

OFFICE MARKET ANALYSIS

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The Portland office market wrapped up the third quarter in strong fashion. However, there are signs that the market may be cooling down. The question on top of mind for those in the office market is where are we relative to the real estate and business cycles? And perhaps even more pressingly, the question is will the large amount of office space currently under construction be able to be absorbed in the marketplace? Without the ability to see into the future, we can only rely on current economic data and the ability to make an educated guess about future market conditions. No one is anticipating a downturn turn to a degree that was experienced during the Great Recession but how deep and when the timing of the downturn is up for debate.

With the talk and concern about a potentially softening in the office market, it's easy to forget about the tremendous gains our once quiet little town has made since the Great Recession. Josh Lehner of Oregon's Office of Economic Analysis recently published a paper titled "Portland in Transition" which highlights some of those gains our market has made. Mr. Lehner points out that "Among the nation's 100 largest metros, Portland ranks fifth best in both high-wage job growth and educational attainment



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increases.” Additionally, “Portland now ranks 16th highest for the share of working-age residents with a college degree. In 2007 Portland ranked 27th highest.” These are remarkable improvements that Mr. Lehner singles out will likely continue to attract talent to our market and keep it relatively strong despite a possible softening in the short run.

Increasingly the ability to attract and retain talent is becoming a big concern for companies. According to the Bureau of Labor Statistics, our national employment rate at the end of the third quarter was 4.2 percent. The strong gains in employment are great for the national economy however, labor is becoming a greater scarcity and companies are finding the need to differentiate themselves against their competitors in the hopes of attracting top talent. One of the ways in which companies are differentiating themselves is by their location. Companies seeking to stand out among their competitors and incentivize potential employees are moving into the central business district. They are seeking amenity rich environments that younger talent especially desire. This has been a trend nationally but closer to home, evidence of this can be seen by Autodesk’s lease of the newly renovated Towne Storage in the Central Eastside as well as companies like Zapproved, Lattice Semiconductor, and Netop relocating from the suburbs to the CBD. This activity and desire for centrally located office space in an amenity rich environment should help drive the CBD office market in the coming years.

Portland Metro’s third quarter at-a-glance:

- JLL sees continued strength in the office market, reporting a total of 220,000 square feet of positive net absorption in CBD Class A Office this quarter. Vacancy rates are up 90 basis points despite the strong absorption as some of the new construction hits the market place faster than the market can absorb. JLL highlights four large office properties currently on the market that could potentially help end the year at post a recession high sales volume.
- While much of the attention has been on what’s happening in the CBD and close-in, Kidder Mathews is highlighting that 403,610 square feet of office space was absorbed in the suburban submarkets this quarter. This has pushed suburban vacancies down to 6.6 percent. Kidder Mathews notes that the bulk of the leasing activity this quarter was from small to medium sized deals. They speculate that tenants needing large spaces are delaying leasing decisions until the larger projects under development are delivered.
- The third quarter office market is performing well according to the Colliers market report. Vacancy is down while net absorption and rental rates are up. This activity is keeping investor confidence strong and sales volume up. This quarter, the highest price paid per square foot was \$583 by Stockbridge Capital for the Wieden & Kennedy Building. However, the substantial development pipeline has tempered expectations, Colliers is predicting vacancy rates to increase as new product hits the market.
- CBRE is reporting a more pessimistic third quarter noting that annual absorption is at 14,111 sq. ft. and the vacancy rate has climbed up. It’s not all bad though as asking rates crept up slightly in the quarter. Broker sentiment indicates that we have reached our cycle peak and are the market is now on the downhill. However, the expectation for the slowdown is that it will be brief. CBRE draws a connection between the San Francisco and Portland office markets. Despite an increasing asking rent, our market is still relatively affordable and some tech tenants in San Francisco will look north to take advantage of our cheaper rents, which will bolster our market.

VACANCY

Overall most firms are reporting a slight decrease in the vacancy rate in Q3. Colliers, Kidder Mathews and Cushman & Wakefield all report a vacancy rate decline ranging from 30 to 60 basis points on the overall vacancy rate. JLL reports an increase of 90 bps year-over-year and CBRE reports an increase of 36 basis points from the second quarter.

The CBD submarket performed very well this quarter with Class A office space leading the way. In fact, in the last three years across all submarkets, Class A vacancy has dropped 280 basis points.

Regardless of how the vacancy data is interpreted, the take away is that vacancy rates remain stable with no sharp increase or decrease anticipated in the near future. The first phase of development coming out of the recession definitely favored multifamily product but the strong office market fundamentals has caught the attention of developers. The uptick in deliveries will most likely outpace the markets ability to absorb the product pushing the rate upwards in the future.

Table 1: Total Vacancy Rates by Brokerage House and Class, Third Quarter 2017

| Brokerage | Total | CBD | CBD Class A | CBD Class B | CBD Class C | Suburban |
|----------------|-------|-------|-------------|-------------|-------------|----------|
| CBRE | 11.7% | 12.4% | 9.5% | 11.7% | 18.8% | 12.3% |
| Colliers | 7.9% | 9.6% | 9.3% | 10.6% | 7.9% | - |
| JLL | 9.9% | 9.7% | 8.7% | 11.8% | 9.1% | - |
| Kidder Mathews | 7.4% | 9.3% | - | - | - | 6.6% |

Source: CBRE, Colliers, JLL and Kidder Mathews

RENTAL RATES

Overall, rental rates climbed upward this quarter. This has been the trend since coming out of the recession and points to the overall strength of the office market to date. Despite the concerns about the rise in construction, the increase in rents this quarter may point to the market having more room to run.

Table 3: Average Direct Asking Rates (\$/sf FSG) by Brokerage House and Class, Third Quarter 2017

| Brokerage | Market Average | CBD | CBD Class A | CBD Class B | CBD Class C | Suburban |
|----------------|----------------|---------|-------------|-------------|-------------|----------|
| CBRE | \$27.34 | \$31.02 | \$34.16 | \$30.33 | \$26.55 | \$23.87 |
| Colliers | \$25.04 | \$30.46 | \$33.07 | \$30.07 | \$23.79 | - |
| JLL | \$28.22 | \$32.49 | \$35.47 | \$31.78 | \$26.03 | - |
| Kidder Mathews | \$25.06 | \$30.16 | - | - | - | \$22.54 |

Source: CBRE, Colliers, JLL and Kidder Mathews

ABSORPTION AND LEASING

Absorption in the marketplace stayed positive in the third quarter. Leasing activity in 2017 got off to a slow start with negative absorption in the first quarter but by the second quarter, the numbers were back in the black. The largest lease signed this quarter was Northwest Natural's new downtown headquarter office building of 180,000 square feet, followed by the 103,279 square feet at Sunset Corporate Park III for a Wells Fargo call center. Adidas also made headlines when they leased out 79,657 square feet at Montgomery Park. Adidas rapid growth has pushed them to seek space outside of their campus in northeast Portland.

Table 4: Net Absorption (in square feet) by Brokerage House and Market Area, Third Quarter 2017

| Brokerage | Overall | CBD | Suburban |
|----------------|----------|-----------|----------|
| CBRE | (63,308) | (209,030) | 22,105 |
| Colliers | 593,781 | 183,833 | - |
| JLL | 302,224 | 156,714 | - |
| Kidder Mathews | 478,730 | 93,755 | 403,610 |

Source: CBRE, Colliers, JLL and Kidder Mathews

Table 5: Net Absorption (in square feet) by Brokerage House and Market Area, Year to Date

| Brokerage | Overall | CBD | Suburban |
|----------------|---------|-----------|----------|
| CBRE | 14,111 | (209,030) | 22,105 |
| Colliers | 685,149 | 269,241 | - |
| JLL | 339,845 | 195,151 | - |
| Kidder Mathews | 619,168 | 248,602 | 422,632 |

Source: CBRE, Colliers, JLL and Kidder Mathews

Table 6: Notable Lease Transactions, Third Quarter 2017

| Tenant | Building/Address | Market | Square Feet |
|-------------------|-------------------------------|-----------------|-------------|
| Northwest Natural | 250 Taylor/ SW 250 Taylor | CBD | 180,000 |
| Wells Fargo | 23175 NW Bennett | Sunset Corridor | 103,279 |
| McAfee | 55 West Bldg 3 | Sunset Corridor | 103,000 |
| Tokyo Electron | Tanasbourne Commerce Center I | Sunset Corridor | 57,000 |
| eBay | Fifth Ave. Building | CBD | 56,645 |
| Farmers Insurance | Pacific Parkway Center | Tigard | 40,250 |

Source: CBRE and Colliers

SALES TRANSACTIONS

Investment sales for office properties continues to be strong in Portland. The third quarter saw two properties trade at the above \$500 per square foot threshold. The most expensive property sold this quarter was the Wieden Kennedy Building at NW 13th and Glisan sold to Stockbridge Capital for \$583.68 per square foot. After that was Pearl West which was reported in the second quarter report but the sale technically fell very early on in the third quarter. That property sold for \$563 per square foot. At the current pace of sales, JLL anticipates 2017 will end with the largest total yearly sales volume since the recession.

Table 7: Notable Sales Transactions, Third Quarter 2017

| Building/ Address | Buyer | Seller | Market | Price | SF | Price/SF |
|---|-----------------------------|--------------------------------|----------------|---------------|---------|----------|
| Weiden + Kennedy | Stockbridge Capital | JP Morgan | CBD | \$103,250,000 | 176,986 | \$583.68 |
| Pearl West | BPM Real Estate | LaSalle Investment Mgmt. | CBD | \$87,500,000 | 155,465 | \$562.83 |
| Meier & Frank | Deutsche Bank | Gerding Edlen | CBD | \$64,852,425 | 133,000 | \$486.66 |
| New Market Theater & Blagen Block | NBP Capital | Swift | CBD | \$32,250,000 | 120,279 | \$268.13 |
| 6Y | KBS Realty Advisors | Swift | CBD | \$28,200,000 | 109,420 | \$260.46 |
| Lloyd Plaza | Weston Investment Co. | Washington Holdings | Lloyd District | \$28,000,000 | 96,052 | \$291.51 |

Source: CBRE, Colliers and CoStar

DELIVERIES AND CONSTRUCTION

The third quarter didn't see much in the way of large deliveries and what was delivered was mostly preleased. The largest projects to hit the market were Towne Storage at the Burnside Bridgehead delivering 108,750 square feet and the Under Armour headquarters off of Barbur Boulevard delivering 108,698 square feet. The Towne Storage project has been leased entirely to Autodesk, which is moving out of their location on Kruse Way. The Under Armour headquarters takes over the former YMCA. The largest speculative project delivered this quarter was the Fair-Haired Dumbell located at the intersection of Martin Luther King Boulevard and East Burnside. This project brought 32,850 square feet of creative office space to the market.

On the construction side, some of the larger speculative projects are nearing completion. By the end of the year, a total of 357,677 square feet of new office space is slated for delivery across five projects and by the end of the first quarter of 2018 a total of 787,885 square feet of office space across an additional eight projects will hit the market. The speed at which this large amount of office space is absorbed will be closely watched by those in the market, but given our strong talent pool and relative market affordability to other west coast cities our market is well positioned for the long-term.

DELIVERIES AND CONSTRUCTION

Table 8: Notable Development Projects Under Construction, Third Quarter 2017

| Building/ Address | Developer | Market | SF | Delivery Date |
|----------------------|-----------------------------------|-----------------|---------|---------------|
| Nike North Expansion | Gerding Edlen | Sunset Corridor | 887,000 | 2018 |
| Field Office | Project^ | NW Close-In | 330,208 | Q1 2018 |
| Clay Pavillion | Killian Pacific | SE Close-In | 75,000 | Q1 2018 |
| 9North | Williams & Dame/ Miller Global | CBD | 202,168 | Q3 2018 |
| Waterfront Block 6 | Gramor | Vancouver CBD | 77,000 | Q3 2018 |
| Broadway Tower | BPM Real Estate - Office | CBD | 177,800 | Q4 2018 |

Source: Colliers and CoStar