THE Neal Spelce AUSTIN LETTER

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Dear Client:

Average office rental rates in the Austin area continued to *increase* in the first half of this year. You would think this means the demand is increasing, but you would be wrong. Occupancy is *dropping*. What's going on here?

When you look at the first half of this year, you find that Austin area *office rental rates increased and the occupancy dropped*. This has an explanation. **Charles Heimsath**, president of Capitol Market Research, points out that "the occupancy rate dropped, due, in part, to the **completion of several buildings that opened with no tenants**."

Well, why are office rental rates going up? "**Landlords are attempting to maintain profitability while facing increases in operating expenses**," he said. Okay, so how do the rising rates affect tenants seeking office space? Predictably, the prospective tenants are balking. Heimsath said this continued **resistance from tenants to the higher quoted rental rates** is particularly noticeable "among the recently completed and under construction inventory."

The one bright spot, according to Heimsath, was the **strong leasing activity downtown**. But this occurred with no new building completions downtown.

The first half of 2008 is history. **What is likely to happen during the remainder of the year**? Because much of the rental/occupancy equation centers around the addition of new office properties, how many new office buildings are in the pipeline?

Heimsath points out that in addition to the 844,000 sq.ft. of space delivered in the first half of 2008, "there are also 14 new buildings under construction, with a total of **2.0 million sq.ft. of space**, ***most of which is not preleased***." And, he says "this new supply is being offered at rates that are substantially higher than rates among older buildings and only a few tenants are committing to the new rates."

Something has got to give. And we're starting to see that. There *is* some movement to try to lease up these buildings. Heimsath says the "effective" rates for new space have begun to come down as "**building owners offer incentives like free rent and enhanced allowances** to capture the few tenants that are actively in the market." And this trend, he predicts, will continue over the next 12 months. This bears watching as one economic barometer.

It appears to be the same song, second verse for the industrial real estate market in the Austin area.

During the first half of 2008, a little more than 1 million sq.ft. of industrial space was *added* to the market, but during the same period, only 253,000 sq.ft. of space was *leased*, according to the semi-annual survey conducted by NAI Austin, a longtime Austin commercial real estate firm with national ties. As a result, **the vacancy rate rose from 11% to 14%**.

Of the 35 million sq.ft. of industrial market in the area, **65% is warehouse/ industrial and 35% is flex/R&D**. What's the difference? Flex/R&D has a higher building finish-out and can be used as low-cost office space. Warehouse/industrial has very little office space and is used for storage and manufacturing.

But the vacancy rate in each category is eerily similar. **Flex/R&D has a current vacancy rate of 15% while warehouse/industrial comes in at 14%**, according to the NAI Austin tally.

What is anticipated for the rest of the year? "In the last half of 2008, a total of 1.2 million sq.ft. of space should be delivered to the market," NAI Austin reports. What does this mean? "While some of this space is pre-leased, **it is still likely that the vacancy rate will climb by the end of the year**." NAI Austin does hold out a little hope for improvement: "This may be partially offset by an increase in the rate of absorption that has taken place historically in the 3rd and 4th quarters for the past five years."

How about same song, *third* verse? The Austin area apartment leasing market seems to be a reflection of the office and industrial markets.

Through the 2nd quarter, the Austin apartment market is following the same pattern of **increased rents and decreased occupancy**. And, once again, the culprit seems to be the introduction of **new, high-end units**, according to **Robin Davis** with Austin Investor Interests.

But the impact was less than anticipated because only about half of the expected number of new units became available in the 2nd quarter. You know what this means. Those unrealized new units will increase the count for the 3rd quarter. **This could be a bummer for the apartment operators as the 3rd quarter usually sports a strong occupancy**. In fact, Davis says that "if developer expectations hold true," more than 5,000 new units may be completed by year-end.

Again, if this scenario develops the way it is trending, you can **look for apartment operators to increase concessions** in the latter half of this year to attract renters.

Austin, accustomed to leading Texas in many economic categories, is taking a back seat these days to the oil patch cities. Austin is still outperforming the nation, but Texas oil towns are stealing the spotlight.

Over the past year, the Austin area has added about 14,000 new jobs and the unemployment rate is 4.2%. **This is healthy**, but it is not up to the pace Austin has experienced in the recent past.

> **The big gainers in economic growth in Texas are areas tied to the burgeoning energy sector**. Shades of the days of the oil wildcatters, when oil well gushers were erupting and Texans flaunted their new-found wealth. Today, Houston, Midland, Odessa, etc. are back atop the economic heap. But the response seems measured. Sure, there is amazing wealth being generated. But it's not flaunted.

Between the two oil booms, there was a downturn in energy areas (remember the bumper sticker: "**Please, Lord, give me one more oil boom and I promise I won't XXXX it away this time**!"). Signs are that oil patch cities may be living up to the old bumper sticker.

One economic indicator where the Austin area seems to be thriving – in fact, going against the national grain – is in air travel.

Air travel cuts two ways. For business travelers, an increase in travel is one indicator of the **relative health of an area's business community**. For leisure travelers, an increase in travel is one indicator of **consumer attitudes and a reflection of their personal financial situation**. When you look at six months of data of travel through Austin-Bergstrom International Airport (ABIA), you get a positive picture.

> **Through 2008's first six months, air travel at ABIA was up 6%**. And a monthly travel record was set the month of June 2008. This is quite impressive in and of itself. But when you consider that airlines have raised fares and fees and have cut back on the number of flights – all due to the increased cost of jet fuel – it really is significant. Talk about going against the grain!
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> Not all airlines that fly through ABIA are sharing in this Austin travel surge. As you might expect, **Southwest Airlines has increased Austin market share at a greater rate than the overall increase**. It is up 8%, compared to 2007's first six months. Since it is building upon the largest market share of all – about a third of all Austin travelers – the percentage increase becomes even more impressive.

The other biggies at ABIA are all down for the year, compared to the first half of 2007: **American is off by 1%, Continental is down 3% and Delta is down 9%**. The shakeout is continuing with the airlines, but Austin travelers appear to be taking it in stride.

With more and more films being shot in Shreveport, **Louisiana** (**Shreveport**???), **what is Austin doing to maintain its position as a favored spot for filming**?

Louisiana and Shreveport in particular are forking over the big bucks and making it easy to shoot films there. Austin, which still enjoys a reputation as a great place for the film industry, is **facing tough competition** as production companies from around the nation are **looking for the best deal and the best facilities** to make their movies.

A national production trade magazine, *Markee*, recently spotlighted Austin as a great place for studios. It's one thing to provide a variety of locations – from rural to urban, to hills and flatlands, etc. – to entice moviemakers. **But most all of the interior scenes in movies are shot in studios**, **on sound stages where everything can be controlled**. Build a set, control the lighting and sound – and the studio can be made to look like any interior of any kind, anywhere.

But studios and sound stages cost a bunch of money. Austin Studios, run by the Austin Film Society, has carved five sound stages out of former airplane hangars at the old Robert Mueller Airport location. ***Markee* has taken notice of a $5 million city bond issue that will fund an upgrade of these facilities and sound stages**.

"The stages will be down from June and July until the end of the year, then we'll unveil the new stages," Studio Operations Director **Catherine Pennington** told *Markee*. The objective: "**We're hopeful of getting additional features**."

The trade pub said Parrington believes the upgrades will "**entice producers to come here from LA or neighboring states**. It will make more people aware we're here and put Austin on the map for filming. We want to get the word out beyond Austin." Austin has had success in the past, now it is focusing on the future – against formidable competition.

Dr. **Louis Overholster**'s surgical procedure on his father was very successful after his dad told him "If it doesn't go well, just remember, your mother is going to come live with you and your wife!"

Sincerely

Neal Spelce

Editor/Publisher