market · in · motion

The Big Uneasy

A year after hurricanes brought thousands of FEMA-funded residents to Houston, the market is holding its breath while waiting for the inevitable occupancy correction.

by **Bruce McClenny**, Apartment Data Services

One year later, the evacuees that Hurricane Katrina brought to Houston's apartment market, in large measure, are still in place. The City of Houston/FEMA voucher program that began last September provided evacuees approximately 15,000 units during its first month of operation. At the height of the program in February and March, evacuees occupied almost 35,000 units. As of August, roughly 25,000 voucher-funded units remained occupied, according to officials at the Houston Apartment Association.

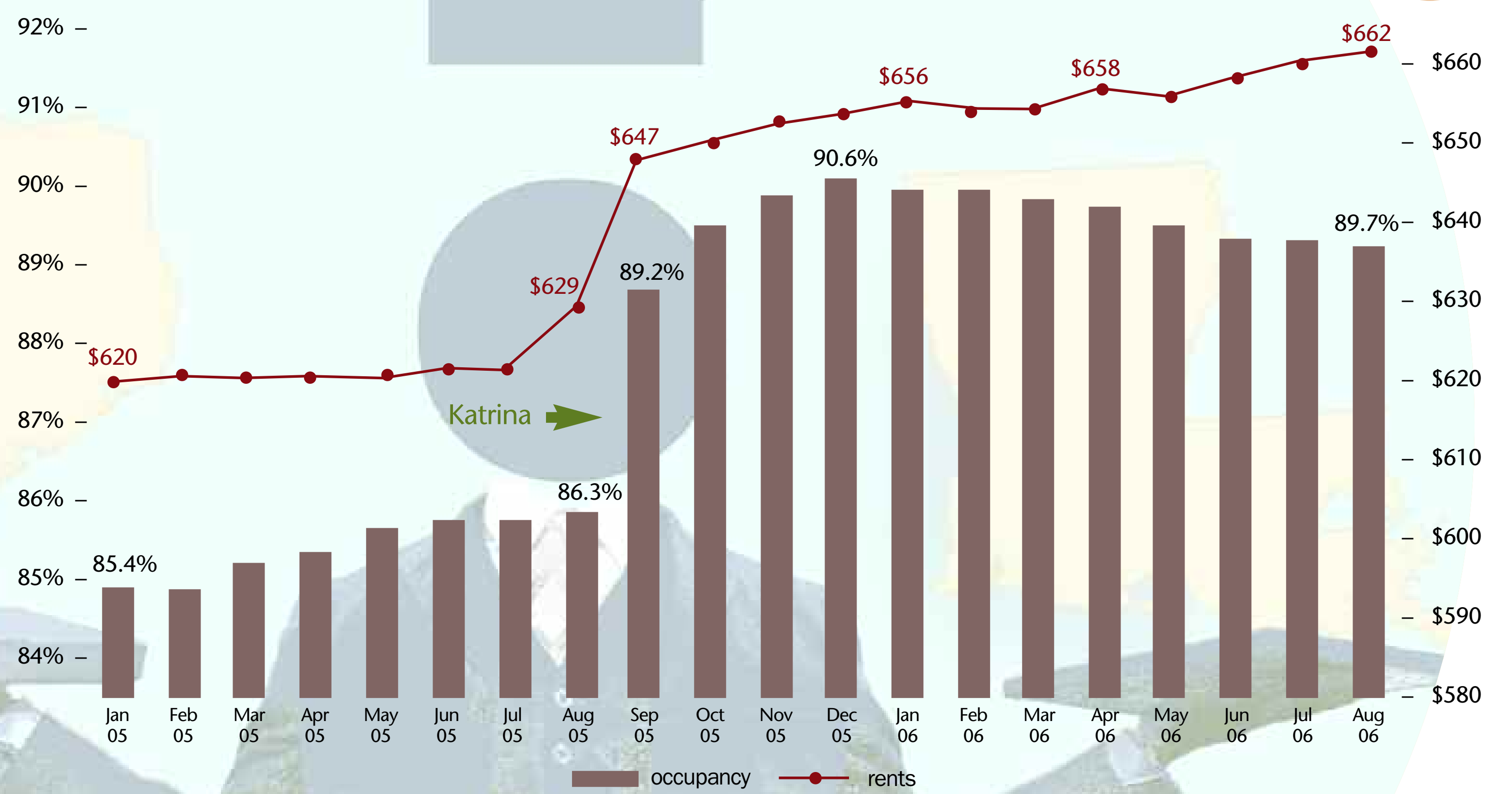
Graph 1 on Page 34 illustrates the initial and continuing impacts from evacuees on the overall Houston apartment market. Prior to Katrina, market conditions were weak but positive. In September 2005, overall average occupancy and rents spiked as the rush of evacuees leasing apartments drove up occupancy by 2.9 percentage points and boosted monthly rents by $18. By the end of September, occupancy stood at 89.2 percent and monthly rents at $647. The evacuee impact on market conditions continued during the last three months of 2005, peaking at year's end as occupancy reached 90.6 percent and rents registered $656.

Since the beginning of 2006, rent levels have held steady through May and in June began to move higher, reaching $662 by the end of August. This rent performance was accomplished while occupancy slowly retreated by 0.9 percentage points. Even though occupancy slipped from 90.6 percent at the beginning of the year to 89.7 percent at the end of August, the demand behind this occupancy performance is deceptively strong. During the first eight months of 2006, voucher recipients moved out of 10,000 units and more than 6,000 new construction units began leasing and were added to supply. Fortunately, occupancy only slipped 0.9 percentage points as the evacuee/voucher move-outs and new unit introductions represented a potential drop in occupancy of 3.3 percentage points.

Overall rents have improved by 2.7 percent over the last 12 months, which is a very respectable performance. This trend includes post-Katrina market momentum of the fourth quarter of 2005 but does not include last September's rent-spike anomaly.

Greater Houston Overall Occupancy and Rental Price

Graph 1



Analysis by Classification As of August 31, 2006

	Supply	Occupancy	Rent $/month	Rent 12-Month Trend	Rent 3-Month Trend	Absorption (Units) 2006 YTD	Absorption (Units) 12 Months
'05 & '06 Construction	17,197	66.7%	$962	–	–	5,218	7,456
Class A (w/o '05 & '06)	129,087	93.1%	$896	1.3%	5.7%	-863	3,989
Class B (w/o '05 & '06)	221,221	90.1%	$598	2.7%	0.5%	-2,532	8,482
Class C	95,592	89.7%	$528	3.7%	-3.3%	-756	3,517
Class D	29,822	85.8%	$390	0.0%	-8.7%	-66	870
Overall	492,919	89.7%	$662	2.7%	2.2%	1,001	24,314

Analysis by Class

An analysis by classification is needed to better understand the many dynamics at work within the overall market and to contrast the varying performance of each class. The table above divides the overall market into five classes and analyzes conditions as of the end of August. Units built and delivered in 2005 and 2006 require a separate classification to provide a more complete absorption analysis as well as create a stabilized/same store analysis for Class A and Class B.

New Construction

Construction activity has been relatively brisk over the last 20 months. Of the 17,197 units delivered during this time, 11,130 came in 2005 and 6,067 in 2006. The occupancy for this class is low because of the lease-up conditions of the 2006 units. Rent trends for this group cannot be accurately calculated due to the volatility caused by a continually increasing number of new units introduced into supply each month.

The '05 & '06 construction class totally dominated the year-to-date absorption for 2006. The absorption performance for this class is the only reason that overall absorption is positive for 2006.

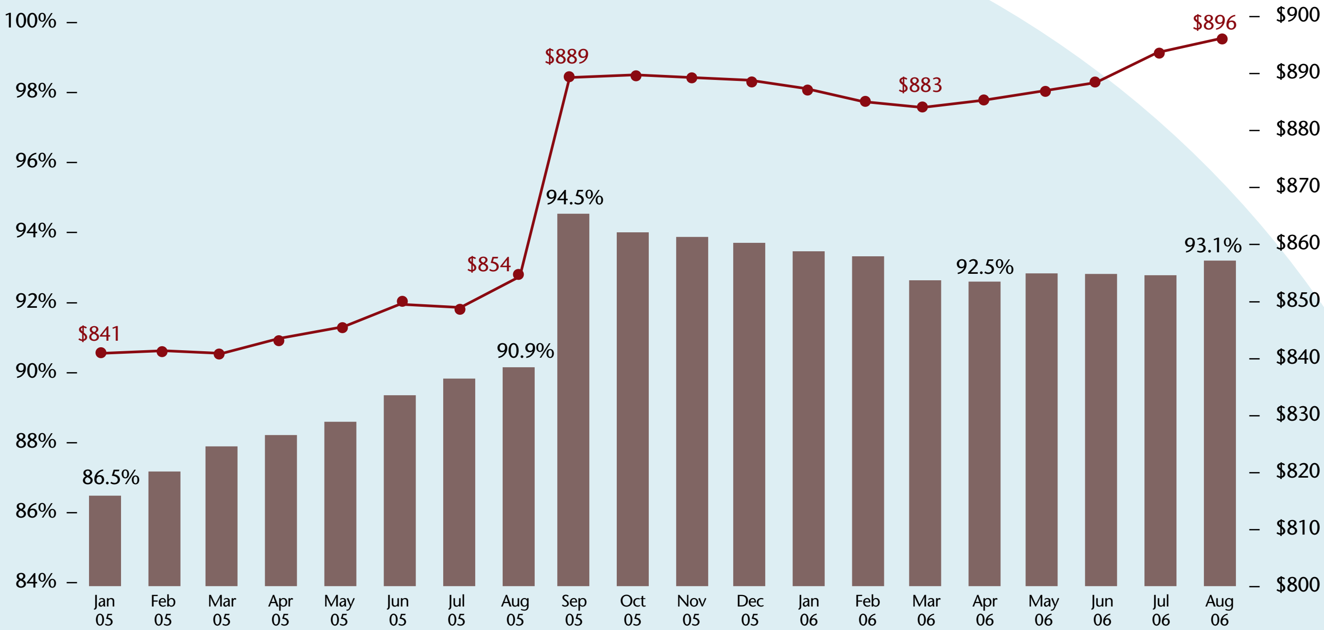
Class A Without New Construction

In general, Class A comprises those units constructed since 1990 with the highest rental rates. Class A without new construction units represents 26 percent of the overall supply and is registering a relatively healthy 93.1 percent occupancy, which is the best of all classes. Graph 2 at right shows how Class A has performed since the beginning of 2005.

Class A's 2005 performance prior to Katrina

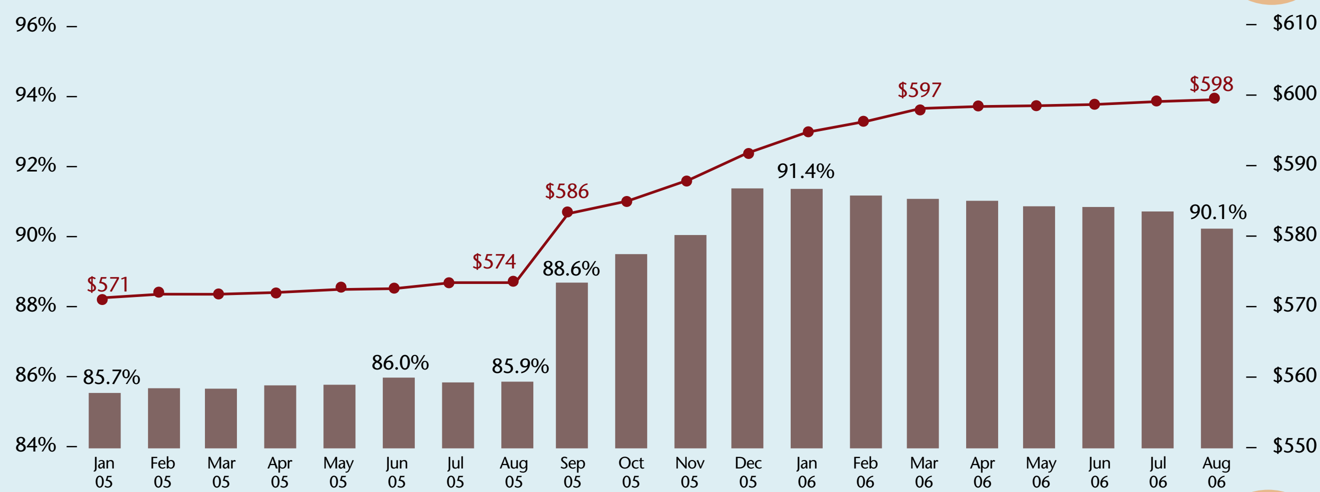
Houston Class A without 2005 and 2006 Construction

Graph 2



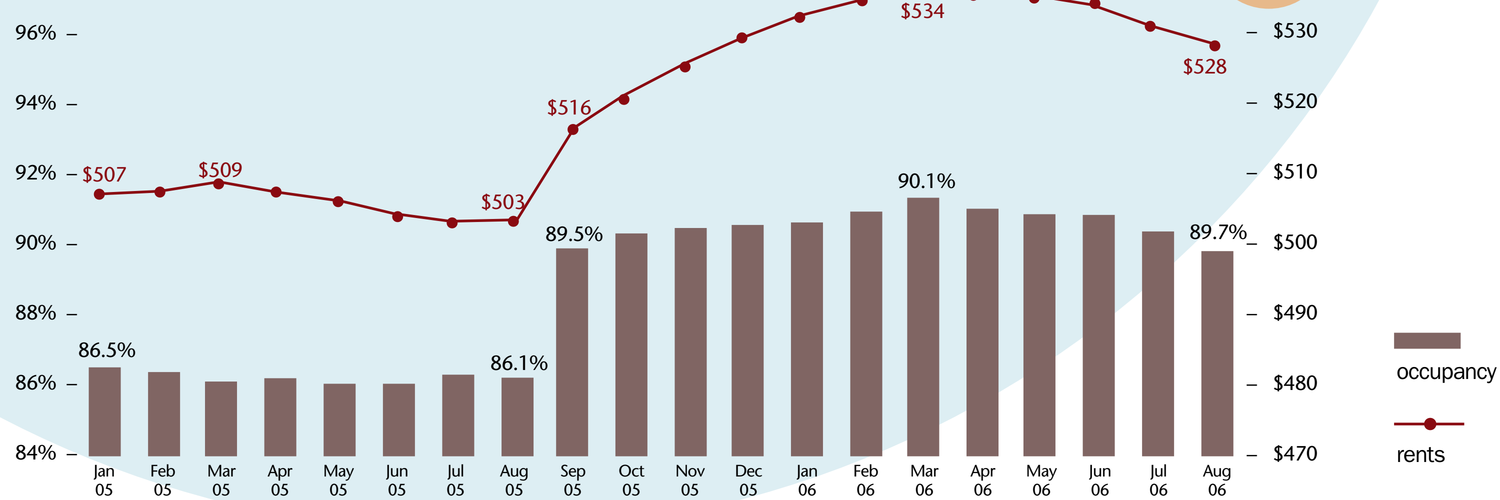
Houston Class B without 2005 and 2006 Construction

Graph 3



Houston Class C

Graph 4



was very good. Occupancy and rents were steadily improving. Class A reached an occupancy high point of 94.5 percent in September 2005, courtesy of Katrina-related leasing. It appears that evacuee leasing for Class A properties was short-term, as occupancy immediately began to slide after September.

Even though the Class Analysis Table (on Page 34) indicates negative absorption in 2006 for Class A, Graph 2 shows that all the negative absorption occurred through April, when occupancy settled to 92.5 percent. Since April, positive occupancy momentum has been at play, which explains the strong three-month annualized rental rate trend of 5.7 percent.

Class B Without New Construction

Class B generally comprises properties built in the 1980s that have rent levels lower than those of Class A properties. Developers built a lot of apartment units in the ’80s, and as a result, Class B units account for 45 percent of the overall supply.

There is an exception to this general classification rule for Class B. The advent of the Low Income Housing Tax Credit program has created a hybrid property type that has overall rents in the Class C range and construction features and amenities of Class A. Therefore, many tax credit properties are classified as Bs. In addition, this situation creates the need to filter out tax credit units built in 2005 and 2006 to provide a stabilized/same store analysis for Class B. Of the 17,197 units built in ’05 and ’06, 36 percent are tax credit.

Graph 3 on Page 35 illustrates how Class B has performed since January 2005. Class B’s 2005 performance prior to Katrina was very flat and lackluster. Conditions changed dramatically in September as occupancy and rents spiked, then continued to build through December. Occupancy peaked at 91.4 percent in December and held steady through February. The classification table indicates that absorption for 2006 is down 2,532 units. This negative absorption performance is illustrated on Graph 3 by the slide in occupancy from 91.4 percent in January to 90.1 percent in August. Rent levels throughout 2006 have held despite the negative absorption scenario.

Class C

Class C generally comprises those units built in the 1970s with rent levels just below those of Class B. Class C constitutes 19 percent of the overall supply. Graph 4 on Page 35 illustrates how Class C has performed since January 2005. Class C’s 2005 performance prior to Katrina was very poor, characterized by declining occupancy and rents. It’s a toss-up as to who needed whom the most – Katrina evacuees desperately needed housing, and Class C properties were just as desperate for occupants. Fundamentally, it was a win-win situation.

After the initial impact in September from Katrina leases, occupancy and rents continued to grow steadily through March, when occupancy peaked at 91 percent and rents topped out at $534. Beginning in April, negative absorption dominated Class C and drove occupancy from the high of 91 percent in March to 89.7 percent in August. Unlike Class B, Class C was not able to maintain rent levels as occupancy moved lower. The slide in rents over the last three months in Graph 4 represents an annualized -3.3 percent trend.

Where's The Absorption?

The absorption distribution shown in the table on Page 34 indicates that overall absorption for 2006 through August was 1,001 units. This number means that 1,001 more units were occupied at the end of August than at beginning of January. A positive absorption number is always a good thing. Absorption is a net number, however, and all the positive absorption was generated by new construction properties in lease-up. Existing properties saw negative absorption.

Market watchers and analysts may have been trapped into expecting a much higher positive absorption number based on the traditional way of estimating absorption as a derivative of job growth. Over the years, the market has come to rely on the idea that for every five jobs created, one apartment unit is occupied. In August, the 12-month change in job growth for the Houston-Sugar Land-Baytown metro area was 65,400 jobs, as published by the U.S. Department of Labor. Therefore, an anticipated absorption performance of 13,080 units (65,400 divided by 5) is created when the traditional formula is applied.

Please pardon yet another "because of Katrina" statement – but the traditional formula does not work this year because of Katrina. Nonetheless, the influx of evacuees in 2005 blew the doors off the absorption performance when 32,588 units were absorbed. It should not come as a surprise to anyone to expect a Katrina correction in absorption in 2006. As mentioned previously, HAA estimates that 25,000 units remain occupied by voucher recipients, a figure that is 10,000 units less than the number occupied at the height of the voucher program in March. In addition, anecdotal evidence suggests that the elevated rent levels of Class A and Class B properties has caused turnover as renewing residents in these properties opt to buy a home as opposed to accepting stiff renewal increases.

The ever-improving level of home sales statistics from real estate agents and builders over the first six months of 2006 lends credence to the notion of A and B turnover loss as residents purchased homes. The Houston Association of Realtors reports that year-to-date sales of existing homes were 14 percent higher in June 2006 than in June 2005. As for new home sales, Metrostudy, a local provider of housing information, reports that new homes sales were 16.6 percent better through June 2006 compared to the same period in 2005.

Houston's Apartment Market: The Big Uneasy

Katrina brought a much-needed boost to the Houston apartment market. All levels of properties received immediate improvements in rent and occupancy levels. So far, the overall market has been able to hold on to most of the gains by way of the 25,000 voucher recipients remaining in apartments at the lower end of the market and by strong job growth keeping the upper end of the market clicking.

Despite the good fortune of the current market, there is a flip side of uneasiness. Many who are close to the market are developing a case of hypochondria. Granted, there are several things to be concerned or worried about, such as the fate of remaining voucher recipients.

FEMA assistance is set to expire on February 28, ending 18 months of housing assistance. As this report was being written, evacuees were required to complete a recertification process with FEMA by the end of October, with speculation that as many as 25 percent of the 25,000 remaining voucher recipients would not pass recertification. At press time, the recertification process has been eliminated with all voucher recipients expecting to receive assistance until the February deadline.

So what can the market expect when FEMA assistance expires in February? Anyone who attempts to answer this question is guessing. Here's a guess that 15,000 voucher recipients will find a way to remain as apartment residents beyond February of next year. Assuming that this guess becomes reality creates an expectation for negative absorption of 3,750 units during the first quarter of 2007. At any level, negative absorption creates adverse consequences for market conditions.

The pace of new construction has also become a source of worry. Presently, more than 12,000 units are under construction. It is very likely that 5,000 of these units will begin leasing by the end of the year, making the total number of new units delivered in 2006 surpass 11,000 units. The number of units on the proposed construction list is over 16,000, which translates into a very aggressive attitude by developers. Unless something quickly causes a change in developer sentiment, expect around 9,000 units to begin construction over the next six months. This level of construction could possibly produce 13,000 units to begin leasing in 2007.

If the saga of voucher recipients and the possibility of developers overdoing it are not enough to make Alfred E. Neuman strike a worried pose, there's more: Hurricane Katrina has brought a dark side to the Houston apartment market in the form of increases in insurance premiums. Premium increases are all over the board according to owners, who are reporting premiums that previously ran $200 per unit now ranging anywhere from $600 to $1,500 per unit.

Another dark development is that crime has increased to the point that the City of Houston is considering an ordinance which rates and indexes crimes on apartment properties. With this ordinance, if a property reaches a certain crime index the city would have the right to require the property to implement costly security measures. At press time, HAA is working with city officials on the terms and conditions of the ordinance and voicing the industry's concerns. See Page 9 for more information.

The Houston apartment market is very diverse and resilient. The current issues that the market faces are just small potholes in the road compared to the huge sinkhole that the market overcame in the 1980s.

Reasons for Optimism

Is there anything to be optimistic about? Absolutely! The Houston apartment market is very diverse and resilient. The current issues that the market faces are just small potholes in the road compared to the huge sinkhole that the market overcame in the 1980s. Job growth should continue to be very strong in 2007. The local single-family housing market will begin to cool from its torrid pace. And the Houston Apartment Association is diligently working to represent owners and management companies to make sure that the best possible solutions for our industry are reached in the city's anti-crime efforts.

Overall market rents for the rest of 2006 should hold steady as occupancy slides closer to 89 percent, influenced by new construction deliveries and the Katrina correction. 2007 is looking to be a challenging year with overall rents moving up no more than 2 percent and overall occupancy hanging around the 90 percent mark.

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.

Do you have an important topic for HAA members? We want your story. Contact the HAA Communications Department at **(281) 933-2224** or e-mail ***comm@haaonline.org***.