

Houston Office Market

Leasing Activity Slows as Tenants Continue to Right-Size

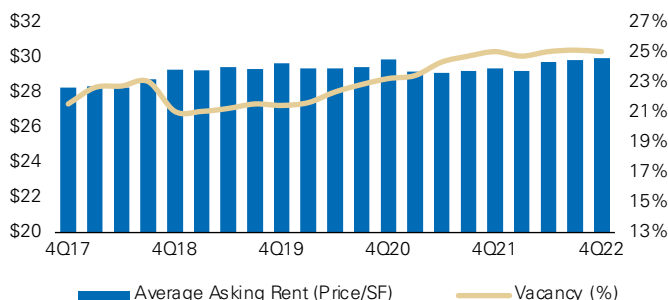
Houston's office market continued to battle high vacancy and diminished demand in the fourth quarter of 2022. Leasing activity slowed to 2.6 million square feet in the fourth quarter of 2022. Year to date, leasing activity is down 3.1% from totals seen in 2021. The sublease market gained 271,793 square feet as tenants continued to right size their footprints. Since the start of the year, almost 1.3 million square feet of sublease space has hit the Houston office market. Net absorption turned negative in the fourth quarter of 2022, but the market closed out the year with 403,419 square feet of positive absorption overall.

Muted Demand Keeps Vacancy Elevated

Vacancy in the Houston market was relatively flat in the fourth quarter of 2022, increasing 30 basis points to 25.1% and remains the highest in the nation among major markets. Overall rental rates rose to \$30.00/SF, an increase of 1.1% year over year while direct rates rose 0.6% in the same period to \$30.37/SF. Sublease rates jumped 10.2% year over year and are now \$24.17/SF. The Houston market ended the fourth quarter of 2022 with a return to negative absorption at -485,394 square feet. For the year, the market saw positive momentum with 403,419 square feet of net absorption, bolstered by strong numbers in the first quarter of 2022. In the fourth quarter of 2022, the availability rate reached 30.1% of the market inventory and available space now exceeds 73.4 million square feet.

Market Analysis

ASKING RENT AND VACANCY RATE

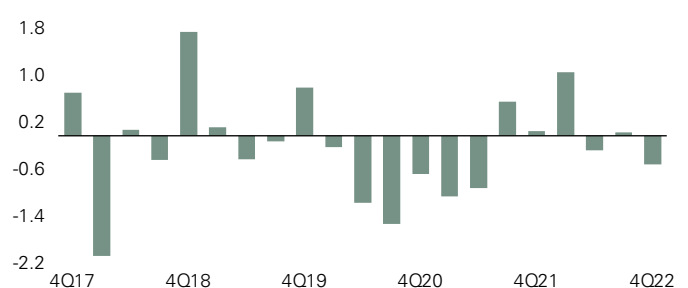


Current Conditions

- Annual full-service asking rental rates increased by 1.1% year over year to \$30.00/SF.
- Vacancy rates remained relatively flat at 25.1%, increasing by 20 basis points quarter over quarter and 10 basis points year over year.
- Construction activity continues to remain conservative with 3.5 MSF currently under construction, accounting for just 1.5% of the market's inventory.
- Despite negative occupancy in fourth quarter at -485,394 square feet, overall yearly net absorption in the market remained positive at 403,419 square feet.

	Current Quarter	Prior Quarter	Year Ago Period	12-Month Forecast
Total Inventory (SF)	240.8 MSF	240.7 MSF	239.9 MSF	↑
Vacancy Rate	25.2%	24.9%	25.0%	↔
Quarterly Net Absorption (SF)	-485,394	57,168	-581,711	↑
Average Asking Rent/SF	\$30.00	\$30.03	\$29.68	↔
Under Construction (SF)	3.4 M	3.2 M	3.3 M	↓

NET ABSORPTION (SF, MILLIONS)



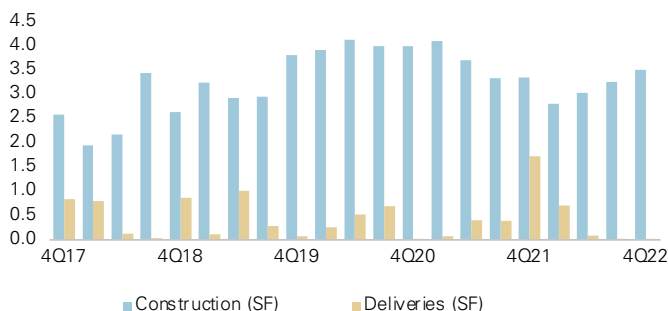
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The Central Business District continues to face headwinds stemming from reduced demand and elevated vacancy from the large inventory of aging assets. In the CBD, vacancy is at 31.4% for the quarter, with an availability rate of 36.8%. Year over year, vacancy in the submarket has increased 64 basis points. In the fourth quarter of 2022, sublease space in the CBD totaled 1.4 million square feet, a slight decrease quarter over quarter. Absorption was negative in the fourth quarter of 2022 as occupiers gave back 11,192 square feet, while leasing activity totaled 223,954 square feet. For the year, the submarket narrowly outpaced the levels of leasing activity seen in 2021, with 2022 activity totaling roughly 2.3 million square feet. Direct asking rents rose slightly to end the quarter at \$42.12/SF. Sublease rates are up from the previous year, increasing 13.1% to \$23.89/SF. The average price discount for sublease space in the CBD is now 46.3%.

Residential conversions will help remove functionally obsolete assets from Houston's office inventory. Conversion renovations continue at 1801 Smith, a former 450,000-square-foot office building, which is being converted to a 372-unit residential building. Construction on the conversion began in August and is set to wrap up in early 2023. Residential units are being added to the top floors during the renovation of the Esperson buildings at 808 Travis St., which is expected to begin in early 2023. Renovations to the combined 600,000-square-foot buildings will include 100,000 square feet of residential units, 400,000 square feet of office and 100,000 square feet of coworking space. The nationwide trend of converting underperforming office buildings to other asset types has yet to fully catch on in Houston, but additional projects could be on the horizon given the growing multi-family sector and rising residential rental rates. Investors with Starwood Property Trust are considering the addition of residential units to 5555 San Felipe in the Galleria/Uptown submarket. The 1.2-million-square-foot property is only 30.0% leased after Marathon Oil vacated its space in 2022. In time, office-to-residential conversions would assist in bringing down elevated vacancy rates, but the lengthy process would not

Construction and Deliveries

SQUARE FEET, MILLIONS



provide immediate relief. In 2022, roughly 42 conversion projects were completed nationwide. Going into 2023, about 217 conversion projects are underway as the office-to-residential trend is expected to continue; however, projects still in the planning stages could be put on hold due to rising financing costs.

Leasing Activity

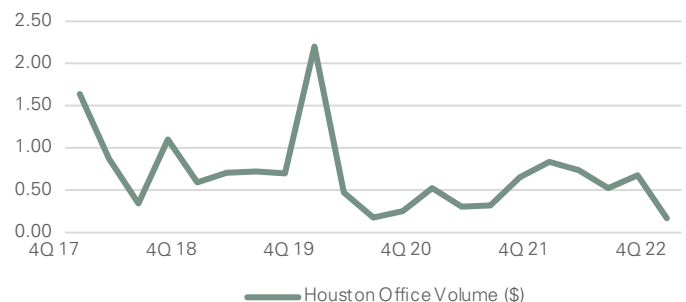
Leasing activity weakened in the fourth quarter of 2022, with 2.6 million square feet in transactions across the Houston Metro. For the year, leasing activity reached over 13.8 million square feet, about 3.1% lower than the total activity seen in 2021. In the fourth quarter of 2022, 506 transactions took place, with an average deal size of 5,233 square feet. Big-block deals helped to bolster activity this quarter, with transactions over 50,000 square feet accounting for almost 40% of total volume. Notable transactions for the quarter include Wood Group's renewal at Westgate III in the Energy Corridor, where the company occupies the entire 226,287-square-foot building. At the end of the quarter, Apache Corporation announced it has renewed and expanded its lease at Briarlake Plaza (2000 W. Sam Houston Pkwy. S.) through 2038. The oil and gas firm will occupy a total of 328,000 square feet in the building by 2024, when it plans to consolidate its remaining employees at its Uptown location. EOG Resources' renewal in the third quarter of 2022 at Heritage Plaza was the year's largest lease at 375,000 square feet.

Development

Despite the Houston market's excessive supply of available and vacant space, the construction pipeline grew in the fourth quarter of 2022 to almost 3.5 million square feet. Projects in the Texas Medical Center account for the lion's share of development in the market, about 56% of total construction, as Houston's life science industry continues to expand. The flight-to-quality trend seen in recent years persists, particularly in the Katy Freeway submarket where 355,694 square feet of construction is underway.

Office Investment Sales

SALES VOLUME (\$, BILLIONS)



Source: Real Capital Analytics

RESEARCH Q4 2022

Metro National continues to build up Memorial City with the addition of 188,550-square-foot of office space at 9753 Katy Fwy, which is set to deliver in the second quarter of 2023. The property is 87.0% pre-leased to Callon Petroleum (107,171 square feet) and BW Energy (67,815 square feet). In the fourth quarter of 2022, 22,329 square feet delivered, bringing the total for deliveries in 2022 to 843,061 square feet of new office space.

Life Sciences Strengthens Houston's Office Market

The Houston life sciences market has over 8.2 million square feet of inventory, with roughly 7.5 million square feet of proposed development. Life science space under construction totaled 994,000 square feet at midyear 2022. The focus of life sciences in Houston centers around the Texas Medical Center expansion, where four buildings are under construction as part of the project's first phase. At TMC Helix Park, formerly TMC3, the 250,000-square-foot Collaborative Building has a delivery date of August 2023 and will be shared by MD Anderson, Texas A&M Health and UT Health Houston. The building will house 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. The expansion of the TMC Innovation Factory campus is set to wrap up in the first quarter of 2023 and will add 46,000 square feet of lab space for early-stage companies and clinical trials. Additional deliveries expected in the first quarter of 2023 include Horizon Tower, which will add 521,000 square feet of medical office, research and life science space to Texas A&M's Innovation Plaza. Phase I of Levit Green was slated for year-end 2022 but has yet to wrap up. The 270,000-square-foot building is

part of a nine-building masterplan for the campus. In November, Sino Biological signed for 10,000 square feet of lab and office space in the building.

The Texas Medical Center recently announced plans to develop a new biomanufacturing facility, TMC BioPort. The 500-acre campus will serve as the home of TMC's biomanufacturing and medical supplies distribution and will include an upskill training center. BioPort will double the size of TMC over the next five years and is expected to create 100,000 new jobs for the region.

Looking Ahead

Houston's recent office market performance has been muted due to lessons learned from the oil downturn in 2015-2016 and the pandemic. Tenants and investors have remained cautious, leading to a slower rebound of market activity. However, the market's strengthening life science sector and recent headquarters relocations indicate a persistent desire for presence in Houston. Going into 2023, investment activity will likely soften due to rising costs of financing and inflation. Houston could see a diminished construction pipeline, as almost every current project is set to wrap in 2023 and restrictive costs could put proposed projects on hold. In the near to midterm, Houston's office market is expected to remain tenant friendly as landlords continue attempts to attract occupiers. Leasing activity may also be subdued as tenants avoid committing to new lease agreements amidst a possible recession. While Houston will face economic headwinds in the coming year, the market's ability to maintain baseline fundamentals will help it weather the storm.

Select Lease Transactions

Tenant	Submarket	Building	Type	Square Feet
Apache Corporation	Westchase	One BriarLake Plaza	Renewal/Expansion	328,000
Wood Group	Katy Freeway	Westgate III	Renewal	226,287
Callon Petroleum Company	Katy Freeway	9753 Katy Fwy	Direct	107,171
Venture Global LNG Inc.	CBD	5 Houston Center	Renewal	88,247
Bechtel	Westchase	CityWestPlace – Bldg 4	Direct	80,634
Gallen College of Nursing	West Belt	Westway One	Direct	71,981

Select Sales Transactions

Buyer/Seller	Submarket	Building	Price	\$/SF
Blue Owl Capital / Principal Global Investors	Katy Freeway	Energy Center 5	\$175 M	\$334
Dhanani Private Equity Group / Acore Capital	Galleria/Uptown	Galleria Park	\$49.0 M	\$114
Mark D Graham / NRG Towers LP	Bellaire/Med Center	NRG Office Complex	Undisclosed	Undisclosed
Fuller Realty Interests / Greystone & Co. Inc.	Katy Freeway	2000 Bering Dr	\$10.5 M	\$55
Wellcom Realty / Oxley Leasing	Bellaire/Med Center	2646 S Loop W	\$10.5 M	\$98

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	39,710,200	386,323	31.4%	-11,192	-81,591	\$42.12	\$22.61	\$41.07
Allen Parkway	6,527,873	0	17.5%	1,330	-82,124	\$34.13	\$30.69	\$34.08
Bellaire/Med Center	13,564,292	1,956,459	15.8%	-80,327	167,058	\$27.63	\$22.18	\$27.13
Clear Lake	7,511,918	106,000	16.9%	-15,398	-77,207	\$23.51	\$20.18	\$23.47
Conroe	1,977,498	0	15.9%	12,853	76,823	\$28.35	\$18.33	\$27.84
East/Pasadena	6,431,434	175,000	17.3%	16,521	-72,689	\$22.58	-	\$22.58
Energy Corridor	23,273,424	0	27.9%	32,177	118,184	\$26.32	\$24.80	\$26.13
FM 1960/249	11,262,149	40,000	24.3%	-128,815	-116,287	\$20.50	\$16.98	\$20.48
Galleria/Uptown	23,207,611	0	27.6%	31,805	234,425	\$34.61	\$24.37	\$34.00
Greenspoint	11,668,508	0	49.7%	-124,332	-128,821	\$17.46	\$13.83	\$17.42
Greenway Plaza	11,060,914	0	24.1%	14,878	-38,514	\$33.97	\$27.32	\$33.81
Katy Freeway	17,177,835	355,694	15.8%	-16,096	245,492	\$29.08	\$32.23	\$29.16
Katy/Grand Pky	3,569,667	23,170	16.1%	23,902	61,027	\$30.03	\$23.16	\$28.99
Kingwood/Humble	1,398,572	0	15.1%	6,477	-39,187	\$22.79	\$18.00	\$22.64
NW Houston	8,112,919	0	20.3%	36,929	30,957	\$19.71	\$17.53	\$19.62
Southwest Fwy	12,268,167	62,400	17.0%	-91,982	-104,217	\$19.33	\$11.40	\$19.32
Sugar Land/Ft Bend	6,835,607	0	22.5%	-51,332	-134,568	\$29.77	\$29.86	\$29.77
West Belt	5,602,308	215,000	27.5%	-66,184	14,251	\$28.36	\$26.16	\$28.27
Westchase	14,545,772	0	30.3%	-63,057	-210,208	\$27.34	\$25.43	\$27.16
The Woodlands	15,111,075	179,134	20.7%	-13,551	540,615	\$32.77	\$24.75	\$30.71
Suburban	201,107,543	3,112,857	23.8%	-474,202	485,010	\$27.07	\$24.54	\$26.91
Market	240,817,743	3,499,180	25.1%	-485,394	403,419	\$30.37	\$24.17	\$30.00

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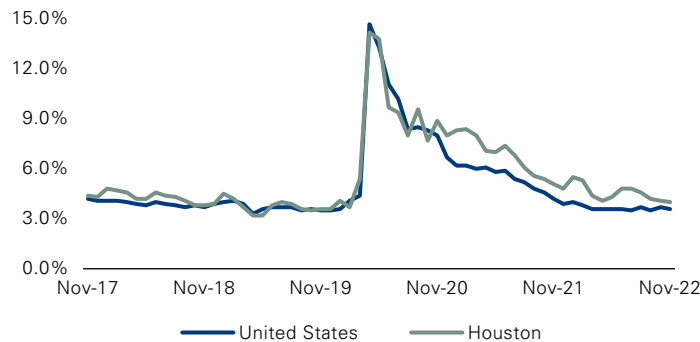
Economic Indicators

Houston's economy continues to outpace the nation due to job growth, declining unemployment, and a PMI that has been in expansion for two years. In December, the average price of gasoline in Houston was \$2.61 per gallon, compared with \$3.21 per gallon nationwide; WTI prices averaged \$76.44 per barrel. In the year period ending in October, consumer prices increased by 7.1% nationwide and 7.6% for Houston. Core inflation increased by 6.3% over the same period. In November, the unemployment rate in Houston fell marginally to 4.0% and is down 110 basis points year over year. The Greater Houston Partnership forecasts the addition of 60,000 jobs in the Houston Metro in 2023. All the industries tracked by the BLS for the region showed 12-month gains in employment growth in November, except for other services, which contracted by negative 2.6%. Rebounds in Houston's energy industry helped strengthen office-using segments, such as professional/business services and financial activities.

Houston's economy is projected to have a relatively healthy response to a potential downturn, given the metro's strong job growth in addition to fully recouping those lost in the pandemic. Industries heavily tied to interest rates and financing are likely to shed jobs but will be offset by growth in other sectors.

Unemployment Rate

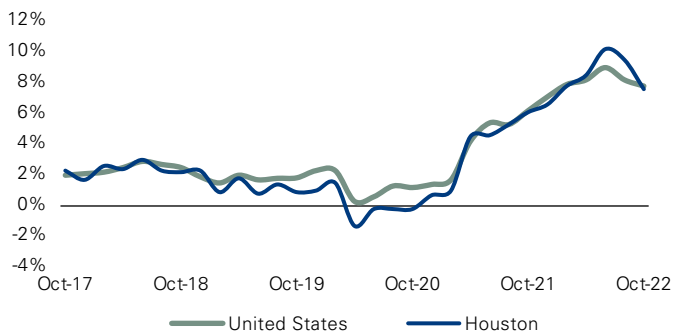
NON-SEASONALLY ADJUSTED



Source: US Bureau of Labor Statistics, December 2022

Consumer Price Index (CPI)

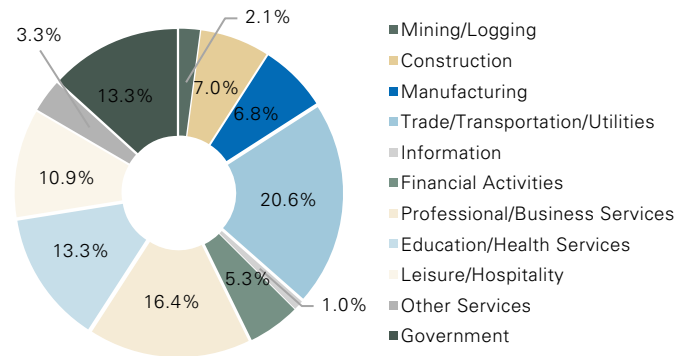
ALL ITEMS, 12-MONTH % CHANGE, NON-SEASONALLY ADJUSTED



Source: US Bureau of Labor Statistics, December 2022

Employment By Industry

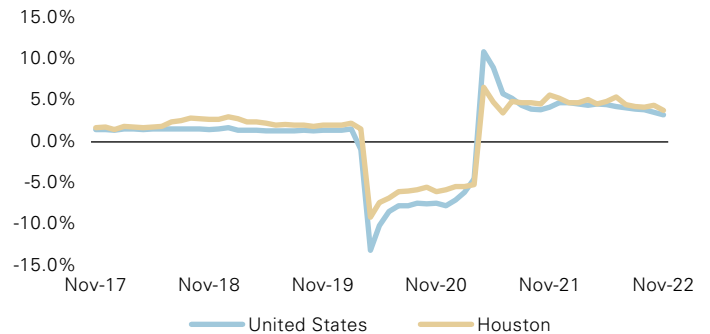
TOTAL NONFARM, NOT SEASONALLY ADJUSTED, NOVEMBER 2022



Source: US Bureau of Labor Statistics, December 2022

Payroll Employment

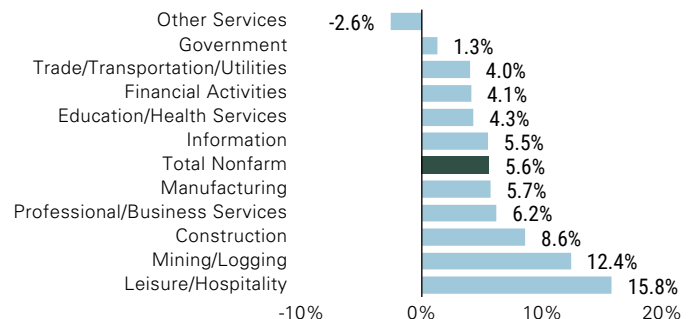
TOTAL NONFARM, NOT SEASONALLY ADJUSTED, 12-MONTH % CHANGE



Source: US Bureau of Labor Statistics, December 2022

Employment Growth By Industry

HOUSTON, NOVEMBER 2022, 12-MONTH % CHANGE, NON-SEASONALLY ADJUSTED



Source: US Bureau of Labor Statistics, December 2022

For more information:

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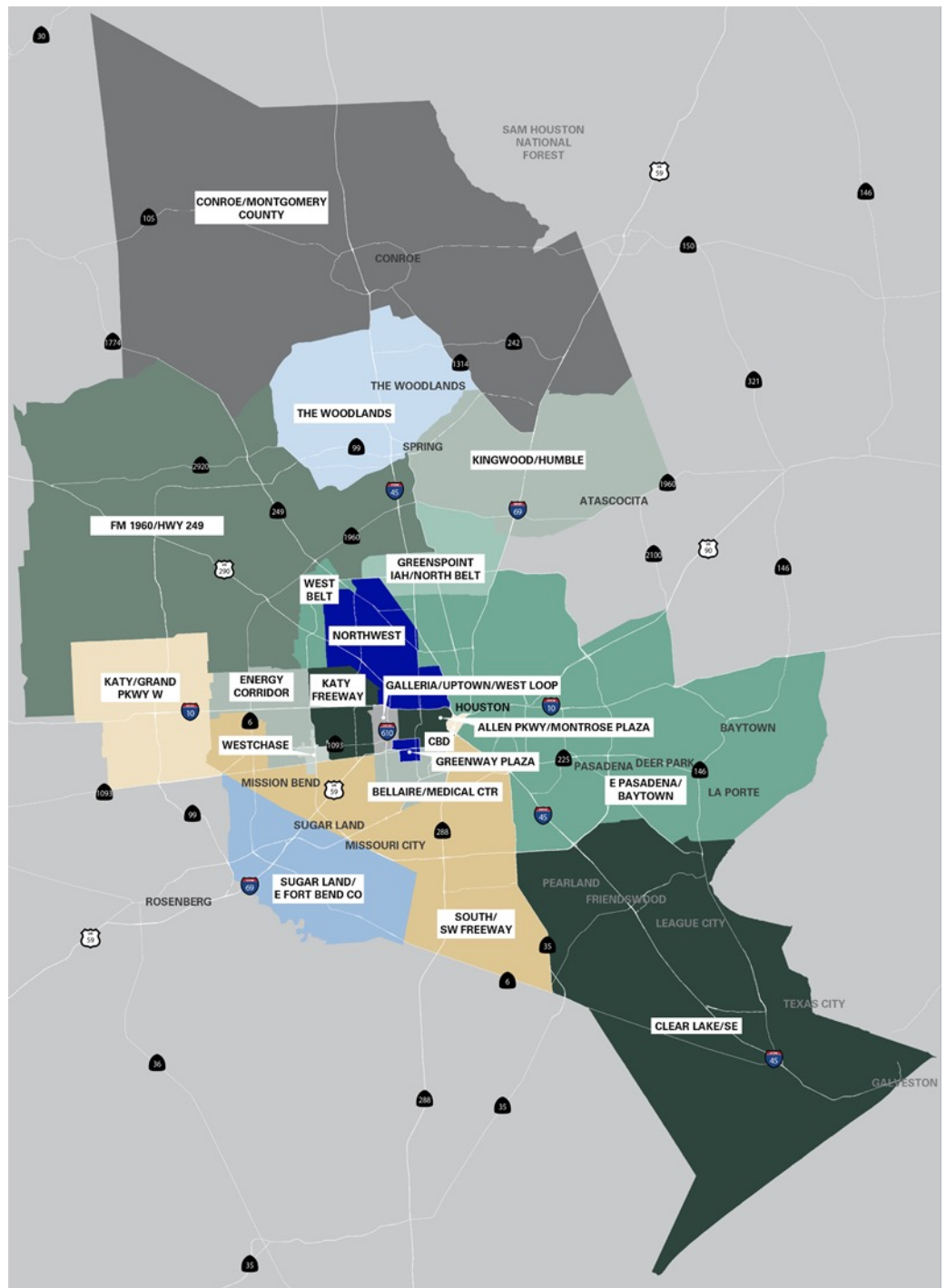
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