Third Quarter 2017 / Office Research Report

Houston

Market Facts

53,500

Jobs added in the last 12 months ending in August, a 1.8% increase in employment.

5.2%

Unemployment rate in Houston, down from 5.8% when it peaked in July 2016.

10.0

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

17.2%

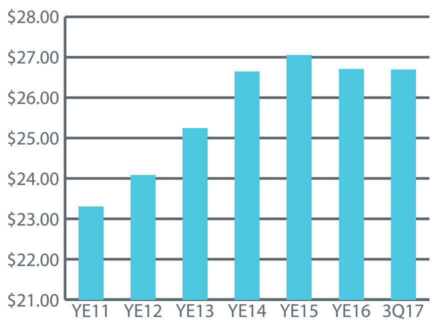
Vacancy in Houston's office market, the highest recorded in the past decade.

Market Overview

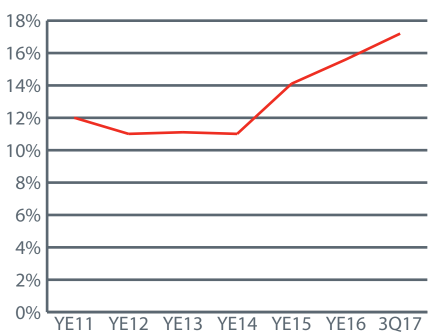
Hurricane Harvey has caused widespread devastation across the Greater Houston area and communities along the Gulf Coast. Measuring the full economic impact of the storm will take months, if not years. Initial estimates rank Harvey as the second most costly storm in U.S. history, behind Hurricane Katrina which struck New Orleans in 2005. Houston experienced massive flooding, resulting in single-family homeowners absorbing the brunt of the storm's impact. Reports from landlords and building owners indicate that Houston's office market was among the least-impacted of property types with only a handful of properties reporting extensive flooding. While the office market experienced relatively minimal damage from the storm directly, disruptions in tenant activity going forward will likely stem from shortages in the construction sector as Houston begins to rebuild and repair the damage. Construction costs are projected to rise further and delivery timelines will likely be pushed back in both tenant improvements and new development projects.

Employment and production in Houston are expected to contract in the near term while the city recovers from disruptions related to the storm. However, rebuilding has begun which is helping to spur economic activity. The Federal Reserve Bank of Dallas estimates that employment will be back to normal by November. Houston is the nation's fourth-largest metropolitan area and a major engine of global economic activity, and Hurricane Harvey is expected to have no long-term impact on the city. The historic storm has not dampened investor interest in Houston, with many large-scale deals still in the works. Brookfield announced they will purchase Houston Center for $875 million, representing one of the largest transactions ever for Houston. The deal was announced after Harvey.

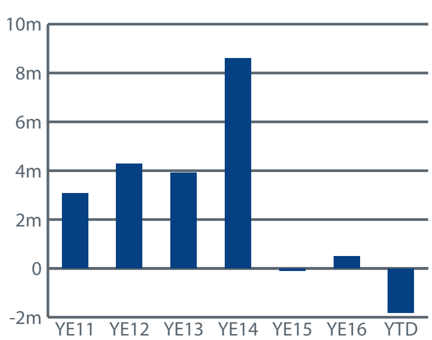
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



Absorption & Demand

Houston's office market recorded a negative net absorption of 817,568 sf in the third quarter, marking the sixth consecutive quarter of negative net absorption. Although leasing activity has improved in the last six months, the market is still feeling the effects of nearly three years of sluggish tenant demand. Year-to-date absorption now totals over -1.8 million square feet (msf). Absorption for the remainder of the year isn't projected to slide much deeper into negative territory, but slow leasing activity indicates that absorption for the foreseeable future will be relatively flat. Many energy tenants leased excess space for future growth during the boom years. Although these tenants are largely finished with shedding this excess space on the sublease market, any sizable office expansion in the energy sector isn't likely to occur anytime soon. Houston has had incredible success in fostering organic growth from existing companies expanding within the market. Although expansion from these companies has slowed, the abundance of quality office product at competitive rates is making it easier for new companies to enter the Houston market.

An up-tick in sublease leasing activity caused sublease inventory to contract further in the third quarter to 10.0 msf, representing 4.1% of the Houston market. NRG Energy signed the largest lease in the third quarter, subleasing 431,307 sf at One Shell Plaza. The energy company will take occupancy of the space in early 2018.

Vacancy & Availability

Vacancy rose by 40 basis points from the previous quarter to 17.2%, representing the highest vacancy rate to be recorded in the past decade. Vacancy registered 15.6% at this point last year. The current construction pipeline now totals 2.9 msf with 47% preleasing. Nearly half of space under construction is scheduled to deliver later this year, which will cause Houston's vacancy rate to rise further in the short term. However, contraction in the energy industry and Houston as a whole has largely abated, and the vacancy rate isn't projected to rise much further in 2018. Houston's slow recovery and abundance of available inventory indicates that the office market will remain tenant-favorable throughout at least the next year.

Asking Rates

Overall average asking rates decreased by $0.13 psf from the previous quarter to $26.69 psf gross. Asking rates have held relatively steady throughout the downturn with landlords offering abatements in the form of tenant improvements and free rent. Asking rates are projected to remain flat for the foreseeable future in Houston's tenant-favorable market.

Investment Activity

Investor interest in Houston office product waned in 2016 amid the uncertainty with only a handful of significant sales transacting. Along with Houston's brightening economic outlook, investor interest has returned and 2017 is poised to put Houston back on track in terms of historic investment volume. Office investment volume through the third quarter this year was up by over 200% compared with the same time frame in 2016. Parkway Inc. sold a 49% interest in Greenway Plaza and Phoenix Tower for $512 million earlier in the year. The deal provided momentum to Houston's office market and prompted several other owners to place trophy assets on the market, including the 4.2-msf Houston Center which is currently under contract for $875 million.

Major 2017 Deliveries

609 Main
(1,000,00 sf) CBD

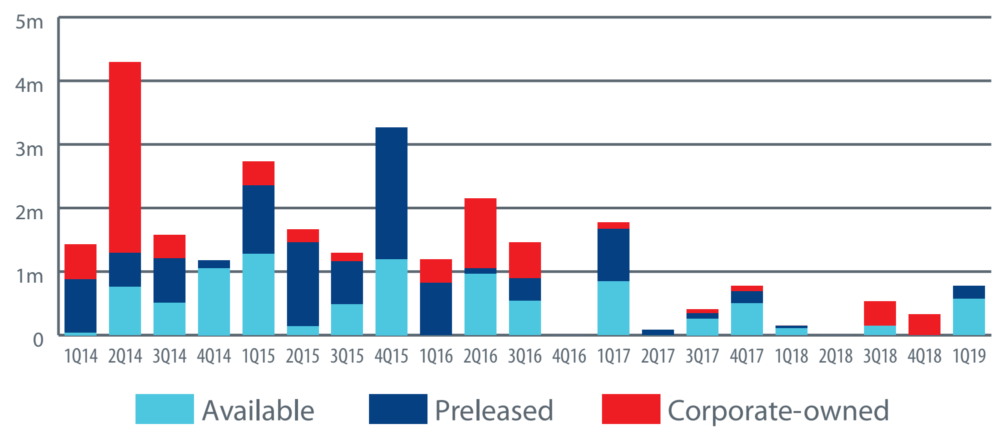
Amegy Bank Headquarters
(380,000 sf) West Loop

Memorial City
(238,173 sf) Katy Freeway East

Insperity Center 4
(100,000 sf) Kingwood / Humble

Park 225
(82,800 sf) Gulf Freeway/Pasadena

Construction Timeline



3Q17 Highlights

- The top-tier **Houston Center Complex** in Downtown is under contract for $875 million to Brookfield, representing one of the largest transactions ever for Houston.
- **NRG Energy** signed the largest lease in the third quarter, subleasing 431,307 sf at **One Shell Plaza**. The energy company will take occupancy of the space in early 2018.
- **Lingerfelt Commonwealth Partners** purchased **1700 West Loop South** for $52 million from Bridge Investment Group. The 272,941-sf building is 81% leased and anchored by Burns & McDonnell. Avison Young was retained to lease the building.
- After a $48.5 million renovation, Allen Center in Downtown Houston gained an anchor tenant at One Allen Center. **Motiva Enterprises LLC**, a downstream company, renewed and expanded its lease to occupy 204,500 sf. The building will now be known as **Motiva Plaza**.
- **Bank of America** preleased 210,000 sf at **Capitol Tower** in Downtown earlier in the year, securing naming rights to the building. The bank will announce the building's name upon completion, which is scheduled in 2019.

Trends to Watch

The price of oil averaged $48.20/bbl. in the second quarter, down from $48.29 /bbl. In the second quarter.

All economic sectors reported growth in the last 12 months except for Construction (-2.1%), Information (-2.4%), and Trade, Transportation & Utilities (-0.8%).

The Purchasing Manager's Index (PMI) registered 46.5 in August, indicating short-term contraction. Respondents noted short-term disruptions to operations but expect activity to increase as Houston recovers from Hurricane Harvey.

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