



Jun 29, 2021, 04:24pm EDT | 2,673 views

Can We Convert Underutilized Commercial Buildings Into Badly Needed Affordable Housing?



Joshua Stein Contributor ⓘ

Real Estate

I write about commercial real estate negotiations, deals and legal issues.



Conversion of commercial real estate to housing might not be as easy as it sounds. CORBIS VIA GETTY IMAGES

Office buildings, hotels, and shopping malls sit vacant or nearly vacant in major and minor cities from coast to coast. Maybe they're obsolete. Maybe commercial real estate has changed to a point where these empty buildings

just aren't relevant any more. Wouldn't it make a lot of sense to convert them into housing, to try to mitigate the housing affordability crisis?

It sounds like a great idea. In a few cases it might be a great idea. As a matter of practicality and economics, though, it's often a challenge.

To start with an obvious problem, these conversions cost money – rarely as much as building from scratch, but nevertheless a substantial capital investment. An owner of, say, an office building already has a substantial investment in the building. Conversion to housing will require additional investment, but that additional investment might not create equivalent (or more) increase in value. During the conversion process, the owner will have no income but will need to pay carrying costs. Any change of use or redevelopment of a building won't always be smooth, easy, and cheap.

Investment in a conversion will make financial sense only when the existing building has become so devalued that it isn't worth much more than vacant land. It may also make sense if the new housing will be worth much more than the building was worth before the conversion. That's the dynamic that helped drive, for example, much residential conversion in New York City's financial district. Many office buildings there were old and impractical and hence not very valuable for office use, and housing was much more valuable. Tax incentives also helped.

In that example, however, converters created (mostly) market-rate housing. The conversion proposals floating around today often contemplate that the newly created housing will be partly or sometimes even completely affordable. That proposition doesn't work economically without some form of huge government aid. So it puts the government further into the business of, directly or indirectly, funding or financing construction of housing. That business can be particularly expensive and capital-intensive in the central business districts where many of today's potentially obsolete office buildings are located.

As a physical matter, commercial buildings don't always lend themselves to residential conversion. For example, office buildings often have very wide and deep floors, because the center of the building may be used for storage or other functions, so doesn't need much light and air.

In contrast, apartments need more light and air throughout. If parts of an apartment lie too far from a window, they may not meet code or the marketplace expectations of buyers or renters. Those large office building floors will also not have in place the building systems necessary for residential use. Bathrooms may be bunched near the building core, the dark area, with plumbing lines serving only that part of the building. A residential building will, in contrast, require bathrooms and plumbing in every unit. Electric service will also need to be rerouted, run through new meters, and often effectively rebuilt from scratch.

Hotels can work better as conversion candidates, especially hotels of the extended stay variety. Even then, the process of combining units to create larger apartments may result in impractical arrangements and the need to extensively reroute utilities.

See Next Page

Shopping malls suffer from the same size issues as large office buildings. They often would have to be completely rebuilt to accommodate housing. It may be more practical to demolish them and start over.

On the other hand, the concept of adaptive re-use is hardly new to real estate, although it doesn't necessarily play well with affordable housing. It works best with real estate whose value has dropped to a point where the incremental value created by the conversion far exceeds its incremental cost. That often involves pioneering developments in temporarily unattractive areas, a/k/a "gentrification," which some say is a bad thing.

Conversions sometimes also produce opportunities and benefits not available with new construction. For example, older office buildings and hotels sometimes have construction details that today's builders just can't economically replicate. Buyers or tenants often like those details, thus increasing the value of the end product. Obsolete office buildings and some retail buildings often have taller ceilings than typical apartments, which buyers and renters will also like. In some cases these buildings are well located, at locations where new construction would be incredibly expensive.

Residential conversion of existing buildings also offers developers one huge advantage over new construction: conversions are far less likely to attract controversy and objections. In today's world, practically every substantial project in any desirable area must endure a protracted approvals process. That process, especially if it includes litigation, can easily take longer than building the actual building. The approval process for a new project is certainly more fraught with issues, surprises, and potential showstoppers. In

contrast, conversion of an existing building often doesn't create as much of a lightning rod for neighborhood objectors. The years saved and carrying costs avoided may help a conversion project make financial sense.

All of which suggests another strategy municipalities might follow if they want to see developers produce more housing: make it easier and quicker. Before ramping up new tax abatement programs (lost tax revenue) and even cash investments by government to produce more affordable housing and future budget crises, local governments might ask if there's something easier and cheaper they can do.

There certainly is. Government can speed up and simplify the approval process for housing developments. Zoning law can be loosened and simplified, providing more flexibility for as-of-right projects and less need for discretionary approvals. This could be done on a municipality-wide basis to reduce the role of local council members, whose constituents will often automatically oppose every specific major proposal brought before them. Building codes can be revisited to provide greater flexibility. Although rent regulation typically burdens only older housing stock, its mere presence distorts the market and hangs over new construction as a dark cloud. Municipalities ought to rethink it and try to phase it out.

Changes like these might do more to solve a housing crisis than any governmental investment (or loss of tax revenue) necessary to incentivize conversion of commercial buildings to residential use, especially affordable housing.



Joshua Stein

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over

300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

Copyright © Joshua Stein 2021.

Published on Forbes.com June 29, 2021.