IN SEARCH OF THE MISSING CONDOS:
AN ANALYSIS OF THE CONDO DEVELOPMENT
MARKET IN THE PORTLAND AREA

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Since the Great Recession, there has been significant multifamily development activity in the Portland metropolitan area and across the country – but it has almost exclusively been rental housing and not for-sale multifamily (i.e. condominium) product. This article will attempt to uncover the main causes of this lack of condominium development in the local market and will also seek to answer if this trend is likely to continue over the next few years. In addition, we will explore if these issues are unique to the Portland market.

The analysis revealed that there are three core reasons underlying the lack of condominium development in the Portland metro:

1. A significant shift towards rental housing demand since the Great Recession, due to factors such as demographics, shifting preferences, changing home and work patterns, higher quality rental supply, and increased standards for qualifying for home mortgages.

2. The impact of failed or challenging condo projects on regulations and perceptions (for the developer, investor, and lender), and the resulting difficulty in

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obtaining capital for condo projects in the current cycle – both for developers and for prospective buyers of condo units.

3. The impact of construction defect liability claims on developer perceptions and on project risk and financial feasibility.

We will first examine the current state of Portland’s condo market and will then dive deeper into each of the core issues outlined above.

PORTLAND’S CONDO MARKET

After peaking at 3,500 sales in 2007, condo sales (of existing and new product) declined in Multnomah County for three straight years before beginning a steady five-year rebound, according to RMLS. Sales volume increased 22% in 2015 to 2,600 sales. Similar trends can be seen in sales of single family homes in Figure 1.

**Figure 1: Total Sales Volume, Multnomah County, 2002-2015**

As with sales volume, median condo prices have been rising for five straight years. At nearly $300,000 as of the first quarter of 2016, values have risen above the pre-recession peaks. A similar trend can be seen in the single family market, although prices have been rising at a faster rate – putting median condo prices at just over 80% that of single family homes, the lowest ratio in 15 years (RMLS).

As with sales volume, median condo prices have been rising for five straight years. At nearly $300,000 as of the first quarter of 2016, values have risen above the pre-recession peaks. A similar trend can be seen in the single family market, although prices have been rising at a faster rate – putting median condo prices at just over 80% that of single family homes, the lowest ratio in 15 years (RMLS).
One of the reasons that condo prices have been rising more slowly than single family prices may be due to the age of the housing stock – there have been very few new condos built since 2008. According to RMLS, after averaging nearly 3,900 new condo units built per year between 2002 and 2008, the Portland metropolitan area has since seen the average plummet to 600 units built per year. Multnomah County has seen only 160 new condo units built per year between 2009 and 2015. In contrast, apartment production has ramped up significantly in the MSA and the County since 2011 (CoStar).

**Figure 2: Median Sales Price, Multnomah County, 2002-2016 YTD**

Source: RMLS
Figure 3: Housing Units Built, Portland MSA, 2002-2015

Source: RMLS, CoStar
This trend looks set to continue, as multifamily permits are at or near record highs in Portland – but nearly all of the planned units are rentals and not for-sale condos (SOCDS).

**Figure 4: Building Permits Issued, Portland City, 1990-2015**

Source: SOCDS (HUD)
SHIFT TOWARDS RENTAL HOUSING

Since the financial crisis and Great Recession that began in late 2007, homeownership in the United States has declined from a peak of 69% to under 63% in the second quarter of 2016 - levels not seen since 1993, according to the most recent U.S. Census figures.

![Homeownership Rates, United States, 1965-2016](source: U.S. Census Homeownership Report)

Oregon and the Portland MSA have largely followed this trend, and as of the second quarter of 2016 the homeownership rate in the Portland metro sits at just over 61% - down from a peak of nearly 73% in 2005. The Portland MSA is about in the middle of the pack in terms of homeownership rates compared to other metros.

Harvard’s Joint Center for Housing Studies’ “State of the Nation’s Housing” report outlines some of the reasons for the decline in national homeownership rates, including: the negative impacts of the Great Recession on potential or existing homeowners (such as reductions in homeowner equity and credit scores), tighter lending requirements, declines in household incomes, increases in student debt, the aging of both the Baby Boomer and Millennial generations, and shifts in household composition (i.e. more singles and unmarried couples). In addition, changes in work type and tenure and in attitudes towards renting have also likely impacted the overall homeownership rate trend (Harvard 2015).
Figure 6: Homeownership Rates, Top MSAs, United States, Q2 2016

Source: U.S. Census Quarterly Vacancy and Homeownership Rates

Because of many of the reasons cited above, key target groups for condo developers, including first-time homebuyers, are increasingly choosing to rent instead of own their housing. This trend has been a headwind against new condo development in the Portland market and nationally. The result is that multifamily development has been dominated by rental product – nationally, accounting for over 90% of all multifamily starts over the past 5 years, versus a historical average of 80% (and a dip to 50-60% during the condo development boom in the mid-2000s). Overall, construction of condo units is running at about half of its pre-boom pace (Anderson 2015; Dietz 2015).
This also has been the case in the Portland metro, as we saw in our review of Portland’s condo market. In fact, an analysis of new housing units in the metro’s largest counties reveals that most of the new housing units built in the past 5 years have been renter-occupied – suggesting that in addition to the purpose-built rental products (i.e. apartments) in the market, renters have also been occupying new units traditionally built for ownership (i.e. single family homes) (OregonLive).
Figure 8: Occupancy Type of New Housing Units, Top Counties, Portland MSA, 2005-2014

RESTRICTED CAPITAL
The Great Recession clearly had a significant impact on condo development in Portland and nationally. Condos were disproportionately impacted during the downturn, as many investors who speculated on price increases in condo towers were unable to make loan payments once demand (from both potential renters and future buyers) froze up, or in some cases walked away from purchases before closing. This impacted perceptions and subsequent actions of banks, developers, and government entities. Many banks, especially ones that had to deal with foreclosed condo units, simply stopped lending to both developers (for construction) and prospective buyers (for purchases of units). Most developers, unable to receive traditional financing and concerned about lack of demand for units, stopped developing condo projects.

Perhaps most significantly, the main Government Sponsored Enterprises – Fannie Mae, Freddie Mac, and the FHA – changed their policies after the Great Recession in ways that made it harder to purchase condo units. As the main purchasers of mortgages in the United States, accounting for half of all mortgage securitization nationally, these policy changes impacted all lenders. These policies included restricted limits on such things as the percentage of units that could be rented in a project, the number of units that could be owned by a single entity, and the percent of units late in paying their condo association dues. The result of these policies is that many condo projects became “unwarrantable” – in other words, the GSEs would not “warrant” them because they did not fit the new criteria – and this meant that
loans effectively couldn’t be made on units in these projects (U.S. HUD 2015; Fannie Mae 2014; Freddie Mac; Gibbs 2014; Glink 2013).

As financing became difficult or impossible to find for purchasing condos, the share of units purchased entirely with cash (and no loan) nationally increased from around 27% prior to the downturn to a peak of 62% of all units in 2012 (Yao 2015). The past few years have seen an increase in loan originations for condos and a decrease in all-cash purchases, in part a result of the GSEs easing up their policies. However, financing remains difficult to access, and all-cash sales are still significantly higher than prior to the downturn.

Figure 9: Condo/Co-Op Mortgage Originations, United States, 2000-2015

Source: CoreLogic

Multnomah County reflects these national trends: all-cash sales have been between 30%-40% of all condo sales since 2009, compared to rates below 20% before 2007 (RMLS).
Figure 10: All-Cash Share of Total Condo Sales, Multnomah County, 2002-2016 YTD

Nationally, there are a number of core condo markets (including Florida, Nevada, and New York) whose all-cash sales have been between 70%-80% of total condo sales – a sign that in the more built-up markets that had more distressed sales after the downturn, financing for purchasing a condo unit is especially difficult (Vitlo 2014).
The John Ross Tower in Portland is a local example of the impact of the Great Recession on condo development. The 303-unit tower in Portland’s South Waterfront neighborhood opened its sales office in 2005 – and took reservations for 229 units in 6 days. However, as the beginning elements of the recession and housing downturn came on in 2007, many of those reservations backed out of their sales closings. Unit buyers couldn’t get mortgages, and some got scared that prices would no longer keep going up. By 2009, the project’s developers lost the project to its lender, which then proceeded to auction off units at prices that were 50% off the original list prices. The developers lost their property (and the investment of their equity partners), the bank had to auction off the units at cut-rate prices, and early buyers saw their home values plummet once the auction re-established market prices for the building (Frank 2010). Fast forward to the present: Homer Williams, owner of one of the development companies behind the John Ross project, told the Portland Business Journal that condo development is “not a path that we’re on at all.” According to Williams, many developers got stung in the downturn and have not warmed to the idea of a large condo project (Bell 2015). In addition, margins can be higher for apartment projects, which also have fewer complications (i.e. liability) as compared to condo projects.

Banks and other capital providers (including the GSEs) have increased multifamily lending every year since 2009 (Urban Institute 2016). However, as apartments now represent over 90% of multifamily starts nationally, the bulk of this financing for development is going towards building apartments and not towards condos.
LIABILITY ISSUES

In addition to the challenges presented by changes in demand and available capital, developers of condo projects must also face another obstacle – liability issues. Following the Great Recession, there was an uptick nationally and in Oregon in construction defect lawsuits brought on by homeowner associations against developers and contractors. In Oregon, there is a 10-year statute of limitation on liability (the “statute of repose”), so developers and their insurers have a responsibility for a decade after a project is developed. In fact, it is common for homeowner associations to bring on lawsuits around Year 8 or 9, just prior to the end of the statutes of limitations, and in many cases the associations may even be found liable for breach of fiduciary duty if they do not file lawsuits within this timeline (Oregonlaws.org; Eyth 2016).

Developers can mitigate their risk by purchasing “wrap-up” insurance policies (also known as Owner or Contractor Controlled Insurance Product), where one policy covers all the participants in a development, including the developer, his general contractors, and sub-contractors. However, these policies often have various limits and exclusions which can still leave developers open to legal liability. In addition, these policies are an added cost – and can be a burden on the financial pro forma, especially for smaller projects or developments with lower-priced units. For larger projects, the cost per unit in Oregon tends to be $2,000-$4,000, or generally about 1%-2% of the unit sales price, and coverage is typically $25,000-$50,000 per unit (Page 2016). The added cost and risk and coverage limits likely favors the develop-
The potential liability, as well as the time and cost that could be involved in litigation, can be a deterrent of development. Chris Nelson, Principal of Portland-based developer Capstone Partners, told the Portland Business Journal: “the insurance, the reserves you have to set aside for future claims and the management of all that stuff, I have no interest” (Bell 2015). The Portland market has seen its share of construction defect lawsuits, including an ongoing case involving leaky plumbing valves in multiple buildings. Importantly, when a project is involved in litigation – which could take years, as is the case with the plumbing lawsuits – lenders will typically not issue loans for units in the project (Njus 2015). This leads to difficulty in selling units and is one of the reasons that all-cash purchases have become increasingly common in Portland and across the country.

Developers in other states must also deal with construction defect liability issues, and there have been recent attempts to mitigate the impact of these laws. Nevada passed the Homeowner Protections Act in 2015, which restricts the definition of what constitutes a home defect, repeals a provision allowing attorney fees and costs in a home defect judgment, requires specific descriptions of defects, and, importantly, reduces the statute of limitations to 6 years (from up to 10 years in current law) (Hudson 2015). Cities across Colorado have also recently enacted legislation to mitigate construction defect laws, with the express intent of encouraging condo development, especially at relatively affordable price points. Denver’s City Council adopted a law at the end of 2015 that requires consent of a majority of homeowners (and not just Board members) before litigation can be pursued, requires alternative dispute resolution (arbitration or mediation), eliminates technical code violations as causes for action, and requires that actual damages, injury, or risk be demonstrated (Fernandez 2015).

LOOKING AHEAD

Despite the challenges outlined in the above sections, there are many potential tailwinds that should help to boost condo development in Portland and across the country. First, demographics favor homeownership in the long-term. According to CoreLogic, household formation across the country doubled in 2015 compared to 2014 as an improving economy allowed more young people to get into the labor force and out of their parent’s house. The youngest members of the Millennials, who are helping to drive growth in the rental markets, will enter prime first-time homebuying years over the 5-8 years – and surveys consistently show that members of this generation have similar desires to own homes as their parents’ generation. Affordability issues, delayed family formation, and desire for proximity to work and amenities should mean that many of these future first-time buyers will be looking at condo units as
choices for homes – if they can find condos that meet their needs and budgets. In fact, the NAR reports that the older segment of Millennials are currently the largest group of home buyers, but that they are not finding affordable product in city centers; the NAR’s chief economist, Lawrence Yun, noted that “limited inventory in Millennials’ price range, minimal entry-level condo construction and affordability pressures make buying in the city extremely difficult for most young households” (NAR 2016). In addition, the largest cohort of Baby Boomers will reach retirement age in the next 5-8 years, and should fuel demand for “empty-nester” condos. These trends should impact Portland as well as other major metro areas across the country (Nothaft 2015).

**Figure 13: Population by Age Cohort, United States, 2014**

In fact, Portland is currently playing “catch-up” in building its housing stock, as the Oregon Office of Economic Analysis estimates that despite overbuilding 10,000 units between 2000 and 2005, the MSA “underbuilt” by 20,000 units between 2006-2014 (taking into account the historical number of housing permits per new residents) (Lehner 2015). This helps to explain the strong price growth seen in condo and single family prices the past few years, as demand is likely outstripping existing supply – and suggests that new development, especially of lower-priced units, would be successful even in today’s market.
Second, the main GSEs – Fannie Mae, Freddie Mac, and FHA – have either relaxed, or signaled that they would ease, the stringent regulations imposed on condo units (and condo projects) in the wake of the Great Recession (Dawson 2014; Harney 2016). This should lead to more projects that are “warrantable” – and therefore to more condo units that can get traditional financing, including FHA loans, which are especially important for first-time buyers. This will likely have a ripple effect – as the GSEs increase the number of financeable condo units, more buyers will be able to purchase units, which will help convince banks that they can lend on the construction of new condo projects. With limited new inventory in most markets, the easing of financing should help to stimulate the development of new units.

Third, the wave of legislation in various municipalities across the country that is reinig in construction defect lawsuits could spread to other areas – including to Oregon or Portland. As cries for affordable housing in the Portland metro increase in intensity, it is conceivable that lawmakers could help to mitigate the litigation issues that are keeping some developers on the sidelines. Liability issues will also keep many apartment projects from converting to condos as demand ramps up, as many contractors require that owners and developers agree not to convert their projects to condos during the statute of limitations period – providing more of a boost for new condo development (Eyth 2016).

And lastly, in Portland there is discussion currently in the City Council about “middle housing” zoning options for increased density within single family neighborhoods. If adopted in the upcoming Comprehensive Plan, this re-zoning of certain areas of the city could encourage small-scale condo development, in the form of pro-
jects of 2-4 units (Redden 2016). Portland has also seen a rise in the development of accessory dwelling units, or ADUs, on single family home lots. These ADUs have typically been used by the homeowner or rented out, but there are a few developers who have turned ADUs (and the home with which they share a lot) into condos, bringing a relatively affordable for-sale option into close-in areas that have seen rapid price growth (Law 2016).

Condo development has indeed come back in certain parts of the country, such as Miami and New York City. Nationally, the condo share of all home sales is approaching pre-recession levels of around 12% (Khater 2014). In Portland and Seattle, the first condo projects are nearly completed, and have had success with pre-sales. It is unlikely that Portland will experience a condo boom like the mid-2000s, but there are many reasons to believe that it and the rest of the country will continue to see a resurgence of condo development as long as strict financial regulations (such as FHA mortgage rules) are eased and frivolous construction defect lawsuits are mitigated.

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