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Converting Older Single-Tenant Facilities to Multi-Tenant Facilities

By Steve Bergsman

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When it comes to converting an older, single-tenant, manufacturing plant into a modern, multi-tenant facility, the question that sometimes arises is whether the building may just be too old and should be torn down instead.

If you ask that question of

Anthony I. Mancuso, CBR, SIOR, President of Mancuso Commercial Realty, who has worked on projects from 80 to one million square feet in the Batavia area for the last 23 years, he would tell you that age is not a factor in determining whether there is a second life for a single-tenant plant. After all, he has successfully converted a 200,000-square-foot building where the core structure was 120-years old.

"We knocked down part of the building, re-skinned elsewhere, and there are still sections that are more than 100-years old," he says.

Now, when he considers a conversion, he looks at location, accessibility, and whether the facility is single-story. That's because most tenants taking up space in converted structures will probably be in the distribution end of the business, and that means the facility has to be close to highways, afford easy access to large trucks and be spread across just one floor.

"Location, loading area, and parking are all critical areas,"

adds **Steven H. Podolsky, SIOR,** whose Podolsky Northstar Realty Partners can be found in Riverwoods, Illinois. "Another key point is access. If the building is tight to the site, where you can not run roads around it, have parking or extra land for truck access and trailer storage, then you might have to look at tearing down part of the building."

Less Is More

Podolsky is an advocate of "having to subtract to go forward." For example, he has worked with a 500,000-square-foot structure where almost 80,000 square feet had to be taken out to create the access that was needed.

Sometimes an initial "subtraction" yields more usable space. There is an old adage in the business of transforming single-tenant facilities to multi-tenant—rectangular is good, square is bad. In a square, a lot of dead space is left in the center after subdivision is completed. So what do

you do with a square building? The obvious solution is to tear out the middle and create two buildings, which is what clients of **Todd M. Barton, SIOR,** of CB Richard Ellis, did in Atlanta.

The first building he brokered was a 220,000-square-foot facility in Atlanta that was being converted from single-tenant to multi-tenant. "Typically a single-tenant facility has been set up for particular user need and might, for example, have 8 to 10 docks all on one side of the building. While the other side abuts the property line." Barton observes, but in a multi-tenant building, "each tenant is going to want a similar box and office pod." The investors elected to remove a portion of the middle of facility, thus creating more usable space.

This technique works with smaller buildings as well. Barton knows of a 60,000-square-foot, single-tenant building, where the new owners created a driveway right through what was once the center of the structure.

What Happens in Rehab?

M. F. DiScala and Company, Inc., in Norwalk, Connecticut has purchased and redeveloped a great deal more than ten million square feet of existing industrial buildings. President and CEO **Michael F. DiScala, SIOR,** gives this account of the process:

First, the purchase price must be low enough to allow for the cost of rehab. While the buildings they purchase originally list at $15 to $20 per square foot, DiScala says, his firm ends up paying between $2.00 and $6.00 per square foot. "The improvement costs generally run anywhere from $10 to $18 per square foot," he says. Next, the building must have the right configuration and adequate room "to add multiple docks so the space can be broken up to sizes as small as 20,000 square feet," he explains.

"Before we begin our retrofit," DiScala says, "we gut the building completely as we find most non-structural walls are never in the right location for the next tenant so we prefer to deal with a clean canvas inside, free of as many walls as possible. We also then remove all unnecessary mechanical equipment that most likely would not be used for the next occupant."

The next steps are to:

- power wash the interior of the facility
- paint the buildings and walls white
- buff the floors
- add new lighting throughout
- add loading docks at a ratio of one dock for every 10,000 square feet.
- pay particular attention to the sprinkler system, ensur ing that it has adequate water supply and pressure.

Code issues are also important. "In most cases, we have to add adequate bathrooms," he says, and for distribution buildings, three to five percent office space usually needs to be added. "Demising walls, depending on the use, may need to be fire rated."

Turning to the exterior of the building, DiScala takes these steps:

- The exterior, including the asphalt, is completely resurfaced, where required, and restripped.
- The entire site is cleaned and re-landscaped.
- Adequate outside lights are added for security
- The exterior façade may be upgraded cosmetically with paint, metal panels, or dryvit.

- Adequate parking is ensured, not only for vehicle but also for truck storage

Further, he says, "We attempt to give identity through canopies, etc. so each tenant feels as though they have their own separate space that is clearly delineated from other occupants."

Ensuring a Profit

The final issue on any conversion is cost, because almost any building can be rehabbed into something else. The thing to remember about conversions to multi-tenant facilities is that, at least at the start, the lease rate attained will probably be less than the rates in newer buildings in the same vicinity. An old building that has been converted into a multi-tenant facility is still an older building even if it suddenly looks like a Christmas tree fully adorned.

The good news is that a lot of older plants can be bought cheaply on a square-foot basis. The bad news is, the cost of rehab is expensive and going up everyday.

In today's market, where the cost of almost everything involved in the construction process is more expensive this moment than one hour ago, keeping a lid on renovation expenses can be tricky.

Mark J. Duclos, SIOR, with Sentry Commercial in Hartford, Connecticut, shakes his head in dismay when considering a 200,000-square-foot, not so old building he subdivided recently. There was already one tenant in the building, but it didn't need all the space so the owner wanted to sublease about 87,000 square feet. A new tenant was found relatively quickly.

"We did our estimated budget, but due to the incredible increase in construction costs over the last couple of years, all the build-outs which we thought would run $200,000, came to $360,000," he says.

Fortunately, what looked like a horror story turned out to be a recoverable deal, because Duclos noticed the rising tide of expenses before the actual lease was signed. "We were lucky to have a reasonable tenant," he adds.

The two things to keep in mind are acquisition and improvement costs, reiterates **Jeffrey Bender, CCIM, SIOR,** Colliers Turley Martin Tucker in Cincinnati. "If you buy it and then find out you have to put just as much or twice as much money into the building to make it functional for multi-tenant then you may have defeated your goals."

Bender has been successful in attracting a bunch of smaller tenants to a former Levi Strauss distribution center in Florence, Kentucky, because the space was cheap. In addition, the new owners of the 350,000-square-foot structure could offer the low rates because they didn't have to put a lot of money into improvement costs.

Bender quickly found two tenants, who took 200,000 square feet, and is close to signing a third, who wants 50,000 square feet. "We quoted various deals under the assumption we were going to take this building that is 30-years old, paint the walls, paint the ceiling deck, build demising walls, take down the fluorescent tube lights, etc.," Bender explains, "but we have yet to invest that sort of money in capital improvements because these particular tenants have been happier with the low rate and [with] taking space that might not be as attractive as you could find in a newer building."

Another way Bender was able to keep the lease rate low and attractive was by offering the tenants shorter-term deals. "We decided to be flexible on lease terms," he says.

When **William E. Mears, CCIM, SIOR,** of Coldwell Banker Commercial/McGuire Mears & Associates in Janesville, Wisconsin, was hired to sell an old textile facility in his home city, he quickly realized he was put into an impossible situation. In 2003, when the owner/occupied building became vacant, the industrial market was extremely weak, the building itself was in "rough" shape, and the owners didn't want to put any money into renovating it.

The structure, an old commercial knitting facility, was located in an industrial park and, quite frankly, says Mears, was "the worst building on the street."

So he and his partner, Tom Lasse, cobbled together an

investment group and bought the facility themselves.

The first important point was being able to buy at the right price in order to afford the rehab and then lease at a discounted price to the market. "We knew we could never find someone to take the whole space, but if we could divide it up, put a fair amount of work into it, we could attract smaller tenants," Lasse notes. "We have been close to 100 percent rented since we bought it."

The second important point was positioning the building competitively. "Our advantage is we can offer space at less than what like-properties are going for," Lasse notes. And like Bender, Mears and Lasse opted to be flexible in regard to lease terms. "Someone who does not want to commit long-term can come here," Lasse notes. "We are generally short-term leases at probably 20 percent less than for what a brand new building would rent."

When DiScala has completed a conversion, he explains, he budgets about two years to occupy the space. "Our budget [is based on our renting] 80 percent of the building. There will always be a high ratio of loss because of hallways and functional obsolescence of certain portions of the building that could never be leased.

"Our target is to be able to lease the facility for 15 percent below the market for comparable space in the geographic area," DiScala says. "The buildings are bought usually on an all cash basis and at an 80 percent stabilized rent roll. We are looking for a minimum of 12 to 14 percent cap for the effort and risk. At that point, we will place a first mortgage on the property, which equals the purchase price plus all improvements, both hard and soft, so that there will be 100 percent return on our capital."

K. Cory Benson, SIOR, an industrial specialist at Boston-based Sinclair Properties also believes that in rehabilitating older properties it is critical that your development pro-forma does not overestimate the amount of achievable rent. Even if you provide tenants with all new building systems including efficient space and loading, you are going to have to offer a rent that is discounted from the going market rate. Tenants want a discount to justify moving into an "older" building regardless of the utility or value received.

Unless you have an A plus location, you probably will have provide a discounted rent—conceivably as much as 10 percent from the market rate. If you have to discount the rent much more than 10 percent, you are probably not going to make any money, unless you bought the property for a bargain price.

To minimize the discount you need to offer, it is important to address the following key building items in the rehabilitation effort:

- *Sprinkler System* – For any big building where tenants will rack product, without a doubt, it makes sense to just install a new ESFR system. Without one, it will be very hard to either land a big tenant, or to retain tenants over time. Take into account the costs that will be incurred to retrofit or install new incoming feeder lines and/or the loop system around the building. This work can be costly.

- *Electrical* – With increasing energy costs it is important to have an efficient lighting system in the facility. The old metal halide lighting does not compare favorably with the new energy efficient, cooler T-5 and T-8 fluorescent fixtures. Check them out. Efficient lighting can be a big selling point to tenants. Also many utility companies provide cash rebates for installing these efficient lights.

When installing new lighting and distributing power in the building it is also important to design a system that is flexible for metering quadrants of the building. Being able to separately meter tenants is a must for maximizing rental rates.

- *Dock Doors* – Most buildings older than 15 to 20 years have 8' x 10' or smaller dock doors. Those doors smaller than 8' x 10' must be replaced. An 9' x 10' door is the standard for all new buildings. For a large building with 8'x10' dock doors, you should consider budgeting to enlarge them to 9' x 10'. Although this may be costly, it could be the difference needed to attract larger tenants who are focused on efficiency of operations.

- *Roof/Floors* – The roof and floor of an industrial building are the two largest building rehabilitation cost items to consider. Always, always have these tested before acquiring the property to determine their current specifications and remaining useful lives. Tenants are apprehensive about leasing a facility with sub-standard roof conditions or underperforming floors. If the tenant finds these items deficient during its due diligence, he may go elsewhere or want a further discount on the rental rate.

- *Building Codes* – It's always a good idea to get a building code compliance audit, especially if the building will be multi-tenanted. The existing mechanical, ventilation, and electrical equipment may not be flexible or adequate enough to meet code under certain building sub-division schemes.

Whitney Kerr Jr., CCIM, SIOR, with Colliers Turley Martin Tucker in Kansas City, recalls that building codes were definitely an issue when he was working with an investor who was converting a 240,000-square-foot Douglas Battery warehouse facility in north Kansas City into a multi-tenant facility.

"If you are constructing demising walls, you have to have exits for fire and emergency," Kerr says, "You cannot exit into someone else's space; you have to be able exit directly outside a building. When you a re converting a single-occupant building into multi-tenant and you are getting [into] compliance with local building codes, it can get expensive and complicated."

That's not the only hidden expense, Kerr says. If you convert a single-tenant structure into multi-tenant and the prior owner or single tenant still retains space, there are often "new tenant" conflicts. "When a new user comes onto that complex, it creates issues with the existing company because they are used to having only their own people on the premises and [having] the run of the place," he explains. "All of a sudden they have to accommodate a different company, a different type of business, while sharing common areas and parking. New security issues have to be worked through."

Quality Materials= Higher Rents

Although he is an SIOR and a Realtor®, **Kevin C. Geenty** of The Geenty Group, Realtors®, based in Branford, Connecticut, sometimes invests in properties and takes on conversions himself. He stresses that important factors in transforming properties are adherence to codes, division of utilities, and common-area maintenance.

"In order to be successful, you have to do a quality job in regard to fire codes and building codes," he says. "There are people who will divide up a building, putting up something cheap and easy, some sort of sheetrock that is neither fire coded nor building coded."

The best thing to do is go in the opposite direction, Geenty suggests. Use better materials, and create dividing walls with sound absorption materials, for example. "The key is taking a building from one use to a higher use."

Geenty says it's absolutely necessary to rewire the utilities for individual billing. It is expensive but it needs to be done. "If it is a single-tenant building, all the wires are coming back to one meter, so you have to take everything out. Just throw it away. Rewire to separate panels or meters. The same thing with the heat and water," he points out. "If you don't do this you can't get top rent."

Another conversion expense that most people don't realize is the cost of common area maintenance. "You have to provide a lot of service, snowplowing, taxes, insurance, lawn care, landscaping, maintenance," Geenty explains. "You have to figure out a budget like a condo association, and everyone's fees are based a percentage of building being leased."

Since most tenants opt for a rehabbed building for the low cost, Geenty warns, "You have to keep common area costs low. We bid these every year, so if someone gets out of line in cost, we can quickly replace them."

These Deals Work

If converting single-tenant facilities to multi-tenant is a risky and sometimes complicated renovation, why do investors opt to go through the process?

The main advantage of making a single-tenant property multi-tenant is that you lower your risk by not having all of your rental income eggs in one basket; you diversify your tenant mix, explains **Brian P. Rettig, SIOR,** a Vice President with CB Richard Ellis in Tampa. "You a re also, therefore, able to accommodate the needs of a variety of users in the marketplace."

Rettig recently brokered a 700,000-square-foot warehouse deal in Tampa, where the new owner decided to transform the space into multi-tenant. He's also working with the new owner to lease the renovated space.

"The main challenge is the cost to multi-tenant the building," says Rettig. This is a matter of taking the existing configuration of the building and determining how to split it up most cost effectively. "At the end of the day," he says, "the reward outweighs the risk as you end up with a tenant mix that keeps you from relying on the rent coming from just one tenant—and one tenant could go dark on you with little or no notice (for example, who thought Enron, WorldCom, GM, or Ford would have the issues they've had?)."

Perhaps, the essential reason transformations are done is because when rehabs get done right, the result is often a home run.

Down in the Raleigh, North Carolina, area, **W. Michael Lewis, CCIM, SIOR,** a principal in The Lewis Group, had a dilemma. He was hired to find a buyer for a vacant 109,000-square-foot facility that was built out in three sections from the 1960s to the 1980s. Similar buildings were selling for 50 cents on the dollar, but his client had certain price-points he needed to meet.

Lewis decided the best option would be to subdivide the building. The hardest piece to market, 42,000-square-feet of relatively low ceiling height went first to a user/investor. The balance was leased to Home Depot and then sold to another investor.

"In effect, the landlord achieved a higher number than he wanted," says Lewis.

Robert D. Oare, SIOR, an industrial specialist with Trammell Crow Co. in Baltimore, was called in on a similar tough situation. In December 2003, London Fog was vacating its 35-acre campus in Eldersburg, Maryland. There were three buildings on the property one 60,000 square feet, one 81,000 square feet and one 235,000 square feet. After about a year on the market, Oare brokered the property to a local investment group, which then hired him to lease the property. He did it by finding a number of smaller tenants who leased pieces of the campus.

"If we could have found a single tenant, we would have done that, but it became very clear just by the people who called that there were good operating companies needing just 50,000 or 60,000 square feet," Oare says. "So, we went to the owners and said, 'You will see two or three smaller deals a year, and when they come, you have to make them.' And we did."

As a bonus, the owner of the property is now planning a 50,000-square-foot expansion because there was a tenant in the market that needed space and the property missed out because it was leased up. "We are still getting calls from people who want to be there," says Oare.

In Hartford, Connecticut, **Nicholas R. Morizio, CRE, SIOR,** President of Colliers Dow & Condon, often finds himself having to broker older industrial buildings that once were owned by major corporations. His answer is usually to convert the facility from single-tenant to multi-tenant, leasing them to smaller tenants in the market.

His success stories are numerous: a 1.2 million-square-foot, former GM facility, leased to three different tenants—sold; he leased 425,000-square-feet to Firestone; raised the roof and converted the remainer to multi-tenant; and a 500,000-square-foot Litton plant, built in 1920s with difficult environmental problems, converted to multi-tenant—sold!

The key is to be flexible in

your approach, says Morizio, because in the crowded Northeast, "some of the old buildings are better suited for other uses."

Flexibility also worked for

Leonard Knauer, SIOR, whose company Knauer Realtycorp in Raritan, New Jersey, was called in to broker one building in a small industrial park, also in Raritan. Once lab space, the plant was a labyrinth of lab rooms and piping—and it had sat empty for four and half years.

Because the building needed major work anyway, Knauer decided to totally gut it, subdivide the space, and create a flex-building. There are now three tenants in the new space, including a large communications firm

Here's the home run part. Average rent for a single-tenant warehouse structure in the area stands around $4.50 a square foot. As flex space, it leases out at an average of $9.50 to $10 a square foot (the office part at $13.50 and the warehouse space at $6.50).

Says Knauer, "You take an antiquated building, update it, convert it to something that is needed in the marketplace, and as a result you can get high rentals."