



*Nexus*

## Where obsolescence ends, new trend begins

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A flour mill, a bowling alley, a former shopping mall. All of these retail centers have one thing in common — they're fated to become creative office space.

The life expectancy of older office buildings hangs in the balance along the streets of Midtown and other sub-markets in Arizona that saw extensive growth in the mid-80s. Now, developers and building owners are faced with finding innovative ways to either save or re-purpose these sites. Will developers take the pre-1990s structures into the 21st century by raising the ceilings and perking up the interiors? Or will they be razed and given a new purpose?

Office vacancy rates are the highest of any other commercial sector at 20 percent in Tucson, according to CBRE's second quarter office report, and just over 20 percent in Phoenix. Despite the numbers, Class-A office is in high demand, as Cushman & Wakefield reported in its second quarter release. Even with high vacancies, Class-A leasing is high and nearly 5 million square feet of new office is under construction in the Valley. New supply is expected to exceed historic average by 58 percent in 2015, DTZ reports.

"The current and future trend of office leasing will focus on amenity-rich environments located in areas of strong labor pools," reads Cushman & Wakefield's report. The key to unlocking the death sentence on older, obsolete buildings is just that — amenities.

That brings the story back to the flour mill, bowling alley and shopping centers mentioned earlier. All of these spaces are near amenities. The Hayden Flour Mill is next to Tempe Beach Park and the Mill Avenue District, as well as Arizona State University. The bowling alley. And the office space next to Fiesta Mall are literally walking distance from an amenity-filled shopping center.

"For reasons of timing and price, there's a perception these will be cheaper than new builds," says Lee & Associates Principal Andrew Cheney, who adds that even Fortune 500 companies are willing to look at adaptive reuse if it's a time-sensitive enough situation.

"There are some companies that just have to have new space," he says. "Other companies that don't. Other companies don't want to wait for new build, so they are willing to look at existing product."

According to DTZ, about 66 percent of new construction is build-to-suit.

The existing space, though, Cheney says, isn't necessarily Class-A. In fact, many of the adaptive reuse projects around the Valley are Class-B by typical standards.

"It's tough to say they become Class-A," Cheney says. SkySong was a complete scrap of its former, failed shopping mall and Circuit, a re-purposing of a manufacturing center, is a single story. Even Discovery and Continuum, Cheney says, are Class-B with Class-A build-outs.

"For right now, the supply of good space will not meet up with the demand," Cheney says. "At 20 percent (vacancy), that still hasn't happened yet. There just won't be enough nice space and right prices for new construction ... the prices between re-purposed buildings and new construction aren't as great as they once were. The gap isn't as big at only \$2 per square foot more."

Big tenants such as InfusionSoft, General Motors, Amkor, GoDaddy, Shutterfly, Northern Trust, Isagenix and Crown Castle have entered the market as build-to-suits. However, these projects don't fix vacancy rates, as DTZ Executive Managing Director Jeff Wentworth says.

"Office tenants are evolving and owners have to evolve as well," Cheney says. "That's why Discovery (Business Campus) did so well. They redid that project and it happened before the tenants showed up."

This is particularly important for Arizona tenants, Wentworth notes.

"The companies coming from out of state or northern California can envision this," Wentworth says of re-purposing obsolete buildings. "When you walk through the property with these tenants, they look at the space and say you're going to tear this down and leave the walls and fireplace. If you take the local tenants that are used to value office, they walk in and generally speaking don't get it. It's a safer bet to go to something newer like a suburban value office near good employment."

When it comes to speculative projects, like Discovery Business Campus or Anchor Centre, it's up to the owner to capture the image. KBS Real Estate, which purchased the Anchor Centre for \$85 million in 2014, blew out the previous building suites to raise the ceilings, add more glass windows and walls as well as trendy designs and pops of color. The group also installed a shared meeting space complete with a kitchen, flexible conference room and billiards for tenants to use to unwind or host clients.

Adding to Arizona's advantage, Phoenix's Class-A properties tend to lease around \$30 per square foot. This is more than 50 percent off what northern California companies are looking at for speculative space in the Bay Area.

"It's not that (adaptive reuse is) a trend, but it's the start," Wentworth says. "If you see success, you'll see more people doing it."

"It can be simply buying a property where the ownership doesn't have capital to make it sing," he says. "Or it can be identifying a market opportunity that other people don't see."

A recent project ViaWest has taken on is Nexus, previously owned by a semiconductor company, and built in the '80s. The company, NXP, stayed for three decades, but downsized, leasing half its building to Wells Fargo and later completely moved out because its equipment rendered obsolete by technological advancements.

"The cost of retrofitting the research and development space and clean rooms would be extraordinary," Schwarz says, adding that they bought it anyway (when the price was right). "It was ignored in the marketplace for its lack of functionality but by working with ASU's Research Park, we were able to enhance the asset."

ViaWest demolished the interiors, built a snazzy lobby area, did some creative site work to boost the parking ratio and adding in glass to make for a classier, updated property. ViaWest currently has 2.5 million square feet under management.

"For a while, we were focused on things with financial issues or suffering from velocity in the market," Schwarz says. "Those opportunities are more gone than they're here. The ones that really make sense now have that element of repositioning of taking something that is not working in its present state and figuring out how to modify it."