Kidder Mathews

Real Estate Market Review

King, Pierce, Snohomish, Thurston & Kitsap Counties

1st Quarter **2016**

Seattle Apartment

Market Trends

	Current
Vacancy	3.3%
Est. 2016 Construction	12,853 units
Avg. Rental Rate (all ages)	$1,343

Notable Transactions 1Q 2016

Tivalli, Lynnwood
383 units
$94,250,000 | $246,084/unit

Carvel Harbour Pointe, Mukilteo
230 units
$46,500,000 | $202,174/unit

Huntington Park, Everett
381 units
$75,000,000 | $196,850/unit

Bella Terra, Mukilteo
235 units
$70,000,000 | $297,872/unit

Reunion at Redmond Ridge, Redmond
321 units
$60,495,815 | $188,460/unit

Heronfield, Kirkland
202 units
$53,182,052 | $263,277/unit

Woodlake, Kirkland
288 units
$74,210,526 | $257,675/unit

Alturas @ Burien, Burien
543 units
$51,800,000 | $95,396/unit

Griffis Belltown, Seattle
233 units
$90,750,000 | $384,534/unit

Mill at Mill Creek, Mill Creek
570 units
$115,438,000 | $202,523/unit

The regional apartment market vacancy rate is currently 3.3%, well below the 20-year average of 5.0%. The regional vacancy rate last peaked at a rate of 7.2% in Fall 2009 as the recession was fully felt. Occupancy has increased ever since, and vacancy has oscillated from 3.3% to 4.0% over the past three years as rising new construction has been met with consistent demand. Rental rates are at historic highs but the rate of increase has moderated in the close-in markets although some of the suburban markets are seeing increased rent growth as they started their recovery later.

Demographic, economic and philosophical factors have changed over the past decade, increasing demand within the apartment market:

- Household creation peaking in the 25 to 34 age bracket; a group traditionally skewed to renting
- The changed "rent" vs. "own" psychology, due to more transitory lifestyles
- Growing preference for urban housing, to be close to the bulk of new jobs being created and allowing residents to be less automobile reliant
- Lack of affordable home or condominium inventory in the neighborhoods most desirable to many new households

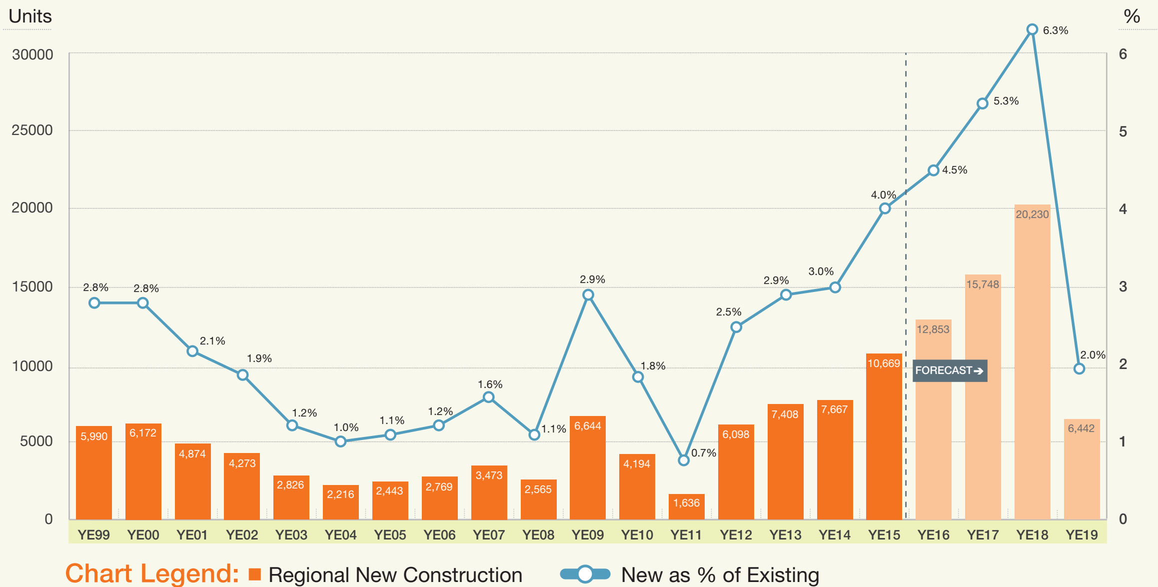
These factors have increased and stabilized demand for apartment units, and are expected to be in force for the foreseeable future.

The apartment market was the first category to recover from the recession. Development started in earnest in 2012 with more than 31,800 units delivered between 2012 and 2015. The 2015 total of nearly 10,700 was the highest annual production since 1991. Currently, there are some 21,179 units under construction, part of 55,273 planned for delivery in 2016-2019, peaking at a forecasted 20,230 units in 2017. These apartment deliveries are expected to increase market vacancy, if only temporarily. Small increases in vacancy have already been seen, enough to cool rent growth that had been in double digits in close-in markets during 2012-2014. Rent growth more typical of a stabilized market and higher construction costs are also squeezing profit margins, which may then delay delivery of some of that anticipated inventory.

→ **Continued, page 2**

Area Review

Regional Apartment New Construction (Units/Year)



Vacancy Trends

According to the Spring 2016 Dupre+Scott Vacancy Survey, the regional (five county) vacancy rate is estimated at 3.3%, down from the Fall report, an encouraging result considering the number of new units opened in the interim. This is a measure of "market" vacancy that excludes units in projects in lease-up and those undergoing significant renovation. Including these units, the "gross" market vacancy is 4.7%. The margin between net and gross vacancy has increased over the past two years and will continue to be wider than shown historically, keyed to high new construction volumes.

Rental Rate Trends

Over the past twelve months the average regional rent increased from $1,231 to $1,343 (9.1%). The King-Central sub-region has the highest overall rent in the region, currently averaging $1,766/month ($2.58/s.f./month), up 7.0% over the past year. The King-Eastside sub-region has the second highest overall rent, currently averaging $1,716/month ($1.89/s.f./month), up 9.2% over the past year. It is important to note that a significant portion of the increase is attributed to the higher prices of new units delivered over the past three years.

While the majority of the markets have moved to effective rental rates, discounting (specials) are still employed, mostly during lease-up or to help move aged vacants. Regionally, the ratio of properties offering concessions has remained below 15% over the past two years. The average discount is currently $855; equal to about 2.5 weeks free rent, or a 5% discount.

The percentage of property managers anticipating increasing rent has decreased to 32.5% of those surveyed, with average growth of 3.6%.

Current Inventory/Supply

Currently there are an estimated 269,825 market rate units in complexes with 20 or more units in the five-county region. King County has the largest share of this inventory. That lead is likely to increase as the planned new development is also centered in King County; 87.1% of the total planned for the next four years. Pierce and Snohomish will account for about 6.5% and 5.6% respectively.

Historically, new construction peaked between 1985 and 1991 with more than 86,000 units delivered during this period – a 70% total increase or 14,350 units per year on average. Excluding this period, new construction delivered averaged about 4,160 units per year since 1980.

Partially offsetting new construction is the loss of some apartment units demolished or converted to another use, most often to condominiums for sale. Since 2000, these losses averaged 540 units per year, excluding the period from 2005 to 2007 when conversion to condominiums for the housing bubble spiked the loss at an average of 5,480 units per year. There was a significant net loss of overall regional apartment inventory in each of those three years. During that time, condominium conversions accounted for 80% of lost apartments, up from the longer-term average of 30%. The net effect was apartment inventory falling back to 2000 levels.

In 2008, after losing nearly 16,500 units over the previous three years, the trend reversed with some projects planned as condominiums were redirected to rental use. Looking forward, the loss to either demolition or conversion is expected to be limited as most obvious under-utilized properties have already been replaced and new financing and renters-rights laws make conversion much more difficult (and expensive).

Projected Future Supply

An estimated 10,667 units were completed regionally in 2015, a 39% increase over 2014. The 2016 new unit count is looking at 12,853 units, almost all of that under construction at this time. Deliveries are set to jump up significantly in 2017 (15,748) and 2018 (20,230).

As apartment construction became feasible, developers looked for sites already entitled with plans that could beat the competition to market. That window has now closed and buyers are willing to entitle their own sites as they look past the peak in 2017-2018. Most projects shown as due in 2016 will be completed as most are already under construction or nearing a start. The additional inventory is expected to apply gradual upward pressure to the vacancy rate as deliveries mount over the next three years.

Most planned new construction has been focused toward the core urban metropolitan locations where job growth has been centered, new houses and condos are scarce and existing infrastructure is present. Of the 55,273 units planned for delivery over the next four years (2016 through 2019), 48,140 units (87.1%) are located in King County. Of these, 30,522 units (55.2% of the region) are in the Seattle sub-region; defined as the King-Central and King-North markets.

Estimate of Future Apartment Demand

The primary demand driver for apartment units is population growth which is mostly supported by employment growth. The latest employment figures for the greater Puget Sound region (including Thurston county) are estimated at 2.09 million jobs.

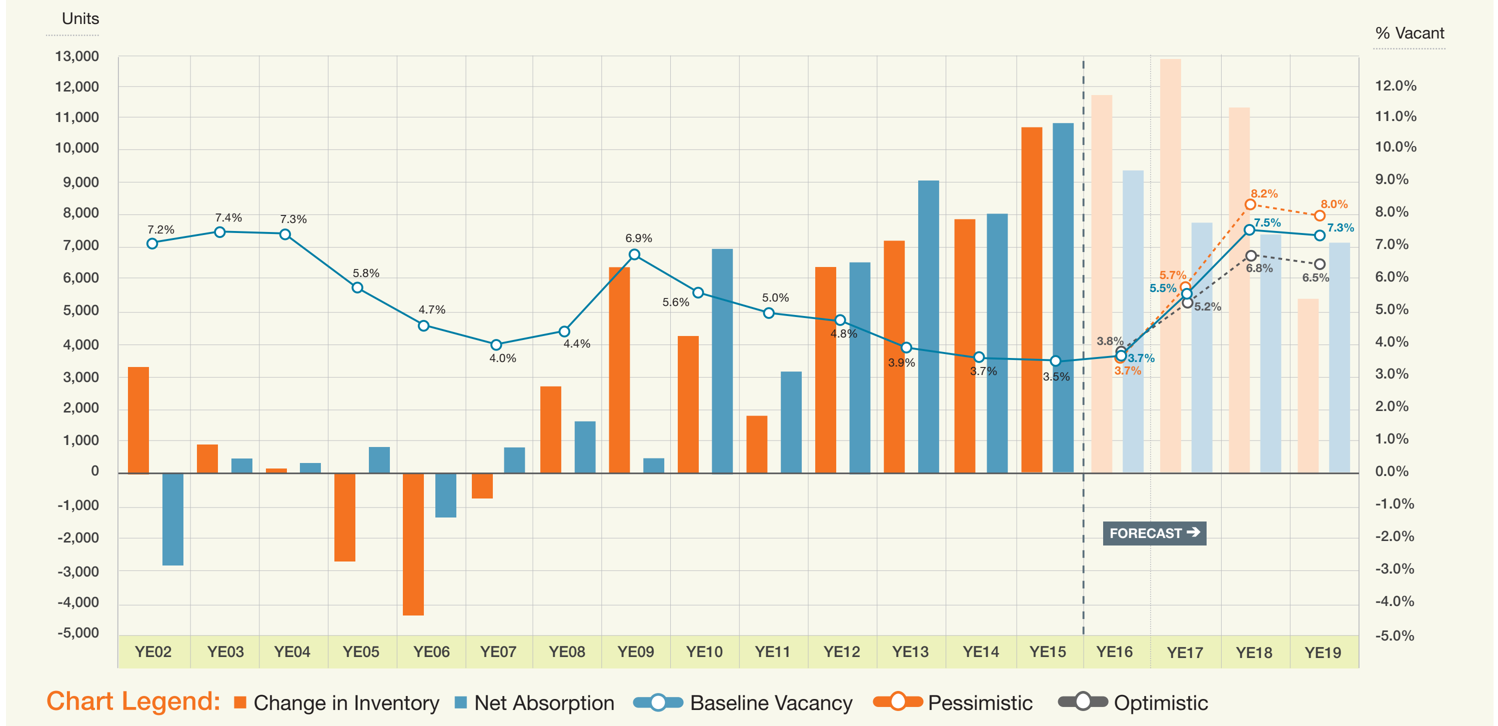
There are an estimated 260,381 occupied apartment units in the region, inferring demand for one apartment for every 8.0 jobs. That ratio has gradually declined over the past seven years (it was 9.1 in 2007) as fewer households are buying homes, either by choice or due to financing being more difficult to obtain. The downward trend in homeownership may slow; however, most economists expect it will continue to decline.

One potential offsetting factor is that higher rental rates and a slowing economy will decrease the number of single-occupant apartments, a category that has grown over the past ten years. In the forecast on the previous page, primary demand is based on the job/apartment ratio starting at 7.9 in 2016 and declining by about 0.10 per year through the forecast.

The primary underpinning of the demand forecast is job growth, which is already a derivative of the overall regional economic trends. Even modest changes in the overall economic forecasts would have a significant effect on future demand projections.

Perhaps the most important of the general economic elements is interest rates. Theoretically, as the national economy shows improvement and unemployment drops, the Federal support of low interest rates should diminish and rates increased. As rates rise, more households are taken out of the homebuying pool as it is estimated that every 50 basis point increase disqualifies about 6% of the potential buying households. Reduced home buying benefits the apartment market, increasing demand or at least lengthening stays in rental properties. Considering the lack of broad based improvement in the national economy and volatile stock market, it is expected that the Fed will be slow to raise interest rates again in the near future.

Historic Absorption and Forecast



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In addition to banks becoming more cautious about lending general, rising Interest rates will also affect development as overall capitalization rates trend with interest rates. Market values and thus financial feasibility will be affected, and it may slow some projects that required longer holds and lease-up, along with strong rent growth to cover peak of the market land prices and construction costs. This has the largest effect on the larger planned tower projects as those costs have risen faster than wood construction and the rental rates have underperformed in several of the recent projects.

Investment Activity

Sales velocity in the Puget Sound Region previously peaked in 2005 with 267 sales ($2.64 billion in volume). Volume fell off slowly as the financial crisis led up to the late 2008 crash. In 2009, the number of sales dove to 53 with combined sales volume of about $333 million, reflecting both lack of confidence and the impossibility of securing financing.

Institutional investors began to view real estate, particularly apartments, as a safe haven in mid-2010 and sales volume more than doubled for the year. The activity continued to improve with volume for 2014 at $3.05 billion (167 sales) exceeding the previous 2005 peak. This trend continued through 2015 with a record $4.36 billion in sales, another all-time high.

It is interesting to note that in the King-Seattle submarket, the 2015 totals included 54 sales, eight fewer than 2014, while the dollar volume increased from $1.17 billion to $1.87 billion. This was the result of institutional acquisition of four tower projects and highlights the confidence of these investors in the Seattle market.

The high ranking of the Seattle market on a national basis is due to the strong economy, broad-based job growth and barriers to entry that limit new construction. In addition to the institutional investor activity, there was an increase in the number of sales in secondary markets and small to mid-sized properties. It appears that two factors are at play: an increase in normal lending on these types of assets, and improved confidence in and diversification into real estate by investors concerned with the higher ratios of risk/return in other investments. This trend expanded through yearend 2015 and this far into 2016.

Overall capitalization rates decreased an average 31 basis points year over year, but a significant part of that was the mix of large institutional sales and secondary market value add properties, both of which tend to have lower capitalization rates. There is consensus that the next interest rate increase will cause capitalization rates to increase, however the institutional investors do not expect rates to increase significantly for over five years. So capitalization rates remain low with new institutional quality properties continuing to sell at rates below 5.0% on pro forma apartment revenue. There is still some leverage at these levels and current interest rates, but the margin is narrowing.

Regional Conclusion

The regional apartment market appears to be on a plateau at the top of this cycle. The general long-term outlook for the Puget Sound region continues to be better than most markets nationwide and it is expected that the peak may be extended if interest rates remain low. Rental rates have reached historic highs and use of concessions at stabilized properties is minimal in most markets. In 2015, 10,669 units opened – the highest level of production since 1991. The forecast for 2016 is 12,853 units, then increasing to 15,748 units in 2017 and 20,230 units 2018. Vacancy has remained at a very low level following the first year of the accelerated deliveries, falling to 3.5% at the end of 2015 from 2014's 3.7%. It is expected that the rate will increase through 2018.

Based on the latest unit delivery timelines projected by Dupre+Scott, our forecast predicts the regional vacancy peaking at about 7.5% in late 2018, then falling back to a more long-term pattern. This spike will moderate rent growth, as existing properties face increased competition and new properties use lease-up concessions to fill their units. This may cause some of the planned projects, especially among the proposed towers, to delay their timelines.

Apartment investment is expected to continue at the level seen in 2015 as long as there are sufficient properties made available for sale. Values will continue to increase, although at a more moderate rate as rent growth slows, capitalization rates remain flat and operating expense continue to increase. There is a significant amount of institutional capital targeting the Seattle market, in addition to a traditionally strong local buyer contingent. No major changes in these trends are anticipated until the next significant increase in interest rates.

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