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Dear Client:

There's an interesting push-pull dynamic between landlords and tenants underway in the Austin area office market and one expert thinks both sides may be forced to give-in.

As we have chronicled previously, quoted *rental rates* have gone up, but the *occupancy rate* has dropped. As a result, the first half of 2007 has been “disappointing” compared to the strong performance in 2006. This is “**due in large measure to the completion of several office buildings that opened vacant, or with very few tenants,**” said Charles Heimsath, president of Capitol Market Research, who has been tracking the Austin office market for decades. And rising office rents have also been a big factor.

“The new market rates are being met with considerable resistance from both existing tenants and companies relocating to the area,” Heimsath said. The dramatic increase in rents is due to the increasing cost of construction and substantial increases in operating expenses, he added.

Fifteen new office buildings under construction are adding to this dynamic. Most of the 2.3 million sq.ft. under construction is *not* pre-leased. **“This new supply is available at rates that are substantially higher than existing leases and very few tenants are committing to the new rates,”** Heimsath noted.

So what is likely to happen, Charles? **“Eventually, the quoted rates will have to move down and the tenants will have to increase the leasing expenses in their annual budgets,”** he predicts.

This dynamic started earlier this year. **“For the first time in several years there were multiple new office completions in the first six months of 2007,”** Heimsath reported. “All together, a total of 760,915 sq.ft. were added in the first six months. **However, only 36% of the new space was occupied upon completion,** therefore when the buildings opened, 483,811 sq.ft. of new vacant space was added to the market.”

Here's where the Austin office market stands at this juncture. Since December, including sublease space, **occupancy dropped 2.5 percentage points** to 85.3% by the first of July. The occupancy for “direct” space decreased from 88.9% in December 2006 to 86.4% at the end of the first half of 2007. Sublease space is stable, new “direct” space is not.

Despite a tug-of-war between office tenants and landlords, investors are elbowing others out of the way to buy office buildings in the Austin market at a frenzied pace.

The buying frenzy experienced last year has continued into 2007 when **more than two dozen multi-tenant office buildings were sold throughout the Austin region**, comprising 6.13 million sq.ft. of space, according to **Charles Heimsath**, president of Capitol Market Research.

Of all the market areas, **Austin's Central Business District (CBD) saw the most square footage sold** during the first six months of 2007 (this included the landmark Frost Bank Tower). But office building buying was not limited to downtown. Other areas were targeted as well.

In the Southwest market area, three buildings were sold. **Eight buildings were sold in the Northwest**. Two buildings were sold in the North Central market area. Three buildings were sold in Far Northwest. One office building was sold in the Northeast and one building was sold in the Central market area. **And eight buildings were sold in the downtown area.**

Heimsath reports the largest transaction, by far, was the Thomas Properties Group acquisition of 10 Class "A" properties for \$1.15 billion. Austin ranked 13th in the nation among major US office markets in terms of transaction values – ahead of Dallas, Denver and Chicago.

Toll roads have been open in the Austin area for a year now. With all the controversy surrounding the toll roads, it seems appropriate to see if Austin area motorists are paying cold hard dollars to drive on the roads. Bottom line: they are — and are surpassing projections.

Nearly a quarter million Texans have purchased TxTags, the decal that allows for automated access to the toll roads, with billing to follow. **And the new Central Texas toll roads are seeing as much as 168% more traffic than originally projected.** Here's the breakout:

Texas 130 is 48% higher than projected, Texas 45N is 168% higher than expected, Loop1 is 30% higher and 183-A is 152% more than the original projections.

Generally, those who purchase the TxTags are those who plan to use the toll roads more frequently. **Who is making these TxTag purchases? Residents from 12 counties** – Bastrop, Bell, Blanco, Burnet, Caldwell, Gonzales, Hays, Lampasas, Llano, Milam, Travis and Williamson. And as you might expect, Travis and Williamson counties account for the highest number of residents holding tags. For cities, Austin and Round Rock rank the highest.

One aspect of TxTag usage not covered in these numbers is **the number of tags purchased because they are good in other Texas cities such as Houston and Dallas.**

Major changes come slowly at large and ingrained institutions such as UTAustin. But certain steps are underway that could bring about significant developments in Austin's largest single economic engine.

For years we have pointed out that state funding of UTAustin has been curtailed dramatically as a percentage of the total budget. And that trend is continuing. "The 80th Legislature gave UTAustin a 1.8% per year increase in state funds for operations – about the same as the compounded annual rate of growth in state funding for the last decade," noted President **Bill Powers**. "**At the current inflation rate of more than 3%, this amounts to a budget reduction for UTAustin.** Moreover, the Legislature is funding UTAustin relatively poorly compared to most other universities in the UTSystem and the state."

"The reality is we have very little control over state appropriations, so we need to focus on those elements that we do control," Powers continued. "With focus and discipline, we can still reach our goals. Our budget is \$1.8 billion, and we need to make the most of it."

Powers' goals are lofty – "**to make UTAustin the best public university in the nation.**" With state funding diminishing as a percentage, UTAustin has been aggressive in seeking grants and outside sources to aid in meeting the goal. But Powers believes there is more to meeting this ambitious goal than money.

"We must pursue excellence in all we do – but not try to do everything," he has said. And this is where the significant changes may be in the offing. He is talking about **reviewing "all our programs to see if there are some that are no longer consistent with our strategic goals."**

Recognizing that change is a difficult and lengthy process in a university environment, Powers has "established a new council, the Policy and Planning Advisory Council, to help me reach **decisions on budget issues and strategic planning.**" He said the group, "which will act much like a cabinet, will include leaders from all our major campus constituencies, faculty, deans, department chairs, administrators, students and staff."

What will this Council do? "I will ask this council to help me **make tough choices about priorities, resources and the direction of the university.**" This is the group to watch as its recommendations evolve to determine how wide and deep the future changes in the university may be.

"This will be a painful process," Powers admits. "In its recommendations, the Commission of 125 emphasized that **the University cannot be all things to all people.** We must pursue excellence in all we do – but not try to do everything."

No timetable has been announced for this effort; but it could re-shape UTAustin's future.

There are great spas in the US where you can be pampered – Canyon Ranch, Grand Wailea, La Costa, The Greenhouse, etc. A spa in Austin has been ranked #2 in the US.

Many years ago, on the upper reaches of Lake Austin just below Lake Travis’s Mansfield Dam, there was a dilapidated group of cabins used for family retreats and a little fishing. The water was so cold, as it came out of the bottom of Lake Travis to form Lake Austin, it was *not* a popular spot for swimming or water skiing. **But it was a beautiful, secluded piece of land.** Out of this was born Lake Austin Spa Resort.

Celebrated Living, the luxury magazine for American Airlines Premium Class passengers, surveyed its readers for the best spas in the US and the **Lake Austin Spa Resort came in #2, just behind the world-famous Canyon Ranch Spa in Tucson, Arizona.**

“**This Texas Hill Country spa combines total luxury with the warmth of a friend’s lake home,**” raved the mag. “And this friend likes to cook!” It went on to point out that “At the 25,000 square foot Lakehouse Spa, guests cherry-pick from more than 100 treatments including the Lakehouse Lavender Signature treatment using lavender plucked from their Healing Gardens.”

While this is not the first national acclaim showered upon the Lake Austin Spa Resort, **it joins some heady company in a magazine read by folks who can afford to travel to a luxury spa resort — and pay for their services.** The other Top Ten spas, following Canyon Ranch and Lake Austin Spa, are: #3 Spa Grande at Grand Wailea Resort in Maui, #4 Sanctuary Spa Camelback Mountain in Arizona, #5 Spa at La Costa, #6 The Spa at Mandarin Oriental, Miami, #7 Spa Montage at Laguna Beach, #8 Spa Gaucin at St. Regis Resort, California, #9 The Greenhouse, Arlington, TX and #10 Spa Ojai, Ojai Valley Inn and Spa, California.

Dr. Louis Overholster was counseling a patient to always tell the truth. As he put it: “They say that George Washington could never tell a lie. My wife can – as soon as she hears it!”

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