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At a Time Many Seek Bargains, Some Office Buyers Are Willing To Pay More

CoStar Analysis Finds One-Third of Purchases Exceeded Replacement Cost

Hines Global Income Trust acquired 1015 Half St. SE in Washington, D.C., for $215.7 million, an amount estimated to be more than its construction cost in today's market. (CoStar)

By Mark Heschmeyer
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When Hines Global Income Trust paid $215.7 million in May for a 396,344-square-foot, 10-story office building near Nationals Park and the Anacostia River in Washington, D.C., it marked a vote of confidence from a firm that hadn't bought an office property in five years. The move also exemplified a risky strategy that nearly one-third of a select group of office building investors are taking in 2021, according to a CoStar analysis.

Hines was willing to pay about 5% more for the 97% leased building than it would cost to build it new, CoStar research shows. When existing buildings trade above replacement cost, that tends to create an opening for other investors to launch new developments. Those properties can then compete more effectively for tenants by offering slightly cheaper rents.

But not always. In today's market, the advantages of building new can be negated by rapidly rising construction costs, the uncertainty of office space demand coming out of the pandemic, and the reluctance on the part of lenders to finance new projects.

"If I'm buying an older existing product, I would generally like to buy it at or below today's replacement value, because I don't want a new product to be able to offer the same rent as me," Alan Pontius, senior vice president and head of real estate firm Marcus & Millichap's office and industrial division, told CoStar News in an interview.

"That said, the reason I might be willing to pay above replacement value in San Francisco or Seattle or Boston is because of the complications, the hurdles and the inflation of construction. It's not that easy to build in those areas. So, what I'm banking on is a calculation against construction/replacement today that by the time [a new] building is coming out, the hurdles are three years down the road, best case." In Boston, he referred to cases where investment in life sciences buildings is "exploding."

Roughly one-third of office buyers, largely big institutional players, paid on average 1.55 times more than the construction replacement cost, according to a CoStar analysis. Nearly two-thirds of buyers in deals examined by CoStar paid prices well below construction replacement costs. They paid on average a 32% discount to the minimum of what it would cost to construct the same building in the same market.

In looking at sale prices versus construction replacement costs, CoStar reviewed individual Class A and Class B office building sales this year of $8 million or more in 20 central business districts and urban locations across the country. Prices were compared to estimated construction costs in those areas provided by Cumming, an international construction project management and consultancy firm.

Office buildings that sold above replacement construction cost tended to be larger and more expensive, according to the analysis, averaging about 191,800 square feet and selling for $845 per square foot. In many cases, the buildings were occupied by investment-grade tenants under long-term leases.

Properties in the group that sold below construction costs averaged about 113,400 square feet and commanded an average of $370 per square foot. Many had high vacancies.

“Looking through the data, it’s interesting to see that the locations that were hit by the stop/start nature of the market — Boston, New York City, Philadelphia — saw figures below the construction cost,” Daniel Pomfrett, national director of forecasting and analytics at Cumming, said in an email to CoStar News. “Los Angeles saw some [sales above construction costs], which is not unexpected as that is currently a hot market that is bouncing back quicker than many other locations on the West Coast. The East Coast seems to have taken the brunt of the cost differences.”

The rising cost of labor and timing of when new projects come to the market will be key to whether the strategy of paying above construction costs provides the best value for the money, according to Pomfrett.

“Construction costs are going to continue to rise, so consideration should also be given to renovations as well as new builds, as often we see properties sold and then a rebranding/upgrade occurring,” Pomfrett said.

Capital Comes Back

On the construction financing side, Brian Ward, CEO of Atlanta-based Trimont Real Estate Advisors, described a positive, but mixed, rebound this year depending on asset type.

“Surprisingly, we are back,” Ward said. “Levels of construction capital flowing into the market are really, really strong.”

But most of the money is going toward multifamily, he said.

“I don’t see [capital flowing to the office sector] because of the macro forces at play,” Ward said. “I think people are going to watch and wait and see how the post-COVID economy employee usage and occupancy per square foot come along. And I don’t see [lenders] will begin to go big in that sector again for a little while.”

In addition, Ward said the “upward pressure on replacement costs will tend to obviously pressure upward [sale] prices. And that increase in replacement costs is just going to continue to help bolster that thesis of those who have invested in existing properties.”

Another factor weighing on investors’ decisions to buy or build is land values beneath potential construction sites, especially as the overall demand for office space remains relatively depressed, according to Marcus & Millichap’s Pontius.

“I don’t think there’s an appetite right now for too much new construction," Pontius said. "Most of the money is quiet, at least from the development standpoint, because the idea of putting up a speculative office development today just doesn’t make sense to anybody.”

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