Green Street

Real Estate Alert

THE WEEKLY UPDATE ON THE INSTITUTIONAL MARKETPLACE

Office-Buyer Strategy Shifts Amid Pandemic

For high-yield office buyers, the popular play of renovating older properties and leasing them up at higher rents needs fine-tuning — and a lot more patience.

In the later years of the real estate bull market, strong leasing demand made it possible for investors to push up rents quickly and turn a profit on a newly renovated office building. But the coronavirus crisis has thrown a wrench into that strategy, raising questions about future occupancy levels and the ability to increase rates.

Now, buyers and owners must shift their sights and expectations. "Investors need to look at a longer time horizon," said **Eric Enloe,** a managing director and capital-markets lead in **JLL's** valuation and advisory practice. "You have to be realistic."

Given the likelihood of tempered rents and slower lease-up periods, buyers with value-added strategies no longer can count on a quick turnaround when it comes to stabilizing a property. Instead of an immediate revenue boost, they'll need to plan for longer hold periods, with the return coming later upon a sale or refinancing.

"Your implementation of the plan may be a little slower in the next 12 to 18 months, because the tenants don't know what they are going to do," said **Paul Gaines** of **Accesso Partners,** a commercial real estate firm in Hallandale Beach, Fla.

With the move to remote working, tenants are reassessing their need for space and, as leases expire, committing to shorter terms.

From July through September, 55% of leasing activity consisted of renewals, increasingly in three- to five-year terms, according to JLL. "Give backs" — tenants reducing space — contributed to a 28.9 million-square-foot decline in occupancy, which dropped to a nationwide average of 86%, while space available for sublease continued to grow.

As a result, firms such as **Morning Calm Management** are still

See STRATEGY on Page 2

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DECEMBER 2, 2020

2 Boston Development Site Teed Up
2 Fund Would Provide 'Rescue Capital'
2 Debt Tied to Brooklyn Project Shopped
4 Apex Sets High Mark for Ariz. Offices
4 Trammell JV Offers Denver Rentals
4 Student Housing Shopped in NC
6 Monday Properties Lands New Backer
8 BH Targeting Distressed Retail, Hotels
10 Recruiter Boosts Retained-Search Unit
12 Suburban Denver Apartments Listed
13 LA-Area Office/R&D Property Shown
15 Family Office Pitches LA Best Buy

THE GRAPEVINE

Quarters Co-Living has hired **James Grasso** to help expand its platform across North America. He started Oct. 26 as director of real estate in the Berlin firm's New York office. He reports to **Rui Barros,** who serves as co-chief executive with **Esther Bahne.** Quarters, which bills itself as the largest co-living operator, invests in properties by acquiring minority equity positions and executing master leases. Grasso previously worked at **PJT Partners, Origin Investments** and **Pearlmark Real Estate.**

Healthcare real estate veteran **Phil Mahler** is working with **Royal Oak Realty** of Rochester, N.Y., to scout medical-office deals. Mahler started last month in a consulting role with the nontraded REIT, which focuses on offices and industrial properties. He was previously chief

See GRAPEVINE on Back Page

Brookfield Nabs San Diego Apartment Tower

In what would be San Diego's second-largest apartment trade ever, **Brookfield** has agreed to buy a downtown high-rise for more than $300 million.

While the exact pricing for the 679-unit luxury complex couldn't be learned, market sources said it's north of $442,000/unit, in line with expectations when the listing came out in September. **Eastdil Secured** is brokering the trade, expected to close next month, for Chicago apartment REIT **Equity Residential.**

The 40-story property, known as Vantage Pointe, previously went on the block in late 2019 via **Berkadia.** The expectation then was that pricing would be around $400 million, which would have set a record for the San Diego multi-family market. It's unclear why the listing was pulled, but market pros say bids never approached that price.

Equity Residential currently holds the record for San Diego's largest apartment sale, according to **Real Estate Alert's** Deal Database. In 2013, it sold the 1,410-unit

See BROOKFIELD on Page 14

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See STRATEGY on Page 12

Large Supermarket Portfolio Hits the Block

A partnership has put a portfolio of a dozen supermarkets on the block, potentially setting the stage for the biggest retail trade of the year.

The package, encompassing 804,000 square feet, consists of 11 **Stop & Shop** stores in New England under 20-year leases and a **Giant** in Northern Virginia under a 15-year lease.

Bids are expected to hit $300 million. **JLL** has the listing for **Winstanley Enterprises** of Concord, Mass., and **Surrey Equities** of Eatontown, N.J. The duo prefers to sell the properties as a package rather than individually.

Stop & Shop and Giant have been at their locations for 30 years on average, and they signed new leases this year. The owners are touting the stability of those agreements, and the marketing campaign is pitching the properties as "pandemic, internet and recession-proof, essential retail."

Both supermarket chains are owned by **Ahold Delhaize USA,** the U.S. arm of the

See SUPERMARKET on Page 13

Strategy ... From Page 1

pursuing deals, but with an adjusted timeline. The Boca Raton, Fla., investment shop recently agreed to buy an office building in suburban Washington leased largely to biomedical and pharmaceutical-related firms with an eye toward upgrading amenities and, eventually, boosting rents. "We assumed zero new leasing done in the first year and very little lease-up during the investment period," said **Mukang Cho**, Morning Calm's founder and chief executive.

His firm and others are focusing on improvements that position properties to compete for a thinner pool of tenants when the pace of leasing picks up again. "We've got to do more to make less," Cho said. "The world is more competitive now than it was pre-Covid. . . . We are going to be fighting for the smaller universe of tenants that are going to be out there. But tenants' leases still expire, so there's always someone to pursue."

Investors also must spend more time and money on what they think tenants will need when they eventually return to the office. That includes new cleaning protocols, measures that enable social distancing, and upgrading ventilation systems to improve air quality.

Gaines of Accesso said his firm is prioritizing some upgrades over others to budget expenses while adding features that will make it "comfortable" for tenants to return. "It's not in our mind that this is going to be temporary," he said. "It is going to be with us for a while."

That's potentially costly for older, outdated buildings that were targeted by buyers for upgrades. Already, office properties were registering increases in capital expenditures that have been eating into net income. General maintenance expenses and leasing-related improvements grew from 4% of net income from 2010 through 2014, to 5.4% from 2015 through 2019, according to a report by **Green Street,** the parent of **Real Estate Alert.**

Add to that the expense of outfitting an older building to comply with pandemic-related safety protocols — and, in some locations, new environmental regulations that increase maintenance costs — and the deal may not pencil out for some buyers.

"The obsolescence risk for office buildings is increasing," said **Daniel Ismail,** senior analyst and office team lead at Green Street. Should occupancy and rents decline simultaneously, "you are going to have the inevitable universe of office buildings that are not worth the cost," he said.

Meanwhile, the ability to find favorable lending terms for value-added plays has diminished — even with today's historically low rates.

"It used to be that rollover in a [building's leases] was an opportunity — it was a chance for a landlord to capitalize on rent spikes. Now that attitude has completely shifted," said **Mark Godfrey,** a senior managing director overseeing the Northeast region for valuation and advisory services at **CBRE.** "Lenders are not looking at value-add leasing opportunities. . . . They do not want to participate in that rollover risk."

Buyers need to find a compelling story — such as a rent roll that turns over later rather than sooner — before making a purchase. "To make it financeable, you need income streams that bridge the gap through this Covid period of uncertainty . . . rental revenue that gets past the more challenging economic conditions," Godfrey said.

Overwhelmingly, market pros agree that for these types of deals to work today, a buyer will require a discount upfront — and keep the faith that an economic recovery will bring a pop in returns at the end. "You need to have conviction there's equal or more residual value upon an exit," said Cho of Morning Calm. ❖