Adaptive Reuse: Turning Blight into Bright

3Q18 Commercial Real Estate Insights Report
Dear Reader:

Welcome to the next installment in the Commercial Real Estate Insights series. These reports, created in partnership with the Alabama Center for Real Estate, represent CCIM Institute’s commitment to providing thought leadership at the highest level to the industry during a time of historic change.

The first report, which was released earlier this year, was titled “Amazon HQ2: A Reset Button for Site Selection.” Driven by the thorough analysis and unique perspective of CCIM Institute Chief Economist K.C. Conway, that report garnered widespread media attention and provided commercial real estate professionals with insights into what corporate RFPs will look like in the future. The response from both the press and CCIMs was overwhelmingly positive. If you haven’t read it, I urge you to visit www.ccim.com/insights. You won’t be disappointed.

In this report, K.C. tackles adaptive reuse — an increasingly common but misunderstood and under-analyzed property segment. As I’ve had the privilege of traveling around the world on behalf of CCIM, I’ve witnessed this as a global phenomenon; from turn-of-the-century warehouses to castles to train stations, developers and investors have untapped enormous value from obsolete building stock. This report represents the first step in the Alabama Center for Real Estate’s effort to redefine and quantify adaptive reuse, elevating it as a distinct product category within commercial real estate. We expect their efforts to result in increased adaptive reuse investment and development activity, and ultimately a stronger, more resilient commercial real estate industry.

The Commercial Real Estate Insights reports are designed to start a conversation that will ultimately help CCIMs and their clients adapt in an evolving industry. If you’re not a CCIM, I encourage you to learn more about the CCIM designation program and our other education offerings at www.ccim.com.

With the support of our members and partners like the Alabama Center for Real Estate, we look forward to bringing you valuable insights for many years to come.

Sincerely,

David P. Wilson, CCIM
2018 President
CCIM Institute
Tracking
Adaptive Reuse

The Birmingham Terminal Station in Birmingham, Ala., was built in 1909. Modeled after the Hagia Sophia in Istanbul, Turkey, it featured a majestic central dome and intricate glass and tilework. But when passenger rail traffic disappeared, so did the perceived need for the building. It was demolished in 1969.

700 miles north in Detroit, the Michigan Central Station building still stands. Opened in 1913, the beautiful 18-story property was designed by the team behind New York’s Grand Central Station. Like the Birmingham station, it thrived during the heyday of passenger rail and then became obsolete. For decades, Michigan Central Station stood abandoned on the skyline as a symbol of Detroit’s own fall from grace.

But in June 2018, Michigan Central Station was purchased by the Ford Motor Co. The company is expected to transform the building into a center of research on autonomous vehicles. Now, a piece of transportation history may inspire the future of transportation.

The story of the Birmingham Terminal Station could have paralleled that of Michigan Central Station, but half a century ago buildings were seen as fungible assets. Today, adaptive reuse holds the promise of saving iconic real estate assets across U.S. metros where urban growth has resurfaced. But there are many other reasons for commercial real estate developers and investors to consider adaptive reuse — including uncertainty about how an extended trade war could affect the price of new construction.

Though it’s been garnering headlines for more than a decade, adaptive reuse (AdRu) is no longer just about repurposing beautiful historic properties in primary markets to entice millennials. A variety of new projects have surfaced in secondary and tertiary markets, where investors see AdRu as a driver of NOI and yield.

We predict that adaptive reuse projects will make up a greater percentage of investment activity than self-storage and other select non-core property types by 2023. But the commercial real estate industry’s understanding of this property segment isn’t keeping up with this growth. This ultimately impedes investment and development.
(Re)Defining Adaptive Reuse

To develop a recommended industry definition for adaptive reuse, ACRE and CCIM Institute interviewed a broad cross section of industry participants, including developers, brokers, municipal government leaders, CCIM instructors, Counselors of Real Estate, lenders, and investors. Utilizing their input, we determined that the following elements are necessary for a project to qualify as adaptive reuse:

There are other elements that are common among adaptive reuse projects but not prerequisites for classification. For example, many involve costly rezoning or local ordinance variances. Communities such as Tucson, Ariz., have incentivized adaptive reuse by officially addressing some of these impediments, thus saving developers time and money.

Also, local community support and a local developer or project team are front and center in every large-scale, successful adaptive reuse project that we studied.

In addition, most adaptive reuse projects involve multiple uses, which requires project participants to be skilled in more than one property type, as well as market analysis.

With an official definition for adaptive reuse, we can begin to quantify investment activity and further encourage the transformation of cities across the country.

I. Existing structure: While adaptive reuse projects may involve some level of new construction or an expansion/addition of space, they always start with an existing structure.

II. Functional and/or economic obsolescence: All adaptive reuse projects commence with a property in a state of disrepair, high rate of vacancy, or with highest and best use in transition. In essence, the old use is no longer productive or economically viable, and the tenants have left.

III. Change of use: The project/property must involve a repurposing of a prior structure and use, not a mere re-tenanting with tenant improvements. This key point distinguishes our methodology from other industry research on AdRu.

IV. Economic viability: The new project/property must pass the ultimate test of highest and best use. Not only does the reuse need to be physically possible and legally permissible; it also has to be economically viable. Local government incentives are sometimes necessary to make a project economically viable due to the cost of assemblage, higher repurposing costs with a greater cost-overrun risk factor than new construction, and speculative lease-up risks.
Quantifying Adaptive Reuse Activity

We estimate that the U.S. has an existing inventory of nearly 32 billion square feet of commercial office, retail, and industrial warehouse space. In addition, the U.S. has an estimated 11 million multifamily units and 2.5 million hotel rooms. Altogether, that amounts to an estimated 32.3 billion sf of core commercial real estate space. AdRu activity is comingle with, and thus hidden among, those billions of square feet.

As a result of this data void, developers, lenders, and equity investors have no source to turn to today that can translate how much of this existing multifamily, hospitality, office, retail, and industrial space has been or is currently undergoing adaptive reuse. They’re unable to discover the impact AdRu is having on existing inventory — and the market implications on absorption, vacancy, and rents — without engaging in an expensive and time-consuming custom market and feasibility study.

To put the significance of this data void in perspective, we identified and studied recently completed or in-process AdRu projects totaling more than 33 msf with a value of approximately $4.4 billion. Collectively, this sample set of projects represents the equivalent of 1 percent of the aggregate commercial real estate space for all property types in five of the largest U.S. metropolitan areas: Los Angeles, Chicago, Dallas-Fort Worth, Atlanta, and Charlotte, N.C. That 1 percent can materially alter supply and demand metrics. In other words, the current level of AdRu activity is enough to impact absorption, vacancy, and rental rates for any property type in almost any primary or secondary U.S. metro.

As a percentage of total commercial space, AdRu will likely increase two-fold over the next five years.
Using this sampling, we estimate that AdRu projects constitute between 1 percent and 2 percent of all commercial real estate space in the U.S. today. That figure will likely increase by two-fold over the next five years, to up to 4 percent, largely thanks to store and mall closings, as well as the impact of e-commerce and artificial intelligence, which will render many properties obsolete.

This means that, as a property segment percentage of total commercial space, AdRu will likely surpass other recognized non-core property types such as self-storage.

<table>
<thead>
<tr>
<th>MSA</th>
<th>Property Type</th>
<th>Inventory Sq. Ft.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles</td>
<td>Aggregated MF, Hotel, Office, Retail and Ind'l</td>
<td>1,500,000,000</td>
</tr>
<tr>
<td>Dallas-Ft. Worth</td>
<td>Aggregated MF, Hotel, Office, Retail and Ind'l</td>
<td>1,200,000,000</td>
</tr>
<tr>
<td>Chicago</td>
<td>Aggregated MF, Hotel, Office, Retail and Ind'l</td>
<td>1,150,000,000</td>
</tr>
<tr>
<td>Atlanta</td>
<td>Aggregated MF, Hotel, Office, Retail and Ind'l</td>
<td>900,000,000</td>
</tr>
<tr>
<td>Charlotte</td>
<td>Aggregated MF, Hotel, Office, Retail and Ind'l</td>
<td>320,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>5,070,000,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Total U. S. Inventory Sq. Ft.</th>
<th>Inventory Sq. Ft.</th>
<th>Units/Rooms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apartments for Rent</td>
<td>9,900,000,000</td>
<td>11,000,000</td>
<td></td>
</tr>
<tr>
<td>Hotel Rooms</td>
<td>1,000,000,000</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>Commercial Office</td>
<td>4,300,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail Space</td>
<td>2,100,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Warehouse</td>
<td>15,000,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>32,300,000,000</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The New Drivers of Adaptive Reuse Activity

Why are we seeing more AdRu projects in this market cycle than in any other cycle since WWII? Factors such as the trend toward urbanism and millennial lifestyle choices, including a focus on real estate “experiences,” have been reported on for a decade or more. But other pressures deserve a closer look.

Cost and scarcity of land: Unlike the suburbs where there has been a plentiful supply of cheap land to scrape and erect new structures, cities tend to have a variety of barriers and limited supply of undeveloped land. This forces developers to reconsider an existing use. And increasingly, the cost to repurpose an old or unoccupied property is cheaper than site acquisition, permitting and approval processes, and ground-up construction, given rising materials prices and scarce construction labor. This would only be exacerbated by an extended trade war.

AdRu now competes effectively against new construction. It can be 15-20 percent cheaper and faster for projects without environmental issues in cities that have sufficiently evolved their zoning and building codes to accommodate it. The wild card is the permitting, engineering, and approval costs for AdRu. These projects are difficult to pro forma and only defined after property acquisition and commitment to repurposing a structure. This is why communities like Tucson, Ariz., have started to proactively supplement their zoning ordinances and building codes to provide for some of the unique allowances needed to encourage AdRu activity as part of economic development (see p.8).

Reinvention of retail and remaking of the supply-chain: Though headlines like “Retail Apocalypse” portend the demise of a sector, e-commerce and new logistics technologies are actually reinventing retail. This now affects everything from apparel to electronics, as well as autos and, more recently, groceries. This one pressure — the change in how we use retail space — is creating most of the space currently available for AdRu, followed by obsolete warehouses.

Combating blight and replacing the tax base: Unutilized structures are creating blight in markets across the U.S. And local governments are losing revenue from both declining sales and property taxes as retail stores close and prior growth industries such as financial services contract. How can cities replace lost sales and property tax revenue from closed stores and branch banks? Ironically, the solution is what local communities least understand and most resist: reusing a structure or property. It is a fear of the unknown and a lack of example that most often keeps local cities from permitting an AdRu project. In the coming years, local governments will invest more economic seed capital to germinate the bright that will eradicate the blight.
Local Collaboration

In December 2016, Tucson, Ariz., Mayor Jonathan Rothschild and the Tucson City Council voted to implement a 24-month pilot program to encourage adaptive reuse, modeled after similar programs used in Phoenix and Los Angeles. The program incentivizes developers and business owners to repurpose existing buildings within the city limits while maintaining and enhancing the current structure.

AdRu projects typically involve controversial and costly rezoning and local ordinance variances for items related to density, parking, and compliance with any number of modern building codes unrelated to life-safety. Communities like Tucson are starting to address zoning codes and other unique AdRu challenges to accelerate the reutilization of empty buildings, which can restore the property tax base and attract new businesses.

The Tucson program primarily focuses on buildings that are 50 years old or older or that have been vacant for thirty years or more, but it also makes allowances for buildings that are at least thirty years old. Projects are also required to provide community benefits and ensure consistency with the plans of the surrounding area and neighborhoods. The incentives for developers and investors include relaxed parking, permit fee waivers, and flexible density and zoning requirements.

“This program will make it easier to get new businesses into old buildings ... [It] will save developers time and money while boosting the economy through job creation and a proliferation of construction projects,” says Jonathan Mabry, the City of Tucson Historic Preservation Officer.

“The collateral effects of adaptive reuse include increased density in our urban core by putting vacant buildings back into use. Historic preservation is achieved by giving new lives to our vintage and historic buildings, and sustainability is created by recycling entire buildings.”

The city of Tucson is on the forefront of adopting policies to encourage AdRu, particularly among smaller markets. It’s a model for other cities looking to pave the way for more AdRu activity to stimulate the local economy and put empty buildings back to productive use. But until we see widespread collaboration from local governments, legal and ordinance/zoning challenges will prevent AdRu from making a positive impact in many markets. According to industry participants, in cities that don’t have a support structure like Tucson, AdRu projects are not for the “faint of heart” or undercapitalized.
What’s Holding Adaptive Reuse Back?

There are five primary challenges ahead for growth in AdRu activity.

1. An industry-recognized definition: This would allow data on AdRu activity to be collected and segmented to facilitate the development of metrics, which in turn would help developers and capital sources in underwriting more investment. This report proffers that definition (see p.4).

2. Collection and reporting of key metrics: This is perhaps the most urgent and challenging hurdle to overcome. Commercial real estate industry participants need to understand, for example, how AdRu activity impacts absorption and vacancy for uses it is displacing and transaction metrics, such as capitalization rates and internal rate of return. Tackling this challenge is not dissimilar to what occurred in the early and mid-1990s to advance CMBS activity. Entities like Trepp and the respective rating agencies (Moody’s, S&P, Kroll, etc.) can be valuable partners in facing the metrics challenge, as access to the capital markets will ultimately be required for AdRu to attain its full potential. Leading national brokerages lack the economic incentive to monetize a large AdRu data research effort, and the leading data-gathering and market intelligence enterprises are behind the curve and lack a plan to monetize the research effort. In contrast, Dodge Pipeline, a leading construction project database, may have the historical data, credibility, and infrastructure to deliver on this need. ACRE is pursuing discussions with these entities to tackle this challenge.

3. Local approval, permitting, and zoning processes and ordinances: This may be why developers and investors are not undertaking more AdRu projects. A developer can perform all the appropriate due diligence and engineer a compelling design, only to learn half-way into a project that an additional approval or zoning variance is required; such unforeseen events cause time delays and cost overruns that can disrupt construction schedules by months and increase project costs beyond the typical 10-percent budget contingencies. These problems are typically caused by density and parking issues. More local governments and municipalities need to revisit their zoning ordinance and approval processes as Tucson, Ariz., has (see p.8).

4. An industry-recognized methodology for underwriting and valuation: National banks are reluctant to take on large AdRu lending given the dependence on local market knowledge and the absence of recognized market data for underwriting. Methods must be developed to address elements such as going-concern; market ratios for density, parking, and common areas that impact absorption, vacancy, and market rent; and acceptable LTV and DSCR underwriting metrics by property type. Today, AdRu projects are largely financed with equity capital. The developer is subject to local banks and regulators, which often use different classifications and methodologies.

5. Acceptance by institutional capital and investors: Life companies and other institutional entities have mostly ignored AdRu because of their risk thresholds. But this will start to change as the industry addresses the challenges of data collection and analysis, as well as local collaboration.
Analyzing Adaptive Reuse Opportunities

While the lack of certain metrics and methodologies is keeping AdRu from reaching its potential across the U.S., local market and financial analysis approaches have allowed developers and investors to maximize ROI on local AdRu projects.

“Market analysis is the key to identify adaptive reuse,” says Stanley Gniazdowski, CCIM, president at Realty Concepts in Guilford, Conn., and a CCIM instructor. “All successful projects are based on current and future demand. An office building might have a highest and best use as multifamily.”

But as property uses evolve thanks to e-commerce, artificial intelligence, evolving retail trends, and other factors, identifying prospective tenants for AdRu projects will become more complex.

Gary Ralston, CCIM, managing partner of Coldwell Banker Commercial Saunders Ralston Dantzler Realty LLC and a CCIM instructor, notes that more than 25 percent of current retail space is occupied by non-retail users. “We think this trend will continue to grow,” he adds. “We expect up to 50 percent of retail space to be occupied by users who are not specifically retail users.”

Ralston applies market analysis tools to create a list of target users, which is based on understanding the demand associated with the characteristics of the population within a certain proximity to the property. He also relies on economic base analysis tools, which illuminate the jobs data in the market, as well as primary research to discover companies that may be expanding or entering the market.

Thorough financial analysis also helps developers and investors make better decisions when evaluating AdRu projects, says Lydia Bennett, CCIM, owner of CRE West Coast in Bellingham, Wash., and a CCIM instructor. She’s especially fond of the discounted cash flow model, which works for AdRu and most other projects. “Costs to get in; costs for rehab; income coming in; reversion … it is all in the model,” she adds.

Gniazdowski, whose AdRu experience includes an award-winning manufacturing facility conversion project, notes that older buildings should be examined for structural integrity issues. “You don’t want to rehabilitate an ongoing repair project that adversely impacts NOI and/or CAM charges,” he explains.

And though a careful analysis may or may not support AdRu for a given property, these industry experts expect AdRu to become increasingly attractive to market participants in the coming years. “With the current price of construction, lower supply, and evolving retail markets,” Bennett adds, “it may be that adaptive reuse is a way for investors to repurpose properties to their highest and best use.”
Adaptive Reuse in Action

The following section includes just a small sample of AdRu projects that are transforming communities around the U.S. They were selected because they represent the breadth of what’s possible when commercial real estate industry participants, local governments, and other key players collaborate to discover innovative uses for obsolete properties.
Liberty Hotel | Boston

The visionaries behind this project turned an old, run-down jail into a 298-room luxury hotel. Built in 1851 in the shape of a cross, the Charles Street Jail housed prisoners until 1990. In addition to the designers and architects, this AdRu collaboration involved the Massachusetts Historical Commission, the Boston Landmarks Commission, the National Park Service, and the Boston Redevelopment Authority. Together, they transformed this property from shank to swank.

Photo credits: City of Boston Archives; Jeff Gunn
Newbern Library | Newbern, Ala.

Adaptive reuse can transform even the smallest tertiary MSAs. Built in 1906, this former bank building was redesigned by Auburn University students to meet another, relatively simple community need: a new town library. AdRu projects don’t have to be overwhelmingly complex. But it pays to leverage local university talent and understand the needs of the surrounding market.

Photo credit: Tim Hursley
The Crosstown Concourse | Memphis, Tenn.

This is one of the most visionary adaptive reuse projects on the list. Built in 1927, the 1.5 million-sf former Sears facility was abandoned in 1993, creating blight in an iconic Southern city. Community groups and developers collaborated to plan and execute a $200 million renovation of the space, which was completed in early 2018. The Crosstown Concourse now features multifamily, office, and retail space, as well as Crosstown High School.

Photo credit: Chad Mellon
The 1.5-acre Grange is one of two vertical farms operated by Brooklyn Grange. This project illustrates that anyone can undertake the development of adaptive reuse — you just need a vision and capital. It also makes it clear that AdRu is linked to the triple bottom line, as it inherently promotes sustainability.
The Lucas | Boston

Designed in 1874, Holy Trinity German Church was recently converted into a 33-unit luxury condominium building. The architects were able to maintain many of the original design elements despite the change of use. Most AdRu projects bring buildings up to 21st-century standards but also showcase the original design and passion that went into a building.

Photo credit: Finegold Alexander Architects
Los Angeles is not known for its green spaces. But on September 28, 2001, Governor Gary Davis signed a bill calling for the state to acquire and clean up a 34-acre former rail yard, creating Los Angeles State Historic Park. The park is the centerpiece of an evolving 52-mile greenway and is considered a catalyst for L.A.'s river revitalization movement.
After Stapleton Airport ceased operations in the 1990s, most of the property was redeveloped as a residential and retail area. But as the rest of the airport disappeared, the old control tower remained — eventually becoming an iconic part of the neighborhood skyline. The city approached Punch Bowl Social about transforming the property into a family-friendly entertainment space. But to add features such as a bowling alley, developers had to get creative. Plus, the height of the tower posed a challenge. Local officials collaborated to address zoning issues and ultimately allowed Punch Bowl Social to preserve the structure.
FedEx Distribution Facility | Mesquite, Texas

This 340,000-sf industrial property along U.S. Highway 80 was once the site of Big Town Mall. Retail industry analysts expect that one-third of the roughly 1,100 malls in the U.S. will close or be repurposed by 2025. Meanwhile, the appetite for industrial space is only growing, with approximately 250 million sf expected to be delivered annually from 2018 through 2020. We’ll see more adaptive reuse of declining retail properties to meet the demand for warehouses and e-commerce distribution centers.
Birmingham Rotary Trail | Birmingham, Ala.

Once an eyesore for residents, the Birmingham Rotary Trail transformed the most marginal of lands, a vacant railroad cut, into a four-block pedestrian pathway. The Rotary Club of Birmingham partnered with the Freshwater Land Trust to divert storm water runoff from the site, which positively impacts the city’s water quality. The trail is part of a larger long-term project to connect pedestrian pathways throughout the county. Adaptive reuse projects like this one are becoming more common in secondary and tertiary markets.

Photo credit: Goodwyn Mills Cawood (GMC)
What are your thoughts?

This report is intended to start a dialogue. Share it with clients and colleagues, and send your thoughts to report@ccim.com.

This report is also available online at www.ccim.com/insights
Endnotes:

1. This was calculated by triangulating available information from national commercial real estate brokerages, leading data aggregating companies, and government data sources. It doesn’t include MSAs with a population of less than 50,000 people, buildings associated with academic institutions, or government owned and occupied space.

2. Among the major data-aggregating and reporting enterprises, only one is currently capable of segregating adaptive reuse activity in a useful way: Dodge Pipeline, the nation’s oldest construction database. But this assumes that AdRu projects can be uniformly defined, coded, and segregated.

3. The sample included projects across all U.S. regions (Northeast, Mid-Atlantic, Southeast, Midwest, and West), encompassing more than 20 major MSAs, such as Tampa, Fla.; Washington, D.C.; Atlanta; Austin; Boston; Memphis, Tenn.; and Chicago.

AUTHOR: K.C. CONWAY

CCIM Institute Chief Economist Kiernan “K.C.” Conway is the director of research and corporate engagement at the Alabama Center for Real Estate (ACRE) housed within the University of Alabama’s Culverhouse College of Business.

Conway is a frequent speaker for the Federal Reserve, FDIC, FHLB, state bank commissioners, academic groups, professional organizations, and industry associations. He previously served as chief economist for Colliers International – US.

In addition to being a frequent lecturer at international conferences, Conway has consulted with major governmental agencies, most notably briefing former Federal Reserve Chairman Ben Bernanke and the Board of Governors on the burgeoning subprime lending and housing crisis and its impact on the commercial real estate industry.
CCIM Institute created the language of global real estate investment. Our courses and worldwide community deploy commercial real estate investment methodologies and tools that speed the pathway between opportunity, a go/no-go decision and success for an asset, taught by instructors who are themselves industry leaders. Today, the organization, through its 50 chapters, continues to innovate best practices and elevate the commercial real estate professional through its core designation program to earn the CCIM pin — real estate’s most coveted credential — and its topical education courses offered through the Ward Center for Real Estate Studies. In addition, membership in CCIM includes the industry’s best technology and operational platform, allowing entrepreneurial and mid-sized businesses to compete with the largest multinational providers. Learn more at www.ccim.com.

The Alabama Center for Real Estate is housed within the University of Alabama’s Culverhouse College of Business. ACRE is organized to provide national thought leadership and relevant resources in the areas of research, education, and networking that enhance Alabama’s real estate industry. The heart of ACRE is advancing relationships by providing servant leadership with a passionate, adaptable, and humble spirit. It was established by legislative act in 1996 with support and guidance of its founding partners, the Alabama REALTORS®, the Alabama Real Estate Commission, and The University of Alabama. For more information, visit acre.culverhouse.ua.edu.