GHOST'S of MARKET'S PAST

The Houston apartment market has performed with the power and spirit of recent markets past, but beware the specter of concessions.

Occupancy remains mysteriously flat despite ample absorption, while job growth should continue to drive rent increases.

The Houston apartment market has performed with the power and spirit of recent markets past. In 2012, the market conjured a 5.5 percent rent growth performance, going from an overall average of $794 to $838 per month. Then in 2013, the market channeled a 6.2 percent improvement in rent by adding $66 per month to the overall average. At the end of 2013, overall rent averaged $904 per month, as the graph on Page 36 shows. The current average monthly rent now stands at $920, which represents an out-of-this-world 8.8 percent trend over the last 12 months.

The market has been positively transformed by the demand created from job growth angels bringing 115,400 net new jobs in 2012, another 76,200 jobs in 2013 and 107,400 jobs over the last 12 months as of the end of August. This job growth produced absorption of 14,719 units in 2012, 16,295 units in 2013 and 15,015 units for 2014. The ratio of all this job growth (299,000 jobs) to the total absorption (46,030 units) results in one occupied unit for every 6.5 jobs, which is very close to the 6-to-1 ratio of jobs to units absorbed that the apartment industry traditionally relies upon to estimate demand.

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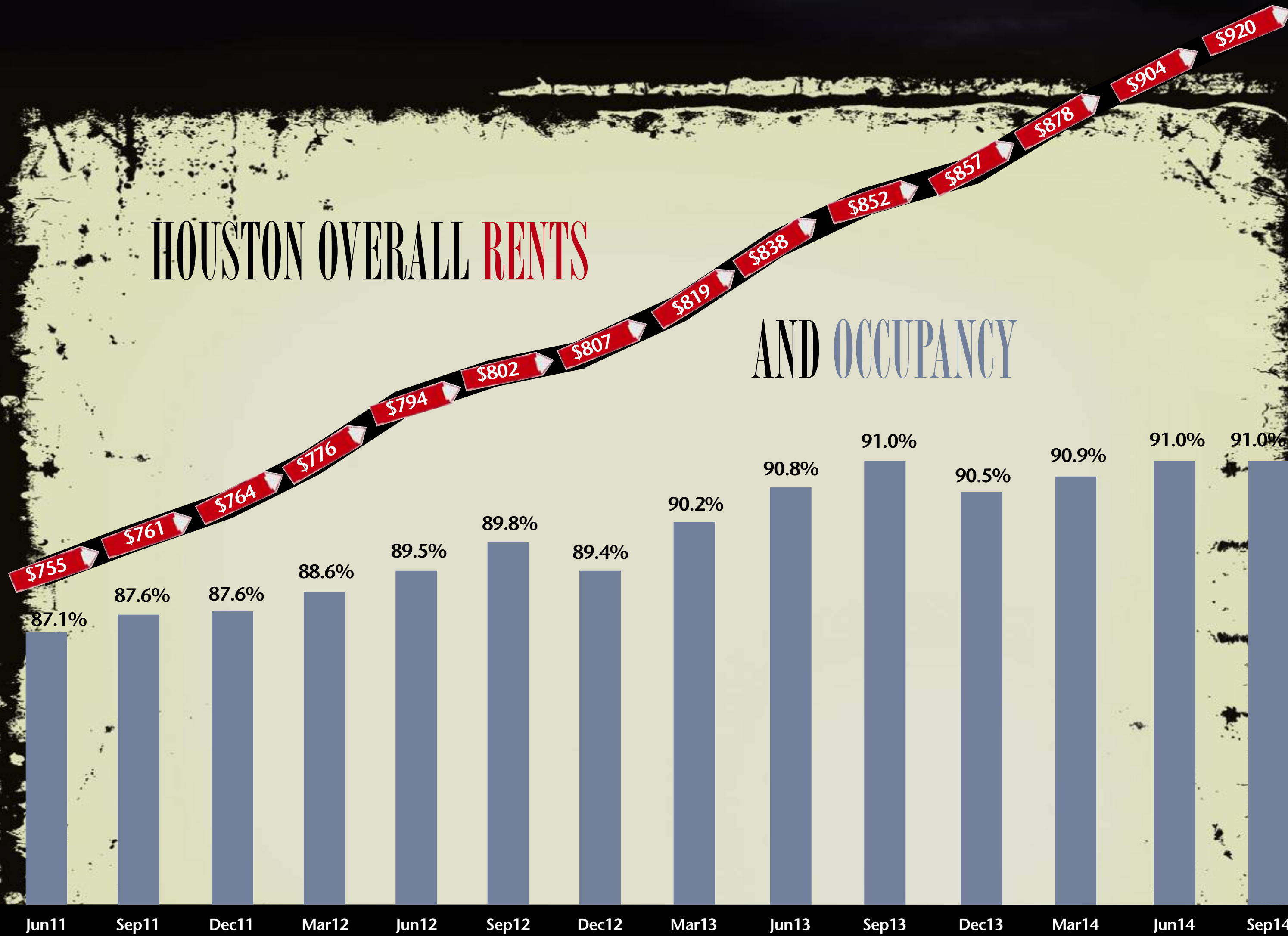
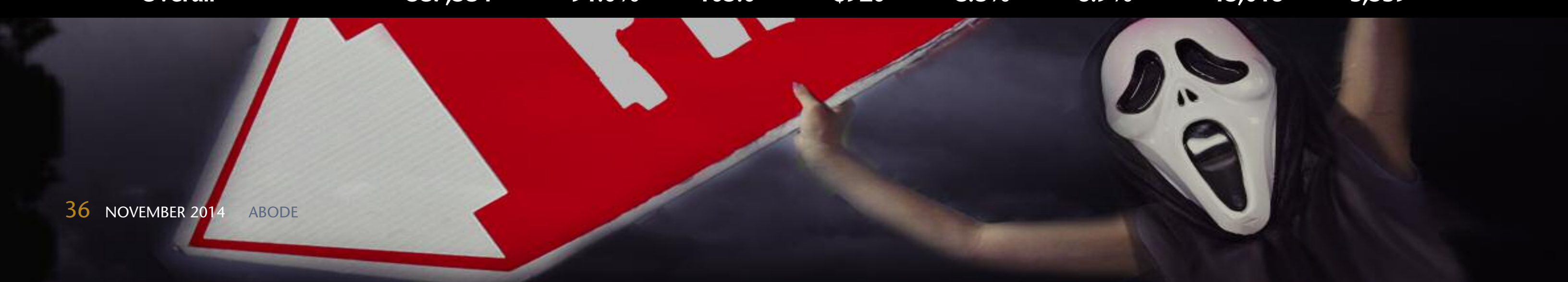
HOUSTON OVERALL RENTS AND OCCUPANCY



ANALYSIS BY CLASSIFICATION

			Rent				Absorption (Units)	
As of September 30, 2014	**Supply**	**Occupancy**	¢/sq ft	$/month	12-Month Trend	3-Month Trend	12 Months	3 Months
2013, 2014 Construction	29,384	50.8%	164.4	$1,557	–	–	9,688	3,803
Class A (w/o ’13 & ’14)	68,655	93.9%	162.7	$1,549	5.0%	-1.2%	-503	-511
Class B (w/o ’13 & ’14)	172,416	94.8%	112.5	$999	8.5%	8.9%	-255	86
Class C	246,704	93.5%	84.9	$717	8.9%	6.6%	4,117	33
Class D	70,425	87.7%	66.0	$562	3.6%	3.7%	1,969	128
Overall	**587,584**	**91.0%**	**105.0**	**$920**	**8.8%**	**6.9%**	**15,016**	**3,539**



Despite the ample amount of absorption, the movement of overall occupancy since the paranormal rent growth began in 2012 has remained mysteriously flat. Generally, an increase in rent goes hand-in-hand with an increase in occupancy. However, the stunted movement of occupancy from 87.6 percent at the beginning of 2012 to the current level of 90.9 percent at the end of September 2014 does not correlate with the exceptional rent growth.

The overall occupancy level masks significant shifts in occupancy between Class A and Class C. Back in December 2011, occupancy for Class A was 92.9 percent and occupancy for Class C was 85.8 percent. As of the end of September, Class A occupancy sits at 81.7 percent, highly diluted, with 56 properties representing more than 16,000 units in lease-up. Class C, on the other hand, is perched at 93.5 percent, a figure achieved by renters seeking more available and more affordable renting options after being priced out of Class A and Class B. This occupancy role reversal is the market's adaptation of Freaky Friday!

ONLY THE SHADOW KNOWS

The overall average statistics of rent and occupancy are an aggregate expression of each class of property. It is important to understand the significant differences in performance between the classes, as the previous example demonstrates. Classes are determined by a bell curve distribution of market rate. The table on Page 36 illustrates how the overall performance as of the end of September 2014 is distributed and highlights how classes differ in rates and trends.

The new construction units delivered in 2013 and 2014 have been filtered out of classes A and B to create a separate classification. This category comprises 109 properties totaling 29,384 units, with 12,186 (45 properties) coming from 2013 and 17,198 units (64 properties) coming from 2014 so far. The product type and geography of the 109 properties that fall into this group are diverse – six high-rise properties, seven affordable senior properties, 38 urban/infill (or Inner Loop and Galleria) properties and 58 suburban properties.

The occupancy of 50.8 percent for this group is low but understandable since most of these properties are in lease-up. The average rent level for new construction delivered is at 164.4 cents per square foot and $1,557 per month. Rent averages per property range from $638 per month (68.8 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 of new units being introduced.

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, 15.4 percent of the operating supply of units achieves the Class A distinction.

Taking new construction units out of Class A provides a stabilized occupancy picture. This group's occupancy is 81.7 percent before new construction is filtered out and 93.9 percent after the adjustment is made. The 12-month rent trend is a healthy 5.0 percent, which represents an increase of $50 per month and 5.4 cents per square foot. This increase is good but does not match up with the increases of 2012 and 2013 when rent was moving up by better than 7.8 percent each year. Since the beginning of 2010, rent has increased for Class A by 30.0 percent.

Based on the three-month annualized rent trend at -1.2 percent, it appears that the long run of rent growth for Class A has finally stalled. It is not unusual for rent to vacillate up and down over short periods of time, but this decline seems different because there is also a significant accompanying downward move in occupancy. Since July, occupancy for this group has fallen from 95.0 percent to 93.9 percent. This weakness in occupancy occurs along with an eerie slowdown in traffic that cannot cover move-outs coupled with aggressive discounted pricing from new construction lease-ups. It seems that the new lease-up properties are frightened by the ghoulish amount of new product that will be delivered in 2015 and are taking drastic steps to accelerate their journey to stabilization. Defining drastic, in this case, may be in the eyes of the beholder. Properties in lease-up are likely operating above pro-forma, even with aggressive discounted pricing. They had the luxury of setting pro-forma rent levels in a rising rent environment.

For the stabilized Class A group of properties, drastic applies! Budget time this year is a scary place, considering that owners are primed to expect another year of strong rent growth as excellent job growth numbers and good overall operating statistics continue to be reported.

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CLASS B WITHOUT NEW CONSTRUCTION

The bell curve distribution of market rate creates a scenario in which some new construction properties are classified as Class B. There are 17 lease-up, new construction properties representing 3,934 units currently in this category. Even though these lease-ups are only 46.0 percent occupied, the overall occupancy of Class B with them included is 93.7 percent, and a very stout 94.8 percent when those 17 properties are excluded. The flatness in Class B's absorption performance is not a concern but rather indicates that it is maintaining its high overall occupancy. Class B's impressive occupancy level has been helped along by renters priced out of Class A.

Class B is showing no signs of fatigue as far as rent growth goes. Over the last 12 months, rent has increased by $67 per month, a very strong 8.5 percent increase. Over the last three months, Class B has surpassed the 12-month performance with an annualized 8.9 percent improvement in rent. Since the beginning of 2010, rent has increased by 25.8 percent. Overall rents have climbed to 112.5 cents per square foot and $999 per month.

CLASSES C AND D

Class C continues to claim the lion's share of absorption over the other stabilized product classes. The 4,117 units of absorption over the last 12 months moved occupancy two percentage points from 91.5 percent to 93.5 percent. With this strong demand generated by renters seeking more available and affordable options, Class C gained pricing power to move rents by an outstanding 8.9 percent over the last 12 months. In addition, rent has increased by $44 per month and 5.3 cents per square foot over this same time frame. The three-month trend is a little slower but still very strong at an annualized 6.6 percent.

Class D is beginning to get occupancy traction with 1,969 units of absorption over the last 12 months. This performance moved occupancy from 84.8 percent to 87.7 percent over the same time frame. With this positive movement in occupancy, Class D found the resolve to raise rents by 3.6 percent over the last 12 months. Over the last three months, Class D has been able to maintain the rate of increase at 3.7 percent, which is remarkable. 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.

THE OUIJA BOARD SAYS

This year has seen tremendous global political and economic uncertainty, with more armed conflict in the Middle East with ISIS and in Russia with attempts to annex Crimea. In the past these events would spike the price of oil. Now the United States is producing 3 million more barrels of oil per day than three years ago thanks to ultra-deepwater drilling, hydraulic fracturing and horizontal drilling, which greatly lessen the impact of these overseas conflicts on oil prices. However, the price of oil is falling with a sputtering European economy and underwhelming output from Japan, Brazil and Russia. A barrel of oil, West Texas Intermediate, last October was around $101 – now the price has slumped to around $85. A lower oil price does not help Houston's economy.

On the positive side, however, a recent report from CBRE notes that 17.3 million square feet of office space is under construction locally, which is 67 percent preleased or owner-occupied. This office space will begin to become occupied during 2015, providing the next wave of renters. In addition, Exxon is in the process of adding petrochemical capacity in the Baytown area at a cost of $5 billion to $6 billion. This project will require 10,000 construction workers.

All this contradictory economic data requires unorthodox methods to sort out our outlook, so the Ouija Board will be consulted on the fate of the Houston apartment market:

• Question: How will the Houston apartment market look at the end of 2014?

There is only one quarter left to complete the year, and the results that are already reported will dominate year-end stats. Overall rent growth for the year will be in the neighborhood of the three-month trend of 6.9 percent. Expect rent growth to be somewhere over 6.0 percent, which will be considered another fantastic year. But not all classes will participate equally: The performance will be driven by new construction deliveries and classes B and C. Stabilized Class A properties will fight to keep rent levels flat to mildly negative while classes B and C continue to raise rents. Prices-change-daily systems will exacerbate the problem for stabilized Class A.

Overall occupancy will be influenced by 2,000 to 3,000 new construction units delivered. Absorption of around 1,000+ units over the fourth quarter will be considered a very good performance. Given these dynamics, expect occupancy to fall slightly from 91.0 percent to 90.8 percent.

• Question: Should value-add, cap-ex projects be done in 2015?

The answer to this question is determined by where a property falls on the classification continuum. For B-minus, C and D class properties, the answer is "yes." Rents for these properties will continue to increase. For B-plus and A-minus properties, the answer is "no" or "proceed very cautiously." Putting unit upgrades in these upper-end properties will probably not yield the rent increases needed to justify the expense because of the flat-to-negative rent growth happening in Class A.

• Question: What will 2015 look like for the Houston apartment market?

Houston will continue to enjoy very positive economic news. Dr. Bill Gilmer, director of the Institute for Regional Planning at the University of Houston's Bauer College of Business, has forecast job growth for 2015 in the range of 68,600 to 73,500 net new jobs. The Greater Houston Partnership has predicted population growth of 125,000 more residents for 2015.

The Houston apartment market is ahead of the curve on providing all these new residents a place to live. With approximately 25,000 units under construction, expect about 20,000 of these units to be delivered in 2015. Based on the job growth predictions above and the 6-to-1 conversion ratio for jobs to occupied units, expect 11,433 to 12,250 units of absorption. Overall occupancy by the end of 2015 should fall by one percentage point to 89.8 percent.

Rent growth for 2015 will be influenced again by all the new construction deliveries and classes B and C. Stabilized Class A will continue to struggle to maintain occupancy and rent levels. With all this in mind, expect overall rent growth of 5.5 percent. Class A will come in at 5.0 percent, driven by a mixture of new construction's higher prices and flat-to-negative growth of stabilized Class A. Classes B and C should do well with 6.0 percent growth, and Class D should continue to show gains of 4.0 percent.

Thank you Ouija Board! Goodbye.

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