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Building investments

A thriving economy and lack of available space has fueled a wave of building purchases in Austin

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Nearly two dozen Austin office properties measuring more than 30,000 square feet each changed hands in 1997, and the count continues into 1998 with the recent sales of the 1 million-square-foot Austin Center downtown and the 300,000-square-foot Cielo Center in West Austin.

Full buildings pulling in premium rent have garnered some of the highest purchase prices in a decade, thanks to the ready coffers of stockholder or policy holder cash wielded by Real Estate Investment Trusts, insurance companies, pension funds and other institutional investors.

But how long will the wave of purchases continue? What will investors buy after the few remaining trophy properties are taken, and what will become of the real estate entrepreneur unable to beat the cheap cost of capital enjoyed by the institutions competing for the same properties?

A national trend

Real estate players say a strong economy and lack of available space is fueling intense buying and selling of real estate across the nation. Businesses growing under a strong economy demand more space, and that demand leads to higher rent and greater revenue for property owners. Owners following the principal of "buy low and sell high" try to sell when their properties are at their most valuable point, when occupancy and rent are at or near their maximum potential.

Added to that longstanding model is the relatively new addition of the real estate investment trusts, or REITs, that have great sums of Wall Street capital that must either be placed within a certain time frame or returned to stockholders. Reits have provided an eager market for many sellers seeking to cash in their real estate.

Investment brokers say Austin is probably enjoying more than its share of the fun because a growing number of national investors want footholds in the market, where high tech and a mix of other industries combine with a relatively affluent and educated populace to support an economy with long-term promise of growth.

And a good investment for office and retail properties.

Frank Niendorff, president of Commercial Industrial Properties Inc., says some institutional investors lower their size requirements when buying in Austin, although they are not likely to lower their requirements for a return on investment.

"In major market areas, REITs tend to limit purchases to a minimum of $5 million to $10 million," Niendorff says. But when a REIT or other institution decides to buy into a secondary market like Austin, it has fewer institutional-grade properties to choose from, and may take a smaller property than it would accept in a primary market like Houston or Dallas.

Niendorff says competition is pushing institutional investors to smaller markets.

"They can't find enough product to satisfy their appetite," he says. An investment group that contacted Niendorff earlier this year, for example, must place $200 million in anchored retail centers this year. He says he also is seeing more institutional money from foreign investors making its way into Texas real estate.

The national economy will continue to fuel investment by institutions, Niendorff says, because stock holders will keep buying shares in successful institutions and those entities must in turn place their shareholders capital in properties that generate a return.

He says the current cycle should last another two to three years, because it will take at least those two years for the supply of new space to catch up with demand. So long as there is a substantial gap between supply and demand, rents will keep climbing and the investment pattern will continue.

Greg Blackburn, a retail specialist at CB Commercial, sees a similar continuation in retail space investments, fueled by demands for space and rising rent.

Rental rates increased an average of 6 percent over the course of 1997, with a 30 percent climb in rates for space at regional retail centers. The rates for anchor tenants in new shopping centers jumped 28 percent, and non-anchor rates climbed 22 percent.

"Austin is growing faster than development," Blackburn says, and that should bring rates up an average of another 6 percent.

Blackburn says the owner of an attractive property may find investors calling even if the property is not designated for sale, and the offer may be too good to pass up. Further, he says some institutional investors may seek to acquire existing properties just because development in Austin requires too much time to suit their needs.

"We've not seen a REIT come into this town and buy some land and build a shopping center yet," Blackburn says. "They're more interested in something that's up and running. They need to place that money."

How long will it last?

Opinions vary on when this latest round of buying and selling will taper off, but Jerry Lumsden, senior vice president of CB Commercial, says most of the trophy properties -- the principal target of national REITs -- will be out of circulation for several years following recent ownership changes. That's because institutional investors, unlike entrepreneurs, make most of their money from shareholder investments rather than building sales. Now that Bridgepoint Square, Cielo Center, Austin Center and other premier addresses have sold to institutions, those investors are likely to hold their acquisitions for seven to 10 years before they are ready to resale.

"So there's a question of how much meat is left on the bone," Lumsden says.

In the early 1990s, buildings sold for as little as 30 percent of production costs and ratcheting rents yielded great returns, Lumsden says. Investors face a narrower potential for value enhancement by 1999, as sales prices that are nearing the cost of new construction yield narrower margins of return by 1999.

"It is still a good market as we speak, and the activity reflects that," Lumsden says. "But when we look beyond 1998 into '99 and the year 2000, the value may not be there, because we've reached a point that the value is at its apex."

Opportunities

Even if most of Austin's large properties go to institutional investors, real estate watchers say small properties will remain the domain of individuals and non-institutional investors for some time. And market events could trigger unexpected sales by institutional property holders.

To remain profitable, a REIT must maintain and increase its Funds From Operations, or FFO, says Laura Beuerlein, senior vice president of Heritage Title Co. of Austin. Without a good FFO to keep stockholders happy, a REIT won't be able to attract new investors to buy its stock.

"You really have to look at REITs like any other public company, like a security investment," she says.

That could mean that a catastrophe on Wall Street will drag real estate down with it, she says. If that happens, REITs may sell off property to raise capital, opening a window for others to step in and buy.

Laws restrict the amount of property institutional investors can sell in a year to about a tenth of their portfolio, Beuerlein says, but that changes if property acquired doesn't fit the criteria established for that REIT's portfolio. An institution acquiring inappropriate holdings through a merger, for example, may quickly sell off the incongruous parcels and reinvest the proceeds in its specialty properties.

Tom Stacy, president of T. Stacy and Associates and a partner in the ownership of several Class B office buildings downtown, is preparing for what he says will be the next wave of office building purchases. Reits unable to find more Class A buildings to buy and improve values with rate hikes will turn to Class B buildings downtown, which now offer rates considerably less than A properties, particularly downtown, and leave plenty of room for enhancing value.

Class B rents will rise nearer to, but still below, Class A rates and tenants leaving the pricey Class A buildings will increase demand for B space, Stacy says.

"That's the opportunity for REITs," he says. "We'll see a wave of REITs that are not household names buying in Downtown Austin, probably all over Austin.

"It's hard to find opportunities we can buy that have the entrepreneurial returns that we've been able to do in the past," Stacy says. "That's the challenge that I have, trying to find deals that are undervalued, underutilized, like the Scarbrough Building, the Perry Brooks Building, that take a lot of imagination and a lot of risk. The REITs can't afford to take the kind of risk to bring the Perry Brooks Building back to the market place, whereas if we're successful in bringing it back, there will be a lot of interest from REITs or larger institutional owners that are willing to take less return but less risk than an entrepreneur will."

Beuerlein believes the next century will bring opportunities for local developers to take similar risks in putting new property on the ground for REITs unable to find appropriate properties. She says the phenomenon is already beginning to happen, citing as an example Sam Zell's Equity Residential partnering with Lincoln Property Co. to develop apartments.

"It's still a relationship business," she says, and REITs interested in development will turn to those who are here and know the market.