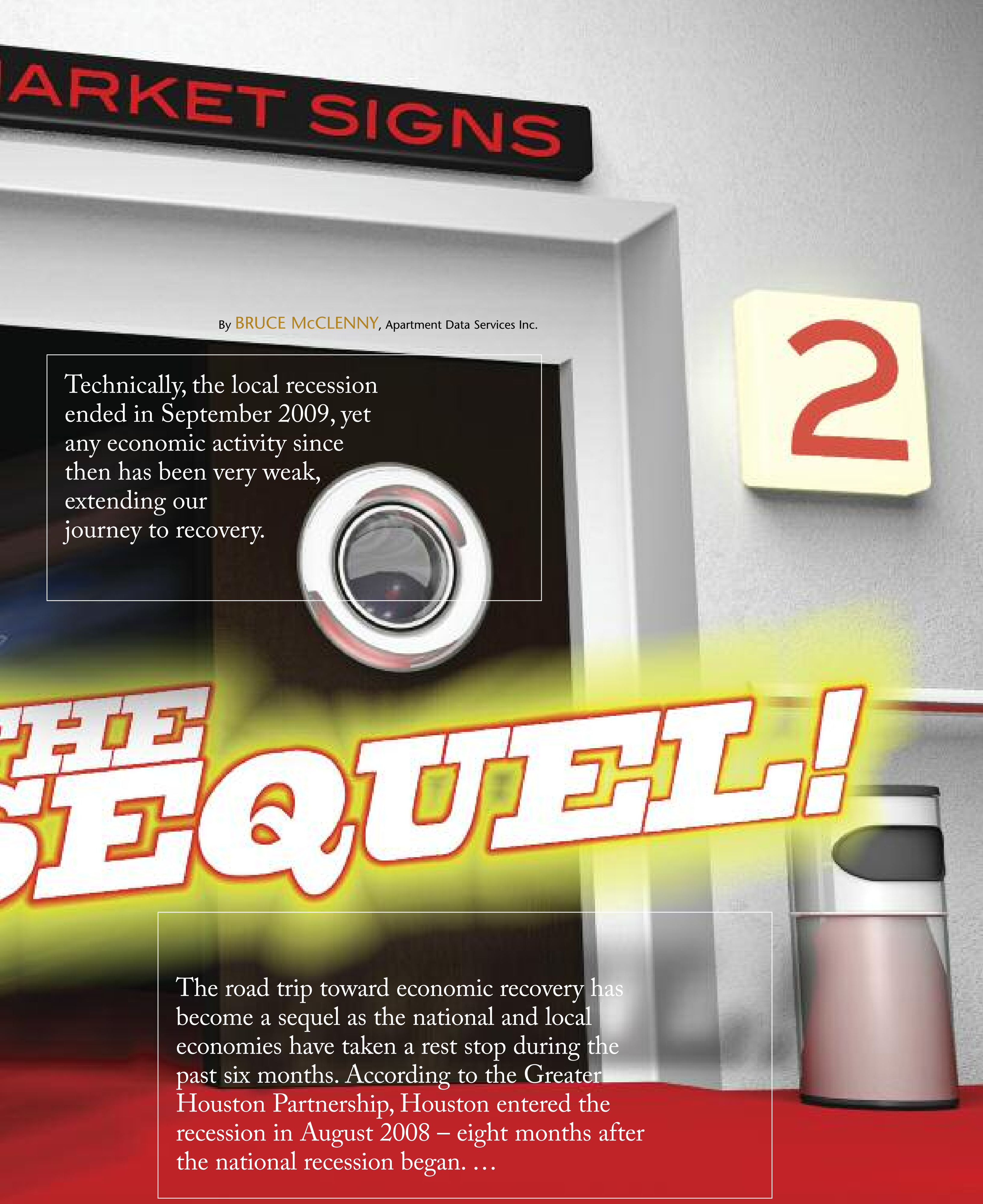

ECONOMIC FORECAST JOB GROWTH OCCUPANCY RENTAL RATES NEW CONSTRUCTION
Are we there yet?

ARKET SIGNS

THE SEQUEL!

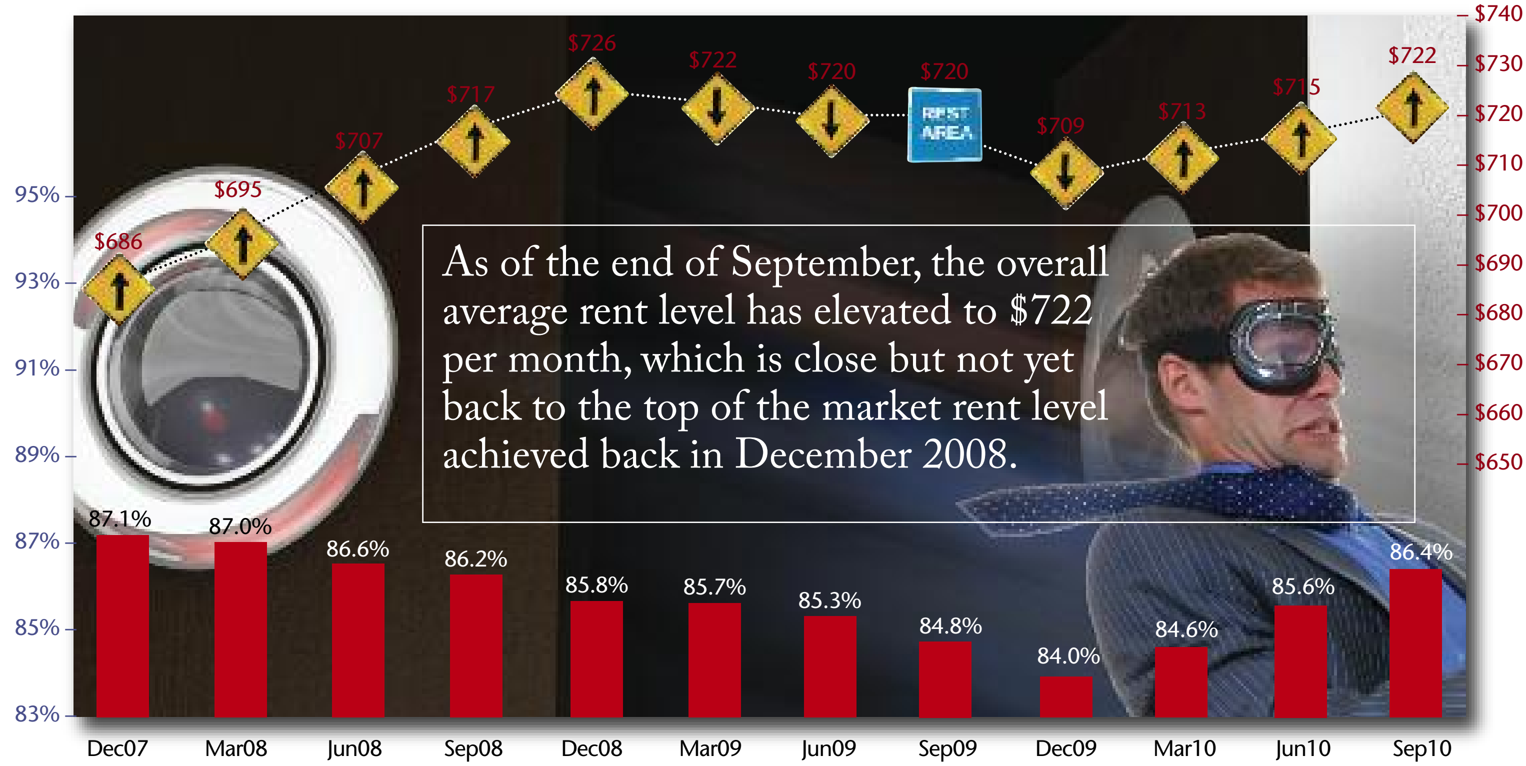


By BRUCE McCLENNY, Apartment Data Services Inc.

Technically, the local recession ended in September 2009, yet any economic activity since then has been very weak, extending our journey to recovery.

The road trip toward economic recovery has become a sequel as the national and local economies have taken a rest stop during the past six months. According to the Greater Houston Partnership, Houston entered the recession in August 2008 – eight months after the national recession began. …

Houston Overall Occupancy and Rents



Additionally, the group declares that Houston's recession is over, based on the bottoming and gradual return to growth of the primary local economic indicators of Purchasing Manager's Index, Baker Hughes Rig Count, air passenger traffic, vehicle sales, home sales and employment. Technically, the local recession ended in September 2009, yet any economic activity since then has been very weak, extending our journey to recovery.

The roadblocks preventing a more fast-paced recovery on a national basis are the unknown impacts of health care reform, new financial regulations, possible cap-and-trade carbon legislation and the pending expiration of the Bush-era tax cuts. Houston's recovery is subject to these national constraints plus the local impact of the five-month offshore drilling moratorium and further potential layoffs at NASA.

The graph above depicts overall average rent and occupancy for the Greater Houston apartment market for the 12 quarters since December 2007. The movement in rent levels closely matches the timing of the beginning and end of the local recession mentioned above. Rents continued to rise after the official beginning of the recession in August 2008, greatly assisted by demand due to Hurricane Ike. Rents peaked in December 2008 at an overall average of $726 per month as the impact of Ike waned and the job losses began to mount.

In spite of the fact that the local recession technically ended in September 2009, rents retreated to $709 by that year's end, driven down by area job losses of 102,800 for the 12-month period. The December 2009 rent level represents the bottom for the Houston apartment market as rents began to recover during the first quarter of 2010. As of the end of September, the overall average rent level has risen to $722 per month, which is close to but not yet matching the top-of-the-market rent level achieved back in December 2008.

The forward movement in rent and occupancy in 2010 should be compared to the recovery in the job market. The Bureau of Labor Statistics reports that the Houston-Sugar Land-Baytown metropolitan statistical area saw a net loss of 900 jobs over the 12-month period ending August 2010. These 12-month statistics are highly influenced by the job losses in 2009, and at face value, provide nothing to explain the upward trend in rent and occupancy. However, these trends make more sense when private sector positive job growth of 49,600 jobs in 2010 is revealed within the 12-month stats. This job growth fueled more than 16,500 units of absorption during 2010.

CLASS DIRECTIONAL SIGNS SHOW THE WAY

The table at the top of the next page 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 classification table contains a lot of mixed signals, some positive and some negative, which is indicative of the early stages of recovery. The overall occupancy of 86.4 percent is weak, yet the year-to-date absorption is extremely strong, coming in at 16,508 units. In addition, the 12-month overall rent trend is positive but unexciting at 0.8 percent, while the three-month annualized trend shows a lot of promise at 4.3 percent.

The very positive year-to-date absorption and the three-month rent trend provide confidence to say that the apartment market downturn brought on by the recession of 2008 and 2009 is in the rear view mirror. Unfortunately, the overall positives cannot be shared equally among the classes, as the following paragraphs discuss.

2009 AND 2010 CONSTRUCTION

The new construction units delivered in 2009 and 2010 have been filtered out of classes A and B to create a separate classification. Since 2009, 18,471 units have been introduced into supply, of which more than 15,000 units are attributable to 2009. Rent trends for this group cannot be accurately calculated due to the continually increasing number of units being introduced each month, but it is safe to

Analysis by Classification

As of September 30, 2010	Supply	Occupancy	Rent ¢/sq ft	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 2010 YTD
'09 & '10 Construction	18,471	73.9%	116.2	$1,127	–	–	9,550	7,780
Class A (w/o '09 & '10)	82,694	93.0%	121.5	$1,135	4.3%	6.5%	3,477	3,421
Class B (w/o '09 & '10)	217,066	90.1%	86.1	$747	1.7%	3.7%	3,246	4,721
Class C	216,854	82.6%	66.9	$562	-1.6%	-0.2%	-2,601	899
Class D	38,358	78.9%	46.8	$397	-3.2%	-2.8%	-577	-313
Overall	573,443	86.4%	83.1	$722	0.8%	4.3%	13,095	16,508

assume that this group is contributing positively to overall rent growth.

The occupancy for this group is low at 73.9 percent, but this is not surprising since the 2010 portion of these units is still in the early stages of lease-up. Back in March, this group's occupancy was 46.3 percent. This significant jump in occupancy was propelled by this year's impressive absorption performance of 7,780 units.

CLASS A WITHOUT NEW CONSTRUCTION

Taking new construction units out of Class A provides a stabilized picture of this product type. This group's occupancy level of 93.0 percent rivals the highest occupancy level for this group over the past 12 years. Not since we hit 93.3 percent in April 2001 has stabilized Class A occupancy been higher.

The rent trends for this group are quickly moving in the right direction. The 12-month trend has achieved a very impressive growth of 4.3 percent, and the annualized three-month trend has set the stage for even greater growth at 6.5 percent. Class A rents have definitely turned a corner and are on a path of ascent. Despite these trends, Class A is still making up the rent ground it lost during 2009. Class A rents in December 2008 averaged $1,167; now the current overall average monthly rent is $1,135.

CLASS B WITHOUT NEW CONSTRUCTION

Class B has joined Class A on the road trip to higher rents! The 12-month trend of 1.7 percent is respectable, and the three-month trend of 3.7 percent really brightens the outlook. However, just like Class A, Class B is still getting out of the pothole that rents drove into during 2009. Back in December 2008, Class B rents peaked at $762; now the overall average monthly rent is $747.

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Class B occupancy at 90.1 percent has moved past the psychological barrier of 90.0 percent. It will be interesting to see if Class B has the horsepower to match the 91.5 percent achieved in October 2005 and the additional muscle to equal the 94.1 percent logged back in October 2001.

CLASSES C AND D

Classes C and D have been caught by a detour that has taken them in the opposite direction from the path that A and B are cruising on. C and D are still looking for a rent bottom as their 12-month and, more importantly, three-month negative trends indicate.

Currently, the overall average monthly price for Class C is $562, which was reached on a descent from an all-time high of $578 in April 2009. Even though rents are still declining, the rate of decline has become very slight as the three-month annualized trend of -0.2 percent confirms. A case could be made that Class C rents are poised to begin recovery as Class B moves higher. Traditionally, there is a lag between the swings of rent levels of Class B and Class C. The last major swing occurred in December 2008 when Class B rent peaked and began a downturn. Class C did not begin its downturn until five months later in April 2009. Class B began its current upturn in January 2010, and nine months later Class C is still awaiting its upturn. As long as Class B keeps upward rent momentum, Class C's turn is imminent. Rents for Class D are unlikely to recover anytime soon, but maybe by the end of the first quarter of 2011.

Absorption for Class C has finally turned positive in 2010. Occupancy began the year at 81.7 percent, and with the contribution of 899 units of absorption, occupancy moved to 82.6 percent by the end of September.

LOOKING AHEAD

The Houston apartment market began 2010 ready to embark on the road to recovery. As discussed above, classes A and B got an early start and have made good progress while classes C and D have yet to get started. At this point, questions arise about how much further can A and B go and when, if ever, will C and D get moving in the right direction?

THE PERFECT ROAD TRIP

The road for Class A appears to be smooth and clear. Prospects for stronger occupancy and rent levels are superb. Somehow between the slump in single-family housing and a sputtering economy that is producing uninspiring job growth, Class A has been able to generate enormous amounts of absorption in 2010. To add power to Class A's engine, new construction's supply tank is almost empty – only 5,000 to 6,000 units of new construction will be delivered in 2010, 25 percent of which will be tax credit or senior units.

The likelihood of these aforementioned drivers of Class A changing anytime soon is slim. Surely change will come, but it would be safe to say that Class A could easily enjoy its current position well into 2011.

What could go wrong with this perfect road trip that Class A is experiencing? Moving too fast! Class A is anxious to really push the rent accelerator pedal on renewals. However, current residents are budget-conscious and still uncertain about their future prosperity. In addition, many current residents leased at huge discounts, such as two to three months free/prorated, making a number of them incapable of absorbing a big hit in their rents. Plus, residents that are financially able to absorb a big bump may be emboldened to buy a home.

Moving too fast on rent increases is a recipe for turnover. Managing increases to hit the sweet spot of turnover will be the challenge of Class A over the next six to nine months.

COME STAY WITH US

Now that Class A has improved its itinerary, Class B has a chance to upgrade its travel plans and meet new friends on its journey into 2011. Class B will be there to comfort and accept those residents who will not be traveling with Class A anymore.

In 2009, many apartment renters were able to move up to a better quality apartment as a consequence of the deep discounts many properties were offering. Now those same residents will be moving back down as Class A executes its renewal strategy.

CAN WE GO TOO?

Classes C and D really could use a trip toward Recoveryville. Some of the better positioned Cs and Cs that have emerged from distress have already started the trip. However, the majority of Class C and all of Class D remains behind a roadblock. For the remainder of Class C to get going toward better fundamentals depends on a combination of two dynamics: 1. more properties emerging from distress and 2. improvement of Class B, providing C with more room for improvement. Forget about Class D ever making the trip.

HOW FAR WILL THE MARKET GO?

2011 is shaping up to be a good year for the Houston apartment market. The stage was set in 2010 as Class A and B began to get significant improvement in occupancy and rent levels. Look for overall rents to improve by 3.5 percent, driven by 9,000 units of absorption, which will produce an overall occupancy of 88.0 percent. Class A should see a 7.0 percent bump in rent levels, Class B a 4.0 percent increase and Class C a 1.5 percent improvement.

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