

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

2007 Forecast - Low Vacancies & Increases in Income Expected

Current Portland Metro Trends

- Unemployment: 4.7%
- Job Growth: 2.3%
- Population Growth: 1.6%
- Portland CPI: 2.7%
- Apartment Construction: Slow
- Apartment Sales: 2006 was a record year
- Apartment Values: up 15% in 2006
- Apartment Rents: Up 7.8%, but income up 3% to 5% in 2006
- Apartment Vacancies: 3.4%

This issue of the Barry Apartment Report is based on a speech given by Mark D. Barry on 12/07/06 at the 19th Annual IREM Forecast Breakfast, and on 01/03/07 at the monthly luncheon of the Oregon/SW Washington CCIM Chapter.

2006 will go down as one of the great years for the Portland area apartment market. With so much positive news available to describe the local apartment market, it is hard to know where to begin in summarizing what happened in 2006. So why was 2006 such a good year for the Portland area apartment market? Well, I think there were four main reasons:

Portland Economy: First of all, we had a decent economy in 2006. We've added 24,000 jobs over the last year, and seen our unemployment rate drop to 4.7%. And over the last two years, we've added 60,000 jobs. This is in comparison with a loss of over 50,000 jobs the previous three years. Oregon is now showing the ninth highest rate of job growth in the nation.

Apartment Construction: 2006 saw slow apartment construction, particularly in Clackamas and Clark County, thus resulting in only limited new supply coming on the market. While the final figures for 2006 will show permits for around 5,000 new multifamily units, this is misleading due to condos not being separated out. My figures show that only 2,000-2,500 new apartment rental units will be added in 2006, or one of the slowest year in the last decade. Some apartment developers have switched to condominium development, with some upgrades in the product. The margins in rowhouse and condominium development have simply been too strong for apartment developers to compete.

Condominium Conversion: The third factor having a big impact on the apartment market was unexpectedly strong condominium conversion throughout both 2005 and 2006, particularly in the urban area. Over the last two years, there have been conversions of an estimated 2,500 apartment units, thus resulting in a loss of around one percent of our apartment inventory. Condominium living in Portland has clearly gained

acceptance, and accounts for 35% of all new home construction in the United States versus 20% in 1998.

Single Family Market: The fourth factor favorably impacting the apartment market was the declining affordability of single family homes, thus making it more difficult for renters to become home owners. Housing price appreciation has outpaced income. The median sales price for November 2006 is \$278,000, or 10% higher than a year ago. While the days of the home buying frenzy are now behind us, more limited affordability of single family homes in the last year has helped the apartment market.

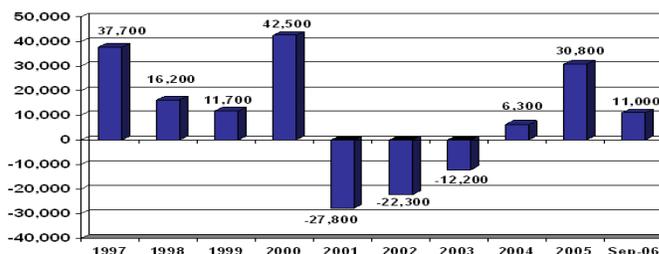


So what else happened in 2006?

Apartment Vacancies: With a better economy, slow apartment construction, a loss of units to condominium conversion, and a decline in single family affordability, everyone expected apartment vacancies to fall. But the big surprise of 2006 was just how far and how fast apartment vacancies declined. In the Fall of 2004, our apartment vacancies were at 7.5%, and a year ago, at 6.1%. But the latest figures from the Metro Multifamily Housing Association (MMHA) show current vacancies at 3.4%, or the lowest in the last decade. We are seeing low apartment vacancies in virtually all submarkets, with the exception of Aloha, outer



PMSA Wage & Salary Employment Annual Change 1997 – YTD 2006

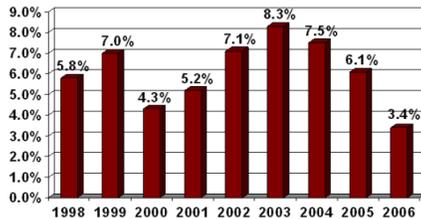


Inside this issue:

- 2007 Forecast 2 & 3
- Turn Back the Clock 4

Southeast Portland, West Vancouver, and the Oregon City/Gladstone area.

Portland Metro Apt Vacancy Rates
1998 - 2006

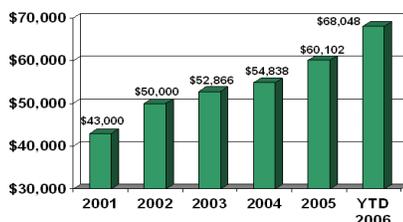


Apartment Rents: With lower apartment vacancies, the days of concessions, specials, gimmicks and giveaways, which were so prevalent from 2002 to 2004, are virtually over. The MMHA figures show an increase in the average turnover rent of 7.1% over the last year. However, my figures show actual collections are closer to 3% to 5% higher this year in comparison with last year.

Apartment Expenses: Apartment expenses were fairly stable in 2006. Advertising showed the most noticeable decline, but insurance costs were stable. Only moderate increases were seen in utilities, though garbage costs in Portland are increasing. Property taxes were all over the board based on the municipality, ranging from an 8% decline in much of the city of Portland to a 12% increase in Beaverton. But with a tighter labor market, personnel costs for both management and repair/maintenance type functions saw some increases.

Apartment Values: The biggest surprise of the year was the run-up in apartment values we saw in 2006. The median price per unit was up almost 15% in 2006 vs. 2005 vs. an average of around 5.5 per year for the previous five

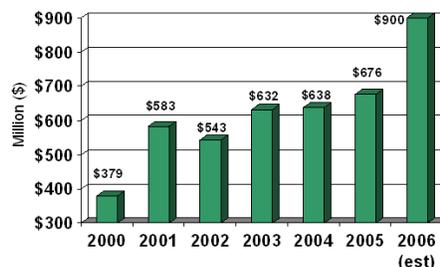
Median Per Unit Sales Price
Four County Metro Area
2001 - YTD 2006



years. More moderate increases were seen in the older 1960-1980 built suburban apartments in East Multnomah County as well as such older units in Clackamas, Washington, and Clark County. But urban apartments built prior to WWII showed a whopping 20% increase, and we can certainly attribute part of this increase to the condominium conversion craze. While the 525 unit Portland Center Apartments conversion is the most visible, we have also seen numerous conversions of smaller older apartments in the city of Portland.

Apartment Sales Volume: I can unequivocally say that 2006 will see the greatest dollar volume of apartment sales activity ever seen in our market. We are on track for around \$900 million in apartment sales volume for the year, or a 33% increase over the previous record in 2005.

Apartment Sales Volume
Portland Metro Area
2000 - 2006



FORECAST FOR 2007

So where is our apartment market going in 2007? My forecast is as follows:

Economy: All the signs are out there of a slowing national economy. While most of the local news has been positive, there has been some well publicized cutbacks. This includes companies such as Intel, IBM, Freightliner, Pixelworks, Federated Department Stores, Georgia Pacific in Camas, Salomon deciding to move to Salt Lake City, and Nike planning to close their Wilsonville distribution center in 2008. Our own Bill Connerly feels there is a 25% chance of a recession in 2007. Our state economist is forecasting a 1.2% rate of employment growth for the state next year, which would translate into around 12,000 new jobs for Portland. Thus, the

consensus is that 2007 will be a slower year for the national economy as well as the local economy.

Interest Rates: Everyone expected interest rates to increase in 2006. We started the year with Treasuries at 4.3%, and by mid year, they were up to 5.25%, but are now at 4.71%. With a slower economy, a slowdown in the housing market, and a decline in oil from \$78 to \$61 a barrel, interest rates are expected to be stable in 2007.

Apartment Construction: Land is too expensive, and the costs do not justify the risks. With higher construction costs, profit margins are too thin to support any significant volume of new apartment construction. In addition, the action is in the row-house and condo market. I expect we will see 2,000 new apartment units in 2007, or one of the slowest years in the last decade.



While dramatic increases in rents combined with low vacancies and strong investor demand would typically result in the start of a new cycle of apartment construction, I feel we are too early to see the start of this cycle in 2007.

Apartment Vacancies: With slow apartment construction and a slower but stable economy, apartment vacancies will further tighten down to the 2.75% to 3.0% range by late 2007, or a record low for the decade.

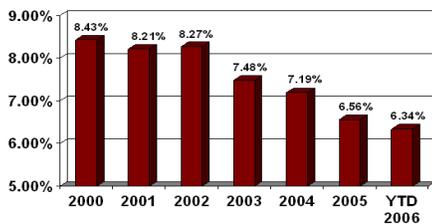
Apartment Rents: While 2006 saw a shift to a landlord's market in most submarkets, the memories of that tough apartment market in 2002-2004 were too fresh in landlords' minds to push rents except on turnover. This will change in 2007, and landlords will try to play catch up after years of flat to declining income. I expect to see a 5% to 8% increase in rents and income in 2007. In addition, while only the more aggressive landlords instituted utility bill

backs for water, sewer, and garbage, we will see more owners and property management companies start utility bill backs on buildings not now separately metered.

Apartment Expenses:

Apartment expenses are likely to trend upward in 2007. Above average increases in property taxes are expected in Portland due to the bond measures approved in the

**Portland Metro
Median Cap Rate for Apartments
2000 – YTD 2006**



November 2006 election. Insurance costs will remain stable, but advertising costs will continue to decline. Utility costs will continue to increase above CPI, though part of this is due to higher occupancy levels.

Apartment Values: Anyone over the last 20 years who has bet against apartment values has been wrong. Since April, mortgage rates have exceeded average cap rates on many apartment sales, making purchases difficult for leveraged buyers.



10/06 Sale—\$43,750/Unit
44 unit Garden Villa Apts.
8435 SE Insley Street

Despite some expected retreat of condo converters, pent up investor demand runs deep, there is a torrent of equity money chasing deals, and there are more buyers than there are properties to buy. I would expect that any increase in values will be

consistent with increases in income. Also, the recent decline in interest rates was unexpected, and could energize the market. But with the expected slowdown in the condo conversion market, it is hard to see that there is



11/06 Sale—\$63,617/Unit
47 unit Courtyard at Cedar Mill Apts.
13000 NW Cornell Road

any upside potential for urban apartments with condo conversion prices of 13 to 15 times the gross income and cap rates of 3% to 4.5%, and my sense is that this part of the market has peaked.

Condo Conversion: We are already seeing slower absorption, some inventory buildup, and fussy buyers. Condo conversions have had a huge upside for the developer. However, the downside risk is that the market will slow down or get overbuilt. The biggest risk for condo converters is if the market dries up, and they end up with a building with a mix of individual unit owners, and renters in the units which they could not sell. Condo conver-



08/06 Sale—\$102,727/Unit
55 unit Cardinell View Apts.
1205 SW Cardinell Drive

sions are way down nationally, and this trend will play out in Portland in 2007.

CONCLUSION

In conclusion, 2006 and 2007 will go down as two of the best years in recent memory for the Portland apartment market. The stars have aligned due to a unique set of market conditions all occurring at the same time. While 2006 will be remembered for the jump up in apartment values and condominium conversions, 2007 will be known as the year that landlords and apartment owners saw significant improvement in their operating income. The Portland area apartment market has so much momentum and so many positive things happening that only a hard landing in the economy or an unexpected jump in long term interest rates could spoil the party in 2007.

“Right now most investors are assuming that Fed Chairman Ben Bernanke is going to pull off a soft landing,” said Alfred Goldman, chief market strategist for A.G. Edwards & Sons, Inc. “But if the housing market gets washed out big time, the odds of a hard landing and a recession go up substantially.”

“We haven’t seen the worst of it yet,” said Robert Nardelli, Chairman & CEO of Home Depot. “75,000 construction jobs are gone. I’ve never seen a pullback so fast. If this is a soft landing, it’s not a plane I want to be riding on.”

“The Great American Housing Collapse is the dog that didn’t bark in 2006, and won’t in 2007. Consumers are still spending. Businesses are still investing. The U.S. economy will do just fine in 2007,” said Rich Karlgaard, publisher of Forbes.

The Barry Apartment Report

Mark D. Barry & Associates
7628 SW 32nd Avenue, Suite 200
Portland, Oregon 97219
503.243.2925 / Fax 503.246.0714
mb@barryapartmentreport.com
Contributors: Barbara A. Carson
and Patrick Oliver Barry



Mark D. Barry, MAI
Apartment Appraisal Specialist

Turn Back the Clock . . .



***1920** - The Apartment House Owners and Managers of Portland met Tuesday night and agreed on stringent new rules. Moving from one apartment to another will cost \$1.50; a 40¢ deposit will be required for a key; managers will require 10 days notice from tenants vacating apartments; \$1.50 will be charged for cleaning an apartment; and no rent paid in advance will be returned. *Oregon Journal*

*** 1932** - Apartment house builders of Portland do not follow with proportions in countries where eating is an art. "We could not even pivot, much less turn around." There's a sameness in many apartments in Portland. "One can sit in the kitchen sink, reach over and fry a steak without perceptively bending your body." *Oregonian*

*** 1942** - In the city's largest apartment deal in recent years, Harry Mittleman announced the purchase of 3 apartments: St. Helen's Court at SW Mont-

gomery, Pembroke at 16th & SE Belmont, and the Raleigh at 24th & NW Raleigh. Adds 83 units to Mr. Mittleman's holdings and brings the total number of buildings to twelve, with 600 apartments. *Oregonian*

*** 1950** - Tenants who are notified by their area rent control office that their landlord has been authorized to increase their payments are not obligated to pay the increase until they receive formal written notice of the rent boost from the landlord himself. *Oregonian*

*** 1978** - Apartment market is as tight as any time since the end of WWII. Vacancies dropped from 5% to 2%. Builders are thwarted by the lack of mortgage money, while zoning has reduced available areas for building, especially in Washington County. Rents have been too low. Groups in heavy need are singles with 1 bedroom units, and families with 3+ kids. "Some of them are panicked, almost hysterical." *Oregon Journal*

***1984** - Despite pleas of neighbors for further design changes, a 74 unit apartment was approved on the west side of SW Hall Blvd. between Hart Rd. and Green Lane by the Robert Randall Co. Neighbors are concerned about tree removal. 69 of 266 trees are scheduled to be removed. *Oregonian*

***1986** - The Portland area condo market hits bottom, with numerous bulk sales of a portion of the units within a larger complex. These include 72 of the 150 units at Willowbrook Condos for \$21,250/unit; 32 of the 63 units at Brookside Condos for \$34,500/unit; and 61 of the 73 units at Bonita Firs Condos for \$36,672/unit. *Oregonian*