

HOUSTON OFFICE MARKET

— Q3 2024 —

A COMPREHENSIVE ANALYSIS

The Houston office market has experienced a notable shift in the third quarter of 2024, marking a significant turnaround from previous trends. This comprehensive report delves into the intricacies of the market's performance, exploring key metrics, emerging patterns, and future projections. As we navigate through the complexities of the commercial real estate landscape in Houston, we'll uncover valuable insights for investors, property managers, and industry stakeholders alike.

MARKET ABSORPTION TRENDS



The Houston office market has demonstrated a remarkable recovery in the third quarter of 2024, with positive net absorption figures painting an optimistic picture for the sector. This upward trajectory signifies a potential turning point in the market's performance, warranting a closer examination of the underlying factors driving this change.

Q3 2024 ABSORPTION METRICS



In the third quarter of 2024, Houston's office market recorded an impressive positive net absorption of 431,967 square feet. This figure represents a substantial improvement compared to the same period in the previous year, which saw a negative absorption of 705,439 square feet. The stark contrast between these two data points highlights the dynamic nature of the market and suggests a shift in occupancy patterns.

YEAR-TO-DATE PERFORMANCE



Analyzing the year-to-date performance provides a more comprehensive view of the market's trajectory. The first quarter of 2024 started on a challenging note, with a negative absorption of 705,070 square feet. However, the market began to show signs of recovery in the second quarter, posting a positive absorption of 531,197 square feet. This upward momentum continued into the third quarter, bringing the year-to-date net absorption to a positive 258,094 square feet.

HISTORICAL CONTEXT AND PATTERNS

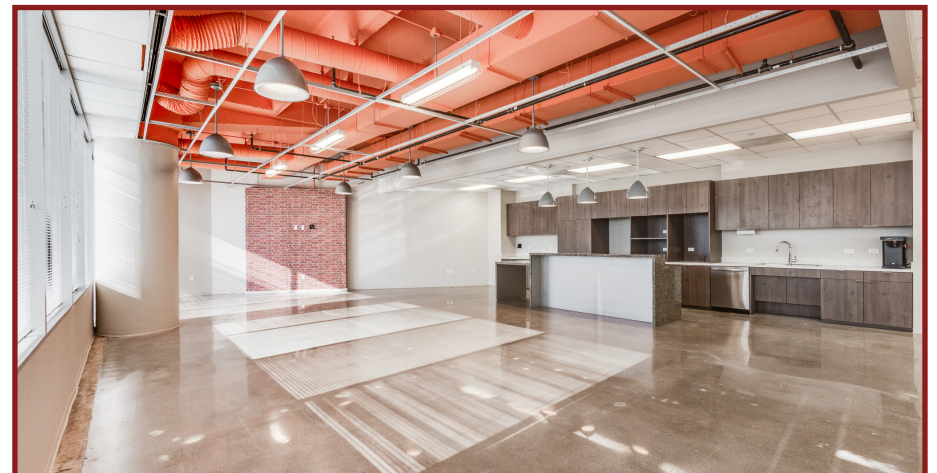


To fully appreciate the significance of the current market conditions, it's essential to consider the historical context. Over the past decade, Houston has experienced fluctuating absorption patterns, with this cyclical nature being observed in three out of the last five years and five out of the last ten. This recurring pattern underscores the importance of long-term analysis in understanding market dynamics.

LONG-TERM ABSORPTION AVERAGE



Since 2014, the Houston office market has faced challenges, with an average negative net absorption of 43,836 square feet per quarter. This prolonged period of negative absorption has had a substantial impact on the availability of office space in the city, contributing to a significant increase in vacant and soon-to-be-vacant properties.



AVAILABILITY RATES AND MARKET SATURATION

The availability rate, which encompasses vacant, soon-to-be vacant, and sublease space, has seen a notable increase over the past decade. This metric provides crucial insights into the overall health of the office market and the balance between supply and demand.

CURRENT AVAILABILITY RATE



As of the third quarter of 2024, the availability rate in the Houston office market stands at 26.0%. This figure represents a considerable increase from the 17.9% recorded in the third quarter of 2014, illustrating the cumulative effect of years of negative absorption on the market.

HISTORICAL PROGRESSION



The progression of the availability rate over the past decade tells a story of gradual market saturation. The consistent negative absorption has resulted in a steady increase in available office space, creating challenges for property owners and opportunities for tenants seeking favorable lease terms.

BREAKDOWN BY PROPERTY CLASS



To gain a more nuanced understanding of the market, it's crucial to examine the availability of office space across different property classes:

- Class A: 43.0 million square feet
- Class B: 23.0 million square feet
- Class C: 1.7 million square feet

This breakdown reveals that Class A properties account for the largest share of available space, followed by Class B, with Class C representing a relatively small portion of the market.

IMPLICATIONS FOR MARKET RECOVERY



The current availability of space, combined with the number of expiring leases and historical absorption levels, suggests that the office market may face ongoing challenges in reducing vacancy rates to healthier levels. The road to market equilibrium appears to be a long-term endeavor, requiring sustained positive absorption and new demand drivers to counteract the existing oversupply.

VACANCY RATES AND MARKET HEALTH



Vacancy rates serve as a key indicator of market health, reflecting the balance between supply and demand in the office sector. The Houston market has experienced significant fluctuations in vacancy rates over the past decade, with recent trends showing signs of stabilization.

CURRENT VACANCY RATE



As of the third quarter of 2024, the vacancy rate in the Houston office market stands at 26.0%. This figure represents a slight improvement from the peak of 28.0% recorded in the fourth quarter of 2022, indicating a gradual but positive shift in market conditions.

HISTORICAL VACANCY TRENDS



Since the third quarter of 2014, vacancy rates in Houston have followed an upward trajectory, reflecting the challenges faced by the office market. The steady increase in vacancies over this period has been driven by a combination of factors, including oversupply, changing work patterns, and economic fluctuations.

RENTAL RATES AND MARKET PRICING

The prolonged period of negative net absorption has had a notable impact on rental rates in the Houston office market. Understanding the trends in pricing provides valuable insights into market dynamics and the balance of power between landlords and tenants.

COMPARISON TO PRE-2015 LEVELS



To put the current vacancy rate in perspective, it's worth noting that prior to 2015, the Houston office market enjoyed vacancy rates below 20%. The significant gap between current and historical levels underscores the magnitude of the market's transformation over the past decade.

CHALLENGES IN REDUCING VACANCIES



Given the current market dynamics, bringing vacancy rates down to more balanced levels presents a considerable challenge. Without substantial positive absorption and the emergence of new demand drivers, the office market may continue to struggle with high vacancy rates in the near to medium term.

HISTORICAL RENT RANGE



Over the past decade, gross asking rents in Houston have remained relatively stable, fluctuating within a narrow range of \$27.96 to \$30.50 per square foot since 2014. This stability in nominal terms, however, masks a different story when adjusted for inflation.

INFLATION-ADJUSTED RENT TRENDS



When accounting for inflation, the real value of gross rents in the Houston office market has actually decreased over time. This decline in inflation-adjusted rents reflects the challenges faced by landlords in a market characterized by high availability and vacancy rates.

FACTORS INFLUENCING RENT LEVELS

The inability of landlords to raise rents significantly can be attributed to several factors:

1. Oversupply of office space
2. Competitive market conditions
3. Changing tenant preferences and space requirements
4. Economic uncertainties and fluctuations

These elements have combined to create a tenant-favorable market, limiting the pricing power of property owners.

CURRENT CONSTRUCTION PIPELINE

As of the third quarter of 2024, the Houston office market has 1.8 million square feet of space under construction. This figure represents a mere 0.7% of the city's total office inventory, which stands at an impressive 258.9 million square feet.



HISTORICAL CONTEXT

The current level of construction activity marks a notable decrease from previous years. In fact, the volume of space under development is less than half of the 10-year average of 4.6 million square feet. This reduction in new supply reflects the market's response to the existing oversupply and challenges in rent growth.

CONSTRUCTION ACTIVITY AND NEW SUPPLY



The construction pipeline in Houston's office market has undergone significant changes in recent years, reflecting the evolving dynamics of supply and demand. Understanding the trends in new development provides crucial insights into future market conditions and potential shifts in the balance of available space.

RECENT DELIVERY TRENDS



- 2022: 1.2 million square feet (lowest since 2012)
- 2023: 3.0 million square feet
- 2024 (through Q3): 1.1 million square feet

These figures illustrate the gradual slowdown in new office deliveries, with 2022 marking a particularly low point in recent history.

COMPOSITION OF CURRENT PROJECTS



Interestingly, medical office projects account for approximately 48% of the office space currently under construction in Houston. This trend highlights the growing importance of healthcare-related developments in the commercial real estate landscape.

PRE-LEASING ACTIVITY



A notable characteristic of the current construction pipeline is the high level of pre-leasing activity. As of the third quarter of 2024, about 88% of the new office space under development was already pre-leased. This significant pre-commitment helps to mitigate the impact of new supply on the overall market vacancy rates.

IMPACT OF WORK-FROM-HOME TRENDS



The shift towards remote and hybrid work models continues to exert a significant influence on the Houston office market. Understanding these evolving workplace dynamics is crucial for anticipating future demand patterns and market trends.

CURRENT OFFICE OCCUPANCY LEVELS



According to the Kastle Systems Back-to-Work Barometer, which tracks employee return to offices based on entry card usage, the average office occupancy in Houston stood at approximately 60% at the end of the third quarter of 2024.

REGIONAL COMPARISONS



Houston's office occupancy levels are comparable to those observed in other major Texas metros, such as Austin and Dallas. However, many other metropolitan areas across the United States have experienced significantly lower return-to-office rates, highlighting the relative resilience of the Texas markets.

IMPLICATIONS FOR LEASE RENEWALS

The ongoing prevalence of remote and hybrid work arrangements has notable implications for lease renewals:

1. Tenants are reassessing their space requirements, often opting to reduce their footprint.
2. There's an increased focus on quality over quantity, with many companies relocating to newer buildings or those offering superior amenities.
3. Flexibility has become a key consideration in lease negotiations, with tenants seeking terms that accommodate potential changes in their workforce strategies.

MARKET SEGMENTATION AND PROPERTY CLASSES

The Houston office market exhibits distinct characteristics across different property classes, each facing unique challenges and opportunities. A detailed examination of these segments provides valuable insights into the nuanced dynamics of the market.

CLASS A PROPERTIES

Class A office spaces, typically representing the highest quality and most prestigious buildings in prime locations, have shown resilience in the face of market challenges:

- Total available space: 43.0 million square feet
- Key features: State-of-the-art amenities, prime locations, professional management
- Tenant profile: Often attracts large corporations and high-profile firms
- Market performance: Generally maintaining higher occupancy rates compared to other classes

Despite the overall market downturn, Class A properties continue to attract tenants seeking premium office environments, albeit with increased negotiating power on lease terms.

CLASS B PROPERTIES

Class B office buildings, which offer good quality space at more moderate rental rates, face a mixed market scenario:

- Total available space: 23.0 million square feet
- Characteristics: Good-quality finishes, adequate systems, average rental rates
- Tenant base: Mix of medium-sized businesses and cost-conscious larger firms
- Market challenges: Competing with both higher-end Class A spaces offering competitive rates and more affordable Class C options

The Class B segment has experienced significant pressure, with some properties undergoing renovations to compete more effectively with Class A offerings.

DIFFERENTIAL IMPACT ON BUILDING TYPES



The work-from-home trend has not affected all office properties equally. As of the third quarter of 2024:

- Newer buildings (completed in the past 15 years) had an average vacancy rate of 15.0%
- Older, vintage buildings (completed before 2009) faced a much higher average vacancy rate of 27.0%

This disparity underscores the growing preference for modern, well-equipped office spaces that can better accommodate evolving workplace needs.

CLASS C PROPERTIES

Class C office spaces, typically older buildings in less desirable locations, face the most significant challenges in the current market:

- Total available space: 1.7 million square feet
- Features: Functional space, often in need of upgrades, lower rental rates
- Typical tenants: Small businesses, startups, and price-sensitive organizations
- Market position: Struggling with high vacancy rates and competition from higher-class properties offering competitive rates

Some Class C properties are exploring redevelopment opportunities or conversions to alternative uses to remain viable in the challenging market environment.

SUBMARKET ANALYSIS AND GEOGRAPHIC TRENDS

The Houston office market exhibits significant variations across its diverse submarkets, each influenced by unique local factors and industry concentrations. Understanding these geographic trends is crucial for investors, tenants, and developers looking to make informed decisions in the market.

IMPLICATIONS FOR INVESTORS AND TENANTS



The segmentation of the market across property classes presents both challenges and opportunities:

1. Investors may find value-add opportunities in well-located Class B properties ripe for upgrades.
2. Tenants have increased leverage in negotiations, particularly in the Class B and C segments.
3. Property owners across all classes are focusing on amenity enhancements and flexible space solutions to attract and retain tenants.
4. The flight to quality trend benefits Class A properties, potentially at the expense of lower-tier buildings.

ENERGY CORRIDOR

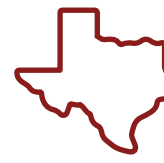


This submarket, historically dominated by energy sector tenants, has faced significant headwinds:

- Vacancy rate: Around 30% in Q3 2024
- Industry impact: Fluctuations in the energy sector continue to influence demand
- Adaptation strategies: Efforts to diversify tenant base and repurpose spaces for emerging industries

The Energy Corridor is gradually evolving, with some properties exploring conversions to life sciences or mixed-use developments.

DOWNTOWN HOUSTON



The central business district continues to be a focal point of the Houston office market:

- Vacancy rate: Approximately 24% in Q3 2024
- Key trends: Increasing demand for mixed-use developments and live-work-play environments
- Notable developments: Ongoing revitalization projects aimed at enhancing urban amenities

Despite challenges, downtown Houston remains attractive for companies seeking prestige and access to a diverse talent pool.



FUTURE OUTLOOK AND MARKET PROJECTIONS

As we look ahead to the future of the Houston office market, several key factors and trends are likely to shape its trajectory in the coming years. While challenges persist, there are also opportunities for growth and adaptation in this dynamic market.

GALLERIA / UPTOWN



Known for its high-end retail and office spaces, this submarket has shown resilience:

- Vacancy rate: Approximately 22% in Q3 2024
- Strengths: Prime location, diverse amenities, and strong transportation links
- Tenant mix: Attracting a blend of financial services, tech, and professional services firms

The Galleria/Uptown area continues to be a preferred location for companies seeking a prestigious address and access to upscale amenities.

THE WOODLANDS



This master-planned community north of Houston has maintained a relatively strong position:

- Vacancy rate: Around 18% in Q3 2024
- Advantages: High-quality living environment, good schools, and growing corporate presence
- Key sectors: Healthcare, technology, and energy companies continue to drive demand

The Woodlands' integrated approach to development has helped it weather market challenges more effectively than some other submarkets.

WEST HOUSTON



This diverse submarket encompasses a range of office environments:

- Vacancy rate: Approximately 26% in Q3 2024
- Characteristics: Mix of campus-style developments and traditional office buildings
- Emerging trends: Growing interest in flex spaces and collaborative work environments

West Houston is seeing increased activity in adaptive reuse projects, transforming older properties to meet evolving tenant needs.



FUTURE OUTLOOK AND MARKET PROJECTIONS

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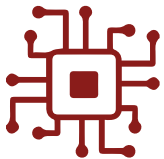
IMPLICATIONS FOR MARKET STAKEHOLDERS



The varied performance across Houston's submarkets offers important insights:

1. Location remains a critical factor, with well-positioned submarkets showing greater resilience.
2. Diversification of tenant base is key to long-term stability, particularly in areas historically dominated by single industries.
3. Amenity-rich, mixed-use environments are increasingly favored across all submarkets.
4. Opportunities exist for strategic investments in underperforming areas with strong fundamentals and potential for revitalization.

SHORT-TERM PROJECTIONS (1-2 YEARS)



In the immediate future, the Houston office market is expected to continue its gradual recovery:

- Absorption trends: Likely to remain positive but modest, with potential fluctuations quarter to quarter
- Vacancy rates: Slow but steady decrease, potentially reaching 24-25% by the end of 2025
- Rental rates: Stable to slight increases, particularly for high-quality, well-located properties
- New construction: Continued restraint, with most new developments focused on build-to-suit or significantly pre-leased projects

The market is anticipated to favor tenants in the short term, with landlords offering competitive terms and amenities to attract and retain occupants.

MEDIUM-TERM OUTLOOK (3-5 YEARS)



Looking further ahead, several factors could influence the market's direction:

- Economic diversification: Efforts to attract non-energy sectors could lead to new sources of office demand
- Workplace evolution: Continued refinement of hybrid work models may stabilize office space requirements
- Redevelopment opportunities: Increased focus on repositioning older assets to meet modern tenant preferences
- Sustainability focus: Growing emphasis on green buildings and energy efficiency as differentiating factors

The medium-term outlook suggests a potential return to more balanced market conditions, albeit with a transformed landscape of tenant expectations and property offerings.

LONG-TERM CONSIDERATIONS (5+ YEARS)



In the long term, structural changes in the office market and broader economic trends will play a significant role:

- Technology integration: Increased adoption of smart building technologies and IoT solutions
- Demographic shifts: Changing workforce demographics influencing location preferences and amenity demands
- Urban development patterns: Potential for increased mixed-use developments and transit-oriented projects
- Climate resilience: Growing importance of properties designed to withstand extreme weather events



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