REAL ESTATE | FEATURE

Bottom-Fishers Snap Up Office Buildings at Huge Discounts

By Bill Alpert Follow and Neal Templin Follow

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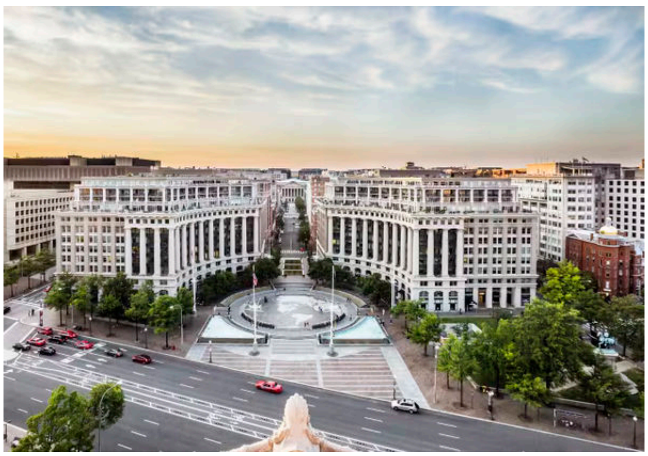


Market Square, the iconic 696,000-square-foot office complex on Pennsylvania Avenue in Washington, D.C. (DAVID MADISON PHOTOGRAPHY)

There's too much office space in every city, says Paul Dougherty. That didn't stop him from buying a pair of Washington, D.C., office buildings in March for $323 million. It's one of the largest office deals this year.

Burdened by a stack of debt, the sellers had written the Market Square office complex down to zero. But it sits on Pennsylvania Avenue between the White House and Capitol, so it is popular with lawyers and lobbyists. Paying half what the sellers paid a dozen years earlier, Dougherty's firm can now charge competitive rents.

"We can buy an amazing piece of real estate at 40% of replacement cost," says Dougherty. "It's a classic example of a great asset that had a bad capital stack but a good leasing story."

Dougherty and other bottom-fishers are betting that if they can snap up office buildings cheaply enough, it won't matter if the sector continues to decline. Because their purchase prices are so low, they say they will be able to charge cheaper rents than competitors and have the money to spiff up the spaces to lure clients.

Office properties are the sick men of America's ailing real estate industry. Remote work and high interest rates knocked half the height off shares of BXP ↓ BXP -1.54%, Vornado Realty Trust ↑ VNO 1.46%, and other office-oriented real estate investment trusts, compared with their pre-Covid skyline.

Investors, and indeed anyone who cares for our cities, scan forlornly for signs of a turnaround. And even buyers like Dougherty's D.C.-based PRP Real Estate Investment Management aren't betting on one soon.

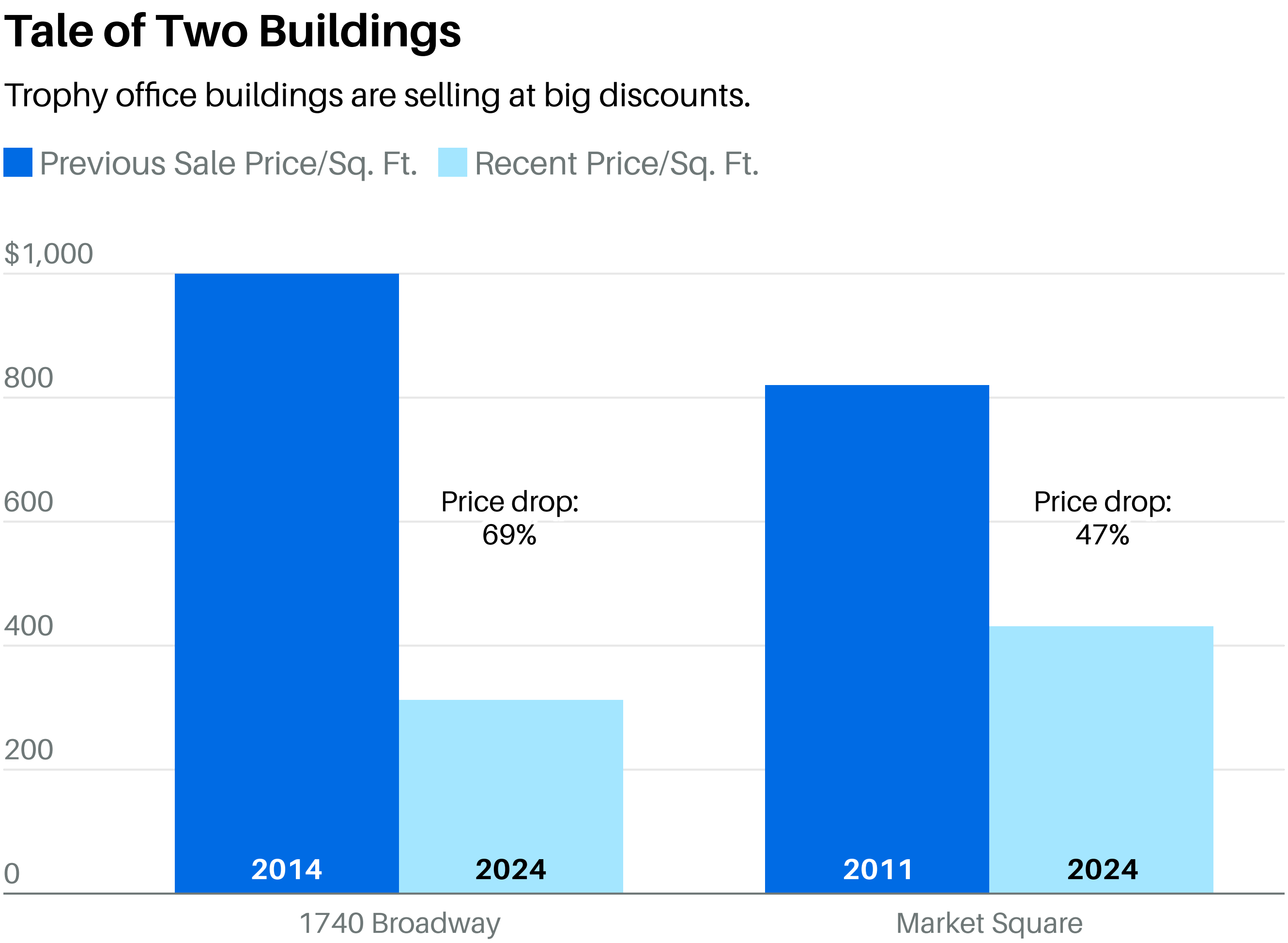
There just aren't a lot of buyers, Dougherty says. Banks won't lend. Insurers are on the sidelines.

Many of the sellers in this year's office deals are the kind of investors that traditionally provide the buying power in rising real estate markets—the "core" nontraded REITs that cater to wealthy and institutional investors. Those REITs now must raise money to satisfy investors demanding redemptions. Dougherty's firm bought Market Square from a joint venture of Blackstone and Pacific Investment Management's Columbia Property Trust, which had paid $615 million in 2011 for the 750,000-square-foot project.

In April, Isaac Hera's Yellowstone Real Estate Investments bought the

Deco-style tower at 1740 Broadway and 56th Street in Manhattan—once known as the MONY building—for $185 million.

Blackstone's EQ Office had paid $600 million in 2014 for the 75-year-old office tower. The Covid pandemic foiled Blackstone's plans to raise rents after renovating the building. In 2022, it defaulted on its $300 million loan.



Source: CoStar Group

"In today's market, sellers are selling their properties because they have to, rather than because they want to," Hera tells *Barron's*. "Some are facing redemption requests, others are dealing with regulatory issues, and some have concentration problems."

"This situation creates unique opportunities for us to acquire properties at prices that do not accurately reflect the correct risk/reward balance," he says.

Bottom-fishers follow a long tradition in every market. In the 1990s, they made hundreds of millions buying office buildings for a song after the savings-and-loan crisis punctured the property market. The new buyers were able to lease buildings at cheap rents, then sell them for big profits after building prices had rebounded.

But the current office building malaise stems from a secular, not a cyclical, downturn: The work-from-home revolution has lowered demand for office space—perhaps permanently. Many older office buildings will be converted to residential buildings. Some will be torn down before the crisis has passed.

Indeed, some real estate pros think it is too early to re-enter the office market despite the deep discounts. Andrew Segal of Boxer Property in Houston made his fortune buying older "Class B" buildings and renovating them for smaller tenants. He is staying on the sidelines for now.

"I still think it's early," Segal says. Suburban buildings could become interesting buys, but he says downtown districts are troubled by big homeless populations.

Others see it differently. Matthew Wideman is willing to bet on downtown Houston. He bought a 900,000-square-foot building complex there earlier this year at a deep discount; he declined to disclose the sales price.

Wideman thinks the Jones on Main office complex will be a moneymaker because he got it so cheap. His Orlando, Fla.–based Wideman Company is investing $50 to $100 a square foot to improve the office space so he can get higher rents and lease all the space. He plans to turn part of the office space into a luxury hotel, and will spend $400 to $500 a square foot to do that.

Like many of this year's buyers, Wideman believes that his basis in the properties is low enough that he will thrive, even if office prices keep declining for several years. "There will be 30% less office demand in the next five years than from the beginning of the pandemic," says Wideman.

Wideman says his group bought the buildings with all cash and no debt and has no plans to sell them in the future. "We have no exit strategy," he says. "We want to own real estate we can own for generations. Our view is to buy high-quality assets cyclically, like we're doing right now, and position ourselves for the long term."

Dougherty's purchase of Market Square and Hera's of 1740 Broadway were among the top 10 office sales in 2024, a year that hasn't seen many large deals, according to the real estate data firm CoStar Group. Several of the largest buys were made by organizations for their own use as headquarters, such as the $560 million purchase of a Manhattan building by Michael Bloomberg's charitable foundation or the $340 million purchase of an Arlington, Va., tower by CoStar Group itself.

The year's biggest deal has been the $635 million purchase of the 17-story office building at Manhattan's 625 Madison Ave. and 58th Street by the privately held Related Companies—known for its trophy properties in Manhattan's Hudson Yards. Related is planning to tear down the 68-year-old office building to put up a condo and hotel tower.

The seller is a publicly traded office REIT, SL Green Realty. Its stock has become a battleground for investors with opposing views on New York office property. While still 30% below its pre-Covid height, SL Green has doubled in the past 12 months. Yet skeptics have sold short some 25% of the REIT's free-trading shares. SL Green has been selling properties to ease its debt load.

Is there a way for the average retail investor to place bets on the office sector rebounding? While it's hard for average Joes to participate in the purchase of a building, they can easily buy the REITs that own office towers.

Analyst Dylan Burzinski of Green Street Advisors says the best office markets right now are in the Sunbelt and in New York City. Most of the markets in the West look soft because of overbuilding and rapid run-ups in prices. Burzinski has Buys on Cousins Properties ↓ CUZ -1.42% and Piedmont Office Realty Trust. Both REITs have properties in the South that are performing well.

Green Street has a Hold on BPX, the big owner of office buildings in the Northeast that used to be known as Boston Properties. Burzinski considers BPX a well-run company. But it owns buildings in some weak California markets and will be hurt by its big development pipeline.

Analyst Steve Sakwa of Evercore also considers Cousins a Buy, and he is more optimistic about BPX. Every REIT has blemishes, Sakwa says, and BPX has most of its buildings in the right markets. He sees BPX stock posting a 21% total return over the next year, after including its 6% dividend yield.

Sakwa also likes COPT Defense Properties, a REIT that specializes in leasing space to government agencies. He sees its stock posting a 20% total return over the next year, including a 4% dividend yield.

As for SL Green, Sakwa has a Sell on the stock.

Nontraded REITs are also selling what buildings they can, says Paul Dougherty, to raise cash and meet investor redemptions while sweating out the downturn with the less-attractive buildings they can't sell. "They've got to try to raise capital, come hell or high water, to satisfy investors and shorten these redemption queues," he says.

That presented him with a rare opportunity. The Market Square campus is one of just eight office addresses between the White House and the Capitol on Pennsylvania Avenue. It is across the street from the Department of Justice and the Federal Trade Commission. The rent rolls are filled with law firms and the government-affairs offices of Fortune 500 companies.

With that good location, good buildings, and a good leasing story, Dougherty lined up financing to buy the office complex at 40% of replacement value. “It’s really hard to find deals like that, that check all these boxes,” he says. “It’s a very, very, hard high-wire act.”

The scarcity of buyers with dry powder has been an opportunity for Yellowstone’s Isaac Hera. He typically pays all cash for properties.

“Often, the seller of the distressed position is a lender who doesn’t want to hold the asset or an owner who lacks the means to cover expenses,” Hera says. “The ability of a buyer to close quickly with all cash, and the certainty of execution that comes with it, is as important to the distressed seller as the price.”

After decades in New York’s real estate market, Hera launched the Yellowstone private-equity fund four years ago. Backed by deep-pocketed institutions, Yellowstone has been able to move quickly in the post-Covid turmoil—snapping up a number of Manhattan hotels that can be fixed up for the condo market.

Hera’s firm got the 1740 Broadway office tower at such a low price that he is confident it will make money, even if office prices continue to drop. Zoning also permits residential or hotel use. The building’s structure will allow the creation of a courtyard and the widening of its wedding-cake top. “We assessed the deal as an office play, while simultaneously considering the potential for conversion to a different use,” says Hera.

Yellowstone has such a low basis in its properties that it is indifferent to the market's moves. "We do not attempt to time the market," Hera says.

Write to Bill Alpert at william.alpert@barrons.com and Neal Templin at neal.templin@barrons.com