Conversion of commercial property into residential units has accelerated in the Covid years

By Malusi Mthuli

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The conversion of commercial spaces into residential units is nothing new to the South African property sector. It's a trend that began well before Covid-19, but it has accelerated significantly in the last two years. Lockdown forced companies to accept that a remote workforce is not only viable, but can also deliver improved cost and productivity efficiencies.

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One of the driving forces behind this trend is the fact that property funds continue to offload large portions of their office stock, which most now consider less viable from a returns perspective than properties in most other sectors. Fortunately, this offloading of office spaces is somewhat serendipitous given the significant upswing in demand for well-located residential properties that align with the changing lifestyles of an evolving working population.

This rising residential demand has been due to a number of factors, the most obvious of which has undoubtedly been record-low interest rates as National Treasury fought to minimise the impact of Covid-19 on households. But at the same time, the pandemic has also delivered a number of benefits on the supply side of the residential property equation as historically high barriers to entry have tumbled for developers and investors who recognise the valuable opportunities in the commercial-to-residential conversion space. Prices of empty office blocks are lower than ever, the costs involved in converting those spaces are far lower than building them from scratch (especially from a utilities infrastructure viewpoint), and local governments are actively seeking opportunities to partner with developers to leverage inner-city residential projects as a way of addressing growing social housing backlogs.

Relaxed home loan qualification criteria

In fact, government is now participating in terms of these property sector public-private partnerships with solid SLAs coming into effect between developers and social housing agencies for grant-based funding of up to 70% of the costs involved in qualifying social housing projects. And most banks are following government’s lead with many far more willing today than they were in the past to provide funding for much of the remaining 30% of development capital requirements. On the demand side, banks are also largely coming to the residential property party with more relaxed home loan qualification criteria and a willingness to once again consider loans to 100% or even 110% of value for qualifying applicants.

The result of all of this is a very compelling case for investment into commercial-to-residential conversions – especially those that include a meaningful social or affordable housing component. However, this certainly doesn’t mean that investment into such conversion projects is an automatic ticket to success and riches. As with any property development in any sector, caution is required.

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Understanding the target market

For one, it’s essential for any developer or investor wanting to get into the commercial-to-residential conversion game to have a very clear understanding of their target market and their prospective buyers, and then design and price the units accordingly. For example, offering a small studio apartment in the heart of Sandton for under R1m is bound to generate a massive amount of interest amongst young, upwardly mobile employees who would otherwise be paying the equivalent of their bond repayments on that amount to rent a similar unit. But try to market the same $25m^2$ units to an older market, even if they have the financial means or credit history to easily take up the offer, and it’s unlikely your sales strategy will ever gain much momentum.

A second key success factor for commercial-to-residential conversions is the age-old adage regarding location, location, location. Fortunately, the majority of vacant office blocks that are becoming available for purchase are already very well located for conversions that meet growing demand amongst younger employees who essentially need enough space to be able to hammer away at their laptops on most days, but then also need to be in relatively close proximity to their office spaces on days when they’re needed at work.

Balancing living and lifestyle spaces

Linked to the above point, the most successful conversion projects are also those that have achieved the right balance between living and lifestyle spaces. The majority of the buyers of these small, high-density residential units either don’t feel the need to own a vehicle, or would prefer to use it as little as possible. As such, their primary consideration is less about whether one unit offers a few square metres of space more than another, and more about how easy it is for them to live the lifestyle they desire, without having to commute long distances to do so. So, adding convenience and lifestyle stores into the development mix, or at least choosing a location with easy access to public transport, is becoming a non-negotiable success factor for most conversion projects.

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'Can it last?'

Of course, the most commonly asked question by those who are considering taking advantage of the property conversion trend is “can it last?” The reasons for this concern are relatively obvious. The work-from-home trend is now morphing into more of a hybrid work arrangement for most companies, which means office space will be required again. In addition, interest rates are on the rise, which could dampen demand for, and access to, home loans. While these are both valid concerns, it’s highly unlikely that demand for, or usage of, office space will ever be what it was a decade or two ago. Hybrid work arrangements require much less office space than full office-based staff complements. And while interest rates are rising, it’s going to be some time (if ever) before the cost of servicing a home loan is so high that it makes paying rent a more appealing proposition.

It's highly likely that the commercial-to-residential conversion trend is here to stay, and that it will, in fact, accelerate in the medium term. And for developers and investors who do their homework, and who are open to partnering with local authorities, there is massive potential for sustainable success.

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