Yardi Matrix

National Office Report

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Distressed Activity to Pick Up in 2023

- In the years since the pandemic unsettled the office market, many have been anticipating a wave of distressed offices. While distressed activity has been few and far between to this point, conditions may lead to a significant uptick in 2023.

- Some of the factors that have kept distressed activity muted are no longer applicable. Long lease terms for office space mean firms that embraced remote and hybrid work have allowed offices to sit empty while waiting for their leases to expire. Cheap money allowed many owners to kick the can down the road, hoping that pre-pandemic office utilization would return, but it seems increasingly unlikely that will happen.

- The converging forces of a higher cost of debt, weak demand, falling prices and a potential recession could lead to an increase in distressed activity this year. Higher interest rates have already put pressure on owners with floating-rate debt and will provide a substantial challenge for loans that need to be refinanced in 2023. Remote and hybrid work have become entrenched, and the tech industry that drove much of the leasing of office space in recent years is now in a contraction. Weak demand is leading to falling prices for office. The national average sale price of an office property fell from $269 per square foot in the first quarter of 2022 to $214 per foot in the fourth quarter. A flood of distressed office activity could trigger a downward price spiral for offices.

- Properties with low occupancy, expiring leases and maturing loans will be most likely to face distress. A tenant flight-to-quality has been taking place since the pandemic, with firms decreasing the size of their footprints but increasing the quality of the space they lease. This puts older assets, especially those that are not well located and have not been well maintained, at high risk of distress, as well. Yet even trophy towers are not exempt, with Brookfield defaulting on $784 million in loans for two office towers in downtown Los Angeles. Yardi Matrix allows subscribers to identify properties that have attributes that could lead to distress.

- We anticipate that distressed activity will increase in frequency this year, but it is too early to say it will be a large wave. With demand for office space continuing to be soft, we expect that many of the distressed properties that are sold may be targeted for conversions into life sciences or multifamily, with some razed and entirely redeveloped.