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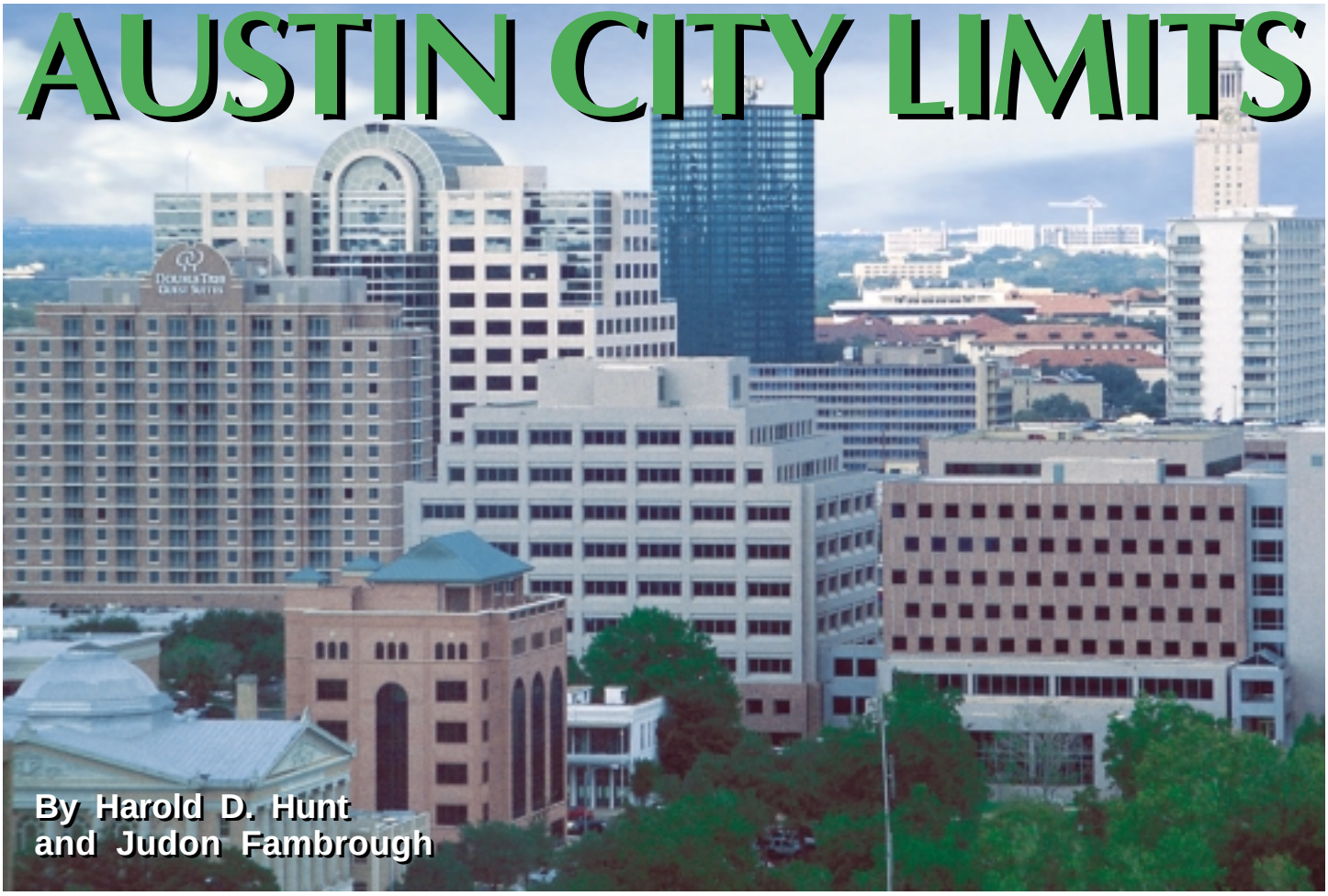
AUSTIN CITY LIMITS



By Harold D. Hunt
and Judon Fambrough

The downtown Austin office market is tight. *Really* tight. And real estate professionals predict it will stay that way indefinitely, even if high-tech tenants begin to abandon trendy downtown offices for lower-cost space farther from the heart of the city.

With an impressive overall occupancy rate of 96.7 percent and an overall rental rate of $22.45 per square foot (see table), how much of Austin's 7.2 million square feet of office space is occupied by technology-related firms? Just 14.4 percent.

Rising property taxes, record occupancy rates, and lack of new office space are fueling rising office rents that may eventually become unacceptable financial burdens for downtown tenants. Furthermore, some downtown office properties may lose preferred tenants over the next several years because of insufficient space to accommodate growth.

Commercial property owners aren't worried, though. Even if technology-related tenants stop shopping for space downtown, other businesses will queue up to sign leases. Besides, some landlords avoid leasing to high-tech firms, especially e-commerce dot-coms because doing so is riskier than leasing to other categories of business.

Commercial property owners' comfort levels with the downtown office market are based on a belief that a strong demand for space will continue for the next few years. They know firms can justify lofty rents if the positive aspects of being located downtown outweigh the costs.

Employee retention often is cited as a reason for leasing offices in the downtown area. Still, remaining downtown to retain top talent can be financially prohibitive. Even in the Silicon Valley, firms have begun moving to cheaper space in outlying areas.

If technology firms begin vacating downtown space, a domino effect might occur. Law firms are the largest single tenant class in downtown Austin, and many depend on technology firms for their primary source of revenue. They might follow their clients to the suburbs. But as long as downtown space is at a premium, such an exodus is unlikely to cool the hot office market.

Developers: Lack of Anchor Tenants

With vacancy rates in downtown Austin at 2 to 3 percent, why aren't developers constructing? One limitation is the stiff preleasing requirements imposed by lenders. Unlike Dallas or Houston, Austin is not known for large numbers of corporate "anchor" tenants. Some major Austin firms opt to build or buy

their own facilities, further restricting developers' efforts to prelease sufficient multitenant space.

It can take two to three years to plan and build an office building. Convincing quality tenants to prelease space that far in advance can be challenging, especially if the targeted firms are technology based, with unpredictable long-term space needs. Prospective tenants generally must be wooed with incentives like better parking facilities, reduced rental rates and the status associated with new or expanded office space.

With downtown property tax appraisals increasing 34 percent in 2000, developers are facing dramatic increases in building operating expenses in 2001. Some may not be willing to gamble that new buildings with higher rents will remain profitable indefinitely.

The City of Austin, known as a model of smart growth initiatives, has adopted a strong prodevelopment stance to stimulate downtown development. Downtown lies within the "Desired Development Zone" where permit acquisitions and environmental restrictions are less onerous. Even so, it may take 18 months or more for developers to obtain the necessary construction permits.

Lenders: Bankers Remain Skeptical

Commercial lenders are still haunted by the overbuilding that resulted in Austin having the nation's highest office vacancy rate for more than 21 consecutive months in 1987 and 1988. As a result, they are choosing a conservative approach to lending.

Finding financing for new construction is not easy. Generally, lenders require a minimum of 40 percent of building space to be preleased and a contribution of at least 30 percent of project costs from the developer. The large capital outlay needed for downtown projects precludes local banks, while larger banks remain skeptical about investing in downtown Austin, preferring the larger metro areas of Dallas and Houston. Permanent lenders, such as pension funds, remain disciplined in their lending practices; many are choosing not to invest in real estate. Real estate investment trusts (REITs) are averse to risk and have been building fewer new office properties since the credit pullback of 1998.

Even with tight capital markets, some new construction is occurring in downtown Austin. CarrAmerica Realty Corporation began construction in May 1999 on a 418,000-square-foot tower on Sixth Street, signing two law firms as anchor tenants. Scheduled to open in December 2001, this will be the first new downtown multitenant office building in 15 years. Some analysts report that capital markets may limit further multitenant construction until the CarrAmerica building proves to be profitable.

Who Pays What in Downtown Austin Office Market

Tenant Category	Total Square Feet	Avg. Rental Rate per Square Foot*
Telecommunications (wireless)	8,423	$30.91
Venture Capital	7,784	$30.66
Brokerage, Fund Management	214,065	$25.68
Computer Services, Consulting	71,075	$25.04
Medical	8,229	$25.02
Computer Software	217,417	$24.65
Legal	1,017,184	$23.65
Accounting and Consulting	174,923	$22.65
Government	37,171	$21.80
Executive Offices	60,997	$20.48
Real Estate	145,700	$20.33
Insurance	208,914	$20.05
Energy	25,861	$19.92
Computer Hardware	37,637	$19.56
Banking	375,504	$19.43
Telecommunications (fixed line)	111,883	$18.44
Trade Associations, Lobbyists	149,035	$17.83
Retailer	132,645	$17.68
Advertising	57,284	$17.07
Other	49,892	$18.74
	3,111,623	**$22.45**

*For a gross lease (base rent plus building operating expenses, excluding parking and amortized tenant buildout expenses)

Source: Real Estate Center at Texas A&M University

What's to Come?

In spite of rising rents, Austin businesses continue to covet office space in the fashionable downtown area. Tougher lending guidelines for developers and a lack of new office space should keep the commercial market hot, giving landlords the upper hand in lease negotiations for years to come.

Editor's note: The Real Estate Center and the Austin chapter of the Building Owners and Managers Association recently surveyed more than 3.1 million square feet of space in ten class A and B buildings in downtown Austin. The goal was to determine occupancy rates and rental rates paid and to identify the types of businesses leasing space. The buildings surveyed represented more than 43 percent of Austin's total commercial square footage in all classes.

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