ApartmentResearch

MARKET UPDATE

Marcus & Millichap

Houston Metro Area *Third Quarter 2010*

Second Half Construction Slowdown to Aid Recovery

While risks of further deterioration remain, modest employment growth and restrained construction will help stabilize Houston apartment fundamentals during the second half of the year. The drilling moratorium in the Gulf of Mexico as a result of the Deepwater Horizon oil spill remains a near-term risk that could result in the loss of thousands of local positions. In fact, some Houston-based drillers have begun developing plans to move workers and equipment out of the Gulf region due to continuing uncertainty. Despite this, a steep slowdown in construction activity and private-sector job growth during the second half will help correct the supply/demand imbalance that has hindered the market for the last several years. The number of occupied units will rise by 2 percent in 2010, while apartment inventory will grow 1.6 percent, marking the first time demand growth will outpace the increase in supply since Hurricane Katrina. Although rent gains to date have been driven mostly by new supply, a forecast vacancy decline by year end will allow owners to raise effective rents and withdraw concessions.

While a few quality assets are trading in the metro, a significant number of available listings involve distressed properties. The opportunity to purchase underperforming Class C units will remain prevalent, as banks try to clear these assets from their books. These deals may face financing challenges, however, paving the way for cash-equipped buyers to acquire these properties at steep discounts and realize upside through operational improvement. Conversely, lenders continue to extend and modify loans for the top-end distressed properties or allow assets to be managed in receivership until marketwide operating valuations improve. A number of stabilized Class A properties have traded, meanwhile, and institutional activity continues to gain momentum. Velocity among assets priced above $10 million is healthy, as historically low interest rates spur demand. Through the end of the year, investors will focus on quality properties in top areas such as the Montrose/River Oaks submarket and the Medical Center/Museum District.

2010 Annual Apartment Forecast

0.8% increase in total employment

Employment: Houston employers will create 21,300 positions in 2010, a 0.8 percent increase. The local economy is stabilizing after shedding 98,300 jobs in 2009, but job growth is well below the 30-year annual average of 1.7 percent.

7,609 units will be completed

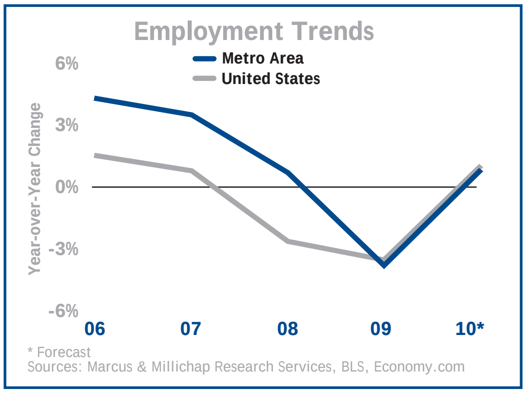
Construction: New apartment construction will begin to slow in the second half of the year. Developers will add 7,609 units in 2010, the lowest total since 2006.

20 basis point decrease in vacancy

Vacancy: Minimal deliveries and continued employment growth will push vacancy lower in the second half. Vacancy will finish the year at 12.1 percent, 20 basis points below the year-end 2009 rate and the first annual decline in four years.

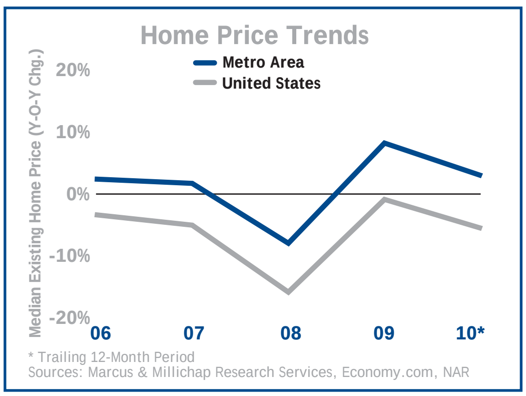
2.5% increase in asking rents

Rents: Increasing tenant demand will lead to rent growth slightly above the national average this year. Asking rents will end 2010 at $765 per month, and effective rents will rise to $698 per month, annual gains of 2.5 percent and 3.6 percent, respectively.



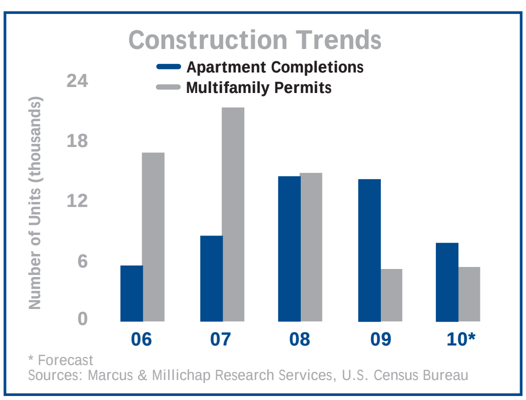
Economy

- In the 12 months ending in the second quarter, Houston employers cut payrolls by 16,000 positions, or 0.6 percent. The economy is beginning to recover, however, as 13,000 positions were added during the first half of 2010.
- The government sector has been a driver of the recovery this year, creating 11,400 jobs in the first half. Many of these positions will be shed in the coming months, however, as census work concludes.
- Just Energy recently announced a $2 million expansion of its call center in the Montrose/River Oaks submarket, which will add 200 positions to the area over the next several months.
- **Outlook:** Houston employers will create 21,300 jobs in 2010, representing a 0.8 percent increase. The local economy is stabilizing after shedding 98,300 positions in 2009, but job growth is well below the 30-year annual average of 1.7 percent.



Housing and Demographics

- Permits for single-family construction increased 13.4 percent over the past 12 months to nearly 22,000 units. Multifamily permits, however, fell 66 percent to just 3,204 units.
- The median price of a single-family home in the Houston metro area was $157,500 in the second quarter, a 3 percent year-over-year increase. Home sales during the first half of the year were 10 percent higher than the same period in 2009.
- Housing remains affordable in Houston, as the median household income is approximately $11,000 more than the minimum needed to qualify for a median-priced home. This income surplus is 39 percent greater than the national average.
- **Outlook:** The steep decline in multifamily permits is a positive sign for the apartment sector, but affordable housing and increasing single-family permits will generate additional competition for Class A properties going forward.

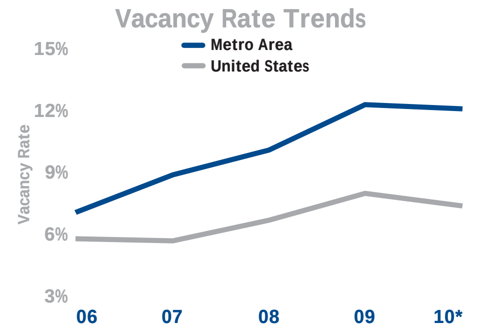


Construction

- Apartment completions totaled 6,155 units in the first half of 2010, representing a 20 percent decline from the same period last year. The Katy/Bear Creek submarket received the largest increase in stock so far this year, as 956 units were added, expanding area inventory levels by 5.4 percent.
- Approximately 1,900 units are under construction in Houston. Nearly 40 percent of these apartments are in the Clear Lake/Nasa submarket. The pipeline of planned developments in the metro is significant, containing 7,308 units.
- Roughly 600 units are under way in the Montrose/River Oaks submarket, all of which will come online by year end. New deliveries will total 2,230 units in the submarket this year, adding 6.8 percent to inventory.
- **Outlook:** Apartment construction will begin to slow in the second half. Developers will deliver 7,609 units in 2010, the lowest total since 2006.

Vacancy

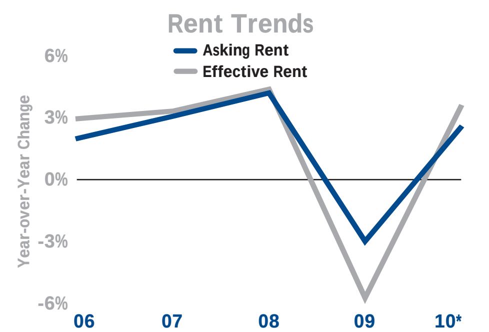
- The vacancy rate fell 50 basis points in the second quarter of 2010 to 12.4 percent, marking the first decline in four years. The average rate is still up 90 basis points from one year ago, however, as significant construction and weak employment weighed on the market.
- After reaching a peak in the first quarter, Class A vacancy retreated 80 basis points to 11.3 percent in the second quarter, as elevated leasing incentives offered in recently completed complexes attracted renters. While new construction in this sector has kept vacancy rates high, a slowdown going forward will allow demand to outpace supply.
- During the second quarter of 2010, Class B/C properties recorded the first quarterly increase in absorption since the third quarter of 2008. Properties in the Bear Creek/Katy submarket have performed particularly well, with lower-tier vacancy falling 310 basis points to 7.5 percent year to date.
- **Outlook:** Vacancy will finish 2010 at 12.1 percent, 20 basis points below the year-end 2009 rate and the first annual decline in four years.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

Rents

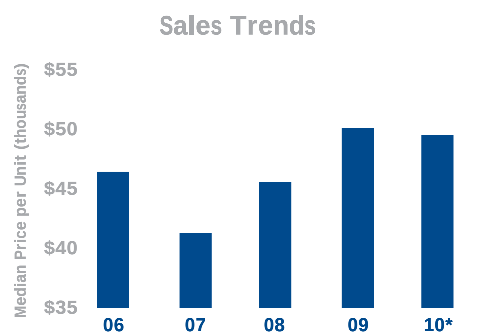
- Stabilization in occupancy has allowed owners to begin easing concession levels. In the first half of this year, asking and effective rents each increased 2.1 percent to $762 per month and $688 per month, respectively.
- After Class A asking rents declined 5 percent in 2009, new construction and rising demand drove up rates 2.4 percent to $935 per month in the first six months of this year. Class B/C asking rents have risen 1.5 percent year to date to $616 per month.
- The average revenue is down 3.2 percent from a year ago, as owners have cut rents to retain tenants. The decline appears to be over, though, as modest improvements in vacancy and effective rents have led to a 2.3 percent revenue increase so far this year.
- **Outlook:** Asking rents will end 2010 at $765 per month, and effective rents will rise to $698 per month, annual increases of 2.5 percent and 3.6 percent, respectively.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

Sales Trends**

- The pace of sales through the first half of 2010 was 24 percent ahead of the same period in 2009. Deal volume doubled over this most recent period as a result of sales of stabilized properties priced above $10 million and distressed trades.
- The median price for properties sold in the first half fell 20 percent from the same period last year to $51,700 per unit. A number of distressed properties changing hands contributed to the decline.
- Cap rates continue to rise, albeit at a slower pace than a year ago. The average market cap rate is 7.8 percent, up 20 basis points year over year.
- **Outlook:** Improving fundamentals will lead to future NOI gains and greater investor interest in Houston apartments. Buyers will target stabilized properties in primary submarkets, such as Montrose/ River Oaks and the Medical Center/Museum District, where renter demand continues to grow.



* Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., RCA

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

Capital Markets

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

- Mixed economic indicators, stock market volatility and concerns surrounding the European debt crisis continue to drive investors to safety. As a result, the yield on the 10-year U.S. Treasury has declined since peaking at 4 percent in April; as of late July, the yield had fallen to 3 percent.

- Capital markets loosened over the past year, with life insurance companies ramping up lending and CMBS showing renewed signs of life. Nonetheless, the agencies remain the dominant sources of multifamily lending. This trend will continue through 2010 as the GSEs' multifamily portfolios outperform their residential mortgage operations, reducing the likelihood of drastic government-mandated changes to their apartment lending arms.

- Multifamily loan originations increased 37 percent in the second quarter but remained below levels reported during the same period last year. Fannie Mae and Freddie Mac's origination volume followed a similar pattern, rising in the second quarter but falling short of year-earlier levels.

- Loan-to-values range from 60 percent to 75 percent for portfolio lenders and push up to around 80 percent for best-of-class, agency-financed deals. All-in rates for five-year agency loans fall into the low-4 percent range, while 10-year loans price between 4.75 percent and 5.15 percent. While life companies will compete at these levels for best-of-class deals, most portfolio lenders are 100 basis points to 225 basis points higher.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Sugar Land/Fort Bend County	7.4%	-60	$844	-3.0%
2	Katy/Bear Creek	9.2%	-50	$746	-2.2%
3	North Loop East/Sheldon	9.4%	-110	$614	-1.8%
4	Bellaire/West University	10.0%	-100	$941	-2.5%
5	Westchase/Woodlake	10.4%	300	$778	-1.1%
6	Cypress/Fairbanks	10.5%	-310	$739	-5.9%
7	Energy Corridor	10.6%	-60	$713	-5.3%
8	Clear Lake	11.0%	0	$702	-5.5%
9	Kingwood/Lake Houston	11.2%	-310	$727	0.6%
10	Pasadena/Deer Park	11.4%	90	$563	-2.8%
11	Medical Center/Museum District	11.6%	0	$613	-2.7%
12	Montrose/River Oaks	12.0%	400	$1,073	-0.7%
13	Spring Branch	12.4%	290	$635	0.6%
14	Sharpstown	12.8%	290	$540	-3.4%
15	Braeswood/Meyerland	13.5%	80	$541	-2.0%
16	Montgomery County	13.6%	-150	$721	-4.5%
17	Alief	14.1%	210	$548	-5.5%
18	San Jacinto/Galena Park	16.2%	320	$547	-2.3%
19	Inwood/Northwest Houston	16.3%	420	$561	-4.6%
20	North Houston	16.9%	230	$500	-4.4%
21	Spring/Champions	16.9%	-150	$627	-3.7%
22	Baytown	20.2%	720	$516	-6.4%
23	Heights	20.5%	450	$532	-4.7%

Marcus & Millichap
NATIONAL MULTI HOUSING GROUP

Visit www.NationalMultiHousingGroup.com or call:
Linwood C. Thompson
Senior Vice President, Managing Director
National Multi Housing Group
Tel: (678) 808-2700
lthompson@marcusmillichap.com

Marcus & Millichap
Real Estate Investment Services

Prepared and edited by
Bryan O'Keefe
National Client Services Manager
Research Services

For information on national apartment trends, contact
John Chang
Vice President, Research Services
Tel: (602) 687-6700 ext. 6803
john.chang@marcusmillichap.com

Houston Office:
Brent Smith
Regional Manager
brent.smith@marcusmillichap.com
777 Post Oak Boulevard
Suite 900
Houston, Texas 77056

Tel: (713) 452-4200
Fax: (713) 452-4210

Price: $150