DAS DEPARTMENT OF ADMINISTRATIVE SERVICES
REAL ESTATE SERVICES

MEMORANDUM

To: Representative Wilde, Joint Ways and Means Subcommittee on General Government

From: Department of Administrative Services, Enterprise Asset Management, Real Estate Services

Date: February 15, 2022

Subject: State of Oregon Office Rent - Recent Market Trends

Executive Summary:

Within the Department of Administrative Services ("DAS"), the Real Estate Services Section ("RES") locates and secures commercial real estate space for state agencies in the private sector. Requests for services are driven by agency needs and are broad in their size, scope and geographic footprint. RES leasing agents are experienced professionals with backgrounds in commercial real estate leasing, and they have successfully navigated previous economic downturns and challenging real estate markets. In early 2013, at the direction of the Executive Branch's Enterprise Leadership Team, DAS began its Improving Government initiative to identify cost savings opportunities and other areas for improvement within state government. RES pivoted from the legacy Procurement-based practices and embraced a market-based approach to private-sector leasing. RES continues to use practices and negotiation techniques identified during that initiative to maintain a competitive private sector lease portfolio.

RES reports that higher demand for smaller office space has increased rents in the last year. Generally, service and utility costs, as well as construction costs, are increasing, and at a higher rate than many landlords anticipated in prior years. RES is seeing a trend of restructuring existing leases (at lease renewal) from a "full-service" rent structure to a "base-year" rent structure so that landlords can recoup the increased costs of the utilities. Recently, RES has fielded more requests during lease negotiations to address inflation and may be able to leverage longer lease terms in the negotiation process to keep rent increases at bay. Agencies establishing new locations (or moving) are seeing increased costs and fewer incentives, with some exceptions regionally. Through the Improving Government initiative (and coupled with the RES team's background and experience), RES has been able to help minimize the ramifications of recent rising commercial real estate costs in lease negotiations.

Statewide Office Rent Market Trends:

Higher Demand for Small Office Spaces driving increases:

Traditionally, RES negotiates for other state entities to lease space in the private commercial real estate office market as a tenant. RES has historically been able to negotiate lower-than-market rates for small office spaces of 1,000 rsf or less. However, RES has recently seen a much higher demand for small office spaces (1,000 rsf or less), and the market rate has increased in the last year because landlords are working to negotiate rents closer to the recent (increased) market rates. In reviewing reports of RES portfolio over the last year, the straight dollar-per-square-foot calculations have increased from $1.13 to $1.29.

Increased Utility Costs driving changes to rent structure:

When renewing leases, RES has seen many landlords prefer to restructure the rent/operating expense structure of an existing lease to account for a dramatic increase in utilities and services, as those expenses have increased significantly.

While many landlords have favored keeping rent the same, RES leasing agents have observed an increase in the number of landlords requesting increased rent escalations to cover the costs of utilities and services.

Alternatively, RES agents have observed that many landlords, when negotiating a renewal of an existing lease, may be willing to continue with the historical rate increases permitted by existing lease provisions, although the rate may be below market. RES can generally negotiate no increase in the base rent (and no change in rent structure) by leveraging a longer lease term (instead of the option proposed by most landlords, i.e, a shorter-term renewal with increased base rent and increased rent escalations).

Therefore, while many of RES leases were previously a “full service” rent structure (with operating expenses, services, and utilities included in the base rent), RES has been switching to a “base year” structure to determine rent escalations. In a “base year” structure, the landlord agrees to pay the property's expenses for the base year (and each year thereafter). After the first (base) year, the tenant agrees to pay its pro rata share of any increases in property expenses.

RES will generally attempt to renegotiate the rent structure to account for the increased cost of services and utilities (without affecting the rent). Landlords have indicated that, if inflation continues to increase at such a rapid rate, RES will continue to see higher rents or negotiations for longer lease terms.

Construction costs and delays, plus inflation, driving modest rent increases and rent escalation negotiations:

Over the last couple of years, RES has noted a substantial increase in construction costs and delays. RES agents are asking for construction bids early in the process, but these bids are only being honored for a short timeframe. RES is seeing agencies foregoing improvements currently to wait until the economy steadies. As a result of the pandemic, there is still a tremendous amount of uncertainty regarding the commercial real estate market.

In addition, fears of inflation (confirmed recently at the federal level with news from the Federal Reserve and talk of increased interest rates) have fueled steady, but modest, rent increases. Recently, as inflation has become an increasing concern, some landlords have requested that annual rent escalations be tied to the Consumer Price Index (CPI) instead of a simple percentage escalation.

New locations and moves seeing higher rent escalations than renewals of existing leases:

RES has seen a steady increase in landlords attempting to negotiate a higher yearly escalation in rent. Historically (for the past several years), RES would typically negotiate annual rent escalations in the 2-3% range. For new locations or moves, RES is now frequently fielding negotiations in the 3-5% range. RES leasing agents consistently indicated that the increased yearly rent escalations are more common when negotiating a “move” or new location (rather than a renewal of an existing lease in the same location). In this market, renewals of an existing lease in the same location may result in an overall savings by continuing the 2-3% annual rent escalations permitted by existing lease provisions (instead of seeing the increased annual rent escalations (3-5%) that the market is bringing to bear).

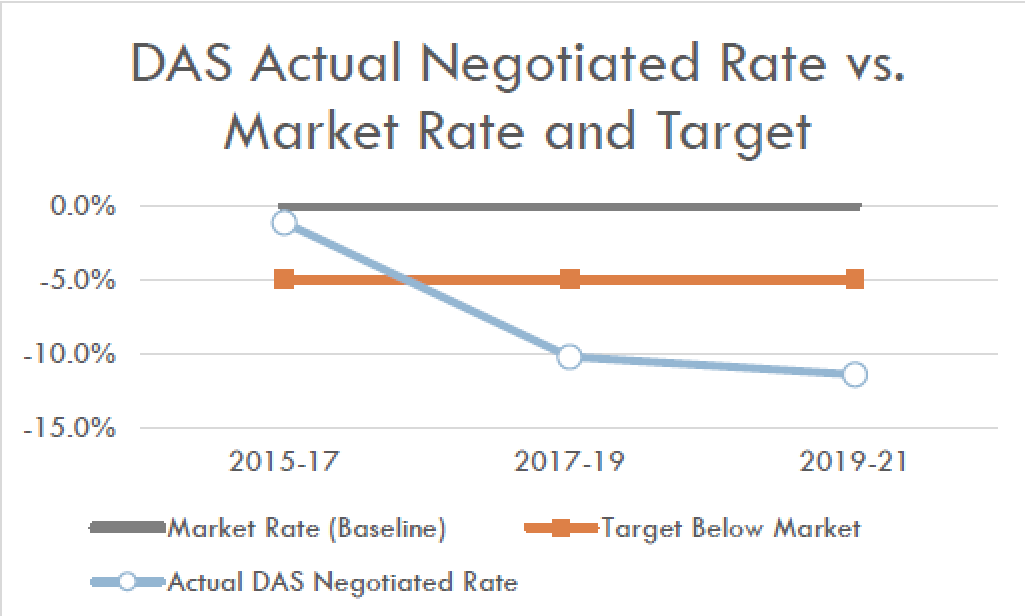
Below Market Rates Negotiated by RES:

RES began tracking market rates in 2015 and set a target of a net effective rate of 5% below the market rate.

When determining the market rate, RES examines the current offerings and the type of rate. RES adds expenses based on market average per square foot to bring the Triple Net rate to an approximation of a Full Service rate. Modified Gross rates are likewise adjusted to be the equivalent of a Full Service rate.

When determining the Net Effective Rate paid, RES reviews the base rent and any additional expenses tenants pay under their lease, then calculates what the equivalent Full Service rate would be.

Through these calculations, RES is able to compare leases to one another on equal footing. For the last three biennia, the RES actual negotiated rate has been well below market.



Regional Office Rent Market Notes:

Salem area:

RES recent property searches in the Salem/Keizer area have noted an increase in rental rates in approximately half of the properties surveyed. Salem and Keizer remain an affordable market from a statewide perspective.

Portland area:

The Portland office leasing market continues to have significant vacancies compared to other major areas of the state. These vacancies mean that landlords must compete for tenants which, in turn, results in rental rates similar to those observed in 2020. In other words, RES has only seen minor to modest increases in rent rates in the Portland area. In addition, landlords have been including turn-key (tenant improvement) incentives and free rent in leasing negotiations.

Southern Oregon region:

The Southern Oregon region also appears to have more office vacancies than the Central Oregon region (which includes Bend). RES has seen fewer requests from landlords to increase rental rates or change the rent structure of existing leases. In this region, landlords are concerned about rising operating costs and lack of contractor availability to comply with lease terms and the high rate of inflation. Many landlords in this area have expressed concerns with current base rent rates if inflation continues to remain high, indicating that future lease rates in this area will increase if these trends continue.

Central Oregon region:

This area has a more competitive market, with low vacancy throughout Bend, Redmond and extending into the outlying areas (such as Prineville). In this region, landlords have indicated a willingness to restructure leases using the CPI to increase existing lease rates or when establishing new tenancies.

Eastern Oregon / Rural Oregon:

Eastern Oregon has historically had low office space availability. In this area, which has experienced an increase in the cost of utilities and lower availability of contractors, landlords have expressed concern for recouping increases in operating expenses. Landlords have not been eager to continue using the full-service rent structure, and instead prefer to account for services and utilities separately due to recent cost increases.