WHITE PAPER

Converting Office Buildings to Residential Apartments: Benefits and Hazards

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Introduction

For the longest time office property has been the best located, best performing and most financially lucrative real estate asset class. Think of the iconic skyscrapers from the Empire State Building (1930) to the Sears Tower (1970) to the Freedom Tower (2014).

Also think of the hundreds if not thousands of other office properties in your hometown, some are office parks in the suburbs, some are high rise buildings in the best part of downtown. Every day, year after year, decade after decade these well-located, well-run properties, regardless of age, performed well for their owners. After all, all businesses always needed space for their office workers.

Businesses of all sizes paid landlords for the location, the amenities and the convivence of having their workforce in centralized locations that had all of the tools needed to do their jobs, such as; computers, desks, printers, management oversight, other co-workers, conference rooms and of course watercoolers. Businesses and their landlords were happy with this arrangement for generations, the workers, well they could take it or leave it as far as the powers at-be were concerned.

One day in the early spring of 2020, seemingly out of the blue, society and its norms stopped turning. Covid-19 frightened not just a small portion of the population, or some far flung corner of the world it affected everyone, everywhere globally and it did it overnight. Flights were grounded as countries closed their borders, people stopped meeting, restaurants closed, and families stayed a part. Funerals were cancelled, birthday parties and in-person schooling became a thing of the past. I really don't need to rehash this because you lived through it. It was scary.

Because of this global shut down businesses, governments, and ordinary people the world over were required to be creative with the technology and information that they had available to keep the economy running, or at least limping forward.

Office workers quickly learned that, for the most part, they could continue on with their jobs in isolation at home, in spare bedroom, on their balcony or hiding from their kids in the basement. These office workers already had all of the tools required to do the basics of their job; a computer, an internet connection and the software to make it happen. Moreover, other tools became a necessity to keep the human interaction going; such as Zoom, Teams and other video conferencing software.

After two years of working from home, office workers started to think that this was a better option for them. And who can blame them? There was no commute, fewer distractions, more convenient scheduling, a more relaxed dress code, simply more time at home with less hassles of working in an office building.

When these workers refused to come back to the office businesses had to make some tough decisions on their culture and on their income statement. If businesses can continue to be successful without the overhead of office rent, why not cut that line-item expense?

Fast forward three years and office property owners, especially of older, functionally obsolete properties are suffering from the one-two punch of declining occupancy and raising interest rates. This forces the owners to come out of pocket to meet their financial requirements and when the debt comes due, they will not be able to refinance into a new loan to pay off their old one.

All of this brings us to today. Experienced, enterprising real estate developers are jumping on the opportunity to buy these vacant office buildings at prices, sometimes, less than the value of the land. Once they have acquired these properties, they change the usage from well-located, vacant office property to well-located multifamily, apartment properties.

The purpose of this white paper is to inform the reader about the tectonic changes that have happened in the office property market. This is not a paper that is just trying to scare you, but it is a well-thought-out look at the landscape of the market and how you, your firm and your family can benefit from these changes.

Office Workers Preference.

People in all types of “office” positions seemingly are only going into the office because they have to, not because there’s a good reason to. Between the lack of a good reason to go to an office and the technological advances that have been made in recent years, it’s no wonder that there is a growing trend of people wanting to work remotely permanently.

The Covid-19 pandemic has upended workplace norms across the United States, with many employees suddenly finding themselves working from home. For some, this has been a dream come true, as it allows for greater flexibility and maybe fewer distractions. However, after more than two years of remote work, many companies are now asking employees to return to the office. This transition has been difficult for some, who have grown accustomed to the benefits of working remotely. Others are excited to return to the office but are finding that the workplace has changed in a significant negative manner since they last set foot in it.

Figure 1. Houston, Texas Class B & C Office Vacancy Trended. February 2023

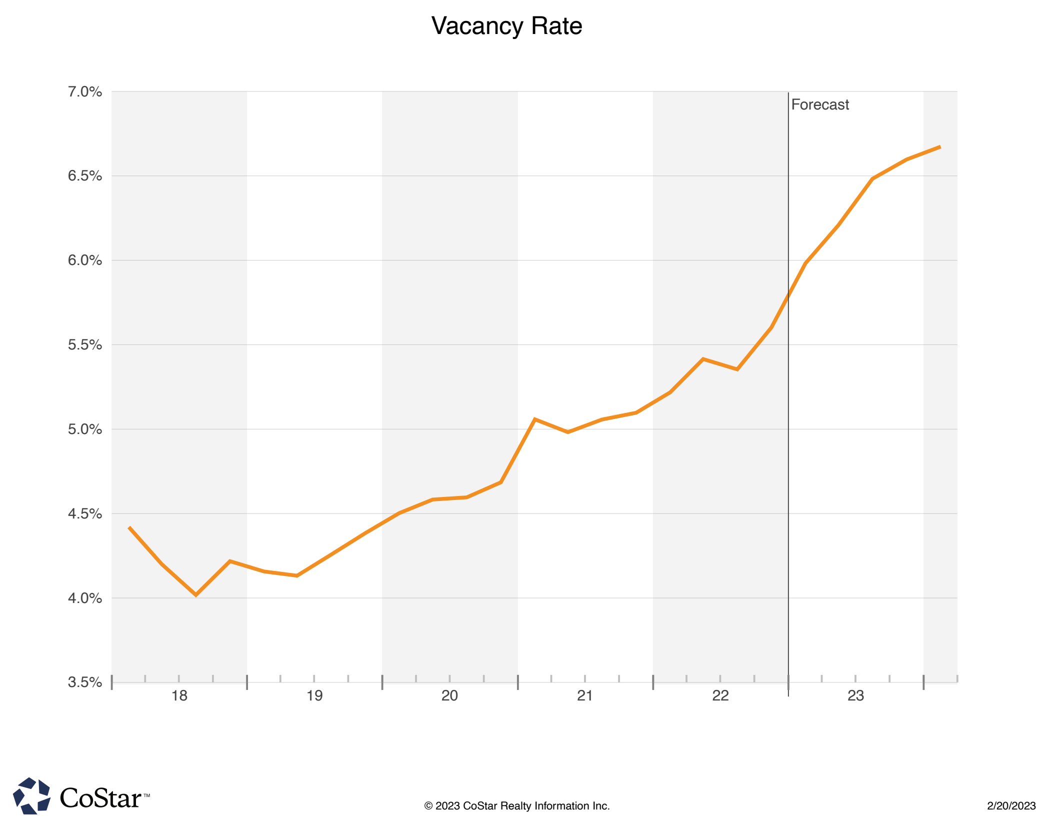
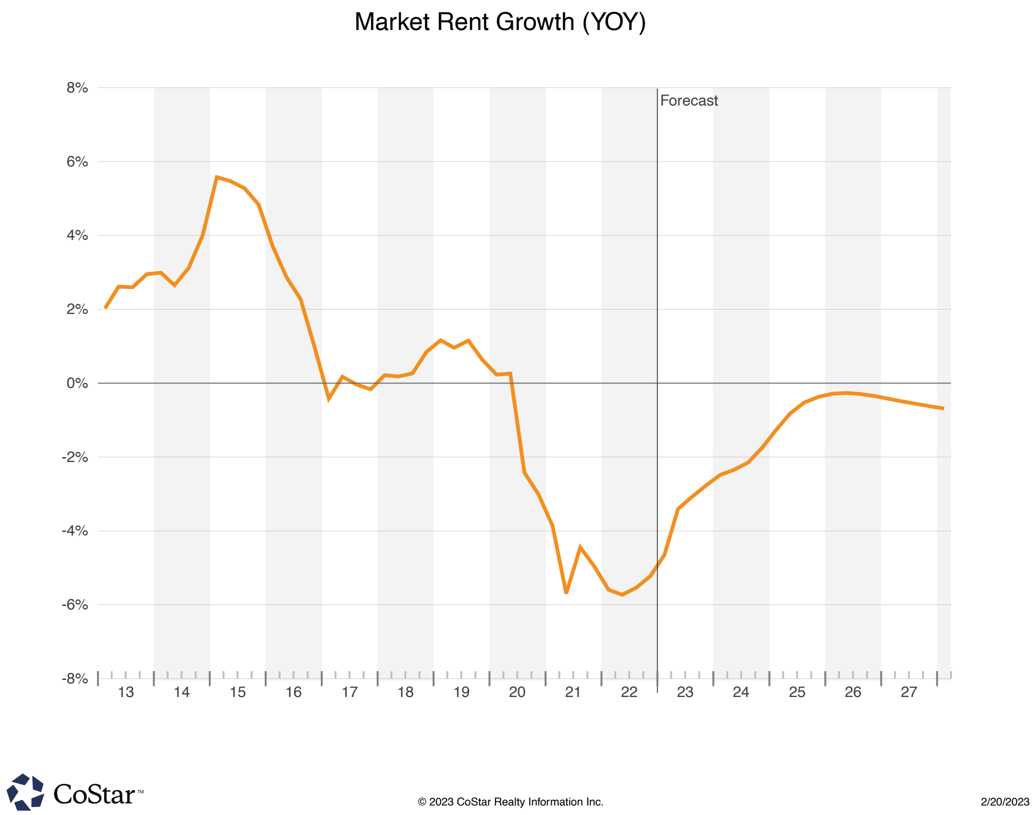


Figure 2. Rent Growth of Class C Offices Houston, Texas. February 2023



Larger numbers of white-collar employees are shifting from living at work to working at home. Before the pandemic, roughly 12% of workers—particularly those in management, business, and financial operations—worked from home at least once a month. In June of 2020, between 31% and half of all workers worked from home—likely for all or most of the time. Over a quarter of recently surveyed Fortune 500 CEOs were leaning toward making telework permanent for at least some of their employees. This trend will increase at variable rates in different U.S. regions, depending on their industrial composition and the pandemic's impact. This is according to Tracy Hadden Loh of the Brookings Institute. (Loh, 2020)

In recent Gallup findings; there are 125 million full-time jobs in America. Of those 50% -- or about 60 million people -- report that their current job can be done remotely. (Clifton & Wigert, 2021)

Of those 60 million potential Work From Home (WFH) employees, a staggering 30% said they would prefer to "never" come into the office during the week. Ten percent (10%) said they prefer working all five days in the office. The middle 60% want a blend of one to four days per week. The most common preference was two to three days in the office per week. (Clifton & Wigert, 2021)

This trend can be seen here in my office. Of the three staff accountants, two come into the office three days a week, and the other works remotely on the other side of the state. On Fridays, I am the only person in the office.

Further, I still send mail. As in packages and other letters to my family investors and other valued partners. When I ask for people's physical mailing addresses, they are surprised—I guess they only expect Amazon to know how to get packages to them. Of the 70 or so people that I have mailed packages, books, and gifts to in the last two years only about 60% of them list their office address as where to mail to. The other 40% tell me that "oh, no send it to my house. I only go into the office once a month or so, if ever".

This is a seismic change in the way Americans work. It rewrites the rule book on office space and requires a total rethink of how we view "work". When the time to make a yearly budget comes, employers may look at their expenses and may not be able to grasp how having the overhead of office space makes much sense anymore.

This isn't an "either/or" situation. The vast majority of employees want a happy medium -- a mix of office and remote work. What does that look like in the future? No one rightfully knows however everyone will agree that companies will require a lot less office space in the coming years.

Overall, the above findings and personal experiences state that the Covid pandemic has irrevocably changed the way we work. The "office" as we know it is no longer the only option for what was formally known as "office workers". And, as more and more employers realize they and their employees can be just as productive working from home, the coffee shop, or the beach the demand for office space will decrease.

The result of all this is that office vacancy rates are expected to increase in the coming years, which will put downward pressure on rents. This will make the cash flows of the properties less which will drastically reduce the value of the properties.

Figure 3. Houston, Texas Class B & C Office Supply and Demand. February 2023. CoStar.

	Inventory			Net Absorption		
Year	SF	SF Growth	% Growth	SF	% of Inv	Construction Ratio
2027	45,528,281	(721,840)	-1.6%	(713,008)	-1.6%	-
2026	46,250,121	(717,126)	-1.5%	(692,321)	-1.5%	-
2025	46,967,247	(714,039)	-1.5%	(623,543)	-1.3%	-
2024	47,681,286	(712,732)	-1.5%	(632,725)	-1.3%	-
2023	48,394,018	(522,281)	-1.1%	(776,901)	-1.6%	-
YTD	48,916,299	0	0%	(28,821)	-0.1%	-
2022	48,916,299	(14,320)	0%	(192,835)	-0.4%	-
2021	48,930,619	(63,880)	-0.1%	420,255	0.9%	-
2020	48,994,499	(106,216)	-0.2%	(494,462)	-1.0%	-
2019	49,100,715	(99,208)	-0.2%	(603,320)	-1.2%	-
2018	49,199,923	(85,003)	-0.2%	39,766	0.1%	-

New Basis

The **basis** is an important part of commercial real estate. The basis is the total cost of buying, building, and occupying a property with tenants. This includes both hard and soft costs. The higher the basis, the less profit potential an owner expects and the higher the risk of losing invested capital. Lowering the basis will make a property more competitive compared to other like properties, increase profits, and make it a safer investment for family and institutional investors.

The cash flows of commercial property are what determine its value. When office buildings in the Houston, Texas market have a vacancy rate of more than 25%, their gross earnings are reduced while many expenses stay constant. This will reduce the **Net Operating Income** (NOI), which will have an impact on **debt servicing** and the overall valuation of the property.

The judicious use of converting vacant or low occupancy office property to residential can be a boon to an equity partner's return on investment. Primarily because the cost to acquire the property is incredibly low. As more and more office buildings become financially and managerially distressed owners will attempt to sell. If they cannot sell the property the bank lenders will take the property back through foreclosure actions and then they will attempt to turn around and sell the property. In the coming years, there will be a dramatic increase in the supply of vacant and low occupancy office buildings, and only a handful of developers and owners will know what to do with these properties. Demand for this office product will be low--creating a severe supply/demand imbalance, and an ensuing race-to-the-bottom in regards to the sale price.

Distressed office properties will and are selling for pennies on the dollar. Making the basis incredibly low.

Older buildings, Class B and C buildings, or buildings that have not been renovated in a long time are good for conversion. This is because they have fewer amenities than newer buildings and they also need rehabilitation anyway--this makes them less attractive to the companies that have a use for office space.

The conversion of existing office space to residential has become more attractive not only due to the low basis but also because less time is needed to bring the renovated property to market. The construction period is about three times faster, and the time required for development review is notably shorter.

Conversions are an appealing option in denser urban areas where developable land and parking are at a premium. Many **central business districts** (CBDs) are facing a glut of office space. The white-collar professionals who fled city centers at the start of the epidemic haven't returned yet. Even as some major employers, such as Google and Apple, begin to implement back-to-work plans, it appears that many will never return.

High-growth suburban markets are also prime for office conversions because these buildings are well located, and have significant "free land" included which normally takes the form of vast parking lots. These parking lots can be sold for cash or put back into service by building additional housing or other types of real estate assets. It is really up to the imagination of the developer how these acres of asphalt can be used.

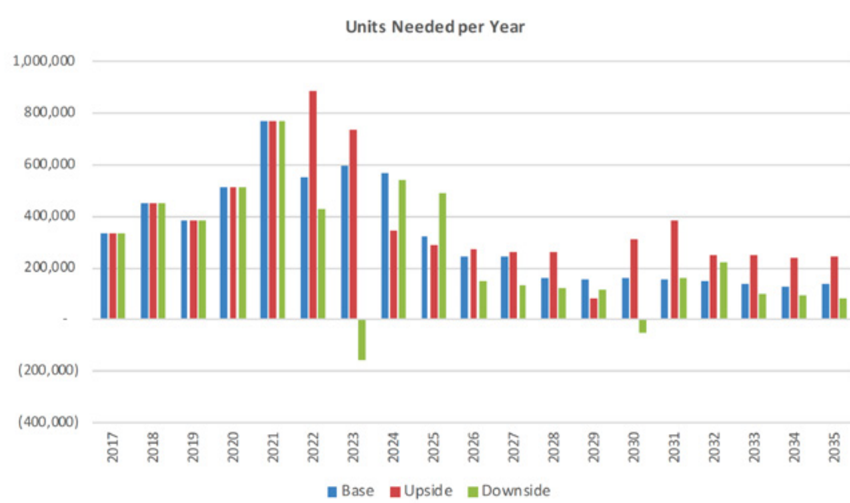
The office market will face challenges in the coming years as a result of the pandemic. However, there will be massive opportunities for enterprising investors who are willing to have an imagination of how these office buildings can be pressed back into service.

Need For Apartments

The National Apartment Association and National Multifamily Housing Council released its updated "U.S. Apartment Demand Through 2035" report in July 2022. It is a comprehensive look at the multifamily housing market, its drivers, and the market's logical path into the future. (Hoyt Advisory Services, Eigen10 Advisors, 2022)

The eye-catching headline is that between now and 2035, the United States will need 4.3 million apartments to meet the demographic need. To satisfy this demand, it will be necessary to deliver more than 350,000 new units each year for the next 13 years.

Figure 4. Needed New Apartment Construction Per Year. NMHC, NAA.



The good news is that, because of this enormous demand, many people in the construction and development industries will be employed for a long time to come. Of course, real estate investors will also benefit from this surge in demand for their investment properties.

Apartment demand is soaring to a decade-high level, while office vacancy rates have spiked, and hybrid work-from-home situations are emerging to be the new normal. This continues the conversation of converting vacant office buildings into housing, particularly multifamily rental housing.

Affordability is still a very pressing housing issue, particularly for renters. In the past five years, rental affordability has decreased slightly in spite of new housing laws and low interest rates. New developments' rents are priced at the top of the market which is out of reach for many renters. The pandemic only made this worse by raising prices on construction materials and resulting in increased overall housing costs which were passed on to the renter.

There are several reasons why developers cannot build new apartments that are considered affordable to the mass of renters. First, land prices have been rising steadily over the past few years, making it increasingly expensive to purchase land for development. Second, construction costs have also been on the rise, further eating into potential profits. Inflation is one of the main drivers of rising apartment costs. Since 2013, the cost of building an apartment has risen by about 30%. This is due to a variety of factors, including the increasing cost of land, labor, and materials.

And finally, most jurisdictions have strict zoning laws that restrict where new developments can be built, further limiting the available land for new apartment buildings.

All of these factors combine to make it very difficult for developers to build new rental properties that are affordable to the average person. As a result, the supply of rental housing is constantly lagging behind the demand, leading to ever-rising rents and an ever-growing number of people who are struggling to find reasonably priced housing.

Not a Silver Bullet

While adaptive reuse of office properties can lead to both market-rate and affordable housing development, it is far from a panacea for creating new supply, but it is a step in the right direction.

A recent study from Harvard University's Joint Center for Housing Studies (JCHS) shed some data-driven light on this topic. The research, carried out by JCHS Senior Research Associate Chris Herbert and his colleagues, examines the current office market landscape in the United States and how it may be revolutionized in the coming years as a result of the pandemic and changing workplace dynamics.

According to Herbert and his team, there is a great opportunity to retrofit old office buildings into residential units. They estimate that as many as 2,000 former office buildings could be converted into nearly 400,000 apartments over the next decade—creating much-needed housing options across the nation.

The JCHS report doesn't only welcome this potential development, but also warns that adaptive reuse is not the one-stop solution for America's housing affordability crisis. The costs of redevelopment can be high and the process to convert an office building into a multifamily home is often complicated. Additionally, the existing stock of office space isn't evenly distributed in different regions across the country which means some areas are more likely to see activity than others.

Even though it can be difficult, adaptive reuse is a good way to create new housing when it is needed. According to the JCHS report, "The potential scale of adaptive reuse...suggests that this approach could make a significant dent in meeting unmet housing needs."

Because adaptive reuse has the potential to create new housing stock, more and more investors are taking an interest in it. CBRE, a commercial real estate services, and investment firm published a report stating that adaptive reuse projects are attracting more attention and capital than ever before. More specifically, they reported that there was a nearly 50% increase in investment for such projects in 2021 alone. (CBRE, 2022)

The Covid-19 epidemic has helped to accelerate this trend, as office vacancy rates have increased and the demand for additional housing has grown more acute. Investors are finding that adaptive reuse is a great way to make a capital return while also helping the community.

Despite the difficulties adaptive reuse presents, its potential rewards make it an attractive and worthwhile endeavor. If taken in the right approach, adaptive reuse can help make a significant dent in the 350,000+ new apartments that are required every year in the United States.

Complexity to Execute

While there are numerous advantages to converting office buildings into multi-family residential properties there are also numerous challenges. Some challenges are very clear and easy to identify such as zoning, and municipality resistance. While others are insidious and can be difficult to overcome such as unknown conditions, and hazardous materials such as asbestos and lead.

Zoning, Municipalities & NIMBY

Any developer that has any experience knows that working with the city on zoning, approvals, and permitting can be a deal killer. To add to the developer's frustrations are the **Not In My BackYard** (NIMBY) neighbors who act as an unmovable and unreasonable boulder on the development path to success.

Cities are opposed to having blighted and vacant real estate, particularly in their downtown area. In the last 20 years, efforts have been made to bring a live-work-play center back from the outskirts of a town to its business district in order for it to be livelier and more exciting.

An examination of the political climate in the area and how a structure is zoned will help a developer determine their strategy for obtaining any necessary modifications to allow the conversion to residential use. While office property taxes are typically greater, urban governments may be considering legislation to provide, or already do so, housing incentives to residential builders to meet a genuine or perceived housing scarcity, or to redevelop certain city's core areas into more livable environments.

Often, the property does not require rezoning, but simply a variance in zoning to allow for multifamily housing. This greatly simplifies the process to start construction.

In the end, whether or not a city is pro-development will be determined by zoning and city officials, who will either support or oppose it. It's up to the developer to assess which way the wind is blowing and make the required changes.

Additionally, when a new residential ground-up project is proposed in the city or the suburbs, there are generally going to be individuals and neighbors that object to it. In suburban neighborhoods, homeowners are often against "transient" renters living close to their homes due to concerns of crime, traffic congestion, and property devaluation. The majority of resistance in the city core comes from other multifamily owners who don't want additional and newer competition in the market. Whatever the cause, these opponents must be appeased, how that is done is much more of an art than a science.

A very strong point in conversion of these properties is that these NIMBY people would rather have new neighbors than a vacant building that is either blighted at worst or an eye sore at best. Often there is no objection or even concern about adapting the property to multifamily. If there are concerns it is clear that it is best for the community to have this property be put back in service rather than have it in its current poor state. So placating NIMBY-ism is easier for developers of conversion projects as opposed to ground-up new development.

Technical Construction Challenges

While the presence of hazardous materials, such as asbestos and lead, can present challenges when updating older office buildings for better purposes, it is important to remember that these materials can be safely mitigated with proper planning and execution. Many organizations have successfully renovated older office buildings while taking into account the potential hazards posed by these materials.

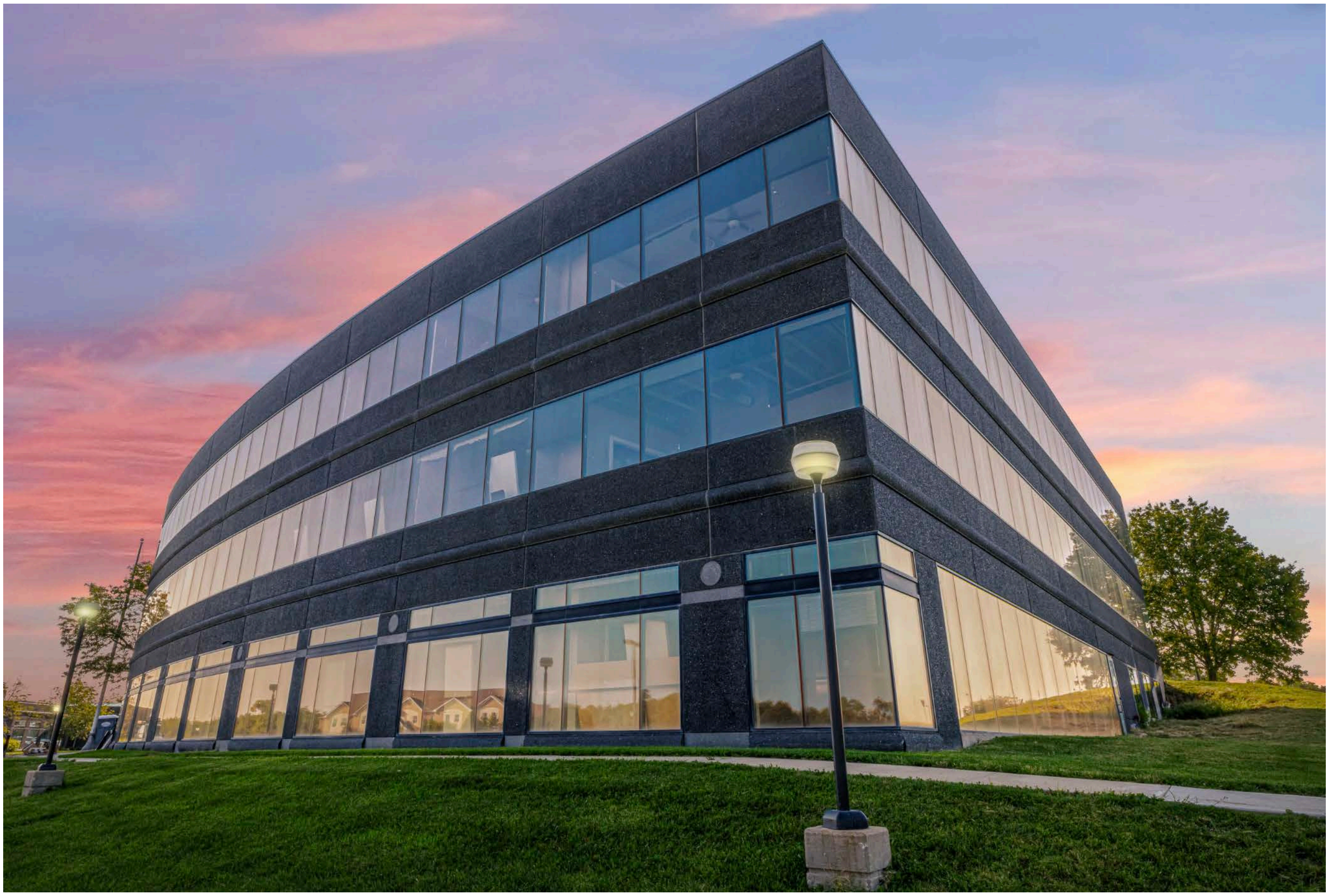
For example, the Asbestos Hazard Emergency Response Act (AHERA) sets forth specific procedures for managing asbestos in schools and other public buildings. These procedures include training for workers who may be involved in asbestos removal, as well as developing and implementing a management plan for any asbestos-containing materials that are discovered. Similarly, the Occupational Safety and Health Administration (OSHA) has established regulations for handling lead in the workplace or in this case a property conversion. These regulations include requirements for worker training, safe work practices, and medical monitoring.

By understanding the potential hazards associated with these materials and following appropriate safety procedures, developers can safely manage any potential risks posed by them. As long as the developer goes in with eyes wide open and understands the significant cost and time delays in mitigating these issues, what could be a challenge could become a very lucrative opportunity.

When renovating an old office building, there are always going to be unknown conditions. The developer must be prepared for the unknown. The best way to do this is the developer must first to understand what they are getting into. And second to have a very healthy contingency budget and of course to acquire the property at an extremely low basis.

An expensive issue could be the poor condition of the foundation or the roof. Another frequent problem is that the HVAC system does not meet residential code requirements, as offices and homes have very different standards. Plan on replacing the entire HVAC system. In addition, fire suppression, egress, greenery, parking, and numerous other systems will require updating to today's standards during the change from office usage to multifamily use.

Finally, how will the developer make what was once a stale and sterile office building which may reside in a suburban office park into an inviting and welcoming place for people to live? With the above considerations, it is clear that "cookie cutter" designs that many developers like to implement will not work in adaptive reuse projects. A special skill set and a proven track record of success are required to make these properties a home.



Experienced Developer

The experienced developers who are able to overcome the numerous challenges inherent in a conversion property and deliver a successful project are those with an intimate knowledge of the market, have a track record of success, and the financial wherewithal to weather any unforeseen obstacles. These experienced developers are able to identify and acquire buildings that may be more technically challenging to convert, but which offer greater upside potential in terms of location and financial rewards.

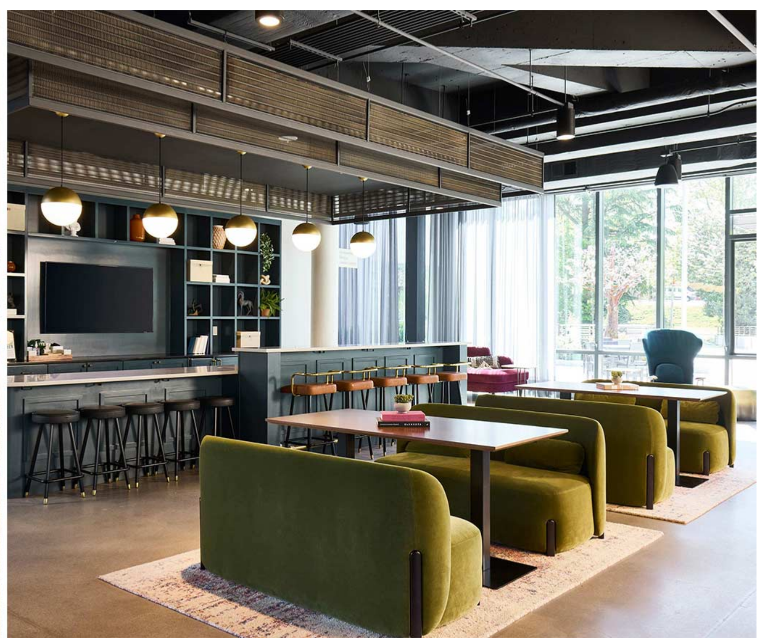
For the less experienced developer, attempting to convert an office property into apartments can be a risky proposition. Not only are there the challenges of design and construction, but also the potential for significant cost overruns and schedule delays. Given the complexity of the task, it is often best left to those with the necessary experience and expertise.

Another challenge is that no two structures are alike, and not all of them can easily be converted into living spaces. Office buildings generally aren't planned with the necessary light and space requirements for apartments. Many of these obsolete office buildings have strange dark places within, making adaptation difficult since various cities have varied building code standards. Once again understanding the future tenant and their needs are paramount to maximizing rentable square footage. This is when an imaginative developer and architect make what could be a property that seems unconvertable into a unique and comfortable place to live.

A seasoned and expert developer may also be able to utilize the highly lucrative historical tax credits (HTC). This isn't something that a newcomer should attempt, as there are many different elements to consider, including construction, facades, and accounting requirements. HTCs are of significant value when handled properly. As an aside, most office structures that would qualify for historic tax credits have never applied for them before. This is crucial since a lot of profit and both federal and state tax savings are available which will make a historic project even more desirable.

If an office building owner determines that a residential conversion will be the highest, best use of the building, and they want to retain ownership then it is strongly recommended that they partner with a developer, or retain team members, who are experienced in these conversions. This background and knowledge base will guide the process of transforming the existing property more efficiently and cost-effectively. Ultimately, the developer's experience will result in a higher-quality project that is delivered on time and within budget.

As stated, office-to-housing conversions are not as simple as they appear.



Conclusion

Office property has historically been the most financially lucrative real estate asset class, but the Covid pandemic and resulting shift in business' operations, office property owners are suffering as occupancy declines and interest rates skyrocket. These challenges have forced owners to sell their properties, in some cases, for less than the value of the land.

Fortunately, this situation has given experienced developers a once-in-a-career opportunity to buy vacant office buildings and convert them into thriving apartment communities. This shift has not only been a financial gain for these developers but it has also enabled growth in areas where housing supply was very limited before and convert the abandoned site into bustling apartment communities at an affordable price.

While working in real estate can be filled with its own unique set of risks, there is enormous potential when it comes to taking calculated risks and making successful investments.

Going forward, there will be even more opportunities for those who can think ahead. It is a powerful testament to how motivated professionals can imagine and perform when presented with unique challenges.

If you would like to learn more about potential equity partnerships related to office-to-residential conversions or have any questions about them, don't hesitate to reach out today.

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CASE STUDY

Corporate Circle Apartments in what is known as the northland of Kansas City is the quintessential case study of converting office to multifamily use.

The complex was originally constructed as an office park in the mid- to late-1980s. For years, it functioned well in its intended capacity. The split ownership of the properties caused some to struggle and others to thrive as offices. Then, owing to mismanagement, death, and the pandemic's advance, two of the properties were foreclosed upon due to poor financial performance.

The lender was anxious to get these foreclosed properties off of their books and with no willing buyers able to re-lease the office properties or developers with a plan the price offered by Clarity Equity Group was readily accepted. Nearly 200,000 square feet of distressed office and more than 6 acres of land were purchased for less than $3.0 million.

Following the acquisition, a plan to adapt the buildings into apartments was underway with a total development budget of $21 million. The property would house 203 class A apartments for a development cost of $114,000 a unit. A comparable property was sold for $217,000 a unit. Meaning that once completed these 203 units would be valued at $44 million. This would represent an $20 million profit on the sale of the property. At the partnership level, the investors will make 3.3x their invested capital.

As the residents move in there is little use for the high-density parking lot. Office property requires 3-4 parking spaces per 1,000 square feet. Apartments need one parking spot per bedroom. The result is that there are acres of unused parking lots. Not one to let an opportunity get away Clarity is planning an additional 80-100 townhouses in these vacant spaces. With the addition of a fully amenitized clubhouse and state-of-the-art smart apartments, the property will be a leader in its class.

There is even a fourth phase planned which will create an additional 100 apartment units. In total there will be more than 415 units on-site and a valuation of close to $100 million.

The combination of the incredibly low acquisition basis, the strong local demographics, the need for apartment housing and the experienced development team make this adaptive reuse project a case study worth being emulated. The real question is how many properties and sites around the country are waiting to be redeveloped by a team like Clarity Group and how will family and institutional investors with a long-term investment horizon be able to succeed alongside them?

The developer, Clarity Equity Group, has more than 15 years of experience in the adaptive reuse space as well as value-add multifamily.

Glossary

Basis
Purchase price or total project cost.

Central Business District (CBD)
The CBD is typically located in the heart of the city, at the intersection of major transportation routes. It is often home to iconic buildings and landmarks that define a city's skyline.

Debt Servicing
The process of managing and repaying loans taken out to purchase real estate.

Historic Tax Credits (HTC)
Federal and state tax credits that reduce the amount of income tax owed by a property owner based on their expenses incurred in order to preserve their historic building.

In order to qualify for these credits, a property must typically be listed on the National Register of Historic Places and meet all applicable preservation standards as set forth by the relevant authority. Additionally, any work done must adhere to certain guidelines regarding respect for historical elements such as materials used and design choices made.

Net operating income (NOI)
The most important metric in valuing commercial real estate. The property's gross income minus expenses not to include debt or capital improvements equals NOI.

Not In My Backyard (NIMBY)
Term used to describe opposition to an activity or development taking place near one's home or business. It is often used to criticize people who oppose activities they deem undesirable while being willing to have them take place in another area.

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Clarity is a well-funded and highly regarded real estate solutions provider of both stabilized and value-add commercial properties. Clarity operates nationwide in deal flow, consulting, capital formation and placement, private debt syndication and arbitrage of commercial assets.

Seth S. Wilson is an experienced property owner with a specialty in property acquisition and asset turnaround procedures. He prides himself on being able to source quality investment properties for his partners and investors. Seth is always on the leading edge of changes in the real estate and capital markets and makes adjustments to not only protect the partnerships and funds under Clarity's care, but to also ensure their ongoing success.

Seth serves part-time in the Missouri Air National Guard in St. Joseph, Missouri, where he fulfills his duty as a pilot of the C-130 tactical airlift aircraft. He is a five-time combat veteran of 17 years.

Seth's most recent book "Flight Plan for Investment Success" guides ultra-high net worth families to proper sponsor selection. Seth, his wife, and his two children live in Kansas City.