METROPOLIS

The Ticking Time Bomb in America's Downtowns

The sad state of office buildings could cause something called the "doom loop." Yes, the doom loop.

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Photo by Sergei Wing on Unsplash.

They call it the “debt wall,” and it is not the kind of wall that protects you. It’s the kind that might collapse and crush your village, or into which you might crash your car. Specifically, it is $1.5 trillion in commercial real estate debt, owed to banks, pension funds, and insurance companies before the end of 2025, and secured by a national portfolio of office, retail, industrial, and multifamily properties that may not be worth what they were five or 10 years ago when those loans got made.

The country’s downtown office buildings, as you may have heard, are in particularly dire shape. The return to the office has stalled, and many once-vibrant business districts have fallen on hard times. According to data from the brokerage Colliers, almost all of the biggest office buildings in downtown Los Angeles are underwater on their loans—meaning, their owners owe more to the bank than the buildings are currently worth. L.A.’s office towers have, on *average*, more than $230 in debt per square foot, Bloomberg’s John Gittelsohn reports, and the only building to sell this year went for $154 per square foot. That’s a lot of water. The city’s biggest commercial landlord, the Canadian property giant Brookfield, has defaulted on more than a billion dollars of loans this year.

I asked Tomasz Piskorski, a property market expert at Columbia Business School, why we should care if some downtown mogul—or better yet, the shareholders in a publicly traded Canadian office company—takes a haircut on their trophy building. For that matter, why should we care if they have to hand over the keys to the bank? He gave me three reasons: First, because city property taxes will decline with the value of their office districts, prompting the so-called “doom loop”—the downward double-helix of revenue-strapped public services and diminished urban activity, each worsening the other. Second, contagion from abandoned office buildings will spread to retail (no daytime shoppers), restaurants (no daytime diners), and street life (no happy hour!), draining the vitality of urban neighborhoods.

Third: Widespread defaults on loans backed by commercial real estate could prompt a crisis at shaky regional banks, prompting tighter credit, bank runs, and ultimately, a financial meltdown.

That last scenario, most experts I consulted said, seems unlikely to produce economic catastrophe. That’s for several reasons. For one, the key indicator of whether commercial property owners are failing to make their payments is down year over year, and more than 70 percent below its financial-crisis high. It *is* creeping up for office space in particular, but don’t let downtown’s struggles cloud your vision: Most office space is suburban, and most “commercial real estate” is not office space—it is also composed of medical offices and malls and warehouses and data centers and even multifamily buildings. Owners of those properties may have their own problems with rising interest rates, but their fundamental business remains sound.

Unfortunately, if you live in a city, you probably do have to care that some big office owners are getting killed on their downtown investments. But you don't have to panic. In fact, downtown might have a bit further to fall before it can be effectively revitalized. Whether the future of downtown is spiffy, hybrid-work-friendly office space, more complicated uses like labs and biotech, or much-needed conversion to residential, it is only possible if owners and bankers give up on their old model, and their old valuation. Piskorski says: "We need more distress to get things moving."

There are three separate reasons commercial real estate is being pummeled. First, it's highly leveraged, or in plain English, landlords usually borrow most of the money they need to buy their properties. Second, interest rates have risen significantly, which means that getting a loan has become much more expensive than it was five years ago. Owners typically refinance the loans in that debt wall, but that's going to be a pricy proposition this year. Selling is no easier; buyers will also have trouble borrowing money. Third, those rising interest rates are not associated with strong demand, as they have been in the past. As the situation in Los Angeles suggests, no one is sure how many people will want to rent downtown office space in the years to come, and corporations are cutting headcounts as well. This is, well, weird: Usually, an overheated economy with rising inflation would have lots of office demand! But pandemic habits are sticky.

To understand why things need to get worse for downtown office space before they can get better, it helps to understand the incentives facing both beleaguered property moguls and anxious lenders. First the lenders: They want to be paid back, of course. But if that's not an option, they may not move immediately to repossess a half-empty, underwater skyscraper. A Great Recession–era rule designed to prevent bank failures allows lenders to give struggling borrowers a long leash if the bankers think they might one day get paid back.

And they have good reason to “pretend and extend.” This lets them keep that big loan on the positive side of their balance sheet, even if they’re not getting interest payments. But this isn’t great for downtown, because the leniency leaves current owner-operators with little incentive to figure out how to bring their buildings back to life.

“Last time this happened, lenders took possession, sold it off, saw people who bought it for 20 cents on the dollar making lots of money,” said Richard Barkham, global chief economist at commercial real estate giant CBRE. “They’re not in a sufficiently stressed position that they need to initiate that.” For perspective, he added, the residential market during the Great Recession was worth $43 trillion. Today’s commercial market is $21 trillion, of which $7 trillion is office, with just a quarter of that seeing serious problems.

Foreclosure, meanwhile, can be worse for a bank than pretending and extending. It takes time and money, and requires telling your depositors and investors that a big chunk of money has been replaced by an abandoned edifice.

And that might be even worse for cities. “These buildings will go into a process that will make them no man’s land—untended, unwanted, unused,” says Susan Wachter, a professor of real estate and finance at the University of Pennsylvania’s Wharton School. “Banks are notoriously bad owners for making decisions. They’re not entrepreneurs and not in a position to actively manage buildings.”

When foreclosures rocked the nation’s single-family homes 15 years ago, the situation was a little different. Then, like now, owners had overpaid or gotten surprised by interest rates (in that case, variable rate mortgages), and wound up in trouble with banks. But as Aaron Glantz shows in his book *Homewreckers*, Wall Street investors knew the homes had value, and were more than happy to snap them up at auctions and begin to assemble the sizable portfolio of homes for rent that characterizes many Sun Belt cities today.

What’s happening now is something like the opposite. For one thing, the owners who are defaulting on their commercial real estate loans in 2023 aren’t struggling mom ’n’ pops—they’re big, institutional investors. And the buyers, as Jim Costello, chief economist for real assets at the financial firm MSCI, explained on the *Odd Lots* podcast recently, *aren’t* big firms. They’re local buyers with appetite for tough projects and relationships with local land-use regulators. “The folks who have been buying these properties so far are local developer-operator-owner types,” he said. “It’s people who know how to swing a hammer.”

What do things look like from the perspective of a skyscraper owner? Some of them have apparently reasoned that their credit can withstand a default or three. Others seem to be whistling past the empty desks. According to data from Kevin Auble, a research analyst at Cushman and Wakefield, office rents are up 27 percent in downtown Chicago since 2013, even as vacancy approaches 25 percent. In Manhattan and San Francisco, office rent is about where it was five years ago. In Seattle and Houston, office rents are slightly up in that timeframe. In all those cities, vacancy rates have climbed above 20 percent.

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Why won't landlords try to fill a few floors by asking for lower rent? It could be that new leases are mostly being signed at the high end, as corporate tenants seek out smaller, nicer spaces—a phenomenon dubbed the "flight to quality." It's also true that "effective rents," which include concessions and handouts, have fallen more than the sticker price. And with high inflation, a steady asking rent is a real decline.

But if office rents aren't as battered as the stock prices of publicly traded real estate investment trusts (REITs), it may also be because landlords are holding out for sunnier skies: an "option value." Lease terms are 10 to 15 years, so if you drop your price, you're making a long, bearish concession. A big rent drop may also trigger terms in a building loan that force you to refinance. And finally, if a landlord thinks renovation, adaptive reuse, or demolition might be the right move—even eventually—you don't want some pesky new tenant in there gumming up the works.

Transactions of whole buildings have crashed, probably because sellers are in denial about prices. But maybe things are starting to change. Earlier this month, the Wall Street Journal ran down a list of recent, bargain-basement office sales. Those new, low valuations are going to hurt on cities' tax assessments, but they free up buyers to do new things. The Journal cites investment manager Hines, which paid $60 million for a D.C. office building this spring—half what it cost to develop it. Too bad for the builder. But good news for downtown, because that low price gave Hines the headroom to renovate and entice a new tenant, law firm Davis Polk, to take half the space.

"That's the way forward," said Wachter, of the Wharton School. "Get the buildings in the hands of owners who will be incentivized to transform them. If they purchase them at low basis, with a vision, they have all the upside."

And for residential conversion, the white whale of downtown reinvention? "Values have to come a lot further down before a wholesale conversion starts taking place," said Barkham of CBRE. "And in some cases, values might have to go negative." It would have been hard to imagine, ten years ago, getting paid to take possession of a downtown skyscraper. But it could happen if rental income falls far short of operating expenses. If it doesn't trigger a regional banking meltdown or a city budget doom spiral, it might, in the long run, help downtown get back on its feet.

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