

More Good News About Office Condominiums

In an article published in our August newsletter ("Why Office Condominiums are Hot"), I outlined the one bright spot to be found in the doldrums of our present San Francisco Bay Area commercial office market: Commercial Condominiums. The bottom line, as we saw in that August article, is that in San Francisco, the demand for commercial condos is currently greater than the supply. For development companies considering the purchase of commercial buildings in San Francisco, that's an important trend to bear in mind.

Condominium commercial space has acquired an increasing attractiveness over leased space, both for user/owners and for real estate investors, for a number of solid reasons—most notably the safety of a long-term mortgage at today's low rates versus the uncertainties of the commercial rental market. And when we examine recent figures for sale prices and leasing rents, both commercial and residential, one trend becomes clear: investors are willing to pay premium prices for office condominiums over what they will pay for rental spaces.

The numbers show a clear trend

In order to understand this point better, it's instructive to look at how much investors are willing to spend on different categories of real estate. The numbers become especially interesting when we compare the amount investors are willing to spend in relation to the income they can expect to generate for each category. What we see is that investors are so attracted to condominium space that they are willing to put up with less short-term income to buy into condos.

A recent study comparing the average sale prices with the average lease/resale rates of five classes of San Francisco real estate illustrates the point. For each category, the study looked at how much investors are spending to purchase property and the return can they expect on that property. The ratio between these two figures was calculated as the average yield. The property types studied were: industrial, office (class B), apartment, residential condominiums and urban retail.

In San Francisco, from June 2002 through May 2003, rental Class B office space was purchased for an average of \$200 PSF. At the same time, the average annual triple net rental rates for this same space is \$12 PSF. This gives us a yield of 6.0% (12/200). In comparison, residential condominium space went for an average \$500 PSF and was leased at \$20 PSF, for a yield of only 4.0%. This was the lowest yield in the study, which also included urban retail space (a yield of 10.8%), apartment space (8.9%) and industrial property (7.2%).

The trends we observe for residential condominium space apply to office condominiums, too, only moreso. While, as we've seen, the average rental Class B office space sells for \$200 PSF, the average office condominium space is closer to \$350 PSF, but with identical average lease rates of \$12 PSF, for a yield of only 3.0%.

This tells us that developers are quite likely to receive higher returns on properties bought as (or converted to) office condominium space than on properties bought as rental office space. But it also makes us ask why investors would be willing to put up with such low yields. The answer is the hope, if not the expectation, that the value of the condo property will appreciate considerable over the long term and more than make of for the differences in short term profit. Tied to the historically low interest rates that make property buying particularly attractive at this time, hopes for substantial capital gains become a significant draw indeed.

The quest for real estate value appreciation

Investors looking to generate cash flow see commercial condominiums as two-way wins over the long haul. Their low-interest loans lock them into relatively small monthly mortgage payments as they earn income from leasing arrangements. Their mortgage payments will stay low even if office rents rise with an upturn in the economy. Investors also stand to gain with the appreciation of the condominium real estate.

Healthy and potentially rising profits from rents and value appreciation over the long term, then, make a higher initial outlay in PSF cost worthwhile to many investors. And since the supply of office condominium space is relatively low, those initial PSF sales rates stay healthy—that's good news for developers.

User/owners looking for safe, permanent sites for their businesses see office condominiums as a great answer. Again, those low interest rates have everybody's attention, especially relatively small business owners who remember the storms of the dot.com era, when many business renters were driven out of town or out of business, or at least into smaller, less desirable commercial spaces. Low fixed mortgages form effective shields against booms and spikes and even more gradually rising rents.

In addition, office condominiums can be particularly advantageous to professional service providers like lawyers, doctors, accountants and architects. Using firm revenues to pay down the principal balance on their loans allows these professionals to build personal wealth in a way they couldn't if they were renting. Appreciation of the real estate assets, of course, adds to this effect, potentially on a very large scale.

User/owners can add to all this the assurance of being able to keep an advantageous location—a doctor being able to retain a desirable office close to a hospital, for example— despite market fluctuations, free from the worry of losing their lease or having rental rates pulled from under them.

A national trend

Given all of these factors, it's no surprise that investors are willing to pay a healthy premium for office condominium space over office rental space. These trends are not isolated here, but are in fact visible across the country. *The Wall Street Journal's* RealEstateJournal.com ("Amid Low Interest Rates, Office Condos Multiply," September 24, 2003) reported that, according to New York brokerage firm owner Bruce Sinder, "while average office-rental rates in Manhattan have fallen about 30% during the last three years, prices for office condos have increased 50% during the same period."

It's unlikely that the supply of high quality office condominium space will catch up with demand in the near future. In the meantime, there is reason to believe that those low interest rates that help make commercial condos so attractive will be with us for some time.

On December 9, 2003, when the Fed voted to keep interest rates unchanged, they remarked, "[W]ith inflation quite low and resource use slack, the committee believes that policy accommodation [low interest rates] can be maintained for a considerable period." This should give developers a healthy window to convert office properties into condos while interest rates are still low and demand is still high.

For more information about the current condominium market and what it can mean to developers, please see my article, "Why Office Condominiums are Hot," in our August 2003 <http://www.skylineleasing.com/Newsletter/PDF/newsletterArticle2.pdf>.