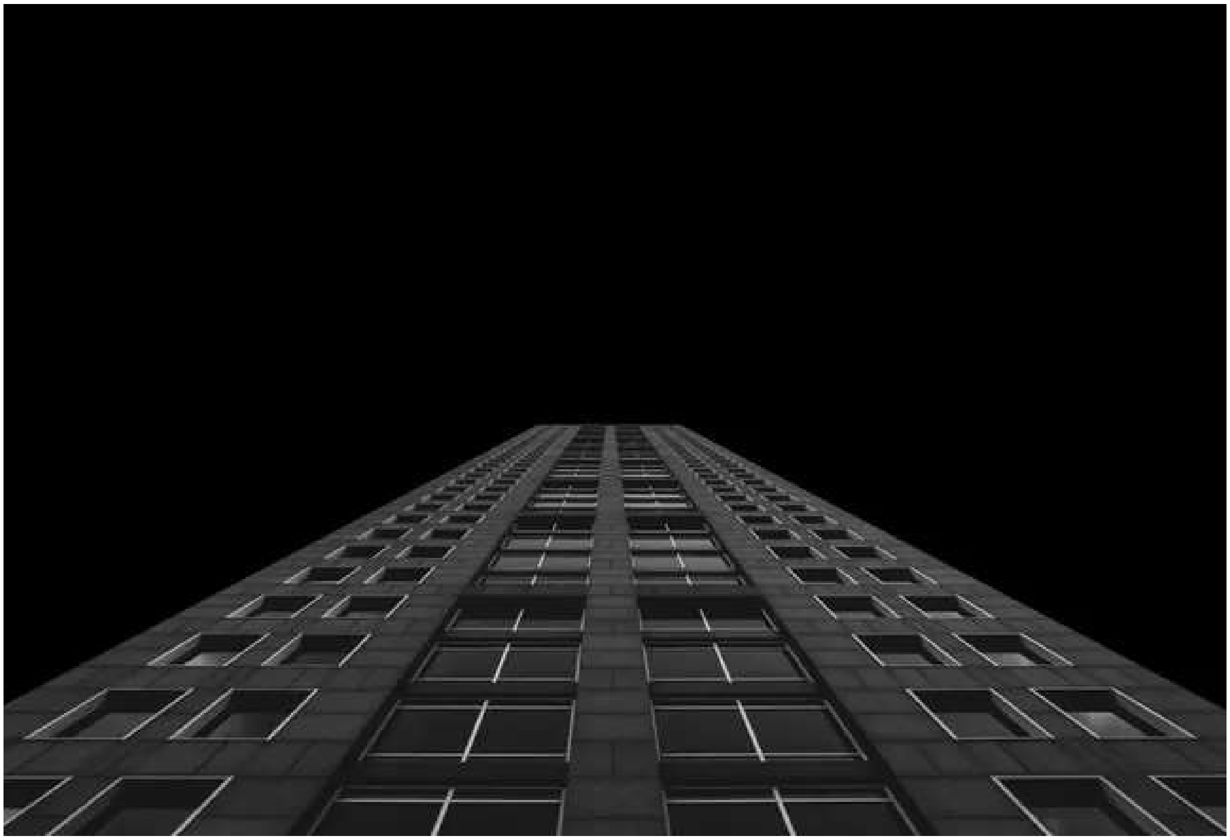
Office Landlords To U.S. Government: Without Help, We're Heading For A Financial Catastrophe

April 2, 2023 | Matthew Rothstein, Bisnow Philadelphia (https://www.bisnow.com/author/matthew-rothstein-51988) (mailto:matt.rothstein@bisnow.com)

Office towers in the heart of the country's biggest cities had always been the gold standard of commercial real estate: a market's most expensive properties, owned by its biggest players and counted on as reliable sources of revenue for owners, lenders and city governments alike.

Now, owners of all but the newest and best buildings and the banks holding their debt are locked in a negative feedback loop (https://www.sfchronicle.com/sf/article/city-economy-doom-loop-17846412.php) of sinking value and vanishing liquidity. Without some sort of intervention or assistance from federal regulators or a bailout from elected officials, industry advocates say the office sector could collapse (https://www.bisnow.com/national/news/capital-markets/jpmorgan-blackstone-execs-see-more-pain-coming-for-cre-118218) — and drag regional banks (https://www.bisnow.com/tags/regional-banks) down with it (https://www.bisnow.com/national/news/capital-markets/regional-banks-on-edge-after-weekend-of-financial-uncertainty-118053), causing the sort of broad financial catastrophe that nearly occurred (https://www.bisnow.com/national/news/capital-markets/regional-bank-uncertainty-upends-cre-capital-markets-118059) with Silicon Valley Bank (https://www.bisnow.com/tags/silicon-valley-bank).



“We’re at risk of what happened in 2008 and 2009, but this time for commercial real estate rather than mortgages,” CCIM Institute (https://www.bisnow.com/tags/ccim-institute) Chief Economist and former commercial real estate adviser to the Federal Reserve KC Conway (https://www.bisnow.com/tags/kc-conway) told *Bisnow*.

One of the reasons why SVB was especially vulnerable to a bank run was its overexposure to one part of the economy, but hundreds of regional banks could be considered overexposed to commercial real estate (https://www.bisnow.com/national/news/capital-markets/banking-crisis-will-have-profound-effect-on-regional-bank-cre-lending-118190), which could lead to regulatory crackdowns, Conway said.

On top of the dropping value of their balance sheet loans, regional banks have already lost hundreds of billions of dollars (https://www.bloomberg.com/news/articles/2023-03-27/small-us-banks-lose-109-billion-in-deposits-in-a-single-week#xj4y7vzkg) to depositors fleeing for national banks deemed too big to fail — severely hampering their flexibility when dealing with a borrower’s maturing loan. The commercial real estate lobby’s immediate priority is convincing regulators not to tip the situation into disaster.

"Our hope would be that by not tightening credit unnecessarily, some refinancings will be able to go forward, even in a difficult environment," NAIOP (https://www.bisnow.com/tags/naiop) Senior Vice President for Government Affairs Aquiles Suarez told *Bisnow*. "But if a bank is forced, based on capital requirements or regulations, to foreclose on a property, then it's a downward spiral economically, and that's what we're trying to avoid."

Even if the Federal Reserve (https://www.bisnow.com/tags/federal-reserve) can somehow thread the needle between fighting inflation (https://www.bisnow.com/tags/inflation) and stabilizing capital markets, suddenly obsolete urban office towers still represent a long-term existential crisis for central business districts. Shrunken tenant demand and the resultant flight to quality (https://www.bisnow.com/tags/flight-to-quality) are destined to turn at least a few big buildings in every major city from key sources of tax revenue to potential blight magnets, said Patrick Sentner, immediate past president of SIOR (https://www.bisnow.com/tags/sior).

To mitigate the damage to civic health, office-to-residential conversions will be in high demand wherever possible, but such transformations are tricky to finance even in simpler times. Industry groups are already gearing up to focus their lobbying efforts with Congress on some form of financial support or incentive program for conversions, Suarez and Sentner said.

"All of the real estate advocates here educating people on the Hill — that's where we're at," Suarez said.

The Office Sector Faces The Music

Across the country, broad acknowledgement has set in among landlords that in-person work will never return to pre-pandemic levels, which has left the entire office sector with a supply glut (https://www.sfchronicle.com/sf/article/s-f-office-vacancy-rises-record-rate-29-4-17862930.php). Even as office occupancy (https://www.bisnow.com/tags/office-occupancy) indicators like Kastle Systems (https://www.bisnow.com/tags/kastle-systems)' Back to Work Barometer have remained stable for weeks (https://www.kastle.com/safety-wellness/getting-america-back-to-work/), many tenants on long-term leases still have yet to make final decisions on how much space they need — but virtually all of them will need less, Sentner said.

"The fundamentals of office leasing have changed, and it's unknown what will happen," said Sentner, a Pittsburgh-based executive vice president for CBRE (https://www.bisnow.com/tags/cbre) focused on office tenant representation (https://www.bisnow.com/tags/tenant-representation). "Do I see [occupancy rates] ever hitting the levels they were before? No."

Transaction activity remains too scarce to build a consensus on just how much value the office sector has lost, but there is enough data to say with some certainty that the loss will be significant and permanent due to reduced demand.

Office real estate values have dropped by 25% in the past 12 months, according to Green Street (https://www.bisnow.com/tags/green-street)'s March 6 Commercial Property Price Index report (https://www.greenstreet.com/insights/CPPI#different). A study published in November (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4124698) by researchers from New York University (https://www.bisnow.com/tags/new-york-university) and Columbia University (https://www.bisnow.com/tags/columbia-university) estimated that permanent shifts in work habits have destroyed $413B of value for the overall U.S. office market. The effect is more acute within central business districts than in suburban markets, in part because commutes to urban cores take the longest and cost the most on average.

Such a collapse has left an unknown-but-significant portion of urban office towers worth less than their mortgages, according to a March 30 report (https://mail-attachment.googleusercontent.com/attachment/u/1/?ui=2&ik=3ac8d319ce&attid=0.1&permmsgid=msg-f:1761807989852718800&th=18733308459dc6d0&view=att&disp=inline&realattid=ahfhQQ72-n8-0W1bUW2NVqxqmE0_cpMr6-nle_4pZya5w2lTsk5Vzge8jBm-ZeKJ0JkHhBirhbuXN7HakYIzs-V_Udc4q_IsHCQa23aGHYnt1WkT9Vhy_SYrqlP9lQGDGK1WkuTYAA8Fk47G9OKU sClN1rYexcY223ZF3NrTWL3JKrRR07-5DETVYcEIS2PECMq20yuLrRLDB0ysBFmT7EJgtvx603g73Gw-KQgiUsD69ujoqMwCe6J-Kg4bILK3Z03YrJ7kIFgxlUSF0vXXdrkNy0JNUukN0XwUdwKfTexv5yep4apMBGppl S9EmLEHXM-50Bp_Sw4SeU17CFr8Kq4TzfVtqpmf_rUjqXJMurMtur8kpuprQ9dS87YFppLtN_8IlI jm-iP106ywVUnugHy2djUuiv-xOiqbeaCWLs_Bm4sHYswPIUqjzyx95ceh3h_kOTvEgdnqWabj1PCBSP3KVI3jkvUCp PxwiapO680K1cNnkEP0E3GTdo-Y0_nMPqpFJBrY106tQRPjnDXXW9gnZfMnHPZG0bz0e_0x8m10rvI0KYq53x6AGA x5Flk3DD0_TdhV_rSPjMdSpzU5FEIbAkU-f2eRA) from credit analysis giant Morningstar (https://www.bisnow.com/tags/morningstar). After a year of the fastest interest rate hikes (https://www.bisnow.com/tags/interest-rate-hikes) in Federal Reserve history, refinancing is all but impossible (https://www.bisnow.com/national/news/economy/federal-reserve-fomc-meeting-25-basis-point-increase-118198). Several office-owning REITs, including Boston Properties (https://www.bisnow.com/tags/boston-properties) and Vornado Realty Trust (https://www.bisnow.com/tags/vornado-realty-trust), were given negative rating outlooks (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/i by S&P Global Ratings on Friday.

“We’re going to see a lot of maturity defaults this year, and if there’s no capital to fill in, you’re going to see price discovery, and the water will drain out of the pool and reveal that people are not wearing swimsuits,” Conway said.

For the first two years after the outbreak of the pandemic, so little was known about its long-term impact on the office market that lenders and borrowers alike were all too happy to reach extension deals and other short-term measures (https://www.bisnow.com/national/news/commercial-real-estate/forbearance-over-foreclosure-what-cre-wants-from-lenders-during-the-coronavirus-crisis-103528), hoping to wait out the tough times (https://www.bisnow.com/new-york/news/office/few-offices-owners-are-delinquent-on-their-loans-but-distress-could-be-on-the-horizon-106239). As a result, $270B in commercial real estate debt is scheduled to mature (https://www.bisnow.com/national/news/capital-markets/banking-crisis-will-have-profound-effect-on-regional-bank-cre-lending-118190) in 2023 — an all-time record, credit monitoring firm Trepp (https://www.bisnow.com/tags/trepp) reports. Office buildings account for $80B, or around 30%, of this year's maturities.

"The stress from Covid hit, and everyone said, 'We can't collapse the economy, so let's paper over everything we can and make sure that nothing blows up until Covid is solved,'" Conway said. "And so now that's coming due."

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Revenue is in the toilet, rates are through the stratosphere, and refinancing approaches.

There is $92 billion of office debt set to mature this year that will need to be rolled at a ~750+ bps wider spread.

Many developers will choose to sell or default on their obligations:

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In total, $317 billion in CRE debt is maturing through the end of 2024.

The average debt service ratio here is 1.25x—revenue from properties is barely enough to cover loan payments, let alone the expenses of owning huge office buildings.

The path of least resistance is default:

Some of the richest owners of U.S. trophy office buildings with maturing debt have turned the keys over (https://www.bisnow.com/new-york/news/office/related-bentallgreenoak-hand-over-keys-at-lic-office-property-117596) to lenders, indicating that they see the writing on the wall. But most office owners risk ruining their reputations with lenders by cutting bait early, leaving them hanging around, waiting for a lifeline or to be foreclosed upon, said Seyfarth partner Christine Kim, whose practice involves representing parties on both sides of commercial mortgages.

“At that point, [office owners] have been trying to work out something with their lenders, but if the debt is coming due and they don’t have the liquidity themselves, the attitude becomes, ‘Fine, then take it,’” Kim said. “In an office market where people can’t rent them out, then it’s a business decision to just take this hit rather than paying out of pocket to save something. Because once you’ve saved it, then what?”

Banks Against The Wall

A surge of maturing office loans would be of extreme concern to regional banks, since they provide a majority of commercial real estate loans (https://www.bisnow.com/national/news/capital-markets/banking-crisis-will-have-profound-effect-on-regional-bank-cre-lending-118190), even if they had nothing else to worry about. But the collapses of Silicon Valley Bank and Signature Bank (https://www.bisnow.com/tags/signature-bank) led to a nationwide trend of nervous depositors moving their money from smaller to larger banks, draining their balance sheets and leaving them unable to extend the same grace to borrowers that they did during the height of the pandemic.

"I don't know if lenders have the flexibility to put together a workout plan," Kim said. "They want to do the deals, but they may find themselves a little handcuffed based on liquidity and governmental oversight."

Generally, banks do what they can to avoid taking possession of commercial buildings, unless they suspect a borrower of mismanagement. But the prospect of dozens of banks suddenly becoming office landlords this year is about more than just the headache involved in direct ownership of a building — it would seal the building's fate as an also-ran in the leasing market, Sentner said.

"If a bank wants to take back an office building right now, they're not going to be able to do anything with it, because the building itself will be stigmatized based on the bank owning it," he said. "So banks do not want these office buildings, whether they know it or not."

If foreclosing on office buildings would be unpalatable for regional banks in an otherwise normal year, then the unprecedented number of maturities makes it an even worse prospect. And many of the same regional banks that became the lifeblood (https://www.bisnow.com/national/news/capital-markets/banking-crisis-will-have-profound-effect-on-regional-bank-cre-lending-118190) of the commercial real estate industry left themselves spectacularly ill-equipped to absorb the coming blow, Conway said.

"We knew that going into Covid, [many] banks had CRE concentration risk, and the banks and supervisors didn't do a damn thing about it," Conway said. "I think there's going to be a huge day of reckoning for bank supervision."

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Here's the even larger issue investors should worry about 🧵

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The banking industry increased its exposure to commercial real estate heading into the pandemic.

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Even if this embattled class of banks had elevated concentration in commercial real estate heading into 2020, the type of asset they were lending against was as different from the volatile startup economy that doomed SVB as could be, Aquiles and Sentner said. The pandemic's one-two punch of causing office demand to collapse and creating a mass maturity event has backed regional banks into a corner.

“This is so different from ‘07, ‘08 and ‘09 where even a high school math student could understand what went wrong,” Sentner said. “The way we were structuring things then is for the most part how debt has been structured for the past five, 10 years. They’re doing things the right way, but the government is taking things in a different direction, which could have a very negative impact on property owners, mostly of office space.”

As dire a situation as it may be for regional banks and their borrowers, and even granting the negative impact of zombie office towers, it may ultimately pale in comparison to the impact of continued inflation (https://www.investopedia.com/fed-economy-vs-inflationn-7372642). The cause of the interest rate spike in the first place has still not been resolved, and if March’s moment of bank panic doesn’t slow inflation down, Powell has said (https://www.bisnow.com/national/news/capital-markets/powell-warns-of-more-aggressive-interest-rate-hikes-117968) the office market won’t prevent the Fed from tightening the screws further.

“I don’t think anyone has the solution, so we’re just trying to help [the Fed] understand our concerns," Suarez said. "Everyone says they’re glad they’re not the Fed, because the Fed has to get rid of inflation, but that hurts everything we’re talking about.”

Outside of the real estate industry, calls are already growing louder within (https://www.bisnow.com/national/news/capital-markets/warren-porter-unveil-bill-to-undo-the-undoing-of-dodd-frank-118095) the federal government and without (https://www.yahoo.com/entertainment/lack-consequences-encourages-bad-behavior-090814144.html) to ensure that banks face real consequences. If a bank can’t survive under tighter regulations, some argue, they shouldn’t be saved (https://www.economist.com/leaders/2023/03/30/america-risks-propping-up-zombie-banks).

“When you look at the money behind office assets, it’s institutional money, it’s wealth funds, etc.,” Conway said. And the public will say, ‘How does this help me?’ … The public hasn’t forgotten the bad behavior by the banks. And I don’t think it would go along with a big bailout.”

Ultimately, the surest way to convince anyone to prevent a tsunami of office foreclosures will be to make the case that the banks left holding the properties would be a contagion risk — and the case is being made (https://www.forbes.com/sites/richardmcgahey/2023/03/30/why-commercial-real-estate-could-cause-the-next-bank-failures/?sh=54ce167817e8). To forestall that contagion without exacerbating inflationary risk may require the creation of a new instrument to, at the very least, buy the office industry some time.

“I do think a solution is going to have to be more purpose-built,” Sentner said. “Because this is not just economics-oriented and financial markets-oriented. This is just companies questioning what their need is for office space; it’s unlike anything we’ve had before.”

One industry group, Real Estate Roundtable (https://www.bisnow.com/tags/real-estate-roundtable), already sent a letter (https://www.bisnow.com/national/news/capital-markets/real-estate-roundtable-asks-government-help-debt-maturity-crisis-bailout-118178) to the Fed and other finance agencies asking them not to flag lenders for offering short-term extensions to borrowers at risk of default on their commercial mortgages. If the Fed is indeed approaching the end of its run of rate hikes — no sure thing — then some sort of ad hoc policy to give maturing loans a grace period could be enough to avoid the worst-case scenario, Conway, Sentner and Suarez all said.

“People would love to hold out for more stable times, but if you have a maturity coming up this year, you don’t really have a choice,” Suarez said.

Even sector-specific advocacy groups are unlikely to ask for any direct assistance from financial agencies to office landlords, Suarez said. Whether to prevent foreclosures or to assist in carrying them out, anything resembling an office bailout would likely flow to the banks, Suarez and Conway said.

But the real estate industry’s message for the Fed and related agencies is clear, and growing louder: If they are serious about preventing contagion, then they would be well-served to help prevent the coming wave of foreclosures that will land office buildings in banks’ begrudging laps.

“When owners turn over a property rather than refinance at higher rates, things get worse for banks,” Suarez said. “In banking like in medicine, it’s really about, ‘Do no harm.’”

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