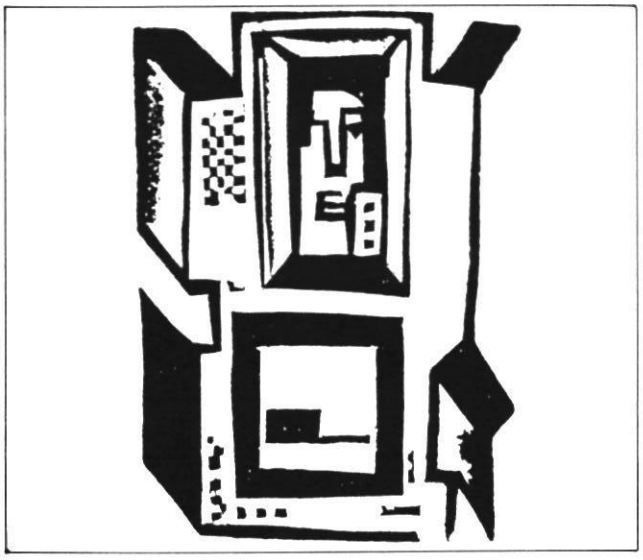
THE COMMERCIAL CONDOMINIUM

by Henry Boeckmann, Jr., CRE

The condominium certainly is not an innovation. From an historical perspective, it has been traced to classical Rome, nineteenth-century France, and Latin America in the 1920s. An astute historian could probably identify some form of condominium ownership throughout mankind's progression, and the system will continue to evolve.



Although not extensive in the United States, the commercial condominium market is well established in Europe and South America. There are indications that this activity is now taking place outside the traditionally limited areas of commercial condominiums, in which medical office buildings seem to predominate.

In San Francisco, a new 23-story office condominium, approximately 102,000 square feet, is being developed; it is reported that sales are taking place at $300 per square foot.

In New York, the potential conversions of 489 Fifth Avenue and 425 East 61st Street will join the limited number of existing commercial condominiums and commercial cooperatives.

By no means does this clearly indicate a trend. An article in the *New York Times* (January 6, 1982) quotes Wylie F. Tuttle, developer of the 1973 three-million-square foot office condominium, "Tour Maine Montparnasse," as citing operating and management difficulties as a major obstacle. It is apparent that the fragmentation of ownership has impaired the economy of operation normally associated with large properties.[1]

As the opportunity becomes more available for small office users in the New York market to own their spaces, we intend to review the various aspects of this form of ownership and its impact on value. It has been traditional for commercial condominiums to appeal to the medical or jewelry trade; they are now being tested in the general market. The question posed to the real estate industry is limited to whether value implications on a before or after-tax basis are to be considered, not to whether a conversion is feasible or whether a specific property is suited for this use.

The final step necessarily may result in identifying investment value, not market value. If, for the sake of reference, one accepts the example of an industrial loft building that has potential for "back office" utilization and will be marketed as such, its retail value as a condominium may be identified through appropriate research and analysis. But, obviously, this is not present market value, nor does it answer definitively the questions of whether the project is feasible or what its value is to a specific investor.

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Background And Definitions

Before proceeding further, it is necessary to provide background and define terms. In simplified form, feasibility refers to the relationship between costs and cash flow. A plan of action becomes feasible when the market, given the identified rewards, accepts the risks. Value is the dollar amount allocated to a given asset.

It would seem that the definition of condominium would be easy, but often it has been lengthy. An excellent study of condominiums, entitled *Commercial and Industrial Condominiums* (Washington, D.C., 1976) and prepared by John C. Melaniphy, Jr., presents this definition: "Condominium ownership is a system in which a person or organization owns a parcel of real estate — a unit, apartment, office, store, plant, or hotel suite — which is usually part of a multi-unit structure, and owns as well a portion of the development's common elements; these common elements are owned jointly by all the development's condominium owners. The owners of the individual units have fee simple titles to their units and to a certain percentage of the common elements.

"Common elements — all the components of the condominium development minus the individual owners' units — may include hallways, central heating and plumbing facilities, walls, lobbies, roofs, basements, stairways, elevators, all nonpersonal improvements such as recreational facilities, parking areas, and utility apparatus, the development's land, and any legal restrictions such as easements, appurtenances, and rights pertaining to the common elements. A monthly maintenance charge is assessed each condominium owner for the upkeep of the common elements and is based on the portion that each unit's size is of the total size of all units in the development."

More simply put, condominium ownership is a form of fee ownership that entails obligations involving common responsibilities.

A review of the advantages and appeal of condominium ownership is useful:

1. The Economic Recovery Act of 1981 provides for a 15-year depreciation schedule. Although some circumstances may justify accepting the recapture tax consequences of electing accelerated depreciation, in general, most owners probably will choose straight line depreciation. The impact is quite significant, since the eroding of the depreciation shelter due to inflation[2] is lessened. Another premise is that the land allocation of the acquisition cost may be minimized; it is hoped in the 10 to 15 percent range.

2. The owner enjoys the potential, given other favorable developments, of a benefit from an actual increase in value. A case could be made that the underlying real estate should be able to retain the purchasing power of the invested principal. But if inflation slows significantly and rates decline, the owner has the potential to obtain cash-free dollars and possibly create value through favorable financing. A large mortgage at favorable rates should prove to be an asset.

3. Some economy may be achieved when acquiring a condominium as the title and attendant burden of the common area is typically held not by a single owner, but is shared by all of the fractional property owners.

4. An occupant may improve the premises without regard to a remaining lease term. This may be particularly appealing to those occupants whose businesses require such items as computer rooms, vaults, etc.

5. An owner, especially one with an accepted credit rating, can always consider a sale-leaseback to generate cash while retaining the utilization of the space.

6. Ownership allows for the avoidance of the rent increases resulting from various escalation provisions.

7. A pride of ownership may fill a need not usually satisfied as a lessee.

8. The owner of a relatively small space in a large building may benefit from the economy of operation generally achieved in larger buildings.

9. In New York City, where a substantial occupancy tax paid by the tenant exists, an owner/user avoids this cost of doing business.

There are also several disadvantages to condominium ownership:

1. An economic recession may cause a softness in market conditions, and the risk is then present that a decrease in value may occur. Liquidity, which is always a difficulty with real estate, may prove to be a problem just when cash is needed most.[3]

2. In order to maximize benefits under current tax regulations, real estate is often sold at designated holding periods,[4] often five to seven years. If the majority of purchasers will be owners/users who may develop tenant fixtures or "goodwill" at their address and are faced with high moving costs, they will not be able to take advantage of a timely sale with favorable tax consequences.

3. Although each unit is held in fee, each condominium building is a collective risk, especially if a single trade or profession predominates. The building may acquire a depressed look or poor reputation, and the remaining viable owners may face increased operating costs and possible loss of value of their fractional asset.

4. The acquisition of a condominium usually requires a capital investment, which may result in lost opportunities in the business itself. Furthermore, the reduction of liquidity combined with added debt may have an initial adverse effect on earnings of publicly-traded companies.

5. For a tenant, all rent payments are tax deductible; it is conceivable that the amortization portion of the mortgage may prove burdensome, especially since no income is present to offset taxes due. The benefit from equity build-up will be realized in the future. In interim years,

however, cash may be needed to meet the current tax. For example, if one assumes an 18 percent, 15-year monthly loan, the debt service constant is .158662. Of this, roughly 94 percent is credited toward interest in the first year. In five years, it is approximately 87 percent and in 10 years, approximately 67 percent.

6. In newly-developed commercial condominiums, especially those of substantial size where a sales force exists and extensive promotion is done, it is possible that a decline in value may occur once sales are substantially completed and the promotional effort is curtailed.

7. A favorable lease may allow a tenant to gain the benefits of a rapidly rising market through subleasing, and, thus, not have to absorb increased operating expenses. Obviously, the circumstances of their current arrangement can answer the economics in ways a condominium would not.

Proving The Point

It is not the intention of this article to demonstrate explicitly the mathematics of buying versus leasing.[5] Nevertheless, an overview is helpful.

We will use the example of a 5,000-square-foot floor in a 40-year-old former industrial loft building which may be conveyed at $625,000 ($125 per square foot). The floor is assumed to be suitable for office utilization. Since taxes have a substantial impact on value, it is wise to consider the investment or after-tax value. The various components (rounded to the nearest $500) of the analysis on an annual basis over the first five years are indicated.

Property: 5,000-square-foot unit acquired for $625,000	
Carrying charges:	
Operating expenses ($6 per square foot)	$ 30,000
Real estate taxes ($3.50 per square foot)	17,500
Financing ($437,500 × .2162; 70 percent of acquisition at 18 percent, 10 years)	94,500
Annual carrying charge	$142,000

An additional cost is the opportunity to have the equity reinvested in either the business or some other alternative. Twenty-five percent return on the equity ($187,500) is $47,000 per annum. Thus, the annual carrying charge ($142,000) plus 25 percent return on the equity ($47,000) equals the adjusted annual carrying charge ($189,000), or $37.80 per square foot.

The next step is to take into account the tax sheltering benefits accruing to the owner. Available average tax deductions over five years are:

Interest payment	$ 69,000
Real estate taxes	17,500
15-year straight line depreciation[6]	35,500
Total available	$122,000

Assuming a combined federal, state, and city tax bracket of 40 percent, $49,000 is the effective savings.

Two related factors should also be considered. First of all, over the five-year projection period, approximately $127,000 of the loan will have been amortized. If the value of the realty has remained stable, then this may be recaptured tax free. Secondly, an additional benefit occurs if value begins to appreciate. Assuming the after-tax value having grown at five percent per annum, the $625,000 base value rises to $797,500. Deducting the mortgage balance of $310,500 leaves a future benefit of $487,000. Because the risk of achievement is present, utilizing a 20 percent discount converts this fixture to a present value of $195,500, or $39,000 per annum. This can be summarized as:

Carrying charge	$189,000
Tax saving	(49,000)
Appreciation	(39,000)
Cost of ownership	$101,000

For a condominium, the cost to own equals approximately $20 per square foot. Whether this should be compared to before-tax or after-tax rent is debatable. Also, the presence of intangibles such as pride of ownership, corporate goodwill, etc., may skew the logic.

Nevertheless, if one looks at rent as a before-tax item, then the offering is competitive as long as the market is interpreted as moving past $20 per square foot. If one treats rent as an after-tax item, then the level approaches $33 per square foot.

The mathematics are projected forward with the assumption that the realty is operated successfully as a commercial condominium.[7] As alluded to previously, certain subjective influences are present, and a prudent investor should blend the insight gained through the exercise in arithmetic with an interpretation of market trends and corresponding values.

This case has focused on the buyer's viewpoint. Value may also be viewed from the position of the sponsor or converter.

The preceding methodology will assist in the pricing of the units, which when spread over the time necessary to sell them shows the gross cash flow from sales. (If rent-paying tenants are present, then this is added in.)

Expenses include not only ongoing operating and consulting fees but also sales commissions, legal and administrative expenses, and perhaps additional maintenance to encourage sales or fees to lenders in order to ensure financing. As the expenses are incurred, they are deducted from the flow. The present worth[8] of the cash flow reflects the value of the realty. A decision may be made as to whether to proceed with the condominium offering after comparing it with the property value and assuming it is held as a rental. The opportunity for a rapid return of a profit is present[9] at the sacrifice of the long-term benefits of ownership.

Conclusions

It would be ideal to draw this review to an end in a fash-

ion that would allow everyone concerned to grasp whether or not there is a profitable future in commercial condominium conversion. I suspect that there is, especially in the initial stages in specialized and concentrated areas such as the toy and jewelry industries and in the medical profession. There are other potential fields that may benefit by being pulled together, such as the real estate industry, the accounting and legal fields, or perhaps the entire service sector.

In the early phase of any new concept that is testing an uncertain market, risks are present. Considerable education must be provided, and most do not want to be the first to incur this expense.[10] I believe that several of the prejudices against condominium ownership are not well-founded. It is difficult to believe that an established business would commit to a 15-year lease when ownership may prove to be even more flexible, that is, option to sell or sublet if space requirements change. Also, there is the element of pride of ownership which, through value appreciation, carries a strong factor of the potential for gain, especially for smaller, closely-held businesses.

I suspect that a considerable portion of what is defined as value in the first group of successful condominiums will lie not in the real estate but perhaps with the entrepreneur. Any analyses must combine this element with an understanding of investment value in order to evaluate successfully the benefits of the commercial condominium.

NOTES

1. Tuttle's suggested solution is to keep the developer in the project as an equity partner with a substantial position. This should ensure quality and efficient management, but it would certainly subjugate any small owner to the decisions of the "large" one.
2. Nevertheless, it is still significant that even a "modest" inflation rate of 5 percent will halve the purchasing power benefit of straight line depreciation in the fifteenth year.
3. A case could be made that it is still better to be an owner in difficult periods as the asset may have some value, but an obligation such as a long-term lease remains a liability.
4. These holding periods are related to the amount of interest and depreciation available to shelter income.
5. We originally became aware of this basic procedure from a format utilized by Citibank in its underwriting procedure.
6. Although subject to negotiation with the Internal Revenue Service, if 85 percent of this price were available for depreciation — $625,000 × .85 = $531,250, over 15 years — the annual write-off would be approximately $35,500.
7. Thus, the analysis must be careful to account for probable changes such as an increase in the assessment.
8. The discount must be sufficiently attractive to compensate the entrepreneur as well as to provide for the risk of capital.
9. The option to fall back to a rental, perhaps the starting point, is a form of insurance.
10. The same scenario faced those who first purchased old loft buildings with the intention of renovating them for residential use.