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OFFICE MARKET ANALYSIS

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With the conclusion of the second quarter of 2010 the office market continues to struggle under the weight of the current recession. Overall, vacancy rates have increased and rents continue to decline. Current office vacancy, according to the major local brokerage firms, ranges from 15.5 percent to 19.5 percent within the metropolitan area. Recent data reveals the office market is showing signs of bottoming out, but the pace of improvement has slowed from the previous quarter and increasing vacancy, primarily within the suburbs, continues to be concern.

Recently, the U.S. Commerce Department issued revised gross domestic product (GDP) numbers indicating the recession was worse than previously thought over the last three years. The Wall Street Journal recently reported:[12]

> [T]he overall depth of the latest recession surpassed that of any other downturn since the late 1940s. GDP fell by 4.1 percent from the fourth quarter of 2007, when the recession officially began, to the second quarter of 2009, when many economists believe it ended . . . the previous estimate for peak-to-trough decline was 3.7 percent.

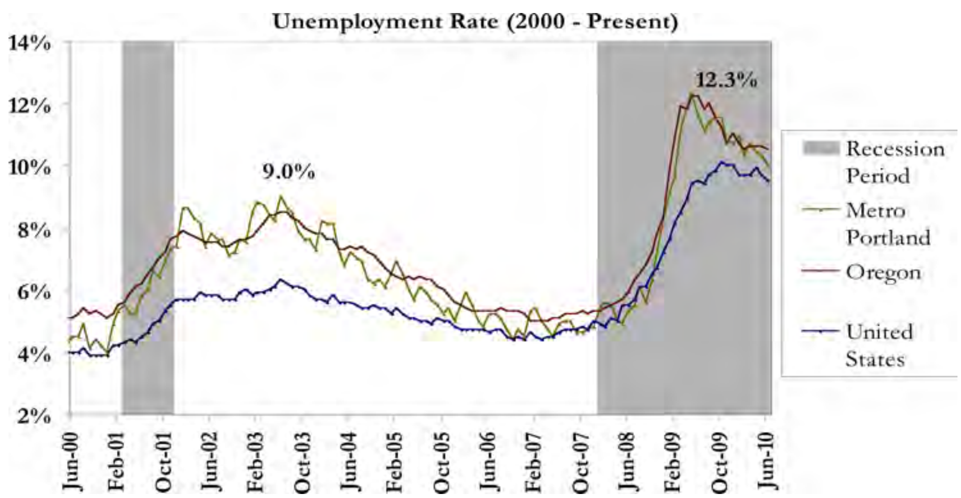
Despite the gloomy GDP report, there were some positive signs, namely the increase in corporate profits. However, it appears that a good portion of the increase in corporate profits can be attributed to belt tightening and not large increases in revenue. In general, higher

[12] Murray, Sara, "Revisions Show Slower Recovery, Deeper Recession," *Wall Street Journal*, August 1, 2010.

corporate earnings have not translated into larger employment gains and U.S. consumers, who account for 70 percent of GDP spending, continue to remain frugal.

The national unemployment rate stood at 9.5 percent as of June. In the metropolitan Portland area, the June unemployment rate was 10.0 percent. Although the local unemployment rate has been at 10 percent or higher since the first quarter of 2009, the rate has dropped 70 basis points since March 2010, which is a larger than the 20 basis points drop recorded nationally over the same time period. Looking forward the Oregon Employment Department predicts that the state and the Portland area will experience slow growth for the second part of 2010. The slow growth should pick up in the next years, but pre-recession employment levels may not be reached until after 2013.

Figure 7.1

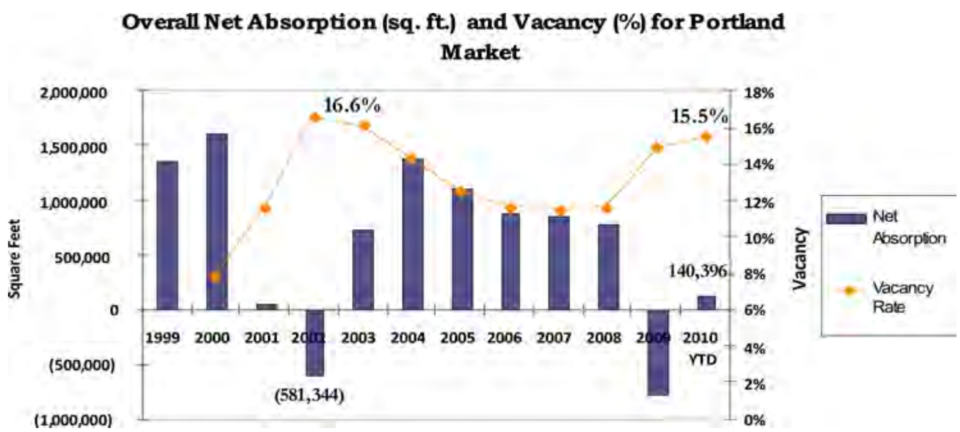


Source: Oregon Employment Department

Grubb & Ellis Co. reports the lowest overall vacancy in the metropolitan market in comparison to figures reported by CB Richard Ellis, Cushman Wakefield and NAI Norris, Beggs & Simpson. Through the first two quarters of 2010 absorption is positive, with most of this attributed to the General Services Administration (GSA) leasing over 250,000 square feet at the recently completed First & Main tower downtown. This leasing activity gives the CBD a net absorption of 283,501 square feet and helps offset the negative 143,105 square feet of space that came back on the market in the suburbs.

Although vacancy has steadily increased in both downtown and the suburbs, knowledgeable brokers feel that vacancy will begin to stabilize due to the lack of new construction. At this time there is only 84,000 square feet of space under construction in the greater Portland area that is not planned for owner-occupancy. Furthermore, the fate of the stalled 330,000 square feet Park Avenue West tower in downtown appears in jeopardy with the PDC's recent decision to stay at their current location and news that the Stoel Rives Law Firm, the largest pre-leased tenant, has exercised an option to renew their Standard Insurance Building lease. As shown in the graph below, construction permits within Portland increased from the low point reached last quarter. However, construction activity is well below the levels seen in 2008 and the first part of 2009.

Figure 7.2



Source: Grubb & Ellis Quarterly Report, Second Quarter 2010

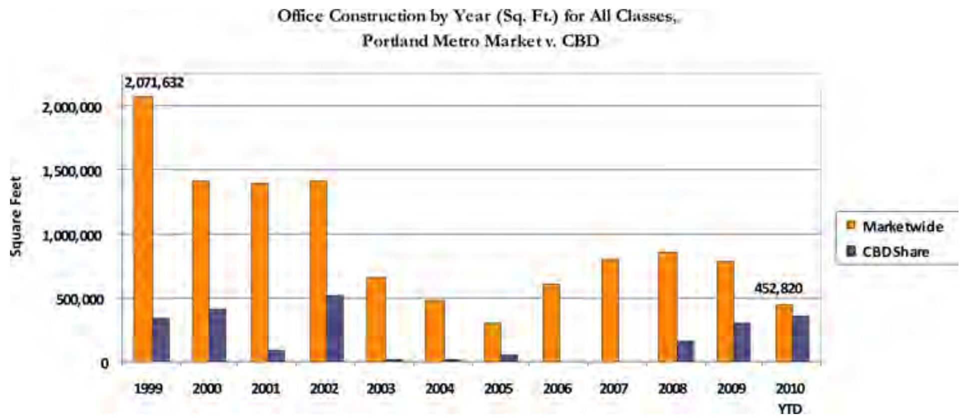
As the recession has dragged on, the suburban office market has struggled significantly more than the downtown office market. Figures provided by the four major brokerage firms featured in this report show the overall downtown central business district vacancy ranging between 10.7 percent and 12.7 percent, with vacancy in the suburbs ranging from 19.5 percent to 23.9 percent. Several brokers report that former suburban tenants have taken advantage of lowered asking rates to relocate downtown. An example is the pending move by Northwest Evaluation Association from Kruse Way to the recently vacated 124,464 square feet Port of Portland building at 121 N.W. Everett Street. The chart below details vacancy rates within the CBD and the suburban Kruse Way, I-5 South and Sunset Corridor submarkets as reported by NAI Norris Beggs & Simpson since the start of the recession. Despite delivering over 400,000 square feet since the fourth quarter of 2007, the CBD has seen only a modest increase in the vacancy rate. Conversely, Kruse Way and the I-5 South submarkets started the recession with a vacancy rate similar to the CBD, but have since increased to 29.4 percent and 28.1 percent, respectively.

The increase in vacancy within Kruse Way has been startling as this submarket, with over 2.3 million rentable square feet, has traditionally been considered the premier location in the suburbs. Those familiar with the market report that it was initially affected by the loss of several financial service and mortgage firms at the beginning of the recession and has since struggled to retain tenants. The submarket also saw the ill-timed delivery of the 108,000 square feet Kruse Oaks III building in the Spring of 2009. In the future Kruse Way is expected to return to a more stabilized occupancy since the location within Lake Oswego with quick access to the I-5 and 217 freeways are significant amenities.

In general, competition for tenants in the suburbs, especially in submarkets with vacancy above 15 percent, is extremely competitive. Joe Kappler, a broker at Macadam Forbes, reports that recent leasing deals have been very much in the favor of tenants. Concessions such as one month free rent for every year of the lease are generally standard for quality

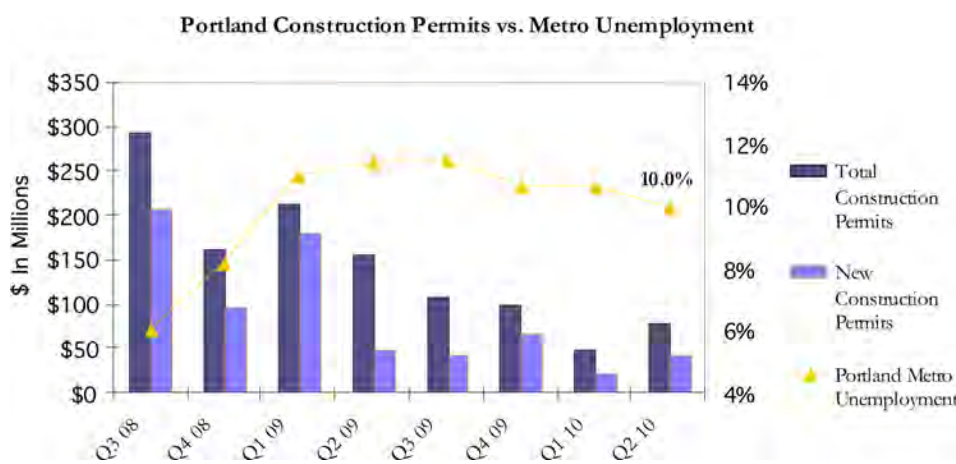
OFFICE Q2-10	CB Richard Ellis	Cushman & Wakefield	Grubb & Ellis	Norris, Beggs & Simpson	Median
Market-Wide Vacancy	**16.1%**	**18.0%**	**15.5%**	**19.5%**	**17.1%**
Previous Quarter	-	17.7%	15.3%	18.0%	**17.7%**
2nd Quarter 2009	14.0%	14.9%	14.0%	16.0%	**14.5%**
2nd Quarter 2008	10.5%	11.4%	11.3%	13.2%	**11.4%**
CBD and Downtown Vacancy	**11.0%**	**11.9%**	**10.7%**	**12.7%**	**11.5%**
Previous Quarter	-	12.8%	10.4%	12.0%	**12.0%**
2nd Quarter 2009	8.9%	10.9%	8.5%	10.3%	**9.6%**
2nd Quarter 2008	7.8%	9.1%	7.8%	9.8%	**8.5%**
CBD Class A Vacancy	**N/A**	**N/A**	**9.2%**	**8.7%**	**9.0%**
Previous Quarter	-	-	8.0%	7.9%	**8.0%**
2nd Quarter 2009	5.4%	8.6%	6.1%	6.3%	**6.2%**
2nd Quarter 2008	5.3%	6.2%	4.9%	6.5%	**5.8%**
CBD Class A Asking Rents	**N/A**	**$26.34**	**$27.03**	**N/A**	**$26.69**
Previous Quarter	N/A	$25.51	$25.88	N/A	**$25.70**
2nd Quarter 2009	$27.02	$26.20	$24.68	N/A	**$26.20**
2nd Quarter 2008	$27.04	$26.49	$25.94	N/A	**$26.49**
Suburban Vacancy	**21.5%**	**21.1%**	**19.5%**	**23.9%**	**21.3%**
Previous Quarter	N/A	22.4%	18.9%	21.9%	**21.9%**
2nd Quarter 2009	19.3%	18.7%	18.1%	19.1%	**18.9%**
2nd Quarter 2008	13.0%	13.5%	13.4%	15.0%	**13.5%**
Suburban Class A Vacancy	**N/A**	**N/A**	**22.1%**	**27.1%**	**24.6%**
Previous Quarter	N/A	-	24.4%	24.2%	**24.3%**
2nd Quarter 2009	N/A	20.3%	19.5%	N/A	**19.9%**
2nd Quarter 2008	N/A	14.0%	14.9%	N/A	**14.5%**
Suburban Class A Asking Rents	**N/A**	**$23.09**	**$23.65**	**N/A**	**$23.37**
Previous Quarter	N/A	$23.32	$22.98	N/A	**$23.15**
2nd Quarter 2009	N/A	$23.59	$23.20	N/A	**$23.40**
2nd Quarter 2008	N/A	$24.47	$24.35	N/A	**$24.41**

Figure 7.3



Source: Grubb & Ellis Quarterly Report, Second Quarter 2010

Figure 7.4



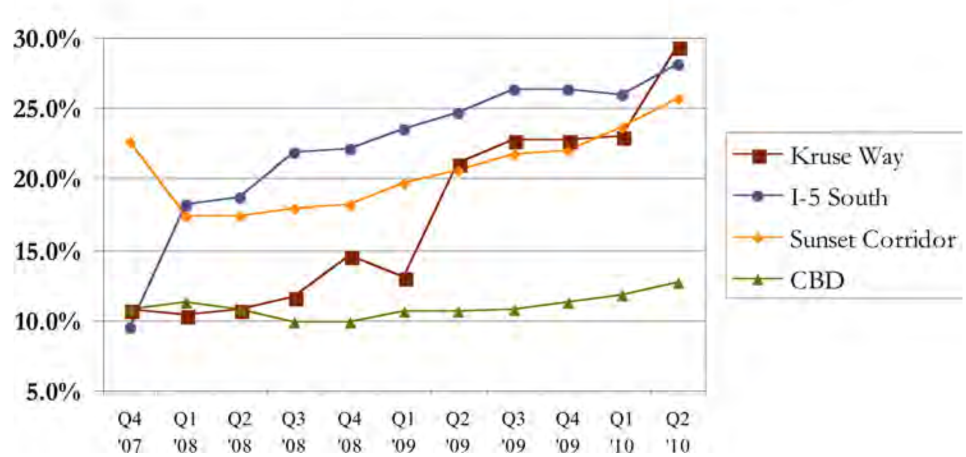
Source: Portland Bureau of Development Services and Oregon Department of Employment tenants. Although there are challenges in the current market, Kappler senses that rents have started to bottom out in some suburban submarkets and that landlords seem determined to hold asking rents at a certain level, even if that calls for offering free rent or generous tenant improvement allowances. Kappler adds that there are great opportunities for owner/user purchases, but there is a lack of good quality single-tenant buildings for sale.

Due to tougher lending standards as well as a challenging business environment many tenants are unable to access capital for tenant improvements. While TI's are always a significant negotiating point, they are more often than not deal breakers. Landlords that can offer space that requires minimal tenant improvements have an advantage over the competition. For newer buildings in cold shell condition, unless a significant tenant improvement budget was initially written into the proforma, these buildings will face strong competition from existing properties.

These same conditions are also present in the downtown market, although the lower vacancy rate allows some landlords to offer less concessions than those offered in the suburbs. Kevin Kaufman, a broker specializing in downtown office properties for CB Richard Ellis, points out that activity over the last few quarters has been dominated by leasing with very few sales. A good portion of activity as of late has consisted of larger firms either renewing or downsizing as well as those looking to upgrade to a better location or a nicer space for roughly the same rent. Kaufman warns, however, that many tenants falsely perceive that all property owners have fallen on hard times and will be willing to offer generous terms in favor of the tenant. The situation varies between properties and location, where owners may or may not agree to terms offered by the tenant. Although vacancy in the CBD has crept up over the past 18 months, Kaufman points out that Portland currently has one of the better performing downtown office markets in the nation in terms of vacancy.

Figure 7.5

Office Vacancy: CBD vs. Select Suburban Submarkets



Source: NAI Norris, Beggs & Simpson

Major Lease Transactions Q2 2010

Lessee	Property	Submarket	Size (SF)
Oregon Institute of Technology	In-Focus Building	Wilsonville	131,793
Freightliner (renewal)	Montgomery Park	Northwest	92,307
Columbia Sportswear	Cornell Oaks	Sunset Corr.	24,478
State Farm Mutual Auto. Ins.	Fanno Creek Place	Tigard	23,172
Northwest Energy Efficiency	Commonwealth Bldg.	CBD	20,003
Conservation Services Group	The Lincoln Bldg.	CBD	17,400

Source: NAI Norris, Beggs & Simpson, Grubb & Ellis Office Reports - Second Quarter 2010

Looking forward, the local Grubb & Ellis Co. office indicates that the CBD will continue to improve over the next few quarters, while tenants in the suburbs will see reduced rents and many space options. Most economists point out that sustained improvement in the office market will only take hold when employment returns to normalized levels. ■

Greg LeBlanc is a Certificate of Real Estate Development Graduate Student and Portland State University and is a Regional Multiple List Service (RMLS) fellow.