Fourth Quarter 2017 / Office Research Report

Houston

Market Facts

46,000

Jobs added in 2017, a 1.5% increase in employment.

4.3%

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

8.8

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

17.2%

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

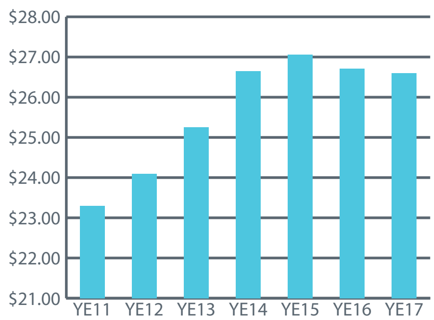
Market Overview

Conditions in Houston slowly improved throughout 2017, but it wasn't until the fourth quarter that the office market took a meaningful step towards recovery. While most other product types reported growth in the past year, the office market lagged behind due to a glut of available inventory and suppressed demand. These trends finally began to reverse at year-end 2017. In the fourth quarter, large tenants in the market took advantage of the glut of available sublease space that offered favorable rates. This uptick in leasing activity helped to reduce available sublease inventory to the single-digits for the first time in two years. Leasing activity has also improved in direct space, leading to positive quarterly absorption after nearly two years of contraction. The vacancy rate, which has consistently risen at an alarming rate since the downturn began, remained flat from the previous quarter.

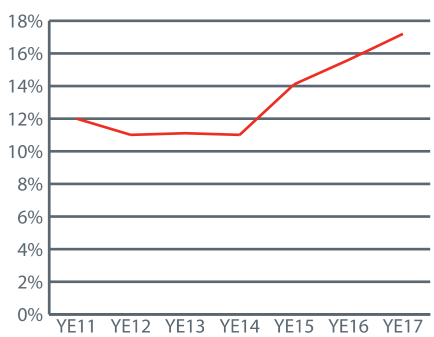
On the supply side, the construction pipeline is at its lowest level since 2013. Aside from small projects and occasional build-to-suits, the recent development cycle has all but ended. Although Houston's office market still has a long road towards achieving equilibrium, the recent gains provide a welcomed reversal in declining trends.

Despite difficulties related to a slowly recovering energy industry and a devastating hurricane, Houston managed to maintain a vibrant, diversified economy. The price of oil rose by 20% in the past year and reached the $60 per barrel mark in late 2017- the highest price since the downturn took hold. 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. Economic conditions in Houston are expected to continue improving throughout 2018.

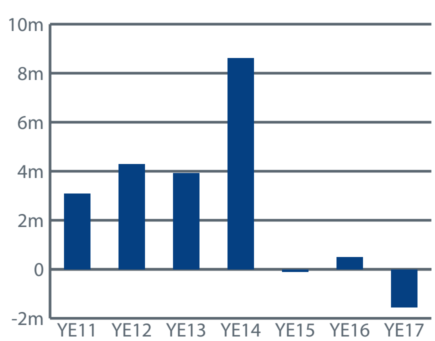
Asking Rates



Historical Vacancy Rate



Historical Net Absorption



Absorption & Demand

After six consecutive quarters of negative net absorption, the Houston office market broke its streak of contraction and posted 176,772 sf of positive absorption in the fourth quarter. A number of large deals, including Saudi Aramco's 340,000-sf lease, contributed to this quarter's positive absorption gains. Class A properties recorded 247,476 sf of positive absorption in the fourth quarter, while Class B and C properties posted negative absorption. The flight to quality continues, with tenants opting for smaller footprints in prime locations. 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.

Leasing activity has steadily improved in the last nine months. At the same time, the number of tenants shedding excess space abated significantly. Although the Houston office market still ended 2017 in the red in terms of absorption, continued improvements in leasing activity indicate that the office market is poised for expansion into the next year. Sublease inventory contracted into the single digits for the first time since 2015, totaling 8.8 msf at year-end 2017.

Vacancy & Availability

Overall vacancy remained unchanged from the previous quarter, registering 17.2% at year-end 2017. Although this still represents the highest rate to be recorded in the past decade, its upward trajectory has been halted by improving conditions. Houston's construction boom has come to an end with just 1.9 msf under construction, and an increasing number of tenants are in the market for available office space. Houston's vacancy rate likely peaked in the second half of 2017, and will begin falling in 2018. Space in Houston's office market has a tendency to quickly disappear in favorable conditions, and recent events provide good evidence that this could happen within the next few quarters. While conditions are improving, the 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 $0.10 psf from the previous quarter to $26.59 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

Houston is the nation's fourth-largest metropolitan area and a major engine of global economic activity. Investor interest has returned now that Houston has emerged from the energy downturn and is in full recovery mode. Although Hurricane Harvey caused concern, the historic storm did not dampen investor interest in Houston. Many large-scale deals are still in the works. Brookfield purchased Houston Center for $875 million, representing one of the largest transactions ever for Houston. The deal was announced after Harvey. Investor interest is projected to remain on the upswing through 2018.

Major 2017 Deliveries

609 Main
(1,000,00 sf) CBD

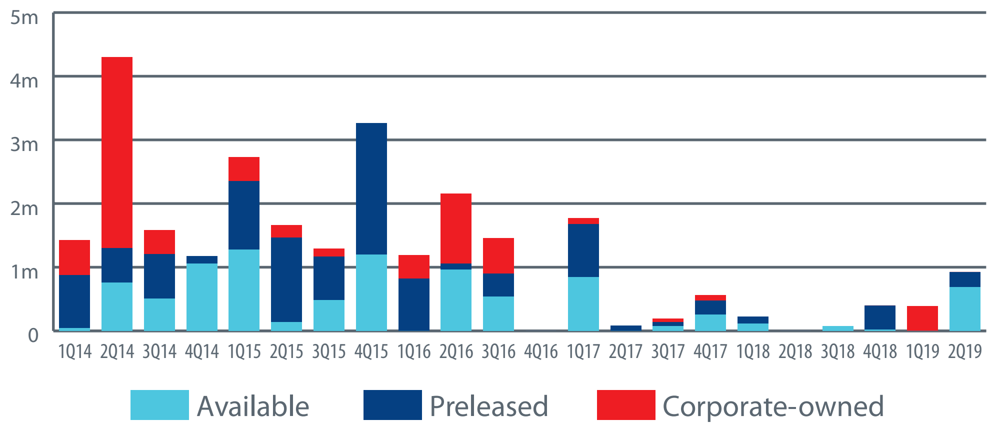
Amegy Bank Headquarters
(380,000 sf) West Loop

Memorial City
(238,173 sf) Katy Freeway East

Kirby Collection
(188,545 sf) Greenway Plaza

Lockton Place
(186,000 sf) Westchase

Construction Timeline



4Q17 Highlights

- Brookfield purchased the top-tier **Houston Center Complex** in Downtown for $875 million, representing one of the largest transactions ever for Houston.
- **WeWork**, which provides coworking space, opened its first Houston location at Galleria Tower I totaling 56,000 sf.
- **NRG Energy** signed the largest lease this year, subleasing 431,307 sf at **One Shell Plaza**. The energy company will take occupancy of the space in early 2018. A number of large sublease deals caused sublease inventory to fall to the single digits for the first time in since 2015.
- **Bank of America** will vacate 156,000 sf at Bank of America Tower in 2019 when it occupies 210,000 sf at the new Capital Tower, where the company has secured naming rights. The Bank of America Tower will undergo a $15 million renovation in early 2018.
- Saudi Aramco subleased 340,200 sf at **Two Allen Center** from Devon Energy and took occupancy of the space in the fourth quarter.

Trends to Watch

The price of oil rose above $60/bbl for the first time since the downturn took hold in 2015.

All economic sectors reported growth in the last 12 months except for Construction (-0.4%), Information (-3.3%), and Trade, Transportation & Utilities (-0.1%).

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

AVISON YOUNG

Intelligent
Real Estate
Solutions

avisonyoung.com

For more information, please contact:

Sandra Hill
713.993.7840
sandra.hill@avisonyoung.com