Kidder Mathews

Real Estate Market Review

King, Pierce, Snohomish, Thurston & Kitsap Counties

3rd Quarter **2016**

Seattle Multifamily

Market Trends

	Current
Vacancy	3.5%
Est. 2016 Construction	11,421 units
Avg. Rental Rate (all ages)	$1,866

Notable Transactions 3Q 2016

Liv BelRed, Bellevue
451 units
$172,000,000 | $ 381,375/unit

Campbell Run, Woodinville
360 units
$98,000,000 | $272,222/unit

Belara at Lakeland, Auburn
430 units
$80,500,000 | $187,209/unit

Walton Lofts, Seattle
163 units
$76,675,000 | $559,672/unit

Lodge at Peasley Canyon, Federal Way
339 units
$70,173,000 | $207,000/unit

Avery at the Reserve, Federal Way
401 units
$63,800,000 | $159,102/unit

Grammercy, Renton
382 units
$61,250,000 | $160,340/unit

Mosaic Hills, Kent
366 units
$51,575,000 | $140,915/unit

Soren, Seattle
111units
$45,553,000 | $392,698/unit

North Creek, Everett
246 units
$42,000,000 | $159,091/unit

The regional apartment market vacancy rate is currently 3.5%, 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 has increased ever since, and vacancy has oscillated from 3.3% to 4.0% over the past three years as rising new construction has been met with consistent demand. Rental rates are at historic highs but only recently has the rate of increase moderated in the close-in markets. Some of the 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 peaking in the 25 to 34 age bracket; a group traditionally skewed to renting
- The changed “rent” vs. “own” psychology, due to more transitory lifestyles
- Growing preference for urban housing, to be close to the bulk of new jobs being created and allowing residents to be less automobile reliant
- Lack of affordable home or condominium inventory in the 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 more than 31,900 units delivered between 2012 and 2015. The 2015 total of nearly 10,600 was the highest annual production since 1991. Currently, there are some 23,123 units under construction, part of 69,587 planned for delivery in 2016-2020, peaking at a forecasted 20,982 units in 2018. These apartment deliveries are expected to increase market 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

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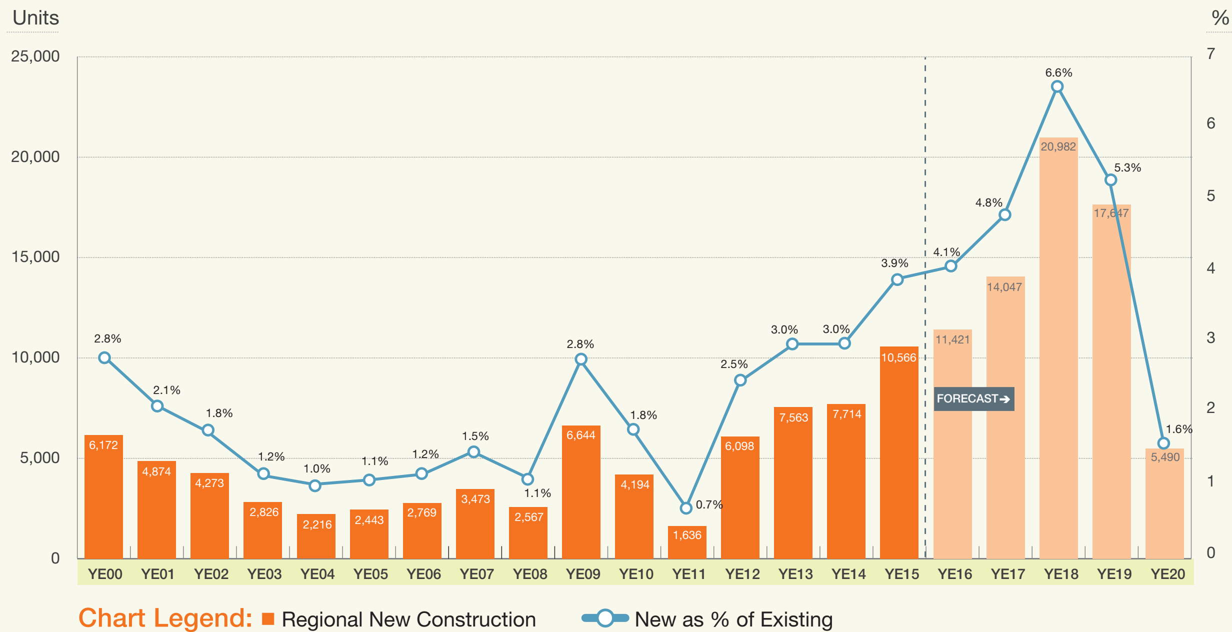
Area Review

Regional Apartment New Construction (Units/Year)



2012-2014. 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.

Vacancy Trends

According to the Fall 2016 Dupre+Scott Vacancy Survey, the regional (five county) vacancy rate is estimated at 3.5%, up slightly from Spring 2016 report, but an encouraging result considering the number of new units opened in the interim. 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 4.8%. 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.

Rental Rate Trends

Over the past twelve months the average regional rent increased from $1,300 to $1,420 (9.2%). The King-Central sub-region has the highest overall rent in the region, currently averaging $1,843/month ($2.71/s.f./month), up 6.3% over the past year. The King-Eastside sub-region has the second highest overall rent, currently averaging $1,809/month ($2.00/s.f./month), up 8.1% over the past year. It is important to note that a portion of the increase is attributed to the higher prices of new units delivered over the past three years, especially in the smaller Eastside submarkets.

Current Inventory/Supply

Currently there are an estimated 278,284 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 63.3%. That lead is likely to increase as 87.1% of the planned new development over the next four years is in King County. Pierce and Snohomish will account for about 6.5% and 5.6% 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 8,275 units.

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 540 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 5,480 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 16,500 units over the previous three years, the trend reversed with some projects planned as condominiums were redirected to rental use. Looking forward, the loss to either demolition or conversion is expected to be limited as most obvious under-utilized properties have already been replaced and new financing and renters-rights laws make conversion much more difficult (and expensive).

Projected Future Supply

An estimated 10,566 units were completed regionally in 2015, a 37% increase over 2014. The yearend 2016 new unit count is looking at 11,421 units. Deliveries are set to jump up significantly

in 2017 (14,047) and 2018 (20,982) then slowing somewhat in 2019 (17,647 units) and 2020 (5,490 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 2018-2019. Most projects shown as due in 2017 will be completed as most are already under construction or nearing a start, after that the attrition of projects increases significantly.

Of the 69,587 units planned for delivery over the next five years (2016 through 2020), 60,274 units (86.6%) are located in King County. Of these, 38,735 units (55.7% of the region) are in the Seattle sub-region; defined as the King-Central and King-North markets. A few aggressive buyers remain active in the market, significantly international parties, who need to place funds and are paying strong premiums for entitled sites to avoid the 2-3 year entitlement process and get projects underway.

Estimate of Future Apartment Demand

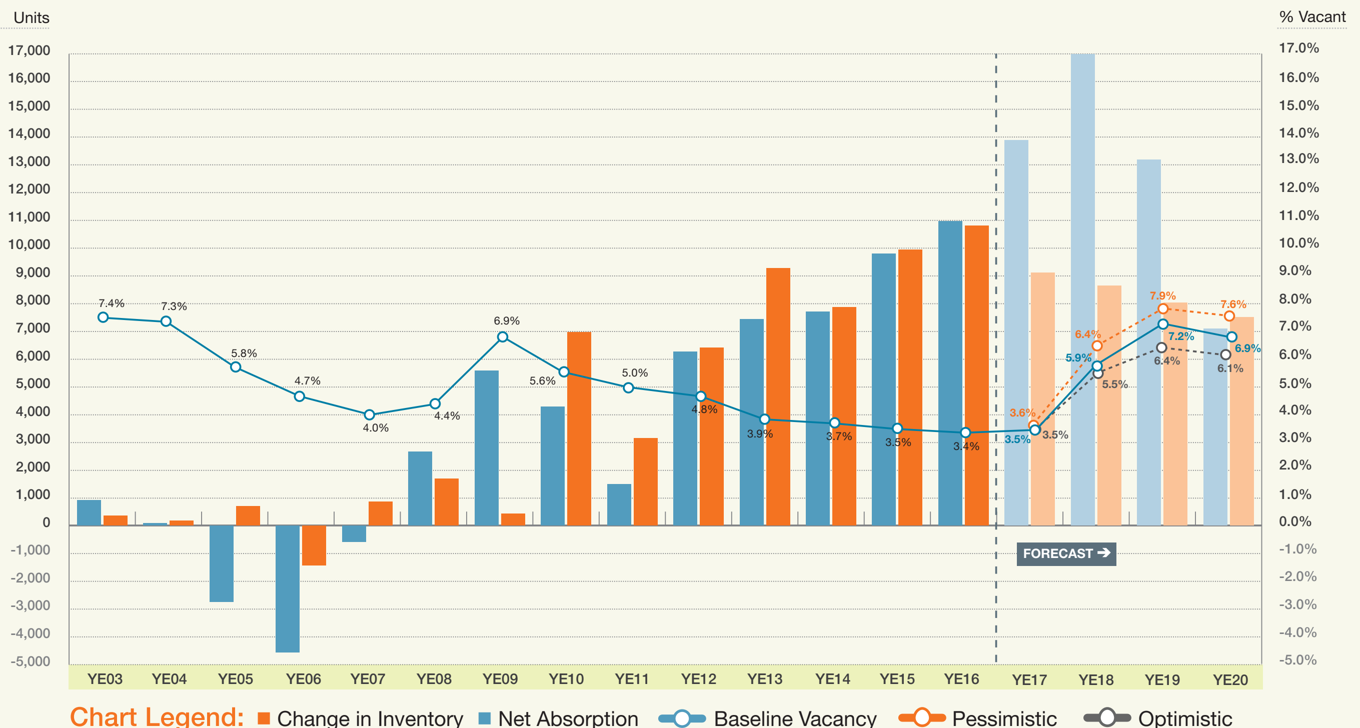
The primary demand driver for apartment units is population growth which is mostly supported by employment growth. The latest employment figures for the greater Puget Sound region (including Thurston county) are estimated at 2.15 million jobs. There are an estimated 271,768 occupied apartment units in the region for yearend 2016, inferring demand for one apartment for every 7.9 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. 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.

In addition to banks becoming more cautious about lending general, rising interest rates will also affect development as overall capitalization rates trend with interest rates. Market values and thus financial feasibility will be affected, and it may slow some projects that required longer holds and lease-up, along with strong rent growth to cover peak of the market land prices and construction costs. This has the largest effect on the larger planned tower projects as those costs have risen faster than wood construction and rents have underperformed in some recent projects.

One element offsetting this demand 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, primary demand is based on the job/apartment ratio starting at 7.9 in 2016 and declining by about 0.10 per year through the forecast.

Investment Activity

Sales velocity in the Puget Sound Region 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



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volume more than doubled for the year. The activity continued to improve with volume for 2014 at $3.05 billion (167 sales) exceeding the previous 2005 peak. This trend continued through 2015 with a record $4.36 billion in sales, another all-time high.

It is interesting to note that in the King-Seattle submarket, the 2015 totals included 54 sales, eight fewer than 2014, while the dollar volume increased from $1.17 billion to $1.87 billion. This was the result of institutional acquisition of four tower projects and highlights the confidence of these investors in the Seattle market.

So far in 2016, the totals are well off 2015's activity, primarily due to a limited number of institutional sales as those investors have pulled back from core apartments. It has been reported that this decision 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.

The overall total sales volume for 2016 will still be very good. The investor classes below the large institutional investors 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 continued 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. This trend expanded through yearend 2015 and this far into 2016.

Overall capitalization rates decreased an average 31 basis points year over year, but a significant part of that was the mix of large institutional sales and secondary market value add properties, both of which tend to have lower capitalization rates. Interest rates have started to move upward over the past few months, which will result in upward pressure on capitalization rates, especially when added to the influence of forecasted rent growth slowing. The rates have not yet shown significant movement, remaining low with newer quality properties continuing to sell at rates slightly below 5.0% on pro forma apartment revenue. There is still some leverage at these levels and current interest rates, but the margin is narrowing.

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 the market trends will be changed by the combination of slower job growth and the 2017/2018 spike in new unit deliveries. Rental rates have reached historic highs and use of concessions at stabilized properties is minimal in most markets. However, the rent growth rates have slowed in some markets already, a trend that is expected to continue over the next few years

In 2015, 10,566 units opened, the highest level of production since 1991. The forecast for 2016 is 11,421 units, then increasing to 14,047 units in 2017, 20,982 units 2018, and 17,647 units in 2019. Through the Fall 2016 surveys, vacancy remained at low levels following the first two years of accelerated deliveries, falling to 3.5% at the end of 2015 from 2014's 3.7%, but inching back up to 3.6% recently. It is expected that upward trend will continue through 2018.

Based on the latest unit delivery timelines projected by Dupre+Scott, our forecast predicts the regional vacancy peaking at about 7.2% in late 2019, then falling back to a more long-term pattern. This spike will 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 is expected to close out 2016 slightly below that seen in 2015 as institutional investors began moving into other property types in mid-2016. 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. No major changes in these trends are anticipated until the next significant increase in interest rates.

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