CoStar - Long Overlooked, Suburban Office Attracting Increased Investor Interest

Buyers Swooping In to Pick Off Both Well-Leased and Increasingly Vacancy-Challenged Office Properties Outside CBDs

By Randyl Drummer
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After taking its lumps well into the ongoing office market recovery, suburban office property is finally garnering increased investor interest. As recently as January 2013, after rounds of corporate downsizing during and after the recession sent suburban office vacancy rates as high as 50% in some markets, analysts were writing the latest obituary of suburban office parks, shopping centers and other far-flung properties as places where no one among the coming wave of millennials would want to work, shop or live.

But now, suburban office is where the action is, thanks to yield-starved real estate investors priced out of expensive CBD assets and continued job growth, especially for office-using industries.

In recent quarters, investors have responded to a spate of opportunistic and value-add plays, many involving vacancy risk that often goes hand in hand with suburban office investments. Buyers have been lured by the wide pricing spreads between well-leased properties north of 90% occupancy and challenged buildings between 50% and 75% occupancy, according to CoStar Portfolio Strategy. While that spread has compressed from 144% in 2011 to 97% in 2014, it is still double the 2006 level of 48%.

"By leasing up a property, investors can still achieve value-add, boosted returns. The icing on the cake for value-add investors is that 75% of metros will likely achieve occupancy gains over the next three years, which makes it easier to lease up vacant space," said CoStar real estate economist Sam Tenenbaumin in a recent client note.

Increasingly overseas investors, usually focused on the safest core properties, are bidding on suburban office properties, according to Mary Sullivan Kelly, senior vice president and chief research officer for Colliers International.

"With the infusion of foreign capital seeking predominantly trophy CBD assets, other institutional equity will be forced to look towards B product and other value-add plays, driving up pricing in that sector," Kelly said.

What has many investors swinging for the suburban ooffice fences is the recent homerun pulled off by Rubenstein Partners and Grubb Properties. In what The Wall Street Journal called "a casebook study of how to make money on suburban office property," the pair of investors paid $26 million for an excess 67-acre office park in North Carolina's Research Triangle Park from telecom company Ericsson. The Rubenstein-Grubb venture planned to upgrade the pair of vacant office buildings totaling 467,000 square feet and put the sapce up for lease, hoping to emulate the success they had in repositioning a former GlaxoSmithKline property nearby.

As it turns out, computer-maker Lenovo Group Ltd. was looking for a home in the Research Triangle area for the server business it had purchased from IBM and decided to lease the entire project from Rubenstein-Grubb in March 2014. With the Lenovo lease in hand, the investors hired Cushman & Wakfield to shop the property to prospective buyers. In February 2015, a joint venture between UK-based

90 North Real Estate Partners and Dubai-based Arzan Wealth bought the suburban campus for $127 million, just 15 months after Rubenstein and Grubb's acquisition of the then-vacant property, and less than a year after Lenovo signed a long-term lease for the entire campus.

That kind of success attracts a lot of interest and many property owners who managed to hold onto their suburban office assets through the recession are eager to test the market. Case in point is New York City fund DRA Advisors and its partner Brandywine Realty of Radnor, PA. According to industry newsletter Real Estate Alert, the pair have put a 1.6 million-square-foot portfolio of 29 suburban office properties in Pennsylvania back on the market seeking a reported $200 million, or $125 per square foot. Market observers are eager to see if the timing proves better this time after pulling the portfolio off the market after it was first offered last summer.

Meanwhile other investors are moving in to take advantage of the improving prospects for suburban office market, attracted by declining vacancy rates amid stepped up leasing volume and historically low levels of new construction.

The most noteworthy being Duke Realty Corp.'s deal to sell a major portion of its suburban U.S. office portfolio for $1.12 billion to a joint venture of Starwood Capital Group, Vanderbilt Partners and Trinity Capital Advisors. The deal involves 62 office buildings with 6.9 million square feet of combined space and 57 acres of undeveloped land and includes all of Duke's wholly owned suburban office properties in Nashville, Raleigh, South Florida and St. Louis.

Just this week, a partnership of New York-based Angelo, Gordon & Co. and Atlantic Realty Cos. acquired four suburban office buildings totaling 499,696 square feet in Reston, VA for approximately $82 million. The portfolio, located near the Dulles Access Road and the new Silver Line Metro station, is only half-leased, which investors increasingly view as hlf-full rather than half-empty.

Chicago: Ground Zero for Suburban Office

There may be no better place to gauge the current condition of the U.S. suburban office market than communities on the outskirts of Chicago such as Libertyville or Hoffman Estates, once the home of such corporate mainstays as Sears Holdings Corp., Motorola and AT&T.

After Motorola Mobility was purchased by Google in 2012 and resold to Lenovo last year, the company relocated 3,000 employees from its Libertyville, IL office campus between 2012 and 2014, leaving an empty shell at the 84-acre property built in 1994 that's typical of the heyday of 1970s through '90s era suburban corporate office properties.

Philadelphia-based Binswanger marketed the property, one of the largest suburban office campuses in the Chicago market, starting in January 2013. The Motorola listing in the Lake County office submarket -- which suffered from a vacancy rate of more than 30% at mid-year 2014, highest among all suburban Chicago submarkets -- lingered on the market for 18 months, similar to the vacancy drag at numerous office parks across the country from Northern New Jersey to the outer suburban rings of Los Angeles, Orange County and San Diego in Southern California.

Last year, Rockville, MD-based BECO Management Inc. scooped up the five-building, 1.1 million-square-foot former Motorola Mobility campus for $9.5 million, a mere $8.50 per square foot. BECO has embarked on a major renovation and the property will be ready for occupancy later this year.

More recently, a partnership of Itasca, IL-based Hamilton Partners and Accesso Partners jointly acquired The Esplanade at Locust Point, consisting of four Class A office and R&D buildings totaling 1.05 million square feet in Downers Grove within Chicago's East-West corridor submarket. The buildings are 89% occupied, with tenants including Coca Cola Co., Prudential Insurance, Hewlett-Packard, Caterpillar Logistics, Siemens, American General Life, General Services Administration and Hillshire Brands/Tyson Foods.

"I can say with great confidence that this is the premier portfolio of suburban office buildings in the entire Chicago marketplace," states Ariel Bentata, managing director investments and co-founder of Hallandale Beach, FL-based Accesso Partners.

Investors hope the risks pay-off as the increased transaction velocity is still a work in progress. Despite the strong finish, the huge corporate departures earlier in the year left the overall suburban Chicago vacancy rate at 21.1%, a bit higher than the 21% posted at year-end 2013.