The Case for Conversion

Owners add value by repositioning single-tenant office assets as multitenant properties.
By Reed Miller and Ken Boyle

In today's economy, owning or leasing your own building is a luxury that few companies can afford. Most corporate real estate budgets have been slashed and companies are cautious with the dollars they spend and the real estate they choose to occupy.

To reduce costs, companies that formerly occupied their own buildings exclusively are now open to sharing space in multitenanted assets. Some single-tenant occupants are considering ways to downsize by either subletting or restructuring their existing leases to give back space.

Companies with new space requirements that previously would have developed build-to-suit properties now are looking at available space in multitenant properties.

As a result, property owners have an opportunity to turn single-tenant buildings into multitenant assets that better fit the needs of today's office space users. In our experience, such conversions are tremendous value-add propositions: They lessen the risk of being dependent on one tenant, and they offer a chance to reconfigure space for today's market as well as for less-typical tenants. In addition, owners can replace mechanicals, add sustainable features, reconfigure common areas, and upgrade finishes to make a property more competitive in the leasing market. For former single-tenant corporate owners or users, this arrangement allows companies to focus on their core business operations, eliminate their real estate responsibilities, and reduce occupancy expenses.

For real estate owners with long-term hold strategies, this is a great way to recession-proof office properties against today's uncertain economic outlook. We look at three properties we have converted from single-tenant to multitenant use to meet the growing demand for downsized, shared office space arrangements.

Getting In-Shape

Previously net-leased to Wells Fargo, a seven-story, 87,000-square-foot office building in Stockton, Calif., was repositioned as a multitenant office tower. We negotiated new direct leases with several of the subtenants and a major long-term lease with regional fitness company In-Shape to occupy almost 34,000 sf, including a ground-level state-of-the-art fitness center and two floors for its corporate headquarters.

We completely demolished and rebuilt several floors in a staged process and then relocated the tenants as the new space was completed. While this complicated sequencing proved challenging, all of the tenants are now occupying first-generation space.

We also renovated the lobbies and bathrooms to make them more suitable for shared tenant use. The final touches, including a new main lobby entrance and elevator upgrades, are expected to be undertaken in the near future.

In-Shape Fitness opened its facility in January. Other tenants include law firms and county government offices, drawn by the property's location near the courthouse. The building has been credited with breathing new life into downtown Stockton, and the tenants are pleased to have an updated facility with a health club in the building.

What's Cooking?

In San Antonio, Texas, we acquired two 60,000-sf office buildings last year that were net-leased to a large regional bank. Both buildings contained bank branches and the older of the two would have been difficult to re-lease as bank space. It did attract a culinary school however; after the school signed a 10-year lease, the bank was converted into kitchen and restaurant space and the upper floors were converted into classroom space. In addition, both buildings' common areas and building systems were upgraded to meet multitenant needs, and more than half the leasable area has been rented.

Marathon Project

One of our more notable transitions was the Marathon Oil Tower in Houston, Texas, which we successfully converted several years ago from a single-tenant net-leased 1.1 million-sf, 41-story office building to a multitenant facility. Over the years, the needs of Marathon Oil changed and as they required less and less space, they sought to sublease to other companies to offset expenses. This was not a situation they wanted to continue. We negotiated a mutually favorable transaction: Marathon signed a new long-term lease for approximately two-thirds of the building, and we assumed the management and leasing, which aligned with our ownership position. Following this restructuring, we evaluated and renegotiated lease agreements with several of the subtenants and entered into several new leases with highly respected companies. We invested millions of dollars into upgrading the property and making it more appropriate for shared use. We also took the opportunity to identify and implement cost-effective energy conservation measures, which included upgrading the lighting and mechanical systems.

Analyzing the Asset

For owners considering transitioning properties to multitenant status, in-depth property evaluation is essential, as not all properties are candidates for conversion. Unusual mechanical or physical characteristics might make them a poor fit at best. In addition, a property must be well positioned in its market so that a variety of tenants will be attracted to its location. Shallow or thin markets, or those dominated by a single industry, need to be carefully assessed.

The property's mechanical and structural systems require special attention to determine, in a cost-effective manner, whether they can meet the needs of the redevelopment. Poorly designed or improperly maintained systems will result in uncomfortable and angry tenants, causing damage to a building's reputation that shiny new lobbies can't offset.

During the actual transition, focus on the common areas, such as lobbies, elevators, and restrooms, to ensure that the space flows together and provides a comfortable atmosphere for the various tenants. Also establish a new set of building standards and finishes that are in keeping with the character of the building and market. This allows tenants to customize offices to fit their needs.

Assemble and rely on a qualified, experienced team of local professionals, such as brokers, architects, engineers, and project managers, to discuss repositioning options. Their input will be of great value when brainstorming and implementing the repositioning strategy. This initial design and idea-gathering phase consumes the most time. All ideas are discussed and vetted and evolve slowly. When you have identified an anchor or large tenant, ideas start to take shape more quickly to accommodate them. Accordingly, a conversion can take anywhere from a few months to well over a year.

Executing the Plan

As a value-add commercial real estate company, Hanover Real Estate Partners funds its own acquisitions and renovations. As part of our strategy, we also negotiate long-term leases and create a marketing plan for every property, working with local brokers to ensure they are familiar with our plans for the updated property and the various ways it could be used. We host broker lunches at the property so that they can get a feel for the space and review architectural renderings or models that illustrate how the space can be transformed to accommodate a particular tenant's needs. As owners who are active in the management, operations, and leasing of our properties, we take pride in attending and participating in various local activities.

It's also important to be responsive when introducing a property to the market. Local tenants and their representatives need to know that although we may not be located in their market, we respond promptly to requests or problems.

While a single-tenant building is far less complicated to own and manage, in today's market it is much easier to re-tenant a building with multiple tenants than it is to find another single large user. By focusing on converting single-tenant net-leased buildings into multitenant buildings, we are able to lower the risk associated with single-tenant properties and provide diversity and stability.

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Changing Corporate Needs

The working patterns of American corporations have changed dramatically over the past few years. Many companies have downsized, reducing the amount of required square footage. The evolution of mobile technology also has allowed a growing number of employees to work from home or remote offices. Reports predict that in 2010, the number of workers telecommuting at least one day a week will rise above 100 million, compared with just 4.4 million in 2003, according to the American Interactive Research Group.

Fewer workers in the office creates different space requirements. Some companies have opted to increase the amount of commuter space they offer, so telecommuters lose their full-time space and use common space when in the office. This means less office space is required and more cubicles or open, shared desk space is needed. In addition, some companies now require space for teleconferencing, social gatherings, even child care, in some instances.

In the current economic environment, companies are now more open than ever to sharing their office space, offering underutilized or shadow space for sublease. Since most companies lack expertise in marketing this space, there is an opportunity for real estate operators and owners to help manage the process. Restructuring net-leased properties provides these companies with an exit strategy that enables them to significantly reduce their leasing costs. These companies can refocus their efforts on their core business operations while we focus on our core business, commercial real estate.