Sell Low, Rent Hig

The slow-down in single-family home sales due to the subprime lending crisis has given the apartment market a big boost.

By BRUCE McCLENNY, Apartment Data Services Inc.

Houston's apartment market has shown resilience and strength during 2008 as the local job market cooled down. Houston's job growth during 2008 has been essentially halved from that of 2007. The 12-month net change in jobs for the Houston-Sugar Land-Baytown metro area at the end of August 2007 was 106,500. By the end of August 2008, the 12-month net change in jobs for the metro area had settled to 53,400.

Generally, a significant slowdown in job growth produces a drag on absorption with a corresponding flat to negative impact on occupancy and rent levels; however, absorption through the first nine months of 2008 was even stronger than the same period of 2007. Year-to-date absorption as of the end of September of 2008 was 9,596 units, while 2007's absorption for the same timeframe was 7,176.

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Undoubtedly, the slowdown in single-family activity caused by the subprime lending crisis has helped give apartment absorption a big boost in 2008. According to the August MLS press release from the Houston Association of Realtors, "the greater Houston area suffered the biggest year-to-year decline ever in August," capping 12 consecutive months of decline in home sales. The statistics reveal that home sales have dropped by 20.1 percent on a year-over-year basis. In addition, construction permits for new homes on a year-over-year basis have plummeted by 29.5 percent as of the end of August.

At the height of the subprime madness somewhere around the end of 2006, when all it took was a heartbeat to qualify for a teaser rate mortgage, HAR boasted of sales activity for 2006 that exceeded 87,000 homes. According to MetroStudy, new home sales for 2006 surpassed 48,000 homes. Now that the anybody-can-qualify party has passed, the number of existing homes sold has settled to around 73,000 during the 12-month period ending in August. The number of new homes sold over the same period was around 28,000.

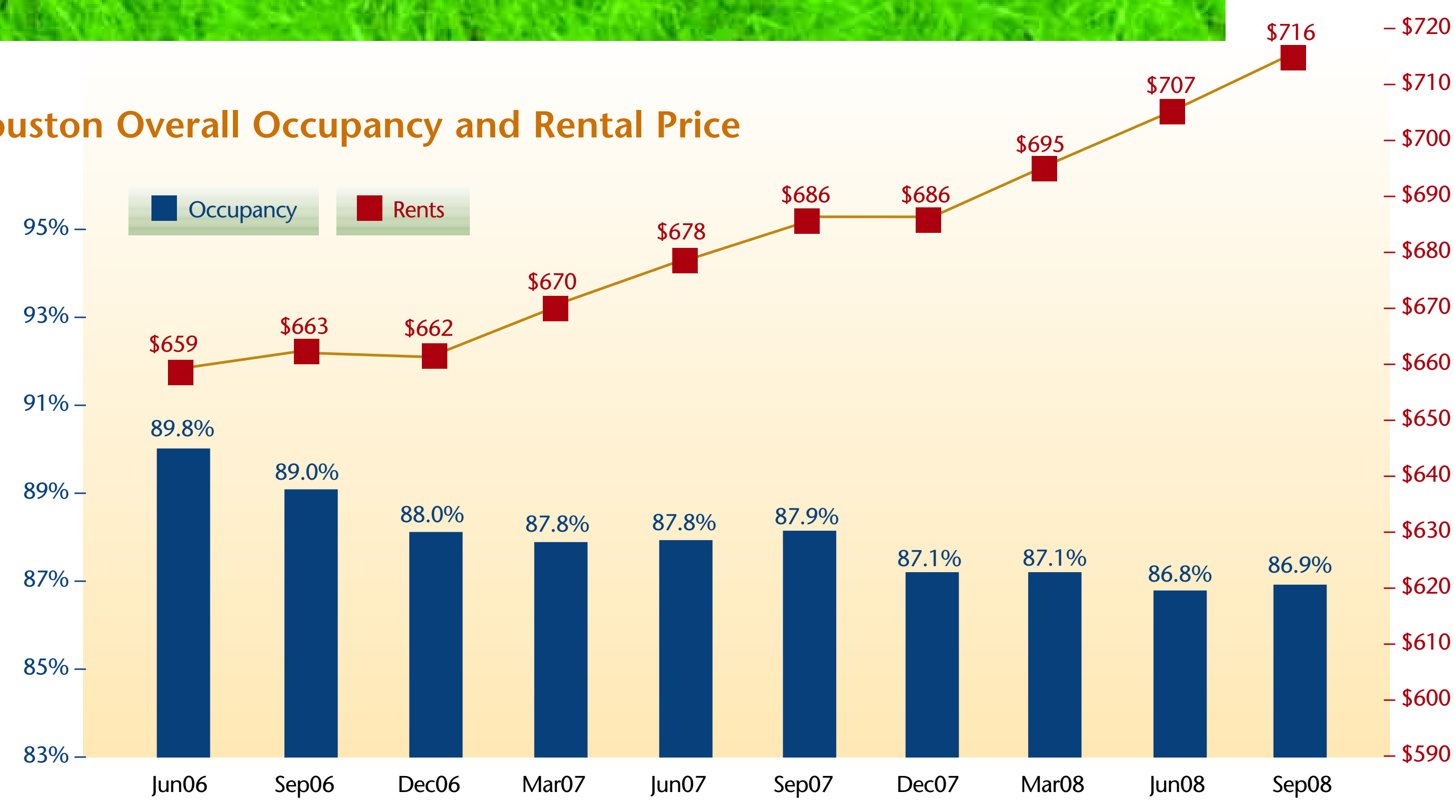
These lower sales numbers reflect the higher qualification requirements and less generous mortgage terms now in place. More importantly, the slowdown in the single-family activity has translated into stronger demand for rental properties as demonstrated by 2008's strong absorption performance.

A FUNDAMENTAL SURPRISE

The graph at right illustrates how the overall market has performed over the past 10 quarters. Rent levels have steadily improved while occupancy has drifted lower. This is quite a surprise! Normally when occupancy levels h

Photo By Karen Roach/dreamstime.com

Houston Overall Occupancy and Rental Price



Analysis by Classification

			Rent				Absorption (Units)		
	Supply	Occupancy	¢/sq ft	$/month	12-Month Trend	3-Month Trend	12 Months	3 Months	2008 YTD
'07 & '08 Construction	28,680	49.5%	111.4	$1,093	–	–	9,123	2,753	8,071
Class A (w/o '07 & '08)	77,386	93.3%	121.2	$1,132	4.2%	6.6%	78	234	780
Class B (w/o '07 & '08)	205,473	91.2%	84.8	$718	2.2%	2.4%	-592	106	517
Class C	206,526	86.0%	66.4	$558	1.8%	3.3%	-1,188	190	313
Class D	32,693	82.2%	44.6	$378	-0.3%	-0.6%	-283	-33	-85
Overall	550,758	86.9%	83.0	$716	4.3%	5.0%	7,138	3,250	9,596

remain persistently flat and less than 90 percent, rents respond in a flat to negative manner.

Even though absorption has been substantial for the reasons described above, a rise in occupancy has been thwarted due to the heavy amount of new construction units delivered during 2007 and 2008. Fortunately, the amount of absorption has been able to move rents by providing enough demand to satisfy the lease-up goals of the new construction supply as well as cover the move-out notices of stabilized product. In other words, absorption has provided enough leasing momentum to give properties the confidence to raise rents despite a relatively low overall occupancy level.

WHAT ABOUT IKE?

Hurricane Ike blew through Houston on September 13 and immediately began to influence occupancy and rent levels. What is shown on the graph for September 2008 is only the beginning of the Ike impact. It remains too early to tell what the overall market impact from Ike might be. To get a better idea, it may be useful to review what happened to the market after Tropical Storm Allison dumped more than 35 inches of rain back in June 2001.

Allison flooded many apartments and homes. Houstonians displaced by the storm, as well as legions of insurance adjusters and construction workers, sought available apartments to lease. This flurry of leasing activity prompted properties to quickly eliminate concessions. Prior to Allison, approximately 50 percent of the

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market was offering some form of a concession or special. By August, only 27 percent of properties were offering concessions. This elimination of concessions spiked the overall average rent by $26 per month.

Rents are quoted on an effective basis, derived by deducting the prorated effect of concessions from the street or market rent. The September 2008 rent level of $716 marks a $6 increase that occurred after the Ike-induced leasing momentum gave the market the resolve to begin eliminating concessions. At the beginning of September, 54 percent of all properties offered some form of a concession. By the end of September, the number of properties offering concessions had eased to 48 percent of the supply.

To be sure, occupancy will improve in the months following Ike. In 2001, the overall occupancy level jumped by 1.2 percentage points during the months following Allison. In addition, more than 20,000 units were flooded, representing about 4.5 percent of the overall supply.

Unfortunately, at this time information about damage from Ike is still very sketchy. It is probably a safe assumption that most all first-floor units in Galveston were flooded. (We are tracking around 5,000 units in the Galveston area.) In addition, all cities along Galveston Bay had properties with various degrees of damage. A best guess for the number of Ike-damaged units ranges from 10,000 to 12,000, which represents about 2.0 percent of the supply.

OVERALL PERFORMANCE ANALYZED BY CLASS

The table on Page 32 provides a snapshot of conditions by class as of the end of September. This table breaks out the performance of each class and shows how each segment contributed to the overall market's performance.

The 12-month trend for overall rent posted a very strong 4.3 percent rate of growth. This stout performance was achieved despite getting a flat start over the last three months of 2007. The overall three-month trend is even better at 5.0 percent. The three-month trend is annualized, which assumes that this trend will continue for the next nine months.

The overall absorption performance discussed above is the hero of this report. It has been strong and unusual and has been the force behind the impressive growth in rents. However, as strong as absorption has been, it has been no match to keep up with the pace of new construction units delivered into supply.

NEW CONSTRUCTION

The new construction units delivered in 2007 and 2008 have been filtered out of Class A and Class B to create a separate classification. Since the beginning of 2007, 28,680 units have been introduced into supply. Approximately 68 percent are Class A, and 32 percent are tax-credit and considered Class B. In addition, 14,752 units were constructed in 2007, and 14,108 units have been constructed so far in 2008.

These properties are in various stages of lease-up, which accounts for the low occupancy level of 49.5 percent. The low occupancy is of little concern, since leasing has been going very well as this category has claimed most all the absorption. Normally the rent levels of new construction properties are higher than the stabilized Class A product. However, because of the relatively large component of tax-credit units in this category, rent per square foot for new construction is lower than that of Class A. Rent trends for this group cannot be accurately calculated due to the volatility caused by the continually increasing number of units being introduced.

CLASSES A & B WITHOUT NEW CONSTRUCTION

Taking the new-construction units out of Class A provides a stabilized analysis of this product type. Twelve months ago, the occupancy level for this group was 93.2 percent, and the average monthly rent was $1,091. By September, occupancy had inched up to 93.3 percent, and rent had improved by 4.2 percent to register an average of $1,132. The past three months have proved to be even stronger, coming in a 6.6 percent annualized growth rate.

Newly constructed tax-credit units create new demands on a classification system. These properties have features and amenities of Class A and price levels of Class C. Because of this mixed identity, these properties are classified as Class B. Since 2007, around 9,200 units of new construction have been added to the Class B category. With these units filtered out, overall Class B occupancy stands at 91.2 percent. This occupancy level is slightly less than the 91.5 percent occupancy level 12 months ago. Even though occupancy drifted lower, rents were still able to move forward by 2.2 percent over the past 12 months.

CLASS C AND CLASS D

During 2007, Class C finally broke into positive rent growth territory after losing ground for several years to tax-credit properties, seniors-only properties and single-family homes. Of course, losing residents to homeownership has become much less of a competitive issue during 2008, and the 12-month rent trend of 1.8 percent lends credence to this notion. It is noteworthy that Class C was able to achieve a positive rent trend when occupancy was falling from 86.7 percent last October to 86.0 percent at the end of September 2008. The 3.3 percent rent trend over the past three months is a very interesting development in that Class C became more aggressive toward raising rents when it received a little positive absorption.

Class D turned in its usual lackluster performance with negative rent growth and absorption.

LOOKING AHEAD

The outlook for Houston's economy, as well as the national and global economies, is fraught with fear and uncertainty. Houston's economy has been cushioned from the downturn in the national economy mainly because of the prosperity of oil-related indus-

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tries. Experts say that Houston's economy is now around 50 percent dependent on oil, whereas in the 1980s it was more than 80 percent dependent. We are not as vulnerable as we were in the 1980s, but with oil dropping into the $80-per-barrel range and the credit crisis slowing the demand for oil in all economies, Houston's economy will begin to look more like the national economy.

The 12-month net change in jobs nationally at the end of August was a loss of 279,000 jobs, which translates to a negative 0.2 percent performance. Comparatively, Houston experienced a gain of 53,400 jobs, a 2.1 percent rate of growth. The Bureau of Labor Statistics has released September's national jobs report, and the news has worsened. The nation has lost 519,000 jobs (12-month net change), equating to a 0.4 percent decline. Houston's September jobs report is due out soon and most likely will not show much change. How will Houston's job picture change in 2009?

Once again, looking back at 2001 and the following years might provide a basis to assume how Houston's job picture might respond to a national downturn. The major events of 2001 are strangely similar to those of 2008. Both years saw Houston experience a flooding event (Tropical Storm Allison in 2001 and Hurricane Ike in 2008) and a catastrophe with global economic consequences (the 9-11 terrorist attacks in 2001 and the credit/banking crisis in 2008). In December 2002, the 12-month net change in jobs for the Houston-Sugar Land-Baytown area was a negative 5,100 jobs, and by December 2003 it was a negative 14,300 jobs. Let's say that this exercise provides us with a worst-case scenario for mildly negative job growth for 2009 and 2010.

A best-case scenario for Houston jobs must consider that oil at $80 a barrel is a price high enough for most drilling companies to keep drilling, that Hurricane Ike will produce reconstruction jobs and that the Medical Center is in the middle of massive expansion plans. In addition, this national downturn might produce local population growth at the expense of other regions of the country as families and individuals seek jobs and a lower cost of living. Let's say that a best-case scenario for job growth for 2009 and 2010 would be around 15,000 to 20,000 jobs each year. Hopefully, local economists will soon give us a jobs forecast based more on scientific methods rather than supposition as the one above.

WHAT WILL HOUSTON'S APARTMENT MARKET DO?

Traditionally, the fourth quarter experiences negative absorption. Last year, the fourth quarter saw negative absorption of 2,458 units. This year's fourth quarter has a good chance of not following tradition because the single-family market is still bogged down with subprime issues complicated even more by the credit crisis. In addition, Ike-related leasing from displaced homeowners and reconstruction workers should buoy absorption.

The favorable conditions of 2008 will continue changing throughout 2009. The homeowners displaced by Ike and the workers rebuiding Ike's damage will begin to move out of apartments, and job growth will start to lose momentum.

The market will need a non-traditional absorption performance to keep occupancy from losing more ground with all the units under construction poised to come into supply during the fourth quarter. Of the approximately 16,000 units under construction, at least 5,000 will be delivered during the fourth quarter. Assuming a flat absorption performance (remember that flat is good during the fourth quarter), the overall occupancy will slide to 86.0 percent by year's end. However, it is very likely that Ike-related leasing could produce an absorption performance of 2,500 to 3,000 units. With this scenario, occupancy would be around 86.6 percent by the end of the year.

If today's rents take a cue from how rents behaved after Tropical Storm Allison, expect rent levels to increase over the last three months of 2008. The overall average rent level could increase by $10 to $20 per month. If so, Houston's overall rent growth for 2008 would range somewhere between 6.0 to 7.5 percent. This type of performance is possible, and if achieved, would truly be superlative.

OUTLOOK FOR 2009

The favorable conditions of 2008 will continue changing throughout 2009. The homeowners displaced by Ike and the workers rebuilding Ike's damage will begin to move out of apartments, and job growth will start to lose momentum. Fortunately for our industry, the subprime crisis will still be a factor that favors renting over buying a home. Not so fortunate, in light of the slower economic times, is the number of under-construction units that will be introduced into supply. Look for about 11,000 units to come online in 2009 from the 16,000 units presently under construction. The proposed construction list shows more than 18,000 units, but the credit/banking crisis will severely limit the funds available to finance construction of any of the properties on the proposed list. Even though financing will be tough to get, look for 5,000 to 6,000 units to start construction.

Occupancy by the end of 2009 should fall somewhere in the range of 85.0 to 86.0 percent, driven by positive absorption of 5,000 to 6,000 units. Rent growth for 2009 could range anywhere from a negative 1.0 percent to a positive 1.0 percent. If the negative end of this range is realized, the economic conditions of 2009 will be more severe than anticipated. For budgeting purposes, flat rent growth for 2009 should actually be considered a good performance. Holding on to the exceptional rent growth in 2008, especially the growth that occurred late in the year, will be a challenge.

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.