Out of office

The office CMBS market is grappling with headwinds brought about by declining occupancy rates and rising costs of borrowing. However, as **Kenny Wastell** reports, the European commercial real estate market may not be as badly affected as its US counterpart.

Rising delinquency rates and falling office occupancies are a cause for concern among CMBS market participants. However, there are signs that the European CRE market may not be as badly affected as the US market – a factor broadly attributed to differing attitudes towards hybrid working, commuter culture and the supply of modern office stock.

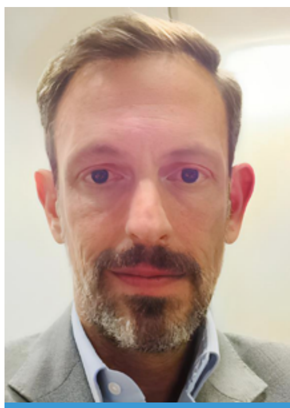
In mid-May, KBRA placed multiple classes across 11 CMBS deals on watch downgrade. The agency attributed the decision to the portfolios' exposure to office-backed loans deemed to be non-performing, identified as KBRA loans of concern, or with a KBRA performance outlook of 'underperform'.

Meanwhile, in a recent episode of DBRS Morningstar's European Securitisation Insights podcast, Andrea Selvarolo, senior analyst in the European CMBS team, notes the agency has a negative outlook for the office CMBS space more broadly. He attributes this partly to shifting work habits following the pandemic and the challenging macroeconomic environment.

"Employees nowadays prefer to have more flexibility when it comes to their workplace," says Selvarolo. "Old fashioned buildings in poor locations may not be attractive anymore. This is especially true if these buildings do not have certain amenities or do not focus on improving employees' well-being and productivity."

This increased flexibility, with hybrid and remote working now commonplace in most office environments, means corporates no longer require the same volume of floorspace. Additionally, he argues, higher energy bills, inflation and a "generally recessionary environment" mean occupiers are cutting costs by reducing inefficient space.

"This will constrain growth in the office leasing market in 2023," Selvarolo says. "That's why ▶



Marty Migliara, Rithm Capital

we expect a general decline in demand for office space. And that's why our outlook for offices is negative."

Earlier this month, data provider Trepp released research stating that, after months of growing "expectations of substantially higher delinquency levels" in office CMBS portfolios, "the tipping point" happened in April 2023. According to the report, the delinquency rate in the US jumped by 125bp month-on-month to 4.02%, its highest rate since 2018 when a number of loans originated prior to the global financial crisis remained outstanding.

It is a point of great frustration for Iain Balkwill, a securitisation and commercial real estate-focused partner at Reed Smith, that unforeseeable wholesale changes to working practices the world over could "tarnish" securitisation. "Historically, a significant amount of large office loans made their way into CMBS and it has been one of the better performing asset classes," he says. "But everything's completely changed with the pandemic."

He adds: "Changes in how businesses look to use office space and the level of daily occupancy is having a negative impact on offices generally as an asset class. It is hugely frustrating when these asset-specific features tarnish securitisation, as ultimately any stress is attributable to the nuances of the underlying collateral, rather than the actual CMBS product itself."

In addition to a rise in vacancies, Marty Migliara, head of Europe at asset manager Rithm Capital, explains that higher base rates have disproportionately affected the property lending market as a whole. However, he highlights that the office space will be impacted more strongly than the residential space owing to supply and demand dynamics.

rated tranches are more vulnerable, only a "limited number of cases" are exposed to principal losses, the report says. It adds that "vacancy assumptions for some transactions would have to double from an already high starting point before ratings are affected".

The S&P analysis highlights that office attendance in London is amongst the lowest in Europe,

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Residential mortgage borrowers will experience payment shock due to rising rates, Migliara says, likely leading to an increase in delinquencies. This, however, won't necessarily translate to significant valuation decreases as there is still strong demand for housing. Commercial real estate will likely be the most affected sector, he argues, due to a combination of valuation uncertainty caused by rates, credit tightening and a wave of refinancings over the next 18 to 24 months.

Pan-Atlantic divergence

Despite the gloomy global backdrop, there are signs that the European CRE market may not be as badly affected as the US market – a factor broadly attributed to differing attitudes towards hybrid working, commuter culture and the supply of modern office stock.

A recent analysis by S&P found that triple-A and double-A rated tranches of European CMBS transactions can withstand increased vacancy rates with little risk of downgrade. While lower

citing data from UK real estate agency Knight Frank that puts vacancy rates at 9.6% in the city. By contrast, a recent report from Moody's finds that the office vacancy rate in the top 50 metropolitan areas of the US currently stands at 18.8%.

"Office vacancies have increased in Europe, but nowhere near the level they have in the US," says Rithm's Migliara. "In Europe they are believed to have increased from historically low levels to somewhere in the 7.5% to 8% range, which is really near the long-term average." The US, by comparison, is seeing vacancy rates in the 20% region, he says.

Part of that, Migliara says, is that public transport in Europe is widely considered to be faster, better and safer than in the US. Additionally, European cities tend to have less suburban sprawl, meaning the typical commute tends to be a shorter distance. Both of those factors render commuting more attractive in Europe compared with the US.

"Europe and the US are very different cultures in many ways and you've always seen that in

Andrea Daniels, Moody's

terms of different working habits and priorities," says Reed Smith's Balkwill. "I think that's what we're sort of seeing play out after the pandemic. It's just brought it into sharp focus. It's not something that we've ever had the opportunity to witness, gauge or measure before. We certainly are seeing that now."

It is a divergence in behaviour on either side of the Atlantic that is also observed by Andrea Daniels, an EMEA- and CMBS-focused associate md at Moody's. Speaking at IMN's Annual Global ABS conference in Barcelona last month, she said: "Although [vacancies in the European office space] have definitely increased significantly since 2020, [just over 8% in aggregate as of Q1] in the US market those vacancy rates nationally are probably pretty close to 20% right now. So from a starting position, it's not as bad; let's put it that way."

Daniels highlighted that there are also differing physical office utilisation trends happening in different markets across Europe. "Markets like Paris and Madrid are pretty much back to pre-Covid utilisation numbers," she said. "That's not the same for London. London is looking a bit like New York from that perspective."

Even within European cities themselves, there are significant differences between office occupancy levels in historical central business districts and newer developments outside the city centre, Daniels said. Occupancy in the centre of Paris and London stands at around 5% and 10% respectively, while purpose-built business districts La Défense and Canary Wharf are seeing percentages in the high teens, she said. In Europe, it appears prime locations are relatively shielded.

Green dividend

Furthermore, Rithm's Migliara argues that availability of modern office stock in Europe and the US differ greatly, further compounding the disparity between the two markets. "There's still a lack of supply of grade A, ESG-friendly space with large flexible floor plates in Europe," he says. "So I don't see working from home having such a big impact, particularly in high-quality offices."

concluding that older offices in outlying locations are facing greater risk of becoming stranded assets. "This risk," it says, "could be reduced by taking early action on climate transition."

DBRS Morningstar's Selvarolo expects to see a dual-speed market, with demand for sustainable and flexible premises actually increasing in the medium term, while outdated stock becomes subject to a "brown discount". The trend is likely to be further reinforced by the outcome of COP27 in November last year, which saw European countries agreeing to tighten environmental targets. The UK is among a number of European countries to have introduced more stringent energy certificate requirements for office rental stock.

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He adds: "In Europe, the pressure will mostly be a function of valuations due to increasing yields, rather than actual performance. There will be some financings that have been done in the past where borrowers' business plans have fallen behind due to constraints caused by Covid. But for the most part, it's really the combination of higher yields and banks tightening lending criteria that will be the pressure point for financing in the near future."

Many market participants share Migliara's observation of a growing divergence between the performance of modern, flexible and energy-efficient office space, compared with out-dated stock. Fitch recently released UK-focused research

"If we look at the UK, starting from April this year, it [became] unlawful to let a building with an EPC [energy performance certificate] rating lower than D, and from 2030 this bar will be further raised to B," says Selvarolo. "In the Netherlands, from January 2023, it's illegal to let an office property rated below C, with penalties applicable whenever a building is not compliant. Given this new tightened regulation from an environmental perspective, the big question is how much of the existing office market in Europe currently fits into that. And this is a big issue."

Fitch points to BNP Paribas figures showing that 24% of inner London commercial stock was likely to become "unlettable" from April 2023,

due to the introduction of these minimum energy efficiency standards in the UK. The agency says that the removal of properties from the letting market will rebalance supply and demand.

"There is actually no reason why a decent office block – which satisfies the latest and greatest ESG requirements and has very strong tenants, in a decent location, that is properly managed and benefits from ongoing investment – should not perform well," says Reed Smith's Balkwill. "Any resultant securitisation should equally benefit from that."

Bridging the refi rapids

However, with the cost of borrowing rising and occupancy falling, it appears likely that defaults will increase in the medium term and issuers may well struggle to refinance portfolios. According to recent estimates by Fitch, 35% of pooled securitised commercial mortgages due between April and December this year will not be able to refinance. The agency notes that while the retail and hospitality sectors face high default risks, the challenges are even more pronounced for office owners.

Euan Gatfield, Fitch

> "IF YOU HAVE A GREEN OFFICE AND YOU'VE GOT A NICE LONG LEASE, THAT'S GOING TO DO VERY WELL"

Indeed, Blackstone recently defaulted on a €531m bond primarily backed by office properties owned by Finnish real estate company Sponda Oy *(SCI 6 March)*. The firm sought and was declined an extension from bondholders *(SCI ABS Markets – 2 March)*.

Euan Gatfield, md and head of EMEA CMBS at Fitch, says there will inevitably be further refinancing issues in CMBS. "There's no escape really when rates have gone up and there are these fundamental questions about office occupancy," he says. "Values of pretty good offices in established locations in the UK are reportedly coming off by 35%, 40%, particularly where there's a vacancy issue."

He adds: "If you have a green office and you've got a nice long lease, that's going to do very well. If it's a brown office with a long lease, that may actually be a handicap, depending on how much work needs to be done. In the latter of those scenarios, there are questions around capex and where the funding will come from."

Market participants appear to agree that the coming months will see the emergence of alternative approaches to financing office properties. Reed Smith's Balkwill says a major difference between the US and European markets is that in Europe, a lot of debt is relatively short dated. As loans hit maturity and borrowers are forced to take action, there are likely to be challenges brought about by valuation expectations. These are driven largely by market conditions at the time of original issuance, prior to the pandemic and recent macroeconomic headwinds.

"The chances are sponsors won't voluntarily sell properties in this market as they will not get the best price," says Balkwill. "Refinancing will inevitably show the value of a fundamentally strong property has deteriorated purely because interest rates have increased. Sponsors are therefore left in the unenviable position of having to either inject more equity into any refinancing or embrace a more sophisticated, leveraged structure and all that entails."

There is likely to be an increased demand for short-term bridging finance, he explains, allowing property owners to reposition office assets. "In the US, CRE CLO products have been a big deal for securitising those sort of loans," says Balkwill. "It'd be interesting to see in Europe whether we also embrace the same technology at scale."

There is also likely to be a growing role played by private credit managers in the coming six to 12 months, says Rithm's Migliara. "The market will be dominated by trying to find creative ways to introduce new capital into refinancings, as bid/ask spreads between buyers and sellers increase, while bank credit is tightening," he explains. "There's an opportunity for private credit that's flexible in terms of coupon and structure to bridge that gap between senior lender and borrower. For good properties with good asset managers, they will be able to work their way through this."

As the office CRE market continues to adapt to a new normal – in terms of working habits, energy efficiency requirements and higher base rates – stability should return once more. In the meantime, market participants are forecasting an interesting two years, where bifurcation, capex injections, delinquencies and new sources of financing will all be prevalent.

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