Commercial Property News

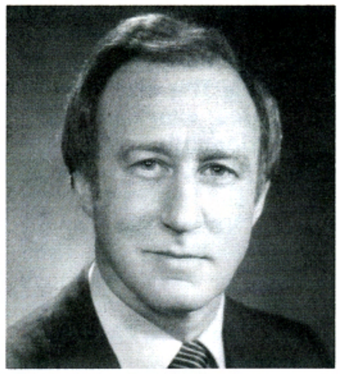
FOR INVESTMENT, DEVELOPMENT, FINANCING, LEASING AND ASSET MANAGEMENT

Few Winners in N.Y. Tower's Turbulent 20 Years

New York—As Marsh & McLennan Companies moves into the 800,000-sq.-ft. office condominium it recently purchased for $250 million, another chapter opens in one of New York City's most vexing real estate sagas.

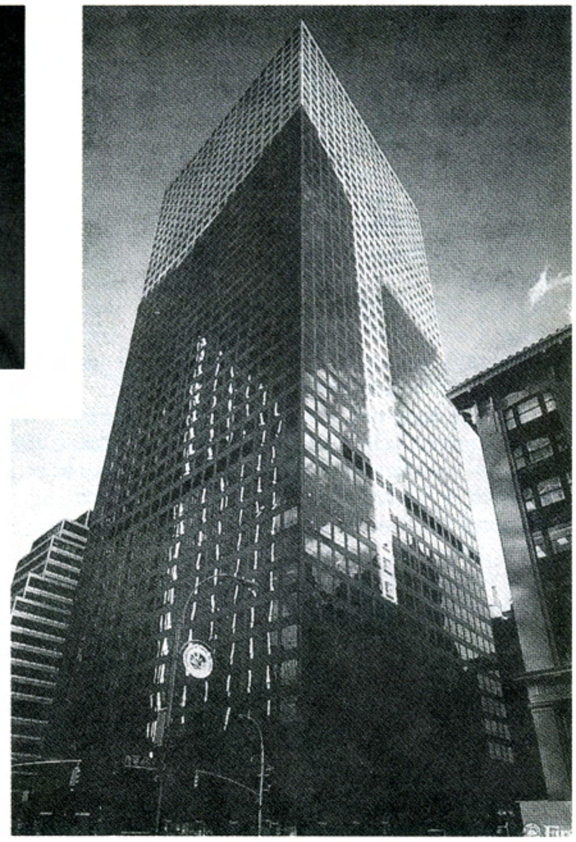
According to Charles S. Isaacs, president of CSI Consultants Inc., a real estate research firm, "Few buildings better chronicle the high-stakes gamble of commercial realty than 1166 Avenue of the Americas. In the 20-year roller-coaster ride of this property's fortunes, there were many losers but few winners."

Those who won the most were Teachers Insurance & Annuity Association (TIAA) and International Paper Co., with combined gains from a series of transactions totaling over $200 million. Engineering these deals was broker Kenneth D. Laub, whose $10 million in fees put his own company high on the short list of winners.



Broker Kenneth D. Laub's estimated $10 million in fees put his own company high on the short list of winners.

Few buildings better chronicle the high-stakes gamble of commercial realty than 1166 Avenue of the Americas. In the 20-year roller-coaster ride of this property's fortunes, there were many losers but few winners.



Tishman Realty & Construction Co. heads the losers' column. Tishman purchased the 45th-46th streets blockfront for $42 million in 1970. The New York State Employees Retirement System (ERS) and two savings banks provided $32.5 million in financing. The seller was Edwin Glickman, who had assembled 28 parcels plus air rights. Holding out at the corner, though, were Bernard and Alfred Pravda, who refused a $320,000 offer for their restaurant.

Tishman had deeper pockets than Glickman, plus a letter of intent from GTE Corp. to relocate its headquarters to the proposed skyscraper, Isaacs explained. The developer agreed to pay the Pravdas $1.35 million, but the sale fell apart when the brothers upped the ante above $2 million at the last minute. Tishman began building around the holdout site. (Eight years later, the Pravdas settled for $820,000.

Tishman traded its ownership of the land for a site owned by real estate veterans Sol Goldman and Alex DeLorenzo, and leased it back for 99 years. Goldman and DeLorenzo took $3.5 million out of the deal through secondary financing from the Jamaica Savings Bank. A Citibank consortium provided construction financing of $45 million.

As soon as construction got under way, Tishman ran into trouble. Cost overruns exceeded $25 million, and GTE had second thoughts about relocation to the building when its existing Manhattan office was bombed. It headed for a more tranquil Connecticut site. Meanwhile, an economic recession developed and the Manhattan office market collapsed. Vacancy rates hit 18 percent and rentals fell through the basement.

In 1974, when the 1.5 million-sq.-ft. building opened, prime Midtown office space was going for $8.50 a foot, 30 percent below the break-even rental Tishman was asking. For the next 18 months, the building remained vacant, costing Tishman $1 million monthly in carrying costs, while the city's financial condition disintegrated. Having lost $30 million, Tishman defaulted on its construction loan.

The empty building soon swallowed millions more. First, the Citibank group walked away from its $45 million construction loan investment and passed the buck to Goldman-DeLorenzo, the fee owners. Not interested in reliving the Tishman experience, the partners defaulted on their own mortgage. The ensuing foreclosure wiped out Jamaica Savings Bank's $3.5 million stake and put the ERS in the hot seat, Isaacs recalled.

Having invested only $32.5 million in the original mortgage, ERS now owned a $70 million building on a $42 million site. The property's value, though, existed only on paper. With no tenant in sight, ERS began looking for a buyer.

The search went on for two years, with the building still hauntingly vacant. On June 9, 1978, ERS sold the property as a two-part condominium. TIAA paid $22.5 million for the two base floors and the top 21 office floors, for which it would try to find tenants. For $14.5 million, the N.Y. Telephone Co. obtained the other 21 office floors for its own use. After recouping its initial investment plus lost interest and other expenses, ERS squeezed out a profit of about $1 million.

N.Y. Telephone is still there, Isaacs noted. As time goes on, the bargain-basement deal looks better and better for the company, and it now sits on enormous capital gains should it decide to sell. While the company can be counted as a winner, many observers doubt the big windfall from a sale will ever be realized, since the law would require the profits to be passed through to consumers through rate reductions.

TIAA appointed the Edward S. Gordon Co. as its leasing agent for the 800,000 square feet. By the end of 1979, Gordon leased several small spaces, but had not yet landed an anchor tenant. One full floor was taken by another real estate firm, Cushman & Wakefield.

Among Cushman & Wakefield's clients was the New York Daily News, which was losing money on both its newspaper and its 220 East 42nd St. headquarters building. With the lease expiration of anchor tenant International Paper nearing, the broker recommended renewal at $7.50 per square foot. The renewal fell apart when The Daily News switched agents, hiring Kenneth D. Laub & Co. Laub argued higher rentals could be achieved in the open market. As the real estate market recovered, the paper company started looking for new quarters. Laub leased its News Building space at $25 to $30 a foot.

International Paper leased 665,000 square feet from TIAA at 1166 Avenue of the Americas, including a private lobby, reception area and plaza entrance. Besides the market rental of $17 a foot, the company invested $65 million in lavish office quarters, a corporate fitness center, multiple dining areas and a conference complex. The plaza was extensively landscaped and named for the company, which took occupancy in 1981. Finally, stability appeared to have arrived at 1166 Avenue of the Americas.

During the next three years, though, the jinx that affected every party previously associated with the building reasserted itself, Isaacs said. The forest products industry went into a tailspin. Forced to retrench personnel, International Paper found itself saddled with 120,000 square feet of empty, expensively appointed office space. Its lease prohibited the company from realizing any profits or even recovering its improvement expenditures through subleasing.

In addition, these improvements would belong to TIAA when the lease expired in 1994, A renewal then could triple IP's rent. Chairman Edward Gee, who had maintained a relationship with Laub since the 42nd Street renewal negotiations, asked the broker for help.

Laub had a "crazy idea" for IP: purchase the condominium, then sell it to another user and move elsewhere. Gee disagreed. He wanted the visible New York City presence 1166 provided.

For more than a year, Laub negotiated with TIAA to modify the sublease clause, buy or lease the space back, or grant some control over operating expenses to his client. But by the end of 1984, International Paper's empty floors were still gathering dust and its costs for the space were rising.

Soon thereafter, John Georges was brought in as International Paper's new chairman, with a mandate to cut costs. Having no personal attachment to the building, he was receptive to Laub's proposal and authorized him to negotiate the condominium purchase. Two thirds of the $153 million purchase price constituted capital gains for TIAA.

Now an owner-user, International Paper gained the flexibility to sell or lease its empty floors while consolidating personnel more efficiently; the security of long-term occupancy without rent increases, control over building operations; a tax depreciation write-off; and a property tax abatement granted by the city prior to construction. Laub convinced Georges these benefits would be worth more to another user than to IP. Phase II of his dream scenario soon was under way: Sell the condo as quickly as possible.

Ordinarily, a block of space this large would be purchased as an investment, Isaacs stated. Foreign investors then were becoming increasingly active purchasers, paying up to $500 per foot for prime Midtown properties. Most foreign investors, though, would not consider condominium purchases, and N.Y. Telephone refused to sell its share of the building. Adding to the challenge was the relative novelty of the office condominium concept, and the wariness of most user-investors toward new ideas. It soon became clear Laub would have to find a user who not only required the space, but who was also financially positioned to handle the purchase price and take advantage of the income tax benefits and property tax abatement.

Within a few months, he sold the deal to First Boston Corp., which was then expanding. The $230 million sale (about $282 per square foot) closed in July 1986. International Paper made a $77 million profit in seven months. Laub earned his second multi-million-dollar commission on the space, and two more names could be listed in the winners' column.

Soon thereafter, Laub arranged for International Paper to decentralize its operations to three lower-price locations, with the bulk of the space leased in Memphis where he negotiated a sweetheart deal from both the developer and the city. According to industry sources, Laub's commissions finally exceeded $10 million.

First Boston was not as fortunate. Shortly after its purchase, the investment banking firm ran into a morass of internal difficulties, including the defections of several top executives.

In July 1988, two years after First Boston purchased the space, Marsh & McLennan bought the condo. At $250 million, First Boston was able to recoup its own purchase price and carrying costs incurred during two years of vacancy.

Time will tell in which column Marsh & McLennan ultimately finds itself, but the insurance brokerage company looks like a potential winner. Assuming it puts about $50 million into additional improvements and moves into the space this spring, Isaacs projects its total occupancy costs between $50 and $60 a foot through the 1990s. Depreciation deductions can cut the after-tax per-sq.-ft. cost to about $27. At a modest 4 percent annual appreciation in the property's value, the condo could be worth in excess of $800 million by the time the depreciation runs its full course.

"But economic projections have a way of derailing, particularly at this address," Isaacs pointed out.