



**Themes for 2023 Credit Situations - Split A/Bs, Conversions, and Total Exposures**

**Servicer actions should have a significant impact on the path maturing or troubled loans take in 2023, and the implications for bond cashflows.**

Special servicer workout decisions on maturing loans that do not refi could potentially ferry borrowers into a more favorable interest rate environment down the road. Complex modifications with redevelopment or conversion components may help property owners address secular headwinds in some property segments, especially office. In turn, master servicer advancing, and curtailment thereof, would be a critical driver of projected loan recoveries and interest shortfalls on subordinate bonds.

**The credit dynamics we expect in the coming year should bring a whiff of déjà vu.** The focus on servicer decision-making echoes the landscape of early 2020, as CMBS servicers debated how to handle a sudden rise of pandemic-driven troubled situations. Servicer advancing emerged as a key factor insulating bonds from the delinquencies spike, especially across retail and hotel loans. The widespread adoption of forbearance agreements, including the reallocation of reserves to debt payments, allowed borrowers to deal with the temporary cashflow shocks, preventing costly foreclosures and elevated losses. In many cases the master servicers could approve such forbearances, without loans transferring to special servicing.

**But the similarities of the fork in the road servicers and borrowers face in 2023 to the one at the onset of the pandemic go only so far.** For example, forbearance agreements are unlikely to adequately deal with potential obsolescence of some office buildings. Rather, borrowers may need deeper, longer-term modifications. In turn, advancing could still insulate bonds from delinquencies in the coming year, but sharply lower appraisals could quickly trigger large appraisal reduction amounts (ARA) and [ASERs](#).<sup>1</sup> Servicers may also be more inclined to make "non-recoverability determinations", which have been relatively rare in recent years. Such determinations allow servicers to immediately recover outstanding advances from monthly principal collections.

Amid this backdrop, we identify a few themes we suggest investors should pay attention to while assessing credit situations in the coming year:

**Theme 1: Watch for Conversion Components in Mod Templates**

**Property redevelopments or usage conversions have the potential to impact valuations and ultimate loan recovery.** A growing number of property owners and investors are pursuing conversion

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<sup>1</sup> "ASER Unpredictable Timing Can Catapult Interest Shortfalls," CMBS Credit Focus, Academy Securities, September 20, 2022

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opportunities, notably office-to-residential. Recent examples include SL Green identifying a few office buildings in their portfolio as conversion candidates, including 625 Madison Avenue (\$194.7 million, COMM 2014-CR14 and CR15), and Silverstein Properties reportedly seeking to raise \$1.5 billion for conversion projects. Interestingly, SL Green also highlighted a few features that may make buildings particularly suitable for resi conversions, such as small center-core towers, or high existing vacancies (Figure 1). Generally, smaller and older buildings are more suitable for resi conversions. In contrast, post-1961, >500K sf buildings with large floor plates, that tend to have curtain walls and no operable windows, are harder to convert. New York City rules prohibit living spaces without operable windows and no access to light and air. That precludes having bedrooms further into building interiors. Many NYC conversions have been concentrated in the Downtown submarket rather than in Midtown, the REIT noted.

Figure 1. New York City Property Conversion Candidates

Building	Size (SF)	Features	CMBS Exposure
625 Madison Avenue	563K	<ul style="list-style-type: none"> <li>• Obsolete design</li> <li>• Large Vacancy</li> </ul>	\$194.7MM, COMM 2014-CR14 and CR15
750 Third Avenue	780K	<ul style="list-style-type: none"> <li>• Small center-core tower</li> <li>• Majority vacant</li> <li>• Commuter access</li> <li>• River view</li> </ul>	NA
2 Herald Square	369K	<ul style="list-style-type: none"> <li>• Shallow floors</li> <li>• Architectural interest</li> <li>• Commuter access</li> <li>• Large vacancy</li> </ul>	NA
Other NYC Conversions		Conversion Type	
609 Fifth Avenue		Resi conversion	
707 Eleventh Avenue		Life science conversion	
55 Broad		Resi conversion	
40 Fulton		Resi conversion	
4 NY Plaza (25 Water)		Resi conversion	

Source: SL Green and Academy Securities

**CMBS loan modifications could include conversion components, tying extensions or other lender concessions to borrower commitment to a redevelopment.** Previous mall modifications set precedent for such mod-driven projects. For example, in Jefferson Mall (\$56.0 million, JPMCC 2012-CBX) the servicer allowed the borrower to divert excess cash for the redevelopment of a vacant Sears box. To be sure, this is a limited scope project. Office-to-residential conversions or similar wide scope projects may require a different approach. In a similar vein, office building demolition and new construction in situations such as on 350 Park Avenue (\$400 million, VNDO 2016-350P, GSMS 2017-GS5, and JPMDB 2017-C5) would almost certainly be done outside the scope of CMBS trusts. 350 Park's sponsor just announced a potential deal to replace the 578.6K sf CMBS property in Midtown Manhattan (along with a couple adjacent non-CMBS properties) with a 1.7 million sf office skyscraper. The loan transferred to special servicing last month.

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**The somewhat obscure “principally secured” REMIC test could stand in the way of pursuing radical conversions or redevelopments while keeping properties within CMBS trusts.** REMIC rules generally prohibit changes to the collateral. The rules allow some exceptions, such as changes done as part of a loan modification. There is likely no breach of the rules if the post-modification value of the collateral is higher than the collateral value prior to the modification.

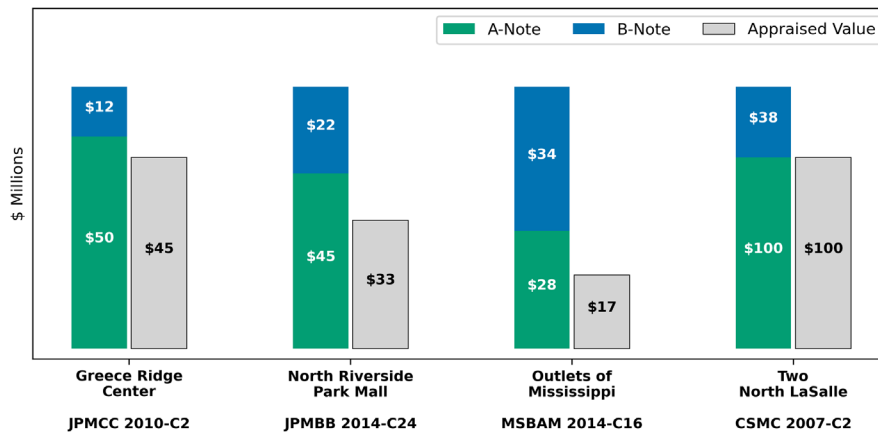
**There currently appears to be very limited conversion activity across the delinquent and specially serviced loan universe.** There is no IRP code that directly identifies conversion projects across CMBS properties. But only a handful of CMBS properties are going through redevelopment, based on a systematic search we pursued across servicer commentary. One example is the \$27.8 million Salem Center (JPMCC 2012-LC9). The mall in Salem, OR, is seeing redevelopment of its Nordstrom box into multifamily, according to servicer commentary.

**Theme 2: Track Cutoff Points on Split A/B Mods**

**The market may see a resurgence of split A/B modifications, a workout approach that has become popular in the post-GFC modification wave.** Servicers design split A/B mods with the goal of motivating new equity partners or fresh borrower capital via inserting borrower recovery ahead of the B component, or the “hope note”. The borrowers also only need to keep paying the (potentially modified) coupon on A note, thereby alleviating the property’s debt service.

**Split A/B mods may particularly align with property redevelopments or loan assumptions.** But they may also immediately trigger interest shortfalls, and put a spotlight on the A/B cutoff point. Servicers may set the split along the property’s most recent appraisal. If the A note allocation exceeds the appraised value, it may telegraph the servicer’s optimistic forecast for the property. A recent case in point is the \$60.5 million Greece Ridge Center (JPMCC 2010-C2). The servicer approved in April 2022 a split A/B for the Greece, NY, retail property, now known as The Mall at Greece Ridge (Figure 2). The \$50 million A note allocation exceeded the \$45 million recent appraisal from September 2020. The A note allocation in North Riverside Park Mall (\$66.9 million, JPMBB 2014-C24) similarly exceeded the most recent valuation of the regional mall outside Chicago, IL.

Figure 2. Recent Split A/B Modification Cutoff Points



Source: MCIA and Academy Securities

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**Consistently identifying split A/B modifications could remain a bit of a challenge even as their frequency is likely to tick up.** Such mods do not have a designated category in the modification code legend, unlike other mod provisions such as maturity extensions, amortization changes, or temporary rate reductions (IRP fields L49, D21, and A149). As such, split A/Bs could land in the “Other” (code “8”) or “Combination” (code “9”) categories. The IRP instructs special servicers to provide a list of loans with any B notes that split mods created. Tracking servicer commentary, mod templates, or the Historical Loan Modification/Forbearance and Corrected Mortgage Loan Report (HLMFCLR) are other ways to identify split A/B mods across deal reporting.

**Theme 3: Mind Loans with High Total Exposure “Ratios”**

**Rising delinquencies and the attendant servicer advancing could significantly elevate loans’ total exposure balances.** This could create wide differences between such exposures and the outstanding balance on delinquent 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.

**There are already quite a few loans with high total exposure “ratios”, which we define as total exposure divided by outstanding balance** (Figure 3). Examples include Milford Plaza Fee (\$275 million, MSBAM 2013-C9 and C10) and Harborplace (\$60.5 million, UBSBB 2013-C5). Milford Plaza, now known as The Row NYC hotel, has total exposure ratio of 1.19x. Outstanding tax & insurance (T&I) advances of \$24.3 million are a major driver of the elevated \$327.4 million total exposure on the loan. In Harborplace, much of the high 1.23x total exposure ratio comes from outstanding P&I advances. The lifestyle retail property in Baltimore, MD, is poised to see a loan assumption following a [receivership sale](#), according to recent servicer commentary.<sup>2</sup>

Figure 3. Loans With High Total Exposure “Ratios”

Loan	Deal	Balance			Property Type	Comment	Total Exposure Ratio
		(\$MM)	Status	Location			
Club Quarters Hotel	BX 2017-CQHP	273.7	90+ DQ	Various	Hotel-Full Service	Servicer in workout discussions with borrower and mezzanine lender	1.25
Harborplace	UBSBB 2013-C5	60.8	90+ DQ	Baltimore, MD	Retail-Anchored	Receiver appointed. Property sale with loan assumption submitted for Court approval.	1.23
Palmer House Retail Shops	JPMBB 2015-C32	58.1	90+ DQ	Chicago, IL	Mixed Use-Retail/Parking/Office	Related to, but not crossed with hotel loan (JPMCC 2018-PHH)	1.21
IRET Portfolio	CGCMT 2006-C5	72.9	REO	Various	Office-Suburban	Two properties remain from original 9-property portfolio	1.21
Beverly Connection	GSMS 2014-GC24; JPMBB 2014-C23; COMM 2014-C20	175.0	90+ DQ	Los Angeles, CA	Retail-Power Center/Big Box	Forebearance agreement out for signature	1.20
Westin Times Square Leasehold	CSMC 2017-TIME	140.0	Current	New York, NY	Hotel-Full Service	Subject to a ground lease	1.20
Milford Plaza Fee	MSBAM 2013-C9; MSBAM 2013-C10	275.0	90+ DQ	New York, NY	Special Use-Leased Fee	Ground lease to the Row Hotel	1.19
Crossroads Marketplace	CGCMT 2007-C6	62.0	REO	Chino Hills, CA	Retail-Anchored	Servicer pursuing re-zoning then sale as redevelopment	1.19
Cipriani Manhattan Portfolio	COMM 2014-CR19	52.0	Fore-closure	New York, NY	Mixed Use-OTHER	Restaurant and event space at 110 E. 42nd and 55 Wall St.	1.17
Palmer House Hilton	JPMCC 2018-PHH	328.9	Fore-closure	Chicago, IL	Hotel-Full Service	Receiver appointed. Foreclosure filed but not completed.	1.16
Harwood Center	COMM 2014-CR20; COMM 2014-UBS5	81.9	REO	Dallas, TX	Office-CBD	Went REO Nov-2021. Servicer working to stabilize asset.	1.16
Hilton Minneapolis	JPMCC 2018-MINN	180.0	90+ DQ	Minneapolis, MN	Hotel-Full Service	Servicer in modification discussions with borrower	1.15
Jamaica Center	GSMS 2012-GCJ9	65.1	Fore-closure	Jamaica, NY	Mixed Use-Retail/Office	Foreclosure in process. Servicer dual tracking workout discussions with Borrower	1.15

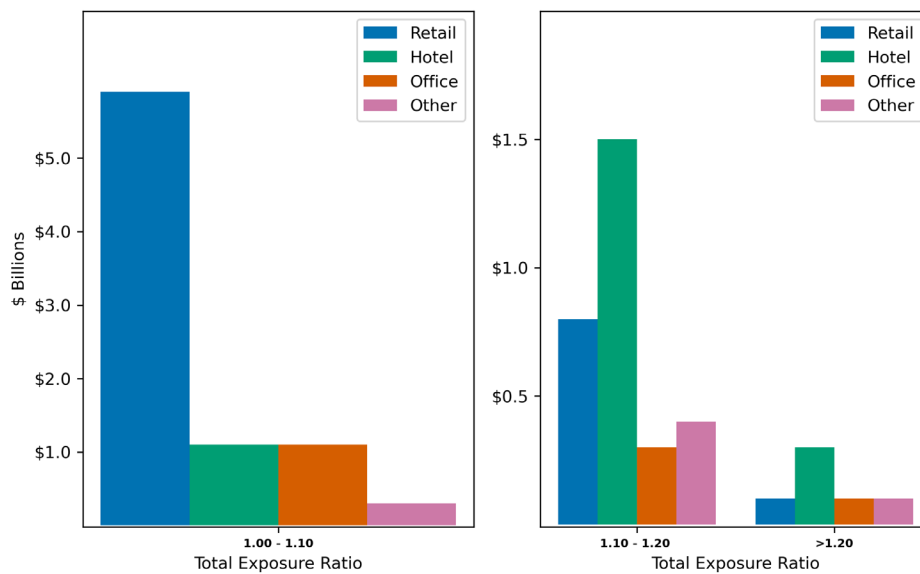
Source: MCIA and Academy Securities

<sup>2</sup> Hotel Receiverships: Palmer House Hilton Spotlights Stabilization Efforts, CMBS Credit Focus, Academy Securities, November 17, 2022

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**Retail and hotel properties currently dominate the high total exposure ratio buckets** (Figure 4). Interestingly, in the >1.10x TE ratio buckets, the relative share of hotels rises compared to retail loans, which comprise a greater share of the 1.00-1.10x bucket. This suggests some hotel loans could see significant loss levels once they are liquidated and servicers recover outstanding advances. In turn, office loans still comprise a relatively low percentage of the high TE ratio buckets. This is consistent with the office sector low delinquency levels so far, amid long term leases that shielded loan cashflows during the pandemic. Rising office delinquencies in the coming months should start pushing loan total exposures [higher](#).<sup>3</sup>

Figure 4. High Total Exposure Ratio Loans by Property Type



Source: MClA and Academy Securities

<sup>3</sup> Office Modifications: 285 Madison Could Offer a Blueprint for More to Come, CMBS Credit Focus, Academy Securities, October 27, 2022

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