OFFICE MARKET ANALYSIS

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The start of the second half of 2018 was strong for Portland's office market. Rental rates continued to increase with some submarkets holding a record amount of rate increases year-over-year. Leasing activity remained strong while construction costs continued to rise, affecting sales transactions. Vacancy rates rose slightly, but because of Portland's attractive appeal as an alternative to other markets in the West, investors remain confident. As Seth Platsman of Macadam Forbes summed up:

> "Portland feels it is uniquely positioned to absorb this vacancy, especially when looking at competing markets. Average gross asking rates in San Francisco have exceeded $70 per square foot. In addition, the median home price in San Francisco is approximately $1.5 million. Portland's pitch to growing companies in the Bay Area: pay 70 percent less for comparable office space and give your employees a more realistic opportunity to purchase a home."

Most notably, a large number of leases in suburban markets will result in a lower suburban vacancy rate than the urban core for the first time in 15 years. In a video from Cushman & Wakefield, Chris Nelson, Principal of Capstone Partners, touched on why rental rates have continued to rise despite new developments in the pipeline in both urban and suburban markets:

> "The migration of companies to Portland is a combination of new incubating companies that are growing and tech companies here in Portland—the companies are just chasing where the people want to be, particularly millennials that are finding Portland as a good place to relocate to."

With Portland Metro's unemployment rate sitting at 3.8 percent and employment growth of 43,200 jobs added year-to-year, there is a large incentive for new tenants to enter the market. Jason DeVries of Cushman and Wakefield's Portland office also confirms, "Companies look at it as: I've got a great labor force, they have a great quality of life, and then you add in the fact that we are a cheaper alternative than Seattle and San Francisco from a real estate perspective—it's kind of a no-brainer."

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VACANCY

Vacancy rates this quarter saw a large variation among brokerage firms. The Portland office market vacancy rose slightly in the second half of the year to end at 11.9 percent according to JLL, ticking just above last quarter's 11.7 percent. Tim Harrison of JLL notes:

> "The downsize of Wells Fargo at the Wells Fargo Center and the closure of the Art Institute at M Financial Plaza together with new development, will push vacancy up in the Urban Core above 12 percent. Conversely, after a tough first half of the year, activity in the Westside suburbs has picked up and a number of large leases have been signed and set to commence in the next six months. This should result in suburban vacancy falling below urban vacancy for the first time in over 15 years."

Newmark Knight Frank and CBRE's vacancy predictions line up similarly to JLL's while Colliers and Kidder Mathews see a lower vacancy rate at 9.7 percent and 7.1 percent, respectively. CBRE notes, "Jive Software's closure was the largest reason for negative absorption … the company downsized from approximately 50,000 square feet and remaining employees will work from home."

Table 1: Total Vacancy Rates by Brokerage House and Class, Third Quarter 2018

Brokerage	Total	CBD	CBD Class A	CBD Class B	CBD Class C	Suburban
Colliers	9.70%	12.50%	10.10%	14.70%	16.50%	-
JLL	11.90%	11.00%	8.80%	14.70%	13.70%	-
Kidder Mathews	7.10%	9.90%	8.60%	10.50%	11.80%	6.20%
Newmark Knight Frank	10.10%	10.50%	-	-	-	-
CBRE	11.00%	10.90%	-	-	-	11.10%

Source: Colliers, JLL, Kidder Mathews, CBRE and Newark Knight Frank

RENTAL RATES

Rental rates were steady in the first half of the year but are now seeing a resurgence in the second half of 2018. According to CBRE, "New construction paired with demand pushed average lease rates up with an increase of 9.7 percent year-over-year for the overall Portland market." The market's average rental rate among brokerage houses ranged from $25.83 to $31.21, while Portland's CBD range was higher, ranging from $31.68 to $35.27.

According to JLL, the close-in Eastside's newest developments are pushing rents to the highest in the Portland metro area. Harrison notes, "The Close-In Eastside took over as Portland's most expensive submarket, with average rents now $40.00 FSG per square foot." This is 24.9 percent above the submarket's average asking rate year-over-year. Other leading submarkets leading the pack are the suburban submarkets of John's Landing at $30.18 per square foot and Kruse Way at $31.99 per square foot.

RENTAL RATES

Table 2: Average Direct Asking Rates ($/sf FSG) by Brokerage House and Class, Third Quarter 2018

Brokerage	Market Average	CBD	CBD Class A	CBD Class B	CBD Class C	Suburban
Newmark Knight Frank	$28.29	$32.73	$34.87	$33.73	-	-
Kidder Mathews	$25.83	$31.68	$34.58	$30.07	$25.48	$22.68
Colliers	$26.11	$32.01	$35.79	$30.86	$26.12	-
CBRE	$29.99	$34.70	-	-	-	$25.07
JLL	$31.21	$35.27	$38.76	$34.58	$27.56	

Source: Colliers, JLL, Kidder Mathews, CBRE and Newark Knight Frank

ABSORPTION AND LEASING

The third quarter saw 250,903 square feet of positive net absorption, contrasting 2017's 428,339 square feet of absorption. The second quarter saw the several downsizes and closures, including Jacobs Engineering in Kruse Way, SureID in the Sunset Corridor, as well as Covergys' call center in the I-5 South Corridor. However, third quarter's absorption assisted their recoveries. JLL noted, "Solid absorption in the Urban Core and Westside suburbs helped the market recover from the heavy losses in the Westside Suburbs in the first half of the year." Year to date, JLL notes of a negative 133,380 square feet in the Portland office market overall, while Colliers reports negative 171,273 square feet year to date.

Table 3: Net Absorption (in square feet) by Brokerage House and Market Area, Third Quarter 2018 and Year to Date

Brokerage	Q3 Overall	YTD Overall	Q3 CBD	YTD CBD
Colliers	$326,165.00	($171,273.00)	$249.89	-
JLL	$84,346.00	($133,380.00)	$56,470.00	$5,509.00
Kidder Mathews	$519,282.00	$1,100,193.00	-37,910	-245,906

Source: Colliers, JLL and Kidder Mathews

The most notable lease transaction was Genentech's lease in the Lloyd Center Tower. The San Francisco-based company already employs more than 400 people on a 75-acre campus in Hillsboro. Looking to expand and continue to build its talent base, the company assessed over ten cities before choosing Portland. In a recent article in the Portland Business Journal, Claire Scott, Vice President of Access Solutions, described Genentech's selection process:

> "When we were looking for locations we took into account what would be a great location in terms of connectivity with the organization and patients and community. We loved the mission-driven culture we found in Oregon and Portland."

In addition, 24 Hour Fitness leased the 48,499 square foot space located at 4204-4224 NE Halsey Street. Block 29 Center for Health and Healing, a project by Oregon Health & Science University, is also 100 percent pre-leased.

ABSORPTION AND LEASING

Table 4: Notable Lease Transactions, Third Quarter 2018

Tenant	Building/Address	Market	Square Feet
Genetech	Lloyd Center Tower	Lloyd District	$61,990.00
24 Hour Fitness	4204-4224 NE Halsey Street	NE Close-In	$48,499.00
Rohde & Schwarz, Inc.	Rock Creek Corporate Center	Sunset Corridor/Hillsboro	$44,142.00
Vetsource	Cascade Station II	Airport Way	35,000
SAIF	2 Centerpointe	Kruse Way	$21,011.00
Cable Huston	Broadway Tower	CBD	17106

Source: Newmark Knight Frank and Kidder Mathews

SALES TRANSACTIONS

According to Costar, "the first six months of 2018 saw 37 office sales transactions with a total volume of $394,609,542." In the third quarter, sales activity dipped. Director of Research at Kidder Mathews, Jerry Holdner, explained:

> "Portland's office market experienced a quarter-over-quarter drop of roughly half in sales dollar volume and building square footage sold. Additionally, average price said per square foot fell 8.5% quarter-over-quarter. While the summer malaise adversely affected the overall office sales numbers for Q3, there were some significant transactions that took place."

These transactions include Unico Properties and American Realty Advisors' purchase of the nearly 400,000 square foot Moda Tower from UBS Financial Services for $178 million. In a recent press release from Unico Properties, Ben Pearce, Vice President of Real Estate Services, stated, "Office tenants and employees are seeking extremely walkable locations with direct access to transit and amenities … [and] MODA Tower is precisely aligned with these demands." Albert Pura, Senior Director at ARA, expanded on why the two companies chose Portland for their second partnership:

Portland's CBD has quickly emerged as one of the nation's fastest growing tech and innovation hubs … Firms are continuing to migrate to the region in search of strong value alternatives as compared to San Francisco, Los Angeles, and Seattle. MODA Tower will benefit from this ongoing economic growth and migration of jobs, driving long-term demand for the property.

Unico Properties also added The Weatherly building, a $20 million investment in the SE close-in submarket, to its portfolio. Located at 615-540 SE Morrison Street, the 63,608 square feet of Class B office space was sold by Mayfield Investment Co, Inc. Other notable sales transactions include Crown Acquisition Associates' acquisition of Sunset Corporate Park, Phase II located in the Sunset Corridor/Hillsboro submarket, which is a 103,279 square foot building that is fully leased. The property was sold by Washington Capital Management for $32,250,000.

In addition, the two mixed-use properties known as The Bailey Building and The Water Tower in the Johns Landing submarket were acquired by ScanlanKemperBard Companies for $24 million. The seller was Melvin Mark Companies who had purchased the Water Tower

SALES TRANSACTIONS

in 2008 for $19.7 million. According to a recent press release from Melvin Mark after the sale, the team was proud of their action plan that "stabilized the building roster, kept long-term tenants happy with the refurbished property and attracted interest from a range of office and retail users." Todd Gooding, the President of buyer SKB, stated in a press release:

> "We are grateful to Melvin Mark for the opportunity to acquire this asset as we are firm believers in the John's Landing Submarket. The water views, neighborhood amenities and historical architectural features provide a unique urban experience at a price point and parking ratio typically found in the suburbs."

Table 5: Notable Sales Transactions, Third Quarter 2018

Building/Address	Buyer	Seller	Market	Price	Price/SF
Moda Tower	Unico Properties	UBS Financial Services	CBD	$178M	$446.77
Sunset Corporate Park, Phase II	Crown Acquisition Associates	Washington Capital Management	Sunset Corridor	$32.25M	$312.26
The Water Tower + Bailey Building	ScanlanKemperBard Companies	Melvin Mark Companies	Johns Landing	$24.8M	$201.32
The Weatherly	Unico Properties	Mayfield Investment Co, Inc.	SE Close-In	$20M	$314.43

DELIVERIES AND CONSTRUCTION

New construction deliveries totaling 507,932 square feet were completed during the third quarter of 2018, contrasting second quarter's 728,355 square feet. The Knight Cancer Institute Research Building, a development by Oregon Health & Science University, delivered its 320,000 square foot space in the Southwest market. This was the largest property to deliver in this quarter. Brian Druker, Director of the OHSU Knight Cancer Institute, said in a press release, "We want this to be the building where we end cancer as we know it…We're trying to bring a collaborative spirit to defeating cancer."

Figure 1: Knight Cancer Institute Research Building Delivered, Third Quarter 2018

Source: SRG Partnership

DELIVERIES AND CONSTRUCTION

The building is on track to receive its LEED Platinum status and comply with the 2030 Energy Challenge. Tiffani Howard, project liaison for Knight Cancer Institute, said, "We believe we can move cancer research forward much faster if we work together in teams, so we are committed to team science." An article from Tradeline Inc. showcases this importance of flexibility and collaboration in the future of office building designs. For OHSU, the design of the Knight Cancer Institute had to meet the changing needs of research. The article explains:

Flexibility is evident throughout the building:

- The structure is post-tensioned concrete, which allows for a wide structural bay and eliminates columns in the labs
- The moveable, flexible lab casework allows write-up desks to change to lab tables or vice versa
- The overhead and service carriers, which provide all of the primary lab utilities, support fluid adjustments
- All offices and small meeting rooms are nearly identical in size, allowing flexibility over time for a growing community

Table 6: Notable Development Project Deliveries, Second and Thrid Quarter 2018

Building/Address	Developer/Owner	Market	SF	Delivery Date
Nike North Expansion Building A	N/A	Westside	412,000	Q2 2018
Knight Cancer Institute Research Building	Oregon Health & Science University	Southwest	320,000	Q3 2018
Field Office – East	Project^	Northwest	165,653	Q2 2018
First Tech Federal Credit Union	Swinerton Builders	Sunset Corridor/Hillsboro	156,000	Q3 2018
Heartline Building	Security Properties, Inc.	CBD	70,702	Q2 2018
Flatiron PDX	Southern Miss, LLC	NE Close-in	28,740	Q3 2018
Convene	Killian Pacific	St Johns/Central Vancouver	45,000	Q2 2018
The Murdock	Gramor Development	Clark County	77,000	Q4 2018
7 SE Stark	Harsch Investment Properties	Lloyd District	70,000	Q2 2019
Tree Farm	Guerilla Development	SE Close-In	43,000	Q4 2018

Source: CoStar

Other notable mentions were the 156,000 square foot First Tech Federal Credit Union by Swinerton Builders as well as Flatiron PDX, a project by Southern Miss, LLC in the NE Close-In submarket. The Flatiron PDX building is expected to deliver this month and also reflects similar attributes to the flexible design concepts previously mentioned in OHSU's project. According to Works Progress Architecture, the project's "five floor plates will be open loft space…[with] unique triangular geometry resulting in a weave of bay windows and open space at the corners." The design has already attracted Remote.ly, which has leased 8,4000 square feet on two floors of the building to compete in the hot coworking field.

DELIVERIES AND CONSTRUCTION

Figure 2: Flatiron PDX – Office Space To Be Delivered

Source: Works Progress Architecture

Table 7: Notable Under Construction Projects, Third Quarter 2018

Building/Address	Developer	Market	SF	Delivery Date
Nike North Expansion Building B	Gerding Edlen	Westside	1,003,585	Q4 2018
Block 29 Center for Health & Healing	Oregon Health & Science University	Southwest	360,000	Q4 2018
9North	Williams & Dame Development	CBD	202,853	Q4 2018
250 Taylor	Third & Taylor Development LLC	CBD	190,825	Q4 2019
Broadway Tower	BPM Senior Living Company	CBD	177,800	Q4 2018
The Press Blocks – Office	Security Properties + Urban Renaissance Group	Southwest	142,000	Q2 2019
5 MLK Office	Gerding Edlen	Lloyd District	119,570	Q4 2019

Source: CoStar

DELIVERIES AND CONSTRUCTION

In addition to Flatiron, rapid development is also still underway, with several projects expected to deliver next quarter. According to JLL's Tim Harrison, the upcoming fourth quarter's "delivery of Broadway Tower, 9North and the Meier & Frank building … will add an additional 4.6 percent of Class A office space to the CBD." Harrison adds:

> "The 19 story Broadway Tower is another successful addition to Portland's office market by development group BPM Real Estate. The mixed-use tower will feature a 180 room Radisson Red Hotel on the bottom 8 floors, while the top 11 floors are 94 percent pre-leased. Additionally, the Meier and Frank Building is roughly 43% pre-leased."

Figure 3: 7 SE Stark Street – Office Space Under Construction – Lloyd District

Source: Costar

With its recent office space of 7 SE Stark Street slated for the second quarter of 2019, Harsch Investment Properties confirmed that the "Central Eastside has long been known as Portland's 'industrial sanctuary' and has seen exceptional growth and revitalization in recent years." As Jon Bell of the Portland Business Journal predicted:

> "This submarket…is in the midst of a renaissance fueled by the in-migration of office users (local and out-of-state) including creative, software, tech, engineering, design and other firms attracted to Central Eastside for its edgy, creative, and urban vibe."

With its 24.9 percent jump in average rental rates year-to-year, the Central Eastside submarket is reflective of Portland's growth and will certainly be interesting to take a closer look at in the upcoming year. With several companies ranging from biotech to medical to tech now choosing Portland and its hot submarkets for cheaper alternatives to other markets, the demand for flexible and collaborative office space has only just started to kick in. ■