Winter 2004-05

The Barry Apartment Report

The Barry Apartment Report is a publication covering economic, financial, and valuation trends affecting apartments in the greater Portland area.

2005 Forecast - Modest Improvement in Second Half

Current Portland Metro Trends

- Unemployment: 6.4%
- Job Growth: 0.6%
- Population Growth: 1.2%
- Portland CPI: 1.8%
- Apartment Construction: Stronger than expected
- Apartment Sales: 2004 was a record year
- Apartment Values: up 2.5% in 2004
- Apartment Rents: Down 2-6% since 2002; bottomed out in mid 2004
- Apartment Vacancies: 7.5%

Inside this issue:

This issue of the Barry Apartment Report is based on speeches given by Mark D. Barry on 12/16/04 at the IREM Forecast Breakfast, and on 1/5/05 at the CCIM monthly luncheon.

In many ways, 2004 was the year of the recovery. This was the year that unemployment in the U.S. went down to 5.5 percent, with 2.2 million new jobs. And today, there are 35,000 more Oregonians now employed than a year ago. The Portland metro economy is better off now than a year ago, with 6.4 percent unemployment and almost 9,000 new jobs.

However, despite some favorable news with the economy, in 2004 the Portland apartment market struggled for the third year in a row, and I think we will look back on 2004 as the toughest of the last three years for the apartment rental market. Now, a year ago, there was guarded optimism that the apartment market would improve. **So what went wrong in 2004?** Well, I think there were four main reasons:

Apartment Vacancies: First of all, we started out the year with almost 19,000 vacant apartments units out of a total inventory of 225,000 units, or a decade high apartment vacancy factor of almost 8.5%.

Portland Economy: Second, despite some positive signs of improvement, our economy has clearly lagged well behind the national recovery. We have 50,000 fewer jobs today than seen at the peak of the expansion in 2000, including a loss of 18% of our manufacturing jobs.

Interest Rates and Home Sales: Thirdly, the overwhelming consensus a year ago was that long term mortgage rates would increase in 2004. Instead, 10 year Treasuries are now at 4.2%, or 10 basis points lower than a year ago. ***A low interest rate environment in conjunction with strong residential construction and home sales has probably had the biggest adverse impact on the apartment market in 2004.*** In the 1990's, there was an average of around 23,000 home sales per year in the Portland area, but single family sales volume is way up since 2000. 2003 was a record year, with 31,000 home sales and we are on track for around 34,000 home sales in 2004.

Residential Construction: Finally, 2004 was another strong year for residential construction.

Single Family Construction: When the economy was strong over

the 1997-2001 period, we saw permits for around 10,000 new homes per year in the four county Portland area. Despite a weak economy in recent years, single family home construction has never missed a beat due to low interest rates, and we will see permits for another 10,000 new single family homes in 2004.

Apartment Construction: Also, when the economy was strong in 1999 to 2001, we averaged around 3,500 new apartments per year. In 2003, we saw permits for almost 5,600 apartments, and it looks like we will see permits for around 4,000 new apartment units in 2004, or another active year.

Now, all the property managers I speak with tell me how tough the apartment market is. So why are we seeing so much apartment construction? I attribute this to:

- A high level of government assisted or subsidized units, including the city of Portland's strong commitment to affordable housing.
- Private builders who want to lock in a low interest rate for their project in anticipation of better times ahead.
- And with values for new units in the $70,000 to $80,000 per unit range, some builders build to sell the property to investors.

These forces have resulted in a higher level of apartment construction which can be justified or supported by the

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market, and have contributed to a more competitive apartment market.

Now I mentioned that this has been a tough apartment market. This is evidenced by:

Rental Levels

Rent levels are down 2.0 to 6.0 percent since 2002. In September 2004, HUD cut the maximum Section 8 rents by around ten percent due to their surveys showing a decline in market rental rates. Renters are stretched thin due to a 6.5 percent average annual increase over the last four years for essential services such as auto insurance, health insurance, gasoline, and utilities, versus median household income increases of just 2.5 percent.

Apartment Vacancies

Most published surveys show current apartment vacancies in the 7.25 to 8.0 percent range, though our surveys show some pockets in the 10 to 15 percent range. Some sub-markets have held their own, and have seen stable or normal occupancy rates. These include the entire close in east side and west side urban area, close-in Hillsboro, Lake Oswego, West Linn, and Vancouver. However, most other areas are seeing apartment vacancies well above historic trends. This includes Southwest Portland, the outer Southeast, Northeast Portland, & North Portland area, Gresham, Wilsonville, Milwaukie, Oregon City, and most of suburban Washington County.

Concessions

Concessions tend to be available in the majority of the sub-markets, and when offered will typically range from one half to one month's free rent. Concessions tend to result in effective rents of four to eight percent below the "street rents." Other complexes have dropped their rents, or effectively dropped their rents by amortizing the concessions over the lease term.

Expense Levels

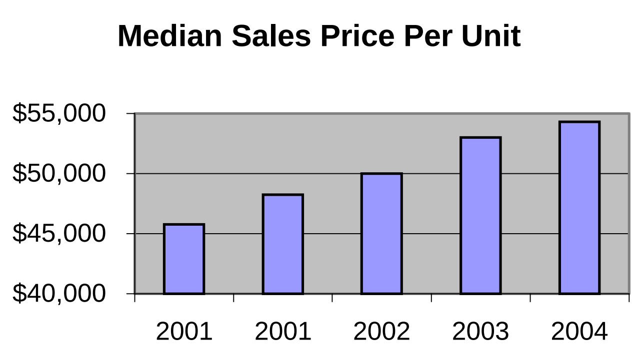
In the face of income levels which have ranged from very modest increases to noticeable declines, landlords have also faced higher expenses. Property taxes were up 3 to 9 percent for the 2003-2004 tax year, and insurance costs are currently 75 to 100 percent higher than a few years ago. Advertising costs as a percent of income are as high as I have seen over the last decade, as landlords compete for a limited pool of tenants. Utility costs continue to show steady increases above the rate of inflation.

Net Operating Income and Cap Rates

With a flat rental market, and increasing expenses, net operating income has been declining the last three years, and in 2004 is at levels last seen back in 2000. However, a lower interest rate environment has resulted in lower overall capitalization rates and increasing apartment values. The median cap rate in 2002 was around 8.25%, but this dropped to 7.50% in 2003, and 7.10% in 2004.

Apartment Values

Despite a declining net income, apartment values were up by 5.0 percent per year from 2001 to 2003. These value increases in recent years were due solely to declining overall capitalization rates.



The question I often hear is *"With income flat or declining, expenses increasing, and net income declining, how long can apartment values continue to increase?"* Well, in 2004, the median per unit price showed a 2.5 percent increase due to a continued decline in cap rates. Older units in the close-in urban areas showed median per unit price increases well into double digits. However, the run up in apartment values that we saw in 2000 to 2003 is losing steam for some older units in the suburban areas, with modest declines in some areas.

Apartment Sales Volume

Apartment sales activity was strong in 2004. Year end 2004 figures should show 275 sales of 9,500 units for $580 million vs. 267 sales for 10,000 units for $562 million in 2003. Thus, 2004 was another great year for the apartment brokerage community, and on par with the record levels we saw in 2003.

FORECAST FOR 2005

Well, so far I've covered the easy part. What can we expect in the Portland area apartment market in 2005? My forecast is as follows:

Employment and the Economy: The forecasts I see, are for around a 1.5 to 2.0 percent annual increase in employment in 2005. This would result in 15,000 to 20,000 new jobs in the Portland area over the next year versus an average of 26,000 jobs per year from 1990 to 2000. However, recent national developments include more expensive oil, slower employment growth in recent months, and a more cautious consumer. I feel we will be seeing closer to 10,000 to 15,000 new jobs in 2005, though after what we've been through over the last three years, I think we'd be pleased if we added 15,000 jobs.

Interest Rates: An improving economy, record federal deficits, and the Federal Reserve's recent raising of interest rates signals the beginning of what is expected to be a slow

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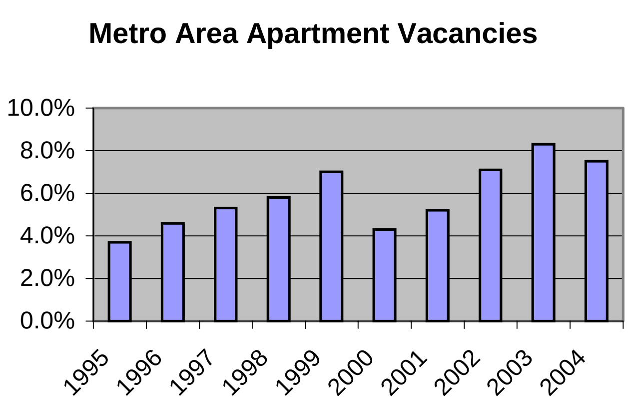
but ongoing rise in interest rates. Many seem to think that interest rates have nowhere to go but up. I'm assuming mortgage rate increases of 75 to 125 basis points over the next year.

Residential Construction:

Single Family: It is the American dream to be a homeowner, and strong federal, state and local programs are in place to encourage home ownership. Home ownership increased from 64 percent of households a decade ago to 67 percent in 2000, and is now at 69 percent, and thus much of this increase has come over the last four years. With all else being equal, a one percent increase in the ratio of home ownership housing here in Portland will result in a three to four percent increase in our apartment vacancy rate. It is a safe bet to assume that 2005 will be another strong year for single family home construction, with 9,000 to 10,000 new homes expected.

Apartment Construction: Low interest rates will continue to encourage apartment construction in the first half of 2005, but increasing rates will slow down apartment construction in the second half. 2,500 to 3,500 new apartment units are expected.

Apartment Vacancies: Apartment vacancies in the Portland area over the last decade have ranged from 3.5% to 8.3%, with an average of 5.9%, as indicated in the Millette Rask Report. The apartment market is expected to stay very competitive in the first half of the year, with modest improvement in the second half. I expect to see apartment vacancies of 6.75 to 7.00 percent a year from now, or 15,000 to 16,000 vacant apartments expected.



Apartment Rents: The apartment market is too competitive and too fragile for landlords to think they can raise rents at this time. The actual collections for the second half of 2004 were about 1 per cent higher than the first half of the year, which tells me that the rental market bottomed out in mid 2004. However, most landlords do not want to risk the loss of tenants, who are already being squeezed with higher health insurance, gasoline, and utility costs. The rental market will be flat for the first half of 2005, with a very modest improvement in the second half.

Apartment Expenses: In 2005, landlords will see more moderate increases than seen in recent years for property taxes and insurance. Advertising costs will start coming down, but both landlords and tenants will get no relief on utilities in 2005, and will see another wave of increases. Also, with heating oil and natural gas prices up by up by 15 to 30 percent, landlords with centrally heated older apartments will be paying a steep price in 2005 and beyond. I expect overall expenses to increase by three percent to four percent in 2005.

Apartment Values: It's always tricky to call the top of a hot apartment sales market. In addition, anyone who has been pessimistic on apartment values here over the last 20 years has been wrong. We are not going to see any significant value problems in 2005. However, apartment values are highly sensitive to interest rates. While there are obvious uncertainties, moderate increases in interest rates of 75 to 125 basis points will have an adverse impact on apartment values.

Mortgage Lending: The length and duration of the low interest rate environment of recent years has never been seen in the adult lifetime of most of us in this room. Some observers think we are in the last inning of a long ballgame. Preliminary figures from the Mortgage Bankers Association show total volume of all mortgages originated in the U.S. fell from $3.8 trillion in 2003 to $2.8 trillion in 2004. In addition, the actual mortgage loan volume in the U.S. declined by 44 percent in the third quarter of 2004. While sales volume is essentially flat, total refinancing could fall by more than half. Those in the mortgage industry and the rest of us who make our livelihood from providing services to the mortgage industry have been on easy street over the last three years. Expect to see a decline in mortgage volume of 25 to 30 percent in 2005.

CONCLUSION

In conclusion, there are some reasons for optimism. These include:

- *A better local economy.*
- *Higher interest rates that will slow down residential construction and home purchases.*
- *Expenses for property taxes, insurance, and advertising which should be more under control in 2005.*
- *Many condo conversions in the urban area, thus reducing the inventory of rentals.*
- *Some signs of slightly higher apartment rental income in the second half of the year in comparison with the first half of the year, with fewer concessions.*
- *And some limited signs of light at the end of the tunnel.*

There are also reasons for pessimism. These include:

- *Apartment construction was too high in 2004.*
- *Single family construction has not missed a beat.*
- *Utility costs are expected to rise.*
- *The national economy is showing signs of slowing down.*
- *And higher interest rates, that two edge sword, which could impact apartment values.*

The 1st and 2nd quarters of 2005 will continue to remain very competitive. Expect to see more light at the end of the tunnel as the year progresses.

The Barry Apartment Report

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Turn Back the Clock . . .

* 1919 – "Tenants are suspicious and see standardizing the regulation and management of apartment houses a sinister purpose of price gouging and extortion," and so are "organizing themselves against the alleged aggression of the landlords." Oregon Journal

* 1919 – Tenants claim overcharging by Dr. Ong, the owner of apartments on Broadway and Clay Streets. He responded, "Several years ago they had me at their mercy; now they are at mine. If they don't like it, let 'em move!" Oregon Journal

* 1932 – Writer Claude Bristol writes about Portland apartments: most kitchens have no room to turn around in, nor do they have windows; the entrances to the buildings are often deceiving as to their luxuriousness; and there is too much racket going on in and around the buildings. Oregonian

* 1934 – Portland residents of apartment houses will be offered a chance to compete in an essay contest for cash and merchandise, on the subject "Why I Enjoy Living in Apartments." Oregon Journal

* 1939 – The week of June 18th is to be known as "Portland Apartments on Parade." Apartments will be opened to the public to visit. "The greatest demonstration of modern apartment living Portland has ever seen." Oregon Journal

* 1941 – The Board of Managers of the Oregon Apartment House Association oppose any rent control legislation. The association represents 500 buildings in Portland. Oregonian

*1951– The 314 unit Ione Plaza, Oregon's largest apartment house, opens in Southwest Portland at a cost of $3,000,000. The 15 story building forms a giant X and takes up an entire block. The property will include a public restaurant on the first floor, and a two level basement garage for 204 cars. Oregonian

*1961 – Ms. CS Jackson deeded the land at 2020 SW Salmon to construct the 7 story Hadley House Apartments. The cost will be approximately $1,000,000. Occupants will be members of an owner's nonprofit organization, which offers tax advantages. Oregonian