THE Neal Spelce AUSTIN LETTER

www.AustinLetter.com

P.O. Box 1905 / Austin, Texas 78767-1905 / 512-498-9495 / Fax 512-327-1976 / e-mail **News@AustinLetter.com**

Volume 31, Number 42

January 29, 2010

Dear Client:

Two downtown Austin high rise office buildings have just sold and a major new regional shopping center/mall was bought out of bankruptcy court. **Does this January activity mean the Austin area economic "winter" may be about to turn to "spring**?"

Only one of these sales is really a typical transaction, so the activity may not indicate a true market shift. The sale of the **Chase Tower at 221 West 6th** was an outright purchase by a Dallas investor group. However, the other two sales are a bit more unique. Travis County has started the process towards possible purchase of the **office building at 700 Lavaca** in June. And, the **Hill Country Galleria** in Bee Cave is being bought out of bankruptcy court by an operator for about half the original development cost.

This activity contrasts dramatically with the fact that **over the last six months of 2009**, **only one office building was sold** – The Starr Building (75,509 sq.ft.). And, it was much smaller than the Chase (389,503 sq.ft.) and the 700 Lavaca St (almost 315,000 sq.ft.) office buildings. **Charles Heimsath**, president of Capitol Market Research, reports that "the national recession, local market uncertainty and the lack of financing" has combined to shut down the market for office acquisitions.

So what does this January activity mean for the future? **Rhonda Toming**, SrVP with local commercial real estate firm, Oxford Commercial, may have been a bit prescient. Before these three deals became public, she said "**the demand for Austin office investments remains strong** in spite of a lack of quality purchase offerings."

She went on to say that "while the overall universe of real estate players has shrunk in the downturn, **a large group of new players have recognized Austin as a primary market and are eager to deploy capital**." She continued: "Although still burdened with the reduction of rental rates and flat absorption, Austin is poised to return to equilibrium as jobs are created through corporate relocation announcements."

What this early spurt of economic activity in 2010 means for the rest of the year is hard to measure precisely, **but it is certainly better than no activity at all**. And it comes on the heels of the national real estate firm, Grubb & Ellis, naming Austin the number one market for long term office investment potential. So the table is getting set. Let's look at some more info.

A perspective is needed in any analysis of the Austin office market economy. **For instance the occupancy rates in area office buildings continued to decline at the end of 2009 and rental rates remained unchanged**, **indicating the market is still somewhat soft**. **What are the prospects for these parts of the equation**?

First of all, one of the major contributors to the decreasing occupancy is that **construction was completed on five office buildings in 2009**, **adding more available space to the calculation**. And now, "the pace of new construction has slowed and there is only one mixed-use building under construction, that contains a total of 35,000 sq.ft. of office space scheduled for delivery in late 2010," reports **Charles Heimsath**, president of Capitol Market Research.

So this vacancy-contributing factor of new construction will be mitigated quite a bit this year – allowing the occupancy to "catch up" as the economy improves. As Oxford Commercial puts it: "**vacancy rates will remain level** as demand for office space grows in 2010 and new construction ceases."

Oxford put this positive spin on the recent construction: "With numerous recently completed Class A office buildings vacant, **Austin is ready to accommodate large corporate relocations and expansions immediately**. Progress has already begun, as Hanger Orthopedics recently announced their plan to relocate their headquarters to Austin in 2010."

There's another perspective needed here. Back in the last real estate recession, there was a massive amount of *sublease* office space available – so much so that our reports tracked those numbers separately. **Tenants that scaled back**, **or didn't expand as they planned**, **put some of their space on the market at decidedly lower rates** – anything to recoup some of their lease obligation funds. It became quite a factor as Austin tried to recover from that downturn.

Last year, there was a dramatic increase in sublease inventory. But **Beverly Kerr**, the Austin Chamber's VP/Research, reports that "Grubb & Ellis' view is that the leveling off seen at the end of the year **insures sublease inventory will remain far off the record levels reached here in the last recession**." Also, Kerr reports that "CoStar, another source of office market data, shows vacant sublease space decreased in the quarter."

And this brings up the other factor to consider – *rental rates*. "Exhibiting a stubborn resistance to the soft market conditions, **a number of owners continue to quote relatively high rental rates**," said Heimsath. But Kerr points out that **net effective rates are certainly lower than asking rents given the kinds of incentives now prevalent**. Grubb & Ellis forecasts that asking and effective rents will **not finally bottom out until late this year or early next year**.

Another observation on rental rates: Oxford Commercial says "**rental rates should decrease** as landlords continue to compete for the growing number of tenants."

This week, Austin Energy (AE) tooted its own horn as having "one of the best showings by any green power program in the country." And it was announced that Texas installed more wind power than any other state last year. What about wind power as a mix in green power?

Austin is one of the nation's leaders in utilizing electricity generated by alternative sources (such as wind, solar, etc.) compared to traditional sources (such as coal, natural gas, etc.). As Austin Energy said this week "**almost 90 Austin Energy GreenChoice® customers are recognized among some 10 EPA lists of top performers**." And this includes a wide variety of users such as school districts, businesses and government agencies.

AE says its "Green Power Partnership is a voluntary program that encourages organizations to **buy green power as a way to develop renewable resources and reduce the environmental** impact associated with traditional power generation."

Wind power is a key part of the green energy choices for Austin Energy. So, what is happening to wind power these days? *The New York Times* reported that a move in the Northeast to replace coal and natural gas with wind power for 20%-30% of the electricity used in the eastern two-thirds of the US by 2024 **would require a reorganization of the power grid and a significant increase in costs**. And it would have **only a modest impact on cutting emissions linked to global warming**."

The article goes on to ask: "How much can the power system use and still remain stable, given that the **amount of electricity generated by wind turbines is as fickle as the breeze**?" The answer, according to the study is that heavy reliance on wind energy is "technically feasible" but will require significant expansion of the power grid. This is a study for the northeast but it has implications here.

So, how heavily is AE, or more precisely the state of Texas, **committed to wind power**? Based on current numbers, **a Las Vegas "Texas Hold 'Em Poker" player might say "all in**." The reason: **Texas installed more wind power than any other state last year**, according to the American Wind Energy Association. And 2nd place was not even close.

Texas reported the highest amount of wind power installations, adding 9,410 megawatts. Iowa came in 2nd with 3,670, then California and Washington with 2,794 and 1,980, respectively. Much of this increase, around the nation, was due to new funding by the American Recovery and Reinvestment Act.

Texas has a lot of wind. Boy, does it ever! But wind power is complicated. **Wind is difficult because of wind's intermittent nature** and the need for back-up generation when the wind is weak. But, the wind generation system could waste large amounts of wind power because, at many times during the year, the power grid might not be able to handle the amount of power that wind turbines were putting out. A better, costly, grid could lead to fewer blackouts.

THE Neal Spelce AUSTIN LETTER www.AustinLetter.com THE Neal Spelce AUSTIN LETTER www.AustinLetter.com

A current focus of community debate is how much the Austin area should give in incentives to companies that will create new jobs here in the Silicon Hills. So it's interesting to note that a new approach is underway in Silicon Valley's San Jose.

A City Councilman in San Jose, California, is making a move to give incentives to businesses that move into the *downtown* area. **He is suggesting city fees be waived, free parking be offered and companies be reimbursed for their taxes.** Specifically, a couple of the San Jose City Councilman propositions:

> **Waiving license fees for new small businesses**, employing up to 8 workers, that apply for a business license during a certain immediate time frame;
>
> **Waiving fees on parking leases** at city-owned parking lots for two years for businesses that sign or renew a lease in a downtown office or retail building, under certain conditions.

"These ideas can work effectively if packaged together to sell San Jose to the rest of the world," said Councilman **Sam Liccardo** in a memo. "The underlying principle of these ideas is simple: **We need to generate business activity to shake our economic doldrums**, and to use any 'net new' tax revenues as an incentive for that activity."

He recognized that his proposals, if adopted, would mean the loss of some short-term tax revenues. But, as he put it, "**defending the status quo, however, merely assures us that the city coffers will receive the same share of zero.**"

San Jose has, in the past, been competitive with the Austin area in economic development efforts. But now, the Austin area's economy is more dynamic than San Jose's. **It will be interesting to see how the California high tech city plays catch-up.**

Dr. Louis Overholster points out to his patients that middle age is when you start to realize that Tylenol may have Extra Strength, but you don't!

Sincerely

Neal Spelce

Editor/Publisher