The Texas Office Market:
Through the Eyes of the Sublease Market

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Newmark Grubb Knight Frank

The Texas Office Market

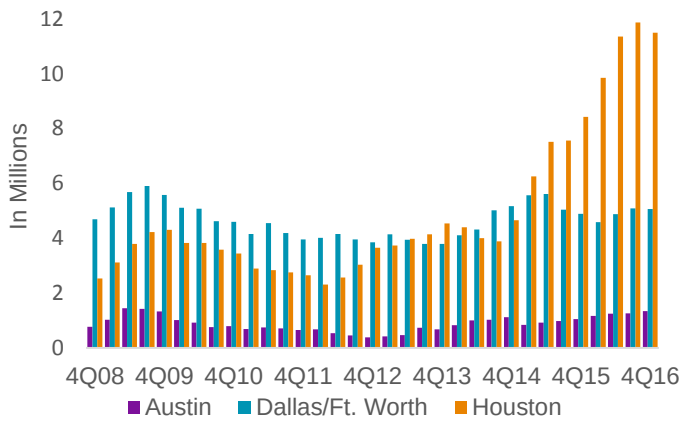
An office market can be analyzed from many different viewpoints, but the number one rule for real estate research professionals is to follow the demand. This is why the amount of available sublease space is often a proxy for forward-looking office demand. In this regard, Houston has been ground zero for the sublease overhang, a topic we covered last year in "Powerful Punch or Casual Tap." This article will view the topic through a different lens. We'll analyze the relative health of the Texas office markets from the sublease market's perspective and highlight trends within the Class A and Class B office segments.

Sublease Market

On an absolute basis, the Houston office market ended 2016 with 11.5 million rentable square feet (RSF) of available sublease space, compared with 5.0 million RSF in Dallas/Ft. Worth and 1.3 million RSF in Austin (Figure 1). Most striking is the divergence in performance that began in 2015, as Houston suffered the impact of the slowdown in the energy sector, while Dallas/Ft. Worth benefitted from a more diversified economy and a massive wave of corporate relocations and expansions. Furthermore, the stability in Austin accurately depicts the longevity of the current technology cycle.

In order to account for different market sizes, let's look at the same data from a common size approach. After all, Dallas/Ft. Worth has more than 215 million RSF of Class A and Class B product compared with 188.8 million RSF in Houston and 53 million RSF in Austin (Figure 2). From this perspective, Dallas/Ft. Worth came out on top with a mere 2.4% of the existing inventory showing up in the form of available sublease space. For the Austin market, which maintained the lowest percentage of sublease space from 2010 to 2015, this suggests the office market is coming up for air following an incredible multi-year expansion cycle.

Figure 1: Available Sublease Space
Class A & B



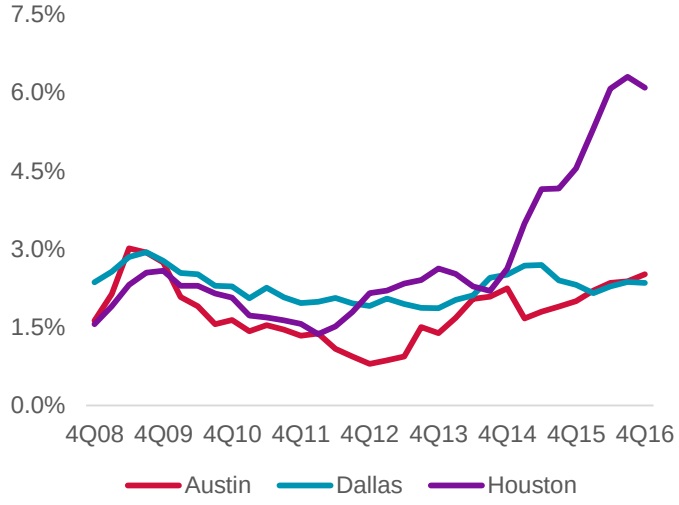
Source: Newmark Grubb Knight Frank

Figure 2: Size of Market

	Class A	Class B	Combined
Austin	29,449,194	23,609,470	53,056,664
Dallas/Ft. Worth	120,157,570	94,989,295	215,146,865
Houston	109,302,866	79,497,696	188,800,562
TOTAL	**258,909,630**	**198,096,461**	**457,006,091**

Source: Newmark Grubb Knight Frank

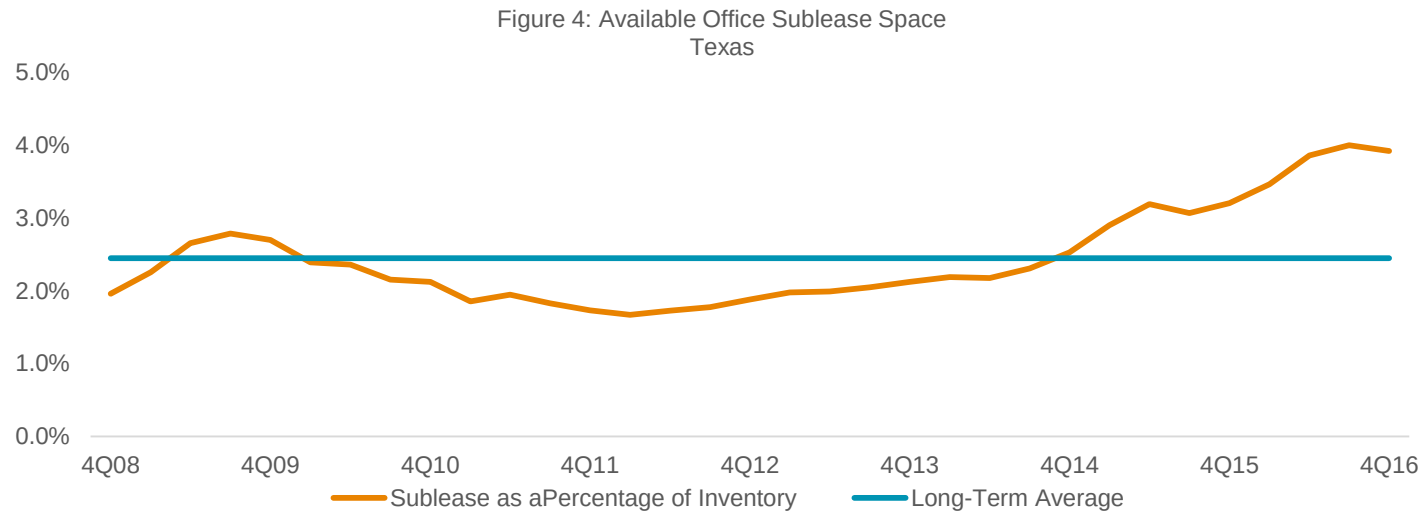
Figure 3: Available Office Sublease Space
As a Percentage of Total Inventory



Source: Newmark Grubb Knight Frank

Where Do We Go From Here?

The amount of sublease space available in the Texas office market remains elevated by historical standards. With that in mind, let's turn our attention to the driving force behind the results: Houston.



Source: Newmark Grubb Knight Frank

Headed into 2017, Houston is showing some encouraging signs and statistically speaking, the local economy appears to have bottomed with a subsequent recovery underway. Consequently, the office market's glut of available sublease space is nearing a top and may already be on the downside of the peak, as mentioned in our Houston office market report for the fourth quarter of 2016. To provide context, the sublease market appears to have peaked in third-quarter 2016 at 12 million RSF, before ending the year at 11.5 million RSF. In addition to leasing activity, two key drivers were in play:

1) Dumping more space onto an already saturated sublease market was no longer a viable solution for companies dealing with excess space.

2) Roughly 2.4 million RSF will be taken off the sublease market and returned to landlords in the form of direct vacancy in 2017 and 2018.

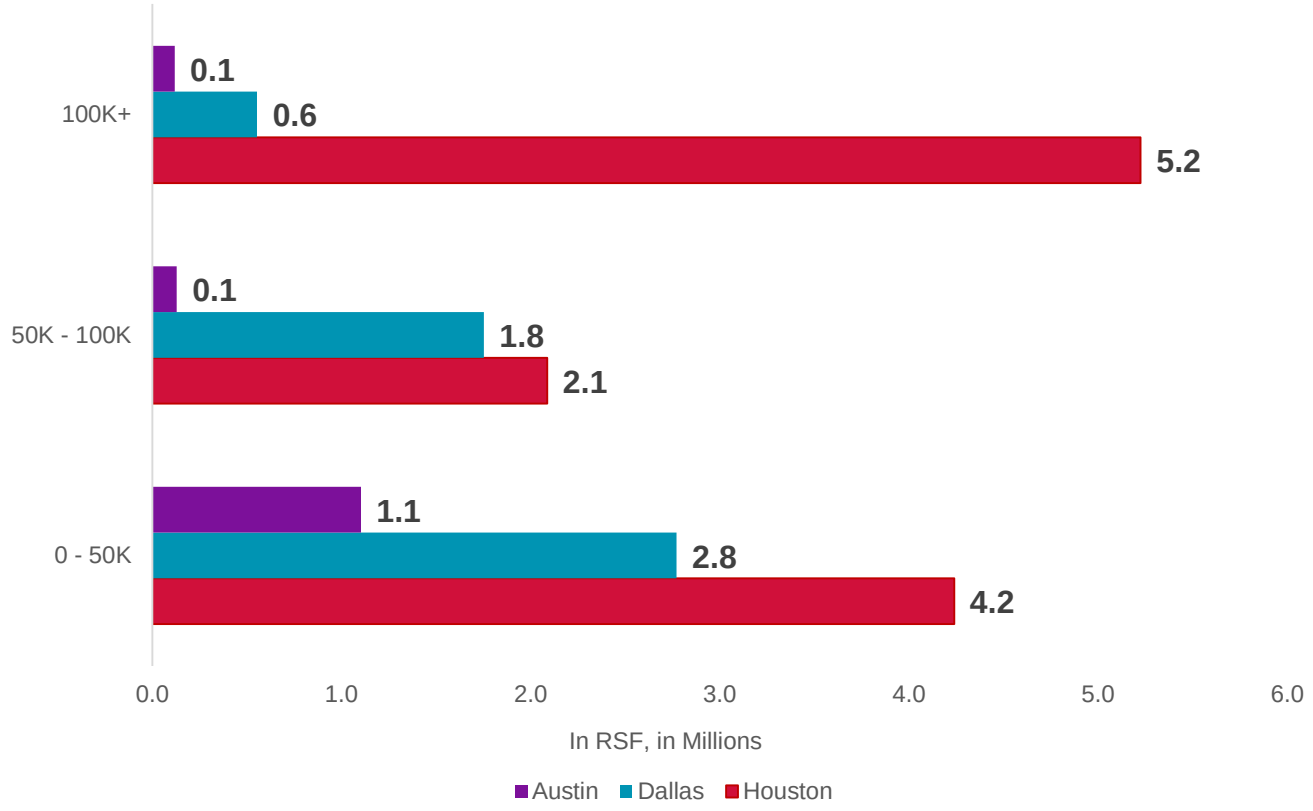
Should Austin's slight uptick in available sublease space be a concern? The short answer is no, but let's explore. As discussed in our Austin office market report for fourth-quarter 2016, net absorption exceeded 1.0 million RSF in 2016, marking the fourth time in the last five years that absorption exceeded the 1.0 million-square-foot threshold. However, the increase in sublease space is the first indication that technology, which drove leasing activity higher in the most recent cycle, may be tapping Austin's brakes. However, any slowdown would likely be short lived: Unlike Silicon Valley, which recorded negative net absorption and a spike in available Class A sublease space in 2016, the flight to affordability has Austin positioned well in 2017.

As for Dallas, the expansion cycle remains in full swing. Robust employment growth, corporate migration patterns and capital flows suggest a healthy outlook, although the supply pipeline is slowing some of the momentum. In addition, a slight uptick in sublease space is expected, as several large companies consolidate into new corporate campuses; however, as mentioned in our fourth-quarter 2016 Dallas/Ft. Worth office report, our 2017 forecast calls for a 50-basis-point reduction in the overall vacancy rate and a 4.5% increase in asking rents.

Getting Back to Equilibrium

How quickly Houston's sublease market regains equilibrium will determine how quickly the Texas sublease figures begin to normalize. It comes down to big blocks of space: Houston currently has 24 blocks of contiguous sublease space in excess of 100,000 square feet on the market, representing more than 5.2 million RSF. By comparison, there are only four big blocks in Dallas and one in Austin. This dynamic creates a multi-year headwind, as the number of big block users will be minimal until the energy sector returns to profitability and begins to hire again.

Figure 5: Texas Sublease Listing
by Size Range



Source: Newmark Grubb Knight Frank

Class A vs. Class B

Why does Class A space typically comprise the bulk of the sublease market? We have a few theories. For starters, property classification can be subjective, which presents the possibility of skewed results. Furthermore, U.S. corporations, which are the largest users of office space, have long gravitated toward Class A office space. Driving this trend are companies searching for office space that aligns with their branding and supports their efforts to recruit and retain employees by providing amenity-rich, sustainable and energy-efficient workplaces. Furthermore, Class B buildings typically are either multi-tenant, making the space tougher to market on the sublease market, or their users represent back-office operations, which historically are more stable tenants. The current trend toward owner-occupied and corporate campuses may also come into play. Whatever the case, Class A space historically represents 69% of the sublease market and 76% today.

Figure 6: Trends in Class A and B Segment

Source: Newmark Grubb Knight Frank

In conclusion, the sublease market provides a good forward-looking indicator for office-using demand and can also be an effective way to measure the relative healthiness of a market. However, property classification trends in the sublease market do not necessarily carry over to vacancy rates. In fact, the Class A vacancy rate is well below that of the Class B product in Austin and Dallas, even though Class A product represents the lion's share of the sublease market. That is not the case in Houston, where the current environment provides a rare opportunity for Class B users to trade up and take advantage of weakness in both the direct and sublet market.

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