CCIM Commercial Real Estate Forecast Competition – February 2020

BY RAY HANKAMER

Keynote Speaker: Mark Dotzour, PhD

We should have a solid economy ongoing in Houston and Texas, with a few 'clouds', such as election year uncertainty, China trade issues, and the Covid19 virus scare. Energy exploration and production will be curtailed due to lack of capital from investor/lenders, which should eventually lead to an upward trend in oil prices. Our current economic expansion is into its 129th month, and going strong. 2020 will be a little slower but consumer confidence and most other economic indicators remain strongly positive. Commerce is so interconnected on the planet that trade disputes will inevitably need to be worked out. Even if 2020 is a little slower, it should create pent-up demand for 2021. Wages are up about 3.5% a year, and lots of job openings remain, despite steady increase of hiring, which has been in the range of 200-300,000 new jobs per year in recent years. Housing starts are up and household debt is down; corporate profits are leveling off-companies did not reinvest savings from last tax cut but instead bought own stock. Unemployment claims are way down, and interest rates are low and going lower. It is a 'given' that we will have a recession in next five years but it is not on the immediate horizon.

Houston Industrial

Moderator: Nathan Gaines, Clark Gaines Properties

Speakers: Alexander Reilly, Boyd Commercial and Walter Menuet, Jr., Colliers

Takeaway: Houston industrial has been tied traditionally to oil & gas, but that is changing. We are having unprecedented new deliveries of space, with 26-30 million SF under construction. Some are immense projects, over 500,000 SF each. Pre-lease rate of new construction has been in the 25-30% range, and there are 8 million SF of owner occupied distribution projects such as Ross Stores, Costco, Dollar Tree, Ikea, and more. Pipeline of new product includes 56 buildings by 30 developers. Development strong in SE, NW, N, and SW markets, and as far out as Chambers County. Finding suitable sites has become more and more challenging. Land sellers have achieved higher and higher pricing as high as $7-8 SF in some cases, as REITs and others compete for prime sites. Consumables for distribution, e-commerce, chemical and plastics have been primary drivers for occupying new space. With big supply in place and in the pipeline, free rent and other concessions are beginning to creep into the market. Flight to quality is leaving some older facilities vacant and open to upgrading where possible.

- Sophisticated tenant-users need to hire engineers to direct their move-in and new space utilization
- Lots of investors are looking for Houston industrial deals and this demand exceeds supply at the moment
- A 540 acre Kansas City Southern rail play is in development as far away as El Campo, including warehouse space
- Large players such as Prologis and Blackstone are buying up sizeable portfolios in the area

Houston Medical

Moderator: Davis Griffin, Trammell Crow Company

Speakers: Nelson Udstuen, CBRE and Justin Brasell, Transwestern

Takeaway: Growing overall population in Houston area, coupled with aging and longer life expectancy explain overall growth in medical real estate, although there are minor headwinds, including rising real estate and rent costs, declining government reimbursements to physicians, and contract disputes between insurers and health providers. Nevertheless, healthcare real estate overall is thriving with the trend toward more patient-friendly medical professional buildings with more amenities, ranging from more natural light to valet parking. Class A space has reached above $30 SF to as much as $35. Tenant buildout in these facilities is very expensive and sometimes the landlord, reluctantly, chooses to add financial back-up to the cost of physicians' suite buildouts.

- Patients' experience in the building is now paramount; older medical office buildings were more functional and less patient- and staff-friendly
- "We are very bullish on MOB rental rates"...although depending on the specialty of the physician, some cannot pay the highest rates
- The Woodlands is seeing high rental rates, with its well-insured population, and high quality construction
- West Houston has plateau-ed for the moment, but is still a strong market
- Inner Loop needs great facilities, but they are expensive due to high land costs
- The Med Center market is super-expensive due to scant availability

Houston Office

Moderator: Bill Brownfield, Brownfield & Associates

Speakers: Matthew Goldsby, Belvoir Real Estate and Marty Hogan, JLL

Takeaway: Houston is still recovering from its energy hangover, and at a much slower rate than many of us would like. We continue to have around 20-25% vacancy, and owners of older buildings are forced to upgrade buildings to keep pace with the latest amenities that are included in new buildings, and even large remodeling expenditures will not guarantee new tenants, but not to renovate is to 'retire from competition'. Mild positive absorption is expected to continue throughout this year.

- Rents and concessions remain stable
- Class A rates in CBD are in $44 range and about $32 SF in suburbs
- The office segment is bumping along bottom, and-if cautious-it is a great time to buy office buildings
- Many existing leases made in stronger times have yet to come due, and tenants will expect to renegotiate them at current (lower) rates
- The traditionally accepted 'stabilization rate" of Houston office market is considered to be 85% occupancy, and we have a ways to go to reach that
- The Greenspoint market remains at 60% vacancy and it alone accounts for about 1% of the overall Houston market office vacancy rate

Houston Retail

Moderator: Ed James, Streetwise Retail Advisors

Speakers: Christie Amezquita, SHOP Companies and Kristen Barker, Wulfe & Co.

Takeaway: Lots of activity and re-concepting of vacated big box lease spaces. Many retailers looking to expand to Houston market. Brick and mortar stores are not going away, but adapting to the eCommerce climate. This includes big department stores, which are hosting mini retail 'pop-ups' on their premises to test out new products, such as renting of high-end clothing. Fast casual concepts abound now in retail centers in food, fitness, entertainment (such as bowling and small movie houses), and other concepts. Newly vacated big spaces are actually welcomed by landlords who can often convert them into higher yielding tenants. Lots of 'ground floor retail' is going in under vertical multi-family and in mixed use developments, of which there are several under construction along Allen Parkway. European style density is happening with retail within walking distance of residential units. Increasing use of Uber and Lyft is reducing dependency on cars, which reduces parking ratios needed.

- Retail follows rooftops, so development is under way in far-flung suburbs such as Fulshear, Richmond, and Magnolia, to name a couple
- Outdated indoor malls are being converted to outdoor malls, with big success
- When large stores like Randalls, Bed Bath & Beyond, and Pier 1 close, landlords can actually better their income by subdividing the space or finding new tenants for the full space such as government offices and community colleges
- Medical service tenants continue to locate in drive up retail centers
- Occupancy in Houston retail is in mid 90s
- E-Commerce is at 16% of total retail and may go to 25%, BUT online-only stores are beginning to open brick & mortar stores…think Apple, and Amazon buying Whole Foods…online sellers are feeling the need to 'know their buyers in person' through brick and mortar interaction

Houston Multi-Family

Moderator: Blake Willeford, Greystone Co.

Speakers: Ryan Terrell, Greystar and Swapnil Agarwal, Nitya Capital

Takeaway: There are 28,000 units under construction, with 2/3 of these inside the Loop and in the West Houston suburbs. Absorption of 8,800 units is forecast. Class A occupancy is 86% and Class B about 92%. 52,000 units will sell to investors in 2020. Houston has had job growth but disappointing amount of white collar jobs, and the recent downturn in O&G has impacted multi-family absorption. There is growing interest in affordable housing opportunities. Rent growth will be nominal this year, about 1.8%. There are more and more vertical projects in Houston, with retail on the ground floor. Class C projects are seeing a higher rent growth, in the 4% range. There are some deals being attracted to Opportunity Zones. Election years give some uncertainty.

- There is a lot of capital looking for the right deal, and Houston sellers are holding out for higher prices compared to other Texas cities.
- Investment funds are buying projects here with no or low leverage. Better rent growth is expected in 2021 as new supply slows.
- Projects are upgrading with slick amenities, such as keyless entry and iPhone apps controlling in-unity gadgetry. Owners are installing 'whistles and bells' to justify pushing their rates.

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Houston Land

Moderator- Bill Byrd, Colliers

Speakers: Keith Edwards, Caldwell Companies and Taylor Schmidt, Lee & Associates

Takeaway: Many Houston fortunes have been made through investing in land, but careful due diligence is required. Are you buying unimproved raw land, or land which has already been prepared for immediate development? Is the location the best, considering demographics, growth projections, and area amenities? Are you buying tracts for residential or industrial use? Have you done the due diligence that your eventual buyer will also do, so that your tract will fit his needs? Houston large tract activity is following expansion of the Grand Parkway and the "Aggie Expressway", which is the extension of SH-249. Increased accessibility/mobility usually leads to population growth and demand for land. "Pricing on industrial land is the highest I have ever seen."

- Houston's population predicted to grow by 3 million in next fifteen years, which should continue to push land values higher
- Risks in land speculation include surprise government regulations such as detention requirements and other flooding related issues, or inability to plug into an existing MUD
- There continues to be lots of activity in retail, multi-family, and industrial in the region, and all of course need land
- "We are all as busy as we have ever been" and activity should remain strong for at least the next two years
- Detention requirements can suddenly be expanded from say 15% to 40%, or government authorities can require donation of large drainage ditch rights of way-all of this increases the cost of the usable remainder of the site
- Shovel-ready sites are very scarce, and conversion of raw land to shovel-ready status is time-consuming and expensive
- There are industrial parks going into Brookshire, Waller, Hempstead, Conroe, Richmond-Rosenberg, Crosby, Dayton, Liberty, & Sealy
- Single family developers look first for good school districts; industrial/distribution users look for easy road access and sometimes rail
- We are seeing land development 360 degrees around Houston, and farther and farther out