OFFICE MARKET ANALYSIS

GEORGE S. MCCLEARY
Owner, MRE Properties
RMLS Fellow, Master of Real Estate Development Candidate

The third quarter brought a continuation of positive trends in Portland’s 2012 office market. The CBD and suburban markets all saw positive net absorption and slowly falling vacancy rates, signaling a slow but steady recovery from the recession. Demand driven by tech industries has been accompanied by other office-using industries, adding to the total office space occupied in the quarter. Speculative building remains low, as an ample supply of existing space is yet to be absorbed. Despite the slow recovery, vacancy rates remain high in many districts, keeping some developers on the sidelines.

Parts of the U.S. economy have improved in the third quarter. Consumer confidence rose to its highest level in seven months in September. Despite these advances, much uncertainty remains for the American economy. The unemployment rate has stagnated between 8.1 percent and 8.3 percent in 2012, and has remained virtually unchanged in the third quarter. Growing concerns over the European debt crisis, unemployment and the impending election have all contributed to the slowdown of America’s economic recovery.

Locally, a number of key leases and sales have helped to bolster the Portland economy. In August, software company Salesforce.com announced that it has chosen the Portland area for a new office. Local unemployment statistics remain relatively flat, with unemployment holding steady at 8.1 percent for the quarter.

George S. McCleary is the owner of MRE properties specializing in commercial real estate investment and development of urban infill properties. He is enrolled in the Master of Real Estate Development program at Portland State University and is an RMLS Fellow in the program. Any errors or omissions are the author’s responsibility. Any opinions expressed are those of the author solely and do not represent the opinions of any other person or entity.
Nevertheless, a Brookings Institution report ranked Portland ninth in comparison with other American cities in overall economic strength. Overall, the economic news and statistics for the third quarter in the Portland office market support the conclusion that things are improving.

**Figure 1: Overall net absorption, Portland office market**

![Net Absorption Chart](image)

*Year-to-date
Source: Jones Lang LaSalle

In the office market, Jones Lang LaSalle reports a 6 basis point decrease in market-wide vacancy to 13.5 percent, down from 14.1 percent in the second quarter. YTD net absorption has pushed past the one million square foot mark for the first time since 2005. Most of this activity has been in the west suburbs, with the CBD responsible for less than 10 percent of this activity. Even so, the central city has benefitted from lower vacancy rates than most of the suburban markets.
Class A net absorption is 306,215 square feet according to Jones Lang LaSalle. This represents over half of the overall net absorption for the year to date. This number is expected to rise through the end of the year.

Overall vacancy rates in the CBD have been on the rise 2012 and have been increasing for the past 12 months. Adding to the Class A inventory will be the newly renovated Edith Green building, which will bring 323,000 square feet of LEED Platinum Class A office space to the Portland market. Net absorption in the CBD is strong, and demand for these types of spaces is expected to be robust.
CBD vacancy rates have been steadily rising while submarket vacancy rates have been falling. Vacancy rates for class A space in the CBD have risen throughout 2012 as companies have relocated or vacated their spaces in favor of the suburbs or Pearl locations. Suburban office space rates have been more affordable since the recession, with vacancy rates holding at above 20 percent. Vacancy rates are expected to remain steady or rise in the CBD with the impending completion of the Edith Green building.

Source: Jones, Lang & LaSalle, NAI Norris, Beggs & Simpson, CBRE
Construction employment is currently at a seasonally adjusted 68,800, with the Portland metro area accounting for 52,100 of these positions. Since the end of the second quarter, Portland has seen a slight rise in construction employment while the state has seen a slight dip. Current construction on the new transit bridge south of the Markham bridge is expected to continue into 2014 with substantial completion scheduled for that year. Multifamily projects conceived during the earlier months of 2012 are expected to break ground soon, adding to the number of construction jobs in the area.
Oregon’s unemployment rate has dropped to 7.6 percent. While the seasonally adjusted number is higher (8.1 percent), both numbers have been dropped slightly during Q3. While these numbers are still historically high, this is the lowest unemployment in Oregon since the figure peaked in 2009 at an average of 11.1 percent. National unemployment remains at a seasonally adjusted 7.8 percent, with recent reports finding positive news for the nation’s employment outlook. CBS news reports that unemployment rates have fallen in 95 percent of all US cities in September.
Construction and mining, professional services, hospitality and technology are expected to drive employment numbers to more favorable levels in the fourth quarter. Three “new enterprise” zones were recently approved by the state which will allow businesses to earn tax breaks for investment in their respective neighborhoods. Any business that builds new operations or expands in an enterprise zone can avoid paying property taxes for three to five years in return for creating jobs. Salesforce.com’s decision to locate an office in Portland was reportedly due to a high concentration of younger, educated workers.
Nearly every submarket in the metro area saw a small increase in lease rates in the third quarter. Vacancy rates inch downwards.

Suburban submarkets have bottomed out, with growth in net absorption and small drops in vacancy, especially in class A space. Despite a ten basis point improvement in vacancy rates in suburban submarkets, the vacancy rates remain in the high teens or above 20 percent in Hillsboro, Kruse Way, Tualatin, Vancouver and Washington Square. The close-in east side, Lloyd and CBD submarkets continue to enjoy vacancy rates that are below those of the other dominant submarkets.

The sunset corridor enjoyed a two percent drop in vacancy rate in Q3, owing primarily to Grass Valley’s lease of 52,000 square feet at Tanasbourne Commerce Center.

Source: Jones Lang LaSalle
The lack of supply in the CBD of class A space is a problem that is likely to persist in the months to come, and continue until new class A space is constructed. Currently there is 315,000 square feet of new office space in the pipeline, per NAI Norris, Beggs & Simpson. With no new class A space available to the market in the near future, the trend of improving vacancy rates in the suburbs is likely to continue for the rest of the year.

**Figure 7: Submarket vacancy rates**
Suburban rents continue to drag along the bottom, but most submarkets posted small gains since Q2. Landlords are hopeful that this is the signal that the bottom has hit. Concessions are likely to continue in the suburbs until vacancy rates drop. Hillsboro reported the largest increase in average asking rents in Q3 at $19.23 per square foot, up $.25 from Q2.
Source: CB Richard Ellis

Source: Jones Lang LaSalle
Figure 9: Office construction completed, Portland

Source: Jones Lang LaSalle

Jones Lang LaSalle reports a total of 292,260 square feet of new supply constructed so far in 2012. This is historically not a high number, but it is a significant improvement from 2011. If current trends continue, we should see this number climb in future quarters. With the current supply on hand it is unlikely that speculative building will reach the levels of the early 2000’s anytime soon, but as supply is absorbed it is likely that developers will reenter the market.
Table 1: Major lease transactions, first quarter 2012

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<th>Submarket</th>
<th>Square Feet</th>
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<td>GE Healthcare</td>
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<td>Daimler Truck America</td>
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One of the most significant transactions in the third quarter was the sale of the CH2M building in the CBD to Portland investment firm Skanlan Kemper Bard. The firm plans to renovate the building, purchased on September 13th for $38,700,000. In Beaverton, the OHSU Knight Cancer Institute sold for $23,700,000.

The third quarter has showed continued improvement in the Portland office market by most measures. Rental rates have collectively climbed $.09 to $19.31 per square foot, continuing the upward rise in 2012. The Portland area has added an average of 2400 per month since the beginning of 2012. This trend is expected to continue as 2013 approaches. While there is still much ground to be made up that was lost during the recession, there is ample evidence of modest upward pressure on absorption and lease rates that is expected to continue.