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Office crash pushes tenants to buy, rather than rent

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Jones Lang LaSalle's brokers report that they are seeing more office tenants looking to buy real estate rather than lease to take advantage of commercial real estate crash that's meant declining prices and a flood of distressed properties.

We asked A Freeman, JLL's managing director of capital markets, to tell us more.

Grant Freeman, managing director of capital markets for Jones Lang LaSalle Photo courtesy of Jones Lang LaSalle 4/2/10

Q: Where is this trend taking root and how widespread is it in Orange County?

A: This acquisition trend can be seen in various markets throughout the U.S., with considerable activity in Orange County. Much of this has been driven by senior management and Boards of Directors for corporate and non-profit organizations having a heightened sense of awareness of the decline in commercial real estate values.

Given the current environment, we are proactively advising clients who have leases coming due in the next few years of the potential economic benefits of ownership versus leasing their facility.

Q: Can you give some examples?

A: Jones Lang LaSalle is currently working with several clients in Orange County and the Western U.S. that are either under Letter of Intent to purchase, or exploring alternatives ranging in value from $10 million to $40 million. This includes public and privately-held companies, and non-profits. Closings are expected to occur in the second half of 2010 and 2011.

Examples of Orange County transactions in 2009 include Abraxis Bioscience acquiring the former Valeant Headquarters building for an estimated $30.5 million; Chapman University acquiring the former CPS building in the Irvine Spectrum for an estimated $22 million; and Allergan purchasing a building that it previously leased for an estimated $22 million. None of these 2009 transactions appear to have been debtor controlled or deeply discounted, so they may not be good examples of the bigger trend to come.

Q: How are these tenants able to swing these deals, and what are the advantages of doing so?

A: Tenants are able to consider purchases if they have substantial liquidity or existing corporate credit facilities that allow for access to low cost capital. They have a significant advantage over investors that have high-equity return requirements and rely on debt, which is very challenging to obtain for properties with low occupancy.

From an economic standpoint, if the property is a headquarters location or core asset, the holding period will likely be a minimum of 15 years, which frequently leads to favorable results when compared to leasing.

However, a significant challenge is identifying an optimal sized facility for tenants looking to purchase, along with syncing up the timing with an upcoming lease expiration. Most corporate and non-profit entities do not want to take on significant leasing risk or function as a landlord so matching their size requirement with distressed opportunities requires patience and having a broker well tuned to the marketplace. Jones Lang LaSalle generally recommends starting the process 12 to 24 months in advance, depending on the size and nature of the requirement.

Anticipated changes in financial accounting rules for leases may also soon contribute to user acquisition activity, as operating lease treatment would be eliminated, thereby taking away certain balance sheet advantages of leasing. Such rules are expected to become effective in 2012 or 2013.

Q: What segments of the leasing market is this more prevalent locally? Retail, office, industrial, etc.?

A: This is more prevalent in the office market due to a marked decline in values (30% to 50%, depending on the market and circumstances), although many companies occupying industrial space are also evaluating purchasing for the same reasons addressed above.

Q: How is this impacting the market? Is this increasing the vacancies in the for-rent properties? Is it raising prices in the for-sale properties?

A: To date, there has not been a significant direct impact on vacancies, although as larger users acquire properties in the next few years, this will result in more large blocks of space becoming available.

Currently it is not raising prices for buildings being marketed for sale. Acquisitions in the next few years will generally be opportunistic in nature, although owner/users can typically justify paying more than an investor for distressed properties, due to eliminating or minimizing re-leasing risk.

Q: When the will market for commercial real estate hit bottom and how long until the market is in recovery? Which segments will revive the quickest, which will take the longest?

A: Over the next few years it will be important to segment commercial properties into different categories in order to fully understand the recovery, in addition to distinguishing between a recovery of transaction volume versus values. Transaction volume in Orange County averaged $2.5 billion in 2005-2006, peaked at $6.9 billion in 2007, and declined to $0.8 billion in 2009. In addition, the average sales price in Orange County declined from $285 per square foot in 2007 to $163 per square foot in 2009, a 43 percent decrease.

For investors seeking core assets, there will be a flight to quality, with stabilized, well-located assets trading more frequently by 2011. This activity will be facilitated by increased liquidity in the debt markets. Values will not reach the peak experienced in 2007 for several years due to lower rental rates and capitalization rates returning to more normal levels.

For properties that are distressed or debtor controlled, there will be considerable challenges and a "recovery" in values will not be noticeable until at least 2013. On average, approximately $370 billion of U.S. commercial loans will mature from 2010 – 2012, on top of $300 billion in 2009. However, we do expect greater transaction volume beginning in 2011 with many investors having geared up for such acquisitions and banks and special servicers being able to work through an already extensive backlog of properties to develop strategies for.