

# HOUSTON BUSINESS JOURNAL

Strictly Houston. Strictly Business.

Vol. 38 No. 46 Week of March 28-April 3, 2008

houston.bizjournals.com

## Houston office market thrives even though capital markets stall

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SPECIAL TO HOUSTON BUSINESS JOURNAL

Tenants in Class A buildings in Houston's major submarkets, including downtown, Greenway, Galleria or Westchase, maybe wondering about rent increases of more than 50 percent over the past 12 to 18 months.

They are also likely to wonder how landlords can get away with such increases, considering all the real estate problems nationwide.

The short answer is that Houston may be one of the few markets in the United States that is largely insulated from the real estate problems developing elsewhere. Houstonians need only step back to analyze the factors contributing to these problems and evaluate how the issues are impacting the office building market here.

Across the country, the capital markets are stalled. Last July, on the heels of the subprime residential meltdown, it became apparent that the market had not been pricing risk appropriately. In fact, mortgage lending had become so competitive that in some instances the debt service on commercial loans exceeded actual cash flow. The ensuing market correction included downgrades by ratings agencies and the exit of hedge funds from the commercial real estate market, as either lenders or buyers, resulting in a significant reduction in liquidity.

There are now fewer buyers of office buildings due to more stringent lending requirements and because the Commercial Mortgage Backed Securities tool, a significant source of capital, is largely unavailable. Nationwide, many buildings are not trading as a result of sellers' unrealistic expectations and the increased cost of financing. Many existing owners are so highly leveraged that they cannot afford to sell properties at less than what they paid 24 months ago when overly optimistic underwriting standards were the norm. The

gap between "bid" and "ask" is too large.

Like the rest of the country, the tight credit market will also limit new construction in Houston, particularly speculative buildings. Building sales activity will also be reduced; but, Houston will still see some properties change hands. Owners of buildings in need of upgrades may find that capital constraints preclude renovation, particularly if the borrowing of additional capital is required.

Because of the continuing demand for space by the energy industry, Houston is one of the true bright spots on the national real estate horizon. Institutional buyers like insurance companies and pension funds that are not dependent on CMBS, many of which previously avoided Houston because of its longstanding "boom and bust" reputation, now appreciate that there has been a paradigm shift as Brazil, Russia, India and China energy demand forever precludes \$9 per barrel oil. Houston's reputation as the energy capital of the world is firmly established.

Upward pressure on rents will persist as larger oil and gas companies expand and push smaller companies aside in their quest for high-quality office space. Indeed, this growth, combined with the shortage and delays of quality development opportunities, has already contributed to a spike in Houston office rental rates. Most of the major submarkets in Houston are at 90 percent occupancy or more, and it will be at least two years before any significant new product is added.

In the meantime, as the leases of smaller companies expire, these companies will be forced to agree to enormous rent increases with their existing landlords or look for new space in more affordable Class B quality buildings. Class B buildings in turn will fill up and rates will rise, narrowing the large delta that



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currently exists between Class A and Class B buildings.

The bottom line is that although the national economy may slow for a time, Houston is poised to emerge largely unscathed. With healthy job growth and sustained demand for office space, the city must expect rental rates to rise significantly over the next two to three years.

What is a savvy office tenant to do? Understand the dynamics of his building, particularly the tenant mix and the owner's motivations. Read the lease and familiarize himself with renewal rights — especially as they relate to the notice provisions.

Many renewal options call for the tenant to announce intention to renew and then to negotiate the renewal rental rate.

A well-negotiated lease gives the tenant better rights in this area. Understand what market rates are and how they are determined. Know that there are still viable options in good buildings. The worst thing a tenant can do is ignore this sea change and hope that rental rates will plummet, because that simply is not in the cards — at least not in the foreseeable future. ■

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