DIAMOND HILL

INVESTED IN THE LONG RUN

A Tale of Two Buildings

May 2024

"It was the best of times; it was the worst of times." is one of the most well-known openings to any novel in history. Even if you've not read Charles Dickens's *A Tale of Two Cities*, there's a good chance you've heard the opening lines of that novel at some point in your life.

One could interpret those famous words as an analysis of the commercial real estate market, though it's a bit of a stretch to say it has been the best of times; there have been significant challenges in the real estate market over the past few years, first with the decay of retail and shopping malls pre-COVID as Amazon rose to prominence and then with the COVID-induced office building exodus.

Like in the Dickens novel, the commercial real estate market is not all bad. This could be a time of great potential for investors willing to delve into various deals and uncover hidden opportunities. In this month's commentary, we delve into two recent headline-making commercial real estate deals, aiming to shed light on where some of the risks (and opportunities) lie.

1740 Broadway, New York City

In early 2022, the property that once inspired Tommy James and the Shondells' 1968 hit song "Mony Mony" took a new turn. The owner of the office building essentially handed the keys over to the servicer, who was then tasked with exploring foreclosure or loan modifications, adding a new chapter to its unique history.

**Per Tommy James, "I had the track done before I had a title. I wanted something catchy like 'Sloopy' or 'Bony Maroney,' but everything sounded so stupid. So, Ritchie Cordell and I were writing it in New York City, and we were about to throw in the towel when I went out onto the terrace, looked up and saw the Mutual of New York building (which has its initials, MONY, illuminated in red at the top). I said, "That's gotta be it! Ritchie, come here, you've gotta see this!" I've always thought that if I had looked the other way, it might have been called "Hotel Taft."*

1740 Broadway is considered a Class B property (completed in 1950). It is highly concentrated with two key tenants, making it a challenging location today. The 26-floor building consists of roughly 600,000 square feet of floor space, serviced by 14 elevators.

The COVID-inspired shifting landscape of office occupancy hit the building hard. In 2021, L Brands, which occupied roughly 77% of the property's leased space, announced plans to exit the building for a smaller, alternate location. Before the L Brands departure, law firm Davis & Gilbert left the building in 2019.

The building was purchased in 2014 for $605 million, with the purchaser financing the deal with a $308 million mortgage, which was then packaged into a commercial mortgage-backed securities (CMBS) deal. The building was sold in May 2024 for roughly $186 million. With the deal's closing, the CMBS structure was repaid with the proceeds, less fees and advances, leaving only $117 million for bondholders and causing losses across most of the deal (Exhibit 1).

Exhibit 1 — 1740 Broadway Loan Structure

Class	Original Balance ($MM)	Sale Proceeds ($MM)	Bond Loss ($MM)	Percentage Loss (%)
A	157.5	117.2	40.3	26
B	38.6	0.0	38.6	100
C	26.7	0.0	26.7	100
D	32.8	0.0	32.8	100
E	44.6	0.0	44.6	100
F	7.8	0.0	7.8	100
Total	**308.0**	**117.2**	**190.8**	—

Source: BWAY 2015-1740.

The ongoing game of chicken between lenders and owners continued over the past two years as pricing was opaque, and owners would instead hold onto assets rather than sell at deep discounts. Now, rising costs and upcoming maturities have forced the hand of investors and thus established values.

The sale of 1740 Broadway could be the opening salvo in the early stages of price discovery in the commercial real estate market. According to Trepp, office building special servicing and delinquency volumes have climbed considerably this year, with a balance of over $17 billion now in the hands of special servicers, an increase of nearly 28% from the end of 2023.

New York City isn't the only zip code feeling some pain. 1101 Vermont Avenue in Washington, DC, sold for $16 million, a significant discount from its 2018 valuation of $72 million. In Chicago, a distressed office building across the street from the landmark Willis Tower sold for $4 million, a sizable discount from the $51 million it sold for in 2012.

But it is not all bad. Jones Lang LaSalle stated that even though vacancy rates are around 22%, roughly 60% of that vacant space was in 10% of all office buildings nationwide, indicating that the problems in the industry are relatively concentrated.

The story of 1740 Broadway isn't over. The new owner plans to convert the property from office to residential, bringing new life to the location. The transformation will most likely benefit the neighborhood. Still, for investors, the uncertainty around how long the process will take, how much it will cost, and the potential roadblocks and headaches associated with the conversion create apprehension.

980 Madison Avenue, New York City

Located on the corner of Madison Avenue and East 76th Street, this building is a 134,000-square-foot mixed-use that contains office space, retail space, and art galleries, which sold for $560 million.

Originally built in 1948, this building served as the headquarters of Parke-Bernet Galleries until 1987. At that point, the Gagosian Art Gallery took over a large chunk of the property alongside a couple of high-end fashion stores. With its lease expiring in 2025, the gallery will vacate the more than 55,000 square feet it has grown to occupy.

Real estate investment firm RFR purchased the property in 2004 for roughly $126 million, expecting it to continue serving as a hub for the New York art community. The recent sale price of $560 million was 60% more than the most recent appraisal, which was $350 million in May 2021. The new owner is affiliated with Michael Bloomberg, and 86% of the property will eventually be leased to Bloomberg Philanthropies.

The building has nearly $200 million of debt that's securitized with two CMBS deals:

- CSMC 2021-980M – a $172.6 million Single Asset, Single Borrower CMBS deal using 980 Madison Avenue as collateral.
- WFCM 2021-C61 – a $25 million loan, one of 61 loans in a conduit deal associated with various properties.

The CSMC deal failed a debt service coverage ratio (DSCR) test in September 2022, signaling that the building wasn't earning enough revenue to assure the loan servicer that the payments could be made. Shortly after that, the failure of the DSCR test moved the debt to the servicer's watchlist, indicating concern about the security's viability. Upon the announcement of the sale, the debt was removed from the watchlist as both CMBS deals are expected to be paid off in full.

Exhibit 2 — Deal Structure for CSMC 2021-980M

Class	Original Balance ($MM)	Sale Proceeds ($MM)	Bond Loss ($MM)	Percentage Loss (%)
A	60.4	60.4	0.0	0
B	11.1	11.1	0.0	0
C	10.0	10.0	0.0	0
D	16.0	16.0	0.0	0
E	24.6	24.6	0.0	0
F	24.7	24.7	0.0	0
G	15.0	15.0	0.0	0
HRR*	10.9	10.9	0.0	0
Total	**172.6**	**172.6**	**0.0**	–

Source: CSMC 2021-980M. *Horizon Risk Retention (HRR) requires a CMBS issuer to retain a share of the most subordinated classes that represent 5% of the securitization's fair value. CMBS issuers are permitted to sell this horizontal interest to a third-party investor, who is required to retain the risk retention interest for a minimum of five years, subject to certain restrictions to ensure the CMBS issuers' interests remain aligned with those of the bondholders.

Not-so-Great Expectations

The successful transaction for 980 Madison Avenue is the exception to recent market activity rather than the rule, but the market may be shifting. The industry expects more deals with resolutions like 1740 Broadway than 980 Madison Avenue.

Renovations to older office buildings in New York City are reinvigorating the office market space, albeit selectively: $120 million spent in repositioning 277 Park Avenue has helped to push office availability near Park and Sixth Avenue to the low level of 11% compared to Manhattan's overall level of 20%.

The office market is not out of the woods by any stretch, but recent developments have provided hope that we've made it through the worst. Any recovery that occurs will be property- and geographic-dependent and not widespread, but at this point, any recovery is good.

The disruption in the commercial real estate market since COVID-19 has been challenging for investors. However, opportunities will present themselves for those willing to do their due diligence and gain a solid understanding of the underlying dynamics.

While the above examples are focused on the office building market, other real estate market areas have felt the pain but have also experienced some relief. Turtle Bay Resort is the perfect example of a trophy property, where it's just as much about the destination as the accommodations. The only resort of its kind set on the North Shore of Oahu, Turtle Bay spans nearly 1,300 acres of lush, historic land, featuring five miles of untouched coastline and 12 miles of breathtaking trails. And unlike the story of 1740 Broadway in New York City, this top-of-the-line resort in Oahu has a happy ending.

The resort was recently sold for $725 million, a significant improvement over the $332 million spent in 2018 to acquire the property. Turtle Bay underwent a transformative renovation while closed from March 2020 to June 2021, taking advantage of travel restrictions and tourist apprehension regarding travel in the early days of COVID. The revamp touched guest rooms, bungalows, pools, the spa and restaurants, and the lobby, retail, and meeting space. Additional updates were made to the exterior and arrival space, including adding a new club lounge. More developments are ahead as the buyer also bought a 49-acre oceanfront property adjacent to the hotel and plans to expand the overall property.

The commercial real estate market has faced challenges and is likely to encounter more, but this volatility also presents opportunities. Investors who carefully analyze specific properties, assess associated risks, and evaluate potential prospects can still discover worthwhile investment opportunities.