Where are you?

As low oil prices shake up the region's economy, location and class drive performance in the still-humming Houston apartment market.

By BRUCE McCLENNY, ApartmentData.com

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Location, location, location has always been the No. 1 rule in real estate for determining value and appreciation. In Houston, during a three-year stretch from 2012 through 2014, it was as if location did not matter anymore. The Houston economy was really on a roll, which expanded and leveled the playing field, letting all classes of apartment product realize greater operational success.

The Greater Houston Partnership points out that 2012 was one of the best years on record for economic performance in Houston. In 2012, the Houston region produced 118,500 or +4.4 percent net new jobs, the second-best performance ever for the area. In addition, Houston led the nation in exports that year, and the Purchasing Manager's Index, a short-term indicator of regional production, held above 59.0 for most of the year.

Houston's economic engines were still humming in 2013 and 2014 as 89,000 and 104,700 jobs were created, respectively. In June 2014, the price of a barrel of West Texas Intermediate crude reached $107.95, and the active rig count for North America was 1,931 rigs as of September 2014. Both of these statistics represent peaks since the Great Recession of 2007-2009.

As mentioned above, Houston apartments from top to bottom were riding the economic wave. Collectively for 2012, 2013 and 2014, a total of 36,000 new units were added to supply, while 47,000 units were absorbed. With such strong demand, overall rents jumped by 5.5 percent in 2012, 6.2 percent in 2013 and 7.8 percent in 2014.

The graph on Page 37 shows overall occupancy and rent levels starting midway through 2012. It is easy to see the strong upward movement in rent, whereas the occupancy level is very flat from September 2013. Overall occupancy began 2012 at 87.7 percent. The absorption during 2012 and the first nine months of 2013 drove occupancy by 3.3 percentage points to 91.0 percent. From then, the flatness in occupancy rolled like a treadmill on which absorption kept pace with new construction deliveries.

DOUBLE-CHECK YOUR LOCATION

The Houston economic landscape began to change in June 2014 when oil prices started to drop. U.S. production had created a substantial oversupply of oil as global growth and demand were fading. By January 2015, WTI crude prices had dropped by 58.4 percent to $44.91 per barrel. With this plunge in price, the energy industry has retreated. Capital expenditure budgets have been slashed by more than 50 percent, the North American active rig count fell by almost 60 percent to 848 rigs, and layoffs have been widespread. In addition, the PMI has dropped to 47.6. A PMI reading below 50, the neurtral point, indicates contraction in area production.

The Houston economy has taken a hit. The indicator that best tracks the impact of the turmoil in the energy industry and how it impacts the overall Houston economy is job growth. As of the end of September 2015, the Bureau of Labor Statistics reported that the 12-month net change in jobs for the Houston-The Woodlands-Sugar Land metropolitan area was 36,200 jobs – quite a different number from the 104,700 jobs created in 2014. These circumstances have caused economists to rethink the job growth picture for 2015. The Greater Houston Partnership has revised its employment outlook to better reflect current economic conditions. The GHP revised forecast now calls for the Houston metro area to add 20,000 to 30,000 jobs in 2015. Dr. Bill Gilmer, director of the Institute for Regional Planning at the University of Houston's Bauer College of Business, has issued a revised forecast as well that calls for 13,000 jobs for 2015.

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This new, lower level of job growth is not catastrophic, but it surely is not the best scenario as Houston has more than 28,000 units under construction. The tables have turned from the past three years when location nor class mattered as the rising economic tide lifted all apartment properties. Now that the economic tide is out, the location of a property and its class are important determinants for performance through 2016.

CLASS MATTERS

The overall average statistics of rent and occupancy are a consolidation of the performance of each class of property. Classes are determined by a bell curve distribution of market rent. The table on Page 36 illustrates how the overall performance as of the end of September 2015 is distributed and highlights how classes differ in rates and trends.

2014 AND 2015 NEW CONSTRUCTION AND LEASE-UPS

The new construction units delivered in 2014 and 2015 have been filtered out of classes A and B to create a separate classification. The 123 properties totaling 33,990 units within this category represent 17,697 units (66 properties) coming from 2014 and 16,293 units (57 properties) coming from 2015 so far. The product type and geography of the 123 properties that fall into this group are diverse: six high-rise properties, four affordable/senior properties, 34 urban/infill (Inner Loop and Galleria) properties and 79 suburban properties. The average rent level for new construction delivered is 159.9 cents per sq.ft. and $1,517 per month. Rent averages per property range from $628 per month (71.0 cents per sq.ft.) for an affordable unit to more than $4,300 per month ($2.87 per sq.ft.) for a high-rise unit. Rent trends for this group cannot be accurately calculated due to the continually increasing number and variety of new units being introduced.

The occupancy for this lease-up group of properties is 52.0 percent. During a lease-up, occupancy becomes a tertiary measure, and absorption and leases per month (leasing velocity) are primary. Both the 12-month (+12,584) and three-month (+3,819) absorption numbers are very good, providing the fuel for velocity. If a property is getting its pro-forma lease-up numbers, then occupancy will be fine in due time.

Anecdotally, many properties are achieving their pro-forma lease-up numbers, yet they are doing it at much higher marketing costs than lease-ups back in the 2013 days. Concessions are four to six weeks with an occasional eight weeks, and commissions for locators have crept up to 100 percent, with a few north of that.

This class of apartments is experiencing intense competitive pressure, and this pressure varies due to location based on new supply in lease-up and new supply yet to come. Katy/Far West has 13 properties in lease-up and seven more properties coming soon. West Memorial/Briar Forest/Energy Corridor has eight properties in lease-up and nine more coming. Montrose/Museum District/Midtown has only four properties in lease-up now, but 15 more are on their way. The combination of more units with diminishing job growth is a bad hand to draw. Wild cards that trump less demand from poor job growth are empty nesters selling their homes and in-migration from wealthy internationals.

CLASS A WITHOUT NEW CONSTRUCTION

In general, Class A represents the highest-priced properties based on their overall average market rate. As mentioned above, a bell curve distribution method determines which properties make the A grade. At this time, 25.0 percent of the operating supply of units achieved the Class A distinction.

Taking new construction units out of Class A provides a stabilized occupancy picture. Occupancy for this group of properties is 84.3 percent before new construction is filtered out and 93.9 percent after the adjustment is made. Occupany for this group has moved in a predictable cycle over the past four years. Occupancy peaks in August, falls through December and then begins to move toward the August peak in February. Looking back over the last four peaks shows that occupancy in August 2012 was 93.8 percent, which is, for all practical purposes, where occupancy rests now for this group of properties. August 2013 and August 2014 represent the highest occupancy figures recorded, both at 95.2 percent.

It will be important for this group of properties to maintain occupancy near its current point over the next year. If so, the rent trend will look similar to the 12-month trend of 2.3 percent that this group sees now. If not, the trend will be flat at best, or negative similar to the current three-month trend.

Some Class As will perform better than others. These better-performing properties are in areas less dependent on upstream, production-oriented energy employment and more dependent on downstream, refining and chemical production, as well as health care and leisure/hospitality employment. Clear Lake, Lake Houston/Kingwood and Highway 288/Pearland are areas where Class As have an advantage.

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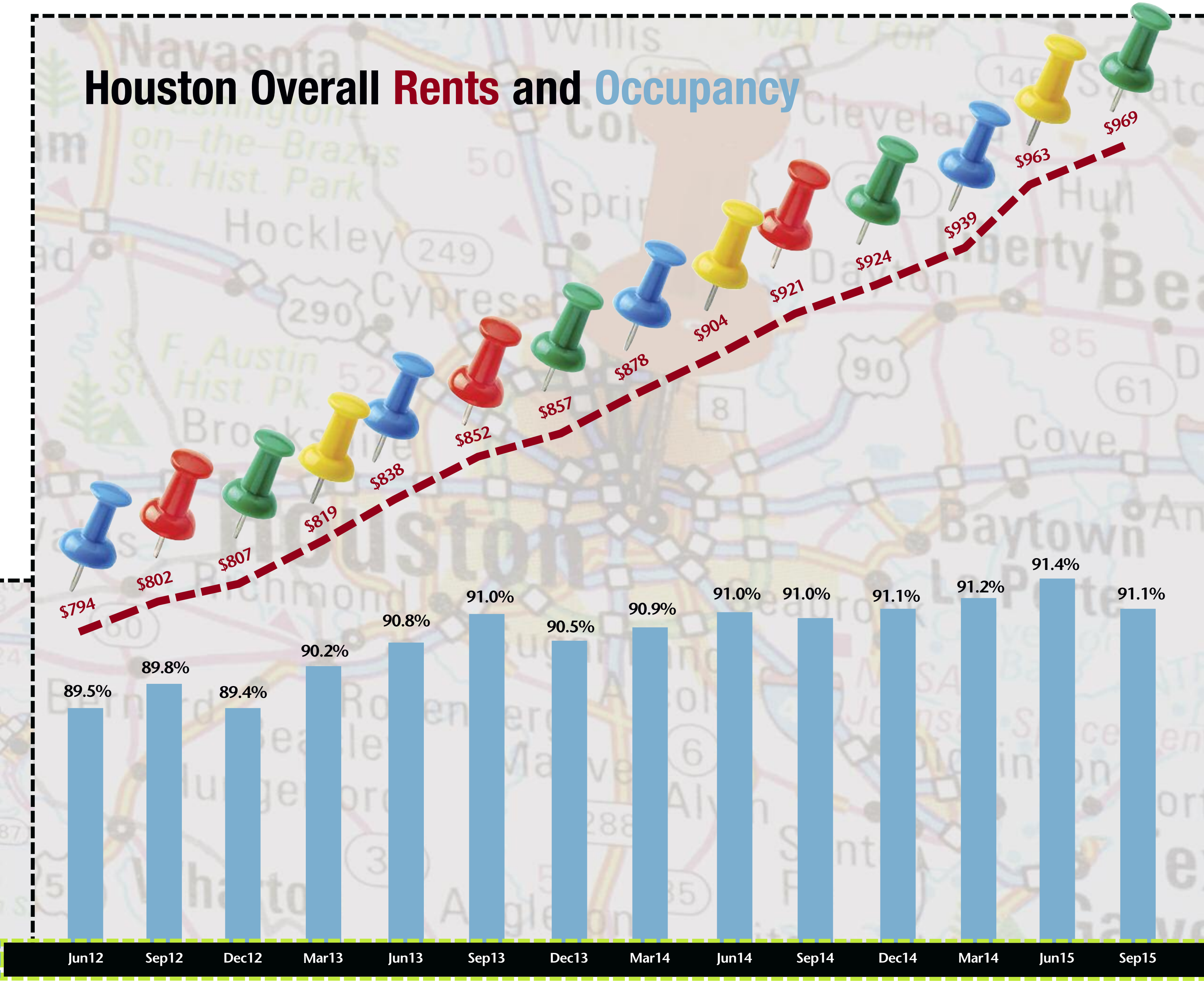
Analysis by Classification

			Rent				Absorption (Units)	
As of September 30, 2015	Supply	Occupancy	¢/sq ft	$/month	12-Month Trend	3-Month Trend	12 Months	3 Months
2014, 2015 Construction	33,990	52.0%	159.9	$1,517	–	–	12,584	3,819
Class A *(w/o '14 & '15 const.)*	117,746	93.9%	150.1	$1,427	2.3%	-1.7%	590	184
Class B *(w/o '14 & '15 const.)*	207,546	94.2%	108.0	$935	5.9%	1.8%	-563	-1,056
Class C	178,200	94.1%	87.8	$743	7.2%	2.7%	782	-520
Class D	65,447	88.6%	69.9	$584	4.1%	3.6%	742	58
Overall	**602,929**	**91.1%**	**110.4**	**$969**	**5.7%**	**2.6%**	**14,135**	**2,485**


Houston Overall Rents and Occupancy
$794
$802
$807
$819
$838
$852
$857
$878
$904
$921
$924
$939
$963
$969
89.5%
89.8%
89.4%
90.2%
90.8%
91.0%
90.5%
90.9%
91.0%
91.0%
91.1%
91.2%
91.4%
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CLASS B WITHOUT NEW CONSTRUCTION

The bell curve distribution of market rate creates a Class B that represents 34.5 percent of the entire market. Class B continues to be a strong performer, with occupancy at 94.2 percent and rent growth of 5.9 percent over the past 12 months. Rent levels over this same time frame have increased by $40 per month and 4.7 cents per sq.ft. The negativity in Class B's absorption numbers is not a big concern but rather bears watching to see if these numbers bounce back at the beginning of 2016. The -1,056 units of absorption over the past three months took occupancy from a peak of 94.7 percent to its present level. The annualized three-month rent trend of 1.8 percent indicates that the pace of rent increases is slowing.

As far as classes go, Class B is in good shape with a few possible exceptions in the suburban submarkets where the average monthly price between Class A and Class B is relatively close, with a difference of less than $300. Katy/Far West and Woodlands/Far North fit this profile.

CLASSES C AND D

Class C represents 30.0 percent of the overall market. Class C can claim the distinction of the best-performing class with overall occupancy of 94.1 percent and rent growth of 7.2 percent over the past 12 months. Rent levels over this same timeframe have increased by $49 per month and 5.9 cents per square foot. Class C's annualized rent growth over the past three months has settled, like all other classes, at 2.7 percent.

Class D continues to gain occupancy traction, with 742 units of absorption over the past 12 months. This performance moved occupancy from 87.0 percent to 88.6 percent over the same timeframe. With this positive movement in occupancy, Class D raised rents by 4.1 percent over the past 12 months.

Rent levels over this same timeframe have increased by $23 per month and 2.7 cents per sq.ft. Over the past three months, Class D has been able to maintain a positive rate of rent growth at 3.6 percent, which breaks with tradition. In years past, Class D's rent movement could be characterized as one step forward and one step back, resulting in a mostly flat performance. Since January 2014, however, Class D's rent curve has been noticeably positive.

WHERE DO WE GO FROM HERE?

Job growth statistics have been the metric most often used to estimate demand or absorption. Developers count on one apartment unit to be occupied for every five or six jobs created. This relationship is calculated by combining at least 10 years of job growth and apartment construction data. This model does not always work, however, especially in times like now, when job growth is retreating.

During the Great Recession, Houston lost around 108,000 jobs in 2009, and absorption was a positive 1,515 units. Absorption for 2015 does not follow the model either, but in a good way. This year, there have been 16,409 new units delivered and 13,144 units absorbed. Discarding the 12-month net change job growth number of 36,200 and using only the job change number for 2015, which is a loss of 9,200 jobs, turns the model upside-down. Yes – there have 13,144 units absorbed through the first nine months of this year, even as employment retreated by 9,200 jobs over the same timeframe.

Obviously, it is not all about job growth. There are other factors at work in our market. As mentioned above, empty nesters are selling homes and becoming renters, and international in-migration is off the job radar screen. In addition, the single-family home market is pushing demand toward renting with an extremely low inventory of new and existing homes, as well as qualification standards that discourage first-time buyers.

Remember, there will be apartments in areas of town that will not be adversely affected as the energy industry sorts out low oil prices. The Houston apartment market is in a very strong occupancy position as the local economy slows down. Stabilized Class A and classes B and C are all around 94.0 percent occupied, while Class D at 88.6 percent looks to improve. The stage is set for overall occupancy to end the year 2015 at 90.5 percent, and overall rent to grow by 4.0 to 4.5 percent. Class A will be flat, while Class B will settle to 4.0 percent. Classes C and D will lead with 4.5 to 5.0 percent.

It is time for a fanatic sports fan metaphor: Our team did not lose the game, we just ran out of time. Applying this adage to Houston's apartment market would go something like this: We did not overbuild, we just ran out of economy. Even though 28,702 units are under construction as job growth diminishes in 2015 and looks to be weak in 2016, somehow the Houston apartment market continues to remain resilient. It is as though we have extra innings and the Houston apartment market keeps producing and fighting to stay in the game.

Bruce McClenny is president of ApartmentData.com. HAA endorses their Market TRAC and market reports. For more details, call 281-759-2200 or email bruce@apartmentdata.com.