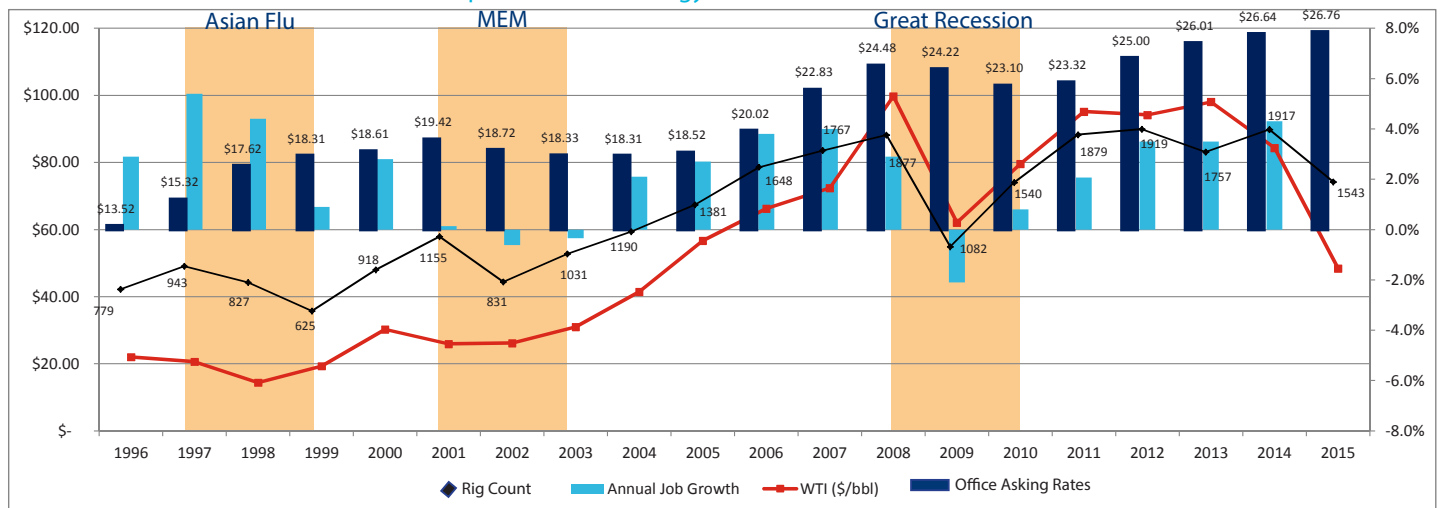


THE PRICE OF OIL AND ITS IMPACT ON HOUSTON RENTAL RATES

A historical review of oil price and the correlation to Houston office rents

Houston has once again found itself at the forefront of a national audience, only this time the discussion isn't centered on the booming market, but rather, how low oil prices will impact the Energy Capital of the World in the coming year. The current downturn is not expected to be a repeat of the 1980's oil crash, but it does bear some resemblance to other periods of low oil prices. In the past two decades, the price of oil has fallen as a result of The Asian Flu (1997-1999), The Merchant Energy Meltdown (2001-2003), and The Great Recession (2008-2010). Oil prices recently peaked at \$107 per barrel in June, and West Texas Intermediate (WTI) was \$51/bbl on February 6, 2015, representing a 52% decline in just 8 months. The general consensus is that WTI will average in the mid-\$50s/bbl range in 2015 and increase to the mid-\$60s/bbl range in 2016. However, the general consensus in the summer of 2014 was that oil would average above \$90/bbl in 2015. Although the price of oil is unpredictable, a look at how the Houston market responded in past downturns can provide insight into what may lie ahead. Of particular interest in this paper are the correlation between WTI, rig count, and job growth, and how these factors impact office asking rates.

Graph 1: Houston Energy vs. the Office Rental Market



*Data is pulled from Avison Young Research, EIA, BLS, & Baker Hughes Rig Count

THE ASIAN FLU (1997-1999)

The Asian Flu downturn, which lasted from the end of 1997 to the beginning of 1999, is arguably the most similar period to what is happening now. Japan and China were major engines of growth, and a significant economic slowdown in these countries led to a 50% drop in WTI. Oil prices remained depressed for a year before recovering. In this time, the rig count dropped by 34%. Overall employment growth slowed but remained well-above negative territory. Houston added 137,600 jobs between 1997 and 1999. However, employment gains came from outside of Houston's economic base in industries such as health care, education, and retail. The energy industry lost 2,100 jobs between 1997 and 1999. The Greater Houston Partnership's (GHP) forecast for 2015 echoes The Asian Flu years, in which overall employment growth will remain positive but come from outside of the economic base while the energy industry will report losses.

The Asian Flu had a "wait and see" impact on the Houston office market, halting everything in Houston including real estate lending and capital investment. Tenants seeking better lease terms could find opportunities in sublease space,

with asking rates that were roughly 15% less than in direct space. However, a “wait and see” approach did not benefit most tenants in the market as direct asking rates improved during this time, albeit at a slower pace.

THE MERCHANT ENERGY MELTDOWN (2001-2003)

The Merchant Energy Meltdown, which came right on the heels of the Asian Flu, had a far greater impact on Houston. This period was different from the Asian Flu and the current environment in that it was led by a national recession that started with the crash in the Tech sector in 2000 followed by 9/11. Houston then had a self-inflicted economic wound to “add fuel to the fire” when Enron’s accounting scandal was uncovered causing their bankruptcy, the dissolution of Arthur Anderson and a cadre of others in the merchant energy business that nearly went under.

During this downturn WTI fell slightly but the rig count took the biggest hit. The rig count fell from 1,155 in 2001 to 831 in 2002 before slightly recovering to 1,031 rigs in 2003. The Houston market therefore experienced slightly negative absorption and job losses in those years. A significant amount of sublease space was placed on the market, giving tenants additional opportunities for better rates. However, direct rental rates during this period held up, barely declining. A “wait and see” approach during this period, which is arguably the most significant recession in Houston since the period between 1982-1987, did not result in better lease terms for the tenant.

THE GREAT RECESSION (2008-2010)

Effects from the Great Recession can still be felt in some metropolitan areas. Thankfully for Houston, a quick rebound in oil prices caused only one year of significant pain for the city. Employment contracted by 2.1% in 2009, the largest amount of job losses in 20 years. The Great Recession was caused by a shutdown in the lending markets as the U.S. banking system struggled to survive. There was no evidence of the “wait and see” strategy, as there was only “panic in the streets” during this period as all lending activity shutdown until governmental intervention took hold to save the U.S. lending system. This period in Houston is more similar to The Merchant Energy Meltdown in that the downturn was led by a national recession. However, during the Great Recession, Houston had no self-inflicted wounds to add fuel to the fire. In fact, the price of oil rallied and led Houston out of the Great Recession faster than the rest of the U.S.

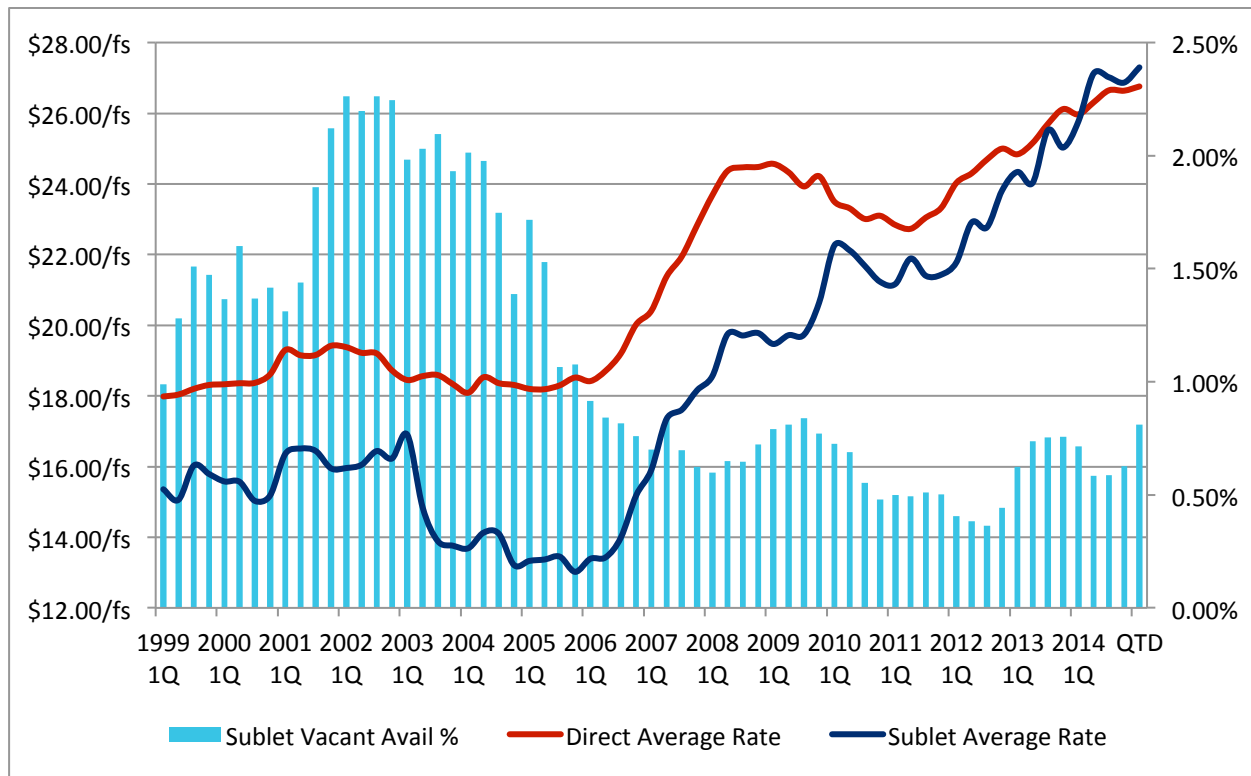
Although the Great Recession hit Houston hard, it didn’t last very long. This downturn resulted in the greatest swing in WTI in history. After peaking at \$145/bbl in June 2008, oil fell to \$33/bbl that December. However, prices recovered quickly and were up to over \$80/bbl by the beginning of 2010. In contrast to past downturns, the amount of sublease space on the market did not significantly increase, nor could tenants find better lease opportunities in sublease space. In fact, sublease asking rates increased during this time. Like the other periods of economic downturn, there was no significant drop in direct asking rates.

CONCLUSIONS

Direct asking rates have held up in the last three major downturns, a trend that is expected to continue in this current economic environment. In the class A office market, the minimum lease term is 5 years, but typically 10 years. Lease term functions like a hedge and provides landlords the ability to ride-out a downturn without having to lower rents. Commercial real estate in Houston is generally very well capitalized. Many leading professionals in today’s age began their careers in the 80’s and remember the excesses that occurred during that time. As a result, the capital markets have kept supply and demand in check, insuring good market fundamentals. For instance, the current overall office market is nearly 90% occupied and there is not an oversupply from new construction, which is very well preleased. Additionally, conservative underwriting by the lenders – 65% LTV, strong sponsorship and strong rental income – insures landlords

have “staying power” in a downturn. Houston learned from its past mistakes, resulting in a disciplined office market that is well-positioned to endure a prolonged downturn. Interestingly, tenants are currently unable to find value in sublease space for the most part. Sublease asking rates surpassed direct asking rates for the first time at the beginning of 2014 and show no signs of subsiding significantly. The amount of sublease space on the market (currently representing 0.8% of the Houston office market) will undoubtedly increase during this downturn. However, the amount of sublease space on the market is low and even with additional space that is projected to hit the market in the coming months, the impact on sublease asking rates is projected to be negligible. Judging from past recessions, a “wait and see” approach is not likely to benefit current tenants in the market in regards to a possible rental rate depreciation, particularly for those making long-term real estate decisions. Decisions involving non-core facilities, or expansions based on procuring future business, a “wait and see” strategy may be appropriate and needs to be evaluated on a case-by-case basis.

Graph 2: Houston’s Sublet Market vs Direct Average Rate



*Data is pulled from Avison Young Research

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