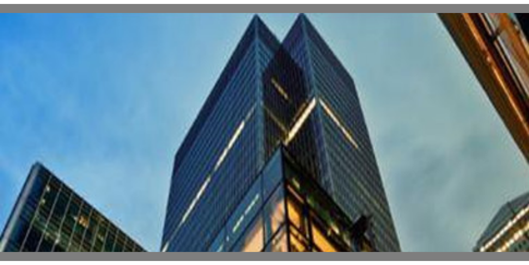
CMBS Credit Focus

The Road to Conversion: Consider Ground Leases and ARD Loans in Office Analysis



625 Madison Avenue Underscores Nuances of Office Exposures

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The situation at the $194.7 million 625 Madison Avenue (COMM 2014-CR14 and CR15) underscores several pertinent structural CMBS nuances as the market intensely focuses on the fate of office buildings, especially older ones, and in markets such as Midtown Manhattan. The future path of the 563K sf property is unclear (Figure 1). It has "large vacancy" (81.9% as of Q3 2022), and the building design is "obsolete", according to SL Green, the building's landlord. Most tenants are in the fashion and retail industries, which may be prone to remote work arrangements and office footprint reductions.[1] SL Green identified the property as a potential candidate for office-to-resi conversion.[2] All told, 625 Madison could easily land on lists of office properties "at risk", as investors surveil exposures.

Figure 1. 625 Madison Avenue Loan and Property Parameters

625 Madison Avenue	
Balance	$194,511,151
Deal	COMM 2014-CR14, COMM 2014-CR15
Loan Type	Fixed-rate, interest only
Maturity	December 2026 (with a December 2018 anticipated repayment date ("ARD"))
Coupon	2.30% until ARD, 5.30% through December 2022, and thereafter set to the greater of (i) 6.05% and (ii) the five-year swap spread plus 3.75%, based the ARD reset provision.
Loan Status	Current
Property Type / Size	Land (leased fee) improved with 563K sf office
Location	New York, NY
Additional Debt	The leased fee also serves as collateral for a $195.0 million mezzanine loan

Source: MCIA and Academy Securities

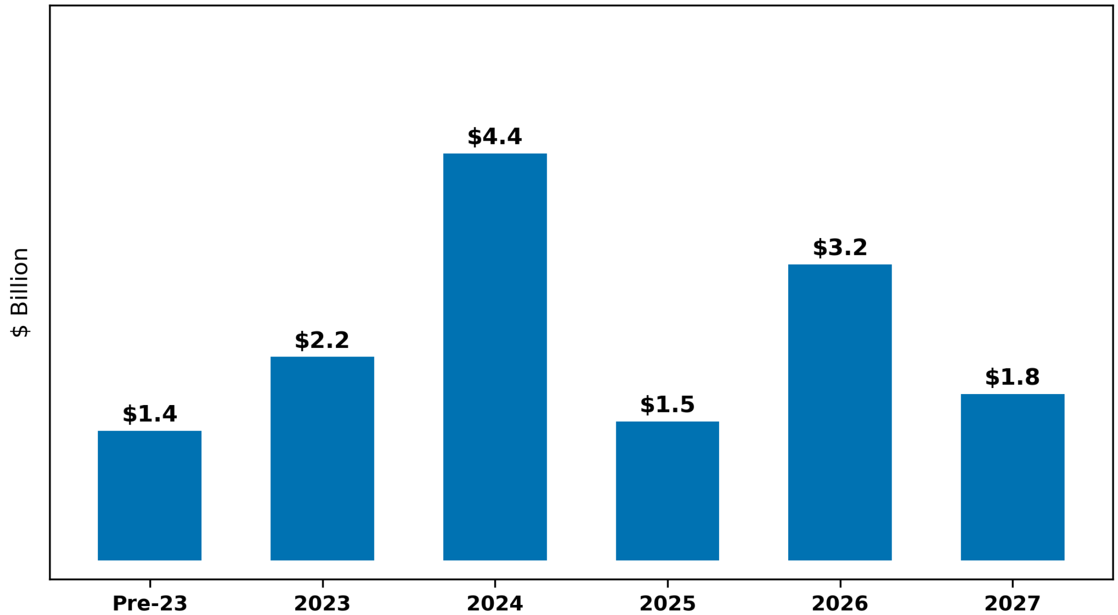
The actual cashflow risk of 625 Madison to the exposed CMBS deals, however, is likely limited, as CR14 and CR15 investors probably appreciate. The collateral of the two deals is the leased fee on the property – the ground rent that SL Green pays to the CMBS loan's sponsor. Leased fee loans, even on struggling office buildings, are less likely to default. Leaseholders (owners of

1 "Office Modifications: 285 Madison Could Offer a Blueprint for More to Come," CMBS Credit Focus, Academy Securities, October 27, 2022
2 "Credit 2023: Advancing and Workout Approaches to Play a Central Role," CMBS Credit Focus, Academy Securities, December 15, 2022

the "improvements", or the building) should be very reluctant to risk losing their building, which could revert to the landowner following ground rent defaults.

Separately, 625 Madison, like many other leased fee loans, was structured as an Anticipated Repayment Date (ARD) loan. Such loans do not default even if they do not pay off at the repayment date. Instead, there is usually a steep interest rate step up. The ARD may also trigger a cashflow sweep to capture all of the property's cash flows into a lender-controlled lockbox to amortize principal. As such, ARDs create an almost built-in modification mechanism, which may provide loan sponsors some buffer (albeit potentially expensive one) to work through property issues (Figure 2).

Figure 2. Conduit ARD Schedule, 2023-2027



Source: MCIA and Academy Securities

625 Madison had its ARD back in December 2018. The loan's interest rate increased to 5.3% from 2.3%. It is set to increase again this month to the greater of (i) 6.05% and (ii) the five-year swap spread plus 3.75%, based the ARD reset provision. The loan's final maturity date is in December 2026.

Landowner/Leaseholder Conflicts Can Muddy Conversions

The prospects of re-developments or conversions may also depend on the interplay between landowners and leasehold owners. Several notable CMBS properties have such bifurcated ownership (Figure 3). Examples include 20 Times Square ($750 million, TSQ 2018-20TS and four 2018-vintage conduit deals) and 530 Seventh Avenue Fee ($55 million, BANK 2021-BN32). Interestingly, some real estate investors have also been focused in recent years on ground lease strategies, looking to separate the land and building ownership. Examples include 195 Broadway (formerly in MSC 2005-IQ10) and 135 West 50th Street. Such ground lease transactions may have increased the number of properties where both the landowner and the leaseholder could have re-development or conversion plans, that may not necessarily be aligned.

Figure 3. CMBS Leased Fee Loans

Loan	Deal	Balance ($MM)	Status	Location	Leased Fee Improvement Type
20 Times Square	TSQ 2018-20TS;UBSCM 2018-C11; UBSCM 2018-C12;CSAIL 2018-C14; CSAIL 2018-CX12	750.0	Current / Special Serviced	New York, NY	Hotel / Retail
Milford Plaza Fee	MSBAM 2013-C10;MSBAM 2013-C9	275.0	90+ DQ	New York, NY	Hotel
625 Madison Avenue	COMM 2014-CR14;COMM 2014-CR15	194.5	Current	New York, NY	Office
100 West 57th Street	COMM 2015-CR22;COMM 2015-DC1; WFCM 2015-NXS1;WFCM 2015-NXS2	180.0	Current	New York, NY	Residential /Retail
32 Old Slip Fee	MSBAM 2015-C23;MSBAM 2015-C24; MSC 2015-MS1	176.0	Current	New York, NY	Office
300 South Riverside Plaza	MSBAM 2015-C22;MSC 2015-MS1	167.0	Current	Chicago, IL	Office
530 Seventh Ave	BANK 2021-BN32	55.0	Current	New York, NY	Office

Source: MCIA and Academy Securities

625 Madison clearly shows this potential landowner/leaseholder conflict of interest. The landowner alluded at the time to the construction of an entirely new luxury condo building on the land, according to press reports. For its part, SL Green mentioned there is a variety of possible strategies for the future of the property. In any event, the parties are in the midst of an arbitration over the June 2022 reset date of the ground rent. The annual $4.6 million rent was set to adjust to 4.5% of the fair market value of the land, based on an updated appraisal. A 2013 appraisal of $460 million would reset the annual rent to $20.7 million. The landowner intimated reset to $80 million, according to press reports.

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