RifleCRE

HOUSTON
OFFICE MARKET
Q4 2024

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A COMPREHENSIVE ANALYSIS

The final quarter of 2024 brought significant developments to Houston's office real estate landscape, reflecting broader economic trends and shifting workplace paradigms. This comprehensive analysis delves into key metrics, emerging patterns, and future projections for one of America's most dynamic metropolitan markets. While certain indicators pointed to ongoing challenges, others suggested potential for future growth.

MARKET ABSORPTION TRENDS

Q4 2024 witnessed a notable shift in absorption patterns. The market experienced a negative net absorption of 295,350 square feet, marking a stark contrast to the previous year's positive figures. This reversal underscores the persistent volatility in demand for office space.

Factors contributing to downturn:

- Continued adoption of remote and hybrid work models
- Corporate downsizing and space optimization efforts
- Cautious approach to long-term leasing commitments

EVALUATION WITH ANNUAL METRICS

Despite the quarterly decline, it's crucial to view this within the context of annual performance. The full year of 2024 saw a cumulative negative net absorption of 277,537 square feet, indicating that Q4's dip was part of a broader trend rather than an isolated incident.

AVAILABILITY AND VACANCY RATES

The availability rate, encompassing vacant, soon-to-be-vacant, and sublease spaces, stood at 25.7% in Q4 2024. While this represents a slight improvement from the peak of 28.2% observed in Q4 2022, it remains significantly higher than the 19.1% recorded a decade ago.

Breaking down the available office space by class:

- Class A: 41.4 million square feet
- Class B: 23.4 million square feet
- Class C: 1.7 million square feet

The vacancy rate, a key indicator of market health, hovered around 24.9% throughout 2024. This stability, while not ideal, suggests a potential plateau in the market's downward trajectory.

RENTAL RATES AND PRICING DYNAMICS

Gross asking rents in Q4 2024 averaged $29.92 per square foot. This figure has remained relatively consistent over the past decade, fluctuating between $27.96 and $30.50. However, when adjusted for inflation, this represents a decrease in real terms.

The stagnation in rental rates can be attributed to:

- Oversupply of available space
- Competitive pressures among landlords
- Tenants' increased bargaining power

It's worth noting that newer, high-quality buildings continue to command premium rates, highlighting the growing disparity between Class A and older office stock.

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.

CONSTRUCTION AND DEVELOPMENT LANDSCAPE

The construction sector in Houston's office market has undergone significant changes in response to prevailing conditions. Let's examine the current state of development and its implications for the future.

CURRENT PIPELINE

As of Q4 2024, approximately 1.9 million square feet of office space was under construction. This figure represents just 0.7% of Houston's total inventory, which stands at an impressive 257.1 million square feet.

Key points about ongoing construction:

- Medical office projects account for over half (51%)
- of the current pipeline
- The average preleasing rate for projects under
- construction is 81%
- New developments are primarily focused on
- specialized or high-end offerings

The reduced construction activity reflects developers' cautious approach in light of market uncertainties and abundant existing inventory.

HISTORICAL CONTEXT

To fully appreciate the current construction landscape, it's essential to consider recent historical trends:

- 2022 saw the lowest amount of new space (1.2 million sq. ft.) delivered in the past decade
- 2023 experienced a slight uptick with 3.0 million square feet of new space
- 2024 deliveries totaled 1.3 million square feet

This data illustrates a clear downward trend in new office development, as the market grapples with absorbing existing inventory and adapting to changing demand dynamics.

FUTURE OUTLOOK

Looking ahead, several factors will influence the trajectory of office construction in Houston:

- Evolving tenant preferences for modern, amenity-rich spaces
- Potential conversion or redevelopment of older, less competitive properties
- Emerging opportunities in niche sectors like life sciences and technology

While large-scale speculative office development is likely to remain subdued in the near term, targeted projects catering to specific market segments may find opportunities for success.

OCCUPANCY TRENDS AND WORKPLACE EVOLUTION

The ongoing transformation of work practices continues to exert a significant influence on Houston's office market. Let's explore the current state of occupancy and the factors shaping workplace decisions:

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.

RETURN-TO-OFFICE PATTERNS

According to the Kastle Systems Back-to-Work Barometer, which tracks office entry card usage, Houston's office occupancy averaged 60% at the end of Q3 2024. This figure positions Houston favorably compared to other major metropolitan areas, where occupancy rates typically ranged between 40% and 50%.

Several factors contribute to Houston's relatively strong performance:

- A diverse economic base with industries requiring in-person collaboration
- Cultural preferences for face-to-face interactions in business settings
- Proactive efforts by local authorities and businesses to encourage office returns

Despite these positive indicators, the 60% occupancy rate still represents a significant shift from pre-pandemic norms, underscoring the enduring impact of remote work adoption.

TENANT BEHAVIOR AND SPACE UTILIZATION

As leases come up for renewal, tenants are demonstrating evolving priorities in their space decisions:

- **Rightsizing:** Many companies are reassessing their space needs, often opting for smaller footprints to align with hybrid work models.
- **Quality over quantity:** There's a growing preference for high-quality, amenity-rich spaces that can attract employees back to the office.
- **Flexibility:** Short-term leases and options for expansion or contraction are very sought after.

These trends are reshaping the competitive landscape among office properties. Buildings completed within the past 15 years boast an average vacancy rate of 14.6%, compared to 27.8% for older structures built before 2009.

IMPACT ON DIFFERENT PROPERTY CLASSES

The diverging performance between newer and older office stock highlights the growing bifurcation in the market:

- **Class A properties:** Generally maintaining stronger occupancy levels, particularly those with modern amenities and prime locations.
- **Class B and C properties:** Facing greater challenges in attracting and retaining tenants, often requiring significant capital investments to remain competitive.

This disparity is likely to drive further segmentation in the market, potentially leading to increased redevelopment or adaptive reuse of less desirable properties.

SUBMARKET ANALYSIS: IDENTIFYING HOTSPOTS AND CHALLENGES

Houston's vast office market encompasses diverse submarkets, each with its unique characteristics and performance metrics. This section examines key areas within the metropolitan region, highlighting notable trends and opportunities

DOWNTOWN CORE

The central business district continues to be a focal point of Houston's office market, albeit with mixed results:

- Vacancy rates remain elevated, hovering around 22% in Q4 2024
- Premium Class A towers maintain stronger occupancy levels
- Increasing interest in mixed-use developments to enhance urban vibrancy

Notable developments:

- Adaptive reuse projects transforming older office buildings into residential or hospitality spaces
- Public-private partnerships aimed at revitalizing streetscapes and public amenities
- Growing emphasis on sustainability and wellness features in office properties

ENERGY CORRIDOR

This submarket, historically dominated by oil and gas companies, is undergoing a period of transition:

- Vacancy rates remain high, exceeding 30% in some areas
- Efforts to diversify tenant base beyond traditional energy sector
- Increasing focus on creating live-work-play environments to attract younger workforce

Key trends:

- Repositioning of large corporate campuses for multi-tenant use
- Integration of green spaces and outdoor amenities to enhance appeal
- Emergence of flex office concepts catering to smaller energy and

GALLERIA/UPTOWN

The Galleria area continues to be a desirable location for office tenants, benefiting from its mixed-use character:

- Vacancy rates slightly below market average, around 20% in Q4 2024
- Strong performance of trophy assets and newly developed properties
- Ongoing redevelopment efforts to modernize aging office stock

Noteworthy developments:

- Increased integration of retail and dining options within office complexes
- Growing popularity of boutique office spaces catering to high-end professional services firms
- Enhanced focus on pedestrian-friendly environments and public transportation access

THE WOODLANDS

This master-planned community north of Houston has shown resilience in its office market:

- Vacancy rates among the lowest in the metro area, around 15% in Q4 2024
- Strong demand for high-quality, suburban office environments
- Continued expansion of healthcare and life sciences presence

Key factors driving performance:

- Attractive live-work-play ecosystem appealing to both companies and employees
- Strategic development of niche industry clusters, particularly in healthcare and technology
- Emphasis on sustainable design and green building practices

INVESTMENT LANDSCAPE AND CAPITAL MARKETS

The investment climate for Houston's office market in Q4 2024 reflects the broader challenges and opportunities present in the sector. This section explores key trends in investment activity, pricing dynamics, and capital flows.

EMERGING SUBMARKETS

Several areas within the Houston metro are gaining traction as alternative office destinations:

- **East Downtown (EaDo):** Growing appeal for creative and tech-oriented firms
- **Midtown:** Increasing development of mixed-use projects with office components
- **Clear Lake:** Expansion of aerospace and technology-related office demand

These emerging submarkets offer opportunities for both developers and tenants seeking alternatives to traditional office locations.

TRANSACTION VOLUME AND INVESTOR SENTIMENT

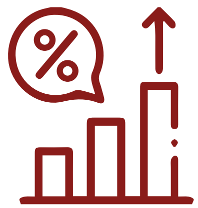
Overall investment activity in Houston's office market remained subdued throughout 2024, with Q4 showing no significant deviation from this trend:

- Total transaction volume for the year was approximately 30% below the five-year average
- Investors demonstrated a cautious approach, favoring quality assets with stable tenant rosters
- Value-add opportunities garnered increased interest from opportunistic buyers

Factors influencing investor sentiment:

- Ongoing uncertainty surrounding long-term office demand
- Challenges in underwriting future cash flows due to evolving lease structures
- Widening bid-ask spreads between buyers and sellers

PRICING TRENDS AND CAP RATES



The pricing landscape for office assets in Houston has undergone notable shifts:

- Average price per square foot for Class A assets declined by approximately 10% year-over-year
- Cap rates for stabilized, high-quality properties expanded by 50-75 basis points
- Distressed assets saw more significant price adjustments, with some transactions occurring at 30-40% discounts to previous valuations

It's important to note that pricing dynamics varied significantly based on property quality, location, and tenant profile. Trophy assets in prime submarkets continued to command premium valuations, albeit with some softening compared to previous years.

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.

CAPITAL SOURCES AND ALLOCATION STRATEGIES

The composition of active investors in Houston's office market evolved in response to changing market conditions:

- **Institutional investors:** Remained selective, focusing primarily on core and core-plus assets in top-tier locations
- **Private equity:** Increased activity in value-add and opportunistic plays, particularly for assets with repositioning potential
- **Foreign capital:** Showed renewed interest, attracted by relative value compared to other major U.S. markets
- **Local and regional players:** Leveraged market knowledge to identify off-market opportunities

Notable trends in capital allocation strategies:

- Growing emphasis on portfolio diversification across property types and risk profiles
- Increased allocation to debt strategies as an alternative to direct equity investments
- Rising interest in office-to-residential conversion opportunities in select submarkets

FINANCING LANDSCAPE

The debt markets for office properties in Houston faced challenges in Q4 2024:

- Lenders maintained conservative underwriting standards, particularly for non-stabilized assets
- Loan-to-value ratios typically ranged from 55-65% for conventional financing
- Alternative lenders and debt funds played an increasingly important role in filling financing gaps

Key considerations for borrowers:

- Higher emphasis on sponsor track record and financial strength
- Growing importance of environmental, social, and governance (ESG) factors in lending decisions
- Increased scrutiny of tenant credit quality and lease structures

TENANT DYNAMICS AND LEASING ACTIVITY

Understanding the evolving needs and behaviors of office tenants is crucial for navigating Houston's commercial real estate landscape, examining key trends in leasing activity, tenant preferences, and emerging occupier strategies

LEASING VOLUME AND DEAL STRUCTURES

Q4 2024 saw a mixed picture in terms of leasing activity:

- Overall leasing volume remained below historical averages, but showed signs of stabilization
- Renewal activity outpaced new leases, reflecting tenant caution and cost-consciousness
- Average lease term for new deals shortened to approximately 5-7 years, down from 7-10 years pre-pandemic

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.

Notable trends in deal structures:

- Increased inclusion of termination options and expansion rights
- Growing popularity of "blend-and-extend" deals to lock in current market rates
- Rise in short-term, flexible leasing arrangements, particularly for smaller spaces

INDUSTRY SECTOR ANALYSIS

Different industry sectors exhibited varying appetites for office space:

- **Technology:** Continued to drive demand, particularly for high-quality, amenity-rich spaces
- **Energy:** Showed signs of stabilization after years of contraction, with selective expansions noted
- **Healthcare and Life Sciences:** Emerged as a bright spot, with steady growth in space requirements
- **Professional Services:** Demonstrated a mix of downsizing and strategic relocations
- **Financial Services:** Maintained a cautious approach, with some firms reducing footprints

TENANT PREFERENCES AND AMENITIES

The competition for high-quality tenants has intensified, leading to evolving expectations for office spaces:

- **Wellness features:** Increased demand for spaces promoting employee health and well-being
- **Collaborative areas:** Growing emphasis on flexible, multi-use spaces for team interaction
- **Technology integration:** Rising importance of smart building features and robust digital infrastructure
- **Sustainability:** Heightened focus on energy efficiency and environmentally friendly design
- **Outdoor spaces:** Greater value placed on accessible terraces, rooftop gardens, and green areas

MARKET FORECASTS AND FUTURE OUTLOOK

As we look beyond Q4 2024, several key factors will shape the trajectory of Houston's office market. This section provides insights into potential future scenarios and short and long-term trends

WORKPLACE STRATEGY TRENDS

Companies continued to refine their workplace strategies in response to changing work patterns:

- **Hybrid models:** Widespread adoption of flexible arrangements combining in-office and remote work
- **Activity-based design:** Shift towards spaces tailored to specific work functions rather than traditional layouts
- **Hoteling and hot-desking:** Increased implementation of shared workspace concepts
- **Satellite offices:** Growing interest in hub-and-spoke models to reduce commute times and enhance work-life balance

These evolving strategies are reshaping not only how companies use office space but also where they choose to locate within the Houston metro area.

SHORT-TERM PROJECTIONS (1-2 YEARS)

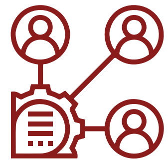
In the immediate future, Houston's office market is likely to face continued challenges:

- Absorption rates are expected to remain volatile, with potential for further negative absorption in 2025
- Vacancy rates may stabilize but are unlikely to see significant improvement without major economic catalysts
- Rental rates are projected to remain flat or experience modest declines in real terms

Key factors to watch:

- Pace of return-to-office initiatives across major employers
- Potential consolidation or expansion activities in key industries like energy and technology
- Impact of macroeconomic conditions on corporate real estate decisions

MEDIUM-TERM OUTLOOK (3-5 YEARS)



The medium-term presents opportunities for market recalibration and potential growth:

- Gradual absorption of excess inventory, particularly in high-quality, well-located assets
- Increasing divergence between top-tier and secondary properties, potentially leading to redevelopment opportunities
- Emergence of new office submarkets catering to evolving tenant preferences

Potential catalysts for market improvement:

- Continued diversification of Houston's economy beyond traditional energy sector
- Infrastructure investments enhancing connectivity and livability in key business districts
- Adaptive reuse projects transforming obsolete office stock into alternative uses

LONG-TERM TRENDS AND STRUCTURAL SHIFTS

Looking further ahead, several structural changes may reshape Houston's office landscape:

- Integration of artificial intelligence and automation in workplace design and management
- Growing emphasis on sustainability and resilience in building design and operations
- Evolution of office spaces as "experience centers" rather than traditional workplaces
- Increased blending of office, residential, and retail uses within single developments

These long-term trends will require stakeholders to adopt flexible, forward-thinking strategies to remain competitive in an evolving market.

CONCLUSION: NAVIGATING CHALLENGES, EMBRACING OPPORTUNITIES

As we conclude our analysis of Houston's office market in Q4 2024, it's clear that the sector faces a complex and evolving landscape. While challenges persist in terms of absorption, vacancy rates, and changing tenant demands, there are also signs of resilience and potential for growth.

WILD CARD FACTORS

Several unpredictable elements could significantly impact the market's trajectory:

- Technological breakthroughs altering work patterns or space utilization
- Major shifts in energy markets affecting Houston's economic base
- Climate-related events influencing development patterns and building requirements
- Regulatory changes impacting real estate investment or development practices

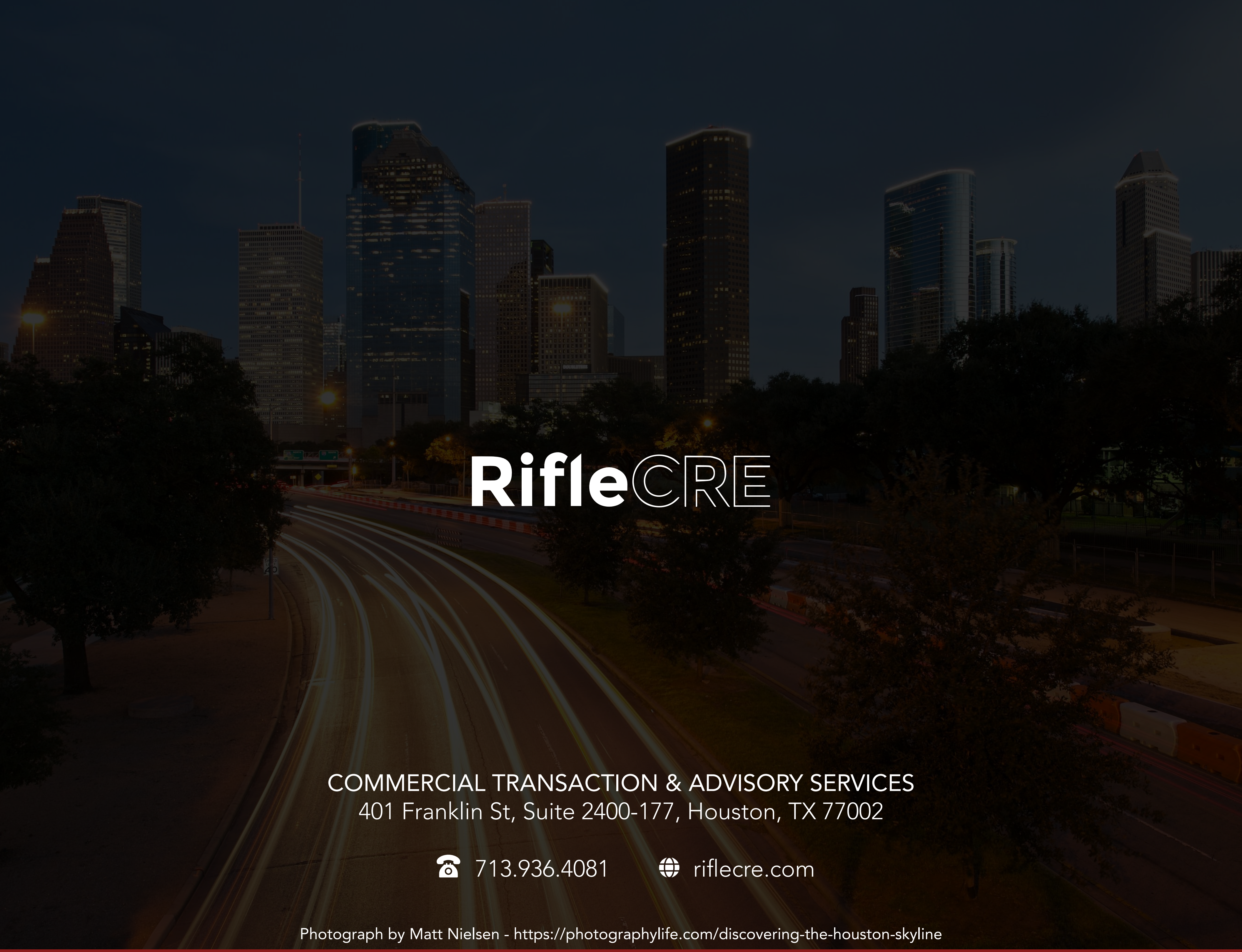
Monitoring these potential disruptors will be crucial for market participants seeking to navigate uncertainties and capitalize on emerging opportunities.

KEY TAKEAWAYS FOR MARKET PARTICIPANTS

- Flexibility and adaptability will be crucial in responding to rapidly changing market conditions
- Focus on quality and differentiation will be essential for success in a competitive environment
- Understanding and catering to evolving tenant needs will drive long-term value creation
- Embracing technological and sustainability innovations can provide competitive advantages

CONCLUSION

Despite the current headwinds, Houston's diverse economy, strategic location, and history of resilience position its office market for eventual recovery and transformation. By staying attuned to market trends, embracing innovation, and maintaining a long-term perspective, stakeholders can navigate the challenges and capitalize on the opportunities that lie ahead in this dynamic metropolitan market.



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