Kidder Mathews

Real Estate Market Review

King, Snohomish, and Pierce Counties

4th Quarter
2012

Seattle Office

Market Forecast

	Current / Projection	
Vacancy	10.31%	↓
Construction	729,265 sf	↔
Rental Rate	Varies*	↔
Absorption	1,187,675 sf	↔

* by submarket

Market Highlights

Regional vacancy rate is at 10.31%, down from 10.75% last quarter. Net absorption for the fourth quarter was 1,187,675 s.f., resulting in an annual total of 2,559,947 s.f. This was slightly less than 2011, primarily due to the last of the new buildings achieving stabilized occupancy.

Office acquisitions ended up fairly evenly balanced between Seattle and Bellevue CBDs; volume reached a historic high in the fourth quarter. The total will be moderated next year by a lack of target properties available for sale. It remains to be seen if interest in the region will expand to secondary locations.

In the north and south ends of the Seattle CBD and in the Bellevue CBD leasing activity has continued and rental rates have moved up, especially for larger spaces. ■

The region's office market continues its gradual overall recovery with net absorption of about 1.19 million s.f. in the fourth quarter. Leasing was widespread, with all five submarkets reporting positive results for the first time in a year. The positive impacts of Amazon in the north end of the Seattle CBD and various gaming and internet companies in the Bellevue CBD continued through the fourth quarter, joined by renewed leasing from more traditional sectors. The most recent beneficiary was the overall Class A category, which saw increased leasing activity in the fourth quarter in legacy Class A buildings such as Columbia Center, Safeco Plaza and 901 Fifth.

Rental rates were unchanged in most markets; increases were achieved in better properties across the Bellevue and Seattle CBDs. The vacancy rates in the other submarkets have not yet reached levels to prompt rent growth, but the rates have held steady and are unchanged in three quarters. The threat of a fiscal cliff did not have an obvious effect on local regional business decisions and, regardless of the eventual resolution (or lack thereof), it is expected that the region will fare better than the nation.

The fourth quarter saw continued employment growth, although it does remain focused on the technology sector. The prognosis for 2013 was recently upgraded in the *Puget Sound Economic Forecaster* report, with employment targeting a 2.7% increase in 2013, the sixth straight quarterly increase. This should support leasing in the office market similar to that seen in 2012.

Investment activity was amazing in the fourth quarter. Amazon purchased the first five phases of their headquarters campus from Vulcan, Prudential/Touchstone sold West 8th (mostly leased by Amazon), and Beacon Capital sold 1201 Third, racking up a total of nearly $2 billion in sales. Also, City Center Plaza in Bellevue and 7th and Madison were both sold for the second time in less than three years. These sales involved a wide variety of national institutional buyers, highlighting the confidence in the core of the region's economy and office market. Capitalization rates for these sales all hovered

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Area Review

SEATTLE CBD/SURROUNDING AREA REVIEW

The larger central Seattle office market vacancy rate moved down slightly this quarter to 10.68%, compared to 10.87% in the third quarter. The availability rate dropped 40 basis points to 13.90%, moving back down to the first quarter rate. The vacancy rate is quite variable across the submarkets within the Seattle area, from 5.0% in Lake Union to 14.1% in the Seattle CBD. Vacancy in Pioneer Square improved significantly to 13.0% following large leases in 705 Union Station and Smith Tower. The middle of the CBD vacancy rate increased 70 bps in the fourth quarter due to the loss of Morgan Stanley and downsizing by other renewing tenants. However, leasing activity in the quarter was strong, and when those leases commence in early 2013, the vacancy should move down from the 14% plateau of the past two years. The Seattle CBD availability rate is now at 16.4%. 2012 ended with a net loss of occupancy in the Seattle CBD of 112,172 s.f., after minor positive results in 2010 and 2011. Looking forward, the Seattle CBD will continue to face challenges in tenant retention, but the leasing activity in the fourth quarter and the lack of full floor space in other parts of the core should prompt better results in 2013.

Average asking rental rates across the Seattle market increased over the past quarter by about 4%, as landlords reacted to the deal volume in the quarter and the tight Class A market in buildings built since 2000. The average asking rental rate in the Seattle market is $29.19/s.f./year, full service. The true change may be slightly higher as the remaining listings have very little space in the best Class A properties in the market.

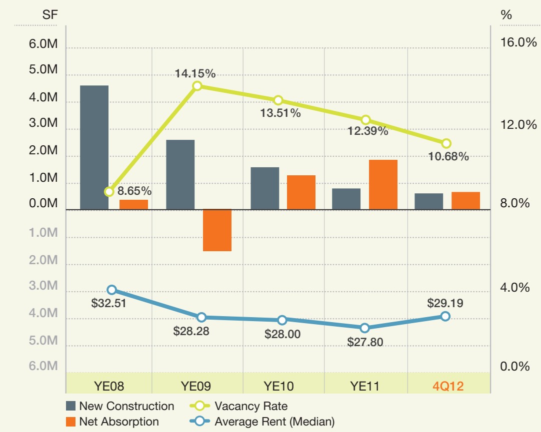
EASTSIDE REVIEW

Eastside office vacancy continued to move downward over the fourth quarter to an average 8.36% from 9.12% in the third quarter, the lowest overall vacancy in the region. The spread between vacancy and availability rates is 432 bps (12.70% available), indicating tenants continue to be in transition. Significant recent examples include T-Mobile vacating space in Sunset North and Verizon leaving one leased building in Eastgate. Absorption over the last quarter was 196,036 s.f., leading to a total of 576,197 s.f. for the year. The vacancy rate in the Bellevue CBD ended 2012 at 8.9%, following net absorption of 257,720 s.f. for the year. The limited supply of Class A office space in the Bellevue CBD now includes only five spaces over 50,000 s.f. and one over 100,000 s.f. Three projects are being fine-tuned to proceed when a major requirement surfaces: Lincoln Square II, Beacon Capital's Eighth Street project, and Summit III. Overall, the Eastside market is expected to continue to outperform the region, driven by the CBD, with the surrounding suburban markets lagging behind. There was one major sale in the fourth quarter. City Center Plaza, a 583,179 s.f. office tower fully leased to Microsoft, sold in November for $642/s.f. by Cole Credit Property Trust to CommonWealth Partners, who had purchased Russell Investment Center earlier in the year. Cole had purchased City Center Plaza in June of 2010 for $532/s.f. Showing just how much stronger the investment market has grown, the capitalization rate in the first sale was 6.5%, dropping to 5.6% in the recent sale.

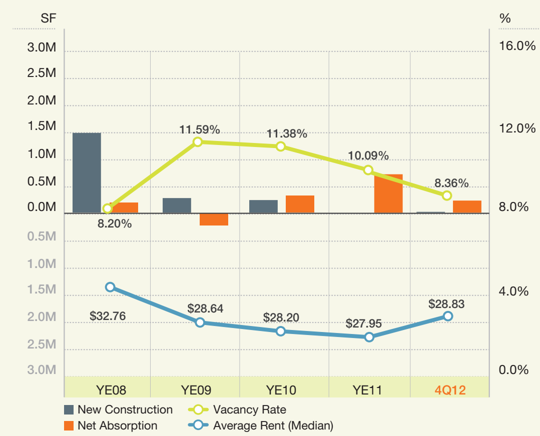
SOUTH KING COUNTY REVIEW

The South King County market vacancy rate ended 2012 at 12.32%, down 54 bps from the beginning of the year. The fourth quarter absorption was 121,722 s.f., making up for some losses earlier in the year. The availability rate ended the year

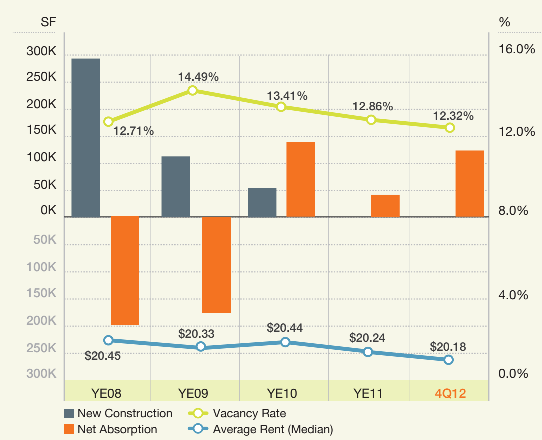
SEATTLE CBD/SURROUNDING AREA



EAST KING COUNTY



SOUTH KING COUNTY



where it started, at 16.30%, the highest of the submarkets. This market has always lagged recoveries, as Boeing's office needs tend to be counter-cyclic. Boeing remains the only major tenant in the market and the smaller businesses which form the majority of the South King office demand are still not exhibiting much confidence in the economic recovery. Rental rates in this market have not changed significantly in ten quarters, and remained virtually unchanged in the fourth quarter at an average asking rent of $20.18/s.f./year full service. This is over 30% lower than the other King County markets, yet it will take a much wider economic recovery for this market to show significant improvement. There were no significant sales in the fourth quarter and only one in all of 2012.

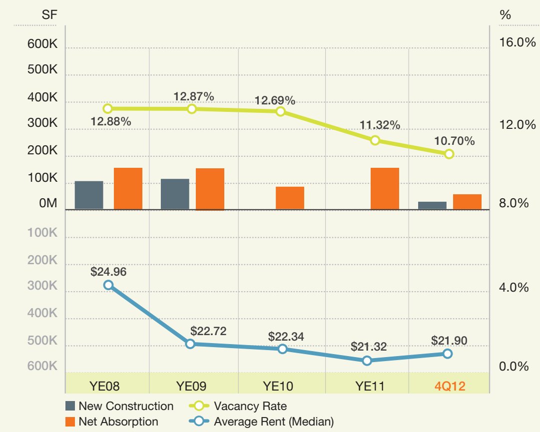
NORTHEND REVIEW

The Snohomish County market continued to see steady, if modest, leasing activity, ending 2012 with two strong quarters and net absorption of 169,686 s.f. for the year. The vacancy rate dropped to 10.70%, with the availability rate falling 30bps over the year to 14.30%. Average asking rent inched upward to $21.90/s.f./year full service. The leasing activity is tied to Boeing's modification of the 787 assembly process which brought more elements in-house or under closer oversight. The addition of jobs for this modification and the ramp-up of the military tanker program have also been an overall boost to the local economy in general. The Northend was also buoyed during the year by Google taking space in Bothell at the southeast corner of the market. Overall, the market remains primarily populated by smaller tenants. Two office projects are under construction, one 24,000 s.f. building in Mill Creek and a 4,000 s.f. building in Edmonds. Both are owner/user projects with 8,200 s.f. of the Mill Creek available for lease. On the investment front there were four sales over $5,000,000 in the fourth quarter in the Northend. The largest of these is the Frontier Communications building in Everett. The owner/user sold the property for $19 million ($65.61/s.f.) and will vacate more than half the project. The indicated capitalization rate on stabilized proforma income was reported at 8.42%, showing the types of returns necessary in this market for value-add projects in secondary locations.

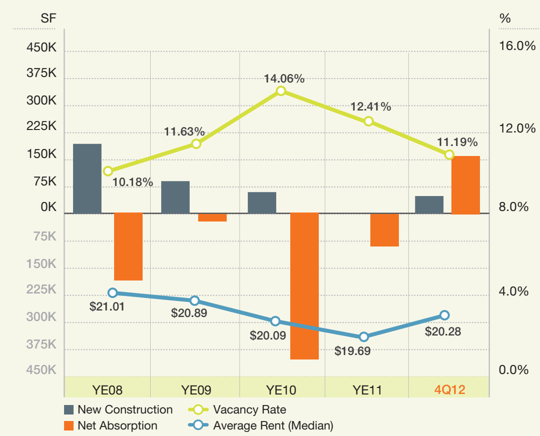
PIERCE COUNTY REVIEW

Pierce County showed the biggest decrease in its vacancy rate in the fourth quarter, ending the year at 11.19% compared with 12.15% in the previous quarter. The availability rate fell by 70 bps to 13.60%, a modest improvement over the third quarter. Absorption was a net 150,337 s.f. in the fourth quarter, offsetting losses earlier in the year to end 2012 with positive absorption of 110,203 s.f. One of the major leases in the fourth quarter was Merrill Lynch taking 14,650 s.f. in downtown Tacoma. The availability rate in the Tacoma CBD is 16.6%, with vacancy at 13.3%. Most of the difference is the Russell Investment space that has had little interest for sublease or accounts for over 25% of the available space. Investment in Pierce County has been limited due to the stubborn high availability rate and the fact that unemployment in Pierce County remains much higher than in King County. Most local businesses which make up this market are also not feeling much of the effect of the region's economic recovery. As a result of these same factors, the average asking rental rates continue to be flat, as there just is not much demand and price is not the deciding factor in that conclusion.

NORTHEND



PIERCE COUNTY



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between 5.00% and 5.75%, reflecting the low cost of financing and a higher regard for the risk/return profile of real estate compared with alternative investments.

VACANT SPACE/VACANCY RATE

Net absorption in the region during the fourth quarter of 2012 was 1,187,675 s.f., bringing the annual total to just less than 2,560,000 s.f. This is slightly lower than 2011, but was the second best year since 2005. The regional vacancy ended the year at 10.31%, down from 11.71% at the end of 2011. The availability rate dipped to 13.87% after starting the year at 14.12%. Considering the number of leases signed during the fourth quarter, both of these rates are expected to continue downward into 2013. Vacancy rates in each of the submarkets showed a healthy decline over 2012, the drops ranging from 54 to 173 basis points (bps). The performance was more muted in terms of availability rates which decreased by 30 to 70 bps, indicating that tenant downsizing has not yet ended in the region. Each of the regional submarkets is still oversupplied, but there are categories of space that are getting tight, such as premier space in Seattle and Bellevue.

NEW CONSTRUCTION ACTIVITY

No new office projects were started in the fourth quarter. The total amount of space under construction in the region is now 729,265 s.f., including 202 Westlake and UW Medicine in South Lake Union, both preleased, Home Plate Center South in the SoDo neighborhood of South Seattle, and Bullitt Center in Capitol Hill. Vulcan has announced an agreement to build two additional buildings for Amazon adjacent to their current campus. Anticipating their continuing pace of expansion, Amazon closed on three city blocks between their campus and the north end of the Seattle CBD. The company has started pre-development for the first of three one million s.f. towers. Within the regional inventory of vacant space, there are only 18 spaces larger than 100,000 s.f. available; only six of those are over 200,000 s.f. This is a relatively small group in a market of about 182 million s.f., although the list of tenants with known requirements above 100,000 s.f. is also short. The realization that two of these spaces are under negotiations, and others are not compatible with the bigger tenants in the market, has caused several developers to dust off plans for office projects in Bellevue and Seattle. Rental rates in both of these markets are getting close to cost-feasible levels for new construction, assuming significant pre-leasing.

RENT FORECAST

Face rental rates were generally unchanged in the fourth quarter, with the exception of the Seattle market. The change in that market was driven by the Class A category, including a 2-3% bump in rental rates for the legacy Class A buildings in the Financial Core. The Bellevue CBD also saw rents increase, contrasting with continued softness in the Eastside's suburban submarkets. The other submarkets did not see significant rent increases in all of 2012 and modest upward pressure, at best, is expected outside the CBDs until late in 2013.

INVESTMENT MARKET

With a flurry of major sales in the fourth quarter, the regional market saw the highest annual dollar volume of sales transactions ever. The annual total was $2.79 billion, with $2.46 billion closing in the fourth quarter. For historic perspective, even without the $1.15 billion Amazon paid for their campus, the total exceeded the previous high in 2006 by over $200 million. Other fourth quarter sales included: 1201 Third, a 1.19 million s.f. multi-tenant tower sold by Beacon Capital to MetLife; 7th and Madison, 205,148 s.f. leased by HAL Real Estate to Polyclinic and then sold to Prudential; West 8th, 497,798 s.f. sold by Prudential to AEW Capital; and City Center Plaza, 583,179 s.f. leased by Microsoft and sold by Cole to CommonWealth. Capitalization rates are back to all-time lows with these sales all showing going-in capitalization rates between 5.05% and 5.6%. The Amazon sale rate is not known but is expected to fall toward the low end of that range or below. Buyers continue to scour the market, but at this point the number of Class A core properties that might be available is limited.

Source: CoStar Data