The $1B Question Will the Money Raised for Distressed Office Be Successful?

As several $1 billion funds are raised to invest in distressed office, here's a look at why capital is now flocking toward an out-of-favor asset class

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Assuming the office market comes back to reasonable health, then Jan. 28, 2024, could be an important date for future historians of finance to consider.

On that day, Chad Carpenter, founder of Reven Capital, and Ethan Penner, CEO of Mosaic Real Estate Investors, announced their launch of Reven Office REIT, a $1 billion, publicly traded real estate investment trust solely devoted to providing office owners and hungry investors with bespoke capital for distressed office assets on either the debt or equity side of the fence.

During COVID-19, as they watched work from home become ingrained in the American economy, and saw office values subsequently plummet, both Penner and Carpenter anticipated the demand for huge office footprints would decrease. But they also intuitively recognized that Americans would still need to use offices, albeit at smaller square footage than before, and that as thousands of leases rolled over, and tenants downsized, an imbalance of supply and demand would occur as vacancy rates rose and rental rates fell.

In other words: the perfect recipe for opportunistic investing.

"All of a sudden office, being a capital-intensive business, had every headwind coming at it, and I said, 'This will be the worst downturn of my career — this is great, I'm getting back in,' " said Carpenter, who has invested in capital markets for 30 years. "I've always been a contrarian investor. I like to buy in cycles, buy low, sell high. I bought lots of

office in the ’90s when that downturn came and then pivoted to buy houses after the GFC crash [in the 2000s].”

For Penner, who is regarded as a Wall Street trailblazer for his work in the first wave of 1980s commercial mortgage-backed securities, a decimated office sector screamed opportunity to him while it generally was perceived as anathema to anyone else, most notably institutional lenders who had no interest in lending against a distressed asset class at uncertain price points.

“We felt the lending side of the business was at the correct time to enter,” Penner explained. “We understood there’s huge opportunities on the equity side, but we felt the real interesting opportunity, the biggest unmet need and the least amount of capital, was coalesced around the lending side.

“You have banks and insurance companies literally shut down at the word ‘office,’ and debt funds are all licking their wounds, so for us it’s became about, ‘Let’s go for the meat here,’ — low-risk, predictable cash flows that lend themselves very well to the public markets,” Penner added.

Despite their preference to lend, the duo also plans to buy distressed office debt at deep discounts, opening their REIT’s investors to all levels of the capital stack.

“The goal is to de-risk this investment and have the lowest basis possible,” said Carpenter.

Copycat city

If Carpenter and Penner appear prescient with Reven Office REIT, it’s only because so many others have come to a similar conclusion in the opening days of 2024, a time when a long-awaited interest rate pause has helped build a consensus around values and spark some of the biggest names in real estate to announce their intentions to invest back into office.

It’s not even an impediment if a company raising a fund had previously been burned on its office properties in the current crisis and had to give back keys or had seen properties cast into special servicing.

On Jan. 22, RXR’s Scott Rechler, together with Ares Management (ARES), announced a plan to launch a $1 billion fund devoted to investing in or acquiring underwater capital stacks of office properties, particularly those in the upper quartile, Class A section of the market. Three days later, SL Green’s Marc Holliday divulged during a first-quarter earnings call that his firm intends to launch a $1 billion debt fund devoted to investment opportunities in distressed New York City real estate, namely office.

“This is a playbook you’ve seen a couple times before — it’s not everyone’s first rodeo,” said Holliday on the call. “It’s been four years since the pandemic, and the business fundamentals of this city are very strong.”

By all accounts, the dust over the beleaguered asset class has finally settled, the blood has largely been drained out of the worst buildings, others have been surrendered, and the top voices in the industry are shouting that it's safe to jump into the water.

In classic real estate parlance: So as the uncertainty ends, the price discovery begins.

"If you don't know where your interest rates are, if you don't know how to value an asset, if you don't know where rents are going, how can you possibly look at an office building and say this building is worth this much?" explained Terri Adler, a real estate attorney in Manhattan. "I think people are starting to get a greater sense of where those values are going to come out, and that is enabling people to think about investing back into office and take advantage of the distress."

To be clear: There remains a remarkable amount of distress in the office sector. Approximately 19.6 percent of U.S. office space remained vacant in the fourth quarter of 2023, according to Moody's — the highest level in more than 40 years. New construction starts of U.S. office buildings fell to 31 million square feet, the lowest total in 13 years, according to a CoStar report cited by The Wall Street Journal.

Moreover, more than $117 billion in commercial mortgages tied to U.S. offices comes due this year, according to The Financial Times. An incredible $2.2 trillion of commercial real estate debt will mature between 2024 and 2027, according to Trepp, a data analytics firm.

While most of those loans have been (and could be) extended over one, two or even three years, eventually the bill will come due on all these distressed office holdings.

"There's about 5.6 billion square feet of office space across the U.S., and 30 percent is functionally or economically obsolete, and that's just a bloodbath for the office market," said Carpenter.

"I think 10 percent will be demolished, just won't pencil for conversion, and 15 percent will be converted for residential, and the top 15 percent of buildings, like SL Green's One Vanderbilt, will be fine, well leased," he continued. "And everything else in between will be foreclosed upon, restructured or repriced. But there will be so much opportunity."

Risk versus reward

If there's going to be winners in this new field of opportunity, then there will invariably be losers, as well. While much of the equity behind any distressed office deal is likely already wiped out, it's the lenders on those same properties who are now trying to save face.

Eric Brody, founder of Anax Real Estate Partners, a debt and equity advisory firm, said that the underwriting beneath most office loans was so aggressive during the pre-pandemic years that investors could get as much as a 65 percent discount off the original values in this new era of distress.

“Because the equity is gone, those lenders have to take a markdown,” explained Brody. “And they’re raising these funds today because the perception is the lenders are prepared to take that markdown, that they’ll be willing to transact on these assets, and that they agree they’re in trouble.”

For these undercapitalized properties, many lenders are understandably reluctant to take back assets, especially since most lenders are not property managers. Therefore, some of these distressed situations might take years to develop mutually acceptable solutions, according to David Bitner, executive managing director of global research at Newmark (NMRK).

However, there’s a middle ground, Bitner said, where the current owner might not want to exit entirely while still being open to having fresh capital come in at a much lower basis that’s enough to satisfy the creditors and make all parties happy.

“They’re raising capital to offer pref-eq [preferred equity] or mezz [mezzanine debt] to come in at much lower basis than the existing borrowers and owners to try and create a situation that keeps the lender from having to operate the assets,” said Bitner. “[This capital] will recognize some of the losses, and create forward-looking returns that are more attractive than the alternative for existing equity and new equity partners.”

Adler said funds like those set up by SL Green, RXR — and also Reven Office REIT — which are structured to attack all levels in the capital stack will do better in navigating through the distress than investors merely looking to buy properties outright.

“If you can play both sides of that table, you can kind of plug and play: some deals you’re preferred, some deals you’re mezzanine, some deals you’re straight equity,” she said. “That’s the beauty of being agile in the capital stack.”

James Millon, president of U.S. debt and structured finance at CBRE, said that office is now “in everybody’s focus” and called the current distress “a generational buying opportunity.” Millon compared the present office landscape — which effectively had been left for dead, considered by all to be difficult, if not impossible, to finance — to what occurred in both retail and hospitality over the last three to four years.

“Those asset classes have gone through a resetting and restructuring, the cap rates have reset, you can actually get accretive leverage and some of the sub-performing B malls have resolved in one shape or another,” explained Millon. “So what we’re left with is a better stock of inventory of the product itself, and I think we can expect the same thing for office.”

Of course, the landscape will vary asset by asset and city by city, if not street by street within those cities. Not all underwater offices carry the same opportunities for returns despite how much fresh capital is in there.

Take the approach of Morning Calm Management, headquartered in West Palm Beach, Fla., and Washington, D.C.

Last April, the vertically integrated real estate firm led by CEO Mukang Cho formed a $500 million joint venture vehicle to invest in distressed office. While Cho has only deployed just under $60 million after 10 months, he argued that a conservative approach that prioritizes the underlying collateral, location and sponsorship of an office asset is the proper investment strategy at a time when so many unknowns remain.

“The bar for us is pretty high,” said Cho. “We don’t mind financing assets that are underleased. We’d rather finance an office building that is high-quality, sterling sponsorship that is underleased than a commodity office asset that is, quote, ‘well stabilized.’ ”

Cho said the strategy of his fund is not to invest capital with the intention of taking an office asset back, but rather to provide liquidity to a marketplace that is severely lacking financing for a particular asset class. The risks woven into CRE investing have informed Cho’s cautious approach a year into investing his $500 million office vehicle.

“We care about financing assets that are highly defensive, so if the markets soften, or occupancy never ticks up, and there are continued challenges, or, God forbid, we end up with assets, ‘Here, lender, take the asset back,’ then we’d rather try to make good money on the proceeds we put out by having to lease up a quality top-tier asset rather than something that is just run of the mill,” he explained.

Even optimists like Reven’s Carpenter and Penner recognize the numerous pitfalls inherent in their pursuit of opportunistic earnings. For one, Penner emphasized that local government policies could turn the tables on any long-term office investment in several markets.

“What we learned in the last few years is that local government can have incredible effects on office building values and real estate values in general, in almost a surprising way,” said Penner, who listed local government policies in California and New York that passed criminal justice reforms that have created an impression those states are soft on crime. “It’s still hard to underwrite, politics and local sentiments can change, so you can have positive surprises and negative surprises and the volatility.

“But this [political risk] is probably the biggest variable every real estate investor faces,” he added.

Carpenter cited a lesson that’s been reinforced to him from his three decades as an investor in distressed housing: There’s risk we can control and risk we can’t control.

“There’s always risk,” he said. “Whether it’s single-family or office, my entire portfolios in Houston and Jacksonville have been flooded, two feet of water in the homes. But if you’re going to invest in office, we’re taking the
lowest-risk way to do it.”

Even amid inseparable risk, the fact that new capital has formed so quickly around a once dismissed asset class is indicative of a vast change in perception.

There’s finally a price point, and buyers — and their billions — are lining up to pounce.

“The overarching theme that all office is dead is not true,” said Ayush Kapahi, principal and founding partner at HKS Capital Partners. “Every deal has a story, and there’s an attachment point on both the debt side and the equity that one is willing to take based on the asset itself.

“There’s a story, there’s a price point, and it will trade in pieces and in assets.”

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