

Houston



Market Facts

5,100

Jobs added in the last 12 months ending in May, a 0.2% increase in employment.

4.8%

Unemployment in Houston, which is now higher than the national unemployment rate of 4.7%.

11.2

Million square feet of space now listed on the sublease market.

105

New office buildings delivered during Houston's construction boom.

Market Overview

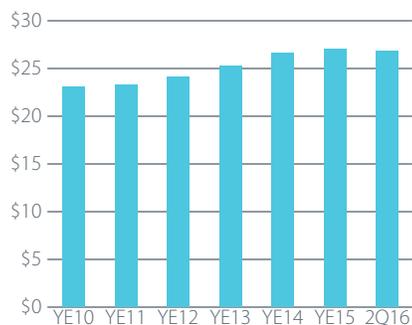
Activity in the Houston office market has remained slow this past year amid the ongoing downturn in the energy industry. At mid-year 2016, the energy industry finally shows signs of recovering with the bulk of energy analysts projecting rising, not falling, oil prices through the end of the year. The past two years in a volatile environment has resulted in multiple Houston-area bankruptcies, as well as large-scale merger and acquisition deals. Office tenants continue to hold out on making lease decisions while they wait out the cyclical nature of the business. Leasing activity through the first half of the year is down by 50% from average.

A substantial amount of available space has hit the market in the form of new construction and sublease space. Available sublease space hit record-highs in 2015 and climbed further in 2016 with a handful of large blocks hitting the market. Additional downsizing in the energy industry is expected this year while oil

prices remain depressed, and available sublease space will likely continue to rise during this time. Houston has led the country in development activity for years, but the construction boom is winding down with the majority of space set to deliver in 2016. While large build-to-suits will contribute to Houston's absorption as tenants occupy the space, there is also a sizeable amount of unleased space that will deliver in 2016, which will add to the already significant amount of available space on the market. Houston's vacancy rate has surpassed the previous peak experienced during the Great Recession and is expected to continue rising in 2016. Vacancy has increased by two percentage points from the previous year to 14.1%. Average asking rates began to fall in the second quarter. Asking rates will likely hold relatively steady through the end of the year, with landlords offering free rent and tenant improvements in place of rental rate abatements.



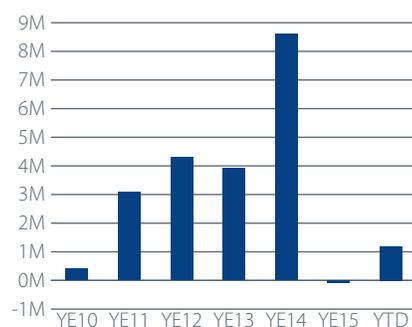
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



Absorption & Demand

With the slowdown in the energy industry, absorption in the second quarter ground to a halt. In the past year, absorption in the Houston market was a result of tenants taking occupancy of newly-delivered space from leases that were signed in 2014. Second quarter absorption totaled -587 sf, but occupancies earlier in the year in large build-to-suits resulted in a year-to-date absorption of 1.2 msf. Absorption through the rest of 2016 is expected to remain positive, but just barely so, with additional planned occupancies counteracting vacated sublease and direct space. Large occupancies in build-to-suits planned for this year include the Phillips 66 campus (1.1 msf) and BHP's Headquarters (56,000 sf). Phillips 66 campus delivered in the second quarter, and the company will begin consolidating 2,200 employees at the location in the third quarter.

Vacancy & Availability

The vacancy rate in the Houston office market increased by 40 basis points from the previous quarter to 14.1% due to new construction deliveries outpacing absorption. Most construction projects are slated for delivery in 2016. Although these projects are heavily preleased, vacancy is expected to continue rising throughout the remainder of the year as these projects deliver. An additional 2.0 msf of sublease space was listed on the market in the second quarter. Available sublease space has reached 11.2 msf, representing 4.6% of the Houston market. Significant new subleases include ConocoPhillips at Energy Center Four (597,000 sf) and BP at Four WestLake Park (560,000 sf), both located in West Houston. Downtown, Greenspoint, and West Houston have been hardest-hit in the current downturn, with 70% of all sublease listings located in these areas.

Asking Rates

For the first time in the current downturn, Class A rates fell from the previous quarter. Class A rates are down by 1.3% from the first quarter to \$34.36 per square foot (psf). Overall rates have remained relatively stable throughout the energy downturn, but the drop in Class A rates pulled the overall average down by \$0.23 psf to \$26.78 psf in the second quarter. Long lease terms function like a hedge and provide landlords the ability to ride out a downturn without having to significantly lower rents. Direct asking rates are expected to remain relatively flat in 2016 due to slow leasing activity and additional available space. Concessions in the form of tenant improvements and free rent will likely continue to increase in an effort to attract tenants.

Construction

Houston's construction boom has added over 24.0 msf to the market since 2013, thereby increasing the size of Houston's office market by 11%. Only 3.7 msf is currently under construction with 48% preleasing. The majority of the space under construction will deliver in 2016. A handful of build-to-suit projects broke ground in the second quarter, including KPRC Channel 2 (60,000 sf) and The Post Oak (160,000 sf). American Bureau of Shipping preleased the entire CityPlace 2, totaling 326,800 sf. Construction on the building, located in The Woodlands, will begin in early 2017. A substantial amount of space is available throughout the Houston market, and additional construction starts are not anticipated for years to come without a substantial amount of preleasing.

2Q16 Deliveries

Phillips 66 Headquarters
(1.1 msf). Westchase

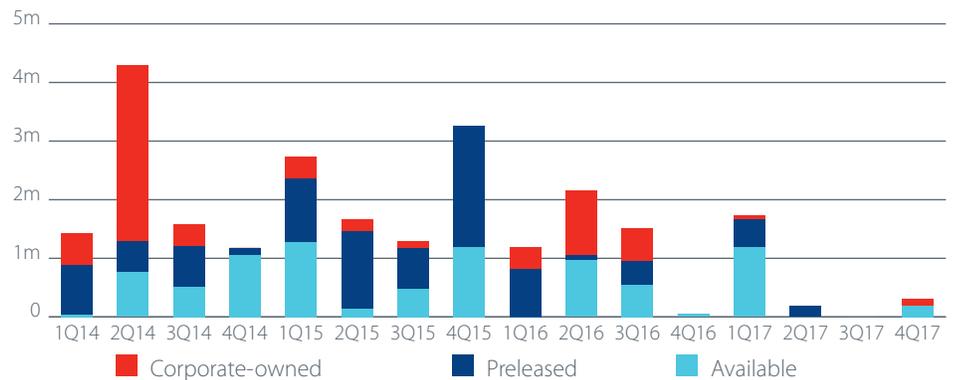
Energy Center Five
(524,386 sf). Katy Freeway West

Havenwood Office Park
(240,000 sf) The Woodlands

1885 Saint James Place
(165,000 sf). West Loop

Grandway West II
(124,017 sf). Katy

Construction Timeline



2Q16 Highlights

- Shell Oil Co. purchased the struggling BG Group in early 2016. The company announced that BG Group will be vacating roughly 380,000 sf at BG Group Place by the end of the year. This space will be added to the CBD sublease market, which currently totals over 2.4 msf. Over 10,000 job losses are expected to occur due to the acquisition.
- American Bureau of Shipping (ABS) preleased the entire 326,800-sf CityPlace 2, located in The Woodlands submarket. The company is expected to vacate existing space in Greenspoint totaling 258,000 sf when CityPlace 2 is completed in 2018. Greenspoint availability has hit 50%.
- ConocoPhillips listed 597,000 sf of sublease space in the newly-built Energy Center Four. The company never occupied the space.
- BP listed 560,000 sf on the sublease market at Four WestLake Park. Sublease availability in the Katy Freeway West submarket now totals 2.9 msf.
- The Phillips 66 campus delivered 1.1 msf. 2,200 employees will begin to consolidate at the campus in the third quarter.
- Tudor, Pickering, & Holt renewed its 88,000 sf lease at Heritage Plaza in the CBD.

Trends to Watch



The price of oil averaged \$45.59/bbl. in the second quarter, up from the first quarter's average of \$33.38/bbl.



Economic sectors reporting growth in the last 12 months include Leisure & Hospitality (5.4%), Education & Health Care (4.8%), Government (2.2%), Finance (1.5%), Construction (1.2%), and Trade, Transportation & Utilities (0.5%).



The Houston PMI registered 45.8 in May, indicating contraction in regional production in the short term. However, this is up from April's PMI of 44.2.