

Transcript

Code 53

From Office to Residential: The Rise of Commercial Conversions in Multifamily Housing

Rick Pollack:

What we really feel like the fundamental question is is how does this change cities?

Alison Johnson:

Welcome back to Code 53, The Apartment Podcast. I'm your host, Alison Johnson with NMHC. On this show, we bring you into conversation with apartment industry executives, leading experts in the multifamily sector and a diverse group of practitioners, all to help you learn everything it takes to create communities, from business strategy, to design, to finance, and leadership.

Today on Code 53, we're exploring the increasingly common business of converting commercial property into residential property. When zoning and housing laws allow and the right market conditions exist, repurposing commercial properties into multifamily housing can be a win for owners, operators, communities, and tenants. Coming up, we'll talk with Rick Pollack from RCLCO Fund Advisors and discuss the ins and outs of commercial conversion, why it's succeeding across a variety of local markets and how it can provide a critical source of housing where shortages persist.

announcer:

The Code 53 podcast is brought to you by NMHC, the National Multifamily Housing Council, the place where the leaders of the apartment industry come together to guide their future success. From owners to managers and developers, NMHC's members create thriving communities by providing apartment homes for 40 million people, contributing \$3.4 trillion annually to our nation's economy.

Alison Johnson:

Cities and suburban centers across the nation are reassessing their needs when it comes to a balance between commercial property and multifamily residential property. In places where once thriving downtown office buildings are now under or unoccupied, the question becomes, is there a second life for this property? What else could it be? Well, converting office to multifamily is both an art and a science. And last month, the Urban Land Institute along with the NMHC Research Foundation dropped a fantastic report on this topic. The authors conducted in-depth interviews with developers of almost 30 projects.

To get details about the conversion process today, we are joined by an expert real estate analyst who helps institutional clients considering these very same issues every day. Rick Pollack is managing director at RCLCO Fund Advisors and has extensive experience advising clients on residential investment

opportunities, including conventional, multifamily, single family and student housing, and he is a former member of the National Multifamily Housing Council Emerging Leaders Committee. Rick Pollack, welcome to Code 53, The Apartment Podcast.

Rick Pollack:

Thanks for having me. Great to be here.

Alison Johnson:

Before we dive into the topic of commercial conversions, for the benefit of some of our listeners who may not be familiar with RCLCO or, in fact, what a real estate investment advisor does, please tell us about your work.

Rick Pollack:

Sure. So, RCLCO was founded in 1967 and was really a pioneer in real estate economic services. So the firm helps owners and investors really understand supply and demand fundamentals around their real estate. We also offer a management consulting practice that helps owners and operators of real estate companies think about the strategies for their businesses, how to grow and sustain their businesses.

My side of the firm RCLCO Fund Advisors, which is an affiliate of RCLCO, has been around for about a dozen years, and we advise institutional investors on their real estate portfolios. So that's primarily public pension funds but also sovereign wealth funds as well. And we help them think everything from big picture, how should they be allocating to the real estate sector, to in the weeds decisions about specific assets, investments, purchases, developments, capital projects, et cetera.

Alison Johnson:

Thanks for sharing that context, Rick. Let's dive into those weeds, shall we? I'd love to talk about what you're seeing in your work and maybe some of the conversations you're having with investors. How should everyone listening think about the conditions needed for a successful commercial to multifamily housing project?

Rick Pollack:

Well, I think you hit on in your introduction, Alison, that there's a lot of focus on these conversions today, but I think it's important for folks to remember that this is not a new phenomenon or a new concept, right? Creative developers have for years repurposed old factories and warehouses, hotels and office into multifamily housing. And as I mentioned when I talked about RCLCO and RCLCO Fund Advisors, we always approach these kinds of questions from a supply and demand perspective. And I know listeners of this podcast understand that there's a critical lack of housing in this country, right? So on the demand side, there's plenty of it.

What does feel a little bit different about today is that there's really a focus on conversion of traditional offices, even skyscrapers in some instances, which are under pressure as an investment class and have seen rising vacancy. And so, many are hoping that repurposing these buildings will create a shortcut to the supply side of the equation. But ultimately, like any development that's going to depend on a number of factors. That includes cost, regulations, which we know adds significant cost to development, the debt and equity capital markets, and rents.

So we started thinking about this really in earnest probably a month or two ago. We think there's going to be a lot of opportunity here for our clients both on the traditional side and on the fund advisor side. And the more that we've gotten into it, what we really feel like the fundamental question is is how does this change cities? Cities are not really prepared for the office to residential conversion from a tax-based standpoint where you have very valuable office buildings contributing, in some cases, significant tax dollars, and you're faced with either significantly less tax dollars as the existing use or maybe significantly less tax dollars but higher costs through the multifamily conversion. And so, I think that that's something that on the municipal side is kind of underappreciated, that this is not really a panacea for some of the headlines about office vacancy.

Alison Johnson:

Gotcha. So let's talk about the supply a little bit more. I mean, you mentioned housing is a commodity and there's supplies and demands. There's a lot of demand in the local communities but not a lot of supply coming online. Or there is a lot of new property coming online, but still not enough to meet the demand. What might property conversions mean for accessibility and affordability of housing in some communities? Does converting these buildings create affordable housing or luxury?

Rick Pollack:

There's certainly no one-size-fits-all outcome. Of course, the lower the cost of the property which will be converted, the greater the ability to offer rents that are affordable to a broader set of renters. I think there's also some interesting opportunities to create lower cost housing through a conversion where there's a lighter lift involved. For instance, think about a suburban extended stay hotel, which might more naturally be converted to multifamily housing than an office building.

I think there are also some opportunities to create family housing through conversions, which the dimensions of an existing building may more easily lend themselves to larger properties. So there's certainly opportunities for, again, more attainable housing to come from conversions, but there's plenty of luxury conversions as well. We've certainly seen this both on the for sale side and on the for rent side. You've seen conversions of premier downtown skyscrapers and historic buildings with significant character. Both of those can generate luxury premiums even over newly built properties.

Alison Johnson:

Great. So, Rick, there's definitely market opportunity, but following on from that, how feasible is it to think that converting unused buildings into multifamily will help address the supply-demand mismatch in these communities?

Rick Pollack:

Well, it's certainly feasible, but the devil is always in the details with feasibility, and I think listeners should understand that these are not easy projects. First and foremost, there's some locations where from a zoning perspective, housing is simply not permitted where there are office buildings, right? So that's the first hurdle that you have to get over. When you can do that from a design standpoint, there are architectural and structural considerations, regulatory considerations like ingress and egress, parking, seismic requirements or other updated requirements that may have been put in place since the building was originally constructed.

And there are livability considerations as well. Light and air, unit configurations, all of these things create a very complex puzzle that a developer has to put together in pursuing a conversion. It really requires a creative development design and consultant team to be able to do that. And all of that comes at a cost, which makes it harder to convert and can really impact the feasibility, particularly I think that it's something that municipalities don't always appreciate. Again, there's a lot of folks that view conversion as a way to solve or address negative fiscal impacts of office vacancy, but it's really not as simple as just taking the existing box and putting housing units inside.

Alison Johnson:

So in your conversations or just from what you're seeing happening in the marketplace right now, what does a good outcome in this space look like?

Rick Pollack:

Sure. So I think there have been some really interesting and creative conversions in this space, the kinds of things that you see in real estate magazines and newspaper articles, again, buildings with a lot of character or buildings where it's a complete transformation of a property and something that doesn't even look like what was there before. We've also seen coring buildings, taking out the middle of an existing property that you wouldn't even know from walking by on the street, but that's necessary to make it into a viable multifamily project.

I don't think that that's necessary for a "good outcome." Right? I mean, I think at the end of the day, we have a housing shortage in this country, and so any conversion, really, is a good outcome because it's creating more supply. And I also think from a resource utilization standpoint, conversion is a good outcome because you are reusing the existing resources that were originally utilized in building whatever that initial property was. So I don't think that folks need to approach these as, "I'm going to completely transform this property that you're not going to know what it was before," or "It has to be top of market, luxury or premium." Ultimately, supply is a good outcome.

Alison Johnson:

I want to touch on something that you said a little bit earlier, that many communities are dealing with some negative fiscal issues and are looking to possible conversions as a way of stabilizing their own budgets and activating some now seemingly vacant downtown spaces. We'll touch on site context in a second, but how much of what happened coming out of the pandemic is pushing transformations right now into overdrive?

Rick Pollack:

I think we're seeing an increase, but I don't know that it's overdrive just yet. I think there's a lot of people that are thinking about this today in the context of what we're seeing in reduced office utilization, but I don't think about it the same way that we do, for instance, the single family rental sector where the pandemic really accelerated demand into that sector. The decrease in office utilization over the last several years, that's more dramatic in some markets than in others. And I think that a looming recession may disrupt those patterns. We're starting to see in some cases there is a reversal of the amount of work from home. I think the pandemic has highlighted the types of offices that workers want to go to, but that doesn't necessarily mean that a conversion to multifamily is higher and better use.

And I think from a fiscal impact standpoint, it's important to remember a few things. So one, the commercial tax base utilizes less resources than the residential tax base does. And so certainly being able to collect taxes on an occupied residential building would seem to be better than a vacant office building. But when we're talking about some office occupancy, that might not be worse from a fiscal standpoint than that residential building. And a lot of the tax base also depends on the value of those commercial buildings. So that's another important factor I think that cities have to think about.

And then lastly, as I touched on earlier, cities have grown where there's, in a lot of cases, a defined employment downtown, and that's separate from the most part from the residential space. And I think there really needs to be a rethinking about what the city will be like and how it will function and what kind of services are there and what kind of retail is there, and hospitality, all of those things if we move away from the traditional office downtown. I think that's a big question that goes a lot farther than just, "Should this particular building be repurposed as multifamily?"

Alison Johnson:

That raises a question about site context that I had. Offices that are underutilized right now are pretty much in communities that were meant to be used from 9:00 AM to 5:00 PM, but a multifamily project flips that on its head where people tend to use it from 5:00 PM to 9:00 AM, or these days, they work from home. So they're going out, yes, they're going out for lunch, but they're also going out to take the dogs for a walk or to pick up their kids from school. Let's talk a little bit about these site context obstacles. What are some of the biggest things that a developer needs to think about when considering commercial to residential conversion?

Rick Pollack:

I think as we talked earlier, they're just not as easy as owners or lenders who may be worried about their collateral or municipalities, who are worried about their tax bases, want them to be. Just because there's an existing structure, it doesn't mean that you're halfway to a viable multifamily property. While this is not a new concept, there are not many folks in the private or public sector with deep conversion experience. And so while it's certainly encouraging to see both groups leaning in, we don't necessarily know that the expectations of those two groups are going to align in terms of what the ultimate project may be. I think also that lack of experience, at least on the private sector side, it leads to a lot of surprises if you talk to groups that have gone through these processes, both physical surprises when they're going through the conversion, as well as regulatory surprises when they're trying to work with municipalities to convert from an office use or a commercial use into a multifamily use.

Alison Johnson:

We've seen these kinds of developments before. I'm sure our listener is like, "Isn't this just another form of adaptive reuse just with a new modern economic twist?" How should we rethink this in today's context? And how might local jurisdictions, somebody in the public sector who's listening to this right now, how might they need to rethink how they can support this kind of physical transformation in their own community?

Rick Pollack:

What's a bit different is the location of these. And again, that we're talking more about office here than other uses potentially in the past. Certainly, cost is always a consideration, and so anything that municipalities can do to reduce the cost burden on developers is going to enable more conversions. And that could be things like tax incentives, but it could also be reducing just the general regulatory burden, right? Streamlining approval processes. You've also seen other municipalities that have been willing to relax some of their regulations, parking in particular, to enable conversions from office to multifamily. Some properties will qualify for historic tax credits, but I don't think that that's the majority of the properties that people have their eye on today for conversion. It's really offices from the '70s, '80s, and '90s that are too modern to qualify for those kinds of tax credits but that are underutilized that people are trying to figure out how to make financially viable.

So I think it's certainly encouraging, again, whenever the public sector wants to partner with the private sector to address the issue that they see in front of them, but I think the private sector needs to understand that, again, the public sector might have a different approach to this. There might be more affordable housing that's required as part of the... So it really needs to be a partnership, again, particularly in locations where this might be the first or second kind of adaptive reuse project that's taking place. The different groups are going to have to work together and figure out what that looks like in that locality.

I think it's more economic than regulatory, right? At the end of the day, these are coming down to dollars and cents to figure out if they work. I think where the rubber is going to meet the road a lot is

going to be with lenders. Is there going to be a conversion by the current owner? Is there going to be a conversion by the next owner? And is that next owner an arm's length transaction, or is that next owner through some sort of foreclosure, whether friendly or not kind of activity? I think that's where we see a lot of folks spending time working on this today, and a small part of that is the regulatory aspect. It comes in, but I don't think it's the fundamental question when it comes to whether or not a conversion is feasible or not.

Alison Johnson:

Rick, I have to say you have been a great voice and counsel in bringing some clarity to this issue. So thank you very much, Rick Pollack, managing director of RCLCO Fund Advisors, for being our guest on Code 53, The Apartment Podcast.

Rick Pollack:

Thanks for having me.

Alison Johnson:

And thanks to everyone downloading and sharing the show. Subscribe and meet us right back here for another episode of Code 53.