SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION

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- **Key business cycle indices continue to point to a turnaround in the US economy which grew at an annual rate of 5.9% in the last quarter of 2009.**
- **The Houston Purchasing Managers Index advanced to 53.2 - its highest level in 15 months.**
- **In January 2010, existing homes sales in Texas were down by 5% versus January 2009; however, the share of prime and subprime loans in foreclosure in Texas remain some of the lowest in the country.**

Executive Summary

U.S. real GDP grew at an annual rate of 5.9% in the last quarter of 2009 - the second consecutive quarterly gain. Although inventory accumulation remained the main driver of economic expansion, non-residential fixed investment posted the first quarterly gain since the second quarter of 2008. Indeed, signs of economic stabilization are leading companies to increase spending on equipment and software as the economic outlook becomes more positive. Furthermore, January's manufacturing and non-manufacturing surveys, released by the Institute for Supply Management, registered the third consecutive monthly improvement, suggesting that a broad based economic expansion may be under way.

In January, the Houston Purchasing Managers Index advanced to 53.2, marking the fifth consecutive month of output growth in manufacturing. The start of an inventory rebuilding cycle and the resumption of foreign demand supports our thesis that a relatively broad based industrial recovery in Texas is underway. Increasing crude oil prices add strength to the relative outperformance of the regional economy here in Texas. Employment in the Texas mining industry grew in the last quarter of 2009, as Texas oil rig drilling resumed. Indeed, the lagged response of employment in mining to higher oil prices implies that this sector is likely to create new jobs in 2010 as well.

That said, it's still too early to declare that the economic recovery has become solidly entrenched. Most importantly, high unemployment rates continue to weigh down on consumer sentiment. Meanwhile, tight credit is making it difficult to sustain consumer spending as incomes and employment continue to decline. Solid growth of consumer and investment spending is necessary to put this recovery on a more sustainable footing. However, at present, businesses are still cautious about increasing capital spending, which is confirmed by the weaker than expected report on durable goods orders. On the upside, the private sector financial balance went into surplus in 2009, as business and households reduced leverage. As a result, non-financial businesses have much stronger liquidity positions compared to past economic downturns, which means they should resume investment spending faster than after previous recessions.

On the employment front, the current recession appears to mirror the initial stages of the last two economic recoveries, when a resumption of output growth went together with a surge in productivity and a declining payroll. A reallocation of workers to new jobs following a permanent loss of employment takes longer than calling back laid-off employees. And this time, the share of permanently lost jobs is even higher than during the last recession. At the same time, during the current recession the adjustments of employment and hours worked to output declines were more pronounced relative to past downturns. In addition, more industrial equipment and machinery stayed idle, while the speed at which they're brought back online has been faster than during previous recessions. And, average productivity growth is slower than after the last downturn. All this means that companies are likely to call back laid off workers sooner if demand for their products and services continues to strengthen.

In January 2010, existing homes sales in Texas fell by 5% versus January 2009, as sales remained weak across major metro areas. Nationwide, distressed properties continue to dominate the housing market, as home sales tend to bounce back faster in areas most affected by the bursting of the housing bubble. A high share of foreclosed homes will delay housing recovery in many large U.S. cities. That said, the quality of loans in Texas remains better than in other large states, which should support stronger housing activity. Indeed, in the last quarter of 2009, Texas had the eighth lowest foreclose rate in the prime market (only 3.2% vs. 7% nationwide), and the third lowest foreclosure rate in the subprime market (18.7% vs. 30.6% nationwide).

Texas Private Equity News Summary

2/22: EnCap launches $2.5B energy fund - EnCap Investments has initiated the fund-raising process for its eighth fund with a target of $2.5 billion. Based in Houston, the firm focuses on oil and gas energy buyouts. EnCap is currently concluding fund-raising for the EnCap Energy Infrastructure fund, which executives estimate will close at $600M.

2/17: Nautic Partners sponsors Healthcare Payment Specialists recapitalization - Nautic Partners has sponsored a recapitalization of Healthcare Payment Specialists LLC, a Ft. Worth, Texas-based provider of healthcare payment and reimbursement solutions. No financial terms were disclosed for the deal, which was done in partnership with company management.

2/12: Catterton Partners acquires Sun Water Systems - Greenwich-based Catterton Partners acquired Sun Water Systems Inc., the drinking-water filter manufacturer. Based in Haltom City, Texas, Sun Water Systems produces its filtration systems under the Aquasana brand. Terms of the deal were not disclosed.

2/12: Intrinsity raises $4M from 11 investors - Chip designer Intrinsity has raised an additional $4M in a new round of funding from investors including Adams Capital Management, Altitude Capital Partners, Goldman Sachs, The Hillman Co. and Northwater Capital Management.

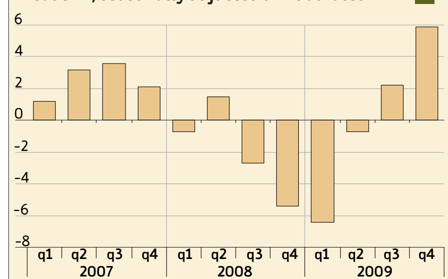
2/10: Insight Equity announces fund close - Insight Equity, a Dallas-based private equity firm focused on middle market investments, has closed its second fund at $525 million, including $90 million for mezzanine investing, which is short of the previously announced $750M target.

Economic Growth

The U.S. economic picture is becoming more optimistic. According to the Bureau of Economic Analysis, real GDP grew at an annual rate of 5.9% in the last quarter of 2009 (see chart 1). Inventory accumulation was the principle driver of economic expansion, contributing 3.9% to overall GDP growth. In addition, nonresidential fixed investment posted the first quarterly gain since the second quarter of 2008, as companies spent more on equipment and software. This implies that the U.S. economy may be stabilizing as expectations of economic rebound lead businesses to increase investment. Indeed, key business cycle indices point to a turnaround in U.S. economic activity. In particular, the Conference Board Leading Economic Index rose in January for the tenth consecutive month. Meanwhile, in the first month of 2010, the Chicago Fed National Activity Index increased to 0.02, which means the economy may be growing at its trend rate. January's manufacturing and non-manufacturing surveys, released by the Institute for Supply Management, registered the third consecutive monthly improvement, suggesting that a broad based economic expansion may be under way.

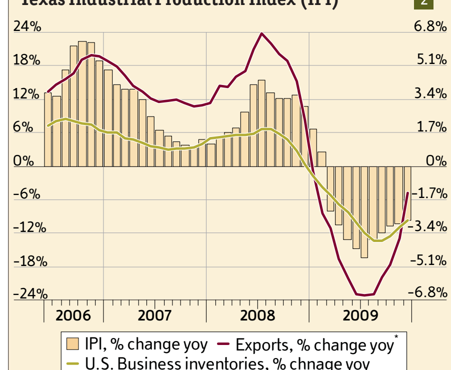
All this bodes well for the Texas economy, as the start of an inventory rebuilding cycle and the resumption of foreign demand support industrial recovery in the region (see chart 2). According to the latest U.S. Regional Outlook released by Moody's, the Texas economy is in recovery mode as demand for intermediary manufacturing goods continues to improve. Higher energy prices add strength to the regional economy as well. Indeed, employment in the Texas mining industry grew in the last quar-

Real GDP, seasonally adjusted annual rates 1



Source: Bureau of Economic Analysis

Texas Industrial Production Index (IPI) 2



* 6-month moving average

Source: The Federal Reserve Bank of Dallas, the U.S. Census Bureau

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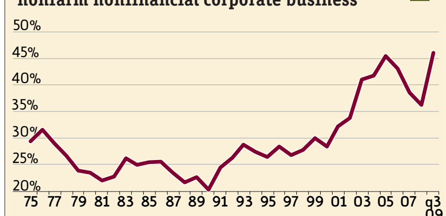
ter of 2009, as increasing crude oil prices prompted the resumption of drilling at Texas oil rigs (see chart 3). And, the lagged response of employment in mining to higher oil prices implies that this sector is likely to create new jobs in 2010 as well.

A gradual uptick in Texas mining and manufacturing may lift economic activity in the broader economy as demand for services supporting goods-producing industries picks up (see chart 4). Texas has a high share of local jobs in goods-producing industries - over 15% (due to a relatively larger mining sector), while the share of manufacturing in the state's economy is about 13%.[1] However, unlike most other large manufacturing states, production of motor vehicles and parts accounts for less than 0.5% of Texas GDP. States where motor vehicles and parts represented over 10% of all manufacturing saw their unemployment rates surge above 10% by the end of 2009. That said, we believe Texas is less exposed to sectors where job losses have been driven by structural changes rather than cyclical adjustments. This means, as the economy starts growing again, Texas employment should return faster to its pre-crisis level compared to other states.

Still, it is too early to claim that the U.S. economic recovery has become solidly entrenched. In February, the Conference Board reported that consumer confidence in the U.S. fell to its lowest level in 10 months. High joblessness continues to weigh on consumer sentiment, while tight consumer credit is making it difficult for the unemployed to offset income shortfalls with borrowing (see chart 5). The housing market recovery is still weak as home sales and construction activity linger well below historical averages. Elevated fiscal and monetary policy uncertainties are exerting a toll on consumer and investor confidence as well. Indeed, a weaker than expected report on orders of durable goods, released by the U.S. Commerce Department in February, implies that businesses are still cautious about increasing capital spending.

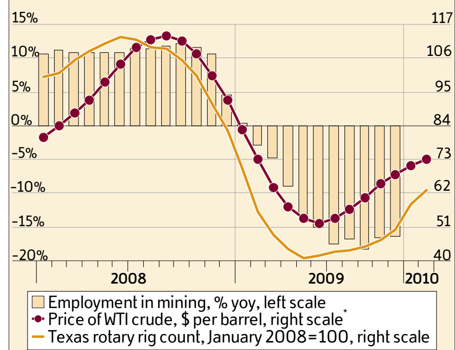
On the upside, aggressive de-leveraging helped push the private sector financial balance into surplus in 2009. The surplus of gross private savings over gross private investments exceeded 6% of GDP in the third quarter of 2009 compared to a 2% deficit at the end of 2007. Personal savings as a percentage of disposable income increased to 4.6% in 2009 (versus 1.2% in the first quarter of 2008), while the ratio of liquid assets to short-term liabilities of non-farm non-financial corporate businesses grew to 46% in the third quarter of 2009 (versus 36% in the first quarter of 2008). This means that households and companies are emerging from this recession in better shape than at the onset of the financial crisis. Furthermore, non-financial businesses have much stronger liquidity positions compared to past economic downturns. As a result, companies may resume investment

Liquid assets to short-term liabilities of nonfarm nonfinancial corporate business 6



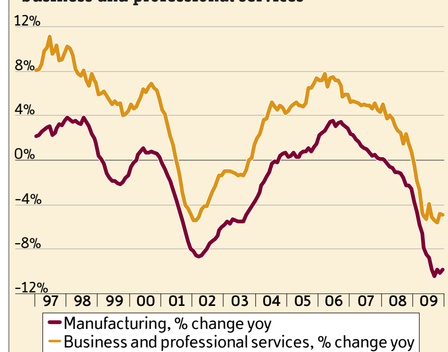
Source: The Federal Reserve System

Oil prices and employment in the Texas mining industry 3



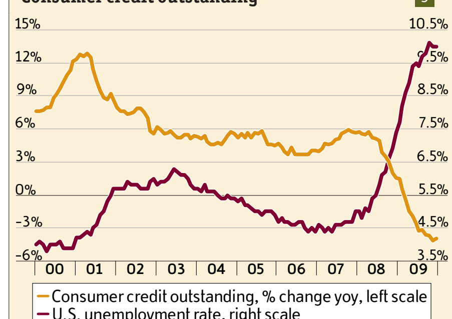
* 9-month moving average
Employment data for January and February 2010 is not yet available
Source: The Federal Reserve Bank of Dallas, the U.S. Bureau of Labor Statistics

Texas employment in manufacturing and business and professional services 4



Source: The U.S. Bureau of Labor Statistics

Consumer credit outstanding* 5



* Seasonally adjusted
Source: The Federal Reserve System, the U.S. Bureau of Labor Statistics

[1]The Bureau of Economic Analysis, Gross Domestic Product by State 2008.

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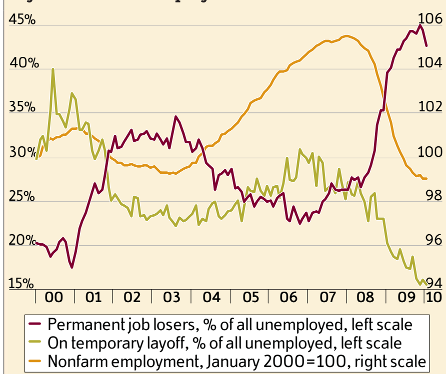
spending faster than after previous recessions, which should help put the nascent economic recovery on a more sustainable footing.

Employment

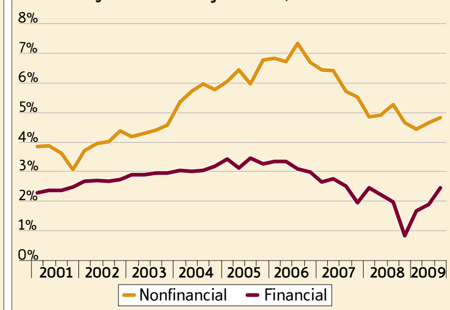
Although U.S. non-farm employment fell by only 20,000 jobs in January versus 780,000 jobs a year ago, the 9.7% U.S. unemployment rate remains the highest in over 25 years. A resumption of real GDP and manufacturing growth still has to trigger the growth of employment for any economic recovery to truly take hold. We believe the current recession closely mirrors the initial stages of recovery after the last two recessions, when a revival of output growth came together with a surge of productivity growth and declining payroll employment. According to the National Bureau of Economic Research, employment declined for 15 and 19 months during the 1990-91 and 2001 economic downturns, respectively. A reallocation of workers to new jobs following a permanent loss of employment takes longer than calling back laid-off employees. And this time, the share of permanently lost jobs is even higher than during the last two recessions (see chart 7).

Unemployed persons by reason for unemployment 7



Source: The U.S. Bureau of Labor Statistics

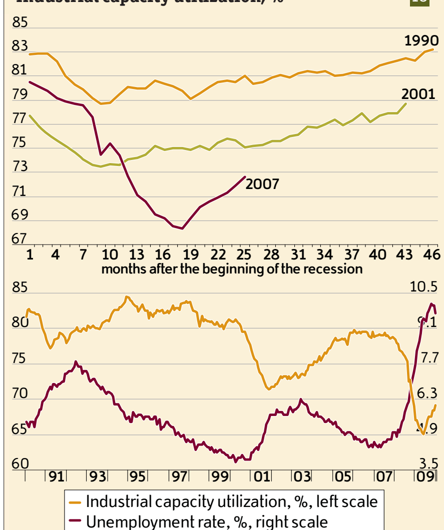
Corporate profits with inventory valuation adjustment, % of GDP 8



Source: Bureau of Economic Analysis

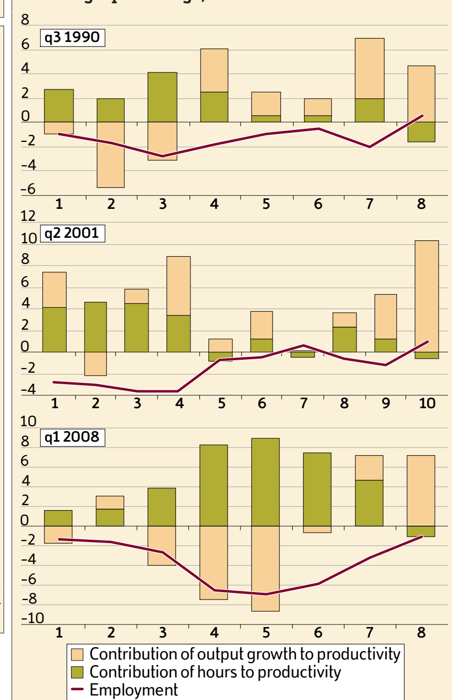
Aggressive cost cutting by businesses, translates into higher productivity growth and better profit margins (see chart 8). Growing productivity in turn, allows firms to delay hiring new staff when demand returns. During the last two recessions, businesses started increasing employment only when they exhausted productivity gains coming from more hours worked by their existing employees. Indeed, employment grew once the contribution of hours worked to productivity growth turned negative (see chart 9). The same chart also shows that during the current recession, the depth and speed of adjustments of employment and hours worked to output declines is more pronounced relative to past downturns. This may imply a faster return to employment growth as well.

Industrial capacity utilization, % 10



Source: The Federal Reserve System, the U.S. Bureau of Labor Statistics

Output per hour (productivity), % change quarter ago, at annual rate 9



Quarters after the beginning of the recession
Source: The U.S. Bureau of Labor Statistics

In addition, this time more industrial equipment and machinery has been idle versus previous recessions (see chart 10). The speed at which this capacity is being brought back online appears to be faster than during prior recessions. This is important, because a turnaround in capacity utilization tends to be followed by the peak unemployment rate as companies stop laying off workers.

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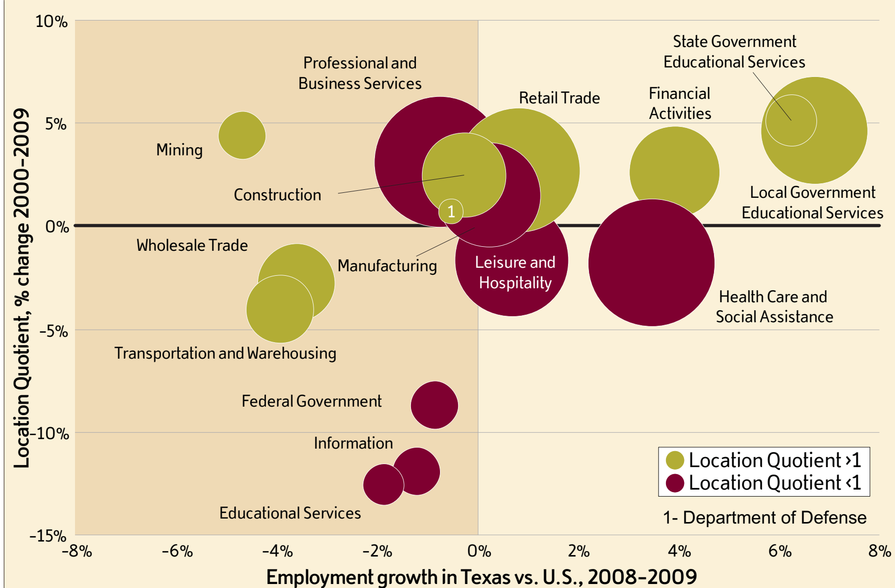
Lastly, companies may not be able to achieve the same scale of productivity gains relative to the 2001 recession. In fact, during the first eight quarters after the 2001 downturn, output per hour (productivity) grew by a greater than 4% average annual rate driven by past investments in information technology and integration with various business processes. This time, average productivity growth is only 3%, which means that companies may call back laid off workers sooner if demand for their products and services continues to strengthen.

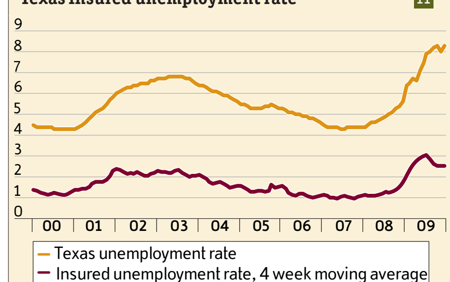
Employment clusters in Texas* 12



*Location quotient compares the local economy to the U.S. economy to identify specializations in the local economy. It is calculated as a ratio of the share of regional employment in the industry to the share of national employment in the same industry. A ratio greater than one indicates a relative concentration of industry in the state.
Source: The U.S. Department of Labor, the Bleyzer Foundation

Turning to Texas, its 8.3% unemployment rate is still below the national level and has not surpassed 10% in the last 33 years.[2] In addition, during the first five weeks of 2009, average weekly initial unemployment claims fell by over 22% compared to the same five weeks the year before. The latest report by the U.S. Department of Labor shows that claims continue to fall in Texas on the back of fewer layoffs in trade, services and manufacturing. In fact, the insured unemployment rate, which is a ratio of claims to covered employment, dropped to its lowest since March 2009, which may indicate that the Texas unemployment rate is likely to reach its peak in the first months of 2010 (see chart 11).

Texas insured unemployment rate 11



Source: The U.S. Department of Labor

Equally important, during the current recession the state's labor market performed better than labor markets in other states because Texas has a large diversified economy, which tends to specialize in relatively recession resilient sectors. Chart 12 shows industries in which Texas became less specialized since 2000 (below the black line) and which performed worse than similar industries nationwide in 2009 (shaded area). First, jobs in industries that employ nearly 60% of all workers in Texas grew faster or declined slower than nationwide in 2009. Second, more than 35% of all Texans work in industries that both performed better than similar industries nationwide and where employment concentration grew since 2000 (the northeast corner of the chart 12). Third, employment concentration in more recession hit industries (such as construction and business & professional services) grew only marginally since 2000, while their performance in Texas was mostly on par with national trends. Fourth, the state continues to employ relatively more workers in wholesale trade and transportation, where employment fell faster than nationwide. However, this is likely to reflect a structural change in those industries, as their share of total Texas employment now approaches national averages.

[2]Out of the ten largest U.S. states, only Texas, Pennsylvania and New York had unemployment rates lower than 10% in December (8.3%, 8.9% and 9%, respectively).

Finally, healthcare and social assistance, and leisure and hospitality (over one fifth of total Texas employment) still employ a relatively smaller proportion of Texans compared to the national average. In 2009, these two sectors performed better than similar industries nationwide and should continue to benefit from both favorable demographic trends in Texas and an upturn in economic activity.

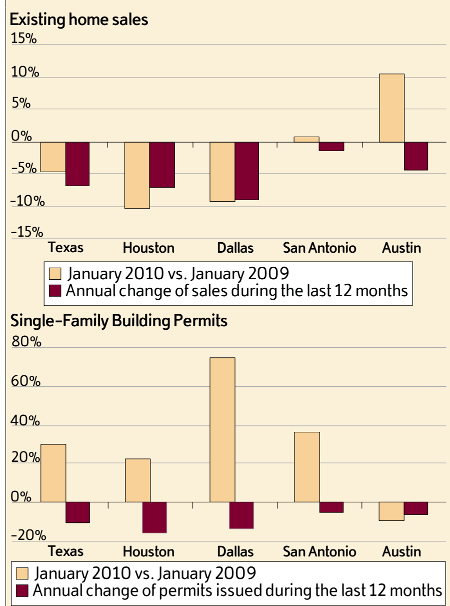
Housing Market

In January 2010, existing homes sales in Texas were down by 5% versus January 2009, as sales remained weak across major metro areas (see chart 13). The National Association of Realtors (NAR) reported a 7.2% drop in national home sales from December to January; however, home sales grew by 11.5% versus January 2009. Still, the median home price nationwide remained unchanged from a year earlier as distressed homes (about 40% of all sales in January) continue to constrain housing price gains.

On a positive note, the U.S. housing market appears to be reaching its bottom as both home sales and prices in major metros have started moving in the same direction, which is a sign of improving demand (see chart 14). Still, distressed properties continue to dominate the market, as home sales tend to bounce back faster in areas most affected by the bursting of the housing bubble. For example, over the last two years, median home prices in Miami/Ft. Lauderdale, New York, Portland, Boston and Baltimore fell by 42%, 19%, 16%, 15.8% and 12.2%, respectively. At the same time, home values in Texas metro areas fell only in Dallas-Fort Worth-Arlington (-3.8%), San Antonio (-2.5%) and Corpus Christi (-1.6%).

A high share of foreclosed homes may delay the housing recovery in many large U.S. cities. That said, the quality of loans in Texas appears to be significantly better than the nation average, which should support an earlier turnaround for the Texas regional housing market (see chart 15).

Housing activity in Texas 13



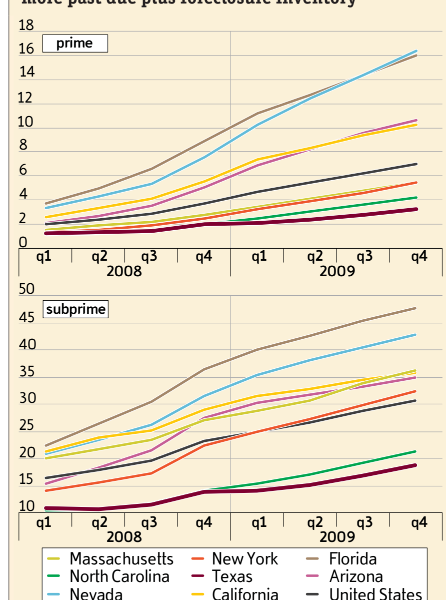
Source: The Real Estate Center at Texas A&M University

Existing home sales in the largest U.S. metros, % change January 2010 vs. January 2009 14

	Median price	Home sales
Atlanta	-9.6%	-2.0%
Baltimore	-3.2%	8.0%
Boston	12.4%	10.5%
Cincinnati	23.9%	-6.6%
Dallas	1.9%	-2.0%
Houston	11.8%	-11.0%
Indianapolis	13.5%	11.8%
Kansas City	9.2%	-4.2%
Miami/Ft. Lauderdale	1.4%	21.7%
Minneapolis	1.3%	-0.4%
New Orleans	9.8%	-10.1%
New York	2.9%	24.4%
Philadelphia	5.0%	3.6%
Phoenix	4.0%	-1.5%
Pittsburgh	10.9%	-1.4%
Portland	-0.8%	33.0%
San Antonio	-4.4%	0.0%
St. Louis	17.4%	-16.8%
Washington DC	2.7%	3.7%
U.S.	**0.0%**	**7.2%**

Source: The National Association of Realtors

Percent of loans in foreclosure, 90 days or more past due plus foreclosure inventory 15



Source: The Mortgage Bankers Association

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