By Greg Frick
HFO Investment Real Estate

All indicators are still positive for the Portland apartment market. However, economic/job growth with increasing wages are the key to keeping the news positive for the apartment market. A strong economy will allow Portland to keep and enhance its high livability factor.

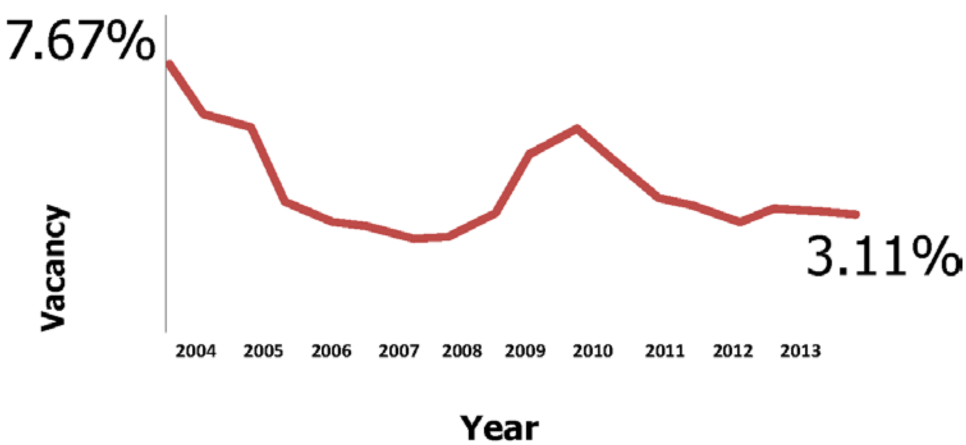
Apartment Vacancy

So where are we today, as we start off 2014?

There have been multiple reports over the last 2 years talking about the Portland metro area's historically low apartment vacancy rates and increasing rents.

Depending on which national report is cited, Portland's apartment vacancy rate continues to rank between the 2nd and 4th lowest of the 75 major metros in the U.S.

In its local survey of over 50,000 apartment units, the MultifamilyNW Fall 2013 *Apartment Report* shows the Portland Apartment vacancy rate fell from a high of 7.7 percent in 2004 to 3.6 percent in 2012 then down to 3.11 percent this year.



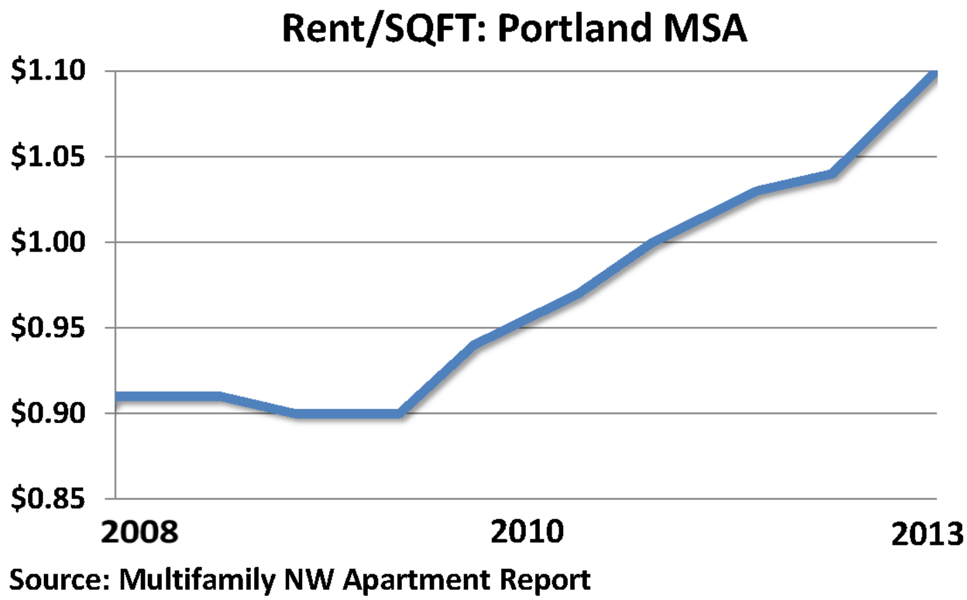
The close-in eastside, north Portland and Beaverton submarkets showed lowest vacancy rates, ranging between 2.1 and 2.3 percent. On the high end are Hillsboro and the Troutdale/Gresham areas, at 4.5 and 5.9 percent respectively.

Apartment Rents

Rent increases in Portland last year placed us as one of the top rental growth markets in the nation. Rents increased nationally by 2.8 percent on average, but the Portland metro area was the third highest in the nation at 6.7 percent. This was a higher percentage increase than in

San Francisco, Seattle, Miami or Austin. Only Denver and San Jose were higher, with rents up an average of 7 percent.

While we expect Portland rents to continue to increase above the national average, this growth may be tempered by the absorption of new units.



Most of the gains in rents since 2004 have occurred since 2010, when market rents increased from an average of $.90 square foot to $1.10 today, translating to annual increases of 7.4 percent.

What are the factors driving the low vacancy rates and rising rental rates?

1. **Shifting of the Buy/Rent Balance**
   While it might not yet be the case in Portland, a recent report by a bank in conjunction with the National Association of Realtors indicated that rising prices of homes combined with rising interest rates are making it cheaper to rent than to buy.

2. **In-Migration**
   As reported in *The Oregonian*, Oregon was the #1 destination for in-migration after four years in the #2 spot. The Portland metro area continues to be a magnet for the college-educated.

3. **City of Portland Population**
   The City of Portland grew almost 10 percent in the past five years – twice as fast as Washington and Clark County, and almost five times faster than Clackamas County.[1]

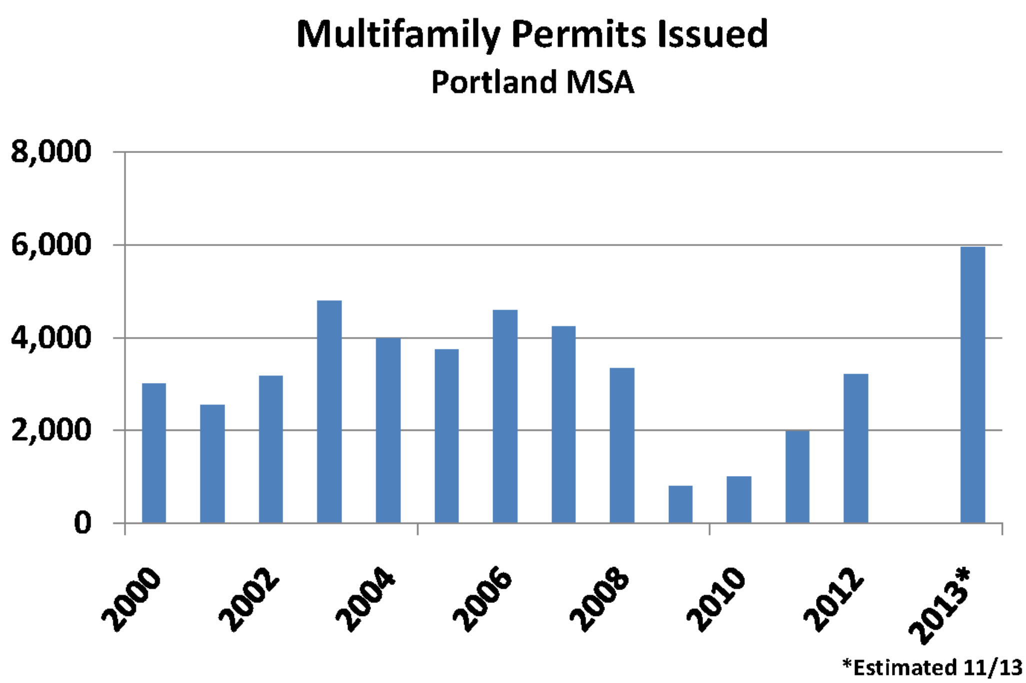
[1] Oregon Employment Department.

4. **Employment**
   The State Employment Department reported that both Portland and Oregon jobless rates were at five year lows, gaining back the jobs lost during the recession.

New Construction – Apartment Pipeline Report

The big topic these days is new construction. There has been a huge increase in construction permits this year. The 2013 total – projected at over 6,000 permits – would be the highest number since the late 90's.

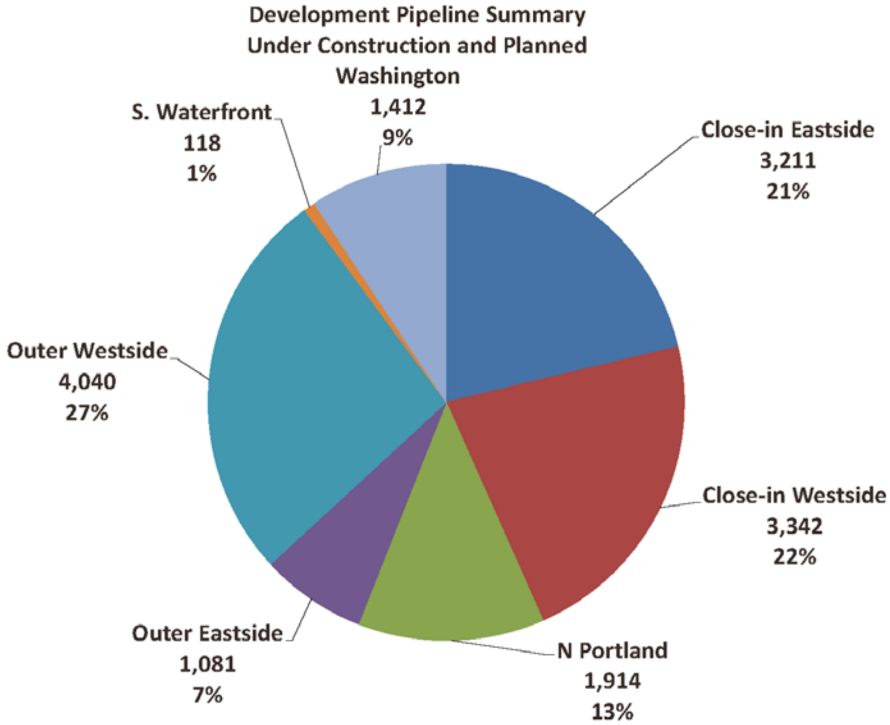
Close-in areas have the largest amount of new projects and the outer Westside has the largest number of total units planned. Intel's expansion will certainly help with the absorption of these Westside units.



Source: U.S. Census
***Estimated based on Permits reported as issued through November 2013. Year-end data available at the end of January, 2014.**

HFO Apartment Construction Report™

The HFO Research staff is tracking the total number of all known units currently under construction and planned. If all 15,118 units were built, here is where they would be located:



Source: Newspaper reports, city permit offices, HFO research.

Development Trends – 2013.

In 2013 we saw

- Developers starting to drop first floor retail space in order to allow for more apartments.
- Opening of the first micro-units began with the new Freedom Center in the Pearl District. These units offer less than 300 square feet of living space and some planned projects have even smaller square footages. Asking rents are between $2.36 and $4.19 a square foot or $708 to $1,257 per month for a 300 square foot unit.
- The city of Portland adjusted its parking requirements for new apartments following pushback from neighborhood groups.

2013 Transactions In Review

- Low vacancy rates
- Continued low interest rates
- Plenty of money managers, banks and owners with capital looking for a good place to invest

The question those of us at HFO are asked routinely is "with all of this new construction, will low vacancy rates and rising rental rates continue?" Our response: The new construction will have an effect on our vacancy rate, but how much is yet to be seen.

The Portland apartment market is viewed both regionally and nationally as a favorable market to place investment capital. Our apartment transaction market is bifurcated between institutional transactions -- those over $10,000,000 -- and those below that threshold.

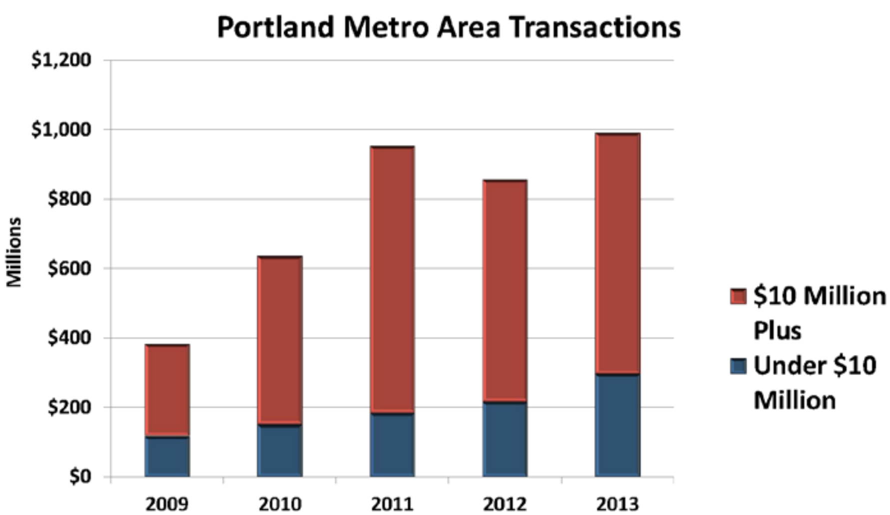
During 2013 there were 21 transactions over $10 million. These include:

- The Cyan: 352 units downtown, $95.75 million
- Savier Flats: 179 units in NW Portland, $61.4 million
- Altamont Summit: 440 units in Clackamas, $54.25 million
- Highland Hills: 400 units in Vancouver, $49.325 million
- Rivercrest Meadows: 338 units in Tualatin, $46.65 million;
- Waterhouse Place: 279 units in Beaverton, $40.85 million

The 21 institutional transactions translate to roughly 14.5 percent of all multi-family transactions of 10 units and more in the Portland market and 70 percent of the total dollar volume.

In 2012, there were 19 institutional transactions accounting for 16 percent of all transactions and 75 percent of the total dollar volume.

CAP rates for institutional properties are as low as we have ever seen. Institutional apartment transactions are trading in the 5.25-6.00 percent CAP rate range, and 50 to 100 basis points lower for projects located in the core.



Source: CoStar Multi-Family 10+ Units

In the non-institutional segment of the market, 2013 saw an increase in buyers looking to enter the market. Low interest rates were and still are a significant factor in the increased activity. In 2012 there were 98 transactions under $10 million and in 2013 there were 124.

This continued rise in demand has caused values to increase above those seen in 2008, depending on location and quality. These non-institutional apartments are trading with CAP rates in the 6.25 to 7.25 percent range, and even lower for core-located properties.

HFO is also seeing an increase in demand for C class properties due to the large amount of capital looking for investment options.

Factors which could negatively impact the apartment market in 2014 are the same one we were watching last year:

1. A rise in interest rates and a corresponding rise in CAP rates. With a rise in CAP rates from 6 percent to 7 percent: a property's Net Operating Income will have to increase by 16 percent to maintain its value. This is not gross rents but Net Operating Income.

2. Wage stagnation. Can we develop jobs and increases wages that will allow people to pay more to live in their apartments?

3. The impact of new construction.

Summary and Forecast for 2014

- The possibility that home ownership will become more expensive than renting apartments.

- Employment is looking up!

- HFO expects Portland area vacancy rates to increase slightly due to the absorption of new units. Even so, our metro vacancy will remain among the nation's lowest.

- Rents will continue to increase but not at the 6.7% level seen in 2013.

- The number of institutional transactions will stay flat, but demand will remain strong.

- Some owners will decide to exit the market due to the recovery of values combined with the large amounts of investment capital looking for secure, stable returns.

Greg Frick is a partner at HFO Investment Real Estate, now celebrating its 15th year in business. HFO's partners have brokered transactions of more than 14,670 units valued at $1.86 billion throughout Oregon and Washington. Greg works with both private market and institutional clients and can be reached directly by phone at 971-717-6332 or e-mail greg@hfore.com.