

Office Building Losses Start to Pile Up, and More Pain Is Expected

The distress in commercial real estate is growing as some office buildings sell for much lower prices than just a few years ago.



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Since the early days of the pandemic, owners of big buildings in New York and other large cities have been desperately hoping that the commercial real estate business would recover as workers returned to offices.

Four years on, hybrid work has become common, and the strain on property owners is intensifying. Some properties are going into foreclosure and being sold for sharply lower prices compared with valuations from less than a decade earlier, leaving investors with steep losses.

While the number of office buildings reaching critical stages of distress remains small, the figure has increased sharply this year. And investors, lawyers and bankers expect the pain to grow in the coming months because demand for office space remains weak and interest rates and other costs are higher than they have been in many years. The problems could be especially severe for older buildings with lots of vacant space and big loan repayments coming up.

The repercussions could extend far beyond the owners of these buildings and their lenders. A sustained drop in the value of commercial real estate could sap property tax revenue that cities like New York and San Francisco rely on to pay salaries and provide public services. Empty and nearly empty office buildings also hurt restaurants and other businesses that served the companies and workers who occupied those spaces.

“There is a lot more trouble coming,” said Mark Silverman, a partner and leader of the CMBS Special Servicer group at the law firm Locke Lord, who represents lenders in disputes with commercial mortgage borrowers. “If we think it’s bad now, it’s going to get a lot worse.”

Assessing the scale of the problem has been challenging even for real estate professionals because of the different ways in which commercial buildings are financed and the varying rules about what must be disclosed publicly.

Roughly \$737 billion of office loans are spread across large and regional banks, insurance companies and other lenders, according to CoStar, a real estate research firm, and the Mortgage Bankers Association.

The delinquency rate for office building loans that are part of commercial mortgage-backed securities was nearly 7 percent in May, up from about 4 percent a year earlier, according to Trepp, a data and research firm. But only a small proportion of office loans, about \$165 billion, are packaged into such securities.

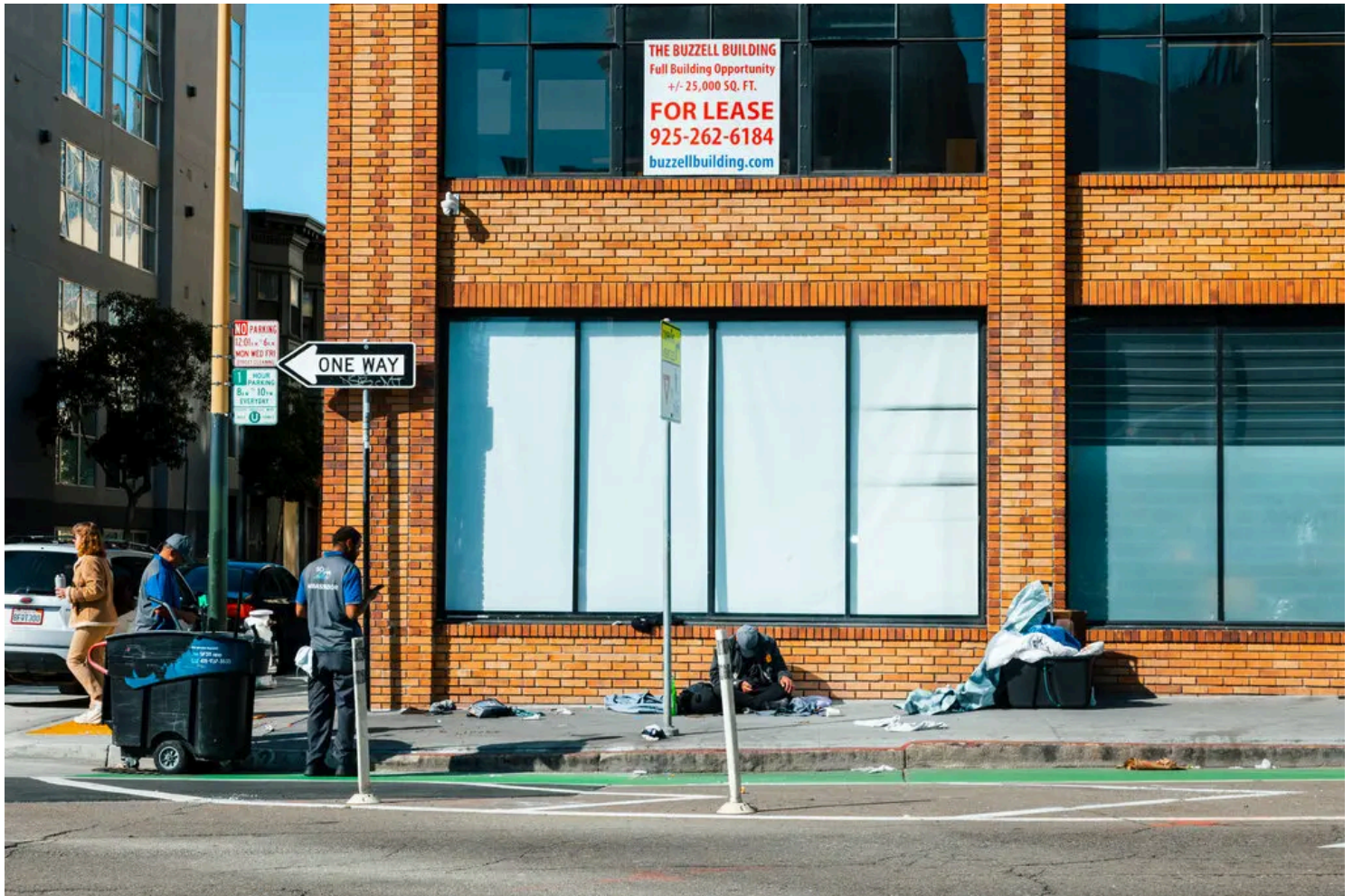
Foreclosures, which can take place months or more than a year after a property owner falls behind on payments, are also climbing. Nearly 30 buildings in Dallas, New York City, San Francisco and Washington whose loans are part of commercial mortgage-backed securities were in foreclosure in April, up from a dozen in early 2023, according to Trepp.

Some buildings around the country have recently been sold for a fraction of their prepandemic prices.

In May, investors like insurance companies and banks in the top-rated, triple-A bond of a commercial mortgage-backed deal — generally considered to be nearly as safe as a government bond — lost \$40 million, or about 25 percent of their investment. Holders of lower-rated bonds from the same commercial mortgage deal lost all of the \$150 million they had invested.

The building that was the collateral for those bonds, 1740 Broadway, was bought by Blackstone in 2014 for \$605 million. Blackstone had borrowed \$300 million against the 26-story building near Columbus Circle. This spring, the building was acquired for less than \$200 million.

“When you see delinquencies rising and foreclosures rising, that means we’re approaching the acceptance stage of the grieving process for office properties — and that’s healthy,” said Rich Hill, head of real estate strategy and research at Cohen & Steers, an investment firm. “But we’re not at the bottom yet.”



A sustained drop in the value of commercial real estate could sap property tax revenue that cities, like San Francisco, rely on to pay salaries and provide public services. Clara Mokri for The New York Times

Mr. Hill said it could take until later this year or sometime in 2025 before the scale of the problems in the office market became clear.

Office leases tend to last as long as 10 years to give property owners time to recoup their investment and broker fees. Long leases also assure investors that they will be paid interest on the hundreds of millions of dollars — sometimes even \$1 billion — that they have lent to real estate developers.

As a result, it can take a long time before decisions by tenants to downsize affect the market. In addition, some mortgages struck at low interest rates haven't yet had to be refinanced. But the longer interest rates remain elevated, the more buildings that were profitable when interest rates were close to zero might run into trouble.

Then there is the slow process of negotiation between borrowers and lenders as they look for ways to reduce potential losses by renegotiating or extending loans.

"Even though there has been a lot of anticipation, it takes a while to play out," said Anthony Paolone, co-head of U.S. real estate stock research at J.P. Morgan.

Part of the delay has also come from the difficulty of valuing buildings after the pandemic. Until enough properties are sold, it has been hard to know the true market value of buildings.

"A lot of that stuff at the moment is just spreadsheet math because there isn't the transaction activity to prove it out," Mr. Paolone said.

The sales that have taken place suggest a severe decline in commercial property values.

This spring, a 1980s-era office building at 1101 Vermont Avenue in Washington sold for \$16 million, a sharp drop from its \$72 million valuation in 2018. And near the Willis Tower in Chicago, an investor snapped up a landmark building late last year at 300 West Adams Street for \$4 million that sold for \$51 million in 2012.

"We went so long without any transactions that it created a lull," said Alex Killick, a managing director at CW Capital Asset Management, a special servicer that works with delinquent borrowers to recoup money for holders of commercial mortgage securities. "Now we are seeing some. There is finally some data to work with."

Some data suggest the pain is concentrated in a small proportion of buildings. While vacancy rates in U.S. office buildings are around 22 percent, roughly 60 percent of that vacant space was in 10 percent of all office buildings nationwide, according to Jones Lang LaSalle, a commercial real estate services firm, suggesting that the problems are concentrated rather than widespread.

Another hopeful sign, analysts said, was that the problems of office buildings did not seem to be endangering banks. After the failures of Silicon Valley Bank and First Republic Bank last year, some investors had feared for the health of other regional banks, which are big lenders to the commercial real estate industry. But few of the commercial mortgages held by banks have become delinquent, according to the Commercial Real Estate Finance Council.

Also largely unaffected by the situation are newer trophy buildings in New York that are able to command rents of as much as \$100 a square foot, double what older buildings can charge, according to the office of the New York City comptroller.



Demand for office space remains weak and interest rates and other costs are higher than they have been in many years. Erin Schaff/The New York Times

The problem is most acute for building owners whose mortgages are coming due and who are losing many tenants. About a quarter of existing office property mortgages held by all lenders and investors, or more than \$200 billion, are set to mature this year, according to the Mortgage Bankers Association and CoStar.

And while investors have been willing to lend new money to owners of warehouses or hotels, few want to refinance office loans.

That could spell the end of a tactic often referred to as “extend and pretend,” which became popular in recent years. It is called that because lenders agree to extend mortgages in the hopes that, given more time, building owners will be able to attract more tenants.

That approach stemmed partly from the hope among landlords and lenders that the Federal Reserve, after ratcheting up interest rates over the last two years, would ease or cut rates relatively quickly. In recent months, most economists and Wall Street traders have concluded that the Fed will not rapidly lower its benchmark rate or return it to the extremely low levels in place before the pandemic.

“There has been a systematic holding of the breath, with everyone hoping that the rapid increase in rates by the Fed would be just as rapidly decreased, allowing people to breathe easier and rates would be restored to lower levels,” said Ethan Penner, the chief executive of Mosaic Real Estate Investors, a firm in Los Angeles. “But that hasn’t happened, and there is only so much time that a lender can provide a borrower in terms of patience and looking the other way, especially once lease income starts to shrink.”

Another hope widely held in the real estate industry was that more companies would require employees to return to the office more frequently — but that has also not panned out.

Law firms and the finance industry have slightly increased the office space they have leased from prepandemic levels, but many other industries have scaled back. As a result, new leases signed are down about 25 percent from 2019 as measured by square feet, according to Jones Lang LaSalle.

Over the course of a full week, roughly half of New York office workers on average are going to offices, according to Kastle Systems, which tracks how many employees swipe their ID badges at commercial buildings. That is roughly in line with the national average.

The numbers exemplify the smaller role offices now play in many white-collar Americans' lives. That shift comes at a time when the U.S. economy is healthy, suggesting that the problems in the office market may not pose a systemic risk to the financial system.

But property owners, their lenders and others connected to commercial real estate remain under pressure.

“I think we are going to be living with a number of tough headlines for a bit longer,” said Mr. Paolone at J.P. Morgan. “These things just take a long time to play out.”

Joe Rennison writes about financial markets, a beat that ranges from chronicling the vagaries of the stock market to explaining the often-inscrutable trading decisions of Wall Street insiders. [More about Joe Rennison](#)

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