MARKET REPORT

Marcus & Millichap

MULTIFAMILY

Houston Metro Area

Q2/19

Vacancy Moves Back Down Amid Curtailing Development and Positive Demographic Trends

Sustained job growth underpins rising demand. Houston continues to quickly expand as household and population growth rates are scheduled to climb higher this year. While many of these new residents will be employed within the energy sector, some are establishing themselves in the metro's prominent healthcare industry. In 2019, job creation is forecast to hit 101,000 — the second most of any metro in the nation. This, coupled with soften development, will keep market vacancy in the lower-7 percent band. A more balanced supply-demand relationship will encourage owners to steadily boost rents in response to market conditions. Rent growth among Class C units should remain stable this year, while gains for Class A and B spaces may continue to vary, potentially adding to the $500 gap between monthly rates of the two asset classes.

Construction ebbs as builders face challenges. Completions will slow this year as concerns of overbuilding and post-Hurricane Harvey flood-control regulations are putting a damper on development. Higher construction costs, fewer desirable sites and prolonged permitting and building processes within the area's flood plains are turning some developers away from Houston. As a result, deliveries will shrink almost 40 percent in 2019, marking the lowest completion volume since 2011. Downtown Houston will again sit at the forefront of apartment development, accounting for 700 new units. Several additional projects will be finalized in inner-ring submarkets where live-work-play communities are progressing.

Multifamily 2019 Outlook

5,100 UNITS
will be completed

CONSTRUCTION:

Completions will decline for the third year in a row as builders continue to cool construction efforts. Roughly 74,000 apartments were built during a four-year span starting in 2014.

0 BASIS POINT
change in vacancy

VACANCY:

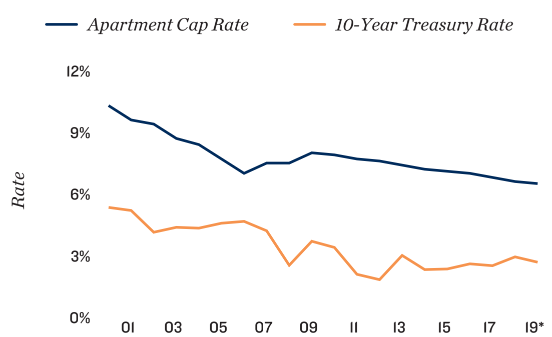
A lull in development will allow demand to catch up to supply, keeping market vacancy to 7.1 percent, still 200 basis points above the national reading.

3.0% INCREASE
in effective rents

RENTS:

Stable apartment demand will support a steady increase to monthly rates, pushing Houston's average effective rent up to $1,132.

Local Apartment Yield Trends



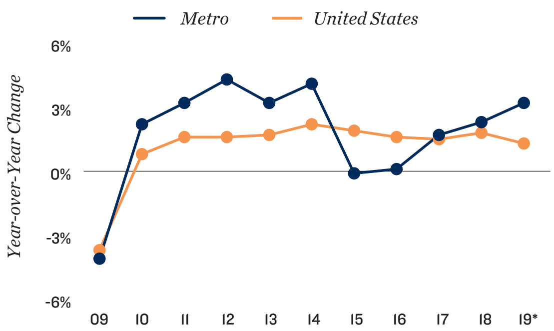
** Cap rate trailing 12-month average through 1Q; Treasury rate as of March 29*

Sources: CoStar Group, Inc.; Real Capital Analytics

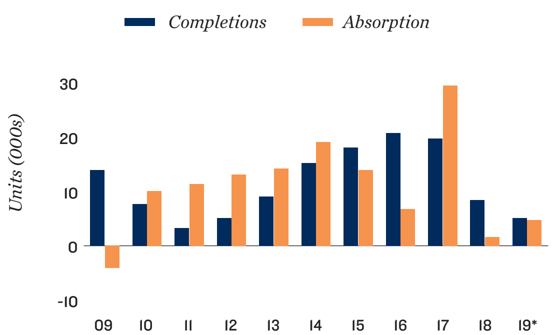
Investment Trends

- Local buyers continued to dominate trading activity as value-add options were frequent across the metro. Southeast Houston as well as parts of Pasadena garnered extensive interest due to proximity to numerous oil refineries and the thousands of workers seeking dwellings near their place of employment. Relatively affordable price tags attracted many entry-level investors.
- Northwest Houston remained a targeted area for investors with its plethora 1960s-built complexes. Though many of these assets require considerable rehab, quick access to I-10 and Beltway 8 boosts their upside. Here, the buyer pool was rather diverse, laced with institutional and private capital as property sizes greatly varied.
- Class B complexes in northern suburbs like Spring and Westfield attracted a number of investors. Exceptional household growth continues to draw attention to the area, keeping bidding strong as cap rates generally fell in the low- to mid-6 percent band.

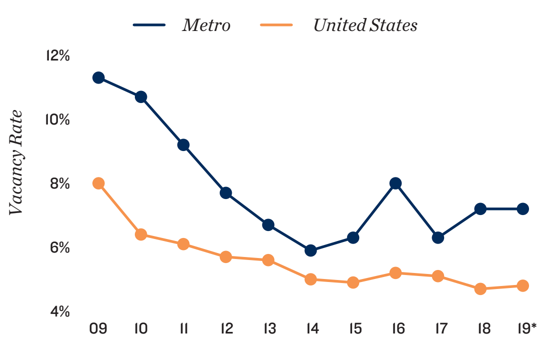
Employment Trends



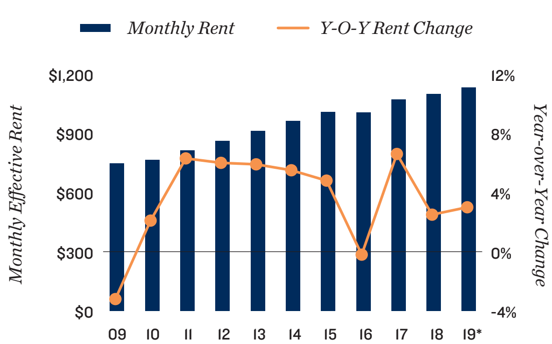
Completions and Absorption



Vacancy Rate Trends



Rent Trends



* Forecast

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

1Q19 – 12-Month Period

EMPLOYMENT

2.5% increase in total employment Y-O-Y

- Houston organizations staffed 75,600 new workers during the past year. The manufacturing and professional and business services sectors each gained 17,000 jobs.
- Metro unemployment retreated 50 basis points to 4.1 percent, supported by additional growth among education and health companies and government agencies.

CONSTRUCTION

6,600 units completed Y-O-Y

- Deliveries receded by approximately 60 percent from the previous year. Completions were most concentrated in downtown as the submarket received more than 1,500 units.
- Outside of the core, construction was most prevalent in the far northern suburbs and some eastern inn-ring submarkets. The Woodlands and Katy each received about 500 new apartments.

VACANCY

140 basis point increase in vacancy Y-O-Y

- High delivery volumes in recent years have substantially affected many parts of the metro, driving up vacancy rates in 33 of 35 submarkets over the past 12 months. This supported a significant increase at the market level, moving the rate to 7.4 percent.
- Availability ticked up among all asset classes, with vacancy in each tier rising by more than 100 basis points. Class B and C apartments witnessed the most substantial increases.

RENTS:

1.8% increase in the average effective rent Y-O-Y

- Climbing vacancy weighed on rent growth as the average effective rent moved up moderately to $1,105 per month. Last year, gains were much more pronounced at 7.2 percent.
- Effective rents in several inner-ring suburbs witnessed strong rent growth over the past 12 months as recent value-add investments came to fruition. Most notably, the East Inner Loop logged a 15.7 percent bump, driving the area's average to $1,195 per month.

Demographic Highlights

Five-Year Population Growth*

621,600

1Q19 Population Age 20-34 (Percent of total population)

Metro 22%

U.S. 21%

1Q19 Median Household Income

Metro $68,420

U.S. Median $64,259

Five-Year Household Growth*

237,500

Population of Age 25+ Percent with Bachelor's Degree+**

Metro 31%

U.S. Average 30%

1Q19 Total Households

Rent 39%

Own 61%

** Forecast ** 2018-2023*

**2018-2023*

SUBMARKET TRENDS

Lowest Vacancy Rates 1Q19

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Average Effective Rent	Y-O-Y % Change
Northwest Houston	5.8%	0	$848	1.7%
Gulfton-Westbury	5.9%	170	$955	-1.6%
East Inner Loop	6.0%	210	$1,195	15.7%
Greater Heights-Washington Avenue	6.3%	-10	$1,529	2.6%
Sugar Land-Stafford	6.3%	70	$1,216	3.3%
Galveston-Texas City	6.4%	120	$957	3.2%
Conroe-Montgomery County	6.7%	110	$1,022	7.2%
Sharpstown-Fondren Southwest	6.7%	50	$782	2.5%
Cypress-Waller	6.8%	-20	$1,222	1.9%
Humble-Kingwood	6.8%	210	$1,061	0.1%
Bear Creek	6.9%	140	$1,050	-0.5%
Overall Metro	**7.4%**	**140**	**$1,105**	**1.8%**

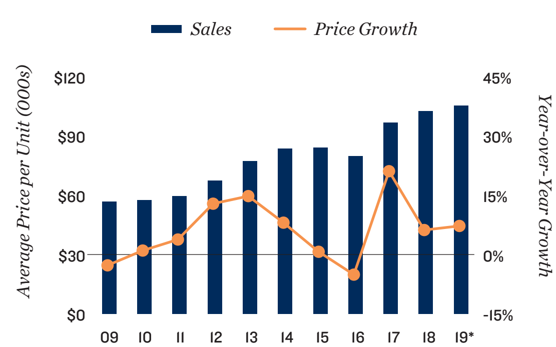
SALES TRENDS

Strong Investment Activity Continues; Favorable Cap Rates Bring Buyers to Southeast Texas

- Solid fundamentals boosted deal flow roughly 30 percent on a yearly basis. Asset appreciation was also strong as the average price per unit rose 7.2 percent to $105,200.
- First-year yields stayed on a downward trajectory, falling 30 basis points year over year to 6.4 percent. Returns among Class A properties, meanwhile, decreased slightly into the low-5 percent area.

Outlook: Increasing economic diversity will make investors more comfortable deploying capital in Houston assets moving forward. Relatively strong first-year yields will also drive investment.

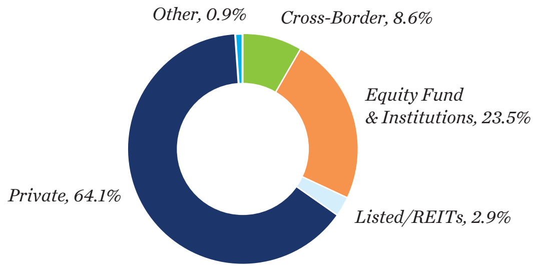
Sales Trends



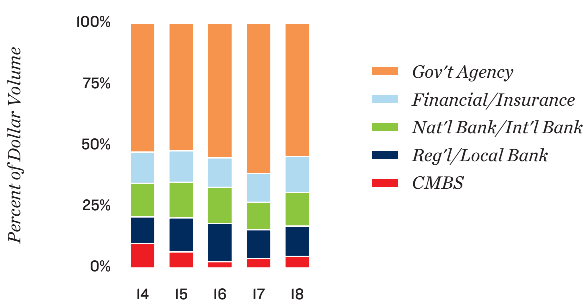
** Trailing 12 months through 1Q19*

Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

1Q19* Apartment Acquisitions By Buyer Type



Apartment Mortgage Originations By Lender



* Trailing 12 months through 1Q19
Includes sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation

- **International pressures weigh on domestic outlook; Fed remains patient.** Amid ongoing trade disputes between the U.S. and China and slowing growth throughout the European economy, the global economic outlook has become more cautious. Market volatility, combined with muted sentiment, has sponsored a flight to the safety of Treasurys, pushing the 10-year yield below 2.6 percent. While domestic growth has moderated recently, the waning impact of the tax cut stimulus will likely trim forward estimates further. As a result, the Fed has decided to cease reducing its balance sheet reduction through quantitative tightening by September and removed the potential for rate increases through the remainder of the year. The bond market has begun to price in a much more dovish Fed, with flattening interest rates reflecting more caution. Fed officials will likely focus on the intersection of a global growth slowdown and continued labor market strength to refine their plans moving forward, keeping interest rates stable for the foreseeable future.
- **Abundant liquidity sources balance conservative approach to underwriting.** The availability of debt for apartment assets remains elevated, spurred by the recent pivot by the Federal Reserve. Sourcing will be led by Fannie Mae and Freddie Mac, in addition to a wide array of local, regional and national banks, and insurance companies. Loan-to-value (LTV) ratios are trending between 65 and 75 percent on stabilized properties. The decline in interest rates has rewidened the spread between cap rates and Treasurys, reducing lender concerns about the risks related to repayment and valuation at maturity. Development and value-add projects have seen more conservative lending due to concerns surrounding overdevelopment and the length of the business cycle, leading to a greater use of alternative financing structures such as mezzanine loans and preferred equity to cover the additional capital requirements.

National Multi Housing Group

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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; RealPage, Inc.; TWR/Dodge Pipeline; U.S. Census Bureau