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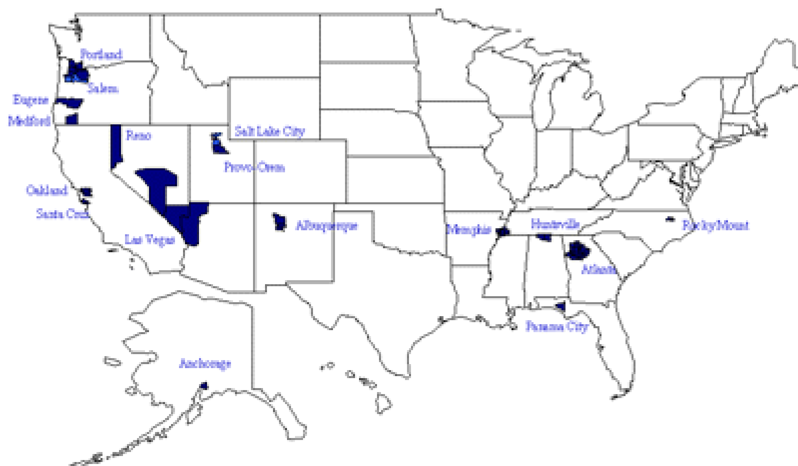
Bank Trends - Metropolitan Atlanta Construction and Development Lending Trends

Although national real estate markets seem to be in equilibrium, some supply/demand disequilibrium appears to be forming in a few metropolitan markets. The Atlanta metropolitan area is one such market that merits attention. FDIC-insured institutions headquartered in metropolitan Atlanta have been actively supplying credit that is fueling the recent wave of building in the area. This paper analyzes the participation of FDIC-insured institutions in the current building boom in Atlanta. Comparisons are made with the last real estate bubble that burst during the economic recession in 1990-91. Current economic conditions in metropolitan Atlanta as well as the condition of the residential and various commercial real estate sectors in the area are analyzed. Moreover, we examine structural forces--in particular, real estate investment trusts--which may be influencing the area's commercial real estate sectors. Bankers should closely monitor economic and real estate conditions in metropolitan Atlanta because of the sizable construction and development lending concentrations at FDIC-insured institutions operating in the area and the intrinsic volatility of this lending.

Map 1

MSAs Where Construction and Development Loan Concentrations Are Twice the National Average and at Least 25% of Institutions in the MSA Have a Concentration of 15% or Higher



Based on data for all insured institutions with assets under $1 billion that are located in an MSA.

Source: Bank and Thrift Call Reports

Metropolitan Atlanta Construction and Development Lending Trends

Booms do not merely precede busts. In some important sense, they cause them. Because people in markets make mistakes, tearing down is an indispensable part of the process of building up. The errors of the up cycle must be sorted out, reorganized, and auctioned off.

James Grant, *The Trouble with Prosperity,* 1996

Cycles are a by-product of a market economy. Real estate markets are no exception. Because much of the nation's bank and thrift loan portfolios are serviced or secured (or both) by real property, there is a positive correlation between cycles in the real estate and banking sectors. Real estate markets were strong throughout the economic expansion of the early and mid-1980s. However, during the recession of 1990-91, it became evident that construction activity (supply) ultimately had exceeded demand. Property values plunged in several regions of the country, eroding the financial strength of many bank and thrift institutions and contributing to the failure of others.

Since 1992, a strong economy and favorable interest rates again have spurred real estate demand and fueled another wave of construction and development. While most national markets remain in equilibrium, signs of possible oversupply are beginning to surface in some metropolitan areas. Metropolitan Atlanta's economic performance has outpaced the nation in recent years, and its real estate markets certainly have been among the most active. The rapid pace of construction activity across the metro area has prompted some industry observers to question Atlanta's ability to maintain market equilibrium if current trends persist.

This paper analyzes construction and development lending trends at FDIC-insured institutions headquartered in metropolitan Atlanta. Comparisons are made to the active real estate markets of the 1980s, and structural changes such as the trend toward asset securitization are examined for their potential impact on real estate market volatility. The paper concludes with a detailed look at current economic and real estate subsector conditions across the Atlanta metro area.

Construction and Development Lending at Metro Atlanta Financial Institutions

Insured financial institutions in metropolitan Atlanta are actively involved in real estate and related lending. Driving through the area, one cannot help but notice the "financed by" signs fronting the many construction projects currently under way. While large regional and superregional banks are either providing or arranging funding for the majority of retail, office, and multifamily projects, smaller institutions are helping to finance Atlanta's continuing residential development boom.

It is difficult to obtain data on the extent to which insured institutions, large or small, are engaging in real estate and related lending in the metro area, as the only source data are Bank and Thrift Call Reports, which do not provide detailed product-type or geographic information. Moreover, the extent of local funding being provided by institutions headquartered outside the metropolitan area cannot be discerned. Call Report data must be parsed and certain inferences made in order to draw conclusions about the area's construction lending environment.

The data set for this paper was culled to include only those commercial banks and thrifts headquartered in the Atlanta metropolitan statistical area (MSA) with assets under $1 billion. This obviously excludes the sizable activities of large in-market banks and thrifts as well as institutions headquartered outside the MSA. Nonetheless, the data set does include smaller "community" institutions, which are likely to have little geographic diversity in their loan portfolios. The prospects of these smaller institutions are much more closely linked to the performance of the local economy and the strength and stability of local real estate markets.

Construction and development (C&D) loan volume grew steadily at metro Atlanta

community institutions from 1992 through 1996, although overall loan levels relative to assets were stable during much of the period. As reflected in Chart 1, this trend reverses that of the previous four years, in which changes in C&D loan volume tracked the overall portfolio.

Chart 1
Construction and Development Lending Increases at Metro Atlanta Community Institutions

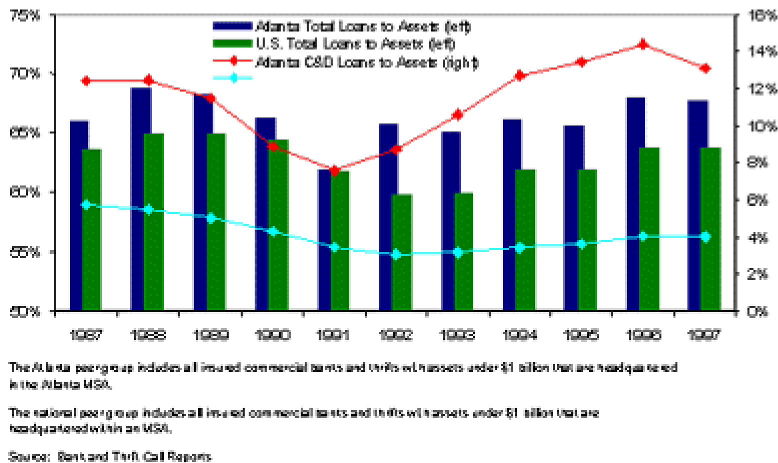


Chart 1 shows that C&D loans as a percentage of assets at metro Atlanta community institutions nearly doubled from a cyclical low of 7.5 percent in 1991 to a ten-year high of 14.4 percent in 1996 before moderating slightly to 13.1 in 1997. Interestingly, the levels seen over the past two years are above those reached at a similar point of five to six years into the last sustained economic expansion (1988). The subsequent decline in absorption rates that occurred in certain segments and a general slowdown in the overall economy may have been contributing factors to the erosion of commercial bank and thrift profitability in 1990 and 1991. Given the very strong development activity that has occurred in metro Atlanta over the past six years, a decline in real estate demand (absorption) again could pressure bank earnings. It is imperative that management of insured institutions anticipate and plan for the possibility of slower growth.

Chart 1 highlights the extent of Atlanta's C&D lending activity relative to the nation's other MSAs. *The average C&D loans-to-assets ratio for all MSAs, for institutions with assets under $1 billion, was 4.0 percent as of December 31, 1997--less than one-third of the metro Atlanta average of 13.1 percent.* Moreover, there was a notable divergence between C&D loan concentrations in Atlanta and other MSAs from 1992 to 1996: The nationwide average rose only 50 basis points, from 3.5 percent to 4.0 percent, compared with a 560 basis point (7.5 percent to 13.1 percent) increase in metro Atlanta.

A final point reflected in Chart 1 is that total loans at metro Atlanta community institutions make up a larger percentage of total assets than at similar-sized institutions in other MSAs (67.7 percent versus 63.7 percent), which may indicate less financial flexibility in the event of an economic downturn.

The increase in C&D loan concentrations reflects strong, sustained growth in this product. In 1996, the 79 institutions comprising the metro Atlanta community bank peer group increased outstanding C&D loans by an average rate of 24 percent,

following robust growth of 19 percent, 29 percent, and 42 percent in 1995, 1994, and 1993, respectively. The 1996 Summer Olympics contributed much to the development activity during this period; however, the pace of construction after the Olympics has not slowed nearly as much as many analysts and economists had anticipated. C&D loan growth did moderate to 11 percent in 1997, consistent with slower growth in residential construction permit issuance. C&D outstandings for the peer group totaled $1.5 billion as of December 31, 1997.

Consistent with the rapid pace of growth and development across metro Atlanta, the percentage of local community institutions reporting high C&D loan concentrations is rising. Table 1 compares current C&D loan exposures to those measured during the high and low points of the past ten years--1988 and 1991, respectively. As of year-end 1997, 14 institutions reported C&D loan concentrations of at least 20 percent of assets. This number is down from 19 institutions in 1988 but represents roughly an equal percentage (17 percent) of the total peer group. Moreover, the percent-of-peer-group measure in 1997 was deflated by the opening of three de novo institutions in the fourth quarter that were included in the peer group but reported negligible C&D loans. When concentrations of 15 percent, 10 percent, and 5 percent of assets are compared across each time period, the current percentage of institutions with C&D loan concentrations is higher in each category than in 1988. Only at the 30 percent concentration level does the current distribution of institutions compare favorably to 1988.

Table 1

Percentage of Community Institutions in Metropolitan Atlanta With High Construction and Development Lending Concentrations Is Increasing

C&D Loans to Assets	December 31, 1997		December 31, 1991		December 31, 1988	
	# of Institutions	% of Institutions	# of Institutions	% of Institutions	# of Institutions	% of Institutions
30% or greater	0	0.0	0	0.0	11	10.0
20% or greater	14	17.1	4	3.5	19	17.3
15% or greater	31	37.8	15	13.0	33	30.0
10% or greater	46	56.1	34	29.6	53	48.2
5% or greater	65	79.3	70	60.9	80	72.7

Source: Bank and Thrift Call Reports

Tracking the performance of the 33 institutions that reported 15 percent C&D loan concentrations in 1988, we find that those institutions performed rather poorly during the real estate market downturn that followed in 1990 and 1991. As shown in Table 2, *7 of the 33 institutions failed between 1989 and 1992*. This represents a 21 percent failure rate for institutions with high C&D loan concentrations, versus only 5 percent (4 of 77) during the same period for metro Atlanta institutions that did not report high concentrations in 1988.

Table 2

Ten-Year Aggregate Performance of Insured Institutions That Reported 15 Percent Construction and Development Loan Concentrations in 1988

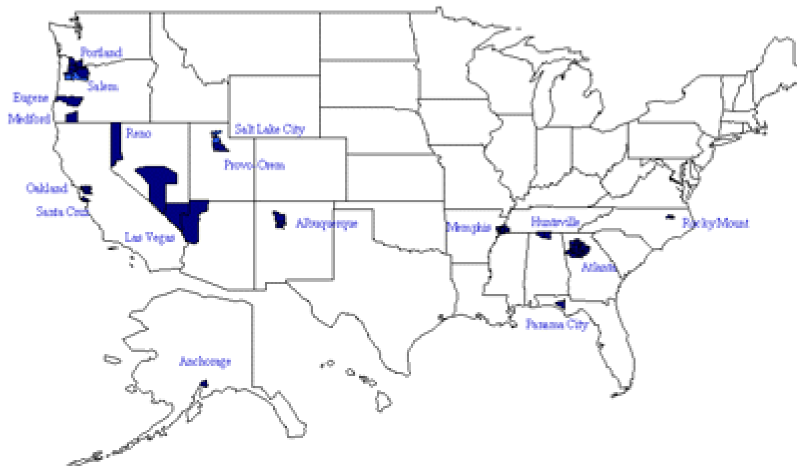
Year	# of Inst.	Reason for Attrition		Average Asset Size ($ million)	Equity to Assets (%)	Return on Assets (%)	C&D Loans to Equity (%)	C&D Loans to Assets (%)	Past Due Loans (%)	Past Due C&D Loans (%)	Loan Charge-Offs (%)	C&D Loan Charge-Offs (%)	ORE to Assets (%)
		Failure	Unassisted Merger										
1997	14	0	1	174,318	8.94	1.48	186.24	16.66	2.32	1.92	0.07	0.00	0.29
1996	15	0	2	508,662	7.34	1.01	129.08	9.48	1.82	1.78	0.28	0.01	0.43
1995	17	0	1	353,014	7.25	0.97	148.15	10.75	1.86	2.02	0.05	0.02	0.32
1994	18	0	1	302,468	6.85	0.86	137.49	9.43	1.27	1.48	0.12	0.07	0.45
1993	19	0	3	248,787	7.76	0.94	126.20	9.79	1.39	0.63	0.22	(0.11)	0.59
1992	22	3	1	216,216	7.27	0.57	109.93	8.00	2.30	3.58	0.61	0.79	0.84
1991	26	3	1	118,551	6.73	(0.52)	185.78	12.50	6.04	9.49	1.27	1.93	2.86
1990	30	0	0	114,481	6.64	(1.06)	234.86	15.60	8.29	10.30	1.48	0.74	2.54
1989	30	1	2	117,935	6.91	0.35	300.20	20.74	3.10	--	0.40	--	1.09
1988	33	--	--	99,715	7.21	0.59	330.99	23.86	1.17	--	0.22	--	0.58

Source: Bank and Thrift Call Reports

Atlanta is not the only area of the country where community institutions are reporting high C&D loan concentrations. Using a nationwide peer group of insured community institutions (assets under $1 billion) that are located in an MSA, Map 1 highlights those MSAs where the average C&D loans-to-assets ratio is at least twice the national average of 4.02 percent and where at least 25 percent of community institutions in the MSA have C&D concentrations of 15 percent or higher. As of year-end 1997, only 17 of 326 MSAs met these criteria. Obviously, some percentages are skewed by the size of the MSA. For example, smaller markets such as Panama City, Florida; Rocky Mount, North Carolina; and Medford, Oregon, show a high percentage of institutions with a 15 percent C&D loan exposure because few institutions are headquartered in these markets. From an assets-at-risk perspective, greater emphasis is placed on the larger metropolitan areas where several community institutions are heavily involved in C&D lending. In addition to Atlanta, other large MSAs (defined here as those headquartering ten or more community institutions, with above-average C&D loan exposures) include Las Vegas, Nevada; Memphis, Tennessee; Oakland, California; Portland, Oregon; and Salt Lake City, Utah.

Map 1

MSAs Where Construction and Development Loan Concentrations Are Twice the National Average and at Least 25% of Institutions in the MSA Have a Concentration of 15% or Higher



Based on data for all insured institutions with assets under $1 billion that are located in an MSA.

Source: Bank and Thrift Call Reports

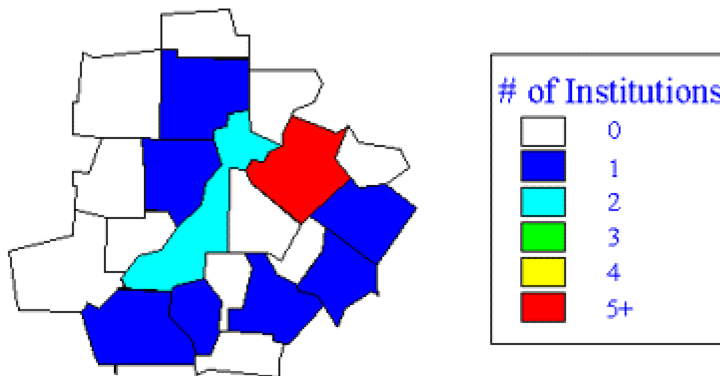
The number of metro Atlanta institutions with high C&D loan exposures, as well as the total assets represented by those institutions, is higher than in most other

MSAs. *Thirty-one institutions in metro Atlanta have C&D loan concentrations of at least 15 percent of assets, which is more than four times the number reported in any other MSA. Further, the $11.7 billion in assets represented by Atlanta's community bank peer group rank eighth among the nation's 326 MSAs and are nearly five times higher than any other MSA highlighted on Map 1*.

The location of metro Atlanta community institutions with large C&D loan concentrations is shown in Maps 2 through 4. Three year-end periods--1997, 1991, and 1988--were mapped to provide a time-series perspective. In 1988, 19 institutions in ten metro counties reported C&D concentrations in excess of 20 percent of assets (Map 4). Following a sharp decline in local real estate markets in 1990 and 1991, only four institutions in two counties had similar concentrations by the end of 1991 (Map 3). By year-end 1997, however, the number of community institutions with concentrations greater than 20 percent had risen to 14 and covered nine counties (Map 2).

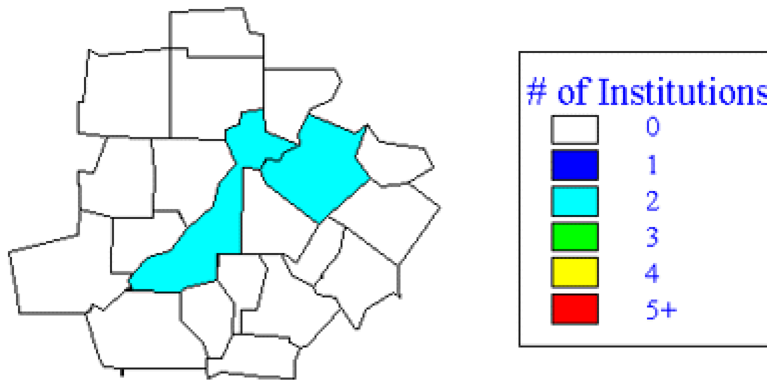
Map 2

Location of Institutions With Construction and Development Loans Greater Than 20% of Assets As of December 31, 1997



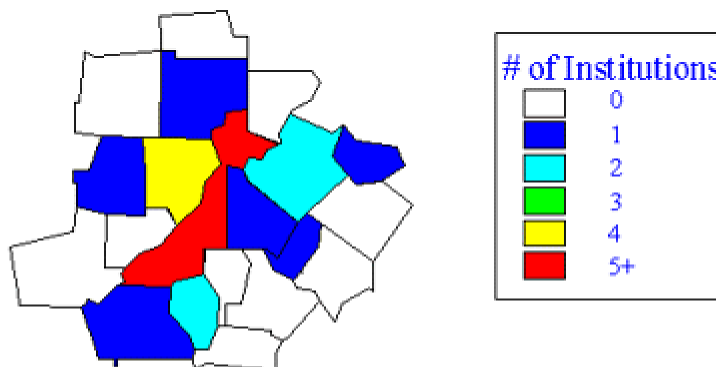
Source: Bank and Thrift Call Reports

Map 3
Location of Institutions With Construction and
Development Loans Greater Than 20% of Assets
As of December 31, 1991



Source: Bank and Thrift Call Reports

Map 4
Location of Institutions With Construction and
Development Loans Greater Than 20% of Assets
As of December 31, 1998



Source: Bank and Thrift Call Reports

When the concentration threshold is lowered to 10 percent, it becomes evident that suburban sprawl is stretching farther beyond the perimeter highway that encircles the city. There is now at least one institution with a 10 percent concentration in 17 of the 20 counties comprising the Atlanta MSA, including 5 counties with four or more such institutions. By comparison, 10 percent concentrations were reported in 16 metro counties

in 1988, and only 3 counties headquartered four or more of those institutions.

C&D loan concentrations could represent an emerging risk to insured community banks and thrifts. In addition to notable parallels between current local real estate and economic conditions and those that preceded the recession of 1990-91, FDIC examiners in the Atlanta metropolitan area report an increase in the number of nonprofessional builders to whom banks are extending credit as well as an increase in the number of speculative loans. Examiners also note intense competition among financial service providers in the C&D product line. An intensely competitive environment can lead to presale downpayment commitments that are not punitive (which essentially renders the related projects speculative) as well as diminished pricing power of institutions to compensate for the risk of possible overbuilding or slower economic activity.

The above concerns are tempered to some extent by the following factors. First, examiners state that most metro Atlanta bank managers are actively monitoring their development lending exposures. Second, banks are better capitalized now than during the prerecession 1980s.
Table 3 shows that the average equity-to-assets ratio for the community institution peer group improved from 7.73 percent in 1988 to 9.45 percent in 1997. Third, loan loss reserves generally are higher now than a decade ago, which could help stabilize earnings in the event of a real estate market correction. Reserves have averaged 1.4 percent of loans over the past four years for metro Atlanta community institutions, up from 1.1 percent in 1988.

Table 3

Construction and Development Lending Trends at Metro Atlanta Community Institutions

Year	# of Inst.	Average Asset Size ($ million)	Equity to Assets (%)	Return on Assets (%)	C&D Loans to Equity (%)	C&D Loans to Assets (%)	C&D Loan Growth (%)	Past Due Loans (%)	Past Due C&D Loans (%)	Loan Charge-Offs (%)	C&D Loan Charge-Offs (%)	ORE to Assets (%)
1997	82	142,366	9.45	0.94	138.62	13.10	10.66	2.51	1.92	0.43	0.08	0.27
1996	79	136,085	9.19	0.82	156.41	14.38	24.07	2.58	2.07	0.43	(0.02)	0.38
1995	95	110,990	9.44	1.26	142.10	13.41	19.20	2.40	2.21	0.29	0.04	0.32
1994	96	100,221	9.20	1.08	138.10	12.70	28.77	2.12	1.14	0.27	0.01	0.37
1993	101	97,031	8.71	0.96	121.63	10.59	41.82	2.63	1.25	0.41	0.12	0.69
1992	111	95,007	9.10	0.56	95.34	8.68	7.24	3.77	4.08	0.72	0.69	1.39
1991	115	98,020	7.90	0.02	95.69	7.56	(12.31)	5.32	7.23	1.03	1.18	1.81
1990	124	95,643	8.17	(0.13)	108.56	8.87	(17.89)	6.23	6.38	1.08	0.58	1.23
1989	115	97,186	7.83	0.37	146.62	11.48	7.45	3.90	--	0.53	--	0.61
1988	110	90,851	7.73	0.65	161.02	12.44	21.74	2.24	--	0.29	--	0.36
1987	98	84,687	8.02	0.91	154.94	12.43	--	1.61	--	0.20	--	0.24

Source: Bank and Thrift Call Reports

To summarize, sustained economic growth, particularly as it stimulates real estate development activity, historically has had a favorable impact on insured institution performance. History also has shown, however, that when the rate of economic expansion slows, banks can experience varying degrees of credit-quality deterioration, including reduced repayment capacity and collateral devaluation, as well as weaker loan demand, lower fee income, and higher charge-offs. The impact of these forces may be greater at smaller community institutions, as they typically have less geographic and product diversification than their larger counterparts. It is important, therefore, that insured institution managers be aware

of emerging trends in the economy, particularly in their local and regional markets, and plan appropriately for events that could impair credit quality. High C&D loan concentrations represent one area that community institutions in metro Atlanta should be closely monitoring, given the inherent volatility in this type of lending as well as some economists' projections of slowing economic growth going forward.

Impact of Securitization on Commercial Real Estate Markets

Some industry analysts believe the real estate sector is undergoing a longer-term structural evolution that could affect market stability in the future. Specifically, this change involves the increasing trend toward securitization, whereby privately owned properties are being pooled and resold to public securities market investors. Growth in securitization is occurring primarily through commercial mortgage-backed security (CMBS) issuance and real estate investment trust (REIT) acquisitions.

Growth in CMBSs has exploded in the 1990s because of the benefits they offer both issuers (typically, financial institutions) and purchasers (institutional and individual investors). CMBSs allow financial institutions (lenders) to transfer credit risk off-balance-sheet while generating sales proceeds that can be used to fund additional growth. Specifically, lenders package pools of commercial mortgages, securitize them into bond-like instruments backed by the collateral and cash flow of the underlying loans, and then sell the securities to market investors. For the investor, CMBSs provide an opportunity to own, as a liquid asset, a prorata share of a diversified portfolio of commercial real estate; in the past, this was not an option for many investors.

Commercial Mortgage Alert reports that CMBS issuance rose from $4.8 billion in 1990 to $44.1 billion in 1997 (an 820 percent increase), and ***Morgan Stanley CMBS Research*** measured year-end 1997 market capitalization of outstanding issues at $133 billion. Some analysts estimate that low interest rates and a strong economy could push 1998 issuance over $50 billion. The level of CMBS activity specific to the metro Atlanta area cannot be discerned, as detailed geographic and property-type information for underlying commercial mortgages is unavailable.

The accelerated trend toward securitization can be attributed, in large part, to the resurgence of the REIT (this discussion focuses on *equity* REITs, as they comprise the bulk of the industry). The market's acceptance of REITs has been somewhat surprising after their poor performance in the 1970s. Today's REITs differ significantly from their predecessors, however; most notably in that modern REITs have, on average, very low leverage and high capital. Management professionalism and expertise also are believed to have improved, and public confidence has been strengthened by more timely and accurate disclosure of property and performance information to the investing public.

According to the ***National Association of Real Estate Investment Trusts*** (NAREIT), there were 210 publicly traded REITs with an equity market capitalization of roughly $141 billion as of year-end 1997, compared with 142 REITs with a market capitalization of only $16 billion just five years earlier. Competitive dividend yields and total returns, as well as investor interest in owning real estate as a liquid asset, have led to a wealth of new and secondary equity offerings. A record amount of REIT capital (over $45 billion) was raised, and a record number of securities (315 initial and secondary offerings) were issued in 1997. In fact, according to NAREIT, the flow of capital into REITs in 1997

exceeded the cumulative funds raised by the industry over the previous three years.

Perhaps nowhere has REIT activity been more prevalent in the 1990s than in metropolitan Atlanta. The volume of properties under REIT management in Atlanta has soared in recent years, and property trusts represent a significant source of demand in the local multifamily, office, industrial, and retail markets. The ***National Real Estate Index of Alliance Capital and CB Commercial***, which tracks transactions in which REITs acquire privately owned properties, identifies Atlanta as one of the nation's most active REIT markets. According to the Index, REIT holdings in Atlanta totaled $9.95 billion at year-end, second only to Washington, D.C., which had $10.2 billion. Also, regarding 1997 REIT acquisitions, Atlanta ranked third nationally with purchases of $2.3 billion, trailing only Chicago ($3.7 billion) and Los Angeles ($2.4 billion).

The bulk of Atlanta's 1997 REIT acquisitions involved office space, but the preferred property type for much of the decade has been multifamily housing (apartment) communities. As a result, market prices per square foot are currently above replacement costs for this segment, which is enticing profit-minded developers to aggressively pursue new construction to take advantage of the high resale prices. According to the ***U.S. Census Bureau***, metro Atlanta ranked fourth in 1997 with 11,026 multifamily permits issued, trailing only Dallas, Houston, and Phoenix. Thirty-seven new apartment communities were developed in the metro area in 1997, mostly in the city's northern suburban markets, despite evidence of rising vacancies, stagnating rents, and increasing concessions. Rent levels are being constrained by the steady supply of new units coming to market as well as low mortgage-interest rates that are luring apartment dwellers toward home ownership.

As mentioned, 1997 REIT activity focused primarily on office space, spawning a wave of new construction in that product, again despite rising vacancies. A first-quarter 1998 market study by ***Cushman & Wakefield*** found that office vacancy rates in suburban Atlanta rose to 12.2 percent in the first quarter of 1998 from 11.7 percent at year-end 1997. The study also reports that *office vacancy rates along North Fulton County's Georgia 400 corridor increased dramatically, from 9.2 percent to 24.6 percent, from the first quarter of 1997 to the first quarter of 1998.* Separate data released by ***LaSalle Partners***, a Chicago-based real estate services firm, indicate that nearly 1.4 million square feet of Class A office space is currently under construction in North Fulton County that, when completed, will represent a 44 percent increase in existing supply. That report places the current vacancy rate for North Fulton County Class A property at 23 percent.

The direction and magnitude of the CMBS and REIT influence on property values in the event of an economic slowdown are uncertain. The fact that the capital markets have emerged as a substantial source of funding for these vehicles has securities investors bearing some of the risk that, in the past, was borne by insured financial institutions. It is also possible that diverse public ownership may help discipline cash flow and, therefore, future development activity, resulting in more stable real estate markets.

However, only about 15 percent of the nation's $1.5 trillion commercial real estate market has been securitized to date, meaning that private owners, many likely using bank financing, retain the majority of property ownership and its related risks. Among those risks is the fact that, in areas where REIT activity has been

particularly strong, such as metro Atlanta, property values may be driven more by the liquidity (acquisition funds) flowing into REITs from the capital markets than by fundamental bases such as discounted cash-flow analysis or replacement-cost comparison. Adding to the possibility of liquidity-driven price appreciation is the fact that, with minimal income retention (REITs are required to pay out at least 95 percent of operating income in the form of dividends), REIT growth must come primarily through acquisitions. The constant need to acquire properties could result in a further decoupling of transaction prices from fundamental values.

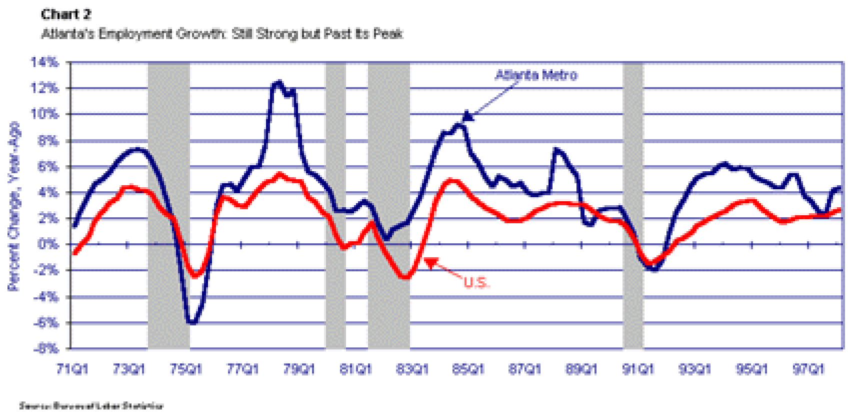
The above concerns were highlighted during two recent meetings of the Atlanta Society of Financial Analysts. At one meeting, the guest speaker, an executive officer of an Atlanta-based retail REIT, alluded to an "overbuilt" local market and expressed "surprise" at banks' willingness to continue to advance construction funds. At a subsequent meeting, an executive from one of the Southeast's largest multifamily housing REITs stated that Atlanta rent growth essentially has stalled and that acquisitions in this market must be made "selectively."

Not only could REIT demand ultimately have a great impact on property values and, therefore, insured institutions' real estate loan portfolios, but an increasing number of institutions are lending directly to REITs on an unsecured commercial basis supported by investment-grade credit ratings. While these funds are being used in various real estate-related activities, the loans are reported as Commercial and Industrial because they are not collateralized by real estate. As a result, real estate exposure as reported in Call Reports may be understated for some institutions. According to NAREIT, banks advanced a record $10.5 billion of unsecured credit to REITs in 1997. Much of this funding is being used to facilitate industry consolidation, which essentially represents purchases of real estate portfolios. Many of today's REITs have not been in existence long enough to have experienced a turbulent market, and there is some concern among industry observers as to the ability of REITs to repay their unsecured loans in the event of a market decline, particularly if access to equity-market funding diminishes.

Current Metropolitan Atlanta Economic Conditions

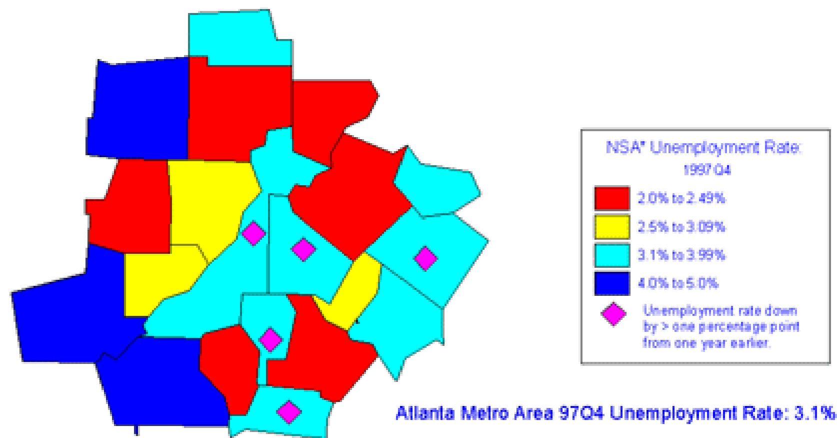
Atlanta is one of the nation's largest metropolitan areas, ranking ninth in terms of population growth and employing nearly two million people in 1997. Key industries in the metropolitan area include retail trade, transportation services, wholesale trade, and office employment.

Current economic conditions in the Atlanta metropolitan area remain favorable. After slowing throughout most of 1997 in the wake of the 1996 Olympics, year-over-year job growth in the metropolitan area rose during the first quarter of 1998 to 4.4 percent. Even so, the economy's expansion remains below the peak of the current business cycle that occurred in 1994 (see Chart 2). Indeed, the impact of the Olympics notwithstanding, the economy still appears to be on a slowing trend, decelerating from its peak four years ago. Many analysts believe that decelerating growth will persist through the end of 1998 as the expansion continues to mature. Continued rapid economic growth, however, may be critical to the health of metro Atlanta's real estate markets, given current levels of construction activity. Slower rates of growth could weaken absorption rates.



The persistent growth has enabled the metropolitan area's jobless rate to decline. In the fourth quarter of 1997, Atlanta's non-seasonally-adjusted rate of unemployment was 3.1 percent, well below the national average of 4.4 percent. The metropolitan area's labor markets are not uniformly tight, however. Most economic development over the past few years has occurred in the northern suburbs. County unemployment rates in these areas are exceptionally tight, often falling below 2.5 percent (see Map 5). The largest declines in jobless rates over the past year, however, have occurred in Fulton County and in the southeastern portion of the metropolitan area. Scarcity of labor and consequent wage inflation may discourage local employers from further hiring and encourage relocating companies to expand operations in other areas of the nation.

Map 5
Labor Markets Tight in Northern Counties



Source: Bureau of Labor Statistics
*NSA = Non-seasonally-adjusted

Residential Construction Activity

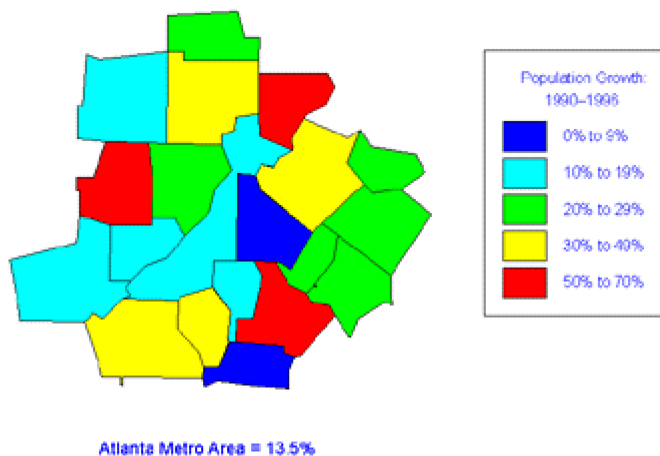
Atlanta's economic performance during the 1990s has been healthy as the area witnessed high levels of corporate relocation and in-migration. Since 1990, the metropolitan area has added nearly 600,000 residents, representing an average annual growth rate of 3.0 percent. In 1996, the ***Bureau of the Census*** estimated

Atlanta's population at just over 3.5 million. Such rapid population growth has fueled demand for new housing. Annual population growth has slowed, however, from its peak at 3.3 percent in 1994 to 2.6 percent in 1997 (Claritas estimate). Although growth is expected to slow further, many analysts foresee Atlanta's population topping 4 million residents within five years.

By a wide margin, Atlanta's population remains concentrated in its centrally located counties (Fulton, DeKalb, Cobb, and Gwinnett). The most rapid growth, in contrast, generally has occurred in outlying areas (see Map 6) such as Paulding, Forsyth, and Henry Counties, where population levels have surged by more than 50 percent during the 1990s. Faster growth in less-developed counties often has overtaxed public infrastructure, such as transportation routes and water resources.

Map 6

Some of Atlanta's Counties Are the Fastest-Growing in the Nation



Source: U.S. Bureau of the Census

Atlanta's single-family real estate market has been shaped by several factors during the 1990s. On the supply side, the metro area has enjoyed six years of growth in new construction (see Chart 3). Strong income and population growth and lower mortgage rates relative to the late 1980s (see Chart 4) have fueled demand for new housing and encouraged renters to purchase homes, creating what might be described as a seller's market. Even with high levels of construction, home prices have continued to climb (see Chart 5).

Chart 3
Single-Family Construction Activity Continues To Rise

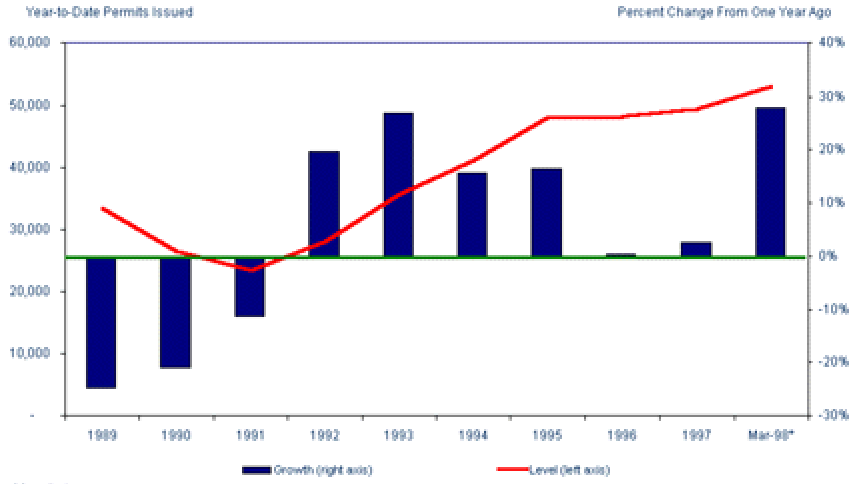
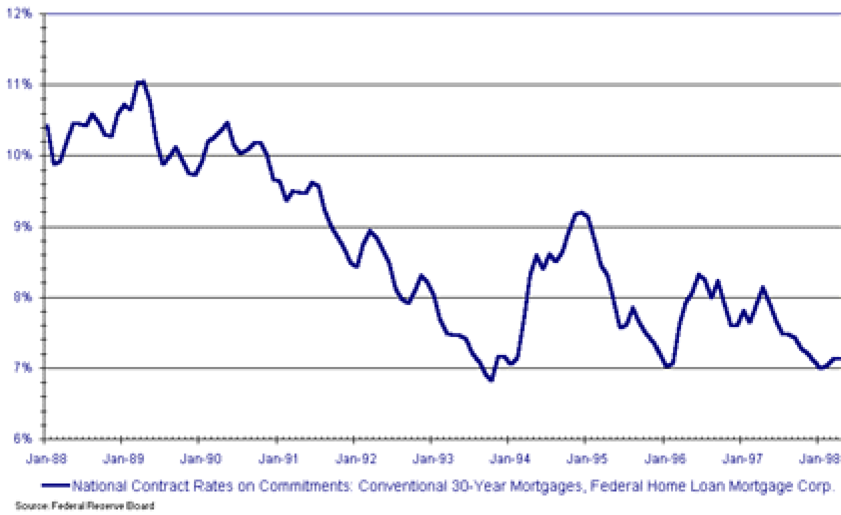
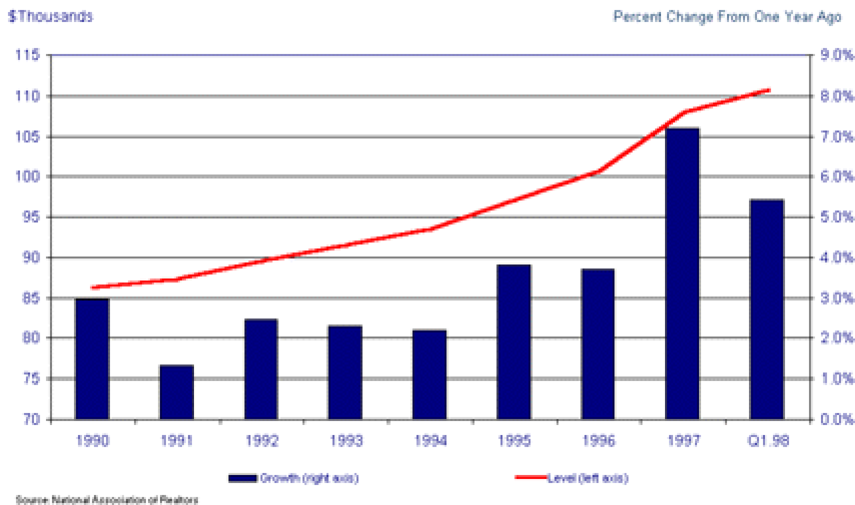


Chart 4
Interest Rates Remain at Historical Lows





Growth in construction activity, however, has been slowing from its postrecession cyclical peak in 1992. During 1997, single-family permit issuance in the metropolitan area increased by 2.5 percent (see Chart 3). Even so, the number of homes under construction in the market by the end of the third quarter of 1997 was below year-ago levels after peaking at 13,600 units in 1996. The previous peak in the number of homes under construction occurred in 1987 at 12,300 units before sliding to nearly half that level during the recession in the early 1990s. A slowdown in construction activity now would likely lead to higher levels of competition as developers fight to maintain market share.

Although first-quarter 1998 home prices were up a soild 8.4 percent from one year earlier, forces of demand may begin to moderate. Part of the recent acceleration in home-price appreciation may be the result of moderating mortgage rates, which often have an inverse relationship with home prices. As Atlanta's economy moves away from its cyclical peak and as population growth continues to slow, however, growth in demand for new housing may cool, easing pressure on home-price appreciation.

Mortgage rates also play a role in shaping demand for new housing. In late January 1998, the average 30-year fixed-rate mortgage fell to 6.79 percent in the Atlanta metro area. This rate is somewhat below the national average, the result, in part, of competitive pressures in the metropolitan area. The current interest rate environment and economic conditions have led to the emergence of a seller's market for new and existing homes as buyers are encouraged by lower rates.

Despite overall slowing growth in market activity, single-family construction continues to expand strongly in some component counties (Carroll, DeKalb, Fulton, Paulding, Pickens, Spalding) (see Table 4). Continued rapid homebuilding in excess of estimated growth in population in Paulding and Pickens Counties may be of some concern (see Map 7). The ratio of permit issuance to resident population also remains well above average across most of the metropolitan area's northern counties.

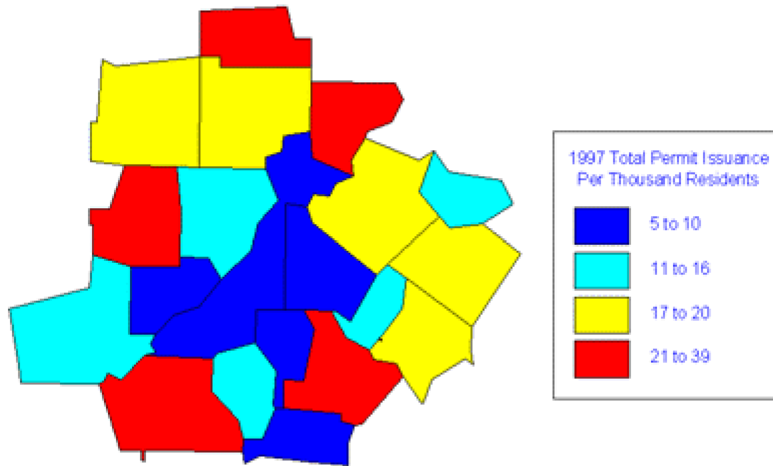
Table 4

Single-Family Permit Issuance	1996	1997	Growth (%)	Share of Metro
Georgia	64,256	59,966	-6.7%	--
Atlanta Metro Area	37,523	38,478	2.5%	100%
Barrow County GA	503	490	-3%	1.3%
Bartow County GA	1,067	1,110	4%	2.9%
Carroll County GA	590	820	39%	2.1%
Cherokee County GA	1,939	1,902	-2%	4.9%
Clayton County GA	1,147	1,181	3%	3.1%
Cobb County GA	5,147	5,314	3%	13.8%
Coweta County GA	1,434	1,366	-5%	3.6%
DeKalb County GA	2,357	2,698	14%	7.0%
Douglas County GA	755	757	0%	2.0%
Fayette County GA	1,269	1,126	-11%	2.9%
Forsyth County GA	2,952	2,839	-4%	7.4%
Fulton County GA	3,655	4,436	21%	11.5%
Gwinnett County GA	7,629	7,215	-5%	18.8%
Henry County GA	2,678	2,568	-4%	6.7%
Newton County GA	954	945	-1%	2.5%
Paulding County GA	1,593	1,778	12%	4.6%
Pickens County GA	316	367	16%	1.0%
Rockdale County GA	408	427	5%	1.1%
Spalding County GA	259	284	10%	0.7%
Walton County GA	871	855	-2%	2.2%

Source: Census Bureau

Map 7

Construction Activity Continues To Expand

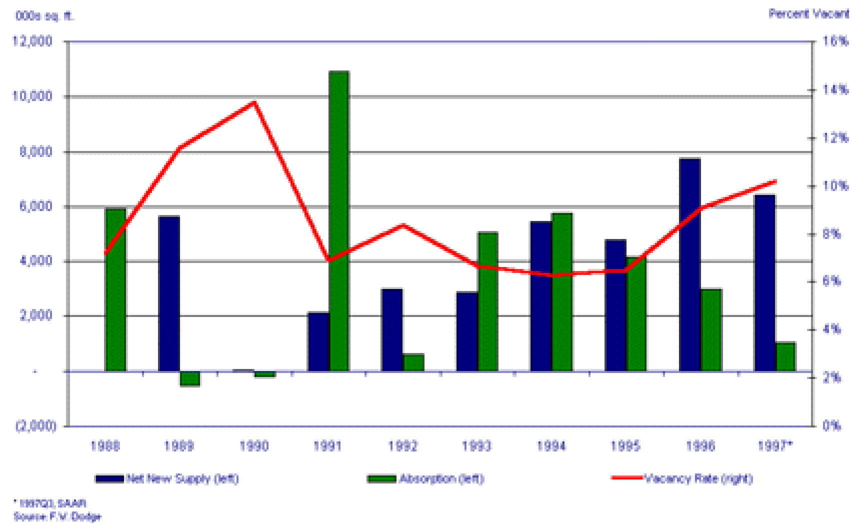


Source: U.S. Bureau of the Census, Claritas

Retail Real Estate Markets

Atlanta's retail sector has enjoyed six years of sustained growth following the recession of 1990-91. Retail-trade employment growth peaked in 1993, then slowed. Even so, the industry has experienced gains well in excess of the national average. This is partially the result of Atlanta's emergence as a regional retailing center in the Southeast. The Olympics in 1996 gave retailers an additional boost. By 1997, however, growth in retail trade had slowed to almost even with the national average. If expansion in the industry continues to slow, absorption rates in retail real estate markets may be affected.

Retail construction activity across the Atlanta Region has been strong over the past few years as developers responded to an economy enjoying rapid growth. Although vacancy rates have started rising in nearly one-half of the Region's metropolitan areas, nowhere has the upward pressure been more noticeable than in Atlanta. *In the third quarter of 1997, the retail vacancy rate in this metropolitan area was 10.2 percent, up more than 3 percentage points from just two years earlier to its highest level since the last recession* (see Chart 6). The rise in Atlanta's retail vacancy rate is, to a large extent, the product of persistent construction activity in excess of absorption rates.



According to data provided by the ***F.W. Dodge Real Estate Analysis and Planning Service***, retail space construction has increased substantially since its cyclical trough in 1991 at 2.13 million square feet of net new supply. In contrast, 7.77 million square feet of net new supply were injected into the Atlanta metropolitan area market in 1996. Third-quarter 1997 data show that construction activity is below last year, but the gap between net new supply and absorption has risen to its highest level since 1989. The overall retail stock now has surpassed 100 million square feet. There are indications that expansion of retail space may continue. According to ***F.W. Dodge***, as of December 1997, retail projects totaling nearly 30 million square feet were in the planning stages, with three new regional malls slated for development over the next few years in the Atlanta metropolitan area.

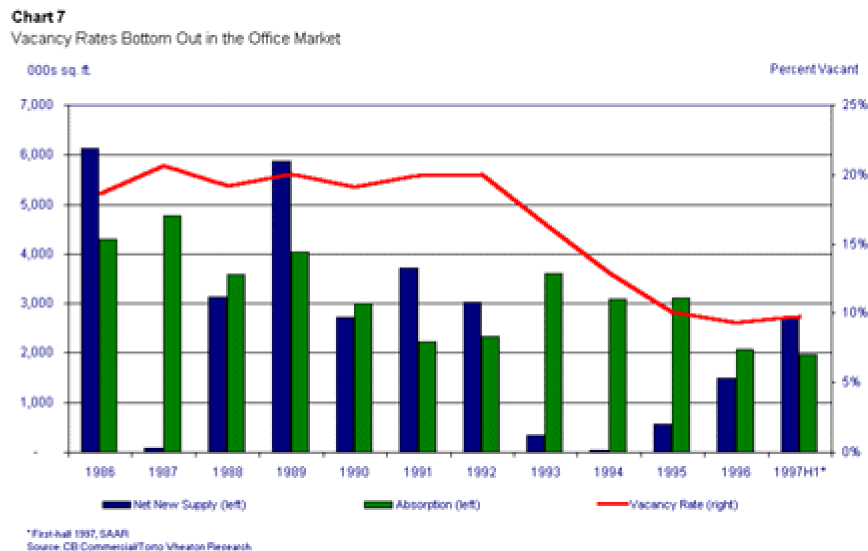
The most active submarket in the Atlanta metropolitan area is Gwinnett County, where over 1.83 million square feet are under development as of year-end 1997, according to a recent report by ***Jamison Research Inc.*** Most building activity, however, is the result of 1.7 million square feet of space under construction for the Mall of Georgia project. Many local analysts foresee that construction activity in the area of the mall will climb as big-box retailers are attracted to the mall site, although construction could be constrained by limited amounts of land.

Office Real Estate Markets

Office employment in the Atlanta metropolitan area continues to grow, albeit at a rate well below its cyclical peak in 1994. In 1997, employment in this category rose by 4.1 percent compared with the national rate of increase of 3.3 percent. Office employment growth is a significant component of demand for office space.

The office real estate market space continues to expand. According to the ***Atlanta Business Chronicle***, over 5 million square feet of new space was injected into the metropolitan area's markets during 1997. Nine million square feet of office space is expected to come on-line within the next two years as construction activity continues unabated.

In contrast to rising deliveries of office space, absorption in the metropolitan area appears to be moderating. Through the first half of 1997, annualized absorption stood at just under 2 million square feet, the lowest level in more than ten years. Slowing absorption in the face of strong building halted a five-year retreat in Atlanta's office vacancy rate (see Chart 7). Tightness remains readily apparent in most suburban markets, however, where vacancies stood at 7.6 percent at year-end 1997. This compares favorably with downtown, where the vacancy rate in the fourth quarter of 1997 was 15.2, according to ***CB Commercial***.



The most active submarkets of the Atlanta metropolitan area remain centered along a line extending from Buckhead through Alpharetta along GA Highway 400 (North Fulton County), where nearly one-third of all new construction activity is taking place. Such has been the pace of new construction that Class A vacancies had risen to 23 percent in early 1998, according to ***LaSalle Partners***. One area that could see greater levels of office and retail development in the coming years, however, may be a corridor located between the site of the Mall of Georgia (northeast Gwinnett County at Interstate 85 and GA Highway 20), which is scheduled for completion in August 1999, and Gwinnett Place Mall.

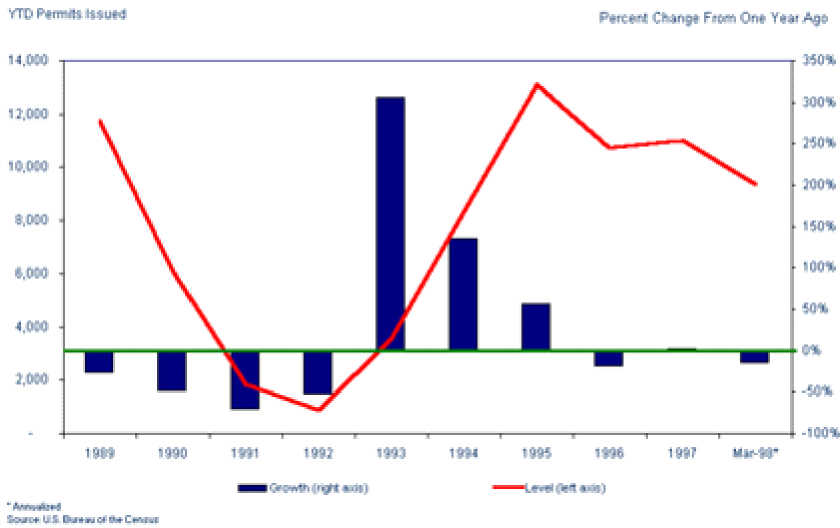
Continued growth in the economy and demand for office space have spurred speculative construction throughout metropolitan Atlanta. Even in the downtown market, plans are being made for the submarket's first speculative office high rise in several years.

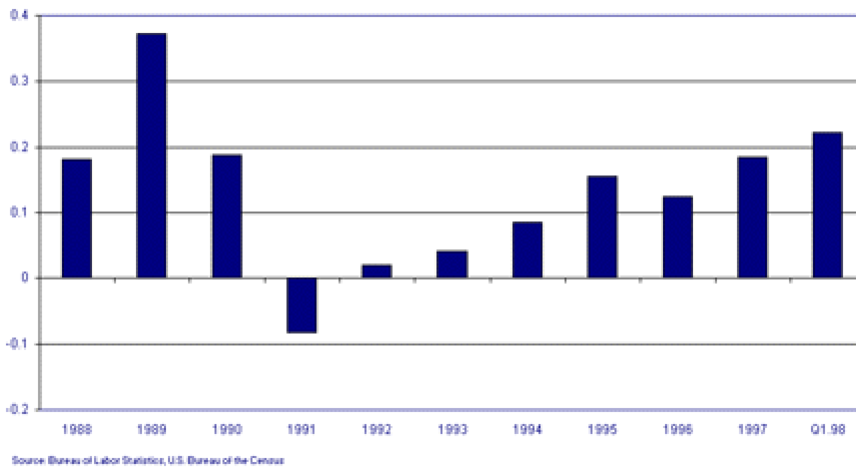
REITs are playing a large role in the recent round of office-space development in the Atlanta metropolitan area. According to a recent ***Lehman Brothers*** study, REIT ownership in the central business district is at 14.8 percent. The ownership share is even higher in the suburbs, where eight REITs control 22.7 percent of office space. The degree to which the market is concentrated may give REITs some ability to inflate rents and, consequently, property values.

Multifamily Real Estate Markets

Although multifamily permit issuance is below its cyclical peak in 1995,

construction activity remains at historically high levels. Year-to-date multifamily permit issuance in 1997 was well in excess of 10,000 units (see Chart 8). Over the past three years, it is estimated that more than 20,000 new apartment units have been delivered to the market. Overbuilding may emerge as a concern if economic and population growth continue to moderate while building activity remains close to current levels (see Chart 9). Rent appreciation has stalled and occupancy rates already have fallen by over 1 percentage point over the past year and currently stand near 94 percent. ***Dale Henson Associates***, an apartment tracking firm, expects that occupancy levels may fall by another 2 percentage points in 1998, as apartment openings surpass 1997 levels and population growth continues to slow. Lower interest rates also may encourage renters into home buying during 1998.





The largest segments of the Atlanta multifamily market remain its core counties. Together, Cobb, DeKalb, Fulton, and Gwinnett Counties accounted for over 80

percent of construction in the market during 1997 (see Table 5). With the exception of Fulton, permit issuance is up more than 10 percent in each of these counties. Permit issuance in Fulton County is down 24 percent from 1996, but this may have been the result of a temporary ban on permit issuance in Atlanta from April 1997 to June 1997 because of growth restrictions associated with overburdened sewer lines. Growth in Fulton County in 1998 may likewise be constrained by other types of moratoria throughout the county.

Table 5

Multifamily Permit Issuance	1996	1997	Growth (%)	Share of Metro
Georgia	15,447	16,904	9.4%	--
Atlanta Metro Area	10,739	11,026	2.7%	100%
Barrow County GA	25	36	44%	0.3%
Bartow County GA	201	85	-58%	0.8%
Carroll County GA	42	58	38%	0.5%
Cherokee County GA	30	257	757%	2.3%
Clayton County GA	192	330	72%	3.0%
Cobb County GA	1,121	1,767	58%	16.0%
Coweta County GA	0	428	n.a.	3.9%
DeKalb County GA	1,372	2,065	51%	18.7%
Douglas County GA	680	2	-100%	0.0%
Fayette County GA	356	74	-79%	0.7%
Forsyth County GA	15	10	-33%	0.1%
Fulton County GA	4,470	3,411	-24%	30.9%
Gwinnett County GA	1,879	2,103	12%	19.1%
Henry County GA	302	20	-93%	0.2%
Newton County GA	4	4	0%	0.0%
Paulding County GA	38	0	-100%	0.0%
Pickens County GA	0	6	n.a.	0.1%
Rockdale County GA	8	292	3550%	2.6%
Spalding County GA	4	30	650%	0.3%
Walton County GA	0	48	n.a.	0.4%

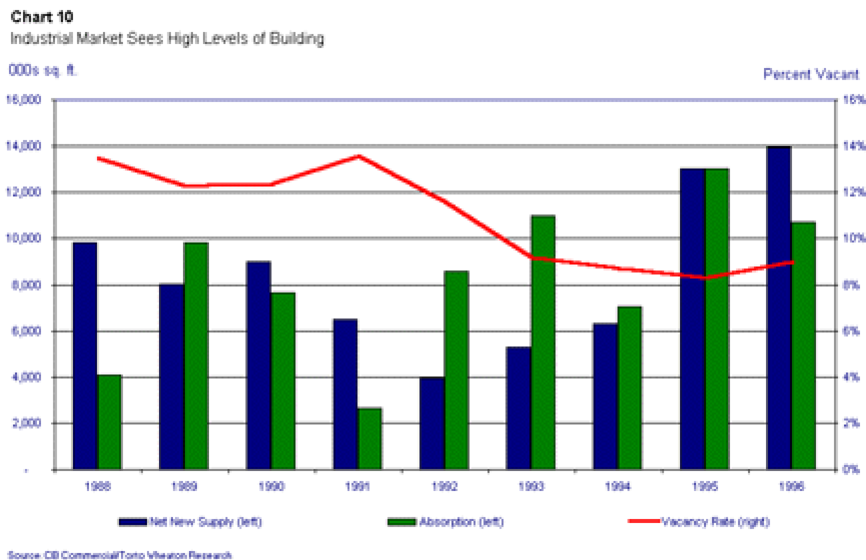
Source: Census Bureau

Industrial Markets

Industrial employment growth in the Atlanta metropolitan area has eased over the past few years and, in the fourth quarter of 1997, fell below the national average for the first time during the 1990s. Nearly 450,000 workers in the Atlanta area are classified as being employed in industrial sectors of the economy, which include manufacturing, warehousing, mining, and utilities. Continued expansion in industrial employment is one factor influencing demand for new industrial space.

Industrial space construction in the Atlanta metropolitan area has enjoyed successive gains for the past several years (see Chart 10), making it one of the most active markets in the country. According to ***Jamison Research Inc.***, an additional 17.2 million square feet was injected into the market in 1997, a

substantial increase over 1996 construction levels. Absorption likewise saw a rise in 1997 to over 13.2 million square feet. The gap between supply and demand, however, resulted in an increase in the metropolitan market's overall vacancy for the second year in a row as development surpassed absorption by 4 million square feet. ***CB Commercial*** estimates that the industrial vacancy rate in the third quarter of 1997 was 11.0 percent, compared with 9.9 percent one year earlier. From 1998 to 1995, in contrast, vacancy rates in the metropolitan area generally trended downward, except in 1991.



The Northeast Submarket (Gwinnett County) dominates Atlanta's industrial market, with 6 million square feet of new space coming on-line over the past year. Absorption in this submarket has remained constant over this period at over 2.3 million square feet. Continued growth in the metropolitan area's economy has spurred speculative construction, and more developers have moved into the market over the past year, according to an article in ***Commercial Real Estate South***. ***Jamison Research Inc.*** estimates that, as of year-end 1997, over 8 million square feet of space was under construction in the Atlanta metropolitan market, three-quarters of which is considered speculative. Higher construction levels and greater numbers of developers could intensify competitive pressures in the future. Although higher levels of competition are expected, the industrial market currently remains relatively concentrated, with six REITs controlling 9.1 percent of the market.

While vacancy rates have risen somewhat over the past year and new supply has surpassed absorption, many analysts do not anticipate a sharp slowdown in industrial space construction during 1998, as much of the existing space is technologically obsolete.

Conclusion

All sectors of commercial and residential real estate development in metropolitan Atlanta remain very active. Projects currently under construction and those in the planning stages that are expected to be completed over the next two years represent a substantial increase in supply. These developments, if completed,

could further aggravate vacancy rates, which have edged slightly higher in a few sectors and submarkets over the past year. A number of these new projects are speculative, and their absorption is largely predicated on a continuation of current economic conditions. Disequilibrium in the Atlanta real estate markets, caused by overbuilding or a change in economic circumstances, could pose a risk to insured institutions. Insured institutions' exposure to the metro Atlanta real estate markets has grown substantially and is at a level not seen since 1988, or two years before the last economic recession. Managers of insured institutions, particularly those headquartered in the metro area, with high construction and development loan concentrations should closely monitor local economic and real estate market conditions, given the inherent volatility of this lending.

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