THE Neal Spelce AUSTIN LETTER

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Dear Client:

At mid-year, Austin area office space is not filling up quite as fast as it did in the 1st quarter, but this hasn't stopped a rise in rental rates, or kept investors from buying office buildings.

Although direct absorption of available office space was positive for the 2nd quarter, it **continued to remain slow, and in fact, dropped to 35,835 sq.ft. from the 49,274 sq.ft. absorbed in the 1st quarter**, according to Oxford Commercial. This hasn't stopped investors, owners and landlords from bullishly barreling ahead, apparently confident in the strong Austin area economy and its prospects.

Oxford says "the demand for office real estate looks promising as **Austin's economy continues to grow stronger** and overall rental rates rise," in spite of this relatively low absorption of space.

So, how much have office rental rates risen? The average market-wide rental rate approached $24.65 per sq.ft. (psf) in the 2nd quarter 2007. **This is a 5.9% increase from the previous quarter and a 16.3% increase from this time last year** – quite a hefty rate of increase.

"**The last time the Austin market has seen an overall average rental rate over $24 psf was back in 2001 when it reached $24.29 psf**," reported Oxford. So, even though demand has softened a bit, rental rates are moving somewhat counter-cyclically as they push upward.

You could logically assume one of the reasons rates are rising as demand softens is that **new owners need to press for a return on their investment**, and potential sellers may be trying to "**sweeten**" **their numbers** in order to get a better price in the marketplace.

And the deals keep coming. **During the quarter, the Blackstone Group portfolio of ten Class A buildings totaling 3.4 million sq.ft. were purchased by Thomas Properties Group for an estimated 1.5 billion dollars**. Hines Interests re-entered the Austin market with its purchase of 301 Congress from Crescent Real Estate Equities. Crescent also sold Austin Centre at 701 Brazos to Walton TCC Hotel Investors. In addition, Triple Net Properties is under contract to buy 816 Congress and Avallon from Crescent. You get the picture.

The risky part of reporting "overall average" numbers is they don't reflect the *extremes* that are combined to come up with an *average*. For instance, there is a significant difference between downtown and the suburbs when you look at office rents.

As we mentioned in the previous item, the average rental rate for office space in the Austin area has risen to $24.65 per square foot (psf) – a high not seen in years, according to Oxford Commercial. But, if you were looking for office space in the Central Business District (CBD) in the past few months, you discovered the **average rate downtown for Class A space was $34.17 psf** — almost ten bucks a foot more than you would pay in the 'burbs. To give you an idea of the rapid rate of rising rents, the same space in 2006 would have cost you an average $29.38 psf.

The "averages" also don't tell you the difference in *classes* of property. Class A is the highest level property class. Class A average rental rates downtown hit that $34.17 psf level in the 2nd quarter, but **you can still office in the CBD, if you don't need fancy digs, for a lesser price**. Some downtown office buildings have rental rates so low, it pulls the highest rate down to where the *average* (there's that word again) is $28.93 psf.

Back in 2000, before the Austin area economy started to slow down, the Class A rental rate downtown shot up to $38.10 psf and there was practically no Class A space available. Demand was driving this price hike. **The occupancy rate at that time was 97.5%**. Currently, it is 85.8% (see the previous story for what is pushing up prices today).

With rising rental rates, some Austin area office tenants are trading luxury for value and moving into space set aside for industrial purposes.

This is particularly true, according to Oxford Commercial, where Research & Development (R&D) Flex space is concerned. **Vacancy rates in the R&D Flex market have dropped five percentage points from this time last year**. Developers that have already taken advantage of the strong industrial market conditions and broken ground for new space are about to be joined by several other players, reports Oxford.

And there is a significant *spillover* effect. Neighboring Hays County (San Marcos), San Antonio, Georgetown to the north, and Bastrop and Manor to the east are becoming **reasonable options for large industrial users seeking lower rental rates, readily available cheap land, and tax incentives**.

Oxford says "these options continue to gain strength as the **Central Texas road systems improve with the addition of several new toll roads and expansions to existing highways**." At mid-year, this activity is a vote of confidence in the area's economic growth.

Where have all the apartment renters gone? The population and jobs are growing at one of the fastest paces in the nation, yet Austin apartment dwellers are declining in number.

One longtime Austin apartment expert, **Robin Davis**, suggests many renters are opting for ownership, and migratory job moves are chipping away at the apartment dweller base. Davis tracks apartment trends through her company, Austin Investor Interests. And she is expressing concern that apartment **"occupancy has stalled, even posting declines over the last three quarters**."

Her concern is heightened by what she sees on the horizon. No, it's not the economy. In fact, she points out all the good economic developments and wonders even more why renters are diminishing. But, long range? Her concern is based on what we have reported in recent weeks: **more than 23,000 new apartment units are proposed or under construction**.

"Another new trend is actually chipping away at supply," she notes. "**Since 2006, condo conversions and redevelopment plans have taken over 3,000 units out of the rentable inventory**. Half of these are 1960-70s product in prime locations that command higher-than-average rents and are set for re-development into high-end rentals."

"Although it is early to gauge demand for this product, it is worthwhile to mention that the few stabilized Class A properties in those areas, priced in that range, are reporting 89% occupancy – **admirable, but overall occupancy is down and herein lies the concern**," she added.

Davis went on about her conversion concern. The onslaught of new construction has yet to hit the Austin market. And she fears that "**many new condo owners will eventually put their units back into the rental market**, adding to the new unit surge that will befall Austin as current construction completes."

Texas political watchers are musing about the political plans of Governor Rick Perry. After all, he is raising money like he had a tough opponent. But the election is a long way off, and should he seek re-election, no opponent is in sight. So, what gives?

It's just good political business to keep a well-stocked war chest when you are in public office. **Perry reported this week he now has more than $1.4 million cash on hand, after raising almost $881,488 just in the last two weeks of June**. Perry will already serve as Texas governor longer than anyone if he completes his term. So, does he have his eye on national office? Maybe a deal with USSenator **Kay Bailey Hutchison** to "trade places?" Or even VP with any number of GOP hopefuls, to balance a ticket geographically, and deliver a huge block of Texas votes to the Republican standard bearer? He has a good start on money. Stay tuned.

If any city has been marked by change over the past few decades, it is Austin. But sometimes the extent of the change doesn't sink in until someone finds a new way to define it. KLBJ's Don Pryor has done just that.

On one of his radio commentaries, Don Pryor (son of the legendary **Cactus Pryor**) was musing and said, "I was just wondering if any of you remember:

Armadillo World Headquarters, The Split Rail, Austin Opry House, Soap Creek Saloon, Liberty Lunch, Mother Earth, Lakeview Inn, The Skyline Club, Triple J Tavern, The Top Hat, The Silver Dollar, Dessau Dance Hall, Palmer Auditorium, City Coliseum, The Stallion, Holiday House, La Tapatia, The Raw Deal, Another Raw Deal, Jerry Jacobs BBQ, Dale Baker BBQ, The Branding Iron, The Pier, 2Js, Youngbloods, Pelican Wharf, The Filling Station,

The Night Hawk, Texas Tumbleweed, Christie's Seafood, GM Steakhouse, Piccadilly Cafeteria, Marimont Cafeteria, Mad Dog & Beans, Mike & Charlie's, The Trading Post, Convict Hill, Toonerville, Villa Capri, The Alamo Hotel, The Gondolier Hotel, Kress's, Skate Land, Boat Town, Scarbroughs (downtown), J.R. Reeds, Merritt Schaefer & Brown, Jack Polk's Dependable Motors, McMorris Ford, Roy Butler Lincoln Mercury, Terminix on Lamar, Bowl-A-Rama,

Rooster Andrews Sporting Goods, KNOW, Capital Plaza Theater, Fox Theater, Southwood Theater, Varsity Theater, Hancock Theater, Aquarius Theater, The Chief Drive In, The Rebel Drive In, Kash Karry, Big Bear, Rylanders, Ballard's U-Tote-M, Handy Andy, A&P, Minimax, Winns, Woolworth, etc."

Pryor had more on his list. And we can add others (Reynolds Penland, Lowell Lebermann Lincoln Mercury, etc.). But there is not enough space. Pryor closed his commentary somewhat wistfully, saying "**If you don't remember**, **too bad**; **you got here too late**."

Dr. Louis Overholster suggests a cellphone ring for his hypochondriac patients: a coughing sound!

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