Diving "Debt-First" Into U.S. Office

We explore what we think is an emerging opportunity in the U.S. office sector—especially for debt investors.

Hines

Work-from-home (WFH) headwinds combined with pressure from elevated interest rates, higher borrowing costs, and decreasing investor flows have hit the U.S. office sector especially hard. Meanwhile, a wave of upcoming loan maturities is creating the need for significant capital when funding availability is challenging. Against this backdrop, we see an opportunity forming for investors to sequence their exposure to the office market—a process we believe starts with a risk-adjusted approach to tactically leveraging debt. However, this is only the case for assets that can thrive in a WFH world. There is convincing evidence that higher-quality, well-located assets may do just that.

Why do we think the U.S. office sector may be especially attractive for debt investors at this point in the market cycle?

1 **Reset Property Pricing:** Valuations are down, and the headwinds from WFH look to be priced in. This should help to lessen risk, particularly for senior mortgage holders on newly originated loans.

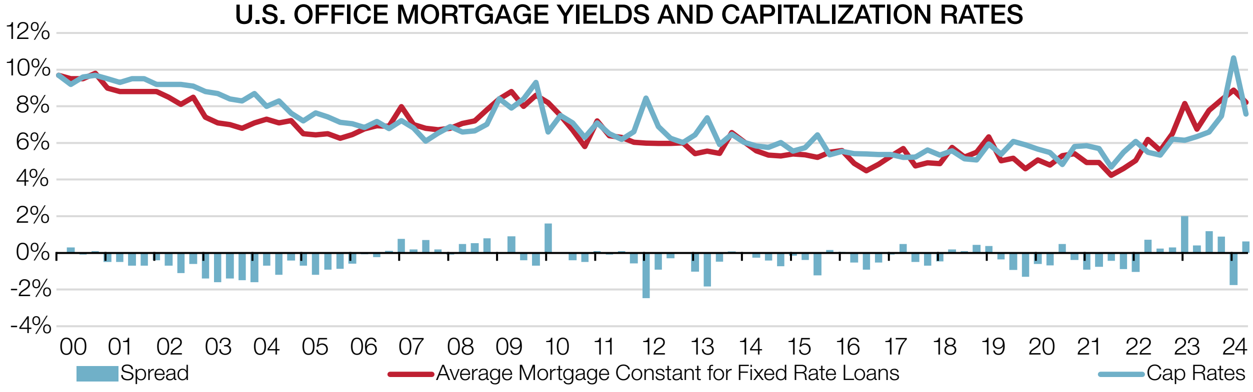
2 **Right-Sized Loan-to-Value Ratios (LTVs) and Debt Yields for New Senior Mortgages:** Lower LTVs at this new price point may further mitigate the risk of any principal loss as the additional equity sitting above their position in the capital stack should provide an increasingly reassuring cushion. High debt yields (Net Operating Income (NOI) divided by loan amounts) should also provide additional cushion.

3 **Re-Priced Loans for Acquisition:** Outstanding loans available for acquisition are more likely to be priced at a discount that reflects current property pricing.

4 **Mezzanine Opportunities Proliferate:** Higher-yielding debt opportunities in the mezzanine tranche are likely to multiply as owners of properties look to fill the gap between equity and likely smaller senior mortgages.

5 **Returns Appear to Favor Debt:** Debt means yield for investors, and although the data is volatile, the average mortgage constant on U.S. office fixed mortgages has exceeded the average yield on equity, as measured by the capitalization rate (see Exhibit 1). This has generally persisted since the middle of 2022. Looking back over history, this hasn't happened very often. We would argue that this inversion presents a rare opportunity for debt investors to earn high cash yields. At the same time, given the potentially competitive net Internal Rate of Returns (IRRs) for private debt funds, an allocation to real estate debt could be viewed as a strong "risk-adjusted" strategy and a competitive absolute return investment in its own right.

Exhibit 1 | Returns Favor Debt at the Moment



Sources: American Council of Life Insurers and Hines Research. As of 2Q 2024. Note: Using the period for which data is available. See endnotes for the definition of "mortgage constant."[1]

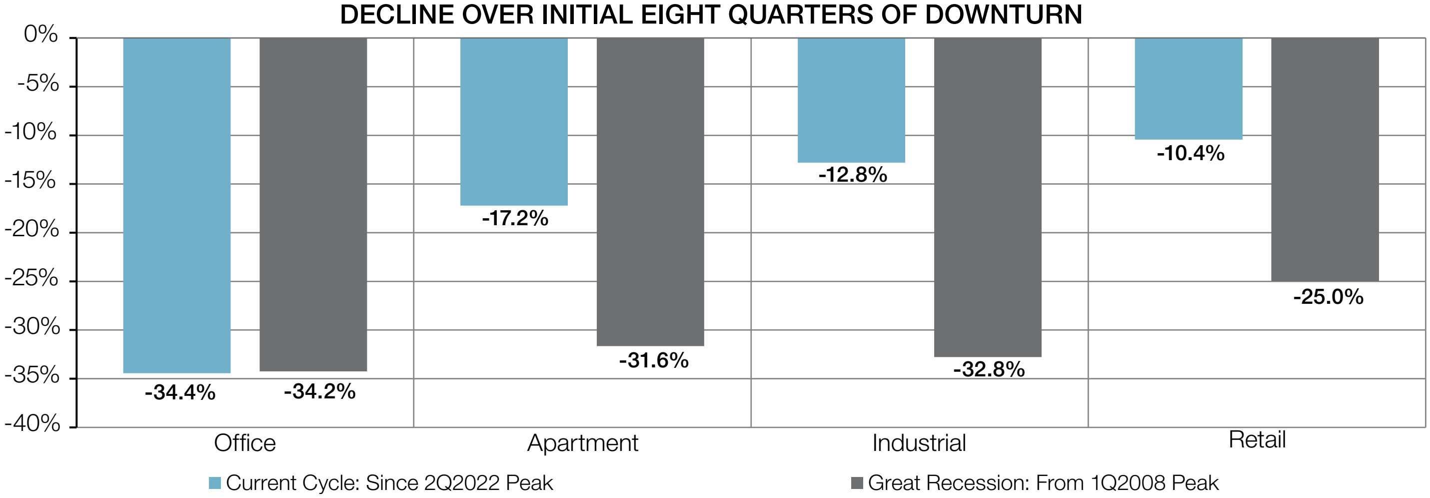
Property Value Declines + A Need for Debt Capital Just as Availability Is Low = **Opportunity**

The U.S. property sector has faced headwinds from elevated interest rates, rising debt costs, and plummeting investor flows. This has resulted in falling values, lower transaction volumes, and pressures on banks' balance sheets—impacting owners on the equity and debt sides of the capital stack. The result has been a reset in pricing but with significant dispersion amongst sectors, something we didn't experience in the more synchronized downturn during the Great Financial Crisis (GFC). Given WFH trends, office has suffered the most, with values down over 30% on an unlevered basis. In fact, office is the only real estate sub-sector where value losses in the current cycle exceed losses experienced in the GFC (see Exhibit 2).

Key Takeaway

We see a compelling thesis, with multiple complementary investment approaches, forming for investors around the office sector's current and anticipated capital needs.

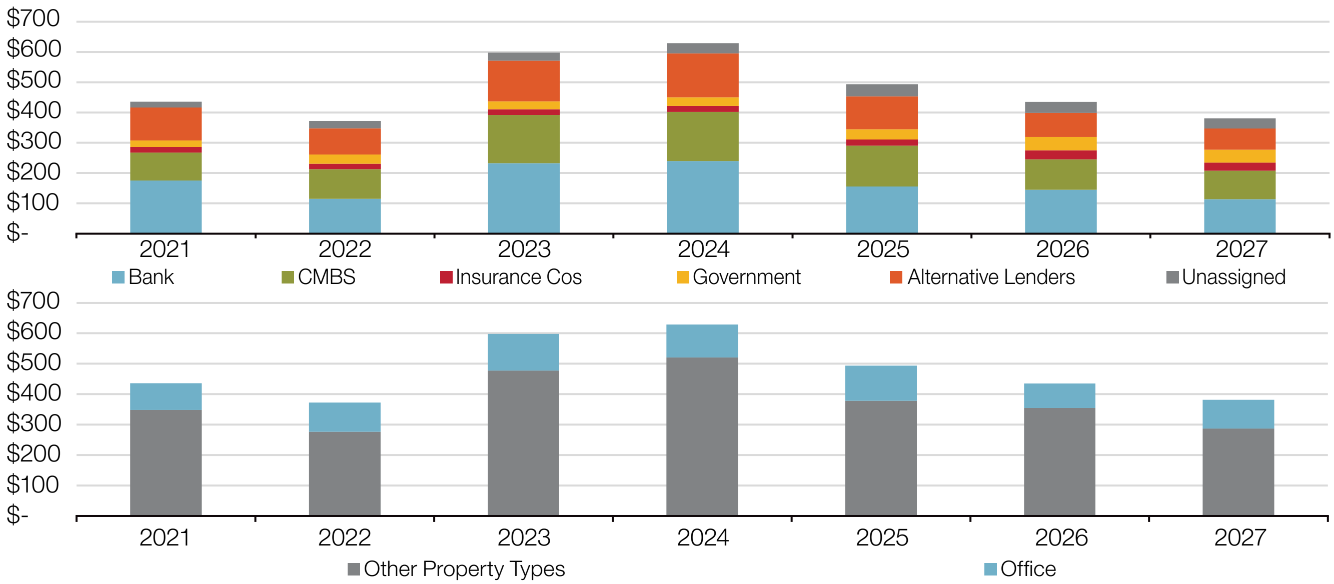
Exhibit 2 | Price Changes by Major Property Type: Current Cycle vs. GFC



Sources: NCREIF and Hines Research. As of 2Q 2024. Note: Data is for properties held in the NCREIF Property Index.[2] Returns are unlevered. Past performance does not guarantee future results.

At the same time, a substantial number of loan maturities are coming due. Specifically, it's estimated that almost $2 trillion in Commercial Real Estate (CRE) loans will mature through 2027. Of that, just under 21% (about $400 billion) are tied to the office sector (see Exhibit 3). Given this scenario, some owners will likely decide to sell, while others will need to refinance, whether working with current lenders (if they are willing) or finding new ones.

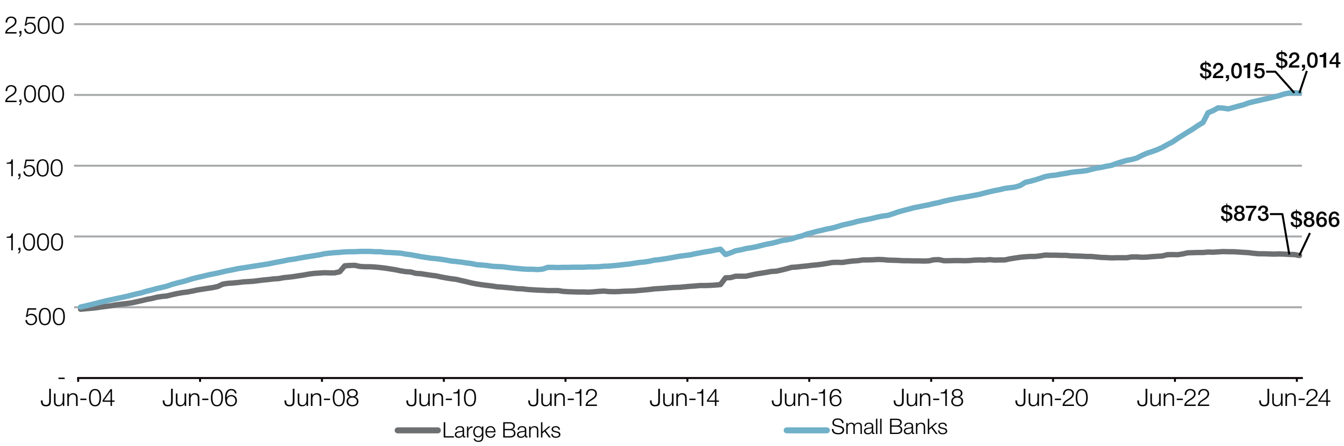
Exhibit 3 | Commercial Loan Maturities, Historical (2021-2023) and Forecast (2024-2027)



Sources: MSCI Real Capital Analytics and Hines Research. As of 2Q 2024. Note: Total maturities cover all property types tracked, including hotels, senior housing, land/development, and specialty residential.

Meanwhile, banks—both large and small—have been shrinking their CRE loan portfolios to offload potentially problematic loans (see Exhibit 4). While lending conditions are not as tight as they once were, the net percentage of banks tightening standards around their CRE lending remained about 20%—meaning that banks that are tightening continue to outnumber banks that are loosening by 20%.[3]

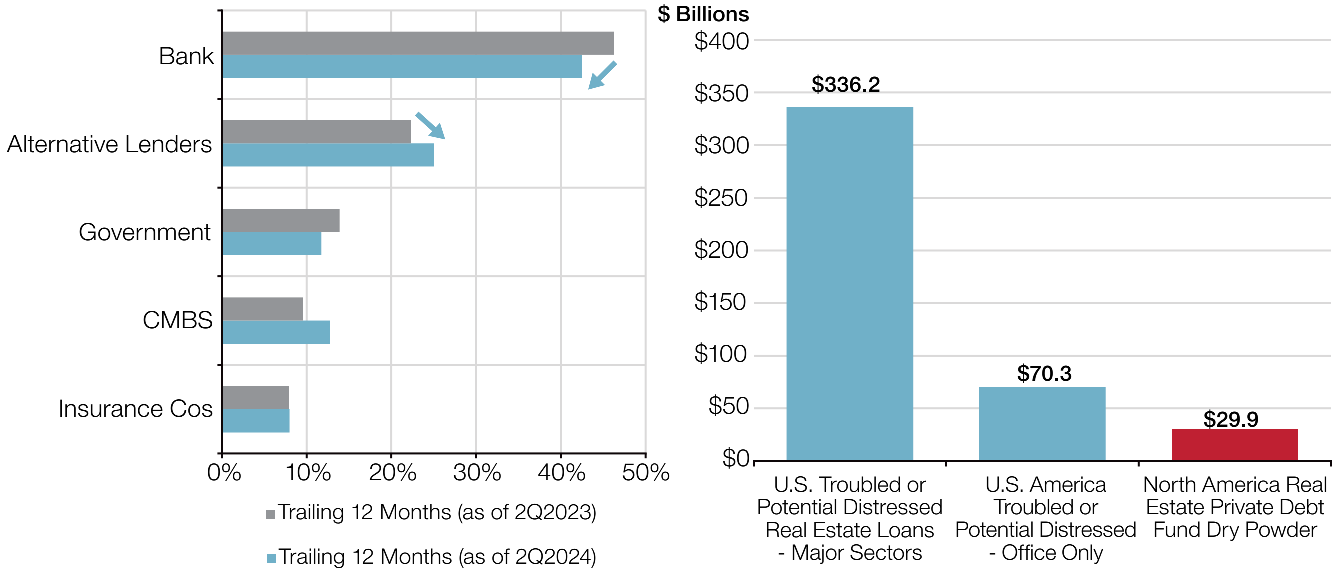
Exhibit 4 | Total CRE Exposure, USD Billions



Sources: Federal Reserve of St. Louis and Hines Research. As of 2Q 2024.

As banks step back, alternative lenders have helped to fill the financing gap, including private debt funds. But we believe that will not be enough. As we see in Exhibit 5, it's estimated that almost $340 billion of current loans are classified as "troubled" or "potentially troubled"—with $70 billion of that coming from the office sector. Meanwhile, the available dry powder in private debt funds is estimated at around $30 billion. That's a $40 billion shortfall even if all that capital was directed at the office sector, which is not a likely outcome.

Exhibit 5 | Total CRE Loan Originations by Lender Type and Value of Troubled/Potentially Distressed Real Estate Loans



Sources: MSCI Real Capital Analytics and Hines Research. As of 2Q 2024. Note: The totals for troubled and potential distressed real estate loans do not include the REO category, i.e. loans associated with properties repossessed by banks.

We believe all this leads to a clear conclusion. There is an opportunity to step in and provide much-needed debt capital at a point of ebbing availability where the demand appears to be the most acute: In the office sector. But that approach only works if investors have conviction that there are office properties that can thrive in a WFH world. Are there?

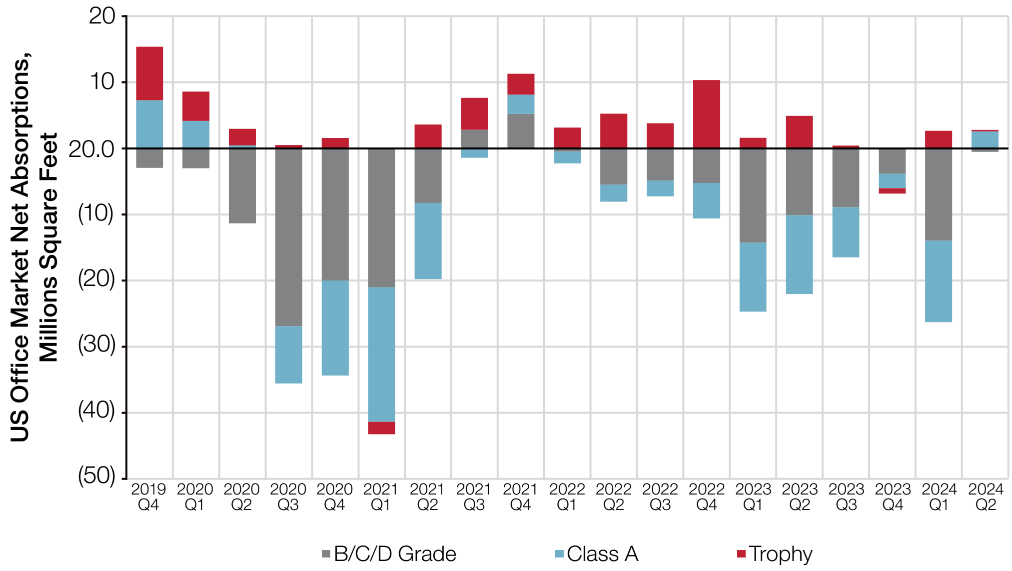
Momentum Is Building **in U.S. Office**

While impacts from the pandemic undoubtedly dragged on performance, there have been bright spots in the office sector that have remained somewhat under the radar. While the U.S. office market has suffered almost continuous negative demand since 2019, U.S. trophy-grade office (top-tier properties that make up just under 6% of the overall office inventory) has continued to see positive demand (see Exhibit 6). However, the trophy space is just a sliver of the overall office market. Recently, we have started to see positive net absorption for Class A office, as demand seeps into the next tier. Class A represents about 28% of the U.S. office stock.

Key Takeaway

Return to work is picking up as the supply of the most desirable office spaces (those that are higher quality, highly amenitized, and well located) remains limited. Given that, demand has broadened and the potential to improve older spaces to meet evolving tenant needs is real.

Exhibit 6 | U.S. Office Net Absorption

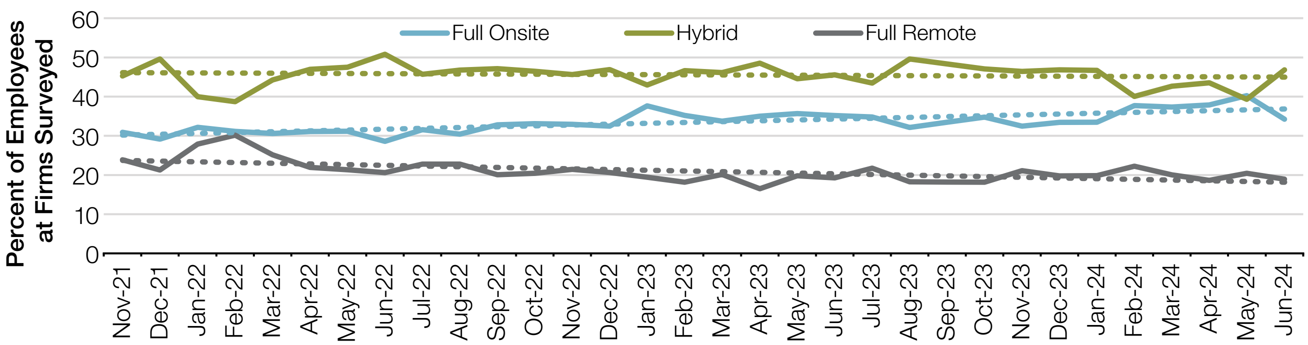


Sources: CoStar and Hines Research. As of 2Q 2024. Note: CoStar has a quality grade that uses star ratings. We have used a 5-star rating as Trophy, 4-star as Class A, and 1-, 2-, and 3-star as the lower grades of D, C, and B.

Meanwhile, demand for office continues to increase as full-time, on-site work trends upward and hybrid work remains popular (see Exhibit 7).[4] Since the pandemic, office tenants have given up over 150 million SF of space while continuing to hire employees. The result is a historically low level of occupied space per employee (227 SF per employee).[5] If space per employee were to return to trend levels, about 245 SF per employee, it would create 578 million SF of U.S. office demand.

That would drop vacancy rates from 13.8% to 7.0%—almost a record low. All told, current workplace trends combined with the fact that many tenants are currently "under-officed" suggests that overcrowding may increasingly become a challenge for companies. This is another reason we believe demand will continue to spill over into well-located assets that have demonstrated resiliency in the face of WFH.

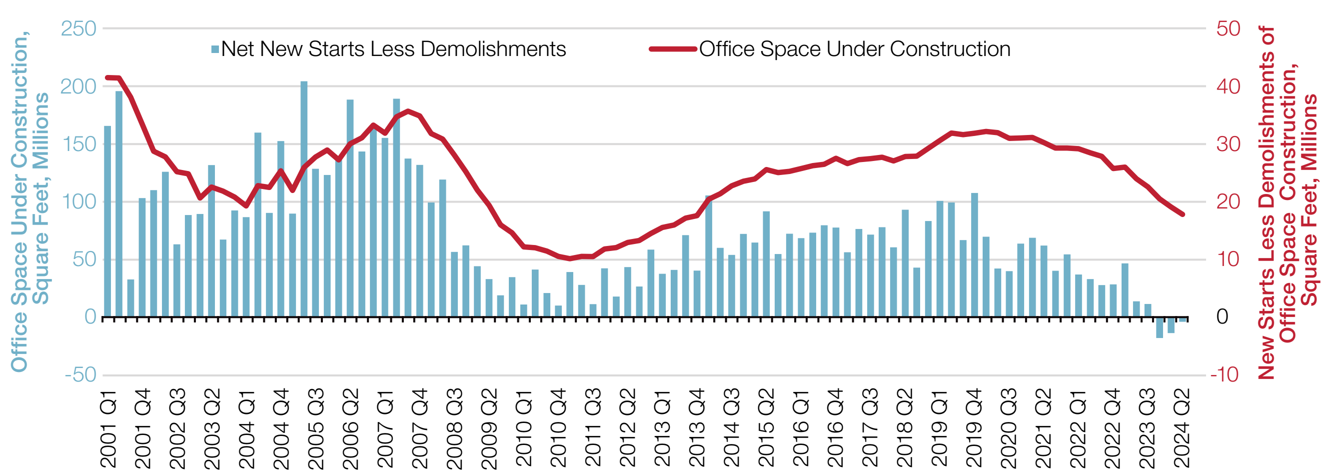
Exhibit 7 | Working Arrangements for U.S. Employees Who Can Work From Home



Sources: Cevat Giray Aksoy, Jose Maria Barrero, Nicholas Bloom, Steven J. Davis, Mathias Dolls, and Pablo Zarate, 2022. "Working from Home Around the World," Brookings Papers on Economic Activity and Hines Research. As of June 2024.

Supply also plays an important role in the U.S. office recovery story. If supply continues to decrease in the face of heightened uncertainty, the market may "right-size" itself, leading to a healthier balance of supply and demand. With that in mind, it's relevant to highlight that space under construction and new starts have been trending downward and have remained below the average of the previous cycle. In fact, new starts have hovered around historic lows (see Exhibit 8).

Exhibit 8 | New Space Under Construction and New Office Starts



Sources: NCREIF, CoStar, and Hines Research. As of 2Q 2024. Note: We subtracted quarterly demolishments in SF (properties that are demolished and thus removed from inventory) from the net new starts data.

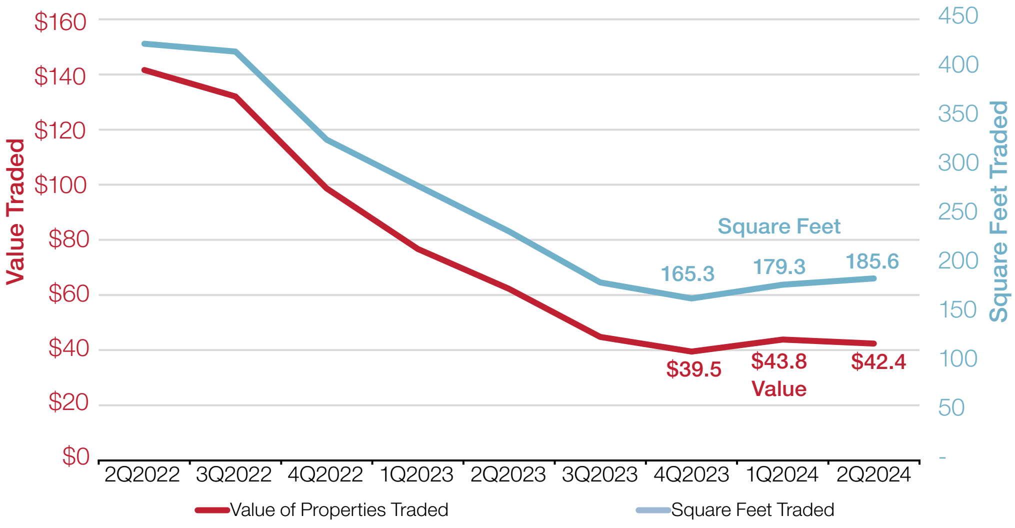
The U.S. Office Debt Opportunity: **Why Now?**

While deal-by-deal underwriting and conditions relative to pricing and cash flow differ, at an overall market level pricing declined in the office sector to the point that any further distress is likely already priced in. In fact, values have fallen in a correlated fashion together with transaction volumes since 2022. Meanwhile transaction volumes, if measured using the value of trades, have stabilized. If we strip value out of the equation by focusing on SF traded (the physical volume), office trades have been picking up since the end of 2023 (see Exhibit 9). In our opinion, this brings us closer to the end of any further mark-downs to office valuations—and we could actually already be there.

Key Takeaway

We believe that debt investments at this point in the market cycle are likely being made in an environment of lower risk, amplifying the case for risk-adjusted return potential. We believe the opportunity is multi-pronged with several avenues all of which could offer compelling performance.

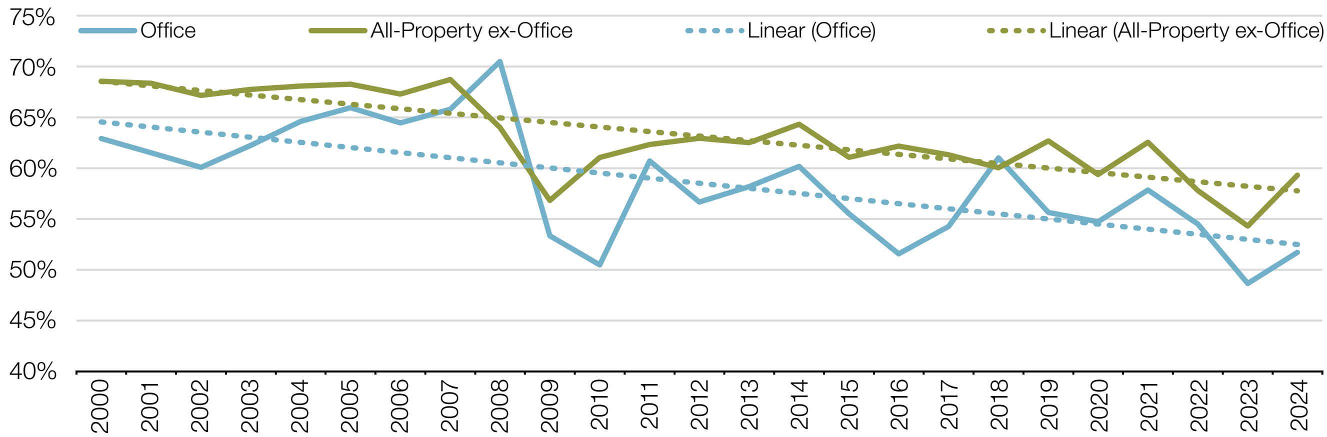
Exhibit 9 | U.S. Office Transaction Volume, Rolling Annual Totals



Sources: MSCI Real Capital Analytics and Hines Research. As of 2Q 2024. Using rolling annual sums for both value and SF traded since the market peak for NCREIF property appraised values in 2Q 2022. Showing values since recent trough to present.

At the same time, loan-to-value (LTVs) for CRE loans have been trending downward for some time (see Exhibit 10). Average levels for "all property" have been at about 60%; for the office sector, between 50-55%.

Exhibit 10 | U.S. LTVs for New Originations of Commercial Loans



Sources: Trepp, Hines Research, and the Hines Debt Team. As of 2Q 2024.

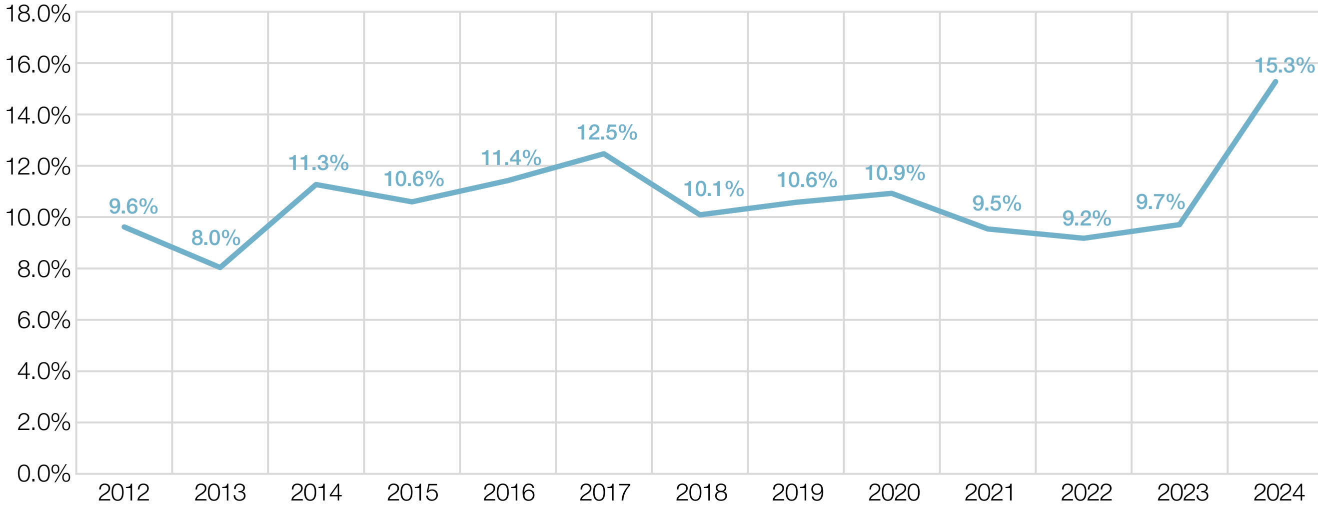
This landscape should be interesting for debt investors as opportunities unfold across three investment approaches, all of which we believe have the potential to offer attractive performance.

- First, with the price declines we've seen in office, the risk to the senior mortgage holder for new originations may be exceedingly low. This means that lenders of senior mortgages have increased amounts of equity sitting above their position in the capital stack. This cushion may reduce the risk to the loan's principal. A further cushion for debt investors should come from debt yields for the office sector, a metric calculated by dividing a property's NOI by its loan value, which reached new highs in 2024. (See Exhibit 11).

- Second, as we noted, banks may be electing to shrink their exposure to the CRE sector, and that can be accomplished by reducing new originations and/or selling off current troubled loans. To attract buyers of those loans, banks may have to price them at a discount that acknowledges the value drops the market has already sustained. For debt investors, this may present another way to invest at compelling pricing.

- Finally, conditions appear favorable for investors looking for higher-yielding debt opportunities in the mezzanine tranche, particularly for current office owners who are refinancing. The need to refinance at a potentially lower LTV on a property with values down anywhere from 20-40% raises issues with receiving enough new debt capital to pay off prior financing and/or finding equity capital. Even for new owners, the latter issue is a real one. Owners looking to "top off" their debt capital will likely fuel a rebounding mezzanine marketplace.

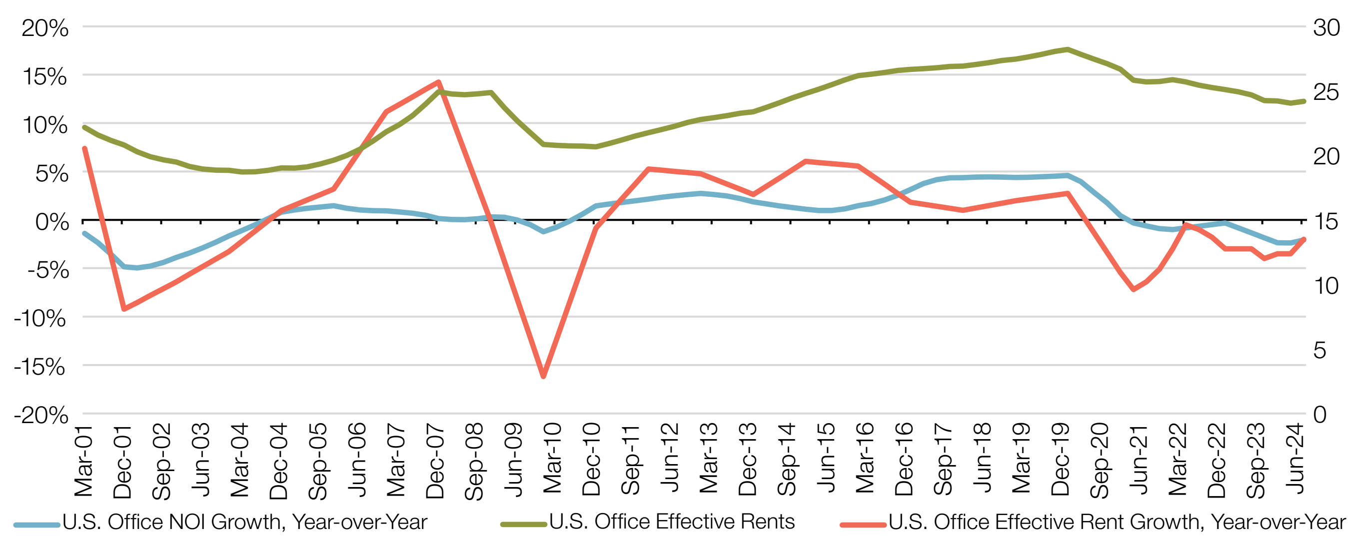
Exhibit 11 | U.S. All-Property and Office Debt Yields (NOI/Loan Values)



Sources: Trepp, Hines Research, and the Hines Debt Team. As of August 2024, using annual aggregates of all data for loans underlying all CMBS loans since 2012.

One risk to consider is future deterioration of cash flow at the property level that could further undermine valuations and the ability to fund debt payments. However, the data doesn't support this, as both overall office NOI and effective rents appear to be finding a bottom. In fact, effective rents actually ticked up in 2Q 2024 for the first time since the end of 2021 (see Exhibit 12).

Exhibit 12 | U.S. Office Top 50 Markets, Rolling Year-Over-Year Net Operating Income and Effective Rent Growth



Sources: Green Street Advisors and Hines Research. As of 2Q 2024.

The bottom line, we believe, is that debt investments at this point in the market cycle are likely being made in an environment of lower risk, amplifying the case that the return potential on a risk-adjusted basis may be attractive. Moreover, with several complementary investment avenues possible, there is the opportunity to pivot from one approach to another as these opportunities unfold.

Return Prospects Favor Debt

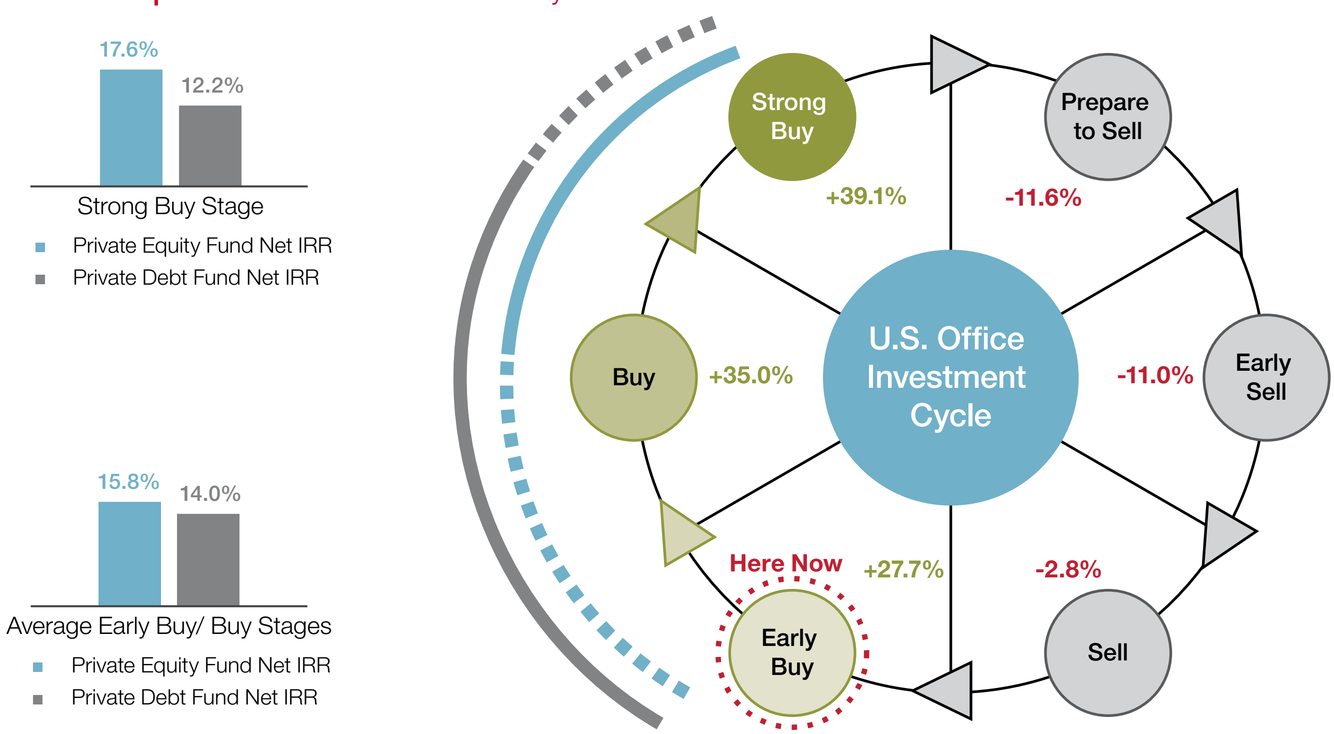
As noted in our introduction and in Exhibit 1, the signal from yields indicates that leading with debt investments likely makes sense now. Given the protection to debt principal previously discussed, it is logical to view a debt allocation as a potentially compelling risk-adjusted strategy.

However, “risk-adjusted” tends to imply a trade-off for the investor, such as giving up total returns for lower volatility, less risk to capital, and/or more robust downside protection. We believe the data tells us that potential total returns for real estate debt funds are attractive enough on an absolute level and that an investor’s debt allocation may stand on its own as a competitive absolute return strategy sustained by high cash yields and recurring income.

To further highlight this point, Exhibit 13 represents a version of our internal Hines Research investment cycle framework, a scoring methodology[6] to determine a sector’s or market’s location in the cycle at any given point using a proprietary view on pricing combined with a view on fundamental momentum. In applying this lens, we have found that returns for property equity investments turn positive once we enter the **early buy** stage when pricing is inexpensive but fundamental momentum is weak. However, the strongest returns for equity investors come when pricing is similarly attractive but fundamental momentum is strong enough to inspire investor confidence. (Note that the U.S. office sector, per the scoring methodology, is now in the **early buy** category.)

History tells us that private debt funds have earned an average net IRR largely similar to private equity (14.0% vs. 15.8%, respectively) in aggregate over the **early buy** and **buy** stages.[7] Once we enter the **strong buy** stage, the strategic case for office equity investment becomes more compelling as private real estate equity fund net IRRs have exceeded debt fund IRRs at almost 18% versus 12%.[8]

Exhibit 13 | The U.S. Office Investment Cycle



Sources: CoStar, Moody’s, Prequin, and Hines Research. As of 2Q 2024.[9]

Conclusion

We believe recent themes in U.S. office are converging into an intriguing (and often overlooked) story for investors. While many have thrown the "good office" out with the "bad," the office market is much more nuanced than that. Many office properties have maintained strong occupancy levels despite recent distress. These locations continue to build increasing demand momentum as companies evolve their in-person work models.

The repricing of the office sector—together with lower capital availability and LTV ratios—could present an opportunity across the capital stack. While some investors might steer clear of the office market in an attempt to reduce risk, others might see the possibility of uncovering untapped value and potential yield as the sector continues to right-size.

We believe that the current office landscape offers a compelling, multi-pronged investment thesis for debt investors that can be viewed as "risk-adjusted" given the low risk to principal, but also as a compelling absolute return strategy. This includes new originations of covenant-heavy senior loans at newly discounted property pricing, the acquisition of discounted current loans, mezzanine financing, and more. In our view, the flexible investor can most effectively navigate this environment, pivoting from one approach to another as the landscape evolves.

About Hines’ **Proprietary Research Team**

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Joshua Scoville (Head of Global Research) and his team, including Senior Managing Director Michael C. Hudgins, the lead author of this paper, are responsible for constructing the Hines macroeconomic view and outlook for commercial real estate market fundamentals and pricing. Hines Research is also responsible for assisting with developing investment strategies for the firm’s investment programs, working closely with the local and fund management teams, clients, and partners, and supporting U.S. regional and international country heads 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. They are essential for reviewing investment strategies and fund portfolio allocations. Additional team members include Tim Jowett, Ryan McCullough, James Purvis, Erik Thomas, Michael Spellane, and Anthony Witkowski.

Disclaimer

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Endnotes

1 The Mortgage Constant is the total debt service required to pay off a loan divided by the loan value. It is shown as a percentage (like an interest) rate but will be higher than the actual interest rate as it takes into account both interest payments and principal payments. While it could be argued that it is not perfectly comparable to a cap rate, which might be compared to an interest rate, we are comparing current spreads to the history, and it is clear that the mortgage constant does not sit higher than reported cap rates for commercial loans very often. And, of course, in the case of amortizing loans (where principal is paid back over time), getting one’s principal back over the course of the loan is attractive, we would think.

2 The NCREIF NPI, short for the NCREIF Property Index is a quarterly index tracking the performance of core institutional property markets in the U.S. The objective of the NPI is to provide a historical measurement of property-level returns to increase the understanding of, and lend credibility to, real estate as an institutional investment asset class. The universe of investments: 1) is comprised exclusively of operating properties acquired, at least in part, on behalf of tax-exempt institutions and held in a fiduciary environment; 2) includes properties with leverage, but all returns are reported on an unleveraged basis and 3) includes Apartment, Hotel, Industrial, Office and Retail properties, and sub-types within each type. The database fluctuates quarterly as participants acquire properties, as new members join NCREIF, and as properties are sold. Sold properties are removed from the Index in the quarter the sales take place (historical data remains). Each property’s market value is determined by real estate appraisal methodology, consistently applied. Please note that when returns are computed for the NPI, the returns for the levered properties are computed on a de levered basis, i.e. the impact of financing is excluded A benchmark Index is not professionally managed. Investors cannot invest directly in an index.

3 Federal Reserve Senior Loan Officer Survey, Hines Research. As of 2Q 2024.

4 Cevat Giray Aksoy, Jose Maria Barrero, Nicholas Bloom, Steven J. Davis, Mathias Dolls, and Pablo Zarate, 2022. “Working from Home Around the World,” Brookings Papers on Economic Activity, Hines Research. As of June 2024. Per this source, employees surveyed expressed a desire to work 2.36 days a week at home.

5 CoStar, Bureau of Labor Services (BLS), and Hines Research. As of 2Q 2024.

6 The Hines Research Investment Cycle utilizes a scoring methodology to determine a sector’s or market’s location in the cycle at any given point using a proprietary view on pricing combined with a view on fundamental momentum. The Composite Capital Market Score (“CCMS”) is an aggregate score (0-100) derived from the following metrics: Price to Trend, Cap Rate Spreads, Growth-Adjusted Spreads, Trailing Price Growth, and Trailing Total Returns. The CCMS is calculated as a percentile relative to each market’s own history. Higher scores indicate that the market is expensive relative to its history. “Very Expensive”—85-100th percentile; “Expensive”—70-85th percentile; “Fairly valued”—30-70th percentile; “Inexpensive”—15-30th percentile; and “Very Inexpensive”—0-15th percentile. This chart averages the CCMS for all markets covered by Hines Research within each Property Type or Region shown. The fundamental momentum is a score derived from the Leasing Environment Health Score and measures the relative health of a market’s current Leasing Environment. It combines vacancy rates, trailing annual rent growth, and trailing annual demand growth into a composite score. The score is a backward-looking snapshot of where the market is today and can help inform a forward-looking view that is most predictive over the next 1-2 years. The score measures the environment relative to the prior environment in the market’s own history. A score of 100 is a strong leasing environment, stronger than 100% of the market history. A score of 10 is a weak environment, worse than 90% of a market’s history. For the main buy and sell stages shown in this paper, the Strong Buy, Buy, and Early Buy also have pricing at <30 (Inexpensive), but differing scores for momentum (>70 for Strong, between 30 and 70 for Buy, and <30 for Early Buy, where a higher score is stronger momentum). The Prepare to Sell, Early Sell, and Sell all have pricing >70 (Expensive) and momentum scores that are respectively, >70, between 70 and 30, and <30. The U.S. office sector, as of 2Q 2024, is 8.4 for the CCMS and 28.9 for the momentum score, putting it in the Early Buy stage.

7 As of 2Q 2024, using Prequin Net IRRs for years that are categorized as Early Buy, Buy, and Strong Buy.

8 Past performance cannot guarantee future results.

9 The analysis covers the period for which there is Prequin data for North American private equity and debt funds (1993 to 2021, as Net IRRs for funds may not yet be reported for more recent vintages). It is annual data as that is how Prequin data is reported. It was determined where the U.S. office sector sat within the framework (investment cycle) for each calendar year, i.e. “vintage” year. Then, five-year forward returns were calculated for the overall U.S. office sector on average for all vintage years falling within each stage shown above. Finally, vintage year median private equity real estate and private real estate debt fund vintages were averaged for each stage shown as well as to determine how equity fund investments have fared relative to debt fund investments by stage for the U.S. office sector. As the Prequin data is not set up to make an office versus an “all property” distinction, the Net IRRs’ results shown are for all North American funds, covering all strategies and all sectors, whether diversified or sector-specific. While we have shown the Early and Buy Stages as an average, the respective Net IRRs for equity and debt funds are 16.5%/16.2% and 15.1%/11.7%. While a sample mix of funds launched can impact levels of IRRs, we believe it is supportive of our case that the delta between the Early-Stage Equity and Debt Net IRRs are the smallest at only 0.3%, the Buy Stage spread of 3.3% the next smallest, and the largest favoring Equity funds, 5.4%, is associated with the Strong Buy Stage. Past performance cannot guarantee future results.