

Subporime

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Aided by strong job growth, the multifamily market makes lemonade from the lemons of the single-family mortgage meltdown.

By **BRUCE MCCLENNY**, Apartment Data Services Inc.

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Houston's apartment market performance during 2007, powered by outstanding job growth and a slowdown in the single-family home market, was very encouraging. The 12-month net change in jobs in the Houston-Sugar Land-Baytown metropolitan statistical area at the end of 2007 was 94,200, which represents a stellar 3.7 percent increase. To have this level of job growth while the single-family industry became deeply mired in the subprime lending crisis created a very fortunate situation for the local apartment market.

MetroStudy, a local firm that tracks single-family construction, reported a 26 percent decline in new home sales. Existing home sales, according to the Houston Association of Realtors, declined by 5 percent in 2007. A closer look into this downturn indicates that the weakest segment of the market comprises homes priced from \$80,000 to \$150,000, which experienced a 16.7 percent decline.

Another consequence of the subprime debacle plaguing the single-family home industry is foreclosures. Harris County foreclosures rose by 24.8 percent in 2007, according to the Foreclosure Information & Listing Service. (See Page 48 for more on foreclosures.)

All this turmoil has shifted the rent-vs-buy pendulum in favor of renting. Due to stricter lending requirements, fewer people qualify to buy a home and more are renting longer. Anecdotally, prior to the subprime meltdown approximately 50 percent of turnover could be attributed to home purchases. Now, turnover due to home purchases has decreased by 20 percent.

Houston Overall Occupancy and Rental Price



As long as job growth remains strong and the single-family industry continues to work through its current problems, demand for apartments will more than likely be strong enough to overcome the traditional relationship between rent and occupancy.

EXTRAORDINARY CONDITIONS FOR THE OVERALL MARKET

The graph above illustrates how the overall market has responded over the past nine quarters. It is easy to see that rent levels have improved, but occupancy is deceptively flat. The drop in occupancy levels during 2006 was overwhelmingly influenced by the exodus of 22,000 Katrina voucher recipients. Fortunately, strong job growth of 105,800 new jobs during 2006 helped minimize the Katrina correction. The flatness in overall occupancy during 2007 was influenced by the introduction of more than 14,000 units of new construction and, to a lesser extent, the continued Katrina correction of about 6,000 units vacated.

The disconnect between the movement of rent and occupancy levels that began in March 2007 in the graph above would normally be a concern. Rent levels generally move in step with occupancy – in other words, rent levels are directly responsive to occupancy levels. Occupancy levels that persistently remain flat and less than 90 percent generally produce a rent

environment that is flat to negative. However, the extraordinary conditions created by the sub-prime lending crisis have temporarily changed this relationship. As long as job growth remains strong and the single-family industry continues to work through its current problems, demand for apartments will more than likely be strong enough to overcome the traditional relationship between rent and occupancy.

AN OVERVIEW BY CLASS SHOWS STRONG RENT TRENDS

The 12-month trend for overall rent as of the end of March registered a decent 2.6 percent. This performance was limited by a slowdown in the fourth quarter of 2007, when all classes experienced a mildly negative rent trend. The fourth quarter is normally a slow leasing season. The market came back to life in the first quarter as the three-month rent trend scored a 4.4 percent increase. The three-month trend is annualized, which assumes that the trend for this three-month period will continue for the next nine months.

Analysis by Classification

	Supply	Occupancy	Rent ¢/sq ft	Rent			Absorption (Units)	
				\$/month	12-Month Trend	3-Month Trend	2007 YTD	Last 12 Months
'07 & '08 Construction	17,368	40.2%	106.9	\$1,054	–	–	5,363	2,017
Class A (w/o '07 & '08)	90,043	92.4%	113.1	\$1,041	3.1%	6.7%	1,402	214
Class B (w/o '07 & '08)	206,178	90.6%	82.1	\$692	1.5%	2.5%	739	312
Class C	192,189	86.4%	64.8	\$546	0.6%	0.7%	344	645
Class D	34,295	82.2%	44.2	\$374	-2.7%	1.4%	-638	-63
Overall	540,073	87.3%	80.5	\$693	2.6%	4.4%	7,210	3,125

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The absorption performance over the past three months came in very strong with 3,125 units absorbed, which provided the stimulus for the equally strong rent trend over the same period.

The table on Page 42 provides a snapshot of conditions by class as of March 31. This table breaks out the performance of each class and shows how each contributed to the overall market's performance.

The absorption performance of 7,210 units over the past 12 months was limited by the slow fourth quarter, when the overall market registered more than 1,300 units of negative absorption. The absorption performance over the past three months came in very strong with 3,125 units absorbed, which provided the stimulus for the equally strong rent trend over the same period.

New construction deliveries are keeping the overall occupancy stuck several points below the 90 percent level. Despite the strong absorption of the first three months of 2008, it was not enough to keep up with new construction additions of more than 4,000 units. Fortunately, the relatively low overall occupancy level has become a non-issue as the super-charged demand as described above has created enough absorption to satisfy the lease-up goals of new construction properties as well as enough absorption to cover move-out notices in the stabilized product. Serendipity!

NEW CONSTRUCTION AT WORK

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, 17,368 units have been introduced into supply. Approximately 11,700 units of the new construction category are Class A and 5,600 units are tax-credit and considered Class B.

These properties are in various stages of lease-up, hence the low occupancy level of 40.2 percent. 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 a continually increasing number of units being introduced.

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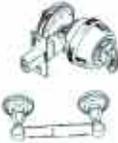
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CLASS A WITHOUT NEW CONSTRUCTION STILL STRONG

Taking the new construction units out of Class A provides a stabilized occupancy analysis of this product type. The occupancy level for this group at the end of 2007 was a stout 92.6 percent, and rents were 115 cents per square foot. By the end of March, occupancy had slipped slightly to a still-strong 92.4 percent, and rents retreated to 113.1 cents. Even with the slide in rents, the 12-month trend came in at a very respectable 3.1 percent. Class A is really feeling sassy, with the three-month rental trend weighing in at a whopping 6.7 percent.

A GOOD YEAR FOR CLASS B WITHOUT NEW CONSTRUCTION

The Low Income Housing Tax Credit program permits developers to build a property with rent levels in the Class C range and the features and amenities of Class A product. These newly constructed tax-credit properties are classified as Class B. Since 2007, about 5,600 tax-credit units have been introduced into supply. With these units filtered out, Class B occupancy stood at 90.6 percent at the end of March. This level of occupancy was good enough to generate a 1.5 percent rent trend over the past 12 months. With the three-month trend standing at 2.5 percent, Class B is setting the stage for a banner year.

THINGS ARE LOOKING UP FOR CLASS C AND CLASS D

In 2007, Class C firmly broke into positive rental rate territory with a 1.2 percent performance. Prior to that, Class C struggled to compete with tax-credit properties, seniors-only properties and single-family homes. Before Class C could realize rental rate gains, Class B needed to lead the way. That happened in 2007. As of the end of March the 2008, 12-month trend for Class C had eased to 0.6 percent, and its three-month trend remained in the same growth range with a performance of 0.7 percent. For Class C to have held on with positive rent growth during the first quarter of 2008 is a positive development.

Class D turned in a negative performance for 2007. However, things began to look up even for Class D as the three-month trend as of the end of March registered a positive performance of 1.4 percent.

LOOKING AHEAD

As Houston's apartment market looks ahead through 2008, we are wishing for more of the same conditions from 2007. Continued strong

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F R E E E S T I M A T E S



Driven by high energy prices, Houston's employment growth over the past three years consistently outpaced the rest of the county.

job growth and a single-family market that must deal with stricter qualification standards and foreclosures are conditions that will set the stage for another strong performance. It is reasonable to assume that economic strife in the single-family market will continue during 2008. However, the continuance of strong job growth in 2008 is not so clear-cut.

Driven by high energy prices, Houston's employment growth over the past three years consistently outpaced the rest of the country. For the first three months of 2008, the nation has lost jobs. The downturn in the national economy raises questions as to how much will Houston's job growth be affected. So far, Houston's job growth remains strong. In January, Houston realized a 3.8 percent improvement and February followed with a 3.4 percent increase in the 12-month net change in

jobs. These percentages equate to a 94,400 increase for January and an 86,000 increase for February. These numbers show virtually no slowdown in the pace of job growth from 2007.

Barton Smith, director of the Institute for Regional Forecasting at the University of Houston, expects a slowdown in Houston's job growth in 2008. He believes that, "if the national economy can avert a recession, Houston's job growth in 2008 should average around 2.2 percent." This level of job growth would represent around 55,000 jobs. Job growth of this magnitude would be good, but it is a significant slowdown from the 12-month net change in jobs indicated above. Adriana Z. Fernandez, an economist with the Federal Reserve Bank of Dallas – Houston Branch, is more optimistic and declares that "it would be reasonable to expect between 80,000 and 85,000 new jobs in 2008."

Houston's apartment market will need a job growth performance closer to Fernandez's forecast to keep the prosperity of 2007 going. Strong job growth will be needed to maintain the current leasing momentum as approximately 18,000 new units come into supply during 2008.

Absorption for 2008 would be 11,000 units under Smith's forecast of 55,000 jobs and 17,000 units under Ms Fernandez's forecast of 85,000 jobs. These absorption estimates are calculated by applying a conversion formula of one unit of absorption for every five jobs generated. With these absorption scenarios, overall occupancy at the end of the year would range from 86.5 percent to 87.5 percent.

If job growth and the downturn in single-family do a repeat performance in 2008 to produce enough absorption to satisfy lease-ups and cover notices, expect overall rent levels to increase by 3 to 4 percent. If leasing momentum falters from the heavy load of new construction and a slowdown in job growth, expect overall rent levels to advance by only 1.5 to 2.5 percent. 📌



Bruce McClemy is president of Apartment Data Services and has been active in the multi-family 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.

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