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Economy

Developers Beckon Companies Back to the Office With Unusual Sell: Why Not Buy?

In hot U.S. markets like Nashville and Austin, some small businesses are opting to own office condos rather than lease.

By <u>Sarah Holder</u> April 28, 2022, 12:00 PM CDT

As some employers are shedding office square footage amid an increase in remote work, a handful of smaller businesses are so bullish on the future of the office that they're buying space.

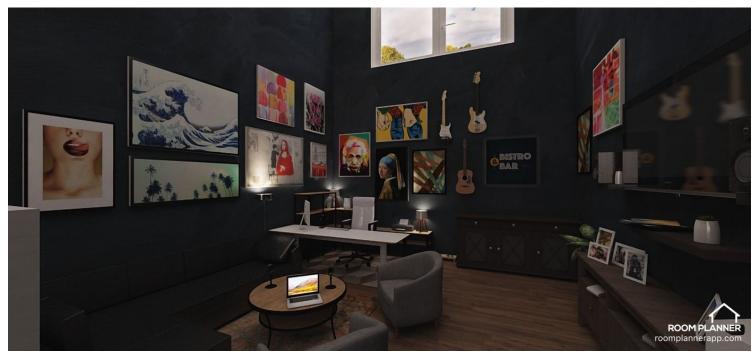
In some hot U.S. markets, developers have started selling office "condos" to employers, betting that high lease prices and inflation may make the idea of owning small office spaces an increasingly attractive proposition.

The vast majority of white-collar employers rent or lease their office space from landlords; the biggest companies, like Apple and Google, own whole campuses. It's much rarer to see small business owners buy their office space outright. A few developers in Austin, Nashville and San Diego are pitching to change that, selling units to solo entrepreneurs, low-headcount companies, and small medical practices that want to invest in their own commercial real estate.

"Basically, our market is small, medium-sized businesses who are like, 'I'll own space for the same price as it is to rent,' which it basically is," said Byron Smith, the co-founder of the commercial

developer XSpace. XSpace started out by selling storage units in Australia, and has since expanded into Austin, Texas, with a commercial condo model that caters to entrepreneurs and creatives.

Sue and Lester Platt bought their \$265,000 XSpace condo in cash, and plan to turn it into a studio for Lester's commercial production business; Sue might use it sometimes to meet clients in her role as a realtor. After looking at rental warehouses for \$3,000, \$5,000 and \$8,000 a month, the couple decided on an XSpace unit because they "could make an investment in the unit and not [have] to be worried about any leasing fees and stuff like that," said Lester. "It's basically going to be mine, and free to do whatever. If it doesn't work I can just rent it to other businesses." He has plans to build a soundproof podcast studio and an area for photo shoots.



A mock-up of Lester Platt's planned studio space in an Austin condo. Courtesy Lester Platt

After XSpace finishes construction on its Austin project next month, Smith says they have plans to build in other high-growth U.S. cities, including Houston, Dallas, and Nashville, where a different office condo project is slated to complete construction next month. The <u>Allston office park</u>, located in the suburban city of Franklin, just south of Nashville, is about 30% pre-sold.

These developers didn't invent the concept of selling commercial condos, which had a heyday in the early 2000s, says Jilliene Helman, founder and CEO of RealtyMogul, a crowdfunding platform for realtors. "It's very much gone out of favor, and you're starting to see it creep back up, given what's going on with rental rates, given what's going on with inflation," she said.

In the metro Nashville area, about 5% of commercial real estate is currently sold as condos, says Byran Fort, a vice president at CBRE who is brokering sales for the Franklin project. "It is a small niche subset of office," he said.

Meg Epstein, the CEO of CA South, which developed the Allston office park, said buying an office condo is "kind of a no-brainer" for clients, particularly consultancies, accounting firms, or medical support offices. "You're investing in a real asset and hedging against inflation, and you're paying less."

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Both Austin and Nashville are Sun Belt cities whose populations are growing, and are gaining particular appeal among tech workers. Nashville's already-hot rental market got a <u>little hotter</u> in 2022, with Class A offices renting for about \$33 a square foot, <u>according</u> to global commercial real estate advisor Avison Young. Across Austin, Class A rents are going for an average of <u>\$35 a square foot</u>, with prices set even higher in the central business district and downtown.

But although Epstein says demand for condo-sized space is high, Nashville's overall office vacancy rate is among the highest in the country, at 18.8% in March according to <u>CommercialEdge</u>, compared to San Francisco's 17.3%. Austin's vacancy rate is around the country's average of 15.9%, while its pace of office construction and share of office workers is also growing rapidly.

One other economic factor might be pushing companies to buy: a change in GAAP accounting rules that means publicly traded companies have to put their whole lease obligations on their balance sheets, instead of just one year. A long-term asset might look better to shareholders than a ten-year lease liability of the same price, said Fort.

In the past few months alone, Helman has seen two office condo deals submitted to RealtyMogul, both in California. One, in San Diego, is selling to attorneys and other professionals. The other is targeting physicians that could run medical practices.

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Michael Kostecka, a Los Angeles-based real estate partner at the law firm Allen Matkins, says he hasn't seen signs that such a movement is afoot in the California markets he works in. Buying an office property isn't ideal for employers that might have plans to get bigger, like tech start-ups, he says. "It's hard for me to see the benefits of that outside of the medical space," he said, where there might be a fixed staff and clients that depend on a permanent location.

In markets like the Nashville suburbs, Fort says buying condos is also a good option for companies pursuing the so-called "hub and spoke" model: allowing employees to work remotely part-time, and opening ancillary offices closer to suburbs where the workforce may have sprawled. Two clients who have signed a contract in the Allston building have an anchor office elsewhere, and are buying a condo as a supplementary space, he said.

Kostecka is more skeptical: Companies investing in the spoke to their hub are likely responding to temporary market trends, he says, and buying property doesn't pair well with flexibility.

Though a mortgage might seem like a rigid commitment, XSpace's Smith sees the model as part of an evolving future of office work that allows for more agile customization – owners can remodel their spaces without any restrictions from a landlord. "I think that the office will reshape itself," he said. "What we're trying to achieve is, alright, today it might be this, but it evolves with your business and your life, and it's a blank canvas."

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