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Real Estate A Special Report

A Tale of Two Cities

As the D.C. market expands, the chasm between haves and have-nots shrinks.

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The recent debate about the feasibility of locating the new major league baseball stadium in Southeast Washington highlighted the dichotomy between two very different real estate markets that coexist in Washington, D.C.

The premier office buildings and high-end residential developments that populate the corridor running from Georgetown to the Capitol have propelled the District to the very top of the list of the most desirable real estate markets in the world. Not more than a few miles away are blighted neighborhoods with substandard housing and rundown commercial establishments.

This chasm has existed for decades and remains a serious problem. But now, for a variety of reasons, these two markets are beginning to converge, as prominent commercial developers and institutional investors pursue developments in the District's so-called emerging neighborhoods.

The District's commercial real estate market has historically been dominated by the federal government and the so-called Three A's—attorneys, accountants, and associations. Notwithstanding the explosion in suburban development that began in the late 1970s and continues to this day, those same tenants remain the pillars of the downtown D.C. office buildings.

Recent studies indicate that the Washington office vacancy rate of 7.1 percent in the fourth quarter of 2004 was the lowest in the nation among major metropolitan areas, and less than half the national average for all central business districts in the United States. Washington leasing rates, averaging $41.15 for Class A office space, are among the highest in the world, and further increases are predicted for 2005.

These numbers have made Washington one of the top office investment markets, both nationally and internationally. In 2004, Washington was the favorite U.S. market for foreign real estate investors, ranking ahead of New York, Los Angeles, and San Francisco.

Such prosperity has had its downside. The growing demand for D.C. properties and the ready availability of investment capital has driven prices to historically high levels, and it is not unusual for Class A office buildings to attract 20 or more qualified bidders, many willing to pay all cash and settle on short notice with little or no due diligence. The fierce competition for existing properties, together with a dwindling supply of developable sites in the traditional downtown area, have made finding suitable commercial investments increasingly difficult and expensive.

Coupled with the strength of the office market, the residential market in the District has undergone a renaissance in recent years. Young, highly educated, and highly paid professionals and affluent "empty-nesters" eager to live near the proliferating cultural and entertainment venues have stoked the demand for apartments and condominiums in and near downtown. Historically low interest rates have helped to fuel the residential boom, and developers have responded with record numbers of new and renovated condos and apartment projects.

As with the commercial market, however, such high demand, coupled with a shortage of available sites in the downtown area, have pushed up prices and have caused developers to look at neighborhoods that were not historically associated with high-end housing, such as the 7th Street corridor, the Mount Vernon Triangle, and 14th and U streets.

In the past, the robust commercial real estate market in Washington's central business district has not spread to the city's lower-income communities, commonly known as "the neighborhoods." The contrast between the robust commercial real estate market and the neglected neighborhoods could not be more striking.

The low-income neighborhoods are filled mostly with single-family homes, town homes, and apartment projects where many live without the benefit of shopping centers or other conveniences taken for granted in the affluent parts of Washington. Many of these neighborhoods have some of the charms of a small Southern town, but for the most part these neighborhoods are beset with the problems plaguing many inner cities around the country—poverty, crime, drugs, and rundown schools.

There have been valiant efforts to regenerate these neighborhoods over the years. Funds from public programs were funneled into the neighborhoods through Department of Housing and Urban Development Community Development Block Grants and local D.C. housing programs. Local banks sought to satisfy their Community Reinvestment Act obligations by making mortgage loans available to residents and local development groups. Low income tax credits have also been used to finance new housing.

In addition, many nonprofit organizations and community development corporations are on the scene in a sincere effort to better the lives of the local residents. These efforts have started producing some tangible benefits. Until recently, these advances have, by and large, focused on improvements to the housing stock and have not promoted meaningful commercial or retail development or new jobs.

Reverse of the Spiral

The downward spiral in these neighborhoods started to reverse itself about a decade ago. The construction and completion of Good Hope Marketplace east of the Anacostia River, which is anchored by a Safeway supermarket, was a harbinger of this reversal of fortune. Although federal and city financing was needed to get that project off the ground, its success has demonstrated both the overdue need for more shopping centers in these areas and their commercial viability. Nonetheless, the pace of change in the neighborhoods has not kept up with the rapid growth in the commercial core in the District, and the gap between these two markets has widened further over the past 10 years.

Against this gloomy record, we are finally beginning to see a confluence of factors that will support a growing revitalization of the local D.C. neighborhoods. A key factor is the scarcity of land for new development and the skyrocketing prices for the available land.

The unquenchable appetite of D.C. real estate developers for land at reasonable prices has already pushed the boundaries of commercial development beyond the traditional core center. For instance, we now have the MCI Center on 6th Street, N.W., the new Convention Center in the Mount Vernon Triangle, and the massive development occurring in the Southeast Federal Center site. The growing demand for more office space and apartments close to the city center is inexorably pointing toward Anacostia and other parts of northeast and southeast Washington as the next logical places for development.

Other factors contributing to this trend include the disillusionment of many people with the crushing commutes to distant suburbs, the overall resurgence of the city itself, and the increased confidence in the city government. Although still only in its incipient stages, we are beginning to see a growing convergence of these formerly very separate markets.

Some new development in these areas is already under way. Many new projects are still only in the pre-development stage and have yet to get off the drawing boards. But for those involved in the local real estate market, the signs of this advancing trend are unmistakable. In addition to the new baseball stadium, several commercial developers who have built many of the large office buildings defining the Washington skyline are now seriously bidding for sites and projects in areas they would not have considered even five years ago.

In addition, the capital needed to fund new construction has become available in ample amounts, both as a result of low interest rates and the Treasury Department's New Markets tax credits program, which provides tax credits for commercial developments in lower-income communities.

In addition to the numerous housing transactions, developers are talking about office and retail developments planned for the Anacostia business district, and at the Rhode Island Avenue and the Benning Road Metro stops. Retail development is progressing at the Camp Simms site in Southeast Washington. More retail is also planned for the Skyland site across from the Good Hope Marketplace in Southeast.

Arts and Culture

Furthermore, in addition to conventional commercial development, the builder community has been enlisted to support cultural development in moderate-income communities. Building Bridges Across the River, a nonprofit organization formed by the William C. Smith Co., is putting the finishing touches on The Arc, a stunningly beautiful, 110,000-square-foot, $25 million development that will provide space for programs run by the Levine School of Music, the Washington Ballet, the Corcoran School of Art, the Boys & Girls Clubs of Greater Washington, Covenant House Washington, the Children's Health Project of D.C., Parkland Community Center, Washington Middle School for Girls, and the Washington School of Psychiatry. On Benning Road, the housing developer A&R THC, in collaboration with the D.C. Housing Authority, has plans for the East Gate Cultural Arts Center, a 25,000-square-foot facility where youth will receive training for music engineering, recording, fashion design, and the visual arts.

Despite the impetus for major changes in the emerging neighborhoods, there are many obstacles that could stymie significant development in this market. Political wrangling and inertia remain a significant impediment. Similarly, the often-conflicting demands of the nonprofits and local community groups, with their competing missions, have caused more than one developer to walk away from projects in the neighborhoods. Moreover, if the economy goes into a major recession, or if there is another terrorist attack, the demand for these new areas could lose momentum.

The coming transformation of the neighborhoods, even if successful, will pose a new set of problems. One challenge already being given serious consideration, in the public and private sectors, is the need to maintain and increase affordable housing—especially at a time when government assistance is dwindling. Another challenge will be the need to find the funds to finance the massive investments in new roads, bridges, and other infrastructure that will be required for all this new development.

So the tale of these two markets seems to have come nearly full circle. The relentless growth of the commercial core of the city is, finally, spurring the rejuvenation of the "other" market in the District. In a city that sends forth government programs to address the nation's problems, it is ironic that the private economy is playing a pivotal role in solving one of Washington's most intractable problems.

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