Investors Who Bought High-Vacancy Office Properties See Big Pay-Off

CoStar's Watch List News Report Focuses on Value Add and Opportunistic Investing -- Today's Most Active Area of CRE Investment Interest

By Mark Heschmeyer April 11, 2016

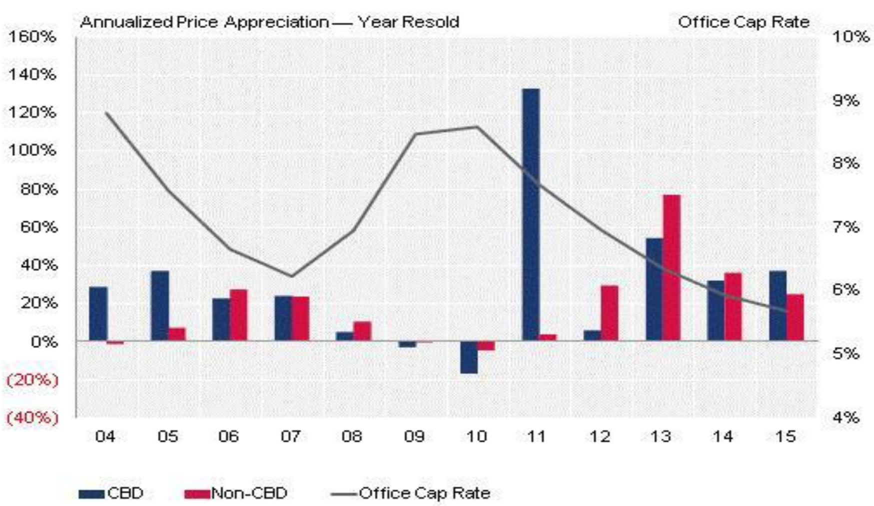
Investing in high-vacancy office properties has always involved a lot of risk. That is no more true than in today's market as more companies adopt more-efficient floorplans that allocate fewer square feet per employee.

However, recent research by Andrew Rybczynski and Suzanne Mulvee of CoStar Portfolio Strategy found that investors who did brave the odds and acquired high-vacancy office properties in this economic-recovery cycle have enjoyed superb returns. In general, value gains from acquiring low-occupancy office property, leasing it up, and selling have averaged 33% during this cycle versus just 20% in average value gains for the same strategy during the last one.

The research also found that office property in central business districts (CBDs) generated slightly more of these gains than suburban assets, as office users have shown a stronger preference for urban over suburban locations up to this point in the cycle.

The CoStar Portfolio Strategy team examined 44 million square feet of office buildings that sold after successfully executing an occupancy turnaround over the past 12 years. These turnaround buildings were defined as those that were initially acquired with occupancies below 70% and then resold one to four years following the initial sale with an occupancy improvement of at least 25 percentage points. The office buildings had to be 10,000 square feet or larger with an initial sale price of $5 million or more.

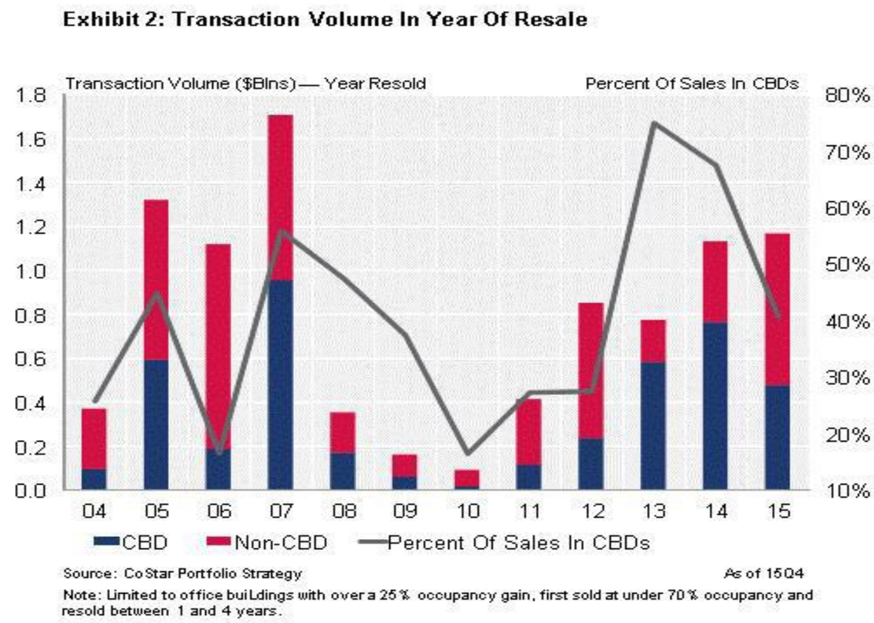
Exhibit 1: Value Gains On Turnaround Properties



Source: CoStar Portfolio Strategy As of 15Q4

Note: Limited to office buildings with over a 25% occupancy gain, first sold at under 70% occupancy and resold between 1 and 4 years.

"The decline in cap rates has certainly provided more of a tailwind for office property values this cycle than was the case for the last one," Rybczynski noted. "However, the outsized value gains realized more likely reflect the greater volatility in rent during this cycle, especially in urban areas. We observed that non-CBD submarkets in recent years have narrowed the gap in delivering appreciation returns, which suggests a better risk discount for non-CBD properties than previously available."



Despite strong demand for core assets and the better price appreciation, the sales volume of successful turnarounds of office buildings with high vacancy has not reached the levels achieved at the peak of the last cycle (see Chart 2 above.) Although it appears more investors are targeting value-add properties today, Mulvee pointed out that more of these opportunistic investors appear to be holding their properties longer.

"While sales of office properties with sub-70% occupancies has been 33% higher over the past three years than in the comparable period of the last cycle, fewer of these assets have re-traded. It seems that these value-add investors are holding their positions longer, looking to increase occupancy and rent to maximize operating cash flows before eventually selling to achieve their return targets," Mulvee said.

However, the window for successfully executing such a strategy may be closing. According to the CoStar Portfolio Strategy analysts, rent gains are expected slow this year for office space as new supply ramps up. As that happens, any additional reward for holding onto assets may not outweigh the heightened risk posed by new supply.