MULTIPLE FUNDAMENTAL SHIFTS SPAWN OFFICE TO INDUSTRIAL CONVERSIONS

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Until the past decade, the thought of demolishing an office building and replacing it with a warehouse distribution or logistics facility would have been considered fanciful or ridiculous. Office space costs more to build and has historically commanded substantially higher rents. Historically the most common type of adaptive reuse of existing space took the form of the conversion of industrial space into office use. Over 2,500 industrial buildings were converted to office space since 1981.[1] Approximately 90% of all office building conversions occurred since 1981[2] as the U.S. economy shed manufacturing jobs and expanded the professional and business services, financial activities, and information sectors which constitute the majority of office using jobs. At the turn of the current century, creative, tech, and media, jobs expanded which generated demand for unique and interesting space. Retrofitted former industrial and mill buildings held particular appeal for these types of tenants seeking open space with a certain cachet and large footprints. The ascension of co-working space further consolidated demand for this type of space. As a result, many urban multi-story light industrial buildings were converted for office.[3]

If once-thriving, industrial cities of the 20th century encountered the right conditions to incentivize conversions *to* office in the past century, 21st century suburban office may have the makings of a similar future of repurposing, but instead to warehouse distribution and logistics facilities. This new trend takes the form of the demolition of the existing suburban office building and its replacement with a logistics facility.[4]

The paradigm shift involving e-commerce and the accompanying increase in logistics demand, coupled with the office demand shift to remote work and the partial obsolescence of older suburban office facilities has resulted in an unprecedented shift of investor interest towards industrial space and away from office investment.

A November 2021 report by Newmark Group Inc. found that since 2018, at least 45 office properties totaling 11.3 million square feet across the U.S. have been redeveloped, or are in the process of being redeveloped, into an industrial use[5]. Major conversion markets include Chicago (3 million SF converted since 2018), Los Angeles (2.1), Orange County (1.5), CA, Boston (1.7), Washington, DC (0.7), and Northern New Jersey (1.5).[6]

[1] Patrick McGregor, “4,283 Office Buildings Created Through Adaptive Reuse in Last 100 Years”, CommercialSearch – Commercial Real Estate Reports, January 4, 2021.
[2] IBID
[3] Many others were converted for residential use as well – but that is beyond the scope of this report
[4] IBID
[5] Liz Berthelette, Mike Laccavole, Lisa DeNight “Industrial Insight: Space to Replace: Divergent Market Fundamentals Drive Office-To-Industrial Conversions” Newmark, November 2021
[6] IBID

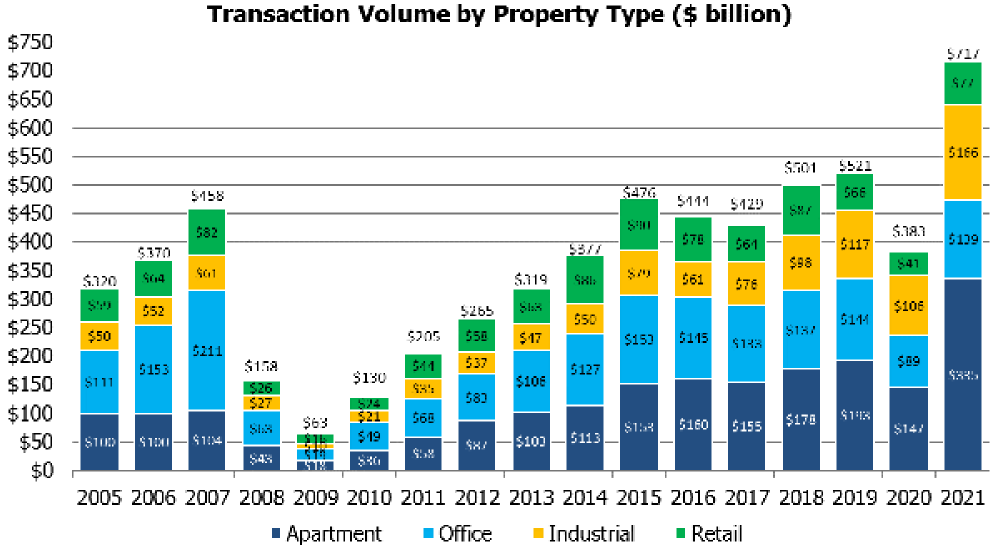
Although Amazon has been the largest demand generator in the logistics space, Walmart, Wayfair and numerous traditional retailers have also driven demand.[7] Existing supply has been insufficient at keeping up with burgeoning demand, not only from E-Commerce, but also from greater inventory needs spawned by supply chain bottlenecks and shortages experienced during the pandemic. Many companies' distribution models went from "just in time" to "just in case".

In many office markets, "flight to quality" (in order to attract workers and persuade them to come into office and not "work from home" WFH) is leading to more demolitions of outdated office buildings and their replacement by logistics facilities.[8] In addition to the desire for newer buildings, environmental laws and mandates will likely cause a bias in favor of newer buildings that require less retrofit in order to be compliant. Environmental retrofit for older class B buildings can be expensive.

In certain jurisdictions the drive to repurpose land currently improved with offices for other uses has also been facilitated by the liberalization of zoning, land use, development, and planning rules. For example, on January 5, 2022, New York Governor Kathy Hochul detailed plans to make it easier for office buildings and hotels to be repurposed for housing units.[9]

We believe conversions in the urban cores of major cities will focus on office-to-apartment transformations, while suburban office decommissioning will focus on demolishing office buildings in favor of either logistics or apartments.[10] The conversions will likely reduce inventory, and as a corollary, cause the suburban office vacancy rate to decline as the less desirable office buildings are decommissioned or demolished. These themes manifested themselves in increased transaction volume and faster value appreciation in the logistics sector. At the same time, we are witnessing a decline in office transactions as a share of total sales and substantially lower value appreciation. These shifts are exemplified in the following charts.

Transaction Volume by Property Type ($ billion)



Source: Real Capital Analytics www.rcanalytics.com. Data through Q4 2021
Note: Includes Apartment, Office, Industrial, and Retail property types

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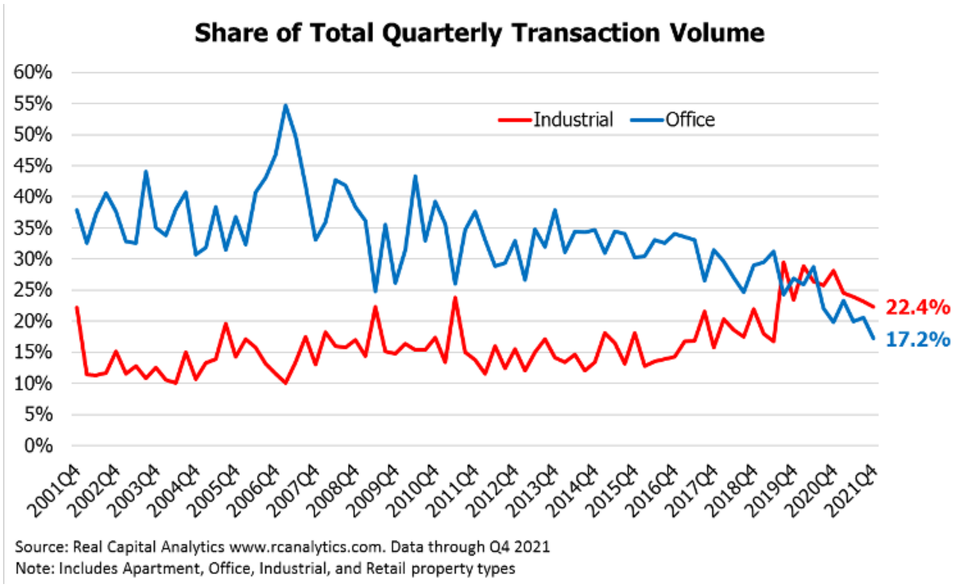
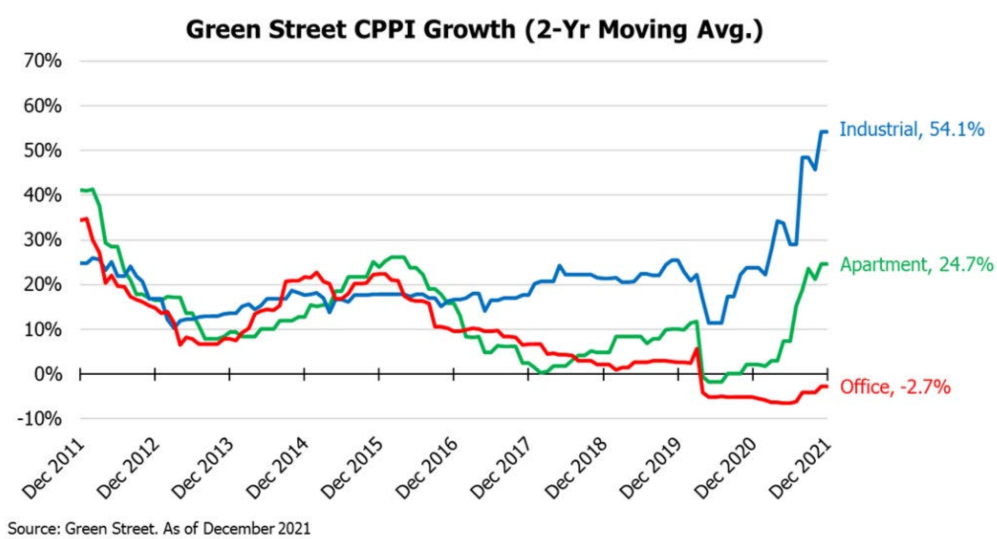
[7] Chuck McShane, "Two Southeastern Port Cities Lead Nation in Industrial Construction Intensity", CoStar News, January 12, 2022.
[8] That same trend is manifesting itself in the adaptive reuse of older newly functionally obsolete office buildings in favor of apartments.
[9] Andria Cheng, "New York Governor Proposes Plan to Loosen Restrictions on Converting Hotels, Offices to Housing", CoStar News, January 5, 2022
[10] Examples of past urban office to apartment transformations include the transformation of multiple building on John street and other parts of downtown Manhattan in the wake of 9/11.

For the office property type, year-to-date transaction volume through the fourth quarter of 2021 totaled $139.2 billion, 56.5% above the $89.0 billion through the full year 2020, but still -3.5% below the $144.3 billion experienced in full year 2019. Since the beginning of Real Capital Analytics, Inc. (RCA)'s historical transaction volume data, office volume has exceeded that of industrial. In full year 2020, the dollar sales volume of industrial properties exceeded office volume for the first time, marking a new era for both property types. Since Q3 2019, industrial volume has exceeded office volume in eight of the last ten quarters.



Similarly, during this period, growth in industrial property values has outpaced office and multifamily property types. On a two-year moving average basis, which diminishes base effect created by the pandemic, office properties have lost 2.7% in value, while industrial properties values have soared over 54% over that period, according to Green Street's Commercial Property Price Index (CPPI).



High logistics sale volumes, more accelerated value increases, and office to logistics conversions reflect the rise of E-Commerce, the need for more space to store inventory and the shrinking office market demand trends that were accentuated by the pandemic. The recalibration of both property sectors has resulted in a new Highest and Best Use calculus for certain properties. Highest and Best Use is defined as 1) "The reasonable and probable use that supports the highest present value of vacant land or improved property, as defined, as of the date of the appraisal. 2) The reasonable probable and legal use of land or sites as though vacant, found to be physically possible, appropriately supported, financially feasible, and that results in the highest present land value. 3) The most profitable use."[11] The amazing value growth of warehouse/distribution facilities towered over the relatively slow growth of suburban office properties over the past decade. This has resulted in the unprecedented Highest and Best Use shift in which logistics facilities are sometimes the most profitable use in places like suburban New Jersey, even considering demolition costs. In general, this is a phenomenon that only began in the past decade. Prior to then, such conversions would almost never be highest and best use.

NORTHERN NEW JERSEY

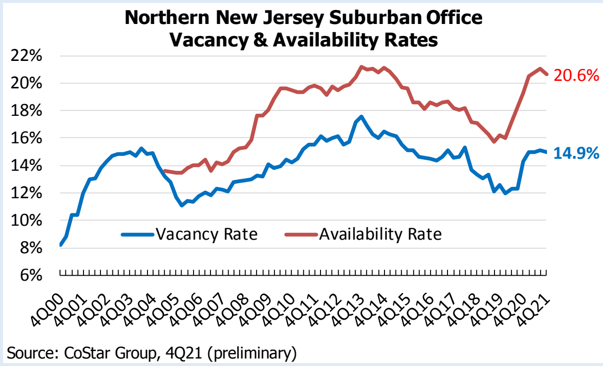
A market with a great confluence of weak office space and an acute demand for logistics space is suburban New Jersey. New Jersey is the most densely populated state in the union[12], is adjacent to the major cities of New York and Philadelphia, and not surprisingly has a shortage of developable land. Therefore, well-located sites for redevelopment are prized.

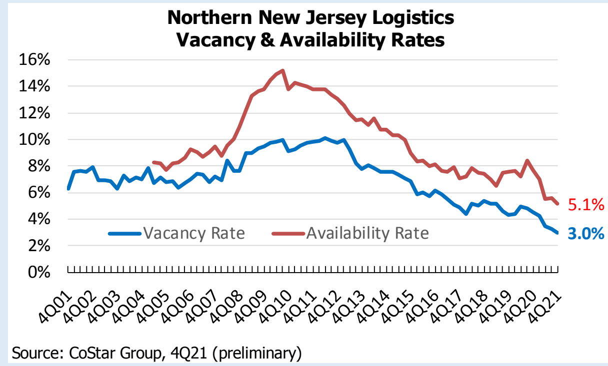
According to a CBRE analysis reported in the Wall Street Journal[13], developers are on track to remove nearly 8.6 million square feet of older office space in New Jersey, as they repurpose the sites with in-demand uses such as industrial and apartments.[14] Although conversions focus on residential uses (4.4 million square feet, or 51%), industrial constitutes 2.3 million square feet, or 26% according to CBRE.[15]

Ensconced along the densely populated and relatively affluent Northeast corridor, the state is an ideal location for logistics. In addition, the state is host to the port of New York/New Jersey – one of the largest in the United States. The scarcity of appropriate logistics space has led to record-low vacancy rates and rent increases. At the same time, much of New Jersey's suburban office space was built in the 1980s and many are exhibiting high levels of obsolescence.[16] The desirability of the urban core of the Tristate area and the overall decline in demand in the wake of the pandemic and the increase in WFH arrangements has resulted in skyrocketing suburban office vacancy rates and lower rents. Since many of these facilities have excellent highway access and proximity to population areas, they are ideal locations for logistics facilities. Accordingly, New Jersey has witnessed numerous suburban office facilities being replaced by warehouse distribution facilities over the past several years.

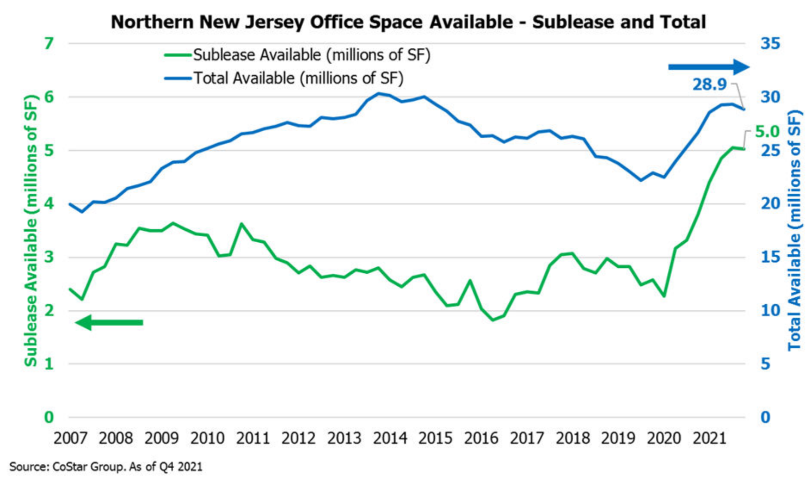
The disparate fortunes of New Jersey office and logistics space are reflected in vacancy, rent growth, absorption, and construction data. While suburban office vacancy soared to 14.9%, logistics vacancy dropped to 20 year low of 3.0%. Additionally, there has also been a substantial increase in the amount of office space made available for sublease in Northern New Jersey with the total availability rate reaching 20.6%.

[11] Appraisal Institute, The Dictionary of Real Estate Appraisal, 4th ed, Page 152
[12] http://ready.nj.gov/mitigation/pdf/2019/mit2019_section4_State_Profile.pdf
[13] Linda Moss, "Some of Those Old New Jersey Office Buildings Are Becoming Apartments", CoStar News, October 5, 2021
[14] Joshua Burd, "CBRE: Pipeline for office conversions on the rise in New Jersey, exceeding 8.6 million square feet", Real Estate N.J., September 16, 2021.
[15] IBID
[16] In the 1980s, New Jersey added over 100 million SF of suburban office space. The amount of suburban office space in the U.S. doubled between 1980 and 1985. See Joan Verdon, "North Jersey office boom, 30 years later: Here's what happened to all those buildings", Bergen Record, November 23, 2018

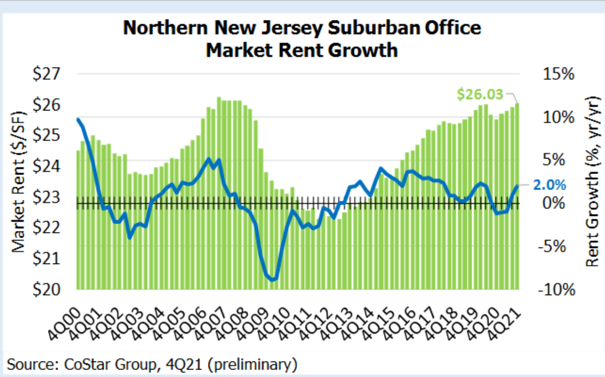


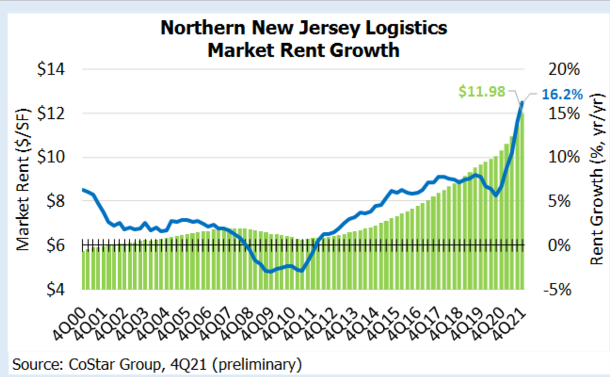


The amount of sublease space grew 117% from its pre-COVID Q1 2020 level of 2.3 million to its Q4 2021 level of 5.0 million SF. At the same time the direct lease available space grew from 22.5 to 28.9 or 28% during the same time period. The amount of space for sublease is substantially higher than it was during the Global Financial Crisis.

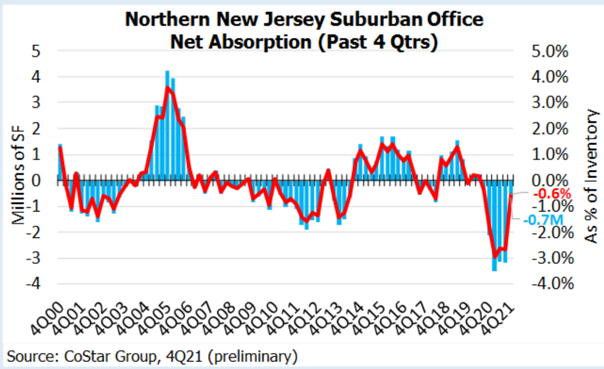


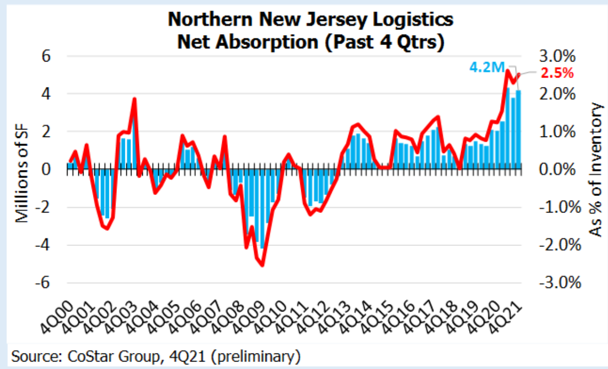
Recent suburban office rent growth has ranged from negative to anemic. Conversely, year over year logistics rent in Northern New Jersey were the highest in the U.S. at 16.2%.



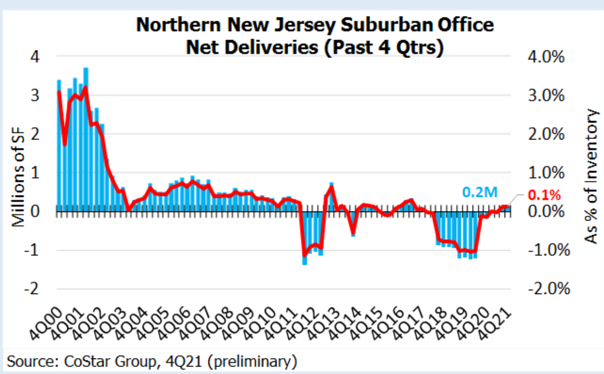


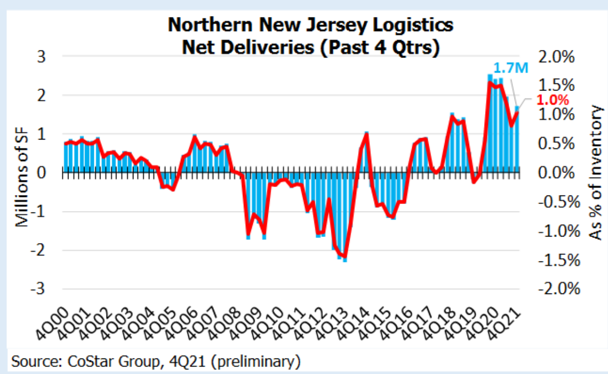
The suburban office market in Northern New Jersey has experienced 25 quarters of negative net absorption since 2010, the most of any suburban office market besides Stamford, CT. Since the onset of COVID, office demand has taken a tumble, with tenant move-outs totaling a combined 2.8 million square feet over the past eight quarters. Conversely, demand for logistics space in the market increased over the past decade. In 2021, an annual record 4.2 million SF was absorbed in the market.



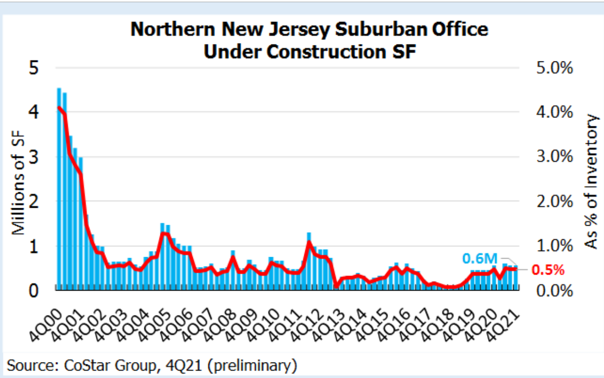


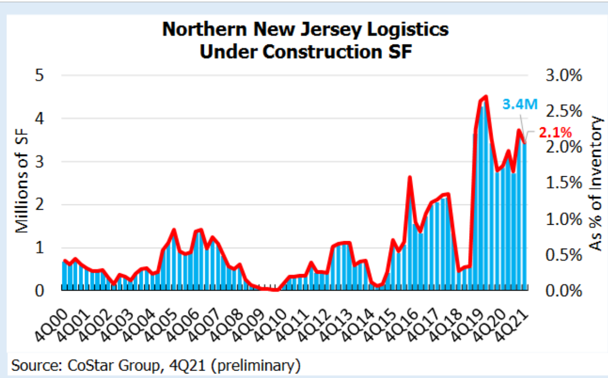
The sluggish tenant demand for suburban office product in this area is reflected by strong developer disinterest. Negative net deliveries over the past three years indicate the market has shrunk, meaning total suburban office inventory is about 2.1 million SF smaller in Q4 2021 than it was in Q4 2017. In 2021, office inventory grew by only 0.1%. On the other hand, logistics grew at 10 times that rate as a share of inventory, with 4.2 million SF delivered in 2021, representing 1.0% of inventory.





The strong demand for logistics space is even more apparent given the robust development pipeline, with 3.4 million SF currently under construction, representing another 2.1% of inventory. Suburban office development in this market is anemic, with 0.5% of inventory under construction.





Although occurring in growing numbers over the past 10 years[17], the phenomenon of suburban office buildings being demolished for conversion to logistics has accelerated since the pandemic began. The conversions usually involved secondary class B suburban office in soft office submarkets but hot industrial markets. Many existing office buildings have a high degree of physical and functional obsolescence and are found in excellent locations proximate to New York City, ports and highways. In addition, office buildings require expensive tenant improvements not required of logistics facilities.

Recent New Jersey conversion examples include:

- A former office building located at 1001 S. Grand Ave in Hammonton, N.J. was sold and converted to light manufacturing and industrial use, according to real estate firm Vantage Commercial. The 105,000-square-foot property is the former home of Whitehall-Robins' research & development and corporate offices.[18]

- 400 and 600 Atrium Drive in Somerset, New Jersey which is being reimagined as two new distribution facilities (294,000 SF and 132,000 SF). The site now has an existing 351,782-square-foot office building and adjacent 7-acre undeveloped parcel.[19]

- Developers bought a 62-acre portion of a 202-acre office campus at State Route 10 and Ridgedale Avenue in East Hanover, New Jersey from pharmaceutical giant Novartis. The campus is currently used as the U.S. headquarters of Novartis. The developers plan to replace 900,000 square feet of office space with an 826,800 square foot logistics property.[20]

Recent examples in other parts of the United States include:

- Bridge Point Kent 300 is a new two-building, 309,028 SF, Class A warehouse distribution development located in Kent, Washington. The site was the former corporate office headquarters of REI, the large outdoor clothing and gear retailer. The 15.85-acre site is located about two miles from I-5, and 1.4 miles from Highway 167 and 17 miles from the Seattle CBD.[21]

- AllState is selling its roughly 2 million SF suburban Chicago headquarters to industrial developer Dermody Properties, which will redevelop the 232-acre site as a 3.2 million-square-foot distribution center.[22] Allstate has stated the sale is related to the recent increase in remote work.

CONCLUSION

The confluence of older office buildings with a high level of physical, functional and environmental obsolescence, challenged by remote work and environmental remediation requirements, together with soaring demand for logistics space in near urban areas has resulted in an unprecedented level of office to logistics conversions. Major conversion markets include Chicago (3 million SF converted since 2018), Los Angeles (2.1), Orange County (1.5), CA, Boston (1.7), Washington, DC (0.7), and Northern New Jersey (1.5). Significant suburban office weakness and logistics strength in densely populated New Jersey has resulted in compelling reuse executions as highlighted in this report.

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[17] Keiko Morris, "In New Jersey and Long Island, Developers Eye Office-to-Warehouse Conversions" Wall Street Journal, November 20, 2016
[18] "Former office building in Hammonton sold; to be converted to industrial use", ROINJ, October 7, 2021.
[19] Joshua Burd, "Developers plan 426,000 sq. ft. industrial campus after buying Somerset office property", Real Estate N.J., September 16, 2021.
[20] With the sale of the parcel, Novartis will retain 112 acres, 15 buildings not including parking garages, and roughly 2.8 million square feet of office space and parking, according to CoStar.
[21] Steve Hunter, "Former REI headquarters in Kent to be demolished for industrial facilities", Kent Reporter, December 22, 2020.
[22] There are contingencies to the sale, including whether Dermody can obtain zoning approvals to redevelop the site as an industrial property. There are purchaser contingencies including the ability to obtain zoning approvals for industrial use and "relating to governmental approvals with respect to the entitlements for the property and certain economic and tax incentives".

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