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Apartment conversions too costly for Baltimore developers

Premium content from Baltimore Business Journal by James Briggs, Reporter
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Despite a surplus of downtown highrises prime for apartment conversion, brokers and developers say economic realities have strangled a would-be solution for Baltimore's swelling office vacancies.

That could change, though, as City Hall turns its attention toward making office conversions more financially feasible.

Kirby Fowler, president of Downtown Partnership of Baltimore Inc., said Mayor Stephanie Rawlings-Blake is preparing an incentives package for developers interested in transforming office towers.

"I believe she has something significant in mind," Fowler said, adding Rawlings-Blake also is weighing incentives for new construction.

Mayoral spokesman Ryan O'Doherty could not be reached for comment.

Devising incentives to spur residential redevelopment would fit with the mayor's plan to bring 10,000 new families to Baltimore. Rawlings-Blake in her State of the City address said she was working on "new ideas, both large and small, on how to attract and retain families."

Downtown Partnership has promoted office conversions as part of its strategic plan. The city has capacity for about 2,000 additional apartment units, Fowler said.

Baltimore has attracted plenty of interest among developers eyeing the city's aging, and increasingly empty, Class B, or second-tier, office stock.

Those buildings, though, continue to garner little interest from prospective office tenants. The Class B vacancy rate in the city's core was 27.8 percent in fourth-quarter 2011, with Class A vacancy at 24.3 percent, according to **MacKenzie Commercial Real Estate Services Inc.**

Colliers International is negotiating with several buyers interested in turning the vacant building at 114 E. Lexington St. into residential units, said Robert A. Manekin, managing director of the brokerage firm's Baltimore office.

"I think you're going to see action in the next three to four months," Manekin said of the former **Provident Bank** building.

The 217,000-square-foot building is one of at least three downtown office towers — including 10 Light St. and 10 N. Calvert St. — that Manekin said could be perfect candidates for residential conversion.

The case for incentives

Such activity, though, is likely to be sparse and perhaps foolish unless the city follows through with incentives, said David Hillman, CEO of **Southern Management Corp.**

During the past decade Hillman has redeveloped four office buildings into apartments, including the Standard Oil Building on St. Paul Street and 39 W. Lexington, the former headquarters of **Baltimore Gas & Electric Co.**

None of the projects has turned a profit, Hillman said, adding the building at 39 W. Lexington, which opened as apartments three years ago, has been a "total loser," bleeding $2 million of red ink in 2011.

"We're feeding it vast sums of money every month," Hillman said. "The building is under water. If we didn't have a profitable company, it would be a very troubled asset."

The Munsey Building, an 18-story property at 7 N. Calvert St., was the city's first major office-to-residential conversion. Redeveloped by **Struever Bros. Eccles & Rouse Inc.**, the property has struggled through high vacancy rates and financial turmoil since opening as market rate apartments in 2002. Federal **Capital Partners** purchased the highrise last year and hired Bozzuto Cos. to turn it around.

Mark Caplan, president of WPM Real Estate Group LLC, an Owings Mills investment firm focused on residential property, said simple math suggests any developer would face similar challenges in converting an office building.

Construction costs average between $100 and $125 per square foot to turn offices into apartments, Caplan said. That means a developer would have to spend as much as $27.1 million to convert the office building at 114 E. Lexington.

Mike Muldowney, executive vice president for **CBRE Group Inc.'s** Baltimore office, said rent for downtown buildings — several blocks from the harbor — goes for between $150 and $160 per square foot.

"Does that justify the cost of conversion from office to rental?" Muldowney said. "My position is, if it did, you'd see more of that going on."

Making the math work

Compounding the problem is that the state historic tax credit — which has aided most, if not all, of Baltimore's major office conversions — is virtually defunct for developers. The state has renamed the tax credit and whittled it down from $30 million in 2006 to $7 million this year.

Hillman, who received multimillion-dollar tax credits on all of his office-to-residential projects, said such conversions have almost no chance for financial success in the current climate.

"Without that subsidy," he said, "they don't work."

The city, though, might be ready to step up and help developers.

Along with Rawlings-Blake's emphasis on housing, Baltimore City Councilman William H. Cole IV has called on city officials to consider what they can do to help developers tackle challenging projects in the city's traditional downtown.

If there are opportunities to transform buildings into vibrant new uses, Cole, whose district includes downtown, said all options should be on the table.

"If it's about helping business owners do the conversion to residential, or do renovations," Cole said, "we have to look at incentives and be as supportive as humanly possible in making things happen."

Besides incentives, Manekin said there are other factors that can make conversion projects more economically palatable. If, for instance, a developer can purchase a building at low cost, maximize the number of units and draw parking revenue, the math can make more sense, he said.

Despite the challenges, Manekin said he thinks construction could start on 114 E. Lexington St. as early as this year, with other downtown buildings lending themselves for future projects — so long as developers find them economically viable.

"There are clearly office buildings that are ripe for that kind of development," Manekin said. "The adaptive reuse of those buildings will add to and enhance the livability and economic vitality of the city of Baltimore."