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Out of office

The status of the U.S. office property sector amid bank turmoil and remote work

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Executive summary

- Bank failures in addition to high-profile property defaults in early 2023 has spurred unending negative media coverage surrounding U.S. commercial real estate (CRE) and the office property sector. In the following paper we aim to help investors interpret the dire headlines and better navigate the CRE landscape moving forward.
- Recent troubles encountered by the largest CRE lender type (i.e., banks) has further impeded the property price discovery phase that was initially set in motion at the start of the rate hiking cycle in 2022. Distress is showing signs of picking up, especially for the most challenged property types (e.g., lower-quality office) and markets (e.g., urban central business districts), a trend we anticipate continuing amid a non-zero interest rate policy environment.
- Reality is finally starting to sink in among market participants that the hybrid work model (i.e., in-office and remote) is not transitory. The monumental shift in work habits has intensified the existing "flight to quality" trend for both owners and occupiers which will continue to pressure office supply-demand fundamentals for the foreseeable future.
- Near- to medium-term tighter financial conditions present the possibility for attractive risk-adjusted returns across the CRE capital stack (i.e., senior debt, mezzanine debt, preferred equity) as well as an opportune time to be a buyer of discounted CRE loan pools as banks prune their balance sheets. Newer, higher-quality office properties will win out over time, but investors' portfolios with diversifying exposure across the real assets spectrum more broadly (including office subsectors medical office and life sciences) will be better positioned to achieve their risk and return objectives with greater downside protection.

Well, that escalated quickly

What are the implications of recent bank failures for U.S. commercial real estate (CRE)?

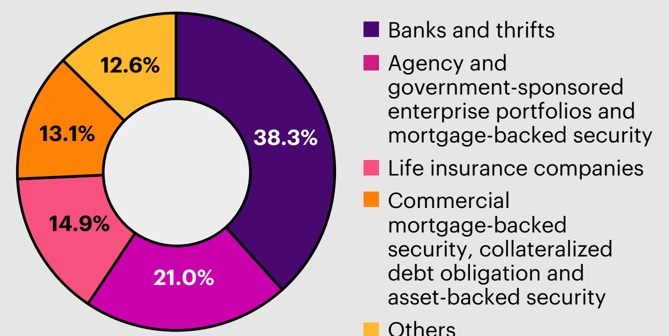
CRE as an asset class is said to be highly "capital intensive" — that is, heavily reliant on debt financing

Institutional-quality CRE acquisitions and development projects require large sums of capital to execute, and thus real estate activity is acutely sensitive to the availability and cost of debt (e.g., mortgage and construction loans). In the wake of a nearly four-decade secular decline in interest rates, the Federal Reserve ("Fed") has raised the federal funds rate eleven times since the start of their hiking cycle in March 2022 through July 2023 to a 22-year high of 5.25-5.50%[1]. Accordingly, the cost of debt financing for real estate borrowers has nearly doubled over that same timeframe, effectively resetting the cost of capital, and putting downward pressure on property values which is still playing out today. Further, as CRE lenders have grappled with uncertainty surrounding interest rate trajectories, the economic outlook, and properties' fair market values, availability of CRE debt has dried up as well. Taken together, by and large, CRE lenders have pared back their activity resulting in a material drop in 2022 property transaction volumes vs. the 2021 all-time highs, with 2023 data coming in even lighter[2].

Further chilling property markets, the largest CRE lender type (i.e., banks) have recently experienced asset/liability duration mismatch issues amid rapid rate increases. Consequently, a seemingly domino-like collapse of the U.S. regional banking system attempted to take hold beginning with Silicon Valley Bank's abrupt implosion in March 2023. It is important to highlight this is not a repeat of the subprime residential mortgage crisis that led to the Global Financial Crisis (GFC) of 2008 which was a systemic credit event. The last decade within the CRE asset class can generally be defined by stricter lending standards, lower debt levels, healthier property fundamentals (mid-2010's retail and today's office sectors being the notable exceptions), and record amounts of capital waiting on the sidelines to be deployed serving as a de facto floor on values.

Despite the financial press running the misinformed headline "70% of total CRE lending is attributable to smaller banks", in reality smaller regional and community banks represent c. 70% of bank CRE lending with all banks representing only c. 38% of the total $4.6 trillion U.S. commercial mortgage market (see *Figure 1*). Regional and community banks are crucial to the CRE ecosystem as a funder of smaller income-producing properties in secondary/tertiary markets (less likely to be owned by institutional investors), the largest lender type in construction financing, and a major buyer of senior commercial mortgage-backed securities. Although the Fed's reactive emergency measures (i.e., Bank Term Funding Program) have appeared to thwart any sort of contagion within the 4,500+ U.S. bank system for the time being, the negative sentiment has weighed down an already stalled CRE market.

Figure 1: **Commercial mortgage debt outstanding by lender type**

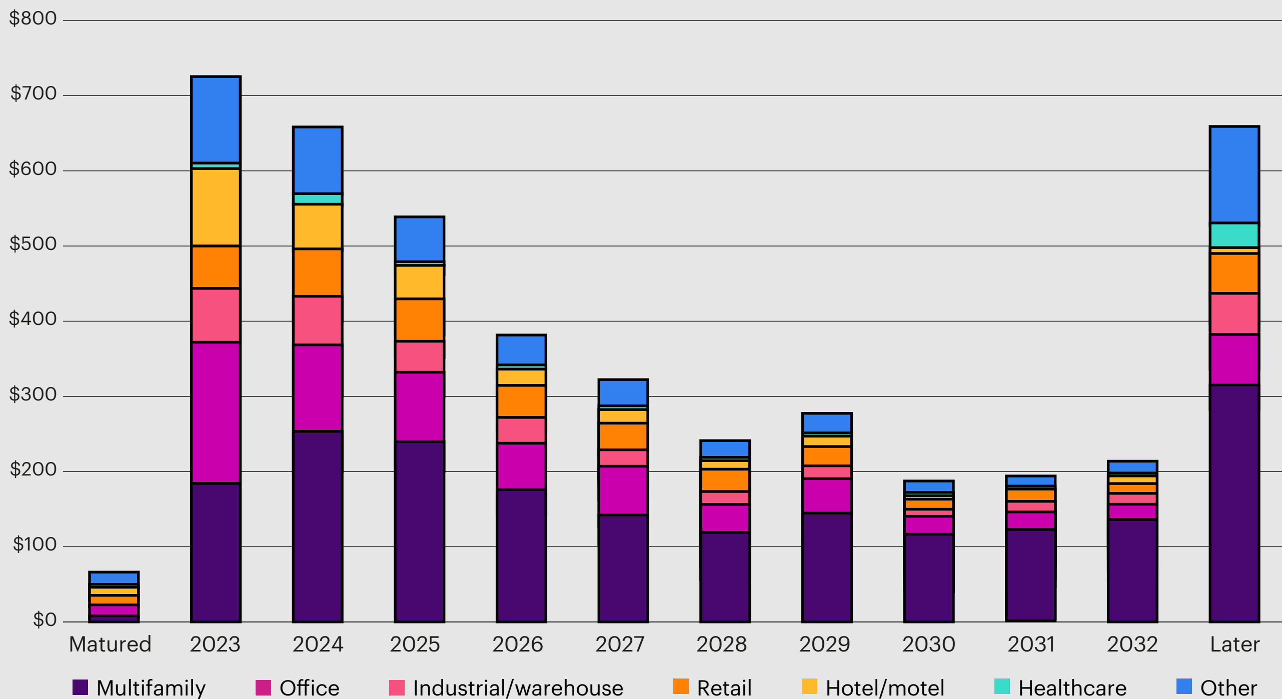


Source: MBA as of March 31, 2023

Banks that are lending today typically have preferred borrowers (e.g., long-standing, well-capitalized clients) and preferred property types/markets, meaning not all debtors will be burdened equally. The restrained lending market will continue to hinder CRE price discovery as transactions are a necessary component in determining true fair market value. Our expectation is bank lending will remain depressed over the near term given the overall uncertainty regarding the economic outlook and increased regulatory scrutiny on the heels of recent bank tumult. However, we believe there is a silver lining in terms of effects on property market fundamentals. Namely, given regional banks are the predominant source of construction lending, it is likely fewer new development projects will be undertaken, and thus less new supply will be coming online over the next several years.

[1]Federal Reserve FOMC statement issued July 26, 2023
[2]MSCI Real Capital Analytics, April 2023

Figure 2: **Estimated volume of maturing commercial mortgages by property type (US$ billion)**



Source: MBA as of March 31, 2023

Running into a [maturity] wall — landlords may face significant refinancing risk over the following years as loans come due in a higher rate environment

Commercial mortgages are commonly structured as 3- to 10-year interest-only loans (i.e., zero amortizing), whereby property owners pay accrued interest in monthly installments over the life of the loan with a one-time lump sum principal payment upon maturity. The so-called principal balance “balloon payment” can cause considerable difficulties for property owners should it come due at an inopportune time. In an environment of tighter lending conditions and deteriorating property values, a landlord's options to pay off, refinance, or sell become more challenging. The “wall of maturities” frequently cited by media outlets refers to the $1.5+ trillion worth of looming commercial mortgages coming due over the next three years through 2025 (see *Figure 2*).

Delinquency rates, representing the percentage of loans with past due payments and are typically a precursor to property owners defaulting, have ticked up materially since the start of the year to 4.4% through July 2023 (2.9% in January) with the office sector driving the increase[3]. Although defaults still sit at relatively low levels vs. past cycles, it is our expectation distress activity will trend higher over the coming years in a slow-burning fashion, especially in the out-of-favor sectors (e.g., lower-quality office) and jurisdictions (e.g., urban central business districts). Likewise, the most at-risk loans are the ones originated in recent years at peak valuations with variable rates.

Grabbing headlines in early 2023, some of the largest and most sophisticated CRE owners opted to “strategically default” on certain properties as sponsors have encountered a few common challenges in today’s landscape: (i) should a property owner attempt to refinance or exercise an extension option upon maturity of their current loan, lenders may require the borrower to pay in additional capital to “rebalance” the loan to account for the fall in property value, (ii) property operating performance suffered (e.g., rising vacancies and expenses) making it difficult to service debt, (iii) floating rate mortgage structure has materially increased debt service costs. The “extend and pretend” playbook deployed by CRE lenders throughout COVID lockdowns will once again become prevalent as creditors strongly prefer not to take ownership of the collateral via foreclosure knowing large amounts of capital expenditure (“capex”) would be required to competitively reposition the asset or an immense haircut upon disposition would need to be incurred.

[3]Trepp CMBS Research, July 2023

Office obliteration

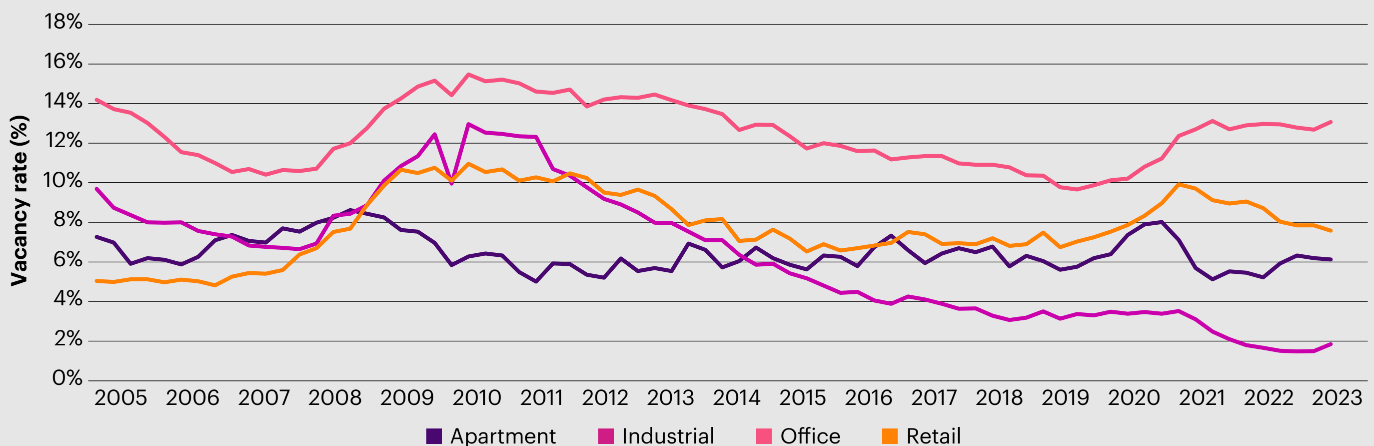
How ominous is the outlook ahead for U.S. office space?

Double whammy — the office sector is facing both cyclical (i.e., economic slowdown) and structural (i.e., remote work) headwinds

After numerous well-publicized property defaults by household name landlords in early 2023, the media went into overdrive calling for the "death of office" and as CRE being "the next shoe to drop". While commentators typically paint CRE with a broad brush, most property types remain relatively healthy from a historical supply-demand perspective. The office sector is the glaring exception as it not only grapples with a potential economic slowdown faced by all property types, but the unique challenges due to the structural change in hybrid work (i.e., in-office and remote) trends.

Since the onset of COVID-19, nationally, U.S. office vacancy has trended upwards towards the highs last seen in the aftermath of the 2008 GFC (see *Figure 3*). Softening the market further, space set to become available when current leases expire (i.e., "shadow vacancy") as well as sublease activity exacerbate the imbalance and sap landlords' pricing power (i.e., ability to raise rents). Moreover, both Big Tech (marginal renter of office space driving positive absorption in recent years) and the Federal Government (single largest U.S. tenant), have begun to reduce the amount of space leased among broader cost-cutting measures. Further evidencing a struggling market, the country's second-largest office coworking operator, WeWork, recently expressed doubt to remaining a going concern[4]. Like all real estate, the story differs depending on the location with some markets more challenged (e.g., San Francisco) and others holding up relatively better (e.g., Sun Belt region). Generally, it is our expectation office fundamentals will remain under pressure for the foreseeable future and vacancy peaking in 2025 or later is a realistic possibility.

Figure 3: **Vacancy rate by property type**

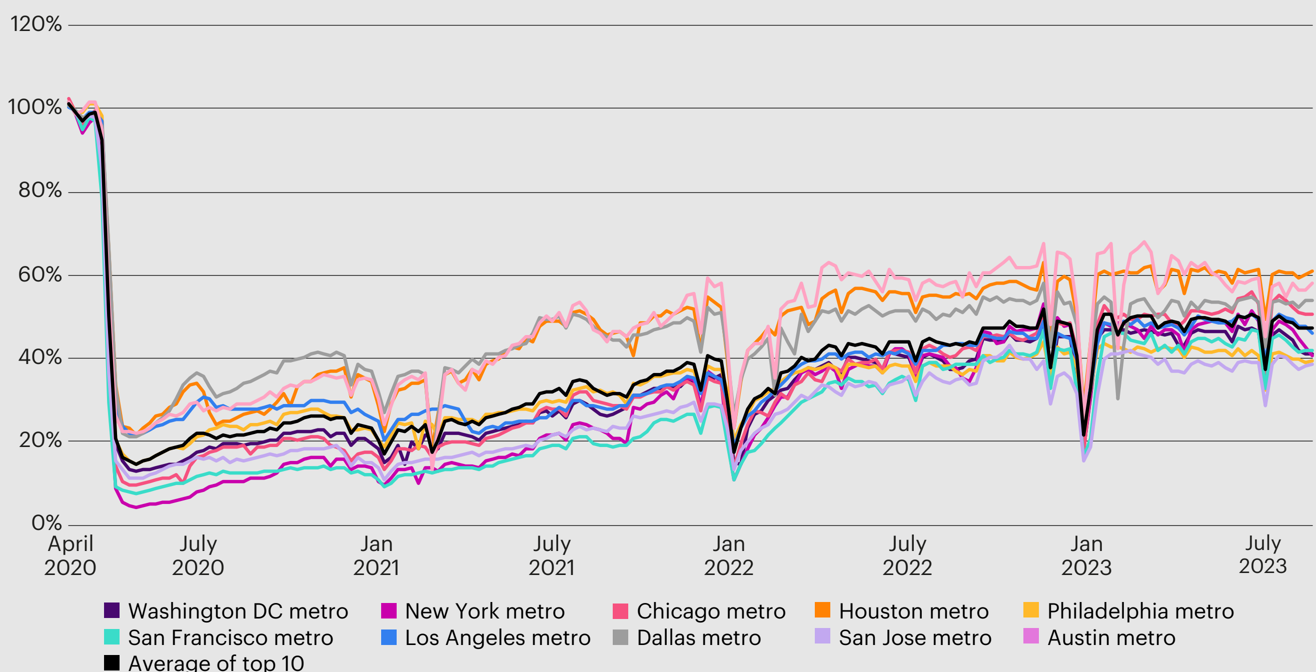


Source: NCREIF Property Index as of June 30, 2023

[4]WeWork Reports Second Quarter 2023 Results, August 2023

Much like the popular “Retail Apocalypse” moniker used to describe the structural headwinds (e.g., changing consumer habits, e-commerce) facing the retail property type back in the mid- to late-2010’s, parallels can be drawn to the challenges setting in for the office sector today. The pandemic released the remote working genie out of the bottle which has proved difficult to put back in the years following. In-office employee attendance is nowhere near 2019 levels for all major U.S. metros. Kastle Systems tracks turnstile key card swipes across 2,500+ office buildings in 138 U.S. cities which market participants have been referencing as a proxy for physical office occupancy (i.e., utilization rates) for the last three years. Their data shows utilization rates range from 40-60% vs. the March 2020 100% baseline across the top 10 U.S. markets (see *Figure 4*). Other well-known research firms, such as McKinsey & Co., claim in-office attendance rates have stabilized at c. 70% of pre-pandemic norms[5]. Regardless of the exact utilization figure, the paradigm shift in hybrid work arrangements will likely lead to a material decrease in the amount of office space tenants require, which will take years to fully understand the effects on overall demand. Moreover, a commonly relied upon metric, the correlation between in-office employment growth and demand for space, has severely delinked, rendering it useless as a forecasting tool and making deploying capital in the sector that much more difficult.

Figure 4: **Office utilization rate by U.S. metro as a percentage of March 2020 baseline**



Source: Kastle Systems as of August 24, 2023

[5]McKinsey Global Institute, Empty spaces and hybrid places: The pandemic’s lasting impact on real estate, July 2023

Downsize then upgrade — office tenants are opting for less space in the newest, highly "ammenitized" buildings

The "flight to quality" trend widely cited in the industry is tangible as the bulk of office leasing activity that is currently taking place is at the newest properties in the most attractive locations (e.g., convenient transportation options, access to talent) with the best amenities (e.g., gyms, outdoor space, etc.) and strong ESG credentials (e.g., Leadership in Energy and Environmental Design (LEED) certification). The divergence between higher quality "trophy" properties winning out was already in place well before 2020 but has become more pronounced as users of space do a bit of soul-searching as leases expire and they reassess their workforces' needs in the hybrid work era.

A growing share of older vintage office buildings (i.e., constructed prior to 1990) are facing functional obsolescence requiring significant capex to maintain and/or competitively reposition. Cushman & Wakefield, a global CRE services firm, estimates 15% of office buildings contain 80% of the sector's vacancy[6]. In other words, vacancy is highly concentrated in the lowest-quality "commodity" properties as they struggle to attract tenants, a trend we expect to continue over the next 5-10 years. Overall, an unprecedented imbalance in supply and demand will likely persist due to remote work arrangements in many markets — forecasted to result in an excess of 330 million square feet of vacant space by the end of the decade[7].

Instinctively, many onlookers are calling for conversion of existing office properties to another use — most notably, residential to address America's chronic undersupply of housing. It is estimated that up to 34% of office buildings in 14 major North American markets could be potential candidates for conversion[8]. While adaptive reuse is a logical idea in theory, it can prove difficult to carry out in practice due to economic infeasibility, zoning regulations, and physical limitations, among other deterrents. Conversions won't be the sole savior to dealing with excess space, although state and local governments have started rolling out incentive programs (e.g., tax abatements) to encourage office-to-residential redevelopment. Reimagination will be imperative as cities will not only be confronted by empty office buildings, but knock-on effects to surrounding retail properties, local transportation (i.e., decreased ridership), etc. hampering tax revenues in the years to come. The cleansing process is already underway as total U.S. office space is expected to shrink in 2023 for the first time since the year 2000, driven by lack of new construction and increased repurposing activity[9].

[6]Cushman & Wakefield, Where Do U.S. Property Values Go From Here?, August 2022
[7]Cushman & Wakefield, Obsolescence Equals Opportunity, March 2023
[8]Avison Young, April 2023
[9]Bloomberg & Fortune, July 2023

Conclusion

How can investors better position their portfolios moving forward?

Mind the gap — the pullback in CRE debt markets presents potential opportunities to fill the funding gap by non-bank capital providers

Given the rise in base rates and spreads in addition to the decline in credit availability, today's market could be described as "lender-friendly". Borrowers that do have access to debt financing are subject to lower loan-to-value ratios (i.e., less proceeds), higher debt service coverage ratios, and less favorable covenants. Property owners experiencing refinancing difficulties over the next several years could be looking for an infusion of "rescue capital", a phrase made popular in the early 1980's stagflationary period. In the near term, shifting property values and tighter financial conditions offer the potential for common equity-like returns for debt-like risk by accessing different segments of the CRE capital stack (i.e., senior debt, mezzanine debt, preferred equity). From a common equity perspective, the aforementioned "wall of maturities" will force sales of properties from liquidity-constrained owners for both in- and out-of-favor sectors presenting attractive opportunities. Market players with the lowest cost of capital (i.e., public real estate investment trusts, private core diversified funds) have effectively been forced to the sidelines but will look to ramp up acquisition activity at more attractive entry price points once market conditions normalize.

Cream of the crop — ownership in the highest quality office buildings will better navigate the headwinds

A demarcation will continue to take shape over the next decade with the newer, higher-quality office properties rising above peers, just as we saw within the mall subsector last cycle. Unless, as an investor, you are able to take a more targeted or opportunistic approach to investing in the office sector, it may be prudent to minimize exposure all together. By no means is this the "death of office", rather prospective return potential must be more than adequate to expose one's portfolio to risk factors that the market doesn't completely understand and appears to have not fully priced in at this point in time. Aside from challenges to the occupier space market, the office sector will likely continue to struggle to gain capital markets interest going forward amidst the bearish sentiment. Office ranks last out of 14 in targeted property types by institutional investors which will further act as a drag on forward-looking returns[10]. Instead, investors could home in on opportunities (both income-producing and conversion) in office subtypes such as medical office and life sciences buildings which are insulated from the remote work challenges plaguing traditional office and have strong secular tailwinds (e.g., expanding healthcare industry).

[10]WMRE, Taking a Timeout, July 2023

Diversification is destiny — accessing the broad range of real assets (i.e., real estate, infrastructure, natural resources) produces more resilient investment outcomes

Real assets are more than just the four main food groups (i.e., office, apartments, industrial, retail) that, up until recently, investors have only had appetite for. These sectors tend to be more cyclical/correlated with other asset classes and thus provide less diversification benefits. As markets have evolved and matured over the past 10-15 years, the real assets opportunity set has expanded and become ever more institutionalized, offering investors the chance to allocate across a multitude of sectors with varying return drivers, risk factors, and economic sensitivities (see *Figure 5*). By accessing the real assets lineup more holistically and focusing on opportunity sets benefiting from thematic tailwinds (e.g., demographics, technology, energy transition), investors' portfolios should prove to be more resilient no matter the economic climate. Additionally, diversifying across geography, capital markets (i.e., public and private), and capital stack (i.e., debt and equity) can enable real assets investors to better attain their risk and return objectives with greater downside protection.

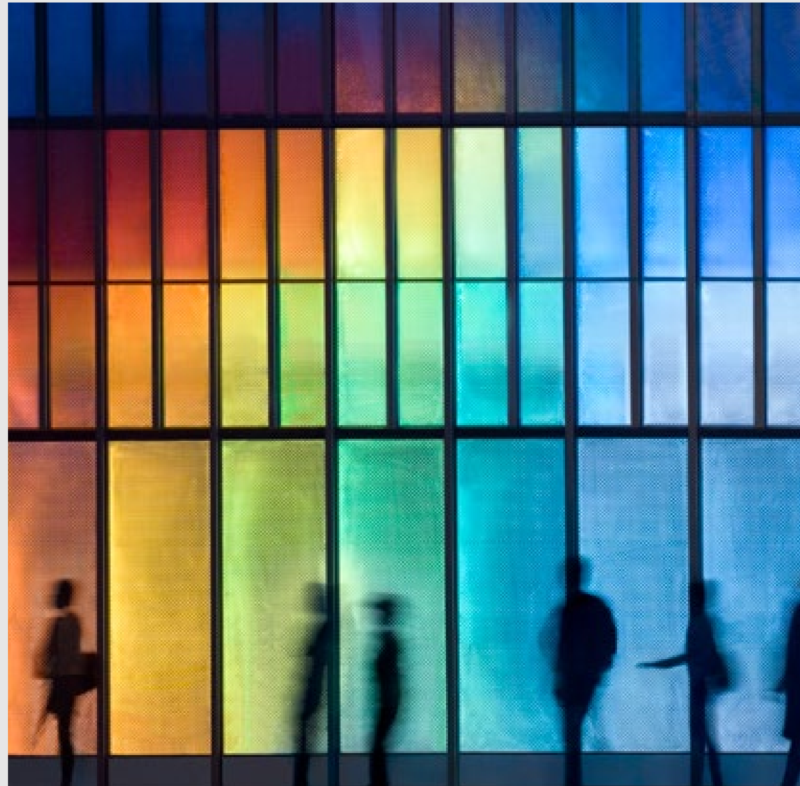
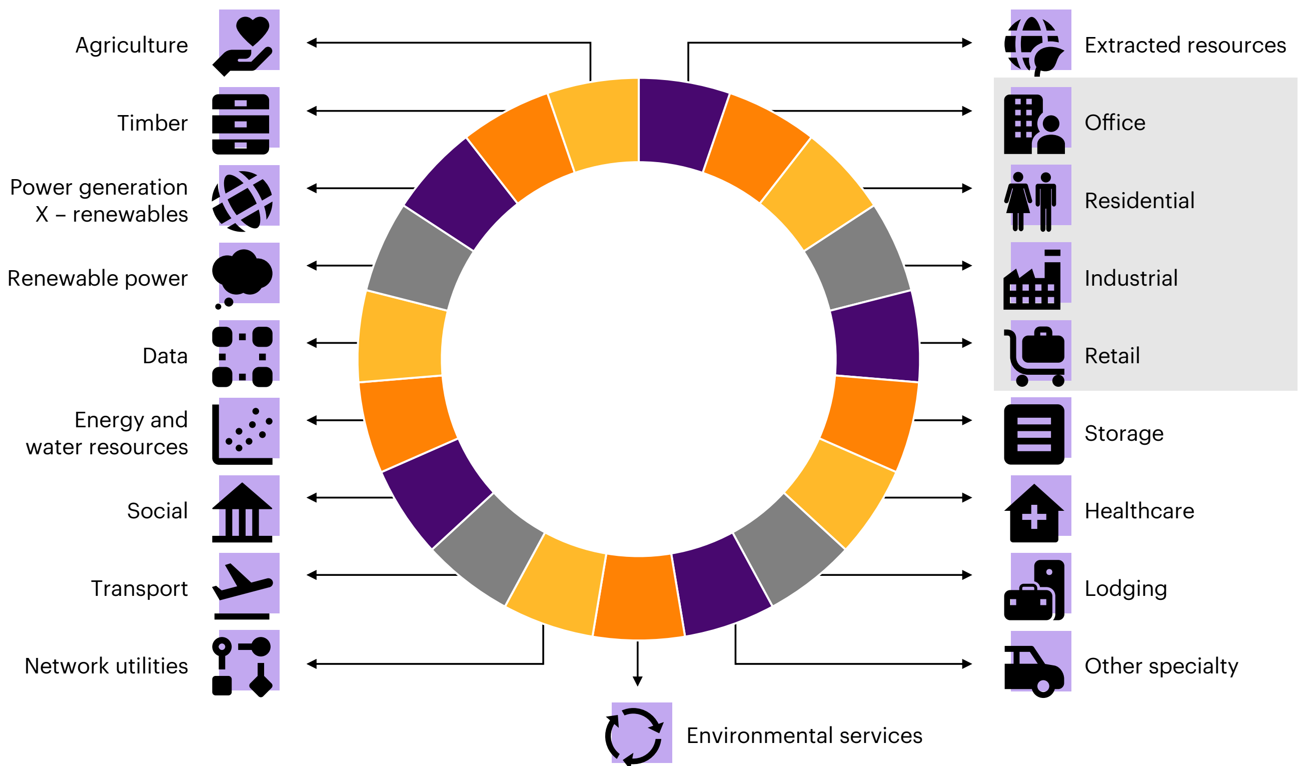


Figure 5: **Real assets investable universe by sector**



Source: WTW

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