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## REAL ESTATE OVERVIEW & OUTLOOK FOR PORTLAND AND THE U.S.

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HESSAM NADJI

Marcus & Millichap

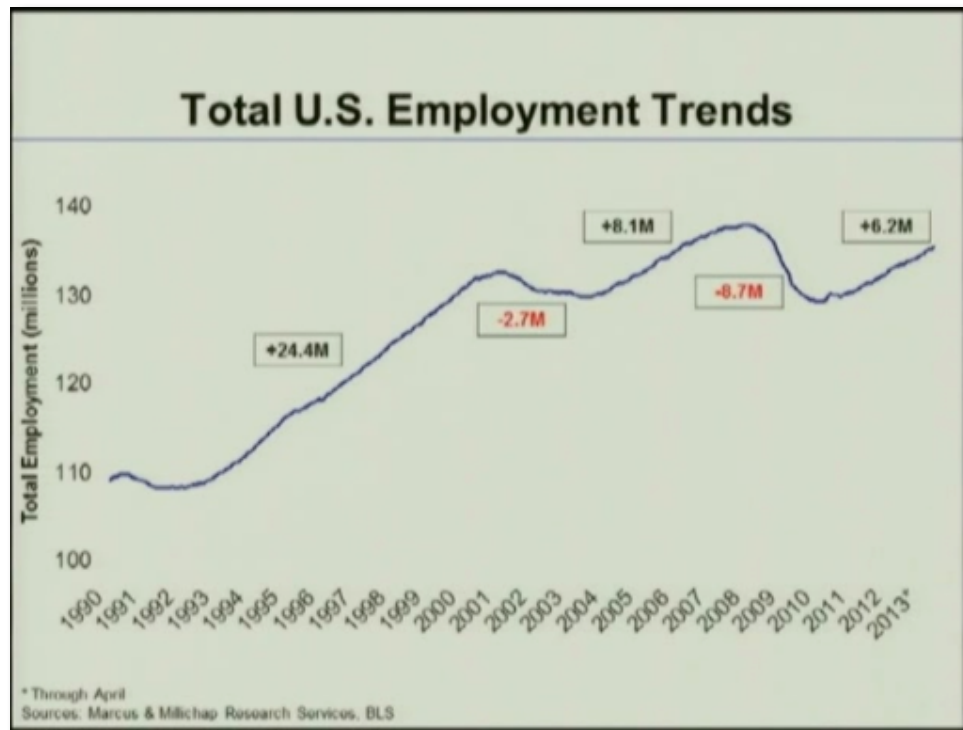
Thank you very much. Good morning. It's a pleasure to be here in Portland. We are honored to be a part of this great program. I'm going to give you a little bit of overview of what's happening with the national and local Portland economy and commercial real estate markets. As someone who works in research, but is part of a brokerage community, accurate forecasting is probably the most important thing that we do. Every year we try to have a diverse set of forecasts for a variety of things that affect our investment community.

### **YOU SAY OPTIMISTIC, WE SAY OBJECTIVE**

Let's start with breaking up some, I won't say misinformation, but very tilted information. The press is so biased against good news. It's interesting—when I get the privilege of being on some TV show afterward I'll get emails from people who say “you are very optimistic.”

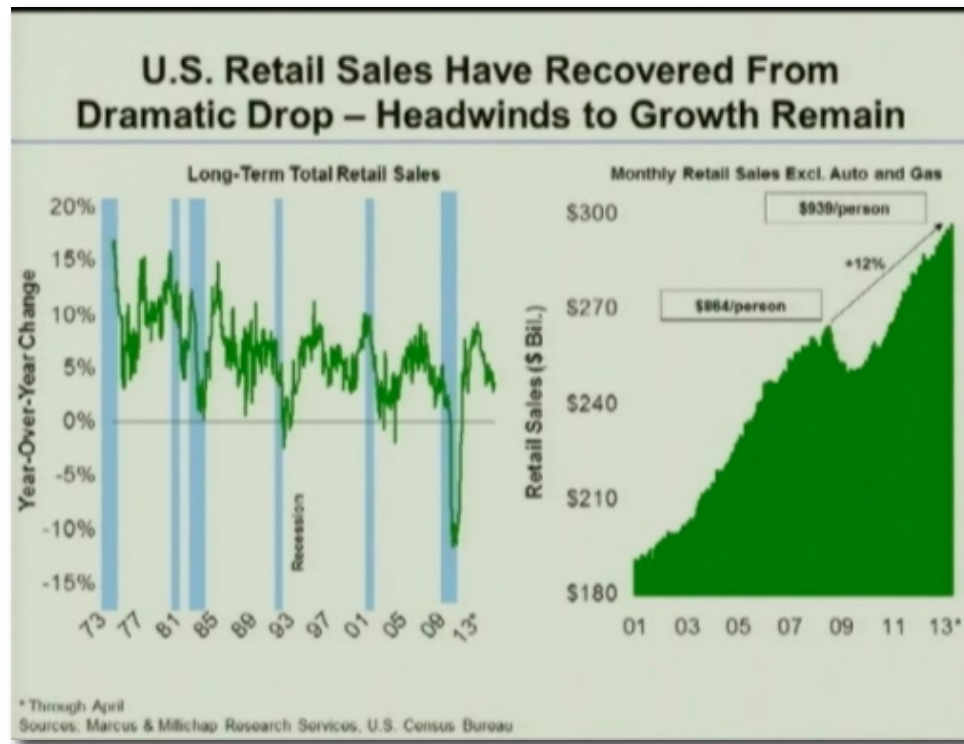
■ Hessam Nadji is Senior Vice President / Managing Director of Research and Advisory Services at Marcus & Millichap. The group's activities and publications support valuation, underwriting and development of specific investment strategies for the firm's brokerage clients. He also manages the design and application of various research and marketing tools and analysis-related technology, as well as various real estate supply and demand analyses and databases. This article was prepared by Angela Guo from his comments at the Portland State University Center for Real Estate's 8th annual conference; comments have been edited for clarity. Any opinions expressed are those of the author solely and do not represent the opinions of any other person or entity.

In reality, we try to be very objective, pointing out the positive and the negative; and just because we point some positive things out that really makes us come across as very optimistic when it comes to the press. But there are a lot of great things going on over the US economy that are not discussed very often. And I want to start with sharing some of those with you.



## EMPLOYMENT

To start with, take a look at this long term chart of total US employment. The U.S. lost 8.7 million jobs in the great recession. Of course you all know it was the worst since the great depression. It could have been a lot worse, by the way. You can debate, in many ways, how the government handled the situation; but in the end, I think the measures that were taken saved us from a much worse outcome. We lost 8.7 million jobs, we've regained 6.2 million of those 8.7. So we are a long way toward recovering the terrible impact on US employment.

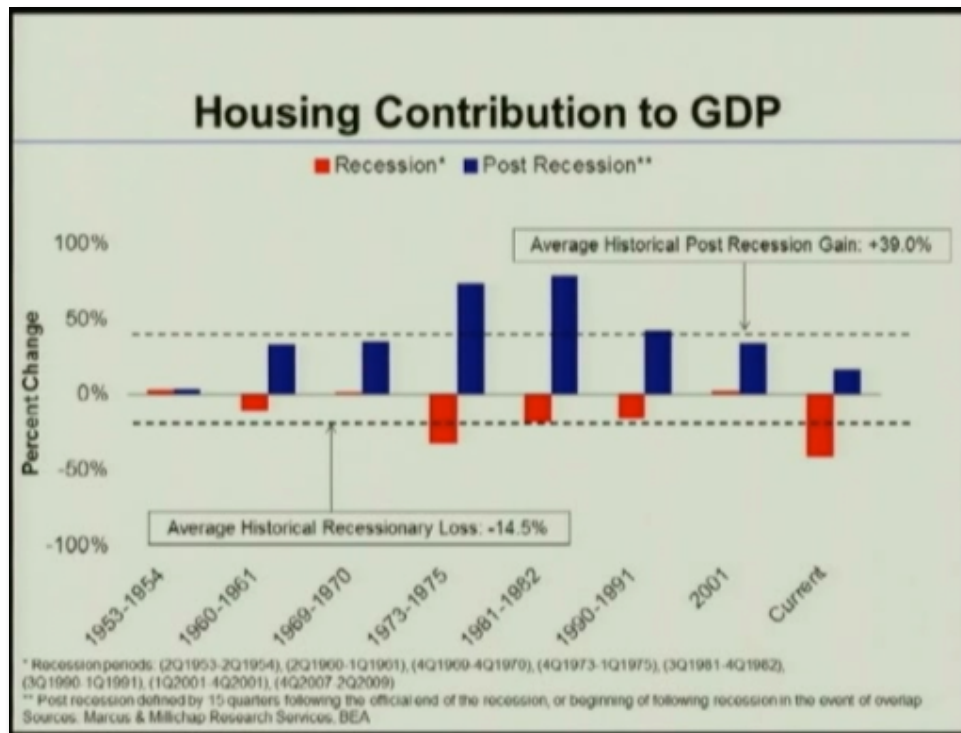


## CONSUMER SPENDING

Take a look at the consumer. The graph above shows, on the left, the percent increase or decrease in retail sales. Seventy percent of our economic output is driven by consumption; and those blue lines there are previous recessions. Retail sales, on a percentage basis, never really collapsed; they never went deeply negative; except this last time, you can see the nose dive in retail in 2009, which was a very scary time because we couldn't really predict where the bottom was.

But since then, we've recovered. And on the right, I'm showing you monthly retail expenditure in nominal terms—core retail, excluding autos and gas—which are very volatile. If you look at the monthly expenditures, we are now 12% higher in total expenditures in the US then we were at the peak in 2007. So the expenditures that were coming out of everybody refinancing their houses every other month, and buying things they clearly didn't need, is now 12 percent higher at the net level.

So, the notion that US consumer was going to hide in caves and never come back again has clearly not held up; and the consumer is giving the US economy a very strong footing. Going back to the chart, if you look at the per capita expenditure; a lot of my colleagues have objected to my optimism on this analysis saying "well the population growth and the size of the economy propels retail sales, so there's no evidence of real health." On the other hand, on a per capita basis, we up about 9 percent, which gives us a strong footing.

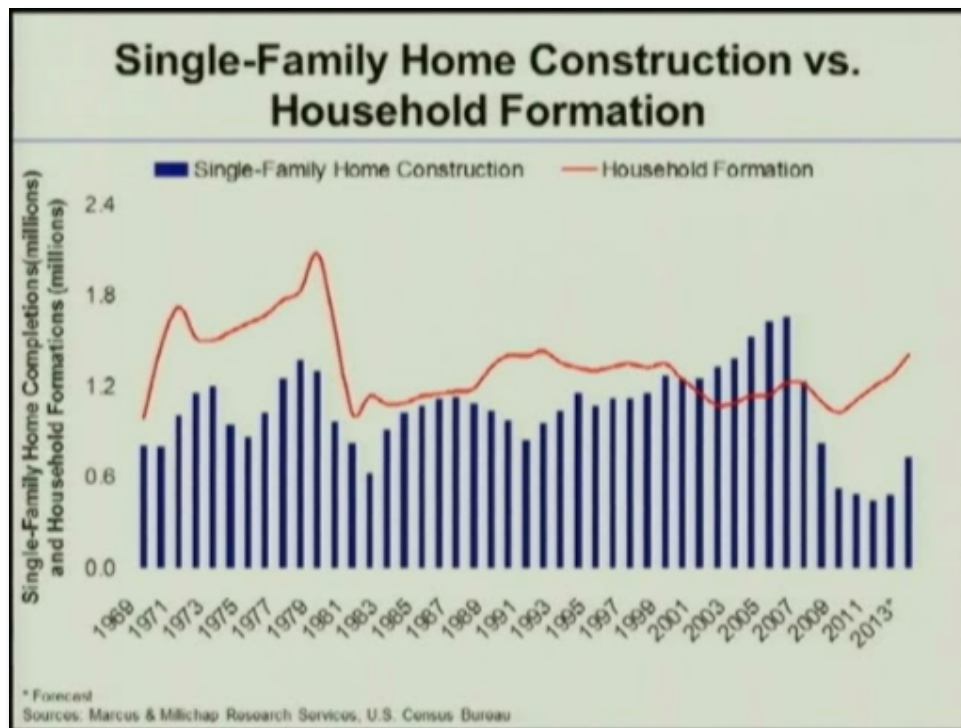
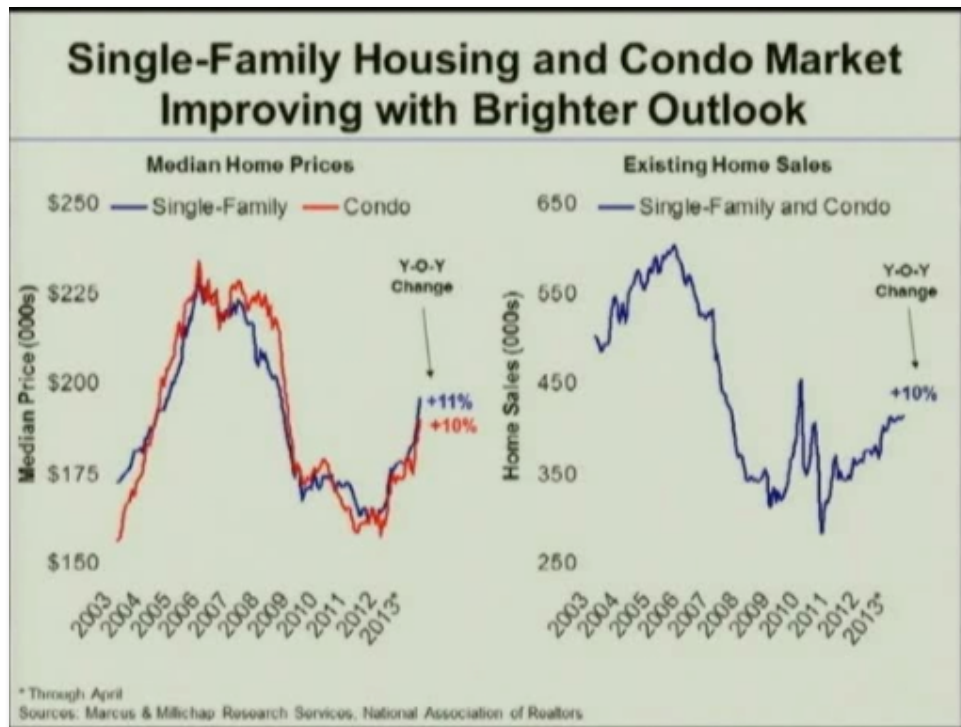


## HOUSING

Housing, which was the culprit of the credit crisis, had a even bigger impact. If you take a look at all of our recession and growth periods going back to 1954, you can see that housing is not usually a tremendous reason for the crisis or the recession, with the exception of the 1973–75 period, which then was followed by an expansion period, in which housing was a big driver.

If you average out all the recessions and recovery periods, by this point along the current recovery, housing would typically contribute 39 percent to economic output. In this recovery, it's contributed, up to now, only 16 percent. So it had a much bigger impact on the way down and a much weaker impact on the way back. This is about to change.

Everything you are hearing about a single family housing market now coming back is real; it's not a head fake; it's sustainable. And the reason for that is shown on the graph below. You can see that the 11 or so percent jump in prices is pretty broad based; you can see that we've got a long way to go from the prior peak, but also sales have improved by 10 percent on a year to year basis; this is across the country.



And why it's sustainable is shown on the lower graph. It shows household formation in red versus single family housing construction shown in blue. Look at the period after 2001 or so, where the blue (the construction) was way outpacing household formation; that's the easy credit, that's the credit bubble, that's the oversupply basically resulting in the credit crisis.

But now look at the reverse, in the last four years, household formation has way outpaced construction. So the market has found its balance. All the other head fakes that we saw earlier were happening too early; the recovery wasn't sustainable. This is giving us the foundation for a sustainable for-sale housing recovery, which is an important, very important, ingredient coming into the national economic scene over the next two to four years.

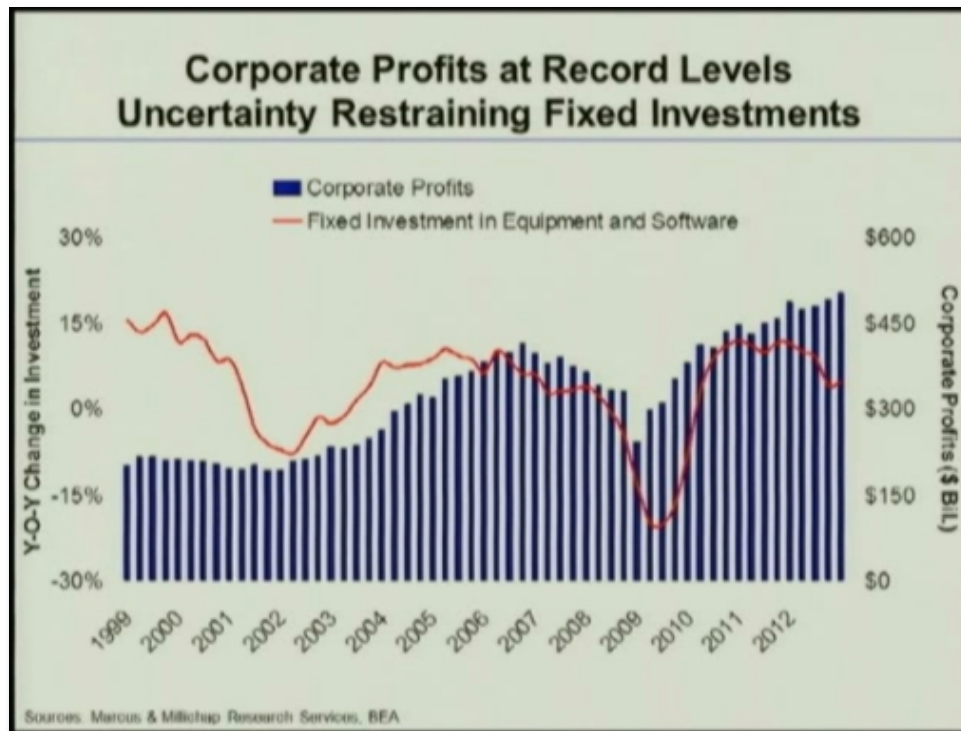
## **CORPORATE PROFITS & COMMERCIAL REAL ESTATE**

So all the notion of terrible job creation, disappointing employment numbers are somewhat true. We added about 2.2 million private sector jobs in the last 12 months, that should be closer to 3 million at this point of a recovery, it's being held back. But the good news is that if you look across the spectrum of the US economy, every major sector is adding meaningful number of jobs. Professional and business services almost 600,000 jobs in the last 12 months. Trade, transportation and utilities 428,000 jobs, that's the industrial market basically recovering. Leisure and hospitality about 400,000. Education and healthcare, which are higher paid jobs, about 373,000.

Even construction jobs are now positive to the tune of 154,000 jobs. That's the linkage back to the for-sale housing because construction is slowly coming back. We are beginning to see some commercial construction in some markets. And manufacturing added about 70,000 jobs, because our exports have been a big contributor to the economy. So the news is pretty good, if you look at the diversity of where the jobs are being created, it's relatively good in terms of the 2.2 million jobs, but it is disappointing from where we should be. Why is that?

Corporate America, having cleaned up its balance sheet, having survived the downturn, having really cut expenses, has now shown tremendous profit growth. Just as I shared with you how far ahead retail sales are than the prior peak, corporate profits are 22 percent higher than they were in the 2006 third quarter peak. So the corporate side of the ledger has also improved dramatically.

In the graph below, the red line is corporate investment in plant equipment and software; it's a precursor to hiring; it's an indication of how aggressive companies are being about expansion. And you can see the red line coming out recession very strong, but in the last few quarters, it's actually slowed down – that's the uncertainty in the market place; that's the ongoing question marks about the logjam in Washington, about taxation, about regulation, about Europe. We haven't heard too much about Europe in the last few months, but it's there. The debt crisis is still there, it didn't go away. So that hesitation is what's keeping corporate America back from engaging into a full scale expansion mode.



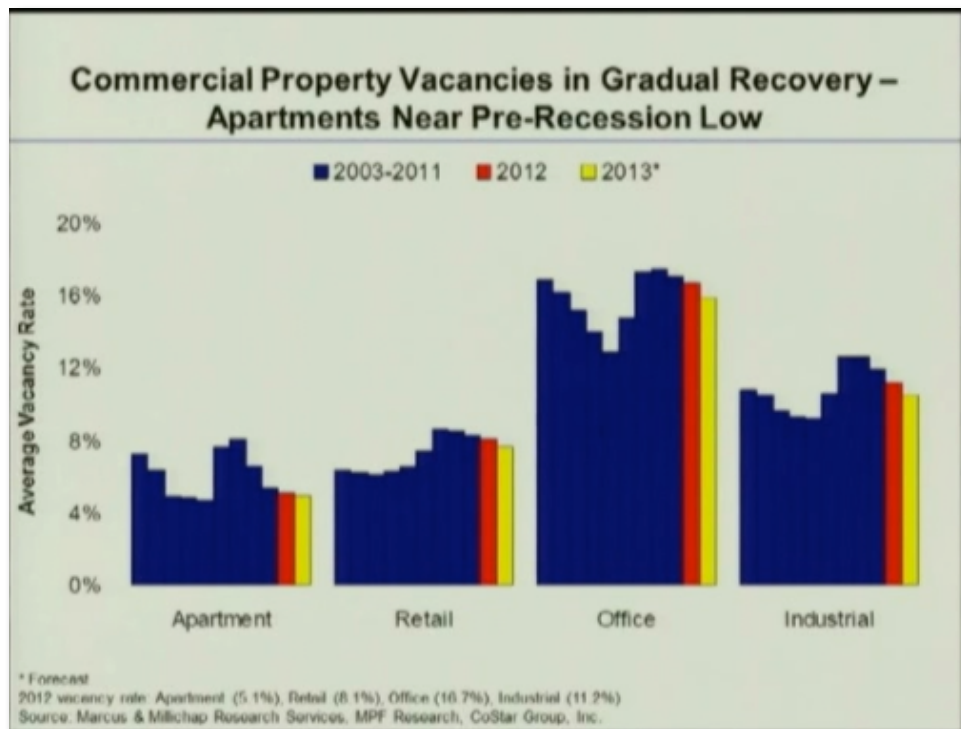
Now for commercial real estate, all of this has been relatively good news. The apartment market almost fully recovered to prerecession metrics. As the home ownership rate was falling—from 69 percent, now down to 65 percent—every point drop in the home ownership was putting over a million households back in the rental pool. It's no wonder that the apartment market has performed so well; plus really favorable demographics.

Outside of apartments, you are now beginning to see a steady but meaningful recovery in occupancies across all property types. The office market is a little bit of a mystery. You saw those professional business service jobs leading the job creation—600,000 jobs—so where is the net absorption?

Well, companies had so much excess space, that so far, any demand has basically been satisfied through excess space, whether it was burning through sublease space, or just excess space that companies were sitting on. Now going forward, you are beginning to see a much tighter correlation between job creation and space demand. Companies are beginning to realize this is the bottom of the cycle, and as your leases are expiring, you are probably going to be a little bit more aggressive about space consumption and lock in the lease rate for the next three to five years. However, there are structural changes in our society—technology, conservative attitudes toward space consumption. So, the two kind of outweigh each other. But if you look ahead, for both office and industrial, 2013 and 2014, I think, are going to be a period of much more rapid recovery in occupancies. And so far, construction is way out



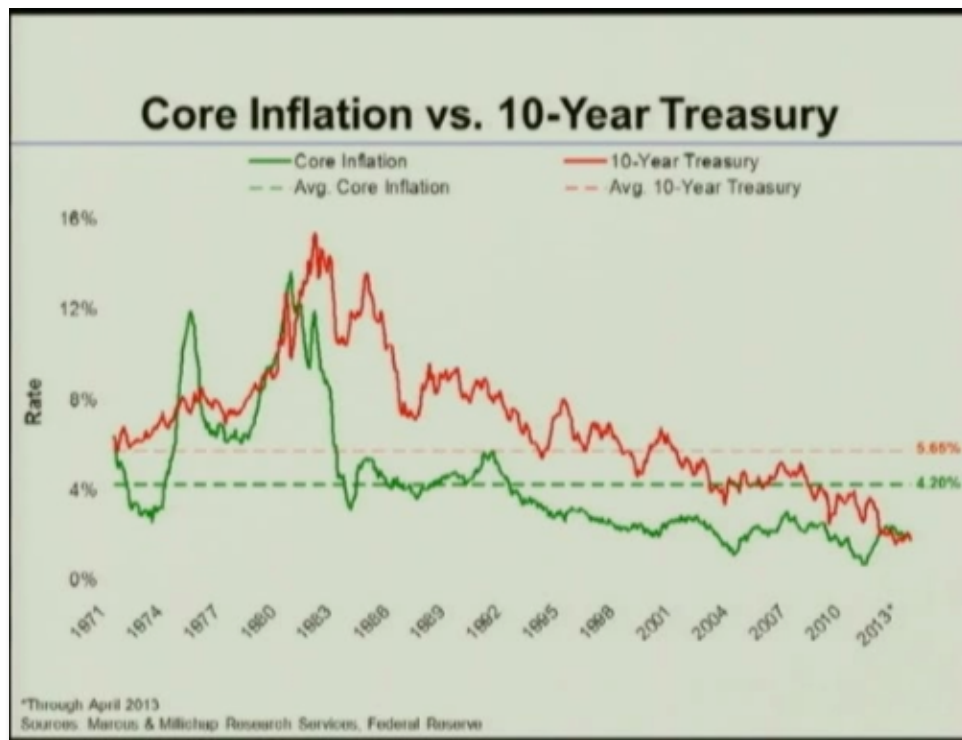
there, so we don't have an oversupply problem. The surprising performer, in terms of sectors, has been retail. We just came out of International Council of Shopping Centers meetings and the attitudes were great. But, more importantly, the reinvention of what's going on with retail is quite spectacular. Once Circuit City fell, for example, everybody thought Best Buy would do extremely well. But online retailing is absolutely changing the landscape, and retailers are having to react to that. Or what's happening in terms of life style centers, or older malls, that are basically having to be completely reinvented or go through reuse. But retail is coming back a lot faster than most people expected.



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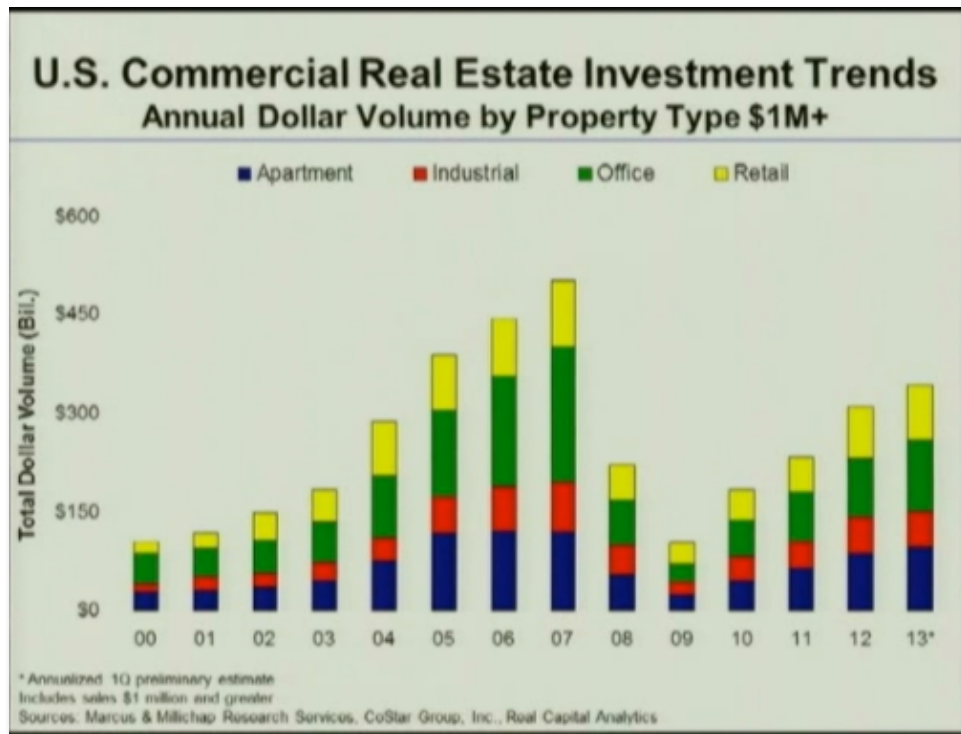


## INTEREST RATES

One of the things that we benefitted tremendously from is interest rates. Of course, the Fed has been extremely accommodative. This has been the lubricant of not just the real estate market coming back, but also the broader economy.

I think we are in a period of continued accommodative stance, but the party's got to end at some point. Generation-low interest rates are something we should all take advantage of in terms investment decision, value added investment; it's a great safety net toward risk. But it is a major driver of why the market has come back as well as it has over the past three to four years.

I don't think we have any kind of a reason to believe interest rates are going to spike any time soon, because there is very little inflation pressure, as you can see. Both housing and wage pressure—the biggest components of inflation—have not been at a level that should cause alarm. But a year from now, I think we will have a different attitude toward inflation pressure, and therefore interest rates. I think we have another 12-month window of this incredibly opportunistic interest rate driven time, but I don't think it's going to go much beyond that.



For the commercial real estate industry, in terms of investment, you can see the trading volume of the 4 major property types pretty much collapsing from about \$500 billion in 2007 down to \$90 billion or so in 2009. I am happy to announce, on behalf of all of our colleagues, we are just wrapping up our group therapy in the brokerage industry, because that was really something, you could not have predicted.

But the market has come back, we are 15 percent to 20 percent below the prior peak, but we are coming back much faster than anybody anticipated. This has been really dominated by institutional capitalism. Blake Eagle (as summarized in his article in the current issue of the *Quarterly*) was talking about the role of institutions. They really pounced with a great strategy, smart money, picking off the low hanging fruit, high quality assets in the best metros in 2009 and 2010 when the market was frozen. Some of those are the astute investors that Blake was talking about. Really

showed just how astute they were; if we only had a time machine. So those first movers really took advantage of the market place.

Having analyzed this in every which way under the sun, in terms of where we are in the cycle and so on, our conclusion—and this has got nothing to do with the fact that I come from a research shop in a brokerage firm—is that it is not only a time to sell but it's a great time to buy. [Laughter]

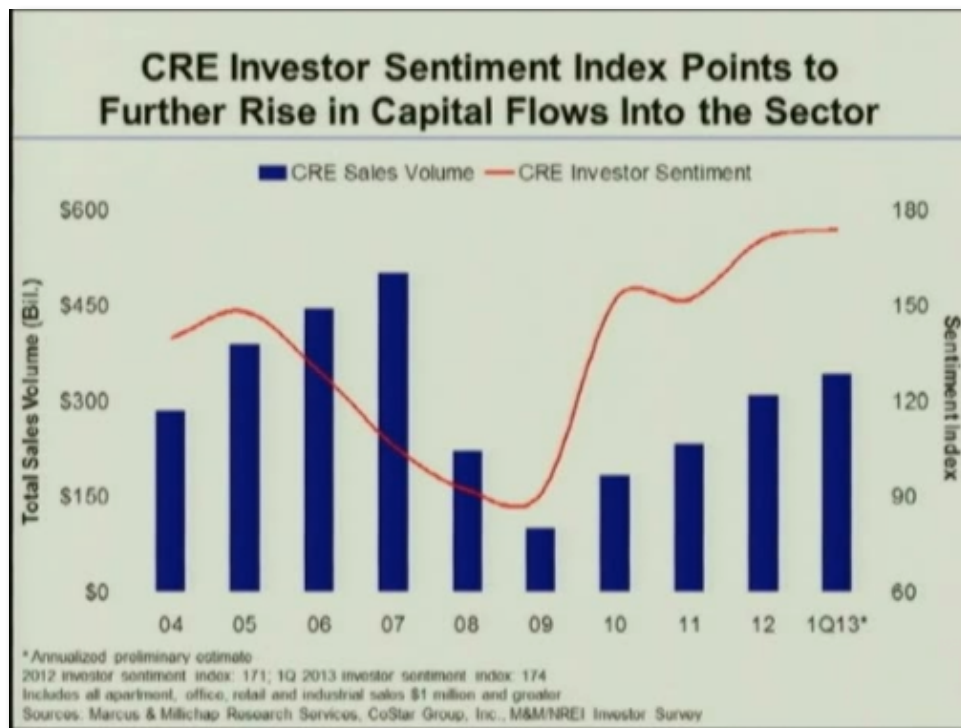
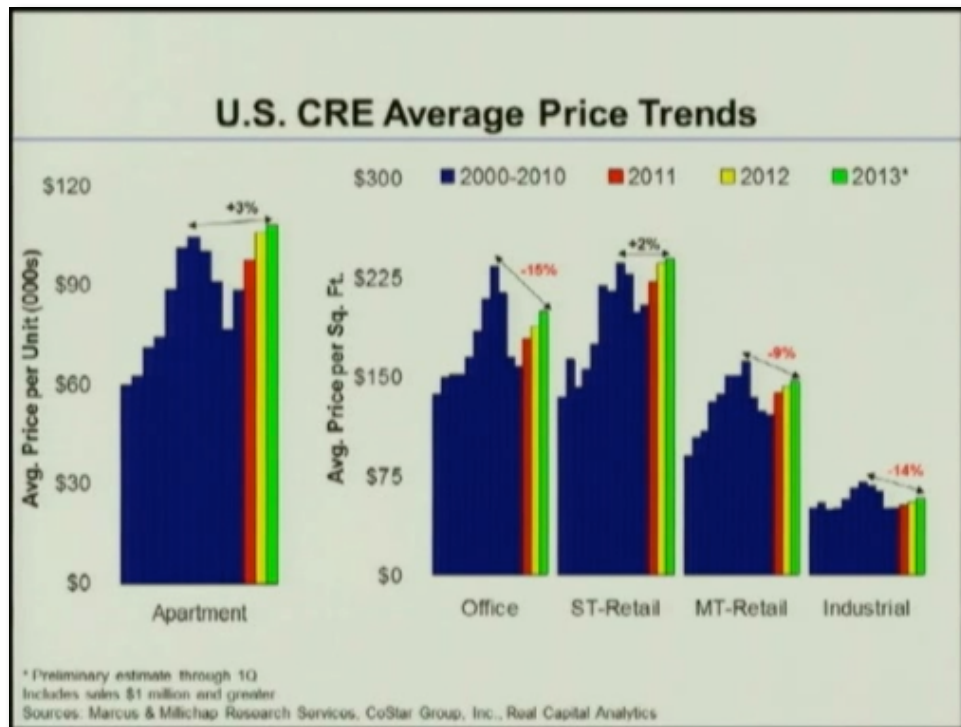
In case any of you fall for that, our team is here with some listing agreement forms right there towards the back wall, we'll meet you after the show. [Laughter]

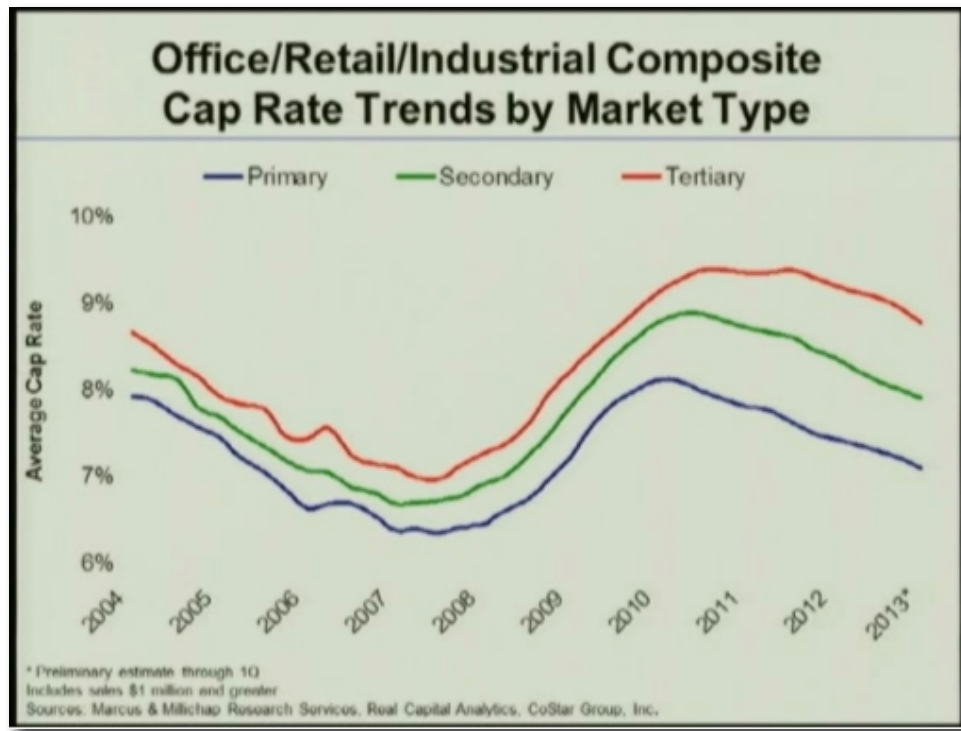
But, you know it's kind of awkward, because what I say, I actually believe that. If you look at the landscape across the country, product types, quality, size and so forth, there is more opportunity in the market place today than there ever was because we have at least that strong footing I talked about in terms of the consumer and corporate America that gives us some level of assurance that the recovery is sustainable; there is very little in the supply underway, and then you have these incredibly low interest rates. So where are those opportunities and how is it going to play out? Let's go back to the graphs.

## LOOKING FORWARD

If you look at what's happened so far, apartments are fully recovered, pricing wise, back to prerecession levels. The office market is 15 percent below peak. This is on an average basis, and I know averages are misleading. Single tenant retail, which is of course a safety play for a lot of private investors, is pretty much on par with where it was before the recession, so fully recovered. Multi-tenant retail is down about 10 percent, and industrial is down about 15 percent. So just from this very simple way of looking at it, really office, maybe multi-tenant retail and industrial are the opportunistic places. But even within apartments, if you take a look at where the capital has flown and where the herd of investors have gone, they have left a lot of the market still untapped. And I'll talk about that. These ingredients are the reasons that the investors are, right now, feeling so good.

One of the things that we publish is a commercial real estate investor sentiment, much like a consumer sentiment, that we have been tracking since 2004. And in the first quarter of 2013, we hit an all-time high in that index. And you can see the red line shows the index. Our community, the commercial real estate community, is very accurate in predicting where the whole economy is going to go and where capital flows are going to go. Look at in 2005 and 2006, when things were going very well, the market was still climbing, the commercial real estate investor sentiment began to fall. So we were sensing that there was some trouble in the woods. And in 2009, we start to see a serious increase in the sentiment. So it's been very accurate. This is an indication of future capital flows into the sector. But where is that capital flow going to go?



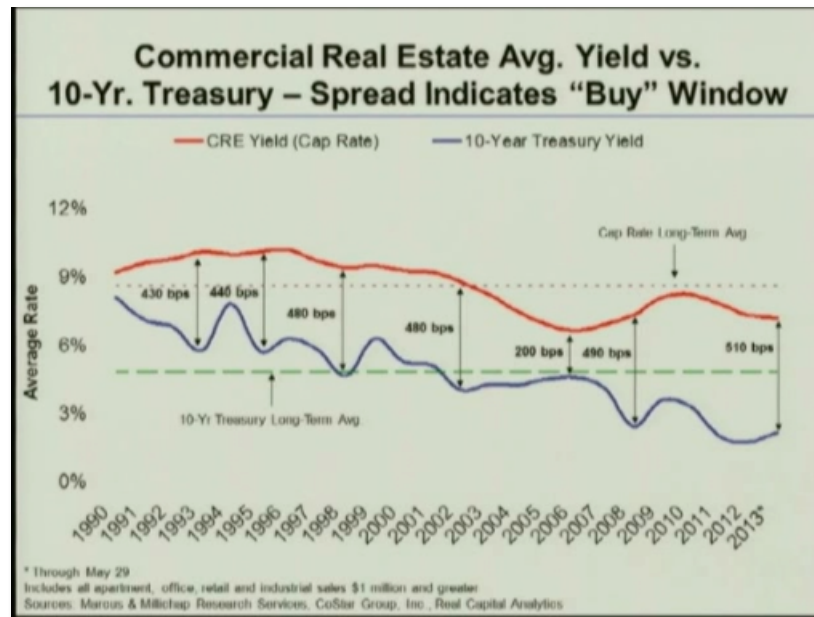


If you look at this metric—this is cap rate movement among the four major property types, cut through primary, secondary, and tertiary markets. This graph tells a few stories.

One story is that cap rates in primary markets have recompressed very close to prerecession levels. Another story is in secondary markets, the green line, which are coming back pretty fast. The cap rates have compressed because of institutional capital pressure coming into the primary markets and class A assets, for the most part. As those cap rates have compressed, now capital is looking to go elsewhere.

A year, or year and a half ago, our institutional clients wouldn't even hear the word "secondary market." Today, they are calling us for secondary market opportunities and in their planning going forward. Tertiary markets, a little bit different, lenders are still very cautious about tertiary markets. But again, a year from now, I think the tune will change. A year from now, that green line will be substantially lower than it is today, more so than the blue line or the red line. But look at the spread that's still there in the market place, versus 2006–07, where the market was not really distinguishing much by quality. So the good news is that there is still discipline in the market place, the question is: Two years from now, is that spread going to go away and are we going to head into another potentially dangerous situation?

You would think that we wouldn't, but then again I think the real estate business also suffers from long-term memory loss; and that could be the reason why we keep on repeating some of these things that we seem to go through.

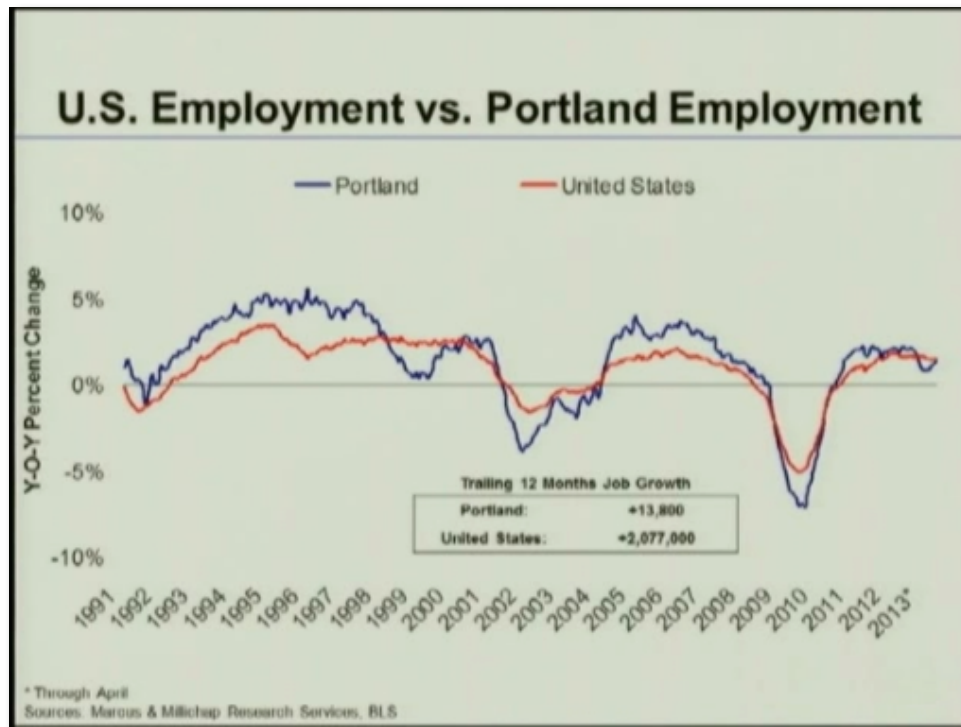


One of the most important indicators when people really object to why commercial real estate is an asset class is the spread between cap rates and interest rates today. If you look at the 10 year Treasury versus the composite cap rate of all product types going back to 1990, you can see that anytime the spread was wide—1992, 1998, 2002 in particular—you would want to go back in time and buy more commercial assets. Today, that spread is wider than it's been since 1990. And again, the power of locking in that low interest rate as a safety net for a five to seven year hold is a tremendous factor.

## PORTLAND FORECAST

One of the things that we are not used to here in Portland is not being one of the leading job creators. If you look at the blue line, which is Portland; in the early 2000s, we were outpacing the national average job creation by a very comfortable margin. And what's happened is that the recession was very tough on Portland, we lost over 80,000 jobs. And the recovery has been somewhat disappointing, not because we are doing any worse than the national average, but because we are used to be doing so much better than the national average.

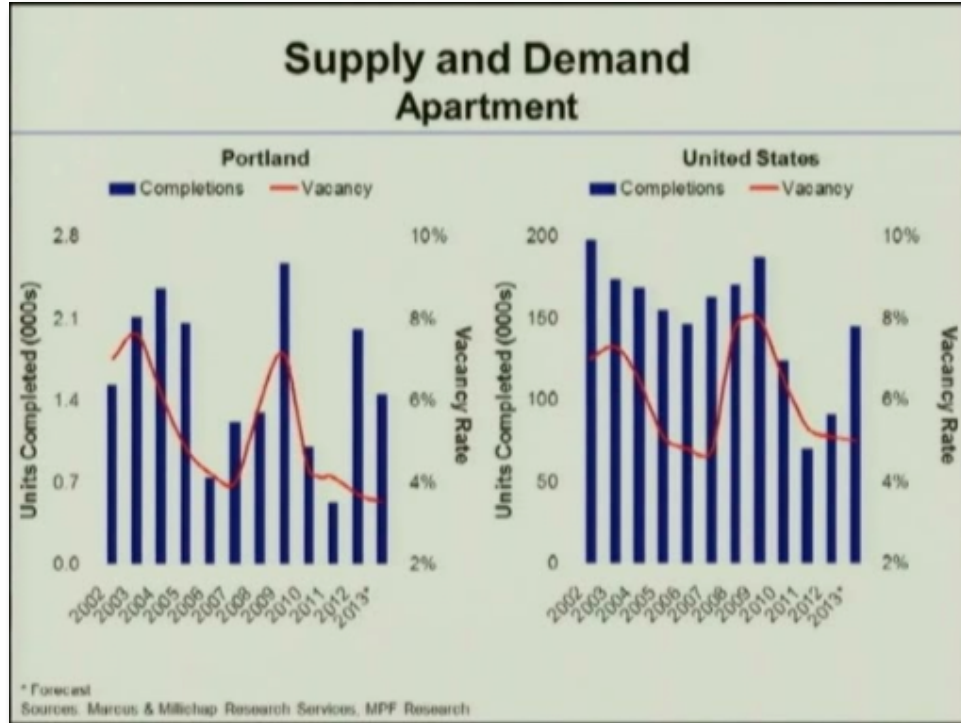
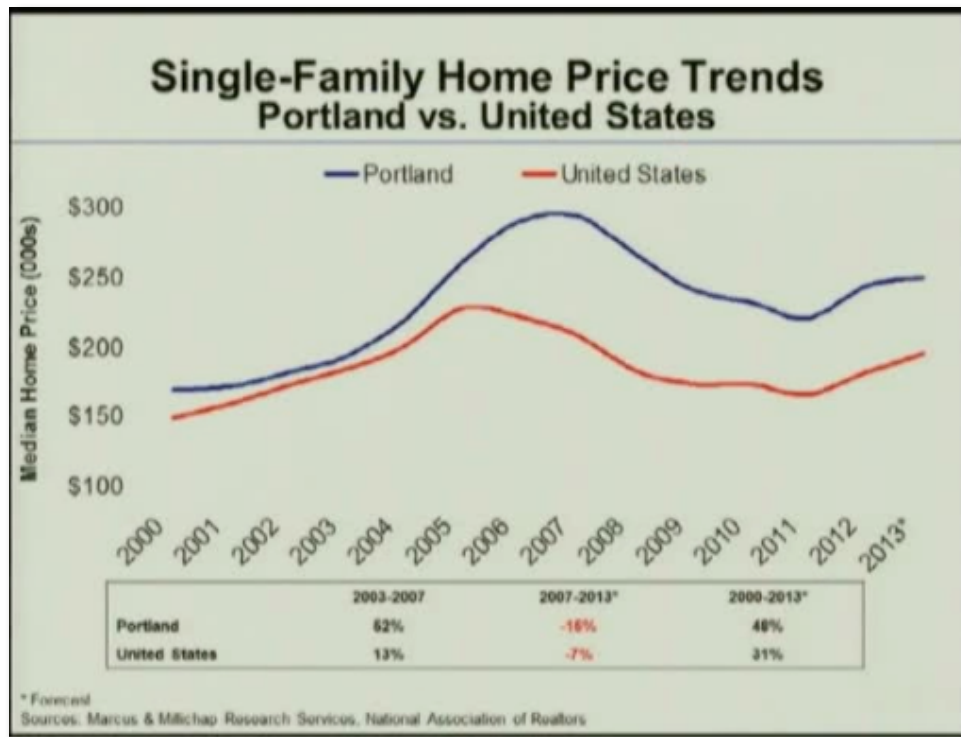


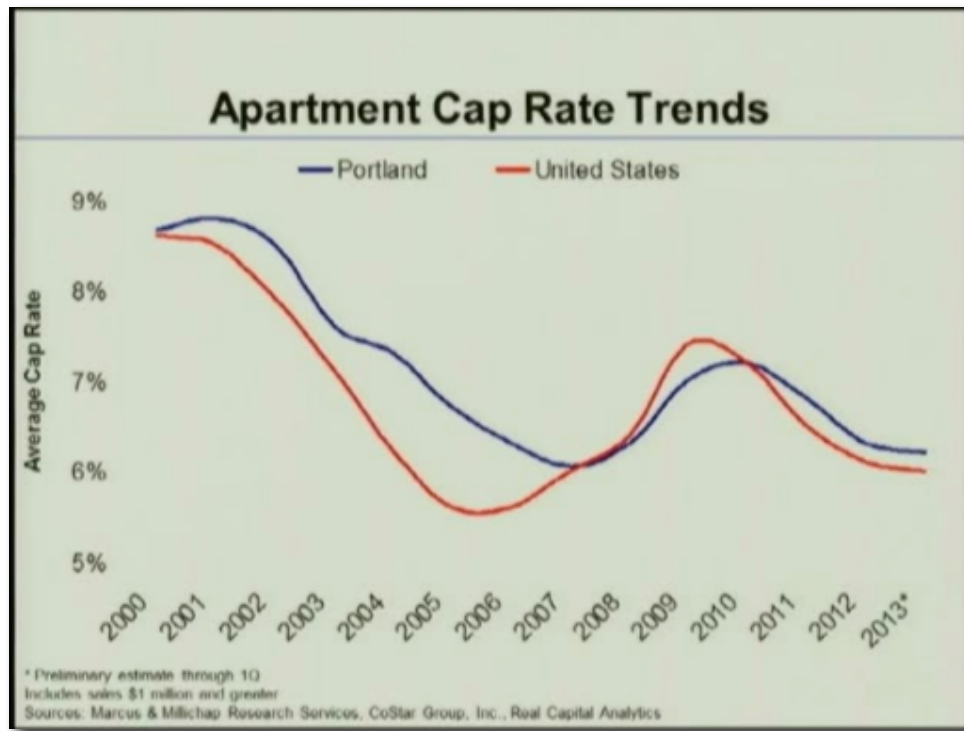


Here's one of the challenges, and I thought about this a lot. Look at the Silicon Valley, which of course is so technology oriented. And, in some ways, so is Portland. Silicon Valley has reinvented its technological orientation over the past 15 to 20 years pretty rapidly. You now have a whole different landscape of technology related jobs and companies that are driving that economy.

Portland has been slower to reinvent in that regard even though it still has a lot of high technology jobs and still benefits from tremendous trade, business professional service job orientation, financial services and so on. So we are in great shape from the stand point of economic diversity, but the technology sector in particular hasn't really adapted as quickly as the Silicon Valley in being the forefront of what is now the technology industry, versus the 1990's and the early 2000's. That is one of the reasons why we are doing pretty much as well as the national average. But I think that is about to change. We've added about 15,000 jobs in the last 12 months; going forward, for the next 12 months, I'm expecting over 20,000 jobs in Portland. I think the turning point is really the second half of 2013.





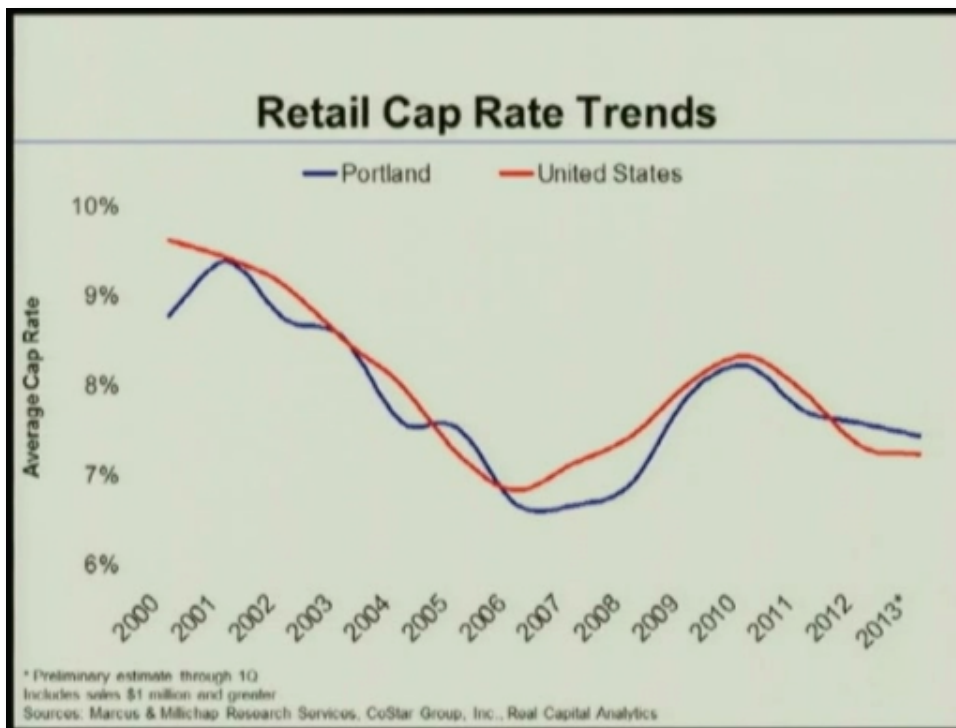
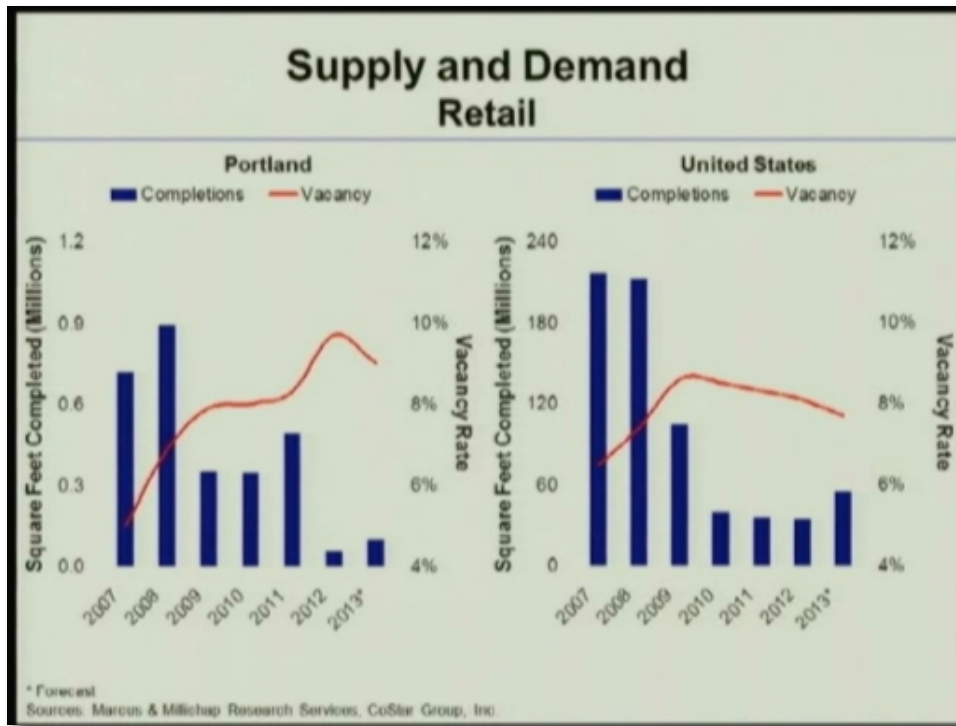


Looking at the housing market, we certainly didn't have anywhere near the crisis in for-sale housing as any other markets did. But it's an important indicator. Today, as we sit, home prices are just about 50 percent higher than they were in 2000. So the real estate market here on the for-sale housing side still is healthy and still is a contributor. And the expectation is that it will continue to do so.

If you look at the apartment market, Portland is one of the best apartment markets in the country. It is a subject of discussion among just about every one of my institutional client tours around Chicago, New York, and Boston, where so much of the capital allocation decisions are made. And it's definitely on the radar screen as one of the best apartment markets. Part of the challenge, though, is the depth of the market. Portland is somewhere between a major metro and a secondary metro. I would not consider Portland a secondary metro, but it also has a hard time competing with the San Francisco Bay Area or Los Angeles or other true major metros. So part of the capital allocation challenge is that kind of in-between primary and secondary metro status. But construction is pretty well in check, our absorption levels are picking up, our vacancies are four percent here in the Portland apartment market, which is a little bit better than the national average.

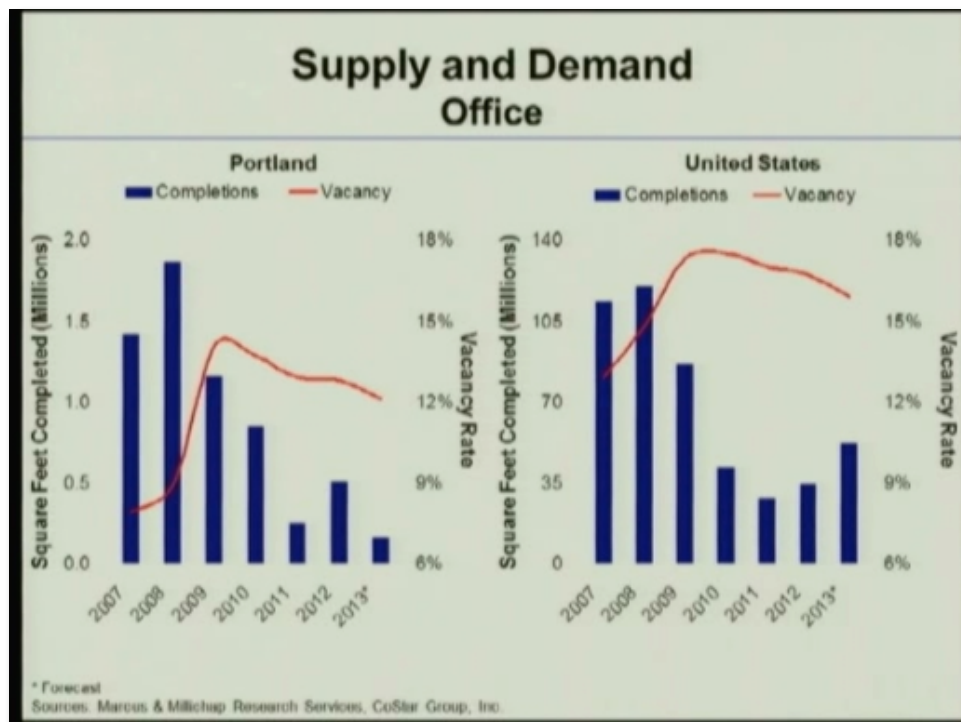
So it's not surprising that the cap rate movement has been pretty dramatic and pretty similar to the national average. Part of the reason why, in the later period of this graph, we are not seeing the same kind of rapid drop in the cap rate is because of that size issue and the pool not being big enough for more institutional capital to

flow into Portland. But the private investors here in Portland, in terms of investing in apartments, are extremely active. And the market has improved substantially.

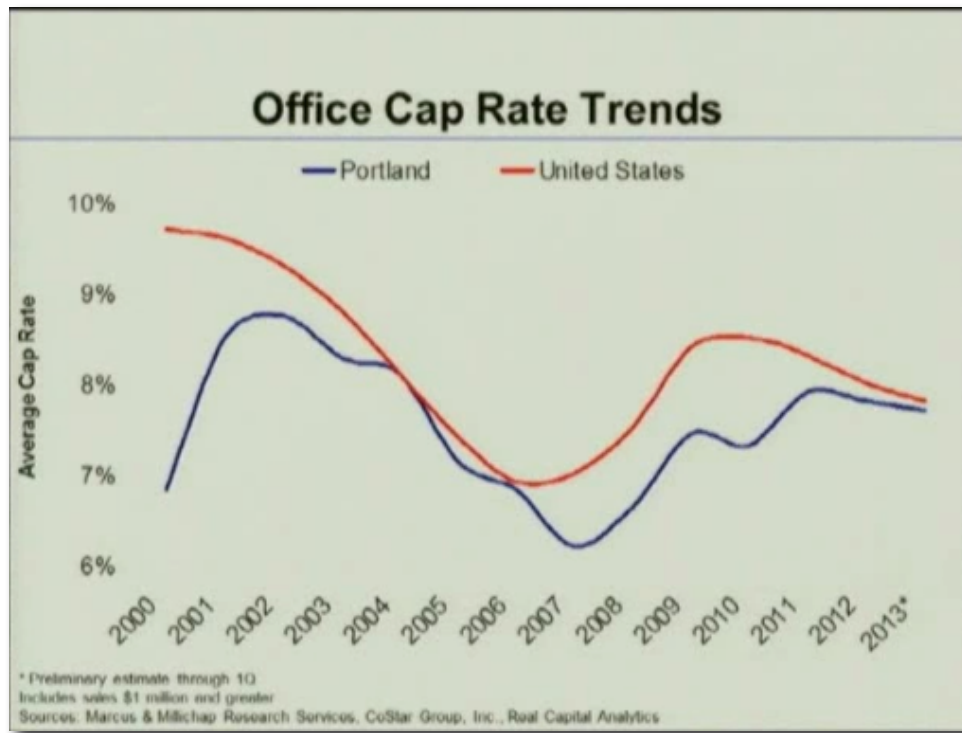


From a retail perspective, we are trailing the national average a little bit. We had a lot of construction happen just similar to the national scene prior to the recession. Then we kind of had another wave of constructions come online in 2011. That's part of the reason our vacancies are stubbornly high. But again, I think retail would reinvent itself very fast.

From an investment perspective, you see Portland has done quite well in terms of cap rates of retail product coming back down and offering a spread. If anything, these cap rate analyses are telling us that there is a story to sell about Portland: There is a cap rate spread, there is an improving job picture, and there is a very favorable vacancy supply demand picture.



On the office market side, Portland is outpacing the national average by quite a bit and shows up as one of the best markets across the country. Again, construction is not a problem at all, vacancy is pushing down to about 12 percent versus a national average of around 16 percent. I anticipate this to continue. By the end of 2014, I think we are approaching the 10 percent benchmark here in Portland.



And the cap rates have shown that. We are well below the national average during the recovery. The national average is beginning to come down now because a lot of investors are now moving into office, as the opportunity play pushing the cap rates down. So the overall Portland commercial real estate economic picture is extremely positive. I expect it to stay that way. Think about the next four to five years: We are going to add 120,000 jobs in the next 5 years (as predicted by most forecast entities in our own work). An additional 200,000 people will be added to the Portland population base. And nearly 50,000 of those people will be in the important age category of 18 to 34 years old. This is a very important indicator, not just for Portland, but for the broader economy.

If you look at one of our most favorable advantages across the globe, is that the US is the only developed country where we had 80 million baby boomers come through the system. You might recognize some of those baby boomers—Bill Gates, the late Steve Jobs, and Michael Dell. (You might question Michael Dell, does he still belong up there with those others given what's happened to Dell.) But nevertheless, these types of minds in the baby boom generation changed everything, both in terms of innovation and size. Unlike Japan, which are losing population; or Western Europe, which is losing population, we have another 80 million people wave coming through the system that are children of those baby boomers. They are going to inherit something like 42 trillion dollars of wealth over the next 3 decades. And that gives us a tremendous advantage. Now how are they going to manage that money, I have no idea. ■