Office: Stabilizing US Markets and Economic Outlook Drives Performance

Trends

Recent macro volatility stemming from uncertainty in the global economic landscape, record low oil prices, and Fed rate hike potential have presented obstacles for expansion in the office sector. Office market growth slowed as firms looked for a clearer indication of economic trajectory in the near future. Firms demonstrated a more cautious approach toward executing their expansionary plans, such that the proportion of expansionary-related leasing activity declined from 52% to 40% between the fourth quarter of 2015 and the first quarter of 2016, according to an office research report released by Jones Lang Lasalle. While concerns about a global slowdown initially sparked fears of another recession during this period, steady employment and oil price growth along with heightened stability in international markets have led to a more calmer market outlook in recent weeks.

Current trends in the office sector have posed challenges for underdeveloped markets and diminished the ability of property owners to lease large amounts of office space. Due to a rise in cloud-based services and online tools designed to facilitate workplace flexibility, employers are providing more options for people to work remotely. The shift has reduced the amount of physical space required by employers for operation, prompting tenants to utilize smaller office space more efficiently. Office space per worker is dwindling and firms are redesigning traditional floorplans to reflect changing work styles and preferences, often favoring more open spaces fostering creativity and collaboration.

The burgeoning prominence of millennial workers in the labor force has also cultivated a greater demand for office space in vibrant metropolitan areas. Employers recognize the importance of Central Business District locations in attracting new talent seeking higher wages and a more urban setting. Suburban markets with outdated resources are no longer equipped to accommodate the needs of modern offices, and continue to struggle to meet rent and occupancy hurdles.

Issuance

Figure 1. Office CMBS Issuance

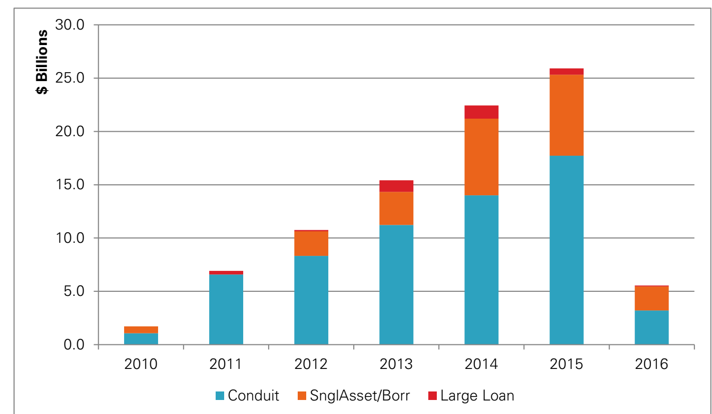
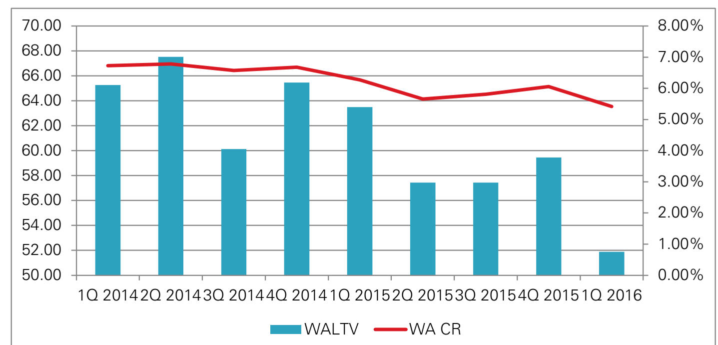
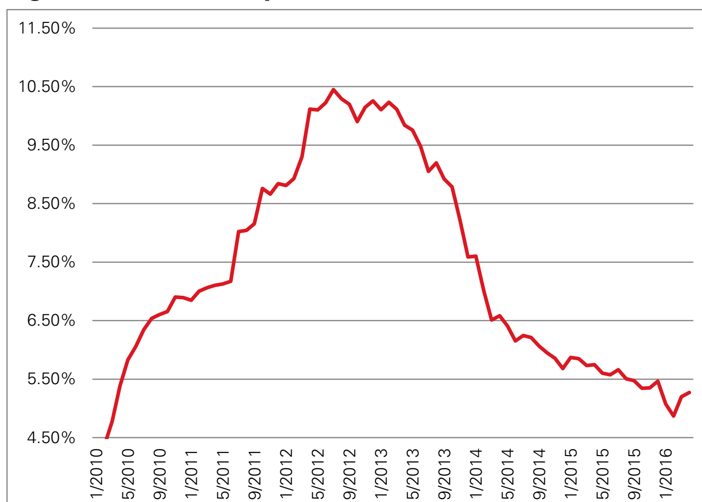


Figure 2. Conduit Office LTV & Cap Rates



Market uneasiness and pricing uncertainty seen in early 2016 have caused a significant drop off in issuance activity so far this year. CMBS office issuance for the first four months of 2016 came in at $5.6 billion, dropping nearly 50.5% from the issuance volume of $8.4 billion for the same period in 2015. In the past 5 years, single asset/single borrower loans have been taking up a larger percentage of total issuance, comprising 40.4% of overall activity for the first four months of 2016, up from 32.1% and 35.2% for 2014 and 2015, respectively. In early 2016, conduit lending scaled back noticeably as spreads widened to levels not seen in years and put a downward pressure on prices, making it difficult for issuers to price loans profitably. Spreads tightened 50 basis points since its widest level in 2015 and newly issued conduits in May 2016 have enjoyed the tightest conduit pricing since last summer. Average LTV and cap rates have also been trending lower in 2015 and 2016 compared to 2014 levels. Average LTV declined 11.60% to 51.89% for the first quarter of 2016, compared to the same period in 2015 while average cap rates have fallen 86 basis points. The change in LTV may be attributed to a greater preference for lower leverage while the decrease in cap rates could be a reflection of higher property valuations or the quality of product going into deals after the spread rout earlier this year.

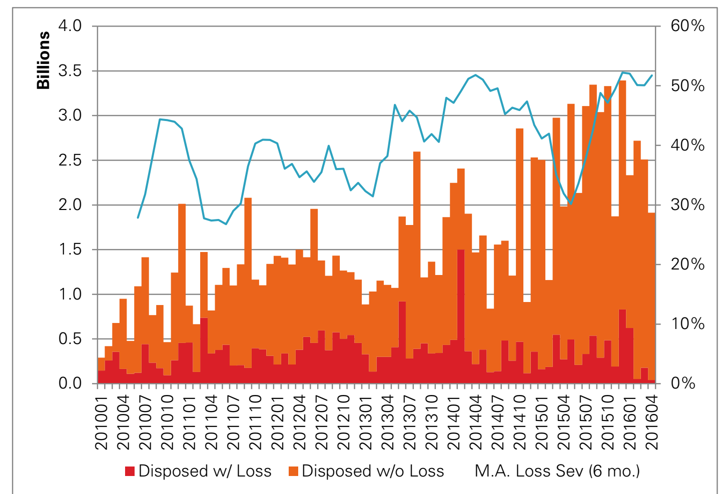
Figure 3. Office Delinquencies



Delinquency and Losses

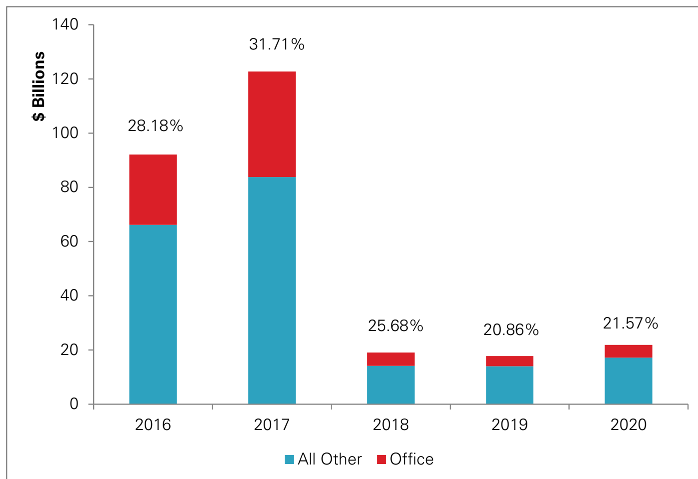
The delinquency rate for office loans has fallen substantially during the recovery and is now almost half of its peak level in 2012. The percentage of delinquent loans peaked at 10.45% in July 2012 and remained in the double-digits until the second quarter of 2013. Fluctuating within the 5% range since October 2014, Trepp's office delinquency rate dipped to 5.27% in April 2016, down 518 basis points from its peak in 2012 and 48 basis points from the same period last year.

Figure 4. Losses on Disposed Office Loans



Through the first four months of 2016, $9.5 billion worth of office loans were liquidated with losses totaling $421.3 million, resulting in a cumulative loss of 4.45%. This is down from 15.89% for the same period in 2014, but comparable to losses for the first four months of 2015 at 4.01%. Due to heavy losses incurred by several large conduit office loans, the 6-month moving average loss severity has been inching up steadily since mid-2015, climbing 19.81% in the past 12 months to 51.73% in April 2016. Overall, loss severity in the last 6 months has largely been pushed up by the resolution of the $363 million Bank of America Plaza loan, the $150 million COPT Office Portfolio (Rollup), and the $127.8 million DRA-CRT Portfolio I, all of which paid off with over 50% in losses.

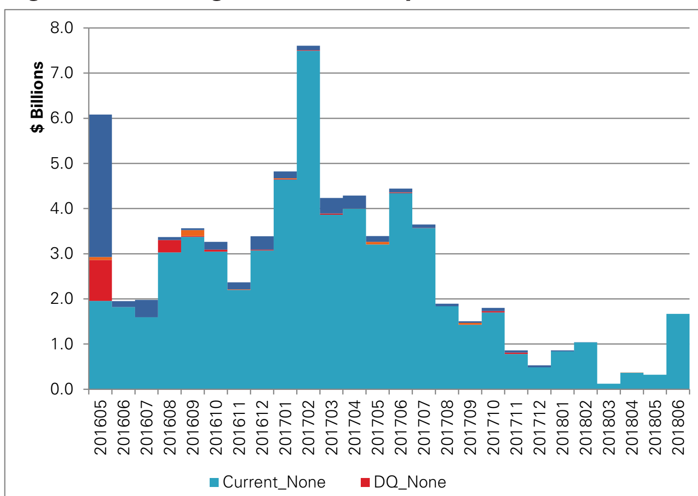
Figure 5. Maturing Office Loans



Maturing Loans

Out of the major property types, office loans totaling $64.9 billion comprise the largest portion of what is left of the "wall of maturities", or the wave of maturing CMBS loans due to mature by 2017. Over $210 billion in non-agency CMBS loans will be subject to refinancing by 2017. Of the amount, 30.2% are made up of loans collateralized by office properties. Office loans constitute a smaller percentage of the maturing balance in 2019 and 2020 as retail loans carve up an increasingly larger share.

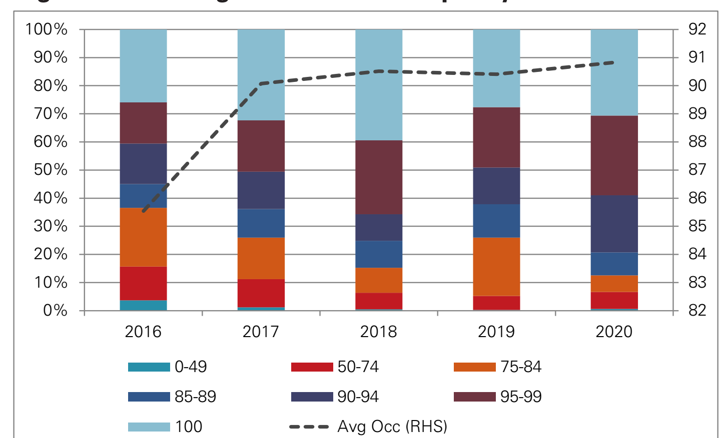
Figure 6. Maturing Office Loans by ARA Breakdown



For office loans maturing through 2017, 11.14% are categorized as delinquent while 9.49% are carrying appraisal reduction amounts (ARAs). ARAs are often used to estimate potential losses at disposition, in the form of unpaid interest and servicer advancements. The distressed pipeline takes on the brunt of the ARAs accumulated by maturing loans thus far. Of the delinquent loans set to pay off in 2016, 82.28% currently have outstanding ARAs. For delinquent loans maturing in 2017, 90.69% have ARAs, which could foreshadow considerable losses for these loans once they are resolved.

For outstanding loans in 2016, the average occupancy of office properties sits at 85.54%. However, for loans maturing between 2017 and 2020, the average occupancy hovers slightly above the 90% mark. Loans due to mature in 2020 reported 72.16% reach occupancy levels above 85% while only 11.76% hold occupancy levels below 75%. Tenancy and vacancy levels of commercial real estate office properties will continue to improve with strengthening market fundamentals, continued office-related job creation, as well as steady absorption of new and existing office space.

Figure 7. Maturing Office Loan Occupancy



Outlook

Post-crisis office market recovery has been aided by higher CRE property valuations and improving conditions in the US labor market. Growing labor force participation, higher average hourly wages, and new job offerings in recent months have eased fears about a potential recession and will encourage firms to ramp expansionary plans for the rest of the year. The massive maturing balance and pre-crisis low in delinquency percentages, coupled with the overall strong occupancy and financial performance of CMBS office properties will provide a large supply for future issuance growth, especially once markets fully recover from the initial rout in early 2016.

For inquiries about the data analysis conducted in this research, contact press@trepp.com or call 212-754-1010.
For more information about Trepp's commercial real estate data, contact info@trepp.com.

About Trepp

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