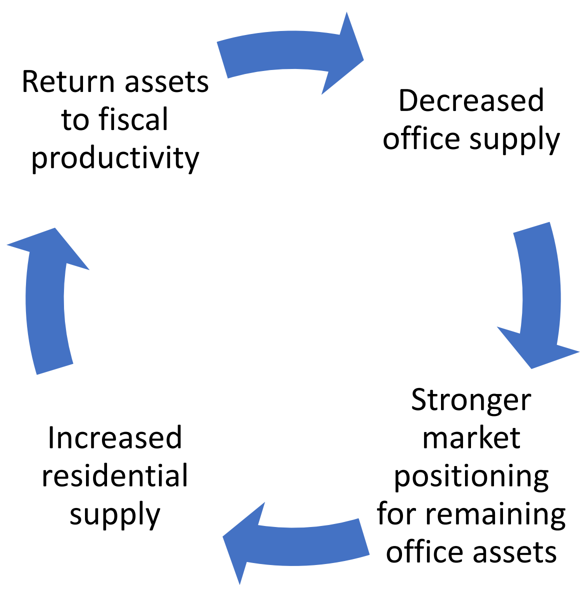
October 2022

OFFICE TO RESI CONVERSIONS MEMORANDUM

SUMMARY OF INITIAL FINDINGS

The structural shifts in the office market locally and regionally will continue a trend towards underperforming office assets being viewed as opportunities for replacement and transition to alternative uses, most likely residential. In Arlington, with much of our commercial and mixed-use areas governed by long-range, transformative land use plans, owners of functionally obsolete office buildings will most likely find it more compelling and financially feasible to pursue site plan redevelopment than go through a conversion process. Arlington can continue to study how its regulatory processes can most efficiently capture the conversion opportunities that do arise. However, attempts to "override" the current market dynamic that favors redevelopment would likely require land use and/or financial incentives that would likely be greater than the benefit the community would receive from the new housing in converted office buildings. Further, the challenges of conversion (including the efficiency of converted units) often means that the rent or prices of the housing that would be delivered may be marginally below new construction housing but still would not be significantly cheaper or more attainable given the costs of conversion.

Why are conversions of underperforming office buildings to residential an important public policy to consider?



What have we have observed from case studies regionally and nationally?

- A supply of structurally underperforming office assets (and continued headwinds on office demand) and a strong residential rental and for-sale residential market has buoyed interest in conversion of existing office assets to residential over the past decade.
- There has been significant conversion activity in Alexandria, Fairfax and to a lesser extent Washington, DC.

OFFICE TO RESI CONVERSIONS MEMORANDUM

- Economically feasible office conversion candidates require:
  - Existing building structure, systems and parking that can be efficiently reused to reduce construction costs associated with conversion relative to new construction.
  - A relatively low land basis for acquisition/refinancing of the office asset that is economically feasible for a conversion investment.
    - Buildings are at or near 100% vacancy with limited additional costs associated with lease buyouts.
    - The asset is not constrained by market value and/or debt that exceeds the feasible land market value for residential conversions.
  - Floor plates, building core/systems and ceiling heights (10' or more) that allow for efficient unit design and unit mixes and natural air and light into units; and,
  - Location in a market area with strong housing demand among key target demographics.
- Generally, projects have been at a larger scale (200+ units) in order to benefit from economies of scale. Often unit designs need to provide creative solutions to accommodate larger office floor plates, which often requires serving a niche consumer market.
  - Several of the Alexandria and Fairfax examples have units designed with a live-work concept, with distinguishable living and work areas, which has allowed for larger and less efficient units.
  - The recent (2015) example in Arlington, We Live (see further detail in Attachment), incorporated narrow micro units and significant shared amenity spaces on each residential floor to overcome challenges with a larger floor plate and a building core designed for office.
- Jurisdictions that have had success with office to residential conversions have put in place regulatory and/or financial pathways and/or incentives. Streamlined processes that remove entitlement risk and increase speed to market are especially critical.
- Office conversions to residential often can provide a unique product type and price point that fills a market need (e.g., live-work units, slightly discounted market-rate units)
  - Inclusion of committed affordable housing units are more challenging economically.

OFFICE TO RESI CONVERSIONS MEMORANDUM

Opportunities and Challenges in Arlington to increasing the number of office-residential conversions

Opportunities	Challenges
Historically high office vacancy rates will continue to force private owner investment decisions to consider conversion. Reinvestment and competitive market positioning of office assets is often still the most efficient course for property owners.	Relatively limited supply of 100% vacant, obsolete office buildings – high vacancies more typically spread throughout office properties.
Conversions can potentially benefit from reduced construction costs due to existing building super structure and below-grade parking.	Structural elements such as building systems and building facades still often need to be replaced during a conversion project. The high acquisition cost associated with an existing office building (even when significantly vacant) in Arlington often is well above the land basis feasible for conversion to residential -- even with potential construction cost savings related to existing structure.
Redevelopment plans support tear downs of older office product that is replaced with higher-density residential achieving similar outcomes to conversions. Opportunities for incentives to increase tear downs may exist outside of currently planned areas that offer necessary density incentives to justify the tear downs.	The tear-down option is generally preferred economically to existing building conversions in areas with land use policy guidance that allows for higher density redevelopment.
Strong residential market that can support high rents/prices that drives revenues.	Floor plates and low ceiling heights of older office buildings make for inefficient units and below-market-rate standards that make it challenging to achieve top-of-market rents that supports the economic feasibility of a conversion. Near-term underwriting challenges due to rising construction costs and interest rates will further limit/stall investment decisions including the decision to pursue conversions.

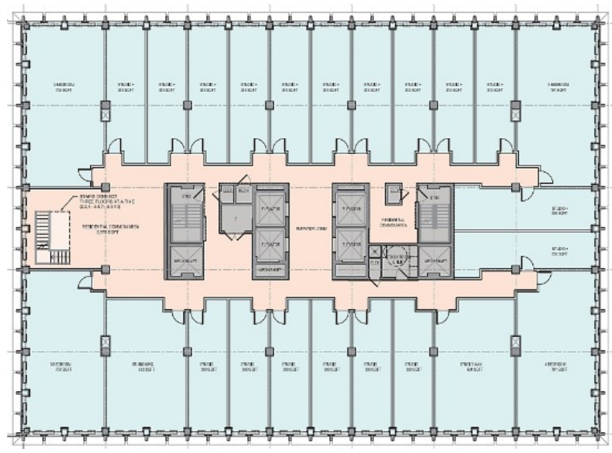
OFFICE TO RESI CONVERSIONS MEMORANDUM

ATTACHMENT

Example of Office to Residential Conversion in Arlington

We Live/We Work
Crystal Plaza 6 (2221 S Clark Street)

In 2015 the County Board approved the conversion of Crystal Plaza 6 from a vacant office building into a concept called We Live (a residential product created by the shared workspace company We Work).



The converted product delivered 221 “micro units” ranging from 300 to 350 square feet, with a narrow orientation that maximized access to windows (light and air) for each unit. In order to make more efficient use of the center of each floor plate, and to provide for amenities that couldn’t fit within the micro-units, each residential floor offered shared amenity spaces, including entertainment areas, kitchens and collaboration spaces.

The reason why this concept was economically feasible for the owner at that time included:

- The conversion used the existing structure, building systems and elevators, and parking in order to reduce costs.
- The project was not viable to be released as an office product and redevelopment options required concurrent redevelopment on an adjacent site that was not expected in the near term.
- The investment was scaled to be intentionally temporary in nature – approximately 20 years – before the site was ready for full-scale redevelopment.
- The micro unit and shared amenity spaces allowed for a more efficient use of the floor plate and did not require any changes to the buildings central systems and elevator core.
- The relatively unique and niche unit sizes and shared amenity concepts was felt to be a missing product type in the DC area that would benefit from strong, pent-up demand.

We Live ceased operations in 2021, but the apartments are still operating under management by the current building owner (JBGS).