

OIL & REAL ESTATE

July 2008

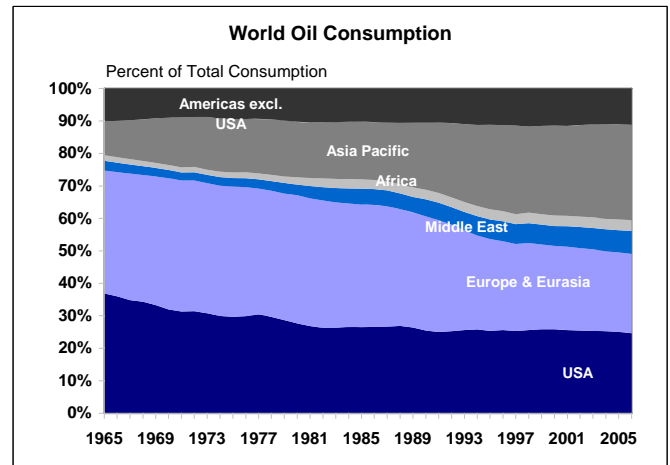
In this month's newsletter, we will examine the impact rising energy costs have on the economy and real estate markets. While this newsletter presents a short summary of our findings, a more in-depth study of this topic is available on our website: <http://www.americanreal.com/publications/OilRealEstateAnalysis.pdf>.

Executive Summary

- The current high price of oil is not permanent, but is most likely cyclical and prices could peak in 2009. High energy prices eventually slow demand and justify increased exploration and production, but it may take several years before the price of oil falls to new support levels.
- Pricing for older less efficient buildings is most at risk, as higher operating costs are likely to cut into net rents more than with newer, efficient buildings.
- From a usage perspective, the industrial sector is the most energy intensive. However, the multi-family and retail sectors are most likely to be impacted by higher oil prices due to higher operating costs, increased tenant turnover costs, and reduced demand from a slowing economy.
- Rising energy costs mean that location is more important than ever. For example:
 - 1) Office buildings located in public transit dominant CBDs should achieve more demand growth than suburban offices without public transit access.
 - 2) Multi-family properties not located near major employment centers should see demand weaken.
 - 3) Warehouse distribution centers in locations that minimize fuel costs, in addition to labor and rent costs, should see increased demand.

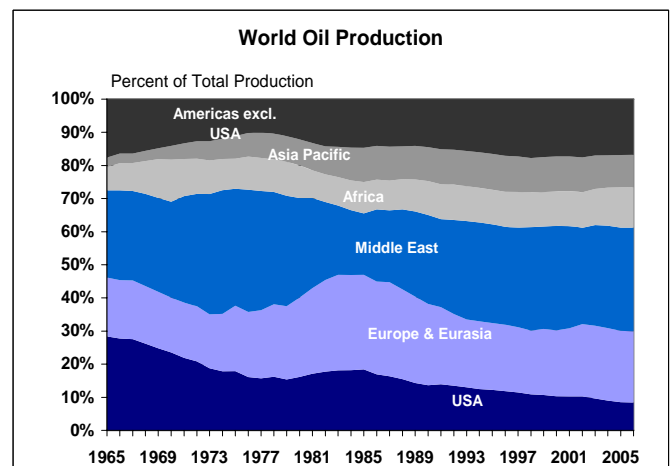
The Oil Market

The past decade has seen strong global economic growth that has been particularly energy intensive due to its concentration in emerging industrial based economies. This growth has led to strong global energy demand, even in the face of rising prices. As of 2007, world oil consumption averaged 85.8 million barrels per day, a 12% increase over the past decade. In 1999, Asia became the largest oil consuming region in the world and by 2006 accounted for nearly 30% of global oil demand.



Source: BP, ARA Research

Over the same time period, world oil production grew 16.3%, with production increases seen in Africa and the former Soviet Union. Nevertheless, global oil production currently averages 85.6 million barrels per day, a 0.2% shortfall. This shortfall is due to supply disruptions across the globe that have strained capacity and hampered increased production.



Source: BP, ARA Research

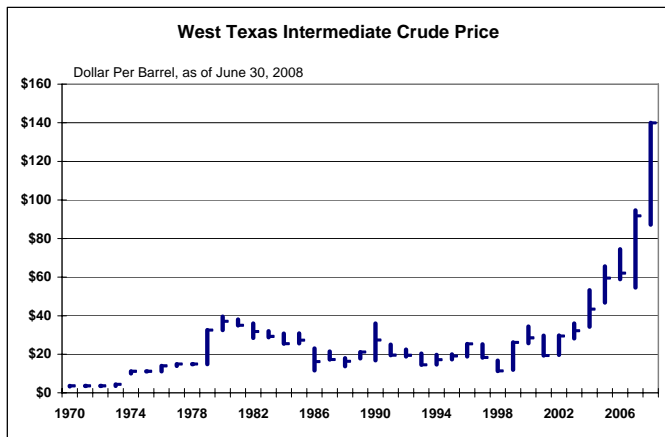
The Price of Oil

Over the past decade, the price of oil has climbed from a 30-year low of \$12.72 per barrel to a monthly average of \$133.88 per barrel as of June 2008, a 953% increase. Several factors are contributing to higher oil prices:

1. **Weak US Dollar:** The weighted average exchange value of the US Dollar has declined 37% since reaching a 16-year high in 2002 and is currently at all-time lows.
2. **Supply Disruptions:** Supply disruptions caused by war and political unrest have resulted in production shortfalls and increased risk premiums for oil.
3. **Surplus Capacity:** In 2005, OPEC surplus capacity fell to a low of only one million barrels per day.
4. **Demand for Distillates:** Emerging economies' demand for diesel as a primary fuel source has strained global refinery capacity and increased demand for light crude oil.
5. **Oil Subsidies:** Emerging economies – such as India, China, Venezuela, and Taiwan – subsidize the cost of oil for domestic use. Demand in these markets is not dampened by higher prices.

Will the Price of Oil Eventually Fall?

Yes. Based on our research of data going back to 1861, oil price spikes are not permanent but cyclical, occurring on a roughly 29-year cycle. High oil prices eventually justify increased exploration and production as well as tame demand, but these adjustments often take many years. During the previous cycle, oil broke through price resistance in 1974 and increased for seven years. Thereafter, oil trended downward for eight years to reach a new price support level. In the current price cycle, oil broke through price resistance of \$40 per barrel in 2004 and, as of today, has increased for five years. Based on



Source: Economy.com, EIA, ARA Research

historical market cycles, oil prices could peak in 2009. Thereafter, it may take several years to fall to new support levels. As a result, we believe higher oil prices will be with us for a long period of time, but the price of oil will eventually fall from current levels.

Why Additional Supply is Likely

There is no shortage of oil reserves. Global proven reserves have doubled since 1980 to 1.3 trillion barrels, representing a 41-year supply. Higher energy prices are now spurring increased exploration and investment in energy production, as the expected return from these projects has greatly increased. OPEC countries are investing \$120 billion into over 100 projects. Of this, Saudi Arabia is spending \$50 billion to raise capacity to 12.5 million barrels per day by the end of 2009. In the US, active rigs have increased to an average of 1,800 in 2008, a 284% increase from an all-time low of only 635 in 1999, when the price of oil was just off a long-term low.

How Does the High Price of Oil Affect Commercial Real Estate?

So far, increasing energy prices have led to increased interest in energy efficiency and have put upward pressure on operating costs, but there has been no impact on real estate demand or values. As the price of oil spikes higher, however, we are likely to see a greater impact upon commercial real estate, as not only the overall price but also the magnitude of price increases affects all aspects of the economy. In general, oil impacts real estate in three basic ways:

1. **Overall Demand:** Real estate demand is tied to employment growth. In our analysis of oil price versus employment growth, we found that when the price of oil increases over 50% in one year, employment contracts an average 0.1% in the following year. In contrast, when the price of oil decreases over 20% in one year, employment grows an average 2.5% in the following year.
2. **Income:** As energy prices are interrelated with inflation levels, energy prices affect both rents and costs. If both rise with inflation, income will not be affected. However, if only costs increase by inflation, income will fall behind. Due to higher operating costs, rising costs are especially problematic for the retail and multi-family sectors, and current first quarter 2008 rents for these sectors were actually negative when adjusted for inflation.
3. **Value:** If real estate demand drops significantly due to a recession, or if net income falls behind inflation for a

sustained period of time, real estate values could fall. Further, values may be more impacted by location, building type and energy efficiency, with older, inefficient and poorly located buildings suffering greater value declines than more efficient buildings in prime locations.

Will People and Businesses Move to Save on Energy Costs?

According to ACCRA’s Cost of Living Index, goods and services plus housing comprise 64% of the total after-tax living costs, while fuel related cost for utilities and transportation account for only 19%. This means that people are, on average, three times more sensitive to housing costs than energy costs. In addition, as higher energy costs generally impact all metros equally regardless of the relative differences in costs, the attractiveness of one metro over another should not be dramatically changed by the current rise in fuel costs. However, to the extent that higher energy costs cause certain marginally affordable metros to become unaffordable for certain cost sensitive operations or too expensive for large portions of the population, higher energy prices could cause some businesses in the long-run to cease or move operations offshore and some cost-sensitive populations, such as seniors, to move to lower cost areas.

have public transportation available, these metros should remain attractive for businesses and residents. Within metros, exurban locations should become less attractive, while locations close to public transportation should become more attractive.

Public Transportation Metros	
New York-NNJ-Long Island	
Chicago	
San Francisco-Oakland-San Jose	
Washington-Baltimore	
Philadelphia	
Boston	
New Orleans	

Source: The Public Purpose, ARA Research

Fuel Cost Impact on the Industrial Sector

Within the industrial sector, labor and facility costs account for the majority of location sensitive costs, but transportation and primary fuel costs can account for up to 25% of variable costs. Because of transportation and energy intensive operations, the industrial sector is the most fuel sensitive property sector. As costs have increased more for truck and air transport, rail and port transport now have cost advantages. As a result, the industrial sector, more than any other property sector, could see relocations in order to reduce transportation costs. As a result, over time we expect warehouse and distribution demand to increase in locations with superior rail (i.e. Chicago) and port (i.e. Houston) access. In addition, we expect a shift from fewer big warehouse facilities to an increased number of smaller facilities in order to reduce trucking distances.

Ranking of Energy Costs		
Top 5 Bottom 5	Utilities (10% of Total)	Transportation (9% of Total)
1	New York City	Honolulu
2	Boston	San Francisco
3	Honolulu	San Diego
4	Juneau	Juneau
5	Buffalo	New York City
41	Charlotte	El Paso
42	Eugene	Des Moines
43	Jacksonville	Memphis
44	San Antonio	Jackson
45	Colorado Springs	San Antonio

Source: ACCRA Cost of Living Index (1Q05), ARA Research

With respect to transportation, costs are generally higher in more sprawling areas than in more densely populated areas, since costs are mitigated in densely populated metros with public transportation. Within the US, 76% of public transit demand is concentrated in seven metros, with New York and Chicago accounting for half of the US public transit usage. To the extent that higher cost metros

Location Sensitive Costs	
Industrial Sector	Percent of Total
Labor	58% - 74%
Facilities	8% - 19%
Transportation	1% - 15%
Electricity/Natural Gas	2% - 10%
Telecommunications	0% - 1%
Taxes	6% - 11%

Source: KPMG, ARA Research

Fuel Cost Impact on the Office Sector

Labor is the most important location-sensitive operating cost within the office sector, accounting for up to 88% of variable costs. For the office sector, fuel-related costs account for only 1% to 3% of total location-sensitive costs, with electricity the primary fuel source. Due to its minor impact on overall costs, most operations are not

electricity cost sensitive and should be less affected by higher fuel costs. However, because labor costs are the largest location sensitive costs, to the extent that higher oil prices and the resulting inflation put pressure on wage increases and the ability to attract workers, metros with lower labor costs could become more attractive to certain cost sensitive service operations. For operations reliant on highly skilled workers located in high cost areas, energy efficient buildings should see increased demand. Finally, as higher fuel costs increase worker transportation costs, businesses located close to transportation or businesses which allow telecommuting should see less wage growth pressure. As a result, locations close to public transportation should experience growth in demand.

Location Sensitive Costs	
Office Sector	Percent of Total
Labor	79% - 88%
Facilities	4% - 14%
Transportation	0% - 1%
Electricity/Natural Gas	1% - 2%
Telecommunications	1% - 5%
Taxes	2% - 7%

Source: KPMG, ARA Research

Fuel Cost Impact on the Retail Sector

Consumer retail demand is impacted by inflation levels. To the extent that higher fuel costs lead to higher production costs which can be passed on to the consumer, the cost of goods and services increases. While most consumers respond to higher purchase and transportation costs with reduced consumption, consumers in the lowest income groups are most impacted, as a greater portion of outlay is allocated to fuel.

Besides reduced consumer demand, retailers must also grapple with higher transportation costs and the pass through of increased property level operating costs. National tenants may be more able to absorb higher operating costs than smaller tenants, but all retail tenants may reconsider locations with higher operating costs, such as enclosed malls with large, climate-controlled common areas. Finally, as a result of slower retail sales growth, the retail sector faces increased tenant turnover which impacts property income.

Fuel Cost Impact on the Multi-Family Sector

Demand for multi-family is impacted by employment growth and personal income growth. To the extent that higher oil prices lead to higher inflation and increased unemployment, multi-family demand should be negatively impacted. As higher fuel prices also impact transportation costs, demand for locations close to public transportation or close to employment centers should increase, while demand for locations far from employment centers or public transportation should drop off.

In addition to changes in demand levels, the multi-family sector is also impacted by higher operating costs and tenant turnover. Buildings with larger interior common areas, such as high-rises, should see a greater increase in operating costs versus garden-style apartments and these costs must be passed on through increased rents. Older buildings that have not been retrofitted with energy saving mechanisms could be harder to rent or sell than newer more energy efficient buildings. Finally, with greater multi-family tenant turnover, properties are exposed to greater renovation costs that may increase faster than market rents, thus impacting property income.

Impact of High Fuel Costs on Real Estate				
	Industrial Sector	Office Sector	Retail Sector	Multi-Family Sector
Increased Demand	<ul style="list-style-type: none"> ❖ Energy efficiency ❖ Fuel switching ❖ Locations with rail spurs ❖ Near ports, intermodal 	<ul style="list-style-type: none"> ❖ LEED certification ❖ Energy efficiency ❖ Near transit centers, major employment centers 	<ul style="list-style-type: none"> ❖ One stop shopping ❖ Strip & big box centers ❖ Energy efficiency ❖ Near higher income households 	<ul style="list-style-type: none"> ❖ Garden-style ❖ Energy efficiency ❖ Near employment centers, public transit
Decreased Demand	<ul style="list-style-type: none"> ❖ Older, inefficient buildings ❖ Locations far from transport 	<ul style="list-style-type: none"> ❖ Large common areas ❖ Older, inefficient buildings ❖ Remote locations 	<ul style="list-style-type: none"> ❖ Enclosed malls ❖ Older, inefficient centers ❖ Remote locations 	<ul style="list-style-type: none"> ❖ High-rises ❖ Older, inefficient buildings ❖ Remote locations

Source: Forbes, ARA Research

Conclusion

Oil price spikes are cyclical phenomena. While the price of oil should eventually fall from current levels, higher prices most likely will be with us for several years. During this time, we expect higher energy costs to have an impact on real estate values – in particular, the location, type and energy efficiency of a property should become even more important in determining values within each property sector, with highly accessible energy efficient properties gaining favor over remote, inefficient properties. While location should have the greatest impact on value, every step towards greater energy efficiency will not only reduce energy demand permanently, but also redefine future Class A property standards.

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