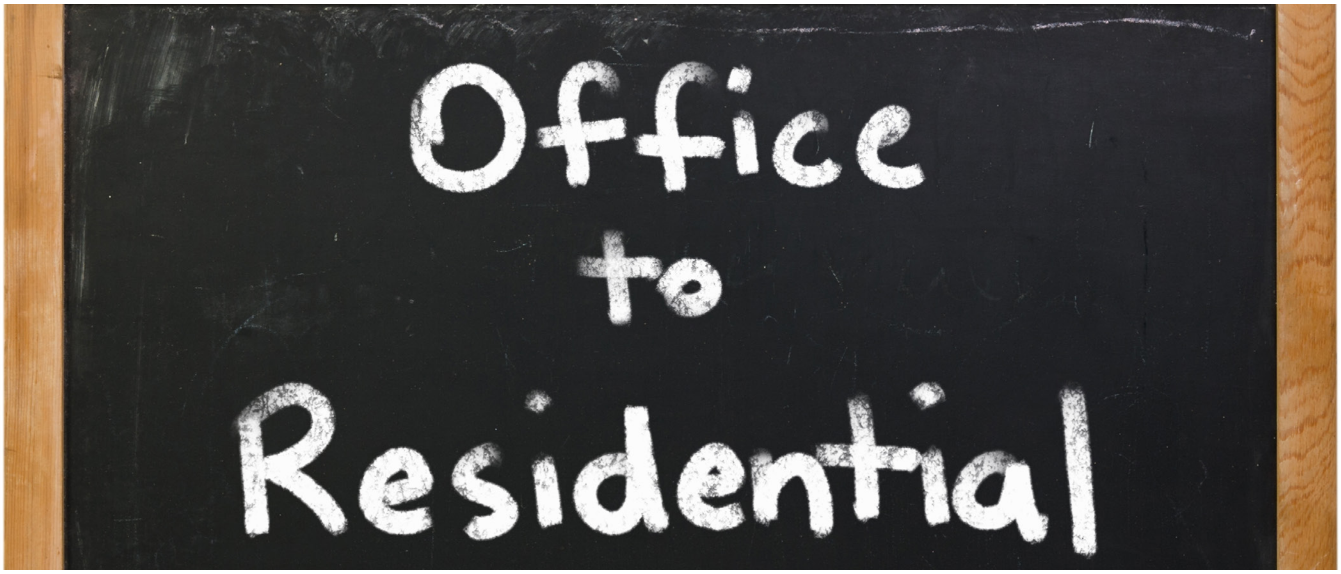
Reshaping CRE: The Challenges and Opportunities of Adaptive Reuse



In the midst of the ongoing crisis in the office sector, a term that commercial real estate (CRE) professionals have become deeply familiar with is "adaptive reuse." Office conversions – into retail, multifamily or other asset classes – are being promoted as a solution to the faltering return to work.

By being adapted, buildings that have stood vacant for months, or even years, suddenly take on a new life, supporting job creation and even anchoring further developments. It's a strategy with the potential to revitalize building stock and add incredible value to previously underperforming assets.

The questions at the heart of the adaptive reuse proposition, however, are: how often is that the case and what factors influence that value?

Conversion Analysis

In a recent article, architectural firm Gensler laid out the results of a study that assessed over 1,000 potential office-to-residential conversions over a period of several years. The buildings assessed spanned dozens of cities across North America.

Of those buildings, Gensler found that only 25% were suitable for conversion. They cited location, floor plate size, and building form (physical characteristics) as key factors in assessing a building's potential for reuse. If, for example, a building has a particularly large floor plate, it's more difficult to convert the area near the building's center to living space, because of a lack of windows.

Site-Specific Concerns

The actual number of buildings that could potentially be converted can be even lower when viewed through the lens of developers, with some noting that as few as 11% of buildings surveyed are suitable candidates for conversion. When financing costs are added, the actual number of projects that qualify to move forward can be very low.

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Additional challenges come from zoning laws, which can complicate the issue of converting from one asset type to another, or which may add costs due to requirements such as minimum parking.

Meeting Needs

Interestingly, Gensler's results did show that some buildings that were poorly suited to their previous purpose can be particularly good candidates for conversion. Poor quality offices, for example, often have features that actually add value in multifamily. They found that removing the low ceilings and ductwork typical of Class C office buildings creates a spacious effect when they're converted to residential units, making them more desirable to potential tenants.

Identifying these value points is really where the expertise of CRE and other professionals begin to enter the equation. The key skill is being able to think outside of the box and to reimagine a space in a way that makes sense for a given location and community while still adding value to the bottom line.

One example is converting an iconic old factory in Brooklyn into a chic office space that preserves the building's outer shell. Another is reworking a failing mall into a much-needed light industrial facility that can boost job creation and generate tax revenue that benefits the surrounding community.

ESG Ethos

These possibilities contribute to the appeal of the adaptive reuse concept for many developers, architects, and real estate professionals. But adaptive reuse also provides additional opportunities to meet environmental, social, and governance (ESG) imperatives.

Converting existing building stock (rather than ground-up development) can reduce carbon footprints, especially when up-front carbon emissions during construction can account for as much as 50% of a property's total lifetime emissions.

These reimagined spaces also provide opportunities for developers and architects to try innovative new environmental models like biophilic design.

Working with Existing Value

In the best cases, ESG and other benefits of a potential reuse project will add to the existing value proposition of a building.

With that said, CRE fundamentals like the property's location, the supply and demand landscape, available financing, and the potential cap rate are still the first aspects that must pencil out before a project can go ahead. As such, adaptive reuse shouldn't be considered a panacea for a faltering market.

It does offer another option which, when combined with a suitably thoughtful and creative approach, can add value to portfolios for years to come.