Fourth Quarter 2018 / Office Market Report

Houston

Quick Stats

114,400

Jobs created during the 12 months ending November 2018

3.8%

Unemployment rate in Houston, unchanged from October but down from 4.4% in November 2017

8

Million square feet of space now listed on the sublease market

16%

Direct vacancy rate in Houston's office market, down from 17.2% at year-end 2017

Market Overview

Houston's office market remains in recovery mode. Direct net absorption recorded during the fourth quarter equaled the positive absorption of the previous quarter, but the combination could not quite offset the losses during the first half of the year. Fourth-quarter direct net absorption totaled 665,781 square feet (sf) to end the year with a negative 67,428 sf, a significant improvement from 2017's negative 1.1 million square feet (msf). Leasing activity is also trending upward, with tenants leasing 3.9 msf during fourth quarter, bringing the year-to-date total to 14.3 msf. This annual total is 9% greater than 2017's year-end leasing total.

Vacancy and availability rates have shown marginal, but consistent, improvement during 2018. The fourth-quarter direct vacancy rate of 16% represents a drop of 20 basis points from third quarter and lower than the 17.2% recorded at year-end 2017.

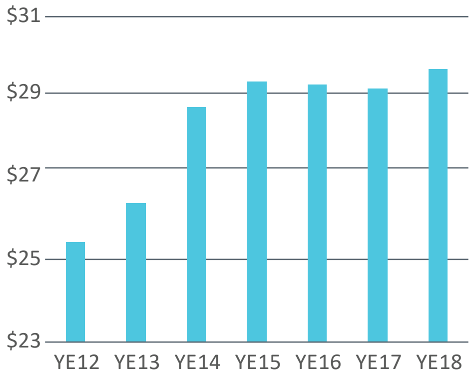
Local employment growth has been steady, with the unemployment rate dropping to 3.8% in November compared to last November's 4.4%. For the 12 months ending November 2018, the Houston metro area created 114,400 jobs, a 3.7% increase year-over-year, according to Texas Workforce Commission statistics reported by the Greater Houston Partnership (GHP). Five sectors, including construction and professional services, accounted for three-fourth of all job gains.

Overall rental rates remain constant, but tenants will remain in the driver's seat based on the amount of availability in the market. The flight-to-quality factor – firms opting for office efficiency in newer properties – combined with mergers, consolidations and right sizing has been keeping availability high and increased the level of leasing activity in the class A segment.

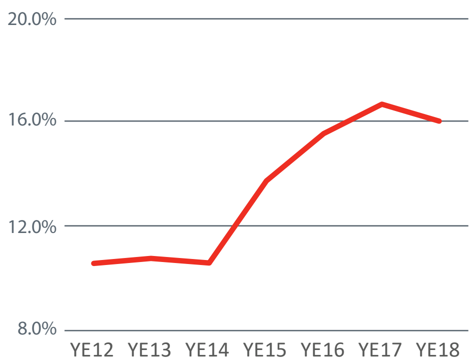
Six of the largest leases recorded in 2018 reflected that flight-to-quality factor. Two deals, Transocean and McDermott International in the Energy Corridor, accounted for taking down almost 825,000 sf of newer space, while the other four deals represented 1.2 msf of preleases in buildings either under construction or proposed. And in the case of Marathon Oil Corp., companies are opting for their own new build-to-suit facilities.

Availability rates remain high but have decreased. The direct availability rate decreased to 20.4% in the fourth quarter from 20.6% in the third quarter, while the overall availability, including sublease

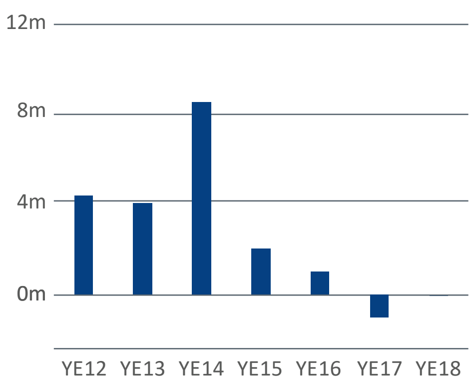
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



space, balanced out at 23.7%, marginally lower than last quarter's 24% but still higher than year-end's 19.1% direct availability rate.

Absorption & Demand

Direct positive net absorption returned to the office market for a second consecutive quarter, with 665,781 sf recorded during the fourth quarter. This brought the year-end net absorption to a negative 67,428 sf. All classes reported direct net gains during the fourth quarter, with class A properties recording the highest absorption of 411,672 sf. For the year, class A properties resulted in a positive 480,734 sf.

Broken down by submarket, The Woodlands submarket recorded the highest positive absorption primarily due to HP's occupancy of the company's two new buildings totaling 378,402 sf in Springwoods Village. Overall, the flight-to-quality trend prevails, as evidenced by leasing activity in the newest buildings. Waste Management is following that trend as the company preleased 284,331 sf in Capitol Tower during fourth quarter.

Total available sublease space dipped to 8 msf from third quarter's 8.3 msf; sublease space represents about 14% of the 57.2 msf available. The largest block of sublease space is Occidental's 746,070 sf in 5 Greenway Plaza.

The construction pipeline remains limited, with eight buildings totaling almost 2.4 msf under construction and 54% preleased. The two CBD buildings represent 80% of the total square footage. Only one 200,000-sf spec building has officially announced breaking ground in early 2019 although other BTS properties are in the mix.

Asking Rate

Overall average asking rates have increased slightly to $29.59 per square foot (psf) gross from the previous quarter's $29.52 psf gross. Asking rates have been relatively stable throughout the downturn with landlords offering concessions and allowances. Class A rates are up to $35.65 psf and gaining ground over end-of-year 2017's $35.16 psf.

Select Fourth-Quarter 2018 Deliveries

CityPlace 2, 1701 CityPlace Drive
(326,800 sf) Spring/The Woodlands

HP Buildings 1 & 2, 11300 & 11400 Energy Drive
(189,201 sf each) Spring/The Woodlands

Q4 2018 Highlights

- **ConocoPhillips** moved into its new building at 925 N Eldridge, occupying the entire 567,628 sf.
- **Hewlett Packard Enterprise** inked the largest deal of the fourth quarter and of 2018 when it signed for 568,000 sf for a new campus in Springwoods Village.
- **McDermott International** will be the first and only tenant in Energy Center Five, a 524,397-sf office tower in the Energy Corridor at 915 N. Eldridge Parkway.
- **Pros Holdings Inc.** has leased 118,000 sf in the new Kirby Collection at 3200 Kirby. The Houston-based technology firm currently offices at 3100 Main.

Trends to Watch

Employment grew 3.7%, creating 114,400 jobs for the 12 months ending November 2018. All but two sectors reported growth, according to the Texas Workforce Commission.

The Purchasing Manager's Index (PMI) registered 54.9 in November, down minimally from 55 in October, indicating short-term expansion in Houston's manufacturing sector.

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