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# The Highest and Best Use of an Office Conversion

There are physical difficulties to a conversion plus financial constraints.

By Joseph J. Ori | December 14, 2023 at 07:10 AM

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The highest and best-use concept in the CRE industry is one of the key economic/investment principles in the sector. It posits the idea of maximum productivity and profit for a given parcel of land. In the CRE appraisal process, the appraiser first determines the highest and best use of the land and building. The appraiser then determines how the highest value for a property is arrived at and how it produces the greatest value, regardless of its actual current use.

A piece of land and related property may be considered to be its highest and best use when it provides the maximum return to its owner or user. The return may be measured in monetary terms, or intangible and social ways, or a combination of such values. However, the value of a piece of land is not static and can change over time. The highest and best use of a property at any point in time is derived from four qualities as follows:

- Legally allowable under local laws and regulations
- Physically possible use of the subject land and building
- Financially feasible for the use of the subject land and building
- Maximum utility/profitability for use of the land and building

In today's struggling CRE market, the highest and best-use concept has been put to the test, with hundreds of office properties around the country ripe for changing from their former use. During the last ten years, there have been two

large changes in use for many CRE properties. The first is the conversion of former commercial sites such as gas stations, older urban office buildings and suburban strip retail centers into high-rise and garden apartment projects. The other and more dramatic, highest, and best-use change is older suburban mall properties that are being converted into industrial, office, hotel, medical office, food courts, fitness centers and bowling alleys. Today, there is a new highest and best-use conversion, office buildings in urban cities to apartments or in some cases hotels.

The major reasons for the highest and best-use conversions in the office sector are the tremendous loss of value of many older and physically obsolete buildings, a change in tenant demand for these properties and potentially higher rents for the conversion of these office buildings into multifamily rentals. Since most of these properties are located in dense urban cities, the change in demand is primarily for apartments and to a lesser extent, hotels. However, the physical process of a conversion to apartments is fraught with risk, can be very expensive and physically challenging and maybe only 10% of office buildings may qualify for this highest and best use change.

Most older office buildings that are candidates for conversion have large floor plates of 10,000 to 25,000 square feet. This requires a new central core, typically around the elevator shafts to provide light and windows for the apartment units on the interior of the building. Many local building codes require that apartments have windows for safety reasons. Each floor will need additional HVAC and plumbing for each unit, which is an expensive endeavor. It can also be difficult to redesign existing office spaces with residential-type windows, common amenities and create a property that is aesthetically attractive.

Outside of the physical difficulties of a conversion, the other major obstacle to these conversions is being able to purchase the existing and obsolete office building at a deep discount and close to the value of just the land for the financial economics to work. Most of the buildings that are viable for this conversion will be distressed assets, either in default or foreclosure and the buyer will need to acquire the asset for no more than one and a half times the land value. This value will provide the buyer with a low enough basis to take the physical conversion, lease-up and financing risks of the project. The concept of the highest and best use is the economic foundation of the CRE investment business. Seeking investments that can be converted to a higher and better use is another way to create value and profits in today's competitive real estate environment.

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