

Redevelopment

Beyond the Façade

What's driving post-recession conversion projects?

by Rich Rosfelder

Across all property sectors, users and developers are eyeing urban locations. And given the lack of available land in central business districts, today's urban infill projects often are adaptive reuse or conversion projects. In the past, good, affordable space for conversions could be scarce. But the down market of the last two years has produced a wealth of vacant, reuse-worthy properties in cities throughout the country. Healthcare and education users, multifamily investors, and developers are snapping them up, capitalizing on the downturn to expand.

But finding the right property takes more than a keen eye. A historic or vacant building's charm may obscure other important factors to consider before pursuing adaptive reuse or conversion. Succeeding with these projects today requires buyers to look beyond the façade, the single building, or the current use. With the proper approach, what you get is more than what you see.

Searching for the Sweet Spot

Whether a property is right for reuse depends, in part, on one's perspective. "We like mixed-use opportunities," says Rob Kost, CCIM, vice president of commercial properties with Sherman Associates, a Minneapolis-based development company. "Around 70,000 square feet to 150,000 sf is our sweet spot." Using LoopNet, CoStar, and CCIM MailBridge, Kost looks for old vacant hotels, vertical warehouses, and 20 percent-occupied historic office buildings on the East and West coasts, as well as in the Midwest. "I'll pick a state and go after it for a week or two," he says.

Retail properties also became prime targets for conversion after the precipitous decline in consumer spending left many owners with vacant space that was difficult to lease up. "The cost to redesign cold retail is usually significantly less than the cost of current occupancy or building from the ground up," says Joshua H. Brown, CCIM, principal with Haag Brown Commercial in Jonesboro, Ark.

Brown recently negotiated the purchase of a vacant two-story retail property in Jonesboro on behalf of a medical services client that needed more space quickly. The property, listed for \$1.1 million, had been on the market for three years. Brown knew the owner was a contractor, so he approached him with a full-price offer contingent upon a turn-key build-out for the buyer. "We sold my client's 7,500-sf building for \$1.1 million, and she was delivered a building twice the size, built to her specs, in a more visible area, and all at the same cost," Brown says.

As market forces continue to exert pressure on conversion projects, a basic analysis of the location becomes even more important. "I recommend that every property identified as a possible reuse candidate first be evaluated as if it were a vacant lot without improvements to determine market demand," says Howard King, CCIM, associate broker with Watts Realty Co. in Birmingham, Ala. If likely tenants can use the structure with adaptations, then the remaining pieces of the puzzle — planning, costs, feasibility, financing — can be addressed. "All of this is guided first and foremost by the location of the site, not the structure," King explains.

That advice rings particularly true for deals in smaller markets. In fall 2010, Mark A. Berezin, CCIM, president of Infinity Real Estate Group in Holyoke, Mass., brokered the sale of a 300,000-sf historic industrial mill building and land parcel in Holyoke to Quantum Properties. "The location along the river was appealing, and we anticipated a three- to five-year turnaround with renovations and cleanup," says Glenn Shealey, founder of Quantum Properties.

Shealey has talked to many potential users who love the building's historic façade, but none of them have committed to saving it. "We've since concluded that the market would be more receptive to a clean demolished property for a campus or one large industrial user," he notes.

Meeting Tenant Needs

For owners and investors, tenant retention became a major concern when the market downturn began. Around this time, R.J. Neary, CCIM, SIOR, managing partner with Investors Realty in Omaha, Neb., and owner of the Bakers Supply Building in Omaha, was facing the potential loss of a medical services tenant that had expanded from 700 sf to 4,500 sf, and required an additional 5,000 sf of office space. "We spent a year designing a new construction addition, but that was too expensive," Neary says. In 2008, he decided to renovate two adjacent buildings to create one property with 12 apartment units, 15,900 sf of office space, and an attached parking lot. "The tenant was willing to make a 15-year commitment for more space," he says.

Owners facing stiff competition may choose to sell rather than risk vacancies. This is exactly what Gant B. Hill, CCIM, president and principal broker of Venterra Realty in Louisville, Ky., advised his client to do when he met a potential buyer with a new vision for his client's property. "Knowing the tenant had options and we didn't, we were proactive on my client's exit of the property," says Hill, referring to his recent sale of a warehouse located just beyond the Louisville central business district.



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At a Rotary Club meeting, Hill met Tony Newbury, the president and CEO of Louisville-based Jefferson Community and Technical College, which was looking to expand its downtown campus. Newbury explained that JCTC had been scouting properties near the CBD without success. Until that day, JCTC hadn't considered the two-block stretch on First Street that included Hill's client's property. "I showed them how they could double their land grab for half of the price," Hill explains.

In March, JCTC acquired Hill's client's property and the surrounding properties in anticipation of a \$200 million redevelopment project. "The education and healthcare uses have been very active in our market recently," Hill says. "Jobs are scarce, so people are going back to school."

Finding the Money

Of course, without proper funding, none of these projects would be possible. When it comes to financing adaptive reuse and conversion, cash is still king — especially in smaller markets. "In western Massachusetts, we don't have the same demand as larger markets," Shealey explains. "Banks will look at projects with a strong credit tenant. Absent that, they're more skeptical."

To offset expenses, developers are relying on a litany of federal tax credits and other government programs. For the renovation of The Roosevelt, a historic office building that Kost found in Cedar Rapids, Iowa, Sherman Associates assembled a package that included funds from the Iowa Finance Authority, general partnership equity and loans, a city deferred loan, deferred development fees, American Recovery and Reinvestment Act 1602 Funds, and federal historic tax credits and equity and federal low-income housing tax credits through WNC & Associates, a tax credit syndicator. "We create a large barrier to entry [for competitors] with our in-house financing team," which researches and pursues all available options, Kost explains.

Another Sherman Associates project, 1,300-unit Riverside Plaza Apartments complex in Minneapolis, is one of the first properties to benefit from the Minnesota Historic Structure & Community Reinvestment Tax Credit program, which was created in 2010. The 20 percent credit, which the company plans to return to the state for a grant of approximately \$14.1 million, plugged critical financing gaps in the \$132 million project. The renovations are on track to be completed in 2012.

Owners also are taking advantage of government programs introduced in response to the economic downturn. "Individuals can now use tax credits to offset their income taxes," says Neary, who used federal historic tax credits amounting to 26 percent of qualified expenses for the Bakers Supply Building renovation. "In the past, only C corporations were able to use them, and you had to sell them to limited partners at a discount," which was too complicated and expensive for smaller projects, he adds.

But financing always has been difficult for these projects, regardless of the market, Berezin says. "Lenders are more interested once they are shown that there is or will be a demand for the adapted space."

Showing — not just telling — also is essential when it comes to selling users on a space's potential. "We are fortunate to have local lenders who have really bucked the norm and are willing to work with local businesses," Brown says. "The obstacle is getting your tenant a visual on what a space can be." Without this, a client may pass on a good property.

For the Jonesboro project, Brown ordered a conceptual drawing from a local builder, who supplied the drawing that helped seal the deal at no charge. With the lack of new development since the market downturn, "architects and builders are willing to go out of their way to get deals," he explains.

Commercial real estate professionals who recognize such opportunities can succeed with adaptive reuse and conversion projects in any market. But no one is going to draw them a picture.

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