HOW WILL THE CRISIS IN SURPLUS OFFICE SPACE BE RESOLVED AND WHAT IS THE GOVERNMENT'S ROLE NOW AND LATER?

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ABSTRACT

There is a crisis of sorts brewing in the United States commercial office space market. A combination of factors, including impracticality and unwillingness of office workers to return to the office, have led to an excess of office space capacity. Could this lead to significant foreclosures? What would be the impact on financial institutions? This study explores the current situation and whether prior crises, especially the savings and loan debacle, provide insights as to what the future holds.

WHERE WE ARE [LAKE]

"It could easily take several years for the office market to stabilize, which is why I've referred to all this as a trainwreck in slow motion," according to Stijn Van Nieuwerburgh, a professor of real estate and finance at Columbia Business School.

Van Nieuwerburgh attributes the impending doom to four factors:

1. It is unclear whether leases from before the pandemic will be renewed.
2. Rents will fall. "Office vacancies are at a 30-year high," said Julie Whelan, CBRE's global head of occupier research.
3. Landlords may need to refinance mortgage loans. "Typically, landlords take out 10-year mortgages . . .."
4. "Interest rates have more than doubled, there are cash flow problems because of vacancies and building values have fallen because of hybrid work and higher interest rates," Van Nieuwerburgh said.

"All of this means that lenders will not be willing to roll over the debt."

"Lastly, city tax assessments are completed infrequently, which could place a lag on helping determine commercial property values. . .."

The crisis may be partially mitigated because "commercial real estate investors may convert buildings into other uses—particularly office-to-residential projects."

Some local reports of vacancies confirm the extent of the problems in specific markets.

> A report in the San Francisco Standard reports that 36 percent of office smpace there is currently vacant [Truong 12/18/2023, Truong 6/29/2023]. "Salesforce Tower, the city's tallest office high-rise, has 1.4 million square feet of rentable space, meaning the vacant space on the market is equal to more than 22 towers."
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> The title of this New York times article says a lot about the situation: "26 Empire State Buildings Could Fit Into New York's Empty Office Space. That's a Sign [Glaser]." The article discusses how the vacancies are harming landlords and the overall economy. Similar vacancies are occurring around the country, including Los Angeles (44,046,970 sq. ft.), Houston (49,168,675 sq. ft.), and Chicago (59,863,725).
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> A 2023 article in The Atlantic [Poleg] asserts that "Offices are struggling perhaps more than most casual observers realize, and the consequences for landlords, banks, municipal governments, and even individual portfolios will be far-reaching" During the first three months of 2023, US office space vacancy top 20% for the first time in decades. These figures understate the severity of the crisis because they only cover spaces that are no longer leased. Most office leases were signed before the pandemic and have yet to come up for renewal. Attendance in the 10 largest business districts is still below 50% of its pre-COVID level, as white-collar employees spent an estimated 28% of their working days at home. With one third of all office leases expiring in 2026, we can expect higher vacancies and significantly lower rents or both. With such grim prospects, some landlords are threatening to "give the keys back to the bank". This would directly impact the banks' asset valuations, default rates, and weaken their balance sheets. Municipal governments have sven more to worry about. Property taxes which underpin the cities budgets were commercial property, mostly offices, contributes about 16% of the city's tax revenue. Further empty offices also contribute to lower retail sales and public-transportation usage. As cities cut services, it could trigger an "urban doom loop" that pushes more people away, hurts revenue, and perpetuates a cycle of decline."
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> An example of repurposing involves a "mostly vacant office complex" in San Diego that is being converted to residential. The 25-story building was purchased for $61 million and $about $140 million is expected to be spent on renovations [Van Grove].

One example of how expensive getting out of unfavorable circumstances is the report that Illumina paid $54 million to get out of some expensive leases [Rocha]. Illumina reduced annual expenses of approximately $100 million.

SAVINGS AND LOAN DEBACLE OF THE 1980S [KAGAN]

"The Savings and Loan (S&L) Crisis was a slow-moving financial disaster. The crisis came to a head and resulted in the failure of a third of the 3,234 savings and loan associations in the United States between 1986 and 1995."

Contributing factors were a volatile interest rate climate, stagflation, and slow growth. “Key to the S&L crisis was a mismatch of regulations to market conditions, speculation, moral hazard brought about by the combination of taxpayer guarantees along with deregulation, as well as

“Some key takeaways were:

- The savings and loan crisis were the build-up and extended deflation of a real-estate lending bubble in the United States from the early 1980s to the early 1990s.
- The S&L crisis culminated in the collapse of hundreds of savings & loan institutions and the insolvency of the Federal Savings and Loan Insurance Corporation, which cost taxpayers many billions of dollars and contributed to the recession of 1990–91.
- The roots of the S&L crisis lay in excessive lending, speculation, and risk-taking driven by the moral hazard created by deregulation and taxpayer bailout guarantees.”

RESOLUTION TRUST CORPORATION [KAGAN]

“The Resolution Trust Corporation (RTC) is a now-defunct temporary federal agency. From 1989 to 1995, it largely resolved the savings and loan (S&L) crisis of the 1980s, which resulted in about a third of such U.S. institutions failing within a 10-year span. The RTC became a massive property-management company, cleaning up what was, at the time, the largest collapse of U.S. financial institutions since the Great Depression.”

The Resolution Trust Corporation closed failed institutions and eventually sold the assets to private investors at heavy discounts. The American taxpayer effectively bore the cost.

TAX POLICY CHANGE CONTRIBUTED/CAUSED THE S&L CRISIS

Tax law was a major contributing factor:

1. Individual tax rates dropped from 1985 to 1986 from a top tax rate of 50 percent to 28 percent (IRC §1).
2. The passive activity loss limitations, although phased in over 5 years, disallowed deductions for losses from passive activities, including most rentals against nonpassive trade or business and portfolio income. (IRC §469).

Example of Passive Loss Limits

Zachary, a Boeing 727 pilot (as I recall, with TWA), purchased a small office building to help fund his retirement. Zachary's savings and compensation pushed him into the 50 percent tax bracket. The tax losses from Zachary's leveraged purchase allowed Zachary to enjoy current benefits with anticipated substantial appreciation over time (name and numbers are fictitious). Factors:

Cost	$400,000
Down payment	$20,000
Annual rent income	$40,000
Operating expenses	$4,000
Annual interest expense	$36,000
Annual MACRS Depreciation	$38,000
Deductible tax loss	$38,000
Tax saving	$19,000
After-tax cash flow	$19,000

With just the tax rate decrease from 50% to 28%:

Cost	$400,000
Down payment	$20,000
Annual rent income	$40,000
Operating expenses	$4,000
Annual interest expense	$36,000
Annual MACRS Depreciation	$38,000
Deductible tax loss	$38,000
Tax saving	$16,640
After-tax cash flow	$-0-

With the tax decrease and the passive activity limit:

Annual rent income	$40,000
Operating expenses	$4,000
Annual interest expense	$36,000
Annual MACRS Depreciation	$38,000
Deductible tax loss	$38,000
Tax saving	$-0-
After-tax cash flow	$-0-

With the tax decrease, increased interest expense, and the passive activity limit:

Cost	$400,000
Down payment	$20,000
Annual rent income	$40,000
Operating expenses	$4,000
Annual interest expense	$48,000
Annual MACRS Depreciation	$38,000
Deductible tax loss	$38,000
Tax saving	$-0-
After-tax cash flow	-$12,000

So, what should Zachary do? Feed the beast?

THOUGHTS ABOUT THE FUTURE

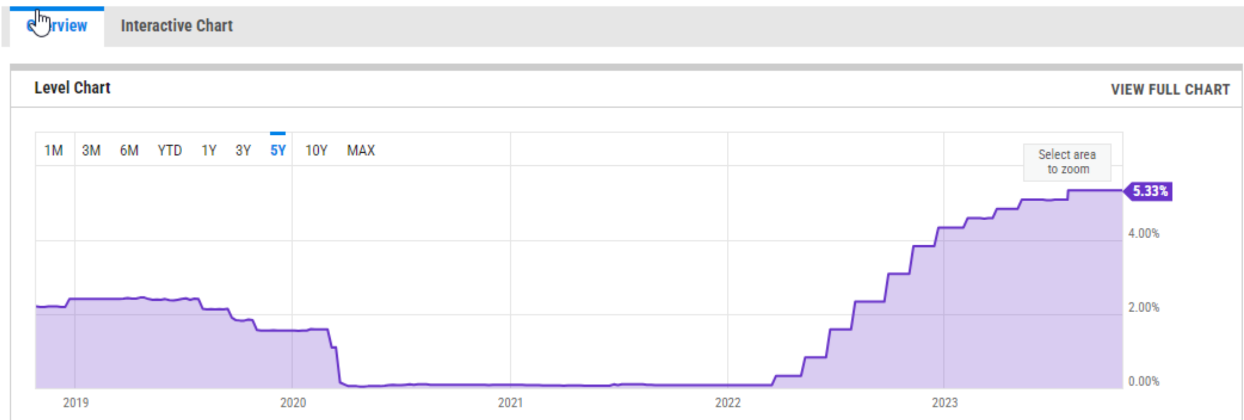
Berkshire Hathaway is not overly active in the Commercial Real Estate Space. In an interview on CNBC, Charlie Munger and Warren Buffet reflected that the "huge hollowing out of downtowns" would be significant and unpleasant. And this would require a different set of owners. $1.4 trillion dollar business: low interest rates mean there were incentives for commercial real estate investors to use this cheap debt to purchase. The rates are typically adjustable. The storm is brewing because a) these debt instruments are resetting and b) interest rates have dramatically increased to unsustainable debt payments, c) the downtown and hospitality properties has experienced an unimaginable decrease of demand for their properties (downtown San Francisco is at a historic 31.8% vacancy). As workers continue to work remotely (49% of workers find it more desirable for a work-life balance to work remotely), office buildings are vacant, and tenants are not renewing their leases. Debt payments at higher interest rates are unsustainable and being 'non-recourse loans,' these investors are handing back the keys to their lenders. There is now about $1.4 trillion dollars of these types of loans about to reset. This means the banks are going to be forced to sell off the property for pennies on the dollar, experiencing huge losses. These banks are typically small domestic and regional banks are typically the ones left holding the bag – or in this case the office buildings/apartment complex/warehouses. As Buffet states "The buildings don't go away, the owners do."

These banks are FDIC insured so the deposits are going to be secure but will need to hold back on future lending, resulting in less hiring and less spending for the local economies.

GOVERNMENT SURPLUS PROPERTY

What effect might excess government office property [GAO 10/26/2023]. Will efforts to "shed" underutilized property be successful and increase the glut already in the market? The Government Accountability Office (GAO) is advising agencies to rent or dispose pf excess property and such steps are being undertaken [GAO 10/27.2023].

The economic impact of this crisis will extend not only to banks, but pension funds, investor portfolios, municipalities, downtown retail, restaurants, subways more., buses, taxis, and others.



Our Thoughts and Conclusion

CONCLUSION FOR NOW

Charlie Munger, Buffets right hand man, states "There is going to be a lot of pain. The question is: who will be the one to bear it"? The real question may be willing the government to step in, yet again, to bail out the banks perpetuating the cycle of co-dependency at the expense of the taxpayers [Buffett].

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