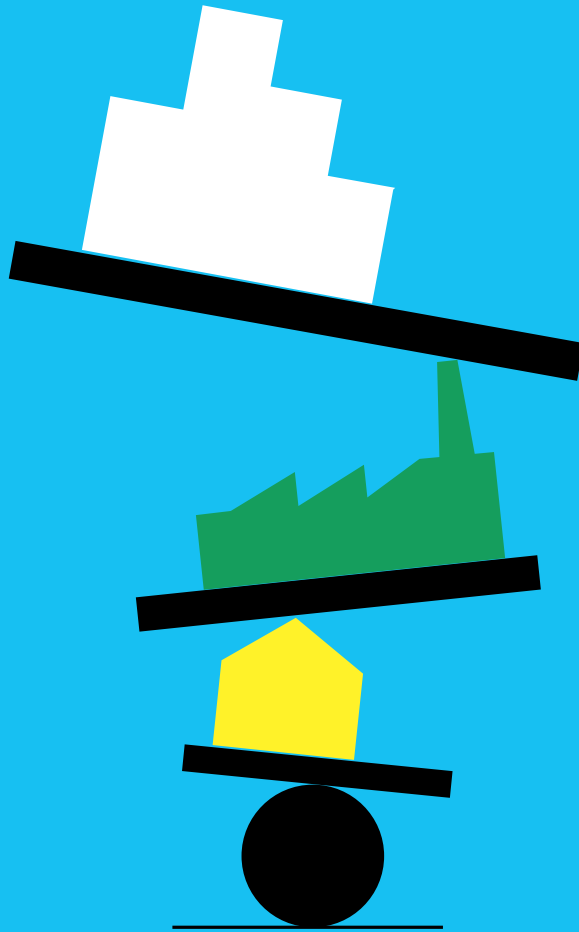


RENEWED PURPOSE



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From retail to office to abandoned factories and warehouses, owners of real estate are rethinking—and reinventing—the future of their investments.

The way humans need, use, and enjoy the built environment is more fluid now than ever. From retail to office to abandoned factories and warehouses, owners of real estate are rethinking the future of their investments, and in many cases—driven by necessity or opportunity—they are reinventing the properties.

Online retail and social media triggered a shift in the retail sector of the commercial real estate industry. By early 2020, COVID-19 became a part of our daily vocabulary and, as we well know, caused significant impacts on retail real estate. What then to do with these huge concrete boxes filled with clothes, toys, office supplies, and electronic devices?

Similarly, the office sector was performing well in early 2019, until our world realized we don't all need to sit together in an office to be productive and profitable. With remote work becoming more permanent, 30% of US office buildings, worth an estimated US\$1.1 trillion, are now at high risk of becoming obsolete in a hybrid-work era.¹

Finally, residential has gone through a similar transition. Take the Tampa/St. Petersburg/Clearwater metro area in Florida as an example. This residential real estate market has benefited tremendously from pandemic shifts in behavior, desires, work obligations, and so forth. The beach areas used to have a season. Now that season is year-round. Simple supply and demand has created a market where in some areas values have more than doubled in just two years. Rents are skyrocketing. How does the working class afford to live? Residential, especially reasonably affordable residential, will require creative thinking.

This brings us to adaptive reuse, or the notion of converting buildings that were built for one purpose into a different use. Adaptive reuse has been in practice for quite some time (for example, as the US economy shifted from manufacturing to services in the '80s and '90s, and the resulting number of warehouses and factories that have been converted to thriving mixed-use facilities). But the pandemic era has brought renewed interest to the practice.

Developers and investors who think creatively, given these behavioral and market-driven shifts, are those likely to outpace others who are following traditional investment guideposts. Following are a few examples to highlight this advantage.

THE GIFT THAT KEEPS ON GIVING

In Tampa, Florida, Armature Works (AW) is the anchor tenant at The Heights, an expansive riverfront neighborhood development. AW is a textbook adaptive reuse project. Developers Chas Bruck and Adam Harden of SoHo Capital looked at this old, abandoned streetcar repair and storage warehouse in a blighted area of Tampa, on the wrong side of the interstate—albeit along the busiest downramp in the State of Florida—and saw an opportunity to capture new value. It took thought, research, vision, creativity, time, and trust to turn AW into what it is: a bustling 73,000-square-foot mixed-use commercial space including Heights Public Market, a food hall and gathering space, event spaces, office, high-end restaurants, and a signature rooftop bar.

The thought and creativity that went into redeveloping Armature Works will pay dividends by driving occupancy of SoHo's other developments within the Heights, including the Pearl, a 314-unit luxury mid-rise apartment development, now fully occupied. Heights Union, two 150,000-square-foot luxury Class A office buildings were almost 95% occupied upon completion, with anchor tenants Pfizer and Axogen and sold for a record-breaking price.

CREATIVE AFFORDABLE HOUSING

Central Florida's economy is largely driven by hospitality, which requires an extensive work force, most of which unfortunately does not make a living wage. Affordable housing is a real challenge in and around Orlando, Florida. Old motels with exterior entrances, which are in abundance, are now considered obsolete in the hospitality industry. Developers are redeveloping these motels into micro-apartments with pro-forma rents set such that they will be affordable for someone making around minimum wage.

The redevelopment of these assets typically includes adding kitchens, combining rooms to create one- and two-bedroom apartments, new fixtures and finishes, upgrading pool areas, adding fitness rooms, and creating new outparcels with retail uses to serve the residents, such as quick service restaurants. The retail parcels can be sold off separately, which can make a huge impact on returns.

Adding these uses and creating new parcels can involve rezoning and platting, which can be timely but when run concurrently with the motel renovation, may not impact the project timeline. The results of this type of reuse are an example of win-win-win: Improvements to the city as blighted properties now look fresh and new; workers have a more affordable and enjoyable place to live; and developers create a profitable project.



Office buildings are a target for adaptive reuse because many are facing obsolescence for meeting their original program, and supply and demand underscores a need for more housing.

OFFICE TO HOUSING

In 2021, there were more than 20,100 apartment conversions and industry experts project at least 53,000 conversions in 2022. Roughly 40% of the conversions are from office buildings over the last two years.² Office buildings are a target for adaptive reuse because many are facing obsolescence for meeting their original program, and supply and demand underscores a need for more housing.

According to the National Association of Realtors, there was positive net absorption of apartment units in 27 major markets, but negative net absorption of office space through the third quarter of 2021, with New York City losing 21.8 million SF of office occupancy, Washington, DC 8.5 million SF, Chicago 6.4 million SF, and LA 6.1 million SF.³

BENEFITS OF ADAPTIVE REUSE

Adaptive reuse is often less expensive than new construction. The more of the existing structure that can be preserved, the more cost-effective the project is.

Adaptive reuse is often environmentally friendly compared to demolishing an existing building and starting over with new construction. Reuse avoids filling landfills with tons of debris that comes from tearing buildings down and new construction. The Environmental Protection Agency estimates that building-related construction and demolition debris account for 26% of all non-industrial waste generated in the United States.⁴ Through adaptive reuse, developers can reduce both the emissions and demolition waste that come with building something new.

Depending on the location and characteristics of the building, government incentives may be available, such as historic, low-income, or new market tax credits, or tax increment financing. Projects located in opportunity zones also come with significant tax advantages for investors with capital gains.

In addition, reuse can bring a new project to market much faster than ground-up construction, resulting in additional cost savings, reducing the carrying costs of a project during construction, and bringing in revenue more expediently.

CHALLENGES OF ADAPTIVE REUSE

A critical challenge of adaptive reuse is the buildings systems themselves: original plumbing, floorplans, and especially lighting can be a challenge. Moody's Analytics estimates that less than 3% of the 1,100 offices in a study of the Manhattan market would be candidates for apartment conversions. Reasons include:

- **Cost:** office values would need to decrease another 30-40% for redevelopment costs, plus purchase price, to make financial sense
- **Design:** deep floor plates (100–120 feet) result in interiors that are too far from windows and lend to poor indoor environmental quality
- **Location:** especially relative to amenities or employment.⁵

DUE DILIGENCE

Recognizing the challenges of adaptive reuse, due diligence takes on added importance. Developers require a seasoned team of architects, engineers, contractors, and counsel to fully evaluate the adaptive potential of an older building. Questions include: are existing load bearing walls structurally sound; will existing systems (HVAC, electric, plumbing) support the new use; does existing zoning support the new use; Americans with Disability Act concerns; sufficient parking; and of course, as with any real estate development, what is the market demand for the new product. Developers should evaluate whether there are incentives or tax credits available, as historic and low income tax credits are particularly applicable to residential conversions.

GOVERNMENT CAN PLAY A ROLE

In some jurisdictions, such as Washington, DC, local government actively partners with developers to encourage adaptive development, often using a public-private partnership model. The District of Columbia is reaching out to the developer community to discuss how it can incentivize commercial-to-residential conversions that could help revitalize its office-heavy downtown.⁶ The District's goals include increasing affordable and workforce housing units in downtown.

In Philadelphia, developers have brought more than 1,800 apartment units online in ten repurposed buildings over the past few years.⁷ This is aided by the city's tax abatement for rehabilitated properties.

Many argue that local governments need to assist to make conversions happen. Governments can identify and help finance conversions. Tax incentives, expedited permitting, and relaxed zoning are all tools that governments have to promote conversions. In a post-COVID world where major downtowns and all the businesses that formerly thrived on robust office occupancy pre-COVID are now struggling, it is in the local government's interest to assist in the conversion of offices to residential. It is a path back to healthy and vibrant downtowns.



ABOUT THE AUTHORS

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NOTES

¹ Dees Stribling, "\$1.1T In US Office Properties At Risk Of Complete Obsolescence," Bisnow.com, updated March 15, 2022, bisnow.com/national/news/office/more-than-1-trillion-in-office-properties-at-risk-in-post-pandemic-world-112245

² "Adaptive Use Reaches Record Levels," Rent Café, naahq.org/one-bedroom-rents-reach-all-time-high, accessed March 25, 2022.

³ Scholastica Cororaon, "Strong Potential for Office-to-Housing Conversion of Class B Buildings in Metro Areas impacted by the pandemic," National Association of Realtors, updated November 16, 2021, nar.realtor/blogs/economists-outlook/strong-potential-for-office-to-housing-conversion-of-class-b-buildings-in-metro-areas-impacted-by, accessed November 16, 2021.

⁴ "Construction and Demolition Debris: Material-Specific Data," US Environmental Protection Agency, updated December 21, 2021, epa.gov/facts-and-figures-about-materials-waste-and-recycling/construction-and-demolition-debris-material.

⁵ "Why Office-to-Apartment Conversions are Likely a Fringe Trend at Best," Moody's Analytics, updated April 7, 2022, cre.moodyanalytics.com/insights/cre-trends/office-to-apartment-conversions/.

⁶ Marissa J. Lang, "DC Mayor unveils plans to incentivize office-to-residential conversions as downtown struggles to recover," The Washington Post, updated December 14, 2021, [washingtonpost.com/dc-md-va/2021/12/14/dc-downtown-offices-convert-to-housing/](https://www.washingtonpost.com/dc-md-va/2021/12/14/dc-downtown-offices-convert-to-housing/).

⁷ Michaëlle Bond, "Philadelphia is a leader in turning old factories and offices into apartments," The Philadelphia Inquirer, updated November 7, 2021, [inquirer.com/real-estate/housing/philadelphia-redevelopment-apartments-historic-buildings-tax-credit-20211104.html](https://www.inquirer.com/real-estate/housing/philadelphia-redevelopment-apartments-historic-buildings-tax-credit-20211104.html).