

Converting History into *Housing*

A once-in-a-generation opportunity to shape the future of urban living

The conversion of offices into apartments can solve the housing shortage crisis. It requires an experienced team who can hit the ground running to create profit for investors and competitively priced units for cities and residents.



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The *Opportunity*

The U.S. is facing dual real estate crises

An extreme housing shortage is occurring as the office market is collapsing.

Recent research suggests the U.S. needs to build an estimated 3.8 million to 6.5 million new homes to keep up with demand.[1] At the same time, office values have declined by $506.3 billion nationwide between the end of 2019 and 2022.[2]

But crisis creates opportunity — in this case, a once-in-a-generation chance to acquire commercial properties at distressed pricing and convert them into market-rate housing. This approach simultaneously solves both issues by using an oversupply of office buildings to correct an undersupply of apartment units. Moreover, it enables cities and developers to reimagine where housing units — and by extension, entire neighborhoods — are located, a necessary exercise as the world rapidly becomes more urban, interconnected, and digitized.

In the post-pandemic era, we're entering a macroeconomic cycle of converging forces — from the surge of remote work to the advancement of AI capabilities — that will lead to an unprecedented volume of trade and transformation of premier real estate assets. The investors, lenders, and developers involved will position themselves to take advantage of a profit potential few other asset classes can offer.

But not every commercial property is a viable choice for housing units. Identifying the best targets and executing the conversion from office to housing requires a team with deep experience in this space. While conversion projects only captured the media's attention in the wake of the COVID-19 pandemic, the team at 3L Real Estate has been tracking the oversupply of office space since the early 2000s and has spearheaded dozens of successful property conversions.

With distressed prices beginning to bottom out, now is a particularly favorable time to take advantage of market conditions and capitalize on a sustainable trend that is poised to shape the future landscape and vibrancy of American cities.



The Office *Vacancy Rate Has Been Growing* for Years

For decades, central business districts have been the downtown heart of cities. While economic activity ebbed and flowed over the years, commercial real estate demand remained consistent, driven by the need for human interaction to advance economic agendas. But in the 1990s, that long-accepted truism began to change — and so did the real estate market.

Businesses began integrating the internet and other digital technologies into daily operations, catalyzing a tech boom that skyrocketed the growth of startup companies — which in turn looked to expand their office footprints, often with trendy spaces that broke traditional office molds. At the same time, capital became cheaper, further fueling the development of new office towers and corporate campuses.[3] Consideration was rarely given to oversupply since the oldest properties could be divided into smaller units, and new entrants to the global marketplace were often willing to take over desirably located vintage spaces and make them cool again. Hotel and multifamily housing developers picked off assets on the edge as well, transforming them out of the supply.

But the pace of conversions wasn't enough to offset the volume of newer, shinier, and technologically advanced square footage erected each year. At the same time, the digital solutions peddled by many of these emerging enterprises made it increasingly possible to conduct business from disparate locations.

Then in 2020, the COVID-19 pandemic hit, launching a remote work transformation that had been slowly gaining momentum for decades. Ghost towns formed in every city center. Many hoped this would be a temporary situation, but a door was opened that will never be closed again.[4]

Working from home was here to stay.

The pandemic accelerated an already growing trend — and it has yet to peak

The current office market is aggressively overbuilt, and demand is declining. The national office vacancy rate[5] increased from 11% pre-pandemic to more than 16% in Q1 2023, with indications it will continue to trend upwards. Some major metros like Dallas are reporting vacancy rates of over 30%.[6] The problem also extends to government office space, which faces similar pressures.[7]

To add to the turmoil, the cost of capital has exploded and supply chains have broken down, hamstringing facility upgrades and remodels. Moreover, economic volatility has caused layoffs and cost-cutting, including a shortage of venture capital willing to fund startups.[8] As a result, the sublease market is gaining even more inventory to compete against traditional vacant space[9]— and as those leases expire, the vacancy rate keeps growing. The instability is unlikely to end soon: Delinquency rates on mortgages did not peak until four years after the Global Financial Crisis of 2008.[10]

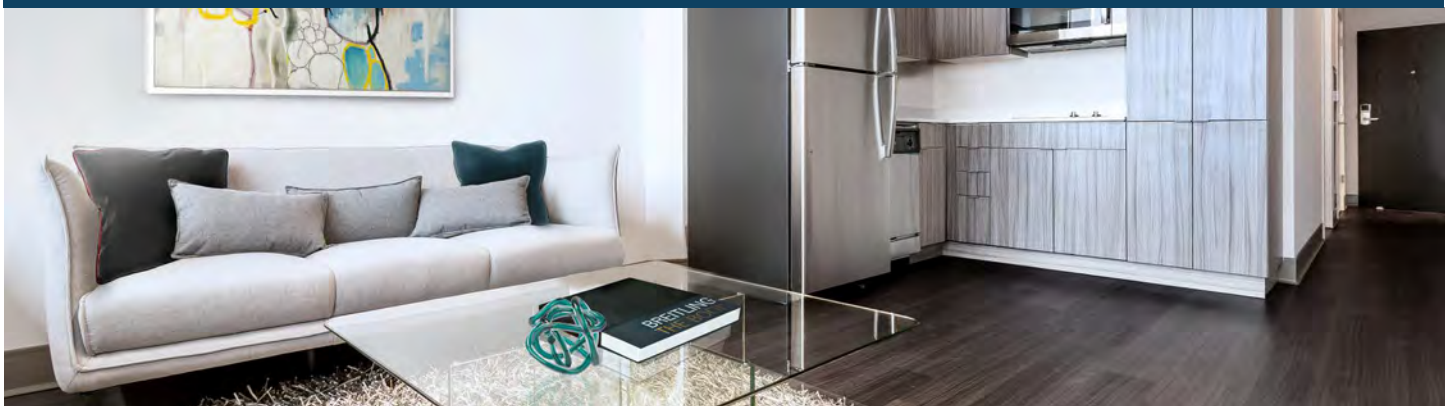
3L strength

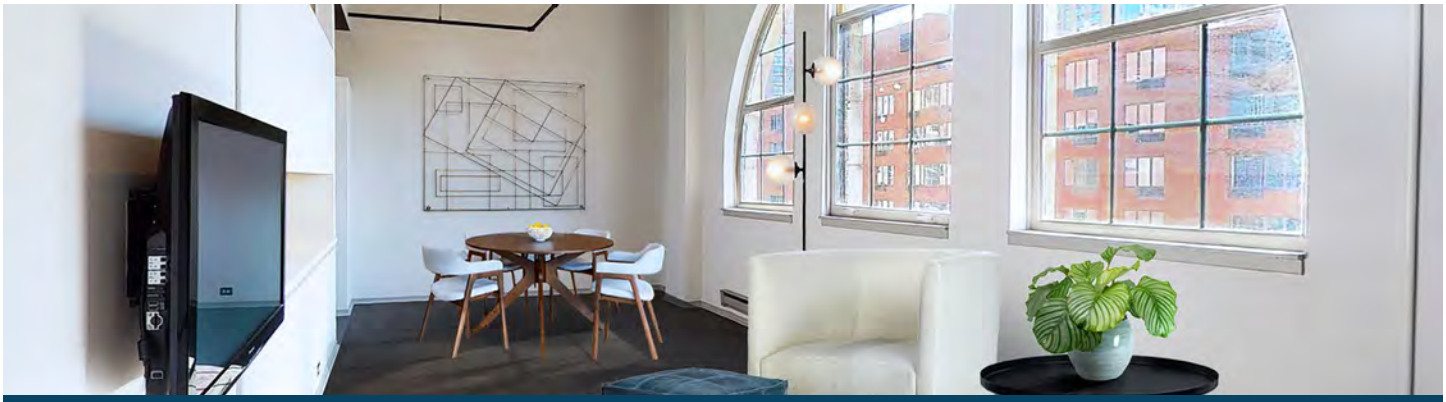
Our team has decades of office-to-housing conversion experience. We've been tracking and capitalizing on this trend since before it was trendy.

Multifamily housing is a stable investment in an unpredictable world

Hard assets like housing — particularly multifamily rentals — present a stable and secure investment opportunity during periods of macroeconomic turbulence and beyond. Returns are steady whether interest rates are high (elevating rents and therefore revenues) or low (reducing costs of conversions). When it comes to supply chain disruption, conversions avoid certain areas of demand, which means they are less impacted by delays and price spikes compared to ground-up projects.

Ultimately, investors who act on the potential to transform existing structures that have outlived their usefulness as corporate centers, but have the capacity to be reclaimed as housing, stand to gain not just profit, but generational wealth.





Why Former *Offices Make Sense* as Housing

The need for entry-level housing is rising. Though a growing number of white-collar workers prefer not to travel to offices, they still value the vibrancy and convenience of city life. And for a sizable share of young professionals saddled with student debt,[11] the expense of car and home ownership keeps them renting in urban areas with public transportation and ride-sharing options.[12]

So, why not make it possible for them to live in the conveniently located buildings where they used to work?

Given approximately 30% of millennials (24 million) reside with family, the savings crisis among younger adults should sustain demand for market-rate rental housing, making conversion projects a solid investment option for years to come.[13] Furthermore, converting former offices into housing creates financeable residential assets, opening up new avenues to finance the buildings through debt and equity.[14] But that's not the only reason the market is ripe for giving offices a second act as housing. Public policy, infrastructure opportunities, and support for sustainability initiatives are also aligned:

Government incentives for conversion projects are expanding

As vacant office properties multiply, cities are worried other downtown businesses — restaurants, retail, service providers — will follow suit without the foot traffic of 9-to-5 workers to patronize them.[15] Cities are already experiencing budget strains from declining real estate tax revenue, which accounted for an average of 17% of total state and local government revenue in 2020,[16] and decreased public transit ridership. City and state governments are increasingly willing to provide incentives to developers interested in tackling office conversion projects. Local governments offering these incentives programs include the cities of Milwaukee,[17] Chicago,[18] New York City,[19] Pittsburgh,[20] Washington, D.C.,[21] and Minneapolis,[22] as well as the state of California.[23] Chicago, for example, recently announced plans to provide developers with millions of dollars in subsidies to convert office towers in the heart of its business district into housing.[24]

There's been movement at the federal level as well. Federal legislation has been introduced to create a tax credit that incentivizes office-to-housing property conversions modeled after the successful historic-preservation tax credit.[25] If passed, it would provide a 20% credit against qualified expenditures and could be layered on top of other federal programs, including HTC, LIHTC, NMTC, C-PACE, and 179D, making it possible to generate capital stacks even in a challenged financing environment.

Office buildings contain the right infrastructure for modern housing needs

Many office buildings are already equipped with the infrastructure and amenities required in residential or mixed-use settings. For instance, elevator and stair cores are often over-sized for use in an office building with rush hour circulation, providing excess capacity in a residential setting or the ability to bifurcate access corridors for a mixed-use scenario. A large share of properties also contain communal gathering areas that benefit potential renters, like lounges, outdoor decks, and on-site gyms — many of them newly updated just before the pandemic.

And then there are the behind-the-scenes features. Most commercial buildings have access and receiving points for commercial deliveries, including loading docks, mail rooms, and valet zones. These are major benefits for high-rises that require easy access points for people moving in and out, as well as space to receive e-commerce deliveries.

Plenty of commercial properties also underwent extensive "behind-the-walls" upgrades before the pandemic to improve energy efficiency.[26] This includes modern HVAC systems integrated with AI monitoring capabilities that reduce energy consumption and operating costs.

As real estate prices adjust, these upgraded properties present some of the most compelling conversion opportunities. Reconfiguring them for apartment users is cost- and time-efficient, and developers benefit doubly from not having to contend with lingering supply chain disruptions and inflated costs for materials. But despite being outfitted with state-of-the-art features, the value of these buildings in the market has plummeted — to the benefit of apartment developers and their investors.

Conversions deliver on sustainability goals

Now more than ever, sustainability and inequity are on peoples' minds. Adaptive reuse of former offices enables residents, cities, and developers to benefit from progress toward Environmental, Social and Governance (ESG) initiatives.

- **Environmental:** Retrofitting existing buildings is more sustainable than tearing down structures and rebuilding, especially in terms of materials and energy. Converting the property also presents the opportunity to upgrade existing facilities with the newest, most energy-efficient technologies if they haven't been updated already.
- **Social:** By addressing the housing crisis, conversion projects offer people with diverse needs more housing choices in desirable areas.
- **Governance:** Good governance involves the engagement of various stakeholders — including residents, local authorities, employees, and investors — in the decision-making process to ensure that the project serves the broader social interests.

Downtown high-rises are the most high-profile and abundant properties available for housing conversions. But they're not the only viable candidates. Similar development playbooks can be applied to other troubled, outdated sectors like suburban malls,[27] and corporate campuses.[28] Further down the line, the same conversion skills and strategies can be deployed to rejuvenate other properties cycling into distress, including hotels, medical offices, and aged apartments.

While ongoing investments in conversions will remain sustainable for many years, the best transactions will occur early — within the next 3-5 years — before property values fully adjust to policy incentives.



3L strength

Our deep relationships with a network of lenders and brokers, as well as legal, tax, and municipal code experts, enable us to structure competitive deals that appeal to buyers and sellers.

How technology will shape the urban housing market

The cost of living in cities is rising. But thanks to technological advances, so is the attractiveness of city life. Apps like Uber, Instacart, and DoorDash have already made city life more manageable in ways that were unimaginable a generation ago.

During the remainder of the 21st century, our lives will become even more integrated with technology, specifically AI software,[29] which is poised to revolutionize the way we interact with the world around us, in ways we're only just beginning to imagine.

As AI technology matures, it will become embedded in our daily lives. Insights from the data it captures will eventually shape the design of future cities and drive efficiencies in the management of transportation, logistics, and energy consumption necessary to sustain urban life.[30]

By 2045, nearly seven in 10 people worldwide will live in cities.[31] With future technology delivering new levels of convenience more cheaply and sustainably, the attractiveness of city life will only increase — creating a sustained market for commercial-to-residential conversions.





What It Takes to Execute *Successful Conversion Projects*

Successful conversion projects start with careful cost management that keeps leasing costs within an competitive pricing matrix that a large share of residents can afford. This is key both for preserving the ESG impact of conversion and protecting profitability.

Units that are overpriced for the market will decrease the viability of the investment by driving down revenues. The early years of the rental life cycle are the most cost-conscious, so units should be leased at entry-level prices. To achieve this, experienced developers take care to:

Consider the neighborhood as a whole

Location is everything when evaluating conversion opportunities. Is it likely to appeal to future renters long term? If not, the converted property won't be able to sustain its rental income and may face challenges in maintaining occupancy levels over time.

The most appealing conversion locations are accessible by public transit and in neighborhoods with municipal investment in essential services, recreation and entertainment, and cultural institutions. As cities seek to revitalize their downtowns, some are redirecting economic development investments away from business and toward initiatives that improve quality of life for residents.[32] These neighborhoods that are supported by municipal investment are primary candidates for housing conversion projects.

Account for unforeseen variables in budget mapping

When converting existing structures, unpredictable hurdles frequently emerge that can stop a project in its tracks. Comprehensive due diligence at the property selection phase enables developers to avoid surprises once construction begins.

Developers experienced in conversions know this means paying close attention to structural elements and anticipating required adjustments prior to closing. Factoring in these anticipated costs makes it possible to negotiate the best purchase price to ensure the project will remain profitable without the need to adjust the design or finishes later.

For example, a 3L conversion project in Chicago required creative problem-solving to overcome critical courtyard and stairwell challenges. Devising solutions to these issues at the transaction phase protected our budget and ensured we were stepping into a viable project.

Be selective about the amenities and perks necessary to attract tenants

Amenities attract tenants, but they also inflate construction costs. It's imperative to remain cautious when determining which amenities to include in a converted property and prioritize those that will have the most impact on how the market will perceive the finished units.

For example, entertainment areas like movie lounges and golf simulators seem attractive on leasing tours, but often go unused once residents move in. And when residents realize they're paying inflated rents for amenities that don't benefit them, they're less likely to renew their leases.

Taking a methodical approach to amenity selection conserves resources and supports capital recycling to produce more housing and, eventually, profits.

Repeating a recipe for success

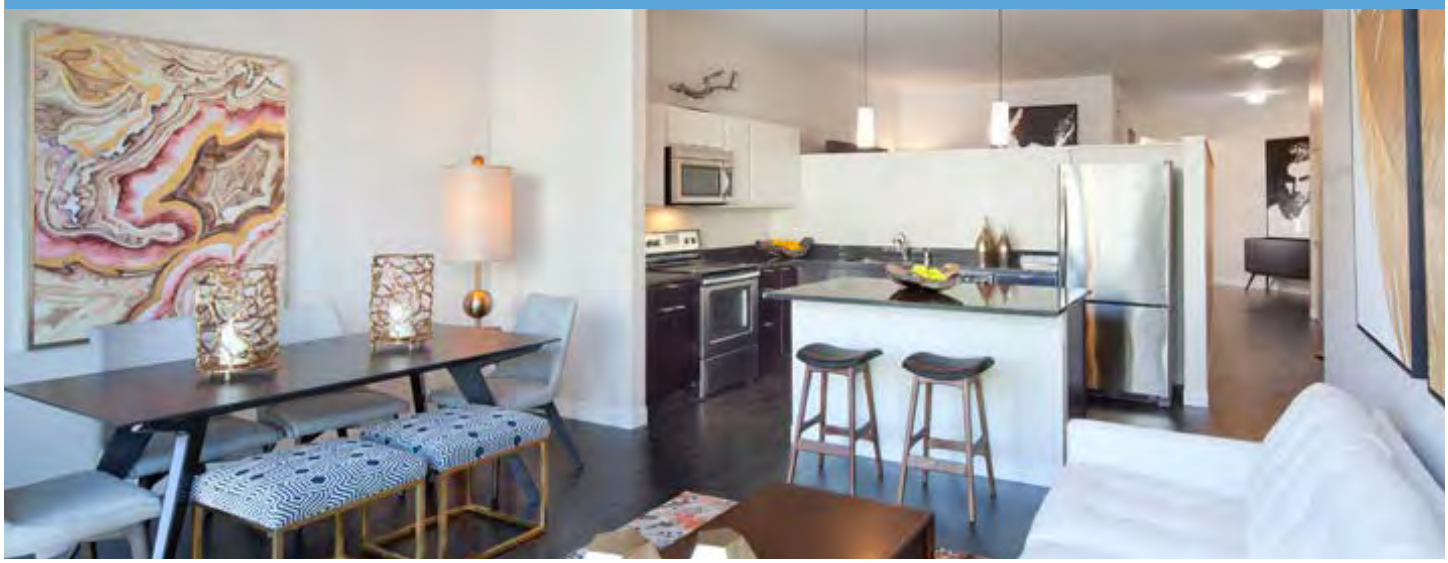
Developers who adopt a scalable approach and create a platform model for their conversion business can foster innovation more effectively. **It's possible to gain efficiencies by concentrating on acquiring or creating "pods" of nearby properties to benefit from economies of scale and cross-selling options.**

This approach makes it possible to execute a portfolio exit after all projects are stabilized, appealing to a wider range of potential buyers than siloed assets can attract. Developers and investors can also choose to refinance the property to recover capital that can then be reinvested until market conditions shift and a more opportune exit moment arises.

Given the current availability of convertible office properties and the dire need for more entry-level housing units, there is a significant market gap waiting to be filled. It's a lucrative opportunity for investors to generate substantial returns at both the enterprise and asset levels — provided they work with an experienced, cost-minded developer.

3L Strength

Our standardized development approach enables us to move quickly to identify and acquire properties with the best conversion potential. By evaluating a wide-range of factors from structure and historical features to location and access, we're able to act on opportunities others miss and design units that actually meet market needs.





Case Study

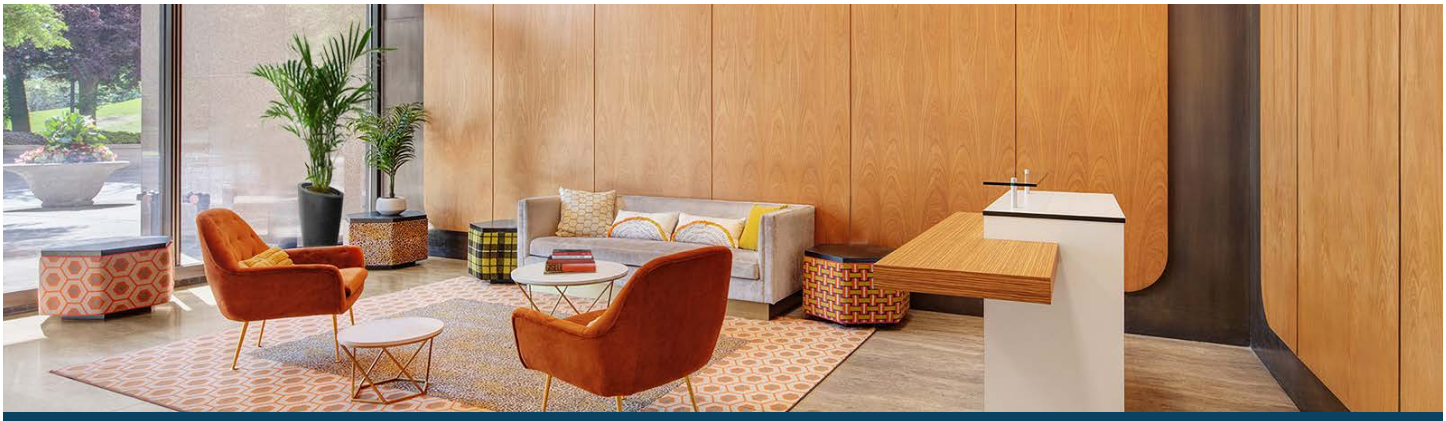
735 West | Milwaukee, WI

The 1960s office structure at 735 W. Wisconsin Avenue in Milwaukee was empty apart from a handful of holdout tenants when 3L became aware of the property in 2017. We worked with the seller to devise an office relocation plan for the remaining tenants while jump-starting a new relationship bank program to fund the acquisition and renovation.

At the time, many large LP partners did not view Milwaukee as an attractive city for housing development and were skeptical of 3L's plan to construct entry-level units. But in the years following the conversion, downtown Milwaukee has blossomed and the competitively priced units are always full.

The building's modern glass curtain-wall structure with a limiting core presented a new construction challenge for our team. After analyzing the building code, we decided to rearrange and preserve the building's core to satisfy change-of-use requirements, rather than cut an opening in the building to create a light well or courtyard (a tactic we often use). We've since repeated this approach with other buildings that would otherwise not have been candidates for conversion.

The building was fully leased in 2019, two years after construction began, and the lender generated a full cash-out refinance (with an extremely attractive interest rate) for a 10-year deal. Ultimately, this building became the first of several nearby properties that 3L developed to create a pod of lucrative market-rate units.



Why *3L Real Estate Is the Right Partner* to Revitalize Aging Offices

Executing on a conversion strategy requires proven experience, patience, and scale.[33] 3L Real Estate has all three.

Commercial property owners and investors often struggle to see beyond a corporate building's current state and imagine how it can be transformed. While the conversion process often involves hurdles like inconvenient layouts[34] and holdout tenants, **3L's team has extensive experience navigating these types of challenges — which enables us and our partners to capitalize on assets valued far below their actual potential.**

Historically, few developers have made conversions a core focus of their business.[35] But 3L's leadership team has a proven track record of successful property conversions, and we have positioned 3L as an early leader in the office-to-housing revolution.

Our approach

We tackle every conversion opportunity using a standardized playbook to ensure complete due diligence and protect profitability. However, our guiding principles also enable us to remain flexible and devise creative solutions to complex conversion challenges. This means we:

- **Identify** the most viable transient structures by meticulously evaluating entitlement, location, and future growth potential.
- **Analyze** the risks and challenges associated with each real estate deal using past successful conversions as reference points, setting conservative growth projections, and accounting for all costs involved in the conversion process. These steps make it possible to align on an appropriate purchase price and ensure a financially sound investment.
- **Negotiate** transactions and construct deals that appeal to current office real estate owners and property conversion investors. Our team has executed transactions with public, private, distressed, institutional, university, and special servicing entities.
- **Design** housing plans that include high-density layouts — which align with the market's desire for lower rent alternatives to luxury housing options — while still providing quality amenities.
- **Manage** projects with meticulous attention to detail, incorporating internal analytics and monitoring to keep projects on trend and proactively reallocating resources as local conditions require. This includes swiftly navigating the red tape required to satisfy building codes and permitting requirements, as well as incentives and tax credit/enhancement opportunities.

Conversion projects will remain lucrative for many years, but the heaviest discounts on office assets will only remain available for a finite window of time. Investors need to move quickly to capitalize on the most desirable convertible properties — and the most efficient way to do so is by partnering with an experienced operator like 3L.

Our team's expertise in the conversion market enables us to move with agility and speed to execute complex projects on ambitious timelines. And a key element of our success is the trust we've built with various stakeholders:

- **Sellers** feel excited to work with us due to our proven performance and financial scale.
- **Cities** feel comfortable that we will be a reliable custodian of historic properties.
- **Lenders** feel confident that our deep conversion experience means projects will be completed within scope.



3L strength

We aim to preserve the history and character of every property we acquire while producing consistent quality in the final conversion. The result is boutique properties that add value to the surrounding neighborhood, delivered with franchise-like consistency.





Case Study

21st Street Lofts | Chicago, IL

61 East 21st Street is the original home of John Hertz's Yellow Cab Company, out of which prohibition-era cab drivers ferried shipments for Al Capone's Chicago outfit. The building's storied past and historical charm were just two of the reasons 3L pegged it as a viable conversion opportunity, despite significant structural hurdles.

Leaning on the team's prior experience in leveraging public policies, 3L developed a zoning-approved plan to maximize density, filling the property with a majority of studio and one-bedroom units. This required heavy construction lifts, including removal of old car ramps and cutting two large courtyards out of the existing structure.

The result is a 137-unit building with superior energy performance (and an EPA Energy Star® certification) that was fully leased within its first 12 months and ready for a cash-out refinancing soon after. However, 3L's private equity partner elected to maintain the original ultra-low leverage loan to maintain flexibility for an eventual sale. With planned mega-developments in the surrounding area and a basis per-unit far below any alternative in the area, the building is well-positioned for an exit or recapitalization.

But the success story doesn't end there: The original sellers of the Yellow Cab building were so impressed with 3L's work that they invested in our first Milwaukee conversion project and remain part of that deal today.

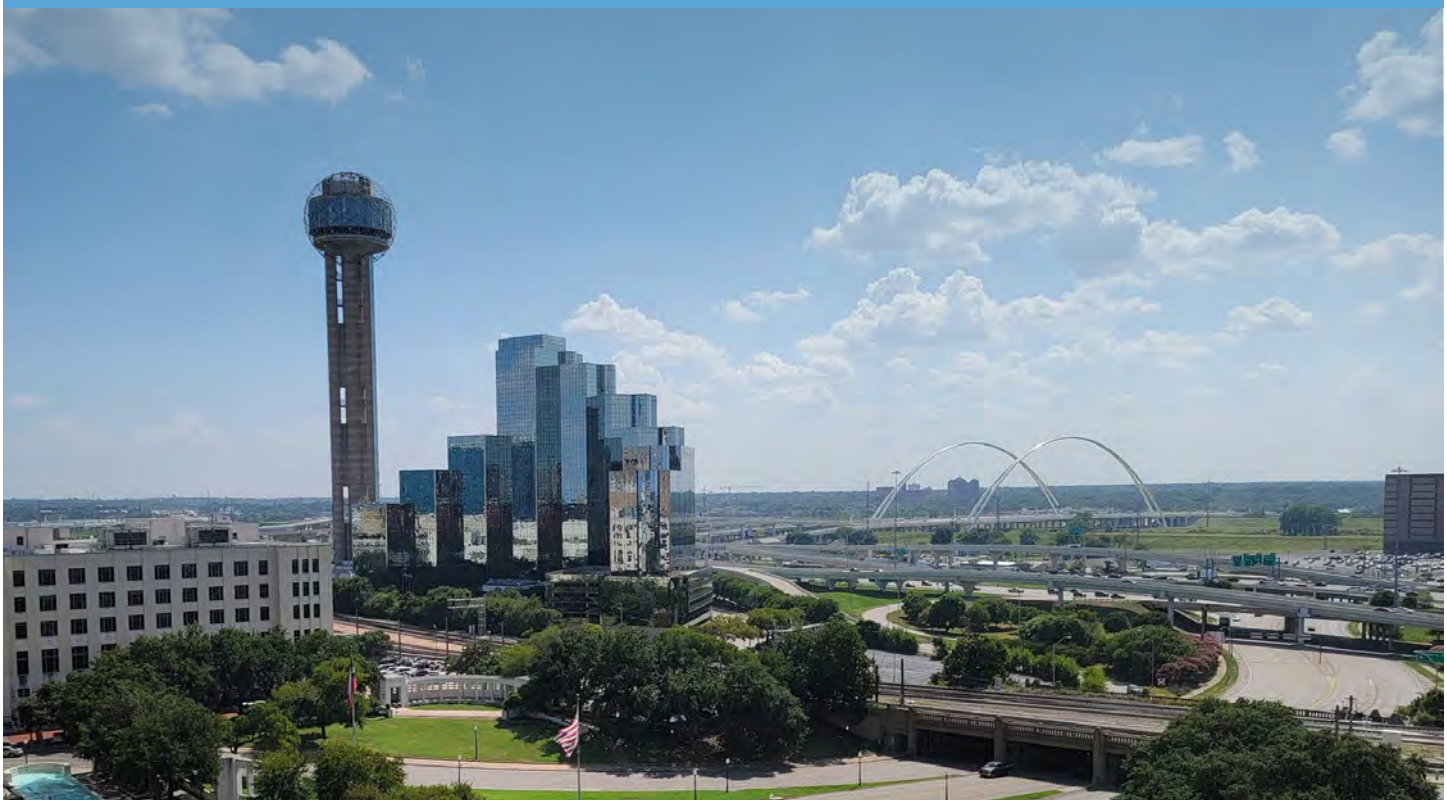
Are You Ready to Help Shape the Future of *Urban Living?*

Addressing the housing gap and simultaneous office market collapse through adaptive reuse is possible. But it requires meticulous planning and a budget-conscious approach that guarantees the finished housing units will be affordable and desirable for a diverse range of residents.

With deep conversion experience that predates the COVID-19 pandemic, the team at 3L is well-positioned to facilitate transformative conversion projects. We possess the innovative thinking, collaborative mindset, and practical experience to tackle groundbreaking conversion ventures at scale.

Interested in investing with us to solve multiple real estate crises and drive radical change at the heart of cities?

Contact us to learn more about our vision — let's talk about how your investment will disrupt the urban housing market.



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