OFFICE MARKET ANALYSIS

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The fourth quarter of 2012 was relatively stable for Portland's office market and the economy at large, despite a stir of national activity. The presidential race, Hurricane Sandy and the fiscal cliff all jolted the economy as investors feared the potential worst-case scenario. A double-dip recession was not to be, and markets remained relatively stable. However, most Americans will see smaller paychecks in 2013 as a result of the fiscal cliff compromises, and Hurricane Sandy is estimated to have caused nearly $60 billion in damages. With office construction and absorption driven by economic activity, these are important factors to consider as Portland's office market emerges from the recession.

The Portland office market improved modestly in 2012, with general economic conditions continuing a slow upward grind. Fundamentals have improved, and unemployment has dropped almost a full percent, to 7.8 percent. Vacancy is down and 100,000 square feet of space was delivered to the market, although speculative construction is still nearly nonexistent. New space is unlikely to be developed before demand increases, forcing lease rates higher.

Nike and Intel have announced major expansions in the area, which will provide additional jobs to the area. Intel's D1X fabrication facility is expected to cost $6 billion, and Nike has indicated that they will invest $150 million in a capital project that is expected to add 500 jobs.

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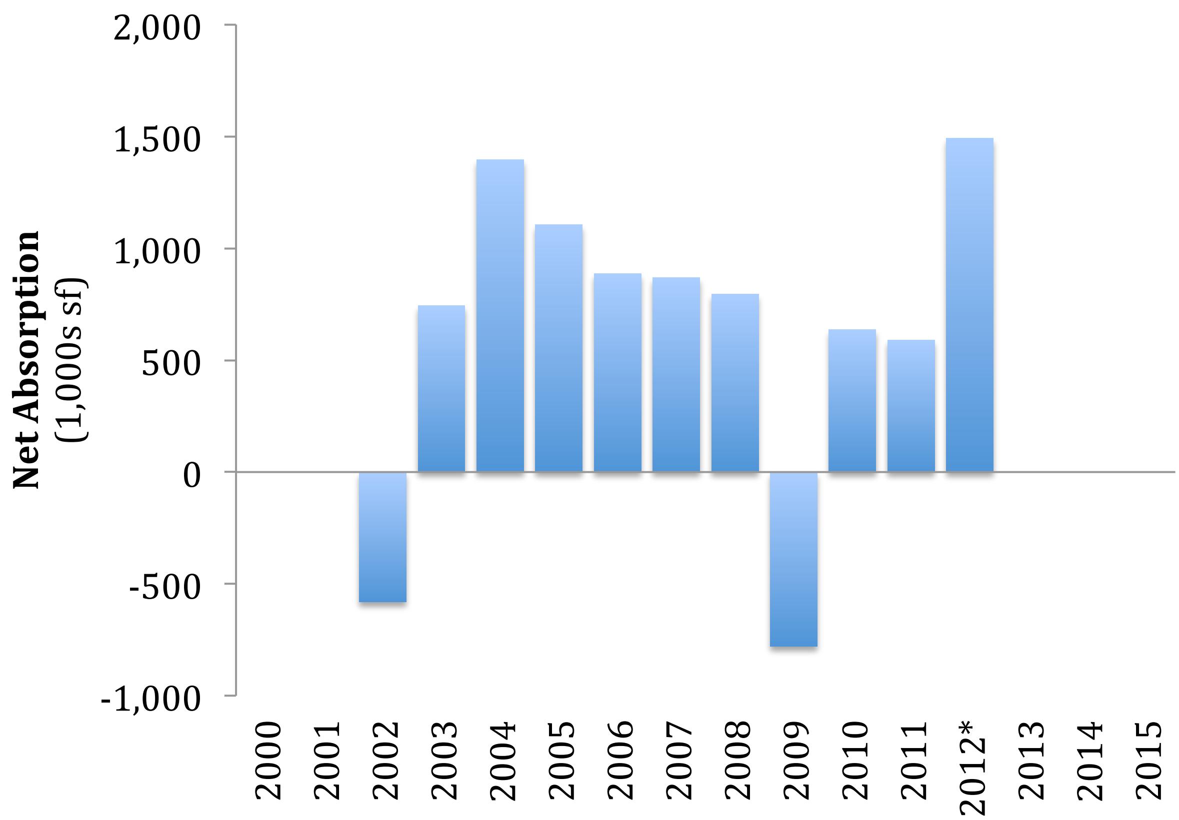
The office market and overall Portland economy is expected to improve throughout 2013. With the election and fiscal cliff resolved, businesses will have more certainty as they make their plans for the coming years.

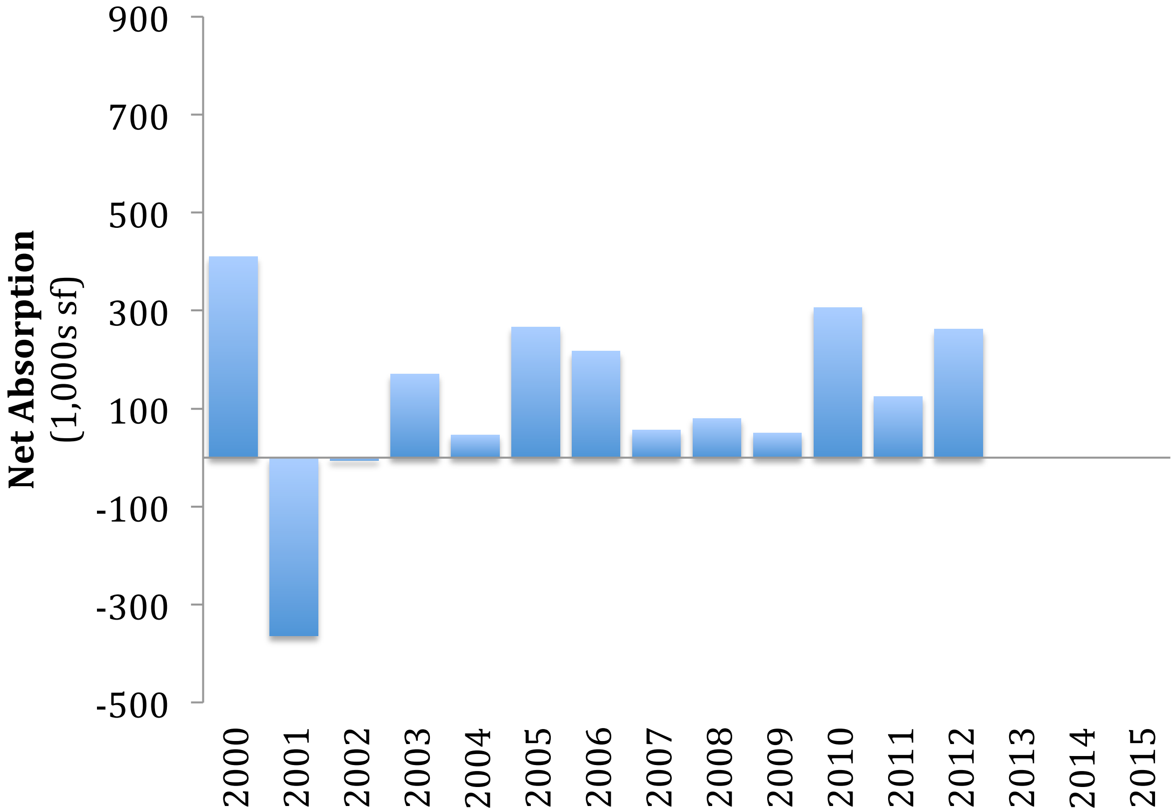
Figure 1: Overall net absorption, Portland office market



*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 12.7 percent, down from 13.5 percent in the third quarter. Year to date net absorption reached 1,492,011 square feet, which surpasses the highest net absorption rate since 2004. The suburbs have been responsible for the bulk of this activity, with vacancy rates that began the year much higher than those in the CBD. As vacancy rates stabilize, it is expected that rates will increase in suburban markets and spur new construction in years to come.

Figure 2: Class A overall net absorption, Portland office market

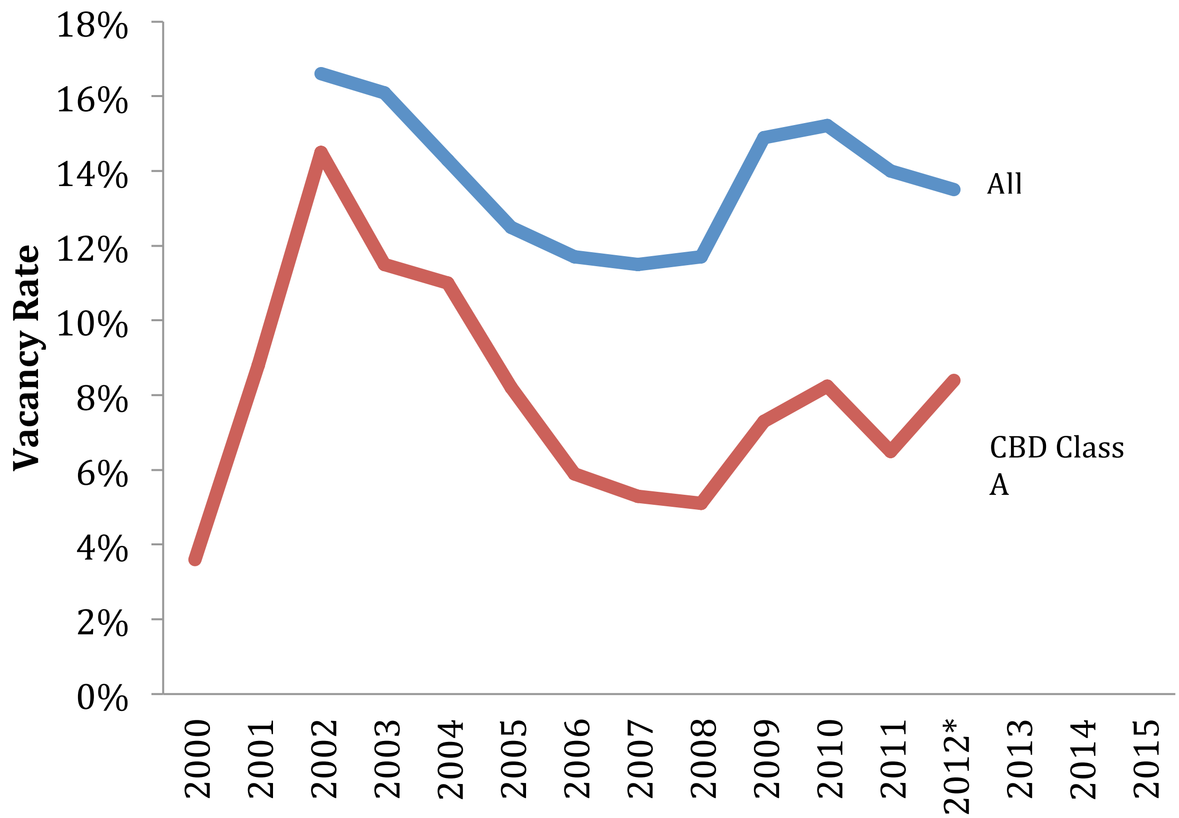


Sources: Jones, Lang LaSalle, NAI Norris, Beggs & Simpson

Class A citywide direct net absorption is 262,843 square feet according to Jones Lang LaSalle. This represents a significant change from previous years. Over half of the overall net absorption was realized in the west suburbs, which had previously experienced very high vacancy rates and negative net absorption.

Overall vacancy rates in the CBD have been on the rise 2012 and increased throughout 2012, owing partly to attractive lease rates in the suburbs. Adding to the Class A inventory will be the newly renovated Edith Green building, which will bring 323,000 of LEED Platinum Class A office space to the Portland market. 2012 ended with class A vacancy in the CBD at 7.7 percent, according to Jones, Lang & LaSalle.

Figure 3: Vacancy rates, Portland office market

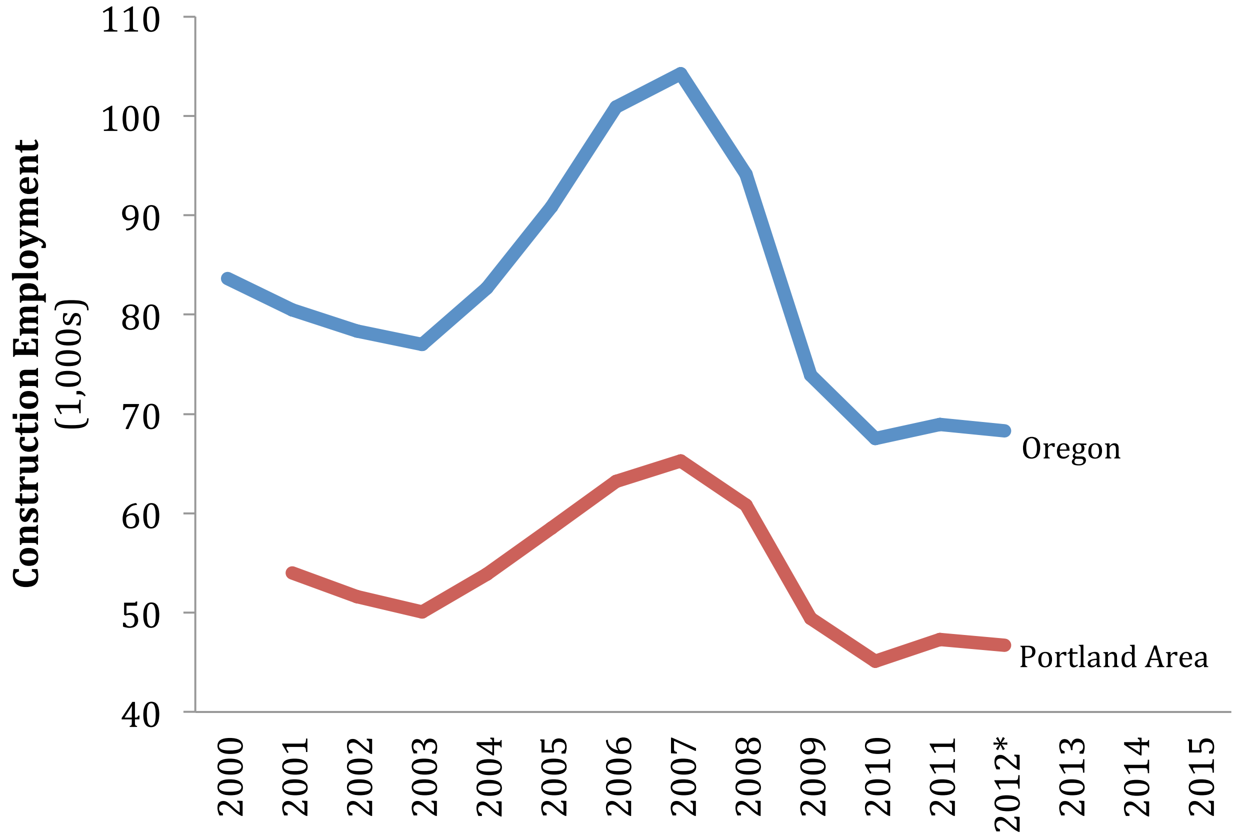


Source: Jones, Lang & LaSalle, NAI Norris, Beggs & Simpson, CBRE

CBD vacancy rates had been slowly rising while submarket vacancy rates have been falling. Vacancy rates for class A space in the CBD had risen throughout 2012, with companies relocating or vacating their spaces in favor of the suburbs or Pearl District locations. The fourth quarter may have signaled the end of this trend, with vacancy dropping to 7.7 percent, down from 8.4 percent in Q3.

Suburban office spaces continue to hold the highest vacancies and most attractive rates. Vacancy rates are expected to remain steady or rise in the CBD with the impending completion of the Edith Green building.

Figure 4: Construction employment, Portland area and Oregon statewide

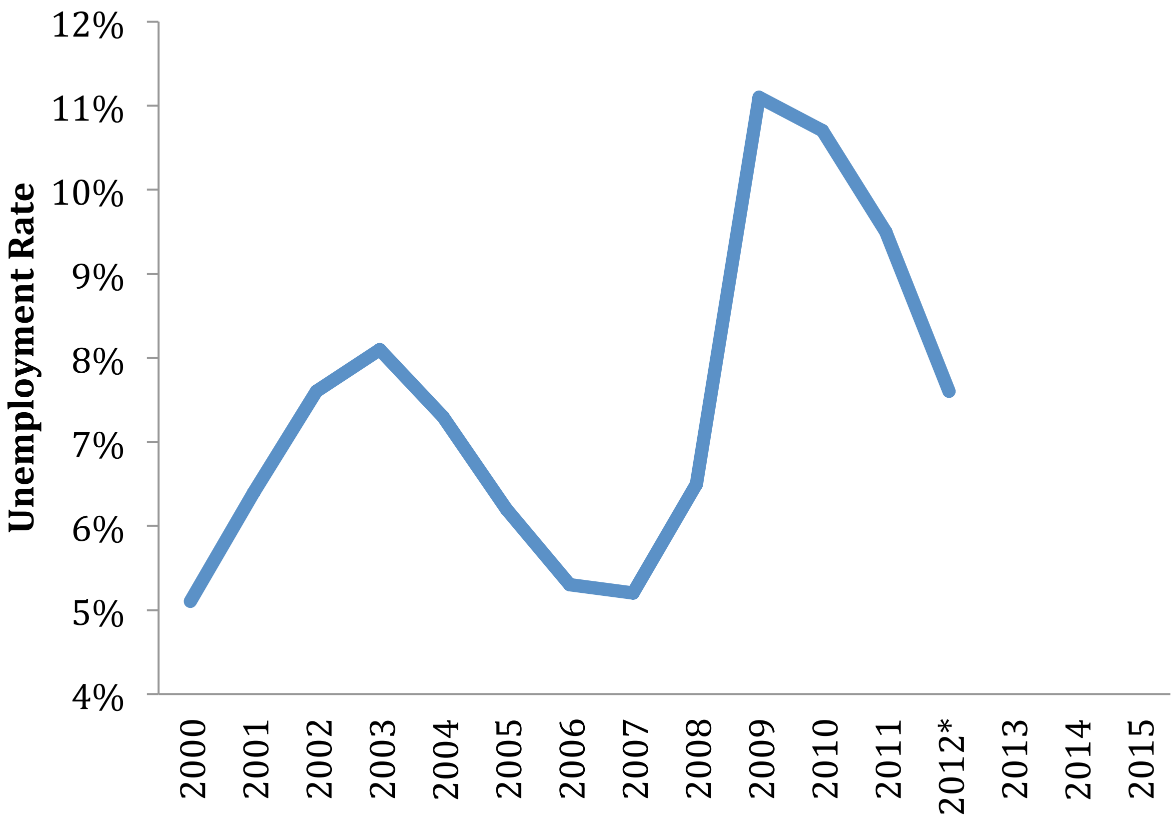


Source: Oregon Employment Department

Construction employment is currently at a seasonally adjusted 68,300, with the Portland metro area accounting for 46,700 of these positions. Construction employment was overall mostly flat during 2012, with a slight dip downwards toward the end of the year. This owes partly to the uncertainty of the fiscal cliff and presidential election.

Construction on the new transit bridge south of the Marquam Bridge is expected to continue into 2014 with substantial completion scheduled for that year. Several large multifamily projects conceived during 2012 are expected to break ground in 2013, which should help bolster construction numbers in the area.

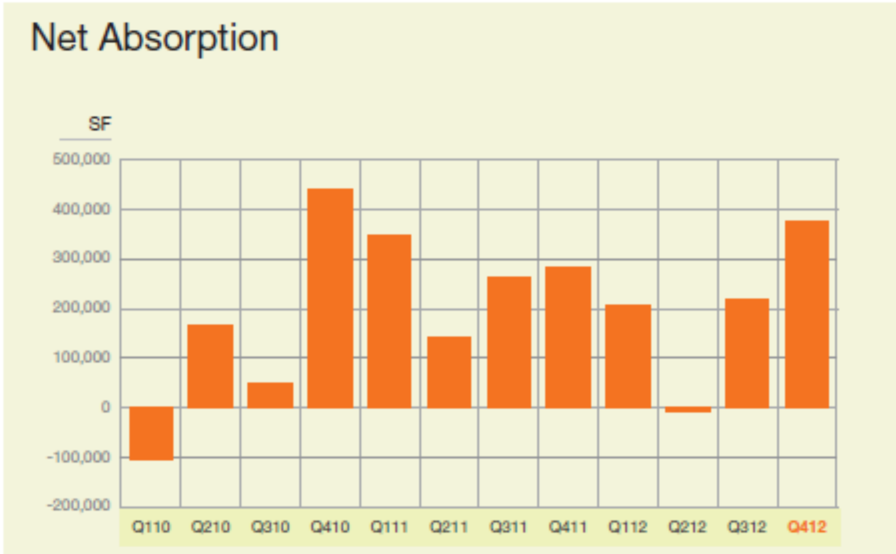
Figure 5: Unemployment rate, Oregon



Source: Oregon Employment Department

Oregon's unemployment rate dropped to 8.4 percent by the conclusion of 2012. Oregon continues to lag behind the rest of the nation employment-wise, but there are reasons to believe that these numbers will improve. This is the lowest year-end unemployment in Oregon since the figure peaked in 2009 at an average 11.1 percent. National unemployment remains at a seasonally adjusted 8.1 percent, rising up from 7.2 percent in the third quarter.

Employment numbers are expected to improve following the fiscal cliff compromise and presidential election, in addition to more robust market fundamentals.

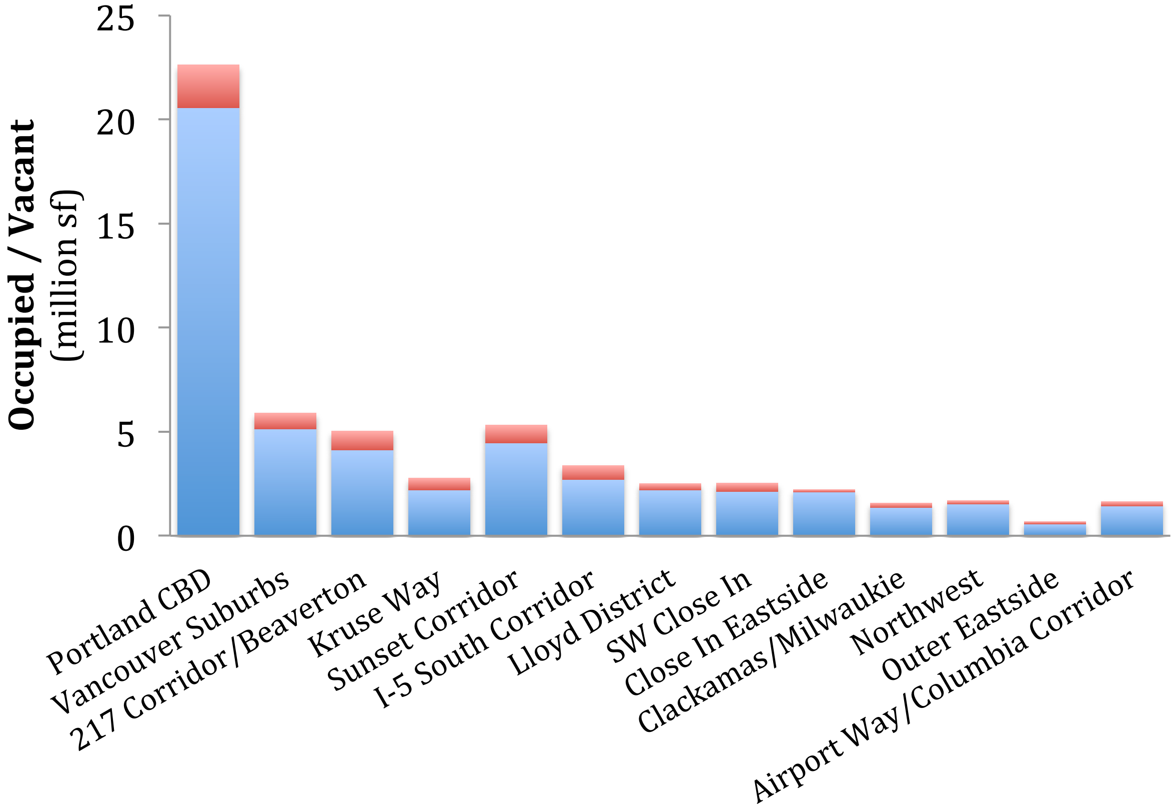


Source: Kidder Mathews

Key market indicators		12-month forecast	
Supply	Supply	→	57,894,035 sf
	Direct vacancy rate	↓	11.9%
	Total vacancy rate	↓	12.7%
	Under construction (% preleased)	→	292,690 (34%)
Demand	Leasing activity 12 mo. % change	↓	-37.0%
	YTD net absorption	↑	1,492,011 sf
Pricing	12-month overall rent % change	↗	+0.9%
	Class A overall asking rent	↗	$24.10 sf

Source: Jones, Lang & LaSalle

Figure 6: Submarket inventory, occupied and vacant

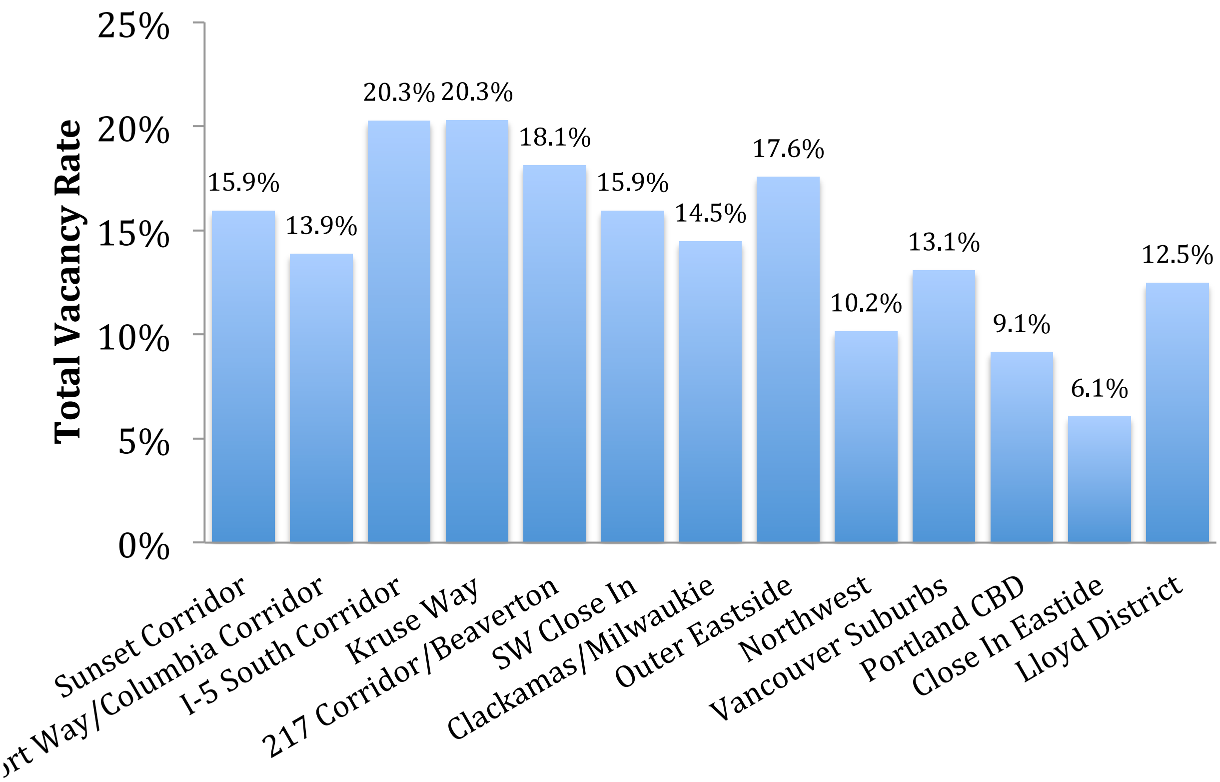


Source: Jones Lang LaSalle

Nearly every submarket in the metro area saw a small increase in lease rates in Q4. With vacancy rates dropping slowly and space slowly being absorbed, rents are expected to climb in submarkets such as the central east side, Northwest, Clackamas/Milwaukie, the Vancouver Suburbs and the CBD, all boasting vacancy rates below 15 percent.

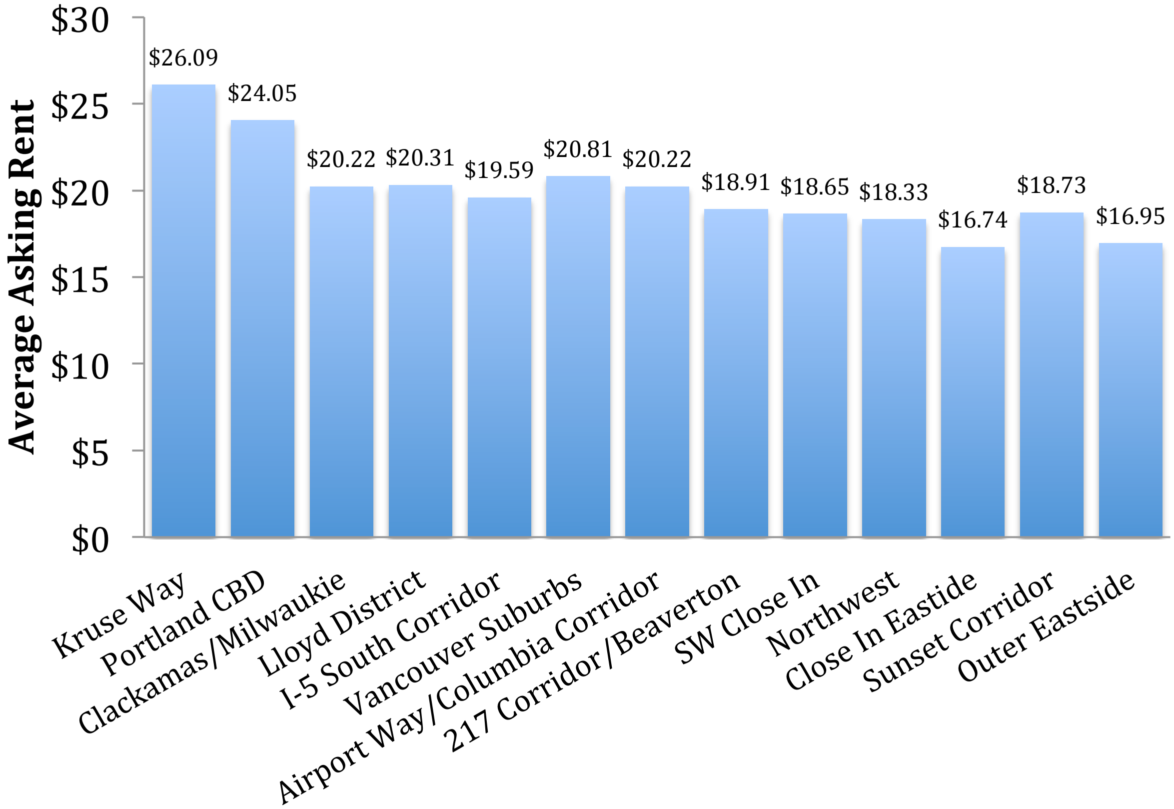
Suburban submarkets such as Kruse Way appear to have bottomed out, with the high vacancy rates being absorbed as rents have remained stable. Growth is expected in fundamentals of these class A spaces, although their vacancy rates remain stubbornly high. Vacancy rates remain in the high teens or above 20 percent in Hillsboro, Kruse Way, Tualatin, I5 South Corridor and the 217 Corridor. The close-in east side, Lloyd and CBD submarkets and continue to enjoy vacancy rates that are below those of the other dominant submarkets. These trends are expected to continue as rents rise and supply remains constant. Currently there is only 98,424 square feet of new office space in the pipeline for all suburban submarkets, according to NAI Norris, Beggs & Simpson.

Figure 7: Submarket vacancy rates



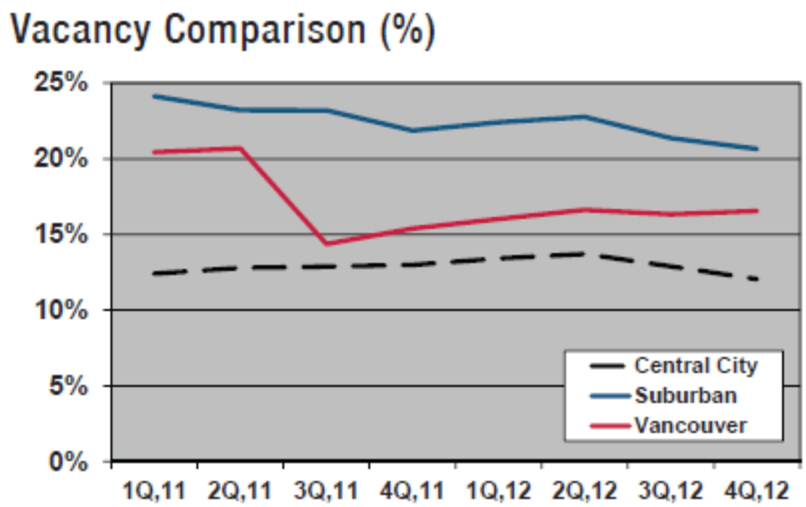
With a year of slow and steady improvement in the suburban submarkets, it is likely that these trends will continue through 2013. Low vacancy such as the 6.1 percent rate in the Central Eastside is unlikely to remedied with ground-up development, but rather the repurposing of existing spaces. This usually represents a lower cost of development, and creates edgy, green spaces such as the Leftbank project on N Broadway.

Figure 8: Submarket average asking rents

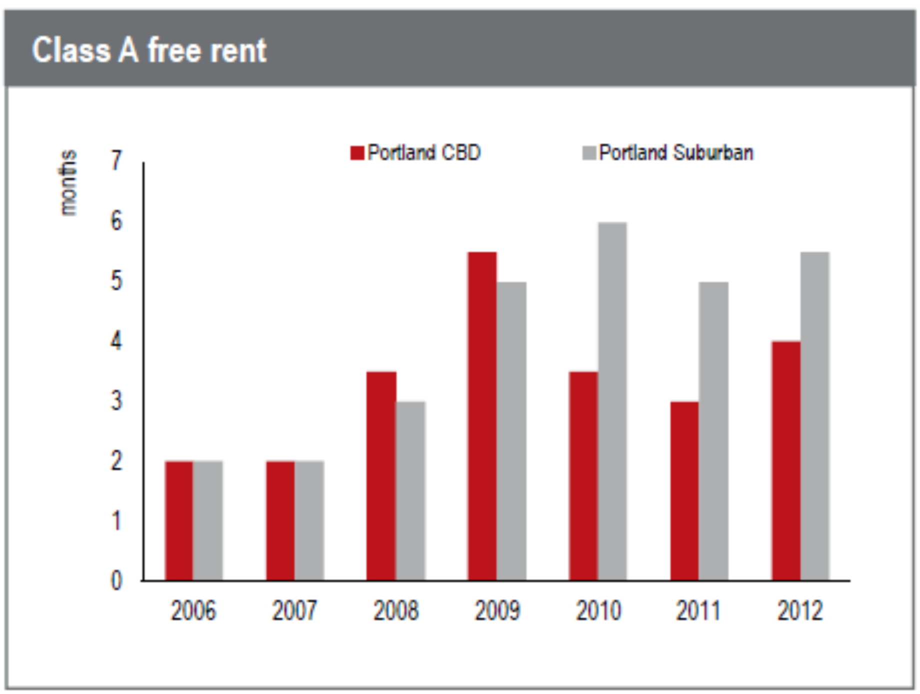


Kruse Way saw an uptick in the average lease rate despite having one of the highest vacancy rates in the metro area. This is likely caused by a higher demand for true class A space, of which the market appears to be running short. This is likely to last until the completion of the Edith Green building in the CBD, which will add approximately 315,000 square feet of new space.

Rents in suburban marts posted small gains in Q4, and these are likely to continue rising through 2013. Landlords are hopeful that this is the signal that the bottom has hit in 2012. Concessions are likely to continue in the suburbs until vacancy rates drop and the market regains balance.

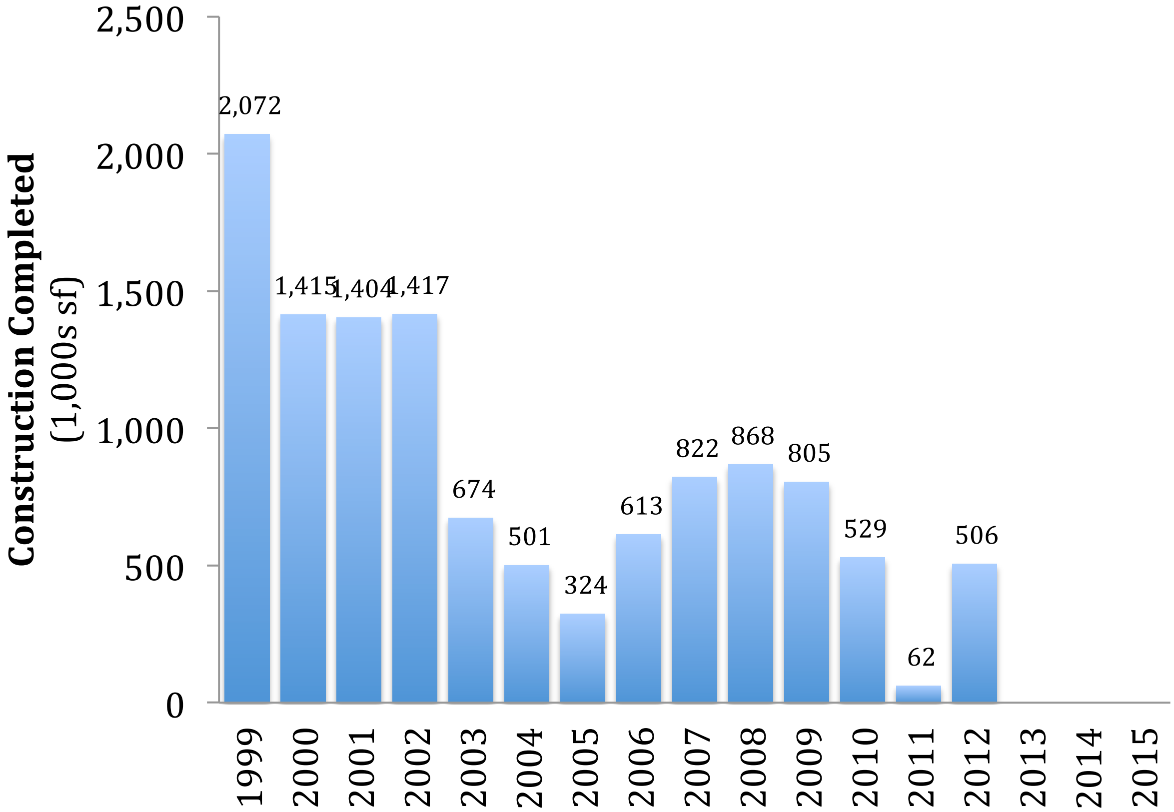


Source: NAI Norris, Beggs & Simpson



Source: Jones Lang LaSalle

Figure 9: Office construction completed, Portland



Source: Colliers International

Colliers International reports 506,025 square feet of space constructed in 2012. This represents a significant improvement from 2011, but is lower than the previous 5 years. This number should climb in future quarters, but most studies agree that speculative construction is still further down the road. 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.

It has been said that Portland developers tend to wait until vacancy is very low before beginning a new speculative building cycle. Other markets, such as those in Texas, have a much lower threshold to develop on speculation and therefore carry higher vacancy rates year over year.

With the success of redevelopments such as the Spaulding-Hamilton, Yeon and Loyalty buildings in the CBD, it is likely that the trend of refurbishing existing spaces will continue until a new construction cycle begins.

Table 1: Major lease transactions, fourth quarter 2012

Completed lease transactions				
Tenant	Building/Address	Submarket	SF	Type
M Financial	Brewery Block 4	CBD	70,000	Renewal
DW Fritz Automation	Wilsonville I-5 Corporate Center	I-5 South Corridor	70,000	New
Jive Software	Federal Reserve	CBD	51,000	Renewal
Daimler	Montgomery Park	Northwest	41,000	Expansion
New Relic	US Bancorp Tower	CBD	38,702	New/Expansion
Thetus	Historic US National Bank Block	CBD	32,000	New
University Medical Group	Con-way Crossings NW	Northwest	25,640	New
ESCO Corporation	Montgomery Park	Northwest	23,000	Expansion
Phoseon Technology	Evergreen Business Park	Sunset Corridor	20,000	Renewal
PriceWaterhouseCoopers	Fox Tower	CBD	19,290	New
Survey Monkey	US Bancorp Tower	CBD	18,973	New
R.V. Kuhns & Associates	Pacwest Center	CBD	18,000	New
M-Six	1st & Ash	CBD	16,000	New

Source: Jones Lang LaSalle

Table 2: Major sale transactions, fourth quarter 2012

SALES ACTIVITY					
PROJECT	CITY	SALE DATE	SALES PRICE	PRICE/SF	TRANSACTION TYPE
Fleischner-Mayer Bldg.	Portland	10/22/2012	$6,000,000	$158	Investment
AmberGlen Corporate Center	Beaverton	10/09/2012	$4,500,000	$60	Owner/User
Johnson Street Professional Bldg.	Portland	11/16/2012	$4,075,000	$272	Investment
HDJ Building, Bldg. B	Vancouver	12/07/2012	$3,600,000	$154	Owner/User

The fourth quarter saw a handful of sizable lease transactions, ranging from M Financial renewing their lease in the Brewery Blocks to Daimler expanding into Montgomery Park in Northwest. The suburbs saw less activity and leases of smaller magnitude. With the economic uncertainty of the election and fiscal cliff behind us, it is likely that 2013 will bring renewed energy to the leasing and transaction market as investors capitalize upon opportunities in a growing market.

It is believed that Portland reached a cyclical bottom in 2012, and that the office market will continue slow, steady upward progress through 2013. There are several large lease turnovers expected this year, which will bring short-term vacancy rates temporary higher. This is expected to pass, along with diminishing tenant concessions and allowances. With unemployment down in 2012 and the single family home market up year over year, a number of signs are pointing to a stronger Portland office market for the next several quarters. ■