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Complexities of office building valuation - by John Nitz

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Appraising office buildings has become more and more difficult in recent years. In years past, the valuation of office buildings involved employing the three approaches to value with specific attention typically given to the sales comparison approach and the income capitalization approach, especially when appraising an older office building. One key to office valuation has been to determine whether a fee simple or a leased fee value was applicable. Although for many office building appraisals, the same principals apply now. Today it is more critical than ever to thoroughly consider other factors such as highest and best use and whether a conversion to an alternative use is financially feasible and maximally profitable. In several office markets across the country, high vacancy levels have resulted in office buildings selling at deep discounts. As of the 4th Quarter 2024, Cushman & Wakefield reported 32.8 % office vacancy in downtown Hartford and 23 % in the Greater Hartford region. Some investors have tried renovating and aggressive marketing programs in an attempt to achieve higher office occupancy levels; whereas, others have purchased office buildings with the sole intent of converting these facilities to apartments.

According to CB Richard Ellis (CBRE), as of the third quarter 2024, 71 million s/f or 1.7 % of the U.S. office inventory has been planned or is already undergoing conversion. Leading the way among office conversion is the multifamily use representing 74 % of the conversions. Other types of conversions are minuscule in comparison and include hotels, life sciences, industrial, and other special purpose uses such as places of worship or recreation. The Hartford Business Journal recently reported several office facilities state-wide, which have been purchased with the intent for conversion to apartments, including facilities in the city of Hartford such as 15 Lewis St., Hartford, CT an office complex, built in 1925, composed of 54,000 s/f, proposed originally for 78 apartments. Now the owner/development team is considering converting 15 Lewis St. into a boutique hotel of 75-90 rooms. Several other office buildings in Hartford are proposed or are in process of conversion into apartment buildings, including 17 and 21 Wells St., 525 Main St., 275 Pearl St., and 30 Laurel St..

In valuing an office building considered for conversion to apartments, several factors require further analysis including 1.) the overall physical condition of the structure, its floor plate, its mechanical systems, and whether a conversion is physically possible, 2.) the legality of such a conversion, including whether zoning permits a conversion, which factors in parking requirements and other zoning requirements, 3.) the financial feasibility of such a project, which includes the time necessary to complete a conversion and the cost for such a project, including the price of the original investment; and 4.) a market analysis to determine competition and supply and demand for apartments. Several of these items require consulting teams including engineers, architects, and other commercial real estate consulting teams having the expertise, such as East Hartford based commercial real estate consultant, Goman & York, who has become more active recently in the consultancy of office conversions to apartments.

A discussion with Michael Goman, principal of Goman & York, revealed that for most conversions to work financially developers will need local governments to work with them either with low-interest loans, the reduction of building permit fees, and/or easing certain regulatory requirements. Goman

noted that the city of Hartford has been cooperative in recent years working with developers on office conversions to apartments.

When performing a bank appraisal of an office building conversion to apartments, an “as is” and prospective market value as complete will be necessary to meet FIRREA bank requirements. Such an appraisal can be complicated in some respects, especially if there are existing office lease agreements for a portion of the building and the construction budget for conversion has not been finalized at the date of value. The “as is” value could represent land value plus the contributory value of the shell building. Another valuation method when establishing the “as is” value is to establish the prospective market value first, then deduct all the conversion costs and account for the time necessary to complete the conversion.

Similar to office building conversions have been the conversion of former school buildings into apartments. In the City of Bristol, CT, there has been at least three successful conversions of former school buildings into apartment complexes. Developers of school building conversions have had similar issues facing developers of office building conversions, including unexpected construction cost overruns and lengthier time frame than expected to complete the project.

The valuation of office buildings has become more challenging for appraisers, given the current diminishing demand for office space, especially those older office facilities situated in a major metropolitan area. Appraisers must also recognize the current demand for alternative uses, especially apartments, which have been exploding throughout the region. These issues and more are just some of the factors necessary to consider when appraising an office building.

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