First Quarter 2018 / Office Research Report

Houston

Market Facts

62,500

Jobs created during the 12 months ending March 2018.

4.2%

Unemployment rate in Houston, down from 5.6% when it peaked in January 2017.

9.3

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

16.2%

Vacancy in Houston's office market, slightly higher from the previous quarter.

Market Overview

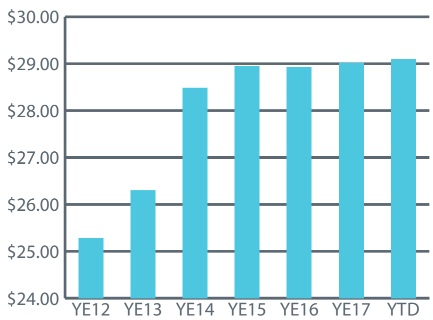
Houston's office market is showing favorable conditions the first quarter of 2018, despite slight negative absorption. Employment forecasts are positive and oil prices have risen, but the office leasing market remains a challenge as available inventory increases. The office market lags other commercial sectors such as industrial and retail -- which are experiencing strong positive conditions -- due to a glut of available inventory and suppressed demand.

Tenants are looking to take advantage of the surplus of available space, both direct and sublease, that is being offered under favorable terms. Unfortunately, additional direct and sublease space appeared on the market during the first quarter, resulting in increased vacancy and availability rates. Available sublease space once again topped 9.3 million square feet (msf); coupled with the increase of available direct space, the total availability rate increased to 22.4%. The direct vacancy rate, which appeared to stabilize in the latter part of 2017, jumped to 16.2% during the first quarter, a record high.

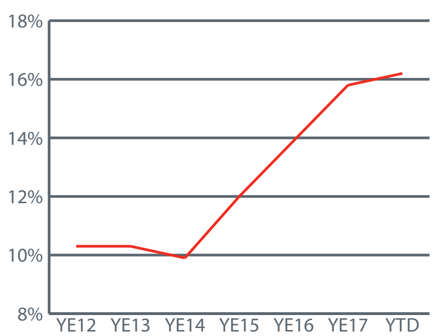
Leasing activity remained constant in the first quarter, with both direct and sublease space leased at levels slightly below the previous quarter. However, transactions appear to be representing smaller square footages as the number of leasing activity deals increased. On the supply side, the construction pipeline is at its lowest level since 2013. Aside from small projects and occasional build-to-suits, the recent development cycle has all but ended. Although Houston's office market still has a long road toward achieving equilibrium, it is a positive sign that leasing activity continues to occur and new construction remains at minimum levels.

Despite the gradual recovery of the energy industry and last year's devastating hurricane, Houston managed to maintain a vibrant, diversified economy. The price of oil rose during the first quarter and reached the $65 per barrel mark - the highest price in three years. The Greater Houston Partnership is forecasting Houston employment to pick up in 2018, driven primarily by the strength of the U.S. and global economies and Houston's links to them, specifically exports. Economic conditions in Houston are expected to improve throughout 2018.

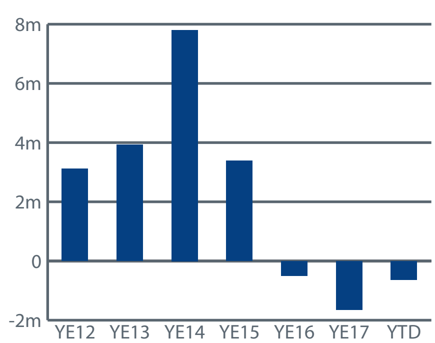
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



Absorption & Demand

After experiencing what many thought was a comeback with positive absorption during the fourth quarter of 2017, that comeback could not be sustained into the first quarter of 2018. The Houston office market experienced negative direct absorption of 637,042 sf during the first quarter, continuing the negative absorption trend of the prior seven quarters in 2016 and 2017. All classes reported negative totals, with Class B properties reporting the largest negative absorption at 519,474 sf. Until demand catches up with supply in Houston's office market, which isn't projected to happen until at least 2019, an increasing number of Class B properties will likely undergo renovations to remain competitive.

The flight to quality continues, with tenants opting for smaller footprints in prime locations, as evidenced by the newest buildings in the Central Business District (CBD). Currently under construction, the new Capitol Tower property has seen more than 73,000 sf of preleasing in the last two quarters. And 609 Main at Texas, open for almost a year, is continuing to lease up as one of its first preleases, United Airlines, moved into its 225,000-sf offices in February, leaving behind more than 300,000 sf in its former offices in two downtown buildings.

More available sublease inventory came to the market during the first quarter even as tenants took a comparable but smaller amounts of space off the market. Total available sublease space, at 9.3 msf, represents 16% of the 58.6 msf available. The largest block of sublease space added in first quarter was TechnipFMC's 375,937-sf space in Energy Tower II in the Katy Freeway West submarket. Mergers and acquisitions such as TechnipFMC are still happening, and the combined companies are placing excess available space back on the market.

Vacancy & Availability

Overall vacancy rates increased slightly to 16.2% during the first quarter from last quarter's 15.8%, representing the highest level recorded in Houston's office history; vacancy rates were as low as 9% to 10% from 2006 to 2007.

One noteworthy first-quarter 2018 delivery was a 104,579-sf building in Tilman J. Fertitta's The Post Oak in Uptown. The current 67%-occupied office building is a small part of the 650,000-sf, mixed-used development that features a 38-story luxury hotel, residential apartments, and restaurants along with high-end retailers.

With only 1.9 msf under construction primarily in four major properties, developers are holding the line and waiting to break ground after securing a large lead tenant. Market conditions appear encouraging as an increase of tenants are seeking available office space. The largest building under construction remains Capitol Tower in the CBD; the 778,344-sf building is 36.4% preleased and scheduled for completion in June 2019. Many tenants have been waiting for the market to reach bottom to take advantage of reduced rental rates and other concessions. While leasing activity remains relatively strong, the abundance of available inventory indicates the office market will remain tenant-favorable throughout this year and into 2019.

Asking Rates

Overall average asking rates increased by $0.07 psf from the previous quarter to $29.09 psf gross. Asking rates have been relatively stable throughout the downturn with landlords offering abatements in the form of tenant improvements and free rent. Class A rates are at $34.84, up slightly from last quarter but down slightly from the first quarter of 2017 at $34.92; class A rates have fluctuated during the last two years. Asking rates are projected to remain flat for the foreseeable future in Houston's tenant-favorable market.

Investment Activity

As the nation's fourth largest metropolitan area and major engine of global economic activity, Houston continues to attract investors as it emerges from the energy downturn. Although Hurricane Harvey caused concern, the historic storm did not dampen Houston's appeal to investors. Many large-scale deals are still in the works. Major sales closed in the first quarter of 2018, such as Marathon Oil Tower, a 1.2-msf property, and the three-building complex known as Brookhollow Central I, II and III. Investor interest is projected to remain optimistic through 2018.

Largest Under-Construction Properties

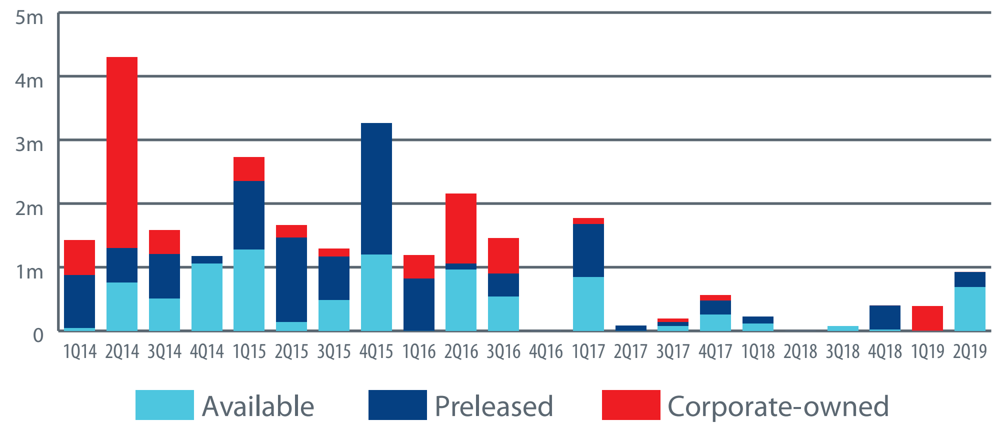
Capitol Tower (CBD)
778,344 sf | 36% preleased
Delivery: Second Quarter 2019

CityPlace 2 (Woodlands)
326,800 sf | 94% preleased
Delivery: Fourth Quarter 2018

HP Building 1 (Woodlands)
189,000 sf | 100% preleased
Delivery: First Quarter 2019

HP Building 2 (Woodlands)
189,000 sf | 100% preleased
Delivery: First Quarter 2019

Construction Timeline



Q1 18 Highlights

- **Apache Corporation** signed the largest lease this year, extending its 364,272-sf space at Post Oak Central One along with its 150,020-sf lease at Post Oak Central Three, both in the West Loop submarket.
- **Transco**'s renewal of 298,955 sf in Williams Tower represented the second largest office lease signed in the first quarter.
- **United Airlines** occupied its new 225,000-sf space in 609 Main at Texas, leaving more than 300,000 sf in 1600 Smith and 600 Jefferson.
- The sale of **Marathon Oil Tower** in the West Loop represented one of the largest transactions to close this year.

Trends to Watch

The price of oil rose above $65/bbl for the first time since the downturn took hold in 2015.

All economic sectors reported growth in the last 12 months except for Information (-4.6%).

The Purchasing Manager's Index (PMI) registered 52.8 in April, indicating short-term expansion in regional production.

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