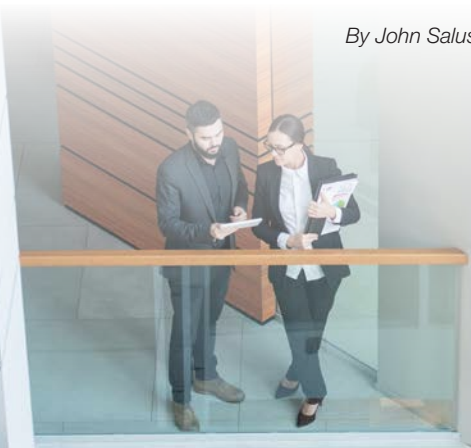


# **BOMA** International **DEEP DIVE**

## Getting Creative With Vacant Spaces

Savvy property owners and managers know you can't spell adaptive reuse without "adapt."

*By John Salustri*



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## THE OVERVIEW

The office is an evolutionary concept. Even in our own lifetimes, we have seen it progress from a relatively stagnant setting, dripping with hierarchy, into a fluid and egalitarian space. We have gone from formal to relaxed, from C-suite-centric to employee-focused. There is a perfect analogy to be made between the gradual relaxation of dress codes (remember those?) and the more casual settings of the office as it stands today. There are exceptions, of course. But even in those spaces where cubicles still rule, the (semi-permanent) walls of formality are coming down.

It is commonly written that COVID-19 accelerated as many trends as it launched, and the evolution of the office might be among those. Note that we said, “might be.” More than a year and a half after we shut down and masked up, the impact of the pandemic has yet to be made clear, especially as reports of new virus variants crop up. What COVID-19 ultimately means to the office evolution will be a matter of time and distance.

Which means that changes we are seeing now might not be permanent. Concepts such as de-densification, work from home and social distancing still have a lot of runway before reaching any degree of permanence. Ditto the slump in leasing and the need for property owners and managers to reconfigure now-unused spaces to capture any semblance of net operating income (NOI). But capture it they must. The need is here and now, and tomorrow can take care of itself.

Happily, owners and managers are a creative bunch, and there is a measurable trend in the adaptive reuse of dormant spaces, not just in the office sector, but also in retail and other asset classes. If conversions to life science uses or to flex space or same-day distribution space or ghost kitchen space result in long-term leases, all the better. And the evolution continues.

Down the road, it is expected that long-term office users will ultimately realize they cannot do without its benefits—the collaboration, the socializing, the impromptu meetings that spark major strategic changes—and then come back with a vengeance. When that happens, we might actually see once more too many tenants chasing too few opportunities. And wouldn't a landlord's office market be a nice change of pace?



**“We’ve been doing some deals with flex-office tenants because it’s no longer just location, location, location. It’s all about flexibility in this uncertain and dynamic environment.”**

– Rob Brierley, Bulfinch

## OF LEMONS AND LEMONADE: THE CURRENT LEASING PICTURE

There was bad news and good news in the office vacancy picture at the start of Q3 2021. The bad, according to JLL, is the overhang of the leasing carnage we experienced last year; the good came at the working end of an economic picture that shows a “glimpse of recovery” in leasing. The firm reports that gross leasing jumped in the second quarter by 28.7 percent, and while this is still relatively anemic compared to the 41.6 percent we saw prior to COVID-19, it was at least the first time we crossed the 30 million-square-foot threshold since the start of the pandemic.

In addition, sublease markets are showing what JLL refers to as “nascent signs” of stabilization, despite rising to a jaw-dropping 158.1 million square feet last year. “The gap between sublease space being advertised and the amount of space actually being vacated has also stabilized at 48 million square feet,” staying near this figure for three quarters.

Net absorption, however, remains in the negative column with 20.7 million feet of occupancy losses recorded in Q2. We have real estate as a lagging indicator to thank for this, along with the still sizable sublease picture. Nevertheless, good news is hidden in those statistics, and Q2 also recorded the second consecutive slowdown in negative absorption.

“In the second and third quarter, we’ve seen a few more tire-kickers, which is good,” says one property professional we spoke to with an office portfolio. “Activity has been fairly brisk with tenants tending to renew leases, but we’re still seeing a preference for shorter terms.”

The fortunes of commercial real estate in general are set against the backdrop of the larger economy, of course, and the U.S. Bureau of Labor Statistics gives a hardy thumbs up on that score. “So far this year, monthly job growth has averaged 586,000. In August, notable job gains occurred in professional and business services, transportation and warehousing, private education, manufacturing, and other services,” which covers, either directly or indirectly, most of the major commercial real estate food groups. But the report goes on: “Employment in retail trade declined over the month.” Well, no surprise there.

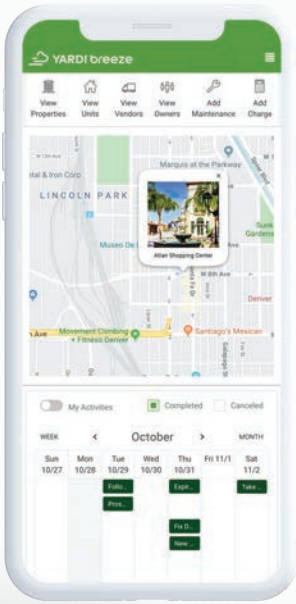


**“We’ve seen museums and bus stations as just some of the outdated asset types adaptively reused for office.”**

– KC Conway, Red Shoe Economics

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Beleaguered as the sector has been, do not assume that the doom-and-gloom retail headlines are the entire story. “Disparity between performing and non-performing assets continues to be accelerated across all retail formats,” says one expert, “and grocery-anchored centers are most in favor with investors, while enclosed ‘C’ malls draw limited investor interest.”

He goes on to say that fundamentals remain “surprisingly” strong, with retailers actually expanding and rethinking their supply chains and physical presence. “Retail sales in many categories have tracked above 2018 and 2019 levels—in some cases experiencing double-digit increases,” he notes, adding that those were two of the highest-flying years in the industry.

New COVID variants might change that picture, however, and he predicts “a leveling off through the end of the year.”

So, allowing for bumps along the way, things overall seem to be on the mend, or at least they did in the second quarter. “It does feel like we’re in a different place than we were in the depths of COVID winter,” says one property manager. “The pace of activity is a bit better, and there’s reason for optimism.”

The question remains whether or not this “glimpse of recovery” will continue, or if we are, like a boat in a storm, caught in a trough between two massive waves of COVID-19 strains. If for now, America is getting back to work, the other question is, where are they working?

Part of the answer, of course, is at their kitchen tables. “We’re finding that existing tenants with leases coming up for renewal are more focused on short-term extensions while we wait for the market to stabilize,” says one contributor who points to a growing need for flexibility, including a work-from-home option, all due to “the uncertain conditions. They want to know what the impact of the pandemic is going to be on the economy before they make any long-term financial commitments.”



**“There’s definitely a focus on keeping costs down in this cautionary environment, and it’s driving some of the shorter lease terms. Conversely, some are expanding their offices to provide more distance.”**

— Brian Cappelli, GBX Group

There really is no surprise here either, not for those who are familiar with the second in a series of [BOMA International COVID-19 Commercial Real Estate Impact](#) studies. Fifty-five percent of the more than 3,000 corporate decision-makers polled for this latest study stated that they were rethinking their office space needs. Reductions in the number and size of private offices and conference rooms, as well as more flexible desk protocols, are all on the potential menu: a clear alignment with a growing trend toward hybrid workplace arrangements.



**There is one food group that is enjoying an undeniable landlord's market: the industrial sector, where tenants, hot to sign Class A space, are being pushed into B spaces due to demand—and, in many markets, are still paying rents that approach A levels.**

“Pre-COVID, 70 percent of our respondents kept employees full time in the office,” stated the report. “Post-pandemic, and projecting as far out as 18 months, that drops to 43 percent,” with most expecting a hybrid approach instead. Plus, our contributors provide anecdotal evidence of companies opting—at least temporarily—for a total work-from-home policy.

We should mention here that there is one food group that is enjoying an undeniable landlord's market: the industrial sector, where tenants, hot to sign Class A space, are being pushed into B spaces due to demand—and, in many markets, they are still paying rents that approach A levels. Here, too, there are exceptions, depending on the specific market, but the overall industrial picture is rosily counter-cyclical.

For the other asset classes mentioned, rather than settling for the tossing and turning of the storm, owners and managers are taking preemptive steps to revitalize their bottom lines, primarily by turning to other (read: non-traditional) uses. →





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## VARIATIONS ON THE THEME OF ADAPTIVE REUSE

Theoretically, any asset can be converted to any use. The deciding factors are CapEx and time. Backfilling a vacant office is one thing. Converting a dying shopping mall is quite another. There is also a question of usage. Refitting an office transitioning from a real estate tenant to a law firm is a relatively easy lift. (This despite the rise in construction costs, which Turner Construction puts at a conservative 1.28 percent increase every quarter since Q1.) Taking on a life science tenant, however, can easily be an exercise in biting off more than an owner can chew. We will have more on this shortly.

Specifics aside, adaptive reuse is becoming big business. How big? Hard to tell, but big. “The size and scope of the adaptive reuse sector are tough to quantify because projects are often commingled in the broader universe of commercial real estate, which spans some 32 billion square feet of office, retail and industrial warehouse space in the U.S.” So says a recent report issued by the CCIM Institute, which predicts that by 2023, makeovers might increase twofold.

Then there is the COVID effect: “The COVID-19 crisis could unleash a bigger wave of adaptive reuse projects due to distress emerging across sectors such as hospitality and retail,” the report goes on to say.

And now for a disclaimer: By rights, given the varied and shifting demands of the marketplace and the complexity involved in converting uses, no matter the asset class, each food group could demand a Deep Dive of its own. For purposes of this piece, what follows is an exploration of various market sectors:

**The Office Market Awaits Its Comeback.** One of the most logical transformations of vacated spaces comes in the office sector, in a move that perfectly dovetails with the uncertainty of tenants—while offering them a glimpse of the benefits that a central location can bring. Flex space is on the rise and promises to represent some 30 percent of all office space by 2030, as Ben Munn of JLL wrote for BOMA International last year.

“The flexible space footprint has grown at an average annual rate of 22 percent since 2010,” he says. “Following the disruption of the pandemic, demand is likely to grow yet again. The future of commercial real estate lies in flexible space—in all its variations—and owners and investors will shape that future.”

The market also has seen renovations that envelope the whole asset. “Right now, we have three office buildings we’re converting to hospitality,” says one expert. Ironically, one of the properties had been used for shared office, but was suffering with low vacancies nevertheless, and one of the tenants actually decided to opt for a full work-from-home policy. Depending on the market, the three assets are in the midst of converting either to boutique hotels, more traditional hospitality offerings or even short-term residential rentals—a la the Airbnb model.



Hospitality might seem an odd choice, given the COVID restrictions that hobbled that sector, but he points to the big business hotels as the major victims. “There are some markets that are really growing, and average daily rates (or ADRs) are way over 2019 levels,” he explains. “Occupancies have tended to continue their growth in certain leisure markets.”

But the more common adaptive reuse path in office is to take space in other asset types. One practitioner points to Nashville’s Vanderbilt Health at 100 Oaks. The medical office facility took over what was Music City’s first indoor mall. The retail entity fell on hard times, “another casualty of urban flight,” according to the project engineer’s website. It made perfect sense, given the prime location of the 56 acres the mall sat on. Interestingly, the building still looks rather like a mall, with clinics lining the 800-foot central corridor.

**Retail: The Haves and Have-Nots.** Speaking of that sector, “redefinition” has been a watchword for much longer than COVID’s duration to date. Market-savvy tenants have been on top of the “experience” trend, looking for enticements to get shoppers into their stores. That, of course, became a moot point with last year’s quarantines. In fact, consumers spent \$791.70 billion online last year, a whopping 32.4 percent jump over 2019. (Amazon accounted for a full third of that.) →

**“Some smaller retailers will close, reducing consumer options and driving more people online. Traditional brick-and-mortar stores can still thrive and serve an important purpose as they begin taking on new and nontraditional roles.”**

— Richard Kenwood, CBRE



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“There’s a bifurcation today of better malls and ‘not-better’ malls,” says one source. “The strong malls, the A malls, are getting stronger. They’re concentrating on better retailers and adding more dynamic components.” In contrast, those that were starting to pant before the pandemic only found their woes accelerating last year. “They’re having more closures, less investment and fewer new retailers. They were ready for higher, better uses.”

But “higher and better” is not as easy as firing up the bulldozer. The source quotes a mentor who observed that: “An enclosed regional mall is one of the greatest commercial inventions in history in terms of what they do for jobs, services, taxes and community. But they are also one of the most inflexible assets ever built; legally, physically and politically.” Frequently there are multiple owners, potentially long-term leases that have a way to run, various entitlements and governmental approvals that need to be secured. “There can always be a higher, better use,” he says, “but it’s often difficult to accumulate all of the pieces necessary to pursue that redevelopment.”

One better use is a “simple” conversion from enclosed mall to outside access. Note the use of quotation marks here. Even a partial adaptation can be a challenge. He is currently replacing an old department store with a new mixed-use development that includes shopping and interactive entertainment. The rest of the mall is “good.” Even then, there could be restrictions on what tenants are allowed to go in, based on the competitive restrictions spelled out in existing leases.

“Rarely is there a huge savings by thinking you can put something new in a vacated box versus just tearing it down and building new,” he says. “It’s challenging from a cost and design perspective to put something else into a 40-year-old box.”

CCIM agrees: “Often, the land underneath the vacant or underutilized retail is worth more than the buildings, especially in urban areas where building sites are scarce.”

**“One of the least understood aspects of conversions for people outside the industry is how expensive and difficult it is to convert existing mall space into something else without tearing it down.”**

– Gar Herring, JLL



Some higher, better uses—in addition to the medical office upgrade cited before? Given the prime location of most retail centers—and especially the road access—fulfillment centers are a very popular option, especially in this age of last mile, same-day delivery. One source puts the total mall-to-warehouse trend so far at 18 million square feet.

Before we leave the retail scene, we need to discuss the rise of ghost kitchens as an alternative to customer-starved restaurants. “Ghost kitchens were a niche strategy for certain eateries before the pandemic,” according to a recent GlobeSt.com report, “but when indoor dining became limited during the health crisis, they became the backbone for many restaurants.”

GlobeSt.com reports that digital restaurant orders, already growing, “skyrocketed during the pandemic,” going from 19 percent year-over-year in January 2019 to 145 percent YOY in December 2020. As the world opens back up in the fits-and-starts manner it seems to be following, we may see a little more of that evolution of spaces. “Ghost kitchens will remain a growing part of the food service mix,” the article predicts. “But there are questions about the durability of the strategy, where they’ll work best and what they need to be successful.”

One place they do not work, at least for one of our sources, is on the first floor of his renovated multifamily building. “It doesn’t do me very much good,” he says. “I want that restaurant and bar space as an amenity for the residents and for the local community.” While not the great draw of a full-service eatery, it does nevertheless fill the necessary vacancy, even if the rents are lower “because the landlord needs the occupancy.”



**Life Sciences: A Big Pill to Swallow.** If retail solutions come with specialized challenges, life science applications are near to impossible, at least for the uninformed. Not surprisingly, especially given the nature of last year’s virus-driven market disturbance, the life science sector is a hot commodity.

“A record \$70 billion of private and public capital (mostly venture capital and initial public offerings) poured into life sciences-related companies in North America in 2020,” Cushman & Wakefield reports. That was a 93 percent increase from 2018—which recorded the previous high of \$36 billion. “And if investment continues at the pace we’ve seen in the first quarter of 2021 (already totaling \$32.9 billion) we could see somewhere in the area of \$90 billion this year alone.”



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And investors are knocking on everyone's door looking for space, which on one hand sounds like a good thing for building owners and managers. "I've been taking calls about converting everything to life sciences, everything from office buildings, warehouses and movie theaters to auto dealerships and nightclubs," reports one source. "You name it. The pandemic put a major spotlight on life sciences."

But as we reported in Deep Dive No. 5: Taking the Pulse of Healthcare Real Estate, life science tenants are not your typical tenants, even within the broader context of, say, medical office. They are part of a community in which proximity to universities and a constant stream of young talent are key, as is the ability to cluster with like-kind operations and mindsets. "It's a totally different dynamic," says one source.

Even if you removed the disco ball, you could not simply plop a lab into a former nightclub. Or office. At least, not without a major infusion of capital. And then would it be state-of-the-art?



**Even if you removed the disco ball, you could not simply plop a lab into a former nightclub. Or office. At least, not without a major infusion of capital.**

"Only 50 percent of the product I come across is viable for conversion to life science uses," says one contributor. "You start with an assessment of the existing facility against the required program you're trying to fit into the space, and then do a gap analysis to understand how to get from point A to point B."

Ventilation and power are two of the major sticking points to upgrading older office space. "Most of the conversions happen in the mechanical and electrical systems," says one practitioner, while most typical office assets recirculate air, life science facilities use 100 percent single-pass exhausted air with much larger ducting than is typical otherwise. Ditto the power and back-up protections.

Even in the unlikely event that a traditional office has the required utilities, there is still a question of bones. "For life science users, 16-foot floor-to-floor heights are ideal," he says, "but 14 or even 12 can work." Most likely, however, a gut rehab is called for. And, as one contributor noted, most tenants are not willing to foot that bill on their own.

"The cost can range from \$150 per square foot to \$500," he estimates. "It's not an inexpensive endeavor." Particularly with specialty, purpose-built facilities coming out of the ground, fueled by the above-mentioned investor interest. Most life science tenants will turn to the prospective landlord to do the heavy financial lift of a major overhaul.

And even if the landlord rolls the dice, the tenant will likely be in a one-off space rather than that new, purpose-built home, surrounded by peer groups for the all-important cluster effect. “If a tenant has the choice,” he says, “they’re always going to make something happen purpose-built rather than trying to squeeze into a conversion.”

“The lack of space availability has especially been a concern to biotechnology groups, with inherently tight time frames and critical needs to get to market with revenue-generating products,” says Cushman & Wakefield. “This immediate need . . . has prompted both traditional biotechnology developers and local developers alike to proceed on a speculative basis.” Not surprisingly, most of these spec builds deliver fully committed.

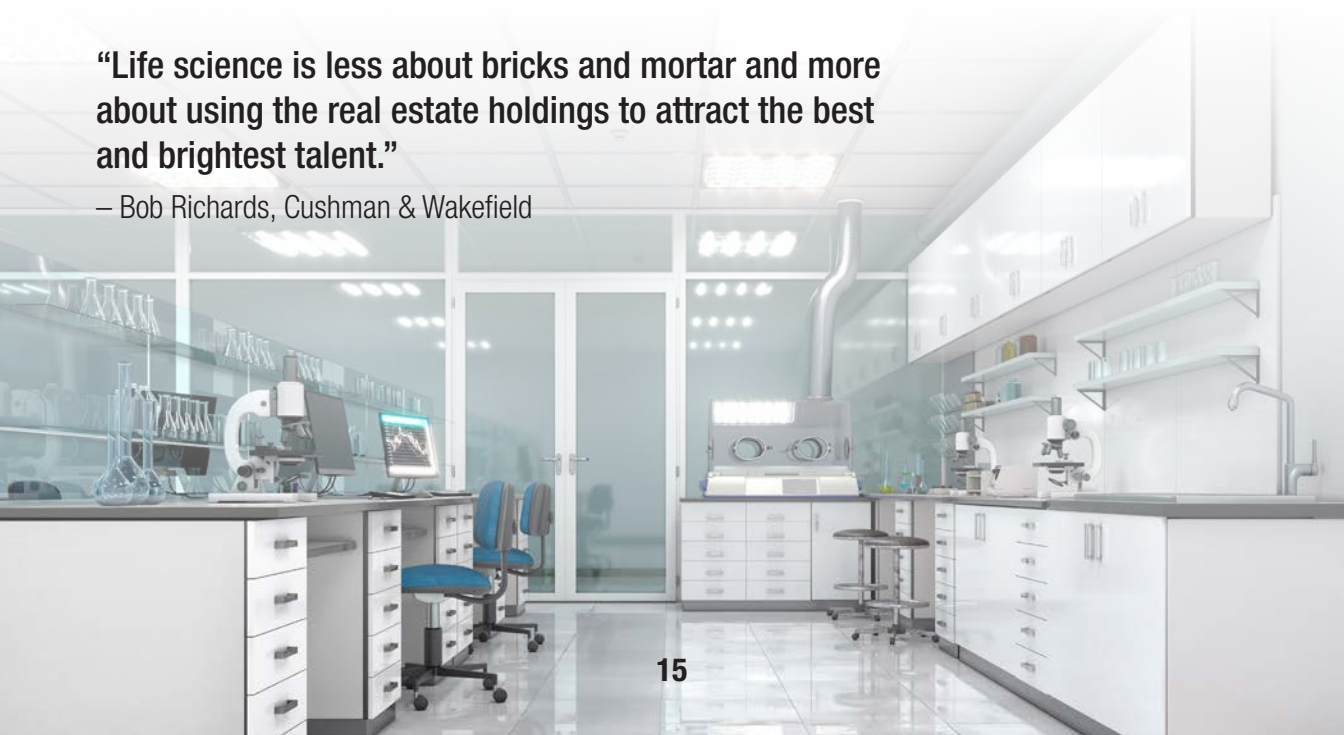
And then we meet another example of market evolution. If the office market currently belongs to the tenant, the life sciences market is a landlord’s market through and through, particularly in such hubs as Cambridge, Massachusetts; South San Francisco and the peninsula; or San Diego—all where vacancies can run in the low single digits. The trend then, as it would be in any office market on the rise, is to push out to the nearby suburbs. And here, close to the cultural vibe of primary submarkets, users in the life sciences space will entertain office conversions. Landlords, have your wallets at the ready.

“The secondary markets are growing in life sciences because the primary markets have gotten so expensive, and there’s a growing lack of space,” says one practitioner. The fierce demand has not yet reached the tertiary markets, apparently, which he describes as “still a heavy lift.”

But the heavy lift does not belong to the landlord alone. If you are a generalist property manager hungrily eyeing the life sciences market, you should plan on sharing the burden.

**“Life science is less about bricks and mortar and more about using the real estate holdings to attract the best and brightest talent.”**

— Bob Richards, Cushman & Wakefield



## BREAKING IT DOWN FOR OWNERS & MANAGERS

Certainly, just as any property can theoretically be converted to any other use, so can owners and managers train and study and learn the details of industrial or retail conversions. “It takes discipline and a lot of mentorship,” says one source. Of course, *you know who* lies in the details.

“The financials of operating a building are not terribly different from asset to asset,” says one contributor. But in life sciences especially, the best (read: easiest) path—though likely much more expensive—is to partner with a knowledgeable company.

“The assumption is that you can buy that expertise,” says one practitioner. Just like Brookfield Asset Management did in early September when it saddled up with life sciences developer King Street Properties. Their plan is to invest \$1.5 billion in the latter firm’s life science platform.

And stating what readers already knew, Lowell Baron, Brookfield’s Real Estate Group managing partner and CIO, said in the press release that, “Life science is an attractive investment sector given the long-term market dynamics of an aging population and increased public and private funding to R&D.”

**“Some facilities would need a heroic effort to convert to life science, and heroic often means time and money. Engage a team experienced in science facilities design to determine feasibility.”**

– David Bendet, Gensler





Partnering is clearly a smart move. “You need very sophisticated engineering and operational people to manage these properties,” says a contributor. “You can’t throw a retail or office person in to manage one of these highly complex properties without proper additional training.”

Even the communications side of things needs a different approach. A mechanical engineer can shut down a traditional office’s heating, ventilation and air conditioning (HVAC) system at pretty much any time. Tenants might find it annoying, but it is not life threatening.

“No harm, no foul,” says one property manager. “But you have to work in lockstep with life science tenants and inform them of every move.” He provides a detailed monthly agenda and needs tenant input on any disruptions that would cause. “If my tenant, let’s say Pfizer, is working on a new COVID vaccine,” he says, “I don’t want to be the one responsible for them losing that product.”



**Your appetite shouldn’t exceed your capacity in terms of your market savvy and your alignment with tenant needs.**

The stakes may not be as high in retail, but expertise is still warranted. “A mall is never stagnant,” says one practitioner. “It’s either getting better or worse. Those that aren’t getting investments for new tenants and new components are typically the malls that are performing more poorly.” Not surprisingly, deals there take longer and are harder to land.

As we saw before, even in malls laden with promise, the road can be bumpy, and owners and managers often need to deal with documents that date back 30 or 40 years, “like reciprocal easement agreements and agreements between various owners,” he says. “There are a lot of restrictions. It takes a lot of work and expertise to go to your tenants and sell them on a new vision or use and then get them to agree to bringing those tenants in.”

The message from our sources is clear. “Your appetite shouldn’t exceed your capacity,” says one property manager. He could have been referring to a night on the town, but it applies as well to your capacity for diversification, your market savvy and your alignment with tenant needs. At the same time, we all follow the money, especially in times of downturn.

“Owners are adjusting and modifying their assets,” he says, and as necessary learning or acquiring the necessary expertise. “They have to adjust to the needs of the market or they’re dead.”

## WILL WE EVER SEE A LANDLORD'S OFFICE MARKET AGAIN?

You may remember a time, prior to the Great Recession, when many otherwise knowledgeable commercial real estate pros, riding an extended wave of megadeals, were talking about how the market is no longer cyclical. Then the market went sideways—and massively so.

Today, as we face that considerable overhang of vacancies in the office market, it might be a good time to remember that, indeed, the market is still cyclical. We don't know quite yet when the pendulum will swing upward, or even (gulp!) if it has reached its nadir. But we do know two things: The market will come back. And it will look different.

"I've been around for a couple of cycles now," says one contributor. "And in every cycle there will be opportunities created for people who can take advantage of them." It could be a permanent conversion of office space to other uses, he says, "or signing a temporary tenant while we wait for traditional office users to come back."

One source points to the onetime Rust Belt of northern cities heavily based in old-line manufacturing, cities such as Pittsburgh, that were revitalized by gleaming, green office environments. No, not every property is salvageable or convertible to a new, hoped-for use. Those that aren't will make way for other applications. Likewise, owners and managers will reevaluate their capabilities and make strategic decisions about new markets and new tenants. It's called progress.

It's also called adaptability.



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### Research work contributing to this paper includes:

- From BOMA International:
  - [“COVID-19 Commercial Real Estate Impact Study,”](#) Q2 2021.
  - Deep Dive No. 5: [“Taking the Pulse of Healthcare Real Estate,”](#) by John Salustri.
  - [“Flex Space Takes a Lead Position in the Post-COVID Normal,”](#) by Ben Munn.
- From CCIM Institute:
  - “[Adapting CRE to COVID-19,](#)” By Beth Mattson-Teig.
- From Cushman & Wakefield:
  - “[Life Sciences on the Rise: 2021 North American Report.](#)”
- From Digital Commerce 360:
  - “[U.S. eCommerce Grows 32.4% in 2020,](#)” by Fareeha Ali, Jessica Young.
- From Envision Advantage LLC:
  - “[Vanderbilt Health at 100 Oaks.](#)”
- From GlobeSt.com:
  - “[The Future of Ghost Kitchens,](#)” by Les Shaver.
- From JLL:
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- From the U.S. Bureau of Labor Statistics:
  - “[The Employment Situation—August 2021.](#)”
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