Here's Why More Corporate Campuses Are Getting Warehouse Conversions

Rising Industrial Property Demand Tips Scales for Developers Eager To Overhaul Office Parks

By Katie Burke and Ryan Ori

When insurance giant Nationwide vacated one of its corporate hubs in Harleysville, Pennsylvania, to kick off a $20 million renovation in 2019, there was no indication the project would coincide with a sudden deterioration of the global office market.

Fast forward nearly four years, and the company's roughly 50-acre campus in suburban Philadelphia is now being redeveloped into an industrial complex. It's one in a growing number of conversion projects in previously top-tier office markets as the demand for warehouse and logistics space far outstrips that for traditional office properties.

Developers across the United States, in regions as varied as the San Francisco Bay Area and greater Chicago, are capitalizing on pandemic-related shifts that have resulted in hundreds of millions of square feet of vacant offices that, thanks to rising demand and pricing for industrial property, are now financially feasible to overhaul into logistics space in markets that just a few years ago weren't practical.

Put another way, even though high interest rates have made commercial real estate deals more expensive, developers have been willing to take on the cost of industrial conversions. That's thanks to a combination of high rents and the potential to exit their investment with a higher sale price that reflects increased valuations for logistics properties.

"We can make these deals pencil now because of the acceleration of industrial rents, especially for high-end industrial and flex space," Velocity Ventures founding partner Zach Moore told CoStar News. "There's a major movement in pricing that is driving the opportunity, which was never a possibility before."

While there are still plenty of development and legislative barriers to overcome, the rate of office-to-industrial conversions has gained momentum in recent years as pandemic-related shifts to remote work — and now layoffs — reduce office demand. That comes as widespread real estate consolidation and a desire for higher-quality buildings have accelerated the obsolescence of some older, sprawling office properties with fewer amenities.

More than 15.2 million square feet of office space is now being converted into logistics use, according to Newmark and CoStar data. Most of that is concentrated in markets where density and land constraints have pushed demand for industrial space higher than the years before the pandemic.

But it's still early days for this trend, and not all local officials are interested when they hear about an industrial property proposal for a residential area.

When it comes to the increasing number of office-to-industrial conversions, “the trend is still relatively niche, but overall, industrial is one of the most desirable real estate classes, and demand has held on when compared to other asset classes,” said Liz Berthelette, Newmark's director of research.

She added that “this will all play out even further in markets where office vacancies have increased, especially in coastal or dense markets where development is more difficult and land is relatively scarce and expensive. A lot of these office properties are becoming more functionally obsolete, and that makes them more attractive for industrial developers.”

Shifting Demand

One such developer is national industrial real estate firm Dermody Properties, a Reno, Nevada-based company expecting to spend hundreds of millions of dollars to acquire underused office campuses from the likes of tech giant Amazon and and insurer Allstate to transform them into higher-demand warehouse space.

The firm — which is helping to legitimize the office-to-industrial-conversion investment — is scouring the country for similar deals it made in the Chicago and San Francisco areas as prospective warehouse tenants jockey for spaces closer to customers’ homes.

Dermody paid more than $230 million last year to acquire Allstate's sprawling headquarters campus in Chicago’s northern suburbs, where it already is in the process of demolishing 1960s and ’70s office buildings and replacing them with more than 3.2 million square feet of logistics space. It is also preparing to close on a deal with Amazon for an office campus in Milpitas, California, the retailer recently acquired but never occupied.

“This is unprecedented territory for us to think that sites like the Allstate campus are in play for us,” Doug Kiersey, Dermody’s president and CEO, told CoStar News. “It’s a very new phenomenon. It’s driven by the two secular changes, how we shop and work from home. Before the pandemic, taking a site like the Allstate site, it had never occurred to me in the 10,000 times that I’d driven past that campus that it could be available for logistics development.”

When the highest and best use for a site becomes industrial, sometimes that involves repurposing existing office buildings into ones that can accommodate light industrial uses, while other times it could mean demolishing the property altogether to capitalize on the land and its location.

In the Silicon Valley suburb of Milpitas, for example, annual rent growth for office space has fallen about 2.5% over the past year, according to CoStar data. Annual rent growth for industrial properties, by comparison, continues to climb, with rates up about 8% over the past year.

Nationally, annual industrial rent growth has surpassed 10.5%, according to CoStar data. And with leasing volumes still setting unprecedented highs, industrial developers and landlords are betting there is still plenty of room to grow.

“It’s really a tale of two worlds,” fellow Velocity founding partner Tony Grelli said. “You hear all the doom and gloom about the financial markets, but then you talk to our tenants and the vast majority of them are doing better than they ever have. At the end of the day, industrial demand is still there — long, long, long runway to continue to be able to climb.”

Rebalanced Formula

The pricing dynamics for new industrial construction have long favored ground-up development. However, strengthened demand — coupled with disintegrating rent growth across most major office markets — has meant that’s no longer the case.

“We’re able to buy a vacant office building today for a comparable or less expensive amount to build a shell industrial building,” Velocity’s Moore said. “Most of our competitors, in order to build new product, have to buy the land, entitle it, build the project and then stabilize it, which can take about 24 to 36 months. With conversions, we can identify former office buildings and go through a six to nine-month redevelopment process. It’s one of the reasons we do it, because it’s incredibly fast.”

Within the past couple of years, plans to transform high-profile office campuses into new industrial uses are unfolding across sites that previously housed companies such as Novartis and Toys R Us in New Jersey as well as medical products company Baxter International in Deerfield, Illinois.

Office-to-logistics conversions could amount to up to 80 million square feet of future industrial space, according to research from Prologis, one of the world’s largest industrial developers and landlords. Warehouse and distribution properties require sites with 8 or more acres of land though, a specification that cuts out a significant chunk of potential conversions.

About 27,000 office buildings in the U.S., or roughly 1.2 billion square feet of ground-floor real estate, include the land necessary to convert them into potential logistics uses, according to data from CoStar and Prologis.

Beyond the location, existing office properties typically include infrastructure and facilities that can be repurposed for future industrial use, Moore said. Sure, the second-floor mezzanines and other features of an aging office property need to be stripped out, but retaining features such as sewer lines, electricity, gas and plumbing can save even more time and money.

“Building an industrial box is one thing, but building it with all the systems in place is exponentially more expensive,” the Velocity partner said.

The increasing number of logistics conversion projects over the past year is “significant to note,” Newmark’s Berthelette said, adding that the advent of last-mile distribution has been an important catalyst for developers looking to capitalize on demand in large coastal markets with high land values and otherwise limited industrial supply.

As for locations near major ports, arterial thoroughfares and affluent markets with plenty of acreage, “10 to 15 years ago the best and highest use in some of these locations was office or residential, but now it’s distribution.”

Legislative Hurdles

The economics of office-to-industrial conversions are shifting in favor of developers, but the realities of convincing local municipalities and communities remain a challenge.

Developers such as Velocity and Dermody have dealt with issues including zoning and entitlement complications as well as government officials concerned about losing the prestige of a Fortune 500 headquarters. Even so, their willingness to endure those potentially prolonged challenges is further testament to the historically high demand for industrial property.

“It’s not about convincing these municipalities, it’s more about educating them on what’s happening with commercial real estate and walking them through the shifts with office and industrial demand,” Moore said.

That can mean explaining when it comes to developing properties for advanced manufacturing companies, smaller logistics operators and other tenants are willing to pay a premium for space to compete with larger industrial users, he added.

“Most city officials then realize they have to do something, because office isn’t coming back the way it used to. We tell them these large, vacant office properties will become problematic assets, and the best opportunity for the site today that will have the least impact on the neighborhood is to convert it to a high-end industrial facility,” Moore said.

Before pursuing any conversion project, Dermody’s Kiersey said the firm meets with local officials to see if they’re receptive to a new use. It makes the case that a logistics facility will generate less traffic than an office campus would have at its peak usage, Kiersey said, adding that, unlike residential developments, industrial projects don’t create concerns about overburdening local schools with new students.

“You don’t want to force yourself on a community,” Kiersey said. “You want to go where you’re wanted.”

National industrial demand has tapered off from its previous record pace as a confluence of macroeconomic factors including interest rates, high construction costs and consumer confidence concerns have complicated real estate deals. Even so, Kiersey said he remains confident in projects such as the Allstate campus conversion and expects to have some leases in hand before completing the first speculative phase of construction.

What’s more, he’s still on the hunt for future deals. Some days, that means driving around entire office markets looking for outdated buildings sitting on large parcels of land, “where you know the site is worth more dead than alive.”

Kiersey joked that “I liken it to pigs who sniff out truffles in the forest. We’re kind of like truffle hunters looking for something valuable, looking for that five-pound truffle.”