CMBS Credit Focus

Reserves vs Advances: Servicers Tap Reserves to Lower Advances

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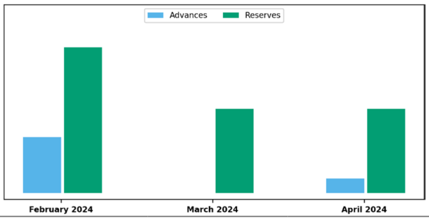
Wells Fargo Center Shows Tradeoff between Healthy Reserves and Elevated Advances

The recent servicer decision in Wells Fargo Center ($277.1 million, MSC 2019-NUGS) to release >$12 million of the loan's reserves to pay down advances underscores a tension between two workout objectives: (1) maintain healthy reserve levels, that could prove critical for troubled properties, especially office buildings in lease-up situations; and (2) prevent accumulation of advances, and excessive interest on advances, that could significantly depress bondholder liquidation payoffs down the road. In NUGS, the servicer used the loan's reserves last month to reimburse itself for ~$8.9 million of outstanding T&I advances, accrued unpaid advance interest, and other advance expenses. The advance reimbursement depleted one of the loan's largest reserve accounts, that plummeted to $1.9 million from nearly $14 million pre-disbursement, as deal reporting showed (Figure 1).

Figure 1. Wells Fargo Center Loan and Property Parameters

Asset	Wells Fargo Center
Deal	MSC 2019-NUGS
Loan Balance ($MM)	$277.1 ($232 psf)
Maturity	December 2022
Coupon / Amortization	TSFR1M + 1.58% floating / Interest-only
Loan Status	Matured Non-Perf & Specially Serviced
Property Type	Office
Property Size / Occupancy	1,195,149 sq. ft. / 85% occ. (Dec 2022)
Amenities	12-story 996-space parking garage
Location	Denver, CO
Borrower Sponsor	Beacon Capital Partners
Largest Tenant	Wells Fargo (20.5%)
Second Largest Tenant	WeWork (10%)
Other	The WeWork lease at this location was not among those identified for "rejection" in their Chapter 11 reorganization. A receiver was put into place at this property in late 2023.

	February 2024	March 2024	April 2024
P&I Advances	$0	$0	$1,258,428
T&I Advances	$8,180,829	$0	$0
Other Advances	$697,461	$0	$1,085,360
Total Advances	**$8,878,290**	**$0**	**$2,343,788**
Tenant Reserves	$9,679,576	$9,680,114	$9,680,652
Capex Reserves	$334,169	$374,027	$374,047
Leasing Reserves	$1,643,330	$1,372,268	$1,372,268
Other Reserves	$11,538,094	$1,950,873	$1,950,873
Total Reserves	**$23,195,169**	**$13,377,282**	**$13,377,841**



P&I Advances: Total principal and interest advances outstanding; T&I Advances: Total taxes and insurance advances outstanding

Source: Deal Documents, Morningstar Credit, and Academy Securities

It may not be clear to investors if a significant advance reimbursement decision such as the one on Wells Fargo Center telegraphs a change in workout strategy, or perhaps an updated servicer assessment of the property's cashflows and liquidation value. To be sure, servicers have previously used property excess cashflows to chip away at outstanding advances ahead of loan liquidations.[1] In the same vein, deal mechanisms such as ARA/ASER, and the more-dramatic non-recoverability determinations, also aim at limiting advances from spiraling out of control.[2]

So far servicers have not appeared to be widely using loan reserves to pay down advances, at least based on anecdotal observations. Tracking reserve account changes is not straightforward, as we discussed in a previous report.[3] If servicers now regularly use reserves to reimburse advances, it would add another wrinkle to investor surveillance of deal cashflows.

Short-term Liquidity Access or Long-term Liquidation Proceeds

The reserves vs. advances servicer decision also has relative value implications. Servicers are essentially sacrificing the ability of a borrower (or a receiver in the case of Wells Fargo Center) to access funds during workout. If the reserve funds are critically needed for a successful workout, the advance reimbursement may jeopardize the workout. On the flip side, if servicer advances and interest do significantly accumulate over a long workout period, bondholders may experience extreme losses at liquidation.[4] This could happen even if the workout efforts end up bolstering the property's valuation.

Tracking Accrued Advance Interest

The NUGS servicer explicitly noted it released the reserve funds to pay down advances and avoid accruing "excessive interest" on advances. The servicer also mentioned there has not been a change in the workout strategy on the 52-story office building in Denver, CO. The loan transferred to special servicing in December 2022 because of maturity default. The borrower reportedly chose not to exercise a second one-year extension option.

Elevated interest rates can play a part in servicers' decision-making on advance reimbursement timing. Servicer advances accumulate interest at the prime rate, currently 8.5%. The cumulative accrued unpaid advance interest on Well Fargo Center loan reached $569.6K just before the advance reimbursement last month. This represented a minor 0.2% of the loan's outstanding balance. Quite a few other loans have much more significant accrued advance interest relative to their outstanding balance (Figure 2). Examples include Sheraton Suites Houston ($33.6 million, GSMS 2014-GC20, $2.8 million accumulated advance interest, 8.2% of the outstanding balance) and 401 South State Street ($42.4 million, CGCMT 2016-P4, 6.9%, pari passu in CD 2016-CD1). Investors can track accumulated advance interest via IRP field L103.

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1 "Excess Cash Allocations: Probing Advances on Positive Cashflowing Loans," CMBS Credit Focus, Academy Securities, May 2, 2023
2 "Blanket NRAs: Shutting Down Advances Upends Credit IO Trades," CMBS Credit Focus, Academy Securities, January 3, 2024
3 "Hotel Reserves: Key Performance Driver after Pandemic-Driven Depletion," CMBS Credit Focus, Academy Securities, April 19, 2022
4 "Crossgates Liquidation: Holdbacks Complicate Severity Projections," CMBS Credit Focus, Academy Securities, September 11, 2023

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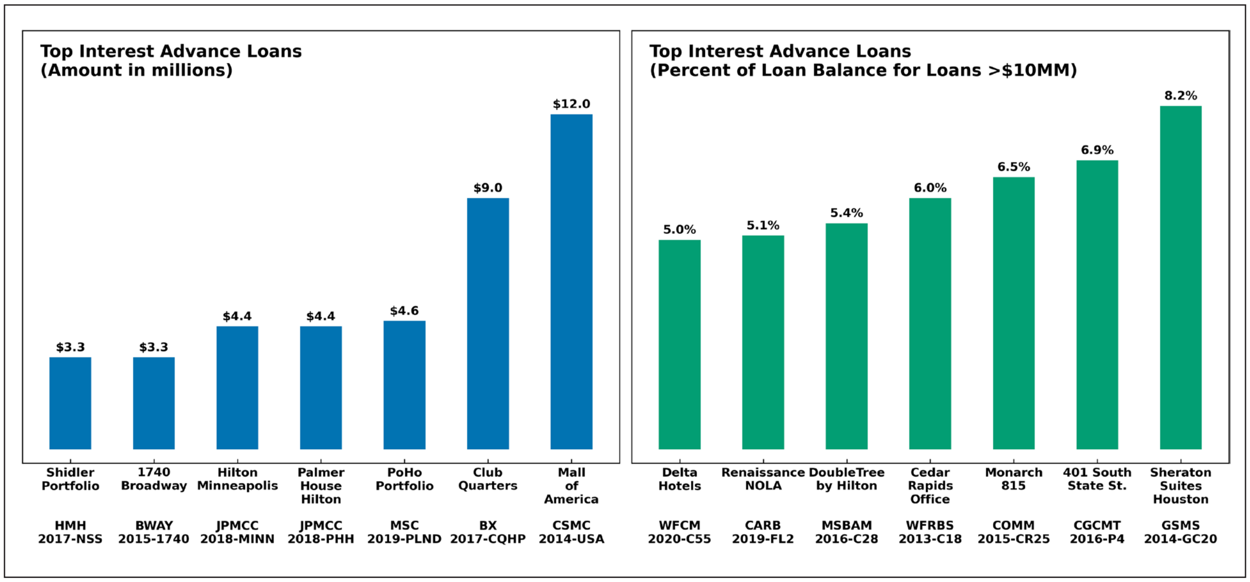
Figure 2. Cumulative Accrued Advance Interest



Source: Morningstar Credit and Academy Securities

Loans with high advance interest underscore yet again the focus on "total exposure" balances. There could be wide differences between total exposures and the outstanding balance on delinquent or specially serviced loans. The total exposure (outstanding balance + cum ASER + advances, or IRP codes L35, L37, L39, L38 and L103) is the parameter we view as most relevant for loan loss projections.[5] Interestingly, in NUGS it appears the servicer continues advancing, right after reimbursing itself of all the outstanding advances last month. The servicer just advanced $1.26 million P&I advances, based on the new remittance report released this week. Recall the reimbursements last month were on T&I advances, adding another angle to the situation.

5 "Credit 2023: Advancing and Workout Approaches to Play a Central Role," CMBS Credit Focus, Academy Securities, December 15, 2022

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