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Transcript of Washington REIT
Fourth Quarter 2017 Earnings Conference Call
February 16, 2018

Participants
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Steve Riffee – Executive Vice President and Chief Financial Officer
Drew Hammond – Vice President & Chief Accounting Officer
Tom Bakke – Executive Vice President and Chief Operating Officer

Analysts
Dave Rodgers – Robert W. Baird
Jed Reagan – Green Street Advisors
Chris Lucas – Capital One Securities
Michael Lewis – SunTrust

Presentation

Operator
Welcome to the Washington Real Estate Investment Trust year-end 2017 Earnings Conference Call. As a reminder, today's call is being recorded. Before turning over the call to the company's President and Chief Executive Officer, Paul McDermott, Tejal Engman, Vice President of Investor Relations will provide some introductory information. Ms. Engman, please go ahead.

Tejal Engman – Vice President, IR
Thank you and good morning everyone. Please note that our conference call today will contain financial measures, such as FFO, core FFO, NOI, Core FAD and adjusted EBITDA that are non-GAAP measures as defined in Reg G. Please refer to our most recent financial supplement and to our earnings press release, both available on the Investor page of our website, and to our periodic reports furnished or filed with the SEC, for definitions and further information regarding our use of these non-GAAP financial measures, and a reconciliation of them to our GAAP results.

Please also note that some statements during this call are forward-looking statements within the Private Securities Litigation Reform Act. Forward-looking statements in the earnings press release, along with our remarks, are made as of today, and we undertake no duty to update them as actual events unfold. Such statements involve known and unknown risks, uncertainties, and other factors that may cause actual results to differ materially. We refer to certain of these risks in our SEC filings. Please refer to pages 9 – 24 of our Form 10-K for our complete risk factor disclosure.

Participating in today's call with me will be Paul McDermott, President and Chief Executive Officer, Steve Riffee, Executive Vice President and Chief Financial Officer, Tom Bakke, Executive Vice President and Chief Operating Officer and Drew Hammond, Vice President Chief Accounting Officer and Treasurer. Now, I'd like to turn the call over to Paul.

Paul McDermott – President and Chief Executive Officer
Thank you Tejal and good morning everyone. Thanks for joining us on our year-end 2017 earnings conference call.

Washington REIT continues to deliver Core FFO and same-store NOI growth while recycling assets and navigating our region's uneven real estate fundamentals. We grew Core FFO by 3.4% year-over-year in 2017 and are guiding to further growth at the mid-point of our 2018 Core FFO guidance range. If achieved, 2018 would be our fourth consecutive year of Core FFO growth despite recycling over a billion dollars of legacy assets since the management transition began here in late 2013. We grew 2017 same-store NOI by 6% on a year-over-year basis, driven by 8.9% growth in office, 3.6% growth in multifamily and 3.3% growth in retail NOI. We project further same-store NOI growth in 2018 as our portfolio continues to outperform the DC Metro Region on both net effective rent growth and occupancy. We have also de-leveraged and strengthened our balance sheet to end 2017 with a net debt to adjusted EBITDA ratio of approximately six times, and have improved our Core FAD dividend payout ratio to approximately 82%.

We are outperforming our market because we have consistently allocated capital out of legacy assets that have reached an inflection point in their NOI trajectories and into assets where we can create value, grow NOI, and strengthen our balance sheet. And finally, we apply research to focus on the highest risk-adjusted growth segments within the DC Metro region, which remains a market of clear winners and losers. Let me discuss our 2017 asset recycling through the lens of our capital allocation strategy and within the context of our region's real estate fundamentals.

Washington REIT continues to strategically shift away from single tenant exposures and toward mid-size leases, where we are able to create a differentiated value proposition in return for lower-than-market total concessions and higher effective rent premiums. In the DC Metro region, demand for small and mid-size leases is growing faster than it is for large leases. Our research shows that the percentage share of leases below 25,000 square feet has grown from 63% of leasing in 2012 and 2013 to 80% of leasing in 2016 and 2017, during which period there were 9.3 times more leases below 25,000 square feet than above. This strategic objective is supported by our recently executed agreement to sell 2445 M Street for approximately $100 million in September this year. The competitive market will have a glut of large-block vacancies with JLL estimating approximately seven to one ratio of supply to demand in 2020. The outlook beyond 2020 remains challenging as new construction augments the existing stock of large-block vacancies. The District has a limited number of large users, which typically are law, accounting or financial services firms. Although demand from large tech companies is rising and law and accounting firms are expecting business growth due to the passage of tax reform, for large-leases specifically we expect competition to intensify, the already-high leasing capital costs to increase, and for IRRs to further erode.

We determined that a redevelopment of 2445 M Street, a 292,000 square foot office asset with large, 32,000 square foot floor plates, needed a minimum pre-lease commitment of 125,000 square feet to justify the base-building redevelopment costs, which ranged from $20 million at the low-end to approximately $60 million for Class A status. The TI and concession package for these leases would have been approximately $225 a foot with two to three years of downtime under the most optimistic re-leasing scenario, and negative cash rents spreads at the lower-end of the redevelopment cost spectrum. Our analysis concluded that this redevelopment risk was disproportionate to the potential returns it offered.

We believe a conversion to multifamily, which came with re-zoning and entitlement risk, would have been the asset's highest and best use given its location. This, however, was challenged by its 145 foot floor depth, which is more than double the 65 foot floor depth that is typical for multifamily buildings. The only viable design solution was to cut a deep crescent into one side of the building and remove a large portion of the building's floor area in order to reduce depth and allow more light. Unfortunately, this brought the conversion's economic returns, which were already thin due to Washington DC's 20% affordable housing requirement, to levels that we believe would have been unacceptable to our shareholders.

With the recent rise in value-add investment capital flowing into Washington DC, we received multiple LOIs from private, opportunistic, leveraged buyers desirous of redeveloping and repositioning 2445 M Street themselves. The bidders preferred to purchase the asset empty or as close to empty as possible because any cash flow received prior to the redevelopment would add to their cost basis and erode their highly leveraged redevelopment returns. We believe there is no opportunity cost associated with executing the sale of 2445 M Street in September this year. Following the Advisory Board's departure announcement in late 2015, the price a redeveloper would pay for 2445 M at any time thereafter was going to be a dollar for dollar adjustment of the asset's remaining cash flows against its sale proceeds, for which the buyer economics have remained broadly unchanged since late 2015. We therefore continued to fully explore all alternatives before executing this sale to a redeveloper. We believe our timing may have benefited from an increase in value-add investment capital flows into the District, where the Class B share of downtown sales in 2016 and 2017 sits at almost 40%, up from 25% five years ago, according to JLL data.

The sale of 2445 M Street demonstrates our commitment to allocate capital out of legacy assets with uncertain near-term value-creation potential and significant repositioning risk, and to move away from single tenant exposures. We expect to reduce our office portfolio's single tenant exposure from 26% down to 13% on a square-footage basis, following the execution of our announced asset recycling this year. Our two remaining single tenant exposures are at 1776 G Street in Washington, DC with The World Bank, whose lease expires on December 31, 2020, and at John Marshall II in Tysons with Booz Allen Hamilton, whose lease expires on January 31, 2026.

We feel optimistic about the long-term prospects for both of these assets. 1776 G Street is strategically located next to the World Bank's headquarters and two blocks from the White House. John Marshall II has below-market rents, is proximate to the Greensboro Metro Station and adjacent to the 4.2 million square foot 'Boro' Town Center development, which will feature the region's largest Whole Foods, a six-story Multiplex, several multifamily buildings and a parkland setting.

Before I move on to Arlington Tower, I would like to share our observations on the investment climate for Class B value-add multifamily assets in this region. We remain firmly committed to growing Washington REIT's multifamily portfolio as we continue to see long-term value-creation potential for the Class B unit renovation strategy with covered land plays. That said, Class B multifamily assets and portfolios being broadly marketed in this region are at prices that leave no room for value-creation and therefore have limited NOI growth potential. Our research has proactively identified a targeted list of Class B multifamily assets that meet our value-add criteria and are located in submarkets with strong long-term growth prospects for value-oriented product. Furthermore, our acquisitions team is working hard to evaluate these future off-market opportunities. While growing Class B multifamily remains a strategic priority, our foremost commitment is to create value for our shareholders. We believe Arlington Tower provides us with a unique opportunity to do just that.

From a strategic perspective, the acquisition of Arlington Tower furthers our objective of building a higher-quality, multi-tenant office portfolio in submarkets that are best positioned to capture growth in both the near term and over the long haul. Through our ownership of 1600 Wilson Boulevard and Bennett Park in Rosslyn, we had been paying close attention to the resurgence of this submarket even before we sourced Arlington Tower. Rosslyn is rapidly transitioning from a nine to five government and defense contractor hub to an amenity rich, 24-hour urban center. The transformation began with multifamily as 4,000 units were added to the Rosslyn-Ballston corridor over the last five years. As a younger and more vibrant demographic moved into Rosslyn, 200,000 square feet of retail amenities followed. Today, approximately 42% of Rosslyn's residents are 25 to 34 year's old and 86% of residents hold a college degree or higher. Collectively they address corporates' quest for talent and are helping Rosslyn attract a wide variety of professional services firms. According to Cushman and Wakefield data, 435,000 square feet of leases committed to Rosslyn in 2017, its best leasing year in 10 years. Moreover, gross office rents in Rosslyn have risen 24% over the last two years as the share of non-GSA leasing has continued to rise. The private sector comprised 85% of the total leased square footage in Rosslyn in 2017, according to Cushman and Wakefield data.

Arlington Tower is a 398,000 square foot, 19-story office building located in the heart of Rosslyn, two blocks from the Rosslyn Metro, with panoramic views of the Potomac River and monuments. The asset has a Walk Score of 95 and offers immediate commuter access to I-66, Route 50 and the George Washington Parkway. Arlington Tower has been extensively renovated over the past five years with capital improvements of approximately $18 million, with nearly $4 million spent on creating a unique roof deck enclosed by glass railing and outfitted with a catering kitchen, in order to leverage some of the best views in the DC Metro Region. Less than 10% of office buildings in Rosslyn have roof decks with views that are accessible to all tenants in the building. Views remain the one amenity that can't be replicated and assets with waterfront views in the DC Metro command double-digit rent premiums on average, according to JLL data.

Arlington Tower has a well-diversified tenant base with no single tenant occupying more than 15% of the asset's total square footage, and it has a manageable lease expiration schedule. The approximately 70,000 square feet of lease expirations in 2019 enable us to create value with a spec-suite leasing strategy focused on creating flexible space solutions with shared amenities at an increased speed to market where tenants pay a premium for all three. We have had tremendous success with our spec suite leasing strategy at 1600 Wilson, which offers $40 rents and is 98% occupied.

We feel confident that this strategy will work at Arlington Tower because there are a limited number of Class A small suites in Rosslyn that offer rents in the $51 to $55 gross range and among those Arlington Tower is the only building with views, according to CoStar data. We believe we can achieve a 7% to 10%

premium on a TI investment of approximately $80 per foot for our flex product. Our target customers for Arlington Tower are the mid-size office tenants in Northern Virginia looking for image at a reasonable price and those in DC that have fewer Class B options due to occupancy gains and increasing rents. Rosslyn offers this tenant the closest possible proximity to DC along with the cache of being in a premium private sector submarket in Northern Virginia that is home to the likes of Nestle, The Carlyle Group, Gartner, Sinclair and Politico.

Moving on to our research-based focus on the highest risk-adjusted growth segments within the DC Metro region, we continue to focus on small and mid-size office tenants both at the image conscious and the value-conscious ends of the spectrum, as well as value-conscious multifamily renters. In a market of winners and losers, we believe these segments are long-term winners in the DC Metro Region because even though they are growing, they are likely to remain underserved by new and existing supply. The redevelopment of the Army Navy Building focused on image-conscious small and mid-size office tenants, delivered on their underserved need for shared amenity space and is now 91% leased with rents that have exceeded our underwriting expectations. Over 85% of our office square footage is composed of floorplates at or below 26,000 square feet and caters primarily to our region's growing base of small and mid-size office tenants. The majority of our DC same-store office portfolio offers the small and mid-size value-conscious office tenant rents that are in the mid-$40s to mid-$50s, a pricing sweet-spot where vacancy continues to fall and net effective rents continue to rise. Finally, our Class B multifamily strategy continues to deliver robust performance in a region with a high cost of living and limited value-oriented housing options.

We grew Class B multifamily average monthly rent per unit by 250 basis points year-over-year in the fourth quarter, with 460 basis points of year-over-year rental rate growth at Riverside. We also grew fourth quarter Class A average monthly rents per unit by 120 basis points year-over-year despite more than 10,000 new unit deliveries in 2017. Our multifamily portfolio is significantly outperforming our region where Class B rents grew 70 basis points and Class A rents were flat year-over-year in 2017 according to Delta Associates.

There are three drivers of our multifamily outperformance. First, our portfolio, and particularly our Class B portfolio, is located in submarkets with strong current and future fundamentals. Approximately 74% of our units are located in Northern Virginia and are not directly competing with the largest wave of Class A supply that is being delivered in the District. Within Northern Virginia, 43% of the future delivery pipeline from 2018 to 2020 is concentrated in the Silverline submarkets, where we have limited multifamily exposure. Our portfolio also benefits from its proximity to major job centers, particularly in Alexandria, where Riverside Apartments, the largest asset in our portfolio, is close to the National Science Foundation and the Patent and Trade Organization, and across the river from MGM National Harbor, now one of the largest private-sector employers in its county. In Arlington, The Wellington is one mile from the Pentagon.

Second, our Class B unit renovation programs are performing well and have strong future growth prospects. 76% of our Class B units are in submarkets with greater than average affordability gaps between Class A and Class B multifamily. Overall, our Class B portfolio has a weighted average rent gap that is double the market-wide A versus B gap. And third, we are capitalizing on our in-house research and hands-on pricing model to closely manage each asset's competitive position in the submarket in order to optimize our portfolio's rental income growth potential. As a result, we have driven renewal trade outs higher by 357 basis points and new lease trade outs higher by 175 basis points in full year 2017.

Now, I would like to provide leasing updates on some of our key growth drivers. As mentioned, we are 91% leased at the Army Navy Building. We are seeing strong pre-leasing activity at Watergate 600 where the lobby renovation is now complete and we are touring or trading proposals with approximately 315,000 square feet of prospects for 70,000 square feet of vacancy on the top three floors of the building that are currently leased to Blank Rome and have a lease expiration date of December 31, 2019. These top floors of vacancy offer spectacular panoramic views of the Potomac River and the monuments, and are receiving solid interest from media users, consulting firms and law firms. In retail, we have seen strong activity at our new development at Spring Valley Village where we are 50% pre-leased after signing two strong food service operator brands for the ground floor, and are seeing demand from a variety of personal and business service users for the second floor.

We have signed an LOI for the 28,000 square feet of hhgregg vacancy at Hagerstown. The 23,000 square feet of hhgregg vacancy at Frederick is seeing interest from discounters in the 12 to 15,000 square feet range and we will likely divide the space to accommodate multiple users. We expect both vacancies to be re-leased this year.

To conclude with the DC Metro region's growth prospects, the recent passage of tax reform followed by the two-year budget deal are both very positive milestones that are expected to stimulate *new* demand in our region. Our portfolio derives its largest share of NOI from Northern Virginia, which is the biggest regional beneficiary of a budget deal that is expected to increase defense spending by approximately $165 billion over the next two years. Our 2018 asset recycling has increased our office portfolio's exposure to Virginia by approximately 11% on a pro-forma NOI basis. Approximately 52% of our pro forma office NOI is driven by our Virginia assets, more than a third of which are currently leased to defense contractors. As importantly, approximately 74% of our multifamily NOI is driven by our Northern Virginia multifamily assets, which directly benefit from job growth in Northern Virginia. As a result, we believe Washington REIT is well-positioned for the regional growth that is likely to be driven by the recently passed legislation.

Now, I would like to turn the call over to Steve to discuss our financial and operating performance in the fourth quarter.

Steve Riffee - EVP and CFO
Thanks Paul. Good morning everyone. 2017 net income attributable to controlling interests of $19.7 million, or $0.25 per diluted share was below 2016 net income of $119.3 million, which included a $102 million gain on the sale of the suburban Maryland office portfolio. Fourth quarter net income of $2.3 million or $0.03 per diluted share included a $25 million gain primarily related to the sale of Walker House, offset by the recognition of a $28 million impairment charge to reduce the carrying values of 2445 M Street and Braddock Metro to their estimated fair values.

Our 2017 Core FFO of $1.82 is 3.4% higher than the $1.76 we achieved in 2016 due to Watergate 600, Riverside Apartments and revenue-led same-store NOI growth of 6% overall, which was driven by 8.9% office, 3.6% multifamily and 3.3% retail same-store NOI growth. This growth more than offset the impact of the sale of the suburban Maryland office portfolio in 2016, Engility Corporation's lease expiration at

Braddock Metro Center at the end of third quarter of 2017 and the sale of Walker House at the beginning of the fourth quarter of 2017. For 2017, our expenses as a percentage of revenues improved by 110 basis points year-over-year to 35.6% driven by lower utility and repair and maintenance costs due to the sale of the suburban Maryland portfolio as well as a continued reduction in controllable expenses in the same-store portfolio.

We delivered $113 million of Core Funds available for distribution, or Core FAD, in 2017 and a payout ratio of 81.6%, which was better than the mid-80s Core FAD payout ratio we had targeted at the beginning of last year.

We reported fourth quarter Core FFO of $0.44 per diluted share versus $0.43 in the same prior year period largely due to the same drivers as outlined for the full year where we grew NOI while improving the quality of our portfolio by recycling out of commodity suburban assets and into quality, metro-centric assets such as Watergate 600 and Riverside that are performing well for us. Sequentially, fourth quarter Core FFO was lower than the third quarter due to Engility Corporation’s lease expiration at Braddock Metro Center at the end of third quarter of 2017, the sale of Walker House at the beginning of the fourth quarter of 2017, normal seasonality in the multifamily portfolio, as well as higher, weather-related seasonal expenses in the fourth quarter.

We grew same-store NOI by 6% year-over-year in 2017 and 2.3% year-over-year in the fourth quarter, primarily due to same-store average occupancy gains in office as well as higher rental growth in multifamily.

Starting with office, same-store NOI grew 2.5% for the quarter and 8.9% for the year, which was driven by 160 basis points of average occupancy gains. Approximately 40% of our fourth quarter year-over-year rental revenue growth was driven by the Silverline Center, with the rest spread across the portfolio with new lease commencements at 1775 Eye Street, 2000 M Street, 1776 G Street, 1901 Pennsylvania Avenue, Fairgate at Ballston and 1600 Wilson Boulevard, some of which were offset by known move-outs at Quantico, which drove same-store ending occupancy lower on a sequential basis. Overall office ending occupancy declined by 100 basis points to 90.1% due to the expiration of Engility Corporation's lease at Braddock Metro Center. The office portfolio was 95% leased at year-end.

We drove strong office rental growth for new leases this quarter as we leased a majority of space to small and mid-size users, which represent our core office tenant base. We signed approximately 22,000 square feet of new office leases in the fourth quarter of 2017 driven by leasing at the Army Navy Building and 1901 Pennsylvania Avenue and committed $11.74 per foot per year of term in tenant incentives largely due to higher leasing costs for several unique spaces, including one build-out of below grade space at 1901 Pennsylvania Avenue. We achieved strong rent roll ups of 17.4% on a GAAP basis and 5.9% on a cash basis.

We signed approximately 49,000 square feet of office renewal leases in the fourth quarter of 2017 with one large lease roll down at Quantico resulting in flat GAAP spreads and 12.2% lower cash spreads. Our office tenant retention rate in the fourth quarter was approximately 68%.

With only 5.7% of space rolling in 2018, our main focus is on leasing our 2019 and 2020 lease expirations, particularly at Arlington Tower and Watergate 600. Following our 2018 asset recycling, we have reduced our 2019 office lease expirations by over a third and expect to have less than 12% of rentable square feet expiring in 2019.

Moving onto Retail, we grew full year same-store NOI by 3.3% while fourth quarter same-store NOI was broadly flat on a year-over-year basis as rental growth and lease termination fee income offset 360 basis points of year-over-year average occupancy declines, mainly related to the former hhgregg spaces that are currently in lease-up. Sequentially, average occupancy declined by 100 basis points due to lower seasonal specialty leasing in the fourth quarter. Our retail portfolio was 91.2% occupied and 94% leased at quarter-end with good activity on vacancies and the opportunity to grow occupancy in 2018 and 2019.

During the quarter, we leased approximately 22,500 square feet of retail space and drove approximately 8% GAAP and 5% cash roll ups on new leases. Renewals were up 15.4% on a GAAP basis and 11% on a cash basis. We paid no tenant incentives on renewals and standard incentives on new leases.

Finally, multifamily same-store NOI was up 3.6% for the year and 4.3% for the quarter. On a per unit basis, the same-store portfolio ended the fourth quarter 94.8% occupied with overall occupancy at 95%. In the fourth quarter, we renovated 20 units at The Wellington and 76 units at Riverside. As a result, at quarter-end, we had 308 units left to renovate at The Wellington and 438 units left to renovate at Riverside. The Wellington unit renovation program is now 55% complete while Riverside is 49% complete. We continue to generate a mid-to-high teen return on cost on the renovation dollars that have been invested at these two assets to date and expect these programs to continue through 2018 and into the first half of 2019.

Now, turning to 2018, our core FFO guidance is expected to range from $1.82 to $1.90 and does not contemplate acquisitions beyond the announced purchase of Arlington Tower, while dispositions could range from $180 million to $240 million, including the completed sale of Braddock Metro Center and the planned sale of 2445 M Street. As Paul mentioned, we expect to complete the sale of 2445 M Street in September this year for proceeds of approximately $100 million and have completed the sale of Braddock Metro Center for net proceeds of $79 million.

Our guidance includes the following assumptions; same-store NOI growth of 2.5% to 3.5%. Office same-store NOI growth of 4% to 5%; multifamily same-store NOI growth of 2.25% to 3.25% and retail same-store NOI growth of 1% to 2% as we expect to backfill the hhgregg vacancies this year with rent commencement in 2019.

We expect our 2018 same-store NOI growth to be heavily weighted to the third and fourth quarter in office as leases commence, in multifamily due to higher anticipated first quarter expenses followed by continued revenue increases from the renovation programs in the second half of the year. Retail comparisons in the early quarters are more challenging due to vacancies created by the second quarter 2017 hhgregg vacancy, while stronger growth is expected in the second half of 2018 including additional lease commencements.

We project office non-same-store NOI, which includes Watergate 600 purchased in 2017 and Arlington Tower purchased in 2018 as well as 2445 M Street, which is now held for sale, to range between $35.5 and $37 million, including approximately $7.5 to $8 million from 2445 M Street depending on the timing of the sale transaction. Our interest expense is expected to range between $51.25 to $52.25 million. G&A is expected to be between $20.5 to $21.5 million.

Our capital plan for 2017 assumes approximately $45 to $50 million of development spending, predominantly for The Trove, where we have executed a guaranteed maximum price contract that insulates us from escalations in construction pricing. Finally, we are targeting a Core FAD payout ratio of 80% for 2018.

Our focus remains on maintaining our balance sheet strength. We expect our net debt-to-adjusted EBITDA to be in our targeted range of 6 to 6.5 times by the fall following the completion of the 2445 M Street sale, but it will temporarily be higher until the sale is completed and the Arlington Tower acquisition contributes to EBITDA.

And with that, I will now turn the call back over to Paul.

Paul McDermott - President and CEO
Thank you, Steve. Although real estate fundamentals in our region have been challenging throughout this cycle, we believe this period will be viewed as a pivotal phase in the DC Metro region's transformation to a private-sector led economy. As of today, the private sector is already the region's job generator and while the federal government will remain a significant part of the Metro economy, we expect it will have a steadying rather than driving influence on real estate fundamentals going forward. Our confidence stems from the quality of our region's workforce. We ranked first out of the 15 largest Metros for workforce educational attainment, according to the Fuller Institute. It is this workforce that has brought the likes of Nestle and Amazon Web Services to the region and that has secured the region three spots on the Amazon HQ short-list. George Mason University's analysis of almost 6,000 job postings at Amazon's Seattle headquarters since 2010 revealed that the Washington Region has approximately two to four times the national concentrations of workers in the top four categories of jobs that Amazon is hiring for. These are software development, management, engineering and R&D, and business development. These will remain the jobs of the future, not just for Amazon, but for corporate America. The DC metro region is among a handful of regions that has the talent pool depth to fill them. We expect continued demand for all our asset classes as the virtuous cycle of private-sector job growth further augments the region's workforce. Furthermore, Washington REIT's long-term strategy is to be a principal provider of high-quality, well-located, and value-oriented assets throughout the DC metro region – particularly in the multifamily space – and every decision we make is designed to increase our ability to achieve this goal.

Now I would like to open the call to answer your questions. Operator, please go ahead.

Operator
Thank you. Ladies and gentlemen, at this time we will be conducting a question-and-answer session. [Operator instructions]. Our first question comes from the line of Dave Rodgers from Robert W. Baird. Please proceed with your question.

Dave Rodgers
Paul, maybe I'll start with you just on the acquisition outlook. I think you've, obviously, closed Arlington Tower here early in the year. Curious, what else you might be looking at? What else is on the horizon? And what the D.C. pipeline is looking at that we kind of fit what you'd be interested here in 2018?

Paul T. McDermott
I think first, just to give you a context of what we're seeing and I don't want to protract the answer. But why don't we talk a little bit about the markets and what we're seeing right now, then talk about how strategically we would overlay an acquisition strategy on that. I think right now, if you're looking at D.C., and I'll pick on office first, I think probably the most active area we're seeing is really along the Toll Road. We're seeing deals come out there and a lot of capital out there, chasing office product along the Silver Line. And they're really underwriting real rental growth. So in the suburbs, that's clearly probably one of the hottest pockets. Downtown here, I think we're seeing no shortage of people looking to pay up for kind of best-in-class office. I'll pick on 1440 New York, 4.5 cap, over 1,200 a foot, 900G, over 1,250 a foot. Interestingly, all of these renovation buildings, that we've seen, appeared on the landscape over the last 24 to 36 months, not seeing any of those hit the market. I'd say the other hot product in our region is, obviously, value-add multifamily. And I think the reason this is so important to talk about with our strategy, we're seeing people coming buying in the low-4s and letting underwriting kind of drag them to upper 5s or a 6. I think the misnomer, Dave, which we see there is a lot of that renovation capital that I think the new capital believes they need to put into those assets to achieve the type of value-add returns that we're seeing, mid-to upper teens in the Wellington and Riverside. We think that that capital, the way we've underwritten those, specifically in some of the submarkets, that's just to maintain their current rents. That's not to really get any juice. And we're also seeing some of the product that is come up in the multifamily space, not in the submarkets that we'd like to see, where we typically see those wider than average affordability gaps. So what does that mean for us? We still want to move forward with the multifamily strategy to Class B renovation strategy with the covered land plays. Our multifamily team here has identified off-market opportunities, we're going to continue to look at those. But we have to be sensitive to where our currency is right now, and what the true opportunity is. I would tell you that, in terms of capital coming into Washington, D.C, we've taken and you all have been apt enough to point out on some of the fundamental flaws in the region. We're clearly seeing no shortage of capital coming – no shortage of capital both on the foreign and domestic fronts coming into Washington, D.C. I'd say about 75% of the capital we see chasing down downtown product right now, Dave, is foreign. Some of it's in the burbs. We saw Middle Easterns with Braddock Metro Center, I've seen German capital, Israeli capital. Most of the value-add multifamily capital has been domestic. So that's who we would be competing against. I think the biggest thing that people have not -- is not on people our radar screens, which would clearly be a lot more in the forefront are the emergence of the debt funds. It was a big topic at the recent MBA CREF Conference. They are very aggressive, they are tightening spreads on life companies and banks and they are definitely pushing up LTVs. I think the number that I read, Dave, there was almost 100 funds raised and have about $40 billion to place. And out of all the capital raised last year, about 1/4 of that was raised for debt. And the reason why these guys are going to be sneaky good this year is, they don't have the reserve requirements that the banks and the life companies have, and they don't have the risk-based models in place. So we think that's going to continue to throw a lot of product to our market this year. But again, if we had our druthers first and foremost, we would like to continue to augment the multifamily stock that we have. And if we could pick something, something like the Riverside and something in the Wellington, but again, we have to be cognizant of our current cost capital and where the stock is.

David Bryan Rodgers
Just as part of your answer, do you think that it's making more sense as you move forward, I know you guys have stabilized your operations, that you would look at joint venturing and partnering with more people as there's more capital in that market?

Paul T. McDermott
Yes and no. Let's talk about that a little bit. I mean, we want to be -- we are investment grade and we're trying to be sensitive to how the rating agencies look and how the accounting rules work for debt consolidation. But I think we're -- all we'll be looking at opportunities to grow -- scale the business and grow the footprint. But I just want to make sure that what the -- some of the capital that we're seeing being allocated to joint ventures right now, we want to make sure it's a realistic. And that you can actually place some of that programmatic capital that's out there. We said it before, bigger isn't better, better is better. And we're trying to make sure that we do the right deals for our shareholders. And I don't want to put Washington REIT in a position where they have a gun to their head, because they've -- we've been approached by private equity funds to do programmatic JVs. And we don't want to put ourselves in a mother may I situation with a large money partner. And we also want to try to control our own destiny, and make sure that the agendas are completely aligned for our shareholders and not necessarily a financial institution being our partner.

David Bryan Rodgers
Great. Maybe one follow-up for Tom. Just comments about Watergate and the activity that you're seeing to backfill the 70,000 square feet at the top. Can you kind of give us a sense where economics are relative to what's in place?

Thomas Q. Bakke
Dave, the -- I think as was mentioned in the commentary that we've got the lobby renovation complete. The activity has sort of spiked up with that. Seeing good demand from tenants in media and consulting, some law firms, again being very interested in views and sort of the iconic nature of the asset. Our mark-to-market on the rents is slightly up, maybe $2 or $3, but we're pricing the asset in the $60 range, mid $60s for some floors. And we're seeing no pushback on pricing. And I think it's just a unique asset as we've discussed before.

Operator
Our next question comes from the line of Michael Lewis from SunTrust.

Michael Robert Lewis
My first question is about concessions in the market. It looks like your TI and incentive spend looked a little high, about $7.8 million. I looked back to last few years, I couldn't find the quarter where you guys spent that much. And it wasn't that heavy a leasing quarter. So I was hoping if you could just comment on that.

Thomas Q. Bakke
Yes, Michael, it's Tom. A lot of that was skewed a little bit by some of the unique spaces that we had to lease that we got done. Frankly, we are happy to get them done. One was a below-grade space at 1901 that we had been sitting vacant for some time. And so that was a big one. We had to stuff some extra capital into that. And then some smaller unique spaces that again some over installations that 1901 drove up some numbers there, where we had to do a little more base building in the capital investment there. So I think it was just a skewed quarter for us.

Michael Robert Lewis
Okay. My second question, I wanted to ask, I guess it's that time pass for all the companies about potential stock repurchases. Your stock hasn't been at the steeper discount to NAV since, it looked like

very briefly, in 2015. So the question, I guess, is really about potential stock repurchases, but also maybe that ties in, do you consider selling more assets to kind of arbitrage that? And I guess, that fits into a broader question about use of the capital right here?

Stephen E. Riffee
Michael, this is Steve. For this time, it's in the cycle that's a good question. I'm sure everyone has to answer it. Look, from our perspective, all of our capital allocations decisions have been, always have been focused on creating long-term value for the shareholders and keeping the balance sheet strong. We are certainly analyzing it, along with all of our other capital allocation scenarios. So I really think it – all parts of your question really do tie together. But if we were to do that, it would have to be on a leverage neutral basis, because we believe in these recently choppy days, it's even more important to have a strong balance sheet and a path to keep it strong. For us to do that on the leverage-neutral basis, that would mean probably the incremental proceeds would come from asset sales. And the only debt that we could pay down, say, with such proceeds alongside of a buyback to keep it leveraged neutral would be our cheapest term debt. And the blended returns in doing that are in the 5s. So then we look at where we are reallocating capital. And how do we think about what we have been doing, and how we still think about things even at today's prices. First thing is, we're allocating capital to our renovation programs, and we're still generating returns in the high-teens. Right now, we are under way with our Trove development, and when we look at our unlevered IRRs, that we are still calculating that those are creating long-term value with -- and they're also synergistic to other properties that we have there in the market. So right now, it doesn't look like that would be the best allocation of our capital. But it is, obviously, something that we have to evaluate alongside everything else.

Michael Robert Lewis
Helpful answer. And then lastly, we've all talked that best corporate governance practices are to split the roles of Chairman and CEO. I thought maybe you could talk about the decision to combine those at Wash REIT, and your thoughts on that?

Paul T. McDermott
Chief Executive Officer, President and Trustee
Sure, Michael. This is Paul. So let's start out with good governance. Our current Chairman, Tuck Nason, who has been in that role for 5 years, we noted at the end of his appointment, this was probably a good time to look at that seat and look at new candidates for that seat after 60 months. Tuck, by the way, and all the members of the board are the main drivers of the transformation that has taken place at this company over the last 4 years. And so I think that thought process was is that we would like to continue that transformation of the company at all levels and maintain what we have achieved over the last 48 months. I think if you were staying with good governance and best practices, you would immediately, if you combine those roles, you would immediately name a lead independent director, and we have done that also. Tuck will assume the role of the lead independent director assuming that both appointments are approved in our shareholders meeting in May. But, what I would also reiterate is that, you will not see any material impact on the operations of this company through this appointment.

Operator
Next question comes from Jed Reagan from Green Street Advisors.

Jed Reagan

I guess just following on Mike's question there. Do you have a share buyback authorization in place at the current time? Or is that something you're talking about at board level?

Stephen E. Riffee
We have not put one in place, but it that time, where administratively we're starting to do our line recast, have to file our shelf, have to renew the DRIP program, probably have to technically setup the ATM program. So it is something that we will be talking to the board in the near future as to whether or not they intend to put one in place. But we have a lot of administrative re-filings that we have to evaluate over the next month or so, Jed.

Jed Reagan
Okay. I appreciate that. It looks like you've got up to $60 million in incremental sales possible in the disposition guidance. Can you talk at all about, what that might include, maybe by property type or region, at least?

Paul T. McDermott
Jed, it's Paul. I mean, we have the sales in terms of Braddock and 2445, which we've already outlined. If we were to sell another asset, I would like to continue to recalibrate the portfolio, make it more multifamily centric, so that would lead us to probably sell an office asset. And we are evaluating those prospects right now, Jed.

Jed Reagan
Okay. And can you give any color on the average lease term of the corporate drive assets in Stafford? And just how is the activity for remaining vacancy there?

Thomas Q. Bakke
Jed, it's Tom. You wouldn't bring up Quantico, would you? Yes, that is a defense contractor building, typical terms are 5-year terms. And when we do get them without termination options, that's always a bonus, but a lot of them have kick outs after 3 years. So I think the answer to the question is, the average term is 5 years. And say, you're churning 20% of your tenant base every year. But we additionally have our biggest vacancies down there as well. We've got about 70,000 feet to lease down there as well. So we've got our hands full with that asset.

Jed Reagan
Okay. And what are your expectations for cash rent spreads in 2018? And can you talk about where the portfolio sits relative to market today, just kind of rents wise?

Thomas Q. Bakke
Yes, so from the D.C. B office portfolio, we don't have a lot of vacancy, but where we do have some opportunity to lease space or mark-to-markets on the B office is generally a couple of bucks up on a cash basis and of course, that're on a GAAP basis. Moving into Virginia on the Silverline assets, we have, which are in Rosslyn, Ballston and then out in Herndon, we've got probably 3% to 5% cash up in those assets. GAAP is probably closer to 8% to 10%. Again, this is on the small amounts of vacancies we do have. We do have some leasing at Fairgate and some at Monument II, good activity at Monument now that defense contracts are starting to percolate. Alexandria, those rents are sort of flat on any of those roles. And I think that Watergate and Arlington Tower, we've talked about those.

Jed Reagan
Okay. And then just last one for me, if I may. Just in terms of your kind of decision on 2445 and the acquisition of Arlington Tower, I appreciate there's obviously very different risk profiles there. I guess, I'm curious just kind of what kind of leverage return a buyer of 2445 M might be able to achieve versus what you think you could achieve at Arlington Tower? And then to what extent was cash flow stability sort of a key consideration for making that change?

Thomas Q. Bakke
Yes, I think the last statement you made was a key one. I mean, we looked at -- we took 2445 to the market with a in -- pretty much the most of 2017 with both a Class A renovation and a class sort of B plus renovation. We had really good schemes, the market was receptive. But we looked at probably 5 large law firm preleases and none of them wanted to go to the West End, unfortunately. And we had one that was really interested in the building. But there were some decision makers that liked the West End, but at the end of the day, they're gone to new construction, which is seemingly the case on pretty much all of these law firms. It's either new construction or the top floors of a pop top, which is technically new construction for those floors. As we looked at the numbers on 2445, when we put our model together, we looked at it by return on cost and especially tried to bridge the downtime that we're going to have there. And our return on cost metrics at 2445 were probably at best a 5, if not below a 5. But then you look at a leverage buyer and how are they looking at it, because we've seen some of their pro formas. I think they believe that they can lever the asset up, and Paul talked about these debt funds. And that they can still get to their low to mid-teens levered IRRs. I don't think we believe that ourselves. The seller at Arlington Tower, they were at the end of a fund. And so that was motivation for them on that sale. And I think their levered IRRs on that were achieved. So I'm not sure what their hurdle rate was? Paul, anything to add?

Paul T. McDermott
No. I think that covers it, Tom.

Jed Reagan
And what about the kind of your return expectations for that asset?

Thomas Q. Bakke
We are going in above a 6, low 6 and then we should stabilize in the mid-6s on that.

Operator
Our next question comes from the line of Chris Lucas from Capital One Securities.

Christopher Ronald Lucas
Just a couple of quick ones. On the back filling on some of the retail boxes, just curious as to when we should be thinking about what -- when rent commencement might begin?

Thomas Q. Bakke
Chris, it's Tom. The activity's been good. Unfortunately, these are long drawn out deals as you might well know. We've had an LOI pretty much done for the space at Hagerstown since late last year. And we're still in lease negotiations. And these deals seem to drag out. We're hoping that we're going to have GAAP rent starting in the second half of the year. But it's anybody's guess on that. And then on the Frederick Crossing space, we've got probably 2 deals in that box. And those are probably last quarter it is looking like.

Stephen E. Riffee
And Chris, this is Steve. I'll just add. Just in general, we look at not just the former HHGregg spaces, et cetera. Our guidance presumes that we'll have some lease commencements in the third quarter and more in the fourth quarter. So that's why we think retail is little bit backhanded for the second half of the year in terms of its same-store growth.

Christopher Ronald Lucas
Okay. And then, I guess maybe bigger picture question. I was at a presentation recently that one of the brokers made a comment that was pretty interesting from my perspective. And they noted that the spread between face and net effective rents is the largest they've ever seen in the market. And it's uniquely large relative to other major markets. I'm just kind of curious as to how or whether or not that sort of approach has sort of infiltrated at this point to the class B office market?

Thomas Q. Bakke
Has not really affected Class B, and in fact we've been seeing concessions still trend down. Basically, we've seen about a month of free rent drop-off off the table in the B segment. That being said, I do think that you guys have asked these questions over the last couple of years, and whether the glass box As are going to start drop in the rate and or drive the concessions to a point where B has to respond. We're anticipating that that could happen, but we haven't seen it yet. And that spread you talk about is just because of the concession packages keep seeming to go up in the A segment.

Paul T. McDermott
Chris, what Tom said is spot on. I think the reason the B space and the reason we have been focused as we have on small to midsized user. We just haven't seen those type of widening concessions, and as a matter fact, it's actually going the other way. If I were to look at the B space, from -- let's pick on since the end of sequestration from '14 through this year, 25 B buildings have been pulled offline, about 4 million square feet. We, Tom in particular has definitely seen concessions compressing in the B space, rather than going the other way. And that's just that there is a lot of demand for those price point that we talk about Chris, that $45 to $55 pricing sweet spot. And we don't see, obviously, a lot of this new product that's trying to unplug in that pricing delta and trying to reconstitute with something with a 7 in front of it. We don't see those being successful. Tom also mentioned, we haven't seen anybody jump down. I hate to keep going back to that number we throw out, but when you look in D.C. and you see that average tenant size of 6,000 square feet, we're just not seeing these glass boxes, or quite frankly, some of -- even these unimproved days, break ranks -- break pricing ranks for that small of a sized tenant.

Operator
There are no other further questions. I'd like to hand the call back over to Paul McDermott for closing comments.

Paul McDermott - President and CEO
Thank you. Again, I would like to thank everyone for your time today and look forward to spending time with you as we get back on the road next month for our NDRs.