Fourth Quarter 2016 / Industrial Research Report

Houston

Market Facts

14,700

Jobs added in 2016, a 0.5% increase in employment.

5.3%

Unemployment in Houston, which is now higher than the national unemployment rate of 4.8%.

13.9

Million square feet of industrial space that has delivered this year.

5.1%

Vacancy in Houston's industrial market remains tight.

Market Overview

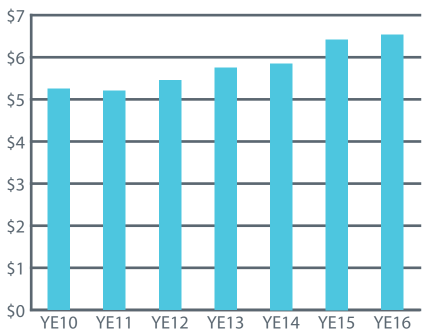
The Houston industrial market ended 2016 with strong absorption gains and a relatively unchanged vacancy rate, which has remained at historic-lows throughout the downturn. A significant number of new projects delivered in 2016, although new construction starts tapered off in the second half of the year and the current construction pipeline is the lowest recorded in the past five years. Although much of 2016 was characterized by the lingering energy downturn, average asking rates are up slightly from the previous year, indicating that Houston landlords have remained optimistic about industrial product. This year, the industrial market was one of the best performers in Houston in terms of product type. Going forward, the industrial market is poised to continue slowly improving as Houston's economic outlook continues to brighten.

Most indicators are suggesting that the economic downturn is over and Houston is in recovery mode. The Purchasing Manager's Index hit 51.1 in October after 21 consecutive months of readings below 50. Readings above 50 indicate regional expansion in the short term. Houston created 14,800 jobs in 2016 and the Greater Houston Partnership is forecasting an additional 29,700 jobs to be created in 2017. OPEC has reached a tentative deal to cap oil production, and most energy analysts project that oil will average in the mid-$50 per barrel range in 2017. While select pockets in the industrial market will take quite some time to recover, the majority of the market is experiencing positive fundamentals. The industrial market will continue to be driven by Houston's strong population growth, the rise in online retail, the downstream energy market, and a healthy U.S. economy.

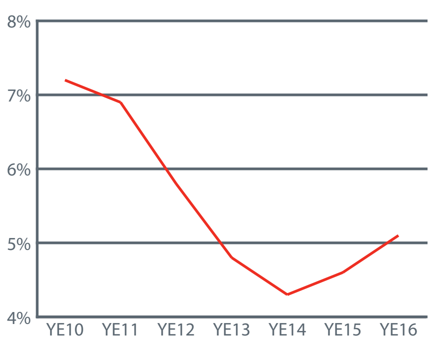
Absorption & Demand

The Houston industrial market finished strong in 2016, absorbing 8.7 msf through year-end. Even though the Houston market began the year with pessimistic sentiment from the lingering energy downturn, absorption in 2016 exceeded the 10-year annual absorption average of 7.0 msf. Over 2.2 msf was absorbed

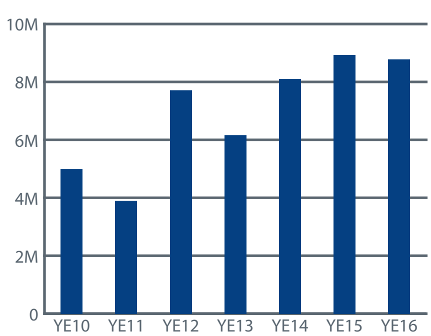
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



in the fourth quarter. The healthy absorption gains this year were mainly attributed to a handful of significant occupancies, most notably Daikin's 3.9-msf manufacturing campus in the Northwest.

Demand across the Houston industrial market has varied by geographical location throughout the downturn, but these differences are beginning to even out as the energy industry continues to recover. The North submarket has been plagued by oversupply concerns brought on by an abundance of crane-served buildings that delivered just as the energy downturn began. Since these buildings are typically leased to energy service companies, the majority have sat vacant throughout the downturn. Leasing activity in these crane-served buildings began to improve in the fourth quarter, albeit slightly. Even though activity is improving in this area, the North is projected to maintain the highest vacancy rate in Houston through 2017. The Southeast remains a bright spot in the region due to petrochemical and trade activity. Demand is particularly high for properties that offer rail-served distribution space near the Port of Houston. In 2016, the Southeast was responsible for 18% of absorption gains and 31% of total leasing activity in Houston, making it the best-performing submarket. The Northwest, Houston's traditional supply and logistics hub, was not far behind. Significant population gains have prompted a growing number of distributors to open locations in Houston, when in the past, they have operated out of Dallas.

Available sublease space hit a new high, up from 2.6 msf at year-end 2015 to 5.2 msf in the fourth quarter. However, available sublease space represents just 1.1% of the industrial market and is projected to begin declining in 2017 as the energy recovery takes hold.

Vacancy & Availability

Overall vacancy increased by 10 basis points from the previous quarter as new deliveries slightly outpaced absorption gains. At 5.1% at year-end 2016, the vacancy rate is still incredibly low by historic standards. At this point last year, the market was very landlord-favorable with a vacancy rate of just 4.6%. The continued construction boom has caused oversupply concerns in the Houston market. However, the vacancy rate has held relatively stable throughout the downturn even though nearly 30 msf of new product has been delivered in the past two years. If the space currently under construction, totaling 5.9 msf, were to remain unleased upon delivery, the vacancy rate would only reach 6.2%.

Rental Rates

Asking rates have increased slightly from the past year, averaging $6.53 per square foot (psf) NNN in the fourth quarter. At year-end 2015, asking rates averaged $6.42 psf NNN. However, there were changes experienced differently across the industrial product types. In the past year, warehouse and distribution rates across Houston have increased by 2.3% to $6.31 psf, while flex rates have dropped by 3.0% to $9.56 psf. Manufacturing rates have remained relatively unchanged, decreasing by just 0.6% to $6.61 psf. Throughout the downturn, landlords largely opted to maintain base rates while increasing tenant improvement allowances and free rent. Asking rates are projected to increase in 2017, albeit slowly.

Construction

Over 13.9 msf delivered to the Houston market in 2016. The Daikin Texas Technology Park was the most significant delivery in 2016. Daikin has invested $417 million in the local Gulf Coast economy with their 3.9-msf new campus, which is the largest tilt wall building in the world. The campus will support 5,000 jobs, a welcome boost in employment after the manufacturing industry was hard-hit by the energy downturn. In the past two years, construction deliveries have totaled nearly 30.0 msf. An additional 5.9 msf is currently under construction, which is the smallest construction pipeline recorded in the past five years. This space overwhelmingly consists of warehouse and distribution product, located primarily in the Southeast and Northwest submarkets. New construction starts in everywhere except the Southeast are expected to taper off in 2017.

4Q16 Deliveries

Cedar Port Distribution Park Bldg. 1
(495,000 sf). Southeast

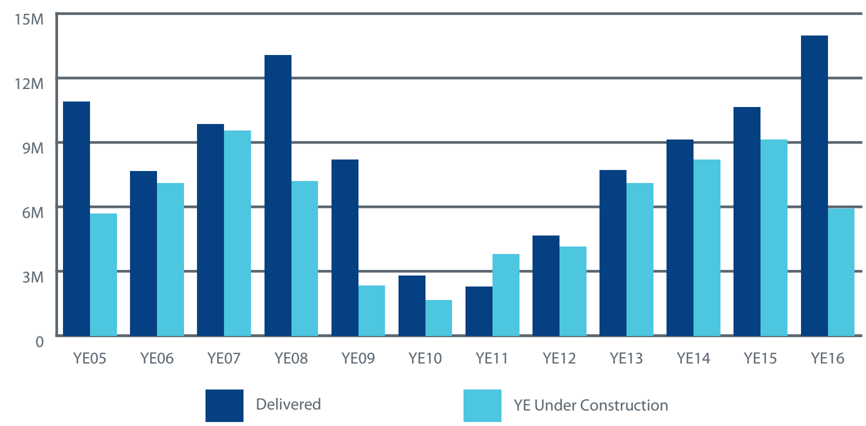
Port Crossing Commerce Center
(415,000 sf). Southeast

Bay Area Business Park Bldg. VI
(212,000 sf). Southeast

Beltway Southwest Business Park
(209,000 sf). Southwest

Park 8Ninety Bldg. III
(209,000 sf). Southwest

Construction Timeline



4Q16 Highlights

- Building 1 at the Cedar Port Distribution Park delivered in the fourth quarter totaling 495,000 sf. IKEA has leased the entire building, and it is the company's first distribution center on the Gulf Coast.
- Hagemeyer renewed its 158,000-sf lease at Port 225 Building 1 in the Southeast submarket.
- XPO Logistics took occupancy of 115,000 sf at Bayport North Industrial Park in the Southeast submarket.
- Largo renewed its lease for 88,100 sf at Clay-Campbell Business Park in the Northwest submarket.
- CME Wire & Cable leased 103,000 sf at Bayou Bend Business Park Building 1 in the Southwest submarket. The company will take occupancy of the space in the first quarter of 2017.
- McKee Tessa LLC purchased 17 acres of land in Pearland for a new industrial manufacturing facility. The company plans for the building to total 55,000 sf.

Trends to Watch

The price of oil averaged $49.30 /bbl. In the fourth quarter, up from earlier in the year when oil averaged $33.38/bbl.

Economic sectors reporting growth in the last 12 months include Leisure & Hospitality (4.2%), Education & Health Services (3.7%), Government (2.3%), Finance (0.8%), and Trade, Transportation & Utilities (1.6%).

The Houston PMI registered 51.1 in October, indicating expansion in regional production in the short term. The PMI has registered below 50 for 21 consecutive months.

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