MARKET**STRONG**

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Fueled by new jobs and high demand, Houston’s apartment market continues to push ahead with new development and rent growth.

By BRUCE McCLENNY, Apartment Data Services Inc.

The Houston apartment market has performed with the strength and endurance of an elite marathon runner over the past four years. Consider that each year is a marathon and that the market ran its first marathon in 2010. That year the market was recovering from injuries suffered from the recession of 2009. The pre-race hope for the market in 2010 was to finish the race healthy and to recover what was lost in 2009.

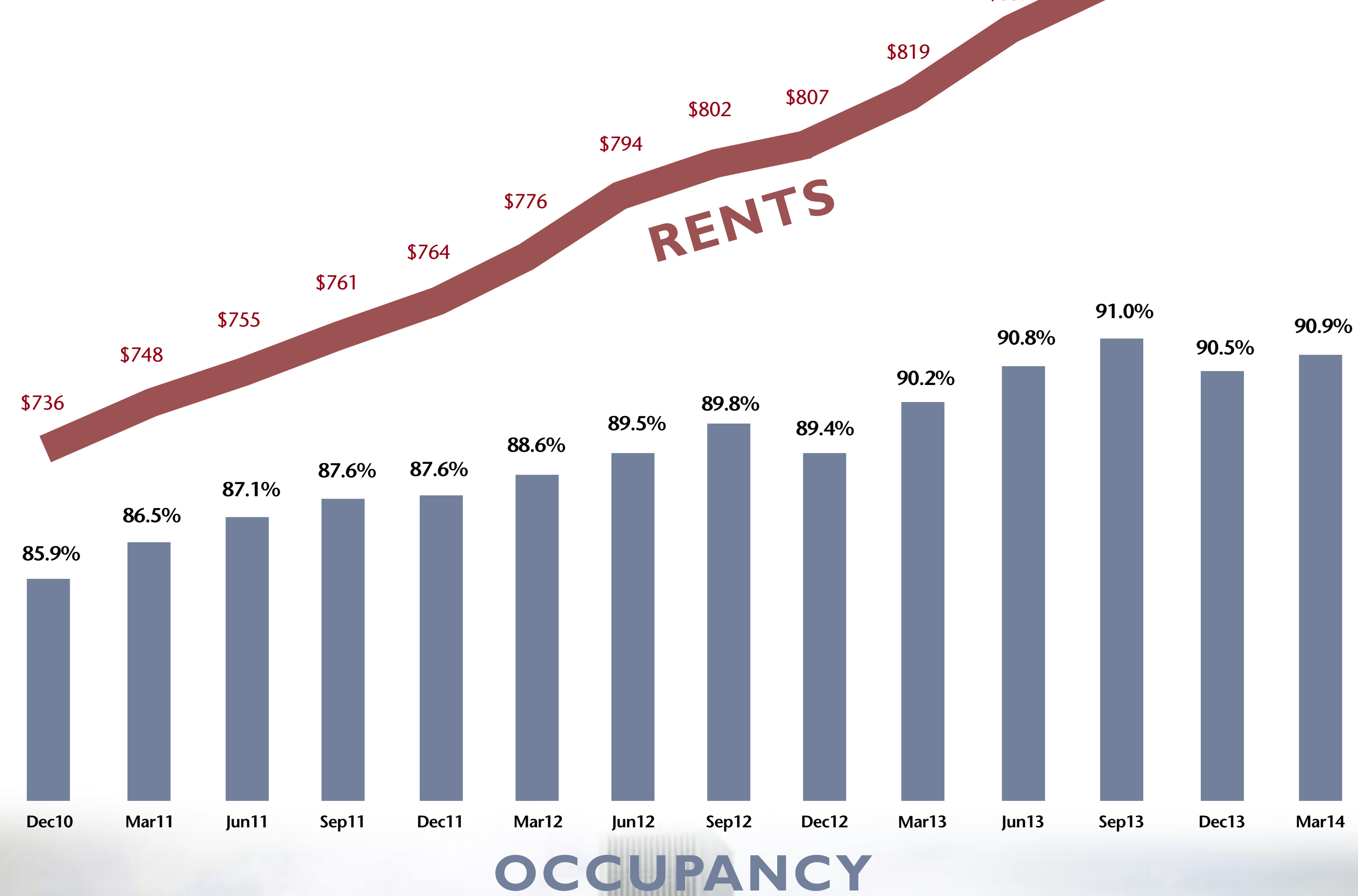
Overall occupancy limped in at the beginning of 2010 at 83.9 percent, hamstrung by slow lease-ups of new construction deliveries and distress in Class C. As the graph on Page 36 shows, 2010 ended the year with occupancy of 85.9 percent, a very decent performance for a first-time marathoner but not a level that impresses. Overall rents moved with moderate speed in 2010, clocking in with growth of 2.2 percent and finishing with an overall average rent of $736 per month. It was a good race, having accomplished the pre-race goals of reclaiming the rent and occupancy levels lost during the downturn of 2009.

During the market’s second marathon year in 2011, the rental growth pace improved to a respectable 3.8 percent, which is good but not at an elite level. This growth pushed rents to $764 per month. Occupancy performed well, gaining almost two percentage points, which added to the base from which elite rent growth could be achieved in future races. Occupancy ended the year at 87.6 percent, assisted by performance enhancing job growth of 81,200 net new jobs.

The course for the marathon in 2012 provided great support with limited new supply, constrained new home sales and a tailwind of 105,700 jobs. What a run! Rents finished with a 5.5 percent growth trend, coming in at an overall average of $807 per month with occupancy moving up to end the year at 89.4 percent. Now we can start talking about elite performance.

With such an outstanding run under its belt in 2012, the market was poised for another great performance in 2013. However, this year’s course offered more hills in

HOUSTON OVERALL RENTS AND OCCUPANCY



the form of 12,000+ new construction units delivered. Market race watchers from afar began to doubt the strength of the market and felt that it would not perform well with the steepness of new supply. Despite the added pressure of new units, job growth winds were favorable again, blowing in at 82,000 net new jobs. Rents were able to sprint to a growth of 6.1 percent ($856 per month), and overall occupancy broke the finish line over the 90 percent mark at 90.5 percent. The market finished 2013 with prize money!

Current Conditions

We are only a quarter of the way through the 2014 run, but as of March 31, the market looks as strong as ever and is on pace to exceed the 2013 results. The table below provides two checkpoints – at three months and 12 months – by which to assess the market's overall performance through the first quarter of 2014. The three-month rent trend indicates that the market has started this year's race at a phenomenal pace of 9.9 percent. The three-month trend is annualized, which assumes that the pace of the first quarter would continue throughout the rest of the year. Traditionally, you can count on fourth quarters to be flat, sort of like hitting the wall at the 20-mile mark, which will bring the trend down. However, coming down from a 9.9 percent mark leaves room for confidence that 2014 could easily post another elite performance of 5.0 to 6.0 percent.

The 12-month rent trend of 6.2 percent indicates that the market is maintaining an elite pace. Other market performance stats are just as impressive, such as the overall market rate, which is now over $1.00 per square foot. This is the first time that the overall rental rate has achieved this level. Just two years ago, the rental rate was below 90 cents per square foot. Fans along the racecourse can now be heard chanting, "Rents over a dollar make me wanna holler! Go, Houston, go!"

Properties, On Your Mark

Just as a marathon has many levels of runners whose start times are determined by their qualifying times, the market has classes of properties that are determined by a bell curve distribution of market rate. The table below shows how each class contributes to the overall performance. The new construction units delivered in 2013 and 2014 have been filtered out of classes A and B to create a separate classification. There are 72 properties totaling 19,357 units within this category, with 12,100 coming from 2013 and 7,257 units from 2014 so far.

The product type and geography of the 72 properties that fall into this group are diverse. There are two high rises, seven tax credit properties, 22 urban/infill (Inner Loop and Galleria) and 41 suburban developments. The occupancy of 41.0 percent is low but understandable, since most of the properties are in lease-up. The average rent level for new construction delivered is 165.7 cents per square foot and $1,571 per month. Rent averages per property range from less than $600 per month (67.5 cents per sq.ft.) for an affordable unit to more than $2,400 per month ($2.63 per sq.ft.) for a high-rise unit. Trends for this group cannot be accurately calculated due to the continually increasing number of new units being introduced.

Class A Without New Construction

In general, Class A before any adjustments for new construction 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, only 15 percent of the operating supply achieved the Class A distinction.

Taking new construction units out of Class A provides a stabilized occupancy picture. This group's occupancy is 85.0 percent before new construction is filtered out, and 94.8 percent after the adjustment is made. Since the beginning of 2010, rent has increased for Class A by 30.0 percent. It appears that these properties took a breather during the last half of 2013 but then really picked up the pace again at the beginning of 2014, as the three-month trend comes in at 9.8 percent. The 12-month rent trend is a healthy 5.8 percent, which represents an increase of $73 per month and 7.7 cents per square foot. This increase is good but does not match up with the increases of 2012 and 2013, when rents were moving up by better than 7.8 percent each year.

ANALYSIS BY CLASSIFICATION

As of March 31, 2014	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 3 Months
2013, 2014 Construction	19,357	41.0%	165.7	$1,571	–	–	5,854	1,639
Class A (w/o '13 & '14)	74,098	94.8%	158.0	$1,498	5.8%	9.8%	916	209
Class B (w/o '13 & '14)	162,254	94.9%	107.3	$958	6.3%	8.6%	1,314	317
Class C	247,779	92.7%	81.9	$693	8.2%	6.3%	5,337	2,311
Class D	73,768	86.1%	64.0	$538	2.3%	2.2%	2,610	1,062
Overall	577,256	90.9%	100.3	$878	6.2%	9.9%	16,031	5,538


Image by Alphaspirit/dreamstime.com

Class B Without New Construction

Class B is doing a good job of following the leader. As Class A has stepped up its pace, Class B has achieved better conditioning with strong rent growth and high occupancy. During the first quarter of 2013, Class B reached a very important milestone, achieving an overall rent rate greater than $1.00 per square foot. Now, one year later, Class B is cruising at 107.3 cents per square foot! Over the past 12 months, rent has increased by $62 per month, a stout 6.3 percent increase. Over the past three months, Class B really turned on the jets, with an annualized 8.6 percent improvement in rent. Since the beginning of 2010, rent has increased by 21.0 percent. Occupancy for Class B is currently at 94.9 percent, which is the highest of any class. Class B's impressive occupancy level has been partially driven by renters that have been priced out of Class A.

Classes C and D

Classes A and B had a two-year head start on Class C, but Class C is not a laggard any more. The occupancy for Class C bottomed out in December 2009 out at 84.0 percent as a result of the recession. Since then Class C has steadily gained occupancy, and with the 5,337 units of absorption over the past 12 months, Class C occupancy is now 92.7 percent. For Class C to claim the lion's share of all absorption makes the statement that renters are adjusting to the higher levels of rent in classes A and B by seeking the more available and affordable product of Class C.

In response to this strong absorption/occupancy performance, Class C was able to move rents by a whopping 8.2 percent over the past 12 months. In addition, rent has increased by $41 per month and 4.8 cents per square foot over this same time frame. The three-month trend is a little slower but still very strong at an annualized 6.3 percent.

Class D's occupancy hit bottom at 77.2 percent in December 2010. Occupancy now stands at 86.1 percent, driven by a respectable 2,610 units of absorption over the past 12 months. In the past, Class D's rent pace resembled a slow jog and then a walk. Class D has finally gained some momentum with a 2.3 percent gain in rent. Over the past three months, Class D has been able to hold the pace at a noteworthy 2.2 percent, but Class D is still a drag on the overall occupancy statistics.

Finishing the Race in 2014

Houston is solidly on pace for another year with overall rent growth better than 6.0 percent. That would be quite an accomplishment with the fourth-quarter wall and more new properties yet to come this year. However, the term "Clutch City" may now apply to Houston's apartment market. As former Rockets coach Rudy Tomjanovich said, "Never doubt the heart of a champion."

Houston has plenty of mojo in the forms of job and population growth. It is expected that Houston will realize 65,000 to 70,000 new jobs in 2014 with population growth of 125,000 more residents. In fact, the Greater Houston Partnership expects this kind of growth every year through 2017! Houston is very well positioned to finish this year's race and more to come in great shape.

The apartment industry has come to rely on a relationship between job growth and absorption. Of the 24,000 units currently under construction, expect half (12,000 units) to begin leasing this year. Add another 7,250 units that have already been introduced in 2014 to bring the total number of new units for 2014 to somewhere around 19,000 to 20,000. The job growth/absorption ratio varies from year to year, but a formula of one unit occupied or absorbed for every five jobs created represents a long-term average and is a reasonable ratio to apply for 2014. Therefore, with a jobs forecast of 65,000 to 70,000 jobs, absorption of 13,000 to 14,000 units should be expected. It will not be a problem that new construction deliveries will outpace absorption. This level of demand/absorption should be sufficient to keep new properties on track to meet their pro forma lease-up numbers.

Post-Race Party

The market is on a 9.9 percent rent growth pace for 2014 after the first quarter. No one was expecting this kind of pace! Surely the market cannot hold this pace indefinitely, but it gives confidence that a number in the 6.0 percent range is not an unrealistic expectation. Also encouraging is that a lot of the strength is coming from Class B and Class C. A conservative forecast for 2014 would be overall rent growth of 5.5 percent, with Class A coming in at 6.0 percent, Class B at 5.5 percent, Class C at 5.0 percent and Class D at 2.5 percent. Overall occupancy should finish the year at 90.3 percent. The Houston apartment market will have another outstanding run in 2014!

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