

AUSTIN ECONOMIC OVERVIEW

October 2007 Office Edition

Summary

- **The state of Texas is roaring, and the capital city is no exception.** The outlook is equally rosy, as Austin is expected to add jobs at a rate of 3.8% per year over the forecast, tops in the PPR54. While the metro has added over 33,000 jobs over the past 12 months ending in July (4.6% — the fastest in the PPR54!), many of these jobs have not been higher-value-add jobs (as office-using employment growth has not kept pace with total job growth).
- **With the vastly improved vacancy picture, developers are now getting underway on a number of projects across the metro.** The Austin office market has had quite a run over the past couple of years, as vacancies have fallen sharply, and rents have spiked. Vacancies are predicted to end the forecast below current levels, but the rapid pace of tightening fundamentals has already begun to ease.
- **Total returns have blown through the roof on the back of exceptional value growth, but that will come to a grinding halt.** Investors have plowed capital into the Austin office market, but the levels of investment and pricing are due for a correction (value losses will hit the market mid-forecast). Yields will rise here at a much faster rate than nationally, and overall, average annual returns of 6% will underperform.

Demographic Trends

Category	2007*		1987-1996		Annual Growth Rates 1997-2006		2007-2011	
	Metro	U.S.	Metro	U.S.	Metro	U.S.	Metro	U.S.
Population	1,585	303,104	3.1%	1.2%	3.5%	1.0%	2.8%	0.9%
Households	600	114,295	3.2%	1.4%	3.4%	1.1%	3.2%	1.2%
Median Household Income	\$51,422	\$51,395	3.7%	3.6%	2.6%	3.2%	3.8%	3.3%

*All units (except for dollar-denominated figures) in thousands.

Employment Trends

NAICS Category	2007*		1987-1996		Annual Growth Rates 1997-2006		2007-2011	
	Employment (000)	Location Quotient	Metro	U.S.	Metro	U.S.	Metro	U.S.
Construction	46	1.09	2.8%	1.3%	4.2%	3.1%	5.8%	0.9%
Manufacturing	60	0.77	5.8%	-0.1%	-1.7%	-2.0%	1.1%	-0.4%
Trade, Transportation and Utilities	134	0.91	4.0%	1.5%	3.8%	0.7%	2.9%	0.5%
Retail Trade	80	0.93	3.2%	1.6%	2.9%	0.7%	2.8%	0.4%
Wholesale Trade	40	1.22	5.4%	1.2%	6.2%	0.6%	2.6%	0.9%
Trans, Ware and Util	13	0.47	6.1%	1.9%	2.7%	1.0%	3.1%	0.5%
Financial Activities	47	1.00	2.9%	1.2%	3.4%	1.8%	4.2%	0.6%
Government	160	1.29	2.7%	1.4%	2.1%	1.2%	3.2%	0.8%
Natural Resources and Mining	4	0.98	1.3%	-1.9%	6.6%	0.9%	0.3%	-0.3%
Education and Health Services	77	0.75	6.0%	4.2%	3.7%	2.7%	4.5%	2.5%
Professional and Business Services	107	1.08	8.1%	3.9%	4.4%	2.6%	5.6%	1.9%
Information	22	1.31	5.2%	2.0%	3.5%	0.2%	2.2%	1.0%
Leisure and Hospitality	80	1.06	4.6%	2.8%	4.2%	2.0%	5.0%	2.3%
Other Services	30	0.97	4.4%	2.8%	3.8%	1.4%	4.2%	1.5%
Total Employment	767	1.00	4.4%	1.9%	3.0%	1.3%	3.8%	1.2%
Office-Using Employment	185	1.03	4.4%	2.1%	3.9%	1.8%	4.3%	1.3%

- **The state of Texas is roaring, and the capital city is no exception.** The outlook is equally rosy, as Austin is expected to add jobs at a rate of 3.8% per year over the forecast, tops in the PPR54. Over the past 12 months ended in July, the metro has posted strong broad-based job growth in each sector, with the exception of education and health services, at rates above the national average (in many cases more than double). But while the metro has added over 33,000 jobs over the past 12 months (4.6% — the fastest rate in the PPR54!), many of these jobs have not been higher-value-add jobs. In fact, office-using employment has expanded by a rather paltry 2.8% (4,900 jobs), nearly 200 basis points below total job growth. However, that will soon change, as the metro should add office-using jobs at a very healthy rate of 4.3% per year over the forecast.
- **The metro's bread and butter — tech — is a mixed bag.** Indeed, Dell, the largest employer in Austin, is cutting workers. The company is in the process of paring back its companywide employment numbers by 8,000 workers. Other firms such as AMD are also trimming their local work forces. But on the flip side, Samsung has opened a \$3.5 billion wafer plant, reportedly the largest single foreign investment in the state of Texas and one of the

largest in the country. AMD is also underway on a major campus expansion, which should complete next year. But broadly speaking, the information sector is trading water. Over the past year, it has added 500 jobs to local payrolls, a 2.3% rate of growth. While that is certainly better than the losses that have plagued the market since the tech wreck, Austin is not expected to see a repeat of the late '90s going forward. In fact, information is expected to add jobs at a rate of 2.2% annually through 2011, 120 basis points above the national average. In comparison, from 1987–1996 and 1997–2006, information employment here outpaced that in the nation by 320 and 330 basis points, respectively.

- **Austin's demand growth will be stellar across the board.** The metro is an attractive relocation target for coastal firms looking to tap into the market's highly educated work force and relatively cheap cost structure. Population and job growth will be terrific, and that translates into solid demand. Over the forecast, apartment (second in the PPR54), office (second), and retail (first), will set the pace for demand growth for those particular property types. Warehouse will fall off the pace to 20th in demand growth. However, that still ranks in the top 50% of metros tracked.

Current Economic Indicators

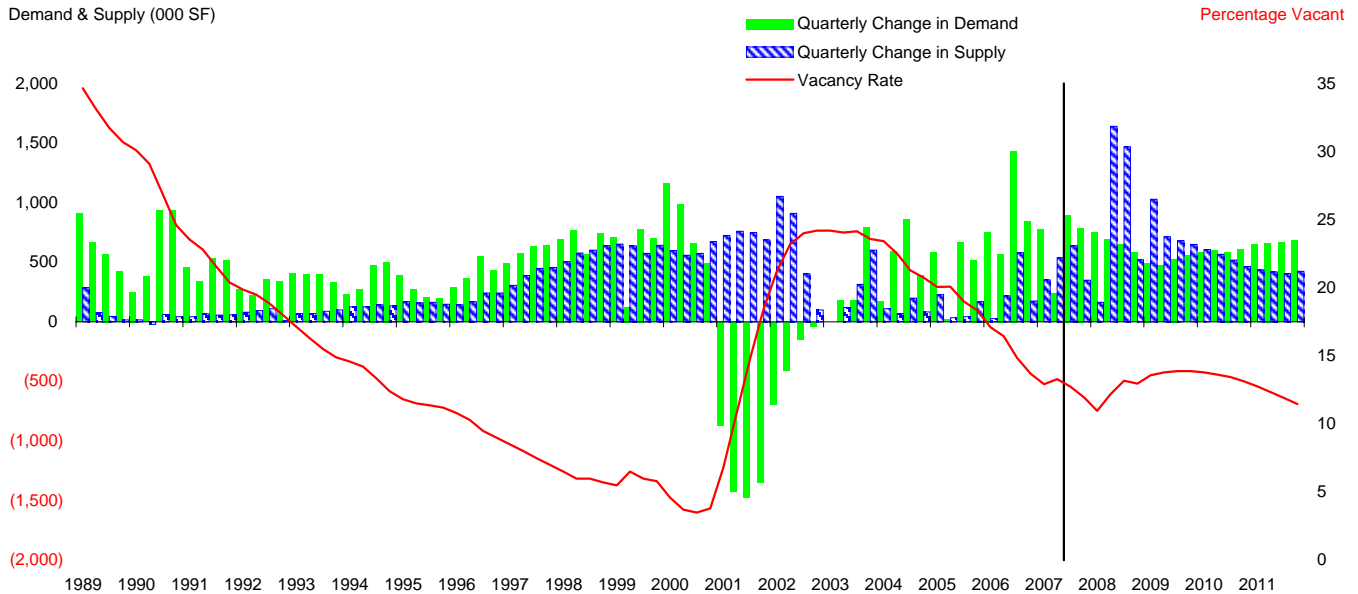
Employment Growth 7/07	Labor Force Growth 7/07	Unemployment Rate 7/07	Employment Volatility Ratio	2006 Net Migration (000)	Cost Indices (U.S. = 100)	
					Business	Living
4.6%	1.8%	3.5%	1.3	30.8	100	99

Sources: Economy.com; PPR

Supply, Demand, and Vacancy

	Metro	PPR54	Metro	PPR54	Metro	PPR54		
Vacancy Peak	34.7%	18.8%	Vacancy Trough	3.5%	10.0%	Current Vacancy	13.3%	14.8%
Date	1989:1	1991:2	Date	2000:3	2000:3	Vacancy in 2011:4	11.5%	14.3%

Demand & Supply (000 SF)



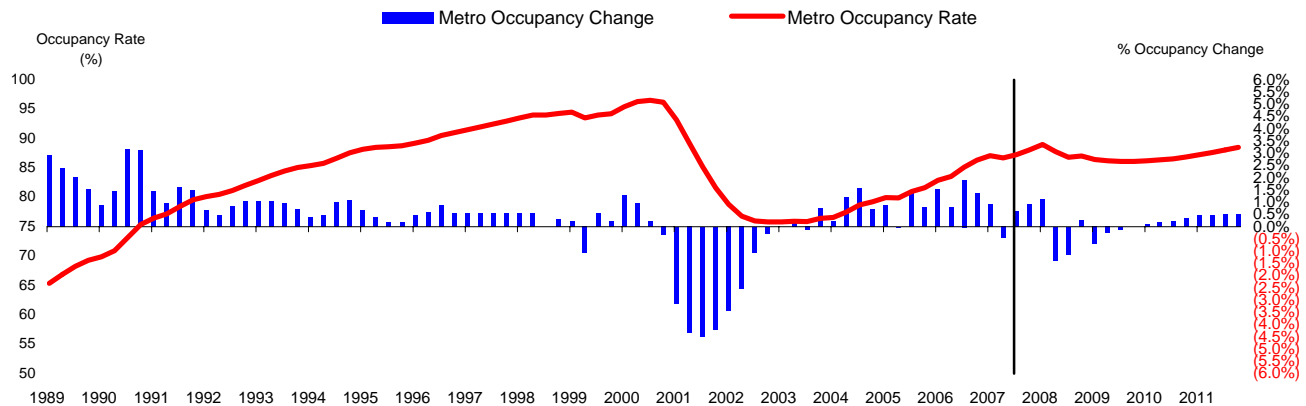
	Historical		Forecast		
	Metro	PPR54	Metro	PPR54	
Annual Supply Growth	5.8%	3.0%	4.0%	1.7%	Historical Supply Volatility Ratio
In Thousands of Square Feet	1,812	122,042	2,599	101,184	2.53
Annual Demand Growth	5.4%	2.6%	4.5%	1.8%	Historical Demand Volatility Ratio
In Thousands of Square Feet	1,528	93,870	2,546	92,677	2.00
Annual Net Demand Growth	-0.4%	-0.4%	0.5%	0.1%	Demand-Supply Correlation
					-0.08

- **With the vastly improved vacancy picture, developers are now getting underway on a number of projects across the metro.** The Austin office market has had quite a run over the past couple of years, as vacancies have fallen sharply, and rents have spiked. But new stock deliveries outpaced absorption in the second quarter, pushing the vacancy rate up to 13.3%. This is a 40-basis-point increase from last quarter, but a 310-basis-point drop from one year ago. So the strongest improvements are now in the rearview mirror. Vacancies are predicted to end the forecast below current levels, but the rapid pace of tightening fundamentals has already begun to ease (it will continue into next year as well), as new developments come to the forefront.
- **Job growth is quite volatile in Austin, and its strong entrepreneurial base is partly to blame.** Austin is home to many small startup firms. In fact, the metro ranks among the highest in the nation on Inc. Magazine's list of the 500 fastest-growing small companies, with 7.3 firms per million residents (third in the country). Of the 38 firms that made the list from Texas, nearly one-third (12) are from Austin. So while this makes job growth harder to capture, as small firms are often overlooked by BLS job estimates (that is why Austin and Texas, for that matter, often see massive job growth revisions), it also makes for tougher times in recessions. In a recent PPR study, Austin ranks as the third-highest beta (2.34) (beta in this case is a measure of a metro's employment response to national employment) in the PPR54 since 2000. The only metros to post a higher beta were San Jose at 4.06 and San Francisco at 2.84. While Austin has benefited strongly from this high beta in recent years (for each job added nationally, Austin has added 2.34 times more), the same holds on the downside. If the nation goes into recession, it is likely that Austin will face a sharper downturn.
- **Austin is a tech market through and through.** The professional, scientific, and technical services sector accounts for the largest share (28%) of the office-using employment base in the metro (add in the information sector, and tech-related employment accounts for nearly 40%), and it is this sector that will contribute almost 40% of new office

jobs over the forecast. While the information sector makes up a small portion of jobs on an absolute basis (less than 3% of jobs in Austin fall into this sector), its location quotient is 1.31, the highest of any in Austin. However, the local office market relies heavily on this sector, as over 11% of the metro's office-employment base is tied to information.

- **Austin is a demand-growth juggernaut.** The metro has a lot going for it right now. Job growth is stellar, relocations are adding to the job base and invigorating the market with new tenants, it has a favorable cost structure, the weather is nice, and the population is young and well educated. Add it all up and the market is ripe for innovation and further economic expansion. In fact, over the next five years, Austin will boast the second-strongest demand growth in the PPR54 at 4.5% per year. Further, office-using job growth will rank among the highest in the nation at 4.3% per year (the national average is a mere 1.3%).
- **Developers are gearing up in response to a vastly improved fundamentals picture.** Developers are underway on several million SF of new space, mostly in the Northwest and Southwest submarkets. And while those two submarkets make up 56% of the metrowide inventory, they will account for 71% of completions due over the next two years! Much of the current construction pipeline is speculative, so vacancies will face significant headwinds once all that new space hits the market. New construction is not unwarranted by any means, as the Northwest and Southwest have seen strong rent pops over the past two years, and vacancies there are among the tightest in the metro. As noted earlier, Austin will clock in with the second-strongest demand growth over the forecast. It's a good thing that is the case, as the metro will also boast the second-strongest supply growth over the forecast (4% per year). New stock deliveries are due to peak in the first quarter of 2009 at 7.5%, the highest rate since the third quarter of 1988, when deliveries topped 7.9%.
- **Supply and demand do not typically move together in this market** (the demand-supply correlation is mostly flat), so oversupply and heavy reliance on tech tenants are major risks.

Metro Occupancy

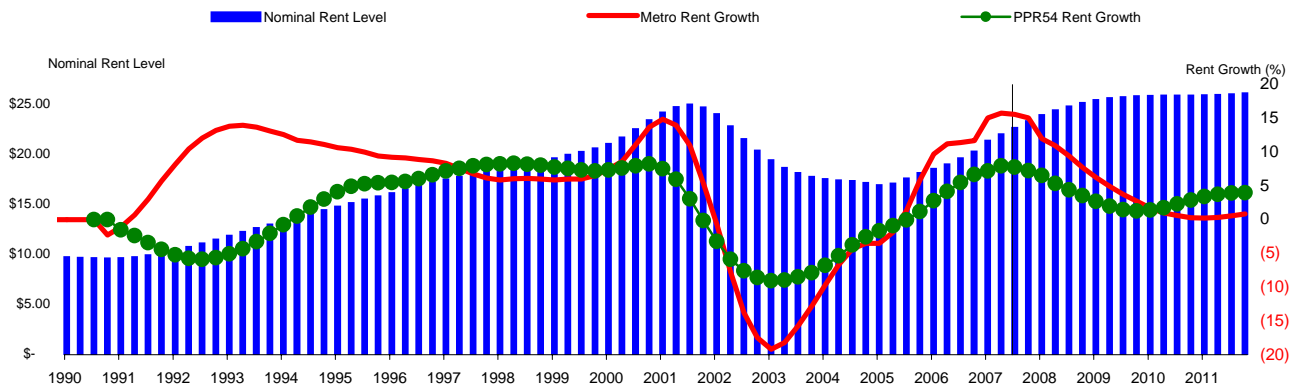


Rent and NOI, 4th Quarter, 1999-2011

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Rent Level	\$ 20.60	\$ 23.42	\$ 24.69	\$ 20.37	\$ 17.76	\$ 17.14	\$ 18.15	\$ 20.28	\$ 23.33	\$ 25.13	\$ 25.82	\$ 25.89	\$ 26.11
Rent Growth	6.5%	13.7%	5.4%	-17.5%	-12.8%	-3.5%	5.9%	11.7%	15.1%	7.7%	2.7%	0.3%	0.9%
NOI Growth	-3.4%	21.6%	11.9%	-5.1%	-6.0%	-8.7%	-9.1%	5.7%	7.7%	9.8%	8.2%	4.8%	2.6%

	<u>Metro</u>	<u>PPR54</u>		<u>Metro</u>	<u>PPR54</u>
verage Annual Forecast Rent Growth (%)	3.4	3.1	Average Annual Forecast NOI Change (%)	6.4	4.9

Metro Rent Vs. PPR54 Average Rent Growth



- Rent growth is surging and is due to top out this year.** In fact, metrowide rents are expected to exceed 15% growth in 2007 — the strongest annual growth ever. However, certain submarkets in Austin, such as the CBD, will post some of the strongest rent growth in the nation. The CBD is expected to expand rental rates at a staggering 21.8% this year, rivaling Midtown North (27.1%) and Midtown South (25.6%) in New York. Momentum has shown no real signs of slowing, so gains could be even stronger than initially anticipated. So while the market is reaping the benefits of the recent sharp decline in vacancies, near-term supply additions will hamper the market, limiting gains to just 3.4% per year through 2011.
- With all of the ingredients for strong income gains in place, Austin will be a clear outperformer.** Rent growth is going gangbusters, and the velocity of vacancy declines over the past two years has been phenomenal (vacancies are at levels not seen since 2001). This in turn has caused incomes to spike, and momentum is on the side of the landlord. In fact, Austin will post top-10 NOI gains in the PPR54 over the forecast, averaging 6.4% per year, 150 basis points ahead of the benchmark. While near-term overbuilding is a risk, vacancies are expected to finish the forecast below current levels, and rents will set a new high-water mark in nominal terms.

Austin Rent Volatility Relative to Other Office Markets



