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INSIGHT

Sitting Pretty, and Mostly Vacant - Office Conversion to Housing

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As COVID-19 persists, and remote or hybrid work further cements itself as a preferred working style for white-collar employees, office building owners continue to endure largely empty buildings. Vacancy rates recently hit a 30 year high, especially for office buildings in downtown locations. The forecast seems even more bleak, with a poll from marketing research firm Gallup, from late last year indicating 37% of workers never intend to[1] return to the office. These realities of the struggling office market are reflected throughout the United States, with the top ten markets experiencing office vacancies ranging from 10.6% in Philadelphia to as high as 25.5% in Dallas. Downtown Portland is currently reporting office vacancy in excess of 26%. City governments are also impacted by the rise in vacancy rates over the past two years; one study reported that jurisdictions are seeing losses of 5% to 7% in tax revenue.

With the impacts to building owner's bottom lines, cities' yearly budgets, as well as the declining quality of downtown areas — amid the ever-growing housing crisis — some are calling for repositioning office space for residential uses. And developers are listening, with more new offices throughout the United States slated for conversion to residential uses. However, repositioning office buildings is difficult and expensive, even for building types that are prime candidates for conversion.

CONVERTING OFFICES: OPPORTUNITIES AND CHALLENGES

Modifying under or unused office space into housing could help mitigate a problem facing millions of renters: landing an apartment can be difficult, and affording one is even more challenging. A 2021 study in Los Angeles found that converting underutilized hotels and offices could provide upwards of 17,000 new residential units. And as the national average cost of a typical apartment rises to $1,659 per month and the national average home value hits over $428,700, the hope is that creating more units could help stabilize housing prices. However, the ability to convert existing office buildings into residential buildings is not only technically challenging but also financially difficult.

The hurdles for converting existing office buildings to residential range widely, but the most fundamental challenge is the building footprint. Residential buildings are typically required by jurisdictions to have access to natural light and ventilation. Because of this, residential units require greater exterior exposure than offices. Additionally, the amount of light able to penetrate a residential unit further limits the depth of the building's floorplate. A 2021 UC Berkeley study found that residential buildings typically had a depth of 25 to 30 feet from façade to interior corridor, while office buildings had depths of 40 to 50 feet from façade to interior core.6 These 10 to 25 foot differences mean that less light can penetrate the interior of the building, which limits the amount of usable, and thus rentable,

1 That is their intent and preference, but it may not be their reality when the labor market loosens up.

space for residential units. While these interior spaces not compatible with housing units could be used as amenities, they can call to question a projects' financial viability. Even building owners whose office floorplates lend themselves well to residential conversion face more challenges. Buildings most suitable for conversion are often older, Class B and C office buildings, as they are typically already due for improvement. However, their vintage exacerbates the risk of renovations because they were constructed under less stringent building code than current standards. They often require costly upgrades like seismic retrofits, environmental remediation, as well as life safety upgrades. The amount of time and cost associated with these upgrades can significantly increase the costs and schedule of a project. For example, the Brockman Apartments in Los Angeles took over seven years to complete and experienced a budget increase from $16 million to $40 million, ultimately causing the project to go bankrupt.

Even without major code-related improvements to the existing building, converting office buildings to residential include significant upgrades to building infrastructure, as apartments require more kitchens, bathrooms, and the associated plumbing and electrical work that comes with it. The upstart costs to bring an older office building to code compliance and then completely renovate its systems to accommodate a residential use can make the prospect of office conversion appear financially infeasible. However, some developers have and continue to bet on the success of office conversions — if they can find buildings with qualities that make them good candidates.

Global architecture firm Gensler recently studied over 300 office buildings across North America to determine what features position an office building for successful conversion, as described in an interview with Duanne Render, Design Manager and Repositioning and Landlord Services Practice Area Leader of Gensler's Toronto office. Using a proprietary algorithmic software developed by the firm, Gensler evaluated multiple factors such as floor plate, building form, envelope, site context and building services for compatibility with residential conversion. Their research found only about 30% of buildings assessed made suitable candidates for residential conversion. Similar to the UC Berkeley study, Gensler found that deep floor plates, core configuration, and access to the exterior façades were critical in an office building's success as a residential use. They also found that certain features that are often considered unappealing in the office market were positive for residential buildings. "Bad offices make good residential buildings," says Render.

Pointing specifically to Class B and C buildings, Render explains most office buildings built before 1970 typically have lower floor to floor heights, 11 feet on average, which in today's market is considered extremely low for working environments. However, this floor to floor height provides a 9 to 10 foot ceiling in residential buildings, which is much more generous than a new residential tower would typically offer. Additionally, these buildings tend to have shallower floor plates. That is considered inefficient for maximizing office rents but is prime for residential unit layouts. Render also highlights

that buildings of older vintages are already reaching the end of their life and in need of upgrades to major systems in order to compete in today's rental market regardless of their use.

Even beyond specific features beneficial to conversion, Render points out benefits that all office buildings have for their possible conversion. Extra deep floor plates can be planned in a way where amenities are on every floor, making use of the interior areas without access to daylight while also providing competitive, unique offerings to the market. Additionally, residential buildings have lower occupancy loads, resulting in smaller mechanical systems, making more space for roof amenities.Office buildings already have centralized mechanical systems and infrastructure, which is more efficient than decentralized systems typically used in ground up residential buildings. These more efficient mechanical systems, as well as new energy efficient facades bring aging office buildings into a more sustainable future. Moreover, Render states that maintaining an existing structure and foundation significantly reduces a building's carbon footprint when compared to new ground up construction.

Despite the opportunities and possible benefits of converting office buildings, developers still appear to be deterred by the overwhelming cost. Render believes developers should shift their perspective on the opportunities office conversion holds and weigh the risks of waiting for the office market to bounce back. "Yes, it's expensive to convert these buildings, but it's also expensive to hold them with high vacancy rates," says Render of Gensler. "Every [Class B and C] building we evaluated is losing money. The question one has to ask is if the market is going to bounce back, and if it doesn't, how will all that space be absorbed?" Gensler appears to have a positive outlook on the possibilities for converting office buildings considering office buildings' current struggles. In their work for the City of Calgary, evaluating 28 existing office buildings for conversion, the firm identified 10 to 12 viable candidates for conversion. Their study estimated that if all 12 buildings were converted, 2,000 units could be brought to market, potentially housing 4,000 new residents in Calgary's downtown core. Render mentions that Gensler has seen growing interest in their research from developers, especially since the beginning of the pandemic.

And this new interest is seen in recent office conversion announcements across the United States. In June 2020, global real estate investment firm Hines announced the acquisition of South Temple Tower in downtown Salt Lake City, with the intent to convert it to residential. The developer is slated to provide 255 luxury units, ranging from studios to two-bedrooms, in the 217,000 square foot, 24-story office tower. Not only do the building's shape and location meet the requirements set by Hines, they also align with Hines' Environment, Social and Governance (ESG) strategy. Citing the reduction of carbon emissions by limiting the use of new building materials such as concrete, as well as the installation of new efficient mechanical systems, Hines expects South Temple Tower will provide lower operational carbon emissions and an improved lifecycle carbon footprint as compared to a new residential tower.

Hines is not the only developer pursuing conversion of office buildings. Developers in Dallas, New York City, and Washington DC also recently announced their own plans to convert existing office buildings to residential. As developers in major cities move forward with conversions, Portland appears to be lagging behind. Leonard Barrett, Principal of Beam Development, a Portland-based development firm specializing in adaptive reuse, explained his thoughts on the seemingly slow pace of office conversion in Portland: "I think there is this kind of continued hope that the office market is going to come back," says Barrett, continuing to say, "It's a relatively risky bet to convert." Barrett identified challenges developers face right now such as upfront cost, the risk involved in renovating aging buildings, and the availability of land as factors in the lack of office conversion projects in Portland.

Despite being experts in adaptive reuse, Beam has not considered converting to residential. Their office building portfolio, which is largely based in Southeast Portland, did not experience the severe vacancy rates like downtown offices. He explains that their office spaces range from 150 square feet to 30,000 square feet, and spaces between 3,000 and 5,000 square feet experienced limited turnover throughout the pandemic. But if their offices were not performing well, Beam would still see more roadblocks to conversions beyond construction costs. "Most of our buildings are located in the Central Eastside Industrial District," says Barrett. "So even if we wanted to convert to housing, we couldn't because they're not zoned for it. Unless we wanted to lobby the city for a sweeping change to land use, I just don't see it happening."

This point about zoning raised by Barrett is critical to cities seeing empty offices converted to new housing. However, the city of Portland and its commission appear to be silent on the matter. Meanwhile, Multnomah County commissioner Susheela Jayapal made calls in July of this year for offices to be converted to affordable housing. In an interview with Oregon Public Broadcasting, commissioner Jayapal noted that she is in talks with private developers about converting existing downtown offices to affordable housing, having also toured a vacant office in early July. However, Jayapal admitted to the limitations and opportunities of turning office buildings into housing: "Not every office is going to lend itself to conversion to housing . . . But the reality is we're at a point where even 200 or 300 or 400 additional units makes an incredible difference.'" While these discussions between local officials like Jayapal and developers seem promising, tangible policy is yet to be actioned.

For now, it's unclear whether the county and city will incentivize developers and building owners to convert office buildings into housing. Without adjustments to zoning, clear pathways for development, and workers returning to the office, building owners are left with little recourse to revive downtown areas. Meanwhile, finding affordable housing will remain a challenge for residents, and empty downtown office buildings will continue to tower over tent encampments, unable to shelter those in most need because of insurmountable logistical challenges. Despite these realities,

developers continue to bet on office conversions, seeing the inherent risks as advantageous rewards. If enough developers continue to reimagine and renovate their office buildings, cities' downtown areas may soon experience a renaissance filled with former mid-century offices reinvented as housing for the new millennium.

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