SEPTEMBER 2024

To Buy or Not To Buy: That Is the Question

Is This Special Real Estate Opportunity Enough to Encourage Buyers?

"[B]e greedy only when others are fearful."
– Warren Buffet

Warren Buffett uttered these words decades ago.

After a prolonged cycle of low interest rates and record-high real estate valuations, the markets seem to be settling — except for office.

Fear is certainly present, as news and media outlets have repeatedly highlighted the current state of distress within the office market. The pandemic proved that many roles can be successfully performed at home, leading tenants to cancel leases or drastically reduce their office space footprint. This shift caused vacancies to reach an all-time record of 19.6% across all major U.S. cities during the fourth quarter of 2023.[1]

A small, select group of users (mostly health and hospital systems, municipalities, educational institutions, nonprofits and forward-thinking corporate leaders) are capitalizing on an opportunity caused by these vacancies.

"Be Greedy" – The Attributes of a Wise Occupier

The team at FTI Consulting believes the current real estate environment is favorable for certain occupiers of real estate to contemplate purchasing their office space instead of leasing. This potential opportunity is being created by drastically low real estate prices, higher inventory availability and lack of competition from investors. However, it may not be the best decision — or return on equity — for every occupier of office space.

The ideal organization to take advantage of the current market is either an institutional entity (e.g., public transit authority, public university, or healthcare provider) or a traditional commercial business with available capital and operating circumstances that deprioritize using cash reserves to expand business operations or pay dividends to shareholders. Both examples of occupiers should have a strategic need to remain in specific locations for the long term, since some real estate professionals are predicting office valuations in some asset classes and/or markets may not return to 2019 highs for another decade.[2]

Case Study #1: Prada Purchases 724 Fifth Avenue

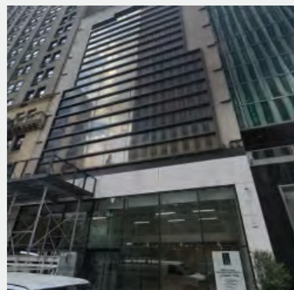
Prada recently purchased its flagship store and a 12-story office building for $425 million[3] in an all-cash transaction. The company had leased the space since 1997.

While rents along the Fifth Avenue retail corridor are still down from their pre-pandemic highs, they remain the highest of any retail corridor in the world. As Prada's flagship store in the heart of Manhattan's Midtown, the location is of strategic importance to the retailer. Additionally, based on New York's history of resiliency in the face of devastating impacts from the 9/11 terrorist attacks, Super Storm Sandy, the 2008 financial crisis and, most recently, the pandemic, the retailer likely sees long-term opportunity in the 11 floors of office space above the prime retail store front. Because of these factors, investing the cash on hand to acquire or expand retail and/or office space anywhere else in the world may not have had the same favorable outlook or returns on equity.

"When Others Are Fearful" — Convincing the Naysayers

Case Study #2: Avi & Co. Buys Former Playboy Club

Avi Hiaeve, the founder and CEO of luxury jeweler Avi & Co., acquired 5 East 59th Street at a foreclosure auction. Hiaeve paid $26.7 million for the nine-story, 57K sq.ft. building.[4]



The building's previous owners, BentallGreenOak and Capstone Equities, purchased 5 East 59th in 2015 with plans to clear the building of tenants and reposition it for a full-building user. This plan ultimately didn't work out for the investors, possibly because of the steep decline in demand for office space, and they fell behind on a trio of loans from United Overseas Bank. BGO and Capstone were notified of foreclosure in 2021, and the property was auctioned in January 2024.

BGO and Capstone paid $85 million for the building in 2015. **Avi & Co.'s purchase price of $26.7 million (at auction) represents a 68% decline in value in nine years.**

To move forward with a real estate transaction such as those highlighted, corporate executives should have a compelling business case to invest substantial capital into relatively illiquid assets during the current environment of high interest rates and increased cost of capital. One way to mitigate risk and increase the probability of a net positive return is to invest in class A and B assets, as they have shown more resiliency and value insulation during recessions and often recover value faster than their class C and unrated property counterparts. Prada's acquisition of 724 Fifth Avenue is a perfect example of a class A asset with factors that give it resiliency, including its prime location along Fifth Avenue and Prada's strategic decision to maintain a long-term presence as a flagship store in a global cultural, financial and tourist hub.

Another option is to either purchase an interest of the building's ownership or invest in a partnership with the current landlord or management company. This option would likely limit upside and operational control, but would provide an opportunity for financial returns at a heavily reduced buy-in. Companies doing this should understand that a potential partner may have a conflict of interest. Partners can try to maximize profits, which may not align with the business's best interests (e.g., lower cost and quality service providers throughout the building).

Tax implications can also significantly impact the business case, depending on the specific facts and circumstances. For example, a lessee of real property can deduct lease payments, which may include property operating expenses depending on the lease terms, with no direct limitations on the amount of deductible lease expenses. Alternatively, an owner of real property can deduct various expenses, including depreciation, interest (if the property is in part financed) and property

operating expenses. In general, more direct and indirect expense limitation provisions may be applicable in property ownership. Regardless, the timing of such tax deductions may be more favorable as a result of depreciation expense in particular. While land may not be depreciated, a portion of the acquisition price of certain real estate (including components and improvements) may be eligible for accelerated depreciation and/or immediate expensing as a result of the passage of the Tax Cuts and Jobs Act (TCJA) in 2017.[5]

The Skills and Expertise To Execute

Owning real estate often requires a different set of knowledge and capabilities to manage and operate than those of the lessee's personnel. This can be achieved by augmenting the capabilities of in-house employees on payroll or by outsourcing to third-party, contracted resources. These capabilities include day-to-day maintenance of the physical buildings, providing services to occupants, as well as handling property accounting, tax and insurance – which presents different challenges and requirements for a real estate owner compared to a leased space occupier. Keeping that in mind, companies that already own and manage some assets in their real estate portfolio today are better positioned to take advantage of the current market conditions and add to their portfolios, as opposed to companies that have only leased assets to date.

Also, due to the significant differences in both the amount and the timing of tax deductions associated with leasing versus owning real property, occupiers should have — or consult with — a tax expert who can model the consequences under each scenario to compare the results, which may not be intuitive, before making any decisions. For occupiers of space in need of enhanced deductions to offset other sources of taxable income, switching to ownership may very well lead to a materially larger tax benefit from a net present value perspective. Also, the ownership of real property can dramatically alter the effective tax rate of the overall company, depending on how it is organized. This is because depreciation deductions and losses may be taxed at ordinary rates, while gains from sale of real property may be taxed at lower capital gains rates. State and local income tax laws may also vary from federal law; therefore, additional expertise and guidance will be needed based on the circumstances of the transaction. Finally, there may be other tax implications associated with acquiring real property in the form of transfer taxes, property taxes and mortgage recording taxes, to name a few.

Taking the First Steps

All these items — strategic importance, financial business case, taxation, and skillsets to manage — must be evaluated on a case-by-case basis and weighed alongside the general business and economic considerations. For the right company, i.e., a large occupier with available capital and a strategic, long-term target location, the tumultuous office real estate market represents a golden opportunity, especially for class A/B assets in urban locations in tier-one or -two cities. Purchasing long-term office space now, instead of renting, could be the first step in a series of strategic transactions that would ultimately improve the operational efficiency and financial performance of the business.

FTI Consulting strongly encourages those with operational real estate teams and capabilities to consider purchasing their long-term, strategic office spaces instead of leasing to take advantage of a drop in office valuations and save on occupancy costs in the future.

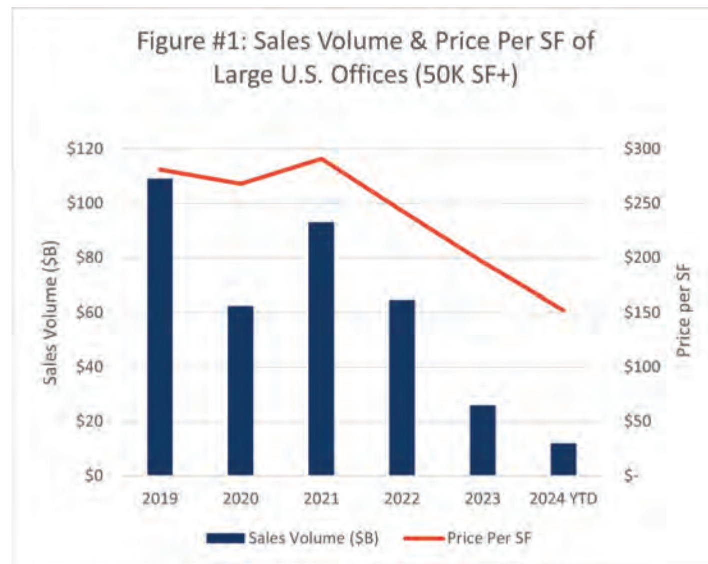
Please reach out to our experts at FTI Consulting to discuss any questions, concerns or opportunities you may have around real estate portfolio strategy, transaction advisory and taxation – particularly if you're contemplating acquiring office space in lieu of a long-term lease.

Appendix: Supporting Data Driving the Steep Decline in Office Valuations

While it is true that the sluggish return to offices following the pandemic is what initially caused the demand for office space to fall, rising interest rates have accelerated the steep decline in the valuations of office assets. Banks and non-bank lenders, saddled with significant office exposure, have put the brakes on new office lending. Many financial institutions, REITs, and pension and sovereign wealth funds consider the product toxic.

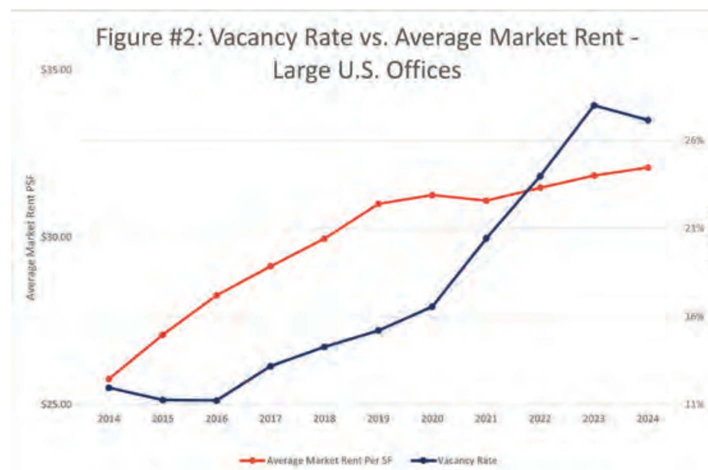
In 2019, prior to the COVID-19 pandemic, the total annual sales volume for large (over 50K sq.ft.) U.S. office buildings was approximately $109 billion across 3,243 total transactions, as office was among the most sought-after asset classes. This year has seen a stark decline from that peak performance. There were 1,227 large U.S. office transactions in 2023, for a total of $20 billion — representing a more than 80% decline from 2019.[6] There was also a similar decrease for the average cost per square foot, which, for large U.S. office spaces in 2023, is $193. This represents a

31% decline from the pre-COVID mark of $281 in 2019 and a 34% dip from the recent high of $291 in the first quarter of 2022, although this is as much a factor of what has been sold as it is of real price declines (refer to Figure #1).



Source: Data Compiled from CoStar (July 2024).[6]

Landlords are feeling immense pressure on the leasing side of the business. Office vacancies have remained high as companies struggle to return employees to the office. The current average office vacancy across the United States is 19.3%, but 23.7% for downtown central business districts.[6] Analysts at CoStar expect vacancies to continue rising for the next two years, with the national average reaching 26% in 2025.[6]

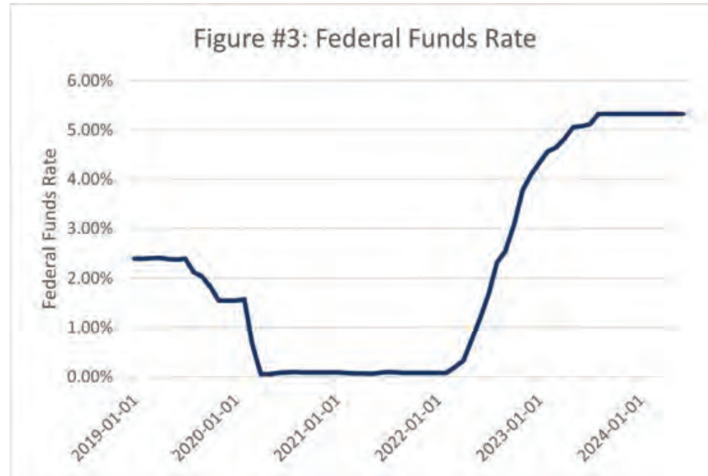


Source: Data Compiled from CoStar (July 2024). [6]

While the vacancy rates are coming off 30-year highs, it is important to realize that ~10% of office buildings account for 80% of the occupancy losses from 2020 to 2022, according to CBRE Viewpoint.[6] Furthermore, the vacancies are heavily concentrated in lower-class (B and C) office buildings, as there has been a steady flight to quality over the last few quarters. From an occupier's perspective, there are increasing opportunities to relocate offices to newer construction or to remodeled buildings in prime locations with better access to neighborhood amenities, entertainment, dining and safe public transportation – often at the same prices that were previously paid for class B or suburban assets. In doing so, organizations are also better able to support a hybrid work environment, and oftentimes, meet their Environmental, Societal, and Governance (ESG) goals.

Interest rates have historically been a driver of the cost of capital and, thus, the real estate market. The federal funds interest rate has steadily increased from a low of 0.05% in early 2020 to 5.33% today.[7] This has discouraged many investors from

acquiring office space assets, as declining demand from occupiers makes it challenging to achieve the required ROI when factoring in the increased cost of debt. It also quickly stamped out the fleeting interest of many owners and investors that were considering taking on additional capital to convert their office space into residential use. As investors fall out of the marketplace, the prices on office assets have sharply declined. In 2023, large office spaces sold for ~16% less than asking price, down from ~10% in 2019. Large offices in urban, central business districts are closing at a staggering 18.2% below asking prices.[7]



Source: Data Compiled from Saint Louis Federal Reserve (July 2024).[8]

The trifecta of high vacancies, low real estate transaction volume and lower prices per square foot indicates a potential buyer's market — particularly for class A/B assets and urban office buildings — and an opportunity for the savvy real estate portfolio manager with available capital. Supporting this hypothesis is the fact that the [average] number of months to sale has increased, while the delta between sales price and asking price continues to be above pre-pandemic levels.[6]

Source: Data Compiled from CoStar (July 2024).[6]

MCRAE THOMPSON
Senior Managing Director,
Leader of Real Estate Tax Advisory
+1 240.968.8734
mcrae.thompson@fticonsulting.com

ROB RAYMOND
Managing Director,
Real Estate Solutions
+1 248.860.4915
rob.raymond@fticonsulting.com

CHRIS LUNG
Senior Consultant,
Real Estate Solutions
+1 332.214.1756
chris.lung@fticonsulting.com

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Endnotes

[1] Thomas Lasalvia, Lu Chen, Nick Luettke, "Q4 2023 Preliminary Trend Announcement," Moody's Analytics, January 8, 2024.
[2] Dror Poleg, "The Next Crisis Will Start With Empty Office Buildings," *The Atlantic,* June 7, 2023.
[3] Ethan Rosenstein, "Prada Buys Fifth Avenue Flagship For $425M," Bisnow, December 20, 2023.
[4] Ethan Rothstein, "Former Playboy Club Sold Out Of Foreclosure To Luxury Watch, Jewelry Retailer," Bisnow, March 4, 2024.
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[6] CoStar, July 2024.
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