THE Neal Spelce AUSTIN LETTER

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Dear Client:

Welcome to 2003 – a year of economic transition for the Austin area. **This year will be better than last year**, **but the positive uptick will not be as rapid as in the boom years of the past**.

Looking around, you see signs of improvement in almost all sectors of the economy, but as is always the case, certain areas of our economy will improve at a faster pace than others. At any rate, the outlook for 2003 for you and your business here in the Austin area is good.

This is especially true when you look at some of the overall indicators — such as jobs. Jobs are at the heart of any economy. **If jobs are being created**, **the economy is on the move upward**. That's what is happening now, and by all credible forecasts, will continue throughout 2003 and for at least the next five years.

The key is *net* job gain. Sure, there will still be some layoffs. But, new jobs will be created at such a pace in 2003 there will be approximately **12,500 *net* new workers added to the 5-county metro area before the year ends**, according to The Perryman Group economic forecasters. And, that number should grow by 2.23% per year to 2007.

Although the recent collapse of the high tech manufacturing sector has temporarily damaged this segment of the economy (though the semiconductor chip industry is emerging from its slump as we speak), Perryman points out the **Austin area continues to be one of the nation's leaders in the computer and peripherals industry**. He notes our area is home to more than 200 companies supported by an extensive network of suppliers.

The economic forecasting group also reports the **software industry has remained strong** in spite of the downturns that accompanied the general economic slowdown over the last couple of years. The **biotechnology**, **film**, **music, and logistics and distribution industries** are also highly valuable contributors to the economic base of the Austin metro area.

Services and trade are expected to remain the two leading industries in terms of number of workers. So Perryman notes the Austin area's **economic prospects will be "positive during the short term**, **with momentum growing over the next several months**." Finally, the area's business-friendly and entrepreneurial-supportive atmosphere and its location on the IH35 corridor will continue to enable the area to be at the forefront of NAFTA-related activities.

What about one of the most visible signs of economic problems in Austin – empty office space? **What's happening there**?

There's no question that vacant office space in the Austin area is a knotty problem. We're in the midst of the **weakest office market in the last ten years** and, frankly, this is one of those areas that will **not improve measurably** right away. In fact, a **new problem** is going to face building owners in 2003 – how to deal with the imminent return of hundreds of thousands of square feet of vacant *sublease* space.

Bill Wendlandt's Office Leasing Advisors (OLA) points out that more than 3.5 million sq.ft. of space continued to be available on the *sublease* market. Landlords, however, continued to receive rent on this space from the original tenants. **The problem starts in 2003 when these leases begin to expire and building owners face the loss of this income stream**.

"In a market where more than 3 million sq.ft. of *direct* space remained unleased, **building owners are certain to feel the pain of these expiring leases** and the uncertainty of how (or when) this space would be leased," predicted OLA. "With the return of this vacant sublease space in 2003, it becomes entirely possible that rental rates will continue to fall."

Rates have already tumbled precipitously. OLA reports "Class A rental rates that peaked 24 months ago in the Central Business District at $40/sq.ft. had dropped to $25-$26 by the end of 2002. **A decrease of another $5/sq.ft. in downtown rates would mean a full 50% drop from the record highs of 2000**. Suburban rates that topped-out at $36 in 2000 showed a decrease to the $24 range."

By one measure the vacant office space is an economic blight but, frankly, it's good economic news for office operations wanting to keep overhead low. In fact, if you're looking for spiffy office space in 2003, you're likely to get a helluva deal. For instance, OLA says **tenants are now able to secure Class A+ space for only $5/sq.ft. or so more than Class B space**. Compare that to 2000 when the spread between Class A+ space and Class B was anywhere from $10-$15/sq.ft. Long-term rates remain the best bets for tenants in 2003 due to low rates and the ability to lock-them-in. Tenants will benefit this year, while building owners may suffer.

Okay, what about the high-rise construction that's underway downtown as evidenced by the building cranes looming in the sky? Construction is scheduled for completion on the 535,000 sq.ft. Congress at Fourth building before year-end. How unusual is this project? OLA says "**it is one of only a handful of buildings under construction in Central Business Districts nationwide**." So, what about pre-leasing, OLA? "Inquiries from interested tenants remain consistent, although it was unclear if any lease had been signed other than those of the two lead-tenant law firms that were completed more than a year ago." Downtown's other new high-rise, Carr America's 300 West 6th St. tower, remains 30% vacant almost a year after completion.

As Dell Computer goes, so goes the Austin high tech economy. Well, not quite. But Dell employs so many Austin area workers, and its stock is so widely circulated through the metro area, that a healthy Dell is essential to a healthy Austin economy. So let's check Dell's pulse.

Dell is going into 2003 in a very strong, vigorously healthy position. In fact, even though the high tech sector has been battered worldwide, Dell reported third quarter 2002 **profits up 31%** from the same period in 2001, as well as **record revenue and units sold**. Dell is **grabbing market share** and **expanding into new products**. And, it is doing this while keeping a lid on just about every expense category except advertising – an aggressive move that helped Dell increase market share while its competitors were pulling in their horns.

One of the reasons Dell has been able to do what it did during an anemic 2002, and is starting 2003 is such a solid position, is the Round Rock-based personal computer manufacturer is flush with cash. **Dell has an enormous cash hoard**.

It's almost an embarrassment of riches. **As of 11/1/02, Dell reported more than $9 billion of cash and liquid investments. Nine billion dollars**! The year before, Dell had eight billion dollars on hand. One analyst says Dell expects to generate another $3 billion in cash from operations during 2003. Wow!

How is the world's largest seller of PCs able to do this during these times? Well, we've been telling you for more than a year how Dell has **aggressively stepped up its take-no-prisoners marketing efforts while others are suffering**. It continues to pay off. The *Wall Street Journal* also provided a little more insight into Dell's cash-generating operations. First of all, Dell cut costs (remember all the layoffs at Dell's central Texas operations last year) to make its famously lean operations even more efficient.

"**Dell halved its factory space, while doubling the number of computers it builds**. Call centers were moved to India. Operating expenses are now less than 10% of revenue, down from 12% two years ago," reports *The WSJ*. Think about this: **operating expenses less than 10% of revenue**! That's not all. Dell excels at converting computers into cash.

"Many sales are by credit card over the Internet, where Dell is paid almost immediately. On average," reports the *Journal*, "**Dell collects its cash 30 days after a sale, compared with 42 days at arch-rival Hewlett-Packard Co.**, which conducts more sales via retail outlets." There's more. "At the same time, **Dell has been making suppliers wait longer to get paid** – 71 days, on average, up from 58 days two years ago. The difference," calculates *The WSJ*, "has **added roughly $1.8 billion to Dell's cash flow over the past two years**."

It's tough for Dell's suppliers here in the Austin area because they have to really manage their cash. But, they know Dell is good for its bills, even though Dell makes them wait to get paid. The tradeoff: a healthy Dell means a much healthier Austin area economy.

No reasonable analysis of the Austin area economy is complete without considering the impact of a war with Iraq.

Remember we told you last September, before the UN inspectors got involved — delaying a potential US attack on Iraq — "**the US will trigger the war in the winter months**" (9/27/02). We believe this is **still true** for the reason we told you back then: "It's better for our troops to wear the heavy, 'hot' military gear to protect against chemical/germ warfare in cooler weather."

A *short* war (on the order of a few months) will actually help the economy – a post-war boom triggered by **lower oil prices and increased US consumer and investor confidence**. And, since our local economy is very globally dependent nowadays, this will be significant for Austin.

Speaking of world turmoil, there's another intriguing facet of the terror attacks on the US that could inure to the long-term benefit of Austin's economic vitality. Small business guru **David Birch** has said "I've talked to an awful lot of people who don't want to locate a business anywhere near the Empire State Building, the Sears Tower, the Transamerica building in San Francisco, or anything that's more than 40 stories high. **I think there's been a fundamental shift in where people want to do business**."

Birch believes "**people are going to be locating small businesses on the fringes of cities**, **in the suburbs**, **even in the exurbs**." And he says areas that are losing population, such as California and New York – especially those with big cities – are going to suffer the most.

Austin, with no 40 story buildings and with thriving suburbs and exurbs in Williamson and Hays counties, **is positioned to be on the crest of this small business wave in the future**. And remember, small businesses – rather than large companies (though they get most of the notoriety) – are the true engines of job creation.

Wisdom for 2003: **Dr. Louis Overholster** says you can't shame or humiliate modern celebrities. What used to be called shame and humiliation is now called publicity!

Sincerely

Neal Spelce

Editor/Publisher

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