THE Neal Spelce AUSTIN LETTER

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Dear Client:

The Austin area's most vigorous leasing quarter of the year provided the largest quarterly increase in apartment occupancy in more than five years.

Occupancy rates rose from 86.5% to reach 89.36% for the 3rd quarter. This 2.84 percentage point increase "represents the highest increase of any quarter since 3rd quarter 1998," reported **Robin Davis** with Austin Investor Interests. She also noted that "**for the first time in 24 months**" **rental rates remained stable**. After a couple years of declining rental rates, this is another sign of a stabilizing economy.

What's happening here? Davis reports "many of the increases and positive trends reported this quarter are a **direct result of returning students** and some positive movement in the area." She also observed that not as many new apartment units are coming on-line, as has been noted in the past, and this allows for absorption of existing units.

"**The development activity pipeline has slowed to levels unseen in many years** and the completion of units currently under construction is not expected to impact the market negatively in any region other than the Southeast," Davis commented.

While the student impact on August apartment occupancy cannot be discounted, we should point out there have been no significant increases reported in the student population this year – and apartment occupancies in the previous five years have not increased as much as this year. Also, this positive development is taking place while there have been the normal "move-outs" and "special jumpers." So, all in all "the news is good," says Davis.

Apartment owners and managers have not let up in their aggressive pursuit of tenants. You may not have seen as many big "free rent" banners draped across large apartment complexes, but Davis assures us **concessions remain prominent**. What happened to lessen the signs is that just more than 24% of properties reduced rents in lieu of specials.

What's next? "In the short run, we can expect occupancy rates to dip" about one percentage point over the next 90 days as we enter a seasonally slow period," Davis predicts. But at the end of this cycle, Davis thinks we will see "**slow but steady movement** in the market for the next few quarters."

Another positive aspect about the increase in apartment occupancies is that it came at a time of huge increases in the sales of Austin area homes.

During a period of low interest rates and a large number of homes listed for sale, many apartment dwellers start looking at their monthly rental costs and decide they can **afford to make that big leap to first-time homeowner**, with little or no increase in their monthly payment.

This is what is happening in the Austin area. "Loss of tenants to home buying is still prominent," admitted Austin Investor Interests' **Robin Davis**, who tracks apartment occupancies. And that makes the vigorous leasing activity in area apartments during the 3rd quarter all the more impressive.

By the way, home sales in the Austin area – as well as around the country – are confounding the gloomers-and-doomers. **Building and home sales have been strong throughout the year**. In Austin, more homes are on the market and more have sold so far this year than last year at this time. Homes do take a little longer to sell than last year, but they are still selling.

Remember, after dipping way down, long-term mortgage rates started rising. That's when you started hearing predictions about how home sales would be impacted negatively. It hasn't happened. And now many who watch housing activity are saying they "underestimated" the strength of residential real estate. That's a nice way of saying they were wrong.

Trying to keep up with the improving apartment market, **Austin**'**s overall *office* vacancy rate improved in the 3rd quarter – after four quarters of stagnation – resulting in positive absorption for the first time in a year**.

This was the finding of Colliers Oxford Commercial Office Market Report. But it hasn't turned into a landlord's market by any means. Colliers Oxford notes "**tenants searching for lease space maintain leverage** as landlords continued to lower rental rates and offer incentives such as aggressive tenant improvement allowances, rental abatements and moving expenses."

The 3rd quarter overall vacancy rate improved by dipping to 22.**9**% — down by more than 300,000 sq.ft. from mid-year, according to Colliers Oxford. The 3rd quarter average full-service (this includes operating expenses) *rental rate* was $18.50 per square foot per year – falling just more than 2.3% from the previous quarter and approximately 13.6% in the past year.

A prediction: **2004 should see a lot of office building sales**. This is the forecast of **Michael Buls**, Buls Hodge Consulting, who is predicting investors looking for bargains "are eager to get into the Austin market or increase the number of properties they have."

What if, ten years ago, the City of Austin had ponied up enough incentives for Dell Inc. to locate its HQ here — instead of in Round Rock? Well, for one thing, Austin's sales tax revenue would be so significant the current financial crisis facing the city would be greatly minimized.

It was around 1993 when the rapidly growing, Austin-based Dell Computer Company started scouting locations for its main campus. (This was just ten years after UTAustin student **Michael Dell** had this "crazy" idea about making computers and selling them direct to the consumer – bypassing the standard retail outlet operation.) **Several possible locations were pinpointed in Austin and another in Round Rock**.

Since each location would work for Dell, the company negotiated with Round Rock and Austin city leaders for incentives. Round Rock officials were aggressive; Austin leaders less so. Round Rock even offered to **rebate a portion of the city sales tax for a while on computers sold out of the plant**, if Dell located at the Round Rock site (remember, as the manufacturer sells direct to the consumer, it charges a sales tax to Texans). Austin didn't match the offer.

Round Rock officials figured, what the heck, they weren't getting any sales tax revenue at all while Dell was in Austin. So, they could "**give up**" **something they weren't getting right now — for a future return**. That proved enough for Dell and, oh, what a sweet deal it turned out to be for Round Rock.

As we've been telling you for a couple of years now, the downturn in the economy has cut into sales tax revenue levied by the City of Austin. This has amounted to millions and millions of dollars and has been one of the contributing factors to the financial crisis in city government. And it's a continuing problem. In fact, **the revenue the City of Austin gets from the sales tax is down by 5.97%** so far this year from the previous down year. It has pulled in $**5,505,987** ***fewer*** **sales tax dollars** during 2003's first three quarters than in the same time frame in 2002.

Meanwhile, **Round Rock sales tax revenues are booming – up 17.31%** so far this year compared to last year at this time. Yeah, but aren't all those new retail operations springing up in Round Rock contributing to that hefty increase? Of course they are (and many of those retailers located there because of Dell). But let's look closer at the numbers to gauge Dell's impact on city revenues.

Round Rock's mayor is quoted as saying Dell's Texas sales alone make up 48% of the city's sales tax collections. If you do the math, you find that **48% of Round Rock's sales tax collections so far this year is a whopping $18,269,794.69**. Think about that. This is more than three times the slippage in Austin's sales tax revenue so far this year. You don't think that would make an impact on Austin's city budget! More than $18 million in sales tax revenue. From Dell's sales alone.

Of course, none of this takes into account the amount of property taxes paid to Round Rock by Dell and the more than 9,000 jobs created, etc. This is an important history lesson.

For as long as you can remember, every time you flew Southwest Airlines you got on the same type plane, with the same seat configuration. And your sole entertainment was the witty commentary of the flight attendants. This may be about to change.

The nation's most profitable airline, Southwest Airlines, has just notched its 50th straight profitable quarter. Other airlines have disappeared, filed for bankruptcy and/or seen their profits vanish to the point of seeming like a faraway dream. During the 9/11 crisis, Southwest was the only airline that didn't lay off employees. **So, if it ain't broke, don't fix it – right?** Maybe not. Word out of Dallas is there may be tinkering and tweaking in Southwest's future.

Southwest's chief financial officer reportedly is telling analysts the Dallas-based airline that flies more Austin passengers – by far – than any other, is considering **adding smaller, cheaper 100-passenger Embraer jets to its Boeing 737 fleet.** One of the keys to Southwest's profitability is that, with only one type of plane in its 385 airliner fleet, it saves bundles on maintenance, parts, supplies, etc.

Also, with witty banter and peanuts as almost the sole sops it gives to passengers, Southwest is also looking at **features that might be attractive to business travelers**, reports *The Dallas Morning News*. What gives here?

In a word: competition. In the past, Southwest's major competition has been the behemoth airlines that offered everything except an in-seat massage to their flyers. Now, in these tight times, other airlines are trying to emulate the Southwest model. A new low-cost carrier not yet flying to Austin, Jet Blue (that is buying a boat-load of the Embraer jets), is offering in-seat satellite TV. So **Southwest is taking a look at its hole cards** right now, deciding whether to "call," "raise," or "pass." Though there's no word they are considering assigning seats to passengers.

Dr. Louis Overholster looks at certain advice coming from Wall Street during the problem years and compared it to the snake in the Garden of Eden: "The snake was the very first Wall Street analyst. It offered bad advice — but only the ones who took it got punished!"

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