Skadden

Adapting to a Dynamic Commercial Real Estate Landscape

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Key Points

- Increased vacancies and higher interest rates and financing costs will likely create opportunities for distressed buyers with dry powder to obtain properties and real estate debt at a discount.
- Office-to-residential conversions present an opportunity to unlock the value of underutilized office space and address housing shortages.
- Refinancing debt on acceptable terms remains difficult and will continue to strain the commercial real estate market.

The commercial real estate (CRE) market is in a transformative period as remote work has reduced occupancy levels at the same time that financing costs have risen rapidly. The changes have created opportunities for investors willing to take on stressed and distressed properties or related debt, and for those willing to tackle the challenges of converting office space to residential use.

In this environment, lenders have altered their approach, lending more cautiously and demanding more protections. Borrowers who foresee potential problems with their properties should act proactively.

The Hybrid Work Revolution

The impact of the COVID-19 pandemic on CRE has been widely discussed. Hybrid work — now an enduring feature of the post-pandemic corporate workplace and not just a temporary adaptation — has led to reevaluations of office square footage and configuration needs, and pushed up vacancy rates, particularly in urban centers.

Hybrid work has also given workers greater flexibility in where they choose to live and work, resulting in the diffusion of demand for office space away from traditional metropolitan areas and into peripheral regions that may provide more affordable space and flexible lease terms. While demand and rental rates for newly constructed high-end office space in certain urban centers like New York City remains high, the market for older buildings lags.

These residual effects of the pandemic, coupled with steadily rising interest rates, financing costs and inflation, have led to a volume of stressed and distressed CRE assets. Many CRE owners, struggling with reduced cash flows, find themselves anticipating difficulties in meeting debt and liquidity obligations. The result will be an influx of non-performing loans into the debt market, with stakeholders looking to offload some CRE holdings.

This environment will offer strategic and well-capitalized buyers the ability to acquire and recapitalize CRE assets at reduced prices, and to purchase discounted debt in order to either reposition the asset or negotiate favorable terms with the borrower. In such a market, we expect opportunistic acquisitions and innovative redevelopments.

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Practice point: In a stressed or distressed sale of CRE, time is of the essence. Distressed acquisitions are typically made in a buyer's market, and buyers often require the ability to move on accelerated timetables. There may not be time to conduct in-depth due diligence. But for those with capital, strategic vision and CRE expertise, 2024 will offer a favorable landscape to leverage those attributes

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and turn challenges into opportunities for substantial rewards.

Opportunities To Repurpose Office Space

The hybrid work revolution presents opportunities to contribute to urban revitalization and combat the national housing shortage by converting underutilized office space into residential units. However, office-to-residential conversions come with significant challenges, including:

- Comprehensive infrastructure adaptations (*e.g.*, additional plumbing).
- Legal barriers to conversions, including restrictive zoning regulations and building codes.

Some U.S. cities, including New York, are actively amending housing regulations to make conversions economically viable. The New York plan includes:

- Expansion of the number of buildings eligible to be reconfigured as residential space.
- Conversions into a wider range of housing types.

While conversions offer a compelling opportunity, including the possibility of creating affordable housing, conversions are not a panacea. The extent to which conversions will contribute to overall affordable housing stock will depend on both public and private efforts.

Given the importance of tax revenue generated by CRE in funding local government services in cities like New York, there is reason to believe that public officials and CRE owners will partner to make necessary reforms and spur redevelopment. However, conversions likely cannot occur quickly enough to stave off significant losses in value to office buildings in the face of increased borrowing costs.

Practice point: Developers considering a conversion should examine strategies for addressing existing tenants, including tenant buyouts and relocations. They should also be aware of financing challenges. Lenders typically exhibit caution in the financing of conversions, given the complexity and risks involved. For example, some lenders are requiring provisions that provide for lender damages if plans and specifications are reconfigured as a result of enforcement actions or a governmental determination of non-compliance with building, zoning or multiple dwelling laws.

Lenders may also expand recourse events to include losses resulting from the relocation and/or buyout of existing office tenants needed to consummate a conversion. Finally, developers should be aware that conversions are not suitable for all buildings and be prepared for alternatives.

Financing Challenges

With all the pressures facing the CRE market, financings have become increasingly expensive and burdensome. In addition, the universe of CRE lenders continues to constrict as traditional lenders become increasingly selective with their capital allocations and small and midsize banks pull back from CRE lending.

In response to the increased risk and interest rate uncertainty, we are seeing lenders adjust their lending strategies to reflect a more conservative outlook. They are running health checks on properties in their existing portfolios. New loan terms often involve higher interest rates and stricter underwriting standards, including more stringent loan-to-value ratios, revised valuation criteria, more rigorous scrutiny of borrowers' and guarantors' creditworthiness, and a focus on properties with strong pre-leasing activity and high-credit tenants.

Going forward, we expect to see lenders increasingly require sponsors to guarantee payment of all operating expenses to ensure the sponsors' vested interest in the continued operations of the properties, as well as expansion of the scope of traditional recourse obligations in certain contexts (*e.g.*, to cover losses to lenders for failure to achieve property conversions by particular dates). These shifts are causing challenges for developers and investors, who now find it more difficult to secure financing for their projects.

A Borrower's Playbook

CRE borrowers need to adjust to the fact that we are in a lender's market, with respect to office and retail assets in particular. Borrowers with debt coming due in the next 24 months should be proactive and strategic.

In preparing for looming debt maturities, borrowers should consider:

- **Early monitoring and assessment.** Proactive planning (*i.e.*, at least 12 months before debt is due) is crucial. Strategic plans should be framed based on timelines, amounts due and any penalties, as well as an understanding of one's overall financial position.
- **Communication.** In a stressed or distressed situation, establishing a clear line of communication with the lender early on can pay benefits. Restructuring debt can be a time-intensive process. Taking preemptive steps may be beneficial, particularly where the lender does not want, or does not have the capability, to own and operate a property. Borrowers with good track records may be able to negotiate loan extensions or other modifications to provide interim relief. Borrowers with larger loan portfolios and/or company- and asset-level debt may also wish to explore holistic opportunities to right-size their overall capital structures.
- **Reserves.** While financings are still occurring, capital accessibility is coming at a premium. If possible, borrowers should work to build up financial cushions and emergency reserves. Available liquidity will expand a company's ability to weather recessionary pressures and preserve options for debt restructurings and distressed acquisitions.