Houston Office Performance Update

Edited by Kathryn Koepke **$499/year** **3rd Quarter 2006**

Top of the Line

As Houston's office market has improved since the beginning of 2005, the Class A market has led the way. Since the first quarter of 2005, Class A occupancy has jumped more than 6 points and absorbed nearly 5.5 million square feet. Class A absorption in two of the past four quarters has exceeded 1 million square feet. The other classes have all posted increases, but they have not been nearly as robust. Class B occupancy has gained 1.90 points over the same time frame, Class C occupancy is up less than 1 point, and Class D occupancy has increased 0.79 points.

Increases in Class A rental rates over the past seven quarters have led the market as well. While overall rental rates have increased $1.01 per square foot, or 5.5%, since the first quarter of 2005, Class A rents have gained $1.28 psf, amounting to a 6% increase. In contrast, rents in Class B have increased $0.80 psf, and Class C rents are $0.38 psf higher over the same time frame. The Class D market reports a $0.08 psf decline in rents since the first quarter of 2005.

The upturn in the Class A market has made investors take notice. Recently, the most notable deal in some time was announced, with Brookfield Properties adding to its large portfolio through their purchase of the long-vacant former home of Enron, Four Allen Center, which they have subsequently leased to ChevronTexaco. Investors have also begun to snap up Class A assets outside the CBD, such as the 1200 Enclave Parkway building in the hot Energy Corridor market, recently purchased by Creekstone Partners. Potential buyers will likely continue to be attracted to the Houston Class A market because of its upside, as many buildings have room to increase occupancy and raise rents.

Developers have also begun to eye Houston in earnest, as a bustling economy drives demand for top-flight space. Trammell Crow Co. has begun construction on a 330,000-square-foot building in the Energy Corridor, with plans for another 300,000-square-foot building alongside it. CORE Real Estate is developing a 174,000-square-foot building along the Katy Freeway in the Park 10 area. In northwest Houston, Duke Realty Corp. has announced plans for Sam Houston Crossing, an office park that is expected to have over 700,000 square feet of space at full build-out. The list goes on.

Class A space is the bread and butter of the office market. As the Class A market goes, so goes the overall market. As investors look for deals in Houston, users are often looking to expand existing space or trade up to nicer digs, and developers continue to give those users more and more options.

By: Chris Law

In This Issue

Houston Office Market at a Glance

	Class A	Class B	Class C	Class D	Overall	Qtr	Yr
Occupancy	89.92%	83.13%	81.37%	78.72%	85.76%	▲	▲
Rent/SF	$22.46	$17.51	$14.00	$11.38	$19.24	▲	▲
Absorption	2,250,700	-166,732	-29,722	-27,591	2,026,655	▲	▲

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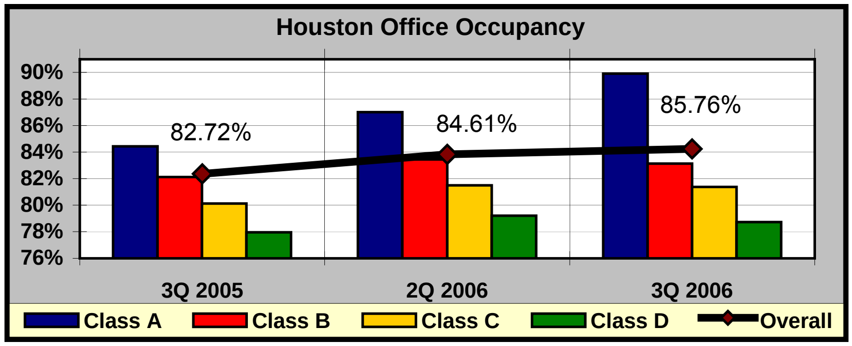
Occupancy & Rent Trends

Metro Occupancy Overview



Quarter	Class A	Class B	Class C	Class D	Overall
3Q 2005	84.44%	82.13%	80.13%	77.95%	82.72%
2Q 2006	87.02%	83.45%	81.50%	79.20%	84.61%
3Q 2006	**89.92%**	**83.13%**	**81.37%**	**78.72%**	**85.76%**

Overall occupancy gained 1.15 points over the quarter to 85.76%. Occupancy has also posted strong gains over the past year, gaining 3.04 points. Despite decreases in occupancy in Classes B, C, and D over the third quarter, a large increase in occupancy in Class A fueled the overall increase.

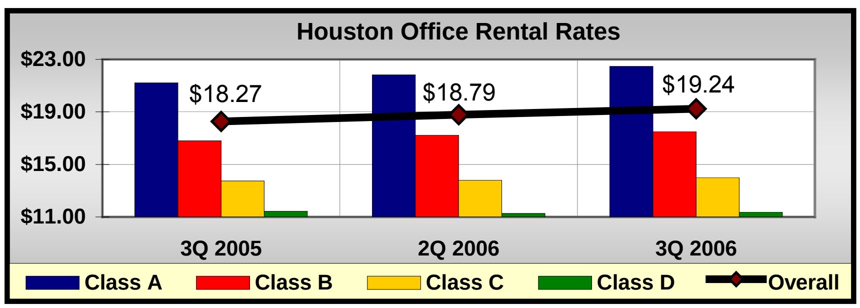
Class A was the only class to post an increase in occupancy over the quarter, up 2.90 points to 89.92%. Occupancy has increased a whopping 5.48 points over the past 12 months. The ***Central Business District*** was a main factor in the quarterly increase, gaining more than 6 points to 90.79%. The ***Southeast*** sector reported an occupancy of 96.90%, while the ***Katy Freeway West*** sector reported an occupancy of 95.77%.

Class B occupancy declined 0.32 points over the quarter; however, occupancy in Class B has gained a full point over the past year to 83.13%. The ***Northeast 1*** sector once again recorded the highest occupancy at 96.56%, while the lowest occupancy was found in the ***Southwest 1*** sector at 60.88%.

Class C reported a 0.13-point drop in occupancy over the quarter to 81.37%. Occupancy has gained 1.24 points since this time last year. ***Southwest 2*** and ***Park 10*** posted the highest occupancy figures at 95.62% and 95.07%, respectively. The ***Fountainview/Gessner*** sector posted the lowest occupancy, at 75.11%.

The **Class D** market posted the largest decline in occupancy over the quarter, falling 0.48 points to 78.72%, but is up 0.77 points over the past 12 months. The sectors with the most Class D space include the ***Southwest Freeway*** sector, which reports an occupancy of 86.14%, as well as the ***Southeast*** sector, with average occupancy at 80.62%.

Metro Rent Overview



Quarter	Class A	Class B	Class C	Class D	Overall
3Q 2005	$21.21	$16.80	$13.74	$11.44	$18.27
2Q 2006	$21.82	$17.24	$13.80	$11.27	$18.79
3Q 2006	**$22.46**	**$17.51**	**$14.00**	**$11.38**	**$19.24**

Overall rental rates continued their steady climb, increasing $0.45 psf over the 3rd quarter to $19.24 psf. Rents have increased $0.97 psf since this time last year. While all classes reported substantial increases in rental rates, overall rental rates were bolstered by a large increase in Class A rents.

Class A rents gained $0.64 psf over the quarter to $22.46 psf, and have jumped $1.25 psf over the past year. The ***Central Business District*** posted the highest rents at $23.89 psf, followed by the ***Katy Freeway East*** sector at $23.61 psf. Rents were again lowest in ***Kingwood*** at $12.00 psf.

Class B rents increased $0.27 psf over the quarter. Currently at $17.51 psf, rents have posted an increase of $0.71 psf since this time last year. The ***Medical Center*** continues to post the highest rental rates at $21.07 psf, followed by the ***Central Business District*** at $18.66 psf.

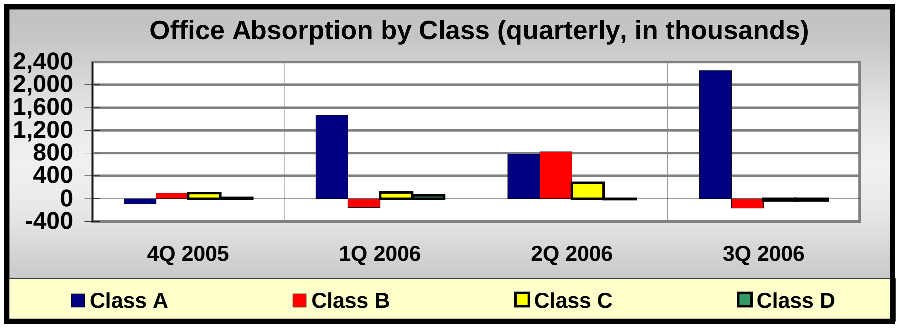
Class C rents gained $0.20 psf over the last quarter to $14.00 psf, the largest quarterly gain since 2000. Rents are up $0.26 psf over the past 12 months. ***Greenway Plaza*** once again posted the highest rental rates at $16.29 psf, while the ***Southwest 1***, ***Southwest 2***, and ***Northeast 2*** sectors posted the lowest rents at $12.00 psf.

Class D rents ended their four-quarter slide, increasing $0.11 psf over the 3rd quarter to $11.38 psf. However, Class D remains the only class to post an annual decline in rents, having declined $0.06 psf. Rents range from $9.75 in the ***Southeast*** sector to $15.36 in the ***Katy Freeway East*** sector.

Absorption, Inventory, & Employment

Metro Absorption Overview

Despite negative absorption in Classes B, C, and D, huge gains in Class A paced the market in the 3rd quarter. Overall absorption over the quarter was 2,026,655 SF, bringing annual absorption to over 5.5 million SF. The ***Central Business District*** led the pack, absorbing over 1.67 million SF over the quarter, with the ***Galleria*** sector a distant second, posting quarterly absorption of 371,105 SF.



12-mo Ending	Class A	Class B	Class C	Class D	Overall
3Q 2004	-245,120	178,952	416,598	273,606	624,036
3Q 2005	672,712	399,364	-266,184	14,100	819,992
3Q 2006	**4,416,064**	**603,500**	**462,384**	**42,365**	**5,524,313**

Class A quarterly absorption was the strongest on record, absorbing 2,250,700 SF. Yearly absorption now stands at a robust 4,416,064 SF. The ***Central Business District*** posted the greatest demand by far, as Chevron's lease of Four Allen Center accounted for much of the quarterly absorption of over 1.67 million SF.

The **Class B** market reported sluggish demand over the quarter after a strong showing in the 2nd quarter. Third quarter absorption in Class B was -166,732 SF, bringing annual absorption to 603,500 SF. The ***Westchase*** sector recorded the highest absorption at 119,387 SF, while the ***Central Business District*** had the lowest at -126,791 SF.

The **Class C** market dipped into the red this quarter as well, absorbing -29,722 SF. However, 12-month absorption remains positive at 462,384 SF. The ***Southeast*** sector reported the strongest demand, absorbing 35,564 SF, while the ***Southwest Freeway*** sector had the weakest absorption at -67,245 SF.

Class D absorption over the 3rd quarter was -27,591 SF, bringing annual absorption to 42,365 SF. The ***Southeast*** sector posted positive absorption of 9,000 SF, while the ***Fountainview/Gessner*** sector had the lowest absorption at -24,014 SF.

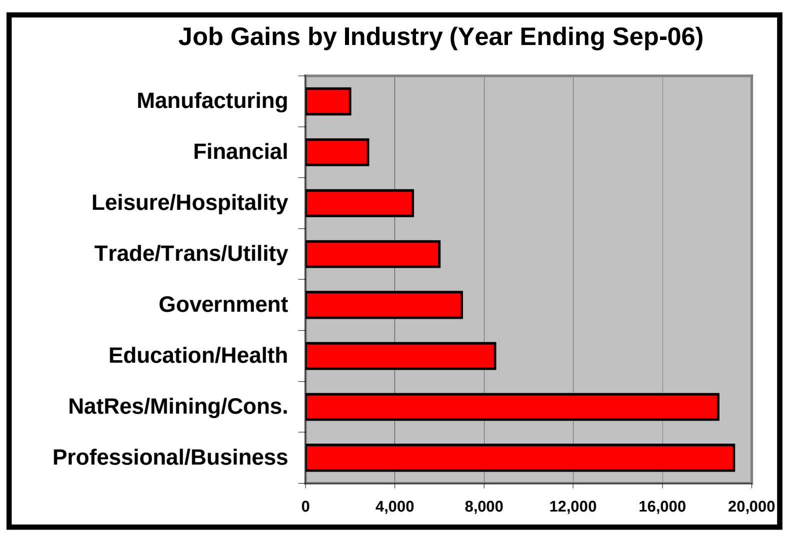
Traditional, Multitenant Office Inventory by Class

There are a total of 1,282 operating traditional, multitenant office properties in the Houston area market with total net rentable square feet of 157,586,089. Approximately 44.91% of the total office space is Class A, 36.81% of the total office space is Class B, 14.71% of the total office space is Class C, and 3.56% of the total office space is Class D.

Type	# of Properties	NRSF
Class A	217	70,775,595
Class B	484	58,011,161
Class C	424	23,187,839
Class D	157	5,611,494
TOTAL	**1,282**	**157,586,309**

Job Growth

The civilian labor force unemployment rate in the ten-county Houston MSA decreased to 4.7%, while the total number of nonagricultural wage and salary jobs increased to 2,442,300 in September 2006, according to the **Texas Workforce Commission**. This month's total is 66,800 jobs more than at this time last year. Of the nonagricultural employers, Professional & Business Services gained 19,200 jobs over the previous 12 months; Natural Resources, Mining, & Construction gained 18,500 jobs; Education & Health Services is up 8,500 jobs; Government added 7,000 jobs; Trade, Transportation, & Utilities added 6,000 jobs; Leisure & Hospitality gained 4,800 jobs; Financial Activities added 2,800 jobs; and Manufacturing added 2,000 jobs. The only industries to lose jobs over the year were the Information and Other Services sectors with -1,500 and -500 jobs, respectively.



Methodology

Data Collection

Our office database contains information on over 1,800 office properties located throughout Greater Houston. Our research team updates property-specific data on a quarterly basis to generate accurate market trend reports on rents, occupancy, absorption, etc. Our surveys also update other property-specific data such as rent types, largest contiguous space available, leasing and management information, and owner information. We perform a current and historical data audit after we close each quarter's survey to identify any data inconsistencies or incorrectly keyed values.

Research

We monitor various news media, press releases, marketing materials, web-sites, CAD records, permit issuance, and other sources to capture new construction, planned projects, financing, and sales. Our researchers conduct phone interviews with relevant developers, brokers, or lenders to gather information on new construction and sales. We add properties to our database on a regular basis to ensure we offer the most up-to-date and complete office database.

Market Coverage

Our office database covers the Greater Houston market and includes properties in Harris, Galveston, Brazoria, Fort Bend, and Montgomery counties. The market is divided into 25 submarkets that correspond to different sectors of the greater Houston area. This approach allows the user to view distinct areas of town in which properties can be identified together.

Glossary

Absorption = Change in occupied square feet, including new construction. Absorption is a proxy for demand.

Occupancy = Percentage of physically occupied square feet on property.

Rents = Market rents.

Class = Properties are classified as A, B, C, & D based on various factors, such as age, location, amenities, overall condition, rents, etc. Class A properties are newer properties, have excellent amenities, prime location, and great appeal, thus they tend to have the highest rents. Class B properties are generally over 15 years old, have good locations, good level of amenities, and are in overall good condition. Class C projects are usually over 20 years old, have few amenities, are in fair locations, and are not very well maintained. Class D projects are generally more than 25 years old, in poor condition, have no or limited amenities, are in poor locations, and tend to have the lowest rents.

Reporting

Occupancy, Rent, and Absorption trend data is based on Operating, Traditional, Multitenant properties. Medical office buildings and single-tenant properties are excluded from the data.