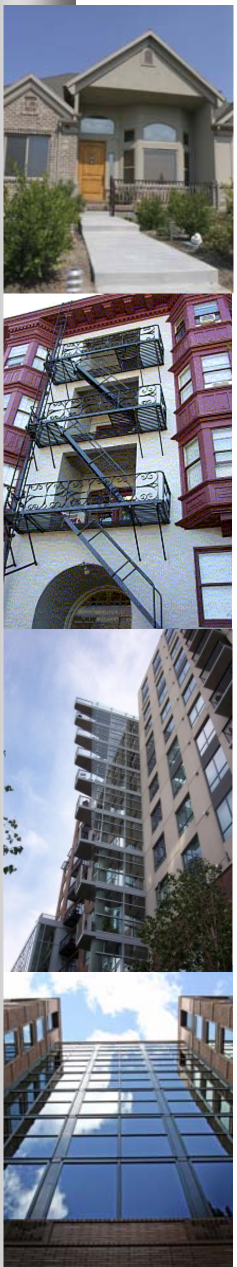

Portland State University Center for Real Estate Quarterly Real Estate Report

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Introduction

Gerard C.S. Mildner, Director, PSU Center for Real Estate

Welcome to the April 2007 edition of the PSU Center for Real Estate's Quarterly Real Estate Report.

The Quarterly Report has been developed with the assistance of several supporters of the Center for Real Estate, including the Oregon Association of Realtors, Norris & Stevens, Wells Fargo Bank, Cushman & Wakefield, and Johnson-Gardner Associates.

In this edition of the Quarterly Real Estate Report, we have three featured guest columns, as well as the Center's analysis of the local residential and commercial real estate market.

In our lead article, I discuss some of the factors that have led to rapid expansions in U.S. home prices in 2000 to 2005 , and why those factors have changed. While the overall economic conditions for the U.S. economy remain strong, for the first time in years, conditions in the housing market could significantly reduce economic growth.

In our first guest column, **Brian Bjornsen**, Managing Director of Norris & Stevens Realtors, forecasts that apartment rents in the Portland metropolitan market will rise in the upcoming year, following five years of relative flat rental growth. Bjornsen attributes these conditions to the slowdown in the owner-occupied housing market and the lasting effects of recent condominium conversions. However, he cautions investors in apartment properties to look for steady cash flows, as capitalization rates and property appreciation rates are unlikely to be as favorable in the future as they have been in the past.

In her review of the condominium market, **Nelda Scott Newton**, Vice President of Wells Fargo Bank, reports that the number of completed downtown condominiums will grow by 40% in the next six months as an additional 1,600 units are completed. Newton finds that the downtown condominium market has slowed down compared to previous years, when properties were sold out long before construction had completed. However, unlike the over-building experienced in markets in California, Nevada, and Florida, the Portland market remains healthy, in part due to the care that Portland developers have taken in limiting sales to speculative investors.

In our lead article, **Michael Williams**, Assistant Director of Research with Cushman & Wakefield, describes how vacancy rates for commercial office space in the Portland Central Business District have tightened, leading to the best conditions in years for new office construction. Williams forecasts that vacancy rates will continue to fall through the fourth quarter of 2008, leading to rising office rents. Given those conditions, Williams forecasts sufficient demand for two of the four proposed office towers in Portland's CBD.

We hope that you find the articles and information presented in this edition of the Quarterly Real Estate Report both interesting and useful. For future editions, the Center welcomes contributions from local real estate industry professionals giving their perspectives on local and national real estate conditions. And as always, we welcome your comments on how we can improve this publication. ■

The US Economy and Housing Market

Gerard C.S. Mildner, Director, PSU Center for Real Estate

The last two weeks of April has seen increasing concern about the health of the U.S. economy, and foremost among those concerns has been the health of the residential real estate market.

The concern begins with the slowdown in U.S. housing price appreciation. Until the summer of 2006, the U.S. had experienced 11 uninterrupted years of rapid and rising housing price appreciation, fueled by steady income growth, declining interest rates, looser lending policies, and expectations of future price appreciation.

Through 2004, the Federal Reserve lowered interest rates, initially to reflect declining inflationary expectations and more recently, to ward off the risk of recession after the World Trade Center attacks in September 2001. Interest rates on 30-year loans fell from 8.05% in 2000 to 5.87% in 2005. Given the extra buying power, American consumers bid up the price of homes from $139,000 in 2000 to $219,600 in 2005, for an annual average increase of 9.6%. Given the significant declines in the stock market from 2001 to 2003, many Americans became convinced that investing in real estate was a guaranteed path to wealth.

Feeding this appetite was a relaxation of borrowing constraints. Young renters were lured into the housing market by interest-only loans, zero down-payment programs, teaser-rate loans, and “low-documentation” loans (known as “Alt-A” loans in the U.S., and more graphically as “liar loans” in Britain). By 2006, approximately one-third of new loans originated with either sub-prime or low-documentation loans. Buyers were further attracted by the low rates on adjustable mortgages, with one-year ARMs reaching a low of 3.80% in 2003. Not surprisingly, the U.S. saw a spurt in the rate of homeownership from 67.1% of households in 2000 to 69.0% of households by 2005.

Impact of Interest Rates and Appreciation on User Cost of Housing

Year	Median Home Price	Interest Rate	Monthly Mortgage Payment	Annual Carrying Cost	Annual User Cost with 2% Growth	Annual User Cost with 3% Growth
2000	$139,000	8.05%	$1,019	$11,189	$8,409	
2005	$219,600	5.87%	$1,299	$12,890		$6,302
	+58.0%		+27.5%	+15.2%		

A relatively simple table can illustrate how the change in interest rates, lending programs, and the change in consumer expectations can lead consumers to increase their housing demand. In the table above, we've calculated the monthly mortgage payment and annual carrying cost (mortgage interest costs, plus the opportunity cost of the down payment) for a typical homeowner in 2000 and 2005.

Despite the 58% rise in the median home price, the rise in the required monthly mortgage payment is only 27.5%, reflecting the decline in interest rates. If you focus instead upon the interest cost (equivalent to the cost of a zero payment mortgage), the rise in costs is only 15.2%. Indeed, the tax deductibility of mortgage interest reduces the impact of the housing price increase even further.

The final two columns show the impact of a slight change in the buyer's expectation of home price appreciation from 2% to 3%. A small change in consumer expectations can have dramatic impacts on the perceived cost and benefits of buying a home. Of course, if consumer expectations change and housing prices are seen as likely to fall (or interest rates rise), consumers' user costs will rise dramatically. In any case, the 9.6% annual housing price growth could not continue indefinitely.

The burst of this housing bubble came in 2006, as the Federal Reserve's policies to tighten the money supply took hold. The average 30-year mortgage rate rose to 6.44% and the average ARM rate rose to 5.50%, creating considerable distress for buyers who planned a quick profit at low financing rates. Perhaps the publication in November 2006 of the book "Flipping Houses for Dummies" was the clearest signal that the housing boom was over.

As we discuss later in this Report, most U.S. metropolitan areas have experienced declines in average home prices in the last two quarters (although not yet in the Portland market). The latest report of the National Association of Realtors shows a decline in U.S. home prices from March, 2005 to March, 2006 of -0.3%. The price decline has led to a decline in home sales, as sellers are naturally reluctant to accept that their main financial asset is not worth the value that they had previously anticipated. Sales of existing homes have fallen by 11% in the past year, and new home sales have fallen by 13%.

Given that home sales are directly tied to sales of furniture, appliances, and other home improvement products, there has been considerable concern about the health of those sectors in the U.S. economy. And the importance of perceived wealth and home value in consumer confidence gives rise to greater concern about the U.S. economy. Indeed, some commentators have even worried that the decline in prices may create rigidities in the U.S. housing market, as workers may be reluctant to accept job offers that require moving to a new region of the country and accepting a less than robust home sale price. Finally, the decline in home values is likely to put a stop to household consumption that has been spurred by borrowing against home equity.

Despite these reasons for concern, broader indicators for the U.S. economy have remained positive. The economic expansion in the U.S. following the recession in 2001 remains unabated. The latest rate of growth for the Gross Domestic Product was 3.1%, with The Economist panel of economists forecasting growth of 2.3% and 2.7% for 2007 and 2008, respectively. Global economic growth remains an opportunity for the U.S. economy as economic growth in China remains high (11.7%) and the German economy (3.7%) is leading an economic boom in Europe.

There are some signs of inflationary pressures in the U.S. economy. Labor markets remain tight, with an unemployment rate in the United States at 4.4% and inflation for the year ending in March estimated at 2.8%, one of the highest among the industrialized countries. Accordingly, the dollar has fallen in the past year by 8.8% against the Euro, 10.7% against the pound, and 3.8% against the Chinese Yuan. Some commentators see this as a correction for America's continued high current account deficit, while others see the decline in the dollar as an opportunity for U.S. exporters.

In conclusion, the U.S. economy continues to grow, but at a slower rate than previous years. For the first time in years, the health of the U.S. housing market has become a significant factor in the overall health of the economy. If the decline in home prices in the past six months persists, and using the example above, consumers start to factor in the risk of a housing price decline in their buying decisions, the impact on U.S. economic growth could be considerable ■

Apartment Capitalization Rates, Cash Flow and Value: A New Dynamic?

By Brian Bjornson, Managing Director, Norris & Stevens Realtors

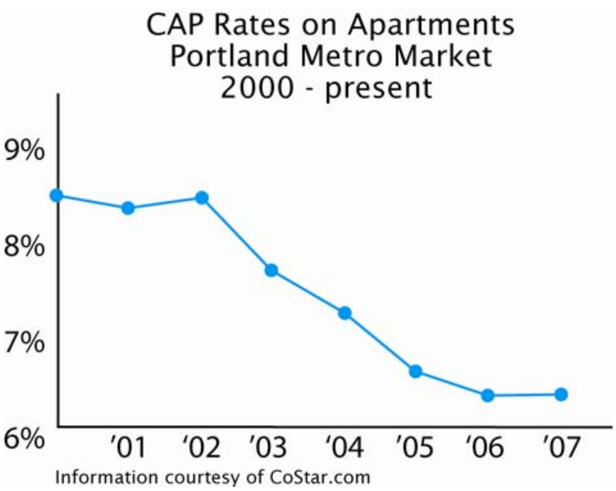
The view of the Portland metropolitan apartment market at the beginning of 2007 was so different from that of six years earlier it might almost have been an alien landscape. Capitalization rates have fallen nearly every year since 2002, reflecting the competition for apartment properties and their rapid appreciation under market pressure. During the same period, income from rent stagnated, or in some cases fell. Summer 2006 was the first time in five years the average rent exceeded that realized at the end of 2001. Market theory expects investors to begin to back off as cash flow drops, supply to begin to exceed demand, and a market correction to occur. So why hasn’t this already happened? Can we expect a correction soon, or are we looking at a new market dynamic?

A number of factors have contributed to the current situation. First, interest rates have been at historic lows for much of the past five years. Cap rates and interest rates tend to rise and fall together, as low interest rates boost demand and price. Another contributing factor was the new interest in condominium conversions as the housing boom accelerated. Condominium developers were willing to pay more for apartment properties appropriate for condo conversion in anticipation of a large return upon sale. This reduced the inventory available to conventional investors and raised expectations for sellers of all apartment property. Local investors began to balk at the higher prices and the low rate of return they could expect during their holding period, even though low interest rates have spurred refinances and made it possible for properties to cash flow in the low cap environment. But local buyers are no longer the majority of the Portland metro apartment market.

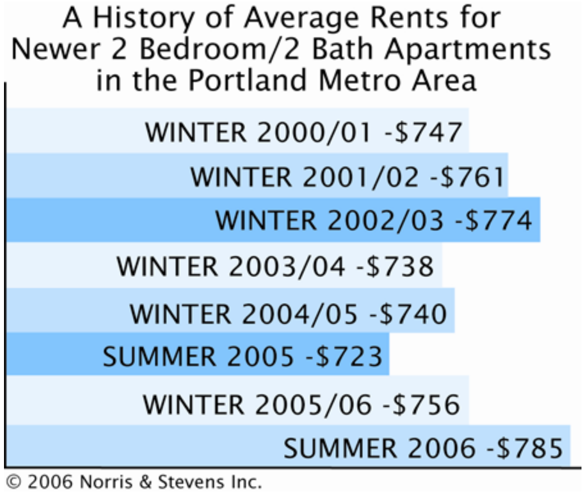
Out of state investors see Oregon as a very attractive market in which to reinvest, after a sale in another market and a §1031 tax-deferred exchange. Apartment property prices here are still lower than most of the large markets in California. Conveniently, under Oregon law, if a non-resident entity sells an Oregon property and exchanges into a property outside Oregon, it can defer the Oregon capital gain taxes until a taxable sale occurs [O.R.S. Chapter 316 and Chapter 317.] Furthermore, some large investors have been buying properties that are in negative cash flow upon closing with the hope of breaking even through increased rents. Some apartment properties have re-sold in one to four years and garnered a strong return from appreciation.

We have been experiencing a new dynamic — one in which the model is profit through appreciation with low cash flow through the holding period. Will it be a permanent change? Probably not. Already, the market is slowly returning to familiar terrain.

First, interest rates are rising and cap rates generally follow the direction of interest rates. Some lenders are adjusting to low cap rates by offering 2 or 3 year “interest only” loans, which allow investors to preserve liquidity during their holding period. But when buyers are unable to leverage as much of the debt, they are less willing to pay more for a property. Next, the single family housing and condo-conversion wave seems to be slowing, leaving in its wake a reduced stock of apartments for rent and a larger pool of renters in the market.



These changes have led to rising rents, which we are seeing in most Portland metro submarkets and throughout the state, which may mean improving cash flow. Finally, investors who anticipate taking their profit mostly or entirely from appreciation are gambling that nothing will change much. They are taking the risk that interest rates will not raise too high, that the economy will continue to grow, that international interests or events will not impact on the U.S. economy and that cap rates will not raise significantly thereby slowing value growth. One or more of these events could cause pricing to falter, and then the appreciation model fails. For the past five years, many have gambled successfully.



We anticipate that investors over the next five years will achieve their goals through a blend of cash flow and appreciation. The former we expect to see grow, while the latter will slow as the bidding wars taper off. Conservative investors will want the best assurance they can get in an uncertain world that cash flow will cover expenses in any real estate investment. The potential of further rent increases driven by a growing population gives Oregon's market a strong trend towards higher rents and higher values ■

Downtown Portland Condominium Market

By Nelda Scott Newton, Vice President, Wells Fargo

There are approximately 4,000 completed and occupied condominium units in the Portland central business district (CBD). These units have, by and large, been constructed over the last eight years or so, and have in most cases sold out by the time construction is completed. With around 3,000 additional units currently under construction or nearing completion, the downtown condominium market has clearly entered a new level of maturity and this is a healthy progression. To date the annual absorption has been constrained only by supply. Going forward absorption is expected to return to a more sustainable pace and projects are likely to sell-out in the “months” following completion, rather than before construction is finished.

Market participants, both developers and lenders, remain active but cautious. Condominium projects take two to three years to get through the design, review and development process. With such a long lead time developers typically have their projects queued up to enable them to break ground and move forward if the market shows continued strength. Local developers are continuing to work through this pre-construction process and, while cautious, are not abandoning plans for future projects.

The only announced cancellation in a condominium project to date is the 200-unit Ladd Tower. Developers of that project recently announced they would not move forward with condominiums and would, instead, consider developing the site with apartments. In comments to the press the developers stated their decision was not an indictment of the condominium market, but rather the belief that apartments might represent a more attractive opportunity at this time. This measured and deliberate thoughtfulness by the development community is a good sign the Portland condominium market will remain healthy and will not become over-built.

Lenders, too, remain willing to underwrite and finance new projects but on a more limited basis and typically with only their best, and existing, customers. Loan pricing reflects this caution and developers are encountering higher financing costs for condominium construction loans. It is also more important than ever for developers to have a strong track record of building and selling condominiums to be successful in procuring financing. In summary, lenders remain willing to finance condominiums but with close scrutiny and strong sponsorship. Like the caution being displayed by developers, the lending communities' discipline bodes well for the ongoing strength of the Portland condominium market.

In addition to developers and lenders, there is one other market participant whose behavior can have a significant, and negative, impact on condominium markets. This last participant is the speculative investor. Portland has so far avoided the significant downturn in condominium activity experienced in other parts of the country, including Florida, California and Las Vegas, to name some of the hardest hit communities. We benefit from, among other things, the focused approach local developers have taken in discouraging sales to investors. The Portland CBD condominium market has been primarily developed by a handful of developers all of whom actively discourage condominium speculators and require buyers to sign statements acknowledging they intend to occupy the premises as a primary or secondary residence. This is not to say that some buyers won't sign the statements with the intent of speculatively selling the units, a certainty that cannot be avoided. Yet, all local developers are actively discouraging this practice and closely watching buyer profiles to minimize this practice to the extent possible.

To get some perspective on the investment activity in recently completed projects, we can look at the number of re-sales on the market immediately following a project's completion. The data suggest that investor speculation in the Portland CBD may be in the 15% to 20% range. This compares favorably to other markets in the U.S. where some estimates peg investor speculation as high as 70%. Additionally, the recent heightened publicity about the number of new projects in the Portland CBD further serves to dampen speculative investment.

In summary, all market participants appear to be taking a measured and deliberate approach to development and lending decisions. That said, the next four to six months offers an important window on the underlying health of the Portland CBD condominium market. During this time period construction will be completed on nearly 1,600 condominium units of the total 3,000 under construction (roughly 75% of the 1,600 units are under signed contracts for sale). As this next wave of projects is completed it will be interesting, and telling, to see if the buyers close as expected, or rethink their purchase decisions. If buyers perform as expected, and if lenders and developers continue to behave in an informed and deliberate way, there is every reason to expect continued health in the Portland CBD condominium market ■

The Portland Plateau

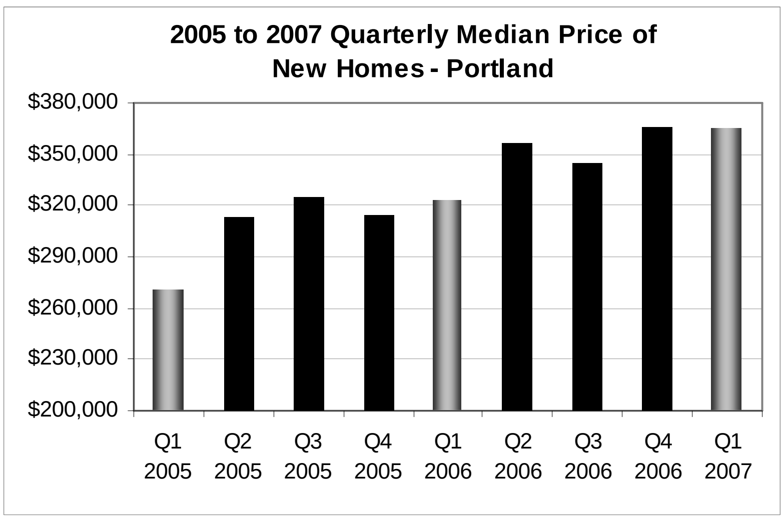
Despite national trends of declining home prices in the last six months, prices continue to appreciate in the Portland-Vancouver metropolitan statistical area (MSA), albeit modestly. The following chart shows how the Portland-Vancouver MSA ranks among other U.S. cities in median sales price of existing homes for 2006, as well as the appreciation rates in the last year and in the last quarter of the year. Both Portland and Seattle housing saw rapid appreciation in the first three quarters of 2006, followed by a flat fourth quarter. Yet both still fared well relative to other cities.[1]

Metropolitan Statistical Area (MSA)	2006 Median Price	2005-2006 % Change	Q3 to Q4 2006 % Change
San Francisco-Oakland-Fremont, CA	736.8	2.9%	-0.7%
San Diego-Carlsbad-San Marcos, CA	601.8	-0.4%	-3.7%
Boston-Cambridge-Quincy, MA-NH**	402.2	-2.7%	-5.9%
Sacramento--Arden-Arcade--Roseville, CA	374.8	-0.3%	-2.7%
Boulder, CO	366.4	5.2%	-1.0%
Seattle-Tacoma-Bellevue, WA	361.2	14.0%	0.1%
Portland-Vancouver-Beaverton, OR-WA	280.8	14.7%	0.1%
Chicago-Naperville-Joliet, IL	273.5	3.5%	-4.0%
Phoenix-Mesa-Scottsdale, AZ	268.2	8.4%	-1.6%
Denver-Aurora, CO	249.5	1.0%	-3.0%
Salt Lake City, UT	203.0	16.7%	3.4%
Spokane, WA	184.1	17.7%	-1.0%
Cincinnati-Middletown, OH-KY-IN	143.2	-1.9%	-4.3%
San Antonio, TX	141.7	5.8%	-4.0%

NAR® (2007) Fourth quarter 2006 numbers are preliminary

Excluding Vancouver, the median price of homes in the Portland metropolitan region rose from $289,000 in the last quarter of 2006 to $294,000 in the first quarter of 2007, representing 6.9% on an annualized basis. On the other hand, new homes saw a slight decline in the median price from $365,400 to $364,300 in the first quarter of 2007.[2]

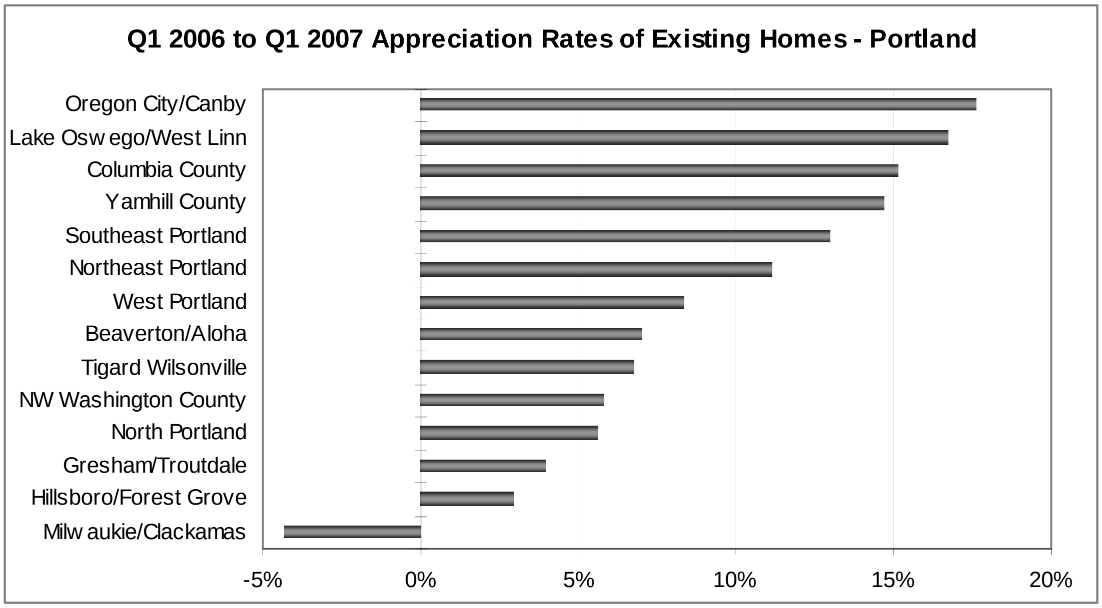
[1] National Association of Realtors® (2007)
[2] The following sections on Portland and Vancouver are based on data gathered from RMLS™.



Source: RMLS™ (April, 2007)

Suburban Appreciation

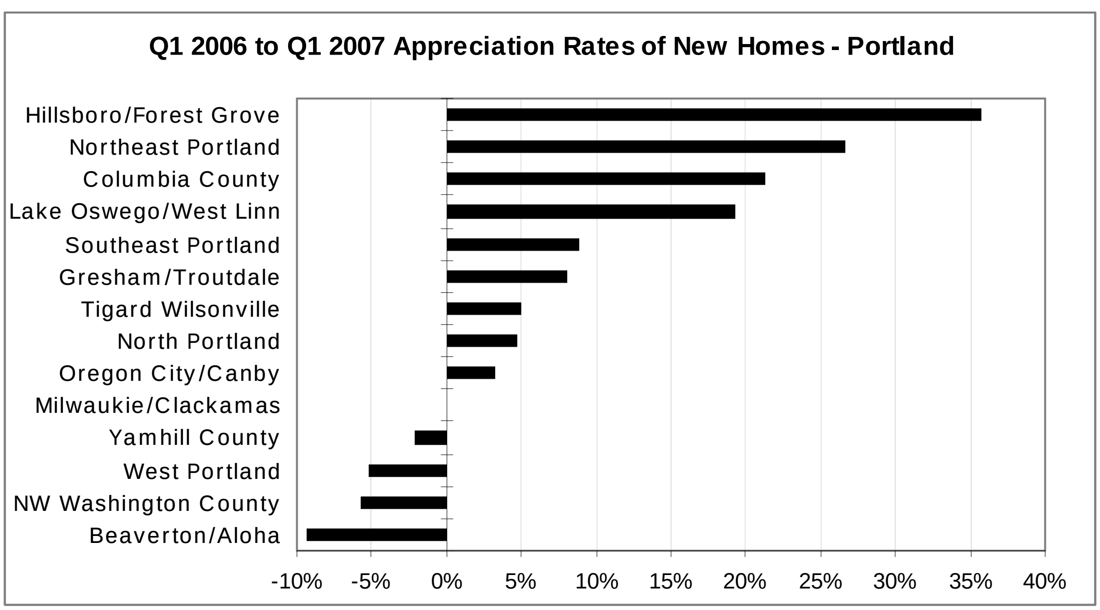
A closer look at neighborhoods in the Portland region shows appreciation of existing homes across the board in the first quarter of 2007 when compared with the same period in 2006. The greatest price increases occurred in the suburban housing markets of Oregon City/Canby, Lake Oswego/West Linn, Columbia County, and Yamhill County. The only declining submarket in this period was the Milwaukee/Clackamas area, which depreciated by 4.3%—a steep decline from their number one position a year earlier when they saw their median home price grow by 21.3%.



Source: RMLS™ (April, 2007)

New homes saw even greater appreciation, although there was great variation among the submarkets. Four submarkets experienced a decline in new home prices—Beaverton, NW Washington County, West Portland and Yamhill County. Hillsboro and Northeast Portland saw the greatest increase in new home prices.

New home appreciation rates are often impacted by migration patterns, and the size and quality of homes built. By comparison, the size and quality of existing homes sold doesn't change as frequently. Additionally, the new home market is much smaller than existing homes, and is therefore subject to greater volatility in median and average sales price.

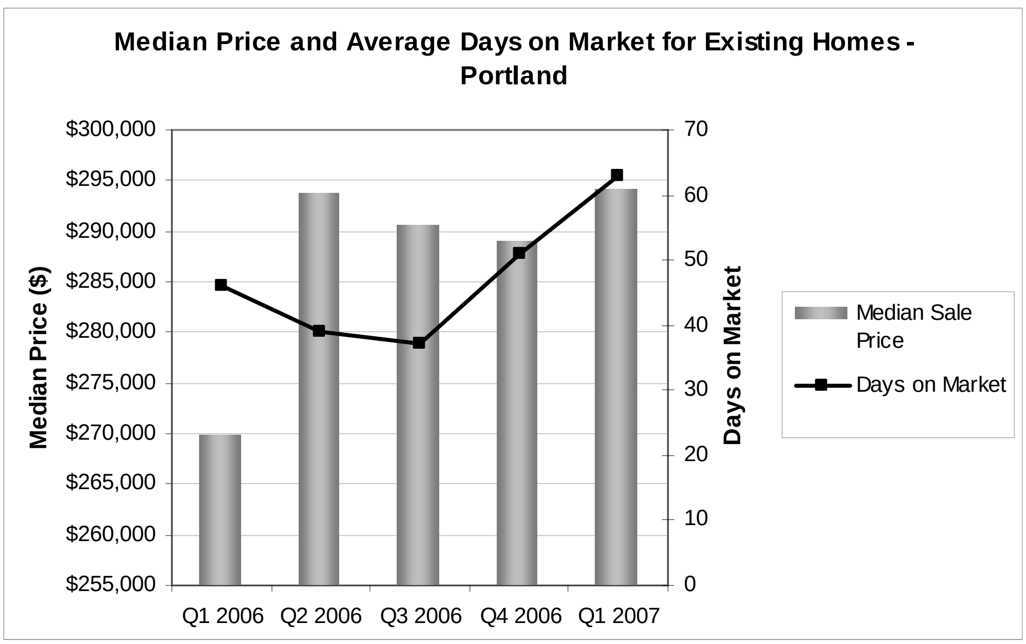


Source: RMLS™ (April, 2007)

A Buyer's Market

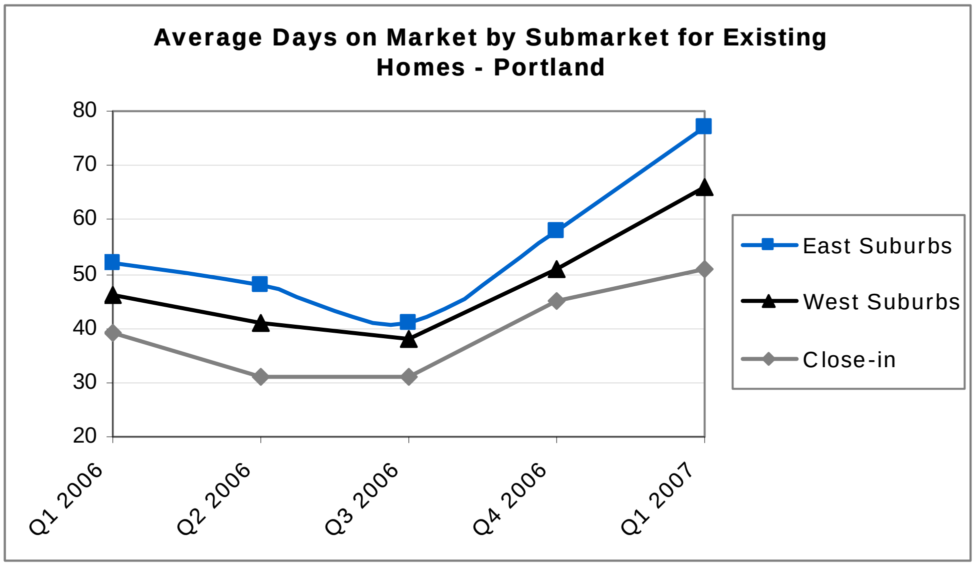
Two standard measures for tightness in the local housing market are the average number of days that homes are on the market and the difference between the original listing price and the sale price. The difference between list price and sale price also reflects the discrepancy between the market and sellers' expectations of the market.

The following chart shows that although the median home price climbed from the last quarter of 2006 to the first quarter of 2007, an indication of a strengthening market, it took on average 12 days longer (63 days total) to sell a home. This trend in days on market may lead to a softening of median home prices if sellers become impatient with the lack of offers. The alternative is for sellers to simply take their homes off the market. Yet, some sellers may not have this luxury of waiting if they purchased beyond their means with the intent to resell or have adjustable rate mortgages.



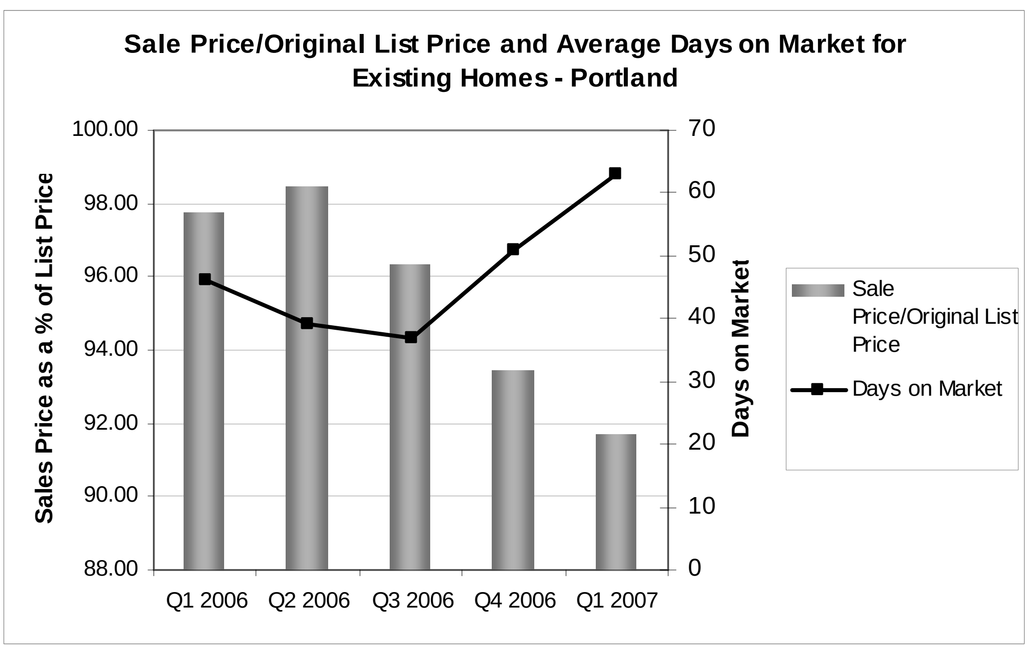
Source: RMLS™ (April, 2007)

The East and West Suburbs as well as close-in neighborhoods all show the same trend in average days on market although homes in the East suburbs are experiencing the longest marketing periods.



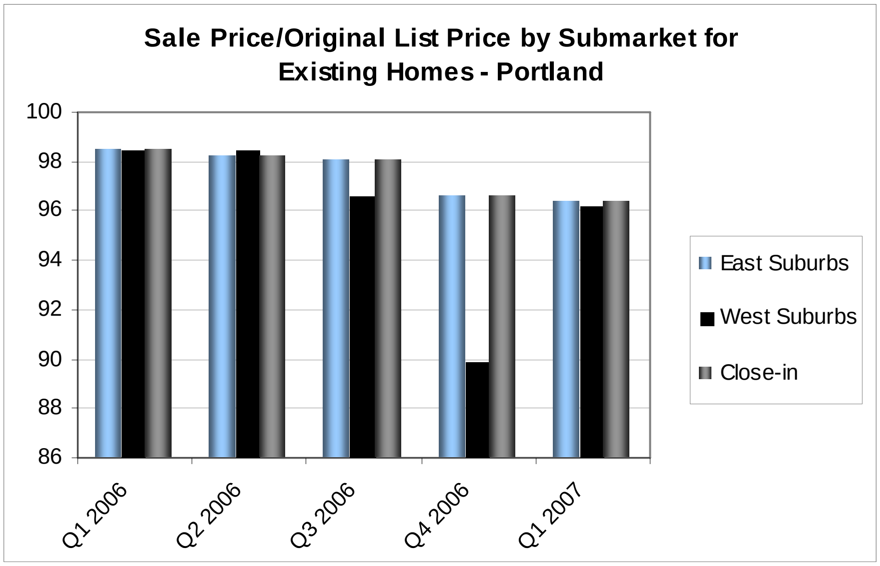
Source: RMLS™ (April, 2007)

The Portland area is also seeing lower sale prices relative to the original list prices, indicating that the market, while still strong, is not appreciating at the rate sellers had been expecting. It may also indicate that sellers are unable to wait out the increasing number of days their homes are on the market without lowering their prices.



Source: RMLS™ (April, 2007)

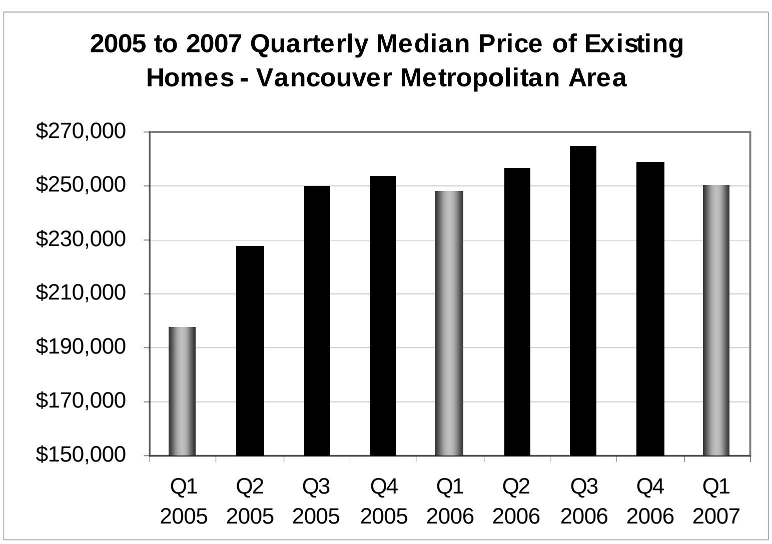
All three submarkets are showing sale prices at approximately 96% of the original list price, suggesting that sellers over-estimate of selling price is not that severe. Although, the West suburbs did experience a steep decline in sales price relative to list price in the fourth quarter of 2006.



Source: RMLS™ (April, 2007)

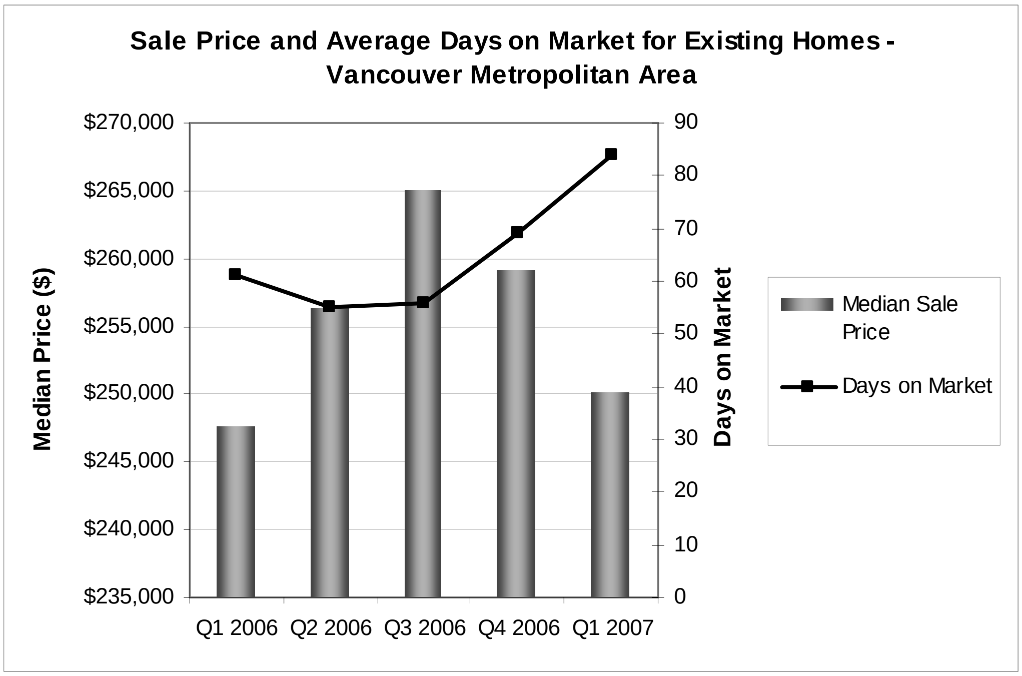
Downstream in Vancouver

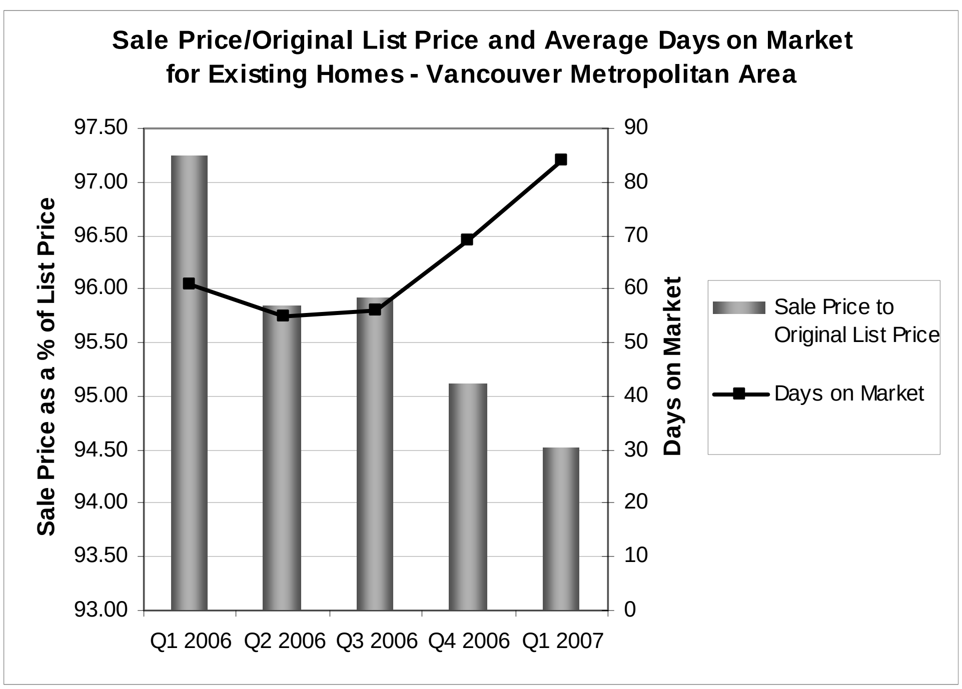
Unlike Portland, Vancouver and SW Washington show clear signs of a softening housing market, with two consecutive quarterly declines in the median price of existing homes. Most recently, the median home price declined 3.5% from the fourth quarter of 2006 to the first quarter of 2007.



Source: RMLS™ (April, 2007)

As is the case in Portland, the average number of days on market for existing homes in Vancouver is rising. However, in Portland, it is taking longer on average to sell houses at appreciated values, whereas in Vancouver it is taking longer to sell at depreciated values—a sign that the market is truly dampening on the other side of the river. Similarly, the sales price has gone down significantly as a percentage of the original list price.





Source: RMLS™ (April, 2007)

Record Harvest Willamette Valley

Willamette Valley experienced year-over-year appreciation in first quarter sales across the board.[1] Benton County, with the highest median price in both 2006 and 2007, has seen the least amount of appreciation. Lane County is closing the gap on Benton County with a 10% increase from 2006 to 2007 reaching $231,000.[2] Polk saw a significant hike, over 18% in its median home price; yet the median price still remains below $200,000.

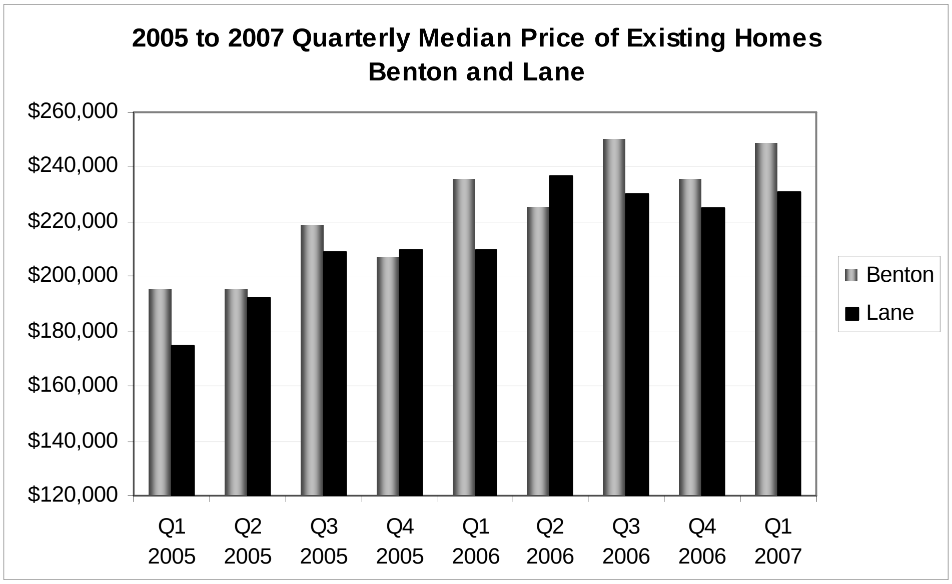
Median Price and Appreciation in Willamette Valley

	Q1 2006	Q1 2007	06-07 % Change
Benton	$234,995	$248,337	5.7%
Lane	$210,000	$231,000	10.0%
Marion	$164,930	$185,000	12.2%
Polk	$151,250	$179,000	18.3%
Linn	$136,000	$149,000	9.6%

Source: WVMLS (April, 2007) and RMLS™ (April, 2007)

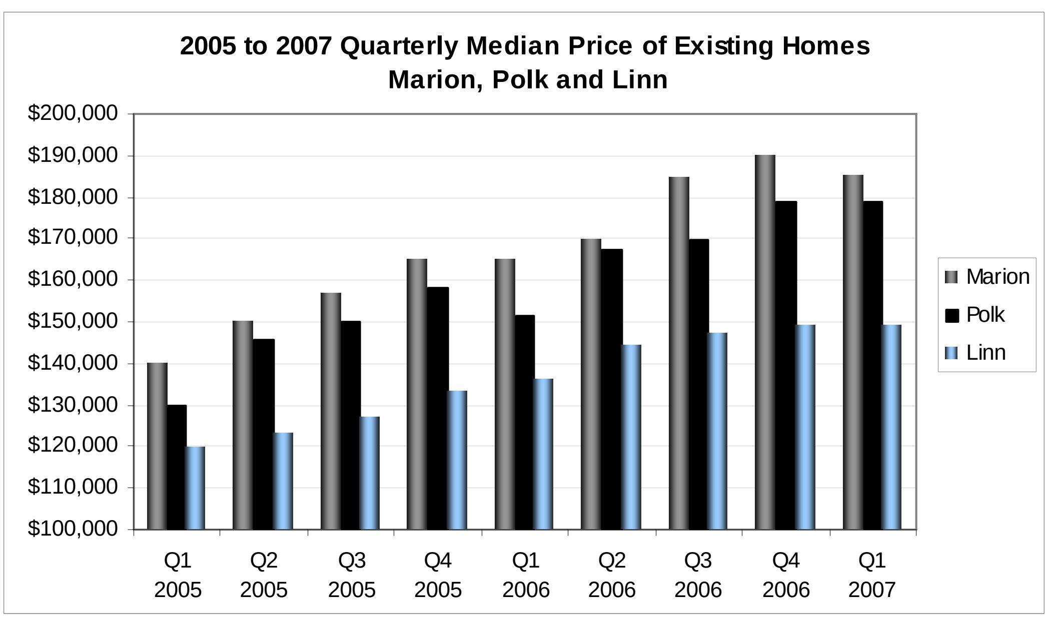
Unlike Polk, Marion and Linn counties, both Lane and Benton counties have enjoyed median home prices above $200,000 since the third quarter of 2005. However, both have also shown quarter-to-quarter volatility. After a decline in the fourth quarter of 2006, both Lane and Benton recovered by 2.7% and 5.7% respectively. It is unclear whether the volatility in 2006 is simply due to seasonality, or whether these two markets were vulnerable to the nation-wide uncertainty regarding the housing market and the mixed messages from industry analysts during that period.

[1] This section uses data from WVMLS for Benton, Linn, Marion and Polk counties and RMLS™ for Lane County.
[2] Data from WVMLS excludes new homes as well as homes built within the calendar year prior to the year sold.



Source: WVMLS (April, 2007) and RMLS™ (April, 2007)

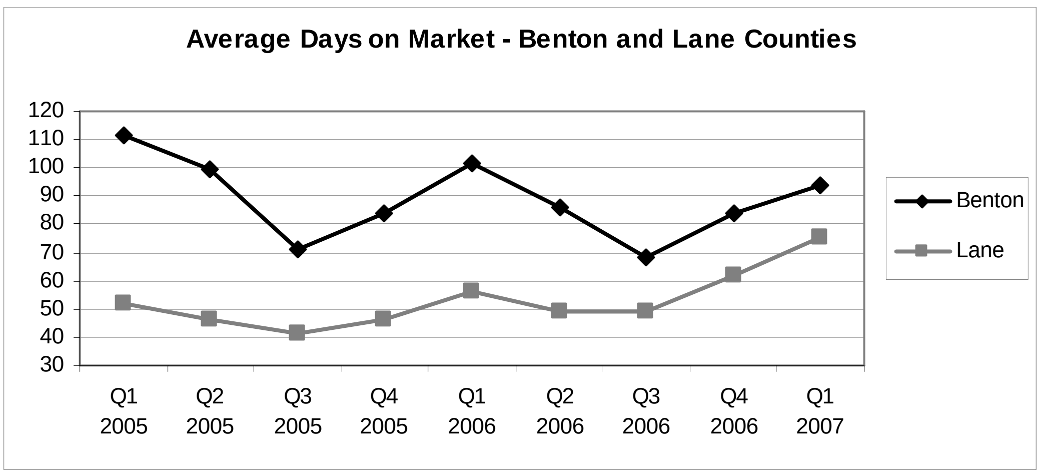
Unlike Benton and Lane counties, Marion, Polk and Linn have sustained steady growth throughout 2006 showing less volatility. All three markets still had room for modest growth even after the housing peak, which helps explain their continued appreciation. None of the three, Marion, Polk and Linn, have reached a quarterly median price beyond the $200,000 benchmark, a phenomenon that is becoming rarer these days. Similarly, all three either showed signs of flattening or signs of a downturn in the first quarter of 2007. However, this may be due to seasonality, since, unlike Benton and Linn, these markets showed vulnerability to seasonality in the first quarter in 2005 as well.



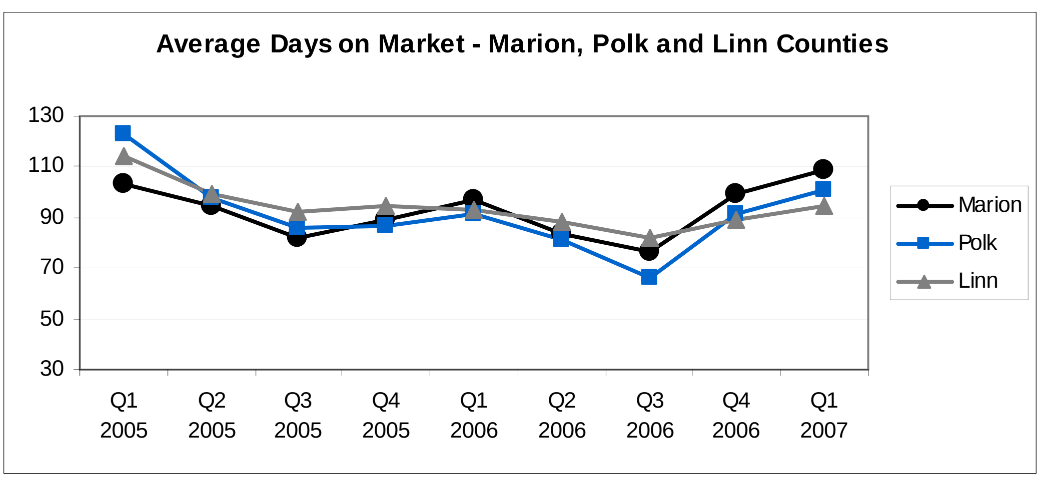
Source: WVMLS (April, 2007)

A Test of Patience

While Benton has maintained a higher median home price than that of Lane for the past three quarters, it has consistently taken longer to sell those homes. All five counties, however, are seeing the average number of days on market increase significantly. Lane County has seen its average days on market increase by more than 20% in each of the last two quarters, ending at 75 days in the first quarter of 2007. Benton has seen an increase of 22% and 12% reaching 94 days (longer than three months). Longer days on market will test the patience of home sellers in Lane and Benton, and if it continues, could lead to a dampening of prices there. Interestingly, Linn, which already has the lowest number of days on market, is seeing a flattening in the growth of this average. As many people have been priced out of more expensive markets, there exists an opportunity for lower priced homes, such as those in Linn, to sell more quickly.



Source: WVMLS (April, 2007) and RMLS™ (April, 2007)

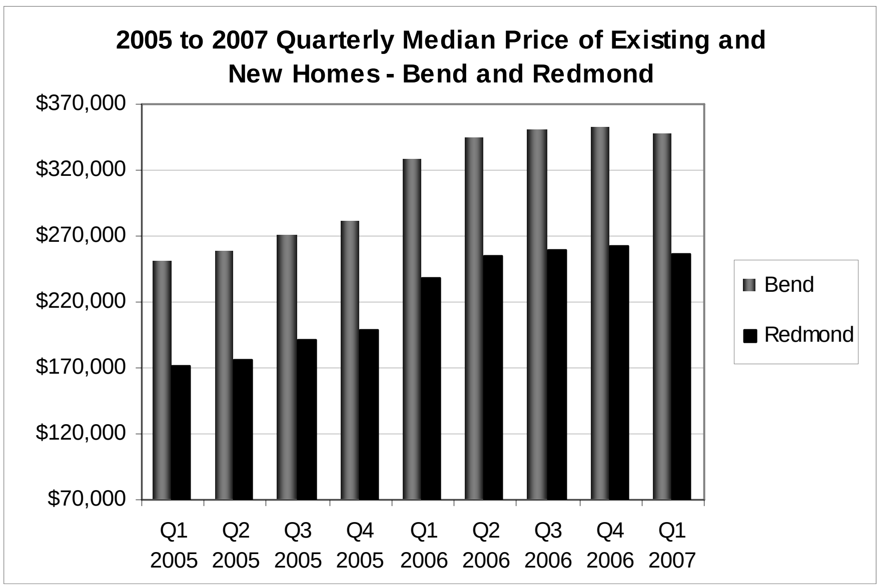


Source: WVMLS (April, 2007)

Boom or Bust in Bend

Two cities in central Oregon, Bend and Redmond, have seen significant growth in their housing markets over the past two years. Surprisingly, the most considerable growth in both of these markets occurred in the first quarter of 2006—a time of year when home sales tend to level off due to the seasonality of the business.

New construction, driven primarily by the significant net migration into these two cities, contributes the bulk of the growth in these markets. Bend in particular is a hot retirement destination, which led to a 17% spike to $327,500 in the first quarter of 2006.[1]



Central Oregon Association of Realtors® (April, 2007)

As shown above, Redmond has closely tracked Bend while remaining 35 to 45% below its median price. Both markets have begun to soften in recent quarters. The median home price for Bend fell 1.2% to $347,750 in the first quarter of 2007, and in Redmond, home prices fell 2.6% to $255,950. On a positive note, both markets have maintained year-over-year growth. Bend grew by 6.2% from the first quarter of 2006 to the first quarter of 2007 and Redmond grew by 7.5%.

While Portland homes continue appreciating even as their average days on market increases, both Bend and Redmond are seeing a simultaneous softening on both dimensions. This double hit to the housing market in each city does not bode well for the rest of 2007 and implies that each

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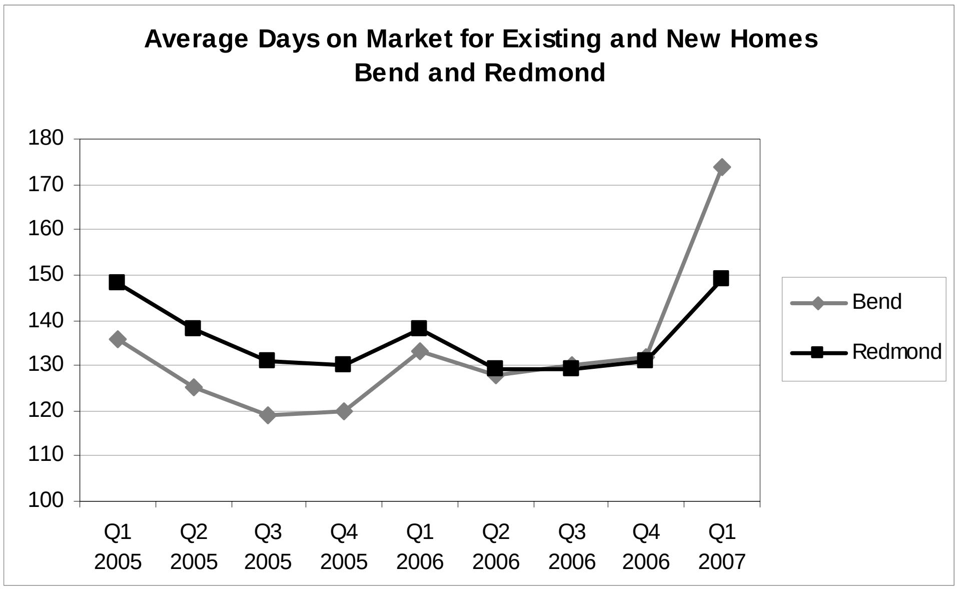
[1] Due to data limitations, these figures include both new and existing homes. Including new homes in samples puts an upward bias on the reported median figure; however, since much of the activity in these two markets took place among new homes, the inclusion of new homes in the data should give an accurate picture of the strength of these markets.

market has been over-built. Since new homes have longer marketing periods (often measured from the start date of construction) the average days on market is naturally higher in reported figures. However, it is the dramatic increase that is cause for concern. Bend in particular saw a sharp climb of 31.8% from 132 days to 174 days, in just this last quarter—a much wider jump than seen in the first quarter of 2006.



Central Oregon Association of Realtors® (April, 2007)

Each of these two markets will depend on increasing net migration, particularly from the Baby Boom generation to absorb the increase in supply seen in the past several years. Both are relatively isolated markets, geographically and economically—thus they depend on their own ability to attract growth, as opposed to urban and suburban markets, which may feed off the expansion of surrounding areas.

A recent report from the National Association of Homebuilders (NAHB) shows that building permits in Bend were down February from the previous year.[1] The chart below shows the number of permits issued in Bend as well as other markets and Oregon as a whole.

[1] NAHB, March 2007

Building Permits Issued in Oregon by City

	Feb 07 Permits	Feb 06 Permits	% Change
Oregon	2,623	3,213	-18%
Bend	324	553	-41%
Eugene-Springfield	172	205	-16%
Medford	204	222	-8%
Portland-Vancouver-Beaverton OR-WA	1,435	1,760	-18%
Salem	147	174	-16%

While all markets saw a drop in permits, Bend saw the most significant decline. Often such a decline signals a recession in housing. Even as Oregon holds strong against national trends, the decline in permits will likely lead at least to stabilization in supply. With continued net migration, this will keep home prices healthy in areas like Bend and Redmond, which were previously over-heated.

Local Housing Summary

For sometime, the Northwest has been the last holdout against the nation-wide housing slump. While several areas are still showing appreciation in Oregon, some preliminary signs that the market might dampen are beginning to emerge. Longer days on market and slowing appreciation are two key indications. In addition, there is the decline in net migration of 8.1% from 2005 to 2006.[1] Finally, Oregonians are getting squeezed by energy prices, due to the high cost of fuel from Alaska, which could increase sensitivity to housing prices. While Oregon as a whole will not likely see plummet as other markets such as Boston have, housing prices and transaction activity will stagnate under current conditions. ■

[1] United Van Lines Annual Migration Numbers (2006).

Downtown Office Market Cycle – a Case for the Next Office Tower

By Michael Williams, Assistant Director of Research, Cushman & Wakefield

Downtown Portland's office market is cycling into an expansion that should result in climbing rents, lower vacancy rates, and more construction. How do we know this? Well, history tends to repeat itself and our current forecast of vacancy and rental rates points towards the need for new development.

With an emphasis on why we think the environment downtown is ripe for new construction, this short briefing describe the office market cycle and then apply this explanation of market cycles to current and forecasted conditions in Portland's CBD.

Market Cycles

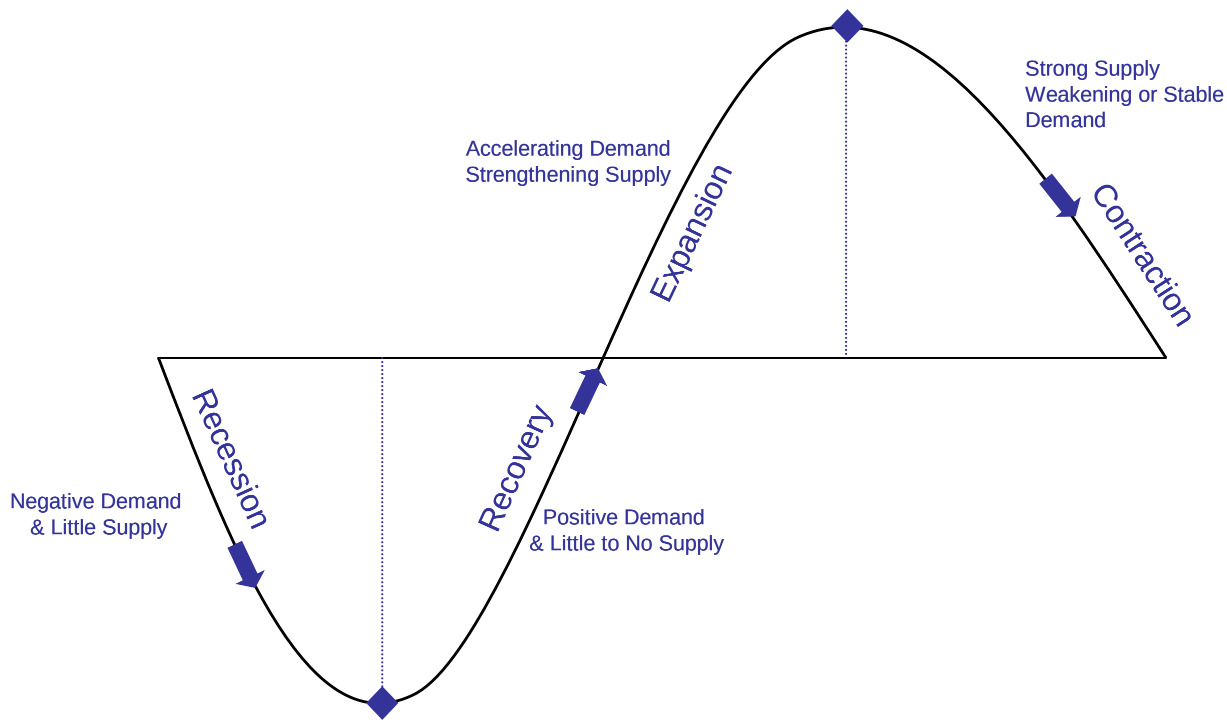
Market cycles are the result of the relative balance of tenant demand and developer supply and are usually expressed in rent growth, vacancy rates or value. The relationship between the supply-demand balance and vacancy rates is fairly straightforward. When demand (net absorption) exceeds supply (new construction) vacancy rates tend to fall and when demand is less than supply, vacancy rates increase.

Movement in rents is more complicated and is usually associated with vacancy thresholds that result in an over- or under-supply of space that markets must meet in order to see rates change. In Portland, a market that Cushman and Wakefield has tracked for more than 20 years, rental rates generally fall when vacancy rates are in double-digits (above 10%) and begin to rise when vacancy rates fall below 7%. Between these two thresholds, rental rates show less movement.

Classical thinking regarding the real estate cycles takes the form of a sine wave and dates back to the 1930's. The four key periods of the cycle, recession, recovery, expansion, and contraction each have a different balance between supply and demand.

Recession: Negative demand and little to no construction best characterize recessions in the office market cycle. Spiking vacancies result in falling rents and increased concessions by landlords looking to keep existing tenants while attracting the few remaining tenants in the market.

Recovery: Recoveries are periods of recuperation for many landlords and their balance sheets. Net gains in tenant demand usually result in stabilized rents and a reduction in concessions like free rent and moving allowances. Rent growth is flat or minimal as is inventory.



Expansions: Demand is high among businesses due to economic growth and prosperity, and developers are receiving high enough rents to justify new construction. Rent growth is positive and accelerating. Vacancy rates are generally on the decline as demand outpaces new construction.

Contraction/Oversupply: This phase is often the result of over-supply (too much construction) and/or slower or negative demand that causes the rate of new construction to outpace tenant demand. Over-supply occurs for a variety of reasons, including inflated expectations of developers, financial and tax incentives, and imperfect market information. Slower demand is usually a result of the natural ebbs and flows in business activity, but can also be a result of demand shocks (spiking energy prices, stock market swings). Rent growth occurs at the beginning of the phase and decelerates throughout.

Equilibrium: Periods of equilibrium are relatively short lived in the real world. Markets are constantly in flux due to a complicated mix of internal and external factors. Most major office markets have such a diverse range of tenants that a portion at any given time is usually considering expansion growth or cutbacks. Finally, the permanence of real estate (decades to centuries) makes it harder to calibrate supply and demand over a period of time than it is for less permanent goods where supply is better able to adjust to market conditions.

Market Cycles and the Portland CBD

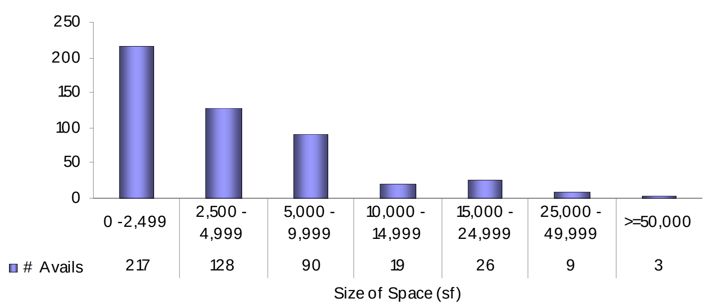
So how does the market cycle apply to current market conditions in Portland? Portland's CBD is moving from a recovery to an expansionary mode and there should be sufficient demand for the development of 400,000 to 500,000 square feet of office space by 2009 without causing a significant enough spike in vacancy rates to threaten rent growth. Class A vacancies and rents will be the focus of this forecast since a majority of new construction is developed for class A users. As a result, new construction has the biggest impact on class A office statistics even though it has significant consequences for all classes of space.

This transition to an expansion is outlined in the matrix below that compares market conditions in an expansionary phase to the current condition of Portland's class A office market. Vacancy rates downtown have declined consistently since 2003 as a result of positive demand and no construction completions. Rental rates have begun to pick-up and are clearly in a growth phase.

Indicators	Expansion	Portland CBD
Supply	Accelerating	Construction has started (The Lovejoy) expect a new tower (300k+) to start by year-end.
Demand	Gains Momentum/ Peaks	Positive for more than three years. Will slow until speculative construction comes on line.
Vacancy	Declines Throughout	Will continue to fall through 2010.
Rents	Significant concessions have dried up. Rent growth begins in earnest.	Significant rent increases have just started. More abrupt spikes are expected as vacancy continues to fall.
Landlords	Soaring occupancy and rental rates result in significant leverage, especially at the peak of the expansion.	Occupancy gains and rent increases bode well for landlords. More leverage in regards to concessions and tenant allowances.
Tenants	Occupancy costs spike. Limited choices for many.	Leverage fading. Large tenants have very limited options for expanding and/or relocating

Compare the criteria for expansions to current conditions. In most cases, Portland's CBD is seen as moving from recovery to expansion.

Portland CBD: Distribution of Available Space



The prospects for large and small tenants are very different. A tenant needing less than 2,500 square feet in the CBD has 217 options, where tenants above 25,000 square feet have only 12 choices. (Source: Cushman & Wakefield)

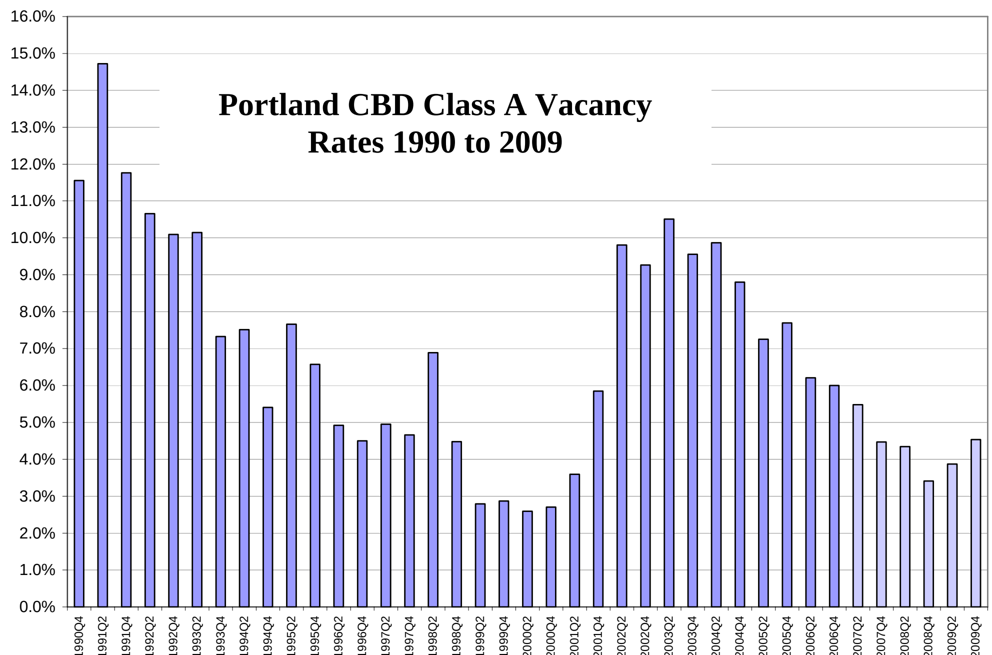
The direct class A vacancy rate in downtown Portland is currently near 6.0% and is forecasted to trend steadily lower through 2009. A relatively conservative forecast puts vacancy near 4.5% by year-end 2007, 3.5% by mid-year 2008. Speculative new construction will likely push vacancies a little higher by the end of 2009. We currently forecast the vacancy rate to approach 4.5% by year-end 2009. We do not believe this is enough of an increase in vacancy to seriously jeopardize rent growth. The last time the market experienced such low vacancy rates in the late 1990's significant rent spikes occurred. Average class A rents should be close to $27.00 or $28.00 per square foot by the end of 2009. Please be mindful that this is an average for an inventory of more than nine million square feet of space and rents can vary as much as $10 within this group.

Active and Proposed Development for Portland's CBD:

Name Location	Size/Stories	Description	Status
The Lovejoy 13th,14th, Lovejoy & Marshall	82,843 s.f Three Floors (7th-9th)	Part of two block development including Safeway grocery & parking.	Under Construction
12th & Washington	85,000 sf	Mixed-Use with Retail and Apartments. Office fully occupied and anchored by ZGF.	Under Construction
First & Main Madison, Jefferson, 1st, 2nd	341,663 s.f. 15 Floors Ground Floor Retail	One Block Development. No Anchor Tenant.	Proposed
100 Columbia Columbia, Clay, 1st & Second	311,425 s.f. 15 Stories Office Ground Floor Retail	Part of three block development, including Koin Center.	Proposed
Park Avenue West	214,300 s.f. on 15 floors.	Three floors of retail & 14 floors of condos above.	Proposed
One Waterfront Place	235,193 sf on 12 floors	Pearl – Waterfront Location	Proposed

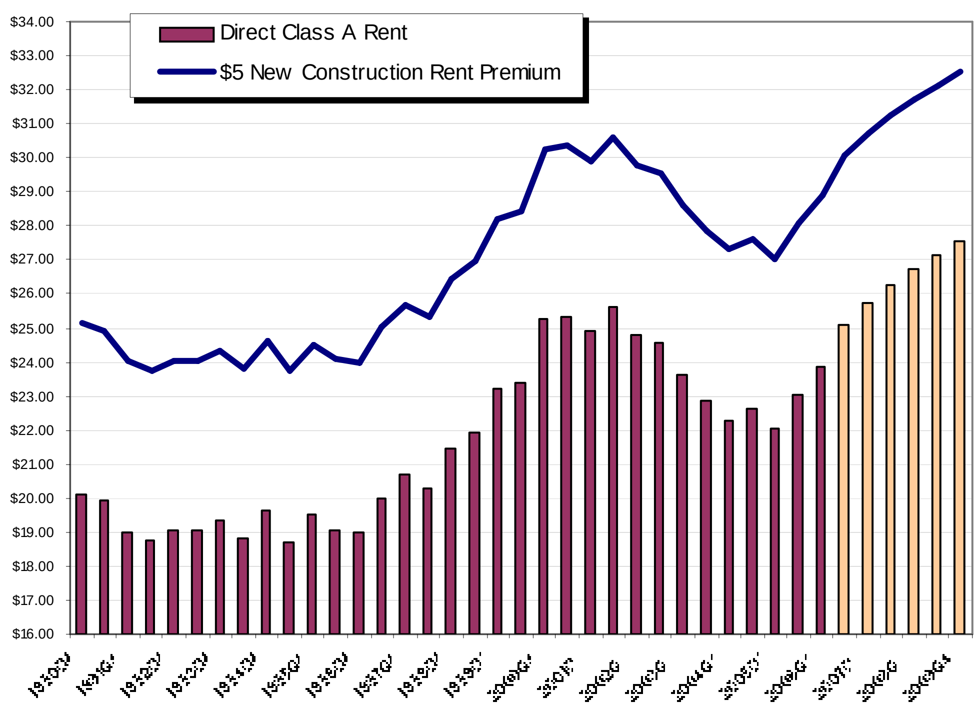
This forecast assumes the delivery of The Lovejoy and at least one office tower ranging between 300,000 and 350,000 square feet by year-end 2009.

Vacancy trends for the 2006-2009 forecast period are similar to the last landlord market in the 1990's and will result in significant rent spikes (see next page).



We expect new construction to demand $33.00 to $35.00 at this time, as new construction costs increase and developers are able to garner premium rents for cutting edge design, building efficiencies and the most current amenities. We came to this threshold by adding a $5.00 to $7.00

new construction premium to our class A rent forecast. This premium is relatively conservative and could be pushed even higher if rents are pushed exceptionally low or a large tenant with less price sensitivity wants to relocate or expand in the CBD. At this point we believe the only thing keeping a new building from starting is the determination of what premium above the $33.00 rent level might be needed to justify construction. This additional premium may very well be a factor of construction costs. The high-cost of construction is a well documented phenomenon and is being fueled by a number of factors, including higher commodity costs and competition with the very active residential high-rise market for materials and skilled trades.



As vacancy rates continue to fall we expect rental rates to start rising steeply. Inflationary pressures, though mild, should push rents above the levels achieved in the late 1990's.

Summary of Findings:

- Based on expected economic growth, net absorption and forecasted rent growth there should be enough demand for 400,000 to 500,000 square feet of additional class A office space in the Portland CBD by 2009.
- Vacancy rates will continue to fall well below equilibrium (around 7%) due to positive net absorption and no new supply.
- There may be temporary increases in vacancy over the forecast period as the market gets very tight and leasing becomes more difficult, especially for large tenants. These up ticks, however, will not be reflective of the overall trend and will not threaten rent growth as vacancy rates stay below equilibrium.

Supply will react cautiously due to sensitivity to capital markets and the gap between construction costs and rents. We do, however, expect the completion of an office tower by late 2009 or early 2010. This cautiousness will result in below equilibrium vacancy rates and further rent growth beyond our post-2009 forecast period■

National Market

Commercial real estate markets continue to receive attention from private equity and pension funds looking to park their excess liquidity. The National Association of Realtors® (NAR) reports a record $306.8 billion in transaction volume in 2006.[1] Office transactions increased by 32% and industrial increased by 9%.[2]

NAR forecasts that investments in commercial real estate will remain robust throughout 2007, with office, hospitality and industrial products topping the preferred list. Yet, many industry experts are talking about the possibility of weakening fundamentals in the commercial real estate market if the U.S. economy begins to dampen in 2007. In addition to the slump in the housing industry, which created ripples through the financial markets, predictions of slower employment growth for 2007 is creating worries that tenant demand for commercial space will soften.

Recent figures show the national office vacancy rate increased by ten basis points (bps) in the first quarter of 2007 to 12.6%.[3] There is no consensus, however, on whether this is simply a seasonal movement or part of longer trend in softening demand, since after all, we are seeing the first increase in office vacancy since the second quarter of 2003.

Overbuilt markets, like Atlanta and Dallas, will be hardest hit if a slowdown in tenant leasing were to occur. The office market in Orange County is also vulnerable due to their high exposure (6.8% of inventory) to the mortgage industry.[4]

The national warehouse market also saw an increase in its vacancy rate by 2 bps in the first quarter of 2007 to 9.6%. Previously, the overall industrial market has enjoyed decreasing vacancy rates during 2006.[5] However, supply has kept pace with demand in many markets, preventing any significant increases in rent. In 2006, imports and exports of goods were a record dollar value of

[1] This does not include the $23 billion dollar sale of EOP to private equity firm, Blackstone, which occurred in 2007.
[2] National Association of Realtors® (March 2007)
[3] Fitch (April 18, 2007)
[4] Real Estate Journal (March 19, 2007)
[5] National Association of Realtors® (March 2007)

$1,859.8 and $1,023.7 billion respectively, representing increases of 10.9 and 14.4%.[1] Strong employment growth in 2006 fostered demand for Asian goods, even as the housing market deteriorated. But now with less than rosy predictions of employment and increasing energy costs, it is unclear how consumer demand for durable goods will sustain.

Portland Office Market

Unlike other markets, Portland has not seen heavy construction of office space in either the suburbs or the central business district (CBD) during the past two years. No new office towers in the CBD have been delivered and only a modest amount of space was newly constructed in the suburbs. CBRE reports 416,000 square feet of new construction in 2006 throughout the metropolitan region. While this is a significant increase over the 152,500 square feet constructed in 2005, it is nowhere near the 1.2 million square feet of activity in 2002.[2] Portland may have learned its lesson from the dot com bust that left several square feet of suburban office space vacant.

In the CBD, the dearth of new construction is attributable to the limit in suitable parcels available for development, the need for parking, and the run up in construction costs over the past few years. However, one developer, TMT Development, is in the process of obtaining permits to develop a tower downtown that will deliver 215,000 rentable square feet of office space, and there is talk that Shorenstein Partners may develop a 15-story tower at First and Main. However, these projects, if begun, will take several years to deliver new office to the CBD. The TMT tower in particular will face a protracted building period due to the residential units included in the project, which involve more complicated construction.

[1] U.S. Census Bureau, February 13, 2007
[2] CB Richard Ellis, March 2007

	CB Richard	Cushman &	Grubb & Ellis
Market-Wide Vacancy	11.5%	11.9%	12.5%
Previous Quarter	11.2%	12.6%	11.7%
CBD Vacancy	8.9%	10.1%	9.5%
Previous Quarter	8.8%	10.7%	9.3%
CBD Class A Vacancy	5.3%	7.1%	6.4%
Previous Quarter	5.0%	6.3%	5.9%
CBD Class A Asking Rents	$23.38	$24.68	$24.31
Previous Quarter	$23.03	$23.87	$23.80
Suburban Vacancy	13.7%	13.7%	14.3%
Previous Quarter	13.7%	14.6%	13.4%
Suburban Class A Vacancy	N/A	13.7%	10.5%
Previous Quarter	N/A	14.8%	8.5%
Suburban Class A Asking Rents	N/A	$23.36	$25.50
Previous Quarter	N/A	$22.54	$24.55

Source: CB Richard Ellis, Cushman & Wakefield and Grubb & Ellis (April, 2007) Vacancy rates above include subleases except those reported by CB Richard Ellis. Class A suburban figures reported by Grubb & Ellis reflect Kruse Way and Washington Square only.

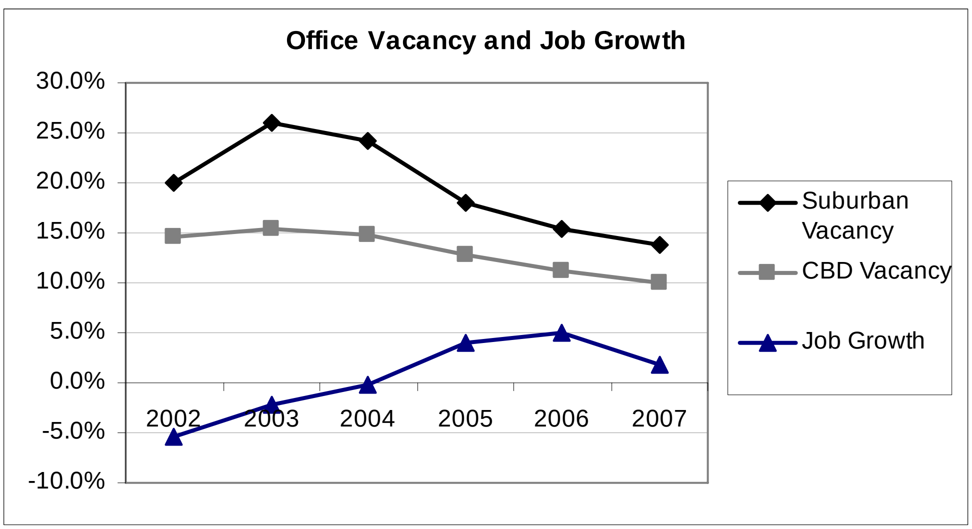
The minimal availability of office space is driving the historically low vacancy rates reported by local brokerage firms (see previous table). Taking advantage of the opportunity, landlords are increasing rental rates. Average asking rental rates for direct leases edged higher in the first quarter of 2007 region-wide and even exceeded the peaks seen in 2002. Class A office rents downtown are pushing past $24 full service annually per square foot. In the suburbs class A asking rents are above $23 and reach as high as $27 to $28 per square foot in Kruse Way.[1] Leasing activity is still strong and, in the first quarter of 2007, exceeded 1.0 million square feet or one third of total leasing activity in 2006.[2]

In addition to limited choices for tenants, job growth, though modest, is helping to improve the landlord's position. The Portland region continues to see year-over-year growth of jobs in the traditional office-using sectors of information, financial activities and business services. However, growth has slowed from previous years. In the most previous 12-month period, Portland has gained a net of 3,900 or 1.7% jobs in these sectors, down significantly from the 10,500 jobs added in the prior 12-month period beginning in March 2005. Of the jobs in the past

[1] Cushman & Wakefield, March 2007
[2] Cushman & Wakefield, March 2007

12 months, the majority (2,800) were gained in the business service sector, a category that includes professional and technical services, administrative and support services and company management. The financial activities sector, which traditionally concentrates in the CBD, received a net gain of 500 jobs. The information sector, which tends to seek suburban office locations, received a net gain of 600 jobs.[1]

Employment growth in these sectors can impact the leasing of office space at an estimated 200 square feet per employee; however, there appears to be a lag before employers respond with space expansions. The following chart shows yearly employment growth for the past two years along with CBD and suburban office vacancy rates. Job growth accelerated from 2002 to 2006, yet vacancy did not begin decreasing until 2003—a delay caused by the necessary planning and preparation that goes into space expansion.



Source: Cushman & Wakefield and Oregon Department of Labor (April, 2007)

In summary, the conditions in the Portland office market are ripe for continued but moderated growth. The limited amount of space, particularly downtown, will help drive rents higher in each class of space, even as employment growth tapers off due to a slowdown in the economy. The average asking rental rate of all classes of space may stagnate, if there are fewer Class A parcels available to drive up the average. New construction will be delivered, but slowly. Ironically, a deficiency in suitable space may drive some prospective tenants out of market, which could negatively impact the vacancy rate from the landlord's perspective. Thus, the limit of supply will be a double-edge sword to the vibrancy of Portland's office landscape.

[1] Oregon Employment Department, April 2007

Portland Industrial Market

Like the office market, the Portland industrial market faces a supply constraint. The impact is greater given the larger parcel sizes (relative to office) needed in the construction of new industrial space.

The region did add 700,000 square feet of speculative new inventory in the first quarter of 2007 and an additional million square feet is underway.[1] In addition, the Port of Portland is planning to enter into a partnership with New Tower Trust Company to develop a distribution center on 114 acres of land in the Rivergate submarket. This site is one of the last large developable parcels in this submarket.[2]

In the first quarter of 2007, Portland saw a market-wide decrease in industrial vacancy to a range of 5.2 to 6.1% as reported by the brokerage firms in the table below. In addition, the area saw 1.5 million square feet in leasing activity and over 1.0 million square feet in net absorption. Sunset Corridor, in particular, took off with 635,000 square feet of net absorption thanks primarily to Solar World's purchase of the 470,000 square foot Komatsu factory, which was previously vacant.[3]

	CB Richard Ellis	Cushman & Wakefield	Grubb & Ellis
Market-wide Vacancy	5.2%	5.4%	6.1%
Previous Quarter	5.6%	6.1%	6.3%
Warehouse/Dist/Mfg Vacancy	N/A	4.6%	5.7%
Previous Quarter	4.6%	5.0%	5.4%
R&D/Flex Vacancy	N/A	9.2%	7.4%
Previous Quarter	11.3%	11.2%	9.0%
Asking Monthly Shell Rates	$0.36 to $0.40	N/A	$0.38
Previous Quarter	$0.34 to $0.40	N/A	$0.37
Asking Monthly Flex Rates	$0.75 to $0.85	N/A	$0.80
Previous Quarter	$0.75 to $0.85	N/A	$0.74

Source: CB Richard Ellis, Cushman & Wakefield and Grubb & Ellis

[1] Grubb & Ellis, March 2007
[2] Port of Portland, April 16, 2007
[3] Cushman & Wakefield, March 2007

Both flex and warehouse/distribution vacancy rates are at historic lows. Asking monthly shell rates for warehouse/distribution space reached $0.36 NNN per square foot in the first quarter and new construction is averaging $0.42 per square foot.[1] Flex rates are in the $0.75 to $0.85 range.[2]

Employment growth in industrial sectors remains steady. Portland added 6,600 net new jobs in the manufacturing and trade, transportation and utilities sectors in the previous twelve months, a 2.0% gain. On top of growth in these sectors, 3,400 jobs in construction were added, representing an increase of 5.7%, due primarily to continued strength in residential construction downtown as well as commercial and infrastructure construction. However, annual employment growth in all of the above sectors softened from the previous year (which saw jobs increase by 13,000 jobs or 3.5%.[3]) One notable example of this softening is the recent layoff of 800 Freightliner employees from the truck assembly line.

So where is the local industrial market headed? Portland's manufacturing sector still remains strong even with the recent Freightliner layoffs, and accompanying this strength are historically low vacancy rates among manufacturing facilities. Yet, manufacturing space encompasses only 12.8% of the 167.6 million square feet of industrial inventory in the Portland metro area. 70% of industrial space is devoted to warehouse/distribution, the strength of which is reliant on Portland's strategic position as a gateway into inland markets and increased import/export activity. While in the past, exports have always exceeded imports, the Port of Portland noted that for the first time, imports have caught up.[4] If the trend continues, signs for continued growth in the Portland industrial market will emerge more from U.S. consumer demand for goods from abroad than from demand for Northwest commodities.

[1] CB Richard Ellis, March 2007
[2] CB Richard Ellis, March 2007
[3] Oregon Department of Labor, April 2007
[4] Port of Portland, April 16, 2007.

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