Kidder Mathews

## Real Estate Market Review

**Portland, Vancouver and Surrounding Areas**

1st Quarter **2016**

# Portland Office

## Market Forecast

| | Current / Projection | |
|---|---|---|
| **Vacancy Rate** | 7.6% | ↓ |
| **Availability Rate** | 9.2% | ↓ |
| **Construction** | 1.8M sf | ↓ |
| **Net Absorption** | 291,004 sf | ↓ |

### Market Highlights

Lenders are enhancing securitization requirements across the board.

Rents are at an all-time high.

Concessions are almost nonexistent for desirable spaces, and tenant improvement allowances are shrinking. At the same time, construction costs are increasing. ■

The Portland office market is a landlords market, and current space availability is becoming increasingly difficult to meet tenants' needs. Rental rates are at an all-time high, and demand for Class A and creative office spaces is outpacing supply. Tenants that have leases expiring in 2016 and 2017 will likely see a significant increase in their rental rates as we are now seeing new "normal" rental rates. Landlords are minimizing concessions and improvement funds for desirable spaces, while construction costs continue to increase and landlords are maximizing their leverage by enhancing lease security provisions with larger deposits, lease guarantees, and letters of credit. Markets are cyclical, and the metro area, especially the central city, is certainly experiencing a rare time where property owners generally have the upper hand in negotiations with tenants requiring space in short supply.

### Vacancy, Availability, and Net Absorption

The vacancy rate for the first quarter decreased slightly to 7.6%, compared to 7.9% at the end of 2015. The amount of available space remains higher at 9.2%, down from 9.8% the previous quarter. Total net absorption was reported at 291,004 s.f., following 512,034 s.f. the previous quarter. Net absorption has been positive for three consecutive quarters, totaling 929,309 s.f. New deliveries to the market over the same period totaled 245,611, barely a quarter of total absorption.

### Leasing Activity

Rental rates are at an all-time high, and the demand for Class A and creative office space is outpacing supply. Rents for desirable new premier, Class A properties in the best locations are now pushing to highs of approximately $41/s.f., full service gross.

Existing Class A assets, not pursuing the creative office sector, are finding rental rates and leasing activity lagging compared to those proactively creating a new type of offering

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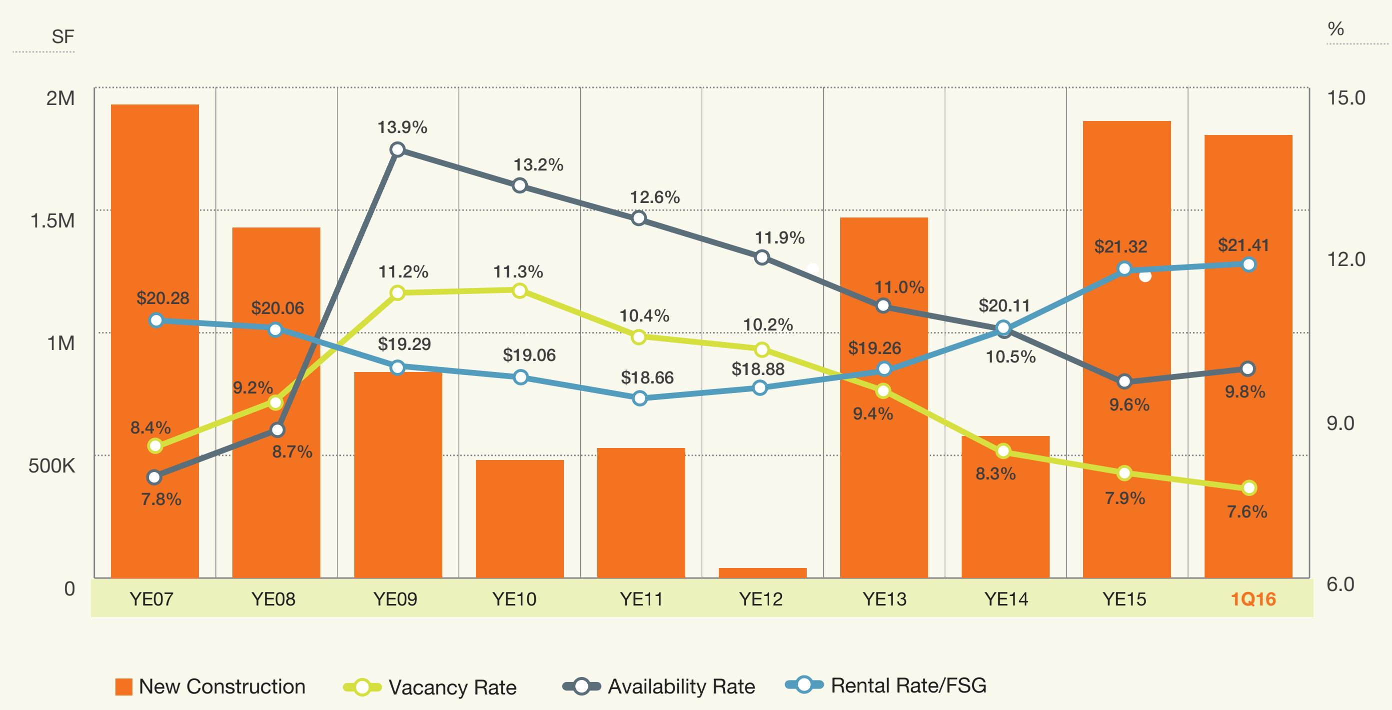
# Area Review

## Portland Office Market Statistics

| Period | Inventory | | Vacancy | Availability | Net | # | RBA | UC Inventory | | Average Asking |
|---|---|---|---|---|---|---|---|---|---|---|
| | # Bldgs | Total RBA | Rate | Rate | Absorption | Delivered | Delivered | # Bldgs | RBA | Rate (FSG) |
| 2016 Q1 | 5,705 | 100,379,009 | 7.6% | 9.2% | 291,004 | 4 | 129,402 | 16 | 1,805,940 | $21.41 |
| 2015 Q4 | 5,706 | 100,380,557 | 7.9% | 9.0% | 512,034 | 5 | 83,249 | 17 | 1,862,274 | $21.32 |
| 2015 Q3 | 5,707 | 100,323,920 | 8.3% | 9.4% | 126,271 | 2 | 32,960 | 17 | 1,367,373 | $21.14 |
| 2015 Q2 | 5,712 | 100,465,912 | 8.6% | 9.6% | -12,649 | 2 | 40,242 | 19 | 1,400,333 | $20.74 |
| 2015 Q1 | 5,713 | 100,432,570 | 8.6% | 10.0% | -160,587 | 2 | 93,348 | 15 | 1,087,064 | $20.37 |
| 2014 Q4 | 5,715 | 100,357,710 | 8.3% | 9.8% | 1,458,952 | 7 | 1,155,691 | 9 | 578,771 | $20.11 |
| 2014 Q3 | 5,714 | 99,252,306 | 8.8% | 9.6% | 200,421 | 4 | 17,244 | 13 | 1,545,841 | $19.90 |
| 2014 Q2 | 5,714 | 99,397,081 | 9.1% | 9.7% | 88,527 | 8 | 33,863 | 13 | 1,479,572 | $19.72 |
| 2014 Q1 | 5,717 | 99,475,353 | 9.3% | 10.2% | 77,275 | 3 | 45,521 | 19 | 1,492,049 | $19.28 |
| 2013 Q4 | 5,721 | 99,528,611 | 9.4% | 10.2% | 51,848 | 0 | 0 | 17 | 1,469,479 | $19.26 |
| 2013 Q3 | 5,726 | 99,570,283 | 9.5% | 10.4% | -125,096 | 1 | 20,000 | 10 | 1,070,680 | $19.14 |
| 2013 Q2 | 5,727 | 99,561,199 | 9.4% | 10.7% | 195,069 | 1 | 10,916 | 4 | 60,794 | $19.09 |
| 2013 Q1 | 5,732 | 99,650,999 | 9.6% | 10.7% | 504,698 | 2 | 8,938 | 2 | 30,916 | $18.91 |
| 2012 Q4 | 5,733 | 99,679,439 | 10.2% | 11.2% | 284,082 | 4 | 100,083 | 4 | 39,854 | $18.88 |
| 2012 Q3 | 5,731 | 99,587,351 | 10.4% | 11.4% | 282,997 | 4 | 44,730 | 7 | 129,021 | $18.65 |

### Construction, Vacancy, Availability & Rental Rates



in their buildings. However, rental rates in more traditional Class A offerings continue a modest move upward ($28-32/s.f.), which preserves net income levels as general operating and real estate tax expenses continue to increase. In effect, market participants enjoy the benefits of a rising tide lifting all boats.

One of the largest leases of the first quarter was Zoom Care's lease of 30,193 s.f. at Pearl West. The lease constitutes the entire 6th floor, as well as the balance that was previously remaining on the 5th floor. The property is now 87% leased, with rental rates of $41/s.f., FSG, with base rent of $31.50/s.f. and NNN of $8.50/s.f. Puppet Labs signed a lease for an additional 37,889 s.f. within Block 300 in March, increasing their overall square footage to over 112,000 s.f. The tenant will not move in to the expansion space until February 2017. Vacasa signed a lease for 37,441s.f. at RiverTec on NW 13th Ave. at the beginning of the year.

The average asking rental rate for all office properties within the Portland MSA was $21.41/s.f., full service gross during the first quarter of 2016, up from $21.32/s.f., full service gross at the end of last year.

## Concessions

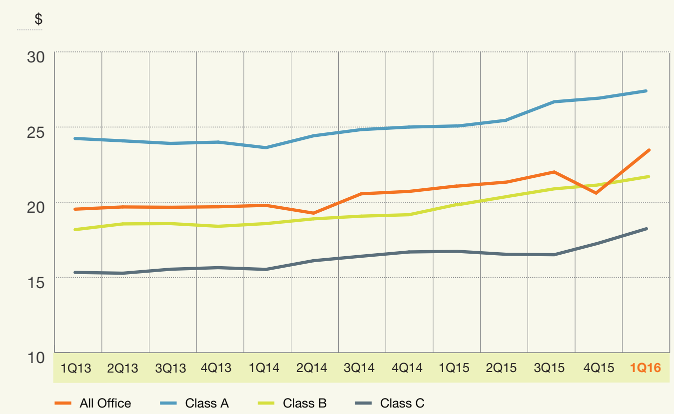
Concessions being offered vary in the market depending on the type of space and location, as new investors in the market work to meet proforma rent projections and existing property owners prepare for near-term sales or upcoming refinancing. Rents for creative office and quality traditional spaces in core locations continue to make new cyclical peaks, which are also nearing historic market highs. Tenant improvement allowances and rental abatement concessions are still healthy for new leases in traditional Class A spaces where leasing activity has been slower relative to creative office. Tenant improvement allowances are shrinking on second generation creative space and lease renewals in creative office space, with $5.00 to $10.00/s.f. typical while newly delivered, high-quality creative space still takes $50.00 to $70.00/SF to deliver "turnkey", depending on the condition of the building and vacancy prior to the conversion.

Given the cost for building owners to deliver new creative space, rental abatement concessions in this product type are minimal and tenants are often required to contribute funds to complete the entire tenant improvement work. In addition, tenant improvement costs continue to increase as commercial construction activity continues and labor inputs rise, further complicating the cost-benefit analysis for metro-area property owners.

## New Construction

Pearl West, a 155,661 s.f., Class A office building, was delivered at the end of the first quarter, and is 87% leased. Other notable deliveries during the first quarter include the redevelopment of

Rental Rates




a 25,000 s.f. warehouse at NW 16th and Overton, and delivery of The Hudson in Vancouver. The warehouse building, formerly home to Rose City Awning Co., was transformed into 29,933 s.f. of creative office space. The building is fully leased to Swift Agency. In Vancouver, The Hudson, a 65,500 s.f., three-story office building, was delivered in March. The property is 61.2% preleased.

There are 16 office buildings currently under construction, which will bring over 1.8 million s.f. of new office space to the market. The two largest projects are Park Avenue West and Daimler Trucks North America Headquarters. Park Avenue West, a 546,000 s.f., 30-story, mixed-use development is slated to be delivered in April. The development includes 13 stories of Class A office space totaling 194,799 s.f., 15 stories of apartments, two stories of retail, and six stories of underground parking. The property is 87% leased, with one 15,725 s.f. office floor remaining and offered as available for $31.00/s.f., NNN. Daimler's 265,000 s.f. new Class A headquarters building on Swan Island is scheduled to be delivered during the second quarter.

## Investment Activity

Sale volume for the first quarter of the year was $175 million, following $150 million at the end of 2015. The average sale price per square foot was $198, up from $179 the previous quarter. The largest sale transaction of the quarter was ASB Real Estate Investment's purchase of the 99,860 s.f. RiverEast Center close in on Portland's eastside. The building was originally constructed in 1952 but was extensively renovated and earned LEED Certified-Gold in 2007. The property was fully leased at the time of sale and sold for $33,500,000, or $212/s.f. The reported capitalization rate was 4.54%, again indicating that investors believe there is substantial future rent growth on the horizon.

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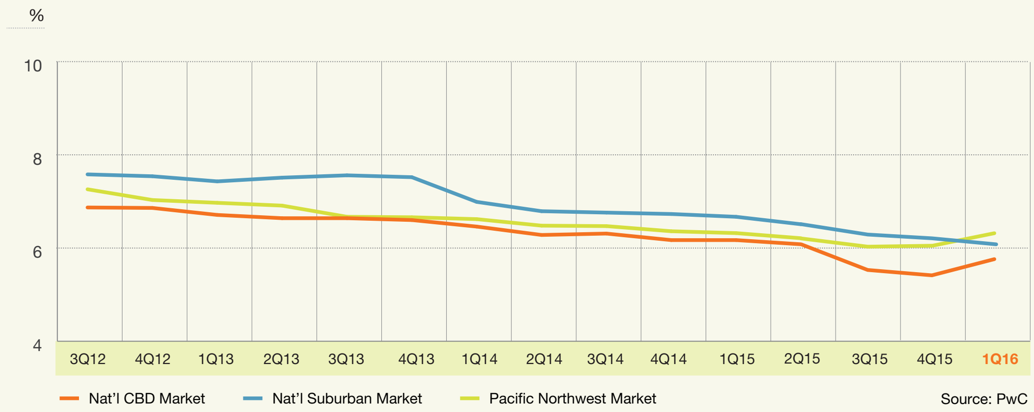
## Average Cap Rates




## Recent Sale Activity of Note

| Property Name | Location | Bldg SF | Sale Price | Price/SF | Sale Date |
|---|---|---|---|---|---|
| RiverEast Center | Portland | 99,860 | $33,500,000 | $335 | Mar-16 |
| Tanasbourne Commerce Center | Hillsboro | 184,971 | $31,100,000 | $168 | Mar-16 |
| Ballou & Wright Building | Portland | 56,532 | $14,000,000 | $248 | Jan-16 |
| 811 @ The Waterfront | Portland | 56,700 | $12,600,000 | $222 | Feb-16 |

The Tanasbourne Commerce Center, a 184,971 s.f. office park comprised of four buildings, sold at the end of the first quarter for $31,100,000, or $168/s.f. Capitalization rate information was not available. The property was fully leased.

Specht Development and ASB Real Estate Investments purchased the historic Ballou & Wright Building in the ever-popular Pearl District in the beginning of the quarter. The 56,532 s.f. building, originally constructed in 1922, renovated in 1997 and formerly the headquarters for Hanna Anderson, was only 8% occupied at the time of sale. The buyers purchased the property for $14 million, or $248/s.f., and plan to invest $10 million, or $177/s.f., to convert the property to prime, creative office space, which will also include a new rooftop deck.

The average overall capitalization rate decreased to 5.3% during the first quarter 2016, down 80 basis points from the end of 2015 when the rate was 6.1%. The overall average was 6.6% for 2015, compared to 7.0% in 2014.

## Summary

The Portland office market continues to be red hot, with demand outpacing supply and rental rates increasing to levels never seen before in this market. It is a landlords market, and it is becoming increasingly difficult for tenants to finalize lease transactions without resetting their expectations, especially for those requiring more than 20,000 s.f. New development and investment activity remain strong, with new buyers entering the market, and multiple projects in the pipeline. We expect the Portland market to continue to strengthen and gain momentum through 2016; however, cool down may be on the horizon as the competition from new sublease space and layoffs from major metro area employers could impact the market in the next year.

*Source: .CoStar*