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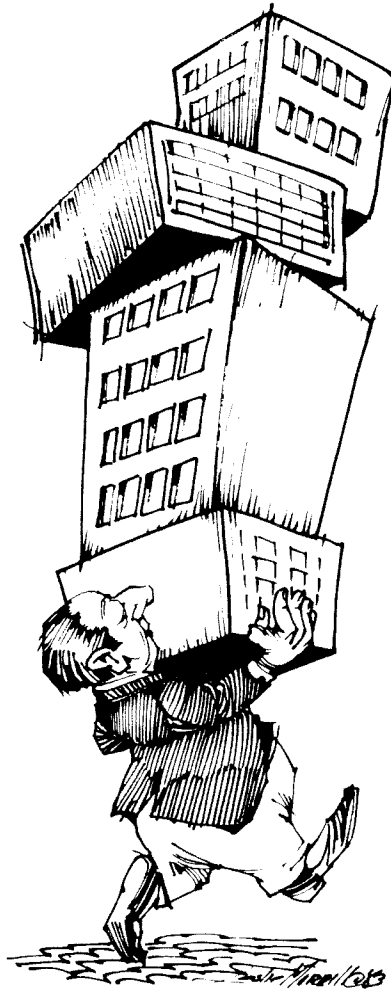
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A look at the advantages and disadvantages of owning your office.

Evaluating the Office Condominium

Kenneth D. Laub



WIDESPREAD EXPERIMENTATION is now taking place throughout the United States with the condominium ownership of office space. This trend creates a new set of challenges for tenants, developers, brokers, and managers.

THE COMMERCIAL CONDOMINIUM MARKET

In a limited segment of the commercial real estate market, the condominium concept has been accepted for some time. The typical project of the 1970s was a small

suburban low-rise building with modular divisions that were purchased by users who required 500 to 2,000 square feet. User-buyers included service groups like accountants, attorneys and consultants, and medical professionals. Condominium enthusiasts predict that a

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far wider market will emerge in the 1980s. If their expectations prove valid, market growth will be evident among:

- Partnerships like the law firms previously mentioned;
- Privately held service companies of all sizes;
- Specialty groups in industries such as jewelry, clothing, and home furnishings; and
- Condominium investors who will lease their units to tenants.

Generally excluded as potential commercial condominium purchasers are publicly held companies. The latter can often build or purchase their own buildings, and they must take into account a wide range of competing investments. Furthermore, their reported earnings are diminished by real estate depreciation.

Although the market potential for commercial condominiums is substantial, this potential can only be realized after condominium pioneers have created, through their own investments, a market for the resale of condominium units. At present, resale markets are limited and exist only in a few cities like Boston, Chicago, Miami, and Los Angeles.

Probably the largest condominium purchase in the United States was that of 1166 Avenue of the Americas, a 1.4 million-sq.-ft. tower in Midtown Manhattan. In 1975, the New York Telephone Company and the teachers' pension fund (TIAA/CREF) each bought half the building for a bargain \$27 per square foot. The Telephone Company occupied its own space, and the pension fund leased its half to tenants. (The bulk of the space was leased to the International Paper Company.) But most New York City office condominiums have been created by the conversions of smaller buildings to condominium ownership by diamond merchants, artists, doctors and clothing manufacturers.

Multiple ownership by nonrelated tenants is now being tested in a conversion at Fifth Avenue and Forty-first Street, for which both user-buyers and investors are being solicited to purchase single full floors at \$250-\$350 per square foot. In addition, several developers of planned rental construction in Manhattan are considering forward sales of large blocks of space to prospective condominium purchasers.

In San Francisco, developers were able to presell all twenty-three floors of Ecker Square, a newly constructed building, at an average price of \$300 per square foot. In greater Miami, condominiums account for 15 percent of all new commercial construction presently being built. In some suburban areas, an absolute majority of new office space is being developed as condominiums. In addition, owners of many urban rental buildings are turning to commercial condominium con-

version as an alternative to the more difficult residential conversion process. Observers are beginning to find parallels between this growing trend and the precedents established in other parts of the world, including Hong Kong, Singapore, Paris, Madrid, and many Latin American capitals, where the office condominium is no longer a new idea.

Most new condominium construction today consists of structures smaller than 150,000 square feet with floor sizes of 4,000 to 8,000 square feet, aimed at small business users, and at investors in the \$2 million to \$4 million range. Larger buildings and a wider market may be on the horizon; the emergence of such a trend would require changing attitudes on the part of developers and prospective purchasers. However, these attitudes are changing rapidly in response to legislative, economic, and general real estate market developments.

COSTING OUT THE CONDOMINIUM

The prospective purchaser of an office condominium (whether as potential occupant or as investor) must learn how to evaluate its long-term financial implications. The investor must establish the combination of purchase price and rent level that will result in the desired return on investment. The user-buyer must be able to compare the net cost of ownership with the rental cost of equivalent facilities. Both types of analysis must take into account the impact of the accelerated cost recovery system (ACRS), market appreciation, financing costs, and projected increases in maintenance expenses.

The first step in both analyses is to project the annual cost of purchasing and maintaining the condominium unit.

An appropriate technique can best be described by example. Exhibit 1 projects ten years of condominium costs based on the following assumptions:

- The purchase price is \$300 per square foot; \$250 is attributable to the building and \$50 to the land (which is nondepreciable).
- 80 percent of the purchase price is being financed over twenty-five years at 15 percent interest; the total annual debt service is \$37.13 per square foot.
- Maintenance costs (operating and management expenses, association dues, property taxes, etc.) are estimated to be \$13 per square foot in the first year; they increase at an annual rate of 8 percent.
- The purchaser is in the 50 percent tax bracket and chooses fifteen-year straight-line depreciation.
- The cost of money, for present-value purposes, is estimated to be 12 percent.

Evaluating the Office Condominium

EXHIBIT 1

PROJECTED CONDOMINIUM COSTS (per square foot)

Line	Item	0	1	2	3	4	Year		6	7	8	9	10
							5						
(1)	Principal payment	\$60.00	\$ 1.12	\$ 1.30	\$ 1.46	\$ 1.72	\$ 1.97	\$ 2.27	\$ 2.61	\$ 3.00	\$ 3.45	\$ 3.97	
(2)	Interest payment		36.01	35.83	35.67	35.41	35.16	34.86	34.52	34.13	33.69	33.16	
(3)	Maintenance expenses		13.00	14.04	15.16	16.38	17.69	19.10	20.63	22.28	24.06	25.99	
(4)	Total gross cost		50.13	51.17	52.29	53.51	54.82	56.23	57.76	59.41	61.19	63.12	
(5)	Depreciation (s/1-15 years)		16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	
(6)	Total tax deductions (lines (2) + (3) + (5))		65.68	66.54	67.50	68.46	69.52	70.63	71.82	73.08	74.42	75.82	
(7)	Tax savings (50% of line (6))		32.84	33.27	33.75	34.23	34.76	35.32	35.91	36.54	37.21	37.91	
(8)	Net cost (line (4) - line (7))		17.29	17.90	18.54	19.28	20.06	20.92	21.85	22.87	23.98	25.21	
(9)	Present value of line (8)	60.00	15.44	14.27	13.20	12.25	11.38	10.60	9.88	9.24	8.65	8.12	

Total present value of costs: \$173.03 per square foot.

Exhibit 1 shows that the down payment is \$60 per square foot. Annual out-of-pocket costs (line (4)) are \$50.13 per square foot in the first year, increasing to \$63.12 in the tenth. However, the net cost after taxes, after deductions for interest, maintenance and depreciation (line (8)) ranges from only \$17.29 in the first year to \$25.21 in the tenth. The present value of this annual net cost declines from \$15.44 to \$8.12 during the ten-year period (line (9)).

One additional item must be factored into the analysis of the costs of ownership. This is equity appreciation, probably the most significant financial advantage of ownership as opposed to renting. (Of course, appreciation is the least predictable element of any analysis, subject as it is to factors like timing, future market conditions and inflation.) If we assume that the purchaser holds this unit for ten years and that during this period the unit appreciates 5 percent annually, its value will rise from \$300 per square foot when purchased to \$488.67 at the time of sale. Deducting the mortgage's remaining principal balance of \$217.11, the seller will be left with cash proceeds of \$271.56 per square foot. From this must be subtracted the 20 percent individual long-term capital gains tax on the combined profit and accumulated depreciation, which amounts to \$71.07 (.20 × \$355.37), leaving net after-tax sales proceeds of \$200.49 per square foot.

The present value of \$200.49 in Year 10 is \$64.55. In order to arrive at the final net cost of owning the unit for ten years, we subtract \$64.55 from the total present-value after-tax outlay (\$173.03). The remaining \$108.48 per square foot, reamortized over ten years at 12 percent interest, yields a net average annual impact of \$19.20 per square foot. The calculations in the last two paragraphs are summarized in Exhibit 2.

SHOULD A USER LEASE OR BUY?

For the user of office space, a market consisting of both rental and condominium units presents a perplexing picture because the cost of buying bears no obvious relation to the cost of leasing. However, a relationship certainly does exist, although its discovery may require extensive financial calculations.

Whether the prospective user-buyer of the unit analyzed here should rent or buy depends largely on the escalation package which can be negotiated for competing rental facilities. The negotiation of leases and attendant escalation clauses has become one of the more sophisticated areas of real estate. Prospective

EXHIBIT 2

NET COST AFTER RESALE (per square foot)

Resale price: $(\$300) \times (1.05)^{10}$	\$ 488.67
Remaining principal balance	- 217.11
Cash proceeds	<u>\$ 271.56</u>
Purchase price	\$ 300.00
(Less) accumulated depreciation	- 166.70
Basis for capital gains liability	<u>\$ 133.30</u>
Resale price	\$ 488.67
(Less) basis	- 133.30
Capital gain	<u>355.37</u>
Tax rate on capital gains (individual)	× 20%
Capital gains tax on sale	<u>\$ 71.07</u>
Cash proceeds	\$ 271.56
(Less) capital gains tax	- 71.07
After-tax proceeds	<u>\$ 200.49</u>
Present value (12%)	\$ 64.55
Total present value of costs	\$ 173.03
(Less) present value of proceeds	- 64.55
Net present value cost	<u>\$ 108.48</u>
Average annual impact (12%)	<u>\$ 19.20</u>

space users must possess substantial expertise merely to compare the cost of competing rental alternatives to one another. Nevertheless, they can make judgments about the lease-or-buy decision by determining the "rental equivalent" of the cost of a purchase.

Determining the Rental Equivalent

Although analysis of the myriad escalation formulae now in use is beyond the scope of this article, one technique of making a lease-versus-buy decision can readily be explained if we assume that the escalation is a simple 6 percent annual increase in rent throughout a ten-year lease term. This technique establishes a "rental equivalent" (expressed as a base year rent) to the average annual impact of the unit purchaser's cost. The example can be understood by referring to the five successive equations of Exhibit 3.

EXHIBIT 3

COMPUTING THE PER SQUARE FOOT RENTAL EQUIVALENT (BASE YEAR RENT)

- (1) $T_t = \text{Total Rent} = R[1 + 1.06 + (1.06)^2 + \dots + (1.06)^9]$
- (2) $PV_t = \text{Present Value} = R(.89 + .85 + .80 + .76 + .72 + .68 + .64 + .61 + .57 + .54) = 7.06R$
- (3) $A_r = \text{Net Average Annual Impact (rental)} = (1.25 \times R)/2 = .625R$
- (4) $A_o = \text{Net Average Annual Impact (ownership)} = \19.20 (from Exhibit 2)
- (5) If $A_r = A_o$, then $.625R = \$19.20$, and $R = \$19.20/.625 = \30.72
- (6) **Occupancy Tax Correction:**
 $R = \$30.72/1.06 = \28.98

Equation (1) merely says that the total rent is the sum of ten years' rent, each year's rental being 6 percent higher than the rental of the previous year. Equation (2) shows the value of each of these ten rental payments discounted at 12 percent to the present. The total present value of these payments (in this case) is 7.06 times the base year rent. It can be determined that a total present value payment of 7.06 R is equivalent to ten equal payments of 1.25 R. Equation (3), therefore, shows average rent as 1.25 R. Thus the first three equations on Exhibit 3 show the effect of escalation on total rent liability, discount these rentals to a present value, and reamortize the amount over the lease term at 12 percent.

Since office rent is totally deductible for income tax purposes, equation (3) then divides the average rental, 1.25 R, in half (50 percent tax bracket) to arrive at the net variable average annual after-tax impact (.625 R). Equation (4) reminds us of the average impact amount established in Exhibit 2. In equation (5), we assume that the average impact of renting (A_r) equals the aver-

age annual impact of ownership (A_o), i.e., $\$19.20 = .625 R$. Thus, we conclude that the condominium unit bought at \$300 per square foot is equivalent in cost to a leased unit with a \$30.72 per square foot base rent. Because rent (but not ownership cost) is subject to municipal occupancy tax, the rental equivalent is corrected to \$28.98 (equation (6)) when that levy is 6 percent, as it is in New York City.

Having conducted such an analysis, the prospective user-buyer is now equipped with the information necessary to evaluate rationally the available alternatives. If the rental market for space equivalent to the proposed condominium unit is higher than the rental equivalent, purchase may well be a wise investment. If not, it would be a costly one. (Naturally, this analysis can be reversed to find the purchase equivalent of a given rental.)

THE OFFICE CONDOMINIUM INVESTMENT

When we discussed the emergence of a substantial market for office condominiums, we included among potential purchasers a category of passive investors with resources of \$2 million to \$4 million, who would purchase one or more floors of a building and lease them to users. Investment in office condominiums would make the tax shelter and appreciation advantages of real estate investment available to individuals and groups that are too small to purchase entire buildings.

For the investor, the chief financial calculus is that of the internal rate of return (IRR), the discount rate that equates an investment's income stream with its equity cost. The main advantages of the IRR method over others, such as cash-on-cash, are that it takes into account the time value of money and is easily suited to comparisons with competing investments.

To illustrate the analysis that investors must make, let us hypothesize that an investor with an IRR objective of 12 percent before taxes is considering an all-cash purchase of our example condominium unit, and that this unit can be leased to a tenant at \$35 per square foot per year, increased through annual escalations of 3 percent of the base rent plus all increases in maintenance expenses. At the expiration of a ten-year lease, the investors plan to sell and realize a projected 5 percent annual appreciation.

Exhibit 4 calculates the maximum purchase price that an investor can pay and still earn a 12 percent IRR during a ten-year holding period. In column (1), each year, the rental is increased by 3 percent of the base plus the amount necessary to reimburse the lessor for increases in maintenance costs. Maintenance costs (from Exhibit 1) are listed in column (2). When these

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EXHIBIT 4 CALCULATING A CONDOMINIUM INVESTOR'S MAXIMUM PURCHASE PRICE (Assume 12% IRR)

Year	(1) Income	(2) Expenses	(3) Cash Flow	(4) Present Value
1	\$ 35.00	\$ 13.00	\$ 22.00	\$ 19.64
2	37.09	14.04	23.05	18.38
3	39.29	15.16	24.13	17.18
4	41.62	16.38	25.24	16.04
5	44.08	17.69	26.39	14.97
6	46.67	19.10	27.57	13.97
7	49.42	20.63	28.79	13.02
8	52.33	22.28	30.05	12.14
9	55.40	24.06	31.34	11.30
10	547.33	25.99	521.34	167.86
		Total present value		\$304.50

costs are subtracted from rent, the difference (column (3)) is the annual cash flow, which is then discounted at a 12 percent annual rate (column (4)). In Year 10, the unit is sold, with the proceeds treated in the same manner as rental income. The total of the cash-flow present values (\$304.50) is the maximum purchase price at which the desired 12 percent IRR can be realized.

The potential investor must now ask whether the assumed rental is actually achievable. Condominium investors will be operating in a mixed market, competing with the owners and developers of both rental and condominium properties. When an investor buys a floor for investment, the price that he pays includes the seller's markup. Thus he expects his tenant to pay a rental that incorporates both the seller's markup and the investor's return on investment. Developers who need satisfy only a single margin of profit will be able to lease space at a lower rental than condominium investors. Thus, it is likely that investors will be able to enter the market only in special situations; those who purchase at retail may find returns severely squeezed by competitive pressures.

LATENCY, LIQUIDITY, AND RISK

The prospective purchaser of the office condominium, whether for occupancy or for investment, must also take into account various drawbacks to real estate investment, compared with others, before making a decision.

Among these is the latency of equity accumulation. The examples in this article all assumed a degree of annual appreciation that affected the user-buyer's rental equivalent and the investor's internal rate of return. Also implicit in Exhibits 1 through 4 is the independent accumulation of equity as the mortgage principal is amortized. Real estate equity exists only on paper, though, until such time as either the property is

sold or some other way is found to convert it into cash. Particularly in the case of the user-buyer, this reality is often advanced as an argument against condominium purchase because the owner's real estate equity is of no benefit in a sudden cash squeeze unless it can be cashed in. However, this difficulty may be overcome through refinancing, a sale-leaseback or a tax-free swap.

Absence of liquidity is a real risk that confronts any prospective real estate purchaser. The most conservative financial projection can be upset if the planned time of sale coincides with the slump of a real estate cycle. The appreciation that is assumed in most investment projections can be wiped out by such factors as overbuilding, serious economic recession or mere sustained price deflation. Although real estate busts tend eventually to lead into booms, the opposite is also true and the complete cycle may take a decade or longer to run its course. The wise investor must therefore have sufficient staying power to avoid possible disaster. Those who purchase condominiums at the peak of a boom (when they appear most attractive due to the inflation of rents) are particularly vulnerable to a possible softening in the market.

NONFINANCIAL ISSUES

Cost control and the anticipation of long-term gain are often not the primary considerations motivating condominium purchasers today. For many user-buyers, the main advantage of ownership is space control, a guarantee of available facilities in which to conduct their business virtually in perpetuity, without having to confront lease renegotiation and possibly forced relocation every five or ten years. In a tight market, this promise alone may justify condominium investment to those who have had their fill of unpleasant lease expiration experiences.

The disadvantage corresponding to space control is diminution of flexibility. A business that leases space in a multitenant office building is likely to enjoy the opportunity to expand or contract as the need arises due to a steady turnover of tenants in the building, each of whom also periodically encounters the need to expand or contract. The owner-occupant of a condominium unit, on the other hand, is likely to have far more limited options.

There is no reason, however, for condominium owners to sacrifice flexibility. In a viable building, expansion and contraction can be controlled through the leasing of surplus space. For example, a user who requires 10,000 square feet might purchase 15,000 or 20,000 square feet and lease the surplus to outside tenants for staggered terms. As these leases expire, the owner-user can either renew them or recapture the space for his

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own operations. Should the owner-user's requirements contract, he can further divide the premises to create additional leaseable space. The key to prudent condominium purchase, as in leasing or any other business decision, is sound long-term planning.

Another adjustment required of office condominium owners is the responsibility of management. Since there is no landlord to deal with the heating, cooling, repair and maintenance of the building, these tasks fall to the condominium association, consisting of the property's multiple owners. Usually, these property owners are somewhat innocent of the complex technological systems involved in keeping a modern building running. Experience has shown that management is best left to professionals, preferably an experienced management firm which reports to the association's board of directors.

Finally, the purchaser of an office condominium must make a psychological adjustment to a new field of business. No longer can the owner of an advertising agency, for example, claim to be "not in the real estate business." A condominium owner is very much in this business, even if all the space is used in the primary enterprise. When the necessity or opportunity to lease surplus space arises, when an air-conditioning unit

must be installed, or when a sale is contemplated, the outcome will depend on the real estate expertise upon which the original purchase and subsequent operating decisions were based.

THE MARKET'S FUTURE

Is the office condominium an idea whose time has come? No one can answer this question with assurance. However, several preconditions must be met if this ownership form is to achieve widespread popularity.

- The commercial real estate market must maintain its strength.
- Financing mechanisms must be developed to meet the special needs of condominium developers and purchasers.
- The legal process of approving development and conversion must be simplified.
- Office space users must be educated about condominium advantages and disadvantages so that they make informed decisions.
- Developers, brokers, consultants, and managers must develop their sophistication and expertise regarding the condominium concept.