

# The Houston Office Performance Update

Edited by Kathryn Koepke

\$499/year

4<sup>th</sup> Quarter 2006

## Bargain Hunting

Houston's office market closed 2006 with another strong quarter, particularly when it comes to rental rates. Another quarterly increase brought the total increase for 2006 to \$1.29 psf. Furthermore, many industry experts believe the rent increases will continue throughout 2007, thanks in large part to Houston's robust economy.

While rents are up across the board, the largest increase by far has come in Class A, followed by Class B. Furthermore, cost increases for higher-end space have been higher than most realize. Operating expenses have increased over the last year due to increases in utility rates, insurance rates, and janitorial fees, and costs for insurance and janitorial services are expected to rise in 2007 as well. Many landlords quote triple net rental rates and pass costs on to tenants.

All of this adds up to some fairly pricey real estate. Average rents for Class A space in Houston's Central Business District have topped \$25 per square foot, and are nearing that figure in certain other parts of town, notably the Midtown/Allen Parkway area, just west of downtown, as well as the booming Energy Corridor. Add operating expenses of \$10 per square foot or more onto that, and some users are looking at upwards of \$30 per square foot for top-flight space. Rent and expense increases could send this number closer to \$40 per square foot in the coming year.

While Houston's economy is in good shape, plenty of tenants cannot or will not pay such high figures. We may see more users who are on the fence between Class A and B space, or Class B and C space, choose the latter in each case. In turn, Class B and C landlords will find room to raise rents due to increased demand. While rents for lower-end space have increased over the past year, the gains pale in comparison to those in Class A, and operating expenses are not typically as much of a factor as well. It is likely that we will see higher rent increases for Class B and C space this year. Even factoring in robust rent increases, many tenants will still see this type of space as a bargain, especially considering the fact that some believe overall Class A rents will reach a Houston record in the coming year.

By: [Chris Law](#)

### Houston Office Market at a Glance

	Class A	Class B	Class C	Class D	Overall	Qtr	Yr
Occupancy	90.24%	83.75%	82.00%	78.36%	86.21%	▲	▲
Rent/SF	\$23.23	\$17.66	\$14.23	\$11.60	\$19.66	▲	▲
Absorption	305,624	420,376	110,122	-3,556	832,566	▲	▲

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## Metro Occupancy Overview

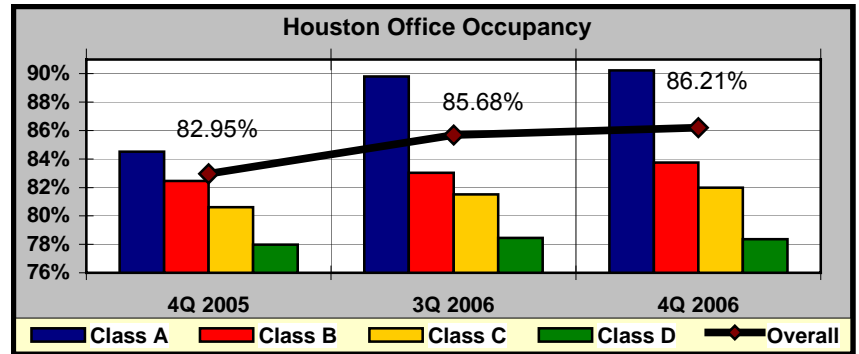
Houston office occupancy picked up 0.53 points over the quarter to 86.21%. Since this time last year, overall occupancy has increased 3.26 points. Occupancy increased in every class over the quarter except Class D, with the Class B market recording the largest increase.

**Class A** occupancy gained 0.43 points over the quarter to 90.24%, marking the first time since the 1<sup>st</sup> quarter of 2002 that Class A occupancy has broken 90%. Occupancy has gained 5.72 points over the past year. The **Katy Freeway West** sector reported the highest occupancy level at 96.35%, while the **Bellaire/West University** sector brought up the tail end at 73.32%.

**Class B** recorded a 0.72-point gain in occupancy over the quarter to 83.75%, bringing the annual increase to 1.28 points. The highest occupancy was found in the **Southwest 2** sector at 97.07%, while the **Southwest 1** sector again reported the lowest occupancy at 68.99%.

**Class C** occupancy gained 0.48 points over the quarter. Currently at 82.00%, occupancy in Class C is 1.38 points higher than one year ago. The **Park 10** sector posted the highest occupancy at 95.38%, while the **Fountainview/Gessner** and **Greenspoint/North Belt** sectors recorded the lowest, at 75.31% and 75.42%, respectively.

**Class D** was the only class to post a decline in occupancy over the quarter, falling 0.09 points to 78.36%. However, Class D occupancy has gained 0.38 points over the past 12 months. The **Sugar Land/First Colony** submarket reported being full, while the **Central Business District** has the lowest occupancy at 32.62%.



Quarter	Class A	Class B	Class C	Class D	Overall
4Q 2005	84.52%	82.47%	80.62%	77.98%	82.95%
3Q 2006	89.81%	83.03%	81.52%	78.45%	85.68%
4Q 2006	90.24%	83.75%	82.00%	78.36%	86.21%

## Metro Rent Overview

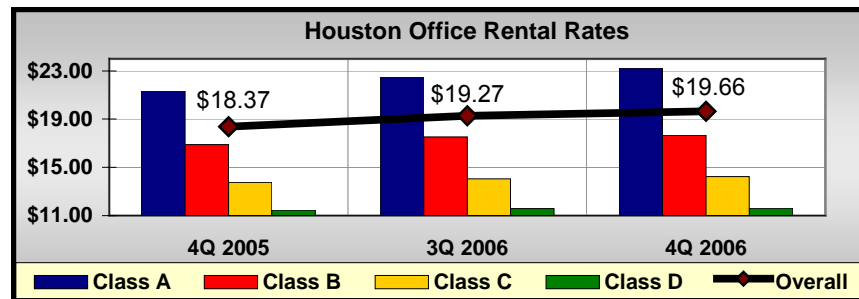
Rental rates posted another strong increase, gaining \$0.39 per square foot (psf) over the quarter to \$19.66 psf. Since this time last year, rents have increased \$1.29 psf. The Class A market led the way once again, although all classes posted increases in overall rental rates.

**Class A** rents spiked \$0.73 psf over the quarter to \$23.23 psf, and have gained \$1.90 since this time last year. The **Central Business District** and **Midtown/Allen Parkway** sectors reported the highest rents, at \$25.21 psf and \$24.89 psf, respectively, while the lowest rents were found in **Kingwood** at \$12.00 psf.

**Class B** rents picked up \$0.14 psf over the quarter to \$17.66 psf, their highest level since the 3<sup>rd</sup> quarter of 2001. Rents have increased \$0.76 psf over the past year. The **Medical Center** once again posted the highest rents at \$22.70 psf, while the **Northeast 2** sector reported the lowest at \$12.75 psf.

The **Class C** market posted a \$0.19 psf increase in rental rates over the quarter. Rents have increased \$0.48 psf over the past 12 months to \$14.23 psf. The **Midtown/Allen Parkway** sector reported the highest rental rates at \$23.06 psf, followed by **Greenway Plaza** at \$16.29 psf. Rents were lowest in the **Southwest 1** and **Northeast 2** sectors, at \$12.00 psf.

**Class D** rents increased for the second straight quarter, gaining \$0.02 psf to \$11.60 psf. Rents are up \$0.14 psf over the past year. **Greenway Plaza** recorded the highest rental rates at \$13.52 psf, with the **Southwest 1** sector trailing the market at \$9.89 psf.



Quarter	Class A	Class B	Class C	Class D	Overall
4Q 2005	\$21.33	\$16.90	\$13.75	\$11.46	\$18.37
3Q 2006	\$22.50	\$17.52	\$14.04	\$11.58	\$19.27
4Q 2006	\$23.23	\$17.66	\$14.23	\$11.60	\$19.66

## Metro Absorption Overview

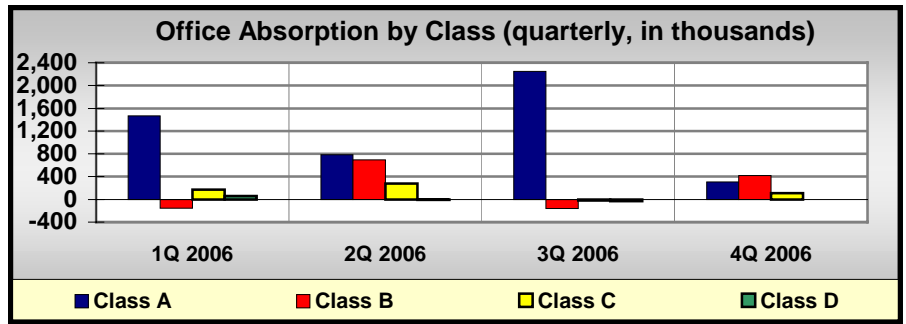
Although absorption failed to top 1 million SF for the first time since the fourth quarter of 2005, fourth quarter 2006 demand was robust. Quarterly absorption was 832,566 SF, bringing the total for 2006 to 6,179,321 SF. The **Galleria** sector posted another strong quarter, this time leading the way with 311,335 SF absorbed, followed by the **Southwest Freeway** sector, which absorbed 202,784 SF.

**Class A** closed the year on a strong note, absorbing 305,624 SF to bring yearly absorption to 4,808,936 SF. The **Galleria** sector reported the strongest demand, absorbing 225,547 SF over the quarter, while the **Central Business District** reversed course from a strong third quarter, absorbing -191,408 SF over the fourth quarter.

The **Class B** market rebounded in the fourth quarter, posting the highest absorption of any class. Quarterly absorption was 420,276 SF, bringing year-over-year absorption to 807,816 SF. The **Southwest Freeway** sector reported the strongest demand, absorbing 224,048 SF, while absorption was weakest in the **Southeast** sector at -54,691 SF.

**Class C** absorption over the quarter was 110,122 SF. Total demand in 2006 was strong, as the market absorbed 540,734 SF. Quarterly absorption was strongest in **Greenway Plaza** at 98,986 SF, while the lowest absorption was found in the **North Loop/Northwest Freeway** sector at -38,488 SF.

**Class D** was the only class to post negative quarterly absorption, absorbing -3,556 SF. However, annual absorption remains positive at 21,835 SF. The strongest demand over the quarter was found in the **Fountainview/Gessner** sector, posting absorption of 17,292 SF, while the **Katy Freeway East** sector posted the lowest absorption at -8,217 SF.



12-mo Ending	Class A	Class B	Class C	Class D	Overall
4Q 2004	-235,808	766,356	262,494	124,936	917,978
4Q 2005	632,548	202,120	34,290	47,398	916,356
4Q 2006	4,808,936	807,816	540,734	21,835	6,179,321

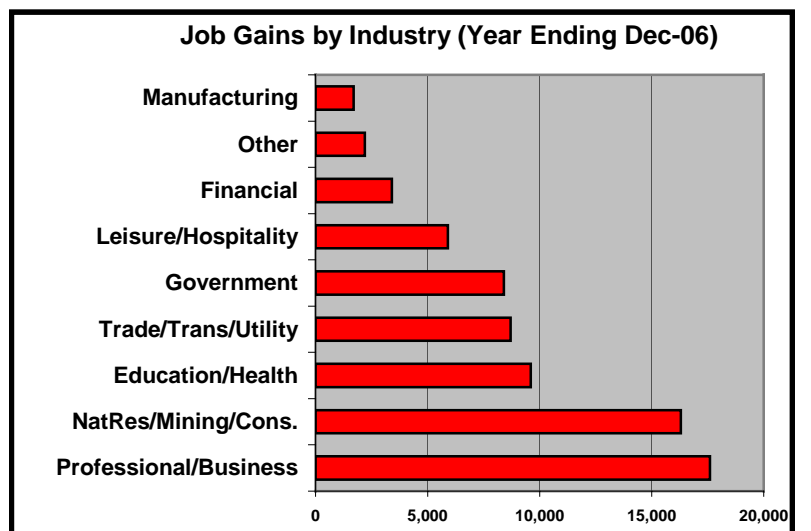
## Traditional, Multitenant Office Inventory by Class

There are a total of 1,277 operating traditional, multitenant office properties in the Houston area market with total net rentable square feet of 156,643,882. Approximately 44.80% of the total office space is Class A, 36.88% of the total office space is Class B, 14.82% of the total office space is Class C, and 3.50% of the total office space is Class D.

Type	# of Properties	NRSF
Class A	218	70,175,357
Class B	482	57,768,065
Class C	424	23,216,087
Class D	153	5,484,373
<b>TOTAL</b>	<b>1,277</b>	<b>156,643,882</b>

## Job Growth

The civilian labor force unemployment rate in the ten-county Houston MSA declined to 4.0%, while the total number of nonagricultural wage and salary jobs increased to 2,477,200 in December 2006, according to the **Texas Workforce Commission**. This month's total is 73,100 jobs more than at this time last year. Of the nonagricultural employers, Professional & Business Services gained 17,600 jobs over the previous 12 months; Natural Resources, Mining, & Construction employment increased by 16,300 jobs; Education & Health Services is up 9,600 jobs; Trade, Transportation, & Utilities gained 8,700 jobs; Government added 8,400 jobs; Leisure & Hospitality added 5,900 jobs; Financial Activities is up 3,400 jobs; Other Services gained 2,200 jobs, and Manufacturing gained 1,700 jobs. The only industry to lose jobs over the year was Information, down 700 jobs.



## 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.



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