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Generations Fall 2023 - Day Pitney Hosts Discussion on Emerging Opportunities with Distressed Real Estate

On November 9, Day Pitney hosted a timely discussion on emerging special situations and distress in the real estate market. The consensus from our keynote speaker and expert panelists is that every market across the country is bracing itself for the turbulence.

The post-pandemic era drove unprecedented growth in valuations as a result of generous government stimulus and continued record low interest rates. Inflation rose significantly and the Federal Reserve acted aggressively to control it; eliminating quantitative easing and raising interest rates to their highest level in decades. Most financial experts and economists expect interest rates to stay at these levels for some time. This presents serious challenges for owners and asset managers as loans mature requiring refinancing with interest rates at these higher rates.

Don Peebles, our keynote speaker, shared data in major cities such as Washington, DC, New York and San Francisco. Each of these markets consist of historically high office vacancy rates driven by work from home or work from anywhere policies during the pandemic. Calls to return to the office have not been successful leading many employers to shed office space in these cities including the federal government. Owners of these office buildings cannot service their debt much less refinance it. This has provoked massive losses in values in these office buildings and caused many owners to turnover their properties to their lenders. Mr. Peebles believes there is still a lot of pain left to permeate through these markets. However, he sees tremendous opportunities in buying these assets at a substantial discount to reposition from office to multifamily, stating "As we continue to diversify our portfolio in key markets, our goal is to capitalize on the unprecedented number of insolvent office buildings and transform them into sound residential and/or hospitality offerings." He also anticipates local, state and federal governments to step in and offer serious incentives to do so. Without the repositioning of these assets, those urban areas will continue to deteriorate and the pain will become systemic causing the retail and multifamily around them to suffer.

Daniel Diaz Leyva moderated a panel consisting of two market leaders for Cushman & Wakefield and Jones Lang LaSalle in their loan sale divisions and two investors in distress assets from Rialto and Blueprint Capital Partners. The comments from the brokers affirmed Mr. Peebles' position that loan sales were on the rise as borrowers could not meet their debt service covenants and maturities were coming due with few alternatives for financing. Investors like Michael Mashioff at Rialto and Carlos Sandino at Blueprint Capital were actively seeking to acquire these assets at a discount or the underlying debt in distress. There was consensus that the market will continue to deteriorate for the foreseeable future. Some anticipate pain through the middle of 2024 until rates start to come down and the government starts incentivizing investment in these distress markets.

Aside from office assets, multifamily properties purchased in recent years at low cap rates with extremely cheap debt will find challenges when refinancing at higher interest rates. Non-compliance with debt service coverage ratios will result in owners having to pay down principal in order to refinance their debt obligations or be forced to sell the asset. This will create opportunities to purchase strong assets at better valuations and recapitalize worthy projects for distress investors. The underlying assets and rental income for some of these multifamily assets are very strong but debt service coverage is simply not sustainable at higher interest rates coupled with higher operating costs with insurance premiums also rising across the country.

The silver lining in the conversations was that there continues to be a lot of capital on the sidelines waiting to take advantage of the right opportunity. This will ensure economic activity continues. Transactions will continue to occur especially in choice markets like Florida where population growth and job creation will largely insulate it from the pain in other markets like Washington, DC, New York and San Francisco. The housing market continues to be severely undersupplied so homebuilders and build to rent projects will continue to be strong investment opportunities in spite of the higher interest rate environment. Provided the Federal Reserve lowers rates, housing will perform even better than it currently stands.

Our firm was thrilled to host over 100 clients and guests for this discussion. "It was an absolute pleasure speaking with so many innovative leaders and like-minded investors at Day Pitney's recent Family Office Event in Coral Gables," Mr. Peebles said. We are committed to creating forums like this and establishing an eco-system of operators, investors, bankers and developers to connect. This is where the magic happens and we are here to support our clients when it does.

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