Kidder Mathews

Real Estate Market Review

King, Snohomish, and Pierce Counties

2nd Quarter
2016

Seattle Office

Market Forecast

	Current / Projection	
Vacancy	7.64%	↓
Construction	8.67M sf	↔
Rental Rate	Varies*	↑
Absorption	668,481 sf	↑

* by submarket

Market Highlights

Regional vacancy rate trended down over the quarter to 7.64%. Net absorption was strong at 668,481 s.f.in the quarter, 78% of that in the Seattle market. Availability rate dropped as only one, fully leased, new project got started in the quarter.

Construction activity increased in the quarter as the 300,000 s.f. FAA office building broke ground. There are now 22 office projects underway; 16 in the Seattle CBD, three in the Bellevue CBD, one each in Kirkland, Renton and Des Moines. Fourteen of the Seattle projects are speculative, currently about 44% pre-leased.

Office property sales was strong in the quarter, with several major institutional-quality sales in the quarter, both new construction and vintage properties. Non-CBD properties continue to see more interest.

Rental rates moved upward slightly in the quarter, a trend expected to continue. ■

Seattle's economy and office market have continued to outperform the nation. The national economy has shown some signs of slowing and the Fed has had to downplay the potential of a relapse into recession. Some of these jitters are a result of the new culture where stock prices are analyzed on an hourly basis, compared with quarterly tracking of not so long ago. The Presidential elections are also having an effect, not because the choice itself will move the financial markets, but because of the concerns it raises in the general population. International issues will continue to slow the world economy, which will affect the United States in the form of trade issues. But for the business sectors that have grown the Seattle economy and office market over the past decade, these factors have limited influence.

Trade imbalances do not have much effect on Google's stock price, for example. The Seattle market is fortunate in that its tech sector has reached critical mass wherein all of the larger companies are expanding here because all of the others are as well. A key to this is the established talent pool here, which is an attractive place to live for typical tech employees. On its face, this tech build-up has some of the characteristics of the dot.com boom of the early 2000s. However, Amazon, Facebook, Google and Microsoft are not too big to fail, but they actually have employees in the space they have leased, unlike many of the dot.com companies in 2001. Overall, the Seattle economy and the resulting demand for office space are considered solid with a modest slowing trend. The office market continues to trend to a stabilized status with manageable rent growth and good absorption.

The regional vacancy rate moved down to 7.6% in the second quarter with the availability rate dropping a bit faster to 11.4%. Net absorption was nearly even with the first quarter, slightly off the 2015 pace, but that is expected to change later in the year when a couple of big projects are delivered fully leased. There are few larger spaces available in existing buildings, but that has not yet resulted in major leases in six of the 13 major towers under construction in the Seattle and Bellevue CBDs. Among the largest new leases in the quarter were Avalara, expanding from a number of smaller spaces into 100,000 s.f. in American Life's Hawk Tower, RedFin leasing 112,000 s.f. at Hill 7 and WeWork preleasing 75,000 s.f. in Lincoln Square II

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Area Review

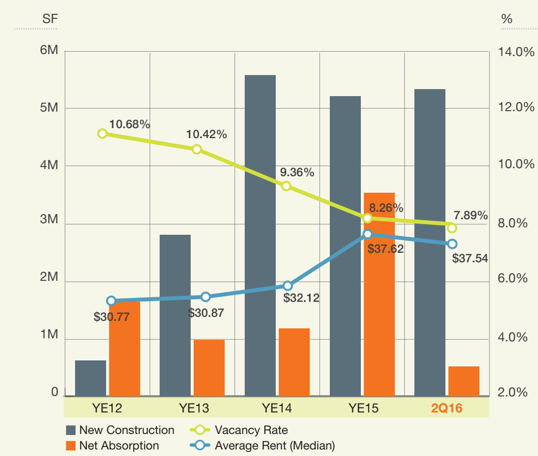
Seattle CBD/Surrounding Area Review

The Seattle submarket recorded another strong quarter with net absorption at 519,889 s.f. The vacancy in the submarket dropped slightly to 7.89% while the availability rate dropped 50 bps to 11.20%, with the absorption not being offset by new space this quarter. In the Seattle CBD submarket, the vacancy rate is 12.5%. The availability rate fell 150 bps but remains high at 17.2%, due to the significant amount of available space under construction. The speculative space under construction in the Seattle market totals just more than 4.0 million s.f. About 44% of that space is pre-leased. Over half of the available space under construction is in the two new high rises under construction in the financial core, with no pre-leasing announced so far. Significant leases continued to be finalized in the last quarter of the year, continuing the pressure on rental rates. The biggest leases in Seattle were in Hill 7 at the border of the CBD and South Lake Union and in Hawk Tower on the south edge of Pioneer Square. The downward vacancy trend in the Seattle market and the Seattle CBD in particular, is expected to continue through the next two years, moderated somewhat by the lack of preleasing in the two core towers. Upward pressure continues to affect rental rates; however, the increases have slowed to a more moderate pace as the new construction continues to be delivered and the prices for legacy Class A rose significantly over the past year.

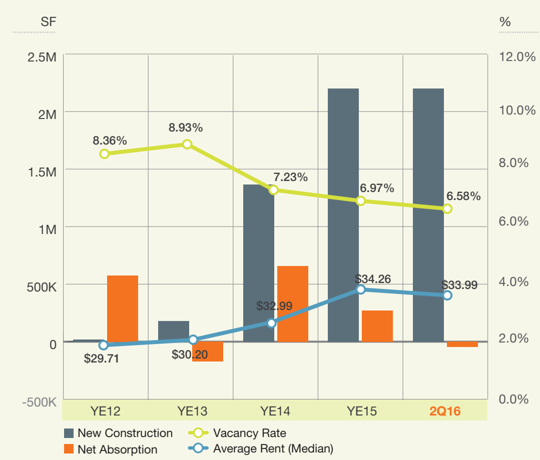
Eastside Review

The Eastside market actually lost a little occupied space in the 2nd quarter with net absorption of -44,940 s.f. As a result, the vacancy rate increased slightly to 6.58%. The availability rate continued to decrease, to 10.4% down 40 bps over the quarter. Vacancy in the Bellevue CBD ended the quarter almost unchanged at 10.5% with the availability rate flat at 19.2%, as most of that is tied to the three towers under construction. There are a few large tenants looking for larger spaces in the Eastside markets, but there have also been growing caution in the face of the volatile stock market and reduced equity funding. Important to the CBD is the fact that Microsoft has been granted a zoning variance on portions of their Redmond campus that would allow 10-story buildings. The company plans to replace some low-rise space with these buildings to bring more employees back to campus. The company occupies about 1.2 million s.f. in the Bellevue CBD. Late last year they had put part of that space up for sublease, planning to bring those employees back to campus. This, added to the pending vacation of Expedia space as they move to their campus in 2017, and delivery of three towers with almost 1.4 million s.f. of available space over the next two years, will likely result in an extended oversupply in the submarket. Outside of the CBD, the Kirkland, Redmond and 520 submarkets continue to perform very well, ending the quarter with vacancy rates between 3.5% and 4.9%. Rental rates in the suburban submarkets around the Bellevue CBD continue to firm up as smaller companies expand and take advantage of mid-$20/sf/year, NNN range for newer product, plus free parking. Sales activity increased significantly in these suburban locations with sales of Eastgate Office Park (as Beacon Properties continues to divest), Symetra Financial Center and several smaller buildings in the suburban markets in the 2nd quarter. Net of the issues in the Bellevue CBD, the rest of the Eastside market is expected to see vacancies trend downward and rental rates upward over the next few years.

SEATTLE CBD/SURROUNDING AREA



EAST KING COUNTY



South King County Review

The South King County market absorbed 113,763 s.f. in the second quarter, the third best quarterly performance in the past five years. The result was vacancy rate dropping a 51 bps to 8.82% and the availability rate by a full percentage point to 16.10%. One quarter of the entire availability is the 840,000 s.f. Southport Office Campus under construction in Renton. The three nine-story 280,000 s.f. office buildings have not yet announced any pre-leasing. Joining this project under construction is the 300,000 FAA office building located near the south end of SeaTac International Airport. In general, leasing activity in South King County continues to consist of mostly small tenants, pointing to the steady rising confidence of small businesses. No major changes from the recent trend are expected in the South King County market in the coming year, resulting in modest reduction in the vacancy rate and some firming of rental rates.

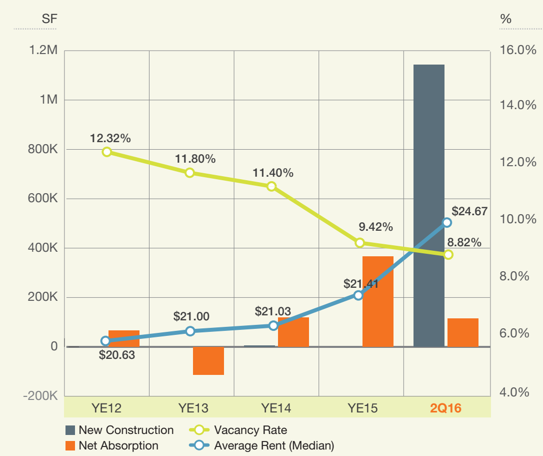
Northend Review

The vacancy rate in the Northend office market continues to move downward, ending the second quarter down 53 bps at 7.56% on the strength of 49,197 s.f. of net absorption. The availability rate dropped to 9.90%, a 60 bps adjustment. The performance was encouraging as it was in spite of Bothell losing over 50,000 s.f. of occupancy in the quarter. The Lynnwood/Edmonds submarket led the improvement with vacancy falling by 60 basis points on net absorption of 27,758 s.f., most of that to a variety of smaller tenants. The Northend submarkets continue to attract tenants looking for a combination of higher value, lower cost office space and more affordable housing for workforces. Asking rental rates have been flat for the past year and are not expected to increase significantly in the near future.

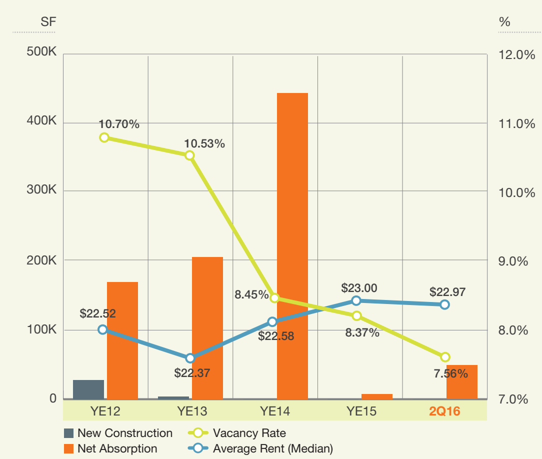
Pierce County Review

The Pierce County market ended the 2nd quarter with net absorption of 30,57 s.f., very close to the first quarter and taking another 23 bps off of the vacancy rate to 8.03%. The availability rate dropped to 12.00%, down 70 bps for the quarter, now down by nearly 300 bps from the 15.9% rate during the depth of the recession and following the loss of Russell Investment in late 2010. Asking rent has been hovering around the $21/sq ft/year rate for the past year. Tacoma CBD vacancy fell to 8.30% this quarter, the third 60-70 bps quarterly decrease in a row. The CBD availability rate is 10.9%, down 110 bps over the past quarter. Part of that improvement was the repurposing of the former Elks Lodge to a McMinamins hotel and brewpub. A number of similar non-functional vintage buildings will create a permanent base level vacancy in the CBD until redevelopment gains more traction. The Old City Hall is another example, carried as vacant office space, but expected to be converted to an alternate use. Sales in this market continue to be focused on smaller properties, primarily owner/user acquisitions. No sales of non-medical office properties over $1.5 million closed in the quarter.

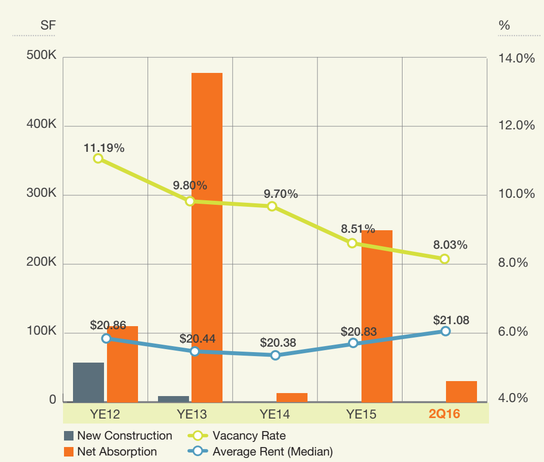
SOUTH KING COUNTY



SNOHOMISH COUNTY



PIERCE COUNTY



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2nd 2016 Seattle Office Sales

Name	City	Date	Price	SF	$/SF
Symetra Financial Center	Bellevue	May-16	$185,000,000	445,089	$415.65
Eastgate Office Park	Seattle	Apr-16	$74,725,000	295,413	$252.95
Redmond Technology Center	Redmond	May-16	$30,250,000	101,855	$296.99
1411 Fourth Building	Seattle	Apr-16	$29,000,000	123,430	$234.95
1550 4th Avenue S	Seattle	May-16	$18,000,000	51,550	$349.18
DJC Office Building	Bellevue	Jun-16	$10,800,000	24,497	$440.87

and potentially 210,000 s.f. in Selig's 3rd and Lenora project. Rental rates were generally flat between the first and second quarters.

VACANT SPACE/VACANCY RATE

All five of the regional markets registered a drop in the vacancy rates again in the second quarter. Overall, the regional rate dropped another 23 bps to 7.64%. This leaves about 14.6 million square feet vacant out of a standing inventory of 191.4 million square feet. The availability rate moved up to 11.36% from 11.92% as no new projects were started in the quarter and absorption was good. The rate is expected to hold near this level near-term as about four million square feet of new inventory is delivered over the next two years. The current quarter shows 42% of the space under construction pre-leased. Worst case, however is not too onerous as without any further pre-leasing the effect of all this new space would be to increase the region's vacancy rate by a total of 210 bps. It is fully expected that there will be a significantly more leasing secured prior to completion of many of these projects.

NEW CONSTRUCTION ACTIVITY

The only new office project to break ground in the 2nd quarter is the FAA's new 300,000 s.f. building in Des Moines just south of the SeaTac airport. This brings the total of major general office buildings under construction to 22. These buildings total 8,673,346 s.f. Of that total, 7,107,350 s.f. is speculative space which is currently 30% pre-leased. The bulk of the unspoken for space is in seven large towers; four in the Seattle CBD and three in the Bellevue CBD. Proposed projects include the South Lake Union expansion of Google (607,000 s.f.), the 3rd and Lenora building, and the reemerging 1.1 million square foot Urban Visions office campus in south Seattle. The latter project would consist of a campus of six 8-10 story buildings located on the Link light rail line. For the most part development has been restrained. Overall, development is well matched by absorption.

RENT FORECAST

Rental rates continue to show moderate increases as in most instances the supply of vacant space is sufficient to keep pressure off pricing. The satellite markets should see more of these increases as smaller business continue to expand and vacancy falls over the next few years. Those increases will be tempered, however as small business economics have improved much slower than those of major companies. Rent growth increases for new Class A space in the Seattle and Bellevue CBD are expected to moderate as the next wave of speculative space is delivered and the number of major lead tenants is limited. Also, the current rent levels are cost feasible which will enable additional construction starts in Bellevue, the pending loss of Expedia has not yet been felt and in Seattle, the effect of Amazon identifying most, if not all, of the space for their stabilized space requirement is yet to be seen in terms of the supply versus demand balance.

INVESTMENT MARKET

Non-medical office sales in the first quarter totaled about $440 million, with a total of 65 sales. Nearly half of the total was accounted for in the sale of Symetra Financial Center in the Bellevue CBD for $185 million. The Eastside's suburban markets active again this quarter including the $74,725,000 sale of the four building Eastgate Office Parks and the $30,250,000 Redmond Technology Center. The capitalization rates for these two projects were 7.40% and 6.51% respectively, influenced by the differing age of the buildings. The average price for the entire quarter's sales volume was $309/s.f at an average capitalization rate of 6.3%, both indicators reflecting the higher ratio of suburban space in this data set. Overall there is strong investor confidence in the region's long-term growth potential, and it is becoming more willing to invest outside of the CBDs.

Data Source: CoStar