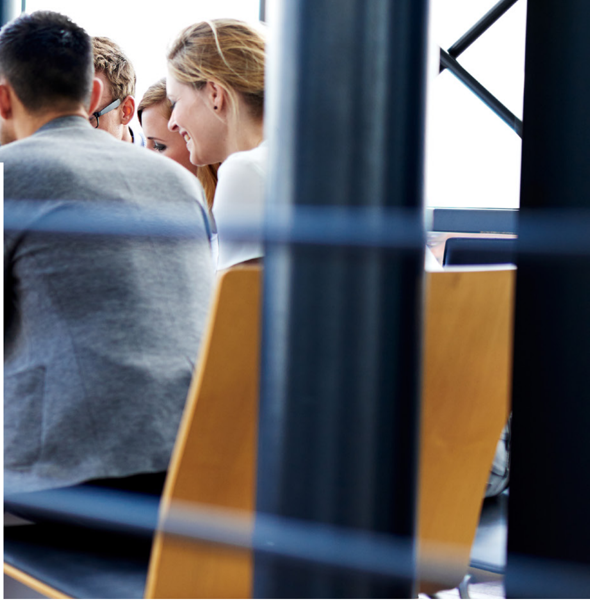
Occupier Strategies Amid Increased Landlord Defaults

Across the country, landlord defaults are on the rise. Several prominent landlords have reported defaults on office buildings and towers in major U.S. cities, and this pattern is likely to continue in the months ahead. **For occupiers, it's important to understand how a landlord default affects your tenancy and the options available to you when facing this scenario.** The following report provides an overview of the factors behind the defaults, predictions for the coming months, and key insights for tenant strategies.

The Trends Behind the Defaults

The long-term impact of the pandemic is largely responsible for the wave of landlord defaults. As hybrid work shrinks the average office footprint and some tenants let their leases expire altogether, office buildings are seeing low occupancy across markets. In addition, high interest rates are forcing landlords to refinance at unfavorable rates as their debt reaches maturity. Given this weak office market, lenders are hesitant to provide mortgages for office buildings unless they are fully leased by long-term, creditworthy tenants. With several factors working against them, many landlords end up defaulting, either because they have no other choice or because it's more economically compelling to default and foreclose than to incur the costs to maintain, renovate, and release the property.



The Default/Foreclosure Process and Timeline

When a landlord defaults on their loan, the lender will inform the landlord of the default via written notice and define a specified period of time (typically 30 days) during which the default must be cured. If the landlord does not cure the default, the foreclosure process will commence. **Foreclosures may be done judicially or non-judicially** depending on the lender preference and the state, however, most lenders prefer non-judicial foreclosures as the process is faster and less costly. While the judicial timeline will vary based on the court system, **the non-judicial timeline to a foreclosure is as follows:**

1. The default notice delivered to the borrower and posted visibly on the premises.
2. Default cure period (typically 30 days).
3. Lender authorizes trustee (designated 3rd party on the property deed) to issue a notice of sale.*
4. No less than 120 days from the issuance of the notice of default, the sale takes place in a public place as specified in the notice of sale and the deed of trust is officially foreclosed.**
5. A Trustee's deed is recorded soon afterwards and the successful bidder becomes the owner.

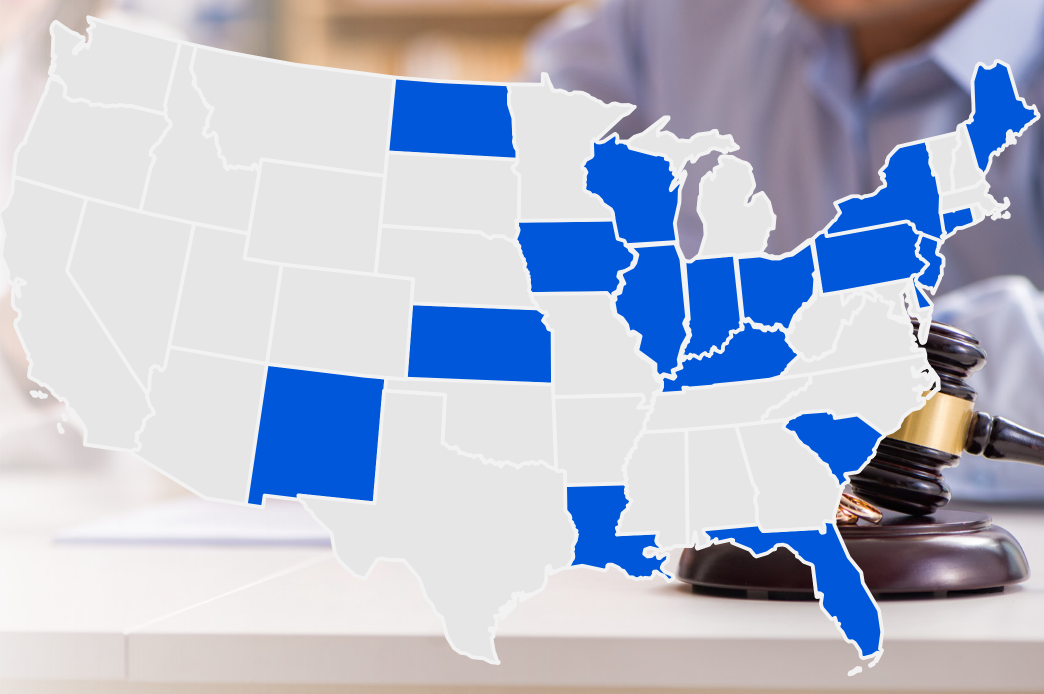
**The notice of sale is sent to the borrower, parties with recorded/filed monetary, the plaintiff(s) in any filed court action, and any party who has recorded a request for notice as specified by law. Tenants should be sure to review postings within their buildings to learn about landlord defaults as soon as possible.*

***The sale may be halted up to 11 days before the sale date if the default is cured or the loan is fully paid. Further, the sale can be postponed if the borrower files bankruptcy. The sale must be held on a Friday between the hours of 9am and 4pm.*

States that Require Judicial Foreclosures

Connecticut
Delaware
Florida
Illinois
Indiana
Iowa*
Kansas
Kentucky
Louisiana
Maine
New Jersey
New Mexico
New York
North Dakota
Ohio
Pennsylvania
South Carolina
Wisconsin

**(unless agreed to by both parties)*



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Looking Ahead

This wave of landlord defaults is expected to continue. Approximately $137 billion of office debt is due in 2023, with $1.5 trillion in CRE debt set to mature over the next two years. Based on these figures, experts estimate that 5-10 properties are at risk of default each month. When paired with the low utilization data, the outlook is especially bleak: the volume of new office leases has dropped 10% from the pre-pandemic era, and 30% of U.S. office buildings are expected to become obsolete. This leaves tenants at risk of occupying outdated, poorly maintained spaces that may reduce operational effectiveness and discourage in-office employee presence.

The Tenant Perspective

As landlords brace for a sustained downturn in the CRE market, occupiers should assess their circumstances to understand the potential ripple effect of a landlord default. While each lease is unique, there are a few scenarios we typically see. Lenders may reclaim properties, which often impacts lease terms and timing. As for space improvements, landlords may be unable to pay tenant improvement dollars agreed upon in the lease, and tenants should expect only basic upkeep, even if larger improvements were promised.

Future-Focused Strategies

During the transaction process, tenants can take steps to protect themselves from landlord defaults and achieve favorable lease terms. To reduce the risk of a default, occupiers should conduct a thorough evaluation of potential landlords' financials before signing a lease. **The most critical financial considerations include the following:**

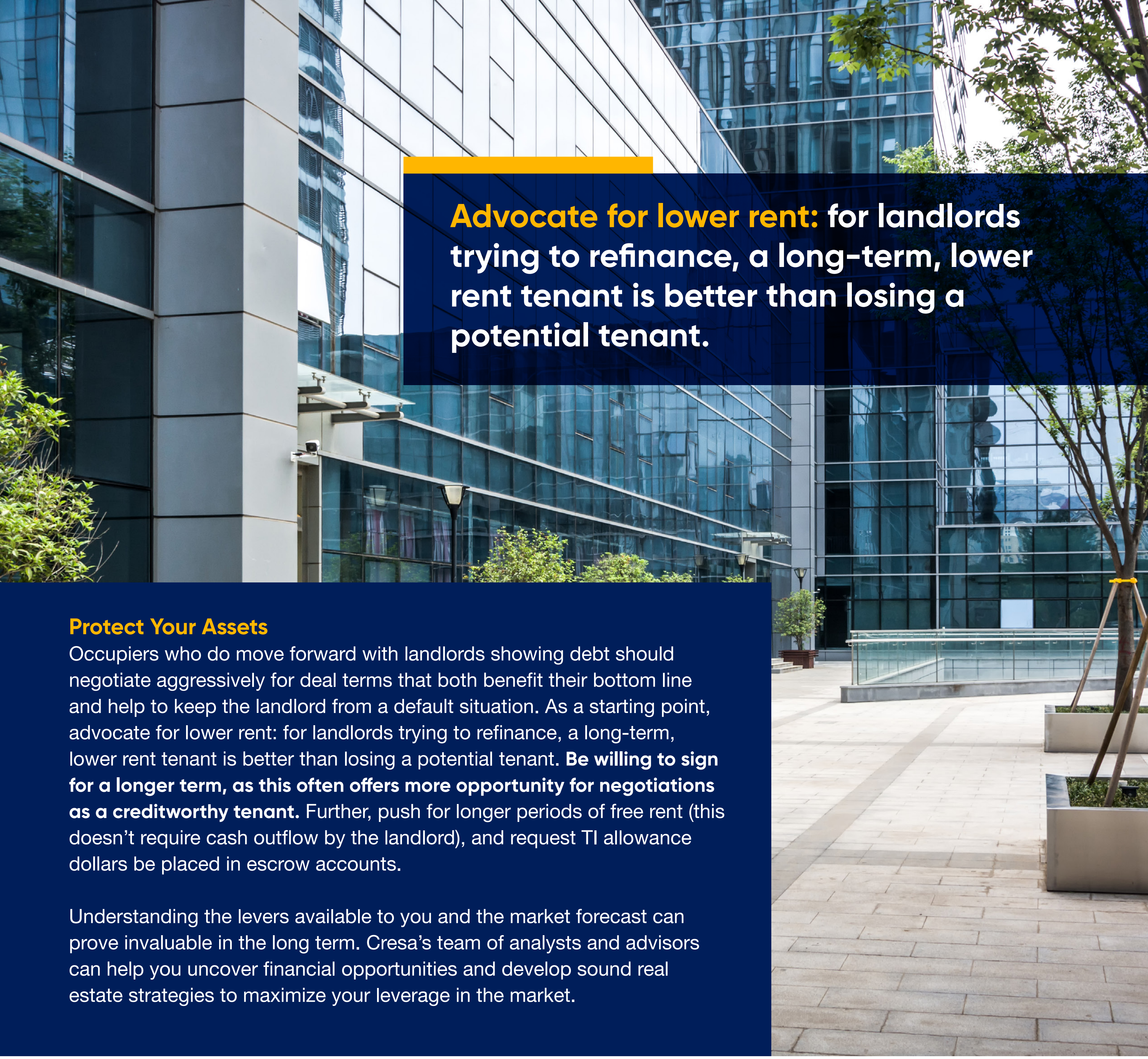
Landlord's Total Indebtedness

Upcoming Repayment Obligations

Current Cash Balance

Owned Asset Profile
What percentage of their portfolio is office & what markets do they occupy?

Ideal landlords will be those who are well capitalized and have little debt. These landlords have the ability to both maintain and improve their buildings to attract competitive tenants and maintain low vacancy.



Advocate for lower rent: for landlords trying to refinance, a long-term, lower rent tenant is better than losing a potential tenant.

Protect Your Assets

Occupiers who do move forward with landlords showing debt should negotiate aggressively for deal terms that both benefit their bottom line and help to keep the landlord from a default situation. As a starting point, advocate for lower rent: for landlords trying to refinance, a long-term, lower rent tenant is better than losing a potential tenant. **Be willing to sign for a longer term, as this often offers more opportunity for negotiations as a creditworthy tenant.** Further, push for longer periods of free rent (this doesn't require cash outflow by the landlord), and request TI allowance dollars be placed in escrow accounts.

Understanding the levers available to you and the market forecast can prove invaluable in the long term. Cresa's team of analysts and advisors can help you uncover financial opportunities and develop sound real estate strategies to maximize your leverage in the market.

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