Kidder Mathews

Real Estate Market Review

King, Snohomish, and Pierce Counties

3rd Quarter
2016

Seattle Office

Market Forecast

	Current / Projection	
Vacancy	7.0%	↓
Construction	7.97M sf	↓
Rental Rate	Varies*	↑
Absorption	1,576,216 sf	↑

* by submarket

Market Highlights

Regional vacancy rate trended down over the quarter to 6.97%. Net absorption was strong at 1,576,216 s.f. in the quarter, 69% of that in the Seattle market. Availability rate dropped to 11.33% as one new speculative space started construction this quarter, offset by strong leasing in the quarter.

University Center was delivered this quarter, replaced by 9th and Thomas to keep the total at 22 office projects underway; 16 n 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 47% pre-leased. Four buildings will open in the 4th quarter, all of these are fully pre-leased.

Office property sales were 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 increasing interest.

Rental rates moved upward 1-2% in the quarter, a trend expected to continue. ■

While the tenor of the approaching Presidential election has had a chilling effect on retail sales and made Wall Street jumpy, the Seattle office market has not slowed a bit over the past two quarters. Leasing activity and office investment both picked up in the third quarter and continued to expand in markets outside of the Seattle CBD where the recovery first started. Tech tenants continue to expand. Vulcan recently gained design approval for Google's South Lake Union Campus, Amazon pre-leased Schnitzer's 425 Centre and Apple is reportedly looking for between 200,000 and 1,000,000 s.f., depending on the source, but other tenant categories have become more involved as well, the Davis Wright Tremaine law firm took eight floors in Madison Center, Samsung leased a full floor in 400 Lincoln, and the Bellevue accounting firm of Clifton Larson Allen leased 25,000 s.f. in suburban Bellevue, as examples. Sales volume in the quarter was nearly a billion dollars, led by the 50-story multi-tenant Safeco Tower, Amazon Campus Phase VII, and Touchstone's Hill7 with a three building total of $814 million. Investors widened their horizon as well, including the 1980s vintage Safeco Tower, Bay Vista Office Tower in Belltown and Lincoln Executive Center in the Eastside's I-90 submarket.

In terms of the numbers, the regional vacancy rate moved down to 7.0% in the third quarter with the availability rate dropping slightly to 11.3%. Net absorption was nearly 20% more than the first two quarters combined. The total for the year is closing in on 3,000,000 s.f., but it looks as if the 2016 total may fall slightly short of the 2015 total. There are few larger spaces available in existing buildings, and this has finally pushed expanding tenants into the new construction projects. There are currently 22 general office buildings under construction in the region with a total of 8.5 million s.f. The 16 Seattle properties are 59% pre-leased and the three buildings underway in Bellevue had

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Area Review

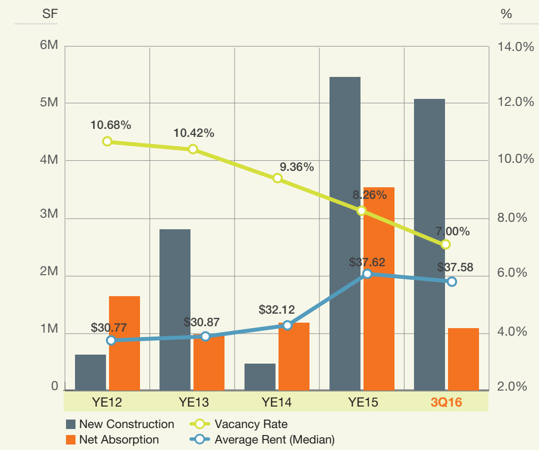
Seattle CBD/Surrounding Area Review

The Seattle submarket third quarter absorption was more than double the previous quarter ringing up 1,085,342 s.f. of net absorption. The vacancy rate dropped 89 bps to 7.00% while the availability rate increased 50 bps to 11.7%, due to the addition of the 9th & Thomas space to the pool of available space. In the Seattle CBD submarket, the vacancy rate fell to 9.6% from 12.5% last quarter after a number of leases signed over the summer commenced. The availability rate fell 50 bps, but remains high at 16.7%, due to the significant amount of available space under construction. The speculative space under construction in the Seattle market totals nearly 4.1 million s.f. About 47% of that space is pre-leased. Over half the available space under construction is in the two new high rises under construction in the financial core, even after Davis Wright Tremaine's 166,500 s.f. lease in Madison Centre. Significant leases continued to be finalized in the last quarter of the year, continuing the upward pressure on rental rates. 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 slow pace 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 new construction projects have held their rates and prices in the legacy Class A properties are as close as possible to new construction after major increases over the past six quarters.

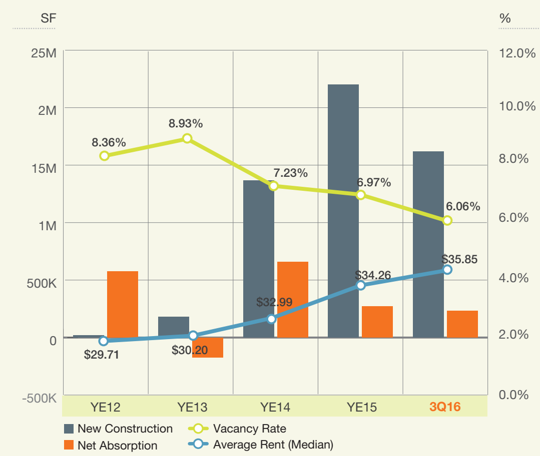
Eastside Review

The Eastside market picked up the pace over the past quarter with significantly more activity in both the Bellevue CBD and the more suburban submarkets. Net absorption was 233,101 s.f. in the quarter, nearly equaling the total for all of 2015. As a result, the vacancy rate fell by 52 bps to 6.06%. The availability rate continued to decrease, to 9.6% down 40 bps again this quarter. Vacancy in the Bellevue CBD ended the quarter at 9.7%, down from 10.5% last quarter. The availability rate change reflects the leasing at 400 Lincoln (Samsung, WeWork, Valve and Stifel Nicolas), and Centre 425 (Amazon), dropping availability by 180 bps to 17.4%. The three towers under construction in the CBD are now 52% pre-leased. There are a few large tenants looking for larger spaces in the Eastside markets, reportedly including Apple. Looming on the horizon in the CBD are the pending vacation of over 500,000 s.f. by Expedia and the possibility of Microsoft not renewing in Bravern as it moves forward with plans to increase the density of its Redmond campus. The company has acknowledged the desire to bring more employees back to campus, but has not indicated where those employees would move from; however, the company did put part of its Bravern space up for sublease in late 2015. The total of Expedia, Bravern and the unleased space in 400 Lincoln and 929 Office Tower is just over 2 million s.f. This will likely result in some level of oversupply in the submarket during the next few years. Outside of the CBD, the Kirkland, Redmond and 520 submarkets continue to perform very well, ending the quarter with vacancy rates between 3.2% and 5.9%. 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, plus free parking, for newer product. Sales activity increased significantly in these suburban locations with sales of Lincoln Executive Center (Beacon Properties last remaining Eastside property), Redmond Woods and several smaller buildings in the suburban markets in the third 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 36,010 s.f. in the third quarter, about a third of the net gain in the previous quarter, but enough to drop the vacancy rate to 8.54% and the availability rate by 30 bps to 15.80%. The main component of that availability rate is the three-building, 840,000 s.f. Southport Office Campus under construction in Renton. No pre-leasing has been announced, but the project is not expected to be open for two more years. The only other major project under construction in the South King market is the 300,000 FAA office building located near the south end of SeaTac International Airport. An encouraging sign was the 33,200 s.f. lease to Cogent Communications at the Davita Data Center in the Federal Way submarket that has struggled recover from the loss of Weyerhaeuser. 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.

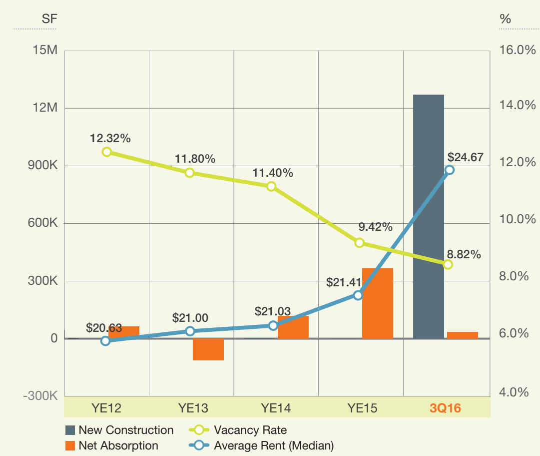
Snohomish County Review

The vacancy rate in the Northend office market continues to move downward, ending the third quarter down 30 more bps to 7.02% on the strength of 107,146 s.f. of net absorption. The availability rate also dropped 30 bps to 9.60%. The performance was encouraging, in spite of the Bothell submarket showing net absorption of only 2,068 s.f. for 2016 to date, resulting in the current 10.1% vacancy rate. The Lynnwood/Edmonds submarket led the improvement with vacancy falling to 7.1% on 2016 YTD net absorption of 112,223 s.f., most of that by 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 moved up 2% in the third quarter; still very affordable at $23.43/s.f/year, full service. The slow decrease of the vacancy rate and increase in rent are expected to continue for the near future.

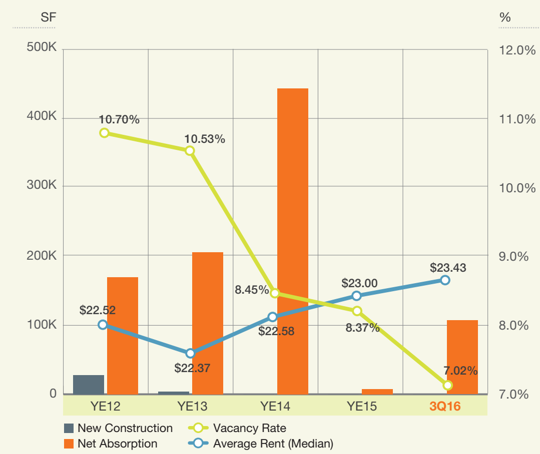
Pierce County Review

The Pierce County market absorption picked up in the third quarter at 114,617 s.f., nearly double the total for the first half of the year. The vacancy fell 66 bps as a result, ending the quarter at 7.37%. The availability rate dropped another 70 bps this quarter to 11.30%, from the 15.9% peak due to the combination of the the recession and the loss of Russell Investment in late 2010. Asking rent has been hovering around the $21/s.f./year rate for the past year, but did move up about 1.5% in the quarter. Tacoma CBD vacancy fell to 7.00% from 8.30% last quarter, continuing that submarket's strong year. The CBD availability rate is 9.7%, down 50 bps over the past quarter. Part of the improvement this year was the repurposing of the former Elks Lodge to a McMinamins hotel and brewpub, and that property being removed from the office inventory. A number of similar non-functional vintage buildings continue to create a permanent base level vacancy in the CBD, but it does appear that redevelopment of some of these is getting closer. 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. Nine sales of non-medical office properties over $1.4 million closed in the quarter. Another $1.4 million of sales was rung up in three medical office projects, showing the importance of that affiliated market category in the Pierce County market.

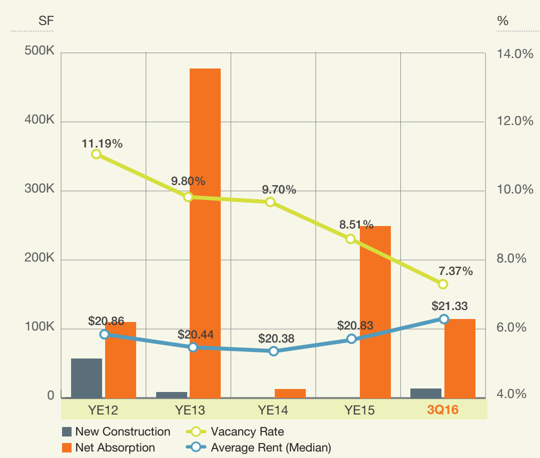
SOUTH KING COUNTY



SNOHOMISH COUNTY



PIERCE COUNTY



Kidder Mathews

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

Orange County
949.557.5000

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.

Richard Briscoe, MAI
206.296.9600
rbriscoe@kiddermathews.com

3rd 2016 Seattle Office Sales

Name	City	Date	Price	SF	$/SF
Columbia Center	Seattle	Aug-15	$711,000,000	1,535,620	$463.01
Safeco Plaza	Seattle	Jul-16	$387,000,000	793,679	$487.60
West 8th	Seattle	Feb-16	$370,000,000	497,798	$743.27
Amazon Phase VIII	Seattle	Jul-16	$246,800,000	317,804	$776.58
2201 Westlake	Seattle	Jul-15	$251,000,000	317,102	$791.54
Amazon Phase VIII	Seattle	Jul-16	$246,800,000	317,804	$776.58

a very good quarter that ended with 52% of that space preleased, but six of the towers have not signed any significant leases. All of this activity and the falling vacancy rate allowed for rent increases in all of the submarkets with the Eastside showing the biggest movement in terms of actual lease rates.

VACANT SPACE/VACANCY RATE

All five of the regional markets registered a drop in the vacancy rates for the sixth straight quarter. Overall, the regional rate dropped 67 bps to 6.97%. This leaves about 13.4 million s.f. vacant out of a standing inventory of 192.6 million s.f. The availability rate barely moved in the quarter, ending at 11.3%,down from 11.4% last quarter. The rate is expected to hold near this level near-term as about four million s.f. of new inventory is delivered over the next two years. The current quarter shows 50% of the space under construction pre-leased on a regional basis. This is not too onerous as even without any further pre-leasing the delivery of the unleased space would increase the region's vacancy rate by only 220 bps. It is fully expected that there will be 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 third quarter was the speculative 168,100 s.f. multi-tenant building at 9th & Thomas in the South Lake Union neighborhood. This building replaces the University Center building that opened in the quarter, keeping the total number of major general office buildings under construction at 22. These buildings total 8,497,398 s.f. Of that total, 7,231,402 s.f. is speculative space which is currently 41% pre-leased. The bulk of the unspoken for space is in six large towers; four in the Seattle CBD and two in the Bellevue CBD. There are indications that a deal may be in the works for some or all of Tilt 49 nearing completion on the south edge of the South Lake Union neighborhood. No new projects were proposed over the quarter and development has been well paced so far.

RENT FORECAST

Rental rates continue to show increases in the third quarter as the vacancy dropped and the inventory of large space tightens. The secondary markets increased by 1-2% over the quarter. In the Southend submarket, the increase was skewed by the fact that nearly half of the vacant space is now in Southport Office Campus, the highest priced space on the market. Small business economic improvement continues to be sluggish and much slower than at large companies. Rent growth increases for new Class A space in the Seattle and Bellevue CBD has been stable as the amount of new space remains relatively high outside of the large contiguous spaces. Also, current rent levels are cost feasible which will enable additional construction starts in both CBDs.

INVESTMENT MARKET

Non-medical office sales in the third quarter totaled about $864 million in a total of 70 sales. Nearly half of the total was accounted for in the sale of Safeco Plaza in the Seattle CBD for $387 million. Also in Seattle, Amazon Campus Phase VIII sold at $247 million and Hill7 sold for $180 million. All three of these sales are indications that institutional investors are elevating office investment to the top of their lists. The Eastside's suburban markets were also active this quarter including the $80.5 million sale of the five building Lincoln Executive Center in the I-90 submarket. The capitalization rate in this sale was 7.14%, a result of near-term leasing and renovation costs. The average price for the entire quarter's sales volume was right at $400/s.f at an average capitalization rate of 5.2%, both indicators skewed by the pricing for the blue chip properties sold in the Seattle CBD. Overall, there is strong and increasing investor confidence and interest in the region based on its long-term growth potential and broad-based employment growth. It is expected that sales of suburban properties will increase as those prices currently offer more upside as values have not yet recovered from the beating taken in the recession.

Data Source: CoStar