Greater Houston Apartment Market TRAC Analysis
Hurricane Katrina Impact - October 2005

By: Bruce McClenny, President
Apartment Data Services, Inc.

Market-TRAC Update-Katrina Impact

What Happened In September `05

Rental Rates/Prices

75.8 ¢/sf/mo

$647 /mo

+2.1 ¢/sf/mo or +$18/mo in Sept '05

Occupancy

89.4%

+3.1 points in Sept '05

Absorption In September '05

+14,993 units

Supply (operating)

484,159 units

2,494 communities

New Supply In '05

7,993 units

35 communities

Supply (under construction)

8,176 units

34 communities

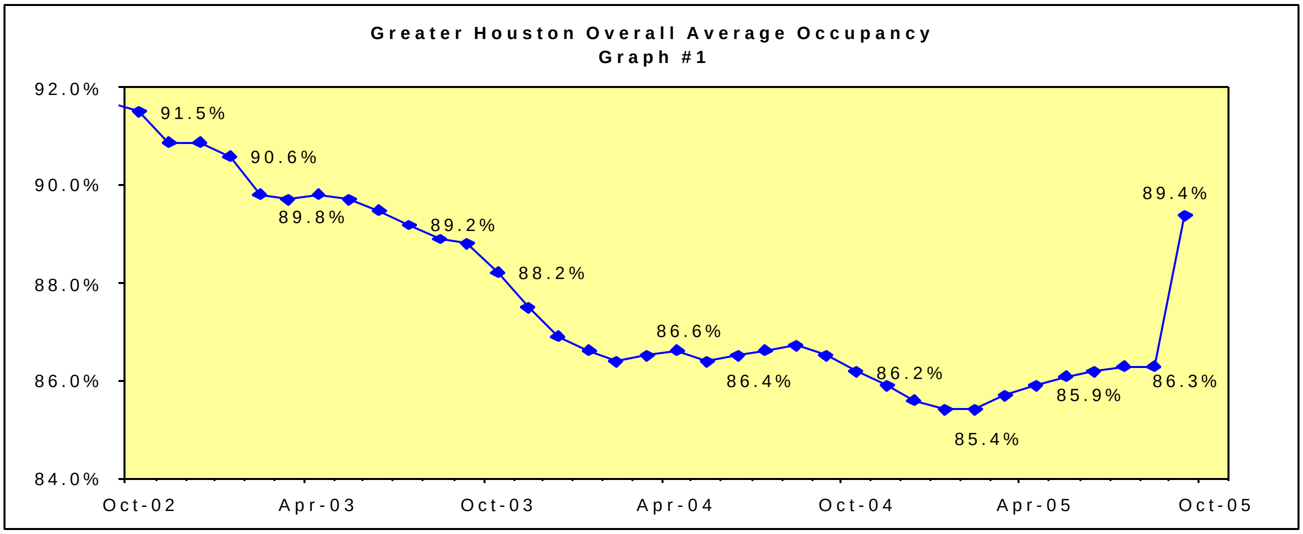
Hurricanes Katrina and Rita dominated and changed the lives of Gulf Coast residents and Houstonians during the month of September 2005. As Houston opened its hearts and doors to evacuees, the local apartment market was changed dramatically. The table of information, on the left, provides a quick snapshot of the sudden impact that Katrina had on overall rental rates, prices, occupancy and absorption as well as quantifying the current level of supply with recent and pending additions.

The statistics generated in September defy traditional quarterly or semi-annual comparisons. The month's improvement in rents, occupancy and absorption simply dwarf all historical, cumulative performances of any quarter or semi-annual period. In fact, most annual performances do not measure-up to September 2005.

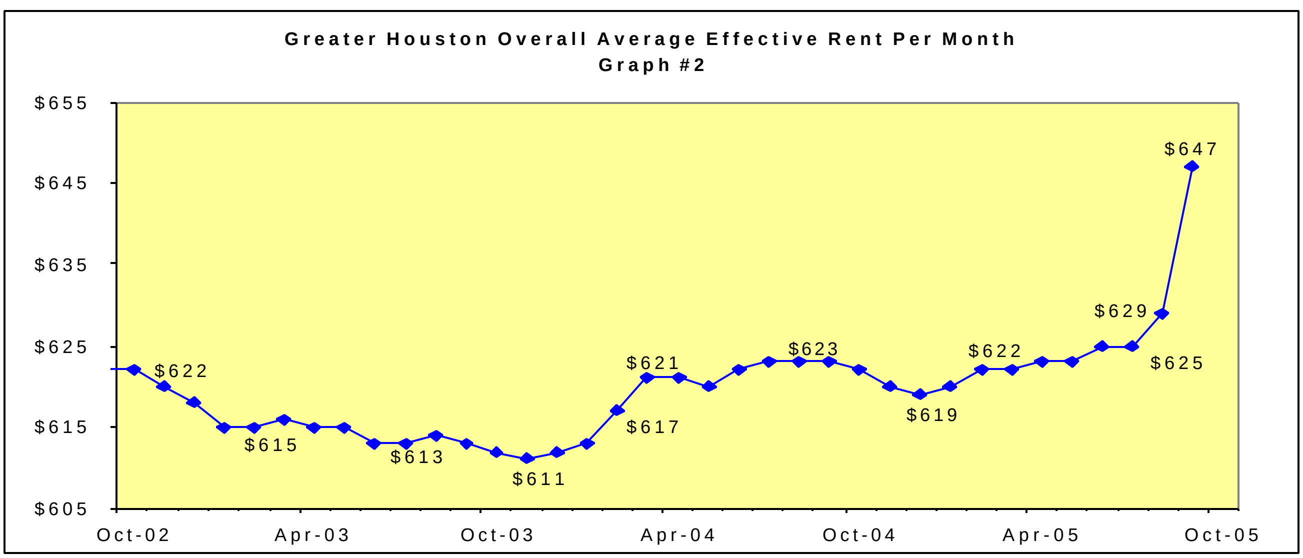
Apartment Data Services has nineteen years of historical information on the Houston apartment market. Only eight of the nineteen years recorded a better annual rent increase of $18, only one year had an occupancy increase greater than 3.1 percentage points and none of the nineteen years had an absorption performance better than 14,993 units. The best annual absorption performance until this year occurred in 2000 when 13,604 units were absorbed having been propelled by job growth of 59,000 and an interest rate on 30 year, fixed Freddie Mac mortgages of 8.05 percent.

Overall market conditions prior to September were weak. The market, for three years, had been suffering from lackluster job growth, a steady exodus of renters to new homes and developers adding to supply with little regard for fundamentals.

Graph #1, on the next page, captures overall occupancy levels over the last thirty-six months. Occupancy steadily moved lower during '02, '03 and '04 as the above-mentioned market-zappers plagued Houston apartments. It appears that occupancy reached a bottom at 85.4% in January 2005. Since January and through August of this year, occupancy slowly reversed its course and began to improve. The spike in September represents Katrina evacuees rushing to lease apartments: individually, by the bus load with FEMA and City of Houston vouchers and by corporate human resources departments working directly with apartments or through corporate lodging companies.



Rents are responsive to occupancy trends. Graph #2 shows overall average effective rents per month over the same time period as Graph #1. Notice as occupancy moved lower in '02 and '03, rents followed with a negative trend. Rents reached a bottom in November of 2003 at $611 as occupancy headed lower. Occupancy held steady in '04 and rents improved briefly to $621 then remained relatively flat until the 4th quarter. As occupancy slid in the 4th quarter of '04 to 85.4%, rents retreated to $619. Absorption narrowly outpaced new construction deliveries during the first eight months of 2005, which allowed occupancy to steadily improve and rents to rise from $619 to $629, a 1.1% annualized trend.



<u>Concessions</u>

Effective rent is the net result of applying a concession or special, on a prorated basis, to a street or market rent. The movement in overall average effective rent can be caused by several market dynamics. Some of these dynamics are changes in street rents, introduction of new construction units and changes in the quantity and amount of concessions. The dynamic that can quickly and most significantly move effective rent is the change in quantity or number of communities offering concessions. The unprecedented movement in effective rent, on Graph #2, between August of $629 and September of $647 was propelled by many communities immediately eliminating all concessions as available units were occupied by Katrina evacuees.

In August, 70% of all units were declaring a concession that impacted those units' street rent by –7.3 percent. In September, the number of units offering a concession plummeted to 46% but the impact of the concessions on these units only decreased by 0.3 percentage points to –7.0 percent. This means that the communities still offering a concession changed their concession very little, or in other words, the one month free that was offered in August was still offered in September.

Classification Analysis

Table #1 drills-down the overall September month-end statistics to analyze the difference in rent levels and trends, occupancy levels, absorption activity and quantity of supply by class. New construction units from '04 and '05 have been filtered out of Class A and B categories to produce another classification category as well as provide a stabilized analysis of Classes A and B.

Greater Houston Apartment Statistics By Class **Table #1**

	Rent / sqft 9/30/05	Rent / mo 9/30/05	Rent Trend 12 Months	Rent Trend 3 Months	Occupancy 9/30/05	Absorption (units) Since 01/01/05	Supply (units) 9/30/05
04 & 05 Construction	94.0 ¢	$930	-	-	73.6%	8,669	19,348
Class A (w/o '04 & '05)	98.2 ¢	$887	3.0%	19.4%	94.5%	7,201	118,266
Class B (w/o '04 & '05)	70.8 ¢	$589	1.6%	9.3%	88.6%	5,300	218,721
Class C	62.5 ¢	$511	0.0%	5.5%	89.7%	3,009	98,524
Class D	45.3 ¢	$381	-0.9%	0.0%	84.0%	464	29,300
Overall	75.8 ¢	$647	2.1%	13.2%	89.4%	24,643	484,159

Class A's recent performance was incredibly strong, registering a 19.4% rental growth trend over the last 3-months and achieving an occupancy level of 94.5% at the end of September. The '04 &'05 Construction category's rent trend is not calculated due to the volatility caused by a continually increasing number of new units introduced into supply each month. The occupancy level for this category is relatively low for the same reason. Yet, it is very safe to say that the '04 & '05 category will receive the same pricing power and leasing momentum of Class A's. These two categories represent 28.4% of the overall supply.

Class B's performance in September was good but mixed considering the hyperactivity of the market. The 3-month rental growth trend was impressive at 9.3%, but occupancy was only able to achieve an 88.6% level. Class B represents 45.2% of the overall supply and is primarily composed of the large quantity of units built in the 1980's.

Class C's received a rental booster shot with a 5.5% rental growth trend over the last three months and occupancy improved to 89.7 percent.

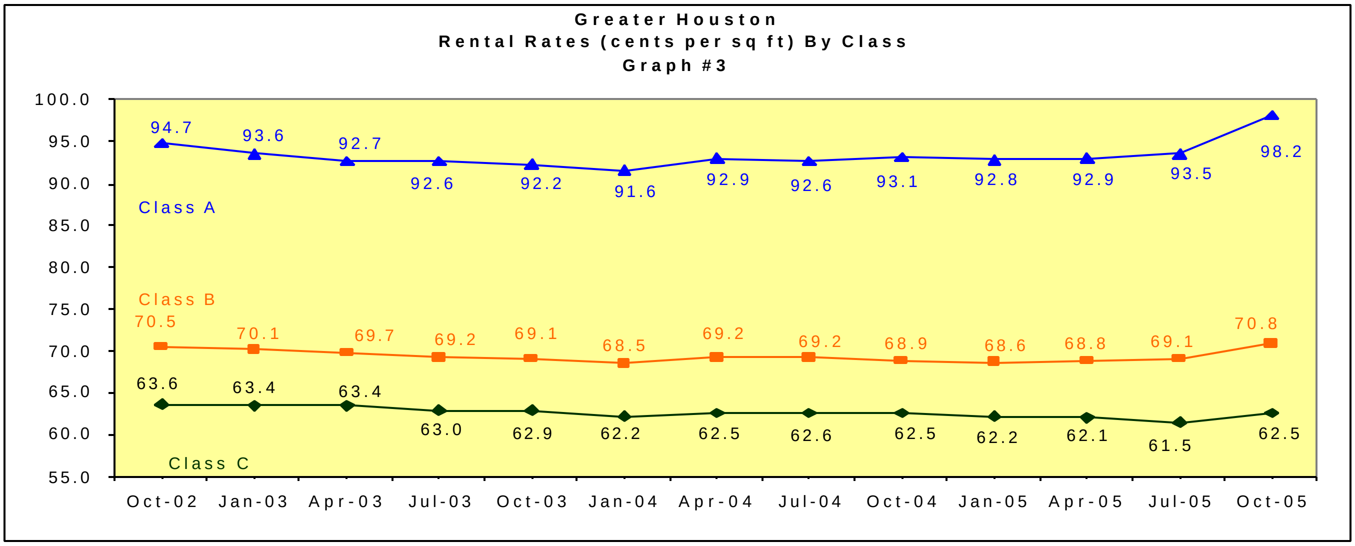
Class D's did not participate in the increase, which is not surprising. Class D is traditionally isolated and generally not effected by trends occurring in the rest of the market.

Trends

The 3-month rent trend is an annualized trend that takes the last three month's rent levels and looks forward with the assumption that the current level of rent will be maintained over the next twelve months. The trend numbers in the 3-months column of Table #1 include the "beyond phenomenal" increases that occurred in September. These trend numbers are an aberration that will not be able to be maintained over the next twelve months. However, rent trends have definitely been altered and elevated to higher levels. The long term trends going forward will, most likely, be one-half to two-thirds of the current 3-month trends for each respective category.

The 12-month rent trend in Table #1 takes the current rent levels and looks back. The 12-month growth trends for Classes A and B are mediocre and for Classes C and D weak. These trends are somewhat surprising considering the euphoria of September, but the mundane rents of the previous eleven months pulled the trends down. Graph #3 shows the lackluster quality of rental rates over the last three years, quarter by quarter.

The 12-month rent trend captures rents between October '04 and September '05. For Class A, the overall average rental rate as of Oct-04 was at 93.1 cents per sq. ft. At the end of the second quarter, Jul-05, rental rates had improved marginally to 93.5 cents then by the end of September rates skyrocketed to 98.2 cents. For Class B, rental rates as of Oct-04 were 68.9 cents. At the end of the



second quarter, rents had barely improved to 69.1 cents and then by the end of September rates jumped forward to 70.8 cents. For Class C, rental rates as of Oct-04 were 62.5 cents. By the end of the second quarter, Jul-05, rates had retreated to 61.5 cents then in September the ground previously lost was regained and rates moved back to 62.5 cents.

Absorption

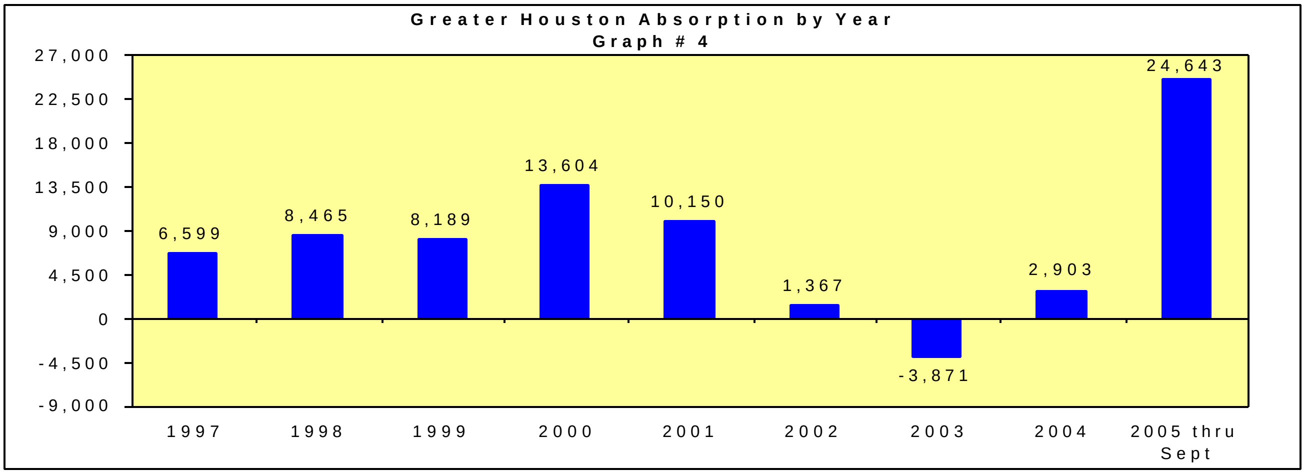
The year to date absorption performance shown in Table #1 of 24, 643 units is mind-boggling. This unprecedented performance deserves a closer look. Table #2 analyzes the 2005 absorption by showing how absorption accumulated during 2005, quarter by quarter, with a special emphasis on the

Greater Houston Apartment Absorption By Class **Table #2**

2005 YTD Sept	2005 YTD Aug		3rd Quarter Sept	3rd Quarter July & Aug	2nd Quarter April - June	1st Quarter Jan - March
8,669	5,898	04 & 05 Construction	2,771	1,227	2,283	2,388
7,201	3,563	Class A (w/o '04 & '05)	3,638	1,014	1,241	1,308
5,300	486	Class B (w/o '04 & '05)	4,814	92	557	-163
3,009	-248	Class C	3,257	365	89	-702
464	-49	Class D	513	-52	43	-40
24,643	9,650	Overall	14,993	2,646	4,213	2,791

difference in year to date absorption numbers between August and September 2005. During the first eight months of 2005, New Construction and Class A categories claimed 98.0% of all the total positive absorption. Absorption in Classes B, C and D from January through August were, for all practical purposes, flat. Katrina evacuees turned the tables in September to provide these Classes 57.3% of the monumental absorption of 14,993 units that occurred in that month.

The absorption of 9,650 units during the first eight months of 2005, despite being unevenly distributed, was a very strong absorption performance. Absorption for 2005, without the effects of Katrina, was shaping up to be the second strongest absorption recorded not quite beating 2000's performance of 13,604 units but edging out 2001's performance of 10,150 units. Graph #4 shows Houston's absorption performance by year back to 1997. Clearly, 2005's performance through



September towers over all other annual performances, but how will absorption end the year? Traditionally, the fourth quarter produces a flat to negative absorption number. Fourth quarters over the last four years have been exceptionally negative. The average fourth quarter absorption performance for the last four years has been –2,340 units, ranging from –1,365 units in 2001 to –3,191 units in 2004. Such negative numbers are not likely to occur in the fourth quarter of this year, pushing the year to date September number even higher. The overall absorption for 2005 will be a number that will stand as the best annul absorption for many years to come.

<u>Long Term Impact of Katrina</u>

The surge in occupancy and rent levels that took place during September happened within a two week time frame. This is simply unbelievable! Prior to September, sentiment was that it would take up to two years to achieve such levels. Since market conditions advanced so fast, it is only natural to wonder how long can these market conditions be sustained. After all, the leases that drove the market are short term and, more importantly, the mindset of these displaced people changes often and quickly. Whenever they decide to move, they will move regardless of the remaining term left on the lease. Local homeowners displaced after Tropical Storm Allison moving back to repaired homes gave us this lesson.

Where does the apartment industry go from here? The answer to this question is inexorably linked to how many evacuees will stay as apartment residents. There are many people in the industry struggling with the answer to the question above because it has tremendous implications to next year's budget expectations.

Here is an unscientific, but practical, method for quantifying the inevitable migration of Katrina's evacuees out of Houston apartments. This exercise develops a set of assumptions about how groups of evacuees will migrate over the next nine months. Unfortunately, an endless number of assumptions (guesses) can be made regarding the evacuees' movement.

The first step in this exercise is to divide the total units absorbed in September into three groups. Group One represents those units occupied by residents with regular, long-term leases not associated with

Katrina. Group Two represents those units occupied by residents, related to Katrina, who own a home. Group Three represents those units occupied by residents, related to Katrina, who were previously leasing.

Of the 14,993 units absorbed in September, how many goes into Group One (regular leases)? Guess is 500 units based on the average September absorption over the last ten years. Of the remaining 14,493 units (14,993 – 500), how many goes into Group Two (Katrina related homeowners)? Guess is 9,710 units (14,493 x 67%) based roughly on a homeownership rate that is a little less than the national average of 69 percent. The number of units that goes into Group Three (Katrina related renters) is 4,783 which is 33% of 14,493.

How many of the 14, 493 Katrina related units leased in September '05 will still remain occupied as of June '06? Guess is 4,800 to 5,800 units, which is approximately 33% to 40% of the Katrina related total units. This guess is based on 25% to 30% of Group Two (homeowners) and 50% to 60% of Group Three (renters) remaining. It is assumed that a large majority of the homeowner group will either go back to repair their homes or buy a home in Houston within nine months.

Based on the results above and the current supply of 484,159 units, the positive long-term impact on occupancy from September's leasing activity is 1.0 to 1.2 percentage points.

According to officials within the Mayor's Office, there were approximately a total of 150,000 Katrina evacuees to come to Houston. As of the end of September, the Mayor's office additionally indicates there remains 25,000 households located in 89 shelters plus another 54,000 people in 15,250 hotel/motel rooms. Rita evacuees account for 15,000 of the 54,000 in hotels and motels.

The Katrina Housing Task Force, created by the City of Houston and Harris County with tremendous assistance and cooperation from the Houston Apartment Association, as of the end of September have placed 5,000 households representing 20,000 people. The Task Force has the very ambitious goal to place all the 25,000 households left in shelters by the end of November. With this continued activity and awe inspiring resolve, look for the occupancy level to move even higher in Classes B and C with additional overall gains in rental rate trends over the next two months.

Market Rent & Renewal Shock

The leasing momentum and occupancy levels that were spawned by Katrina immediately gave 24% of the Houston apartment market the confidence to totally eliminate concessions. The "herd mentality" that propped-up concessions over the last three years will work in reverse to increase the number of communities eliminating concessions. As communities begin to renew the leases on long- term residents, market rent is now in play. This means that renewing residents will be staring at increases from 8.33 to 25.0 percent. Increases in this range are the equivalent to the evaporation of one-month to three-months free on a prorated basis.

Communities are going to feel justified, on a supply and demand basis, to stick to their market rent guns, however beware that properties presently under construction, condo-conversions and the single-family home market are anxious to feast on upcoming renewals. Current anecdotal evidence suggests that one-half of all move-outs are for home purchases.

New Apartment Construction and Single-Family Homes

Expect 3,000 to 4,000 units of the 8,000 units under construction to begin taking occupants in the fourth quarter of 2005. In addition, another 3,000 units should start construction from the 13,000 units that are being tracked as proposed.

The Multiple Listing Service of the Houston Association of Realtors reported that 8,106 properties were sold in August 2005. This is a 16.6% increase over last August's sales. The annual start rate of single-family homes has increased by 12.4% over last year, from 39,850 to 44,783, according to MetroStudy, a local company that tracks the single-family industry. In addition, Freddie Mac 30 year fixed rates as of October 11, 2005 were 5.68 percent which is 16 basis points lower than a year ago.