

July 09, 2008

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High Gas Prices Driving Real Estate in New Directions

Impact of Rising Energy Prices Compelling Practical, Psychological Changes to Real Estate Decisions

The \$4-plus/gallon of gas threshold hit this summer has pushed the real estate industry in unforeseen ways -- fundamentally altering how it behaves and its understanding of markets.

It is changing the way brokers market property, how brokerages charge clients, how managers budget improvements, how tenants decide where to locate, how local governments are approaching development and transportation issues, how consumers decide where to spend money, how logistics firms manage their distribution centers, how landlords calculate their expense pass-throughs, and how lenders fund construction projects and acquisitions. It has investors adjusting their acquisition criteria and has asset managers recalculating cash flows. And these are just a few of the ways.

CoStar Advisor surveyed readers across the country this week to gauge if and how high gas and diesel prices are impacting commercial real estate. As a measure of how pervasive the topic is in their typical workday, we received more responses to the question than to any other we have previously asked.

The impact has been both practical and psychological -- showing up across the board. It's most obvious at the micro level where everyone has felt the pinch of \$1 more a gallon over last summer's prices. It's commonplace now for the cost of a tank of gas to top \$100 and it's not uncommon to go through that every two or three days.

"Gas prices are killing me," said Charles Paxton, president of Carolina Homes & Land Realty in Harrisburg, NC. "I spent \$600 last month and barely left town. I must travel to see the site and meet the clients but I am now forced to transact as much as possible over the phone. I am now telling buyers to pay me an advance towards earned commission if they want more than I can provide over the phone. This is not going over well but I can't continue to go broke on a sale that may never take place."

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But the high gas prices are also menacing at the macroeconomics level.

"Oil prices (more so than gas alone) are impacting world economies and financial markets in dramatic fashion," said Carl Trotto, vice president of acquisitions for Esplanade Capital in New York. Trotto joined the company this year from Cushman & Wakefield where as a capital markets professional he structured and executed commercial real estate transactions.

Energy prices "are exacerbating the present concern in the financial markets," Trotto explained. "This negatively impacts real estate valuations as it does valuations of all assets. In fact, the impact on real estate is arguably more dire than for other asset classes because of the leverage (and tax incentive of leverage) associated with real estate finance.

"At the microeconomic level, oil prices (and higher inflation to be sure) are causing firms in a variety of industries to forestall expansion and/or retrench existing operations. Both of these impacts have obvious repercussions for the buying, selling, and leasing of real estate," Trotto added.

In short, said Edward L. Miller, managing director and principal of Colliers Arnold Commercial Real Estate Services in Tampa, FL, "high gas prices suppress the optimism essential to investor confidence."

Geographically Undesirable

On the housing front, the rising cost of gas is wiping out any of the savings that homeowners found in the outlying areas of cities across the country.

"Gas prices have killed the tertiary new home market as the "drive until you qualify" buyer is no longer in existence," said Dave Miller, vice president/national accounts and commercial sales manager for Chicago Title in Phoenix.

"As the price of gas continues to rise the affordability differential of living in suburbs and bedroom communities is diminished," said Michael Beach a director at Captec Financial Group in Southern California. "We see population growth stronger nearer the city center and, if prices continue to rise, a likely drastic reduction in urban sprawl. Likewise, we expect reduced traffic at regional malls and outlet centers in markets where there are alternative places to shop."

"It's viewed as a big negative for the outlying markets here in Phoenix," said Jason Weber, director of acquisition for Cole Cos., which is focused on land acquisition and commercial development. "Many of the areas that boomed two to three years ago are 40 to 50 miles from downtown Phoenix. The cost of gas will definitely negatively affect demand for housing in these areas, because the cost of people's commute has essentially doubled."

Journey to the Center

The dynamic of gas price cost to distance is turning residential investors' attention toward closer in markets.

"Savvy multifamily investors are looking for deals nearby -- or preferably next to -- bus stops or other public transit locales," said Alex J. Beachum with Income Property Organization in Bloomfield Hills, MI. "Their logic is that as prices continue to climb, more and more tenants will turn to this form of transportation to alleviate the burden of gas prices. And a complex with immediate access to such transportation will be alluring to these conservation-minded tenants."

"From a land development and building perspective, the price of gas absolutely is affecting the market," said Richard MacDonough, vice president of Fraser Forbes Land Sales in McLean, VA. "I am seeing profound interest in core area development projects - inside the Beltway in both Baltimore and [Washington] DC. That is particularly the case with sites near Metro stations and major transit hubs where commuters can share transportation.

"Denser sites close in create efficiencies for builders, reduce construction costs, allowing the developers to have a profitable deal but keeping home prices within reach of most buyers," MacDonough added. "A lot of our developer clients are creating new ways to reach out to this market, and I see government looking for ways to make projects like this work."

Density

We heard from several others that municipalities across the country, which have seemingly dragged their feet on addressing development and transportation issues, are now being forced into action.

"In our town (Fairfield, CT), the Plan and Zoning Commission is already looking at implementing aspects of the model "smart code" (higher densities and pedestrian-friendly mandates). This would have never happened a few years ago as NIMBY or "just say no to development" activists would have shot it down," said Stuart Baldwin, principal of American Capital LLC.

"The long-range effect will favor close-in redevelopment, particularly around existing or planned public transportation," said Mark Squires, a realtor with Coldwell Banker Commercial NRT in Maitland, FL.

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"Transit Oriented Development (TOD) is big and getting bigger. TOD needs the various cities and counties to loosen their development codes in the areas of height, density, FAR, etc., and in many cases we're seeing that here in Florida despite some citizen opposition.

"The trend here is really against massive outlying sprawl and new subdivisions, strip centers, etc., and toward close-in population concentrations, where people can work, play, live, shop, etc. in a small, dense area, but with required parks and green space. This trend, of course, has been existing for several years, but the high gas prices are accelerating it," Squires added.

End of Drive Bys

Even the broker tenant relationship is changing as both sides deal with the rising price of commuting across metropolitan areas and as they alter their expectations and needs.

"In my daily routine, the price of gas only comes up when discussing properties to visit that require a drive to get to. I find investors are using brokers, attorneys, accountants, etc. to gather more information before making a site visit. I have even had potential buyers make offers without visiting the property," said Stephen Fuerst of Centrus Group Inc. in Akron, OH.

From a brokerage standpoint, Graig Griffin, principal of Coldwell Banker Commercial KGA in St. George, UT, is seeing some definite trends.

"Agents are being much more judicious about showing property in peripheral areas, doing a better job of prequalification before getting in the car with clients. This is even more true of residential agents and most will not tour a buyer without an exclusive representation agreement," Griffin said. "Agents are carpooling more for market tours and site visits. In my office, it is now common to here "I am headed to X area - does anyone else need to head that direction?"

Positioning

Griffin also is seeing a host of changes from the tenant.

"Market positioning is becoming much more crucial with delivery-based firms exploring traffic modeling/drive time analysis," he said. "As typical, businesses are willing to pay more for locations that service their client base better, shoring up in-fill prices for land and occupancy for space. And companies with a high cost of product or raw material transportation are seeking rail-served property more often."

Brian S. Brennan, director, real estate acquisitions for Allianz of America in Westport, CT, is seeing the same phenomenon.

"When comparing rail cost versus truck cost, the distance traveled by the goods via rail is shrinking for the rail option to be preferable to truck," Brennan said. "The rule of thumb used to be 400 miles or longer made rail a viable option. Now with the cost of diesel, the cost competitive distance for rail may be as low as 200 miles."

It is also impacting where overseas goods are unloaded, Brennan noted.

"Container ships now take "all water" routes to the East Coast of the U.S. rather than offload on the West Coast and truck the containers on land," he said. "Eastern seaports are seeing container volume rise while Western seaports are seeing volume shrink."

Hence industrial tenants, particularly logistics firms, are rethinking where their distribution points should be.

"Super regional distribution centers (800,000 square feet to 2 million square feet) built in rural locations are now less cost effective and some logistics are being re-engineered to put product in smaller buildings closer to population centers, Brennan said.

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Mark Killough, senior vice president of Hartz Mountain Industries Inc. in Secaucus, NJ, noted the same trend.

"I believe that if gas prices stay at the current level, companies will have to reexamine their logistics models," Killough said "The large distribution center servicing a 500-mile radius may not be as efficient with the increase in trucking costs. It may warrant having smaller and more distribution centers to service the same territory."

"The price of gas affects the distribution businesses and the contracting service businesses," said Michael E. Nelson, senior associate of CB Richard Ellis in Stamford, CT. "The distribution businesses located in large warehouses with multiple loading docks in heavy industrial zones usually cannot make a move to improve their location closer to the markets they serve. However, the smaller contractors, like cablevision trucks or home audio businesses that need to reach into large residential zones can move closer to these markets if they watch the opportunities closely. Up until now it hasn't been a factor, but it may surface in the next two quarters."

Passing on Costs

Another area where the price of gas affects real estate decisions is related to raw material prices that are oil-based derivatives, CoStar Advisor readers told us.

"Prices for asphalt roof tiles and other asphalt applications in construction projects are rising at an unbelievable pace," said Tyson Strauser an investment analyst with Longhorn Capital in Dallas. "Though concrete prices have also risen, asphalt is up nearly 50% since January because it is an oil-based product."

"Construction costs are skyrocketing," said Jennifer Britt Starbuck, an asset manager for Pitcairn Properties in Jenkintown, PA. "We've received notices from suppliers for steel, drywall, carpeting indicating 10% to 30% price increases in the next 90 days. Some of this is the result of transportation cost increases (everything is shipped by truck). Some is the result of increased manufacturing costs for petroleum-based products (carpeting). Another example of the latter is asphalt - we've been getting pricing in for asphalt repairs at nearly 40% higher than the same scope last year."

The result of these increased construction costs is that landlords will see lower returns, Starbuck added. "A typical standard tenant build-out is generally the landlord's responsibility in most markets, regardless of cost. In many of the markets we operate in, spaces that could be retrofitted for \$25.00/square foot last year are running \$30/square foot this year. And projects that can be deferred (like sealcoating or asphalt repairs) may be pushed off in the hopes of increased supply in 2009 driving prices back down."

It is also driving up building expenses.

"The issue that is affecting our decisions is not gas but heating oil," said Neal Lorberbaum, principal of Peryn Realty LLC in Westport, CT. "The price of oil has almost doubled in the last 12 months. Since it is a large component of the operating expense here in the Northeast, the increase in cost is amplified when considering the value of an asset depending on the prevailing cap rates."

Smaller Loans

The rising property costs are not going un-noticed by lenders either.

"A few months ago I would have been able to get larger loan amounts and higher loan to values for restaurant startups," said Daniel Cabrera, senior account executive of Empire Commercial Funding Group LLC in Albuquerque, NM. "Now besides both of those being lower today, more collateral is required to back the loan because of higher default rates. All these are directly related to the cost of fuel."

"Lenders have stated that as a direct result of gas prices being higher, they are experiencing more defaults," Cabrera said. "For the obvious reasons: Revenues are down and costs are up. The cost of supplies i.e. food etc to make the meals is higher. Prices for meals have to be raised. However the amount

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of disposable income of the consumer is lower because they're spending more of it on fuel etc. Additionally costs such as getting to the restaurant have to be factored in now when before it would have been ignored. Therefore the restaurateurs are being hit on both sides."

"I was discussing lending criteria as it relates to property value and gas prices," Corey Schwartz, president of Serinova Financial LLC in Phoenix said. "We concluded that the cost of gas is probably not coming down and that property values in the outlying areas of the city are going to be adversely impacted by the cost of gas. Our lending criteria have been adjusted to reflect this."

To see how gas prices have hurt retailers, see [Nearly 4,500 Store Closings ... And Counting ...](#), by Sasha M. Pardy, senior news editor.