HOUSTON APARTMENT MARKET 2000-2001

Wow – Who-da thunk?

Wow, who would have thought that absorption would almost double from 1999 to 2000? According to Apartment Data Services total Year 2000 absorption was 13,771 units versus 8,323 in 1999. Pretty Spectacular!!! Vacancies decreased over the prior year with a vacancy rate of 10.6% in 1999 versus a vacancy rate of 9.3% in 2000. That is a 12% improvement folks. All sources indicate that more units sold (approximately 39,000) than in the prior year (approximately 22,000). Overall rents were up moderately, about 4% in metered projects. All in all, a very good year!!! Here's how the market fared by Class and what is anticipated throughout 2001.

Conventional Market

Class A – This market segment had a major turnaround from the prior year. A total of 2,445 units changed hands in this sector, in 9 projects, more than double the prior year. According to the Campbell Property Services database, the range in prices on a stabilized basis, varied from $65.36 to $109.70 per square foot, with an average price of $85.74 per square foot and an average price per unit of $79,918. The Gables River Oaks had the distinction of garnering the highest price per unit $134,000, and the lowest overall capitalization rate, 7%. It is notable that overall capitalization rates did not increase significantly in spite of increasing interest rates. The range in capitalization rates observed varied from about 7% to 9.34% (stabilized basis), with an overall average of 8.4%. The majority of sales were premier locations, "Inside the Loop" or infill locations. Average rents in this sector were approximately $0.88 per square foot per month, with an average occupancy of 88.9%. Year 2000 also witnessed the first foreclosure of a new Class A project, Mallard Creek, just off of US Highway 59 in the vicinity of Kingwood.

Class B – This sector is comprised of projects typically pushed out of the top rung of the ladder by the newer 1990's projects. They are typically constructed from 1979 to 1989. Out of 27,898 Class B units surveyed by Campbell Property Services (CPS), a local real estate brokerage and consulting firm that tracks apartment data in association with The Gerald A. Teel Company, the weighted average occupancy by project was 94.3%, with an average asking rental rate of $0.688 per square foot per month. This market has been gaining favor, as a lower cost alternative to the Class A project, due to lenders perceptions, lower sale prices, and higher average occupancies. Out of 5,479 units confirmed sold, the average sale price was $29,111 per unit. According to Apartment Data Services, "Market Trac" the average effective rent was $0.66 per square foot per month, with an average occupancy of 92.3%. Capitalization rates extracted on approximately 1,918 units sold varied from 9.34% to 14.05% with an average of 10.52%.

Class C- During 2000, the C in Class C stood for cash, lots of it. These properties were a much sought product, as investors were drawn to the stable rents and good occupancies these properties bring when renovated. Properties that were in unleasable condition were able to achieve sale prices of over $10,000 per unit, as the competition to purchase such properties was stiff.

CPS uncovered the sale of 46 Class C projects from January 2000 through October 2000. These 46 projects contained 9,088 units and had an average age of 27 years. Of the 9,088 units sold, CPS confirmed sales of 2,879 units during that same time period. The average sale price was $17,591 per unit. This property type often requires a significant renovation budget, driving the price higher than the purchase price would suggest. CPS and the The Gerald A. Teel Company surveyed 25,551 operating units in Harris County with ages at least 24 years. The average quoted rental rate was $0.62 per square foot per month and the average weighted occupancy was 95%.

Travis Soule of American Housing Preservative Corporation in Portland, Maine entered the Houston market last year with the purchase of 868 Section 8 units. Their firm is presently looking at other projects in Houston. When asked why they chose to enter the Houston market, Soule stated "Houston is the nation's 2nd largest apartment market (behind New York City) and is much less restrictive in terms of buying and selling. The economies of scale in Houston are good, and we plan to continue to look for properties in Houston in 2001." This attitude is typical of local and out-of-town investors, as Houston is seen as a market that is accommodating to owners and still has opportunity in this sector.

Affordable Housing

With housing affordability being an issue across the country, the Houston market is no exception to increases in housing costs. A 1995 State Low Income Housing Plan reports 35% of all low-income households in the state pay more than 50% of their gross income in rent. Houston was among the nine largest metropolitan cities nationally with the highest incidence of overcrowding among poor renters. The two largest government programs for low-income housing are Section 8 and Low Income Housing Tax Credits (LIHTC).

Tax Credit Market – This market continues to be very active, with new funding recently hitting the market. Since 1987 over 89,000 units in Texas have been constructed or renovated through this program. There continues to be a lot of competition for the awarding of tax credits and in 2000 179 applications seeking $109.4 million were filed. Of those, only 28% (55) were awarded tax credits. To obtain the maximum number of points, hence increase the likelihood of being awarded the credits, developers are scrambling to determine the most desirable mix of units, location, energy efficient construction, county poverty and cost burden levels, serving special needs populations, and by providing supportive services for residents. Usually, this entails including 2 and 3 bedroom units, and 4 bedroom units on occasion. As a result, in an attempt to get the maximum points allowed, a segment of the market is being ignored. Developers cannot get the maximum points for one-bedroom units, yet it is the one bedroom unit that is typically the most popular. This bespeaks of a proverbial Catch 22, as the very segment that could use help is being ignored in some instances. This should prove to be an interesting year in this market, as we are now seeing some financial problems arise. Some of the projects constructed within the last 8 years are having difficulty maintaining a high enough occupancy to cover expenses and debt service.

Section 8 - In Houston, HUD lists 7,716 units in 61 projects as Section 8. These units are available to qualifying families/individuals based on income. These projects are privately-owned with guaranteed rents and occupancies from the federal government. With these guarantees, these projects are attractive to many investors. However, HUD recently instituted a mark-to-mark program whereby owners can only charge the government market rents. Historically, owners had contracts for rent well in excess of market. The implementation of this program has not been without problems, as the lower rents have caused many investors to withdraw from the program. Not wanting to lose affordable housing, HUD has made some revisions to the policy, and some investors have circumvented the program by using analysts that generously estimate market rent.

Financing

Lenders are still wary of Class A projects in a number of markets in Houston. To this end, the feasibility of the project receives more scrutiny than in prior years and more equity may be required. With lenders "pulling in the reins" in 1999 and 2000, the amount of new construction was almost cut in half compared to 1997 and 1998. Class B and C projects with stabilized occupancies are not being scrutinized as closely, and funding is available. Some developers are turning to other sources of financing for new projects such as various Department of Housing and Urban Development (HUD) loans like the 221(d) 4 program. The appeal of HUD loans are lower interest rates in most instances, sometimes higher loan to value ratios, and longer amortization periods, often up to 40 years. However, HUD loans typically take longer to procure and are time consuming. HUD requires reserves to be escrowed, which effectively increases the equity investment. HUD also has programs for substantial rehabilitation and purchase or refinancing of existing projects, referred to as 221(d)4 Substantial Rehab and 223(f). The amount of interest in these loan programs is on the rise. HUD has initiated the Multifamily Accelerated Processing (MAP) program in an effort to streamline this process. Based on the activity witnessed in our offices, it appears to be gathering momentum.

Conclusion

Considering the bleak forecast for 1999, Year 2000 was stellar. The Houston apartment market was generally positive through 2000, although Class A product did not perform as well overall. Class B and C units were not only in demand by tenants, but also by investors. These two classes accounted for 86% of all units sold.

Also, rents in Class C only trailed Class B by $0.068 per square foot per month. Occupancies in these two classes were similar. In the Class A market, average monthly rents were approximately $0.88 per square foot and occupancies averaged just under 90%. In spite of higher interest rates during most of 2000, the nominal change in the overall capitalization rate implies that investors were willing to accept a slightly lower return on equity dollars due to competition primarily for the Class B and C product. Class A properties will continue to experience softness in effective revenue due to concessions and sub-stabilized occupancies. Naturally, some submarkets will be hit harder than others, with inner city locations likely to outperform suburban projects.

Gerald Teel of The Gerald Teel Company, a local real estate appraisal firm, stated “the Houston apartment market in 2001 is anticipated to be relatively flat. We will spend most of the year digesting the product that came on line in 1999 and 2000. There are definitely pockets, which are firmer than others, but any new construction will be very selective in 2001. However, with interest rates continuing to decline, I would anticipate more new construction in 2002 than in 2001 and believe that our job growth would increase in order to meet that demand. Overall, the 2001 I believe is going to remain in equilibrium with better times in 2002.”

Although the outlook for 2001 is mixed, most investors agree that substantial amounts of new product will not be developed. The exception to this is in the affordable housing sector. The affordable market continues to show strength and the primary drive of this market continues to be the ability of the developer to “pull out” their developers profit quickly, hence allowing them to go on to other projects and locations. As a result there will continue to be significant demand in this sector. Some of the most desirable locations (because the are given priority and more points), called Qualified Census Tracts, are being overrun with applications and interest. This market is still in its infancy stage and will likely undergo more changes over the next several years.

Campbell Property Services *is a multi faceted brokerage and consulting firm. Campbell Property Services specializes in various property types from land to apartments, as well as tenant representation. The company has a well-balanced mix of analytical and sales experience allowing them to represent their clients in numerous capacities. Chris Lantz and Tim Treadway, CCIM are principals in Campbell Property Services and associates in The Gerald A. Teel Company.*