Commercial property

New York's 'zombie' office towers teeter as interest rates rise

Fed tightening is the final blow for many investors battered by Covid and remote working

Average weekday attendance in New York City offices remains below 50 per cent. © Angela Weiss/AFP/Getty Images

Joshua Chaffin in New York DECEMBER 3 2022

During a prolonged bull market fuelled by historically low interest rates and nearly free money Doug Harmon and his team presided over record-breaking sales for many of Manhattan's trophy office buildings.

No longer. These days, Harmon, the chair of capital markets at Cushman & Wakefield, the real estate services firm, spends much of his time performing "triage", as he puts it.

The world's largest office market has of late endured the departure of big-spending Chinese investors, the rise of Covid-era remote working and the economic fallout from the Ukraine war. Now there is mounting concern that the dramatic rise in interest rates will be too much for many owners to sustain and that a long-awaited reckoning is drawing near.

"There's a consensus feeling that capitulation is coming," said Harmon, who likened rising rates to petrol igniting an office firestorm. "Everywhere I go, anywhere around the world now, anyone who owns office says: 'I'd like to lighten my load.'"

The industry is rife with talk of partnerships breaking up under duress, office buildings being converted for other uses and speculation about which developers may not make it to the other side. Meanwhile, opportunists are preparing for what they believe will be a bevy of distressed sales at knockdown prices, perhaps in the first quarter of the next year.

"We're going to see distress," said Adelaide Polsinelli, a veteran broker at Compass. "We're seeing it already."

Since January, shares of SL Green and Vornado, two publicly traded REITs that are among New York's biggest office owners, have fallen by half.

Fresh signs of strain came this week. Blackstone, the private equity firm, told investors it would restrict redemptions in a $125bn commercial real estate fund.

It also emerged that Meta, the parent company of Facebook, would be vacating about 250,000 square feet of space at the new Hudson Yards development to cut costs. It and other tech companies had been among the last sources of expansion in Manhattan's pandemic-era office market.

The small collection of offices like Hudson Yards — with new construction and the finest amenities and locations — are still in high demand, according to Ruth Colp-Haber, who, as head of Wharton Properties, consults companies on leasing.

Meta has announced it will vacate about 250,000 square feet of space at the new Hudson Yards development as it cuts costs. © AFP via Getty Images

But, she warned, the real "danger lurks downstairs in the class B and C buildings that are losing tenants at an alarming rate without replacements." All told, Colp-Haber estimated that roughly 40 per cent of the city's office buildings "are now facing a big decision" about their future.

Prognosticators have been forecasting doom for the office sector since the onset of the Covid pandemic, which has accelerated a trend toward remote working and so decreased demand for space. According to Kastle Systems, the office security company, average weekday occupancy in New York City offices remains below 50 per cent. A particularly dire and oft-cited analysis by professors at Columbia and New York University estimated that the collective value of US office buildings could shrink by some $500bn — more than a quarter — by 2029.

The sector has so far defied such predictions. Leases generally run for seven to 10 years and so tenants have still been paying rent even if few of their workers were coming to the office. In the depths of the pandemic, lenders were also willing to show leniency or, as some put it, to "extend and pretend."

But the sharp rise in interest rates may, at last, force the issue. Financing has suddenly become more expensive for owners and developers — if it is available at all. "If you have debt coming due, all of a sudden your rates are doubled and the bank is going to make you put money into the asset," one developer said.

Lower quality buildings may be the most vulnerable. As leases expire, many tenants are bolting or demanding rent reductions. Even as their revenues dwindle, owners must still pay taxes and operating expenses.

Bob Knakal, chair of investment sales at JLL, sees a growing horde of “zombie” office buildings in Manhattan that are still alive but have no obvious future. The typical zombie may have been purchased generations ago and supplied monthly cheques to an ever-expanding roster of beneficiaries.

“Now the building is not competitive from a leasing perspective because it needs a new lobby, and new elevators and windows and bathrooms. And if you went to those 37 people and said: ‘You know what? You have to write a cheque for $750,000 so we can fix the building up.’ These people would have a heart attack,’” said Knakal.

If there is debt to roll over, lenders will require the owners to contribute more equity to make up for the building’s declining value. “There’s a reckoning that’s going to come,” said Knakal, “and I think it’s going to be challenging for a lot of these folks to refinance.”

That appears to be spurring a flurry of backroom discussions between borrowers, banks, private lenders and others.

Manus Clancy, an analyst at Trepp, which monitors commercial mortgage-backed securities, likened the situation to that facing brick-and-mortar shopping malls five years ago as their prospects deteriorated. Many ultimately fell into foreclosure. Whether an office loan could be refinanced, he predicted, would depend on the newness of the building, its occupancy levels and the length of the leases. “There isn’t a lot of distress, per se, there’s a lot of concern,” he said.

Some obsolete office buildings may be converted to residential, which, in theory, would help to ease New York City’s chronic shortage of housing. But that is easier said than done, say many experts. It would require zoning changes. Even then, many office buildings may not be suitable candidates for residential conversions — either because their floor plates are too large, their elevators are wrongly situated, their windows do not open or their neighbourhoods are unappealing. To make such projects worthwhile, owners would have to sell at deep discounts.

That has not happened — at least not publicly. “Nobody wants to be the first one to dip their toe in this because nobody wants to set a new low unnecessarily,” David Stern, founder of Townhouse Partners, a consultancy that performs due diligence for commercial real estate underwriters, said. “That’s what everyone is waiting for: this incredible revaluation.” In more colloquial terms, a developer quipped that some owners, accustomed to holding properties for years, had not yet “seen Jesus” — but they would.

In the meantime, some recent transactions have hinted at the market’s shift. In July, RXR and Blackstone sold 1330 Sixth Avenue for $325mn, down from the $400mn RXR paid in 2010. In 2014, Oxford Properties, a Canadian investment firm, paid $575mn to win a bidding war for 450 Park Avenue, a 33-story tower. It was sold by a subsequent owner in April for $440mn.

“What is it worth today?” one broker asked. “Less than $440mn.”
