

ApartmentResearch

M A R K E T U P D A T E

Marcus & Millichap

Houston Metro Area

Fourth Quarter 2009

DEVELOPMENT CREATING OPERATIONAL CHALLENGES IN HOUSTON

The addition of new stock this year will push apartment vacancy in Houston to the highest rate in over 20 years, leading to an increase in concessions. Outlying submarkets such as Montgomery County and Spring/Champions will post the largest declines in occupancy as anticipated population gains fail to materialize due to the softer employment market. The vacancy rate in high-end, close-in submarkets, meanwhile, will likely remain below the metro average, but concessions in these areas are expected to register the metro's largest increases as owners attempt to fill recently completed, vacant units. Operators in the Montrose/River Oaks and Bellaire/West University areas, for example, have added nearly a week of free rent to leasing incentives in the past year, the largest gains in the metro. Heavy job losses in white-collar sectors, including professional and business services, have suppressed demand for top-tier units. Nonetheless, the long-term outlook remains bright. Job growth is expected to resume in early 2010, and permitting activity has dropped off significantly, which should bring supply and demand closer to equilibrium.

The decline in apartment transaction velocity in Houston is not as considerable as in some more high-profile markets, and sales activity has likely reached a sustainable pace. Few top-tier deals will change hands over the next few months, however, as large buyers are raising capital in anticipation of a market bottom in the first half of 2010. In addition, cap rates that are in high-8 percent range will probably have to inch up to lure cash-heavy investors to the metro due to the significant discounts being offered on assets in some traditionally stable markets. Middle- and lower-tier properties should continue to change hands as investors target well-located assets that are facing refinancing hurdles. Buyers may be able to find attractive deals in first-ring suburbs where owners have deferred maintenance to continue to cover their debt service.

2009 ANNUAL APARTMENT FORECAST



Employment: The pace of job cuts in Houston is anticipated to slow significantly in the fourth quarter, resulting in an annual loss of 80,000 positions, or 3.1 percent of metrowide payrolls. Next year, employers are expected to resume adding jobs.



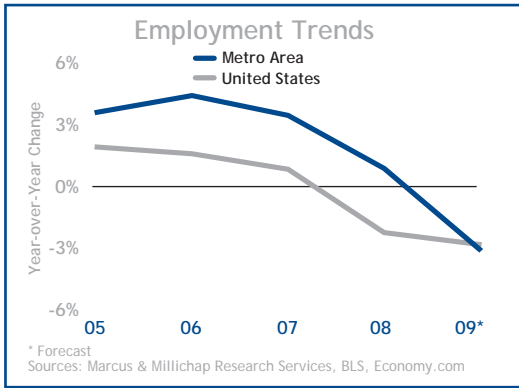
Construction: Builders are on pace to deliver 13,800 units in 2009, the highest amount in any metro in the country. During the past five years, annual stock additions have averaged 9,100 units.



Vacancy: Inventory growth is projected to push up vacancy to 12.4 percent in the fourth quarter, a rise of 230 basis points from the end of 2008. Despite the increase in vacancy, renter demand will expand 0.3 percent this year.

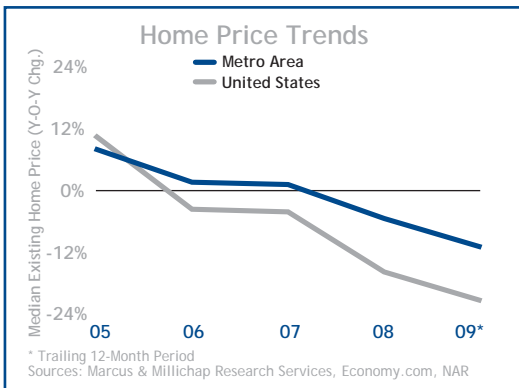


Rents: Although the delivery of new stock is expected to buoy rents, owners will need to modify concessions to fill vacant units. In 2009, asking rents are forecast to slip 1.8 percent to \$755 per month while effective rents retreat 3.4 percent to \$691 per month.



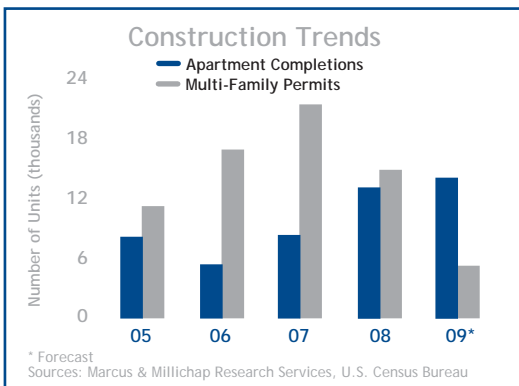
ECONOMY

- ◆ According to preliminary estimates, employers in Houston eliminated 77,700 positions in the 12-month period ending in the third quarter, a 2.9 percent reduction to payrolls. The metro arrived late to the national recession, resulting in the loss of 56,100 jobs during the past six months.
- ◆ The professional and business services sector has contracted by 20,300 workers since the beginning of the year, weighing on apartment demand in high-end submarkets such as Montrose/River Oaks.
- ◆ Although job losses have mounted in recent months, Houston's attractive business climate continues to encourage employers to move operations to the area. Farouk Systems, for example, plans to relocate from China, adding nearly 1,300 positions to the metro this year and 4,000 jobs over the next four years.
- ◆ **Outlook:** The pace of job cuts in Houston is anticipated to slow significantly in the fourth quarter, resulting in an annual loss of 80,000 positions, or 3.1 percent of metrowide payrolls. Next year, employers are expected to resume adding jobs.



HOUSING AND DEMOGRAPHICS

- ◆ Permitting activity in the single-family sector fell 38 percent in the most recent 12-month period to 18,500 units. Multi-family developers, meanwhile, pulled 7,700 permits, a decrease of 54 percent from the previous year.
- ◆ Home prices have begun to retreat, declining 10.9 percent year over year to \$139,300 in the third quarter. The median household income has slipped 2.5 percent in the past year to \$53,900 annually but remains 40 percent higher than the minimum qualifying income for a median-priced home.
- ◆ Using traditional financing, the typical mortgage obligation on a median-priced home was \$77 per month less than the average Class A asking rent. Mortgage payments have been lower than top-tier rents since the fourth quarter of last year, which has applied downward pressure on rents.
- ◆ **Outlook:** Home affordability will remain a concern for apartment operators this year, though more significant stresses on occupancy at existing properties may emerge in early 2010, when job growth is expected to resume.

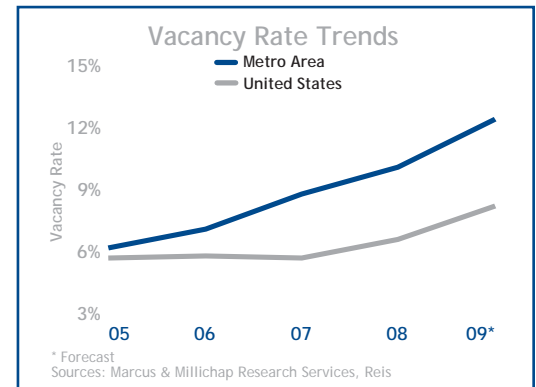


CONSTRUCTION

- ◆ Developers have added 10,200 apartments to the metro since the beginning of the year, expanding stock by 2.2 percent. According to early figures, 3,400 units were delivered in the third quarter.
- ◆ Over 5,200 units are under way in the market, including 3,600 units slated for delivery in the fourth quarter. The planning pipeline has thinned to 7,700 units, indicating a slowdown in development in 2010.
- ◆ In the Montrose/River Oaks submarket, nearly 2,700 units are scheduled for delivery this year, representing an 8.5 percent increase to stock. An additional 5,700 units are under way or planned for development in 2010 or later, though some of these projects face delays due to financing concerns.
- ◆ **Outlook:** Builders are on pace to deliver 13,800 units in 2009, the highest amount in any metro in the country. During the past five years, annual stock additions have averaged 9,100 units.

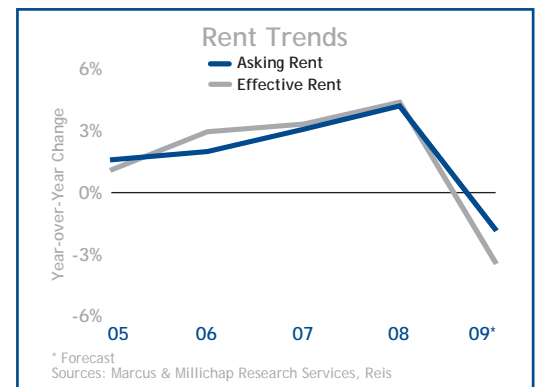
VACANCY

- ◆ According to preliminary estimates, vacancy reached 11.9 percent in the third quarter, an annual climb of 240 basis points. As new construction has come online, vacancy has pushed up 140 basis points in the past six months.
- ◆ Class A vacancy has climbed 160 basis points to 12.1 percent during the last two quarters. In the lower tiers, vacancy has risen 120 basis points to 11.7 percent in the last six months.
- ◆ As renters gravitate to either end of the apartment spectrum to take advantage of concessions or reduce expenses, middle-tier submarkets have struggled. Areas ranked in the middle one-third of effective rents have posted an average 300 basis point rise in vacancy over the last year.
- ◆ **Outlook:** Inventory growth is projected to push up vacancy to 12.4 percent in the fourth quarter, a jump of 230 basis points from the end of 2008. Despite the increase in vacancy, renter demand will expand 0.3 percent this year.



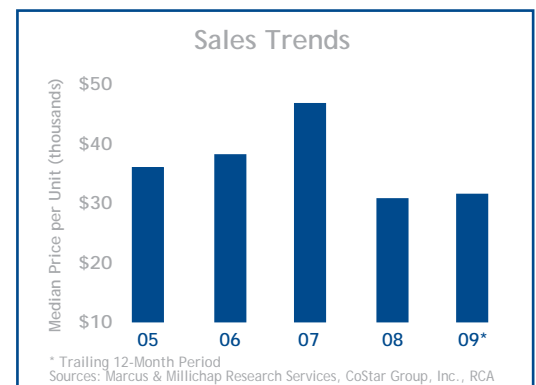
RENTS

- ◆ Asking rents fell to \$763 per month in the third quarter, a decrease of 1.2 percent from peak levels six months earlier. Effective rents have retreated 2.1 percent from the first quarter peak to \$702 per month.
- ◆ Class A asking rents are down 2 percent over the last two quarters to \$940 per month. In the Class B/C segment, asking rents have slipped 1.1 percent to \$624 per month.
- ◆ According to early figures, metrowide concessions climbed to 29 days of free rent in the third quarter, an increase of three days from the same period last year. Owners are projected to add two days of free rent to concessions in the fourth quarter.
- ◆ **Outlook:** Although the delivery of new stock is expected to buoy rents, owners will need to modify concessions to fill vacant units. In 2009, asking rents are forecast to slip 1.8 percent to \$755 per month while effective rents retreat 3.4 percent to \$691 per month.



SALES TRENDS**

- ◆ In the most recent 12-month period, sales velocity fell 30 percent, as out-of-state buyers moved to the sidelines due to housing woes in coastal markets. Deal flow among local buyers has dropped 24 percent in the last year, compared to a 55 percent decline in out-of-state activity.
- ◆ The median sales price has slipped 6.2 percent in the past 12 months to \$31,420 per unit. Buyers have targeted smaller complexes, reducing the average size of each transaction by over 100 apartments to 225 units.
- ◆ Average cap rates have increased 130 basis points over the last year to the mid- to high-8 percent range. First-year yields for assets in escrow are 20 basis points higher, indicating additional gains in the coming months.
- ◆ **Outlook:** Although some REIT activity may emerge in the fourth quarter, sales velocity over the next few months will likely be driven by REO assets coming to market or investors purchasing notes from banks.



** Data reflect a full 12-month period, calculated on a trailing 12-month basis by quarter.

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CAPITAL MARKETS

By WILLIAM E. HUGHES, SENIOR VICE PRESIDENT, MARCUS & MILLICHAP CAPITAL CORPORATION

- ◆ Compared to other core property sectors, apartments have fared best due to the availability of financing through government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Recent modifications to GSE guidelines will impact lender decisions, however, as borrower requirements include more substantial apartment ownership experience.
- ◆ Loan-to-value requirements range from 55 percent to 75 percent. Portfolio lenders are issuing loans at all-in rates of 6.00 percent to 6.75 percent for a five-year term and 6.9 percent to 8.0 percent for a 10-year term. Rates among agency lenders are roughly 150 basis points to 175 basis points lower. The government recently assumed full control of Fannie Mae and Freddie Mac, which may boost confidence in the GSEs, putting downward pressure on rates, but it also creates several near-term uncertainties.
- ◆ Delinquencies will rise further as a wave of maturities approaches; however, at-risk borrowers may find lenders amenable to loan extensions/modifications. Furthermore, Freddie Mac is under way on its second securitization of multi-family debt this year, and the government's TALF program is expected to at least provide a much-needed spark to the traditional CMBS market.

SUBMARKET VACANCY RANKING

| Rank | Submarket | Vacancy Rate | Y-O-Y Basis Point Change | Effective Rents | Y-O-Y % Change |
|------|--------------------------------|--------------|--------------------------|-----------------|----------------|
| 1 | Westchase/Woodlake | 7.8% | 160 | \$782 | -2.5% |
| 2 | Montrose/River Oaks | 8.4% | 190 | \$1,073 | -2.0% |
| 3 | Sugar Land/Fort Bend County | 8.4% | 100 | \$864 | -1.0% |
| 4 | Bellaire/West University | 9.6% | 510 | \$958 | 1.3% |
| 5 | Spring Branch | 9.8% | 130 | \$626 | -0.9% |
| 6 | Katy/Bear Creek | 10.0% | -70 | \$759 | -1.1% |
| 7 | Sharpstown | 10.4% | 100 | \$555 | 0.3% |
| 8 | North Loop East/Sheldon | 11.0% | 250 | \$620 | 2.6% |
| 9 | Pasadena/Deer Park | 11.0% | 250 | \$575 | -0.5% |
| 10 | Clear Lake | 11.6% | 200 | \$738 | -1.0% |
| 11 | Energy Corridor | 11.8% | 140 | \$747 | -1.4% |
| 12 | Medical Center/Museum District | 12.2% | 300 | \$625 | -0.3% |
| 13 | Alief | 12.6% | 180 | \$576 | 2.3% |
| 14 | Inwood/Northwest Houston | 12.7% | 190 | \$584 | -1.2% |
| 15 | San Jacinto/Galena Park | 13.1% | 160 | \$556 | -1.0% |
| 16 | Braeswood/Meyerland | 13.3% | 120 | \$549 | -1.5% |
| 17 | Baytown | 13.4% | 90 | \$548 | 1.0% |
| 18 | Cypress/Fairbanks | 14.3% | 340 | \$780 | 1.8% |
| 19 | Kingwood/Lake Houston | 15.2% | 620 | \$718 | -1.8% |
| 20 | North Houston | 15.3% | 470 | \$519 | 0.4% |
| 21 | Montgomery County | 15.8% | 440 | \$749 | 0.3% |
| 22 | Heights | 16.8% | 480 | \$554 | -5.1% |
| 23 | Spring/Champions | 19.3% | 640 | \$647 | -3.0% |