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Telco Hotels Lure Investors, Worry Cities

By Shirley Leung Staff Reporter of the Wall Street Journal, The Wall Street Journal, 835 words
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Even as California cities rush to restrain the spread of "telco hotels," investors can't get enough of them.

Wall Street and private investment firms have already committed more than $1 billion to develop buildings in California devoted to wall-to-wall telecommunications equipment, say real-estate brokers and investors. And that's just the beginning: A total of $4 billion could be headed to the state for these telco-hotel projects in the next year, according to an analysis by Jones Lang LaSalle Inc., a Chicago-based real-estate services firm.

The reason? California is a hotbed of Internet use, which is fueling demand for these specialty projects. More than half of the money, the Jones Lang analysis indicates, will be headed to traditional tech centers such as Los Angeles, San Francisco and San Jose, but money is also flowing to such emerging markets as San Diego, Sacramento and Orange County.

Typically, funds go to acquire old buildings to renovate, but increasingly the money is used for new construction. Already, the state is home to about nine million square feet of telco hotels, according to Bank of America Corp.'s telecommunication-facility finance unit, and several million more square feet are either under construction or being negotiated, say real-estate brokers and investment firms.

"The supply of money is there, and there is demand," says Charles Bruni, a senior vice president at Jones Lang LaSalle. Wall Street "is going for huge returns."

The inflow of Wall Street money to develop these projects comes as cities across the state try to control their growth.

While telco hotels are attractive to landlords because they take up space that frequently is shunned by traditional office tenants, city leaders fear the projects -- which require few employees -- will hinder efforts to make downtowns more populous and vibrant.

Sacramento is the latest city to try to rein in the spread of telco hotels. Officials there are drafting an emergency ordinance that would require developers of telecommunications projects to seek a special permit from the planning director before moving into downtown. What's more, the ordinance aims to regulate the design and location of telco hotels -- similar to a proposal Los Angeles is studying. The Sacramento City Council will consider the emergency ordinance at the end of the month. If passed, it would take effect immediately while permanent rules would be studied.

Sacramento officials started drafting an ordinance in late June, after learning that two buildings in prime locations in downtown might be converted into telco hotels. "We want to make sure we don't have a neutron bomb city, where . . . all that's left is the infrastructure there," says Chuck Dalldorf, the assistant to Sacramento Mayor Jimmie Yee.

The telecom building frenzy started to heat up this year when Dallas-based Archon Group LP, a majority-owned subsidiary of Goldman Sachs Group Inc., and Morgan Stanley Dean Witter & Co., among others, set aside money to finance telco-hotel projects world-wide. Morgan Stanley alone established a special $1.25 billion telco investment fund.

What makes the projects so attractive to investors? They say they can get returns of 20% or more on the projects, compared with the 10% returns more common in real-estate investments. That's because telecommunications tenants sign longer leases, exceeding 10 years, and even offer to pay higher rents than office tenants.

Rusty Perry, director of acquisitions at Archon Group, says Wall Street money enables developers to get buildings completed more quickly. Indeed, developers say traditional lenders are more reluctant to finance projects, while Wall Street is more comfortable with the risks because it sees the telco hotels as an Internet investment as much as a real-estate deal.

"Traditional lenders see this as somewhat specialized property, therefore higher risk," says John Wilson, president of Cambaytele.com LLC, a telecommunications real-estate development company based in San Francisco. "They don't know enough about it."

But one downside may be that the Wall Street newcomers are financing so many deals that they're driving down yields on telco projects. "There's an abundance of venture capital bidding up acquisition prices," says Linda Neaman, senior vice president and head of Bank of America's telecommunication-facility finance unit in Westwood. That, she adds, "ultimately leads to reduced yields and profitability."

Indeed, the flurry of activity does have some investors warning of overbuilding. While telco hotels can be lucrative, the risks are also high. These projects carry tens of millions of dollars in capital costs, such as adding bigger power supplies and stronger floors for heavy equipment. What's more, some tenants are start-ups with no track records, and if they drop out and developers can't find other telecommunications tenants, the developers are sunk because traditional office tenants won't pay premium prices for those specialized improvements.

Jeff Markley, partner in Markley Stearns Inc., a Los Angeles-based real-estate services firm that has specialized in telecommunications for more than a decade, likens the frenzy to the dot-com craze. "There are a lot of people rushing in and trying to make anything work," Mr. Markley says. "I think a lot of people will fail."