# CMBS MASTERMINDS

## WEBINAR

**June 2023**

Presented by:

**1st Service Solutions**

1ST SERVICE SOLUTIONS®

# Speakers

**Stephanie Whittington**

SVP of Operations

**Ann Hambly**

Founder and CEO

**Douglas Scott**

Senior Director of Workouts

# Today's Guest Speaker

CBRE

**Greg Greene**

Executive Vice President

1ST SERVICE SOLUTIONS®

# The Office Capital Markets Today

CBRE

Greg Greene
Executive Vice President
Debt & Structured Finance

JUNE 2023

# Today's Topics

Human Nature

The Office Capital Markets

Office Leasing

Interest Rates

# Human Nature

01

# *Human Nature Told Us:*

### 2016 to 2021

Bricks and mortar retail is dead, killed by a conspiracy between the internet and Amazon.

### 2019

Hospitality real estate is dead, especially major convention hotels, killed by COVID 19.

### 2010

The beaches of the U.S. gulf coast are uninhabitable for perhaps a decade, destroyed by the BP oil spill.

*"Abnormally good or abnormally bad conditions do not last forever. This is true of general business but of particular industries as well. Corrective forces are usually set in motion which tend to restore profits where they have disappeared, or to reduce them where they are excessive in relation to capital."*

*Benjamin Graham, mentor to Warren Buffet*

# Today’s Office Capital Markets

02

# *The Office Capital Markets - Equity*

OBSERVATIONS

- Office values have fallen by an average of 30% from pre-Covid values. *(Real Estate Alert 5/30/23)*
- Peak to trough, office values are expected to fall by 34% before beginning to recover in 2024/2025 *(CBRE Research Q1 2023)*
- Price discovery is underway and difficult due to the small number of office transactions in the past 12 months
- The AA and A properties have held their values as tenants use office space as a recruiting and retention tool. Rents for these buildings actually increased 2.4% in 2022. *(CBRE Research Q1 2023)*
- Vacancy is 17.8% at the end of Q1 2023, the highest rate in 30 years *(CBRE Research Q1 2023)*
- All - cash buyers are becoming more prevalent

# Americas Investment Volume

## Q1 2023 vs Q1 2022

▼ 56%
Total Market Volume

▼ **71%**
Office Market Volume

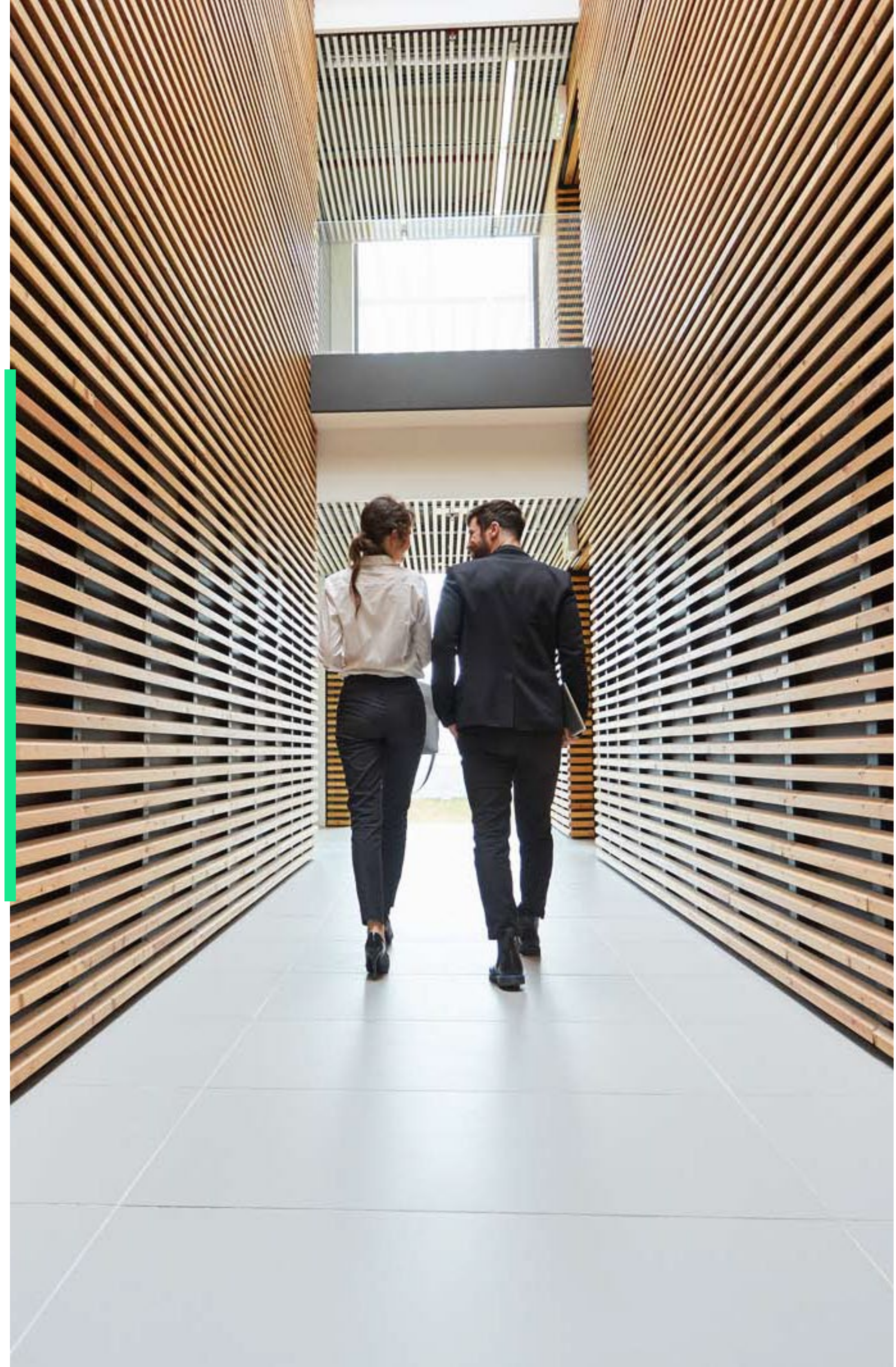
▼ 49%
Industrial Market Volume

▼ 32%
Retail Market Volume

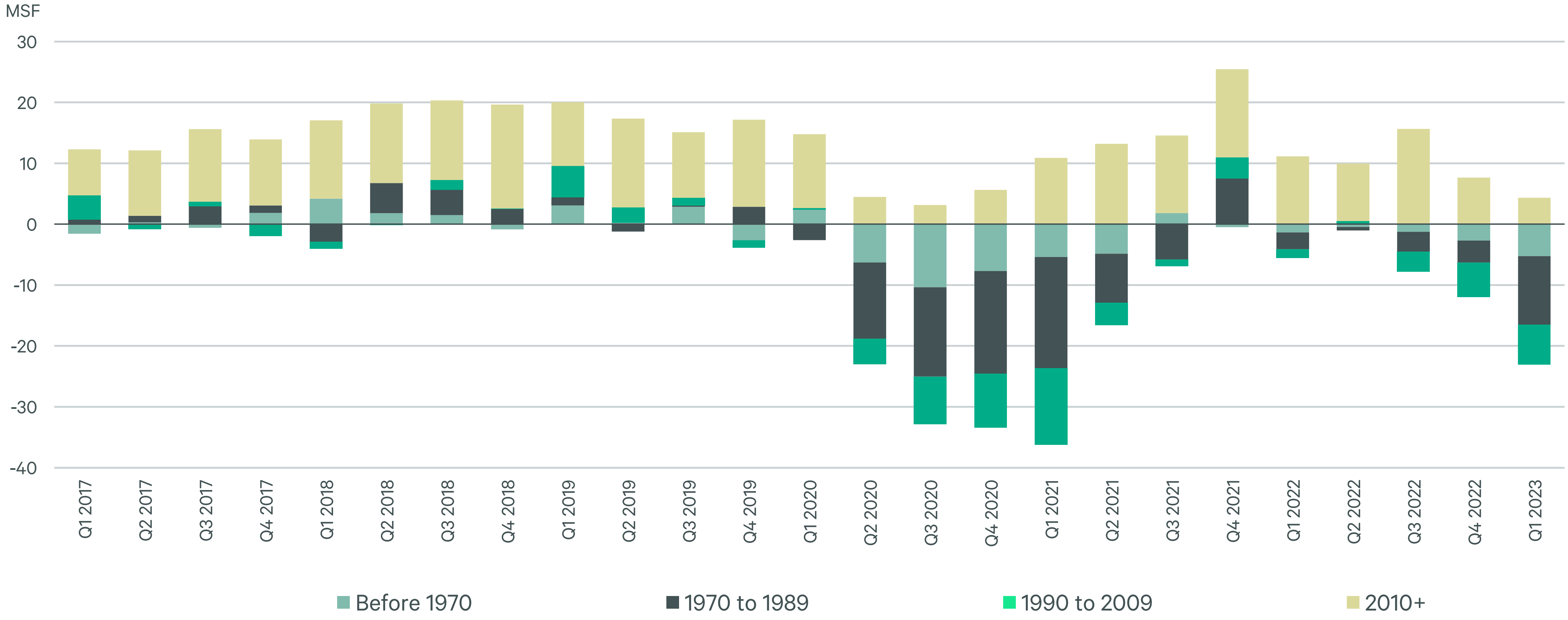
▼ 64%
Multifamily Market Volume

▼ 50%
Hotel Market Volume

Source: CBRE Research, Q1 2023

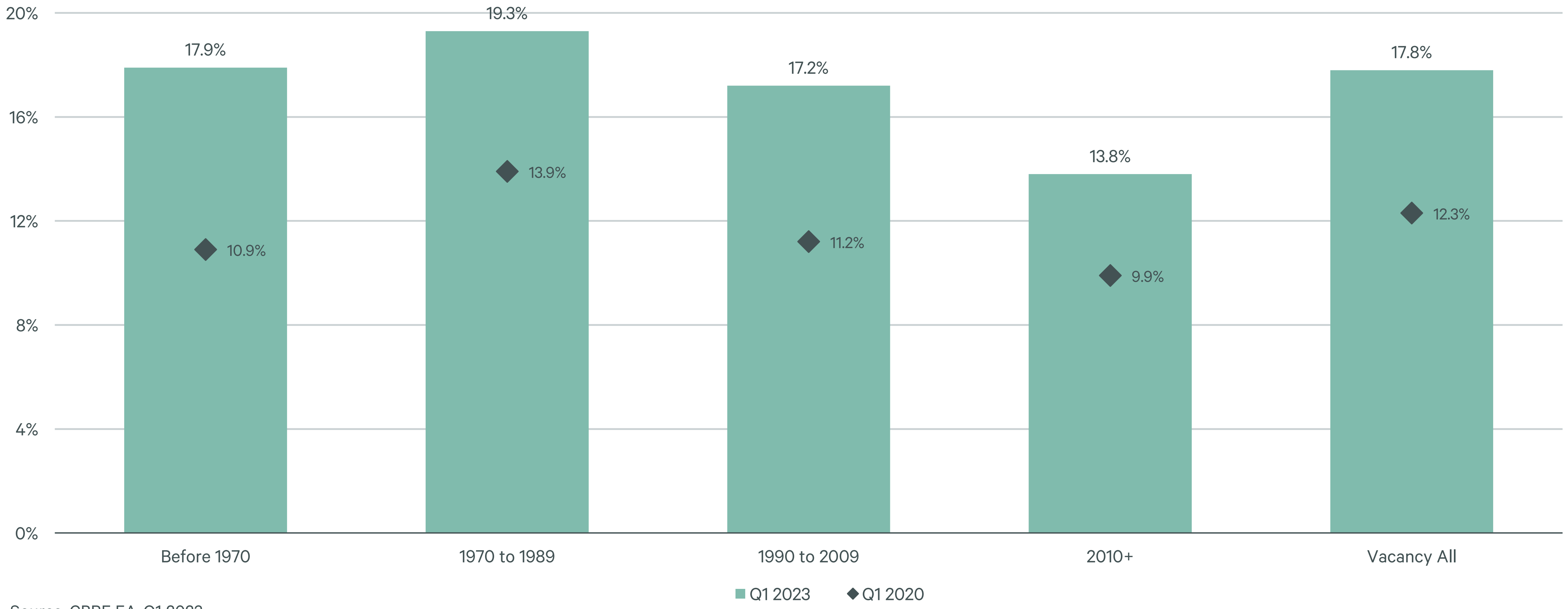


# *Demand for Modern Space Remains Positive*




Source: CBRE EA, Q1 2023.

# *Vacancy Rate by Building Vintage Highlights Preference for Modern Buildings*




Source: CBRE EA, Q1 2023.

# Office Hardest Hit Buildings

HHBs

**CBRE estimates that if no widespread action is taken to remove, revive or repurpose existing HHBs, they will push the long-term U.S. structural vacancy rate to 14.5% from 12%, creating an additional 103 million sq. ft. of vacant space**

10% of all office buildings in each market accounted for 80% of total occupancy loss by square footage between Q1 2020 and Q4 2022

The majority of HHBs were built between 1980 and 2009

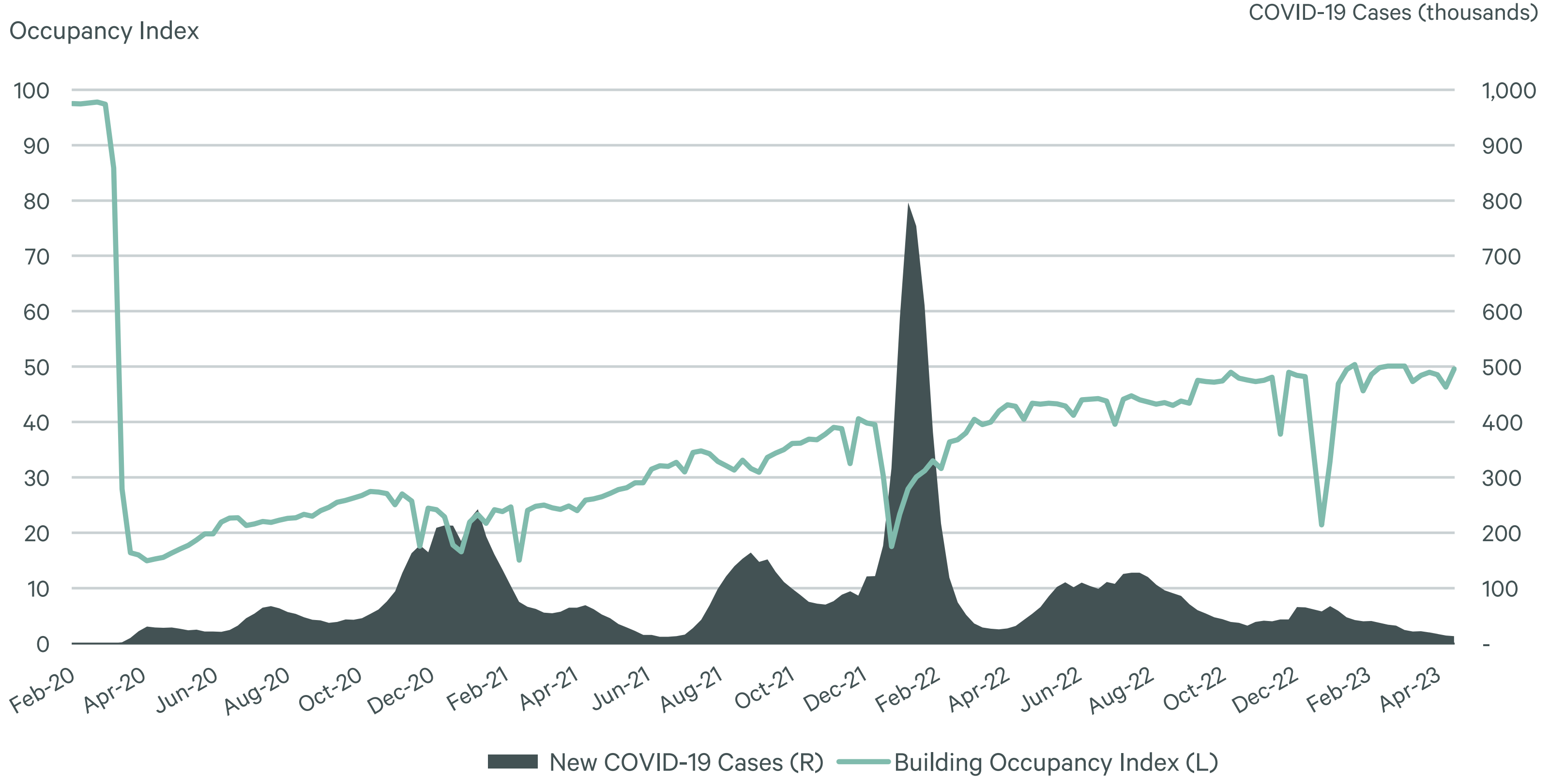
Downtown markets have a higher share of HHBs, largely due to higher crime rates

San Francisco

# *Office Utilization Settles Near 50%*

The barometer reflects swipes of Kastle access controls from the top 10 cities, averaged weekly. It summarizes recent weekday building access activity among business partners, not a national statistical sample. Percentages reflect user entries relative to a pre-COVID baseline.

## Office Occupancy Index vs COVID Cases----Is This the “New Normal”?



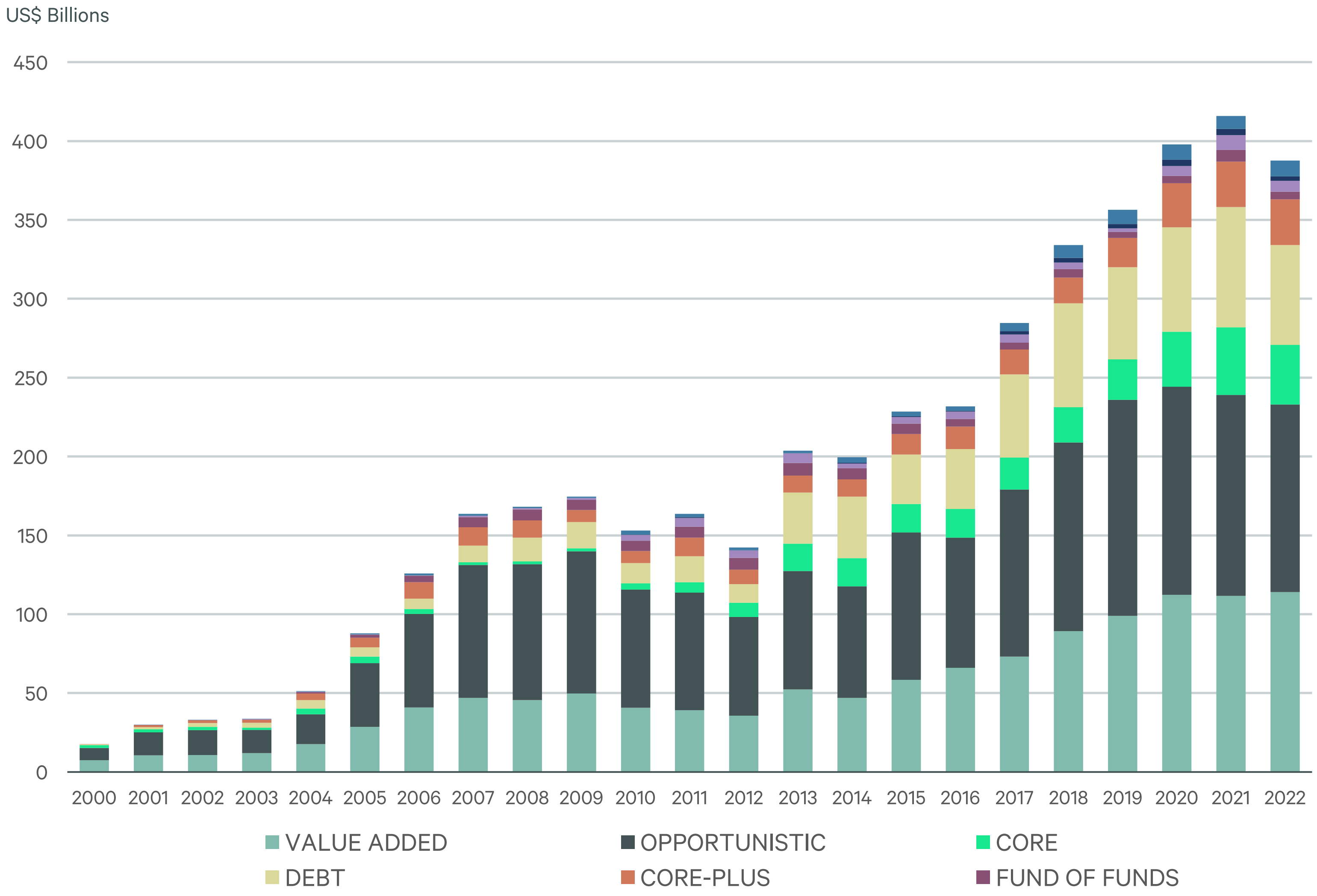

Source: CDC, Kastle Systems, April 2023.

Occupancy is indexed (Feb 2020 = 100)

# *Investors Possess Ample Capital Available for Deployment*

While the amount of dry powder available in 2022 fell from 2021 levels, investors with value added and opportunistic strategies still possess ample capital for deployment.

Global real estate dry powder by strategy, US$ billions




Source: Preqin, CBRE Research, Q4 2022.

# *The Office Capital Markets - Debt*

## OBSERVATIONS

- It is very difficult to finance an office building today
- Seller financing is likely to become more prevalent
- The great majority of lenders do not want the property back
- Look for the return of extend and pretend

### COMMERCIAL BANKS

Very reluctant to lend on office due to: (1.) Federal or internal mandates (2.) Concerns over their own balance sheets and liquidity (3.) Existing office loan exposure (4.) Headline risk

### CMBS

Can make office loans, but limiting office to 20% of total loan pools

### DEBT FUNDS

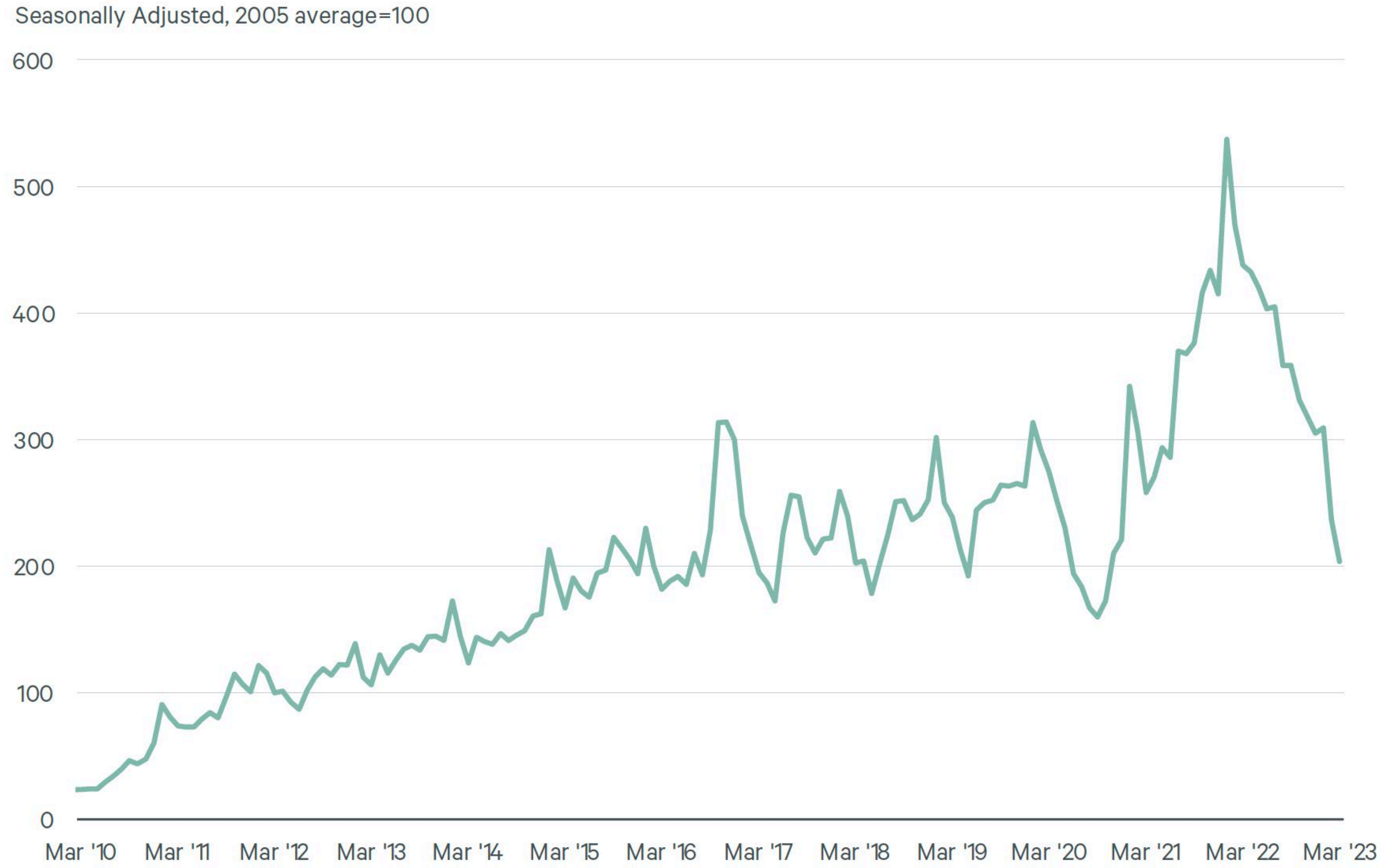
Reluctant to lend due to: (1.) Concerns over existing office loan exposure (2.) Difficulty obtaining an A note on an office deal (3.) CLO issuance difficulties

### LIFE COS

Reluctant to lend on office due to: (1.) Concerns over existing office loan exposure (2.) Relative risk to A rated corporate bonds

# *Lending Momentum Index falls in Q1*

- Total loan closing fell in Q1. Lending Momentum index ended March with a value of 204, one-third below its December closing value of 305.
- Compared with the strong loan volume of a year earlier, the index was down by 53.5%.
- The CBRE Lending Momentum Index tracks loans originated or brokered by CBRE, Capital Markets. The Index has a base value of 100, which represents average activity for 2005.




Source: CBRE Capital Markets and CBRE Research, Q1 2023.

# *Falling Values and Tighter Lending Impacts Investors*

Figure 1: Annual Baseline Value Index

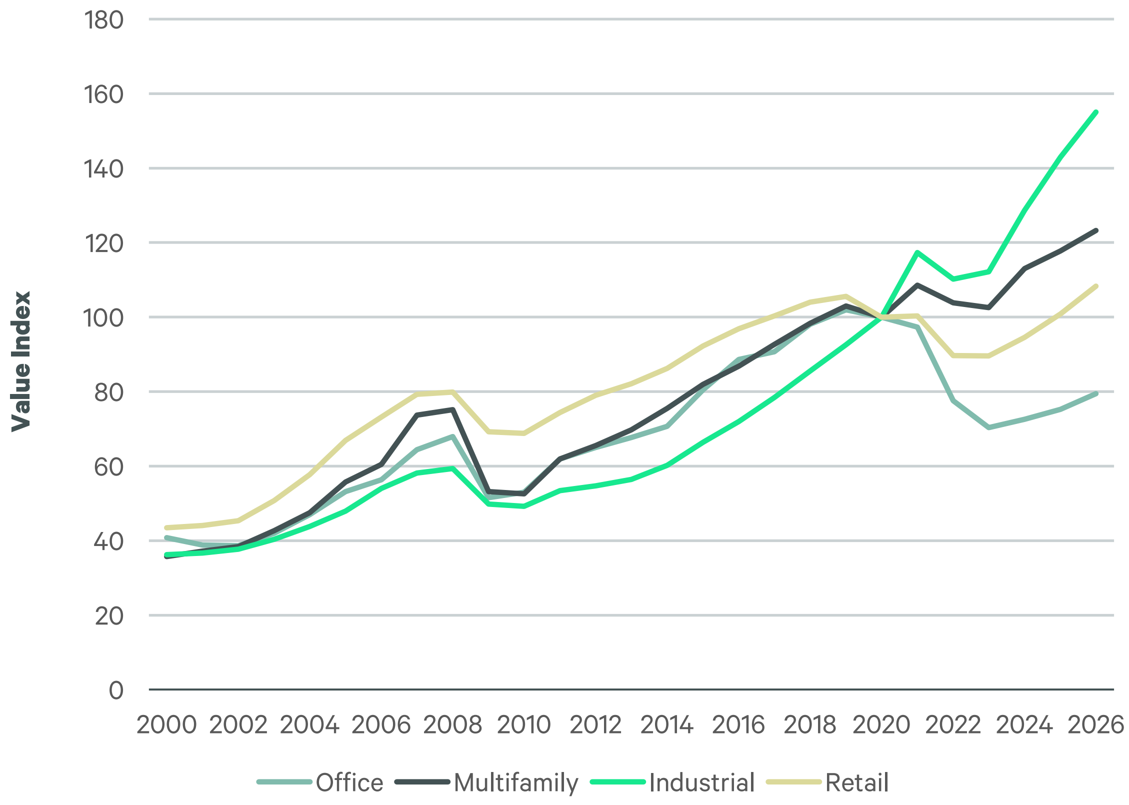
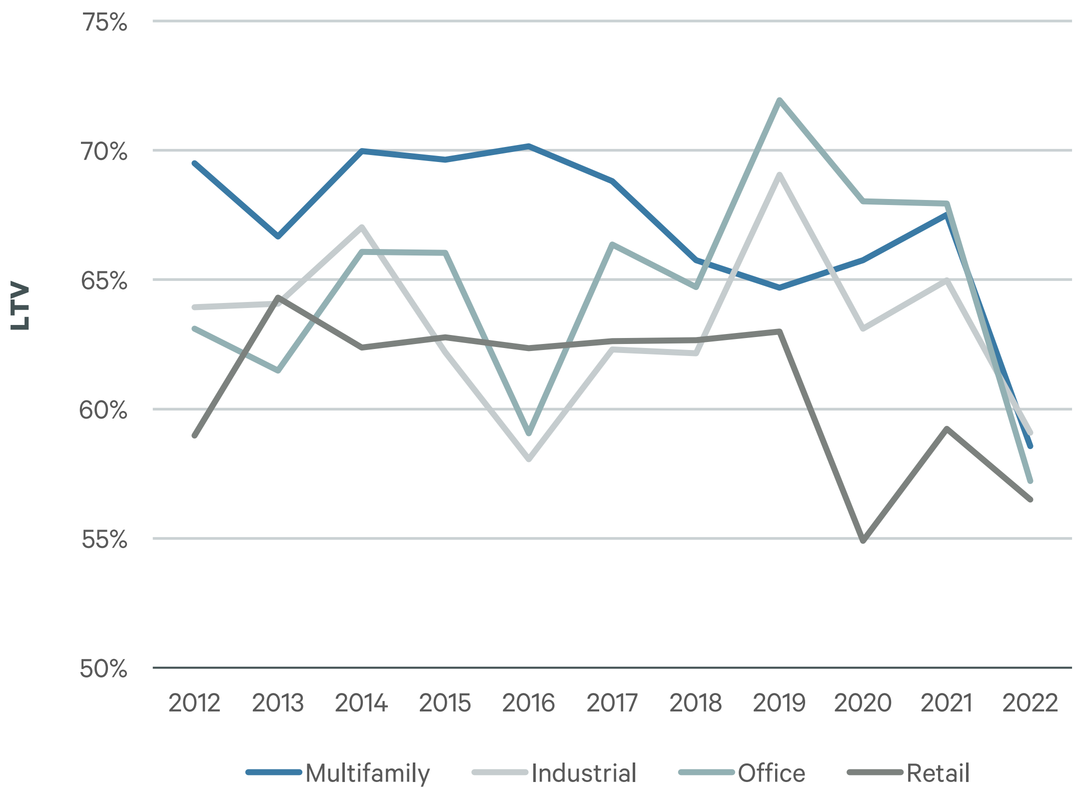


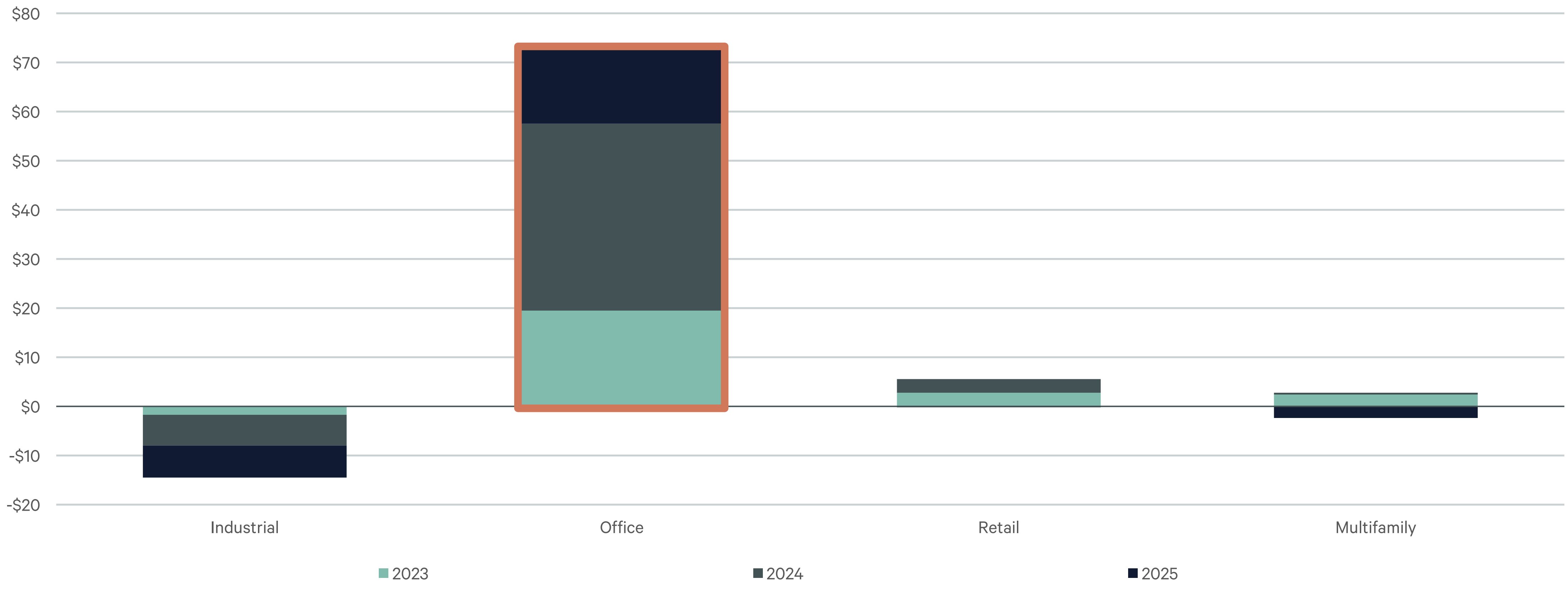

Figure 2: Annual Average LTV




CBRE Econometric Advisors

# *Office Sector Faces Large Cumulative Funding Gap*

Figure 6: Debt-Funding Gap by Maturity Year by Sector ($ Billions) 5-year loans originated in 2018, 2019, 2020



# Office Situation on Par with GFC

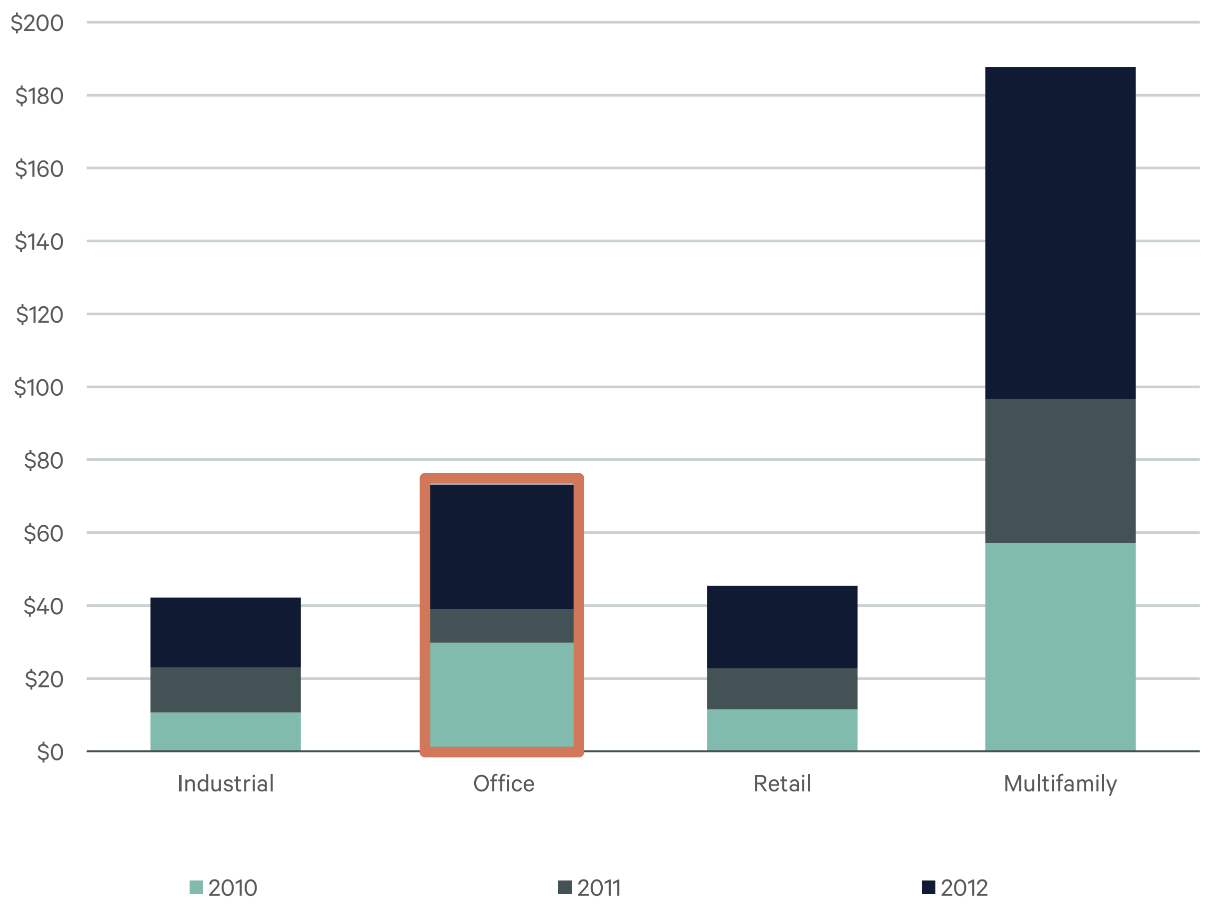



Figure 7: 2019 Debt-Funding Gap by Maturity Year by Sector ($ Billions): 5-year loans originated in 2005, 2006, 2007

# Office Leasing

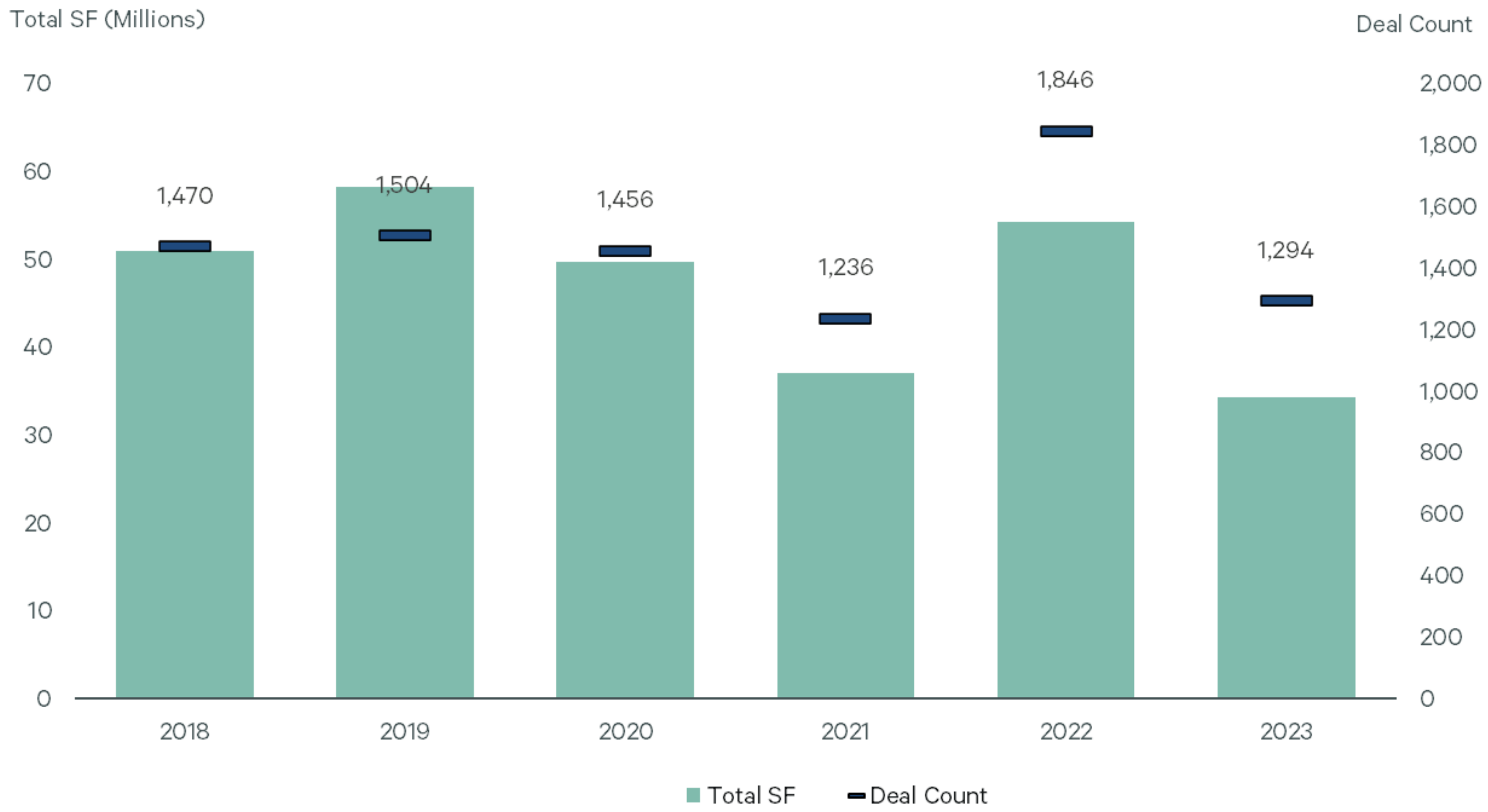
03

# *Tenants Are Signing Smaller and Fewer Leases Amid Lower Utilization*

- Total leasing volume (square footage) in Q1 2023 was down by **37%** from the pre-pandemic average.
- The number of leases in Q1 2023 was **13%** lower than the pre-pandemic (2018/2019) average.
- **The average lease size in Q1 2023 was 26,470 SF, down 28% from the pre-pandemic average.**

**Q1 Leasing Volume vs Deal Count, 2019-2023***

Consists of new leases and renewals




*Leasing data through Q1 of each year.

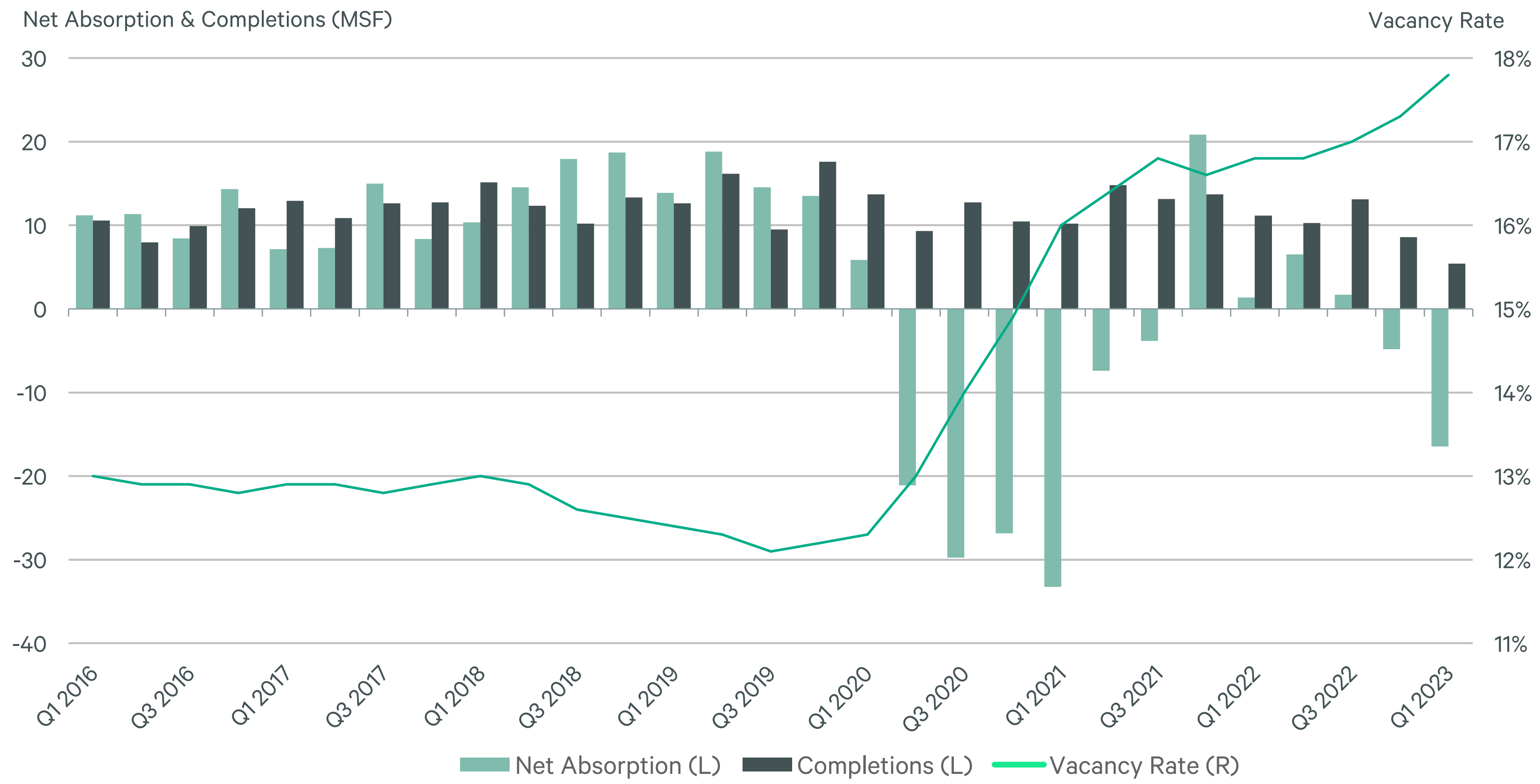
Source: CBRE Research, Q1 2023.

# *Demand Further Weakens in Q1*

U.S. Office Trends

- Q1 2023 net absorption of -16.5 million SF marked the weakest quarter for office demand in two years.
- The 5.4 million SF of new supply outpaced demand in Q1. The imbalance lifted the vacancy rate by 50 basis points quarter-over-quarter to 17.8%, the highest rate in 30 years.

## U.S. Office Supply & Demand

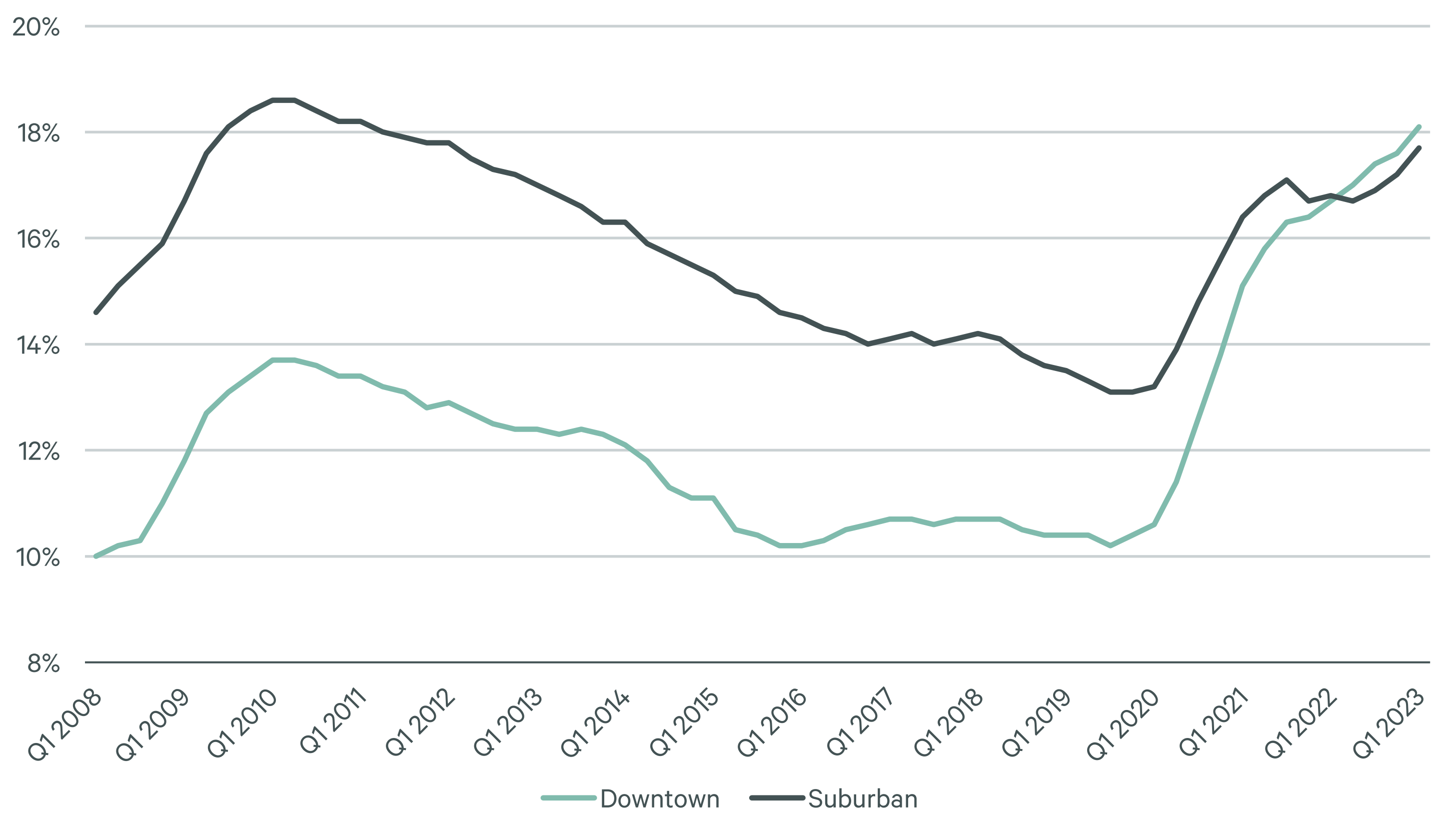



Source: CBRE EA, Q1 2023.

# *Downtown Vacancy Remains Above Suburban Rate*

- Downtown and Suburban vacancy increased by 50 basis points quarter-over-quarter to 18.1% and 17.7%, respectively.

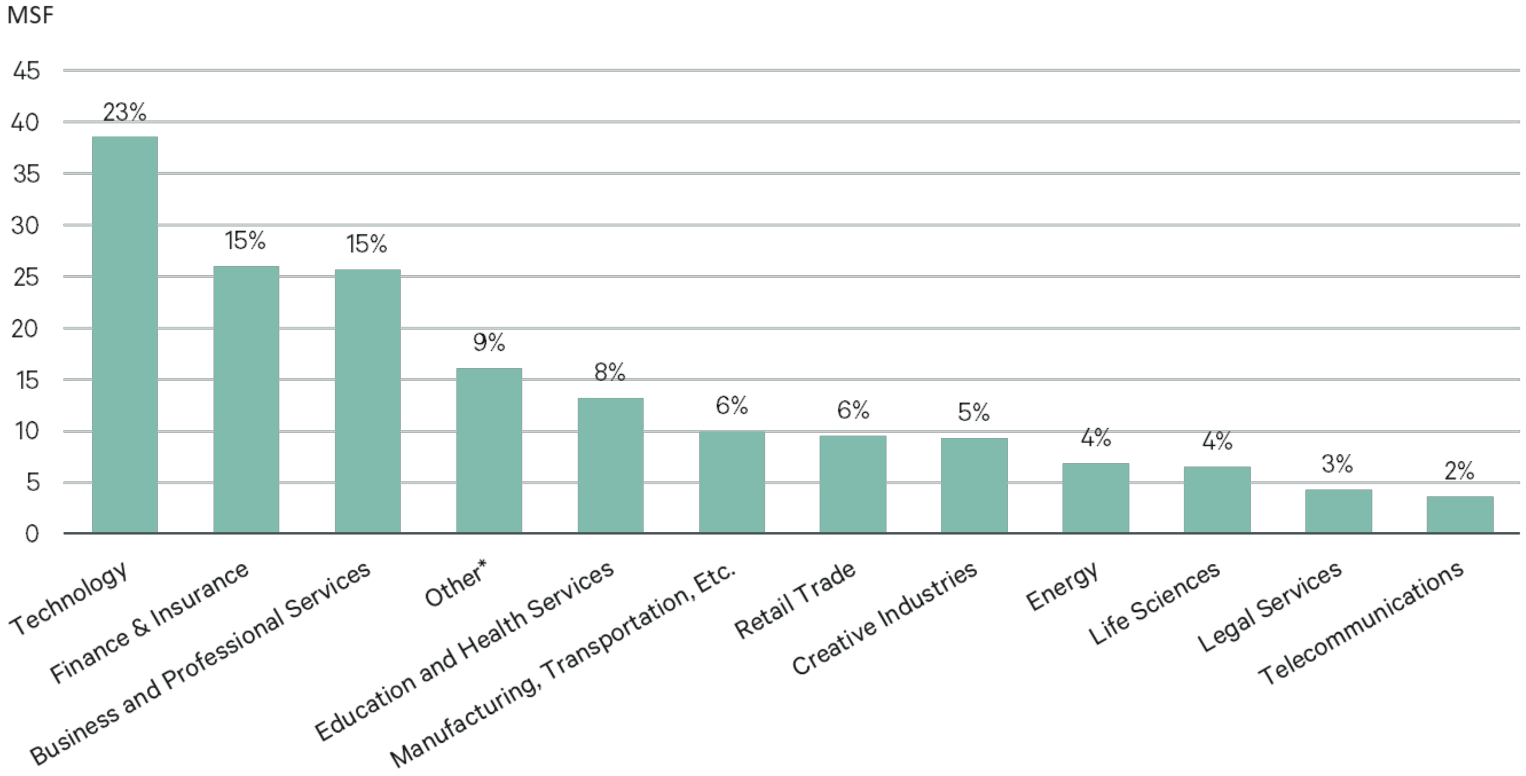
## Office Vacancy Rates




Source: CBRE EA, Q1 2023.

# *U.S. Office Sublease Availability by Industry*

- **Tech space makes up the most sublease availability of any sector, comprising 23% of all subleases on the market.**
- Finance & Insurance and Business and Professional Services follow, each making up 15% of all sublease availabilities.
- All other sectors make up 9% or less of total availabilities.

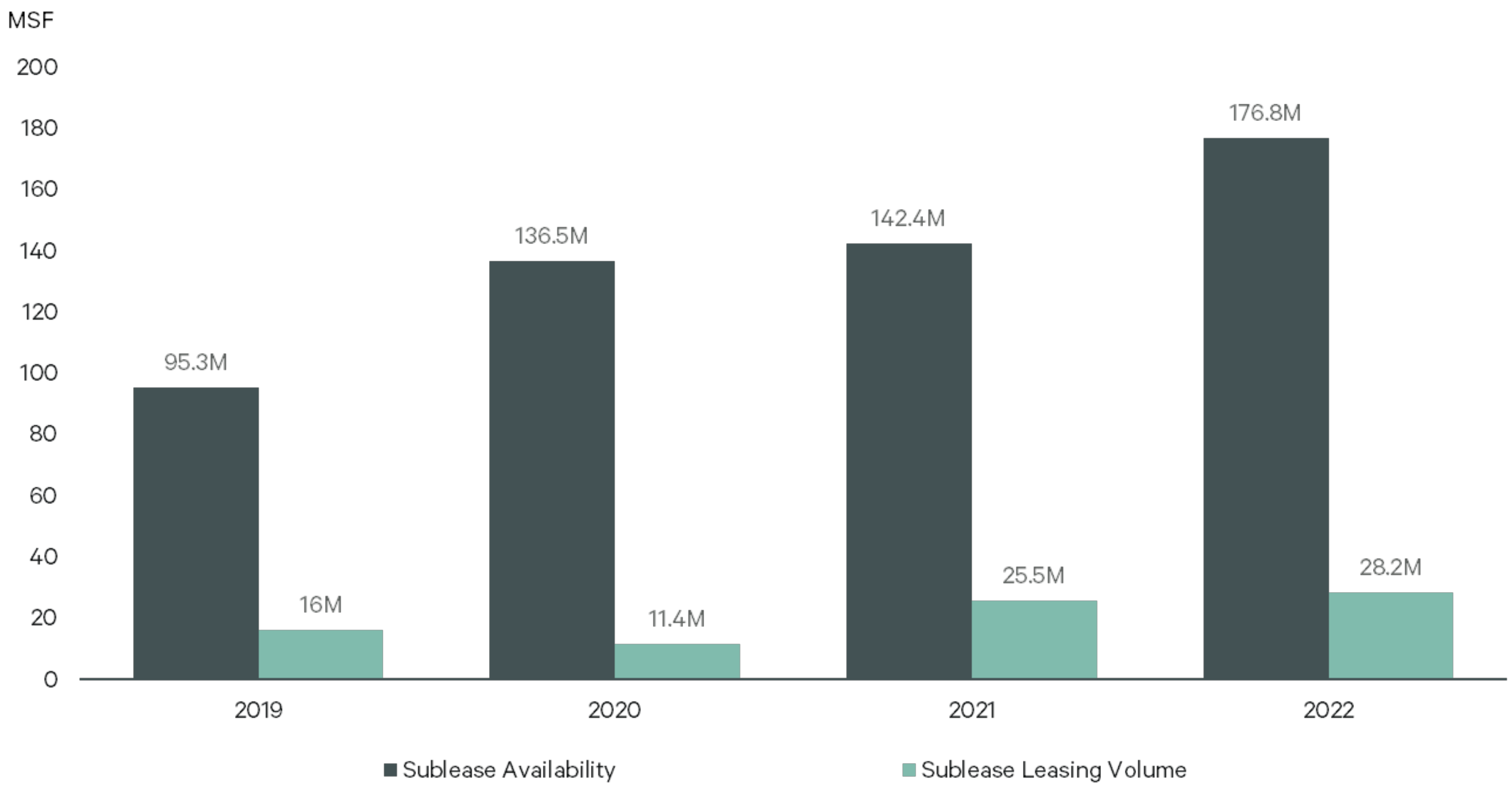



*Other includes Leisure & Hospitality, Government & Non-Profits and Aerospace/Defense, and Unknown Tenants

Source: CBRE Research, February 2023

# *Sublease Availability vs. Sublease Leasing Activity*

- While subleasing activity has increased modestly since 2020, it has not kept pace with additional sublease availability added to the market.
- Local market data / insights point to a 20-40% asking rent discount for sublease space compared to direct space, varying by market, class, and remaining term.



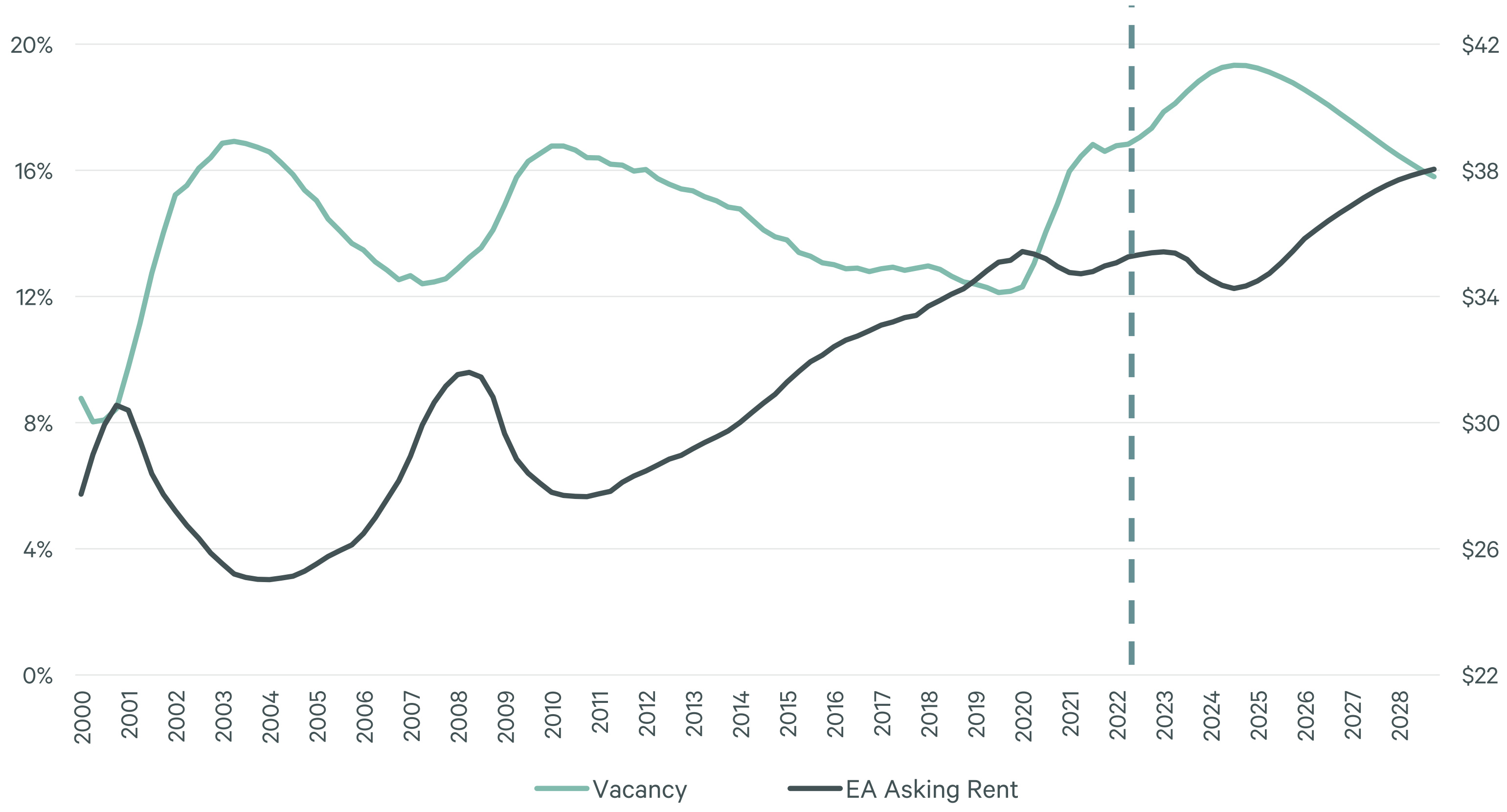

Source: CBRE Research, February 2023, CBRE Econometric Advisors, Q1 2023.

Note: Subleasing activity consists of deals over 10,000 SF

# The EA Baseline Forecast

- Asking rents fall 2.6%, cumulatively (peak to trough). Trough is in Q1 2025.
- **Vacancy peaks at 19.3% in Q3 2024.**
- Both vacancy and rent growth have been revised downward due to a weakening macroeconomic backdrop and the continued rightsizing of occupiers.
- The economic recovery, and associated job growth, will rebalance markets beginning in 2025.
- **Full recovery to pre-pandemic rent levels will occur by Q3 2025.**

## Office Vacancy & Rent Forecast

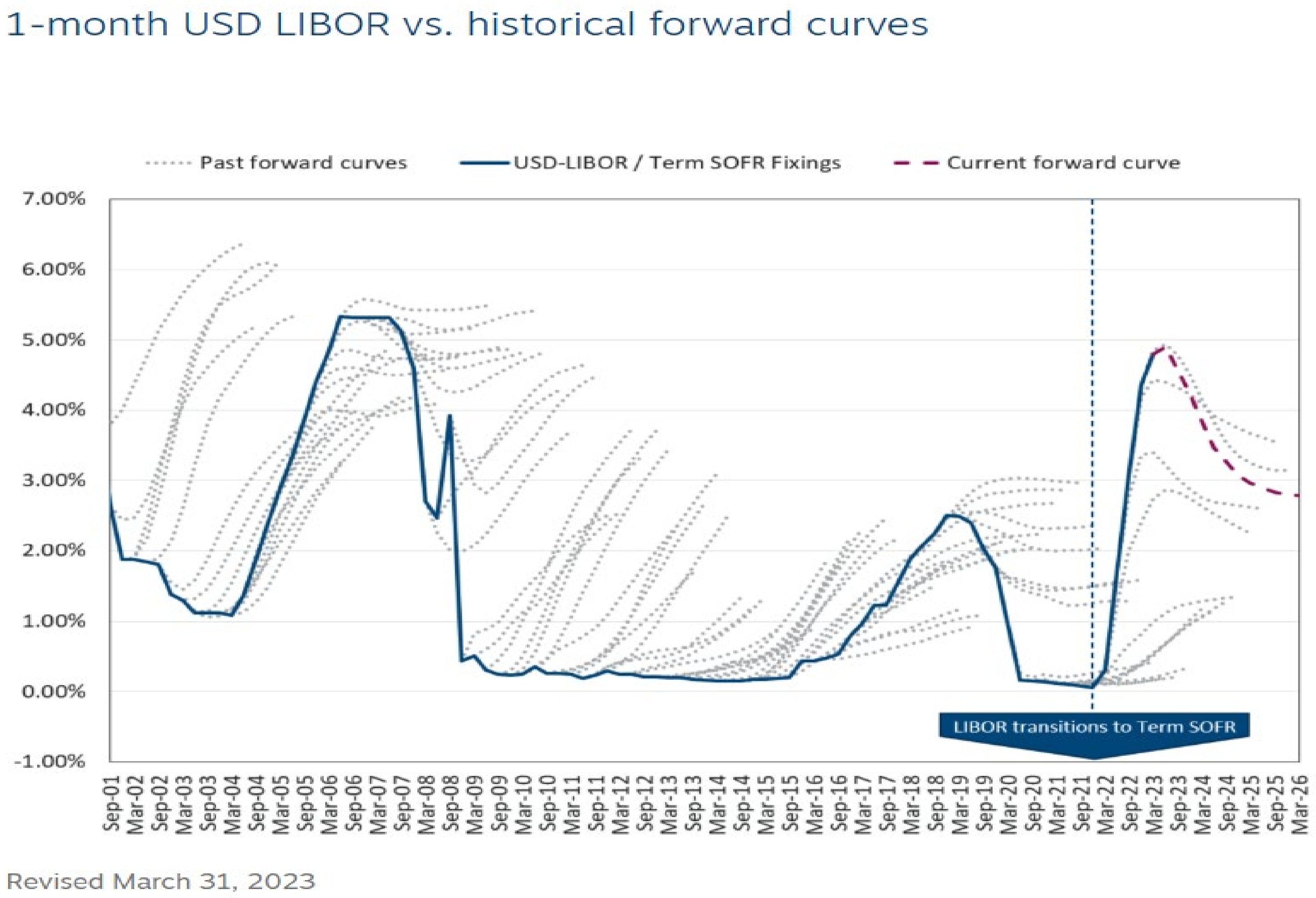



Source: CBRE Econometric Advisors, Preliminary data Q1 2023.

# Interest Rates

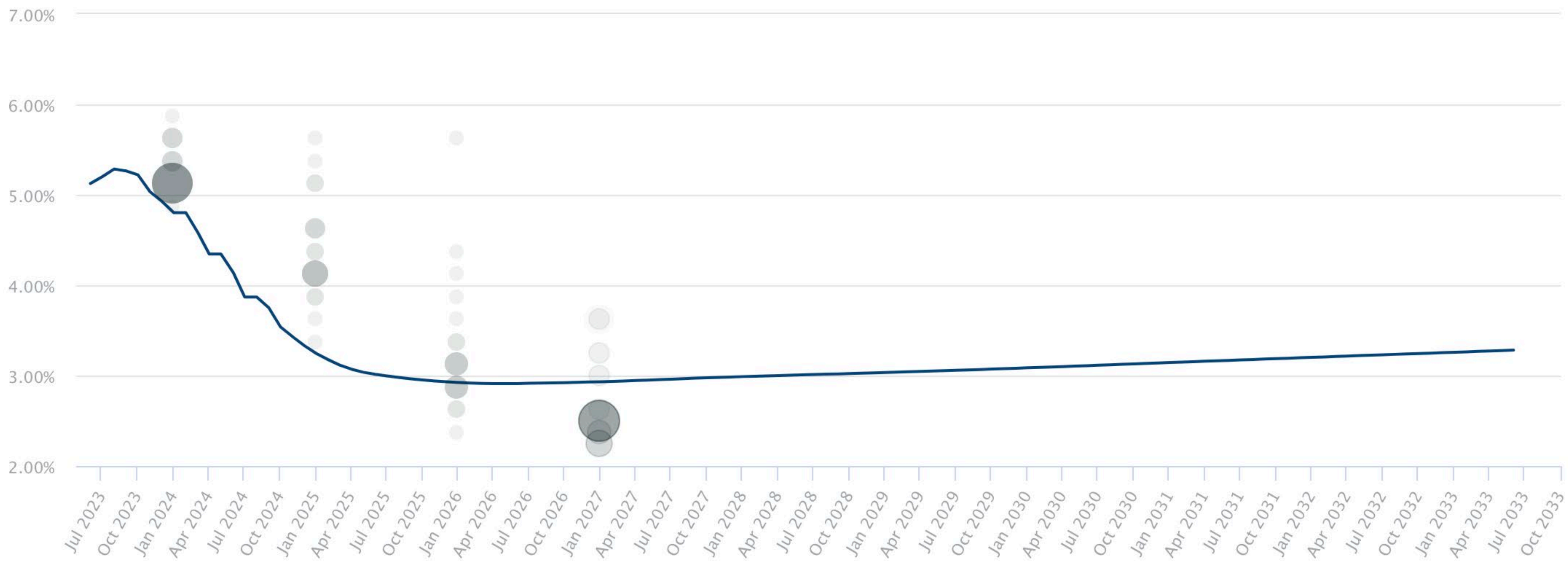
04

# The "Hairy" Graph



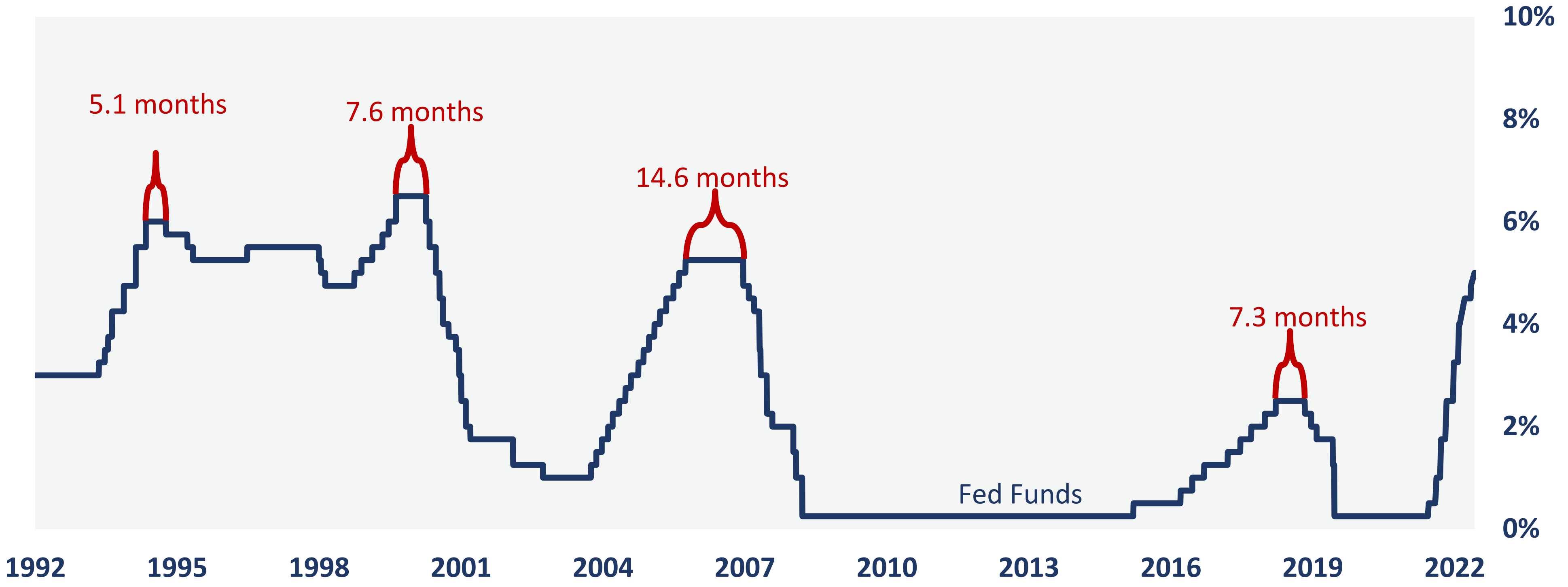

Source: Chatham Financial

# *1 Month Term SOFR Forward Curve & US Fed Dot Plot*




Source: Chatham Financial

# *Fed Pause-to-Cut Timing*




Source: Pensford, Q1 2023

# Conclusions

1. The “back to the office” question remains unanswered and will continue to weigh on leasing, buying and lending decisions.

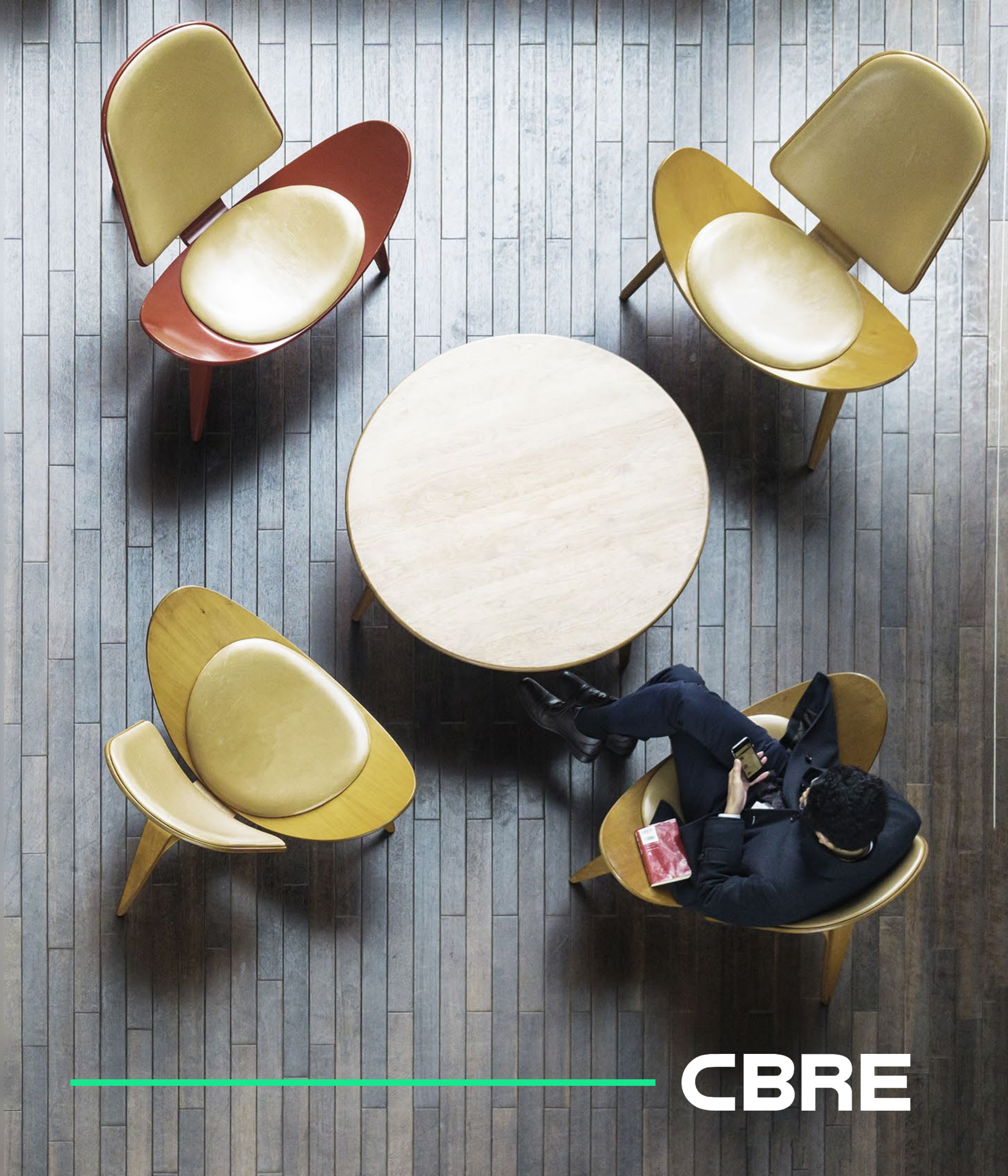
2. Office leasing will remain challenging through 2024 and begin to improve in 2025 after a 34% drop in valuations peak to trough.

3. The AA and A buildings will continue to thrive as tenants use their office space as a weapon.

4. The near-term arrival of terminal rates will make it easier for buyers and lenders to underwrite opportunities.

5. This environment will prove both a challenge and an opportunity creating both winners and losers.

# Questions

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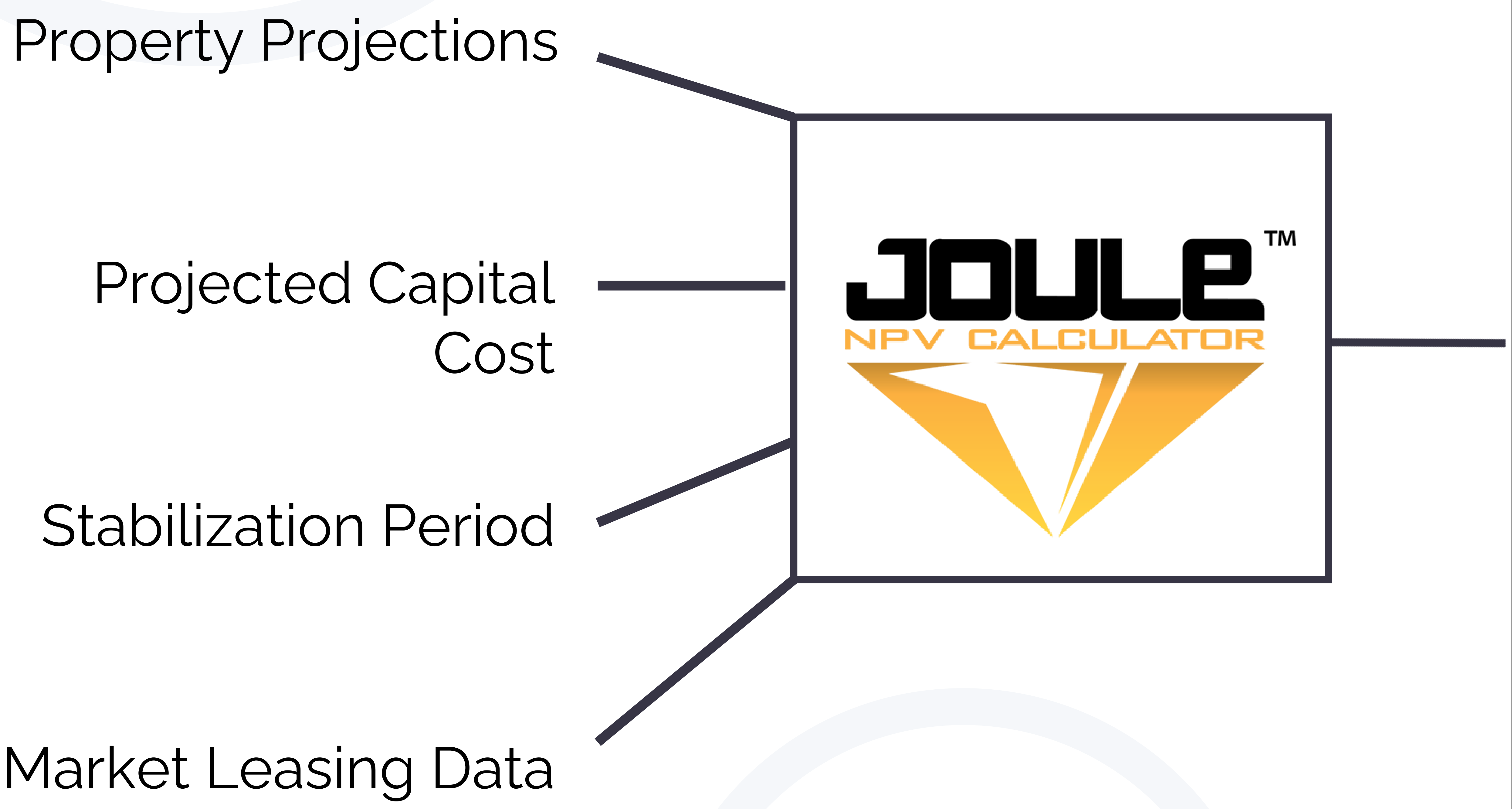
# Option Analysis




Summary - 9% Cap Rate

| | 10% At Close | | | |
|---|---|---|---|---|
| A-Note Amt | $40,000,000 | $50,000,000 | $60,000,000 | $70,000,000 |
| B-Note Amt | $45,200,000 | $35,200,000 | $25,200,000 | $15,200,000 |
| Total (UPB) | $85,200,000 | $85,200,000 | $85,200,000 | $85,200,000 |
| Projected Capex + Leasing | $24,800,000 | $24,800,000 | $24,800,000 | $24,800,000 |
| Exit Date | Dec-26 | Dec-26 | Dec-26 | Dec-26 |
| Exit Cap | 9.0% | 9.0% | 9.0% | 9.0% |
| Exit Value | $147,400,000 | $147,400,000 | $147,400,000 | $147,400,000 |
| Exit Value/SF | $165 | $165 | $165 | $165 |
| Bwr Fees at Mod Close | $1,000,000 | $1,200,000 | $1,400,000 | $1,600,000 |
| Bwr Invest at Mod Close | $4,000,000 | $5,000,000 | $6,000,000 | $7,000,000 |
| Bwr Contrib During Term | $0 | $0 | $60,000 | $1,780,000 |
| Bwr Total Contrib | $5,000,000 | $6,200,000 | $7,500,000 | $10,400,000 |
| Pref Return | 15.0% | 15.0% | 15.0% | 15.0% |
| Bwr Pref Return | $6,400,000 | $8,000,000 | $9,700,000 | $13,200,000 |
| Bwr B-Note Proceeds | $53,300,000 | $46,200,000 | $43,700,000 | $42,900,000 |
| Bwr Sale Proceeds | **$59,700,000** | **$54,200,000** | **$53,400,000** | **$56,100,000** |
| Remaining B Balance | $8,330,000 | $1,810,000 | $0 | $0 |
| Mezz Balance | $23,600,000 | $23,600,000 | $23,600,000 | $23,600,000 |
| Final Bwr Proceeds | **$27,800,000** | **$28,800,000** | **$29,800,000** | **$32,500,000** |
| New Money Mult | **5.58** | **4.66** | **4.01** | **3.14** |
| Bwr IRR | **53.7%** | **46.9%** | **41.7%** | **36.9%** |
| B Lender Whole? | **Yes** | **Yes** | **Yes** | **Yes** |
| Mezz Lender Whole? | **Yes** | **Yes** | **Yes** | **Yes** |

# 7 Possible Options

1. Keep Loan Current
2. Sell the Property
3. Extension
4. A/B Structure
5. Future Discounted Pay Off (DPO)
6. Discounted Pay Off (DPO)
7. Hand Back the Property

# 1. Keep Current

- Loan to remain “as-is”
- Wait and attempt to ride out the current market conditions
- Keep loan current, even if property income is not sufficient to cover debt service and operating expenses

# 2. Sell The Property

LTV < 100%

1. Assume
2. Extend Maturity

LTV > 100%

1. Short Sale
2. DPO
3. Pay Down/Write Down

# 3. Extension

How much time can be granted?

What are the potential fees?

What is required of the Borrower?

# 4. Sample A/B Structure

**A = (as is) Appraisal Amount**

Payments made on A note can be I/O or amortizing

Also can be reduced interest rate

**Capital = Borrower** (or capital partner) provides TI-LC and all capital needs

New capital can earn pref

**B Note = Hope Note**

Difference between A note and total loan

Maturity date can be extended

# Liquidation Event

1. A note payoff
2. Capital + Pref
3. Split of remainder until B note is paid off
4. Remainder of B note is written off

# 5. Future Discounted Payoff (DPO)

- Property is under water today
- Little to no value will be recovered by maturity date
- Property is currently cash flowing
- Agree to formula for DPO at maturity
    - Borrower Appraisal
    - Lender Appraisal
    - 10%

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# 6. Discounted Payoff (DPO)

- Property is under water today
- Little to no value will be recovered by maturity date
- Can be executed through:
  - Short Sale
  - Note Sale
  - Discounted Payoff

# 7. Hand Back The Property

- CMBS is Non-Recourse
  - Beware of carve out guarantee
- The Borrower has the option to hand the property back to the Lender
- Another option:
  - Connect you with capital providers
  - Work with the owner and servicer to work out a deal off market
    - Benefits:
      - No foreclosure on record
      - No further liability

# Why **1st Service Solutions?**

**1st Service Solutions is a team of people who were former servicers, or even CEO's & Managers of Special Servicing Shops.**

*We have relationships with decision makers within servicing, know the rulebook of CMBS, have sat on credit committees and apply all of that inside knowledge to help you achieve your goals. Our CEO was a CEO of various large servicing companies.*

"Ann Hambly knows the CMBS rules, structure and players as well as anyone I know. She has been a part of setting industry guidelines from the very beginning of CMBS. That knowledge is the key to being a successful borrower advocate."

**Pat Sargent**
*Partner, Alston & Bird LLP*

"Our $1.2Billion transaction would not have closed without 1st Service Solutions."

**Joe Dykstra**
*Westwood Financial Corp*


"Ann Hambly is one of a kind. She is the preeminent expert on CMBS servicing and is so much more than that."

**Ethan Penner "Godfather of CMBS"**
*Managing Partner, Mosaic Real Estate Credit*

# CONTACT INFORMATION

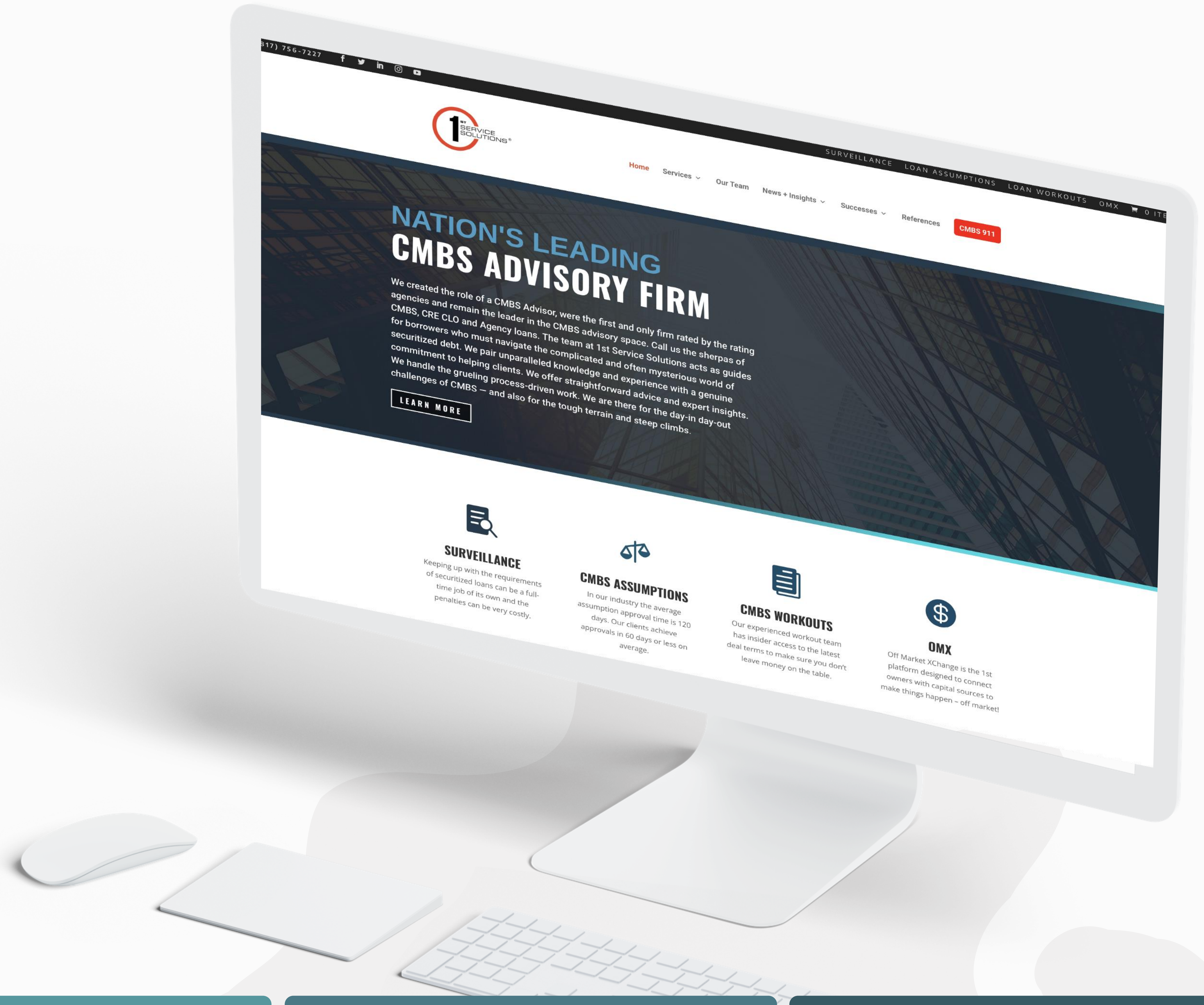
## 1st Service Solutions

1ST SERVICE SOLUTIONS®

1stsss.com
(817) 756-7227

### #1 Borrower Advocate

We created the role of a CMBS Advisor, we're the first and only firm rated by the rating agencies and remain the leader in the CMBS advisory space.




| | | | | |
|---|---|---|---|---|
| $30 Billion<br>**RESTRUCTURES**<br>WORKED OUT | 3,200<br>**ASSUMPTIONS**<br>CLOSED | 42 Days<br>**FASTEST**<br>ASSUMPTION CLOSED | 50 States<br>**PROPERTIES**<br>WORKED ON | 80%<br>**REPEAT BUSINESS**<br>FROM SATISFIED CUSTOMERS |