Compared with the rush of activity in a strong 4th quarter finish to 2016, the region’s office market coasted through the first quarter of 2017. All trends held their course; vacancy falling, absorption positive, rents increasing, investors buying, but the changes were modest. The regional vacancy rate inched downward from 7.73% to 7.69% while 19 bps were shaved off the availability rate dropping that indicator to 10.82%. This on net absorption of only 43,375 s.f. in the quarter. The average asking rent was up in each of the submarkets, ranging from 1% in East King County to 5% in South King County. The net number of projects under construction fell to 19 in the quarter with the delivery of Amazon II (now called Day 1) and the Commons at Ballard. The total amount of space underway is 7.33 million square feet. Overall, these buildings are 55% pre-leased, including 44% of the 5,930,000 s.f. of speculative space. Part of these numbers is the first quarter announcement that Amazon will lease the 290,700 s.f. Tilt49 building nearing completion on the south edge of the South Lake Union neighborhood. Also this quarter, Kemper Development announced that the Lincoln Square II office building is 90% leased to 11 tenants with additional leases in progress. This leaves only the 929 Tower with significant blocks of available space out of the three towers built so far this cycle.

One interesting change in the office market was the decision by Capstone Partners to redirect their development site adjacent to Dexter Station, which is fully leased by Facebook, from a 150,000 s.f. office project to apartment use. The office was expected to provide expansion space for Facebook; however late last year Facebook announced a major lease for two buildings to be built by Vulcan. It is too early to tell if this is a sign of caution for the office market or a tribute to the apparently insatiable demand for housing in the South Lake Union neighborhood.
Area Review

Seattle CBD/Surrounding Area Review

There was negative net absorption in the Seattle submarket in the first quarter, mostly a function of new space being delivered with occupancy by pre-lease tenants lagging completion by a few months. There were no major vacations of downsizing in the market. The Seattle submarket vacancy rate increased slightly to 7.30% from 7.10% last quarter. The availability rate fell 60 bps to 10.40%, highlighting the effect of the leased but not yet occupied factor. Amazon taking Tilt49 was the largest lease announced in the quarter. Amazon also announced its plans for a half block north of the recently completed Day 1 building. A 17-story 405,000 s.f. building is envisioned, tying in to the 853,000 s.f. in two buildings it has planned on its block across 7th Avenue to the east. In the Seattle CBD submarket, the center of the CBD, the vacancy rate decreased slightly to 10.4% from 10.6% last quarter, and the availability rate fell 30 bps to 14.8%. These moves are welcome news for this neighborhood, which continues to look for ways to compete for the tech tenants with South Lake Union and funky Pioneer Square space to the south. The speculative space under construction in the Seattle market totals nearly 4.2 million s.f. About 50% of that space is pre-leased. Fully half of the available space under construction is in The Mark and Madison Centre, where preleasing of the total of 1,250,000 s.f. remains at 13%. The downward vacancy trend in the Seattle market and the Seattle CBD should continue through the next two years with a minor blip as The Mark and Madison Centre open and are added to the vacant space. On the investment side, the closing of Urban Union in January represented the only significant sale in the submarket.

Eastside Review

The Eastside office had strong first quarter absorption of 214,802 s.f., which is good start to 2017 after 734,500 s.f. of vacant space was added to the market at year-end 2016 with the delivery of 929 Tower and 400 Lincoln. The first quarter vacancy dropped down to 7.37% compared to 7.86% vacancy for the 4th quarter 2016. The Bellevue CBD is the center for most of the new Eastside office construction. Bellevue CBD vacancy decreased slightly from 17.4% last quarter to 16.6% this quarter while the availability rate increased slightly from 11.6% to 12.5%, resulting in mostly flat rents over the past year and thus far into 2017. Still looming is the pending vacation of more than 500,000 s.f. by Expedia in the CBD and uncertainty surrounding Microsoft’s future at Bravern and Advanta as they continue to consolidate back to the main campus in Redmond. The total of Expedia, Bravern and the unleased office space in 400 Lincoln and 929 Office Tower is just over two million s.f. which will likely result in some level of oversupply in the submarket during the next few years, keeping CBD vacancy in the double digits and rents flat. That said, there does remain some interest from outside tenants looking for Eastside space. The submarkets outside of the CBD continue to perform quite well, ending the quarter with vacancy rates of 6.6% and 2.9% respectively in Kirkland and Redmond, and 6.1% along the I-90 Corridor. Rental rates in the suburban submarkets around the Bellevue CBD continue to firm up as smaller companies are re-positioning while rates continue to increase in the strong submarkets with little new construction underway. Aside from the near-term office availability in the Bellevue CBD, the balance of the Eastside office market is likely to see vacancies continue to trend downward and rental rates increase over the next few quarters. Sales activity in Eastside during the first quarter 2017 was quiet relative to the end of 2016, but activity in small to mid-sized properties was still good. Notable sales for this quarter include Building E of Willows Commerce Park II, 2229 Building and Building 2 of the Evergreen Office Park.
South King County Review

The South King County market continued to lose occupancy in the 1st quarter with negative net absorption of 56,630 s.f. compared with a total loss of 94,198 s.f.in 2016. The vacancy rate increased to 10.91% and the availability rate held at a region-wide high of 17.40%. The main component of that availability rate is the 748,000 s.f. Southport Office Campus under construction in Renton. No pre-leasing has been announced. The only other major project under construction in the South King County market 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, most of whom are still not showing major recoveries after condensing operations in the recession. No major changes from the recent trends are expected in the South King County market. Traditionally this market is the last to recover, providing lower rental rates as the more active Eastside and Seattle markets price out some tenants.

Snohomish County Review

The Northend office market showed gradual improvement through 2016 and continued this positive trend into 2017 with a 1st quarter vacancy rate of 7.18%, down from year-end 2016 vacancy of 7.29%. The availability rate also dropped by 10 bps to 10.10%, compared to the year-end rate of 10.20%. Net absorption for the 1st quarter 2017 was positive at 30,811 s.f. following strong 2016 absorption of 450,739 s.f. The Everett CBD has been fairly quiet with a current vacancy of 6.5%. The Lynnwood/Edmonds submarket remains one of the more active Northend submarkets with a 1st quarter vacancy of 6.0%, down from the year-end 2016 vacancy rate of 6.9%, fueled by strong 2017 year-to-date net absorption of 58,883 s.f. and no projects currently under construction. The Northend submarkets continue to attract smaller office tenants looking for a combination of affordable office space and good proximity to lower cost housing for its employees. Asking rates moved up by $0.21/s.f. from last quarter to $23.79/s.f./year, full service which compares favorably to other regional office markets. The gradual decline of vacancy and slow but steady increase in rent quotes are forecast to continue through 2017.

Pierce County Review

The Pierce County market extended the strong absorption seen at the end of 2016 into the first quarter of 2017 with net leasing of 30,811 s.f. The vacancy rate moved down to 7.30%, and the availability rate fell by 60 bps to 11.0%. The Tacoma CBD vacancy rate is 7.6%, down 50 bps over the quarter, and the availability rate is down 70 bps to 9.4% over the past quarter. The reason for the improvement was the conversion of the functionally obsolete vintage Washington Building to residential use. The trend of non-functional vintage buildings being redeveloped is expected to accelerate as the Tacoma CBD is seeing a renaissance in terms of office, residential and retail support. Rental rates in the Pierce County market increased 3% in the quarter. With the exception of the Washington Building, sales in this market are focused on smaller properties, primarily for owner/users, or for redevelopment. The pace improvement in the market overall is expected to increase, especially in the CBD.
1Q 2017 Seattle Office Sales

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<tr>
<th>Name</th>
<th>City</th>
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VACANT SPACE/VACANCY RATE

The regional office market has right at 15 million square feet of vacant space, out of a standing inventory of 195.2 million square feet. The vacancy rate at 7.63% is the lowest since 2000 at the height of the dot.com bubble. The availability rate is also at its lowest point since this benchmark started being reported in 2005 quarter. Both of these indices are expected to continue falling, with the vacancy rate vulnerable to a minor spike as The Mark and Madison Centre deliver over a million square feet of vacant space later this year. That space is enough to increase the regional vacancy rate by 55 basis points. It is fully expected that there will be significantly more leasing secured prior to completion of many of these projects now underway.

NEW CONSTRUCTION ACTIVITY

The total amount of space delivered in the first quarter was large - 1.122 million s.f.- but that included only two buildings; one of those the 1,100,000 s.f. Amazon II (Day 1) tower. There are a number of buildings expected to open in the next few months including The Mark, Madison Centre, Midtown 21 and Tilt49. The first two are traditional buildings struggling to sign up tenants, or are being extraordinarily tight-lipped regarding leases. Midtown 21 and Tilt49 are 20+/- floor towers on the south edge of the hot South Lake Union submarket. Those two buildings started off on spec, targeting multi-tenant occupancy before succumbing to the unending space needs of Amazon. The trends highlighted by these four buildings set the general profile of the total space under construction. The buildings under construction in the region now total 7.33 million s.f. of which 3.33 million s.f. is still available. 89% of all the unspoken for space is in five properties: 333 Dexter in South Lake Union, The Mark and Madison Centre in the center of the CBD, Southport in Renton and the Kirkland Urban project. A number of large tenants are looking for space, including Apple, Alibaba and Cisco and it is fully expected that deals will start to roll in over the next two quarters as the large blocks of space are becoming scarce. Looking forward there still appears to be little potential of significant over-supply in the near term.

RENT FORECAST

Rental rates have been stable for the past year with modest annual growth rates typical of a balanced market. The quarter to quarter adjustments are attributable to a large degree to the quality of the available space. Actual deals have been more consistent. The economy has allowed even small businesses to support rent growth but that will be squeezed as interest rates, wages and taxes take larger portions of available income. Even with construction costs continuing to increase, the current rent levels remain cost feasible. The forecast is for rent growth at a steady 3-5% annual rate, depending on location and asset class.

INVESTMENT MARKET

The office investment market also took a bit of a breather in the 1st quarter with a total of 17 sales for $335 million. There were only four sales over $5 million and Urban Union accounted for over 80% of the total dollar amount. Institutional investors are very interested in the market, but there is limited inventory of properties for sale. Capitalization rates remain at or below the 5% mark for newer core properties, pushing up into the 6% range for seasoned suburban properties. Investors are moving toward those second tier properties looking for better returns and quicker upside as economic growth continues to slowly filter down to smaller tenants. Overall, there is strong investor confidence and interest in the region based on its long-term growth potential and broad-based employment growth.

Data Source: CoStar