FORECASTING 2017:

A PREVIEW OF WHAT IS TO COME FOR OFFICE AND INDUSTRIAL MARKETS

Rand Stephens, Managing Director & Principal of Avison Young's Houston office

Jeannie Tobin, Avison Young's Regional Research Director Houston office

BY BRANDI SMITH

"It's certainly better than it was."

That may not sound like a ringing endorsement, but Rand Stephens, Managing Director and Principal of Avison Young's Houston office, is hedging his bets after a rough 2016.

"Just starting out in January 2016, oil went down to $28 a barrel. There were a lot of gloomy faces in Houston," he says. "Houston is an incredibly optimistic place, but there is definitely an air of pessimism."

Outlook for office

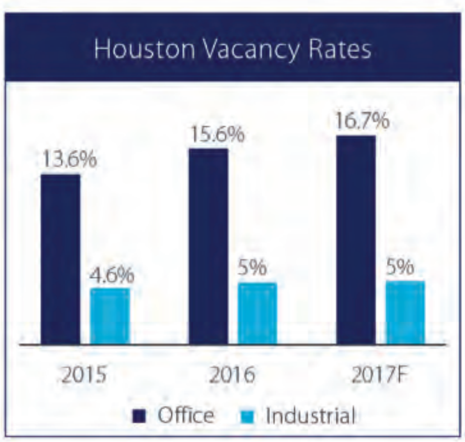
The low price of oil prompted corporate mergers, layoffs and, in some cases shutdowns, resulting in skyrocketing office vacancy rates. Per Avison Young's Office Research Report, 38 million square feet of office space was available in the fourth quarter. Roughly 11.6 million square feet of that was in the form of sublease space. Examples include 262,000 square feet at Energy Center II offered by Worley Parson and another 380,000 square feet left behind by BG Group at 811 Main.

"Sublease tends to put downward pressure on the rental rates, but the buildings are still leased and they're still paying rent," Stephens says. "A lot of that sublease space is from oil and gas companies in the Energy Corridor."

In mid-2016, as total available space reached the highest rate recorded in the past two decades, new deliveries also flooded the already saturated market.

"I would say that we bottomed out," Stephens says.

In Q3 alone, Houston saw more than a million square feet added via projects including BHP Headquarters (560,000 square feet), West Memorial Place II (385,532 square feet) and Wildwood Corporate Centre II (201,618 square feet). Stephens, though, says it could have been worse.



"After the Great Recession, acquisitions and development have been underwritten and financed much more conservatively," he says. "That conservative financing really gives owners and investors sustaining power that they need when you hit a downturn."

Stephens and Jeannie Tobin, Avison Young's Regional Research Director, both predict slow and steady growth in the Houston office market in 2017.

"Going into this year, the construction boom is wrapping up, so we're going to see less of an impact from new deliveries going forward," Tobin says.

"The outlook is one of guarded optimism," describes Stephens.

He says one signal the Houston office market is turning around will be the shrinking amount of sublease space.

"I do think that sublease space is going to remain high throughout 2017," Tobin says. "You're really not going to see it disappear until really the energy market turns around and then it will be slow recovery in 2017."

"It can go away in a hurry. Oil and gas companies can just say, 'You know what? We're just taking that off the market. Now we're going to occupy it,'" says Stephens. "I think we'll start to see some declines in sublease space and that will be the first indicator that the office market is recovering."

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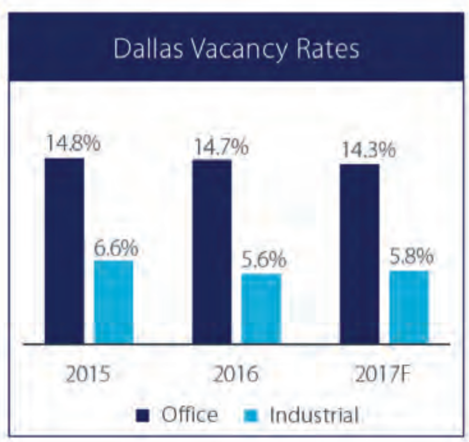
Stephens says, "Though oil prices still aren't at the level they were a couple years ago, the energy industry has adjusted and reorganized in a way that will allow positive growth in the year to come."

As much as Houston struggled in 2016, other metro areas of Texas boomed. Avison Young expects that growth to continue.

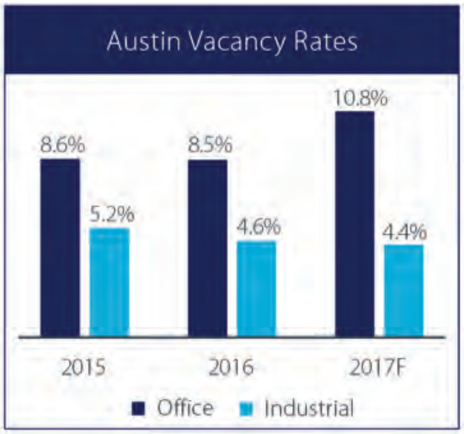
"Dallas, Austin and San Antonio have excellent economies," Stephens says. "Dallas has one of the best in the country and so does Austin."

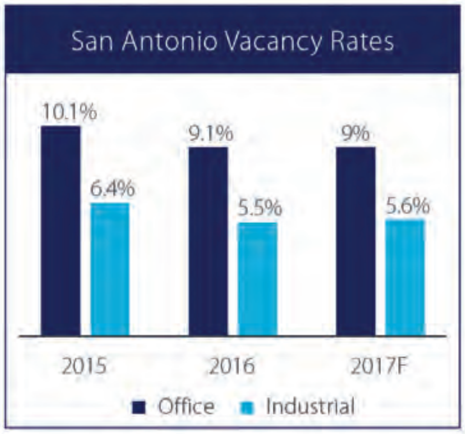
The Metroplex, for example, saw its office vacancy rates drop to 14.7 percent and net absorption reach 1.6 million square feet by the end of 2016. Avison Young predicts vacancy rates will hold around 14.3 percent in 2017.

"Dallas is a very attractive place for investors right now because it's established itself as a place that avoids the boom and bust behavior and also shows years of substantial growth," says Tobin.



The company's North America, UK and Germany Forecast says, "Many large tenants are opting to expand into new space in an effort to attract and retain a talented workforce. The space left behind is quickly being backfilled, causing vacancy to remain relatively stable even as new





construction continues to be delivered to the market."

"Highly landlord-favorable" is how Avison Young describes Austin. The third quarter of 2016 saw the Texas capital rebound into positive absorption with a vacancy rate hovering around 8.5 percent.

"Should tightening occupancy carry through 2017, rental rates and new construction are expected to sustain year-over-year growth," the Forecast reads, predicting office vacancy to increase to 10.8 percent in 2017.

San Antonio celebrated similar growth: decreasing vacancy rates (9.1 percent) and increasing absorption (roughly 700,000 square feet). In 2017, Frost Tower, the city's first new high-rise building in 30 years is expected to break ground and Avison Young reports 250,000 square feet of the tower have already been preleased.

"The new tower could mark the beginning of the revitalization of San Antonio's urban core," the 2017 Forecast says.

Outlook for industrial

While Houston's west side took a hard hit in the office sector, industrial development on the east side took off.

"There are a lot of companies that are here because they buy chemicals and they buy refined products that they use in manufacturing. They're here to buy those raw materials, make something, then ship it out around the world," Stephens says. "Those kinds of companies have been doing great because cost of their raw materials are down."

Proof is in the numbers: though 13.9 million square feet of industrial space (including Daikin's 3.9-million square foot manufacturing campus) was delivered in 2016, the market has maintained a 95 percent occupancy rate. In 2016, more than 8.7 million square feet of industrial was absorbed.

"The industrial market has done incredibly well over the last couple years," says Stephens. "We've seen great opportunities on the east side of Houston. A lot of our clients who are third-party logistics companies have expanded to accommodate the growth."

Sublease space is also an issue when it comes to industrial. In fact, Avison Young reports the amount available more than doubled from 2.4 million square feet in Q4 2015 to 5.2 million square feet in Q4 2016, though the most of that space is in North or Northwest Houston.

The industrial market is doing well across the state of Texas as population growth continues at a record pace.

"There are some pockets of the industrial market that are struggling and will take a little while to recover. Quite a few crane-served buildings were recently built for the energy industry with the assumption that they would be preleased quickly, but they weren't," Tobin says. "The activity on the east side is more than compensating for those little pockets that aren't doing so well."

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In Dallas, Avison Young credits population boom to a "demand in industrial users." The company's 2017 forecast points to e-commerce suppliers as examples of users who have DFW in their crosshairs. In 2016, the region recorded the highest quarterly absorption in 10 years even as construction levels reached historic highs.

"The Dallas metro area has world-class transportation access via air, rail and road, making the city an ideal location for warehouse and distribution properties," the report says, predicting a slight uptick in vacancy rates from 2016's 5.6 percent to 5.8 percent in 2017.

San Antonio, meanwhile, is working to position itself as a distribution hub with considerable success. Absorption rates increased in 2016, a trend Avison Young expects to continue in 2017. The company also anticipates industrial vacancy rates around 5.6 percent, down from 2014's 6.4 percent.

Compared to its neighbors along I-35, Austin's industrial market is moving along quite slowly, though the city added 1.8 million square feet of industrial space in 2016.

"Austin's industrial market faces a growing challenge from a declining employment rate in the manufacturing sector and the threat of industrial space being redeveloped for mixed-use and creative office space," Avison Young's 2017 Forecast explains.

The company expects the industrial market there to stay tight, averaging 4.4 percent vacancy in 2017.

Avison Young was a winner of Canada's Best Managed Companies program in 2011, 2012, 2013 and 2014 and re-qualified in 2015 to maintain its status as a Best Managed Gold company