Challenges Abound When Transforming Office to Residential

Zoning changes, design constraints and financing are among the hurdles.

By Lindsey Postula and Maria Fuentes, Gray Reed

What can be done with another sparsely occupied 600,000-square-foot office building? Transforming a lackluster office property into a residential haven seems like an obvious solution. However, without planning, patience and capital, it may not be a success.

In a post-pandemic world, it's easy to attribute the oversupply of office property to an increased desire to work from home. The rise of Zoom, Teams, WebEx and comparable platforms permit workers to collaborate from anywhere. However, The Wall Street Journal reported in August 2022 that the so-called "U.S. office glut" has been building since changes to the tax code in 1981 that allowed for quicker depreciation of commercial property. The same article also attributed the oversupply of office buildings to decades of low interest rates and even some false demand created by WeWork and similar coworking companies.

Redesigning an office building to transform it into residential use can be challenging on many levels.

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Legal and Business Considerations

Before transitioning a property to residential use, an owner's initial consideration should be the overall vision for the property and how the residential component will affect other existing and future uses of the building and how it will fit within the larger community. For example, if the addition of residential materially increases the overall occupancy of the project, that may drive up the value and success of the property's retail components. On the other hand, the addition of residential use (which may include unruly guests, wayward pets or owners in swim apparel) may drive away existing office tenants who no longer perceive the building to be suitable for professionals.

A change in property use is not an easy or low-cost undertaking. Layers of legal considerations must be carefully examined. An owner will have to reopen many diligence questions surrounding the property that arise following an acquisition: zoning, use, legal compliance, environmental conditions and others. These questions can be further complicated by the passage of time and the encumbrances and leases related to the property's existing office use.

One obvious challenge is zoning. Depending on the breadth of the property's existing zoning and use classifications, the office building owner may have to apply for a change in zoning, meet with city planners and go through appropriate public hearings to change the property's zoning classification. Depending on the jurisdiction, the nature of the property and the concerns of surrounding property owners, this process could take weeks or months. Even if the municipality has no zoning, there may be restrictive covenants that prohibit residential use or make conversions from office to residential difficult. The process of modifying restrictive covenants may require many third-party consents and can be much more challenging than a change in zoning.

On the diligence front, an owner will also need to consider whether a change in use is feasible based on the design of the building and compliance with certain laws, including local ordinances and federal laws such as the Americans With Disabilities Act. Additionally, some existing offices may not make for desirable living spaces. For example, they may lack adequate natural light or open floorplans. Addressing these issues could require a much more extensive and costly remodeling effort to attract residents than the simple interior modifications that office owners may envision. The owner may also face challenges related to environmental conditions, such as asbestos remediation.

Limitations regarding the physical structure of an existing property are not the only potential hurdles for office owners. They also may have to engage in significant modifications to their business structure as well, including potentially amending their governing documents and existing services agreements to bring in new partners, capital or key personnel to facilitate the change in business direction. Depending on whether the owner will sell residential units, it may be necessary to establish a condominium regime. Although the costs associated with these changes may not be as high as those incurred to physically alter the existing property, they still represent an initial outlay that must be adequately budgeted before commencing work.

Economic Challenges

Any large-scale office space conversion and renovation project is likely to require a significant injection of cash. If an owner needs to acquire additional capital, doing so may be difficult in the near term.

Businesses today are operating in a fundamentally different capital landscape than at the beginning of the year. In the current lending climate, office building owners are unlikely to find loans from institutional lenders on terms anywhere near as favorable as those they could expect to obtain a few months ago. At the start of 2022, the applicable federal annual long-term interest rate was 1.81%. That rate was set at 3.92% for November and is likely to keep climbing thanks to the Federal Reserve's efforts to combat inflation. If an office owner is unable or unwilling to take on additional debt, they may have to rely on outside investors who are willing to buy into the new residential business venture. However, as economic uncertainty continues cast a pall over potential equity investors, it may become increasingly difficult to find new partners who are willing to buy into an existing business or new joint ventures.

The pace of any office transformation will also be affected by the duration and terms of any existing office leases. If the office space is largely vacant, this may not be a major obstacle. However, even a few existing tenants may be able to tie up the property and thwart an owner's plans. For example, if a major renovation of a vacant space on one floor of a building would require contractors to access space on another floor occupied by a current tenant (e.g., to install pipes, vents or other necessary building systems), the presence of the existing tenant could delay the entire project until the tenant's current lease expires or the terms are renegotiated.

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Final Thoughts

The legal hurdles, financing and existing obligations to current tenants can all work against an owner's ability to plan, budget and commence the project. Unpredictability in the labor market and ongoing supply chain problems can also work to frustrate a planned conversion project. So, while office building owners may be eager to transform unoccupied office space into profitable residential spaces as soon as possible, the actual process of seeing those plans through can be far more complicated and costly than they may anticipate. The success of converting existing structures into new residential spaces will largely hinge on whether owners are able to bring sufficient capital and expertise to bear on the project. ■

Lindsey Postula is a partner in Gray Reed's Houston office. **Maria Fuentes** is an associate in Gray Reed's Houston real estate practice group.