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Loan Workouts and Modifications—Renew, Extend and Pretend

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I. INTRODUCTION

The cyclical nature of commercial real estate and its necessary companion commercial real estate finance is a fact, and downturns are not new. Many lawyers reading this, however, have not seen a real estate market that does anything but rise given the historically low cost of funds, seemingly endless rental income upside and limitless value accretion seen in the last decade. The sector is now facing some very real challenges and headwinds, that, while not new, have unique origins in this cycle. While the problems of the global financial crisis (GFC) were primarily due to over-leverage resulting from lax underwriting, in many cases on inflated pro-forma rent rolls, today's challenges are different. Current factors impacting real estate include rising interest rates that have risen from an average of 4%-5% a few years ago to closer to 7% in today's market putting stress on the ability to refinance. Adding to that is the permanent impact of COVID on the use of office space, making work-from-home and/or hybrid work arrangements the norm. While office users were already re-thinking their need for office space before COVID, after everyone was forced to work from home, many companies and employees realized that a remote model could work and that companies could expand their ability to attract talent if they were not limited to a single required location. In addition, many employers saw the remote work option as a necessity for maintaining staff given a job market where employees were willing to quit and move to another company in order to retain their right to work from home. In addition, many businesses determined they could enjoy a nice boost to their bottom line from the real estate cost savings of downsizing or even eliminating their office space.

With fewer or no people in the office, demand for office is significantly diminished. Those companies who choose to require employees to return to the office desire to make the return more attractive by seeking out office space that has significant amenities such as gyms, green space, state of the art air filtration, close proximity to restaurants and easily accessible prime locations. Thus resulting in the "flight to quality" as tenants leave their space in older vintage, outdated and less amenitized properties to newer properties. Many of the old obsolete buildings are in the CBD of major cities and the lack of tenants has spillover effect on adjacent restaurants and retail as there is less foot traffic in these areas.

Compounding the issues are the bank failures of earlier this year that have caused bank lending to tighten and new bank lending on office properties to be almost non-existent. According to the Mortgage Bankers Association research, commercial and multifamily originations were down overall by 53% in the second quarter of 2023, compared to a year ago.[i] The MBA research broke that down to a 69% decrease year over year for depository institutions, 60% decrease for investor-driven lenders, 49% for life insurance companies, 23% for CMBS and 11% decrease in GSE lending, all by dollar volume.[ii] By property type there was a 66% decrease year over year in loans on office properties, 55% decrease for retail properties, 55% decrease for industrial properties , 48% decrease in multifamily lending and 32% decrease for hospitality loans. [iii] The lower lending volume is a function of interest rate volatility causing borrowers to hesitate to lock in rates; higher rates resulting in less available loan proceeds and/or requiring additional equity contributions to get a loan; waning appetite for office loans by banks and investors due to heightened risk in that sector and the increased property operating costs that are putting pressure on cash flows and values.

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