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office market analysis

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Approximately eight months have gone by since Governor Kate Brown issued the state-wide "stay at home" order, and the impacts of the pandemic and policy responses are continuing to have a detrimental effect on the office market in the Portland metro area and beyond. As the Fall and Winter seasons are approaching, and with no vaccine available for distribution, there has been a continuous decline in leasing and investment in the Portland Metro area. The most notable trend we're seeing is the shift of interest from the central business district to less dense, suburban markets to the west. [1]

DELIVERIES

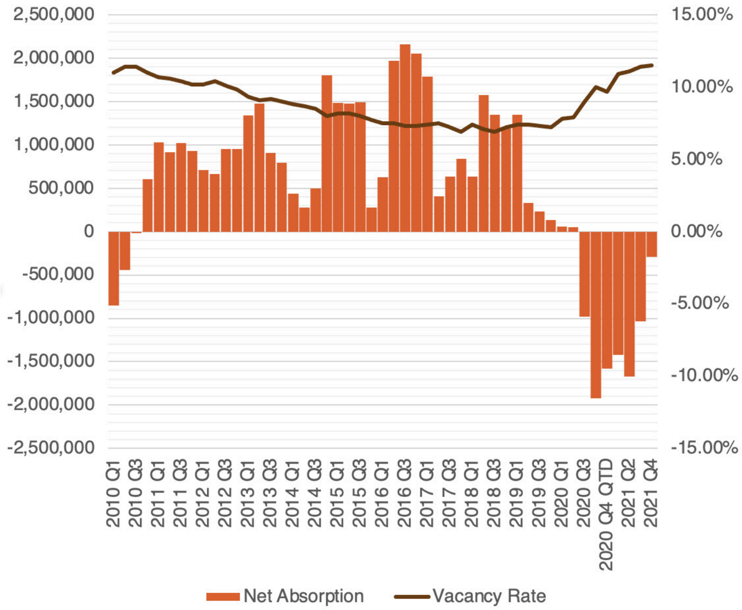
After a relatively stagnant second quarter of 2020, there was approximately 400,000 square-feet of new deliveries in the Portland Market during the third quarter. [2] This represents a nearly 500% increase compared to the second quarter. However, the vast majority of this new office product was already in the pipeline prior to any knowledge of COVID-19.

One of the more significant additions to the Portland office market is the 5 MLK building, a Class A mixed-use building with 220 multi-family units and 120,400 square feet of available office space.[3] Developed and managed by Gerding Edlen, this 17-story building offers office space in a highly desirable location with its ease of access to public transit and sustainable design.

Another significant addition to the central business district is the Canvas at Press Blocks.[1] Located west of the traditional CBD near Providence Park, Canvas at Press Blocks is the first delivery of a planned three-part development. Canvas is a multi-use building, including eight floors of creative office space totaling 150,000 square feet.[4] Together, 5 MLK and Canvas at Press Blocks account for approximately two-thirds of the office product deliveries in the third quarter of 2020.

Regarding future deliveries in the pipeline, both Nike and Adidas have built-to-suit additions to their respective headquarters expected to be delivered in over next six months. These developments account for 1,183,585 square feet of additional office product.[5] The other major construction in the pipeline is the Block 216 building in the central business district. Block 216 is a 35-story multi-use building that will include 169,188 square feet of Class A office space. [5]

TABLE ONE
NET ABSORPTION AND VACANCY RATE



ABSORPTION

As we have seen throughout the first half of 2020, more and more companies are moving out of office spaces around Portland, leading to an overall negative net absorption. However, with the inability of companies to fully utilize office space due to the effects of COVID-19, we saw a record setting -834,905 square feet of negative absorption in the third quarter of 2020.[2] This is by far the worst net absorption observed in the Portland area over the past decade. It should be noted that the vast majority of this negative absorption is attributed to "tenant move-outs of less than 20,000 square feet each",[2] mostly located in and around the central business district. Social distancing guidelines that encourage employees to work from home have made many of these office spaces impractical. Additionally, the relatively high rents are a huge financial burden on all tenants with reduced revenues but are especially harmful to smaller businesses without strong capital reserves. Furthermore, the Urban Core "afflicted by the ongoing pandemic and civil unrest accounted for more than half of the [third quarter] negative absorption." The extent of this trend of negative absorption is not fully known, but it's expected to continue through the end of 2020 and beyond until both economic and social order is restored.

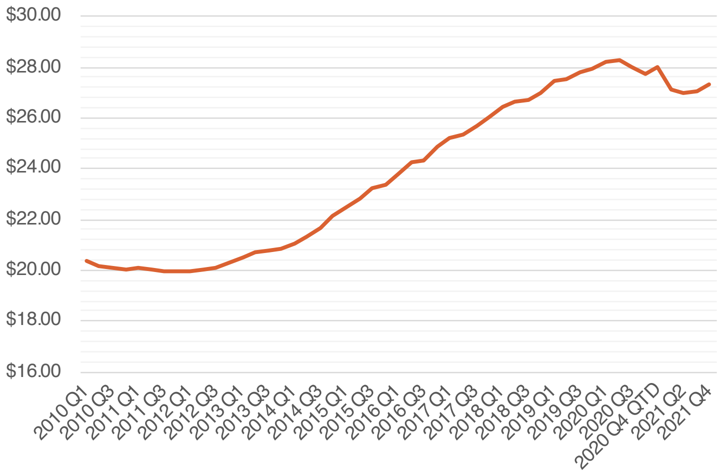
Despite the overwhelming negative absorption in the Central Business District and Downtown, there are a couple submarkets with significant positive absorption. The 217 Corridor (Beaverton) and the East Columbia Corridor had total net absorptions of 28,320 square feet and 46,341 square feet, respectively.[5] Again, this statistic illustrates the prevailing trend of office tenants preferring spaces in less dense, suburban environments. Suburban office products allow tenants significant financial and social benefits due to relatively lower rents, and distance from the vandalism and disorder taking place downtown as part of ongoing social conflicts.

VACANCY

The primary factors impacting office vacancy rates in the Portland Office Market are the high number of deliveries and decreasing leasing activity. Portland has become a highly competitive job market, especially for technology-based endeavors. Investors and developers have been working over the past five years to build enough office spaces to accommodate these needs; however, we're now seeing an inflection where the boom in office market deliveries is surpassing the demand. This delivery boom, coupled with the decrease in demand due to tenant caution stemming from the COVID-19 pandemic have led to the highest vacancy rates in the past eight years. Another contributing factor to the decrease in office space demand is the increase in telecommuting, particularly in technology sectors. Some employers are finding that allowing their employees to work from home is more efficient than leasing office space. At the end of Q3 2020, the vacancy rate for the Portland office market was estimated to be 9.0%, a significant 1.1% increase from Q2 2020.[2] Although this trend is a negative indicator of the Portland office market, the vacancy rate is 1.7% lower than the national vacancy rate.[2]

This trend of rising vacancy rates is not only affecting Portland, but is being observed in markets nationwide. Due to nationwide stay-at-home orders, many businesses are operating close to full capacity without utilizing their dedicated office spaces. It only makes sense that a number of these companies will determine that leasing dedicated office space isn't necessary for them to operate and will opt for having a fully remote workforce in the future. Microsoft, for example, is currently rolling out an initiative to allow employees to work from home up to 50% of the time. The software developer has unveiled a hybrid workplace guidance that will allow for far greater flexibility once offices around the country finally reopen.[6] In some cases, abandoning traditional office spaces may not be an option, but a necessity for some struggling companies to stay in business. Due to the continued delivery of new office product and the unknown duration of COVID-19, vacancy rates are expected to continue to rise throughout the next year.

TABLE TWO
MARKET RENT PER SF



LEASING

Due to the 'stay-at-home' guidelines resulting from COVID-19, tenants have been maintaining a heightened sense of caution when committing to new leases. Future revenues are too unpredictable, as is the ability to utilize traditional office space. For the most part, this means that relatively few leases have been executed in Q3 2020. Of the 379,955 square feet of leased space in Q3 2020, 299,251 square feet (or 78%) of the total space was located in suburban areas."[5] As for the leases that have been signed, parties involved have had to get creative with lease conditions, where short-term and flexible leases are being highly favored. In addition, many leases are now including a number of concessions (i.e. tenant improvement allowances, free rent, etc.) that wouldn't have been necessary a year ago. One example of a newly executed lease was by Brainium Studios, LLC, a game developer who has committed to leasing 22,600 square feet of office space at Tanner Point in the Pearl District.[7] This is a great example of the growing technology industry in the Portland area.

While overall leasing has all but paused, the prevalence of subleases has almost doubled over the past year. "Sublease space is a key office market indicator, and Portland's overall office market has experienced a 92% YOY increase in the availability of sublease space, closing the third quarter with 589,000 square feet of sublease space being advertised. The majority of the new sublease opportunities are in Downtown Portland."[7] This sharp increase in subleases opportunities represents a clear drop in market demand, and is driving a steady decrease in market rents.

Over the past decade, following the economic recession in 2009, market rents for office properties throughout the country have been steadily increasing at a rate of $0.94 per square foot per year. Portland's market has followed the same general trend but has consistently been approximately 20% below the national rate. In Q3 2020, the average rent per square foot of office space in Portland was $27.89, and the average rent per square foot in the United States was $34.35. These relatively low market rates have attracted a lot of companies to move to Portland, particularly technology and distribution-based companies like Intel and Amazon, to expand from other hubs such as the Bay Area and Seattle.

TABLE THREE
SALES VOLUME AND MARKET SALES PRICE PER SF

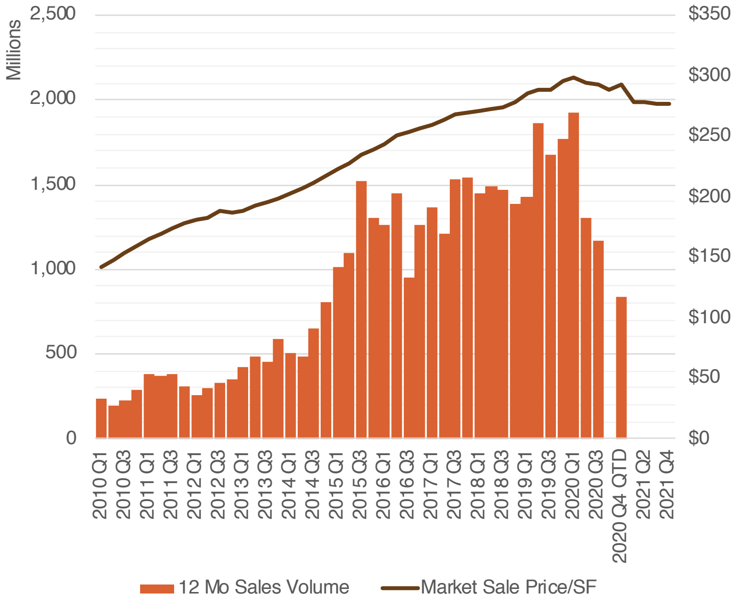


IMAGE ONE
NIMBUS CORPORATE CENTER

SALES

The Portland office market has been a lucrative investment opportunity over the past 10 years due to high demand, a thriving economy, and an increase of investment from distribution and technology companies looking to avoid the high property values in Seattle and the Bay Area. However, due to the COVID-19 pandemic and related uncertainty, sales volume has been relatively stagnant. In Q3 2020, the Portland Office Market only saw $150M of total sales, compared to $450M in Q1 2020. Market prices have also dropped from $304 per square foot to $297 per square foot.[2] This is the first time market prices have dropped in the last 10+ years. Once COVID-19 either subsides or can be effectively managed and there is a greater level of certainty regarding sustained impacts, the market is expected to pick back up, but the timeline for that to happen is unknown. In the midst of this relative stagnation, Q3 2020 did see the single largest purchase of the year; “the Nimbus Corporate Center [was bought] for $130M by DRA Advisors and Prescott Partners.”[1] The Nimbus Corporate Center is a 16-building office campus in Beaverton, Oregon, one of the fastest growing suburban communities near Portland. The campus has a total of 691,036 square feet of usable office space, and is currently leased to tenants involved in technology, financial services, insurance, and manufacturing. “The market is demonstrating increased demand for suburban, flex office product as more millennials look to move to the suburbs along with tenants continuing to refine their real estate strategy during COVID-19.”[8]

CONCLUSION

The COVID-19 pandemic and ongoing civil unrest have been the main factors affecting the office real estate market in Portland, Oregon. All the parameters we've analyzed are indicating an overwhelming shift in the demand for office space from the central business district to suburban areas. Office Market absorption reached an all-time low in Q3 2020, along with a steady decrease in leasing activity and overall investment. Due to the high supply and relatively low demand for office space, property owners are being forced to offer additional concessions and negotiate flexible, short-term leases for tenants that are operating with an increased level of caution.

While the Q3 2020 data has given us a better understanding of immediate effects of COVID-19, tenants and investors alike are reluctant to make any significant investments until we have a more complete vision of the future of office space.
The last major recession in 2009 was a housing related recession that led to more people moving into cities and living in more densely populated, multi-family developments. In our current economic downturn, we're seeing the opposite effect; people and businesses alike are being incentivized to transition to more suburban settings, where property prices and population densities are lower. Regardless of what happens, it's safe to say that the real estate market is adapting to these new conditions, and will continue to do so for the foreseeable future.

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