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Commercial Real Estate

New incentives aim to jumpstart conversions of office buildings. Here's why they won't be a silver bullet.

This former office building in Newark, New Jersey, is being converted into 92 residential units.

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Municipalities have long used incentives to spur investments they hope to see in their cities, or to solve for a persistent problem they've deemed requires private-sector participation.

Now, city officials are introducing or expanding upon programs to encourage office-to-residential conversion projects in America's downtowns in the wake of a weak post-pandemic office market. With the national office vacancy rate hitting a record 19.6% at the end of the fourth quarter, and a key source of tax revenue dwindling as office building values decline, it's become a top priority for elected officials and economic developers to figure out how to make more conversion projects happen.

The projects aren't easy.

Based on physical characteristics alone, it's estimated that 60% of office buildings are poor candidates for conversion to residential use, according to a 2021 algorithm developed by design and architecture firm Gensler. There's also the state of financing on the building in question, the kind of investment that'll be needed to bring the building to a new use, and how much a nearly empty office building could trade for. Developers frequently say it needs to trade at a deep discount if it's earmarked for conversion.

Still, the desire to see more housing — and to see obsolete office buildings reimagined to make them revenue-generators once more — is top of mind nationwide. Affordability continues to be a serious challenge for homeowners, with the monthly mortgage payment on a typical U.S. home up 96% from early 2020, according to Zillow Group Inc.

data. That's thanks to rapidly rising mortgage rates since 2022 and record-high home-price appreciation during the pandemic. And, while the rental market has slowed, many U.S. metros saw double-digit percentage gains in rental-housing costs during the pandemic, and a record-high 22.4 million renting households are considered cost-burdened.

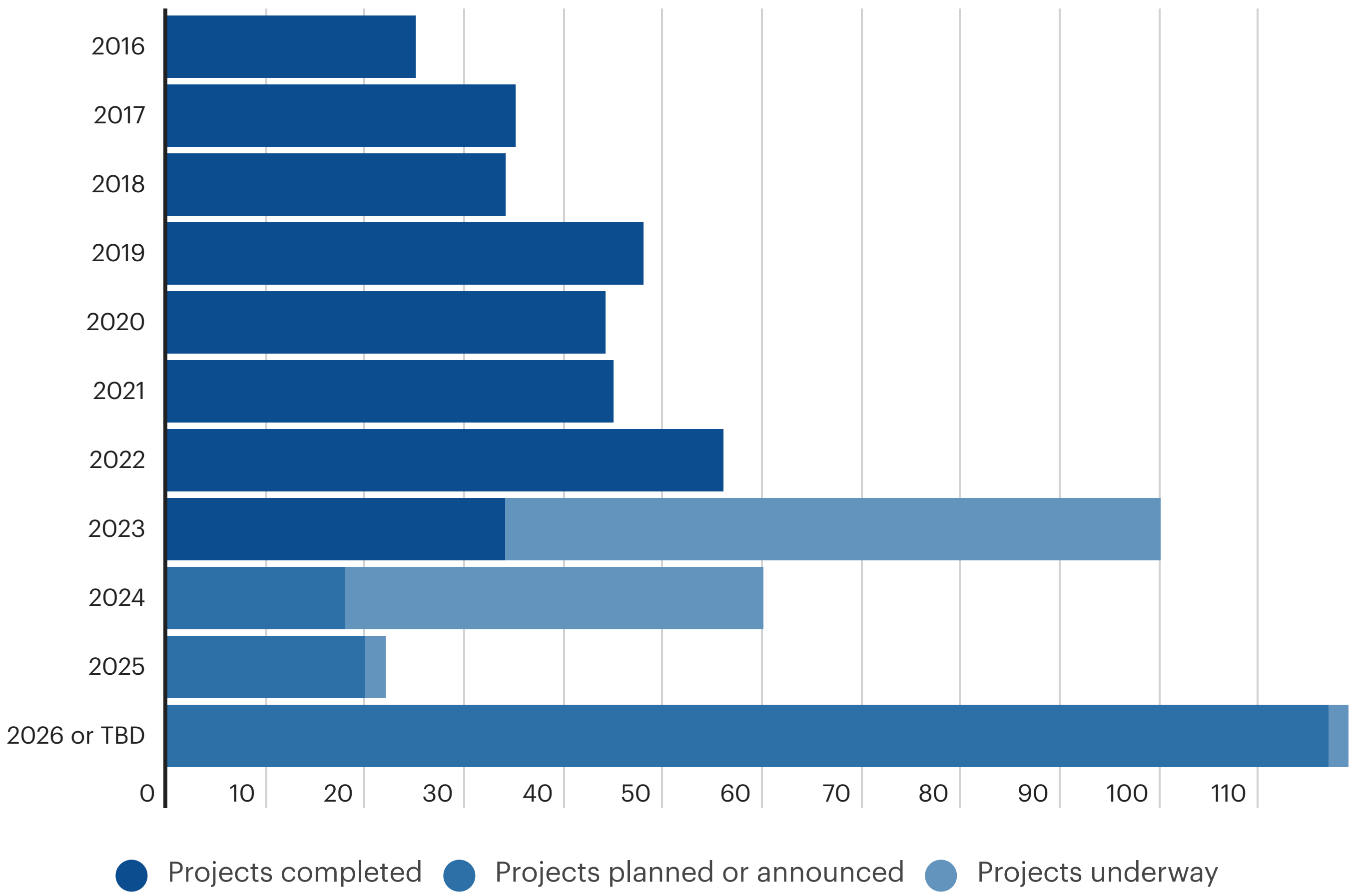
To spur office conversions, mechanisms like tax-increment financing, tax abatements and tax waivers are being proposed or are already in play in cities across the country as ways to reduce the cost of converting office buildings into housing or other private-sector uses, such as a hotel, lab or data center.

While incentives are typically viewed as deal-sweeteners, those working on conversion projects today argue they're more of a necessity than a bonus for a lot of conversions to make sense, especially given the current capital markets.

"It's absolutely critical," said Steven Paynter, building transformation and adaptive-reuse leader at Gensler. "There are very few other options to getting these projects moving at the moment at any kind of scale. The high interest rate on, especially, construction lending ... is a dealbreaker for the projects."

CONVERSION PROJECTS

Number of U.S. office conversions planned, underway or completed, as of Q3 2023



Source: CBRE Group Inc.

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CBRE Group Inc.'s data on conversions shows an uptick in the number of office conversions underway nationwide since the Covid-19 pandemic but no evidence of a windfall, said Julie Whelan, global head of occupier thought leadership at CBRE.

"We know more housing is needed," Whelan said. "It's just that fulfilling that demand in the way that it needs to be fulfilled is very difficult to make work when you're putting numbers down on paper."

The Goldman Sachs Group (NYSE: GS) had similar findings in a recent analysis it did on the financial feasibility of converting office buildings into residential units. It found about 0.4% of office space had been converted into multifamily units on an annual basis before the pandemic, which rose only to 0.5% in 2023.

In many conversions, either the housing being added into a former office building has to rent or sell at a certain price (usually top-of-market), or the upfront basis — the cost of purchasing the building — has to be low enough that the project makes sense financially, Whelan said.

That's difficult in many cities because office building trades haven't necessarily reached those ultra-low levels yet. So, without aggressive incentives at the municipal level, a lot of conversions won't pencil, Whelan said.

At the same time, she added, most downtowns aren't lacking in luxury housing. Instead, affordable housing is what's badly needed, and that usually requires some degree of subsidy, even for a traditional, ground-up development.

Goldman Sachs, using a discounted cash-flow model, also found current acquisition costs for struggling office towers are still too high for a conversion into a multifamily building to be financially feasible because of how much it costs to do that conversion.

Nationally, the average price of what Goldman deems as nonviable office buildings — those built before 1990, haven't been renovated since 2000 and have a vacancy rate higher than 30% — has fallen 11% since 2019. In the hardest-hit cities, average transaction prices have declined by 15% to 35%.

If an office building is acquired for $307 per square foot (the average transaction price of nonviable offices, according to Goldman's model) and the cost to convert it to a new use is $280 per square foot (slightly above average for a typical conversion cost), that project would result in a $164 loss per square foot if high-end multifamily units added in that building are rented at $4.50 per square foot. That means current office prices would need to fall by about 50%, or about $154 per square feet, for conversion costs to pencil, according to Goldman.

On the financing side, there's a limit right now on banks' willingness to lend to commercial projects, Paynter said. He added that the risk tolerance among lenders to take on conversion projects, which can come with unexpected costs and delays, has also been diminished.

Many capital sources won't invest in a conversion until it's significantly underway or close to completion. A five-story office building in downtown Newark, New Jersey, that's being converted into a 92-unit residential development recently obtained a $22 million loan from Northwind Group. It was underwritten at the 70% or 80% completion stage, said Ran Eliasaf, founder and managing principal at Northwind.

"A conversion is a complicated execution," he said. "It typically takes longer and costs more than what developers underwrite."

Federal incentives available for conversion projects

In October, the White House issued guidance on how existing federal programs could be leveraged in the conversion of office buildings into other types of development, especially housing. The guidance includes programs from the Department of Transportation, the Department of Housing and Urban Development, and the General Services Administration.

Developers say while the programs are a good start, being able to put those incentives to work is another matter.

Paynter said the spirit of the guidebook is a good one, but there are a lot of fine-grain details and challenges in figuring out what the rules are for applying those programs to conversion projects.

"Because these programs weren't really set up to deal with housing creation, there are some oddball requirements," Paynter said. "It's not as simple as everyone had hoped."

Some developers are concerned about how long it might take to put that capital to work even if their deals qualify for any of the programs.

Since the pandemic, Keystone Development and Investment has waded into the conversion game. The West Conshohocken, Pennsylvania, company historically has been a significant office investor. It recently completed a conversion of the historic Curtis building in center city Philadelphia into life sciences space. It now is pursuing a conversion of several floors at The Washington — another historic building in Philadelphia — into luxury housing, in addition to converting a suburban office building it owns on a mall property in Plymouth Meeting, Pennsylvania, into housing.

Keystone Development and Investment is seeking to convert a former office building in Plymouth Meeting, Pennsylvania, into housing.

KEYSTONE DEVELOPMENT AND INVESTMENT

Michael Brookshier, vice president of development at Keystone, said the company to date has leveraged traditional tools such as state historic tax credits for its conversions. But with higher interest rates and construction costs, new and different types of incentives are being considered by the developer.

Among the incentives offered in the White House guidance, Keystone is considering two DOT programs. Brookshier said that's primarily because those programs don't carry an affordable-housing requirement — Keystone is developing market-rate housing in its conversion deals — and many of the firm's properties are close to mass transit, with the DOT programs specifically intended to incentivize new housing near transportation.

Echoing Paynter, Brookshier said because the programs are newly being used for housing conversions, everybody is still figuring out how they're going to work. And with 2024 being a presidential election year, there's potential risk the programs could go away if there's a change in administration after November.

But the biggest challenge Brookshier sees with leveraging federal incentives for conversions is the time it could take for them to be deployed for projects his firm is pursuing right now. From letter of intent to closing on the financing, that could take 12 to 18 months, he said.

"I have a project I'd like to close on in March and June of this year, so [that] doesn't work from a timing perspective," Brookshier said. "On the flip side, there are projects I'd like to build in the future, so maybe I should get the application in so I have things in process ... but at that point, you're predicting the future."

It also would be useful if there were one simple process to submit applications for federal incentives being offered, Paynter said.

Eric Stavriotis, vice chairman of advisory and transaction services and leader of the location incentives group at CBRE, said it's most helpful when a developer can sift through a basket of incentives to figure out which ones make the most sense for their particular project. That could range from a tax-increment financing structure to the ability to use city transportation dollars at a former office site so as to make the property more accessible for residents instead of daytime office workers.

From conversations with CBRE clients, Stavriotis said it doesn't seem the federal guidance alone is spurring deals.

"The old axiom applies here: All politics are local," Stavriotis said. "Most of what we're seeing nationally is that the assistance that is moving the needle for a developer — usually a private developer that's looking to do a project — is oftentimes more local in nature than federal."

Federal money can be an important part of a project capital stack, but many of those funds are channeled through the state or local level, even if it has federal origin, Stavriotis said.

Local and state officials propose incentives

San Francisco arguably has one of the nation's bigger office-market problems. That metro's office market ended 2023 with an eye-popping record-high vacancy rate of 35.6%, according to CBRE. Yet conversions haven't taken off in San Francisco, even with

12 out of 36 buildings in the city's downtown having been identified as good candidates for conversion, according to a 2022 study by Gensler.

Local developers and land-use attorneys say a number of initiatives have been proposed at the state and local level to try and spur those projects, but more is needed.

"This is classic economic development," said Jack Sylvan, founder and principal of SDG LLC and the director of think tank San Francisco Bay Area Planning and Urban Research Association (SPUR). "The public invests in order to catalyze the private development, and that's what San Francisco needs in this moment."

Voters earlier this month were asked to weigh in on a measure known as Proposition C. If approved, the measure would waive a San Francisco transfer tax for projects that convert office buildings into housing.

But even before the vote, Prop C was deemed in an economic-impact report by the city controller's office to be a largely insignificant measure to spur conversions. It determined the cost savings from waiving the transfer tax for those projects would be worth about $33,500 per unit for apartment projects and $9,000 per unit for condo projects, the *San Francisco Business Times* reported. It also projected it would take the city 29 years and 102 years, respectively, to recoup the revenue it foregoes from waiving the transfer tax in those projects.

As of last week, the outcome on Prop C was still too close to call, although "yes" votes had a slight edge.

Speaking ahead of the March 5 voting, Sylvan said it's not that waiving the transfer tax itself will lead to a lot of conversions. Rather, it's just one of many tools needed to make conversions feasible.

Sylvan said he's estimated that between legislation passed by the city of San Francisco last summer that streamlined planning requirements and Prop C, if it were to pass, those measures would solve about one-quarter of the feasibility gap per unit in conversion deals. SPUR estimates there is a current feasibility gap of $267,000 per unit.

San Francisco is one of the more challenging markets for turning obsolete office inventory into new uses.

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Another measure being closely watched in San Francisco and elsewhere in California is at the state level.

California Sen. Scott Wiener last month introduced State Bill 1227 that would give developers converting office buildings into new uses in downtown San Francisco a temporary exemption from the state's Environmental Quality Act and also would expand a tax exemption for those projects from strictly affordable housing to also include workforce housing.

Sylvan said the measures collectively "are no silver bullet" but they start to unlock the potential for projects to begin and for capital to be reinvested in downtown San Francisco real estate.

"If you're waiving fees, you're waiving fees that would never be charged because nobody is doing anything with that building," Sylvan said. "It's basically foregoing [a tax] that [the city] would never have collected. It doesn't exist but for the conversion.

"To me, that's the most important piece of the policy conversation," he said. "Yes, you are providing an incentive, but the city isn't giving anything up because it wasn't going to get anything [if] a building sits [empty]."

Conversions call for more than incentives

Beyond financial considerations, San Francisco is not unlike other U.S. cities in having inclusionary housing requirements that Sylvan said could be a barrier for conversions. That means even if more incentives become available, it could still be a challenge to get conversion deals done without policy changes, he said.

Other requirements can add cost and risk to conversion efforts. For example, converting an office building to a residential use may trigger earthquake-related code requirements, which could necessitate significant seismic upgrades, said Caroline Chase, a partner at law firm Allen Matkins Leck Gamble Mallory & Natsis LLP, who specializes in land-use law.

"That would likely include a substantial seismic upfit [and] that could hinder projects from moving forward," she said.

She added that SB 1227 has prevailing-wage and skilled/trained workforce requirements associated with it that could create challenges and added costs for construction workforce.

The hurdles to converting office buildings in San Francisco into new uses are but one example in one city — albeit one of the more challenging markets to turn obsolete office inventory into new uses. But what's stymying projects there illustrates how policy and regulation change are a significant piece of the puzzle in getting conversions anywhere in the U.S. across the finish line.

In some places, it's simply how long it takes to get a project through a city land-use and planning department. Those focused on downtown revitalization and development say making that process more streamlined is one way to get projects approved quicker and provide greater certainty to developers embarking on already risky conversion deals.

Nolan Marshall, executive director of the South Park Business Improvement District in Los Angeles, said in a recent interview a lot of municipalities have struggled to streamline their regulation process.

"You have to disentangle the process and make it easier for people to get permits for capital to flow in your community, and flow in a fast way," Marshall said. "It’s challenging enough to figure out how to do a conversion from an office building to a residential building. If it takes a developer 12 months in L.A. — and that’s being optimistic — [and] it takes them five months in Austin, Texas, that capital will flow to Austin, Texas."

Paynter said state and local governments have the ability to move more effectively and quickly than the federal government, even if they are smaller-scale efforts. But in many places, he said, local programs on the whole are overly complicated.

Both Paynter and Whelan cited Calgary, Alberta, Canada as an example of a government with a relatively simple conversions program, including the clarity that's provided around incentives.

Calgary says it currently has 13 office buildings actively being converted, and four under review, into new uses. In cities across the U.S., there were only 42 office conversions actively underway in September that were expected to be finished in 2024, according to CBRE.

"In talking to developers, the two terms that come to mind are certainty and ease," Whelan said. "The lack of certainty in this whole process, given the risk and expertise associated with these projects, is holding some developers back from doing these projects."