THE Neal Spelce AUSTIN LETTER

www.AustinLetter.com

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Dear Client:

With tightened credit keeping many from buying a home and with Austin area median home prices rising, you would think the *apartment* market would be a big beneficiary. If so, you would be wrong.

The current fundamentals of the Austin metro market have been quite good – better than in most other markets around the nation. Apartment owners and managers have been loving it. **Rental rates have been on the rise for 12 consecutive quarters**. This is in spite of the fact that occupancy rates have teeter-tottered and shown very little positive growth.

Until now, there has been little cause for concern. Now, however, "**things are about to change**," according to Austin apartment researcher, **Robin Davis** at Austin Investor Interests. "The biggest challenge for Austin is about to come from the apartment market itself."

What's happening? Davis reports there are currently more than **17,000 new apartment units under construction** throughout the Austin area. What is really significant is that **10,000 of these are expected to hit the market during the next year at the rate of 2,500 units per quarter "regardless of economic conditions**," Davis said.

Up to this point, the number of new apartment units coming online has been gradual. But 10,000 new units hitting the market cannot be called "gradual," even though they will span several quarters. **These units are out of the ground and many are nearing completion**, so work stoppage is not a desirable option.

Is this important? You bet. This is "**unwelcome news to a market that has seen little gain in occupancy over the past couple of years**," Davis observed. As we have been reporting to you, the recent Austin apartment history shows that, save for a quarter of two, occupancy rates have remained relatively flat.

So what can you expect if these new apartment units start flooding the market? **Renters will benefit**. **First of all, look for those big banners to sprout on apartment buildings offering concessions to lure renters**. But the numbers that will be reported over the next year should show declines in occupancy as owners/landlords scramble to get renters.

A glut of new apartments soon to flood the Austin market, all competing for tenants, augurs a change in the local rental situation. So, armed with this info, what are investors doing?

Apartment buildings, always a measure of an area's economic health, have also been a part of many investors' portfolios. A good apartment building, full of tenants, in a growing market, can usually provide investors with solid cash flow and appreciation – so that, at the end of the day when the project is sold, the investor usually is satisfied. **Well, with an onslaught of new apartment units soon to come online, what are the investors doing?** Or, as some would put it, what is the smart money doing?

> Austin Investor Interests' **Robin Davis** pointed out that "although the number of sales during the first quarter was down from the last few quarters, there are still **17 reported transactions, totaling 4,002 units with a combined total price of $263,450,000**." Not bad. Not great, but not bad.
>
> So, what about the deep pockets' folks who are just now coming to the investment table – especially with the cash flow prospects dimmer than in the past, as we reported in the previous story? Davis says that "by the end of the first quarter, there were **91 properties reported on the market for sale. Seven already had contracts pending**."

This is a question without an answer today. **Let's wait and see what happens after investors crunch the numbers and analyze the economic prospects for Austin in the near term.** If they still come to the table and put up real money to buy apartment buildings, then that is a vote of confidence in Austin's economy. On the other hand, if they sit back and say "I think I'll wait awhile to see what happens," then we have another scenario. We'll watch it for you.

Is the Austin area different from other Texas markets when you analyze what is happening in the apartment market segment of the economy?

Taking a look at the fiscal year, ending in March 2008, it's interesting to see how **Austin's occupancy and rent trend lines stack up with other major Texas metros**, according to ALNsystems.com.

Occupancy in **Austin** decreased from 93.6% in March 2007 to 92.8% in March 2008. Average monthly rent increased from $790 to $805. Occupancy in **Dallas** increased from 90.1% to 90.9%. Rent went from $772 to $805. Occupancy in **Fort Worth** dropped from 88.8% to 88.7%. Rent rose from $681 to $714. Occupancy in **Houston** decreased from 87.9% to 87.3%. Rent increased from $717 to $745. And occupancy in **San Antonio** decreased from 90.5% to 89.9%. Rent increased from $686 to $715. **Rents rose in all the big metros, while occupancy declined in all markets except Dallas.** Austin is basically in line with the rest of the metros.

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A Texas tax revolt is brewing beneath the surface among small business owners. **It should erupt publicly in a few weeks and culminate with a full-court press when the Texas Legislature convenes in Austin in January 2009**.

The objective of this revolt is to modify Texas' new margin tax. The Texas franchise tax was re-worked in a special legislative session in 2006. You'll recall legislators were wrestling with an equitable way to fund education and one of the efforts was to try to plug loopholes in the franchise tax. When enacted, the changes resulted in the "margin tax" moniker because the **franchise tax was changed to be based on a company's gross *margin*, not profitability**.

Bear with us for a moment as we get through the mechanics. The margin tax, applies to companies whose gross revenues exceed $300,000. It is calculated one of three ways, whichever is smallest: 1) total revenue multiplied by 70%, 2) total revenue minus the cost of goods sold, or 3) total revenue minus compensation. **Some accountants say this is the only tax of its kind in the US**, **maybe even the world**. It is complex and a big change in the way Texas businesses are taxed.

The tax was due in two weeks – 5/15/08. But State Comptroller **Susan Combs**, recognizing the complexities of the new tax (as well as the complaints), has now **extended the deadline for payment of the margin tax by 30 days**.

But it's not only the complexity that is causing an uproar among small businesses around the state, it is the perceived *unfairness* of the margin tax. One small business owner was quoted as saying "it's not a fairly levied tax." **He said it penalizes businesses when they're not in a profitable mode**. As he put it: "It disregards your net revenue." And he followed that up by his own example.

He said his business reported a loss of $18,000 in 2007. **But he calculates he will owe the state of Texas $6,000 in margin taxes**, because the margin tax applies to his cost of material. He says he will have to take out a loan to pay the margin tax.

The revolting small businesses, still organizing as we speak, will probably push for legislators to **exempt businesses that are losing money or that are marginally profitable**. In fact, they may suggest the exemption from gross revenues be upped from $300,000 to $1 million. Also, under the new margin tax law, a business cannot deduct the cost of contract labor. They will likely push to change that.

How did this margin tax come to be? As we mentioned, it was part of the contentious effort to re-work state finances due to the mandate to re-do the funding of education. The Texas Tax Reform Commission, appointed by GOP Gov **Rick Perry** and chaired by former State Comptroller **John Sharp**, a Dem, formulated the margin tax. The Legislature passed it and the governor signed it into law. Stand by. You'll hear a lot more about this in the coming weeks.

The conversation and cussing surrounding health care costs too often do not include the cost of nursing home care. Nursing home care costs in Austin have risen faster than the national average, but are still lower than the nation's average.

So what does it cost for a year in a nursing home in Austin? Well, first of all, you can go high-dollar or bare minimum – as is the case with most purchases. But a financial security company based in Richmond, Va., Genworth Financial, conducted a **national Cost of Care survey to come up with average *increases* and average annual *costs***. The results are a bit enlightening.

Over a five-year period, the **cost of nursing home care in Austin increased 20**%. **And the average cost for a year in an Austin nursing home is** $**54,890**. The *national* average percentage increase is 17% and the nationwide annual cost is $76,460. For *Texas*, the comparable numbers are an average 24% increase over five years and the annual cost for one year in a private nursing home is $52,590.

San Antonio not only has the most expensive nursing home rates in Texas ($**67,624**), **but the costs in the Alamo City increased at the fastest rate** (34%) as well. By the way, for reasons unexplained by Genworth, Houston costs actually were *down* by 1%, while all others increased substantially.

But, be thankful that Austinites and Texans don't have to pay California rates for nursing home care. One year in a San Francisco nursing home now costs an average of $100,101. SanFran's rates only increased 12% over the five-year study span, while rates shot up 44% in Sacramento ($92,094) and 21% in Oakland ($92,740). It appears Sacramento and Oakland are in a race to raise rates to get them into San Francisco's stratosphere.

By the way, in addition to the relevance for those who may be facing paying for nursing home care, **these numbers also have implications for retirees as they consider places to spend the later years of their lives – thereby making an economic impact on their destinations**.

Dr. Louis Overholster is now calling the hucksters who sold subprime mortgages – entremanures!

Sincerely

Neal Spelce

Editor/Publisher