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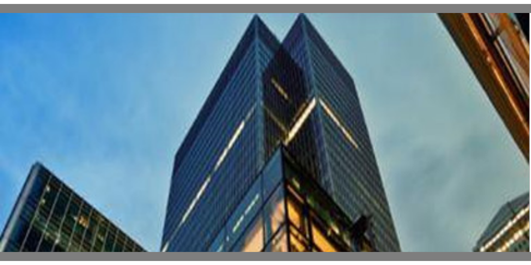
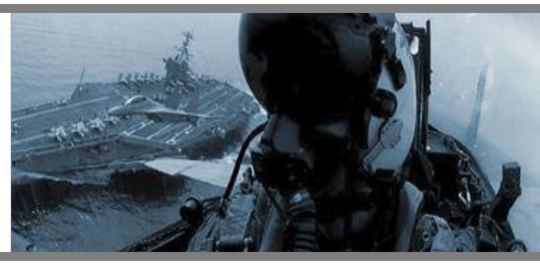
Securitized Products Special Topics

Office Contractions: New Term Rollover Risk, and Perhaps Swelling Reserves





CMBS with DC Office Exposure in Flux, as GSA and GSEs Rationalize Space

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Large reductions of office space in Washington, DC, are introducing significant term rollover risk to CMBS deals with exposures to properties in the area. The Federal government, the largest office tenant in the market, is undertaking major cuts to its office space, according to official memos.[1] Publicly available documents that General Services Administration (GSA) produces each time it is looking to execute a lease can telegraph specific contractions. GSA is the federal agency that leases space for the government workforce. GSA could publish these so-called lease "prospectuses" years before actual lease expirations.[2]

The $398 million Constitution Center loan (BANK 2022-BNK41-44 and MSC 2022-L8) is a case in point. A prospectus on the Federal Trade Commission's lease at the property shows that the government plans to cut the leased space by 64K SF, to 179K SF (26% reduction). The current lease expires in February 2027. The loan matures in March 2032. Most of the loan's five pari-passu notes are the largest, or top-3 exposures in their respective 2022-vintage conduit deals.

Hefty Termination/Contraction Fees, Before Fannie Reverses Course

Fannie Mae's dramatic contraction at Midtown Center ($525 million, DCOT 2019-MTC and two 2019-vintage conduits) spotlights other deal implications, beyond rollover risk. Fannie recently announced a new lease, that reduces its footprint at Midtown Center, in DC's East End submarket, to 340K SF (39% of NRA) from 713.5K SF (86.3%). Interestingly, in early 2024 Fannie reportedly planned to fully terminate the lease via an early termination option. The GSE tenant also executed several contractual contraction options, before reversing course and negotiating the new agreement at the property.

The earlier exercise of Fannie's termination and contraction options required paying substantial fees. Fannie paid a termination fee of $53.1 million, as well as contraction fees totaling $18.6 million on the exercise of four separate contraction options. The $70+ million fees made their way to the loan's tenant reserve (Figure 1). This confirmed that investors should generally expect to see large reserve deposits once tenants pay termination/contraction fees.

1 See, for example, OMB Report to Congress on Telework and Real Property Utilization, The Office of Management and Budget, August 2024
2 "Government Tenants: Short Termination Notices and Specialized Properties," CMBS Credit Focus, Academy Securities, March 28, 2022

Figure 1. Midtown Center Loan and Property Parameters

Asset	Midtown Center
Deal	DCOT 2019-MTC; BANK 2019-BN22; COMM 2019-GC44
Loan Balance ($ per sq. ft.)	$525,000,000 ($605 per sq. ft.)
ARD / Maturity	October 2029 / September 2033
Coupon	3.085% fixed
Amortization	Interest-only
Loan Status	Current
Property Size / Occupancy	867,654 sq. ft. / 100% occupancy (June 2024)
Property Type / Location	Office (95%) and Retail (5%) / Washington D.C.
Appraisal History	$960.0 million (August 2019)
Total Cash Reserves	$48.0 million (October 2024)

Lease Expiration Schedule

Tenant	Sq. Ft.	Expiration
Fannie Mae	45,610	May-2025
Fannie Mae	39,759	May-2026
Fannie Mae	28,951	May-2027
Fannie Mae	45,841	May-2028
Fannie Mae	553,339	May-2029
WeWork	109,943	Nov-2036
Retail	44,211	Various
Total	**867,654**	

Note: Above is from the most recent servicer-provided data and does not include any new executed leases

Source: Morningstar Credit and Academy Securities

Fannie's decision to keep a portion of its Midtown Center presence, effectively extending its lease, creates uncertainty over the treatment of MTC's termination-driven reserves. The servicer noted that the reserve funds will be primarily used for re-leasing the vacant space. The landlord executed a new 120K SF lease at the property. In another twist, deal documents show that the tenant reserve balance dropped to $47.6 million in September. The servicer noted this week that $24.8 million was disbursed to the loan's borrower from the "Fannie Mae Termination Funds Reserve." The servicer added that the disbursement represented leasing commissions.

All told, as office tenants rationalize their space needs, we are not surprised to see reversals on termination or contraction decisions. This leaves in flux various property and loan parameters, including rollover schedules and reserve balances.

Tighter Utilization Rates and Prevalent Telework Drive GSA Reductions

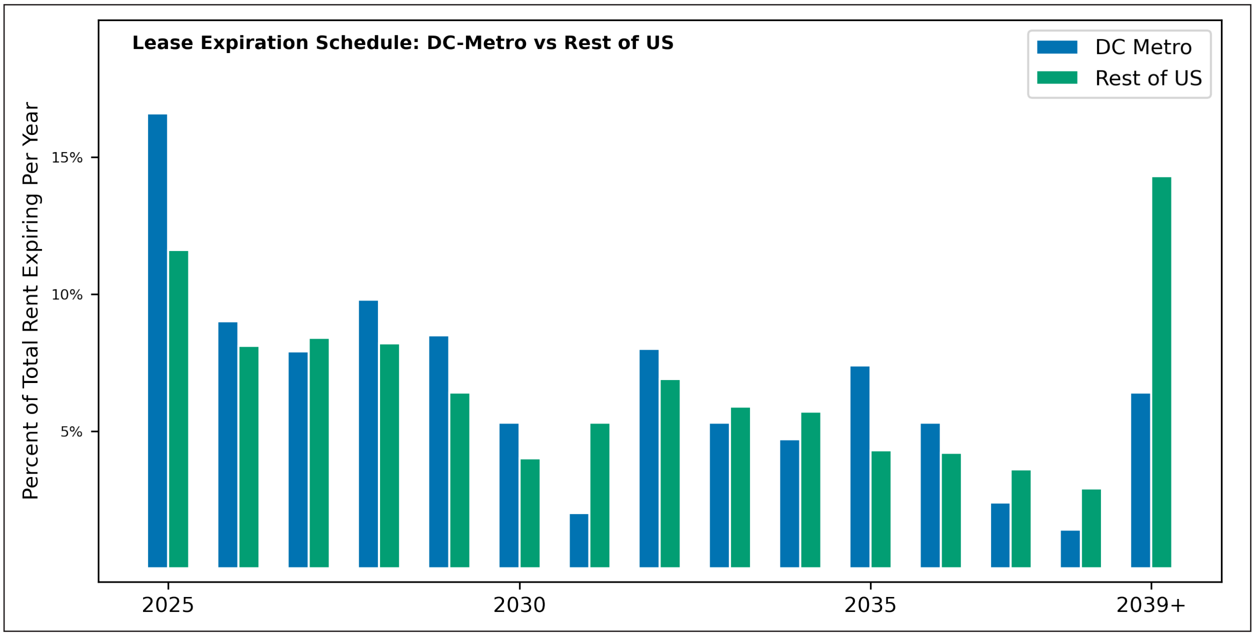
The GSA space reductions and consolidations could reflect dramatic drops in so-called space utilization rates, and/or shifts to remote work across federal agencies. The Constitution Center lease prospectus we alluded to at the outset shows the overall space utilization rate dropping to 126 from 182, and the usable square feet (USF) per person decreasing to 200 from 278. The prospectus does not make a direct reference to remote or "telework" at the agency.

In contrast, a separate prospectus that telegraphs the Department of Treasury 92K SF space reduction (–47.2%) following relocations and consolidation from two existing locations in DC, mostly focuses on rising telework at the department. The prospectus notes that about half of the personnel at the Treasury locations are moving to increased telework and will not be accommodated under the office consolidation.

Interestingly, Treasury's post-reduction drops in space utilization are much less dramatic compared to FTC's lease in Constitution Center. Treasury's proposed consolidation would decrease the space utilization rate to 97 from 108, and USF to 179 from 187. Still, Treasury's proposed space reduction is much larger than FTC's on a relative basis. The ultimate lease Treasury executed at its new location, at 1575 Eye St NW, may have resulted in an even bigger footprint reduction, of 65%, according to commercial brokers and press reports.

The varied drivers GSA cites in prospectuses make it a bit harder to project office reductions across the government space. High USF levels on existing leases may not necessarily portend large reductions. Relatedly, it may be difficult to gauge the prevalence of telework at specific government agencies.[3] The Telework Transparency Act of 2024 that is making its way through Congress may shed some light down the road. The legislation would require federal agencies to collect data on how remote work impacts their property decisions. In the meantime, what is clear is that we will closely track the GSA rollover schedule, especially in DC Metro (Figure 2). The GSA leases ~173 million square feet of office space across the country, according to CoStar.

Figure 2. GSA Lease Rollover Schedule



Source: Morningstar Credit and Academy Securities

3 The OMB report to Congress we cited above does provide some data on the "telework-eligible employees" across different federal agencies, as well as estimates on the percentage of agency regular working hours spent in person. For example, 89,733 of the Treasury's 109,268 total employees, are eligible for telework. In the GSA itself, 12,511 of the agency's 12,795 total employees are telework-eligible.

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