Yardi Matrix

National Office Report

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Debt Service Looms Over Offices

- The wave of office distress that many anticipated has yet to materialize, but research from Yardi Matrix shows that many markets are exposed to potential distress.

- Debt service coverage ratios—a measure of net operating income against current debt obligations—have declined for offices in recent years, due to the two components of the ratio moving in opposite directions. As interest rates shot upwards in the last year-and-a-half, so did debt costs for commercial real estate. At the same time, cash flow has fallen—vacancy rates spiked as firms downsized or eliminated physical office footprints altogether—and expenses have grown. Despite DSCRs' downward movement, market-level average ratios show only a handful of markets exposed to widespread risk. Using aggregated and anonymized income and expense data along with researched loan information and vacancy rates, Yardi Matrix estimates market-level DSCRs for many of the metros covered by the service.

- In March, five of the 91 markets analyzed by Yardi Matrix had average DSCRs below 1.0: Brooklyn, N.Y. (0.81), Oklahoma City (0.89), Chicago (0.90), El Paso (0.92) and Cleveland (0.96). Another eight markets—including Manhattan (1.05), St. Louis (1.16) and Nashville (1.25)—sit at or below the 1.25 ratio that most lenders require. However, it is important to note that these market-level rates are only estimates, and DSCRs can vary vastly from property to property. Many properties within markets with low average DSCRs continue to perform well, while properties in markets with a high average DSCR face distress. Yardi Matrix has DSCR estimations at the property level to identify potential future distress situations.

- The forces behind downward pressure on DSCR are unlikely to reverse in the near future. Demand for offices remains stagnant, as hybrid and remote work has become fully entrenched within many firms. Expense increases, like insurance and maintenance, have cooled in recent months but continue to eat into NOI. Interest rate cuts may begin this summer, but in all likelihood will not be steep enough to save properties that are teetering on the edge of distress. Office loans that mature are at greater risk of distress and delinquency because of the difficulty of generating enough cash flow to cover debt obligations in the current environment. Many in the sector have adopted the mantras of "extend and pretend" and "survive until '25," hoping for circumstances to improve in the next year.