

SOUTHWEST MARKETS NEWSLETTER

MARCH 2023

Southwest Commercial Markets

As we commence the 2023 year, it warrants taking stock of where we are statistically. According to CoStar, LoopNet, and Crexi, the three largest tracking services, we are at all-time lows in vacancies in industrial space. From West Hillsboro, down Highway 217, and Interstate 5 to Wilsonville, vacancies are less than 1.5% out of the approximately 64 million square feet of space. Since serious tracking of these properties began, this is the low watermark for industrial properties. Over the 40 years I have been in this business, a more typical number would be between 7% and 9%.

The office market in this region, which is comprised of 31 million square feet, realized a vacancy of 7.3% at year-end. This is a healthy number and this area is faring far better than the Portland Urban Core.

Industrial Markets

In 2022, approximately 970,000 square feet of industrial space was delivered to the Southwest I-5 market, of which nearly 910,000 square feet was leased as of year-end. I was personally involved in 800,000 square feet of this activity, and each successive transaction pushed rents ever higher from the initial transactions to the last. "Shell" rents on new industrial space increased by 14% last year. This is unprecedented rent growth. The expected deliveries of new industrial product in 2023 will be 750,000 square feet. The largest delivery of new space will be the Sherwood Commerce Center, that represents our half of this total. I expect rents to increase throughout 2023 for all types of Industrial properties.



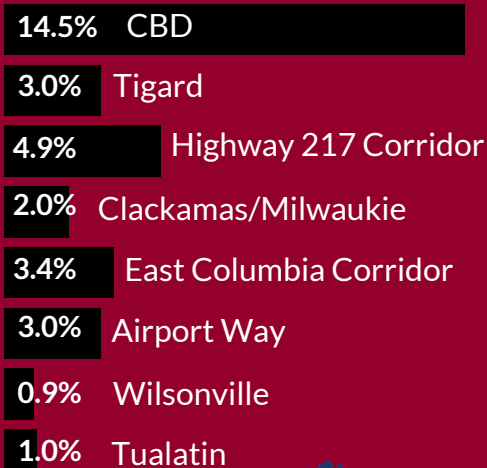
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E-Commerce has driven tenants' need for industrial space for the last five years. However, since the disruption created by the pandemic, the reconfiguring of the supply chain, international political tensions, and onshoring of manufacturing are factors that have created an additional boost in demand for industrial properties. Additionally, industrial demand in the I-5 corridor has been augmented by the flight of companies from Multnomah County, with taxes and employee safety being the main catalysts for this trend. The primary headwinds I foresee in 2023 facing the industrial product type are the interest rate increases and labor supply, which continues to be tight.

Interest rates are still a powerful factor in the valuation of real estate, and the rate increases have put a severe crimp on industrial sales. Over the past three years we saw dramatic increases in the valuation of industrial properties, this was, in large part, fueled by low interest rates. But the spate of borrowing cost increases has left the market in a discovery phase. The short term result is likely a 10-20% reduction of valuations across the board for investment and owner-user sales of industrial properties.

There will likely be a push for industrial space south of the Metro area in the coming years. There is precious little, if any, serviced industrial land inside the Metro areas' Urban Growth Boundary. In addition, many of the suburban markets' restrictive zoning ordinances exacerbate the situation by creating additional risk to development. As a result, speculative development is being experienced south of Wilsonville for the first time. Large leases have been signed in that market, and institutional development is occurring. The most significant industrial transaction of 2022 was the purchase of 100 acres by Amazon and the subsequent construction of the 3,850,000 square foot facility on the west side of the freeway just south of the Woodburn exit, bringing 2000 high-paying jobs to the mid-valley.

Industrial Submarket Vacancy



 CoStar
As of: 2/28/2023

"Despite the headwinds created in the fight against inflation, industrial activity still holds its own region-wide"

- Stu Peterson



Snapshot of SW Suburban Industrial Markets

Sunset Corridor/Hillsboro | \$5.7B Asset Value Portland - OR

Inventory SF	28.4M ↑	Market Rent/SF	\$1.18 ↑
Under Constr SF	150K ↓	Annual Rent Growth	6.4% ↑
12 Mo Net Absorp SF	2.8M	Market Sale Price/SF	\$199 ↑
Vacancy Rate	1.9% ↓	12 Mo Sales Vol	\$46.8M ↓

Wilsonville | \$1.4B Asset Value Portland - OR

Inventory SF	8.6M ↑	Market Rent/SF	\$0.93 ↑
Under Constr SF	0 ↓	Annual Rent Growth	6.6% ↑
12 Mo Net Absorp SF	151K	Market Sale Price/SF	\$165 ↑
Vacancy Rate	0.9% ↓	12 Mo Sales Vol	\$75.1M ↓

Tualatin | \$2.5B Asset Value Portland - OR

Inventory SF	12.6M ↑	Market Rent/SF	\$0.83
Under Constr SF	194K ↓	Annual Rent Growth	6.3%
12 Mo Net Absorp SF	438K	Market Sale Price/SF	\$197
Vacancy Rate	1.0% ↓	12 Mo Sales Vol	\$97.6M

Sherwood | \$432M Asset Value Portland - OR

Inventory SF	2.2M ↑	Market Rent/SF	\$0.82 ↑
Under Constr SF	0 ↓	Annual Rent Growth	5.3% ↑
12 Mo Net Absorp SF	61.5K	Market Sale Price/SF	\$193 ↑
Vacancy Rate	2.7% ↑	12 Mo Sales Vol	\$0 ↓

Tigard | \$1.8B Asset Value Portland - OR

Inventory SF	8.1M ↓	Market Rent/SF	\$1.09 ↑
Under Constr SF	0 ↓	Annual Rent Growth	6.1% ↑
12 Mo Net Absorp SF	24.1K	Market Sale Price/SF	\$222 ↑
Vacancy Rate	3.0% ↓	12 Mo Sales Vol	\$8M ↓

Lake Oswego/West Linn | \$286M Asset Value Portland - OR

Inventory SF	1.3M ↓	Market Rent/SF	\$0.98 ↑
Under Constr SF	0 ↓	Annual Rent Growth	5.8% ↑
12 Mo Net Absorp SF	86.5K	Market Sale Price/SF	\$215 ↑
Vacancy Rate	0.1% ↓	12 Mo Sales Vol	\$5.2M



Office Markets

The office market across the country has been devastated by the work-from-home transition discovered during the pandemic. As a result, many professional firms need to downsize and significantly change their office configurations to accommodate employees who visit the office less frequently. This has created a seismic effect on the office market across the country. As a result, the future of this product type is murky.

The situation in our Metro area stands out as an outlier. Not only is the work-from-home edict ravaging our urban core, but the three-headed hydra of crime, homelessness, and local taxes are driving tenants from the urban core into class-A suburban products in Hillsboro, Lake Oswego, and Vancouver. As a result, most market observers feel that the SW suburban office market is holding its own solely because of the flight from the urban core.

According to CoStar the official vacancy rate in the Portland Central Business District (CBD) is over 25%. As of February 2023, projections are much more dire than that, with many predicting a rate as high as 40% as leases continue to expire. Rates are in a discovery phase, and no one knows where they will settle. One law firm that recently relocated to less space in the CBD was granted 24 months of rent abatement. There are rumors of up to 15 core area buildings being in default of loan covenants. A recent CoStar survey shows 50 available spaces of 40,000 square feet or more in the CBD and surrounding markets, causing an existential situation that will result in significantly lower valuations in the region's most valuable real estate. There are estimates of up to a \$90 million loss in tax revenue from this fallout. A local consulting firm polled existing tenants in the Portland Metro area, and a third said they wanted to exit the CBD, indicating that this will likely get worse before it gets better.



This flight has benefitted the class-A products in the suburbs. Likewise, Lake Oswego, and Kruse Way in particular, has benefited from this diaspora of downtown tenants. This movement is enough to offset the work-from-home issue, keep the suburban market stable, and keep it from succumbing to the remote work sentiments. If it continues, hopefully, it will inflate the Class-B and C products in the southwest areas that have not benefitted thus far from these relocations.

The sale of suburban office buildings has slowed substantially as interest rates have risen. In addition, lenders' reluctance to loan on office products has aggravated office sales because of the systemic issues described herein.

Snapshot of SW Suburban Office Markets

Sunset Corridor/Hillsboro | \$4.6B Asset Value

Portland - OR

Inventory SF	15M	Market Rent/SF	\$27.15
Under Constr SF	0	Annual Rent Growth	2.2%
12 Mo Net Absorp SF	137K	Market Sale Price/SF	\$306
Vacancy Rate	4.7%	12 Mo Sales Vol	\$118M

217 Corridor/Beaverton | \$652M Asset Value

Portland - OR

Inventory SF	2.7M	Market Rent/SF	\$1.97
Under Constr SF	0	Annual Rent Growth	1.6%
12 Mo Net Absorp SF	(42.3K)	Market Sale Price/SF	\$239
Vacancy Rate	16.1%	12 Mo Sales Vol	\$2.6M

Tigard | \$1.3B Asset Value

Portland - OR

Inventory SF	4.9M	Market Rent/SF	\$2.30
Under Constr SF	0	Annual Rent Growth	3.6%
12 Mo Net Absorp SF	28.5K	Market Sale Price/SF	\$261
Vacancy Rate	12.1%	12 Mo Sales Vol	\$41.5M

Tualatin | \$361M Asset Value

Portland - OR

Inventory SF	1.4M	Market Rent/SF	\$2.55
Under Constr SF	0	Annual Rent Growth	6.4%
12 Mo Net Absorp SF	(2.1K)	Market Sale Price/SF	\$262
Vacancy Rate	11.7%	12 Mo Sales Vol	\$3.9M

Kruse Way | \$929M Asset Value

Portland - OR

Inventory SF	2.8M	Market Rent/SF	\$3.07
Under Constr SF	0	Annual Rent Growth	3.8%
12 Mo Net Absorp SF	(104K)	Market Sale Price/SF	\$328
Vacancy Rate	25.0%	12 Mo Sales Vol	\$9.9M

Lake Oswego/West Linn | \$334M Asset Value

Portland - OR

Inventory SF	1.1M	Market Rent/SF	\$2.51
Under Constr SF	0	Annual Rent Growth	3.1%
12 Mo Net Absorp SF	17.9K	Market Sale Price/SF	\$297
Vacancy Rate	7.7%	12 Mo Sales Vol	\$10.2M

Wilsonville | \$359M Asset Value

Portland - OR

Inventory SF	1.3M	Market Rent/SF	\$2.49
Under Constr SF	0	Annual Rent Growth	3.9%
12 Mo Net Absorp SF	58.4K	Market Sale Price/SF	\$272
Vacancy Rate	3.6%	12 Mo Sales Vol	\$10.6M

 CoStar
As of 2/28/2023

Major Tenant Relocations From Portland CBD To Southwest Portland

Tenant	New Location	Previous Location
Allen Trust Company	5000 Meadows	Bank of America Financial Center
Bank of the West	4949 Meadows	KOIN Tower
Century West Engineering	Kruse Oaks III	Water Tower
Hewlett Packard	Kruse Woods II	Block 300
Hyas Group	Peterkort Centre II	Graphic Arts Building
KBF CPAs	Kruse Woods I	US Bancorp Tower & Plaza
KinderCare Education	Kruse Woods III	Liberty Centre
Macadam Forbes Inc	Two Centerpointe	Harrison Square
Norris, Beggs & Simpson	4949 Meadows	Bank of America Financial Center
Precision Cast Parts	Kruse Woods V	PCC Corporate Center
RBD Wealth Management	4949 Meadows	Fox Tower
Steward Partners	4949 Meadows	Fox Tower
Umpqua Bank	Kruse Woods V	Fox Tower
Wells Fargo Advisors	Peterkort Centre II	KOIN Tower

The above tenants accounted for 180,000 square feet of leases in the suburban markets and vacated over 400,000 square feet from the Portland CBD. However, the trend is slowing, especially with average rents in Kruse Way now eclipsing the CBD and the lack of real quality space.

In conclusion, while predictions are matters of opinion. My opinion is that we will see a continuation of the present situation throughout 2023. However, if the Federal Reserve can successfully tame inflation and avoid igniting a recession, it may be a very banner year in the south I-5 corridor.



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