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December 06, 2023

San Francisco Office Conversion

13% of San Francisco Offices Are Viable for Multifamily Conversion

Table of Contents

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13% of San Francisco Offices are Viable for Multifamily Conversion

San Francisco is the epicenter of the urban doom loop discussion. It is a beautiful coastal city with mild weather, rich culture, great talents, leading tech titans and emerging clusters of GenAI start-ups. That said, commuting workers are not eager to return to offices full time as downtown foot traffic has only recovered two-thirds of its pre-pandemic level[1]. As of the third quarter, San Francisco's office vacancy reached 17.3%, with stress especially manifested in Van Ness/Civic Center (41.2%), Yerba Buena (32.5%), and Jackson Square (24%). Many dinosaur office buildings sitting at premium locations remain deeply underutilized, giving business owners a second thought about the future of the city's valuable commercial space. It begs these questions:

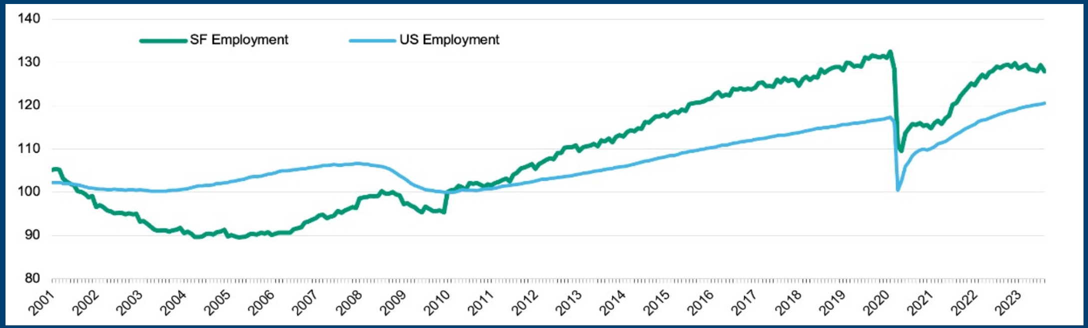
Why is foot traffic in many other urban centers fully recovered (such as Las Vegas) or close to a full recovery (such as San Jose), but not for San Francisco?

What can the city do to recreate a critical mass and prevent an urban doom loop?

If dynamic work is the new norm, what will happen to underutilized office space?

[1] https://downtownrecovery.com/charts/rankings

FIGURE 1: San Francisco City Employment Growth Outpaced the US Average (Index Jan 2010 = 100)

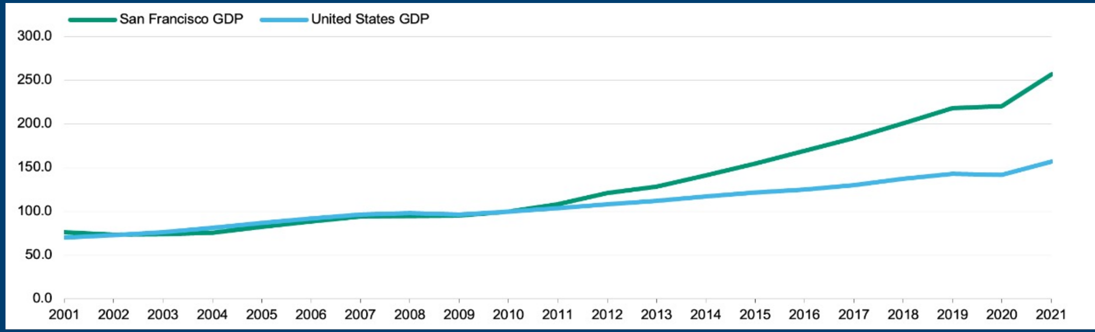


US Census Bureau, Moody's Analytics

When Vacant Office Meets Housing Problems

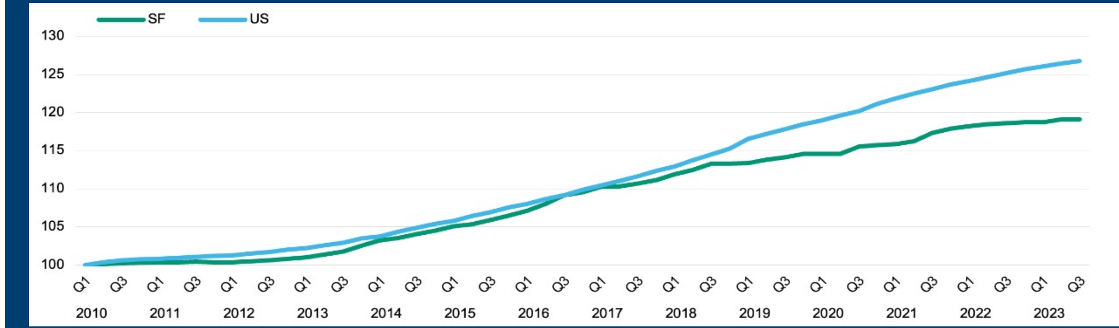
In stark contrast to the negative rhetoric on the commercial real estate side, San Francisco's total non-farm employment and economic growth significantly outpaced the US average since the Great Financial Crisis (GFC) (Figures 1 & 2). However, partially due to its highly restrictive building codes, housing inventory growth lagged behind population growth (Figure 3).

FIGURE 2: San Francisco GDP Grew Faster than the US Average (Index Jan 2010 = 100)



BLS, Moody's Analytics

FIGURE 3: San Francisco Apartment Inventory Grew Slower than the National Average (Index Q1 2010 = 100)



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Historically, San Francisco's home ownership has dwarfed the state, region, or national average, with over 60% of residents staying in the rental market as compared to only 34% at the national average (Figure 4). According to Census Bureau's latest American Community Survey (ACS) 1-year estimate, owner occupied housing units only accounted for 23.6% of the city's total housing stock, making home ownership extremely competitive. More than three quarters (75.8%) of single-family homes cost $1,000,000 or more and 32% of rental units cost $3,000 or more per month, ranking San Francisco as one of the least affordable places to live in the nation. Although the city's median household income reached $136,692 – nearly 50% higher than the state level – when accounting for moderate to low-income households or even 10% of households below the poverty line, the housing needs are glaring.

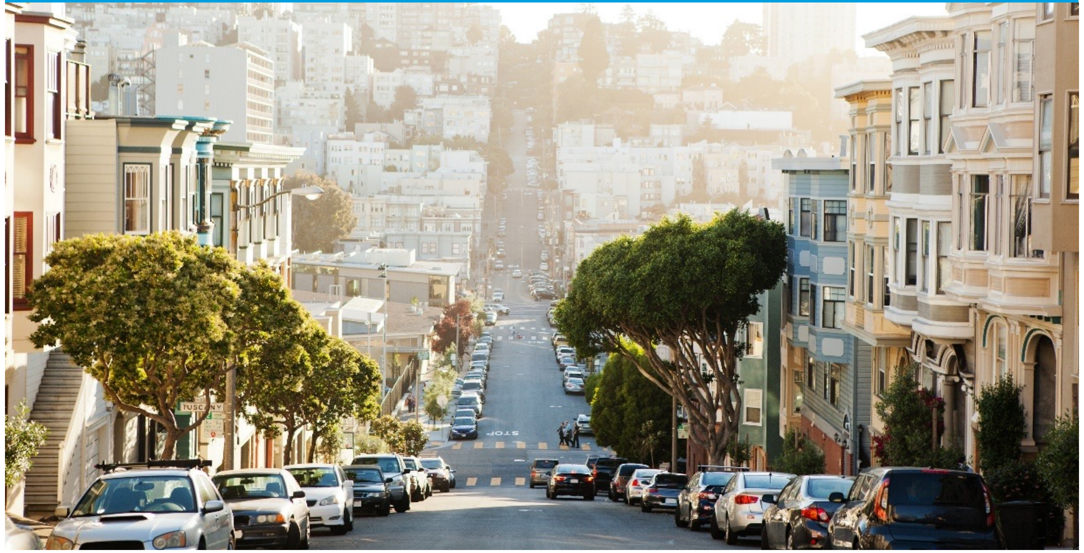
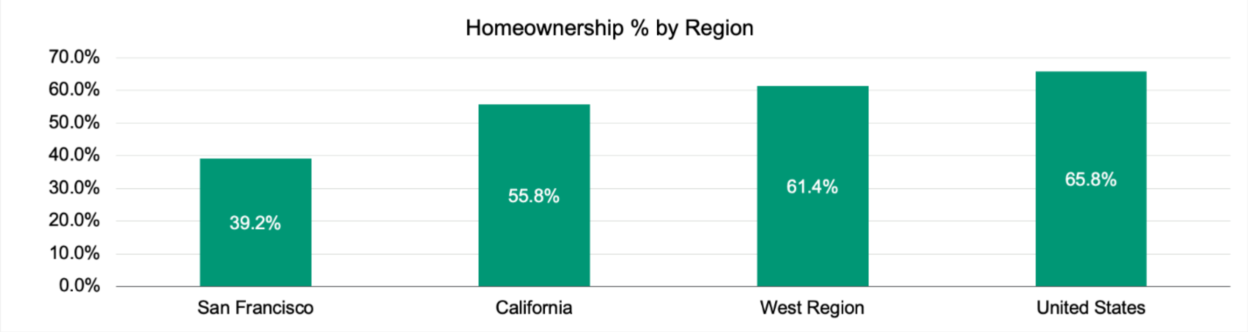
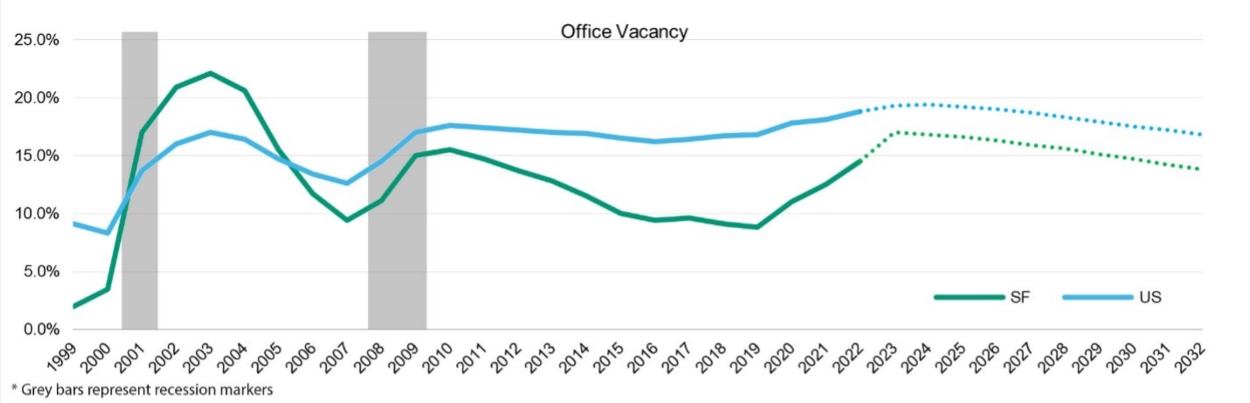


FIGURE 4: San Francisco Homeownership Stayed Significantly Under National Average



US Census Bureau 2022 American Survey 1-Year Estimates, Moody's Analytics

FIGURE 5: Underutilized Office Space



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[2] https://sfplanning.s3.amazonaws.com/default/files/publications_reports/2022_Housing_Inventory.pdf

Urban Vertical Expansion: San Francisco's Housing Inventory Growth and Its Implications

It came as little surprise that nine out of ten housing units added over the last five years involve buildings with 20 or more[2] units, according to San Francisco City Planning. An outsized renter population and vertical growth of new apartment space made some of the city's tall office buildings natural candidates for expanding its housing inventory for renters who started their career in the city, enjoy urban living, and are not ready to establish homeownership yet (whether voluntarily or involuntarily).

As residents move in, building owners and investors would also create and bring other amenities to the mixed-use community. Offices around the new residential center will benefit from the renewed energy and foot traffic.

What Have We Learned from Office Conversion Projects in Other Parts of the Country?

Moody's Analytics CRE examined publicly available permit data from New York City, Chicago, and Washington DC, and analyzed 77 conversion projects that occurred over the past 20 years. Close examination of these projects – 52 in New York, 18 in DC, and seven in Chicago – revealed some common factors which made these obsolete office buildings successful candidates for residential conversion:

Building Age

These buildings tend to be older. The average year built of converted properties in the sample is 1932, with 94% of the buildings being built before 1990.

Building Size

Smaller buildings are typically converted, with the average size of a conversion 24% smaller than comparable buildings. The average estimated depth from the center point to the outer walls of a converted property is 60 feet. The smaller layouts help these properties conform with acceptable dwelling requirements, including a minimum light requirement for each unit. Once converted, these properties typically offer rents that average 15% above comparable non-conversion properties, in an effort to offset the sometimes lofty costs to convert.

Zoning

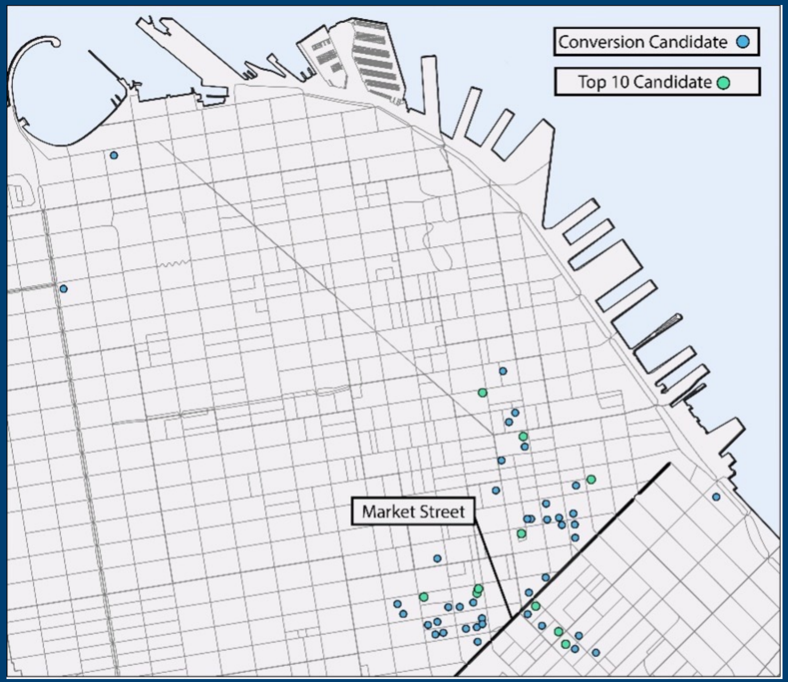
A small but important aspect for these projects: they must be in a zoning district that allows for multifamily properties. Thankfully, many cities have begun to relax zoning regulation to allow for more dynamic housing space like New York's Office Conversion Accelerator program, and Washington's Housing Framework for Equity and Growth. San Francisco has made strides with the Roadmap to Downtown San Francisco's Future, which evaluated legislative changes to make these projects more feasible for developers, while attempting to introduce some aspect of affordability at the same time.

The Billion Dollar Question: Which San Francisco Offices May Be Good Candidates for Conversion?

To identify how many properties in San Francisco would be good candidates for conversion, we built a 360-degree view of the city's office market by combining public building-level data such as dimension, zoning, and transit locations, with Moody's Analytics CRE data including the neighborhood safety score, lease terms, property age, size, and class. We started with a total sample size of 406 properties[3] and then trimmed down to the final candidates by examining the opportunities and challenges of each building.

These filter conditions narrowed down to 13% of the original sample that are most suitable for conversions (Figure 6):

FIGURE 6: Potential Conversion Locations



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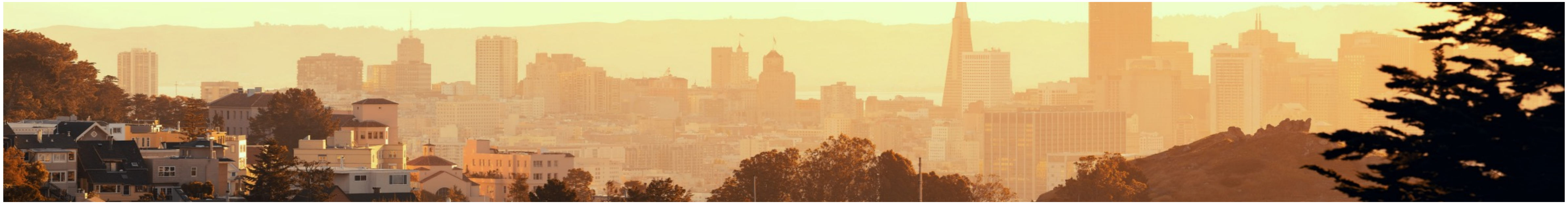
[3]The Moody's Analytics CRE Data holds a total sample of 970 office properties in San Francisco, 515 in San Francisco City, and 406 Properties that have corresponding leasing data.

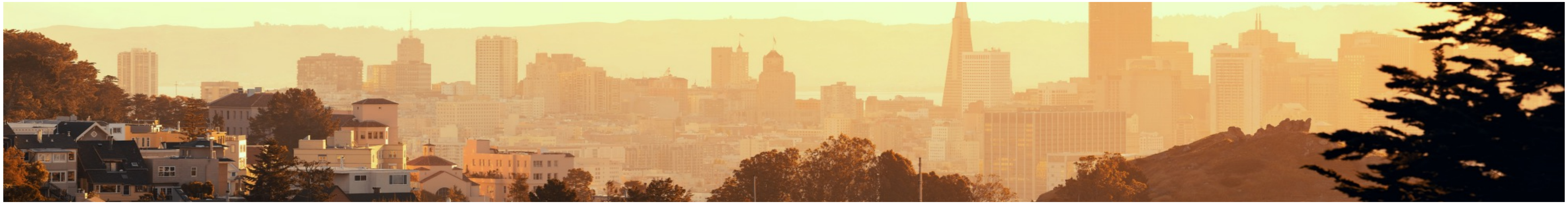


1

We began with **older buildings built before 1990** , because they typically have a lower purchase price per-square-foot (sqft) than newer buildings. However, older properties can present unique challenges, as their façades may not allow enough acceptable light to conform to legal standards. An example of this can be found at 25 Water Street in New York which used to house The Daily News and JPMorgan Chase. The façade has very slim windows that are infrequently scattered, so the developer is forced to rebuild a new glass façade. Regardless, **we assume older buildings are still at a better situation to pencil out as compared to more expensive newer ones**.

2

Then the **focus turns to Class B/C properties**. In the struggling office market, flight-to-quality has continued to drive divergent performance between Class A and BC offices in the city's core, as demand continues to shift towards trophy properties with new amenities that can better host purposeful gatherings and entice workers back to the office. This has pushed down Class B/C office valuations to **meet the slim margins that make conversions work**.

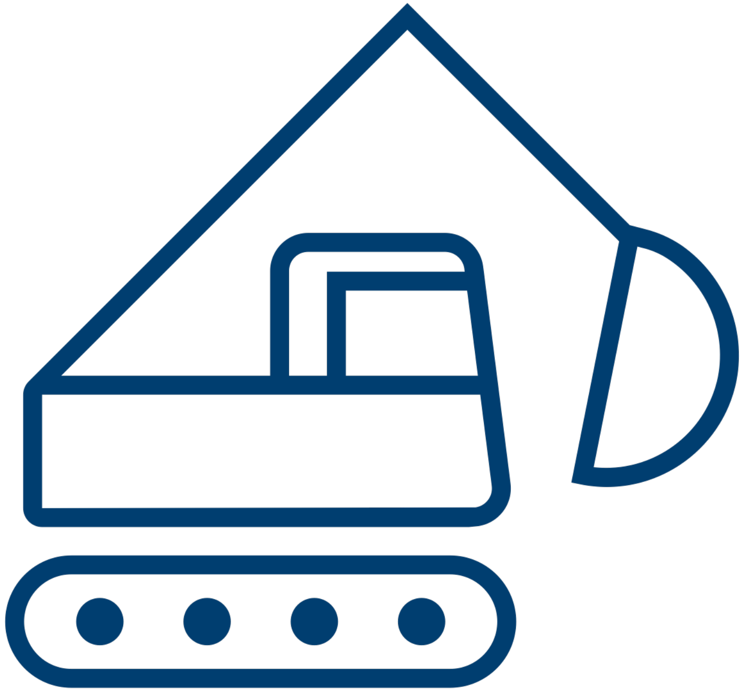


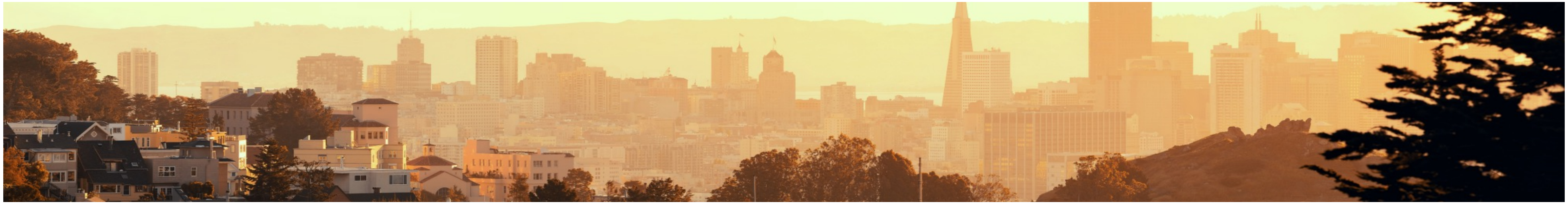
3

The next filter is a **minimum total building size of 25,000 square feet**, as economies of scale works best with larger properties which in turn have the most impact on the strained multifamily market. Smaller conversion projects can be feasible but bigger projects will have the most impact on the city's recovery.

4

Next, only buildings that are **within the C-2 and C-3 zoning designations** remained as per the Commercial to Residential Adaptive Reuse ordinance that was adopted in July.





5

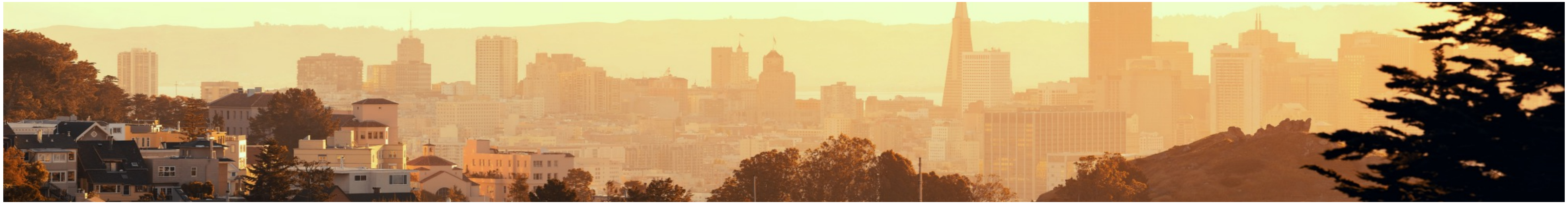
One of the more tenuous aspects of conversion is to identify candidates with ‘**Goldilocks’ floorplates** - not too large, not too small, but just right. Although the awe-inspiring cases where centers were cored out to conform to light standards have happened, **smaller floorplates generally make easier conversions**. To identify properties with smaller floorplates, the distance from the center of each property to its outer walls was estimated, and properties that have an estimated[4] depth of 60 feet or less are included.

6

The next consideration landed at properties that have **available space to convert**. Some properties that still have tenants remained in this step, as long as they have leases that expire soon, or the opportunity to buy out tenants. By estimating the remaining years of a property's leases, the sample was further shaved down to **those buildings with none or few long term leases**[5].

[4] Most properties are rarely built as perfect polygons. To account for this we take the mean of 30 different measurements alternating by 12 degrees from its center point to form our estimated depth

[5] We use a weighted lease duration estimation as described in: https://www.nber.org/system/files/working_papers/w31530/w31530.pdf



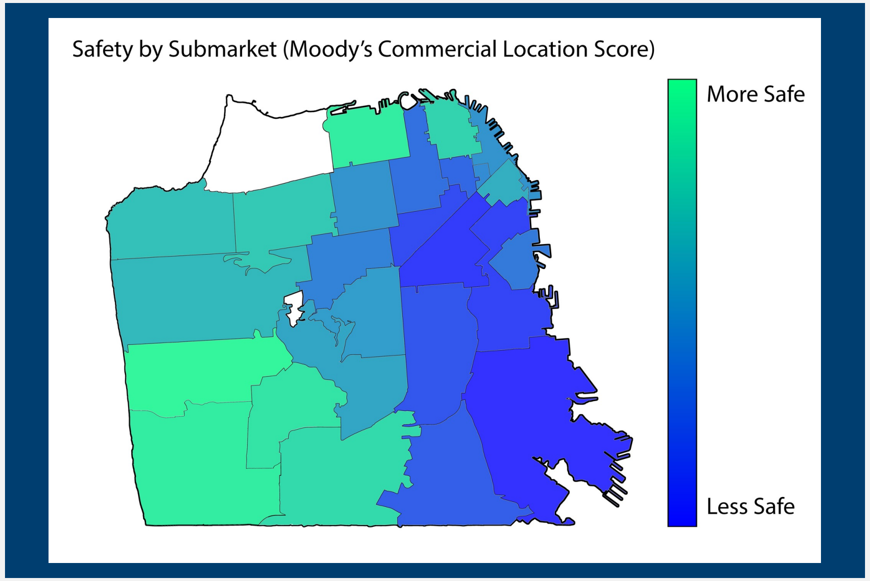
7

Next, the **safety** of each building's location was considered as properties in safer zip codes will often hold higher demand over less safe neighborhoods. In this step, **Moody's Analytics Commercial Location Score** was used to assign a numerical safety score based on the crime per capita at the zip code level, and only properties on the safer[6] end of distribution were included.

8

The last imposed restriction focused on the increased demand a property should receive because of its **proximity to public transportation** . Any properties that are more than 500 feet away from the closest MUNI (San Francisco Municipal Railway) stop were excluded.

FIGURE 7: Safety Score Location Meter



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[6] The neighborhood distribution of our properties shows two modes, and so we take only the safer neighborhoods

The vast majority of conversion candidates are scattered around the North Financial District, South Financial District, and Union Square submarkets adjacent to market street. Among them, the top 10 most convertible buildings which have short lease durations and are the closest to neighborhood amenities (MUNI stops, restaurants, major grocery store chains, public green spaces, and colleges) are listed in the table below:

TABLE 1: Top 10 Potential Conversion Locations

Rank	Address	Estimated Remaining Lease Duration (Rank)	Distance to the Nearest Park	Distance to the Nearest University	Distance to the Nearest Restaurant	Distance to the Nearest Super Market Chain	Distance to the Nearest MUNI Sto
1	602-606 Mission St, 94105	1	2050	107	15	120	85
2	211 Sutter St, 94108	2	894	517	32	214	109
3	391 Sutter St, 94108	5	550	681	53	809	112
4	601 Market St, 94105	1	1567	456	60	494	97
5	222 Front St, 94111	1	669	1223	18	646	142
6	535 Pacific Ave, 94133	4	925	521	92	591	116
7	250 Montgomery St, 94104	7	824	668	92	685	112
8	545 Sansome St, 94111	1	770	343	63	968	194
9	611 Mission St, 94105	6	2231	260	102	204	130
10	133 Kearny St, 94108	3	1011	644	71	359	143

Note: Distance is the estimated feet

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Would Office to Residential Conversions Work in San Francisco?

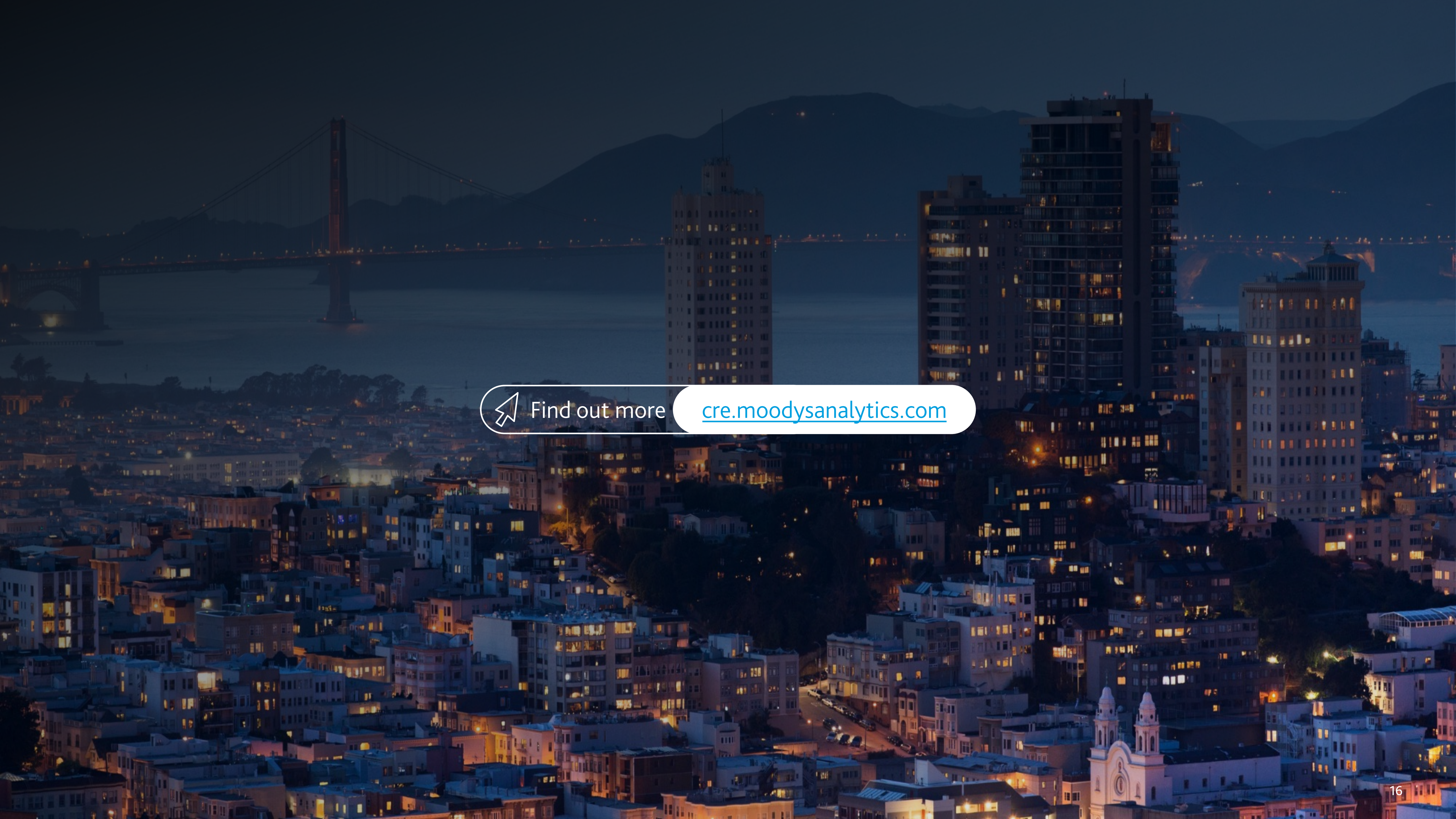
Vacant office space provides a unique challenge for cities, and even more so for San Francisco. The city must promote a more balanced live-work-play community to thrive in the post pandemic economy. For San Francisco, this means addressing long commute times, eroding street safety, and hefty taxes which left some businesses to consolidate or even relocate as a result. Many of these issues can be attributed to the city's chronic housing shortage which intensified the homelessness crisis and lack of housing amenities. Adding more housing and strategically repurposing some of the underutilized office space could fundamentally change zoning segregation and revitalize the city's core.

The passing of the city's Commercial to Residential Adaptive Reuse Ordinance and the White House's recent support was a great leap forward for broader public and private partnerships. Ultimately, conversions will never be easy, especially considering situations when facades have to be rebuilt or centers have to be cored out or levels need to be added. It takes vision and innovation from individual investors to work out the architecture, structural engineering, and finance, but there is space for the Fog City to recreate a critical mass and revitalize the broader commercial space.

There are methodology and focus differences between this report and Moody's Analytics CRE's 2022 research on NYC office-to-apartment conversions. The 2022 report filtered MA CRE's property dataset by properties that have a vacancy greater than 30%, and rents per sqft of less than $55 to provide conversion viability from a financing perspective. This report dives into property-level characteristics to identify commonalities between successfully completed conversions and applies that methodology to the REIS sample.

References:

1. https://www.brookings.edu/articles/myths-about-converting-offices-into-housing-and-what-can-really-revitalize-downtowns/
2. https://www.nber.org/papers/w31530
3. https://www.spur.org/publications/research/2023-03-28/office-residential-conversion-san-franciscos-changing-real-estate
4. San Francisco officials introduce plan to convert vacant downtown offices into housing
5. Skyscraper Becoming 1300 Apartments – Largest Resi Redo Ever



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