



Upcoming Office Mods to Juggle Diverse Space Demand, Termination Options, and Re-developments

A potential upcoming modification of the \$235 million 285 Madison Avenue loan (NCMS 2018-285M) could chart the path for a flurry of office loan mods we expect in the coming months. The 285 Mad loan matures in a couple weeks, on November 11 (Figure 1). It has been transferred for a second time to special servicing last month, according to fresh servicer commentary. The loan first transferred to the special back in May following the borrower's request for maturity extension. It returned to the master shortly thereafter. The second transfer and the new commentary reiterate the borrower's mod request.

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Figure 1. 285 Madison Avenue Loan and Property Parameters

285 Madison Avenue				
Balance	\$235,000,000			
Deal and Exposure	NCMS 2018-285M			
Loan Type	Fixed-rate, interest only			
Maturity	November 2022			
Coupon	3.85%			
Loan Status	Special servicing			
Property Type / Size	Office / 511,208 sf			
Year Built / Renovated	1926 / 2017			
Location	New York, NY			
Financials	<u>1H 2022 (Annualized)</u>	<u>Securitization (UW)</u>		
Net Operating Income	\$21,793,596	\$22,985,974		
DSCR	0.95 x	1.00 x		
Occupancy	95.5% (as of 1/1/2022)	85.7%		
Debt Yield	8.04%	8.48%		
Top Tenants	<u>Tenant Name</u>	<u>GLA (% total)</u>	<u>Expiration</u>	<u>Tenant Business</u>
	PVH Corp	219,800 sf (43%)	Oct-2033	Clothing
	General Electric Co	44,297 sf (9%)	Aug-2032	Conglomerate
	Finastra Technology	34,767 sf (7%)	Jun-2028	Software
	Ziff Capital Partners	26,211 sf (5%)	May-2026	Venture capital
	NetApp Inc	18,242 sf (4%)	Mar-2027	Technology hardware

Source: MCIA and Academy Securities

285 Madison is backed by an old (but renovated) 27-story, 511.2K sf office building in Midtown Manhattan. The situation appears to at once capture several key aspects in assessing office loan performance, as the sector reckons with softening demand and changing tenant preferences:

- **Diverse tenancy can blur demand projections.** Many office tenants are re-assessing their space needs amid shifts to remote or hybrid work arrangements.

Office Modifications: 285 Madison Could Offer a Blueprint for More to Come

The projections for the broader drop in office demand vary quite a bit, and may reflect the exploratory phase many firms are going through. For example, a majority of organizations (53%) will make remote working permanently available to all employees by 2025, according to JLL's recent The Future of Work survey. But an even greater share (72%) believes that in the long term the office will remain central to their organization's ecosystems. Office demand could further diverge across different tenants and industries, depending on post-pandemic adopted office models. Some industries are strongly pushing towards "office-first" approach, notably financial-services firms. Others are more inclined to embrace "remote-first" approach, mostly technology firms. This could make especially tricky projecting demand for buildings that feature a diverse mix of industries. The top tenant at 285 Madison (PVH Corp., a clothing company) is clearly adopting a hybrid approach, based on the firm's job postings and public statements. Among the building other top tenants are a financial services software provider, a technology company, and a venture capital/investment firm. Each of those could have very different space needs in 285 Mad going forward.

- **Early termination options cloud lease rollovers.** 285 Mad in-place leases feature a nuanced structure of early termination options. This could substantially move up the building's rollover schedule, that on the surface appears back-ended (76.8% of the UW base rent expires after 2026, according to deal documents). The leases of PVH, General Electric, and Misys, 285 Mad's top tenants, expire in October 2033, August 2032, and June 2028, respectively. PVH has a termination option on a small portion of its space, effective March 2028. GE and Misys have much more consequential options, allowing the tenants to terminate most or all their spaces five years before their lease expirations. Termination fees would offset the risk to some extent. But clearly tenants are increasingly taking advantage of contractual termination options, as notable examples such as United Airlines in Willis Tower in Chicago showed.
- **Will office mods include re-developments?** Office tenants are showing preference for new office buildings, that feature ample amenities. This is forcing many older properties to undergo significant updating/re-development to remain competitive. The trend echoes the pressure put on landlords of old/dated malls to re-purpose or re-develop their properties. Some mall loan mods included re-development provisions, requiring the borrower to achieve certain milestones to execute extension options or benefit from other concessions. The Jefferson Mall mod (\$56.5 million, JPMCC 2012-CBX) is one example, where the servicer allowed the borrower to divert excess cash for the redevelopment of an vacant Sears box. Upcoming mods of loans backed by old office properties may adopt a similar approach. 285 Mad was built in 1926. The building went through a \$75.8 million renovation in 2014-2017. It is not clear if such renovation could keep 285 Mad competitive amid new supply in Hudson Yards, Manhattan West, or deeper re-imaginings of older

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properties such as One Madison or 425 Park Avenue. We will look to see if the servicer requires any additional capital expenditures as part of a loan modification, aside from standard leasing reserves (Figure 2).

Figure 2. 285 Madison Avenue, as of October 26, 2022



Source: Academy Securities

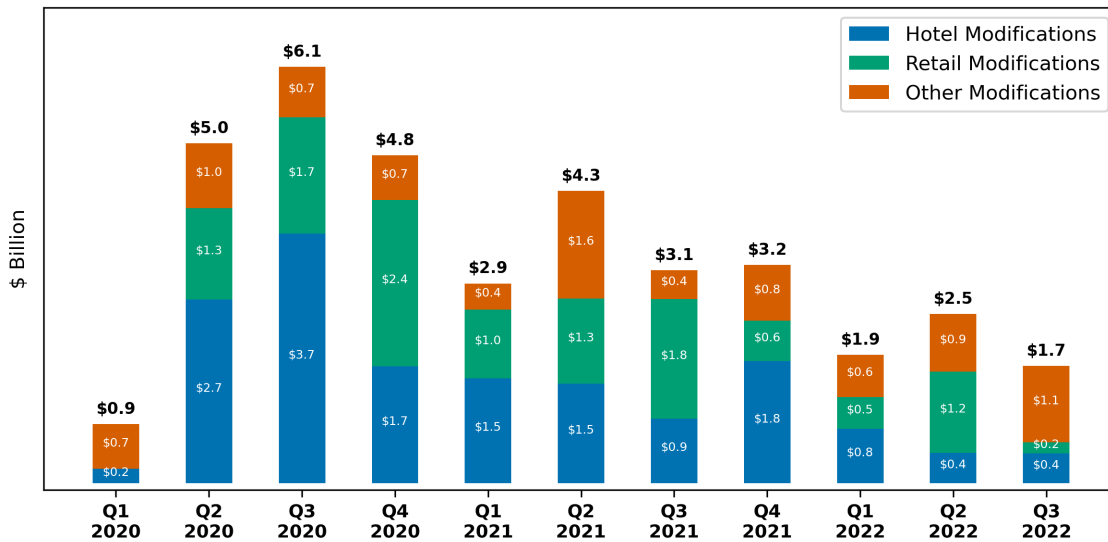
- Will mezzanine lenders intervene?** The presence of subordinate mortgage notes and mezz positions has impacted the workouts of troubled properties in the past. This was evident in the Hudson & Delano Portfolio (\$218.6 million original balance, CSMC 2017-HD). A junior mezz position exercised its purchase option and fully paid the CMBS debt back in 2020. We expect to see similar dynamics in upcoming large office workouts. In addition to the \$235 million senior mortgage in the 285M deal, the property also has a \$35 million B-note, a \$120 million senior mezz position, and \$85 million junior position. A mortgage default may trigger the mezz position cure and purchase rights. As the special negotiates a modification with the borrower, the mezz lenders may need to be at the table as well. In some cases, loan modifications brought in mezz lenders to replace defaulting borrowers, sometimes incorporating fresh equity injections. The presence of a motivated mezz lender also could potentially put some pressure on the borrower if it still has an economic stake in the property it wants to keep.

Retail and Hotel Dominate Recent Mods

Complex office modifications would have very limited recent precedents to rely upon. Hotel and retail properties dominated the mods servicers executed over the past couple of years. This is hardly surprising as these two sectors bore the brunt of the pandemic headwinds up until now. Hotel and retail mods represent 43% and 33% of the total mods since the pandemic onset (Figure 3). Office mods account for a meager 9%.

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Figure 3. CMBS Modifications by Property Type, 2020-2022



Source: MCIA and Academy Securities

To be sure, we expect upcoming office mods to potentially include key provisions of previous non-office mods, such as extensions, amortizing-to-interest only switches, split A/B structures and so on. Special servicers working on office situations will not need to reinvent the wheel. But the aspects we discussed above demonstrate office buildings present different dynamics than retail or hotel properties. Loan mods may consider some of those dynamics. Trends in the office markets should also impact decision-making as servicers debate among various workout approaches. Similar to other property types, servicers may be more inclined to negotiate modifications with motivated borrowers that show commitment to their [properties](#).¹ Unlike retail situations, servicers may not necessarily see the urgency of keeping existing landlords in place given a competitive landscape for sophisticated office landlords.

Pandemic Relief Agreements Offer Limited Guidance for Troubled Office

The few office modification templates servicers released during the pandemic relate mostly to forbearance agreements, rather than complex modifications. For example, in 50 Varick Street (\$77.9 million, UBSCM 2017-C4 and C5, and CGCMT 2017-C4) the mod template from May 2020 notes the predicament of the event space industry. The tenants in the 158K sf office property in Downtown Manhattan offer event services, collaborative workspace, and social club. The agreement allowed the borrower to use the security deposit reserve for 90 days to keep the loan current. In 525 Park Avenue (\$18 million, COMM 2015-CR23) the servicer noted that the tenant at the Upper East Side property is a radiation imaging company that was not able to open during the early parts of the pandemic. The August 2020 agreement allowed the borrower to divert existing cash reserves to fund debt payments, and to defer the funding of various reserve accounts.

¹ See "Mall Foreclosures: What to Track as Servicers May Shift Away from Modifications," CMBS Credit Focus, Academy Securities, March 1, 2022

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The \$25.6 million 677 Broadway (WFRBS 2014-C23) is perhaps one of the few office loans that saw a more substantive modification in the past couple of years. The loan, backed by a 12-story, 177K sf office building with mostly law firm tenants in Albany, NY, moved to special servicing in June 2020 amid lease expirations and rising property taxes. Interestingly, the mezz lender foreclosed in October 2020, and negotiated the March 2021 modification agreement. The servicer extended the loan maturity by one year, and allowed a two-year accrual of monthly interest. The borrower provided a significant new equity contribution towards leasing costs, according to servicer commentary.

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