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Dear Client:

**Even as the Austin area climbs out of the recession, the commercial real estate sector needs to hunker down for the long haul.**

So far, the national crisis in *commercial* real estate (CRE) has looked more like a slow-motion train wreck than the massive explosion felt when *residential* mortgage-backed securities failed. There is no need to go too deeply into esoteric economic analysis, but to fully understand the complexities affecting commercial real estate, some background is important.

First of all, according to the economists at the Real Estate Center at TexasA&M University, the CRE crisis is both financial and fundamental. **The *financial* crisis is being fueled by a lack of available debt financing.** Financial entities, except in the rarest of cases, are cracking down on commercial real estate funding.

**The *fundamental* crisis is being driven by changing consumption levels.** Consumers are spending less and saving more. And when they do shop, they look for lower-cost goods and services. The results are being felt in corporate earnings.

The dominant trend this year has been for firms to exceed profit expectations, but miss on revenue expectations. Profits are greater than expected **because firms are cutting employees, reducing real estate holdings and negotiating lower rent levels with landlords.** This has had a direct negative impact on net operating income for commercial real estate.

The real estate economists at TexasA&M predict that “**the commercial real estate crisis is likely still in its early stages.**” As a comparison, they point out the *residential* crisis did not suddenly materialize in the fall of 2008. They cite data that shows the crisis “took nearly two years to evolve ... reaching a crescendo in the fall of 2008 when Lehman Brothers and AIG failed and the Troubled Asset Relief Program (TARP) was born.”

The TexasA&M takeaway: Commercial real estate will not have as large an impact on the financial system as the residential mortgage crisis, but **the next four years will bring rising commercial foreclosures.** An increase in the personal savings rate will dampen the demand. To avert a severe crisis, bank balance sheets must be repaired or the commercial mortgage-backed securities market must be restored. Keep reading for an evaluation of the Austin area.

**Commercial office building construction in the Austin area is down. In fact, it is at a three-year low. Demand in the office market is not high enough to warrant new projects. What can be expected in the months and years ahead?**

The reason the Austin area construction is at a three year low, is that for the past three years there was a tremendous surge in office building construction. According to **Ted Doucet**, with Oxford Commercial, **more than 4.7 million square feet of new office space has been delivered to the Austin office market in the past three years.**

Of that new construction, less than 2 million square feet has been leased. Hence, a current glut. Doucet points out the current overall vacancy rate hovers around 22%. So what is the outlook for the office market? **“We believe the market will continue to soften for the next 12 to 26 months,”** predicts Doucet.

**And this is giving financial institutions that financed the tenant-hunting office buildings the heebie jeebies.** Many of these tenant-hungry buildings are not generating the revenue needed to meet obligations to their lenders. **Does this mean a surge in foreclosures?**

Ummm, not so fast. The economists at the Real Estate Center at TexasA&M say the staffing levels at the Federal Deposit Insurance Corporation (FDIC) make it **“difficult for them to force banks to foreclose on commercial real estate if doing so would place the bank in jeopardy.** The FDIC could not achieve an orderly unwind of banks if too many failed simultaneously.”

So, the TexasA&M real estate economists are saying **“at present, it seems that the forces working against a surge in commercial real estate foreclosures are stronger.”**

But they hedge their bets by saying the **“key to preventing a severe crisis will be to either repair bank balance sheets or develop a meaningfully large commercial mortgage-backed security market.** In the absence of these actions, the risk of a large wave of foreclosures *in the next year* rises significantly.” Otherwise, the trend in foreclosures could match loan maturity dates that are stretched out over the next four years.

Just this month, a **major Austin commercial real estate project – the W Hotel condo retail downtown project – secured new funding,** after its Chicago-based lender collapsed. *Don't underestimate the significance of this.* It not only was a vote of confidence for the developer and the Austin economy, but it was very rare in the current national commercial lending environment.

Still, it'll take a while to shake out. Meantime, **rental rates on Austin office building space continue to decrease.** So tenants are in a good position to get a good deal in office space.

**Several Austin organizations, as well as others in Texas, have made the Environmental Protection Agency's (EPA) Green Power Partnership's Top Partner rankings.**

The EPA rankings were awarded based upon high annual "green power" usage. And the Top Partner rankings were nationwide in scope and analysis.

**The Austin and Round Rock Independent School Districts ranked #1 and #2 respectively among US schools** for using the most power from renewable energy sources. AISD used 65.6 million kilowatt hours (kWh), while RRISD used nearly 17 million kWh. Pflugerville ISD ranked #12 in the nation with 996,000 kWh.

The #1 local government in the country was Houston, with annual usage of 438 million kWh. Dallas, #2, followed with 333.7 million kWh. **The City of Austin ranked #9 with 62.5 million kWh** and the Dallas-Fort Worth International Airport ranked #11 in the US with 52.5 million kWh.

In the college/university category, **TexasA&M ranked #6** with 43.4 million kWh. It was the only Texas university to make the Top 20.

EPA's Green Power Partnership works with more than 1,100 organizations to voluntarily purchase green power. The objective is to reduce the impacts of conventional energy use.

**Speaking of alternate energy, Texas still leads the nation in total megawatt hours of wind-generated energy installed and in megawatts added during the 3<sup>rd</sup> quarter 2009.**

If you've traveled across the vast expanse of West Texas lately, you have doubtless taken note of the many wind-turbine windmills — **looking more like airplane-propellers-on-a-pole than the old fashioned windmills of the historic Texas past.** Instead of pumping water out of the hardscrabble West Texas land, these new-fangled windmills generate electricity that is then fed along transmission lines to more populated areas of the Lone Star State.

The American Wind Energy Association reported this month that **Texas added 436 megawatts of energy during the 3<sup>rd</sup> quarter alone**, 185 more megawatts than added by the 2<sup>nd</sup> leading state, Oregon.

Not all the wind farms are in West Texas. Some are springing up along the Texas Gulf coast. **The state's total operating wind capacity is now 8,797 megawatts.**

Wind farms are still being constructed, with fanciful names such as Gulf Wind, Papalote Creek and Penescal. When these three farms are operational later this year and into 2010, they will **add almost 665 megawatts** to the current 8,797 megawatts wind energy Texas production total.

**The incredibly violent drug wars in Mexico, especially along the border with Texas, have had an impact in Austin, but especially in Texas border towns such as El Paso.**

As far back as May 2007, we cautioned against travel in certain areas in Mexico. Then earlier this year (click on the “archives” button at the top of this page and go to Volume 30, Number 47, March 6 2009) we gave you anecdotal evidence how **wealthy and influential Mexicans have purchased homes in Austin to move family members away from the violence.** But it is even more pronounced in Texas border cities, such as El Paso.

The flight of many of Ciudad Juarez’s entrepreneurs and residents across the Rio Grande to El Paso was described by one El Paso City Councilman as “**the largest migration of wealthy Mexican nationals since the Mexican Revolution.**”

The economic impact on El Paso is substantial. The city’s Hispanic Chamber of Commerce reports that **businesspeople from Juarez started more than 200 companies in El Paso in the 12 months ending July 31 2009.** This is a 40% jump from the same period last year.

**El Paso’s unemployment rate was 9.8% in September, the same as the national average** — but far lower than in other Texas border towns such as Brownsville and McAllen.

**Meanwhile El Paso area real estate agents report a bump in homes sales to Juarez residents and the apartment occupancy rate is about 92%,** higher than occupancy rates in many Texas major cities. Our previous reports about the violence in Mexico have addressed the *safety* concerns – especially for US citizens. Obviously, as this story out of El Paso indicates, there are also *economic consequences*.

When **Dr. Louis Overholster** was asked the best medical advice he gives to his patients, he didn’t hesitate to reply: “Never, under any circumstances, take a sleeping pill and a laxative on the same night!”

Sincerely



Editor/Publisher