THE Neal Spelce AUSTIN LETTER

www.AustinLetter.com

P.O. Box 1905 / Austin, Texas 78767-1905 / 512-498-9495 / Fax 512-327-1976 / e-mail News@AustinLetter.com

Volume 24, Number 45

February 21, 2003

Dear Client:

While your stock market portfolio and your 401k declined dramatically last year, **the value of your home went up**. **But despite higher sales prices**, **homebuyers found homes to be just as affordable in 2002 as they were the previous year**.

You can thank lower mortgage interest rates, because "homebuyers could **buy the same home as the previous year for the same monthly burden**," said **Jack Harris**, research economist with the Real Estate Center at TexasA&M. "The payment to income ratio remained constant."

Actually the increase in home values could have been caused by lower interest rates. How's that? Well, low interest rates "allowed buyers to pay more for a home," noted Harris. "**Lenders were able to qualify borrowers for larger loans**, **thereby accommodating the higher prices**."

Also, "low mortgage interest rates allowed many buyers to enter the housing market who would not otherwise have been able to afford a home," said **Eldon Rude**, director of consulting for Metrostudy's Austin division. There was another aspect to 2002's low mortgage rates. "There was strong move-up activity in the Austin market," noted Rude. "Existing homeowners took advantage of the equity in their homes to **purchase larger and more expensive homes**."

The entry of first-time homebuyers into the Austin market as a result of low interest rates has impacted the types of new homes. "Our new home data indicates that the rate of new home starts priced *above* $200,000 has fallen over 35% since 2000, while the annual rate of starts priced *below* $200,000 dropped less than 5% during the same two-year period," Rude said.

We've been so consumed by the economic downturn over the recent past it's hard to realize we've had **four straight years of a sellers market in residential real estate**. And with the continuing low mortgage interest rates, "a seller's market still exists," said Harris. But, the growth in home prices is slowing so Harris thinks this may be a signal that "we are **nearing the end** of the seller's market."

To support his "the end is near" theory, Harris points out Texas homes appreciated 5.2% in 2001, then dropped to an appreciation of an average 3.5% in 2002. His kicker though is that the **median income rose only 1**.2%. So he thinks the tide could soon turn. Stay tuned.

Some numbers just don’t tell the whole story. **For instance**, **the citywide office vacancy rate at year-end 2002 was 16% — the highest rate in 11 years**. **But what happens when you add available sublease space to that total**?

When you assess the economy, some argue you should not count office space available for subleasing. After all, they say, landlords are still getting rent on that space. It’s still “leased.” All you have are some tenants looking for a little help while building owners are still getting a return on their investment.

But the fact remains, sublease space impacts the market — driving down rates for directly leased space. So what happens when you add sublease space to direct-lease space? NAI Commercial Industrial Properties (NAI CIP) ran the numbers and came up with **a huge 25% vacancy rate citywide at year-end 2002**. In the northwest, the number is much greater – 31%. It’s 26% in the SW and 22% downtown.

The amount of space on the sublease market is substantial. In fact, it has been hovering around the 3 million sq.ft. mark for some time now. It’s interesting to look at those subleases. When you do, you find **only three subleases account for about 37% of all sublease space**.

Those are big chunks and they have remaining terms exceeding 90 months, according to **Michael Buls**, of Buls Hodge Consulting. The three: **Schwab**, 452,000 sq.ft. … **Solectron**, 462,000 sq.ft. and **Las Cimas**, 156,000 sq.ft. And, get ready for another 100,000 sq.ft. to be added to the list when **Brobeck**, the California law firm that came to Austin in the high tech boom, closes its doors.

Buls says “sublease space will continue to be a major competitor to direct space.” In fact, he points out the **average term citywide is still in excess of 33 months**, while sectors such as the SW and NW have average terms of 43 and 49 months respectively.

Office rental rates citywide have dropped 23% over the last two years, according to NAI CIP. Where are they falling the fastest? NAI CIP reports the **largest percentage decrease over the last year was 18% in the NW**, **16% in the SW and 14% in downtown**. Average rates now equal those of 1998. Where will the greatest rate drops occur in the future? The greatest changes over the next 12 to 18 months will be downtown.

NAI CIP predicts this will happen due to two factors. One, downtown retains the highest quoted rates in the city at an average of about $24.20/sq.ft. So they have further to fall to get in line with the rest of the city. And, two, new construction will come on line in late 2003/early 2004 …large subleases will return to owners … and moves are already planned by significant tenants. “Overall, with more than 8 million sq.ft. available for occupancy, **tenants will remain in high demand and have significant control for the foreseeable future**,” predicts NAI CIP.

Now that the formal filing period for the Mayor and City Council election has opened, **will term limits have an impact on re-election plans as occured in the last election**?

The quick answer is no. Two of the council members who are up for re-election – **Danny Thomas** and **Raul Alvarez** – are *first*-termers. Term limits restrict council members to a max of *two* 3-year terms. **Will Winn** has opted to give up his council seat to run for mayor and Mayor **Gus Garcia** has said he will not seek re-election.

It'll be interesting to see how the actual filing for mayor and the three council seats (a majority of the seven-member body) shapes up. **If the races feature high-profile candidates in hotly contested races**, **it could mean a fairly high turnout** – especially since there will be other items on the ballot, such as additional funding for Austin Community College.

Then again, it wouldn't take too many voters to exceed the turnout in recent city elections. In the last regular mayor/council election 5/6/00, only 7% of the registered voters turned out to re-elect Mayor **Kirk Watson** (in 2nd place: cross-dressing street "person," **Leslie Cochran**). In the last election when the mayor's office was not on the ballot, 5/4/02, a 9% turnout elected **Daryl Slusher**, **Jackie Goodman** and **Betty Dunkerley** (they're now in the midst of a 3-yr term). Only in the special mayoral election 11/6/01 when **Gus Garcia** was elected to fill the un-expired term when Watson resigned, did the turnout reach double digits – 14%.

Proponents of increased taxes on tobacco are touting a statewide survey that shows widespread support for such a "**sin tax**." **But further analysis of the survey shows some interesting opinions about *other* forms of taxation**.

The survey participants were asked "If the Legislature is unable to balance the state's budget for the next two years, do you favor or oppose any of these possible proposals?" The options they were given: introduce a state income tax for corporations … introduce a state income tax for individuals and households … increase the sales tax … increase the gasoline tax … increase taxes on tobacco products and increase taxes on alcoholic beverages.

> **Quick now**, **guess which tax was the *least* popular**? State personal income tax? Increase the state sales tax? Nope, they tied for second *least* popular (only 21% favored) behind – **increasing the gasoline tax** (only 13% favored). Even instituting a corporate income tax was favored by less than a majority (42%).

As you would expect, the "sin taxes" were the only two options favored by a majority of Texans – **69% favored increasing taxes on alcoholic beverages and 75% would support increasing taxes on tobacco products**. While this was an independent scientific survey conducted by the reputable Office of Survey Research at UTAustin and has a margin of error of only plus-or-minus 3%, it really will only be one bit of info to be considered by Texas lawmakers.

Looking back at airline performance over the past decade, the history of a "low-cost-carrier-within-a-carrier" is not particularly positive. So is the rush to emulate Dallas-based Southwest Airlines' success doomed to failure?

United Airlines failed with its United Express concept. USAirways couldn't make a go of it with its MetroJet service. The Delta Express concept also died. Yet, as we told you 2/7/03, Delta is rolling out a new low-cost carrier called "Song;" United said it is going to try it again; and now, American Airlines confirmed to *The Dallas Morning News* this past week it hasn't ruled out coming up with a low-cost carrier approach.

This much appears certain. Every major US air carrier is changing the way it does business – except Southwest, which is only fine-tuning its solid business model which proved itself in the aftermath of 9/11. **The other carriers will be different, but not alike**, after they complete their metamorphosis. For instance, United could emerge from bankruptcy protection as a low-cost carrier, Delta will run two airlines (what's with the name "Song" for an airline???) and American will probably get concessions from its unions to keep attracting business travelers.

What kind of fine-tuning is Southwest doing? Well, you already know the airline didn't lay off a single employee and it has said it will slow its rapid growth during this uncertain economic time. Its flight attendants still sing over the PA on certain flights and peanuts are still a staple. But – what about that coffee?

Finally, Southwest is doing something about the gasoline it calls coffee! Those early-morning flights just became a bit more tolerable. The profitable Southwest grounded a Sara Lee brand of coffee and replaced it with a Canadian (with a plant in Ft. Worth) brand called Mother Parker's, a brand that is served to good reviews in the Corner Bakery Café chain. It isn't shade-grown Colombian or Sumatra for the coffee connoisseur, but it's an improvement.

Dr. Louis Overholster points out February has always been called the shortest month. This, of course, was in the days before creative accounting!

NEAL SPELCE AUSTIN LETTER (ISSN 1071-0612) is published weekly, except last two weeks of the year, for $150 (plus tax) per year or $249 (plus tax) for two years. To subscribe, call 512-498-9495. Periodical Postage Paid at Austin, TX 78767 by Austin Letter, Inc., 1407 Wild Cat Hollow, Austin, TX 78746. POSTMASTER: Send address changes to: Neal Spelce Austin Letter, P.O. Box 1905, Austin, TX 78767-1905.

Sincerely

Neal Spelce

Editor/Publisher