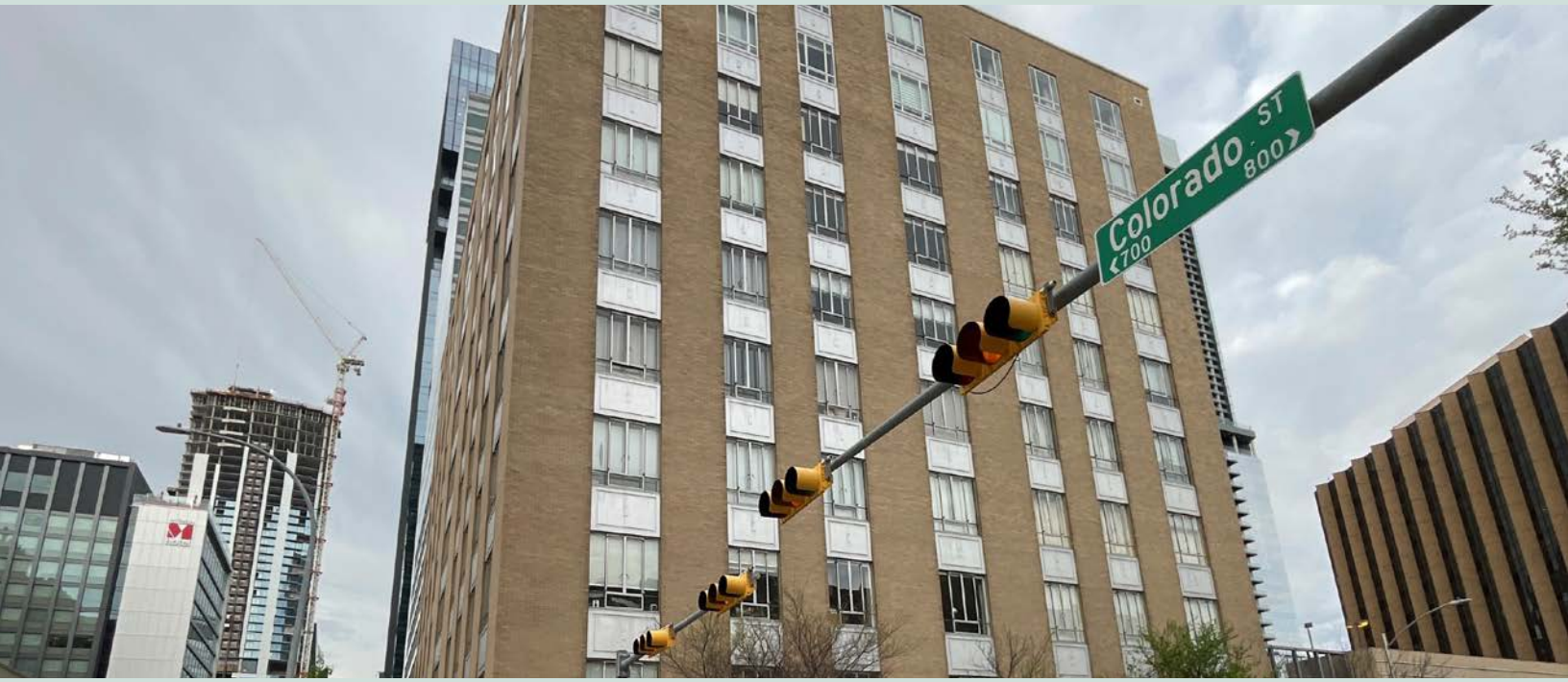
City of Austin
Office of the City Auditor

Special Report

Office Conversions

April 2024



Office conversions can turn empty office space into another purpose. They have been viewed as a way to simultaneously address both the rise in office vacancies and housing shortages across the country. Office conversions require stakeholders to consider the structural, environmental, legal, and financial factors involved in the process of retrofitting a building. Those who pursue office-to-residential conversions have challenges to overcome including, but not limited to, undesirable ceiling heights, elevator locations, awkward floor-plate shapes and sizes, and aging mechanical, electrical, plumbing and HVAC systems. Additionally, when converting an office into residential housing, developers must address legal requirements such as zoning restrictions and various residential code requirements. Cost is a significant factor for developers to consider during a conversion, and developers may choose to create luxury housing in order to be more profitable. Local, state, and federal governments can incentivize developers to convert office spaces into residential housing through programs such as tax abatements, fee waivers, and the easing of restrictions around zoning.

Contents

Cover: Auditor site visit, March 2024

Objective

The objective of this special request was to answer the following questions provided by the City Council:

1. Identify buildings that are not temporarily vacant and are actively listed for sale or lease within the city of Austin.
2. Identify a sample of properties in peer cities that have successfully converted office space into housing and summarize relevant information about those properties.
3. Summarize information about studies and other research that addresses the economic feasibility, financial implications, and potential return on investment of converting vacant office and retail spaces into residential housing units.
4. Based on available research and practices in other cities, identify potential regulatory barriers and challenges associated with the conversion of office and retail spaces into residential use and any strategies or incentives that have been used to overcome them.
5. Identify considerations of office to mixed or other use conversions as an alternative option to residential conversions.

Background

The city of Austin has seen an increase in office vacancies in recent years. As of December 2023, Austin's overall office market had an office vacancy rate of 16.8%. Industry projections suggest that the vacancy rate will continue to increase to more than 21% this year. As remote work cements itself as a common practice and fewer workers return to the office, many companies are opting to downsize their office space and move from large, lower-quality offices to smaller, newer, and higher-quality ones. As a result, some developers are seeking creative solutions for utilizing vacant office space. One strategy to address empty office space is to consider an office-to-residential conversion. These conversions reconfigure office space to suit residential uses such as apartment units. Cities like Chicago, Boston, and New York City are pursuing conversion projects to help increase housing options, and in October 2023, the White House announced that their administration was taking action to help cities create more housing through conversions.

What We Learned

Summary

Office-to-residential conversions have been viewed as a way to simultaneously address both the rise in office vacancies and the housing shortages across the country. However, office conversions require stakeholders to consider the structural, environmental, legal, and financial factors involved in the process of retrofitting a building, and they should not be viewed as the sole solution to office vacancies or housing shortages.

Those who pursue office-to-residential conversions have challenges to overcome including undesirable ceiling heights, elevator locations, awkward floor-plate sizes and shapes, and aging mechanical, electrical, plumbing and HVAC systems. Additionally, developers must address any legal requirements involved in converting an office into residential housing such as zoning restrictions and various residential code requirements. Cost is a significant factor for developers to consider during a conversion, and developers may choose to create luxury housing in order to be more profitable. Local, state, and federal governments can incentivize developers to convert office spaces into residential housing through various programs. Common incentives include financial support through subsidy programs, tax breaks or abatements, and fee waivers. Government leaders can also incentivize developers by easing restrictions around zoning or by expediting the review process.

Question 1

Identify buildings that are not temporarily vacant and are actively listed for sale or lease within the city of Austin.

The Office of the City Auditor worked with the Office of Real Estate Services to generate a report showing vacant buildings for sale or lease within the city of Austin. The report identified 16 buildings that were vacant and within 8 miles of the Central Business District, as seen in Exhibit 1.

Buildings are classified as Class A, Class B, and Class C. These “asset classes” are assigned through a number of factors including the building’s age, quality, and amenities available on the property. For example, a recently built 50-story office building with an attached garage might be listed as a Class A property, while a 30-year-old building that is outside of the Central Business District might be listed as a Class C property. We did not conduct work to determine whether any of these properties might be a good candidate for an office-to-residential conversion.

Exhibit 1: Vacant Office Buildings for Sale in Austin Identified by the Office of Real Estate Services*

#	Address	Class	Total Square Footage (SF)	Year Built	Number of Floors
1	2105 E Martin Luther King Jr Blvd, Austin, TX 78702	A	32,942	2023	3
2	8601 Ranch Rd 2222, Austin, TX 78730	A	35,389	1999	2
3	4544 S Lamar Blvd, Austin, TX 78745	B	109,540	1986	1
4	1112 W Ben White Blvd, Austin, TX 78704	B	26,594	1982	4
5	5811 Trade Center Dr, Austin, TX 78744	B	15,690	2016	1
6	4902 Grover Ave, Austin, TX 78756	B	11,520	1971; Renovated 2023	2
7	901 Barton Springs Rd, Austin, TX 78704	B	11,220	1980; Renovated 2000	3
8	903 Barton Springs Rd, Austin, TX 78704	B	10,808	1980; Renovated 2000	1
9	3601 Bluestein Dr, Austin, TX 78721	B	4,465	1998	2
10	1200 W Slaughter Ln, Austin, TX 78748	B	2,554	1984; Renovated 2023	1
11	1300 E Anderson Ln, Austin, TX 78752	C	62,784	1980; Renovated 2022	2
12	500 Pampa Dr, Austin, TX 78752	C	12,708	1975	2
13	504 W 7th St, Austin, TX 78701	C	5,074	1951	2
14	8740 N Lamar Blvd, Austin, TX 78753	C	3,388	1973	2
15	8203 Sam Rayburn Dr, Austin, TX 78753	C	1,840	1971; Renovated 2022	1
16	802 W St Elmo Rd, Austin, TX 78745	C	1,016	1934	1

*The exhibit is a snapshot of available real estate as of December 15, 2023, and may not show currently available properties.

Source: Report from Office of Real Estate Services, December 2023

Question 2

Identify a sample of properties in peer cities that have successfully converted office space into housing, and summarize relevant information about those properties.

According to reports, nearly 20,000 housing units have been created nationwide since 2016 through conversions. However, we spoke with staff in multiple City departments and were only able to identify one notable office-to-residential conversion that has occurred in the city of Austin. The Brown Building, located at 8th Street and Colorado, was originally built in 1938 as an office building and was converted to residences in the mid-2000s.

Our research indicates that successful office conversions have historically occurred in cities with higher population densities than Austin and with a larger stock of older buildings. Other cities with successful office-to-

residential conversions include Boston, Chicago, Dallas, Los Angeles, Memphis, New York City, and Washington D.C. Exhibit 2 highlights examples of office conversions.

Exhibit 2: Peer City Examples of Office-to Residential Conversions

Building Name	Population density per Square Mile	Year Completed	Number of Floors	Estimated Number of Residential Units	Conversion Incentive Used
Brown Building Lofts (Austin, Texas)	3,006.4	2004	10	90	Y
The Archer Residences 💎 (Boston, Massachusetts)	13,976.7	2019	7	67	Y
Millennium on LaSalle 💎 (Chicago, Illinois)	12,059.8	2021	14	216	Y
The National 💎 (Dallas, Texas)	3,841.1	2020	51*	324	Y
Pegasus Apartments 💎 (Los Angeles, California)	8,304.2	2003	13	322	Y
Crosstown Concourse (Memphis, Tennessee)	2,131.8	2017	10*	260	Y
180 Water Street 💎 (New York City, New York)	29,303.2	2017	29	580	Y
The Wray 💎 (Washington, D.C.)	11,280.7	2020	8	158	Y

💎 Building is advertised as luxury residential housing.
*The National and Crosstown Concourse are mixed-use buildings that contain both residential and commercial floors.

Source: OCA analysis of peer city office conversions, February 2024

Staff we spoke with voiced concern that due to the high cost of a typical office-to-residential conversion, they did not generally add affordable housing. Indeed, most of the office-to-residential conversion examples we found were for luxury residences with some units costing over $2 million. Some of the conversions we identified advertised amenities such as 24-hour concierge, valet service, and private entrances into select homes. For office conversions to be successful, developers must have rent prices high enough to justify forgoing potential office rents. Even with high unit prices, most of the conversions we identified relied on economic and development incentives to make the projects financially feasible. Incentives for developers included tax abatements, which serve as an economic development tool available to cities to encourage development through property tax exemptions or reductions.

Question 3

Summarize information about studies and other research that address the economic feasibility, financial implications, and potential return on investment of converting vacant office and retail spaces into residential housing units.

Supporters of office conversions believe conversions can be financially feasible in a broad range of markets, building conditions, and circumstances. Some developers report that office conversions can be completed more quickly and at lower costs than demolishing the original building and building something new in its place. Additionally, the Deloitte Center for Financial Services predicts that office-to-residential conversions may become more profitable within the next five years due to shifts in rents, valuations, acquisition costs, and conversion costs.

However, not every office building is a good candidate for residential conversion, and some cities may be better suited for conversions than others. As previously stated, for a developer to pursue an office-to-residential conversion, the projected residential rents need to be high enough to cover the expense of the conversion and justify forgoing office rents, which typically are higher than residential rents per square foot. As a result, conversions tend to be in cities with high population densities and limited undeveloped land.

Additionally, office conversions have unique challenges compared to new developments. For instance, developers may need to retrofit plumbing for individual bathrooms, kitchens, and sprinkler systems, adjust ceiling heights, and/or install new windows. Adding to the challenge, developers may not know the true condition of the building they are planning to convert, and these unknowns may make it difficult to predict whether a conversion will be financially viable. For example, once a conversion begins, developers may discover that the building's wiring or plumbing is no longer up to code, and they would have to address these issues at additional cost. Furthermore, while office buildings can lease 100% of their total square footage, a typical residential building is only able to rent 80% to 95% of the building due to common spaces like corridors, communal storage rooms, and fitness centers.

As a result of these challenges, staff we spoke with said that office-to-residential conversions tend to focus on luxury units that can command high rents. Staff expressed concern that any conversions in Austin would be unlikely to add to the stock of affordable housing without substantial City subsidies. However, staff also noted that there may be other reasons to incentivize conversions. Specifically, staff said there may be environmental reasons to convert a building that might otherwise have been torn down. Studies show that building construction produces 11% of global carbon emissions, and it can take up to 80 years for a new, energy-efficient building to offset its own carbon emissions. Developers and government leaders can choose whether to consider affordability and environmental impacts when determining the potential costs and benefits of engaging in an office conversion.

Question 4

Based on available research and practices in other cities, identify potential regulatory barriers and challenges associated with the conversion of office and retail spaces into residential use and any strategies or incentives that has been used to overcome them.

Challenges and Barriers

At least three conditions must be met for an office conversion to be suitable: the building must be physically suitable for a conversion, the zoning and building codes must permit a conversion, and the conversion must be financially viable for the developer. Building-specific factors stakeholders may consider when converting an office building include, but are not limited to:

- Floor-to-floor heights
- Column spacing
- Elevator locations
- Floor-plate sizes and shapes
- Mechanical, electrical, plumbing, and HVAC systems
- Window locations and access to natural light

For example, the location of structural support columns helps determine the layout of residential units and rooms, and buildings with large floor-plates tend to be more difficult to convert due to a lack of natural light. In addition, there may be building code requirements, such as requiring each bedroom to have a window, that may be seen as a challenge for developers. Any one of these factors can quickly become a barrier.

Additionally, any conversion in the city of Austin would require a change of use permit from the Development Services Department and may also need a zoning change. For safety reasons, residential zoning has stricter requirements than commercial zoning. Staff we spoke with noted the need for developers to make changes to the building's plumbing and fire suppression systems, which may not be possible with the building's existing ceiling height. Developers may also be required to install new entrances, exits, and other features.

Strategies and Incentives

Local, state, and federal governments have sought approaches to incentivize developers to pursue office conversions. Strategies that have been used include tax credits and breaks, subsidy programs, easing zoning and building codes, and offering developers an expedited permitting process.

Cities can support office conversions by helping developers financially. In 1995, New York City established a tax abatement, known as 421-g, to encourage office-to-residential conversions in the Lower Manhattan area. Likewise, Washington D.C. recently launched a $2.5 million, 20-year tax abatement program to incentivize conversions. Similarly, the City of Chicago offers tax increment financing for certain residential projects. Reports noted that many of the residential projects in Chicago would also utilize the low-income housing tax credit (LIHTC) and historic tax credits for funding.

Besides tax incentives, cities reviewed local ordinances and codes to see how to incentivize developers to pursue office conversions. For example, to spur more residential housing, New York City rezoned some areas

that were previously restricted to office and manufacturing spaces. One statistic found that by 2006, 13% of Lower Manhattan's office space had been converted to residential spaces, which resulted in nearly 13,000 new housing units. In Los Angeles, their Adaptive Reuse Program, adopted in 1999, has contributed to conversions that have resulted in 12,000 residential units in the city's downtown. To support more conversions, Los Angeles has proposed an expansion of this program that would apply citywide and include buildings 15 years old and older. The expansion would also assist in faster approvals of conversions.

Exhibit 3: Local, State, and Federal Government Incentives

Source: OCA analysis of government incentives, December 2023

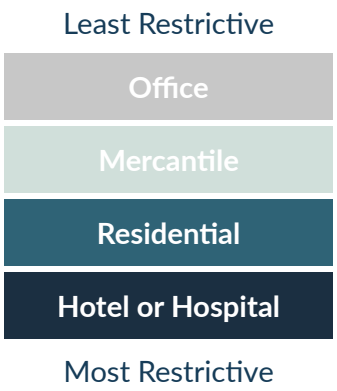
In October 2023, the White House announced that their administration was taking action to help create more housing through conversions. Although no current federal program is devoted solely to encouraging office-to-residential conversions, we identified federal loan, grant, tax credit, and technical assistance programs across seven agencies aimed at helping to convert commercial properties to residential use. For example, several existing U.S. Department of Housing and Urban Development (HUD) funding streams can support office conversions. One of them, HUD's Section 108 Loan Guarantee Program, which provides low-cost financing for development projects, was successfully used by a non-profit in Memphis, Tennessee, to convert the Crosstown Concourse, a historic 10-story building, into a multi-use facility that includes 260 apartment units.

Question 5

Identify considerations of office to mixed use or other use conversions as an alternative option to residential conversions.

Offices can be converted into uses other than residential, such as stores, restaurants, or studio spaces. These conversions may have fewer barriers than converting to residential units. When considering building codes, office buildings generally have the least restrictive requirements, followed by mercantile spaces (like stores and restaurants), residential housing, and lastly, hotels and hospitals. Accordingly, fewer changes would need to be made when converting from offices to mercantile spaces than when converting to residences.

Exhibit 4: Code Requirements by Building Type



Source: Interview with Austin Fire Department, December 2023

In addition to less restrictive use codes, office to mercantile conversions may not have as many factors to consider as office conversions to residential spaces. For example, when converting an office into a residential space, developers must consider how to add individual bathrooms and kitchens. This may not be needed for a mercantile space.

Some developers have opted to pursue mixed-use conversions in which an office building is converted into multiple purposes such as having both retail and housing. For example, The National, located in Dallas, Texas, is an office conversion of a 51-story building that not only has 324 residential units but also has commercial spaces, retail spaces, and a hotel. The Crosstown Concourse project, located in Memphis, Tennessee, is described as a mixed-use "vertical urban village." The multi-use facility includes apartments called Parcels at Concourse, as well as art galleries, restaurants, a high school, and a YMCA.

Appendix A: Federal Resources for Office Conversions

In October 2023, the White House released a Commercial to Residential Federal Resources Guidebook with over 20 federal programs that can be used to support conversions. According to the Guidebook, there are federal loan, grant, tax credit and technical assistance programs across seven agencies that can be used to convert commercial properties to residential use. The seven agencies are the Department of Energy (DOE), Department of Interior (DOI), Department of Transportation (DOT), Environmental Protection Agency (EPA), Department of Housing and Urban Development (HUD), Department of Agriculture, Rural Business-Cooperative Service (USDA), and Department of the Treasury (UST).

Agency	Program Type	Program Name	Summary
DOE	Loans, loan guarantees	Title 17 Clean Energy Financing Program	Loans and loan guarantees for clean energy projects
DOI/UST	Tax credits	Rehabilitation Tax Credit	Tax credit for rehabilitation of historic buildings
DOT	Loans, loan guarantees	Transportation Infrastructure Finance and Innovation Act	Below-market interest rates loans and guarantees for transit-oriented development
DOT	Loans, loan guarantees	Railroad Rehabilitation & Improvement Financing	Below-market interest rates loans and guarantees for transit-oriented development
DOT	Technical assistance	Thriving Communities Program	Technical assistance to advance transportation activities, including housing
DOT	Grants	Neighborhood Access and Equity Program	Grants for projects that improve transportation and associated land use
EPA	Grants, loans*	GGRF: Solar for All	Grants and loans for solar for low-income communities
EPA	Grants, loans*	GGRF: National Clean Investment Fund	Grants and loans for projects including energy-saving retrofits and clean energy
EPA	Grants, loans*	GGRF: Clean Communities Investment Accelerator	Grants and loans for projects including energy-saving retrofits and clean energy
HUD	Loan guarantees	Section 221(d)(4): Mortgage Insurance for Rental Housing	Loan guarantee for projects involving substantial rehabilitation or construction
HUD	Loan guarantees	Section 220: Mortgage Insurance for Rental Housing for Urban Renewal and Concentrated Development Areas	Loan guarantee for new construction or rehabilitation of multifamily housing located in urban renewal and concentrated development areas
HUD	Grants^	HOME Investment Partnerships	Formula grants for buying, building, and rehabilitating affordable housing
HUD	Grants^	Housing Trust Fund	Grants for states for the construction or rehabilitation of extremely low-income housing
HUD	Grants^	Community Development Block Grants	Formula grants for community development activities
HUD	Loan guarantees	Section 108 Community Development Loan Guarantee	Low-cost long-term financing for community development activities
HUD	Technical assistance	Thriving Communities Technical Assistance Program	Technical assistance, including conversions and housing supply efforts

Appendix A: Federal Resources for Office Conversions, Continued

Agency	Program Type	Program Name	Summary
USDA	Loans	Business & Industry Guaranteed Loan Program	Loans supporting various uses, including temporary or workforce housing
UST	Grants*	State and Local Fiscal Recovery Funds	Formula grants for various uses, including development of affordable housing
UST	Tax credits	New Energy Efficient Home Credit (45L)	Tax credit for energy efficient homes, including multifamily housing
UST	Tax deductions	Energy Efficient Commercial Buildings Deduction (179D)	Tax deduction for energy efficiency improvements to commercial buildings, including multifamily buildings greater than three stories
UST	Tax credits	Investment Credit (48, 48E)	Tax credit for investment in eligible renewable energy projects (48); technology-neutral tax credit for facilities that generate clean electricity and energy storage (48E)

*Federal funding is awarded to third parties (e.g., city, state, lender, etc.) that then award grants, loans, or other financial products to other entities.
^Federal formula grant funding is awarded to State and/or localities that then may award funding in the form of grants, loans, or other instruments to other entities such as nonprofits, developers, and small units of governments.

Source: Commercial to Residential Conversions: A Guidebook to Available Federal Resources, pages 9 and 10, October 2023. https://www.whitehouse.gov/wp-content/uploads/2023/10/Commercial-to-Residential-Conversions-Guidebook.pdf

Why We Did This Report

This report responds to a request from Council Member Mackenzie Kelly and Council Member Leslie Pool regarding office conversions.

Scope

The audit scope included identifying six cities with successful examples of office conversions.

Methodology

To complete this special request, we performed the following steps:

- interviewed staff from the following City departments:
  - Development Services Department
  - Housing Department
  - Office of Real Estate Services
  - Economic Development Department
  - Law Department
  - Austin Fire Department
  - Department of Transportation and Public Works
  - Austin Water;
- interviewed staff from the Texas A&M Real Estate Research Center;
- analyzed information received from peer cities;
- analyzed information from various academic, governmental, commercial, and media sources related to office-to-residential conversions;
- analyzed reports generated by the Housing Department and the Office of Real Estate Services

Project Type

Special request projects conducted by the Office of the City Auditor are considered non-audit projects under Government Auditing Standards and are conducted in accordance with the ethics and general standards (Chapters 1-3).

The Office of the City Auditor was created by the Austin City Charter as an independent office reporting to City Council to help establish accountability and improve City services. Special requests are designed to answer specific questions to assist Council in decision-making. We do not draw conclusions or make recommendations in these reports.

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