A Tale of Two Markets

The Crown Jewel of International Commercial Real Estate Markets

The downtown Washington DC commercial real estate market has been viewed for a number years as one of the strongest markets in the United States. Today, many consider it the top market world-wide for institutional real estate investors. While other cities have crashed and burned (for example, Phoenix, with a vacancy rate approaching 25% and a projected decline in Class A office values of close to 50%), the downtown DC office market has shown great resiliency.

In DC, we have seen a substantial decline in the number of sales, a modest increase in vacancy rates, and an assumed 150 basis points change in cap rates with knowledgeable brokers quoting rates of 6-1/2% to 7% for trophy properties and slightly higher rates for other Class A buildings. However, the DC market is one of concentric circles, with the close in suburbs such as Arlington and Bethesda holding values close to those of downtown DC, but with significantly wider spreads in cap rates in areas further out such as Tysons Corner and Silver Spring. And, there are dozens of empty office buildings along the Dulles Toll Road corridor and similar problems in the bio-tech area along I-270 in Montgomery County, with only guesses as to the value of these buildings.

A Snapshot of the DC Real Estate Market Over the Last Twenty Years

Recently, the trend of office building values in DC has been an unbroken upward spiral. That was not always the case.

In late March 1989, our firm closed the sale of 1200 New Hampshire Avenue. This 265,000 square foot office building sold for the equivalent of $85.2 million pursuant to a complicated lease transaction that was intended to result in the move of Arnold & Porter's headquarters to the to be developed Investment Building. At the time, the sale of 1200 New Hampshire to Square 70 Associates was at the highest price per square foot ever paid for an office building in DC. This sale was followed by a significant real estate recession that seized up the lending markets and resulted in plummeting prices. Our contemplated move to the Investment Building never occurred because the project could not be financed and instead, the firm moved to the East End.

The valuation curve then was similar to what we are seeing today: modest decreases in values of downtown DC real estate (compared to other CBD markets) and significantly higher decreases as you moved further out in the suburbs. It took years for the market, even in downtown DC, to spring back. An April 11, 1994 article in the Washington Post had this headline, entitled "For a Change, D.C. Office Building Sale Brings Profit to Seller," stating that "a recent downtown sale provides the most tangible sign yet that the market has turned around." It described the sale of 1201 Connecticut Avenue to Equitable Real Estate for $31.25 million by a group of Italian families which bought the building in March 1992 for $28.2 million. Joyous news brought about by a 12% profit over 2 years. If such performance was projected by an investment broker a decade later, his or her phone calls and emails would not have been returned by potential buyers.

The sale history of 1200 New Hampshire Avenue provides some anecdotal evidence of the market over the past two decades. Square 70 Associates held the building through the real estate trough and finally sold the building in October 1999 for $81.3 million -- ten years later and at a $4 million loss. The new buyer, 1200 NH Washington DC Prop LP held the asset for eight years and in late October 2007 sold 1200 for almost $165 million.

How Overheated was the DC Market?

A handful of other sales demonstrate the upward spiral of values. In 2004, the Gallup Building at 901 F Street, sold for $56 million, or $493 per square foot. At that time, the record sales price was set by the Acacia Building at 51 Louisiana Ave. But that 204,000 square foot building, which sold for $600 per square foot, also included rights to double the size of the building.

Prices continued to spike upward when at the end of 2006, Tishman Speyer paid $2.8 billion for 16 buildings, with the assets on Pennsylvania Avenue fetching prices in the range of $650 per square foot. During this period, trophy buildings brought in even substantially higher prices. In that year, 1801 Pennsylvania Avenue was sold for $826 per square foot and at the tail end of the spiral, 2099 Pennsylvania Avenue sold in 2008 for $867 per square foot.

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In the last two years, the lack of financing, particularly in the CMBS arena, has substantially reduced the velocity of sales. Previously, a red hot and in retrospect overheated market produced high water mark sales starting in 2005 and continuing unabated through 2007. Many experts fear that forced sales of those vintage properties may occur at prices substantially below their initial purchase prices.

A simple example highlights this issue. A property bought for $100M, with $80M in financing (based on a 5% cap rate and a $5 million net operating income) would be worth $64.3 million, if cap rates have increased to 7% and there has been a 10% decline in net operating income. Although this is a reasonable set of assumptions for DC's downtown and East End, it would result in a complete loss of the initial $20 million equity and a $15.7 million shortfall to the lender if sold today. Fortunately, for the owner and the lender of these types of assets, many buildings continue to throw off sufficient cash flow to pay debt service, although clearly violating loan to value and debt service coverage ratio covenants. These 2005 to 2007 vintage problems are tomorrow's issues and there are at least two views as to what tomorrow will bring.

Where is the DC Market Headed?

As real estate brokers, lawyers, and owner/developers hone their golf and tennis games they also have begun to philosophize on the market. Optimistically, the view is that the worst is over. The more pessimistic view is that the other shoe has yet to drop. As Dylan says, "Time will tell who has fell and who has been left behind as you go your way and I go mine."

The Good News -- 1999 K Street

On September 1st, Vornado/Charles E. Smith stunned the local real estate industry with the announcement of its sale of 1999 K Street for a near-record setting price. In an industry starved for good news, Vornado delivered.

In fact, this was the second time that 1999 K Street surprised our market with good news. Two years ago, Vornado announced the signing of a lease with Mayer Brown LLP for substantially all of the 250,000 square feet of office space in the building - after a lease negotiation conducted, start to finish, over a mere 17 days. A lease negotiated for Vornado by my partner, Jennifer Perkins.

This time around, Vornado announced the sale of the building to Deka, the German open-end fund sponsor. The price was $208 million, all cash, - some $830 per square foot. This price was second only to that achieved by another Vornado success story, the sale of 2099 Pennsylvania Avenue last year for $867 per square to another European buyer. The pricing of 1999 K Street implied a cap rate of about 6.3%, substantially below the rate generally assumed by market experts.

Is the sale of 1999 K Street a harbinger of better times to come this fall?

The Glass is Half Full

Mitchell Schear, President of Vornado/Charles E. Smith, received many email reactions to the sale of 1999 K Street, including a pithy: "Hope returns." Why is there hope?

- Many economists believe that we are nearing the end of the recession.
- The DC market will continue to thrive because of the huge appetite for space of the federal government.
- New government spending will reverse unemployment and there will be positive job growth in DC.
- Alternate lending sources and new lending models will emerge.
- Foreign capital is looking for a home and is poised to help fill the void left by the withdrawal of domestic lenders and buyers.
- There is no significant pressure on lenders to force sales of currently distressed assets. Judicious extensions of maturity dates and minor tinkering of loan terms and interest rates will allow debt service to be met on a current basis.

All of these positive forces will lead prices to spring back quickly to the prior high water marks.

The Bad News -- 555 11th Street, NW

On April 1, 2005, the Ruben Capital Management sold this building, known as Lincoln Square, at a record setting price of $668 per square foot. The total consideration was approximately $265 million. The buyer, an individual real estate investor and developer, subsequently put in place a first mortgage of $285 million from Citibank. The A piece of $220 million was securitized and the B note had a face amount of $65 million was not. Similarly to 1999 K, Lincoln Square has as a lead tenant a major international law firm and a host of other creditworthy tenants.

Recently and very quietly, the B note was privately marketed for sale. It is our understanding that the B note was sold for approximately $26 million, representing a discount of sixty percent.

The Glass is Half Empty.

Is this bad news? Yes, for the B noteholder, but today, not for the owner who apparently pulled his equity out, continues to hold the property and service timely its debt. However, a strong argument can be made that the Lincoln Square restructuring is more indicative of the serious issues confronting other owners in what appears to be a relatively healthy DC office building market. The biggest tipping point for these owners may be buildings that face vacancy issues. In those instances, where current valuations show equity underwater, will the owner be willing or able to fund tenant improvement costs, brokerage commissions, free rent, and other lease-up costs which might total more than $100 per square foot? Other indications of a glass half empty include:

- Many 2005 to 2007 vintage acquisitions used financing structures similar to that employed at Lincoln Square. Although the financing for this asset unraveled earlier than other situations, it is likely that other similar assets will need to be restructured due to resets of debt service levels when interest only loans convert to amortizing loans, possible spikes in LIBOR based interest rates if inflation kicks in, and maturity of these loans.
- Cash buyers like Deka are rare and cannot fuel an increase in the velocity of DC transactions. Today and in the foreseeable future, there will be no CMBS money and life company and financial institutional money will be at very low loan to value.
- Many experts believe that the cap rate two or three years ago on 1999 K Street would have been 5% or lower. Thus, "hope" comes with a price tag. If sold at a 5% cap rate, the price of 1999 K would have been some 20% higher than its $208 million sales price.
- The extraordinarily low cap rates and high values were a function of creative and aggressive financing vehicles that will not be replicated in the next 10 years as lenders retrench and cautious underwriting becomes the norm again.
- Increased vacancy rates will reduce net operating income and values, and the resulting tenant friendly leasing market will further depress values.
- The federal government as the largest user of space is already using its strong bargaining power and using sophisticated outside brokers to drive very favorable deals as a tenant, which will further depress values.
- Part of the market was fueled by section 1031 exchanges through TIC and other vehicles and this like kind exchange market is gone for the foreseeable future.
- Bank failures continue to mount -- at last count there have been 84 so far this year. Capmark may be on the verge of a bankruptcy filing. Those failures may lead to more aggressive efforts to realize value currently on problem loans.
- The past is a prologue to the future. It took ten years for values to recover in the late 1980s and early 1990s and there is no reason to assume a better outlook in today's world.

Stay Tuned

Based on the more pessimistic view of the market, my colleague, Amy Rifkind, and I will provide our perspective in the next issue of Pipeline on the playing field for the significant number of real estate workouts and restructurings and purchases and sales of distressed assets, which we expect to see in the DC market over the next two years.

George E. Covucci is senior partner at the law firm of Arnold & Porter LLP, practicing in the areas of real estate, real estate workouts, bankruptcy and tax. He and Gretchen Dudney are co-chairs of the DCBIA Subcommittee on Distressed Assets, Workouts and Restructurings and are coordinating a series of breakfast programs for DCBIA members. George's practice currently focuses on real estate workouts and restructurings and the purchase and sale of distressed loans and real estate. He has led a number of seminars on these subjects and wishes to thank his colleagues, Michael D. Goodwin, Amy Rifkind and Eileen Ferrara for their assistance in the preparation of this article. ▲