

Where the Brunt of the Coronavirus Impact Will Be Felt First in the Office Market

CoStar Insight: Those With Exposure to the Energy and Hospitality Sectors Likely to See Pullback in Demand



Office markets that have a higher concentration of energy companies such as Houston, Texas are dealing with the double shock of coronavirus and a plunge in oil prices. (iStock)

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While fears sparked by coronavirus have already been reflected in the volatility of financial markets, the impact on commercial real estate, aside from hotels, will take longer to come into focus.

What has become very clear is that uncertainty triggered by the pandemic, along with ongoing efforts to curtail transmission of the virus among people by health and government officials, will restrain global and U.S. economic growth in the near term, resulting in decreased demand for

apartments, office space, stores and distribution centers. Although how much and for how long remains to be seen.

Firms that had been considering relocating or expanding offices will likely delay or even cancel real estate decisions in this heightened period of uncertainty, driving slower office leasing activity during at least the first half of the year.

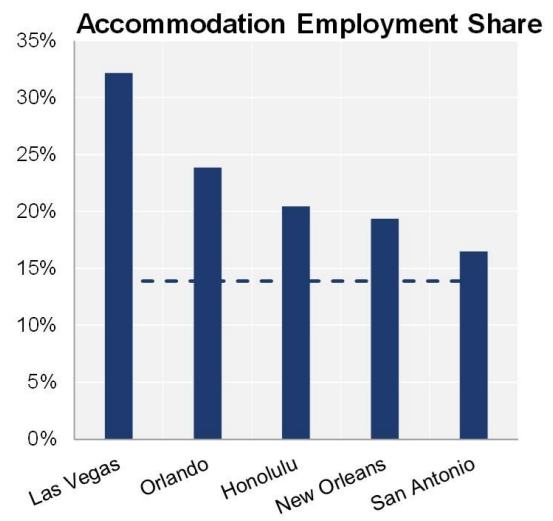
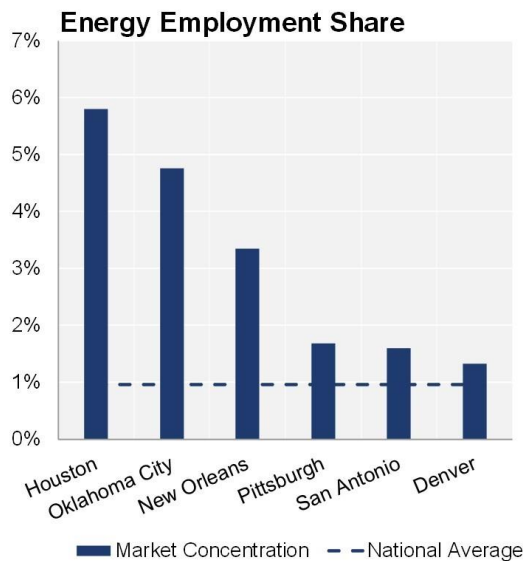
While it is still too early for a slowdown in office leasing activity to show up in the data, industries expected to feel the [impact from coronavirus](#) first may provide a road map for seeing the first signs of the market impact. Two industries in particular, energy and hospitality, already have had significant impacts from the spread of the coronavirus, and both have heavy office concentrations in a handful of markets.

Energy Sector Suffers Back-to-Back Blows

The fallout from the coronavirus must seem like adding insult to injury after the recent oil price shock rocked energy markets. While global demand for oil already had begun to decline in 2020, discussions regarding production limits between the Organization for Petroleum Exporting Countries (OPEC) and Russia following the outbreak of coronavirus fell throughout last week. The resulting price war sent oil prices tumbling to lows not seen since 2016.

The benchmark West Texas Intermediate (WTI) crude price fell from over \$60 per barrel at the beginning of January to nearly \$30 per barrel as of the second week of March. There was an uptick in energy company bankruptcies, as oil prices drifted lower on weaker demand from China at the end of last year. Now, with the possibility that low oil prices could remain for an extended period as Saudi Arabia and Russia attempt to undercut each other and U.S. producers, office markets exposed to the energy firms are at increased risk.

Emerging Risks Concentrated In Energy And Accommodation



Source: BLS; CoStar Portfolio Strategy

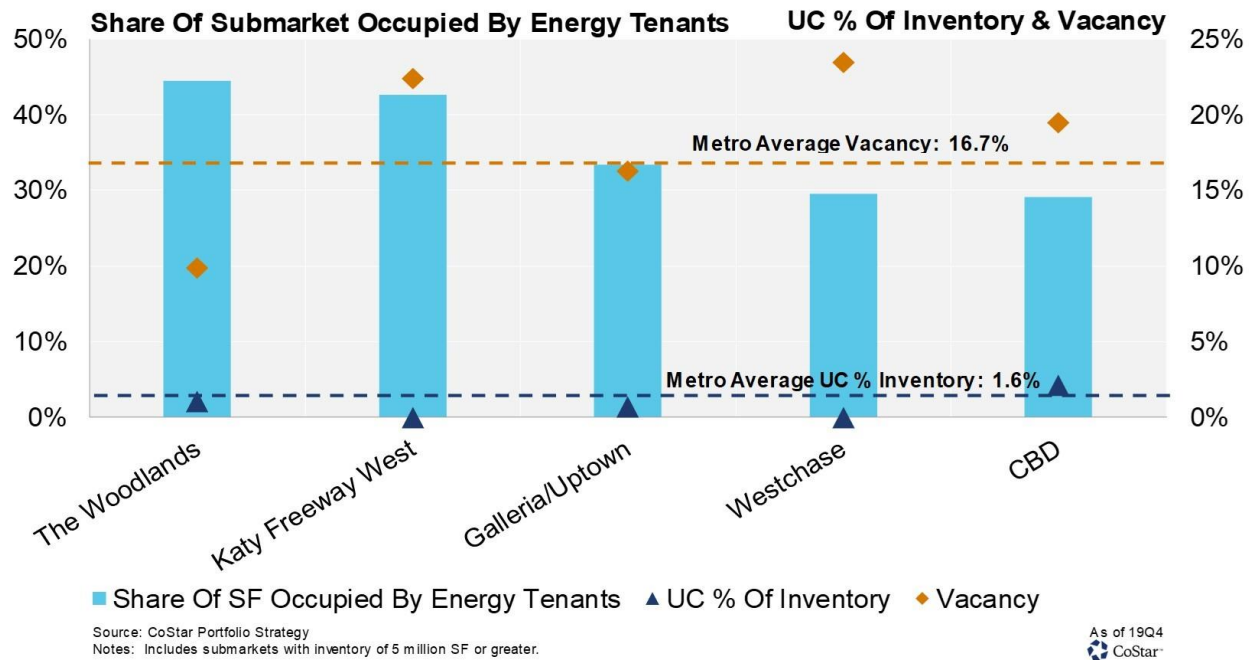
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Among office markets with the most exposure to the energy sector are Houston, Oklahoma City, New Orleans and Denver. Houston is the largest and most exposed of these institutional markets, with nearly 6% of its employment base working directly for energy firms. On average, energy employment comprises about 1% of total employment nationally, meaning energy jobs are six times more concentrated in Houston than at the U.S. level.

Within Houston's office market, the most significant exposure to the energy sector can be found in a handful of submarkets. For some context, CoStar is tracking 46 office submarkets nationally that have a meaningful exposure of at least 500,000 square feet, or 6%, of the office space occupied by energy firms.

Of these submarkets, 19 have more than 20% of their office occupancy tied to energy tenants, and half of those are in Houston. The Woodlands, home to ExxonMobil's headquarters, and the Katy Freeway West submarket, known as the Energy Corridor, have the heaviest exposure with energy companies accounting for over 40% of the office tenant base in each submarket.

Houston's Energy-Focused Submarkets Still Recovering



The current decline in oil prices will likely exacerbate weak market conditions remaining from the last oil downturn in many of these energy-focused submarkets. In Houston's Katy Freeway West and Westchase submarkets in particular, office vacancies are already well above the market average. And as a point of reference, Houston has the highest office vacancy rate in the nation at 16.7%.

Fortunately, office construction is relatively light across most of Houston, so the worst-case scenario of a demand-side shock in the midst of a supply wave should be avoided. Still, any slowdown in leasing activity or a pullback from energy firms will likely delay Houston's recovery even further.

The story is similar in other energy-focused submarkets. In Denver, energy firms are focused almost exclusively in the downtown central business district and lower downtown, or LoDo, with nearly 20% of occupancy in these two submarkets directly tied to energy firms.

The office vacancy rate in Denver's CBD has declined from over 15% in 2017 to 13.4% in the fourth quarter of 2019, but remains more than three percentage points over the market average after suffering declining demand in the last oil downturn.

Other energy-focused submarkets, including Oklahoma City's and New Orleans's CBD also continue to suffer from the last oil downturn with above-average vacancies or stagnant demand.

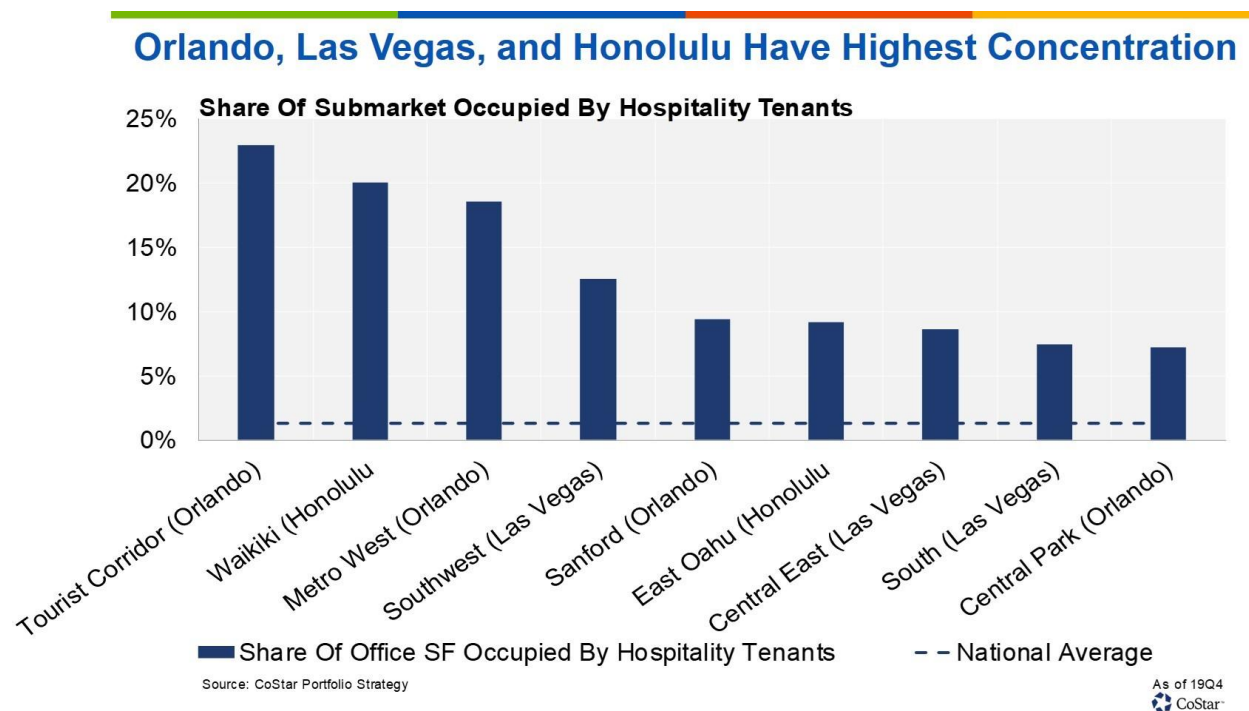
Layoffs Mount at Hotel Operators

The U.S. hospitality sector has also suffered under the impact of coronavirus, with key metrics such as occupancy rates, room rates and revenue per available room (RevPAR) declining precipitously in the past week. Our colleagues at STR have reported that U.S. hotel occupancy rates fell 7.3%, average daily room rates were down 4.6% and RevPAR declined 11.6% on a year-over-year basis for the week ending March 7, 2020.

As travel restrictions and group event cancellations continue to mount, the uncertainty over lost business will continue to stress hospitality companies, with layoffs already beginning in the sector.

While the hospitality industry makes up a larger proportion of most local market economies than energy, it typically is a much smaller office-user. As a result, hospitality layoffs industry-wide are not likely to have a direct effect on most office markets nationally.

However, major markets with an outsized direct exposure to hospitality employers, including Las Vegas, Orlando and Honolulu, remain at a heightened risk of lower office demand in 2020, especially since it remains to be seen how the many smaller businesses providing services to the hospitality sector in these markets are impacted by the coronavirus.



As the current situation continues to evolve, we will gain a clearer understanding of the effects on commercial real estate, including those segments that are more insulated from current volatility and those that may be more at risk.

For example, in the retail sector necessity-based neighborhood retail centers and e-commerce based shopping may outperform while malls continue to lag as consumers take social distancing

to heart. In the industrial market, last-mile distribution centers may experience an upswing in demand as e-commerce delivery increases, while West Coast logistics centers that are dependent on international trade could see a slowdown.

Costar Advisory Services will provide further coverage on the risks and opportunities across the other property types in the coming weeks.

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For more information about ongoing research on this topic and the custom consulting work of CoStar Advisory Services, please contact [Michael Cohen](#).