OFFICE MARKET ANALYSIS

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The first quarter of 2013 saw improvement in nearly every sector of the economy, with consumer confidence, employment and leasing all gaining strength. With the stock market surging, Portland's office market steadily gained ground towards what many believe to be the beginning of a new construction boom. Suburban markets have seen solid returns, with net absorption climbing from the depths of the recession to more healthy occupancy rates. Larger leases from big companies in the tech sector have helped boost leasing, and their growth rates show positive signs for continued engagement with the Portland workforce.

After several weeks of sequestration, most of America has yet to feel the pinch of these cuts. However, many of the cuts have not taken effect and can expect to be felt in the second quarter. Federal employees in particular are expected to face layoffs and will offset rises in private sector employment. Some economists predict that this could lead to lower spending and GDP, and subdue markets that have been thriving since the first of the year. To combat against these possibilities, the Federal Reserve has announced that rates will be kept low until employment falls below 6.5%, which is not expected to happen until 2015.

Internationally, Europe continues to drag anchor toward recovery. The Cyprus debt crisis ended with a $12.8 billion bailout from the European Union and IMF. This renewed skepticism in the European markets, and caused employment num-

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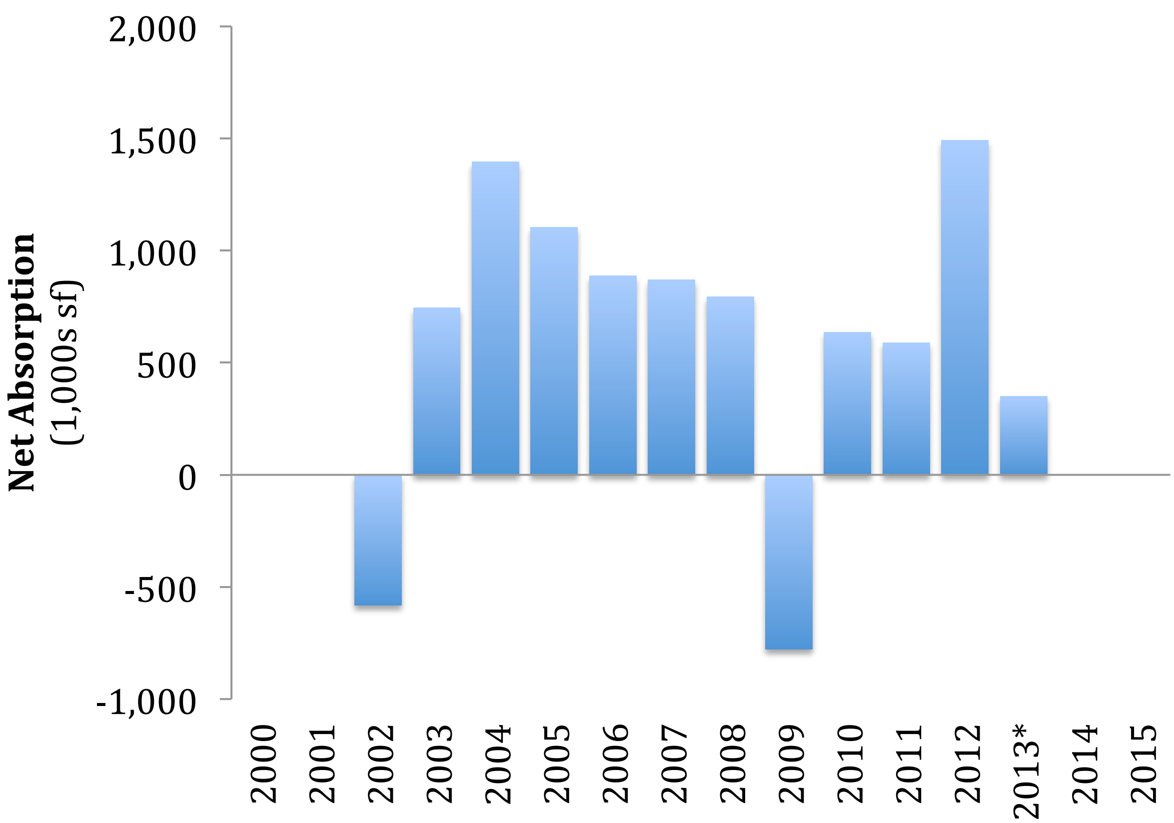
bers to stagnate. They remained stubbornly high at 12% through February, rising slightly at the end of the quarter. US unemployment dropped thirty basis points to 7.6% during this same period.

Despite international woes and domestic uncertainty, Portland's office market has continued to rise steadily for the past several quarters, slowly repairing the damage from the downturn. The CBD vacancy rate of 8.7% is one of the lowest in the country and shows signs of growth yet to come. With a tightening supply citywide, tenants have been quick to snap up quality space as it comes available. Currently there are only six Class A blocks of space from 50,000 to 100,000 square feet on the market. As the market shifts to one that favors landlords rather than tenants, the landscape should shift as these changes occur.

Figure 1: Overall net absorption, Portland office market

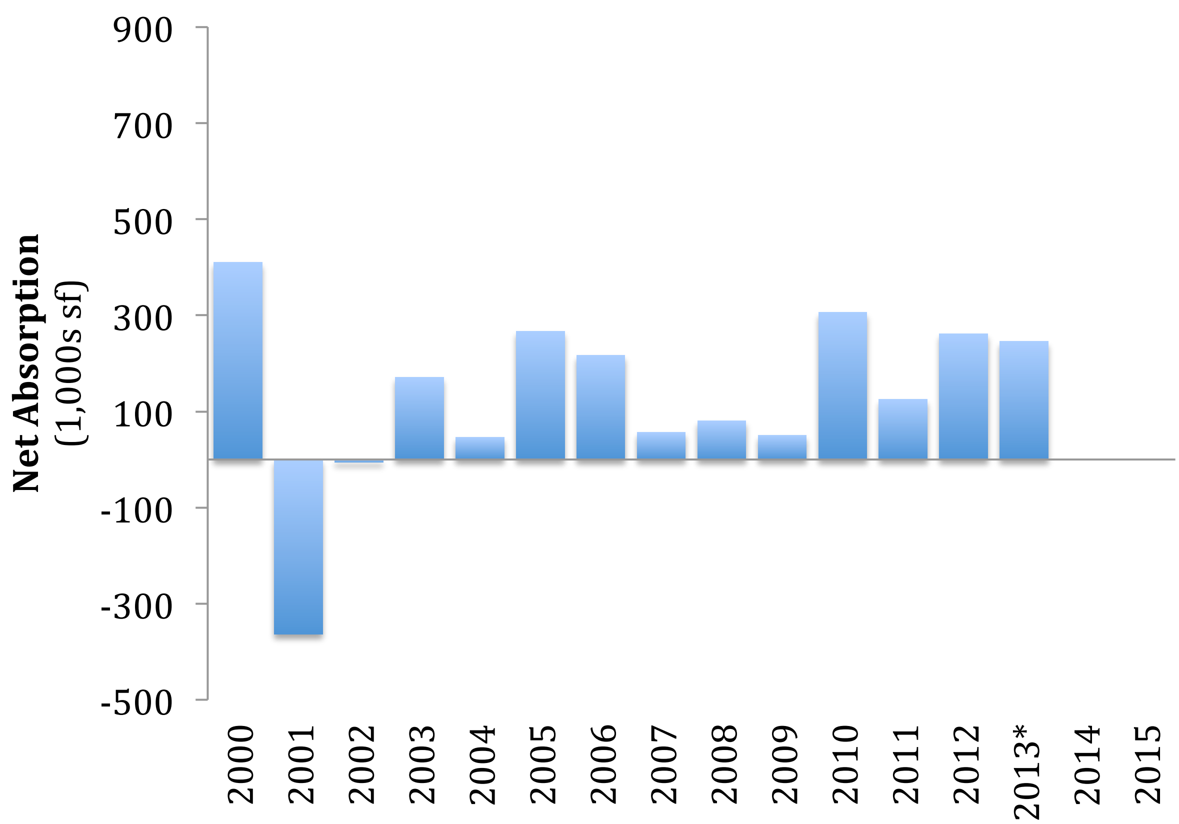


Jones Lang LaSalle reports that net absorption climbed in the metro area as a whole by 351,232 square feet with the suburban markets leading the charge. The largest single lease signed during the quarter was by technology provider salesforce.com, who leased 116,500 square feet in the Synopsys Technology Park. It

was suggested by insiders that the company might have opted for a more central location, but the lower lease rates in the suburbs ultimately prevailed.

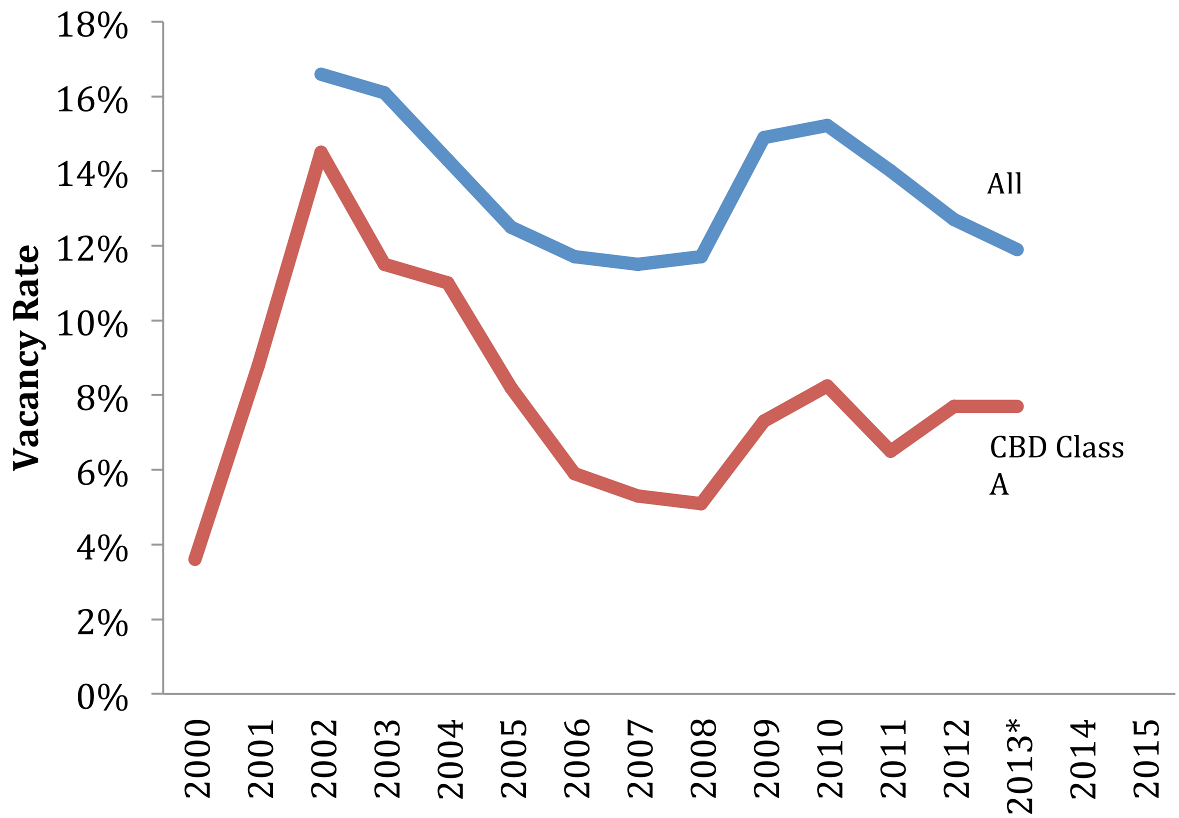
While not measurable in terms of net absorption, it is notable that the market benefitted from the renewal of several larger-scale leases. Capital One renewed its 120,000 square foot lease at the Tigard Corporate Center. Tripwire and Schnitzer Steel both renewed leases of 49,053 and 41,000 square feet, respectively.

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



Jones Lang LaSalle reports Class A net absorption to be 246,785 square feet. This represents the bulk of the square footage absorbed in the market in the first quarter. With an increasing scarcity of true Class A space, tenants and landlords can expect rates to rise accordingly. In sectors such as the CBD, vacancy rates have fallen or remained stable, leading many to believe that speculative construction could be on the horizon. This number is expected to rise, although with a shortage of available Class A space it stands to reason that there may not be enough to sustain this growth for the duration of the year.

Figure 3: Vacancy rates, Portland office market

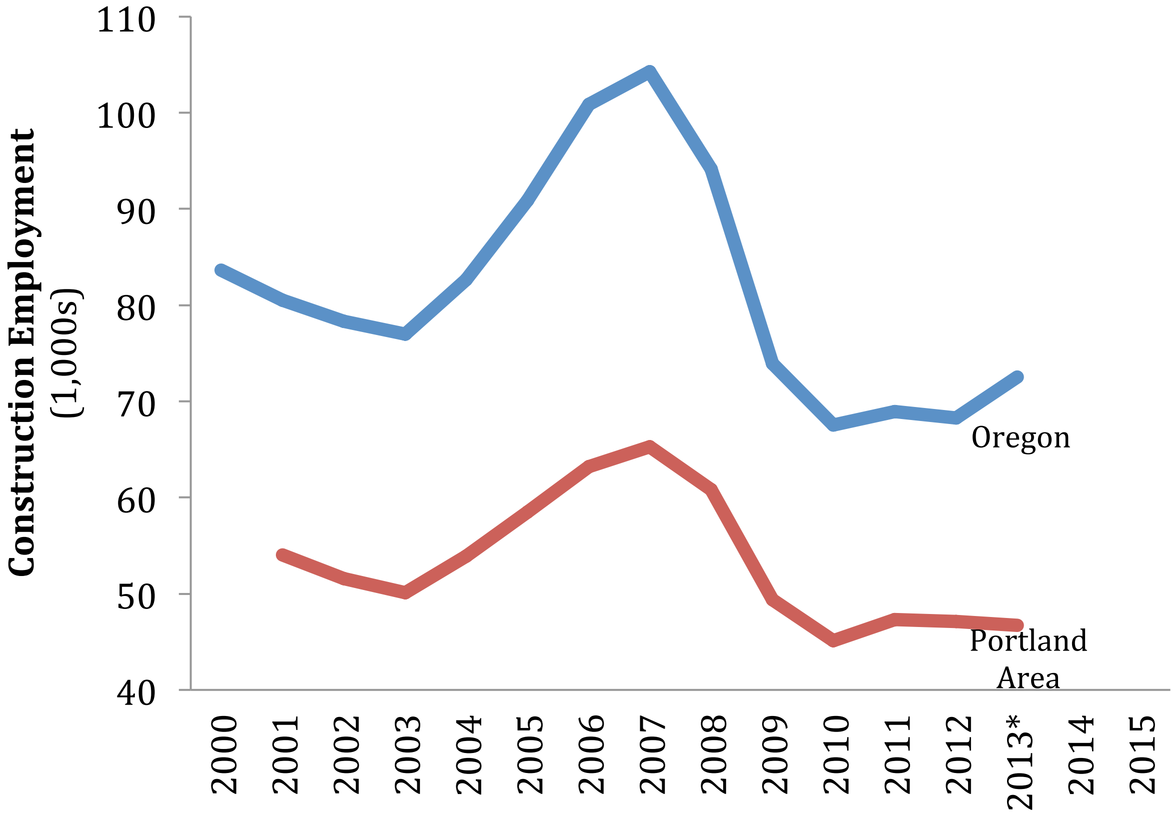


Source: Jones, Lang & LaSalle, NAI Norris, Beggs & Simpson

Since 2010, vacancy rates have declined in the metro area. Positive absorption is expected to continue in suburban markets, while Class A and the CBD both remain strong. Vacancy rates for class A space in the CBD had risen throughout 2012, with companies relocating or vacating their spaces in favor of the suburbs or Pearl locations. With rates stabilizing, users can expect rates to climb in 2013.

Despite increases in net absorption, suburban spaces still offer the most attractive rates in the market, especially for Class A and B space. This will slowly change as more space is occupied and concessions are less prevalent.

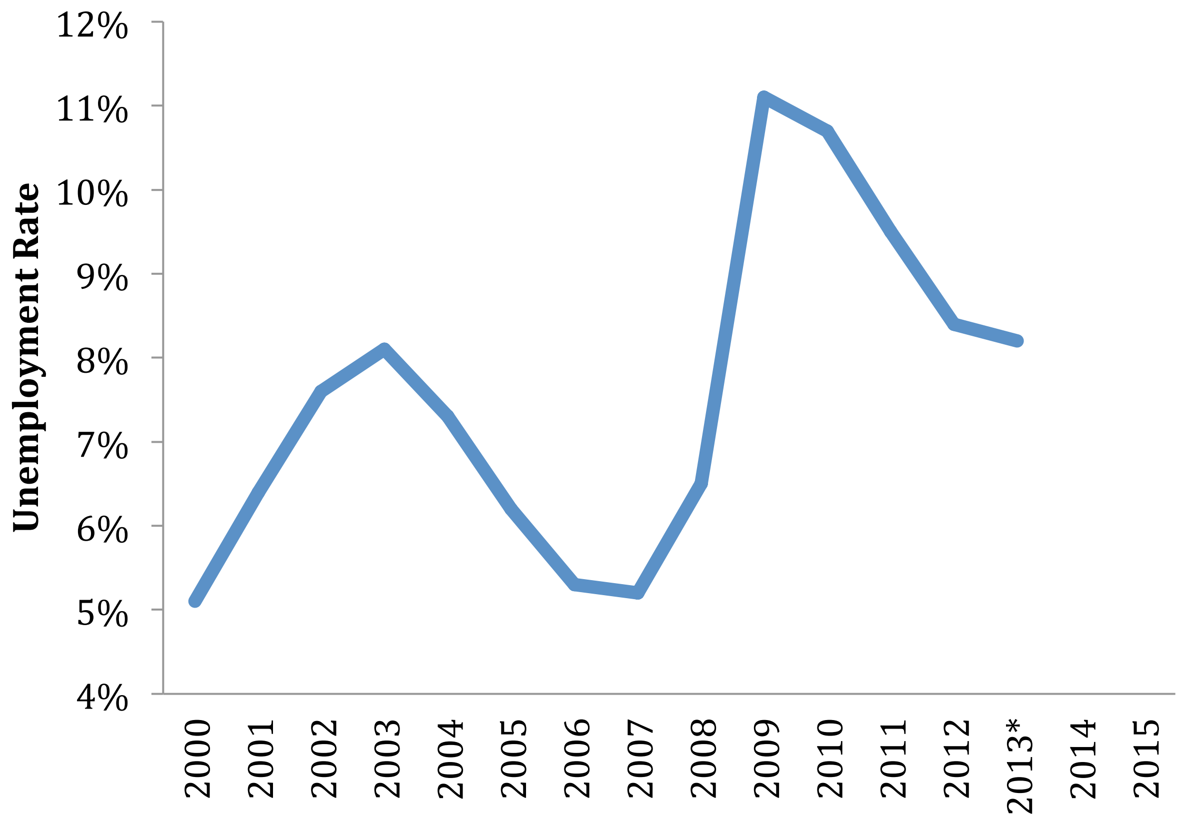
Figure 4: Construction employment, Portland area and Oregon statewide



Source: Oregon Employment Department

Construction is currently at a seasonally adjusted 72,500 jobs, with the metro area accounting for 46,700 of these positions. While this represents a slight uptick in both markets, construction employment growth remains stubbornly low. However, construction employment has begun to benefit from a renewed housing market. Home prices rose as much as 8.3% in the past year, triggering a number of home builders to spring into action. Multifamily apartment complexes continue to spring up to meet robust apartment demand, and the transit bridge project is scheduled for completion in 2014. Commercial buildings and infrastructure improvements are on the horizon, leading experts to believe that construction employment could be on the rise for the next several quarters.

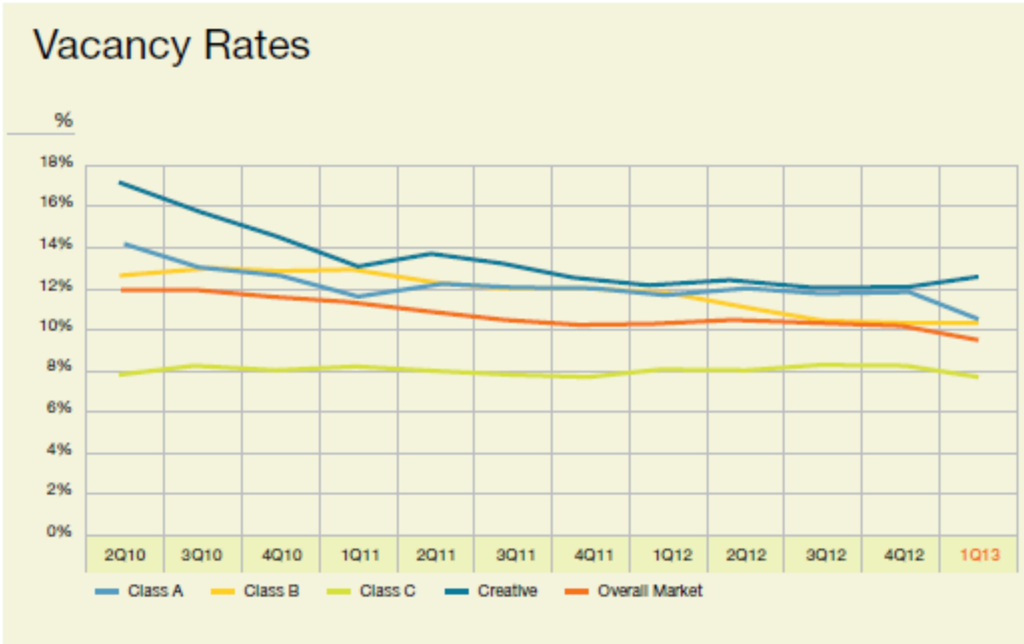
Figure 5: Unemployment rate, Oregon

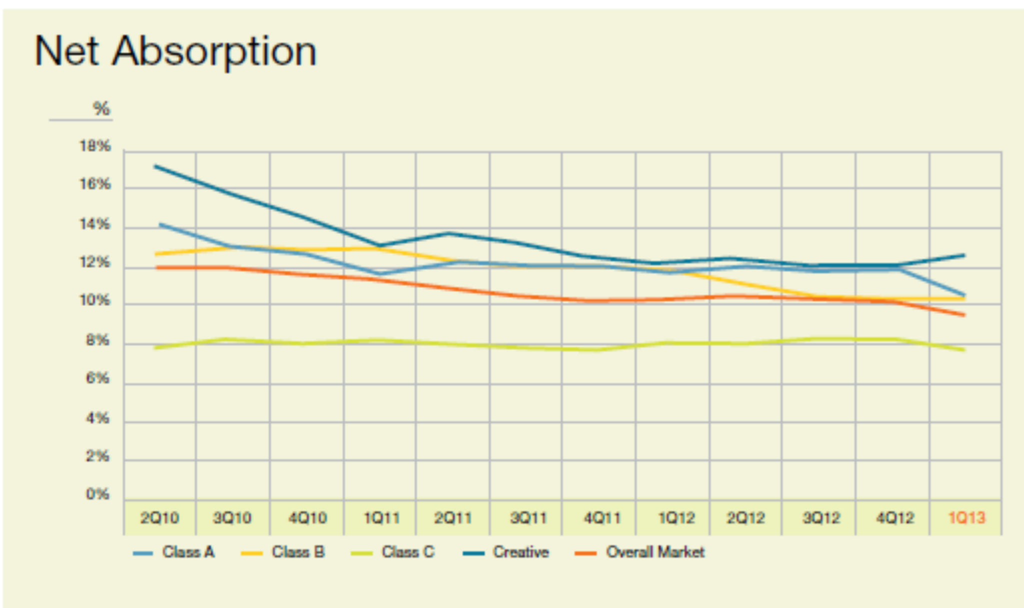


Source: Oregon Employment Department

Portland added 23,000 jobs in the first quarter of 2013, and nearly every sector saw additional employment growth. Unemployment dropped 20 basis points to 8.2% for Oregon, and 10 basis points to 8% for Portland. Sectors driving employment growth are manufacturing, finance, insurance, professional services and technology, which all saw gains from 1-3%.

Analysts predict continuing growth in all sectors, but are weary of government cuts and tax increases as a result of the sequestration. These forces are expected to counteract each other with a slight favorability towards employment growth. Despite these gains, Oregon still lags behind the national unemployment rate of 7.6% at the conclusion of Q1.

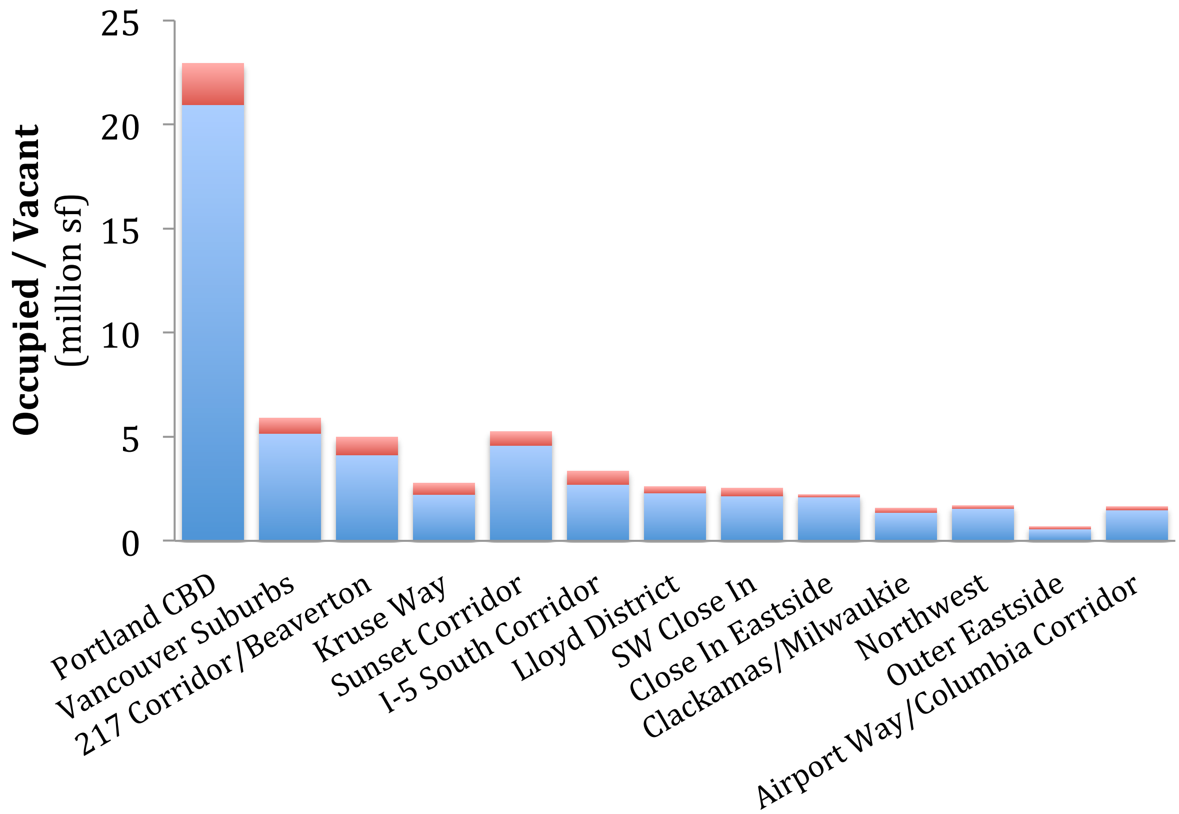




Source: Kidder Matthews

Vacancy rates and net absorption have been on similar trajectories in the past three years, with vacancy trending downward and net absorption remaining steady and positive quarter over quarter.

Figure 6: Submarket inventory, occupied and vacant



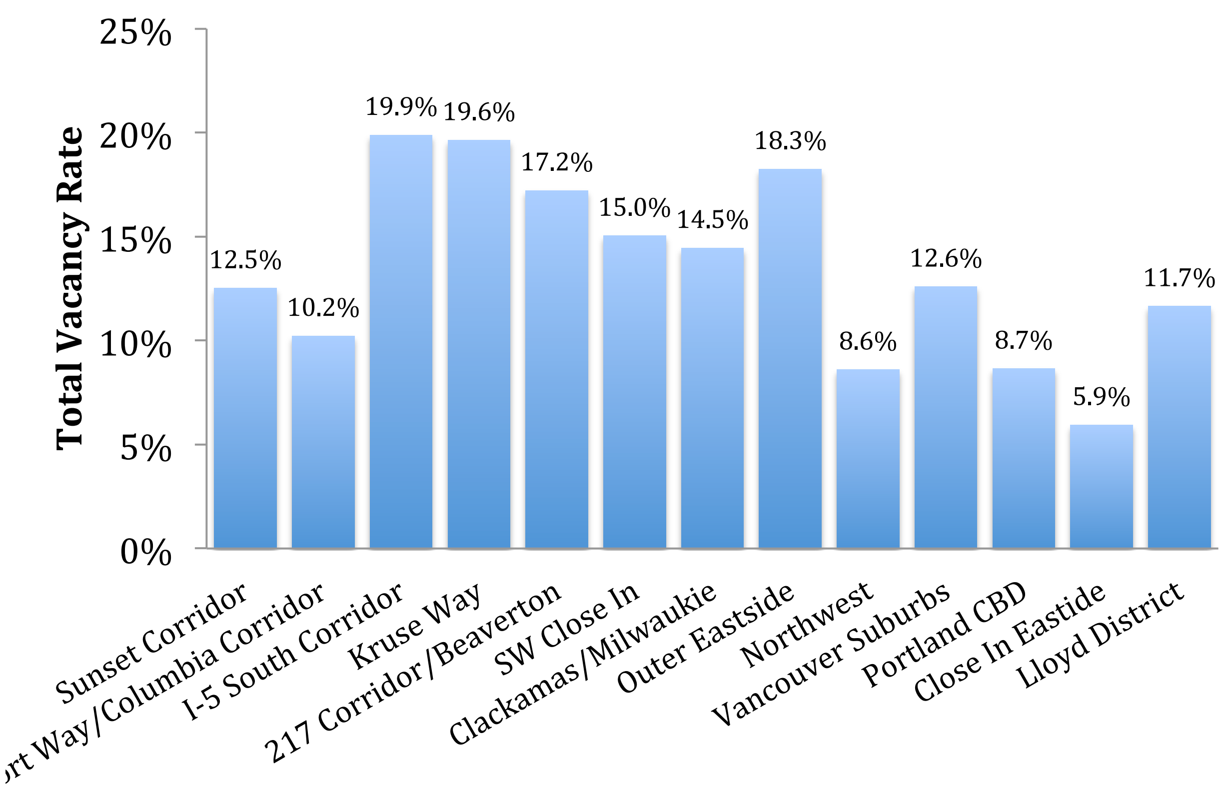
Source: Jones Lang LaSalle

Nearly every submarket saw either small or substantial gains in occupancy in Q1. With increasing demand and a scarcity of space, landlords have benefits from a more robust tenant base and a shift to a balanced market. The 217 submarket saw the greatest increase in occupancy, with a total of 189,883 square feet absorbed during Q1. This dropped the vacancy rate from 15.9% to 12.5%. Other winners included the Northwest submarket, which dropped from 10.2% vacancy to 8.2%, and Airport Way/Columbia Corridor, which dropped from 13.9% to 10.2% vacancy.

Other submarkets saw decreases in vacancy rates from 50 to 100 basis points, reaffirming the assertion that these markets have bottomed out and are on the upswing. Vacancy rates are still in the high teens in Kruse Way, 217 Corri-

dor/Beaverton and the Outer Eastside. The Outer Eastside saw the biggest increase in vacancy at 60 basis points to 18.3%. There was a slight uptick in the CBD occupancy rate, further fueling speculation of construction on the horizon. The close-in east side, Northwest, Lloyd and CBD submarkets and continue to enjoy vacancy rates that are below those of the other dominant submarkets. Inventory is expected to remain low in these markets for some time.

Figure 7: Submarket vacancy rates

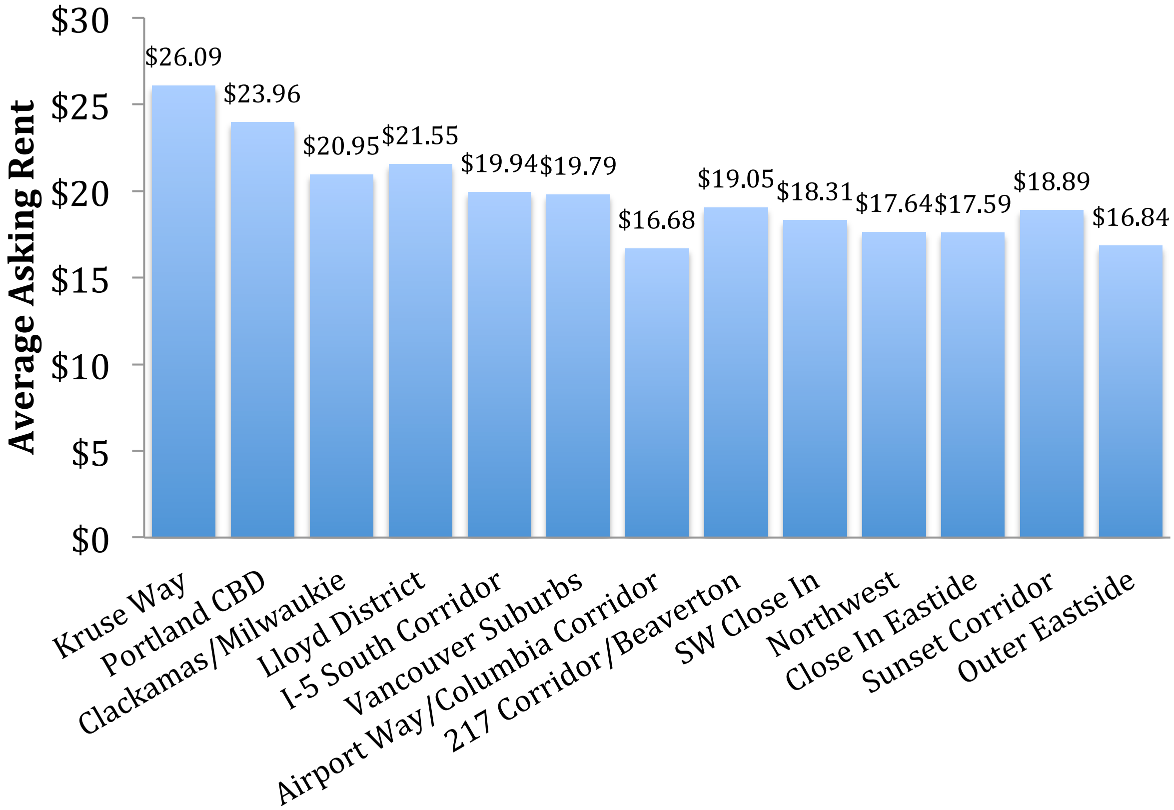


Source: Jones Lang LaSalle

Nearly all submarkets saw a drop in vacancy in Q1. Exceptions include the CBD (up 40 basis points) and the Outer Eastside (70 basis points). The CBD occupancy rate is still very strong, while the Outer Eastside continues to struggle. Recent articles in USA Today and the Los Angeles times report that poverty is on the rise in outer-ring suburbs and exurbs of major cities. High crime areas in Portland over the past 20 years have steadily moved from the central city to the city limits to the east

and west. Lease rates and occupancy have been reflective of this trend, and it appears that these markets face an uphill battle in the coming years.

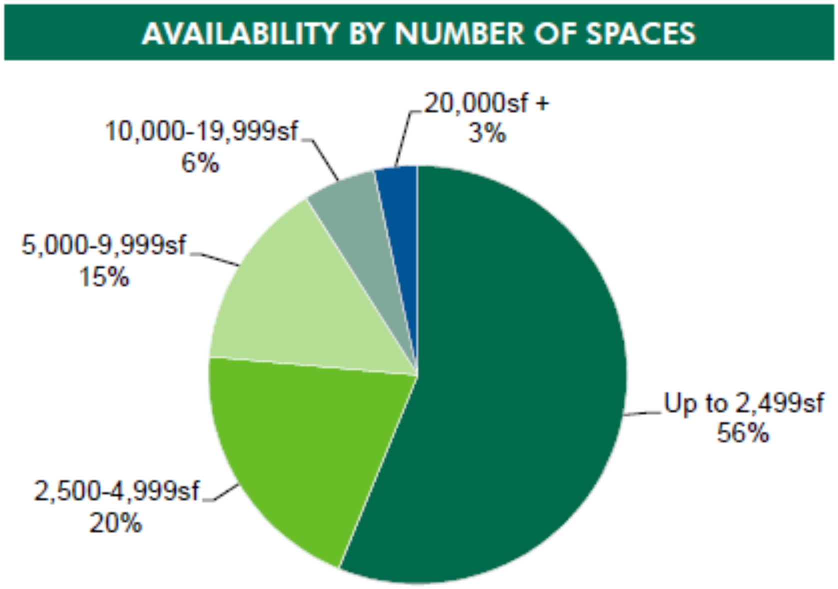
Figure 8: Submarket average asking rents



Source: Jones Lang LaSalle

While absorption was positive in nearly all submarkets, lease rates fell in some cases. Airport Way/Columbia Corridor's rates fell to $16.68 per square foot, down from $17.33 the previous quarter. The CBD fell slightly from $24.05 to $23.96, and the Vancouver Suburbs fell from $20.81 to $19.79. All other submarkets saw either stable rates or slight increases in average rent.

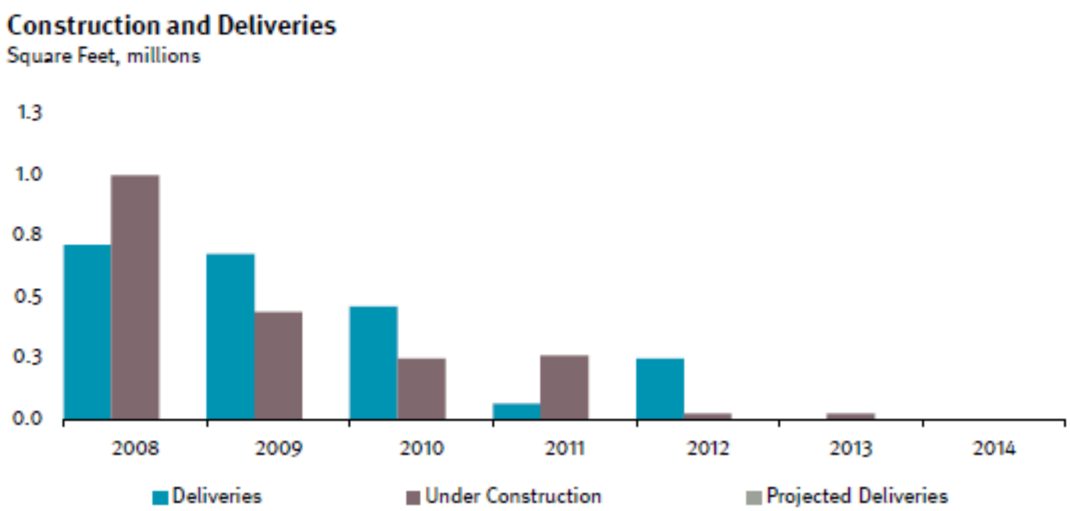
In submarkets with higher vacancy such as Kruse Way and the I5 South Corridor, lease rates remained relatively stable, or had a very slight uptick. If rates are rising even with vacancy rates in the high teens, it indicates that landlords are optimistic about future leasing prospects.



Source: CB Richard Ellis

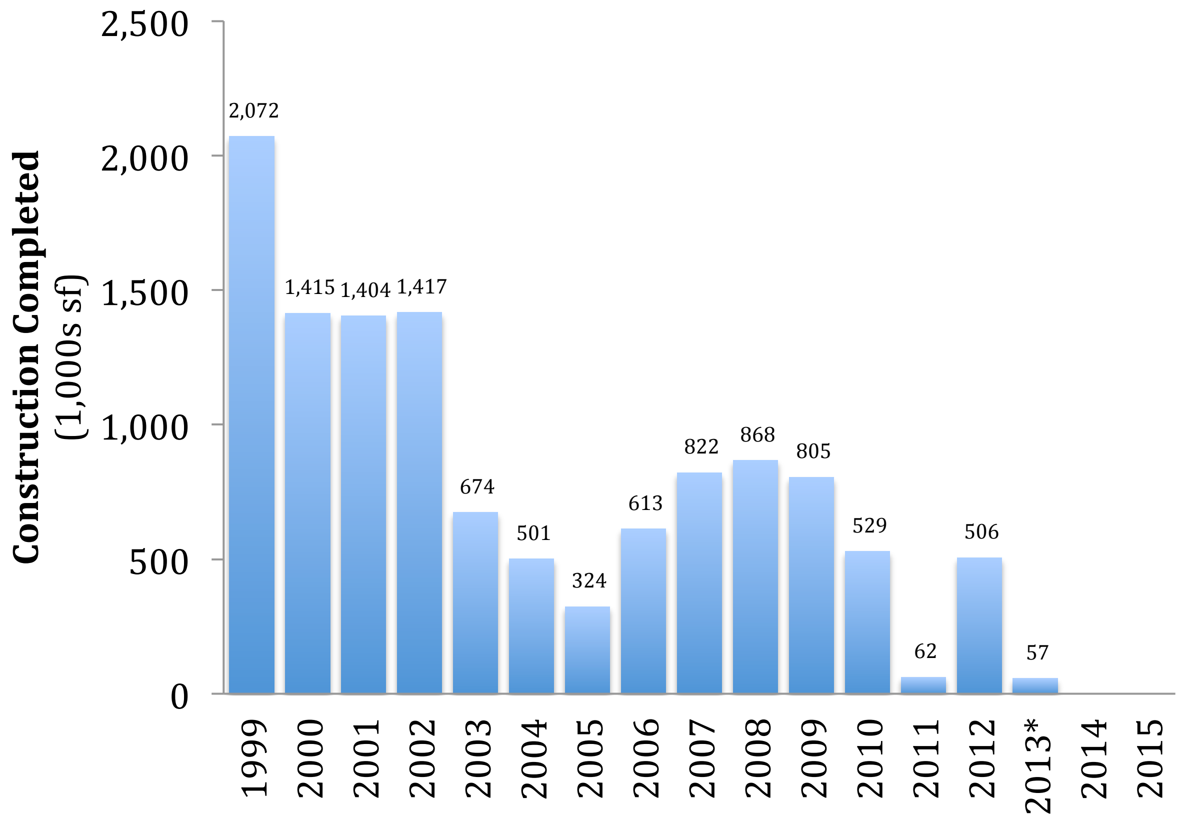
Companies looking for larger, class A spaces have very limited options, while smaller companies have a large selection of places. This trend is expected to continue until more space is constructed in future quarters.

With new construction at a near standstill for two years, the next construction cycle is expected to begin as rates rise, vacancy falls and the economy improves.



Source: Grubb & Ellis

Figure 9: Office construction completed, Portland



Source: Colliers International, Jones Lang LaSalle

Very little new construction was delivered during the first quarter of 2013. With few projects currently in the pipeline, it is unlikely that this number will climb significantly in 2013. With the current supply on hand it is unlikely that speculative building will reach the levels of the early 2000's anytime soon, but as supply is absorbed it is likely that developers will reenter the market. Portland developers traditionally wait until there are lower vacancy rates than do developers in other cities.

Centennial Mills, a centrally located century-old mill, is being redeveloped in a partnership between the Portland Development Commission and Harsch Investment Properties. Several firms have been engaged for possible tenancy, although there is some opposition to the development containing only office space. Schoolhouse Electric, a local purveyor of electrical fixtures and hardware, has set up shop in the Pacific Hardware and Steel Company building in the NW industrial district. These two redevelopments signal a trend for office space that favors preservation over demolition and renovation over new construction.

Table 1: Major lease transactions, first quarter 2013

Completed lease transactions				
Tenant	Building/Address	Submarket	SF	Type
Capital One	Tigard Corporate Center	217 Corridor/Beaverton	120,000	Renewal
Salesforce.com	Synopsys Technology Park	Sunset Corridor	116,500	New
Tripwire	One Main Place	CBD	49,053	Renewal
Schnitzer Steel	KOIN Center	CBD	41,000	New
Urban Airship	Vestas	CBD	40,000	New
PacifiCorp	PSU	CBD	40,000	Renewal
Ruby Receptionists	Murray Scholls Town Center	Sunset Corridor	30,822	New
Columbia River Inter-Tribal Fish Council	Lloyd 700 Building	Lloyd District	26,200	New
DTI	Pittock Block	CBD	22,000	New
Oregon Health Authority	Lincoln Building	CBD	21,500	New
Exterro	The Round	217 Corridor/Beaverton	20,309	Sublease
Harris myCFO	River Forum	SW Close In	20,290	New

Source: Jones Lang LaSalle

Apart from major leases by Capital One and Salesforce.com, the majority of larger lease transactions were between 20,000-40,000 square feet. A higher number of new leases helped to boost net absorption, while renewals and subleases demonstrated a strong continuation of economic activity.

Q1 2013 Deals of Note

Property Name	Submarket	Size (SF)	Date	Sale Price	Price/SF
Owner-User Office	SE Close-In	4,914	Mar-13	$650,000	$132
Pacific Tower	Clark County CBD	40,000	Feb-13	$3,200,000	$80
Social Security Admin.	NE Close-In	12,990	Feb-13	$2,150,000	$166
The Gregory (Condo Interest)	Pearl District	47,000	Feb-13	$10,571,317	$225
Low-Rise Office Property	Lloyd District	21,000	Jan-13	$1,650,000	$79
Low-Rise Office Property	Pearl District	13,713	Jan-13	$627,000	$46

Source: Kidder Matthews

Most sources agree that Portland reached a cyclical bottom in 2012. 2013 brings renewed hope in the market, amidst a handful of present or impending setbacks. Submarkets that were hit hardest by the recession have made healthy gains, and with the endorsement of powerful tech companies it is likely that these markets should continue to flourish. A lack of available space in certain sectors will eventually bring lease rates to the point where speculative construction once again takes center stage. Portland office development has tended to wait until the last minute to meet demand. Ultimately, developers will enter the market as landlord leverage is peaking, which will stabilize the landlords' market. Overall, the outlook is cautiously strong in the Portland office market, with optimism from tenants, landlords and developers alike. ■