Texas Economic Update

SigmaBleyzer
THE BLEYZER FOUNDATION

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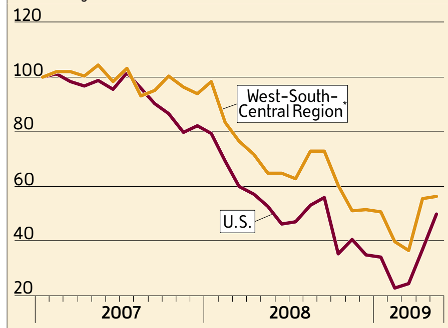
- **Texas is experiencing a less painful economic slowdown than other U.S. states, and will likely lead the recovery in the U.S. economy.**
- **Texas manufacturing activity was essentially flat during the first half of 2009, compared to an almost 15% decline at the national level.**
- **Texas' unemployment rate is still 2 percentage points below the national average of 9.5%.**
- **In the first half of 2009, Texas manufacturing lost only 7% of jobs compared to 13% in Ohio and 10% in Illinois and North Carolina - three largest manufacturing hubs after California and Texas.**
- **The Dallas component of the S&P/Case-Shiller Home Price Index bottomed out at the beginning of 2009 and has been recovering since March.**
- **While Texas exports declined by 22% between January and May 2009, there are signs that foreign demand may be returning, fueled by stronger growth in Asia.**
- **Investors' appetite for private equity investments remains weak. Nevertheless, a revival in U.S. equity markets should strengthen investors' willingness to take advantage of the unprecedented 'liquidity premium' currently available in the market.**

Economic Overview

Texas continues to feel the impact of the global economic slowdown. Although recent data points to a moderation of the rate of decline, weakening labor markets are weighing down consumer and investor sentiment. Indeed, increasing unemployment and stagnant wages are overshadowing nascent signs of stabilization in the real estate and financial markets. Consumer confidence is still low (see chart 1) - eroded by job losses, higher gas prices, tighter credit conditions, and a sizable drop in household wealth. On a positive note, the resurgence of foreign demand for U.S. goods should help fuel exports, supporting a rebound of U.S. manufacturing activity. This bodes well for Texas, since the state's manufacturing sector relies more on exports compared to other U.S. states. In addition, the sheer size and diversity of the Texas economy adds an extra layer of resilience versus other state economies. Unlike other parts of the country, Texas has a large and rapidly growing population, which helps sustain demand for housing, and consumer goods and services. Furthermore, the Texas residential real estate market has experienced only a modest correction compared to collapsing home values in many other parts of the country. As a result, lower foreclosure and unemployment rates, and lower household indebtedness, continue to mitigate the effect of deteriorating household finances, which benefits local consumer spending. Finally, the recent robust growth in Asia is likely to contribute to the weakening of the U.S. dollar and should support the recovery of oil prices. This is good news for Texas, as an oil producer and exporter of manufacturing goods to these markets. All told, an export-driven recovery will help Texas exit this recession faster than other states whose growth has historically been driven by consumer spending and a credit fueled construction boom.

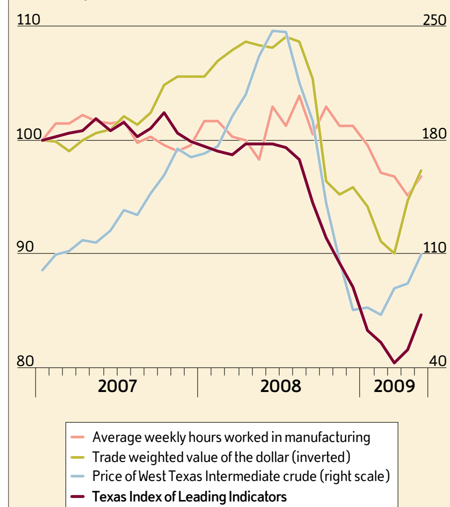
The Dallas Fed's Texas Index of Leading Indicators appears to be signaling a reversal of the current economic downturn. In May, the index continued its uptrend, which now stretches back to March, gaining 3.8% over the previous month (see chart 2). This improvement was due to the revival of equity and commodity markets, tentative signs of stabilization in the real estate sector, and an easing of stress in the labor market. On top of that, Texas exporters gained from the recent weakening of the U.S. dollar.

Consumer Confidence Index 1
January 2007=100



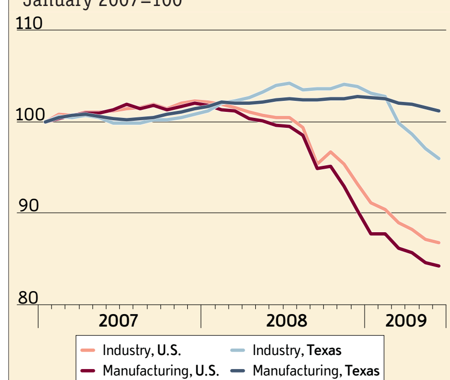
*Includes Arkansas, Louisiana, Oklahoma, Texas
Source: Texas Comptroller of Public Accounts, The Conference Board

Texas Index of Leading Indicators and its key components 2
January 2007=100



Source: Federal Reserve Bank of Dallas

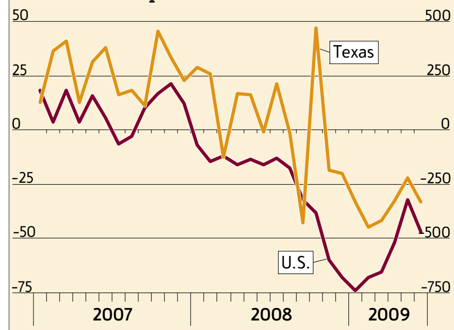
Industrial Production Index 3
January 2007=100



Source: Federal Reserve Bank of Dallas

In sum, partially thanks to high oil prices, the Texas economy entered the current U.S. recession later than many other states. In addition, the fundamentals of the local economy were healthier, which helped to significantly ease the adjustment of consumer spending and housing markets. Finally, Texas industry is better geared to gain from government stimulus spending (both in the U.S. and abroad) and from the resurgence of foreign demand. This means Texas is likely to experience a less painful economic slowdown and may even lead any recovery in the U.S. economy. Nevertheless, at present, economic activity in the state remains low. July's Dallas Beige Book survey indicates that businesses continue to cut costs and reduce payroll as a response to a very uncertain outlook. Despite clear signs of the slowing pace of output and job losses, businesses - from food producers to airlines - report downward price pressures. At the same time, Texas is a large and well-diversified economy that is fueled by both domestic consumption and foreign demand. This will allow for a less painful economic adjustment compared to many other U.S. states.

Monthly job losses, seasonally adjusted thousands of persons 4

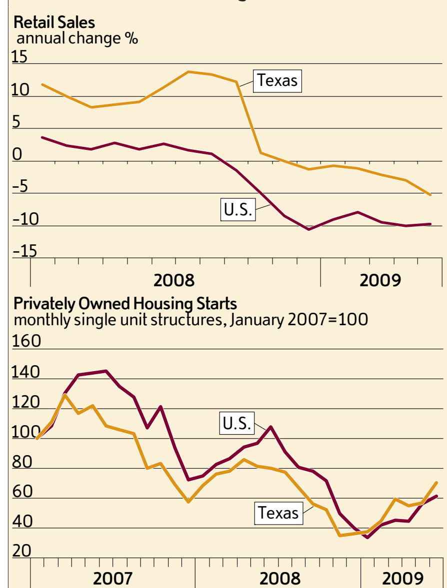


Texas - left scale
Source: Federal Reserve Bank of Dallas

Output & Spending

A less dramatic contraction for Texas industry provides strong evidence of the stronger capacity for the local economy to weather the current recession (see chart 3). Indeed, during the first half of this year, the Texas Industrial Production Index fell by only 2.9% compared to a drop of 12.4% at the national level. Much of this fall in Texas industrial output is due to declining mining and exploration activity, rather than declining manufacturing. Over the first half of this year, Texas crude oil and natural gas production dipped on the back of lower industrial demand and falling oil prices. Nevertheless, recent data shows that the number of active oil and gas rigs and well permits is starting to increase from their lows. Thus, industrial contraction should moderate as crude prices rise and the summer driving season raises demand for petroleum products in general.

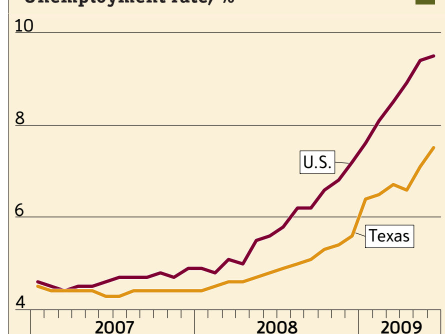
Retail sales and housing starts 5



Source: Federal Reserve Bank of Dallas, Federal Reserve Bank of St. Louise

Texas manufacturing appears remarkably resistant to the ongoing economic slowdown. During the first half of this year, Texas manufacturing output fell by only 0.12%, compared to a staggering 14.6% decline at the national level. A different mix of manufacturing activity in Texas and a greater reliance on foreign demand helps explain this divergence between national and local performance. Texas manufacturing is almost evenly split between durable and nondurable goods, compared to a larger share of durable goods in U.S. manufacturing as a whole. This helped cushion Texas from the massive consumer retrenchment from spending on big ticket items - such as cars, furniture and home appliances - that occurred in the past 18 months. In addition, Texas nondurable goods manufacturing is dominated by petroleum and chemical products, and relies less on consumer spending on food and clothing. Indeed, Texas is the largest chemicals producer in the U.S., accounting for over one seventh of the national output of chemical products. This means the recent decline in natural gas prices[1] has helped to boost the competitiveness of Texas chemicals producers. As a result, in June, production of nondurable goods in Texas grew by 2.3% versus June 2008, compared to a decline of 8.6% at the national level.

Unemployment rate, % 6



Source: Bureau of Labor Statistics

Employment

The Texas labor market started to weaken seven months after the beginning of the U.S. recession, in December 2007 (see chart 4). Since July 2008, seasonally ad-

[1]According to the U.S. Energy Information Administration, in May 2009, Texas industrial natural gas prices were almost twice as low as in December 2008. In addition, thanks to its large reserves (more than 35% of the U.S. total, including Federal offshore fields), Texas has the lowest natural gas prices among all U.S. states.

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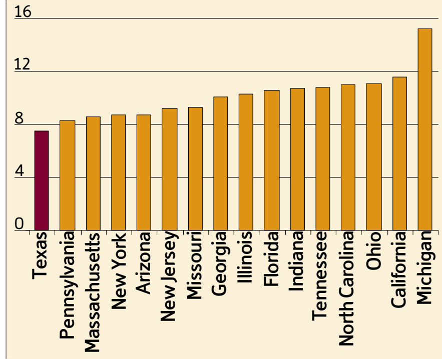
justed, non-farm employment in Texas fell by 243,100 jobs, as global demand and oil prices collapsed. As a result, the mining and manufacturing sectors jointly lost nearly 100,000 jobs. Still, during the first half of 2009, Texas manufacturing lost only 7% of jobs compared to 13% in Ohio and 10% in Illinois and North Carolina - three largest manufacturing hubs after California and Texas. This striking divergence reflects the much heavier dependence on domestic consumption of durable goods for other U.S. states versus Texas. Despite this, job losses in the Texas services sector mirror the overall trend in the U.S. economy, with trade, transportation and business services shedding the most jobs. In June alone, employment in these two sectors declined by 24,700 in Texas, accounting for nearly half of all monthly job losses. Since employment tends to lag behind the business cycle, firms tend to lay off workers even if economic conditions start to stabilize. In particular, retail sales and the housing market remained depressed during the first quarter (see chart 5), and this triggered job losses in the retail industry on the whole, and in home improvement retailers in particular.

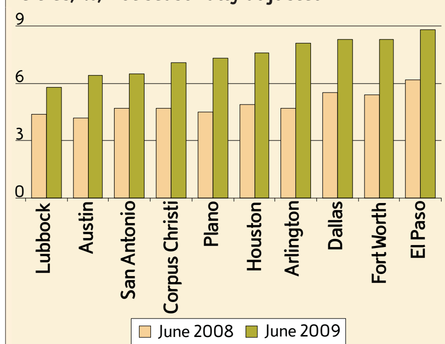
All said, the Texas unemployment rate is still two percentage points below the national average. In June, the seasonally adjusted unemployment rate increased to 7.5% in Texas, compared to 9.5% overall for the U.S. (see chart 6). Furthermore, Texas has the lowest unemployment rate among the 15 largest states (see chart 7). Nevertheless, labor markets in all major Texas cities remain weak. Over the past 12 months, unemployment rates in the 10 largest cities (which provide about one third of all jobs in the state) grew on average by 2.5 percentage points (see chart 8).[2] In particular, the unemployment rate tended to grow fastest in cities which rely more on business demand for goods and services, i.e. Houston, Arlington, Dallas and Fort Worth. In addition, a higher share of jobs in trade and transportation has contributed to more job losses in these locations. Indeed, DFW and IAH airports both saw a sharp decline of passenger and freight traffic.[3] On top of that, jobs in transportation are threatened by declining sea port cargo and container traffic, which will continue to exert pressure on business activity in Houston, Beaumont, and Corpus Christi (although, Corpus Christi relies more on less volatile military traffic). Finally, unemployment in El Paso has been growing due to weak manufacturing activity and an anemic retail industry. This is not surprising given that manufacturing and trade in counties bordering Mexico depend on demand from neighboring Mexican manufacturing clusters (maquiladoras[4]) and Mexican consumers. Peso depreciation and ailing global manufacturing supply chains continue to depress trade traffic at the U.S.-Mexico border (see chart 9).[5] On a positive note, metropolitan areas specializing in healthcare, education, tourism and government services - sectors that created 123,000 new jobs in Texas over the last 12 months - have seen a relatively milder deterioration of local labor markets. In particular, unemployment rates in Austin, Lubbock, and San Antonio remain below the state average due to a larger share of jobs in these industries. Finally, Austin, which is home to a high technology cluster, appears to be benefitting from a less severe contraction in demand for high technology products compared to traditional manufacturing.

Unemployment rate in the 15 largest U.S. sates*, % 7



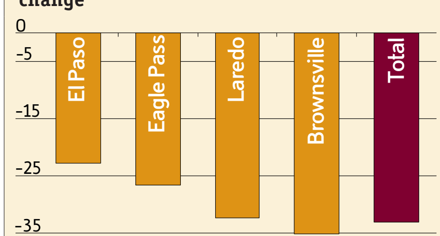
*These states account for about two thirds of all employed and 70% of all unemployed workers in the U.S.
Source: Bureau of Labor Statistics

Unemployment rate in the 10 largest cities, %, not seasonally adjusted 8



Source: Bureau of Labor Statistics

Truck crossings* across the U.S.-Mexico boarder in January-May 2009, % change 9



*All commercial vehicles crossing through international bridges
Source: Texas A&M International University, Texas Center for Border Economic and Enterprise Development

[2]In June, the average unemployment rate in Texas metropolitan areas was 7.8% compared to 9.6% in the U.S. More than that, Texas major metro areas saw a slower unemployment growth compared to other large U.S. cities. For example, the average unemployment rate in the large metro areas of California, Michigan, Florida and New York stood at 13%, 14.4%, 11% and 8.2%, respectively.

[3]During the first half of 2009, passenger and freight traffic at IAH fell by about 10% and 15%, respectively. Meanwhile, in the first five month of this year, DFW reported a 5% reduction in passenger traffic and a 12% drop in freight traffic.

[4]Maquiladoras located at the Texas boarder tend to specialize in transportation equipment, electronics and electric machinery - industries that were badly hit by the slump in U.S. and global demand for manufacturing products.

[5]Declining cross-border traffic may also be attributed to March's cancellation of the NAFTA Cross Border Demonstration Trucking Project. This project allowed Mexican trucks to freely access the U.S. road network. Following the cancellation, Mexico hiked tariffs on about 90 U.S. imported goods.

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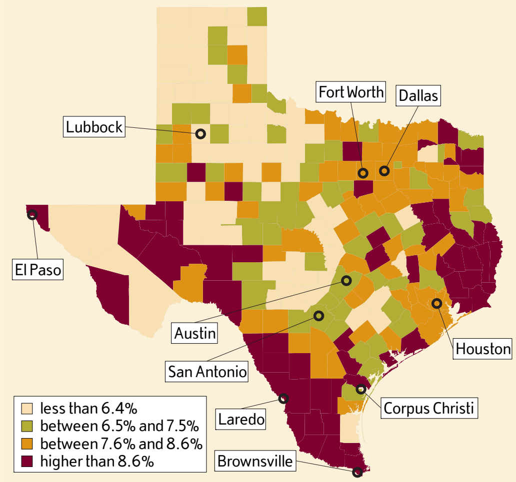
To conclude, pockets of higher than average unemployment are emerging in the south and west of Texas, due to slower trade with Mexico, while lower crude and natural gas prices remain a drag on business activity in the Gulf Coast region (see chart 10). At the same time, crop producing counties located in the Panhandle have managed to weather the economic downturn better than more urbanized parts of the state. Indeed, crop producing counties have profited from last year's spike in global food prices, as well as from growing investment in alternative fuel programs (including ethanol production and wind farms).

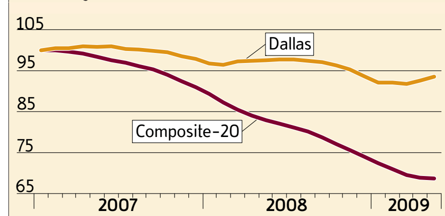
Lastly, Texas is unlikely to go through a permanent loss of manufacturing jobs compared to other U.S. states. In particular, the U.S. as a whole entered this recession with a relatively large share of workers employed in the automobile industry and consumer durables (such as furniture and electronic appliances). The share of workers employed in more productive high technology manufacturing (computers and semiconductors, aerospace products, machinery, etc.) was higher in Texas. This means that manufacturing in Texas will experience a relatively milder structural adjustment compared to other U.S. states. Indeed, during the last 18 months, the transportation equipment industry accounted for only 8% of all job losses in manufacturing in Texas, compared to over 20% nationwide. Finally, the number of Texans employed in service industries is still below the national level (84% in Texas versus 86% nationwide), which means a higher demand for education and health care, fueled by rapid population growth, will continue to support job creation in the state.

County unemployment rates in June, %, not seasonally adjusted 10



Source: Bureau of Labor Statistics

S&P/Case-Shiller Home Price Indices 11
January 2007=100

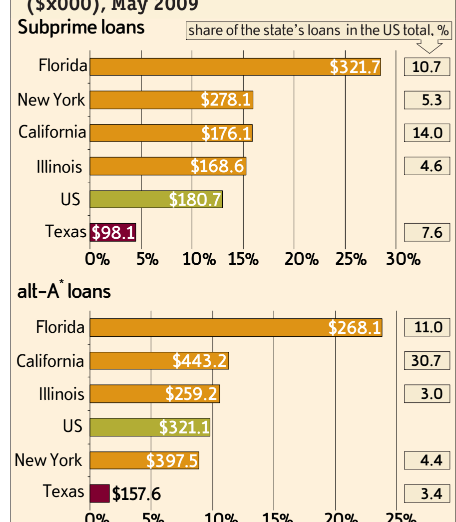


Source: Standard & Poor's

Real Estate Market

Home values in Texas experienced only a relatively modest correction compared to other states as healthier fundamentals helped mitigate downward price pressures. Indeed, the Dallas component of the S&P/Case-Shiller Home Price Index leveled out at the beginning of 2009 and has been recovering since March. In fact, in May, Dallas home prices grew by about 1% from the previous month. As a result, home prices in Dallas managed to regain the value lost during the first quarter of 2009, while home prices in 20 major U.S. cities have lost 7% on average since January (see chart 11). Importantly, the U.S. housing market may be nearing the end of its worst slump in more than two decades. The National Association of Realtors reported that in June, existing home sales increased by 3.4%, growing for the third consecutive month. Meanwhile, median home prices gained 4.1%, and the supply of unsold homes narrowed to 9.4 months (compared to 11 months the prior year). Since housing is a major household asset, stabilizing home prices provide essential support to an economic recovery. And since falling home values and collapsing equity markets erased $11 trillion of household wealth in 2008,[6] consumer spending will remain subdued until households can rebuild their balance sheets. Thanks to more robust housing and labor markets in Texas, the impact on the wealth of local consumers is likely to be less severe. Indeed, foreclosure rates in Texas are the lowest in the country. In addition, relatively lower housing prices (and, consequently, lower outstanding loan balances) mean lower household indebtedness (see chart 12). According to the American Bankruptcy Institute, in the first quarter of 2009, total bankruptcy filings in Texas increased by only 14.3% versus the first quarter of 2008; compared to

Foreclosure rates (% of owner occupied homes) and average loan balances ($x000), May 2009 12



*Near-prime higher-balance loans made to borrowers who might have past credit problems, but not severe enough to drop them into subprime territory
Source: Federal Reserve Bank of New York

[6]Source: The Federal Reserve Board, Flows of Funds Accounts of the U.S.

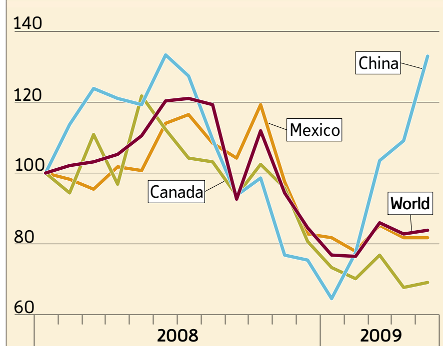
67% in California, 49% in Florida and 34.5% in the U.S. on average. Furthermore, the personal bankruptcy filing rate[7] increased by only 9.7% in Texas, compared to 32.1% in the U.S. overall. All this means that Texas households should come out of this crisis relatively unscathed assuming recent, tentative signs of stabilization in housing, labor and commodity markets translate into a sustainable economic recovery.

Despite good news in the Texas residential market, the commercial real estate market is likely to struggle in the large metropolitan areas of Texas, which have significant exposure to retailers and financial, business-related and professional service firms. Furthermore, Texas regional banks have significant exposure to commercial real estate. According to the Federal Deposit Insurance Corporation, commercial real estate loans account for over 40% of all real estate loans extended by Texas commercial banks, compared to only 26% in the U.S. on average.[8] About 37% of all commercial real estate loans in Texas sit on the books of regional banks with less than $1 billion in assets (versus only 26% in the U.S.). As a result, small regional lenders remain vulnerable to large price and activity fluctuations at the local level. According to the National Association of Realtors, in the first quarter of 2009, the year-on-year decline of commercial real estate sales prices stood at 12% in Texas. Still, the Texas market looks relatively healthy compared to other large states, where commercial real estate has lost between one fifth and one third of its value (prices declined by 33% in Nevada, 22% in California and 23% in Florida).

Foreign Trade

Slower global trade and falling oil prices led to a 22% decline in exports in January-May 2009 for Texas. Nevertheless, the largest component of exports - industrial machinery and computers (about one fifth of all exports) - fell by only 10%, while exports of aerospace products increased by 12%. This implies that Texas can maintain its competitive edge in high technology manufacturing. More importantly, there are signs that foreign demand may be returning, fueled by stronger growth in Asia, and foreign government spending on large infrastructure projects. Indeed, having declined by over 27% during the first quarter, April-May exports to China grew by 0.7% compared to the same period last year. Exports to NAFTA trade partners (more than 40% of all exports) appear to be stabilizing as well (see chart 13). Still, Texas' exporters are likely to face weaker foreign demand in the medium term on the back of economic difficulties in Canada and Mexico.

Monthly volume of exports from Texas, January 2008=100 13

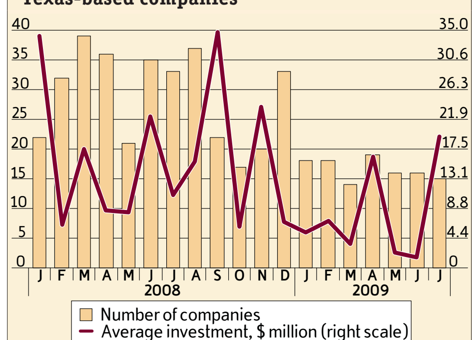


Canada, Mexico and China absorb nearly a half of all exports from Texas
Source: U.S. Census Bureau

Private Equity Market

Tight access to funding, risk aversion, and a high level of uncertainty have greatly reduced investors' appetite for private equity investments in the U.S. Since the beginning of 2009, total private equity investments in the U.S. fell by about 60% to $25 billion. The volume of private equity investments into Texas-based companies was nearly three times lower than the year before, declining to $1.2 billion (or about 5% of all private equity investments in the U.S.). About 150 private equity firms invested into 110 Texas-based companies (versus 250 firms and 208 companies a year ago), while the average investment per company fell by about 35% to $10.5 million (see chart 14).

Private equity investments into the Texas-based companies 14



All private equity related investments, including startups, expansions, buyouts and acquisitions.

Private equity fundraising also remains challenging. According to a study by the Dow Jones Private Equity Analyst, during the first half of 2009, 173 U.S. private equity funds raised $54.9 billion, down 64% from $152.7 billion by 261 funds a year ago. The private equity industry has been badly affected by an erosion of confidence from large institutional investors who, facing large losses on their stock portfolios, have shied away from less liquid private investments. On top of that, lingering debate on the reform of the U.S. financial system is creating an additional layer

[7] Bankruptcy fillings per 1000 population. Source: Federal Deposit Insurance Corporation.
[8] As of March 2009.

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of uncertainty. Still, a recent revival in U.S. stock markets may strengthen investors' willingness to take risk, which should rekindle demand for private equity and venture capital investments.

Tight financial markets have depressed capital market activity. Since the beginning of 2009, the value and number of completed M&A deals in the U.S. dropped by 21% and 35%, respectively (to $423 billion and 3,321 deals). According to the PricewaterhouseCoopers IPO report, during the first two quarters of 2009, 14 U.S. companies went public raising $2.3 billion, versus 43 IPOs and $27.7 billion the year before.[9] On a positive note, during the second quarter of this year, the value of U.S. IPOs more than doubled (growing to $1.6 billion) versus the first quarter, increasing quarter-over-quarter for the first time since the 4th quarter of 2007. Notably, the second quarter saw the IPO of SolarWinds - an Austin-based technology company controlled by two private equity firms - Bain Capital Ventures and Insight Venture Partners.[10]

Private equity-backed acquisitions of the Texas-based companies in 2009

Date	Target Name	Target Location	Industry	Acquirer Name	Deal value, $ million
Jan-09	NetVersant Solutions Inc	Houston, TX	Internet service providers	Patriarch Partners LLC	$130.0
Jan-09	Whole Foods Market Inc	Austin, TX	Grocery stores	Yucaipa Cos LLC	ND
Jan-09	RCI Technologies Inc Records Consultants Inc	San Antonio, TX San Antonio, TX	Investment advice Management consulting services	Investor Group	$1.75
Feb-09	Federal Flange Inc	Houston, TX	Valves & pipe fittings	KRG Capital Partners LLC	ND
Feb-09	Alta Mesa Resources LLC	Houston, TX	Oil & gas	Denham Capital Management LP	ND
Feb-09	International Development Corp	Roanoke, TX	Residential electric lighting fixtures	Sorenson Capital Partners	ND
Feb-09	Greatwide Logistics Services	Dallas, TX	Transportation & infrastructure	D. E. Shaw Group Centerbridge Partners	$73.6
Mar-09	SunTerra Resources	Houston, TX	Oil & gas	HM Capital Partners LLC	ND
Apr-09	Alsay Inc	Houston, TX	Building, construction & engineering	Venquest Capital Partners LLC Lone Star CRA Fund LP	ND
Apr-09	Global Thermoplastics LP	Houston, TX	Plastics materials & synthetic resins	Monomoy Capital Partners LLC	ND
Apr-09	Entrust Inc	Dallas, TX	Software	Thoma Bravo LLC	$123.9
May-09	American Institute of Allied Health	Lewisville, TX	Educational services	The Riverside Co	ND
May-09	Argyle Security Inc	San Antonio, TX	Professional services	MML Capital Partners LLC	$6.3
May-09	Big Red Ltd	Waco, TX	Bottled & canned soft drinks & carbonated waters	Argus Capital Group	ND
May-09	Southwaste Services Inc	Houston, TX	Water and waste management	Rock Hill Capital Group	ND
May-09	Presidio Investments Ltd	Dallas, TX	Loan brokers	Birch Hill Eq Partners Mgmt	ND
May-09	GTESS Corp	Richardson, TX	Computer programming services	BlueCrest Capital Finance LP	ND
May-09	WorkTree.com	Houston, TX	Internet software & services	Florida Merchant Capital Investors	ND
Jun-09	Jefferson Dental Clinics	Dallas, TX	Healthcare providers & services	Management Black Canyon Capital LLC	ND
Jun-09	Gabriel Ride Control Prod Inc	Brentwood, TX	Motor vehicle parts & accessories	OpenGate Capital	ND
Jun-09	Allis-Chalmers Energy Inc	Houston, TX	Oil & gas field services	Lime Rock Partners LP	$36.36
Jun-09	Allis-Chalmers Energy Inc	Houston, TX	Oil & gas field services	Lime Rock Partners LP	$49.72
Jun-09	Crump Energy Investments LLC	Midland, TX	Crude petroleum & natural gas	Quantum Energy Partners	ND
Jul-09	Goodman Networks Inc	Plano, TX	Wireless telecommunications	Stephens Group LLC	$62.0
Jul-09	HVAC Agent LLC	Lake Dallas, TX	Internet publishing & broadcasting & web search portals	Teakwood Capital LP	ND
Jul-09	Hy-Bon Engineering Company Inc	Midland, TX	Energy and power, pipelines	Pfingsten Partners LLC	ND
Jul-09	Jus-Made LP	Dallas, TX	Food and beverage	SigmaBleyzer	ND
Jul-09	Manexa	Austin, TX	Data processing, hosting, and related services	Management Teakwood Capital LP	ND

ND - Not disclosed
Source: Reuters, Bloomberg, Dallas/Houston Business Journals (www.bizjournals.com)

[9] The largest U.S. IPO in history - the Visa Inc IPO, which raised $17.9 billion in the first half of 2008, may exaggerate this year's decline in IPO activity. However, excluding the Visa Inc IPO, IPO volume still fell by 76% in January-June 2009.
[10] SolarWinds share price gained nearly 50% since the company went public on May 20th when it raised $151.5 million.

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