REDnews 2021 Houston Commercial Real Estate Forecast Summit

BY RAY HANKAMER

Office Market Update **Moderator:** Gil Staley-The Woodlands Area Economic Development Speakers: Robert Cromwell-Moody Rambin; Stephanie Burritt-Gensler; Ryan Barbles-Stream Realty Partners

Takeaway: The pandemic layered more pain on the office market in Houston, following as it did the slump in oil prices and the resulting employee layoffs. The flight to the suburbs from the CBD and indecision regarding co-working space has further muddled the picture, and has added to landlord anxiety.

Bullets:

- Houston leads the country in office vacancy rate; hopefully this year will see a bottoming out and a slow return to absorption

- There is a flight to newness, as most Houston office product was built in the '80s to serve that boom in oil

- The CBD and Energy Corridor have suffered the highest vacancy rates, with Uptown Houston also feeling pressure; employees working from home are enjoying freedom from long commutes; elevator and park and drive anxiety has driven the work from home phenomenon

- There is also a flight to the suburbs, and some CBD-based companies have established mini-boutique spaces in the suburbs as well

- There is a new term spawned by remote working: FOMO, or "fear of missing out" on what is happening within the company; collaboration is a big part of forming resilient company cultures and it is much weaker when working via Zoom

- Landlords are considering increasing ventilation even as Covid fades, but there is only so much humid air one can bring in from the outside in Houston

- Business interruption and force majeure clauses have confused holders of insurance policies, but in general insurance companies are not compensating companies hit by Covid

- Investment sales in office are very tepid; foreclosures are happening as are deeds in lieu; more of this to come although bank regulators have allowed lenders to be creative in working with their office building borrowers

- It is very difficult for investment sales brokers to establish values in this market-what is a building really worth?

- Lease rates are dropping but can't drop too much since if they go too far they may attract less desirable tenants, which causes existing quality tenants to leave; it is a delicate balance between concessions and actual lowering of lease rates

- Some existing tenants are taking this current climate as opportunity to extend 5-7-10 years at today's low rates

- Some landlords are offering co-working space as an amenity so existing tenants can 'spread out'; Houston office cycles are a roller coaster and the 'we-work' space may be able to serve as a kind of buffer between cycles

- Few if any spec buildings are in the near future as they are not going to attract capital; oil prices need to get to the triple digits again for rates and occupancy in existing buildings to recover; vacancies currently range from 19-25% depending on sub-market

- Humans are social creatures and they will return to offices; productivity is a bit higher from home in some cases, but employees miss out on important aspects of their careers by lingering at home; for some the laptop is 'the only office they need', but this is a short-sighted approach

- Outdoor spaces for employees have become a hot amenity, and they are being created by savvy landlords; social space is key to maintaining company culture, which is vital to every company; employees are learning that they lose relevance if they do not interact with their peers-and bosses

- Adaptation of office building to life science uses is problematic and few buildings can be adapted; how the mix between home and office work shakes out remains to be seen, but the trend is back to working in a common space and not from home

Industrial Real Estate Update Moderator: Rives Nolen-CenterPoint Properties Speakers: Boone Smith-Stream Realty Partners; Kevin Sager-EastGroup Properties; Walker Barnett-Colliers International

Takeaway: Industrial is booming and has 'never been this good'. Investment sales have buyers standing in line bidding on the best properties. "We have a smile on our faces in this segment."

- There is an incredible appetite for industrial product in the investment sales arena; some core deals attract twenty-plus offers; it is a great time to be a seller

- Covid has accelerated demand for warehouse space, to serve e-commerce; in spite of the pandemic, 2020 was a record year for absorption, with high expectations for 2021

- Developers are having to go further and further out to find land, and getting it shovel-ready is taking longer than ever; costs are rising due to taxes and construction issues; but demand for A, B, and C product is high

- There are sub-markets around Metro Houston and they each have their own cycles; development is spilling over into West Chambers County since it has rail, Interstate Highway access, and is close to the Port of Houston
- The Grand Parkway has opened up 70 and soon 100 miles of new highly accessible roadway and development is going there, since it is also where people live, and the closer a warehouse is to the end user of the product passing through it, the cheaper the delivery

- Construction materials are soaring in cost and it is hard for developers to pin down their numbers, and to keep lease rates on the necessary upward trajectory to make deals work

- Covid greatly accelerated the number of consumers buying online, and fulfilment must follow rooftops; the large e-commerce players are gobbling up Houston real estate, and not just amazon, but big furniture retailers and many others

- The Port is increasing in volume due to several factors, and warehouses have to step up to accommodate; Houston is the country's 7th largest Metro area and the 26th largest consumer globally
- There was a short term Covid disruption in industrial, but it quickly bounced back in

Houston; as O & G slowed in Houston, activity in renewable energy picked up the slack in warehouse demand

• There is a flight to quality in new warehouse design and construction, and a flight to efficiency; in some instances Class B industrial space gets higher rents than A, if the B is closer to the consumer

• There is industrial growth in Conroe; it is harder and harder to find entitled land near quality available labor

• Landowners are sitting on land and holding out for the highest prices, and prices are rising; flood plain issues add to costs

• Cold storage warehouses are much more expensive to build, but there is increasing demand for them; Houston's location on the third coast enables us to serve the entire American Midwest from our port more cost-effectively than the other coasts

Biggest Missed Opportunities with Stimulus and Tax Planning **Moderator:** Gene Garcia, RSM US LLP Speakers: Cindy Pham-Asset Preservation; Patrick O'Connor-O'Connor & Associates; Jeff Hill-RSM US LLP

Takeaway: There have been so many short term modifications to existing laws and so many new and temporary programs provided by the federal government during the pandemic that it is advisable to hire a professional financial planner, tax expert, CPA, attorney, or all of the above to navigate the considerable benefits available, without making a mistake.

Bullets:

• PPE loans are still available; get a professional to guide you through the process

• There are tax credits available based on your number of employees if your sales have dropped during a quarter during the pandemic; get a professional to navigate and the benefits are real

• There are huge accelerated depreciation opportunities for both existing and new build real estate-great programs regarding depreciation available at the moment; get help to guide you through the process

• 100% deductible business lunches are back, momentarily at least, to help the restaurant industry

• 1031 like kind definitions are now in the hands of local authorities; personal property values can now be included in 1031 valuations (think hotels with all their FF&E), but again, CPA advice is essential; certain deadlines have been extended due to the winter storm

• 1031 people are super-busy and there is a possibility that this 100 year old law may change, so if you are considering a 1031 exchange...; there are schemes available for 1031 users to buy fractional shares if a like kind property is available; again, see an expert-many tax laws are currently in flux

• There are tax benefits for employee retention; for casualty losses that are not insured; for damage to commercial or residential properties

Retail Update: Opportunities and Trends-State of the Market **Moderator:** Eric Lestin-Cushman & Wakefield Speakers: Johnny Carrabba, Carrabba Family of Restaurants; Hannah Tosch-Colliers; Kenneth Katz-Baker Katz; David Morrell, Jr.-HooverSlovacek LLP

Takeaway: The worst is over for retailers and there is only a 6% vacancy in the sector.

Continued on Page 22>

Forecast
< Continued from Page 21

The retailers who failed during the pandemic were the ones who were weak going into the pandemic. Landlords worked hand in hand with their tenants, to keep them. Good retailers don't feel threatened by e-commerce but see it as another tool to move merchandise.

Bullets:

• There are 400 million retail SF in operation in Houston, with 2 million more under construction; e-commerce makes up about 18% of total retail sales, and it accelerated during the days of Covid, but is flattening out now

• There is a trend toward smaller footprints (floorspace) for retailers, as retailers always experiment and innovate

• Many "credit tenants" were the first ones to come to their landlords on bended knee to ask for rent abatement/adjustment when the pandemic struck

• Restaurant owner Johnny Carrabba has always seen the benefits of take-out business and it comprised 20% of his business before the pandemic; he manages the take-out side like a separate business to ensure a smooth operation

• 90% of retail landlords are receiving full rent now; the sector is 'out of the woods' as shoppers return; people are tired of being caged in and are going out now to shop

• Landlords should remember that recasting leases without lender approval could lead to their loan being called and the personal guaranty (if any) invoked, so...be cautious when trying to help a tenant!

• During the crunch time last year local bank lenders were the most flexible with retail borrowers; this enabled most landlords to be gracious and accommodating to their tenants; rent deferrals prevailed over rent abatements, and regulators gave leeway to banks to work with borrowers

• Returns to brick and mortar stores of unwanted online orders sometimes result in customers seeing something in store they want to purchase; consumer confidence is returning

• People will always like to dress up, go out, see and be seen; retail and restaurants are having trouble attracting back employees, as many remain on unemployment benefits

• Most of the grocery chains have leveled off their expansion-except HEB

• The Grand Parkway is seeing a lot of retail development, as stores always follow rooftops...and the Parkway is 70 miles long, soon to expand to 100, and eventually to 180-the distance to San Antonio

• The trend of retail and restaurants to locate on the ground floors of office and apartment buildings does not always suit the retailer or restaurant, due to parking difficulty and other conflicts

Apartment Market Overview- State of the Market **Moderator:** Bruce McClenny-Apartment Data Services Speakers: Philip Morgan-The Morgan Group,Inc.; Matthew Bronstein- BHW Real Estate; Jennifer Ray-Walker & Dunlap; John Boriack-Veritas Equity Management

Takeaway: Over the past six years uncommon turbulence has been evident in this sector, with falling oil prices, then heavy occupancy demand from Harvey displacements, and then the pandemic, which saw tenants leaving higher density inner loop projects and moving out to the suburbs. Rebalancing is in process with move-ins, and subsequently with rates. Class A was hardest hit by Covid rate-wise but is now trending back. Houston Metro has 89% occupancy overall.

Bullets:

• Class A needs job growth in high paid jobs to start its return to stabilization. Many people in the US are moving to Sun Belt locations but Austin and DFW are deemed a little more exciting at the moment than Houston. Suburban markets have seen a big boost during the pandemic but there is a drift now back to more expensive but exciting inner loop living

• Suburban markets are enjoying a boom, and rents are up; investors in multi-family are starting to return to Houston; due to soaring construction costs, rents are going up in tandem and are struggling to catch up; some tenants are leasing online before even seeing their apartment

• Texas is a big target for investment capital, especially in the M-F sector, and sales are presently at an unprecedented high rate; Texas remains a business friendly market and thus attracts people and businesses; investors are buying MF projects during lease up and are paying a price 'as if stabilized'

• Taxes and insurance are up on MF projects, and significantly; once in a deal, many investors do not want to sell

• It is difficult for landlords to get evictions, when warranted, but very few delinquencies in Class A; majority of tenants are honest and pay

• Some developers specialize in new build and some in rehab of B & C units; developers are struggling with lumber, appliance, and other construction costs

• Investors are on bended knee to be able to buy MF projects

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