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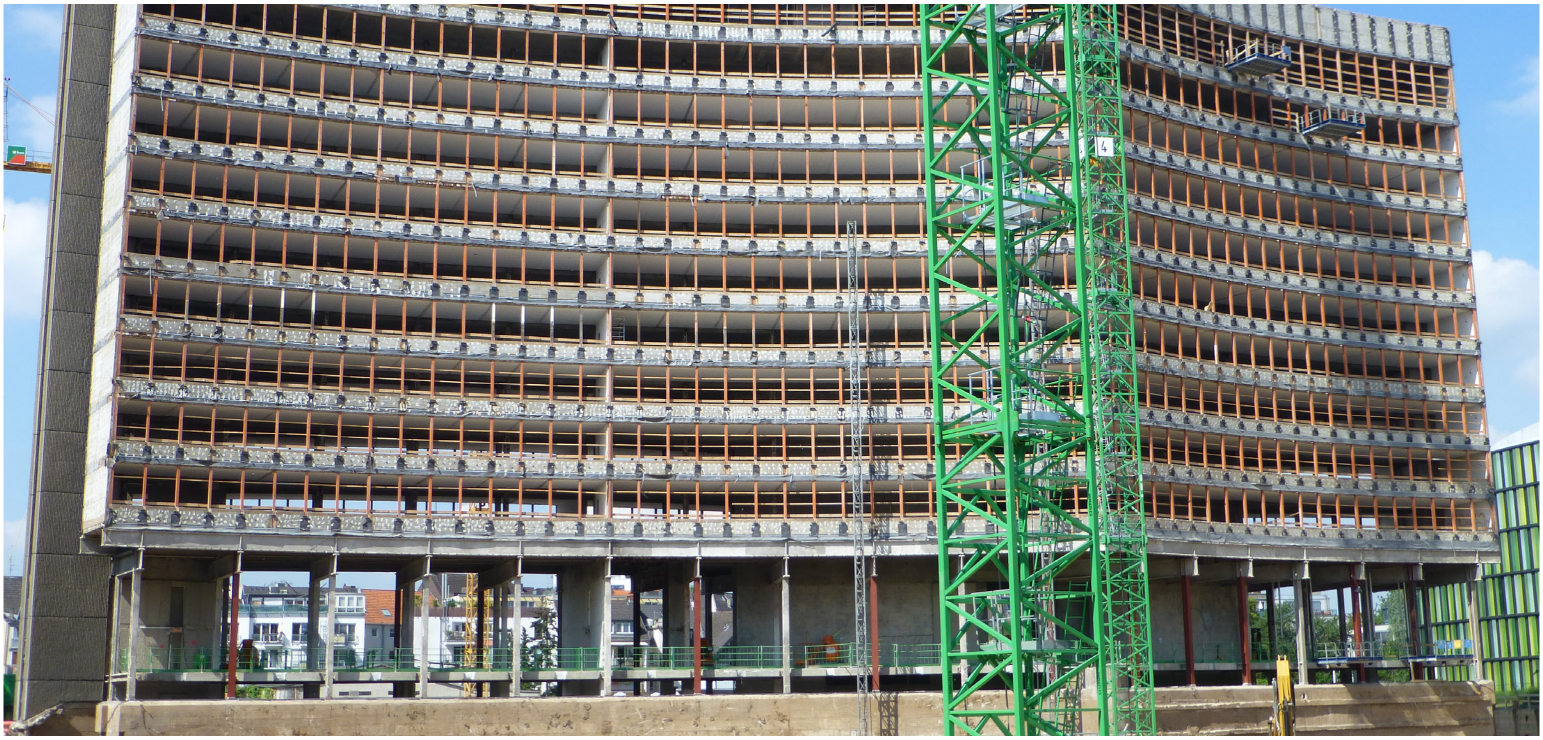
News & Information

May 31, 2023

Adaptive Reuse? Changing Supply and Demand Dynamics in Multifamily Real Estate



Perhaps one of the biggest trends that has come out of the pandemic is the conversion of offices and other assets to meet growing demand from the multifamily sector. This process of 'adaptive reuse' isn't anything new. It's been a solid strategy for shifting value in commercial real estate (CRE) for decades, and has been used to re-imagine and re-purpose everything from schools to power stations.

What's recently changed is the rate at which adaptive reuse is taking place. Over the past few years, conversions of offices, factories and even medical buildings to multifamily assets has accelerated to the point where large amounts of inventory are now poised to enter markets across the US.

But according to data from the Q4 2022 growth report by Apartments.com (a subsidiary of CRE analytics firm CoStar) showing a "swift and unprecedented" reversal for the multifamily sector, will this trend continue to deliver value in the face of growing economic uncertainty?

A "Significant Imbalance"

According to CoStar's National Director of Multifamily Analytics, Jay Lybik, the figures show that things are likely to be exceedingly tight for multifamily in 2023. He states: "We ended the year with absorption barely remaining positive and vacancy rates trending upwards… With 2023's national forecast predicting the highest new supply totals since the 1980s, expect vacancy to rise above 7% and rent growth to push much lower."

The Apartments.com report further highlights that absorption for the entire year of 2022 was just 169,000 units, where 431,000 were delivered.

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Inventory Build-Up

The large influx of inventory delivering now is the result of projects started at the height of the trend.

Back in 2020-2021, conversions of other CRE assets to multifamily surged, with Yardi Matrix division RentCafe reporting a 25% jump in adaptive reuse over the period. As they noted in their recent report: "More precisely, this increasingly popular real estate niche brought a total of 28,000 new rentals in 2020-2021, well above the pre-pandemic years of 2018-2019 when 22,300 apartments were brought to life through adaptive reuse."

Over that same period, the growth rate of adaptive reuse outstripped the growth rate of new apartment construction and adaptive reuse of offices increased 43%, representing an "all-time high" for this kind of conversion.

RentCafe added that at the time of publication (December 2022), there were 77,000 more apartments under conversion, and that "8,300 apartments have already been converted and opened to the public this year as of July 2022."

What all of this means for multifamily is that, in the midst of the current downturn, we can expect to see a lot more deliveries as converted offices, hotels and industrial buildings hit the market as new apartments.

RentCafe notes that the leader of the pack in this regard is Los Angeles, where more than 1,200 completed conversions were delivered in the first half of 2022 alone and more are likely to be incoming

Multifamily Still in Demand

As the above figures show, there's no getting around the fact that 2023 is likely to be a tricky year for multifamily. Declining rents and a mismatch between buyer and seller expectations will shape the first half of the year, even as new apartment conversions continue to flood into the market.

Despite this, many investors and CRE professionals remain optimistic about the prospects for both the multifamily market and the future of adaptive reuse. Kevin Crook, Director of Acquisitions and Dispositions for Investors Management Group, puts it like this: "There are interesting deals out there that we're looking at in certain micro markets where rents and values will outperform."

Ken Munkacy, Senior MD at Kingbird Investment Management, remains similarly positive, stating that the US housing market is still "chronically undersupplied." He adds, however, that developers need to refocus their attention towards projects targeting workforce housing rather than Class A rentals.

Officials in major US cities seem to be thinking along the same lines, with both New York and Boston recently eyeing up empty office space for conversion to affordable multifamily housing.

Shifting Usage

Taken together, the data seems to point towards a landscape of shifting usage, and shifting markets, for capitalizing on the adaptive reuse trend. For CRE professionals, navigating these changes in the multifamily market will therefore require adaptability and keeping developing trends top of mind.