With Capital And Patience Dwindling, Short Sales Begin To Hit The Office Market

By Matt Wasielewski

Investors raised billions of dollars last year as they awaited distressed real estate assets to come to market at steep discounts. However, they found few opportunities as office owners largely found ways to hold on to their properties. That's now starting to change.

Office buildings across the country are starting to trade at significant markdowns, in many cases selling for less than the value of their loan. Those types of transactions, executed in concert with the buildings' lenders, are known as short sales.

Lenders have lost patience waiting for an office sector recovery that has failed to materialize and owners of struggling assets are finding it difficult to refinance debt at terms they can actually pay, market insiders say, kicking off a wave of forced sales that are expected to dominate capital markets throughout the year.

"We're definitely seeing owners want to give up the properties, especially ones that were recently purchased, where their equity has likely been wiped out," said Holly MacDonald-Korth, CEO of Miami-based investment firm KDM Financial.

"If they had 10% or 15% equity in a building and the building is marked down 25% or 30%, they feel like they're wiped out," she said. "They would probably be made full if they were a long-term owner, but a lot of them are looking to give back the keys."

Economists at the National Bureau of Economic Research estimate that about 44% of all office properties are underwater on their loans, facing more debt than the value of their property. If a landlord were to refinance a loan that had a 3.97% interest rate, nearly a quarter of office owners would be unable to pay down the debt, the researchers found.

Banks are sitting on around $2.7T in aggregate loans across all commercial real estate sectors, the NBER research shows. But, thus far, the financing distress that is forcing short sales is isolated to office buildings, according to JPMorgan Chase, which set aside an additional $142M in reserves last quarter due to the deterioration of loans.

The four largest U.S. banks, JPMorgan Chase, Bank of America, Wells Fargo and Citigroup, have collectively increased their loss provisions by 40.7% year-over-year at the close of 2023, Trepp reported.

While the performance of bank loans is often opaque, the CMBS marketplace offers a clear window into the office sector's health. Moody's Analytics tracked a little over $8.5B in CMBS office loans that matured in 2023 and found that only $3B were fully paid off, said Matt Reidy, the firm's director of commercial real estate economics.

"That leaves another $5.5B that we're going to have to figure something out on," he said, adding that another $15B in office CMBS debt matures in 2024.

Reidy expects more than half of office sales in 2024 to be driven by some form of distress, including in the form of lender-facilitated short sales, with activity concentrated in markets that have seen a sluggish office recovery. The handful of large transactions that have cropped up since the start of the year are just the beginning, he said.

Two properties in the Washington D.C. area traded at steep discounts in early January. Melrose Solomon paid $18.2M for 1101 14th St. NW, less than a third of the $61.7M seller TA Realty had paid in 2017.

In Bethesda, Maryland, the 16-story, 335K SF property formerly known as the Clark Building sold to South Florida-based In-Rel Properties for just under $30M. The sellers, Stonebridge and Rockwood Capital, paid $133M for the building at 7500 Old Georgetown Road in 2019.

The previous owners had secured a $103M loan on the property from Invesco that was sold to Wells Fargo in 2020, and In-Rel senior adviser Jackson Siegal told Bisnow the bank took a loss on the sale.

Reidy said that almost 80% of the CMBS office debt coming due in 2024 was either already with a special servicer or is facing significant lease rollover issues.

"There's going to be more of this, but it's going to take time to work through," he said.

A similar trend is playing out in Chicago. This month, the 12-story building at 300 W. Adams St. sold for $4M, or slightly less than $16 per SF, an 89% decline from its $38M purchase price in 2012.

The property was sold by a Morgan Stanley-managed entity that acquired the building in 2021 as part of a deed-in-lieu of foreclosure. The previous owner took out a $25M loan on the property that Morgan Stanley packaged and sold to CMBS investors.

"Sometimes the values have deteriorated for office so fast that the borrower doesn't want to put good money after bad, and the lender wants a paydown," said Kevin Shannon, the Los Angeles-based co-head of U.S. capital markets at Newmark.

Shannon represented seller Hammer Ventures this month in the lender-facilitated sale of the vacant Tower 180 in San Diego for $61M. Hammer had paid $54.4M for the property in 2016, The San Diego Union-Tribune reported, but took out an $82M loan to finance the acquisition and extensive renovations.

The renovation was completed in 2020, but the pandemic stalled efforts to lease the space. The new owner, San Diego-based hotel developer J Street Space, is now planning to convert the property into a hotel and residential tower.

In New York, at least two office buildings are also on the market as short sales.

Clarion Partners and MHP Real Estate Services came to an agreement with ING Capital to list their 41-story building at 180 Maiden Lane for a discount. The venture had paid $470M in 2015 for the property with $248M in financing from Blackstone that was refinanced for $372M in 2020 with ING, The Real Deal reported.

JLL is also marketing the $308M loan backing 1740 Broadway at a 50% discount. The loan is serviced by a division of PNC Bank after Blackstone defaulted on the debt in March 2022, The Real Deal reported.

Blackstone has written off the building — which lost $430M in value, according to a recent appraisal — and said it would work with the buyer of the debt to transfer ownership.

Short sales are dominating the distressed marketplace because they're easier to execute, Reidy said, with borrowers and lenders aligned in their goal to recover at least some of their capital.

The move to cut losses is an admission that office occupancy is coming back at a slower pace than the industry had expected. Kastle Systems' Back To Work Barometer pegged office occupancy in the 10 largest U.S. cities at 46% of pre-pandemic levels in late January.

The slow recovery is dragging down office values, with more hurdles on the horizon. More than 800M SF of office leases in buildings backed by CMBS loans are set to expire by 2028, and the stickiness of work-from-home and hybrid models has left many owners grappling with anemic rent rolls and rising vacancy.

Class-A properties in performing markets that have benefited from tenants' flight to quality are still finding lenders amenable to loan extensions and renegotiations, but the rest of the sector has been left with few options.

"Some of the nicer assets and the nicer markets, people are going to hold on longer and do the pretend and extend," Shannon said. "But if you're in a market where it's tough to get clarity on the fundamentals for the next three years, you are seeing some people say 'I don't have the patience nor the capital to get through that long.'"

Private equity from funds and investment firms are expected to be the major buyers this year, but they're also among the most likely to be putting assets out to market as they look to trade losses on underperforming properties for capital to make new acquisitions, Reidy said.

"I could see private equity being much more of the mindset of, 'Hey, look, we're confident that we're not going to see a strong recovery on this property. Let's cut our losses and get the capital so that we can look for places where there are better opportunities,'" he said.

MacDonald-Korth at KDM Financial launched a $350M fund this month to capitalize on the opportunity. The cash will mostly be deployed on multifamily bridge loans, but MacDonald-Korth said the firm was allocating around 20% of the funding to target distressed properties including office space.

"Bank transactions are still largely going to be off the table, and banks are still going to be highly capital constrained," MacDonald-Korth said. "A lot of private lenders, including us, are putting together capital to be able to fill that gap."

Office values for Class-A properties have fallen 35% since the Federal Reserve began raising interest rates, according to Green Street, while Class-B buildings have seen a 60% decline. When the dust fully settles, overall values could be down between 40% and 70%, Lonnie Hendry, head of commercial real estate and advisory services at Trepp, told Bisnow earlier this month.

The lack of transaction volume in 2023 was largely blamed on a wide gap between what sellers were asking and what buyers were willing to pay. But, analysts and brokers said the dam has begun to crack, with discounted sales starting to bring some gloomy clarity to the marketplace.

"The more comps that print, the more the appraisals catch up with valuations, and the more the bid-ask gap diminishes," Shannon said. "The deeper we get into this, the more it's hard to be in denial about where valuations are."