
CS ECONOMIC FORECAST JOB GROWTH OCCUPANCY RENTAL RATES NEW CONSTRUCTION
Are we

Just as the kids ask the proverbial question "are we there yet" on family road trips, the Houston apartment industry is asking the same question about local economic recovery. The road to recession that Houston traveled during 2009 saw job losses of 102,800.

Apartment fundamentals react negatively to job losses as evidenced by the graph on Page 36, which shows overall occupancy and rent levels heading south throughout 2009. Overall average rent went from an all-time high of $725 to settle at $709 by year's end. Overall occupancy began the year at 85.7 percent then deflated to a bottom of 84.0 percent.

The occupancy and rent paths made a turn to the north between December 2009 and March 2010. This upward movement provides hope and confidence that asking "are we there yet" is timely and not premature.

WHAT WAS THAT?

Getting that upward move in occupancy and rent in March was like seeing a road sign that says there are only 30 miles left to get to your destination when you thought it was more like 45 miles left to go. A welcome sign, but all of a sudden doubt enters as to whether you should trust the sign or your instinct.

The sign that the industry most closely watches to assess economic vitality of the market is job growth, generally expressed as a 12-month percent change or a 12-month net change. As of March, job growth for the Houston-Sugar Land-Baytown metro area, according to the Bureau of Labor Statistics, registered a -2.3 percent job growth (or job losses of 60,200) over the last 12 months.

The negativity of the 12-month signs for jobs discussed above does not match the upward path for overall occupancy and rent taken during the first quarter of 2010. How can positive movements in fundamentals be

there yet?

The multifamily market has made a turn to the north. Are we headed in the right direction, or is it an economic caution sign?

By BRUCE McCLENNY, Apartment Data Services Inc.

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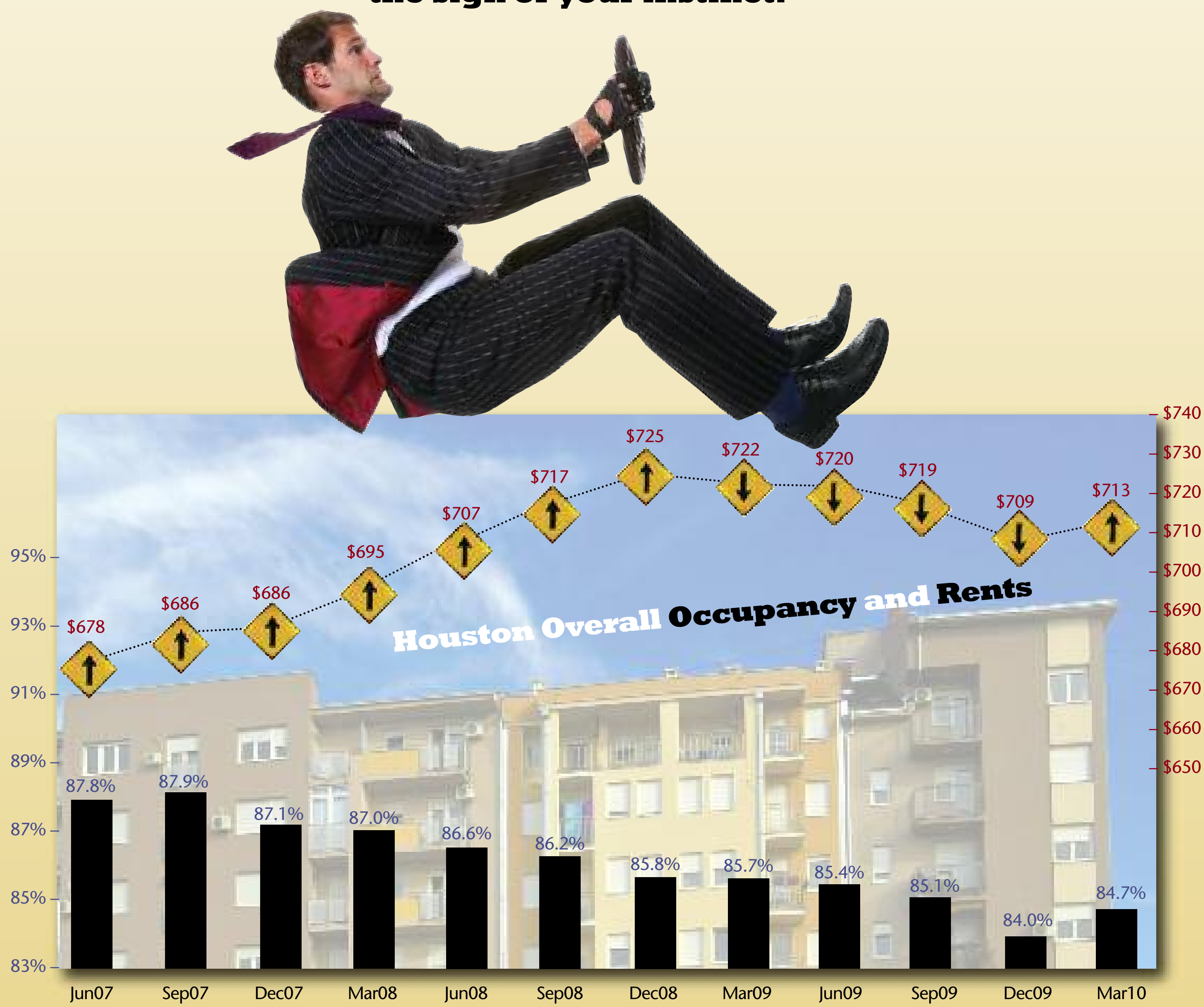


reconciled with negative job growth? Consideration should be given to making the one-month net change in jobs the go-to indicator during 2010 because the 12-month change is overwhelmingly influenced by strong job losses in 2009.

The one-month net change in jobs for March is 14,800 and 12,400 for February, which better corresponds to the first quarter's positive movement in occupancy and rents. In addition, such job growth is more consistent with the three-month overall absorption performance of 4,853 units shown in the table on Page 38.

SLOWER TRAFFIC KEEP RIGHT

The classification analysis in the chart on Page 38 illustrates how the overall performance at the end of March 2009 is distributed among each class and points out how classes differ in rates or trends of acceleration or deceleration.

The new construction units delivered in 2009 and 2010 have been filtered out of classes A and B to create a separate classification. Since 2009, 16,306 units have been introduced into supply, of which more than 15,000 units are attributed to 2009. The rent levels of new construction on a cents-per-square-foot and dollars-per-month basis are less than stabilized Class A because of the inclusion of more than 2,000 units of affordable/tax credit product. Rent trends for this group cannot be accurately calculated for this group due to the continually increasing number of units being introduced each month.

The new construction units claimed the lion's share of absorption, but there is a lot more leasing left to do as the low occupancy of 46.3 percent for this group indicates.

CLASS A WITHOUT NEW CONSTRUCTION

Taking new construction units out of Class A provides a stabilized analysis of this product type. This group's occupancy level of 90.0 percent is quite anemic. The main reason behind this tepid level of performance comes from the properties constructed in 2008, which have an occupancy level of 84.0 percent.

Normally, new construction properties reach what is considered to be a stabilized occupancy level of 90.0 percent or greater after 12 months. However, 2009 proved to be anything but normal with the economic recession stunting the growth of lease-ups and challenging older properties to maintain occupancy. Even with the 2008 properties omitted from this analysis, occupancy for Class A through 2007 construction only comes in at 91.5 percent.

Ironically, the 2008 properties that weighed down the occupancy level provided almost 5,000 units of the 12-month absorption of 5,703 units. The 2008 properties, at this time, are a misfit that defies classification without qualification.

The 12-month rent trend of -2.0 percent has eased from the depths of decline experienced during the concession crazed times of 2009. At the end of 2009, this group of properties had realized a negative rent trend of 6.8 percent. With job growth making a comeback early in 2010, the three-month annualized trend has responded with a positive 6.4 percent performance.

CLASS B WITHOUT NEW CONSTRUCTION

The 2009 downturn did not spare Class B (minus new construction) from negativity as the 12-month rent and absorption statistics show. Rent levels appear to have hit bottom in December 2009,

Analysis by Classification

As of March 31, 2010	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 3 Months
'09 & '10 Construction	16,306	46.3%	112.4	$1,091	–	–	7,046	2,059
Class A (w/o '09 & '10)	83,821	90.0%	118.1	$1,111	-2.0%	6.4%	5,703	1,022
Class B (w/o '09 & '10)	221,095	88.4%	84.9	$732	-3.1%	3.0%	-807	1,550
Class C	217,168	82.5%	66.6	$561	3.4%	-2.3%	-7,287	607
Class D	33,157	79.6%	45.7	$388	-1.6%	-3.1%	-309	-385
Overall	571,547	84.7%	82.1	$713	-2.2%	2.2%	4,346	4,853

Slower traffic keep to the right – The classification analysis shown above illustrates how the overall performance at the end of March 2009 is distributed among each class and points out how classes differ in rates or trends of acceleration or deceleration.

when the average cents per square foot and dollars per month were 84.1 cents and $725, respectively. The bottom for occupancy was 87.6 percent, which coincided with the bottom for rent.

Fortunately, sufficient economic activity in the first quarter allowed Class B to join Class A in getting positive traction to drive the three-month annualized rent trend to 3.0 percent. Classes A and B are now positioned to be looking at the downturn of 2009 in the rear-view mirror.

CLASSES C AND D

Classes C and D share the distinction of not yet feeling the limited positive energy that the local economy created during the first quarter. Individually, Class C brought in the worst performance over the last 12 months as occupancy dove 3.5 percentage points, driven by negative absorption of 7,287 units. In March 2009, Class C occupancy stood at 86.0 percent. By the end of 2009, occupancy reached a nadir of 82.3 percent and then recovered to 82.5 percent in March 2010, enabled by the mildly positive three-month absorption of 607 units.

Class C rents are still looking for a bottom, with the rate of decline slowing from -3.4 percent on a 12-month basis to -2.3 percent on a three-month annualized trend.

Class D occupancy has dipped past the psychological barrier of 80.0 percent. Occupancy has not been in this territory for Class D since mid-2005. The rent level for Class D is moving ever lower as the three-month trend of -3.2 percent indicates.

WHERE DO WE GO FROM HERE?

To understand where our trip will take us, let's review how we arrived where we are today. We begin in 2006, which could be considered a launching pad for the Houston apartment market when the metro area realized 105,800 jobs and the single-family home market began to unravel with the subprime mortgage crisis. It is an extremely rare occurrence when strong job growth mixes with a slowdown in the single-family market. Such a combination produced supercharged demand for apartments, which sent developers, fueled with very favorable financing, on a building spree in 2007.

Traditionally, rent levels move in step with occupancy. However, tradition was broken in 2008 (as the graph on Page 36 shows) as rents ascended and occupancy descended. The driver for the occupancy moving lower was new construction deliveries of 15,000 units in 2007 and 21,000 units in 2008, overwhelming a total absorption for these two years of 13,200 units. However, absorption was sufficient to create plenty of renters to satisfy the lease-up goals of new construction properties as well as cover move-out notices in the stabilized product. The years 2007 and 2008 turned out to be enchanted, turning what surely looked like a frog of an overbuilt market into a prince of rent growth.

Unfortunately, the market's enchanted state was rudely disturbed by the recession arriving in the Houston area late in 2008. In 2009, job losses put the brakes on demand while the new construction engine was still in high gear, delivering another 15,000 units. These ingredients combined to bring tradition back to the relationship between rent and occupancy levels as both moved lower together (as the 2009 points on the graph indicate).

POINTS OF INTEREST ALONG THE WAY

So here we are ready to embark on what's left of 2010 and beyond. The place where our previous travels have brought us is one of extremely low overall occupancy combined with an overall average rent that goes back to a level not seen since early 2008.

The vistas on the trip in 2010 will be much more pleasing than the squalid landscape seen in 2009. This year we will find surroundings of positive job growth and a miniscule construction pipeline, a combination of dynamics that are bound to improve occupancy and rent levels.

It is uncertain how much job growth there will be in 2010. Thankfully it is off to a good start, as indicated by the one-month net change numbers presented above. Barton Smith, a local economist who heads the University of Houston's Institute for Regional forecasting, expects Houston to create no more than 1,500 jobs per month throughout 2010. Recent news headlines about Continental's merger with United, NASA's shuttle program departure and BP's Deepwater Horizon disaster have raised many questions about the possible impact on jobs for the Houston area. Regardless of these negative developments, job growth for 2010 should still remain positive.

As for new construction, only 4,000 to 5,000 units will be delivered in 2010. Even though almost 15,000 new units have been proposed that developers are eager to begin, construction will not start until it becomes more financially feasible to do so. Once the ice breaks on this lending stalemate, expect almost all these proposed properties and others to begin quickly.

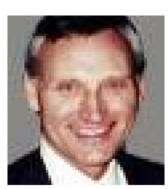
The single-family home market will remain in the ditch during 2010 as qualification standards remain high, which will continue to provide extra power to rental demand. This misfortune of the single-family industry has been a luxury for the rental market since 2007. Sooner or later this trend will end, which will most likely happen in 2011. Until then, a point to remember is that the single-family market considers an occupancy rebound in apartments as a source of greater demand for them.

LOOKING AHEAD

The route for the Houston apartment market in 2010 is set to be a year recovery. The degree of recovery is directly related to the level of job growth that the area creates during 2010. A variety of job forecasts have been put forward from The Greater Houston Partnership, Barton Smith of the University of Houston and Keith Phillips and Bill Gilmer of the Federal Reserve Bank of Dallas. Their forecasts range from 2,000 to 45,000 jobs, which unfortunately reflects more uncertainty than consensus.

Let's be optimistic and assume that the job growth will come in somewhere between 25,000 and 40,000 new jobs. Based on this performance, absorption by year's end should register between 5,000 to 8,000 units calculated on a conversion ratio of one occupied unit for every five jobs created. With such absorption, overall occupancy will range between 83.0 and 85.0 percent by year's end.

Rent levels at the end of the first quarter are trending at 2.2 percent, and given the positive outlook for occupancy, look for rents to improve in the neighborhood of 3.0 to 4.0 percent.



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