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# **CENTER FOR REAL ESTATE**

## **Quarterly Journal**

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Volume 4, Number 3

Summer 2010

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## SUMMARY AND EDITORIAL

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While the recession has been declared officially over for more than a year, many parts of the economy are waiting for recovery. Real estate is one of those parts. Much of the real estate market is relatively flat. Even so, some market participants are beginning to see improvement. For example, this journal's **residential market analysis** finds that an increase in sales activity has been partially offset by a slight decline in median prices. At the same time, our **multifamily market analysis** reports that owners and managers are seeing improved conditions to the point that some have scaled back the use of concessions and introduced modest rent increases. This issue of the *Real Estate Quarterly* focuses largely on the causes and consequences of what has been called the "Great Recession."

Real estate markets, and housing in particular, have taken much of the blame for the current recession. Many hope that fiscal and monetary policies can correct what they see as failures in the market. **Randall Pozdena** takes a different approach. He argues that monetary and other government policy interventions set the housing market up for a fall. In addition, the "bail out mania" that has dominated federal policies in the wake of the recession has gotten in the way of the forces of supply and demand and may have the effect of dragging out the recession rather than stimulating the economy.

The recession's impact on credit markets has produced a paradox. We are now in an era of rock bottom interest rates and high levels of liquidity. At the same time, we are in an era of constrained credit in which borrowers can neither take advantage of the low rates nor obtain loans to pursue their projects. For borrowers that can overcome the cash costs and other challenges of refinancing, however, **John Petersen** sees some sparks of activity.

**Julie Serote** reports that the disappearance of financing and equity from the real estate market means that developers are no longer following business models from years past. She finds that developers who continue to survive utilize their entrepreneurial and creative skills to form new business models in order to keep the lights on.

On the fiscal side of the economy, Oregon again faces challenges from its public employee retirement system, known as PERS. From reporter at *Willamette Week* to Oregon's secretary of state, **Phil Keisling** has spanned the state. In this issue, he writes on the future of the state's public employee pension system. He finds that a combination of factors—especially the recent recession which has impaired PERS' investment returns—mean public employers will face steep increases in payroll costs over the next decade. These increases will likely exacerbate future state and local budget problems as employee costs rapidly rise. In turn, state and local governments will be pressured to increase revenues through higher taxes, fees, and charges.

Turning away from the economy, **Walter McMonies** examines an overlooked and under-reported issue affecting many Oregon buildings. Portland is home to numerous unreinforced masonry apartment buildings, many of which has historic or architectural importance. At the same time, Western Oregon and Washington have been identified as being subject to massive if infrequent “subduction zone” earthquakes. Mr. McMonies reports that the owners of unreinforced masonry apartment buildings can expect to face pressure from casualty insurers, mortgage lenders, and the local government to seismically reinforce their buildings. He explains that in many cases such efforts do not “pencil out” in that the costs of the reinforcement likely exceed the expected incremental cash flows from the effort. He argues that building owners, architectural preservationists, structural engineers, mortgage lenders and insurers, and city and state officials need to work collaboratively to reduce impediments to and increase incentives for seismically upgrading affected apartment buildings.

Despite the recession, something new is happening almost every day in Oregon's real estate markets. To chronicle that news, I have created a feed of news stories involving Oregon real estate. It covers almost every paper in the state, including *Portland Business Journal* and the *Daily Journal of Commerce*. I have done my best to filter the results to get only relevant real estate related news stories. Even so, there may be some “junk” stories that will pop up. This is a work in progress that will require some tweaking. For most web browsers you can simply paste this link into your address bar: <http://bit.ly/PSURealEstate>.

This is my first issue editing the *Real Estate Quarterly*. I welcome any constructive comments and ideas for future issues. If you would like to submit an article, please feel free to contact me. All the best.



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## HOUSING AND THE ECONOMY: A NEW PARADIGM?

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RANDALL J. POZDENA

QuantEcon, Inc.

Many see activities in the housing and mortgage markets as causes of the current economic malaise and monetary and fiscal policies as a reaction. This article challenges this notion and argues that the current recession, like most prior recessions in history, did not arise because of endogenous problems in the housing sector but rather because of policy interventions that set the housing market up for a fall. The article discusses what this perspective says about the likely path of recovery and the efficacy and necessity of the administration's interventions to spur recovery.

The connection between housing and the economy has always been intimate. For decades, in fact, the housing sector was the channel through which monetary policy influenced the pace of the economy. Today, many attribute the current economic malaise to problems that originated in housing and mortgage markets. Monetary and fiscal policy changes are seen as the consequence, rather than the cause, of the depressed housing market.

This article challenges the notion that this represents a new paradigm in the relationship between economic policy and the housing sector. Rather, I argue that the current recession, like most prior recessions in history, did not arise because of endogenous problems in the housing sector but rather because of policy interventions that set the housing market up for a fall. Along the way, we discuss what this perspective says about the likely path of recovery and the efficacy and necessity of Obama administration interventions to spur recovery.

## THE OLD DAYS

In most of the post World War II decades, monetary policy exploited anomalies in banking and mortgage policy to regulate the real economy. If the central bank wanted to slow an overheated economy, it did so by elevating interest rates and, thereby, the cost of mortgage credit. Higher mortgage rates would slow the rate of new home sales and with it, the level of construction activity, appliance sales, and furniture sales. The resulting, sharp reduction in aggregate demand for these products would propagate throughout the economy and slow the pace of income and output growth.

The connection between Federal Reserve policy, housing and the economy was amplified in most of the 20th century by the nature of financial products that banks and savings and loan associations could offer. First, banks were restricted from paying interest on bank deposits. As a consequence, when market interest rates increased, a process known as disintermediation occurred. Depositors would withdraw their funds from non-interest paying depository institutions and buy interest bearing instruments from brokerage firms and government borrowers. With fewer deposits on hand, lending contracted sharply.

Because our banking system, like most modern banking systems, is a fractional reserve system, withdrawal of small amounts of deposits would cause much larger, system-wide reductions in lending as the loss in reserves (vault cash and deposits at the Federal Reserve bank) necessitated reduction in lending by an amount that was a multiple of the deposits withdrawn. This disintermediation channel persisted until innovations in methods of providing checkable access to non-bank balances and, ultimately, the abandonment of Regulation D, reduced the virulence of disintermediation.

The other phenomenon that helped create a channel for monetary policy to influence housing was the nature of mortgage instrumentation and regulation. Specifically, most home mortgages were standard, self-amortizing fixed rate loans. Cycles in interest rates translated directly into changes in mortgage payments on new loans. Adjustable-rate mortgages and mortgages with whose contract rate and amortization features could vary with the interest rate cycle were uncommon. Whereas today mortgage instruments allow payments to grow over time with the households' ability to pay, the standard fixed rate mortgage made access to mortgage credit more difficult during high interest rate parts of the business cycle. Other innovations, such as longer mortgage terms, mortgage insurance, and inclusion of spousal income in loan qualification standards, increased the resilience of mortgage credit flows to interest rate shocks.

By the 1980s, weakened disintermediation processes and more flexible mortgage instrumentation limited considerably the impact of monetary policy on housing and mortgage markets. Coupled with a new Federal Reserve operating strategy introduced under the chairmanship of Paul Volcker, the stage was set for economic growth to be much less volatile than in earlier decades. This is precisely what happened. By the end of the 1990s, journals such as *Foreign Affairs* went so far as to herald the end of the business cycle (Weber, 1997).

## GOVERNMENT CAN'T KEEP ITS HANDS OFF HOUSING

The 1980s and 1990s were a period of prosperity, as the high inflation and interest rates of the Carter years were replaced by a steady downtrend in both indicators. Coupled with reductions in marginal tax rates initiated in the Reagan years, the 1980s were particularly



prosperous, and prior budget deficits gave way to modest surpluses in the Federal budget. The stage was set for an extended period of prosperity, and growth and stability in the housing sector.

Unfortunately, politicians do not get rewarded for husbanding the status quo. Prosperity allows politicians to believe that they now have the latitude to “do good” by intervening in the way the economy is distributing the resulting economic largesse to its citizens. In particular, the notion of credit “democratization” became a hallmark of Clinton administration banking policy. An old mythology dating from the Carter years was resurrected, and various policies were put in place to address the alleged tendency for mortgage and other lenders to discriminate against protected classes of individuals or certain communities in their application approval processes.

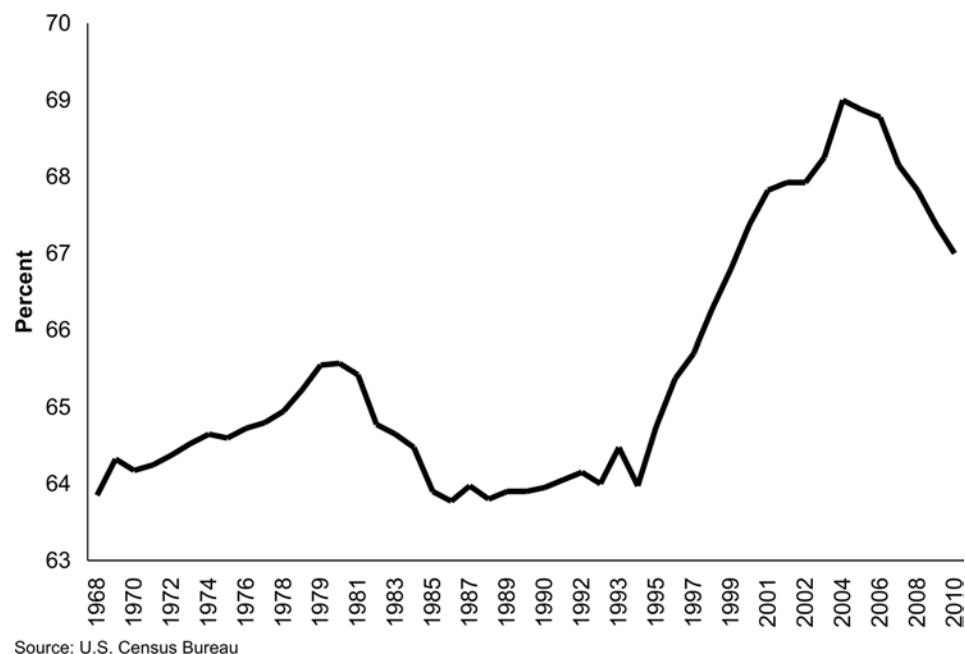
As a result, a series of initiatives were undertaken in the mid-1990s to aid the “democratization” and anti-discrimination initiative and to provide additional tax incentives to home buyers. This included plans to send “testers” (individuals posing as borrowers) into the offices of lenders to see how they were treated, passage of reforms of the Community Reinvestment Act (CRA) to hold banks to the same ratios of loan rejection across races and communities, applying pressure to the secondary mortgage market makers (e.g., Fannie Mae and Freddie Mac) to adopt looser standards in their definitions of conforming mortgages, and the passage of the 1997 Tax Act, that allowed capital gains tax exemption on homes held for as few as two years.

For its part, the investment banking community provided securitization services to help get pools of substandard loans into the hands of investors, thereby channeling funds that fueled the democratization process. Indeed, in 1997, the ill-fated Bear Stearns investment bank was underwriter on the first security backed by Community Reinvestment Act loans. The success of this sale was heralded by the Comptroller of the Currency and other regulators, as were the aggressive efforts by Countrywide Bank and others to market loans to sub-par quality credits.

The cheerleading of junk lending by regulators, the Clinton administration, and community groups was combined with laxer standards and higher leverage permitted at the government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. These GSEs are important secondary mortgage market makers via provision of credit enhancement. In the name of democratization of credit, they tilted credit flows sharply toward home ownership in general, and homeownership by poor credits in particular. These policies began in earnest in the mid-1990s, and their distortionary effect on home ownership rates can be easily seen in the figure below. Homeownership jumped nearly five percent, drawing in many households lacking the job stability and credit-worthiness to take on the burden of home ownership.

## DEMOCRATIZATION BITES THE HANDS THAT FED IT

Non-market credit allocation is never a good idea, but it is a particularly bad idea when the distortions are glossed over by the eagerness of social engineers to “do good.” Although 1990s housing policy was creating a ticking time bomb of poor credit, few people sounded the alarm. Although there was no mistaking the trend toward junk mortgage lending, attention was not focused on the accumulating risks, but rather the seemingly good things that were happening as a result of the policies. In 1997, in a speech in New York, for example, Eugene



**Figure 2.1** The Effect of Mid-1990s Credit Democratization on Home Ownership Rates

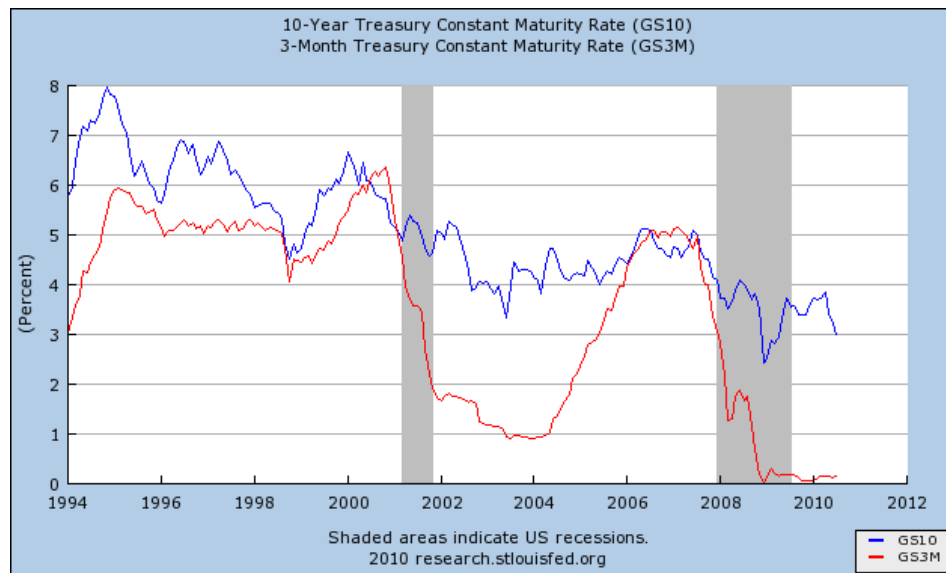
Ludwig, Comptroller of the Currency, spoke with pride of the fact that lending to protected classes and communities was growing faster than lending to borrowers with traditional credit profiles.

Liberal economists also let the goals of the policy blind them to the looming risks in the mortgage market. In 2002, Nobel laureate Joseph Stiglitz and Peter Orszag co-wrote an article for Freddie Mac that concluded that the risks to the secondary market and holders of mortgage backed securities were extremely small (Stiglitz, Orszag, and Orszag, 2002):

The paper concludes that the probability of default by the GSEs is extremely small. Given this, the expected monetary costs of exposure to GSE insolvency are relatively small—even given very large levels of outstanding GSE debt and even assuming that the government would bear the cost of all GSE debt in the case of insolvency.

Indeed, the sprinkling of a bad credit here and there in the loans backing mortgage bonds would not have posed a serious risk to the housing market or the economy. The problem, however, was that events were to unfold at the Federal Reserve Board that sent a synchronized shock throughout the mortgage market.

Specifically, after abruptly drawing back the excess liquidity that it had injected in anticipation of a calamitous Y2K event, the Fed found itself with a recession on its hands. Chairman Alan Greenspan spearheaded a sharp decline in the Federal Funds rate that persisted from 2001 to 2004–05, with the aim of engineering a sharp recovery from the recession. The low rates added further fuel to the distorted mortgage market by increasing the spread between short and long rates. The low short-term interest rate environment also exaggerated the use of adjustable rate mortgages.



**Figure 2.2** The “Greenspan Put”

Home price appreciation accelerated, creating the impression of high returns to housing investment. Capital gains tax reforms policies encouraged short-term ownership and “flip-ping” of homes to capture the tax-free capital gains appreciation. On top of this, momentum-based investment strategies drew in inexperienced investors who naively thought that such appreciation can go on forever and tend to think that they will be able to bail out of the market before it turns down.

Unfortunately, a combination of rising oil prices and asset inflation lead the Fed to believe that the economy and prices were becoming overheated. In 2004, the Fed abruptly raised rates with a rapid succession of rate hikes totaling nearly five percentage points. The abrupt removal of cheap credit revealed the poor quality credits for what they were. Instead of mortgage bond holders having to absorb losses from a few, random badly made mortgages, the market suddenly faced a systematic, simultaneous deterioration in the quality of the assets backing mortgage securities and lender portfolios.

The diffusion of credit risk among many investors and the “stripping” of mortgages into tranches of varying levels of risk had been thought to be protective in an environment of junk lending. It could not be protective, however, in an environment of systemic risk. The synchronous weakening of investor and bank portfolios everywhere posed a huge threat to the functioning of financial intermediation in a fractional reserve banking world. Financial institutions big and small teetered on the edge.

## BAIL OUT MANIA

Few economists question the need for central bank intervention in a setting in which the supply of loanable funds is collapsing exponentially. Financial intermediation is a crucial

lubricant of economic activity. Hence, the steps taken by the Fed and the Treasury in the waning months of the Bush administration likely were needed to quell a much more rapid decline in financial activity.

Unfortunately, the new Obama administration chose to take steps that had little prospect of bootstrapping the economy, and most likely aggravated the recession. Specifically, the Obama administration resurrected long-discredited classical Keynesian policies under the guise of “fiscal stimulus.” Under this notion, the taking of private resources and spending them in the public sector somehow is supposed to stimulate the economy. In fact, of course, public spending can increase only by either taking current resources from the private sector (through immediate taxation) or by saddling the private sector with debt (i.e., a burden of taxes to be collected later).

In addition to a giant \$870 million fiscal stimulus program, the Obama administration engineered programs specifically targeting the housing sector. Unwilling to let market forces deal with the imbalance in housing supply and ability to pay, the administration crafted dozens of programs to try to keep these inevitable forces from working to restore balance between housing supply and demand.

There are several key features of the policy initiatives. First, there were efforts to encourage banks to renegotiate mortgage terms for those borrowers who, in all probability, should never have been given a mortgage in the first place. Most of these efforts simply prolonged the inevitable, since these borrowers were self-selectively financially naive, lacking in sufficient income or over extended speculators. Hence, the net macroeconomic effect of this program was to delay the adjustment of housing supply and demand to correct the imbalances caused by the earlier, imprudent efforts to democratize credit.

A second key feature was the extension of the Mortgage Forgiveness Debt Relief Act, first passed by Congress at the end of the Bush Administration, but extended through 2012 under the Obama administration. This act removed an important disincentive to a home owner walking away from a mortgage loan. Specifically, under long-standing IRS regulations, if a homeowner walks away from a mortgage, the value of the mortgage left unpaid is considered income to the homeowner and subject to federal income taxes. This policy provides a strong disincentive to letting a home go into foreclosure even if the home’s value has fallen below its loan obligation. By removing the tax burden associated with walking away from a mortgage loan, this policy has the perverse effect of accelerating, rather than containing, the pace of foreclosures.

A third policy tried to address the weakened demand for housing by subsidizing (through tax credits) the purchase of homes by first-time homebuyers. Like the “Cash for Clunkers” program in the automobile market, this program’s only effect is to create a temporary strengthening in prices, followed by a likely equal or larger weakening when the program is over. Hence, it is yet another program with no prospects of positive effect, but at the cost of further enlarging the deficit.

A fourth policy is so-called financial reform. Policy makers have refused to accept that government intervention in mortgage markets was the precipitating cause of the current housing market and macroeconomic malaise. Instead, the financial agents that accommodated to these distortions have become the target for blame, and the justification for further government involvement in the marketplace. Instead of focusing on restoration of a normally functioning banking market, policy makers have chosen to focus on creating a diversion from their culpability by lambasting industry participants.

## THE FUTURE FOR HOUSING AND THE ECONOMY

In my view, the Keynesian stimulus policy pursued by the Obama administration has done little to restore or preserve economic growth and employment. It has distorted Fed policy by adding long-term debt management challenges to the Fed's already-full plate. It has also increased the temptation to bring down deficits through repeal of the Bush-era tax rate cuts and increases in Social Security and Medicare payroll tax rates.

The Obama administration's "Cash for Clunkers" and first-time homebuyer tax credits have only further served to aggravate the deficit, with little or no net effect on the target markets except to shift purchases in time. Its persistence with, and extension of, the Mortgage Forgiveness Debt Relief Act has very likely amplified the number of homeowners walking away from their mortgage debt. Such an effect would further depress, rather than stimulate, home prices and cause further foreclosures and slow the re-entry of investment in housing.

As Stanford economist John Taylor testified before Congress, cycles in the economy are much more strongly related to investment activity than government spending (Taylor, 2010). Ironically, Obama's own Chair of his Council of Economic Advisors, Christina Romer, concluded in a recent paper published with her economist husband that, indeed, tax cuts, rather than fiscal stimulus with tax increases, is most likely to stimulate economic growth (Romer and Romer, 2010). Thus, the depression of investment caused by the threat of higher tax rates on high-income households and the Administration's perverse approach to the home-price and foreclosure problem continue to threaten recovery.

As two decades of missteps by Japanese policy makers has illustrated, the pursuit of Keynesian policies, enlargement of deficits, and tax rate increases—if continued—will only lengthen economic malaise. The first series of Japanese fiscal stimulus programs (begun in 1991) totaled 21 percent of annual GDP. By way of comparison, ours was 5.5 percent. Add in Japan's subsequent 5.1 percent package in 1998, and it makes one wonder why there remains in the U.S. a call from some for further fiscal stimulus. All such behavior got Japan was a 180 percent debt-to-GDP ratio.

In sum, investment in general, and housing investment in particular, remain important channels of economic growth. Under current policies, unfortunately, we seem bent on delaying the reinvigoration of these channels. ■

**Randall J. Pozdena** is president of QuantEcon, Inc., an Oregon-based economics, finance and planning consultancy. He is the author of the textbook, *The Modern Economics of Housing*. The views expressed herein are the author's alone.

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## INTEREST RATES: WHAT GOES UP MUST COME DOWN

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JOHN M. PETERSEN

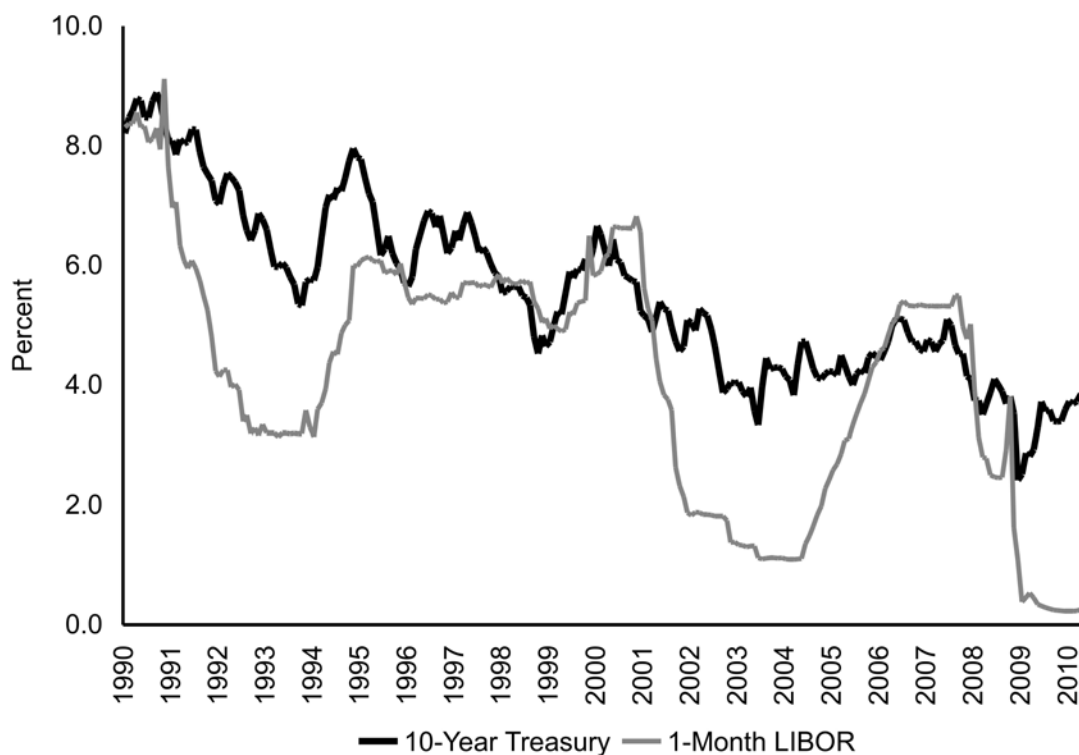
Melvin Mark Capital Group, LLC

What an interesting time to be asked to write something about interest rates! Our practice emphasis is commercial real estate capital markets (also known as finance and investment). I will use this opportunity to discuss rates in that context. I will also attempt prediction as to future rates. However, with comfort, it would be difficult to do worse than recent consensus.

“Interest rates” mean different things to different market participants. In addition the market is faced with many different interest rates: LIBOR, SWAPs, prime, SFR mortgages, Treasuries, Fed funds, bond rates, and so on.

My comments will focus on those facets of the interest rate universe that impacts commercial real estate the most: the 10-year Treasury in particular, but also cap rates, the yield curve, LIBOR, and risk spreads. The U.S. Treasury bond rate is the standard for risk free, fixed income investing. Treasuries are viewed by many as a barometer of market sentiment, anticipating both central banker behavior and global economic trends; the forecast is worrisome. Treasuries span durations ranging from from 3 months to 30 years. At the start of the year there was strong consensus of rising rates on Treasuries over the second half of 2010. When the investment world becomes unpleasant or uncertain, as has happened several times this year, investors move toward what they expect to be safer investments. This “flight to quality” drives bond yields lower and bond prices higher. We have now had a series of runs taking the yield on the 10-year Treasury from more than 4 percent to less than 3 percent This is in contrast to earlier forecasts that predicted increasing yields. The

market has set and reset record lows for 2-year Treasuries and have seen decades-long lows for 5- and 10-year Treasuries.



Source: Federal Reserve System; wsjprimerate.us

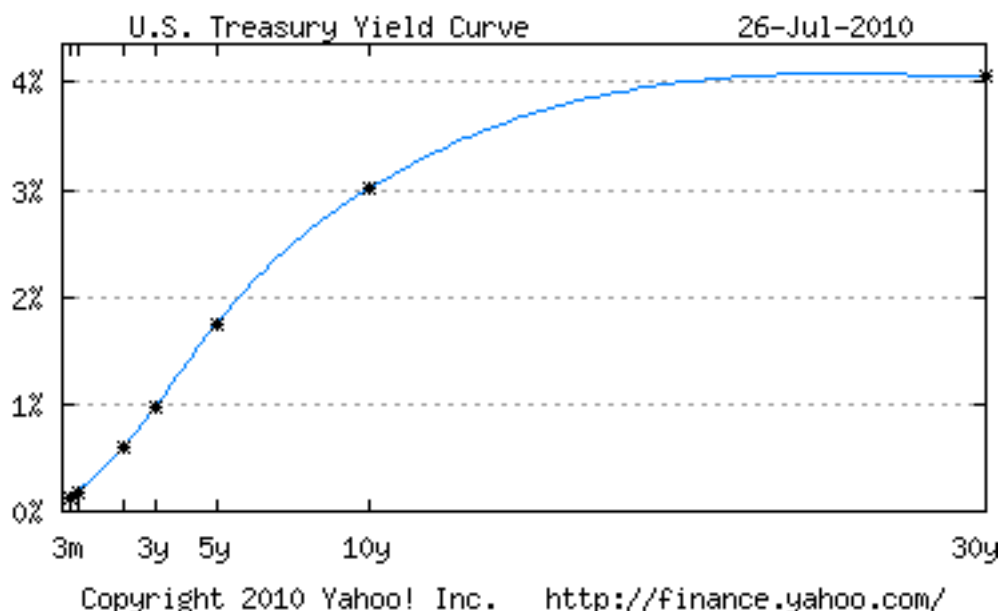
**Figure 3.1** Interest rates on 10-year Treasury and 1-month LIBOR, monthly, 1990–2010

As the standard for risk free returns, Treasuries are commonly used to benchmark pricing for mortgage loans or bonds. Typically, these instruments add a risk spread or premium to the quoted benchmark. Top rated bond risk, for corporate or mortgage backed instruments, termed “AAA,” is defined as best quality or “*nearly* risk free.” Commercial mortgage-backed securities, or CMBS, typically are separated into series of tranches from rated from lower risk (e.g., AAA) to higher risk (e.g., B). The blended pricing from all the tranches drives the loan pricing and the profitability on securitization and sale.

At the height of the capital markets surge approximately three years ago, the AAA CMBS tranche priced at 25 basis points over Treasuries with the same maturity. A basis point is 0.01 percent, so 25 basis points is the same as 0.25 percent. At the peak of the correction following the bubble two years ago, AAA spreads were as high 1000 bps (i.e., 10 percentage points) higher than Treasuries and there were few if any takers. In fact, CMBS took a two year hiatus. Life insurance companies, traditional source of long term fixed rate mortgage financing, have returned cautiously. More recently, the best pricing on high quality properties has improved to 200 basis points over Treasuries, down from twice that 18 months



ago Even so, these more favorable rates are seen only on “least risky” assets with leverage levels of 55–60 percent.



**Figure 3.2** U.S. Treasury bond yield curve, 2010

The “yield curve” describes the difference in yields among bonds with shorter maturities and those with longer maturities. The yield on a 30 year U.S. Treasury typically is higher than the yield on a 1 year U.S. Treasury. The higher yield reflects a number of factors, such as inflation uncertainty, that make holding a long-term security riskier than holding a short-term security. Currently, shorter maturity Treasuries are at record lows and they the yield curve is historically steep. Other short term rates are facing near-record lows. For example, the Fed Funds rate is 0.25 percent, money market rates are between 0.10 percent and 0.20 percent, and 1-month LIBOR stands at 0.33 percent, all at or near all-time lows.

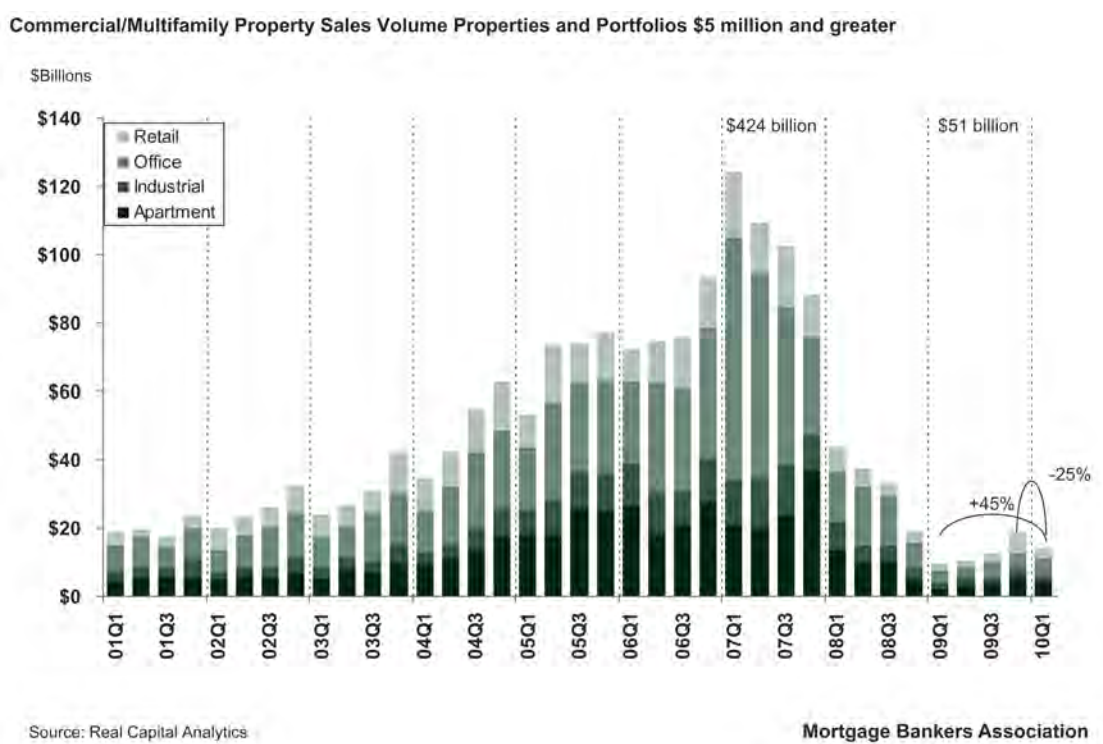
Part of the demand pressure on shorter term Treasury rates has resulted from the capital accumulation following the subprime liquidity crisis. Once the capital markets began to return, those with access to capital took advantage. Banks and life insurance companies currently hold close to double their historical levels of liquidity. Real estate investment trusts (REITs) and opportunistic funds have accumulated war chests. Public companies in every sector have taken advantage of recovering bonds markets to build historically high levels of cash. That massing of liquidity competes for safe, short term yields, while awaiting productive deployment.

The market seems primed for activity once a catalyst gets it started. Mortgages or mortgage bonds represent one of several fixed income alternatives available to investors. Current rate levels are very attractive from a borrowers perspective, while at the same time,

lenders find mortgage spreads relatively attractive both historically and compared to alternative fixed income investments.

Many commercial loans, however, include payment protection. Prepayment protection is typically provided in the form of prohibition, yield maintenance or defeasance. Yield maintenance calculates a “make whole” prepayment penalty while defeasance provides for preservation of scheduled payments from replacement bond collateral. The steep yield curve makes either very expensive from a borrowers perspective: borrowers must give up substantial cash up-front to obtain the savings from lower interest rates. As a result, early refinance has become very challenging, frustrating borrowers and lenders alike.

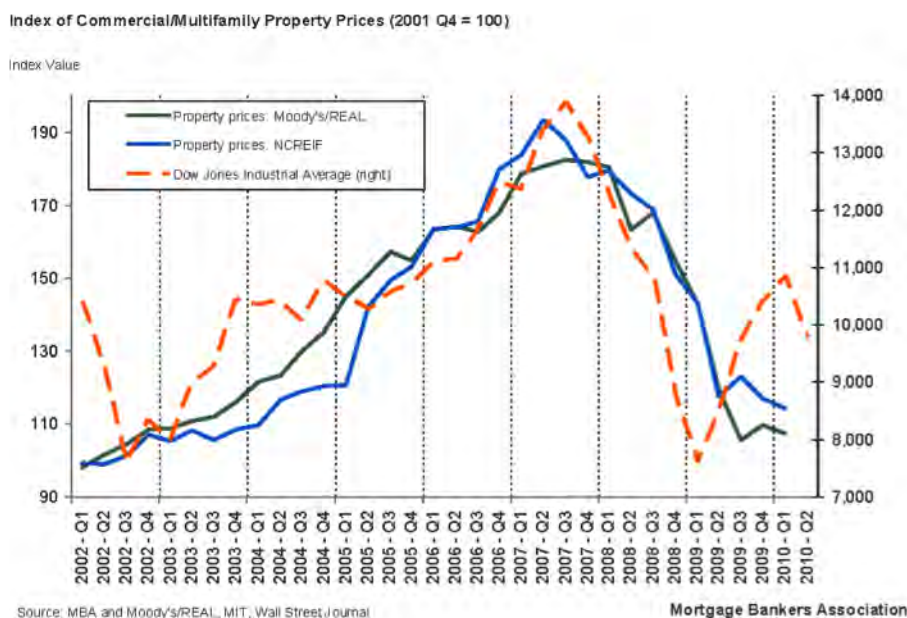
A “cap rate” is the ratio between the net operating income (NOI) produced by an asset and its capital cost (the original price paid to acquire the asset). Cap rates had compressed or tightened to historic lows at the peak of the capital markets surge in 2007. A dramatic reduction of (nearly 90 percent) in commercial real estate sales volume since that peak, however, makes market cap rate data scarce. At the market peak, cap rates were tightly grouped without much differentiation between markets, asset types or relative quality. Today, there is drastic differentiation, with bottom tier assets drawing little market interest except from all-cash opportunists.



**Figure 3.3** Small transaction volume means a lack of meaningful comparable cap rate data

The availability and cost of debt affects the price buyers are able or willing to pay for commercial real estate assets. Easy access to historically aggressively sized and priced

debt at the peak of capital markets surge influenced valuations three years ago, as have the ebbs and flows since. The gradual return of debt availability over the past two years has supported a return of valuation growth, although this has been mostly true of top tier assets and multi-family which enjoy more favorable access to debt. After peaking in 2007, valuations fell by as much as 40 percent or more depending on asset particulars, and have recovered modestly this year. Now, values have reset on average to where they were in 2000.



**Figure 3.4** The rise and reset of property prices and other equity investments

Positive leverage depends on the relationship between the cap rate and the cost of debt, either enhancing or diminishing the investment return. With cap rates having reset to historical or higher levels and debt pricing at or near historical lows, positive leverage has been restored at least with regard to top tier assets. However, earlier this year we shared forecast concerns about the risk of rising Treasuries becoming an issue for owners who had not yet refinanced. We now expect a more gradual upward shift, delayed until the year's end or early next year. Offsetting global pressures should cause this to be a more subdued and extended recovery cycle.

We are seeing the best mortgage pricing currently at 5 percent or less for 10 year borrowing, and 4 percent for 5 year borrowing. This results from accommodative central banker policy and something of a "perfect storm" of too much capacity competing for too few transactions. When the market begins to find supply/demand equilibrium, we may see rates moving back toward more normal favorable levels into next year, with 10-year loans in the 5.5 percent to 6.5 percent range and 5-year loans approaching 5 percent. Beyond that we see the 10 year Treasuries working back toward a more low/normal 5 percent to 6 percent range, with credit spreads settling back to a 175–225 basis point range, for "all in" pricing

in the mid 6 percent to mid 7 percent range. Those who are in a position to transact over the next year and a half will be pleased that they did. ■

**John M. Petersen** is president of Melvin Mark Capital Group, LLC, a mortgage banking company that focus on arranging capital and financial solutions for regional owners, buyers and developers of commercial real estate.

## PERS IN CRISIS: THE SEQUEL

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PHIL KEISLING

Public employers in Oregon, such as state and local governments, support employee retirement benefits via contributions to the state's Public Employee Retirement System (PERS). Historically, these contributions have averaged 12 percent to 15 percent of public payrolls. However, a combination of factors—especially the recent recession which has impaired PERS' investment returns—mean public employers are facing steep increases in payroll costs over the next decade. These increases will likely exacerbate future state and local budget problems.

On May 29, 2009, the five member board that oversees the Oregon Public Employee Retirement System (PERS) convened for one of its regular, bi-monthly meetings.

No journalists apparently attended this meeting, nor did any legislator. At the time, Oregon's 90 lawmakers were holed up in the Capitol building in Salem, trying to grapple with a \$4.5 billion projected budget deficit—a deficit that was driven by Oregon's worst economic crisis in a half century.

In a lengthy presentation the actuary hired by PERS, Mercer Consulting, outlined the recession's severe impact on PERS' financial fortunes. In less than two years, PERS' main account, known by its acronym OPERF, had fallen from a peak of \$63 billion to \$45 billion. The "funded status" of OPERF—the ratio of PERS assets to liabilities—had fallen from almost 100 percent funded to 74 percent funded.

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For the State of Oregon, total PERS related obligations amount to about 15 percent of payroll

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Mercer's actuaries then described an even more brutal reality. Historically, OPERF earnings have provided 70 percent of what the PERS system needs to meet its actuarial and contractual obligations. The remainder is then largely made up by direct employer contributions, with rates set every two years by the PERS board based on OPERF's past (and projected future) returns, plus a wide range of other assumptions.

As the Mercer report noted, with OPERF so ravaged by the market downturn, there was only one other source for necessary funds: Oregon taxpayers, the ultimate financiers of any public employer's contribution rate. Even with a relatively quick and robust recovery of OPERF earnings back to about 8 percent annual returns Mercer's conclusion was breath-taking. By decade's end, Oregon's public employers would likely need to pony up an additional \$5 billion a biennium (compared to 2009–11 levels) to keep PERS adequately funded.

This is real money. Even half that amount, or \$2.5 billion, would allow the hiring of 20,000 new K–12 school teachers; or could entirely abolish tuition for all of Oregon's university and community college students; or could provide health insurance for 300,000 uninsured Oregonians.

## STATE EMPLOYER CONTRIBUTIONS AND THE EMPLOYEE "BURDEN RATE"

When I first came across the Mercer report, I was a Vice President for Beaverton-based CorSource Technology Group, an IT and software services company that provided contract staffing and project services to many Oregon businesses. So I was familiar with the basic concept of a "burden rate" for calculating total employee costs.

All employers, private and public, are required to pay certain taxes, such as Social Security and Medicare payroll taxes. In addition to other mandatory costs, such as unemployment insurance and workers compensation, most private employers provide employee benefits such as health insurance and retirement contributions. In the private sector, the combined total of all these "burden costs" is typically between 30 percent and 35 percent of payroll. So an employer, hiring an employee at \$50,000 a year, needs to budget an additional \$15,000 to \$17,500 to cover all these obligations.

PERS obligations vary for each of Oregon's 800+ public employers. But for the State of Oregon itself, total PERS related obligations amount to about 15 percent of payroll for 2009–11.

Based on the Mercer report's analysis of the "50 percent probability" scenario for future financial market returns—and assuming the continuation of existing policies and practices—by 2017–19 the burden rate for PERS related obligations alone or a typical public employer would be about 35 percent of payroll. (Further assuming the state also continued to provide current levels of health insurance and other benefits, the total employee burden would also rise, to about 70 percent of payroll or more than double the typical rate in the private sector.)

While Mercer's most recent analysis now projects typical rates peaking at about 30 percent by decade's end, this still represents an historic sea change. Since 1975, the core "employer contribution rate" paid by state and local entities to support their PERS obligations

was fairly stable. Over this period, it stayed within a narrow band of 9 percent to 12 percent of payroll, even during the recession earlier this decade.

### WHAT ABOUT THE PERS REFORMS IN 2003?

The 2001 recession triggered major changes in PERS. In the wake of the recession, OPERF lost about 17 percent of its value in the 2001–02 period. With potential unfunded liabilities projected to soar to \$17 billion, and employer rates projected to hit 25 percent, in 2003 the Legislature enacted major changes in PERS.

These reforms, which are still controversial, were championed by Democratic Governor Ted Kulongoski, most Republican legislators, and a few Democratic legislators like Rep. Greg MacPherson. Even so, many reforms were widely opposed by PERS recipients and public employee unions, who challenged the reforms in court. In the end, the Oregon Supreme Court rejected the most ambitious reforms, but retained others.

From 2003 to 2007, OPERF grew at an annualized rate of 15 percent. The combination of relatively high returns and other changes made by a newly-constituted PERS board allowed PERS rates to remain relatively stable. “Crisis averted” was the dominant emotion and PERS essentially vanished from the public policy radar screen.

In 2008, OPERF plunged an historic 28 percent. Though OPERF has rebounded from its March 2009 low point of \$41 billion, its \$50 billion value (as of December 31, 2009, a key date for rate-setting purposes) is still down about 21 percent from its \$63 billion high point of 2007.

If Oregon’s string of public finance crises were a chain of horror films, the latest predicament might be called *PERS in Crisis: the Sequel*. It even has its own scary plot line: Even if OPERF can consistently earn 8 percent a year, every year for the next decade, employer contribution rates will still soar so that for the state of Oregon (and many other local governments) total PERS obligations will approach approximately 30 percent of payroll.

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If Oregon’s string of public finance crises were a chain of horror films, the latest predicament might be called *PERS in Crisis: the Sequel*

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### THE UPS AND DOWNS OF SIDE ACCOUNTS

The state as well as many K–12 school districts and local governments face another potential PERS problem due to a once-promising “hedge strategy” that could end up adding to their deficit. Over the last decade the state of Oregon and over 100 local government entities sold more than \$6 billion in pension obligation bonds. In so doing, they borrowed money at about 5 percent interest, and then invested the proceeds in OPERF “side accounts.” They did so in the expectation that OPERF returns would be higher than the interest rates they would pay on the bonds. Through this arbitrage strategy they hoped they could “buy down” their employer contribution rate by as much as three percentage points.

The strategy worked brilliantly during the 2003–07 market run-up. Some jurisdictions reduced their entire employer contribution to zero through side account earnings.

But, bonds are debt and debts have to be repaid. What’s more, many jurisdictions decided to repay their bonds on an escalating schedule of about 8 percent more each biennium, on

the assumption that their payrolls would also increase about 8 percent. For example, under this repayment schedule, the Portland public school district will pay about \$61 million in bond repayments during the 2009–11 period. By the 2019–21 biennium, those obligations will rise to about \$106 million. Contrast this with how most homeowners repay their mortgages or home equity loans, with fixed, regular payments until their loan obligations are fully discharged.

Public finance experts will likely debate the wisdom of the pension obligation bond strategy for years to come. But at the risk of some over-simplification, the strategy is similar to a homeowner taking out a \$100,000 second mortgage to invest in the stock market. This homeowner then further assumed his or her salary would steadily increase, so that the increasing repayments would remain constant as a percentage of household income. Needless to say, a wrong bet, either with respect to future investment returns or future household income, can quickly cause real problems.

Of course, unlike most homeowners, public pension funds have a much longer investment horizon, and since 1975 the Oregon Treasury calculates OPERF's annual rate of return at 10 percent. But for the 1999–2009 period, the return rate was just 4.5 percent and now some jurisdictions are losing money on their side account investments.

## THE SIX PERCENT PICKUP

The final major component of PERS obligations involves something known as the “6 percent employee pick up.” By law, a PERS beneficiary must contribute 6 percent of his or her pay to participate in PERS. But over the last 30 years, and often through negotiated contracts, most public employees in Oregon now have their 6 percent share paid, in full, by the public employer. (There are, however, exceptions; in the 1990s, the Portland school board negotiated a contract with its employees that included pay hikes and the abolition of the employer-financed pick up.)

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Few issues so raise  
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While the 6 percent pick up issue can legally be re-visited as part of any new contract negotiation, for decades it has been widely treated as a “built in” component. For example, its assumed continuation is part of the state's current projected state general fund deficit of \$2.7 billion. Even so, Governor Kulongoski's recent “Reset Cabinet” report recommended reducing the state's pick-up contribution.

Few issues so raise hackles as much as the 6 percent pick up issue. Proponents of the pick up argue that it is justified because employees in past years agreed to forego what they considered to be deserved pay increases in exchange for this pick up. Critics of the pickup note that most private sector workers (and public workers in other states) must make some contribution from their own pockets to their retirement plans.

A further wrinkle is that, since the 2003 reforms, these employee contributions have gone into separate accounts, which are more like “defined contribution” plans than PERS' core “defined benefit” plans whose value is based on factors such as salary, years worked, and date of original hire. This means a portion of today's public employees' retirement plans are also subject to market uncertainties, though certainly to a lesser extent than for workers solely reliant on their 401(k) plans.



## CONCLUSION

Regardless of the various legal and political debates surround PERS, few would disagree that an adequate, stable retirement plan is an essential ingredient to any well-designed, well run public compensation system. It is the various details of PERS that will be key issues for policy makers, public employees, and courts in coming years, especially as public employers at all levels grapple with unprecedented budget deficits that could well persist long after the economy recovers. With PERS, some of those details have already been resolved by various court decisions. But other details can and likely will be discussed (e.g., the 6 percent pick up) as public officials now confront a “perfect storm” of a lingering economic recession, near double-digit unemployment, and yet another round of massive budget cuts.

Already, that grappling is evident, as PERS costs are beginning to play a much bigger role in state and local budget crises. For example, beginning with the 2011–13 biennium the state and other Oregon public employers will face about a 6 percent hike in their net employer contribution rates. Put another way, they must come up with an additional \$1 billion relative to the 2009–11 biennium just to stay even with their PERS obligations.

And of course, the timing could not be worse. The state currently faces a projected \$2.7 billion deficit for 2011–13 (this is on top of an additional 9 percent in state general fund cuts recently ordered by Governor Kulongoski). Meanwhile, some local governments may be even worse off than the state. Many have already started to lay off employees, due to current revenue shortfalls and partly in anticipation of looming PERS hikes.

Indeed, even though these increased PERS costs have not technically “hit the books” yet, there is no escaping that they will arrive with all the certainty of an Oregon summer eventually turning to a rainy winter. That is all the more reason for policy makers to start discussing PERS now, lest the passage of time (or more bad economic news) make the problems even more difficult to resolve. ■

**Phil Keisling** served as Oregon Secretary of State from 1991 to 1999. Prior to that he was a member of the Oregon House of Representatives, and spent six years as a journalist for *Willamette Week* and *The Washington Monthly* magazine in Washington, D.C.



## DEVELOPERS USE CREATIVE STRATEGIES TO KEEP THE LIGHTS ON

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JULIE SEROTE

Portland State University

With the disappearance of financing and equity from the real estate market, developers are no longer following business models from recent years past. They have had to retune their strategies. The developers who continue to survive utilize their entrepreneurial and creative skills to form new business models in order to keep the lights on. As a result, innovation and conservatism have emerged. Some have expanded into property management or fee-based development. Others have transferred their development skills overseas. Some who were laid off have started their own businesses utilizing their development expertise. New development work in the U.S. now exists around a few scarce industries where financing continues to exist. Developers are still working. But the job description of a developer has certainly expanded.

What exactly are real estate developers doing now that new development has virtually stopped? With pen and paper in hand, I hit the pavement to get answers to this question. The findings were much of what you would expect, mirroring the most recent recessions in the 1980s and 1990s, with many expanding into areas such as property and asset management and others having little time to pursue new ventures due to the extensive time spent managing creditors. Some developers who have the financial wherewithal are simply waiting it out until some sign of market cash flow appears. Others have become financially

overwhelmed and cease to exist. Many continue to work, day by day, persevering through adversity to create ways in which they can stay in business. Amidst the challenge of finding or creating work, I found stories of success where unemployment or lack of financing lead developers to new, innovative business plans and unexpected blessings in disguise. These are their stories.

## EXPAND THE BUSINESS MODEL

In past years, Kirk Olsen, Partner for DP Partners' northwest region, spent much of his day raising capital and overseeing development of speculative and build to suit developments. Now, he is spending much of his time looking for land and, to survive in a depressed market, he has broadened the services his company provides.

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From a  
construction point  
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opportune time to  
build

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Based in Reno, Nevada, DP Partners recently signed a contract with an institutional investor to manage their portfolio of Portland properties. Olsen noted that expanding their business model to include third party property management was a natural transition given their experience managing their own portfolio of properties nationwide.

DP Partners has diversified its business model by acquiring existing buildings at prices below their replacement cost, adding value, and taking on the lease-up risk. Here they are utilizing their expertise in positioning and leasing new properties and transferring those same skills to existing properties.

While the company has traditionally developed properties for their own portfolio, DP Partners has begun developing property on a fee basis. Completed in May, 2010, Morgan Distributing recently moved to its new 105,000 square foot build-to-suit headquarters located at LogistiCourt at Portal Way in Portland, Oregon. This high-end, \$12 million project allowed Morgan Distributing to consolidate their headquarter facility in Oregon City with their distribution facility in The Dalles. Finding a company in an industry that is more recession-proof, such as beer distribution, was a fortunate find for Olsen and enabled him to develop one of only three industrial sites to complete construction in 2010.

## FIND A MARKET THAT IS FINANCEABLE

Isaac Scott, Principal with Anthem Memory Care and Alumni of PSU's Graduate Certificate program, indicated his company has been fortunate to have active debt markets for their products. After experiencing the demand for secondary homes dry up, the principals of Pacific Santa Fe, a Portland-based development company with over 25 years development experience, formed a new development company in 2008. The company, Anthem Memory Care, develops senior housing specific to individuals with Alzheimer's disease. Funded through the HUD 232 program, Anthem currently has two, 54–60 bed communities underway, with construction expected to break ground by year-end.

Scott feels fortunate to be in a market where they can take advantage of some of the opportunities that come with a depressed construction market. From a construction point of view, it is an opportune time to build, as construction costs have decreased, primarily due to labor but also due to the reduced costs for certain materials. Land prices are low and the

entitlement process can be easier than in years past due to the absence of requests for new building permits.

When asked if Anthem's move into the memory care facility business was a reaction to the down economy, Scott responded affirmatively, but also indicated that it was a response to the realization of a huge unmet need in senior housing. Anthem determined that there was enormous demographic support for Alzheimer care facilities, and they spent approximately 6–8 months of their first year building a market research model to help them determine exactly which markets most needed a memory care facility. To date they have performed research on more than 150 submarkets, enabling them to discern where market demand is the strongest. Anthem's goal is to have four to six additional projects underway nationwide in 2011.

## CREATE FINANCING AND INNOVATION

At the crux of the suspension of new development has been a lack of financing. With the capital markets essentially dry, developers have been forced to put proposed projects on the back burner, and many have significantly downsized their staffing as a result. How has Gerding Edlen Development, one of Portland's most prominent developers, responded to this recession? Dennis Wilde, principal with Gerding Edlen Development, noted three strategies they have underway.

First, Gerding Edlen has created a fund to raise capital for deep green renovations by updating or replacing dated, energy-consuming building systems with more efficient systems. Having extensive experience in green building and environmentally responsible systems, Gerding Edlen has shifted their business model to utilize their green building expertise from new construction to an existing stock of office and multi-family properties located in high growth, urban markets within the United States. With financing virtually non-existent, the company created the Green Cities Fund. It pools investor funds, primarily union pension fund money, for the purpose of acquiring existing buildings with good bones and a good location to perform a deep green renovation, with subsequent re-leasing and portfolio management. To date the Green Cities Fund has reached \$140 million to \$150 million of its targeted \$600 million in funding, according to Wilde.

Gerding Edlen Sustainable Solutions (GESS) is another arm of Gerding Edlen that is using its understanding of the need for energy, water and waste conservation by creating a new venture involving energy management. The company is joining forces with EqRM International to facilitate the sale of power to utility companies. GESS facilitates the management of an energy resource within a building or campus for property owners. The property owner experiences reduced utility bills. The energy saved is treated by the utility company the same as new energy generated, and it can sell the energy on the open market. The utility companies finance the renovation and retrofits that produce the energy savings at costs substantially lower than constructing new generation sources, thus providing lower cost energy than available from traditional generation sources. GESS earns a fee for their development management services.

Specifically, GESS first performs a detailed audit of the energy consumption of a building or campus and outlines specific action items that the building owner can take to improve the efficiency of their facilities. GESS then determines the necessary financing and returns that will be needed. Building owners do not pay for the energy efficiencies, but rather GESS finds

off balance sheet financing (i.e. investment partners) for their projects. GESS is working with EqRM to create some innovative financing structures that will allow building owners to reach for deeper savings than the typical 15–20 percent that they can normally achieve. “The GESS goal is to obtain a 50–70 percent reduction in energy and 50 percent reduction in water consumption,” Wilde notes.

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Gerding Edlen created its own property management and leasing arm. Now they can better manage the environmental innovations that were originally developed to be part of the building

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The “efficiency energy” that is produced results in lower gas, oil, or electricity costs for the building owner. This energy savings is sold to the utility company via a power purchase agreement. The building owners come out ahead because they are paid a percentage of the value of the energy generated (saved) for the use of the building “site.” GESS manages the project for the owner to assure that the targeted savings are achieved. Essentially, a profit incentive is utilized to create energy innovation and conservation.

Historically, Gerding Edlen’s development team has developed a fairly unique skillset working with innovative, green technologies such as conservation, solar and wind power in new development. This skillset, combined with their 15 years of public/private development experience, enables GESS to reposition their development services in a novel new business.

Finally, Gerding Edlen created its own property management and leasing arm to manage and lease their own portfolio. This not only has saved the company from paying outside fees, but also has resulted in their being able to better manage the environmental innovations that were originally developed to be part of the build-

ing. For example, in the past a tenant or condo owner might remove the low flow fixtures in their units in an attempt to increase water flow. Property managers in the past had not been diligent in educating the tenant or owner not to do this. As property manager, Gerding Edlen now has a better handle on ensuring that owners are not negating the green technologies that were intended for the building.

## LAUNCH YOUR OWN COMPANY

When Nancy Hubbard was laid off along with the bulk of Avamere’s development staff in March 2009, she decided to dust off her consultant hat and look for independent contract work where she could utilize her 20+ years of development experience. She had a solid background of development experience, ranging from land acquisitions and entitlement work, to working as the Development Director for the Vancouver Housing Authority. Prior to being laid off, she was developing senior independent living and assisted living facilities for Avamere Health Services.

After six months of marketing efforts, Hubbard responded to a RFP for Riverdale School District and was awarded the contract to be their owner representative for the construction of the new grade school. In this role she used her construction and development expertise to represent the owner (Riverdale School District) in facilitating the communication between the school district, staff, and public for the development of the new grade school. She eventually became the project manager for the Riverdale development project, which is slated for completion in August 2010. She also landed a contract with the West Linn/Wilsonville

School District to help them purchase owner supply items (i.e. furniture) for both new schools and five remodeling projects for existing schools in the district.

Hubbard not only found herself a job in a tough economic environment, but also found one that is fulfilling. She said that her new development niche (school development) is similar to the work she did in affordable housing and senior housing. "It's a good feeling at the end of the day to go home and know that the work I did is making a difference in people's lives." She also is enjoying the benefits of owning her own company and the flexibility of working independently. "The funny thing is that if someone offered me a development job now (as their employee) I would turn them down because I'm happy with what I'm doing."

## TRANSFER DEVELOPMENT SKILLS OVERSEAS

John Bartell left Opus Northwest in May, 2009, to utilize his development skills to the creation of Camana Bay, a new urbanist town on Grand Cayman. Already underway, phase one of Camana Bay is the development of the town center consisting of approximately 550,000 square feet of built space, of which 100,000 square feet is retail, 63 apartment units, and the remainder being office space. Phase two, beginning later this year or early 2011, is the housing phase consisting of approximately 200 single family homes. John also manages and leases a six-building class B office park for the same owner as Camana Bay.

Bartell, who is filling the role of Director of Property Management, spends the majority of his time managing the properties, but also does some work with the development and leasing teams for Camana Bay. "I'm doing the same thing companies did 20 years ago in the recession. Companies like Trammell Crow and Koll reinvented themselves as property management companies, buying property management companies to obtain fee income, acquiring new clients, and managing a portfolio until the development market returns."

Bartell says he has been able to easily transfer his 26 years of development experience overseas. It is a matter of understanding the market, according to Bartell, so he has gotten to know his tenants and understands their needs, allowing him to effectively negotiate their leases as they expire. He is taking his operating practices and discipline that were so ingrained in his years of development work in the U.S. and transferring them to projects overseas.

Originally Bartell's contract for the Camana Bay project was two years. Needless to say, with a five minute walk to work from his ocean-front apartment, he now plans to be there longer.

PSU Real Estate Certificate student Mazen Abualhaija has over 10 years of development experience and has also taken his skills overseas. Abualhaija currently works for a large development company based in Dubai. While the company shrank from approximately 400 to 100 employees, the company is focused on completing projects that were already underway prior to the construction slowdown.

The scale of developments in Dubai is massive compared to those in the United States. Abualhaija is currently working on two residential towers: a 91-story tower and a 107-story tower. Once complete, the latter project will be the tallest residential tower in the world at approximately 414 meters tall, or 1,358 feet (108 feet taller than the Empire State Building), and contains 1.7 million square feet. Currently on the 83rd floor, this project is slated for completion at the end of 2011 and is close to 100 percent sold.



**Figure 5.1** The tallest residential tower in the world, under construction in Dubai; plan for the “Tallest Block in the World” in Dubai

Abualhaija notes that if someone has a financial background, due diligence and valuation skills, then there are opportunities to transfer those skills overseas. Political changes and increased investor confidence in countries such as Saudi Arabia have resulted in increased development and the hiring of labor pools from countries such as Australia and the United



Kingdom. A recent report from Jones Lang LaSalle, a financial and professional services firm specializing in real estate services and investment management, notes:

Saudi Arabia is by far the largest real estate market in the Gulf and is poised to be one of the fastest growing markets in the region over the next three years, with up to 30 million square meters of commercial (office, retail and hospitality space) forecast across the major cities within the Kingdom by 2012. Unlike most of the other GCC markets, the Saudi real estate market is driven primarily by internal demand generated by the rapidly growing local population.

Saudi Arabia is just one example of a handful of countries that are now welcoming foreign developers' expertise as a result of recent changes in governmental policies and restrictions.

## CONCLUSION

Developers are known for their entrepreneurial spirit, creative problem solving skills, and tenacious attitude to persevere through insurmountable challenges. These same skills are being used by developers today to survive this economic crisis. Change is inevitable, and the job description of developers will continue to evolve until the market settles on a "new normal." Developers will need to continue to be innovative in finding ways in which to make money in a world where new construction barely exists. Transferring development skills and knowledge such as project management, working with public officials, green building and energy efficiency, and creative problem solving into less traditional areas of development will enable developers to continue to do business. In the short term, developers may have to relocate either nationally or internationally to find development work. While developers have downsized staffing, new jobs will slowly emerge as they expand their business models into new ventures. Yes, the Great Recession has caused some developers to close up shop, but silver linings centered around innovation and ingenuity will undoubtedly appear, creating completely new businesses, and jobs, for the future and success for those developers who persevere through the storm. ■

**Julie Serote** is the assistant director at the Center for Real Estate, Portland State University. Her responsibilities include industry outreach, career counseling, administering industry networking and mentor programs, coordination of the Center's annual real estate conference, and fundraising for the Center. Ms. Serote brings more than nine years of real estate experience, including asset management, underwriting, loan servicing and workouts, and affordable housing lending to PSU's Center for Real Estate. She has an MBA from Portland State University and a bachelor's in Business Administration from Pepperdine University.



## PORTLAND'S UNREINFORCED MASONRY APARTMENT BUILDINGS: A THREATENED SPECIES?

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WALTER W. McMONIES

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Now that Western Oregon and Washington have been identified as being subject to massive if infrequent “subduction zone” earthquakes and that the vulnerability of unreinforced masonry (URM) buildings to damage or collapse in a major earthquake has been documented, the owners of URM apartment buildings can expect to face gentle but inevitable pressure from casualty insurers, mortgage lenders and the local government to seismically reinforce their buildings. The challenge facing such owners is that the (1) cost of a standard seismic retrofit of an URM building will in many cases approach 20 percent of the value of that building, but (2) the retrofit adds little to the cash flow of the building aside from marginally lowering earthquake insurance premiums and mortgage interest rates. Given the large number of and historic/ architectural importance of URM apartments to Portland, URM building owners, architectural preservationists, structural engineers, mortgage lenders and insurers, and city and state officials need to work collaboratively to reduce impediments to and increase incentives for seismically upgrading URM apartments.

By 1991, geologists led by Brian Atwater of the U.S. Geological Service had established that Western Oregon and Washington are subject to periodic but infrequent (every 300-600 years) Cascadia Subduction Zone (“CSZ”) earthquakes of enormous destructiveness,

approximately Magnitude (“M”) 8.7 to 9.2. The most recent CSZ quake occurred 310 years ago in January, 1700. Geologists now estimate that there is at least a 10 percent probability of another CSZ, M 9 quake affecting Western Oregon in the next 50 years.

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In 2001, the City of Portland published a database identifying URM buildings in Portland. Of those, by this author’s count, about 200 are apartment buildings, totaling over 5,200 units and conservatively worth over \$350 million. At least 70 of these URM apartments are of National Register historic quality. Another 100 historic apartment buildings, more or less, listed on the database of the State Historic Preservation Office (SHPO) are of similar masonry construction, although not strictly URM’s.

A URM building is vulnerable to damage or collapse in a major earthquake because such buildings generally: (1) are rigid, lacking flexibility, (2) are not securely connected together, such that their foundations, exterior walls, floor and roof diaphragms are prone to separation and (3) lack lateral strength sufficient, given the relatively heavy weight of masonry, to withstand large and sustained horizontal forces (shaking). This damage or collapse, in turn, will result in the injury or death of many occupants, the loss of a substantial percentage of Portland’s urban (in-close) rental housing, and the loss of much of Portland historic fabric.

Some casualty insurers and commercial real estate lenders are becoming hesitant to insure or loan on URM buildings in locales like Portland which have been identified as having a high earthquake risk.

Portland’s URM apartment buildings are too important to “write off.” Similar buildings in Los Angeles and San Francisco have been seismically retrofitted, albeit at substantial cost, to anticipate and ameliorate the effects of a major earthquake.

There are tax incentives to the renovation of historic buildings including a 10-year (or with extension 20-year) Oregon historic property tax assessment freeze, a 20 percent federal historic rehabilitation tax credit for substantial renovation, and Oregon and federal charitable deductions for building facade (conservation easement) donations. Additional incentives, especially for URM apartment buildings that are not of National Register historic quality, are advisable. Minimal “life-safety” seismic upgrades to URM’s may need eventually to be made mandatory.

## **EARTHQUAKE RISK IN WESTERN OREGON AND THE VULNERABILITY OF URM BUILDINGS**

The vulnerability of Western Oregon (as well as coastal British Columbia and Western Washington) to a large subduction zone earthquake along the Cascadia Subduction Zone (“CSZ”), the intersection of the subducting Juan de Fuca (Tectonic) Plate and the overriding North American (Tectonic) Plate, has been known for almost 20 years (Atwater, Musumi-Rokkaku, Satake, Tsuji, Ueda, and Yamaguchi, 2005). An earthquake in 1700 relieved hundreds of years of tectonic plate pressure and resultant uplifting of the coastal areas of Oregon and Washington with one massive fault line correction which resulted in a several meter drop of coastal areas and incidentally created a “ghost forest” of dead red cedar trees in a tidal salt marsh near Grays Harbor, Washington. This forest was a key clue

to the discovery of the CSZ. The exact date (January 26) and intensity (M 8.7 to 9.2) of the 1700 earthquake were established based on an analysis of Japanese archives from that year recording the effects of an “orphan” tsunami that struck Japan on the next day, apparently without any local Japanese earthquake having occurred (Atwater, Musumi-Rokkaku, Satake, Tsuji, Ueda, and Yamaguchi, 2005; Tobias, 2010). Atwater, Musumi-Rokkaku, Satake, Tsuji, Ueda, and Yamaguchi (2005) cite buried soil evidence in Washington of “. . . five great earthquakes of the past 3000 years . . . [and] seven earthquakes from the past 3,500 years.”

Analysis of coastal sediment cores has disclosed a 10,000 year history of large (1.5 to 2.0 meter) periodic drops of coastal land in Oregon and Washington, evidence of other CSZ quakes. Investigation of undersea landslides by a team of researchers headed by Oregon State University Professor Chris Goldfinger has indicated 19 distinct, approximate M 9 CSZ earthquake events in the last 10,000 years (Rojas-Burke, 2010). These events involved a rupture along the entire 600 mile long Cascadia fault. Previously 13 such events had been identified as having occurred since the eruption of Mt. Mazama 7,700 years ago with an average repeat time of 600 years (Goldfinger, Nelson, and Johnson, 2003). Some geologists, including Goldfinger, have theorized that the larger M 9 Cascadia quakes come in clusters separated by 1000-year periods of inactivity (Rojas-Burke, 2010).

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A large subduction zone earthquake not only has an extremely high magnitude and a long duration, but also has long-period waves which particularly affect tall buildings (Cascadia Region Earthquake Workgroup, 2005). A M-9 quake radiates twice the energy of a 90-mph hurricane if it blew for a month (Atwater, Musumi-Rokkaku, Satake, Tsuji, Ueda, and Yamaguchi, 2005). The shock waves emanating from an earthquake will typically be amplified with respect to a particular building if the soil under a building is soft, especially if the soil is either saturated with water and could liquefy or if the soil is artificial fill (Cascadia Region Earthquake Workgroup, 2005).

In a M-9 CSZ quake occurring close to Portland, many or even most (whether URM or not) buildings in Portland will be at risk of substantial damage or collapse, but the amount of damage to a particular building will depend upon factors including: the intensity and duration of the quake’s shaking, the depth and horizontal distance of the quake’s epicenter from the building, the site’s soil conditions, including the amount of water in the soil, the slope of adjacent hillsides, the building’s type of construction and state of repair, and the proximity of other earthquake-vulnerable buildings which might collapse on the subject building.

The Federal Emergency Management Agency (“FEMA”), in surveying eight major United States earthquakes in the period from the 1886 Charleston, S.C. quake (M 7.7) to the 2003 San Simeon, CA quake (M 6.5), concluded that URM buildings bore a disproportionate share the damage suffered in such quakes. Taking the eight quakes together, 4,457 URM buildings were involved of which 5 of 6 (or about 83 percent) were damaged enough for brickwork to fall and one fifth (or about 20 percent) were damaged to the point of partial or complete collapse (Reitherman and Perry, 2009).

The vulnerability of URM buildings to earthquake damage arises from the following:

1. The inadequacy of an URM building’s exterior and/or load bearing walls to resist horizontal (“shear”) forces and the walls’ lack of flexibility (“ductility”), such that in a large

quake the floors move laterally and disintegrate in a manner akin to how the layers of a wedding cake might be affected if violently shaken,

2. The heavy weight of the building and its floors creating enormous momentum once in motion,
3. The lack of structural connections variously between (a) exterior walls and floors diaphragms, (b) exterior walls and roof diaphragms and (c) exterior walls and the foundation,
4. The weakness and consequent susceptibility of the roof and floor diaphragms to deflection in an earthquake, resulting in inadequate lateral support for the walls,
5. The prevalence of parapets, cornices, chimneys, and stone ornamentation prone to breaking off and falling in a quake, and
6. The fact that URM buildings were typically designed totally without reference to seismic forces (Reitherman and Perry, 2009).<sup>1</sup>



**Figure 6.1** Example of parapet failure (l) and parapet bracing (r)

The earthquake performance of URM buildings gives rise to various types of loss and damages:

1. Injury to Persons. Bricks are heavy and when they fall can injure or kill people. Parapet walls, chimneys and cornices are all vulnerable to falling off and hitting people. URM buildings can partially or entirely collapse in a major earthquake, trapping, injuring and even killing occupants.
2. Damage to Property. Because URM buildings typically lack any integrating reinforcement or any tying together of structural elements, a major earthquake can potentially

<sup>1</sup>See also, Look, Wong, and Augustus (1997).

cause their partial or total collapse. As a result, a URM building may be costly to restore after earthquake damage occurs such that demolition often is the only feasible alternative. For instance, the 1989 Loma Prieta earthquake (M 7.1) near Santa Cruz, California damaged the Pacific Avenue Historic District with the result that 52 percent of the URM brick buildings were quickly demolished and another 16 percent were “red tagged” (closed to use by the City inspectors because unsafe to enter).<sup>2</sup>

3. Loss of Use. Even modest earthquake damage to an URM building can require closure until repairs are made. Typically post-quake repairs will need to be coupled with seismic upgrades, such that closure may be for many months (Reitherman and Perry, 2009).

### THE RESPONSE OF INSURERS AND LENDERS TO WESTERN OREGON'S EARTHQUAKE RISK

In the mid-1990's, soon after the discovery of a history of CSZ quakes in the Northwest became public and well before any increased lender concern about the earthquake risk in Western Oregon, some of casualty insurance companies changed their ratings of Western Oregon and Washington with respect to earthquake casualty risk and took steps to limit their exposure to this risk. This retrenchment began in part as a reaction to the enormous losses suffered by the insurance industry in the January 1994 Northridge Quake in Los Angeles. In the immediate aftermath of the Northridge Quake, the insurers estimated \$3 billion in insurance claims, but ultimately paid out more than \$15 billion, on losses of nearly \$18 billion (Treaster, 1999; Missouri Earthquake Insurance Task Force, 2008). In response, 90 percent of the pre-existing insurers writing earthquake insurance in California withdrew from that market. To insure this risk, the California Legislature created the California Earthquake Authority, a state backed and managed but privately funded organization (pool) which provides basic or “bare bones” earthquake coverage in California (Missouri Earthquake Insurance Task Force, 2008).

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Financial institutions offering apartment loans in Portland now are becoming somewhat cautious about loaning on URM apartments

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In the Northwest, by contrast, most casualty insurers offering residential and/or commercial earthquake coverage have not withdrawn from the market. However, most have lessened their risk by: (1) raising their policy deductibles to 10 percent or even 20 percent of the amount of the *coverage*, not a percentage of the amount of *loss* (Oregon Department of Consumer and Business Services, 2010), by (2) covering primarily direct physical loss to property and by not covering landslides, erosion, tsunami or volcanic eruption, even if part of an earthquake event (Oregon Department of Consumer and Business Services, 2009), and (3) excluding from coverage items such as personal property, ancillary improvements and rental income replacement. In 2006, Allstate announced it was dropping earthquake coverage for most of its customers nationwide (Associated Press, 2006; Meyer, 2006). Several

<sup>2</sup>Reitherman and Perry (2009), citing Architectural Resources Group (1990).

other carriers including Mutual of Enumclaw and Rocky Mountain Fire have also withdrawn from the Oregon earthquake market.<sup>3</sup>

Commercial earthquake insurance is still available for URM buildings in Oregon through various carriers, in particular Lloyds of London, but coverage is expensive and is typically written through the “surplus lines market” as opposed to the more regulated “admitted market.”<sup>4</sup>

Commercial real estate lenders active in the Portland, Western Oregon and Southwest Washington mortgage market are becoming more conservative in making loans collateralized by URM buildings. Fannie Mae, Freddie Mac and HUD/FHA have since 2008 provided over 80 percent of all multifamily lending by dollar volume in the U.S. (Cassidy, 2010). However, the most accessible multifamily loan program from Fannie, Freddie and HUD, namely the popular Fannie Mae DUS (Delegated Underwriting and Servicing) loan program does not loan on URM buildings unless already seismically upgraded.

In December 2006, Fannie Mae, in its DUS Program [Underwriting] Guide, imposed the following requirements on potential borrowers relative to seismic risk:

1. Provide 100 percent full replacement cost earthquake insurance (maximum 10 percent deductible) as mitigation of the earthquake risk,
2. Commission a Level I, Seismic Risk Assessment (PML Study)<sup>5</sup> for all loans over \$20 million and for all loans on properties located in seismically active areas (Seismic Zones 3 and 4), in particular (a) for even reinforced masonry if constructed prior to 1994, (b) for any building with a weak (soft) story at the first level above grade, such as glass storefronts. (Additional risks are identified for properties in Seismic Zone 4.)
3. Achieve a PML of 20 or less, in other words, “The acceptable level of seismic risk is represented by a . . . PML at a 10 percent/50 year exceedance probability which does not exceed 20 percent.”

Given the fact that an un-retrofitted URM might have a PML in the mid to high 30s,<sup>6</sup> URM buildings are not acceptable for financing under the DUS program, at least in Seismic Zones 3 or 4 (Fannie Mae, 2006). Moreover, Fannie Mae representatives have indicated that although the DUS program will accept seismic upgrading of URM apartments to satisfy the 20 PML, it will do so only if the work is completed prior to loan funding.

Other financial institutions offering apartment loans (principally banks) in Portland now are becoming somewhat cautious about loaning on URM apartments. They typically require earthquake insurance. Some have underwriting guidelines which limit the loan to value ratio (LTV) and increase the debt service coverage (DSC) ratios on URM building loans. Conversations with several lenders suggest that although the interest rates and maturities offered URM owners are still competitive, principal amortizations may be faster and therefore less favorable (25 year versus 30 year), and personal guarantees of the principals of the borrower(s) will be standard.

<sup>3</sup>Author’s telephone conversation with CeCe Newell of the Oregon Insurance Division, May 27, 2010.

<sup>4</sup>Author’s telephone conversation with CeCe Newell of the Oregon Insurance Division, May 27, 2010.

<sup>5</sup>A term used in the insurance industry and commercial real estate. It is generally defined as the anticipated value of the largest loss that could result from the destruction and loss of use of the property. With regard to seismic risk, PMLs are typically performed according to the scope of work published by ASTM International (2007).

<sup>6</sup>Author’s conversations with Wade Younie, Structural Engineer, DCI Engineers (Winter, 2009–2010).





**Figure 6.2** Trinity Place Apartments, Portland, Ore.

## PORTLAND'S UNREINFORCED MASONRY APARTMENT BUILDINGS

The typical URM apartment building in Portland was built between 1902 and 1935. In the 1930s, as building codes began to address seismic risk, reinforced masonry techniques including concrete and reinforcing iron/steel (“rebar”) came into greater use. Still, small URM apartments apparently were built in Portland into the 1950s.

As mentioned above, the City of Portland, using work/study students, conducted a rough count of all URM buildings (not just apartments) in Portland and created an Unreinforced Masonry Database (“URM Database”).<sup>7</sup> The URM Database discloses, by this author’s analysis, that there are approximately 200 URM apartment buildings (including both rental apartments and apartments converted to residential condominiums) constituting over 3.8 million square feet and 5,200 apartment units in the City of Portland. By way of comparison, the Metro Multifamily Housing Association’s Spring, 2010 rent survey encompassed only 9631 rental apartment units within the City of Portland and 32,202 units in the entire Portland/Vancouver metro area (McConachie, 2010). Hence URM apartment buildings constitute a significant percentage of Portland’s rental housing stock. Since, the median year of construction of the URM apartments in URM Database is 1912, URM apartments, espe-

<sup>7</sup>Hagerty (2001).

cially “close in,” represent a key component of the city’s historic fabric, making an aesthetic and architectural contribution to the city.

## FEASIBILITY AND COST EFFECTIVENESS OF SEISMIC RETROFITTING OF URM

Since URM buildings are vulnerable to substantial damage in a major earthquake, one might well wonder whether it is technically possible to seismically retrofit them and, if so, whether such a retrofit is cost effective. The short answer is that a seismic retrofit is feasible, but expensive.

The feasibility of seismically retrofitting a URM building has been established by several studies of the performance of seismically retrofitted URM buildings in specific earthquakes.

In 1981, the City of Los Angeles adopted an ordinance mandating the seismic upgrading or demolition of approximately 14,000 URM buildings. By the time of the 1994 Northridge Earthquake (M 6.7), most URM buildings in L.A. had been seismically retrofitted, not to the seismic standards for a new building, but with the goal of bringing the URM buildings to a “reasonable level of safety.” [Analogous to what the author calls “Basic Life Safety.”] For example Reitherman and Perry (2009), citing California Seismic Safety Commission (2004), explain:

As would be expected, unretrofitted URM buildings performed worse, in general, than both reinforced masonry buildings and retrofitted URM buildings . . . The performance of buildings retrofitted to the [“reasonable . . . safety”] standard . . . was generally in line with that criterion . . .

In the 2003 San Simeon Earthquake (M 6.5), the seismic retrofitting of URM’s was again tested. The nearby town of Paso Robles was severely impacted:

Of 53 unreinforced masonry buildings in Paso Robles, the nearest affected city, none of the nine [0 of 9] that had been retrofitted experienced major damage. Many of the others were damaged so extensively they were subsequently demolished.”

As to cost, in general, it is prohibitively expensive to bring an URM brick apartment building up to the current seismic standards for a newly constructed apartment building. Even a more limited seismic retrofit of an URM apartment costing (say) \$20 per square foot would, for a 40,000 gross square foot apartment building, cost \$800,000. With 3.8 million square feet of URM apartments, the upgrades for the approximate 200 URM apartment buildings in the City of Portland would cost by very rough estimate in excess of \$75 million or over \$14,000 a unit. For comparison, the average sale price of an apartment unit in Portland Metro area in the fourth quarter of 2009 was about \$87,000 (Barry, 2010).

## THE HISTORIC FACTOR IN URM RETROFITTING

The technical feasibility and monetary cost of a seismic upgrade are not the only factors to be considered. There is also the potential aesthetic cost, that is, the adverse impact of an insensitive seismic upgrade on historic and architectural values. Many of Portland’s historic apartment buildings are beautiful examples of early 20th Century American interior and exterior apartment architecture designed by some of Oregon’s leading early 20th Century architects, such as Ellis Lawrence (Belle Court Apts.), Whitehouse & Foulhoux (705 Davis Apts./ now Condominium) and William Knighton (Trinity Place Apts.). These architectural



**Figure 6.3** Example of a floor joint tie back in Trinity Place Apartments

gems could be aesthetically “ruined” by an insensitive addition of exterior steel reinforcing beams, interior moment frames, gunnite reinforcing walls and the like.

To date, about 48 historic apartment buildings in Portland have been individually listed on the National Register of Historic Places (“National Register”). Approximately another 110 apartment buildings (excluding duplexes and row houses), while not individually listed on the National Register, have been inventoried and listed as primary or secondarily contributing historic properties within designated a National Register historic or conservation districts in Portland (“District Inventory”). Important Historic or Conservation Districts in Portland include the Alphabet Historic District in Northwest, the Ladd District in Southeast and the King’s Hill Conservation District in Southwest.

Approximately 69 historic apartment buildings in Portland are identified in the URM Database as URM buildings. As a consequence of a building’s identification as an historic landmark, its renovation is regulated by the Portland Landmarks Commission enforcing

City Code.<sup>8</sup> If a building is listed individually on the National Register or if deemed historically compatible in a District Inventory and if the owner has taken the additional step of applying for an historic property tax abatement, then in such case a building's renovation is further subject to regulation by the Oregon State Historic Preservation Office ("SHPO") enforcing the regulations of the National Park Service.

## LEVELS OF SEISMIC UPGRADING FOR HISTORIC BUILDINGS

There are various levels of seismic upgrading available to the owner of an historic URM apartment building. The degree of seismic upgrade chosen by the owner is likely to be determined by:

1. The requirements of the local government, e.g. the City of Portland,
2. The requirements of the owner's lender and/or insurer, if any,
3. The owner's financial strength and perception of earthquake risk,
4. The availability of reasonably priced renovation financing and of tax incentives,
5. The importance or uniqueness of the building, and
6. The costs of engineering design, permitting, construction and loss of rental income from the seismic upgrade project.

## Preservation

By the author's rough estimate, a "premium" seismic upgrade would cost at least \$50 more a square foot (i.e. \$2 million or more for a 40,000 square foot building). Such an upgrade would not be appropriate for a typical URM commercial or apartment building. It is normally reserved for important public buildings, hospitals, and irreplaceable historic structures like the 1897 Pioneer Courthouse in Portland. Recently the Courthouse (57,000 square feet) was not only seismically reinforced, but the entire building was seismically isolated from its foundation with "friction pendulum isolators." The construction manager on the project reports that the total cost of the Courthouse's renovation was \$20 million, but this included numerous improvements unrelated to seismic issues, e.g. creating an underground parking area, refurbishing all interior areas, and replacing all mechanical systems. This level of upgrade promises to protect the building from a major earthquake almost intact, so it can continue to be open and in operation.

## Full or Standard Seismic Retrofit, Zone 3

This level of seismic upgrade is estimated to cost in the range of \$20 to \$40 per square foot depending on building design and condition (i.e. a minimum of \$800,000 for a 40,000 square foot building). Under this approach, an historic building is substantially retrofitted to meet, to the extent possible, the prescribed IBC (building code) provisions for renovation of a

<sup>8</sup>City of Portland, Title 33, Planning and Zoning, 33.445 Historic Resource Protection Overlay Zone and 33.846 Historic Reviews.

building to Seismic Zone 3 standards.<sup>9</sup> Some substantial, but repairable, damage would be expected after a major earthquake. This is the level of upgrade one might use for an historic quality URM apartment building.

### Basic Seismic Upgrade

This level of upgrade is estimated to cost from \$10 to \$15 per square foot depending on building design and condition (i.e. \$400,000 to \$600,000 for a 40,000 square foot building). Under this approach, the building is selectively upgraded to substantially reduce damage and loss in a moderate earthquake. Inherent deficiencies found in older buildings, such as poor floor to wall framing connections and un-braced masonry walls would be corrected. After a design-level (moderate) earthquake, some structural damage is anticipated, such as masonry cracking, and the building would be temporarily unusable, but it would be repairable; moreover occupants would be able to exit the building in relative safety.

### Basic Life Safety

This upgrade is estimated to cost in the \$5 to \$10 per square foot range depending on building design and condition (i.e. \$200,000 to \$400,000 for a 40,000 square foot building). This type of project addresses the most serious life-safety concerns by correcting those deficiencies that could lead to serious human injury or total building collapse. Upgrades may include (i) bracing and tying the most vulnerable elements of the building, such as parapets, chimneys, and projecting ornamentation, or (ii) reinforcing routes of exit. It is expected that if an earthquake were to occur, the building would not collapse but would be seriously damaged requiring major repairs (Look, Wong, and Augustus, 1997).

## INCREASING INCENTIVES AND REMOVING OBSTACLES TO THE SEISMIC UPGRADING OF URM APARTMENTS

URM building owners, architectural preservationists, architects, structural engineers, mortgage lenders, the City, SHPO, all need to work collaboratively to increase incentives and reduce or impediments to undertaking seismic upgrades of URM apartments. These impediments and possible solutions include:

1. The inability of many building owners to benefit from the 20 percent Federal Historic Tax Rehabilitation Credit because of alternate minimum tax ("AMT") limitations.<sup>10</sup>  
**Suggested solution:** Short of inducing Congress to change AMT rules, the City, through (say) the Portland Development Commission ("PDC"), might commit to facilitate the "sale" and potentially help "create a market" for the "sale" by the building owners of historic tax credits to local and national corporations able to use them.
2. The onerous expenditure requirements (i.e. 10 percent of the building's Real Market Value as determined by the county assessor in 5 years) which must be agreed to in a

<sup>9</sup>See Oregon Structural Specialty Code (2007), Section 1613, Earthquake Loads.

<sup>10</sup>See Internal Revenue Code, Section 47 and Regulations 26 CFR 1.48-12.

“preservation plan” and accomplished by the historic building owner to qualify for or extend an Oregon historic property tax assessment freeze for 10 years.<sup>11</sup>

**Suggested solution:** Modify ORS 358.487(2)(a) so that a phased seismic upgrade of an historic building over as long as a 15 to 20 year period, so long as the expenditures during the each 10-year freeze period total at least 5 percent (as opposed to 10 percent) of the property’s initial RMV, is sufficient to qualify the property for a full 20 years (10 initial years and 10-year extension) of assessment freeze.

3. The perception (if not reality) that City Building Inspectors, Portland Landmarks Commission and SHPO approvals of rehabilitation plans for historic buildings are often bureaucratically determined with little reference to practical realities and that costly plan changes are sometimes required. Note that typically, no City Landmarks approval is required if there are no exterior modifications.

**Suggested solution:** Encourage the City and SHPO to appoint a joint task force, including representative architects, engineers and building owners, charged with analyzing and expediting the rehabilitation plan approval process and criteria for review of seismic upgrades.

4. The unavailability of most historic tax incentives to the owners of non-historic quality URM apartment buildings in Portland.

**Suggested solution:** Lobby Congress to remove the “no-residential” exclusion from the 10 percent rehabilitation credit for seismic upgrade work in Seismic Zones 3 and 4 and lobby the Oregon legislature to pass a property tax assessment freeze to non-historic URM apartments undergoing seismic upgrading.

5. The higher cost, higher deductibles and more limited coverage of earthquake insurance for URM buildings.

**Suggested solution:** The Oregon Insurance Commissioner should set up a task force, including representative URM apartment owners and insurance companies, to study the potential need for and steps required to set up a state- organized commercial earthquake insurance program for URM buildings.

6. The expense of building-specific engineering studies of seismic risk (\$2,000 to \$10,000) and of seismic upgrade designs needed by the owner of a URM building to analyze his/her building’s seismic condition and to design seismic upgrades to address deficiencies.

**Suggested solution:** A mechanism for pooling technical information on current seismic upgrade technology and design for URM buildings and for subsidizing engineering inspections of URM apartment buildings so as to facilitate the analysis of URM building deficiencies and the design of seismic upgrades.

7. The relative unavailability and, if available, the costliness (high loan fees and interest rates) of renovation (construction) loans for URM apartment buildings.

**Needed:** A State or City/ PDC grant and/or low interest subordinated loan program (possibly funded by municipal bonds) affording URM building owners renovation loans sufficient to cover a majority of the cost of at least life safety seismic upgrades.

<sup>11</sup>ORS 358.475-545



8. The difficulty of making extensive seismic upgrades to an apartment building especially to interior spaces without terminating all tenants and the consequent loss of income.

**Suggested solution:** The owner should be allowed by the City inspectors and its renovation lender, if any, to undertake the project in discrete stages over several years. For instance, the exterior work (less intrusive) first, interior common area work next, and work that necessitates unit entry on a unit by unit basis, as much as possible on unit turnover (vacancy).

These impediments to seismic upgrades of URM apartment buildings, together with the general lack of knowledge among URM apartment owners of either the earthquake risk or the feasibility of seismic upgrades, compounded by the natural tendency of investment property owners to avoid voluntary capital expenditures that do not improve the “bottom line” cash flow, these factors have resulted in a very slow pace for seismic upgrades of URM apartment buildings in Portland. Given the risk of an M 9 earthquake in the next 50 years, this pace must be accelerated for the owners, the tenants, and the City. As the creation of additional generous governmental incentives to seismic upgrading are unlikely in the current economic climate, some combination of (i) a governmentally mandated timetable for minimum (Basic Life Safety) seismic upgrading timetable (over say 15 to 20 years) for URM apartments and (ii) changes ameliorating the impediments listed as items 1 to 8 above, may be the only feasible approach. ■

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## OFFICE MARKET ANALYSIS

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With the conclusion of the second quarter of 2010 the office market continues to struggle under the weight of the current recession. Overall, vacancy rates have increased and rents continue to decline. Current office vacancy, according to the major local brokerage firms, ranges from 15.5 percent to 19.5 percent within the metropolitan area. Recent data reveals the office market is showing signs of bottoming out, but the pace of improvement has slowed from the previous quarter and increasing vacancy, primarily within the suburbs, continues to be concern.

Recently, the U.S. Commerce Department issued revised gross domestic product (GDP) numbers indicating the recession was worse than previously thought over the last three years. The Wall Street Journal recently reported:<sup>12</sup>

[T]he overall depth of the latest recession surpassed that of any other downturn since the late 1940s. GDP fell by 4.1 percent from the fourth quarter of 2007, when the recession officially began, to the second quarter of 2009, when many economists believe it ended ... the previous estimate for peak-to-trough decline was 3.7 percent.

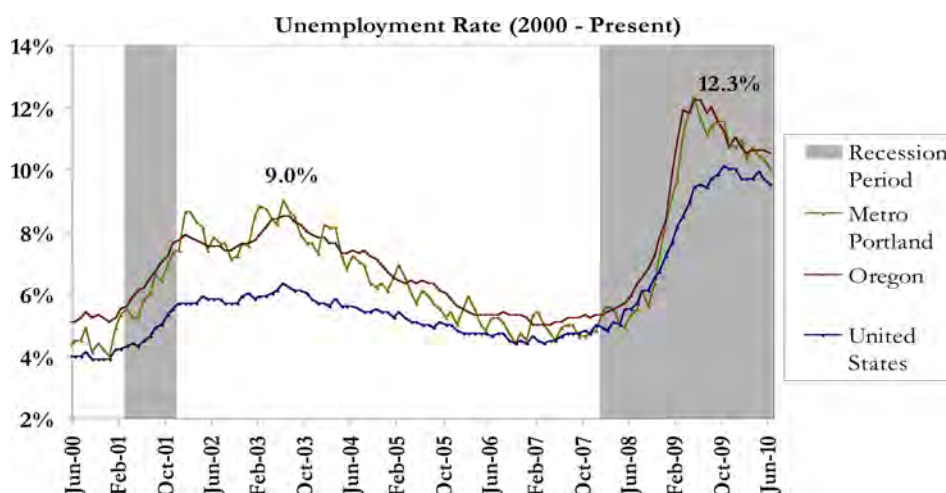
Despite the gloomy GDP report, there were some positive signs, namely the increase in corporate profits. However, it appears that a good portion of the increase in corporate profits can be attributed to belt tightening and not large increases in revenue. In general, higher

<sup>12</sup>Murray, Sara, "Revisions Show Slower Recovery, Deeper Recession," *Wall Street Journal*, August 1, 2010.

corporate earnings have not translated into larger employment gains and U.S. consumers, who account for 70 percent of GDP spending, continue to remain frugal.

The national unemployment rate stood at 9.5 percent as of June. In the metropolitan Portland area, the June unemployment rate was 10.0 percent. Although the local unemployment rate has been at 10 percent or higher since the first quarter of 2009, the rate has dropped 70 basis points since March 2010, which is a larger than the 20 basis points drop recorded nationally over the same time period. Looking forward the Oregon Employment Department predicts that the state and the Portland area will experience slow growth for the second part of 2010. The slow growth should pick up in the next years, but pre-recession employment levels may not be reached until after 2013.

Figure 7.1

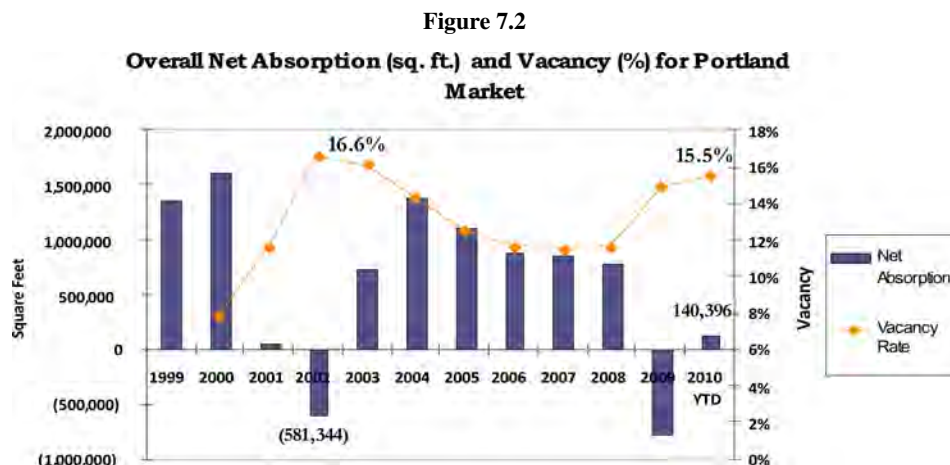


Source: Oregon Employment Department

Grubb & Ellis Co. reports the lowest overall vacancy in the metropolitan market in comparison to figures reported by CB Richard Ellis, Cushman Wakefield and NAI Norris, Beggs & Simpson. Through the first two quarters of 2010 absorption is positive, with most of this attributed to the General Services Administration (GSA) leasing over 250,000 square feet at the recently completed First & Main tower downtown. This leasing activity gives the CBD a net absorption of 283,501 square feet and helps offset the negative 143,105 square feet of space that came back on the market in the suburbs.

Although vacancy has steadily increased in both downtown and the suburbs, knowledgeable brokers feel that vacancy will begin to stabilize due to the lack of new construction. At this time there is only 84,000 square feet of space under construction in the greater Portland area that is not planned for owner-occupancy. Furthermore, the fate of the stalled 330,000 square feet Park Avenue West tower in downtown appears in jeopardy with the PDC's recent decision to stay at their current location and news that the Stoel Rives Law Firm, the largest pre-leased tenant, has exercised an option to renew their Standard Insurance Building lease. As shown in the graph below, construction permits within Portland

increased from the low point reached last quarter. However, construction activity is well below the levels seen in 2008 and the first part of 2009.



Source: Grubb & Ellis Quarterly Report, Second Quarter 2010

As the recession has dragged on, the suburban office market has struggled significantly more than the downtown office market. Figures provided by the four major brokerage firms featured in this report show the overall downtown central business district vacancy ranging between 10.7 percent and 12.7 percent, with vacancy in the suburbs ranging from 19.5 percent to 23.9 percent. Several brokers report that former suburban tenants have taken advantage of lowered asking rates to relocate downtown. An example is the pending move by Northwest Evaluation Association from Kruse Way to the recently vacated 124,464 square feet Port of Portland building at 121 N.W. Everett Street. The chart below details vacancy rates within the CBD and the suburban Kruse Way, I-5 South and Sunset Corridor submarkets as reported by NAI Norris Beggs & Simpson since the start of the recession. Despite delivering over 400,000 square feet since the fourth quarter of 2007, the CBD has seen only a modest increase in the vacancy rate. Conversely, Kruse Way and the I-5 South submarkets started the recession with a vacancy rate similar to the CBD, but have since increased to 29.4 percent and 28.1 percent, respectively.

The increase in vacancy within Kruse Way has been startling as this submarket, with over 2.3 million rentable square feet, has traditionally been considered the premier location in the suburbs. Those familiar with the market report that it was initially affected by the loss of several financial service and mortgage firms at the beginning of the recession and has since struggled to retain tenants. The submarket also saw the ill-timed delivery of the 108,000 square feet Kruse Oaks III building in the Spring of 2009. In the future Kruse Way is expected to return to a more stabilized occupancy since the location within Lake Oswego with quick access to the I-5 and 217 freeways are significant amenities.

In general, competition for tenants in the suburbs, especially in submarkets with vacancy above 15 percent, is extremely competitive. Joe Kappler, a broker at Macadam Forbes, reports that recent leasing deals have been very much in the favor of tenants. Concessions such as one month free rent for every year of the lease are generally standard for quality

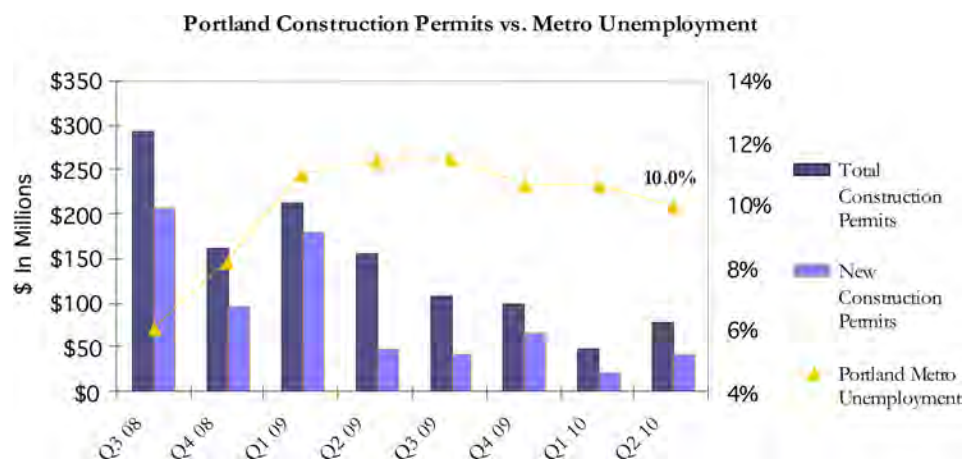
OFFICE Q2-10	CB Richard Ellis	Cushman & Wakefield	Grubb & Ellis	Norris, Beggs & Simpson	Median
<b>Market-Wide Vacancy</b>	<b>16.1%</b>	<b>18.0%</b>	<b>15.5%</b>	<b>19.5%</b>	<b>17.1%</b>
Previous Quarter	-	17.7%	15.3%	18.0%	17.7%
2nd Quarter 2009	14.0%	14.9%	14.0%	16.0%	14.5%
2nd Quarter 2008	10.5%	11.4%	11.3%	13.2%	11.4%
<b>CBD and Downtown Vacancy</b>	<b>11.0%</b>	<b>11.9%</b>	<b>10.7%</b>	<b>12.7%</b>	<b>11.5%</b>
Previous Quarter	-	12.8%	10.4%	12.0%	12.0%
2nd Quarter 2009	8.9%	10.9%	8.5%	10.3%	9.6%
2nd Quarter 2008	7.8%	9.1%	7.8%	9.8%	8.5%
<b>CBD Class A Vacancy</b>	<b>N/A</b>	<b>N/A</b>	<b>9.2%</b>	<b>8.7%</b>	<b>9.0%</b>
Previous Quarter	-	-	8.0%	7.9%	8.0%
2nd Quarter 2009	5.4%	8.6%	6.1%	6.3%	6.2%
2nd Quarter 2008	5.3%	6.2%	4.9%	6.5%	5.8%
<b>CBD Class A Asking Rents</b>	<b>N/A</b>	<b>\$26.34</b>	<b>\$27.03</b>	<b>N/A</b>	<b>\$26.69</b>
Previous Quarter	N/A	\$25.51	\$25.88	N/A	\$25.70
2nd Quarter 2009	\$27.02	\$26.20	\$24.68	N/A	\$26.20
2nd Quarter 2008	\$27.04	\$26.49	\$25.94	N/A	\$26.49
<b>Suburban Vacancy</b>	<b>21.5%</b>	<b>21.1%</b>	<b>19.5%</b>	<b>23.9%</b>	<b>21.3%</b>
Previous Quarter	N/A	22.4%	18.9%	21.9%	21.9%
2nd Quarter 2009	19.3%	18.7%	18.1%	19.1%	18.9%
2nd Quarter 2008	13.0%	13.5%	13.4%	15.0%	13.5%
<b>Suburban Class A Vacancy</b>	<b>N/A</b>	<b>N/A</b>	<b>22.1%</b>	<b>27.1%</b>	<b>24.6%</b>
Previous Quarter	N/A	-	24.4%	24.2%	24.3%
2nd Quarter 2009	N/A	20.3%	19.5%	N/A	19.9%
2nd Quarter 2008	N/A	14.0%	14.9%	N/A	14.5%
<b>Suburban Class A Asking Rents</b>	<b>N/A</b>	<b>\$23.09</b>	<b>\$23.65</b>	<b>N/A</b>	<b>\$23.37</b>
Previous Quarter	N/A	\$23.32	\$22.98	N/A	\$23.15
2nd Quarter 2009	N/A	\$23.59	\$23.20	N/A	\$23.40
2nd Quarter 2008	N/A	\$24.47	\$24.35	N/A	\$24.41

Figure 7.3



Source: Grubb & Ellis Quarterly Report, Second Quarter 2010

Figure 7.4



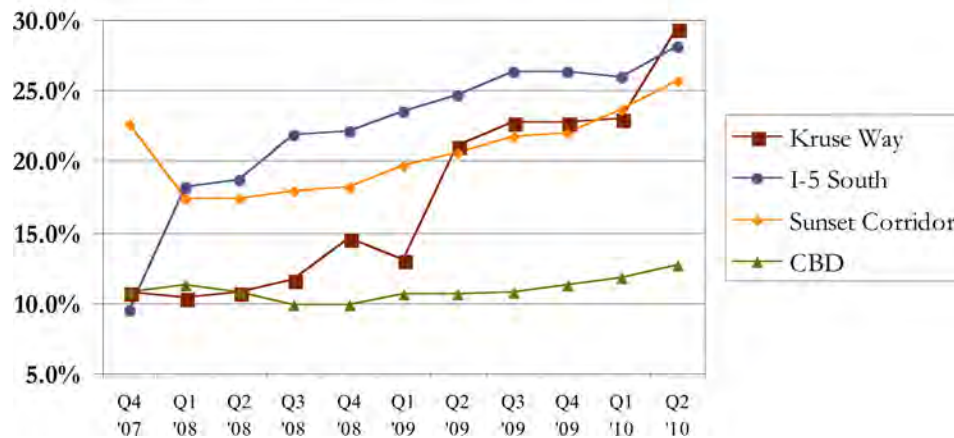
Source: Portland Bureau of Development Services and Oregon Department of Employment

tenants. Although there are challenges in the current market, Kappler senses that rents have started to bottom out in some suburban submarkets and that landlords seem determined to hold asking rents at a certain level, even if that calls for offering free rent or generous tenant improvement allowances. Kappler adds that there are great opportunities for owner/user purchases, but there is a lack of good quality single-tenant buildings for sale.

Due to tougher lending standards as well as a challenging business environment many tenants are unable to access capital for tenant improvements. While TI's are always a significant negotiating point, they are more often than not deal breakers. Landlords that can offer space that requires minimal tenant improvements have an advantage over the competition. For newer buildings in cold shell condition, unless a significant tenant improvement budget was initially written into the proforma, these buildings will face strong competition from existing properties.

These same conditions are also present in the downtown market, although the lower vacancy rate allows some landlords to offer less concessions than those offered in the suburbs. Kevin Kaufman, a broker specializing in downtown office properties for CB Richard Ellis, points out that activity over the last few quarters has been dominated by leasing with very few sales. A good portion of activity as of late has consisted of larger firms either renewing or downsizing as well as those looking to upgrade to a better location or a nicer space for roughly the same rent. Kaufman warns, however, that many tenants falsely perceive that all property owners have fallen on hard times and will be willing to offer generous terms in favor of the tenant. The situation varies between properties and location, where owners may or may not agree to terms offered by the tenant. Although vacancy in the CBD has crept up over the past 18 months, Kaufman points out that Portland currently has one of the better performing downtown office markets in the nation in terms of vacancy.

**Figure 7.5**  
**Office Vacancy: CBD vs. Select Suburban Submarkets**



Source: NAI Norris, Beggs & Simpson

*Major Lease Transactions Q2 2010*

Lessee	Property	Submarket	Size (SF)
Oregon Institute of Technology	In-Focus Building	Wilsonville	131,793
Freightliner (renewal)	Montgomery Park	Northwest	92,307
Columbia Sportswear	Cornell Oaks	Sunset Corr.	24,478
State Farm Mutual Auto. Ins.	Fanno Creek Place	Tigard	23,172
Northwest Energy Efficiency	Commonwealth Bldg.	CBD	20,003
Conservation Services Group	The Lincoln Bldg.	CBD	17,400

Source: NAI Norris, Beggs & Simpson, Grubb & Ellis Office Reports - Second Quarter 2010

Looking forward, the local Grubb & Ellis Co. office indicates that the CBD will continue to improve over the next few quarters, while tenants in the suburbs will see reduced rents and many space options. Most economists point out that sustained improvement in the office market will only take hold when employment returns to normalized levels. ■

**Greg LeBlanc** is a Certificate of Real Estate Development Graduate Student and Portland State University and is a Regional Multiple List Service (RMLS) fellow.





## RETAIL MARKET ANALYSIS

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KYLE SMITH

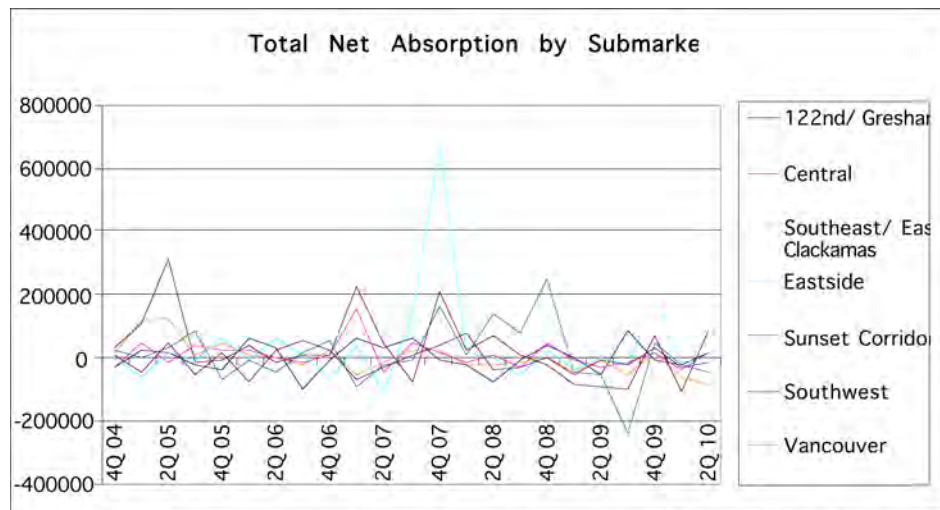
Portland State University

Retail vacancy rates remained unchanged during the second quarter at 8.0 percent, but there was negative absorption of 20,547 square feet according to the Norris, Beggs & Simpson retail report. Central City experienced a vacancy decrease of nearly one percentage point, down to 10.9 percent, while Southeast/East Clackamas vacancy increased over one percentage point to 6.5 percent.

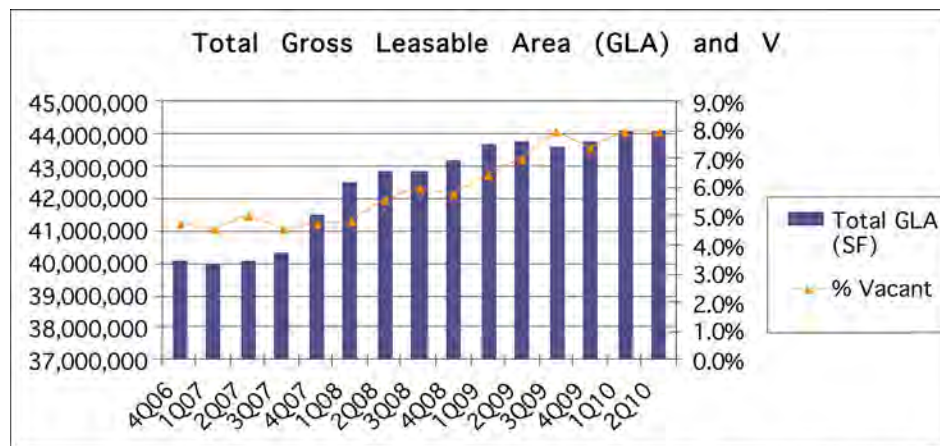
Norris, Beggs & Simpson notes that there was substantial leasing activity among big-box stores, which are not included in its retail report. The Salvation Army leased around 40,000 square feet on SE 82nd at the former Linens 'n Things and Dick's Sporting Goods leased approximately 50,000 square feet at the former Joe's Sports in Clackamas' Johnson Creek Crossing.

As reported in last quarters issue, H & M and Saks Fifth Avenue Off Fifth will be opening soon. H & M has confirmed its store will open this fall at Pioneer Place, and Saks is set to open at Bridgeport Village on September 2nd. In other clothing news, Nordstrom Rack has leased 48,344 square feet of space at Beaverton's Cascade Plaza Shopping Center.

Construction and deliveries to the market continued to be slow during the second quarter. There is 29,099 square feet currently under construction in the metropolitan area, about 5,000 more square feet than the first quarter according to Norris, Beggs & Simpson. There is some construction activity on the horizon though. Big Al's, which operates a bowling center in Clark County has opened an additional 66,000 square foot center in Beaverton at



**Figure 8.1** Retail net absorption: Negative 85,000 SF net absorption in Southeast/East Clackamas and positive 85,000 SF in Southwest submarkets



**Figure 8.2** Total gross leasable area: Vacancy rates and GLA remain unchanged

Progress Ridge. The developers of the property have signed New Seasons and Cinetopia to the site.

Nationally retail sales increased by a seasonally adjusted rate of 0.6 percent during April, then fell by 1.2 percent in May. The Consumer Confidence Index had been rising since February then decreased by about ten points to 52.9 in June, surprising many economists that did not expect that large of a decrease.

New York based Retail Opportunity Investments Corporation has been active in the Portland metropolitan market. The company recently purchased Vancouver Market Center for



Source: Norris, Beggs & Simpson Retail Report - Second Quarter 2010

**Figure 8.3** Retail construction: Construction inches up by about 5,000 square feet



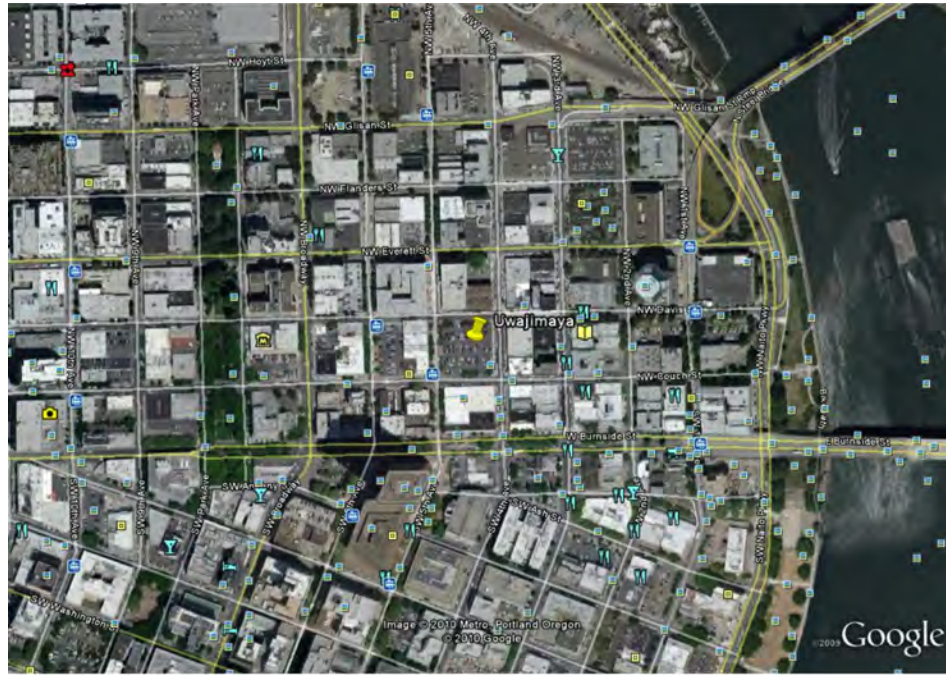
Source: Norris, Beggs & Simpson Retail Report - Second Quarter 2010

**Figure 8.4** Retail construction: Southeast and Vancouver submarkets remain the only sites with current construction activity

\$11.9 million and four other retail centers in the area from Gramor Development. Purchase price for the four center portfolio is approximately \$90 million.

Specialty Asian grocer, Uwajimaya signed a letter of intent at the end of June with Sockeye Development for a store in Old Town as a part of a mixed-use development. The store would cover the whole city block that is bordered by Fourth and Fifth avenues and Couch and Davis streets. In its current configuration the project will have a 24,000–28,000 square

foot street-level grocery store, additional street-level retail space, a courtyard, further mezzanine level retail space, one floor of office on the second floor, 140 units of mixed income apartments and three stories of underground parking.



**Figure 8.5** Uwajimaya site

If opened, it would be the second Uwajimaya in Oregon. The company currently has a store in Beaverton. The *Daily Journal of Commerce* reported that the letter of intent gives the Portland Development Commission (PDC) six months to come up with \$10 million for the building which has a total estimated cost of about \$80 million. The project was originally slated for construction to begin in late 2009, but the project stalled in 2008 because of a lack of public funding and the recession. Construction is now scheduled to start between 2012 and 2014, around ten years after the PDC performed a conceptual development study in 2003. The PDC currently has \$8 million in the Waterfront urban renewal area budget, \$2 million short of the \$10 million needed.

A non-scientific report produced by the Portland Business Alliance concluded that there is an increase in downtown pedestrian traffic compared to last year. The report relies on traffic numbers taken over a three day period in June at 15 different intersections in downtown Portland. Pedestrian traffic increased at eight of the eleven intersections this year compared to 2009 figures. The largest increase was at SW 3rd and Clay Street which was up 92 percent. The report notes that this number is skewed by foot traffic which was generated by a performance of the *Lion King* which took place near the intersection at Keller Auditorium. Other significant increases were observed at 5th and Morrison (59 percent increase), 5th and Couch (57 percent increase), and 6th and Taylor (66 percent increase). ■

**Kyle Smith** is a Certificate of Real Estate Development Graduate Student and Portland State University and is the Regional Multiple List Service (RMLS) fellow.



## PORTLAND INDUSTRIAL MARKET ANALYSIS

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KYLE SMITH

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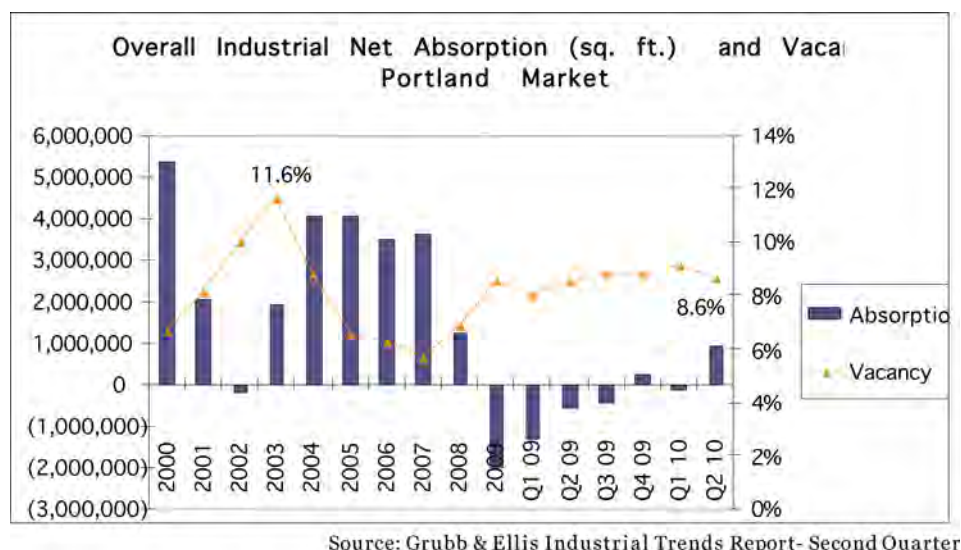
The Portland metropolitan industrial market experienced declining vacancy rates and positive net absorption during the second quarter of 2010 according to Grubb & Ellis. The market reversed the trend of rising vacancy rates and negative net absorption that has been occurring for about a year. During the quarter vacancy decreased by 50 basis points to 8.6 percent, and there was positive net absorption of 954,635 square feet. Nationally vacancy decreased by 30 basis points to end the second quarter at 10.6 percent and had 19.2 million square feet of absorption. This ends the ten consecutive quarter trend of weakening conditions.

Norris, Beggs & Simpson (NBS) reported substantially different market data in its Industrial/Flex Report than Grubb & Ellis did, due to a reliance on different data. While Grubb & Ellis reports decreasing vacancy rates and positive net absorption, NBS reports increasing vacancy rates and negative net absorption.

According to NBS, industrial vacancy increased 60 basis points up to 15.2 percent with a negative net absorption of 354,330 square feet, while R & D/flex vacancy increased by 20 basis points to 18.2 percent with 23,633 square feet of negative net absorption.

According to Grubb & Ellis, the warehouse and distribution sector of the market had positive net absorption of 827,729 square feet and vacancy decrease of 60 basis points to 8.5 percent. The R & D/flex market posted a 126,906 square foot positive net absorption and a 40 basis point vacancy decrease, bringing the sector to 8.8 percent vacancy. R & D/flex rents





**Figure 9.1** Industrial absorption: decreased vacancy rate coupled with positive net absorption for the first time in over a year

have bounced back up \$0.03 to \$0.77 after dropping \$0.04 per square foot during the first quarter of 2010. Grubb & Ellis also reports that owners continue to offer free rent, turn-key office build-outs and other concessions to entice possible tenants.

Colliers segments the market into Industrial and Flex and produces separate reports for each. According to their reports the Industrial segment vacancy dropped 20 basis points to 7.9 percent while the Flex segment vacancy increased slightly to 12.7 percent. For the Industrial segment this is the lowest vacancy rate that Colliers has published since the end of 2008. The same reports indicate that there were 49,939 square feet of positive absorption and 87 transactions where 780,190 square feet of space was leased in the Industrial segment. Flex posted negative absorption of 42,071 square feet with leasing volumes totaling 225,355 square feet in 48 transactions.

There was one building delivered to the market during the quarter, which was a 105,000 square foot build-to-suit project for Morgan Distributing in the NE/Columbia Corridor submarket. The 415,000 square foot FedEx shipping hub is the only building in the construction pipeline. It is scheduled to be delivered during the third quarter of 2010.

The I-5 South Corridor had a large reduction in vacancy and positive net absorption due to Medlines occupancy of 109,000 square feet of the former Nike warehouse in Wilsonville and two additional large tenants which leased space at 115th Commerce Park. Vacancy rates within that submarket dropped by 160 basis points down to 10.0 percent. Other notable submarket gains were NE Columbia Corridor which had about 200,000 square feet of positive absorption and Rivergate which experienced a vacancy decrease of 210 basis points, bringing vacancy down to 9.3 percent. Norris, Beggs & Simpson reports that Farwest Steel will be purchasing over 20 acres for approximately \$5 million from the Port of Vancouver. The company is planning to build a new steel processing and distribution facility at a cost



**Table 9.1** Portland industrial market

<b>INDUSTRIAL: Q2-10</b>	<b>CB Richard Ellis*</b>	<b>Cushman &amp; Wakefield</b>	<b>Grubb &amp; Ellis</b>	<b>Norris, Beggs &amp; Simpson</b>	<b>Median</b>
<b>Market-wide Vacancy</b>	-	<b>8.6%</b>	<b>8.6%</b>	<b>15.2%</b>	<b>8.6%</b>
Previous Quarter	8.2%	8.7%	9.1%	14.6%	<b>8.9%</b>
Second Quarter 2009	8.1%	8.0%	8.5%	13.9%	<b>8.3%</b>
Second Quarter 2008	5.8%	6.3%	6.7%	N/A	<b>6.3%</b>
<b>Warehouse/Distribution</b>	-	<b>10.0%</b>	<b>8.5%</b>	<b>N/A</b>	<b>9.3%</b>
Previous Quarter	-	10.4%	9.1%	N/A	<b>9.8%</b>
Second Quarter 2009	N/A	7.7%	8.6%	N/A	<b>8.2%</b>
Second Quarter 2008	N/A	5.8%	6.8%	N/A	<b>6.3%</b>
<b>R&amp;D/Flex Vacancy</b>	-	<b>10.0%</b>	<b>8.8%</b>	<b>18.2%</b>	<b>10.0%</b>
Previous Quarter	-	-	9.2%	18.0%	<b>13.6%</b>
Second Quarter 2009	N/A	9.6%	7.9%	15.1%	<b>9.6%</b>
Second Quarter 2008	N/A	9.2%	6.5%	N/A	<b>7.9%</b>
<b>Asking Monthly Shell Rates</b>	-	<b>N/A</b>	<b>\$0.41</b>	<b>N/A</b>	<b>\$0.41</b>
Previous Quarter	\$0.39	N/A	\$0.41	N/A	<b>\$0.40</b>
Second Quarter 2009	\$0.40	N/A	\$0.41	N/A	<b>\$0.41</b>
Second Quarter 2008	\$0.39	N/A	\$0.42	N/A	<b>\$0.41</b>
<b>Asking Monthly Flex Rates</b>	-	<b>N/A</b>	<b>\$0.77</b>	<b>N/A</b>	<b>\$0.77</b>
Previous Quarter	\$0.75- \$1.00	N/A	\$0.74	N/A	<b>\$0.74</b>
Second Quarter 2009	\$0.85- \$1.05	N/A	\$0.80	N/A	<b>\$0.80</b>
Second Quarter 2008	\$0.85- \$1.06	N/A	\$0.82	N/A	<b>\$0.82</b>

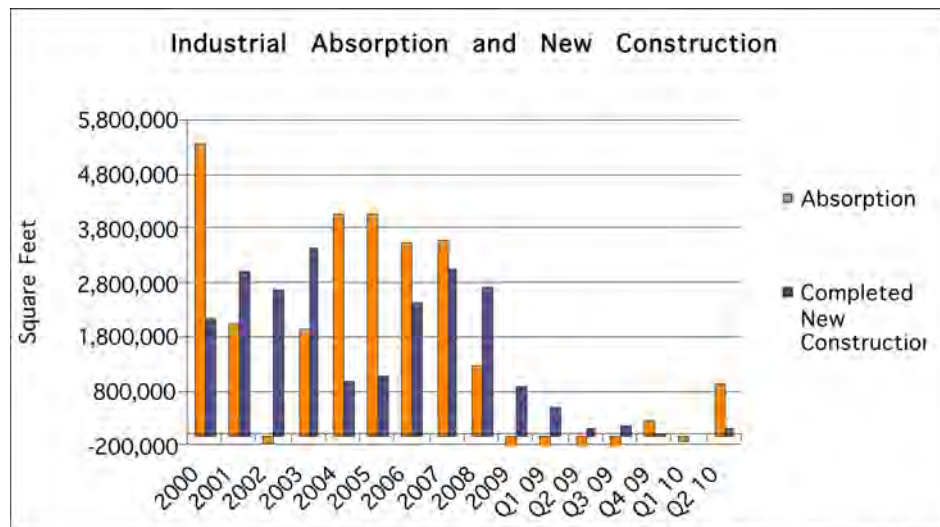
Sources: CB Richard Ellis, Cushman &amp; Wakefield, Grubb &amp; Ellis, Norris, Beggs &amp; Simpson

\*CB Richard Ellis second quarter reports were not complete at time of publishing

between \$20 and \$30 million. The facility will create 125 new jobs and employ roughly 200 people total.

<b>Tenant</b>	<b>Property</b>	<b>SF</b>	<b>Submarket</b>
Medline	Former Nike Warehouse	109,000	Southwest I-5
Stanton Furniture	115th Commerce Park	92,960	Southwest I-5
West Coast Metals	2455 Nicolai St.	78,375	Northwest
Consolidated Molding & Millwork	115th Commerce Park	48,000	Southwest I-5
<b>Total</b>		<b>328,335</b>	

Renewable energy companies, spurred by government grants and loans have been active in the market. Solexant, a photovoltaic cells manufacturer, is expected to receive a \$25 million loan from the state to build a factory which will develop ultra-thin-film solar cells. The facility is set to initially employ about 100 people, but could rise to the same capacity as So-



Source: Grubb & Ellis Industrial Trends Report- Second Quarter

**Figure 9.2** Industrial absorption and new construction: Morgan Distributing's 105,000 SF build-to-suit was the sole building delivered to the market during the quarter

larWorld in Hillsboro. When SolarWorlds Hillsboro expansion is completed this fall it will employ about 1,000 individuals. A \$5 million grant was awarded to battery maker ReVolt Technology which will help build a Portland plant to develop plug-in vehicle batteries.

Ajinomoto Frozen Foods announced in June that the company is growing its Marine Drive facility with a \$12.5 million expansion. Ajinomoto manufactures ethnic frozen foods, and the expansion is in response to increased demand for the companys fried rice products. Once the expansion is finished the company plans to add 30 additional employees to its current staff of 160 full-time employees and 40 temporary workers. ■

**Kyle Smith** is a Certificate of Real Estate Development Graduate Student and Portland State University and is the Regional Multiple List Service (RMLS) fellow.

## MULTIFAMILY MARKET ANALYSIS

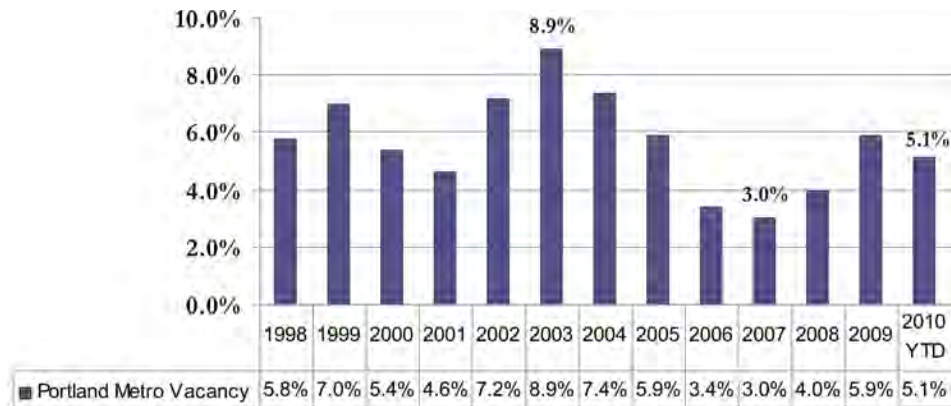
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GREG LEBLANC

Portland State University

Through the first half of 2010 the local multifamily market has improved. According to the Spring 2010 survey by the Metropolitan Multifamily Housing Association (MMFHA), vacancy dropped to 5.1 percent in the metropolitan Portland market, down from 5.9 percent in the fall 2009. Similar results are seen in a more recent survey completed by Norris & Stevens, a local brokerage firm specializing in multifamily. The summer 2010 Norris & Stevens survey showed that the Portland area vacancy rate dropped to 5.75 percent, down 1.14 percent from the last survey in the fall of 2009. At this time many owners and managers are reporting improved conditions within the market and have scaled back the use of concessions and started to introduce modest rent increases in some cases. The encouraging signs seem to have indicated that the worst conditions in the multifamily market have passed and investment interest in the market is picking up as illustrated by several large sales in the last two months. Whether or not this growth can be sustained in the face of high unemployment and continued turmoil within investment markets remains to be seen.

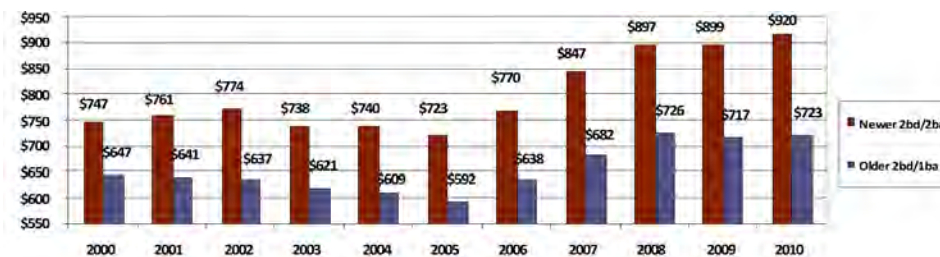
The drop in the local vacancy rate reflects similar conditions in the national apartment market. Data released by Reis Inc., a New York real estate research firm, showed that the national multifamily vacancy rate stood at 7.8 percent at the end of June. The *Wall Street Journal* reports this was a modest decrease from the 8 percent vacancy reported in the first quarter of 2010, which was the highest national vacancy rate in 30 years.



Source: Mark Barry \& Assoc. and the Metropolitan Multifamily Housing Association

**Figure 10.1** Multifamily vacancy, Portland metro

The recent Norris & Stevens survey shows asking rents for older two-bedroom/one-bath units to be flat since 2008 (see graph below). Asking rents for newer two-bedroom/two-bath units have increased slightly over this time period, going from \$897 per month to \$920 per month in 2010. This survey, however, only pertains to asking rents and does not make an adjustment for rent concessions, which were prevalent in the market last year and still common today. As reported by Norris & Stevens in their Summer 2010 Apartment Investors Journal “Most submarkets are currently seeing some concessions, but rents seem to be holding steady, or increasing slightly. Downtown rents in new construction are pushing the average gains up for newer units citywide, but most areas have seen at least small increases.”



Source: Norris \& Stevens Summer 2010 Rent Survey

**Figure 10.2** Multifamily rents, average, Portland metro

Since the fall/winter 2009 survey, Kirk Ward, a broker at Norris & Stevens, reports that conditions within the multifamily market are improving. In addition to conducting a survey of the metropolitan rental market, Norris & Stevens also manages 9,000 units within 135 multifamily properties, most within the Portland area. According to Mr. Ward, only 12 of the 135 properties managed by Norris & Stevens were experiencing vacancy rates above 5 percent at the end of June. Sean Keyes, who operates Steed Properties, reports similar conditions within the 1,500 unit portfolio that his company owns within Oregon and southwest Washington. As of mid-July, 2010, the Steed portfolio was 98.5 percent occupied and the company was beginning to increase monthly rents by \$50 to \$100 per month at a majority of their locations.

At this time the multifamily sector appears to be benefitting from a few trends. The first is tighter mortgage standards, which is preventing a number of renters from owning homes. Prior to the recession some individuals that didn't qualify to rent were able to obtain home mortgage loans. This is no longer the case. Also, the current turbulence within the home market may be keeping some qualified home buyers on the sidelines longer until homes stop depreciating. Lastly, there are some supply concerns as new apartment construction in the last 18 months has slowed to a fraction of the construction levels seen in the last decade. As the region continues to gain new population there is a concern that the Portland area may actually be facing an apartment shortage in the next few years.

As indicated by Mr. Ward, multifamily is the only commercial asset class that has experienced lower vacancy and has also been able to raise asking and renewal lease rates. Financing terms for multifamily are also more favorable, with low rates available from Fanny Mae. Overall, the multifamily market appears to be improving at a faster rate than predicted, considering the poor results from 2009. Both nationally and locally apartments are getting significant attention from large institutional players and investors. Within Portland there have been five sales of multifamily properties since December, 2009, that have each exceeded \$38 million. The chart below highlights four of the most recent sales, in addition to the December, 2009 sale of Gerding Edlen's 352-unit Cyan for \$65,000,000, or \$184,659 per unit.

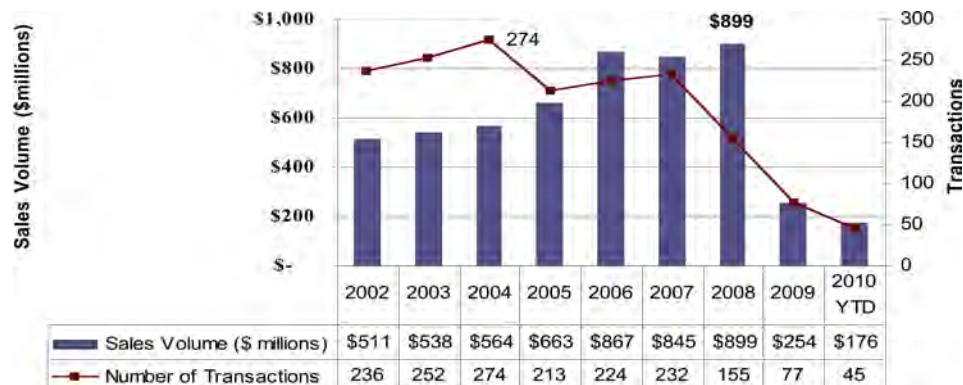
Major Sale Transactions						
Date	Building	Buyer	Price	Units	Price/Unit	Submarket
6/10	Harrison Tower	Alecta Real Estate Invest.	\\$39,500,000	186	\\$212,366	Downtown
6/10	Meridian at Murrayhill	Gerson Baker \& Assoc.	\\$24,500,000	312	\\$78,526	Beaverton
6/10	Clackamas Village	Matteson Co.	\\$20,750,000	372	\\$55,780	Clackamas
5/10	Tupelo Alley	Behringer Harvard Hold.	\\$38,750,000	188	\\$206,117	Close-in N.E.

These high profile multifamily sales in Portland were highlighted by the May, 2010, sale of Trammall Crow's 188-unit Tupelo Alley for \$38,750,000 (\$206,117 per unit) and the Matteson Co.'s June, 2010, sale of the 186-unit Harrison Tower for \$39,500,000 (\$212,366 per unit). June also saw the purchase of two 300+ unit garden-style suburban properties, Meridian at Murrayhill and Clackamas Village, by separate California-based real estate investment companies. Based on these sales, it appears that Portland is on the national

radar of large real estate companies and institutional investors. The Dallas-based REIT of Behringer Harvard Holdings, which purchased both the Cyan and Tupelo Alley, saw an opportunity to purchase new, well-located assets at a discount (both sales are believed to be below current replacement cost). According to Scott Bader, an acquisitions analyst at Behringer Harvard, the recent purchases were attractive based on the perception that the Portland market was at or near the bottom in terms of vacancy and rents. Since there are strong barriers to construct new development in Portland due to high land costs, system development fees, and long design/review periods, the acquisitions of two centrally located properties made sense. Considering the location and quality of Tupelo Alley and the Cyan, Behringer feels that each property offers significant upside potential for future rent appreciation.

The largest multifamily asset currently listed for sale in Portland is the 23-story, 332-unit Ladd Tower. The building was completed by Opus Northwest in May 2009, and was 80 percent leased as of early July. Opus and its lenders jointly decided to list the building on the market in an effort to capitalize on the recent sales within Portland. The current asking price is not known, but the property is being marketed by the local CB Richard Ellis office. As reported in the Oregonian, the construction loan for Ladd Tower is believed to be in excess of \$80 million, which would indicate a sale price of around \$241,000 per unit needed to cover the cost of the loan.

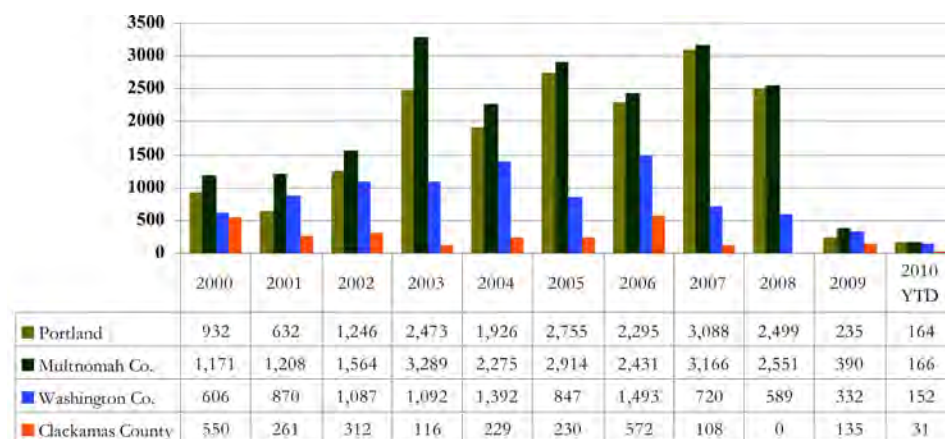
Despite the recent large multifamily sales, however, the number of transactions within the current market is still down significantly from levels seen in 2002 through 2008. The graph below shows the sharp drop-off in transactions and total dollar value in 2009 and continuing through the first part of this year. For smaller properties that are not being sought by larger institutional buyers, the market appears to be affected by a large bid-ask gap between buyers and sellers. Other issues include stricter lending guidelines that require a larger equity investment, lenders “blending and extending” troubled assets instead of disposing of them, and potential buyers attempting to low-ball owners based on the perception that all properties are in difficulty. The end result is that there is currently a lack of good quality smaller properties that are listed for sale, leading to the current low sales levels.



**Figure 10.3** Multifamily transactions and sales volume, Portland metro



These issues, however, are gradually starting to resolve within the market, according to Gary Winkler, a multifamily broker and principal of Winkler & DuPont. Winkler reports that potential sellers are gradually coming to terms with the reality of the current market. Coupled with the desire of investors for good-quality properties, Winkler anticipates more sales activity in the market for the second half of 2010.



Source: U.S. Census Bureau

**Figure 10.4** Multifamily permits issued, number of units, Portland metro

Not surprisingly, new apartment construction has followed a path similar to multifamily sales. As shown by the graph above, multifamily permits experienced a strong drop-off in 2009 when only 235 multifamily units were permitted within the city. This was well below the yearly average of 1,982 permits issued between 2000 and 2008. Much of the increase in multifamily development in the years 2003 through 2008 was related to the construction of large condominium and luxury apartment towers within the Pearl District, downtown and the South Waterfront. Still, factoring out the large-scale multifamily development in Portland still shows current construction to be well behind historical levels. This trend is also consistent in suburban areas. Through the first six months of 2010, only 166 multifamily units have been permitted in Multnomah County, with 152 units and 31 units permitted in Washington and Clackamas County, respectively. Based on these numbers, 2010 will be another slow year for apartment construction. Factors contributing to the current void in new construction include the weak economy, difficulty obtaining financing, and the current gap between replacement cost and market value. In light of the current low 5.1 percent vacancy rate in the metropolitan region and lack of new construction, many knowledgeable multifamily brokers and investors are predicting a shortage in apartments by 2012. This shortage will be felt first within the urban core and later in the suburbs, where there is slightly more inventory. ■

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# RESIDENTIAL MARKET ANALYSIS

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National housing market statistics reflect an increase in value from the prior year, bucking the multi-quarter trend of declining sales prices. Median home prices were up 4.2 percent annually in May, and up 5.3 percent from \$215,400 to \$226,800 in the western part of the United States. During this same time period the Portland metropolitan area experience slightly declining median sales prices, but a measurable leap in sales volume. The median sales price dropped 0.6 percent annually from \$246,700 to \$245,300 and the number of transactions in the metropolitan area increased by 40.6 percent.

	U.S.	West	Portland Metro
May 2009 Median Sales Price	\$172,100	\$215,400	\$246,700
May 2010 Median Sales Price	\$179,400	\$226,800	\$245,300
% Change in Median Sales Price	4.2%	5.3%	-0.6%
% Change in Number of Sales May 2009–2010	0.7%	4.7%	40.6%

Standard & Poor’s Case-Shiller Index for Portland was 146.25 at the end of the second quarter (April), down 0.07 percent from the first quarter (January) and down 0.4 percent annually. The 20 city composite is up 3.8 percent compared to the same time last year. The index data shows that in the major U.S. metropolitan cities, home prices are at comparable to what they were in the late summer of 2003. The 20 city composite is down 32.6 percent from its peak in June–July of 2006.

The National Association of Realtors Pending Home Sales Index dropped 30 percent, from April to May 2010 and is down 15.9 percent annually from May 2009. The data measures contracts, not closings, so it is a forward looking indicator. The index decline was expected by many and was heavily influenced by the expiration of the home buyer tax credit, which was partially responsible for three consecutive months of strong gains in the index.

Near the end of June the U.S. Senate voted unanimously to give homebuyers a little more time to close and still be eligible for the homebuyer tax credit. The bill allows buyers who signed a letter of intent to purchase on or before April 30th an additional three months to close. The original closing deadline was June 30th and now homebuyers have until September 30th. The National Association of Realtors estimated that about 180,000 buyers would not have been eligible for the tax credit if the deadline to close was not extended.

Mortgage rates are hitting historic lows that haven't been seen since the 1950's. On July 22, Freddie Mac reported that average rate on the primary mortgage market for a 30 year mortgage was 4.56 percent with 0.7 of point in fees. The *Oregonian* reports that rates are the lowest they have ever been since Freddie Mac starting keeping records in 1971. Rates haven't been lower then they currently are since the 1950's. However, during that time the majority of loans were amortized over 20 or 25 years.

The number of single family building permits issued nationally in May was up 29 percent annually, with an increase of 26 percent in Oregon. Every major submarket in Oregon experienced an annual increase in building permits issued. Salem had the largest percentage change (71 percent) followed by the Portland metropolitan area (49 percent).

**Table 11.1** Building permits issued (year to date)

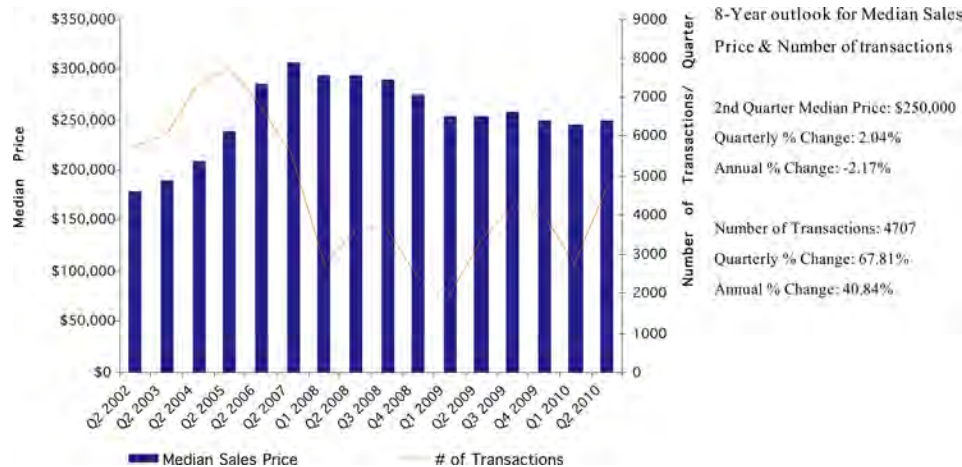
	SINGLE-FAMILY			MULTIFAMILY		
	May-10	May-09	PCT CHG	May-10	May-09	PCT CHG
<b>UNITED STATES</b>	<b>202.2</b>	<b>156.9</b>	<b>29%</b>	<b>53.4</b>	<b>59.2</b>	<b>-10%</b>
OREGON	2.69	2.13	26%	0.37	1.27	-71%
Bend OR	0.16	0.14	17%	0.01	0.03	-69%
Corvallis OR	0.02	0.01	7%	0.02	-	-
Eugene-Springfield OR	0.23	0.16	46%	0.01	0.05	-76%
Medford OR	0.12	0.12	0%	0.02	0.01	89%
Portland-Vancouver-Beaverton OR-WA	1.65	1.11	49%	0.25	0.45	-45%
Salem OR	0.19	0.11	71%	0.02	0.09	-74%

*Source: National Association of Home Builders (May 2010)*

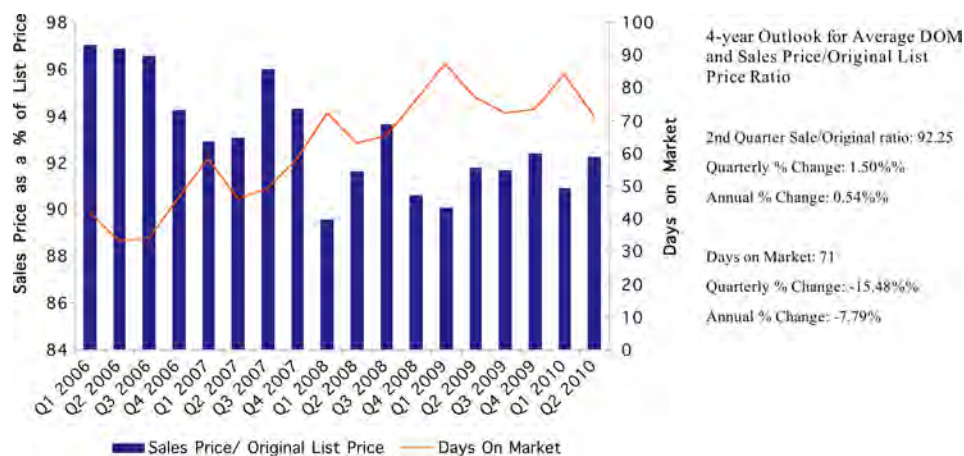
## PORTLAND

The number of Portland metropolitan area home sales increased by 67.8 percent during the second quarter, as buyers closed on purchases of 4,707 existing homes. This is a 40.8

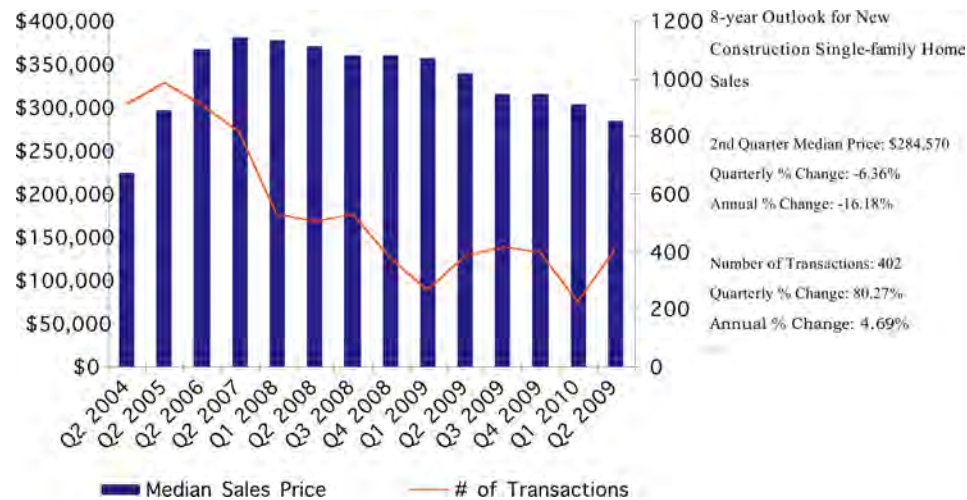
percent increase from the second quarter of 2009 when there were 3,342 transactions in the metropolitan area. Median prices for the first quarter were at \$250,000, which represents a 2 percent increase over the previous quarter but a 2.2 percent reduction annually. Sales price to original list price are coming closer together, with average sales taking place at 92.25 percent of the original list price. This is an increase of about 140 basis points from the previous quarter, and a 50 basis point increase annually. Sellers in the Portland area have their homes on the market for an average of 71 days before closing, reflecting a 5 day decrease from 2009 and a 13 day decrease from the first quarter.



**Figure 11.1** Median sales price and number of transactions, existing detached homes, Portland metro



**Figure 11.2** Ratio of sale price to original list price and average days on market, existing detached homes, Portland metro



**Figure 11.3** Median sales price and number of transactions, new detached homes, Portland metro

Eight of the submarkets listed on the next page experienced quarterly price appreciation on existing detached homes, while the other seven submarkets experienced quarterly price depreciation. Home prices in Southeast Portland increased the most at 6.12 percent, followed by Northeast Portland at 5.82 percent, Beaverton/Aloha at 4.39 percent, Milwaukie/Clackamas at 4.17 percent, Yamhill County at 3.45 percent, Gresham/Troutdale at 1.45 percent Oregon City/Canby at 0.76 percent and NW Washington County at 0.51 percent.

The Tigard/Wilsonville submarket experienced the highest quarterly depreciation rate at -20.66 percent followed by Mt. Hood/Government Camp/Wemme at -15.12 percent and Hillsboro/Forest Grove at -7.49 percent.

Annual results are negative for all but two Portland area submarkets. Lake Oswego/West Linn median sales price is up 3.04 percent from the second quarter of 2009 and the Beaverton/Aloha submarket is up 2.56 percent.

Mirroring the quarterly results, the largest annual depreciation was experienced in Tigard/Wilsonville at -19.41 percent and Mt. Hood/Government Camp/Wemme at -17.89 percent.

## VANCOUVER

Vancouver's median home price was \$192,500 resulting in a quarterly decrease of 1.28 percent and an annual decrease of 1.3 percent in home values. The number of homes sold throughout the second quarter increased substantially to 764, up 67.18 percent quarterly and up 17.54 percent annually. The average number of days on the market is down to 81. First quarter average number of days on the market was 94, while it was 100 during the second quarter of 2009.

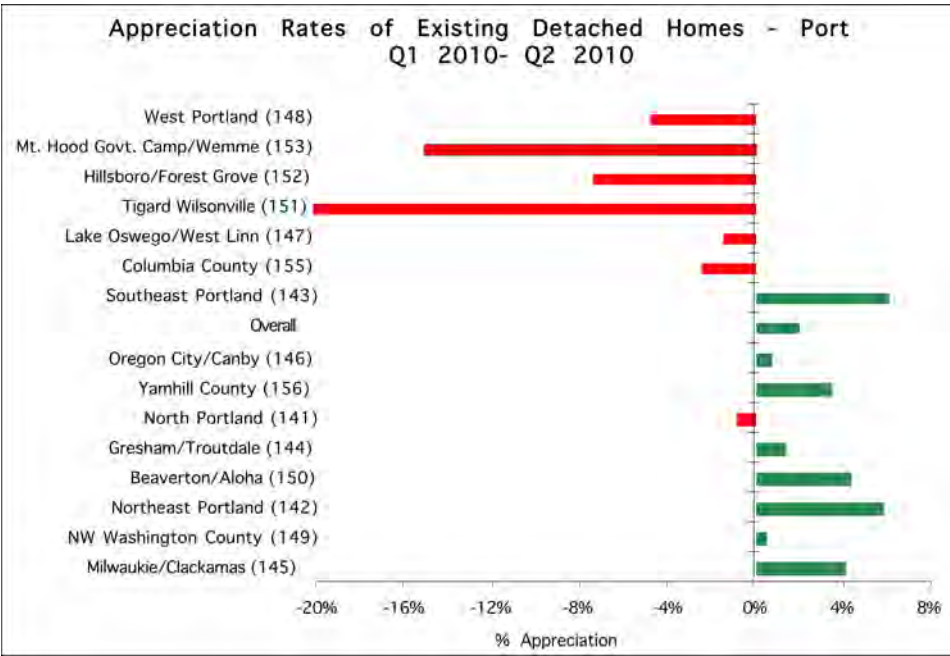


Figure 11.4 Appreciation rates, existing detached homes, Portland metro

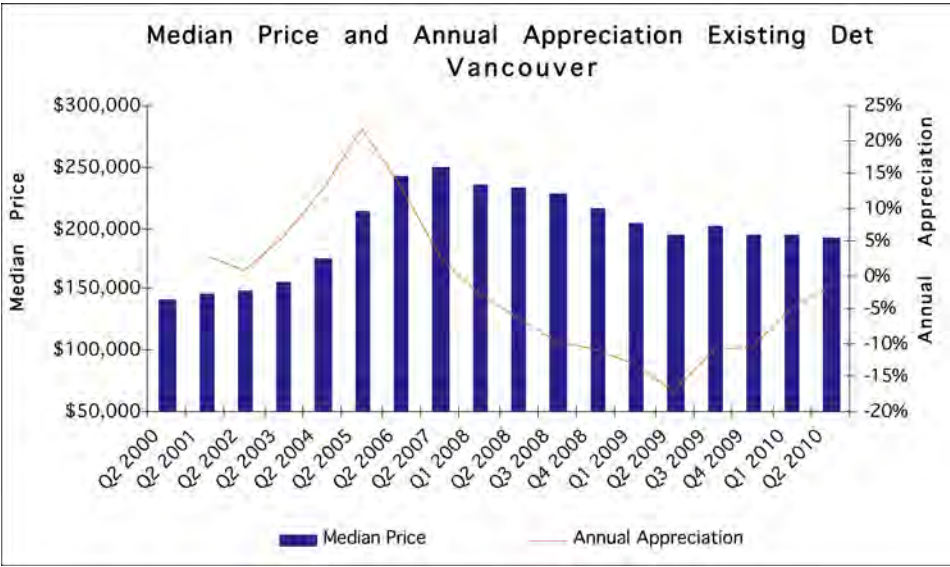
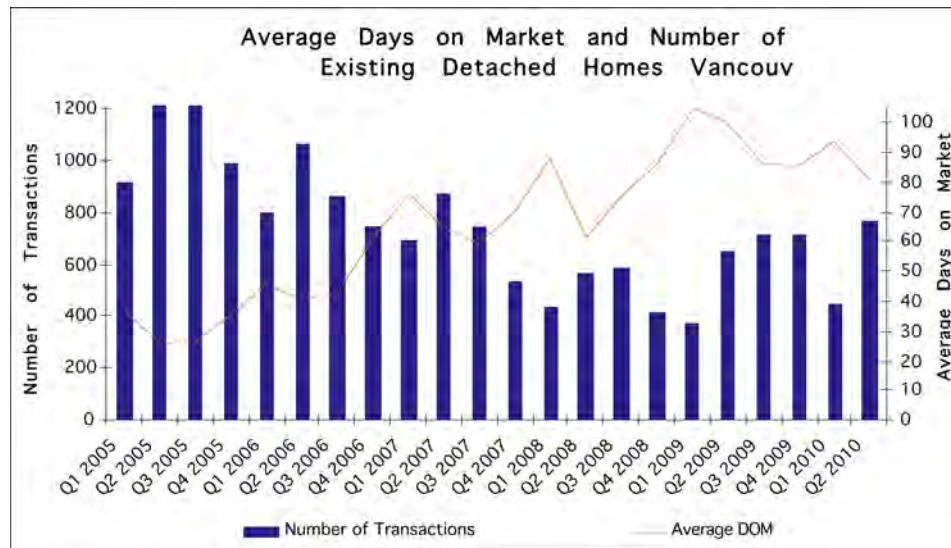
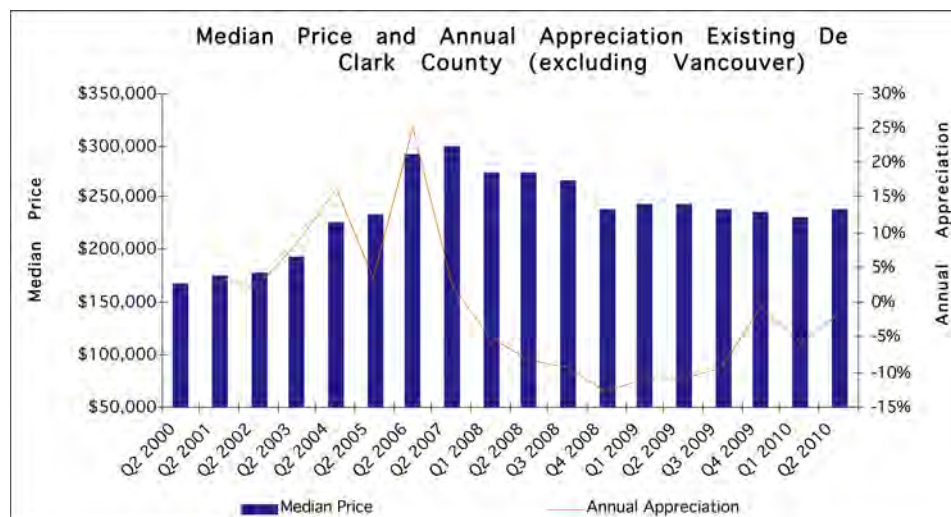


Figure 11.5 Median price and annual appreciation rates, existing detached homes, Vancouver





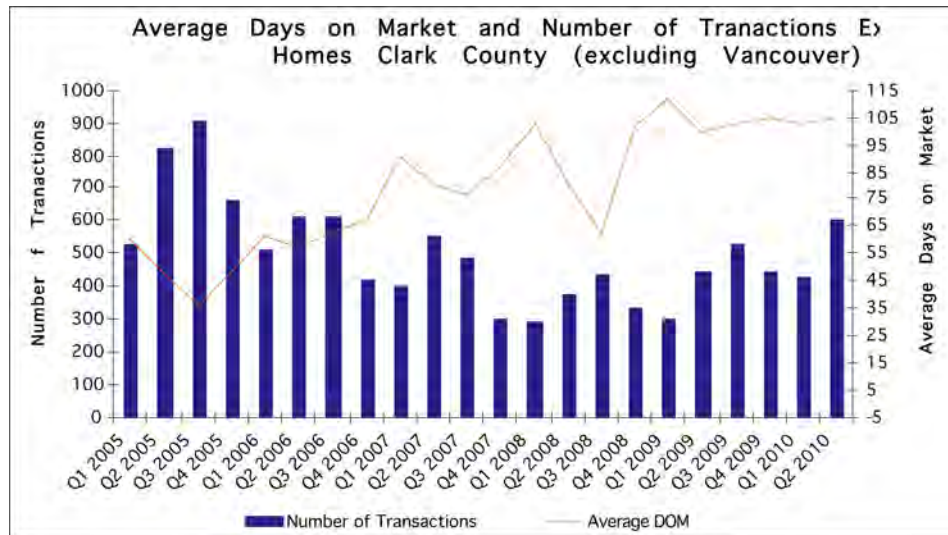
**Figure 11.6** Number of transactions and average days on market, existing detached homes, Vancouver



**Figure 11.7** Median price and annual appreciation rates, existing detached homes, Clark County, excluding Vancouver

In the Clark County suburbs home prices have increased to \$240,000. This is a 3.45 percent increase from the previous quarter's median price, but a 2.04 percent decrease annually.

The number of home transactions in Clark County's suburbs is up 41.2 percent for the quarter and up 36.2 percent annually. There were 610 transactions during the second quarter. The average number of day on the market crept up from 103 to 105. During the second quarter of 2009 homes averaged 100 days on the market.



**Figure 11.8** Number of transactions and average days on market, existing detached homes, Clark County, excluding Vancouver

Eleven Vancouver/Clark County submarkets experienced price appreciation for the quarter. The Northeast Corner submarket posted the highest gains with an appreciation rate of 56.9 percent (based on only four transactions) followed by Southwest Heights at 46.2 percent (in seven transactions) and Southeast County at 25.8 percent (in eleven transactions).

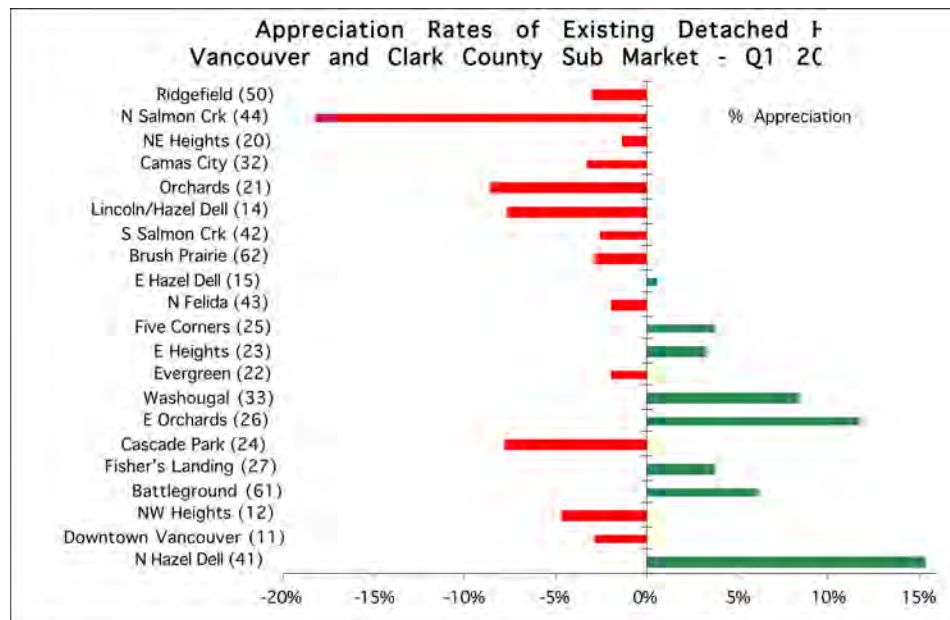
Conversely 16 submarkets had price depreciation. The Northwest County, East of I-5 area had the highest quarterly depreciation rate of -25.9 percent followed by North Salmon Creek at -18.3 percent and Woodland Area at -14.5 percent.

Annual changes show that eleven submarkets had higher median sale values, with Central County (34.6 percent), North Hazel Dell (18.9 percent) and Yacolt (17.9 percent) submarkets increased the most in value.

East Heights (-34.6 percent), Woodland Area (-27.23 percent) and Downtown Vancouver (-22.2 percent) submarkets saw the greatest annual depreciation.

## CENTRAL OREGON

Both Bend and Redmond continued to experience increases from the previous year with respect to the number of homes sold. Bend home sales under one acre are up 28 percent to 458 while Redmond's increased 32 percent to 202. More significant transaction increases

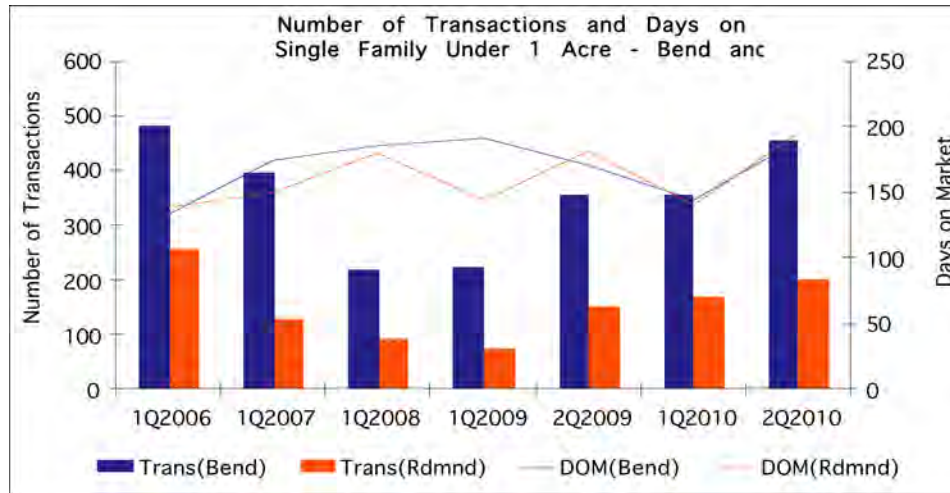


**Figure 11.9** Appreciation rates, existing detached homes, Clark County

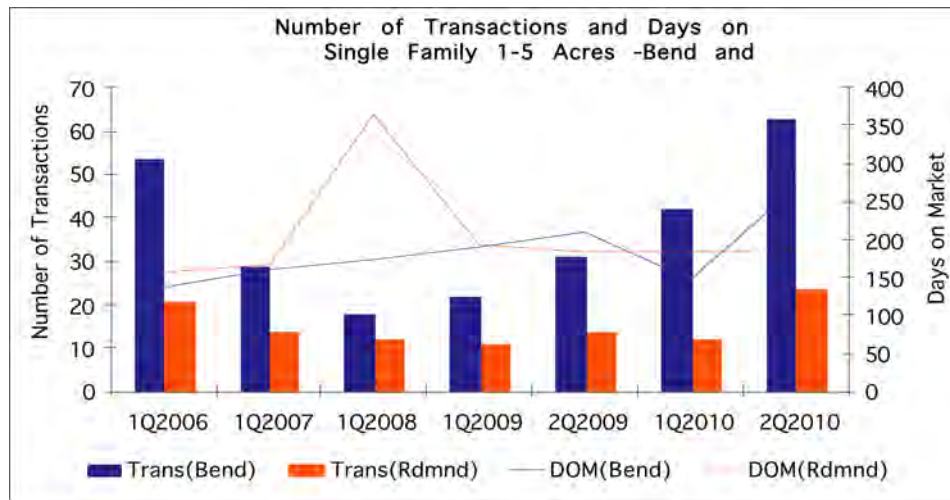
were seen with homes on 1–5 acres where volumes increased by 103 percent in Bend up to 63 sales and by 71 percent in Redmond up to 24 sales. The average number of days on market spiked from 143 (in the first quarter 2010) to 190 (in the second quarter 2010) in Bend and from 141 to 195 in Redmond for homes on less than one acre. In Central Oregon's reports, the housing stock is separated by lot size, properties under one acre and those between one and five acres. Price per square foot data is provided to control for lot size between both categories.

The median home prices for both Central Oregon submarkets remained fairly constant during the second quarter after the significant decline during the first quarter of 2010. However, annually they are down 6 percent in Bend and down 22 percent in Redmond. The declines grow larger once current median home sale prices are compared to their peak during the first quarter of 2007. The median price for homes under one acre in Bend were \$347,750 and are now \$196,000. The median price for Bend homes with 1–5 acres was \$565,000 in 2007 and now is \$315,000. The Redmond submarket experienced similar changes in median sale price during this time frame with homes under one acre dropping from \$255,950 to \$124,500 and homes with 1–5 acres dropping from \$447,450 to \$196,250. Price-per-square-foot numbers were either unchanged or positive for both submarkets and subcategories from the first quarter to the second. Homes on under one acre increased 4 percent to \$106 in Bend and remained unchanged in Redmond at \$76. Price-per-square-foot on homes with 1–5 acres was up 8 percent in Bend to \$143 and up 7 percent in Redmond to \$113.

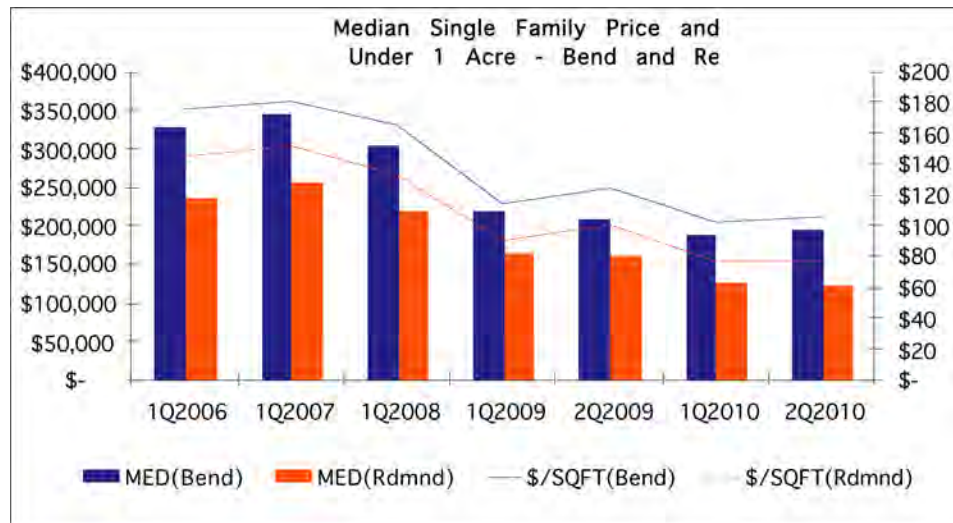




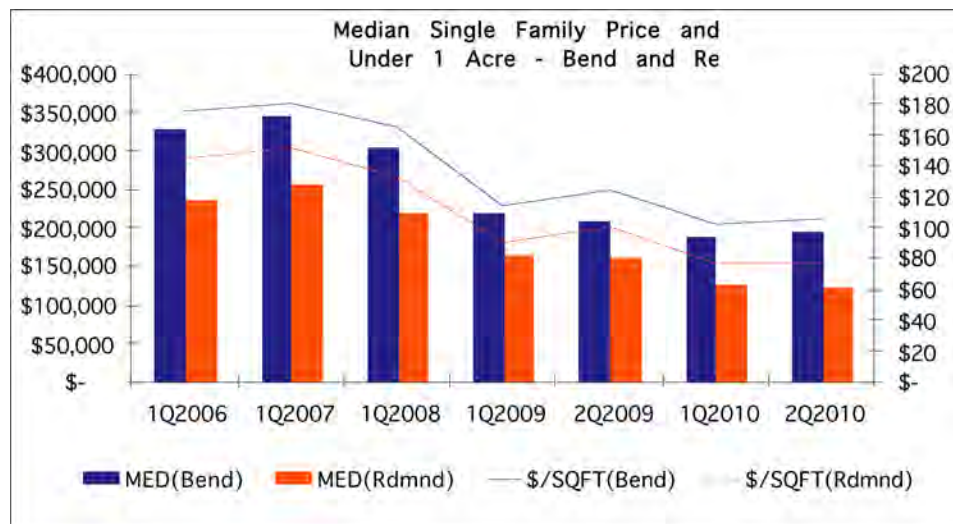
**Figure 11.10** Number of transactions and average days on market, single family under 1 acre, Central Oregon



**Figure 11.11** Number of transactions and average days on market, single family 1–5 acres, Central Oregon



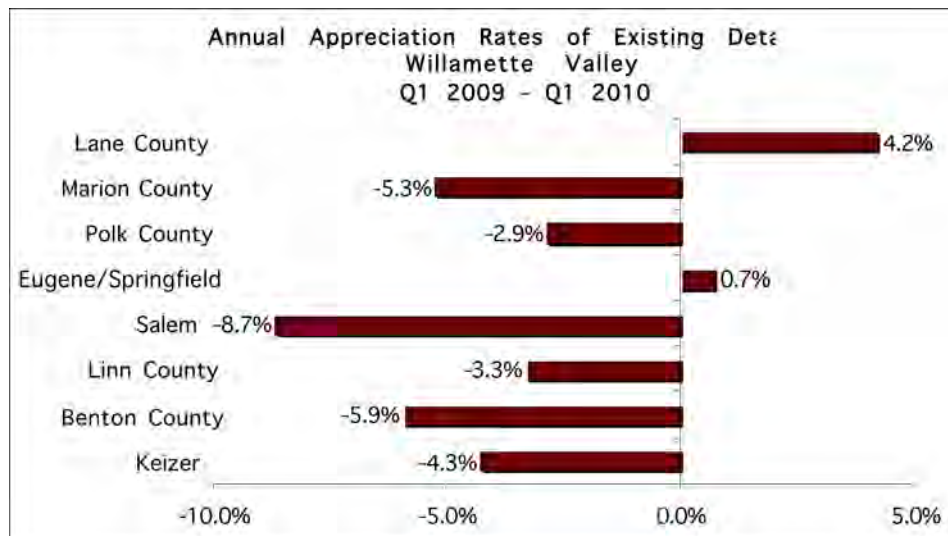
**Figure 11.12** Median price and price per square foot, single family under 1 acre, Central Oregon



**Figure 11.13** Median price and price per square foot, single family 1–5 acres, Central Oregon

## WILLAMETTE VALLEY

All Willamette Valley submarkets experienced annual depreciation on existing home prices except Lane County (4.2 percent) and Eugene/Springfield (0.7 percent). Salem had the worst year in the valley with price depreciation of -8.7 percent followed by Benton County at -5.9 percent



**Figure 11.14** Appreciation rates, existing detached homes, Willamette Valley

The number of transactions over the past year increased annually for all of these submarkets with Linn and Benton Counties up the most at 52.1 percent and 50.9 percent respectively.

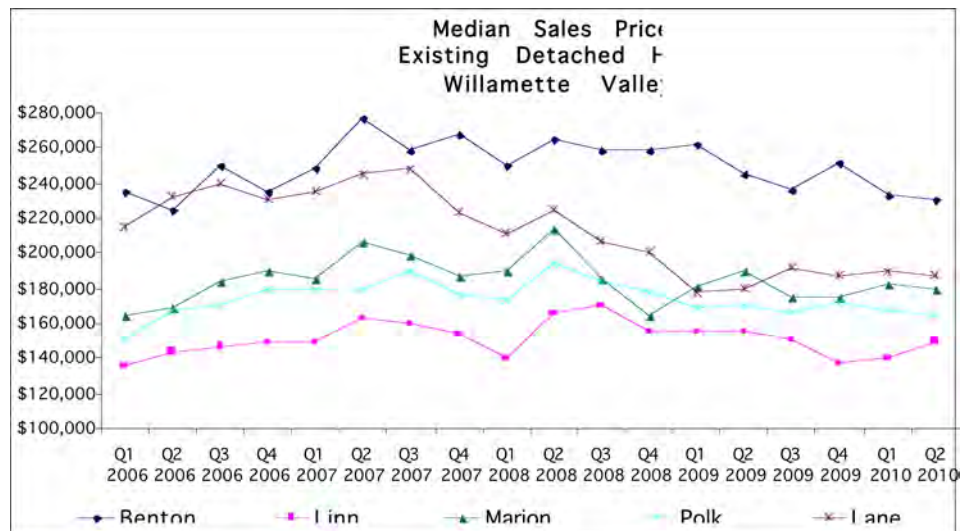
The number of days on the market decreased both annually and quarterly for all of these submarkets with the exception of Marion County outside of Salem which was up 12.6 percent from the second quarter of 2009. The largest drop in average days on market was Linn County which dropped from 152 days during the first quarter of 2010 to 117 during the second quarter. Linn County is down 15 percent annually.

## SALEM

Salem's housing market again experienced annual depreciation while the number of days on the market increased. However, the number of transactions increased from the second quarter of 2009.

Prices declined 8.68 percent from the previous year to \$173,500. Meanwhile, the average number of days on market increased to 140 from 136 in the first quarter. Average days on market in the first second quarter of 2009 was 141.

The number of transactions remained flat from the previous year at 140 during the quarter, but there has been an upward trend in transaction volume since the first quarter of 2009 (except for the seasonal dip during the first quarter of 2010).



**Figure 11.15** Median price and annual appreciation rates, existing detached homes, Willamette Valley



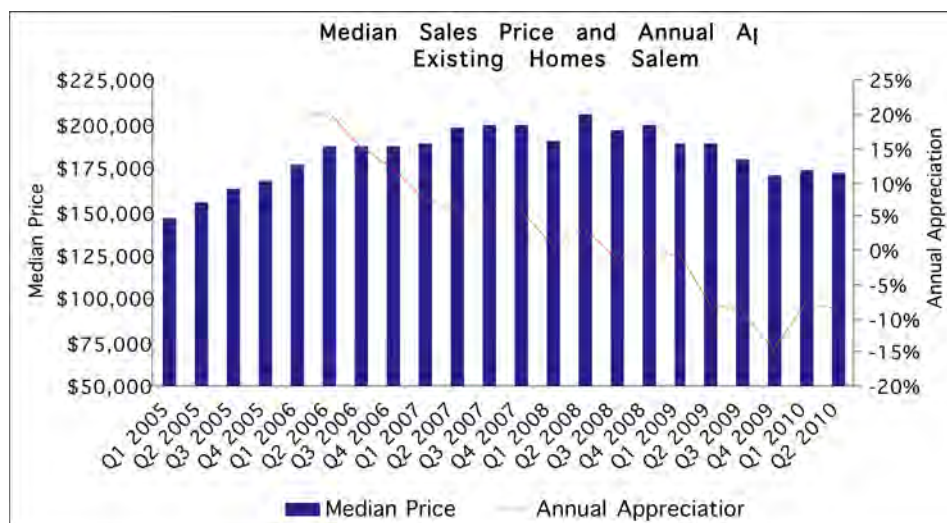
**Figure 11.16** Median price and annual appreciation rates, existing homes, Salem



**Figure 11.17** Number of transactions and average days on market, existing homes, Salem

## EUGENE/SPRINGFIELD

The Eugene/Springfield area experienced increasing home prices relative to the second quarter of 2009 and the number of transactions rose 35.9 percent annually to 663. The number of transactions year over year have been increasing since the second quarter of 2009. The median price was up 0.71 percent to \$214,900. ■



**Figure 11.18** Median price and annual appreciation rates, existing detached homes, Eugene/Springfield

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