



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

CHAPTER 10:

OFFICE: THE POSTER CHILD OF PRETEND AND EXTEND

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In Manhattan's Financial District, a 30-story office tower built in 1985 sits 65% vacant, its remaining tenants clustered on lower floors while upper levels remain dark and unmarketable. The building's loan file contains an appraisal from 2022 showing stabilized value at \$180 million based on assumptions of 85% occupancy and \$55 per square foot rental rates—figures that bear no relationship to current market conditions where comparable buildings struggle to achieve \$35 per square foot with extensive concessions.

This property exemplifies the office sector's role as the most visible and persistent example of extend-and-pretend behavior in commercial real estate. Despite fundamental shifts in workplace patterns, plunging occupancy rates, and systematic obsolescence of older building stock, the office sector continues operating under financial assumptions that reflect pre-pandemic realities rather than post-pandemic economic truths.

The scale of valuation avoidance in the office sector has created a dangerous disconnect between market reality and institutional reporting that poses systemic risks to fund performance, capital market confidence, and the broader credibility of commercial real estate as an asset class. The time for denial has passed, yet institutional momentum continues supporting valuations that cannot withstand scrutiny against observable market conditions.

The Scale of Office Overhang

The magnitude of office market distress extends far

beyond isolated problem properties to encompass structural oversupply that affects entire metropolitan areas. Major cities report Class B and C office vacancy rates exceeding 30% in core submarkets, with some secondary locations experiencing effective vacancy above 50% when accounting for tenants seeking to sublease space or operating under significantly below-market arrangements.

The repricing of office assets in public markets provides stark contrast to the valuations maintained in private portfolios. Office REITs have lost approximately 40% of their market value since 2022, reflecting investor recognition of permanently reduced demand for traditional office space. Yet bank loans secured by comparable properties continue reflecting valuations that assume eventual recovery to pre-pandemic performance levels.

This disparity between public and private market recognition creates artificial stability that masks the true extent of office sector distress. Federal Reserve research indicates that 16% of bank commercial real estate portfolios consist of loans approaching maturity, with office properties representing a disproportionate share of this exposure. The concentration of office-related debt in near-term maturity periods amplifies the potential for synchronized losses when extend-and-pretend strategies become unsustainable.

Geographic analysis reveals particular concentrations of office market stress in secondary metropolitan

areas where economic diversification limited and remote work adoption rates proved higher than anticipated. Cities that experienced significant office construction during the 2010s boom now face fundamental oversupply that cannot be absorbed through normal market cycles, particularly for properties lacking the amenities and configurations demanded by contemporary tenants.

The structural nature of office demand reduction distinguishes current conditions from previous cyclical downturns. Survey data consistently shows that hybrid work arrangements have stabilized at levels requiring 20-30% less office space per employee than pre-pandemic patterns. This permanent reduction in space demand occurs simultaneously with a flight-to-quality trend that concentrates remaining demand in newer, amenity-rich properties while leaving older buildings with limited competitive positioning.

Valuation Avoidance Tactics

The office sector has developed sophisticated mechanisms for avoiding valuation recognition that maintain artificial stability while deferring inevitable adjustments. Serial maturity extensions represent the most common approach, allowing borrowers to avoid reappraisal requirements that would reflect current market conditions. These extensions often include minimal modifications to loan terms while maintaining original principal balances based on outdated assumptions about property performance.

Discounted cash flow models used in office valuations frequently incorporate lease-up assumptions that conflict with observable market data. Properties showing persistent vacancy for multiple years continue receiving valuations based on projections of stabilized occupancy that comparable buildings have been unable to achieve. Rental rate assumptions often reflect asking rents rather than effective rents after concessions, creating additional artificial value support.

Appraisal practices in the office sector often rely on comparable sales from more favorable market periods or properties with superior characteristics that do not reflect the subject property's actual competitive position. The limited volume of office transactions in many markets enables selective use of comparables that support optimistic valuations while avoiding recent sales that might establish lower value benchmarks.

Income approach valuations frequently apply capitalization rates that fail to reflect increased risk premiums associated with office sector uncertainty. Properties with obvious tenant retention challenges, lease rollover risks, and capital improvement requirements continue receiving valuations based on cap rates appropriate for stabilized assets in normal market conditions.

Functional Obsolescence

The persistence of obsolete office buildings in portfolios reflects institutional reluctance to acknowledge that many properties no longer serve viable economic functions in their current configurations. Buildings constructed during the 1970s and 1980s often feature floor plates, ceiling heights, and mechanical systems that cannot accommodate contemporary tenant requirements without substantial capital investment.

Layout configurations designed for traditional office hierarchies prove incompatible with collaborative work styles and flexible space arrangements preferred

by modern tenants. Many older buildings lack the common areas, amenity spaces, and technology infrastructure expected in competitive office markets. The cost of retrofitting these properties often exceeds reasonable projections of future cash flow generation under current market conditions.

Location factors compound obsolescence challenges for many office properties. Buildings in suburban office parks designed around commuting patterns that have permanently shifted face particular challenges attracting tenants who prioritize transit accessibility and urban amenities. Properties in secondary locations within metropolitan areas struggle to compete with prime downtown locations that offer superior access and building quality.

The regulatory environment often complicates adaptive reuse strategies that might provide alternative value creation paths. Zoning restrictions, building code requirements, and permit processes designed for different market conditions can make conversion projects economically unfeasible under current ownership and financing structures.

Impact on Funds and Public Markets

The persistence of outdated office valuations creates systematic distortions in institutional portfolio reporting that affects investor confidence and capital allocation decisions. Open-end funds utilizing quarterly appraisals may be overstating net asset values by relying on lagging valuations that do not reflect current market conditions, creating artificial stability that masks underlying performance deterioration.

Real Estate Investment Trusts face particular pressure from the disconnect between public market pricing and private market valuations held by comparable assets. When publicly traded office REITs trade at significant discounts to reported net asset values, investor confidence in the entire sector suffers as market participants question the reliability of private market valuation methodologies.

Pension funds and institutional investors with significant office allocations confront the challenge of explaining performance that may not reflect underlying asset value changes. The delay in recognizing office sector repricing creates timing mismatches between reported returns and economic reality that complicate asset allocation decisions and beneficiary communications.

The credibility of commercial real estate as an institutional asset class depends on maintaining reasonable alignment between reported valuations and market-based pricing. Extended periods of valuation disconnect undermine investor confidence and may lead to reduced capital commitments across the entire commercial real estate sector.

Conversion Requires Clarity

The transformation of obsolete office buildings into productive economic uses depends fundamentally on realistic valuation that enables appropriate capital deployment. Until current market values are acknowledged, developers cannot underwrite conversion projects with confidence in their acquisition costs and financing structures.

Successful office-to-residential conversions require acquisition pricing that reflects the costs and risks associated with adaptive reuse rather than optimistic assumptions about continued office viability. Cities seeking to encourage conversion must work with realistic baseline valuations to structure appropriate incentive programs and regulatory frameworks.

The capital formation necessary for large-scale office repositioning depends on institutional recognition of current market conditions rather than continued hope for sector recovery. Investment funds focused on value-add or opportunistic strategies require transparency about underlying asset values to deploy capital effectively.

The Path Forward

The office sector must confront the reality that many properties no longer serve viable economic functions in their current configurations. Continued avoidance of this recognition delays necessary capital reallocation while imposing costs on investors, communities, and the broader commercial real estate sector.

Four Corners Valuations provides market-based assessment that reflects current economic realities rather than institutional wishful thinking. Our field-integrated approach delivers transparency about which office assets retain conversion potential and which represent permanent value impairment requiring write-down recognition.

The office sector's recovery depends on honest assessment of current conditions rather than continued pretense that pre-pandemic patterns will return. Institutions that acknowledge reality first will be positioned to capitalize on opportunities for productive asset repositioning, while those that continue avoiding recognition will find themselves holding increasingly obsolete assets in a permanently changed market.



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