Seizing the “Debt-First” Office Moment

Timing Extended, Opportunities Unlocked

Hines

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As we progress into 2025, Hines Research believes market conditions continue to support the thesis for debt investment in the U.S. office sector.

In October 2024, Hines Research released a whitepaper titled Diving "Debt-First" Into U.S. Office, where we identified an emerging opportunity for investors to sequence their exposure to the U.S. office market.

In that piece, we argued that there was a compelling opportunity to gain exposure to the U.S. office sector through investments offered by the debt portion of the capital stack, focused on assets best positioned to thrive in a work-from-home (WFH) world.

We provided evidence that not only did this avenue offer attractive risk-adjusted returns—as would be expected—but that private lending to the office market could stand on its own as a total return investment underpinned by healthy cash distributions given the elevated level of short and long-term interest rates.

As ongoing market volatility continues in 2025, we believe this tactical opportunity is gaining traction.

That's happening for three key reasons:

1| **"Higher for Longer" Interest Rates:** There had been expectations of interest rate cuts over the course of 2025, but with stickier-than-expected inflation and a murky outlook on U.S. economic policy, many believe that interest rates will remain elevated (relative to the previous two decades) throughout most of 2025 (and one could argue into 2026 or later) even if the U.S. suffers a mild recession induced by a global trade war. While debt investing arguably can offer attractive risk-adjusted returns relative to other investment ideas throughout the cycle, **all things equal, "higher for longer" generally equates to "higher returns for longer" for debt investors who base their mortgage yields on either short or long-term interest rates. We believe the window for earning peak debt investment returns this cycle has only been extended.**

2| **Positive Momentum in the U.S. Office Sector:** Bright spots continue to emerge in the U.S. office sector, including healthier fundamentals, stable (if not improving) pricing, and broadening demand growth into the broader "Class A" segment of the market. **On the margin, improving fundamentals typically reduce the risk of future delinquency, and stable pricing lends even more support for a safe equity cushion for the debt holder.**

3| **The Opportunity Set Is Expanding:** The U.S. office sector still faces a wall of maturities and a situation where an increasing number of properties are considered distressed. This is forcing owners to make decisions to either sell or accept terms on new debt capital. **Those sales necessitate transaction financing, and deciding to hold will likely result in an uptick in refinancings. All this creates potential opportunities for alternative lenders as there are continuing signs that traditional sources of capital remain reluctant to significantly increase their exposure to the U.S. office sector.**

The convergence and escalation of these forces over the past few months have served to bolster the investment thesis we identified in the latter half of 2024. In fact, as the U.S. office market continues its slow but steady march toward recovery, we'd argue that the risk-adjusted opportunity for debt investors has only become more attractive.

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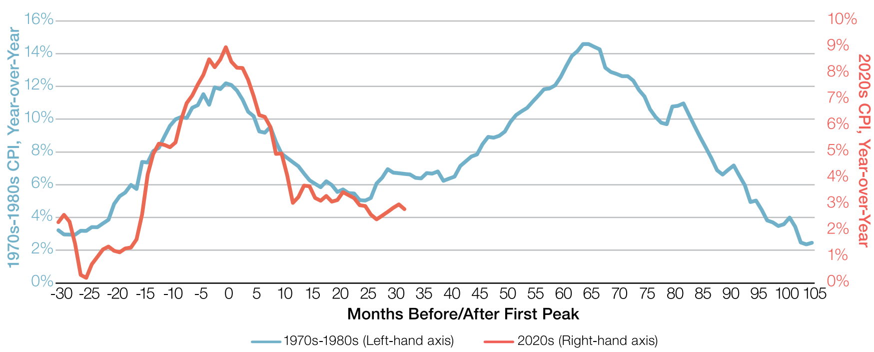
Will Inflation History Repeat?

U.S. inflation levels have been stickier than many expected at the end of 2024 and into the beginning of 2025. As of the writing of this paper in March 2025, inflation remains above the U.S. Federal Reserve's target of 2%, with expectations that recent actions related to tariffs, immigration, and tax policy may keep inflation elevated or send it even higher.

Historical context doesn't offer much solace. Current inflation levels are tracking dangerously close to the trend lines experienced in the 1970s and 1980s—a time when the Fed thought the inflation battle had been won, only to see it come raging back to new heights (see Exhibit 1). Given this historical precedent (likely top of mind for policy makers), the Fed is expected to handle interest rate cuts with extreme caution going forward.

There is also a scenario where a U.S.-initiated trade war propels the global economy into a recession, giving the Fed justification to cut interest rates. However, it's our view that any recession would be mild and induced by external factors (tariffs) rather than by cyclical economic or financial imbalances. In this "manufactured" recessionary environment, the inflationary nature of the tariffs largely responsible for the economic slowdown may very well end up tying the Fed's hands, forcing them to moderate rate cuts much more than they did in previous downturns like the Great Recession from 2008 to 2009.

Exhibit 1: U.S. Inflation Rate, All-Urban Consumer Prices, Seasonally Adjusted, Year-Over-Year Change

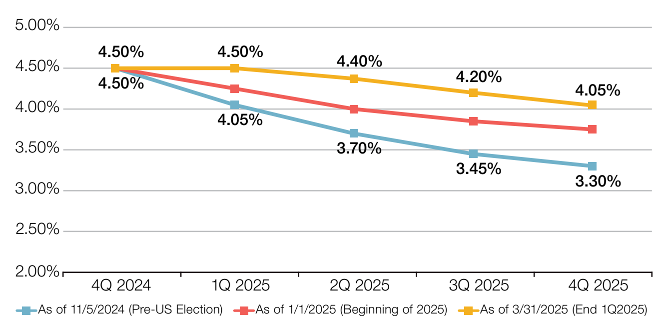


Sources: Federal Reserve Bank of St. Louis and Hines Research. As of February 2025.

"All things equal, 'higher for longer' generally equates to 'higher returns for longer' for debt investors who base their mortgage yields on either short or long-term interest rates.

Indeed, consensus forecasts for the Fed Funds rate have risen since the November 2024 U.S. election through the end of 2024; and have continued to increase through early 2025. The market clearly thought that the Fed would not cut rates as quickly as they had predicted ahead of the election. The expectation for cuts could very well shift up and down, depending on investor views on recession or not, tariffs or not, but conditions do suggest that the scope for cutting policy rates is much reduced relative to what has occurred in previous recessions Moreover, the question of when those cuts will occur remains uncertain. All things being equal, higher interest rates generally mean higher yield potential for lenders.

Exhibit 2: Consensus Forecast: U.S. Federal Funds Rate Pre-Election and Current



Sources: Bloomberg Consensus Forecasts and Hines Research. As of March 31, 2025.[1]

Office Demand Is Finding Its Footing

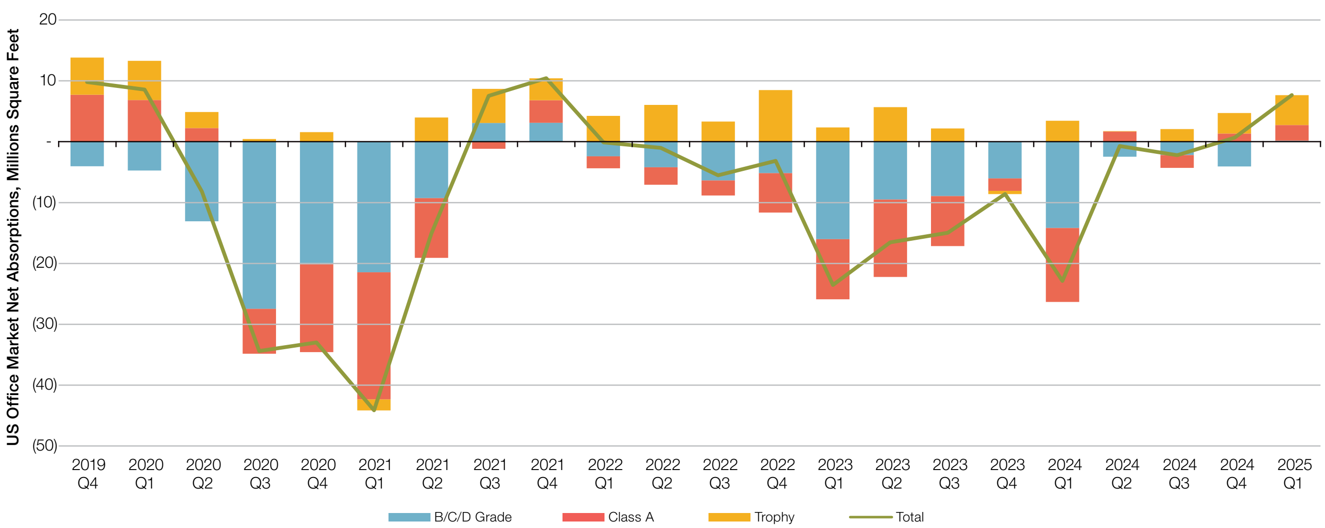
Meanwhile, the U.S. office market has recently experienced significant positive demand growth for the first time since the end of 2021, even though WFH and hybrid work arrangements remain commonplace.

In this landscape, U.S. trophy-grade office space has continued to see positive demand despite broader office market challenges (see Exhibit 3). But this is only a slim slice of the overall U.S. office market, at just under 6% of total inventory.[2] What is encouraging is that the next tier, Class A, which makes up about a further 30% of overall inventory, has also seen positive demand over three of the last four quarters (see again Exhibit 3).

> **"Improving fundamentals reduce the risk of future delinquency, and stable pricing lends even more support for a safe equity cushion for the debt holder.**

This could be a signal that available trophy office space in the right locations has become rare enough in many markets that demand is seeping into the next tier of office properties. This is all good news for lenders because healthier fundamentals typically decrease the risk of delinquency. Additionally, the broadening out of demand also expands the opportunity set for debt investors.

Exhibit 3: U.S. Office Net Absorption by Grade Since 2019, Using Quarterly Data

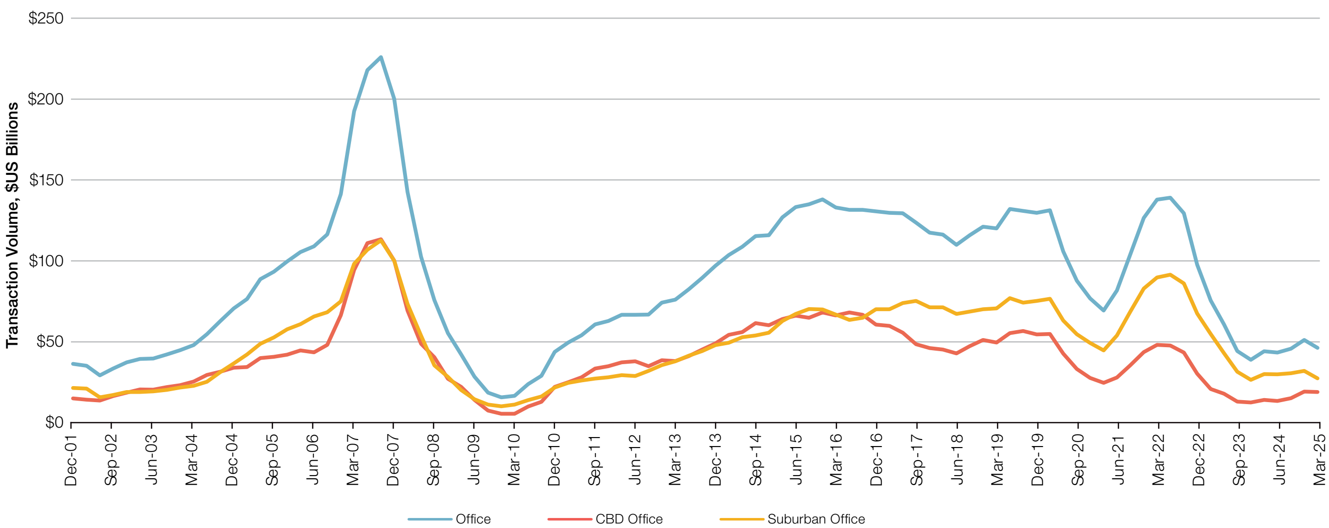


Sources: CoStar and Hines Research. As of 1Q 2025.[3]

Investor Interest Driven, Perhaps Surprisingly, by Central Business Districts

We see a correlation between transaction volumes and property pricing, and, overall, pricing seems to be stabilizing, at least for higher-quality properties.[4] As per Exhibit 4, the rolling 12-month total transaction volume for the overall U.S. office sector had picked up moderately since the end of 2023 before turning down a bit in the first quarter. It is noteworthy (and potentially unexpected) that this improving trend appears to have been driven by transactions for properties in metro CBDs, i.e. downtown submarkets, while suburban totals were relatively flat; and the recent decline is also the outcome of a drop in the value of suburban office transactions. This is positive news for the overall sector and specifically for much-maligned downtown properties, which have been plagued by worries about the economic impacts of WFH. At long last, capital appears to be returning to downtown areas, a trend that could reduce principal risk for lenders as price declines become less likely.

Exhibit 4: Transaction Volumes for U.S. Office in Total and for Central Business Districts Versus Suburban

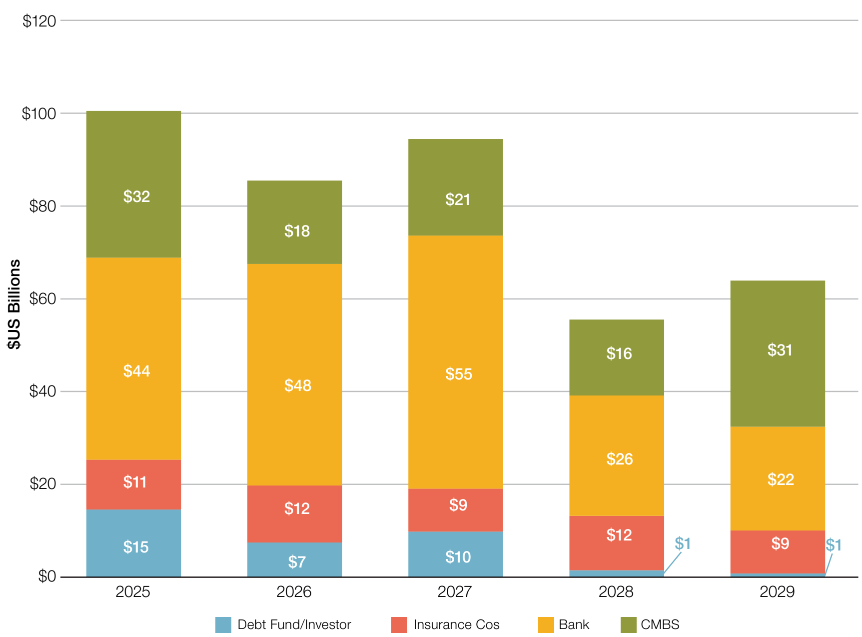


Sources: MSCI Real Capital Analytics and Hines Research. As of 1Q 2025. We are showing rolling 12-month totals for transaction volumes.

The Deleveraging Process Still Has a Long Way to Go

Against that hopeful backdrop, U.S. office loan maturities remain elevated, with about $400 billion of loans coming due over the next five years. Bank loans constitute more than half of near-term loan maturities. Commercial Mortgage-Backed Securities (CMBS) loans are also sizable (see Exhibit 5). Both of these lender types will likely be highly selective about the office properties to which they will even consider lending, and also demanding when offering terms for refinancings or recapitalizations. The bottom line is the deleveraging process has only just begun in the U.S. office sector, and with traditional sources less active relative to history, this could translate into opportunities for alternative lenders.

Exhibit 5: U.S. Office Loan Maturities by Lender Type



Sources: MSCI Real Capital Analytics and Hines Research. As of 4Q 2024.

Bank Originations Are Ticking Up, But Not for Office

And, in fact, there is evidence that traditional sources of debt capital do not currently favor the U.S. office sector. While bank loans constitute more than half of near-term loan maturities, this comes at a time when banks are likely to be in a structurally unfavorable moment to absorb them. Indeed, while bank originations ticked up overall in 2024, they are still falling for the office sector. Note that the apartment sector is still getting significant attention (representing almost 43% of total loans originated by banks in 2024, see Exhibit 6), which may limit the opportunity for alternative lenders in that sector.

On the CMBS front, issuances have been improving, with non-agency CMBS issuance picking up convincingly with over $100 billion in 2024, the highest total since 2007.[5] However, the share of issuances going to the office sector was low (with only $6.6 billion in 2024), a 6% share of the total. For context, 2019 office issuance was over $30 billion, accounting for roughly 17% of that year's total.[6]

> **"There are continuing signs that the traditional sources of capital remain averse to significantly growing their exposure to the U.S. office sector.**

In the early months of 2025, we have seen more interest in the office sector coming from the CMBS market, with a handful of office loan securitizations, the majority being single asset/single borrower issuances. However, almost all are backed by urban properties in New York, San Francisco, and Los Angeles, are high-performing (average occupancy of 95%), and could be categorized as "super-trophy," the tip of even the slim trophy segment mentioned above.[7] Given the scale of loans coming due (including for the broader Class-A office subsegment) the opening-up of the CMBS market will not, in our view, thin out the opportunity set for private debt lenders/investors in any meaningful way.

Exhibit 6: Total Real Estate Loans Originated by Banks, by Year, Share of Sectors

Sources: MSCI Real Capital Analytics and Hines Research. As of 4Q 2024.

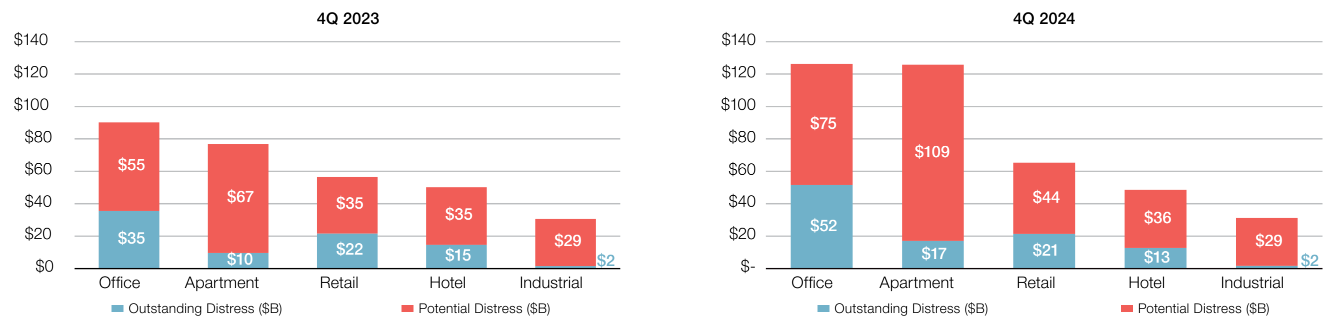
Meeting the Financing Needs of Distressed Properties

The U.S. office sector leads the other major property types in terms of the total value of property that is considered distressed or potentially distressed (see Exhibit 7). Per MSCI Real Capital Analytics, distressed sales in terms of total value transacted were up almost 40% in 2024 versus 2023. Office made up the largest share of those sales (37%) in 2024 after trailing only the retail sector in 2023.

With the impending “wall of maturities” looming, some properties need to make some decisions, which could include selling to new owners (who may refinance based on new pricing) or accepting terms on new debt capital. The fact that office debt originations and CBD transaction volumes have recently risen (even if moderately) could mean that office owners are already starting to make those decisions.

The apartment sector had similar totals at the end of 2024, but office has had the highest total for actual outstanding distress of any of the major property types—three times the rate over the apartment sector. Because banks and agencies are more willing to lend to multifamily properties, those owners may not have to work as hard to find alternative lenders or compromise on debt terms to the same extent that office owners will.

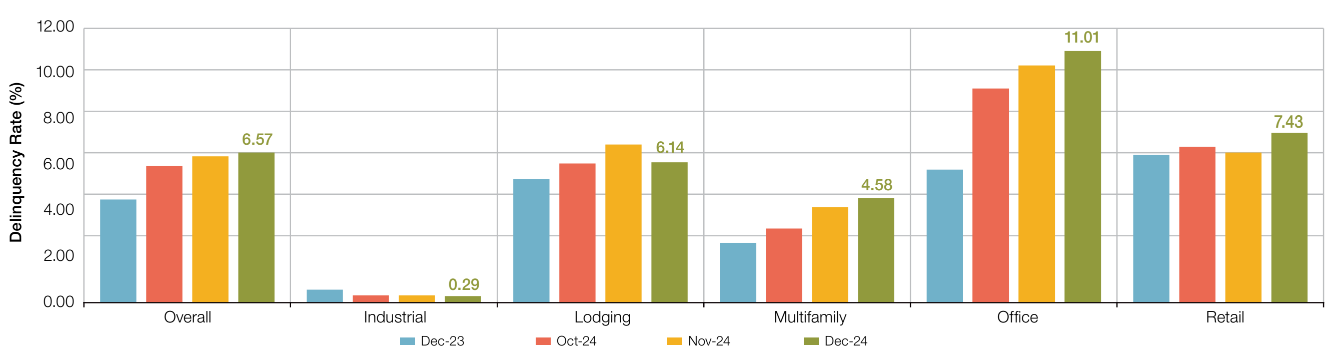
Exhibit 7: U.S. Property Current Cumulative Distressed Property, 2023 vs. 2024



Sources: MSCI Real Capital Analytics and Hines Research. As of 4Q2024.[8] Value in USD, billions.

Meanwhile, delinquencies on office CMBS loans hit historically elevated levels at the end of 2024, far outstripping those of other sectors (see Exhibit 8). These conditions indicate that many property owners are likely in a place where decisions must be made. Once again, note that the multifamily loan delinquency rates are steadily increasing, but are still the second lowest for the sectors analyzed (and less than half the rate for office).

Exhibit 8: U.S. CMBS Loans: Delinquency Rate by Property Type (%, 30 Days+)

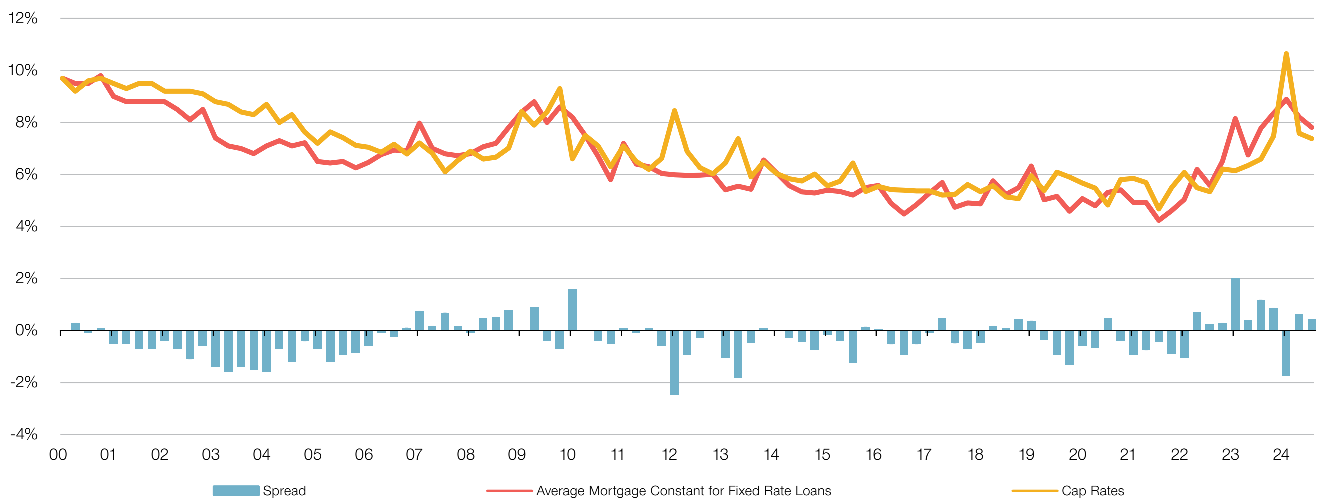


Sources: Trepp and Hines Research. As of 4Q 2024. Referencing the Trepp CMBS Delinquency Report for December 2025. The periods shown are those provided.

Debt Yields Don’t Often Exceed Yields on Equity

In our previous paper on this topic, we noted that yields on U.S. office loans exceeded the average yield on equity, as measured by the capitalization rate, see Exhibit 9. We saw this measure as a clear signal that investors could sequence their exposure to the office sector by initially providing debt capital to distressed owners of high-quality property. A quarter later (the most recent data point available), the signals remain strong for debt-first investments.

Exhibit 9: U.S. Office Mortgage Yields and Capitalization Rates



Sources: American Council of Life Insurers and Hines Research. As of 3Q 2024. Using the period for which data is available.

Conclusion

Higher for longer interest rates, a recovering office sector, and rising demand for financing are all reasons that we think debt investors should continue to be bullish on the U.S. office market at this point in the cycle. Hines Research came out with a strong point of view on this opportunity late in 2024, and we believe that as 2025 unfolds, turbulent market conditions will likely continue to bolster this investment thesis.

About Hines’ Proprietary Research Team

Joshua Scoville and his team, including Michael C. Hudgins, Senior Managing Director, and the lead author of this paper, are responsible for constructing the Hines macroeconomic view and the outlook for commercial real estate market fundamentals and pricing. Hines Research is also responsible for assisting with the development of investment strategies for the firm’s investment programs; working closely with the local and fund management teams, clients, and partners; and supporting geographic leaders in identifying market/submarket opportunities and risks. The views of the local and fund management teams on the latest market developments are exchanged regularly via biweekly conference calls and quarterly market updates, and are essential for reviewing investment strategies and fund portfolio allocations. Additional members of Hines’ Proprietary Research team include Ryan McCullough, James Purvis, Tim Jowett, Erik Thomas, Michael Spellane, and Anthony Witkowski.

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Endnotes

1 Forecasts from Bloomberg are not available beyond 1Q 2026; showing what market forecasts expected at the as of date shown for the last quarter of 2024 and the full year 2025. Showing pre-election (11/5/2024), beginning of 2025 (first trading day, 1/1/2025), and mid-February (translates to closest trading day of 2/18/2025).

2 Sources: Costar and Hines Research. As of 4Q 2024.

3 CoStar has a quality grade that uses star ratings. We have used a 5-star rating as Trophy, 4-star as Class A, and 1-, 2- and 3-star as the lower grades of D, C, and B, respectively.

4 Sources: NCREIF, MSCI Real Capital Analytics, and Hines Research. As of 4Q 2024, and beginning the analysis from 2001 when transaction volume data begins. Year-over-year changes in price and rolling 12-month transaction volumes for U.S. Property have a correlation of 0.77 and r-squared of 0.59.

5 Sources: Trepp and Hines Research. As of 4Q2024. Note that the 2024 total is based on a sum of the original loan balances for all CMBS loans issued in that year.

6 Sources: Trepp and Hines Research. As of 4Q 2024. Using Trepp's aggregate of CMBS loans issued by year, per value at origination. May include both agency and non-agency (private label) CMBS issuances.

7 Sources: Trepp and Hines Research. As of March 2025.

8 MSCI Real Capital Analytics assigns properties as distressed based on the status of mortgages on the property. "Outstanding Distress" indicates direct knowledge of property-level distress. Known through announcements of bankruptcy, default, and court administration, as well as significant publicly reported issues—such as significant tenant distress or liquidation—that would exemplify property-level distress. This also includes CMBS loans transferred to a special servicer. "Potential Distress" indicates possible future property-level financial trouble due to events such as delinquent loan payments, forbearance, and slow lease up/sell out, among others. This also includes CMBS loans placed on master servicer watchlists.