The Outlook for Commercial Real Estate in the Southeast

Joel Parker

Technological advances, changes in living and working styles, and the economic challenges of building downtown have fueled commercial development in the suburbs. Some observers consider commercial real estate to be an industry driven less by market demand than by the availability of capital.

Commercial building forms a large, vital segment of the southeastern construction industry. Commercial and residential construction combined employ over 683,000 people in the Southeast, accounting for over 5 percent of the region's employment and almost 5 percent of its personal income. Commercial builders' efforts can be seen all over the Southeast in such structures as Georgia-Pacific's headquarters in downtown Atlanta, the Omni International complex in Miami, and the River Front redevelopment in Nashville. Despite the high profile of such properties and their importance to local economies, the public's understanding of the processes that led to their constructon is generally dim.

To clarify some facets of commercial real estate development, the Federal Reserve Bank of Atlanta recently sponsored a workshop in which industry experts discussed their roles. From their diverse perspectives as consultants, developers, architects, financiers, and leasing brokers, the participants addressed common—and sometimes disputed—issues. For instance, each questioned whether developers and financiers made adequate use of available market information to analyze the need for additional office space. The consensus was that all too

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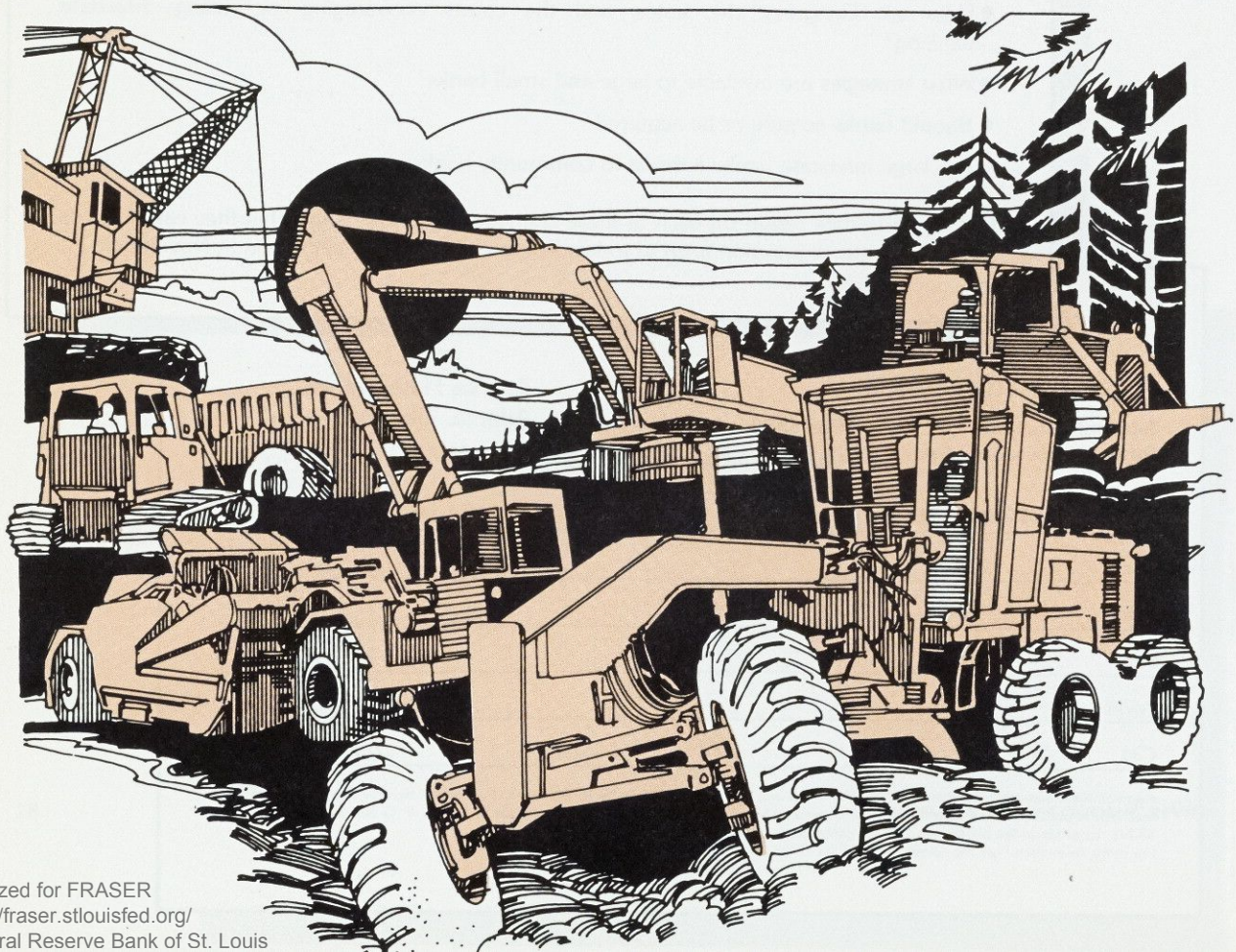


often the decision to develop rested instead on the mere availability of funds. This tendency suggests that commercial development is a "capital driven" rather than "market driven" industry, which would explain much of the excess space in some southeastern markets. Another shared concern was the apparent movement of businesses to the suburbs and the hurdles confronting developers who wish to work in downtown areas. A third thread running through the presentations was technological progress and its impact on the design, location, and market size for commercial development. The insights gleaned from this workship are summarized below, following an overview of the phases of commercial real estate development.

Phases of Commercial Development

The developer of an office building initiates the whole construction process and assumes the risk of failure. First he must acquire the land on which he plans to build. If the land is in parcels with two or more owners, the developer must negotiate the best possible price with each. Preferably for the developer, the landowners should not know what is planned for the property; otherwise they may hold out for higher prices, possibly lowering the project's final rate of return. In builders' jargon, this process of buying the building site is called "land assembly."

Once land has been acquired, the developer selects design specifications for the building. The architect takes his initial charge from the developer, but his final design proposal factors in the qualities of the particular site, surrounding infrastructure, type of tenants expected, local climate, and esthetics. In choosing a design, the developer considers an approach he thinks will lease well and the time required for construction. If the design is too expensive to construct or insufficiently attractive to prospective tenants, the developer's targeted rate of return may be jeopardized. Developers today recognize the positive contribution that the integration of functional and artistic design can make toward a building's financial success.

After selecting a design, the developer must determine whether the project complies with local zoning regulations and, if not, he must apply for a zoning variance. While differing from community to community, the rezoning process can be lengthy, even to the point where it undermines acceptable financing arrangements as interest rates climb.

Once the developer has the land, a viable design, and the legal go-ahead to use the land as he proposes, he either finances the project internally or presents the package to a potential financier. Possible sources of outside financing include mortgage bankers, insurance companies, investor groups, syndications, commercial banks, and savings and loan associations. Developers may seek financing only for projects they are reasonably certain will deliver their expected rate of return.

When all arrangements are completed except letting the contracts and beginning physical construction, a press release is sent to the local media. Until this point, the developer is careful not to publicize his efforts, because prior media coverage could drive up land prices and perhaps intensify local government or neighborhood opposition to zoning variances. After the critical contracts are signed, publicity works in the developer's favor by announcing to potential tenants the upcoming availability of new office space.

Site Selection and Timing of Entry

Where and when should a developer build? Industry wags respond, "Wherever and whenever he can get financing." Raymond Torto, partner of Torto, Wheaton and Associates, a Boston consulting firm, explained how a developer or financier might "do his homework."

Torto pointed out that market research should answer three questions for the developer. First, which markets will allow him to build, lease, and turn a profit? Second, in which submarkets should he locate his project? Third, when is the opportune time to bring a building "on stream" in the market? While good market research provides answers, it is only one part of a complex profit equation. In practice, Torto said, many developers either research the market only informally before building, or they do no market research at all.

Commercial real estate market analysts have a multitude of variables to consider. Torto explained that the vacancy rate, the ratio of unleased space to total space in the market, is

the first variable. Sometimes space is calculated in total square footage and sometimes in usable space footage, but one tells the story as well as the other. A declining vacancy rate generally indicates a tightening office market. Vacancy rates rise when economic downturns result in tighter space utilization by firms, or when new office space "comes on line" faster than it can be leased.

The price of office space, the second variable, is quoted in dollars per square foot. Rising prices indicate that space demand is squeezing supply, which bids up prices. But in any market there are several grades of office space, each selling for a different price. Hypothetically, the prices of one grade of space could be bid up without affecting the others appreciably. Rising prices indicate a more lively and competitive market overall.

Torto noted that the per square foot ratio of lease price to construction cost can be a helpful consideration. The higher this ratio, the higher the markup over cost. This indicator overcomes a shortcoming of the simple price trend as an indicator—that prices rise in response to rising costs. A developer who leases his space for more than the building across the street does not necessarily enjoy a larger margin over costs. For instance, if construction costs are rising more quickly than leasing prices, compressing the price and cost margins on new office space, price alone would not signal that new space was becoming less profitable over time.

According to Torto, the size of the office leasing market determines how changes in other market variables should be weighted. A city or metropolitan area such as Atlanta, Miami, or Jackson, Mississippi serves as the basic market unit, although most medium-sized and larger cities have identifiable and important submarkets. Taking office vacancy rate as an example, we would expect an indicator to change more slowly in Atlanta with its large inventory than in Jackson.

When a developer considers building in a market, his ability to prelease a portion of the space could make the difference between undertaking or aborting the project. With high vacancy rates, prospective tenants can shop around for the best deal, which makes preleasing difficult. Atlanta has a reputation among area developers for resisting preleasing. A high ratio of preleased space to total space under construction implies a strong demand for new space.

The rate of new construction in a market must be weighed against the leasing rate for existing vacant space, Torto said. Because of the long lead time for planning and construction (commonly 12 to 18 months), a building's availability for leasing does not necessarily coincide with the emergence of a demand for space. To double-check whether a market's low vacancy rate indeed indicates a need for more office space, the rate of subleasing should be used. Businesses tend to sublet if they ascertain that they have overcommitted on space for present and future needs. A high rate of subleasing points to excess capacity in the market, which a low vacancy rate can conceal.

Torto indicated that the average number of square feet per employee in a market also can

reveal a market's latent excess capacity. If the number significantly exceeds the industry's 200 square feet per employee rule of thumb, the vacancy rate may be understated in that market. If the businesses there could be released from their lease contracts, many probably would lease less space. Firms may tolerate poorly used space for a time, but ultimately they are likely to sublet it.

Businesses usually prefer to place all employees of like function in the same building rather than in scattered offices. If no single available block of space is large enough to accommodate

them, they may build or lease elsewhere. Thus even a high vacancy rate can be suspect in that it conceals information on the availability of large blocks of contiguous space.

Absorption, which Torto cites as the key variable in office market analysis, is commonly quoted for gross space absorbed and space absorbed net of moves within the market. Net absorption is a better indicator of the market's capacity for absorbing new space, for when firms simply move within the market that space is not counted as absorbed. Market analysts commonly divide the amount of unleased space on hand by the yearly absorption rate to discover the number of years' supply on hand at current absorption rates. The shorter the duration of complete absorption, the better for the prospective developer.

Data for these indicators are available for most medium-sized and large cities. Even so, Torto notes that many of these markets are chronically overbuilt and nursing in excess of a year's worth of unleased office space. (Houston's unleased office space exceeds the total office space inventory of Boston.) Office market analysts say the methods used to gather data are not always refined. For example, vacancy rate surveys are rarely a representative sampling of holders of office space in a city, and so they introduce a larger than necessary error in the rates. And while the "box of tools" available to market analysts has a number of components, it is woefully deficient in forecasting a market's capacity. Not a single leading indicator is among the variables discussed above; all are coincident indicators. In addition, Torto observed that the common indicators emphasize office space supply over demand. To predict the successful leasing of a building in the planning stage, we must develop some way of forecasting market demand.

Urban Commercial Development

Regardless of demand, the downtown developer faces a unique obstacle: "The critical problem in downtown areas really is land assembly." Raymond Gotlieb, president of Metropolitan Properties in Birmingham, remarked that time and the existence of multiple layers of previous development have made urban land assembly a cumbersome and costly chore. In the suburbs, where single landowners hold large tracts of land, acquisition is a straightforward process. The density of past development in the downtowns frequently forces developers to assemble a piece of land by buying it from several parties.

Dealing with a number of owners during land assembly leads to a sort of "prisoners' game" in reverse. The individual parcels have little value to the developer because he needs the whole tract for his project. The less aware that landowners are of the developer's overall scheme, the more likely they are to sell their parcels quickly without bargaining for a premium price. But should any owner realize that the developer has acquired every parcel except his own, he gains excellent bargaining leverage. If the developer must pay the premium to buy the holdout's land, Gotlieb remarked, this outlay will depress the project's final rate of return.

Gotlieb explained that in buying from as many as 20 or more landowners to complete a particular tract, a developer stands a good chance of encountering at least one holdout. This probability is greater in downtown areas because the local media are more likely to publicize the story than if the land was in the suburbs. Carried to its extreme, the difficulty could induce developers to avoid downtown areas altogether. Gotlieb surmised that this obstacle has contributed to the slow progress or lack of redevelopment in the downtowns of some southeastern cities.

Alternative solutions to the downtown land assembly problem include leaving the market to its own resources, promoting some form of condemnation by municipal governments, or urging government officials to play a strong advocacy role in the development of downtown areas. Gotlieb's preference is the third solution, which he views as a middle ground. Many downtowns need redevelopment but cannot attract developers who see easier money in the suburbs. Developers are the entrepreneurs in this industry; they decide when and where to build.

Most workshop participants agreed that the first solution, allowing the market to function naturally, will not promote urban commercial development in cities where financial incentives are absent. Developers build in areas offering the greatest profit opportunities, of course. Gotlieb believes that attracting development to downtowns where land assembly costs more than in adjacent suburbs will require either

government incentives or a lengthy wait for the market itself to reverse the relative incentives, independently of the desires of developers or city officials.

Another possible solution is for cities to condemn portions of their downtowns and auction the land to developers. The burden of land assembly then would shift to city governments. But, as Gotlieb noted, such a radical departure from market guidance of activities—and one that directly affects the wealth, income, and political influence of so many—would be politically unworkable almost everywhere. The condemnation procedure is associated too closely in the public mind with high-handed governments serving special interests.

City government advocacy of some urban commercial development steers the middle course between free market and condemnation driven development. Without interfering with the market, city government acts as a catalyst to remove obstacles to desirable development and to facilitate its progress. The City of Atlanta's joint venture with the Rouse Company to redevelop Underground Atlanta seems to offer a good example of this kind of municipal leadership.

Gotlieb pointed out that developers sometimes associate a greater risk with downtown projects than with those in the suburbs. The higher cost of land frequently dictates that a large building be constructed to show "pro forma" profitability. Developers can control risk in the suburbs by building in phases of approximately 12 months' duration. This schedule enhances the builder's ability to anticipate interest rate and leasing difficulties and to delay later phases until profit is more certain. Large downtown buildings seldom can be phased in this manner, and so the developer's risk is increased. Gotlieb said that, excepting special circumstances or incentives, many developers choose to reduce the risk they perceive by concentrating their work in the suburbs.

If tenants prefer to lease in the suburbs, the builder's risk of building downtown is compounded. The builder could mount his own campaign to sell prospective tenants on the advantages of the urban work setting, but government can do this far more effectively. Many southeastern city dwellers apparently prefer to work in the suburbs rather than downtown.

"Amenity" is a buzzword for developers building in the suburbs, but it is critically important to urban development as well. Narrowly defined, amenities refer to dedicated athletic facilities, good restaurants, free parking, park-like settings, an easy commuting distance, and the prestige of the area. Amenities enhance a worker's perception of the work environment. Government can do much to foster development of urban amenities just as it contributes to infrastructure through police, fire protection, and road construction. As a result, government can indirectly reduce a developer's risk and enhance the likelihood of his developing downtown.

In some southeastern cities, downtown white-collar workers evacuate to the suburbs after 5 p.m. According to Gotlieb, before a steady demand for restaurants, shops, theaters, and the like can emerge, people must take up residence in the downtown area. But with the abundance of land and inexpensive housing close to the centers of most southeastern cities, residents do not feel compelled to live "close in," he said. Even suburban commuters often are relatively close to downtown. Gotlieb questioned whether southeastern downtowns can attract the "people traffic" needed to spur investment in amenities that are prerequisite to extensive office development. He is dubious that this will happen soon.

Suburban Commercial Development

Land assembly is not the formidable barrier to the suburban developer that it is to the downtown developer. Thus he may have greater latitude for responding to the dictates of the market. J. Donald Childress, Atlanta partner of Dallas-based Trammell Crow Company, contended that developers are listening to their markets and, to some extent, basing their decisions on local market conditions. However, some developers' decisions apparently are founded on the availability of funding or on the existence of other building activity in a location. The commercial real estate depression of the mid-1970s probably resulted in part from such practices. He observed that Atlanta, Orlando, and Tampa experienced a commercial building boom through the first quarter of this year. Charlotte, Miami, and Richmond, on the other hand, have not developed nearly as fast recently.

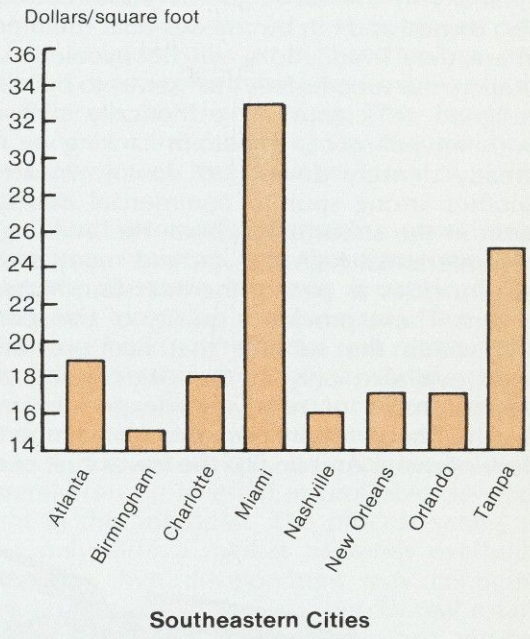
Childress' experience is that business must be handled on a local basis by those most familiar with the market. In his estimation Trammell Crow, the nation's largest commercial real estate developer, personifies the achievement of this method. The firm builds nationwide through local partners such as Childress, who own the projects they develop. Successful development makes a partner wealthy, but partners also share the cost of failure.

When developers build only in their local markets, there can also be drawbacks. If a market becomes overbuilt, developers who know only that market must either build at high risk of losing money or remain idle. Some developers cannot afford a hiatus, and even those who can may simply choose to take the risk. This risk-taking aggravates existing marketing difficulties for overbuilt areas. A regional or national perspective may alleviate the developers' tendency to build in their markets regardless of demand. For instance, firms developing in several markets can exercise control over which deserve current attention and which should be left fallow.

According to Childress, an important impetus to the commercial construction boom in southeastern cities is the huge supply of capital that banks, savings and loan associations, insurance companies, and other investors are willing to commit to real estate today. In fact, so strong is their desire to invest in commercial real estate that representatives of these institutions call on developers concerning their financing needs. The force of their conviction that commercial real estate is a good investment probably encourages some to relax their lending standards. An important safeguard that usually exists in this type of dealing—an adversary relationship—thus is undermined, and loan officers under pressure to make more loans may fail to exercise sufficient caution.

In Childress' view, the evidence suggests that a significant percentage of the commercial development in the Southeast is not a response to the market's demand for new space. Rents for comparable space in the West, Southwest, and Northeast commonly exceed those in the Southeast, where new office space demand is insufficient to push up rates. In the absence of high rents, it would seem that developers are attracted to the Southeast owing to the availability of capital for development (see Chart 1).

Chart 1. Cost of AAA Office Space



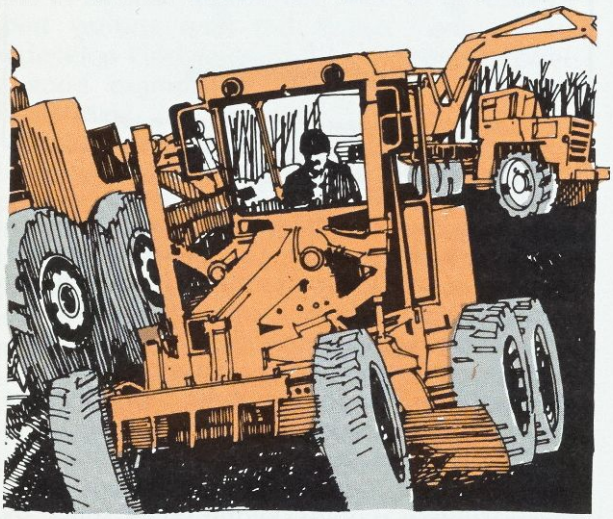
Source: Coldwell Banker data as of first quarter 1984.

Childress cited deregulation in several industries as a source for new office space demand. The breakup of AT&T, for example, ushered in an immediate demand by many of the new companies that were spun off. Companies that once shared the same offices or building required new buildings to establish their own identities as rivals. With deregulation of the financial services industry, new business opportunities have given rise to many new institutions. All of these likewise require unique office space by which the public can identify them.

Business office space began to move from downtown areas to the suburbs in the late 1950s and early 1960s, Childress explained. The widespread use of the telephone loosened the bonds that had constrained businesses to concentrate in one area of a city to facilitate good communications. The advent of high quality, high speed data transmission technology in the late 1960s and early 1970s cut the last tie binding the business community together in the downtowns. The stage was set for firms to

situate wherever they pleased. Childress himself expects "there will be a relentless and uninterrupted migration to the suburbs."

Initially in the move to the suburbs, those who owned and ran businesses built them near where they lived. Along with convenience of location, the suburbs lent themselves to buildings designed to create an esthetically pleasing work environment, a benefit lacking in the already densely developed downtown areas. Another strong spur to commercial development in the suburbs has been the building of circumferential highways around many southeastern cities as part of the interstate highway system. These provide a quality of transportation within the suburbs that had previously been available only at the cities' hubs, and opened miles of relatively inexpensive land that had been too inaccessible for commercial development. And finally, the lower cost of the



suburban land strongly attracted developers because it enabled them to build more profitably. The construction itself could be phased in ways that are not possible with most downtown development.

Childress noted that while not forced to construct large buildings for "pro rata" profitability, suburban commercial developers recently have introduced both large and tall buildings outside downtown. Until now, most suburban offices were low-rise structures that took advantage of inexpensive acreage. He cited his company's recently completed Atlanta Galleria complex as a pathbreaker in this high-rise market segment. Childress remarked that the success of the Galleria and other huge office buildings in the suburbs is linked to large companies' preference for suburban locations. These companies require vast blocks of contiguous space, which up to now were available only in the downtowns. The large firms also desire the prestige of structures such as the Galleria, and may have avoided the suburbs until such accommodations became available. Downtowns thus have become the province of professional firms, large financial institutions, convention facilities, and other firms that consider their image as a citizen of the local community to be of utmost importance.

An Architect's Perspective on Commercial Real Estate

Whether a project is located downtown or in the suburbs, whether it is redevelopment or new office space, its design has advanced to the fore as a critical factor in marketing to prospective tenants. With excess office capacity pandemic in medium-sized and large cities nationwide, developers must pursue every advantage—and good design can give them an important competitive edge. With its appeal to tenants seeking the prestige of an attractive structure and setting, a handsome property is more likely to achieve full occupancy. Gerald Hines, one of the nation's largest developers, has placed striking, esthetically pleasing design in the vanguard of his firm's marketing efforts.

Joseph Amisano, president of Toombs, Amisano and Wells of Atlanta, emphasized that building function and esthetics cannot be separated. The failure of either can undermine a project financially. Office development continues to increase in the suburbs, and suburban offices facilitate a different work style than do those downtown. Amisano remarked that both architects and developers can take advantage of the demand for structures supporting the new style, which favors easy commuting, an environment left as natural as possible, less formal work hours, and greater integration of work and non-work life.

New technologies may give rise to the most radical changes in the way an office building should function. The combination of telecommunications and microcomputers potentially can give information workers near independence from the traditional office. Amisano contends that no one yet believes the traditional office will disappear, but increasingly it looks as if the demand will be for a different kind of office space. Information workers can work at home three or four days out of five, traveling to the office only to consult with supervisors and to stay in touch with company events. The financial services industry already has taken great strides toward delivering its services electronically through automated teller machines, point-of-sale terminals, and credit and debit cards.

The chief challenge to architects in this rapidly changing business environment is to design structures that will function for many years. The so-called "high tech" building attempts to accommodate developments in office technologies by providing preinstalled hookups for data, text, and remote video conferencing. The design of such buildings must be flexible enough to embrace future innovations, yet not be so imposing or special purpose as to limit potential renters only to high-tech firms.

Commercial Real Estate Financing

Once the developer has acquired land and accepted a design, he can present his plan to a host of potential financiers: real estate financiers, banks, savings and loan associations, independent mortgage bankers, insurance companies, pension funds, syndication funds, and private investors. "The real estate financing business is experiencing an expansion in the Southeast," said Peter VanGraafeiland, president of the Oxford Mortgage Company of Raleigh, North Carolina. Atlanta, Tampa, and Orlando are attracting a large share of present attention, but it appears that up-and-coming growth areas include Gainesville, Florida, Greenville, South Carolina, and Greensboro and Raleigh in North Carolina. VanGraafeiland argues that these cities have been overlooked by commercial developers in their haste to build in Miami, Atlanta, and Charlotte, and in his opinion they are underdeveloped relative to the larger cities. This may be an example of the developer's bias in favor of markets where considerable building activity already is underway.

Particular types of industry seem to prefer the Southeast over other sections of the country. Corporate relocations to the Southeast are heavily weighted toward high-technology, low pollution, white-collar businesses such as Northern Telecom, IBM, and Wang. They locate in the region for the quality of life, the quality of the work force, and a lower cost of doing business.

New and relocating companies, commercial developers, investors, and those managing the financing all seem to have recognized the Southeast's potential simultaneously. But, VanGraafeiland said, commercial real estate financing has the same tendency as development: overbuilding. Banks, insurance companies, pension funds, and syndicators reportedly have more funds earmarked for real estate than currently can be invested in profitable development in the Southeast. The process seems to slow only after a market becomes overbuilt, and even then development may continue. Clearly, portions of the commercial real estate financing community ignore indicators and bypass market analysis just as do many developers.

VanGraafeiland, like Torto, implied strongly that the long-run stability of the commercial real estate industry depends heavily on financiers' and developers' hard-nosed analyses of the potential profitability of proposed building projects. Too often developers seem to consider the economic viability of a project as an afterthought to their decision whether to build. While developers trust that their projects eventually will show a profit, apparently few undertake a formal analysis beforehand. Those providing the financing likewise seem to put less faith in standard credit screening techniques than in the fact that many developers and financiers favor the prospects for a particular market, a tendency noted by Childress.

When faced with default on a commercial development loan, VanGraafeiland said that the financier does not always take a loss on the deal. If commercial property reverts to him, the lender conceivably could still turn a profit. A combination of deep pockets and moderate to high inflation can enable the lender to carry a property, whether it produces a positive cash flow or not, while seeking a buyer. Not infrequently, inflation over 5, 10, or 15 years will

allow the lender to dispose of the collateral at a cash profit, as some insurance companies have done.

As Torto and Childress earlier implied, a correlation exists between knowledge of the local market and the long-run profitability of a commercial building. Thus corporate lenders who develop and manage properties from a distance have more trouble realizing profits than do lenders with a strong local presence. VanGraafeiland noted that over the long haul, local lenders have been more adept at selecting projects best suited to their communities. The higher success rate indicates an opportunity for joint ventures between local developers and large corporate developers, yet these seldom work out, he said. First, large corporations resist giving up any autonomy, whether in real estate development or elsewhere. Second, local developers, entrepreneurial by nature, clash with the cumbersome business style of their would-be partners.

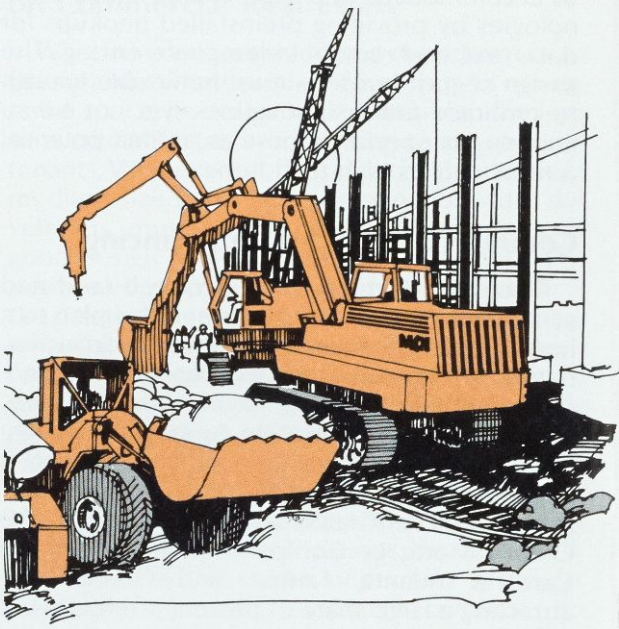
Large corporate lenders' difficulties may be rooted in their size and bureaucratic structure, VanGraafeiland said. Corporate decisions, frequently made by committees, require compromises that can take considerable time to work out. He agreed with Childress that real estate in most of the Southeast is a local business, one best understood and conducted by those who live in and know the local market. Centralized corporate decisionmaking, in real estate as elsewhere, can be rigid and thus unresponsive to demand and supply conditions that vary in each market. He feels that the tendency toward uniform policies reduces the expense of administering real estate operations in many markets but penalizes the profitability of each market's operations.

VanGraafeiland pointed out that corporate financiers tend to favor large structures that draw public attention, which may be an advantage for downtown developers. The time, expense, and overhead associated with any corporate project all favor large buildings. Georgia-Pacific's new corporate headquarters in downtown Atlanta typifies this approach. The company required only part of the space in the building, erected in a submarket burdened with unleased office space. But the large structure creates an identity for the corporation and the location offers maximum visibility.

One strong point of the large corporate lenders, their huge financial reserves, can sometimes prove a weakness. Plentiful reserves may cause them to carry a project through what they think is merely a cyclical market downturn; only later do they realize that the problem is more lasting. Smaller local lenders probably avoid funding a project in the face of a cyclical downturn. For this reason, small commercial real estate lenders likely contribute less to long-run overbuilding than do their larger corporate counterparts.

Syndications

At the other end of the spectrum from the large corporate lender is the individual investor who participates in financing development through syndications. Syndications funnel investors' funds to developers and owners of real estate to generate income and tax benefits for the investors. Richard Schwartz, executive vice president of First Capital Companies in Coral Gables, Florida, attributes the success of syndications over the past 10 to 15 years to the American public's growing interest in real estate investment.



The Southeast has attracted 28 percent of the dollars raised in public syndications, the largest share of any region. The Northeast, with

10 percent, has garnered the least. Among southeastern states Florida captures the most syndication investment, followed by Georgia, the Carolinas, and Alabama. Nation-wide, capital for investment in syndications flows most heavily from California, Texas, and Florida, the first two because of their large populations and Florida because of its high concentration of retirees with their extensive savings. New York, Michigan, and Illinois, conspicuous by their absence from this list, restrict the sales of limited real estate partnerships. Of all syndication monies, roughly half are invested in apartments and 48 percent in office buildings, shopping centers, and industrial real estate.

Investors are looking increasingly to real estate because they judge it is a better hedge against inflation than the national stock and bond markets. As people experience "bracket creep," they pay ever-increasing shares of their incomes in taxes while their buying power stays the same or declines. To counter this drain, wage earners seek investments that appreciate but do not deliver a taxable flow of income, and real estate can meet these requirements. Heightened general awareness of economics and finance and intensifying media coverage of business topics have brought real estate increasingly to the public's attention as a possible investment. As Schwartz commented, "Real estate development and ownership are still considered at the very core of American free enterprise."

Syndications—real estate partnerships composed of general and limited partners—have become the most popular vehicle for individuals investing in real estate, he said. The general partner, a person or company with expertise in evaluating and making real estate investments, manages the property portfolio for the limited partners. The limited partners furnish the capital to be invested.

In Schwartz's estimation, the popularity of limited partnerships can be traced to three main factors. First, just as when they hold stock in a corporation, limited partners enjoy limited liability. If the partnership fails or loses money, they lose only their investment. Second, the general partner handles day-to-day operating details of the business, freeing the limited partners from oversight of their investment. And third, tax consequences such as deductible interest, depreciation, and tax credits are passed on to the limited partners. A business loss by the partnership is deductible pro rata by each limited partner—an attractive arrangement to many high-income taxpayers.

Schwartz explained that limited real estate partnerships can be divided into private and public placements. Generally, private placement partnerships accept fewer than fifty investors, each having minimum incomes of $200,000 per year and considerable investment expertise. This type of investor usually seeks tax savings, not income from the partnership. The limited partners' investments sometimes are paid in installments, with the general partner providing the balance in the form of a loan with interest. Payment of the final installment retires the loan. Such leverage minimizes the limited partners' financial participation and maximizes their tax benefits. Private placements usually concentrate on a single specified piece of property per partnership.

Private placement limited partnerships frequently have been cited in criticism of tax shelter uses. Schwartz mentioned that the IRS routinely scrutinizes income tax returns for the deduction of interest whose actual payment is deferred (the accrued interest method) and looks at the general partner's policies concerning what is expensed in the current year and what is depreciated over several years. Yet recent revisions of the tax law have for the most part preserved the tax advantages associated with holding and investing in real estate.

Public placements, the other category of limited real estate partnership, target smaller investors with lower incomes, generally those making $30,000 per year or more. This investment vehicle accommodates annual $2,000 IRA investments and regular investments of as little as $5,000. Schwartz noted that one large syndication firm attributes 40 percent of its sales in the first four months of the year to IRAs alone. Investors in public placement tend to seek income more than private placement investors do. Their investments are accumulated into what are called "blind pools" before the general partner decides where to place them. An average public placement holds capital ranging from $5 million to $25 million.

From 1970 through 1983 public placements raised about $12 billion, of which two-thirds was accumulated in the 1980-1983 period. Fifty-five percent was collected by the industry's six largest firms; however, their profits and the ease of entry have lately attracted many new

competitors. Large stock brokerage firms and insurance companies consider their existing customers a potential source of funds for public placement limited partnerships in which they act as the general partners. The intense competition has focused more on where to invest than on how to increase the already plentiful supply of funds.

Schwartz contends that limited partnerships have removed some of the obstructions to the investing public's view of real estate as a high-quality investment. First, even those experienced in the corporate equity and debt markets realize their expertise is not directly transferable to real estate. In a limited partnership, where the general partner serves as the expert, participants are freed from the necessity of becoming knowledgeable in every area into which the partnership might venture. However, potential investors must carefully weigh past success and good reputation when selecting the firm that will act as their general partner. Many individual investors also see real estate's poor liquidity as a drawback. Even though limited real estate partnerships cannot legally make the limited partners' funds liquid without compromising their partnership status, the lack of liquidity is a drawback only when viewed from outside the balanced investment portfolio context. Before the day of limited partnerships, small investors could not diversify their real estate investments without leveraging extensively. Because public placement syndications each invest millions of dollars, they can diversify into different types of properties in different markets to achieve an optimum balance between risk and return.

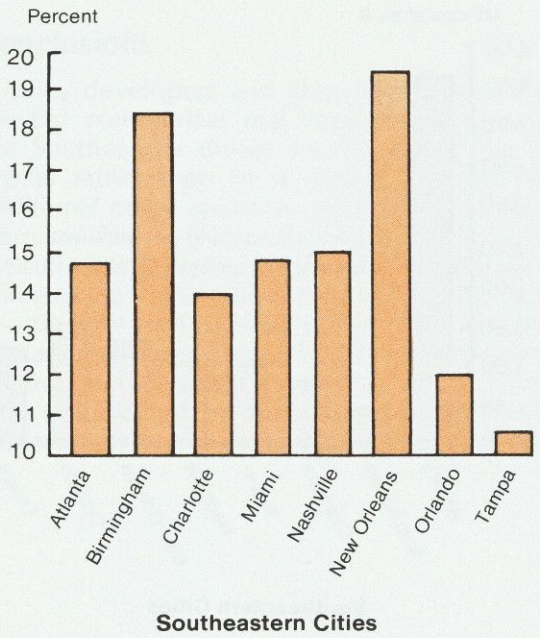
Despite the success of syndications, Schwartz cautioned that investment in real estate retains some well-recognized risks. Reduced inflation and more controlled economic growth temper opportunities for the large capital gains of the recent past. Schwartz observed that, whereas past growth in the industry bailed out many poor investments, this safety net will be much less reliable in the future. Particularly in the Southeast, the inmigration that fueled the region's real estate markets has slowed. Typically, residential housing markets diminish first, followed in 12 to 18 months by the commercial real estate markets. A tapering of southeastern residential market activity began early this year. In addition, as Amisano remarked in the context of office design, new technology is coming on line that will allow people to work, bank, invest, and shop without leaving home, and this may cut the demand for commercial real estate. Evolving technology will alter some commercial markets radically, sending valuable properties the way of the blacksmith shop and the full-service gasoline station.

Public syndications have invested most heavily in residential apartments because tax laws allow them to be written off faster than other real estate investments. On a per-unit basis, apartments can be purchased for less than the cost of building new ones, and they allow for larger rent increases and cash flows than do newly constructed apartments. On the downside, Schwartz said, maintenance and upkeep can severely limit the cash flow from an apartment complex. Moreover, renters close to buying their own homes effectively place an upper bound on rents: large or too frequent rent increases will motivate them to vacate their apartments in favor of purchasing homes.

Established commercial real estate can provide even greater security to the investor than do apartments, Schwartz said. Large lessees, called "major credit tenants," rarely vacate on short notice. In retail shopping malls anchor stores serve this function; in office properties banks and professional firms do the same. The investor strongly prefers properties where rents from the major credit tenants cover the debt service, ensuring a positive cash flow in all but the worst of times. According to Schwartz, a "net lease" is the most secure form of commercial real estate investment, with the tenant or tenants managing the space they occupy. But the investor's gain in security from a net lease is offset by the inability to negotiate frequent rent increases.

Since 1971, Schwartz noted, limited real estate partnerships have achieved an average 18-20 percent appreciation of equity, taxed at the favorable long-term capital gains rate after liquidation. This figure excludes the return from an additional 5 to 7 percent of cash flow, which brings the total closer to 30 percent per year. Such favorable returns would seem to indicate that syndications will remain a popular investment vehicle and source of development funds.

Chart 2. Office Vacancy Rates in the Southeast



Source: Coldwell Banker data as of first quarter 1984.

Office Leasing in the Southeast

Leasing is the final step in the commercial real estate production cycle. The process may be substantially complete by the time the building is finished if the developer preleases successfully. But even if 100 percent preleased, which is unusual, most medium-sized to large properties experience some tenant turnover, and so require a more or less continual leasing effort. Thus while new properties create the most obvious need for leasing, business relocations within an existing market also create business for office space brokers.

The office space broker and leasing agent see the market from a different perspective than the developer or financier. Regardless of the vacancy rate, a broker can earn a living so long as the market has some activity. According to Samuel Friedman, Jr., president of AFCO Realty Associates, in Atlanta, for instance, the vacancy rate has been high by most standards for many years and now rests at about 15 percent (see Chart 2). As a rule of thumb, a building must be 75 to 82 percent leased before it begins to break even, and so it would appear that the market is an unprofitable one in which to build. Yet, Friedman said, developers consider Atlanta a prime market, at least for the next six months to a year. This discrepancy is explained by the existence of multiple submarkets within the overall Atlanta office market. In some submarkets the finished-building occupancy rates exceed 90 percent.

Friedman suggested that in their analyses developers should consider the secular success of buildings in a particular submarket rather than relying wholly on the market's cyclical trend. He believes that long-run profitability is the best indication of market demand for new space. To operate on this basis the developer must have sufficient capital to survive the start-up period, especially during a cyclically slow leasing time. "There is no way in our free enterprise system that we are going to see building supply and demand generally in cycle the way we would like it to happen," Friedman said.

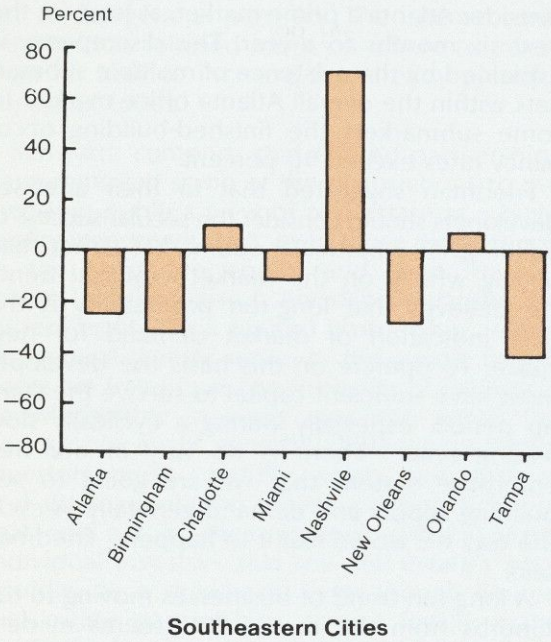
A long-run trend of businesses moving to the suburbs from the downtowns seems evident from the office broker's viewpoint. In his contacts with firms seeking to lease office space, Friedman perceives a gradual change in life style and business culture that will reinforce employees' preference for working near their suburban homes. An Atlanta financial executive captured the spirit of the movement when he asked his broker, "Why should I drive an hour so I can get on the phone for eight hours and drive another hour to get home?"

Outlook for the Southeast

Workshop participants agree that continued migration of people and businesses to the Southeast will maintain commercial real estate as a growth industry in the region. However, not all markets will share the benefits of this growth equally (see Chart 3). And the profit potential for developers, financiers, and office brokers will vary widely from market to market.

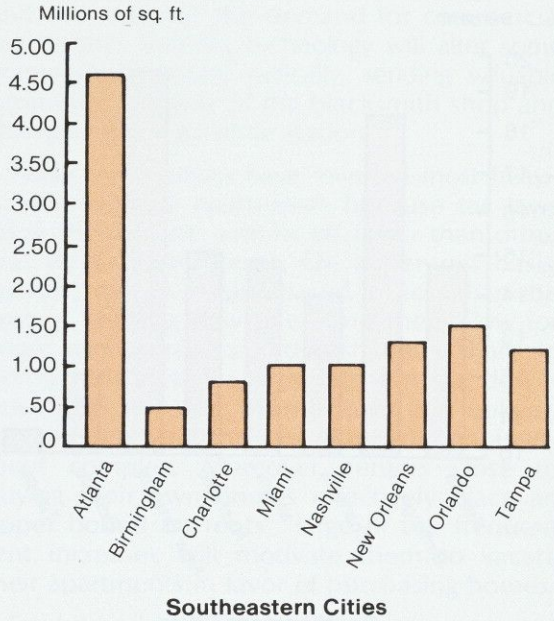
Atlanta, Orlando, and Tampa seem to offer especially bright prospects. Development and leasing continue in Atlanta in spite of its being considered overbuilt by some analysts. The city's ability to attract as many as 25,000 new residents annually because of the availability

Chart 3. Nonresidential Construction Contracts
Percent Growth from June 1983 to June 1984



Source: McGraw Hill, F. W. Dodge.

Chart 4. Average Office Space Absorption Rates (gross)



Source: Coldwell Banker. Rates calculated through the first quarter of 1984.

of jobs and quality of life will assure its important role in southeastern commercial building and leasing activity. Developers in slow markets who are hoping to expand look to Orlando. Already a major tourist destination, the city is acquiring a thriving commercial sector founded on advanced technology manufacturing. Another Florida city, Tampa, rates high in potential: its office vacancy rate has plummeted from 5 percentage points above the national average to 2½ points below for four consecutive calendar quarters.

Charlotte, Miami, and Nashville all have benefited from recent office market growth and are assimilating existing space. Charlotte added considerable office space in the late 1970s and early 1980s, but development has now slowed considerably. As the commercial hub of the Carolinas, the city eventually should absorb enough office space to attract commercial developers again (see Chart 4). Nashville has been regarded by some as a rival to Atlanta for firms relocating in the Southeast, but recent commercial construction may outpace demand. Nashville's office vacancy rate soared from 10½ to almost 15 percent in the first quarter of this year. Miami's vacancy rate has remained high since the first quarter of 1983, and out-of-town developers do not consider it a "hot" location for building. But Miami's vacancy rate declined this year for the first time in five calendar quarters, which may bode well for the city's future.

Birmingham and New Orleans currently suffer from insufficient demand and excess supply. Even with Birmingham's recent economic progress, the demand for commercial space in the city probably will be slow for some time as its economy adjusts away from manufacturing and toward service industries. New Orleans' office space vacancy rate bounded from 19.5 percent in the first quarter to 20.5 percent in the second quarter of this year, close to its historic high of 21 percent at the end of 1983.

Once the World's Fair closes, the current oversupply problem may be aggravated.

Conclusions

Many developers and financiers believe the present commercial real estate expansion in the Southeast is driven by the availability of capital rather than by a market demand for additional office space. In many markets, they warn, neither the short- nor long-term prospects are sufficient to justify the planned expansion of office space. Financiers rich in funds to lend are courting developers, who in turn are using the availability of funds to justify more development.

Developers, financiers, and leasing executives who participated in our workshop agree that southeastern businesses are continuing to move from the downtowns to the suburbs. Except for large financial institutions, professional firms, and convention facilities, our panelists believe new market entrants are likely to continue locating in the suburbs. They concur that the suburbs will remain popular with commercial developers despite the renaissance taking place in the core cities of many urban areas. Frequently, developers cannot justify the additional risk of building downtown compared with the risk of building in the suburbs, especially since technology can support information businesses in both locations. The seeming preference of many people for living and working in the suburbs, the sometimes prohibitive challenges of redeveloping in southeastern downtowns, and the availability of technology that permits management to operate a business almost anywhere may push firms progressively farther from cities' historic business districts.