Kidder Mathews

Real Estate Market Review

King, Snohomish, and Pierce Counties

4th Quarter
2016

Seattle Office

Market Forecast

	Current / Projection	
Vacancy	7.7%	↑
Construction	7.94M sf	↔
Rental Rate	Varies*	↑
Absorption	3,509,976 sf	↑

* by submarket

Market Highlights

Regional vacancy rate trended up over the quarter to 7.73%, a reflection on new building deliveries. Net absorption was very strong at 3,509,976 s.f. in the quarter, 77% of that in the Seattle market, driven in large part by the delivery of Amazon's first self-built tower. Availability rate dropped to 11.01% as only one new speculative project started construction this quarter.

Six buildings were delivered to the Seattle market this quarter, along with two in the Bellevue CBD. There is now a total of 21 office projects underway; 17 in the Seattle CBD, one in the Bellevue CBD, one each in Kirkland, Renton, and Des Moines. Fifteen of the Seattle projects are speculative, currently about 42% pre-leased.

Office property sales were strong in the quarter, including numerous major institutional-quality sales in both Seattle and Bellevue. Non-CBD properties continue to see increasing interest.

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

Apple, Cisco, eBay, and Alibaba, these familiar names are examples of tenants looking for new or more office space in the Seattle and Bellevue markets. This follows expansions announced in 2016 by Google, Facebook, Tableau, Salesforce, Valve, Wave Broadband, WeWork, and, of course, Amazon. The growth in the tech industry continues to place the region's office market near the top national markets. This growth is currently bumping up against a shortage of large, tech-friendly, spaces. Even with all of the new space added in the past three years, and that under construction, the regional market has only 14 available spaces over 100,000 s.f. in existing buildings and only six of those are over 200,000 s.f. Only three of the 14 spaces are in projects built after 2000. Limited options are on the way with only seven buildings under construction that have remaining spaces over 100,000 s.f. This situation has prompted some developers with sites previously slotted for apartment projects to consider a shift to office use, especially in the hot tech micromarkets like South Lake Union and SoDo. This is probably a good thing for both market categories as there was concern of over-supply on the apartment side, especially in terms of highend towers. There are over 40 proposed office projects over 100,000 s.f. regionwide. It is expected that commitments from one or more of the tenants circling the markets will prompt some of these projects to get underway in the coming year.

In terms of the numbers, the regional vacancy rate increased to 7.7% at the end of the fourth quarter while the availability rate dropped slightly to 11.0%. Net absorption in the last quarter was strong, more than the first three quarters combined, pushing the annual total to 6,430,000 s.f., 45% higher than 2015. The strong demand has allowed for rent increases across the region with the average asking rate up by about 4%. There are currently 21 general office buildings under construction in the region with a total of 8.45 million s.f. Overall these buildings are 57% pre-leased including 39% of the 5,950,000 s.f. of speculative space. The 17 Seattle properties are 62% pre-leased and the sole

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Area Review

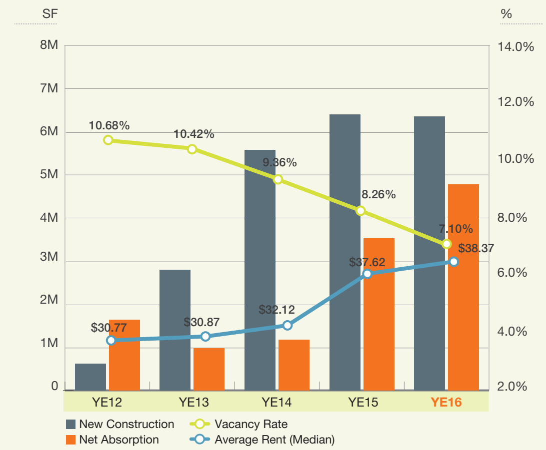
Seattle CBD/Surrounding Area Review

The Seattle submarket fourth quarter net absorption was 2,703,718 s.f., more than half of the 2016 total of 4,785,194 s.f. This mostly offset the new deliveries, but the overall Seattle vacancy rate increased slightly to 7.10% from 7.00% last quarter, but wound up the year 116 bps less than 2015. The availability rate fell 70 bps to 11.00% on the strength of pre-leasing by Facebook and Google in Vulcan projects and Amazon taking all of Trammel Crow's Midtown 21 building of 365,000 s.f. In the Seattle CBD submarket, the vacancy rate increased to 10.6% from 9.6% last quarter, but the availability rate fell 160 bps to 15.1%. The speculative space under construction in the Seattle market totals nearly 4.2 million s.f. About 42% of that space is pre-leased. Nearly half of the available space under construction is in The Mark and Madison Centre, two new high rises in the financial core. These buildings are expected to open in the first half of 2017 with a total of 1,250,000 s.f. So far only one lease, for 166,500 s.f. in Madison Centre, has been announced. Significant leases continued to be finalized in the last quarter of the year, furthering the upward pressure on rental rates, specifically for larger contiguous spaces. The downward vacancy trend in the Seattle market and the Seattle CBD should continue through the next two years as the pace of new construction should be well matched by demand, although that pace will be moderated by the slow pace of preleasing in The Mark and Madison Centre. On the investment side, there were several major sales closed in the fourth quarter- 5th & Bell, Urban Union and just after the quarter ended the Amazon Ia Building sold, with the common threads of being leased by Amazon and overall capitalization rates hovering between 4.5% and 5.0%.

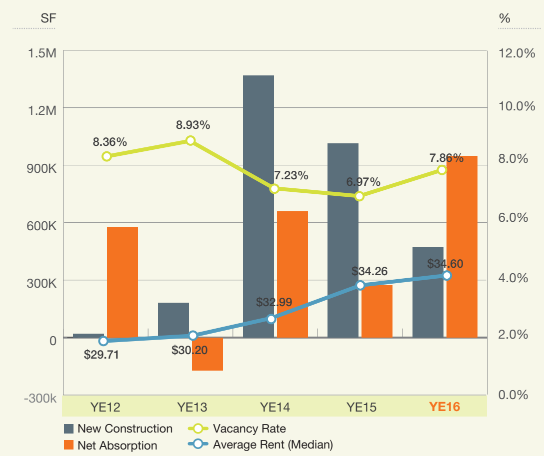
Eastside Review

The Eastside market saw vacancy increase over the fourth quarter as 734,500 s.f. of vacant space was delivered to the market with the opening of 929 Tower and 400 Lincoln. The year ended at 7.86% vacancy, even with net absorption of 947,001 s.f., the largest since 2007. The Bellevue CBD showed the brunt of the new construction with CBD vacancy increasing from 9.7% to 17.4% over the quarter. The availability rate showed a smaller increase from 10.5% to 11.6%. The result of this was soft rents for most of the year. Still on the horizon in the CBD are the pending vacation of over 500,000 s.f. by Expedia and the possible loss of Microsoft in Bravern as that company continues to consolidate back to its Redmond campus. 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, although there are a number of tenants looking for Eastside space. Outside of the CBD, the Kirkland, Redmond and 520 submarkets continue to perform very well, ending the quarter with vacancy rates between 2.3% in the 520 Corridor to 3.5% in Kirkland and Redmond and 6.1% in the I-90 Corridor. Rental rates in the suburban submarkets around the Bellevue CBD continue to firm up as smaller companies are making moves before rates increase any further. Net of the near-term 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. Sales activity increased significantly in the quarter across the Eastside with sales of 112th @ 12th, 110 Atrium, and Civica Commons in the CBD, several Microsoft-leased buildings in Redmond Woods and several smaller buildings in the other suburban markets.

SEATTLE CBD/SURROUNDING AREA



EAST KING COUNTY



South King County Review

The South King County market had negative net absorption in the fourth quarter of 275,622 s.f. led by Boeing vacating space in Triton Towers in Renton. The vacancy rate jumped to 10.65% from 8.54% at the end of the third quarter and the availability rate increased to 17.40%, up 160 bps. The main component of that availability rate is the three-building, 748,000 s.f. Southport Office Campus under construction in Renton. That attractive project is positioned to deliver Class A lake view space designed for tech tenants. So far no pre-leasing has been announced, and historically it has been difficult to entice new economy tenants to locate this far south of I-90. 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, pointing to the steady rising confidence of small businesses. No major changes from the recent trends are expected in the South King County market with slow improvement following the setback in the fourth quarter.

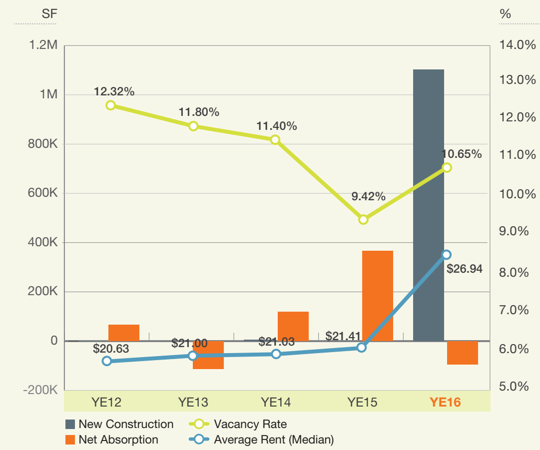
Snohomish County Review

The Northend office market showed gradual improvement through 2016, ending the year at 7.29% vacancy, down 108 bps from the end of 2015. The availability rate dropped 30 bps over the year, ending at 10.20%. Annual net absorption was 450,739 s.f., the best total in over 12 years. In Bothell, the year ended strong with 215,640 s.f. of net absorption and the vacancy rate falling to 7.5%. The Lynnwood/Edmonds submarket continued to outperform the other submarkets with a yearend vacancy rate of 3.9% following total 2016 net absorption of 195,971 s.f., almost all 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 1% in the fourth quarter; still very affordable at $23.58/s.f./year, full service. The slow decrease of the vacancy rate and increases in rent are expected to continue for the near future.

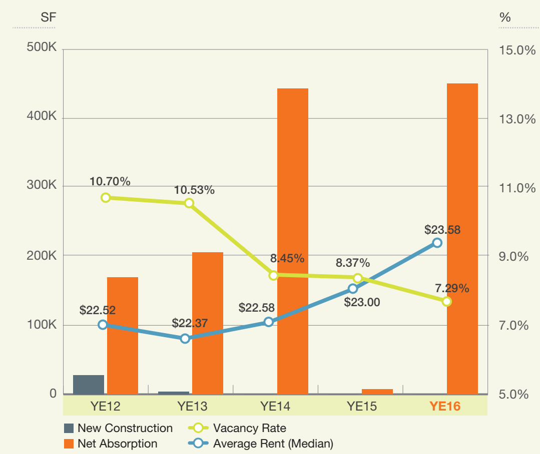
Pierce County Review

The Pierce County market absorption closed out 2016 with the strongest quarter in five years at 160,672 s.f. for an annual total of 338,854 s.f. The vacancy rate ended the year at 7.46%, down 101 bps over the year. The availability rate bumped up slightly in the fourth quarter to 11.60%, still down 130 bps over the year. The Tacoma CBD vacancy rate ended the year at 8.1%, up over the fourth quarter; the availability rate is 10.1%, up slightly over the past quarter. Significant improvement in both CBD rates are expected next quarter as the nearly vacant 124,000 s.f. vintage Washington Building sold in the quarter to Unico, that plans to convert the building to residential use. Removing that building from the office inventory would reduce the vacancy rate by 120 bps and the availability rate by 144 bps. Other non-functional vintage buildings are getting closer to redevelopment, which will further reduce these rates. Rental rates in the market have been hovering around the $21.50/s.f./year, full service rate for the past year, but did move up about 1.0% in the quarter. With the exception of the Washington Building, sales in this market are focused on smaller properties, primarily owner/user acquisitions. There were 14 total sales of non-medical office properties in the quarter, only four were over $1.0 million. Another $1.7 million of sales were racked up in three medical office transactions.

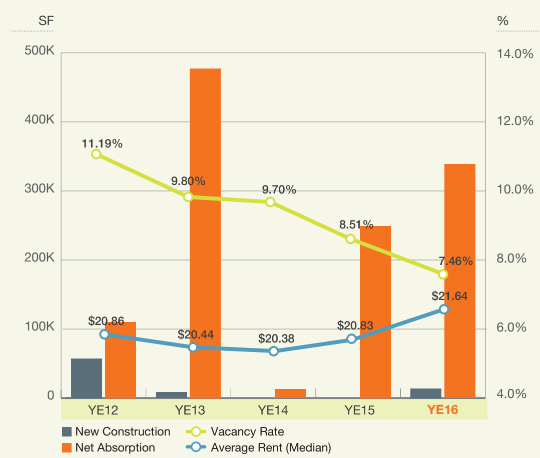
SOUTH KING COUNTY



SNOHOMISH COUNTY



PIERCE COUNTY



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4Q 2016 Seattle Office Sales

Name	City	Date	Price	SF	$/SF
One Twelfth@ Twelfth	Bellevue	Dec-16	$217,000,000	480,389	$451.72
Amazon VII	Seattle	Nov-16	$244,000,000	317,189	$769.26
Civica Commons	Bellevue	Nov-16	$193,000,000	312,295	$618.01
Hill 7	Seattle	Oct-16	$200,000,000	285,680	$700.08

remaining building underway in Bellevue is fully leased to Amazon. The two recently completed projects in Bellevue, 400 Lincoln and 929 Tower, are 38% leased, but there are a number of large tenants expected to make leasing decisions in early 2017.

VACANT SPACE/VACANCY RATE

The regional vacancy rate increased over the quarter, fueled by the delivery of new inventory in the Eastside market and a significant give-back of space by Boeing in the South King County market. The yearend vacancy was 7.73%, up from the third quarter but still down 37 bps from yearend 2015. There is about 15.1 million s.f. vacant out of a standing inventory of 194.9 million s.f. The availability rate dropped in the fourth quarter, ending the year 11.0%, down from 11.6% at the end of 2015. The rate is expected to hold near this level near-term as about 8.5 million s.f. of new inventory is delivered over the next two years. The development market is showing good restraint and even without any further pre-leasing the delivery of the unleased space would increase the region's vacancy rate by only 165 bps to 9.4%. 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

In the last quarter of 2016 a number of buildings were delivered, including 400 Lincoln in Bellevue and 450 Third, Urban Union, Troy Block South, and North Edge in Seattle. In the quarter Kilroy broke ground on their 650,000 s.f. 333 Dexter and Vulcan started on the two Arbor Blocks buildings with a total of almost 400,000 s.f., fully pre-leased by Facebook. Both of these are in the hot South Lake Union market. The buildings under construction in the region now total 8,450,000 s.f. of which 3,640,000 s.f. is still available. The bulk of the unspoken for space is the newly available 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. It is reported that tenants with requirements totaling more than 10 million s.f. are looking at the market, so it would appear there is currently little concern regarding over supply.

RENT FORECAST

Rental rates continued to increase in the fourth quarter even as the vacancy rose slightly overall. The Eastside market saw a minor decrease in the average asking rent quarter-over-quarter, but that is thought to be a short-term reflection of the available inventory rather than a general trend. The Seattle and other markets increased by 1-2% over the quarter. The Southend did see some softness that was masked by the fact that over a third of the marketed space is now in the Southport project that has asking rent of $34/s.f./year NNN. Small business economics have improved and are looking forward to the perceived pro-business stance of the new Federal administration. Rent growth increases for new Class A space in the Seattle and Bellevue CBD has been stable as the tenants active in those market niches are preforming very well and are able to step up to secure desirable space. Current rent levels continue to be cost feasible, but that will be tested by increasing interest rates and additional construction cost increases.

INVESTMENT MARKET

Non-medical office sales in the fourth quarter totaled about $1.94 billion, in a total of 108 sales. Institutional investment was responsible for the bulk of the total dollar volume. In Seattle the activity was led by the sales of Urban Union ($269 million), Amazon Campus Phase VII ($244 million), and Hill7 ($180 million), all in the South Lake Union submarket. As mentioned above, the Eastside was also active this quarter with sales including 112th @12th ($217 million) and Civica Commons ($193 million). This was the fourth sale of Civica Commons in its 15-year life. Hines divested the property at a loss (their mid-2015 acquisition was at $205 million) as they sought to close out a fund. The capitalization rates in these leading sales were around or below the 5% mark, showing these investors' confidence in these markets and in the tenants in place. Total sales for 2016 ended up at $4.62 billion in 371 transactions. The average price for all 2016 sales was right at $400/s.f. with the prices of core assets creeping toward the $800/s.f. mark. The average capitalization rate was 6.3%, reflecting the much higher rates still being achieved in secondary markets. Overall, there is strong 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 continue to increase as those prices currently offer more upside as values have not yet recovered from the value loss at the beginning of the recession.

Data Source: CoStar