
Born to Raise Rent

A Shot in the Arm

Job growth and a slowdown in the single-family housing market have combined to boost the multifamily market's performance in 2007.

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In 2007, the Houston apartment market has begun to flex its muscles. This newfound strength and vigor come as a result of injections of a performance-enhancing supplement of high-quality job growth in 2006. Another strength-boosting supplement was added in 2007 to make the job-growth injections even more effective as a gradual slowdown in single-family construction and sales closings combined with job growth to pump up absorption and rents.

The most recognized and relied-upon indicator of apartment absorption performance is job growth. In 2006, the Houston-Sugar Land-Baytown metro area realized a 4.0 percent increase in job growth, which equates to 95,900 more jobs. Through August 2007, the 12-month net change in jobs has eased from the torrid pace of 2006 to a decent 2.6 percent rate of growth, or 64,400 jobs.

"ARM" WRESTLING: THE MORTGAGE FACTOR

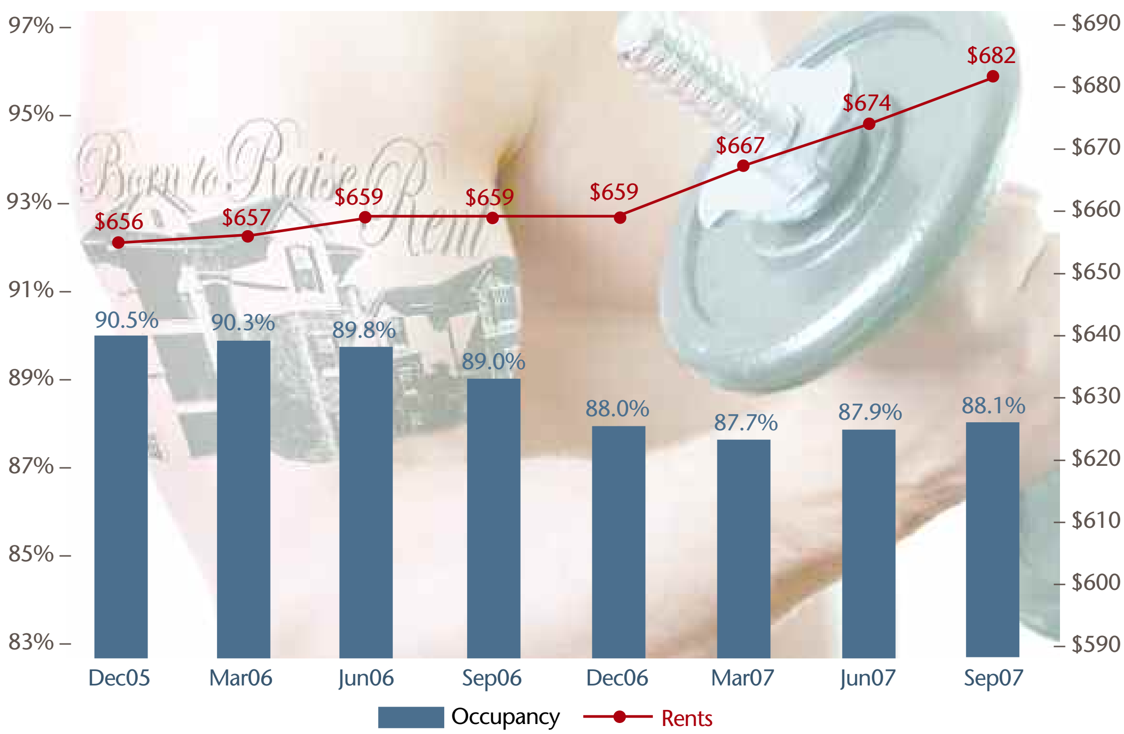
Several factors combined over time to cause the slowdown in single-family construction and sales closings. The main culprit was the ill-advised acceptance of adjustable rate mortgages by too many homebuyers who were allowed to qualify with incredibly lax lending standards. The lending term we continually hear on the news that refers to this group of homebuyers is "the subprime market." ARMs in general are not a bad mortgage product. However, ARMs were an absolutely terrible mortgage for this group of homebuyers, especially when interest rates were at 40-year lows as they were from 2002 through 2005. The only way for mortgage payments to go for this group was up.

In June 2004, the Federal Reserve Bank initiated a series of rate increases that took the Fed funds rate to 5.25 percent by June 2006. These increases would eventually begin to activate adjustments in rates, causing monthly payments for ARMs to move higher. Many homeowners could not keep up with the newly adjusted payments, and foreclosures increased. In Harris County, according to Foreclosure Information & Listing Service, year-to-date postings and foreclosures have increased by more than 50 percent through August 2007. With foreclosures up, lenders have done away with the lax standards of no verification of income, no down payments and low credit scores. More stringent lending standards have put the brakes on single-family construction and home sales.

MetroStudy, a local firm that tracks single-family construction, reports that housing starts for the first eight months of 2007 are 23 percent behind the same period last year. Overall existing home sales for the same period, according to the Houston Board of Realtors Multiple Listing Service, are down just 1.2 percent. Digging deeper into the overall sales numbers reveals that the weakest segment of the market is homes priced from $80,000 to $150,000. This segment in August experienced a 12.6 percent decline in sales compared to August 2006. Another indicator of the slowdown in existing home sales is the increase in active listings, which are 15.7 percent higher than last August.

It is a rare occasion when strong job growth mixes with a slowdown in the single-family market. The combination of these two ingredients creates more demand for rental housing. The graph below shows how the overall market has responded over the last eight quarters to these

Houston Overall Occupancy and Rental Price



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Analysis by Classification

	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 2007 YTD	Absorption (Units) Last 12 Months
’06 & ’07 Construction	19,070	52.5%	104.7	$1,047	–	–	5,942	7,127
Class A (w/o ’06 & ’07)	129,180	93.4%	103.1	$944	4.6%	6.0%	1,249	1,034
Class B (w/o ’06 & ’07)	230,093	88.5%	72.4	$606	2.1%	3.3%	1,389	-1,946
Class C	97,005	88.4%	65.2	$534	0.3%	-1.5%	-76	-1,556
Class D	28,049	83.8%	45.6	$382	-0.1%	-2.3%	-462	-745
Overall	503,397	88.1%	79.4	$682	3.7%	4.1%	8,042	3,914

extraordinary conditions. It is easy to see that rent levels have strengthened, but occupancy is deceptively flat. The drop in occupancy levels during 2006 was totally influenced by the exodus of approximately 22,000 Katrina voucher recipients. The strong job growth of 2006 helped minimize the Katrina correction by making the net move-outs or absorption for 2006 only -5,694 units. The flatness in overall occupancy during 2007 has been influenced by the introduction of more than 10,000 units of new construction.

NEW CONSTRUCTION: 2006 & 2007

The new construction units from 2006 and 2007 have been filtered out of Class A and Class B to create a separate classification. Since 2006, a total of 19,070 operating units have been introduced into supply. Around 5,000 units, or 26 percent of the new construction units, are tax-credit and considered Class B.

It is not surprising that the occupancy level for new construction is very low at 52.5 percent, since more than 10,000 units of the total in this category were introduced in 2007. Of course, the highest rent levels and the lion's share of absorption are found in the newest product group. Rent trends for this group cannot be accurately calculated due to the volatility caused by a continually increasing number of units being introduced.

Confidence abounds throughout most of the market since Class B joined the rental market increase party. It will be interesting to see whether the market holds on to the prosperity found in the first nine months of 2007 as the normally slow leasing season of the fourth quarter approaches.

To better understand the many dynamics at work in the market, the table on Page 34 provides a snapshot of overall market conditions and shows how performance varied among the various classifications of apartment communities as of the end of September 2007.

THE OVERALL MARKET

The 12-month trend for overall rents is an outstanding 3.7 percent, with the three-month trend indicating that rents are moving even higher at 4.1 percent. The three-month trend is annualized, which assumes that the trend for the latest three-month period will continue for the next nine months. Overall absorption statistics may seem transposed because the 12-month absorption performance is less than the nine-month year-to-date performance for 2007, however, this is correct. The last three months of 2006 experienced a negative absorption performance of over 4,000 units as Katrina voucher recipients were still moving out and the single-family home market mounted a push to close deals before year's end.

The 2007 YTD absorption of 8,042 is a very stout number, while overall occupancy remains puny at 88.1 percent. The new construction deliveries are keeping a lid on the occupancy level. Fortunately, the market is performing a fine balancing act where there is plenty of absorption and not too many new construction units introduced. This equilibrium allows the market to maintain a leasing momentum that moves rents despite a relatively low occupancy.

CLASS A WITHOUT NEW CONSTRUCTION

Taking the new construction units of 2006 and 2007 out of Class A provides for a stabilized occupancy analysis of this product type. At the end of September, this group weighed in with an eye-popping 93.4 percent occupancy level, which is the highest occupancy this group has recorded since September 2001. With the occupancy level and absorption so strong, this group is really moving rents. The 12-month trend for rents is 4.6 percent, with the three-month trend indicating that rents are moving at a 6.0 percent annualized pace.

CLASS B WITHOUT NEW CONSTRUCTION

Some new construction properties are classified as Class B, created by the advent of the Low Income Housing Tax Credit program that permits developers to build a property with rent levels in the Class C range and features and amenities of Class A. As mentioned above, since 2006 more than 5,000 tax-credit units have been introduced into supply. With these units filtered out, the Class B occupancy is not very impressive at 88.5 percent. However, what is impressive is the 2007 YTD absorption performance of 1,389 units on the heels of a very negative fourth quarter of 2006, when absorption was -3,335 units. Despite the negativity of the fourth quarter, the 12-month rental trend is a decent 2.1 percent. The absorption performance of 2007 has given Class B the confidence to pump the three-month annualized rent trend up to 3.3 percent.

Class B represents a large portion, 45.7 percent, of the overall supply. The success or shortcomings of Class B greatly influence the overall statistics. The current strength of the overall market's rental rate performance is due to Class B's recent confidence to raise rents.

CLASS C & CLASS D

The performances of classes C and D are in stark contrast to the other classes. Both classes have posted negative absorption for the last 12 months. With net move-outs plaguing these groups, rental trends are flat at best. For Class C rents, the 12-month trend is an anemic 0.4 percent, with the most recent trend for the last three months retreating at an annualized pace of -1.8 percent. Movement in Class D rents is up and down. However, the performance of Class D has very little significance considering that the average rent for this group is $384.

LOOKING AHEAD

Confidence abounds throughout most of the market since Class B joined the rental increase party. It will be interesting to see whether the market holds on to the prosperity found in the first nine months of 2007 as the normally slow leasing season of the fourth quarter approaches. Further testing the market and providing a possible stumbling block to maintaining momentum stands a heavy load of new construction units, ready to begin leasing. Of the 16,500 units presently under construction, more than 5,000 units will be delivered into supply by year's end. With such a large number of new units being introduced, the overall occupancy level will not increase from its present level of 88.1 percent. In fact, the occupancy level will probably move lower by at least by 0.5 percentage points.

Even though an increasing number of units available to lease will put pressure on rent levels, the conditions that stimulated the market during 2007 will still be in place. Whether the combination of job growth and the single-family slowdown will remain as potent for Houston's multifamily market in the future is not certain. Overall rent trends for 2007 should come in somewhere around 3.5 percent, which will represent a very good year for rent growth.

In 2008, new construction deliveries will remain brisk as the remaining 11,000 units under construction begin leasing and 10,000 more units start construction from the approximately 18,000 proposed. Expect around 14,000 units to be delivered in 2008.

There are too many economic uncertainties to predict in which direction job growth will go. The subprime issues in the single-family market may go deeper to undermine the overall economy, causing a recession and derailing job growth. If this scenario happens, it will not bode well for a repeat performance of 2007. However, if the subprime problem manages a soft landing and job growth keeps a pace in the 2.5 to 3.0 percent range, 2008 rent growth could match 2007's pace.

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.