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Dechert Real Estate Leader Sees 2 Sides Of The Office Coin

By **Andrew McIntyre**

Law360 (April 11, 2023, 11:58 AM EDT) -- More than three years into the COVID-19 pandemic, lenders continue to exercise a certain degree of caution when it comes to providing financing and refinancing for office properties, one of Dechert LLP's real estate leaders told Law360 in a recent wide-ranging interview.

David Forti

David Forti, who's co-head of global finance and real estate at Dechert and this summer will become co-chair of the firm, said the newer office properties that offer a wide slate of amenities generally have high occupancy rates, while older buildings with fewer amenities remain a major question mark.

And with the additional juxtaposition of the continued question of how many employees will return to the brick-and-mortar office and at what frequency, lenders are particularly cautious when it comes to the older buildings, which already have lower occupancy rates.

Forti, who's based in Philadelphia, also said he's seeing strong construction activity in the life sciences and multifamily spaces in the City of Brotherly Love.

This interview has been edited for length and clarity.

I wanted to start with banking, if we could, and I wanted to get your take on SVB and Signature Bank and the [broader] impact that that might have on commercial real estate. What are your thoughts?

On the broader impact of these bank failures, I think you have to look at how important the smaller banks are to the commercial real estate market. Small and regional banks provide a tremendous amount of financing to commercial real estate. So the impact of these failures — and let's assume that there's no more, and it just stops here — hopefully won't be that significant; although, many of those smaller banks have lost deposits. People moved their funds out of those banks, so they'll have less to lend with. Presumably, they're going to be a little more conservative on their credit. So there probably is going to be an impact on commercial real estate, just as we would expect credit to be less available and maybe a little harder to get.

I want to stick with banking for a minute. I know you do a lot of work in the CMBS space as well, so I want to get your take on the CMBS market right now and rising interest rates. What impact that's having on CMBS in terms of refinancing of loans.

Today, there's no real clear direction on what spreads should be. So that makes it a little harder for CMBS lenders to price and close the loan when they're not quite sure what the bond market pricing is going to be when they package up and sell those bonds backed by those loans. I think the Fed's trying to provide some certainty by saying, "Look, we're stabilizing rates." And now of course everyone is looking at what's going to happen next in the banking sector. Obviously, there are worries that maybe we're going to head into a recession, but we would expect at some point spreads would stabilize. The benchmark rates would stabilize. So the CMBS lenders will feel more confident in closing loans, because they'll have a good idea of what the bondholders are going to demand in terms of yields. It's possible that if the regional banks start lending less, CMBS could become more attractive as an alternative for borrowers to get financing.

And how would the rates compare there? Can borrowers get a bit of a better rate if they do a 10-year CMBS loan?

So that varies. That's going to be dependent on spreads and what the commercial mortgage bond buyers are going to demand in terms of spread. Historically, CMBS was pretty efficient, meaning that it could price a loan competitively or better than a local bank, and potentially with higher proceeds.

I'm curious to hear what specifically you're seeing in the office, retail and hotel spaces regarding CMBS.

We have a big practice in originating large loans for CMBS, and we currently have deals moving forward in all three of those spaces: hotel, office and retail. Hotel is doing fairly well. People call it revenge travel, where there was a bunch of pent-up demand, but it seems that particularly the resort hotel industry is doing well. Business travel is increasing. We're seeing quite a bit of activity in the hotel space.

With respect to retail, particularly malls, we're doing mall transactions as well. For a while, retail was pretty disfavored, but over the last few years, a bunch of malls around the country closed, so what's left is generally a better stock and underwritable. And so those type of properties are able to get loans that will go into CMBS.

Office is and is not challenged right now. So certain types of office are doing quite well. If it's newer construction office with lots of amenities, they tend to have pretty low vacancy rates. Have good tenants that have signed up leases. There's also a portion of the office segment that's challenged: buildings that maybe don't have all the nicer amenities. There are some headwinds facing office, which includes the future work, how much hybrid work will last, will people come back to the office? How do people utilize their space? Are they trying to be more efficient so there'd be less need for office space? Obviously, interest rate increases have adversely affected office as well as other property types. Office and some other property types also have some headwinds around complying with local laws that have begun to develop regarding ESG. Often, those laws are going to require some capital be expended at these properties so that they can comply with various local standards that are being developed. That includes places like New York City, Boston and Seattle.

There's been a lot of talk about rising interest rates and potential for distress in certain sectors. If you think about that question of distress, which of these sectors [office, retail or hotel] comes to mind, in terms of the sector that could see the biggest challenges in doing refinancings due to rising rates?

Rising rates are going to affect all sectors just because the carried cost of the debt is higher. As rates go up, values can go down. There's less free cash flow. There are a variety of ways that rising rates have a negative impact across all property types. So ultimately, it's somewhat equal. So then the question is, "Well which property types themselves are going to do well going forward in this environment?" And we've seen quite a few that are doing well, including hotel as we mentioned before, data centers. There continues to be more demand for data centers, so that space is sought after and doing well. Multifamily continues to do well. Self storage, and then maybe some not-so-traditional uses. Things like movie studios and such. They've been building in a variety of places around the country.

I also wanted to ask you about Philadelphia. I know you're based there. Talk to me about

what's going on in the construction sector in Philly right now.

So I'm looking out my window right now, and I'm in university section of Philadelphia, near Penn and Drexel, and there are quite a few cranes that I can see. A lot of the buildings that are going up are for lab space, life science-type work, which, similar to other places around the country, near university centers you're often seeing an increased growth in science- and lab-related fields. Also multifamily. Throughout Philadelphia [and] within the city center, there's quite a bit of multifamily building that has been and continues to go on.

I also want to talk about firm leadership. I understand you're in the midst of a couple of transitions in leadership. Talk about that and how that came about and what your new role will be.

So I have been the co-head of our global finance and real estate practice. Starting on July 1, the firm elected me to be co-chair of the firm. So my primary responsibilities will change from running up the global finance and real estate practice group to assisting our partners with running the entire firm. I'm looking forward to it.

And how will that affect the scope of your real estate work?

I spend a lot of time on management-related duties now with respect to running the global finance and real estate group. So those hours, I'll be able to move to the firm management level and still intend to be able to maintain a practice.

The last one I have for you is to just look ahead over the next couple of months, and I'm curious to hear what are the things you're watching in the economy or in the commercial real estate space? What are the trends that you have your eye on?

It's hard to say what's going to happen in a couple of months. We'll be watching what happens with interest rates. We'll be watching what happens with inflation. We'll be watching what happens with the banking crisis. Longer term though, we're bullish. We think that clearly this current downturn's not going to last forever. Inflation will be tamed. Rates will normalize. People will get used to a slightly higher-rate environment than we had for the prior 15 years. And life will go on, and it should be good.

--Editing by Alyssa Miller.
