

Downtown Houston Office and Employment Overview

Central Houston, Inc.

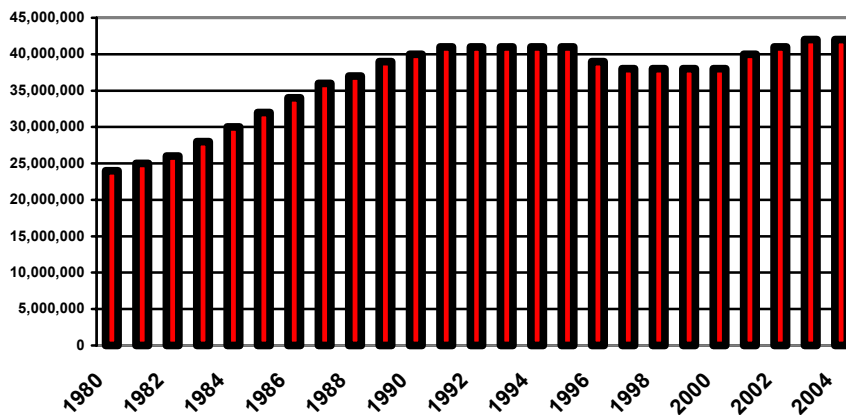
August 19, 2004

Introduction

The prime mover of downtown's economy is the downtown office market. Houston's downtown is one of the largest in the country based on its employment level of approximately 140,000. While four decades ago downtown dominated the commercial office market, Houston experienced the rapid creation in the 1970's and 1980's of multiple employment centers ranging from Greenway Plaza and Uptown to The Woodlands. For the past decade downtown has maintained about 22 to 23% of the regional commercial office market.

Office Supply

At the time of Central Houston's creation in 1983, more than ten million square feet of Class A office space was being completed in downtown. By 1990 downtown space leveled off at approximately 41 million square feet. The supply began to shrink in the mid 1990s. First, class C and D buildings were put to better use through rehabilitation into residential or hotels. The second action was the purchase by the City of Houston of 1200 Travis and 611 Walker for use as City offices. A third, and perhaps less significant reason, was that Central Houston worked with the office data providers to remove some structures that are functionally obsolete and really are no longer part of the commercial office market.

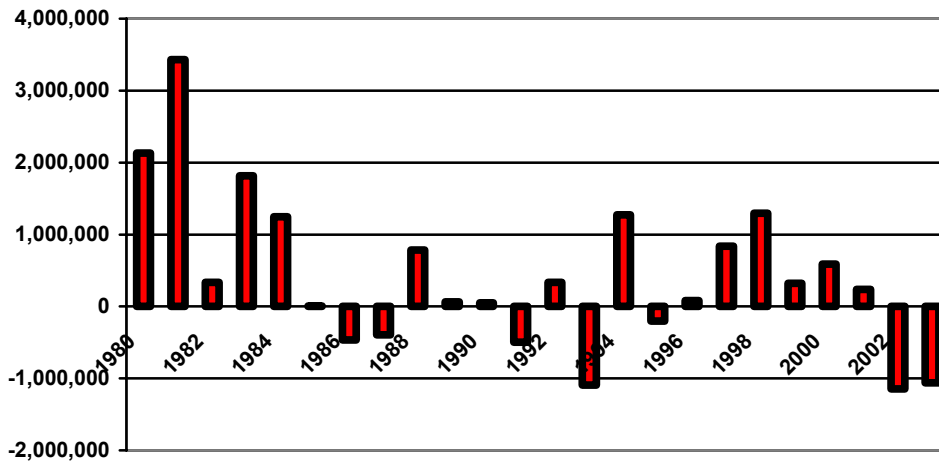


Commercial Office Space 1980 –2004 (in gross building area)

More recent growth of office space is the result of the completion of 1500 Louisiana, Five Houston Center, Reliant Resources Center, and Calpine Center. These new structures add slightly over three million square feet to the inventory.

Absorption

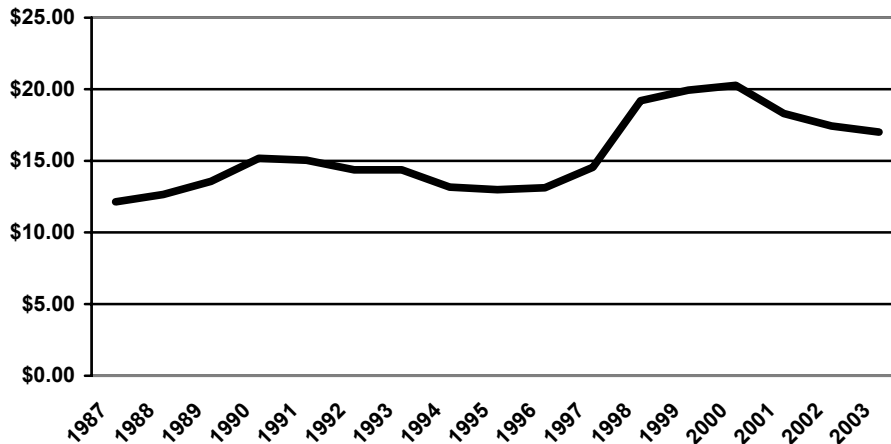
Historical absorption has been cyclical. The energy boom of the 1970's and early 1980's produced massive growth in the downtown office market. The oil bust beginning in 1984 began a period of little net growth in demand. The merchant energy boom of the mid to late 1990's produced the only period of sustained positive absorption. Then with the meltdown of merchant energy business, the past two years have produced record negative absorption. This year is seeing a reversal of this situation with the ChevronTexaco and TOTAL Atofina being the three largest deals thus far.



Commercial office absorption 1980-2004 (in square feet)

Occupancies and Rates

The cyclical nature of the market is clearly reflected in occupancies and average rental rates. Interestingly, the downtown occupancy rate remained in the vicinity of 80% for most of the 1980's and well into the 1990's. Rates also reflect this trend. Average rates remained in the \$15.00 per square foot range until the surge in demand from the merchant energy sector in 1997 and 1998. Occupancies peaked in late 2001 at 94% (Class A 97%) and then have fallen sharply into the 78-80% range. As would be expected rents have fallen but not as sharply. The most significant question is whether the market has reached a bottom. Substantial blocks of available space and competitive rates increase the likelihood of other large deals being done such as ChevronTexaco and TOTAL Atofina.



Average rental rates for all classes of office space 1987-2004

Downtown Employment

Accurate measurement of downtown employment is challenging in most cities and especially in Houston where there is no local wage tax or other reason for reporting employment by location. Various approaches of estimating employment have been attempted by Central Houston and the Downtown District including a census. This work is difficult because of issues such as reporting locations, temporary employees, contractors, and multi-shift workers. The 140,000-person employment level that is commonly used is supported by our research. It is clear that around 2000, the number was significantly higher as the merchant energy decline resulted in a loss in the range of 10,000 to 15,000 employees. We are aware that some of this loss has been made up by new jobs in recently opened hotel, food and beverage and attraction projects.

Future Issues

A trend that we have watched closely is the presence of corporate headquarters in downtown. There seems to be a trend of concentration of headquarters functions in downtown with relocations including Continental Airlines, Waste Management, Burlington Resources, and TOTAL Atofina. While not a headquarters per se, ChevronTexaco is a significant consolidation of functions into downtown. Presently, downtown is home to 11 of Houston's 20 Fortune 500 companies. This trend merits pursuit by downtown stakeholders.

We have attached a brief paper by Economic Research Associates that looks at the future for the downtown office market. Key points made by ERA:

- Downtown is positively aided by its new image as a place with many activities; however, ERA noted that new activity is located in nodes and not over all of downtown.
- The energy sector remains critically important to downtown.

- Other traditional sectors include banking, law and accounting and these should be looked to for new opportunities.
- Downtown's central location remains an asset.
- Downtown's economic future will parallel closely that of the region.
- Downtown may have a unique opportunity for administrative and business functions associated with the Texas Medical Center because of the new light rail connection.

Economic Research Associates

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Memorandum

Date: April 8, 2004

To: Laura Van Ness and Guy Hagstette

From: Patrick Phillips

RE: Office Market Review

Central Houston has engaged Economics Research Associates to conduct a focused review the office market in the downtown submarket. The purpose of the exercise is to provide an informed, independent backdrop to the organization's current update of the downtown development framework.

The need for such a review is occasioned by the significant decline in the health of the downtown office sector over the past 24 months or so. A loss of downtown jobs, coupled with the completion of substantial blocks of new space, has led to soaring vacancy and falling rents. The specifics of the market metrics are well covered elsewhere, and are not recapitulated here, but these data formed an important part of the motivation for this review.

Our methodology included a review of such recent market data, along with an update from Central Houston staff regarding recent downtown initiatives and accomplishments, which have been substantial. The core of the work was a series of interviews held over a two-day period in Houston during February 2004. A list of those interviewed is appended to this memorandum, and includes downtown office building developers, owners, managers, leasing agents, and key tenants from the major industry sectors.

An important underlying assumption for some, as they review the existing market conditions, is the need to diversify both the regional economy and the composition of downtown office tenants. In fact, Houston has diversified considerably over the past two decades, but the economy remains inexorably tied to the international energy sector. This review did not include a detailed examination of industry sector information to assess the degree to which downtown has actually diversified. Instead, we used the interviews to test ideas regarding the desirability of downtown to particular tenant types.

Our findings are summarized in the following paragraphs.

The Current Cycle

Widespread agreement exists that this cycle is fundamentally different from prior downturns. In previous down cycles, developers used leverage to build speculative new towers, several key industry sectors were hit by crises, and downtown Houston had little in the way of regionally important amenities to help it retain tenants.

This time around, the ownership of most Class A space is strong and stable; asset values more closely reflect cash flow and buildings are much less leveraged. The fall in rents should be more gradual and moderate. I do not foresee a “tipping point” that would lead to a sharper increase in vacancy, a dramatic fall in rents, or a crash in values.

Similarly, the economy is improving, and the core sectors of energy and banking are fundamentally sound. As in the national economy, these relatively healthy conditions are also characterized by industry consolidation and by ongoing improvements in productivity, both of which retard the demand for new office space.

Downtown’s New Profile

Further, Downtown has reinforced its underpinnings since the last downturn, with new housing and hotels, more retail and restaurants, and significant regional destinations that draw suburbanites to the core on a frequent basis. In fact, when considering the components already in place, with the exception of a relatively weak retail sector downtown Houston is as “complete” as nearly any downtown in the country. Houston’s leaders have taken to heart the adage that “if there’s going to be only one of something, it needs to be downtown.”

Compared to most others, in my qualitative assessment, Houston has a stronger cultural component, a more robust corporate headquarters segment, and more outstanding civic amenities (ballpark, arena, and convention center.) Its depth and variety of hotel offerings is substantially improving, and downtown is a regional nightlife destination.

However, street-level activity is limited to a few vibrant pockets. As others have pointed out, Houston has a great skyline, but those buildings are most successful when viewed from a distance, rather than experienced at the sidewalk. Because much of the office population shops and dines in the tunnel and skywalk system, the streets above can seem empty and forbidding, even at mid-day. And while many of the components are in place, downtown Houston is spread out which, coupled with the climate, dampens the beneficial inter-relationships between them.

The Energy Sector

Still , there is a lot of empty space to fill, even with ChevronTexaco’s consolidation at 1500 Louisiana. Since the vacant space is an objective fact, the only way to view it is as an asset—a standing inventory of contiguous, state-of-the art, extremely well-priced space.

The paradox is that the energy sector alone is unlikely to fill the space, but without energy we could be spectacularly successful in all other sectors and still not come close to filling it. Any successful strategy has to be fundamentally grounded in the energy sector. The real positive here is that downtown’s position with respect to energy is solid. Even if energy is mainly consolidating or growing very slowly, this bodes well for supporting professional services and other firms that benefit from proximity to the energy companies.

Other Key Sectors

While energy companies, and firms that cater to them, dominate downtown occupancy, several other key sectors exist downtown. Banking and financial services, for example, play

important, and high profile roles. They locate downtown for the same reasons as the energy companies: centralized access to the region's workforce, high-quality office space, key regional amenities, and an agglomeration of nearby clients and customers. It seems likely that as long as downtown remains the location of choice for the dominant economic engine (energy) the banks will be similarly inclined to stay downtown. And as major banks continue to consolidate, new opportunities may exist to attract new banking and financial services tenants to downtown.

Bank One's recent development of a call center in downtown has suggested to some that this may be an opportunity to fill additional office space. However, such functions carry very high parking requirements and, as Bank One admits, are probably better located in suburban locations. Moreover, a downtown-office recovery strategy based on a cost advantage may see some short-term success, but will be ultimately unsustainable. This includes call centers or other large users attracted by low rents and lots of available space. Downtown should continue to position itself as the preeminent business location in Houston, not as a back office or lowcost administrative center.

The near-term economics are very favorable for ambitious smaller and mid-size firms in the region. A logical target is companies that may aspire to be located downtown, but have been historically priced out at the margins. At current rents, and with downtown's new image, it would seem likely that regionally prominent accounting, legal, architectural, and other service firms could be attracted to downtown.

For example, the big four accounting firms are already downtown and their position seems relatively secure. An opportunity may now exist to attract strong Houston-based accounting firms that may be located in other submarkets. Similarly, national architectural firms that may have opened a Houston branch outside of downtown to save costs or because downtown was less competitive may now be strong recruitment candidates. Downtown is now both better and less expensive.

Two Downtowns?

An interesting downtown office phenomenon in Houston is driven by the tunnel and skywalk system. Because apparently all of the top tenants see it as imperative to be connected to the system, the network of climate-controlled walkways has had the effect of concentrating, or even limiting, the physical dimensions of the Class A office market. New Class A towers have been built contiguous to the existing core district for the last several decades.

However, many of downtown's most positive features lie well outside this office-tower district: the arts and cultural destinations, the stock of adaptable historic buildings, many of downtown's most interesting hotels, and the new sports and convention facilities. These amenities to some degree stand physically apart from one of the elements of downtown, its Class A office tenants, that they were intended to benefit most.

This raises the question of whether there are really "two downtowns" emerging: one that serves the Class A office tenants and is more or less uniformly comprised of office towers, parking structures, and below-grade retail and food service; and another that more fully resembles a vital urban district, with a mix of uses, street-level shops and restaurants, and an

18-hour cycle. The challenge is that you can't really have one without the other. Downtown Houston will benefit the most when these "two downtowns" are seamlessly integrated.

More recently, close attention has been paid to the way the "tunnel meets the street," with more visible, more transparent openings and more dramatic and inviting entrances to the tunnel system. This seems like a valuable precedent that can be further developed in the future. The aim is to get more of the Class A tower denizens up onto the street, as well as to ease access for others down into the tunnel system. The tunnel/skywalk system is a fact of life. Rather than decrying their impact on streetlife, it makes sense to make the interface between the two systems as appealing as possible.

The older historic buildings downtown are a valuable asset. However, the smaller floorplates, limited parking, and other characteristics of the smaller office buildings tend to limit their attractiveness to major tenants. The tenants that gravitate toward the historic district tend to be smaller, and are those that gain an advantage from proximity to the courthouse or other nearby public functions. Because the historic area is less able to provide parking at ratios similar to the Class A district, additional housing and strong transit access should boost its marketability. As long as the Class A space remains relatively low-priced, most candidate tenants will gravitate to the larger buildings. Because of this, the performance of the historic buildings is likely to lag the Class A space.

Downtown and the Region

The recent investment in downtown infrastructure and amenities, and the emergence of a downtown housing market, has clearly helped to solidify downtown's position as the most desirable office submarket in metro Houston. There appears to be a consensus that for national headquarters in the energy business, or for regional headquarters in many other supporting sectors (e.g. professional services) downtown is firmly at the top of the list of preferred locations. This is not the case for many central cities, and is a profoundly important advantage for downtown Houston.

One important reason for this is that downtown continues to offer a median location with respect to the area's labor force—downtown is centrally located in a way that many suburban submarkets can never be. Given the recent experience of the Uptown area, which faces significant mobility challenges, it will be important for downtown to monitor transportation and access issues that extend well beyond its own boundaries.

However, for companies outside the area considering a relocation, a central challenge still appears to be Houston's regional-scale issues: environmental quality, congestion, climate, and image. As one source put it, "if Houston is firmly on the list, downtown will compete well. The problem is getting the region firmly on the list." The downtown community has clearly done its part by improving downtown's quality. It is firmly in downtown's long-term interest to play a strong role in regional quality of life issues.

Similarly, the regional economic development and recruitment effort would clearly benefit by showcasing downtown, which is one of the region's most significant assets. By all accounts, new leadership at City Hall can play a significant role in attracting new companies to Houston. The Mayor represents the entire city, of course, and may be unable to focus

exclusively on downtown. He will certainly understand that a thriving downtown is in the broad public interest. And, again, the hard part appears to be getting firms to commit to the region.

The Medical Center Linkage

The Texas Medical Center is another critically important regional asset, and a likely source of significant job growth over the next several years. The new light rail linkage between downtown and the Medical Center can potentially encourage a continued—and expanded--symbiosis.

The specific dimensions of this linkage are not yet clear, but deserve further study as part of the ongoing downtown planning effort. At one level, for example, it appears that medical center workers are more likely to visit downtown during the day for shopping or dining. Coupled with expanded downtown housing opportunities, it is also likely that more will live downtown.

Downtown may also be suitable as a location for administrative functions in support of the medical center. No deals have been signed, but local brokers report that some medical institutions have considered taking office space downtown, where space is available and may be less expensive. Clearly, some financial and professional services firms are likely to seek downtown locations to be proximate (via train) to the medical center.

All of these behaviors are plausible and beneficial for both downtown and the medical center. One way to further study and, one hopes, to cultivate this relationship is to establish a joint study group or planning committee on an ad hoc basis with stakeholder representatives from both areas. Sophisticated development and management organizations exist in both locations. While some may perceive a competitive relationship between downtown and the Texas Medical Center, it appears that this is more than offset by the potential synergy. The benefits of the relationship catalyzed by the new rail link is something that in my opinion can be enhanced through institutional cooperation and joint planning and marketing between the two areas.

The Importance of Retention

Among potential tactics to reinforce the office market, probably nothing is more important than a strong, ongoing retention program. Retaining key tenants as leases roll and as consolidation decisions loom is fundamentally important and should be a downtown priority.

Because of their dominance, this has to include the big energy companies, but it should also encompass smaller companies—which have been known to grow into big ones. A well conceived and adequately funded retention program is the foundation for a recovery strategy.

Key Questions to Consider in the Planning Process

As the downtown community revises and updates its development framework, several key questions related to the recovery of the office sector should be considered:

- What are the dimensions of the linkage between the Medical Center and Downtown? How can this relationship be optimized?
- What role should the downtown community play in addressing regional-scale issues? Is the regional economic -development and business-recruitment function organized to sufficiently showcase Downtown? Can it be?
- Given the requirement of the tunnel/skywalk system, how can streets be more fully activated in the core Class A office district?
- What are the appropriate regional and sub-regional access and mobility issues that must be addressed to ensure downtown's continued competitive advantage?

These questions are all, of course, long-term. They relate to the ongoing health of the downtown office sector over the next decade or more. What about filling the empty space that exists now? Given historic al trends in economic growth and office absorption, most observers predict a seven to 10-year pace of recovery to stabilized market conditions. What actions might shorten this period?

One is simply to continue to make downtown a priority—to continue the recent pattern of downtown attention and public investment in amenities. Arguably, as grim as the statistics look, the office sector is in better shape now than it would have been without the significant downtown improvements of the past five years. Accelerating the recovery will be less likely if downtown is less of a public priority. To conclude from the market data that the recent efforts made no difference would be a grave mistake.

A related action would be to use an expanded business-retention program to stiffen the spine of existing businesses, and to build momentum on the heels of near-term leasing successes. Washington DC has recently implemented a broad-based business outreach program as part of its larger economic development strategy, a program that may be worthy of study.

With respect to specific market segments, local offices of national and the headquarters of regionally prominent professional services firms—architects, accountants, attorneys, and the like—are logical near-term opportunities. These firms may be drawn by favorable occupancy economics and downtown's emerging cachet.