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## Odd Times

These are odd times. Atlanta's economy has sputtered for two years and the real estate market has followed suit. Yet, many developers and investors are acting like nothing is wrong, and capital flows belie these troubled times. The usual symptoms of a down market are evident in soaring vacancy rates, falling rents, and slack demand, but the flight of capital that typically accompanies a real estate slump has not occurred.

A reflective person might ask why. First, interest rates are ridiculously low by historical standards. This has provided a great stimulus to the "for sale" housing market, particularly at the entry level. Low interest rates also favor commercial real estate because this positive leverage helps "make the numbers work" due to sharply reduced capital costs. Second, real estate shines right now relative to alternative investments. The stock market is struggling and highly uncertain, and yields on financial instruments are pitifully low, causing a flight to tangible assets. And third, optimism still abounds about Atlanta's future. The city has weathered previous setbacks and remains the economic capital of the Southeast. Continued strong in-migration, even in the face of declining employment, is the best evidence of this sanguine view of the future.

This combination of a depressed real estate market and abundant capital has produced some unusual conditions. The most striking is that no significant correction in real estate prices has occurred, and distressed property sales have been virtually non-existent. Developers are still aggressively pursuing new projects, following the "That's What I Do" mindset. The appetite for land acquisitions, which usually dissolves in soft real estate markets, has hardly diminished.

The apartment market presents the greatest puzzle. The vacancy rate slipped to 89.4 percent at

year-end 2002, after reaching as high as 96 percent just two years earlier. The usual culprit is overbuilding, but that has not been the case in this development cycle. Apartment construction during the 1990s was well below levels achieved during the 1980s, while population growth was greater in the 1990s. Coupling increased potential demand with diminished supply growth usually means a balanced market. Low interest rates turned many renters into first-time homeowners, however, and the 20 to 24 age cohort grew at a much slower pace than the overall population during the 1990s.

Another irony is that several major office developments are on the drawing boards because large tenants have leases expiring and want to achieve better operating efficiencies. They are considering relocation from perfectly good buildings to new office towers, even though their current landlords are surely making it economically attractive to stay put.

Perhaps the most disturbing and unprecedented oddity is the amount of phantom occupancy and available sublease space in the office market. A tremendous volume of space was leased but never occupied, estimated at over 7.0 million square feet. The market has recorded negative absorption for two straight years, which has never happened before. With approximately 32 million square feet available for lease, the return of speculative office development is unwarranted.

All of this is a little scary. The rebound in demand hinges on the economy's recovery, and the forecast for 2003 is not particularly bright. Abundant capital is artificially propping up real estate values and helping to fund new developments that should be shelved, at least for now. Thus, the current supply-demand imbalance is likely to linger for some time. It is truly ironic that the real estate industry is a magnet for investment capital at a time when market conditions suggest otherwise. ■