NEWS CoStar

Office Investors Decide It's Time To Buy Vacancy

Economy Seen Providing Risk-Adjusted Opportunity To Acquire, Reposition Existing Office Buildings

By Mark Heschmeyer
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An economy producing a steady stream of new jobs, combined with a dwindling supply of affordable core office properties, has reversed investor sentiment for office properties that were largely discredited and ignored by investors as recently as one year ago.

In a telling statistic, CoStar Analytics shows that the average vacancy of multi-tenant office buildings acquired in the third quarter just ended stood at a little more than 20% -- about 8 percentage points above the current national average.

By contrast, the average vacancy for multi-tenant office buildings acquired in the same quarter a year ago was a notch above 12%, which was the overall national vacancy at the time.

As that trend and the recent performance of CoStar's repeat-sale index makes clear, more office investors are moving further out on the risk spectrum to acquire office properties with sizable vacancies.

"Office investors are pursuing 'value add' transactions in non-primary markets where they think that via better management and/or a renovation program new owners can lease up vacant space," said Tarik Bateh, vice president Capital Markets Group of Jones Lang LaSalle in Jacksonville, Florida. "This investment philosophy is being assisted by the increasingly liquid debt markets."

Last week, we saw office REIT Parkway Properties Inc. strike a deal to buy a 22-building, 3.1 million-square-foot southern U.S. office portfolio with an average vacancy in the low to mid 30% range. Parkway agreed to the deal specifically to get its hands on three Class A office properties in Tampa's tony Westshore office enclave where its existing portfolio is 96% leased.

"The assets are currently well below market occupancy, and we believe we can leverage our existing regional operating platform to add value to the assets and replicate our recent leasing success within the Westshore submarket," said James R. Heistand, president and CEO of Parkway Properties.

Dale Peterson, senior vice president at CBRE | Capital Markets in Tampa, said he sees signs of that thinking on the part of more investors across many markets.

"Investors are willing to move further out on the risk curve and have begun to underwrite vacancy more aggressively," Peterson said. "Investors are seeing similarities in a large number of secondary markets in the Southeast. Markets like Raleigh, Charlotte, Nashville, Ft. Lauderdale, Orlando and Tampa are seeing population and job growth, residential/housing growth and recovering local economies, all of which fuel demand foroffice space."

At the same time Peterson said, activity and continued investor interest for core properties has driven up pricing in core markets, forcing certain investors to look in secondary and tertiary markets for values in search of yield.

Parkway is not alone in the strategy in targeting properties with lots of unfilled space. In fact, it joined the ranks of some of the most elite investors in the world.

Norges Bank Investment and its joint-venture partner MetLife Inc. in July acquired One Beacon Street, a 1.02 million-square-foot office building in Boston. One Beacon Street, with more than 1 million square feet of office space, is more than 20% vacant.

Norges manages Government Pension Fund - Global, also known as The Oil Fund, the world's largest sovereign wealth fund powered by a nation that is the fifth-largest oil exporter and third-largest gas exporter in the world. Norges secured a minority 47.5% interest in the $561.5 million purchase of the 34-story tower while MetLife will own 52.5%.

Also, last week in Boston, a fund sponsored by CBRE Global Investors acquired 100 High Street, a 28-story office tower in the heart of the city's Financial District. That 546,336-square-foot property is more tha one-third vacant.

"Boston, which is in the midst of a robust recovery, is one of the nation's strongest gateway office markets," said Vance Maddocks, CBRE Global Investors' president of Strategic Partners U.S. "Changing workforce demographics are fueling urbanization and driving leasing velocity in the Financial District. The startups, tech and communications firms moving downtown are seeking large floor plates, proximity to other tech companies and immediate access to public transit, all of which can be found in 100 High Street."

Separately this summer, The Roseview Group and PM Realty Group formed Roseview-PMRG Fund I, a $250 million discretionary fund to acquire and reposition office properties across the United States.

Roseview and PAM are seeking to acquire and reposition existing office assets, which can be acquired below replacement cost, by investing capital to upgrade building common areas and mechanical systems and to fund tenant improvements and leasing commissions. Their fund is targeting returns in the mid-teens with total investment per asset of $15 million to $65 million in primary and secondary markets.

"The economy continues to recover and is fueling new job growth in many markets. As a result, we believe there exists a strong risk-adjusted opportunity to acquire and reposition existing office buildings and the fund is well-positioned to competitively pursue these opportunities," said Vince Costantini, managing partner and CEO of The Roseview Group.

Earlier this year, the fund closed on its first acquisition, paying $14 million or $103/square foot for a Houston building at 2900 Weslayan St. The 137,000-square-foot building is 23% vacant.

And in yet another example, Brookwood Financial Partners this week acquired 125 E. John Carpenter Freeway and 5100 N. O'Connor Blvd., a two building, multi-tenant office property in the Urban Center of the Las Colinas submarket of Dallas. The 61.1% occupied property contains 451,195 square feet. The price was not disclosed.

Brookwood plans to reposition the property in the Las Colinas submarket by investing $3.7 million in targeted capital improvements in the property. Rental rates in the Las Colinas submarket have increased 7.6% over the previous six quarters, but rates are still 5.4% below their pre-recession peak, according to said Thomas W. Brown, Brookwood's director of acquisitions.

Brown said he expects demand for office space will remain strong in the submarket due to a surging economy, growing population and business-friendly environment.

Mark D. Avilla, senior vice president of Cassidy Turley in San Diego said the limited supply of available office space is one factor driving the trend.

"The main factor is supply," Avilla said. "There are fewer core assets available, which is forcing investors to look at secondary markets. Additionally, the leasing market fundamentals are much stronger than a year ago and continue to improve, which is allowing investors to consider higher vacancy."

In a briefing report released yesterday, Tim Wang, head of investment research at Clarion Partners in New York, said that momentum for broad-based absorption presages stronger rent growth.

"While tech and energy industries continue to grow rapidly in key markets, office demand growth drivers in second-tier cities vary widely, encompassing traditional and non-traditional office users," said Wang. "Vacancy rates are falling further below or closer to long-term averages, indicating that stronger rent growth may occur over the next few years."