Multifamily Research

Market Report

Fourth Quarter 2017

Houston Metro Area

Institutional Property Advisors

A Division of Marcus & Millichap

Harvey Floods Strengthen Apartment Demand, Reinvigorate Investors

Demand rises as displaced Houstonians seek apartments as temporary housing. Apartments will play a pivotal role in housing those displaced by Hurricane Harvey, strengthening demand for units through the remainder of the year. When Hurricane Katrina flooded New Orleans, apartment vacancy in the metro declined 500 basis points in the three months that followed, staying well below historical norms for two years. Houston could realize a similar trend as displaced residents funnel into units while homes are repaired. Vacancy in September remained elevated as the full effect from Harvey on the local apartment market was not yet realized; however, the rate will contract 500 basis points below the long-term average of 8.0 percent.

Apartment construction timelines impacted by Harvey flooding. Houston was in the middle of a construction boom before the flooding from Harvey began, and nearly 25,000 apartments were slated for delivery in 2017. Approximately 16,200 units opened in the first nine months of 2017, but completions could taper in the final months of the year. Rising material costs and labor shortages have become exacerbated while existing housing stock is restored and construction timelines are pushed out. Owners of existing apartments will also contend with remediating any damaged stock. Developers and owners will press hard to get units completed as housing needs are elevated.

Multifamily 2017 Outlook

22,000 units will be completed

Construction: The flooding pushes out construction timelines for projects slated to open in the final months of the year. As a result, deliveries will dip from 2016.

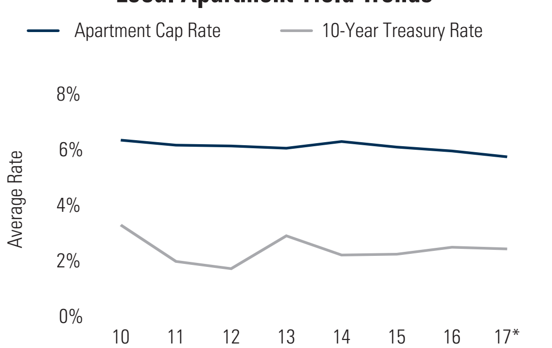
380 basis point decrease in vacancy

Vacancy: More than 45,000 apartments will be absorbed this year as residents seek temporary housing, pushing down vacancy to 3.0 percent.

6.7% increase in effective rents

Rents: Tight conditions prompt a strong advance in the average effective rent this year, reaching $1,086 per month.

Local Apartment Yield Trends



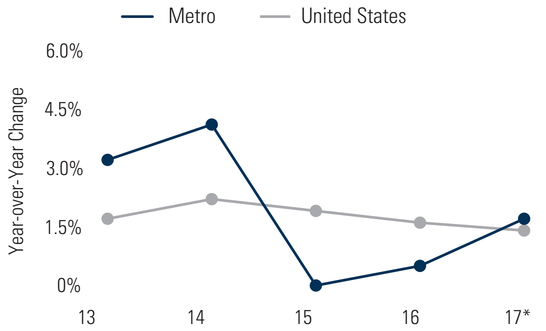
* Cap rates trailing 12 months through 3Q17; 10-year Treasury rate through Oct. 20.
Sources: CoStar Group, Inc.; Real Capital Analytics

Investment Trends

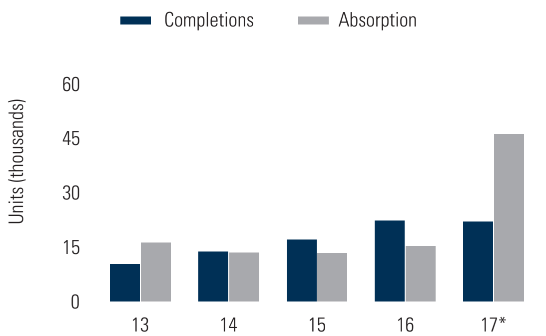
- A stabilization of oil prices and a resumption of broad-based employment growth brought institutional investors back to Houston after private capital dominated the $20 million-plus transaction market from 2014 and 2016. Year to date, institutional buyers have closed on just over 30 percent of recent sales compared with 14 percent in 2016.
- The return of institutional capital into the market has had a positive impact on pricing with cap rates declining slightly to an average of 5.7 percent and per unit prices up 12 percent to $107,000.
- Sales momentum has been growing throughout 2017. Year-to-date 2017 sales volume through 3rd quarter almost tops full year 2016 volume. Hurricane Harvey could cause a brief pause in the fourth quarter as investors digest the locations with the worst flooding and potential insurance premium increases on pro formas. Yet, the strength that drove the rising sales before the storm remains in place and should keep the pace of sales expanding.

Houston

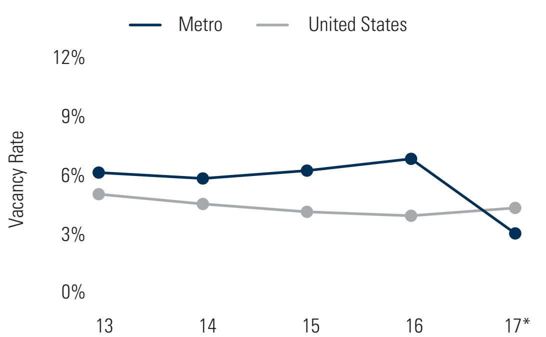
Employment Trends



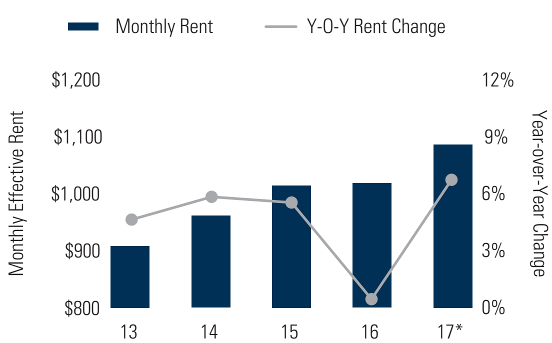
Completions and Absorption



Vacancy Rate Trends



Rent Trends



* Forecast

3Q17 – 12-MONTH PERIOD

EMPLOYMENT:

0.6% increase in total employment Y-O-Y

- Employment growth in Houston slipped as a number of residents were out of work after catastrophic flood damage. Out of the 16,500 positions added, 13,000 were in the manufacturing sector.
- Unemployment in the metro declined 60 basis points over the last year to 4.9 percent in September. The rate now sits 50 basis points above the previous low.

CONSTRUCTION:

23,750 units completed Y-O-Y

- Apartment developers added 5,850 apartments to inventory during the third quarter. Nearly 1,200 units were delivered in the Downtown/Montrose/River Oaks submarket over the three-month period.
- Completions will begin to taper over the next two years as 8,700 apartments are underway and scheduled for delivery in 2018 and 2019.

VACANCY:

120 basis point decrease in vacancy Y-O-Y

- Apartment vacancy ticked up to 7.7 percent in Houston during the third quarter. Effects on vacancy from Harvey will be strongest in the final three months of the year.
- An estimated 47,000 units were vacant in Houston in the second quarter. A housing shortage is expected, however, as demand for rentals rises at a time when nearly 43,000 apartments were potentially flooded.

RENTS:

1.6% increase in effective rents Y-O-Y

- Apartment rent grew at its strongest annual pace in the last four quarters, reaching $1,044 per month.
- Rent growth over the last 12 months was strongest in North Central Houston and Memorial, rising 8.0 percent and 7.8 percent, respectively.

DEMOGRAPHIC HIGHLIGHTS

FIVE-YEAR POPULATION GROWTH*

648,200

3Q17 POPULATION AGE 20-34
(Percent of total popluation)

Metro 22%

U.S. 21%

3Q17 MEDIAN HOUSEHOLD INCOME

Metro $63,308

U.S. Median $58,218

FIVE-YEAR HOUSEHOLD GROWTH*

253,000

POPULATION OF AGE 25+
PERCENT WITH BACHELOR DEGREE+**

Metro 30%

U.S. Average 29%

2Q17 TOTAL HOUSEHOLDS

43% Rent

57% Own

* 2017-2022

**2016

SUBMARKET TRENDS

Potentially Damaged Apartment Stock

Submarket	Existing Units	Damaged Units	Share Damaged	Average Rent
Far West Houston	30,916	4,754	15.4%	$1,009
Galleria/Uptown	23,324	3,244	13.9%	$1,411
Spring/Tomball	14,540	3,070	21.1%	$1,095
North Central Houston	23,671	3,048	12.9%	$746
Pasadena/ Southeast Houston	27,241	2,967	10.9%	$824
Gulfton/Westbury	33,468	2,910	8.7%	$898
Humble/Kingwood	15,993	2,848	17.8%	$998
Friendswood/Pearland	14,993	2,368	15.8%	$1,154
Greater Heights/ Washington Avenue	13,641	2,022	14.8%	$1,477
Bear Creek/Katy	33,986	1,993	5.9%	$1,108
Overall Metro	**667,611**	**42,977**	**6.4%**	**$1,044**

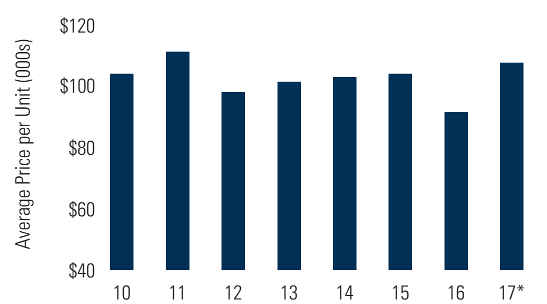
SALES TRENDS

Return of Institutional Capital Invigorates the Transaction Market, Especially for New Developments

- Transaction pricing picked up over the past 12 months compared with 2016's nadir as the average per unit price rose almost 12 percent to $107,000 and cap rates compressed by 30 basis points to 5.7 percent.
- Activity for newly developed properties has accelerated with the return of institutional capital to the market. Newer properties are typically trading in the $125,000 to $160,000 range with select midrise deals trading slightly higher.

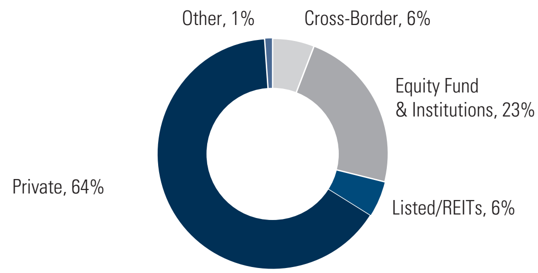
Outlook: While the market may see a slight pause in transaction activity due to Harvey, the metro will regain the positive sales transaction environment seen in the first half of 2017 and carry that forward into 2018.

Pricing Trends

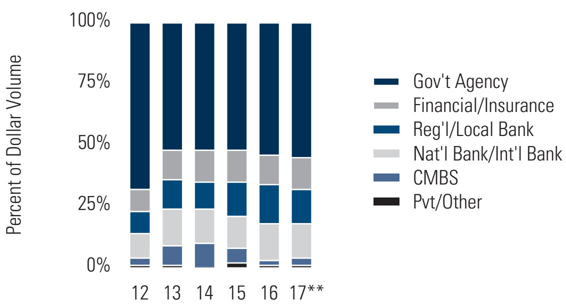


* Trailing 12 months through 3Q17
Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

Apartment Acquisitions By Buyer Type*



Apartment Mortgage Originations By Lender



* Trailing 12 months through 2Q17
** Through first half 2017
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- **Monetary policy in transition.** Despite the Fed raising its benchmark short-term rate three times in seven months and signaling another rise before the end of the year, long-term rates have remained stable. The yield on the 10-year U.S. Treasury bond remained in the low- to mid-2 percent range throughout the third quarter of 2017. The Federal Reserve wants to normalize monetary policy and, in addition to raising its funds (or overnight lending) rate, has announced it will begin to taper its balance sheet by allowing an initial $10 billion in securities to mature without reinvestment. By reducing its acquisitions of securities, 10-year Treasury rates should drift upward, thereby widening the spread between short- and long-term rates.
- **Increase in interest rates over the course of the year, pushing up the cost of capital.** While commercial real estate fundamentals remain strong, rising costs associated with debt financing will tighten the spread between cap rates and lending benchmarks. This environment could weigh on transaction activity as investors evaluate their yield options. Cap rates have remained relatively stable over the last year, but upward movement in Treasury rates has amplified the expectation gap between buyers and sellers.
- **The capital markets environment continues to be highly competitive.** Government agencies continue to consume the lion's share, just slightly over 50 percent, of the apartment lending market. National and regional banks control approximately a quarter of the market. Growing uncertainty about federal policy and global geopolitical concerns are keeping long-term interest rates down with pricing residing in the 4 percent realm with maximum leverage of 80 percent. Portfolio lenders will typically require loan-to-value ratios closer to 75 percent with interest rates in the high-3 to mid-4 percent range. As uncertainty remains regarding the possibility of tax policy revision, rental demand remains strong with the national apartment vacancy at 4.5 percent.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; National Association of Realtors; Moody's Analytics; Real Capital Analytics; MPF Research; TWR/Dodge Pipeline; U.S. Census Bureau