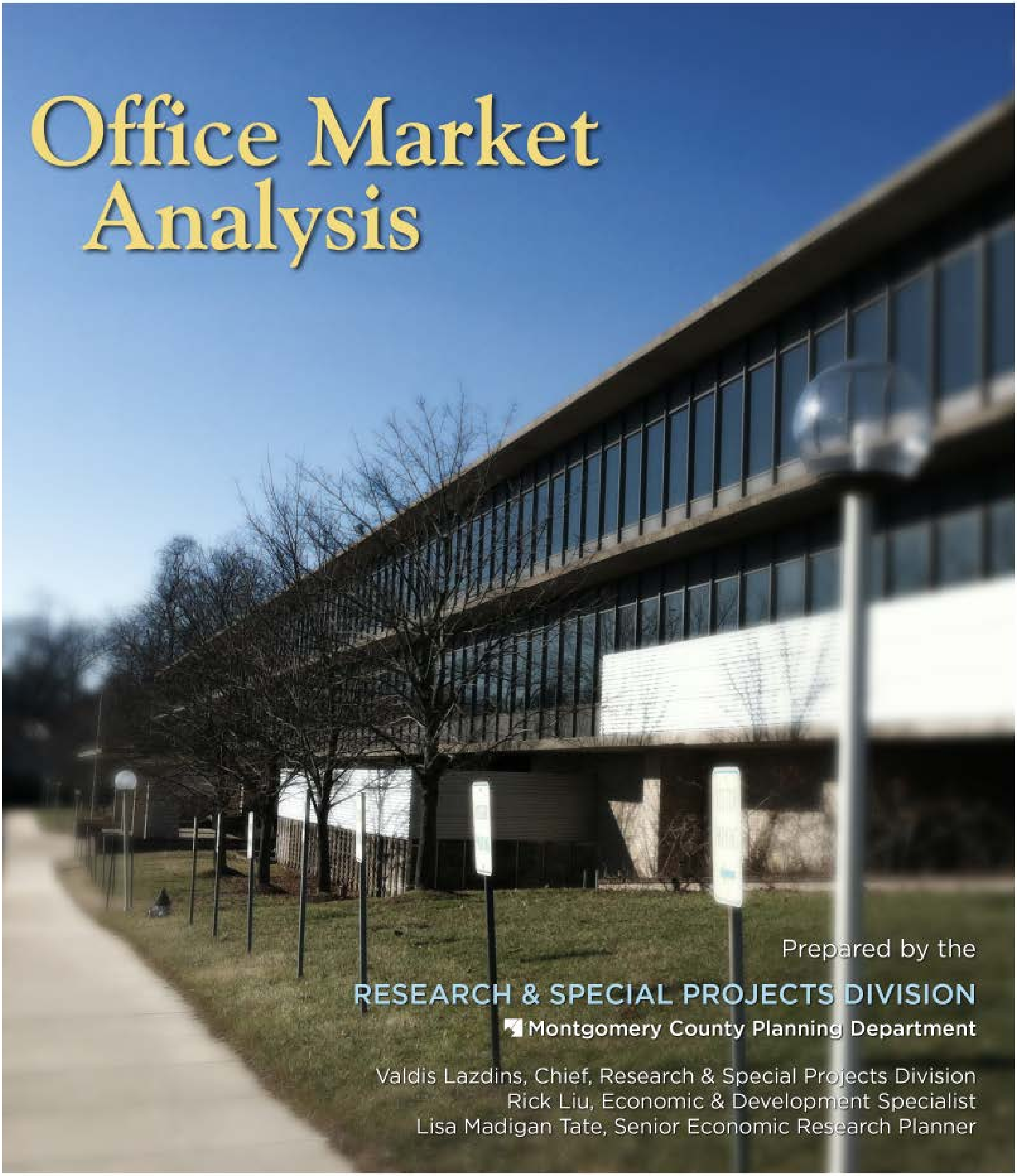
MONTGOMERY PLANNING

market STUDIES

aspen hill minor master plan amendment

May 2015



Office Market Analysis

Prepared by the

RESEARCH & SPECIAL PROJECTS DIVISION

Montgomery County Planning Department

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INTRODUCTION

This report assesses the general feasibility for future office uses within the proposed Aspen Hill Minor Master Plan Amendment (MMPA) area. It focuses on whether the market is likely to absorb existing vacant office space or support construction of a comparable amount of new office space in Aspen Hill as a whole and on the BAE/Vitro site in particular.

METHODOLOGY AND ASSUMPTIONS

This analysis begins by examining key trends shaping office demand in general and quantifies existing levels of office supply and demand in the region. The analysis then assesses the economic feasibility of large scale office use in Aspen Hill. It gauges Aspen Hill's ability to attract office users relative to alternative locations, given tenant preferences regarding transit accessibility, building design and proximity to commercial centers. Site-specific challenges to reusing, retrofitting or replacing office space in the MMPA area also are discussed.

IMPACT ON DEMAND FOR OFFICE SPACE IN ASPEN HILL

A long period of sustained economic growth and market adjustments may be needed to absorb the existing vacant office inventory in the regional economy, indicating that there will likely be fierce competition for office tenants in the foreseeable future. Changing office tenant location preferences also have put suburban centers that lack Metrorail access or a strong non-retail commercial presence—such as Aspen Hill—at a significant competitive disadvantage.

It is important to note that the BAE/Vitro property, which accounts for most of Aspen Hill's office inventory, was custom-built for a large, federal defense contractor at a time when there was less risk associated with long-term leases. In the current market climate, it would be particularly difficult to attract a tenant large enough to absorb all of its 242,000 square feet of office space. Most tenants who do not want to co-locate with other users are seeking smaller buildings that can be customized to their needs, as well as proximity to business partners as well as Metrorail.

The BAE/Vitro building's current interior layout (e.g., oddly placed stairwells and wall partitions) was designed for a unique user and would be obsolete and unappealing to contemporary tenants. Because the building was constructed with reinforced concrete, the cost of retrofitting these features to accommodate a new tenant would be unusually high.

Subdividing the building into a multi-tenant property would also be cost-prohibitive because it would require removing nearly all existing building components and essentially creating a new code-compliant structure over the existing foundation. This option would be more expensive than fully demolishing and building anew. Even then, it would be extremely challenging to find multiple tenants, given the overall weakness in the current office market.

Based on these factors, it can be reasonably concluded that the market probably will not absorb the existing block of vacant office space or support the construction of a new or replacement office space in the MMPA area in the near future. Limited demand may exist for community-serving office uses, such as a medical or a professional building.

OFFICE MARKET OUTLOOK

National Office Market Assessment

Despite a brighter economic climate in recent years, office users nationwide are choosing to maintain smaller physical footprints. Government and private sector tenants alike are consolidating operations, lowering their square foot-per-employee ratios, taking on new space more slowly and negotiating shorter-term leases.

These trends are driven by more than a desire to reduce occupancy costs. Telecommuting, new technologies and changing workplace designs (such as unassigned work spaces and smaller, impromptu meeting spaces) make it easier for employers to use space more intensively, but also appeal to workers seeking more flexible, creative and collaborative work environments.

Changing tenant preferences for office locations and building characteristics also are fundamentally reshaping the office market. Companies want to co-locate with clients and suppliers, reinforcing the pull of existing business clusters. Tenants increasingly favor more attractively designed, greener and transit-accessible office spaces.

Newer spaces in higher density, mixed-use environments are best positioned to compete for these tenants. Older or obsolete properties, especially those located outside business clusters, are at a growing competitive disadvantage.

Medical offices may be an exception to the move to smaller, centralized and transit-centered offices. Demand for non-hospital healthcare space will be robust over the long term due to an increase in patients insured under the Affordable Care Act (ACA) and continued growth in the senior population. Medical providers increasingly favor suburban locations that are convenient and accessible to patients, fostering a boom in medical office construction--according to Colliers International, 25 percent of all office space under construction in the nation is medical office space.

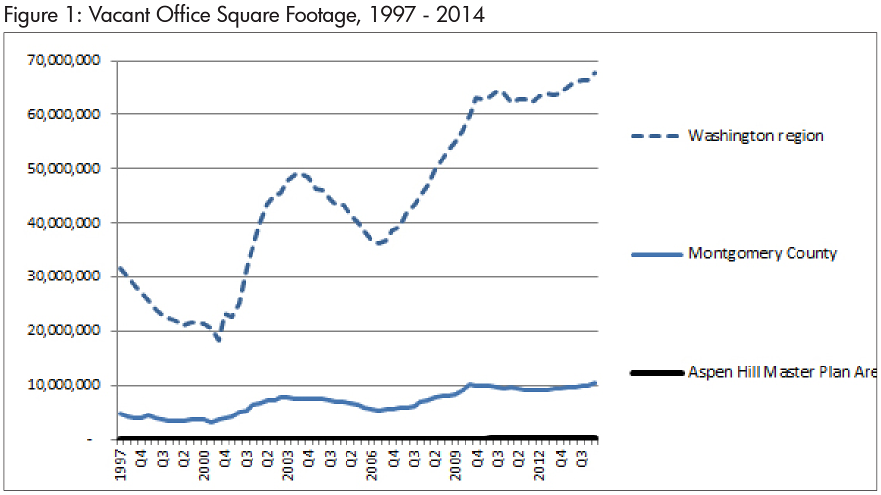
This category of demand will not necessarily cure rising vacancy rates in existing suburban office buildings, as ACA compliance demands and cost containment are expected to spur consolidation in both healthcare and insurance industries, potentially creating vacancies in medical and office buildings currently occupied by smaller providers. Medical offices have higher build-out costs and other increasingly specialized space requirements; newer and larger healthcare establishments typically prefer build-to-suit over existing office structures, and close proximity to retail centers.

Regional Office Market Assessment

The vacant BAE/Vitro property represents a very minor part of the surplus of office space within Montgomery County and the Washington, DC metropolitan region. Currently, there is roughly 10 million square feet of vacant office space in Montgomery County and nearly 70 million square feet of vacant space in the Washington, DC metro region as a whole (Figure 1).

Part of this surplus can be attributed to the lingering impacts of an unusually long economic recession and federal budget cuts to hiring and leasing activity. Long development cycles and project costs make it difficult to quickly adjust the delivery of new space to market changes, adding to the oversupply.

Figure 1: Vacant Office Square Footage, 1997 - 2014



Source: CoStar as of 1Q 2014

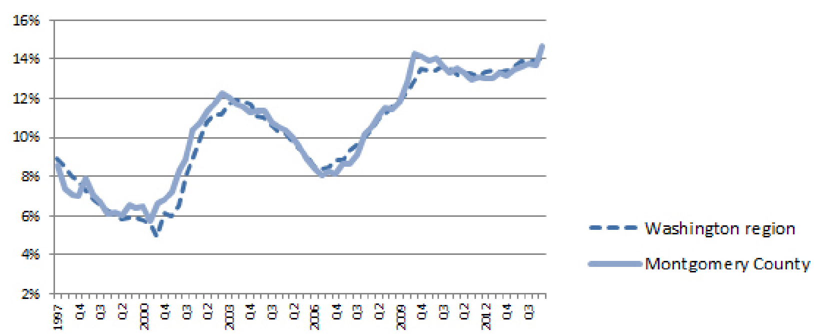
Even so, such "normal" market ups and downs do not fully explain the office glut. As shown in Figure 2, there has been a persistent rise in office vacancy rates across multiple business cycles over the past two decades, an indication that broader trends are contributing to the current oversupply of office space.

The federal mandate for reducing office footprints is likely to only increase the vacancy rate: consolidation of federal space is expected to release 1 million square feet of space into Montgomery County's office market alone. The current record-high 13.7 percent office vacancy rate for Montgomery is consistent with weakness in the office market region-wide (Figure 3).

Aspen Hill Office Market Assessment

The 242,000-square-foot office building currently on the BAE/Vitro site accounts for the vast majority of office inventory in Aspen Hill. Consequently, the loss of the building's sole tenant in 2010 and the owner's reported inability to re-lease the space has had an outsized impact in Aspen Hill, where the vacancy rate has hovered at around 71 percent. The BAE/Vitro vacancy has pushed the vacancy rate in its wider Kensington-Wheaton office submarket to around 25 percent (Figure 4).

Figure 2: Regional Office Vacancy Trends, 1997 - 2014



Source: CoStar as of 1Q 2014

Figure 3: Office Vacancy Rate - Washington, D.C. Region

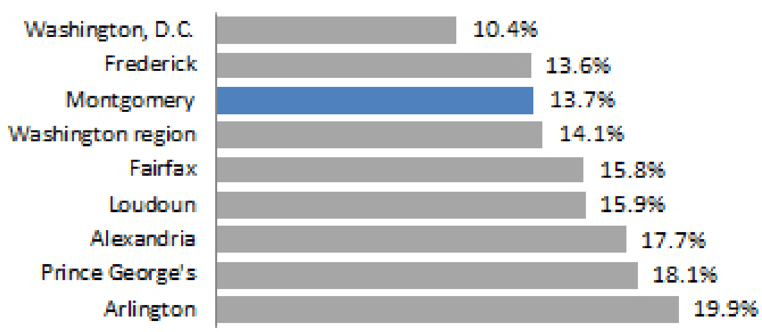
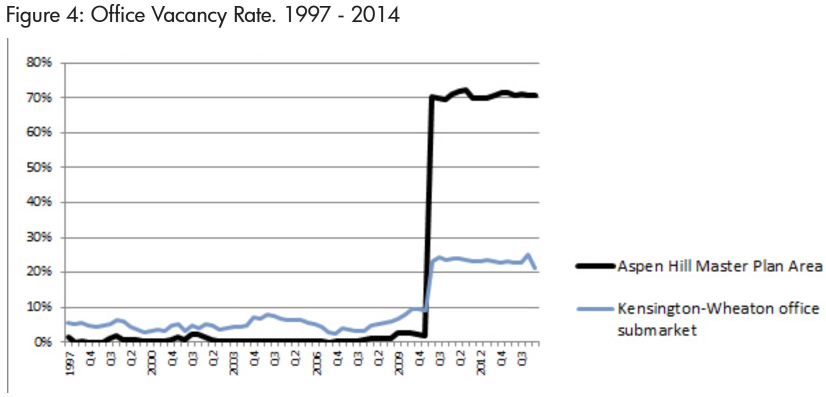


Figure 4: Office Vacancy Rate. 1997 - 2014



Source: CoStar as of 1Q 2014