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Could more than 1B square feet of US office space become obsolete?

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Getty Images (Chris Ryan)

As much as 1.4 billion square feet of U.S. office space could become functionally obsolete by the end of the decade.

As much as 1.4 billion square feet of U.S. office space could become functionally obsolete by the end of the decade.

That's according to a new analysis by Cushman & Wakefield PLC (NYSE: CWK), which examined which categories of office space could become outdated in the coming years. When factoring in the national office market's natural vacancy — 13% before the

pandemic — the decade could end with 330 million square feet of excessive vacant office space, according to Cushman.

Unsurprisingly, it's expected obsolete space will be largely contained within older office buildings that aren't renovated, sustainable or in desirable locations for today's office tenants.

Another analysis by CoStar Group Inc. (Nasdaq: CSGP), per a request by *The Business Journals*, found about 20,000 office buildings completed before 2014 are at least 25% vacant and comprise about 1.1 billion square feet, or about 13.4%, of total inventory nationally. That type of space accounts for 54.2% of the 1.07 billion square feet currently vacant nationally, signaling it's fallen out of favor with tenants making real estate decisions in the wake of pandemic-induced hybrid work trends and a rockier economy.

Abby Corbett, global head of investor insights at Cushman, said despite the growing obsolescence of some office space, there's potential opportunity for office buildings at risk of becoming irrelevant to be reimaged once the economy strengthens.

"The relationship between office employment growth and office demand is going to re-solidify and strengthen in the coming era," Corbett said. "It's going to get worse before it gets better."

While conversions into residential, medical office or labs have become a trendy solution to deal with the growing glut of office space nationally, it's a challenging design, engineering and financial feat to get those projects across the finish line.

Some properties that secure loans in default and can't be refitted into another use could be sold for land value, demolished and rebuilt into a new use, which there are already examples of, Corbett said.

But it's too early to say just how many office buildings may be at risk for that outcome, if they remain obsolete as office space and can't easily become a new use, she continued.

Tenants in older office buildings, dating to before 2014, have given back nearly 300 million square feet in them since the onset of the pandemic, or more than a quarter of the inventory they represent, CoStar found.

"With future demand estimated to be 600 million square feet lower and nearly 1.1 billion square feet of undesirable space currently on

the market, the challenges are obvious," said Phil Mobley, national director of office analytics at CoStar, who handled the analysis, in an email. "Some of these buildings — especially those of higher general quality — are likely to receive capital investment for repositioning. Others could become targets for redevelopment or adaptive reuse, such as conversion to lab or residential use. For the rest, functional obsolescence is a real danger."

Even for owners who have identified major renovations or conversion into a new use as a logical play for their portfolios, the capital markets remain frozen, making it tough to find capital to help fund a significant overhaul to make those buildings relevant in a post-pandemic world.

Corbett said lenders have entered wait-and-see mode in terms of underwriting and deploying debt capital, although alternative buyer sources, such as investors focused on distressed assets, are waiting for opportunities.

"They might be acquiring the asset for a really low basis and then waiting," Corbett said. "It is a predicament right now because we have this secular change unfolding and a necessarily evolution (taking place) ... but, overall, the debt and capital markets side is quiet, given the broader macro environment."

For properties that don't have a loan expiration for many years, that could allow time for the economy and capital markets to recover, but a significant amount of loans backed by office properties are coming due in the coming years.

Some \$40 billion in outstanding office loans are facing some kind of trouble or distress, according to Cushman. Meanwhile, debt maturities totaling more than \$130 billion in the office sector are coming due within the next two years, and 20% of all office loans maturing in that time period have a debt structure of three years or less, Cushman found.

Those properties may especially face issues as property values have, in that time period, compressed with higher interest rates, capitalization rates and weaker demand for office space.

For some landlords, the change happening in the office sector right now will necessitate a complete shift in approach, Corbett said. That's especially true for owners who have treated owning office properties as a bond-like investment by holding it for a

period of stability and achieving returns without having to invest a lot.

For troubled loans backed by office space coming due, Corbett said those borrowers may look to bring in joint venture capital or other infusion.

"We're still seeing loan losses from the global financial crisis now coming to fruition," she continued. "Things take time to work through that default process, so we're seeing things that were in default in 2013 now realizing that loan loss. But the lenders are not positioned with the operational infrastructure to tackle these sorts of things so, ultimately, as they come to a head, they will sell at a basis that becomes attractive to funds interested in (distressed opportunities)."

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