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Office Meltdown Part I—Top CRE Landlords Continue to Return the Keys in the Ongoing Crisis in the CMBS Market: Interview with CMBS Hedge Fund Polpo Capital

By Peter Michael Allen

In August of 2022, *The Investment Lawyer* published "MBS Meltdown Imminent (Again) and CLO Bubble: Hedge Funds Short on Malls' CMBS Bonds Just the Beginning of Signs of Distress as the End of the "Easy Money" Era Will Add Pressure to the CMBS and CLO Bubbles."[1] In this article, the first of a two part series, we continue with the ongoing crisis in the commercial mortgage-backed securities (CMBS) market post pandemic. In the July issue, we will continue our coverage of this topic in Part II.

For this article we interviewed Daniel McNamara, founder and chief investment officer of Polpo Capital, a hedge fund focused on long and short investments related to CMBS. McNamara expects offices to be at the "center of distress" for the next few years. Previously, McNamara was part of the Big Short 2.0 by shorting several shopping malls via credit default swaps shorting the CMBX 6 index. By May of 2020, one of the hedge funds McNamara managed had a net return of approximately 120 percent to investors.

As we indicated in August 2022, top tier commercial real estate (CRE) asset managers such as BlackRock and Brookfield have been giving up on properties, defaulting, and returning the keys to properties to special servicers. In late March of this year, Brookfield, one of the largest real estate asset managers in the world, decided to return the keys on two large office buildings in Los Angeles with $784 million in CMBS bonds.[2] Brookfield determined it was more prudent to default and give up on the buildings rather than to try to refinance.[3] Offices are over 29 percent empty in San Francisco, about eight times more than before the pandemic.[4]

The office sector may collapse absent assistance from the federal government according to office industry backers.[5] Commercial real estate is at risk of crashing as residential real estate did in 2008 and 2009 say certain analysts.[6] Remote work has permanently substantially reduced the demand for office space according to several analysts.[7] In the past 12 months, values of office properties have decreased by 25 percent.[8]

A substantial portion of office towers in cities are worth less now than their mortgages, according to a recent report from Morningstar.[9] During the first two years of the pandemic from early 2020 through early 2022, lenders and borrowers in the office space typically agreed to extension deals and forbearance agreements, which resulted in $270 billion in commercial real estate debt being now scheduled to mature this year in 2023, an all-time record.[10]

As a sign of the pending distress in offices, some of the wealthiest owners of office buildings including

Black Rock have abandoned certain offices.[11] The high amount of maturing loans may cause heightened stress on regional banks, which provide most of the loans for commercial real estate.[12]

With borrowing costs increasing and remote work making many office properties obsolete with downtown offices in Manhattan and San Francisco half empty, wealthy landlords are returning the keys on many of these office properties.[13] For institutional investors such as private equity and hedge funds, defaulting on CMBS bonds can be a strategy to initiate debt restructuring since sponsors with CMBS need to technically default on the bonds in order to renegotiate terms.[14]

CMBS bonds are nonrecourse against the sponsor meaning borrowers can return the keys and walk away and creditors are unable to foreclose on the assets the borrowers own.[15] A CMBS pool uses a special purpose entity (SPE) to be legally separate from the sponsors, which means the CMBS bonds are only secured by collateral that the SPE holds.[16]

The sponsors have been increasingly giving up on office buildings and returning the keys to the lenders. With top tier private equity sponsors giving up on office properties for strategic reasons rather than inability to pay this likely will lead to increasing distress and sizable re-pricing in office buildings.[17]

Prior to the COVID-19 pandemic, high quality office buildings were considered to be a very safe investment. However, the remote work trend brought on by the pandemic is completely reshaping the market for office properties.[18] Currently, the average office usage is about half of what it was prior to the pandemic.[19] In late February of this year, Columbia Property Trust, which is owned by Pacific Investment Management Co. (PIMCO), defaulted on about $1.7 billion of CMBS bonds on seven buildings in San Francisco, New York, Boston, and Jersey City, New Jersey.[20]

Big Short 2.0

Previously, in 2018, MP Securitized Credit Partners, the hedge fund at which McNamara was an investment manager, was part of the Big Short 2.0 when it took a $2 billion short position by shorting several shopping malls including Crystal Mall in Waterford, Connecticut.[21] McNamara and an analyst would take field trips to malls including Crystal Mall in Connecticut and Eastview Mall in New York State and several other malls to examine first hand for signs of distress.[22]

McNamara and analysts at MP Securities began visiting several malls in 2017. By February 2020, they determined that the timing was right to launch the "MP Opportunity Fund I," which was solely created to short the CMBX 6 index via credit default swaps.[23] The CMBX 6 index tracks the performance of 25 commercial mortgage-backed securities. CMBS 6 index has greater exposure to retail than other indices.[24]

Certain mutual funds had massive long positions in the CMBX 6, which was propping up the CMBX 6 index price despite the weakening fundamentals of retail properties. Carl Icahn's large short position in the CMBX 6 index along with the publicity of Icahn's short position led to increased shorting of the CMBX 6.[25] By May of 2020, the MP Opportunity Fund had a net return of approximately 120% to investors.[26]

As for the future of malls, McNamara and others believe that high quality Class A malls will survive. Mall owners Simon Property Group and Brookfield hold the greatest number of Class A malls and have been returning the keys on their lower quality malls.[27]

In our interview of McNamara, he stated that he views "offices as similar to retail. Class A offices will do fine like with Class A retail [while lower tier offices will struggle]."

Interview with Daniel McNamara, CIO and Founder of Polpo Capital

Allen: I am very interested in hearing your outlook on the CMBS market and what you think the possibilities are for the upcoming future in the next 3-5 years.

McNamara: I firmly believe that the CMBS market is going to be the heart of distress in the next year or two to say the least. 2022 was all about, in my opinion, was all about interest rates and us adjusting and markets adjusting to higher interest rates. But, I think 2023 for CMBS and commercial real estate in general is going to be about adjusting to this new dynamic, post-COVID world, whether it be first and foremost office but then what's going to happen with certain lower class retail or what is going to happen with hospitality and business travel. Obviously leisure is doing very well so from that perspective I think that we have 300 to 400 basis points higher interest rates and now we have all of these fundamental issues with offices I think being the most fundamentally challenged going forward.

Allen: There definitely are quite a few counterforces—delay, stalling tactics—"amend and pretend"—with malls.… It is my understanding that you're not in the short zone yet, you're waiting right?

McNamara: Yes, we do interest rate hedge our long security book, which consists mostly of interest only securities because they are the one security in CMBS that is going to benefit from this extend and pretend mentality. So you have these cash flows that may be modeled as a two or three year cash flow but it's going to end up being a three, four or five year cash flow because some of these higher LTV loans while they could be a good asset and a good sponsor if maturity hits next year, refinancing options in the CMBS market are very limited and almost basically shut off completely right now. The few deals that are being done are legacy deals that have been on the banks' books for a long time or some of the shadow banks in CRE CLOs. So from that perspective, I think that the interest only space is really interesting from a long [position]; but we do pair those things and hedge the market risk using CMBX.

For the most part we try to find different tranches and indices that are over exposed to office. But, we haven't seen anything like what we saw with CMBX 6, which was the regional mall short. At one point in just the CMBX 6 credit space like single As, triple Bs and double Bs, I believe there was something like 15 billion of open interest at one point. That doesn't exist anywhere to the extent, we're talking about a few billion of open interest across many series. So, I think that office in the last 1-2 years has been pretty telegraphed in the sense that we're going to have issues. The only question is how much. I guess it was a little bit similar but I think people are staying away from the office space right now and are just worried. You don't see many people pounding the table and saying I want to go long office here. So you don't have that dynamic, that technical in the CMBX market like you had with CMBX 6, a couple of years ago before COVID.

Allen: Could you be looking at purchasing more of the lower grade tranches of the CMBS with the aim of gaining control of the collateral later?

McNamara: Yes, while the interest only tranche doesn't have the potential for control, what we like to do in times of distress is purchase controlling class securities; the lower tranches, whatever is left remaining [with value] at the bottom of the deal. Right now, I think that we are in the early innings of distress. I don't think that the fundamentals have necessarily played out yet. So we think that the credit curve in CMBS has steepened dramatically for the year of 2022. But in reality, I think there is a ways to go at the bottom. That's why on the long side we are taking advantage of the "extend and pretend" and buying interest only securities that will extend with these loans at the detriment of the principal bonds. Because if you own a principal bond in a CMBS and it trades at a discount like everything does in our market and if it goes from a five-year bond to a six or seven-year bond due to extensions, your yield drops. The flipside to that is that with interest only (IO) tranche, you're not getting principal back so you're just getting cash flow back so your yield goes up.

We're trying to take advantage of servicer behavior. Special servicers, in general, they're never quite staffed fully for what is coming down the pike, which is almost impossible because it is so cyclical so I think they are going to struggle to deal with all of these defaulted assets. It's going to take a long time to work through. That being said, I think a lot of these sponsors [of CMBS] deserve modifications. There are assets that are wildly over levered. The LTV is well through a 100 and in most cases it's probably better to give the keys back. There are a lot of cases where it was a 60 LTV loan but now it's a 80 or 90 LTV loan and they are the best sponsor and if the special servicer can work out a fair deal where they're kicking in equity and supporting the property then as a CMBS investor, I'm short and long, I'm happy to help extend some of these loans if they deserve it. But, that's the biggest issue for me, there are a lot of loans that do not deserve it; there's no equity kicked in [by the sponsor] or no real commitment by the sponsor then I think the keys should go back and [the property] should be liquidated as fast as possible because when these things going into special servicing as they sit there are three years for the most part it is not good. The "extend and pretend" only works if it is a decent asset and whatever is going on is more cyclical. In the case of some of these regional malls that have been in REO; there was one in Vegas that got a lot of press [Prism Malls], Carl Icahn has been all over it. That thing was sitting there for over three years, which is against REMIC rules and the valuation dropped from $120 million to the sale price of about a half million dollars and once you take the fees out of it; you're left with nothing.

Allen: About your mall short, the CMBX 6 index short, as the Esquire piece detailed you did quite a bit of field trips of several malls. Similarly are you taking field trips to office buildings?

McNamara: What you could see from the malls when you were walking through them is the inflated occupancy in some of the lower quality malls and that was really what you were looking for. You're looking for, is this mall really 85 percent occupied [as the mall claims] and if so, what kind of tenants are these. Are these mom-and-pop local tenants, are they real tenants; what's the condition [of the mall]. We walked some malls where we just would see entire wings of malls shut. So if the mall does that, you can increase occupancy pretty quickly. But that being said it's all fake and eventually you have to pay the piper. It's not as easy to walk these office buildings but it is helpful in any asset that we do if we can get out there and see it, touch it, and feel it and see what we're looking at.

Allen: How long do you think it will take for distress in offices to take hold?

McNamara: It's a long duration asset because the leases are long. With the maturity wall [of 2023], that's going to cause issues. I view offices as similar to retail. Class A offices will do fine like with Class A retail [while lower tier offices will struggle].

We thank Daniel McNamara for his time with this interview.

Mr. Allen is a corporate finance and restructuring lawyer and adjunct law professor at Temple University Beasley School of Law, Japan campus.

NOTES

1. "MBS Meltdown Imminent (Again) and CLO Bubble: Hedge Funds Short on Malls' CMBS Bonds Just the Beginning of Signs of Distress as the End of the "Easy Money" Era Will Add Pressure to the CMBS and CLO Bubbles," *The Investment Lawyer*, Vol.29, No.8, p.15, August 2022, Peter Michael Allen.
2. *The Economist*, "Commercial-property losses will add to banks' woes," Mar. 29, 2023.
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4. *Id.*
5. *Bisnow.com*, "Office Landlords to U.S. Government: Without Help, We're Heading For A Financial Catastrophe," April 2, 2023, Matthew Rothstein, Bisnow Philadelphia.
6. *Id.*
7. *Id.*
8. *Id.*
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11. *Id.*

12 *Id*.

13 *Bloomberg*, "Even Wealthy Landlords Are Skipping Payments on Office Buildings," Natalie Wong and John Gittelsohn, March 9, 2023.

14 *Id*.

15 *Id*.

16 *Id*.

17 *Id*.

18 *Id*.

19 *Id*.

20 *Bloomberg*, "Pimco-Owned Office Landlord Defaults on $1.7 Billion Mortgage," John Gittelsohn, February 23, 2023.

21 *Esquire*, "The $2 Billion Mall Rats," Ian Frisch, Nov 30, 2020.

22 *Id*.

23 Petition.com, Notice of Appearance: Daniel McNamara, Principal at MP Securitized Credit Partners, Apr 14, 2021, available at: *https://petition.substack.com/p/danmcnamara?utm_source=url*.

24 *Id*.

25 *Id*.

26 *Id*.

27 *Id*.

Wolters Kluwer