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Project name:
Feasibility Analysis of Adaptive Reuse Projects
Supported by the Proposed ARO Update

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Memo

Subject: Preliminary Findings, Feasibility Analysis of Adaptive Reuse Projects Supported by the Proposed ARO Update

The City of Los Angeles Department of City Planning (LACP) has engaged AECOM to prepare economic analysis to inform policy development for the Citywide Housing Incentive Program (CHIP). The analysis contained in this memorandum represents preliminary findings from Task 8: Analysis of Adaptive Reuse Developments and Policy Recommendations in AECOM's scope of work. The purpose of the task is to:

1. Explore the economic feasibility of the proposed Adaptive Reuse Ordinance (ARO) update by analyzing three prototypical development projects; and
2. Test the capacity of the prototypical development projects to support a mandatory affordable housing requirement.

This memorandum is a precursor to a final report, which will feature an expanded discussion of project methodology, more detailed and possibly refined findings, and a complete technical appendix.

Adaptive Reuse Ordinance (ARO) Regulatory Framework

The proposed update of the Adaptive Reuse Ordinance expands on the original ARO, which was adopted by the City of Los Angeles in 1999. The original ARO provided a schedule of incentives the key provisions of which were:

- Eligible area covered Downtown Los Angeles (expanded in 2003 to include Hollywood, Wilshire Center/Koreatown, Chinatown/Lincoln Heights, and the Figueroa and Central Avenue corridors in South and Southeast Los Angeles)
- Eligibility of all buildings constructed before July 1, 1974
- Allowance to convert commercial to residential uses subject to maintaining an average unit size of 750 square feet and minimum unit size of 450 square feet
- Permission to build mezzanine space
- Exemption from the site plan review process
- Exemption from minimum parking requirements
- Permitted retention of non-compliant floor area, height, and setback conditions

The 2024 ARO update proposes to expand the incentive schedule in meaningful ways by:

- Enabling buildings aged 15 years or older to qualify for by-right review (while retaining Planning review for buildings under 15 years old and for historic resources)
- Expanding geographic eligibility beyond the 2003 boundaries to include the entire city
- Eliminating unit size requirements (both average and minimum) and allowing more flexibility to construct full intermediate floor levels for optimization of floor space within the existing building envelope
- Allowing a rooftop addition to be used for shared amenity space without counting towards FAR or overall building height
- Creating greater flexibility for Unified Adaptive Reuse by leveraging infill development alongside adaptive reuse projects

Methodology

To illustrate the opportunity represented by the ARO update and the capacity of an ARO project to support an affordability requirement, AECOM tested the development economics of three potential adaptive reuse projects. The project typologies were developed with input from City Staff to represent key opportunities for adaptive reuse. For each prototype, gross area remains the same between the initial and converted uses. While some adaptive reuse opportunities may add gross area through additional stories or adjacent construction, such projects are not tested here, as they reflect idiosyncratic and non-standard approaches. It should be noted in general, however, that while the tested typologies are examples of projects that might be enabled by the proposed ARO update, they do not represent the full range of potential projects.

The three project typologies include:

- Typology 1: High-Rise Office Tower to Residential
- Typology 2: Suburban-Style Mid-Rise Office to Residential
- Typology 3: Legacy Low-Rise Retail to Residential

Each project typology is tested as an all-market-rate project and under different affordable set-aside scenarios. The affordability scenarios reflect the minimum set-asides by affordability category to qualify for benefits under the City's Transit Oriented Communities (TOC) program:

- 8% of units as extremely low income (ELI)
- 11% of units as very low income (VLI)
- 20% of units as low income (LI)

Each scenario is tested using assumed rents at four Market Tiers representing submarket strength, where Market Tier 1 represents the lowest area rents and home values across Los Angeles, and Market Tier 4 represents the highest rents and home values. Cost assumptions include typical underwriting inputs for direct and indirect costs. In addition, the affordable housing linkage fee and ULA taxes are applied where appropriate.

The output of each scenario is residual land value (RLV). Residual land value is the value that remains after estimated development costs (excluding the cost of the underlying land and improvements) is deducted from estimated sale proceeds. Estimated scenario residual land value is compared to values of recent land transactions observed in the market. If the estimated residual land value is consistent with observed market land value, the scenario is considered feasible.

Prototypes Tested

AECOM based the high-rise and mid-rise office-to-residential prototypes (Prototype 1 and Prototype 2) on project examples found in the Los Angeles area. Each prototype assumes site characteristics generally considered necessary for a feasible office-to-residential adaptive reuse project. These characteristics include:

- Sufficient structured parking for a fully parked residential project
- Minimum floorplate depth of less than 100 feet
- Gross area less than 500,000 square feet

The retail-to-residential prototype (Prototype 3) is based on a white-paper concept developed by the design firm Omgivning. Like the office-to-residential prototypes, the retail-to-residential prototype assumes site characteristics believed necessary for adaptive reuse including sufficient structured parking for a fully parked residential projects and sufficient gross area to support creation of a fair number of units.

Findings

Prototype 1: Office High-Rise to Residential: The all-market-rate scenarios as tested are infeasible in Market Tiers 1-3 and borderline feasible in Market Tier 4. Compared to the all-market rate scenario, ELI and VLI scenarios generate 20% less residual value, and the LI scenario 37% less value.

Prototype 2: Office Mid-Rise to Residential: The all-market-rate scenarios as tested are infeasible in all Market Tiers. The market rate scenario generates the highest value per built square foot while the ELI scenarios give up about 33% of value, VLI loses 37%, and LI loses 42%.

Prototype 3: Low-Rise Retail to Residential: The all-market-rate scenarios as tested are feasible in Market Tiers 3 and 4, and the ELI scenario is feasible in Market Tier 4. However, the low-rise retail-to-residential conversion may not be the highest and best use for the prototypical site, as legacy strip center retail offers many advantages for residential infill for developers interested in maximizing available FAR, which typically is at least twice that of the existing retail use. A comparison of Prototype 3 RLVs with estimated RLVs for potential townhome, courtyard, and podium projects shows that new build scenarios generally outperform the adaptive reuse scenarios.

Sensitivity testing of key input factors indicated two variables in particular that could have a meaningful impact on feasibility. The first concerns unit size. Under the current ARO, project units must average 750 square feet and be a minimum of 450

square feet. The proposed ARO update would eliminate these requirements. As tested, lowering the average unit size (to 600 square feet for each prototype) has a substantial impact on feasibility, because smaller units typically command a higher rent per square foot than larger units.

The other key variable concerns capitalization rates. Capitalization rates are a measure reflecting how the market values the cashflow a project generates. Lower capitalization rates correlate to higher value, and higher rates to lower value. The strong real estate market that preceded the pandemic, fueled by institutional investors seeking reliable investments in an otherwise volatile market, led to an unprecedented reduction in residential capitalization rates resulting in high valuations for completed projects. Should current capitalization rates fall to pre-pandemic levels, the financial feasibility of adaptive reuse projects (and all residential real estate in general) will increase substantially.

Implications for Adaptive Reuse Feasibility

The market analysis found that only Market Tier 4 rents in the all-market-rate scenarios generate consistently borderline feasible results for office-to-residential prototypes, and scenarios with affordable set-asides further underperform this standard. This reflects the general challenge presented by adaptive reuse projects, which typically must be undertaken and financed assuming the highest potential rents to account for risks inherent in converting an existing structure.

In general, market land costs for office entities need to fall substantially below current rates to support a larger volume of office-to-residential adaptive reuse. This is somewhat unlikely in the current office market, even with high office vacancies, because office owners can usually achieve cash flows from office rents (which are higher than multifamily rents) to pay off existing debt without taking on the risk of conversion.

As tested, the all-market-rate retail-to-residential prototype slightly outperforms the office-to-residential prototypes. However, comparison with ground-up infill alternatives suggest that in many—and possibly most—cases, the market will elect to redevelop legacy strip center and inline center retail by demolishing existing improvements to make way for ground-up infill development rather than adaptively reusing it.

The most important element predicting success of an ARO project is the condition and characteristics of the existing building(s) and site improvements. The building form should allow internal partitioning that yields units with marketable size, proportions, and amount of window area. The structure should require minimal amounts of reinforcement, and on-site parking should be sufficient to not require additional construction. Given these requirements for existing buildings to be deemed suitable for adaptive reuse, the pool of eligible properties is necessarily limited. Consequently, the proposed ARO update provisions to expand the geographical area and age of eligible properties should also expand the supply of eligible properties meaningfully.

As noted above, most all-market rate scenarios as tested are infeasible in most market tiers, and all scenarios with affordable set-asides perform even worse. Given the challenges in finding suitable buildings for conversion, an affordable housing mandate would render even more potential sites infeasible for conversion. Nonetheless, the proposed incentives in the current draft Citywide Adaptive Reuse Ordinance, together with the proposed elimination of minimum unit size and average unit size requirements, should provide greater flexibility for adaptive reuse conversions. Adding smaller units to the mix can contribute to feasibility by increasing the share of higher-rent units and by allowing developers additional flexibility to creatively partition and program an existing structure.