When Retail-to-Residential Conversions Make Sense

Sometimes they do but there are definitely challenges to this process.

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There has been much discussion around converting older office buildings into multifamily residences. Less has been said about a similar strategy for retail that has become obsolete but many of the same advantages and disadvantages apply here as well.

The successful redevelopment of a commercial property or underutilized site can pay significant dividends for a real estate owner. Exploring what the highest and best use of a particular property can mean the difference between an investment that cash flows and one that sits vacant. If an owner has an under-leased or underutilized retail property, for example, converting a portion of it to multifamily or mixed-use introduces an immediate and direct customer base for the remaining stores. In other scenarios, investors may have small-footprint properties on large parcels of land. By demolishing the existing improvements and building vertically, the increased density translates to increased value.

Not every underutilized commercial asset, however, is a good candidate for redevelopment. Several characteristics may limit – or even prevent – the possibility of repositioning a property. First is the size of the parcel. Some parcels may be too small to accommodate multifamily construction. Consider a one-acre outparcel to an anchored shopping center. It may be sitting vacant, undeveloped, and therefore underutilized, but a parcel this size in most locations would not be able to accommodate apartments in addition to all the required or expected amenities, such as covered parking or a swimming pool. Generally speaking, investors should refrain from considering a multifamily development if their parcel is less than one and half acres at a minimum, with exceptions for highly dense urban areas. On the flip side, some larger urban tracts can be ripe for large scale mixed-use redevelopment, which generally have a large multifamily component.

Location is also a consideration. Proposed developments located further away from commercial corridors may meet resistance from established neighborhoods, be limited by zoning and use restrictions, or encounter other challenges that would prevent the project from going forward. It's also possible that residential tenant demand could be lower if a property isn't well located or easy to access.

Economics presents yet another challenge for investors. Rent comparables in the immediate area must be able to support a new development. Constructing a new multifamily community can be extremely expensive, and if a proper market analysis isn't conducted in advance, an investor may not get the deal to pencil.