Second Quarter 2018 / Office Market Report

Houston

Quick Stats

94,600

Jobs created during the 12 months ending June 2018

4.6%

Unemployment rate in Houston, down from 5.6% in January 2017

9.4

Million square feet of space now listed on the sublease market

16.2%

Direct vacancy rate in Houston's office market, same as the previous quarter

Summary Overview

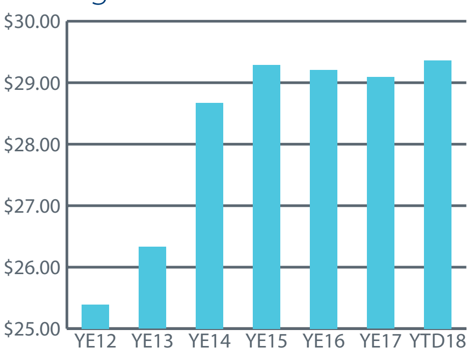
Optimism for a quicker recovery of Houston's office market is being fueled by the slight acceleration of the city's leading economic indicators such as positive job growth. Asking rental rates have remained moderately steady, despite increasing amounts of available space, which have driven landlords to offer impressive concessions such as rental abatements for up to a year and allowances covering the full construction cost of tenant improvements. Vacancy and availability has remained constant during 2018; the direct vacancy rate stands at 16.2%, the same rate as last quarter, but slightly lower than the 16.8% recorded second quarter of 2017. Adding the sublease's vacant available space brings the combined vacancy rate to 18.3%.

Tenants will remain in the driver's seat based on the amount of availability in the market. As companies continue to merge and consolidate, there could be excess office space once the cycle completes. Those business decisions are still in play as companies "right-size"; the flight-to-quality is also a factor as firms opt for office efficiency and smaller footprints in newer properties.

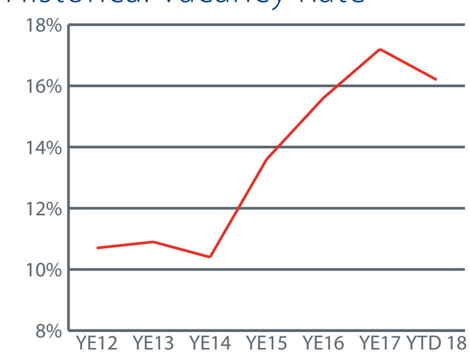
Recent economic reports are attributing positive employment numbers to Houston's growing energy industry due to broader global economic strength and continued growth in the U.S. economy. For the 12 months ending June 2018, the Houston metro area created 94,600 jobs, a 3.1% increase. That reflects a significant jump from the 81,200 jobs created in the 12 months ending in May, according to Texas Workforce Commission statistics reported by the Greater Houston Partnership.

Employment growth does not quickly affect office space needs; most firms hold off increasing office space until the growth is stabilized. Office leasing activity did slow this quarter to 2.7 msf, dropping 30.4% from leasing activity recorded during the first quarter of the year. However, deals are being signed overall at a faster pace than last year, as the mid-year total of almost 6.7 msf represents a 25.5% increase from mid-year 2017. Direct space is maintaining steady levels as some sublease space reverts to direct. Based on deals alone, sublease space is being taken; however, the overall total jumped up to 9.4 msf this quarter, primarily due to the addition of almost 800,000 sf from one company. This total amount is a decrease from the 10.7 msf recorded a year ago.

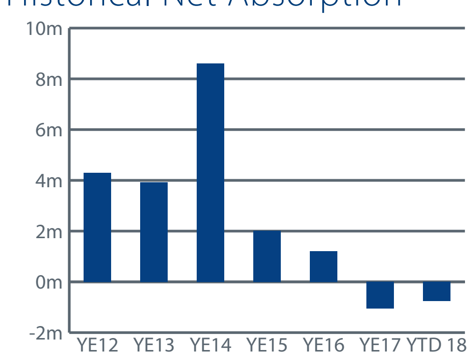
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



On the supply side, the construction pipeline remains low with a couple suburban spec projects breaking ground during the second quarter. But the big news is Hines and partner Ivanhoé Cambridge announcing the ground-breaking of a 1-msf, next-generation office tower in the Central Business District (CBD), joining Skanska's Capitol Tower as key new projects in the CBD. At 37% preleased, this new project represents a level of leasing confidence that can only trigger a more positive outlook for Houston's office market.

Absorption & Demand

While the economic picture improves in Houston during the second quarter, the office market continues to experience negative direct net absorption of 761,477 sf for a mid-year total of a negative 1.4 msf. All classes reported losses for the second quarter, with Class B properties registering a negative 578,014 sf. Until demand catches up with supply in Houston's office market, which isn't projected to happen until 2019, an increasing number of Class B properties will likely undergo renovations to remain competitive.

The CBD market area was one of nine submarkets to report positive net absorption during second quarter, although all positive totals were under 100,000 sf. Class A properties in the CBD reported positive absorption of 167,244 sf, the most of any market area. Tenants contributing to that total were Talos Energy, which represented 101,072 sf in Three Allen Center along with Yetter Coleman, 24,494 sf, and Gilbaine, 21,158 sf, both in BG Group Place. Two tenants occupied 33,685 sf in 609 Main. The Katy Freeway East is the only submarket to show positive absorption of more than 100,000 sf during second quarter, resulting from Envoy Mortgage's 40,000-sf move into 10496 Old Katy Road along with several move-ins for Memorial City buildings.

The Greenspoint submarket experienced the largest direct negative net absorption total (-598,687 sf) during second quarter as Exterran Holdings vacated more than 205,000 sf in two separate buildings.

More available sublease inventory continues to plague the market due to company mergers, acquisitions and consolidations. Total available sublease space, at 9.4 msf represents 16% of the 58.3 msf available. The largest block of sublease space added in the second quarter was Occidental Petroleum's total 800,000-sf spaces in 3 and 5 Greenway Plaza properties; reports indicate Occidental may take space out in the West. Other prominent energy-company-related space added to the sublease market during second quarter included Dynegy's 103,000 sf at 601 Travis and Linn Energy's 64,319 sf at next-door 600 Travis, both in the CBD, along with G&E Oil & Gas' 182,004 sf along with National Oilwell Varco's 75,954 sf, both in the West Belt market.

Yet companies are taking advantage of the best sublease offerings. Signed sublease deals reported during the second quarter included Enable Midstream Partner's 48,000 sf in One Shell Plaza, Fiesta Mart's 28,621 sf in 5444 Westheimer and HighRadius Corp.'s 24,844-sf in Four Westlake Place.

Overall, the flight-to-quality continues, with tenants opting for smaller footprints in prime locations, as evidenced by leasing activity in the newest buildings in the CBD along with Hines' decision to start a new 47-floor office tower. And, Class A properties report a positive absorption of 869,126 sf for the second quarter when sublease space is added to the direct net absorption totals, even if some of that positive square footage represents sublease space coming back on the market as direct space.

The largest direct deal during second quarter is the 118,986-sf lease by Harris County Veterans Service Office in 500 Jefferson in the CBD. T-Mobile also signed a long-term, naming rights deal for 29,142 sf at 4126 Southwest Freeway, soon to be called T-Mobile Tower, with move-in next January. Other smaller deals in the 10,000- to 30,000-sf range were signed by tenants representing a variety of industries.

Vacancy & Availability

Overall direct vacancy rates remained constant at 16.2% during the second quarter, equal to the first quarter rate, which is the highest level in Houston's history. The rate jumps to 18.3% when vacant available sublease space is added. Availability rates also inched up, with direct rates now 20.1%, up from 18.8% last quarter; adding sublease space takes the availability rate to 23.9.

With only 1.9 msf under construction - primarily in three market areas - and 57.8% preleased, developers are reluctant to break ground without securing a large lead tenant. Two spec properties, 156,000-sf Chasewood Crossing Three in the 249 Corridor and CityPlace 2, a 149,500-sf project in Springwoods Village, broke ground during the second quarter.

Announced after the second quarter ended, the new Hines project is scheduled for a 2021 completion and is about 37% preleased. Hines plans to move its headquarters into 155,000 sf from Williams Tower, and Vinson Elkins has committed to 212,000 sf, with plans to move from its long-time space in 1001 Fannin.

Many tenants have been waiting for the market to reach bottom to take advantage of reduced rental rates and various concessions. While leasing activity remains relatively strong, the abundance of available inventory indicates the office market will remain tenant-favorable throughout this year and into 2019.

Asking Rates

Overall average asking rates have increased by $0.27 psf from the previous quarter to $29.36 psf gross. Asking rates have been relatively stable throughout the downturn with landlords offering concessions in the form of rent abatements for as long as a year and allowances covering the full cost of tenant improvement construction. Class A rates are at $34.84, remaining constant from last quarter but down slightly from the second quarter of 2017 at $35.59. Both class B and C rates showed a slight decline from last quarter. Asking rates are projected to remain flat for the foreseeable future in Houston's tenant-favorable market.

Q2 2018 Ground Breakings

Chasewood Crossing Three
(156,000 sf) FM 1960

CityPlace 1
(149,000 sf) The Woodlands

Trends to Watch

The price of oil rose above $67/bbl, an increase since the downturn took hold in 2015.

Employment grew 3.1%, creating 94,600 jobs for the 12 months ending June 2018. All sectors reported growth except for Oil & Gas Exploration (-5.0%), Information (-4.0%), and Other Services (-0.9%).

The Purchasing Manager's Index (PMI) registered 55.5 in June, indicating short-term expansion in regional production.

Q2 2018 Highlights

- Announced in mid-July, **Hines and partner Ivanhoé Cambridge** will be starting a 1-msf, next-generation office tower in the CBD, counting Hines and Vinson & Elkins as new tenants, preleasing 155,000 sf and 212,000 sf, respectively.
- The largest deal signed during the second quarter was the **Harris County Veterans Services Office**'s 118,896-sf lease at 500 Jefferson in the Central Business District. The building is now 68.2% leased.
- **T-Mobile** signed a long-term, naming rights deal for 29,142 sf at 4126 Southwest Freeway, soon to be called T-Mobile Tower, with move-in scheduled for next January.
- **Sidley Austin, LLP** has renewed and expanded its offices to 80,000 sf in Wells Fargo Plaza in the CBD.
- **Kiewit Engineering Group** subleased and occupied 52,834 sf for its second Houston-area office in Energy Center IV. The space was subleased from BASF Corp.
- Several tenants including **Hancock Whitney Bank** (23,369 sf) occupied their new spaces in the Kirby Collection in the Greenway Plaza submarket.
- Positive absorption was reported for the CBD, with **Talos Energy**'s occupation of its new 101,072-sf space in Three Allen Center partially responsible.
- **Acclara Solutions** signed an 82,941-sf lease in Remington Square's Building III on the West Belt, scheduling a September occupancy. The building is now 91.4% leased.

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