Kidder Mathews

Real Estate Market Review

King, Snohomish, and Pierce Counties

2nd Quarter
2013

Seattle Office

Market Forecast

	Current / Projection
Vacancy	10.46% ↓
Construction	411,872 sf ↑
Rental Rate	Varies* ↔
Absorption	244,161 sf ↔

* by submarket

Market Highlights

Regional vacancy rate is at 10.46%, up slightly from 10.31% last quarter. Net absorption for the second quarter was 244,161 s.f., lower than the first quarter, putting the YTD performance behind the 2012 pace.

Office acquisitions continued to be active, including one of the first major transactions outside of the Seattle and Bellevue CBDs with the sale of Redmond Town Center to Shorenstein Properties. The Wells Fargo Center sale to Ivanhoe Cambridge showed the overall confidence in the entire Seattle CBD market.

Tacoma took the leasing spotlight with State Farm's 300,000 s.f. lease poised to bring that submarket's vacancy rate below that of the Seattle and Bellevue CBDs. Rental rates are flat across the region so far in 2013, with the exceptions of continued firming in parts of Seattle and the Bellevue CBD. ■

The second quarter of 2013 continued the trends of the first quarter, although, while leasing continued, absorption activity was slower. Some large leases were inked, including State Farm taking 300,000 s.f in downtown Tacoma and Amazon snapping up Metropolitan Park North, recently vacated by Nordstrom, as the two largest. The region's quarterly net absorption was 244,161 s.f., with another loss in the suburbs of the Eastside market. South King County had another good quarter with a variety of businesses taking space. The region's vacancy rate increased slightly to 10.46% from 10.31% last quarter. In general the activity was not sufficient to create much movement in rental rates, but they continue to firm up in the CBDs.

The big news in the quarter was the number of new construction starts announced. Beacon Capital has committed to start a tower in downtown Bellevue before the end of the year and Vulcan and Touchstone also have four towers scheduled for this year. Vulcan's are pre-leased, but the others are moving ahead on a speculative basis. This indicates developers expect rental rates to increase strongly in these micromarkets at least enough to make the projects pencil out.

Investment activity trended well in the second quarter, with $717 million in the top three sales alone. The Seattle CBD again had the largest sale; the Wells Fargo Center at just under $390 million. Redmond snagged the second place sale, showing that the suburbs are not totally off-limits to institutional investors. The number of sales was larger this quarter, including more smaller owner/user acquisitions.

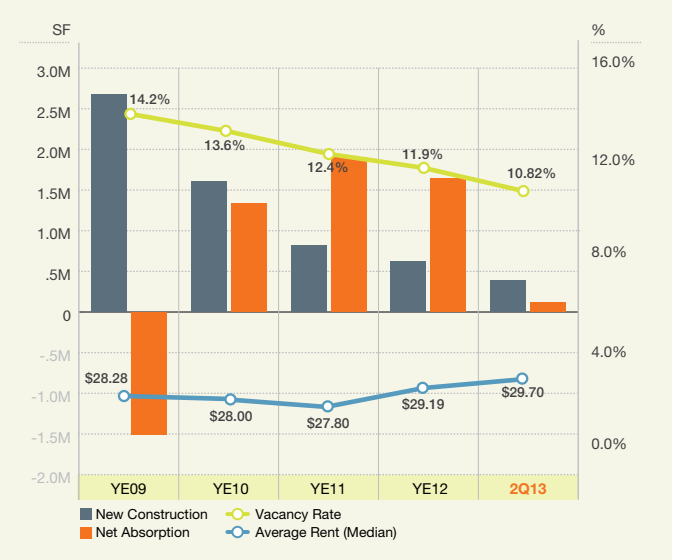
Capitalization rates were generally unchanged from the previous quarter, indicating that the equity rate absorbed the increase in lending rates, further solidifying the market's attraction to investors. The expected return is still disparate with Class A properties dipping down to the 5% level while the rest of the market is perched at 7-8% rates.

Area Review

Seattle CBD/Surrounding Area

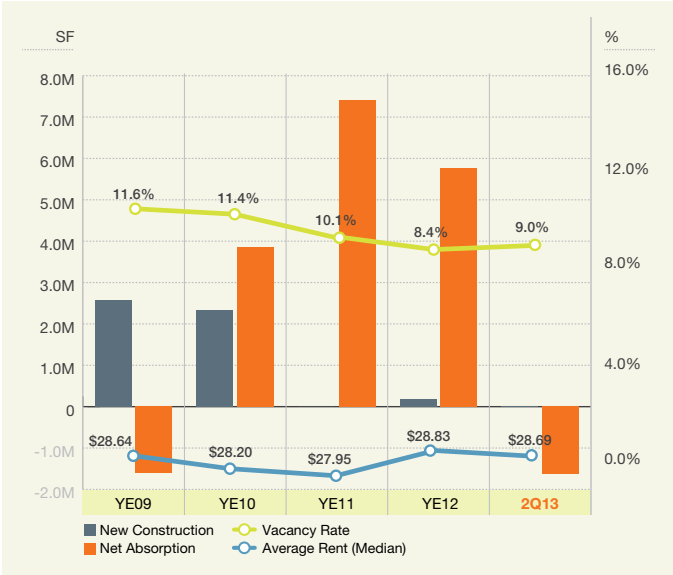
The larger central Seattle office market vacancy rate moved up slightly this quarter to 10.82%, compared to 10.38% in the first quarter. The availability rate fell to 13.0% from 13.90%, portending a decrease in vacancy in the coming quarters. The vacancy rate varies widely across Seattle's submarkets, from 5.3% in Lake Union to 14.5% in the Seattle CBD; availability at 6.4% and 17.0%, respectively. Over the next two quarters the Lake Union vacancy rate should fall below 4% with the commencement of Amazon's leases in 1800 9th Avenue and Metropolitan Park North. Pioneer Square vacancy continued to move downward, improving significantly in the quarter to 11.1% from 12.3% last quarter, due to leasing in the Union Station and Smith Tower buildings. The core of the CBD has seen steadier leasing activity and while the vacancy rate was flat over the quarter, leases did drop the availability rate by 170 basis points. The new owners of the Wells Fargo Center are planning renovations aimed at attracting the tech tenants that typically gravitate to South Lake Union and Pioneer Square. It will be interesting to see if these changes and the lack of large blocks of space in these micromarkets will do the trick.

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 $29.70/s.f./year full service. The true change may be slightly higher as the best Class A properties in the market that have very little vacancy remaining.



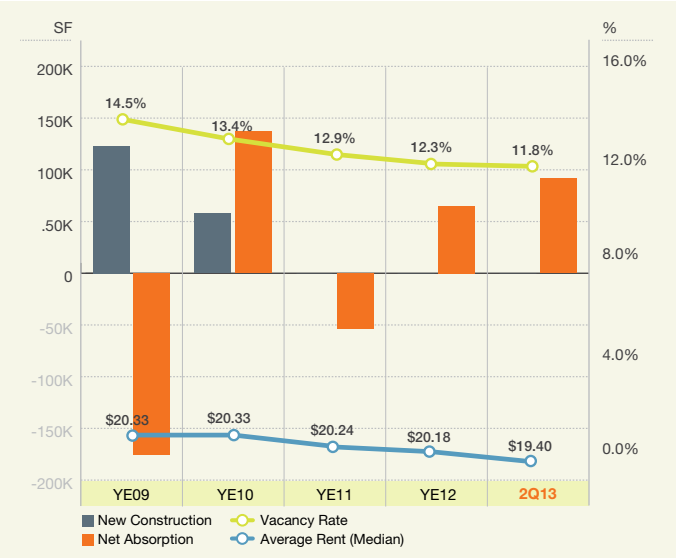
East King County

Vacancy in the Eastside office market changed little over the last quarter, at 9.00% currently compared to 8.90% in the first quarter of 2013. It continues to post the lowest vacancy of the five major regional market areas, remaining well below the average regional office vacancy rate of 10.46%. The low vacancy and appeal of the Bellevue CBD have not gone unnoticed in the market place, with two major Bellevue CBD land purchases closing last quarter. An overseas developer purchased the 1.34 acre DNTNO-1site at 435 108th Ave NE in June for $31 million. Two blocks to the south, the 0.54 acre Opus Bank branch site at 200 108th Ave NE closed for $7.1 million. It is zoned DNTN-MU. The land purchases are a clear sign that developers continue to position themselves in downtown Bellevue. Both sales are expected to be interim holds with development expected down the road. Absorption during the second quarter 2013 was -151,489 s.f. and the availability rate on the Eastside also remains relatively high at 13.3%, indicating tenants continue to be in transition and keeping options open. This further indicates there are still a few hurdles to overcome in the Eastside market, although new office tower construction is imminent with the Class A office supply in the Bellevue CBD remaining in very limited supply for large users. Asking rental rates in the Eastside market finished the quarter nearly identical to last quarter, at $28.69/s.f. full service compared to $28.66/s.f. (1Q-2013). While investment sale activity has slowed some over the last quarter, the interest in the Eastside core assets remains very high. Owner-user activity also remains active and more sales are expected in 2013 as rents continue to rise and interest rates remain attractive.



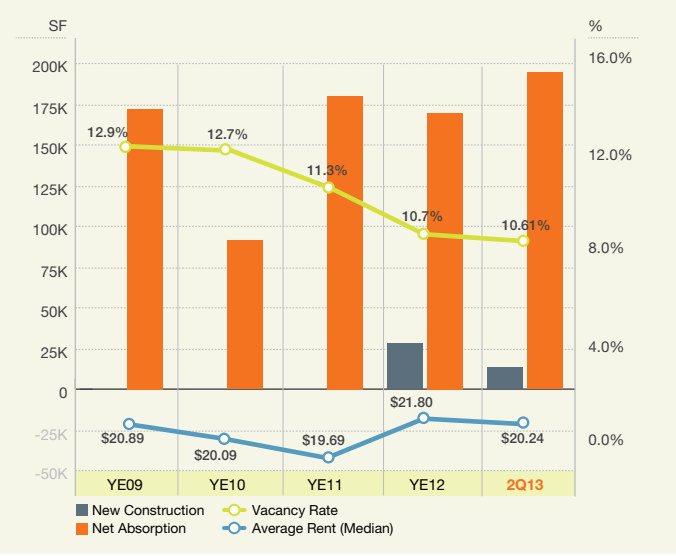
South King County

The South King County market continued the positive trend of the first quarter, absorbing 91,590 s.f. and dropping the vacancy rate back to the year-end 2007 level of 11.8%. This rate is still 100 bps higher than the next highest market, but the improvement has been encouraging. The availability rate is also the highest in the region, but declined to 15.60% from 16.00% last quarter. The 2013 year to date absorption is remarkable as it bested eight of the past ten years. This was done without any significant leasing by Boeing, still the largest tenant in the market. Asking rental rates remain the lowest in the region, prompting some of this activity. This market should benefit from Boeing contractor expansions as the new generation 737's move through the development phase into production. The market also will benefit from the continuing loss of affordable office space in the South Seattle submarket as that market continues to redevelop.



Snohomish County

The Snohomish County vacancy rate has dropped slightly from 10.78% last quarter to 10.61% currently, with the availability rate also changing modestly for the better from 14.40% last quarter to 13.90% currently. Rental rate quotes decreased from last quarter, with a current average asking rent of $20.24/s.f./year full service compared to $21.80/s.f. last quarter. The majority of new leases in the Northend market have remained small in size, but have lead to the healthy absorption of 180,061 s.f. over the last quarter. There is a very nominal 16,210 s.f. of new office space under construction in Snohomish County presently. Boeing also opened its new Everett Delivery Center. This new 180,000 s.f. facility triples the amount of office, conference and delivery operations space provided by the old building and also increases Boeing's operational efficiencies. On the investment front, the Northend remains an owner-user and local investor dominated market.



Pierce County

Details regarding the planned State Farm expansion into downtown Tacoma continue to emerge following the initial announcement reported last quarter. Two leases were signed: the entire 224,406 s.f. former Russell Investments building and 73,004 s.f.in the Columbia Bank Building. Both leases commence in October, for an initial group of about 400 employees, to be followed by additional hiring to a forecasted total of 2,000 employees in this space. Signing of these leases has already shown up in the availability rate for the larger Pierce County Market, which fell to 12.80% from 14.20% last quarter. The effect will be seen in the vacancy rate in the fourth quarter, equating to a 150 basis point reduction as the leases start. The current vacancy rate is 10.71% for the larger market. The results are even more dramatic in the Tacoma CBD submarket, where the availability rate fell from 18.8% to 14.4% with the lease signings. The current vacancy rate there is 13.0%, and will fall to 8.2% as the leases commence.

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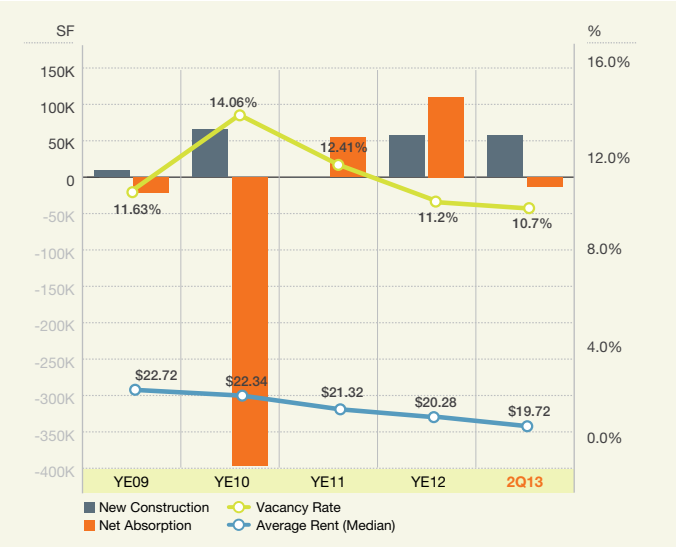

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Outside of the direct effect of these deals, they will also put a new spin on the Tacoma CBD location and likely create some ancillary leasing. This is the first major positive development in the county, which has continued to lag the region in terms of job growth. The average asking rental rates have not yet reacted to these events and are virtually unchanged over the past quarter at $19.72/s.f./year full service.

Vacant Space/Vacancy Rate

Net absorption in the region during the second quarter was 244,161 s.f.; lagging the first quarter and putting the market well off the mid-year total of last year. The regional vacancy bumped up slightly to 10.46% from 10.31%, mainly due to an increase in the Seattle market. A positive indication for the next few quarters is that the availability rate decreased rather sharply to 13.45% from 14.01% last quarter. This indicates there are a number of larger leases region-wide that are due to commence in the next two quarters, but it may not be enough to reach the 2012 total. In general, the regional office market is oversupplied, but specific locations are lacking larger spaces; South Lake Union, Pioneer Square, and downtown Bellevue being the major examples.

New Construction Activity

In the second quarter, Beacon Capital stepped up and announced a start date for a 24-story, 513,000 s.f. tower on their premium site in the Bellevue CBD. Several developers had been fine-tuning plans as the Bellevue CBD vacancy rate fell and rents for Class A space jumped. Beacon plans to start later this year and deliver in the fourth quarter of 2015. Trammell Crow also presented plans to start on a 19-story tower on the Washington Square block. Timing of that project has not been disclosed. In the Seattle market, Touchstone announced they will start this year on their two tower project on the Troy Laundry block in South Lake Union. Vulcan announced that Phases VII and VIII of the Amazon Campus will get started this year for 2015 delivery. These will join Phase VI already under construction. This quarter saw the delivery of the Bullitt Center on Capitol Hill and Home Plate Center South in Seattle's SoDo neighborhood, dropping the total square footage currently under construction. Tower cranes are up over Capstone's Dexter Station, a 345,992 s.f. speculative building, as well as the aforementioned Amazon Phase VI and UW Medicine. 202 Westlake is expected to be delivered to Amazon in July. Still waiting for approvals of minor plan tweaks, Amazon is already excavating the site for the first of its three 1,100,000 s.f. towers. It will likely be added to the under construction roll next quarter, with delivery tentatively scheduled for 2015.

Rent Forecast

Asking rental rates across the region were virtually unchanged over the past quarter with some exceptions. Downtown Bellevue saw increases in rental rates, as well as Seattle, including its Central Business District (CBD), which until recently has lagged behind South Lake Union and Pioneer Square. The CBD is now seeing more leasing activity and firmed up rental rates. In most markets, rental rates remain well below cost-feasible levels (the lower rents do not yet justify the cost of new construction). However, as the vacancy rate in these leading submarkets continues to fall, rental rates will continue to rise rapidly to a point where new construction is financially feasible. As for the rest of the market, expect to see very moderate rent growth as vacancy rates are slowly reduced.

Investment Market

Office investment was active again in the second quarter, including over fifty individual transactions totaling $824 million. Large institutional purchases again dominated, with three transactions accounting for $717 million of that total. The largest was Beacon Capital's sale of the Wells Fargo Center building in the middle of downtown Seattle. The 966,000 s.f. 1983 vintage building sold for $404 per square foot to Ivanhoe Cambridge. The reported capitalization rate was 5.47%, a strong number considering that the building was 70% leased at the time of sale. In Redmond, the office portion of the Redmond Town Center mixed-use project sold for $185 million, or $318/s.f. The capitalization rate on that sale was just under 5.6%, reflecting the strength of the two main tenants: AT&T and Microsoft. Elliott West, a three building project in Seattle's Queen Anne neighborhood, sold to Cole as they reinvest in the market after selling City Center Bellevue in late 2012. The fourth largest sale has perhaps the most interesting history. Built in 1918, 51 University was a typical waterfront mill building with the upper floors mostly unused until the 1980s, when they were fully renovated as lab space for Seattle's largest biotech company, Immunex. After that company's lease expired, the space stood vacant as demand for lab space was weak. The building was purchased by Goodman Real Estate, a local developer, to convert the upper floors to office space. After preliminary planning and removing the lab improvements, the building was flipped to Equity Residential in shell condition. Equity built-out and leased the floors as office space, although they had initially intended to convert to apartments or demolish. The most recent sale was to Unico, the long-time manager of University of Washington real estate holdings, who anticipated stronger demand for the space when the Alaska Way Viaduct is removed, providing the building excellent water views.

At least two major sales are in the works in downtown Seattle and investors outnumber opportunities in the Seattle and Bellevue markets. Activity in second and third tier locations and Class B or C properties has not yet accelerated. The recent increase in interest rates does not appear to have had much effect on real estate return requirements. This indicated acceptance of lower equity return rates and greater confidence in real estate investment.

*Source: CoStar Data