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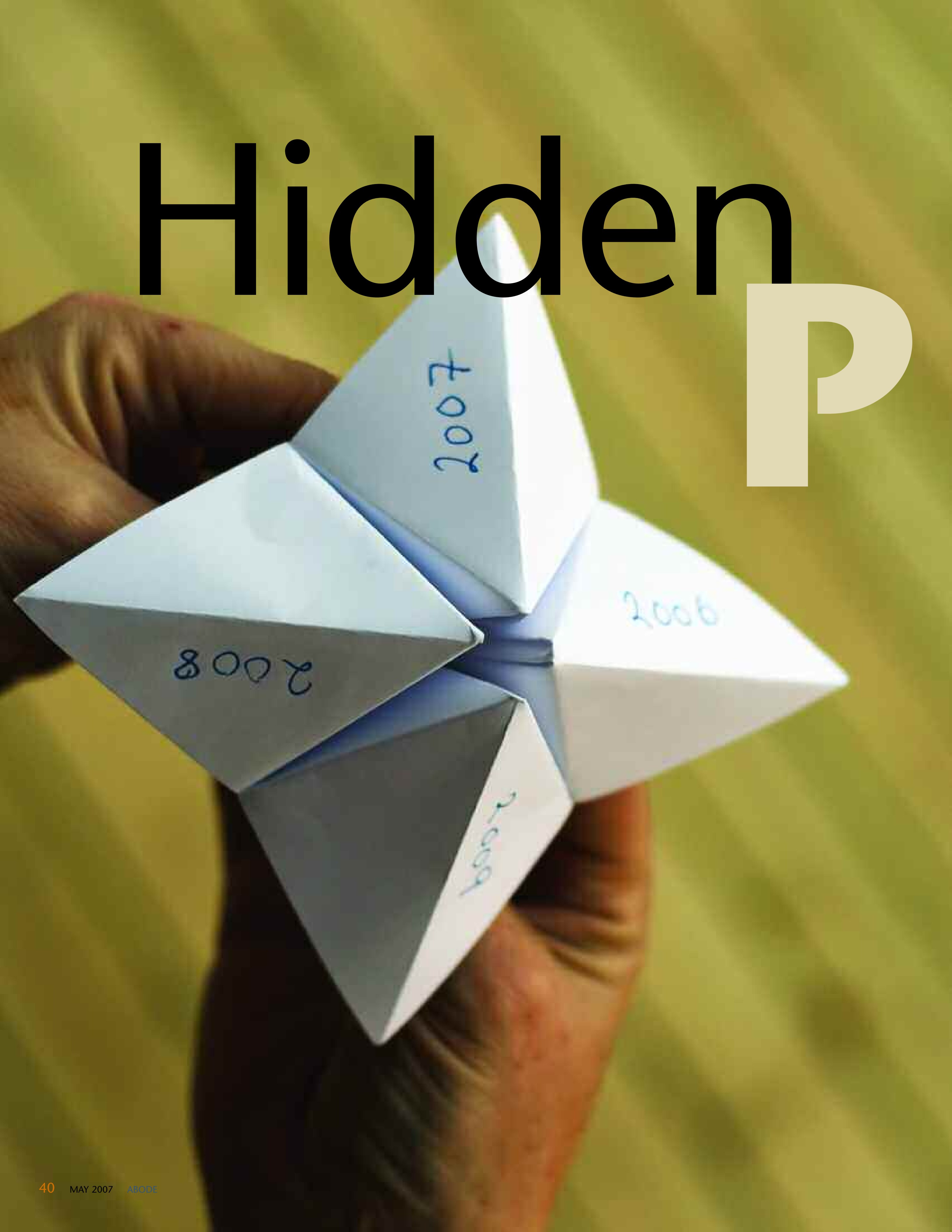

Looks can be deceiving when considering local market absorptions, occupancy and rental rate levels after Katrina and Rita.

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A look back at the performance of the Houston apartment market cannot be fully understood without looking back to the extraordinary conditions generated by the hurricanes of 2005, Katrina and Rita. In the last four months of 2005, the market was overwhelmed with hyper-leasing activity created by the immediate need for housing from more than a quarter of a million evacuees.

The graph on Page 42 captures Katrina's impact by showing overall occupancy and rent levels since January 2005. Prior to Katrina, market conditions were weak but slowly improving. Between July and October 2005, overall average occupancy and rents spiked as the rush of evacuees leasing apartments in September drove up occupancy by 3.1 percentage points and boosted monthly rents by $21. In review, 2005 was a very fortunate year for the Houston apartment market. Absorption registered an incredible 32,589 units, overall occupancy rose by 5.1 percentage points, and the overall monthly rental price scored a 6.0 percent improvement.

During the first quarter of 2006, the City of Houston/FEMA voucher program topped out, providing more than 36,000 apartment units for evacuees. Overall occupancy held steady during that time frame. In April, occupancy started to move lower as the "Katrina Correction" began. By October, occupancy had inched down to 89.1 percent as the number of units occupied by voucher recipients slid to approximately 25,000. Occupancy settled to 88.1 percent by the year's end, driven by another 11,000-unit reduction in vouchers. Sources at the Houston Apartment Association reported that at the end of 2006, approximately 14,000 units remained in the voucher program. In addition, the retreat in the occupancy level throughout 2006 was assisted by the introduction of around 9,100 new construction units into supply.

ABSORPTION: NOT WHAT IT SEEMS IN 2006

The overall net absorption performance for 2006 was a negative 5,271 units. This statistic is very deceiving, and a strong case could be made for a large component of positive absorption during 2006. Consider that voucher-related units in 2006 decreased from 36,000 to 14,000, which represents a negative absorption of 22,000 units. However, the net absorption for the year totaled only a negative 5,271 units. Hidden in the difference between the "Katrina Correction" of a negative 22,000 units and the year's net absorption performance of a negative 5,271 units is a positive 16,729 units. A positive absorption performance of this magnitude makes sense in view of the 4 percent job growth reported for the Houston-Sugar Land-Baytown metro area by the Texas Workforce Commission. This rate of growth represents 95,900 jobs. The traditional conversion formula of one apartment unit occupied for every five jobs created supports 19,180 units (95,900 divided by 5) of positive absorption.

RENTS HOLD STEADY

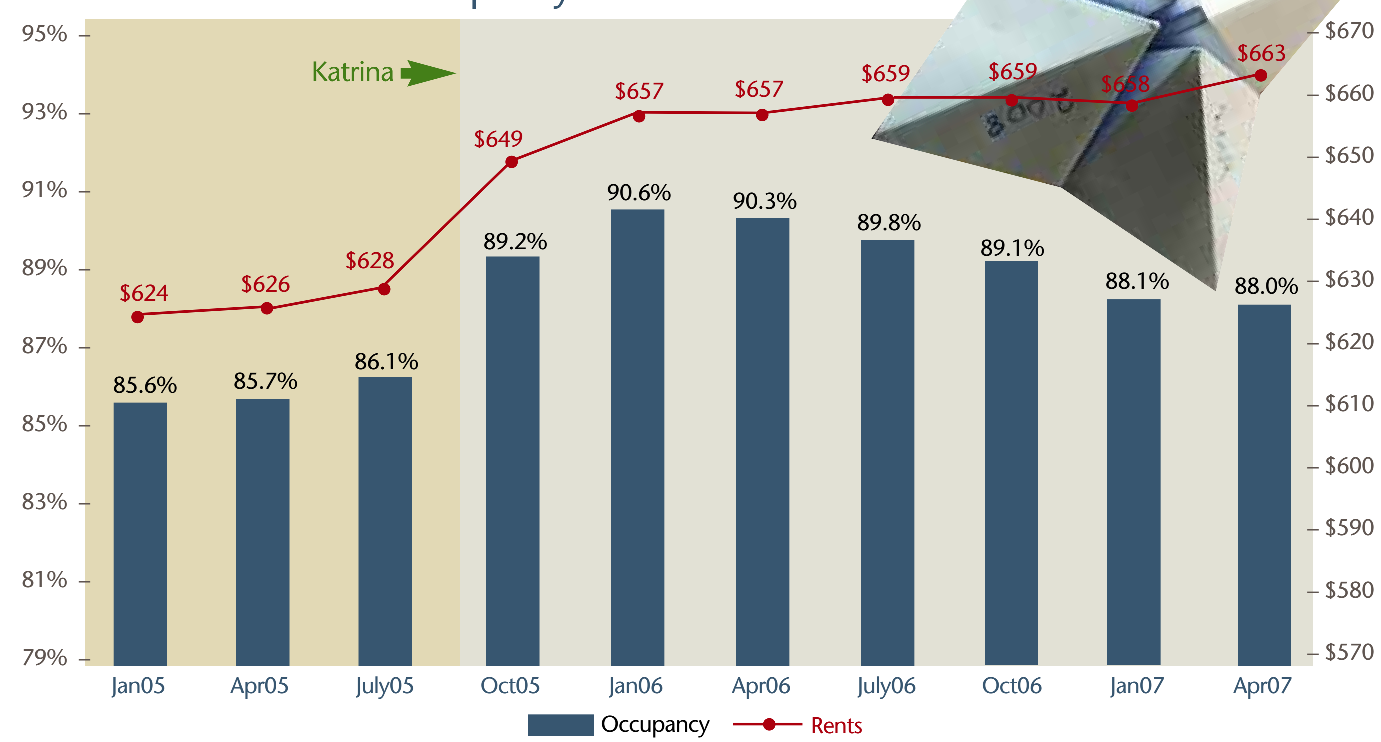
Overall rents remained firm all year despite the 2.5 percentage point drop in occupancy that occurred over the course of 2006. At the beginning of the year, the overall rental price was $657 per month. During the year, the level of rents moved very little. The highest level of rents was $659, and by the year's end the level had settled to $658. This limited movement in rents resulted in rent growth in 2006 of 0.2 percent. In any other year, this type of rent performance would have been disappointing. However, huge movements in rent happened in the last four months of 2005, when rent levels rose from $628 to $657. For the market to hold on to the elevated level of rents from 2005 makes the flat performance of 2006 deserve an impressive rating.

By the end of February 2007, the overall average monthly rent level made a very positive move forward to $663 while the overall occupancy level remained flat. To better understand the dynamics behind these conditions, the table below divides the market into five classes and provides a market snapshot as of the end of February.

NEW CONSTRUCTION DOMINATES

Units built and delivered in 2006 and 2007 require a separate classification to provide a clearer picture of absorption distribution and create a stabilized/same store analysis for Class A and Class B. The pace of construction units delivered to supply since the beginning of 2006 has been relatively brisk. Of the 9,218 units delivered during this time frame, around 8,900 units came in 2006 and the remainder in 2007. The occupancy for this class is low because these units are still in lease-up. Rent trends for this group cannot be accurately calculated due to the volatility caused by a continually increasing number of new units introduced into supply each month. The 2006 and 2007 construction class has totally dominated absorption performance since the beginning of 2006.

Houston Overall Occupancy and Rental Price



Analysis by Classification As of February 28, 2007

	Supply	Occupancy	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 2006 YTD	Absorption (Units) 2007 YTD
'06 & '07 Construction	9,218	50.4%	$987	–	–	4,071	578
Class A (w/o '06 & '07)	135,569	92.0%	$909	1.9%	5.9%	704	-137
Class B (w/o '06 & '07)	223,412	87.9%	$598	-1.2%	3.0%	-6,672	-213
Class C	98,512	87.3%	$529	-1.5%	-0.4%	-3,263	-509
Class D	28,484	84.5%	$382	-2.6%	-2.4%	-111	15
Overall	495,195	88.0%	$663	0.5%	3.8%	-5,271	-266

A ROBUST CLASS A WITHOUT NEW CONSTRUCTION

In general, Class A comprises those units constructed since 1990 with the highest rental rates. Class A without new construction units of 2006 and 2007 represents 27 percent of the overall supply and has a relatively healthy 92.0 percent occupancy, which is, by far, the best of all classes.

Class A's absorption in 2006 registered a mildly positive 704 units. This performance masks the tremendous clash in market forces between job growth and single-family home sales.

On the positive side of absorption, the Houston-Sugar Land-Baytown metro area generated 95,900 jobs, which is a 4.0 percent improvement over 2005. On the negative side of absorption, the Houston Association of Realtors reported 87,435 existing homes sold in 2006, a 10.7 percent improvement over 2005 closings. In addition, MetroStudy reported that annual closings for new homes increased to 48,324, which produced a 9.7 percent gain over the fourth quarter of 2005. These overwhelmingly strong statistics suggest a lot of volatility at the top of the market.

Even though a steady stream of existing renters moved out to become homeowners, an even greater number of move-ins was generated from job growth. As a result of this positive leasing momentum, rent growth for stabilized Class A units over the last 12 months registered a decent 1.9 percent. Over the last three months, despite a relatively flat absorption performance, Class A rents are moving at a robust 5.9 percent annualized rate.

A CONFIDENT CLASS B MOVES RENTS

Class B generally comprises properties built in the 1980s with rent levels lower than those of Class A. Developers built a lot of properties in the '80s, making Class B units about 45 percent of the overall supply. There is an exception to this general classification rule for Class B: The advent of the Low Income Housing Tax Credit program has created a hybrid property type that has overall rents in the Class C range and construction features and amenities of Class A – therefore many new tax credit properties are classified as Bs. In addition, this situation creates a need to filter out tax credit units built in 2006 and 2007 to provide a stabilized/same store analysis for Class B; 39 percent of the 9,218 units built in 2006 and 2007 are tax credit units.

Class B began 2006 with an occupancy level around 91.0 percent. Since then, occupancy has slipped 3.1 percentage points to 87.9 percent. Just as in Class A, the upper-end Class B properties are losing residents to single-family homes. The lower-end Class B properties are dealing with voucher recipients moving on and the exodus of existing residents being lured to brand-new tax credit properties.

Prompted by this lower level of occupancy, rent growth for Class B over the last 12 months is negative 1.2 percent. Over the last three months, absorption is slightly negative, yet the Class B market feels the confidence to move rents at an annualized 3.0 percent pace.

CLASS C GOES FLAT

Class C generally comprises those units built in the 1970s with rent levels just below those of Class B. Class C constitutes 20 percent of the overall supply. Class C occupancy at the beginning of 2006 was 90.8 percent. By the end of 2006, occupancy had retreated by 2.9 percentage points to 87.9 percent, moved by negative absorption of 3,263 units. Class C's negative absorption over the last 12 months was induced by the same factors that drove losses in the lower end Class Bs described above. Over the last three months, absorption and the rent trend for Class C are both flat to slightly negative.

LOOKING AHEAD

In 2007, the effects of Hurricane Katrina will not dominate market conditions as in 2005 and 2006. Even though approximately 14,000 units still participate in the voucher program, a large portion of the remaining voucher recipients are most likely to remain as apartment residents under some form of permanent housing assistance. At any rate, voucher assistance has been extended once again and is set to expire sometime in 2008.

The Greater Houston Partnership has forecasted job growth of 2.6 percent for 2007, which translates into a net gain of 65,000 jobs. Applying the traditional conversion formula for apartment absorption from job growth – one unit absorbed for every five jobs created – results in 13,000 units of positive absorption. A small negative correction could come from voucher recipients, but there also could be a positive impact from homeowners turned back into renters by the crisis in the mortgage industry. Let's assume that these two forces cancel each other out, which brings us back to a net 13,000 units of positive absorption as an absorption forecast for 2007.

Construction activity for 2007 will be relatively heavy. Currently, more than 17,000 units are under construction. Expect at least 12,000 to 13,000 of those units to be introduced into supply during 2007. Such a large number of units has not been brought into supply within a year's time since 2003, when 14,605 units came onboard. More than 15,000 units are proposed; expect around 9,000 units from this list to begin construction during 2007.

Considering the predicted absorption performance of 13,000 units and the new units anticipated to be introduced into supply, overall occupancy will change very little from its current position of 88.0 percent. Rental rate growth for 2007 is off to a great start as indicated by the three-month annualized growth in Class A of 5.9 percent and 3.0 percent in Class B. If all the new unit introductions do not cause an escalation in concessions, overall rental rate growth for 2007 could come in as high as 3.5 percent. However, if competition becomes more intense with all the new unit introductions and the current confidence to raise rents diminishes, expect overall rent growth in the range of 2.5 to 3.0 percent.

Bruce McClenny is president of Apartment Data Services and has been active in the multifamily industry and HAA since 1983. HAA endorses ADS's Market TRAC and market reports. For more details, call 281-759-2200 or see www.apartmentdata.com.