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Once a Strong Bet, Renovating Offices Now Looks Riskier

Benefits of Overhauled Offices Often Fleeting As Tenant Space Needs Change

Atlanta's iconic King and Queen buildings at Concourse Parkway in the Central Perimeter area were renovated since 2020, helping to secure a new headquarters lease from Newell Brands. (CoStar)

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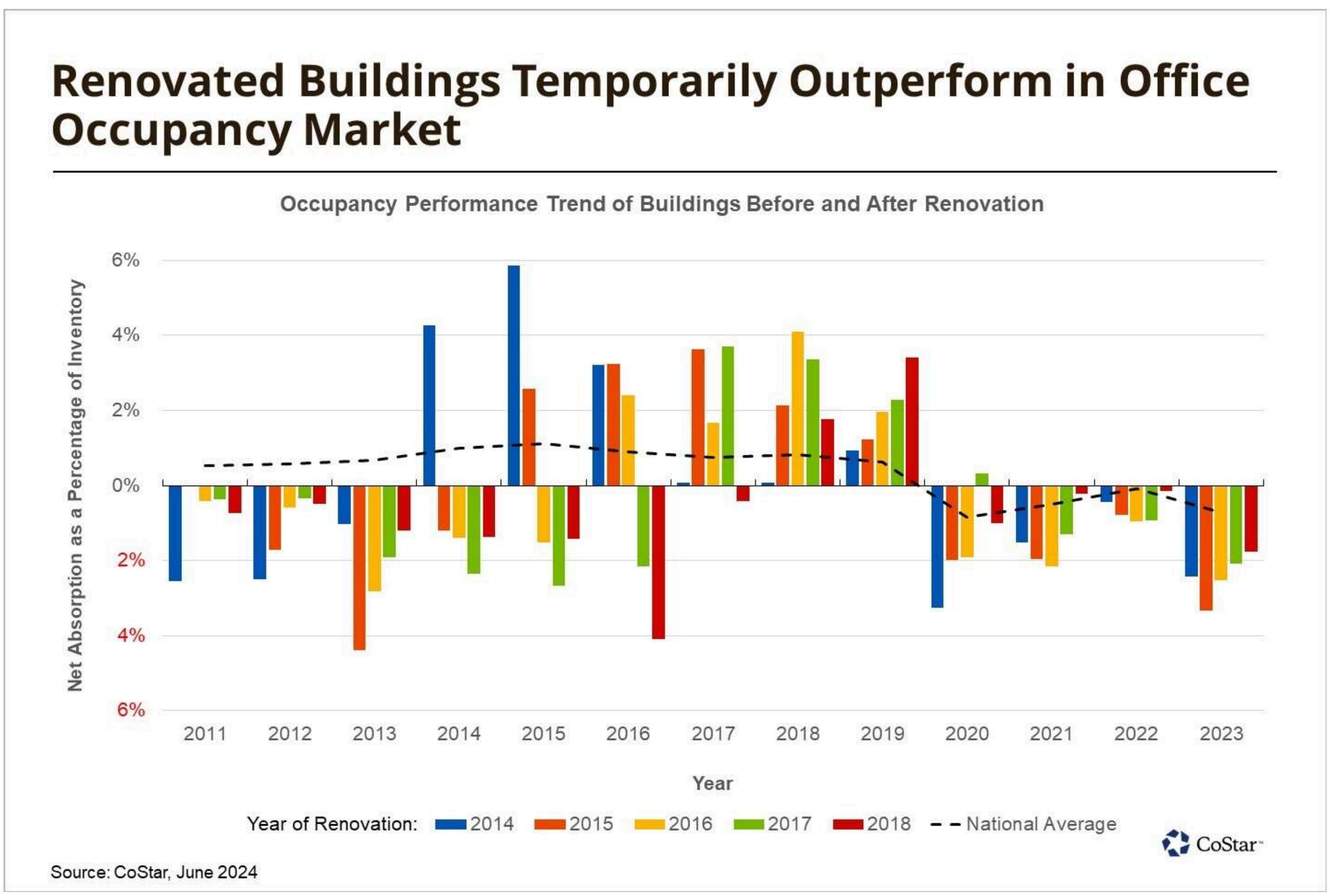
Renovating older office buildings is a time-honored strategy for maintaining occupancy. Despite this track record, however, recent history suggests that a future payoff for this approach is far from certain.

The U.S. office market is now in its fifth year of adjustment to the demand shock catalyzed by the COVID-19 pandemic. Amid the general malaise, the passage of this time has brought a degree of clarity about what current occupiers still value. Dated office buildings in major markets, including the four-star properties sometimes termed "commodity Class A" have tended to lose the most occupancy and have struggled to fill space when tenants move out.

Owners of such buildings face a dilemma. On the one hand, these buildings lack the fit, finish and amenities to compete for top-tier office tenants. A renovation would thus seem to be in order. On the other hand, however, there is no guarantee that even a significant capital investment will make these buildings truly competitive. The recent performance of renovated buildings shows that, while the rewards are real, they tend to be temporary. Furthermore, the benefits in terms of return on investment may have diminished relative to what landlords once achieved.

Unsurprisingly, office buildings often perform relatively poorly in the years leading up to renovation. The mediocre performance itself signals to building owners that the time for an upgrade may have arrived. Beyond this, much occupancy loss associated with renovations is intentional as tenants temporarily relocate to enable construction.



This pattern is evident in analyzing historical net absorption, defined as the net change in occupancy, that occurred in office buildings renovated between 2014 and 2018. These buildings saw negative average annual absorption of about 2.5% in the four years leading up to their renovation. This performance trailed the overall office market, which generally saw positive annual absorption of about 1% of inventory during this time.

Once renovated, these buildings outperformed the market substantially. They had annual positive absorption of about 3% of inventory for the four or five years immediately following renovation, far above the national average.

They did not gain a competitive advantage for long, however. When the pandemic-related downturn hit in 2020, they almost universally experienced occupancy losses greater than the national average. The pattern has persisted through the first few years of the decade, with buildings renovated in the mid-2010s consistently suffering disproportionate negative absorption.

The demand environment that has prevailed for the past few years helps explain this phenomenon. Office tenants have taken less space than they once did, often shrinking their footprints when relocating or consolidating locations. They have also gravitated toward new buildings, often securing big landlord contributions to build out premium, bespoke workplaces.

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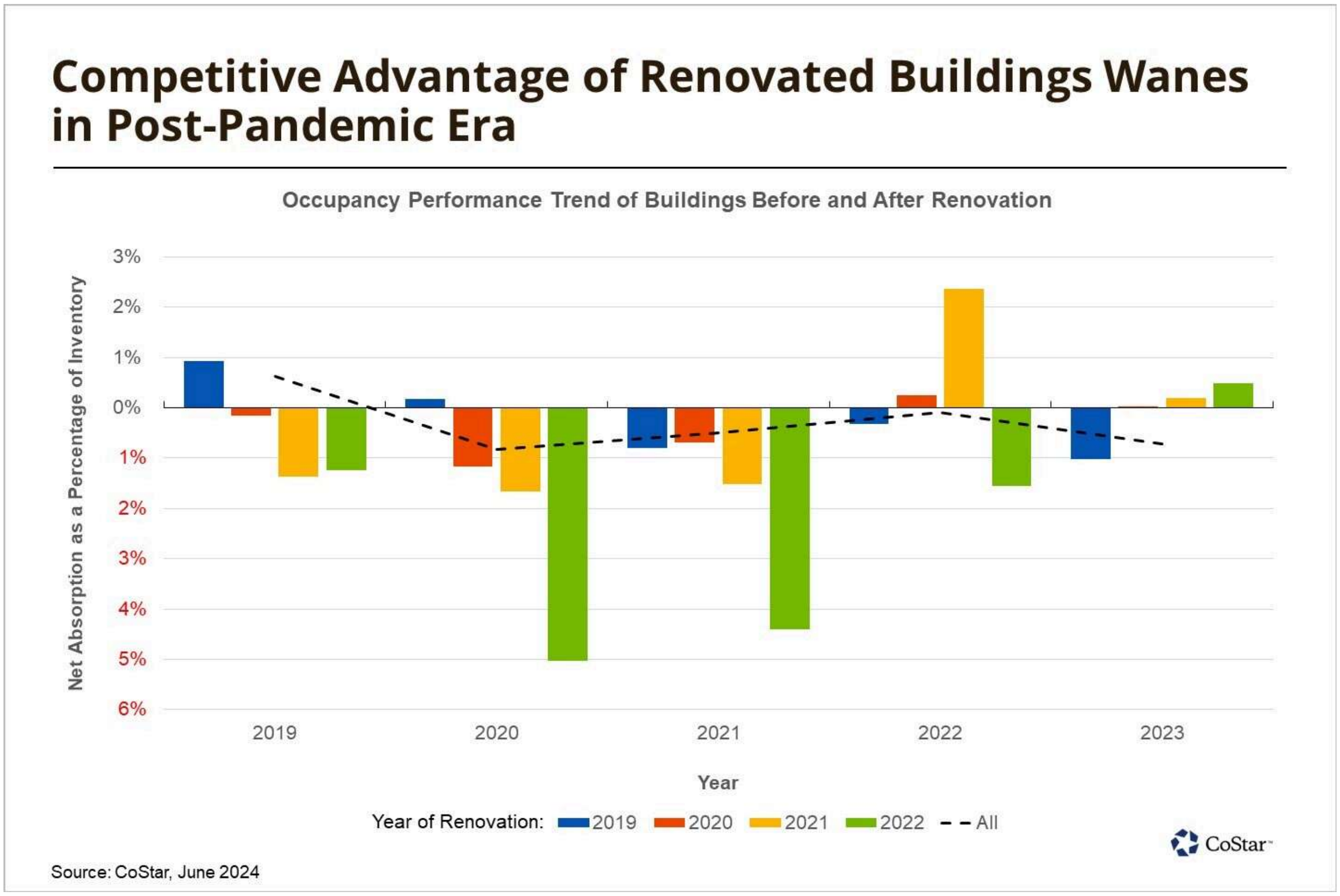
Meanwhile, the owners of renovated buildings spent heavily to execute their upgrades. Those costs must be paid for through higher rents, making it difficult for owners to maintain occupancy by lowering rates.



Though there is less data available on buildings renovated in the past five years, the preliminary evidence adds to the murkiness for landlords mulling future renovations. It is difficult to see a clear trend of outperformance in buildings renovated since 2019, though it does appear that they saw positive demand in 2023.

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These buildings also face the same challenges as their previously-renovated peers. The completion of upgrades in these buildings coincided with changing tenant space needs, and they also have little flexibility to lower rents to attract occupancy.

As long as there is new office space to be had, which won't be forever, these newly renovated office buildings could struggle to compete for tenants.

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