COSTAR INSIGHT

Office-to-Residential Conversions Could Require Leap of Faith — and Government Help

For Cities Facing a Housing Shortage, the Logic Is Sound, but Barriers Are Real

The Fisher Building at 343 S. Dearborn St. in Chicago spent the first century of its life as an office building before being converted to apartments in the early 2000s. (CoStar)

By Jay Lybik and Phil Mobley
CoStar Analytics

June 21, 2023 | 4:19 P.M.

For many Americans, the cost of housing can feel exorbitant, especially in some major metropolitan areas. Though growth in home prices and residential rents has leveled off since a mid-pandemic run-up, there is still a shortage of housing — and especially affordable housing — to accommodate the generation of young adults who are now ready to form new households.

Coinciding with this lack of affordable housing is record-high office vacancy, the result of a pandemic-driven demand shock that has left some offices in a near-existential crisis. Facing the possibility of the large-scale functional obsolescence of office buildings, a number of owners, city leaders and real estate industry professionals have put forth the notion of converting under-utilized offices into apartments.

On its face, the idea has obvious merit. But digging deeper into the details of past successful conversions shows that the rigid requirements that make such adaptive reuse financially feasible are likely to limit the scale of future conversion activity.

Developers with experience in conversions emphasize three factors that stand out in making an office a viable candidate for conversion: location, floorplate size and cost. Beyond these, there are also political considerations that can affect the feasibility of conversions.

RELATED CONTENT

The Path for Converting Office to Residential Is Narrow > >

As is always the case with real estate, everything starts with location. The cost of converting office buildings for residential use will be explored in more detail below, but industry practitioners say that the cost of conversions averages about 20% more than ground-up development. Given this, the premium rents that go with a truly irreplaceable location are crucial for a financially successful conversion.

It is also worth noting that multifamily converters compete with hotel developers for ideal sites. Over the past five years, CoStar has tracked 20 major office-to-hotel conversions across major central business districts.

Shape Considerations

A building's physical characteristics is the next consideration. At the most basic level, apartment buildings require a shorter distance from the center to the exterior walls than do offices. This is to accommodate access to windows and emergency egress, as well as to maximize the possibility of using existing elevators, staircases, plumbing, HVAC and other building systems.

This physical feasibility can be approximated by the size and shape of the building's floorplate, or footprint. Historically, office buildings that have worked best for conversions are rectangular, with floorplates ranging from 8,000 to 12,000 square feet.

It should be noted, however, that buildings with larger overall floorplates can still be good candidates if they are shaped like a capital "H," "I" or "L."

Age comes into play as well. Older buildings tend to work better, in part because they typically have smaller footprints. A CoStar examination of 34 office-to-multifamily conversions across the nation showed an average age of 93 years old.

Contemporary conversions aren't that different. Of the almost 30 conversion projects currently underway, the average age is 65 years.

Once a building clears the physical hurdles necessary for conversion, it must then meet financial conditions that will allow it to perform as a multifamily property. This implies that its current performance as an office will be poor enough that the prospective acquisition cost basis will allow for the necessary renovations to be performed and still have a cost-competitive multifamily property.

Hard Costs

A recent study by the Urban Land Institute evaluated about 20 recent office-to-multifamily conversions deemed successful by the principals involved. An analysis of these projects shows the typical hard costs of retrofitting a building range from $250,000 to $300,000 per unit.

With the current average market price of a multifamily property at just under $250,000, it is apparent that meeting the financial feasibility test will not be easy for most office buildings.

Real-world examples illustrate the practical difficulty in achieving financial feasibility. At the National Apartment Association's recent Apartmentalize conference, a converted office building in downtown Wilmington, Delaware, penciled out only because the developer was able to acquire it for just $7 per square foot. Another developer at the conference said his firm targets an acquisition cost no higher than $35 per square foot, or approximately $35,000 per unit.

Even with the current softness of the office market, public incentives would likely be necessary to get most potential office conversion projects off the ground. One way local governments could support conversions and increase the housing supply would be to deploy tax incentives to increase the financial feasibility of some projects.

City leaders in several U.S. cities have held discussions of such incentives, and outside of the U.S., cities such as Calgary have demonstrated success.

But these public initiatives can be politically fraught. The example of New York is instructive. After discussions of public incentives to support conversions, the city, so far, has merely instituted the Manhattan Commercial Revitalization Program, which provides tax relief for certain office buildings that invest in upgrades — but still function as offices.

These on-the-ground physical, financial and political realities mean that the actual number of suitable candidates for office-to-residential conversion is likely much lower than some optimistic projections suggest.