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Houston commercial real-estate market: the boom is turning into a blowout

by Richard Freeman

The commercial real-estate markets of Dallas and Houston, which have been among America's biggest boom towns of the past two decades, will collapse by early 1983. The current value of the combined markets, if land values are included, is on the order of $50 billion; the crash will convince even the stubbornest believer that "we won't have a depression here in Texas," that he indeed lives within the boundaries of the United States. It is also likely, in combination with the collapse of the giant New York City office real-estate market, to bring on a general panic.

While the high-rollers and smart-money boys of the Lone Star State are crawling out from under the wreckage, as the big banks and insurance companies buy them out at 50 cents or less on the dollar, Texans can reflect on their toleration of the man most responsible—Federal Reserve Chairman Paul Volcker.

It was Volcker's 15-20 percent interest rates which, since 1979, have sucked investors into Texas real estate. In combination with the short-lived oil deregulation boom and the "runaway corporation" phenomenon of the 1960s and 1970s, the interest-rate explosion attracted "hot money" into Dallas and Houston office building, because not much else looked like a fast way to big profits. But sooner or later, without a growing productive economic base, no "overhead" activity like office-building can be sustained.

Between January 1980 and December 1982 some 50 million square feet of Houston office space will have been erected. That is the equivalent of five of New York City's World Trade Centers—the world's biggest office building—and about one-fifth the size of the entire New York City market. Office-building rents had quadrupled from 1969 to 1981, and the streets of Houston were paved with gold.

But suddenly, in 1982, whole buildings are unfilled and landlords have taken to giving away rent-free space to attract occupancy.

Because the Houston and Dallas markets—the fourth and sixth largest in the U.S.A.—are highly leveraged, the collapse will be swift and savage. Much of the newest construction in the Houston market was financed on a get-rich-quick speculative shoestring—in many cases by short-term bank loans tied to the prime rate. Paul A. Lynn, who owns a Houston commercial real-estate brokerage, commented recently, "If the Houston market crashes, a lot of people are going to be sucking wind"; many who came into the market for a quick 12-month turn-around are going to lose their properties.

"These properties will be repossessed by the banks," Lynn continued. "And since the banks don't want the properties, they will sell them at a reduced price. The insurance companies, like Prudential Investment Company, Equitable, and Metropolitan, will get the properties for practically nothing."

The J. R. syndrome

This type of behavior, not uncommon elsewhere in the United States, might be termed "the J. R. Ewing Syndrome." Otherwise normal people have allowed themselves to be deluded into ignoring the historic role of road-building, port development, canal-building, and river-widening, and such government-fostered activities as the aircraft industry and the space program, in promoting the industrial and agricultural growth of Texas. Instead they attribute the state's success to the "free market" ("God loves Texas") and their own greed ("As long as the government leaves me alone, I'll get rich").

In the 1970s, Heaven did indeed seem to be smiling on the Texas commercial market. Many major Northeast and West Coast firms relocated to Houston and Dallas. Texas-based companies themselves were also growing and needed larger quarters.

After the 1978-1979 increase in world oil prices from $12 to $26 barrel, Arab investors started to open offices in the U.S. petroleum capital of Houston. When President Carter decontrolled domestic oil prices in 1979, the boom was on. The multinational oil companies expand-

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ed their Houston operations (Texaco and Shell are headquartered in Houston, and Exxon, Arco, Gulf and others have large offices there). And the era of the "independent" began, as the number of oil rigs in use doubled, and every Jack-and-Jill energy independent which went from 10 employees in 1978 to 100 or more by 1981 wanted its own building.

The office-construction boom brought with it lawyers and accountants who worked for the oil industry; prosperous banks; engineering construction firms, like Bechtel, Flour, and Kellogg. The big insurance companies—Prudential, Equitable and Metropoliian Life—moved in, as did foreign money.

The price of a square foot of space in a Houston office building which had been approximately $10.50 in 1978, reached $21-$24 by February 1982.

Volcker's reality

A component of the "J. R. Ewing Syndrome" is the view that "The rest of the country may go into a depression, but that won't affect us here in Texas." Paul Volcker has proven this wrong.

Volcker's interest rates, by closing down industry and auto purchases, have dramatically reduced oil consumption. First oil-import levels tumbled; then the domestic oil production levels suffered.

In Houston, the shake-out of oil companies, and oil field supply, service and equipment industries, has had devastating consequences. According to studies released by the Rice Center of Rice University, as of August 1981, 61 percent of all the companies renting space in Houston's central business district were energy and energy-related. In the Galleria area, the second-largest office-building concentration in Houston, 36 percent of the firms are energy-related. In Greenway, another large commercial concentration, the figure is 47 percent.

For example, Dreco Drilling Company, a company with an annual revenue of $250 million, announced Chapter 11 bankruptcy June 25. According to Lynn, Dreco had authorized the construction of an office building of 100,000 square feet, into which it was prepared to move. The building is more than half complete, and now there is no tenant.

"There are a lot of 6- to 10-story office buildings with 100,000 to 150,000 square feet that are going to be wiped out," said Lynn. Already, in the southwest Regency district, spanking new six-story buildings are completely empty and devoid of tenants.

The second most important users of space in Houston are the engineering-construction firms, who not only do oil-related building, but worldwide construction. "But how much building is Bechtel doing in Saudi Arabia or Iran these days?" Lynn asked.

Because of the collapse of international trade, the port of Houston, one of the five largest in the United States, has suffered a decline in volume. Then there is the downturn in the electronics industry, which has led Texas Instruments to lay off 2,800 workers this year in Dallas and Houston.

Blowout

According to Robert Barndollar of the Rotan Mosle Mortgage Company, the majority of buildings being erected in Houston are financed by unsecured, expensive construction loans. Normally, a builder attempts to prelease 40 to 80 percent of a building. But many developers started construction in Houston with 10 percent or less of the planned office building preleased, and with bank loans for two to five years, tied to the prime rate. Houston office developers will have built 22.9 million square feet in 1982.

"Many of these developers had bet the prime would come down, and they would make more on renting or selling the building than they paid in interest, but they bet wrong," said Lynn. "Now there is no one to buy their buildings."

After the rental price of a square foot of new office space reached $24.42 in February of this year, it fell to $23.10 in March and April, according to the New York-based Julien Studley Company.

Patricia Cronkright, real-estate reporter for the *Houston Business Journal,* reported on April 12 that to attract tenants, office developers are now offering between 3 and 12 months of free rent on five-year leases.

Houston broker Lynn says, "I can get people into office buildings for less than they paid three years ago and a large tenant can get for free a 10 percent equity stake in the building. This allows the tenant to write off part of the depreciation of the building. When you combine this with several months' free rent, you're knocking as much as $4 or $5 [per square foot] off the quoted rental price of a building."

While the vacancy rate in the central business district of Houston is still low, it is above 8 percent in other parts of Houston, more than one and a half times the national average. And it is rising fast. Lynn reports that the new Cullen office tower in central Houston, one of the city's prized new buildings, has not lined up a single tenant. "Some of the big builders, like Gerald Hines, could wind up with several million square feet of unsold office space."

In Dallas, where Olympia & York, the Canadian real-estate developer, has been building at a rapid clip, the amount of vacant space is piling up fast. The Swearingen Company, one of the city's largest builders, reported in April that of total constructed and planned office space in that city in the first quarter of 1982, 26 percent was vacant. It is only a matter of months before the "softness" in the Houston and Dallas markets gives way to collapse.