



Rough, tough market

Slow economy, high vacancy put developers in a downward spiral

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Last year, *The Business Journal* asked several real estate professionals to predict when the economy would likely turn around. Many were optimistic: 2002, they said, by the second or third quarter.

Those hopes have since been dashed, and market watchers now say Portland's real estate market has been in a tailspin for two years. The most dire predictions say recovery—evidenced by steady economic growth and drastically reduced vacancy rates—could take as long as five years.

Developers who kicked off projects in the red-hot economy of the late 1990s were behind the curve, and they are taking some of the biggest hits now, with see-through buildings bereft of tenants. By the time their projects were ready for occupancy, many tenants were scaling back or vanishing altogether.

In 2002, Portland's new real estate economy is driven by tenants, not landlords. The best example of this was the hubbub surrounding Schwabe Williamson & Wyatt and Miller Nash, when each law firm contemplated whether to renew their leases or move

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The Marshall-Wells Lofts reused a 90-year-old parcel chute as a spiral fountain in the building's central atrium, above.

At left, artwork graces the lobby of Hotel Lucia in downtown Portland, which opened this year in what was once the Imperial Hotel.



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Development: Plans aplenty but no groundbreaking

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to another building. Both elected to stay put, squelching the hopes of four developers who wanted to get cranes in the air and start work on new office towers.

The Louis Dreyfus Co. has designs on the block between First and Second avenues for a building called 100 Columbia. Two blocks away, Trammell Crow Co. would like to launch Two Main, adjacent to One Main Place. Just north of the Broadway Bridge, Jim Winkler and Bob Naito plan to join forces on One Waterfront Place. And Schnitzer Northwest has plans for Block 38, now home of the Governor Building.

Despite the developers' assertions of increasing tenant interest, despite high-concept designs and glossy computer-generated "pictures" of the proposed buildings, no groundbreaking is planned.

Developers are forced to be more conservative in their projects because financial backers want substantial pre-leasing in a building—at least a third, and in many cases half—to guarantee income. They're learning from others' mistakes.

FEW DARE TO BUILD ON SPEC

The success story of the Fox Tower, which Tom Moyer pushed ahead without pre-leasing, but filled almost to capacity by its opening day, probably could not be replicated in today's market. The 11-story building at 1201 Lloyd Boulevard still stands almost completely empty; at press time, only one 3,000-square-foot lease had been signed in the 222,777-square-foot building.

"The Lloyd District is a solid marketplace, but traditionally it has been a slow lease-up market," said Doug Bean, owner of Doug Bean & Associates. "The development strategy has been pre-leasing or having a partner in development." Ashforth Pacific filled half of Liberty Centre and the Lloyd Tower leaned heavily on PacifiCorp's lease.

But on the other side of the river, Gerding/Edlen Development Co.'s Brewery Blocks are doing remarkably well, landing the Art Institute of Portland and M Financial as key tenants in Block Four—and this spring opening Block One, which includes Whole Foods Market, at full occupancy.

Gerding/Edlen is still working to fill the historic and Class A office space in Block Two, the site of the historic brew-house and a planned location for a Gordon Biersch brewpub.

Speculative development has been virtually nonexistent this year, in part because high vacancy rates and lots of sublease space have forced rental rates down. Many companies signed larger-than-necessary leases during economic boomtimes, but are now offloading excess space in subleases. For these companies, it's not about getting market-rate rents, it's about covering liabilities, so in many cases they drastically undercut prices on direct lease rates.

This causes two problems for landlords. First, they are forced to compete with their own tenants in leasing space. Second, landlords are forced to offer major rent concessions, hefty tenant improvement allowances and other perks to reel the tenants in.

Because it is much more costly to find a new tenant than it is to renew an existing tenant, brokers advise their landlord clients to do everything they can to hold onto their tenants.

BROKERS TO TENANTS: SHOP AROUND

Brokers advise their tenant clients to



Modern art and furnishings make Hotel Lucia's lobby, above, distinct from cookie-cutter hotel chains. Below, the Streetcar Lofts are a new residential landmark in the Pearl District.



shop around. Companies that have leases expiring two years from now are trying to renegotiate their leases while the market is weighted heavily in their favor. Large firms with good credit are shopping as early as five years in advance of their lease expiration dates.

This early shopping perks up developers, who would have ample time to begin construction of a new office tower. But typically a new building's asking rates are higher than asking rates in an existing building, making it less competitive.

"My sense is you've got to soak up that sublease space before a tenant is going to go into a nice new building," said Mark Fraser, an office broker at Colliers

International.

The market was all about technology companies gobbling up big spaces a few years ago, but this year brokers seem to be getting back to basics, doing smaller deals on behalf of traditional business tenants, such as those in the insurance, mortgage and banking industries.

Large blocks of space, some in the form of subleases, remain in the central business district, including at the U.S. Bancorp Tower, Wells Fargo Center, Fox Tower, 1201 Lloyd Boulevard and the Brewery Blocks.

Although subleases are driving rental rates down, landlords are still looking toward the future to protect their invest-

ment. They realize, one real estate professional said, that they'd better not "give away the store" by signing incredibly cheap, long-term leases, because when the market turns around, they don't want to be leasing their space well below the going rate.

BRIGHT SPOTS: HEALTH CARE, EDUCATION

Drivers for today's development are, predictably, elements of the economy that remain stable in a recession. In Clark County, both Southwest Washington Medical Center and Legacy Health System are undertaking major building projects.

At SWMC, major seismic upgrades, renovations and space for additional hospital beds are planned.

Legacy plans to build a new hospital—which will become SWMC's first major competition north of the Columbia River—in the Salmon Creek area. Developers are responding to this plan by creating complementary uses in that area, such as medical office buildings.

Schools and churches are fruitful places for architects and contractors to find work, in response to the passage of school bonds, long-term capital campaigns by churches and growing population. Also, as tenant improvement packages offered by landlords get sweeter, those in the building industry find work creating new spaces.

Government work also has kept some developers and contractors busy. Specht Development beat out Gerding/Edlen Development Co. and Trammell Crow Co. for the right to develop Hillsboro's city hall, library and civic core.

Still, there hasn't been enough work to go around. Many architecture firms cut pay, cut staff or loaned staff to other firms. The largest general contractors, who in years past wouldn't bother to bid on little jobs, are now competing for jobs of every size. One casualty of this competitive environment was McCarthy Building Companies, which shut down its Northwest operations in Portland and Seattle late last year.

Owner-occupied buildings have also put contractors to work, but many companies are reluctant to build on land that is not their own. Much of the Portland metropolitan area's available industrial land is for ground lease only, leaving some industrial users unsatisfied.

UGB IS KEY TO FUTURE GROWTH

While office landlords' greatest woes are vacancy rates, which have steadily climbed over the past two years, the concern in the industrial market is a lack of available land. Mike Burton, Metro's executive director, acknowledges that his recommendations for expansion of the urban growth boundary fall short of the projected need for industrial land.

When local government officials talk about the need for more land within the UGB, their most pressing concerns are jobs, economic development and a sufficient tax base for local government. Each jurisdiction made its pitch for growth during a series of bus tours to the edges of the UGB, but not all were rewarded for their efforts. Gresham got Burton's approval for its Springwater Plan, while Forest Grove's proposed wetland-for-industrial-land swap was denied.

Business leaders especially bemoan a lack of available land on the west side, where clusters of technology companies



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The muddy hole near Powell's City of Books has been filled with two and a half blocks of underground parking and the Brewery Blocks' signature blend of historic and new buildings.

Speculative: *Some projects go against flow*

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are expected to grow. Hillsboro's request to bring farmland into the UGB sought to meet that need, and Burton concurred.

Part of the blame for a lack of industrial land in the region is directed toward office and flex developers, who used industrial land for non-industrial purposes. Now hundreds of thousands of square feet of office space stand empty in the Sunset Corridor, and by some estimates it could take years for the market to fully absorb that space.

BUCKING THE TREND

Some suburban markets have remained strong, especially Kruse Way in Lake Oswego. Equity Office Properties Trust has such faith in that market that the company is developing a \$34 million speculative, 184,000-square-foot office building, Kruse Way V.

Also bucking the trend is The Round in Beaverton, a project that fizzled in good economic times, but now is sizzling during the doldrums. After its first developer failed to get enough financing to finish the project, The Round stood empty for years, leaving the structure to rot.

Developer Dorn-Platz Associates has resurrected the MAX-centered project and plans to complete its first office building in November. Already Coldwell Banker Barbara Sue Seal Properties has leased the ground floor of the office building and 24 Hour Fitness solidified plans to build a 37,000-square-foot sport club on the ground floor of the development's parking garage.

Several new hotels are entering a market decidedly less hospitable than it was when they were on the drawing board. The Hilton Executive Tower opened this fall with a restaurant, parking garage and upper-level rooms, but Melvin Mark Properties has failed to fill more than 15,000 square feet of ground-floor retail space facing Fifth Avenue. Walgreens seemed close to a deal last fall, but this fall brokers are still marketing the space.

Meanwhile, Hotel Lucia revamped and re-energized what was once the Imperial Hotel. The results have been well-received, from 679 awe-inspiring photos that adorn the hotel to a "pillow menu"



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The Naito family invested \$1 million to renovate the Galleria building downtown.



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Details on the Brewery Blocks serve both decorative and seismic purposes.

for guests to choose exactly how they'd like to rest their heads.

HOUSES REMAIN HOT

The residential real estate market, bolstered by ultra-low interest rates, has

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