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PORT SETS PACE FOR HOUSTON INDUSTRIAL MARKET

With $178 billion in statewide economic impact, the Port of Houston is poised for even more growth.

By Haisten Willis

The Port of Houston is riding a wave of growth, posting an annual economic impact of $178 billion statewide and supplying 1 million jobs to the Houston region. This year, the port has approached equilibrium between exports and imports.

As the Houston Ship Channel celebrates its 100th birthday, the city around it continues its fastest industrial growth cycle in decades. Today, the Port of Houston has an annual economic impact statewide of $178 billion and supplies 1 million jobs to the region. According to CBRE, more than 22 million tons of cargo crossed the port's docks during the first seven months of this year.

In the third quarter of 2014, the metro Houston industrial market recorded 2.6 million square feet of positive net absorption, the second highest quarterly total on record. Meanwhile, the vacancy rate fell 10 basis points from the second to third quarter and now stands at 5.3 percent. There are 70 buildings and 6.1 million square feet of industrial projects underway in the Houston area.

One sign of Houston's growing importance in the industrial economy is the emergence of a non-stop flight from the city to China. Air China now runs four weekly non-stop flights between Beijing Capital International Airport and George Bush Intercontinental Airport. Houston is the fifth North American city with a direct

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LOW INTEREST RATES: THE GIFT THAT KEEPS ON GIVING

MBA figures show the industrial and hotel sectors have posted the largest rise in loan originations in 2014.

By Haisten Willis

The persistence of a low interest rate environment is fueling an already hot Texas commercial real estate market and bolstering the confidence of borrowers and lenders alike when it comes to dealmaking.

"We are at a historic time when it comes to the intersection of interest rates and availability of capital," says Rushi Shah, senior vice president of Aries Capital LLC, a Chicago-based company that both directly funds and arranges commercial real estate loans. "Two years ago, interest rates were below 4 percent, but there was no capital available. Now interest rates are still relatively low, below 5 percent, and we have bridge lenders, bridge to CMBS and more capital sources. A tougher deal gets done now that wasn't done two years ago."

Shah estimates there are around 40 CMBS lenders right now. Two years ago, he says that number was in the teens.

Shah's company is heavily focused on hospitality properties in Texas. One deal recently completed by Aries was the $10.5 million refinancing of a 108-room Courtyard by Marriott hotel in Victoria, Texas. The new loan paid off the hotel's original loan, which was provided by a local bank and slated to transition into an SBA loan.

Under the new loan, the borrowers have two years to ramp up and stabilize the hotel before refinancing the property into a long-term, fixed-rate, non-recourse CMBS loan.

"It's a win win-win," says Shah. "The lender got in at an early stage, the borrowers received flexible capi-

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PORT SETS PACE FOR HOUSTON INDUSTRIAL MARKET

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flight to China, joining Los Angeles, New York, San Francisco and Vancouver.

The largest project of the year in Houston was Greens Crossing at Pinto Business Park, a 971-acre, master-planned development completed by Hines, Pinto Realty Partners and Kohlberg Kravis Roberts & Co.

HD Supply occupies a 500,000-square-foot distribution center in the park and will lease another 100,000 square feet.

For a closer look at the industrial market in Houston, *Texas Real Estate Business* conducted interviews with John Talhelm, senior vice president of the JLL Industrial Services group; Michael Keegan, vice president of NAI Houston; and Holden Rushing, a senior associate with NAI Houston.

Texas Real Estate Business: In July, the Port of Houston moved more steel across the docks than in any month since 2008. What role is the port playing in Houston's hot economic climate?

Talhelm: The Port of Houston plays a key role in Houston's economic expansion. Steel imports are primarily for the oilfield services business and focused in the area of drill pipe, casing and transmission pipelines. In addition, dry and liquid petroleum cargos are expanding and represent more than 85 percent of the port's total tonnage. Containerized cargo represents approximately 8 percent of the total tonnage. This year, the port has approached equilibrium between exports and imports, with approximately 53 percent of the total tonnage in exports and 47 percent in imports.

Keegan/Rushing: According to the Port of Houston Authority, the port plays a critical role in Houston's economy. It is the country's largest port in foreign tonnage, the nation's number one steel port and is Texas' preeminent seaport.

The Port of Houston has helped to drive economic growth and the regional industrial complex through its offerings to deep-water vessels, its technological advances and its vast infrastructure. Spending $1 billion every five years in infrastructure and capital development, the Port of Houston is central to Houston's strong economy.

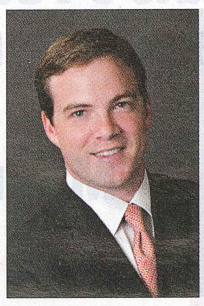
TREB: The price of natural gas remains low. Meanwhile, the port is expanding to accommodate bigger ships coming from the Panama Canal. Which of these factors do you think plays a bigger role in the growth of the Houston industrial segment in the future?

Talhelm: The expansion of petrochemical plants in the Houston and Gulf Coast region will play a major role in Houston's industrial segment. The impact will be seen across all segments of the industry, starting with the expansion of our engineering and technology sector.

Plans and refineries follow closely and will produce the downstream products to the truck, rail and marine companies that export the finished goods. The port will play a role in the logistics of these operations as well. However, due to the limits of a 45-foot draught, the port will serve a reduced percentage of the ships that will pass through the new locks of the Panama Canal when they open in late 2016 (45 feet is the depth of the Houston Ship Channel).

Keegan/Rushing: Both natural gas and expansions in the port to accommodate ships from the Panama Canal are important drivers of Houston's industrial segment. Of course, underlying demographics of a growing greater metropolitan population are critical as well. According to representatives at the Port of Houston Authority, bigger ships are moving trade around the world, including in particular those of Europe and the TransPacific Asia trade of the Panama Canal. The strong industrial complex, a growing population base and associated economic factors of the region are all drivers requiring larger ships to carry more cargo imported and exported through the Port of Houston.

Holden Rushing
Senior Associate,
NAI Houston



Michael Keegan
Vice President,
NAI Houston

John Talhelm
Senior Vice President
JLL Industrial Services

TREB: Do you see construction accelerating in metro Houston in the next several years? Why or why not?

Talhelm: The development community has done a great job in balancing the delivery of new warehouse inventory with demand. More than 95 percent of all new construction is concentrated in the North and Northwest submarkets, creating a temporary oversupply of Class A, dock-high storage (which refers to storage spaces that can be loaded or unloaded directly onto a tractor-trailer).

The size of these new facilities has increased to support larger tenant requirements. However, tenant demand for space of more than 100,000 square feet represents approximately 12 to 15 percent of the total market. Tenants requiring 50,000 to 90,000 square feet represent the highest percentage of market requirements.

Once landlords respond to accommodate the needs of these smaller tenants, absorption of this new inventory will proceed. Currently, landlords seem content to wait for 100,000-square-foot tenants rather than subdividing their buildings to accommodate smaller tenants. As vacancies persist over time, that approach will change.

Keegan/Rushing: Three interrelated factors shape the future trajectory

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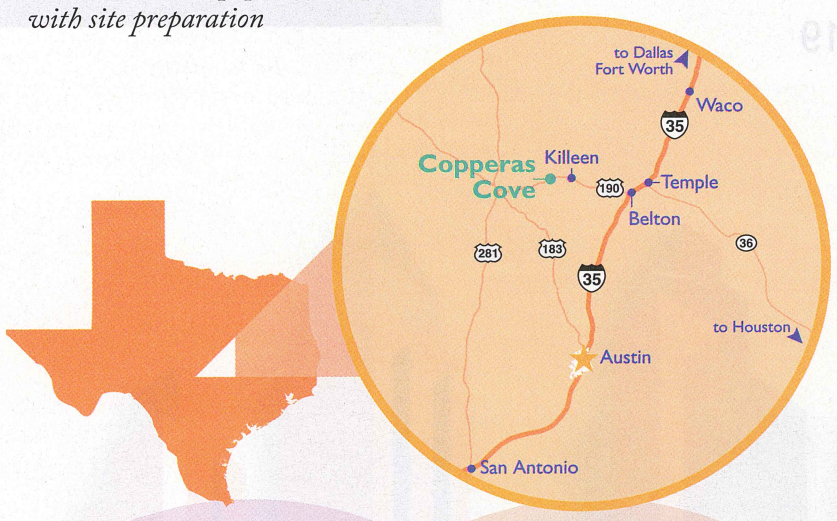
Demographics

Population

1 mile radius	3,173
3 mile radius	30,377
5 mile radius	61,839

Average Household Income

1 mile radius	$52,882
3 mile radius	$52,257
5 mile radius	$55,425



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of construction in the Houston area, namely demand for space coupled with existing supply, regional shifts in the oil and gas industry under the international climate of pricing, and pending changes in interest rates with the Fed's end of quantitative easing.

Construction is not a solitary problem, but rather hinges on these three dynamic variables. Houston's industrial real estate market has been climbing for at least four years, including demand for various types of industrial products.

These include small freestanding warehouses of 5,000 to 10,000 square feet, medium-sized, crane-served freestanding warehouses of 10,000 square feet to 50,000 square feet, and large multi-tenant distribution facilities larger than 50,000 square feet.

TREB: Industrial employment in Houston increased by 7,950 jobs, or 3.2 percent, between the third quarter of 2013 and the third quarter of 2014. What factors are contributing to the growth of industry in Houston?

Talhelm: Industrial employment in the Houston market is dominated by the petrochemical industry. With more than $40 billion in plant expansions — coupled with projects centered on liquefied natural gas, exports and pipeline construction as well as the manufacturing of the pumps, valves and other components — the demand for engineers, technicians and tradesmen will continue to increase.

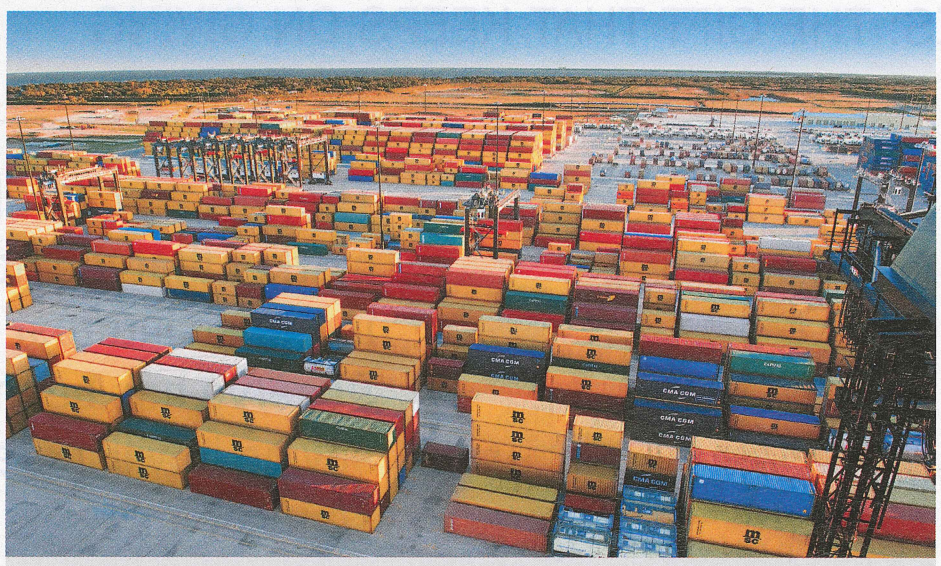
If successful, the reorganization of Mexico's energy industry will provide additional expansion in Houston as the energy capital of the world.

Keegan/Rushing: Major factors contributing to the growth of industry in Houston include geographic location, petrochemicals, gas exploration and production, gas and oil engineering, wholesale trade and oil prices. Houston's geographic setting is invaluable to manufacturing, transportation and logistics companies providing services throughout North America.

The latest figures published by the Bureau of Labor Statistics for the 12-month period ending September 2014 show a 2.9 percent increase of jobs in trade, transportation and utilities, a 3.4 percent increase in manufacturing and 7.1 percent increase in construction in metro Houston.

Houston's economy is as healthy as it has been in decades. With continued growth and a city with flourishing surroundings, Houston will continue to lead the charge in just about every category.

TREB: Grand Parkway, which connects Highway 290 and I-69 on the west side of metro Houston, has emerged as a significant industrial corridor. What submarkets are the hottest for industrial growth and new construction right now?



According to CBRE, more than 22 million tons of cargo crossed the Port of Houston's docks during the first seven months of 2014.

Talhelm: Igloo, Medline and Rooms To Go have located large distribution facilities in the Katy area due to a number of influences concerning their supply chains.

The Grand Parkway is an integral factor in their decisions on where to locate, thereby providing an important line to I-69/SH 59.

This connection allows companies to distribute goods to Corpus Christi, San Antonio, Austin and Beaumont, in addition to servicing the Houston metropolitan area.

The combination of the Grand Parkway, I-10 and the Sam Houston Tollway places these logistics-based facilities in the center of their regional distribution area.

Keegan/Rushing: At the end of the third quarter, the strongest submarkets include the North submarket, with 1.9 million square feet, and the Northwest submarket, with 3.1 million square feet under construction.

The North and Northwest submarkets boast year-to-date deliveries of 3.4 million square feet and 2 million square feet, respectively.

The North submarket's recent surge in new industrial development can be directly tied to the activity surrounding the new Exxon campus south of the Woodlands.

Development breeds more development, and so institutional investors are flocking to this historically underdeveloped market to construct distribution center projects on a speculative basis.

TREB: Is demand strongest for small buildings, large multi-tenant warehouse and distribution facilities or mid-sized industrial facilities?

Talhelm: The highest demand in all submarkets is for single-tenant, crane-ready facilities ranging in size from 25,000 to 30,000 square feet and located on two to three acres. The second highest demand is for Class A, dock-high warehouse space that provides efficient ingress and egress for today's larger trucks, as well as expanded truck courts, on-site trailer storage and energy-efficient lighting. Space demand in this category is the highest between 50,000 and 90,000 square feet.

Keegan/Rushing: Demand is up across the board for nearly all types of industrial facilities.

For example, there is currently little to nothing available on the market for space users seeking 20,000 to 30,000 square feet of second-generation, bulk distribution space in Northwest Houston. That said, demand is greater for smaller, crane-serviced industrial facilities in the same range.

The smaller oil field service companies of the world that are contracted by major oil and gas companies have been the key players for such crane-served facilities.

Demand has dramatically increased since the Eagle Ford Shale kicked into high gear beginning in late 2009. (The Eagle Ford Shale is a sedimentary rock formation lying underneath much of south Texas and one of the most actively drilled targets for oil and gas in the United States).

TREB: Developers will bring 8 million square feet on line this year. Do you see the potential for overbuilding in some submarkets?

Talhelm: The development community has struck a good balance in the North and Northwest submarkets between both the size of the warehouses and the total inventory. With buildings designed for the full range of tenant demand, absorption of current inventory in these submarkets will progress at a reasonable rate.

The Southeast submarket continues to struggle with vacancies due, in part, to the over-construction of large warehouse facilities of more than 500,000 square feet.

These large warehouses were built based on some incorrect assumptions and a misunderstanding of the type of goods flowing through the Houston Ship Channel.

Containerized cargo represents only 8 percent of the total tonnage in the port. Currently, 53 percent of that cargo is exported, with only 47 percent imported.

The development community overbuilt in the Southeast port market with buildings too large to accommodate the tenants in the market.

In addition, developers overbuilt the storage space needed by misreading the total tonnage to be stored. Of the 240 million tons of cargo that moves through the Houston Ship Channel, 185 million tons are liquid petrochemicals that are not stored in warehouses.

TREB: Average rents have risen 5.5 percent in the past year, reaching $6.06 per square foot net. Do you see rent prices continuing to climb over the next year?

Talhelm: Rents have risen in most submarkets, except for the Southeast submarket, where rent growth has been marginalized due to numerous factors.

It is important to note that rents for warehouse space in the North, Northwest and Southwest submarkets average $4.80 to $5 per square foot net on an annual basis.

Rents for single-tenant, crane-ready buildings average more than $8 per square foot net, and flex space is similarly priced.

The Southeast submarket will rise more slowly due to the lack of demand for large space, coupled with the rent compression, as a result of the economics of a logistics-oriented operation.

The North and Northwest submarkets are closer to the direct sales stores and major highways, so while the large warehouses in the Southeast are closer to the port, that's not necessarily an advantage.

Keegan/Rushing: Overbuilding is ultimately a function of supply and demand, which itself is variable on timescales not always consistent with that of construction.

There certainly is potential for overbuilding if all proposed construction is actually built. However, Houston has been on a hot streak as of late from a real estate perspective. That said, institutional investors are getting more cautious.

Access to equity is getting tighter, which will put the brakes on new spec development.

Nevertheless, if the Houston industrial market absorption statistics continue trending upward as they have for the first three quarters of 2014, we should finish the year without being overbuilt. ■