Securing the Future of the D.C. Office Market

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The Washington D.C. office market is likely in the early stages of a very big change. And, arguably, it's a massive market shift that has never been experienced before, driven by an unexpected mix of conditions. Over the course of several years there was a steady evolution of workplace technologies. The adoption of these technologies accelerated markedly under the strain of the global pandemic's dramatic and sudden shut down of traditional office buildings. In its wake was proof that traditional in-office businesses could thrive as remote or hybrid endeavors. Not only did the new technologies make it easier to support a work-from-home culture, but people also liked working this way and have cumulatively demanded a change in where they work. However, the hybrid work culture presents real challenges to the owners, operators and lenders of office buildings, begging the question: what are the options as this unsettling pivot unfolds?

While some may find comfort in how the D.C. office market has historically weathered difficult circumstances, things don't feel quite the same this time around. Unlike other major cities, Washington D.C. has been relatively insulated from the high vacancy rates that accompany recessions. Enjoying a more stable market under the blanket of steady federal government-related demand, Washington D.C.'s commercial real estate owners were able to successfully hunker-down and wait out past crises. This strategy worked because in large part the past crises were crises of liquidity in which the underlying fundamentals of the market remained unchanged. If an owner could hold onto a property for a couple of lean years, it could reasonably expect a success rebound. But the recession of today is very different because of the seismic shift in the fundamental use of office space. The occupancy of Washington D.C.'s business districts is at a low point and a quick bounce back seems unlikely. This situation requires commercial real estate owners and lenders to find ways to operate in this new real estate market.

Emerging Options for An Uncertain Market

- **Stay the Course (With a Twist):** As in the past, owners of well-situated commercial real estate could opt to wait out the recession by holding onto their existing office space, but it won't be business as usual. Lease pricing for even high-end office buildings will likely drop and tenants will be in the driver's seat until a new equilibrium is reached. And as tenants continue to adapt to the hybrid workplace model, they will likely have new demands for retrofitting spaces to meet their needs. This could include footprint changes that use fewer individual offices but add more collaborative workspaces, upgraded ventilation systems, and hospitality-style amenities to tempt workers to come into the office. In addition, tenants may require higher levels of space flexibility as new leases are signed, likely requiring more options to give back unused space or acquire additional space as they work through the hybrid work model over time. All these changes will require owners to work collaboratively with increasingly selective lenders because these changes, some considered outside of traditional office building mortgage underwriting, add a nuanced layer of risk for funding these properties.

- **Office Conversions:** Converting office buildings into residential, hotel, or mixed-use purposes is becoming a popular and important option. These complex shifts require owners to re-invest in ways they may not have anticipated or planned for. For instance, when undergoing office-to-residential conversions, it is important to sort through all the related business and legal issues involved, including affordable housing, tenants' rights, zoning and environmental matters. And with office-to-hospitality conversions, owners may enter into sophisticated hotel management and franchise agreements that have significant long-term effects on the value of their properties. Ultimately, every conversion presents unique challenges that must be overcome operationally, financially, and legally.

- **Relinquishing Properties:** With fewer lucrative options for lower tier assets, owners who don't have enough equity to convert those properties to new uses may need to consider selling or maneuvering a give-back to the lenders, perhaps through a short sale or some other arrangement. When this happens, a host of tax considerations and liability issues are triggered, such as transfer taxes or income taxes and guarantee and other potential liabilities. Because of current bankruptcy law and the way most commercial real estate loans are structured, a bankruptcy filing will not be an option in most cases. However, a chapter 11 proceeding, with lender consent, can be helpful in addressing high transfer taxes in some situations.

Conclusion

Washington D.C.'s real estate market is in for a long period of flux, specifically in the office market. It shouldn't be surprising that the path-forward for different properties may vary considerably, and so it will be more important than ever to work with experienced multi-disciplinary counsel who know how to successfully negotiate challenging issues in leases, guide successful building conversions and, when necessary, work with lenders to manage property relinquishments cleanly and efficiently. As office tenant leases sort through the new workplace environment, more considerable changes may be coming. One thing is for certain, it is time to think strategically about what works for each particular property and set up a team who can make the best of one of the most challenging times in the Washington D.C. office market.