# CENTER FOR REAL ESTATE

## QUARTERLY REPORT

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# 01

INSIGHTS

# Residential Quarterly Production Report


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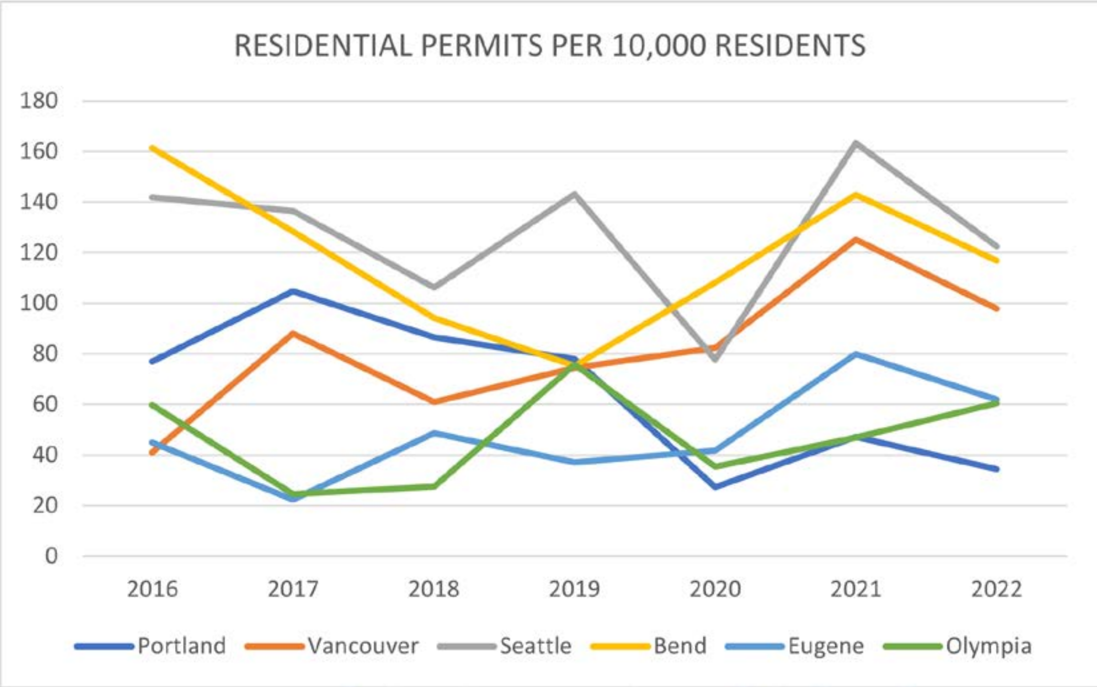
As we wrap up the data for 2022 a few trends become clearer. In previous articles I have highlighted how Portland's volume of residential permits has continued to decrease since 2018, alarmingly so considering the increase in volume of every other permitting body in this dataset. The idea to quantify permit volume in a per capita ratio of permits per ten thousand residents came about last summer as a way to better understand Portland's production volume compared to other cities and counties in the region. In calculating the overall per capita volume and percentage of regional production, it is clear that both Multnomah County and Portland (which issues the vast majority of residential permits in the county) started to see a decline in volume in 2019, a pattern which continues today.

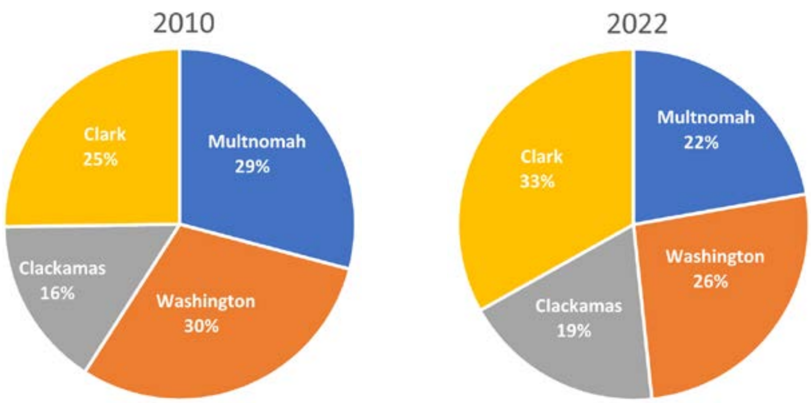
U.S. Census Bureau




In 2010 Multnomah County's regional share of residential permit production was 29%. Eight years later, it reached a high of 48%. In 2018, Multnomah County's share of regional permit production started falling, from 38% in 2019, to 21% in 2020. We saw a slight increase in 2021 to 25%, but it fell again to 22% in 2022. The county's overall share of single-family residential permits, as compared to the total county volume, stood at 28% in 2022, an increase from only 20% in 2021, with the lowest percentage in 2019 at only 15%.

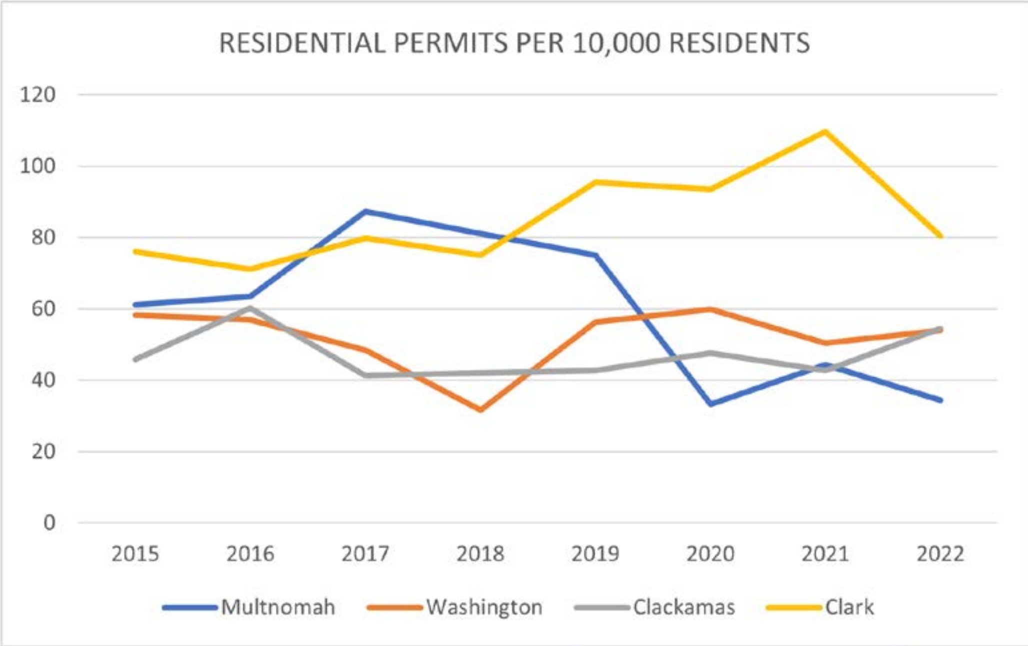
U.S. Census Bureau

**REGIONAL RESIDENTIAL PERMIT VOLUME BY COUNTY**



When comparing county permit volume per ten thousand residents the data is even clearer. Since reaching a local high of 104.8 permits per ten thousand residents in 2017, the rate drops considerably to 33.2 in 2020, in stark contrast to the other counties rates of production.

U.S. Census Bureau




Continuing the comparison of all new residential permits per ten thousand residents we see again that Portland's permit production falls well below that of other cities in the region. Overall, Portland's BDS issued 34.3 residential permits per ten thousand residents in 2022 compared to 47.2 in 2021, while Seattle issued 122 permits per ten thousand residents in 2022, a decline from 163.2 in 2021. A look at other cities in the region shows that Bend issued 116.9, Vancouver issued 97.9, Eugene issued 62, and Olympia issued 60.4 permits per ten thousand residents in 2022. Olympia was the only City to see an increase in this rate, the city only issued 47 permits per ten thousand residents in 2021, while every other city in the dataset saw a decrease from their 2021 volume.[1]

With a new governor focused on housing production and an acknowledgement of the current housing shortage, we would not be remiss to expect the largest city in the state to lead the way with new development, especially since the elimination of exclusive single family residential zoning, but so far the numbers show that Portland and Multnomah County both are seeing a steady and continuous decrease in residential permit volume this decade compared to the previous decade. How can we meet the state's production targets and continue to accommodate internal growth, not just make up for the lack of under building in years past, if our largest City is continually decreasing their rates of residential development?

## THE CASE AGAINST SINGLE FAMILY ZONING

A recent study estimated Oregon's housing shortage at over 110,000 units[2] and its houseless population at just over 18,000 (2022 HUD Report). In fact Oregon is one of the five states with the largest increase (22.5%) in the number of unhoused residents since 2020[3]. The other states on this list include California, Louisiana, Tennessee, and Arizona. Just like the solution to hunger is food, the solution to homelessness is housing. This is literally a problem we must build our way out of, but in many communities land is one of the largest supply elasticity constraints. Where do we put all this new housing while preserving our farms and natural resources?

Oregon made history in 2019 with SB2001, becoming the first state in the nation to effectively eliminate single family zoning for all towns with populations over ten thousand people. This means that in areas of town where the zoning code formerly only permitted one home per parcel, the zoning code now allows two. Portland went a step further and now allows between two and six units on a lot formerly designated for only one. This new infill and multi-family housing, also known as "missing middle" housing, introduces a variety and diversity of residential accommodations in an otherwise homogeneous neighborhood. In the few years since, only two other states passed similar statewide legislation, California and Maine, while Washington state is currently debating their policy in the state senate. This pushback against exclusionary zoning is the beginning of the political movement to properly address the roots of the current housing crisis.

"The recent passage of local ordinances and state laws…signal a desire to move away from single-family zoning in order to redress its racist origins and to increase racial equity in housing and neighborhood access."[4]

As mentioned in a previous policy analysis on inclusionary zoning and the issue of affordable housing, exclusionary zoning is the process of placing legal restrictions on the types of housing that can be built in a specific neighborhood. Restrictions can include, but are by no means limited to, aspects like minimum lot sizes, large setbacks, height restrictions, off-street parking requirements, and outright bans on multi-family housing.

In terms of housing supply and affordability the simplistic supply and demand concept needs no further embellishment. When housing supply is restricted, the value of homes increases. Thus, to alleviate the constraints on supply and mitigate the runaway inflation of home values we must lift restrictions that prohibit housing development in all forms. This includes removing exclusive single family residential zoning across the board, but in order for this policy change to have the most impact it must go hand in hand with parking reform. This, more than anything else, can hinder or spur development. To simply allow for duplexes, or other middle density housing typologies, without alleviating the often onerous and unnecessary requirement to provide off-street parking is a legal and guaranteed way to undermine the efficacy and intention of this policy.

Oregon followed SB2001 with an administrative move by the State's Land Conservation and Development Commission. Taking effect on January 1st, 2023, this new rule eliminates parking requirements in residential areas within half a mile or less of a transit stop. This comes with two big carve outs though, it only applies to homes under 750 square feet or less, and only in the eight largest metro areas. While the state put an outright ban on parking minimums for affordable housing, this too only applies to the eight metropolitan regions. It is as if the state does not realize that rural communities face the same land use restrictions and parking requirements that inhibit residential development just like the larger cities do. This is in no way an argument for a ban on parking, rather a plea to let developers make the decision on how much parking is needed provided the location and target market of

1 *K.R. Andersen. "SOCDS building permits database: Query results." Quarterly Report: Building Permits Database. https://socds.huduser.gov/permits/output_monthly.odb*

2 *April Ehrlich. "Oregon has an extreme housing shortage. Here's what could be done," OPB, July 26, 2023, https://www.opb.org/article/2023/07/26/oregon-cost-of-living-housing-construction-building-land-use-high-rent/.*

3 *Meghan Henry, et al. "The 2020 Annual Homeless Assessment Report to Congress". U.S. Department of Housing and Urban Development, Office of Community Planning and Development, January, 2021, https://www.huduser.gov/portal/sites/default/files/pdf/2020-AHAR-Part-1.pdf.*

4 *David Garcia, et al. "Unlocking the Potential of Missing Middle Housing," University of California Berkeley, Terner Center for Housing Innovation, December 7, 2022, https://ternercenter.berkeley.edu/research-and-policy/unlocking-missing-middle/.*

their project.[5] We need to instill "smart growth" principles in town planning across the board, not only once municipalities reach a specific population benchmark.

Speaking strictly from a financial and infrastructure standpoint, urban sprawl carries many more costs than infill development, such as the creation of new roads, extension of the power grid and plumbing/water systems, etc. resulting in a cost increase of 10%-40%. According to a recent study by the Global Commission on the Economy and Climate, "Analysis of Public Policies that Unintentionally Encourage and Subsidize Sprawl" urban sprawl costs the country one trillion dollars every year, or $3000 per person.

"The most sprawled American cities spend an average of $750 on infrastructure per person each year, while the least sprawled cities spend close to $500."[6]

The "smart growth" principles embodied in this movement support an increase in diversity of housing typologies within existing cities, providing more opportunities for families of different sizes and economic means. Often referred to as "missing middle housing", residential types include duplexes, triplexes, four-plexers, cottage clusters, row houses, etc. This is a mid-density, multi-family development that can fit on an existing standard single-family residential lot. By responsibly increasing density a city can reduce the per person cost of infrastructure. Likewise, increased density provides more people with a closer proximity to schools and stores, meaning urban areas can decrease driving times and have a positive impact on air quality.

In 2019, when SB2001 was first introduced in Oregon, duplexes were outlawed in over 77% of residential areas of Portland, the state's largest city.[7] In Seattle, single-family zoning, which didn't exist until the 1923 comprehensive plan, occupies over 80% of the residential area.[8] In Germany, the country that originated the idea of the "use based" (as opposed to form based) zoning, exclusive single-family zoning doesn't exist. Instead, their lowest density zoning allows for single-family homes, pubs, restaurants, shops, and small apartment units. The same is true in countries including Switzerland, Austria, and Japan. Contrary to the oppositions' claims of elimination, no policy existing or proposed bans the construction of single-family homes.[9]

When developers and/or property owners have pricing power due to tight market conditions and limited incentive to build more units, housing costs increase. In a healthy supply and demand market, the production of the commodity meets the general need for more supply, which eases the demand and helps stabilize costs, maybe even bringing them down. In the US, the focus on housing as a commodity rather than as a basic human right causes a greater degree of consumption by those with wealth. Since housing is a reliable vehicle for wealth generation through asset inflation, it is coveted by people and corporations seeking to maximize their return on investment. By hoarding a commodity investors create a false shortage in the market, keeping prices high. To counter this type of manipulation we must provide a prolific amount of quality, affordable housing; by flooding the market we disrupt the current imbalance and introduce affordability through proliferation. Policies like SB2001 enable this proliferation of housing by opening up more development opportunities for a variety of housing typologies in existing neighborhoods.

Another aspect of this argument against single use zoning is perfectly illustrated in the current crisis of empty office space. A reliance on single use zoning creates

5 *Michael Manville , Alex Beata and Donald Shoup. "Turning Housing Into Driving: Parking Requirements and Density in Los Angeles and New York, Housing Policy Debate," University of California Los Angeles, Department of City and Regional Planning vol 23, no. 2 (2013): 350–375.*

6 *"Release: Urban sprawl costs US economy more than $1 trillion per year," The New Climate Economy, March 19, 2015, https://newclimateeconomy.net/content/release-urban-sprawl-costs-us-economy-more-1-trillion-year.*

7 *Julia Shumway. "White House: Oregon single-family zoning law could be model for Nation," Oregon Capital Chronicle, October 29, 2021, https://oregoncapitalchronicle.com/2021/10/29/white-house-oregon-single-family-zoning-law-could-be-model-for-nation/.*

8 *Mike Eliason. "A brief history of Seattle's anti-urban zoning," Medium, March 1, 2018, https://15kwhm2a.medium.com/a-brief-history-of-seattles-anti-urban-zoning-380e09fd0dd3*

9 *Sonia Hirt. "Mixed Use by Default: How the Europeans (Don't) Zone," Journal of Planning Literature, vol 27, no. 4 (2012): 375–393.*

inevitable weaknesses as industries and technologies continually develop. The technology advances that allowed the workforce to largely shift to remote work during and after the pandemic have gutted neighborhoods and buildings around the country. The inability of these buildings to easily and affordably adapt to other uses compounds the problem of neighborhood decline. Allowing a mix of uses and typologies from the beginning creates flexibility and encourages adaptation. We see this in the natural world, where forests with greater degrees of biological diversity are more resilient to blight, disease, and fire.[10] This is also true in our built environment, where single use zoning districts are inherently predisposed to rigidity through monotonized building typology and use. A lack of flexibility means a lack of adaptation and resilience. Likewise, neighborhoods with a greater degree of physical and programmatic diversity are more resilient to economic shifts as shown by research of mixed-use districts during the pandemic compared to single-use office districts.[11] Diversity matters, even in housing typology and community development, which is why we must continue to lobby for smart growth development principles and against single-use zoning across the board.

10 *Mackey, Brendan, et al. "Forest resilience, biodiversity, and climate change: a synthesis of the biodiversity/resilience/stability relationship in forest ecosystems." Secretariat of the Convention on Biological Diversity, Montreal, Technical Series, no. 43 (2009): 1-67.*

11 *Mischke, Jan, et al. "Empty spaces and hybrid places: The pandemic's lasting impact on Real Estate," McKinsey Global Institute, July 13, 2023, https://www.mckinsey.com/mgi/our-research/empty-spaces-and-hybrid-places.*

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02

COLUMNS

# Industrial Real Estate Research 2022 Q4

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## INTRODUCTION

Like other major U.S. cities, Portland's industrial real estate market is accustomed to local and global shifts. Portland, however, has unique land use regulations and a political environment which have contributed to localized real estate phenomena such as fast rising land costs, unusually low vacancy rates, limited new construction supply, and consistent rent growth. With increased interest rates on debt and many institutional investors on the fence regarding a positive economic future, capital markets have tightened, making it more difficult for developers to obtain debt. The higher cost of debt has made new development deals less feasible, causing a noticeable decrease of new supply in the pipeline compared to the previous four quarters. Higher interest rates have also made owners rethink selling industrial assets due to buyers having less purchasing power and requiring higher rates of return, thus reducing sales volume by 14.2% compared to 2021.[1]

# MARKET ASSESSMENT

### VACANCY AND RENT GROWTH

Continued demand for industrial space from tenants looking to expand and renew leases has compressed vacancy rates for the eighth consecutive quarter. Looking at Figure 1, comparing the 12-month average rent growth to the overall vacancy rate, the vacancy rate has a five year average of 3.9% and a ten year average of 4.4%. These averages depict an overall stable market with a decreasing vacancy rate that gives property owners pricing power and the ability to ask for higher rents. The 12-month rent growth has a five year average of 6.1% and a ten year average of 5.6%. These averages match up with the five and ten year averages for vacancy rate, reflecting that a tighter market increases year-over-year (YOY) rental growth. While there is a general inverse correlation between the Figure 1 data from 2012 to 2022, the fourth quarter has seen a slight decrease in year-over-year rental growth, a positive correlation with decreasing vacancy rates, which could be a result of a decreasing inflation and leasing activity. The 12-month consumer price index decreased from 9.1% at the end of the second quarter to 6.5% at the end of the fourth quarter.[2] Leasing activity during the first quarter was just under 4 million and has decreased to around 1.7 million in the fourth quarter. Overall, Portland's current vacancy rate of 3.4% continues to be below metro's historical average of 6.5% and is 70 basis points (bps) below the national average of 4.1%.[3]

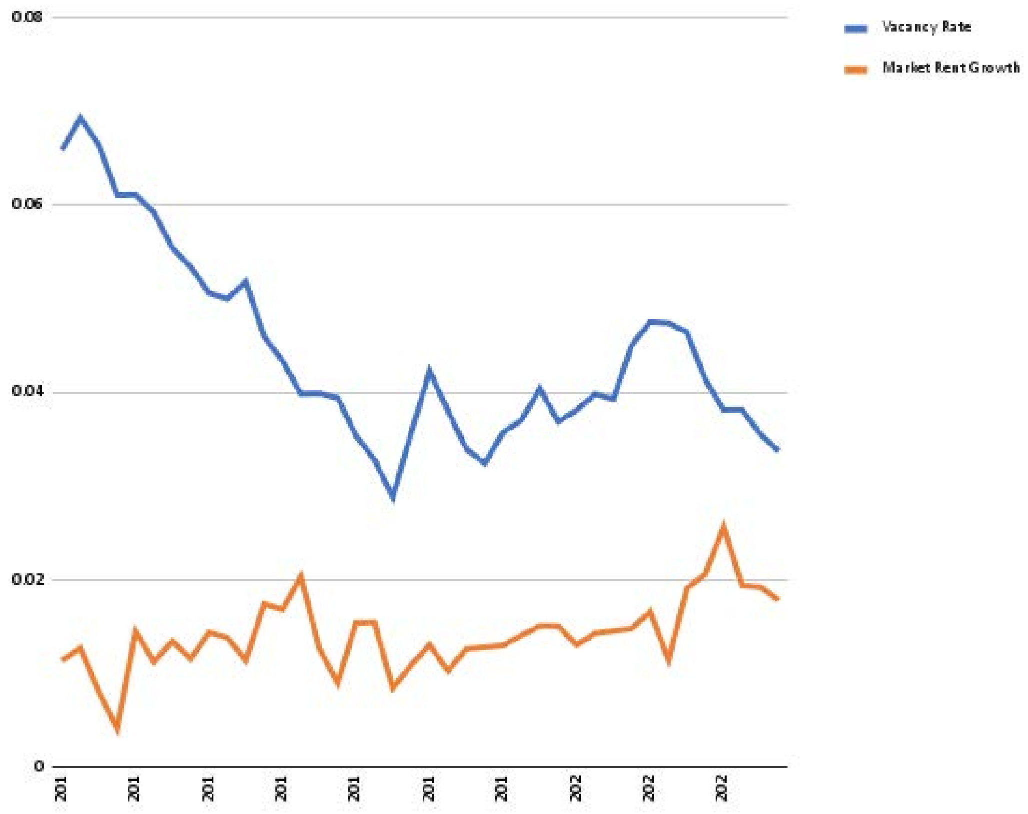
1 *CoStar, Portland Industrial Market Report, May 2023.*

2 *The Economics Daily, "Consumer prices up 4.9 percent from April 2022 to April 2023," U.S. Bureau of Labor Statistics, https://www.bls.gov/opub/ted/2023/consumer-prices-up-4-9-percent-from-april-2022-to-april-2023.htm#:~:text=The%20Consumer%20Price%20Index%20for,month%20increase%20since%20April%202021.*

3 *Norris and Stevens, Industrial Market Report Q4, 2022.*

CoStar

FIGURE 1: VACANCY RATE AND RENT GROWTH 12-MONTH



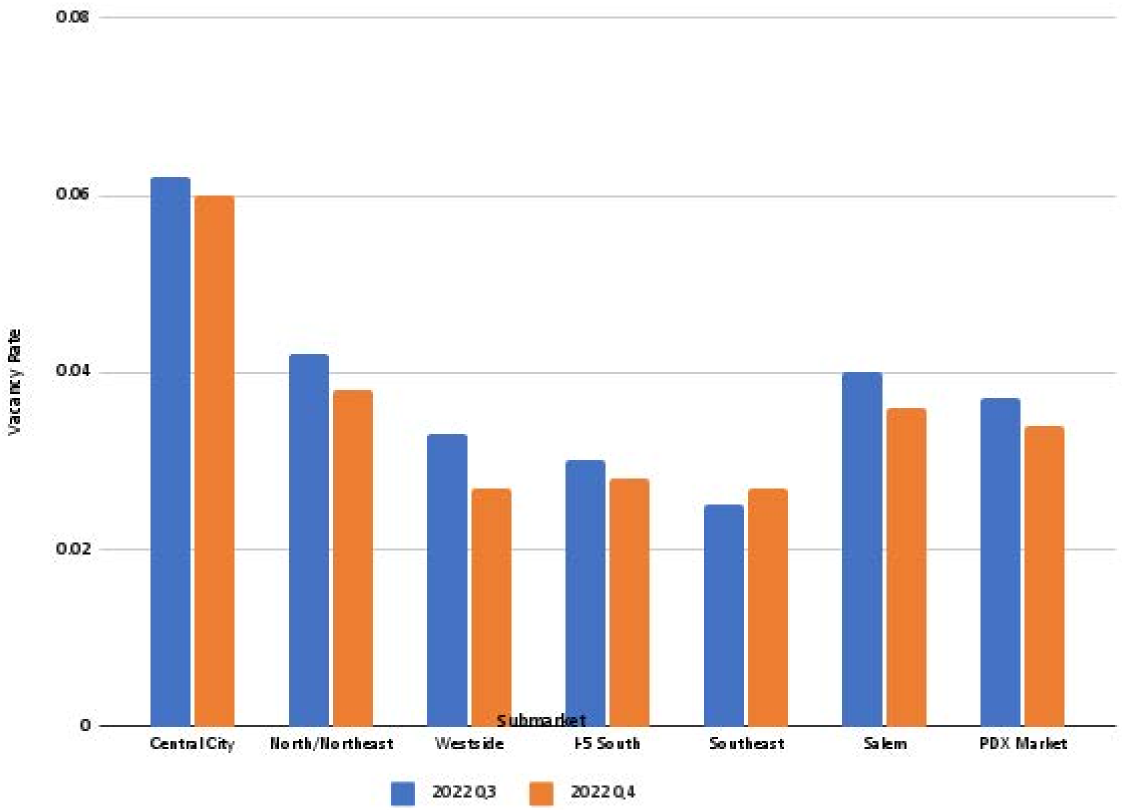

Taking a more in-depth look at vacancy rates in Portland's submarkets, there has been a compression in percent vacancy from the third quarter to the fourth quarter everywhere except the Southeast submarket (Figure 2). The 0.2% increase in vacancy rate can likely be attributed to a negative net absorption in the fourth quarter of 52,067 square feet while 99,948 square feet is under construction.[4] While this increase in vacancy is something to keep an eye on going forward, it does not appear to indicate a larger trend since the net absorption year to date (YTD) was 405,140 square feet.

Looking at Figure 3, there is a fascinating situation where triple net rents shoot past market rents in the second quarter, creating an 8.3% difference. Typically, triple net leases have less expensive base rents since the tenant pays for property tax, insurance, utilities, and maintenance costs. The sharp increase in triple net rents could be a result of property owners having stronger negotiating power than the tenants in this high demand market, as land supply is tight in Portland. This might be a trend that lasts until the tables turn and tenants acquire more negotiating power.

4 Colliers, *Portland Industrial Report Q4, 2022.*

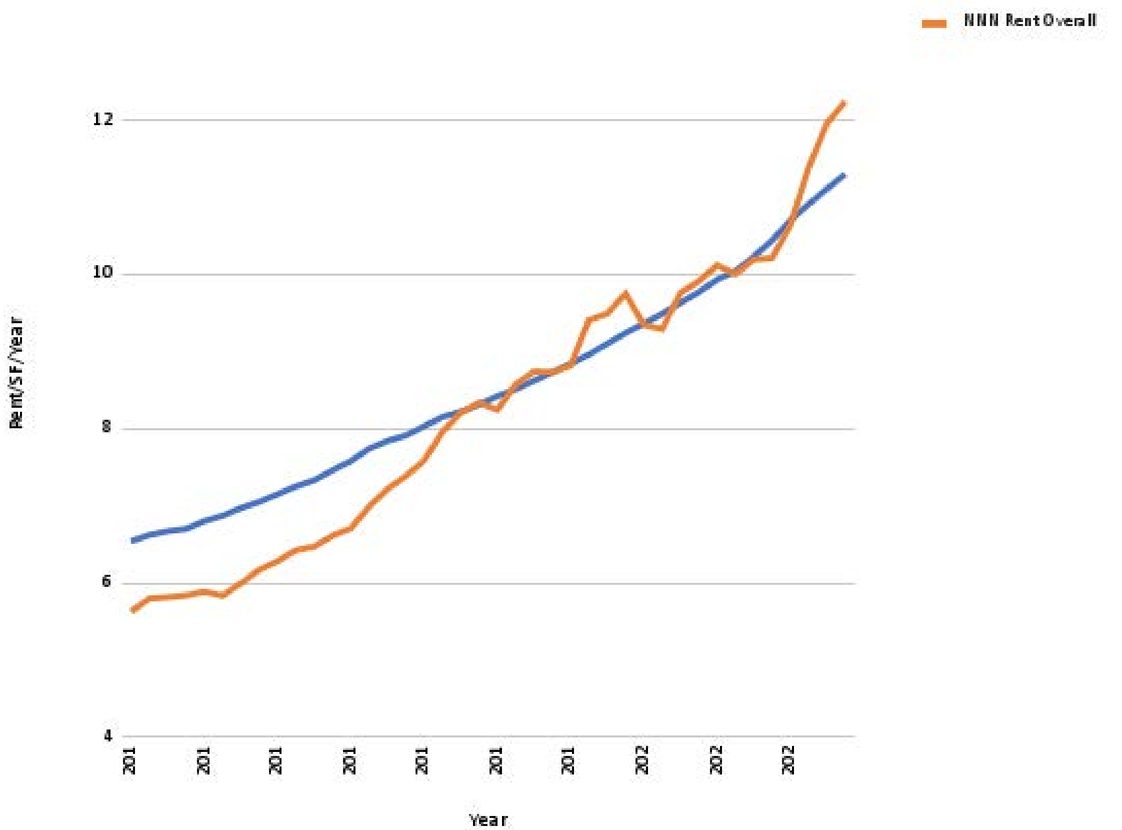
Colliers

FIGURE 2: SUBMARKET VACANCY RATE CHANGE Q3 TO Q4




CoStar

FIGURE 3: MARKET RENT/SF AND NNN RENT OVERALL



## SUPPLY AND ABSORPTION

While industrial absorption and supply continue to stay positive, they have decreased quarterly for both metrics from the second quarter to the fourth quarter of 2023. As illustrated in Figure 4, net absorption has decreased by 47% and net delivered space has decreased by 65%. The cumulative net absorption and delivered square feet has increased from 2021 to 2022. The cumulative net absorption and net delivered space was roughly 3.2 million square feet in 2021 and 2.4 million square feet in 2022. The cumulative net absorption and net delivered for 2022 was 6.5 million square feet and 4.8 million square feet, respectively. This reflects an increase in net absorption of 205% and net delivered space of 199%. While quarterly supply and absorption for 2022 portrays a weakening market, the yearly change from 2021 and previous years indicates a strong market.

The industrial construction pipeline has been limited due to global economic factors, most notably increased interest rates and a tightening capital market. Since the cost of debt has increased, meaning larger cumulated interest over the loan term, developers have been recently having a harder time making projects financially feasible. From a tenant's point of view, there is a lack of confidence in expanding within an uncertain market, reducing demand. On the other hand, build-to-suit projects are still popular, as these tenants have more certainty in their business model during the possibility of a weakening economy. Around 49% of all development under construction in 2022 was speculative and remains available for lease.[5]

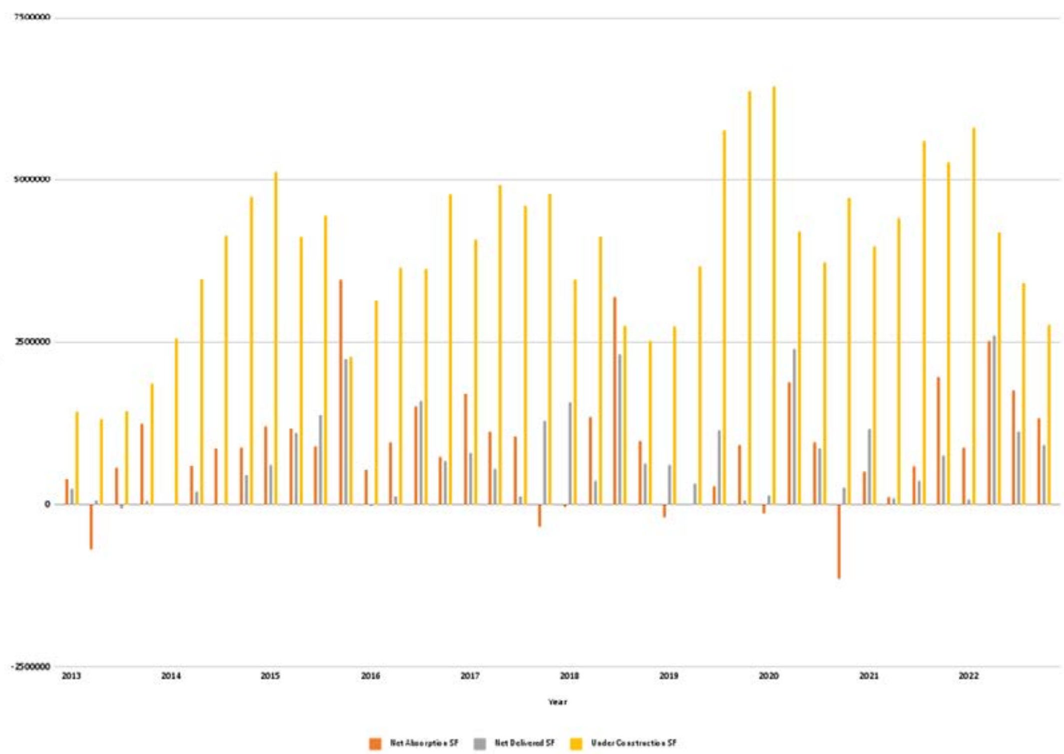
As a consequence of the increasing cost of debt, construction, and land, developers have been including a percentage increase to account for extra costs, acting as a calculated contingency to counteract the risk of the increasing costs. Construction costs have been increasing about 1.2% per month, putting an immense amount of pressure on developers to look for ways to save during the development process if tenants cannot absorb the cost increases.[6] The positive side of this is that we live in a free market, and when prices get too high, developers are forced to pause future development until costs come down or achievable rents rise.

5 CBRE, *Figures Portland Industrial Q4, 2022.*

6 CBRE, *2022 U.S. Construction Cost Trends, 2022, https://www.cbre.com/insights/books/2022-us-construction-cost-trends.*

CoStar

**FIGURE 4: NET ABSORPTION VS. NET DELIVERED VS. UNDER CONSTRUCTION**




## LAND USE CAUSE AND EFFECTS

Due to the Portland metropolitan area's Urban Growth Boundary (UGB) and industrial land constraints, there is a restricted amount of land that is available for industrial development. Depending on who you ask, the UGB has had a positive or negative effect on industrial development and the industry. These measures have restricted the amount of land which can be developed as industrial within the UGB area.

Senate Bill 100 was passed in 1973 responding to suburban sprawl and a lack of cohesive land use goals between state and local government. Since then, many components of Oregon's land use system have been replicated in other states. While Portland has been trying to balance the demand for development growth and ESG practices, they have seen scrutiny more recently regarding the consequences of their stringent land use practices. For example, at least partially due to a lack of large and attractive industrial sites, Oregon's largest employer (Intel) chose Ohio over Oregon to build $20 billion dollar leading-edge chip factories on a 1,000-acre campus in January 2022.[7] This would have provided around 7,000 construction jobs and 3,000 full-time employees that would have represented a significant contribution to the Portland metro area's economy.[8]

As expected, the cost of undeveloped industrial land has increased over the last ten years. Compiling industrial zoned land sales data over the past 10 years in Portland, excluding sales that cost more than $50 per square foot, and taking the yearly averages, shows that the cost has increased around 375%. In 2022, Prologis acquired industrial land that ranged between $9 and $11 per square foot compared to $5 and $7 per square foot in 2013. While this is only a 160% to 180% increase, the cost increase is around 17% YOY. This outpaces the CPI

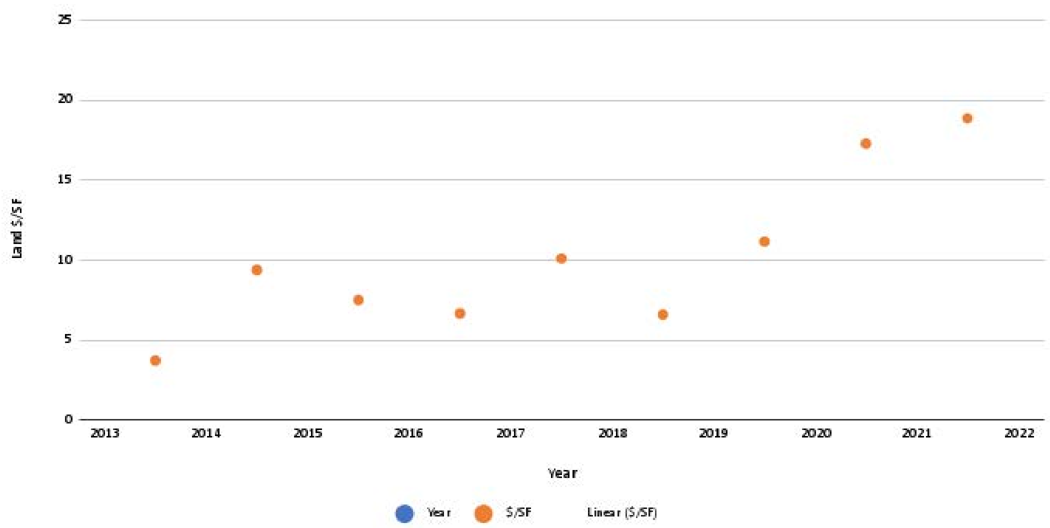
*7 Pat Dooris, "Why Did Intel Pick Ohio Instead of Oregon for $20 Billion Expansion?", KGW, January 26, 2022, https://www.kgw.com/article/money/intel-ohio-expansion/283-c7608521-670f-4571-88c9-dad7a32a1730.*

*8 Intel Newsroom, "Intel Invests in Ohio," Intel, January 23, 2023, https://www.intel.com/content/www/us/en/newsroom/resources/intel-invests-ohio.html#gs.wzxnph.*

index of about 2% and the S&P 500 of 11.9% year-over-year. With hard cost increases putting pressure on development projects, the increased land cost is another factor that has made development in Portland that much more difficult.

CoStar

**FIGURE 5: INDUSTRIAL LAND COST PER SQUARE FOOT**




Senate Bill 4 recently passed as part of the semiconductor task force initiative. Part of this bill gives Governor Kotek executive authority to designate land outside the UGB to be used as a supersite, a single site greater than 500 acres, for semiconductor chip manufacturing. This is largely a result of not having readily available sites this size with access to infrastructure, utilities, and mostly level lots. The largest lot available is around 472 acres located on West Hayden Island, but has zone restrictions that only allow marine industrial use.[9] Some of the sites available that have been brought up by UGB advocates, such as 1000 Friends, have been private golf courses.[10] While this is not an impossibility, these suggestions pose their own issues to making it a win-win for the community. Furthermore, Hillsboro and North Plains have been pushing to expand their UGB to continue economic growth and tax revenue for their city. With Senate Bill 4 recently being passed along with boundary cities expressing interest in utilizing their land to compete for CHIPS and Science Act funding, it will be interesting to see how industrial development will be impacted as a result.

*9 Mackenzie, Regional Industrial Site Readiness Inventory Report (2017 Update), October 20, 2017.*

*10 1000 Friends of Oregon, Mid-Session Legislative Recap, April 25, 2023, https://friends.org/news/2023/4/mid-session-legislative-recap.*

## CONCLUSION

Overall, the industrial market in Portland, Oregon has been doing very well, especially when compared to other commercial development types. Compared to retail, office, and multifamily, vacancy rates have decreased to near historic lows. Absorption has also been quick, likely because of less speculative development and a significant level of build-to-suit projects. With steady demand, stable supply, and restrictive zoning and land supply in Portland, cap rates are expected to stay relatively steady. It will be important to keep an eye on new construction starts as we enter the new year. If the first quarter of 2023 continues to see a reduced amount of new construction, there might be ripple effects on other market metrics. Even with Amazon canceling proposed projects and Intel announcing employee cuts, the industrial market continues to benefit from ecommerce disruption to dated brick and mortar business models as well as newer business ventures. With a focus on supply chain and a decreasing global economy because of COVID disruption, the industrial market will continue to thrive.

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# 03

COLUMNS

# Fourth Quarter 2022 Retail Market

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Maclaine is a graduate student in the Master of Real Estate Development (MRED) Program.

The Portland retail market has situated itself in a good position to endure a job loss shock heading into the fourth quarter. This job loss could occur as a result of the tight monetary policy of the Federal Reserve. The retail market has seen persistent high inflation, which is not responding well to these policies by the Fed. The past four quarters have shown similar trends resulting from the return to pre-pandemic life.

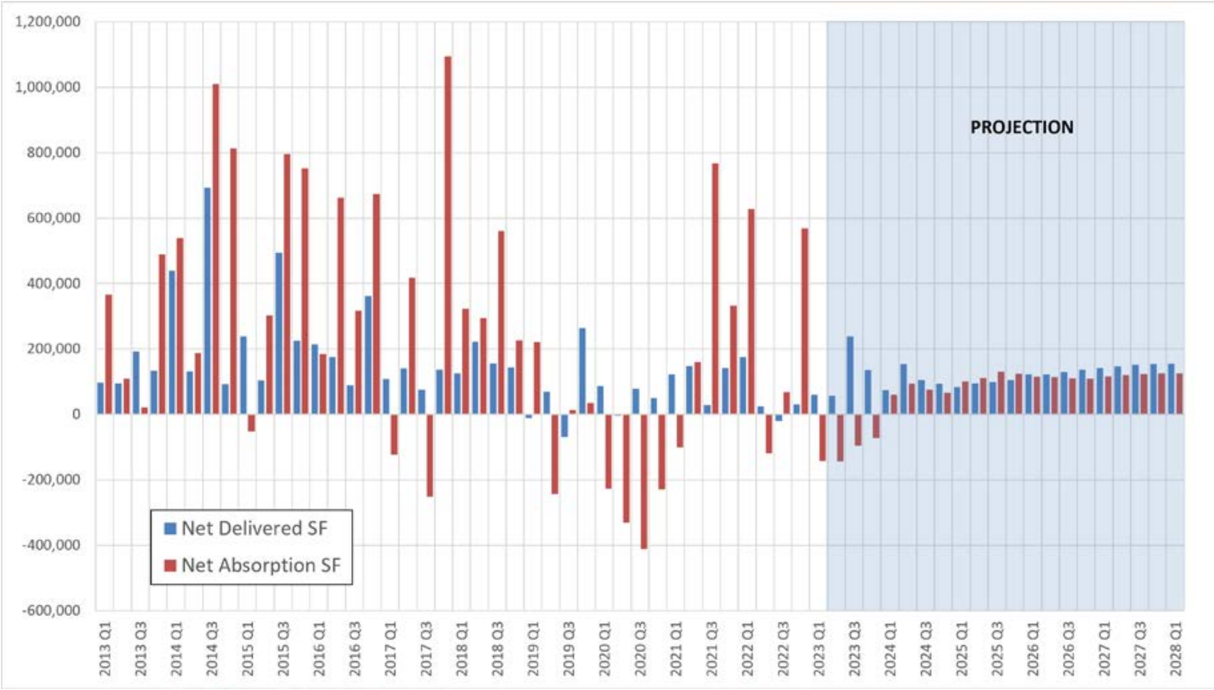
The better part of the last 18 months has seen a resurgence from regions all across the country associated with a return to normal life. Oregon, compared to most states, was one of the last to remove COVID restrictions, which has led to a higher demand for in-person activities. Retailers in Portland noticed the demand and have sought more space in faster-growing parts of the metro area.

This report focuses on the following four metrics: the twelve-month deliveries in square feet, twelve-month net absorption in square feet, vacancy rates, and twelve-month rent growth. Deliveries over the last twelve-month were 296,000 square feet, the twelve-month net absorption in square feet was 434,000, average vacancy rates were 3.4%, and twelve-month rent growth averaged 2.1%.

Retail centers in the region have reported stable performance following the decrease in COVID-19 restrictions. Change in most areas was quite neutral in the fourth quarter. There was change but the market was more steady than it was in the first quarter. The year-over-year change is much larger because we are starting to pull away from the side effects that COVID-19 had on our market. The conditions in the last quarter were steady but also promising. Investors are continuing to acquire retail assets in Portland which is consistent with the promising future in this market

Leasing activity has been on the rise and this trend is expected to continue heading into 2023. Meanwhile, the expected annual net absorption is around 400,000 square feet for retail properties in 2023. That is significantly greater than the five-year average of 240,000 square feet.

**NET ABSORPTION**



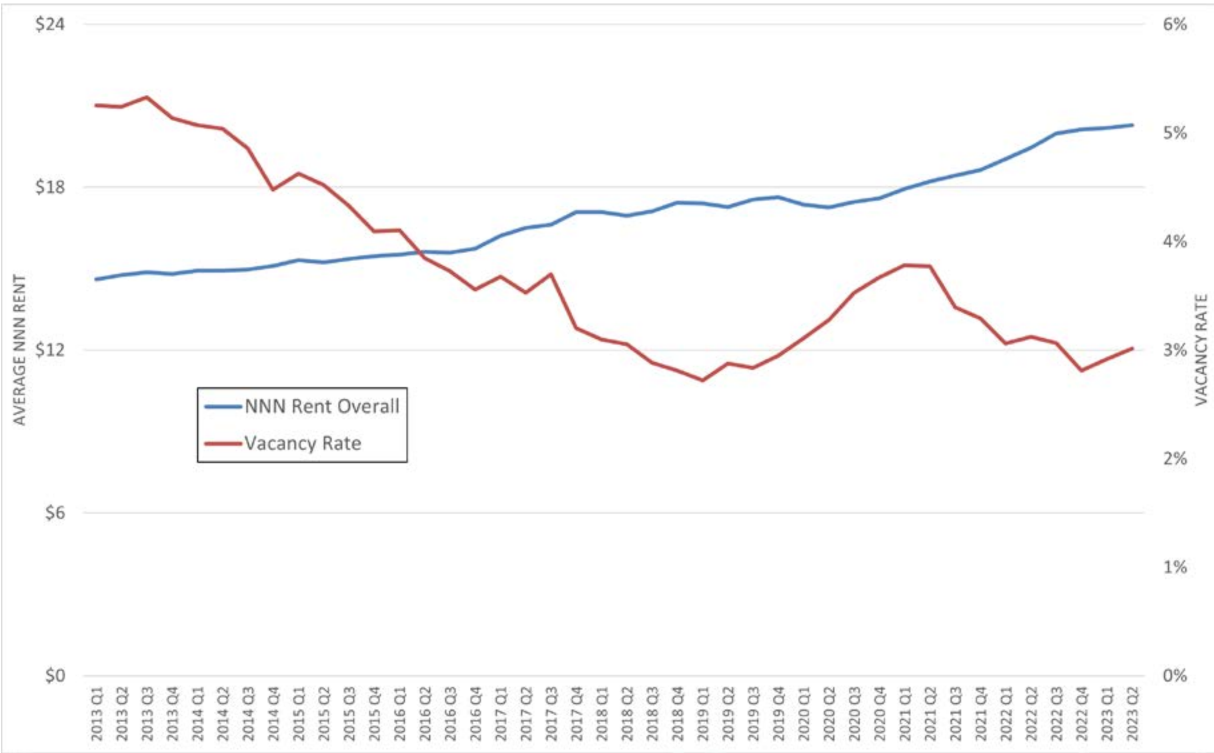
Net absorption has been significant in less dense areas in Portland. The suburbs have emerged to be the hot spots for the retail market right now and that is a result of workers not being ready to leave remote work. The persistent change in work patterns have inspired retailers to take advantage of these spaces. An example of this is Dick's Sporting Goods leasing out 66,000 square feet at Jantzen Beach Center. Other retailers that took up space during the fourth quarter were fitness centers.

In comparison, the retail community was well diversified in net absorption in 2022. This retail market ranged from gyms to shopping centers and restaurants. There were a few experimental retailers during this time because of the reduction in COVID restrictions.

Most of the vacancy Portland has seen for the retail community has come from the heart of downtown Portland. This area was significantly impacted by the pandemic and riots, and has not yet seen a resurgence in the retail sector. Downtown Portland remains damaged, safety concerns are still high, and daytime population levels are significantly lower, yet there is a possibility for a recovery. The expansion of the OHSU campus and the coming completion of the Ritz-Carlton have contributed to the possible bounce back of future retail stores to take part in the downtown rebirth.

Portland's rent growth has stayed positive, with year-over-year gains at 2.1%. In comparison, the national performance is higher at 3.6%, and the average annual rent growth for Portland is 1.9%.

**VACANCY RATES**




Rent growth is varied through sections in Portland. One area that remains in high demand is the Commercial Business District (CBD). Block 216, the development that is home to Ritz-Carlton, is a high end mixed-use project that will include several notable retailers at the base of the building and a five star restaurant on the 20th floor. The starting quoted rent for ground floor space was $50.00 per square foot. The CBD is still struggling with ground floor vacancies in many areas, as the reduced level of daytime population continues to present a challenging environment for retailers.

The CBD rent growth is positive, but the highest rent growth performances have been observed in the suburbs of Portland, away from the urban core. The suburban markets that performed the best during the third quarter are the Vancouver Mall, Airport Way, and Greshman. There are other rent growth suburbs on the rise out there, but these three are the most noticeable, with each of them posting a year-over-year growth of 3%.

These markets are not known for their wealthy shopper population, but they are stable because of their solid employment bases compared to their finite retail market. These factors mixed with the attractive cost of living have created a larger draw for more residents. All these elements have contributed to a growth of businesses and a decrease in vacancies, which have resulted in a rise in rents.

The Ritz-Carlton has multiple different assets within the building. The bottom floor of the Ritz is going to be focused on retail. The best way for the retail companies to thrive will be partly from the tenants that are in the office space in the building. This is something to be concerned about because of the way the office market has been heading, with sharply reduced occupancy in the core area. As such, the retail section on the bottom floor needs further support.

With all that being said, the bottom of the Ritz-Carlton will take host to an exciting food hall that will involve 9 to 10 different vendors. Some of the included vendors in this food hall are Hillsboro's Prime Tap House, Nong's Khao Man Gai, Kim Jong Grillin, and Birrieria La Plaza. Some other possible tenants include Zab Thai, Queen Mama Mediterranean, Artly Coffee, Hamono Sushi, and Cake Bar. The 20th floor restaurant is another great addition to Portland's diverse food selection, which is one of the most culturally diverse; the local restaurant scene is an attraction in itself.

The 20th floor will include a bar and the restaurant will seat more than 100 customers, serving breakfast, lunch, and dinner. Chef Pedro Almeida is going to be the executive chef at this restaurant. His focus will be on New American with a heavy emphasis on produce and meats from Oregon. Almeida wants to bring the "farm life" back to Portland. The addition of the Ritz-Carlton and the nearby 11W building may bring new excitement to Portland and attract more residents and tourists.

# 04

COLUMNS

# Economic Analysis

**Jerry Johnson**

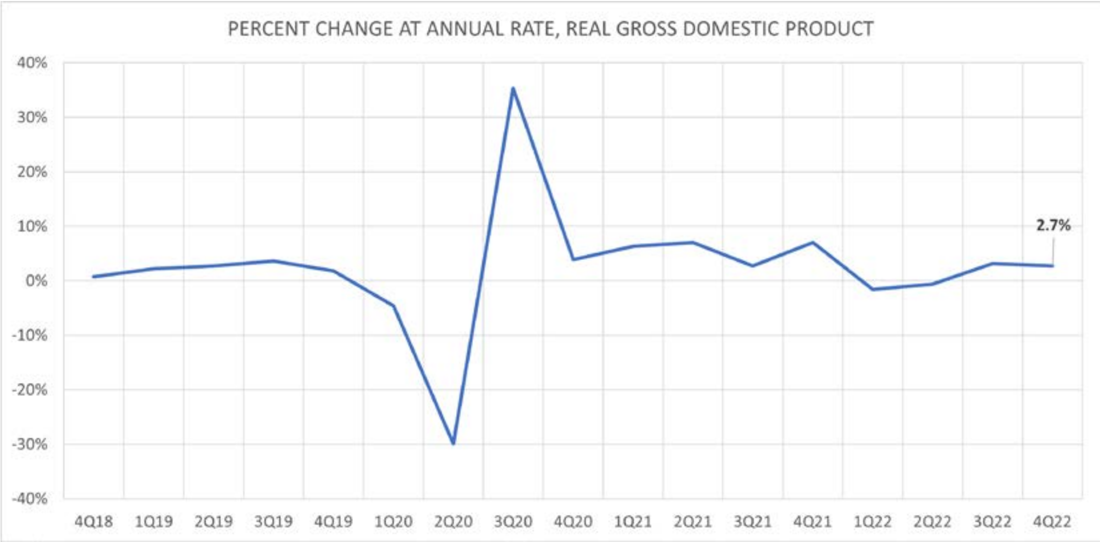
Portland State University

Jerry Johnson is an adjunct professor at Portland State University's Center for Real Estate. He is also the Managing Principal of Johnson Economics, a consultancy based in Portland.

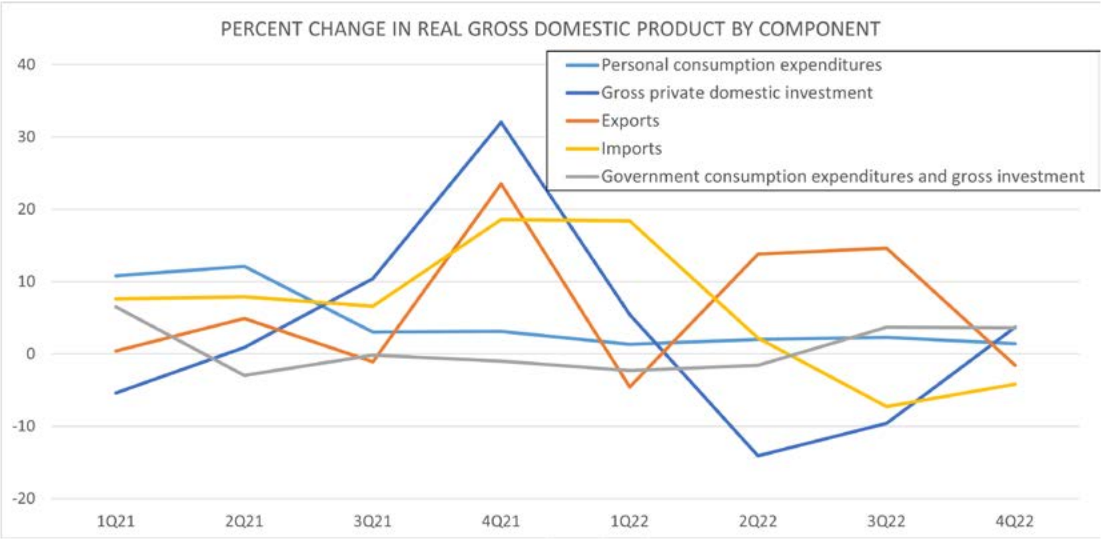
The economy continued to expand in the fourth quarter of 2022, with estimated GDP growth of 2.7% during the period. This reflects a modest decrease from the third quarter levels. Government consumption, private domestic investment, and personal consumption drove the increase, with exports dropping sharply during the quarter. Meanwhile, the post-pandemic expansion appears to be continuing at a modest rate, despite negative growth in the first and second quarters of 2022.

The State of Oregon has consistently outperformed the national average in terms of GDP growth over the last few decades. The statewide GDP has expanded by 50% since the first quarter of 2005, while the national GDP expanded 36% during the same period.

U.S. Bureau of Economic Analysis[1]



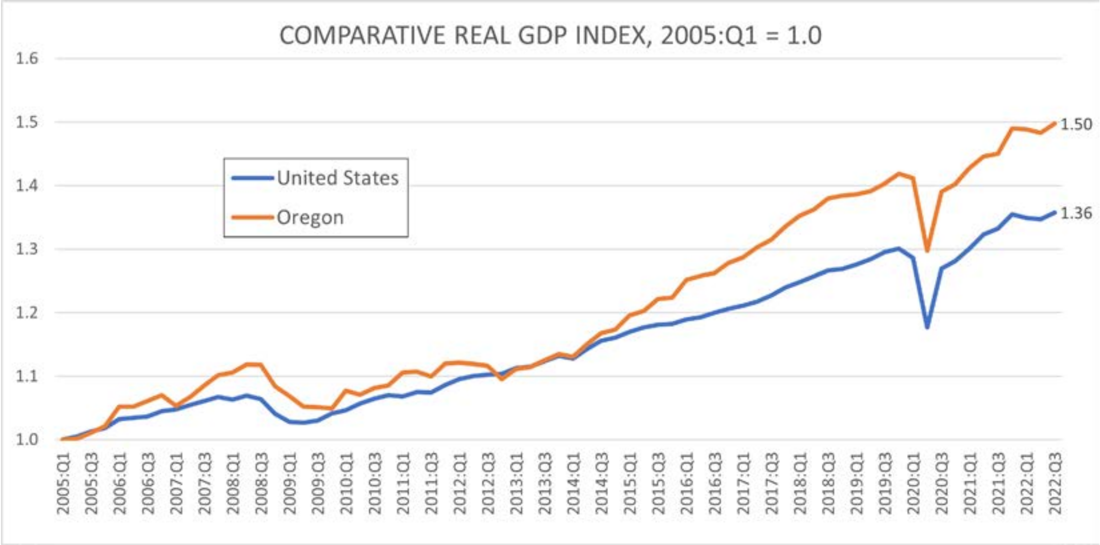

U.S. Federal Reserve Bank of St. Louis[2]




1 *https://www.bea.gov/news/2022/gross-domestic-product-third-estimate-gdp-industry-and-corporate-profits-revised-third*

2 *https://fred.stlouisfed.org/*

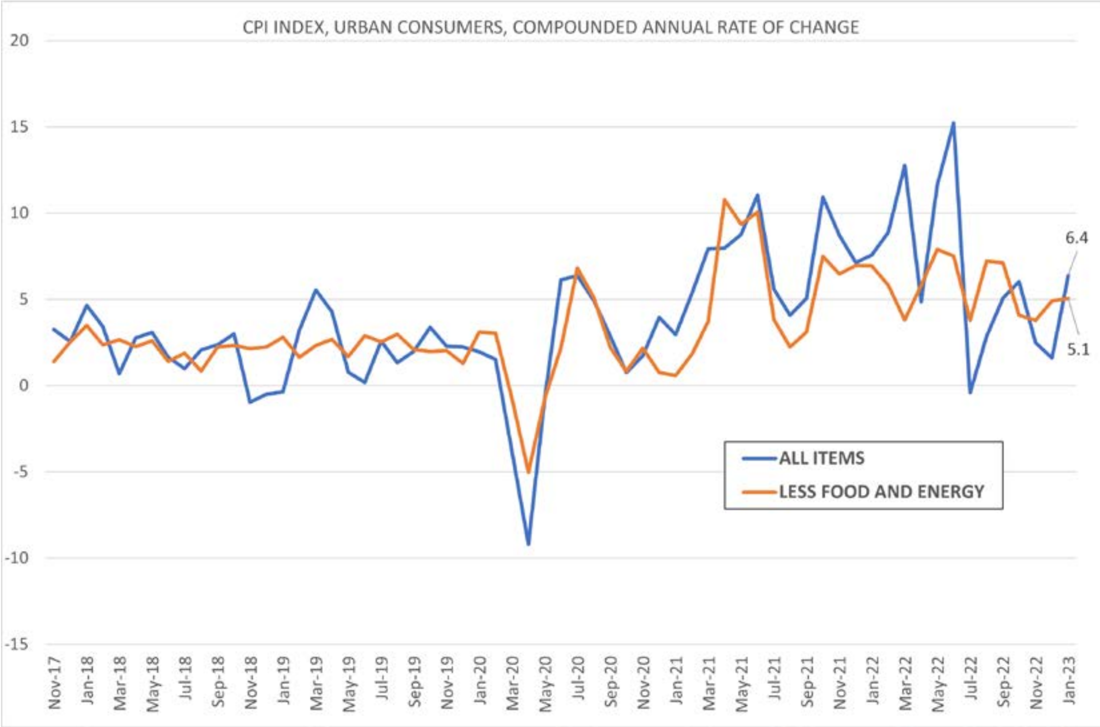
U.S. Bureau of Economic Analysis[3]




Inflation continues to represent a serious challenge, with the Consumer Price Index (CPI) showing a compounded annual rate of change of 6.4% in January 2023. If "food and energy" is removed from the index, the increase was 5.1%. Both are below recent levels but still historically elevated.

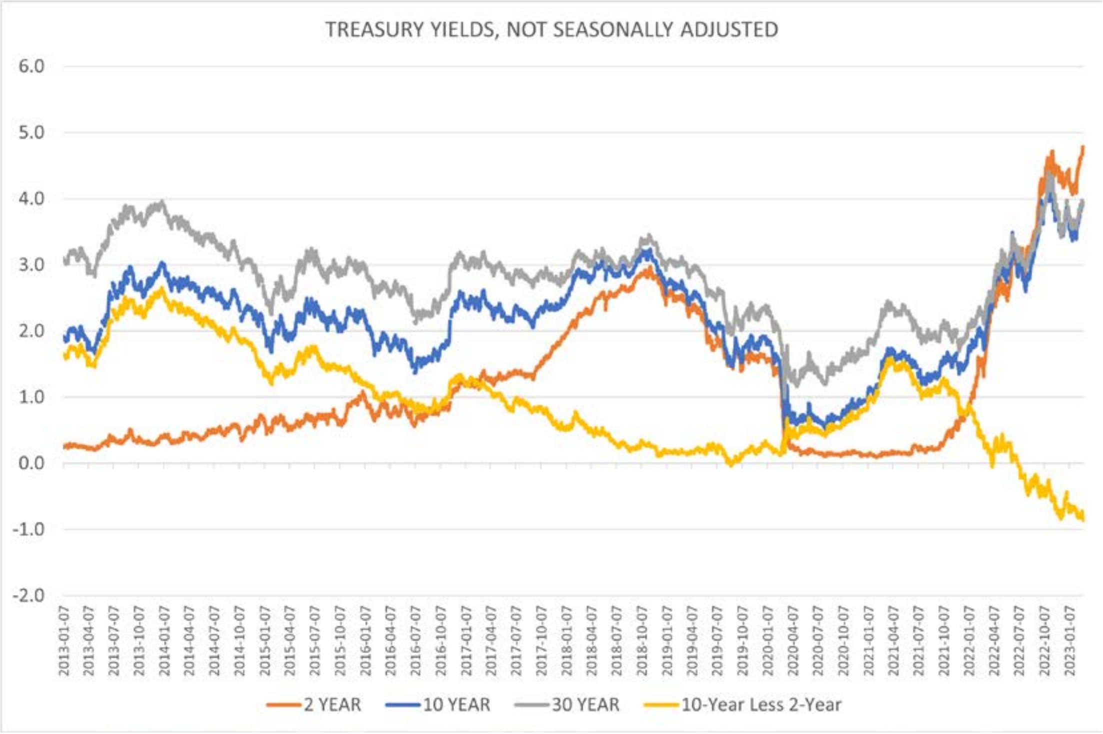
The Federal Reserve has responded to the persistent inflationary pressure by announcing continued rate increases to slow the economy and reduce demand side pressure. The inverted yield curve has become more pronounced, with two-year treasury yields almost 100 basis points above ten-year yields. As noted last quarter, an inverted yield curve has typically been a strong indicator that a recession is imminent.

U.S. Federal Reserve Bank of St. Louis



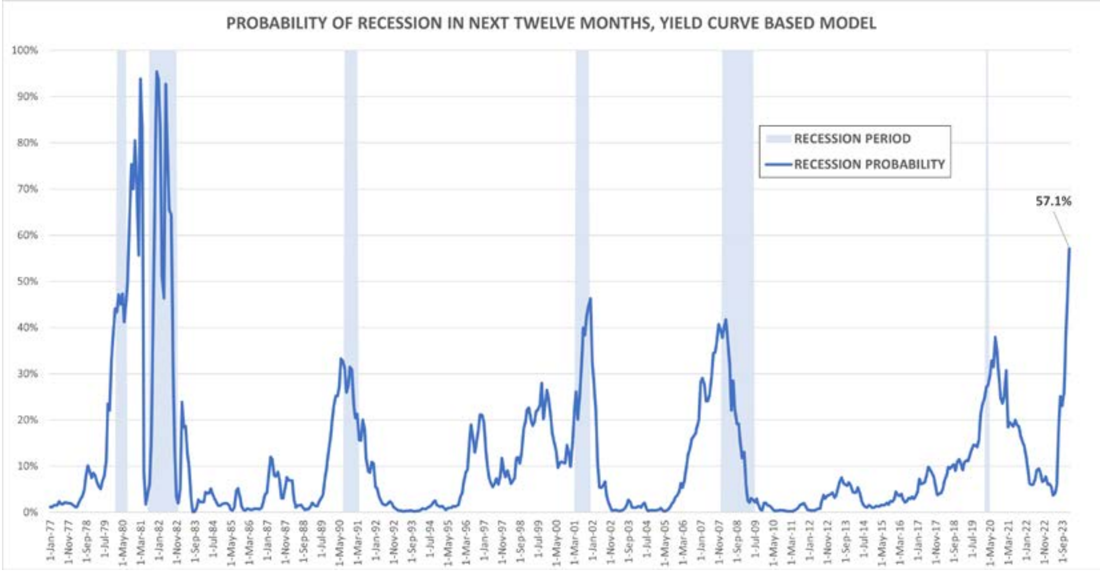

3 https://www.bea.gov/news/2022/gross-domestic-product-third-estimate-gdp-industry-and-corporate-profits-revised-third

U.S. Federal Reserve Bank of St. Louis



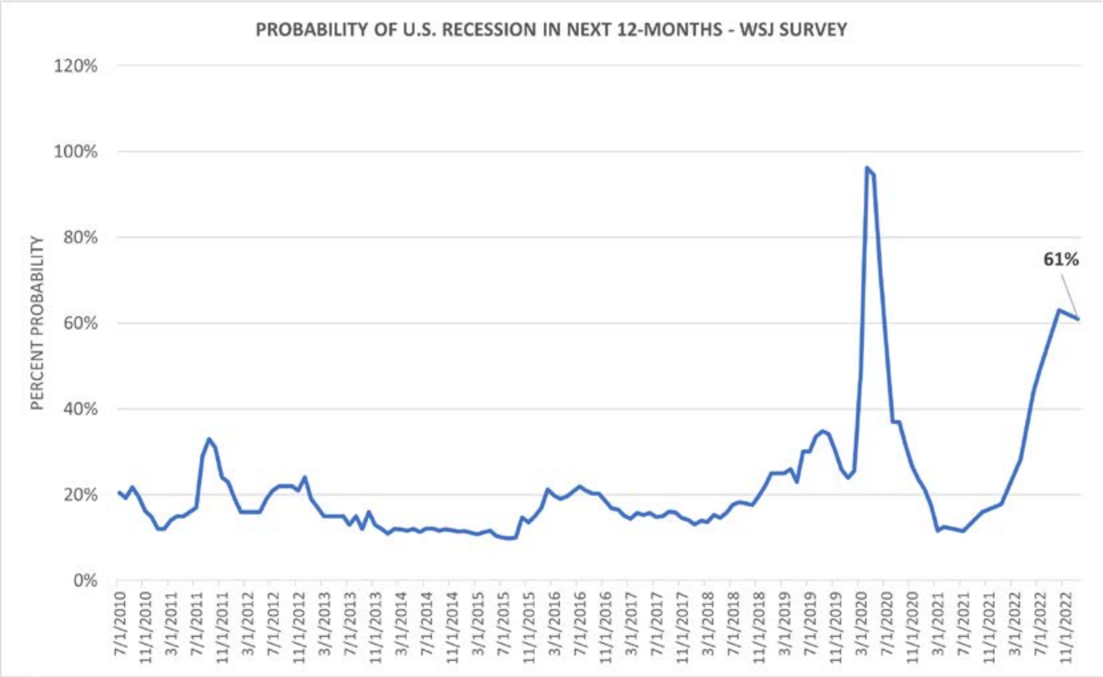

The Federal Reserve Bank of New York's recession probability model based on yield curves estimates the probability of recession in 2023 at over 57%. The Wall Street Journal's survey of economists places the recession probability at 61%. While a recession has been expected for the last several quarters, it has stubbornly not shown itself. Anticipation of a recession can often induce responses that trigger it, which can make the anticipation a self-fulfilling prophecy. Nonetheless we continue to see positive employment growth and tight labor markets at the national level.

U.S. Federal Reserve Bank of New York[4]




4 https://www.newyorkfed.org/research/capital_markets/ycfaq.html#/

Wall Street Journal[5]




In addition to inflation, rising interest rates represent a significant threat to the current expansion. Tightening monetary policy by the Federal Reserve has contributed to a sharp rise in rates, with the average 30-year mortgage rate rising above 7.0% for a short time during the quarter. Rates have subsequently dropped somewhat in anticipation that the Fed will slow the pace of rate increases, but the persistence of inflation makes this doubtful. Rising rates have a significant impact on broad sectors of the economy, but the real estate industry is disproportionately impacted due to high rates of leverage.

U.S. Federal Reserve Bank of St. Louis


5 *https://www.wsj.com/articles/economic-forecasting-survey-archive-11617814998*

The sharp rise in interest rates have triggered a commensurate drop in the value of bond and mortgage-backed holdings, which are often held in quantity as a relatively safe asset class. This is expected to place significant stress on financial institutions and investors with large holdings in these sectors.

| | Scenarios | |
|---|---|---|
| Annual Income | $125,000 | $125,000 |
| % of Income to Housing | 26% | 26% |
| Down Payment | 20% | 20% |
| Mortgage Term/Years | 30 | 30 |
| Interest Rate | 4.00% | 6.50% |
| Supportable Mortgage | $2,708 | $2,708 |
| Supportable Home Price | $709,114 | $535,610 |

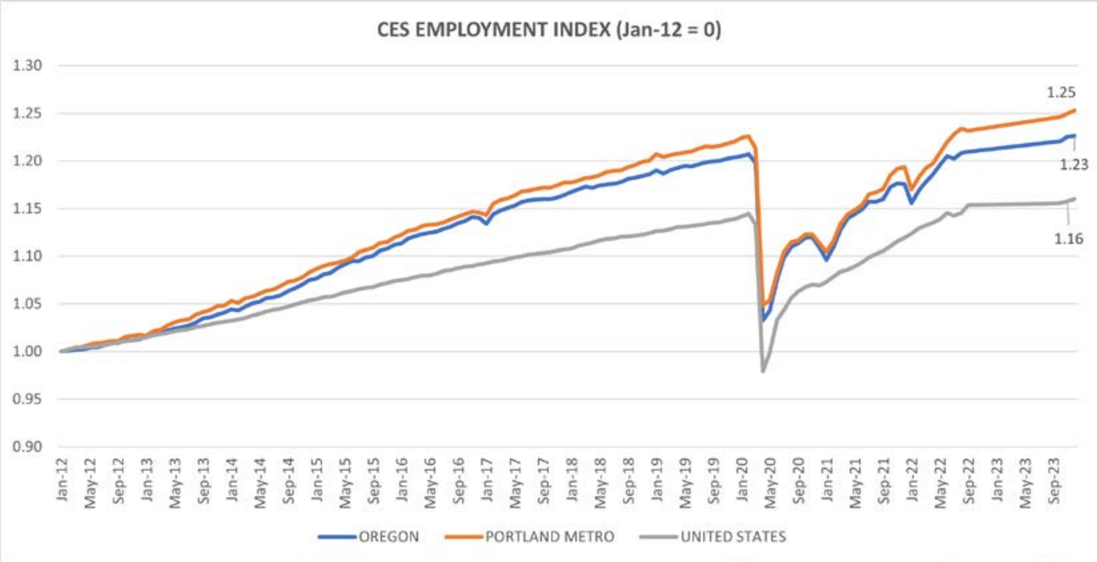
Downward pricing is placed on most assets, but the single family residential market receives the most direct impact. As shown in the table to the left, changing the rate on a thirty year mortgage from 4.0% to 6.5% for a household earning $125,000 reduces the price of a home they would qualify for by 24%.  This reduces the pool of qualified buyers, establishing pricing pressure on ownership housing as well as driving an increasing share of households out of the ownership market. While downward pricing pressure is expected, it will be offset to some extent by the relative lack of residential supply in the current market.

The Portland metropolitan area recorded one of its most robust years of employment growth in 2022, with employment levels averaging over 60,000 higher than in 2021. We do not expect this rate of growth to be sustained, as much of it reflected a one-off recovery from the pandemic. Employment in the metro area is now roughly 3% higher than pre-pandemic levels, but growth in the next few years will be challenged by rising interest rates, a likely national downturn, and a tight labor market. Employment in the metro area economy is 25% higher than it was at the end of 2011, while statewide employment is up 23% and nationwide employment is up 16% during the same period.

Oregon Employment Department, Qualityinfo.org[6]


6 *https://qualityinfo.org/ceest?rt=0&cesCode=00000000&cesArea=4101000000&cesSeasAdj=1&cesSeries=or&cesYear=2019*

Oregon Employment Department, CES series, Johnson Economics




## DEMOGRAPHIC SHIFTS

The Census Bureau recently published microdata samples through 2021. These allow for custom tabulations of variables that are not included in the standard tables. The data includes several key variables that inform our understanding of housing absorption on the regional (four-county Portland Metro) level. It is important to recognize that the estimates have relatively wide margins of error and show a lot of variability from year to year. However, the data still provides indications of underlying trends. To reduce the variability, we use our own estimates of housing inventory by type, derived from assessor data, and use smoothed estimates of households by householder age. Also, incomes are inflation-adjusted to 2022.

Recent household growth in the Portland Metro Area has been driven by singles and couples, while the family segment has been stagnant. This is largely because the children of the baby boomers – the millennials – have been exiting their parents' households, forming their own one- and two-person households and leaving their parents in (mostly) two-person households. Though the millennials are having children, they do so at a higher age and a lower frequency than previous generations. Thus, millennial family formation is not yet offsetting the dissolution of family households among boomers. On the other hand, there was a significant decline in two-adult households in 2020, especially in the younger segments. This was likely due to roommates – especially students – splitting up during COVID and returning to their parents.

The 65-74 age group has been the fastest growing age segment over the past 15 years, reflecting the aging of the baby boomers. This cohort is now entering the 75+ age group, which should be the fastest growing segment in coming years. Note that growth in these segments is more a function of aging in place than in-migration. The State of Oregon's reliance on income taxes makes it a relatively unattractive destination for high-income retirees. The millennial cohort, on the other hand, has been the main driver of in-migration to the region, contributing to growth first in the 25-34 age group and more recently in the 34-44 age group, as this cohort is aging. Economic conditions forced many millennials to stay with their parents in the first half of the last decade, but the increase in apartment supply accommodated stronger household formation in the second half.

In terms of income levels, the growth has shifted to higher brackets over the past 15 years – even when adjusting for inflation. In general, there have been declines among households earning less than $50,000 a year (except a recent increase below $25,000). Some of this is due to falling unemployment through 2019. However, the shortage of affordable housing has also contributed by pricing some low-income individuals out of the housing market and forcing them to live as part of other households. The $50,000-75,000 income bracket has largely been unchanged over the past 15 years, while growth has taken place above $75,000 – with the strongest gains above $150,000.

05

INSIGHTS

# Fourth Quarter 2022 Retail Market


## Marnie Rose

Portland State University


Marnie is a graduate student in the Master of Real Estate Development (MRED) Program.

## INTRO

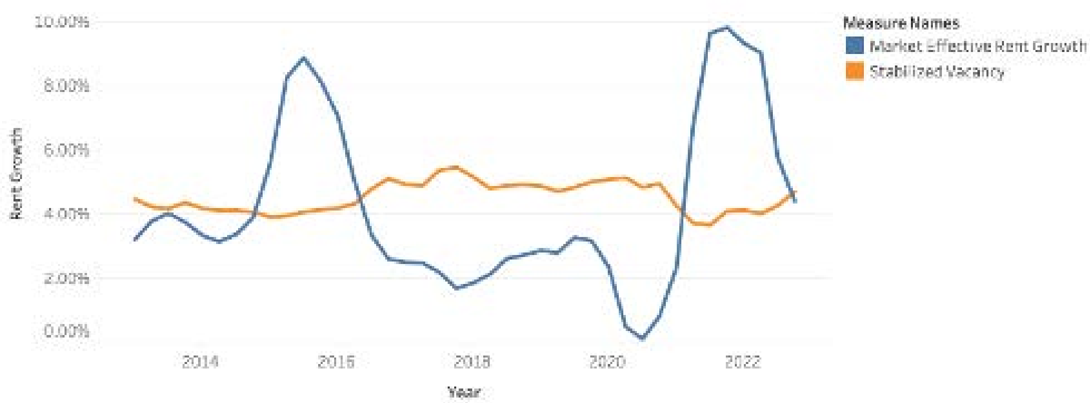
Federal Reserve Chairman Jerome Powell, in an address to economists and investors in Washington DC in early February, set expectations around the economy's "disinflationary process." While Powell assured listeners that this process—one in which inflation lowers over time either naturally or due to intervention by the Federal Reserve—is well underway, it will be slow, bumpy and closely tied to data on jobs and wages.[1] While the FED continues its attempt to shorten the time it will take for the economy to level out by introducing rate hikes and other measures, Powell's remarks are an important reminder that recovery takes time. Portland's economic outlook and its effect on the rental housing market is no exception. Despite a growing number of construction starts and data suggesting that residents are beginning to get back into the city's urban core, the overall picture of Portland's residential rental market is still one of slowed growth and investment.

## MARKET UPDATE

Rent growth, while still positive since the first quarter of 2022, has been on a downward trajectory. While rent escalation dropped the most between the second and third quarter of 2022, from 9.02% to 5.76%, it dropped an additional 1.37% by the end of the fourth. This is a reflection of slowing leasing activity and increased vacancies reported across the Portland metro area. Figure 1 plots 12-month rent growth and stabilized vacancy from 2013 to 2022. The vacancy rate rose nearly half a percentage point between the third and fourth quarter of 2022, echoing a similar rise between the third and fourth quarter of 2021. While the graph suggests that a reduced pace of leasing during winter months in the area is historically common, vacancy in the Portland metro area has been on the rise since last spring.

Costar

**FIGURE 1: STABILIZED VACANCY & MARKET EFFECTIVE RENT GROWTH 12-MONTH**



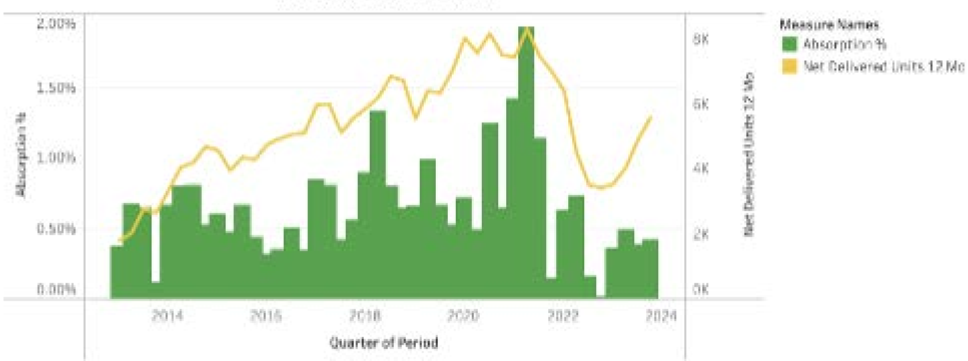

While still below the 5% vacancy benchmark considered the standard for assessing whether a market can absorb new units of rental housing, vacancy in Portland is expected to continue to rise through 2023 as a growing number of new deliveries are expected to hit the market. Figure 2 depicts net delivered units and absorption percentage from 2013 with a projection through 2023. After a sustained drop in the number of delivered units between the second quarter of 2021 and the fourth quarter of 2022, the graph shows an upward trend in new deliveries through 2023. More

1 Jeff Cox. "Fed Chair Powell says inflation is starting to ease, but interest rates still likely to rise,"CNBC, February 7, 2023, https://www.cnbc.com/2023/02/07/fed-chief-powell-says-the-the-disinflationary-process-has-begun-but-has-a-long-way-to-go.html.

inventory, coupled with uncertain economic conditions that have led to a slowdown in household formation, could cause rental pricing to shift into a tenant's favor through at least the first part of 2023.[2] This shift will also contribute to less rental gains and fewer opportunities for rent increase.

Costar

FIGURE 2: NET DELIVERED UNITS & ABSORPTION




Net absorption, which is a good indication of demand, fell 0.15% between the third and fourth quarters of 2022 but is projected to rise through 2023. Growth in absorption figures could be attributed to median home prices in the Portland metro area that are still out of reach for many potential homebuyers, shifting the tenure split and keeping demand for rentals high.

Outside of Portland, declining rents and increasing deliveries are noteworthy trends nationally. According to the Wall Street Journal, the national rental housing market "faces a significant headwind in the biggest delivery of new supply since 1986 (...) Nearly half a million new apartments are coming on line this year as developers seek to cash in on high rents that tenants have been paying."[3] Projects that were developed in response to the pandemic's housing boom, where tenants were willing to pay more for added space as a tradeoff for not being able to afford a home due to high interest rates, are being delivered to the market at a time when rents are falling and home sale prices are declining. As a result, tenants will have more options, which will limit a landlord's ability to raise rents to the degree they were early last year.

While rent growth remains positive nationally, vacancy has risen, as is the case in Portland. Despite the similarities between local and national trends, the unique circumstances that shape Portland's housing market—from the Urban Growth Boundary to statewide rent control—restrict the economics of rental construction and have created a severe housing deficit in the region.

Despite unfavorable lending conditions and high construction costs, investors remain interested in the region. These conditions require investors to come up with more cash to secure financing. While the market saw nine fewer transactions in the fourth quarter than the third quarter of 2022, total sales volume was up nearly 79% during the same period, as large institutional investors continue to pursue portfolio deals in the area. While the market saw cap rates raise only marginally between the third and fourth quarters of 2022, from 4.33% to 4.34%, investors can expect a starker rise in cap rates in the quarters to come.

As cap rates continue to rise, investors will expect greater returns to compensate for higher cost investments. However, according to Daniel Weldon, VP and Sr.

*2 CoStar. Portland Multi-Family Market Report. April 2023.*

*3 Will Parker. "Apartment Rents Fall as Crush of New Supply Hits Market," Wall Street Journal, January 3, 2023, https://www.wsj.com/articles/apartment-rent-increases-slow-a-relief-to-tenants-after-two-years-of-steep-rises-11672701414?mod=article_inline.*

Relationship Manager of Commercial Real Estate Lending at WaFd Bank, purchasing at a lower cap rate and letting cash flow slowly grow over the long term can allow the patient investor to achieve higher returns at exit. Weldon highlights a general shift towards a long-term investment strategy during the current economic cycle and notes an uptick in lending on value-add investments in Portland, as those willing to invest in underserved properties can reap positive returns over a long-term hold period.

While new development will be tough over the next twelve to twenty-four months due to the tightening of available financing and fewer opportunities for rental growth, the market will normalize and recover in the long run. According to Weldon, depressed economic periods can lead to the rise of opportunistic investments for the savvy investor willing to take a risk on uncertain markets and submarkets.[4] In Portland, the urban core, which lost investment during the pandemic as investors flooded suburban markets, is a place well served for these types of investments going forward.

## LEGISLATIVE UPDATE

In January, the Oregon state legislature assembled for its eighty second legislative session under the leadership of Oregon's new governor, Tina Kotek. In her first days in office, Kotek made clear her intentions to address the region's housing production problem by introducing several executive orders aimed at increasing housing production and reducing homelessness across the state.[5] As part of these executive orders, she set a statewide housing production goal of 36,000 new housing units per year. The details of Kotek's plans, including her expectations around working with private developers to meet this goal, are not yet clear, but her urgency around housing could be a positive sign for developers and investors going forward.[6]

While both parties agree that housing, and more specifically housing affordability, is a key state issue, new problem-solving policies that have been introduced during the current legislative session vary substantially, and could have major implications on the state's rental housing market. More specifically, SB 611, introduced by Senator Wlnsvey Campos, proposes dropping the rate of allowable rent increase to 3% plus CPI per year, with a total maximum increase of 8% per year. In addition, the bill would change the clause in Oregon's current rent stabilization policy, SB 608, that exempts landlords of multifamily properties that are 15 years or newer from rent cap laws, allowing exemptions for buildings just 3 years or newer.

These proposed restrictions and further tightening of the state's current rent control policy, if passed, will discourage housing production and investment across the state. According to Greg Frick, Partner at HFO Investment Real Estate "implementing rent control discourages the construction of new buildings and the investment in property improvement. Consequently, this can lead to a decrease in the overall supply and quality of housing, worsening the issue of housing affordability and availability."[7] Rental increases, particularly during high inflationary periods, are an essential tool that landlords are able to use to cover costs associated with operating a building as they naturally rise over time. By significantly restricting the power of these increases, SB 611 threatens to all but dry up investor interest in the state. In addition, without the power to sufficiently raise rents, landlords will likely begin to defer routine maintenance and major repairs on buildings, which could eventually lead to

4 *Daniel Weldon, interview by author, Portland, February 2, 2023.*

5 *Dave Miller. "Portland State expert says Gov. Tina Kotek's housing plan is a good first step, but she'll need help," OPB, January 15, 2023, https://www.opb.org/article/2023/01/15/portland-state-expert-on-oregon-governor-tina-kotek-housing-homeless-initiatives/.*

6 *Anna Griffin. "Oregon Gov. Tina Kotek takes first actions on 'humanitarian disaster' of homelessness," OPB, January 10, 2023, https://www.opb.org/article/2023/01/10/oregon-housing-crisis-homeless-population-governor-tina-kotek-executive-orders/.*

7 *Greg Frick. Personal entry, LinkedIn, February 24, 2023, https://www.linkedin.com/search/results/all/?fetchDeterministicClustersOnly=false&heroEntityKey=urn%3Ali%3Afsd_profile%3AACoAAABGaWMBPkFqTZVaJw1IzCNlrmTmGSCeYwY&keywords=greg%20frick&origin=RICH_QUERY_TYPEAHEAD_HISTORY&position=0&searchId=6e33cbce-23ae-4e79-b802-6a754725adfd&sid=*Sm.*

long-term building disrepair. For Frick, SB 611 and other rent control laws fail largely because they neglect to address the root cause of housing instability. As a result, he argues that the state should consider alternative solutions that promote affordable development and rental assistance programs.[8]

While SB 611 likely won't pass in its current form, the bill is particularly ill timed and demonstrates a general lack of understanding from state legislatures. In reality, landlords have had few opportunities for rent increases since 2020. The pandemic halted rental increases from 2020 to 2021. In addition, few landlords were able to raise rents in early 2022 as the market recovered. While rental increases have picked up in the last six months, the reality is that landlords have not been able to use rental increases as a tool to keep up with inflation.

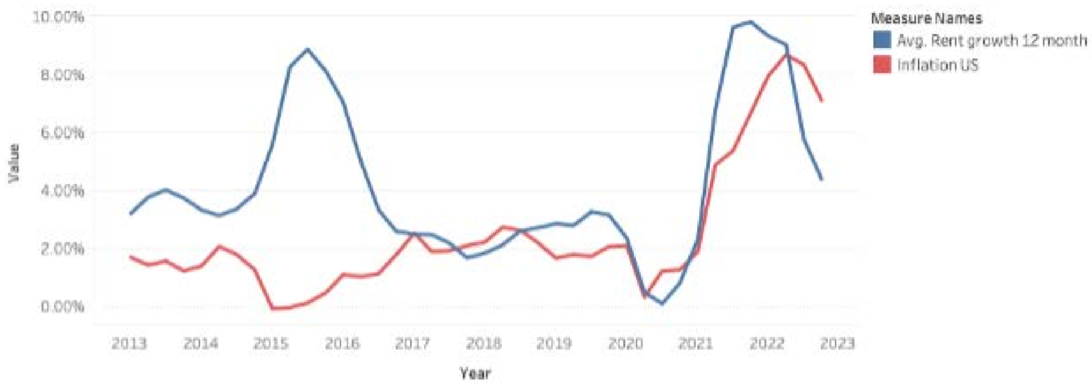
As Oregon's long legislative session continues, we should get a clearer sense of how Kotek's stance towards the development of affordable housing takes shape and whether the policies that are enacted into law will be enough to support her goal of producing 36,000 units of new housing. Both HB 2001 and 5019, which would carve out about $200 million dollars to build more affordable housing and prevent those on the cusp of homelessness from losing their housing, are headed to the House for vote and could potentially receive approval by the end of the month.[9]

## RENT FILTRATION STUDY IN NW PORTLAND

In recent quarters, inflation has drastically driven up operational costs including wages, property taxes, insurance, and general maintenance costs. Landlords rely on rental increases as a mechanism for covering. However, data on rental increases in the second half of 2022 suggests that slowing rental increases have failed to keep up with the rapid pace of inflation. Figure 3 depicts the average US inflation rate and 12 month rent growth in the Portland metro area from 2013 through 2022.

Costar, St. Louis FED

**FIGURE 3: INFLATION AND 12 MONTH MARKET EFFECT RENT GROWTH**




The graph shows that, despite a dip between 2017 and 2018 and again in mid 2020, rent growth has mostly exceeded inflation during this time. However, in the third and fourth quarters of 2022, rent growth fell below inflation by 2.57%, and 2.71% respectively. This is likely due to shifts in consumer demand as a response to inflation, including renters tightening their budgets, as well as slowed household formation. In both the long and short term, the impact of slowed rental gains in response to soaring inflation can have a significant effect on operations, potentially leading to deferred maintenance in the short term and general building disrepair in the long term.

8 *Ibid.*

9 *Lauren Drake. "Key Oregon housing package in state Legislature moves closer to law. KLCC, March 12, 2023, https://www.klcc.org/politics-government/2023-03-12/key-oregon-housing-package-in-state-legislature-moves-closer-to-law.*

To better uncover and understand recent rent escalation trends in Portland, I conducted a survey of buildings within the Uptown District submarket, which includes Nob Hill and the newly developed Slabtown neighborhood. I collected rent escalation data between 2013 and 2022 for market-rate multifamily buildings within this submarket built before 2010 and in 2010 or later. While older buildings typically have more opportunities for rent increases due to the fact that newer deliveries tend to set rents more aggressively as they are delivered to the market, the data suggests that buildings built in 2010 or later have experienced significant volatility in rent escalations in recent years, while buildings built before 2010 have struggled to achieve rent escalations that keep up with newer deliveries. Figure 4 depicts an index of rental rates for these two segments of buildings since 2013. The index allows for comparison of the two products over time by designating a single point in time as "1." Figures 5 & 6 depict the average rent per square foot and annualized rent escalation since 2013 for buildings built prior to 2010 and buildings built in 2010 or later, respectively.

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**FIGURE 4: INDEXED COMPARISON OF RENTAL RATE TRENDS**

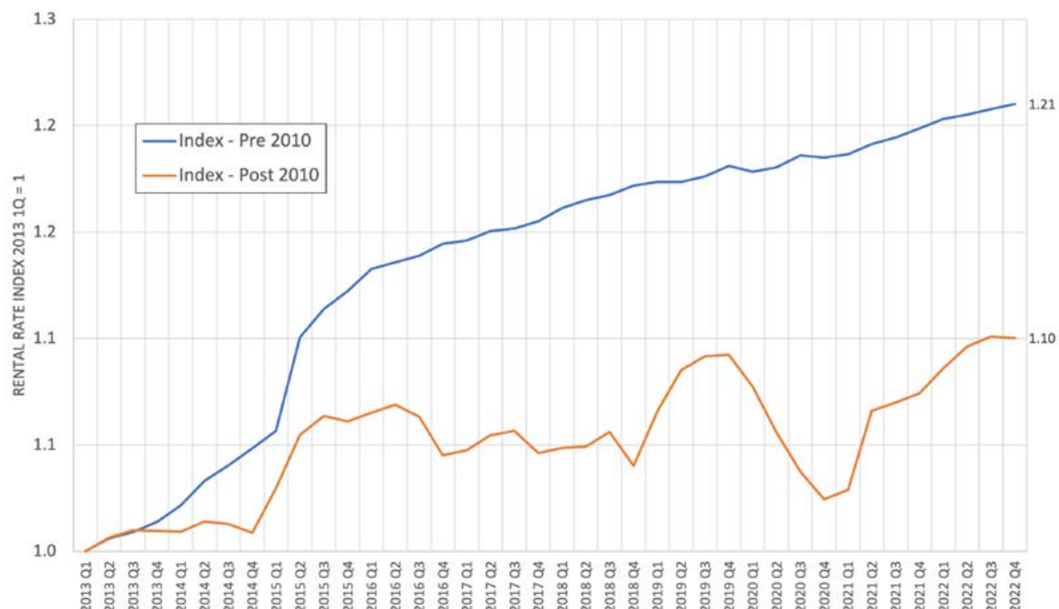


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**FIGURE 5: BUILDINGS BUILT PRE 2010 RENT TRENDS**

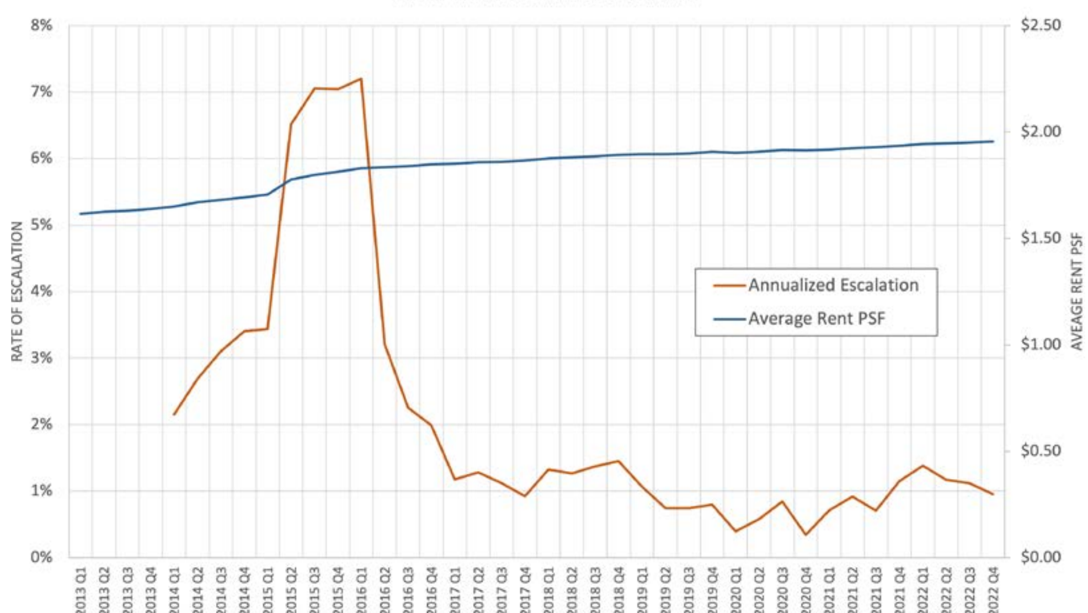

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**FIGURE 6: BUILDINGS BUILT POST 2010 RENT TRENDS**

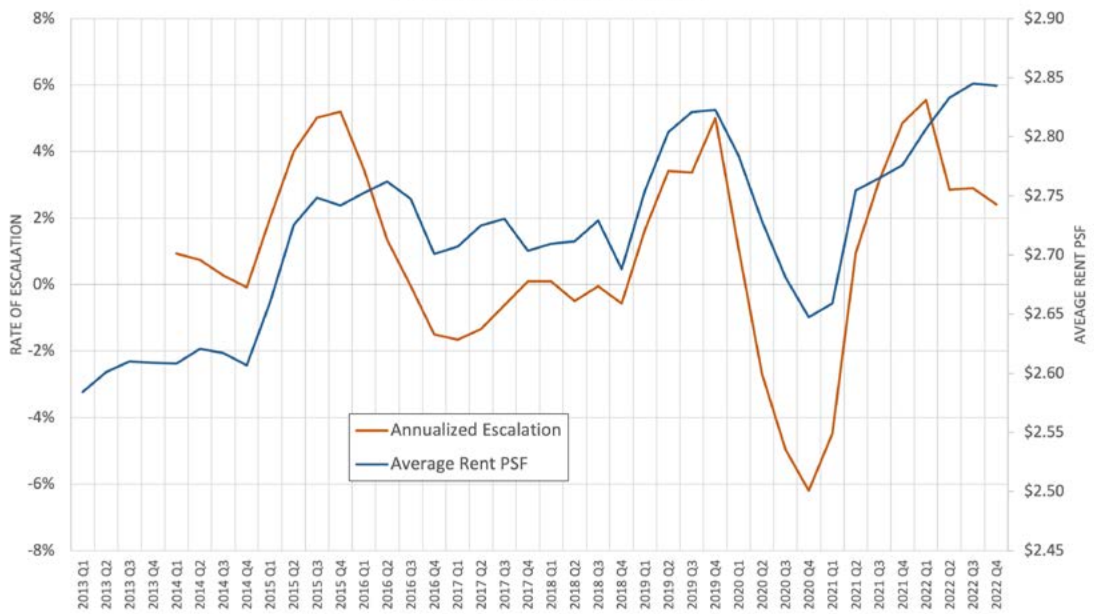


Figure 4 shows that the older segment of buildings, while experiencing consistent rent growth over time, is struggling to achieve rents that keep pace with the newer segment of buildings with very modest rent escalations. The newer segment of buildings, meanwhile, has taken a much more volatile path regarding rent escalations. Newer buildings have seen just a 7% increase in rents since 2015. This figure is likely below projected pro forma numbers for newer developments, and suggests that newer buildings are struggling to lease up. New products that fail to escalate can have a significant impact on older buildings within a given market since they tend to set rents based on the performance of newer ones. Once newer deliveries start discounting rents, older buildings are required to respond similarly to fill vacancies.

While these findings are limited to the NW Portland submarket, they provide important insights into how buildings are performing over time. Inconsistent rent escalations for newer buildings and consistent yet low rent escalations for older buildings can be problematic for investors, especially during high inflationary times. Rent escalations that fail to keep up with the rate of inflation translate to lower returns for investors, which could have a significant impact on investor interest in the Portland market going forward.

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