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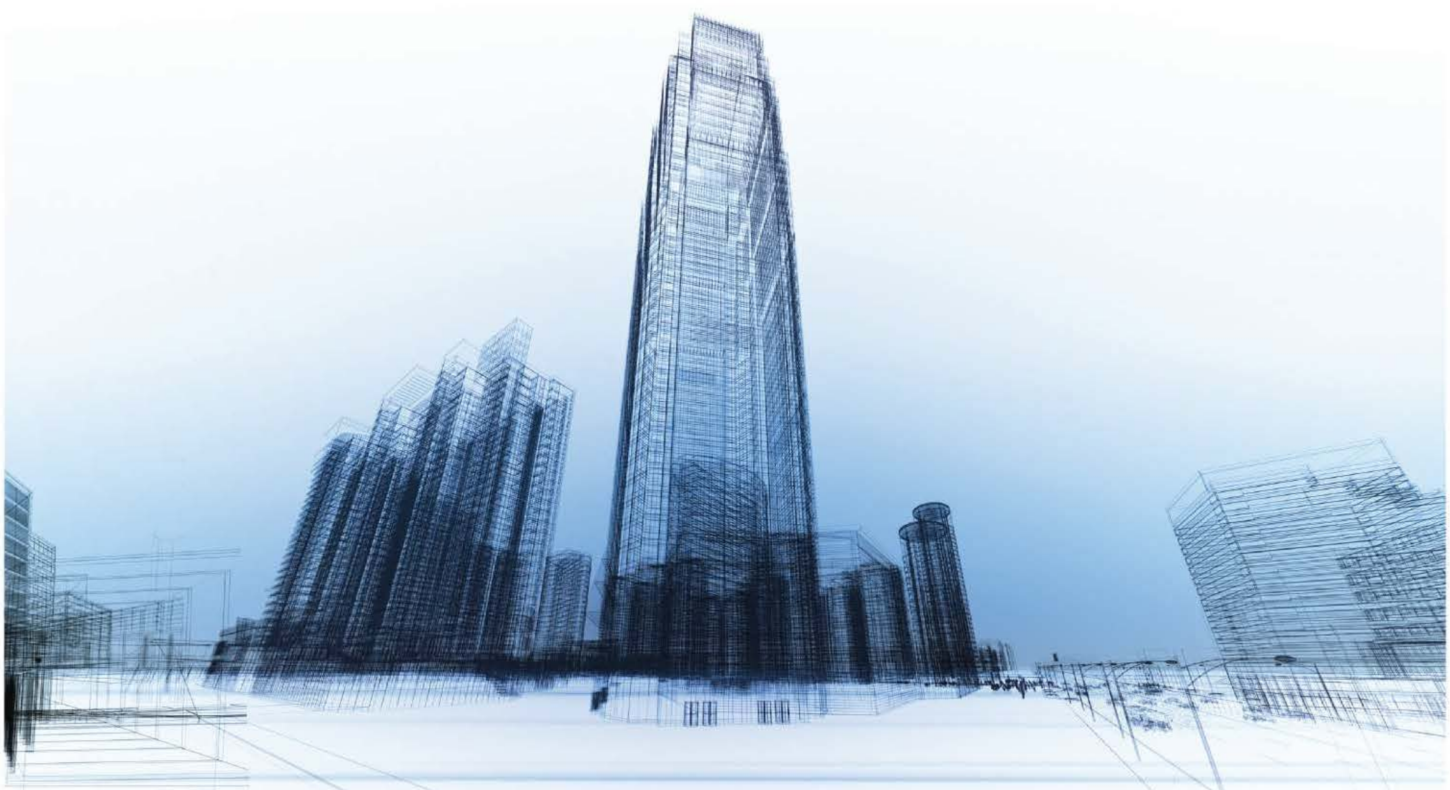

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Presto chango

Converting office buildings to multifamily communities

by Sheila Hopkins

The office sector is struggling. The overall vacancy rate increased by 30 basis points to 17.3 percent in fourth quarter 2022, reaching a 30-year high, according to CBRE Econometric Advisors. With unemployment standing at a near record low of 3.4 percent, the prospect of finding people to fill those empty buildings — at least the older ones — appears bleak.

At the same time, the United States has fallen 3.8 million units short of meeting housing needs, according to a study by the nonprofit research group Up for Growth. This has resulted in record-low apartment vacancies and sustained, elevated rent growth.

Looking at these two sets of statistics, it's not surprising that more than one developer has said, "I have the solution. Just turn those underutilized office buildings into residential buildings. Problem solved!"

If only it was that easy

Executing a successful conversion is difficult. Whether it involves financing, engineering, zoning, architectural configuration, getting the neighbors or a local historical committee on board, or simply attractiveness to tenants, each building is unique.

"Our research demonstrates that there's no 'cookie-cutter' formula for executing a successful

project," says Anita Kramer, senior vice president of the ULI Center for Real Estate Economics and Capital Markets.

Yet, despite the fact that developers need to come up with solutions specific to each building, the challenges facing those attempting an office-to-residential conversion are remarkably similar.

One among many

At this stage of the real estate cycle, there is no lack of office stock available for conversion. Thus, the challenge isn't finding an underutilized or vacant building; it's choosing the one that works best for residential, for the skillset of the team you have assembled, and for the goals of your investors. So, what do developers look for?

"First and most importantly is acquisition cost per foot," explains David Zucker, co-founder of Zocalo Development. "This is fundamentally the biggest issue. The number of unforeseen conditions both inside the building and impacting the building from the city's or county's policies and laws require these first-mover projects to be acquired in the range of $75 to $90 per building foot — in Zocalo's analysis and depending on the market — though many variables impact this figure."

If the price is right — and the bargain valuations now being posted for some very attractive buildings makes that more likely than we've seen in decades — the developer begins to analyze the bones of the building. Office buildings can have deep, dark cores and centralized elevators, plumbing and other services. Apartment buildings are dispersed, with multiple access points, windows and individual plumbing and utility hook ups. Changing from office to residential takes a lot more than just putting apartment numbers on doors.

"Ease of conversion is a vital factor in making the numbers work," continues Zucker. "For example, it is usually easier to convert a steel frame building versus a concrete frame asset. Post-tensioned office buildings will be problematic due to required floor penetrations. If the floorplate is too deep, an atrium will need to be cut through the floors to provide natural light to interior apartments. This has its limits since an atrium may not be viable over a certain number of floors. We'll need to look at what systems need to be upgraded to meet residential code and how much that will cost. Finally, you need to think residential versus office tenant suitability, such as where do residents walk dogs. Each building brings its own set of advantages and challenges."

Determining cost basis isn't just looking at current valuation, debt costs and fees. It can be manipulated a bit to take into account other factors that might not be available to ground-up developers. For example, conversion developers will often look at what type of upgrades would be needed for the building if it remained an office asset. The cost of these upgrades is akin to sunk costs — the conversion isn't adding any additional costs that wouldn't be required anyway.

"Over the next decades, we will require a capital investment to achieve lower carbon emissions for existing building stock," says Daniel Colombini, principal at Goldman Copeland Associates. "When considering a conversion of an existing office building to another use, part of the economics of that deal could involve incorporating capital improvement investment that would have to be made anyway as part of remaining office."

After working out the cost basis, the acquirer needs to figure out how that will be paid for. Knowing the prevailing rents in the area — where they are today and where they are expected to be tomorrow — is crucial. Understanding the area demographics — Is the city growing? What types of tenants will the building attract? — comes into play. Can the city or county help? Some states, such as Ohio, have passed tax credits to encourage these types of housing conversions.

"You need the right attributes," says Alfonso Munk, CIO of Americas at Hines. "Location, of course, is important. But so is the community — and Hines prioritizes the placemaking perspective. Do tenants want to live in the area? Are there transportation routes, retail stores, work and entertainment venues nearby? Then you need to look at the bones of the building. It is often easier to demolish the interior of the building and start fresh. To get it right, you need experienced top-notch architects, engineers and construction teams."

In addition to working with the physical building, developers need to work with the city and community, as well. Converting an office building to a residential building may require rezoning, which can be a lengthy and difficult process. Local zoning laws may also place restrictions on the number of units or residents allowed in a building, which can limit the potential profitability of the project. In addition, many of these buildings are older. If they are in a historic district, you now have to deal with the historic commissions.

"Communities are generally supportive of these conversions," says Munk. "They don't want half-occupied, older, office buildings taking up space. The municipality much prefers an occupied, tax-generating building. Besides taxes, residential buildings can also generate ancillary revenues, as restaurants, retail and services that grow up around the residential property and further enhance the community."

Although it often appears from the outside that zoning changes make sense, when you get multiple stakeholders involved, decisions can be complicated. Where the building is located — city or suburb — how it fits in the community — historic or relatively new — and how additional residents will impact the community — schools, parking, noise, etc. — can make a huge difference in how easy it is to rezone.

"These are complicated decisions on both the private real estate side, but also for the city," says Colombini. "The goal is to find the best balance because there is no perfect solution."

With all of these factors and complexities, even the most attractive deal can fall apart at any time.

"Of all the office buildings that we look at, typically, less than 1 percent are suitable for conversion, mainly because of how technically complex and difficult conversions are," says Munk. "It is important to have a strong due-diligence process for these types of investments to ensure the numbers make sense and is the right opportunity for all stakeholders."

The ESG factor

Despite the challenges, office conversions are attracting attention. Not only can they be lucrative if all the stars align, but they can be part of the solution to both excess office stock and a dearth of housing stock, which is a social good in and of itself.

Despite the challenges, office conversions are attracting attention. Not only can they be lucrative if all the stars align, but they can be part of the solution to both excess office stock and a dearth of housing stock, which is a social good in and of itself.

"Converting office buildings to residential is not a silver bullet, but it could be an important part of the solution to the housing crisis by just increasing the rate of housing production, which is the most important thing that we, as an industry, could do to mitigate the affordability crisis," explains Adam Ducker, CEO of RCLCO.

The ESG impact of these conversions can tip the scales in favor of going forward with a project if there is some uncertainty. Nearly every firm has ESG metrics. Investors are requesting them, and municipalities are often requiring them.

"These tired assets can be reused and repurposed in a way that serves today's market needs," says Colombini. "At the end of the day, all of this revolves around existing assets that are trying to find ways to adapt to the current market and what our society's current needs are. Before we put up new buildings all over the place, I hope we can reuse what we have and take the best advantage of that."

And the simple fact that these assets are reusing space rather than using new concrete and steel — two of the largest contributors to carbon emissions — moves it into a true ESG category.

"Fundamentally, harnessing the embodied energy by building reuse is the most central of all sustainability tenets," says Zucker. "So, the fact that we're reusing the building is more sustainable than new construction, even if that new construction has features that are considered more environmentally efficient."

Uncertainty ahead

Over the years, the conversion of older and less competitive office buildings to other uses has become increasingly attractive. However, despite the growing interest, completed projects have not significantly increased since the pandemic. According to CBRE, an average of 39 office conversions were completed annually between 2017 and 2021. As of the end of 2022, this number had only increased to 63 completed office conversions, with 196 others either under way or planned. It is important to note that these conversions encompassed all real estate sectors, not just residential.

While office conversions offer some relief to older buildings, they alone cannot significantly decrease the surplus office supply nor improve housing availability. Even if all planned office conversions are completed, along with those completed since 2016, only 91.1 million square feet would be removed from the market, accounting for just 2 percent of the total U.S. office inventory.

"This is just a drop in the bucket," says Jessica Morin, head of U.S. office research at CBRE. "It's less than 2 percent of the entire U.S. office inventory. So, it's not market moving, and it's not, so far at the pace we're seeing, a solution for getting rid of this glut of outdated office space."

Much of this slow uptake can likely be attributed to the lack of best practices and a steep learning curve. "As an industry, we don't have the technical knowledge yet," says Ducker. "It's hard to find the architects and engineers who know how to do it. My hope and expectation are that we will gain this knowledge. But today we're very much in the infancy as an industry and understanding how to do this."

If these early conversions prove profitable, investors and developers both will be giving the process a closer look. It's not easy to do good while achieving market-rate returns. Office conversions might just be the answer to more than just housing. ❖

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