Colliers Capital Markets

Do Office Conversions Work?

AUGUST 2023

Office conversions have emerged as a hot topic in commercial real estate. With the stalled out return to office and surplus of vacant office space, conversions seem to be the logical next step. But what will these buildings become? And are the economics viable? Every city and every building have a unique set of challenges. For conversions to work, the right incentives must be in place. And all fingers point to changes in public policy. Colliers Capital Markets Director of Research Aaron Jodka sat down with Colliers Capital Markets office expert Frank Petz and distinguished architect Maren Reepmeyer of SGA to discuss the challenges facing today's office market and where things need to go from here.

Jodka: We're seeing a recalibration of office market fundamentals. The return to office has clearly changed the way we occupy office space. Hybrid work environments shot U.S. vacancy rates to all-time highs at midyear.

Rents have generally held, but effective rents are down due to an increase in concessions. Demand for Class A—particularly trophy properties—continues to be very strong. I heard anecdotally that 90% of tenants are looking for 10% of the buildings. So, where does this leave the rest of them? To me, that's the looming question right now: What will become of all the vacant office space? What are you seeing on the conversion front?

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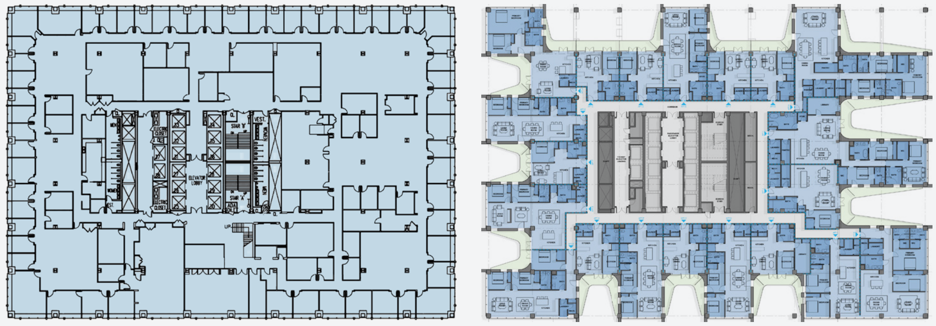
1633 Broadway, New York, New York



SGA conceptualized creative and unique solutions for a residential conversion of a 1972 tower in Manhattan. Proposed strategies maximized light and air, with increased density to offset the costs of conversion.

Reepmeyer: In urban markets, most of the interest lies in residential. We are seeing some different uses such as life sciences, higher education, and hospitality emerge; but largely the conversation revolves around residential in downtown CBDs. Part of this stems from government agencies and jurisdictions looking to solve the housing crisis while bringing vibrancy and occupancy to vacant office buildings. This solution is particularly enticing because it brings activation to the urban core which is a big win when it comes to ensuring the enduring vitality of our cities. Two birds with one stone, if you will. It seems like a simple enough solution—converting office buildings into residential—however, effective execution requires complex decisions and careful attention must be paid to the project's budget.

Change of use is rarely easy, but there are a particular set of challenges that comes with office-to-residential conversions. Mid-rise, Class B buildings may require less work from a structural and infrastructural standpoint if the geometry and cores are right-sized but larger, high-rise buildings can be a different story, especially those constructed post 1970 with larger floorplates and non-operable windows. Bringing light and air deep into those floorplates can drive costs exponentially. It's often a density play in the form of a vertical addition that makes these projects viable.

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Petz: Assuming all the structural elements can be met, there's still a broad \$450-\$650 per square foot price range for a conversion, depending on the extent of renovation necessary.

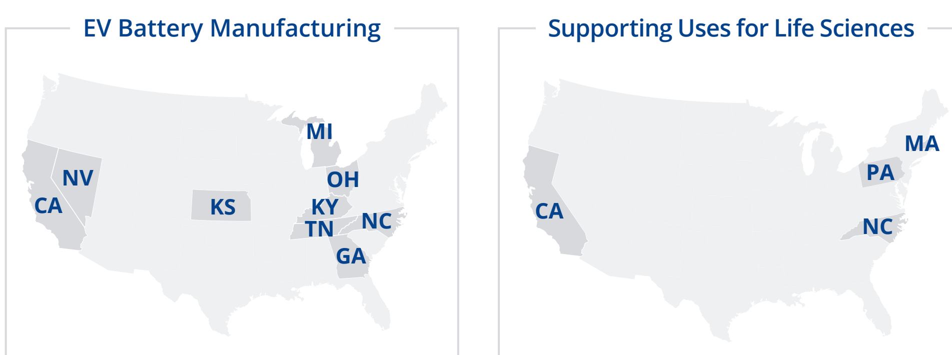
This makes many conversions economically infeasible when we look at the building's cost versus value. We're starting to see pricing for Class B urban product in major cities like San Francisco and Boston dip in the \$100-\$150 per square foot range, maybe even \$200 per square foot. At these numbers a conversion starts to make sense. But we're still talking about all-in costs which total somewhere around \$550-\$850 per square foot. Residential values in Boston are roughly \$500-\$600 per square foot. So, when we sell the actual asset, there's no margin at those costs. Obviously, we need more than just economics to have conversions to residential work.

Jodka: Outside of residential, what types of conversions are you seeing? Self-storage, for example, is starting to gain some traction. Is this something we can expect to start seeing in downtown CBDs? What else might these office buildings become in the future?

Petz: I don't know how many self-storage facilities we can have in downtown, but certainly it's a lower cost conversion. So yes, some of the buildings that don't work for residential could potentially be used for self-storage. You don't have to worry about window lines and there are more variables to work with. Hotels are obvious considerations for the right locations, but these are further stretches.

What will probably be more popular after residential or self-storage is demolition of some of the outdated office buildings serving beyond their useful life. And with demolition, new residential development will benefit from better zoning, higher densities, and quicker approval processes. In New York, they're tearing some buildings down but they're going up 60 stories, creating density. Boston is considering increasing density, three- maybe four-fold, which is huge, so we also need to start thinking about the associated land values.

Jodka: Let's shift to suburban for a minute, since suburban markets have other demand drivers. Tough tech, for example, has been a topic of conversation lately with Georgia, Kentucky, and Michigan projected to dominate U.S. electric vehicle battery manufacturing in the next decade. States like Kansas, North Carolina, Ohio, and Tennessee will also emerge as leaders in new energy. Maren, what other conversions are you seeing in suburban locations?



Sources: Colliers, U.S. Department of Energy, Argonne National Lab

Reepmeyer: It's more of a mixed bag in the suburbs. In places like Boston and Denver, there's more interest in life sciences, tech, R&D, industrial, and auxiliary spaces supporting science, research, and manufacturing. Given rapid advancements in technology and the demand for more sustainable products and systems, we're seeing a variety of tech categories—each with a unique set of design and infrastructure parameters. Depending on these requirements, conversions sometimes come with a high price tag associated with mechanical and electrical upgrades. On the flip side, a substantial amount of suburban inventory is well-suited for these types of conversions given their high bays and long spans from a structural perspective.

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This infrastructure is also suitable for use types related to storage and distribution such as warehouse and last-mile facilities which are typologies people are also seeking in suburban markets. We're seeing very few residential conversions—It's less of a market driver than in the urban core where there's more demand, though values are lower from a basis point perspective and there is more space to work with.

Jodka: In regard to needing more than economics for residential conversions, for example, to pencil out, what can the local municipality do to advocate for development and conversion?

Petz: Well, a public policy decision must be made around housing and affordability. And affordability puts even more pressure on economics. The first thing local municipalities can offer is tax abatement. Second, is financing support, especially in today's market where bank lending has tightened dramatically. We also need accelerated permitting and broader zoning. We'll have to keep an eye out for costs down the road, specifically around commitments cities have made to carbon neutrality because of its burden on Class B buildings. It's a long list, but it's all necessary for the economics to make sense.

1633 Broadway - New York, NY - Urban Highrise Conversion
SGA conceptualized creative and unique solutions for a residential conversion of a 1972 tower in Manhattan. Proposed strategies maximized light and air, with increased density to offset the costs of conversion.

Jodka: When we're talking policy changes, what's the timeline? How long before we see the results of governments taking action?

Petz: To get the results needed, policy changes must be abrupt and clearly defined. Whatever tools are at their disposal, they must be put in place immediately and they must be the best. If we dribble policy out inch by inch, we won't get anywhere in the long run. The current office market has deep repercussions to tax revenues within cities and therefore cities must act. They can't afford to let our office stock slip away.

Reepmeyer: Many cities are already implementing changes such as re-zoning to allow more height and density, introducing expedited permitting processes, and offering tax and other financial incentives. These policies are specifically designed to kick-start more of these projects .

For instance, Boston has just unveiled plans to implement a pilot program that would reduce tax burdens by 75% over a 29-year period, for office properties converting to residential use, if they meet certain criteria and timelines. This action is following the lead of other cities such as Chicago and New York that have implemented similar development-promoting programs and modified zoning. We'll see an influx of conversions nationwide in coming years as we start to see meaningful policy changes driving worthwhile returns on investments.

18–22%

Office represents 18% of San Francisco's property tax revenue, according to The San Francisco Standard. Bisnow reports its closer to 22% in Boston.

Municipalities Considering Density, Tax Incentives, or Other Policy Changes

- Atlanta
- Boise
- Boston
- Chicago
- Los Angeles
- New York
- Newark
- Pittsburgh
- Portland
- Salt Lake City
- San Diego
- San Francisco
- St. Petersburg
- Washington, D.C.

Jodka: So, in terms of the future, where do we go from here? Record amounts of capital are sitting on the sideline. Investors are holding out for the value-add opportunities that are emerging—whether that's keeping office at a new low basis, a conversion, or a reimagination of our downtown and suburban markets.

Reepmeyer: Even in the midst of a shifting CRE landscape, there will always be a need for commercial office space, and the flight-to-quality will continue as long as supply outweighs demand in the commercial office sector.

Companies that will continue to thrive are those with bold future-forward thinking and a willingness to adapt. Many are taking advantage of market conditions by seizing this opportunity to improve their corporate footprint, promote culture, and

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prioritize the human experience as it relates to their organization. This shift includes upgraded user-focused working environments, access to vibrant sought-after amenities, and a new-found focus on collaboration and community-building.

It’s interesting that these attributes are not unlike the placemaking and activation that are so strongly desired at city and neighborhood scales. In general, we’re seeing a renewed focus on the human experience, which is beneficial at all scales - macro to micro. Cities will be shaped by a dynamic and diverse blend of hybrid mixed-uses within our urban cores. This all leads to active city streets and thriving communities. These spaces will be flexible and can adapt to changing ways of living, working, and connecting.

Petz: Right, and it’s important to note that all office is not dead. Office isn’t going away. Yes, there are select buildings that won’t make it. And yes, there will be less demand and we’ll have to pare down some office supply. But there are a significant number of office buildings in our cities that will be viable. The majority will be necessary.

And it’s also worth noting that some cities are even seeing a renewed interest in office. There’s been talk around the advancement and momentum of AI luring people back to San Francisco. The highly skilled technical workforce which previously fled is starting to see an opportunity to make money again. So, we may start seeing this population pulled back into the city which is good news for office. This isn’t the end of office. This is merely a survival of the fittest.

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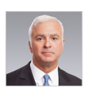
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SGA is a national, multi-disciplinary firm whose work spans architecture, interior design and master planning for life sciences, academic, multi-family, mixed-use and commercial clients. With offices in Boston and New York City, the firm has a team of over 130 professionals who strive to create meaningful experiences through great design. The firm consistently delivers sustainable, state-of-the-art facilities and dynamic, flexible spaces for its clients that foster collaboration and breed innovation. Through its virtual design and construction practice and proprietary SGA Dashboard, the firm is redefining how buildings and campuses are visualized and delivered, creating a highly collaborative design approach and seamless integration of the design, development and construction process.

Office Conversion Compatibility Chart