RifleCRE

HOUSTON
OFFICE MARKET
Q1 2024

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MARKET OVERVIEW AND KEY INDICATORS

The Houston office market experienced a mix of challenges and opportunities in the first quarter of 2024. Several key indicators paint a nuanced picture of the current state of affairs:

TRENDS AND INSIGHTS

The Houston office real estate landscape continues to evolve in the first quarter of 2024, presenting both challenges and opportunities for stakeholders. This comprehensive analysis delves into key market indicators, leasing activity, investment trends, and economic factors shaping the Bayou City's commercial property sector.

As we navigate through the intricacies of Houston's office market, we'll explore how shifting workplace dynamics, economic uncertainties, and industry-specific trends are influencing demand, vacancy rates, and rental prices across various submarkets. Our in-depth examination aims to provide valuable insights for investors, tenants, and industry professionals seeking to make informed decisions in this dynamic environment.

From the bustling Energy Corridor to the prestigious Galleria area, we'll uncover the nuances of each submarket, highlighting notable transactions, emerging patterns, and future projections. Join us as we dissect the data, analyze market forces, and paint a vivid picture of Houston's office real estate landscape in early 2024.

VACANCY RATES AND ABSORPTION

The overall vacancy rate in Houston's office market climbed to 25.1% by the end of Q1 2024, representing an 80 basis point increase year-over-year. This uptick reflects ongoing adjustments in space utilization and a continued focus on workplace optimization among tenants.

Net absorption dipped into negative territory, registering at -552,926 square feet for the quarter. This reversal from the previous quarter's positive absorption underscores the fluid nature of occupancy trends in the current market climate. Class B properties bore the brunt of this shift, accounting for a significant portion of the negative net absorption.

LEASING ACTIVITY AND VELOCITY

Despite the challenging absorption figures, leasing activity showed signs of resilience. Quarterly leasing velocity, encompassing both new leases and renewals, reached 2.6 million square feet. While this represents a modest 3.5% increase over the previous quarter, it remains below historical averages, indicating a cautious approach among tenants.

Notable lease transactions in early 2024 included Kraken's 48,040-square-foot commitment at 945 Bunker Hill and Enstor Gas's 43,598-square-foot sublease deal at CityWestPlace. These deals, along with others, highlight the continued demand for quality office space in strategic locations.

SUBMARKET ANALYSIS AND PERFORMANCE

Houston's diverse office submarkets exhibited varying degrees of performance in Q1 2024, each influenced by unique local factors and broader market trends:

CONSTRUCTION AND DELIVERIES

The construction pipeline experienced a significant contraction, with only a single 27,000-square-foot medical office building completed in the Northwest submarket during Q1 2024. This marks a stark departure from previous quarters and reflects a 55% year-over-year decline in construction activity.

The dwindling pipeline suggests a potential tightening of supply in the coming quarters, particularly for newer, high-quality office spaces. This trend could have implications for rental rates and tenant options in the medium term.

RENTAL RATES AND PRICING TRENDS

Average asking rates showed mixed performance across property classes. Class A properties reached a new record high, while Class B rates experienced a moderate decrease. The overall full-service average stood at $30.22 per square foot, representing a 1.2% increase from the first quarter of 2023.

The Central Business District (CBD) maintained its position as the premium submarket, commanding an average asking rate of $39.16 per square foot – nearly 30% above the overall market rate. This pricing resilience in prime locations underscores the enduring appeal of high-quality, well-located office assets.

WEST HOUSTON'S CONTINUED DOMINANCE

The West Houston submarket emerged as a standout performer, dominating the leasing scene in early 2024. This surge was driven by a combination of factors:

Early lease renewals by existing tenants

A pronounced western migration trend, particularly among energy sector companies. The completion of Town Centre Two, which added 167,141 square feet of prime office space to the submarket's inventory. Notable transactions in West Houston included Dow Chemical's commitment to 210,000 square feet at 903 Town and Country Lane, underscoring the area's appeal to major corporate tenants.

CENTRAL BUSINESS DISTRICT (CBD) RESILIENCE

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CENTRAL BUSINESS DISTRICT (CBD) RESILIENCE

Despite challenges, Houston's CBD demonstrated resilience in Q1 2024:

The submarket recorded positive net absorption of 55,747 square feet.

Class A properties in the CBD outperformed, with 132,489 square feet of positive absorption.

High-profile leases, such as Venture Global's 58,200-square-foot commitment at 1401 McKinney Street, reinforced the CBD's status as a prime business hub.

However, Class B properties in the CBD faced headwinds, experiencing negative absorption of 76,742 square feet. This divergence highlights the growing preference for premium office spaces in central locations.

EMERGING SUBMARKETS AND NICHE OPPORTUNITIES

Several submarkets showed promising signs of growth and specialization:
The NASA/Clear Lake area witnessed positive absorption of 23,209 square feet, driven by the expanding aerospace and technology sectors.
Sugar Land/Fort Bend County attracted significant interest, with Frazer leasing 150,000 square feet at 1410 Gillingham Lane
The FM 1960 corridor saw increased activity, including SynergenX Health's 54,200-square-foot lease at 11445 Compaq Center West Drive. These trends underscore the importance of niche markets and industry clusters in driving localized demand for office space.

TENANT TRENDS AND SPACE UTILIZATION

The first quarter of 2024 saw evolving tenant preferences and space utilization strategies across Houston's office market:

Rightsizing and Optimization

Many tenants continued to reassess their space needs, leading to:
Reduced footprints in some cases, as companies embraced hybrid work models
Strategic relocations to higher-quality buildings with enhanced amenities
Increased focus on flexible workspace solutions and shared facilities
This trend was particularly evident in the energy sector, where companies like Noble Drilling opted for more efficient layouts in their new 110,200-square-foot lease at 2101 CityWest Boulevard.

EMPHASIS ON EMPLOYEE EXPERIENCE

Tenants placed a premium on office environments that enhance the employee experience: Demand surged for properties with state-of-the-art wellness features, outdoor spaces, and collaborative areas. Buildings with advanced technology infrastructure and sustainability credentials garnered increased interest. Proximity to amenities, such as dining options and fitness centers, became a key consideration in location decisions

INDUSTRY-SPECIFIC TRENDS

Different sectors exhibited unique space utilization patterns:

Technology firms favored open, flexible layouts that facilitate collaboration and innovation.

Healthcare and life sciences companies sought specialized spaces with laboratory capabilities and advanced research facilities.

Professional services firms balanced the need for private offices with collaborative spaces for team meetings and client interactions.

INVESTMENT SALES AND CAPITAL MARKETS

The investment landscape in Houston's office market showed signs of recalibration in Q1 2024:

Transaction Volume and Pricing

Overall transaction activity moderated compared to previous quarters:

The cumulative 12-month sales volume stood at $186 million, reflecting a sharp decline from historical levels

122 deals were completed over the past year, with an average transaction price of $69 per square foot

The average cap rate for office transactions was 9.2%, indicating investor caution and adjusted risk perceptions

Notable sales included Granite Properties' divestment of The Tower at 290, a 245,846-square-foot office building, for $11.8 million or $48 per square foot. The property's 62% occupancy rate at the time of sale underscores the challenges faced by some assets in the current market.

INVESTOR SENTIMENT AND STRATEGY

Investors adopted a more selective approach in early 2024:

Value-add opportunities garnered increased attention, with buyers seeking assets ripe for repositioning or redevelopment.

Core assets in prime locations continued to attract interest, albeit with adjusted pricing expectations.
Some investors explored alternative strategies, such as conversions to residential or mixed-use properties.
The acquisition of 777 Post Oak Boulevard by Landry's/Tillman Fertitta exemplifies the ongoing appeal of well-located Class A assets, even in a challenging market environment.

Capital Sources and Financing Trends

The composition of active investors evolved in response to market conditions:

Institutional funds and banks emerged as potential sources of capital for discounted assets.

Private equity firms remained selective, focusing on properties with strong fundamentals and value-creation potential

Local and regional investors leveraged their market knowledge to identify off-market opportunities

Financing conditions remained challenging, with high interest rates and tightened lending criteria impacting deal structures and valuations.

ECONOMIC DRIVERS AND MARKET FUNDAMENTALS

Houston's office market performance in Q1 2024 was influenced by broader economic factors and local market dynamics:

EMPLOYMENT AND JOB GROWTH

The Houston metropolitan area demonstrated resilience in its labor market:

The unemployment rate held steady at 4.4% as of December 2023

Employment grew by 0.8% (annualized) from September through December 2023, adding 6,517 net new jobs

Education and health services led growth, expanding by 6.7% and offsetting declines in other sectors

However, the energy sector's employment levels remained below pre-pandemic figures, impacting demand for office space in certain submarkets.

POPULATION GROWTH AND MIGRATION TRENDS

Houston continued to attract new residents, supporting long-term demand for commercial real estate:

The metro area added nearly 140,000 residents in 2023, ranking second among U.S. metros in population growth

In-migration contributed to a 3.8% increase in the labor force since April 2022, outpacing national averages

The influx of new residents and businesses bolstered demand for housing, retail, and office space in growing submarkets

ENERGY SECTOR DYNAMICS

As a key driver of Houston's economy, the energy industry played a crucial role in shaping office market trends:

The U.S. oil (WTI) spot price stood at $86.91 per barrel, influencing decision-making among energy companies

While some firms continued to optimize their real estate footprints, others expanded or relocated to newer, more efficient spaces

The ongoing energy transition spurred demand for office space among renewable energy and cleantech companies

CHALLENGES AND OPPORTUNITIES

The Houston office market faced a mix of headwinds and tailwinds in Q1 2024, presenting both challenges and opportunities for stakeholders:

Challenges

Elevated vacancy rates and negative absorption in some submarkets

Ongoing adjustments to hybrid work models and evolving space requirements

Capital markets correction impacting property valuations and investment activity

Competition from newer, amenity-rich buildings putting pressure on older assets

Opportunities

Increasing demand for high-quality, well-located office spaces

Growing interest in adaptive reuse and property repositioning

Emerging submarkets and niche opportunities in specialized sectors

Potential for attractive acquisitions as some owners face refinancing challenges

FUTURE OUTLOOK AND PROJECTIONS

As we look ahead to the remainder of 2024 and beyond, several key trends are likely to shape Houston's office market:

SHORT-TERM PROJECTIONS

Vacancy rates are expected to stabilize as the construction pipeline dwindles and leasing activity gradually improves.

Rental rates for Class A properties may see modest growth, while Class B assets could face continued pressure.

Flight-to-quality trends are likely to persist, benefiting newer and recently renovated buildings.

MEDIUM-TERM OUTLOOK

The office market may experience a bifurcation, with high-quality assets outperforming older, less desirable properties.

Adaptive reuse and conversions could accelerate, particularly for outdated office buildings in prime locations.

Sustainability and wellness features will become increasingly important factors in tenant decision-making.

LONG-TERM CONSIDERATIONS

Houston's diverse economy and population growth are expected to support long-term demand for office space

The evolution of work practices may lead to new office designs and space utilization strategies

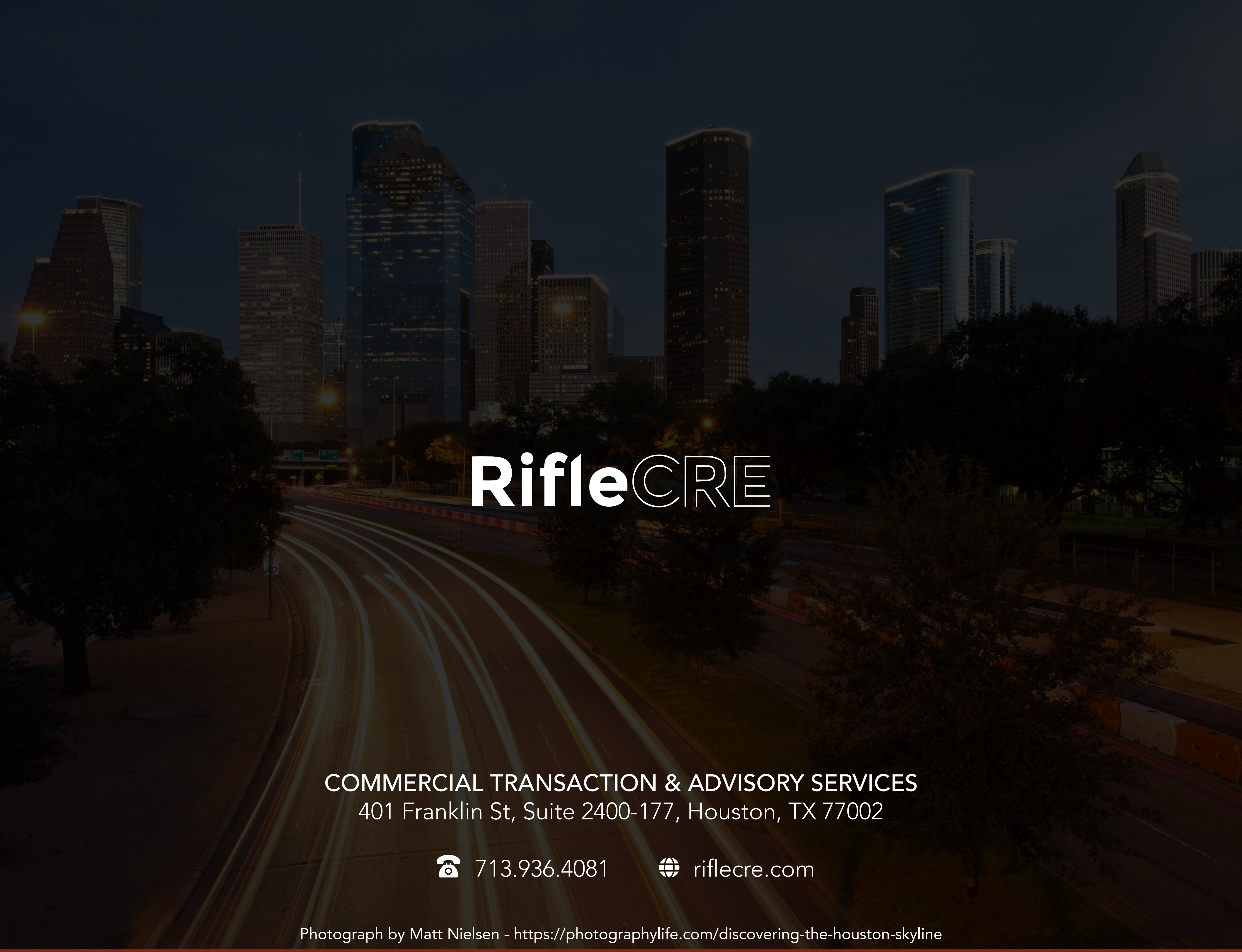
Continued investment in infrastructure and urban development could reshape the city's office landscape

CONCLUSION

The Houston office market in Q1 2024 presents a complex picture of challenges and opportunities. While overall vacancy rates and absorption figures indicate ongoing adjustments, pockets of strength emerge in select submarkets and property types. The flight to quality, emphasis on employee experience, and evolving work practices continue to shape tenant preferences and investment decisions.

As the market navigates economic uncertainties and changing workplace dynamics, stakeholders must remain agile and forward-thinking. The coming quarters will likely bring further evolution in office space utilization, design, and valuation. Those who can adapt to these changes and capitalize on emerging opportunities will be well-positioned to thrive in Houston's dynamic commercial real estate landscape.

By staying informed about market trends, economic drivers, and shifting tenant preferences, industry professionals can make strategic decisions that align with the evolving needs of Houston's diverse business community. As the city continues to grow and transform, its office market will undoubtedly play a crucial role in shaping the future of work and urban development in the region.



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