

Why Office Condominiums are Hot

By Peter Rosenthal

Currently the commercial office market in the San Francisco Bay Area is widely regarded as depressed and conditions are being compared to the real estate recession of the late 1980's. Economists generally report that the economy is showing only minor signs of recovery and that the Bay Area's larger than average job losses are impeding growth. The most obvious sign of weakness in the commercial office market is that rents have fallen almost 50% since the highs reached in September 2000. There is however, one bright spot in the commercial office market. Commercial Condominiums, where end user tenants purchase rather than lease their space, are on the rise across the country and the market conditions necessary for their development here in San Francisco are present.

End user demand has proven to be strong in many of the markets where commercial condos have been developed. In Florida, Arizona, Minnesota and cities such as New York, Atlanta, Washington D.C. and Los Angeles commercial condo development has yielded high returns for investors. Within San Francisco and in other parts of the Bay Area there has been some activity developing commercial condos as well. In San Francisco, with the current market conditions, there is greater demand for commercial condos than has been met by developers to date.

What are the market conditions that promote the development of Commercial Condominiums?

Historical lows in the debt market encourage the purchase, rather than lease, of commercial space by tenants. The adjustable 10yr ARM has fallen from a high of 8.21% to a recent low of about 4.75%. By purchasing their space, many tenants can lock in a lower mortgage payment than their lease payment would be. The argument parallels the argument for purchasing a residential condo rather than renting an apartment in low interest rate climates.

Access to capital through the Small Business Administration (SBA) has made purchasing easier than ever. Commercial Condominiums are particularly attractive to smaller, stable sized businesses. These businesses often qualify for SBA loans, which lowers the economic hurdle of ownership

The rent spikes of the late 1990s and early 2000s are still fresh in the minds of many small businesses. Many of these businesses had to move out of San Francisco or into Class B and C space as rents shot up and their leases came up for renewal. Purchasing a commercial condominium grants the business owner greater security during times of rapid rent appreciation.

There is a lack of small buildings in the 5-10K sq. ft. range available for purchase in San Francisco. The commercial condominium, in this way, serves much the same purpose as the residential condominium market for small, urban households. Namely, providing the right size product for a smaller business that only demands 5-10K sq. ft.

What businesses are attracted to Commercial Condominiums?

Professional Service Firms, such as Lawyers, Doctors, Accountants, Engineers and Architects, with established and stable practices are attracted to commercial condominiums. For these businesses there is little opportunity for the firm principals to build equity in the core business practice. By using firm revenue to pay down the principal balance on the condominium loan, coupled with the appreciation of the real estate asset, firm principals can build wealth by owning rather than renting the space required for the operation of their business. Owning the space within which the business operates allows for founding principals to retain some income after they have retired from the practice and passed the business operation to younger partners. These types of professional service firms are attracted to commercial condos.

Firms that are very sensitive to location have a greater tendency to purchase a commercial condominium in order to secure their long-term address. The classic example of this is a doctor's reliance on proximity to a nearby hospital. Many medical professionals will pay a premium to guarantee their continued proximity to this resource.

There are tax advantages to owning real estate that are conferred to the principals who own the real estate their businesses require to operate that attract firms to commercial condos. By renting to their businesses, principals become landlords and are offered the tax shelter of depreciation. In markets such as San Francisco where there is no effective depreciation of real estate assets, this allows principal/landlords to defer income tax until sale of the condominium. Taxes are then assessed at capital gain rates, which are lower than income tax rates. Principal/Landlords who are particularly savvy can employ I.R.C. Section 1031 exchanges and thereby extend the tax deferral past the sale of the condominium.

How to take advantage of the opportunity?

It is clear that the fundamentals for developing commercial condominiums are strong. To successfully take advantage of the opportunity, it is important to understand the procedure for converting existing commercial property into commercial condominiums and to understand the size of the market. As identified above, it is primarily small businesses that benefit from purchasing commercial condos. Just how big are these tenants as a percentage of the market? Tenants under 10,000 sq. ft. comprise 80% of the marketplace in the San Francisco.

The process of converting a commercial office property into commercial condominiums has two components. First, physical conversion must occur. For many properties this is nothing more than demising the space with walls or floors. Sometimes utilities need to be divided as well. In some cases, seismic or ADA upgrades will be required. Second, legal conversion must be accomplished. Most attorneys have concluded that this is a rather smooth process usually taking about one year but if expedited it can take as little as six months.

What buildings are conducive for Commercial Condominium conversion?

Buildings that are over 10,000 SF are having difficulty renting in the current market conditions. Owners of these properties might be better served to subdivide these larger spaces and convert them to commercial condominiums. Buildings with floor plates that are sub-dividable to around 5,000 SF are also particularly well suited to conversion. Recent sales of Commercial Condos indicate demand in the 1000-5000 SF range.

Examples of Recent Commercial Condo Sales

Address	Price	Square Footage	\$/SF	Submarket	Tenant Use	Parking	Sales Date
1399 Post Street	\$1,300,000	3,255	\$399	Van Ness Corridor	?	none	Aug-02
6050 Geary Blvd.	1,060,000	2,400	442	West of Van Ness	?	none	Feb-01
4355 Geary Blvd. #101	950,000	3,125	304	West of Van Ness	?	6	May-01
2299 Post St. #108/B1	875,000	3,855	227	West of Van Ness	medical	in common	Jan-01
1901 Van Ness Ave. #R01	600,000	1,437	418	Van Ness Corridor	?	2	Oct-01
500 Bryant St. #102	539,000	1,297	416	Rincon/South Beach	?	none	Sep-02
355 Bryant St. #106	390,000	1,095	356	Rincon/South Beach	?	1	Sep-01
203 Willow St. #304	360,000	1,135	317	Van Ness Corridor	?	in common	Nov-02
728 Pacific Ave.	280,000	810	346	Chinatown/Nob Hill	?	none	May-01