Houston CRE Market Shows Resilience in Face of Hurricane Harvey

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Hurricanes, tropical storms and floods are familiar occurrences in Houston and the surrounding Texas Gulf region; more than eight severe floods/hurricanes have impacted the Houston MSA since 1998.

But when Hurricane Harvey struck the region near Rockport, TX on August 25, the Category 4 storm was the strongest to hit the region since 1961, dumping more than 50 inches of rain in a matter of days and causing extensive property damage due to flooding.

In addition to its devastation on Greater Houston, Harvey's impact was national in scope as well. Port Houston-the largest U.S. port in foreign tonnage and home to the nation's largest petrochemical complex--closed for 4 1/2 days after the hurricane and reopened on September 1. Most refineries along the Texas Gulf Coast, which is the nation's largest producer of oil and gasoline, have also restarted operations, while others, such as Valero, have returned to pre-storm fuel-making rates. Nationally, consumers will see an increase in gas prices of about $0.08 - $0.10 for the next several months.

Houston is a major distribution hub because of its massive seaport and strategic location along well-established supply networks. Interstates 10, 69 and 45 are among the busiest highways in the U.S. and ultimately connect Los Angeles to Jacksonville, Houston to Port Huron, and Houston to Dallas. Flooding and other unforeseen hazards caused disruptions to not only regional, but also global supply chains since late last month. Re-routing inefficiencies, costing approximately $53 million daily, will be short-lived as water and other obstructions are cleared from Houston highways.

In Hurricane Harvey's aftermath, CBRE Research has completed an initial assessment of the impact on local and national commercial real estate. Following are highlights of our findings.

Source: Robert Kramp, CBRE
Director of Research & Analysis
Texas and Oklahoma Region
robert.kramp@cbre.com

Office Market Mainly Unscathed

Nearly all of Houston's office buildings escaped the worst flooding. CBRE Research estimates that of the city's 1,200-building, 214 million-sq.-ft. total inventory, fewer than 40 buildings totaling approximately 9 million sq. ft. had some level of damage. Most of the office product impacted by flooding is in four areas to the west and northwest of the CBD--West Houston, Allen Parkway, West Loop/Galleria and FM 1960/ Highway 249. These submarkets comprise 74.6 million sq. ft., or 35% of the total Houston office market, which were 84% occupied at the end of the second quarter.

Displaced tenants are already actively searching for suitable, furnished and turn-key temporary space. Many of these tenants expect to return to their original locations as soon as next month. Consequently, many of them will sign very short-term leases rather than longer-term direct ones. There was more than 11.1 million sq. ft. of available sublease space in Houston at midyear, providing numerous options for these tenants. As a result, we expect to see a decline in sublease availability in the third quarter. Meanwhile, some direct tenants previously marketing sublease space have removed their sublease availabilities from the market for two main reasons: orchestrating an office move in the next several months will be difficult, and office build-outs of their future space will face construction delays caused by a shortage of materials and construction workers.

Industrial Real Estate Occupancy to Rise

Labor and resource reallocation--along with short-term disruptions, including lost productivity and interrupted supply chains--are some of the immediate pressures facing Houston's industrial market. There were isolated instances of damage to institutional, dock-high Class A product, particularly on the West Side and along the I-10 corridor. The clear majority of Houston's industrial product weathered the storm with no major structural damage.

Figure 1: Harvey by the Numbers

		Source
51.88	inches of rainfall in five days—a record for a single tropical storm in the continental U.S.	
24.5	trillion gallons of rain fell in Southeast Texas and Southern Louisiana	Washington Post (Sept. 2)
$81 billion - $108 billion	estimated cost of property damage and economic loss	Moody's
10%	of nation's fuel-producing capacity impacted by Harvey	Texas Monthly
30,000-40,000	homes destroyed	Harris County
~40	office buildings had some level of damage (mostly lobby and parking garage)	CBRE
~105,000	apartment units damaged	Houston Apartment Association

Houston's largest industrial cluster, the inner Northwest and inner North/Northeast, reported few "major damaged" or "destroyed" properties, according to the Federal Emergency Management Agency (FEMA). Moody's Analytics estimates a loss of 6% to 8% of industrial value, or $2.6 billion, based on analysis and comparison to similar occurrences. The damage likely is greater within older properties and those located near Houston's bayous.

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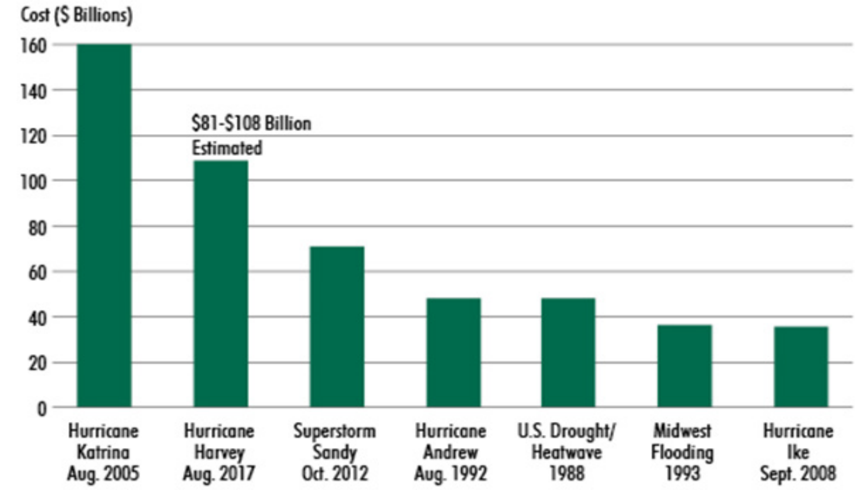
Figure 2: Top 10 Costliest Natural Disasters in U.S. History



Source: Moody's Analytics, Houston Business Journal, National Centers for Environmental Information.

Several national building supply companies are presently securing additional space for the extensive $100 billion+ rebuilding effort that will occur over the next year. A spike in requirements ranging from 20,000 to 500,000 sq. ft. is expected to put downward pressure on industrial vacancy rates over the near term, driven by building suppliers, charities and distributors of consumer goods. Many non-flood-related industrial requirements will likely now go unfulfilled.

Houston's massive reconstruction and repair project (including an estimated 100,000 homes) likely will fuel a significant increase in industrial occupancy--particularly in light-industrial space, which correlates highly with building and construction material distribution. Wholesale and retail distribution activity should also increase, as consumers replace damaged furniture and other household goods.

Affected Texans will also have to replace nearly 660,000 destroyed or severely damaged vehicles. This will help jump-start vehicle sales, which have been slowing in recent months, which should benefit multiple markets along the complex automotive and automotive parts supply chains.

Retail Leasing Market Will Tighten

Prior to Harvey, Houston's Class A retail market was 97% occupied in the second quarter--a record high. Hurricane damage to retail properties was not widespread; it was mainly limited to neighborhood and strip centers in the hardest hit areas, such as the suburban and mainly single-family residential neighborhood of Kingwood to the northeast, Cypress in the northwest, and to West Houston.

As a result, Harvey is not expected to impact national retailers' expansion plans, although a market strained by limited availability will continue to hinder leasing. Displaced retail tenants have already begun searching for temporary space, with little success due to the tight market conditions. Home improvement and related retailers already active in the robust housing market are expediting their location decisions to capture demand for housing repairs due to the historic flooding.

Local retail sales will increase, especially for durable goods such as automotive, home improvement, furniture and appliances, as Houstonians begin to rebuild their homes. Retail sales tax receipts will spike mainly in Harris, Montgomery and Fort Bend counties.

Soft Multifamily Market Will Reverse

Residential properties were the most affected by flooding. The majority of these were single-family homes in suburban areas to the northeast, west and southwest of downtown Houston, or in just three of the nine counties comprising the 700-square-mile+ Greater Houston market.

As many as 100,000 multifamily units (one out of six) were flooded, which means that any spot softness in the market is now gone. A small number of high-density submarkets sustained damage in as much as 30% of existing inventory totaling approximately 22,300 occupied units and creating immediate leasing demand.

Apartments currently for rent and that escaped the storm in west, northwest and northeast Houston will see sharp occupancy increases by the start of the third quarter. Concessions and competitive move-in specials characterizing the rental market since 2016 are expected to quickly rescind, and renters with leases expiring in the next six months should not anticipate any type of renewal incentives.

Hotel Occupancy to Rise

Hotels throughout the region should see a rise in the number of people seeking accommodation, given the extensive home damage. FEMA is already housing 53,000 people in government-funded hotel rooms. Although initial reports are of relatively few closures among Houston's 868 hotels totaling 85,615 rooms, some properties that remained open suffered flooding and/or reduced services.

Looking at hotel data from four comparable disasters (Hurricane Katrina, Superstorm Sandy, Hurricane Ike and Hurricane Andrew), demand rose by 10% to 40% in the surrounding markets in the month after each event. Demand was still up an average of 15% four months after each event because of displaced residents, FEMA staff, emergency personnel and construction workers. Growth rates by market will vary from Hurricane Harvey's impact, with Houston likely to see the largest increases in demand. Nearby cities like Austin, San Antonio and Dallas-Ft. Worth may also see demand from meetings and conventions originally booked for Houston.

Assuming that Hurricane Harvey has a similar impact as past major storms, that there is no significant increase in room rates and that there is no major decline in the number of available hotel rooms, then hotels in the five major Texas markets could generate an additional 3.4 million room nights of demand and roughly $430 million in additional revenue. Given CBRE's current U.S. forecast of a 3.5% increase in RevPAR for Q4 2017, this additional demand would increase the RevPAR growth rate to 4.4% for the quarter and raise the overall RevPAR outlook for the year to 3.1% from our current forecast of 2.8%.

Projected increases to supply could be significantly curtailed as hotels in Houston close for repairs and construction supplies becoming scarce, which limits the feasibility of adding new supply. Houston currently has more than 5,000 rooms under construction and many of those projects are now expected to be delayed because of the storm.

Infrastructure Upgrades Likely for Subdivision Land

Houston's land market is dominated by retail, industrial and single-family development, as the office and multifamily sectors were over-supplied prior to Harvey. Northwest Houston will remain the desired industrial land choice, and vacant commercial sites in the Port Houston area will be even harder to find. Retailers acquiring land sites could change the footprint for completed retail product as smaller warehouses with retail storefront space replace traditional big-box and junior-box retail spaces.

From a single-family residential perspective, land prices will be tested as increases for construction and labor rise. The highest estimates of damage are 196,000 single-family homes. More than 73,000 National Flood Insurance Program (NFIP) claims have already been submitted and $13.2 million in advance payments have been issued. Displaced homeowners likely will lease Class A multifamily units and developers may look for sites to develop sooner than previously anticipated. In addition, new development requirements for flood control and water drainage will likely be imposed on new, large single-family land tracts despite existing drainage requirements for new subdivisions, such as detention ponds, curbs, gutter drains and levees. ■