OFFICE BUILDING DEVELOPMENT AND INVESTMENT: SELECTED INTERNATIONAL REGIONS AND COUNTRIES

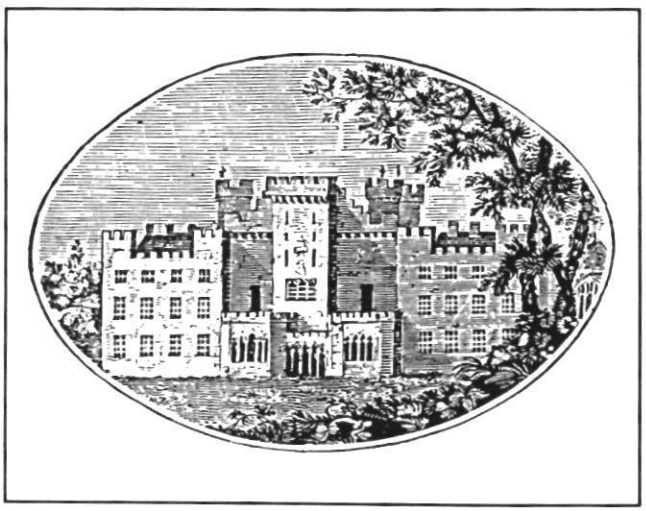
by Mary Alice Hines

Office building development and investment is a strategic area for scrutiny by international real estate investors as a prime form of income property investment no matter what region of the world, country involved or city analyzed. Many international investors have observed some extraordinary office building yields in recent years, and as the world's economy recovers from the recession, yields from office buildings will remain attractive as the businesses and governments of the various countries expand.

In this article, the focus will be on the demand for office building space, leasing, the complexities of land acquisition, construction costs and investment yields throughout the world.

Office Building Space Demand

On a national scale, the developing countries probably exhibit the highest demand for office space. For example, the economy of the People's Republic of China is rapidly expanding under the current national economic policies which encourage a free market system and an element of capitalism within the socialist economic structure of the communist country. As foreign joint ventures are promoted and domestic business thrives, office space is needed for both the domestic and foreign companies who do business on PRC soil or offshore. The economic expansion of Japan and Southeast Asia in the industrial, shipping and financial sectors is very promising, and consequently, there is also a strong demand for office space.



If Hong Kong loses some of its vitality as an offshore banking center when the British Colonial land leases expire in 1997, Singapore and Japan hope to attract the business that leaves. Similarly, if industry and shipping declines in Hong Kong, Taiwan, along with the other countries of the Far East and Southeast Asia, hopes to benefit. For these reasons, as 1997 approaches office space demand may increase in Singapore, Japan and Taiwan.

Even with the uncertainty about Hong Kong's future, high quality office space is being built and occupied by foreign companies who continue to establish branch and regional offices in Hong Kong so they can benefit from the potentially profitable Hong Kong and China trade. Hong Kong is becoming an entrance way to the vast markets of China, and China will allow Hong Kong to retain its financial, legal and industrial systems that currently provide prosperity. Two years ago the Hong Kong and Shanghai Bank announced plans to build its new headquarters which when completed would be the highest building in Hong Kong. Just the expansion of its banking

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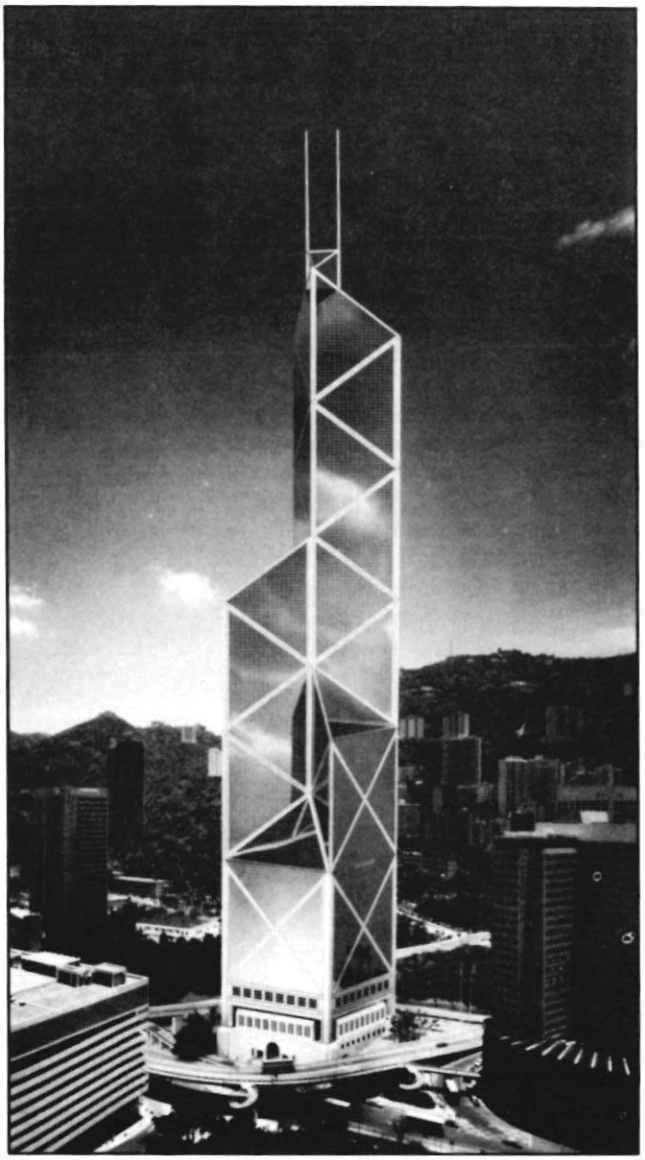
EXHIBIT

Design of the Bank of China Building in Hong Kong



Source: Hong Kong Trader, August/September, 1984, No. 14, p. 1 (A publication of the Hong Kong Trade Development Council)

and affiliated businesses prompted an expectation of full occupancy in the new building by just the bank. Consequently, the Bank of China now has announced plans for an even higher Hong Kong structure to be located in the central district of Hong Kong Island close to the new bank building. The 70-story Bank of China building, designed by I. M. Pei the renown architect, is scheduled for completion by 1988. (see Exhibit).

As the industrialization of India continues, more office space in South Asia will be needed for the foreign joint venture companies and domestic firms needing headquarters and regional administrative space. Since India has not exhausted its credit potential and has rapidly increased its industrial base, more quality office space will be needed as new and higher industrial plateaus are reached and domestic and foreign trade develops. Its natural resources, including oil and a trained workforce, promise continued economic growth.

In Central and South America the economic, political and financial troubles have discouraged company expansion and subsequently there has been limited need for office space. The high levels of inflation and unemployment must be overcome and positive foreign trade balances established in order to increase the financial reserves of the various Latin American countries. For the present, financial institutions and the International Monetary Fund forecast a long road back to economic stability and adequate financial reserves with low levels of inflation.

Western Europe has long represented a stagnant economy and the African countries' economies, with the exception of South Africa, are very depressed. In general the independent African nations are trying to raise their economies by their boot straps though some of the vestiges of colonial rule have aided in their development. The African countries are a long way from economic prosperity. Recent droughts and floods have been devastating to Zimbabwe and South Africa, and the drop in oil prices has been felt in Nigeria, Libya and the other oil producing areas of Africa.

In the Middle East office building demand is generally depressed compared with the previous demand in the 70s. This is due to the reduction in oil prices and the military confrontation between Iraq and Iran. The economic expansions of Kuwait, Bahrain and Saudi Arabia slowed in the early 80s even though some office building development and construction continues.

Canada is still recovering from the recession of the 80s. Its foreign exchange rates have suffered, and office space demand also has declined.

Eastern Europe and the U.S.S.R. continue to suffer from engineered economies where private business ownership is generally not permitted and business interests are subservient to government interests and the Five-Year Plans. As long as the barter system is necessary because the Soviet satellite countries of Eastern Europe do not have the necessary foreign exchange for the traditional financial transactions, the economies of these bartering nations will not encourage major business expansion with high levels of office space demand. As growth does occur, however, the space will be provided by the government and not from development activity and construction expertise of private, domestic or foreign organizations. The U.S.S.R. and its satellites do not permit office building development and investment by foreign investors, public or private, within their national boundaries.

Office Building Leasing

Office building leases are written for fewer years than

before with less renewal provisions incorporated into the original lease, if included at all. Covered in the agreements are indexing of base rents with periodic rent renewals to assure market rents regardless of indexing patterns. Most office leases have service charges and may be characterized by partially net terms. The landlord still pays a minimal amount of building insurance, property tax and maintenance costs. Included in their rent the tenant usually pays a proportionate share of the building's operating costs. Many landlords ask for key money deposits. Such deposits are generally not interest bearing and may cover the first three months or more rent in advance (Table).

Rent Levels

The highest office rents per square foot in U.S. dollars are in London, New York, Tokyo and Paris. The high rents reflect the high land values and the ratio of the high land-to-total property value. London's Richard Ellis and Weatherall Green and Smith have maintained research studies of international office rent levels which confirm the cities that offer the highest, lowest and middle-range rents.

Trends In Office Rents

While office rents have taken a nose dive in Hong Kong since their peak in 1981, office rents in the United States and Japan have tended to continue their upward trend. Higher annual increases occurred in many U.S. cities during 1979-1982. This changed from 1982-84 due to an oversupply of office space. According to an article in the October 3, 1984 *Wall Street Journal,* office rents in midtown and downtown Manhattan rose at a compound annual rate of 11% over the past 13 years. In just the last six years, the annual compound rate of office rental rate increase was even more impressive at 22%.[1] This staggering office rent increase occurred while an average of six million square feet of office space has been added annually to the Manhattan market.

The rent decline in Hong Kong has been blamed on the approaching land lease termination date and the resulting business uncertainty due to the impending Chinese government control. The Japanese office rental increases have been due to the scarcity of office space. As the economy continues to flourish, land owners retain their ownership and reject purchase offers just as land use controls discourage land development.

Rent Controls

Most parts of the world do not utilize commercial rent controls. They do exist though in the Middle East, Africa, the U.S.S.R. and Central and South America. The following regions/countries maintain commercial rent controls: Middle East, Iran; Africa, Zimbabwe; Central America, Mexico; South America, Brazil and Venezuela; and the U.S.S.R. Other countries including the United Kingdom, Hong Kong and Spain have utilized office building rent controls in emergency situations when the government saw a fast rise in rents occurring that could be detrimental to the business community. In contrast, many countries maintain residential rent controls.

TABLE

Selected International Office Building Lease Examples

Hong Kong

Length of Lease: 2 to 5 years

Renewal Provisions: Renewal clause if the original lease term exceeds three years

Rent Review Frequency: Every three years

Extent of Net Lease Terms: Partial, not full payment of landlord costs by the tenant

Singapore

Length of Lease: 3 or 5 years

Renewal Provisions: 3 years plus 3 years or 5 years plus 5 years

Service Charge: Yes

Extent of Net Lease Terms: Full payment by tenant of traditional landlord costs

Spain

Length of Lease: 3 or 6 years

Renewal Provisions: None

Rent Review Frequency: Every 3 years

Indexing Base: Annual Consumer Price Index

Service Charge: 10 to 15 percent of prime rents

United Kingdom

Length of Lease: 20 to 25 years

Renewal Provisions: None

Rent Review Frequency: 3 or 5 years

Indexing Base: None

Service Charge: 15 to 20 percent of prime rents

Extent of Net Lease Terms: Full payment by tenant of traditional landlord costs

Sources: Annual and special reports of English chartered surveying firms, personal interviewing and other secondary data sources

Land Acquisition Complexities

There are problems in acquiring the right location for office building development. A number of complexities or barriers exist to frustrate the international office building developer or investor. For example, in many countries land owners refuse to sell such sites. Some of these owners are private parties; some are municipal and central governments and their agencies; and some are native tribal groups. Private land owners in Switzerland and Japan are slow to sell urban land. Where governments

1. Guenther, Robert, "Investors Seek Sizable Return on Manhattan Office Rentals," *The Wall Street Journal,* Wednesday, October 3, 1984, p. 35.

own all or a major portion of the land, they have no reason to sell their holdings for private office building development. These governments and their agencies, namely the U.S.S.R., the People's Republic of China, Sudan, Tanzania and Burma, wish to retain ownership and only extend leases for the land use. The Eastern European countries that are Soviet satellites tend to own the land within their boundaries. Some governments such as the United Kingdom, Nigeria, South Africa (and other African sub-Sahara countries), own large portions of the country's land.

New office building land has been developed due to recent land reclamation in some countries. The Hong Kong government continues to engage in large land reclamation projects as do the governments of Bahrain, Singapore and the United States. In the U.S., new office and residential large-scale projects are being built and have recently been completed on reclaimed land in Manhattan and Chicago. The World Financial Center is being constructed on reclaimed land in Manhattan and many apartment, hotel and office buildings are being built on reclaimed waterfront land in Chicago's Loop area.

Land vacated for office building development via urban redevelopment projects is being constructed on the waterfronts of Yokohama, Japan; Liverpool, England; and the older major cities on the east coast of Australia.

Title problems may inhibit land acquisition in various locations and countries. For example, in Africa, among the sub-Saharan countries, title uncertainties arise from inadequate title registration systems and the conflicting land ownership claims of tribal groups, municipal and central governments and private individuals and organizations. Developing countries often regard title registration problems as an area needing further development for economic progress.

Strict and comprehensive urban planning controls may depress the level of office building development and construction. The particularly rigid controls of the United Kingdom, France, West Germany and Japan tend to prompt such results in the office building sector.

Relatively high construction costs have occurred in Hong Kong, Singapore, West Germany, the United Kingdom and Switzerland while low construction costs have been associated with Italy, Belgium and France.

Hong Kong imports the vast majority of its building materials. The island and Kowloon Peninsula do not offer an abundance of natural resources for quality building products and this same situation is true to a lesser extent in Singapore. Some building materials are procured from the Southeast Asian area rather than imported from Europe, Japan and other such distant sources. In Singapore, construction labor and management expertise is imported, and by using the competitive bidding process, the cost for imported construction labor, materials and management are kept down.

In the United Kingdom most of the high quality office buildings are built in London. Other metropolitan areas also have substantial office centers but the office building construction costs for the U.K. generally reflect the high level of office building construction in London. Here and in West Germany the building regulatory authorities promulgate stringent building codes and enforce detailed zoning ordinances to promote high quality, durable construction. The highest building costs are associated with newer office buildings which have central heating and air conditioning.

Investment Yields

Some of the highest investment yields from office buildings come from the United States, Indonesia and Spain. However, the numerical yields are not reliable because the published and unpublished sources do not reveal how the office building investment yields are calculated. Since a number of calculation methods are used with differing responses from even a single property, the numerical quotas are not particularly significant. For example, annual office building yields from the U.S., quoted on an internal rate of return basis, have approximated 12-15% in the last two years. The internal rate of return calculations in the U.S. usually reflect relatively short investment holding periods with estimates of net cash proceeds from eventual property sale. Quotes from Indonesia reveal annual returns of 12-15%. These yields may or may not be calculated by the same methods used in the U.S. Most Western European yields are based on net operating cash flows, very long institutional investment holding periods and no allowances for capital appreciation at the time of property sale. The 10% annual yield quoted for Spain may be calculated the same way as the five percent annual yield for the U.K. and the 6 to 7¼% annual yields for central Paris. Generally these three yield quotes come from English chartered surveyors who reflect the Western European calculation methods.

Conclusion

Many international real estate investors diversify their real estate portfolios to increase their yields commensurate with risk reduction. The United States' office building market has been the prime target for most of the available overseas money for such investment. Since many U.S. office markets are saturated for some years to come, many international investors continue to review yield prospects in other countries. As a worldwide economic recovery occurs, the international real estate investor can expect many profitable, prospective office building locations and existing buildings to surface in many countries.