

OFFICE PROPERTIES *Quarterly*

Market Update

Lender approaches are changing for office space

There have been many predictions by commercial real estate industry experts on what the short- and long-term pandemic impacts will be to office properties as we adapt to social distancing and remote working. And, not surprisingly, there seems to be a reasonable counter argument for every prediction. For example, some experts predict companies will increase their office space requirements to allow for a higher amount of space per person, while others believe companies will decrease their space requirements as working from home becomes widely adopted. Some investors are betting there will be a migration of office users from the central business district to the suburbs as employees become less willing to utilize public transportation. This could result in CBD office vacancy rates that exceed their suburban counterparts. Some office investors are assuming that social distancing will lead to a major reduction in the coworking industry, while other leasing brokers are indicating national coworking tenants in the suburbs have experienced more recent demand compared to their CBD locations during the pandemic.

Employees usually are a company's most important asset and the needs of critical employees will continue to be an important factor in selecting office locations and designs. Whereas key employees may have been more willing to drive longer distances to work in amenity-rich submarkets such as Denver's CBD or Lower Downtown,



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these preferences may change in the coming months and years as social distancing becomes normalized. Key employees may be more willing to consider single-story office properties with a walk-up entrance and no common areas or elevators in submarkets that allow them to avoid public transportation. Some experts foresee a trend where suburban office could outperform urban locations with low parking ratios and high density, reversing the trend toward more urban locations. On the sales activity front, investment sale brokers who specialize in office have been reporting there is pent-up buyer demand for office properties, but it's anticipated pricing discovery will remain difficult until a vaccine(s) is widely available or antibody testing indicates a herd immunity has occurred. Office investment brokers are indicating some buyers are willing to transact at cap rates approximately 50 basis points above where they were at the end of 2019, which indicates the gap between buyer and seller expectations isn't too far apart and transaction activity should pick up in the later part of the year. Transactions getting done now typically are motivated by an agenda such as a 1031 exchange,



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a maturing loan or an equity recapitalization. Otherwise, most sellers are anticipated to wait on the sidelines and avoid selling at a discount until buyers become more comfortable underwriting sustainable rent growth and vacancy rates that more closely match year-end 2019 numbers. From a lending perspective, office properties still rank in the middle of preferred property types for lenders, as it did pre-pandemic, but we expect lender demand for office product to increase in the second half of the year as they reallocate their capital away from retail and hospitality property types, which have seen the greatest impact from the shift in consumer activity as a result of the pandemic. Based on an overview of the loans serviced by our group, office landlords have been experiencing much lower rent-relief requests from tenants compared to hotel and retail landlords, with the exception of administrative offices for the restaurant, hotel and health club industries.

Most lenders have changed their approach to underwriting office assets. These changes include:

- Any office tenant that has requested rent relief most often will be underwritten similar to month-to-month tenancy (vacant space).
- Tenants such as oil and gas com-

panies, and administrative offices for restaurant chains and health clubs will be heavily scrutinized as sustainable tenants. A positive story is required for a lender to underwrite the rent.

- Structuring around tenants of concern likely will be required and could take the form of leasing capital and debt service reserves.
- A greater importance is being placed on sponsor strength and experience, especially with bridge loan requests.
- Lenders are trying to anticipate shifts in office occupancy by underwriting higher market vacancy rates.
- The most recent effective rents on new leases and renewals will be scrutinized more compared to the average rent in place vs. market.
- There has been little change to minimum underwritten debt yields: Average of 9.5-10% for suburban office and 8.5-9% for CBD.
- Lenders are limiting proceeds, with overall loan to values down 5-10% from year-end 2019.

In general, most lenders are bullish on Denver and believe it is well positioned to weather the economic impacts from the pandemic. Denver is ranked in the top 10 metropolitan statistical areas for office investments and very few balance sheet lenders, such as life insurance companies, are over-allocated to office mortgage or equity. Current fixed rates aren't too far from where they were at the beginning of the year but loan proceeds are down across the board by 5-10% with all types of lenders. See the table on Page 5 for more details on how lending criteria and metrics have changed since the beginning of the year. ▲

Interest Rates	Jan. 1, 2020	June 1, 2020
10-year Treasury	1.88%	0.67%
30-day LIBOR	1.73%	0.18%
Life Company	Jan. 1, 2020	June 1, 2020
Max LTV	65%	60%
Spread	140-200 bps	280-340
Avg. 10-yr. fixed rate	3.6%	3.8%
Term	3-30 years	No change
Amort.	20-30 years	No change
Avg. min. debt yield	9.5%	10%
Low leverage i-o	Up to 10 years	Up to 5 years
High leverage i-o	None	None
Min. DCR	1.35x	1.5x
CMBS	Jan. 1, 2020	June 1, 2020
Max LTV	70-75%	60-65%
Spread	170-230 bps	330-380
Avg. 10-yr. fixed rate	3.9%	4.1%
Term	5, 7 & 10 years	Mainly 5 & 10 yr. terms
Amort.	25-30 years	No change
Avg. min. debt yield	8.5%	9%
Low leverage i-o	10 years	No change
High leverage i-o	1-2 years	None
Min. DCR	1.30x	1.40x

Bank (non-recourse)	Jan. 1, 2020	June 1, 2020
Max LTV	60%	50%
Spread	170-220 bps	425 bps
Avg. 10-yr. fixed rate	4.25%	5%
Term	Up to 10 yrs. fixed	Most at 5 yrs. max
Amort.	25-30 years	No change
Avg. min. debt yield	9.5%	11%
Low leverage i-o	1-2 years	None
High leverage i-o	None	None
Min. DCR	1.35x	1.50x
Debt Fund / Bridge	Jan. 1, 2020	June 1, 2020
Max LTV	85% LTC	70-75% LTC
Spread	LIBOR plus 175-400	LIBOR plus 350-600
Avg. initial rate	5%	6.5%
Term	1-5 years (3+1+1)	No change
Amort.	Interest only yrs. 1-3	No change
Avg. min. debt yield	N/A	No change
Low leverage i-o	N/A	No change
High leverage i-o	1-3 years	No change
Min. DCR	N/A	N/A