THE Neal Spelce AUSTIN LETTER

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Dear Client:

While politicians bandied around the bank rescue plan this week in Washington, Austin area financial institutions were still trying to do business in a very uncertain situation. Let's look at what is happening to local banks and bankers.

When you analyze what is happening in local financial institutions, you need to factor in the regulators. **Regulators are the watchdogs who guide and control most of a financial institution's policies and procedures**. Lending standards are tight. There is a very fine line separating the banks and the regulators, a line that impacts the Austin area bank customer directly. Here's how our friends at *Kiplinger* describe this push-pull effect:

> The regulators must **exercise sufficient strictness** to restore the integrity of the banking system – **without making credit so tight** it risks deepening the recession.
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> The bankers must be **tough enough with borrowers** to improve the bank's balance sheets and meet regulator's standards – but be **lenient enough not to drive more borrowers under**.

So how are Austin area bankers tiptoeing along this tightrope? Verrrry carefully.

> First of all, both new and existing loans are receiving **very careful case-by-case consideration**. Bankers know that many current borrowers are likely to be struggling and may need some forbearance. For instance, if existing loans are not in default – but borrowers are at some risk, maybe out of compliance with some of the regs – calling the loan is not a sure thing.
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> So the decisions by Austin bankers need to take into account not only what shape the borrower is in, but also the relative health of the Austin area and Texas market. **The one-size-fits-all national regs may not be entirely appropriate for Austin**. As a result, the bankers and regulators need to work closely with borrowers.

A personal relationship between Austin area borrowers and their friendly banker is essential during these times. Make no mistake, some area banks are under great stress. What is happening in Washington may ease the pressure somewhat because money needs to flow more freely through the economy. The verdict is still out. This requires very close monitoring.

One sector of the Austin economy that depends heavily on financing is commercial real estate. So what is the 2009 outlook for this segment of the Austin area economy?

In many ways, commercial real estate is fairly easy to predict for the short term. Leases are long-term with precise end-dates. Construction takes a few years, so units coming on-line can be pinpointed with reasonable accuracy. Pre-lease contracts help determine what is in the pipeline. Future demand is a bit more dicey to predict, but current trends are helpful there. So, **what do the Austin area experts envision for this year**?

> "**In most areas, 2009 will be challenging and very competitive** as building owners compete aggressively to capture tenants with expansion needs, or retain those whose lease terms are up for renewal," says **Charles Heimsath**, president of Capitol Market Research.
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> He does see one area with a silver lining. "**A notable exception is the Central Business District and the west end of 5th Street** where the higher occupancy rate and strong tenant demand will result in higher lease rates and continued positive absorption."

In looking *ahead*, Heimsath looked *back* and noted "the last half of 2008 fizzled to a close as occupancy continued to drop and absorption was eroded by the completion of new space." And he pointed out that **citywide "quoted" rental rates continued to move *upward***. The reason: landlords were trying to maintain profitability while facing increases in operating expenses.

> But future rental rates will reverse the upward trend. Austin's Oxford Commercial said "we predict **quoted rental rates to *decrease* between 10% and 20%** during 2009." The basis for this prediction is that "there is a vast amount of speculative office supply that has come online during 2008 and **landlords are eager to make deals to build value for their assets**."

The vacancy rate for office buildings underscores the reason for landlords to be aggressive in luring tenants. **The last time the Austin market experienced a vacancy rate over 19% was four years ago** when the overall vacancy posted a rate of 19.2% during the 4th quarter 2004. **The Austin office building vacancy rate for the most recent period, 4th quarter 2008, hit 19.4%**, according to Oxford. A year ago, the vacancy rate was 14.4%.

> What about *industrial* space? "**2009 should be a good year for corporate users to lease or acquire industrial space in Austin**," according to an Oxford Commercial report. The reason: there is an increasing amount of **businesses who are contracting and giving space back to the market**. As a result, Oxford suggests that absorption numbers will be low or negative for 2009.

Bottom line for office and industrial: **good year for tenants, difficult year for landlords**.

Well then, what about Austin area apartment buildings? How are they doing? After all, the UTAustin student body population is near record levels and they are big apartment dwellers.

College students may very well be major apartment dwellers. But there is this little thing called "supply and demand." Can you say "overbuilt?" According to **Robin Davis** at the apartment trend-tracking firm of Austin Investor Interests, **there are more than 10,000 units already under construction with the majority of these units expected to be complete this year**.

"Added to an uncertain economy rife with daily announcements of job loss, expect these units to **make 2009 a bumpy ride for the Austin area**," she said.

"This market has struggled with occupancy over the past three years," she pointed out, "and is now **facing the daunting task of welcoming an abundance of new units** in a period of time that is expected to be turbulent at best."

The 4th quarter 2008 results just reinforced her prognosis. The 4th quarter saw occupancy fall 2.2% and rental rates dip a bit. Declines are the norm for the 4th quarter. But she called it "**concerning" for a market that will "see approximately 7,000 new units added to an already faltering inventory**." This is what she means by a "bumpy ride."

Some changes are underway with certain airlines at Austin-Bergstrom International Airport (ABIA). And a couple of them are good news.

What could be the biggest development was the recent announcement that Alaska Airlines will begin new service at ABIA in six months — **flying non-stop flights between Austin and Seattle**. **Don't let the name "Alaska" fool you. The airline is headquartered in Seattle**. So the new Seattle-Austin service could open up a number of connecting flights for Austinites, not only to Alaska, but to a wide variety of other destinations.

Secondly, the airline that carries more Austin travelers than any other this week launched testing of airborne Internet access. Southwest Airlines is testing the system's effectiveness on only three planes for now. If the test is successful and is implemented system-wide, **it will enable passengers to log onto the Internet via their own Wi-Fi enabled devices**.

Finally, we have an update – somewhat incomplete – on the **merging of operations between Delta Air Lines and Northwest Airlines**. Both serve Austin travelers at ABIA. Delta will be the surviving entity with the Northwest name eliminated. As expected, gates will be dropped at airports where there is overlap or not enough service to justify using all gates currently allocated to the two airlines. This will save the merged entity big bucks. **No word yet on what will happen at ABIA**. But Delta promises to have all airports nationwide converted by year-end.

A once-thriving, often glamorous, Austin area industry has been ailing of late. Now a move is underway in the current session of the Texas Legislature to make it more competitive.

At one point, Austin was a major location for **feature and independent film production**, **television programming**, **commercials and video games**. But this activity has slowed the past couple of years. What's changed? The Austin area is still as attractive from a talent, atmosphere, infrastructure, etc. standpoint. The assets that made this area a hub for such activity have not changed.

What *has* changed is that other states have become more aggressive and are throwing money at the media producers. Many states have enacted specific fiscal incentives to attract and retain the media industry. Texas allows only a 5% tax rebate for these companies while the nationwide median is a 25% tax credit.

Some states **recently increased their incentives significantly to roughly five-to-nine times the amount Texas offers**. As a result, areas such as Shreveport — Shreveport! – have supplanted Austin as a major filmmaking location. Since 2002, Louisiana's film dollars have increased from $30 million to $620 million.

Supporters of the Austin film industry spout a raft of figures pointing out the economic impact – such as jobs and revenue generated — that comes from such activity. Two bills, Senate Bill 605 by **Bob Duell** (R-Greenville) and House Bill 873 by **Dawnna Dukes** (D-Austin), have been introduced in the Texas Legislature to give the state **more flexibility in offering fiscal incentives**.

Dukes called the bills a "win-win solution" to "keep producers coming to Texas, keep existing movie crews based in Texas and boost video game production." We should know soon if these measures are enacted because the Legislative session ends in less than four months.

Dr. Louis Overholster says he is excited about a new movie coming out: *The Good, The Bad and The Dow Jones Average*!

Sincerely

Neal Spelce

Editor/Publisher