Office-to-Multifamily Conversion: Weighing the Potential, Making the Decision

Major topics addressed in this Yardi thought leadership article

Office-to-multifamily conversions as an option

Evaluating office properties for multifamily makeovers

The expanding role of government incentives

How Yardi's new Conversion Feasibility Index and other tools can help guide the process

On the surface, it might seem that converting obsolete, poorly occupied office assets into much-needed housing is an obvious move, given the long-term need for multifamily product and the paradigm shift of the office sector. But this specialized category of adaptive reuse presents both unprecedented opportunity and a raft of challenges. Only a detailed, clear-cut strategy can determine the suitability of the property—and then carry out the transformation.

The Office Sector Dilemma

The conversion conversation begins with a look at needs. As Peter Kolaczynski, director of Yardi CommercialEdge, pointed out: "COVID is to the office market what e-commerce was to retail." As a result, he added, "there's too much office space in the market right now." By the third quarter of 2024, office vacancy stood at 19.42% nationally, a 1.63% year-over-year uptick, according to CommercialEdge research.

And while that vacancy rate implies an office population of 80 percent, "physical occupancy is really at 50 or 55 percent," Kolaczynski noted. The issue leaves few markets untouched and is notably more pronounced in gateway cities and older assets. Leasing tends to focus on upper-tier, Class A assets. That creates a deficit of interest in older spaces, which dominate the inventory. (**JLL reports that 70 percent of gateway office stock is more than 30 years old**.)

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Add to that issue what some call the coming tsunami of maturing debt. By the end of 2026, office loan maturities will total $251.3 billion, CommercialEdge estimates. While the Federal Reserve has started to cut interest rates, the industry is still awaiting the impact on lending. Despite the Fed's move, "the risk of default of near-term maturities has risen in recent months," observed Doug Ressler, manager of business intelligence at Yardi Matrix. This trend creates "a debt dilemma in the commercial real estate industry that presents real estate investors with tough decisions" at a time when property values are often underwater.

To cite an example, a Class B office asset in Minneapolis that commanded $73 million in 2019 recently changed hands again for just $6 million, according to Chris Voss, vice president of affordable housing at Yardi. "And that's just one of hundreds of downtown assets sitting at a lower occupancy rate," he said.

Asset values have been in a state of flux since the start of the decade, reported Brian Bailey, subject matter expert for commercial real estate at the Federal Reserve Bank of Atlanta. "Lenders and commercial real estate industry participants already struggle with higher interest rates, oversupply and financing issues," **he wrote in a recent article** for the Urban Land Institute. "All these factors have put added pressure on the most important aspects of commercial real estate: value and cash flow."

Addressing the Apartment Shortfall

Meanwhile, the housing shortage poses a long-term national issue. A 2022 report from the National Multifamily Housing Council and the National Apartment Association estimated that the U.S. must build 4.3 million new rental units by 2035 to keep up with demand. Yet new construction has lagged of late, under pressure from economic uncertainty, high costs and regulations. Citing Census Bureau figures, NMHC noted that construction starts for properties of five or more units declined 37 percent year-over-year in the second quarter of 2024. Meanwhile, the multifamily market remains tight, posting a 94.8 percent occupancy rate by September 2024, according to **Yardi Matrix's monthly survey**.

Conversion addresses the dual problems of office vacancy and housing need. As of early 2024, only a small fraction of U.S. office inventory, 70 million square feet, was **undergoing conversion**, according to CBRE. Multifamily projects accounted for 63 percent of that total. Yet even after all planned and in-progress office-to-multifamily conversions are completed over the next few years, CBRE notes, they will add less than a half-percent to the nation's multifamily inventory — a small fraction of the new supply needed, and a sign of the opportunity for conversions to help meet the demand

Tapping Into Incentives

An encouraging trend is the growing recognition at all levels of government that reinventing office properties can help ease the housing crunch. An increasing number of incentives and zoning regulations aim to reduce the costs and risks of conversion. On the federal level, the **Housing Supply Action Plan** is designed to:

- Reduce barriers to residential development, such as costly land use and zoning rules;
- Expand financing for affordable, energy-efficient and resilient housing;
- Promote commercial-to-residential conversion, particularly for affordable and zero-emissions housing.

Another federal initiative, the **Community Development Block Grant Program**, provides grants to states, cities and counties. The program's stated mission is to help provide decent housing and expand economic opportunity, principally for low- and moderate-income residents, with the goal of creating viable urban communities.

State and local governments are getting on the bandwagon, as well. California has opened commercial-use zones for residential conversions and cut red tape for

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John Sweeney
Managing Director, Cordish Living

Midland Lofts, Kansas City, Mo. The street-level Reading Lounge (left) is located where Kansas City Bank & Trust once stood (right).

entitlements. Chicago offers incentives to repurpose empty central business district (CBD) assets. New York City's Conversion Accelerator offers a go-to contact so owners can complete projects in a code-compliant, timely manner.

"Essential": That's how John Sweeney, managing director of Cordish Living, describes such incentives. In the Power & Light District of Kansas City, Mo., the firm has invested in both new development and the restoration of historic buildings. These include the B&B and Midland theaters and more recently Midland Lofts. Listed on the National Register of Historic Places, Midland Lofts now offers 135 apartment homes that were more than 90 percent leased at most recent report.

Key to the project's success were the federal Historic Tax Credit and other incentives, "especially with rising construction costs, higher interest rates and the inherent challenges of adaptive reuse," Sweeney related.

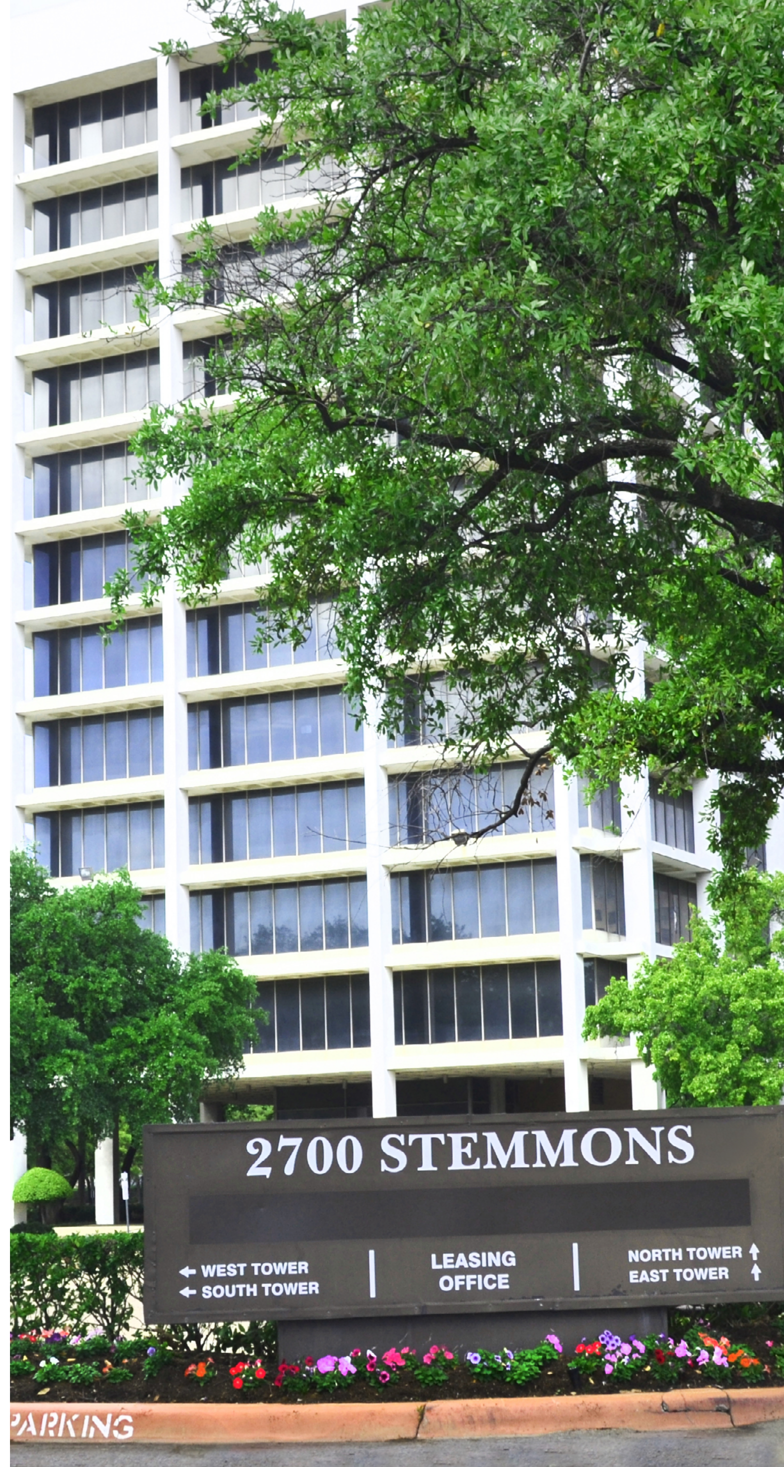
These projects are setting records as well as setting the pace for this trend. Northwind Group recently provided a $75 million acquisition loan to a joint venture of Metro Loft Management

and David Werner Real Estate Investments for **New York City's biggest conversion to date**: the repurposing of Pfizer's former two-building Midtown headquarters as more than 1,400 housing units.

Even projects on the scale of the Pfizer headquarters makeover are only a drop in the bucket for housing-starved markets such as Greater New York City. "The metro area is growing again, and drawing from 40,000 to 60,000 people a year," said Northwind Group founder & managing partner Ran Eliasaf. That translates into local demand for at least 100,000 new units, he added.

The inventory of underperforming and obsolete buildings is robust, but developers must identify conversion candidates with potential resident appeal. Architectural or historic significance is often a magnet for renters. "People like to live in iconic designs," said John St. Clair, executive managing director of Younger Partners' land division.

He pointed to his hometown of Dallas, which he said was once "the greatest city in the world for big glass-mirrored office boxes." Yet these buildings aren't good candidates for conversion. St. Clair's firm helped facilitate Sava Holdings' acquisition of Stemmons Towers, an architecturally significant 1960s office campus. As reported by Multi-Housing News, the new owners are **launching a conversion of the buildings** to 394 upscale apartments.



Almost scrapped for its land value, Stemmons Towers in Dallas will now provide 294 upscale apartments

Then what makes a viable conversion candidate—and how do investors and developers identify it?

As-of-right zoning helped secure a new multifamily role for the former Pfizer headquarters in Midtown Manhattan

Sizing Up Viability

"Determining the conversion potential of a non-residential building to residential uses involves a comprehensive analysis of several factors," noted Ressler. Two questions should start the conversation. The first, he said, is to determine "the current realistic value of the asset and the probability of future change." The second and related question is the potential return on the investment.

That second question is key because, among other reasons, old walls often hide costly secrets. "One of the biggest challenges in converting Midland was addressing unknown conditions," Sweeney reported. Another issue for the project was installing modern features—plumbing and life safety elements, for instance—without affecting the building's structure or historic aspects. "Collaboration between design, historic and construction teams was key to overcoming these obstacles," he added.

The basic questions seem straightforward but determining when it's practical to convert a property is more complex. "The longstanding misunderstanding was that most conversions are so difficult or so expensive that only a very small percentage of buildings were actually candidates," Kolaczynski pointed out. The expansion of government incentives is among the factors that expand the pool of conversion candidates beyond what's often assumed.

The capacity for more comprehensive analysis would make a valuable addition to decision-making, executives say. As Northwind's Eliasaf noted: "It would be great to have more input of feasibility and potential for conversion."

With that need in mind, Yardi spent eight months researching 81,000 buildings in its national database. "Of the 8 billion square feet we surveyed," said Kolaczynski, "we discovered that 1.25 billion square feet—roughly 15 percent—were eligible for conversion."

This research laid the foundation for the development of a new tool, the Yardi Conversion Feasibility Index. The index is based on weighted scores of wide-ranging characteristics, such as the building's age, configuration, access to natural light and transit accessibility.

The Index classifies office properties into three groups:

- Tier One represents the strongest candidates, those that score 90 or higher. According to Ressler, "these buildings exhibit the most favorable characteristics for conversion, suggesting a high likelihood of success with minimal challenges."
- Tier Two candidates, with scores from 75 to 89, offer "strong potential for conversion and may require some modifications or adjustments to optimize their suitability for residential use."
- With scores below 75, Tier Three buildings "face significant challenges or limitations that may hinder their conversion potential and require extensive modifications or creative solutions to achieve a successful transformation."

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Making It Work

A raft of considerations figure into the feasibility of office-to-multifamily conversion. Among them are a building's age, architectural or historic significance, location, zoning and debt load. Today's highest-profile examples of conversions offer valuable takeaways. When Pfizer decamped to its **new headquarters at The Spiral**, a Tishman Speyer property in Manhattan's Hudson Yards, that opened up an opportunity at the pharma giant's former Midtown home—two buildings at 235 E. 42nd St.

The buildings were a potential conversion target since Pfizer decided to leave, according to Northwind's Eliasaf. As-of-right zoning helped make conversion feasible and the 42nd Street location "makes it good for residential use," he noted. By late 2025, conversion of both buildings is expected to be underway.

The decision to convert was not driven by zoning and location alone. In current market conditions, "it's cheaper to buy an existing building and convert it than buy land and build," at a cost of $250 to $400 a foot, Eliasaf said. He pegs Northwind's loan for the Pfizer buildings at roughly $130 per square foot. "An affordable housing component at this future market-rate asset is possible if it's accretive," he added.

At the four-building Stemmons Towers in Dallas, market-rate apartments are the goal—but that wasn't always the case. "We placed the value on the dirt," said Younger Partners' St. Clair. The 1960s-era assets were obsolete, with inadequately sized floor plates, too-small elevator cores and out-of-code HVAC. Plans initially called for demolishing the towers and repurposing the 13 contiguous acres–a site of rare size near Downtown Dallas. Only two of the buildings were occupied, and the minimal tenant roster was relocated. All that changed when Sava Holdings, the new owner, brought in a team of architects, engineers and financiers for a look.

"They saw the possibility of a multifamily conversion," said St. Clair. "It's also close to a commuter rail line and in proximity to our medical district." Considering the assets' architectural significance, he believes a historic designation (and the tax credits that could follow) might be in the offing.

No matter the particulars of these widely varied conversion opportunities, their significance to the local community cannot be overemphasized. Midland Lofts is a centerpiece of the Kansas City Power & Light District, amid downtown markets, health clubs, a streetcar line and, as Cordish's Sweeney noted, "dozens of restaurants, shops and entertainment venues and cultural destinations like the Kauffman Center for the Performing Arts." The residential aspect of the Power & Light District was clearly key to the overall mission for the area "to thrive as the vibrant 24/7 neighborhood it is today."

The risks and rewards of mounting a conversion project are ever-

present, and what Sweeney said of local efforts resonates nationally: "The reality is, it's much easier to build beautiful high-rise buildings than renovate a historic building, but it is so important that these buildings be saved and brought back to their former glory and for the community to celebrate our amazing history."

THE NEW CONVERSION TOOLBOX

Determining the best fit for a converted property—to market rate, student or senior housing, to name some options—poses extra challenges. Yardi tools offer additional intelligence to inform the choice.

These include:

- Yardi Voyager, the foundational tool for accounting and property management; and
- Yardi Construction Manager, to facilitate management of the development process.

No matter the project, lenders are bound to be involved. Such upfront data "would help standardize the criteria they need to obtain financing," noted John St. Clair, executive managing director of Younger Partners' land division.

Executives also say the analysis will assist investors by helping standardize the criteria necessary to secure financing.

Neither the office market's issues nor the housing crisis will be fixed quickly or by a single analytical tool. Peter Kolaczynski, director of Yardi CommercialEdge, emphasized that "this is not a cure-all."

That said, he cites an analogy to COVID's impact on retail. "The issue the office market is facing now is no different than what the retail mall industry has been going through for the past 25 years," he said. And like owners of those assets, "the people who are most successful will be creative in addressing the problems they have."

If you're ready to see CommercialEdge in action, reach out to request a personalized demo.

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