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Drilling Deeper into Houston Space | May 2015

The connection between energy prices and Texas commercial real estate is more much complex than it was thirty years ago. The rule of thumb is that a prolonged decline in oil prices is negative for producer states and positive for non-producer states. Theoretically, the non-producer states will be beneficiaries of lower energy prices (such as gasoline and utilities), which should increase consumer spending, a major component of GDP growth. In contrast, the benefits of lower energy prices in producer states are offset by contraction at energy-related businesses, leading to lower wages and potentially layoffs.

Despite Texas receiving most of the headlines, Oklahoma, North Dakota, and Wyoming are estimated to have the highest percentage employment decline from a fall in oil prices, according to a study by the Council on Foreign Relations (or CFR). Though Texas would be negatively impacted, the CFR study projects that five states would be impacted worse. A study by BBVA confirms these findings, putting eleven states ahead of Texas for employment declines in the case of falling oil prices. Figure 1 shows the top outperformers and underperformers in such a case. Of those states, publicly traded REITs are only remotely present Texas, which comprises 8.3% of the Bloomberg REIT Index exposure by square footage as of December 31, 2014. Thanks to an effort to diversify away from energy, Texas significantly reduced its dependence on energy prices since the 1980's.

Figure 1: Estimated Effect (100's bps) on Employment Growth by State for a 10% Drop in Oil Prices

Source: BBVA, Haver Analytics

From October 31, 2014 ($80.53 per barrel of West Texas Intermediate, or WTI) to March 31, 2015 ($47.72 per barrel of WTI), REITs with more than 20% of NOI from Texas[1] have produced a total return of +5.3%. In comparison, the MSCI US REIT Index had a total return of +8.9% over the same period. From conversations with REIT CEOs, local brokers, and relevant industry contacts, we believe the stock prices for REITs with elevated exposure to Texas, especially Houston, are the victims of a 'pile-on' trade that has been self-sustaining without much evidence of value destruction… yet.

Texas…1980's All Over Again?

Texas is widely regarded as oil country. Thus, when oil declines precipitously, fear rises that the economy will suffer. In the first quarter of 2014, Texas created over 78,000 jobs. In the first quarter of 2015, job creation was only 21,000, with March producing the first negative job growth number since 2009. Oil and gas business contraction was apparent, as the industry claimed responsibility for 6,900 jobs lost in the first quarter. Even services employment, typically resilient, turned negative in March.

The Texas Manufacturing Outlook Survey fell below zero in March and remained there in April, posting a -4.7 number. Readings below zero are early indicators of a slowdown in the economy. The situation does not appear to be rapidly reversing as new orders have fallen further into negative territory.

Houston, Austin, and Dallas saw a slowing of job growth in the first quarter of 2015. Over the first quarter of 2015, Austin created 4,800 jobs, which compares to 11,600 in the same period last year. Dallas showed a similar deceleration, slowing from 20,300 in 2014's first quarter to 6,000 in 2015. Houston, the "Energy Capital of the World", created only 2,300 jobs in the first quarter of 2015, down from 30,700 in the first quarter of 2014.

1: American Campus Communities (NYSE: ACC), American Residential Properties (NYSE: ARPI), Camden Property Trust (NYSE: CPT), Cousins Properties (NYSE: CUZ), CyrusOne (NASDAQ: CONE), Eastgroup (NYSE: EGP), Franklin Street (NYSE: FSP), LTC Properties (NYSE: LTC), Mid-America Apartments (NYSE: MAA), National Retail Properties (NYSE: NNN), Parkway Properties (NYSE: PKY), Post Properties (NYSE: PPS), Retail Properties of America (NYSE: RPAI), Sabra Health Care (NYSE: SBRA), Sovran Self Storage (NYSE: SSS), Starwood Waypoint Residential Trust (NYSE: SWAY), The GEO Group (NYSE: GEO), Universal Health Realty Income (NYSE: UHT), Weingarten Realty (NYSE: WRI), Whitestone REIT (NYSE: WSR)

However, it's likely that San Antonio, Austin, and Dallas will actually be net *beneficiaries* from a decline in oil prices, as their oil-related business is not significant enough to offset the anticipated savings from lower energy prices. According to BBVA Economist Boyd Nash-Stacey, these economies should experience average *additional* 2015 GDP growth of 120 basis points (or bps) if oil prices average approximately $43 per barrel of WTI for the year. Houston is projected to be the only city of the top four by population to experience a deceleration of GDP growth in the scenario, taking away 180 bps from GDP growth. Houston comprises 2.4% of the Bloomberg REIT Index as of December 31, 2014.

Houston, the Market Thinks You Have a Problem

From October 31, 2014 to March 31, 2015, a basket of nine REITs[2] with more than 10% of their Net Operating Income (or NOI) derived from Houston underperformed the MSCI US REIT Index by 957 bps.

Some perspective is necessary when attempting to completely revalue Houston commercial real estate based on a few leading indicators. Often perceived as a 'boom or bust' economy, Houston has been one of the most consistent GDP, employment, and population growers since the early 1990's. Employment and population growth in Houston proved resilient through both the 2000-2001 and the 2008-2009 recessions, while 'gateway' cities like San Francisco and New York City experienced extremely quick and deep changes to their economies. Even Washington, DC had a pronounced stagnation in 2013-2014!

In 2000-2001, the San Francisco Fed Tech Pulse Index peaked at 118 in October 2000 before falling precipitously for the next several months, and finally bottoming at 64.4 in January 2003. From December 2000 to December 2003, the San Francisco metro area lost over 190,000 jobs. Over the same period, Houston lost only 10,000 jobs. The Tech Pulse index has not made it back to October 2000 levels — even in the age of Facebook (NASDAQ: FB) and Twitter (NYSE: TWTR) — and the metro area only recovered to prior peak employment levels in October 2014.

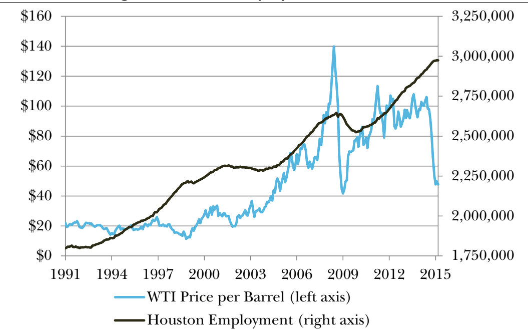
> *"As of mid-2014, Houston is 11.5%, or $53 billion, larger than Washington DC."*

New York City lost 270,000 jobs from December 2007 to December 2010 (NYC only reports annual numbers) as a result of the financial crisis, many of them tied to the high-paying finance industry. In the same period, Houston lost only 35,000 jobs.

Finally, Washington, DC lost 2,000 workers from February 2013 to March 2014, a period when Houston *added* more than 90,000 jobs. In 2011, the Houston economy was smaller than Washington, DC. As of mid-2014, Houston is 11.5%, or $53 *billion*, larger than Washington, DC.

San Francisco, New York, and Washington, DC each had an elevated concentration in a particular part of the economy, which magnified a decline for the city when that industry contracted. However, each of the three markets is considered to be a 'gateway' city, which buoyed property prices. Houston is in a similar position, but is being treated as if it is a secondary city that will come and go with the price of oil. As shown in Figure 2, oil prices have been all over the place since 1990, while employment growth has been steady.

Figure 2: Houston Employment and Oil Prices



Source: St. Louis Fred, Bureau of Labor Statistics (BLS), Seasonally Adjusted. As of March 31, 2015.

The State of Houston

Houston is overbuilding in the 1980's. As we showed in the January 2013 Chilton REIT Outlook titled 'Bull Market in Bayou City', Houston doubled its total office square footage from 1982 to 1987. However, from 2000 to 2012, Houston averaged only a 1.4% increase in office square footage, which compared to average annual job growth of 2.1%. As a result, occupancy increased to cyclical highs by mid-2014, driving rents to all-time highs. To catch up with demand, Houston experienced new office supply growth of 3.9% in 2014, one of the highest in the top 20 US cities.

As of March 31, 2015, Houston had 14.0 million square feet (or sqft) of office space under construction, of which 65% was preleased. 14.0 million sqft amounts to approximately 7% of existing inventory. In addition, sublet space of

2: American Residential Properties (NYSE: ARPI), Camden Property Trust (NYSE: CPT), Cousins Properties (NYSE: CUZ), CyrusOne (NASDAQ: CONE), Eastgroup (NYSE: EGP), Franklin Street Properties (NYSE: FSP), Parkway Properties (NYSE: PKY), Weingarten Realty (NYSE: WRI), Whitestone REIT (NYSE: WSR)

2.6 million sqft has been added to the market in the past three months, which could put pressure on rents.

The naysayers who have sold down Houston-related REIT prices could be correct. Due to the effect of a stronger dollar, exports from the Houston ship channel could decline, resulting in lower GDP growth. The Houston PMI survey is sitting at its lowest level since 2009, indicating that employment, production, and orders are expected to decline. Average wages, and therefore consumer spending and potentially home prices, could decline if some of the higher paying energy-related jobs are cut. For reference, the average pay for a Houston mining (oil and gas) worker is $185,000, which is about three times the Houston average.

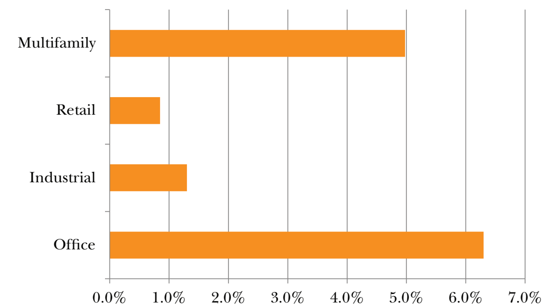
However, these are all merely indicators. The economy grew in the first quarter by adding 2,300 jobs. Despite losing 3,100 jobs in energy-related sectors, the economy added 6,600 leisure and hospitality jobs, while health care and education added 2,900. The weak March Houston PMI stated that, "the current predicted downturn has been driven by weakness in the oil and gas exploration area along with support industries". But it also said, "Utilities, health care, and durable goods manufacturing unrelated to the energy sector reported good results this month. Sales/new orders were up for these industries…."

Houston has the largest port in the country as measured by tonnage, as well as the largest medical center in the world by number of jobs and acreage. The petrochemical industry is a major contributor to the economy, which actually benefits from lower energy prices. Finally, Houston drivers are some of the most prolific in the country, tied for the second longest commute out of the top cities. As such, the savings on gasoline will disproportionately benefit consumer spending for those who are able to keep their job in the midst of an extended pullback in oil prices.

Houston's population growth also screens attractive, especially relative to other top 20 US cities. From April 2010 to mid-2014, Houston added 569,690 people to its population according to the US Census Bureau. This is more than NYC, Dallas, or Los Angeles. Boston and New York are actually seeing domestic *emigration* from the cities.

Houston single family home sales increased by 3.8% in March from a year earlier despite the negative press. Even if job growth slows, the strong projected population growth could act as a floor for GDP growth, driving spending, manufacturing, and even home prices (or apartment rents). The BBVA economist believes that Houston home prices would increase by 0.6% in a scenario where WTI falls to $43 per barrel.

Figure 3: New Construction as a Percent of Total Inventory



Source: Colliers, ARA. Multifamily, Office, Industrial as of March 31, 2015; Retail as of December 31, 2014.

As shown in Figure 3, there is significant office and multifamily construction underway, but little in the way of retail construction. Industrial construction is also relatively low, and comments from brokers and EastGroup (NYSE: EGP) indicate that demand is keeping up with supply, as evidenced by the 3.8 million sqft absorbed in the first quarter of 2015, up 81% compared to the same period last year. Lending has been cutoff to all multifamily construction, and any office project that can be halted has been. As such, the pullback in oil prices may create more opportunity for rent and occupancy growth in 2016 and beyond as new supply moderates.

Think Before You Sell

With the recent underperformance in Houston-related REITs, the market is assuming the fall in oil prices will create an imbalance between supply and demand that could eventually result in lower cash flows and higher cap rates. Given the available data and projections, we believe that it's too early to drastically write down the values of commercial real estate in Houston owned by REITs.

A survey released in April by the Kinder Institute for Urban Research stated that 69% of respondents believe Houston provides "good" or "excellent" job opportunities, the highest reading since 1982. Axiometrics recently reaffirmed their projection for 73,000 jobs, and the Greater Houston Partnership projects population growth of 125,000 for the year. In comparison, Washington, DC had flat job growth from February 2013 to March 2014, but a basket of REITs with more than 20% of NOI from DC[3]

had average total returns of 5.5% over the period, which compared to 6.7% for the MSCI US REIT Index. Investors should take a deeper look into the underlying Houston exposure by market, submarket, rent roll, and development.

For example, Camden Property Trust (NYSE:CPT) derived only 13% of its NOI from Houston in 2014. Using the consensus Net Asset Value (or NAV) of $84 per share from SNL as of April 30, 2015, CPT's stock price of $75.08 per share as of the same date is an 11% discount to the price at which analysts believe CPT could sell its portfolio. When compared to the 2% NAV *premium* for the entire apartment REIT sector, CPT's stock price essentially assumes that its Houston portfolio is worth nothing! CPT's Houston portfolio produced same store revenue growth of +3.9% in the first quarter of 2015, and recent transactions indicate cap rates have increased 25-75 bps. The higher cap rates justify some value destruction, but even a 100 bp increase in cap rates (from 5.5% to 6.5%, for example) would only result in a 15% loss of value.

Cousins (NYSE: CUZ) owns office buildings in the West Loop/Galleria and Greenway Plaza submarkets, two areas with little new construction. Combined, these markets have only five office buildings under construction for a total of 1.6 million sqft, of which 57% is preleased as of March 31, 2015. In 2015 and 2016 *combined*, CUZ has less than 500,000 sqft of space expiring in Houston, which equates to 2.9% of their total portfolio. CUZ estimated that the expiring rents are between 11% and 12% below market, meaning that Houston rents could decline by 10%, and CUZ would still produce same store revenue growth for the Houston market.

Parkway Properties (NYSE: PKY) has similar projections, with only 3.6% of their total portfolio expiring in Houston in 2015 and 2016 combined. PKY estimates that expiring rents are between 16% and 20% below market.

Eastgroup's Houston industrial portfolio stood at 97.2% leased as of March 31, 2015, producing positive leasing spreads of almost 15% in the first quarter. EGP has only 3.7% of its total portfolio expiring in Houston in 2015 and 2016, and energy-related tenants constitute only 20% of the 3.7%.

Last, the quality of the management teams should not be forgotten. REITs typically invest in high quality locations, and most management teams have displayed an impressive recent track record for capital allocation, which should give investors confidence in leasing, development, and transaction decisions. Outgoing EGP CEO David Hoster gave us a reminder about the dominance of EGP's 3.2 million sqft World Houston Business Center in EGP's first quarter 2015 earnings call: "…if you can't build at World Houston, you probably are not going to build anywhere in the Houston market given its success, central location, and quality…."

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3: Boston Properties (NYSE: BXP), Corporate Office Properties (NYSE: OFC), Dupont Fabros (NYSE: DFT), Federal Realty Trust (NYSE: FRT), First Potomac Realty (NYSE: FPO), Government Properties Income Trust (NYSE: GOV), Home Properties (NYSE: HME), PS Business Parks (NYSE: PSB), Ryman Hospitality Properties (NYSE: RHP), Saul Centers (NYSE: BFS), Washington REIT (NYSE: WRE)