RESIDENTIAL MARKET ANALYSIS

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As has been the story for the last couple of years, multi-family projects continue to deliver while others continue to break ground at a record pace in the Portland metropolitan area. Projects still in the vesting period of pre-Inclusionary Zoning, are continuing to move forward. However, the effects of IZ were expected to be delayed and the pipeline of projects permitted after the regulations kicked in has been significantly decreased. This combined with additional city regulations (unreinforced masonry, tenant screening and tenant protections), rising construction costs, interest rate increases, and fears of market oversupply are headwinds in the current multifamily boom in Portland. With a steady, but slowing, stream of net migration, there is still a forecasted shortage of housing in Portland for the foreseeable future. Thus, the Oregon Office of Economic Analysis, still expects that the Portland economy has room to run.

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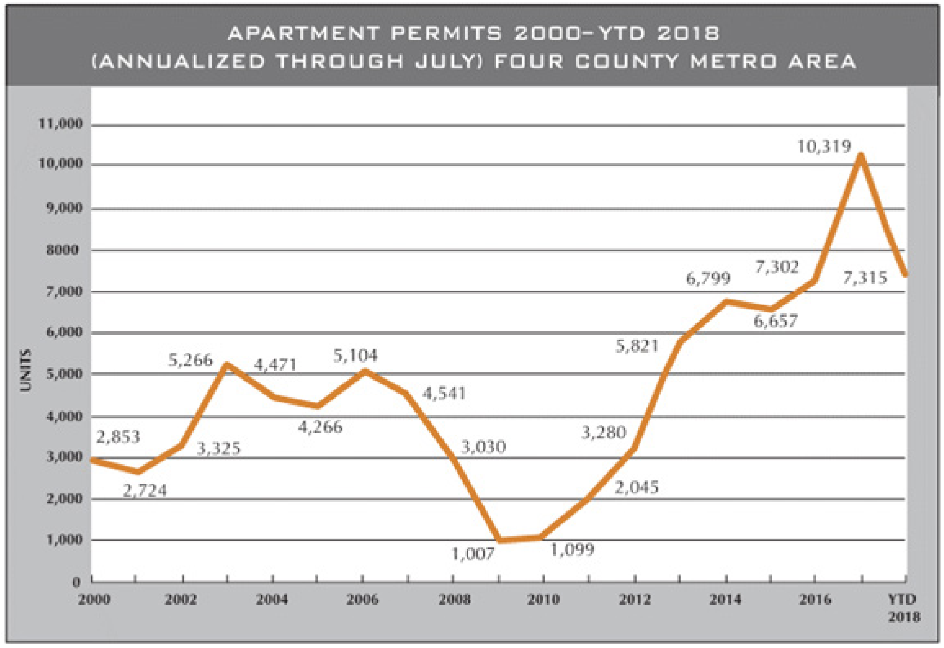
PERMITS AND SUPPLY

Figure 1: Apartment Permits YTD



Source: (McConachie, Barry, Knakal, & Lehner, 2018)

The Portland's inclusionary zoning (IZ) ordinance the city introduced in February 2017 has had a significant impact on number of permits submitted prior to and submitted after the ordinance went into effect. The Bureau of Planning and Sustainability has released the most recent permitting numbers and only 5,000 of the original 19,000 units that were submitted for permits prior to IZ have received building permits. Figure 1 shows the decline in apartments unit submitted in the last year. BPS has stated that they want to leave the program as-is for three years before making any changes, but have already started looking at modifications to get voluntary participation for pre-IZ vested projects to fall under the IZ regulations. While IZ was a part of the decline in permits submitted, the market has also been facing a labor shortage and regulations that are affecting construction costs, making many projects not feasible.

The first three quarters of 2018 have delivered around 4,300 units so far, and a total of around 6,000 are slated to be delivered by years end, according to CoStar. This still leaves almost 10,000 units under construction. The effects of IZ have not yet effected the supply, but a lag was expected because of the time span between permitting and actual construction. A vested permit can keep its status for three years with proper extensions. Forecasting out to 2020 and beyond, if IZ remains in place, it is likely when the number of new units will decrease dramatically, especially in the Central City. It should be noted that outside of the Central City, where IZ regulations have not been put in place, the area has seen an up-tick in multifamily projects as developers look to find where projects are feasible.

CONSTRUCTION COSTS

There is a familiar story with construction costs nationally and locally. Construction costs in the Portland MSA have increased 6.51 percent in the last year, according to the North America Quarterly Construction Cost Report. These increases are close to the nations highest, with only Chicago (6.79 percent) at a higher year-over-year increase.

The reasons for cost increases includes tariffs, a fear of regulatory volatility, lack of skilled workers, and the amount of projects in construction. Suppliers, for commodities such as

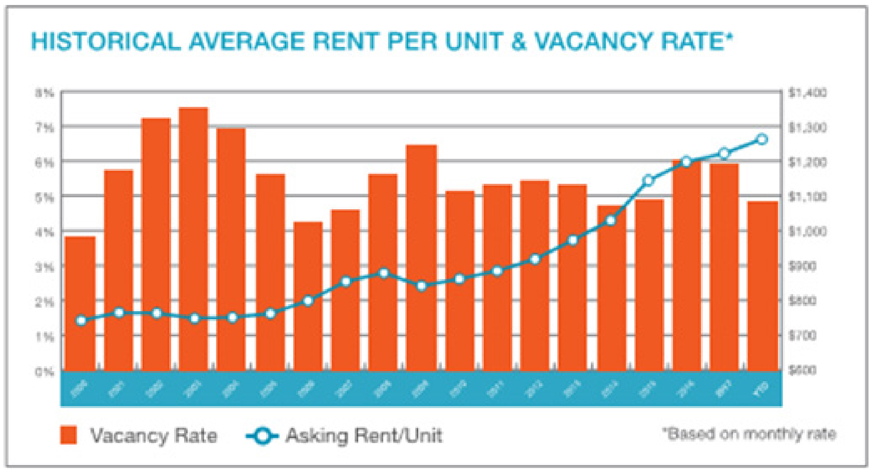
CONSTRUCTION COSTS

steel, have been only holding quoted prices for a short period—24 hours to a week—due to the trade and regulatory climate. Developers are feeling the crunch with one high profile project, Framework in the Pearl, being shelved for the time being. The significance of that is the Framework project was supposed to be an example of how cross-laminated timber can be a viable alternative to steel and concrete high-rise construction. While the seismic, fire and acoustics have proven out, the cost volatility has proven insurmountable at this point.

Subcontractors in the market have been so busy the last few years that they've been very selective on projects they will look at. With the drop in multifamily permitting activity, the sector is set to see a lull once the pre-IZ projects either fall out of the permit process or are completed, could turn the market for subcontractor services a buyer's market.

RENTS AND VACANCIES

Figure 1: Apartment Permits YTD



Source: (McConachie, Barry, Knakal, & Lehner, 2018)

With the glut of pre-IZ supply coming on the market, the sentiment in the market was that vacancies would increase and rents would level out. Instead, vacancies actually decreased by 0.45 percentage points and rents have continued to rise, according to the economists at the State of Oregon.

The Portland metro area's average vacancy is down to 4.4 percent while average rents are now $1.62 per square foot. Downtown Portland and northwest Portland have the highest vacancies at 6.09 percent and 6.33 percent, respectively. The corresponding average rents have increased to $2.47 per square foot and $2.11 per square foot. Downtown and northwest are where much of the Class A multifamily product has been delivered. Higher vacancies and increased concessions on virtually all new deliveries show that there is a softening in this part of the market.

Elsewhere in the region, the number of buildings offering incentives have lowered slightly in many areas since Spring 2018. The Troutdale/Fairview/Gresham area has the lowest vacancies around 2.87 percent and have the lowest average market rates at $1.32 per square foot.

The Bend/Redmond submarket has an average vacancy rate of 2.99 percent and average rent of $1.60 per square foot. This could be interpreted as a signal for developers to start to venture outside of the Portland MSA, where IZ and construction costs have been deterrents of development in the last year.

SALES

Cap rates have flattened out for multifamily projects at 5.3 percent, with a median per unit price of $169,000 for the latest quarter, according to MultifamilyNW. There was a total of 52 transactions this quarter, with the largest being Indigo @ Twelve I West, which sold for $206 million. With the current regulations slowing new construction, Portland's multifamily could see an upside in the purchase of multifamily properties in Portland in the near future. ■