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As Consumers Cheer, Plunge in Oil Prices Poses Test for Texas Real Estate

Analysts Worry Protracted Price Slump Could Affect Office Leasing In Houston, Austin, Other Sunbelt Markets

The price of a barrel of oil has fallen to its lowest level in five and a half years and analysts are crediting a big bump in November retail sales as less expensive gasoline and heating oil leave extra dollars in the pockets of U.S. consumers available for holiday shopping.

The new numbers confirm the speculation of economists about the impact of the recent oil price collapse on commuters, shoppers and businesses. Consumer price inflation fell by 0.3% in November, its largest drop in six years, as gasoline prices plummeted.

But while Santa has brought an unexpected bonus to happy shoppers, retailers and shopping center owners, the news -- and subsequent investor pullback -- has been as welcome as a lump of coal for those with ownership interests in office and other commercial property in certain energy-focused U.S. markets.

First and foremost among these is Houston, the Energy Capital of the U.S., where the previous oil and gas boom has triggered a surge in employment and the construction of millions of square feet across every building type in recent years.

For now, analysts cautioned the fallout is confined to rental rates rather than investment sale prices.

"The Houston office market has been white hot and the oil price declines may be the trigger for some inevitable cooling," said Ki Bin Kim and Michael R. Lewis, REIT equity analysts for SunTrust Robinson Humphrey, Inc. "Rents are more likely to see an impact than cap rates, which are being supported by very high investor demand, including from foreign sources.

"In a way, the lower oil prices may be a good thing in the long-term, likely shelving a lot of potential new starts," they added.

Meanwhile, the 17 million square feet of office space under construction in Houston should pose little threat to fundamentals as nearly 70% of the space is preleased, Kim and Lewis said.

Wall Street invetsors have been reluctant to see that silver lining noted by the SunTrust Robinson Humphrey analysts, hammering the stocks of property companies focused on the Texas markets. Following OPEC's November decision to maintain current production levels in a bid to prop up sagging oil prices, concerns about the plunging price of oil were cited for a post-Thanksgiving plunge in the shares of REITs with major real estate holdings in Houston, Austin, Dallas and other energy markets that helped lead the nation out of the Great Recession.

The plunge in energy prices continued this week. The WTI Crude Oil this week fell to as low as $54.21 a barrel, a 40% drop from its 52-week high of $102.53 on June 25, the lowest since mid-2009. The last time oil fell south of $60 was during the recession, but some analysts now project that prices for crude could fall as low as $50 by the end of December and major producers such as ConocoPhillips and BP in recent days have announced cuts in investment and jobs, among other retrenchment measures.

The price deflation may be good news for the overall economy by bolstering consumer spending in other areas as prices at the gas pump fall. After an initial lukewarm response to Black Friday and Thanksgiving weekend shopping, November retail sales jumped 0.7% to $449.3 billion from October, and increased 4.9% from the same month a year ago, according to the Commerce Department.

Shoppers, Start Your Engines

After 2013's lackluster shopping season, retail analysts were exceedingly cautious heading into this year's holidays, predicting 3.5% retail sales growth, slightly better than last year's moribund 3.3%, according to Garrick Brown, vice president of research for Cassidy Turley's Western region.

But that was before what appeared to be a short-term trend of falling oil prices turned into a free fall.

"Thanks to the economic boost that falling gas prices will give American consumers, we now anticipate final sales numbers for the 2014 holiday sales season to come in somewhere between 4% and 4.5%," Brown said in the company's winter 2014 National Retail Review. At the current rate of decline, the average price of a gallon of gasoline will be $2 by March 2015, Brown noted.

"Based on last year's levels of fuel consumption, the decline in prices has already put an extra $26.2 billion into the pockets of American shoppers. At the current rate of decline, this tally will be $87.8 billion by the end of March 2015 and will be approaching $100 billion just one month later."

Other energy hubs such as Denver, where one-fifth of the downtown market is occupied by energy tenants, and Pittsburgh to a lesser extent, may also be impacted by energy price movements, according to a new report CBRE Research Director Sara Rutledge. Both market however are more tied to natural gas and have higher concentrations of other industries such as technology and finance.

However, those regions with major employment and commercial property exposure to energy-related sectors such as Texas, Oklahoma and Louisiana could suffer the most in the event of a protracted price slump.

Take the Lone Star State, for example. As one of the world's leading oil-producing regions, Texas has been a national leader in job growth and real estate development in recent years. But the economy has always been subject to boom and bust cycles and despite the ongoing diversification of the state's employment base, office real estate fundamentals in particular show sensitivity to energy sector dynamics.

Complicating matters are two of the largest energy company mergers of the last century. In November, Kinder Morgan completed the $44 billion merger of holding companies into a single publicly traded company. Halliburton announced a $35 billion merger of Baker Hughes. The two companies 2 million square feet of office space and 2.7 million square feet of industrial space in the Houston metro.

No other economic input has as much power over the U.S. and global economy as oil prices, as evidenced by the fact that an oil shock has preceded every U.S. recession since the 1960s, said John Affleck, research strategist for CoStar Portfolio Strategy. On the other hand, low and falling energy prices can help produce economic boom times, as in the late 1990s.

Houston: Do We Have a Problem?

CoStar Portfolio Strategy analyzed the effect on local GDP of a further 20% drop in oil, with Houston leading the list with a reduction of more than 2%, followed by other energy centers like Oklahoma City and New Orleans. Sunbelt markets like Atlanta, Phoenix, Tampa and Orlando would enjoy the most upside, growing up to 2%, with the increase adding about 0.5% growth to national GDP.

Office vacancies declined in Houston when the price of crude oil increased in 2004. A precipitous drop in crude prices at the beginning of the Great Recession was followed by a rise in vacancies, which then compressed again as oil recovered. The Houston vacancy rate has started to move slightly higher following the more than 25% decline in the price of crude oil since June.

However, the potential hit to Houston may be overstated. Given the recent local growth and U.S. economic strength, growth in the nation's energy capital will likely only slow to 3%-4% from the 5%-7% growth of the past several years, CoStar Portfolio Strategy said.

"In other words, Houston will look more and more like a typical U.S. growth market - but with a massive supply wave on the way and discordantly high pricing," Affleck said.

Falling share prices of Cousins Properties Inc. (NYSE: CUZ) and Parkway Properties Inc. (NYSE: PKY), publicly traded REITs which have significant exposure to Texas and Houston in particular, are an early indicator of the volatility of energy prices in the Lone Star State. Both stocks traded down recently on concerns over lower oil prices, falling to their lowest levels since March and prompting downgrades of Cousins Properties shares by Bank of America and Stifel due to concerns about the impact of falling oil prices on Houston's office market.

Cousins' office portfolio includes six properties located in Texas totaling 8.1 million square feet, representing 60% of CUZ's total net operating income, with 48% in the Houston metro area alone. The company’s top 20 tenants represent 42% of the entire portfolio, including four giant publicly traded oil and gas firms, and 20% of the Cousins leased office portfolio is expected to expire in the next three years.

Parkway Properties also has a strong presence in Houston, with 10 properties totaling 4.3 million square feet making up 34% of the company’s wholly owned portfolio. The company also has exposure to the Austin market through a joint venture portfolio of 2.4 million square feet.

Both companies have been in growth mode during the Texas real estate boom, acquiring and building assets across the Sunbelt and Texas. Underwriting of those richly priced deals assumed robust leasing growth against a backdrop of strong energy industry job growth, said David Toti, senior REIT analyst for Cantor Fitzgerald.

Crude oil prices and vacancy rates in the Houston, Austin, and to a lesser extent Dallas office markets are have been highly sensitive to crude oil prices over the past decade, Toti said.

"Although we do not see a significant risk here, we believe if the slump continues and the energy sector displays further signs of weakening, the re-leasing dynamic in the Texas office markets could be challenged," he said, noting that 37% of Parkway's office space is scheduled to expire in the next three years --including Halliburton Energy Services, Inc., the largest energy tenant and Parkway's second biggest overall with 2.9% of annualized rent, set to roll in early 2015.

"We believe significant stress in the energy industry could potentially revive investor fears and increase risk aversion relative to the Texas/Sunbelt-exposed REITs," Toti said.

The economic impact on office, apartment and industrial real estate is largely a Texas story for now.

In an analysis of CMBS loans secured by office and industrial properties exposed to oil and energy, Morgan Stanley identified 59 properties encumbered by 50 loans across 37 deals with a total allocated loan balance of $2.2 billion. Over 60% is located in Texas with 45% in Houston, and another 20% in Denver. No other city has more than 7.5% exposure and no other state has more than 5% exposure, according to Morgan Stanley CMBS analyst Richard Hill.

The largest loan exposure is the $168 million securitized loan encumbered by Brookfield Office Properties' Two Allen Center in Houston. Chevon subleases more than 300,000 square feet from Devon Energy until January 2020 and Eni S.p.A, a major integrated energy company, leases 141,171 square feet of the property until January 2020.

Houston Gets 'Natural Breather' From Fast Growth
Sandler O’Neill’s analysis of REITs with major Houston exposure, including Parkway, EastGroup Properties

and apartment owner Camden Properties Trust, is a bit more circumspect.

Oil price declines are not likely to change the Houston landscape in the near-term for two main reasons. Initial cutbacks will likely affect new oil and gas exploration sites rather than existing production, and the petrochemical industry seems to be continuing unabated.

"Barring a total collapse of the energy market, we believe that Houston is likely to take a natural breather after a long healthy run, but the low cost of living and diverse economy should soften any energy related slowdown," said Sandler REIT analysts Alexander Goldfarb, adding that Houston's job growth flourished even when oil prices were lower than today.

That being said, "we understand investors' desire to either pare Houston exposure or express negative sentiment on the market's outlook" given the oil price collapse and the U.S. oil shale revolution that has upended global oil market pricing criteria, Goldfarb said in a note to investors.

"We estimate any earnings impact to be minimal, though asset pricing is likely to be affected as institutional buyers potentially step back from the market and others temper their underwriting enthusiasm," Goldfarb said.

Matthew Deal, principal of Houston-based real estate valuation and counseling firm Deal Sikes & Associates, said Texas real estate fundamentals remain strong and the retreat in oil prices will not immediately deflate property markets.

"However, if oil prices fall precipitously and oil rigs are mothballed, Texas real estate markets would be impacted later in 2015," Deal said, adding that commercial land for development will be the most susceptible to softer pricing.

With low vacancy rates and rising rents in most sectors, the health of real estate markets will be enough to sustain the momentum in the short term, even with the many new projects being completed, Deal said.

The Houston market, ranking in the top five for office growth in 2014 through 2016, should continue to perform well over the next few years, but sustained oil price pressure could affect the vacancy rate the Katy Freeway West submarket, also known as the Energy Corridor, if demand slows as significant new supply comes on line, noted Well Fargo Securities in an analysis of CMBS issuance.