



Pretend and Extend: A Deep Dive into Commercial Real Estate Lending's Hidden Crisis.

CHAPTER 07:

THE RISE OF ZOMBIE ASSETS: HOW BUILDINGS THAT EXIST ON PAPER ARE ECONOMICALLY DEAD

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In downtown Pittsburgh, a 1970s-era office tower maintains a facade of normalcy that belies its economic reality. The building appears in loan servicing reports as “performing,” shows up in municipal tax assessments at pre-pandemic values, and continues receiving minimal maintenance to preserve basic operations. Yet with occupancy below 40%, deferred capital improvements exceeding \$15 million, and no viable path to attracting quality tenants, this property represents something new in commercial real estate: a zombie asset that exists on paper while remaining functionally dead in the market.

This building, and thousands like it across American cities, exemplifies the unintended consequence of extend-and-pretend practices that dominated commercial real estate lending from 2022 through 2024. While these practices successfully delayed immediate losses and maintained portfolio stability in the short term, they also created a growing inventory of stranded assets—properties that no longer support their debt service, attract meaningful tenant interest, or justify the capital investment necessary for competitive repositioning.

These zombie assets represent more than individual property challenges. They constitute anchors on neighborhood recovery, drains on municipal tax bases, and distortions in market comparables that affect broader valuation and investment decisions. The longer they persist in their current limbo, the greater their negative impact on surrounding properties, local

economic development, and the efficient allocation of capital within commercial real estate markets.

Defining the Zombie Asset

Zombie assets share common characteristics that distinguish them from temporarily distressed properties with viable recovery prospects. These buildings typically exhibit occupancy rates below 60%, with remaining tenants often concentrated in month-to-month arrangements or significantly below-market lease rates. The tenant base frequently consists of marginal businesses, short-term users, or legacy tenants unable to relocate despite declining building conditions.

Physical obsolescence represents another defining characteristic. Many zombie assets suffer from configurations that no longer meet contemporary tenant requirements—floor plates too small for modern office users, retail spaces designed for foot traffic patterns that have permanently shifted, or industrial buildings lacking the ceiling heights and loading capabilities required by current logistics operations. The capital required to address these deficiencies often exceeds any reasonable projection of future cash flows.

Deferred maintenance compounds these challenges. Zombie assets typically show evidence of systematic underinvestment in building systems, common areas, and tenant improvements. HVAC systems operate inefficiently or inconsistently, elevator service

becomes unreliable, and parking areas deteriorate. These conditions create a downward spiral where declining building quality drives away remaining viable tenants while the reduced income prevents investment in necessary improvements.

Financial indicators provide additional clarity. Zombie assets consistently show negative trends in net operating income, debt service coverage ratios below 1.0 for extended periods, and capital improvement needs that exceed reasonable return projections. These properties often require continuous owner subsidies for basic operations while generating insufficient income to service existing debt obligations. Why They Persist

The persistence of zombie assets reflects the convergence of multiple incentives that encourage avoidance rather than resolution. Lenders facing capital constraints from rising interest rates and securities portfolio losses find foreclosure proceedings expensive and time-consuming while potentially forcing immediate recognition of substantial losses. The extend-and-pretend approach allows these institutions to maintain loan classifications that avoid triggering additional reserve requirements or regulatory scrutiny.

Borrowers contribute to this dynamic through their own avoidance calculations. Property owners facing negative equity positions often lack economic incentives to invest additional capital in failing assets

while maintaining hope that market conditions might eventually improve sufficiently to restore viability. Walking away from properties typically triggers personal guaranty obligations and credit consequences that many owners prefer to defer indefinitely.

The regulatory environment inadvertently supports zombie asset persistence through capital rules that discourage loss realization. Banks can often minimize regulatory capital impact by extending troubled loans rather than foreclosing and recognizing losses immediately. This regulatory arbitrage allows institutions to spread potential losses over extended time periods while maintaining optimistic assumptions about eventual recovery.

Appraisal and inspection processes often lag behind market reality, providing institutional cover for maintaining optimistic valuations. Traditional comparable sales analysis may rely on transactions from more favorable market periods, while physical inspections focus on structural integrity rather than economic viability. This disconnect between professional valuation and market reality enables continued extension of credit facilities that no longer reflect underlying asset values.

Consequences of Inaction

Zombie assets impose significant costs that extend far beyond their immediate property boundaries. Neighborhood deterioration accelerates when prominent buildings exhibit obvious decline through reduced maintenance, increased vacancy, and declining tenant quality. This deterioration affects property values, business attraction, and resident satisfaction across broader geographic areas.

Municipal tax base erosion represents another substantial cost. While zombie assets may continue generating property tax revenue based on outdated assessments, their actual contribution to local economic activity declines substantially. Reduced

employment, decreased consumer spending, and lower property values in surrounding areas compound these negative fiscal impacts.

The presence of zombie assets discourages new investment in surrounding properties. Potential investors and tenants recognize the negative externalities associated with prominently failing buildings and adjust their willingness to commit capital accordingly. This creates geographic pockets of disinvestment that can persist for years while zombie assets remain unresolved.

Market distortion effects extend beyond immediate geographic areas. Zombie assets that remain classified as performing loans or maintain inflated appraisal values skew comparable property analysis and risk assessment frameworks. This distortion affects lending decisions, investment underwriting, and portfolio management across broader market areas.

Identification and Mapping

Systematic identification of zombie assets requires analysis of multiple data streams that reveal economic viability rather than mere technical performance. Occupancy trends provide the most immediate indicator, particularly when vacancy persists above 40% for extended periods despite market recovery in comparable properties. Net operating income trends offer additional insight, especially when properties show consistent year-over-year declines despite stable or improving market conditions.

Debt service coverage analysis reveals financial sustainability issues that may not be apparent from occupancy or income metrics alone. Properties consistently operating below 1.0 debt service coverage ratios while requiring owner subsidies for basic operations demonstrate clear viability challenges regardless of technical loan performance classifications.

Capital improvement assessments provide crucial insight into long-term viability prospects. Properties

requiring capital investments exceeding 40% of current appraised values to achieve competitive market positioning often lack viable paths to economic recovery under current ownership and financing structures.

The Federal Reserve Bank of New York's research on extend-and-pretend behavior provides additional framework for zombie asset identification. Properties with persistently negative net operating income growth, serial maturity extensions, and systematically low reassessed default probabilities despite observable performance deterioration often exhibit zombie asset characteristics.

Geographic clustering analysis can reveal broader patterns of zombie asset emergence. Areas with multiple struggling properties, declining commercial activity, and reduced municipal investment often harbor concentrations of economically nonviable assets that may not be apparent from individual property analysis.

Policy and Planning Implications

Municipal governments must develop systematic approaches to zombie asset identification and resolution before these properties become permanent anchors on local economic development. Inventory processes should combine property tax assessment data, building permit activity, occupancy surveys, and local business registration patterns to identify potentially stranded assets early in their decline cycle. Economic development strategies should incorporate zombie asset resolution as a priority component rather than focusing exclusively on new development attraction. The negative externalities imposed by failing properties often outweigh the positive impacts of new investment, making resolution of existing problems crucial for sustainable economic growth.

Asset managers must develop more sophisticated triage frameworks that distinguish between temporarily distressed properties with viable recovery

prospects and truly stranded assets requiring different resolution strategies. This analysis should incorporate realistic capital requirements, market positioning challenges, and long-term demand projections rather than relying on optimistic assumptions about market recovery.

The Path Forward

The rise of zombie assets represents a predictable consequence of extend-and-pretend practices that prioritized short-term stability over long-term market health. Resolution requires systematic recognition that some properties lack viable futures under current configurations and ownership structures, followed by proactive strategies to minimize broader negative impacts.

Four Corners Valuations provides crucial independent assessment capabilities for zombie asset identification and resolution planning. Our field-to-report integration offers unbiased evaluation of true market viability, helping stakeholders distinguish between properties worth saving and those requiring alternative resolution strategies. We combine physical condition assessment, market positioning analysis, and financial viability evaluation to provide clear guidance for difficult triage decisions.

The commercial real estate industry must evolve beyond the assumption that all properties can eventually be restored to viability through patience and market recovery. Some assets have become economically obsolete and require recognition as such. Early identification and appropriate resolution of zombie assets will ultimately prove less costly than allowing them to persist as anchors on broader market recovery and neighborhood revitalization efforts.



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