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Perspective from

Commercial real estate's office sector: An accelerating fire

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Richard Byrne
President
Benefit Street Partners

While steeply rising interest rates and falling property valuations have sparked flames in the broad commercial real estate (CRE) market, problems in the office sector are fueling an inferno.

Anyone who works in an office building today can see the distress. You do not have to be a CRE professional. Parking lots are barren. Fields of cubicles sit empty and collecting dust. Buildings once bustling with activity now look like backlot sets from some dystopian zombie movie. And without customers, ground-floor businesses are forced to shutter, plastering windows with "For Rent" signage.

How did we get here?

Investors like to point an accusatory finger at COVID, and the ensuing work-from-home explosion. Of course, the pandemic and remote work had a significant impact, but other factors were already at play. Office supply was already oversaturated before COVID. Building valuations were already declining before the spike in interest rates drove them down further (in some cases 20% or more). And automation and artificial intelligence (AI) were already changing office dynamics. AI does not need a desk or cubicle, just a server.

Vacancies rising

Given these headwinds, vacancies are rising at a record pace. As shown in Exhibit 1 on the next page, a staggering 19.7% of office space in major US cities wasn't leased as of the fourth quarter 2023, according to Cushman & Wakefield, up from 17.7% a year earlier.

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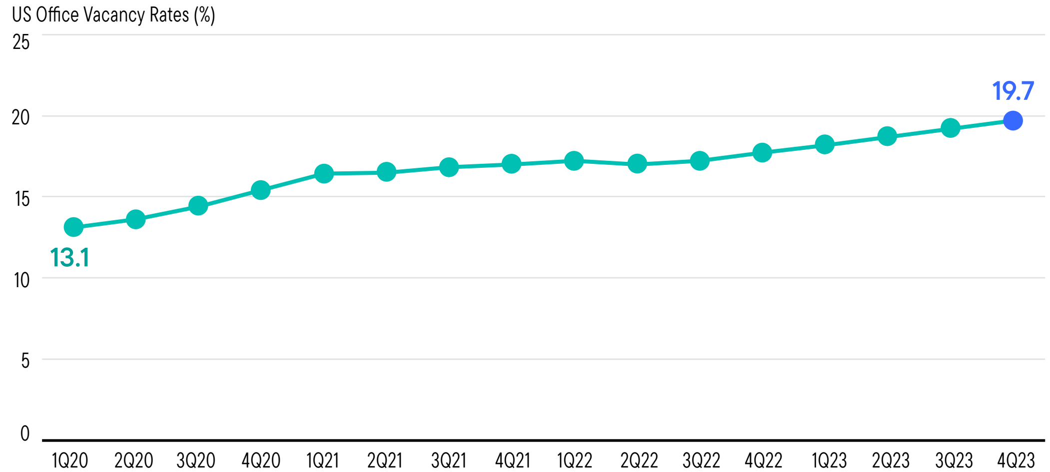
Exhibit 1: Office Vacancies Rapidly Rising



Source: Cushman & Wakefield U.S. National Office MarketBeat Reports, Q1 2019 through Q4 2023.

That is slightly above the previous record of 19.3% set in 1986, and the highest number since at least 1979, according to Moody's Analytics. More than the numbers, we see the upward slope of the graph—a trend we believe is going to continue or accelerate—troubling.

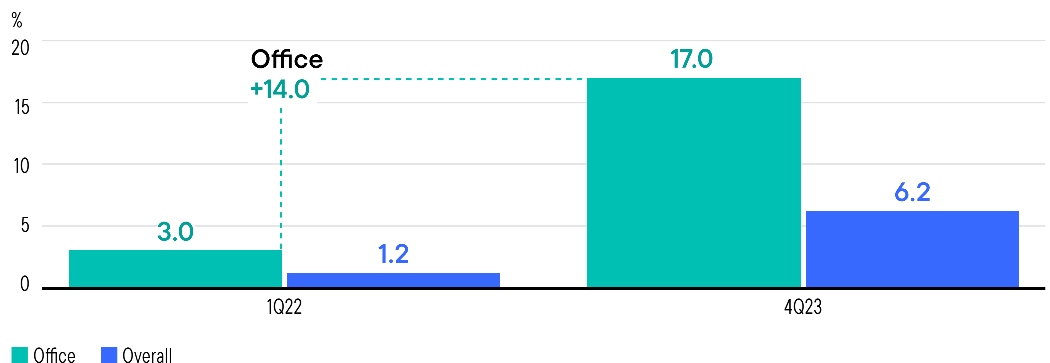
Considering all the vacancies, valuations are down everywhere. There may be some differentiation as far as office building class, location and vintage, but broadly speaking none are doing well. It's just different degrees of pain.

Office parks in the suburbs and in smaller metropolitan markets are suffering the most. Consider a recent story in the Wall Street Journal about the struggles associated with a building in St. Louis, Missouri. The AT&T Tower, a 1.4 million-square-foot 40-year-old office building, sold for $205 million in 2006. In 2022 it changed hands for a mere $4 million. That is hard to fathom—1.4 million square feet, in the heart of a major midwestern city, selling for $4 million!

Delinquencies rising

In addition, in 4Q23 we saw delinquencies rise across CRE, again primarily in the office sector. In Exhibit 2, we observe CRE collateralized loan obligation (CLO) delinquency rates are significantly above rates from two years ago. For office, they jumped from 3% in 1Q22 to 17% in 4Q23. Defaults are increasing, and some sponsors—even well-capitalized, sophisticated big boys—are simply walking away.

Exhibit 2: Delinquency Rates on the Rise



Source: DBRS Morningstar, February 16, 2024, and May 9, 2022.

Adding to the bleak outlook for the sector, office remains one of the most expensive asset classes in terms of tenant improvements (TI), maintenance and capital expenditures. The capital needed to keep an office building full in "normal" times was significant; the TI packages being offered to tenants today defy logic and cannot be sustained, in our view.

Debt coming due

Against this backdrop, a (US) $1.2 trillion wall of real estate debt is set to mature over the next two years. Office owners will find it difficult to refinance—given the resetting of property values and lack of demand for space. To try and finance a building in today's market, save for the most desired properties backed by the most capitalized buyers, would be like catching a falling knife. Lenders to the sector today are sparse, with many having been wiped out by the fire themselves.

Some remain, however. These are managers that did not overextend leverage in post-COVID originations or overexpose themselves to the office sector. These are managers with dry powder still on hand. They are well-positioned and will have access to a large and fertile investment landscape. They will be able to lend to high-quality properties at deeply discounted loan-to-value ratios—potentially capturing high yields with low leverage.

Not all bad

Not all office properties will bring trouble. There will always be demand for some office. Class A buildings in good markets should continue to operate successfully, provided the landlord is well-capitalized. But, if owners do not have the means or desire to spend on properties, we believe some offices will not be worth much more than the land on which they sit. It will be the "haves" and mostly "have nots" in office space. One building 90% occupied; the other three across the street abandoned.

A long recovery

In short, we see the office sector as a largely broken asset class—at least for the foreseeable future. While other property sectors may be struggling, we consider their issues tied to broken balance sheets, not underlying fundamentals. They are still viable properties, with loans that may only require some modifications/workouts. In contrast, the office sector's broken properties will not be worked out quickly.

Someday office will stabilize—as construction stalls and underperforming buildings close or repurpose—supply and demand will normalize, perhaps in 3 to 5 years. Until then, bring a fire extinguisher.

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Risks of investing in **real estate investments** include but are not limited to fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by local, state, national or international economic conditions. Such conditions may be impacted by the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, and environmental laws. Furthermore, investments in real estate are also impacted by market disruptions caused by regional concerns, political upheaval, sovereign debt crises, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Investments in real estate related securities, such as asset-backed or mortgage-backed securities are subject to prepayment and extension risks.

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