Kidder Mathews

Mid-Year
2018

Real Estate Market Review

West Coast Office

West Coast office markets enjoyed a strong first half, as absorption began to catch up to the accelerating pace of new completions, indicating ample demand to fuel further growth. Office vacancies were at 9.7% at end of the mid-year, 10 basis points below their pre-recession point of 9.8% in 2007, and 30 basis points down over the past 12 months. Construction completions this half increased to over 10 million square feet, with 2.2 million square feet located in Silicon Valley, set for occupancy by the technology giants which are the lifeblood of the West Coast's primary office markets.

Nonetheless, developers and investors are exercising caution, as the economic recovery approaches one of the longest recoveries ever. Construction starts were well short compared to a year ago, bringing the volume of active projects down by 16.0%, and sale volume fell by 11.35% from 2017's total, which was already off by 20.5% from the year before.

Moreover, developers have largely neglected single-family home construction in favor of high-end, urban rentals, creating an abundance of supply for affluent renters while leaving middle- and lower-income renter households under-supplied and would-be homebuyers with few options. These underserved markets are thus ripe for enterprising developers to capitalize. Although premium, high-end, amenity-rich product face upward vacancy pressure, demand for such multifamily units is still extremely strong. All of these signs portend continued growth in the sector for the near to mid-term.

Overall Market Breakdown

	1H18	2H17	1H17	Annual % Change
Completed Construction	10,133,405	11,480,055	9,501,072	6.66%
Under Construction	34,559,006	40,034,787	41,175,400	-16.07%
Vacancy Rate	9.70%	10.00%	10.00%	-3.00%
Availability Rate	13.00%	13.10%	13.40%	-2.99%
Asking Lease Rate	$36.30	$30.96	$34.52	5.16%
Lease Transactions	46,084,287	61,794,390	59,302,913	-22.29%
Sales Transactions	45,080,688	60,009,176	50,850,213	-11.35%
Cap Rate	6.25%	6.12%	6.14%	1.79%
Net Absorption	14,156,700	10,881,777	7,422,558	N/A

Market Reviews

Seattle

5.9M SF	6.8%	2.8M SF	$32.16
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

Seattle has one of the tightest office markets in the country, but it is still far less expensive than major metros like New York City, San Francisco, and Washington D.C. This relative affordability is part of Seattle's charm for major companies. Development has returned to the metro in grand fashion, with most of the large deliveries occurring in Bellevue, Lake Union, and Seattle CBD. Despite a glut of new supply over the last few years, vacancies have fallen significantly this cycle, since many of the big deliveries are build-to-suit or mostly preleased. Rent growth is well above the national average but could decline in the face of a record number of projects expected to deliver in the near term.

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Portland

3M SF	7.4%	986,458 SF	$25.44
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

Portland's economy shows no signs of slowing down, spurring demand for the area's office market. Limited new speculative construction should allow vacancy compression to continue in the near term. Rents are significantly lower in Portland than in premier West Coast markets such as San Francisco, Silicon Valley, and Seattle, but they have grown strongly over the past few years and remain on an upward trajectory, making the metro area a logical target for investors. Peripheral submarkets have outperformed thanks to strong fundamentals, while vacancies in the CBD are higher than the metro average but tighter than in many other BDs in the country. Many owners have successfully repositioned downtown properties to appeal to tech tenants, but this remains more of a niche strategy in Portland, even though the sector's share of the economy is growing.

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Oakland / East Bay

1.4M SF	6.7%	623,346 SF	$42.36
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

The East Bay's office market rally is extending in 2018. Rents are increasing at a healthy rate and market occupancy remains high, as tenants priced out of other Bay Area markets, such as San Francisco and Silicon Valley, look to the East Bay for more fiscally sensible opportunities. With solid transportation infrastructure and relatively affordable housing, Oakland and the emerging East Bay submarkets have benefited from an influx of tenants from across the bay. Additionally, long-term East Bay tenants have tended to stay and expand in the area, leading to strong occupancy gains. A handful of office properties are under construction, though most developers continue to wait to secure an anchor tenant before beginning construction. With office buildings selling at record highs, landlords have plenty of flexibility and reasons to be optimistic.

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San Francisco / Peninsula / San Mateo

8.2M SF	6.7%	3,820,110 SF	$66.52
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

Demand from tech tenants overwhelmed San Francisco's office market early in the economic expansion cycle. Rising corporate valuations and ample venture capital investment funding helped fuel the market's strong leasing volume and positive net absorption, cutting market vacancy in half since 2010. Competition among global tech companies for an increasingly rare supply of large space availabilities is strong, but vacancy has essentially stabilized over the past two years, as new supply has balanced tenant demand. Construction completions are expected to reach a cyclical peak by year end 2018, with 6 million square feet set for delivery. After stabilizing for much of 2017, rental rates began to climb amid increased demand pressure at the end of the year. That same trend continued in the first half of 2018.

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Silicon Valley

3.9M SF	10.5%	2.9M SF	$53.64
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

Silicon Valley ranks as the second leading office market in the country for rent growth since the end of the recession, following San Francisco. Rents have continued to increase in 2018. Developers and large owner-users have constructed new office inventory to satisfy rapidly growing space needs. Deliveries have slightly outpaced tenant expansion over the past two years. Vacancy rates have risen steadily since 2015 due to the market's supply additions, as well as a sizable rise in sublease space, though there is a wide split between submarkets. While some South Bay cities have vacancy rates of 10% or higher, the most coveted suburbs popular with the world's largest tech companies remain extremely tight. The overall market should remain balanced in the face of new supply.

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Sacramento

576,026 SF	10.2%	602,385 SF	$21.48
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE

After being hit especially hard by the recession, Sacramento has benefited this cycle from job growth that has outpaced the national average in many sectors. The Golden 1 Center helped to put downtown Sacramento on the map, and Kaiser Permanente's new offices across from the arena should continue to help. A combination of limited new inventory and steady demand has pushed vacancy down toward 10%, well below the metro's historical average, and rent growth is more than triple both the national rate and Sacramento's long-term average.

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Reno

132,868 SF	9.3%	-17,979 SF	$19.08
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▲	◀▶	▼	▲

Reno has diversified its economy beyond tourism and gambling since the recession, which has helped reverse a painful contraction that subsided in 2013. Job gains have been particularly strong in educational/health services, business services, and trade. Low costs of living relative to in other West Coast cities and a business friendly economy have made Reno an attractive destination for businesses. Office vacancies compressed every year after the recession until 2016, and were well below the metro's historical average at the start of the year. Little new product has been introduced this cycle, and few projects of note are under construction. Sales volume reached an all-time high in 2018, on the heels of a couple of outsized transactions.

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Los Angeles

5.7M SF	11.7%	712,311 SF	- $35.52
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▼	◀▶	▼	▲

The Los Angeles office market maintained momentum, as rent growth continued to outpace the national average. Demand accelerated after a slow start to the year, and the vacancy rate was essentially unchanged throughout the past 12 months. The Westside has been the biggest beneficiary of late, especially in properties that cater to the media, tech, and sundry creative industries. Supply in the form of conversions and redevelopment is increasing in response to demand, and with development or near its cyclical peak, absorption will need to pick up to maintain the market's current fundamentals. Annual rent growth was about 4%, well above the national average but less than half the rate achieved at the peak of the cycle.

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Orange County

1M SF	10.3%	-178,210 SF	$31.44
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▲	▼	▼	▲

An expanding and diversifying employment base, coupled with a well-educated workforce and limited early-cycle development, has set the Orange County office market on firm footing. The Irvine submarkets highlight the market's innovative foundation, with Newport Beach providing the backbone of the financial industrial. Speculative development has picked up in Irvine Spectrum, in addition to a new tower in Irvine. Stable vacancies and healthy rent growth have bred confidence among investors, and capital continues to target the market for average yields that are more favorable than those achieved in apartment assets.

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Inland Empire

469,519 SF	8.6%%	366,599 SF	$20.04
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▼	▼	▲	▲

Demand for office space in the Inland Empire grew for the eighth year in a row in 2018, as vacancies, which topped 16% in the depths of the recession, have compressed by more than 700 basis points, driving modest rent growth. The Inland Empire is an overflow office market, serving primarily as a low-cost alternative for tenants priced out of Los Angeles and Orange County, so its rebound is partially tied to the strong recovery enjoyed by those metros. However, developers are proceeding with caution in spite of inbound demand growth, with the severe impact of the recession on the local office market still fresh in their minds. No major offices have delivered this cycle, though a few are under construction and many more have been proposed.

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San Diego

1M SF	10.3%	-87,169 SF	$32.64
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▲	▼	▼	▲

The San Diego office market's fundamentals improved in 2018, on the strength of an increasingly diverse employment base, a well-educated workforce, and a paucity of speculative development. The Golden Triangle submarket are the county's central tech and life science hubs, with Downtown aiming to establish itself as the home for the next wave of startups to accommodate those flocking there for new apartments. Tightening vacancies, limited sublease space, and steady rent growth contributed to investor confidence in a market where average office yields trump those seen in the apartment sector.

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Phoenix

2.8M SF	13.3%	2M SF	$24.72
UNDER CONSTRUCTION	VACANCY	NET ABSORPTION	ASKING LEASE RATE
▲	▼	▲	▲

With occupancy demand exceeding 1.7 million square feet, leasing activity above 2.0 million square feet, direct vacancy declining more than eleven percent from this time last year, and rental rates approaching, but as yet not surpassing, levels not seen since the peaks of the previous cycle established a decade ago, the conclusion simply cannot be gainsaid: the Phoenix office real estate market is in the throes of a vibrant renaissance. Concentrated mostly in the retail, finance, and services sector, the Phoenix MSA has proven to be a vibrant, business-friendly local economy with a capacity for strong job creation. Notwithstanding potential headwinds from the recently commenced trade wars, expect continued growth in the Phoenix real estate market in the near to midterm.

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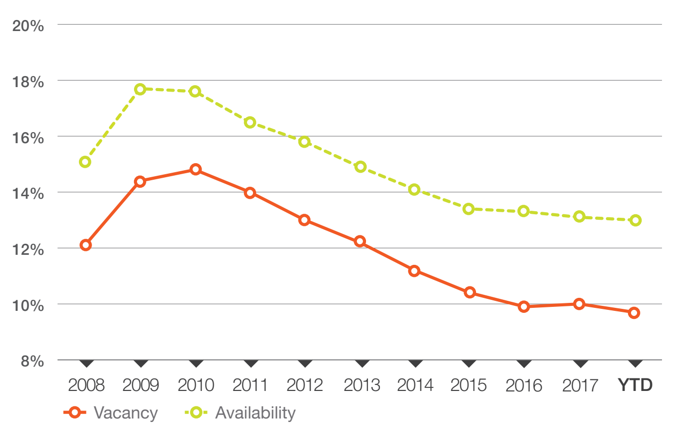
Note: Arrows indicate current trends not forecasts.

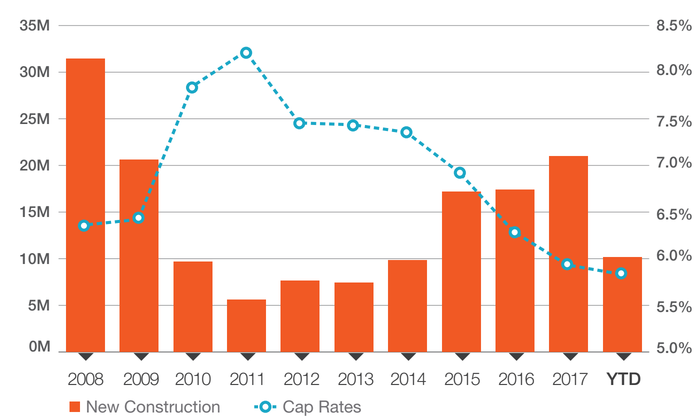
Mid-Year 2018 West Coast Office Statistics

Submarket	Total Inventory	Under Construction	YTD Completed Construction	Total Vacancy	Total Available	YTD Direct Net Absorption	YTD Total Leasing Activity	Avg Cap Rate	Avg Sales Price/SF	Avg Direct Rental Rate (SF)
Seattle	201,838,616	5,984,876	685,340	6.8%	9.3%	2,383,334	5,773,695	6.1%	$361.37	$32.16
Portland	95,894,795	3,015,086	101,504	7.4%	10.0%	986,458	2,588,260	6.5%	$239.28	$25.44
Pacific Northwest	**297,733,411**	**8,999,962**	**786,844**	**7.0%**	**9.5%**	**3,369,792**	**8,361,955**	**6.2%**	**$322.05**	**$30.00**
Oakland / East Bay	50,437,932	1,450,709	343,237	6.7%	10.4%	623,346	884,214	4.9%	$403.89	$42.36
Peninsula / San Mateo	38,885,893	3,383,505	579,689	7.9%	11.8%	244,073	835,731	5.3%	$506.29	$59.64
San Francisco	108,788,180	4,952,436	2,432,117	5.5%	9.6%	3,576,037	6,792,749	4.6%	$607.65	$73.39
Silicon Valley	117,845,222	3,935,250	3,428,227	10.5%	12.2%	2,930,520	9,775,984	5.3%	$629.50	$53.64
Sacramento	96,997,555	576,026	148,648	10.2%	13.1%	602,385	1,663,024	6.9%	$181.87	$21.48
Reno	15,132,292	132,868	14,513	9.3%	11.5%	(17,979)	464,686	6.9%	$205.12	$19.08
Northern CA / NV	**428,087,074**	**14,430,794**	**6,946,431**	**8.4%**	**11.5%**	**7,958,382**	**20,416,388**	**5.5%**	**$469.75**	**$49.37**
Los Angeles	352,934,907	5,732,865	1,061,731	11.7%	15.1%	712,311	4,366,606	4.9%	$354.76	$35.52
Orange County	128,047,960	1,002,052	477,226	10.3%	15.5%	(178,210)	4,430,224	5.7%	$270.98	$31.44
Inland Empire	41,080,971	469,519	143,058	8.6%	10.9%	366,599	765,471	8.5%	$201.42	$20.04
San Diego	101,858,727	1,061,694	48,954	10.3%	14.4%	(87,169)	4,126,590	6.7%	$322.34	$32.64
Phoenix	153,582,777	2,862,120	669,161	13.3%	17.0%	2,014,995	3,617,053	7.1%	$173.34	$24.72
Southwest	**777,505,342**	**11,128,250**	**2,400,130**	**11.4%**	**15.2%**	**2,828,526**	**17,305,944**	**5.9%**	**$292.78**	**$31.52**
West Coast Total	**1,503,325,827**	**34,559,006**	**10,133,405**	**9.7%**	**13.0%**	**14,156,700**	**46,084,287**	**5.8%**	**$348.97**	**$36.30**

VACANCY VS. AVAILABILITY



HISTORICAL NEW CONSTRUCTION & CAP RATES



Data Source: CoStar

Kidder Mathews is the largest, independent commercial real estate firm on the West Coast, with more than 700 real estate professionals and staff in 21 offices in Washington, Oregon, California, Nevada, and Arizona. We offer a complete range of brokerage, appraisal, property management, consulting, project and construction management, and debt equity finance services for all property types.

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1,500 — ASSIGNMENTS ANNUALLY

36/21 — TOTAL # APPRAISERS / MAI'S

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