The Barry Apartment Report

Winter 2006

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

2006 Forecast - Continued Improvement Throughout the Year

Current Portland Metro Trends

- Unemployment: 5.3%
- Job Growth: 2.4%
- Population Growth: 1.56%
- Portland CPI: 2.5%
- Apartment Construction: Slow
- Apartment Sales: 2005 was a record year for dollar values, but fewer transactions
- Apartment Values: up 12% in 2005
- Apartment Rents: Flat, but income up 1-2% in 2005
- Apartment Vacancies: 5.9%

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This issue of the Barry Apartment Report is based on a speech given by Mark D. Barry on 01/04/06 at the monthly luncheon of the Oregon SW Washington CCIM chapter.

After three years of flat income and above average apartment vacancy rates, the Portland metro apartment market saw a clear reversal of fortunes in 2005. Strong employment growth, limited apartment construction, continued population growth, and elimination of 1,250 apartment rental units from the effective inventory due to condominium conversion have all contributed to the Portland metro area apartment market stabilizing, and getting back in balance in 2005. While we started 2005 with a 7.1% apartment vacancy rate, we ended the year with a 5.9% vacancy rate, the lowest since 2001. So what contributed to this turnaround in 2005? Well, I see four main reasons:

Portland Economy: A year ago, our unemployment rate was 6.5%. In 2005, we added 22,800 jobs, and saw our unemployment rate drop to 5.3%, or the lowest since 2001. The State of Oregon showed the sixth fastest rate of job growth in the nation in 2005.

Apartment Construction: In 2002-2004, more apartment units were built here in Portland than warranted by the demand. This changed in 2005. While we averaged around 4,700 new units per year from 2002 to 2004, apartment construction (after elimination of the condominium units) declined to under 3,000 units in 2005.

Population Growth: The Portland area population growth continues to outpace the state and the nation. From 2000-2005, our population increased by 1.56% per year versus 1.25% for Oregon, and 1.04% for the U.S. as a whole. We are adding about 12,500 new households per year.

Condominium Conversion: The strength and depth of the condominium conversion market surprised most observers in 2005, and this phenomenon gained momentum as the year progressed. The September 2005 purchase of the 537 unit Portland Center

Apartments for $77.5 million for condominium conversion was a hot topic of conversation in the apartment community this last year, and was quickly followed by the 120 unit The Terraces at Lake Oswego being purchased for conversion. Our figures show 15 condo conversion apartments sales of 1,250 units for $150 million in 2005. This trend contributed to low vacancies, particularly in the urban area.

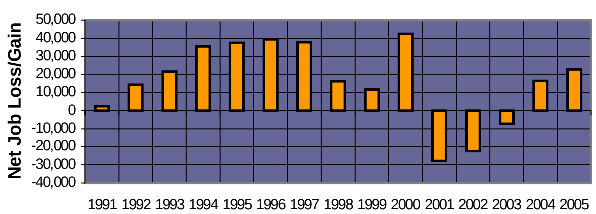
Summary—2005 Apartment Market

So what else happened in 2005?

Rental Levels, Concessions, and Income: Rent levels were essentially flat in 2005. Landlords were more concerned over maintaining their occupancy levels. This was clearly shown in the Fall 2005 *MMHA Apartment Report*, which actually reported a slight decline in the rent per Sq. Ft. from $0.79 per month a year ago to $0.77. However, there have been noticeable fewer concessions. Based on our appraisal work in the fourth quarter of 2005, income levels are up 1% to 2% from a year ago, with most of this increase in the second half of the year.

Apartment Vacancies: All of the main providers of apartment vacancy data for our market—MMHA, Norris & Stevens, Hendricks & Partners, REIS, RealFacts, Marcus & Millichap, and NAI—Norris Beggs Simpson—seem to show similar

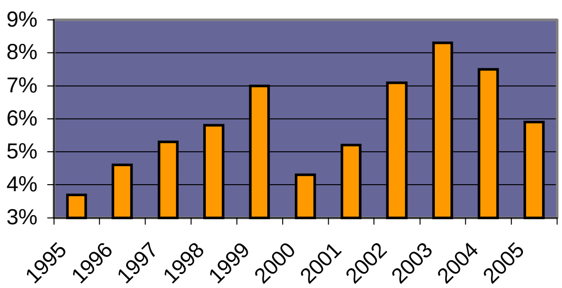
Employment



YEAR	NO. OF SALES	NO. OF UNITS	$ VOLUME (MILLION)
2005	195 (est)	8,800 (est)	$600 (est)
2004	283	9,923	$575
2003	267	10,037	$562
2002	255	9,223	$521

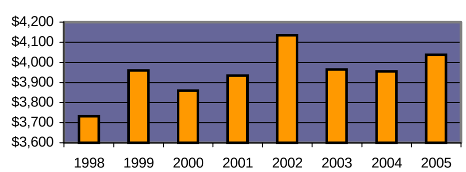
results: the Portland metro apartment vacancy rate is now at around 5.5% to 6.0%. Particularly low vacancy rates are being seen downtown, the NW/SW urban area, Wilsonville, and Clackamas. Areas seeing above average apartment vacancies are Lake Oswego/West Linn, Oregon City/Gladstone, the outer SE/NE Portland area, and West Vancouver.

Portland Area Apartment Vacancies



Expense Levels: The big news was the 8.2% decline in property taxes in most of the city of Portland due to the expiration of two bond levies. Property taxes showed moderate 2 to 4% increases in most other areas, though Beaverton was hit with a 10% increase. Insurance costs are stable to declining, while advertising costs are down considerably due to a better market. Utility costs continue to rise well above the level of inflation. Centrally heated apartments are bearing the brunt of hurricanes Katrina and Rita, with costs up 25 to 40% from a year ago, and total utility costs often pushing $100 per unit per month. 2005 was a more favorable environment to introduce and firm up a RUB utility bill back system, though administrative costs are often particularly high.

Median Net Income Per Unit/Year

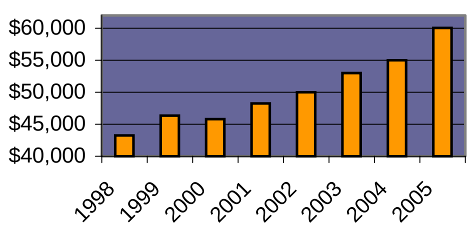


Net Operating Income: Net operating income declined from 2002 to 2004. The 2005 net income increased by 2%, though is still below the level we saw in 2002.

Cap Rates: Cap rates have been declining since 1998. The median cap rate for the 2005 sales was 6.72%, or over 150 basis points lower than cap rates we saw just three years ago.

Apartment Values: One of the major surprises in 2005 was the big jump in apartment values. Based on the recorded sales for the first 9.5 months of 2005, the median per unit sales price is up by around 12% for the metro area, but over 15% for Multnomah County.

Median Price Per Unit



Apartment Sales Volume: Data available for the first 9.5 months of 2005 shows 151 apartment sale transactions of 6,759 units for $478 million. Based on this trend, we expect that when the final figures are in, there will be 25% fewer sales transactions in 2005 with 8% fewer units, but with overall sales volume up by 9%.

FORECAST FOR 2006

Well, so far I've covered the easy part. Where are we going in 2006?

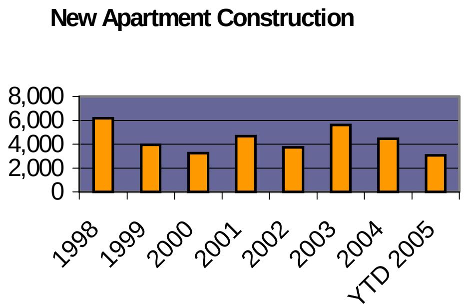
Employment and the Economy: 2006 is expected to be another good year, though down slightly from 2005. Based on the consensus forecasts of over 50 prominent business economists, in 2006 we can expect 3.3% GDP growth (vs. 3.6% in 2005), 4.9% national unemployment rate (vs. 4.6% in 2005), $54/barrel for oil (vs. $61 in 2005), and 2.6% CPI (vs. 3.8% in 2005). State economist Tom Potlowsky expects a 1.8% rate of job increase in Oregon in 2006 vs. 3.0% in 2005. And the forecasts I see for Portland metro are for 15,000 to 25,000 new jobs.

Interest Rates: Despite forecasts of higher interest rates over the last few years, Treasuries stayed in a narrow range of around 3.7% to 4.7% in 2005, with Treasuries currently at 4.35%. Consensus forecasts from *Business Week* and the *Wall Street Journal* are for Treasuries to be at 5.0% by the fourth quarter. The Mortgage Broker's Association is forecasting 30 year loan interest rates of 6.75% by late 2006, or a 50 basis point increase.

Residential Construction:

Single Family: Single family construction has not missed a beat in the Portland area over the last four years, and has averaged 10,000 new

homes per year. However, greater inventory buildup, high construction costs in light of Katrina and Rita, and upticks in interest rates are all expected to result in slower single family construction in 2006. Expect to see ***7,500 to 9,000 new homes***.



Apartment Construction: Apartment construction simply does not pencil out with the current rents and sale prices. Also, many of the smaller apartment builders are now building condos, where the margins are far better. Apartment developers also can't compete for land with condo developers. Finally, 2002-2005 saw unprecedented construction of units with various forms of subsidy. Expect to see 2,500 to 3,000 new apartments in 2006, or ***the slowest year for apartment construction here since 1993***.

Apartment Vacancies: The apartment market is expected to stay competitive but in balance in the first half of 2006, with noticeable improvement in the second half. With a stable economy, slower apartment construction, greater condo conversion, and some anticipated increases in interest rates, ***I expect to see apartment vacancies of 4.50 to 5.25% by late 2006***. Assuming an inventory of 230,000 apartment units, we should have 10,500 to 13,000 vacant apartments by late 2006.

Apartment Rents: Modest increases in income of 1% to 2% were seen in 2005. Once we get through the Winter of 2006, expect to see landlords try to play catch up on rents. For the first time in four years, I expect landlords will be in a position to raise rents, with a ***2% to 5% increase in income in 2006***.

Apartment Expenses: The stable expense environment we have seen in most submarkets is expected to carry over into 2006. However, utility costs will show close to double-digit increases. Both landlords and tenants will get no relief on utilities in 2006, and will see another wave of increases. Also, with heating oil and natural gas prices up by up, landlords with centrally heated older apartments will be paying a steep price in 2006 and beyond.

Apartment Values: There is an unprecedented wave of capital flowing around the world searching for a better return due to a global savings glut that has kept interest rates low. Too much money is chasing investment real estate. Apartment values in Portland are up over 20% since 2002, with an average of around 7.0% per year. Cap rates have dropped over 150 basis points during this time. If net income increases by 3%, *and interest rates rise by 50 basis points*, I would expect that ***apartment values will flatten out and stabilize in 2006***..

Mortgage Lending: As of late 2005, real estate was a tale of two markets: residential sales are slowing down, while commercial real estate is strong as buyers set new records with the prices paid and the amount of money borrowed. Total mortgage volume in the U.S. went from $3.8 trillion in 2003 to $2.8 trillion in 2004, with around $2.8 trillion for 2005. The Mortgage Bankers Association is estimating a drop in mortgage volume to around $2.25 trillion in 2006, or a 20% decline. Some retrenchment is already being seen at some of the big national lenders as loan volume comes down from record highs. 2006 will be a leaner year for mortgage lenders and those of us providing services in real estate finance.

1/06 Sale—$65,667/Unit
30 unit Sunset Station Apts.
10765 SW Barnes Road

Condo Conversion: The condo market remains healthy, and converters are actively seeking existing buildings. A strong pace will push over into 2006, but ***we won't come close to the record number of units converted in 2006***.

5/05 Sale—$71,533/Unit
15 unit Timothy Sullivan Apts.
2220 NE Multnomah Street

> *"I wake up every year, and say "it can't be this good again." I find it hard to believe the robustness of the markets." Steve Kantor, Global Head of Real Estate Markets, Credit Suisse First Boston*

CONCLUSION

In 2006, I expect to see a shift from an apartment market in balance to the early stages of a landlord's market—it has been a long time in coming. By the end of the year, landlords will finally start to gain the upper hand and some pricing leverage for the first time since 2001. With increasing income, cash flow to owners will finally start to improve. The investment market is not expected to see the frenzied run up in values we have seen in recent years.

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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
Portland Metro Apartment
Appraisal Specialist Since 1982

Mailing Address Line 1
Mailing Address Line 2
Mailing Address Line 3
Mailing Address Line 4
Mailing Address Line 5

Turn Back the Clock . . .

* 1907 – 6 room steam heated flats in beautiful new building on Flanders Street. $50 per month, with every convenience. *Oregonian*

* 1919 – A big apartment house is planned; 8 stories at Broadway and Madison. 90 apartments, 2, 3, 4, rooms each. All rooms will have windows and steam heat, and electric ranges. *Oregon Journal*

* 1922 – Beautiful, modern furnished 6 room apartment for $65 per month. Large, light outside rooms equipped for 4 persons; first class janitor services guaranteed. They're fine. The Columbia Apartments at 11th & Columbia. Portland's most popular apartments. *Oregonian*

* 1929 – If Portland reduces the size of the rear and side yard requirements for apartment house buildings, the time will come when "a majority of its population would have to live in apartments that are little better than sunless caves, damp and unhealthy and reducing the resistance of their occupants in disease." Astronomy was called on to demonstrate just how much sun an apartment house dweller would get under certain conditions. *Oregonian*

* 1931 – Apartment houses replace mansions. W. Park Street's building activity is transforming residences of yesteryear into striking modern apartment houses, resulting in Portland having a "cliff dweller's" avenue comparable to that on Park Avenue in Manhattan, New York, such as the new Queen Louise Apartments, a five storied structure erected by Harry Mittleman. *Oregonian*

*1942– Criticism that apartment house owners provide too little heat and hot water and too high rent raised the tempers of the Oregon Apartment House Association officials. Opinion is that it could result in a serious health problem in winter. This puts "apartment men between the devil and the deep blue sea." *Oregonian*

*1983 – Charles Engle purchases five older urban apartments—the San Carlos, the Winter, King Hill, Savoy, and Multnomah. The price is $4.0 million for 317 units, or $12,618 per unit. Ben Franklin Savings and Loan, the leading local apartment lender, has financing available at 13.5%.