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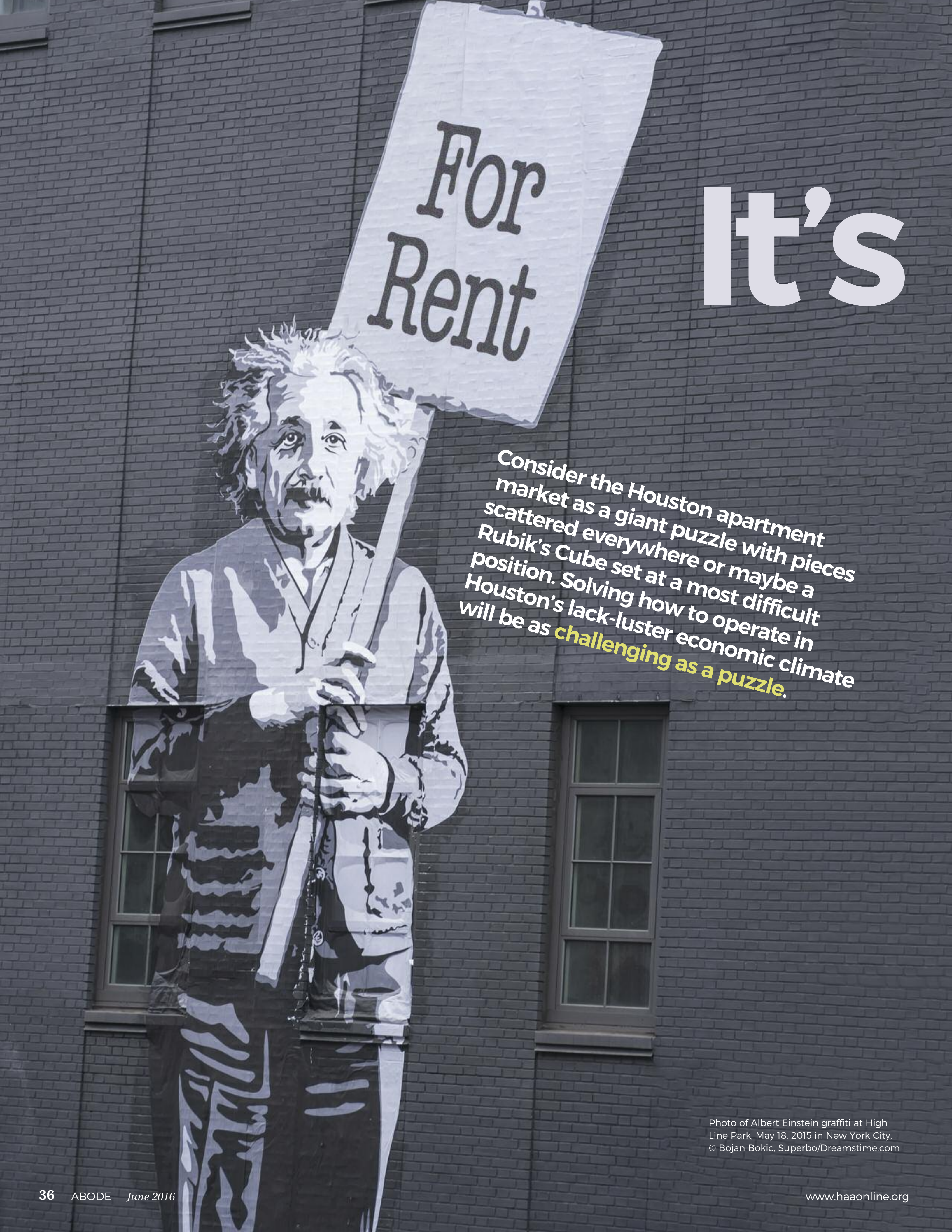


Photo of Albert Einstein graffiti at High Line Park, May 18, 2015 in New York City. © Bojan Bokic, Superbo/Dreamstime.com

It would be great if understanding the dynamics of Houston's current apartment market were as simple as the theory of relativity or rocket science, but it's complicated.

By **BRUCE MCCLENNY**, ApartmentData.com

Complicated

It would be great if understanding the dynamics of Houston's current apartment market were as simple as the theory of relativity or rocket science, but it's more complicated than that. Industry watchers from afar have tried to simplify matters by writing off Houston entirely, but again, it's more complicated than that.

It is true that the Houston economy has been hit hard by the over-supply of oil and its price collapse. The price for West Texas Intermediate (WTI) crude peaked in June of 2014 at $107.95 per barrel. In January 2016, the price for WTI fell to $32.49 per barrel. As oil prices were falling, so did rig count and job growth, which are two measures that are closely followed and indicate economic trends in the oil industry's capital.

The North American rig count peaked in September of 2014 at 1,931 rigs. By the beginning of 2016, the rig count was 664 – an almost two-thirds decline in the number of active rigs. From 2012 through 2014, Houston created 326,300 jobs, representing the best consecutive three-year job creation in Houston's history.

By the end of 2015, job growth had dwindled to 15,200, driven by groups of winners and losers of industry sectors. It's not hard to imagine the losers being associated with drilling and related services. The industry sectors of mining, manufacturing and engineering along with four other sectors lost over 50,000 jobs during 2015.

The main industry sectors that contributed to job growth in 2015 were accommodations/food service, health care/social assistance, construction and government. Additionally, there were seven other industry sectors that contributed toward positive job growth for a total just over 65,000 jobs.

To recap, the losing sectors gave up 50,000 jobs and the winning sectors added over 65,000 jobs to produce a 15,200 net of new jobs for 2015.

The graph on Page 38 shows overall occupancy and effective rent levels starting midway through 2012.

The graph should be viewed and analyzed in relation to the economic information presented above. The exceptional job growth of 2012, 2013 and 2014 spurred strong absorption of almost 47,000 units while new supply delivered during this period was almost 36,000 units. This activity moved overall occupancy from 89.5 percent in June of 2012 to 91.1 percent by the end of 2014. With such strong demand, overall rents jumped by 5.6 percent in 2012, 6.2 percent in 2013 and 7.8 percent in 2014. As Houston's economic fabric began to unravel so did the strength of apartment performance.

The 15,200 added jobs in 2015 did not provide enough demand to keep up with the 20,450 new units delivered, and as a result occupancy began to slide from a high of 91.5 percent to 90.6 percent and rent growth eased to 4.8 percent.

As job growth languishes, the overall market slowly dips lower much to the disappointment of real estate observers who are looking for distressed deals expecting to see more damage in market conditions. As of the end of March 2016, occupancy has settled to 90.2 percent and overall rent levels have remained flat over the last six months.

What complicates the overall scenario is the fact that parts of the market are still doing well. The table shown on Page 38 shows a classification analysis of overall market conditions as of the end of the first quarter of 2016. This distribution shows how market performance is mixed and how classes differ in rates and trends. Classes are determined by a bell curve distribution of market rate.

2015 and 2016 New Construction – Lease-Ups

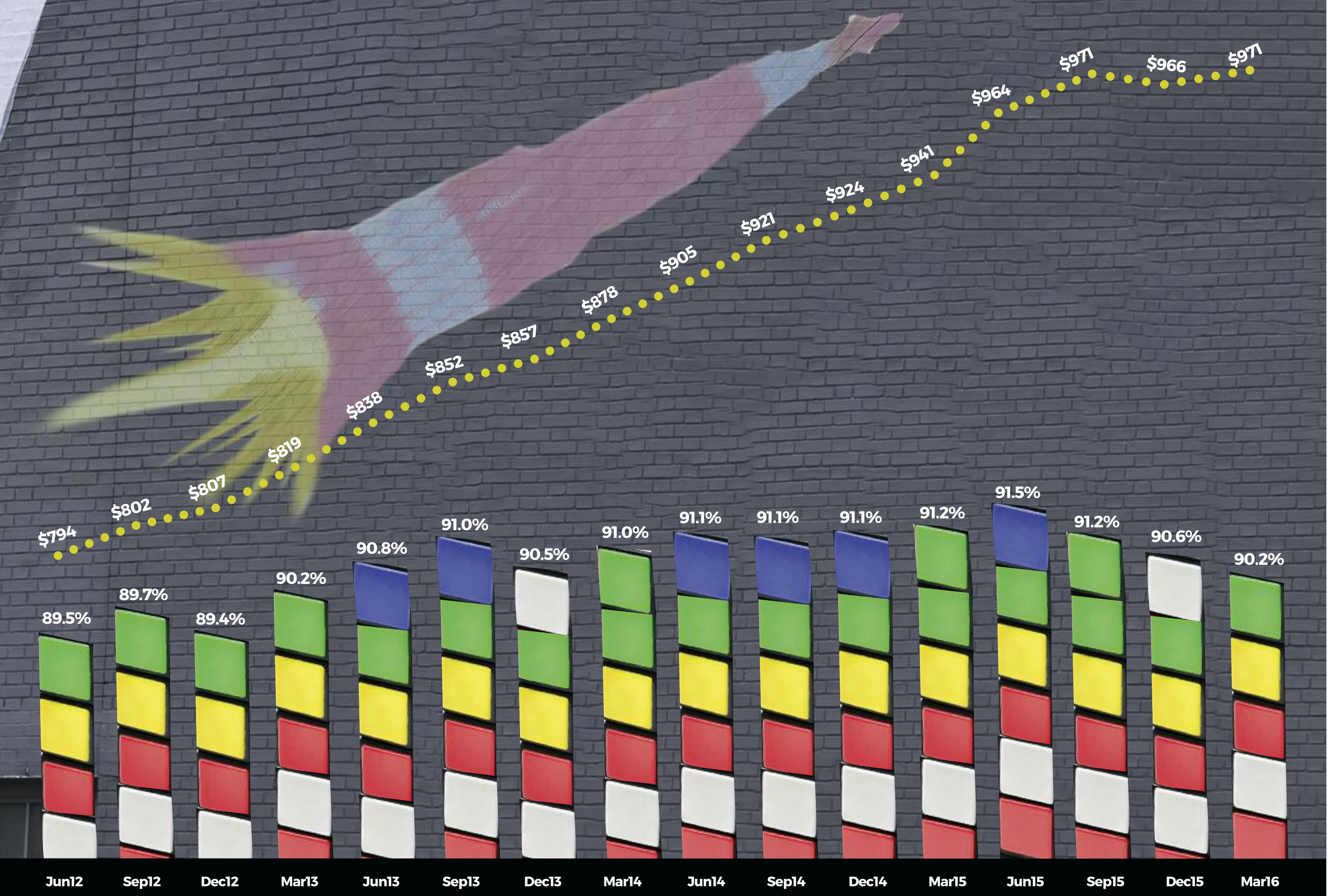
The new construction units delivered in 2015 and 2016 have been filtered out of Class A and Class B to create a separate classification. There are 95 properties totaling 26,355 units within this category with 18,420 units (63 properties) coming from 2015 and 7,935 units (32 properties) coming from 2016, so far. The product type and geography of the 95 properties that fall into this group are diverse.

There are three high-rise properties, four affordable and/or senior properties, 30 urban and/or infill (such as the inner loop and Galleria-area) properties and 58 suburban properties. The average rent level for new construction is delivered at 155.7 cents per square foot and $1,481 per month. Rent averages per property range from $468 per month (59.2 cents per sq ft) for an affordable unit to over $3,400 per month ($2.37 per sq ft) for a high-rise unit. Rent trends for this group cannot be accurately calculated due to the continually increasing number and variety of new units being introduced.

The occupancy for this lease-up group of properties is at 32.8 percent. During a lease-up, occupancy becomes a tertiary measure and absorption and leases per month or leasing velocity are primary. Both the 12-month absorption of 8,080 units and three-month absorption of 2,339 units are astonishingly positive, considering the 12-month absorption performance occurred with a net job growth of 15,200 and the three-month absorption occurred when there was a net job loss of 33,500 jobs.

Even though this absorption was surprising in a good way, it was not enough to keep concessions from mounting. Of the 95 properties in the new construction category, 30 percent of the properties are offering two months free; 15 percent are offering six weeks free; 35 percent are offering one month free;

Houston Overall Rents and Occupancy



Analysis by Classification

As of March 31, 2016	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 3 Months
2015, 2016 Construction	26,355	32.8%	155.7	$1,481	–	–	8,080	2,339
Class A (w/o '15 & '16 const.)	116,783	91.5%	150.8	$1,433	-3.2%	-3.9%	4,949	436
Class B (w/o '15 & '16 const.)	232,542	93.1%	108.7	$942	1.1%	0.5%	-1,923	-592
Class C	180,026	93.8%	88.5	$754	4.9%	2.1%	-2,151	295
Class D	57,033	91.1%	71.2	$598	3.3%	-0.7%	1,688	325
Overall	**612,739**	**90.2%**	**110.5**	**$971**	**2.0%**	**1.3%**	**10,643**	**2,803**

5 percent are offering dollars-off and 15 percent do not have concessions.

Obviously, new properties are experiencing intense competitive pressure and this pressure varies due to location based on new supply in lease up and new supply yet to come. Katy, Cinco Ranch and Waterside have 13 properties in lease-up and six more properties coming soon. Energy Corridor, City Centre and Briar Forest have 10 properties in lease-up and five more coming. Montrose, Museum District and Midtown have four properties in lease-up now but 10 more are on their way. Tomball and Spring have seven properties in lease-up and eight more properties coming.

The combination of more units with diminishing job growth is a bad hand to draw to. Wild cards that trump less demand from poor job growth are empty nesters selling their homes and in-migration from internationals.

Class A Without New Construction – Stabilized

In general, Class A represents the highest priced properties based on their overall average market rate. As mentioned above, a bell curve distribution method determines which properties make the A grade. At this time, 19.5 percent of the operating supply of units has the Class A distinction.

Taking new construction units out of Class A provides a stabilized occupancy picture. This group's occupancy is 79.6 percent before new construction is filtered out and 91.5 percent after the adjustment is made. The occupancy has been flat at this level since September 2015. In addition, rent peaked for this group in September at $1,490 per month and then steadily moved lower to $1,433 by the end of March.

A few aggressive concessions are in place but the negativity for this group is predominantly driven by "prices change daily" systems. Rents for this group are essentially at the same level as they were two years ago. The slide in rents for stabilized Class A has been pretty much universal except for the sub markets of Baytown, Pasadena, Deer Park, La Porte, Friendswood and east Pearland.

Some stabilized Class A's are performing better than others, but on the whole this group is suffering from the concessions that lease-up properties are wielding.

Class B Without New Construction

The bell curve distribution of market rate creates a Class B that represents 36.8 percent of the entire market. The occupancy of 93.1 percent is good, but occupancy has been slowly leaking as the 12-month negative absorption of 1,923 units suggests. In June of 2015, Class B occupancy stood at 94.4 percent.

Class B has been impacted by the competitive turmoil between new construction lease-ups and stabilized Class A. It's understandable that if Class A rent levels are moving lower that Class B's ability to raise, rent would be restricted. Over the last three months, rents have been essentially flat at 0.5 percent. The 12-month rent trend is mildly positive at 1.1 percent. Back in September of 2015, Class B's 12-month rent trend was 5.9 percent.

Class B is the most difficult or complicated category to understand due to very mixed performance by location. Out of 42 submarkets in Houston, 19 are showing a positive trend, 13 are flat and 10 are negative. Most of the positive trends are found in sub markets in the south and east parts of the metro area.

It should be no surprise that Baytown leads the sub market parade with its Class B properties gaining $41 per month over the last year. The sub markets where Class B's are having the toughest time are suburban markets with the most construction activity, such as Energy Corridor, City Centre, Briar Forest, Katy, Cinco Ranch and Waterside. Class B rents have retreated the most in The Woodlands and south Conroe submarket with a $46 per month decrease over the last 12 months.

Classes C and D

Class C represents 31.0 percent of the overall market. Class C can claim the distinction as the best performing class with overall occupancy of 93.8 percent and rent growth over the last twelve months of 4.9 percent. Rent levels have increased by $35 per month and 4.1 cents per square foot. Class C's annualized rent growth over the last three months has settled to 2.1 percent, a slower pace but far better than any other class. Class C achieved this performance despite negative absorption of 2,151 units over the last 12 months.

Class D continues to gain occupancy traction with the 1,688 units of absorption over the last 12 months. This performance moved occupancy from 90.2 percent to 91.1 percent. With this positive movement in occupancy, Class D raised rents by 3.3 percent. Rent levels have increase by $19 per month and 2.4 cents per square foot. Over the last three months, Class D lost a little ground with a rent trend of negative 0.7 percent.

It is very noteworthy that Class D has firmly moved over the 90 percent occupancy mark where rent increases become more sustainable. In years past, Class D's rent movement could be characterized as one step forward and one step back resulting in a mostly flat performance.

Looking For Solutions

Consider the Houston apartment market as a giant puzzle with pieces scattered everywhere or maybe a Rubik's Cube set at a most difficult position. Solving how to operate in Houston's lackluster economic climate will be as challenging as a puzzle. The Greater Houston Partnership has forecasted that job growth will be around 20,000 for 2016. This level of job growth just does not bode well for the 24,000 units currently in lease-up nor those 20,000 additional units that will be delivered this year. The competitive concessionary environment for lease-ups will surely persist and trickle down to the existing Class A and Class B product.

The rent growth performance for stabilized Class A for 2016 will be negative in the neighborhood of negative 3.5 percent. Class B will be mildly positive around 1.5 percent. Class C will keep its favored class status and grow rents organically as well as by value-add upgrades which are still happening but at a much slower pace. Expect Class C rents to grow by 4.5 percent. Class D should continue to improve rents at a 3.5 percent trend.

Forecasting absorption for 2016 has gone off the grid. Traditionally, absorption can be estimated as a relationship to job growth. Developers count on one apartment unit to be occupied for every five or six jobs created. This model does not always work; especially in times like now when job growth is retreating. Absorption for the first three months of 2016 was 2,339 units. Absorption stats are now available for April bringing the 2016 year-to-date absorption to 4,639 units. Despite the anemic job growth numbers, more units are being occupied by empty nesters, seniors, international in-migration, shadow-market conversions and any other segment of demand that is not job related. With the current run rate of 4,639 units, assume that absorption for 2016 will be 10,000 units which will bring the overall occupancy level to 89.3 percent by year-end.

Many in the industry are looking for 2017 to be a year of recovery but it's too early to tell. Economists are still concentrating on 2016 job growth revisions. It's for certain that construction of new units will moderate with approximately 12,000 units scheduled for delivery.

Best of luck with your piece of the puzzle.

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