

Office Condominiums

by Kenneth Laub

During the past 20 years, the real estate industry has experienced many new developments in the ownership, occupancy, and operation of office buildings. Long-term leases, double-digit inflation, changing concepts of rent escalation, energy shortages, new technologies, and a surge of foreign investment are only a few of these changes. Today, another transformation is beginning to emerge: condominium ownership of office space. Experimentation now taking place throughout the United States could signal a new set of challenges to tenants, developers, brokers, and managers.

The condominium market

Within a limited segment of commercial real estate, the condominium concept has been accepted for some time. The typical office condominium project of the 1970s was a small suburban low-rise building with modular divisions, purchased by users with requirements of 500-2,000 sq. ft. User-buyers included service groups (accountants, attorneys, and consultants) and medical professionals. Condominium enthusiasts of the 1980s predict a far wider market, one which has already begun to develop. If their expectations prove valid, market growth will be evident among: partnerships, including law firms, and privately held service companies of all sizes; specialty groups in industries such as jewelry, clothing, and home furnishings; and investors who lease their units to tenants.

Publicly held companies generally are considered as a force in the condominium market of the future. These firms often can afford to purchase their own structures; these firms have a wider range of competing investments; and publicly held

companies' reported earnings are diminished by real estate depreciation. However, condominium purchase as an interim step, followed by a sale-leaseback, can offer these companies many of the advantages of ownership without the drawback of depreciating assets. In addition, many companies are facing capitalization of leaseholds under the Financial Accounting Standards Board's Regulation 13 which, in some cases, negates the advantage of operating in leased quarters.

But even without public companies, market potential for office condos is substantial, especially as the nation's economy gravitates toward a service orientation. At present, resale markets have developed only to a limited degree and only in a few cities, among which are Boston, Chicago, Miami, Los Angeles, and Phoenix. Nationwide activity is likely to nurture this market, however.

Probably the largest commercial condominium purchase in the United States was 1166 Avenue of the Americas, a 1.4 million sq. ft. tower in midtown Manhattan, by the New York Telephone Company and the teacher's pension fund (TIAA/CREF), each of whom bought half the building for a bargain \$27 per sq. ft. just before the end of the last real estate slump. More common in New York City have been conversions of smaller buildings to condominium ownership by diamond merchants, artists, doctors, and clothing manufacturers; several of these conversions have been concluded successfully during the past few years. Multiple ownership by nonrelated tenants is now being tested in a conversion at Fifth Avenue and Forty-first St., where both user-buyers and investors are being solicited to purchase single full floors.

In San Francisco, developers were able to pre-sell all 23 floors of newly constructed Ecker Square for an average of \$300 per sq. ft. Condominiums in the Miami area account for 15% of all new construction presently being built. In suburban Miami, new office space is being developed as condominiums. Across the country, owners of many urban rental buildings are turning to commercial condominium conversion 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 capitols, where the office condominium is no longer a new idea.

New condominium construction now consists primarily of structures smaller than 150,000 sq. ft. with floor sizes of 4,000-8,000 sq. ft. aimed at a market of small business users and investors in the \$2 million-\$4 million range, whose resources do not permit purchase of an entire building. Theoretically, larger buildings and a wider market may be on the horizon, depending on how developers and prospective purchasers view the financial, operational, and psychological issues of condominium ownership. These attitudes are changing rapidly in response to legislative, economic, and general real estate market developments.

Tax legislation

A major spur has been the 1981 Economic Recovery Tax Act, specifically the provision for an accelerated cost recovery system (ACRS). The ACRS established new rules for investment property depreciation, simplifying the former

regulations and allowing for more rapid writeoff of assets.

Although there is no guarantee that condominium conversions will be spurred by the generous rehabilitation credits granted under the 1981 tax law, certainly all forms of real estate investment have become more attractive due to the reduced period of depreciation. Furthermore, all forms of commercial real estate—office buildings, warehouses, shopping centers, small office condominium units—receive the same treatment from the Internal Revenue Service. Even the straight-line method, in combination with long-term financing, enables investors to continue the deductibility of interest, claim depreciation far in excess of amortization, and avoid recapture entirely. Capital gains would be taxed at a maximum rate of 20%.

Costing out the condominium

No prospective office condominium owner purchasing the unit for either occupancy or investment should enter into such a transaction without a complete evaluation of its long-term financial implications. For the investor, this analysis should determine the purchase price or rent level that will result in the desired return on investment. For the user-buyer, it should compare the net cost of ownership with the rental cost of equivalent facilities. In both cases, the impact of the ACRS must at some point be taken into account, as well as market appreciation, financing costs, and projected increases in maintenance expenses, all of which require present-value discounting to facilitate comparisons.

The first step in such an analysis is to project the annual cost of pur-

chasing and maintaining the condominium unit. As an illustration, *Table 1* charts a hypothetical ten-year projection, given the following assumptions:

1) The sales price is \$300 per sq. ft., built to suit; \$250 of this is attributable to the building and \$50 to nondepreciable land.

2) 80% of the purchase price is being financed over 25 years at 15%; the total annual debt service is \$37.13 per sq. ft.

3) Maintenance costs (operating and management expenses, association dues, property taxes, etc.) are estimated at \$13 per sq. ft. in the first year, increasing at an annual rate of 8%.

4) The purchaser is in the 50% tax bracket and chooses 15-year straight-line depreciation.

5) The cost of money is estimated

Figure 1
Projected Condominium Costs (per square foot)

		Year											
Line	Item	0	1	2	3	4	5	6	7	8	9	10	
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)		16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	16.67	
6	Total 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 sq. ft.													

at 12% for present-value purposes.

As shown in the chart, the total annual out-of-pocket costs amount to \$50.13 per sq. ft. in the first year, increasing to \$63.12 in the tenth, in addition to the \$60 per sq. ft. down payment. However, the net cost after taxes ranges from \$17.29 in the first year to \$25.21 in the tenth, after deductions for interest, maintenance, and depreciation. On a present-value basis, this annual net cost declines from \$15.44 to \$8.12 during the 10-year period.

One more item must be factored in before comparisons can be made: equity appreciation, probably the most significant financial advantage of ownership as opposed to renting. Of course, appreciation is the least predictable element of such an analysis because it is subject to timing, market conditions, inflation, etc. If we assume, for purposes of exposition, a ten-year holding period for the unit under consideration, with annual appreciation of 5%, its value at the time of sale will be \$488.67 per sq. ft. Deducting the remaining principal balance of \$217.11, the seller will be

left with cash proceeds of \$271.56 per sq. ft. From this must be subtracted the 20% long-term capital gains tax on the combined profit and accumulated depreciation (\$355.37), which amount to \$71.07, leaving net after-tax sales proceeds of \$200.49 per sq. ft.; the present value is \$64.55 per sq. ft. To compute the final net cost of owning the unit during the ten-year period, subtract this amount from the total present-value outlay after taxes (\$173.03); the remaining \$108.48 per sq. ft., reamortized over ten years at 12% interest, yields a net average annual impact of \$19.20 per sq. ft. These calculations are summarized in *Table 2*.

Lease or purchase?

The office space user is confused by a market consisting of both rental and condominium units, because the cost of buying bears no obvious relation to the cost of leasing. However, a relationship between these considerations certainly does exist, although its discovery may require extensive financial calculations.

The prospective user-buyer of the unit analyzed earlier would be imprudent to proceed to a purchase without first determining the rental equivalent: the point at which the cost of owning and leasing are equal. Having analyzed the cost of owning this unit, the remaining calculations depend primarily on the escalation package which can be negotiated for competing rental facilities. Escalation, as most landlords and tenants now know, has become one of the more sophisticated areas in lease negotiation during the past several years, requiring substantial expertise to merely compare the cost of competing rental alternatives. Although analysis of the myriad formulae now used goes beyond the scope of this article, *Table 3* illustrates the crux of the lease-or-buy decision—the rental equivalent—by postulating a simple 6% annual increase in rent throughout a ten-year lease.

In the hypothetical example presented, we have first computed the ef-

**Figure 3
Computing the Rental
Equivalent**

R = Rental equivalent (per sq. ft.)
 $T_r = \text{Total rent} = R[1 + 1.06 + (1.06)^2 + \dots + (1.06)^9]$
 $PV_r = \text{Present value} = R(.89 + .85 + .80 + .76 + .72 + .68 + .64 + .61 + .57 + .54) = 7.06R$
 $A_r = \text{Net average annual impact} = (1.25 \times R)/2 = .625R \text{ (rental)}$
 $A_o = \text{Net average annual impact} = \$19.20 \text{ (from Figure 2) (ownership)}$
 If $A_r = A_o$, then
 $.625R = \$19.20$, and
 $R = \$19.20/.625 = \30.72
 Occupancy tax correction:
 $R = \$30.72/1.06 = \28.98

**Figure 2
Net Cost After Resale
(per sq. ft.)**

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

fect of escalation on the total rent liability, then discounted this factor to its present value and reamortized it over the lease term at 12%. Because office rent is totally deductible for income tax purposes, we have divided this number in half (50% tax bracket) to arrive at the net variable average annual after-tax impact. This result is then equated with its ownership counterpart from *Table 2*. Given the assumptions underlying this analysis, the condominium unit bought at \$300 per sq. ft. is equivalent in cost to a leased unit with a \$30.72 per sq. ft. base rent. Because rent alone is subject to municipal occupancy tax, the rental equivalent is corrected to \$28.98 if that levy is set at 6%, as in New York City.

When this analysis is completed, the prospective user-buyer has the information needed to rationally evaluate 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. This analysis can be reversed to find the purchase equivalent of a given rental unit.

The office condominium investment

As mentioned earlier, there is probably a substantial market for office condominiums composed of passive investors with resources of \$2 million-\$4 million, who would purchase one or more floors of a building and lease them to users. Office condominiums offer tax shelter and other advantages of real estate investment to individuals and groups whose financial resources are too small to purchase entire buildings.

For the investor, the foremost financial calculus is 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 other methods 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.

For example, presume that an investor with a pre-tax IRR objective of 12% is considering an all-cash purchase of the condominium unit described earlier, and that this unit can be leased to a tenant at \$35 per sq. ft. annually, increased through escalation annually by 3% of the base rent plus all increases in maintenance expenses during the term of the lease. At the expiration of this ten-year lease, the unit will be sold and the projected 5% annual depreciation will be realized.

Table 4 calculates the maximum purchase price which will yield a 12% IRR during a ten-year holding period. Each year, the rent is increased by 3% of the base plus the amount necessary to reimburse the lessor for increases in maintenance costs. Subtracting maintenance costs from the rent, we arrive at the annual cash flow, which is then discounted at a 12% annual rate. 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% IRR can be realized.

The question here is whether the assumed rental can actually be achievable. Condominium investors will be operating in a mixed market, competing with owners and developers of both rental and condominium properties. When space is bought for investment, the price will include the seller's mark-up, which must be factored in, along with the investor's return on investment, before leasing the unit becomes feasible. Developers who require only a single margin of profit will be able to lease space at a lower rent than the condominium investor. Thus, it is likely that investors will be able to enter the market in special situations, such as where lower prices can be negotiated from a developer anxious to avoid partnerships with sources of long-term financing. Those who purchase at retail will find returns severely squeezed by competitive pressures.

Latency, liquidity and risk

The prospective purchaser of an office condominium for either occupancy or investment must also consider various drawbacks to real estate investment compared with other types of investment.

Among these drawbacks is the latency of equity accumulation. In the previous examples, we have assumed a degree of annual appreciation before calculating the rental

equivalent for the user-buyer and the internal rate of return for the investor. Also implicit in Tables 1-4 is the independent accumulation of equity as the mortgage principal is amortized. But even if these assumptions are accurate, real estate equity exists only on paper unless either the property is sold or some other way is found to convert it into cash, and this is often used as an argument against condominium purchase; detractors can point out that the user-buyer's real estate equity would be useless in a cash squeeze.

Fortunately, investors in other types of real estate have already developed—at least in theory—several solutions to this problem:

Refinancing. The unit could be refinanced at the original, or a higher, value, generating tax-free proceeds approximating the sum of appreciation and amortization.

Swap. The unit might be traded for another without incurring tax liability. If the value of Unit A is greater than that of Unit B, the owner of Unit A could receive cash in addition, which would be treated as a capital gain for income tax purposes.

Sale-Leaseback. The owner-occupant of the unit might sell it to an investor and lease it back, thus generating immediate cash proceeds without relinquishing occupancy.

Liquidity limitations present another drawback to any real estate investment. Real estate cannot be sold as easily and quickly as stocks or bonds, and usually must be viewed as a long-term investment. In the case of the office condominium, detractors further argue that throughout most of the country little if any market currently exists for resales. Promoters counter this argument by claiming that growing acceptance of the condominium concept will create such markets, and that individual floors then will be far more liquid than other real estate equities, such as entire buildings or real estate partnership shares. Only time will tell which prognosis is accurate; in the meantime, absence of liquidity is a real

Figure 4
Internal Rate of Return
(12% hypothesis)

Year	Income	Expenses	Cash Flow	Present Value
1	\$35.00	\$13.00	\$22.00	\$19.84
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

risk confronting many prospective purchasers.

Of course, the greatest risks relate to value. The most conservative financial projection can be upset if the planned sale coincides with a real estate slump. Most investment projections presume some degree of appreciation, which can be wiped out by such factors as overbuilding, serious economic recession, or merely sustained disinflation of prices. Although real estate busts tend to eventually lead into booms, the opposite is also true. Those who purchase condominiums at the peak of a boom, when the properties 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 motivations for today's office condominium purchasers. For many user-buyers, the main advantage of ownership is space control: a guarantee of available facilities in which to conduct business virtually in perpetuity, without confronting lease renegotiation or forced relocation every five or ten years. In a tight market, this promise alone will justify condominium investment to those who have had their fill of unpleasant lease expirations.

The disadvantage corresponding to space control is decrease of space flexibility. A business that leases space in a multitenant office building is likely to expand or contract as needed 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, probably will be far more limited.

There is no reason, though, for condominium owners to sacrifice flexibility. If the building can attract a rental market, expansion and contraction can be controlled through the leasing of surplus space. For example, a user requiring 10,000 sq. ft.

might purchase 15,000 or 20,000 sq. ft. and lease the surplus to outside tenants for staggered terms. The owner can either renew the leases upon expiration or recapture the space for his own operations. If the owner's space requirements decrease, the premises can be divided further to create additional leasable space.

Another adjustment required of office condominium owners is the responsibility of management. Because there is no landlord to monitor the heating, cooling, repair, and maintenance of the building, this task falls to the condominium association, consisting of the property's multiple owners. Usually, these property owners know little about the complex technological systems involved in keeping a modern building running. Experience has shown that management is best handled by professionals, preferably an experienced management firm that reports to the association's board of directors. Most owners of residential condominiums have already learned that the management fee is more than justified by efficient expenditure of money and time.

Development and conversion

Developers face additional issues that must be resolved before office condominiums are fully accepted. For example, many potential developers have been discouraged by the time-consuming and expensive approval processes required for condominiums, particularly for conversions of existing structures.

Developers may also be reluctant to relinquish their equity. When money is tight, though, there often is little choice, because financing usually entails equity participation. Under these conditions, some developers would prefer to sell a portion of the projects to future occupants, rather than sacrifice a percentage of equity in order to obtain permanent financing.

Insurance companies and other sources of long-term financing who prefer equity to debt have not been

enthusiastic about providing developers with the end-loan commitments. This reluctance is partly due to general economic trends, but office condominiums present additional complexities in financing that exceed the scope of this article. It is sufficient to say that a shortage of financing is likely to impede office condominium movement for some time.

Meanwhile, some developers find only short-term money available, at high interest costs keyed to the current prime rate. In anticipation of condominium purchases, long-term financing sometimes can be provided by large corporations who can sell bonds at a lower rate. Developers and purchasers, as well as the traditional sources of funding, will have to exercise considerable creativity if office condominiums are to be financed, constructed, and marketed on a significant scale.

The market's future

Is the office condominium an idea whose time has come? No one can answer this question with confidence. However, the experimentation that has taken place so far identifies several conditions that must be met if office condominiums are to achieve widespread popularity.

- The commercial real estate market must maintain its current 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 advantages and disadvantages so that informed decisions are possible.
- Developers, brokers, consultants, and managers must develop their sophistication and expertise regarding the condominium concept.

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