DENTONS

Guiding Principles for Navigating Ongoing Office Real Estate Market Meltdown

By Andrew Rankin

Grow | Protect | Operate | Finance

Throughout the United States it is easy to see signs of the ongoing struggles in our office real estate market. From the years-old "For Lease," signs outside the office towers to continuous news of foreclosures and high occupancy rates, it is clear that challenges in the office market will continue for years and even decades to come.

The pandemic kicked off these issues in early-2020, and the resulting shift to work from home has proven to be the largest challenge any sector of the U.S. real estate market faced since the 2008 Financial Crisis. With the pandemic thankfully fading, the market's hope for return to the office initiatives has failed to materialize given the continued tight labor market and workers' desire for remote work as an employment perk. Whether employers can implement return to office initiatives when the labor market softens remains to be seen.

Regardless of the causes and potential solutions, the effects and challenges are clear. The U.S. office market's vacancy rate at the end of 2023 hovered around 20 percent. This marks an increase from vacancy rates in the low-teens throughout the latter-half of the 2010s.

The headlines tell the tale of this market on a weekly, if not daily basis. Prestigious towers that have been fixtures in various city skylines face financial challenges, foreclosure or redevelopment. Other, smaller buildings in various cities' cores and surrounding suburbs face similar challenges.

All this doom and gloom begs the question: What can individuals and companies who have a stake in this office market do to navigate these challenging conditions and ensure future success?

The stakeholders

To understand the answer, we must first identify the applicable stakeholders: 1) **Owners/Landlords**: This group owns the building, pays for its upkeep, pays the taxes, collects rent, pays the building's mortgage and negotiates and signs the leases; 2) **Lenders**: This group lent the owners/landlords money to purchase, construct, improve, maintain and operate the underlying office property. They hold the property's mortgage and receive monthly payments; 3) **Tenants**: This group leases space within the building from the owner and makes rental payments in exchange for occupancy; 4) **Property Managers**: Owners and landlords occasionally self-manage their properties, but frequently engage third-party property managers to manage the day-to-day operations of a property, including its maintenance, collection of rent and other sums from tenants, communication regarding tenant requests and landlord responses, and even lease negotiations; 5) **Real Estate Brokers**: These brokers are specialists in the office market, understand current market trends, handle the marketing of office buildings for owner clients and procure available space for tenant clients; and 6) **Asset Purchasers**: In any challenging market, there will always be third parties who seek to identify and purchase assets which experience financial difficulties. These purchasers look to acquire assets at a beneficial price during a crisis and realize efficiencies that the prior owners did not have either the foresight, ability or financial strength to execute. In doing so, these purchasers are betting on their ability to turn a distressed, unprofitable asset into a viable and profitable one as market conditions improve.

Guiding principles

There are two guiding principles when facing challenges such as those presented by the current commercial office market. The first: do not ignore the problem and hide your head in the sand. Whether you are an owner, lender, tenant, property manager or broker, you should understand the financial and physical condition of your assets in as close to real time as possible. Owners, lenders and property managers must understand their assets' income, expenses, mortgage terms (including key dates), mortgage rate fluctuations, reserves, upcoming capital expenditure budget and requirements, key tenant renewal and expiration dates, and the payment history of their key counterparties. Tenants must monitor their lease terms, any upcoming opportunities for renegotiation, their premises and the building's condition, alternatives within the market and their landlord's relationship with its lender. Property managers and brokers must help their clients understand all these conditions.

Monitoring these conditions lets the various parties know if an office building is financially and operationally healthy, or whether a problem (or opportunity) exists. If owners or lenders identify a problem such as a failing tenant or an owner unable to pay its mortgage, then the second piece of guiding advice comes into play. That advice is this: once a problem is identified, engage all interested parties to negotiate a solution as soon as commercially possible. Understand the underlying facts and legal duties, rights and remedies first, but once a party has that understanding it is necessary to commence negotiations as soon as possible.

Speed is critical because resources, and the flexibility in negotiations those resources represent, are finite. A landlord does not have an unlimited budget to offer new amenities or lease incentives to a tenant. Similarly, a lender does not have unlimited room on its balance sheet to offer forbearance or work outs. A favorable outcome is more likely to occur when a party understands its rights and engages in negotiations as soon as a problem emerges and its scope is understood.

Specific strategies

Having identified the interested parties (owners/landlords: lenders, tenants, property managers, real estate brokers and asset purchasers) and the need to act quickly, it is necessary to examine specific strategies to navigate the current office crisis. Potential solutions exist in four areas: 1) operational negotiations; 2) financing negotiations; 3) restructuring; and 4) acquisition, redevelopment and land use opportunities. Working with their respective legal and financial professionals and firms, each of the stakeholders should understand and utilize the remedies available to it and its potential counterparties in each of these areas.

Operational Negotiations

Operational remedies are most readily available to landlords and tenants, and the brokers, property managers and legal professionals who advise them. Landlords should seek to engage tenants with expiring leases and secure their future tenancy as soon as possible to establish as much certainty as possible in their revenue stream. From a potential new tenant's perspective, once the tenant identifies a space it is useful to understand potential financial and operational challenges within a building. Understanding the overall market and a particular building's challenges within that market leads to an advantageous negotiating position. The same is true for existing tenants with upcoming lease expirations. Ideally, an existing tenant would extend or renegotiate its lease 18-to-24 months prior to expiration for maximum leverage. Given current market conditions, however, that period may be extended to maximize market-based leverage.

Given current conditions, landlords should consider offering and tenants – whether new to a space or renewing an existing lease – should consider requesting some or all of the following concessions, depending on a building's occupancy and desirability: 1) reduced rent from prior terms; 2) a term of abated or free rent; 3) fixed operating costs, insurance or tax expenses; 4) early termination rights for all or a portion of the space; 5) unilateral long-term renewal rights at fixed rent; 6) increased signage and visibility; 7) purchase options or rights of first refusal; and 8) other financial and operational incentives based on the building. All parties should understand that these incentives allow the landlord to "win" in a limited pool of available tenants and allow the tenant to realize savings and operational benefits that could be the difference between financial success and failure.

Financing Negotiations

While operational negotiations primarily involve landlords and tenants, this category primarily involves lenders and landlords/owners. When a lender looks at an asset and sees tenant defaults or non-renewal or, worse, its borrower misses a payment, the lender should immediately place that asset under a magnifying glass. The lender must first understand its remedies in such situations, from triggering financial covenants, to commencing the default/foreclosure process, to notifying the property's tenants of lock-box procedures pursuant to which they must pay rent directly to the lender. The lender must obtain a full picture of all the tools it possesses. Then, the lender may engage with its borrower (the owner/landlord) to understand its condition, the operational condition of the leveraged asset and negotiate potential resolutions. Although a negotiated solution may be preferable, the lender should also consider whether the current asset is salvageable with its current owner and be prepared to impose contractual remedies up to foreclosure.

Conversely, if the asset's owner knows that either it or its building's financial or operational condition may result in a violation of contractual covenants or missed or insufficient payments, the owner should consider a proposed solution and approach its lender with that solution as soon as possible. Again, a lender's resources and balance sheet are limited and the sooner an owner understands its problem and approaches its lender with a solution, the higher the probability of a negotiated resolution.

Restructuring

Although nobody likes to consider the dreaded "B" word, the bankruptcy and restructuring process contains advantages for both lenders and their borrowers/property owners. At a minimum, lenders, tenants, property managers and brokers must be able to navigate the process to protect their respective rights if an owner files for applicable protections.

Property owners who are unable to meet their current financial obligations, but understand that their assets may possess underlying value currently or if market conditions improve, may utilize the restructuring process as a negotiating tool and to protect an asset's existing equity. Keep in mind that this process is based on federal law and all parties should engage legal and financial parties who are familiar with that law, applicable regulations and the best possible strategies.

Redevelopment and Land Use Opportunities

The previous categories largely dealt with strategies and opportunities available to lenders, owners/landlords, tenants, property managers and brokers, while leaving the final stakeholder, asset purchasers, neglected. Asset purchasers, particularly those with a strong financial position through cash holdings or readily available financing, provide a valuable service to a struggling market while also realizing the opportunity for profit.

These purchasers negotiate with owners or the lenders who control distressed properties to acquire those distressed properties at favorable pricing or terms. The purchaser then utilizes its industry knowledge or strong financial position to improve the asset with its current use intact, realize operating efficiencies or redevelop the property to a new use. Keep in mind that even with an historically high vacancy rate approaching one-fifth of all office space in the U.S. market, that vacancy is not evenly distributed. Offices that offer the right mix of amenities, incentives, location and other desirable factors will succeed and achieve full or near-full occupancy, while the operators who are unwilling or unable to offer that competitive mix will earn more than their fair share of vacancy.

Alternatively, an asset purchaser may consider a new use for a current office property. Mixed-use, residential condominium, retail, multi-family residential, and even light or heavy industrial may be available, desirable and financially viable. Government bodies and their land use arms understand the challenges the current office market presents and possess a greater willingness to collaborate with a purchaser who desires to change a property's use.

The acquisition, revitalization and potential use change associated with a distressed office asset require significant preparation. The asset purchaser should engage with local brokers and property managers to understand the market, its challenges and potential opportunities. The purchaser must utilize its brokers and even governmental development agencies to engage with both lenders and owners to determine what assets are or may be available at favorable pricing. Finally, the purchaser must have its financial and legal teams ready so that it may proceed with the speed and certainty necessary to obtain favorable pricing and realize a property's best and most profitable use.

Conclusion

The commercial office crisis presents challenges to all its stakeholders. While these challenges are likely to persist and even worsen, bright spots both geographically and within certain uses remain. While some of these challenges may prove to be insurmountable for certain stakeholders, employing the strategies outlined above and collaborating with parties who understand both the market and the building/asset as soon as a problem (or opportunity) arises remains the best method to achieve a favorable outcome.

Andrew Rankin is Of Counsel in Dentons' Indianapolis office. With more than 20 years of real estate experience, he advises clients in commercial and industrial real estate matters, including in purchase, disposition, financing, construction, leasing and operation.

CSBrand-146422-Guiding Principles for Navigating Ongoing Office Real Estate Market Meltdown-02 — 14/06/2024