World’s Empty Office Buildings Become Debt Time Bomb
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(Bloomberg Businessweek) -- In New York and London, owners of gleaming office towers are walking away from their debt rather than pouring good money after bad. The landlords of downtown San Francisco’s largest mall have abandoned it. A new Hong Kong skyscraper is only a quarter leased.

The creeping rot inside commercial real estate is like a dark seam running through the global economy. Even as stock markets rally and investors are hopeful that the fastest interest-rate increases in a generation will ebb, the trouble in property is set to play out for years.

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After a long buying binge fueled by cheap debt, owners and lenders are grappling with changes in how and where people work, shop and live in the wake of the pandemic. At the same time, higher interest rates are making it more expensive to buy or refinance buildings. A tipping point is coming: In the US alone, about $1.4 trillion of commercial real estate loans are due this year and next, according to the Mortgage Bankers Association. (Other estimates are a bit lower.) When the deadline arrives, owners facing large principal payments may prefer to default instead of borrowing again to pay the bill.

Major institutional owners including Blackstone, Brookfield and Pimco have already chosen to stop payments on some buildings because they have better uses for their cash and resources.

“There’s significant stress,” says Harold Bordwin, a principal in New York at Keen-Summit Capital Partners LLC, which specializes in renegotiating distressed real estate. “People don’t give up assets so easily unless they just don’t see any hope and they recognize that they’re pretty well underwater.”

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The number of transactions is plunging—and when deals do happen, the price declines are stark. In the US, where return-to-office rates have been lower than in Asia and Europe, values for institutional-quality offices are down 27% since March 2022, when interest rates started going up, according to data analytics company Green Street. Apartment building prices have declined 21%, and malls are off 18%. Office prices are expected to fall more than 25% in Europe and almost 13% in the Asia-Pacific region before hitting a trough, PGIM Real Estate, a unit of Prudential Financial Inc., forecasts.

What PGIM analysts have called “the great reset” of values is likely to be agonizingly slow. It took six years for US office prices to recover after the 2008 financial crisis, even though that episode was centered on residential real estate.

“This time we think it’ll take 10 years,” says Richard Barkham, global chief economist for CBRE Group Inc.

Commercial real estate’s woes will add to the stress on a financial system that’s already reeling from this year’s crisis in regional banks. And as the downturn deepens, it stands to have a transformational impact on some cities as they contend with empty buildings and lower property tax revenue.

The question is whether the commercial property correction will be big enough to destabilize the wider economy. As broad as the forces arrayed against the real estate sector may be, it’s also very local business, encompassing not only urban skyscrapers but small-town shopping centers, suburban apartment buildings and sprawling warehouse parks.

“Cities all have different stories to tell,” says Peter Hayes, a managing director of investment research for PGIM Real Estate in London. “They’ve all been changed by different localized shocks. You end up in a world where investors have to think more about geography than they have.”

Already, debt distress has stretched from Los Angeles to Sweden and South Korea. Here’s how the troubles are unfolding in some major financial and business centers around the world.

San Francisco

Nowhere in the US is the crisis more pronounced than in San Francisco, where a downward trend is gathering momentum as one building after another slips into default. Property prices in the tech hub reached record heights in the past decade, so they had a long way to fall. The city boomed with hot startups—Airbnb, Twitter, Uber Technologies—along with established giants such as Salesforce. Now many of them have cut jobs and office space.

The downtown is struggling to re-attract employers and employees who flourished working remotely. The area consists largely of office towers, leaving it feeling particularly empty. Those workers who do come in endure among the nation’s longest average commutes. San Francisco’s homelessness crisis is also concentrated downtown, and highly publicized retail theft has led to some stores closing.

In the once-fashionable Union Square district, the owners of the city’s largest mall, Westfield San Francisco Centre, in June essentially handed the keys over to holders of a $558 million mortgage. The move came after Nordstrom Inc. announced it was shutting its department store in the complex. With tourism slow to rebound from the pandemic, Park Hotels & Resorts Inc. has stopped payments on $725 million in debt tied to two of the city’s biggest hotels, Hilton San Francisco Union Square and the Parc 55 San Francisco. Veritas Investments Inc., a major local landlord, defaulted on $675 million in debt on a portfolio of apartments valued at more than $1 billion in 2020. The loans are now on the market.

The office-vacancy and availability rate has tripled from pre-pandemic days. In one of the city’s few office deals, Wells Fargo & Co. recently sold a 13-floor tower at 550 California St. for about $200 per square foot, down from the 2019 market peak of more than $1,000, according to Newmark Group Inc., a real estate services company. Lower prices are getting some investors to consider potential opportunities. “We’ve never bought in San Francisco,” says Mike Pestronk, chief executive officer of Post Brothers, a developer in Philadelphia with $4 billion in multifamily property. “But it seems like it’s getting very interesting.”

But what’s interesting to an outsider is excruciating for owners. “There’s no way to avoid the price reset that’s coming,” says David Bitner, an analyst in San Francisco for Newmark. “Office is bearing the brunt, but there’s also older retail and more recent multifamily that’s being affected.”

The city’s coffers are taking a hit, with Mayor London Breed projecting a $780 million two-year budget deficit. She’s proposed diversifying the downtown, including the conversion of more buildings to housing, and suggested the Westfield mall could be used in other ways, reflecting a “new vision” for the property. For now, there’s a lot of empty space to fill.

New York

Although New York City’s streets are bustling with tourists and residents, only about half of office workers are back at their desk, according to building security company Kastle Systems. Scores of buildings are struggling with the loss of tenants and the need for upgrades. As employers work out their updated office needs, they can choose spaces in newly built towers in such areas as Hudson Yards or near Grand Central Terminal rather than aging properties.

These choices helped put even iconic buildings in the world's financial capital into troubled situations. At the Seagram Building, a 1950s skyscraper in Midtown that's renowned architecturally for its modernist design, owner RFR Holding had to negotiate a one-year extension on $1 billion of debt set to mature this year after failing to secure financing. RFR spent $25 million on upgrades, including a vast sports complex and a wellness center, and the property was 95% leased as of earlier this year. Still, it lost Wells Fargo to a newer development prior to the pandemic, while private equity firm Clayton Dubilier & Rice is relocating to a renovated Madison Avenue tower.

Developer GFP Real Estate received a two-year extension on the DuMont building, an art deco tower on Madison Avenue, after being unable to repay the $103 million mortgage when it came due. To hash out the deal, GFP had to commit capital for helping to boost its future leasing prospects in the building.

Mayor Eric Adams has called for a wider return to the office, urging Wall Street leaders to enforce more in-person work. Offices, expected to reach a record 22.7% vacancy rate this year, typically account for about 20% of the city's property tax revenue. A joint study from researchers at New York University and Columbia University found that offices in the city will lose 44% of their pre-pandemic value by 2029 because of the impact of remote work.

"The landlords are really seeing a real witches' brew of obstacles right now—they've got problems on every side," says Ruth Colp-Haber, CEO of brokerage Wharton Property Advisors. "The best buildings with the top owners are going to hang on, and they're going to get through this. But for the buildings that have a large vacancy and also need a lot of work, the economics just aren't going to pan out."

Atlanta and Other Boomtowns

Cities beyond the US coastal financial centers are feeling the pain, too. Atlanta's office availability rate for lease and sublease climbed to 31% in the first quarter, almost double the pre-pandemic level, according to British real estate services company Savills Plc. Companies are looking for smaller spaces in hotter neighborhoods.

Tenants vacated an additional 290,000 square feet in downtown Atlanta "class A" office space in the first quarter, according to Jones Lang LaSalle Inc. Some demand shifted to Midtown, where asking rents are 44% higher than downtown and tenants added a net 32,000 square feet. Landlords are facing a wall of balloon payments: Almost 30% of the Georgia capital's office space has debt maturing between now and 2025, more than any US metro area, according to Yardi Systems Inc., which makes property management software.

There are similar stories across the Sun Belt and the mountain West, where many workers and companies relocated during the pandemic. Even Austin, which emerged as a low-cost alternative to Silicon Valley, now faces surging vacancies that will make it harder for landlords to raise rents. Space available for sublease more than doubled in the Texas capital since June 2022, to 5.9 million square feet, the fastest rise of any US metro area, according to CoStar Group Inc. Only San Francisco and San Jose have higher shares to sublet. “Austin has had a breathtaking increase,” says Phil Mobley, CoStar’s national director of US office analytics. “Tech companies definitely have a propensity to work remotely.”

Elsewhere, new supply is meeting falling demand. In Colorado, a pair of towers built in the late 1970s, formerly the Denver Energy Center, are for sale after lenders seized them. The buildings are only 32% leased. Lenders have also taken over Houston’s Pinnacle at Westchase, a nine-floor suburban office complex whose appraised value is off more than 75% compared with 2012, according to loan documents.

There’s a widening divide between winners and losers, says Doug Ressler, senior research officer for Yardi. “It’s bifurcated,” he says. “The trophies should hold up. The ‘B’ and ‘C’ offices are going to have to look to repurpose.”

But not every old building can find a new purpose. “It’s really hard to turn a 1990s office tower into something other than a 1990s office tower,” says Lea Overby, a commercial real estate analyst with Barclays Capital Inc. “It’s just not cool.”

London

The widespread adoption of hybrid working is hitting London unevenly. Office vacancy rates in London’s West End, home to the city’s buzziest retail and nightspots, are almost at record lows as companies look for space in the best buildings and locations to help lure workers back. Rents are rising, too, because companies are prepared to pay more per square foot, while taking less space overall.

The Canary Wharf district, home to 1990s-era glass-and-steel towers, is in the deepest trouble. The neighborhood, perceived by most as a place built solely for bankers, is having a harder time staying relevant for major office tenants. Law firm Clifford Chance is leaving in favor of a new—and much smaller—office in the more centrally located City of London

district. HSBC Holdings Plc is looking for a new headquarters, with most of its shortlisted options in the City as well. The YY building, a recently completed redevelopment of Thomson Reuters Corp.'s former headquarters that occupies the prime site right outside the Canary Wharf tube station, remains entirely vacant. Two office buildings that were considered "trophy" only a few years ago are now in the hands of lenders. A consortium led by Lloyds Banking Group Plc appointed receivers on 5 Churchill Place and 20 Canada Square after the buildings' owner, China's Cheung Kei Group, failed to repay loans secured against them. Both face vacancies and significant costs for refurbishment.
Another issue looming over London's real estate market is the prospect that hundreds of buildings will be rendered obsolete because they don't meet UK environmental regulations. Properties are graded on energy performance, from A to G. By 2030 it will be illegal to rent commercial buildings that are ranked below B. That leaves landlords forced to make costly upgrades or risk offices sitting empty. Brexit has also contributed to London losing some of its financial allure, says PGIM's Hayes. Office buildings are "very, very vulnerable for the near term," he says.

Stockholm

For Sweden's property market, the main problem isn't vacant offices but the sheer amount of debt some property companies amassed during the era of rock-bottom rates. A lot of that financing came from short-term and floating-rate bonds, so yields and costs are going to soar. Landlords in the biggest Nordic nation must roll over or refinance $42 billion of bonds over the next five years, nearly a third of which falls due next year.

No company typifies the problem more than SBB, as Samhallsbyggnadsbolaget i Norden AB is more commonly known. The social housing landlord began to see its $13 billion empire unravel following a downgrade to junk in early May. Asset sales and a scrapped dividend haven't been enough to arrest a slide in its share price, which is down more than 90% since the end of 2021. SBB is currently the subject of a probe by the country's financial watchdog into whether it violated accounting rules, and its founder has been ousted as chief executive.

Hong Kong

A 26-floor building with a sweeping view of Hong Kong's famed Victoria Harbour made headlines in the city in 2015 when China Evergrande Group, not a global name at the time, purchased it for $1.6 billion—more than double the previous record for an

office tower. The deal exemplified the property market boom in the Asian financial hub, which in the years that followed attracted ambitious Chinese capital to buy everything from office blocks to land plots, often at record-breaking prices.
Investing in offices appeared to be a safe bet in a city with tight space and strong demand from mainland Chinese companies.
Then came antigovernment protests and the strict lockdown measures of Covid-19 in 2020, which made investors rethink Hong Kong's status as a financial hub. Adding to the turmoil: a Chinese property debt crisis, with Evergrande at the center.
With hundreds of billions of dollars in debt, the developer sought to raise cash in every way possible and, in late 2020, pledged the office building to a bank in return for a HK$7.6 billion ($971 million) loan. Last year a receiver took over the property. The new owner put the building up for sale but failed to get a bid that reached its target. The tower is now only about 25% occupied, in part because prospective tenants are put off by its complicated ownership. It was fully occupied when Evergrande bought it.
Across the city, cost-conscious foreign banks and Chinese companies are no longer taking up space at a time when new supply is increasing. The vacancy rate for top-tier Hong Kong office buildings climbed to 15% in April, more than three times what it was in 2019, data from Colliers International Group Inc. show.
Unlike landlords in New York and London, Hong Kong's can't blame remote work for the slump. The city's highly efficient public transport system and tiny apartments have given residents fewer reasons to work from home. The city is already back at the office; subway ridership surpassed 2019 levels in March.
But the commercial market slump in a rising interest-rate environment still has property owners such as Evergrande in a tough situation. They can't refinance buildings because of falling values, nor can they easily find buyers for them. The choice is to sell at a steep discount or stomach interest payments. Instead of providing liquidity and stability, real estate assets have become a burden. —With Charles Daly
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