

Resolving commercial real estate distress after the COVID-19 pandemic: Real versus financial resolution

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Summary

Switches between property types (redployments) are common in New England!

Most 'new' properties are in fact switches between property types

Empirically, main determinant of whether improved property gets redeployed to a different use are

- ▶ **Presence of a mortgage:** ↓
- ▶ Population density: ↑
- ▶ Age of building: ↑
- ▶ Land share of value: ↑

Model of CRE lending that incorporates obsolescence of property where bank regulators impose a cost on banks of foreclosing on a CRE property

Overall Impression: Empirics

Facts about redeployment are new, carefully established, and important

First paper documenting these facts to my knowledge

Paper is essentially good news for CRE and cities

- ▶ If redeployment infrequent, we may have a Detroit problem in a lot of central business districts (CBDs) post-COVID
- ▶ May have a bunch of unused office towers and shopping malls going forward which reduces agglomeration benefits

Would like to see paper drill down specifically in what specific use types are most frequently converted to other use types

Would like to see change in valuation between specific property types to get a guesstimate as to how costly redeployment is

Overall Impression: Model

Captures idea of obsolescence well

Model purpose is a little murky

- ▶ Is goal to explain empirical finding that mortgaged properties get redeployed less frequently?
- ▶ Is goal to study optimal capital charges for foreclosures?

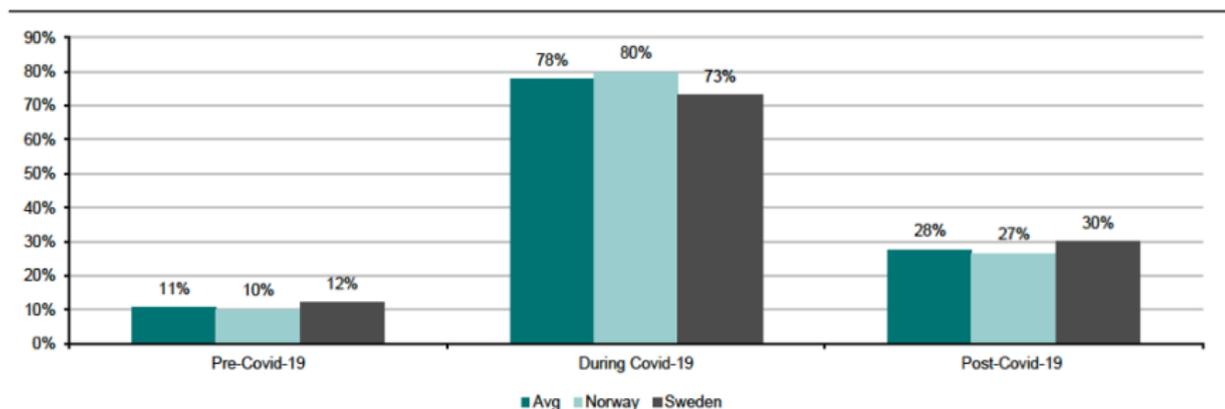
In discussing the model, paper alludes to positive externalities from foreclosure on CRE

- ▶ In contrast to negative externality we think of in residential
- ▶ Agglomeration economies in both consumption and production support this assumption and it's novel
- ▶ But this is not actually modeled

Model assumes lenders face a capital surcharge from foreclosing on CRE but more explanation of why this is key friction would be helpful

Why Care about Redployment? Revaluation of CRE Post-COVID

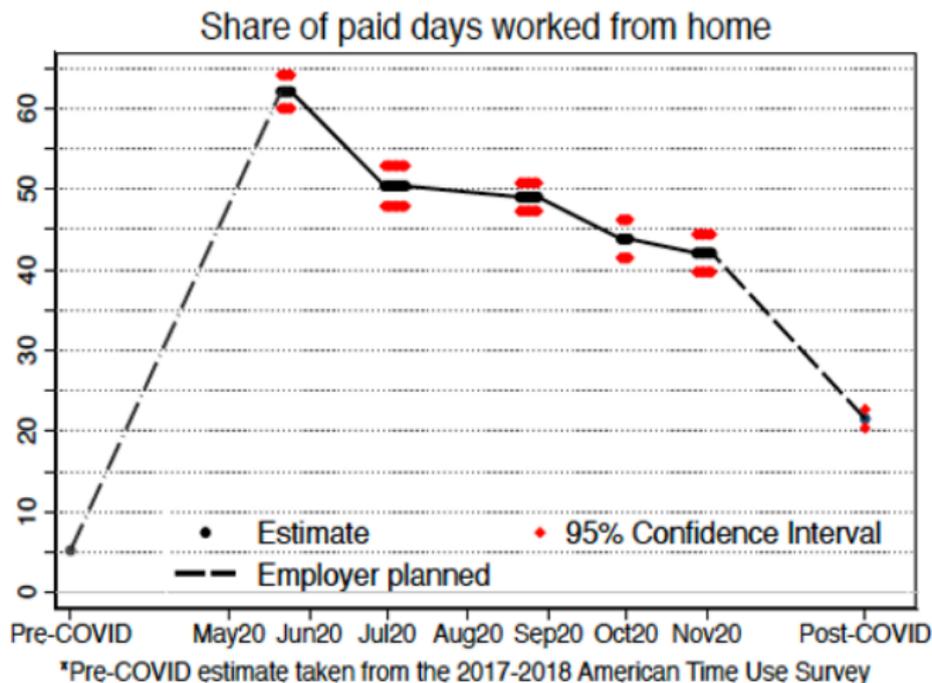
Work-from-Home (WFH) is here to stay, albeit in hybrid form



Source: DNB Markets (2020) Survey of *Employers*

Revaluation of CRE Post-COVID

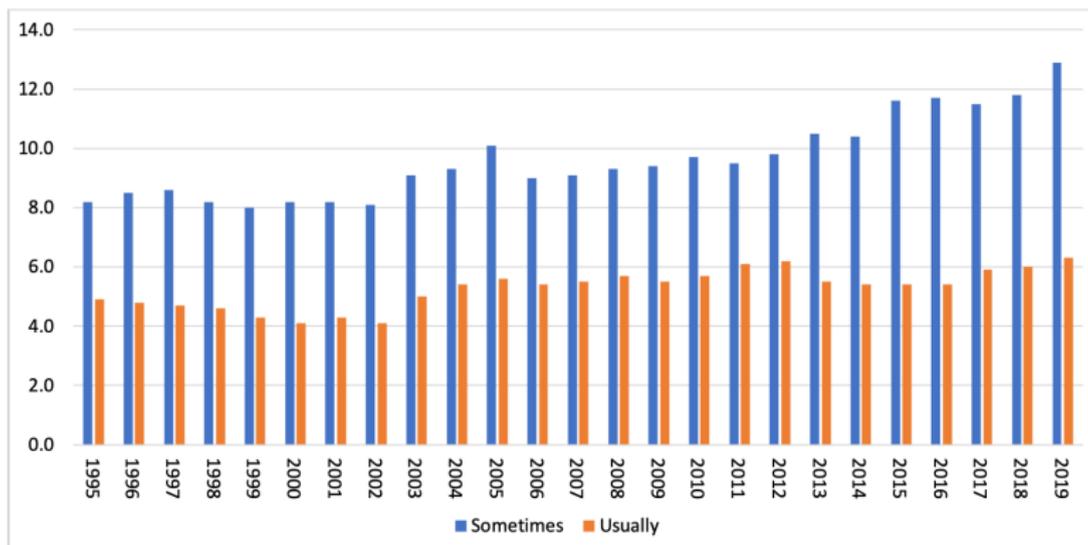
WFH is here to stay in the US



Source: Barrero, Bloom, and Davis (2021) Survey of *Households*

Revaluation of CRE Post-COVID

WFH *complement* to work at the office for most workers

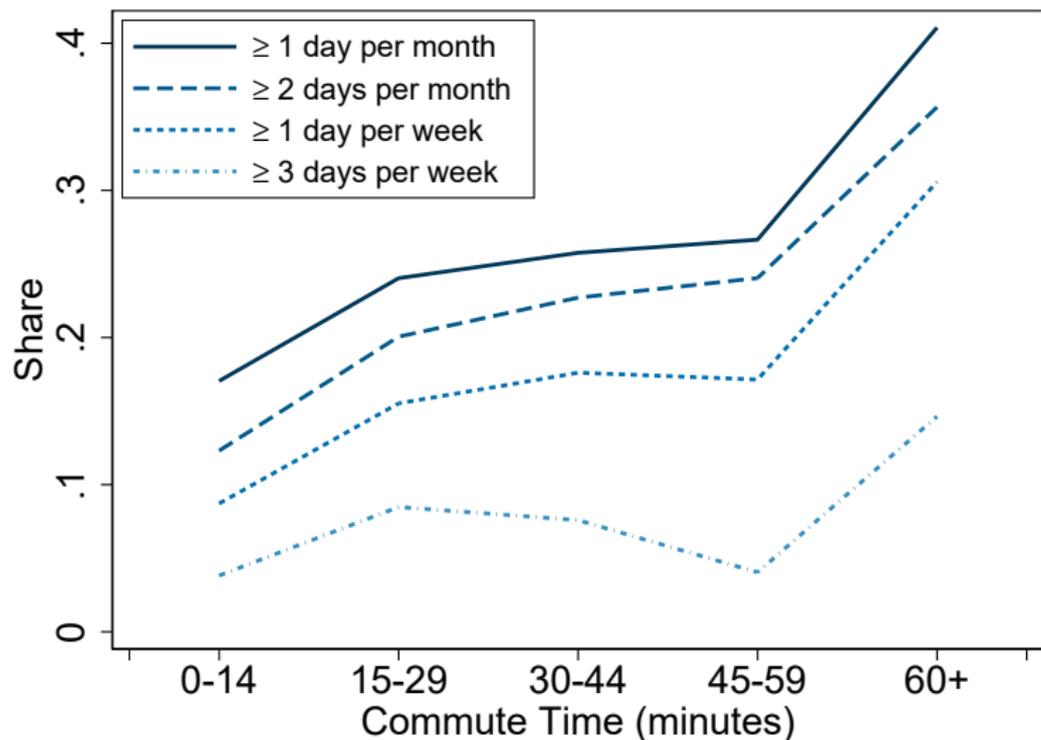


Source: Eurostat

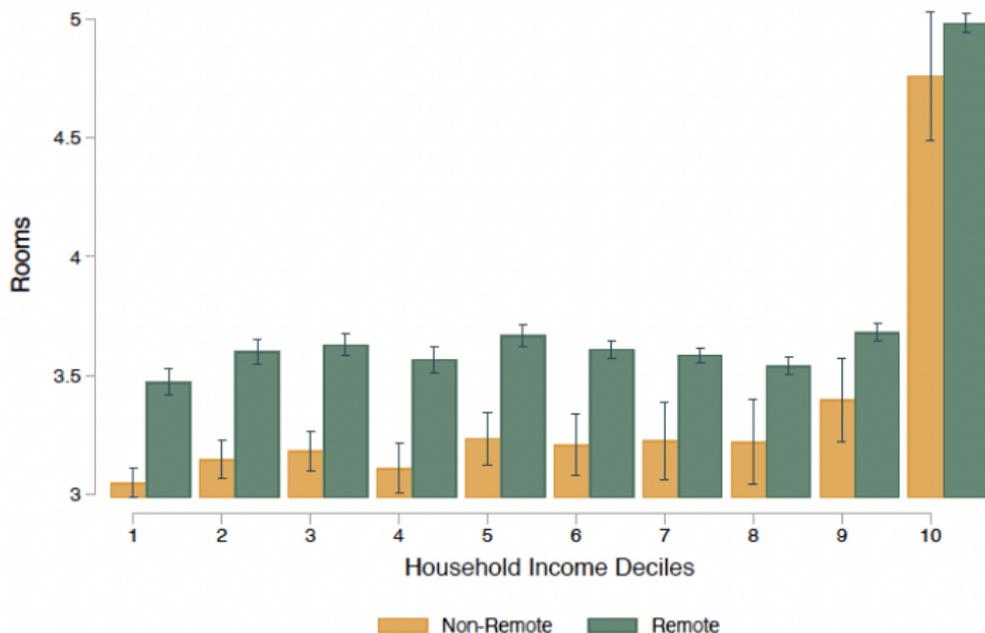
- ▶ More workers sometimes than usually WFH
- ▶ Growth in WFH driven by “sometimes”

Revaluation of CRE Post-COVID

WFH *complement* to work at the office for most workers



Revaluation of CRE Post-COVID: WFH Requires Space



Source: Stanton and Tiwari (2021)

Most of us aren't as productive at kitchen table as in home office

Implications of Increased WFH for Urban Form

- ▶ Complementarity between WFH and work at the office implies most reallocation will be *within* rather than *across* cities
 - ▶ Few people can fly from Boise to Chicago once a week
- ▶ Significantly less demand for office space in CBD
- ▶ More willingness by college-educated workers to live further from CBD since less weekly commute time
- ▶ Greater demand for residential space overall due to increased demand for home offices

Biggest need for conversion is office to residential

But perhaps least costly conversion is hotel to residential?

Relative Rents Post-COVID (Davis, Ghent, Gregory, 2021)

Calibrated model of effect of tripling of WFH relative to pre-COVID on rents

- ▶ Short-run (SR): Supply of space has yet to adjust
- ▶ Long-run (LR): Supply of space has fully adjusted to bring rents back down to pre-pandemic ratios
 - ▶ i.e., convert Manhattan and SF office towers to residential
- ▶ Long-run Putty-Clay: Stuck with NYC and SF office towers

	Pre-COVID	SR	LR	LR Putty-Clay
<i>Rents:</i>				
CBD Office	1.00	0.85	1.00	0.84
Inner Suburb Residential	0.35	0.38	0.35	0.35
Outer Suburb Residential	0.24	0.28	0.24	0.24

- ▶ CBD rents fall by 15% in SR and 17% in LR Putty-Clay
- ▶ Residential rents rise 9% in inner suburbs and 13% in outer suburbs in SR due to increased demand for home office space

Relative Rents Post-COVID (Davis, Ghent, Gregory, 2021)

	Pre-COVID	SR	LR	LR Putty-Clay
<i>Rents:</i>				
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- ▶ Can Loewenstein et al.'s analysis tell us whether LR or LR Putty-Clay scenario is more likely?
 - ▶ Likely somewhere in between depending on location, age, etc...

Revaluation of CRE Post-COVID

Other LR implications of COVID for CRE redeployment

1. Less demand for retail
2. More demand for industrial
3. Less demand for hotel(?)

Most useful conversions are likely retail to industrial and office to residential given locations

- ▶ Is this prohibitively costly?
- ▶ How often do we see these types of redeployments?

Suggestion: Property-Type to Property-Type Transitions

	Use 2011				
Use 2019	Office	Retail	Hotel	Industrial	Residential
Office					
Retail					
Hotel					
Industrial					
Residential					

Ideally, two tables like this:

1. Percent of each property type in existence in 2000
2. Percent change in value of each property type

Use 2019 rather than 2020 since 2020 contaminated by pandemic

Is there a Detroit Problem?

How much of certain property types is too costly to be redeployed but maintenance costs exceed revenue producing ability

- ▶ Optimal outcome is vacancy
- ▶ Seems unlikely given aggregate stats authors have provided but maybe they can drill down on this

Model

I like the idea of formally modeling obsolescence risk

- ▶ Captured by parameter δ

Model captures COVID shock as $\delta \rightarrow \delta^z$ which seems sensible

I didn't understand the intuition from the model for how debt prevents redeployment

- ▶ Is regulatory capital charge for foreclosures why properties with mortgages on them less likely to redeploy?
- ▶ Why? Is foreclosure necessary to redeploy? Are lenders less able to redeploy than equity owners?

Model Suggestions

I was unaware of all CRE lenders taking a capital charge when they foreclose.

- ▶ Is this true for regional banks, large banks, CMBS, GSEs, and insurers?

Section 5 of the paper has about one paragraph discussing a statement early in the pandemic about avoiding capital charges

Much more description of specific capital charge regulations pre-pandemic, over the course of the pandemic, and during the pandemic would be helpful

If this capital charge the main friction that prevents redeployment on properties that have a mortgage?

Model Suggestions

What is the motivation for the capital charge for foreclosures?

Institutional description of the regulatory environment regarding CRE foreclosures for each CRE lender type would be helpful

Presumably regulators see some benefit from the capital charge?

Would be nice to more formally incorporate positive agglomeration economy from redeployment if that tradeoff is what the model is trying to get at

Model vs. Economic Motivation

If the goal of the model is to show there's different incentives to avoid foreclosure for CRE loan and contrast that with social benefits, not clear a verbal description won't do just as well

Maybe some empirical evidence of different foreclosure incentives of different lender types would help illustrate that the capital charge is the main friction?

Writing

Writing of the paper is quite rough with lots of typos and fragments

- ▶ Does either Federal Reserve Bank offer proofreading services?

Very little reference to the long literature on agglomeration economies introduction and conclusion allude to

Model section does not seem well integrated with the rest of the paper

Conclusion

Redeployment potential is critical to understand how COVID will affect CRE valuations and urban form

Paper offers valuable evidence that this happens frequently in New England

Model is a good step towards understanding obsolescence but could be better integrated with the empirics