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Research

# Sizing Up Office-to-Logistics Conversions

Prologis IPC 10, Tracy, California.

Surging demand and rising barriers to new development have collided to create an extreme scarcity of logistics space where it's most needed. One way to mitigate supply shortfalls is converting office space to logistics space.

Offices face lingering uncertainty because of the pandemic-driven shift to remote work. Health and safety concerns are driving a flight-to-quality and adding to the cost of retrofitting older office buildings. In the fourth quarter of 2021, for example, the office vacancy rate was 16.6%, 4.4 percentage points higher than Q4 2019.[1] In contrast, the logistics vacancy rate declined 1.4 percentage points during the same period to an all-time low of 3.4%.[2] This contrast might suggest high potential for office-to-logistics conversions, but challenging economics add hurdles to the land availability, regulatory and competitive fronts.

## TAKEAWAYS

**Small-scale.** Office conversions to logistics could amount to 40-80 million square feet (MSF) over the next decade, or:

- <1% of existing logistics real estate facilities.
- <3% of typical annual logistics real estate new completions.
- <10% of the logistics space needed to meet the incremental demand generated by right-sizing U.S. inventories and building in future resilience.

**Concentrated in locations with high barriers to development and high land prices.** Offices have limited reuse potential as logistics facilities and must be demolished, adding to an already complex process, lengthening development timelines and boosting the rents needed to financially justify conversion.

### Sizing the opportunity

Logistics uses require larger land parcels, typically 8 acres or larger. In the U.S., approximately 27,000 office buildings, or 2.2 billion square feet in total office stock and 1.2 billion square feet in ground floor real estate, meets this criterion, according to Costar data.[3] This analysis focuses only on Prologis' top 25 U.S. markets. Given the wide spread between rents and values for Class-A office and logistics space, we narrow the opportunity set to Class-B and below office buildings, which encompass roughly 65% of square footage in Prologis' markets. Ultimately, Prologis Research estimates that about 40-80 MSF will be converted to logistics over the next decade.

**OFFICE CONVERSION SIZING**

| | |
|---|---|
| Total Ground Floor NRA, MSF | 1,200 |
| Share in Prologis Markets | 47% |
| Share as Class-B & Below | 65% |
| Convert to Logistics | 10-15% |
| Increase Coverage | 1.2-1.4x |
| **Logistics Supply, MSF** | **40-80** |

Source: Office data comes from Costar. Conversion rates come from Prologis.

### Economics limit the conversion rate

The above estimate is filtered primarily on functionality: large-enough land sites, increased obsolescence as office product, and the ability to convert surface-level parking to expand site coverage. Prologis Research detailed the challenges facing retail-to-industrial conversions in depth, and while office conversions face many of the same challenges, some distinctions underscore our 10-15% estimated conversion rate for eligible properties.

- **Office conversion creates an even bigger basis reset than retail.** Unlike certain types of retail, office properties cannot physically accommodate logistics uses. They would need to be demolished to convert to a usable logistics site, adding to an extended carry period, de-tenanting costs, and a higher required return to compensate for rezoning risks, relative to a typical greenfield project. Office campuses with a single tenant or large anchor are more attractive targets, due to a simpler de-tenanting process.
- **Only locations that can achieve premium rental rates justify the high cost to convert.** Large, coastal markets with high land values and limited logistics supply are likely targets, and include the suburbs of New York, Southern California, San Francisco and Washington, D.C. Even though Class-B/C office rents generally exceed logistics rents in these locations, lower cap rates and tenant improvement costs for logistics properties add to the conversion rationale.
- **Logistics-specific requirements further limit what constitutes a feasible site.** Logistics users focus on proximity to transportation infrastructure while typical office use prioritizes access to a skilled workforce.
- **Regulatory resistance is an obstacle.** Office conversions may not generate the same community resistance as retail conversions. Offices are often set back from residential areas, may exist in an industrial overlay zone and loss of sales tax revenue is not a concern. However, the implied loss of white-collar jobs associated with office conversions can complicate the already-lengthy rezoning/permitting/approval process in these high-cost areas, adding cost and time.

### In summary

Despite potential opportunities, the office-to-logistics conversion trend is likely to be minimal. Successful redevelopments will be concentrated in areas with high land costs and limited competition from nearby logistics properties. New supply from this source will take time to come online because resolving existing agreements, demolition, rezoning, entitlement, permitting and approvals take much longer than a typical greenfield logistics development.

## Endnotes

1. CBRE
2. Prologis top 25 markets. CBRE, CBRE-EA, JLL, C&W, Colliers, and CoStar
3. CoStar

### Forward-Looking Statements

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### About Prologis Research

Prologis' Research department studies fundamental and investment trends and Prologis' customers' needs to assist in identifying opportunities and avoiding risk across four continents. The team contributes to investment decisions and long-term strategic initiatives, in addition to publishing white papers and other research reports. Prologis publishes research on the market dynamics impacting Prologis' customers' businesses, including global supply chain issues and developments in the logistics and real estate industries. Prologis' dedicated research team works collaboratively with all company departments to help guide Prologis' market entry, expansion, acquisition and development strategies.

### About Prologis

Prologis, Inc. is the global leader in logistics real estate with a focus on high-barrier, high-growth markets. As of December 31, 2021, the company owned or had investments in, on a wholly owned basis or through co-investment ventures, properties and development projects expected to total approximately 1.0 billion square feet (93 million square meters) in 19 countries.

Prologis leases modern logistics facilities to a diverse base of approximately 5,800 customers principally across two major categories: business-to-business and retail/online fulfillment.

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