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Converting office space to residential poses significant challenges

Introduction: In recent years, the vacancy rate (percentage of available office space that is not under a rental agreement) has climbed to worrisome levels in many cities including Pittsburgh. According to real estate firm Jones Lang LaSalle, the second-quarter 2024 vacancy rate of class A space in the central business district (Downtown) was 17.2 percent and 21.7 percent in the Pittsburgh area. The class B Downtown vacancy rate stood at 25.9 percent.

Nationally, and locally, there has been increasing discussion about the persistence of high vacancy rates as the "work-at-home" phenomenon, started during COVID lockdowns, is not showing strong signs of reversal. A major topic currently is how and whether to encourage conversion of unused space from office usage to residential. This *Brief* addresses the problems with such conversions.

Background

Many cities are actively looking at ways to encourage conversion of office space into residential. This is not a new phenomenon. But it has become much more intense in the face of persistently high office market vacancy rates which, in turn, lower the value of buildings, which, in turn, affects property tax collections (*Policy Brief Vol. 24, No. 19*).

In some cities there are shortages of housing space, making conversion of office to residential a double win by reducing the excess in one and enhancing the supply of the other. Several cities, including Pittsburgh, and states have already launched programs of financial and other assistance to facilitate conversions.

"The Pittsburgh Downtown Conversion Program was launched in April 2022 as a response to high vacancy rates in the central business district, commonly known as the Golden Triangle. The initiative supports converting vacant and aging Class B and C office buildings to new workforce and affordable housing use through tax abatements and through allocation of the American Rescue Plan Act's Coronavirus State and Local Fiscal Recovery funds to projects that reserve 20 percent of their units for low-income families." (Center for American Progress). In July 2024, the conversion of the Triangle Building Downtown had been completed and is currently available.

Other cities and states with such initiatives include Chicago; San Francisco; Baltimore; Cleveland; New York; Wisconsin and California. They have had modest success in conversions of office space into apartments.

Obstacles to conversion

There are several potentially serious obstacles to conversion. First are zoning or other legal covenants or restrictions on building use. There are cost and/or financing restraints and there are possible problems regarding the fitness and conditions in the structures being considered for conversion. Finally, there is the question of potential demand for multi-family, high-rise residences at the rental rates necessary for profitability.

Assuming the municipal governing bodies are willing and able to remove zoning constraints and other legal limitations, the question becomes primarily an economic one. In short, can or will a conversion project be profitable for the owner? Of course, each city will have its own set of conditions that will determine to what extent economic viability of projects will exist and how many projects could work.

Cost and profitability estimates

In February 2024, Goldman Sachs released a report that examines the financial issues surrounding conversion of office space to residential. The report focuses on the average valuations of several major markets.

The report includes data for percentages of space converted for each year for the last 20 years. The percentage reached a high in 2022 of 0.5 percent after averaging 0.3 percent per year for the previous two decades. This, despite the fact that only about 4 percent of office space is viable for conversion.

Goldman Sachs puts the 2023 average price of convertible office space in the 12 cities studied at $307 per square foot or about 11 percent below the 2019 reading. The national average was closer to $196, with average rent at $37 per square foot (a ratio of 5.3-to-1).

Prices vary widely in large cities across the country with San Francisco at just over $500 after falling 35 percent from the 2019 average of $800. At the other end of the range, Houston's average price was about $125 and down only 2 percent from 2019.

Unfortunately, the Pittsburgh area was not included in the Goldman Sachs study. However, recent data show the average value of office space in Pittsburgh to be about $125 per square foot and well below the national level. Rental rates for class B averaged $23 per square foot and the rent-to-cost ratio was in line with the national ratio.

Goldman Sachs puts the cost of conversion at $280 per square foot using the high-priced urban areas and a total cost of $587 ($456 adjusted for financing considerations). Obviously, the total in Pittsburgh would be significantly lower. Goldman Sachs then assumes a rental rate of the apartments to be about $4.50 per square foot (times 12 to convert to annual) and, including operations cost and interest payments, which produces a net present value over 10 years that is $164 per square foot lower than upfront acquisition and conversion expenses. On net then, the Goldman Sachs analysis suggests that for the cities studied, conversion to residential, on average, does not work financially.

However, since there are conversions taking place, there likely have to be some non-average buildings in terms of costs or rental rate variance from average that makes the deal profitable. That could be a question of desirability of location or building amenities or design that enable the owner to charge higher than average rents making the building conversion feasible. It could also mean that government programs of financial assistance have made enough difference in owner out-of-pocket outlays to make a project viable.

In Pittsburgh, recent (not including 2022 and 2023) sale prices for class B office space have dipped to $95 per square foot. As noted, it had been averaging around $125 before the COVID effect. Assuming a fairly low (compared to the national level) conversion to residential space cost of $150 per square foot, the total cost of purchase and conversion would be $245 per square foot. Obviously, for luxury apartments the cost would be considerably higher.

The latest figures available for the Pittsburgh area put the rental rate on a two-bedroom, 1,000-square-foot apartment at $20 per square foot or $20,000 per year. The monthly rent would be $1,666 (the current monthly average.)

Would an investment of $245 per square foot in a 1,000-square-foot ($245,000) apartment be financially viable? Assuming a 3 percent annual rent increase and 7 percent discount rate over a 10-year period, the rental income over the period would have a present value of just over $158,000. And if the investor horizon for return on investment is only 10 years, the purchase would not happen.

For a 20-year horizon, the 7 percent discount rate would produce a present value of $266,340, which would cover the investment. Of course, this assumes the apartments would always be 100 percent leased and does not factor in unexpected maintenance, mandated repairs or upgrades. If these assumptions are not met, the relatively small profit expectation would not justify the investment.

Of course, all this assumes the conversion cost is feasible and that cannot be known for sure until the restoration work is underway. There could be serious problems with plumbing and electrical systems or damaged steel work or woodwork that would lead to cost overruns.

Conclusion

There is plenty of discussion and research being done on the problems created by the high vacancy rates in office space in cities across the country. The fact is, there are few conversions in terms of percentage of unleased space around the country. Expectations of profitability are almost certainly too low for many structures and, therefore, the call for more government assistance will almost certainly increase.

Jake Haulk, Ph.D., President-emeritus

Allegheny Institute for Public Policy
305 Mt. Lebanon Blvd.* Suite 208* Pittsburgh PA 15234
Phone (412) 440-0079
E-mail: aipp@alleghenyinstitute.org
Website: www.alleghenyinstitute.org
X (Twitter): AlleghenyInsti1