09

COMMERCIAL MARKET

Office Market Analysis

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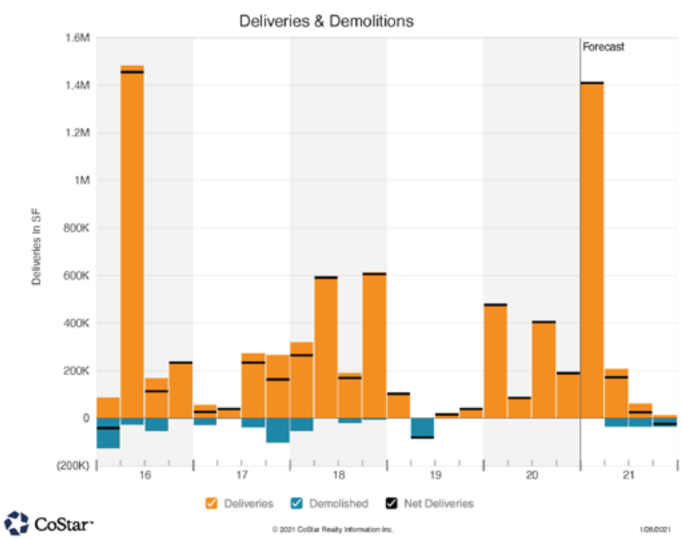
https://bora.co/bora-announces-new-office-targeting-net-zero/

INTRO

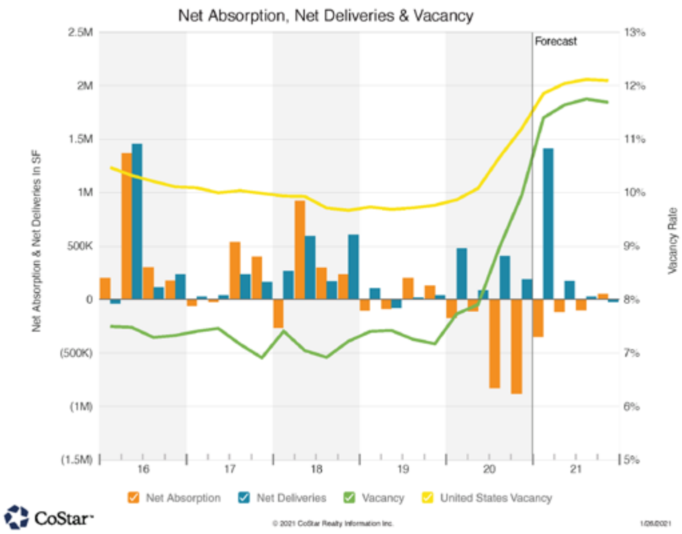
Portland's office market has been disrupted and transformed over the past year due to several external factors. Prior to the Coronavirus pandemic, Portland was widely viewed as an increasingly attractive market for capital investment. In 2017, the Urban Land Institute ranked Portland #3 in its "Emerging Trends in Real Estate" report. However, in the latest 2021 report, Portland has fallen to #66[1]. While this can be partly attributed to the effects of COVID-19 and the nation-wide trend of suburbanization, a larger influence on this decline of investment interest is due to the negative representation of Portland being portrayed in the media due to civil unrest. While the areas affected by social clashes around the city are relatively small, the media has cast the city in a light of disorder. To reverse this trend of reduced investor interest and confidence, Portland will need to take action and repair the "reputational damage" (Mike Wilkerson, ECONorthwest).

DELIVERIES

Due to surplus supply and diminishing demand over the past year, there was a sharp drop in speculative market deliveries throughout 2020. In the fourth quarter of 2020, the Volta creative office space in the central eastside was the only new delivery in the Portland metropolitan area. Developed by Killian Pacific, Volta is a 30,000 square foot electrical warehouse that has been reimagined and converted into a sustainably designed Class A creative workspace. Bora Architecture & Interiors, the primary architect that designed the new space, will be occupying approximately half of the new building, while the remaining half is still available for lease[2]. Volta, as part of a network of five new creative workspace properties known as the Electric Blocks, is part of the transformation of the central eastside from its industrial roots to a cluster of creative office spaces designed to serve the "needs of visionaries, innovators, and free-thinkers"[3].



Significant upcoming deliveries include the 1.0 million square foot addition at the Nike Campus in Beaverton and the 180,000 square foot addition at the Adidas headquarters in the Overlook Neighborhood, marking the highest volume of new product in four years.



ABSORPTION

As a continuation of the same trend we have observed over the past year, the fourth quarter of 2020 has once again set a record low for net absorption at -886,674 square feet[4]. Originally, stay-at-home orders in response to COVID-19 led to many employees having no choice but to work from home. However, as social distancing restrictions have been relaxed, companies are realizing it may not be necessary to lease designated workspaces in order to successfully run their businesses. This shift to telework-oriented companies is expected to be sustained at some level, even after the threat of COVID-19 has been removed.

Again, the Central Business District (CBD) continues to be the hardest hit submarket in the Portland Metropolitan area, accounting for approximately half of the overall negative absorption in the fourth quarter. Tenants that were once leasing the highest value office properties in the city are now vacating their CBD properties, and turning to subleasing in an attempt to recover a portion of their investments until their leases expire. The effects of this shift will continue to play out as more long-term leases come to an end, and property owners struggle to stand out and attract tenants. Nike, the largest private company in Oregon, is vacating approximately 280,000 square feet of office space being leased in the Sunset Corridor[5]. While this was a planned move due to the new delivery of approximately 1.0 million square feet at Nike's Headquarters, the rapidly declining demand for office space means it is very unlikely that this space will be backfilled any time soon. This marks a significant shift from earlier in the year when the Sunset Corridor was actually growing in popularity and experienced positive absorption.

VACANCY

Historically low net absorption and declining demand for office space has led to a steady increase in vacancy rates over the past year. In the fourth quarter of 2020, vacancy rates topped out at approximately 13.5% for the Portland metro area office market[6]. This rate is 1% higher than the third quarter, and the highest vacancy rate in over ten years. This is due to the large increase in office supply (particularly Class A office space) and a sharp decline in demand, particularly around the CBD. While Portland's vacancy rate is still below the national average, the gap has closed significantly over the past year. Portland's office market is increasingly affected by the negative reputation regarding public safety in the city's urban center. Until Portland can repair its reputation and overcome limitations brought on by the pandemic, our vacancy rates will continue to drop to national levels as businesses opt for other urban areas.

LEASING

Stay-at-home orders and social distancing requirements brought on by COVID-19 have had a drastic effect on businesses all around Portland. Depending on what services are being provided, some businesses have struggled more than others in adapting to a teleworking environment. For those that have been enduring, the question remains whether or not they will return to traditional working spaces once the immediate risks of COVID-19 have subsided.

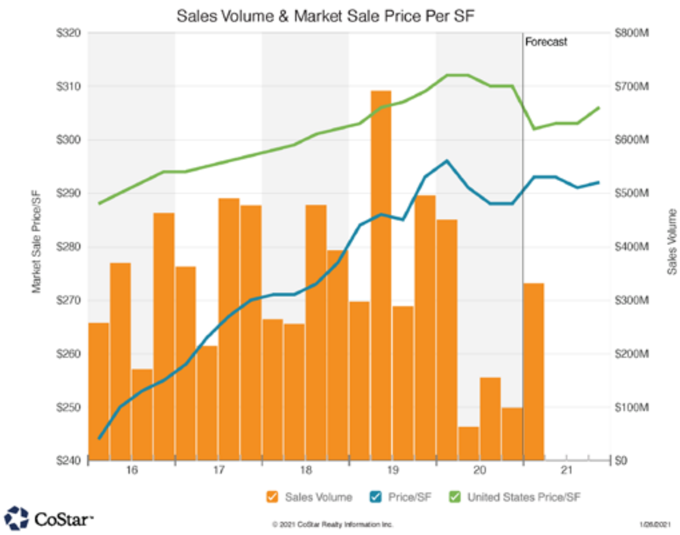
One major sign of the distress in the Portland office market is the sharp increase in sublease activity over the past year. Over the past year, the amount of reported sublease availability has grown substantially "with tenants adding 915,000 square feet"5 of space to the market. The reduced rates being offered for subleased space is causing stressed on market rate rents, with sublease asking rents approximately 16% lower than direct asking rents5. If this trend continues, it is expected that direct asking rents will need to decrease to become more competitive with the significant amount of sublease properties available.

With many companies abandoning leases or subleasing their properties, Microsoft stands out as an exception to the rule. With the biggest lease signing of the quarter, Microsoft is taking over approximately 85,000 square feet of office space in the Ambercreek building in the Sunset Corridor submarket6. This is a key example of the types of companies that are thriving during the pandemic. Due to its relatively low property costs and growing employee pools to draw from, Portland has become a lucrative market for tech companies on the west coast.

While the increase in vacancies is market-wide, there is one sector that is increasing its market presence:

bioscience. The Oregon Translational Research and Development Institute (OTRADI) and the Oregon Bioscience Association have been instrumental in growing the presence of research-driven businesses in the Portland metro area. During the pandemic when most companies are decreasing office space or stagnating at best, bioscience companies are doing the opposite. Twist Bioscience, a synthetic biology and genomics company, recently pre-leased a 110,000 square-foot office and laboratory space in Wilsonville, Oregon[7].

AbSci, another biotechnology-focused company, recently leased approximately 61,000 square feet of office space in the Vancouver submarket[8]. This represents the beginning of a wave of bioscience-focused development in the Portland region.



SALES

For the most part, capital investment in real estate has been essentially nonexistent since the onset of the pandemic. However, that all changed in Q4 with the monumental sale of Pittock Block, a historical mixed-use office space, retail, and data center development in downtown Portland. At a staggering price of $326 million, Pittock Block "was the single biggest asset sale in the state for more than five years"[9]. Although the Pittock Block building has always accommodated office space, it also originally contained a steam power plant. In the modern day, it acts as one of only two primary internet exchanges in the Pacific Northwest. The interest in this location as a strategic location for a data center and telecommunication hub is a testament to Portland's designation as a top prospect for the technology industry. While technically an office sale, this transaction reflects demand for data centers as opposed to office space.

Aside from this outlier, the capital investment market is expected to remain relatively stagnant until investors have a better understanding of the emerging trends of the office market in a post-COVID world. Sellers that are looking to get out of the market are being forced to do so at relatively lower rates. After steadily climbing to $305 per square foot in the first quarter of 2020, the highest value ever, the average market sale price per square foot has dropped by more than 2% in a single year4. This reduction in value is ultimately driving up the market cap rate, which is now approximately

6.3%. These lower property values will set the precedent for a starting price point when the interest in capital investment bounces back.

CONCLUSION

The Coronavirus pandemic has completely upended the Portland metro area's office market over the past year. We've now experienced a full year of decreased capital investment, a sharp decline in demand, and historically low net absorption. These effects are proving to be even more detrimental to the central business district submarket, where the additional stresses of high-density design and damages due to unresolved social unrest are also factors. As a result, the vast majority of leasing activity observed over the past year has been in the suburban submarkets, indicative of an outward migration away from the urban center. We expect to see this trend continue until social distancing is no longer necessary, and the sense of public safety has been restored.

The office market is likely to continue being fraught with uncertainty until there has been widespread vaccine distribution. Even then, it is likely that many companies, particularly small to medium sized businesses, will continue to rely to an increasing extent on teleworking as a permanent means of operations. Developers and designers will have to work hard to produce creative office spaces that provide more benefits than the traditional office spaces of the past. With the surplus supply currently on the market, and the historical amount of discounted sublease space available, the leasing market will be extremely competitive once conditions change, and demand begins to bounce back. There is no doubt that 2021 will be a challenging period for the Portland metro area's office market, and the ability to adapt to new market circumstances will be the key to success.

RESOURCES

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