Texas Economic Update

March 2010

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- **Texas manufacturing remained in expansion mode as the Houston Purchasing Managers Index increased for the sixth straight month in February, improving by 37% since March 2009.**
- **Texas' unemployment rate stood unchanged at 8.2% for the fourth consecutive month in February.**
- **According to the Institute for Supply Management, U.S. manufacturing and service sectors are expanding, however construction activity remains weak on concerns over demand sustainability as the home tax credit expires in April.**
- **According to the latest Moody's Economy.com U.S. Regional Forecast, Dallas and Houston are among the few large U.S. metro areas that have already emerged from recession.**

Executive Summary

The U.S. economic recovery is gathering pace. Indeed, manufacturing and service sectors continue to expand, according to the Institute for Supply Management. In March, the business activity index for non-manufacturing sectors jumped to its highest level since early 2006. Meanwhile, the employment index reached a break-even point, meaning that firms in the service sector are hiring again. In addition, data on consumer spending (including retail sales, chain store sales and personal consumption expenditures) point to improving demand. Growing sales and lean inventories will continue to support the economic recovery as businesses increase stock on more optimistic economic expectations.

At the same time, consumer spending, which before the crisis grew faster than personal income, thanks to increasing consumer debt, is unlikely to support strong growth anytime soon. Indeed, falling consumer credit, slower growth of wages and salaries, weak labor markets, and ongoing consumer deleveraging imply that consumption growth will lag behind income growth as the economy recovers. This means that exports will likely replace domestic consumption as the major source of sustainable growth in the U.S. economy. There are promising signs of an export-led recovery in U.S. factory activity. In January, exports from the U.S. jumped nearly 20% on stronger shipments of manufacturing goods, including machinery, electronics, equipment and vehicles. This means that a higher share of exports in U.S. regional economies will be an advantage during this recovery (and Texas is the largest exporting state).

In fact, an upturn in Texas manufacturing has been accelerating since November 2009 on improving domestic and foreign demand for high-tech products, machinery and chemicals. Texas metros are benefitting from a competitive manufacturing base, stable housing markets, and a resurgence in commodity prices. According to the Texas Manufacturing Outlook Survey, the state's factory activity grew for the fifth consecutive month in March, with the production index jumping to its highest level in two years. Meanwhile, manufacturing firms are starting to bring back workers. Still, construction-related products remain weak for Texas manufactures as residential and commercial housing activity lingers at record low levels. However, higher crude oil prices support a rebound in mining, as Texas well permit applications and rotary rig counts reached their highest levels in over a year.

Both the U.S. and Texas have been losing jobs at a slower rate since August 2009. In February, Texas nonfarm employment fell by only 2.3%, while the unemployment rate has been flat at 8.2% for the past four months, and was smaller than the national unemployment rate by 1.5 percentage points. In addition, Texas has the lowest unemployment rate among the 10 largest states (the second lowest rate is New York at 8.8%). The pace of job losses in construction, professional and business services, leisure and hospitality, and trade and transportation decelerated in 2010. As a result, the number of nonfarm jobs in the state remained virtually unchanged (during the first two months of 2009, Texas lost about 118,000 jobs). Lastly, jobs in professional and business services grew during the first two months of 2010. While national employment in this sector returned close to its 2000 level, falling by 8.7% since December 2007, Texas lost only 3% of these jobs during the current recession. As a result, Texas managed to retain a large portion of its technical, research and business management skills. This represents another advantage that favors a more dynamic recovery for the Texas economy.

The national and Texas housing markets are stabilizing, although construction activity remains well below pre-crisis levels. In particular, the end of the first-time and repeat home buyer tax credits, which expire in April 2010, and a high level of foreclosed properties, continue to threaten the sustainability of the housing recovery.

Texas Private Equity News Summary

3/16: Sterling Group closes $820M fund - Houston-based private equity firm The Sterling Group announced it has held the final closing on its third fund of $820M. The fund will be invested in middle-market manufacturing, industrial service and distribution companies between $100M and $500M in enterprise value. Deals will be accomplished through corporate carve-outs, buy and build strategies and family-owned businesses.

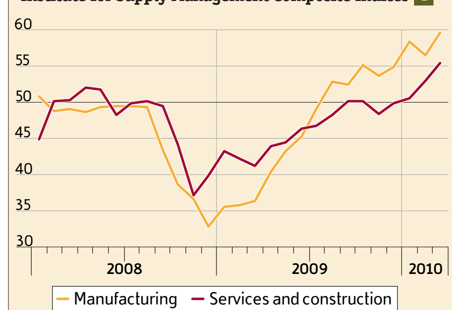
3/10: Metaswitch acquires AppTrigger Inc. - Metaswitch Networks, a London-based provider of carrier systems and communications software solutions has acquired Apptrigger, a Richardson-based maker of technology that allows software designed for one type of network run on other types of networks. No financial terms were disclosed. AppTrigger has raised between $40-50M in venture financing from backers such as Sevin Rosen Funds, CenterPoint Ventures and the former Hunt Ventures.

3/10: Lone Star revives Korean Exchange Bank sale - Dallas-based Lone Star Funds has resumed efforts to sell its majority holding in Seoul's Korea Exchange Bank and will offer the stake to both domestic and foreign investors. Lone Star managing partner John Grayken is reported to have said that the fund expects to sell the stake in the next six months.

3/1: CCMP Capital Buys Francesca's Collections - CCMP Capital has acquired a controlling interest in the Houston-based company for an undisclosed amount. Francesca's Collections is an operator of 160 small-box women's fashion retail stores across 33 states.

Economic Growth

Institute for Supply Management Composite Indices 1



A reading above 50% indicates expansion.
Source: Institute for Supply Management

The U.S. economic recovery appears to be gathering pace. Indeed, in March, nonfarm employment registered the largest monthly gain in three years. And, a revision of the GDP growth in 2009 points to stronger growth of corporate profits and business investment in equipment & software. Manufacturing and service sectors continue to expand, as indicated by the surveys of the Institute for Supply Management (see chart 1). In particular, in March the business activity index for non-manufacturing sectors increased to 60.0 percent; its highest level since early 2006. Meanwhile, the employment index improved to 49.8 percent from its record low of 32.8 percent a year ago. This means that firms in the service sector (which employ over 85 percent of all nonfarm workers and accounts for two thirds of the U.S. economy) are increasingly likely to resume hiring.

More optimistic business and labor market conditions generally improve consumer sentiment, which fell sharply in February. In March, the Conference Board Consumer Confidence Index improved to 52.5% from 46.4% the month before. Although, the unemployment rate remains close to 10%, employed workers are starting to feel more comfortable about increasing their spending. After all, labor markets have stabilized, economic growth resumed in the last quarter of 2009, and households' net worth increased by over 11% (or $5.6 trillion) over the last three quarters. Meanwhile, interest rates and inflation remain at record lows. And, according to the Bureau of Economic Analysis, real wages and salaries have been growing for the last five months; which pared the 12-month decline to only 0.05% in February, from its worst level of nearly 5% in the third quarter of 2009. All of this has helped to release pent-up demand after more than 24 months of economic slowdown. Indeed, according to the U.S. Census Bureau, seasonally adjusted retail sales grew by 0.3% in February versus the previous month and were 3.9% above February 2009. Real personal consumption expenditures, which include outlays on services, returned to growth

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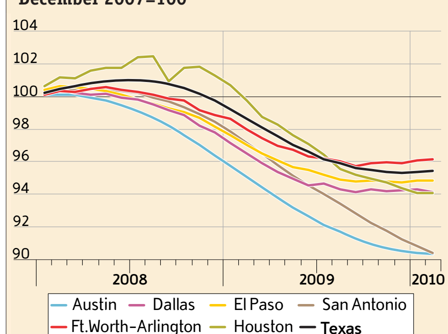
in the last quarter of 2009 (see chart 2). And chain store sales, tracked by the International Council of Shopping Centers, jumped by 9% in March - the strongest reading since 1999.

These recent improvements in sales are likely to accelerate inventory restocking in the first half of 2010. In fact, according to the U.S. Census Bureau, the total business inventories to sales ratio fell to 1.25 in January 2010 compared to 1.46 a year ago, which means that at the beginning of the year companies were still hesitant to build up stock levels depleted through the recession. However, in the first two months of 2010, new orders of manufacturing goods have been growing on a monthly basis, and in February were up by 12.5% compared to the same month a year ago. This implies expectations of future economic conditions are getting more optimistic, adding strength to business demand for inventories.

A manufacturing recovery appears to be gaining strength in Texas as well. According to the Texas Manufacturing Outlook Survey conducted by the Federal Reserve Bank of Dallas, the state's factory activity grew for the fifth consecutive month in March 2010, with the production index jumping to its highest level in two years (see chart 3). The employment situation in Texas manufacturing is getting better, as the Number of Employees Index turned positive for the first time since July 2008. This means, on the balance, manufacturing firms are starting to bring back workers. In February, Texas industrial production, which also includes mining and utilities, grew by an annualized, seasonally adjusted, rate of 4.4% as economic activity continued to improve (see chart 4). In particular, the Houston Purchasing Managers Index, which tracks economic activity in the Houston area, has improved by 37% since March 2009.

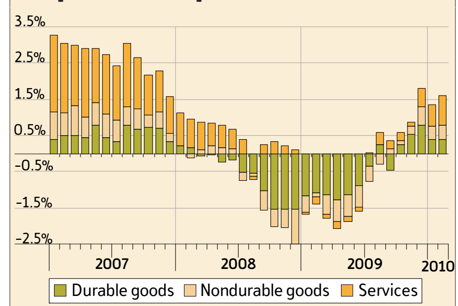
Texas and Metro Business Cycle Indices, December 2007=100 5



Source: The Federal Reserve Bank of Dallas

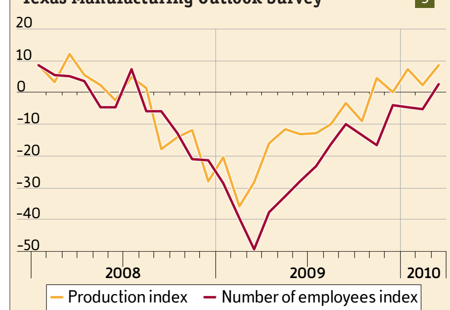
The Metro Business-Cycle Indices show that Texas metro economies are already stabilizing, with Fort Worth - Arlington returning to modest growth (see chart 5). According to the latest Moody's Economy.com U.S. Regional Forecast, Dallas and Houston are among the few large U.S. metro areas that have already emerged from recession. After all, metros with a strong manufacturing base, stable housing markets and commodity producers are recovering faster thanks to improving exports and inventory restocking. Indeed, higher crude oil prices (the price of West Texas Intermediate crude has more than doubled since February 2009) have supported a 7.5% rebound in mining since March 2009. Texas well permit applications and the rotary rig count reached their highest levels in over a year, increasing by 60% versus a year ago. Meanwhile, a recovery in manufacturing has been accelerating since November 2009, on improving domestic and foreign demand for high-tech products, machinery and chemicals. At the same time, construction-related products remain a soft spot for Texas manufacturing as residential and commercial housing activity lingers at record low levels.

Contributions of spending on services and goods to annual % growth of real personal consumption 2



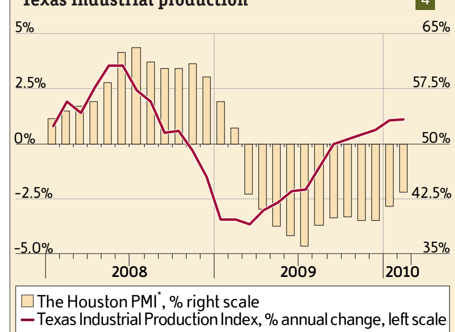
Source: The Bureau of Economic Analysis, The Bleyzer Foundation

Texas Manufacturing Outlook Survey 3



Source: The Federal Reserve Bank of Dallas

Texas industrial production 4



*Purchasing Managers Index, a value greater than 50% indicates expansion

Source: The Federal Reserve Bank of Dallas, Institute for Supply Management

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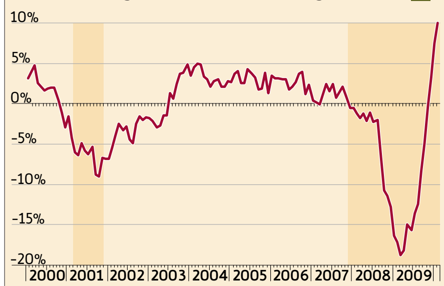
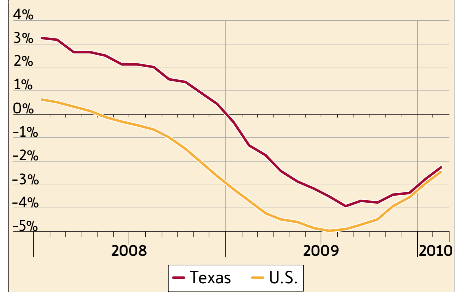
Finally, in February 2010 the Texas Leading Index (TLI), compiled by the Federal Reserve Bank of Dallas, climbed by 12% after reaching its bottom in March 2009. Although, the largest 12-month drop of the TLI during the previous recession was twice as small as in 2009, this time the index is recovering faster. Indeed, the TLI started registering modest annual gains 28 months after the beginning of the 2001 economic slowdown versus a strong rebound off the lows just 24 months after the 2007 recession (see chart 6). This implies that this time, a protracted economic recovery in Texas is less likely than in 2001.

Texas Leading Index, % annual change 6



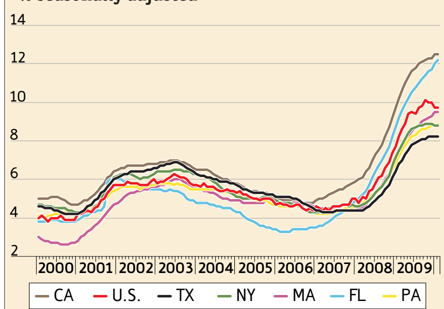
Source: The Federal Reserve Bank of Dallas, NBER

Nonfarm employment, seasonally adjusted % annual change 7



Source: The U.S. Bureau of Labor Statistics

The U.S. and Texas unemployment rates, % seasonally adjusted 8



Source: The U.S. Bureau of Labor Statistics

State unemployment rates 9

	Unempl. rate	Empl.% change	% of the U.S. empl.
Virginia	7.2%	-2.7%	2.8%
Texas	8.2%	-2.3%	7.9%
New York	8.8%	-1.9%	6.5%
Pennsylvania	8.9%	-2.5%	4.3%
Massachusetts	9.5%	-2.5%	2.4%
Washington	9.5%	-3.1%	2.2%
New Jersey	9.8%	-2.1%	3.0%
Indiana	9.8%	-2.7%	2.1%
Georgia	10.5%	-3.5%	2.9%
Ohio	10.9%	-3.4%	3.9%
North Carolina	11.2%	-2.4%	3.0%
Illinois	11.4%	-3.3%	4.3%
Florida	12.2%	-2.9%	5.5%
California	12.5%	-4.1%	10.7%
Michigan	14.1%	-2.8%	3.0%

Source: The U.S. Bureau of Labor Statistics

Employment

The pace of job losses has been decelerating in both the U.S. and in Texas since August 2009. In February, Texas nonfarm employment fell by only 2.3%, versus 4% in August 2009; meanwhile, the nationwide job loss rate narrowed to 2.4% from 5% (see chart 7). The unemployment rate in Texas increased to 8.2% in February 2010 from 6.8% a year ago, while the U.S. unemployment rate was at 9.7% - up by 1.5 percentage points (pps) during the same period. The unemployment rate in Texas has been smaller than in the U.S. for more than three years, while the difference between the U.S. and Texas unemployment rates widened from 0.2 pps in January 2007 to 1.5 pps in February 2010 (see chart 8). This means that during the recent economic downturn, the labor market in Texas was more resilient than in many other large U.S. regional economies. Indeed, out of the 15 largest states, which provide about 2/3rds of all nonfarm jobs in the U.S., Texas has the second lowest unemployment rate (see chart 9). The unemployment rate in Virginia, which has the lowest jobless rate among these 15 states, increased by 0.5 pps in 2010, while the Texas unemployment rate remained unchanged for the last four months. Indeed, during 2009, the Virginia labor market benefitted from a higher share of jobs in relatively recession-proof sectors, such as health care, education and government (about 37% of all nonfarm jobs in Virginia vs. only 31% in Texas). However, in February 2010, the pace of job losses in construction, professional and business services, leisure and hospitality, and trade and transportation accelerated in Virginia, while the opposite trend was observed in Texas. As a result, the number of nonfarm jobs in Texas remained virtually unchanged (during the first two months of 2009, Texas lost about 118,000 jobs).

In particular, during the first two months of 2010, Texas added about 14,000 new jobs in professional and business services - the third largest sector by employment after government and trade, transportation, and utilities. A reversal of the employment downtrend in business and professional services is significant in its own right due to the sector's large contribution to output and employment. This sector employs 12% of all nonfarm workers in Texas (or about 13% nationwide) and accounts for about the same share of output. More importantly, the growth of this sector reflects an improving capacity of the Texas

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Where Opportunities Emerge

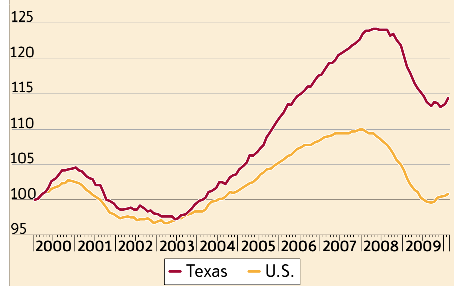
economy to produce technical, research and scientific innovations. All this helps boost productivity growth and strengthens the ability of Texas businesses to compete both nationally and worldwide. Indeed, a indicated in Chart 10, the number of jobs in business and professional services in Texas has increased considerably since the 2001 recession. And while national employment in this sector returned to its 2000 level, falling by 8.7% since December 2007, Texas lost only 3% of these jobs during the current recession. This means that, despite a harsh economic environment, Texas managed to retain a large portion of its technical, research and business management skills. And this represents another advantage that favors a more dynamic recovery for the Texas economy.

Housing Market

According to the Real Estate Center at Texas A&M University, in February home sales in Texas grew by 28% compared to the month before, on stronger sales in Houston and Dallas. At the same time, year-over-year home sales declined by 2% as sales of homes in Dallas and Houston dropped by 9% and 5% versus February 2009. This means that weaknesses in the housing market continue to persist as 12-month sales remain well below their 2007 levels across all major metros (see chart 11).

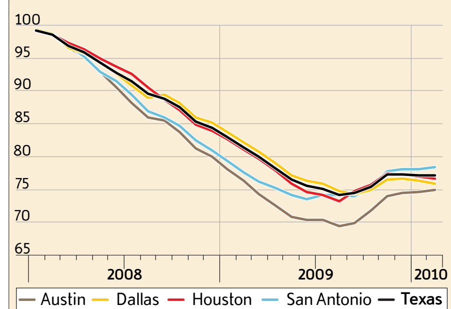
Nationwide, the housing picture, although stabilizing, is still mixed as the tax credit and a flood of foreclosed properties make it difficult to judge whether a recent uptick in demand is sustainable. Indeed, according to the National Association of Realtors, February was the eighth straight month of annual gains nationwide in existing home sales. However, the first-time and move-up/repeat home buyer tax credits, which expire in April 2010, may have added much more strength to this home buying activity than would otherwise be the case.

Jobs in professional and business services, seasonally adjusted, January 2000=100 10



Source: The U.S. Bureau of Labor Statistics

Texas home sales during the last 12 months, 2007=100 11



Source: The Real Estate Center at Texas A&M University

Median home prices and existing home sales in February 2010, % annual change 12

	Median price	Home sales
Atlanta	-3.7%	-3.7%
Baltimore	-7.4%	8.3%
Boston	5.4%	15.1%
Cincinnati	11.5%	-19.0%
Dallas	1.7%	-2.8%
Houston	6.2%	-4.9%
Indianapolis	6.0%	39.5%
Kansas City	-4.8%	-4.1%
Miami/Ft. Lauderdale	-7.5%	21.0%
Minneapolis	6.0%	4.2%
New Orleans	2.1%	-20.6%
New York	0.8%	12.8%
Philadelphia	4.0%	-2.0%
Phoenix	8.7%	-2.9%
Pittsburgh	10.2%	-0.1%
Portland	-8.4%	25.1%
San Antonio	-1.9%	8.3%
St. Louis	3.3%	-1.3%
Washington DC	7.0%	-8.1%

Source: The National Association of Realtors

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