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Seattle Office Conversion

14% of Seattle's office properties are suitable for multifamily conversion.

Table of contents

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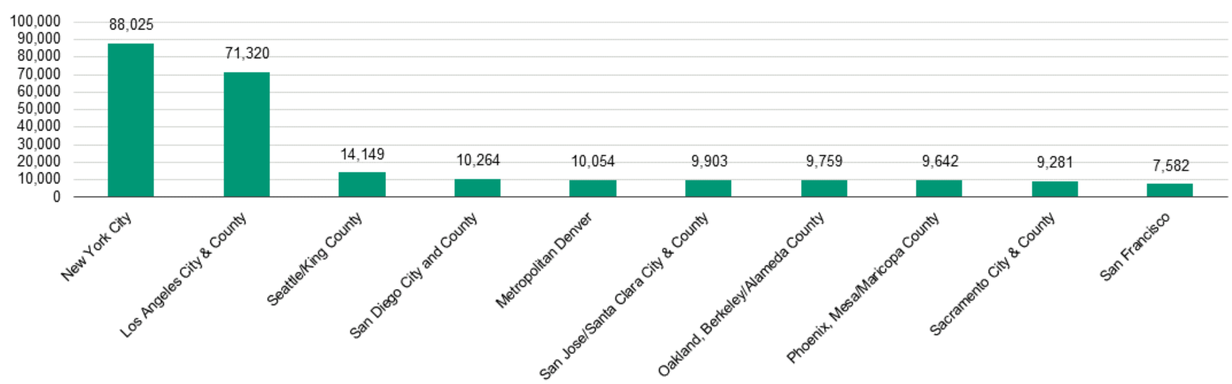
14% of Seattle's Office Properties are Suitable for Multifamily Conversion

Seattle has been championed as a global cloud-computing and software powerhouse since the early 2000's. Its economic development benefited from a highly trained, well-educated labor force. Abundant job opportunities, great culture and mild weather have attracted above average population growth which stimulated local housing demand over the years. However, a highly left skewed income distribution combined with the rapid growth of housing costs created long-lasting housing unaffordability and homelessness. Based on HUD's point-in-time count of people experiencing homelessness in 2023, Seattle once again ranked the third-highest among the nation's major cities/counties in homeless population, only after New York and Los Angeles (Figure 1).

FIGURE 1 Top 10 Metros with the Highest Homeless Count (2023)

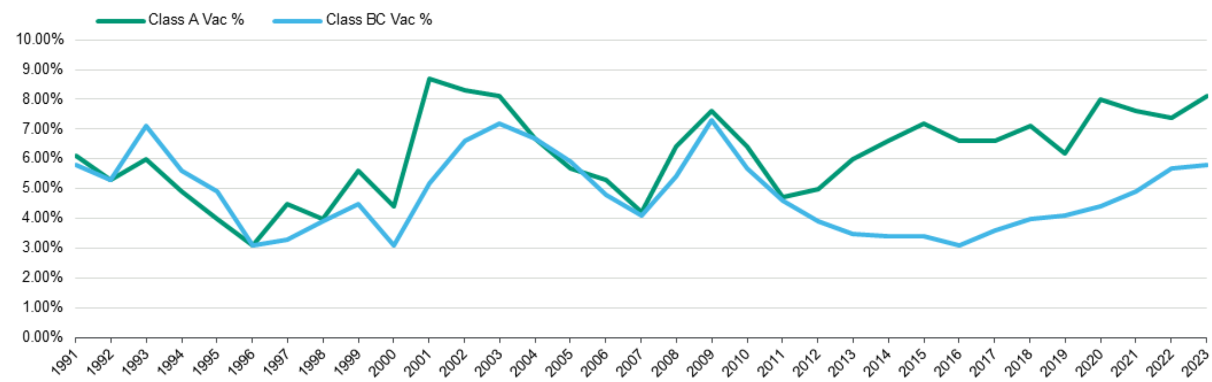


Source: HUD

Although homelessness might be an extreme outcome, Seattle's housing unaffordability remained acute for its homeowner and renter populations. Based on the Census' latest 2022 American Community Survey results, 22% of homeowners in Seattle spent more than 30% of their monthly income on housing related costs while nearly half (45.7%) of renters are considered rent burdened[1]. Although multifamily housing construction has been catching up to demand over recent years, a frictional housing shortage continued to exacerbate Seattle's housing crisis. Highly concentrated interests in constructing luxury homes and high-end apartments have been driving a bifurcated market (Figure 2), as illustrated by the diverging vacancy trends for Class A and Class B/C apartments. As demand heightened for more affordable rental units, Class B/C apartment market remained tight.

[1] Rent burdened is defined as spending 30% or more of monthly income on rent and utility cost.

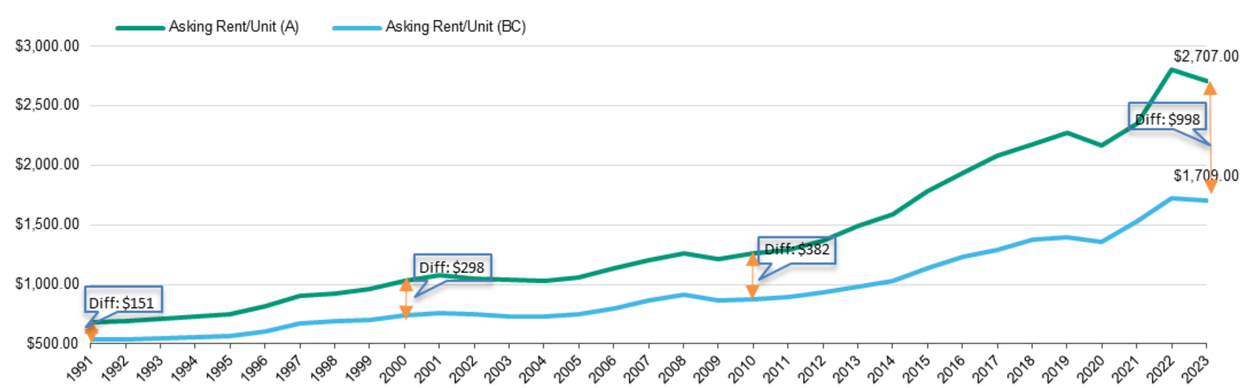
FIGURE 2 Class A vs BC Apartment Vacancy Changes (1991 – 2023)



Source: Moody's CRE

While supply growth at the higher-end of the housing market is still welcome news to the overall housing deficit, the widened gap between Class A vs. B/C rents (Figure 3) made it increasingly challenging for moderate- and lower-income households to take advantage of the moderation in rents (if any). An amenity effect can also push desirable neighborhoods further out of reach for rent burdened households and make the filtering process across segments of the rental housing market long and cumbersome.

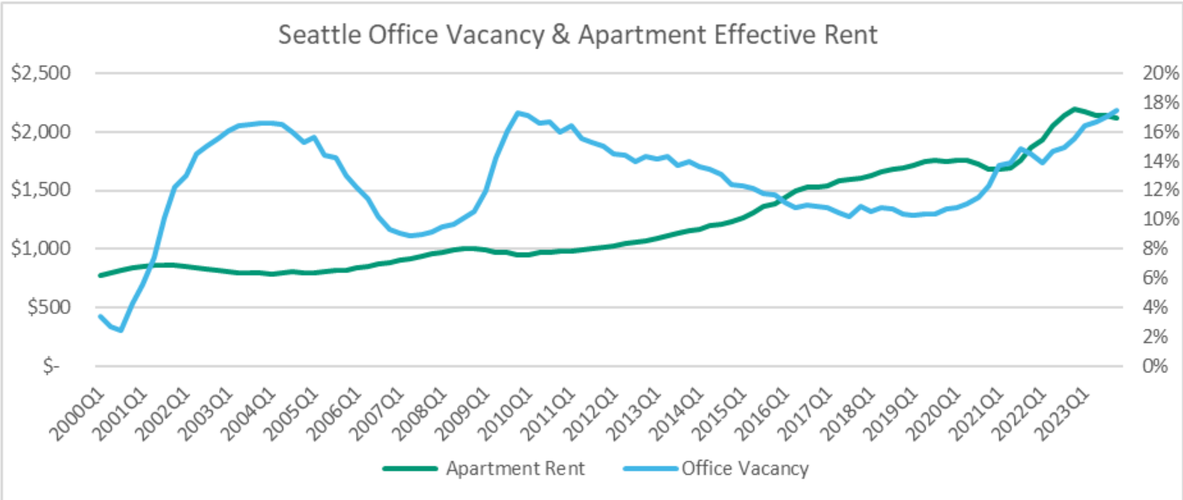
FIGURE 3 Widening Rent Gap Hindered the Filtering Process



Source: Moody's CRE

The pandemic also created unique challenges for the city's housing and overall commercial real estate ecosystem. The popularity of remote work—especially in a tech centric city like Seattle—has added to Class A's strength as these workers often require larger spaces to fit desks, and look for luxury amenities like business centers. Remote work has also lowered the city's office utilization rate, which resulted in high office vacancies and slowed downtown foot traffic recovery. This has pushed the metro's office vacancy to a decade high at 17.2% in Q4 2023. Office vacancies in the Central Seattle submarket more than doubled from 9.3% pre-pandemic to an all-time high of 19.9% by the end of last year. A dilemma has emerged as the office sector struggles with unutilized space while the housing sector fights for more (affordable) space (Figure 4). The city's once bustling downtown area is in desperate need of more foot traffic, especially when commuting workers are not so eager to come back to offices at a fast enough pace.

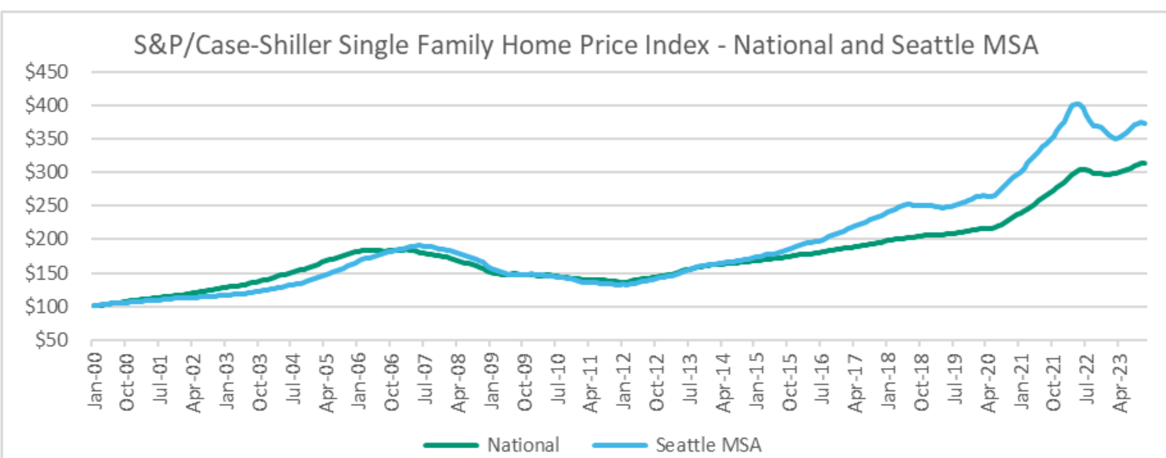
FIGURE 4 Seattle Office Vacancy and Apartment Effective Rent Rose Together



Source: Moody's CRE

As multifamily rents grew by 21% from 2020, single family home prices followed suit. The median single-family home price grew by 37.4% since 2019 (Figure 5). Median income households are now spending 45% of their monthly income on their mortgages alone, assuming living in median priced housing with 20% down payment and 30-year fixed mortgage. On the supply side, the total number of new homes built each year fell by 55% since 2006 according to Census permit data. More broadly, the cost of producing any amount of new construction has risen by 43% across the US, according to the [Producer Price Index for Construction Materials.](#) This has pushed potential first-time home buyers further away from homeownership and hindered household formation, intensifying the need for more rental options. In the long run, this will pose major risks for the city's tax revenue, as more residents will be priced out and forced to move to the outer reaches of the metro, or even to another city all together.

FIGURE 5 Intensified Housing Cost Locked Out Potential First-Time Home Buyers



Source: [Moody's Analytics (ECCA)](#)

WHAT IS THE RECIPE FOR OFFICE TO RESIDENTIAL CONVERSION PROJECTS?

For a metro to consider converting vacant office space into apartments, a few core conditions need to be met. First, abnormally high office vacancies that make property owners look for creative solutions, which often comes with depressed valuations that more creative developers will see as an opportunity. Second, a high demand for more multifamily housing, as developers will only build what makes economic sense, and if multifamily as an investment vehicle can't outperform office, developments will not pencil out. Lastly but most important is the city's zoning legislation. Developers can only build what they are allowed to, and most commercial properties lie in zoning districts that only allow commercial buildings.

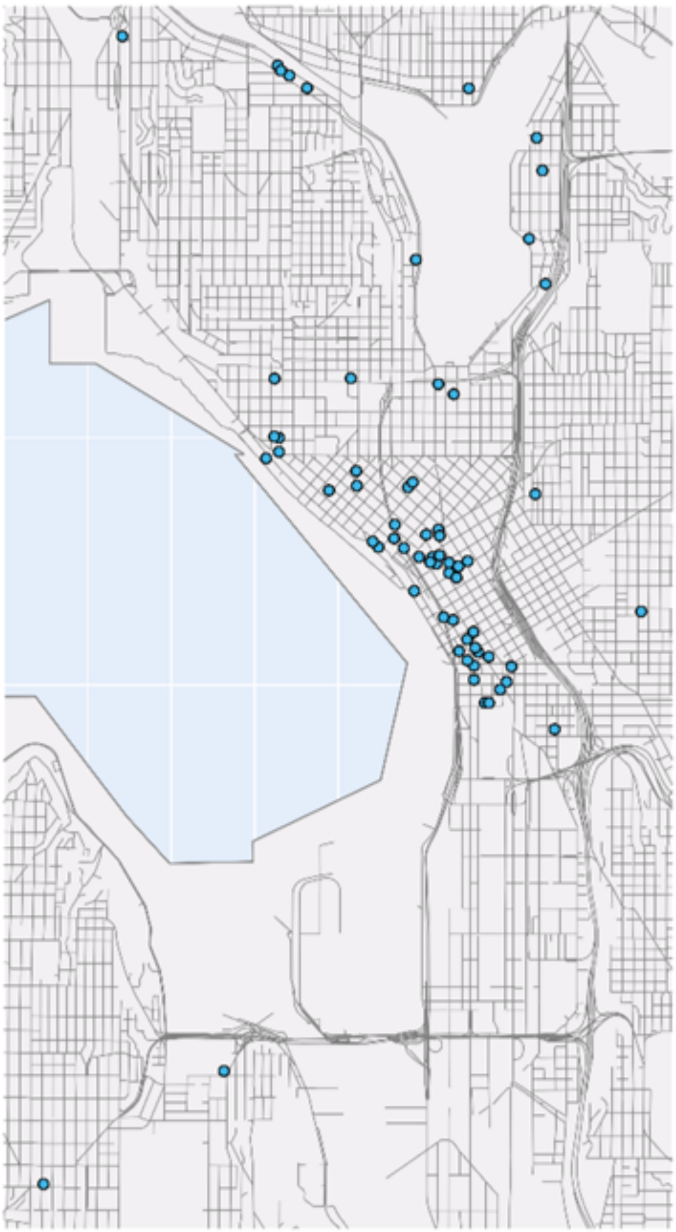
Incentivized to (re)-densify their downtowns, many metros have already made zoning exceptions to allow conversions. New York City leads the way and allows buildings in commercial districts to be converted to housing if they are built prior to 1966 (with exceptions for buildings in the Financial District built pre-1977 or in special mixed-use districts built pre-1997). Seattle has been making some strides in this direction as well. Earlier this year, initial steps were taken to waive the design review process for conversions, along with the Mandatory Affordable Housing fee. More recently, the mayor proposed guidelines for these projects that would permit them in certain zoning districts and exempt them from the city's Mandatory Affordable Housing requirement all together. The city may see its first post-pandemic conversion project begin at 201 Queen Anne Avenue North by Stream Real Estate and Marymoor Storage Partners, although it is unclear what the finished property will look like. So, given Seattle's high office vacancies, increasingly tight housing market, and shift towards easing development restrictions, **how many properties in Seattle can be converted?**

Using the conversion framework discussed for New York and San Francisco, we compiled a dataset of building level data from Moody's CRE and Seattle Open Data and reduced our sample down according to a set of criteria.

1. Include buildings built before 1990, because older properties tend to have a lower price per square foot purchase price which allows for greater economic returns.
2. Include properties that are marked as Class B/C for similar reasons.
3. Keep properties that have a minimum size of 25,000 square feet, to keep only properties that will have the largest impact on the housing supply.
4. Include properties that are in the city's Downtown, Commercial, Neighborhood Commercial, Seattle Mixed, Midrise and Highrise zones.
5. Include properties that have a distance from its center to its outer walls no greater than 60 feet. This is because smaller properties are easier to comply with acceptable light standards, where some larger floor plates need to be "cored-out."
6. Consider properties that have the available space to convert, by including only properties that have none, or a few, long-term leases.
7. Include properties in safer zip codes which will offer more desirable amenities.
8. Include properties that are within 500 feet of a public transit stop, for similar reasons.

14% We find that an estimated 14% of Seattle's office properties are most suitable for conversion into apartments (about 70 properties in our representative sample).

FIGURE 6 Office Conversion Candidates



Source: Moody's CRE, [Seattle Open Data]

Top 10

The top 10 properties which are most suitable for conversion are displayed in Table 1. These properties are ranked by spatial demand, measured by estimated remaining lease term, and proximity to amenities such as:

- nearest library
- public park
- grocery store
- bar/restaurant
- hotel
- parking lot or garage
- public transit stop

The majority of these properties are located in the city's Central Business District, with a few located in **West Seattle**, **Queen Anne**, and **East Lake** submarkets.

TABLE 1 Top Ten Convertible Properties in Seattle

Rank	Address	Lease Rank	Library Distance	Park Distance	Grocery Distance	Bar / Restaurant Distance	Hotel Distance	Parking Distance	Bus Stop Distance
1	217 PINE ST 98101	1	1959	447	336	274	31	5	30
2	101 YESLER WAY 98104	16	1767	152	85	91	116	149	5
3	1601 2ND AVE 98101	1	2240	791	5	72	72	165	16
4	615 2ND AVE 98104	13	1317	185	5	71	490	61	52
5	601 1ST AVE 98104	1	1631	113	319	196	287	5	66
6	1520 3RD AVE 98101	1	1863	232	494	290	145	110	46
7	1415 WESTERN AVE 98101	1	1941	409	288	150	132	17	211
8	2106 2ND AVE 98121	1	2015	551	187	31	444	97	70
9	705 2ND AVE 98104	20	1215	289	124	71	630	90	23
10	820 2ND AVE 98104	1	767	759	3	480	253	108	69

*Distance is in estimated feet

ARE OFFICE TO RESIDENTIAL CONVERSIONS VIABLE FOR SEATTLE?

Office to residential conversions would help the city's housing shortage, but it would ultimately be a small percentage of the total amount of new housing needed to support the city's continued prosperity. Persistently high office vacancies challenge a city's commercial real estate ecosystem, downtown vitality and tax revenue. Seattle, like most other major cities, has relied heavily on commuting workers to foster a successful metro. But that fundamental draw has been challenged for some time, and in response, the city should do everything it can to promote a live-work-play society that incorporates all the necessary amenities to attract and keep its vibrant communities afloat. Recently, the city approved a sales tax exemption for such projects, and an office to residential conversion competition was held to promote ideas for creating more housing at the Mutual Life Building, Smith Tower and others. But these projects will only commence if the economics work.

On which assets might be more profitable for developers—affordable housing or luxury condominiums—a recent report published by Moody's Investor Service estimated that a handful of defaulted CMBS office properties that featured substantial value depreciation would make the math work if they are converted to luxury condos rather than mixed-income rental apartments with affordable housing allocation, but even this will depend on sources of funding. The report assessed average appraisal value declines of 35% (for the 78 properties that have had a second appraisal), ranging from 1% to 85%. Funding help is available at the federal level in the form of the Low-Income Housing Tax Credit (LIHTC), Railroad Rehabilitation & Improvement Financing (RRIF), and Transportation Infrastructure Finance and Innovation Act (TIFIA), which can trim total purchase price as well as some hard and soft costs for most properties in Seattle's metro area.

Ultimately, converting vacant office space will not solve the metro's housing troubles entirely. It will help, but it's just a drop in the bucket compared to what is needed to relieve rent pressures and support a growing economy. That being said, it is probably the most efficient use of a cities infrastructure—as all metro's need to constantly adapt to its ever changing population's needs. As long as the fundamentals of a tight housing market, high office vacancies, flexible zoning, and adaptive public support remain, we expect more of these projects to pop up in the coming years.

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