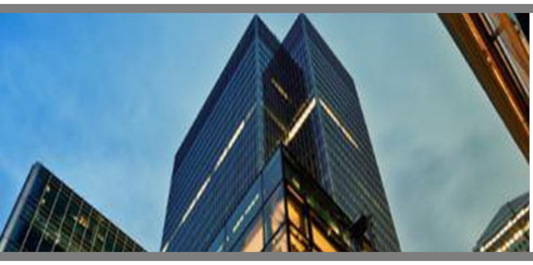
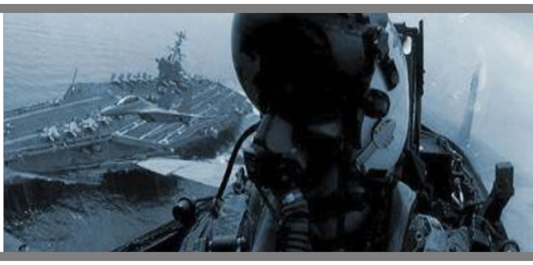
Securitized Products Special Topics
Recovering Shortfalls: Credit IO Value in Distressed Office





1740 Broadway Liquidation Shows Path for Subordinate Bond Payments

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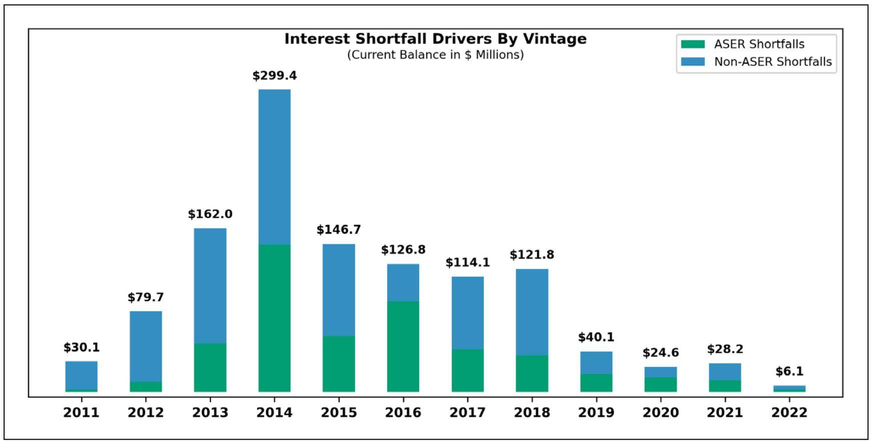
The recent liquidation of the $308 million 1740 Broadway loan (BWAY 2015-1740) underscores how servicers' choice between curtailing interest advances (via ASER) or terminating them (via NRA or non-recoverable advances) could have dramatic impact on subordinate bond value. Perhaps counter-intuitively, the more drastic non-recoverability determination actually could bolster subordinate bonds' credit IO trade returns. While the servicer immediately shuts off interest payments to all bonds following a non-recoverability determination, subordinate bonds may be able to recover those shortfalls at liquidation at the expense of principal payment to senior bonds. This is not the case if ASERs are driving the interest shortfalls. At liquidation, ASER recoveries typically will be subordinate to principal paydowns.

As such, subordinate classes may welcome non-recoverability determinations in highly distressed situations. This is especially the case when the servicer makes the determination around the arrival of a new low appraisal that would lead to elevated ASERs. The ASER-driven shortfalls may not be much lower than NRA-driven shortfalls. But the NRA shortfalls recovery prospects could look brighter. We have seen a significant rise in the frequency of non-recoverability determinations, including blanket NRAs across entire deals, and expect more to come.[1] In the same vein, investors may find value in subordinate classes of deals that have non-ASER shortfalls (Figure 1).

Figure 1. Interest Shortfalls Drivers



Note: ASER - Appraisal subordination entitlement reduction
Source: Morningstar Credit and Academy Securities

1 "Blanket NRAs: Shutting Down Advances Upends Credit IO Trades," CMBS Credit Focus, Academy Securities, January 3, 2024

Pre-Liquidation Sleuthing for Shortfall Drivers

1740 Broadway's liquidation proceeds paid $9.0 million shortfalls ahead of principal payments because those shortfalls were associated with non-recoverable interest. The shortfalls payment, combined with $48.5 million servicer advance/interest reimbursement, $2.9 million holdback, and other expenses, left only $117.2 million net proceeds on $179 million liquidation price (Figure 2). The overall loss to the deal was $190.8 million, including a write-down to the originally triple-A rated class A.[2]

Figure 2. 1740 Broadway (BWAY 2015-1740) Liquidation

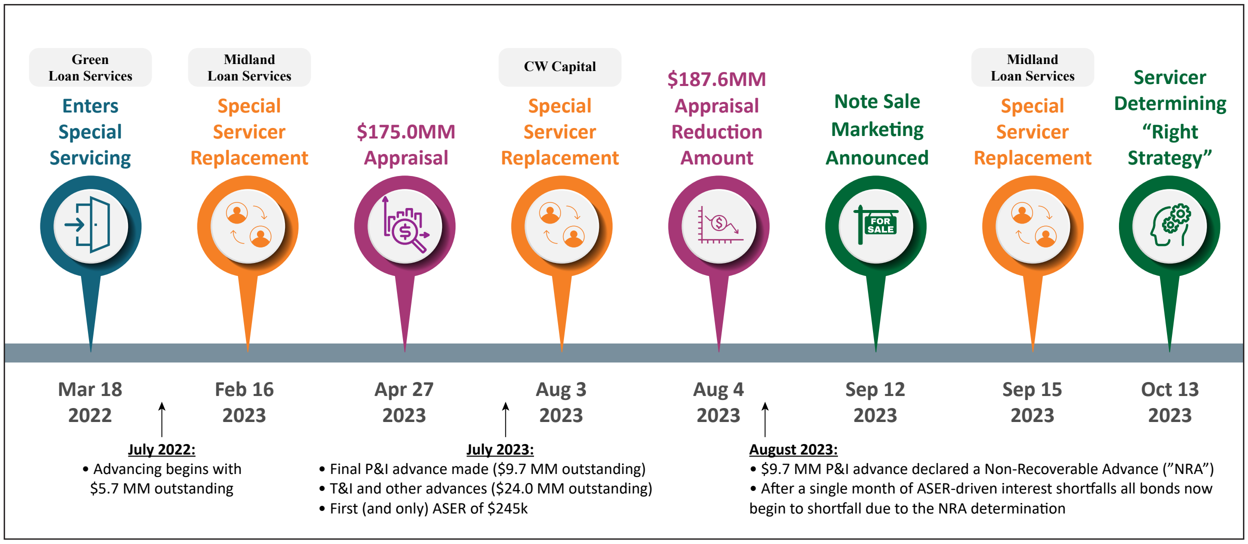
	Net Liquidation Proceeds ($ Millions)	
Original Note Balance	$308.0	
Note Balance At Liquidation	**$308.0**	
Liquidation Proceeds	**$179.5**	**(Net of selling costs)**
Fees To Servicers	$1.0	**(Liquidation Fee)**
Advances (Incl Adv. Interest)	$48.5	**(P&I, T&I, Other)**
Accrued Interest	$10.0	**(Includes previous NRA)**
Holdback - Unknown	$2.9	
Total Fees/Expenses	**$62.3**	
Net Liquidation Proceeds	$117.2	
Realized Loss to Trust	**$190.8**	
Loss Severity	62%	

Net Liquidation Proceeds Allocation				
Class	Principal Balance	Paid	Accrued Interest	Paid
A	$157.5	$117.2	$3.8	$3.8
B	$ 38.6	-	$1.0	**$1.0**
C	$ 26.7	-	$0.7	**$0.7**
D	$ 32.8	-	$1.1	$1.1
E	$ 44.6	-	$1.6	$1.6
F	$ 7.8	-	$0.3	$0.3
XA	-	-	$0.3	$0.3
XB	-	-	$1.1	$1.1
Total	$308.0	$117.2	$9.9	$9.9

Source: Morningstar Credit and Academy Securities

Interestingly, the servicer made a non-recoverability determination on the 1740 Broadway advances only a month after ASERs kicked off. This essentially shifted the driver of the accumulating shortfalls to non-recoverable interest from ASER, eventually leading to the priority of the shortfall payment at liquidation (Figure 3).

Figure 3. 1740 Broadway Timeline



Source: Morningstar Credit and Academy Securities

2 "Special Servicer Replacements: 1740 Broadway Crystalizes Implications," CMBS Credit Focus, Academy Securities, October 16, 2023

The shortfalls payment priority in 1740 Broadway reminded the market that only ASER shortfalls were de-prioritized at liquidation in CMBS 2.0. But the situation also showed the challenge in tracking interest shortfall drivers. Investors had to observe the low $245K pre-liquidation cumulative ASER, compare it to the pre-liquidation $8.9 million cumulative shortfalls, and conclude that non-ASER drivers created the shortfalls on the deal. Such conclusion should anticipate shortfalls priority at liquidation. All those data points are peppered throughout deal reporting, requiring some sleuthing. In addition, some PSAs may have provisions that de-prioritize some components of NRA-driven shortfalls, similar to ASER, further complicating liquidation waterfall projections.

All told, Investors no longer can rely only on loans' "total exposures" as a reasonable base case for liquidation expense projections.[3] The shortfall prioritization nuances, as well as any unexpected holdbacks, are creating large differences between actual liquidation expenses and what total exposures predict.

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

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