Houston Industrial Market QuickTake

Spring 2020

How we're advising our industrial clients during these unprecedented times

The Houston region is moving towards safely reopening the economy through a gradual process in the direction of a new normal. The business community has a vested interest in getting this right.

The primary topics of discussion have included 1) How COVID-19 and oil price war will impact jobs; 2) energy indicators; and, 3) the impact on the Houston Industrial Market and whether these unprecedented occurrences alter rent payments. We elaborate on these topics below. Source: Dallas Federal Reserve Bank of Dallas.

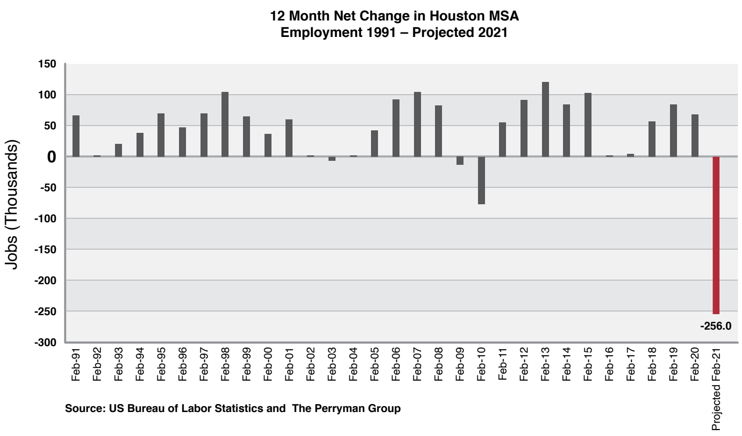
I. COVID-19 and Oil Price War Impact on Houston's Jobs

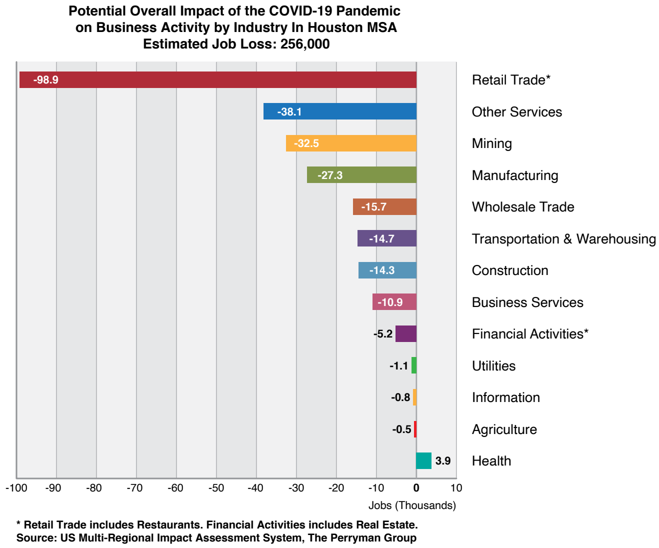
Data for March in Houston have begun to show the effects of efforts to contain the coronavirus (COVID-19) pandemic. Employment contracted, and the unemployment rate rose sharply for March. Weekly initial claims for unemployment insurance in April remained elevated.

Initial estimates for the February-to-March change in employment show a 3.6% annualized decline in total employment (-9,800 jobs), the sharpest one-month decline since August 2009. Declines were led by leisure and hospitality (-5,300), construction (-4,800) and manufacturing (-3,600). Job gains were led by other services (2,000; includes various services such as auto mechanics, dry cleaners and animal boarding).

Unemployment rates shot up in March. Houston's unemployment rate was 5.0%, Texas' reached 4.7%, and the U.S. rate was 4.4%. Initial claims data for the past several weeks suggest that Texas unemployment is likely to more than double to 12.4% (with caveats), an increase likely to be mirrored by Houston, whose shares of Texas' weekly initial claims filings have been persistent at 26–27%.

Initial claims for unemployment insurance in Houston slowed in mid-April but remain elevated. The number of claims allocated to the metropolitan area peaked the week of April 4 at 76,000 but had slowed to 57,800 the week of April 18. However, state-level claims for the week ending April 25, 2020, increased to 437,300. Statewide, claims from workers in the oil and gas sector have been late to rise relative to other sectors like leisure and hospitality, which were hard hit relatively early in the pandemic.





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 in Q1 2021.

II. Energy Indicators

Prices for crude oils fell further in April as weak demand from refiners and consumers drove production into storage. Spot prices at regional hubs traded lower, with West Texas Intermediate (WTI) priced in Midland at $17.

WTI crude futures contracts for May delivery traded below zero for the first time in history on April 20, 2020, as rapidly depleting spare crude storage capacity left many futures market investors unable to find buyers at a positive price before having to close out their positions due to market rules. As funds flowed into the June contract the last week of April, the futures contract for delivery of a barrel WTI in June averaged under $15, down from $27 for the week ending April 17.

The number of active drilling rigs declined sharply in April. The Permian Basin rig count fell 43% to 219 from the end of March to the week ending May 1, its lowest level since November 2016. Across other oil-focused basins, the count dropped by more than half to 69 rigs and drilling in the rest of the U.S. dropped by nearly a third to 120 rigs.

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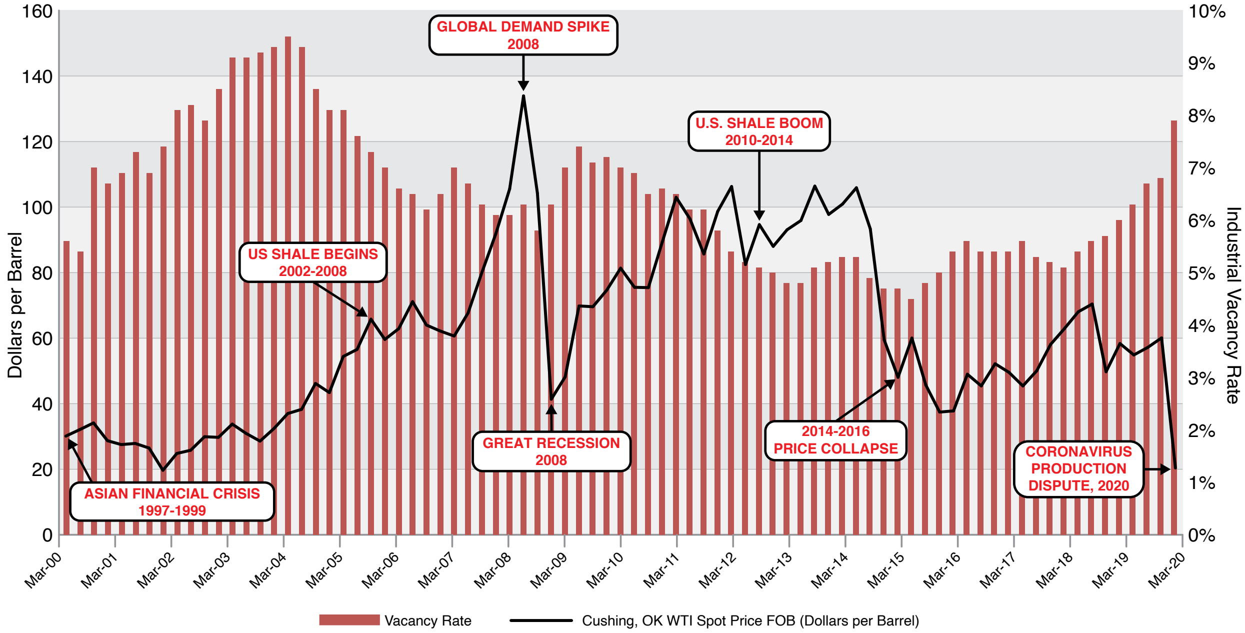
WTI Spot Price & Industrial Market Vacancy Rate



III. Impact and Long-Term Effects on Houston Industrial Market

Houston's industrial market was no doubt the metro's best-performing property sector recently and seemed relatively unaffected by the recent oil downturn in 2014/2015. As the population in Houston and surrounding areas flourished, so did the demand to distribute goods. The previous relatively steady price of oil combined with the population growth made the Houston area a very desirable market for industrial developers, resulting in record levels of completed construction. However, Houston's industrial market does face headwinds amid the ongoing pandemic and oil price war.

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 industrial client responses during and after the pandemic runs its course.

- E-commerce. The surge in online ordering and home delivery makes last-mile distribution and logistics space even more valued. That said, the industrial sector faces downside risks due to declining consumer demand—especially for non-essential items—and supply chain disruptions.
- Port Houston. Port Houston is part of a critical infrastructure industry as identified by the Department of Homeland Security, and continues to operate to keep the supply chain moving and keep commerce flowing to support our region and the nation.
- Construction. Houston has experienced record-breaking amounts of industrial product under construction with the current amount at 18.1 million sq. ft. Even prior to the coronavirus pandemic and the oil price war, there were discussions around whether our industrial market risked becoming overbuilt. The coronavirus pandemic may lead to project delays or a slowdown in groundbreakings over the next few months, as owners, lenders, and developers come to terms with the changing economic environment both locally and nationally.

IV. Rent Payments

Houston's industrial market vacancy rate sits at 7.9% as of Q1 2020. With additional space likely coming available in Houston, larger industrial tenants will arguably have more leverage than at any time in the last decade with regards to negotiating rental rates, terms, tenant improvements and concessions. 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.

We continue to assist our clients by evaluating their current options on a case-by-case basis, including recommending they apply for the CARES Act where applicable, restructuring leases, and reviewing loan covenants, among other solutions.

Moving Forward

While there are a great many things for us all to contend with, it's also important to note that this too shall pass. As we come out on the other side of things there will be new and numerous opportunities for real estate users—and in many cases the circumstances are likely to be even more positive than many of us have seen for some time.

Please take care of yourselves and your loved ones as we get through this crisis together, like we always do with hard work and perseverance. And don't hesitate to contact your NAI Partners broker should you need anything, as this collective experience has even further reinforced for all of us our company's most important core value: putting the client first, always.