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Distressed Commercial Real Estate: What Lenders and Investors Need to Know

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The commercial real estate (CRE) sector is currently navigating a crisis that poses risks to banks, family offices, institutional investors and the broader economy. Defaults are approaching historic highs, properties are being deserted, and financial forecasts are in jeopardy. The *Wall Street Journal* reports that more than $38 billion in office buildings within the U.S. currently face foreclosure — the highest dollar amount since 2012.[1]

In addition, interest rates are rising as central banks combat inflation, with recent rates climbing to around 5-6 percent. At the same time, construction costs have surged, with the National Association of Home Builders reporting a 19 percent increase in material costs over the past two years.[2] As previously discussed, the shift toward remote work has resulted in higher vacancy rates.

These circumstances are unlikely to reverse in the near term. As the crisis grows and greater regulatory lending pressures continue, financial institutions and investors must seek effective strategies to preserve their investments or find ways to extract themselves while minimizing losses and extended liability. This article examines in detail the trends affecting the CRE marketplace and identifies the steps that lenders and investors must take to protect their assets.

Multiple Forces Are Negatively Impacting the Market

One obvious factor negatively impacting the market is the COVID-19 pandemic-induced shift to remote and hybrid work models. Pre-pandemic, large office leasing was significant in major markets across the U.S. Today, it is estimated that only 40-60 percent of leases greater than 10,000 square feet from that period are still active. According to CoStar Group, the U.S. office vacancy rate has soared from a relatively stabilized 9.4 percent at the end of 2019 to a record 13.8 percent today.[3] This vacancy increase, coupled with a negative net absorption of 53.7 million square feet, has intensified competition for quality tenants and caused a deceleration in effective rental rates in most major markets. Furthermore, the long-term nature of these leases (five- to 10-year base terms) suggests that many landlords will soon face substantial rollover risk.

Another negative contributing factor is the high-interest-rate environment. Moody's estimates that 73 percent of the $18 billion in office loans maturing in the next 12 months will be difficult to refinance due to high interest rates and cash-flow pressures caused by rapidly increasing operating expenses, insufficient property income and escalating vacancies.[4]

Inflationary pressures are further aggravating the issue. Costs related to construction and maintenance are rapidly and persistently increasing, with no end in sight. A recent release from the Association of Builders and Contractors suggested that nonresidential construction costs have increased a staggering 41.6 percent since 2020.[5] In response, property owners are implementing cash-preservation tactics and delaying projects, including necessary maintenance and contracted tenant improvements. According to real estate services firm Cushman & Wakefield, nearly 60 percent of U.S. office space needs substantial reinvestment, and 20 percent is completely undesirable without major renovations.[6] Although property owners' efforts to delay expenditures are understandable, these actions erode leaseholder relations and significantly reduce the future value of a property.

Yet another factor impacting the market is the increasing trend of property owners walking away

1 Peter Grant, "Office-Loan Defaults Near Historic Levels with Billions on the Line," *Wall Street Journal* (April 30, 2024), *available at* wsj.com/real-estate/commercial/office-buildings-past-due-loans-record-51a373a6 (subscription required to view article; unless otherwise specified, all links in this article were last visited on June 27, 2024).

2 Natalia Siniavskaia, "Square Foot Prices More than Double Inflation in 2022," National Association of Home Builders (Nov. 9, 2023), *available at* eyeonhousing.org/2023/11/square-foot-prices-more-than-double-inflation-in-2022.

3 Peter Grant, "The Office Market Had It Hard in 2023. Next Year Looks Worse," *Wall Street Journal* (Dec. 19, 2023), *available at* wsj.com/real-estate/commercial/the-office-market-had-it-hard-in-2023-next-year-looks-worse-b7f088ed (subscription required to view article).

4 Matt Reidy, Christopher Rosin, Kevin Fagan & Twinkle Roy, "Office Loan Maturity Monitor: Has the Dust Settled, or Is There Hope for Further Workouts in the Future?," Moody's (April 23, 2024), *available at* cre.moodysanalytics.com/insights/cre-news/office-loan-maturity-monitor-has-the-dust-settled-or-is-there-hope-for-further-workouts-in-the-future.

5 "Construction Materials Prices Increase 0.4% in March," Association of Builders & Contractors (April 11, 2024), *available at* abc.org/News-Media/News-Releases/abc-construction-materials-prices-increase-04-in-march.

6 "Obsolescence Equals Opportunity: The Next Evolution of Office and How Repositioining and Repurposing Will Shape the Future," Cushman & Wakefield (2023), *available at* image.comm.cushmanwakefield.com/lib/fe31117171640578741178/m/1/Obsolescence+Equals+Opportunity+Report.pdf.

from their holdings. Across the U.S., buildings are being voluntarily surrendered to lenders through deeds-in-lieu of foreclosure. The *Wall Street Journal* reported that major institutions, including Blackstone and Brookfield Asset Management, are already in the process of surrendering high-profile properties to their lenders,[7] and they are not alone: Other examples include San Francisco-based Clarion Partners returning 410 Townsend Street after failing to pay back a $36.8 million loan, and Santa Monica-based Vista Investment Group returning 3100 North First Street in San Jose.[8] Office property deeds-in-lieu made up 6 percent of all foreclosures during the first half of 2022. Shockingly, this number grew to 33 percent in the first half of 2023.[9]

The convergence of rising vacancies, increasing interest rates, and inflation-driven operating expenses and construction costs is pushing CRE to the brink of collapse. While obviously damaging to property owners, investors and tenants, this crisis also poses risks to the banking sector. According to a Florida Atlantic University analysis of new federal data for the first quarter of 2024, the CRE loan portfolios of 67 of the nation's largest banks are at higher risk of failure because their exposure to CRE is greater than 300 percent of their total equity.[10]

The Crisis Is Global

The CRE crisis is not just confined to the U.S.; it is a global phenomenon affecting major markets worldwide. Cities like London and Paris are grappling with high office vacancies and declining rental incomes as businesses adopt flexible work models. According to Savills, the office vacancy rate in Central London reached almost 9 percent in the first quarter of 2024, one of the highest levels in more than a decade. In Paris, the vacancy rate increased to 8.8 percent, up from 6.5 percent pre-pandemic.[11]

Likewise, Asian markets such as Tokyo and Hong Kong face similar challenges. In Tokyo, the office vacancy rate hit 4.47 percent in July 2024, a significant rise from 0.91 percent in 2019.[12] Hong Kong's office market is seeing vacancy rates reaching 14.6 percent as political and economic uncertainties continue to affect business sentiment.[13] Understanding these regional differences is crucial for global investors seeking to diversify their portfolios and mitigate risks.

Déjà Vu

Ours is not the first CRE crisis. Similar scenarios have unfolded at least twice in the past 50 years. From 1979-87, the Federal Reserve, under then-Fed Chair Paul Volcker, raised interest rates to combat inflation. This led to a surge in borrowing costs, with the federal funds rate peaking at 20 percent in June 1981. The increase in the cost of borrowing made the financing of new projects prohibitively expensive and strained existing CRE investments. The situation was exacerbated by a boom in construction that took place in the late 1970s, which led to an oversupply of office spaces. When the economic slowdown hit, vacancy rates soared and property values plummeted, and office vacancy rates reached more than 20 percent in some major cities.

The 2008 financial crisis marked another significant downturn for CRE. Triggered by the collapse of the housing market and the subsequent credit crunch and severe recession, CRE was hit hard, with property values dropping by 40-50 percent in many regions. Vacancy rates soared as businesses shuttered or downsized, and construction projects were halted or delayed due to the unavailability of financing. The delinquency rate for commercial mortgage-backed securities peaked at 10.34 percent in 2012. Recovery was slow, with the market beginning to stabilize only after the introduction of various monetary policies and government interventions, such as the Troubled Asset Relief Program and the Federal Reserve's quantitative easing measures.

The looming crisis today is largely different from these two more recent examples. Unlike previous downturns, today we find ourselves at a unique point of intersection of factors impacting the market. Excess commercial real estate capacity, shrinking office space requirements, overleveraged developers and investors due to declining asset class values and increased cost-for-debt service, and mounting regulatory pressures for lenders are converging in new ways. With billions at risk, understanding the lessons of the past helps inform a new playbook where a diverse set of stakeholders collaborate to chart pragmatic courses of value-protection for all stakeholders.

History suggests that while the road to recovery may be arduous, strategic interventions and adjustments will eventually lead to stabilization. Until this happens, economic pressures are forcing lenders to make critical decisions. Regulated lenders will be under pressure from the Federal Deposit Insurance Corp. to re-classify loans as noncompliant. Unregulated lenders will feel similar pressure from internal credit policies and their investors. These controls force urgency and place lenders in a position to proactively protect assets and monetize collateral.

While action is necessary, hasty decisions could lead to further devaluation. Rushed sales and foreclosures have historically negatively impacted property values in a submarket. A recent article published by NAIOP suggests that distressed-asset sales can fetch prices up to 80 percent below market rates.[14] Moreover, rapid reclassification of loans and aggressive credit policy enforcement strain relationships, leading to lost opportunities for collaborative restructuring that may better preserve the long-term value of a property.

Strategic approaches should balance the need for immediate action with long-term asset-preservation. Engaging in

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7 *See supra* n.1.

8 Sarah Klearman, "Clarion Partners Sends 410 Townsend St., Once a Symbol of the Roaring 2010s Tech Economy, Back to Its Lender," *San Francisco Bus. Times* (Dec. 11, 2023), *available at* bizjournals.com/sanfrancisco/news/2023/12/11/410-townsend-clarion-nationwide.html.

9 Mark Heschmeyer, "More Office Building Landlords Are Giving Properties Back to Lenders," *CoStar News* (Nov. 26, 2023), *available at* costar.com/article/1384869720/more-office-building-landlords-are-giving-properties-back-to-lenders.

10 "Data Analysis: More Banks at Risk of Failure as CRE Loans Reprice," *Florida Atl. Univ.* (June 3, 2024), *available at* fau.edu/newsdesk/articles/commercial-real-estate-screener-banks-failure.

11 "Spotlight: European Office Development," Savills (June 11, 2024), *available at* savills.co.uk/research_articles/229130/362952-0; Manuela Moura, "The Market in the Greater Paris Region," Jones Lang LaSalle, *available at* jll.fr/fr/etudes-recherche/recherche/office-market-in-the-greater-paris-region.

12 "Monthly Office Market Data of Tokyo Area, Toyoko Central 5 Wards," Sanko Estate, *available at* www.sanko-e.co.jp/en/data/city.

13 "Hong Kong Office Leasing February 2024," Savills (March 8, 2024), *available at* savills.com/research_articles/255800/215306-1.

14 *See* Adam Gower, Ph.D., "How to Navigate Risk and Maximize Returns When Investing in Distressed Real Estate," *NAIPOP* (Fall 2023 Issue), *available at* naiop.org/research-and-publications/magazine/2023/fall-2023/finance/how-to-navigate-risk-and-maximize-returns-when-investing-in-distressed-real-estate.

transparent negotiations with borrowers, exploring forbearance agreements or restructuring loan terms can provide more stability. This measured approach not only mitigates immediate risks, it also fosters stronger lender/borrower relationships, ultimately safeguarding the interests of all parties involved and promoting market stability.

Proactive Restructuring Is Key

Proactive restructuring of financial agreements (*i.e.*, modifying and extending loan terms to provide relief during challenging periods) is crucial for stabilizing properties under financial stress. For example, extending loan maturities by five to 10 years or renegotiating interest rates to lower levels can significantly reduce immediate financial pressures. This approach is particularly important for properties not meeting performance expectations, as it allows owners to meet obligations without default and provides the necessary time to achieve improved performance. In more severe cases, receivership or out-of-court settlements offer structured approaches to addressing financial issues while preparing properties for sale or revitalization.

Extending loan maturities and renegotiating interest rates can offer immediate financial relief and prevent foreclosure. This approach will often require the utilization of third-party experts, such as financial consultants, legal advisors and restructuring specialists, who can identify opportunities to restructure terms in a way that benefits both the property owners and the lenders, ensuring long-term sustainability.

Effective communication and negotiation are essential during the restructuring period. Transparent discussions about financial difficulties and potential solutions create a bridge for lenders and borrowers to design successful outcomes. According to a webcast produced by EY Americas, communication and collaboration are critical success factors in working through distressed scenarios regardless of underlying asset class, and lenders, borrowers, attorneys and advisors must all come to the table to review loan documents and determine the best path forward.[15]

15 "How to Navigate the Impact of Higher Interest Rates on Commercial Property," EY (July 13, 2023), *available at* ey.com/en_us/insights/real-estate-hospitality-construction/higher-interest-rates-and-the-impact-on-real-estate.

Lenders and Investors Need a Team of Experts

The CRE crisis demands a multifaceted approach. The lessons learned from past crises underscore the importance of lenders and investors assembling a team of seasoned experts to assist them as they navigate the turbulent landscape. Effective collaboration among experts is crucial for assessing risks and identifying opportunities for asset-repositioning. Financial analysts play a key role in evaluating the economic viability of properties and advising on restructuring terms that can provide immediate relief. Legal advisors are essential for navigating the intricate regulatory requirements and ensuring compliance with contractual obligations. Valuation specialists help determine the true market value of properties, guiding decisions on whether to hold, sell or repurpose assets.

Another valuable member of the advisory team is the construction manager, who can provide specialized construction expertise to manage both buildings under construction and those currently occupied. Preserving and restarting halted construction projects requires comprehensive planning and skilled management, as does ensuring structural integrity, compliance with updated building codes and the integration of new technologies or materials. For occupied buildings, maintaining property values through proper upkeep is equally critical. Financially strained landlords might defer necessary maintenance and repairs, which could lead to such significant issues as structural damage, HVAC failures and safety hazards. Seasoned construction managers bring valuable insights into the feasibility of resuming halted projects and implementing necessary renovations, and they should be an integral part of any team.

By assembling a diverse team of specialists, lenders and investors can better protect their assets, optimize financial outcomes and position themselves for future growth. The integration of financial, legal, construction and valuation expertise will not only address immediate challenges, but also lay the foundation for a resilient and adaptable real estate portfolio. As the market continues to evolve, staying informed and agile will be key to turning crisis into opportunity and ensuring long-term success in the CRE sector. abi