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The Impact of New Market-Rate Housing on Neighborhood Affordability

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In recent years, and in response to the mounting affordability crisis, a vocal contingent of progressive housing advocates, policymakers, and community members has emerged in opposition to new market rate housing projects. These advocates argue that unless projects contribute meaningfully to the affordable housing supply, new construction projects ultimately exacerbate rising housing costs, thereby accelerating gentrification and resident displacement. At the core of this perspective is the assumption that new construction attracts wealthy households, signals to landlords to increase rents, and brings in new community amenities.[1] Market responses like these outweigh any benefit incurred from an increase in market-rate supply. The emergence of this contingent is not politically insignificant and has helped successfully block proposed development projects. In a fascinating turn of events, it seems affordable housing and tenant advocates have both aligned their interests with anti-development Not-In-My-Backyard (NIMBY) organizations and pit themselves against the Yes-In-My-Backyard (YIMBY) movement.[2]

This analysis responds to the well-intentioned but empirically undefended position held by this contingent. By drawing upon recent scholarship describing the impact of housing production on rental rates within a neighborhood, this article shows that, in general, the supply effect dominates the demand effect. In other words, new construction is usually tied to a decline in housing costs at the local level.

These findings fill a critical gap in research on housing production outcomes. While there is significant evidence showing that increased housing supply reduces pricing across a region, much less is understood about effects at the neighborhood scale. The results from recent studies deepen the empirical understanding of how new construction impacts local housing costs.

Moreover, these outcomes hold real policy implications. Policymakers can and should utilize new housing production in order to grapple with the affordability crisis rather than shackling developers with new burdensome regulations. Having said that, policymakers should also recognize that new production will not benefit all residents, particularly very low-income households, and thus must continue to bolster affordable housing programs and subsidies.
The paper will be divided into four sections. The first one identifies and reviews key concepts that support the analysis' central argument, including the supply and demand effects, gentrification, displacement, and filtering. The second section examines how housing production increases affordability

1 Vicki Been, Ingrid Gould Ellen, and Katherine O'Regan, "Supply Skepticism: Housing Supply and Affordability," Housing Policy Debate (2019): 6.

2 Perhaps the best example of this dynamic occurred during the debates around Senator Scott Weiner's SB50, which proposed upzoning single-family parcels around transit and job centers. Laura Bliss describes how low-income community members and housing advocates connected the bill to rampant gentrification in high cost Californian cities. Laura Bliss, "The Political Battle Over California's Suburban Dream," CityLab, published April 5, 2019, https://www.bloomberg.com/news/ articles/2019-04-05/the-suburbs-that-fear-california-s-housing-bill. Another illustrative example comes from Pennington's work. She describes an article from 48 Hills that celebrates a proposed market-rate project's conversion into affordable, stating that "market-rate housing . . . would drive up prices [for] everyone else in the area and lead to massive displacement." Kate Pennington, "Does Building New Housing Cause Displacement?: The Supply and Demand Effects of Construction in San Francisco," (August 9, 2021): 2.

and reduces housing costs across regional and/or metropolitan markets. The third section examines the paper's central question: how does new construction affect housing affordability at the neighborhood level? The fourth and final section considers what the results of the study may mean for policymakers and considers what those findings may mean for Portland, Oregon.

SECTION I: HOUSING TERMS, CONCEPTS, AND CONTEXT

a. Affordable Housing Crisis in America

Even prior to the COVID-19 pandemic, which exacerbated existing trends in housing unaffordability, the share of rent burdened households in the U.S. was growing.[3] Of particular concern, the number of cost-burdened middle-income households has steadily risen. In 2018, 55.7% of households earning $45,000-$74,999 experienced a rent burden and 27% of homeowners earning $45,000-$74,999 were cost burdened. This reflects increases of 5.4% and 4.3% respectively since 2011.[4] Inextricably tied to these metrics are the decline in low-cost rentals across the country. Between 2012 and 2017, the number of units renting for over $1,000 increased by 5 million, while the number of units renting for $600 or less decreased by 3.1 million. In all 50 states and Washington, DC, the number of low cost rentals fell, reducing their overall share of the national rental stock from 33% in 2012 down to 25% in 2017.[5] The realities and impact of these market dynamics are the following: in 2019, a full-time worker earning the average renter's wage could afford a two-bedroom apartment price at the HUD-designated Fair Market Rent (FMR) in only 10% of counties across the U.S. and one-bedrooms in only 40%.[6]

The severity and breadth of the housing crisis requires empirically supported policy solutions. Expanding affordable housing production for low and very-low households is a proven, but insufficient strategy. Increasing the housing supply—hotly contested politically and hampered by regulatory regimes—is another tool and the focus of this analysis.

b. The Supply and Demand Effects of Housing Production

The supply effect of market-rate production promotes housing affordability by slowing rent escalation or reducing rent prices. In a standard housing model, increased supply shifts the supply curve right, corresponding to increased demand at a lower equilibrium price. Thus, increased availability relieves pressure on the existing housing stock. The demand effect (also

3 Note that this study looks specifically at renter households. The share of cost-burdened homeowners is also rising. Shwartz notes that 24% of homeowners earning between 80% and 120% AMI experienced moderate or severe cost burdens in 2017, up significantly from 2000. See: Alex Shwartz, Housing Policy in the United States, 4th edition (New York: Routledge, 2021): 31.

4 "America's Rental Housing 2020," A Report by the Joint Center for Housing Studies of Harvard University (2020): 4.

5 "America's Rental Housing 2020," 2.

6 Shwartz, Housing Policy in the United States, 34. FMR rates are used to determine payment standards for affordable housing programs. They are calculated based upon the 40th percentile of gross rents for standard quality units within a metropolitan area. For more on this see: "Fair Market Rents (40th Percentile Rents)," Department of Housing and Urban Development, accessed February 22, 2022, https://www.huduser.gov/portal/datasets/fmr.html.

referred to as the "amenity effect") of market-rate production decreases housing affordability by increasing rental rates. New construction, according to the logic of this effect, drives in-migration from high-income residents living in other city areas, attracts new community amenities like restaurants and coffee shops, and thus increases demand for the surrounding neighborhood. The demand effect is strongly correlated with gentrification.[7]

As discussed in more depth in section III, determining the relative impacts of these two empirical processes is challenging. Developers do not invest in markets at random, but rather target those that will generate the highest rate of return and that are experiencing significant appreciation.[8] Therefore, the supply and demand effects occur concurrently, making it "difficult to disentangle the effect of increased local supply from shifting neighborhood characteristics before and after new construction is completed."[9] Nonetheless, researchers have identified new, creative solutions to control for this complication.

c. Filtering

Filtering describes a process in which affordable homes are made available to low-income households. Wealthy households can afford and demand higher quality housing units, which, in general, are provided through new construction or rehabilitation projects.[10] Over time, a household's unit ages and declines in quality. At that point, the household may elect to move into a different newly constructed unit, making their previous dwelling available to middle- or low-income households. New construction projects, including luxury developments, thus play a role in relieving pressure on housing costs across the income spectrum. Been et al. reports that, between 2003 and 2013, filtering was the largest contributor to additions to low-cost rental stock.[11] Because it promotes market-rate affordability over time, filtering is associated with the supply effect.

d. Gentrification and Displacement

Gentrification is characterized by higher-income households moving into a neighborhood currently housing relatively less affluent households. Rising income and levels of education are two key household characteristics indicative of a gentrifying neighborhood. In response to this shift in resident demographics, new amenities appear in the area in the form of

7 These effects are summarized in the UCLA report on the local impact of new housing construction. Shane Phillips, Michael Manville, and Michael Lens. "Research Roundup: The Effect of Market-Rate Development on Neighborhood Rents," A UCLA Report (February 17, 2021): 4. It's also important to note that researchers monitor the possibilities of new construction creating a dis-amenity effect as a result of the added population in a neighborhood. A plausible example would be congestion: traffic increases as new residents are added to a community, rendering it less desirable and reducing rents. Therefore, a dis-amenity effect and supply effect will both reduce rents in the area. Distinguishing between them is important when attempting to weigh the relative impact of these market processes.

8 Each of the articles here articulates this challenge: Xiodi Li, "Do New Housing Units in Your Backyard Raise Your Rents," in Essays on Urban Real Estate (PhD diss, New York University, May 2020), 4-65; Pennington, "Does Building New Housing Cause Displacement?," 1-57; and Anthony Damiano and Chris Frenier, "Build Baby Build? Housing Submarkets and the Effects of New Construction on Existing Rents," a Center for Urban and Regional Affairs Working Paper (October 16, 2020): 1-47.

9 Damiano and Frenier, "Build Baby Build?," 2.

10 Ibid., 6.

11 Been, Ellen, and O'Regan, "Supply Skepticism," 1-22.

restaurants, retail, and other attractive businesses, which drives increased demand for the neighborhood and housing cost escalation. This process of changing community characteristics, amenities, and aesthetics explains why gentrification is strongly linked to the demand effect.

Displacement refers to push migration as households move from one neighborhood to another, typically lower-income and with less economic opportunity.[12] While these processes may happen simultaneously, gentrification and displacement can occur independent of one another.[13] For example, displacement may occur when one minority community moves into a neighborhood predominated by another minority community. Similarly, Professor Suleiman Osman of George Washington University observed that Brooklyn renters facing significant pressure to leave gentrifying neighborhoods were displaced at comparable rates to non-gentrifying blocks with high vacancy rates and abandonment.[14]

SECTION II: HOUSING PRODUCTION AND REGIONAL RENTAL RATES

In contrast to those housing advocates who oppose new housing construction as a viable solution to managing the affordability crisis, urban economists and researchers have found that, at the regional level, building more housing slows pricing escalation or reduces housing costs. Alan Durning of Sightline Institute, for instance, argues that cities not only can build their way out of the affordability crisis, but have been doing so for decades.[15] Durning examined cities across the globe that have experienced significant population growth while managing housing costs. He offers the example of Houston, the fourth largest city in the United States and among the fastest growing. When adjusted for inflation, Houston's housing costs in 2018 were less than housing costs in 1980 and the city has accommodated over four million more residents. While it may be heavily automobile-dependent and sprawling, Houston has achieved "extraordinary affordability" by easing regulatory and bureaucratic barriers to new construction.[16] Tokyo, the world's largest city at just under 40 million residents, provides another illustrative example. Compared to Seattle's median home price at $748,000, a close-in home in Tokyo sells for $300,000. With flexible zoning rules, few legal obstructions, and minimal red tape, Tokyo has established a uniquely construction-friendly culture. In the decade before 2018, rent in the metropolis fell as housing construction outpaced demand.[17]

12 Pennington, ""Does Building New Housing Cause Displacement?," 2.

13 In her article, Jerusalem Demsas notes that the evidence tying gentrification to displacement is a "mixed bag," noting that some researchers have found gradual residential turnover where others have identified rapid displacement and others none at all. Jerusalem Demsas, "What We Talk About When We Talk About Gentrification," Vox, published September 15, 2021, https://www.vox.com/22629826/gentrification-definition-housing-racism-segregation-cities.

14 Here I'm drawing upon Demsas' discussion in: Demsas, "What We Talk About When We Talk About Gentrification."

15 Alan Durning, "Yes, You Can Build Your Way To Affordable Housing," Sightline Institute, published September 21, 2017, https://www.sightline.org/2017/09/21/yes-you-can-build-your-way-to-affordable-housing/?gclid=Cj0KC QiAr5iQBhCsARIsAPcwRONr-Wyi0IGGUzX3W10snzQ_ola5mE0SVmcQ9lYsahWGHsq4sLwXz8rkaAr7BEALw_wcB.

16 Durning, "Yes, You Can Build Your Way To Affordable Housing."

17 Ibid.

From Chicago to Montreal, Vienna, and Singapore, Durning found that housing construction reduced rents across metropolitan areas: "Building plenty of housing is not just one way to affordability, it is the only way—the foundation on which other affordability solutions, measures against displacement, and programs for inclusion rest."[18]

Rethinking Federal Housing Policy by Edward Glaeser and Joseph Gyourko offers another authoritative work documenting how a lack of housing production deepens regional unaffordability.[19] Glaeser and Gyourko argue that the country's housing markets suffer from two affordability challenges: the first is around delivering adequate subsidized housing units to those living in deep poverty and the second is the ballooning cost of middle-class housing in coastal markets. While both challenges require specific solutions, they ultimately write that "true affordability is more likely to come from improving supply than subsidizing demand."[20] Improving supply, however, is restricted by onerous land use restrictions, especially in high-cost markets.

There is a direct correlation between housing cost and strict land-use controls. For instance, they reference a nationwide survey on regulatory conditions showing that areas with the most restrictive land-use policies saw housing prices an average of $130,000 more than locales with average land-use regimes.[21] These local policies vary widely, but some of the most impactful are limitations on the number or size of units allowable on a parcel of land. In the most extreme examples, a web of policies overlaps to virtually freeze housing supply despite growing demand and soaring prices. For Gyourko and Glaeser, loosening these restrictions generates development opportunities, which grows the supply and brings down pricing. Simply put, when "a locality builds, it makes housing more affordable for everyone."[22]

Been, Ellen, and O'Regan's article on "Supply Skepticism" directly addresses anti-development housing advocates and reaches the same conclusions as Durning, Glaeser, and Gyourko.[23] The authors identify four assumptions undergirding the belief that new construction projects exacerbate housing unaffordability. These assumptions include: (1) that housing is such a constrained good that market rate housing comes at a direct expense of affordable housing; (2) that filtering does little for affordability challenges at the bottom of the housing market; (3) that housing construction drives 'induced demand'; and (4) that spillover effects like gentrification and displacement will occur in the immediate neighborhood seeing new construction. The authors go on to debunk each of these assumptions, showing that housing does respond to the rules of supply and demand and highlight that filtering is a quantitatively supported phenomenon. They make the good point that skeptics draw anecdotal evidence from rising rents in areas with new

18 Vienna and Singapore offer slightly different case studies because they have achieved affordable rents through a long history of unparalleled public-sector involvement.

19 Edward Glaeser and Joseph Gyourko, Rethinking Federal Housing Policy: How to Make Housing Plentiful and Affordable (Washington, D.C.: AEI Press, 2008).

20 Glaeser and Gyourko, Rethinking Federal Housing Policy, 4.

21 Ibid., 9.

22 Ibid.

23 Been, Ellen, and O'Regan, "Supply Skepticism," 1-22.

construction; what they don't see, however, is the greater pricing increases that would have resulted had there been less construction.[24] Ultimately, the authors state unequivocally that "the preponderance of evidence suggests . . . new construction will moderate price increases and therefore make housing more affordable to low and moderate income families."[25]

Eric Cress, a principal of Portland's Urban Development + Partners (UD+P), discussed a number of these issues over a brief call. To contest the notion that development somehow deepens unaffordability across a market, Eric offered two sets of provocative thought experiments. First, what would happen if you destroyed all the newly developed housing in a community? If development was truly the driver of housing unaffordability, then undoing that work would, under this perverse logic, somehow make a market more affordable. Second, how would housing costs respond to a market that was oversupplied with housing? Would costs come down or increase? His point is a good one and the simplicity of the scenarios works to their advantage. These questions strip away the complexities of local housing politics to show that, at its core, housing development adheres to the laws of supply and demand; the greater the supply, the lower the cost.

If researchers and practitioners agree that new construction supports regional or broader-market housing affordability, there is much less of a consensus around how new construction affects affordability for a neighborhood. What happens to the immediate vicinity when a new market-rate project is built? Do nearby landlords increase rents in anticipation of new demand? Or does the increase in supply suppress rents? Until recently, there were few studies on this subject.

SECTION III: HOUSING PRODUCTION AND NEIGHBORHOOD RENTAL RATES

This section does not examine one particular housing submarket; instead, it synthesizes recent scholarship attempting to quantify the relative impact of the demand and supply effects for new market-rate projects at the neighborhood level.[26] Overall, studies generally agree that the supply effect dominates the demand effect, thereby reducing housing costs nearby.[27] Multiple studies also found that new construction projects influence rents differently depending on the neighboring property's housing quality—buildings charging higher rents and thus targeting higher-income households are more likely to see declines in rents than low-income properties.

24 *Ibid., 4.*

25 *Ibid., 3.*

26 *Pennington, "Does Building New Housing Cause Displacement?"; Li, "Do New Housing Units in Your Backyard Raise Your Rents,"; Asquith, Mast, and Reed, "Supply Shock Versus Demand Shock;" and Damiano and Frenier, "Build Baby Build?"; and Rebecca Diamond and Tim McQuade, "Who Wants Affordable Housing in Their Backyard? An Equilibrium Analysis of Low-Income Property Development," Journal of Political Economic 127, no. 3 (April 9, 2019): 1063-1117.*

27 *For more on this subject and a larger housing production discussion, see Ezra Klein's conversation with Jenny Schuetz of the Brookings Institute. See: Ezra Klein and Jenny Schuetz (hosts), "Why Housing is So Expensive—Particularly in Blue States," The Ezra Klein Show (podcast), July 19, 2022, https://www.nytimes.com/2022/07 /19/opinion/ezra-klein-podcast-jenny-schuetz.html.*

a. Methods

Three of the studies reviewed (Li, Damiano and Frenier, and Pennington) examine a single housing market: New York City, Minneapolis, and San Francisco respectively. Asquith et al., as well as Diamond and McQuade, on the other hand, aggregate data, analyzing outcomes across multiple metropolitan areas. All studies examined parcel or building level rent data through a variety of databases, including Zillow, Craigslist, CoStar, and various public resources. Two studies, Pennington and Asquith et al., also tracked in- and out-migration patterns by evaluating address histories via Infutor Data Solutions. The advantage to examining migrations is that it sheds light on demographic change and potential displacement. Additionally, maximum radiuses around new construction projects range from 500ft (Li) to 800m (Damiano and Frenier).

b. Results

Asquith et al., who used Zillow data from 2013 to 2018, find that new buildings lower nearby rents in low-income neighborhoods. The researchers estimate a 5-7% reduction in rents, corresponding to savings of between $100-$159 per month per unit. They thus conclude that the supply effect dominates the demand effect:

> *[I]f new housing is built, many high-income households will choose this option instead of a nearby existing unit, reducing rent and out-migration pressures in the area. The new building could theoretically change local amenities or reputation by enough to instead increase demand and raise rents for nearby units, but our findings suggest this is not the case.* [28]

The authors did test for a possible dis-amenity effect from increased congestion in the greater area, which would have increased the relative impact of the supply effect, but ultimately found no evidence in support of that hypothesis. In their second round of results related to migration patterns, the researchers found that new construction decreases the average income of neighborhoods experiencing out-migration by 2%. They also found an increase in the share of in-migrants from very low-income neighborhoods by 3%. Their findings thus support the positive impacts of filtering at the local level, writing that "new buildings reduce costs in lower segments of the housing market, not just in the high-end units that are the most direct competitors of new buildings."[29]

In her study on supply and demand effects in New York City, Xiodi Li found that new high-rise construction (greater than seven stories) caused nearby high-end and mid-range rental building rents to decrease. In the area within 500ft of the high rise, rents decreased by 1.6% one year after construction completion. This corresponds to a 1% decrease in rents for every 10% of housing stock added to the supply.[30] These results indicate an alleviation of demand pressure on existing housing stock and suggest the early stages of

28 *Asquith et al., "Supply Shock Versus Demand Shock," 22.*
29 *Ibid., 3.*
30 *Li, "Do New Housing Units in Your Backyard Raise Your Rents," 29-30.*

filtering. While decreases were detected among high and middle-tier housing developments, Li did not observe significant rental decreases for housing at the low-end of the market. These results likely stem from the fact that newly constructed units offer good substitutes for existing high and middle-tier units, while lower-tier stock offers a poor substitute. By tracking restaurant and coffee shop openings near the new high-rise, Li did observe a demand or amenity effect; a year after completion, immediate neighborhoods saw a 9% increase in restaurant openings. The decreases in rent, however, demonstrate that the supply effect dominates the demand effect.[31]

In her study of San Francisco, CA, Pennington concludes that the supply effect outweighs any demand effect. On average, for buildings within 100m of new construction projects, rents fell by $28 per month. Interestingly, the supply effect impacted the market at a kilometer-wide radius, while the demand effect had a narrower radius. This dynamic suggests a more localized impact from increased amenities, while additions to supply have a broader impact. Demand effect outcomes like permitting new construction projects, residential renovations, and business turnover occurred primarily within eyeshot of the subject property.[32] Reduced eviction notices for rent-controlled units were also observed: Pennington found that the probability of receiving an eviction notice dropped by 31% for buildings within 100m of a new project. Overall, the researcher concludes that new construction may benefit incumbent tenants by "reducing rents, evictions, and the risk of moves to poorer zip codes. It also attracts wealthier newcomers and new endogenous construction, slowly gentrifying neighborhoods without displacement." [33]

Pennington's study also monitored outcomes associated with 11 new affordable housing construction projects. Because affordable housing contributes no additional units to the market-rate supply, these properties may be characterized by a slight demand effect. Pennington shows that the net impact of affordable housing is weakly positive, with insignificant pricing increases, and has no effect on displacement risk. [34]

Damiano and Frenier found mixed results in their study of Minneapolis, MN, showing that the net impact of the supply and demand effects is dependent on the condition and quality of the nearby property (market tier). For high tier properties rent growth slows in the immediate vicinity due to the ability to substitute comparable unit types; high tier housing rents close to new construction were 3.2% lower than comparison buildings in the control group.[35] This result connects with similar findings from Li. At multiple radii, the researchers did not observe statistically notable changes in rents for middle tier properties. Low tier housing, on the other hand, saw a 6.6% rise in rental pricing compared to comparison units. The authors did

31 Like Asquith et al., Li considers dis-amenity impacts in the form of obstructed views, shadows, and unwanted physical changes, but finds minimal impact. Ibid., 22-24.
32 Pennington, "Does Building New Housing Cause Displacement?," 5.
33 Ibid.
34 Ibid., 18.
35 Damiano and Frenier, "Build Baby Build?," 28.

note an important caveat to the finding that the demand effect dominates the supply effect for low tier properties. Because new construction projects tended to occur in core urban areas and in emerging markets, there were "a limited number of low market tier buildings in th[e] distance band." [36] Damiano and Fernier propose that increased rents for low tier properties may result from signaling to landlords about new demand in the housing submarket. They also suggest that because low tier units are poor substitutes for high tier new construction, the supply effect will be much weaker at the lower end of the housing market.

Diamond and McQuade's article is unique in that it specifically analyzes the impact of subsidized housing developments on neighborhood home values. 7,098 Low-Income Housing Tax Credit (LIHTC) projects were examined across 129 counties in 15 states. The researchers found that LIHTC developments have varying effects on local house prices depending on neighborhood income levels. In lower-income areas, affordable housing developments are causally linked to neighborhood appreciation. The same is true for areas with a high minority share. In local areas with higher median incomes and low minority shares, the introduction of affordable housing is tied to depreciation. The authors attribute this in part to ownership preferences. In lower-income neighborhoods, newly constructed affordable housing is viewed as an amenity, indicating new investment and growth. As such, relatively higher-income households are willing to pay higher home values in the immediate area.[37] Higher-income households, on the other hand, perceive affordable housing as a dis-amenity and pay more to live farther from the development. It is important to note that this study does not examine rental rates, nor does it look at the short-run impact on housing supply. This makes Diamond and McQuade's article an outlier compared to the others reviewed here. Nonetheless, their contribution expands our understanding of the heterogeneous impacts of new construction on different neighborhood types, finds evidence for amenity and dis-amenity effects, and suggests noteworthy policy implications.

In summary, the studies reviewed in this section fill a critical gap in the literature around housing production. While the impact of regional or metropolitan housing production on affordability is well documented, neighborhood-level impacts were relatively understudied. The results from these studies show that, in general, the supply effect outweighs the demand effect. They also suggest that the relative impact of each may vary based upon the quality and condition of nearby properties.

SECTION IV: POLICY IMPLICATIONS AND LOCAL CONSIDERATIONS

The results identified in section III have significant implications for planners, real estate practitioners, and policymakers. This section examines those implications first for metropolitan areas in general and then applies them to the Portland region.

36 Ibid., 18.

37 The researchers also observe reductions in both violent and property crime. Diamond and McQuade, ""Who Wants Affordable Housing in Their Backyard?," 1114.

At its most fundamental, the findings from section III should encourage policymakers to implement strategies that expand housing supply in order to promote affordability. If, as Gyourko and Molloy write, "the vast majority of studies have found that locations with more regulation have higher house prices and less construction," then cities must reevaluate or relax those regulatory policies that substantially deter housing production.[38] Contrary to housing and tenant advocates arguing that new construction is intrinsically a "gentrification machine", policymakers should eliminate barriers to development and incentivize building. When so many metropolitan areas are severely underbuilding housing, this is absolutely critical to addressing the affordability crisis.

Evidence from the studies above also provide warning signs about the winners and losers of market-rate construction. While rents may be reduced for more expensive property types, lower end buildings may not see substantial changes or, in some situations, may see increased housing costs. What's more, it is highly unlikely that new construction can deliver affordable market-rate properties to households across the entire income spectrum. For this reason, policymakers should not only remove barriers to development, but also continue to deliver subsidies for the most vulnerable residents. That means continuing to develop local solutions, including voluntary inclusionary zoning policies, bond initiatives, and housing trust funds that support federal programs and add to the affordable housing supply. A dual supply strategy—market-rate and affordable—will achieve greater levels of affordability than would be possible from just one approach.

To that end, Pennington makes a few noteworthy recommendations for how market-rate and affordable housing projects may be used tactfully and in conjunction. She characterizes these two housing types as "complementary" policy levers. Market rate construction has nearby spillover effects in the form of reduced rents and gentrification by attracting wealthier households. Affordable housing, on the other hand, reduces displacement risk and prevents short-term gentrification by reserving units for low-income households.[39] Used in tandem, then, they can "achieve long-term income diversity by retaining lower-income people permanently, while market rate housing contributes to gradual gentrification."[40] This represents a valuable strategy for planning new construction projects.

McQuade and Diamond would likely add that by targeting low-income neighborhoods for market-rate and affordable development, positive spill-over effects would be maximized in the form of appreciating home values. There are limitations to that approach—namely the short-term concentration of poverty, deepening of segregation, and potential lack of access to high-opportunity areas. If we take Pennington's idea of complementary levers,

38 Joseph Gyourko and Raven Molloy, "Regulation and Housing Supply," National Bureau of Economic Research, NBER Working Paper Series (2014): 42.

39 Pennington, "Does Building New Housing Cause Displacement?," 21. Note that Pennington's conclusion here would be contested by Diamond and McQuade's findings if the

40 Ibid., 22.

however, it may be possible to use market-rate and affordable development to balance negative spillover effects in high-income neighborhoods. If both housing types were situated in the same wealthy neighborhood, would an affordable housing development's downward pressure on home values outweigh the market-rate project's upward pressure or vice versa? The answer to that question suggests that coupling housing types together may mitigate the downsides of each individual type. Home values might not be adversely affected, gentrification may occur as higher-income residents migrate to the neighborhood, and lower-income residents would be ensured an affordable home for the medium to long term.

What lessons can the Portland region glean from these recommendations? Four stand out. First, Portland's decision makers must stimulate new development. There are several avenues to do so, including: streamlining the costly and time-consuming regulatory approval process (design review in particular); expanding the urban growth boundary to add to the region's developable capacity; incentivizing projects now allowable under the Rapid Infill Program; and revising the burdensome Inclusionary Housing policy. As Eric Cress at UD+P noted in the conversation, all these local fees on development, or absurd housing-development "sin taxes" as he called them, undoubtedly add up, driving up costs and deterring production. While building more housing in these areas won't halt upward pressure on housing costs, they will slow price escalation. The city should take a strong, data-driven stance against those housing advocates who create an oppositional dichotomy between market-rate and affordable housing. Indeed, to oppose development, especially at this time, is to only deepen the affordability crisis.

Second, if new construction's impact on an immediate area varies depending upon the income of nearby residents (e.g. a weaker supply effect at the lower end of the housing market), then Portland's planners may opt to prioritize development in higher-income submarkets. Different development incentives could be offered in these submarkets to drive housing production, which will bring down nearby rental rates (supply effect dominates), and generate a filtering process as higher-income households move-in. In other words, the results reviewed in this analysis should be evaluated as specific communities are considered for development.

Third, policy makers should explore how market-rate and affordable projects may be paired together to maximize the favorable outcomes of both property types in changing neighborhoods. Creative solutions like these offer a nuanced approach to housing development.

Finally, this analysis complicates traditional narratives about what gentrification "looks" like in Portland. So often, new market-rate multifamily properties are presented as convenient distillations of a neighborhood's gentrification and its residents' displacement. This is a misleading and deceptive narrative; this analysis suggests that expanding the housing supply actually resists those processes of unwanted community change. Darrell Owens, a data analyst with California YIMBY, argues that, over time, a sustained lack of development drives unaffordability, exclusion, and a lack of class- and race-based diversity: "If you treat your city like a suburb, then it'll have the demographics of a suburb."[41] Portland decision makers should simultaneously recognize development as a powerful tool for promoting affordability, while also empirically engaging with communally harmful outcomes, like the displacement of BIPOC communities.

Ultimately, this is an emerging area of study. Additional analyses are needed to help with understanding how new development impacts neighborhood housing costs. And, equipped with that research, policymakers can make more informed decisions about how to maximize outcomes, accommodate growth, and promote a more affordable city.

41 Darrell Owens, "The Look of Gentrification," The Discourse Lounge, published September 18, 2021, https://darrellowens.substack.com/p/the-look-of-gentrification?utm_source=url.

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"America's Rental Housing 2020." Joint Center for Housing Studies of Harvard University (2020): 1-40.

Asquith, Brian, Evan Mast, and David Reed. "Supply Shock Versus Demand Shock: The Local Effects of New Housing in Low-Income Areas." Upjohn Institute for Employment Research (2019): 1-66.

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02

INSIGHT

Sitting Pretty, and Mostly Vacant - Office Conversion to Housing

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As COVID-19 persists, and remote or hybrid work further cements itself as a preferred working style for white-collar employees, office building owners continue to endure largely empty buildings. Vacancy rates recently hit a 30 year high, especially for office buildings in downtown locations. The forecast seems even more bleak, with a poll from marketing research firm Gallup, from late last year indicating 37% of workers never intend to[1] return to the office. These realities of the struggling office market are reflected throughout the United States, with the top ten markets experiencing office vacancies ranging from 10.6% in Philadelphia to as high as 25.5% in Dallas. Downtown Portland is currently reporting office vacancy in excess of 26%. City governments are also impacted by the rise in vacancy rates over the past two years; one study reported that jurisdictions are seeing losses of 5% to 7% in tax revenue.

With the impacts to building owner's bottom lines, cities' yearly budgets, as well as the declining quality of downtown areas — amid the ever-growing housing crisis — some are calling for repositioning office space for residential uses. And developers are listening, with more new offices throughout the United States slated for conversion to residential uses. However, repositioning office buildings is difficult and expensive, even for building types that are prime candidates for conversion.

CONVERTING OFFICES: OPPORTUNITIES AND CHALLENGES

Modifying under or unused office space into housing could help mitigate a problem facing millions of renters: landing an apartment can be difficult, and affording one is even more challenging. A 2021 study in Los Angeles found that converting underutilized hotels and offices could provide upwards of 17,000 new residential units. And as the national average cost of a typical apartment rises to $1,659 per month and the national average home value hits over $428,700, the hope is that creating more units could help stabilize housing prices. However, the ability to convert existing office buildings into residential buildings is not only technically challenging but also financially difficult.

The hurdles for converting existing office buildings to residential range widely, but the most fundamental challenge is the building footprint. Residential buildings are typically required by jurisdictions to have access to natural light and ventilation. Because of this, residential units require greater exterior exposure than offices. Additionally, the amount of light able to penetrate a residential unit further limits the depth of the building's floorplate. A 2021 UC Berkeley study found that residential buildings typically had a depth of 25 to 30 feet from façade to interior corridor, while office buildings had depths of 40 to 50 feet from façade to interior core.6 These 10 to 25 foot differences mean that less light can penetrate the interior of the building, which limits the amount of usable, and thus rentable,

1 *That is their intent and preference, but it may not be their reality when the labor market loosens up.*

space for residential units. While these interior spaces not compatible with housing units could be used as amenities, they can call to question a projects' financial viability. Even building owners whose office floorplates lend themselves well to residential conversion face more challenges.
Buildings most suitable for conversion are often older, Class B and C office buildings, as they are typically already due for improvement. However, their vintage exacerbates the risk of renovations because they were constructed under less stringent building code than current standards. They often require costly upgrades like seismic retrofits, environmental remediation, as well as life safety upgrades. The amount of time and cost associated with these upgrades can significantly increase the costs and schedule of a project. For example, the Brockman Apartments in Los Angeles took over seven years to complete and experienced a budget increase from $16 million to $40 million, ultimately causing the project to go bankrupt.

Even without major code-related improvements to the existing building, converting office buildings to residential include significant upgrades to building infrastructure, as apartments require more kitchens, bathrooms, and the associated plumbing and electrical work that comes with it. The upstart costs to bring an older office building to code compliance and then completely renovate its systems to accommodate a residential use can make the prospect of office conversion appear financially infeasible. However, some developers have and continue to bet on the success of office conversions — if they can find buildings with qualities that make them good candidates.

Global architecture firm Gensler recently studied over 300 office buildings across North America to determine what features position an office building for successful conversion, as described in an interview with Duanne Render, Design Manager and Repositioning and Landlord Services Practice Area Leader of Gensler's Toronto office. Using a proprietary algorithmic software developed by the firm, Gensler evaluated multiple factors such as floor plate, building form, envelope, site context and building services for compatibility with residential conversion. Their research found only about 30% of buildings assessed made suitable candidates for residential conversion. Similar to the UC Berkeley study, Gensler found that deep floor plates, core configuration, and access to the exterior façades were critical in an office building's success as a residential use. They also found that certain features that are often considered unappealing in the office market were positive for residential buildings. "Bad offices make good residential buildings," says Render.

Pointing specifically to Class B and C buildings, Render explains most office buildings built before 1970 typically have lower floor to floor heights, 11 feet on average, which in today's market is considered extremely low for working environments. However, this floor to floor height provides a 9 to 10 foot ceiling in residential buildings, which is much more generous than a new residential tower would typically offer. Additionally, these buildings tend to have shallower floor plates. That is considered inefficient for maximizing office rents but is prime for residential unit layouts. Render also highlights that buildings of older vintages are already reaching the end of their life and in need of upgrades to major systems in order to compete in today's rental market regardless of their use.

Even beyond specific features beneficial to conversion, Render points out benefits that all office buildings have for their possible conversion. Extra deep floor plates can be planned in a way where amenities are on every floor, making use of the interior areas without access to daylight while also providing competitive, unique offerings to the market. Additionally, residential buildings have lower occupancy loads, resulting in smaller mechanical systems, making more space for roof amenities.Office buildings already have centralized mechanical systems and infrastructure, which is more efficient than decentralized systems typically used in ground up residential buildings. These more efficient mechanical systems, as well as new energy efficient facades bring aging office buildings into a more sustainable future. Moreover, Render states that maintaining an existing structure and foundation significantly reduces a building's carbon footprint when compared to new ground up construction.

Despite the opportunities and possible benefits of converting office buildings, developers still appear to be deterred by the overwhelming cost. Render believes developers should shift their perspective on the opportunities office conversion holds and weigh the risks of waiting for the office market to bounce back. "Yes, it's expensive to convert these buildings, but it's also expensive to hold them with high vacancy rates," says Render of Gensler. "Every [Class B and C] building we evaluated is losing money. The question one has to ask is if the market is going to bounce back, and if it doesn't, how will all that space be absorbed?" Gensler appears to have a positive outlook on the possibilities for converting office buildings considering office buildings' current struggles. In their work for the City of Calgary, evaluating 28 existing office buildings for conversion, the firm identified 10 to 12 viable candidates for conversion. Their study estimated that if all 12 buildings were converted, 2,000 units could be brought to market, potentially housing 4,000 new residents in Calgary's downtown core. Render mentions that Gensler has seen growing interest in their research from developers, especially since the beginning of the pandemic.

And this new interest is seen in recent office conversion announcements across the United States. In June 2020, global real estate investment firm Hines announced the acquisition of South Temple Tower in downtown Salt Lake City, with the intent to convert it to residential. The developer is slated to provide 255 luxury units, ranging from studios to two-bedrooms, in the 217,000 square foot, 24-story office tower. Not only do the building's shape and location meet the requirements set by Hines, they also align with Hines' Environment, Social and Governance (ESG) strategy. Citing the reduction of carbon emissions by limiting the use of new building materials such as concrete, as well as the installation of new efficient mechanical systems, Hines expects South Temple Tower will provide lower operational carbon emissions and an improved lifecycle carbon footprint as compared to a new residential tower.

Hines is not the only developer pursuing conversion of office buildings. Developers in Dallas, New York City, and Washington DC also recently announced their own plans to convert existing office buildings to residential. As developers in major cities move forward with conversions, Portland appears to be lagging behind. Leonard Barrett, Principal of Beam Development, a Portland-based development firm specializing in adaptive reuse, explained his thoughts on the seemingly slow pace of office conversion in Portland: “I think there is this kind of continued hope that the office market is going to come back,” says Barrett, continuing to say, “It’s a relatively risky bet to convert.” Barrett identified challenges developers face right now such as upfront cost, the risk involved in renovating aging buildings, and the availability of land as factors in the lack of office conversion projects in Portland.

Despite being experts in adaptive reuse, Beam has not considered converting to residential. Their office building portfolio, which is largely based in Southeast Portland, did not experience the severe vacancy rates like downtown offices. He explains that their office spaces range from 150 square feet to 30,000 square feet, and spaces between 3,000 and 5,000 square feet experienced limited turnover throughout the pandemic. But if their offices were not performing well, Beam would still see more roadblocks to conversions beyond construction costs. “Most of our buildings are located in the Central Eastside Industrial District,” says Barrett. “So even if we wanted to convert to housing, we couldn’t because they’re not zoned for it. Unless we wanted to lobby the city for a sweeping change to land use, I just don’t see it happening.”

This point about zoning raised by Barrett is critical to cities seeing empty offices converted to new housing. However, the city of Portland and its commission appear to be silent on the matter. Meanwhile, Multnomah County commissioner Susheela Jayapal made calls in July of this year for offices to be converted to affordable housing. In an interview with Oregon Public Broadcasting, commissioner Jayapal noted that she is in talks with private developers about converting existing downtown offices to affordable housing, having also toured a vacant office in early July. However, Jayapal admitted to the limitations and opportunities of turning office buildings into housing: “Not every office is going to lend itself to conversion to housing . . . But the reality is we’re at a point where even 200 or 300 or 400 additional units makes an incredible difference.’” While these discussions between local officials like Jayapal and developers seem promising, tangible policy is yet to be actioned.

For now, it’s unclear whether the county and city will incentivize developers and building owners to convert office buildings into housing. Without adjustments to zoning, clear pathways for development, and workers returning to the office, building owners are left with little recourse to revive downtown areas. Meanwhile, finding affordable housing will remain a challenge for residents, and empty downtown office buildings will continue to tower over tent encampments, unable to shelter those in most need because of insurmountable logistical challenges. Despite these realities, developers continue to bet on office conversions, seeing the inherent risks as advantageous rewards. If enough developers continue to reimagine and renovate their office buildings, cities' downtown areas may soon experience a renaissance filled with former mid-century offices reinvented as housing for the new millennium.

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03

COLUMNS

Local Housing Production 2022 Q2

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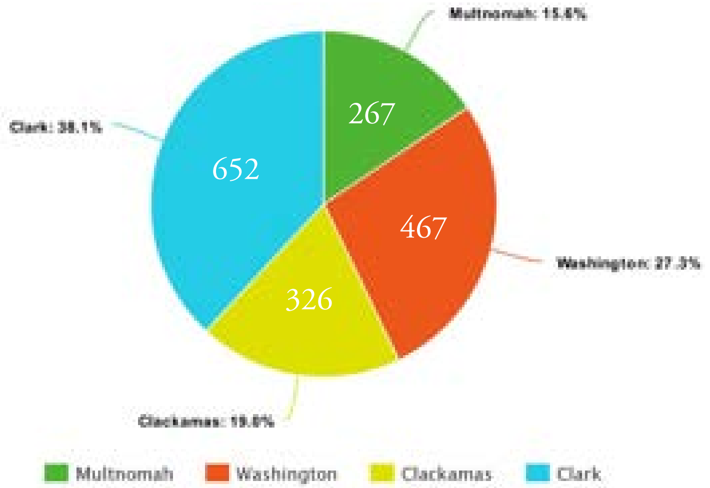
REGIONAL HOUSING PRODUCTION

All in all residential production remained relatively stable. Analyzing new single family residential ("SFR") building permits for the region shows that the overall number didn't change much from the first quarter to the second quarter, only a slight decrease of 5.7% representing 98 permits (Q1 = 1,712, Q2= 1,614). Multnomah County saw the largest decrease with a difference of 100 permits reflecting a 37.4% drop from 267 in the first quarter to 167 in the second quarter. Washington County was the only one to see a rise in residential permits, going from 467 to 504 for a 10% increase. Clark County once again issued the most permits in the second quarter with 641, a modest 1.3% decrease from the first quarter. These numbers follow a clear pattern established by Clark County, which continues to lead the region in new SFR permits. Clackamas County approved a total of 302 permits, a slight decrease from the first quarter. Considering Multnomah has the largest population of the four counties in the region, these numbers reveal a considerable lack of development when compared to the less populated ones, especially when we look at the number of permits per 10k residents.

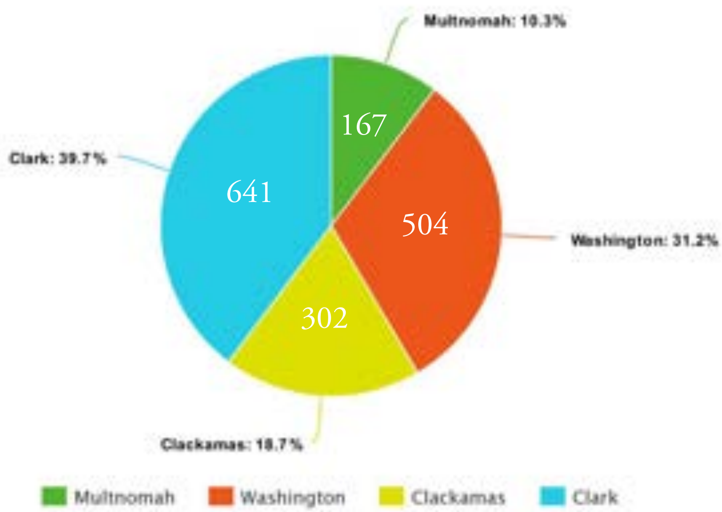
When analyzing the data based on the number of permits per 10k residents, we see that Clark County clearly outperforms the other three counties in the metro area. In 2018 Clark County issued 75.1 permits per 10k residents compared to Multnomah County's 81.2. Contrast that with 2021, when Clark County followed three successive YoY increases with a rate of 109.7 permits per 10k, while Multnomah County only issued 44.34. Year to date 2022 shows Multnomah County once again trailing the region with only less than 14 permits per 10k, less than half the volume of Clackamas and Clark counties.

Multnomah County represented just 15% of regional residential permits during the second quarter, compared to 31% in the first quarter. Looking back to pre-COVID we see that Multnomah County granted 46% of the regional residential permits for the entire year of 2018. These numbers stand in stark contrast to Clark County's steady increase in share from 25% in 2018 to an average of 38% in the second quarter of 2022. Washington County also increased its share from 19% to 30% in the second quarter of 2022. Clackamas County saw the smallest increase in regional share representing just 17% this quarter, but still an increase from 11% in 2018. Every county except Multnomah recorded steady gains in the number of new residential permits since 2018.

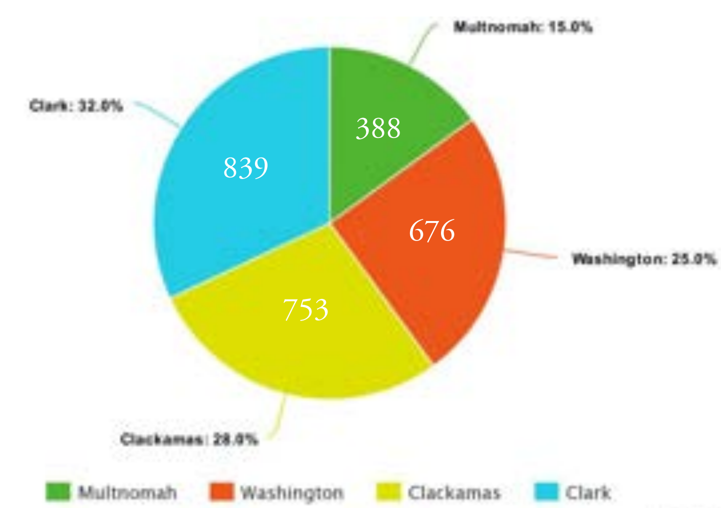
SINGLE FAMILY RESIDENTIAL PERMIT VOLUME BY COUNTY 2022 Q1



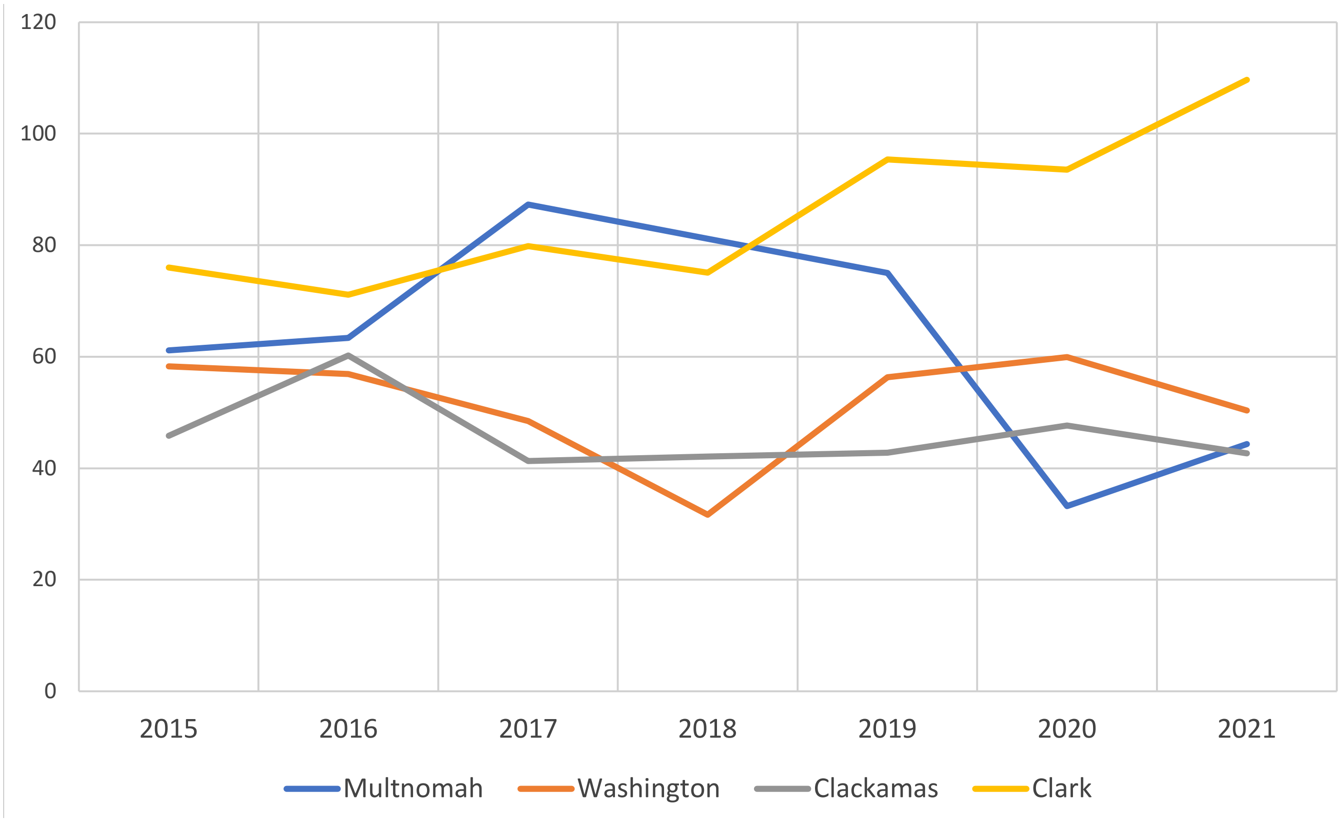
SINGLE FAMILY RESIDENTIAL PERMIT VOLUME BY COUNTY 2022 Q2



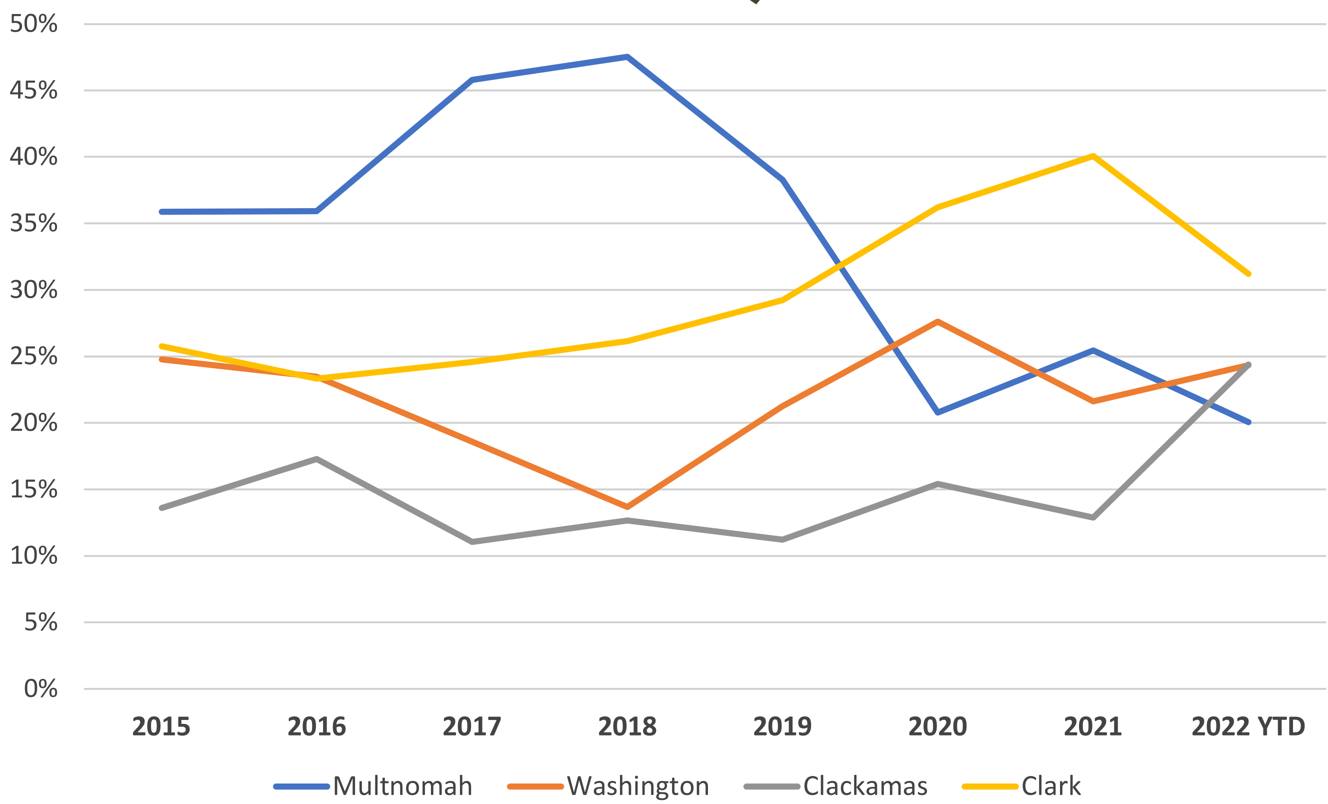
TOTAL RESIDENTIAL PERMIT VOLUME BY COUNTY 2022 Q2



RESIDENTIAL PERMIT VOLUME BY COUNTY PER 10,000 RESIDENTS 2015-2022 Q2



RESIDENTIAL PERMIT VOLUME BY COUNTY 2015-2022 Q2



RESIDENTIAL PERMIT NUMBERS LAG BEHIND REGION

Comparing data from 2018 through June 2022 we see stark differences in the number of new residential permits in cities around the region when compared to Portland.

For this investigation data from Portland, Bend, Eugene, Seattle, Vancouver, and Olympia was collected and analyzed. The parameters for the data included all new residential permits per year from 2015 through 2021, with current running totals for 2022. The population of each city, based on Federal Census data, was used to calculate the number of new permits per 10,000 residents.

According to the data collected from HUD, Portland issued 86.5 new residential permits per 10k residents in 2018, compared to only 47.2 in 2021. This overall drop represents a decrease of 46%. Meanwhile, Seattle saw its new residential permits per 10k increase from 106.3 to 163.2 in the same time frame, Vancouver increased from 60.9 to 125.0, Bend went from 94.1 to 142.8, Eugene saw an increase from 48.7 to 79.8, and Olympia saw the smallest increase going from 27.6 to 47.0

As the previous graph shows, the cities of Portland and Seattle maintained similar populations over the past seven years, only recently seeing the difference grow to just over 100k with Seattle topping out around 733k in 2021 (Portland = 641k). Seattle's growth the past few years can easily be tied to its increase in residential capacity. In 2021 Seattle issued 116 more permits per 10k residents than Portland did, in fact Seattle's 2021 total of 163.2/10k is more than triple that of Portland's 2021 total of 47.2/10k.

The data shows a direct correlation between Seattle's steady increase in total population with a net gain of +125k since 2010, and its increase in new residential permits while Portland's population plateaued in 2016 with a net gain of less than 3k residents represented in 2021.

According to the US Census, overall vacancy rates in the "west" in general are the lowest in the country with an average of just 4.8% in the first quarter of 2022, dropping to 4.3% in the second quarter. Nationwide rental vacancy rates have hit a low of 5.6% in the second quarter. Seattle currently maintains an average vacancy rate of 6.5% across the 9 regions of the City according to CoStar, while the current vacancy rate across Portland's 8 neighborhoods (Portland City, not Metro) averages to 6.1% with projections that it will dip to 2.8% by the end of 2022.

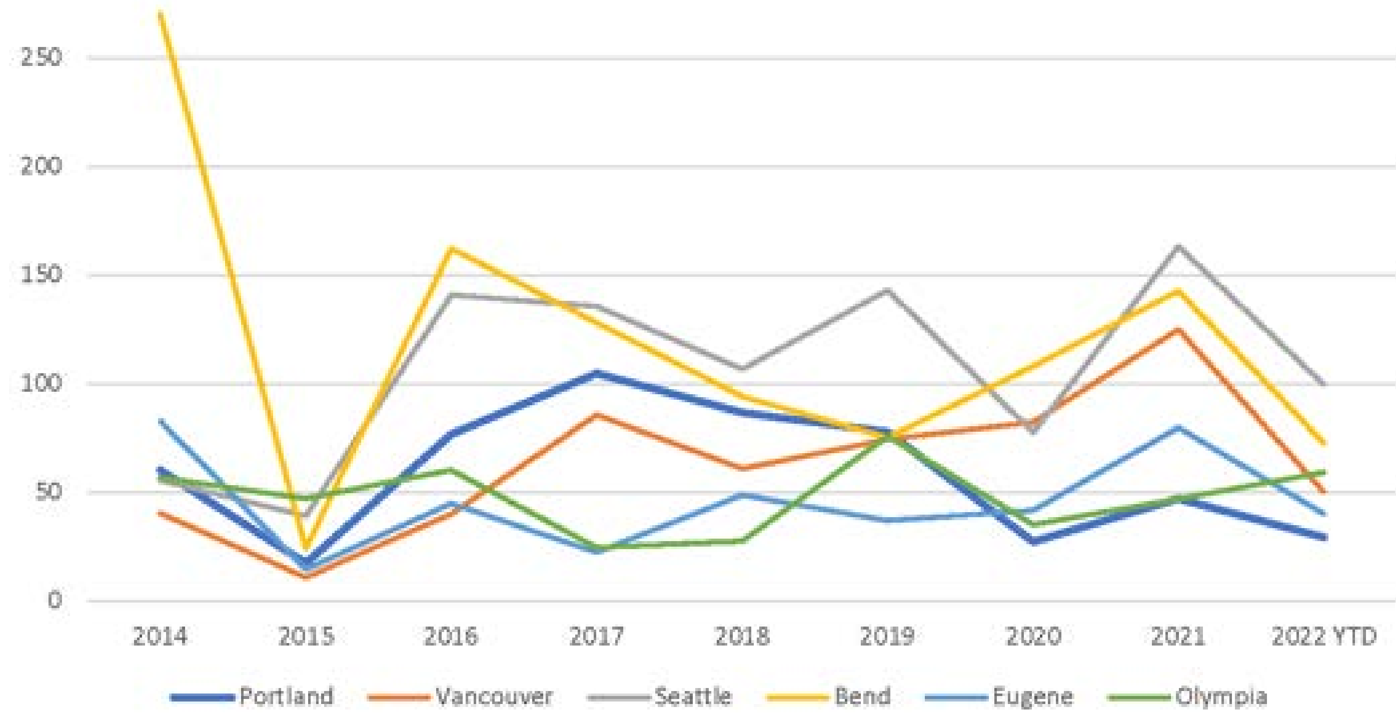
IS PORTLAND BDS CONTRIBUTING TO THE PROBLEM?

In March 2021 an internal audit of building permit review times by Tenzin Gonta and Kari Guy found a lack of transparency, governance, and accountability at Portland's Bureau of Development Services (BDS). The highlights from the audit include findings that BDS fails to meet its own timeline goals, does not adhere to its own customer service policies to resolve complaints, fails to provide equitable treatment of customers, and fails in general to track and report on activities necessary for performance assessments.

A key finding of the audit states:

> "An essential function of Portland's building permits system does not work as it should. City plan reviews of permit applications are too slow, and the City does not follow its own customer complaint policy to resolve these delays. The result is Portland falls short of its goals and commitments to customers." (2)

PERMIT VOLUME PER 10,000 RESIDENTS 2015-2022 Q2



CITY POPULATIONS PER US CENSUS

Date	Portland Population	Vancouver Population	Seattle Population	Bend Population	Eugene Population	Olympia Population
2010	583,776	161791	608660	76639	151860	46478
2015						
2016	639,863	174826	704352	91122	166575	51202
2017	647,805	175673	724745	94520	168916	51609
2018	653,115	183012	744955	97590	171245	52555
2019	654,741	184463	753675	100421	172622	52882
2020	652,388	191071	738172	99533	172802	55626
2021	641,162	192169	733919	102059	175096	55919

The Portland City Council is composed of seven City Commissioners, each overseeing a City Bureau (building, planning, parks, water, etc). These individual bureaus are responsible for processing construction permits in order to assign specific development fees. For instance, to add a residence either by new construction or a space conversion, each bureau (parks, water, transportation, etc) must assess the permit application and assign a fee based on specific criteria of density and use. If you're only adding a new bathroom you only need the water bureau and BDS involved; but if you're adding that bathroom in a new ADU and increasing the property's density, then you will involve all seven bureaus.

The audit found that the fragmented system of government lacked a centralized tool for tracking and management of permit applications for review. This audit from 2021 might provide insight into the reasons behind the decrease in new residential permits and general lack of population growth. While correlation doesn't always point to a causation, the forced, complete transition to online permitting in the wake of COVID(2020) might be contributing to the situation as well. Seattle was much more prepared to go fully remote as their online permitting system had been in use for about 8 years at this point.

The audit also found that in 2019 only 7% of residential permits were reviewed on-time, this fact alone offers a logical explanation for the declining number of permits issued.

> "Delays may also damage Portland's reputation and reflect poorly on its ability to provide an essential government service. Developers may opt to build elsewhere, resulting in an economic loss for Portland." (3)

CONCLUSION

> "Solving these problems requires sustained, focused City Council leadership." (3)

The data presents a strong argument for the lack of population growth in the City of Portland, at least partially, resulting from the lack of new residential permits. Overall the vacancy rates in Portland remain below the national average for the past 10+ years which clearly demonstrates the need and demand. The arguments that Portland's rental market was somehow previously "overbuilt" in 2018 simply isn't reflected in the vacancy rates. The failure to meet demand by increasing the housing supply will continue to impact the affordability of the City's existing housing stock and its ability to attract new residents, new employers, and accommodate our current internal rates of growth. Whether this lag is due to delays with BDS or the structure of the permitting system in general is a question that needs to be addressed further if we're to properly remedy the situation and reverse this 4 year trend of decline.

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04

COLUMNS

Economic Analysis

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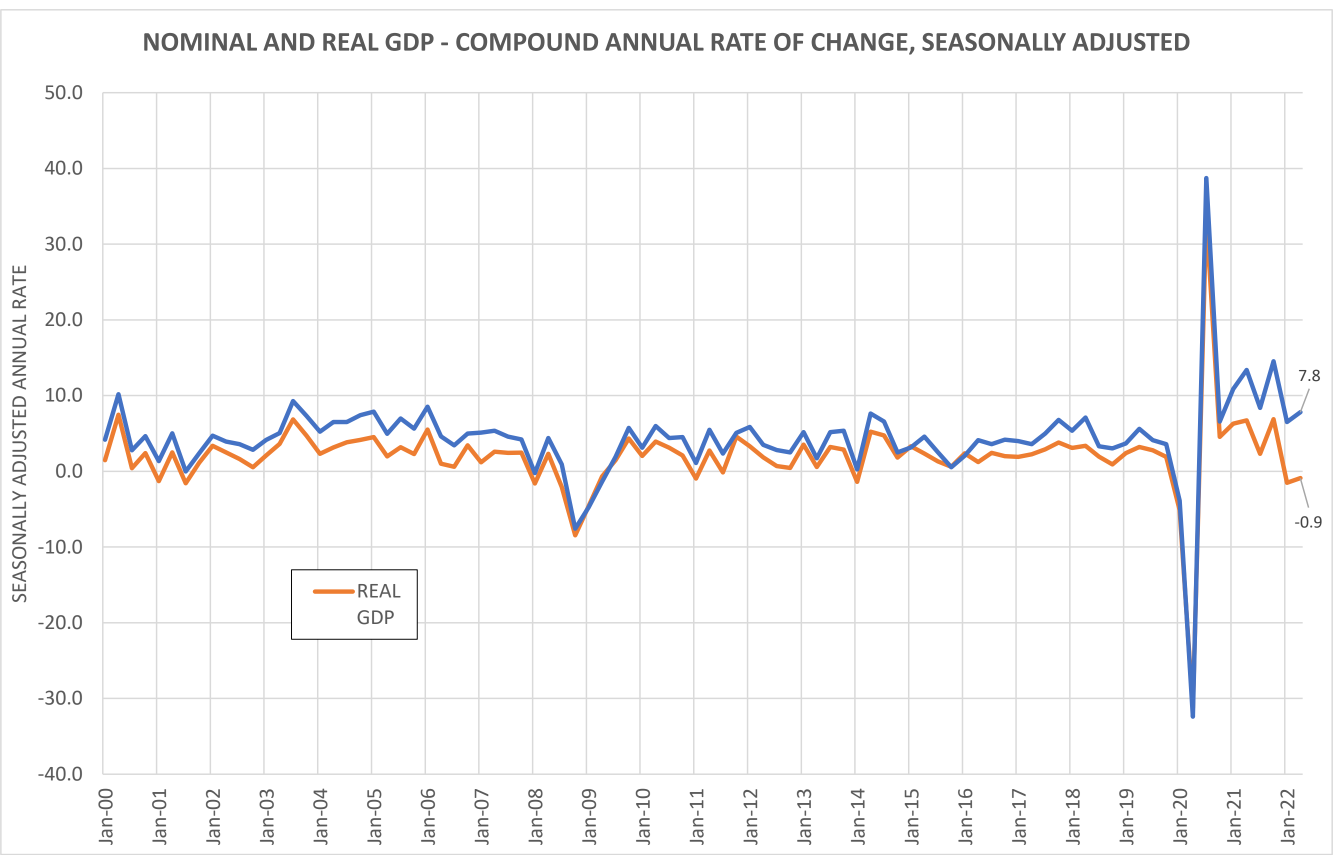
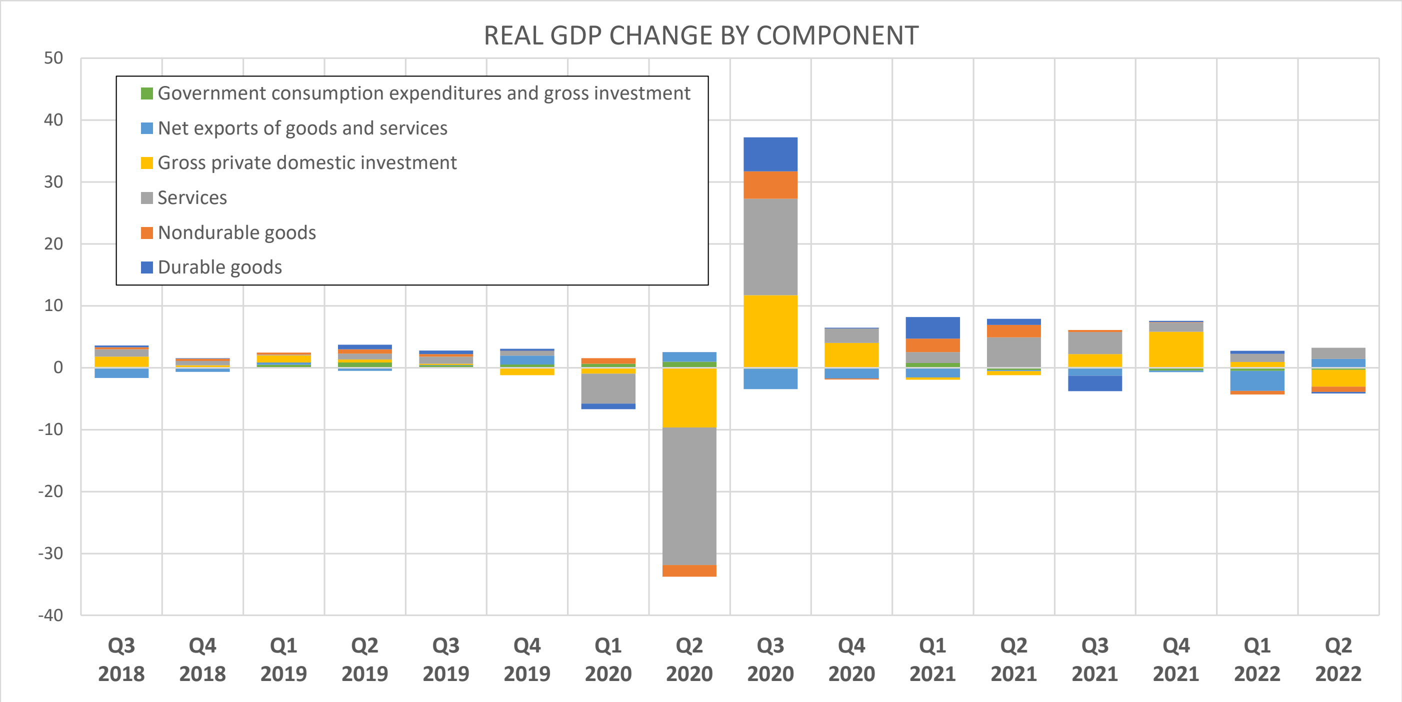
The national economy continued to stall during the second quarter of 2022, with real GDP declining for the second consecutive quarter (-.09%). The decline reflects continued elevated rates of inflation which more than offset what would have been robust GDP numbers. We are expecting higher rates to slow economic growth, but hopefully falling short of a full recession. The forecast for real GDP growth in 2022 is now closer to 1.4%, remaining below 2.0% through 2023. While two quarters of consecutive negative growth is often used to define a recession, this downturn has been odd. Industrial production, employment, and real personal income continue to increase, but overall production has been unable to match the pace of inflation.

Declines in gross private domestic investment and goods offset growth in services and net exports during the quarter. Many firms have been reducing inventory levels as inflation has reduced the demand for goods as well as changed the nature of consumer demand. Walmart recently canceled billions of dollars in orders to align inventory levels with projected demand.[1]



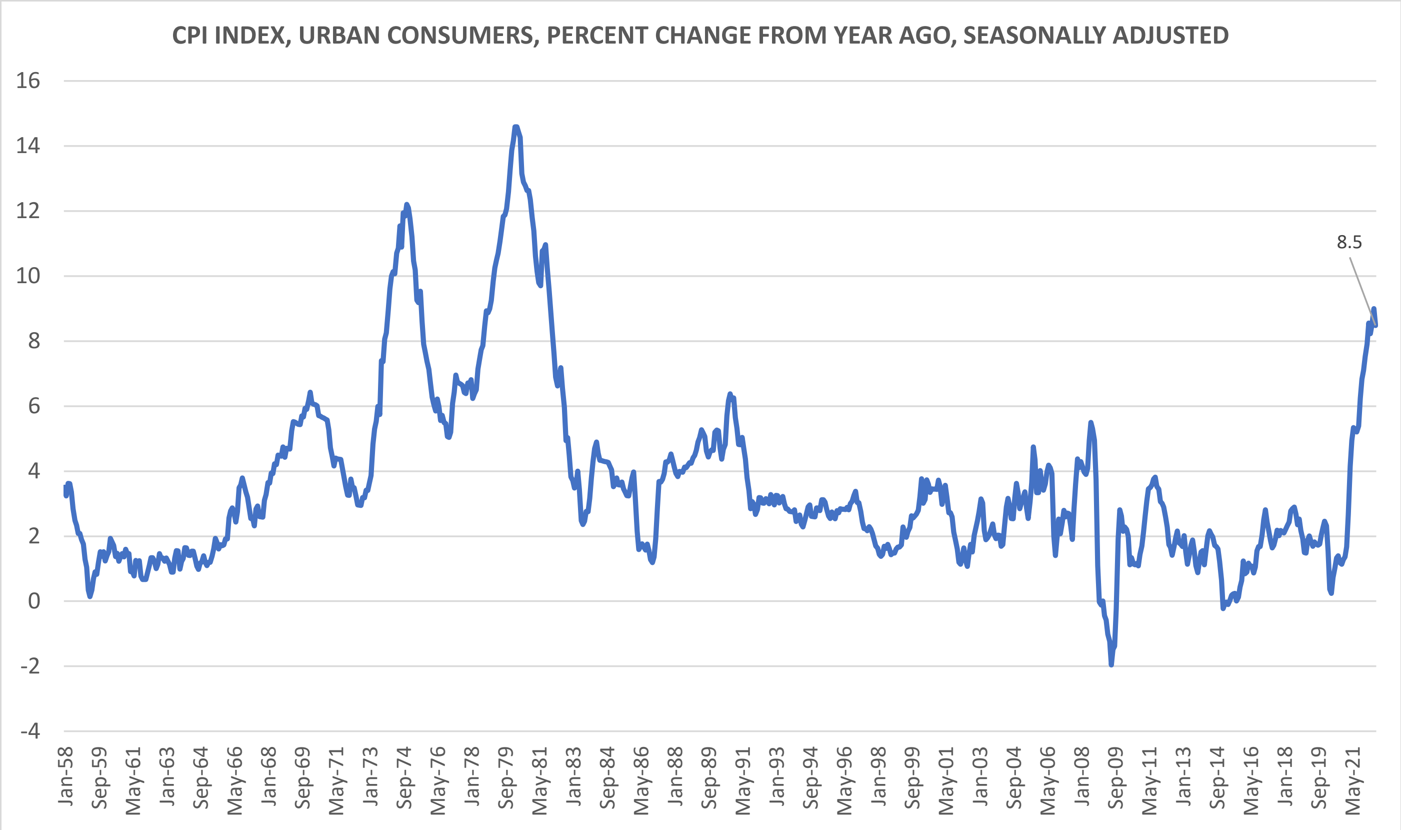
Federal Reserve Bank of St. Louis

1 *https://www.freightwaves.com/news/walmart-cancels-billions-of-dollars-in-orders-to-right-size-inventory-levels, August 16, 2022*



U.S. Bureau of Economic Analysis

Inflation continues to be the most significant issue in the national economy, with the consumer price index for all urban consumers (CPI-U) up 8.5% year over year.

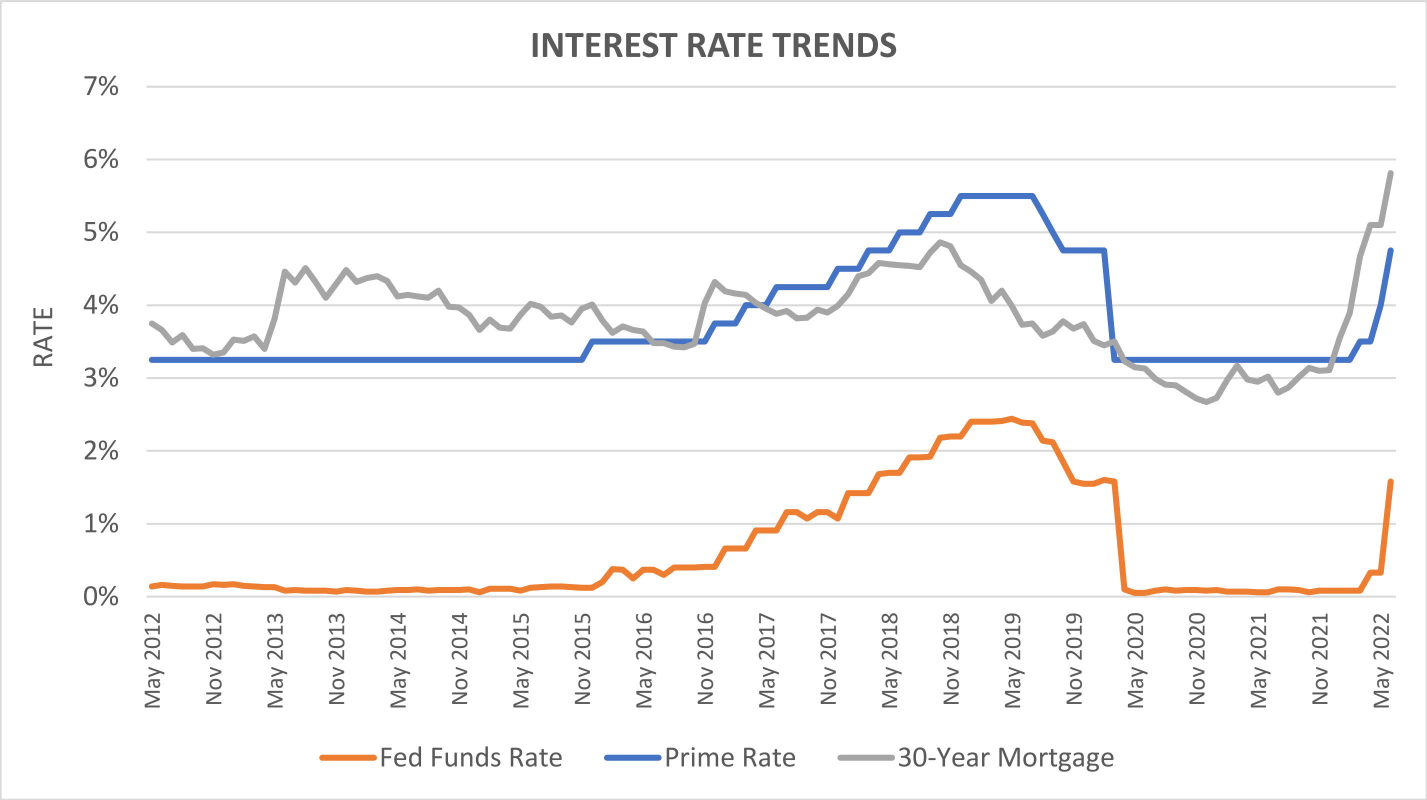


Federal Reserve Bank of St. Louis

The inflationary environment has widespread implications for the economy and the real estate industry specifically. The Federal Reserve has begun to tighten in earnest, which has already had a significant impact on interest rates and the ownership residential markets. The cost of debt and equity have already risen and over time capitalization rates may increase as well.

While rising rates are typically used as a tool to moderate demand and slow the economy, the impact on residential markets may be mixed in this instance. Residential construction has not been keeping pace with demand for the last decade, leading to record low inventory levels and rising prices. Rising interest rates will significantly increase housing payments and decrease ability to pay, but the low standing inventory relative to demand will likely lead to sticky prices in the residential market.

To bring inflation closer to its 2.0% target, the Federal Reserve has raised interest rates and started reducing its holdings of mortgage-backed securities. This has caused mortgage rates to nearly double in the span of a few months, while the prime rate that forms the basis for most commercial real estate loans also has moved higher.



Federal Reserve Bank of San Francisco

With the rapid price increases on necessities like food and gas, households must cut back on other spending. Luxury goods, leisure activities and vacations are usually the first items to be sacrificed. Housing is further down the list, in part because it represents costs that may be locked in for longer periods. However, households in transition are forced to consider their budgets when making housing decisions, and the surge in inflation is therefore likely to cause a shift in demand toward more affordable options. This would be a reversal of the trend earlier in the pandemic, when the home became a top priority and households could afford more expensive options because of savings on things like gas, restaurant visits, and vacations. We saw this in the apartment market in the form of more demand and stronger rent growth for newer and larger units.

In isolation, high inflation should cause a reversal of this trend. However, one of the effects of the higher interest rates might counteract this. The recent doubling of mortgage rates has added $500 (+40%) to the monthly payment on a 30-year $300,000 loan. According to the National Association of Realtors, the move in mortgage rates from 3% to 5% earlier this year priced 2.6 million households in the 25-44 age group out of the ownership market nationwide. As mortgage rates are now approaching 6%, this number may have increased to 4.0 million households. With ownership out of reach, these households are relegated to the rental market.

This does not mean that rental demand will increase by 4.0 million units. Most of these households are presumably already renters. Moreover, with the strong price gains in the Portland Metro ownership market in recent years, many of these households may already be priced out in our region. However, it does likely mean a slower shift to the ownership market among millennials transitioning into the family stage, and more demand pressure in the apartment market. Apartment demand from the households who would have qualified to buy their first home earlier this year is likely to be concentrated in the upper half of the market. As such, the mortgage rate effect is likely to counteract the loss in demand for newer and larger units caused by the high inflation – at least in part.

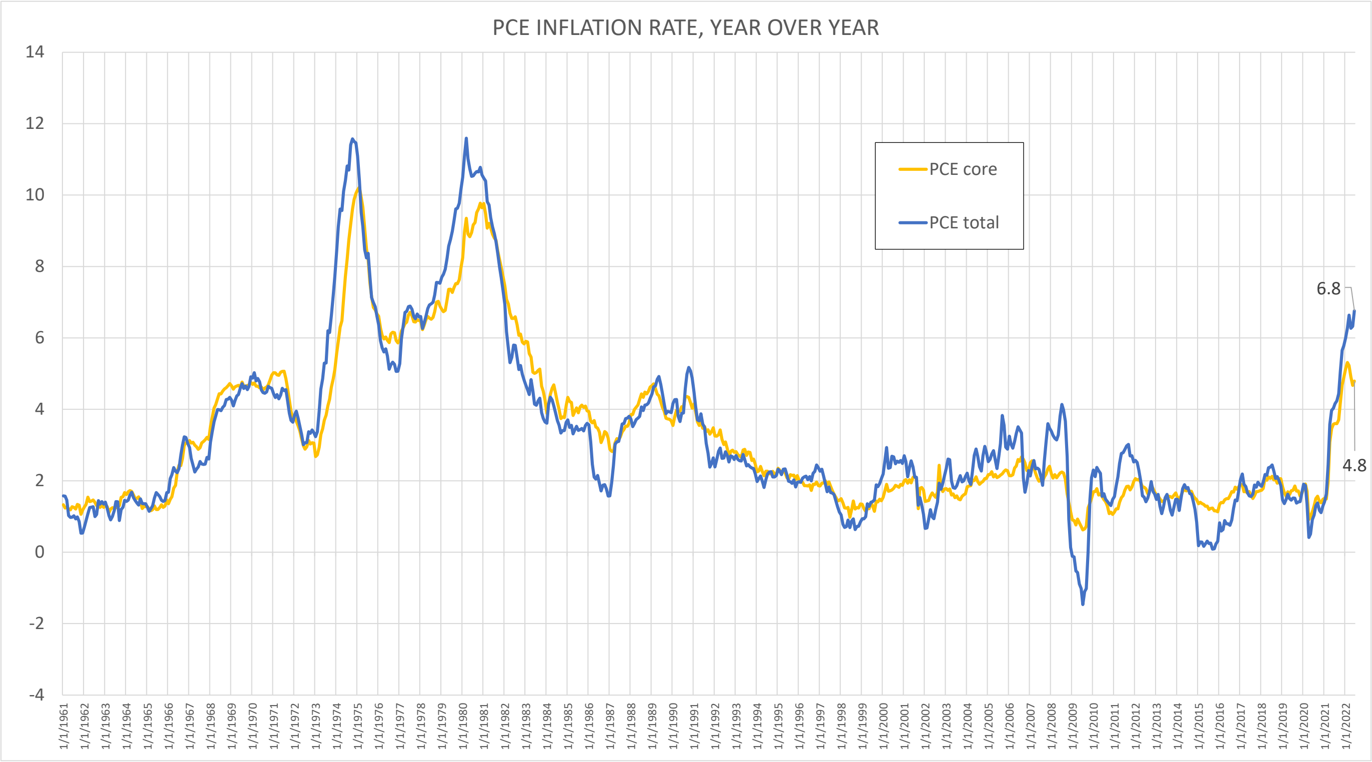
Rising inflation and interest rates will also impact real estate development. Inflation has already had a significant influence, as the construction industry was one of the first to see price increases due to supply chain disruptions caused by COVID. More recently, higher gas prices have increased the freight cost for materials. However, financing costs have been low until recently. These are about to normalize, though interest rates on commercial construction loans have not increased as much as in the mortgage sector. The inflation component may ease somewhat over the next year or two if supply chain issues from COVID and the Ukraine war are sorted out.

While the effect on development costs is important, the effect on investor demand for income properties may be more significant. As interest rates rise, the cost of leveraged property acquisitions goes up, reducing investor returns. Moreover, with higher interest rates, institutional investors may shift some of their asset allocation from real estate to bonds or other assets that have yields that move in tandem with interest rates. As yields rise in these asset classes, they become relatively more attractive from a risk-return standpoint.

In addition to CPI, we can look at the Personal Consumption Expenditure (PCE) index to measure inflation. While less well known, the PCE index is designed to track the consumer side by measuring changes in the cost of living for households. Core PCE is the preferred measure of inflation for the Federal Reserve, and the PCE's basket of goods and services changes to account for consumers shifting their spending due to price inputs. As a result, PCE tends to show lower rates of inflation reflecting shifting behaviors, with consumers mitigating rising prices by shifting their consumption patterns.

The PCE index shows a similar pattern as the CPI index, with headline inflation at 6.5% and core inflation at 4.8% from June 2021 through June 2022. The Federal Reserve Bank of San Francisco has developed a methodology to divide inflation rates into supply and demand driven groups of spending categories. They define "demand-driven" categories as those where unexpected changes in price move in the same direction as the change in quantity. "Supply-driven" categories are defined as those that see unexpected changes in price while the quantity declines. The data isolate the unforeseen component of the change in prices and quantities because they are likely to represent a shift in demand or supply rather than longer-run factors. The procedure uses a regression analysis of the previous ten years to establish predicted values, and unexpected values are the difference between expected and observed.

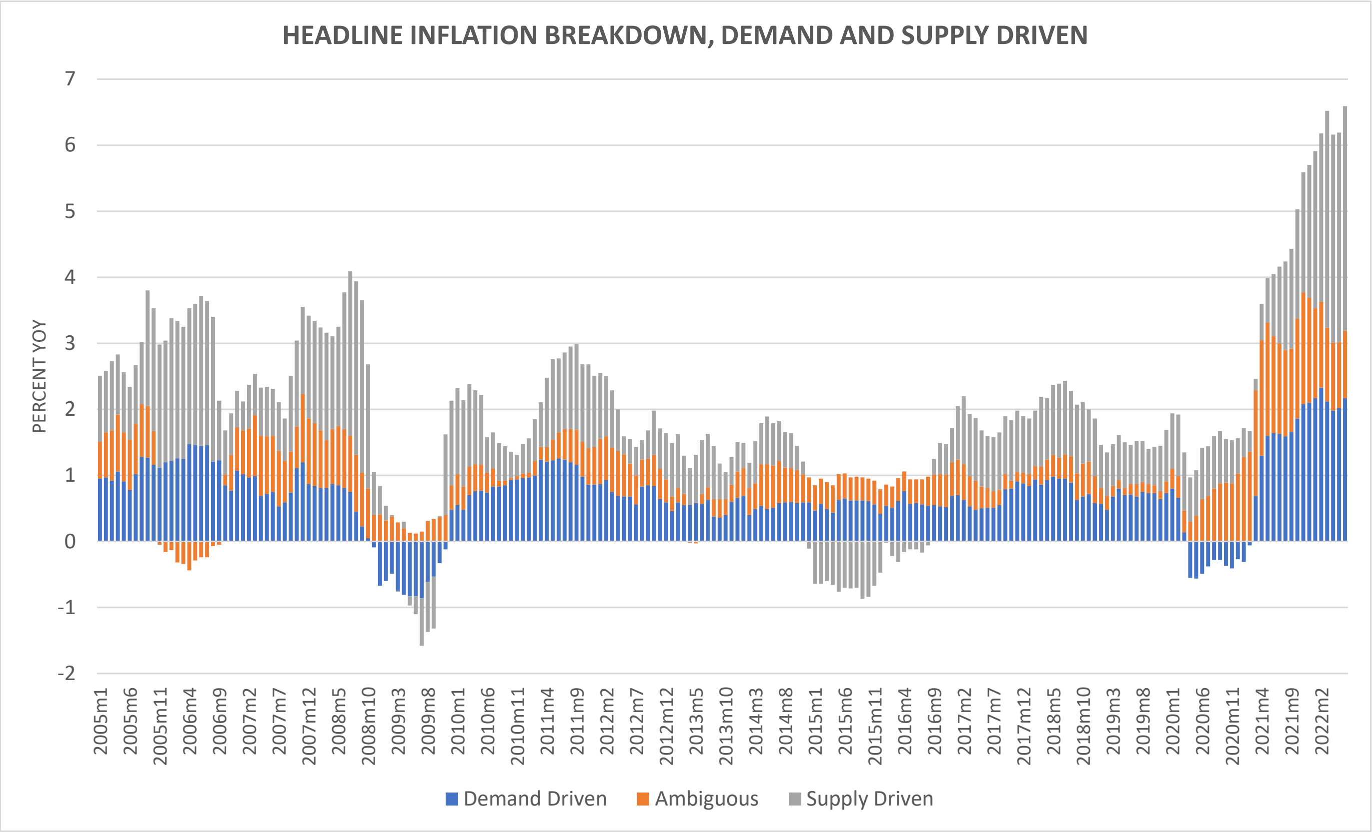
The analysis was done for the overall headline PCE measure and the "core" PCE measure that excludes food and energy prices. As shown in the accompanying graphs, both core and headline inflation have been driven by both demand and supply issues in the current inflationary cycle. During the pandemic-related downturn inflation was purely a function of supply issues. In the last few months, supply-driven categories have begun to significantly outpace demand-driven categories as contributors to observed inflation.



Federal Reserve Bank of St. Louis

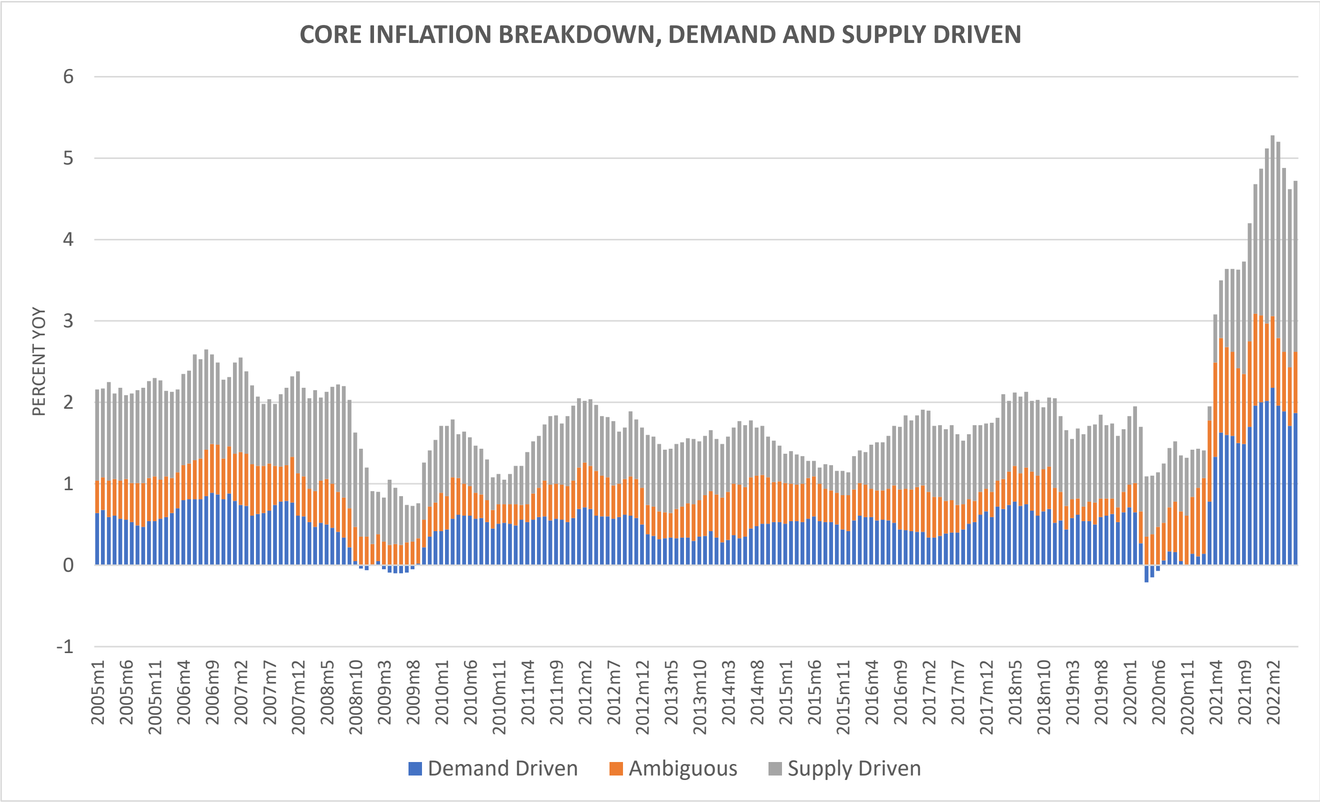
Rising prices have driven commensurate pressure on wage rates, although wage increases have significantly lagged inflation. Real earnings peaked during the pandemic, fueled by federal stimulus payments. Average real hourly earnings have declined over the last year as inflation has offset gains, with the employment cost index following a similar trend.

Employment growth in the Portland metropolitan area has been robust, with employment levels during the first half of 2022 running over 72,000 higher than the same period in 2021. While much of this gain can be attributed to a continued opening of the economy, local employment now exceeds the pre-pandemic levels. The Portland metro area has consistently outperformed the nation as well as the State of Oregon over the last decade. Most sectors are now above their February 2020 employment levels, although educational services, government, and leisure & hospitality have yet to regain their recent losses.



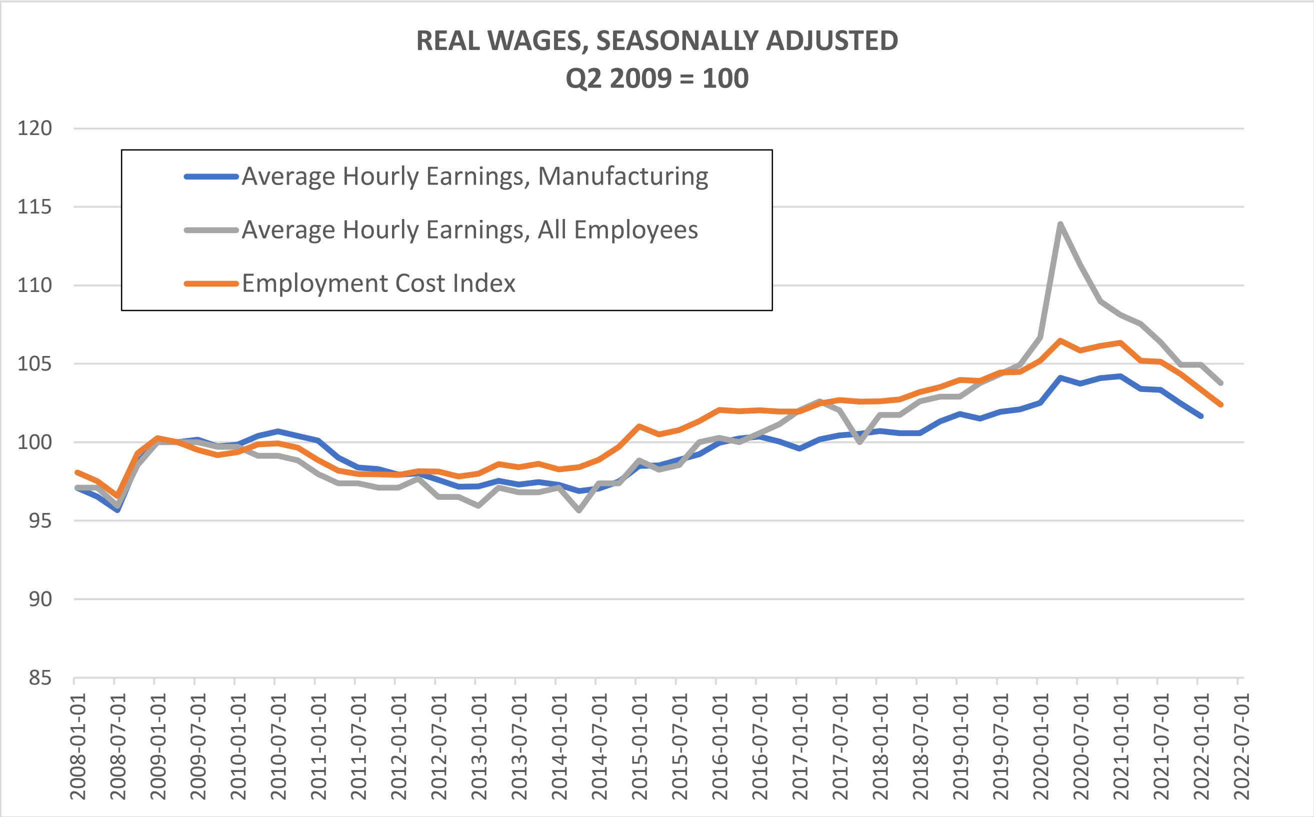
Federal Reserve Bank of San Francisco

The metro area has seen significant strength in construction, professional and business services, and manufacturing.

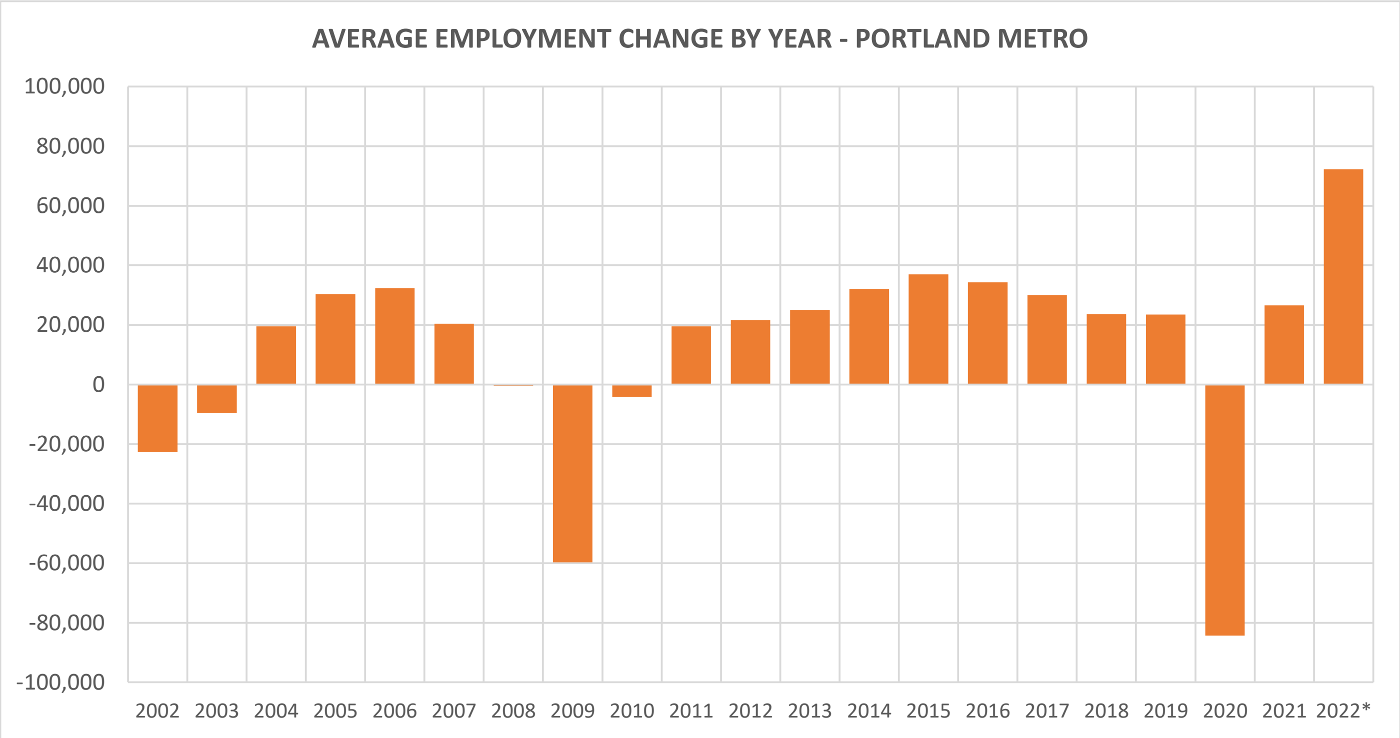


Federal Reserve Bank of San Francisco

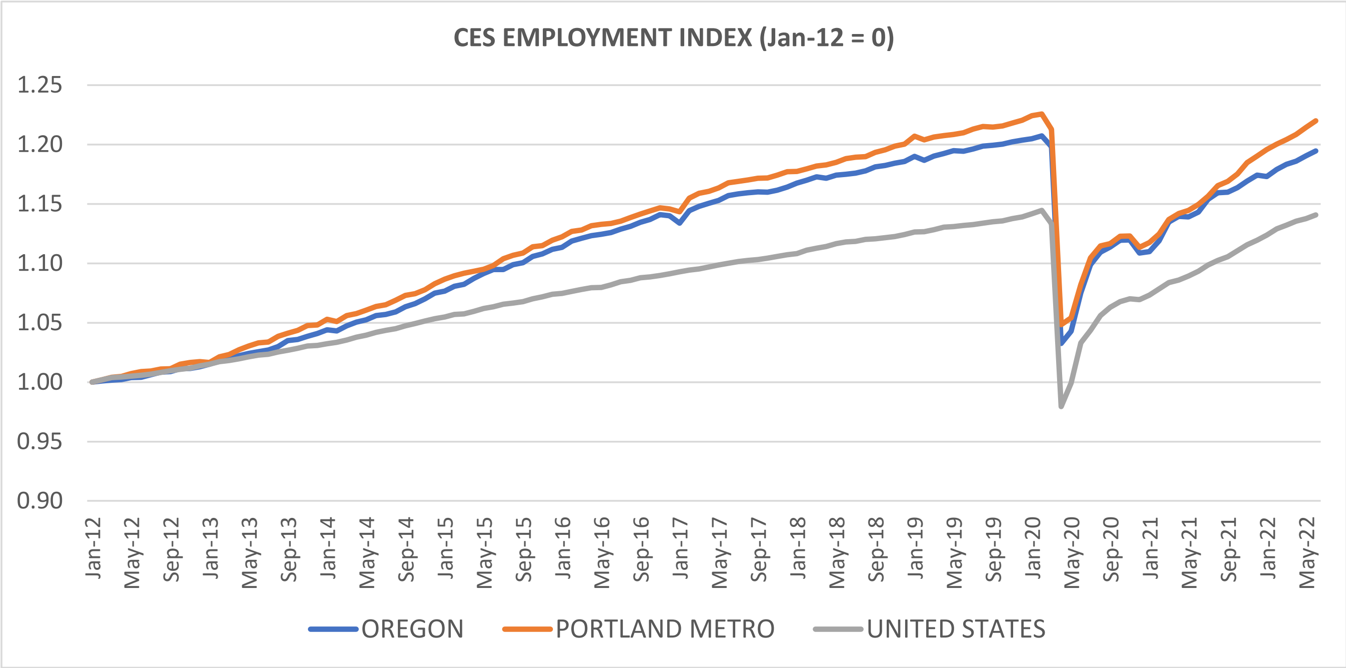
The unemployment rate has dropped to 3.5% at the statewide and metro area level, and 3.6% at the national level. The tight labor market and high inflation rate is expected to continue to place pressure on wage levels.



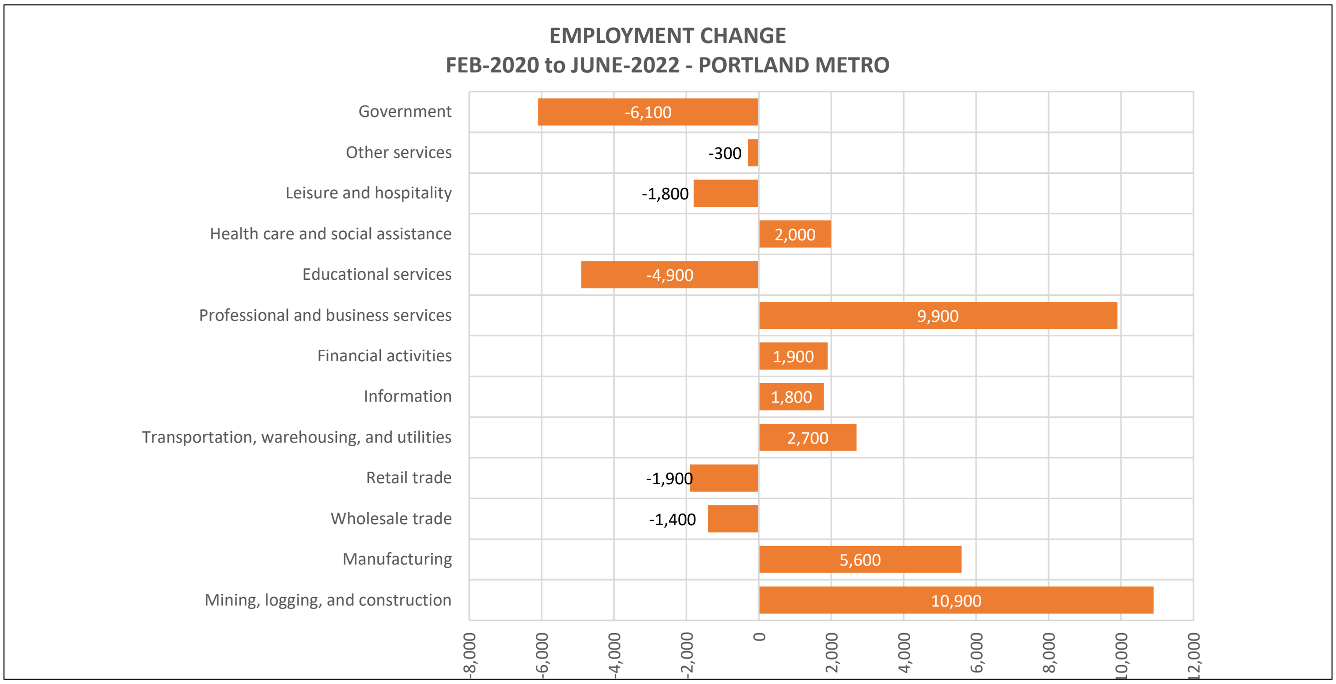
Federal Reserve Bank of St. Louis



Oregon Employment Department, Qualityinfo.org

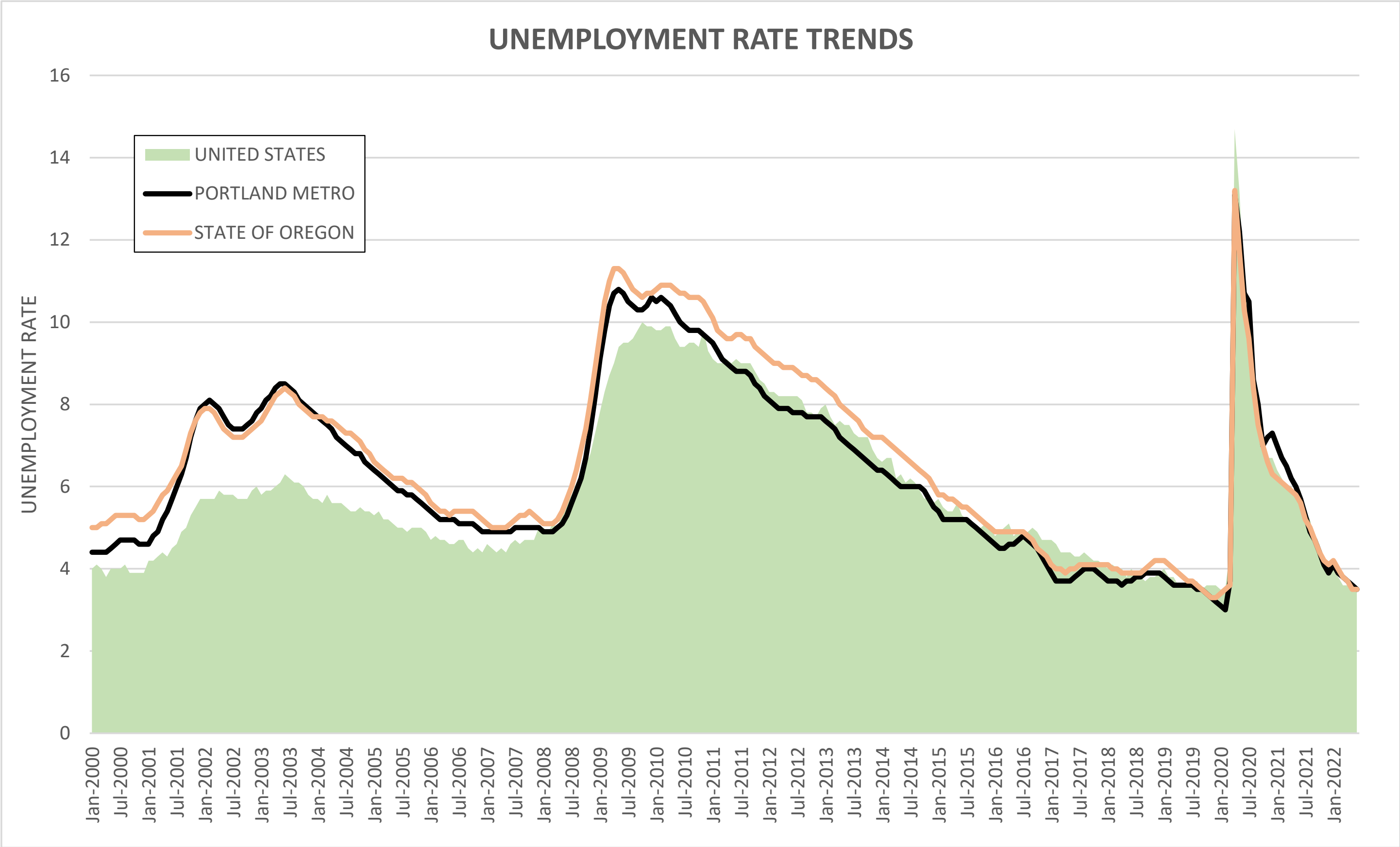


Oregon Employment Department, CES series



Oregon Employment Department, CES series

While the Portland metropolitan area's economy has been performing well over the last year, Portland's downtown core has lagged well behind the overall region in terms of recovery. The pandemic triggered a sharp change in commuting patterns, dramatically reducing the daytime population in the CBD's employment core. This had a devastating impact on downtown retailers, who lost a significant portion of their support base. The persistent protests and riots in 2020 added to these issues, as has an influx of people experiencing homelessness camping in the core area. The overall impact has been a significant erosion of the marketability of Portland's downtown core.



Oregon Employment Department, Qualityinfo.org

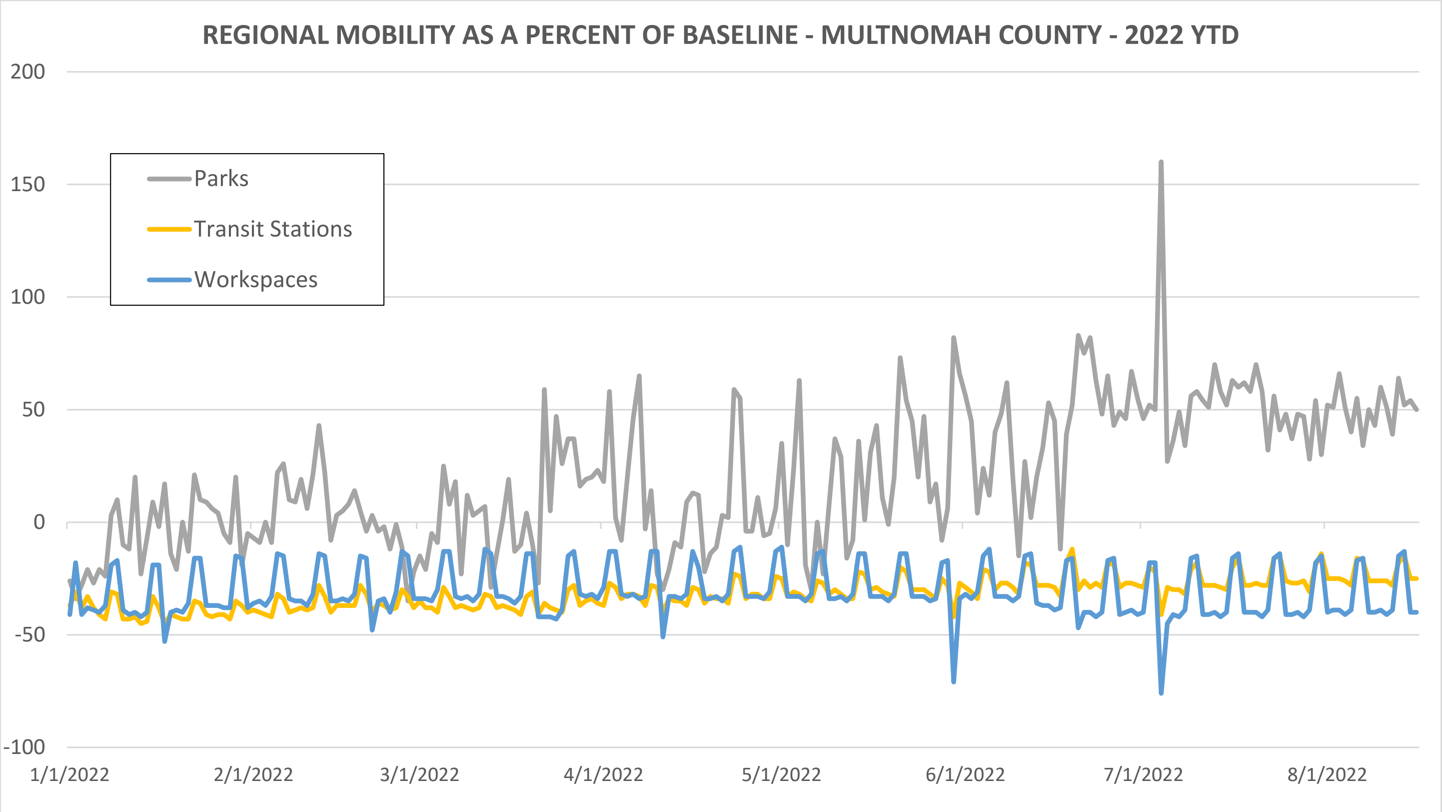
A recently published research report ranked Portland as 30th out of thirty-one large-sized cities surveyed in terms of downtown recovery, performing better than only San Francisco.[2] The analysis indicated that activity in Portland's downtown core was at only 41% of March 2020 levels based on tracked cellular devices. Data from Google indicates that workplace traffic remains down by about a third from pre-pandemic levels in Multnomah County, while transit station activity is down by roughly 25%. Conversely, park usage is up by 50%.

The impacts of this are widespread. Property owners with investments in office and retail properties have seen rising vacancies and reduced effective rent levels. The current vacancy rate is estimated at 26% in the downtown office market, up from 13% in the second quarter of 2019.[3] There was over 1.0 million square feet of sublease space in the downtown submarket. The core is losing major tenants such as JE Dunn (Beaverton), Unitas (Tigard), Umpqua Bank (Lake Oswego), KinderCare (Lake Oswego), and OCHIN (virtual). With

2 Chapple, Karen, "The Death of Downtown? Pandemic Recovery Trajectories across 62 North American Cities", Institute of Governmental Studies, University of California Berkely, June 2022, https://www.downtownrecovery.com/death_of_downtown_policy_brief.pdf
3 CBRE

roughly 2.0 million square feet of space entering the market in the next 18 months, it will be some time until the market regains its footing. The tourism sector is also heavily impacted, with a decline in the City's image as a destination and a high percentage of hotel rooms located in the downtown core.

To the extent that the significant shift in commute



Google

patterns is durable, it will have implications on consumer preference patterns and transit ridership. If the cost of commuting is reduced as a factor in location decisions, preferences would be expected to marginally shift towards suburban and rural locations. In addition, lower levels of commuting will have a direct impact on transit usage, while changing commute patterns will alter system needs and efficiencies.

05

COLUMNS

Ownership in the housing market

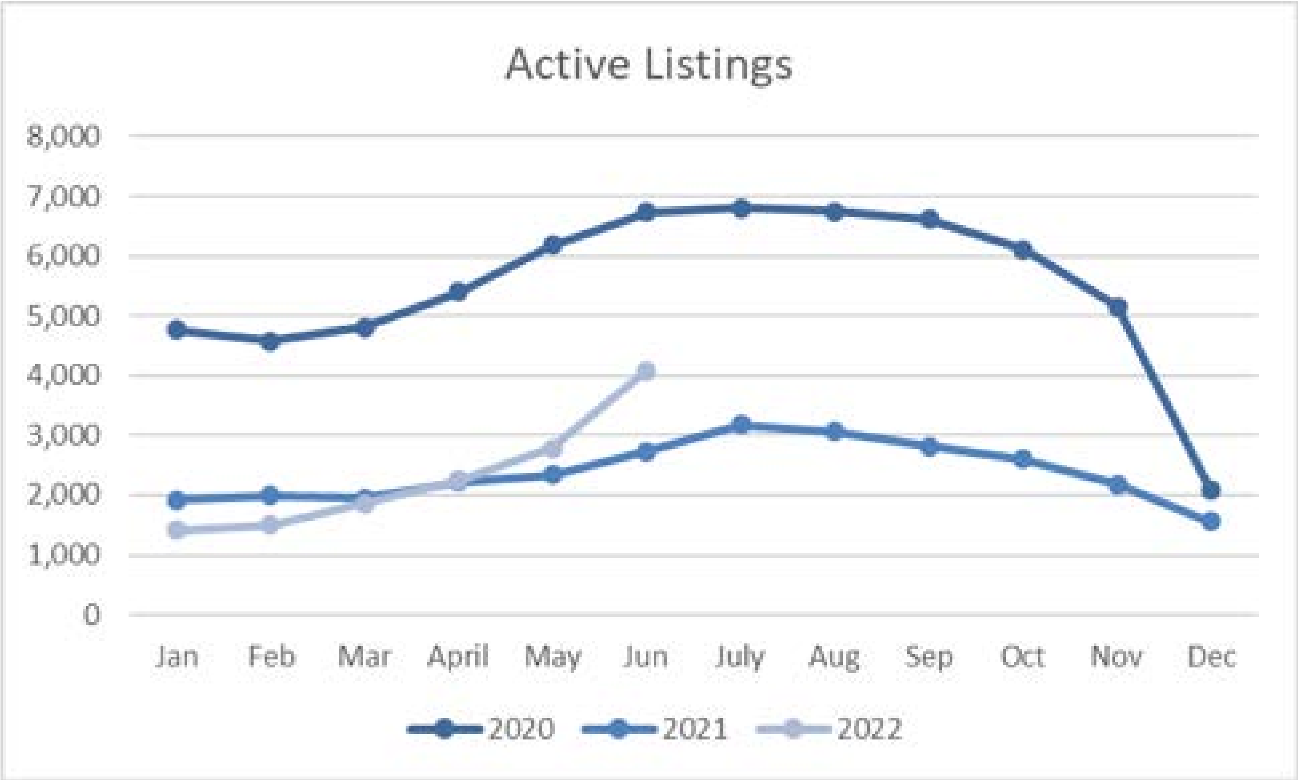
Parker Webb

Portland State University

Parker Webb is a candidate in the Master of Real Estate Development (MRED) program and a Regional Multiple Listing Service (RMLS) Student Fellow.

The ownership housing market in Portland, Oregon may finally be starting to shift, very slightly. It is still a very competitive market with sellers having the advantage, but with the increase in interest rates, the market is changing.

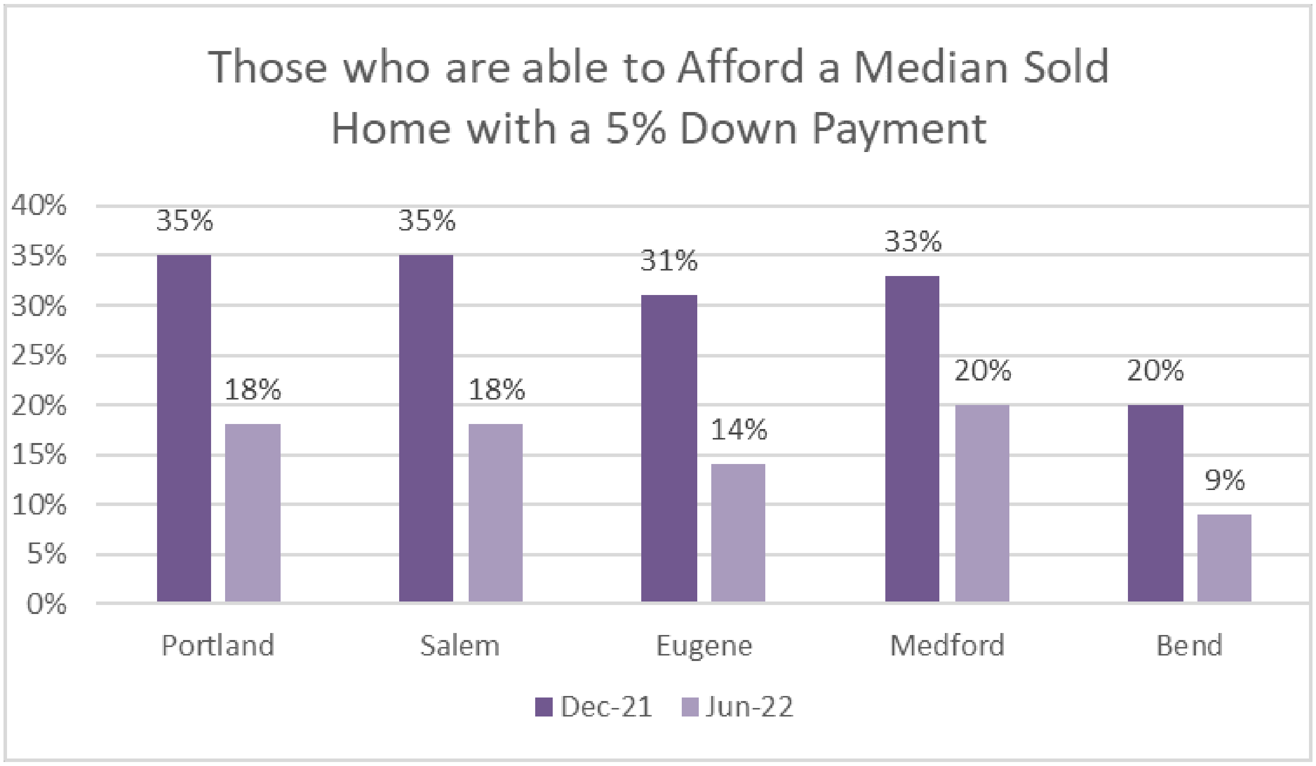
Just a couple of months ago, the active listings in the Portland Metropolitan area were significantly lower at 1,412 in January, 1,496 listings in February, and 1,867 listings in March. Jumping forward to today, there were a total of 4,085 active listings at the end of June, 2022, the highest level we have seen since July of 2020. Not only have the active listings gone up, but the monthly inventory has also increased (total listings divided by the average monthly sales pace over the previous year). The lowest the inventory has been this year was at 0.7 in March. There has been a consistent increase since April at 0.8, May at 1.0, and a significant jump in June to 2.0. The median sales prices for homes are still very high compared to prior years, but there have been slight decreases these past few months. In April 2022, the median sales price was at $560,000, May had a $15,000 increase to $575,000, and June had a $5,000 decrease to $570,000. Although this decrease is modest compared to the significant increases we have seen in the market, it still shows signs of softening.



So, what does this mean for Portlanders in the market for a home? These statistics are showing signs of a more balanced market. With greater inventory and active listings, buyers are getting increased options to purchase a home that suits their needs. In the past few years, sellers have been in complete control of the housing market because they could list their homes and have multiple offers that very week. Homes are now staying on the market longer, which is increasing supply.

Unfortunately, home prices remain well above what is affordable to many households, which is compounded by rising mortgage rates. Due to inflation, many households in the metro area are being pushed out of the housing market because the prices are beyond their means. According to an article written by Jayati Ramakrishnan, about 168,000 Portland Metro households have been priced out of the market since December, 2021. Another 69,000 has also been priced out in cities surrounding the Metro such as Salem, Eugene, Medford, and Bend. Median prices of homes are expected to go down, but not because they are becoming more affordable, according to broker Chris Suarez. There has actually only been a decrease in luxury homes while the prices of homes on the lower end of the spectrum are staying the same.

With rising interest rates, the effective cost of owning a home continues to rise. In recent months, the typical mortgage payment has increased 40% to 50%, which cut the potential pool of homebuyers in half since December, 2021. Economist Josh Lehner estimated that 168,000 Portland area households got pushed out of the market and are no longer able to purchase a median income home due to this mortgage increase.



Expenditures for homeowners versus renters in the United States have a significant gap. Compared to prior years, it is starting to condense. One of the largest gaps was in the 2008 housing crisis, when the annual U.S. renters' expenditure was at $12,479, and homeowners' annual expenditure was at $19,442, a $6,963 difference. The latest data given was in 2020, when the annual expenditure for U.S. renters was at $18,609, and homeowners annual expenditure was at $22,866, a $4,257 difference. This gap is getting smaller, but expenditures overall are continuing to grow. Since 2010, the growth rate in expenditures for renters has increased 44.90% while the growth rate for homeowner expenditures has increased 23.58%. (FRED)

This makes it very difficult for the younger generations who are wanting to purchase a home but do not have the funds of those who have been in the workforce longer and/or own housing and have benefitted from rising prices. The average median household income in Portland Oregon is at $43,811. Current homeowners are paying nearly half of that in expenditures and renters are not far behind.

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06

COLUMNS

Rental Housing

Marnie Rose

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Marnie Rose is a Master of Real Estate Development (MRED) candidate and a real estate investor with an interest in data & analytics.

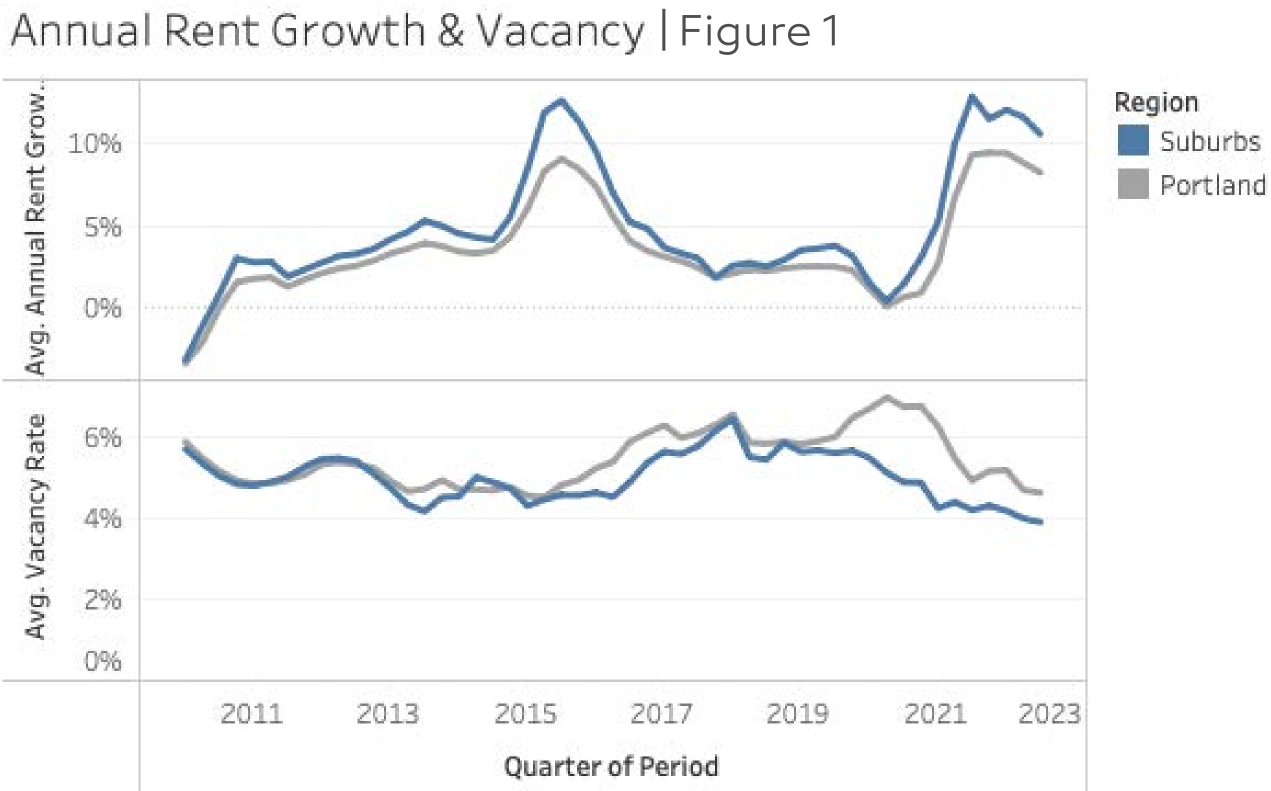
Portland's rental housing sector remains remarkably strong through the second quarter. As the national and regional economy react to rising interest and inflation rates, Portland's rental residential sector is already showing signs of resiliency in the face of a potential recession. Rents continue to grow, vacancy and cap rates remain low, and price per unit is soaring above the national average. As with prior periods in recent years, a lack of new construction resulting in fewer units being added to the market continues to exacerbate the region's housing shortage.

As the cost of homeownership rises, multifamily investors in the Portland market are eager to capture increased rental demand from potential homebuyers priced out of the market. Given the region's restrictive regulations such as inclusionary zoning, coupled with high construction costs and the limited supply of available land, the data shows that developers see Portland as an increasingly challenging option for new development. However, the volume of transactions over the last several quarters suggest that, due to exceptional annual and quarterly rent gains and low vacancy, investors are confident in the strength of Portland's multifamily market. So confident, in fact, that they remain willing to accept historically low cap rates that translate to slimmer returns.

RENTS AND VACANCY

While at a slightly lower rate than the previous one, rents continued to grow across Portland and its submarkets through the second quarter of 2022. The suburbs continue to experience the greatest gains in rental rates and the lowest vacancy rates, as renters leave the city and opt for suburban living. Figure 1 depicts annual rent growth and vacancy rates since 2010 in Portland and the suburbs. The suburban markets experienced an average annual rental growth of 11.6% in the second quarter, with an average vacancy rate of 4.0%. Portland's annual rent growth reached 8.9% with a vacancy rate of 4.7% during this same period. The graph suggests that these communities are performing better than the Portland Metro region as a whole, but with similar trends in the data. With rents increasing and vacancy rates remaining below 5% in both Portland and the suburbs, rental residential remains a strong overall market for investors.

In July, The Oregonian reported that Multnomah County lost roughly 12,000 residents in the last year, nearly a third of which were millennials between the ages of 25 to 29.[1] This is the first time since 2004 that Multnomah County registered a loss in population. Cited in the article, Oregon economist Josh Lehner contends that people moved away from the city in search of cheaper housing made possible by new norms surrounding remote work.

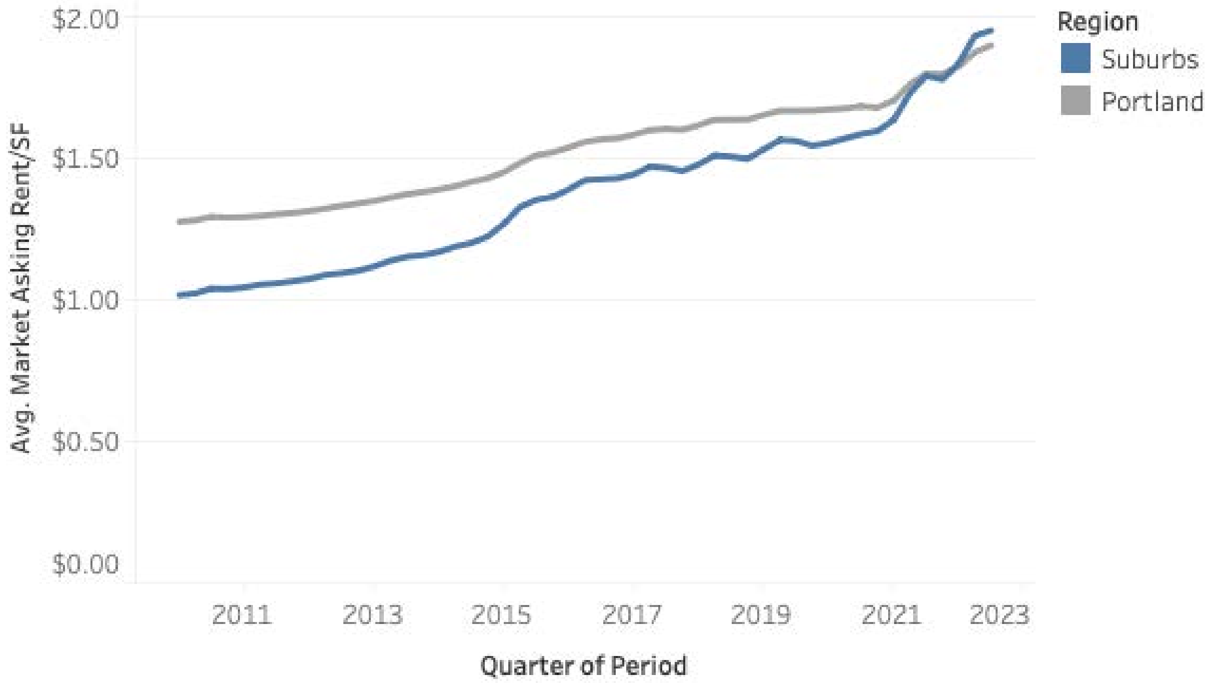


Federal Reserve Bank of St. Louis

Portland's suburban units are not only experiencing higher rent growth than the city, but they are also now achieving higher rents per square foot than Portland on average. Figure 2 depicts the average market asking rent per square foot for Portland and its suburbs since 2010. Like Figure 1, the data for each region reflects similar trends and patterns throughout time. Portland's rent per square foot remained comfortably above the suburbs up until the first quarter of 2021, when the average rent per square foot in the suburbs began increasing significantly faster. In the first quarter of this year the suburbs surpassed Portland. In addition, Figure 3 shows that, since the first quarter of 2015, the suburbs earn higher average market asking rent per unit than Portland. While both the suburbs and Portland take on a similar growth pattern over time, the average rent per unit in the latter has been increasing at a higher rate than in Portland starting in the fourth quarter of 2020. This will be an interesting trend for investors to follow.

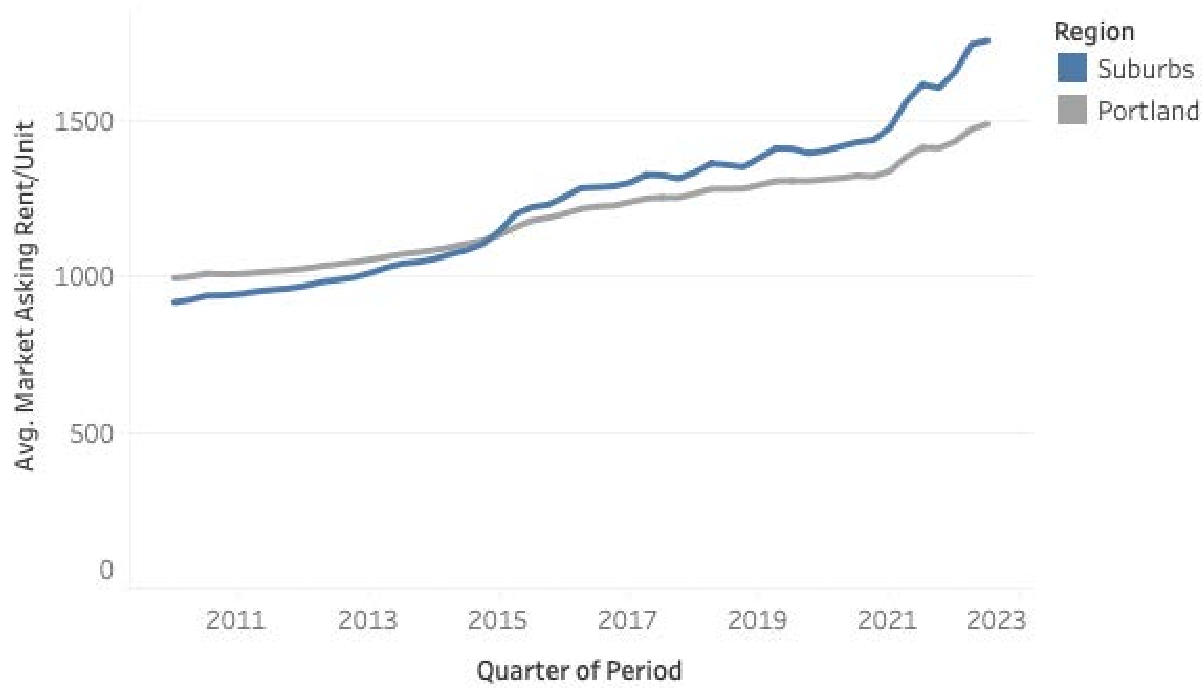
1 *Zarkhin, Fedor. (2022, Jul 11). Multnomah County lost 12,000 people in past year. Here's who drove those declines. The Oregonian.*

Market Asking Rent Per SF | Figure 2



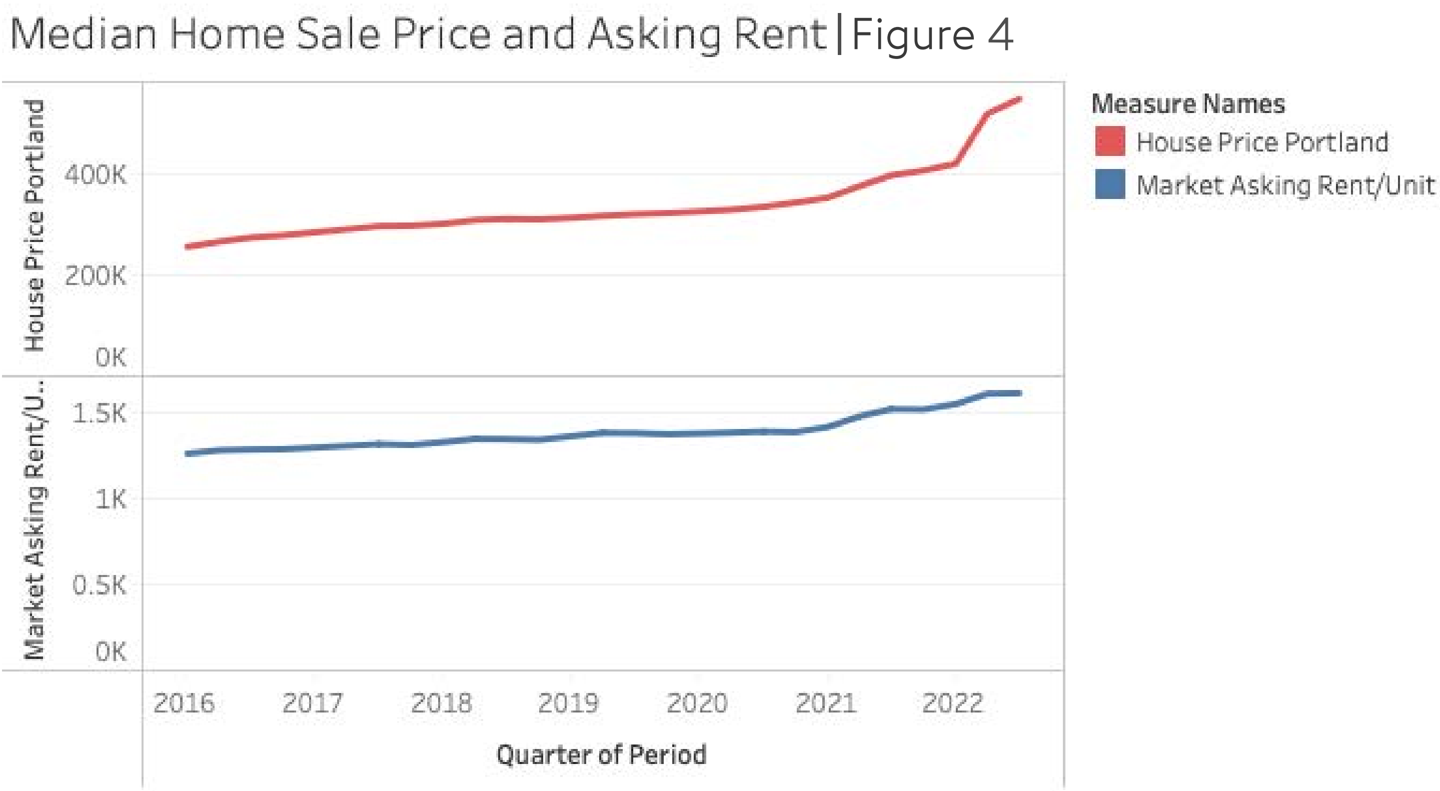
Costar

Market Asking Rent Per Unit | Figure 3



Costar

There are plenty of opportunities for rent increases in the near term for Portland rental residential properties. As interest rates rise and home ownership becomes less affordable, demand for rental units has been increasing, keeping vacancy rates low and rental rates growing. Interest rates for a 30-year fixed rate mortgage have risen from 3% at the end of 2021 to just over 6% at the end of June. In addition to rising interest rates, Portland's median home price continued to grow in the second quarter. Figure 4 represents Portland's median home price and asking rent from 2016 to 2022. The data shows that, aside from rising interest rates, home prices alone have risen significantly. Rental rates across this time show similar increases, albeit not quite as steep. Buying a home in Portland has become noticeably more expensive in the last quarter. In July, Redfin released a report citing that 14.9% of all homes nationally that were under contract in the month of June fell through.[2] This is the highest percentage on record with the exception of March and April of 2020, when uncertainties around the pandemic briefly stalled home sales. The increased demand for rental housing should keep vacancy rates low and rental rates growing in the near term. Regarding housing prices going forward, it is possible that sellers will be willing to lower prices as supply begins to build up and homes sit on the market longer. In light of the current market times, which are historically low, it may take quite a while until prices drop significantly.

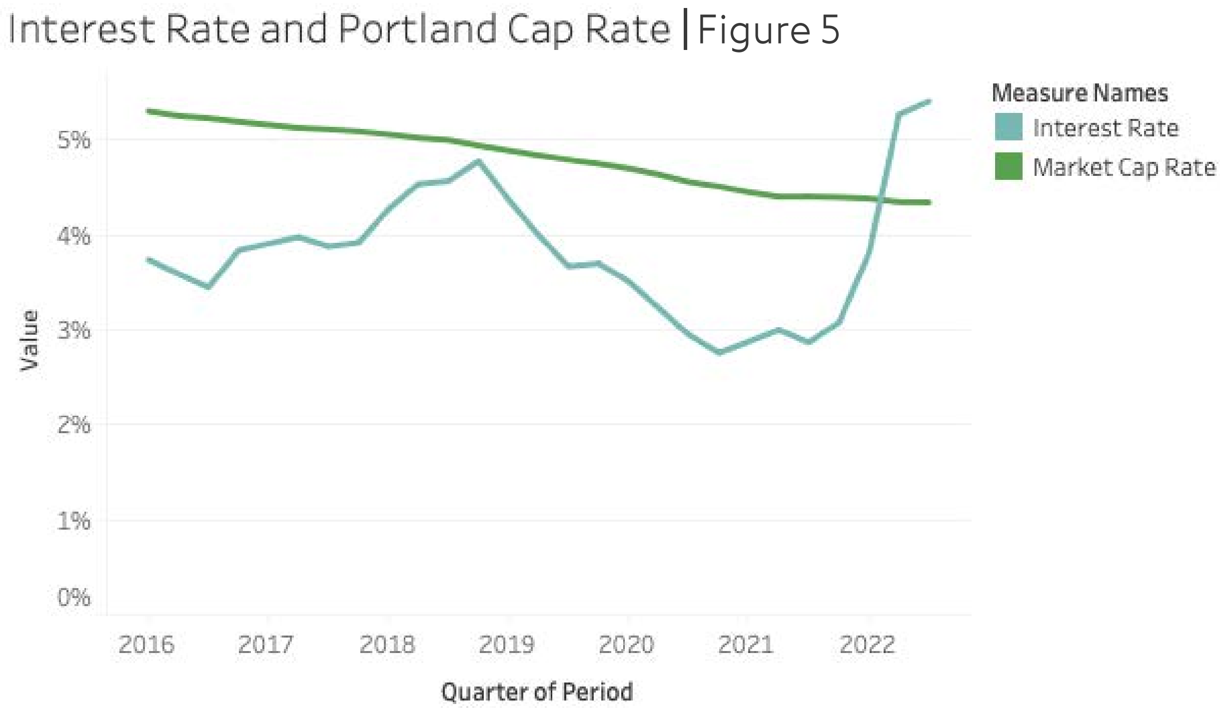


St. Louis Fed FRED Economic Data, Costar

2 *Katz, Lily. (2022, Jul 11). The Deal Is Off: Home Sales are Getting Canceled at the Highest Rate Since the Start of the Pandemic. Redfin.*

CAP RATES & SALES ACTIVITY

Despite gradually raising interest rates in the second and third quarters, market cap rates across Portland and its submarkets remain remarkably low. Figure 5 plots interest rates and Portland's cap rates since 2016. At 4.37%, Portland's third quarter cap rate is down .06% from one year ago and remains well below the national average cap rate of 5.0%. Cap rates in most suburbs are even lower. Beaverton entered the third quarter with a 4.22% cap rate, while Sherwood/Tualatin and Hillsboro were even lower, at 3.93% and 3.86%, respectively.



Freddie Mac, Costar

That investor demand is continuing to push cap rates down despite the rising cost of ownership signals the strength of the rental residential market in Portland, with investors willing to accept lower returns. According to CoStar, Portland saw an uptick in value-add investments during the second and third quarters as confidence that older Class B and C buildings have upside potential grew among investors. Lower cap rates may have reflected this trend as investors look to maximize their returns. With Oregon's adoption of rent control in February 2019, which caps annual rent increases at 7% plus inflation for assets 15 years or older, the uptick in value-add investment last quarter is surprising. With less potential for annual rent growth, value add investments for properties 15 years or older assume a higher degree of risk. That lower cap rates are potentially motivating investors to take on riskier projects for higher returns provides interesting insight into how investors navigate a market through regulations and economic periods.

Analysis of transaction data further underscores investor demand for the Portland market. With an average price per unit reaching $293,041 at the start of the third quarter, investors in the Portland metro area are paying well above the national average of $259,196 per unit. Sales volume in the second quarter exceeded $879 million, nearly double the sales volume in the first quarter. Overall, 12-month sales volume is up nearly 63.6%. Two of the second quarter's largest multifamily transactions occurred in Hillsboro and Beaverton and came from institutional investors.[3] Suburban submarkets are becoming increasingly more active than Portland.

It is likely, however, that the market has yet to fully adjust to rising interest rates. A degree of uncertainty in even near-term market conditions remains among local investors. Steve Rose, CEO of Portland-based real estate investment and management firm Bristol Urban Apartments, shares this sentiment. "There will be an inflection point;" Rose says, "a point where investor requirements for a return will exceed what the market can deliver given current cap rates. We may well be there but it is too soon to say with any degree of certainty."[4] In true cyclical fashion, when we do get to that point, we will see deals sitting on the market longer and cap rates gradually pushed back up.

It will be key to keep an eye on investor behavior over the next several quarters as cap rates begin to adjust to raising interest rates and an inflationary environment. With less available capital and higher rates in alternative investments, investor activity should slow as cap rates level up. The effects of an investor slowdown could be far-reaching and impact key metrics tied to the overall health of the Portland market.

CONSTRUCTION

The second quarter showed no signs of improving Portland's housing shortage. With just under 7,000 units under construction in the Portland Metro area, housing supply will only increase by 3.2%.[5] As with

3 CoStar. (2022). CoStar Portland Multi-Family Market Report. Washington DC: CoStar

4 Steve Rose, Interview by Author Jul 19, 2022.

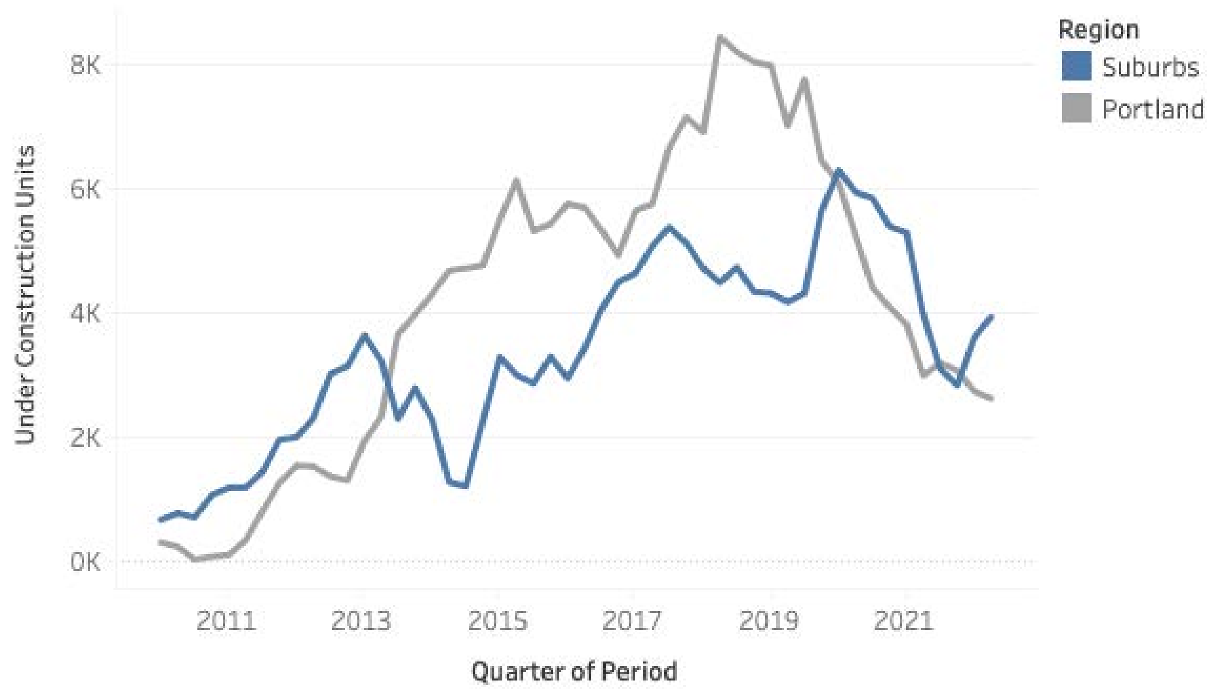
5 CoStar. (2022). CoStar Portland Multi-Family Market Report.

prior quarters, skyrocketing construction costs, relatively stagnant rents, coupled with Oregon's inclusionary zoning laws, have developers seeking other markets.

In line with strong rental growth and lower vacancy rates, the suburbs are seeing more new units under construction than Portland. This is particularly the case in Vancouver, where developers do not face the burden of inclusionary zoning or tenant displacement relocation payments.[6] As a result, roughly 1,800 of the 6,900 units under construction in the Portland market are located in Clark County.

Figure 6 plots under construction units in Portland and the suburbs since 2010. Construction of new units in Portland generally followed an upward trend starting in late 2010 and peaking in the second quarter of 2018, before inclusionary zoning kicked in. Since that time, construction of new units has been steadily declining in Portland. The suburbs experienced a slightly more volatile path since 2010, with several peaks and valleys. However, in the first quarter of 2020, the suburbs surpassed Portland in new under construction units.

Under Construction Units | Figure 6



Freddie Mac, Costar

While they briefly dip below Portland in the fourth quarter of 2021, the suburbs once again surpassed Portland in new units under construction in the first quarter of this year.

6 *Washington DC: CoStar*

LOOKING FORWARD

As with the prior quarter, interest and inflation rates will remain significant catalysts driving investment metrics for rental housing in the quarters to come. While the cost of ownership for prospective homebuyers is increasing, the commensurate increase in demand for rentals as potential buyers are priced out of the market should provide ideal conditions for increased rent growth and sustained rental residential demand. Cap rates over the next quarter indicate investor confidence in the Portland market. The market will continue to grapple with ways to address the region's housing shortage. Despite the passage of House Bill 2001 in 2019, which allows for increased density on previously zoned single-family lots to encourage development of more affordable multifamily units while preventing urban sprawl, rising construction and land costs will continue to pose a challenge to the viability of new construction. Increasing replacement costs for new construction will place additional pressure on residential pricing in the market.

Whether or not Portland will be able to sustain its continued growth and current impressive investment trends amid the changing economic environment is unknown. Should we find ourselves in a recession, if we are not already in one, the strength of the market and the widely accepted notion that multifamily and rental housing are recession-proof or at least recession resistant investments will be put to the test.

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COLUMNS

Return to the Office

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The near-term outlook for the office market is mixed as Downtown Portland grapples with the lingering effects of the COVID-19 pandemic and the civil unrest that rocked the city in 2020. As the second quarter comes to a close, nearly two-thirds of office workers continue to work remotely or in a hybrid environment, and it does not appear that they will return en masse anytime soon. In June 2022, the city of Portland conducted a survey of approximately 3,500 municipal employees (nearly half of its workforce) and discovered that a majority of workers had no interest in returning to the office full-time. Moreover, three-fifths of respondents said that they would quit if they were required to report to the office for more than two days per week. Nike and Intel, the region's two largest non-healthcare, non-government employers have adopted hybrid work policies as have other tech companies such as Google, Apple, and Microsoft, all of which have offices in the region. Portland, along with other west coast markets, is struggling to fill tech office space as many major tech headquarters have implemented a permanent hybrid or fully remote work offering. Not requiring employees to return to the office has influenced the overall trends of tech office leasing and had a significant impact on the office market overall.

The absence of office workers has reduced foot traffic in the CBD which has contributed to substantial retail vacancies at the street level. This lack of activity has been blamed for increased levels of crime and homelessness. According to Portland Police Bureau crime statistics, there were 905 "person crimes" for the year ending (YE) in June 2022, compared to 870 in the year ending in June of 2019 – a 4% increase from pre-pandemic levels. However, property crimes were up 23% over pre-pandemic levels (3,539 YE June 2019 | 4,369 YE June 2022). Consequently, the weak demand for office space coupled with the perceived safety risks has resulted in ballooning sublet availabilities and increased vacancy rates. The current climate has many companies reevaluating their space needs and spurred a trend toward relocation to the suburbs.

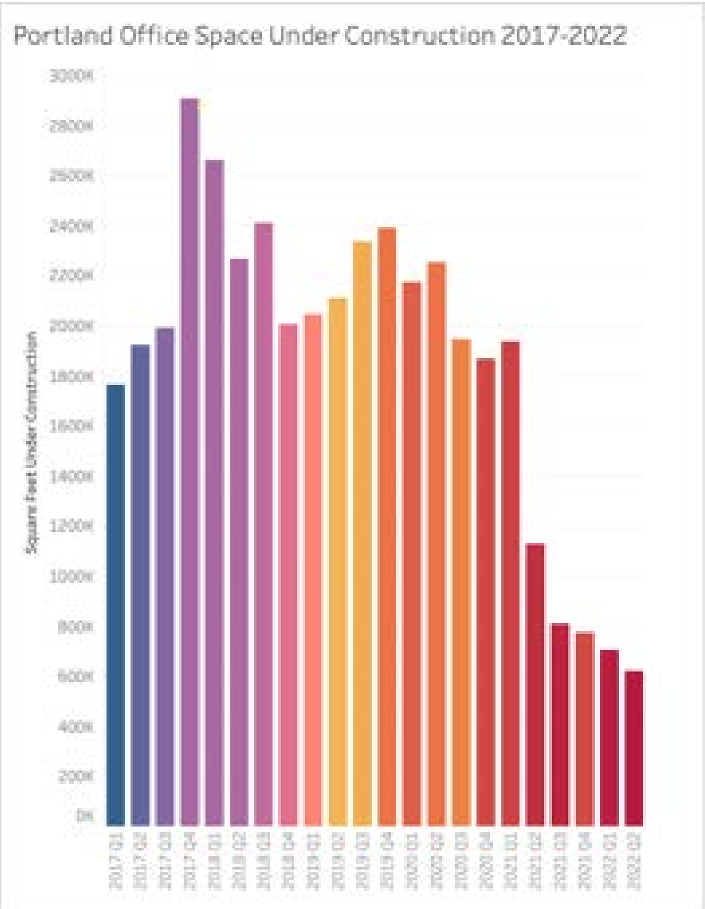
ECONOMY | EMPLOYMENT

While the Portland office market continues to experience challenges, the regional economy remains strong. Despite record high inflation, the local economy was resilient throughout the second quarter, and in many aspects is outpacing the U.S. economy overall. The unemployment rate dropped to 3.1% in May 2022, a 210 bps decrease year over year (YOY) (5.3% May 2021). Over the past year, the local economy added 69,000 non-farm jobs – a 5.9 % increase YOY which was markedly better than the larger U.S. economy (4.5%). In addition, Portland maintains steady population growth, has incomes that exceed the national average, and has a skilled workforce with education levels well above the national average. Notwithstanding, the Federal Reserve raised the federal funds rate by 75 bps in June in an attempt to curb inflation, and has warned of additional rate hikes in the coming months. Moreover, the U.S. economy shrank by .9 % in Q2 making two consecutive quarters of negative GDP growth. While most analysts agree that we are not currently in a recession, we could be headed there by year-end. Oregon's expansions and recessions typically align with the nation, but tend to be more volatile, which can result in more severe stagnation, yet stronger recoveries – leaving the future of the Portland office market in a state of uncertainty.

SUPPLY | DEMAND

Portland office market vacancies began to surge in the second quarter of 2020 and continued to increase as the quarter came to a close. The Portland metro area office market had an overall vacancy rate of 18.3%, which is 370 bps higher than the previous quarter (14.6%), but 460 bps higher than the same period last year (13.9%). The CBD saw the biggest increase as it had an overall vacancy of 24%. This was 228 bps higher than the previous quarter (21.72%) and 720 bps YOY (16.4%). Despite elevated vacancy rates, the quoted rental rates remained relatively flat seeing a $0.42 increase for the overall market and $0.25 for Class A space. These trends are largely driven by companies choosing not to renew leases or give space back to the sublease market. With fewer workers reporting to the office on a daily basis some companies are moving their offices to the western suburbs in search of cheaper rent and less space.

Leasing activity was slower than in the first quarter but the Portland West suburban market outperformed the CBD. The overall office market added 485,000 square feet of occupied space, 61% of which occurred in the west suburbs – with large transactions at 217 Corporate Place in Washington Square (29,000 square feet) and Kruse Oaks in Lake Oswego (13,000 square feet). The vacancy rate in the suburban office market was 12.4% which is significantly lower than downtown and the market overall. Among the businesses that have moved or have announced plans to move are Umpqua Bank, Unitus Credit Union, and JE Dunn. This has led to record sublet availabilities that exceed 1.7 million SF – 13% of which is concentrated in the downtown core. While there have been some businesses leaving, several have reinvested in office space in the CBD. Trimet is moving its administrative offices to the 95,000 SF One Main Place, and Legacy Health has leased space in Slabtown.



CONSTRUCTION | DELIVERIES

Portland saw a surge in office building construction following the 2008 recession. In 2018, 3 million square feet were under construction. In contrast, today there is less than 650,000 square feet under construction with 60% of the active development occurring in the CBD. There have been no new starts in the last year. In the second quarter of this year, Block 10, a 75,000 square foot office, was delivered in Vancouver and is 67% leased. One new construction project of note is the 167,000 square foot Block 216, a 35-floor office tower on SW Washington. Additionally, a 117, 285 square foot office space will be fully available for direct lease in 11W.

CONCLUSION

The increased vacancies and stagnant rental rates will likely continue near-to-mid term as many workers prefer to work remotely. Furthermore, the U.S. labor market remains strong with two job openings for every available worker making it difficult for companies to mandate a return to the office. This dilemma is not unique to Portland, as many major U.S. cities struggle to attract workers back to their urban cores. When the dust settles, class A office space will likely become more affordable and attractive to companies that previously could not afford it. In the mid-to-long term, rising rents of office space in the suburbs will likely draw businesses back to the CBD. However, the city may need to reimagine the existing office space before it experiences a full recovery.

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08

COLUMNS

Retail Market

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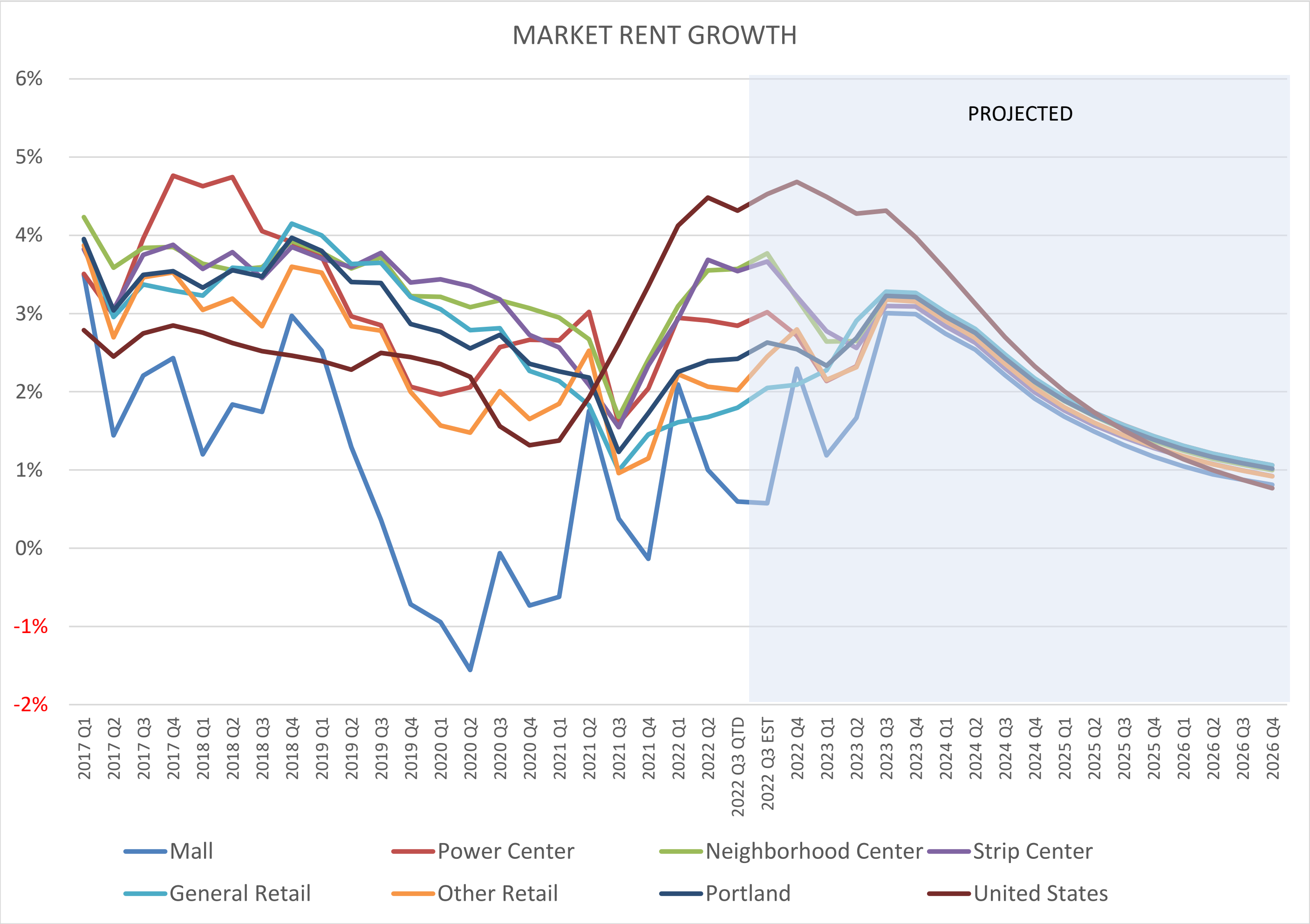
The spread of COVID-19 in 2021 significantly impacted the local retail market, but the decline in pandemic-related restrictions during 2022 has allowed for there to be a rebound for retail in the Portland metro area. The State of Oregon largely dropped the mandate for masks during the first quarter which has allowed for an exciting return of the pre-pandemic life during the second quarter. Oregon was one of the last states to continue the COVID-19 restrictions, and the ending of them has led to a commensurate increase in foot traffic and travel in general. Overall, sales are picking back up because people have fewer limitations. The trends that will be highlighted through the second quarter are the average rents, vacancy rates, new construction, and market absorption



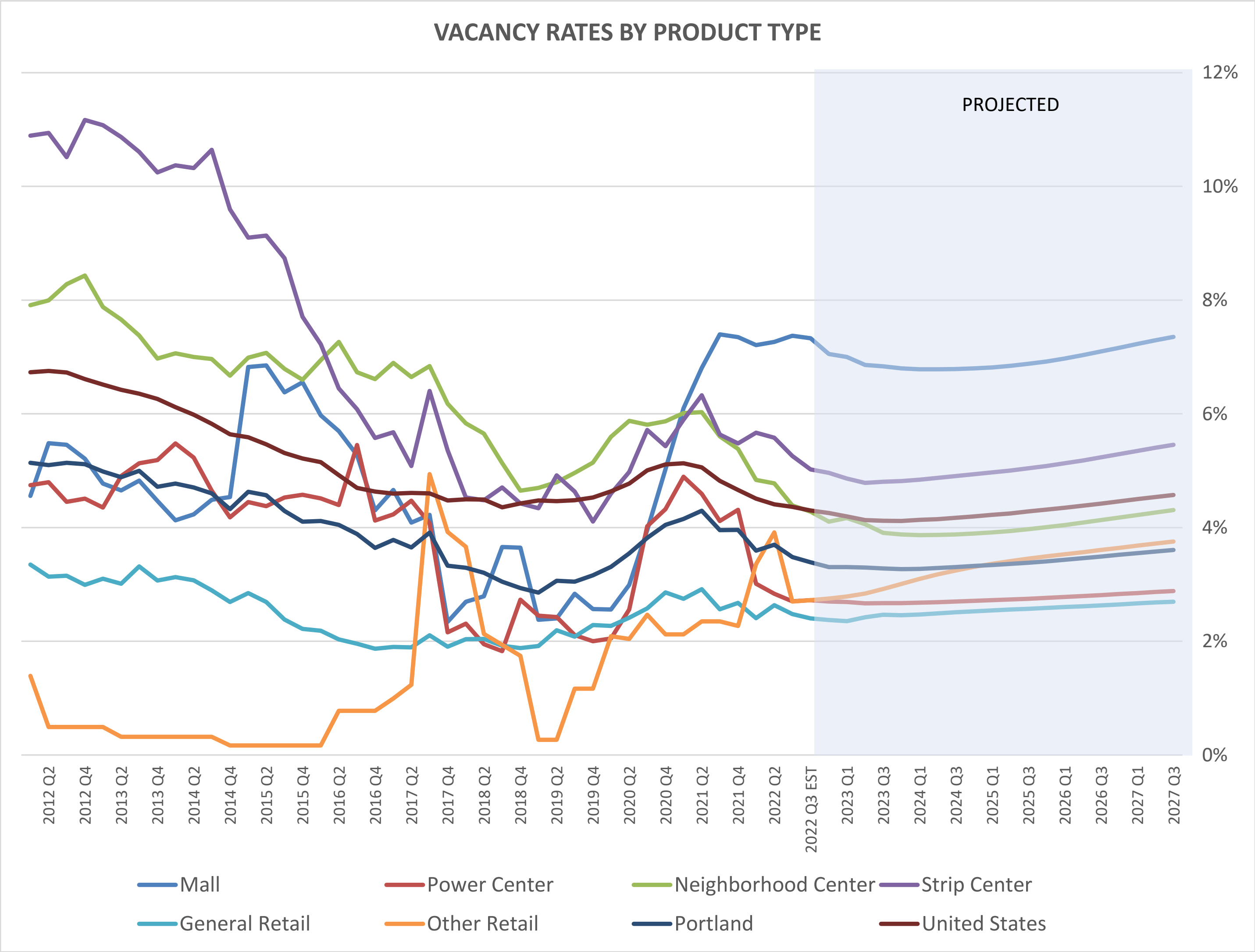
The demand for physical in-person retail space is on the rise this summer, coinciding with the reduction in restrictions and the seasonal tourism. Portland is a beautiful city that has a lot to offer, but it has been three years since people have not had some level of COVID-19 restrictions. This summer has opened an opportunity for a boost in retail-based employment. CoStar already reports that Portland is rebounding well from the pandemic lows the past few summers. Employment in the retail trade sector posted a change of 2,463 jobs from a year ago. Retail leasing is seeing a trend upward which is catching up to the historical averages.

The average rent level in Portland grew 1.9% during the quarter, with gains of 1.8% year-over-year. The national gains are 4.4% over the same period.

Comparing the urban cores and the suburbs when it comes to rent growth shows that the best performances have been in the suburbs. The rent in the suburbs for places like Airport Way, Gresham, and Oregon City have posted year-over-year growth in excess of 3%. These areas do not tend to draw many active shoppers, but they have shown to have a stable employment base and are closer to residential concentrations. The cost of living in such areas has encouraged more residents to live there, increasing local buying power which supports local retail businesses. These factors have allowed businesses to keep their occupancy rates higher and expand their services. These factors have also resulted in rising rent levels.

According to CoStar, the overall vacancy rate in the Portland metro area retail market was 3.5% at the end of the second quarter, compared to the national average of 4.4%. The overall retail vacancy rates have gone down 0.65% since last year. The asking rent per square foot at the end of the second quarter was $21.00 and the vacancy rate was around 3.5%. The vacancy rates have been a roller coaster for the past ten years while the asking rent per square foot has steadily increased. Rates decreased steadily from 2012 to 2018 and then skyrocketed in 2020 due to the pandemic. The vacancy rates are slowly dropping as we focus on the light at the end of the pandemic tunnel.

Over the last four years, there has been more demolition of retail spaces than construction of new ones. There were less than 500,000 square feet of new retail space that was built in the Portland metro area during the last four years, while roughly 625,000 square feet were demolished during the same period. This has helped in some ways by reducing inventory in a weak market, but it hurt the retail market as well. It has helped because of the decline in demand that occurred during the worst pandemic months. It mitigated those damages during those challenging times. Consequently, there has been noticeably limited leasing availability. The new deliveries have been focused on the suburbs of the Portland area, which are the most desirable right now. Developers are focusing on them because they are experiencing significant population growth and shifting back to in-person activities as the health situation improves. The suburbs have also benefited from the growth in working at home, which has increased local buying power and daytime populations.



SALES AND ECONOMY

Investment for the retail community in Portland has been doing well, catching a "tailwind", as CoStar has put it. Retail investments are usually less than office, industrial, or multifamily, but we are starting to see the annual investment for retail go up post-pandemic. The Portland metro area's economic recovery has been incremental. The food service industry is still struggling with unemployment, but it is nowhere as bad as it was during the pandemic. It is quite interesting that consumers have shown to be spending in resilient amounts despite the intensely high inflation rates. Consumers are wanting and willing to travel. They appear excited to get out and spend, which may be a response to the pandemic-era restrictions. In Portland, there has been a focus on adding payrolls for hotels and other similar services.

CONSUMER BEHAVIOR

Coldwell Banker Commercial Atlantic published a fascinating article on a topic that is highly relevant to the estate retail market. Consumer behavior has been a popular conversation recently as we are coming out of a pandemic that trapped shoppers inside and had them focus heavily on online shopping. Consumer behavior has changed drastically over the past two years. In the article, it states, "the rise of omnichannel, shifts toward hybrid work, the growth of leisure activities, and increased economic uncertainty all contribute to rapid and unpredictable changes in when, how, and where consumers shop." The retail strategies have evolved quite a bit in recent years. The three main ones that have changed are chain-level considerations, shelf-level arrangements, and product-specific decisions. The strategy that is discussed for chain-level considerations is when to open stores. Store hours have changed because a lower percentage of workers have a defined 9 to 5 workday which was common before the pandemic. More people now work remotely from home which changes when the best time is to open stores. The shelf-level arrangements focus on the placement of products and the product-specific decisions are for pricing, marketing goods, and packaging.

A common theme during the pandemic for consumers was "mission-driven shopping." This phenomenon occurred when shoppers would try and take as few trips to the store as possible. That means that they would load up on supplies for the house so that they would require fewer visits and reduce their exposure risk. The past few months have seen an opposite trend. With more foot traffic than in the past few years. Now shoppers make more frequent trips, but they acquire less from the stores.

These consumer behaviors have impacted their in-store behavior. Promotion strategies are changing because consumers are not buying the same products that they were the past two years. For example, Macy's has seen a shift from consumers who are trying to find clothes for special occasions. Another item they noticed is that consumers have been shopping for women's dresses and tailored men's items. The obvious substantial change is that public events are happening more often which means people need clothes for those events. Styles change all the time and now that we are returning to normal life there will be a shift in styles and shopping strategies compared to the last two years.

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