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RISING INTEREST RATES TAKE TOLL ON FANNIE, FREDDIE DEAL VOLUME

Elevated borrowing costs coupled with economic uncertainty have led to an extremely slow start out of the gate in 2023 for the GSEs.

By John Nelson

The multifamily divisions of Fannie Mae and Freddie Mac are off to a slow start this year as the government-sponsored entities (GSEs), their network of lending partners and multifamily borrowers contend with rising interest rates.

Fannie Mae's volume of new multifamily business totaled $10.2 billion in the first quarter of 2023, which is a 36 percent decrease from the same period a year earlier when the agency closed $16 billion. Freddie Mac closed $6 billion in new multifamily business in the first quarter, a year-over-year decrease of 60 percent.

Seasoned agency lending professionals all point to elevated borrowing costs as the primary reason for the two agencies closing less business thus far in 2023.

"The rapid increase in rates across the board has really been a shock to the industry," says Vic Clark, senior managing director and head of conventional multifamily production at Lument.

At its May meeting, the Federal

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Architect BKV Group is working on the transformation of Landmark Towers in St. Paul into residential space.

INDUSTRY PURSUES SOLUTIONS TO OFFICE MARKET WOES

Renovating or repurposing buildings and offering ready-made spaces are some of the ways to adapt.

By Kristin Harlow

There's no denying the office sector is undergoing a critical period marked by myriad challenges. The question is, how will it all turn out?

Currently, the inventory of U.S. office space is 5.56 billion square feet — and will likely reach over 5.68 billion square feet by the end of the decade. But today's "flexible" workforce will only require 4.61 billion square feet to accommodate its needs, according to a Cushman & Wakefield report titled "Obsolescence Equals Opportunity."

"The U.S. will end the decade with 1.1 billion square feet of vacant office space, 740 million square feet of which qualifies as normal or natural vacancy and 330 million square feet of which qualifies as excess vacancy attributable to remote and hybrid strategies," the report states. "The overall level of vacancy will therefore be 55 percent higher than was observed prior to the pandemic."

Those numbers are jarring, but opportunists say the office sector just needs to evolve and adapt, much like the retail market has done.

"Just as retail didn't die in the years following the e-commerce boom, the office sector is not in danger of demise," states the Cushman & Wakefield report. "Recognizing the challenges and opportunities head-on with a proactive, creative and strategic approach will help both existing ownership and the prospective investment community ensure the viability of millions of square feet of commer-

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cial real estate space."

The two main strategies for struggling office assets are to renovate them or repurpose them into new uses.

"Given there is a shortage of housing across the country, and since housing can take shape in many different forms and typologies, it's a natural fit for repurposing office properties," says Mike Krych, senior design leader and managing partner with Minneapolis-based architecture firm BKV Group. "The concept of converting office to residential is not a new one, but [the situation] has become much more acute now with a lot more space available."

Naturally, some office buildings are more suitable for multifamily conversions than other property types. Krych says that pre-World War II properties constructed between 1900 and 1940 are particularly well suited for multifamily adaptive reuse because they are naturally ventilated with operable windows and feature shallower footprints. Modern office buildings are often more challenging to convert because of deep footprints that don't rely on natural light or ventilation, and instead utilize mechanical systems, resulting in open floorplates without windows.

BKV Group is currently transforming a modern commercial building, Landmark Towers in St. Paul. When it was built in the early 1980s, the development featured five levels of condominiums at the top and 213,000 square feet of office space on the middle levels. The office floors are now abandoned, and the plan is to convert the space into 186 apartment units. Historic tax credits will help finance the $80 million project being undertaken by Sherman Associates.

David Lockwood, executive vice president and COO with Colliers South Carolina and SIOR global president-elect, says that all office owners are evaluating how much money to spend on upgrades to attract and retain tenants or whether a building is not worth the expense. "We see Class A tenants moving to Class A+, Class B tenants moving to Class A, but nobody's really backfilling the B and C space," he says.

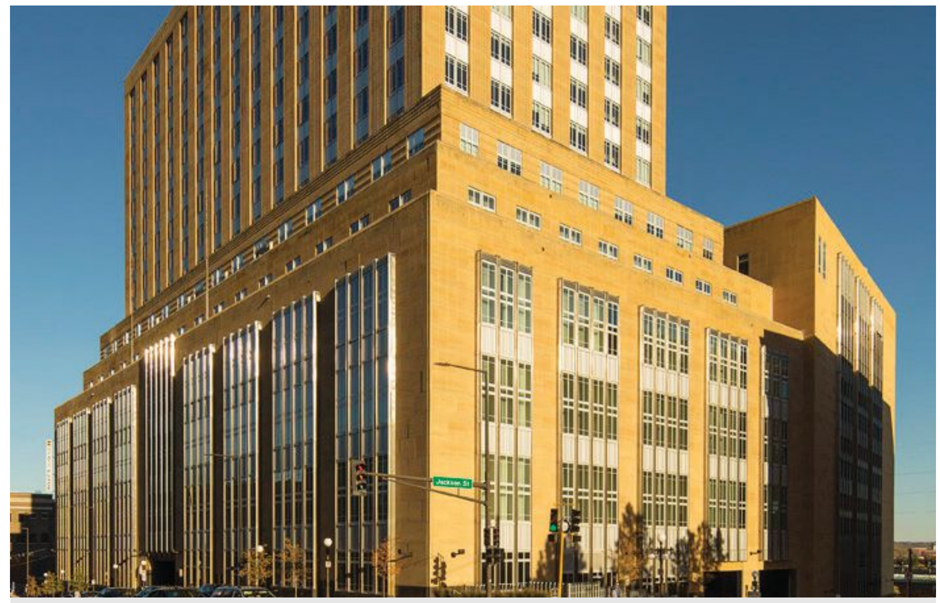
The flight to quality occurring in the office market often translates to tenants downsizing their square footage in exchange for higher-quality space. On the other hand, some industry professionals say certain tenants are still showing an interest in Class B and C spaces.

"The assumption is that everyone wishes to have a Class A space with all the bells and whistles, but the older and underutilized office product is not going away because it remains attractive to smaller entrepreneurial companies that are starting out, or companies that prefer to operate from a smaller location and need a storefront persona," says Marilyn Russel, interior design project manager with Baker Barrios Architects, which maintains offices in Orlando, Tampa, Nashville and Chicago. "These spaces are affordable and attractive to the right tenant."

Adam Johnson, executive vice president of capital markets and office services for Oakbrook Terrace, Illinois-based NAI Hiffman, echoes this sentiment, emphasizing that there will always be a need for cost-effective space. "Service-related industries, startup companies and others need a place that fits their budget."

Financial woes

Given the supply-demand imbalance and cashflow problems plaguing many office building owners today, the property sector has fallen out of favor with investors. Total returns year-to-date through May 23 for office REITs fell 21.2 percent, as tracked by the FTSE Nareit Equity Office Index.



BKV Group worked on the conversion of the 740,0000-square-foot City of St. Paul's Main Post Office into an apartment development named Custom House.

On a year-over-year basis through May 23, total returns for office REITs plummeted nearly 41 percent. There are 19 office REITs included in the index.

Atlanta-based Piedmont Office Realty Trust (NYSE: PDM) reported a net loss of $1.4 million in the first quarter compared with net income of $60 million in the first quarter of 2022. Philadelphia-based Brandywine Realty Trust (NYSE: BDN) reported that its net loss allocated to common shares totaled $5.3 million in the first quarter compared with net income of $5.9 million this time last year.

On April 26, New York City-based Vornado Realty Trust (NYSE: VNO) announced it would suspend its common stock dividends until the end of the year. The REIT also authorized the repurchase of up to $200 million of its outstanding common shares under a newly established share repurchase program. Cash retained from dividends or from asset sales will be used to reduce debt or fund share repurchases.

Many landlords are also at risk of defaulting on loans. According to Cushman & Wakefield, $40 billion in outstanding office loans currently face some form of trouble or distress, representing 1.7 percent of total outstanding loans. The office sector is also facing a wave of oncoming debt maturities representing more than $130 billion over the next two years.

Lockwood says much of that distress stems from Class B and C buildings where there may be nonrecourse loans attached to properties without high occupancy. "Owners will have to make the decision of whether they put more money into the building, or whether they default on the loan," he says. "That's where the biggest challenge is going to be."

"This is a difficult situation and we're going to see it play out over a period of time that extends beyond this year," says Darin Mellott, a vice president of capital markets research for CBRE. "In terms of hard numbers, it's difficult to say right now. But we'll see more distress surface in the coming months."

Distress is also mounting in the form of property sales. *The Wall Street Journal* recently reported that owners are starting to unload troubled office buildings at fire-sale prices. According to the newspaper, the uptick in these types of sales indicates that more owners believe that weak tenant demand is here to stay.

NAI Hiffman's Johnson states that most distressed sales will be tied to buildings that have lost a large anchor tenant. He foresees more distressed sales to come, but not at the pace some might expect, particularly in the suburbs. "The underwriting by banks coming out of the Great Recession has been conservative for office, so many loan-to-value ratios and personal guarantees will keep many buildings from going back to the lender," he says.

A joint venture between Wingspan Development Group and Tucker Development acquired 5400 Old Orchard Road in Skokie, Illinois, with plans to redevelop it into luxury apartments and rental townhomes. The site currently houses an office building, demolition of which is scheduled to begin this fall. (Rendering courtesy of HKM Architects + Planners)

Health of communities

The retail and restaurant segments are also feeling the negative ripple effects of the struggling office market, particularly in downtown areas. The low foot traffic is a legitimate concern for cities.

"It's the urban core areas that are suffering the most from the retail fallout associated with the lack of employees," says Lockwood. In his eyes, it's a wait-and-see mindset until employers have the upper hand in the job market and are able to demand that employees return to the office.

"Right now, employees have the control. They can name their price and move from job to job," says Lockwood. "We're seeing the market evolve and change right now. At some point, there will be a shift where employers have the upper hand again — but I don't see that happening anytime soon."

The national unemployment rate has held relatively steady for the past year. As of May, the rate was 3.7 percent. Meanwhile, the labor force participation rate remained unchanged in May at 62.6 percent and continues to be below pre-pandemic levels for reasons that aren't entirely clear.

Mellott says that the commercial real estate industry is beginning to play a role in educating policymakers about the impact of the shifting dynamics in the office market and the effect on the health of cities.

"There is room for policy to ensure that our communities remain healthy," he says. "I'm not talking about bailouts, but appropriate incentives that can help solve problems in communities and ensure a stronger long-term outlook. I know these types of conversations are occurring."

Mellott believes that the greatest opportunity for policy is to incentivize investors to either make necessary upgrades to office assets or aid conversions to residential or other uses. He also notes that companies will likely get more vocal about the return to the office if the economy weakens, resulting in more leverage for employers.

Adapt or wither on the vine

Russel's advice for office owners is summed up in one word — adapt. "Adapt to stay current, adapt to remain relevant and adapt to be attractive," she says. "Seek to embrace rather than challenge the 'office is dead' mentality by offering transformative spaces."

Lockwood's best advice for owners is to think long term. "Tenants are not afraid to sign long-term leases. They're also not afraid to put money into the improvements themselves."

This summer, Vornado Realty Trust is opening new amenities at THE MART office building that it owns in Chicago. River Park is a yard space where tenants and the public can gather. (Rendering courtesy of THE MART and completed by Evolution Virtual)

Johnson says that owners need to remove as many obstacles as possible for tenants when it comes to inking new deals. One example is speculative suites or ready-made office space. "These types of spaces are the first to lease because it is an 'easy' button for tenants," he explains. "There are no worries about cost overruns, timing or needing to design the space, so tenants are able to move in quickly."

Johnson's second piece of advice is to know the competition. "Try to be the best, but don't overspend on upgrades and amenities to compete with a higher-class building. That is usually a losing proposition," he says. "Spend money on functional layouts that can be reutilized for future deals."

At the end of the day, the question is whether the office market will ever return to utilization rates experienced prior to the COVID-19 pandemic. Lockwood says "yes" because right now there is limited new construction and vacancy rates are dropping in Class A space.

"If older office stock is taken off the market because it gets transitioned into new uses, then the natural effect is for the market to get tighter," explains Lockwood. "It will take a while, but it will return." ■