high. Buildings should have very little functional obsolescence and deterioration. Class C buildings are typically 15 to 25 years old but are maintaining steady occupancy. Tenants filter from Class B to Class A and from Class C to Class B.

In a normal market, Class A rents are higher than Class B which are above Class C. This makes sense because Class A buildings offer higher quality to the tenants and cost more to provide.

Building Size and Floor Plate Size

In general, Class A buildings are newer and larger, with larger floor plates. Class C buildings are older and smaller with smaller size floors. The larger size of Class A buildings allows them to provide more amenities by spreading the cost of more rentable area. Class A buildings have large floor plates, usually 18,000 to 30,000 square feet per floor in mid- to high-rise speculative buildings, that give both large full-floor tenants and smaller tenants flexibility in using the space. Larger floor plates and higher ceilings are suitable for the open office configurations that have been popular with some users. They also accommodate an adequate core of elevators, stairs, restrooms, hallways, elevator lobby and utility closets. The floor plate standard has been increasing; fifteen years ago 16,000 to 25,000 square feet was considered the norm. The average size floorplates for buildings in Montgomery County are as follows: Class A buildings, 23,550 square feet, about in the middle of the usual range; Class B buildings, 17,660 square feet; and Class C buildings, 12,100 square feet.

Age

Class A buildings are newer than Class B and C. Most Class A buildings in the County were built

during the 1980s and their average age is ten years. Class B buildings here are, on average, seventeen years-old and Class C, twenty-nine years-old.

Location

True Class A buildings have the prime locations, where the activity, access, and prestige levels are high. The prime locations are partially defined by where the best buildings are clustered so this is somewhat circular in causation. If the Class A location is very specific, two to three blocks away would usually be considered a Class B location and Class C locations are even less accessible to the prime area.

Physical Characteristics of Class A, B, and C Office Buildings

Montgomery County, Maryland

	Class A	Class B	Class C
Average Rentable Area	141,900	61,600	36,700
Average Floorplate Size	23,550	17,660	12,100
Average Age	10 years	17 years	29 years
Floor to Ceiling Height	8'6"to 9'+	8' min.	8'
Average Firm Size (employees)	46	24	10
Equivalent Space for Average Firm (At 250 sq. ft. per employee)	11,500	6,000	2,500

Tenants

Class A buildings can usually be selective about their tenants and require excellent financial strength and credit worthiness. Firms in Class A buildings tend to be larger and longer established than those in Class B and C. In Montgomery County, the average tenant in Class A buildings has 46 employees compared to 24 in Class B and 10 in Class C. More employees take more space; 200 to 300 square feet is typical. Class B and C buildings must often accept less financially substantial tenants and run some risks of non-payment.

Ceiling Height

Ceiling height is an important physical characteristic which can distinguish different classes of office buildings. The height between the concrete slabs that make up the floor and ceiling cannot

be changed. However, if the space is tight, creative things can be done with the duct work in the plenum space to maximize the height between the floor and the finished ceiling. Open floor plans with cubicles make ceilings appear lower so more height is an important characteristic for these plans. The larger the visual expanse of an office the higher the ceiling needs to be so high ceilings go with the larger floor sizes of Class A and lower ones with the smaller Class C floors. Class A buildings have finished ceiling heights of eight feet six inches to nine feet and this standard is increasing. An 8 foot minimum ceiling is an attribute of Class B buildings, and finished ceiling heights of less than eight feet are considered a Class C characteristic.

Amenities

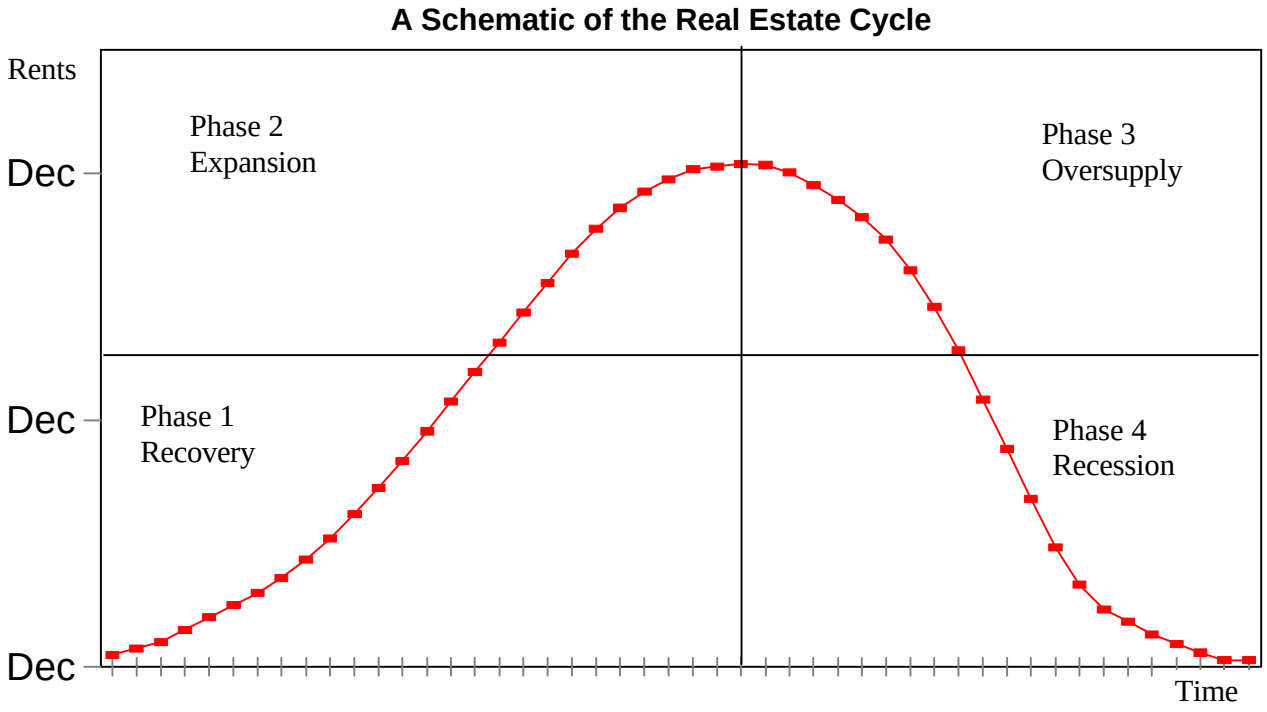
Many office buildings offer amenities to their tenants. Class A buildings tend to offer more than B which tend to offer more than Class C. Among the amenities offered in Montgomery County are:

- On-site management
- Concierge
- Mail Room
- Atrium, courtyard, and balconies
- Exercise facilities
- Conference facilities
- Raised floor (for computer & communication wiring)
- Banking, Travel Agency
- Food service and restaurants
- Dry cleaner, Convenience store
- Metro at-site or shuttle

II. Real Estate Market Cycles

This section in large part is based on the article, "Understanding Real Estate's Physical and Financial Cycles" by Glenn R. Mueller, Ph.D. a faculty member of the Berman Real Estate Institute at Johns Hopkins University. A copy of the article is included as Appendix B of this report.

Real estate markets are cyclical due to the "lagged" relationship between demand and supply for physical space. The market cycle can be divided into four phases: recovery, expansion, oversupply, and recession. At any point in time in the cycle demand and supply are attempting to move to a point of equilibrium. Market equilibrium is defined as that point in the cycle when supply and demand are in balance including a normal amount of vacancy in the supply side. Two characteristics of the market cycle impact the achievement of equilibrium, and reinforce the cyclical pattern of market performance: 1) developers, attempting to gauge demand/supply status, operate with imperfect information and a high degree of uncertainty. Decisions are often speculative, and overshoot the market, in an effort to achieve a competitive advantage; 2) also, the time required to convert demand into supply is relatively long -- one to two years from project conception--thus heightening the possibility that imperfect information in the market will



eventually lead to over supply and a cyclical downturn.

Currently, most areas of Montgomery County appear to be in the early stage of the Expansion Phase of the real estate cycle: vacancy rates are low and rents have been rising. A few buildings have been recently, or are in the process of being, renovated. Since almost no new office buildings are expected in the next two years, supply will tighten further and rents will continue to increase as demand rises.

An outline of the dynamics of the real estate cycle is as follows:

Phase 1 - Recovery

- Phase 1 follows the bottom of the cycle which occurs when the vacancy rate stops increasing because less office space is being constructed than is being absorbed.
- At this point there are high vacancy rates because supply has grown faster than demand for some time.
- No new speculative construction takes place during this time and vacancies are slowly absorbed.
- Rental rates, which have been declining, stabilize and slowly begin to rise.
- Eventually, enough excess supply is absorbed by growth in demand so that excess supply

no longer exceeds the amount needed to meet future expected demand plus market turnover friction. At this point supply and demand are said to be in equilibrium and phase 2 begins.

Phase 2 - Expansion

- Vacancy rates fall below the equilibrium level.
- Supply is tight in market.
- Rents rise rapidly.
- **The flow of capital back into real estate begins with the renovation of existing buildings.**
- Some speculative construction may start in anticipation of cost-feasible rents.
- Rising rents reach the point where they will support new construction. Rents supporting new construction vary from one market to another depending on the quality of construction. For the two to four story, 30,000-60,000 square foot building type typical of many office parks the required rents are in the $24-26 range. Today's cost-feasible rents for down-County high rise office are estimated to be about $31 per square foot. This rate was just reached in Bethesda in June 1997.
- If the rise in rents to levels supporting new construction is not adequately anticipated there may be a period of very tight supply and rent spikes before any new or renovated buildings are delivered.
- This tight market should benefit Class B and trickle down to Class C as space choices for tenants become limited and rising rents force some to consider lower class space.
- The tight market also will push some tenants into geographic markets other than their first choice. Silver Spring is benefiting from this market spillover in the summer of 1997.
- Those who renovate Class B and C buildings and get them on the market during this time of tight supply should do well.
- Once new supply starts to be delivered, demand and supply may grow at similar rates for a period of time. (Dr. Mueller comments "Long expansionary periods are possible and many historic real estate cycles show that the overall up-cycle is a slow uphill climb.")

Phase 3 - Over Supply

- The peak of the cycle and the beginning of Phase 3 is reached when the rate of demand growth drops below the rate of supply growth.

- At the beginning of Phase 3 vacancy rates are still below their long term average levels and so many developers do not recognize that the peak has passed.

- Vacancy rates begin to rise as new buildings, initiated during Phase 2 expansion phase of the market, continue to be delivered.

- Rental rate increases slow or stop as competition for tenants increases.

- With supply increasing faster than demand, the equilibrium of supply and demand is soon reached on the way down ending Phase 3.

Phase 4 - Recession

- During Phase 4 new buildings started a year or more earlier continue to be completed.

- Landlords lower rents to compete for market share and to try to cover their expenses.

- If demand growth is negative, as in an economic recession, the decline will be especially swift. This is what happened in the early nineties. With hindsight we can see that employment growth, and therefore demand for space, began to slow after 1985 and turned sharply negative at the end of 1990.

- The bottom of the cycle is reached when new building stops or demand starts to grow faster than supply so that the excess supply of space stops growing. The bottom of the cycle ends Phase 4 and begins Phase 1 of the next cycle.

Class B Office Building Performance

During the Four Phases of the Real Estate Cycle

	PHASE 1	PHASE 2	PHASE 3	PHASE 4
Gross Floor Area	100,000	100,000	100,000	100,000
Rentable area	90,000	90,000	90,000	90,000
Gross Rent per Sq. Ft.	$17.00	$23.50	$22.00	$16.00
Operating Expenses per Sq. Ft.	$6.76	$6.96	$6.88	$6.64
Vacancy Allowance	20.00%	3.00%	10.00%	30.00%
Net Income 6.)	$737,136	$1,443,567	$1,224,639	$589,491
Overall Capitalization Rate 3.)	10.00%	10.00%	10.00%	10.00%
Indicated Value	$7,371,360	$14,435,666	$12,246,390	$5,894,910
Value per Sq. Ft.	$81.90	$160.40	$136.07	$65.50
Gut Rehab Costs	**$8,000,000**	**$8,000,000**	**$8,000,000**	**$8,000,000**
Cost per Sq. Ft.	**$80.00**	**$80.00**	**$80.00**	**$80.00**
Cash-on-cash return 4.)	**9.21%**	**18.04%**	**15.31%**	**7.37%**
Gap 5.)	**($628,640)**	**$6,435,666**	**$4,246,390**	**($2,105,090)**
Rent Required for Feasibility	$17.87	$16.13	$16.76	$19.34
Cash-On-Cash Return	10.00%	10.00%	10.00%	10.00%
Percentage Change in Rent Req.	5.14%	-31.37%	-23.83%	20.88%

3.) A factor used to reflect the 'return on' and 'return of' capital in an investment
4.) Defined as ratio of Stabilized Net Operating Income to Conversion Project Costs
5.) Defined as Indicated Value minus Rehab Costs
6.) Defined as Rentable area * Gross Rent per Sq. Ft. minus Operating Expenses

Based on E.R.A. 7/96 Analysis of Gramax Building, Draft Executive Summary,
"South Silver Spring, Strategies for Revitalization," Sponsored by MC DHCA

Effects of the Real Estate Cycle on Feasibility of Renovation

Simple pro forma tables are used to measure the effect of changes in rent and vacancy levels on return on investment in major renovation of office buildings. In Phase 1 - Recovery and Phase 4 - Recession, when vacancy rates are high and rents are low, office building owners are unable to get a satisfactory return on a major renovation investment. Assuming a minimum acceptable return on investment is 10 percent, "typical" Class B building net incomes will make major, $80 per square foot renovation possible during the strong Phase 2 - Expansion and Phase 3 Oversupply when rents and vacancies are better than their long term "equilibrium" levels. Our Class B hypothetical building analysis shows returns on renovation investment of 9.2%, 18.0%, 15.3%, and 7.4% in Phases 1 through 4 respectively.

Class C Office Building Performance
During the Four Phases of the Real Estate Cycle

	PHASE 1	PHASE 2	PHASE 3	PHASE 4
Gross Floor Area	50,000	50,000	50,000	50,000
Rentable area	45,000	45,000	45,000	45,000
Gross Rent per Sq. Ft.	$12.00	$17.00	$16.50	$11.00
Operating Expenses per Sq. Ft.	$5.76	$5.96	$5.88	$5.64
Vacancy Allowance	20.00%	3.00%	10.00%	30.00%
Net Income 6.)	$224,568	$481,708	$430,070	$168,746
Overall Capitalization Rate 3.)	10.00%	10.00%	10.00%	10.00%
Indicated Value	$2,245,680	$4,817,083	$4,300,695	$1,687,455
Value per Sq. Ft.	$49.90	$107.05	$95.57	$37.50
Gut Rehab Costs	**$3,250,000**	**$3,250,000**	**$3,250,000**	**$3,250,000**
Cost per Sq. Ft.	**$65.00**	**$65.00**	**$65.00**	**$65.00**
Cash-on-Cash return 4.)	**6.91%**	**14.82%**	**13.23%**	**5.19%**
Gap 5.)	**($1,004,320)**	**$1,567,083**	**$1,050,695**	**($1,562,545)**
Rent Required for Feasibility	$14.79	$13.41	$13.91	$15.96
Cash-On-Cash Return	10.00%	10.00%	10.00%	10.00%
Percentage Change in Rent Req.	23.25%	-21.12%	-15.72%	45.10%

3.) A factor used to reflect the 'return on' and 'return of' capital in an investment
4.) Defined as ratio of Stabilized Net Operating Income to Conversion Project Costs
5.) Defined as Indicated Value minus Rehab Costs
6.) Defined as Rentable area * Gross Rent per Sq. Ft. minus net operating expenses

Based on E.R.A. 7/96 Analysis of Gramax Building, Draft Executive Summary,
"South Silver Spring, Strategies for Revitalization," Sponsored by MC DHCA

The table above shows the values assumed for vacancy rates, rents, and operating expenses that produced these returns. Assuming a minimum acceptable return on investment is 10 percent, "typical" Class C building net incomes will make major, $65 per square foot renovation possible during the strong Phase 2 - Expansion and Phase 3 - Oversupply when rents and vacancies are better than their long term "equilibrium" levels. Our hypothetical Class C building analysis shows returns on renovation investment of 6.9%, 14.8%, 13.2%, and 5.2% in Phases 1 through 4 respectively. The table above shows the values assumed for vacancy rates, rents, and operating expenses that produced these returns.

III. Factors Affecting the Viability of Class B and C Office Buildings

The future for Class B and Class C office space in Montgomery County is defined by the interplay of market forces and physical condition.

MARKET

There is always a market for well maintained Class B and Class C buildings at below Class A rents. They have a price advantage and meet the needs of many firms. Firms leasing B and C buildings trade off lower rents for older buildings, in less convenient or less prestigious locations. Class B and C office buildings serve employers that cannot afford or do not need the higher quality and prestige of Class A buildings. Examples of such employers are: back office operations where customers are not seen, non profit entities, young businesses, and local government agencies. Some employers keep some Class B or C space on hand just to handle large temporary projects.

The smaller size of typical Class B and C buildings is a good match for the vast majority of small businesses. Since Class B and C buildings are smaller with smaller floor plates, they are often a good match for the thousands of small businesses in the County. Among the private businesses in the County the overwhelming number of them are small. Fifty-six percent have between one and four employees and eighty-seven percent have fewer than twenty employees. Of the firms in commercial office space in the County, the larger ones tend to be found in Class A space with an average firm size of 46 employees, requiring office space of 11,500 square feet. Firms in Class B space average 24 workers, requiring about 6,000 square feet. Firms in Class C space are smaller, averaging 11 workers requiring 2,750 square feet at the average of 250 square feet per worker.

Employment growth creates demand for office space. The basic force that fills office space is the growth of firms. Successful firms have expanding sales which lead eventually to the need for more workers and more space. In the past decade the County has had to deal with a number of shocks that tended to interrupt the growth of employment. During the national economic recession of 1990-91 the County lost 20,000 jobs and has been slow to regain them due to federal and corporate downsizing and the moving of a number of firms out of the County, particularly to northern Virginia. Lately, firms have been downsizing the amount of office space per worker which has postponed the need for new office space.

Few office buildings are truly physically obsolete. With adequate market demand, almost any older office building can be successfully renovated. Older buildings, though not built to the most modern standards (and not up to Class A potential), can be stripped and renovated to modern standards of electrical service, lighting, elevators, ADA accessability, fire protection, finishes, floor layouts, etc. into a perfectly acceptable Class B buildings. This can be financially feasible if there is enough demand for office space in the market area to provide high enough rents and occupancy levels. In mid-1997 Bethesda-Chevy Chase, North Bethesda, and Rockville, with average Class B rents of near $20 or higher, can support many renovations. Rents in the mid-

teens, such as found in Silver Spring and Kensington-Wheaton will make few feasible.

For example, the renovation of the Gramax Building in south Silver Spring (as studied in the 1996 DHCA report by ERA) did not deliver the minimum ten percent return on an $89 per square foot renovation at hypothesized $14 per square foot annual rents. But, if south Silver Spring were a more desirable market, rents of $17.10 would bring the return up to the minimum ten percent level. At the present time even $14 rents are probably not achievable in south Silver Spring but, if the renaissance of Silver Spring proceeds, it is not hard to imagine rents of $17.10 and higher in south Silver Spring. These buildings are only obsolete if Silver Spring's perceived attractiveness does not improve with the new private and public investment and other revitalization programs underway.

PHYSICAL CONDITION

Office buildings deteriorate with age but can be maintained through regular reinvestment/maintenance. The physical needs of buildings are of three types:

- Maintenance: the repair, replacement, and renewal of existing building elements
- Compliance with changing codes
- Upgrades to keep up with increasing market standards

All three of these types of work tend to be done together. Naturally, it is much easier to keep up with the physical needs of the building when the high occupancy and rents of a strong market are providing a good cash flow.

Maintenance

Different building components have different effective life spans. The basic structure of the frame and the floors lasts the longest, typically more than 50 years. The building exterior -- skin and windows -- last next longest. Electrical wiring also has longevity but increased demand on electrical service by users often requires upgraded systems. Mechanical systems including Heating, Ventilation and Air Conditioning (HVAC) last 20-30 years and are often the biggest cost item in renovations. Tenant finishes are short lived, about 5 years.

There is a continual schedule of required maintenance, repair, and replacement for all buildings more than a few years old. This is a critical factor for sustainability and market demand. Well maintained buildings retain value and market demand; poorly maintained buildings lose value and market demand.

Here are a few examples of maintenance that should be scheduled:

- A 50 ton air conditioner, for about a 15,000 square foot building, needs to be rebuilt every 10 years at an estimated cost of $41,418 and replaced every 20 years for $43,825.

- Built up roofing requires major repair every 20 years at $297 per 100 square feet and replacement after 28 years at $488 per 100 square feet.

- Boilers need to be repaired every 7 years for $1,317 and replaced every 30 years for $147,300 (10,000 MBH).

- Fluorescent light fixtures require maintenance every 10 years for $105 per fixture and replacement every 20 years for $159.

During the bottom periods of the market cycle, when cash flows are low due to increased vacancies and reduced rents, it is almost inevitable that time optional maintenance will be postponed. Postponed maintenance rarely saves money in the long run.

The capital maintenance and equipment replacement needs increase every year. R.S. Means Company (the standard construction cost information source) estimates that starting in the second year (first year repairs are covered by warranties) an amount needs to be set aside equal to one percent of the total cost of the building. Each succeeding year this amount is increased by five percent over the previous year in inflation corrected dollars. By the thirtieth year the cumulative value of this fund is equal to 62 percent of the initial value of the building. In reality capital reserve funds are rarely maintained at these levels.

The most typical pattern for major maintenance and renovation of buildings is a gradual schedule with the building kept in operation, rather than a major rehabilitation of a vacant building. To the extent possible, work in tenant spaces is done during tenant "turnovers."

Nearly half the renovation work is done on fully occupied floors; about one-fourth in vacant individual tenant spaces; about 20% involves gutting an entire floor; and approximately five percent involves gutting and rehabilitating an entire building.

An associated cost of maintenance is reduced occupancy and revenue from spaces left vacant while maintenance proceeds. Work in occupied tenant spaces costs about 50% more because most of it is done on overtime during nights and weekends. Major work is sometimes so disruptive that it results in loss of some tenants and this adds to the effective cost.

At 51 Monroe Street in Rockville, owned by Washington Real Estate Investment Trust (WRIT), renovations included roof replacement, new elevator controls, HVAC equipment, an energy management system, new fire alarm and sprinkler systems, renovated main lobby and common hallways. This work was started in 1995 and will be finished this year. During these changes occupancy averaged 90% in 1995, 86% in 1996 and is now over 93% leased. Rents dropped to $13-14 and are now up to $19-20.

In another recent example from WRIT, a 1960 building in Washington, DC underwent extensive renovations in 1995 and 1996; renovations to the main lobby, elevator cabs, hallways and restrooms, modernizations to mechanical systems and the installation of a new roof, fire alarm, sprinkler and energy management systems as well as asbestos removal. Occupancy levels fell to 57 percent in 1995; were at 65 percent in March 1996; and, had recovered to better than 90 percent by March of 1997.

Code Compliance

Code compliance presents a challenge for older buildings in need of renovation. It is often very difficult to completely meet the letter of new code changes in older buildings. However, most codes offer some flexibility for older buildings.

Important code compliance issues in the maintenance of B and C office buildings include:

Asbestos Removal: Building owners have been required to survey their buildings and identify asbestos. Occupational Safety and Health Administration (OSHA) regulations effective October 1995, require owners of buildings constructed before 1981 to actively determine whether their buildings have asbestos containing material (ACM). Most buildings built before the early 1970s and some built up to 1981 used asbestos in their construction. Asbestos removal is hard to do around tenants and is best accomplished on at least a full floor at a time.

Life Safety: The main life safety code requirements are for two exit stairways serving each floor and sprinklers for buildings over 75 feet tall. All buildings requiring sprinklers are now required to have a five-year plan to get them installed. Sprinkler installation costs about $1.00 per square foot assuming that an adequate pump is already in place.

1990 Americans with Disabilities Act (ADA): Building owners must comply with ADA requirements for accessibility and new fire alarm systems with visual as well as audible warnings. Some building owners add a third, single use, unisex, handicapped access restroom on each floor if the other restrooms are too expensive to modify. A bathroom with a sink and toilet costs about $3,300 and reduces the formerly rentable area by a few square feet per floor. Some typical costs for ADA compliance are:

- Furnish and install a three step ramp: $4,800
- Upgrade a single bathroom: $1,500
- Change elevator numbering to add Braille: $825
- Change door hardware to lever style: $150 each door

Ventilation: The requirements for outdoor air exchange and ventilation of office buildings have

also increased.

Upgrades to Keep up with Increasing Market Standards

The standards expected by tenants have increased for a number of building systems over the years. Tenants using computers and other electronic equipment need more electricity. In recent years tenant demands for electrical service have increased from 3.5 watts per square foot to 5 watts or more. Computers also generate heat and require increased air conditioning. Energy management systems increase tenant comfort while significantly reducing operating costs.

Tenant improvements (TI) are an obvious way to meet tenant needs. They consist of paint or wall covering, carpet, divider walls between offices, partitions, ceiling finish, lighting, and sprinklers. Tenant improvements are usually renewed at the time of lease renewal and when requested (at extra cost) during the lease period. Tenant improvements range from new paint and carpet for about $4-5 per square foot all the way up to a full gut renovation of the space for $20-22 per square foot and up. The cost of a high end complete renovation depends on the cost of materials and can be very expensive. A partial gut TI with new drywall will cost $10-12 per square foot.

Standard tenant improvements upon renewal of a five-year lease are usually paint and carpet, with the quality of the materials depending on the Class of the space. A few other minor changes such as moving a wall may also be done at this time. In a building at the bottom of the Class C market where both the owner and the tenants are operating on very thin margins it is quite possible that no tenant improvements will be made at lease renewal. In these marginal situations leases are sometimes month-to-month. Major gut renovations to tenant space are usually done for new tenants and not for renewals. Most tenants will not want to go through the disruption of a major renovation and if the space does not meet their needs in a major way they move to another building.

Other than tenant improvements, many of the maintenance and code requirements discussed in the sections above are necessary but do not increase the value of the building from the tenants' point of view. When building components are being replaced in the course of routine maintenance, or to comply with codes, there is a chance to upgrade the building to increase the attractiveness or functionality of the building for present or future tenants. This repositioning of the building upward in the market is an important element of the renovation process because it enables the owner to maintain occupancy and increase rents upon lease renewal or turnover. These increased revenues are the way to continue the viability of the building.

Buildings with doubtful futures usually face a combination of market and maintenance handicaps that can only be overcome by a fortunate combination of circumstances. They are often in weak markets and therefore cannot generate the income needed for the physical upkeep of the building. Many have been allowed to become dilapidated. Some also have exceptional renovation needs, such as additional elevators, to bring them up to market standards. Sometimes the solution for these buildings is sale at a cost so low that the extensive needed renovations can be accomplished

by the new owner within a feasible total cost. During the late eighties and nineties a number of office buildings have been sold at a loss. A sound future for a building does not always mean a profitable future for the present owner.

IV. Recent Montgomery County Experience

The Last Real Estate Recession

Many of the problems of Class B and C office buildings can be traced to the overbuilding of the 1980s and the resulting recession of the early 1990s. During this period many new buildings were unable to lease their new space and went bankrupt. These buildings were taken over by their creditors or the Resolution Trust Corporation and often sold at well below the cost of building them, for prices as low as 35 cents on the dollar. The large amount of space could not be filled quickly by normal growth of the economy but with such low initial costs, the new owners could offer concessions in the form of rent abatements, generous tenant improvement allowances, and other inducements to attract new tenants. Many tenants were attracted from older Class B and C buildings by the tremendous deals being offered.

During the 1980s, 286 office buildings with 23.4 million sq. ft. of space were built in Montgomery County. Sixty-three percent of this space is Class A. Vacancies in many Class B and C buildings increased dramatically during this time as tenants left for better space at bargain prices. According to Spaulding and Slye's first quarter reports, Class B vacancies increased from 7% in 1987 to a high of 24% in 1994. During this time vacant Class B space increased by two million square feet. Since 1994, one million square feet of Class B vacant space has been absorbed. Class C space shows an even more dramatic story with vacancy rates hitting a low of 1.9% in 1988 and then rising dramatically to 31.0% by 1994. From 1987 to 1994 nine million square feet of Class A space was absorbed. Some of the Class A occupants came from about 2.6 million square feet of vacated Class B and C space. (Note: the Spaulding and Slye reports are used because they provide a longer time series than the CoStar data base, but since Spaulding and Slye covers fewer small buildings the numbers are not directly comparable to CoStar numbers used elsewhere in this report.)

To further aggravate the situation, the overbuilding of office space in the late eighties occurred throughout the region and the nation. In Fairfax County, the 1980s overbuilding was more dramatic than in Montgomery County. Fairfax built double Montgomery's amount of space with 569 office buildings and 47 million square feet of space during the 1980s. Seventy-five percent of these buildings are Class A. Both counties had vacancy rates just below 14 percent in July 1986. Fairfax's soared to a peak of 23 percent by July 1991 compared to Montgomery's 19 percent. Then Fairfax's rate dropped much faster than Montgomery's as many of these buildings were offered for bargain rates, often after bankruptcy. The heavily discounted rents for Fairfax's "see through" office buildings attracted a number of firms from around the region including Montgomery County, which furthered the migration from Montgomery County's B and C space.

As vacancy rates climbed, rental rates were cut as landlords tried to hold on to their market shares. The immediate effect on the Class B and C buildings was a severe loss of cash flow. That led to deferred maintenance and deterioration of the physical state of some of these buildings. Some buildings, particularly those where a single tenant had completely occupied the building and left, became totally vacant. As of January 1997, six completely vacant Class B buildings accounted for 32% of the Class B vacant space. By August this was reduced to four buildings and 26%. Some of these have been completely renovated and are renting up while others remain vacant. The recently renovated Fairmont building in Bethesda was 98% leased by the time it opened in June. On the other hand, the old Computer Sciences Building, now Jemal's Colesville at 8728 Colesville Road in Silver Spring was renovated in June 1994 and was still only 22% occupied in August 1997.

In general, a whole regional office market goes through the real estate cycle more or less at the same time. However, some subregional areas are ahead or behind others. Fairfax County, for instance, recovered to Phase 1 and Phase 2 sooner than Montgomery County. Within the County, most areas, particularly the Bethesda CBD, are now into Phase 2, although the Silver Spring CBD is still in Phase 1.

The Current Recovery

The County market in general is now into the Phase 2 expansion of the real estate cycle and the Class A office market is tightening up quickly. The vacancy rate for Class A buildings, including sublet space, has fallen from 9.2% in the second quarter of 1996 to 5.5% at the end of the second quarter of 1997. A total of 857,100 square feet of Class A has been absorbed in these four quarters. Although a total of 1.3 million square feet of vacant Class A, direct and sublet, space is available in the County in early July 1997, there are only five buildings with more than 50,000 square feet available. Over the past four years net Class A space absorption in Montgomery County has increased from a negative 188,000 in 1994 to positive amounts of 679,000 in 1995, 107,000 in 1996 and 562,700 sq. ft. in the first six months of 1997.

Now that little space is available in Class A buildings, many prospective tenants will have no good choices other than Class B or C space. Some of the firms that left Class B and C space for Class A space in the early nineties will be returning to Class B and C space as their leases expire and the normal spread of rents between the Classes returns to the market.

Managers of Class A buildings can now be more selective about tenants. In addition to charging higher rents, they are toughening other lease conditions including deposits and credit worthiness requirements. Some tenants, lured from Class B and C buildings a few years ago, are finding that they can no longer qualify. Some will move from Class A buildings back into Class B & C space.

Note: most empty or nearly empty office buildings are not really in the office market. If they have been vacant for more than a few months, they will probably require extensive renovation before they are leased and occupied. They act in the market more like a building in the pipeline than an

existing one. For this reason they are listed separately in the following discussion.

The resurgence in the office market has reached both Class B and Class C buildings. Over the past three-and-a-half years Class B vacant space in occupied buildings has been reduced by 1.2 million sq. ft. and the vacancy rate cut from 13.5 percent to 6.4 percent. Over half of this drop has occurred in the 12 months prior to July 1, 1997. Another 1.1 million square feet of vacant space remains in 266 Class B occupied buildings plus another 456,000 square feet in four empty Class B buildings. One of these four empty buildings with 69 percent of the space is in Silver Spring.

Class C buildings have benefitted less than Class A and B buildings from the recent increase in occupancy. In 1995 net absorption was a negative 24,500 square feet. This improved dramatically in 1996 with 155,000 square feet or 2.5% absorbed. The first half of 1997 saw negative absorption of 28,000 feet. Since the end of 1995 the amount of vacant direct and sublet space in 192 Class C occupied buildings has decreased from 594,000 to 397,000 square feet and the vacancy rate has dropped from 9.7% to 6.5% of the 6,109,000 square feet of rentable building area as of July 1, 1997.

Four Class B buildings totaling 456,000 square feet and eleven Class C buildings with 603,021 square feet of space are completely or nearly vacant now and some have been vacant for more than a year. Most of these buildings have been vacant for some time and will need extensive renovation before they are marketable. They will not be readily absorbed by the improved economy. Seven of the buildings with over 73 percent of the space are in Silver Spring.

The vacant buildings are:

New Construction of Office Buildings Should Start Soon

Empty Class B Buildings in Montgomery County

(Over 10,000 sq. ft. and Vacant for One Year or More)

Address	Class	Stories	Yr. Built	Yr. Renovated	Rentable Area	Floor Size	SF Available	Vacancy Rate	Asking Rent	Market Area
8757 Georgia Ave	B	14	1970		316,000	21,832	308,816	98%	$17.50	Silver Spring
5650 Nicholson Ln	B	4	1975		48,000	12,000	48,000	100%		North Bethesda
708 Quince Orchard Rd	B	2	1982		52,000	26,000	52,000	100%	$12.75	Gaithersburg
23 W Diamond Ave	B	2	1985		40,000	20,000	40,000	100%	$10.00	Gaithersburg
Totals & Averages		**5.5**	**1978**		**456,000**	**19,958**	**448,816**	**98.4%**	**$13.42**	
					114,000					

Empty Class C Buildings in Montgomery County

(Over 10,000 sq. ft. and Vacant for One Year or More)

Address	Class	Stories	Yr. Built	Yr. Renovated	Rentable Area	Floor Size	SF Available	Vacancy Rate	Asking Rent	Market Area
8060 13th St	C	15	1960		180,000	12,000	180,000	100%		Silver Spring
7915 Eastern Ave	C	12	1957		96,000	8,000	96,000	100%		Silver Spring
7981 Eastern Ave	C	4	1959	1979	80,000	20,000	80,000	100%	$12.00	Silver Spring
7923 Eastern Ave	C	8	1959		60,000	7,500	60,000	100%		Silver Spring
8485 Fenton St	C	4	1955		34,119	8,530	30,707	90%		Silver Spring
8435-8439 Georgia Ave	C	3	1960		12,000	4,000	12,000	100%		Silver Spring
50 Monroe St	C	4	1974		22,375	4,475	22,375	100%		Rockville
3 Choke Cherry Rd	C	3	1974		41,786	13,928	41,784	100%		North Rockville
9426 Stewartown Rd	C	3	1986		27,000	9,000	27,000	100%	$14.50	Gaithersburg
7222 47th St	C	2	1965		33,741	11,100	33,741	100%		Bethesda/Chevy Chase
4801 Montgomery Ln	C	2			16,000	8,000	16,000	100%		Bethesda/Chevy Chase
Totals & Averages		**5.5**	**1965**	**1979**	**603,021**	**9,685**	**599,607**	**99.4%**	**$13.25**	
					54,820					

With little vacant space available in the Class A market, and rents rising past the point necessary to support new construction, new office buildings will soon start to be built in the County. The CoStar data base identifies only one 23,000 square foot building under construction, for completion in August 1998, and one 122,000 square foot building under renovation at the present time. Seventy-three buildings totaling 27 million square feet are listed as proposed but only one at 60,000 sq. ft. is identified for delivery in the next 24 months. Only five of these buildings have some preleasing. According to this information the supply of office space is virtually fixed for the next two years.

However, with the Class A market as tight as it is there is a strong incentive to deliver new buildings as soon as possible and it seems likely that some already approved buildings will be delivered sooner than two years. If the economy keeps recovering we can expect the vacant space will become tighter and tighter as absorption continues. Class B and C buildings will undoubtedly be beneficiaries of both occupancy and rental rate increases. These increases will result in much stronger cash flows that will make many renovations feasible. Weaker market areas such as Silver Spring will also likely benefit, although to a lesser degree.

Office Space in Square Feet (Occupied Buildings), July 1, 1997				
	Class A	Class B	Class C	Total

Office Space in Square Feet (Occupied Buildings), July 1, 1997				
Direct Vacant	841,000	905,200	387,300	2,133,500
Sublet Vacant	470,100	170,000	10,100	650,200
Total Vacant	1,311,100	1,075,200	397,400	2,783,700
Rentable Area	23,766,100	16,845,100	6,108,700	46,719,900
Vacancy Rate	5.5%	6.4%	6.5%	5.9%

As of early July 1997 the amount of available space including sublet space in the County totals almost three million square feet as shown in the above table. The overall vacancy rate is 5.9%, virtually at the "normal" rate of five percent, with only another 447,700 square feet to be absorbed to reach that level. This is an indication of how tight the market is now and how tight it is apt to become before significantly more supply is available in a couple of years.

X. Analysis and Recommendations

What, then, does this information indicate for the future health and role of B and C office space in the County?

Overall Prospects

The data in this report clearly indicates that the high vacancy rate experienced in the B and C office market in the 1990's was the result, in large part, of the normal real estate market cycle. It was compounded, however, by the overheated construction market in the late 1980's which exacerbated the over supply that occurred after the real estate market collapse in the early 1990's. The normal market tendency to "overshoot" demand was aggravated by the extreme level of activity in the late 1980's and the severe recession which followed. The result was high vacancy rates in B and C office space.

The research has further indicated that this vacancy level was worsened by the significant movement of B and C clients to Class A space, which by the mid-1990's was being offered at severely discounted rates. The real estate collapse in the early 1990's resulted in bankruptcies and sell-offs at a fraction of previous value. Severely discounted rents made A space affordable to clients who would otherwise be occupying B and C space.

The information also indicates, however, that the market cycle has passed through the recession phase and is in the recovery and/or expansion phase, with strong demand for A space beginning to develop. Associated with this increase are higher rent rates for A space and less concessions for tenants. Many of the effects of the recession are being eliminated and some tenants now in A space will be returning to B and C as the leases mature. This will "rebalance" the distribution of tenants and reduce the previously high levels of vacant B and C office space Countywide.

As the economy continues to improve, there will be increased demand for A space that cannot be met over the short run, forcing some tenants into upper level B office space as the best available alternative. Concurrently, the expansion of the economy and office demand will absorb B and C space directly via companies and clients that are comfortable in B or C space rather than the premium Class A market.

These conditions indicate that Class B and Class C office space, with some notable exceptions, will return to acceptable vacancy rates (5%±) through the operation of the market cycle in the late 1990's. It appears that the office market and the economy are both in an expansion period and the expansion is likely to continue with demand exceeding supply for the foreseeable future.

The B and C office market vacancies, in general, should be absorbed and the market remain healthy without the need for significant public intervention. Also, with the normal maintenance and reinvestment anticipated by owners, it is likely that B and upper level Class C space will continue to serve part of the Class A demand for the next several years. Until anticipated new construction is commenced and completed, excess demand for A space will continue to be addressed by a compression of the market into premium quality Class B space.

However, existing Class B and C space is not of the quantity -- particularly in the I-270 corridor-- to offset the anticipated shortfall of supply in Class A space during the upcoming recovery. Anticipated demand growth for A space is likely to continue and will only be satisfied through new construction, not absorption of B and C into the market. The Class B space and Class C space markets will reabsorb vacancy through the normal cycle and only partially assist in the anticipated demand for Class A in the future.

With the high demand for premium space in the County in general, and the anticipated absorption of the majority of B and C buildings into the market recovery, the future of this space seems likely to be positive and healthy. As rental rates rise, and demand for upper level space increases, it is likely that the private investment necessary to maintain the buildings over the foreseeable future will be economically feasible and indicated from a business standpoint.

The combination of market demand and maintenance investment are likely to assure that these segments of the office market remain healthy and productive. Public intervention or subsidy does not appear to be necessary or indicated at this juncture.

Renovation of Non-Conforming Properties

One concern about major renovations is the issue of nonconforming use. This occurs where the underlying zoning category of the building to be renovated has been down zoned and the building is larger than is currently allowed. As a consequence of this, certain difficulties may be encountered in renovation. It may be difficult to get any increase in floor area ratio approved, even for non-rentable space like an added exit stairway, or an enclosure for expanded utilities. If the building were to suffer a fire, destroying more than half the building during renovation there is no assurance that it could be rebuilt. These uncertainties may make it difficult to obtain financing for renovation; financial institutions are reluctant to provide loans without certainty that their investment would be protected in case of fire or other destruction of the renovated structure.

Changes in the zoning code to clearly establish that rebuilding could occur and that very minor, non-revenue producing changes in the footprint were allowed would make it easier for older buildings to be improved.

The Silver Spring Situation

While the prospects are favorable for the Class B and Class C office markets in the County in general, there is a substantial sector of the Class C office market that is in difficulty. As indicated above, there are seven buildings in the Silver Spring market area, that are vacant, have been so for at least 12 months, and will likely not become productive participants in the office market without substantial renovation and reconstruction. These buildings have projected revenue/expense "gaps," when renovation costs are factored into the equation, which indicate they will not be easily absorbed into the market without some form of catalyst from the public sector.

A list of these properties are as follows:

Empty Class B and C Buildings in Silver Spring

(Over 10,000 sq. ft. and Vacant for One Year or More)

Address	Class	Stories	Yr. Built	Yr. Renovated	Rentable Area	Floor Size	SF Available	Vacancy Rate	Asking Rent
8757 Georgia Ave	B	14	1970		316,000	21,832	308,816	98%	$17.50
8060 13th St	C	15	1960		180,000	12,000	180,000	100%	
7915 Eastern Ave	C	12	1957		96,000	8,000	96,000	100%	
7981 Eastern Ave	C	4	1959	1979	80,000	20,000	80,000	100%	$12.00
7923 Eastern Ave	C	8	1959		60,000	7,500	60,000	100%	
8485 Fenton St	C	4	1955		34,119	8,530	30,707	90%	
8435-8439 Georgia Ave	C	3	1960		12,000	4,000	12,000	100%	
Totals & Averages		**8.6**	**1960**	**1979**	**778,119**	**11,695**	**767,523**	**98.6%**	**$14.75**
					111,160				

Contrary to the market factors fostering absorption and heightened demand for the majority of the Class B and C market, these properties face a different set of economic factors. These buildings require significant renovation; and they are in an office market with low effective rents at this juncture. There is not sufficient market demand to generate the private investment necessary to achieve "effective" reentry into the office market. Further, should this reinvestment take place, the reentry of properties at this point would face stiff competition in a sluggish market. It is unlikely that a strong market position could be obtained by anyone undertaking a major renovation at this juncture.

It appears that the success of older office space in Silver Spring depends ultimately on the revitalization of the economy of Silver Spring *per se*, not an extensive public financial intervention in the market. A set of financial subsidies could be devised that would induce renovation of some of the buildings; however, without a market recovery, this would result in a "surge" in the supply of newly renovated office buildings without additional demand.

As indicated above, there is already an ample supply of office space in the Silver Spring submarket to accommodate increased interest by employers at this time. There is 675,000 square feet of vacant space in occupied office buildings in Silver Spring as of July 1997. Class A space accounts for 276,000 square feet of this space; Class B accounts for 210,000 square feet; and, Class C produces 189,000 square feet. This is in addition to the seven vacant buildings that are "effectively" not in the market, but, total 778,000 square feet of additional space.

Added supply at this point in Silver Spring's office cycle would increase the vacancy rate and likely depress rents further.

Likewise, conversion to housing could likely be effected -- with significant public financial subsidy. However market factors indicate the inadvisability of housing conversion. The conversion analysis presented in this report indicates that costs of housing conversion is much greater than office renovation and presents a greater "gap" between revenue and expense. Significant public subsidies would likely be required -- at least over the mid term -- to make such conversion attractive under current market conditions.

Recommendations for Action

How, then, should the County respond to this submarket situation?

We believe that the problem facing the Silver Spring submarket, particularly the seven properties discussed herein, needs to be addressed through an improvement in the general investment climate and market perception, rather than through an extensive set of public market interventions. The Silver Spring market suffers from depressed rents *vis-a-vis* the other submarket areas due to a history of unsuccessful revitalization efforts and a lack of a clear vision for the community's future. Silver Spring needs a clear direction for redevelopment of the Central Business District, with the resultant increase in market confidence that will follow. The CBD while still a weak market, has had strong absorption, rent increases and other positive changes in the past year and will further benefit from the general market upswing. Now is the time to move strongly to build on these positive signs, to strengthen the CBD and take advantage of the positive phase of the real estate cycle.

As indicated in this report, Montgomery County has adopted a number of the intervention techniques used in other jurisdictions to assist ailing B and C office properties. The County offers a "fast track" review to all businesses needing permits in the Silver Spring Enterprise Zone; a "green tape" team is available to aid applicants through the reviews and inspections by providing a customer service caseworker in the Department of Permitting Services; and zoning changes have allowed certain flexibility in meeting requirements and to assist conversions to residential use, either by right or by special exception.

Of major potential benefit to these properties is the Enterprise Zone tax credit procedures on the increased assessed value of the property. For properties located within the boundaries of the Enterprise Zone, owners that make capital improvements to the property may receive tax credits on the increased assessed improvement value, for a period of ten years, on a declining scale. Businesses may also apply for State income tax credits for additional staffing. This provides a potentially significant benefit to the Silver Spring properties in question *vis-a-vis* areas not within an Enterprise Zone.

However, several additional initiatives could be considered by the County to effectuate a successful disposition of these properties and stimulate investment interest in the surrounding areas:

1. Extensive focus groups with the investment community, recently undertaken by the Silver Spring CBD Team, indicate the requirement for a clear and definitive public sector investment commitment to the Silver Spring CBD in order to change the economic equation, stimulate rental demand and encourage investment. Investors feel the lack of a strong vision for the greater CBD area and are reluctant to commit significant funds without further clarification of the public commitment to the revitalization of Silver Spring.

A coordinated multi-agency, five-year capital expenditure plan, involving the Executive Branch, County Council, Park and Planning, and WSSC has been identified as a desirable forerunner to heighten private interest in the CBD and facilitate an increase in market demand and investment interest. These changed market factors would lead to higher market rates, rental rate demand, and lead to renovation of some of the buildings in question.

Several major projects in that mode are currently in implementation or final design: Silver Spring Transit Hub; Montgomery College Expansion; Wayne Avenue "Green Trail"; Urban Renewal Project. These will support an improved perception of public sector commitment to the Silver Spring CBD, particularly if framed within the broader context of a coordinated capital improvement effort by the County agencies. A strategic, coordinated approach to allocation of available resources among the agencies is necessary, perhaps coordinated through the Silver Spring Policy Group, to assure the public coordination with private investment interests.

2. For several buildings in an advanced state of deterioration, a "window" for constructive demolition could possibly lead to the removal of functionally obsolete structures and the future investment in new income properties. A combination of assisted demolition and the ability to reconstruct existing FAR -- even in a grandfathered situation -- could encourage the removal of several of the older buildings and provide impetus for current or future reconstruction. A credit against future real estate taxes could be offered to offset demolition costs. The program should require that the lot be put in a finished condition, either grass or paved as parking. Eligibility should be limited to the Enterprise Zone area and expire after five years.

3. In Montgomery County, the job capacity of vacant office buildings is counted in the Annual Growth Policy as if the buildings were occupied. Allowing the sale of this job capacity to others wishing to develop within the policy area would be a possible incentive in Silver Spring and help leverage either demolition or conversion to housing. Under certain circumstances the County may wish to purchase the capacity to encourage the removal of the buildings from the office market inventory.

4. An issue raised in the current update of the Silver Spring CBD Sector Plan is the establishment of "performance" zoning in South Silver Spring. The lack of significant demand for the properties in question could be addressed through a more flexible approach to project development that would allow consolidation of properties, transfer of development rights within the area, and flexible zoning based on site plan approval by the Planning Board. The economics of a more fluid approach to development proposals in the area could lead to the elimination of the problem properties and their replacement with more functionally adequate development.

5. Strong interest was exhibited by participants in the recent focus groups for creation of a public/private partnership to facilitate heightened stakeholder ownership in the revitalization, promotion, and marketing of the Silver Spring CBD. Creation of a new vehicle to bring additional resources of the stakeholders to the table, and, more importantly, mount a concerted campaign at promotion and advocacy for the CBD would likely lead to heightened interest in the properties in question.

   Success in other jurisdictions has indicated that the general economic climate and economy can be significantly strengthened by such an effort. Based on expressed interest in such a vehicle in the community, establishment of a public/private ownership could be facilitative of the Silver Spring submarket in a meaningful way.

The challenge faced in the Silver Spring market area is one, to repeat, of perception and related market demand. Direct intervention to subsidize operational pro formas would create artificial supply and require excessive public subsidies to effectuate. A more permanent, lasting solution to the market problems is a visible, focused, and strategic public/private partnership effort to revitalize the Central Business District. All of the recommended actions above would be facilitative of this effort.

Conclusion

In conclusion, the assessment of the economic health and prospects for Class B and C office buildings in the County reveals a strong and positive outlook in general. The conditions impeding the Silver Spring submarket area can be addressed through a concerted vision and strategic County commitment that is in many instances in the nascent stages at this point. Continued commitment and the more strategic application of public resources should leverage additional private investment, interest and financial participation.

PART II

RENOVATION AND CONVERSION DYNAMICS

RENOVATION AND CONVERSION DYNAMICS

I. The Process of Complete Renovation

Although only an estimated five percent of renovated buildings undergo a complete or "gut" rehab, this is very important to the office market because it allows these buildings to move from deteriorated, non-productive status back up into the solid Class B market. A few buildings are renovated by floor to ceiling gutting of every floor and complete renovation including the replacement of most or all major building systems. This often happens after a building goes totally vacant and market conditions support renovation.

While keeping a building occupied, and handling maintenance and renovation on an ongoing basis, is the preferred option, there are factors that may tend to move a building toward a full gut rehab:

- Complete vacancy
- Accumulated postponed maintenance
- Accumulated code compliance needs
- Need to reposition a building upward in the market to increase occupancy and rents

Buildings that have been vacated after being completely occupied by a single tenant for a number of years may be in a position where a complete gut rehab is the best solution and the only one apt to attract new tenants. This is especially true if maintenance has been allowed to fall behind and new tenants are not found quickly. Prolonged vacancy and deterioration due to sitting empty do not add much to the costs of a complete renovation because almost all the required work probably would have to be done anyway.

When Class B or C buildings are renovated they are usually repositioned upward in the market structure, but rarely become Class A buildings. Even though completely renovated, they are still older buildings built to the standards of another time and they are not apt to be in the prime location, which is largely defined by where the newest buildings are located.

All major renovation work is much easier to justify in a strong and rising market. Assurance of rapid leasing up at good rents will encourage the building owner to undertake expensive renovations. The need for renovation comes in part from the market, part from regulation and the need for code compliance work, and part from the building itself and its need for updating and maintenance.

CASE STUDY: THE RENOVATION OF BUILDING X

The owner of Building X provided us the data on the due diligence and renovation costs with the request that we not reveal the identity of the building. Building X, a 120,000 square foot, vacant, Class C building in Montgomery County, was stripped down to the concrete floors and ceilings and renovated to Class B+ condition.

Due Diligence

The first step in a major renovation is a process called due diligence, intended to uncover all the needs and problems of the building and estimate the costs of correcting them. Understanding the detailed renovation needs of the building is very important because the owner wants a smooth process and no costly surprises. The due diligence period for a building being purchased is usually 45-60 days before closing is required. For a difficult property it might be up to 90 days. There is usually not time during the due diligence period to go through the permitting process. Owners or prospective owners rely on their architects and engineers, who are familiar with the requirements of the jurisdiction, to tell them what will be required to solve problems.

Approximate costs of due diligence, for a building such as Building X, are between $73,000 and $133,000 or between $0.60 and $1.09 per square foot as follows.

- Legal advice for contract, not dependent on size of building but on nature of the deal $25,000-75,000.
- Survey of property $2,000-3,000.
- Structural survey including all the building systems $10,000-15,000
- Concrete garage study for damage from chlorides $5,000
- Phase 1 environmental survey $3,000
- Phase 2 environmental survey for asbestos or groundwater contamination if indicated, another $3,000
- If a major renovation is going to be done architects and engineers need to be engaged during due diligence for another $25,000-30,000 before closing.

Renovation Costs for Building X

Building X is a 120,000 square foot, 1960's building which was recently completely renovated bringing it up from a low Class C market to near the top of Class B where it can compete with buildings near the bottom of the Class A market. Renovation included gutting down to the concrete floors and rebuilding. The total cost of renovation was $76 per square foot. As shown in the table, this included $1.1 million spent on the on the building's skin or exterior. The direct costs

of the work, excluding tenant improvements, totaled $4.9 million or $41 per square foot. Tenant improvements added $17 per square foot, a little above the standard rule of thumb of $15. Soft costs of contractors fees, permits, architecture, engineering, contingencies, etcetera added another $2.2 million or $18.66 per foot for a total cost of $9.2 million or $76 per square foot. While every building is unique and will have different costs, complete gut rehabs such as this contain a number of common elements in that all the major building systems are torn out and replaced with new systems. There will be variations in quality of materials and finishes and every building presents its own unique challenges and costs but these costs per square foot can be regarded as fairly typical for buildings of this general size and age.

Timing is very important during the whole renovation process. The length of the due diligence process is fixed by contract so it must be completed and a decision made to close on the building or not. The potential buyers of the building are often large institutions such as pension funds. These institutional buyers are very sensitive to problems that may hang up the renovation process. Not only is there a lot of money tied up without return during the renovation process but the timing of getting a building on the market at a certain stage of the cycle is very important to the competitive success of the building. Problems that may indicate long delays in the permit approval or construction process may cause the institutional buyer to drop out.

The costs of buying an old building and doing a quality renovation on it may nearly approach the cost of a new building. The cost differential usually ranges from five percent to thirty percent.

BUILDING X RENOVATION COSTS

CLASS C- TO CLASS B+ BUILDING REDEVELOPMENT
MONTGOMERY COUNTY MARYLAND

BUILDING NET RENTABLE SQUARE FEET **120,000**

BASE BUILDING WORK	**TOTAL**	**TOTAL PER NRSF**	
BUILDING EXTERIOR	$1,111,000	$9.26	
SITEWORK	109,000	0.91	
ROOFING	52,500	0.44	New roof.
DEMOLITION	147,000	1.23	Demolition to bare concrete slab.
MAIN LOBBY	78,000	0.65	
UPGRADE STAIRCASE	50,000	0.42	
BASE BUILDING PARTITIONS	102,000	0.85	
TENANT SIGNAGE	15,000	0.13	
TOILET ROOMS	230,000	1.92	Twenty-four toilet rooms.
ELEVATOR LOBBY TO MULTI TENANT FLOORS	21,000	0.18	
ELEVATORS	305,000	2.54	Three elevators.
MECHANICAL	1,532,000	12.77	All new systems.
FIRE PROTECTION	280,000	2.33	All new systems.
ELECTRICAL	730,000	6.08	All new systems.
GARAGE - NONSTRUCTURAL WORK	155,000	1.29	
DIRECT COSTS	4,917,500	40.98	
GENERAL CONDITIONS	200,000	1.67	
GENERAL CONTRACTORS FEE @ 4%	196,700	1.64	
PAYMENT & PERFORMANCE BOND	37,000	0.31	
TOTAL COST BASE BUILDING	5,351,200	44.59	

TENANT BUILD-OUT	**TOTAL**	**TOTAL PER NRSF**	
OFFICE SPACE BUILD-OUT	1,534,000	12.78	$17 per square foot of office.
RETAIL BUILD-OUT	305,000	2.54	
OTHER	157,000	1.31	
	1,996,000	16.63	
GENERAL CONDITIONS	82,000	0.68	
GENERAL CONTRACTORS FEE @ 4%	79,840	0.67	
PAYMENT & PERFORMANCE BOND	11,000	0.09	
TOTAL TENANT BUILD-OUT	2,168,840	18.07	

SOFT COSTS	**TOTAL**	**TOTAL PER NRSF**
BASE BUILDING ENGINEERING	65,000	0.54
BASE BUILDING ARCHITECTURE	117,000	0.98
OTHER DESIGN	10,000	0.08
MARKETING/ADVERTISING	55,000	0.46
PERMITS & FEES	40,000	0.33
CONSTRUCTION MANAGEMENT	150,000	1.25
TOTAL SOFT COSTS	437,000	3.64

BASE BUILDING CONTINGENCY	**TOTAL**	**TOTAL PER NRSF**
BASE CONTINGENCY @ 10%	795,704	6.63
ADDITIONAL CONTINGENCY	400,000	3.33
	1,195,704	9.96

RE-DEVELOPMENT TOTAL COST	**$9,152,744**	**$76.27**

II. Conversion to Residential Use

Requirements for Successful Conversion to Housing

The most extreme change that can be made to a building, short of demolition, is its conversion to another use. The first requirement for successful conversion of office to housing is that the office building has to be in an area that offers good support for housing. The American Planning Association's *Planning Advisory Service Memo*, January, 1997 article "Planning For Downtown Housing" gives guidelines for what is required for successful residential projects downtown. It does not specifically address adaptive reuse of older office buildings but discusses factors affecting downtown housing in general. The bullets below are largely quoted from that article.

The APA article identifies three categories of prospective tenants. The first two groups might be considered good market prospects for converted office buildings.

- Childless 25- to 45-year-old professionals, who work downtown and live there as a matter of convenience.

- Empty nesters, married couples who either chose not to have children or whose children are grown and have moved away. Many empty nesters are former suburbanites who view downtown living as an exciting alternative to the suburbs.

- Students and artists are also likely candidates for downtown living. Downtown universities attract students to nearby neighborhoods. However, students usually need low cost space and are therefore not natural candidates for office conversions which tend to be inherently expensive. Old industrial spaces, with their large windows and high ceilings appeal to artists looking for studios but most office conversions, with their low ceilings and expensive space, would not make good spaces for artists.

The APA article discusses five characteristics of areas which provide good neighborhood environments for residents.

- Community character. Several residential projects together, away from main thoroughfares, provide enough residents for a sense of community and a customer base to attract a variety of retailers.

- Parking. “Most downtown residents own a car even if they walk or use public transit for most of their transportation needs. The assurance of convenient parking is often the deciding factor for an individual considering a downtown move.”

- Public Transit. “People who move downtown will choose public transit, when available and convenient, as their primary method of getting to work.”

- Parks/Open Space. “Urban parks and open space provide residents opportunities to escape the feel of the city without having to leave their neighborhood.”

- Retail and Entertainment. “Downtown residents expect convenient access to retail stores and entertainment facilities. For example they might look for grocery stores, restaurants, and movie theaters when considering a move.”

Each proposed conversion would have to be evaluated for these neighborhood support and market characteristics. Many areas with neglected office space would not meet these livability criteria and, thus, not be good candidates for conversion to housing.

Building Design and Adaptive Reuse as Housing

There are some basic conflicts between optimal design for office and good design for housing. One of the basics is the size and shape of the floor plate of the building. Buildings that support conversion to apartments have a shallow enough depth to core to divide up into 1,000 to 1,100 square foot units with only a 30 to 35 foot depth to the core. For buildings with a central core this means a width of 80 feet or less. This allows more glass and natural light, an important factor in residential use. This is less than the optimal depth for an office building which might be 100 to 120 feet wide by about 250 feet long giving a 25,000 to 30,000 square foot floor plate and a 45 to 50 foot depth to core. Some of the older office buildings in the County have narrow shapes with their cores along one side. Measurement of each individual building would be required to evaluate for this factor although some of the older Class B and C buildings have smaller floor plates so may be more supportive of conversion from this standpoint.

However, office buildings that are small enough to provide adequate light are probably too small to provide enough units, at 1,000 square feet per unit, for the most efficient management . The rule-of-thumb is that 180-200 units in a complex is an efficient size for on-site management but many complexes operate with as few as 60-80 units. Fewer units per complex can be handled if a management company has several buildings or complexes in a small geographic area. Large apartment buildings usually have relatively narrow shapes that are inefficient for office operations. Considering these two conflicting requirements, mid-size office buildings with 35 foot or less depths to core are probably the best for conversion. Each building would have to be evaluated on its own.

Costs and Revenues

The conventional wisdom is that conversion of older office buildings to housing is difficult because it costs about as much as new construction and the financial returns are not as great as for continued use as office space. The low number of unsubsidized conversions suggests that the conventional wisdom is correct. There may be unusual cases where the numbers work and there have been some successful conversions using incentive packages to close the financial gaps.

M-NCPPC, Research & Technology Center, Class B & C Office Study

Feasibility of Renovation as Office Versus Conversion to Housing

		GRAMAX BUILDING		EASTERN AVE		PHILLIPS BUILDING	
		OFFICE	HOUSING	OFFICE	HOUSING	OFFICE	HOUSING
Gross Floor Area		144,640	144,640	193,275	193,275	103,767	71,362
Rentable area		130,176	130,176	173,948	173,948	93,390	60,390
Sq. Ft. per Unit			1,162		1,160		671
Gross Rent per Sq. Ft.		$14.00	$10.20	$13.00	$10.20	$23.00	$14.98
Gross Rent per Unit			$988		$986		$838
Operating Expenses		$6.59	$5.00	$6.52	$4.99	$6.59	$5.00
Vacancy Allowance		5.00%	7.00%	5.00%	7.00%	5.00%	7.00%
Stabilized Year Net Income	6.)	$916,374	$629,531	$1,070,824	$842,830	$1,455,903	$560,504
Overall Capitalization Rate	3.)	10.00%	12.00%	10.00%	12.00%	10.00%	12.00%
Indicated Value		$9,163,740	$5,246,093	$10,708,239	$7,023,585	$14,559,034	$4,670,865
Value per Sq. Ft.		$70.40	$40.30	$61.56	$40.38	$155.90	$77.35
Value per Unit			$46,840		$46,824		$51,898
Rehab & Conversion Costs		$12,995,904	$14,539,213	$17,365,759	$19,428,003	$7,886,267	$7,029,000
No. of Units			112		150		90
Cost per Sq. Ft.		$89.85	$100.52	$89.85	$100.52	$76.00	$98.50
Cash-on-cash return	4.)	7.05%	4.33%	6.17%	4.34%	18.46%	7.97%
Gap	5.)	($3,832,164)	($9,293,120)	($6,657,520)	($12,404,418)	$6,672,767	($2,358,135)
Rent Required for Feasibility		**$17.10**	**$1,880**	**$17.03**	**$1,875**	**$15.48**	**$1,119**
Cash-On-Cash Return		**10.00%**	**12.00%**	**10.00%**	**12.00%**	**10.00%**	**12.00%**
Percentage Change in Rent Req.		**22.13%**	**90.31%**	**30.99%**	**90.21%**	**-32.70%**	**33.63%**

3.) A factor used to reflect the 'return on' and 'return of' capital in an investment
4.) Defined as ratio of Stabilized Net Operating Income to Conversion Project Costs
5.) Defined as Indicated Value minus Rehab Project Costs
6.) Defined as Rentable area * Gross Rent per Sq. Ft. minus net operating expenses

Based on E.R.A. 7/96 Analysis of Gramax Building, Draft Executive Summary,
"South Silver Spring, Strategies for Revitalization," Sponsored by MC DHCA

The Pro Forma Table:

The above pro forma indicates that renovation of older office buildings for continued office use is much more financially feasible than conversion to housing. Conversion to housing costs more than renovation as office and the revenues are considerably lower. A change from office to housing only makes sense if:

1. The supply of older office buildings is very large and the demand so low as to preclude marketing the building as a renovated office space.

2. Substantial subsidies are available for conversion to residential use.

3. An identifiable market exists for the converted housing.

Some cities meet all of these conditions and are converting a few buildings to apartments.

This pro forma compares the feasibility of renovation as office use *vis-a-vis* conversion to residential use for three buildings in Montgomery County. The table is based on one in "South Silver Spring, Strategies for Revitalization," done by ERA for Montgomery County DHCA in July 1996.

Two of the buildings, the Gramax Heliport Building at 8060 13th Street and 7915-7923 Eastern Avenue are in south Silver Spring and the data for them are from the ERA report. (7915-7923 Eastern Avenue are actually two buildings built about six feet apart. They are treated as one combined building here.) The other building is the Phillips Building at 7900-7920 Norfolk Avenue in Bethesda's Woodmont Triangle.

The table gives the size of the buildings and the estimated number of units that would be achieved if converted to housing. In reviewing the pro forma the following definitions should be utilized:

- "Operating Expenses" include cleaning, regular repair and maintenance, grounds, security and administrative expense, and utilities for the office but not the apartments where tenants are assumed to pay directly.

- The "Stabilized Year Net Income" is the projected total income minus "Operating Expenses" for the year that the building is leased to its expected normal occupancy rate (100 percent minus the "Vacancy Allowance") of 95 percent for office or 93 percent for apartments.

- The "Indicated Value" of the building is equal to the "Stabilized Year Net Income" divided by the "Overall Capitalization Rate." The capitalization rate is higher for apartment use than for office use because apartments are considered riskier investments than offices, therefore a higher return is needed to induce investment.

- The "Cash-on-Cash Return" line is the "Stabilized Year Net Income" divided by the "Rehab & Conversion Costs" In other words the percentage of rehab costs that can be made back in net income each year. Except in the case of the renovation of the Phillips Building as office this fails to meet the standard of the "Overall Capitalization Rate."

- The line labeled "Gap" is the difference between "Indicated Value" and "Rehab & Conversion Costs." at the "Overall Capitalization Rate." A subsidy of this amount would bring the return to the target level.

- The three lines in the shaded area of the table show the rents required to make the "Overall Capitalization Rate" return.

The Gramax Building and Eastern Avenue Buildings

The Gramax Heliport Building at 8060 13th Street is at the south end of the Silver Spring business district. It was built in 1960 and was occupied by a federal government tenant. It is totally vacant and has been for sale for over four years. It is a 130,000 square foot, 15-floor high rise building. The Gramax building renovated as office has a revenue/expenditure "gap" of $3.8 million at the projected rent of $14 per square foot annually. To close this gap requires a 22 percent rent increase to $17.10. However, the conversion of the Gramax Building to housing has a much bigger gap. To close the gap of $9.3 million would take an increase in the monthly rent from $988 to $1,880 -- a 90 percent increase. The difference between the office renovation and housing conversion and renovation for Gramax is $5.5 million.

With an improvement of the south Silver Spring economic market one could imagine an increase in office rents from $14.00 to $17.10 (since Class B rents in the Silver Spring CBD now average $16.58 and go as high as $18.50). Such renovation is still far from a sure thing. On the other hand the average 1996 turnover rent at the Lenox Park, the newest high rise apartment building in Silver Spring, is $931. Even a handsomely converted and renovated Gramax would not equal the quality or location of Lenox Park. The $747 average 1996 turnover rent for all high rise units in the Silver Spring CBD is probably a better comparison. An average rent of $1,880 for a converted Gramax building seems impossible in the foreseeable future.

The story for the two adjacent buildings in the 7900 block of Eastern Avenue is virtually the same as for the Gramax Building. The difference between the office renovation and housing conversion and renovation for the Eastern Avenue buildings is $5.7 million.

The Phillips Building

The Phillips Building at 7900-7920 Norfolk Avenue in the Woodmont Triangle area of Bethesda was built in 1964 and was renovated as office in 1996. Its situation is better because of the strong Bethesda market. The $23 per square foot office rent its owners are receiving gives an estimated return of over 18%, at 95 percent occupancy, well above the target rate of 10% which would only require a rent rate of $15.48.

In 1995 the Montgomery Housing Partnership made a study of converting the Phillips Building to housing. They planned to convert the nine top floors of the eleven story structure to 90 apartments, plus community space, and have the lower floors developed as retail space. These floors average 8,000 square feet of space. The plans called for about 6,770 net square feet of apartment space per floor. They estimated the costs of rehabilitation to be $60 per square foot or $45,160 per unit, plus additional common area costs, for total development costs of $66,700 a unit. Total costs, including acquisition costs, development fee and renovation were estimated at $88,000 per unit. Estimated market rents average $14.98 per square foot annually or $838 per unit per month without utilities.

The proposed conversion to housing by the Montgomery Housing Partnership (MHP) was closer to market feasibility than the south Silver Spring buildings. It still fell short of market feasibility by $2.4 million or a rent difference of 33.5 percent. It is conceivable that this could have been accomplished if the office market had not been improving and the better return as an office renovation had not been perceived. Bethesda Place apartments get higher rents than Phillips would require but the Phillips units would not have been as well located and are very small, only 671 square feet compared to the standard 1,000 to 1,100 square feet. So the Phillips conversion still would have needed subsidy even if it didn't have to compete with the more economically feasible office use.

This MHP acquisition was not completed and Douglas Development Corporation bought the building for $2,150,000, or $23 per square foot, in December 1996 and renovated it as office space. Renovations included all life safety, HVAC, electrical and plumbing systems. All common area lobbies, restrooms, and elevators were refurbished and brought to current market and access standards. Total cost, including renovation, is estimated at a little less than $100 per square foot. From January to July 1997, 51% of the building has been leased at $23 per square foot.

Although these costs and revenue estimates are not definitive they indicate that costs are the same to renovate for either office or residential use. However, office use provides substantially greater revenue than housing, while operating costs per square foot for office and apartments are quite similar. The financials clearly favor office use, indicating that market supported conversion to housing takes an unusual set of circumstances.

III. Demolition

Sometimes the negative prospects for a building reach the point that demolition is considered the major alternative. Demolition is a strategy to reduce carry costs and potential liability in preparation for a long-term hold of the property or immediate redevelopment. The building's physical condition, the subsidy necessary to achieve a reasonable return on investment after rehabilitation or conversion and/or the negative market conditions affecting the property indicate chances for productive use are minimal.

In the down-County area, where most of the buildings in this category exist, the amount of floor area allowed in a new building is often considerably less than exists in the present building because of past down zoning. This provides a powerful incentive to keep the older building, which can be rehabbed within the existing shell, in hopes that future economics will favor renovation. Allowing retention of current density rights after demolition would encourage the removal of dilapidated buildings.

IV. Renovation Assistance Programs

Changes in zoning, flexibility in building code enforcement and related programs are some of the methods the County has employed to improve the disposition of the area's older office buildings. While many of the programs offered by the County are not specifically geared for older office buildings they have the potential of providing areas of relief and/or improvement.

Zoning Code Changes

Several changes to the County Zoning Ordinance have allowed for both a greater variety of commercial uses in existing office buildings as well as conversion to residential use, either by right or by special exception. In the CBD zones, in addition to allowing the conversion of a nonconforming office building to residential, the building's gross floor area may be marginally increased to improve lobbies and public waiting areas. Office buildings in the C-O zone may also be converted to residential use. In many of the commercial and industrial zones, residential uses are now permitted by special exception.

Building Code Flexibility

The applicability of current building code standards depends on whether the proposed construction is related to new or existing buildings. For an existing building where a change in use is considered, or the value of an alteration exceeds 25% of the building value, the building is required to be brought to current code standards. The Building Code itself provides for some flexibility in compliance. Chapter 34 of the Building Officials and Code Administrators National Building Code allows for the evaluation and possibility of an alternative strategy to achieve compliance. In addition, permitting staff will allow for alternative approaches to satisfy code requirements provided that the intent of the code is met.

Separate building code requirements relating to Life Safety for new construction and existing structures are also used. If an owner of an existing building is unable to meet a life safety requirement they may go through the "Exception Process," and offer compensationary action. The process allows for the possibility of waiving one code requirement by providing another or improving an existing life safety measure. Applications for exceptions are reviewed by committee.

Silver Spring Enterprise Zone

For properties located within the boundaries of the Silver Spring Enterprise zone, owners that make capital improvements to their property, may receive property tax credits on the increase in assessed value of the property for a period of ten years (declining scale). The minimum qualifying capital investment is $10 per square foot of building area improved, and at least 20% of total building floor area must be improved.

Businesses may also apply for State income tax credits for additional staffing. One-time state

income tax credit of $500 given for each newly-hired full-time employee or each employee relocated from outside Maryland; and state income tax credit of up to $3,000, over a three year period, for each economically disadvantaged employee hired to fill a newly-created job.

The County also offers a "Fast Track" review to all businesses needing a permit in the Silver Spring Enterprise Zone. A "Green Tape" team will be available to aid applicants through the various reviews and inspections by providing a customer service caseworker located in Downtown Silver Spring.

Other Programs

A number of DHCA run programs provide assistance to targeted areas within the County for commercial revitalization. Although these programs are not directly targeted for office buildings they may improve a marginally operating office building. Current programs in place include the County's Facade Easement Program and State funded Neighborhood Business Development Program.

The Facade Easement program provides capital to improve the exterior of older commercial buildings. A facade easement is purchased by the County with Federal Community Block Grant or project bond funds. Public sector financing is based on the owner's contribution.

The State funded "Neighborhood Business Development Program" provides gap financing for small business owners in designated areas. Eighteen commercial areas within the County are currently under review for inclusion to the program. Among other things, proceeds from the program may be used for real estate acquisition, renovation, or construction. Available financing ranges from $25,000 to $500,000.

APPENDIX A

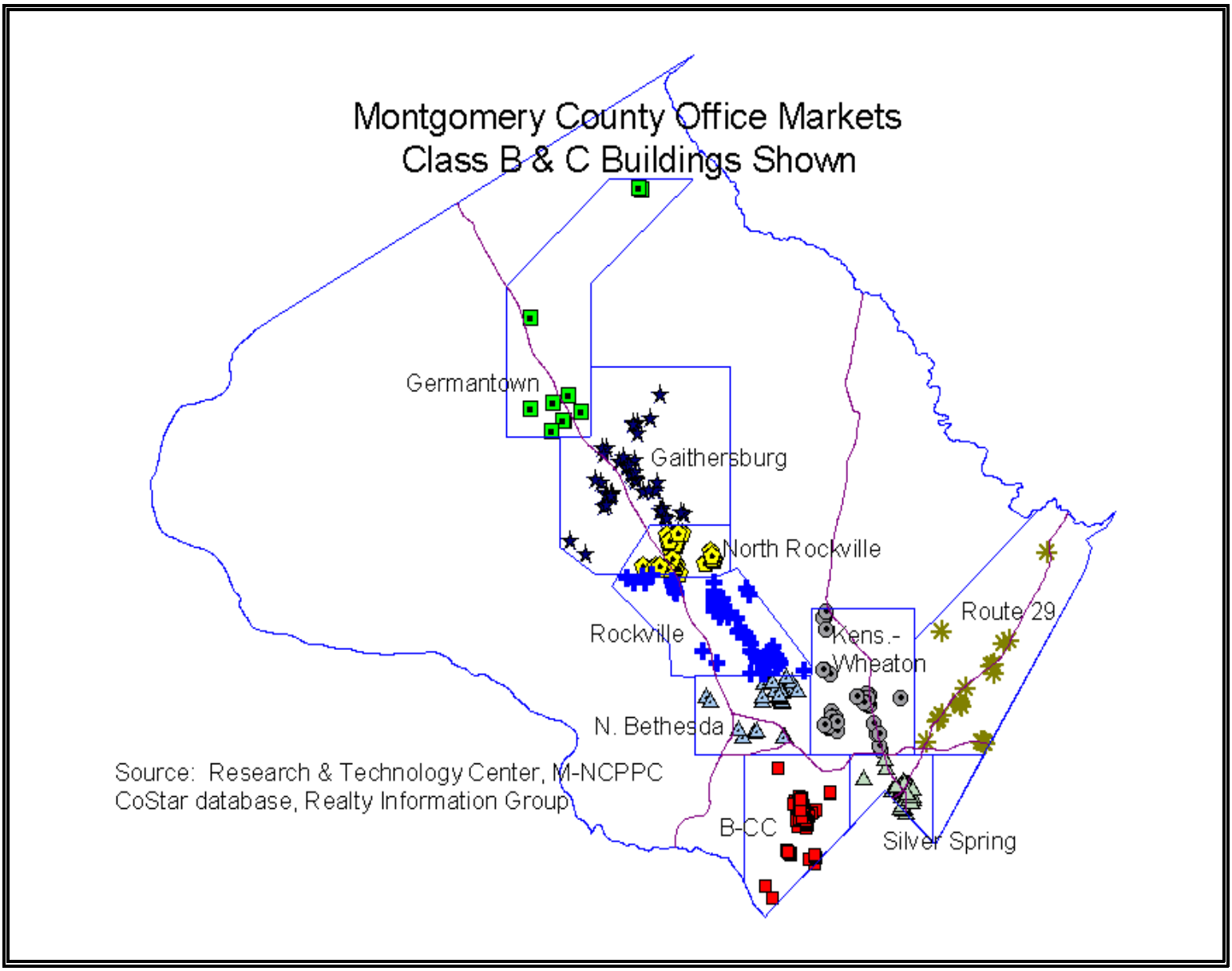
APPENDIX B

APPENDIX C

APPENDIX C

Profiles of Office Market Areas in Montgomery County

The following tables, graphs and commentaries cover present information on office markets in Montgomery County and its nine major office market areas. The data are from the early July 1997 edition of the CoStar database from the Realty Information Group. As a practical matter this report uses the classifications assigned to buildings by CoStar. Market areas with few office buildings (Olney, Poolesville, Potomac and Takoma Park) are not displayed. Brief commentary precedes each table. Vacancy rates include sublet space since this affects the market. The following Market Area Profile tables, graphs, and commentaries cover the County and nine major market areas.


Montgomery County Office Markets
Class B & C Buildings Shown
Germantown
Gaithersburg
North Rockville
Rockville
Kens.-
Wheaton
Route 29
N. Bethesda
B-CC
Silver Spring
Source: Research & Technology Center, M-NCPPC
CoStar database, Realty Information Group

Montgomery County Office Market Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	162	23,903,499	147,552	5.5%
Class B	266	16,845,059	63,327	6.4%
Class C	192	6,108,707	31,816	6.5%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	4	456,000	114,000	98.4%
Class C	11	603,021	54,820	99.4%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	1,131,434	857,068	322,604	458,892
Class B	362,270	684,791	537,503	341,432
Class C	79,716	62,998	101,719	39,074

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	5.5%	1,311,100	1,195,175	115,925	2
Class B	6.4%	1,075,151	842,253	232,898	4
Class C	6.5%	397,394	305,435	91,959	18

Rent Levels of Occupied Buildings (w/o Sublet)

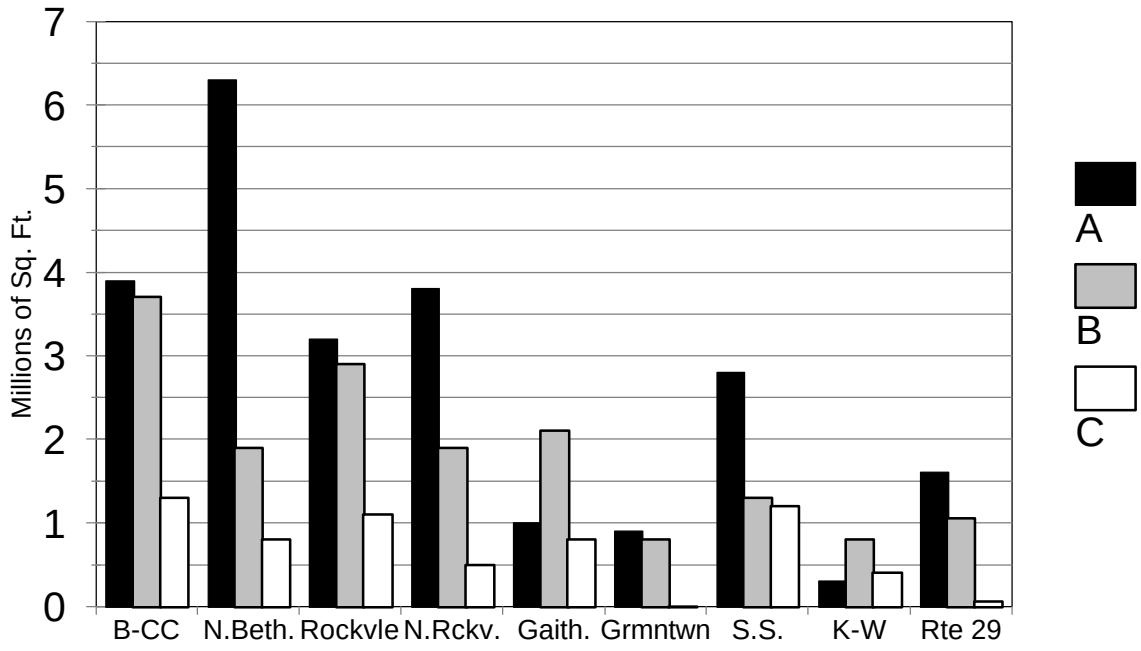
	Average Rent	Percent of Class A Rent	High Rent
Class A	$20.66	100%	$31.00
Class B	$17.99	87%	$40.00
Class C	$14.44	70%	$22.35

Proposed Buildings:

	Delivery	Office Space
1 Building	16-18 Months	60,000
177 Buildings	Beyond 24 Mo.	26,910,612
Total		26,970,612

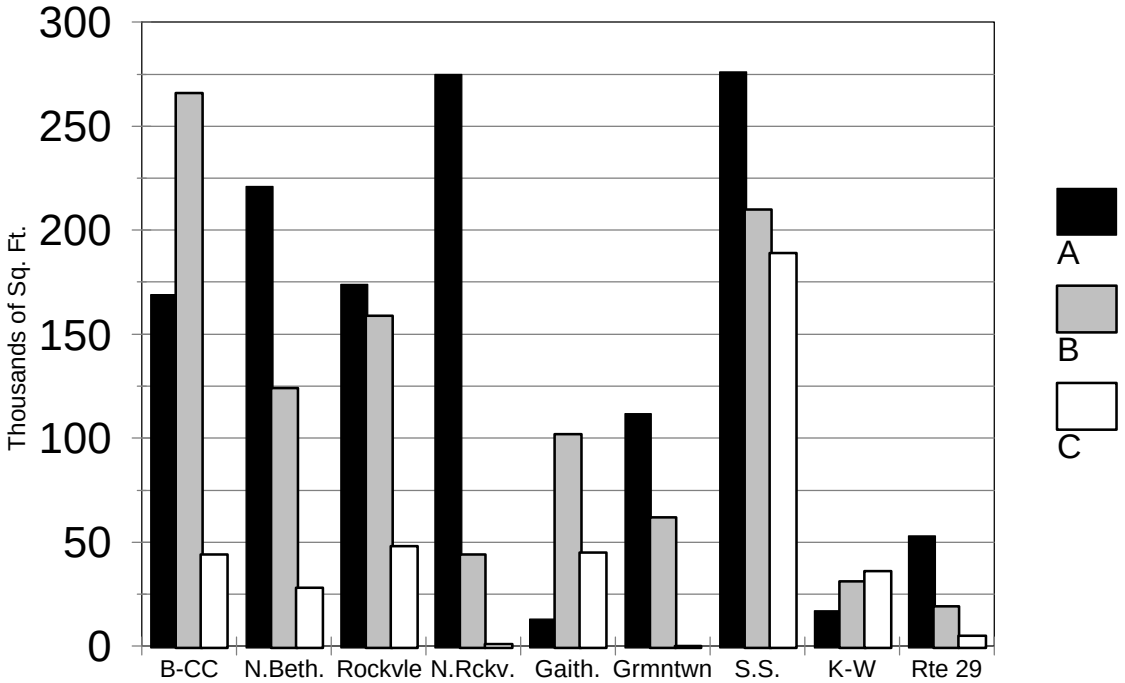
Office Space by Market Area & Class

In Occupied Buildings



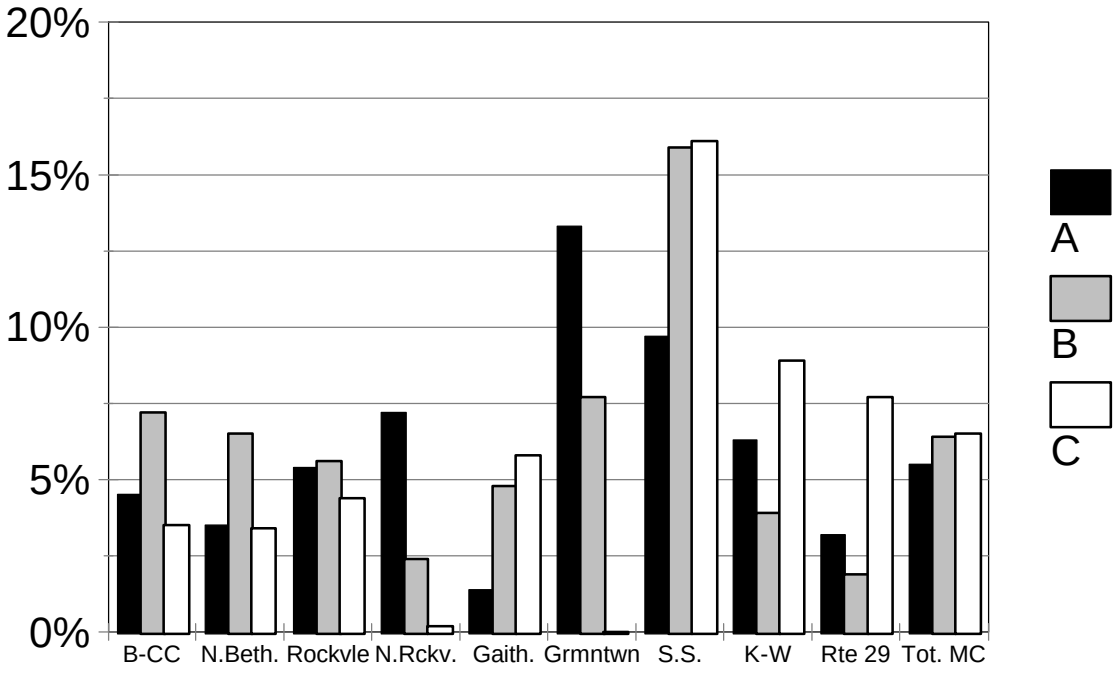
Vacant Space in Occupied Buildings

by Market Area and Class



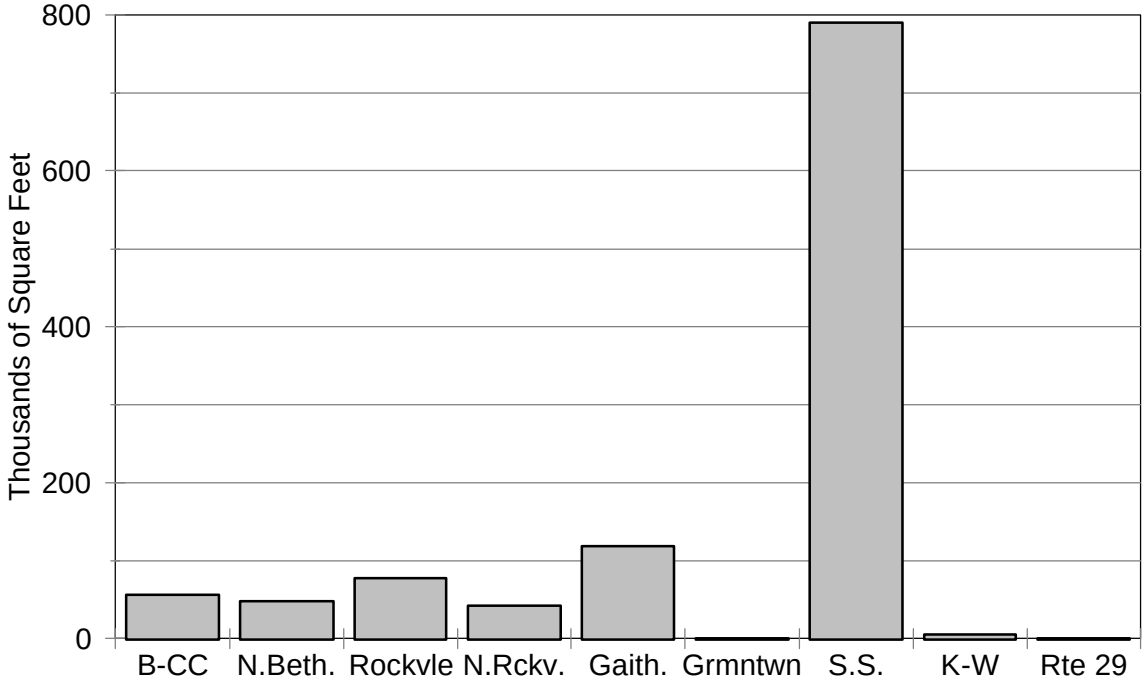
Vacancy Rates in Occupied Buildings

by Market Area and Class



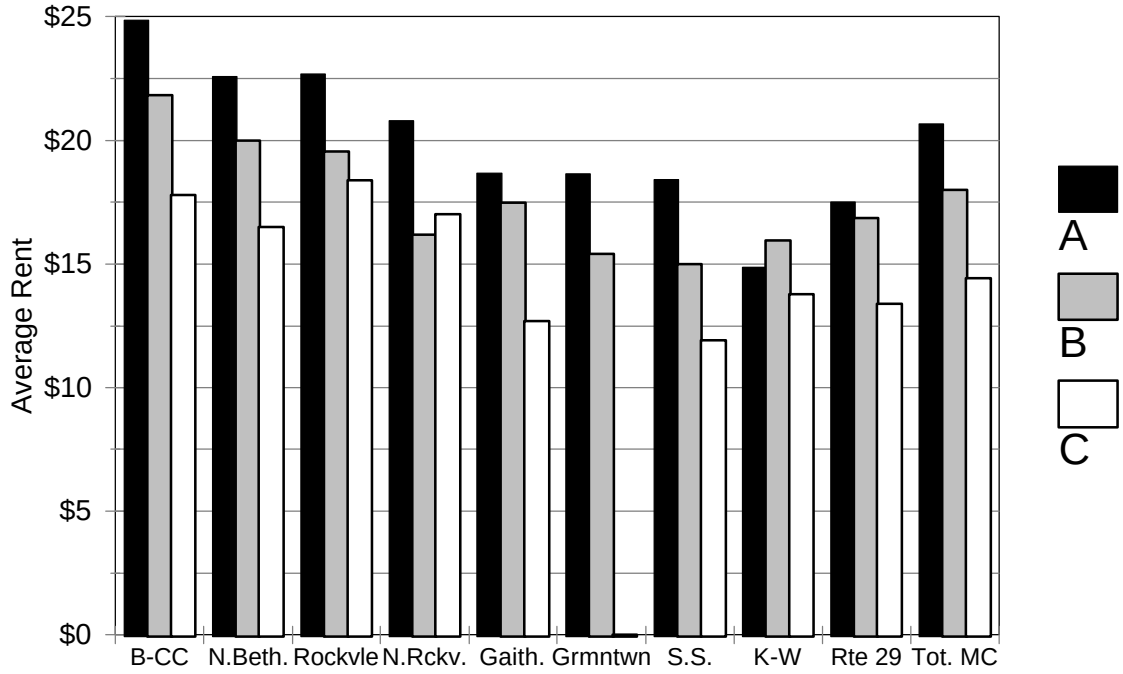
Empty Buildings

Space by Market Area



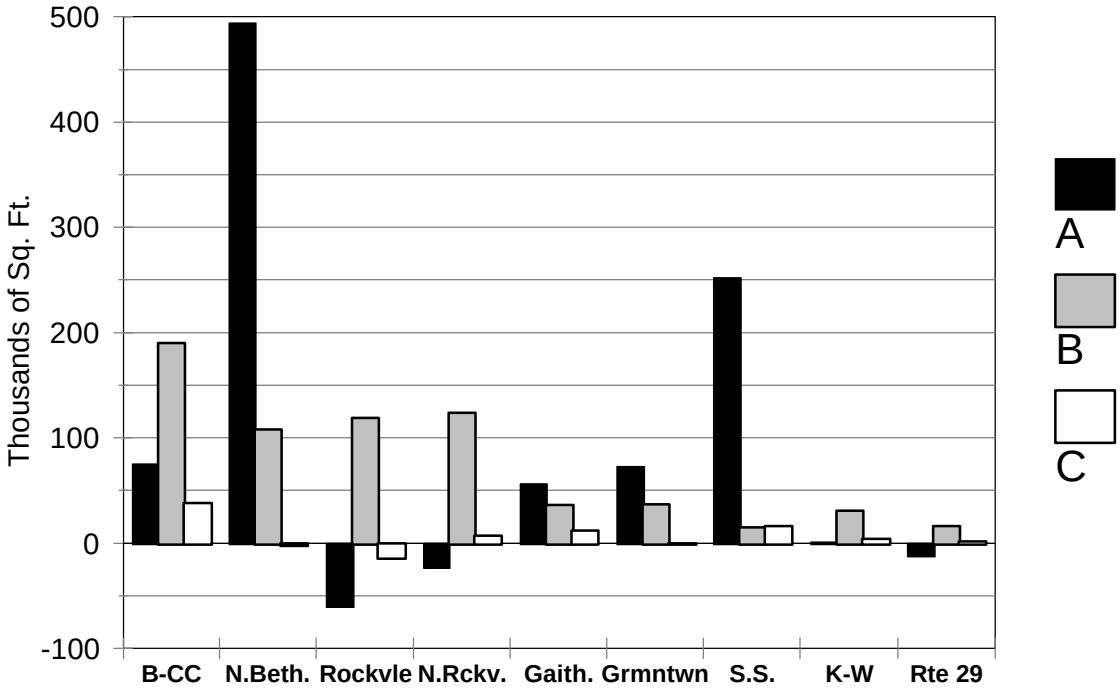
Average Rents

By Market Area and Class



Net Absorption of Vacant Space

In Past Year by Market Area and Class



Bethesda-Chevy Chase Market Area

This market area covers the Bethesda-Chevy Chase Planning Area located inside the beltway, west of Rock Creek. Total office space in the market is 8.8 million sq. ft. in 104 buildings. The principle office areas are the Bethesda CBD and Friendship Heights. It is second only to North Bethesda in total office space.

B-CC is one of the strongest market areas. It has the highest average Class A and Class B rents in the County. Its Class A and Class C vacancy rates are already below the five-percent norm. Class B, with a 7.2 percent vacancy rate, had 190,000 sq. ft. of absorption in the past 12 months.

The highest Class A rents reached $31 in June, high enough to support new construction. The Fairmont Building on Old Georgetown Road was completely renovated from vacant, Class C- condition to B+ over the past year and was 98 percent leased by the time it opened in June. This quick lease up time indicates the strength of the market. No additional buildings are due for delivery in the next two years and with strong demand rent spikes are likely on lease renewals. In the past three months there have been several rent increases of about $1.00 per sq. ft. in Bethesda.

There are five proposed office buildings in the B-CC area in CoStar, representing 1,338,392 sq. ft. net space. The 280,000 sq. ft. Francis G. Newlands (ex Lorenz) Building is slated for September 1999 completion, the others merely indicate delivery beyond 24 months or past July 1999.

There are two small empty Class C buildings, averaging 25,000 sq. ft. One is being demolished to make way for the Newlands building and the other is being sold for renovation as soon as approvals are granted.

Bethesda-Chevy Chase Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	24	3,879,785	161,658	4.5%
Class B	39	3,700,959	94,896	7.2%
Class C	41	1,254,166	30,589	3.5%

Vacant or Near Vacant Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	0	-	-
Class B	0	0	-	-
Class C	2	49,741	24,871	100.0%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	(44,000)	74,919	29,868	67,878
Class B	116,996	189,516	159,823	126,091
Class C	(19,316)	37,827	32,419	10,117

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	4.5%	169,373	193,989	(24,616)	0
Class B	7.2%	266,210	185,048	81,162	5
Class C	3.5%	43,996	62,708	(18,712)	0

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$24.84	100%	$31.00
Class B	$21.82	88%	$26.50
Class C	$17.79	72%	$22.35

Proposed Buildings:

	Delivery	Office Space
2 Bethesda Metro Center	Sep-99	280,092
Montgomery Ave at East-West Hwy	> July '99	24,000
7501 Wisconsin Ave.	"	750,000
7600 Wisconsin Ave.	"	190,000
7251 Wisconsin Ave.	"	94,300
Total		1,338,392

North Bethesda Market Area

The North Bethesda market area corresponds loosely to the North Bethesda Planning Area with the exception that Montrose/Randolph Roads and north are in the Rockville market area. It also includes two small buildings near Seven Locks and Tuckerman. Concentrations of office space occur in Rock Spring Park, Executive Boulevard, and along Rockville Pike.

This area's 9.1 million sq. ft. is the largest concentration of office space in the County. Class A space is dominant with 6.3 million sq. ft., by far the largest concentration of Class A in the County.

This is a very strong market with Class A and Class C vacancy rates well below five percent in July 1997. Absorption has been strong in all classes, particularly in the past six months with 380,000 sq. ft. absorbed and only 374,000 sq. ft. left available.

Rental rates average $22.59 for Class A space with a high of $25.00, approximately the rate needed to support new construction of two to four story campus style buildings, but well short of the $31 thought to be required for high rise.

One 60,000 sq. ft. building is scheduled for completion in January 1999 at Rockville Pike and Montrose Road. Another 1.7 million sq. ft. are proposed for completion beyond July 1999, almost all of it clustered in and around Rock Spring Park. New construction is expected to begin soon in this market since several of the proposed buildings have been planned for some time.

North Bethesda Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	29	6,342,585	218,710	3.5%
Class B	21	1,902,797	90,609	6.5%
Class C	21	827,567	39,408	3.4%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	1	48,000	48,000	100.0%
Class C	0	-	-	-

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	597,822	494,377	183,902	109,839
Class B	108,932	107,956	106,423	41,362
Class C	54,424	(1,607)	23,093	15,102

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	3.5%	221,363	317,129	(95,766)	0
Class B	6.5%	124,435	95,140	29,295	3
Class C	3.4%	28,443	41,378	(12,935)	0

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$22.59	100%	$25.00
Class B	$19.98	88%	$23.00
Class C	$16.50	73%	$16.50

Proposed Buildings:

	Delivery	Office Space
6720 Rockledge Dr	> Jul '99	423,508
6730 Rockledge Dr	"	280,797
6740 Rockledge Dr	"	260,000
Fernwood Rd, Marriott Int'l HQ Parc 1	"	220,000
Fernwood Rd, Marriott Int'l HQ Parc 2	"	220,000
Rockledge Dr @ Rock Spring Dr, Rock Spring Center	"	100,000
Motor City Dr @ Westlake Ter., Vaswani Place, Ph 2	"	80,000
11919 Rockville Pike, 1 Montrose Metro Ph 2	Jan '99	60,000
5001 Nicholson Ln, Nicholson Center	> Jul '99	45,000
10411 Fernwood Rd.	"	40,000
Total		1,729,305

Rockville Market Area

The Rockville market area has a number of concentrations including the city center, south Research Blvd. Rockville Pike north of Montrose Road, the Parklawn area and the new area at Montrose and I-270. After North Bethesda and Bethesda-Chevy Chase, Rockville has the largest amount of office space: 7.2 million square feet, with 55 percent in 86 Class B and C buildings. The 3.2 million sq. ft. of Class A space is concentrated in 14 buildings averaging 230,000 sq. ft.

Rockville is a strong market with vacancy rates for all three classes of space close to the five percent norm. Average rents are very close to those of the North Bethesda market area. Class A rents are clustered tightly near the area high of $24.50, and approximately the level required to support new construction in a campus setting. Absorption of space is mixed positive and negative as might be expected when space is 95 percent occupied and most transactions are lease turnovers rather than absorption of vacant space.

Fourteen proposed projects could add 6.4 million square feet of space. None are slated for the next two years. They are predominantly clustered around Montrose Road at I-270 with 3.5 million sq. ft. and Middle Lane near the city center with 2.2 million sq. ft.

Rockville Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	14	3,228,330	230,595	5.4%
Class B	46	2,860,699	62,189	5.6%
Class C	40	1,102,384	27,560	4.4%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	0	-	-	-
Class C	1	22,375	22,375	100.0%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	(245,566)	(59,887)	(13,670)	111
Class B	56,034	119,486	24,812	17,958
Class C	(18,308)	(13,013)	(6,852)	(14,878)

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to Absorb @ Rate of Past 12 Mo.
Class A	5.4%	174,238	161,417	12,822	n.a.
Class B	5.6%	159,444	143,035	16,409	2
Class C	4.4%	48,417	55,119	(6,702)	6

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$22.67	100%	$24.50
Class B	$19.56	86%	$40.00
Class C	$18.39	81%	$21.00

Proposed Buildings:	Delivery	Office Space
Montrose Rd @ I-270, Tower Oaks	> Jul '99	2,000,000
Montrose Rd @ I-270, Fortune Parc	"	1,500,000
E Middle Ln @ Hungerford Dr, Rockville Metro	"	825,000
Rockville Pike @ Middle Ln, Rockville Cntr 2	"	530,000
Rockville Pike @ Middle Ln, Rockville Cntr 1	"	427,500
Rockville Pike @ Middle Ln, Rockville Cntr 3	"	375,000
460 Hungerford Dr.	"	220,000
5630 Fishers Ln., Ph II	"	130,000
1445 Research Blvd, Research Plaza	"	104,748
12530 Parklawn Dr, Parklawn Metro Center	"	83,374
5635 Fishers Ln.	"	75,000
Tower Oaks Blvd	"	60,000
Montrose Rd @ Tower Oaks Blvd.	"	20,000
107 W Jefferson St.	"	9,800
Total		6,360,422

North Rockville Market Area

The North Rockville market area is clustered around the Shady Grove Road and I-270 interchange. This area is famous for research and development, particularly in biotechnology. There is 6.2 million sq. ft. of office space in this area, 62 percent of it Class A. There are only seven Class C buildings with less than 500,000 sq. ft. of total space.

This is another strong market area. Class B and C vacancy rates are extremely low, well below five percent and with only 45,000 sq. ft. of remaining vacant space in occupied buildings. The Class A vacancy rate is 7.2 percent with absorption in the last six months of 218,000 sq. ft. with only another 83,000 sq. ft. remaining above the five percent level. There is only one empty building in the area, Class C of 42,000 sq. ft.

Rents for Class A space are close to supporting new construction in the low- to mid-rise style typical of this area. Class B and C rents are in the upper teens. There is 8.3 million sq. ft. of proposed space, the bulk of it located at the old King Farm and the Washingtonian.

North Rockville Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	33	3,847,834	116,601	7.2%
Class B	31	1,874,381	60,464	2.4%
Class C	7	486,015	69,431	0.2%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	0	-	-	-
Class C	1	41,784	41,784	100.0%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	436,166	(22,009)	76,365	135,652
Class B	(32,904)	124,266	130,151	60,193
Class C	22,646	7,061	2,762	10,837

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	7.2%	275,056	192,392	82,664	n.a.
Class B	2.4%	44,088	93,719	(49,631)	0
Class C	0.2%	1,098	24,301	(23,203)	0

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$20.78	100%	$24.50
Class B	$16.18	78%	$18.50
Class C	$17.00	82%	$17.00

Proposed Buildings:	Delivery	Office Space
I-270, Irvington Ctr	> Jul '99	3,200,000
Washingtonian Blvd	"	3,000,000
Washingtonian Blvd, Three Washingtonian Center	"	500,000
9509 Key West Ave, Decoverly Bldg 7	"	282,000
9417 Washingtonian Blvd, Two Washingtonian Center	"	270,000
2273 Research Blvd., Research Office Ctr Ph 3	"	175,000
2103 Gaither Rd., Park Plaza at Shady Grove, Ph 2	"	125,535
9501 Key West Ave, Decoverly Bldg 3	"	120,000
9230 Corporate Blvd, Shady Grove Exec Ctr 8	"	120,000
9220 Corporate Blvd, Shady Grove Exec Ctr 7	"	120,000
15215 Diamondback Dr., Decoverly Bldg 8	"	105,500
9700 Decoverly Dr, Decoverly Bldg 6	"	72,900
Crabbs Branch Way, Franklin Office Park 3	"	63,000
1398 Picard Dr	"	60,918
2403 Research Blvd., Research Office Park 3	"	30,000
2451 Research Blvd., Research Office Park 2	"	27,000
Total		8,271,853

Gaithersburg Market Area

The Gaithersburg market area has much less office space than the areas in the Bethesda-Chevy Chase through North Rockville part of the corridor. Class B makes up 55 percent of the total 3.87 million sq. ft., followed by Class A with 25 percent and Class C with 20 percent. It is one of only two areas with more Class B than Class A space.

The area's vacancy rates are low with moderate absorption. The Class A space is virtually full (1.4 % vacant) and the B and C space is near the normal five percent vacancy level. The high rents in Class A are at $19.50, well below the $24-26 level needed to support new construction. There have been a few modest increases in rent levels over the past three months in response to the tight market. There are three vacant Class B and C buildings in the area, totaling 119,000 sq. ft.

Over 2.2 million square feet of office space is proposed for the area, mostly around the Route 28 and Quince Orchard Drive area.

Gaithersburg Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	14	985,683	70,406	1.4%
Class B	32	2,114,904	66,091	4.8%
Class C	21	766,935	36,521	5.8%

Vacant or Near Vacant Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	0	-	-
Class B	2	92,000	46,000	100.0%
Class C	1	27,000	27,000	100.0%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	91,110	56,458	43,471	127,168
Class B	(15,910)	35,673	52,591	60,981
Class C	(3,658)	12,312	38,974	7,946

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	1.4%	13,485	49,284	(35,799)	0
Class B	4.8%	101,500	105,745	(4,245)	0
Class C	5.8%	44,785	38,347	6,438	6

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$18.67	100%	$19.50
Class B	$17.47	94%	$18.00
Class C	$12.68	68%	$15.00

Proposed Buildings:

	Delivery	Office Space
Orchard Ridge Dr., Quince Orchrd Corp Pk	> Jul '99	1,800,000
Orchard Ridge Dr., Ridges 2	"	100,000
Rt 28 @ Quince Orchard Rd, Kentlands	"	92,000
Grt. Seneca Hwy @ Long Draft, Ch. Ch. Bnk	"	63,000
Professional Dr. @ Rt 355, Overlook Building	"	62,000
65 W Watkins Mill Rd, Bennington Corp. Ctr.	"	47,800
55 W Watkins Mill Rd, Bennington Corp. Ctr.	"	38,000
Game Preserve Rd @ Rt 355, McShea & Co., Inc.	"	10,000
Total		2,212,800

Germantown Market Area

This area has 1.7 million sq. ft. of office space in 26 buildings approximately evenly split between Class A and B. There are no buildings rated as Class C.

Germantown has the highest Class A vacancy rate in the County (13%) and its Class B rate (7.7%) is second to Silver Spring's. Still, excess space in the market has been absorbed at moderate but steady rates, reducing the Class A vacancy rate by 8.5 percentage points in the past year and 21 percentage points in the past three-and-a-half years. The Class B rate has been cut by 4.5 percentage points in the past year. If the absorption of the past year continues, the vacancy rates will be down to 5 percent within 11 months for Class A and 7 months for Class B.

The rental rates are modest with Class A rates near $19, about equal to Silver Spring and Gaithersburg. These rents will increase as the market continues to tighten but they have a long way to go before they reach the $24-26 needed to support new construction.

A significant 6.1 million square feet of office space is proposed for Germantown, 3.7 times the existing size of the market. At the absorption pace of the last twelve months it would take 56 years to absorb that much space.

Germantown Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	11	854,894	77,718	13.3%
Class B	15	802,343	53,490	7.7%
Class C	None	-	-	-

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	0	-	-	-
Class C	0	-	-	-

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	53,126	72,979	26,499	51,069
Class B	11,750	36,536	26,425	4,601
Class C	-	-	-	-

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	Jul '97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	13.3%	111,630	42,745	68,885	11
Class B	7.7%	61,514	40,117	21,397	7
Class C	-	-	-	-	-

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$18.63	100%	$19.00
Class B	$15.41	83%	$18.00
Class C	-	-	-

Proposed Buildings:

	Delivery	Office Space
I-270 @ Rt 118 & Rt 27, Seneca Meadows Corp. Ctr.	> Jul '99	2,000,000
Father Hurley Blvd., Waters Landing Corp. Park	"	1,300,000
Rt 355 @ Rt 27, Milestone	"	1,000,000
I-270 @ Rt 121, Gateway 270 Business Center	"	1,000,000
Middlebrook Rd., Trevlon Corp. Park, 3-5	"	450,000
Rt. 118	"	125,300
Rt. 118, Germantown Business Park, 1	"	125,000
Rt. 118, Germantown Business Park, 2	"	60,000
Rt. 118, Germantown Business Park, 3	"	46,600
I-270 @ Rt 118, Cloverleaf Ctr., Ph 1	"	19,600
Total		6,126,500

Silver Spring Market Area

Silver Spring is currently the weakest office market in Montgomery County. There are 81 occupied office buildings in the Silver Spring market area as defined by the CoStar real estate database plus nine empty or nearly empty buildings. The overall vacancy rate for the 90 buildings in the area, including sublet space and nine empty buildings, is 24 percent.

Silver Spring's CBD is not considered a prime location for most businesses. Its Class A rents are over six dollars lower than Bethesda-Chevy Chase's. The twice unsuccessful ten-year effort to find a suitable developer for the core of the CBD, the once threatened demise of NOAA, and other image problems have plagued the market. However, strong office absorption over the first six months of 1997, in all three Classes, indicate that the recovery is underway. Hopefully, proposed public investment at the Transit Center, a proposed new campus for Montgomery College, other public initiatives and proposed private investments will give increased upward momentum to the area's real estate market. The new public private initiative for the core site is gaining momentum.

Fourteen of the market are Class A buildings and contain over half the rentable area of all 90 buildings. The Class A buildings had a vacancy rate of 9.7 percent in July, 1997. 252,000 square feet has been leased in the past year to reduce their vacancy rate from 18.6 percent. If this absorption rate continues, the Class A vacancy rate will be down to the normal 5 percent within 6 months. There are no empty Class A buildings in Silver Spring. Although the Class A absorption and vacancy is good it has not pushed rents up anywhere near the levels needed to support new construction. The average rents for Class A space are $18.40 per square foot and the highest rent is $22.00, a long way from the $31.00 needed to support new construction in a CBD.

The Class B and C buildings are not doing as well. Their vacancy rate is about 16 percent for occupied buildings and there are nine empty buildings with nearly 800,000 square feet of space. Most fully vacant buildings are not currently in the office market since they need full renovation before they are likely to be leased and such renovation takes about a year to accomplish.

In the past six months, a net of 16,000 square feet of Class B space was absorbed; virtually no space was absorbed in the six months before that. Over the past three-and-a-half years, Class B space was absorbed at a modest net annual rate of 26,800 square feet for a total of 94,000 square feet or 7.1 percent of the total space in Class B occupied buildings. In the month prior to July 7, 1997 there was only one office rent change in the Silver Spring CBD, an increase from $14.00 to $14.50 in a 10,000 square foot, Class B building -- a small positive sign.

In the past six months, 15,000 net square feet of Class C space was absorbed; virtually no space was absorbed in the six months before that. For the past three-and-a-half years the average annual net absorption for Class C space in Silver Spring has been about 12,500 square feet for a total absorption of about 44,000 square feet or only 4 percent of the space in occupied buildings. At current rates it would take eight years to absorb all the Class C space in occupied buildings.

Note: Silver Spring has an additional 778,119 square feet of Class B and C office space in unoccupied buildings which are not included in the numbers presented in this area analysis. Their vacancy for more than 12 months removes them from the "effective" market.

Silver Spring Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	July '97 Vacancy Rate
Class A	14	2,842,926	203,066	9.7%
Class B	27	1,315,314	48,715	15.9%
Class C	40	1,174,168	29,354	16.1%

Vacant or Near Vacant Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	July '97 Vacancy Rate
Class A	0	0	-	-
Class B	1	316,000	316,000	98.0%
Class C	6	462,119	77,020	99.2%

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	223,704	251,834	(8,827)	(35,114)
Class B	29,974	14,802	17,345	26,832
Class C	31,530	16,277	4,715	12,560

Vacancy of Occupied Buildings

	Vacancy 7/97 Rate	Vacancy 7/97 Sq. Ft.	5% Vacancy Sq. Ft.	July '97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	9.7%	276,020	142,146	133,874	6
Class B	15.9%	209,540	65,766	143,774	117
Class C	16.1%	189,113	58,708	130,405	96

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$18.40	100%	$22.00
Class B	$14.99	81%	$18.50
Class C	$11.91	65%	$16.50

Proposed Buildings:

	Delivery	Office Space
Georgia & Colesville, Moore & Assoc.	> Jul '99	740,000
8711 Georgia Av., Zalco Realty	"	124,000
Total		864,000

Kensington-Wheaton Market Area

The Kensington-Wheaton market area has the least amount of office space of the market areas covered in this report -- 1.5 million sq. ft. of space in 47 mostly small buildings. More than half the space is in Class B buildings.

The Class B vacancy rate is 3.9 percent with moderate absorption in the past year. Class B asking rents are actually higher than the Class A rents in the area. The Class A and Class C vacancy rates are a little above the five percent norm and their absorption has been slow. There are only two tiny empty buildings in the area and only one 10,000 square foot building is proposed. This will not be a major growth area in the County's office market.

Kensington-Wheaton Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	8	271,255	33,907	6.3%
Class B	21	804,779	38,323	3.9%
Class C	18	408,628	22,702	8.9%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	0	-	-	-
Class C	0	-	-	-

Annual Absorption of Occupied Buildings

	At Annual Rates			
	last 6 mo.	last year	last 7 qrtrs	last 3.5 years
Class A	5,564	650	3,401	13,308
Class B	50,622	30,748	3,854	(3,762)
Class C	17,052	3,590	2,934	(4,475)

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	6.3%	17,165	13,563	3,602	67
Class B	3.9%	31,266	40,239	(8,973)	0
Class C	8.9%	36,147	20,431	15,716	53

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$14.87	100%	$20.00
Class B	$15.94	107%	$25.00
Class C	$13.79	93%	$20.00

Proposed Buildings:

	Delivery	Office Space
Georgia Ave @ Weisman Rd.	> Jul '99	10,000
Total		10,000

Route 29-Eastern County Market Area

The Route 29-Eastern County market area has 2.8 million square feet of space in 39 buildings. This is a large area geographically with buildings in Burtonsville, Fairland, White Oak, and Hillandale. More than half of the space is in 14 Class A buildings and there are only three small Class C buildings. The remainder are Class B.

The Class A and Class B vacancy rates are well below the five percent norm. Absorption has been low to moderate indicating that vacancy rates have been low for some time. At $17.52 this area has the second lowest average Class A rents in the County.

Only two buildings are proposed, both in the West Farm project near Route 29 and Randolph Road. One will be owner occupied by Kaiser Permanente. The other is 100,000 square feet. It does not look as though this area will be an important growth area in the County's office market in the next few years. In the longer view, the consolidation of the federal Food and Drug Administration at the old Naval Surface Warfare facility in White Oak will provide a modest economic impetus to the area. However, best estimates are that construction of this facility is still years in the future.

Route 29 Market Area Profile

Occupied Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	14	1,638,207	117,015	3.2%
Class B	22	1,056,628	48,029	1.9%
Class C	3	60,844	20,281	7.7%

Empty or Near Empty Buildings

	Buidings Count	Rentable Area Sq. Ft.	Average Size	7/97 Vacancy Rate
Class A	0	-	-	-
Class B	0	-	-	-
Class C	0	-	-	-

Annual Absorption of Occupied Buildings

	At last 6 mo.	Annual Rates last year	last 7 qrtrs	last 3.5 years
Class A	7,508	(12,253)	(18,403)	(11,020)
Class B	17,356	15,843	12,559	5,599
Class C	(4,866)	1,273	2,943	2,072

Vacancy of Occupied Buildings

	Rate Vacancy 7/97	Sq. Ft. Vacancy 7/97	Sq. Ft. 5% Vacancy	7/97 - 5% Difference	Months to 5% @ Rate of Past 12 Mo.
Class A	3.2%	52,770	81,910	(29,140)	0
Class B	1.9%	19,725	52,831	(33,106)	0
Class C	7.7%	4,673	3,042	1,631	15

Rent Levels of Occupied Buildings (w/o sublet)

	Average Rent	Percent of Class A Rent	High Rent
Class A	$17.52	100%	$19.00
Class B	$16.84	96%	$23.00
Class C	$13.39	76%	$17.00

Proposed Buildings:

	Delivery	Office Space
Broadbirch Dr., Westfarm, Carroll Bldg	>Jul '99	100,000
Plum Orchard Rd @ Broadbirch Dr., Kaiser Permanente (owner occupied)		294,873
Total		394,873

APPENDIX D

APPENDIX D

Inventory of Renovated Class B & C Office Buildings

Renovated Class B & Class C Office Buildings **(8/19/97 data)**

Address	Market Area	Class	Stories	Yr. Built	Yr. Renovated	Rentable Area	Floor Size	SF Available	Vacancy Rate	Asking Rent
4630 Montgomery Ave	Bethesda/Chevy Chase	B	6	1950	1996	31,568	5,515	0	0%	
7979 Old Georgetown Rd	Bethesda/Chevy Chase	B	11	1966	1996	52,237	6,500	15,502	30%	$19.50
7801 Norfolk Ave	Bethesda/Chevy Chase	C	3	1958	1991	15,000	3,750	0	0%	
5480 Wisconsin Ave	Bethesda/Chevy Chase	B	15	1967	1991	35,639	11,000	2,188	6%	$19.75
4915 Auburn Ave	Bethesda/Chevy Chase	C	3	1974	1989	24,033	9,000	0	0%	
7220 Wisconsin Ave	Bethesda/Chevy Chase	B	4	1960	1986	39,445	9,861	9,832	25%	$19.00
4930 Del Ray Ave	Bethesda/Chevy Chase	B	6	1964	1986	32,012	5,200	0	0%	
6935 Arlington Rd	Bethesda/Chevy Chase	B	5	1958	1985	41,291	8,326	16,310	40%	$20.00
7307 MacArthur Blvd	Bethesda/Chevy Chase	C	2	1958	1982	22,000	11,000	0	0%	
11426-11428 Rockville Pike	North Bethesda	B	4	1972	1992	54,000	13,000	2,059	4%	$18.00
11420 Rockville Pike	North Bethesda	B	4	1971	1991	42,000	10,500	2,284	5%	
801 Thompson Ave	Rockville	C	4	1960	1998	48,000	12,000	48,000	100%	
17 W Jefferson St	Rockville	B	3	1986	1991	22,950	7,650	2,475	11%	$17.00
170 Rollins Ave	Rockville	C	2	1964	1991	6,000	3,000	6,000	100%	$17.50
2 Metro Center Pl	Rockville	B	2	1985	1989	115,000	57,500	0	0%	
51 Monroe St	Rockville	B	21	1979	1988	212,000	11,000	28,966	14%	$18.75
121 Congressional Ln	Rockville	B	6	1970	1981	52,100	10,000	12,151	23%	$20.84
4 Research Pl	North Rockville	C	3	1970	1990	78,035	23,145	0	0%	
444 N Frederick Ave	Gaithersburg	B	4	1982	1990	70,000	17,500	6,788	10%	$17.00
1 Bank St	Gaithersburg	B	3	1973	1988	32,457	10,819	5,000	15%	$17.00
7 Dalamar St	Gaithersburg	B	2	1970	1985	20,000	10,000	5,000	25%	$11.00
8728 Colesville Rd	Silver Spring	B	13	1969	1994	124,451	9,741	97,340	78%	$15.00
801 Wayne Ave	Silver Spring	B	4		1990	27,000	6,750	6,750	25%	$15.00
1104 Spring St	Silver Spring	C	3	1962	1989	15,000	5,000	852	6%	$12.00
8630 Fenton St	Silver Spring	B	13	1971	1989	262,707	21,063	32,253	12%	$16.28
8101 Georgia Ave	Silver Spring	B	2	1941	1989	20,000	10,000	0	0%	
8830 Cameron St	Silver Spring	B	6	1968	1987	37,364	6,627	7,523	20%	$14.00
816 Thayer Ave	Silver Spring	C	3	1962	1986	11,000	3,666	0	0%	
1111 Bonifant St	Silver Spring	B	3	1962	1982	10,560	3,520	1,517	14%	$14.50
7981 Eastern Ave	Silver Spring	C	4	1959	1979	80,000	20,000	80,000	100%	$12.00
4110 Aspen Hill Rd	Kensington/Wheaton	B	3	1978	1990	27,000	9,000	0	0%	
10400 Connecticut Ave	Kensington/Wheaton	B	6	1965	1988	55,000	9,800	14,504	26%	$14.34
11160 Veirs Mill Rd	Kensington/Wheaton	B	7	1963	1986	72,000	10,000	10,138	14%	$17.00
11161 New Hampshire Ave	Route 29	B	4	1970	1990	21,347	5,335	1,800	8%	$17.00
1620 Elton Rd	Route 29	B	2	1970	1988	12,000	6,000	0	0%	
344 W University Blvd	Route 29	B	3	1971	1987	23,500	7,500	1,095	5%	$18.50
Totals & Averages			**5.3**	**1967**	**1989**	**1,844,696**	**10,841**	**416,327**	23%	**$16.56**

ACKNOWLEDGMENTS

Montgomery County Park and Planning Department

Rodney H. Irwin, Director
Drew Dedrick, Chief, Research and Technology Center

Project Team

Frederick R. Peacock, Research Coordinator, Author
Tonia R. Bleecher, Assistant to the Director
Lembit Jogi, Research Planner

Other Staff

Sally Roman, Research Coordinator
Lonnie Rorie, Research Planner
Charles Coleman, Reproduction