Marginalized CRE Credits Q1:
Interest Rate Relief Not Coming to the Rescue

By Keith Botvinik, Managing Director, Grace Realty Capital LLC

The State of the Market

As investors of troubled CRE/ADC assets, I wanted to share what I am seeing as we approach the end of Q1. The anticipated interest relief didn't materialize to rescue marginalized CRE credits. The recognition that rates aren't going down has had a sobering effect on lenders resigned to transact at discounts off principal balance and borrowers scrambling to preserve equity.

It's becoming increasingly difficult for lenders to posture behind stale appraisals and cap rates to back up values in the light of the transactional volume, increasingly at losses. There continues to be denial amongst some market participants in accepting current market valuations, but as more comps, data, and intelligence emerge, the reality is clear. Compounded by weakness in underlying fundamentals, there's an absence of any real or potential NOI growth. The debt load can't be sustained "as is" or "as stabilized," and preserving equity is becoming more remote as property values deteriorate.

Risk Rating, Volatility, and Market Pressures

There were note sale opportunities at PAR based on live-time values prompted by the usual suspects: maturity, performance, rate reset issues, or lender fatigue. However, many credits, regardless of the interest rate climate, don't support the real estate as a viable business enterprise at the existing basis to merit full UPB. The Fed could be on the cusp of ending the Risk Rating charade, compelling bankers to mark credits not on performance but on asset quality and accelerate the come to Jesus moment.

The uncertainty the administration is fueling adds even more volatility to a cocktail already baked for disruption. With the wave of maturities, exacerbated by the end of one-year extensions, someone has to press reset. To make economic sense and invigorate investment, someone has to take a hit: either the debt, the equity, or both.

With values plummeting the reluctance to extend is understandable

A rate reset never appeared and is looking increasingly unlikely for the next 18-24 months with higher for longer neutral interest rate level projected upward. Even falling bond yields and anticipated rate cuts aren't going to stimulate growth and support marginalized assets in an atmosphere of volatility and uncertainty. Notwithstanding the relatively elevated interest/cap rate environment, much of the real estate just isn't profitable especially with the current debt obligations. With plummeting values the reluctance to extend is understandable. The absence of profitability is also a driver for mortgage banking where downsizing and consolidation maybe more efficient with the economic head winds (see below). The deteriorating operational fundamentals are leaving behind any real income growth in its wake. The downward pressure on rental income limits landlords' ability to raise rents and cover rising operational costs. Cash flow especially with value add loans doesn't meet as is or as stabilized DSCR hurdles. The credits/relationships with these challenges under extension or facing maturity that were banking on interest rate reduction will be revisited and reassessed. The new projections may not afford time for if and when lower interest arrive and valuations to recalibrate. Essentially there isn't the runaway out as anticipated. When you examine the most recent property level NOI figures and compared them to underwritten expectations, there is a sizable disconnect that won't be cured with rate relief.

What is getting extended

Many credits have burned through one year extensions along with their hopes of takeout financing without a pay down. With extensions exhausted balance sheet lender patience are being tested in consideration of further relief. There aren't any free rides to push out maturities without some meaningful enhancement or reduction in legal balance. According to the recent MBA CREF conference "Lenders will likely take a "no more free extensions" stance, adding to the maturities and forcing some action in the form of sales, refi, loan workouts or foreclosures" I have seen bank extensions clipping a 10% coupon and requiring paydowns. I have also seen CLO issuers forced to extract ineligible credits pivoting to their "hostile" bank lines paying double digits to park the risk. When the music stops these problematic situations transition into deeper downgrades and litigation. Fitch Ratings cited that loan modifications are likely to continue but will temper overall delinquencies, however higher defaults will occur due to the still-elevated interest rates, deteriorating operational fundamentals, tight lending, and an eventual reduction in times allowed for workouts and fewer special servicing options. They continue "the lingering question is how long the modifications will be offered. All along, the hope in the industry has been that lenders could justify modifications, putting off taking actions like foreclosure and defaults because eventually interest rates would return to where they had been and the circular pattern of refinance under interest only, come to maturity, and refinance again would restore balance." From fresh data Refi/new capital continues to be cautious to support anything but the most secure collateral and sponsors. With nearly $1 trillion in CRE mortgages set to mature in 2025, many borrowers and lenders waiting for the drop will be left with limited options. Lending will continue to be conservative and discerning until the sense of uncertainty is lifted and a new norm established.

Regulators change tune

The regulatory environment is about to change as well. The SEC recently published a paper on rent regulated multi risk remarkably calling out several lenders by name. "rising inflation and maintenance costs … could jeopardize loan repayments and may create financial instability for banks holding these loans." It continues "The SEC's request is part of a wider trend of financial regulators looking at risks across the entire CRE sector." Now that banks have had 1-2 years to shore up capital, the Risk Rating masquerade may come to a halt. Performance shouldn't override credit quality and dictate risk rating. How borrowers maintain performance, especially when not generated from the cash flow of underlying collateral, is material to credit quality and ratings. I just had a lengthy conversation with a friendly EVP and head of CRE Risk at a $10B regional bank. He's retiring and candid on kinks in the CRE amour. "Risk Rating shenanigans will get flushed out by surprise visits from the Fed". It shouldn't come as a shock when your regulator recommends the time is now to start taking charge offs not deferring to stale 2022 appraisals and applying antiquated cap rates to justify a pass rating. Even if you weave a good story and argue you have been following the guidance, downgrades are inevitable. With enough marks you're facing recommendations, a MOU or a FDIC consent order. Some banks who have regularly taken advantage of relaxed oversight, been creative, or think they have carte blanche bypassing credit quality may find themselves besieged and cease operations for new business.

Government not helping with GSA turmoil adding fuel to the fire

The turbulence associated with a new administration hasn't inspired confidence either. Mixed signals from leadership to tame inflation or stimulate growth doesn't appear to be a concerted effort with little hope for consensus on the horizon. The turmoil created from GSA office lease debacle threatens to further destabilize the asset class. Although the federal government typically isn't able to end property leases before their maturity dates, they may cancel those leases based on lack of appropriations. DOGE is focusing on leases with near expirations or those that include options to get out of leases early." One industry pro confirmed that withdrawal of funding through appropriations is grounds for termination in many of those leases and the fallout could be catastrophic for office buildings and owners. The Federal government also controls massive amounts of office space that often has remained vacant and hardly used. Releasing this bulk supply into the market will only further dilute office values although most of this is obsolete and poorly maintained. In an extraordinary reversal March 5th the General Services Administration removed from its website about 440 federal buildings representing nearly 80 million square feet of space that only hours earlier it had listed for sale. One congressman said "It's flummoxing to me why there's this headlong rush from the GSA to do these things that they're having to pull back on anyway," Unpredictability doesn't reassure markets by injecting chaos. Jim Zelter, president of Apollo Global Management, noting that the White House "leads by headlines, leads by provocation." "that's their biggest challenge, to keep calm in the markets."

Denial coming to a boil and bubbling up

There comes a point where maintaining sub performing real estate and credits isn't sustainable or goes unnoticed. Misrepresentation or suppression of accurate reporting contributes to lag in value recognition. With clarity comes conviction. There is a growing pool of information, data and intelligence reporting supporting a dislocation and need for a correction. It's here and no longer possible to ignore we're approaching a boiling point as distress bubbles up across the CRE spectrum. The times of "Badges? We don't need any stinkin badges" are fading. CMBS, CLO, the GSEs and the rating agencies are being examined and held accountable for their operations as more intel surfaces. Its undeniable there has been some monkey business/manipulation to maintain optics for stakeholders, analysis and the public. The Fed is onto it as well. One federal regulator mentioned "some fund managers are pushing appraisers to keep values stable to moderate deterioration and minimize redemptions."

For CRE CLO the grim reality is that almost 80% are in some form of distress. "Distress has been steadily rising as these floating-rate loans are failing to pay off at their maturity dates" as the Commercial Observer report. Many of these loans originated in 2021 at times where cap rates were low, valuations were high, and interest rates were lows. The data showed 18.8 percent of the CRE CLO loans are current. Combining current loans with the loans that are considered late (within the grace period or less than 30 days delinquent), the percentage increases to 22.1 percent. Meaning 77.9% of CRE CLO is at least 30 days late. It's a $75B market with 15% delinquency rates that grew over 190bps in January one official pointed out. There are only so many buckets to pivot into before its time to own up as folks at Arbor and MF1 have acknowledged. In conversation with MF1 their strategy is pivot troubled assets into OREO and wait until the market rebounds to make their equity whole. Arbor has also embraced the playbook publicly acknowledging the distress started to show on their books (see below). The REIT launched a multi-billion dollar modification strategy to float borrowers on the bet rates would come down. Delinquencies have spiraled into foreclosures and mounting onto Arbor's REOs balance sheet and will grow further, the firm said. The uptick will likely burden the lender with carrying costs that will pressure earnings squeezing or suspending dividends. The REIT reported $176 million in real-estate owned or REO assets in the fourth quarter – twice what it posted last year. Now, Arbor's game plan — alongside loan modifications and pay-offs — is to play landlord to those deals until it can find fresh sponsors to run them. CEO Kaufman projected the REO line item could hit $400 or $500 million, and that it would take one to two years to get the deals back in good shape. "The performance of these assets has been greatly affected by poor management and from being undercapitalized," he said, detailing their average occupancy is a staggering 35 percent. Question is when and if that event arrives, at what recovery and has loss been mitigated by a true fiduciary or a fund manager who may not have aligned interests. How long can investors be patient with the accumulation of illiquid assets, their equity deteriorating, waiting for the market to turn while those same managers continue to collect fees?

There is also rising concern for the interconnectedness of CLOs and bank ABL lines that provides credit facilities to CRE debt funds and issuers. With the economy starting to show more signs of slowing, the one thing that held up was CRE performance which appears to be wavering. Weakness in CLO ADC and value-add loan performance impacts banks who provide lines to these CRE debt funds/issuers. ABL lines to debt funds are dependent on the performance of the underlying collateral. As a consequence of performance, credit quality and value deterioration those line lenders need to reevaluate their exposure and risk. One regional Bank ABL team leader said they closely

monitor often re-underwriting deals requiring their debt fund clients to right size, modify terms or extract individual credits before they extend maturities and release additional capacity. Those relationship can sour especially for funds that play both sides of the same coin. Madison Realty Capital (MRC) for example occupies both places as an issuer and borrower of debt to support their origination and fee simple platforms. The cracks are apparent as they foreclosure and are foreclosed upon (strategically defaulting?) on loans they have issued and on the real estate they own on balance sheet. Some balance sheet loans were defaulted as far back as Q3 2023 and only now being litigated. Rialto, the servicer on many of those credits, doesn't take prisoners and takes a hard line approach for delinquent borrowers and MRC won't be an exception.

CMBS distress is approaching its highest levels since 2008 GFC. NYC's multifamily CMBS market saw a major jump in conduit issuance last year, reaching $6.7B in 2024—four times 2023's total—according to a KBRA report. Distress levels climbed alongside the lending boom. By the end of 2024, the distress rate—delinquent loans or in special servicing—hit 8.5%.The broader conduit distress rate more than doubled YoY, rising from 7% to 14.4%, with multifamily loans making up 43% of the distressed balance. The delinquency rate for CMBS tied to office properties reached 10.4 percent in November 2024, approaching the 10.7 percent peak reached during the 2008 financial crisis. The ascent is the fastest two-year increase on record, with rates climbing 8.8 percentage points since late 2022, significantly outrunning the 6.3-point rise seen during the financial crisis nearly 15 years ago. …Property values, particularly for older office buildings, have plummeted, with many losing 50 to 70 percent of their market value and in some cases becoming effectively worthless. According to Morningstar The International Corporate Center in Rye, NY 170,000 SF office complex "recently transferred to special servicing after precipitous declines in the collateral office property's cash flow and occupancy. Morningstar DBRS' liquidation scenario for that loan reflected a haircut to the most recent appraised value, which represented a decline of more than 60.0% from the issuance appraised value. Morningstar DBRS also has concerns regarding the accumulation of interest shortfalls, which have increased by $2.7 million from the previous credit rating action and are accumulating at a rate of approximately $250,000 per month". The December 2014 $29.6 million acquisition loan for the 1990 vintage build had a 10-year, fixed-rate CMBS loan, 5 years IO, a 4.32% rate and a 75% LTV. These scenarios have left portfolio managers and building owners unable to borrow, refinance or sell properties, contributing to rising delinquencies and foreclosures.

The rating agency merry go round

Although they have made adjustments The Rating Agencies are being called out again on some inexplicable ratings. Across almost all asset classes there are troubled SASB CMBS loans backed by office, hotel, retail, and multi-family mortgages and self-storage. Trepp reported that the single loan behind CGCMT 2021-PRM2 has gone into special servicing after failing to pay off at maturity (the borrower does have an extension option). Further, the collateral is now appraised at below the CMBS loan balance. Despite these conditions, neither rating agency on the deal (Fitch and KBRA) has downgraded any of the tranches. Along with the voices of investigative reporting, Rod Dubitsky has been a recurring critic on the rating agency modus operandi. Dubitsky recently posted as a follow up to an analysis of a dozen questionable rated deals "highlighting obviously and recklessly inflated ratings of 12 AAA rated SASB CMBS, backed by defaulted loans." As a update he estimates the true ratings using an approach similar to the ratings agencies. "My ratings were far lower than the actual ratings. I was pleased my article was covered by both the FT and Trepp – there would be no escaping Rating Agency awareness that they were being called out. Since my earlier articles ...the actual ratings have been plunging with several even lower than my earlier estimates" Only two deals retain a AAA by two RAs and for both these deals my rating estimates were higher – Single A. T. This isn't just about SASB CMBS. This is a big flashing yellow warning that the ratings industrial complex is as broken as it was in 2008. The explosion of private credit and the awarding of "investment grade" ratings that wallow in the dark shadows of financial markets should concern all market participants. Public ratings are dubious enough. When they lurk in opaque private markets, with 7 possible rating agencies to choose from, my message is... we are approaching 20 years post GFC and a flawed ratings ecosystem is still propagating risk with inflated ratings. Here are he briefly discussed two of the more troubled deals:

BFLD Trust 2020-EYP Secured by a loan on E&Y Plaza in downtown LA. S&P cut the rating to CCC owing to a dramatic drop in the appraisal - 30% in less than 12 months. S&P notes: "In addition, we assessed that all the classes will likely incur principal losses upon the eventual resolution of the specially serviced loan based on the current and our projected total loan exposure." ALL classes will take losses including the once and former AAA. Meanwhile KBRA still has a AA- rating.

MSC 2019-PLND, backed by two Portland, OR Hilton Hotels, according to DBRS, “There has been no interest distributed to bondholders since May 2024, when the Notice of Non-Recoverability was provided.” Clearly, they shouldn’t be any better than CCC – the whole deal is in default. AAA will likely be hit.

Values slide

There is no doubt values continue to decline. Besides forced sales what’s trading is largely at a discount of current market value. Everyone in this market is looking for a deal, even applying real cap rates there is no assurance of a transaction or achieving the strike price. Rent-regulated properties will continue to languish facing financial pressure as inflation runs beyond allowable rent increases. 312 East 106th Street a Manhattan 29 unit multi sold for less than $300,000 a fraction of its valuation and its debt ($8.8 MM paid 12/2016 see below) Office vacancy continues to plague NOI driven by persistently high vacancy rates and declining rents. 256 West 38th Street. and 229 West 36th Street two midtown NYC office buildings are trading at less than a third of what they paid for it 2017. The decreased rate of absorption due to ongoing rise in new multifamily product coming on line continues to put downward pressures on rents. Please see below a handful of live time war stories I can attest to personally followed by recent sales in last 90 days

- Dallas B-/C+ multifamily 679 units value add acquisition in 2000 underwritten @4.5 cap with a 4% rate now floating, at 7 cap at best 6.5. equity completely wiped out
- Underhill Avenue Brooklyn Multifamily in foreclosure extended 9 times
- Hull Avenue Bronx multifamily current collections barely able to cover expenses let along debt coverage with one third of units in LT court, 3% rate 2020, rate resets 11/2025
- 46th Street Manhattan Mixed use in foreclosure due to rate reset risk. effective contract rate changed from 4% to 9.625% here is an excerpt: As of January 24, 2025, the 5-year interest rate published by the Federal Home Loan Bank of New York for an adjustable mortgage was 7.125%. interest accruing at a rate of 4.00% per annum calculated based on a thirty (30) year amortization schedule commencing on December 1, 2016 and continuing on a monthly basis through November 1, 2021. Commencing on December 1, 2021, the interest rate was to adjust by adding 2.50 (2.50%) percentage points to the annual rate of interest equal to the five (5) year Federal Home Loan Bank of New York
- The Bowery Manhattan vacant mixed use loft building, following a chapter 11 filing lender willing to assign credit bid for $5 MM. debt in excess of $8.5 MM

With no interest relief on the horizon, extensions burning and upcoming maturities, borrowers and debt issuers are confronted with a dilemma - pay up for risk or face the consequences. The exuberance due to artificially low interest rates led to today’s over levered investments, which should of been cleared when the central bank let rates rise, reflecting the true cost of capital. Something we are now living. Economic performance fundamentals are spirally downward that don’t support the debt load let alone current valuations. From recent sales and reported data it’s here. If borrowers and debt issuers are unqualified or unwilling/unable to pay up the music stops and these problematic situations transition into deeper downgrades and litigation dipping into bank and investor equity. As misrepresentation gets flushed out there is clarity on the fact pattern allowing investors to gather real intel and adjust risk premiums. The surprise visits from your regulator isn’t for the coffee and Dunkin Donuts. They are coming to base exams and risk rating on credit quality not performance. The political climate is adding fuel to the fire without clear coordinated policy guidance. For the market to clear there needs to be a seismic shift in value recognition. Trades have occurred but mainly below market and forced sales with sellers feet to the fire. The solution is a reset to make economic sense, attract investment to get unstuck. To ignite transaction velocity someone has to take a hit, forced or by volition, either the debt, the equity or both. Depending how to you choose to navigate will mitigate loss. You can either endure the slow burn via extend and pretend or take the Rialto approach and take no prisoners. Either way it’s bitter medicine but necessary for the patient to recover.

Article by: Keith Botvinik | Managing Director | Grace Realty Capital LLC