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CMBS Credit Focus

Credit 2024: Workout Nuances Come to the Fore

Subtle, Harder to Track Angles To Reward Opportunistic Investors in 2024

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Workout projection and analysis of distressed situations will take center stage in 2024, offering compelling returns for credit work. The broader debate about the extent of trouble in commercial real estate markets is still raging. Both CRE bulls and bears have valid arguments. The double whammy of elevated rate environment and secular headwinds in some property segments (read office) creates a serious challenge even for loans that may have been prudently underwritten a few years ago. But the market should not ignore meaningful differences across property segments, the continued resilience of many loans, and even nuances across the more troubled sectors (for example, class-A office properties in desirable submarkets/neighborhoods vs. old, obsolete commodity office space).

Even across those advocating for a more constructive view on CRE (as we have throughout the year), there is no denial that distress is vividly present. In fact, that is part of the constructive view. The distressed situations should help prune the market of non-viable properties and capital structures. They facilitate price discovery and enable the market to better handicap the extent of distress. Yet the process takes time. We expect the coming year to bring more clarity on how quickly and in what way distressed situations play out. In the meantime, deep credit analysis and appreciation of the structural factors that drive outcomes can offer outsize returns.

We identify a few aspects relevant for such analysis:

1. Borrowers' incentives and commitment to properties

Servicers generally have been inclined in distress periods to negotiate forbearance agreements or loan extensions and modifications with borrowers that have shown commitment to their properties. This has been evident post-GFC, during the pandemic, and more recently in cases such as the $536 million AON Center (JPMCC 2018-AON and BMARK 2018-B4, B5, and B7) or the $152.8 million West County Center (JPMCC 2012-LC9 and LC10). But predicting borrowers' commitment as properties struggle has been a challenge. It may not be readily apparent if a borrower is seriously interested in keeping ownership and is prepared to make concessions (reserve replenishment, partial paydown, etc.) or is planning to walk away from the property. Rationalizing portfolios is clearly leading some landlords to hand back properties to their lenders,

as prominent examples such as 1740 Broadway (BWAY 2015-1740) showed.[1] Potential situations of “strategic defaults”, where borrowers default to initiate modification discussions with special servicers, further complicate the assessment of borrower incentives.

For publicly traded borrowers, there are signals to evaluate borrowers’ interest. For example, when mall landlords transferred properties to so-called “other” category from their core holdings list, that was a clear signal the sponsor is planning on to walk away from the CMBS loans, as happened in The Mall at Tuttle Crossing (MSBAM 2013-C10 and C11) and Crystal Mall (UBSBB 2012-C2). In a similar vein, we will be on the lookout for borrowers’ telegraphing their plans on particular properties even before the loan transfers to special servicing and/or workout negotiations kicks off. For example, when a sponsor discloses a significant write-down of a CMBS property in their financial reports, as happened recently on Fashion Outlets of Niagara Falls ($85.9 million, COMM 2010-C1), this could suggest limited or no interest in negotiating a mod with the special.

2. Workout approach and modification terms

If the borrower remains committed to the property, we continue to believe a loan modification is the likely outcome of troubled situations. But we expect significant variation across mod terms, crystalizing the complicated impact mods can have on property performance and bond cashflows. Office modifications are becoming more prevalent. In contrast, hotel and retail mods have been much more dominant in recent years. New office mods do include key provisions of previous non-office mods, such as extensions, reserve funding, and interest only/amortization switches. Mods continue to vary on the length of extension special servicers approve, ranging from a short one-year extensions (with an extension option) in cases such as the $96.0 million Gateway Center (JPMCC 2013-C10), to longer multi-year extensions as in the AON Center mod.

Recent office mods also introduced some interesting provisions such as lender lease consent via tightening of the “Major Lease” definition (300 Park Avenue, $485 million, COMM 2013-300P) or hyper-amortization of excess cash flow (515 Madison Avenue, $95.5 million, WFRBS 2013-C11). It remains to be seen how impactful some borrower concessions might be. For example, in 515 Madison, there has been no excess cash remaining after debt service and operating expenses since the loan modification, based on deal reporting.

3. Mezzanine lenders

Mezz lender actions can significantly impact mortgage workouts. The mezz can exercise their negotiated cure or purchase rights, and quickly resolve mortgage defaults. Mezz loan sales may introduce another twist as new mezz holders join the property capital structure, potentially at a different cost basis. Many of the large office loans that recently defaulted or transferred to special servicing have mezz loans below the CMBS mortgage exposures.

1 “Special Servicer Replacements: 1740 Broadway Crystalizes Implications,” CMBS Credit Focus, Academy Securities, October 16, 2023

The large AON Cener mod this year demonstrated a combined mortgage/mezz workout. The $141.5 million mezz positions, sitting below the $536 million CMBS mortgage, agreed to accrue interest during the three-year extension period, while the mortgage loan should remain current. Interestingly, it appears that the servicer sought to secure the cooperation of the mezz lender, even though the mezz position is out of the money given the $440 million collateral valuation the servicer cited (deal reporting also disclosed other valuations, all below the outstanding mortgage). The inclusion of mezz lenders in workout negotiations matters. Unless the mortgage lender formally forecloses on the property and wipes out any subordinate positions, mezz lenders retain their rights, including the ability to pursue UCC foreclosures on their equity collateral and delay the entire workout process. Interestingly, UCC foreclosure notices on mezz property loans surged in 2023, exceeding the GFC period. Lenders filed 62 notices in the first ten months of the year, based on WSJ-compiled data.

4. Expected recoveries as a function of liquidation expenses

Loan dispositions should pick up in 2024 as borrowers walk away from properties, and special servicers work through their pipeline. The past year has seen relatively limited liquidations, perhaps defying the expectations of some observers who expected rapid meltdown of the CRE market. Now, the rising number of dispositions will re-focus attention on the many moving parts that determine the ultimate paydowns to bonds, especially various liquidation expense items.

Recent large liquidations revealed some unusual items that dramatically impacted principal payments – either negatively or positively. In Crossgates Mall loan (COMM 2012-CR1, CR2, and CR3) nearly 50% of the liquidation expenses chalked up to holdbacks, leading to $97.9 million realized loss, or 40.4% severity.[2] In contrast, in The Mall at Tuttle Crossing, $6.3 million of the liquidation expenses apparently allocated to NRA recovery, which made liquidation-driven principal paydowns higher than what the reported loss severity implied.[3]

5. Master servicer decisions

Master servicer actions will have a significant impact on bond cashflow and the path of troubled loans. Special servicers' discretion and decision-making is understandably receiving much attention in troubled situations. Master servicers historically have been mostly in charge of procedural cash collections and advancing. But now the masters are becoming more influential. For example, the ability of the master to execute forbearance agreements, prevalent during the pandemic, could frustrate bondholders that may prefer to see quick transfer to special servicing and loan workout, before property performance continues to deteriorate.

In turn, the rising number of non-recoverability determinations, another key master decision, could abruptly terminate bond cashflows, and lead to pre-liquidation principal losses. The

2 "Crossgates Liquidation: Holdbacks Complicate Severity Projections," CMBS Credit Focus, Academy Securities, September 11, 2023

3 "Recovering the Non-Recoverable: Liquidation Waterfall Nuance Bolsters Bond Paydowns," CMBS Credit Focus, Academy Securities, November 6, 2023

judgement-driven non-recoverability decision is very different from an appraisal-driven curtailment of advancing. After a new appraisal on a specially serviced loan, the master simply follows the appraisal reduction amount (ARA) and appraisal subordination entitlement reduction (ASER) calculations and limits advancing based on those calculations. Such ASER-driven curtailment of advances is typically gradual and leads to interest shortfalls on subordinate classes. In contrast, nonrecoverable advances (NRA) decisions immediately stop all advances, and can trigger principal losses.[4]

Look Beyond Standard Reporting

An interesting common thread across most of the items we listed above is that disclosures and data around them typically are not readily available to investors. For example:

- The availability of realized loss templates remains sporadic, making it hard to handicap liquidation expense breakdowns;
- Consistently tracking mezz positions across the CMBS universe remains nearly impossible;
- Identifying non-recoverability determinations or their rationale poses a challenge as well.

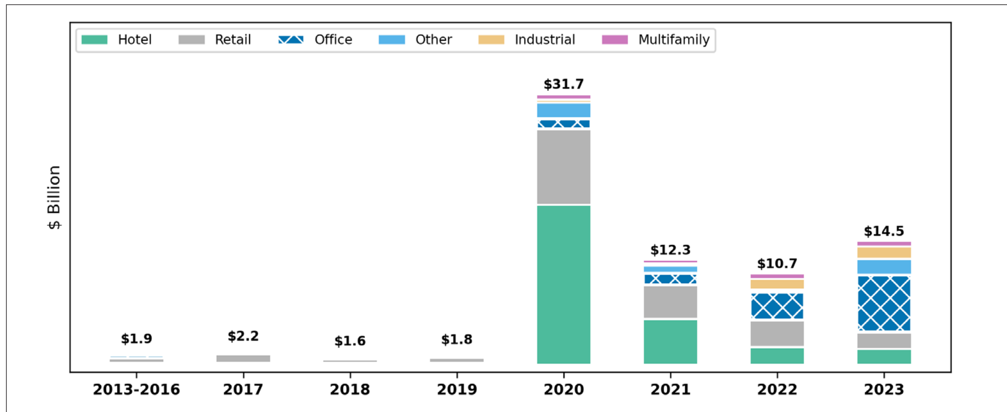
To be sure, investors have always grappled with the timing or projection of key workout milestones, such as new appraisals or mod executions. But some of the items we now view as critical for troubled situations analysis do not lend themselves to IRP fields, standard monthly disclosures, or handy data on cashflow systems.

The good news is that signals emerged in recent months, shedding light on how investors should assess some of the more nuanced aspects of loan workouts. For example, master servicers have disclosed their rationale for making non-removability determinations in cases such as the $558 million Westfield San Francisco Centre (DBJPM 2016-SFC and five 2016-vintage conduit deals) and the $250.5 million 175 West Jackson (COMM 2013-CR12, CR13, and CR14). Some loss templates showed unusual expense items that investors now know they need to consider. And a trickle of fresh mod templates suggests the blueprint investors should expect on workouts with committed borrowers.

4 "Non-Recoverable Advances: Unveiling a Rationale for a Key Servicing Decision," CMBS Credit Focus, Academy Securities, May 18, 2023

Office Modifications Take Center Stage

Figure 1. CMBS Modifications by Property Type, 2013-2023

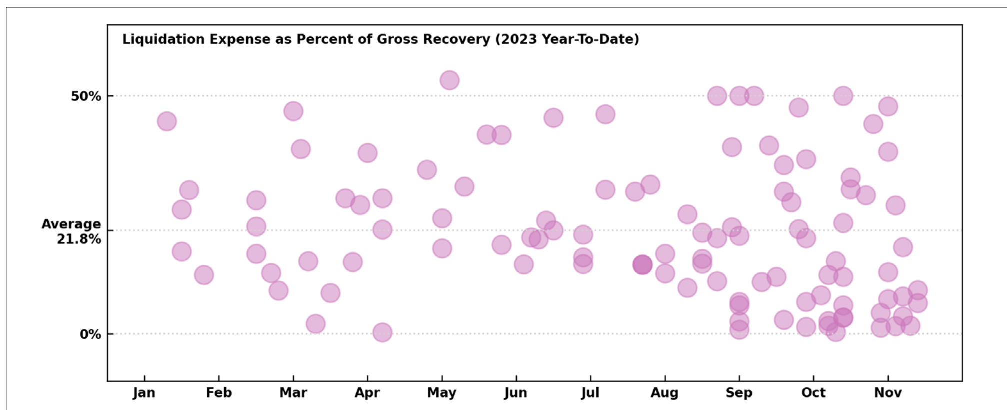


Source: Morningstar Credit and Academy Securities

- **Expect wide variation on extension periods, with short extensions likely including additional extension options**
- **Expect significant borrower cash injections, in the form of paydowns and reserve funding**
- **Track cash trap provisions, lease consents, and cutoff points on split A/B mods**

Expect Rising Liquidations in 2024

Figure 2. Liquidation Expenses on Recent Loan Resolutions

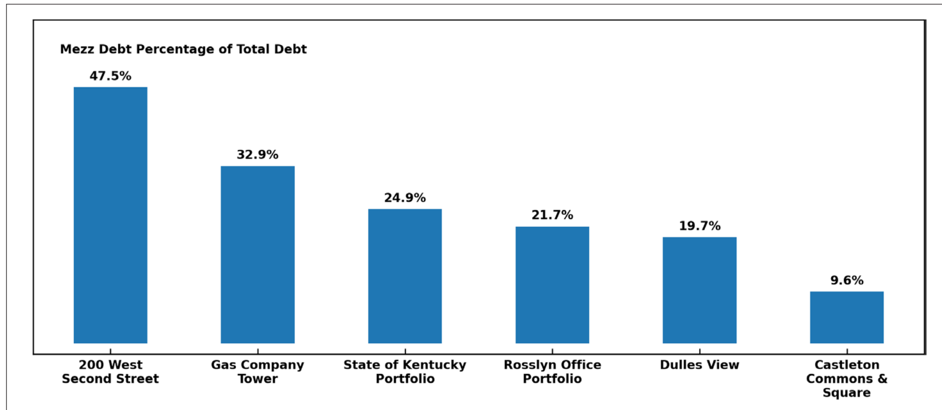


Source: Morningstar Credit and Academy Securities

- **Track total exposure ratios; high ratios (>1.15x) telegraph elevated liquidation expenses and lower principal paydowns**
- **Consider the possibility of holdbacks, NRA recoveries, and other unique expense items aside from the components of total exposures**

Mezz Lenders Poised to be Influential in Mortgage Workouts

Figure 3. Mezz Debt Percentage on Recently Delinquent or Specially Serviced Large CMBS Loans



Source: Morningstar Credit and Academy Securities

- **Track mezz positions on your CMBS exposures**
- **Assess economic interest of mezz position to project mezz actions in a workout**

Expect a Pickup in Non-Recoverability Decisions

Figure 4. Large Loans with a Non-Recoverability Determination

Loan	Deal(s)	Balance ($MM)	Property Type	Status	P&I Advances ($MM)	Total Advances ($MM)	NRA Repay ($MM)	NRA Reimbursement Period
Westfield San Francisco	DBJPM 2016-SFC; DBJPM 2016-C3; JPMCC 2016-JP3; CD 2016-CD1; COMM 2016-COR1; JPMDB 2016-C4	558.0	Retail	Foreclosure	2.1	2.1	0.0	Future Period
Milford Plaza Fee	MSBAM 2013-C9; MSBAM 2013-C10	275.0	Leased Fee	90+ DQ	28.0	37.2	29.7	Apr-2023
Poughkeepsie Galleria	UBSC 2011-C1; UBSCM 2012-C1	135.9	Retail	Mty NP	0.0	0.0	5.7	Jan-2022 to Nov-2022
Palmer House Retail Shops	JPMBB 2015-C32	57.7	Mixed Use	90+ DQ	5.5	9.3	0.0	Future Period
West Ridge Mall & Plaza	COMM 2014-CR16	45.8	Retail	REO	0.0	0.0	2.4	Dec-2021
401 South State Street	CGCMT 2016-P4; CD 2016-CD1	42.4	Office	REO	7.8	18.4	0.0	Future Period

Source: Bloomberg and Academy Securities

- **Assess outstanding volume of performing loans on seasoned deals, especially in 2013- and 2014- vintage deals**
- **Track the SASB component of SASB/conduit pari-passu troubled loans**

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Device Payment ABS: Expect Stable Performance as Collateral Evolves

CRE CLO Mods: Rising Volume Not Immediately Telegraphing Distress

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Self Storage: Aspects to Watch as Performance Decelerates

Transitional Multifamily: Collateral Migration Away from CRE CLO Offers Different Deal Profile

Recovery Bonds: No Need to Closely Watch the Fed or the Economy Here

Affordable Mortgages: Fee Elimination Spotlights Convexity Profile

Investor Non-QM: Rental Exposure with Some Structural Twists

Data Centers: A Strong Segment Juggles ABS and CMBS

Small Balance Multifamily: Value Ahead of Slow Prepays

Future Funding: Potential Key Performance Driver as CRE CLO Pipeline Builds Up

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Manufactured Housing: Resilient Segment Amid Potential Multifamily Softness

Tender Offers: Expect More to Come, Though Not on a Predictable Schedule

NYC Multifamily: Rent Increases to Support Cashflows Amid Regulatory Restrictions

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Senior Housing: Focus on Segment Selection Amid Pandemic Impact

Disaster Performance: Pandemic Forbearance Resolutions Bode Well for Future Stresses

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

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Inflation-Resistant Leases: Rent Steps Offer Some Revenue Protection, though Not Much

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Hotel Reserves: Key Performance Driver after Pandemic-Driven Depletion

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