RifleCRE

HOUSTON
OFFICE MARKET
Q2 2024

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ANALYSIS AND TRENDS

The Houston office market continues to evolve in Q2 2024, presenting a complex landscape of challenges and opportunities for investors, tenants, and property owners. This comprehensive report delves into key metrics, emerging trends, and economic factors shaping the commercial real estate sector in one of America's largest metropolitan areas.

As we navigate through the intricacies of Houston's office market, we'll explore vacancy rates, absorption trends, leasing activity, rental rates, and new developments. Our analysis will provide valuable insights for stakeholders looking to make informed decisions in this dynamic environment.

MARKET OVERVIEW: A TALE OF CONTRASTS

The Houston office market in Q2 2024 presents a nuanced picture, characterized by both positive indicators and persistent challenges. On one hand, we've witnessed increased leasing activity and rising average asking rents, particularly in high-quality Class A properties. Conversely, overall vacancy rates continue to climb, reflecting the ongoing recalibration of office space demand in the post-pandemic era.

Key highlights of the quarter include:

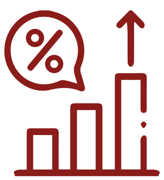
- A slight uptick in positive net absorption, reversing the negative trend observed in previous quarters.
- Continued divergence between top-tier and commodity office spaces in terms of demand and rental rates.
- Robust leasing activity, with several notable transactions in prime locations.
- Delivery of new office developments, albeit at a more measured pace compared to previous years.
- These contrasting trends underscore the importance of a granular approach when analyzing Houston's office market, as performance varies significantly across submarkets, property classes, and individual assets.

ECONOMIC CONTEXT: HOUSTON'S RESILIENT GROWTH

To fully appreciate the office market dynamics, it's crucial to examine the broader economic landscape. Houston's economy has demonstrated remarkable resilience, with several sectors contributing to job growth and overall economic stability.

Key economic indicators include:

- Strong labor market growth across multiple sectors
- Continued importance of the energy industry, with growth shifting towards mining-related services.
- Robust performance in education, health services, and leisure and hospitality sectors.
- Moderating inflation and positive real wage growth
- This economic backdrop provides a solid foundation for the office market, even as it grapples with the ongoing transformation of workplace strategies and space utilization patterns.



VACANCY RATES: A PERSISTENT CHALLENGE

The overall vacancy rate in Houston's office market reached 26.3% by the end of Q2 2024, representing a 120 basis point increase from the previous quarter. This figure underscores the ongoing challenges faced by property owners and investors in a market still adapting to evolving tenant preferences and work models.

Several factors contribute to the elevated vacancy rates:

Legacy of pre-pandemic construction: Some properties delivered just before or during the pandemic are still in the process of stabilizing.

Rightsizing by major tenants: Many companies continue to reassess their space needs, often resulting in reduced footprints.

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SUBMARKET DISPARITIES:

Vacancy rates vary widely across Houston's diverse submarkets, with some areas faring significantly better than others.

QUALITY DIVIDE:

Class A properties, particularly those with modern amenities and sustainability features, tend to outperform older, less desirable assets.

Despite these challenges, there are pockets of strength within the market. Notably, the Pearland/South and Northeast submarkets boast single-digit vacancy rates, highlighting the importance of location and property characteristics in driving performance.

ABSORPTION TRENDS: SIGNS OF IMPROVEMENT

Q2 2024 saw a positive net absorption of 402,024 square feet, marking a significant improvement from the negative absorption recorded in both the previous quarter and the same period last year. This uptick in absorption offers a glimmer of hope for the market, though it's important to contextualize this figure within the broader trend.

Key observations regarding absorption include:

- Class A properties continue to drive the majority of positive absorption, accounting for 73% of the total.
- Newer, high-quality assets with modern amenities and flexible layouts are proving more attractive to tenants.
- Some submarkets are experiencing stronger absorption than others, reflecting varying levels of demand across the city.
- The positive absorption, while encouraging, is still outpaced by new deliveries, contributing to the overall increase in vacancy rates.
- Notable move-ins during the quarter included OneSubsea's sublease of 99,501 square feet at Energy Center V and Up Excellence Academy's lease of 59,000 square feet at 330 N Sam Houston. These transactions highlight the ongoing demand for quality office space, particularly from education and energy-related sectors.

LEASING ACTIVITY: A BRIGHT SPOT IN THE MARKET

One of the most encouraging aspects of the Q2 2024 Houston office market report is the robust leasing activity. Quarterly leasing velocity, encompassing both new leases and renewals, reached 3 million square feet – a 17% increase from the previous quarter's 2.6 million square feet.

Several significant lease transactions contributed to this positive momentum:

Blue Cross Blue signed a lease for 136,800 square feet at West Belt Office Center I

Noble Corp. leased 110,250 square feet at CityWestPlace

Orion Group Holdings secured 47,416 square feet at East River One

These transactions not only bolster current market activity but also set the stage for future positive absorption as tenants move into their new spaces. The diversity of industries represented in these leases – from healthcare to energy to construction – speaks to the broad-based nature of office demand in Houston.

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KEY TRENDS IN RENTAL RATES INCLUDE:

Class A properties commanding premium rates, with an average of $35.35 per square foot

Class B space averaging $22.06 per square foot, reflecting more moderate demand

High-quality assets achieving near or at record-high rates

Commodity properties experiencing continued, albeit moderate, rental rate declines

This bifurcation in the market underscores the growing importance of property quality and amenities in attracting and retaining tenants. Landlords of older, less competitive assets may need to consider significant capital improvements or repositioning strategies to remain viable in an increasingly discerning market.

NEW DEVELOPMENTS: MEASURED GROWTH

The pace of new office development in Houston has moderated compared to previous years, reflecting a more cautious approach by developers and investors. In Q2 2024, new office deliveries totaled 521,323 square feet, slightly outpacing the quarter's positive absorption.

Notable new deliveries included:

1550 on the Green: A 386,323-square-foot office property in the Houston CBD, part of the Discovery West business park. The project is approximately 50% leased, with anchor tenants including Norton Rose Fulbright (117,454 sq ft) and Boston Consulting Group (53,007 sq ft).

Kelsey-Seybold Clinic: A 135,000-square-foot medical office property at 11555 University Blvd in Sugar Land.

The limited pipeline of new construction – with only one Class A project totaling 308,000 square feet (68.2% preleased) currently under development – suggests that supply and demand may begin to rebalance in the coming quarters, potentially supporting market fundamentals.

INVESTMENT SALES: CAUTIOUS ACTIVITY

The investment sales market for Houston office properties remains subdued, reflecting broader economic uncertainties and the challenges facing the sector. According to CoStar Capital Market Analytics, the cumulative 12-month sales volume for Q2 2024 stood at $206 million, representing 124 office properties sold at an average price of $74 per square foot and an average cap rate of 9.4%.

Notable transactions during the quarter included:

- The Wideman Company's purchase of 708 and 712 Main, a two-building complex totaling 889,186 square feet
- Goddard Investment Group's acquisition of Energy Center II, a 306,721-square-foot office property with major tenants including Baker Hughes, AES Drilling Fluids, and Equifax

These transactions highlight continued investor interest in well-located, quality assets with strong tenant rosters, even as overall investment volume remains constrained.

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SUBMARKET SPOTLIGHT: DIVERSE PERFORMANCE

Houston's office market is characterized by significant variation across its numerous submarkets. Understanding these differences is crucial for investors, tenants, and developers seeking to navigate the market effectively.

Key submarket trends include:

CBD/Downtown: Continues to attract high-profile tenants and command premium rents, benefiting from urban amenities and transit accessibility.

Galleria/Uptown: Remains a sought-after location, with properties like San Felipe Plaza attracting significant leasing interest.

The Woodlands: Demonstrates resilience, exemplified by Ovintiv's lease renewal for 168,600 square feet.

Greenspoint/North Belt: Faces challenges with the highest vacancy rate at 50.1%, highlighting the need for potential repositioning or redevelopment strategies.

Pearland/South: Boasts the lowest vacancy rate at 7.6%, benefiting from limited supply and growing suburban demand.

This diverse submarket performance underscores the importance of location-specific analysis when evaluating office market opportunities in Houston.

ENERGY SECTOR IMPACT: EVOLVING DYNAMICS

The energy industry continues to play a significant role in Houston's office market, though its impact is evolving. While production jobs have declined year-over-year, growth has been concentrated in mining-related services. This shift reflects the ongoing transformation of the energy sector and its real estate needs.

Key observations include:

- Consolidation among energy companies leading to additional sublease inventory
- Continued demand for high-quality space from energy firms, as evidenced by recent leasing activity
- Growing focus on sustainability and energy efficiency in office properties, driven in part by the sector's evolving priorities
- As the energy industry continues to adapt to global market forces and technological advancements, its influence on Houston's office market is likely to remain significant, albeit in evolving ways.

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LOOKING AHEAD: OPPORTUNITIES AND CHALLENGES

As we look towards the future of Houston's office market, several key themes emerge:

- Flight to quality: The divergence between top-tier and commodity office spaces is likely to persist, driving investment in property upgrades and amenities.
- Flexible workspace solutions: The growing demand for adaptable office configurations and short-term leasing options may reshape traditional leasing models.
- Sustainability focus: Increasing emphasis on environmental performance and wellness features in office properties, driven by both tenant preferences and regulatory pressures.
- Submarket opportunities: Continued outperformance of certain submarkets may drive targeted investment and development activity.
- Adaptive reuse potential: Some underperforming office assets may present opportunities for conversion to alternative uses, such as residential or mixed-use developments.
- Technology integration: Growing importance of smart building technologies and digital infrastructure in attracting and retaining tenants.

While challenges persist, Houston's diverse economy, strategic location, and ongoing population growth provide a solid foundation for long-term optimism in the office market. Stakeholders who can navigate the current complexities and position themselves for future trends stand to benefit as the market continues to evolve.

CONCLUSION

In conclusion, the Houston office market in Q2 2024 presents a nuanced picture of resilience amidst ongoing challenges. With positive signs in leasing activity and absorption, alongside persistent high vacancy rates and rental rate disparities, the market demands a sophisticated, data-driven approach from all participants. As Houston continues to adapt to changing workplace dynamics and economic shifts, opportunities abound for those equipped with deep market knowledge and strategic foresight.

CONTACT FOR MORE INFORMATION

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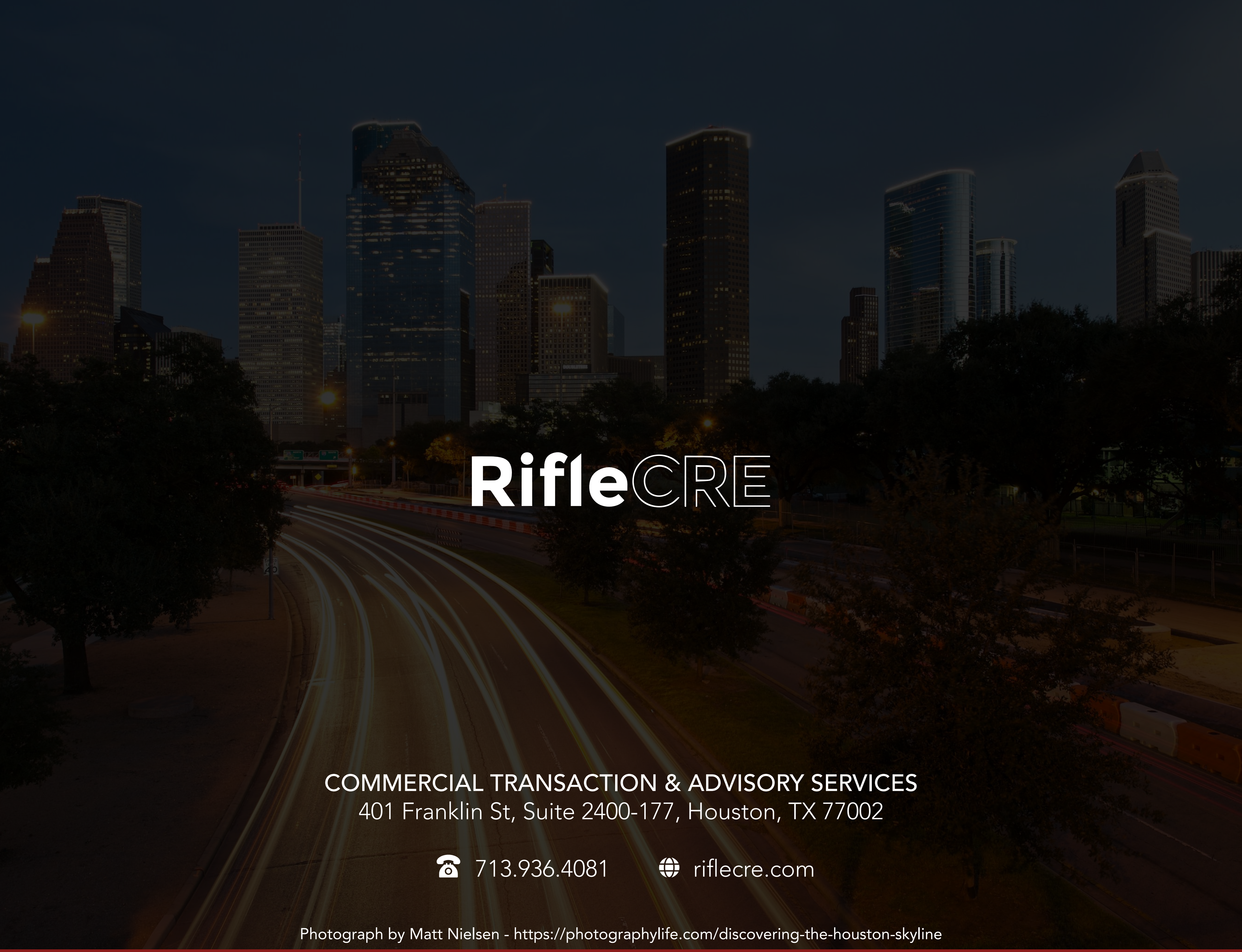

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