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BEYOND THE TECH WRECK

Austin Commercial Market Recovers

By Harold D. Hunt

Five years have passed since the "tech wreck" of 2000. The Austin area's economy suffered a substantial blow when technology stocks plummeted and funding for technology startups dried up. Thousands of jobs were lost.

But Austin's commercial real estate markets are bouncing back. Transportation improvements are already providing a foundation for new commercial development opportunities (see "Movin' On").

The latest employment numbers from the Texas Workforce Commission reveal that job growth, a crucial component in the success of commercial real estate, is on the mend. Total nonfarm employment in the Austin–Round Rock metropolitan statistical area increased by more than 16,000 between June 2004 and June 2005, a 2.4 percent increase. By comparison, nonfarm employment actually declined by 8,200 jobs during the four years from June 2000 through June 2004.

Office Market Picks Up

Absorption and construction statistics from Capitol Market Research reveal that the 2000 downturn seriously affected Austin's office market. About 3.7 million square feet of new office space was produced in the Austin area during the five-year period from 1995 through 1999 with more than 5.1 million square feet of net absorption. But from 2000 through

2004, new construction rose to 6.9 million square feet while net absorption fell to 2.3 million. As of mid-year 2005, no new office buildings were under construction in the Austin area.

Both occupancy and rental rates are down significantly from their 2000 highs as well. Yet the Austin office market recently set a new sales price record. Bart Matheney, senior vice president of CB Richard Ellis, says that two things are at work here.

"Lower cap rates are reflecting the popularity real estate is enjoying as an alternative investment to the equity and bond markets. Austin also tends to be a high beta office market that should produce a rebound exceeding the national average as the economy improves."

According to Matheney, this is partly because of tech-related firms' ability to increase or shed jobs rapidly as conditions warrant.

Austin has added knowledge-based jobs during the recent recovery, which is a positive for the office market. As high-tech firms have begun to hire again, Austin and surrounding cities have been targeting companies that would normally create new jobs in San Francisco, San Jose or Boston.

"More firms are discovering that they can substantially reduce their labor costs just by moving to the Austin area," says Andy Carlson of the Greater Austin Chamber of Commerce.

Tenants are also migrating to higher-quality office properties. According to Derek Silva, office specialist at NAI Commercial Industrial Properties, "Average office rents are being driven by Class-A absorption. Tenants are moving up to Class-A space because the rents are still affordable."

The glut of sublease space that once plagued Austin has finally shrunk to less than 650,000 square feet in a 34 million-square-foot market. This should strengthen office rents. However, a significant gap still remains between current rental rates and rents that could support new construction. As a result, rents could rise further before new construction returns, allowing office landlords to enjoy a level of return not seen in several years.

***RENTS FOR HOT CLASS-A SPACE** such as the Frost Bank Tower (previous page) and One American Center (above) are still affordable, prompting local tenants to move up to classier digs and out-of-state businesses to consider relocating to Austin.*

Flexible Industrial Space

"We are finally beginning to experience some rent stability," says Royce Lacey, vice president of NAI Commercial Industrial Properties, regarding the improving industrial market.

NAI reports that overall rental rates increased 10 percent during the first six months of 2005 while the 18 percent overall vacancy marks a three-year low. No new industrial space was under construction as of June, other than one 56,000-square-foot flex building that was recently put on hold.

Rising replacement costs have been a major factor limiting construction of new industrial space. Chris Whitworth, a principal with the development firm Capitol City Partners, remarks, "We hear a lot about how low inflation has been. But I've seen a 30 percent increase in some construction materials during the last three years."

Suppliers to Austin's major high-tech firms are ramping up and taking more warehouse-distribution space according to Andy Thomas of Hill Partners, an Austin real estate development and investment company.

"The market for distribution space is robust and tenant concessions have virtually disappeared," says Thomas. "We've also seen our tenant credit 'watch list' decrease from a high of about 40 tenants to just two. That's out of a tenant roll that exceeds 300, and the watch list has been a pretty good market indicator in the past."

Thomas still remains cautious about the future, saying, "Some of the current absorption could come back on the market if the economy begins to stumble. The major high-tech firms are always looking for the lowest price from their suppliers, and they renegotiate their contracts annually."

As a result, suppliers hedge their space needs through use of termination options. The options give tenants the right to terminate their lease if they should lose their supplier contract. A significant turnover or reduction in suppliers could translate into a rapid increase in empty warehouse-distribution space.

As the Austin office market tightened in the late 1990s, flex-R&D space emerged as a cheap alternative to conventional office space for many firms. Historical construction numbers from Torto Wheaton reveal that more than five million square feet of flex space was constructed in the Austin market between 1996 and 2002, about one-third of the total flex inventory.

Flex space can generally be developed much more quickly than office space in the Austin market. One reason is that the construction is simpler. And because industrial space is usually built inside "preferred development" corridors, the permitting process is smoother than that for constructing office space in the highly desirable but environmentally sensitive southwest side of Austin, for example.

Much of the flex space was originally constructed for use by large tenants, such as Dell, before they shifted to owner-occupied space. As yet, no large tenant has emerged to occupy a significant portion of the available flex space, which explains the sector's 22 percent vacancy rate.

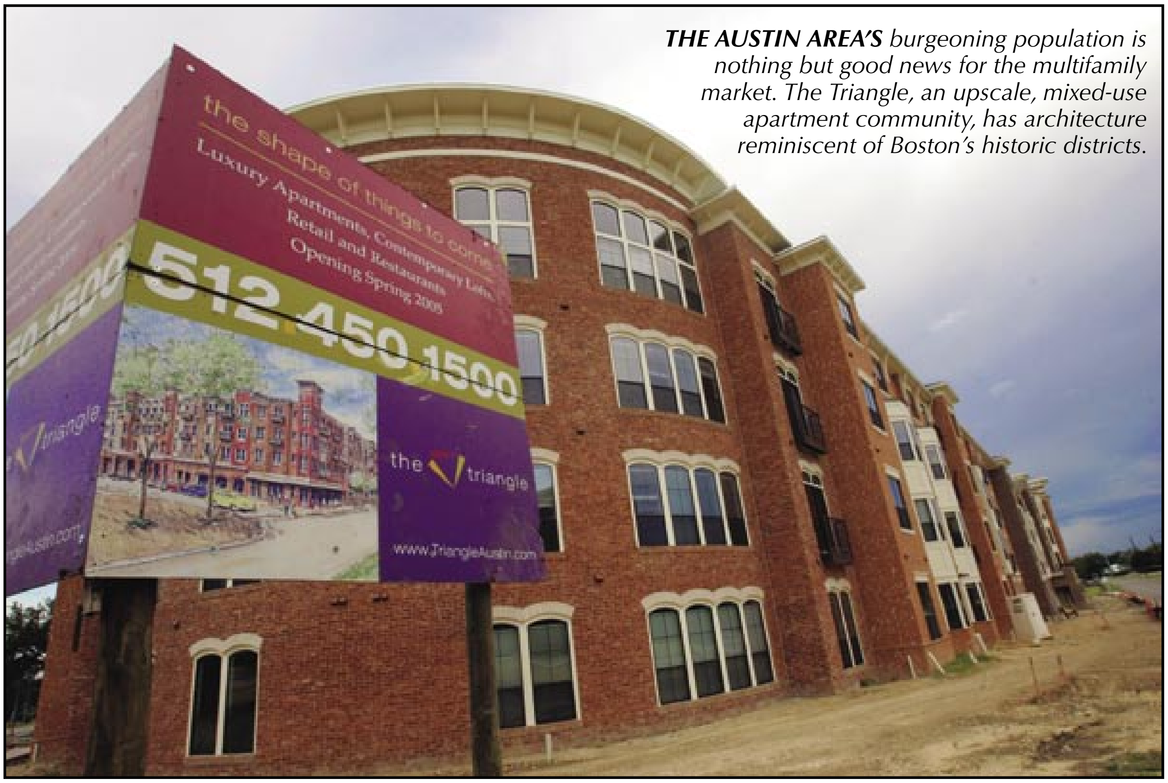
Spending $20 per square foot to subdivide large flex space buildings for smaller users is not cost effective under current market conditions. The smaller flex space that does exist has been largely successful in attracting new tenants. Total flex absorption in the first six months of 2005 exceeded 360,000 square feet, according to NAI.

New Retail Waves

In their heyday, regional malls offered consumers something new — shopping, dining and entertainment under one roof. But few if any enclosed regional malls are being constructed in the United States today.

"There has been a trend away from a shopping 'experience'

SHOPPERS TODAY *want to park close, shop fast and head out. The half-mile-long La Frontera Village development features multiple big box stores and smaller specialty shops catering to this trend.*



THE AUSTIN AREA'S *burgeoning population is nothing but good news for the multifamily market. The Triangle, an upscale, mixed-use apartment community, has architecture reminiscent of Boston's historic districts.*

to no experience," says Nate Nickerson of Primus Real Estate Services, a local commercial brokerage and services firm specializing in retail properties. Nickerson is referring to a transition from leisurely shopping to a more serious, business-like approach to shopping.

In the Austin region, construction is underway on almost every other type of retail development, including mixed-use properties, power centers (anchored by large retailers), lifestyle centers (unanchored specialty strip centers) and outlet malls.

Big-box power centers have become especially popular. Consumers continue to favor retail venues where a wide array of products can be purchased. Certain anchors, such as Target, have become especially popular with developers because other tenants such as Ross Dress For Less and TJ Maxx often come on board after Target makes a commitment.

The teaming up of big-box "category killers" will continue to make it harder for small, older retail establishments to survive in Austin.

"Some B-grade shopping centers in the 10,000- to 30,000-square-foot range that have lost tenants are spreading their risk by seeking out more service-based or medical-based tenants instead of traditional retail users," says Sherry Naquin-Sanchez, retail specialist for NAI Commercial Industrial Properties.

At the other end of the retail spectrum, The Domain shopping center, part of a 235-acre mixed-use development currently under construction in north Austin, will be home to some of the region's first true luxury retail tenants. Neiman Marcus will be one of the anchors.

The retail market continued to show its strength through the first half of 2005. Overall occupancy is a healthy 93.5 percent, with more than half a million square feet of positive absorption, according to Capitol Market Research.

Multifamily: It's All Good

Much like the office market, the apartment market has seen a flight to quality — people moving up to nicer apartments for the same amount of rent. Capitol Market Research reported in June that the average rental rate is down 17 percent from the mid-year 2001 high of 99 cents per square foot. However, rents have been rising slowly but steadily during the last year and overall occupancy was near 93 percent as of mid-year 2005.

Most incentives are gone, but rents are still below replacement cost to support new construction.

"The news is all good for the apartment market," says Charles Heimsath, president of Capitol Market Research.

A mere 714 units came online in the second half of 2005 while absorption topped 3,300 units.

Population growth is another big positive for the apartment market. Cities in Travis and Williamson County have witnessed tremendous population increases. Pflugerville's population was only 662 in 1980; the current estimate is about 28,000. Round Rock has grown from 12,740 to an estimated 82,000 in the same period.

Surrounding counties, such as Hays and Bastrop, are experiencing impressive growth as well.

The implication for Austin and its outlying areas is clear. As the population and number of households increases, so will demand for apartment communities.

"Every apartment builder is looking at the Austin market," says Kurt VanderMeulen, land and investment specialist for NAI Commercial Industrial Properties.

Things are clearly looking up for the Austin commercial real estate market.

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MOVIN' ON

Poor highway infrastructure has afflicted the Austin area for decades. Austin is the most congested midsize city in the country, according to the Texas Transportation Institute's 2005 Urban Mobility Report. However, relief is on the way in the form of toll roads, commuter rail and a new "rapid bus" service.

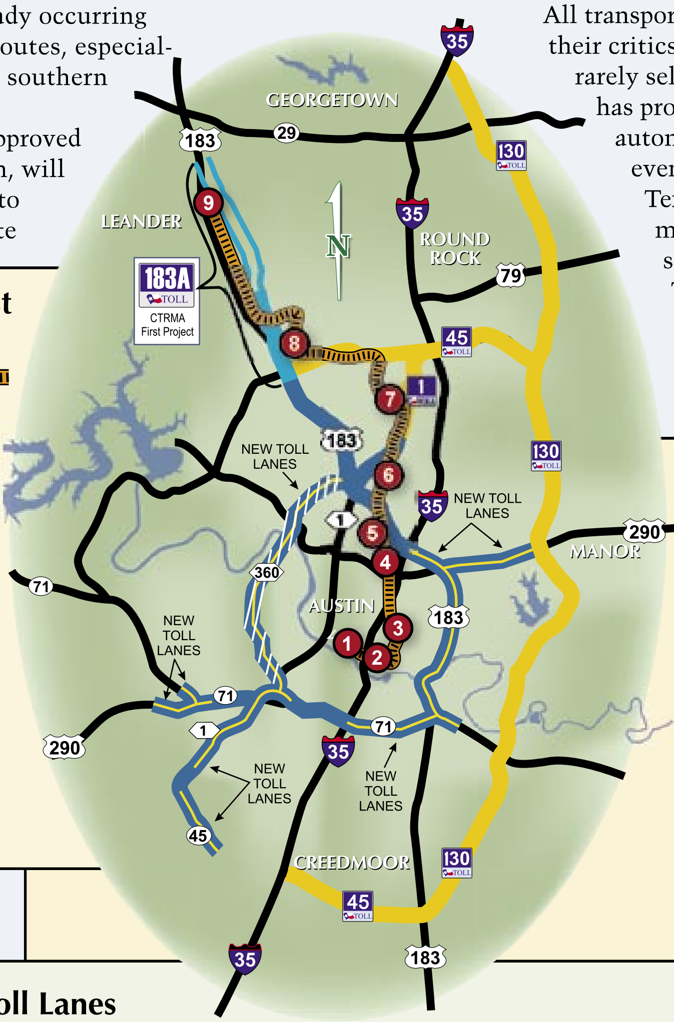
For years, Austin has sorely needed an alternative to Interstate Highway 35 that could divert traffic away from the city's center. The area also suffers from lack of major east-west thoroughfares. Both concerns are being addressed with new toll road construction. Significant new commercial real estate development is already occurring along portions of the new toll routes, especially those in northern Travis and southern Williamson Counties.

The commuter rail system, approved in a November 2004 referendum, will extend from downtown Austin to Leander. The system will operate on existing railroad rights-of-way. City officials in both Austin and Leander are hoping the nine planned transit stations will be catalysts for dense mixed-use, transit-oriented development.

The commuter rail line will integrate with the bus system to give passengers access to other parts of the city. Park-and-ride lots will be available at some stations as well. Completion of the rail line is set for 2008.

The rapid bus will combine a visually attractive vehicle designed for quick loading and unloading with other new high-tech features to reduce transit time by as much as 30 percent along some of the city's popular bus routes. Rapid buses will be able to extend green-light periods to minimize stops at red lights. Global positioning software will inform waiting passengers when the next bus will arrive. The system should be in place by 2007.

All transportation options have their fans and their critics. Commuter rail and bus systems are rarely self-supporting. However, mass transit has proven to be a viable alternative to the automobile when planned intelligently, even in Texas. The University of North Texas Center for Economic Development and Research published a 2002 study showing that Dallas Area Rapid Transit (DART) light rail stations had fostered new economic development and had a positive impact on most property values within one-quarter mile of the stations.



Downtown/Northwest Commuter Rail Line

Stations

1. Downtown
2. Saltillo Plaza
3. MLK Blvd./Airport Blvd.
4. Highland Mall
5. Lamar Blvd./Justin Lane
6. UT Pickle/Braker Lane
7. Howard Lane/MoPac
8. Northwest Park & Ride
9. Leander Park & Ride

Access to hike and bike trails are along entire route.

Other Projects

- Capitol Area Metropolitan Planning Organization (CAMPO) approved turnpikes under construction
- New toll lanes added to roadways under CAMPO Plan
- Existing roadways
- Included in CAMPO 2025 Plan as turnpike but not funded

CTRMA First Project

- Phase 1 - frontage roads only
- New toll roadways

Future Toll Roads and Toll Lanes

Roadway	Description	Status*
State Hwy. 130	4-lane Toll Road	2007 Completion
State Hwy. 45 (northern section)	4-lane Toll Road	2007 Completion
Loop 1	4-lane Toll Road	2007 Completion
Hwy. 183A	4-lane Toll Road	2007 Completion
Hwy. 183 (I-35 to Hwy. 71)	Toll Lanes Within Existing Road	2010 Completion
Hwy. 71 East	Toll Lanes Within Existing Road	2011 Completion
Hwy. 71 West	Toll Lanes Within Existing Road	2012 Completion
MoPac South (Hwy. 71 to South SH 45)	Toll Lanes Within Existing Road	Not Yet Funded
State Hwy. 45 (southern section)	4-lane Toll Road	Begin Construction in 2007
Loop 360	4-lane Toll Road	Not Yet Funded
Hwy. 290 East	Toll Lanes Within Existing Road	Begin Construction in 2007

*Completion Dates are Tentative

The gasoline tax, the primary source of funding for new highway construction, has not been increased in more than a decade. Austin voters have decided that highway tolls are preferable to sitting in traffic while federal and state governments agonize over how to raise taxes for needed transportation improvements.

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