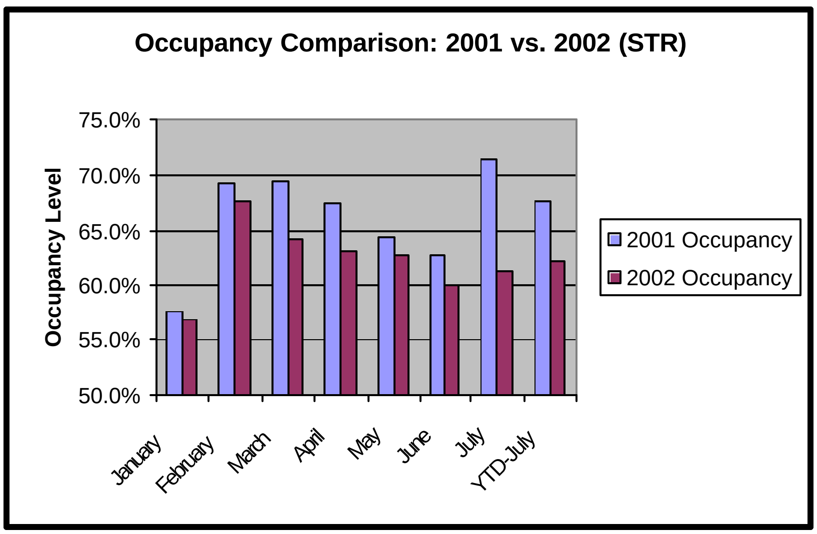
Houston Market Update

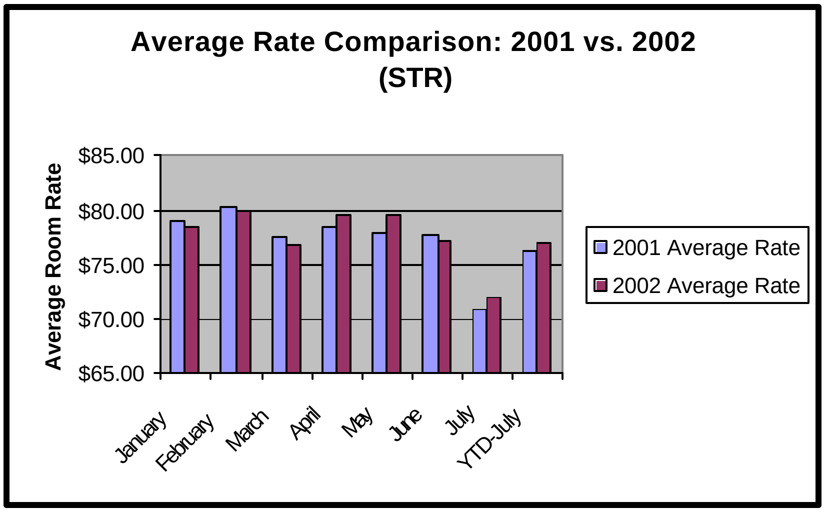
By Gretchen Hazel, Vice President

During the first seven months of 2002, Houston has noted declining levels in hotel occupancy and minimal growth in average rate, influenced primarily by the lack of weather-related demand which was present in 2001, the downturn in the energy trading sector, and continued supply increases.

According to Smith Travel Research, occupancy for the seven months ending July 2002 dropped to 62.2% for the MSA, off from almost 67.6% a year earlier. Houston's occupancy levels during each month have noted lower levels than those in 2001. The greatest disparity occurred during July of 2002 with occupancy at 61.3%, roughly ten percentage points below the 2001 levels. The June and July disparities are primarily attributed to the after effects of Tropical Storm Allison, which came with little advance notice to the city of Houston in early June 2001. The storm caused flooding in the area and widespread damage. As a result, the area's hotel demand in the market increased considerably following the storm because of insurance adjusters visiting the market, displaced residents in the community, and other storm related factors. By comparison, hotel occupancy for Houston was 63.9% for January through July of 2000, and 62.2% for the same period in 1999 (identical to the 2002 year to date figure). The fact that 2002 year-to-date occupancy is at the 1999 level certainly points to relative stability in the Houston market; by comparison, the Dallas MSA hotel occupancy through July 2002 was 56.8%, compared to 64.0% in 1999.



Also according to Smith Travel Research, average rate has increased minimally by 0.9% thus far in 2002, to $76.94 from $76.28 in 2001. While at a somewhat slower pace, this continues a trend experienced in prior years. In July 2001, year-to-date average rate had increased 1.4% over the 2000 level, and in July 2000, year-to-date average rate had increased 1.2% over the 1999 level. Declines year-over-year in average rate were noted during January, February, March, and June, while the remaining months showed slight increases. Again, we note that relative to the Dallas MSA, Houston is faring much better in maintaining rate integrity. Through July 2002, the Dallas market has experienced a 3.7% rate decline.



According to a recent report prepared by Lodging Econo*metrics* in September 2002, hotel openings recorded in the Houston area since September of 2001 have totaled 14 hotels and 1,163 guestrooms. There are currently an additional 14 hotels accounting for 3,166 guestrooms under construction throughout the Houston market area. The majority of these hotels are expected to enter the market within the next 12 months. The largest hotel project currently underway in Houston is downtown's 1,200-room Hilton Americas which has an anticipated opening date of November 2003.

Houston's office market has seen better days prior to the general downturn in the market's energy trading industry, the downturn in the economy, and corporate downsizing, but the market appears to be holding its own relative to other major Texas markets. According to the CB Richard Ellis 3rd Quarter Market Index Brief for Houston, the overall Houston office market (encompassing 143,907,038 net rentable square feet) realized a 14.55% vacancy rate and average asking lease rate of $18.84 (by comparison, the D/FW market was positioned with a 22.2% vacancy and a $18.71 average asking lease rate for its net rentable supply of 170,672,011 square feet). The vacancy levels indicated a slight decrease from the 2nd quarter level in 2002 of 14.61%. These levels are slightly higher than the levels noted during 2001, which were generally in the low 13 percent range. During the 3rd quarter of 2002, the vacancy levels throughout the greater area of Houston ranged from 9.57% in the Richmond/Greenway sub-market to 23.11% in the Southwest sub-market. The Central Business District features the largest amount of office space at more than 31.5 million square feet. During the 3rd quarter, this sub-market achieved a relatively healthy vacancy level of only 9.84% when compared to the other Houston area sub-markets, an average lease rate of $22.51, and a positive net absorption of 322,453 square feet.

Overall, the entire Houston office market achieved a positive absorption of nearly 600,000 square feet during the 3rd quarter of 2002, which is the first positive absorption level since the 4th quarter of 2001. This is primarily attributed to the completion of two multi-tenant buildings within the CBD, including Five Houston Center located at 1401 McKinney. Also, according to a recent report in the Houston Chronicle, New York based Intell Management and Investment posted the highest bid at $102 million on October 9, 2002, for the 40-story Enron Center during a recent auction. The center is located in downtown Houston and encompasses roughly 1.2-million square feet of space and is pictured as follows.

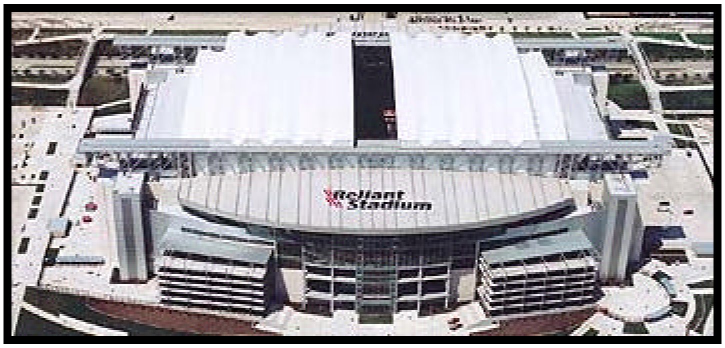
Unemployment in 2002 for the Houston MSA recorded levels higher than the levels noted in 2001. Overall, unemployment levels have ranged between 5.0% and 6.5% during the months of January through August 2002. The highest unemployment level was noted in June of 2002 with an unemployment rate of 6.5%. During July and August, unemployment levels have dropped somewhat from June's level to 6.2% in July and 5.9% in August (by comparison, the Dallas MSA unemployment level was 7.0% in August 2002).

The energy trading sector has historically played an integral part for the market, particularly downtown, however recent conditions have put a damper on the overall industry. According to a recent Houston Business Journal article, "Being an energy trader was an exciting, high-pressure job with a big salary and plenty of attractive perks." Cutbacks in this sector have been noted at a number of Houston area companies including Reliant Energy, El Paso Corporation, Dynegy, CMS Energy, and Duke Energy. Reports from the Houston Business Journal, dated October 16, 2002, indicate that Dynegy will drop its energy trading segment of the company's operation completely and decentralize its corporate structure. The company's decision has come at the cost of 780 jobs, including 600 of those jobs being cut at the company's headquarters in downtown Houston. Following this restructuring, Dynegy will have approximately 4,600 employees worldwide which includes 775 in Houston.

During the spring of 2002, Hewlett Packard (HP) officially closed its merger with Compaq; the merger prompted layoffs that are expected to top 15,000 by the end of 2002. Compaq and HP will retain separate brand identities, with Compaq (a major Houston employer) focusing on business computer models.

Houston's George Bush Intercontinental Airport continues to note declines in passenger traffic in 2002. The year-to-date period ending August 31, 2002 recorded 23,251,155 enplaned and deplaned passengers, which was a decline of 6.3% when compared to the 2001 level (D/FW International total passenger traffic declined 10.7% during the same period). Continental Airlines, the primary airline carrier in Houston, reported its 3rd quarter 2002 financial results on October 17, 2002. The results indicated a pre-tax operating profit of $46 million but a net loss of $37 million. The airline attributed the net loss to security costs, taxes, and government restrictions. In terms of passenger traffic, Continental Airlines noted a decline from 20,498,626 in 2001 to 19,319,465 in 2002, which represents a constriction of 5.8%. Overall, Continental Airlines and George Bush Intercontinental Airport is faring well in the airline industry when compared to other airlines and airports during these difficult economic times. This is revealed when we compare this airline's performance with the results of other major airlines. On October 16, 2002, Dallas-based AMR Corporation (American, TWA) reported its third quarter results indicating a net loss of $475 million before special items. Atlanta-based Delta Airlines announced on October 15, 2002 that the company incurred a net loss of $326 million for the third quarter. On October 18, 2002, Chicago-based United Airlines announced that it incurred a $503 million third quarter loss.

The official ribbon-cutting ceremony occurred at the brand new Reliant Stadium on August 16, 2002.



Reliant Stadium, constructed at a cost of $449 million, features a total of 1.9-million square feet of space, seating for 72,000 fans, 221 luxury boxes, and a retractable roof. The stadium is the new home of the Houston Texans, which is a newly formed expansion football team in the National Football League. On September 8, the Houston Texans played there first in-season game at Reliant Stadium and beat the Dallas Cowboys 19-10 before 69,604 fans. The 2002 season features eight home games for the Houston Texans.

Overall, Houston's hotel market is facing more difficult times in 2002, unable to benefit from a strong energy trading industry and weather-related demand that occurred in 2001. However, occupancy levels remain in line with 1999 and 2000 levels, and the city continues to experience much stronger occupancy levels when compared to Dallas/Fort Worth. Moreover, average rate expansion is still occurring, which is significant in light of typical declines in the 5.0% to 10.0% range in other major markets. By the end of 2002, the market is expected to stabilize, and be poised to benefit from expected, stronger economic times in the months ahead. With the George R. Brown Convention Center and its new headquarters hotel coming on line by the end of 2003, a revitalized convention presence should also support the city's hotel market over the longer term horizon.