ADAPTIVE REUSE:

Converting Underperforming Offices & Hotels Into Multifamily Communities

X-CALIBER

LENDING & INVESTING FOR THE GREATER GOOD

Although much of the U.S. economy has rebounded from the depths of the COVID-19 crisis, the same cannot be said about certain commercial real estate sectors, especially office and select hospitality impacted by a slowdown in business travelers. However, creative developers, architects, and cities are using this decline in demand for office and hotel space to repurpose some of these obsolete buildings into much-needed multifamily units.

Office Sector Insights – Shift in Working Arrangements Redefines New Normal

Between 2019 and 2021, data from the Census Bureau's American Community Survey showed the share of those working mostly from home more than tripled to nearly 18% of the workforce. In some markets – especially those with a higher concentration of tech-related firms – the share was one-third or more. According to a recent report by the McKinsey Global Institute, office occupancy has stabilized at about 30% below pre-pandemic norms.

For office properties, the strong shift and desire by employees to keep remote working arrangements and/or a hybrid model has contributed to significant drops in lease revenue, occupancy, lease renewal rates, and market rates in the office sector. For example, according to Kastle System's popular Back to Work Barometer for the week following July 4, office occupancy for 10 major cities tracked by employee keycard entries averaged 49.1%. However, there is also considerable variation between cities, with average occupancies ranging from 38.1% in San Jose to 60.8% in Houston.

A primary reason for the variation in office occupancy among cities is because productivity booms that were noted during the pandemic appear to be temporary, prompting more employers to demand workers return to the office. This variation is the result of certain job types that can more easily be performed remotely such as those in information technology, human resources, and marketing.

Office and public transit use still down 40% from pre-pandemic levels.

However, Stanford University researcher Nick Bloom notes that while productivity may decline for fully remote positions, it edges higher for hybrid solutions in which employees are in offices at least three days per week. With office and public transit use still down 40% from pre-pandemic levels – or matching two days working from home – and the return to office push running out of steam, the new status quo could likely feature three days in the office per week. In turn, there is a strong probability this will result in more permanent office vacancies.

Yet, office occupancies alone don't appear to account for the potential damage to urban areas whose tax structures are dependent on a mix of property, income, and sales taxes, as well as the fees collected by public transit systems. The tracking of anonymous cell phone activity by the School of Cities at the University of Toronto shows that between December 2022 and February 2023, the number of calls made in downtown San Francisco was 32% of its pre-Covid levels. This decline supports the importance of repopulating these downtown areas for municipal finances.

Not surprisingly, the School of Cities research shows those markets with the highest vacancy levels are the same as those with the most remote workers. The research suggests that newer Class A buildings in the best locations will continue to perform relatively well. However, it is difficult to predict the long-term effects on Class B and C buildings, especially those in suburban areas.

It's not yet clear just how permanent these shifts will be, with the exodus from urban to suburban and rural areas reversing in 2022. An analysis of Census Data by the Brookings Institution's senior demographer William Frey shows that 11 of the 15 largest metro areas gained residents or lost fewer people compared with the previous year, including the D.C. metro area, New York City, the San Francisco Bay Area, and Seattle.

As reported by the Urban Land Institute's (LI) semi-annual Real Estate Economic Forecast released in May 2023, 2022 office vacancy rates rose a total of 510 basis points to 17.3% in Q4 2022 . Rates are expected to rise by another 135 basis points to 18.7% in 2023, edge up to 19.0% in 2024, and remain at that level in 2025.

Until recently, long-term leases and low-rate mortgages still in effect from existing loans were shielding many building owners from having to adjust their office buildings down to true market value based on lower demand. However, short-term mortgage debts need to be refinanced under a landscape where office leases come up for renewal in a tough market, and may lead distressed owners to either sell, raise needed capital, or give their properties back to their lenders. These new comparables will force owners, lenders, and appraisers to assign lower values more in line with current market conditions. This could lead to a feedback loop of further declines in values, foreclosures, and abandoned office buildings, especially Class B and C properties.

While many lenders had been willing to look the other way and "extend and pretend" that it's only a matter of time until office occupancy levels return to pre-pandemic levels, a growing list of landlords are running out of time and are either selling at deep discounts or handing the keys back to the lender.

Office vacancy rates rose a total of 510 basis points to 17.3% by the end of Q4 2022. Rates are expected to rise by another 135 basis points to 18.7% in 2023, and edge up to 19.0% in 2024.

Slowdown in Business Travelers and Rise of Short-Term Rentals (STR) Impacts Some Hotels

With many companies not yet ramping up business travel and most hybrid offices full only Tuesday through Thursday, the demand for hotel rooms for certain traveler types is often below break-even levels. In fact, domestic leisure travel has been ramping up as consumers engage in "revenge travel." At the same time, the strong U.S. dollar is limiting visitors from overseas, even as it encourages more international travel. In addition, the rise of the short-term rental (STR) business across the globe has also impacted Class B and C hotels and motels, further limiting traditional hotel demand from both leisure and some business travelers.

On a recent edition of Moody's Economics "Inside Economics" podcast, Glenn Mueller of the University of Denver says success has become split between the 'haves' and the 'have-nots,' and for hotels, the have-nots have mostly included lodging for business travelers. As of mid-June, although Smith Travel Research showed U.S. hotel performance improving from the previous week, year-over-year comparisons were more mixed:

Year Over Year Performance

July 11-17, 2023 vs. Comparable Week in July 2022*

- Occupancy: 70.8% (-1.1%)
- Average daily rate (ADR): US$159.82 (+2.6%)
- Revenue per available room (RevPAR): US$113.17 (+1.5%)

*SMITH TRAVEL RESEARCH

The strongest markets year-over-year included Oahu Island, Los Angeles, and Las Vegas, while the weakest markets were New Orleans and San Francisco.

For its part, PriceWaterhouseCoopers (PwC), a leading professional services network, says U.S. hotels continue to outperform expectations. They say leisure travel continues to be strong, even though growth levels are slowing, and individual business travel and group business has slowly re-emerged, contributing more significantly to future growth expectations. PwC forecasts flattening occupancy levels now through 2024, with revenue growth expected to come almost entirely from daily room rates, rising 3.5% year-over-year. This level would be approximately 118% of pre-pandemic levels.

Multifamily Sector Continues Strong Performance

Even with strong construction activity over the pre-pandemic decade, the same ULI report cited above also shows the apartment sector continuing to perform well. Vacancy rates decreased steadily from 7.0% in 2009 to 4.1% in 2019, and increased only slightly during the pandemic year of 2020 to 4.7%. Although rates dipped substantially in 2021 to 2.6%, they returned to 4.6% in 2022.

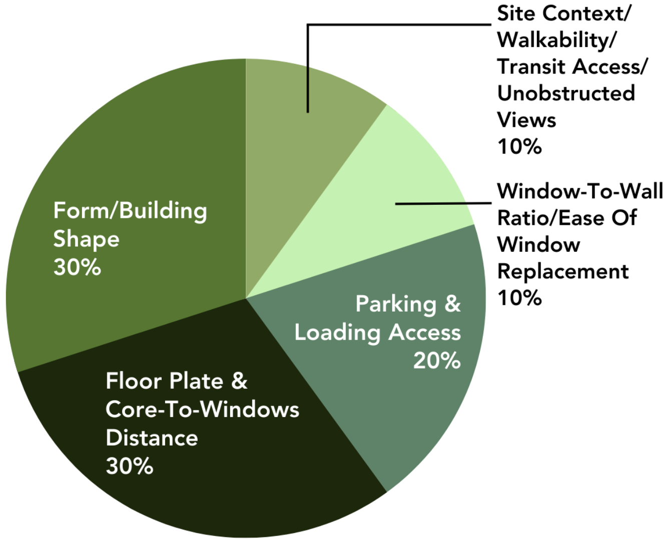
As of May 2023, Yardi Matrix shows continued strength in the multifamily market, even as year-over-year rent growth has slowed to 2.6%. Still, in some markets, rent growth has turned negative in several metro areas due to a decline in demand and rapid growth in new supply being delivered. National occupancy rates remained at 95.0% in April, indicating resilient demand even with some economic uncertainty. On a year-over-year basis, however, occupancy rates fell in all but one of the top 30 markets: New York, averaged 98.0% occupancy in April. The ULI report forecasts vacancy rates moving up 60 bps in 2023 to 5.2%, exceeding the long-term average. Rates in 2024 and 2025 are forecast to remain at that level, with a two-year average of 5.2%.

ULI expects rental rate growth to moderate for all of 2023 to 3.0%, but remain above the long-term average, then dip below the long-term average to 2.3% in 2024 before returning to above-average growth of 3.2% by 2025.

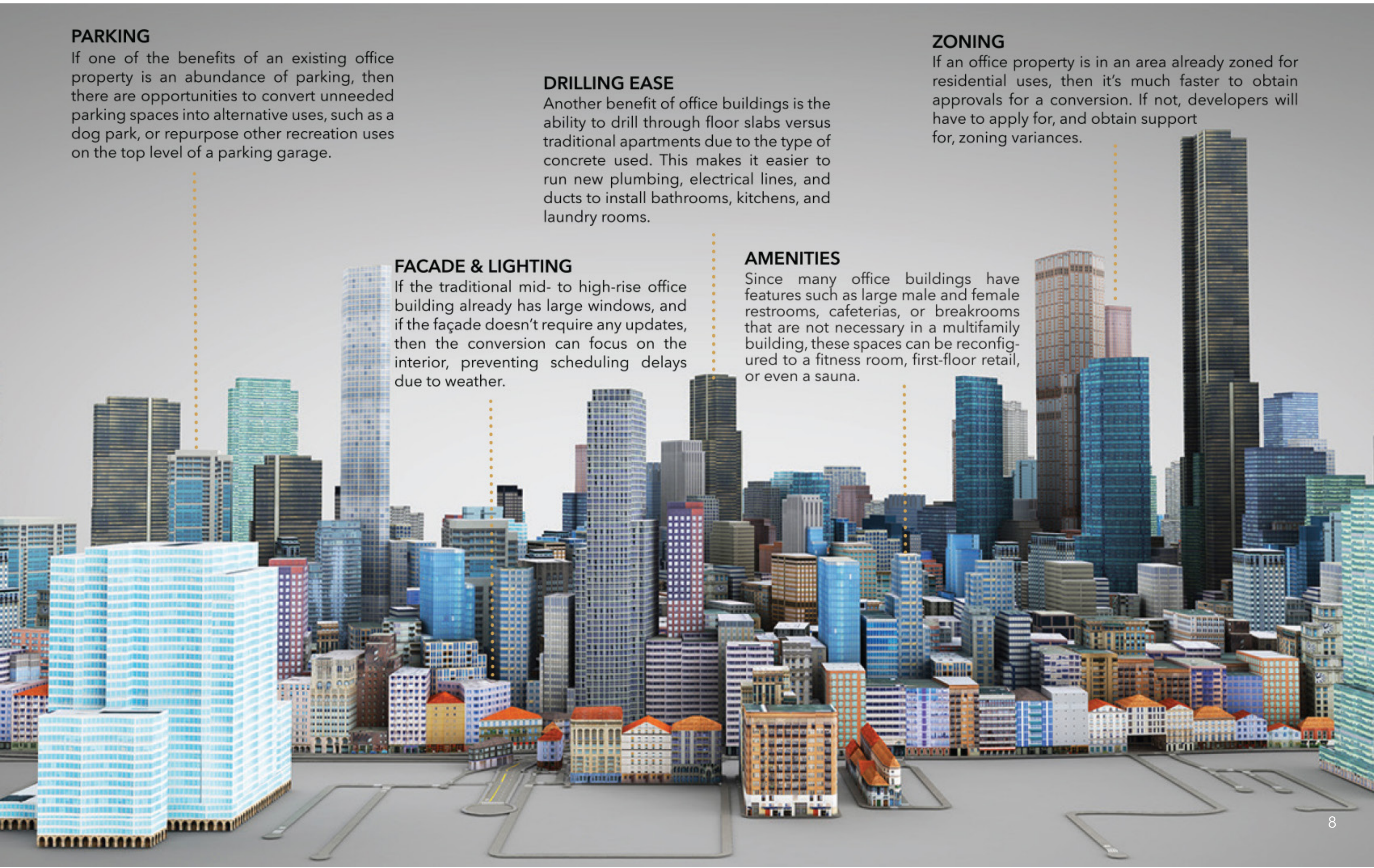
The Conversion Process - Office to Multifamily

According to a survey by commercial real estate broker Avison Young, up to one-third of older office properties across North America are ripe for conversion into apartments. In general, these buildings were built prior to 1990 and have floor sizes under 15,000 square feet, which are easier to carve up into living spaces. Most of these opportunities are in New York, Los Angeles, and Chicago.

For its part, the global architecture giant Gensler has developed a formula to determine if an office can successfully be converted to residences:



Let’s Breakdown The Success Formula



The Conversion Process - Hotel to Multifamily

According to Geraldine Guichardo, former head of global research for JLL's Hotels & Hospitality Group and Americas Hotels Research, Living Platform USA, more owners of obsolete hotels and motels are open to selling their properties to multifamily investors. With strong competition for well-located hotels driving pricing up 25% to 35% above market hotel values, Guichardo expects continued interest in this space due to multifamily capitalization rates for these types of deals falling to 4% or even lower. Even after paying a premium for a lodging property, it may still often be less costly overall to convert to apartments than to buy or build them.

Indicative Construction Costs Per Square Foot

| Multifamily Residential | Selected Cities |

City	QUARTER	LOW	HIGH
NEW YORK	Q2 2019	$200	$375
	Q2 2023	$225	$435
	Cumulative Change	12.5%	16.0%
WASHINGTON D.C.	Q2 2019	$200	$350
	Q2 2023	$205	$355
	Cumulative Change	2.5%	1.4%
LOS ANGELES	Q2 2019	$220	$325
	Q2 2023	$245	$385
	Cumulative Change	11.4%	18.5%
SAN FRANCISCO	Q2 2019	$375	$520
	Q2 2023	$400	$625
	Cumulative Change	6.7%	20.2%

Source: Rider Levett Bucknall

95%

National multifamily occupation rate as of April 2023

The Conversion Process for Hotels

DESIRABLE LOCATION

Not all hotels are good candidates for conversions, because what may seem like an advantage for a short-term stay – such as a bustling downtown – may not be as attractive as a place to live. Similarly, business hotels near airports, although ideal for travelers eager to catch a morning flight, would be less appealing to tenants. However, if a hotel property has an interesting history, compelling architecture, or was once a highly regarded property, converters could leverage those factors in marketing to prospective tenants.

CONFIGURATION

While some hotels may boast luxury suites with multiple bedrooms, most hotel rooms offer studios and single bedrooms. While studios are a popular unit type for affordable housing conversions, most market-rate conversion projects will require combining units to offer more bedrooms. In this case, altering the structure itself may be too costly, especially if it means moving concrete or steel support beams.

PLUMBING

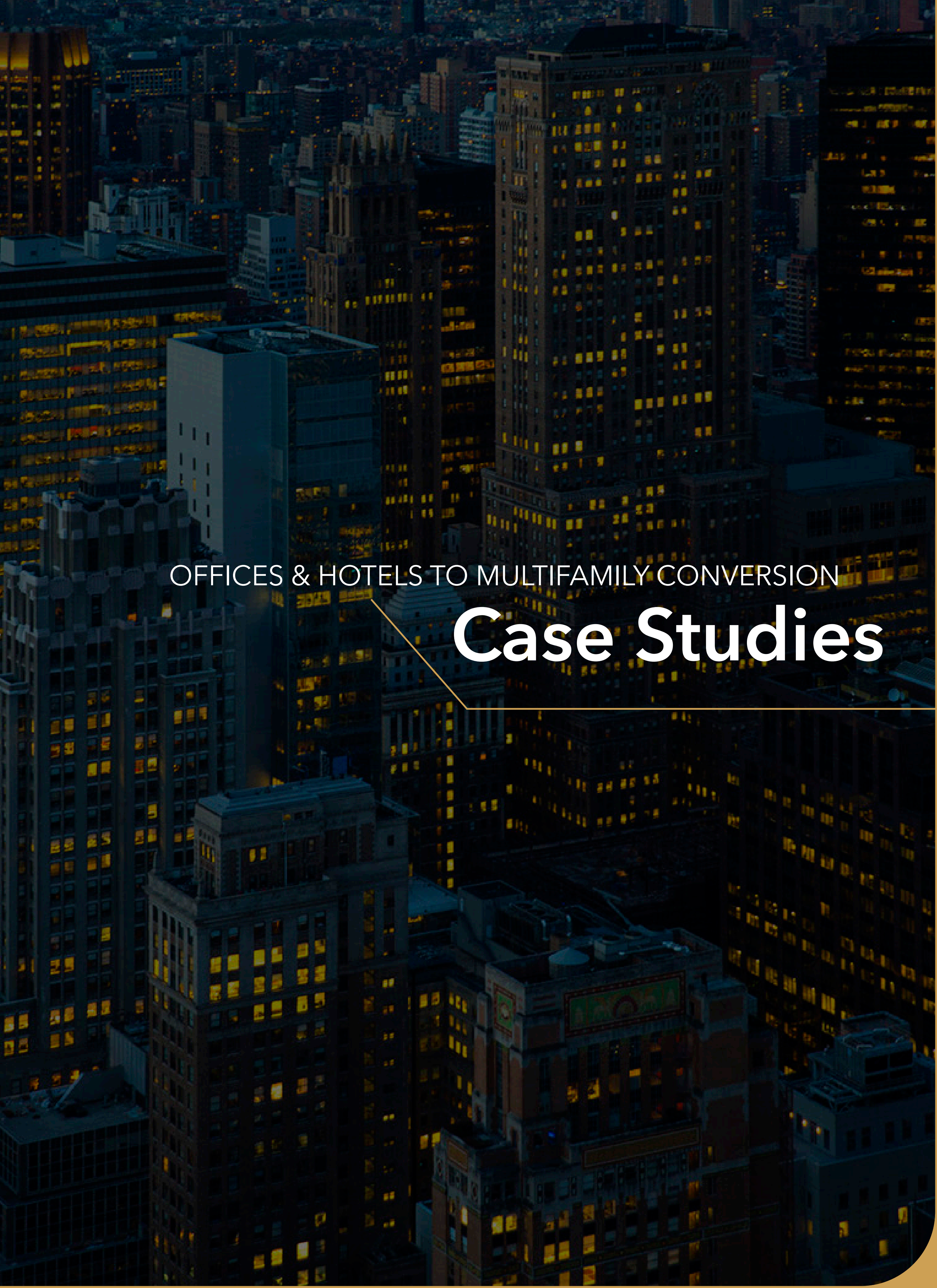
While having one bathroom per unit is ideal for a property full of studio rentals, once you start combining units, you'll likely have to move or remove some of the bathrooms from each floor. Unfortunately, because hotel bathrooms are generally located in central columns for vents to align, the new design will need to accommodate that. While installing new vents and ductwork is possible, this will increase costs.

EXISTING AMENITIES

Depending on the service level of the hotel, some may include cavernous spaces such as commercial kitchens; or laundries, which may require some creativity for new uses. Alternatively, common spaces such as ballrooms or formal lobbies can be repurposed, while fitness centers and outdoor pool areas can be updated or expanded for the new tenants.

ZONING

Similar to office properties, the conversion of hotels to apartments is much easier if the property is already zoned for long-term residential uses.



OFFICES & HOTELS TO MULTIFAMILY CONVERSION

Case Studies

OFFICE TO MULTIFAMILY

ALEXANDRIA, VIRGINIA

Park+Ford

The apartment complex was originally a Class B office complex known as Park Center. With twin 14-story towers, plus an adjacent office building with 115,000 square feet, it was the longtime home to the U.S. Department of Agriculture (USDA). However, when the USDA vacated the office, the building was unable to compete effectively against newer competition.

Today, the property is a new 435-unit apartment complex offering larger-than-usual floor plan sizes with new colorful facades, balconies, and numerous outdoor amenities including a bocce court, barbecue grills, fire pits, private cabanas, and a dog park. With expansive floor plates, which left some interior areas far from windows, the developers created interior dens that opened into living spaces with floor-to-ceiling windows. Inside, the studio, one-bedroom, and two-bedroom units range in size from 580 to 1,238 square feet. Other amenities include an on-site daycare, a package room for e-commerce deliveries, and a recreation space with a golf simulator.

With an estimated conversion cost of $126 million, or $289,655 per unit, the adjacent office building also features a 55,000 square foot X-Sport Fitness Club.

PHOTO CREDIT: CONNECT CRE

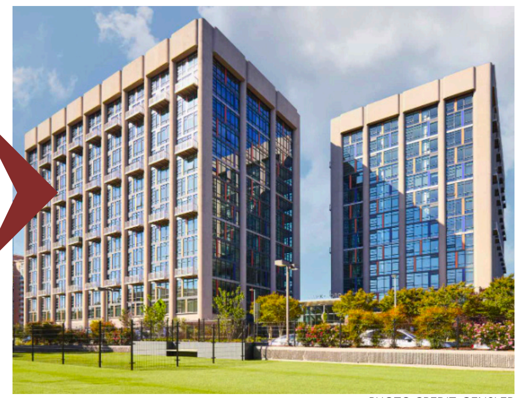


PHOTO CREDIT: GENSLER

OFFICE TO MULTIFAMILY

MANHATTAN, NEW YORK

160 Water Street

This property was a 24-story office building in New York City's Lower Manhattan (Financial District) and is being converted by the Vanbarton Group into 588 residential units that will range from studio to two-bedroom layouts. The estimated price tag of the project is $272.5 million (or about $463,000 per unit including common area improvements).

The commercial conversion process includes infilling a mechanical floor, adding five new residential floors above the existing structure, and reskinning the exterior to add operable windows. Vanbarton Group is also planning to add 34,000 square feet of amenity space, including a lobby lounge, coffee bar, fitness center, and rooftop deck.

With relatively small floor plates offering light and air on three sides, it's much easier to create legal apartments in which every bedroom is required to have a window. Otherwise, the property would need to have an atrium cut into the core of the building, adding significant costs.

PHOTO CREDIT: CONSTRUCT CONNECT

PHOTO CREDIT: GENSLER

MANHATTAN, NEW YORK

180 Water Street

This property, also located in New York City's Lower Manhattan, was a 24-story office building completed in 1971 and converted to housing in 2017 by the developers Metro Loft Management and Vanbarton Group. A larger floor plate placed interior spaces too far from windows and as a solution, the developers carved out a 40-foot wide, 1,200-square-foot courtyard near the center of the building above the second floor. This creative approach delivered three benefits; the avoidance of structural columns for this new open-air space, additional windows, and natural light for living spaces, and the ability to reclaim lost rentable space by adding several new floors on top of the original structure.

Today, the 29-story, 480,000-square-foot tower offers 580 market-rate studio and one-bedroom apartments with 10-foot ceilings, 10,000 square feet of retail space, and amenities that include a 24-hour doorman, a roof-top terrace with a pool, a fitness center, a children's playroom, and a tenant lounge.

While neither the unit sizes nor the costs of renovation are available, indicative costs for multifamily residential units by Rider Levett Bucknall for New York City in the second quarter of 2017 ranged from $200 to $375 per square foot.

PHOTO CREDIT: 180WATERST.COM

PHOTO CREDIT: STREET EASY

> "It really measures and evaluates the physical assets and compares them to what the residential market in that city is looking for. However, we then weigh the scoring against the things [that] most impact cost. So a building that does not require a façade replacement, for example, will score higher than one that does, because it will cost significantly less. We also factor in the building's location in a significant way, as it has to be a place that people will want to live.

- Gensler's Steven Paynter on His Office Building Conversion Algorithm

QUEENS, NEW YORK The Hilton

This hotel is located at John F. Kennedy (JFK) International Airport in the Queens borough of New York City and was recently sold for under $70 million. The Slate Development Group and Riseboro Community Partnership plan to transform the 356-unit hotel into 318 apartments for homeless persons and low-income households by 2025.

Built in 1986, and located within a mile of JFK, this 207,000-square-foot hotel was forced to close when international travel fell sharply during the pandemic. With rooms ranging in size from 306 to 459 square feet, the apartments will include a mix of studios, and one- and two-bedroom floor plans.

Sixty percent of the units will be reserved for people struggling with homelessness. The remaining units will accommodate lower-income households with estimated rents of $1,250 (one bedroom) and $1,500 (two bedroom).
While the hotel appealed to the development team because of its relatively large room sizes, a spacious lobby, various on-site amenities, and its affordable price, it also already zoned for residential development, thus greatly simplifying the process. As is common with permanent supportive housing for recently homeless persons, RiseBoro will also provide additional services to residents such as mental health care.

The project is the first to take advantage of a 2021 state program to make conversions easier, more affordable, and faster. Of the total $150 million conversion cost (or about $472,000 per unit including common area improvements), $48 million will come from the state's Housing Our Neighbors with Dignity Act, with additional subsidies coming from the city's Housing Development Corporation and Department of Housing Preservation and Development.

PHOTO CREDIT: BOOKED.NET

PHOTO CREDIT: KAYAK.COM

> "We can solve the housing crisis. We can create hundreds of units of new housing out of hotels and underutilized assets.

- RiseBoro Community Partnerships, CEO Scott Short

HOTEL TO MULTIFAMILY

ANAHEIM, CALIFORNIA

Buena Esperanza

Buena Esperanza is an affordable housing community and former motel that was converted by Jamboree Housing in 2021. The multifamily property provides 70 studio apartments for people experiencing homelessness.

The property was originally a 70-room Econo Lodge built in the 1970s, and the redesign into an apartment complex was transformational and was awarded for its impact. Although the overall design kept the existing footprint to avoid moving walls, rooms ranging from 150 to 325 square feet were gutted and reconstructed with high-quality, environmentally friendly materials and products. In addition, a new one-story, 1,800-square-foot community center was also added to provide both supportive services and a gathering place for residents.

Structural issues like dry rot and water damage pushed the cost of Anaheim project up to $410,000 per unit–well above the state's $130,000 average. This compares with multifamily construction costs of $225 to $370 per square foot (or $33,750 to $120,250 for these unit sizes) in the greater Los Angeles area during the third quarter of 2021.
The project was funded primarily with city bonds and low-income housing tax credits (LIHTCs), but the high cost left a funding gap of more than $2 million that was filled with help from the Orange County Housing Trust, a low-interest loan from the Disneyland Resort, and a gift from the Home Depot Foundation.

PHOTO CREDIT: URBANIZE


PHOTO CREDIT: FUSCOE ENGINEERING

HOTEL TO MULTIFAMILY

CHARLOTTE, NORTH CAROLINA

The Spoke at McCullough Station

The property was originally built as a 118-unit extended stay hotel most recently branded as Homewood by Hilton. Acquired by Blaze Partners and Argosy Real Estate Partners in 2021, it was converted into The Spoke at McCullough Station as it is situated across from the McCullough Station of the LYNX Blue Line light rail service.

It is now a 124-unit community that includes three buildings with a mix of studio, one- and two-bedroom floorplans. The renovated floor plans offer studios and one-bedroom plans ranging from 325 to 583 square feet. The community also features a freshwater pond, a clubhouse including a fitness center, media room and outdoor pool. In addition, the developer also intends to construct more apartments on some vacant land on the site, and it was partly this vacant land which made the purchase even more attractive. No cost data was available for this conversion.


PHOTO CREDIT: BOOKED.NET

PHOTO CREDIT: TRULIA

In conclusion, the COVID-19 pandemic has had a profound impact on the office and hospitality sectors of the commercial real estate market, leading to underperforming hotels and offices. However, developers, architects, and cities are embracing adaptive reuse strategies to repurpose these obsolete buildings into much-needed multifamily units.

The shift in working arrangements, with a significant increase in remote work and hybrid models, has resulted in drops in lease revenue, occupancy, and market rates for office properties. The decline in business travel and the rise of short-term rentals have also contributed to the softening of the hospitality sector.

The conversion process from office and hotel to multifamily involves considering many logistical, architectural, zoning, and other factors. Despite the challenges, many older office properties and obsolete hotels present opportunities for conversion, especially in desirable locations and with careful consideration of the necessary modifications. As the market evolves, adaptive reuse can provide a sustainable solution for transforming underperforming buildings into valuable assets that meet the changing needs of communities.

Learn more: **x-caliber.com/news-insights**

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