Kidder Mathews

Real Estate Market Review

King, Pierce, Snohomish, Thurston & Kitsap Counties

1st Quarter

2015

Seattle Apartment

Market Trends

	Current
Vacancy	3.4%
Est. 2015 Construction	12,219 units
Avg. Rental Rate (all ages)	$1,231

Notable Transactions 1Q 2015

Rollin Street Flats, Seattle
208 units
$138,203,000 | $619,744/unit

Stack House, Seattle
278 units
$126,000,000 | $440,559/unit

Alley 24, Seattle
172 units
$58,200,000 | $326,966/unit

REO Flats, Seattle
108 units
$47,580,000 | $413,739/unit

Olde Redmond Place, Redmond
192 units
$47,000,000 | $244,792/unit

Gates of Redmond, Redmond
180 units
$45,250,0000 | $251,389/unit

Pine+Minor, Seattle
120 units
$43,000,000 | $349,593/unit

Sunset Electric, Seattle
92 units
$42,155,000 | $430,153/unit

Waters Edge, Kent
304 units
$40,200,000 | $132,237/unit

Seasons, Lynnwood
228 units
$39,800,000 | $174,561/unit

The regional market vacancy rate is currently 3.4%, well below the long-term average of 5.0% over the past 20 years. The regional vacancy rate last peaked at a rate of 7.2% in fall 2009, falling in most surveys since and now oscillating from 3.4% to 4.0% over the past two years. Rental rates have reached historic highs and use of concessions at stabilized properties is minimal in most markets.

The ongoing favorable market performance in the apartment sector has been attributed to several demand factors including:

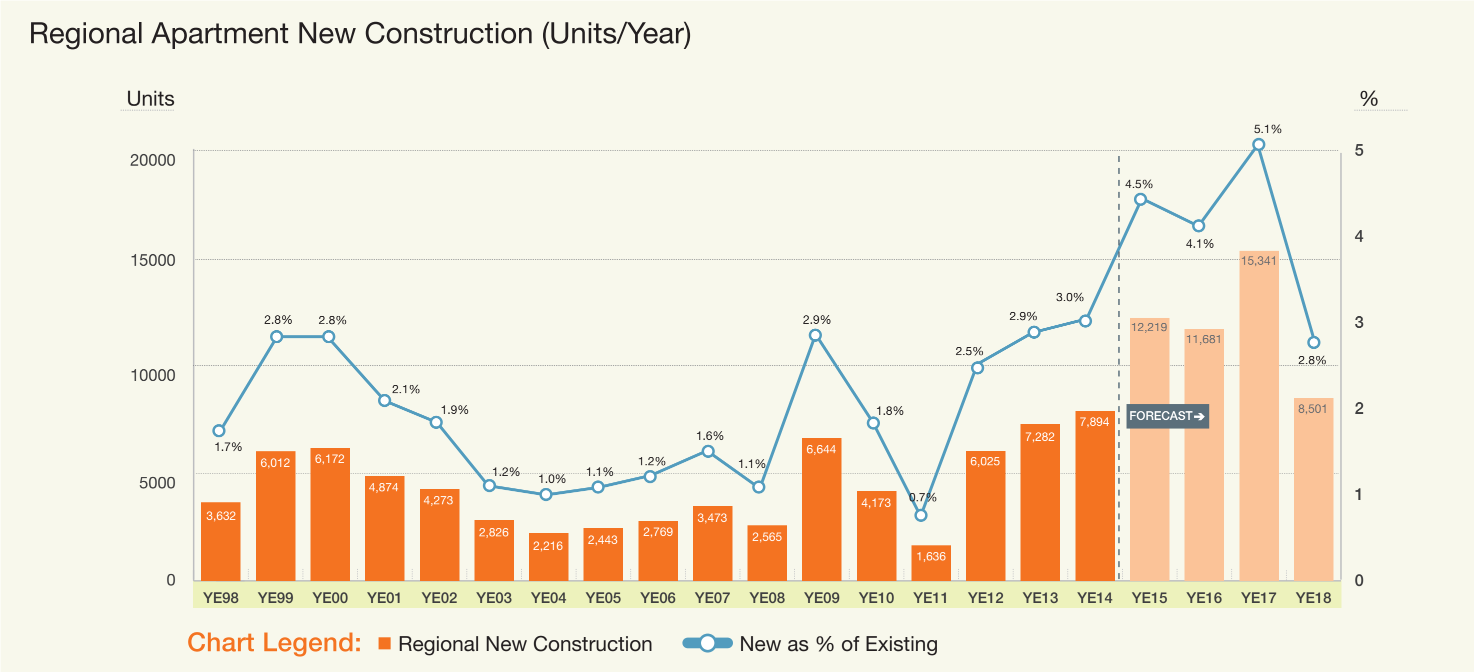
- Household creation will peak in the 25 to 34 age bracket over the next five years and this group is traditionally mostly renters.
- The apparent durability of changed "rent" vs. "own" psychology, due to more transitory lifestyles and residual lack of confidence in the housing market.
- Return toward traditional lending regulations with large down payment requirements has postponed many home purchases and will likely keep a portion of the population as renter households.
- Lack of affordable condominium inventory in the neighborhoods most desirable to many of the potential entry level buyers.

These factors point toward continued demand for apartment units over the next few years, especially better quality apartments, as a significant number of the new jobs being created are transient, but also high wage.

The likely outcome is increased demand for rental housing. In addition, there will likely be some loss of apartment inventory as conversions of newer or planned apartments to condominiums will eventually provide entry level units as the for sale market continues to recover.

→ **Continued, page 2**

Area Review



New apartment development has accelerated with over 21,000 units delivered over the past three years. In 2014, nearly 7,900 opened – the highest level of production since 1991. That will be surpassed by 12,219 new units targeting delivery in 2015. Currently, there are over 20,359 units under construction, part of 47,742 planned for delivery over the next four years (2015 through 2018). These apartment deliveries will put upward pressure on the market vacancy, if only temporarily. Some evidence of this is already apparent in some markets with renewed use of concessions and rising vacancy in some markets where deliveries have been focused. Region-wide the market is still strong.

Based on the latest new unit delivery timelines projected by Dupre+Scott, our forecast predicts the regional vacancy peaking at about 6.0% by early 2018. As these new units are delivered, it is expected that use of concessions will temporarily increase with rent growth moderating as these new units make their way through the system.

Vacancy Trends

According to the Spring 2015 Dupre+Scott Vacancy Survey, the regional (five county) vacancy rate is estimated at 3.4%. 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 4.6%. The margin between net and gross vacancy increased over the past six to twelve months and will continue to be wider than historically, keyed to the above normal amount of new construction.

The ratio of properties offering concessions has remained mostly stable between 15% and 20%. Regionally, the average discount is currently $744, equal to about 2.4 weeks free rent, a slight uptick from six months ago.

Rent Rate Trends

Over the past twelve months the average regional rent increased from $1,146 to $1,231 (7.4% increase). The King-Eastside sub-region has the highest overall rent in the region, currently averaging $1,577/month, up 7.0% over the past year. The King-Seattle sub-region has the second highest overall rent, though the highest on a per s.f. level, currently averaging $1,528/month ($2.14/s.f./month), up 8.1% over the past year. It is important to note that a portion of that increase is attributed to the higher prices of new units delivered over the past two years.

Current Inventory/Supply

Currently there are an estimated 262,400 market rate units in complexes with 20 or more units in the five county region. King County has the largest proportion with 61.9% of the total, followed by Pierce County with 17.5% and Snohomish with 13.3%. The smallest sub-region is Kitsap County with 2.9% of the regional supply.

Historically, new construction peaked between 1985 and 1991 with more than 86,000 units delivered during this period, a 62% total increase or 14,333 units per year on average. Excluding this period, new construction delivered averaged about 3,930 units per year since 1980.

The region is currently experiencing another period of expansion. In 2014, 7,894 units were delivered (reflecting an addition of 3.0% to the existing housing stock), 12,219 units (4.5%) are expected for 2015 delivery, 11,681 units (4.1%) for 2016, 15,341 units (5.1%) for 2017, and 8,501 units (2.8%) in 2018. Projected new construction over the next four years (if all completed) would increase inventory by 18.4% (47,742 units), compared with job growth of 7.7% (156,600 jobs regionally 2015-2018), resulting in our projected up-tick of the region's vacancy rate.

Offsetting new construction is the loss of apartment units that have been demolished or converted to another use. Since 1994, these have averaged 735 units per year, excluding the period from 2005 to 2007 when the rate spiked to an average 5,505 units per year, decreasing the overall apartment inventory. This loss of units was mostly driven by condominium conversions, which grew from about 30% of removals to more than 80% during this period.

From 2005 to 2007, more than 16,500 units were removed from the rental market. This reduced the overall apartment inventory in 2007 to levels existing in 2000. In 2008, this trend reversed with some condos converted to rental use.

Projected Future Supply

A total of 7,894 units were completed regionally in 2014. The 2015 new unit count is looking at 12,219 units, with all projects under construction. Deliveries are set to take a slight break in early 2016 then increasing further in 2017 before dropping back toward 2014 levels by 2018.

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 2016-2017. Most projects shown as due in 2015 through second quarter 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 next year and into 2017.

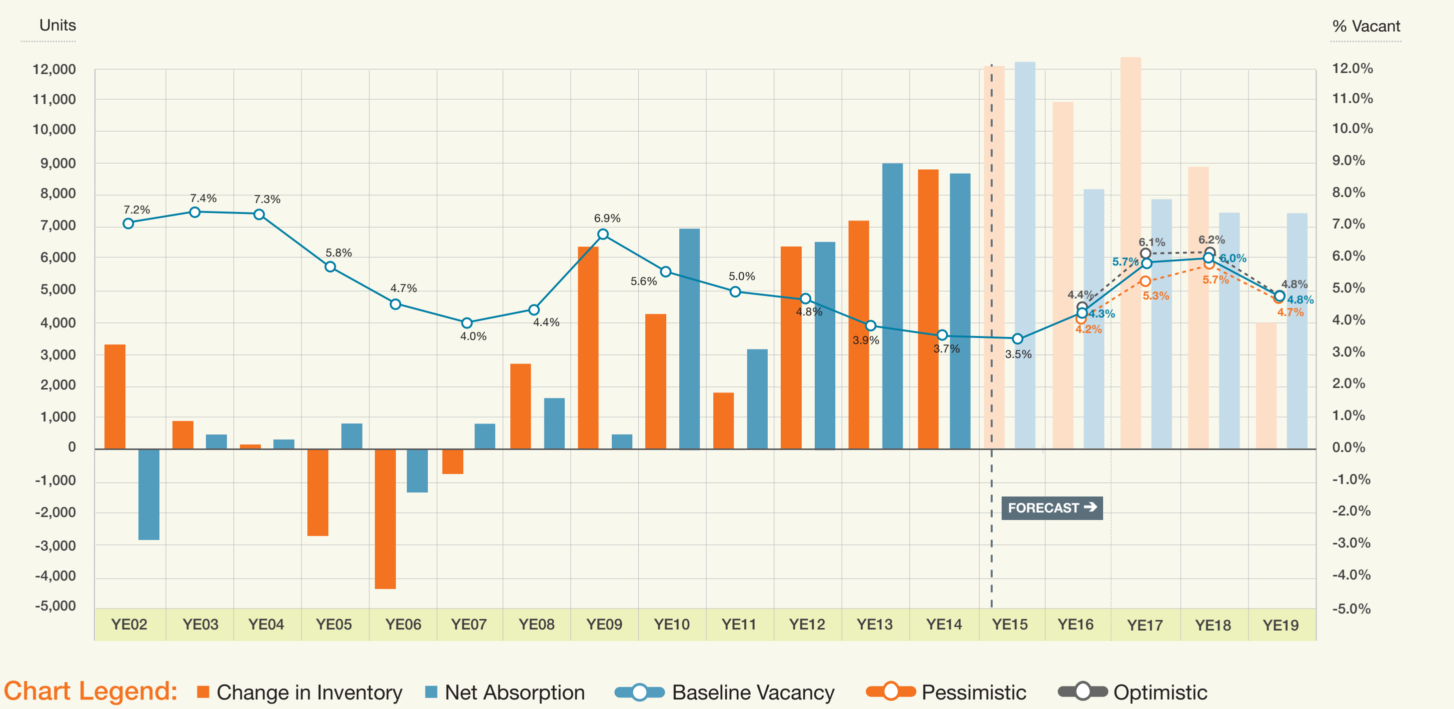
Most planned new construction has been focused toward the core urban metropolitan locations where job growth has been focused, new houses and condos are scarce and existing infrastructure is present. Of the more than 47,742 potential units planned over the next four years (2015 through 2018), 42,608 units (89.2%) are located in King County. Of these, 26,393 units (61.9%) are in the Seattle sub-region.

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 2.08 million jobs. There are an estimated 262,700 occupied apartment units in the region, inferring demand for one apartment for every 7.9 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. This is good news for apartment owners and developers.

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 2015 and declining by about 0.09 per year through the forecast.

Historic Absorption and Forecast



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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. As the national economy continues to improve and unemployment drops, support of low interest rates at a national level will diminish and rates should begin to increase. As these rates rise, one result will be more households taken out of the home buying 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.

Interest rates will also affect development as overall capitalization rates trend with interest rates. Market values and thus financial feasibility will be affected, possibly slowing some of the more aggressive development, especially as rent growth moderates. Some of the larger planned tower projects are particularly sensitive to these factors.

Investment Activity

Sales velocity previously peaked in the Puget Sound Region in 2005 with 267 sales ($2.64 billion in volume). The pace fell off slowly as the financial crisis led up to the late 2008 crash. In 2009, the number of sales dove to 53 with a combined sales volume of about $333 million, reflecting a 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 improvement continued in 2012 aided by sellers motivated by the 2013 increase of capital gains rates, almost equaling the 2005 record. Year-end volume for 2014 was $3.05 billion (167 sales) exceeding the previous 2005 peak.

Institutional investors continue to place Seattle at the top of investment lists for its strong economy, varied job growth and barriers to entry that limit new construction. In addition, 2013 saw an increase in sales of seasoned and smaller properties to regional and local investors. 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.

Capitalization rates have reached a plateau and investors expect that the next interest rate increase will cause capitalization rates to increase. Even so, capitalization rates remain low with new institutional quality properties continuing to sell at below 5.0% on apartment revenue. There is still some leverage at this level and current interest rates, although the margin is narrowing.

Regional Conclusion

The regional apartment market appears to be reaching 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 2014, nearly 7,900 units opened, the highest level of production since 1991. That will be surpassed by 12,219 new units targeting delivery in 2015. Currently, there are over 20,359 units under construction, part of 47,742 planned for delivery over the next four years (2015 through 2018). Although vacancy has remained at very low levels for the past several years, accelerating unit apartment deliveries should begin to put some upward pressure on the market vacancy.

Based on the latest unit delivery timelines projected by Dupre+Scott, our forecast predicts the regional vacancy peaking at about 6.0% in early 2018, then falling back to a more long term pattern of around 5.0% in 2019. This spike will moderate rent growth, as existing properties face increased competition and new properties use lease-up concessions to fill their units.

Apartment investment is expected to continue and values continue to increase. There is a significant amount of institutional capital targeting the Seattle market, in addition to a traditionally strong local buyer contingent. Capitalization rates have been stable but are expected to increase as rent growth continues to slow. No major changes are anticipated until the next significant increase in interest rates.