HOUSTON — ask the *magic 8 ball*

Although uncertainty clouds our outlook, the market remains healthy despite a decline in oil prices and job growth.

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8 Ball image by Eclipse Digital Imaging Inc. and Houston image by Chris Boswell/ Dreamstime.com

do we have a problem?

Many questions are being asked about the Houston apartment market, and justifiably so, with the drastic drop in the price of a barrel of oil, job growth forecasts being reduced and the imminent delivery of 34,000 units during 2015 and 2016. In response to these economic uncertainties and supply worries, the overall Houston apartment market continues to generate very good rent growth.

The overall fundamentals of rent growth, occupancy and absorption over the past 12, months as well as the first three months of 2015, are solid and reassuring. Yet this information is not enough for our inquiring minds, so the Magic 8 Ball will be employed to answer all the questions being posed by market watchers. Even though the lead question of this article is a spin on a very over-used phrase, "Houston, (do) we have a problem," it is one that is continually being asked. The Magic 8 Ball response is "Ask again later" – a neutral answer, but one that implies that economic shocks may come later or that it is probably too early to tell.

The graph on Page 40 shows the overall average rent rising from $764 per month back in December 2011 to its current level of $939 per month. On a straight-line basis, that's a 23.0 percent increase, which pencils out to better than a 7.0 percent per year performance. Granted, most of the heavy rent lifting was done in 2012 and 2013, but the improvement in rent over the past 12 months weighed in at a very respectable 5.7 percent.

Overall occupancy over the last two years, since March 2013, has been treading in a very narrow range between 90.2 percent and 91.2 percent. The flatness during this period conceals a very active market with new construction deliveries of almost 33,000 units, positive absorption of more than 35,000 units and teardowns greater than 3,000 units. Such a performance highly demonstrates that demand has more than kept up with new supply and should calm fears of over-supply up to this point. Absorption for the first three months of 2015 is remaining stout at 5,598 units. This level of absorption is healthy and sufficient enough to proclaim that there are no signs of economic slowdown present in these numbers.

ARE ALL PROPERTIES PARTICIPATING EQUALLY IN OVERALL PERFORMANCE?

This question is asked assuming that a rising tide lifts all boats – or in this case, a rising rent environment lifts all apartment properties. The Magic 8 Ball response to this question is "Don't count on it." The overall average statistics of rent and occupancy are a consolidation of the performance of each class of property. Classes are determined by a bell curve distribution of market rent. The table on Page 40 illustrates how the overall performance as of the end of March 2015 is distributed and highlights how classes differ in rates and trends.

ARE NEW CONSTRUCTION PROPERTIES LEASING UP?

The new construction units delivered in 2014 and 2015 have been filtered out of classes A and B to create a separate classification. The 93 properties totaling 24,700 units within this category comprise 17,912 units (63 properties) coming from 2014 and 6,788 units (29 properties) coming from 2015 so far. The product type and geography of the 93 properties that fall into this group are diverse, with five high-rise properties, four affordable/senior properties, 26 urban/infill (Inner Loop and Galleria) properties and 58 suburban properties.

The occupancy of 39.9 percent for this group is low but understandable since most of these properties are in lease-up. The 12-month absorption of 8,413 units is a good indicator that new construction units are being sought by prospective renters. The average rent level for new construction delivered is at 160.0 cents per sq.ft. and $1,533 per month. Rent averages per property range from $628 per month (71.0 cents per sq.ft.) for an affordable unit to more than $4,300 per month ($2.87 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 Magic 8 Ball response to the question whether new construction properties are leasing up is "Yes definitely." This is a good response, but unfortunately the Magic 8 Ball is leaving interested parties wanting more information as to the quality and quantity of leasing activity. Drilling down into the 31 properties making up the urban/infill and high-rise groups located in the Inner Loop and Galleria reveals that properties have been leasing at a rate that would achieve stabilization in the neighborhood of 12 months. This rate ranges from 17 to 24 leases per month. To achieve lease-up, five of the 31 properties are offering two months free, 10 are offering six weeks free, 11 are offering one month free and five have no special. The properties with no specials began leasing early in 2014 and have occupancy levels greater than 94 percent.

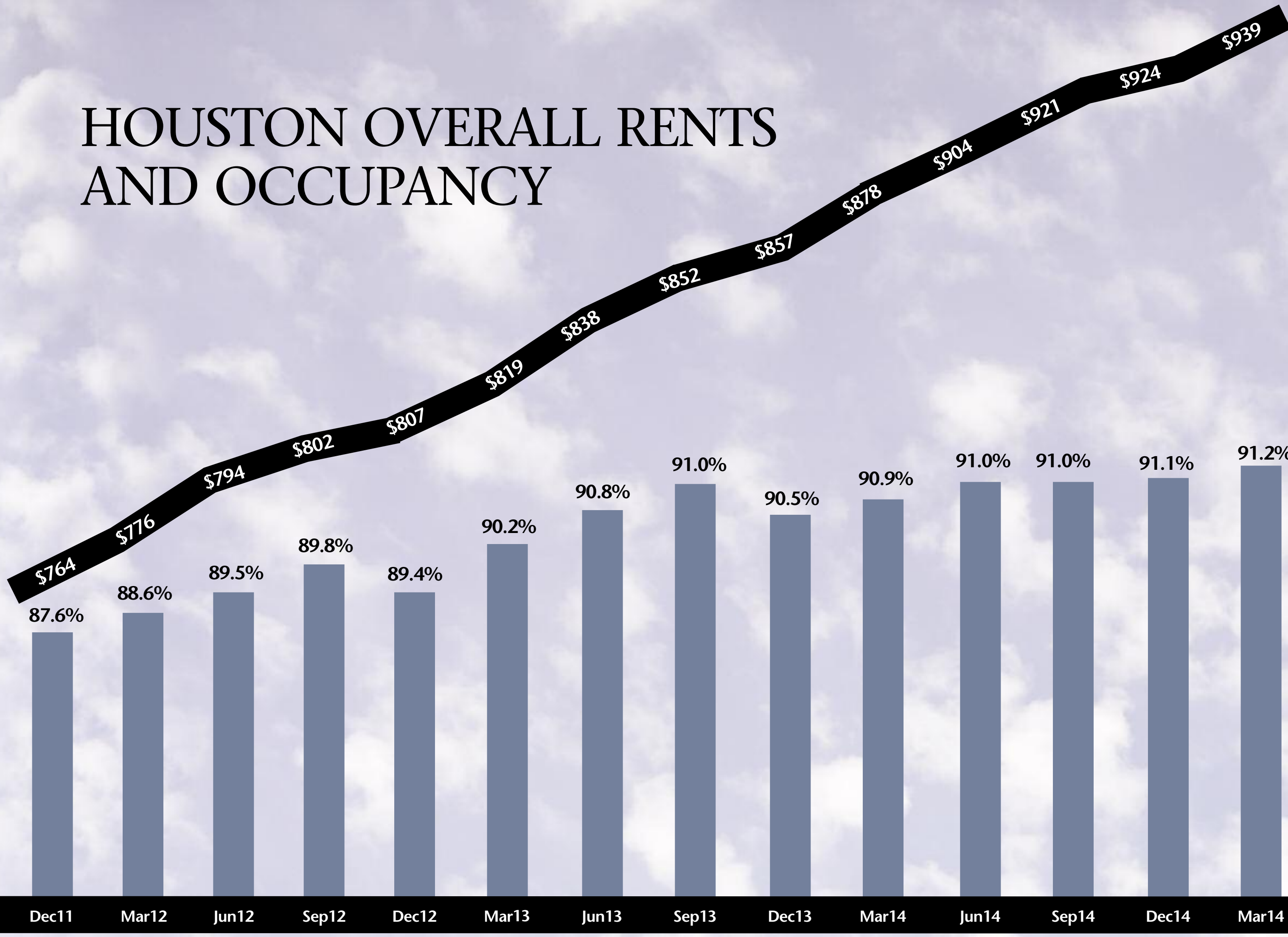
A closer look at the 58 suburban properties finds that achieving stabilization (occupancy equal to or greater than 90 percent) takes longer than 12 months. Suburban lease-ups can be grouped into two categories: One are those that began leasing prior to September 2014, and the second includes those that began after September 2014. Properties that began leasing prior to September 2014 closed 20-plus leases per month. Properties that began leasing after September saw 10 to 15 leases per month. Perhaps the traditional slowness of the fourth quarter accounts for the slowing in leasing velocity? The Magic 8 Ball response to this question is "Reply hazy, try again." Perhaps what is providing the haze for our spherical sage is the drop in the price of oil that occurred late in 2014?

WHAT ABOUT SUBURBAN LEASE-UPS AND PROPERTIES DELIVERED LAST YEAR?

Of the 58 new suburban properties, five are offering two months free, eight are offering six weeks free, 32 are offering one month free, and 12 have no special. Katy, the Energy Corridor and The Woodlands/Springwoods areas account for 40 of the 58 suburban properties and the most aggressive specials. The Energy Corridor is leading the way with the most aggressive specials, with four properties offering two months free as well as another four offering six weeks free. The Woodlands and Springwoods area has one property offering two months free and four giving six weeks free. The 18 properties in the areas of Tomball, Cypress, Fort Bend, Pearland and all points east of Highway 288 and Interstate 45 are where all of the "no specials" can be found.

The properties delivered in 2013 – 47 properties totaling 12,186 units – have been singled

HOUSTON OVERALL RENTS AND OCCUPANCY



ANALYSIS BY CLASSIFICATION

			Rent				Absorption (Units)	
As of March 31, 2015	**Supply**	**Occupancy**	¢/sq ft	$/month	12-Month Trend	3-Month Trend	12 Months	3 Months
2014, 2015 Construction	24,700	39.9%	160.0	$1,533	–	–	8,413	2,370
2013 Construction	12,186	91.1%	155.3	$1,475	1.1%	3.6	3,309	309
Class A (w/o '13+ Const)	112,063	93.6%	147.0	$1,402	2.4%	4.5%	-1,403	211
Class B (w/o '13+ Const)	197,095	94.5%	105.4	$914	7.0%	6.7%	404	312
Class C	179,518	94.0%	84.6	$713	6.1%	7.1%	3,204	1,514
Class D	68,681	89.0%	67.8	$568	3.7%	2.1%	1,944	882
Overall	**594,243**	**91.1%**	**107.1**	**$939**	**5.7%**	**6.6%**	**15,871**	**5,598**

out because some of these were still leasing up throughout 2014. This group comprises one high-rise, six affordable/senior properties, 15 urban/infill properties and 25 suburban properties. The overall average rate for an infill property is 202.6 cents with an average monthly price of $1,884. The overall average rate for a suburban property is 124.9 cents with an average price of $1,213 per month. The 12-month rent trend of 1.1 percent is lower than that of Class A without new construction. The properties in 2013 are experiencing the most competitive pressure from the properties in lease-up built in 2014 and 2015.

CLASS A WITHOUT NEW CONSTRUCTION

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, 24.8 percent of the operating supply of units got the Class A distinction.

Taking new construction units out of Class A provides a stabilized occupancy picture. This group's occupancy is 84.3 percent before new construction is filtered out and 93.6 percent after the adjustment is made. Occupancy for this group was 94.5 percent 12 months ago. In July 2014, occupancy peaked at 94.8 percent and has settled from there to its current position of 93.6 percent. This decline in occupancy is attributable to increased competition from new construction and an uptick in home purchases. This decline in occupied units is expressed as negative absorption of 1,403 units.

Now is as good a time as any to ask the Magic 8 Ball – is the Houston apartment market over-built? This question is very similar to "Houston, do we have a problem?" but much more specific. The Magic 8 Ball response to the over-built query is "Not at this time." Maybe the performance of Class A is why the omniscient orb can confidently say that Houston is not over-built at this time. This group of properties will be where the first signs of stress will appear. Class A is the bell cow for the market over the next two years. If and when Class A experiences two consecutive quarters of negative growth, that will commence the over-built warning.

The rent levels of Class A without construction from 2013 forward is performing admirably, considering the elevated levels of new product deliveries. With more competition, rent trends have moderated to a modest rate of 2.4 percent over the past 12 months. Back in 2012 and 2013 when competition was not as fierce, Class A average rent increased better than 7.0 percent each year.

Based on the three-month annualized rent trend of 4.5 percent, it appears that Class A was able to regain some pricing power. Obviously, this rate of improvement is better than the 12-month trend, but most importantly, it reversed the fourth quarter's negative growth of -1.2 percent. The stage was set for two consecutive quarters of negative growth, but Class A mightily trounced that threat!

CLASS B WITHOUT NEW CONSTRUCTION

The bell curve distribution of market rates creates a Class B that represents 33.4 percent of the entire market. Class B is the performance darling of the Houston apartment market, with overall occupancy topping the charts at 94.5 percent and impressive rent growth over the past 12 months of 7.0 percent. Rent levels over this same time frame have increase by $60 per month and 6.5 cents per sq.ft. The flatness in Class B's absorption numbers is not a concern but rather indicates that it is maintaining its high overall occupancy.

Class B has a substantial amount of headroom to maneuver more rent increases, as the three-month annualized improvement of 6.7 percent indicates. The difference of $500 per month between the overall average Class A rent as compared to Class B provides the basis for continued rent growth along with high occupancy and low availability.

CLASSES C AND D

Class C represents 30.4 percent of the overall market. Class C is giving Class B a close race for best-performing class with overall occupancy of 94.0 percent and rent growth over the past 12 months of 6.1 percent. Rent levels over this same time frame have increase by $48 per month and 5.7 cents per sq.ft. Class C's annualized rent growth of 7.1 percent over the past three months is the overall market's best rent performance.

It should be noted that the success of Class C's future performance is dependent on Class B's continued ability to raise rents. There is only a $200 per month difference in the overall average rents of a Class B and Class C property, which creates a competitive ceiling for Class C. The good news is, as pointed out above, that Class B has a lot of room to continue to raise rents.

Class D keeps gaining occupancy traction with 1,944 units of absorption over the past 12 months. This performance moved occupancy from 86.0 percent to 89.0 percent over the same time frame. With this positive movement in occupancy, Class D raised rents by 3.7 percent over the past 12 months. Rent levels over this

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same time frame have increase by $20 per month and 2.8 cents per sq.ft. Over the past three months, Class D has been able to maintain a positive rate of rent growth at 2.1 percent, which breaks with tradition. 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. Since January 2014, Class D's rent curve has been noticeably positive.

Class D is poised to achieve a milestone of reaching an occupancy level of 90 percent! Will Class D surpass the 90 percent mark in 2015? The Magic 8 Ball response is "Without a doubt."

OIL STILL MAKES THE DIFFERENCE IN HOUSTON

Dr. Bill Gilmer, director of the Institute for Regional Planning at the University of Houston's Bauer College of Business, recently made a presentation titled "Good Times or Bad? Oil Still Makes the Difference in Houston." In July 2014, the price of a barrel of West Texas Intermediate crude was $103. By January 2015, the price had dropped to $47 per barrel, driven down by weak demand in Europe, Japan and emerging markets, coupled with almost a doubling of production from Gulf of Mexico and U.S. shale producers. To absorb this price shock, U.S. producers began shutting down rigs in November 2014 when the Baker Hughes Rig count was 1,929 rigs. That number has now declined by 922 rigs. To further control costs, exploration companies began layoffs. The Greater Houston Partnership has sorted through the employment data from the Bureau of Labor Statistics and gleaned that in March, Mining and Logging lost 700 jobs, Wholesale Trade lost 2,200 jobs, Business and Professional Services (engineering) was flat, and Employment Services (temporary and contract workers) lost 1,800 jobs. The GHP anticipates more layoff announcements in the coming months.

As of the end of March 2014, the 12-month net change in jobs for the Houston-The Woodlands-Sugar Land metro area was 82,500 jobs, which represents a 2.9 percent gain. Keith Phillips, assistant vice president of the Dallas Federal Reserve's San Antonio branch, has scaled back his 2015 jobs forecast for Texas. Initially, Phillips' 2015 forecast called for Texas to see job growth in the 2.0 to 2.5 percent range, which is just a skosh below Houston's current growth percentage of 2.9 percent. However, his revised forecast for Texas job growth comes in between 0.5 and 1.5 percent. He goes on to say that "Houston's payroll growth (for 2015) will probably shake out somewhere close to zero." Gilmer's forecast is a tad more positive but just as grim, calling for job growth of 0.4 percent, or about 13,000 new jobs for Houston in 2015. The good news is that Gilmer sees job growth rebounding in 2016 to a 2.1 percent rate of growth, which nets out to 61,300 jobs.

DO WE HAVE A PROBLEM?

You had no idea that the Magic 8 Ball's answer to this question at the beginning of this article – "Ask again later" – would mean by the end of the article! Unfortunately, Houston's economic fortunes can change in the time it takes to read a magazine article. The Magic 8 Ball response to this question now is, "As I see it, yes."

The problem facing the Houston apartment market is the number of new apartments that are poised to deliver this year. As of the end of April, about 9,000 units had already been delivered. Of the approximately 25,000 units under construction, expect another 8,000 to 10,000 units to be delivered. With this scenario, there will be somewhere around 17,000 to 19,000 units delivered in 2015.

We might as well as ask the local weatherman to forecast absorption for this year. The east side of Houston is booming with petrochemical plant and Port Authority expansions, whereas the west side of town is offering early retirement packages, not renewing contract workers, sending expatriates home and laying off others. It is a very mixed bag to sort out for an absorption forecast. The traditional metric of one unit occupied for every six new jobs does not work in a declining job market.

Year-to-date absorption as of the end of April is already 7,363 units. Where do we go from here? Best guess is that there will continue to be positive absorption of an additional 5,000 units net of residents turning in keys and paying lease cancellations to outright skips. This puts the estimated absorption performance for 2015 around 12,500 units. Occupancy will settle from 91.1 percent now to 90.5 percent by year's end.

Overall rent growth for 2015 should still be relatively strong at 4.0 to 4.5 percent, highly influenced by classes B, C and D. Class A will remain flat, propped up by new construction deliveries. Expect Class B to achieve a 4.5 percent gain, Class C to grow by 4.5 percent and Class D continuing to improve at 3.0 percent.

Thank you, Magic 8 Ball. We will take a look into the market's future again this fall.

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