Out
of
Gas?

Houston's market is running on fumes and it's taking the multifamily industry along for the ride.

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Dr. Bill Gilmer with the University of Houston's Bauer College of Business characterizes the Houston economy as "in limbo, an uncertain situation where there is no progress or improvement."

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Houston Overall Rents and Occupancy

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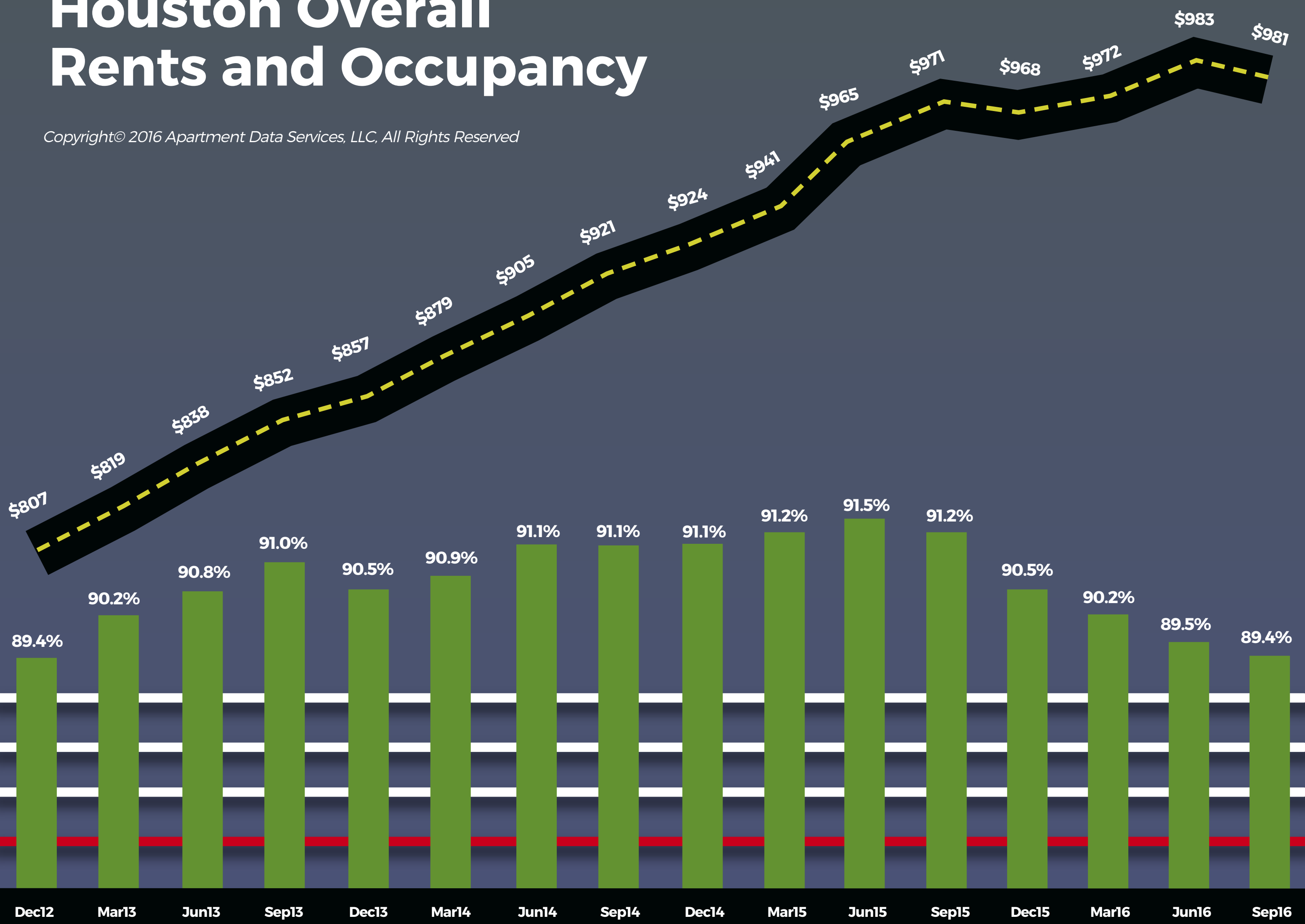

Analysis by Classification

As of Sept. 30, 2016	Supply	Occupancy	¢/sq ft	Effective Rent $/month	Effective Rent 12-Month Trend	3-Month Trend	Absorption (Units) 12 Months	Absorption (Units) 3 Months
2016 Construction	17,592	18.2%	159.0	$1,501	–	–	2,935	2,048
2015 Construction	20,036	70.0%	151.1	$1,443	–	–	9,976	2,787
2014 Construction	17,697	90.7%	153.8	$1,461	-6.2%	-3.6%	2,033	484
Class A (w/o '14+ const.)	93,791	92.4%	147.9	$1,405	-4.3%	-3.2%	-1,648	-138
Class B (w/o '14+ const.)	232,842	92.5%	109.4	$953	0.4%	-1.8%	-2,740	-1,524
Class C	190,494	92.6%	89.9	$763	2.4%	-0.9%	-2,236	-1,244
Class D	50,736	89.9%	72.3	$610	2.8%	1.7%	-1,291	-466
Overall	**623,188**	**89.4%**	**111.4**	**$981**	**1.6%**	**-1.1%**	**7,029**	**1,947**

Houston being out of gas is an absurd thought considering the over-supply conditions that have tanked the price of oil. However, to say that Houston's economy is out of gas or running on fumes is appropriate.

Dr. Bill Gilmer with the University of Houston's Bauer College of Business characterizes the Houston economy as "in limbo, an uncertain situation where there is no progress or improvement."

Regardless of how Houston's economy is characterized, the job growth dynamics for the industry sectors of oil production, oil services, machinery, fabricated metal, wholesale trade and oil-related business services lost more than 50,000 jobs during 2015. To offset these losses, other industry sectors, such as restaurants and bars, healthcare, construction and government, contributed more than 65,000 new jobs. The net result of these winning and losing industry sectors created only 15,200 jobs in 2015. This outcome is many tank-fulls short of the 117,800 new jobs created in 2014 or the 89,800 jobs created in 2013. Those years of job growth sufficiently primed the economic pumps to fuel enough absorption to satisfy lease-ups and produce rent growth of 7.8 percent in 2014 and 6.2 percent in 2013.

The graph at left captures overall occupancy levels and effective rent prices over the last 16 quarters, all the way back to the beginning of 2013. The good economic times of 2013 and 2014 are evident on the graph as rents in 2013 rose from $807 to $857. Rents continued to climb in 2014 and by the end of the year were perched at $924. The exceptional economic growth of 2013 and 2014 also revved-up absorption to 32,000 units while new supply during this period was 30,000 units. This activity moved overall occupancy from 89.4 percent in December of 2012 to 91.1 percent by the end of 2014.

As job growth sputtered in 2015, so did the power in holding the occupancy level and advancing rents. Occupancy reached a peak of 91.5 percent in June of 2015 and then began to slowly move lower. Overall average rent peaked at $971 per month in September of 2015 and moved lower in the fourth quarter. During the first six months of 2016, rent levels were able to recover and move higher to a new peak of $983 per month in June of 2016. In September, rents slipped back by a couple of dollars to $981.

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 rates. The table at left shows how overall market performance is mixed and how classes differ in rates and trends. In addition, new construction supply, or properties in lease-up, has been separated out to provide a stabilized look at Classes A and B.

2015 and 2016 Construction – Lease-Ups

The 2015 and 2016 construction units are listed separately in the distribution table but are addressed together in this section. There are a total of 37,628 units, or 140 properties, comprising the supply delivered in 2015, plus the first nine months of 2016. The product type and geography of these 140 properties are diverse. There are nine high rises, four affordable/tax credits properties and five seniors-only properties to demonstrate product diversity. As far as geography goes, there are 43 urban/infill, or Inner Loop and Galleria, properties and 97 suburban properties. Effective rent averages per property range from $807 per month (73 cents per sq. ft.) for an affordable unit to more than $3,200 per month ($2.50 per sq. ft.) for a high rise unit. Rent trends for these properties cannot be calculated due to the continually increasing number and variety of new units being introduced.

The occupancy for these lease-ups is obviously low. However, during a lease-up, occupancy becomes a tertiary measure and absorption and leases per month, or leasing velocity, are primary. The combined absorption over the last 12 months for 2015 and 2016 construction is good at 12,911 units, but not good enough to stop the concessions from mounting. The competition for renters is reminiscent of 2009 when the dreaded "three months free" last appeared. Of the 43 urban lease-up properties, 90 percent are offering some form of a concession. Just counting: four properties are offering three months, two properties are offering two and one-half months, 20 properties are offering two months, three properties are offering one and one-half months, five properties are offering one month and five properties are offering a variety of concessions that are less than one month.

Of the 97 suburban lease-up properties, 80 percent are offering concessions, which are: three properties at three months, four properties at two and one-half months, 33 properties at two months, 28 properties at one month and nine properties at something less than one month.

The current concession frenzy is nominally not that much different than it was in 2009. However, what is different is that the properties now in lease-up had the great benefit of creating pro formas after the Houston apartment market realized more than 33 percent in rent growth since 2009. Alliance Residential has 10 properties in various stages of lease-up in the Houston area. Cyrus Bahrami, managing director at Alliance Residential, judges these properties by how they are doing in relation to their pro formas. As a panelist at a recent multifamily conference, Bahrami let the attendees know that his 10 Houston properties were at lease-up velocity of 108 percent of pro forma and that effective rents were 96 percent of pro forma. This approach puts a different view on how the current concession environment is impacting lease-up properties. For those properties operating on a budget, it's not as nice-sounding.

2014 Construction – Lease-Ups

The 17,697 units or 65 properties delivered in 2014 have been separated-out as lease-ups in the Classification Analysis at left. These properties as a group did not reach the 90 percent occupancy level, the threshold of stabilization, until July of 2016. Twelve months ago, the properties delivered in 2014 were 79.8 percent occupied and now sit at 90.7 percent, pushed by 2,033 units of absorption over that time frame.

The 2014 vintage is experiencing negative rent growth of 6.2 percent over the last 12 months. 72 percent of these properties are offering concessions very similar to those listed above for the properties delivered in 2015 and 2016. In September of 2015, the overall average rent was $1,548 per month, or 162.8 cents per sq. ft., and now, one year later, rents are $1,461 per month or 153.8 cents per sq. ft.

Class A Without New Construction – Stabilized

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.

Taking new construction units out of Class A provides a stabilized occupancy picture. This group's occupancy is 80.1 percent before new construction is filtered out and 92.4 percent after the adjustment is made.

One year ago, occupancy for this group was 94.1 percent. Negative absorption of 1,648 units over the last 12 months fueled this 1.7 percentage point slide in occupancy. As occupancy weakened so did rent as this group sustained -4.3 percent rent growth. In September of 2015, overall average rent was $1,477 per

month or 155.7 cent per sq. ft. Now rent levels are $1,405 per month or 147.9 cents per sq. ft.

The slide in rents for stabilized Class A has been concentrated in the Central, Northwest and Southwest submarkets or where there is the most construction activity. Class A in the Southeast submarkets have been raising rents by 2.6 percent over the last year. In the Lake Houston/Kingwood sub market, the only Class A market in the Northeast, rent levels have been flat.

Class B Without New Construction

The bell curve distribution of market rate creates a Class B that represents 37.4 percent of the entire market. The occupancy of 92.5 percent is good, but occupancy has been slowly leaking as the 12 month absorption of -2,740 units suggests. In June of 2015, Class B occupancy stood at 93.9 percent.

Class B has been impacted by the competitive turmoil between new construction lease-ups and stabilized Class A. It's understandable that if Class A rent levels are moving lower that Class B's ability to raise rent would be restricted. Over the last three months, rents have become mildly negative at 1.8 percent. The 12-month rent trend is flat at 0.4 percent. Back in September of 2015, Class B's 12-month rent trend was 5.9 percent.

Class B is the most difficult or complicated category to understand due to very mixed performance by location. Out of 42 submarkets in Houston, 15 are showing a positive trend, 10 are flat and 17 are negative. Most of the positive trends are found in submarkets in the south and east parts of the metro area. The submarkets with the best Class B performance are in the Northeast part of town with Greenspoint, Northline, FM 1960 E and I-69 N leading the pack. The submarkets where B's are having the toughest time are suburban markets with the most construction activity, such as Energy Corridor/CityCentre/Briar Forest and Katy/Cinco Ranch/Waterside. Class B rents have retreated the most, by $42 per month over the last 12 months, in the Woodlands/South Conroe and the Galleria/Uptown submarkets.

Classes C and D

Class C represents 30.6 percent of the overall market. Class C can claim the distinction of having the best overall occupancy of 92.6 percent. It was a close race with Class B, which was only one-tenth of a percentage point behind. Class C experienced negative absorption of 2,236 units. 12 months ago, Class C's occupancy was a full percentage point higher at 93.6 percent. The negative absorption has really throttled rent growth. The 12-month rent trend for Class C in September of 2015 was 7.2 percent. Now the the trend is 2.4 percent.

It's no surprise Class D has lost its advantage of being more than 90 percent occupied when rent growth comes easier. Even though rent growth may become more difficult in the future, Class D scored the best growth of 2.8 percent over the last 12 months. The -1,291 units of absorption drove occupancy from 91.1 percent in September of 2015 to its current parking spot of 89.9 percent.

Looking For Assistance

The original job growth estimate for Houston by the Greater Houston Partnership (GHP) for 2016 was approximately 20,000 jobs. The latest figures on job growth from the Bureau of Labor Statistics from August shows the 12-month net change for Houston is 14,200 jobs. The Federal Reserve Bank of Dallas came out with a preliminary revision for jobs in 2016 for Houston and Jesse Thompson, an economist with the Houston Branch of the Dallas Fed, says, "the outlook is grim." According to Thompson, this revision estimates that job growth for 2016 will be in the range of -0.5 to -1.5 percent, which equates to 5,000 to 40,000 jobs lost. The revision is based on oil-related job losses being under-estimated and job gains in hospitality being over-estimated.

Whatever the outcome for jobs in 2016, it appears that Houston's economy has run out of gas on a lonely, abandoned stretch of demand waiting on assistance. This assistance can only come from an improved and sustained price of a barrel of oil to jump-start the upstream energy industry to put more rigs in production. Currently, West Texas Intermediate (WTI) crude is trading around $50 per barrel. The GHP points out in its October 2016 edition of "The Economy at a Glance" that the U.S. Energy Information Administration forecasts the spot price for WTI to average $52 per barrel in the third quarter of 2017 and move up to $57 per barrel in the fourth quarter of 2017.

In addition, GHP shows other estimates for the average price of WTI in 2017 to range from $80 per barrel from Raymond James to $45 to $50 per barrel from Goldman Sachs. There are several other estimates in between these extremes, such as $69 from Merrill Lynch, $60 from Piper Jaffray and $51 from Morgan Stanley. The GHP further asserts that in a recent survey of energy firms, conducted by the Federal Reserve Bank of Dallas, the average price for firms to profitably drill a well was $51 per barrel in the Permian Basin, $53 in the Eagle Ford and $55 in other parts of Texas.

Assistance may be on the way. Despite all this information, the Dallas Fed outlook for Houston in 2017 is 15,000 net new jobs, at best.

The writing is already on the pavement for the Houston apartment industry. Presently, there have been about 18,000 units delivered in 2016 with another 18,000 more units under construction. Over the fourth quarter, expect 5,000 to 6,000 more units to be delivered to supply, bringing the total number of deliveries in 2016 to be 23,000 to 24,000 units.

Absorption in the fourth quarter is notoriously flat. Over the last six, fourth quarters, going back to 2010, the best absorption performance for a fourth quarter was 577 units in 2014. There is a possibility that the 1,200 or so first floor units lost in the April floods in Greenspoint will come back online and push fourth quarter absorption out of its historical norm.

Current overall occupancy is 89.4 percent. By the end of the year, overall occupancy will slip to 88.9 percent. Overall rent growth for 2016 will be around 1.0 percent. Class A stabilized rent growth will be negative in the neighborhood of -3.5 percent. When new construction Class A is included with the stabilized Class A, rent growth will be flat. Class B rent for 2016 will be flat to mildly positive, say 0.5 percent. Class C rent will be 2.0 percent and Class D will be 2.5 percent.

2017 will be a challenging year with 23,000 to 24,000 units in lease-up and only 15,000 jobs to fuel absorption. Plus, there will another 12,000 units delivered in 2017.

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