HOUSTON

# OFFICE MARKET REPORT

*First Quarter 2020*

BELVOIR

REAL ESTATE GROUP, LLC

*Going Places*

BROKERAGE / DEVELOPMENT / MANAGEMENT / INVESTMENT

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# *A Message from Matthew Goldsby, Belvoir Managing Director*

There is no way around the fact that the combined impact of the OPEC oil price war and the coronavirus pandemic will have a material impact on Houston's office market. These factors come on the heels of an office market that has not yet fully recovered from the previous fracking bust. One differentiating factor in the current oil shock is that the Houston supply pipeline is essentially silent – during the fracking bust, Houston's office supply pipeline was in the process of delivering over 30 million square feet into a rapidly deteriorating market.

However, the longer-term outlook offers a brighter picture in Houston, as pandemics tend to result in a V-shaped recovery curve in the wake of a steep decline in economic activity. This "baked-in" recover should help to pull at least half of Houston's economy quickly back into growth mode. The outlook for the energy industry is more tenuous, as it hinges much more on the global economic climate and geopolitical considerations outside of the U.S.'s control.

The first quarter statistics reflect energy's impact on the market. Houston had 0.8% growth, and the vacancy factor across the city was 16.8% and net absorption was 10,000 square feet. Over the past 12 months, Houston offices saw negative absorption of almost 450K square feet, driven by low energy prices. Our immediate future may be increasingly tied to the growth of medical, biotech, and digital tech companies which have only just begun to take flight. MDA Cancer Center's announcement of a $15M deal for lab space and the manufacturing of cell therapies is just one of many such announcements to come in the near-term.

In face of the new COVID-19 pandemic and guidelines issued nationally and locally, retail and the service industries have been hit hardest, and offices have been largely limited to essential personnel. While the retail effects may be more long-lasting, office sector use and employment is expected to rebound faster, and with less severe long-term damage. For Houston specifically, while energy sector employment will see layoffs and budgeting cuts, the depths of the restructuring is not expected to exceed the fracking bust, given that the most damaging excesses of that era were previously drained from the system. Given the unprecedented nature of the impacts surrounding the pandemic, we expect a clearer picture of the effects of the shutdown to become more apparent in the second and third quarters of this year. As we navigate these unprecedented conditions, we remain hyper-focused on how best to position real estate in the current market and into the future, and how to share these insights with our clients in an actionable way.

# OFFICE MARKET SNAPSHOT

## LEASING

The recent oil price crash and coronavirus pandemic pose serious downside risks to Houston's office market. Net absorption amounted to about 10,000 SF last quarter and -440,000 SF over the past year. Houston had recently experienced a tremendous flight to quality, a trend also seen at the national level. Of the 100 largest new office leases signed last year, over 70% were for 4-star space, and nearly 20% were for 5-star space. Houston currently has the highest vacancy rate in the country. In this tenants' market, landlords must offer significant amenities and compete in terms of price.

## RENT

Houston office rents, even for 4- and 5-star space, are being offered at a deep discount to both the U.S. average and coastal metros, an attractive proposition for companies looking to relocate to an affordable, large U.S. metro. However, Houston offices may experience declining rent growth in the coming months, as the market deals with the economic and social fallout stemming from the coronavirus pandemic. Rent growth over the past year was strongest inside the Loop, the area that is seeing the most new development and absorption activity. West Houston submarkets located in and near the Energy Corridor trail just slightly behind, a result of resurgent leasing activity in the area.

## CONSTRUCTION

Houston's office supply pipeline was already down significantly since the oil downturn of 2015-2017, as the market worked through significant oversupply, prior to the coronavirus pandemic and recent oil price crash. However, there are still a few new projects underway. Among the largest, Hines is under construction with its 1.1 million SF Texas Tower in downtown Houston, which is set to deliver in 2021. Hines is developing Marathon Oil's new 440,000 SF headquarters in City Centre, which is expected to deliver by the end of 2021. Property owner Rice University is expected to spend a reported $100 million on the redevelopment of the 270,000 SF former midtown Sears building. Upon completion, it is expected to eventually serve as the de facto innovation tech hub for Houston.

## SALES

The current outlook for transaction activity in 2020 was deteriorating rapidly due to the coronavirus pandemic and oil price crash. And as noted, Houston is in the midst of its second oil downturn in just five years – with oil prices in the $20s/barrel – and the U.S. is in a recession for the first time since 2008, which are both likely to negatively impact transaction activity and the demand for Houston office properties. This is important because roughly half of Houston's economy is based on the health of the energy sector and the other half on the health of the global and national economies. Houston again ranked in the top 15 U.S. markets for office transaction volume last year, with $4.7 billion in trades.

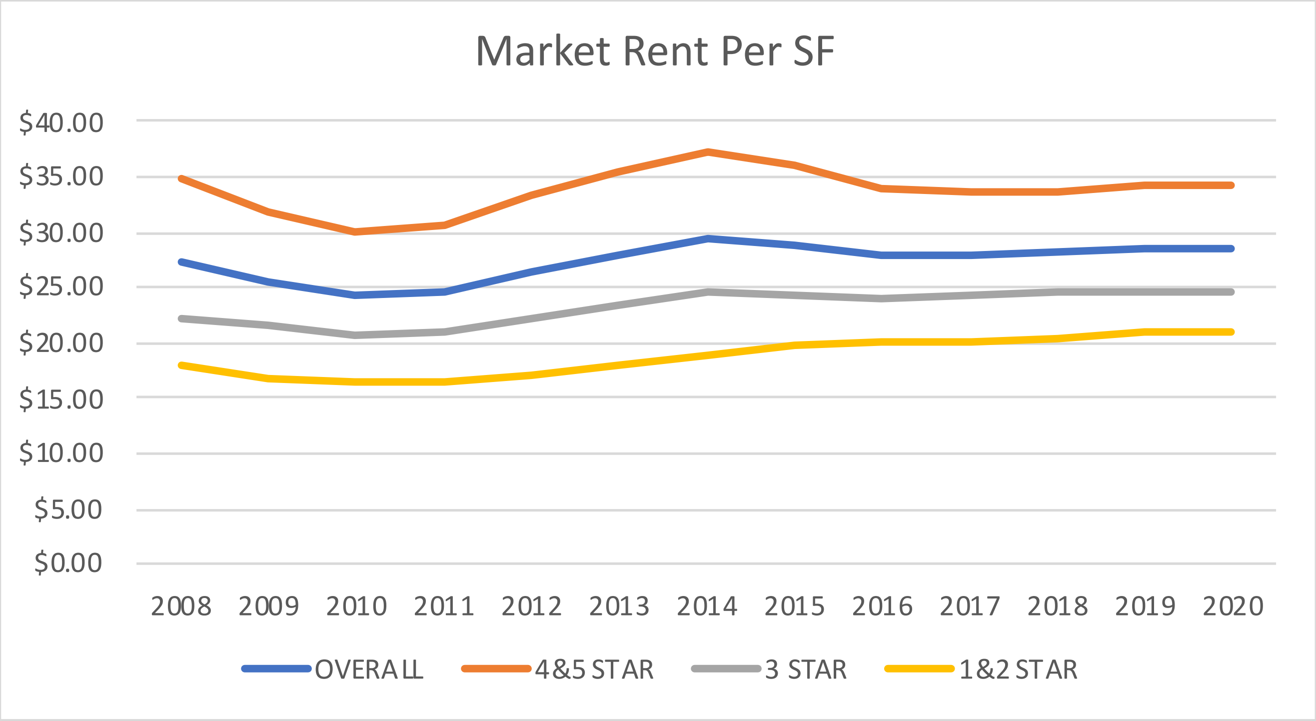
The largest transaction in terms of size last year included the $627 million sale of 600 and 601 Travis downtown to New York-based private equity firm Cerberus Capital in partnership with Hines. Cerberus took a reported 90% stake in the towers alongside JV partner and original developer Hines (10%). The JP Morgan Chase Tower at 600 Travis — the tallest building in Texas and one of the largest, at over 1.6 million SF— was 86% occupied at the time of sale, facing significant near-term roll, and in need of major capital improvements.

*Source: CoStar Property©*

| Market | Existing Inventory | | Vacancy | | YTD Net Absorption | YTD Deliveries | Under Const SF | Rent Per SF |
|---|---|---|---|---|---|---|---|---|
| | Bldgs | SF (000) | SF | Percent | | | | |
| Bellaire | 92 | 5,237 | 704,142 | 13.4% | 85,649 | 1 | 53 | $21.17 |
| CBD | 160 | 51,212 | 10,339,359 | 20.2% | 43,395 | 1 | 1,252 | $37.09 |
| E Fort Bend Co/Sugar Land | 432 | 10,120 | 1,092,662 | 10.8% | 25925 | 21 | 164 | $27.56 |
| FM 1960/Champions | 262 | 4,403 | 704,917 | 16.0% | (132,918) | 0 | - | $19.13 |
| FM 1960/Hwy 249 | 464 | 9,624 | 1,526,137 | 15.9% | (262,352) | 24 | 157 | $25.57 |
| Galleria/Uptown | 66 | 16,850 | 2,685,570 | 15.9% | (25,982) | 0 | 70 | $31.19 |
| Greenspoint/N Belt W. | 117 | 10,897 | 5,034,481 | 46.2% | (13,499) | 0 | - | $18.95 |
| Greenway Plaza | 273 | 12,668 | 1,958,078 | 15.5% | (201,699) | 0 | - | $30.54 |
| Gulf Freeway/Pasadena | 649 | 8,080 | 958,425 | 11.9% | (186,972) | 0 | 62 | $22.25 |
| Katy Freeway East | 263 | 11,702 | 1,118,691 | 9.6% | 178,168 | 2 | 1,350 | $31.38 |
| Katy Freeway West | 262 | 27,957 | 5,813,568 | 20.8% | 745,070 | 2 | 15 | $30.57 |
| Katy/Grand Parkway W. | 466 | 6,427 | 757,977 | 11.8% | (45,874) | 15 | 159 | $28.94 |
| Midtown | 583 | 9,942 | 930,140 | 9.4% | (45,740) | 2 | 395 | $31.13 |
| NASA/Clear Lake | 537 | 10,308 | 1,383,986 | 13.4% | 66,675 | 5 | 62 | $24.27 |
| North Loop West | 362 | 6,206 | 977,392 | 15.78% | 66,972 | 2 | 136 | $23.55 |
| Post Oak Park | 44 | 4,607 | 1,165,136 | 25.3% | (124,294) | 0 | 207 | $31.80 |
| San Felipe/Voss | 50 | 5,352 | 1,077,092 | 20.1% | (45,215) | 0 | - | $26.42 |
| South Main/Medical Center | 240 | 13,013 | 800,574 | 6.2% | (142,474) | 0 | 5 | $28.41 |
| Southwest Beltway 8 | 190 | 7,364 | 1,364,791 | 18.5% | (33,607) | 0 | - | $18.08 |
| Southwest/Hillcroft | 110 | 5,318 | 886,729 | 16.7% | (7,519) | 0 | 5 | $17.30 |
| The Woodlands | 663 | 23,694 | 2,625,098 | 11.1% | (289,287) | 10 | 178 | $31.95 |
| West Belt | 113 | 6,320 | 1,348,658 | 21.3% | (138,744) | 0 | 4 | $28.43 |
| Westchase | 140 | 18,925 | 4,550,458 | 24.0% | (3,090) | 0 | - | $27.29 |

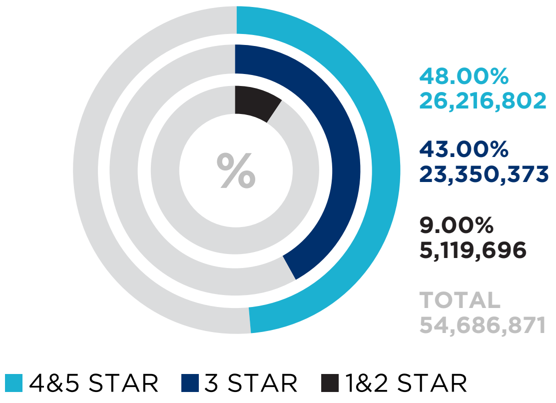
*Source: CoStar Property©*

## HISTORICAL AND FORECAST RENTAL RATES BY CLASS



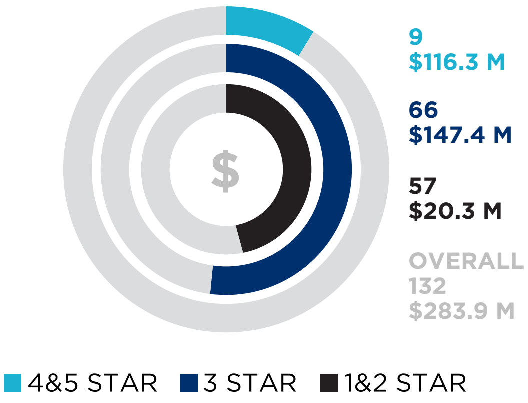

*Source: CoStar Property©*

## VACANCY BY CLASS




*Source: CoStar Property©*

## SALES BY CLASS

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