Markets

A Third of Office Mortgages Packed Into Bonds Are at Risk of Default

- Some $52 billion of loans have defaulted or might, Kroll says
- Chicago leads list of cities with largest share of risky loans

By Scott Carpenter
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About $52 billion, or 31%, of all office loans in commercial mortgage bonds were in trouble in March, according to KBRA Analytics.

That share is up from 16% a year ago, according to the firm. Some cities have bigger headaches than others, with Chicago and Denver offices having 75% and 65% in jeopardy, respectively.

The office sector is wrestling with twin challenges of low occupancy and rising interest rates that have pushed valuations sharply lower. Lenders are still absorbing losses and placing loans on watchlists, while borrowers have been extending loans in hopes that values will rebound.

This week offered some hope for borrowers holding out for lower interest rates. On Friday, relatively soft job gains data suggested the economy is cooling, causing traders to pull forward bets on the first Federal Reserve rate cut to September from November.

Even so, strain in the office sector could get worse before it gets better, said Michael Cohen, a managing partner at commercial real estate consulting firm Brighton Capital Advisors.

"I don't think there can be rate cuts fast enough to save commercial office buildings and other assets that are poor performing or over leveraged, like multifamily, without a loan modification from the lender," said Cohen in emailed comments.

According to KBRA Analytics, its 31% assessment includes single-asset single-borrower as well as conduit CMBS.

Relative Value

Weaker-than-expected payroll data this morning combined with a dovish Fed earlier this week have lessened the tail risk of further rate hikes, and against that backdrop investors might consider dipping into conduit CMBS at the top of the capital stack, write Barclays strategists Lea Overby and Anuj Jain in a note dated May 3.

- Additionally, CMBS has underperformed corporates recently and conduit AAA CMBS has begun to look attractive compared with corporates as a result
- However, the strategists remain cautious on mezzanine debt as well as SASBs and CRE CLOs
- "While special servicing and delinquency rates remain well below their Covid peaks, they are considerably higher y/y and appear to be rising"

What's Next

Ford, GM Financial, Pagaya, Sallie Mae Bank and Vertical Bridge started premarketing deals on Thursday, ensuring next week will be busy as all are expected to price.

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