Houston Office Market QuickTake

April 2020

How we're advising our office tenant clients during these unprecedented times

As Houstonians continue to adjust their lives under the Stay Home Work Safe Order and both the Federal Government and Harris County extend social distancing guidelines through the end of April, we are having a wide range of conversations with our office tenant clients around the disruption to the Houston economy caused by the COVID-19 pandemic combined with the recent oil price war.

The primary topics of discussion have included 1) How COVID-19 will impact jobs; 2) Houston's Office market; 3) What the long-term effects of the decline in oil pricing will be; and, 4) whether these unprecedented occurrences alter rent payments. We elaborate on these topics below.

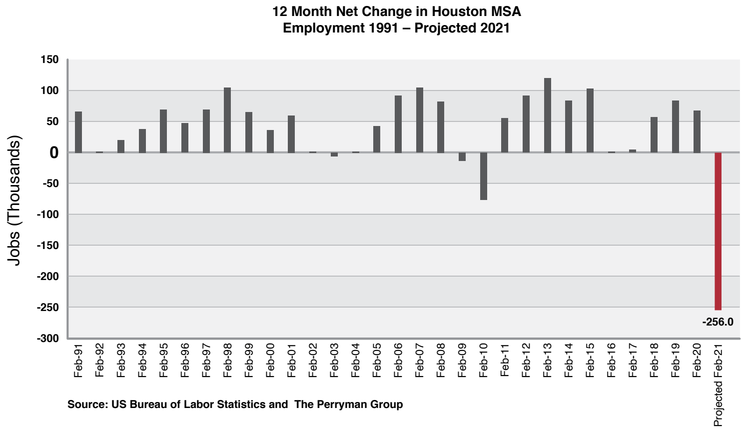
I. COVID-19 Impact on Houston's Jobs

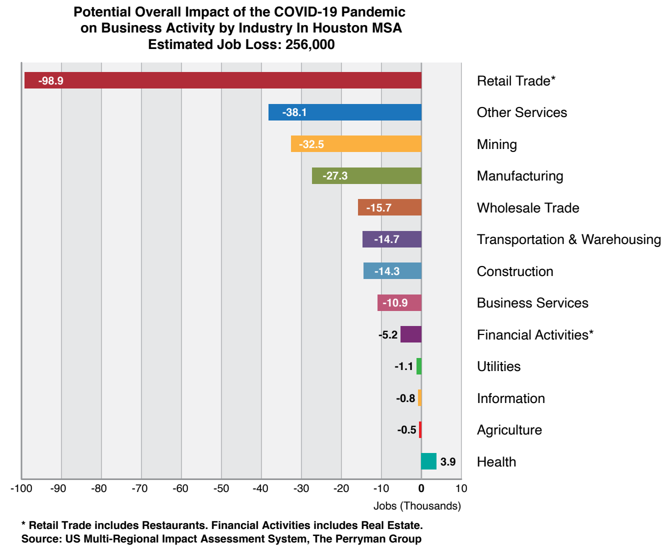
Houston is likely to see significant job losses and an extended burden on its economy from the COVID-19 coronavirus. Given the single week of job losses based on the initial claims for unemployment insurance in Texas and Houston's share of Texas' jobs, it is estimated that mid-March losses in the region will be around 37,945 jobs, reported Patrick Jankowski, Senior Vice President of Research with the Greater Houston Partnership.

The Partnership conducted a recent survey of its small business members and found that 29% were unable to deliver goods or services; 59% are operating below half capacity; and, most concerning, that 41% can survive only 1 to 4 weeks. The three industry sectors that are most at risk during this initial period (and the massive 777,000 jobs tied to those sectors) **are all non-office occupying**, and include: 1) retail—those impacted by social distancing; 2) plumbers and other home services—those whose services can't be delivered remotely; 3) the arts—those that aren't considered essential; and 4) most small businesses that tend to operate on thin margins.

The Perryman Group developed a possible scenario for estimating the eventual effects of the coronavirus based on a variety of public and private source materials, with projected job losses in Houston-The Woodlands-Sugar Land MSA totaling nearly 256,000.

The next Bureau of Labor Statistics' jobs report, which will include the surge of layoffs that happened during the third and fourth weeks of March, will be released in early May and will show the real impact on the job market.





II. COVID-19 Impact on Houston Office Market

While of course no one can predict precisely how long the disruption will persist, one thing we can do is make some educated predictions around possible office tenant responses during and after the pandemic runs its course. Some things we expect to see include:

- Houston's office market already sits at 21.5% as of the most recent data. With even more space—both direct and sublease—likely coming available in Houston, office tenants will arguably have more leverage that at any time in history with regards to negotiating rental rates, terms, tenant improvements and concessions. However, since the market was already soft prior to the current situation, the relative impact to occupancies and rents may not be as significant as would be expected.

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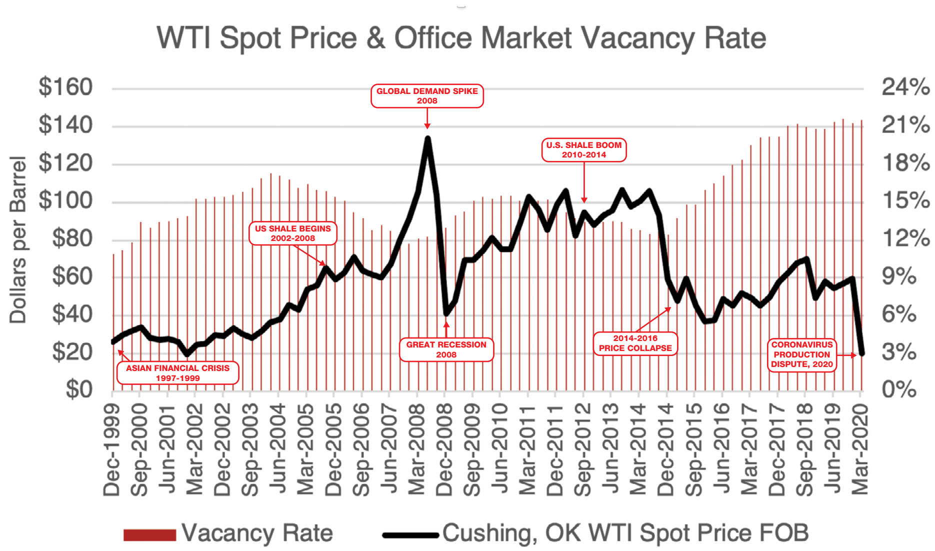
- As appealing as remote work appeared to be becoming about a decade ago, our current collective experience is reminding many in the workforce of the innate desire for structure, scheduling, routine, repetition, and human interaction. This should spell good news for the office market as companies increasingly recognize the business value—not to mention heightened employee satisfaction—of talent collaborating in the same physical space.
- On the other end of the spectrum of the above comment, we've already seen a pushback across many businesses with regards to the open concept workplace, and there will likely be an increased number of requests for office floorplans and/or buildouts with more defined barriers and increased distance between workers.



III. Long-Term Effects of Oil Price War on Houston Office Market

The drop in oil and gas prices will impact the Houston office market; however, the market was already weakened and struggling to recover from the recent oil downturn in 2014/2015. Houston has had one of the highest vacancy rates in the country since the downturn, and NAI Partners' recently released Houston Economic QuickTake projects that it will remain at its current level or marginally increasing over the next year.

It is possible that the Houston office market may experience decreasing rent growth in the near-term months, as the market gets a hold on the economic outcome resulting from the coronavirus (COVID-19) pandemic. Asking rents recently began to recover although that might have been interrupted by the recent course of events. The vacancy rate has climbed to 21.5% in the first quarter of 2020, and there is no assurance that Houston office demand will pick up in the wake of COVID-19 and the current decline in oil pricing.

IV. Rent Payments

Disruptions from COVID-19 will also have an impact on commercial real estate landlords and tenants as difficult decisions are made to adapt to these sudden changes. Many small tenants—particularly retail tenants—have seen revenue drop 50% to 100% in some cases and simply can't pay their rent.

The CARES Act recently passed by Congress provides at least two months' rent and wage relief for companies of 500 employees or less; landlords expect tenants who are able to do so to apply for these funds in order to pay rent.

Landlords are struggling with multiple rent relief requests while still having to pay property expenses and mortgage payments. Most landlords are not simply providing rent relief without either a strong financial case for relief or trading some type of lease extension or other recapture of any abated rent.

We are advising our tenant clients who are having revenue challenges and looking for rent relief to:

1. Immediately apply for any relief via the CARES Act.
2. If necessary, be prepared to provide to the landlord financial information that supports a significantly short-term decline in revenue.
3. Contact your broker and ask them to help with landlord discussions to see if some sort of lease restructuring is possible.