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Office Meltdown Part II—Fire Sales Threaten the Office Market As Signs of Distress are Showing with the Debt Maturity Wall Coming Due This Year: CMBS Hedge Fund Polpo Capital Views Office as a "Dumpster Fire"

By Peter Michael Allen

Last month in June issue of *The Investment Lawyer*, we published our interview with Daniel McNamara, chief investment officer and founder of Polpo Capital, a hedge fund focused on long and short investments relating to commercial mortgage-backed securities (CMBS).[1] In our interview, McNamara noted that "[w]ith the maturity wall [of 2023], that's going to cause issues" in commercial real estate (CRE); indeed, with an all-time record amount of debt of $270 billion coming due this year, we are just starting to see signs of distress in the CRE market. Due to the increasing trend of work from home brought on by the pandemic and further exacerbated by steadily rising interest rates, the office sector in several major cities has fallen on hard times. "Office is a dumpster fire," remarked McNamara.[2]

In early May of this year, the Fed Reserve Bank announced another interest rate increase making the increase the tenth consecutive rate increase to fight high inflation, thereby increasing the benchmark federal funds interest rate to a range between 5 percent and 5.25 percent, which is the highest rate within the last 16 years.[3]

Office Sector at the "Center of Distress"

Prior to the pandemic, San Francisco had some of the most valuable commercial properties in the world. San Francisco's California Street, one of the longest streets in the city, runs through the financial district and features numerous offices for banks and tech companies.[4] Recently SKS Real Estate Partners agreed to purchase an office tower at 350 California Street, a 22-story building, valued at about $300 million in 2019, in a deal that is still pending for a price between $60 million to $67.5 million, which is about 75 percent lower than the price of the building when it was marketed initially in 2020.[5]

Due to the pandemic, several major US cities, including San Francisco, Manhattan, and Los Angeles have experienced a dramatic rise in office vacancies.[6] Several of San Francisco's most well-known corporate tenants such as Salesforce and Facebook have decided not to wait for their leases to expire; rather they have opted to flood the office market with space for sublet.[7]

San Francisco's office vacancy rate, which is close to 30 percent, is over eight times greater than prior to the pandemic.[8] The current value of the offices in the financial district in San Francisco is difficult to ascertain because deals have nearly come to a halt.[9] The sale of the 350 California Street office tower could establish dramatically lower pricing for the city's financial district.[10]

"We're all really on the edge of our seats to see the first office trade in San Francisco," remarked J.D. Lumpkin, an executive managing director at Cushman & Wakefield, a real estate services firm.[11] Approximately $80 billion worth of loans secured by US office properties are due this year, according to Trepp Inc., with the majority of the loans needing to be refinanced in the face of tightening credit and substantially higher interest rates and decreased occupancy.[12]

Recently, Wells Fargo stated that the amount of loans for office buildings, for which the bank expects to no longer receive full interest and principal payment, increased to $725 million in the first quarter of this year from $186 million in the fourth quarter of 2022.[13] The office building at 350 California Street has a vacancy rate of 75 percent due to the primary tenant, Union Bank, mostly vacating the property.[14] Any purchaser of 350 California office tower, which was built in the 1970s, is expected to need to spend roughly $50 million in additional upgrades for interior spaces, the rooftop deck, a high quality fitness center and other improvements, which are all standard in top tier buildings, to entice new tenants.[15]

Much of San Francisco's innovative tech industry including Dropbox and Yelp have shifted to increased remote work and need substantially less office space now.[16] The average asking rent for offices was $75.25 per square foot for this year's first quarter down from the average of $88.40 for 2020's first quarter.[17] However, currently, tenants are obtaining sublease space for as little as $25 per square foot, which only covers the cost of electricity, heat, and other operating costs of a building.[18]

The seller of the 22-story 350 California Street office tower is Mitsubishi UFJ Financial Group, which is headquartered in Tokyo.[19] California Street's office vacancy rate has increased to a record of 32.7 percent, in contrast to 4 percent prior to the pandemic.[20] Previously, Mitsubishi UFJ owned Union Bank. Union Bank at one point occupied the entire building at 350 California Street. In December of last year, U.S. Bancorp purchased Union Bank from Mitsubishi UFJ.[21]

SKS Real Estate Partners, an investor and developer of commercial real estate based in San Francisco, has previously brought properties in distress, and then invested in them.[22] The sale is "a potential boost of confidence for other market participants who have been waiting on the sidelines.[23] This market is going to provide more opportunity than anyone has seen in 40-plus years," stated Derek Daniels, a research director at Colliers International in San Francisco.[24]

Top tier landlords such as Brookfield and Blackstone will continue to retain Class A office properties, according to Polpo Capital and other CRE industry sources including Brookfield and Blackstone, who have publicly made statements about their plans to focus on retaining Class A offices.[25] Recently, Brookfield Corp. defaulted on a CMBS loan for several office properties in the Washington, DC area further adding to the trend of top tier landlords abandoning Class B and below office properties.[26] The office sector faces the threat of a wave of delinquencies.

The assets in the CMBS portfolio are primarily located in Maryland's suburbs within the Washington, DC metro area; the assets are mainly small Class B properties. The CMBS loan has now transferred to a special servicer that is in talks with Brookfield to consummate a pre-negotiated agreement.[27] Since last year, the monthly payments for the CMBS loan had increased by more than twice the amount.[28]

"[Blackstone has] always focused on quality so 95 percent of what we own are trophy (and Class A) buildings that continue to see strong demand globally and benefit from the flight to quality," stated a spokesperson for Brookfield in New York City.[29] The spokesperson added that "[w]hile the pandemic has posed challenges to traditional office in certain (US) markets, this represents a very small percentage of our portfolio."[30]

Further, in late April of this year in a first quarter earnings call, Blackstone's Chairman and CEO Stephen Schwarzman has stated that [v]acancies in offices have reached all-time high levels, and owners of many of these assets may be unable to extend financing in a more constrained capital environment… we have minimal exposure to traditional US office, having reduced our holdings from over 60 percent of the real estate equity portfolio at the time of our IPO in 2007 to less than [two] percent today."[31]

Prior to 2023, due to increasing interest rates, the upcoming maturity wall in 2023, decreasing values and lack of certainty of demand post pandemic, concerns about the office sector were already high, according to data firm Trepp in a report for April of this year.[32] For the fifth consecutive quarter, office vacancies continued to rise, rising to 19 percent in the first quarter of this year; almost as high as the 19.3 percent record amount in 1991.[33] CMBS defaults are often the first step that leads to negotiations between landlords and their lenders. Often times, landlords and lenders then agree to an extension of the loan on restructured terms.[34]

In April of this year, a PIMCO owned landlord entity defaulted on a CMBS loan secured by office properties in California, New York, and New Jersey in the face of rising monthly CMBS loan payments due to increasing interest rates.[35] In May of this year, Brookfield opted to default on a CMBS loan for over 12 office buildings, mainly in Los Angeles and in the areas around Washington, DC.[36]

Repurposing offices to residential properties have been a hotly debated topic since the beginning of the pandemic induced vacancies in office properties.[37] This year, Coretrust Capital Partners defaulted on the CMBS loan for 48 story downtown Los Angeles office tower in foreclosure to the private equity firm Oaktree.[38]

Pursuant to the Uniform Commercial Code (UCC), in an auction, Oaktree initiated foreclosure on Coretrust's office tower located at 444 South Flower Street, which is a 914,000 square foot property in Bunker Hill.[39] The UCC foreclosure auction was one among many signs of increasing distress within the office market in downtown Los Angeles, which has increasingly struggled since the pandemic began.[40]

Regional Banking Crisis Adds Fuel to the Fire

Adding fuel to the fire, the collapses of Silicon Valley Bank and Signature Bank in March has increased concerns about the loans for office properties. Considering regional banks, small and medium sized, account for 80 percent of CRE lending, industry professionals are concerned the situation may further deteriorate.[41] Morgan Stanley analysts forecast that CRE prices may decrease by as high as 40 percent, "rivaling the decline during the 2008 financial crisis."[42]

PacWest Bankcorp., a Beverly Hills based regional bank, is currently experiencing acute financial distress after three regional California based lenders collapsed.[43] PacWest currently is in discussions with its financial adviser and has been weighing its options including breaking up the company or raising additional capital, according to sources.[44] PacWest has roughly 70 branches, mostly in California, about $44 billion in assets, and has been in trouble since a run on deposits led to the current banking crisis including the collapse of Silicon Valley Bank.[45]

The volume of office space for lease in Manhattan increased to a record amount during first four months of this year; the total square foot amount for office space in Manhattan that is available for lease is about 94 million, a record and the vacancy rate of 17.4 percent in Manhattan equaled the rate from February 2022, the highest recorded rate, and the vacancy rate for Manhattan has increased over 70 percent since the start of the pandemic.[46] The amount of vacant office space in Manhattan is more than the combined amount of vacant office space in Houston and Dallas-Fort Worth. Manhattan's financial district has a 25.6 percent vacancy rate and Times Square in midtown has a vacancy rate of 19.9 percent.[47]

In late April of this year, reports of First Republic Bank's collapse started surfacing.[48] By early May, First Republic Bank's collapse led to its being seized by the Federal Deposit Insurance Corp., and then a sale to JPMorgan Chase.[49]

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NOTES

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8 *The Economist*, *supra* n.2.

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