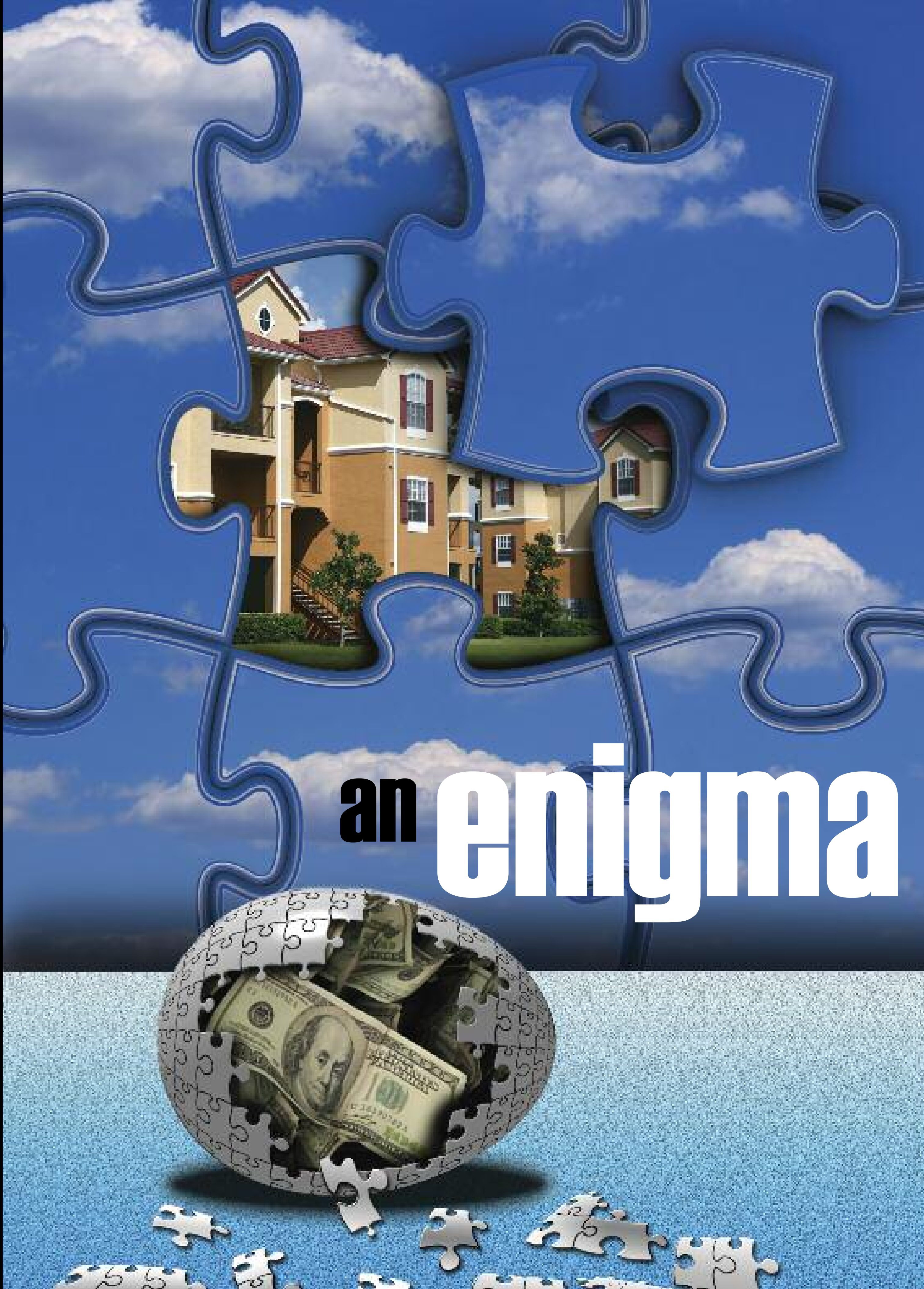
fall 2009 occupancy, rental rate & new construction survey



The Houston apartment market is an enigma wrapped in a conundrum. But what could be so puzzling about the market? After all, it is a certainty that a global economic recession is well under way, and the Houston economy has not been spared from participating. As of the end of August, the Bureau of Labor Statistics reported that the Houston-Sugar Land-Baytown metro area had lost 95,100 jobs over the past 12 months, which equates to a -3.6 percent rate of decline.

Job growth (or the lack of it) is a metric that the industry has come to rely on to predict demand for apartments. When job growth is positive, demand for apartments follows with positive absorption, and the converse generally holds true.

The last time the Houston area experienced a loss in jobs was 2003 when 11,400 jobs were lost and the market responded with a negative absorption performance of more than 4,000 units. Now that the area has posted a job loss of 95,100 over the past 12 months, expectations should be that absorption would be negative or at least flat. However, overall absorption for this period has registered a positive 9,284 units as the classification table on Page 32 shows.

This level of absorption is more indicative of very strong job growth and is the main source of the market's enigmatic behavior. How could the market produce such positive absorption as the area's job market records the worst job losses since the 1980s?

There are at least two reasons for this extraordinary absorption performance. The first is Hurricane Ike, which struck last September. Along with property damage, Ike produced absorption-enhancing renters from displaced homeowners and armies of insurance adjusters and contractors. Overall absorption during the fourth quarter of 2008 was greater than 2,500 units. Without Ike, absorption would have been much less considering that the economic downturn had arrived in Texas.

wrapped in a conundrum

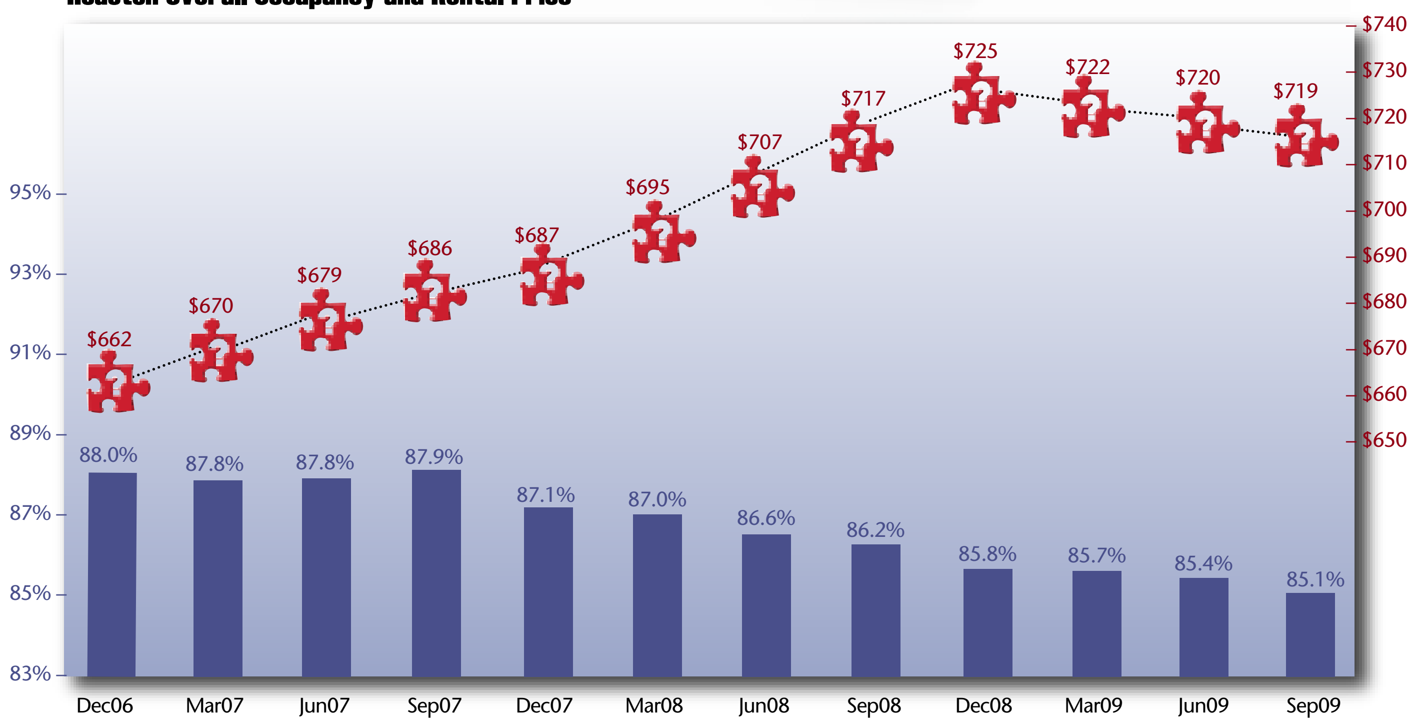
Houston apartments are seeing positive absorption in spite of a shaky economy, but its source remains unclear.

By BRUCE McCLENNY, Apartment Data Services Inc.

Analysis by Classification

As of Sept. 30, 2009	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 2009 YTD
'08 & '09 Construction	34,510	56.3%	111.2	$1,091	–	–	14,187	11,074
Class A (w/o '08 & '09)	73,334	91.0%	117.6	$1,101	-5.5%	0.0%	264	-297
Class B (w/o '08 & '09)	212,436	88.9%	85.4	$732	-0.9%	-1.1%	-2,764	-2,279
Class C	215,510	84.5%	67.7	$569	0.7%	-1.3%	-2,560	-2,026
Class D	33,129	82.0%	45.4	$386	-0.6%	-1.9%	157	255
Overall	568,919	85.1%	82.8	$719	-0.7%	-1.3%	9,284	6,727

Houston Overall Occupancy and Rental Price



Ike explains the fourth quarter's positive absorption number, but 2009's absorption of 6,727 units is not so easy to explain. Since the beginning of 2009, the economic downturn has grown longer and deeper and the positive leasing impact from Ike reversed as homeowners moved back into their repaired homes and contractors left as their work dried up. These aspects set the stage for a negative absorption scenario, yet absorption has defied these traditional expectations.

The second possible reason for absorption to remain inexplicably strong generates from the unrelenting downturn in the local single-family home market. According to the August 2009 MLS Press Release from the Houston Association of Realtors, "total property sales (from existing homes) tumbled 11.0 percent in August on a year-over-year basis." This 11.0 percent decline is piled onto the worst year-to-year slide ever recorded by HAR last August when sales declined by 20.1 percent.

To add more bad news to the single-family industry's woes, permits for new homes are down by 37.0 percent on a year-over-year basis as of August 2009, according the Real Estate Center at Texas A&M. To quantify the precipitous drop in permits, consider that the 12-month moving total for permits as of August 2008 was 28,833 – the comparable number for August 2009 is 18,121.

The continued decline in single-family sales of existing homes as well as the permitting of new homes provides a tremendous competitive advantage to the rental market. This advantage is difficult to quantify but definitely exists as a result of tougher qualification standards and mandatory down payments at a time of great economic uncertainty for would-be homebuyers. The demand pendulum is certainly swinging in favor of renting as a safer and wiser course of action than buying.

2008 & 2009 CONSTRUCTION

All the absorption went into the "black hole" of new construction units delivered since 2008. As the table on the page at left shows, this is quite a large hole of 34,510 units. Over the past 12 months, this grouping of properties claimed 14,187 units of absorption, which left the other classes paying the absorption bill. Overall absorption is a net number and is not designed to capture the change in occupied units when a resident moves from one community to another. Thus, these moves do not create a countable absorption unit. They do, however, create one unit of negative absorption in, for instance, Class A and one unit of positive absorption in new construction.

Over the past 12 months many residents have made such moves as new construction properties adopted a "heads on beds" strategy, offering concessions of up to three months free. At some properties, lavish move-in gifts like flat screen televisions were also provided.

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Even though rent trends cannot be accurately calculated for this group due to the continually increasing number of units being introduced each month, be assured that rent levels were moving lower designed to steal residents from the stabilized properties and quickly attract and secure any other prospective renters.

CLASS A WITHOUT NEW CONSTRUCTION

The occupancy level of Class A minus new construction is 91.0 percent as of the end of September 2009. In December 2008, occupancy for this group was closer to 92.0 percent, boosted by Ikerelated leasing. The downward movement in occupancy was assisted by the Ike correction and the new construction group's pricing strategy as discussed above.

To keep occupancy from moving even lower, Class A had to adopt aggressive concession policies as a defensive strategy. The negative rent trend of 5.5 percent shows the hit that stabilized Class A took to buy occupancy over the past 12 months.

The good news is that the three-month rent trend has flattened out at 0.0 percent. Back in April, the three-month trend was a negative 11.0 percent. It appears that the torrid concession pace has temporarily eased and is taking a breather. The bad news is that the traditionally slow leasing season of the fourth quarter has arrived, the new construction group of properties is sitting at 56.3 percent occupied and economic conditions do not seem ready yet to provide a leasing stimulus. It would not be surprising if concessions began to escalate again over the next six months.

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CLASS B WITHOUT NEW CONSTRUCTION

Newly constructed tax-credit properties create exceptions in a classification system of apartment product. 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. Taking these new construction properties that represent about 8,000 units out of Class B allows a stabilized occupancy and rent analysis.

As of the end of September, Class B stabilized occupancy stood at 88.9 percent. Occupancy has been on a steady decline since December 2008, when occupancy registered 90.3 percent. In response to this 1.5 percentage point retreat in occupancy, rent levels have moved slightly lower, staying consistently in the -1.0 percent ballpark with the 12-month trend at -0.9 percent and the three-month annualized trend at -1.1 percent.

CLASS C AND CLASS D

In terms of rent growth over the past 12 months, Class C is the best performer of all, coming in with a gain of 0.7 percent. To remain slightly positive when all others are negative is notable. However, the three-month annualized trend has turned negative as a continual slide in occupancy from 85.9 percent in March to 84.5 percent at the end of September brought on more concessions.

Class D turned in its usual uninspiring performance of negative rent growth and minimal absorption.

HISTORICAL OVERALL MARKET CONDITIONS

The graph on Page 32 illustrates how the classes combined to produce overall market results over the last 12 quarters. The graph goes back to better market times in 2007 when net job growth reached 87,000 and the rent line trended in a positive manner despite a flat-to-declining occupancy performance (driven by more than 14,000 units of new construction overwhelming absorption of 4,744 units). The occupancy and rent performance of 2008 presents much the same story as 2007, only super-sized. The rent line continued its climb in 2008 as the overall occupancy moved lower and lower, caused by almost 21,000 units of new construction being introduced as the market produced 8,651 units of absorption on net job growth of 22,500.

The single-family sub-prime crisis, which began in 2006 and still continues today, has provided enormous support for the disconnect between the rent line heading north and the occupancy bars south. The sub-prime crisis slowed turnover and stoked the level of absorption enough during 2007 and the first half of 2008 to give properties the confidence to raise rents in the face of relatively low overall occupancy levels.

Hurricane Ike induced the rise in the rent line from September to December 2008. Notice that the rent line topped out in December 2008 at $725 then began to move lower in 2009 as the economic downturn pressured the new construction properties to promote their "heads on beds" pricing strategy and bringing stabilized Class A into the concession frenzy.

See ENIGMA, Page 61

ENIGMA, Continued from Page 37

MORE PUZZLING BEHAVIOR

If the absorption performance is the enigma, the rent performance is the conundrum. Sentiment about market conditions is negative from all levels of the industry. The recession, combined with strong job loss numbers, has given everyone a psychological beating. This negative sentiment plus the aggressive offering of concessions earlier in the year set expectations for rent trends to be more negative than the -0.7 percent 12-month trend and the annualized three-month trend of -1.3 percent. Rent performance was able to beat expectations only because the offering of aggressive concessions was confined to new construction properties and stabilized Class A. In addition, these groups of properties scaled back concessions during the third quarter.

LOOKING AHEAD

Uncertainty is rampant among economic pundits. Keith R. Phillips with the Federal Reserve Bank of Dallas states that he is "hesitant to forecast 2010 so far in advance since many things can change between now and the end of the year." However, based on the current momentum in the economy and the recent positive changes in the Texas Leading Index, Phillips is encouraged enough to set the expectation for a mild rebound in Texas job growth next year of about 1.0 to 1.5 percent. Assuming that this forecast will hold and that Houston will participate at these same growth rates, local job growth for 2010 would come in somewhere between 26,000 to 40,000 jobs. This scenario seems very optimistic, especially when any amount of job growth for 2010 would be welcomed.

The stage is set for very few units to be introduced in 2010 as the financial crisis has put the lid on any new development – despite a proposed construction list of 13,000 units. The only deals getting done are through HUD's Section 221 D 4 financing program and by developers who can find equity partners. These financing alternatives should produce around 2,000 units.

The ingredients of any positive job growth combined with the introduction of a very low number of new supply units is a recipe for 2010 to be a year of recovery for the Houston apartment market.

The ingredients of any positive job growth combined with the introduction of a very low number of new supply units is a recipe for 2010 to be a year of recovery for the Houston apartment market. Overall occupancy by the end of 2010 should climb over 86.0 percent, and rent growth for the year should trend positively between 1.0 and 2.0 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.