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Commercial Real Estate

The past, present and future of Houston's Energy Corridor

Hindered by the recession, Energy Corridor may fare well in long term

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Judging by its tenants, the commercial area of Houston known as the Energy Corridor is the nerve center of the world's energy capital.

From the late 1960s to today, the stretch of Interstate 10 between Kirkwood and Fry roads has served as a hub of oil and gas commerce. Today, the area is a home to major industry players including BP America Inc., Citgo Petroleum Corp., ConocoPhillips and ExxonMobil Corp., as well as a host of other exploration and production, oil services and peripheral oil and gas companies.

Today: the Recession takes hold

The recession has prompted a slowdown in new tenants and construction starts for the area market, but those familiar with commercial real estate in the Energy Corridor say the submarket is faring better than others in the city and expect it to perform well in the long term.

"The Energy Corridor is not immune to the current market — we've definitely seen a slowdown in absorption," says David Hightower, executive vice president of Wolff Cos. and president of Energy Corridor Management District. "But when you look at the region, it's probably one of the strongest submarkets."

For the short term, experts offer less-than-optimal forecasts for the health of the submarket. Long term, however, the outlook remains positive.

Louis Rosenthal, vice president at real estate services firm Jones Lang LaSalle Inc.'s Houston office, says the recent expansion of Interstate 10 along the corridor will provide increased access to future and existing buildings and promote growth. In the short term, though, the more than 1.25 million square feet of space coming online, combined with low natural gas prices, will provide downward pressure on lease rates.

"It will lead to a softening in the market," Rosenthal says. "But it is potentially a great opportunity to acquire space."

According to a midyear market report by real estate and development firm Transwestern, vacancy rates are trending up sharply while absorption drops.

In 2007, the overall vacancy rate stood at 6.4 percent. In 2008, that dropped to 5.7 percent, but by midyear 2009 it had risen again to 8.8 percent. Net absorption was at 1.2 million square feet in 2008, although by June 2009, it reached only 48,000 square feet.

"The result is that there is going to be downward pressure on prices, but more good choices for tenants," Rosenthal says.

At midyear, lease rates for Class A space were around $27.35 per square foot, with the top spaces going for around $30, Rosenthal says. Most of the price pressure will be centered around new buildings, but Rosenthal says that, compared to previous cyclical downturns, the fall-off won't be as dramatic.

"(Although) clearly with the new buildings they are not going to be able to achieve the rate that they (established pro-forma) when they started the projects a year and a half ago," Rosenthal says.

He adds that he doesn't feel the market has overbuilt, but rather is suffering the predictable slowdown in absorption as tenants cease to expand, and new tenants are few and far between because of the economy.

Eric Anderson, executive vice president at Transwestern, agrees that the submarket is not overbuilt. Although it may seem counter-intuitive, Anderson says the Energy Corridor's commercial office market has benefited from the capital market's meltdown over the past year and a half.

"The funding for new projects was extremely difficult, but the underlying fundamentals of Houston's economy remained strong for another 12 to 15 months," Anderson says.

With a limited amount of money available for speculative projects, Anderson says the Energy Corridor did not overbuild, even though Houston's economy was doing comparatively well and demand was high.

"We would have delivered three times the amount of product if the capital markets hadn't melted down on a national basis," Anderson says.

The tightening in new construction kept the bottom from falling out of the area market when Houston was finally hit by the recession and demand for new office space ground to a halt.

Anderson says that once the existing new construction is completed, he doesn't see any new buildings coming online in the near future — at least not until the financing market for speculative projects stabilizes.

Among projects slated to begin construction soon are the 477,000-square-foot Energy Tower III from Mac Haik Realty Ltd. on the Katy Freeway, the 170,000-square-foot Enclave Corporate Center and the 230,000-square-foot Energy Crossing II, developed by Phoenix-based Opus West Corp. on the Katy Freeway.

Under Construction

Currently, 13 new office buildings are being constructed in the Energy Corridor, according to the Energy Corridor Management District.

Major developments coming online in the near future include the 300,000-

square-foot Three Eldridge Place at 737 North Eldridge Parkway being developed by Dallas-based Behringer Harvard; the 447,000-square-foot Energy Tower II, which is expected to be completed this fall and will be occupied primarily by Technip; and Eldridge Oaks I, a 350,000-square-foot building at 1080 Eldridge Parkway being developed by Transwestern.

In all, the market will gain an estimated 1.25 million square feet of new space, of which about 33 percent is pre-leased. Class A vacancy is expected to increase by about 50 percent this year, its highest rate in five years, according to market experts.

The PAST vs. the FUTURE

The Energy Corridor, which dates back to Houston's westward expansion during the late 1960s, was not always the resilient market it is today.

As the city's booming population began to settle into newly constructed subdivisions in the area, major employers from the oil and gas industry such as Conoco and Shell Oil Co. began to move office space to the stretch of Interstate 10 in the early 1970s.

"They tried to be more convenient to employees, and rental rates were going up in downtown and Greenway Plaza," High-tower says. "The whole corporate environment was going to a lower-density, more campus-type environment."

As more companies established their headquarters in the area, it began to coalesce into a real estate submarket with developed commercial and residential areas.

That growth is expected to continue after the Energy Corridor shrugs off the latest recession. In a recent study commissioned by the Energy Corridor Management District, Houston-based consulting firm CDS Market Research says the number of employees in the area is expected to increase to more than 97,028 by 2025, with total office space increasing by 36 percent.

Even though the market is expected to see vacancy rates go up over the next 12 months, Anderson says as the economy picks up, the Energy Corridor's large tenants will drive a quick recovery.

"The corridor has the critical mass of major oil companies to be successful long term," Anderson says. "While we are suffering and losing jobs currently, oil and gas is a long-term viable business and the area will bounce back quicker than most, partially due to its heavy concentration of oil and gas firms."