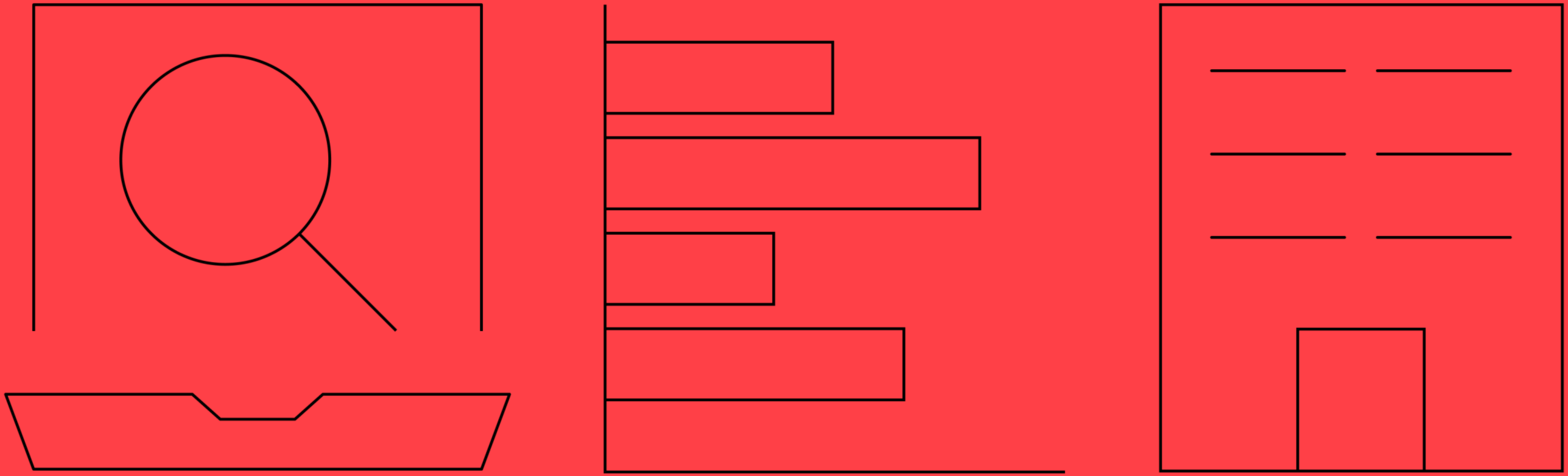
Introduction to Small Office Buildings



RSQUARE RESEARCH CENTER **GANG-MIN RYU**

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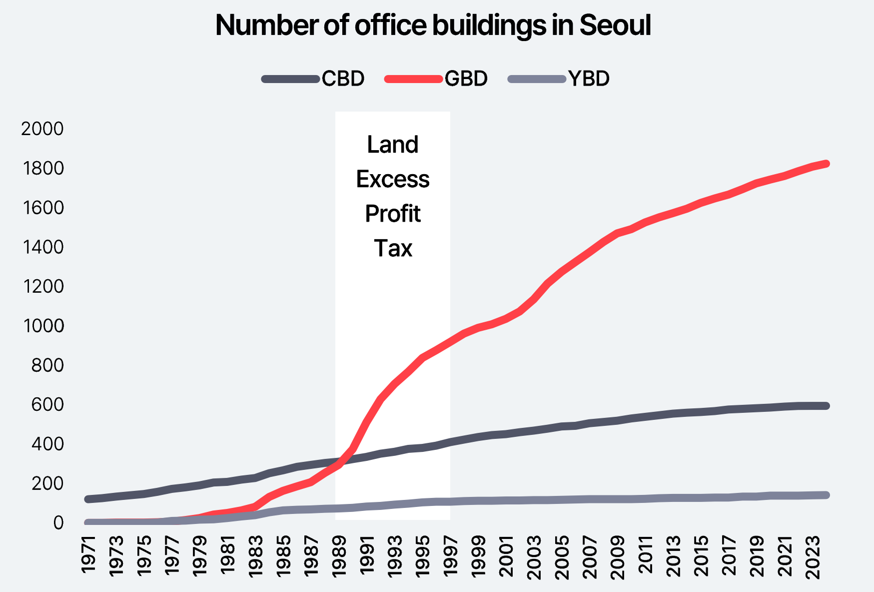
High Density of Small Offices in Gangnam

Development of Gangnam

- In the 1970s, overcrowding caused problems such as lack of infrastructure facilities and environmental degradation as the population concentrated in the north of Seoul ▶ **Development of Gangnam**, formerly an agricultural area, was initiated in the 1980s
- According to the Yeongdong District development plan, Gangnam was to be primarily residential (92% residential, 89% commercial), with small plot sizes
  Smaller plot sizes mainly attracted individual investors with a significant proportion of purchases for speculation.
  As such, new construction activity on the area was relatively scarce.
- The government aimed to ease new building supply by implementing *land excess profits tax
  * Land Excess Profits Tax: A tax levied to recover a portion of excess gains from idle land owned by individuals or non-business land owned by corporations, enacted in 1989 and repealed in 1998.
- Gangnam saw an increase in new office building supply after the enactment of the Land Excess Profits Tax. However, small offices dominated the new supply as small plot size and high proportion of individual-owned lands led to a relatively higher construction cost.



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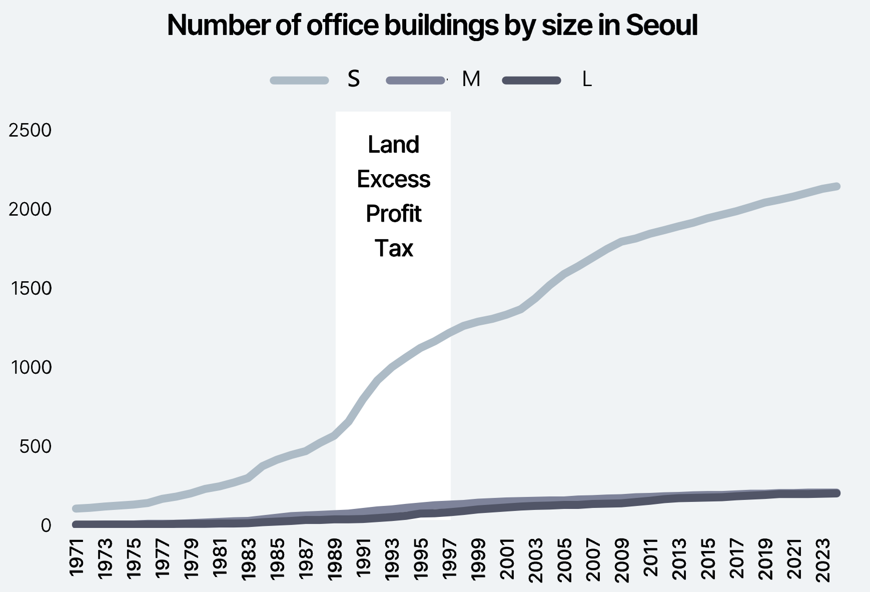

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High Density of Small Offices in Gangnam

Rise of side streets in Gangnam

- In the 1980s, the government aimed to host the Asian Games and the Seoul Olympics, but small building-dominated landscape showed limitations in showcasing Seoul's development.
- To improve the streetscape of Teheran-ro, the minimum plot size standards set by the 'Yeongdong District Promotion Plan (1973)' were strengthened under the 'Teheran-ro Urban Design Guidelines (1984).'
- **Minimum land area requirements:** minimum 600 sqm along Tehran Road and minimum 1,000 sqm around intersections for development permit

Minimum land area on Yeongdong District Promotion Plan

Category	Minimum Area	Source
Minimum Area	27py(90m²)	Enforcement decree of the Building Act
Yeongdong District	50py(165m²)	Yeongdong District Urban Plan, Seoul City Council
- Commercial	100py(330m²)	
- Residential	70py(231m²)	
- Mixed	50py(165m²)	

Minimum land area on Urban Design Guidelines for Teheran-ro

Category	Minimum Area
Near intersection	1,000m²
Near Teheran-ro	600m²
Near North-South Arterial Road	300m²
Land adjacent to roads	200m²

Source Heekyung Yang(2020), Univerisity of Seoul master's thesis

- Landowners with small plots were forced to merge their plots, resulting in **large office buildings on lands adjacent to Teheran-Ro. Plots on side and rear streets were supplied with small office buildings due to the Excess Land Profit Tax**, as they were not subject to the minimum plot size regulations. ▶ **A unique phenomenon found only in Gangnam**
- The contrasting streetscape along the side roads is unique to Korea and shows a contrast to that of Yeouido that was developed around the same time.
  ▶ In Yeouido, larger plots have resulted in a dominant supply of medium to large office buildings.

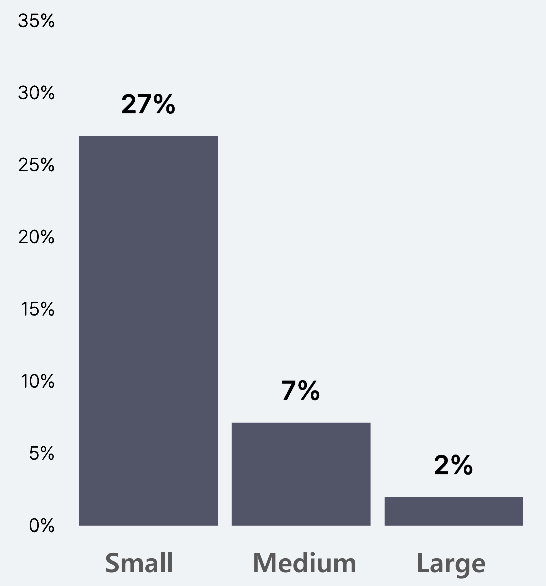
Key Characteristics

Rent & Cap Rate

1. Rent

- As mentioned earlier, the small offices that have formed around Gangnam today were built by individual landowners through loans to avoid the Excess Land Profit Tax.
- To cover the burden of the loan, landlords sought to maximize deposits that resulted in smaller offices having a higher proportion of deposit to monthly rent than those of medium and large offices. Additionally, landlords are increasing the conversion rate between deposit and monthly rent to incentivize tenants to pay more deposit.
  * rent conversion rate: The percentage used to convert security deposit to rent or vice versa.
- The higher the conversion rate, the higher the monthly rent when converted from the deposit money. Tenants are inclined to pay more deposit to avoid the burden of high rent

Percentage of Seoul offices individually owned



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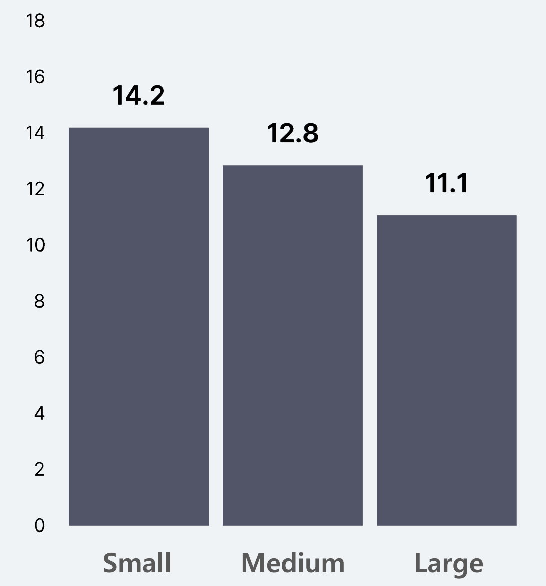
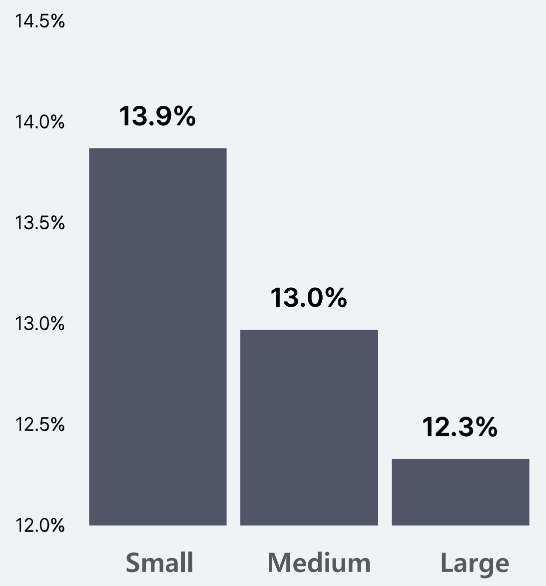
Seoul Office Security Deposit / Monthly Rent



Source RSQUARE

Seoul Office Rent Conversion Rate



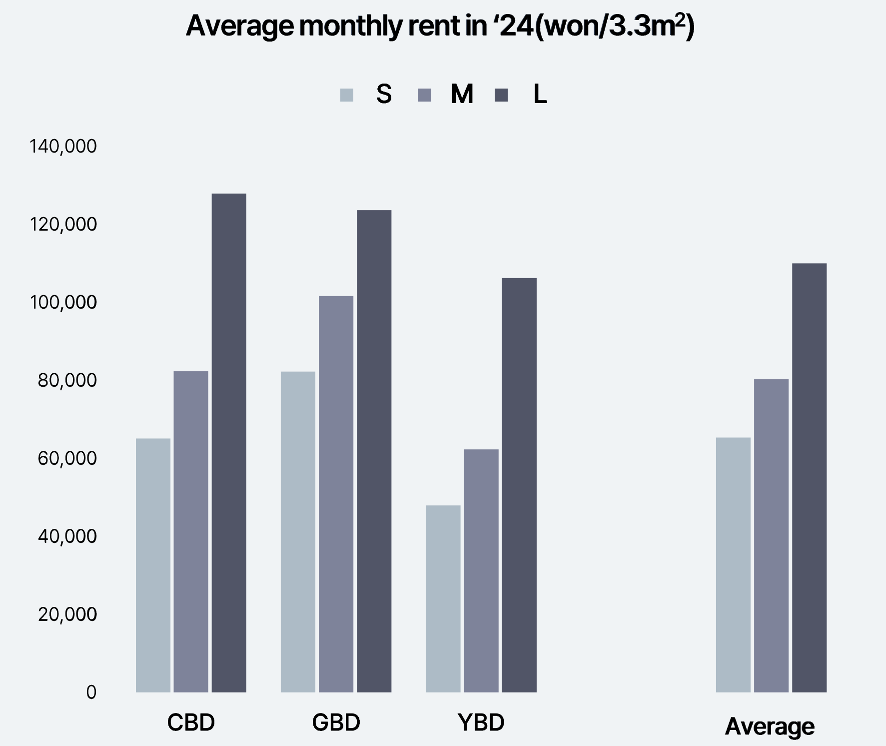
Source MatePlus ('18.4Q)

Key Characteristics

Rent & Cap Rate

2. Cap Rate

- Office rent tends to grow proportionate to the gross floor area (GFA) of a building ▶ Its landmark character and service quality improve with bigger GFA
- Sales prices on the other hand, small buildings trade on a price per area alike their medium or mid-sized counterparts.



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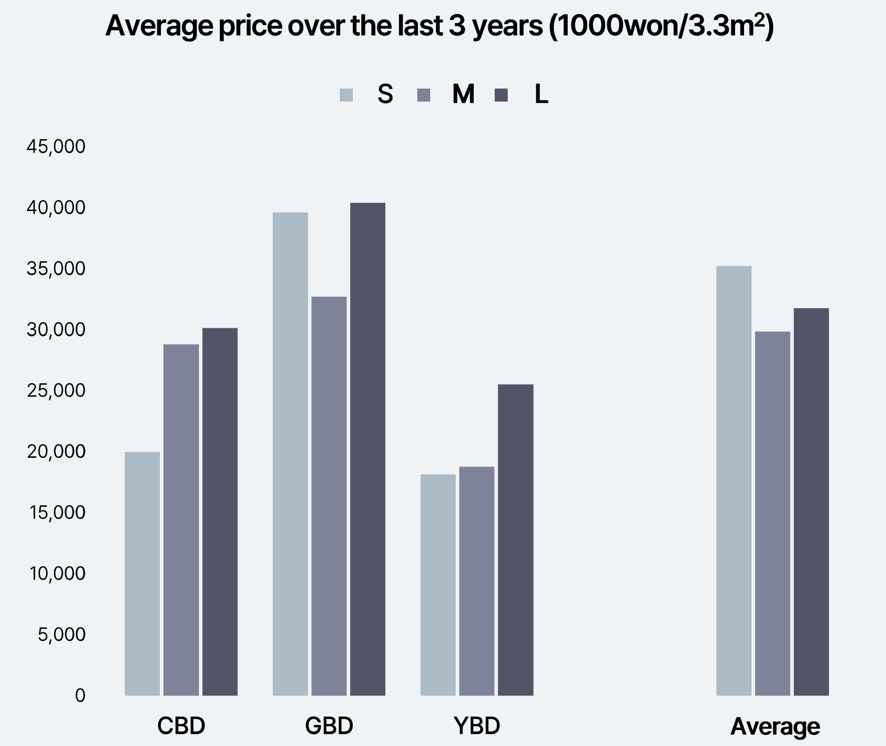


Source RSQUARE

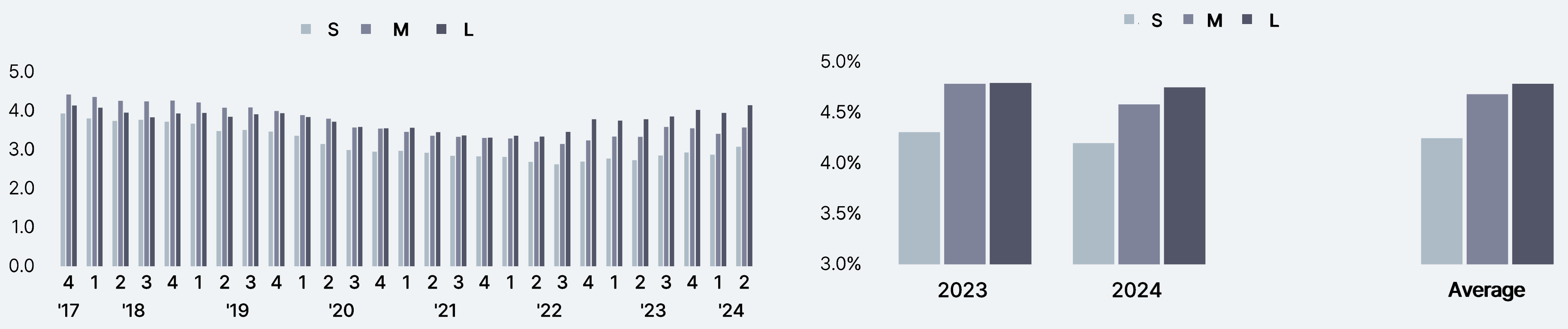
Key Characteristics

Rent & Cap Rate

2. Cap Rate

- Normally the higher the NOI, or rent level, the higher the sale price as prices usually follow NOI. But in practice, smaller buildings also show high sale prices.
- Low NOI and high sales prices of small office buildings are reflected in the cap rate. The trend of office cap rates published by KB Real Estate below shows that medium-sized buildings have the lowest cap rates (excluding small buildings); larger the area, the higher the cap rate.
  Small buildings are excluded from the chart. But given the flow, we can infer that small buildings will show the lowest cap rate.

Seoul Office Cap.Rate



Source KB Real Estate

Source RSQUARE

- Such a high sale price relative to operating income is unusual and relatively difficult to understand. In fact, some asset managers have commented that the low cap rates in the small office building market pose as an entry barrier

If so, do low cap rates for small office buildings remain as a mystery?

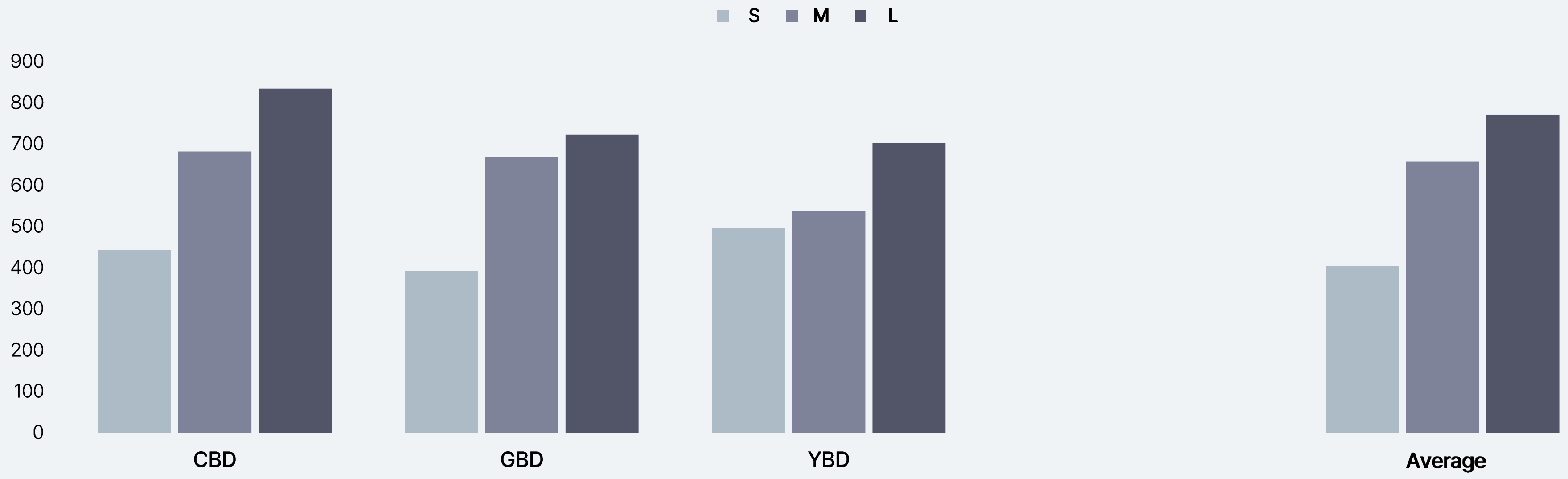
Key Characteristics

Rent & Cap Rate

3. Development news is key to pricing

- The history of small office buildings development provides a hint to the question. High sales price for small buildings is due to their development prospect/good news relevant to their development.
- The low cap rate of small office buildings is because they shine prospects to be rebuilt with higher floors when demolished.
  Owners of small office buildings are primarily individuals and ess likely to have high credit scores
  Hence, they may have built buildings with lower than permitted floor area ratios to address tax issues.
- The floor area ratio of small buildings is lower than that of medium and large buildings, so if they are demolished and rebuilt, it is possible to construct a larger building than the current one and expect an increase in NOI.

Floor Area Ratio of Office Buildings in Seoul



Source RSQUARE

Key Characteristics

Rent & Cap Rate

4. Other Attributes

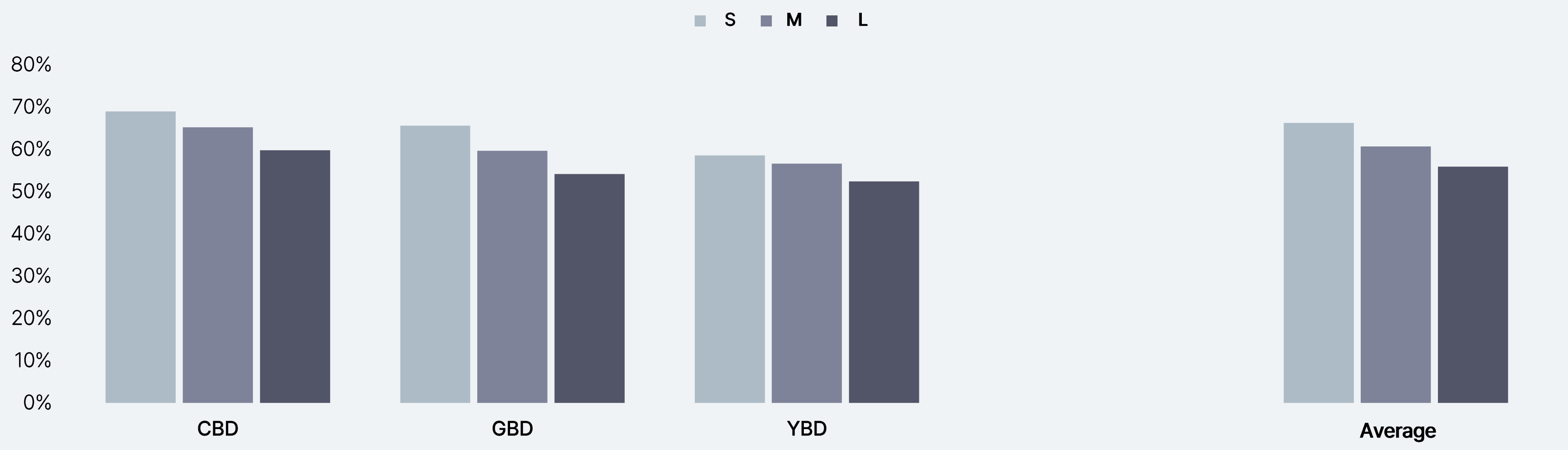
Tenants

- **Tenants in small office buildings and mid-large office buildings have differing characters**
  Low rents tend to attract businesses that prefer low rents, so the high deposit requirements are likely to attract tenants who have more cash on hand.
- **From a landlord's perspective, tenant selection can be challenging due to the small floor space and potentially high reliance on ground floor retail.**

Efficiency Rate

- **Smaller office buildings have a higher percentage of net leasable area than large buildings. This means they have less common area such as parking lots, E/V, lobbies and corridors. Therefore, if you are a tenant who does not require much parking lots and emphasize more on office space itself, a small office building may be a better fit than a medium or large office building.**

Efficiency Rate of Office Buildings in Seoul



SOURCE: RSQUARE

Conclusion

Small office buildings are alike

Houses

- **Small office buildings in Gangnam expanded as individual owners invested in small plots of land**

  Developed in small parcels in the 1980s, with predominant individual investments, and the impact of the Land Excess Profits Tax promoted the construction of small buildings.

- **Low rents, high sales prices result in low cap rates, but retains high market value with development potential**

  Buildings with lower than permitted floor area ratios can add value through redevelopment.

- **Small office buildings are more alike houses**

  1. High portion of individual investment and ownership
  2. Similar to 'Jeonse' in the housing market, deposits are used to reduce the equity required to build/buy a small office building
  3. Higher portion of deposit in contrast to medium-large office buildings
  4. Pricing is driven by good news of development

     ex) Gangnam Eunma APT is a small and old apartment yet it is traded at a high price due to its redevelopment potential

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