Texas Office, Industrial Markets Mostly Healthy Despite Energy Bust

By Laila Assanie

ABSTRACT: Texas commercial real estate activity is poised for a solid performance in 2016, though energy sector-related weakness will constrain prospects, particularly in Houston where an office space overhang should persist.

Texas commercial real estate activity remains strong despite weakness in Houston, which in 2015 began feeling the repercussions of oil prices that started tumbling in mid-2014.

Net absorption of office space set records in 2015 in most major Texas metros, and continued solid demand kept industrial vacancy rates in the low single digits despite high levels of ongoing construction. Rents rose for both industrial and office space and increased markedly in some markets.[1]

Texas' underlying economic expansion has weakened, however. Last year, job growth in Texas downshifted to 1.5 percent from a torrid 3.7 percent in 2014, most notably due to oil prices. Moreover, a strong dollar contributed to a decline in statewide exports and manufacturing output. Consequently, job gains were weak in energy- and manufacturing-dependent metros such as Houston and Fort Worth. Growth remained resilient elsewhere, with Austin and Dallas climbing nearly 5 percent in 2015.

Commercial construction and real estate activity play a noteworthy role in the state's economic expansion, adding to its output and job gains. A healthy and broad-based expansion occurred in Texas office and industrial real estate markets in recent years. The Texas economy declined less than the nation during the Great Recession and grew much faster from 2010 to 2014, fueling commercial property sector growth.

The commercial real estate sector, apart from Houston's office market, should likely continue growing this year. Planned corporate expansions and relocations will fuel expansion in Dallas, and an expanding technology sector will buoy demand in Austin. San Antonio, with a diverse industrial base and a large leisure and hospitality sector that is benefiting from low gasoline prices, will experience moderate growth.[2]

Construction Surge Ebbs

Residential construction contract values held up last year, while nonresidential and nonbuilding construction (principally public works-type projects) first climbed and then pulled back at year-end.[3] The surge was mainly a result of several large projects breaking ground, most notably Facebook's $570 million data center in Fort Worth, Methodist Hospital's $540 million tower in Houston and a $9 billion liquefied natural gas (LNG) export terminal in Corpus Christi—part of a boom in downstream refinery, petrochemical and LNG plant construction and expansion along the Coastal Bend into Louisiana.[4]

Overall, Texas office markets strengthened during the recovery from the Great Recession. Vacancy rates began ticking downward in some Texas major metros as early as 2010, marking the beginning of a turnaround.[5] Office demand was remarkably strong across all major metros from 2012 through 2014, thanks to the shale-oil boom that helped propel the state's economic recovery (*Chart 1*).

Inflation-adjusted total construction contract values set a record by mid-2015, eclipsing the previous peak in 2014. Values remained well above their long-term average—recorded over the May 1970–December 2015 period—as of February 2016.[6]

Dallas–Fort Worth placed second and Houston third on the *Forbes* 2015 list of building-boom cities, ahead of Los Angeles and Chicago. Austin and San Antonio also ranked among the top 20 U.S. metros in terms of total construction starts.[7] Total construction starts (excluding public projects and utility construction) in DFW reached $17.8 billion in 2015, up 19 percent from 2014, while in

Houston, it totaled $16.7 billion—just half its 2014 volume.

Houston construction is expected to slow further this year and into 2017, affecting statewide totals.[8] According to the Beige Book, the Federal Reserve Bank of Dallas' anecdotal survey of economic conditions, funding for new office and multifamily projects has dried up in Houston, and there is not much in the pipeline once projects currently under construction are completed.

Total housing permits (a leading indicator for new-home and apartment construction) in Houston, which made up one-third of the state's total last year, were down 16 percent year over year in February. Moreover, petrochemical plant construction is expected to wind down beginning in 2017.

Houston, We Have a Problem

Plunging oil prices have most affected Houston's office market. Energy firms' leasing and expansion decisions have been put on hold amid cost cutting and downsizing. This is not surprising, given that from 2010 to second quarter 2014, energy firms accounted for 80 percent of Houston's office leasing activity tied to relocation and expansion, compared with 5 percent for DFW and 21 percent for San Antonio.[9]

Employment growth in Houston was weak in 2015 at 0.7 percent due to job reductions among oil producers, their suppliers, service providers and equipment manufacturers. These layoffs have continued in 2016, including the March announcement from Anadarko Petroleum Corp. of a 17 percent workforce reduction.

As a result, the office direct vacancy rate—reflecting space not under a direct lease—increased 2.6 percentage points in 2015 (*Chart 1*). However, when the 7.3 million square feet of available sublease space (as of fourth quarter 2015) is added—a sizeable share of which went on the market in 2015—total availability climbed 3.9 percentage points to 17.6 percent. The total vacancy rate (availability rate) is roughly where it stood in third quarter 2009, but lower than the recent peak in third quarter 2010, in the aftermath of the Great Recession.

Available sublease space increased again in early 2016, to 8.5 million square feet, more than twice the combined size of the Empire State Building and the U.S. Bank Tower in Los Angeles, according to CBRE Research. Houston submarkets such as the West Houston energy corridor, where 58 percent of the office space is occupied by energy companies, and the central business district are among the hardest hit.[10] Surprisingly, net absorption was positive in 2015. However, excluding build-to-suits and single-tenant deliveries, leasing demand fell by nearly 1 million square feet, according to CBRE.[11]

Business contacts in Houston note that building owners are increasingly making concessions, which include six to 18 months of free rent and allowances for space improvements. There is weakness in rents for sublease space; for example, ChaiOne—a technology startup in Houston—obtained a three-year sublease for $9 per square foot, one-third of the going direct lease rate of $26.[12]

Houston was the nation's leader in office space under construction, with nearly one-third (32 percent) of suburban office space being built nationally in 2014, which by year-end 2015 had dropped to 12 percent.[13] Despite the pullback, Houston remains the frontrunner in office space under construction (of which 52.4 percent is preleased) among the four Texas major markets. With several projects expected to be completed in 2016 and further increases in sublease space expected, office vacancies will increase further if oil prices remain below $40 per barrel and hiring prospects remain bleak.

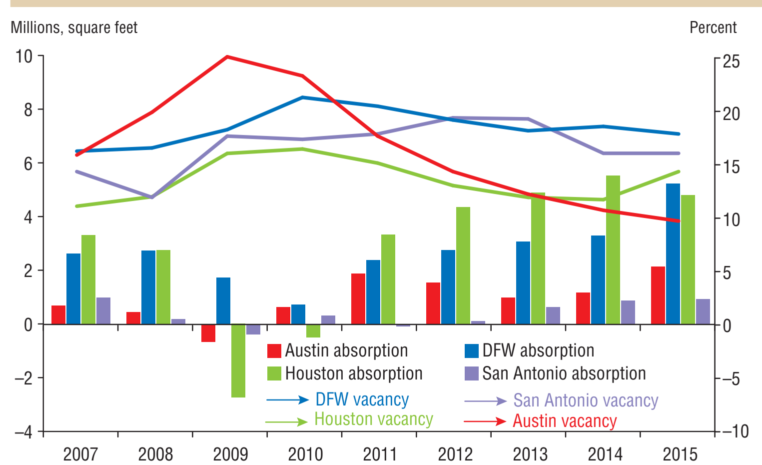
Strong Metro Growth

Net office absorption in Austin reached an all-time high of 2.1 million square feet in 2015; asking rents climbed to a record $31.81 per square foot, according to CBRE. The vacancy rate slid below 10 percent in fourth quarter 2015—the only major Texas metro with a single-digit office vacancy rate, suggesting a very tight market.

Austin was the first major metro to regain jobs lost in the Great Recession. Thanks to an expanding high-tech sector, Austin's declining office vacancy rate has led other major metros (*Chart 1*). Moreover, with the beginning of several large leases executed in early 2015, strong absorption should continue through the first half of 2016, according to JLL Research.[14]

The DFW office market also experienced a banner year in 2015, with nearly 6 percent year-over-year rent growth and record net absorption, thanks to large corporate relocations and expansions such as State Farm and Raytheon. This strength is confirmed by data from JLL Research, which placed Dallas on top of the list in 2015 in terms of total net

Chart 1 Texas Major Metros' Office Markets Diverge



SOURCE: CBRE Research.

absorption among the 50 office markets that it tracks. Thus, by third quarter 2015, the DFW vacancy rate fell to 17.7 percent—the lowest since second quarter 2001.

Similar to Austin and Dallas, net absorption in San Antonio—the smallest of the major Texas office markets—was at a postrecession high in 2015 and rents edged up. Year-over-year vacancy was flat due to speculative space in new properties. Still, investor confidence remains strong with sales of office properties reaching $1.2 billion in 2015, according to JLL Research.

Industrial Vacancies Low

The state's industrial markets were strong in 2015. Net absorption totaled 29 million square feet, of which more than 60 percent was in DFW—a major national trade and distribution center with the state's largest share of industrial space (*Chart 2*). Strong leasing demand pushed vacancy rates in the low single digits in Austin, El Paso and McAllen, suggesting a tight industrial market statewide.

DFW also led Texas major metros in industrial space square footage under construction at 19.7 million square feet in fourth quarter 2015.

Lower oil prices have affected growth of Texas manufacturing output and exports—both key drivers of industrial demand (*Chart 3*). Manufacturing activity has been lackluster since early 2015, according to the Dallas Fed's Texas Manufacturing Outlook Survey. Exports declined 8.7 percent in 2015, largely because of low oil and gas prices, a strong dollar and weak demand, particularly from Texas' major trading partners in Latin America, Canada and China.[15]

Caution in 2016

The future of Texas' industrial and office markets depends on the state's broad economic expansion. The Texas commercial real estate market is in the advanced stages of its expansion cycle, and recent data provide reason for some caution, especially in energy-dependent areas such as Houston.

Continued weakness in Texas exports and manufacturing activity is a discouraging sign for the industrial market. Statewide industrial construction is elevated at 30 million square feet; however, with vacancy rates at multiyear lows in most major metros and Texas inland ports doing well, the industrial market appears to be well positioned to absorb the impact from slowing demand.

Texas service sector job gains have slowed (from 3.3 percent in 2014 to 2.6 percent in 2015), including in information, finance and professional and business services sectors that typically drive office demand. The overhang in Houston's office market will intensify in 2016 as downsizing continues, more sublease space becomes available and new buildings are completed and open amid weakening demand.

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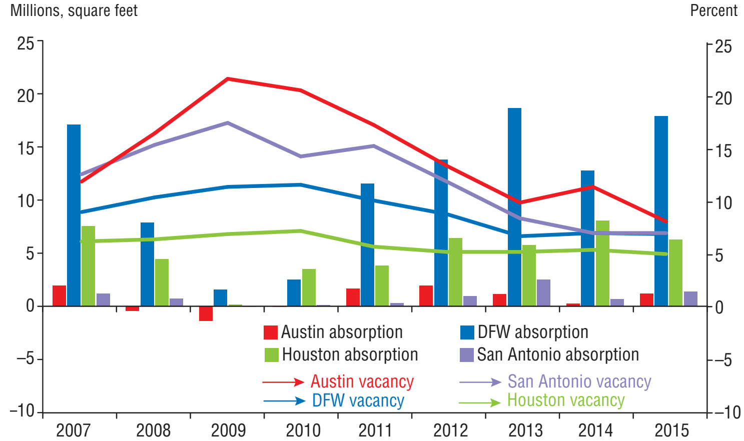
Chart 2 Texas' Industrial Markets Tighten



SOURCE: CBRE Research.

Moreover, a large share of growth in Texas' office market has been driven by corporate relocations and expansions, which accounted for 30 million square feet of occupied space from 2010 to second quarter 2014.[16] This, in turn, supported strong rent growth (*Chart 4*).

While the office market in Houston will continue to weaken, DFW office and industrial markets will continue to perform well in 2016, due to a lesser dependence on energy and the many planned corporate relocations and expansions, including Toyota, Liberty Mutual, Kubota Tractor Corp. and McKesson Corp.

CBRE's Americas Investor Intentions Survey 2016 ranked DFW third on its list of preferred investment metros, behind Los Angeles and New York City.[17] Similarly, prospects for Austin are also strong, with its economy generally unaffected by the oil bust. It was the only other Texas metro to make the CBRE list; it ranked No. 12.

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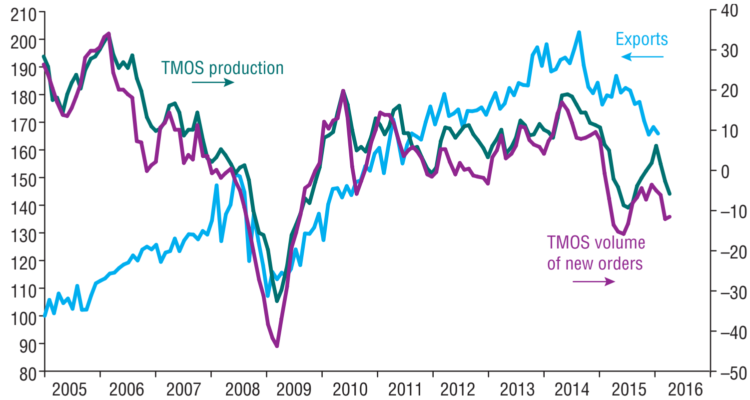
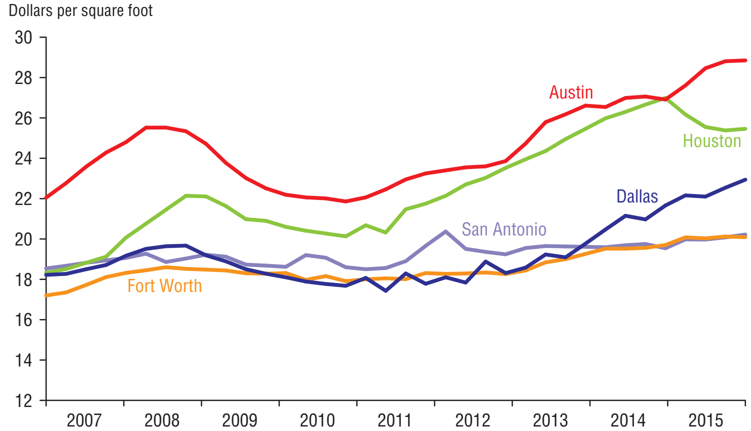
Chart 3 Texas Exports and Manufacturing Output Plunge Following Healthy Growth



SOURCES: Federal Reserve Bank of Dallas Texas Manufacturing Outlook Survey (TMOS); Census Bureau; WISERTrade; seasonal and other adjustments by Federal Reserve Bank of Dallas.

Chart 4 Houston Office Rents Slide; Other Metros Grow Strongly



SOURCE: CBRE Econometric Advisors.

Notes

[1] *Site Selection* magazine awarded Texas its Governor's Cup for top performing state in 2015 (based on the total number of new and expanded corporate facilities)—Texas' fourth consecutive win.

[2] For more detail on Texas metros' industrial profile, see "At the Heart of Texas: Cities' Industry Clusters Drive Growth," by Laila Assanie, Kristin Davis, Pia Orrenius and Michael Weiss, Federal Reserve Bank of Dallas Special Report, February 2016.

[3] Nonresidential construction includes hotels, motels, dormitories, commercial buildings, manufacturing plants, hospitals, schools and colleges, and other public and private buildings. Nonbuilding construction includes highways, bridges, dams, utility systems and power plants.

[4] For more information on petrochemical plant expansion, see "Upstream Bust Meets Downstream Boom in Houston: The East Side Earns Some Respect," by Bill Gilmer, *Forbes* blog post, December 2015; "Diversified Houston Spared Recession … So Far," by Jesse Thompson, *Southwest Economy*, Third Quarter, 2015.

[5] Texas major metros are Austin, Dallas–Fort Worth, Houston and San Antonio.

[6] Real contract values are the inflation-adjusted dollar value of new construction, additions and major alteration projects, but not maintenance. The consumer price index is used to convert nominal values to real. Data are smoothed using a five-month moving average.

[7] *Forbes* 2015 list of Building Boom Towns is available at www.forbes.com/sites/erincarlyle/2016/02/10/building-boom-towns-the-metro-areas-with-the-most-new-construction/#b3cc3595a5e0. The list contains the nation's 20 metropolitan statistical areas where the most money was spent on new construction in 2015.

[8] Over the past two years, 58 percent of Texas major metros' office construction delivered was in Houston.

[9] "Texas Special Report: Impact of Corporate Expansions and Relocations on Major Texas Office Markets," by Sara Rutledge and Lauren Paris, CBRE Research, September 2014.

[10] "Houston Commercial Real Estate: Some Reasons for Optimism Despite Lower Oil Prices," *Viewpoint Houston*, CBRE Research, March 2015.

[11] JLL Research data confirms this weakness. See JLL Research, *Office Insight*, Houston, Fourth Quarter, 2015.

[12] "Behind the Deal: How a Tech Startup Got a Massive Discount on the Sublease Market," *Houston Business Journal*, March 10, 2016.

[13] See CBRE Research, *U.S. Office MarketView*, Fourth Quarter, 2015.

[14] See JLL Research, *Office Insight*, Austin, Fourth Quarter, 2015.

[15] See "Texas Ports Stay Busy as Trade Values Fall Along Gulf, Rise Inland," by Jesse Thompson, *Southwest Economy*, Fourth Quarter, 2015.

[16] See note 9.

[17] See CBRE Research, Americas Investor Intentions Survey 2016.