RESEARCH Q1 2022

# Houston Office Market

## Houston Office Market Stands Still in First Quarter of 2022

At the start of 2022, Houston's office market is still facing challenges related to the ongoing pandemic. Elevated vacancy rates and the absence of strong leasing demand from the energy sector prior to the pandemic have left the Houston market in a state of prolonged recovery. While Houston had a strong quarter with 463,649 square feet of positive net absorption, new supply is still outpacing demand; leasing activity is down 3.3 million square feet year-over-year. Soft market conditions are allowing tenants longer lead times for decision-making prior to lease expirations, while others are offloading space in attempts to right-size their footprints in conjunction with hybrid work-from-home models. Year-over-year, Houston added 642,289 square feet of sublease space to an already saturated market, with 206,610 square feet added in the first quarter of 2022. Currently, Houston's office market performance remains near the bottom within the U.S., and the market is expected to struggle through the remainder of 2022.

### Troubling Fundamentals

Not since the oil bust of the 1980s has Houston's office market maintained structurally high vacancies. In 2020, vacancy reached 23.4%, while 2021 closed at 25.1%. The marker has barely moved in the new year, with 24.8% vacancy across the market at the close of the first quarter of 2022. At the end of 2021, Houston

### Current Conditions

– Vacancy dropped slightly to 24.8% but remains one of the highest in the nation

– 206,610 square feet of sublease space was added to the market in the first quarter, brining the total amount of sublease space to 7.6 MSF

– Leasing activity totaled 2.0 MSF, a 61.4% decrease from pre-COVID levels

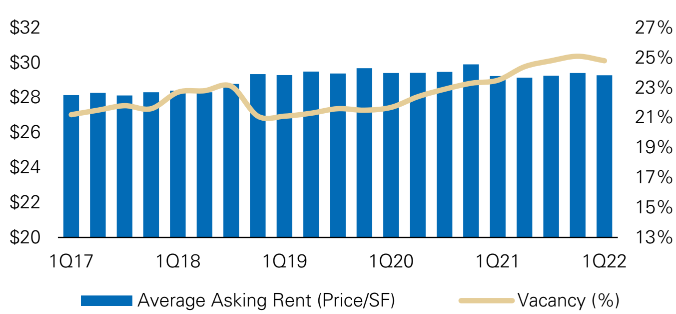
– Construction pipeline offloads 564,195 SF of delivered space; 1.6 MSF is underway across the market

### Market Summary

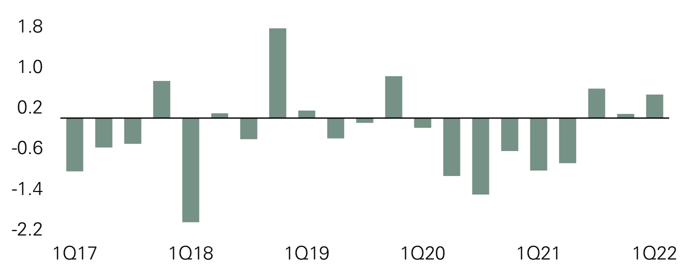
| | Current Quarter | Prior Quarter | Year Ago Period | 12-Month Forecast |
|---|---|---|---|---|
| Total Inventory (SF) | 243.4 MSF | 242.9 MSF | 240.2 MSF | = |
| Vacancy Rate | 24.8% | 25.1% | 23.8% | ↓ |
| Quarterly Net Absorption (SF) | 463,649 SF | 81,548 SF | -716,875 | ↑ |
| Average Asking Rent/SF | $29.28 | $29.41 | $29.29 | = |
| Under Construction (SF) | 1.6 MSF | 3.6 MSF | 4.1 MSF | ↓ |

### Market Analysis

ASKING RENT AND VACANCY RATE




NET ABSORPTION (SF, MILLIONS)

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had the highest vacancy rate in the nation among the major markets, closely followed by Dallas-Fort Worth at 24.0% and Atlanta at 22.3%. The Class A market, consisting of more than 50% of the region's building stock, has a vacancy rate of 27.9% and 1.6 million square feet of space under construction.

Since 2019, rental rates have hovered in the $29.00/SF range. In the first quarter of 2022, rates were flat at $29.28/SF, seeing very little movement year-over-year. The year started with moderate positive net absorption at 463,649 square feet, the majority of which occurred in The Woodlands submarket. The market has had only three quarters of positive net absorption since the end of 2019. In 2021, tenants gave back 1.3 million square feet of space. In 2020, the market posted -5.0 million square feet in net absorption, making it the worst year on record and roughly double the previous low seen in 1987. Available space in the market totals 71.2 million square feet, roughly 29% of inventory.

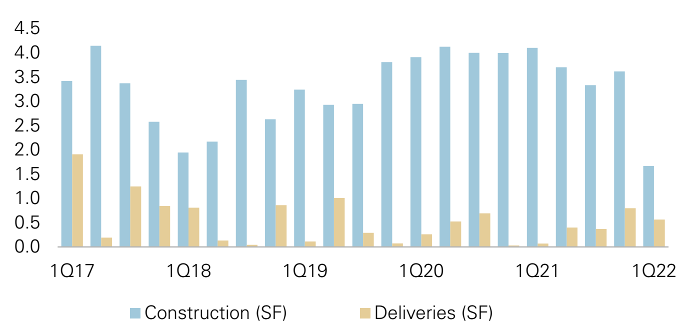
The Woodlands is one of the best-performing submarkets due in part to its lure of satellite offices, which are gaining traction once again in the wake of the pandemic. Suburban submarkets are expected to do well in the coming years, as companies look to offer shorter commute times and offices closer to employee bases. In the first quarter of 2022, The Woodlands buoyed the market's net absorption, as tenants took up 481,860 square feet of space in the submarket.

In the Central Business District, vacancy reached 31.1% in the first quarter of 2022, with an availability rate of 35.3%. Vacancy in the submarket has increased by 11.5% since the start of 2021, when the rate was 27.9%. The CBD continues to struggle as tenants gave back more space than they took on, ending the quarter at 111,081 square feet of negative net absorption, while leasing activity totaled 273,359 square feet. Rental rates are seeing downward pressure to accommodate the submarket's high vacancy and have fallen 3.4% year-over-year. At quarter close, overall rates in the submarket were $37.65/SF. Prior to the pandemic, rates in the submarket were in the mid-$41.00/SF range and direct rates were over $43.00/SF. Sublease rates in the CBD are at $23.57/SF, 38.0% lower than direct asking rents, which are currently $38.50/SF.

The Energy Corridor is showing small signs of life amidst weakened energy leasing demand. The submarket has wrestled with elevated vacancy and availability since before the pandemic. While things have looked good for the Energy Corridor in recent years, vacancy has likely flattened and is projected to begin declining by the end of 2022. In the first quarter of 2021, net absorption was again positive, with 99,031 square feet of space taken up. Leasing activity totaled 205,917 square feet, down from 2021's quarterly average of 297,152 square feet, but an indication that momentum has not fully slowed. Rental rates in the submarket are falling at a steady pace, dropping 11.6% from the first quarter of 2020. Currently, overall rental rates in the Energy Corridor are at $25.69/SF. A substantial price discount can be found amongst sublease availability in parts of the submarket, with some spaces listed as much as 65% below the overall rental rate. The average sublease rate is $20.57/SF, a slight increase from the previous quarter. At $26.57/SF, direct rates however are compressing, down roughly 9.7% from their level one year ago. The recent announcement of Enbridge's move to the Energy Corridor highlights the submarket's sustained allure, even in times of distress. The company will move into 292,892 square feet of McDermott's sublease space in Energy Tower V later this year.

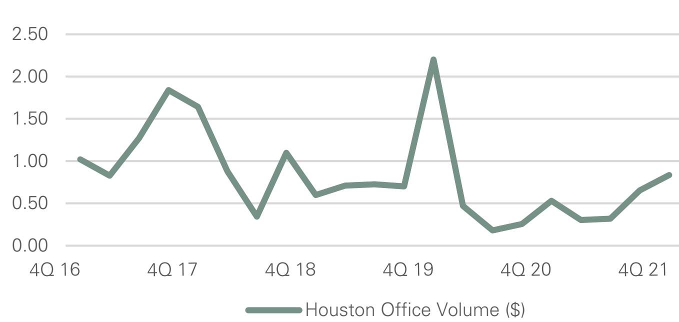
## Construction and Deliveries

SQUARE FEET, MILLIONS




## Office Investment Sales

SALES VOLUME ($, BILLIONS)




Source: Real Capital Analytics

## Swimming in a Sea of Supply

Houston's glut of office space is cause for concern as another quarter closes on diminished demand and leasing activity. In the first quarter of 2022, leasing activity fell again, down to 2.0 million square feet from the 3.3 million square feet of activity in the previous quarter. Overall, leasing activity remains 61.4% lower than pre-pandemic levels as supply vastly outpaces demand. Office leasing remains weak, with 612 transactions occurring during the quarter as tenants continue to take advantage of soft market conditions and focus on right-sizing their footprints and giving back space. In the first quarter of 2022, tenants in Houston added 206,610 square feet of sublease space to market, bringing the market total to 7.6 millions square feet. Since the beginning of 2021, roughly 642,300 square feet of sublease space has hit the market. The largest transaction of the quarter was Enbridge's sublease from McDermott, while SPB Hospitality also signed a sublease for 42,290 square feet in the Katy Grand Parkway submarket.

With the excessive supply of existing office space, development is expected to lag throughout 2022. Given current market conditions, developers have become more restrained with new construction, reducing Houston's supply risk in 2022. There is currently 1.6 million square feet of space under construction, with the Texas Medical Center accounting for the lion's share. Outside of the Medical Center and CBD, the Katy Freeway submarket has the greatest amount of space underway, with 186,000 square feet. In the first quarter of 2022, five buildings delivered, totaling 564,195 square feet.

## Life Sciences Strengthens Houston's Office Market

There is roughly 6 million square feet of life science/biotech development proposed in the Houston market, with nearly 50% of that development within the 610 Loop. The other 50.0% is spread between other suburban areas, including the West Belt and The Woodlands. In the Texas Medical Center, the TMC3 Collaborative Building topped out in March. The 250,000-square-foot building will feature a 43,000-square-foot research lab, which will be shared by MD Anderson, Texas A&M Health and UT Health Houston. The building is designed to allow for collaboration and innovation between academic, healthcare and private industry partners. The TMC3 Collaborative Building will also include 85,000 square feet of lab space and office/coworking space, 7,000 square feet of lecture space and 14,200 square feet for strategic projects. Delivery of the building is planned for August 2023. Construction is also underway on the anchor facility for the first phase of TMC3, which will comprise 700,000 square feet and is being developed by Beacon Capital Partners and Braidwell.

Also in the Texas Medical Center, Horizon Tower is expected to deliver in the first quarter of 2023 and will bring 521,000 square feet of medical office, research and life science space to the Texas A&M Innovation Plaza. Just down the road from Horizon Tower, Levit Green broke ground in the fourth quarter of 2021. The 270,000-square-foot building is part of a nine-building master plan and will offer lab and office space, along with a 9,500-square-foot standalone vivarium. The building is slated for delivery in December 2022.

While the expansion of the Texas Medical Center remains the major focus of life sciences in Houston, the sector is finding inroads throughout the market. Houston is strategically positioned at a crossroads of technology, engineering, energy and healthcare, making the market particularly attractive to life science startups and venture capitalists. According to recent findings from the Greater Houston Partnership, in Houston, 15 out of 100 VC deals goes to a life science company, compared to the national average of 10 out of 100 deals. The Houston market is well-poised to see additional growth in the life science sector due to the rich talent pool of undergraduates from Baylor, Texas A&M and the University of Houston, along with many two-year associates coming out of Houston Community College. In March, the TMC Venture Fund received an additional $50.0 million in capital from the Texas Medical Center Board of Directors to further invest in technology startups, medical devices and therapeutics developers. Houston ranked #12 out of 14 life science clusters in Newmark's 2021 Year-End Life Science Overview, with favorable marks in the Future Growth sub-score.

Notable startup growth includes Roboze, an industrial 3D printing company that relocated to Houston from Chicago in 2020, recently raising several million dollars in new funding. The company took space in Northwest Houston to accommodate its manufacturing, warehousing and office needs.

Additionally, Symplr, a healthcare technology company based in Houston, is in the process of acquiring Midas Health Analytics Solutions. The acquisition is one of several that that company has undertaken in recent years. Symplr currently occupies 15,000 square feet at Bayou Place II in the CBD.

## Looking Ahead

The Houston office market will remain challenged throughout 2022, with demand projected to pick up in 2023, albeit at a slower pace than previously seen. A main concern for Houston's office market is the lack of organic growth from new industry entering the market to satisfy the amount of available supply, leading to a longer timeframe for market correction. Rental rates have likely plateaued for the foreseeable future as landlords attempt to attract tenants until demand jumpstarts. Houston office tenants will maintain the upper hand in the near- to mid-term. Reinvestment from owners into assets should be seen as a benefit rather than a concern, as it prevents a large portion of Houston's building stock from going into obsolescence. Additionally, office space is being converted to multi-housing, life science/laboratory facilities and data centers, as owners take advantage of demand in these sectors. In past downturns, the market rebounded with a combination of economic upswing, increased investment and new development. This time around, it appears the focus will be on tending to the market's current tenants and inventory, ensuring that the building stock remains attractive and ready for future growth.

### Select Lease Transactions

| Tenant | Market | Building | Type | Square Feet |
|---|---|---|---|---|
| Enbridge Inc. | Houston – Energy Corridor | 915 N Eldridge Pky | Sublease– New | 292,892 |
| Strike Corporation | Houston – The Woodlands | 460 Wildwood Forest Dr | Direct – New | 43,230 |
| SPB Hospitality | Houston – Katy Grand Pkwy | 19219 Katy Fwy | Sublease – New | 37,205 |
| Kurray America Inc. | Houston – Katy Grand Pkwy | 2625 Bay Area Blvd | Direct – New | 25,811 |
| Marathon Petroleum | Houston – CBD | 500 Dallas St | Direct – New | 23,285 |
| Smith Seckman Reid, Inc. | Houston – Energy Corridor | 900 Threadneedle | Direct – New | 20,923 |

### Select Sales Transactions

| Buyer/Seller | Market | Building | Type | Square Feet |
|---|---|---|---|---|
| Fuller Realty/ Skanska USA | Houston – Westchase | 15375 Memorial Dr | $147,000,000 | $205 |
| John Quinlan/ Heights Medical Tower LTD | Houston – Katy Fwy | 550 Westlake Park Blvd | $21,000,000 | $51 |
| CCI Pasadena LLC/ National Health Investors | Houston – East/Pasadena | 3801 Vista Rd | $5,100,000 | $86 |

## Submarket Statistics

| | Total Inventory (SF) | Under Construction (SF) | Total Vacancy Rate | Quarter Absorption (SF) | YTD Absorption (SF) | Direct Asking Rent (Price/SF) | Sublet Asking Rent (Price/SF) | Total Asking Rent (Price/SF) |
|---|---|---|---|---|---|---|---|---|
| **CBD** | 41,123,165 | 386,323 | 31.1% | -111,081 | -111,081 | $38.50 | $23.57 | $37.65 |
| **Allen Parkway** | 6,146,386 | 0 | 16.8% | -46,360 | -46,360 | $35.74 | $23.88 | $35.67 |
| **Bellaire/Med Center** | 13,824,468 | 948,192 | 15.0% | -16,052 | -16,052 | $28.76 | $21.10 | $28.10 |
| **Clear Lake** | 7,666,145 | 0 | 9.1% | 21,906 | 21,906 | $22.03 | $18.00 | $22.02 |
| **Conroe** | 1,949,226 | 0 | 19.2% | 25,969 | 25,969 | $28.27 | $19.25 | $26.87 |
| **East/Pasadena** | 6,378,909 | 0 | 16.3% | 11,465 | 11,465 | $21.27 | $18.75 | $21.23 |
| **Energy Corridor** | 23,079,081 | 0 | 28.2% | 99,031 | 99,031 | $26.57 | $20.57 | $25.69 |
| **FM 1960/249** | 11,359,124 | 0 | 23.4% | 65,611 | 65,611 | $21.50 | $19.48 | $21.49 |
| **Galleria/Uptown** | 24,862,519 | 77,189 | 26.9% | -35,098 | -35,098 | $35.15 | $24.53 | $34.59 |
| **Greenspoint** | 11,851,355 | 0 | 48.1% | 85,034 | 85,034 | $17.82 | $15.62 | $17.81 |
| **Greenway Plaza** | 10,930,044 | 0 | 23.8% | 10,159 | 10,159 | $34.38 | $25.63 | $34.11 |
| **Katy Freeway** | 16,884,110 | 186,000 | 16.6% | 104,307 | 104,307 | $29.59 | $32.97 | $29.72 |
| **Katy/Grand Pky** | 3,563,267 | 20,758 | 18.4% | -11,659 | -11,659 | $30.58 | $24.97 | $29.81 |
| **Kingwood/Humble** | 1,400,463 | 0 | 12.4% | -1,231 | -1,231 | $23.28 | $18.00 | $23.16 |
| **NW Houston** | 8,304,068 | 0 | 20.1% | 10,417 | 10,417 | $19.51 | $17.01 | $19.42 |
| **Southwest Fwy** | 12,265,798 | 0 | 17.2% | 29,919 | 29,919 | $19.03 | - | $19.03 |
| **Sugar Land/Ft Bend** | 6,682,746 | 0 | 20.6% | -28,233 | -28,233 | $30.42 | $32.21 | $30.48 |
| **West Belt** | 5,367,993 | 0 | 29.2% | -157,628 | -157,628 | $24.66 | $21.09 | $24.51 |
| **Westchase** | 14,808,526 | 0 | 34.3% | -83,333 | -83,333 | $27.75 | $29.62 | $27.83 |
| **The Woodlands** | 15,000,785 | 50,400 | 19.0% | 481,860 | 481,860 | $32.80 | $24.19 | $30.31 |
| **Suburban** | 202,369,771 | 1,282,539 | 23.6% | 574,730 | 574,730 | $27.24 | $23.35 | $27.00 |
| **Market** | **243,492,936** | **1,668,862** | **24.8%** | **463,649** | **463,649** | **$29.66** | **$23.39** | **$29.28** |

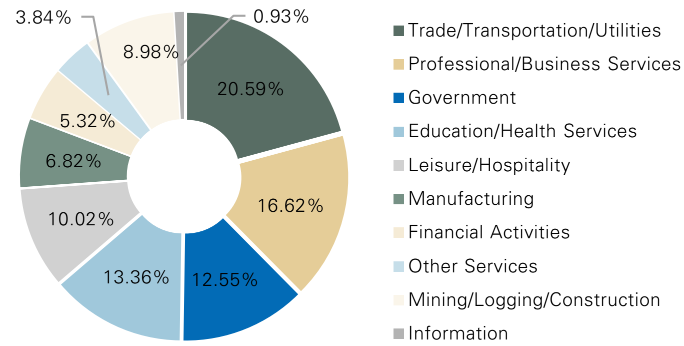
## Economic Indicators

Houston remains in the recovery phase of the business cycle but is on track to recover the jobs lost during the pandemic by June 2022. While the rebounding oil and gas sector benefits the region, area consumers are hampered by record-setting fuel prices. Since January, a gallon of regular gasoline has risen by $0.88 per gallon; by mid-March, the average price was $3.97 per gallon. In February, WTI prices surged past $90 per barrel due to increased demand and pressure on the global supply given the Russo-Ukrainian War. The Greater Houston Partnership is anticipating gains of 75,500 jobs in 2022. In February, GHP reported 45,500 jobs had been created in the Houston Metro, marking the highest February on record. The Houston region is expected to outpace national growth in 2022, and the overall outlook for the Houston economy is positive.

In the year period ending in February, consumer prices increased by 7.9% nationwide. Core inflation increased by 6.8% over the same period. In the Houston Metro, the Consumer Price Index was at 7.8% for February, and the unemployment rate in Houston rose slightly in January to 5.5% month-over-month but was down from 7.9% a year prior. All the industries tracked by the BLS for the region showed 12-month gains in employment growth in February, with financial activities gaining the largest share at 15.1%.

### Employment By Industry

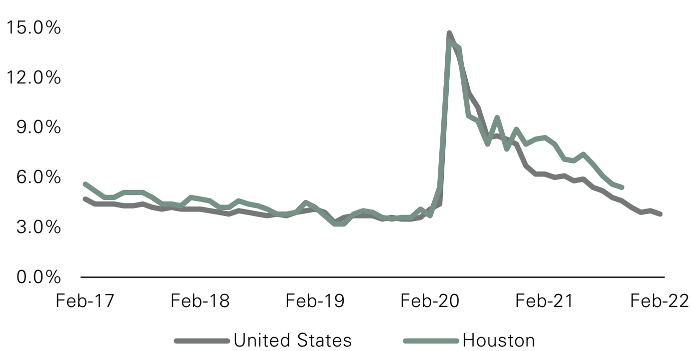
**TOTAL NONFARM, NOT SEASONALLY ADJUSTED**




Source: US Bureau of Labor Statistics, March 2022

### Unemployment Rate

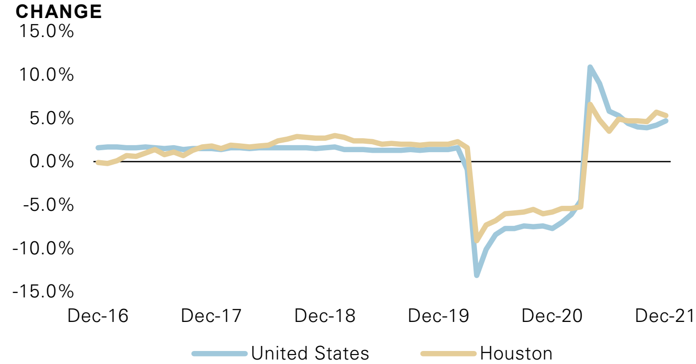
**NON-SEASONALLY ADJUSTED**




Source: US Bureau of Labor Statistics, March 2022

### Payroll Employment

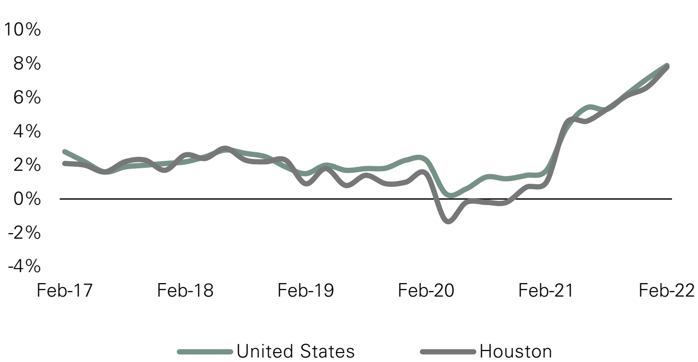
**TOTAL NONFARM, NOT SEASONALLY ADJUSTED, 12-MONTH % CHANGE**




Source: U.S. Bureau of Labor Statistics, March 2022

### Consumer Price Index (CPI)

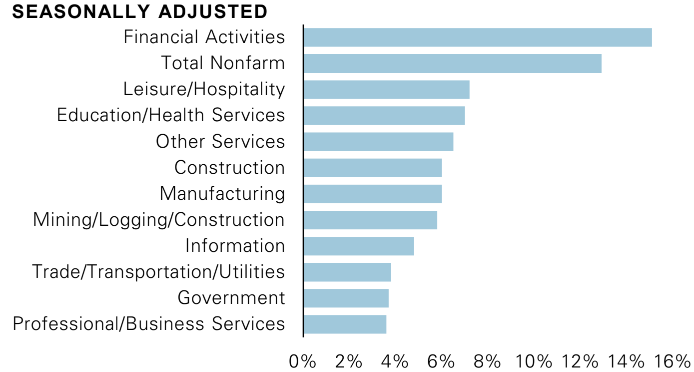
**ALL ITEMS, 12-MONTH % CHANGE, NON-SEASONALLY ADJUSTED**




Source: U.S. Bureau of Labor Statistics, March 2022

### Employment Growth By Industry

**HOUSTON, FEBRUARY 2022, 12-MONTH % CHANGE, NON-SEASONALLY ADJUSTED**




Source: U.S. Bureau of Labor Statistics, March 2022

*For more information:*

**Houston**
1700 Post Oak Blvd
2 BLVD Place, Suite 250
Houston, TX
t 713-626-8888

**Kirsten Kempf**
*Analyst*
*Texas Research*
kirsten.kempf@nmrk.com

**nmrk.com**