nyrej

Why CRE performance will hinge on the return to the office - by Robert Brasfield

August 03, 2021 - Front Section

Experienced investors in distressed commercial real estate know that significant societal change always leaves some businesses to struggle, as surely as it creates winners of organizations best suited to new mainstream preferences and business models. And by any measure, the world has experienced more than a year-long traumatic event that continues to transform behaviors.

Many have been surprised at the lack of distress so far among commercial property owners. The pandemic is bringing change on a grand scale that will have lasting implications for how populations use real estate, yet many managers of distressed funds have found few opportunities to deploy their stockpiles of dry powder.

In the United States, a federal moratorium on evictions for non-payment of rent plus a host of similar measures - including foreclosure moratoriums at the state and local level, and the prodigious federal stimulus programs - have largely masked the economic fallout from changes in work styles, consumer preferences and migration patterns. Observers have been left to speculate where and when concentrated distress will occur because the support they needed delayed knowing when real distress would appear.

Rest assured, distress is inevitable. When it occurs, a key to preserving value will be identifying opportunities quickly and stabilizing assets and non-performing debt before further damage is done. That is why lenders and fund managers are alert for signs of unfolding trouble in the post-pandemic recovery.

Here are the top trends we feel will drive distress in the post-pandemic real estate market, and a few of the reasons we expect office properties to be the first dominoes to fall.

1. Remote work is here to stay. More than three quarters (77 %) of business leaders expect to leverage a hybrid workforce upon returning to the office, according to a survey by staffing firm LaSalle Network. Major employers including Apple, Google and Microsoft have announced plans for hybrid scheduling, in which employees will work some days at home and others in the office. Although some highly competitive industries and markets may see more workers return to five-day weeks in the office, that may not become a universal norm for years.

In the meantime, office occupiers will begin adjusting their leased space to serve fewer onsite employees each day. Some organizations may desire more space to accommodate private offices and socially distanced workstations as a safeguard, while others may actually desire more collaborative space as the need to socialize and collaborate at the office increases because people are together less. A broader change in the use of office is expected as more people work from home, but the overall trend is likely to reduce s/fage in relation to total employee count.

As demand for offices weakens, landlords will be forced to compete by lowering rent, weakening their buildings' cash flows. In the flight to quality that typically occurs with excess supply, look for high-end properties to maintain occupancy levels while Class B and C properties experience elevated vacancy levels and income loss.

2. Flexible leases to undermine property values. With tenants in the driver's seat in lease negotiations, office landlords will consent to increasingly shorter lease terms, such as a one-year lease with multiple renewal options rather than a traditional, multiyear lease. Even if the tenant's credit quality is excellent, lenders and investors will consider a building occupied on short-term leases as presenting greater risk than the same property leased on five- to 10-year leases. For some borrowers, that reduced credit quality will complicate refinancing the property's debt upon maturity, or even jeopardize compliance with existing loan documents.

3. Migration headaches ahead. When the pandemic haze clears, some landlords – and even entire submarkets – will discover that they lost substantial segments of their employment base during the pandemic. Untethered from their workplaces during government-ordered shutdowns, many businesses and tens of thousands of mobile or unemployed workers pulled stakes and relocated in the past year.

These ongoing moves include population shifts from dense urban environments to the suburbs and vice versa, as well as pronounced migration from high-tax states and communities to areas offering lower costs, better perceived living standards or other advantages. Landlords and communities on the losing end of these moves may lose employers large and small to other markets, weakening occupancy, rent streams and their ability to meet debt requirements.

Other sectors to follow

Distress in the post-pandemic commercial real estate markets is more likely to develop in pockets than to strike entire communities. As the property type most vulnerable to changes in work styles, office properties unable to adjust will be first to stress. When an office park or district begins to lose tenants the parking operators, retailers, restaurants, hotels and apartment complexes that relied on those office users will also suffer and transmit distress to their landlords.

We are only beginning to see these changes play out in property performance. Lenders and investors who keep a close eye on the above trends will be better able to anticipate and pinpoint distress as it develops and can position themselves accordingly.

Any commercial property can suffer if it falls out of step with how people use space. In the emerging, post-pandemic economy, it all starts with how the world goes back to work, and those corporate decisions will play out first in the office sector.

Robert Brasfield is managing director of credit & asset management at Trimont Real Estate Advisors, Atlanta, GA