Investors Go Prospecting In Sale by Golden State

California Gov. Arnold Schwarzenegger is set to find out Wednesday whether the ambitious price the state put on a portfolio of two dozen office buildings is realistic or California dreaming.

The state is hoping dozens of investors will bid on the closely watched portfolio—which includes the San Francisco Civic Center and the Junipero Serra state building in Los Angeles—driving the value of the deal to more than $2 billion including debt. That would net as much as $1 billion for the state after it pays off the debt on the property, which is in the form of bonds.

The state originally hoped to net about $660 million from the sale. Officials are hoping for more thanks to the strong investor interest and because the cost of retiring the bonds could be less than projected, according to people familiar with the transaction.

But some real-estate investors who have looked at the properties predict California will have trouble hitting its price for the portfolio, which includes some 7.3 million square feet of office space in Los Angeles, San Francisco, Sacramento, Oakland and Santa Rosa.

The state's plan is to lease back the back the buildings from the buyer for 20 years at rents that would produce roughly a 7% return for an investor who paid $2.1 billion for the portfolio. "We're hoping that the low risk of the state buildings and guaranteed tenancy" will drive up the price, says Jeffrey Young, a spokesman for the California Department of General Services, charged with managing California's massive real-estate holdings. "We know it's aggressive and unprecedented, but these are unprecedented buildings."

California's financial crunch might turn off some prospective bidders, however. Many landlords look favorably on large, creditworthy tenants who will sign long-term leases, because the guaranteed income stream lowers their future risks. But California's credit took a hit over the summer when state leaders failed to agree on budget solutions and California began issuing individual registered warrants—essentially IOUs—to pay its bills. Fitch Ratings has an A-minus credit rating on California, the lowest rating for any state in the country.

Also, unlike most sale-lease-backs, the new owner or owners would provide trash, security and other property-management services to the state. It is more typical for tenants to take on all operating costs in sale-lease-back transactions, and that can cut into profits for the building owner. That's because the owner will be on the hook to pay the costs of those services, which are likely to rise, says Gordon DuGan, chief executive of W. P. Carey & Co., a New York company that specializes in sale-lease-backs. Mr. DuGan says his firm is planning to put in a bid on part of the portfolio.

Investors could get the same 7% return by buying California municipal bonds, without taking on the expense risk.

At the same time, the state's sale-lease-back plan and aggressive pricing will likely cut out the many private firms and REITs that are scouting the commercial-real-estate market for distressed properties they can add value to by leasing up and the selling off at a profit in a few years. Shooting for a price of more than $2 billion "sounds aggressive," says Mr. DuGan. "It will be a real test of the commercial-real-estate market."

Already, some of the roughly 450 registered bidders have decided to pass, according to people familiar with the transaction. Among them is privately held Beacon Capital Partners of Boston. The company passed on the cluster of properties after determining that they didn't fit its strategy, according to people familiar with the deal. The portfolio's many Sacramento buildings don't match up with Beacon's typical focus on larger cities. While the state has expressed a willingness to consider individual property sales, some bidders expect the state to give preference to buyers interested in the full portfolio.

Mr. DuGan says many more investors would be attracted to the deal if the yield was closer to 9%. But that wouldn't likely be accepted by the state, as it would reduce the price to the $1.6 billion range, and the net proceeds would likely be in the $500 million range.

There is of course the possibility no deal will get done at all. Political controversy will likely put pressure on the state to walk away from negotiations rather than accept bargain-basement offers.

Jerry B. Epstein, a longtime member of the Los Angeles State Building Authority, which must approve the payoff of the bonds, said in an interview that he was fired last month after he asked for a market study that would compare the cost of renting the buildings with keeping them.

In an interview, the California Department of General Services' Mr. Young said that Ron Diedrich, the acting director of the department, found replacements for Mr. Epstein and another member of the authority—along with two members of a similar authority in San Francisco—because Mr. Diedrich was looking for members more aligned with new state initiatives that are shifting away from owning real estate. But Mr. Epstein says the timing of the sale amid the distressed real-estate market makes no sense. "This is a gift to the developers, who are going to get this at a fire sale," says Mr. Epstein.

Write to Maura Webber Sadovi at maura.sadovi@wsj.com