CMBS Credit Focus

Government Tenants: Short Termination Notices and Specialized Properties



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Track GSA Exposure as the Government Adjusts Office Needs

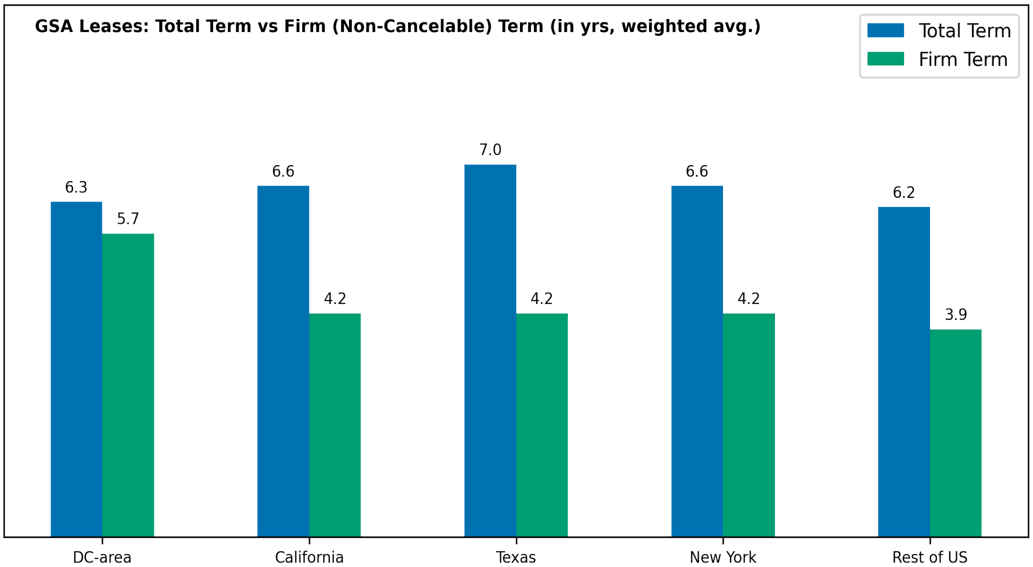
CMBS office properties with government tenants merit particular attention, as federal and state agencies assess their post-pandemic real estate needs. Recent guidelines from the Office of Management and Budget ("OMB") and General Services Administration ("GSA") clearly emphasize the focus on remote work and "untethering" federal work from geographic locations and/or specific buildings. GSA, the federal agency that leases space for the government workforce, is now condoning short-term leases (4-6 years), as various federal agencies determine their long space requirements. This bucks a trend developed over recent years. A 2016 policy guided GSA property officers to sign long-term leases (10+ years) whenever possible.

We see a few factors relevant for assessing government lease terminations or renewals:

- **Short termination notice periods.** Government tenants may have surprisingly short notice periods once lease termination options begin. For example, federal tenants in the $50 million GSA Portfolio (WFRBS 2013-C13) have only 60-90 day notice periods, according to deal documents. Most tenants in the portfolio, including DEA – Tucson, AZ, the largest tenant (18.6% loan exposure), can now exercise early termination options. The DEA lease matures in November 2026.
- **Lower termination risk for specialized facilities.** So-called "mission-critical" or specialized government facilities likely face low early termination risks, even amid agencies' focus on remote work and reduction of real estate footprint. For example, deal documents describe Pentagon Center ($210 million, across four 2017-vintage deals) as a "Level IV secure office facility…[with] dark fiber access to the Pentagon and DoD network", which would cost $200/sf to replicate. The GSA leased the property since 1993, and the DoD has been the only tenant there since 2003. To be sure, the DoD leases in the Pentagon Center property expire during the CMBS loan's term. But even late into the pandemic, the GSA stressed the importance of securing long-term leases on specialized facilities. GSA's examples for such facilities include (1) the judiciary, (2) federal inspection agencies operating at land ports of entry, (3) law enforcement components, and (4) those agencies using laboratory spaces.
- **Longer "firm" lease periods in the DC-area.** We see elevated early termination risks on so-called commodity office space in the Washington, DC area. The reduction of such space could easily fit into agencies' goal of distributing the federal workforce

nationwide and the potential to advance equity and inclusion, as a GSA leasing memo emphasizes. However, GSA leases in the DC-area have shorter early termination periods than government leases in the country. Put differently, DC-area leases have longer so-called "firm" (non-cancelable) portions of the contract. The DC-area cancelable periods represent about 10% of the "total" lease term (Figure 1). This compares to 36-40% cancelable periods in GSA leases in California, Texas, and New York, the states with the most significant government-leased space outside of the DC area.

Figure 1 GSA Leases: Total Term vs. Firm (Non-Cancelable) Term (in years, weighted average)



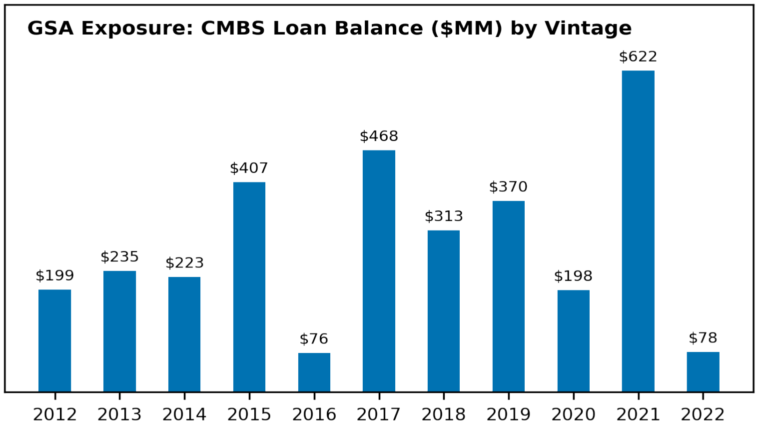
Source: GSA Lease Inventory, Academy Securities

- **GSA "prospectuses" foretell leasing decisions.** Publicly available documents that GSA produces each time it is looking to execute a large lease could provide valuable indications on the leasing agency's plans for CMBS properties with federal tenants. The GSA could publish these so-called prospectuses years before actual lease expirations. For example, a fresh GSA prospectus suggests that the agency plans to renew the lease for the largest tenant in 1100 & 820 First Street NE, in Washington, DC ($211.2 million, in BBCMS 2021-C12, BMARK 2021-B30, BBCMS 2022-C15). The 131K sf (20.1%) space of the Department of Veterans Affairs in the downtown DC office building expires in June 2026, during the loan's term. The newly released GSA prospectus proposes a 20-year lease extension. This proposed extension is encouraging, especially as the VA has successive termination options on the entire space starting in 2024.

CMBS GSA Exposure

CMBS deals have about $3.2 billion outstanding exposure to GSA leases across more than 420 loans (Figure 2). GSA exposures peak on the 2017- and 2021-vintages.

Figure 2 CMBS GSA Exposure

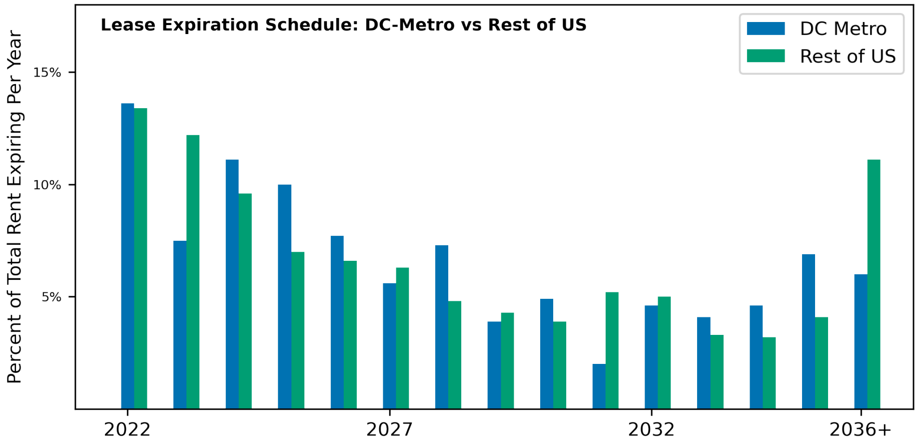


Source: MCIA, GSA Lease Inventory, Academy Securities

Identifying GSA exposure across the CMBS universe is not straightforward. Deal data files could show federal tenants as "GSA", the actual federal agency that occupies the space (e.g., FBI, IRS, DEA), or permutations of the agencies' names. We identified the CMBS GSA exposure by matching properties' location data to the GSA's complete lease inventory, which includes information on 7,762 federal leases.

The GSA lease rollover schedule in the coming years suggests some differences between DC-metro lease expirations and the rest of the US (Figure 3). In the DC-metro there are elevated lease expirations in most years until 2028. Outside DC we see a declining rollover schedule in the coming years. Both DC-metro and the rest of the country have peak expirations this year.

Figure 3 GSA Lease Rollover Schedule



Source: MCIA, GSA Lease Inventory, Academy Securities

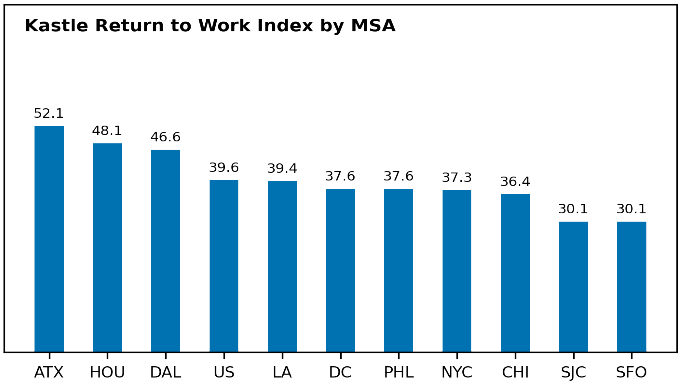
Space Needs to Vary by Market and Employer Type

Public communications and anecdotal evidence suggest government employers are more likely to embrace remote work compared to the private sector. Various GSA and OMB memoranda clearly point to the federal government adopting remote work-from-home arrangements, as we alluded to at the outset. Many government agencies are also slower to return to work or adopt very flexible hybrid work plans. For example, the 2,300 employees of the Federal Reserve Bank of New York are working "on a schedule that works for them", according to the Fed's COO. Several federal agencies, such as the Securities and Exchange Commission, pushed back RTO dates to June, according to Bloomberg.

Accelerating the focus on space reduction also ties into the GSA's goal of reducing its usable square feet (USF) per person in leased spaces. For example, the proposed lease renewal of the VA space in 1100 First Street we mentioned above would reduce the USF/person to 109 from the current 129.

Interestingly, the DC area's overall "back to work" measure is not particularly low compared to other metros. Employees back at the office in the DC MSA represented 37.6% of pre-pandemic levels as of March 16, according to Kastle Systems (Figure 4). This compares to 52.1% and 48.1% levels in Austin, TX, and Houston, TX, MSAs, and 30.1% in both San Jose, CA, and San Francisco, CA. The national average is 39.6%. But the overall return-to-office levels may mask stark differences across employers. Consistent with the apparent federal government approach to remote work, state governments are also adopting the practice. Connecticut recently allowed permanent remote work for most of its employees, according to press reports.

Figure 4 Back to Work Measures Across Large MSAs



Note: The back-to-work levels show the percentage of workers who went to the office compared to pre-Covid-19 levels.
Source: Kastle Systems, Bloomberg, Academy Securities

All told, the confluence of data and anecdotal evidence suggest that assessing future space needs of office tenants and their leasing decisions could vary by the type of tenant and perhaps geography. For example, San Francisco and Silicon Valley appear slower to return to work. Such markets also have a concentration of technology firms that, like the government, might be more fully embracing remote work. In contrast, financial services tenants, or office markets in Texas, may see less post-pandemic space reduction pressures, all else equal.

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