Real Challenges. Real Solutions.

The Complex Path From Empty Offices to Residential Solutions in Urban Centers

By Charvi Gupta

Vacancy rates in office buildings in major metropolitan areas like New York City have surged, driven by the widespread adoption of remote work policies as well as the relocation of major corporate headquarters. With housing shortages exacerbating the issue, there is a growing discourse surrounding the conversion of these vacant office spaces into residential units. According to the Wall Street Journal, one billion square feet of office space sits vacant across the U.S. While the numbers cover only office mortgages packaged into bonds — so-called commercial mortgage-backed securities (CMBS) — they reflect a broader freeze in the lending market for office buildings.

However, the journey from empty office buildings to habitable residences is far from a linear path or a straightforward one and comes with considerable challenges. In this article, we delve into the complexities, offer insights from the perspective of financial restructuring consultants, and explore current conversion examples.

Conversion Challenges from Office Buildings to Residential

The conversion process is becoming increasingly difficult. Construction loans are far more expensive than they were 18 months ago, and banks continue to be cautious about development lending, with many conversion efforts on hold because of higher interest rates.

Although more cities are trying to speed up the process, getting permits can take years. Long approval times are particularly brutal when combined with higher interest rates because developers often have to make debt payments while they wait for the green light. Without large government subsidies, some housing analysts have doubted office conversions would ever become large enough to help address the U.S. housing shortage.[1]

There are additional challenges involved in the conversion process:

1. **Structural and Utility Limitations** Many office buildings are ill-suited for conversion into residential spaces. For example, some feature deep floor plates that pose challenges in bringing natural light into the newly divided rooms — a feature residential occupants invariably desire. Additionally, centralized utilities and shared bathrooms designed for office tenants necessitate extensive plumbing and HVAC modifications to meet residential standards. Some older office buildings may also boast large courtyards, which can further complicate the conversion process.
2. **Rent Disparities** Office spaces command higher rents per square foot than residential units. This cost differential can deter developers from pursuing conversions, as the potential return on investment may not be as attractive when transitioning to residential use.
3. **Zoning Restrictions** Zoning requirements in many cities may not permit the conversion of office buildings into residential spaces. Overcoming these regulatory hurdles often involves complex negotiations with local authorities and may require changes to existing zoning laws, which can be a time-consuming and uncertain process. Major metropolitan cities and regions around the country are not immune to the ongoing struggles of office CRE, but the epidemic has been highlighted in the San Francisco office

market, which hit a new high vacancy rate of 31.6% in the second quarter of 2023.[2]

4. **Existing Office Tenants** In situations where office buildings have numerous vacancies, some office tenants may still occupy the premises under long-term leases. The process of vacating these tenants before initiating conversion can be protracted and financially burdensome, especially when dealing with ten-year lease agreements.

Current Conversion Examples and Prospects

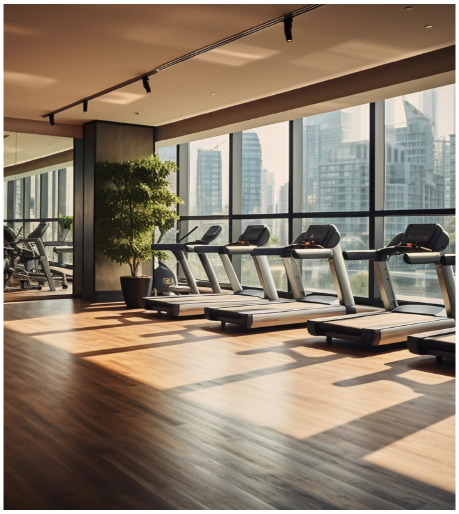
While the challenges are formidable, some projects, such as the redevelopment of 25 Water St. in downtown NYC, have already begun. These projects serve as testing grounds to evaluate whether cities and states can adapt zoning laws and offer incentives to developers to undertake costly conversions. The result is often luxury rentals and condominiums, emphasizing the need for bigger incentives to address the affordable housing crisis.

The federal government is trying to give conversions a boost. The White House recently stated that it was updating guidance for existing grants and spending programs to make billions of federal dollars available for conversion projects and seek the conversion of more government-owned properties into housing.

Exploring Alternative Options for Building Owners

When conversion is not feasible, building owners facing a vacancy crisis may consider alternative strategies:

1. **Negotiation with Lenders** Building owners may explore discussions with lenders to delay and strategize for a market recovery. Depending on their lender relationships, they may secure temporary relief and assess their options.
2. **Building Upgrades** Investing in building upgrades and amenities can attract new tenants and solidify relationships with existing ones. Owners must evaluate the capital required to revitalize interest in the property, keeping in mind the risk of no substantial return if demand for office space remains low.
3. **Partnerships** Collaboration with an external partner can provide financial support for interim action plans, reducing the burden on individual owners.
4. **Diversify Usage** Where zoning permits, owners may consider adding public and retail spaces to create mixed-use developments to enhance property value. However, adaptive reuse projects in the Bay Area will surely prove challenging. Construction costs in the region remain exorbitantly high, and the demand for the types of adaptive reuse projects that have proved successful or promising in other areas of the country, including hospitality and retail, remains depressed. Demand for housing, especially more affordable housing options, remains high in San Francisco.[3] An additional example is Chicago's downtown office space, which posted a 22.4% vacancy rate in Q1, 2023. Some projects, such as the LaSalle Reimagined Initiative, attempt to fill the void with creative solutions to repurpose LaSalle Street's 5 million square feet of vacant commercial space into affordable, mixed-income housing. The proposal includes a request for funding from the city to help subsidize the projects, which are anticipated to take up 1.6 million square feet of space.[4]
5. **Discounted Sales** In cases where no other options prove viable, some owners resort to selling their distressed office buildings at deep discounts, contributing to lower market comparisons and rent reductions.



The Broader Impact

A McKinsey report in July 2023 estimated that between $800 billion and $1.3 trillion may be wiped out from the value of office buildings in what it called the world's nine superstar cities, with San Francisco and New York being hardest hit.

The office sector relies on a steady stream of debt. Landlords typically buy buildings with big mortgages, and when they mature, they pay them off by taking out new loans or by selling. That worked well when buildings were full and loans cheap and plentiful: In the first nine months of 2019, for example, 88% of CMBS office loans were paid off when they matured, according to Moody's Analytics.

As interest rates and vacancies rose, that share dropped to 71% in the first nine months of 2022 and to just 31.2% this year. Data from Moody's showed that 50% of CMBS office loans that mature in 2024 are at risk of delinquency.

Many banks try to reduce their exposure to the struggling office sector, and the easiest way to do that is to not issue any new loans. Completing the complex future outlook are these loans from owners and investors facing defaults with nearby small and mid-sized businesses supporting white-collar workers significantly affected, fluctuating interest rates, and upcoming lease renewals.

The challenges in converting empty office buildings to residential use are substantial, complex and multifaceted. The high financial and logistical risks involved require careful consideration for potential solutions. Both individual owners and the broader economy will need to navigate these challenges in an ever-evolving landscape.

About Getzler Henrich

As a pioneer in the turnaround and restructuring space, we're tuned in to the objectives and sensitivities of all parties and help companies identify and work toward the best solutions. It is in that context that we provide the full array of turnaround, workout, crisis and interim management, corporate restructuring, bankruptcy, financial advisory and distressed M&A services.

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She joined the company in 2018, and has over ten years of experience across corporate turnarounds, operational and financial restructuring, M&A, and bankruptcy situations. She specializes in working with underperforming companies to develop and implement business-transformation strategies, performance-improvement approaches, and turnaround plans. Charvi's experience spans multiple industries including retail, healthcare, commercial real estate and hospitality, security alarm, automotive, consumer products and restaurants.

Previously, she was an investment banking associate at MTS Health Partners, where she focused on M&A and private placements in the healthcare industry. Prior to that, Charvi was an investment banking senior analyst at Deutsche Bank in Mumbai and Hong Kong, where she focused on M&A and financing in the consumer and retail industry. She has also worked in project finance at one of the leading infrastructure companies in Mumbai.

Charvi is actively involved in various industry associations and initiatives. She is a member of the Turnaround Management Association and serves on NY Chapter's NOW committee. She is a member of the International Women's Insolvency & Restructuring Confederation and serves on its Finance committee at the international level. Charvi is also a member of the American Bankruptcy Institute (ABI) and was recently honored as one of ABI's 40 Under 40 Emerging Leaders in Insolvency Practice for 2023. She has participated in several panels and podcasts, and written thought leadership articles. She was part of the team that received M&A

Advisor's 16th Annual Turnaround Awards for Sec. 363 Sale (2022) & 15th Annual Turnaround Awards for Restructuring & Majority Recap (2021).

Charvi holds an MBA from Columbia Business School, an MS in Finance from the University of Rochester, and a BA in Economics and Statistics from St. Xavier's College, Mumbai.

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[1] *"Turning Empty Offices Into Apartments Is Getting Even Harder"*
[2] *"San Francisco Office Figures Q2 2023"*
[3] *"Hearts Are Still In San Francisco—The Bay Area's Case For A Comeback"*
[4] *"Chicago's Ambitious Plan to Convert 5 Million Square Feet Of Empty Office Space Into Affordable Housing Places A Big Bet On Remote Work"*