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Execs Remain Hesitant About Costly Office Conversions

61% of executives surveyed are not likely to invest in office-to-residential or mixed-use conversion projects in 2024.

By Richard Berger | February 27, 2024 at 06:20 AM

With banks increasingly realizing potential losses on office loans, there's a looming possibility of a major repricing event, potentially leading to the demolition of many underutilized office buildings. Amidst this scenario, there lies an opportunity for the strategic conversion of select properties into residential spaces, which can present a promising avenue for urban revitalization.

"Yet the harsh reality remains – many structures simply lack the structural feasibility for cost-effective conversion," Gregor Watson, Co-Founder of 1Sharpe Capital, tells GlobeSt.com.

"Where a realistic path for such conversions exists, there will be substantial financial commitments required, so it becomes imperative to foster collaborations between government entities and private stakeholders," Watson said.

“By pooling resources and expertise, navigating regulatory challenges, and securing necessary funding, public-private partnerships can ensure the viability of these projects while positively impacting community development and urban renewal efforts.”

Most CRE executives are not willing to try their hand at this complex process, though, at least not this year, according to a new survey by Seyfarth.

Some 61 percent of CRE executives are not likely to invest in office-to-residential or mixed-use conversion projects in 2024, compared to only 5 percent who are very likely to make such an investment, Seyfarth’s 9th annual Real Estate Market Sentiment Survey revealed.

Despite cries touting office-to-residential or to-mixed-use conversions as a panacea for stagnating central business districts, market participants remain hesitant.

“Given growing investor interest, incentives provided by various levels of government, and the housing crisis, this is likely to be an area worthy of continued attention,” the report said.

Pierre Debbas, Partner and Founding Member, Romer Debbas, tells GlobeSt.com that office-to-residential conversions will only work out from an investment perspective if the office building is being acquired at a substantial discount.

“Banks have been working with borrowers to keep them afloat and you have not seen the level of distress needed for these conversions to take place more frequently,” he said.

“You also have to factor in the city in which these conversions may take place and if that city is willing to rezone a business district to allow for residential use and if they will provide any tax abatements to incentive these projects and perhaps tie those abatements to an affordable housing mandate.”

California-based LaTerra Development has evaluated office-to-residential conversions but has found the required price of the office building needs to be in the $100 to $150 per square foot range in Southern California markets to make it economically viable due to its design challenges and hefty conversion costs.

“These are often less than the underlying loan amount,” Chris Tourtellotte, Managing Director, LaTerra Development, tells GlobeSt.com.

Grant Bollman, Senior Associate, Lee & Associates of Illinois, tells GlobeSt.com that he believes that the idea of conversion is “way more palatable and less wasteful” than knocking down obsolete office buildings, but that the reality is that office-to-residential conversions are almost always prohibitively expensive.

Reconfiguring the typical 30,000-square-foot office floor where cubicles take most of the open space and private offices and conferences are on the perimeter sounds easy “until you put pen to paper and actually try to execute it,” Bollman said.

He said the high costs due to splitting electrical and HVAC – not to mention giving every resident a window, a bathroom, and multiple sinks – put most conversions in the same financial ballpark as new construction.

In Chicago, “Some projects in densely populated areas may come to fruition, but suburban assets will most likely be knocked down and replaced with brand new industrial, retail, or multifamily,” according to Bollman.

Bill Shopoff, President and CEO, Shopoff Realty Investments, tells GlobeSt.com that converting office to residential only fits a small number of buildings within a small subset of markets in the country.

“Frequently, you can build new for less than the cost of converting,” Shopoff said. “It is all about the basis to make this concept work and that is generally below where buildings are trading.”

Yet Yardi Matrix sees rapid growth in the office-to-conversion phenomenon.

Office conversions now represent 38% of the 147,000 apartments in future adaptive reuse projects, according to Yardi Matrix.

The average age of office buildings to be transformed into rentals is 72 years, 20 years younger than those previously converted, it said.

The trend is most prominent in Washington, D.C. (5,820 units), followed by New York (5,215 units) and Dallas (3,163 units).

Entering 2024, “Our cities are riding a wave of change that’s been building up for the last four years,” Doug Ressler, Business Manager, Yardi Matrix, tells GlobeSt.com.

“The urban landscape is getting a makeover, shifting from corporate to community. Office buildings, once the epicenters of the 9-to-5 grind, are being transformed into the new homes of urbanites, in a pandemic-driven remote-work new reality.

“During the past four years, there’s been extraordinary growth in the conversion of office buildings into living spaces.”

In 2021, a modest 12,100 apartments were being crafted out of old office spaces, according to Yardi Matrix. By 2022, that number had nearly doubled to 23,100. The climb continued as 2023 saw an increase to 45,200, and in 2024, the pipeline has reached 55,300.

“That’s more than a fourfold increase since the trend began,” Ressler said. “It’s a testament to how our cities are transforming for a new generation that wants to live where they used to work.”