Distressed Debt Deep Dive

Impact of Higher Interest Rates

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Introduction

In advanced economies, interest rates have surged by a staggering 400 basis points since late 2021. Meanwhile, emerging markets have witnessed an even more astonishing increase of 650 basis points. These aren't just numbers – they're the seismic shifts in interest rates made by policymakers over the past two years. And with inflation on the rise, central banks are digging in their heels, leaving borrowers grappling with doubled, even tripled interest costs. In this volatile landscape, understanding the fallout is crucial.

In this second article in our Distressed Debt series, we explore the consequences of this significant rise in interest rates over the past two years. We'll examine how distress rates on floating rate loans have surged compared to fixed rate loans. Additionally, we'll take a closer look at debt service coverage ratios (DSCR) and remaining terms for distressed versus non-distressed loans. By analyzing the magnitude of these effects, you'll gain a deeper understanding of the factors driving distress, where to identify distress, and what to anticipate for various loan profiles.

Methodology

Our research dataset consists of 21,291 loans and properties supporting agency and non-agency CMBS and CRE-CLO transactions. When analyzing distress, we define the following four distress categories:

- Loans reported as being in workout
- Loans reported as having servicer advances of principal and interest
- Loans reported as delinquent or matured with an outstanding balance
- Loans with upcoming maturities in the next year which require a capital investment of at least 25% of existing loan balance to refinance.

For the latter refinancing calculation, we assume DSCR<1.0 on the existing loan balance using the most recent NCF and a 7% loan payment rate. Results will vary for other definitions.

Using these categorizations, we identify 1,291 of the 21,291 loans in our dataset as distressed. This equates to an overall distress percentage equal to 6.06%. Figure 1 below shows percentages for the four distress categories.

Figure 1: Distress Categories

NUMBER OF LOANS	NUMBER OF DISTRESSED	% DISTRESSED - TOTAL	% WORKOUT	% SERVICER ADVANCES	% DELINQUENT	% UPCOMING MATURITY
21,291	1,291	6.06%	2.15%	2.95%	3.22%	2.80%

When reviewing this categorization, keep in mind that these distressed categories will often overlap (i.e., a distressed loan may be in more than one distress category). For this reason, the sum of percentages across the four distress categories will always exceed the aggregated distress percentage for the full dataset. It is noteworthy from Figure 1 that all four categories contribute by similar magnitudes to the overall distress rate. In Figure 2 below, we show the same breakout for primary property types.

Figure 2: Distress Categories by Property Type

PROPERTY TYPE	NUM. OF LOANS	NUM. OF DISTRESSED	DISTRESS RATE	% WORKOUT	% SERVICER ADVANCES	% DELINQUENT	% UPCOMING MATURITY*
Office	1,698	193	11.37%	5.6%	5.9%	7.3%	4.7%
Mixed Use	636	50	7.86%	3.8%	4.4%	5.3%	3.3%
Hotel	1,288	100	7.76%	3.7%	4.8%	4.3%	3.3%
Multifamily	12,237	761	6.22%	1.8%	2.7%	2.9%	3.1%
Healthcare	248	17	6.85%	3.2%	3.2%	4.0%	4.4%
Retail	3,310	133	4.02%	1.9%	2.6%	2.9%	1.5%
Industrial	485	14	2.89%	0.2%	0.8%	0.8%	2.1%
Manufacturing	503	10	1.99%	0.0%	0.8%	0.8%	1.4%
Self Storage	747	5	0.67%	0.0%	0.3%	0.4%	0.3%

KEY
AVG. = Average
NUM. = Number
REM. = Remaining

*DSCR prevents full refinance

Reviewing Figure 2, we see that the Office property type has the highest percentage of distressed loans by a significant percentage. We also see that Multifamily is far-and-away the most populated property type. The high proportion of Multifamily loans is due in large part to the dominant role of agency multifamily lending programs in the securitized loan market. Healthcare and Manufactured housing are also dominated by agency lending. In all three of these housing sectors, the largest component of distress derives from refinancing risk on upcoming maturities. The smaller amounts in delinquency and workout categories for the housing sectors reflect stronger underlying property performance as well as generally superior underwriting and borrower profiles for agency origination, and consequently less migration to delinquency and workout. We will also see in the analysis below that these housing sectors have significantly higher concentrations of floating rate loans, which have much higher distress due to higher interest rates as discussed below.

Interest Rates

A primary driver of current distress is the 400+ basis point rise in short-term rates and 300+ basis point rise in longer term rates experienced in the last two years. Rising interest rates impact distress in two primary ways:

- For floating rate loans, there is the direct impact of higher loan payments and consequently a distressed debt service coverage ratio. To hedge this risk, floating rate borrowers typically (and specifically for agency floaters) purchased interest rate caps with strikes at the substantially lower interest rates that were prevailing at the time of loan origination. These interest rate caps typically have short expirations, and the borrower is typically required to escrow cash to purchase new caps upon expiration of the in-place caps. With the 400+ basis point rise in short-term interest rates, cap purchase prices and escrow requirements have skyrocketed. This significantly impairs the ability of borrowers to service existing debt and in turn leads to delinquency, servicer advances, and eventually workout. These are our first three categories of distress in Figures 1 and 2 above.

- For both floating and fixed rate loans, an upcoming maturity requires that the borrower either sell the property or refinance into a new loan. With higher interest rates and distress in the marketplace, sales prices are down, and sellers are faced with potential losses. The alternative is to refinance into a new loan. The amount that can be borrowed is constrained by the DSCR requirement on the new loan calculated at today's higher interest rate. The higher the new loan rate, the less that can be borrowed. This leads to a higher percentage of loans that will require new capital to refinance. This is our fourth category of distress in Figures 1 and 2 above and often a precursor of delinquency, servicer advances, and workout.

Fixed versus Floating Rate Loans

Figure 3 below shows distress rates on fixed versus floating rate loans and the average DSCR and remaining term on loans identified as distressed versus those which are not.

Figure 3: Fixed versus Floating Rate Loans

INTEREST RATE TYPE	NUM. OF LOANS	% OF LOANS	NUM. OF DISTRESSED	DISTRESS RATE	AVG. CURRENT DSCR (DISTRESSED)	AVG. CURRENT DSCR (NOT DISTRESSED)	AVG. MONTHS REM. IN TERM (DISTRESSED)	AVG. MONTHS REM. IN TERM (NOT DISTRESSED)
FLOAT	3,379	15.9%	640	18.9%	0.86	1.22	42	94
FIXED	17,912	84.1%	651	3.6%	1.36	2.21	27	55

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The major takeaway from Figure 3 is that the distress rate for floating is over 5x higher than the distress rate on fixed rate loans. This directly reflects the 400+ basis point rise in floating rate coupons and its impact on current DSCR in comparison to fixed rate loans. For both fixed and floating rate loans, we see the expected pattern of current DSCR being significantly lower on distressed loans versus non-distressed. On a loan-level basis, this is attributable to a combination of initial underwriting (i.e., LTV and DSCR) and property performance since origination (i.e., NOI growth). The last item to note in Figure 3 is the significantly lower remaining term on distressed versus non-distressed buckets. This reflects the refinancing pressure from higher interest rates on new loans that we discussed in the interest rate section above (our fourth category of distress).

Fixed versus Floating Rate Loans (Property Types)

Figure 4 breaks out fixed versus floating rate loans, DSCR, and remaining loan terms for the different property types.

PROPERTY TYPE	NUM. OF LOANS	NUM. DISTRESSED	DISTRESS RATE	% FLOATING	FLOATING DISTRESS RATE	% FIXED	FIXED DISTRESS RATE	AVG. CURRENT DSCR (DISTRESSED)	AVG. CURRENT DSCR (NOT DISTRESSED)	AVG. MONTHS REM. IN TERM (DISTRESSED)	AVG. MONTHS REM. IN TERM (NOT DISTRESSED)
OFFICE	1,698	193	11.4%	5.5%	51.1%	94.5%	9.0%	1.15	2.14	14	47
MIXED USE	636	50	7.9%	3.8%	37.5%	96.2%	6.7%	1.16	2.08	17	49
HOTEL	1,288	100	7.8%	2.6%	21.2%	97.4%	7.4%	1.21	2.37	19	37
HEALTHCARE	248	17	6.9%	28.6%	8.5%	71.4%	6.2%	1.01	1.62	4	41
MULTIFAMILY	12,237	761	6.2%	24.9%	18.1%	75.1%	2.3%	1.04	1.98	47	71
RETAIL	3,310	133	4.0%	0.4%	28.6%	99.6%	3.9%	1.37	2.01	15	44
INDUSTRIAL	485	14	2.9%	4.3%	38.1%	95.7%	1.3%	1.29	2.52	19	55
MANUFACTURING	503	10	2.0%	12.5%	4.8%	87.5%	1.6%	0.96	2.22	14	53
SELF STORAGE	747	5	0.7%	0.8%	33.3%	99.2%	0.4%	1.66	2.95	22	50

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Figure 4 is an interesting set of numbers. Firstly, note that the three housing sectors of Multifamily, Healthcare, and Manufactured Housing are the only property types with a meaningful percentage of floating rate loans. This is due to Freddie Mac's active floater origination business, whereas non-agency CMBS are largely fixed rate loans. Secondly, notice the overwhelmingly higher distress rates for floating rate loans versus fixed rate loans across all the property type buckets. For the office property type, floating rate loans comprise only 5.5% of the total origination and have a whopping 51% distress rate.

For Multifamily, the distress rate for Floating Rate loans is 8x the distress rate for Fixed Rate loans. The higher concentration of Floaters in the Multifamily property type coupled with the higher distress rate on Floaters together account for the 6.2% distress rate. This 6.2% distress rate is higher than would be expected based on better housing sector property performance and generally superior underwriting and borrower credit profiles for Agency versus non-Agency CMBS loan origination. This is attributable to the higher Floater concentrations.

Other Property Types follow a similar pattern although not as pronounced due to the small Floater concentrations. Likewise, both the current DSCR and Remaining Term follow the same pattern as we see in Figure 3, with distressed loans showing significantly lower DSCR and shorter Remaining Term. In simplest terms, DSCR is impaired and refinancing risk is high, particularly in Floating Rate loans.

Conclusion

As we wrap up our analysis of distressed debt, it's clear that we've only scratched the surface of understanding its impact on the commercial real estate market. Our insights carry weighty implications for investors, lenders, and property owners alike, highlighting the necessity of navigating the complexities of distressed loans with precision. Stay tuned for our upcoming deep dives, where we'll explore individual CMSAs and property types within CMSAs. We also will drill down to property attributes, demographics, and recent operational performance to assess and understand the impact of these factors on distress. Don't miss out on the opportunity to stay informed and empowered.

Next Steps

At Thirty Capital, we're your partner across the asset and investment lifecycle, including distressed debt. With our expertise and industry knowledge, we can provide valuable guidance and tailored solutions to navigate debt distress.

Reach out to us today by visiting ThirtyCapital.com.