

Houston

Multifamily

Executive Summary

Trends and Forecast



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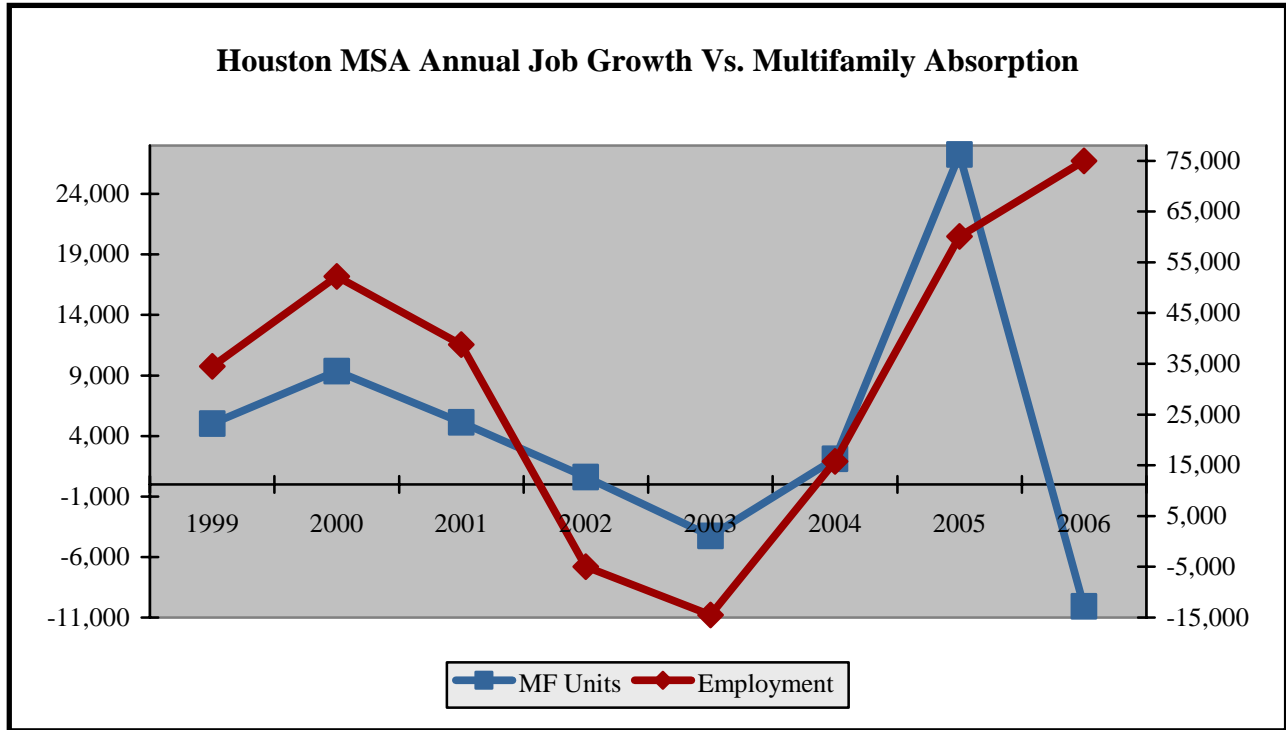
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Pertinent Issues Facing Houston's Multifamily Market

Employment

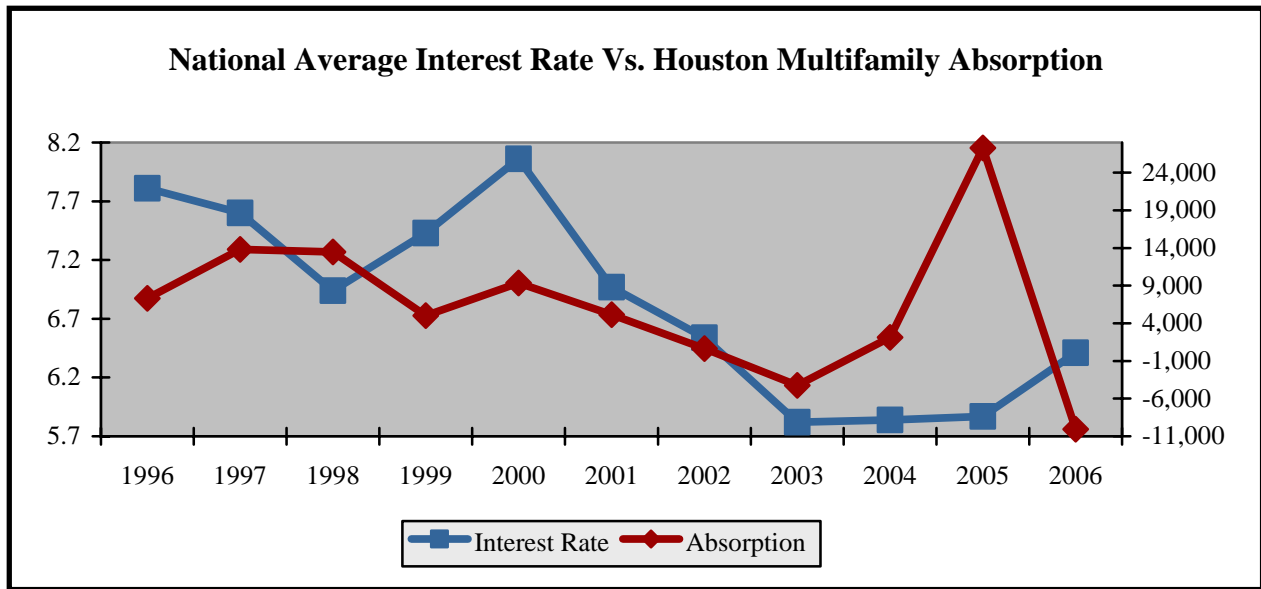
The job market is a significant determinant and predictor of health in Houston's multifamily market. The following graph depicts the relationship between job growth and absorption.



As depicted in the graph, absorption has followed a similar pattern as job growth; when there has been positive job growth, absorption has increased and when job growth declined, absorption declined as well. In 2006, however, there was significant positive job growth combined with significant negative absorption. This came about as a large number of Hurricane Katrina evacuees moved out of Houston area apartments. We expect patterns to return to normal in 2007, with positive job growth and positive multifamily absorption.

Interests Rates

As interest rates fall, single-family homes become more affordable. Over the last few years there have been record low interest rates, which helped fuel a boom in the single-family market. Generally, lower interest rates negatively affect the multifamily market. This has not always been the case in the Houston area, as there have been a multitude of other factors affecting the multifamily market, specifically construction rates. The following graph depicts the relationship between average interest rates and multifamily absorption in the Greater Houston area.



In 1996 when interest rates were at 7.81%, multifamily absorption was relatively low at 7,295 units. Rates subsequently declined, while absorption increased. In 1998 interests rates fell to 6.94%, while annual absorption totaled 13,489 units. Over the next two years interest rates climbed higher, while absorption remained relatively steady. Post 2000, as the economy experienced a slowdown, both interest rates and absorption declined. In 2003, interest rates averaged 5.82%, while absorption was in the red at -4,258 units. It was also during this timeframe that the single-family market flourished, as homes become more affordable in the wake of declining interests rates. Despite continued record low interest rates, absorption rebounded in 2004, as 2,121 units were absorbed. Absorption figures in 2005 were an anomaly due to major effects from Hurricane Katrina. During the year, interest rates remained low (5.87%), while absorption skyrocketed (27,263 units). As the economy has improved, interest rates have begun to rise. In 2006, interest rates averaged 6.41%, which though higher than it has been over the last few years, is still historically low. Hurricane Katrina continued to affect the multifamily market in 2006, as countless evacuee households made their way out of Houston area apartments. Absorption in 2006 totaled -10,070 units. As the overall economy improves, interest rates are expected to continue to creep upward. However, we do not expect rates to rise significantly enough to cause a collapse in Houston’s single family market.

Subprime Lending

Providing a boost to the multifamily market in 2007 will be the decrease in subprime loan offerings. Subprime loans are loans that are offered at a rate above prime to individuals who do not qualify for prime rate loans, as they have poor credit histories, questionable incomes, or are otherwise more risky applicants. Subprime loans tend to have a rate that is 0.1% to 0.6% higher than the prime rate, which translates into thousands of dollars worth of additional interest payments. The number of subprime loans has ballooned over the last few years, coinciding with the boom in the single-family market. The Mortgage Bankers Association reports that in 2000, only 2.3% of mortgages were subprime. That figure has dramatically increased, as 13.5% of mortgages originating in 2006 were subprime, accounting for \$600 billion of the \$3 trillion mortgage market. Alarmingly, the percentage of subprime loans in the Houston area is above the national average, at 16.7%, according to First American LoanPerformance. Worried about a

potential collapse in the subprime market, Fremont General Corp., a major lender, recently announced plans to fully abandon the subprime business. In addition, the nation's second largest subprime lender, New Century Financial Corp., suspended subprime applications and filed for Chapter 11 bankruptcy protection amidst a federal inquiry into their accounting and trading practices. The negative news has already taking a toll on the stock market, as multiple single-family related businesses including lenders, builders, and product suppliers have seen their stocks depreciate in value.

Adding to the subprime issues has been the increase in the number of other non-conforming mortgages, including interest-only loans, Adjustable Rate Mortgages (ARMs), and extended-term mortgages (i.e. the recently released 50-year mortgage). In 2003, non-conforming mortgages made up only 6% of all mortgages. In 2006, the percent of outstanding non-conforming mortgages reached 25%. The majority of non-conforming mortgages are attributed to first-time homebuyers, who often over-extend themselves to fulfill homeownership dreams.

With the number of subprime and non-conforming mortgages at an all-time high, the rise in interest rates over the last year has proved disastrous. As interest rates have crept upward, so have delinquencies, with delinquencies on subprime loans considerably higher than on traditional mortgage loans. By the end of 2006, subprime delinquencies more than 60 days late were at 13%, almost double the rate seen in 2005, according to First American LoanPerformance. As for delinquencies on all mortgage loans, Moody's Economy.com reports that nationally 2.96% of mortgage loans were more than 30 days late during the first quarter of 2007. The situation is worse in the Houston area, as 4.38% of all mortgage loans are more than 30 days late, which represents a 2.34-point increase over last year's figure of 2.04%. The Houston area boasts the fourth highest 30-day delinquency rate in the nation, behind Detroit, MI, Miami, FL, and Riverside, CA.

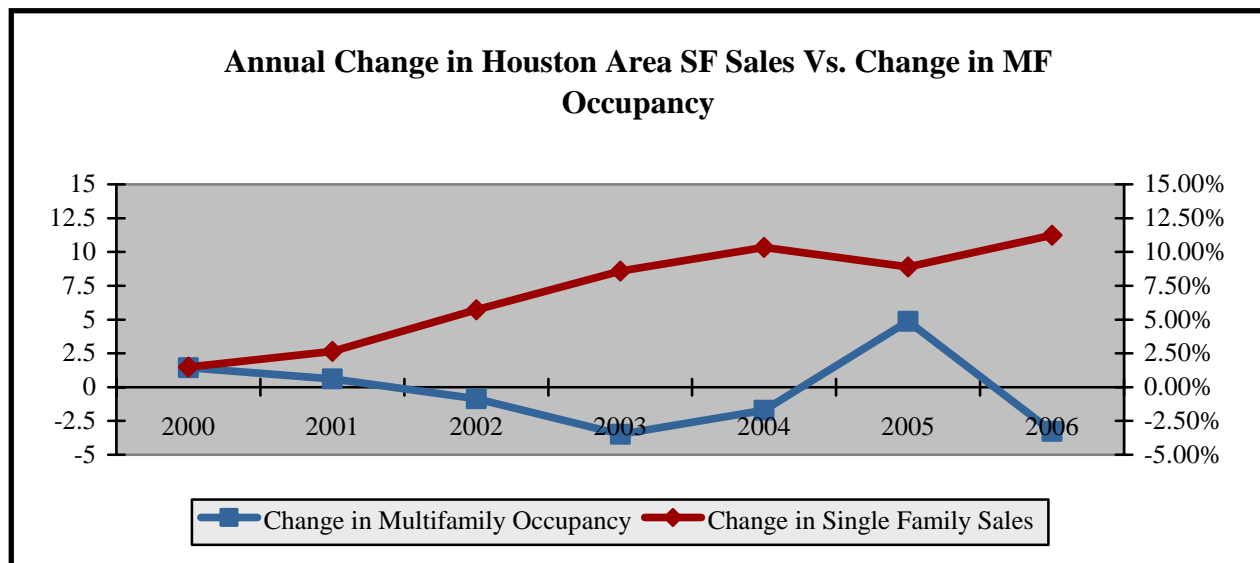
The rise in interest rates for subprime and non-conforming mortgages has also led to an increased amount of home foreclosures. RealtyTrac, Inc. reported nationwide foreclosure filings in 2006 totaled over 1.2 million, which represents a 42% increase over foreclosure filings in 2005. On a state-by-state basis, foreclosures in 2006 in Texas totaled 156,876, the highest aggregate total of all states. Texas ranked fourth in the overall foreclosure filing rate, with one in every 51 households having their home filed for foreclosure. In terms of MSAs, the Houston-Baytown-Sugar Land MSA ranked 18th, as 11,983, or one in 43, homes were foreclosed on in 2006.

Experts predict the foreclosure situation will likely worsen in the near future. The Center for Responsible Lending predicts nearly 20% of all subprime mortgages undertaken in 2005 and 2006 will end in foreclosure, which will lead to significantly tighter standards in the lending market. Here in the Houston area, where the percentage of subprime loans, delinquencies, and foreclosure rates are higher than the national average, we expect there to be significant fallout in the coming year. The tighter lending standings will likely put an end to the drain of Class B and C renters from the multifamily market to the single-family market. Previously, the vast availability of subprime and non-conforming loans allowed a large portion of Class B and C renters to become homeowners. In addition, the increased amount of expected home foreclosures in the area will increase the number of renters in the market. Those with foreclosures on their record will not have good enough credit ratings to rent at Class A apartments, and will be forced into Class B and C properties. Thus, it appears that the Class B

and C markets are poised to reap the most benefits in terms of occupancy and rental rates from the collapse in the subprime lending market.

Single Family Homes

Houston is a city known for its comparatively inexpensive real estate. Over the last year, even as other parts of the country suffered through a depressed housing market, Houston's continued on as strong as ever. According to HAR's Multiple Listing Service (MLS) data, year-end sales in 2006 totaled 87,435 properties with total sales exceeding \$16.6 billion. In 2005, year-end sales totaled 79,012 properties worth \$14.2 billion. Additionally, the median sales price in 2006 reached a record \$149,610, which represents an increase of 5.4% compared to 2005. The average sales price in 2006 was \$198,503, an increase of 5.5% compared to the previous year's average price. The gains in Houston's single-family market were made despite increasing interests rates. In 2006, the average 30-year mortgage inched up to 6.41%, which is the highest annual average since 2002 when a 30-year mortgage averaged 6.54%. Houston's affordable single-family market has played a major role in the health of the multifamily market over the last few years. The following chart displays the historical effect of single family home sales vs. multifamily occupancy.



As depicted in the graph, sales of new single family homes have continually increased over the last six years. At the same time, multifamily occupancy in the Houston area has declined. The lone exception occurred in 2005, which was an anomaly in the multifamily market due to Hurricane Katrina. In 2006 there remained lingering effects from Katrina, as evacuees made their way out of Houston area apartments. Over the course of the year, single family home sales increased by 11.23%, while overall occupancy declined from 91.74% to 88.46%.

To further illustrate the effect of Houston's affordable single family market on the multifamily market, the following graph plots the historical relationship between new single family home starts and multifamily absorption.