Kidder Mathews

3rd Quarter
2017

Real Estate Market Review

Seattle Multifamily

Regional apartment market vacancy rate is currently 3.9%, well below the 20-year average of 4.9%. Vacancy last peaked at a rate of 7.2% in Fall 2009 as the recession was fully felt. Occupancy increased ever since, with vacancy oscillating from 3.3% to 4.0% over the past four years as consistent demand has nearly matched the significant amounts of new inventory. Rental rates are at historic highs, but recently the rate of increase has moderated in the close-in markets. Some 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 remains strong in the 25 to 34 age bracket; a group traditionally skewed to renting
- A "rent" vs. "own" psychology continues due to the transitory nature of tech employment, but more households are maturing into home buying
- Preference remains for urban housing that is close to work, entertainment and restaurants, and light rail has added a variety of housing hubs with desirable new apartment options
- Home or condominium for sale inventory remains low and prices high in 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 nearly 31,900 units delivered in 2012-2015. The 2015 total of 10,595 was the highest annual production since 1991. Currently, 28,321 units are under construction, part of 73,149 planned for delivery in 2017-2021, peaking at 19,988 units in 2019. These apartment deliveries are expected to increase 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 2012-2015. 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.

The continuous delivery of new units has moderated rent growth over the past year, a trend expected to continue through 2019. It is forecast that rent will peak by mid-2019. Significant rent decreases are not anticipated, but there will likely be 2-3 years of flat or minor decreases

Market Trends

	CURRENT
Vacancy	3.9%
Est Current Units Under Construction	28,321
Avg Rental Rate (All Ages)	$1,531

Notable Sale Transactions

Hadley
209 units on Mercer Island
$95.75M ($437,215/unit)

Bridges @ 11th
184 units in Seattle
$64.40M ($348,108/unit)

Venn at Main
350 units in Bellevue
$176.50M ($468,170/unit)

Avante
382 units in Kent
$54.10M ($141,623/unit)

8th + Republican
211 units in Seattle
$101.25M ($452,009/unit)

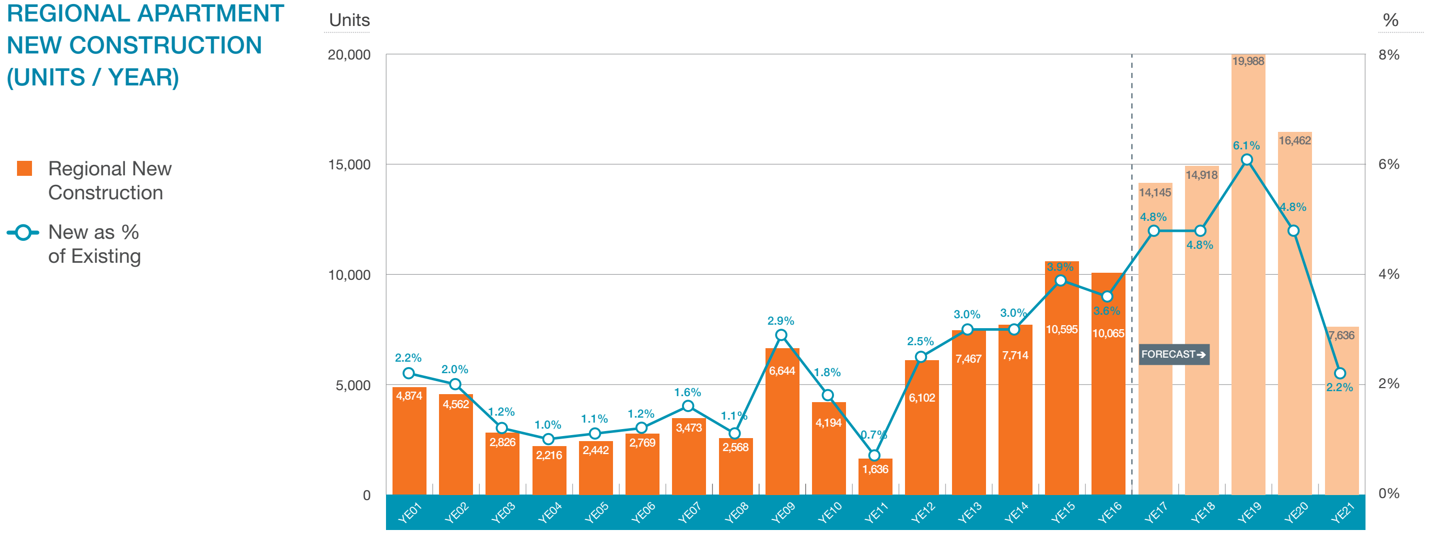
Helix and Ellipse
150 units in Seattle
$54.25M ($354,575/unit)

Avaya Trails
162 units in Renton
$43.00M ($265,432/unit)

Carroll's Creek Landing
288 units in Marysville
$60.60M ($210,409/unit)

Area Review

REGIONAL APARTMENT NEW CONSTRUCTION (UNITS / YEAR)



as the market absorbs the large amount of inventory in 2018-2020. Many economists are forecasting another recession within the next few years. The effects of that should be subdued in the region and if it does occur, much of the proposed inventory could be put on hold. Overall, the region's urbanizing trend is still relatively new and its strength and durability are vital to the apartment market. If, for example, the exurbs regain appeal to new generations, the effect on the apartment market would be significant.

Vacancy Trends

According to the Fall 2017 Dupre+Scott Vacancy Survey, the regional (five county) vacancy rate is estimated at 3.9%, up from 3.4% reported in the Spring 2017 report, the first indication of a leveling of the landlord/tenant balance. This main rate reported is a measure of "market" vacancy that excludes projects in lease-up or undergoing significant renovation. Including these units, the "gross" market vacancy is 5.4%. 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.

Rent Rate Trends

Over the past twelve months the average regional rent increased from $1,420 to $1,531 (7.8%). The King-Central sub-region has the highest overall rent in the region, currently averaging $1,964/month ($2.90/sf/month), up 6.6% over the past year. The King-Eastside sub-region has the second highest overall rent, currently averaging $1,910/month ($2.10/sf/month), up 5.6% over the past year. A portion of the increase is attributed to the higher prices of new units delivered over the past three years. Some submarkets like Ballard, Greenlake, Redmond, and Bellevue West have seen new units surpass the starting inventory of three years ago.

Concessions

While the majority of the markets have moved to effective rental rates, discounting (specials) are now being seen throughout the entire lease-up and have increased from a half-month to as high as two months on a 12-month lease in some submarkets. Regionally, the ratio of properties offering concessions has remained below 15% over the past two years. The average discount is currently $921; equal to about 2.5 weeks free rent, or a 5% discount.

Planned Rent Increases

The percentage of property managers anticipating increasing rent has remained flat at 33.0% of those surveyed, with average growth anticipated of 3.1% over the next six months. Extending this over the coming year, this would indicate a weighted average regional rent growth forecast of 2.05%.

Current Inventory / Supply

Currently there are an estimated 288,528 market rate units in complexes with 20 or more units in the five-county region. King County has the largest share of the inventory at 64.1%. That lead is likely to increase as 87.2% of the planned new development over the next four years is in King County. Pierce and Snohomish will account for about 6.4% and 4.3% 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. In comparison the annual average from 2012 to 2016 was 8,389 units.

Projected new construction over the next five years (if all completed) would increase inventory by 26.2% (73,149 units), compared with job growth of 7.5% (162,400 jobs regionally 2017-2021), it is obvious that vacancy will increase. That change is expected to be greater in the close-in markets where the bulk of new units will be delivered. The inventory growth rate is above the 30 year annual average of 3.2%, but is below the 1985-1991 period when inventory swelled by an average of 7.7% per year.

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 546 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 5,553 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 16,700 units over the previous three years, the trend reversed with some projects planned as condominiums were redirected to rental use. The future loss to demolition or conversion is expected to be limited as most obvious under-utilized properties have already been replaced and construction defect, financing and renters-rights laws make conversion much more difficult (and expensive).

Projected Future Supply

An estimated 10,595 units were completed regionally in 2015, a 3.9% increase over 2014; 2016 saw 10,065 units, a 3.6% increase. Deliveries jumped up significantly in 2017 with 14,145 units expected by year end, increasing to 14,918 in 2018 and peaking at 19,988 in 2019 before slowing in 2020 to 16,462 units.

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 2018-19. Most projects shown as due in 2017 and 2018 will be completed as most are already under construction or nearing a start, after that the attrition of projects increases significantly.

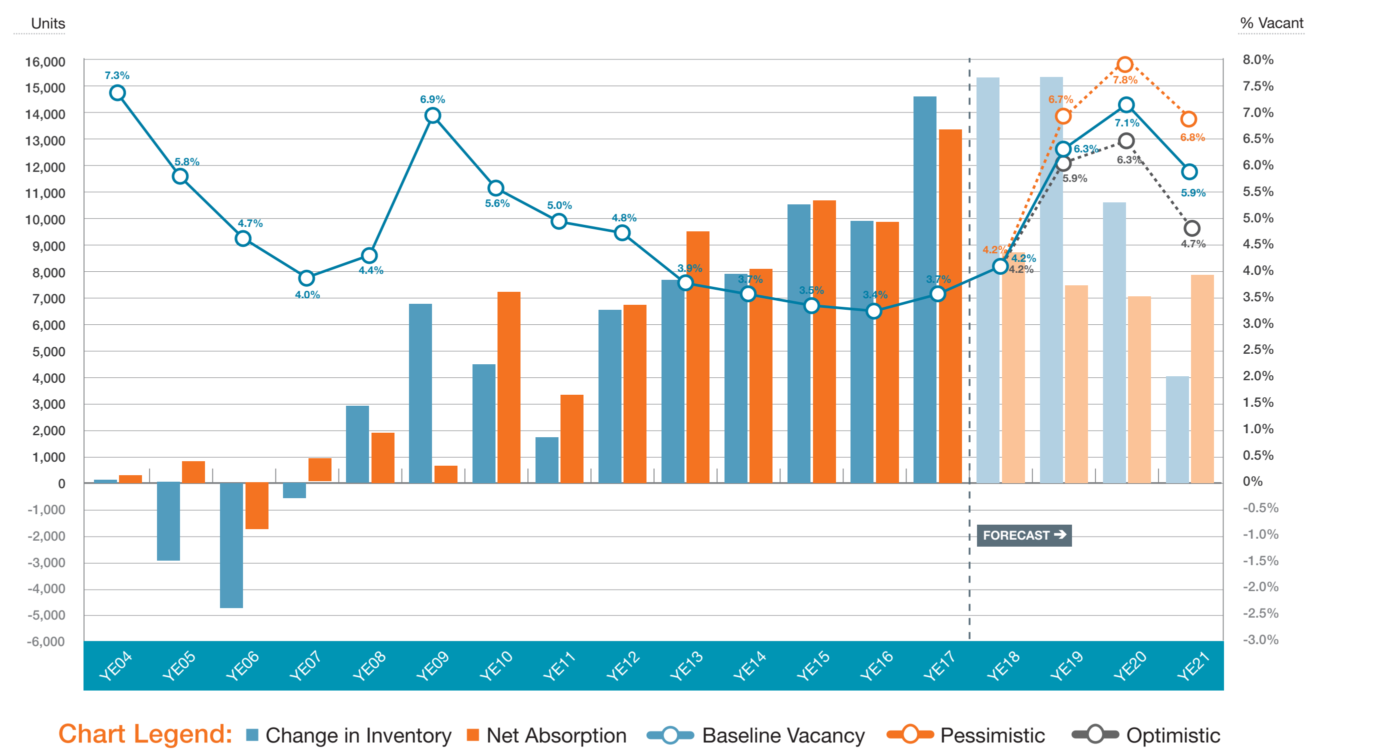
Of the 73,149 units planned for delivery over the next five years (2017 through 2021), 63,762 units (87.2%) are located in King County; 40,837 units (55.8% of the region) are in the Seattle sub-region; defined as the King-Central and King-North markets.

Estimate of Future Apartment Demand

The primary demand driver for apartment units is population growth which is mostly supported by employment growth. Employment figures for the greater Puget Sound region (including Thurston county) are projected at 2.2 million jobs for year-end 2017 and there are currently an estimated 282,400 occupied units in the region, inferring demand for one apartment for every 7.8 jobs. That ratio has gradually declined over the past nine years (it was 9.1 in 2007) as fewer households are buying homes, either by choice or due to prices jumping up in close-in neighborhoods and financing being more difficult to obtain with large down payment requirements. The downward trend in homeownership may slow; however, most economists expect it will continue to decline. This trend will be accelerated when interest rates increase, pricing more potential buyers out of the homebuying market. It is estimated that every 50 basis point increase disqualifies about 6% of the potential buying households.

One element offsetting this demand is that higher rental rates and a decelerating 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 7.8 in 2017 and declining by about 0.10 per year through the forecast.

HISTORIC ABSORPTION AND FORECAST



kiddermathews.com

Offices

Seattle
206.296.9600

Bellevue
425.454.7040

South Seattle
206.248.7300

Tacoma
253.722.1400

Olympia
360.705.2800

Portland
503.221.9900

San Francisco
415.229.8888

Redwood Shores
650.769.3600

Silicon Valley
408.970.9400

Sacramento
916.970.9700

Roseville
916.751.3600

Los Angeles
213.880.5250

Commerce
323.727.1144

Long Beach
562.472.0071

Orange County
949.557.5000

Inland Empire
909.764.6500

San Diego
858.509.1200

Carlsbad
760.430.1000

Reno
775.301.1300

Phoenix
602.513.5200

Contact

Brian Hatcher
Executive VP, Brokerage
Pacific Northwest
206.296.9600
bhatcher@kiddermathews.com

The information in this report was composed by the Kidder Mathews Valuation Advisory Group.

Jeremy Streufert, MAI
Gary Klockenteger, MAI
Richard Briscoe, MAI

Investment Activity

Sales velocity in the Puget Sound Region for properties with 20 or more units 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 (168 sales) exceeding the previous 2005 peak. This trend continued to a total of $5.14 billion in 2016. There was a definite change in the second half of 2016 with activity moving out from the Seattle core and into suburban markets as larger investors chased rate and better upside in these slower to recover submarkets.

In fact, sales in the core King-Seattle submarket fell from 54 for a total of $1.87 billion in 2015 to 46 sales totaling $1.13 billion in 2016. This was the result of both the move of capital in to other submarkets, but also the fact that 2015 included institutional acquisition of four major tower projects.

Through the 3Q 2017, sales are off 2016's activity, primarily due to a limited number of institutional sales. It has been reported that this pull-back was based on the increased risk of near-term weak rent growth and a fulfilment of allocations to this property type. Some of those investors have moved to value-add apartment acquisitions, but many are moving into office and industrial properties where long-term leases will provide more consistent income growth over the next two to five years.

It is expected that total sales volume for 2017 will land closer to the long-term average around $3 billion. All investor classes remain very interested in the market which does have strong fundamentals with broad-based job growth and barriers to entry that limit new construction in a number of regional submarkets. Local individuals and partnerships have been very active in the number of sales in secondary and small to mid-sized markets, prompted by attractive lending terms 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.

Overall capitalization rates for 2016 averaged 5.2%, a slight uptick from the 2015 average 5.1%. The average 2017 year to date has dropped to 4.9%, which is somewhat surprising given gradually slowing rent growth, increasing operating expenses (especially property taxes). The bottom line is that recent sales of newer projects with rents close to market are still attracting numerous potential buyers at 4.5%-5.0% returns, reinforcing the perceived positive risk/return at these rates to be better than many other investments.

Regional Conclusion

The regional apartment market remains 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, but there are definite signs that underlying fundamentals will be challenged by the combination of slower job growth and an expanding number of planned units. Rental rates have reached historic highs. However, the rent growth rates have slowed in core markets already, a trend that is expected to continue over the next few years as deliveries mount.

In 2015, 10,595 units opened – the highest level of production since 1991. The total fell slightly in 2016 to 10,065 units, then increasing to 14,145 units in 2017, 14,918 units 2018, and 19,988 units in 2019. Through the Fall 2017 surveys, vacancy has ticked up regionally by 0.5% over the past six months to 3.9% in response to accelerated deliveries and slowing job growth. The rate is now expected to continue inching up through 2020.

Based on the latest unit delivery timelines projected by Dupre+Scott, our forecast predicts the regional vacancy peaking at about 7.1% in late 2020, then falling back to a more long-term pattern. This spike will further 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 volume closed out 2016 at another all-time high; however the end of the year and the first three quarters of 2017 showed a slowing, especially in the core of the Seattle market. Institutional investors continue a move into value-add and secondary market properties and some have refocused on other asset categories as the apartment market is peaking. Local and regional partnerships and local individuals have picked up some of the slack. Values should continue to increase, although at a more moderate rate as rent growth slows, capitalization rates remain flat and operating expenses continue to increase. This trend should continue until the next significant increase in interest rates.