

## VIEWPOINT

## Idiosyncratic Risk: Foreign Ownership of Properties Tenanted by High-Security Federal Agencies

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CMBS credit concerns, in our experience, often fall into one of two categories: common themes related to aggressive underwriting (the principal agent problem) and idiosyncratic risks that are unique to a specific property and/or sponsor.

Credit issues related to aggressive underwriting stem from the principal agent problem – the fact that originators, as agents, transfer risk to the CMBS trust (and thereby bond investors) at issuance, instead of holding that risk for the loan term, as principals. Credit-negative stories we consistently work to avoid include: capital-constrained borrowers looking for maximum leverage for an otherwise-out-of-reach acquisition, cash-out refinancing for borrowers monetizing a property's cyclical peak net operating income (NOI) valued at today's historically low cap rates, and borrowers with histories of default that benefit from the credit amnesia of some CMBS lenders.

Idiosyncratic risks, on the other hand, represent credit concerns unique to a specific property and/or sponsor that are often uncorrelated with loan metrics and can be highly binary in nature. Unlike the more common themes of aggressive underwriting, idiosyncratic risks cannot be programmatically identified with credit overlays and are thus often underappreciated (or even overlooked) by cursory loan reviews and generic default-and-loss assumptions. In our experience, thoroughly reviewing the background of a transaction offers a helpful starting point for identifying what property and/or sponsor-specific risks might negatively impact the CMBS credit.

One of the more interesting idiosyncratic risks we've reviewed recently is foreign-ownership of properties tenanted by high-security federal agencies. Curiously, high-security federal agencies are often unaware that the space they occupy is foreign-owned because there is no established policy for documenting and disclosing building ownership to agency occupants.<sup>1</sup> Despite increased scrutiny this year, the CMBS market financed two foreign purchases of properties tenanted by high-security federal agencies – a Department of Defense (DoD) Pentagon-annex in Arlington, VA and the headquarters of the National Aeronautics and Space Administration (NASA) in Washington, D.C.

## Idiosyncratic Risk: Foreign Ownership of Properties Tenanted by High-Security Federal Agencies

### Background: General Services Administration (GSA) and High-Security Federal Agency Tenants

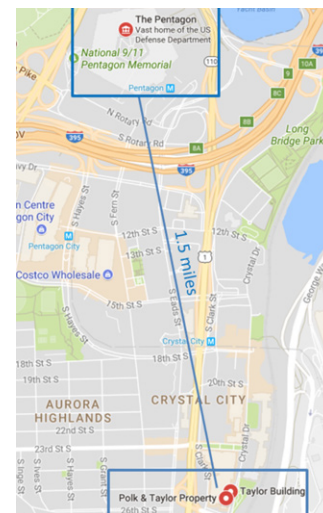
The General Services Administration (GSA) manages the workspace of federal agencies, including high-security spaces occupied by law enforcement and members of the intelligence community (representing around 17% of GSA leases).<sup>2</sup> High-security measures are required for tenants that utilize their space for classified operations, data centers, and to store items such as weapons and important evidence.<sup>3</sup> Despite the sensitive nature of some of its tenants, the GSA has not historically reviewed or disclosed (to end-users) the ownership of properties in which it leases space. As a result, federal agencies are often unaware of foreign ownership and thus unable to evaluate, monitor, and mitigate the risk.<sup>4</sup>

Earlier this year, the Government Accountability Office (GAO), an independent and nonpartisan agency that works for Congress, published a report highlighting concerns that “leasing space in foreign-owned buildings could present security risks such as espionage, unauthorized cyber and physical access to the facilities, and sabotage.”<sup>5</sup> The report also noted that foreign ownership of properties near high-security tenants may present surveillance risks.<sup>6</sup> The GAO concluded its study with a recommendation that the GSA determine whether the beneficial owners of its high-security leased spaces (located across an estimated 850 buildings) are foreign entities and, if so, share that information with the tenant agencies so they can pursue any necessary security mitigation.<sup>7</sup>

### Pentagon I (“Polk Building”) and Pentagon II (“Taylor Building”) Owned by Two Foreign SWF’s



Sources: Kroll Presale, Google Maps



### CMBS-Financed Foreign Acquisitions:

#### Department of Defense (DoD) Pentagon-Annex Property in Arlington, VA

The Pentagon Center is a 911,818 square-foot Class B-office complex consisting of two buildings, Pentagon I (“Polk Building”) and Pentagon II (“Taylor Building”), in the Crystal City submarket of Arlington, Virginia, a suburb of Washington, D.C. The single tenant at the property is the DoD, the oldest and largest government agency in the U.S., responsible for managing military forces to deter war and protect national security.<sup>8</sup> The DoD has occupied the Pentagon Center since 2003 and uses the space as an annex for its headquarters, the Pentagon, located less than 1.5 miles away. A shuttle service runs between the annex property and the Pentagon every 15 minutes during the workday.<sup>9</sup>

The Pentagon Center complex features Level IV security,<sup>10</sup> the second highest level for government offices, as well as dark fiber access to the Pentagon (a Level V security property) and the broader DoD network. The dark fiber infrastructure provides the DoD with direct control of its network (rather than through network providers) for enhanced speed, performance, and security.<sup>11</sup>

In February, the Pentagon Center was sold to a newly created joint-venture that is 97.5%-owned by two sovereign wealth funds and 2.5%-owned by the domestic seller, which remained in place as the property manager. The CMBS market provided \$210MM of acquisition financing, which was securitized across four conduit transactions.

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### NASA Headquarters at Two Independence Square, South of the National Mall and the Capitol Building



Sources: CSMC 2017-MOON OM, Google Maps

#### NASA Headquarters, Washington, D.C.

Two Independence Square is a 605,897 square-foot Class A-office tower located just south of the National Mall and Capitol Building in the Southwest Washington, D.C. submarket. The area is home to a number of “mission-critical” GSA facilities, including the headquarters for over 12 federal agencies.<sup>12</sup> Two Independence Square was built-to-suit for NASA in 1992 to serve as the national space program’s headquarters, from which all administrative operations across the agency’s field centers and facilities are organized. NASA, established in 1958, oversees all U.S. space exploration and is responsible for the civilian space program as well as aeronautics and aerospace research.

Similar to the Pentagon Center property, Two Independence Square features Level IV security. The property also benefits from high-tech computer and conference rooms, recording studios, sound control, and an uninterruptible power supply (UPS) system to ensure continuous 24-hour operation. According to the building manager, everything can be done from the property short of operating an in-flight shuttle.<sup>13</sup>

In July, a domestic Real Estate Investment Trust (REIT) sold Two Independence Square to a foreign asset manager. To complete its purchase of NASA headquarters, the foreign asset manager created its own U.S. REIT sponsor, hired a domestic property manager, and borrowed \$225.7MM from the CMBS market, which was securitized across a Single Asset Single Borrower (SASB) transaction and two conduits.

#### Analyzing Idiosyncratic Risks: Foreign Ownership of High-Security Properties

Although the federal government routinely leases space (including high-security space) from private sector landlords, the extent to which these landlords are non-domestic entities is unknown due to the GSA’s lack of policy and procedures regarding foreign ownership.<sup>14</sup> Per the GAO’s recommendations (the agency has no enforcement power), the GSA should determine whether the beneficial owners of its high-security leased spaces are foreign entities and, if so, share that information with the tenant agencies so they can address any related security risks.<sup>15</sup>

While the DoD Pentagon-annex property and NASA headquarters benefit from domestic property management and Level IV security, the ongoing concerns surrounding foreign-ownership of properties tenanted by high-security federal agencies represents idiosyncratic risk for the CMBS debt. In a worst-case scenario, if other risk-mitigation efforts are deemed insufficient, the high-security tenants might be able to negotiate a contraction and/or termination of their leased space. A significant reduction or elimination of leased space in the single-tenant properties could destabilize the encumbered assets, risking a term default on the CMBS debt. Furthermore, heightened regulatory scrutiny related to foreign ownership of properties tenanted by high-security federal agencies (and nearby properties) might discourage or even disqualify foreign capital from participating in the market – representing a valuation headwind and a potential risk to recovery values.

#### Conclusion: Identifying Idiosyncratic Risks Is an Important Part of CMBS Credit Review

Concerns related to foreign ownership of properties occupied by high-security federal agencies represents one example of idiosyncratic risk financed in the CMBS market. Importantly, identifying these unique credit issues requires asset-specific analysis beyond the scope of standardized credit overlays and generic default-and-loss assumptions. Performing this diligent asset-level analysis represents a fundamental part of our CMBS credit review process – and we believe the value added is worth the effort invested. ■

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### Footnotes and Sources:

1. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, summary page and p.24
2. Percentage of total lease count, referencing GAO/GSA estimated ~1,400 leases of high-security space out of 8,300 leases total. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, p.7
3. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, p.1
4. The GAO's study found roughly 64% of agencies contacted were unaware that their space was foreign-owned. The GAO also reported being unable to identify ownership of ~35% of high-security leases. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, summary page and p.19
5. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, p.20
6. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, p.11; additional reference to the GAO's December 2014 report, "Defense Infrastructure: Risk Assessment Needed to Identify if Foreign Encroachment Threatens Test and Training Ranges" <http://www.gao.gov/assets/670/667550.pdf>
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8. DoD Website, "About," <https://www.defense.gov/About/>
9. March 2017, Kroll presale, BANK 2017-BNK4 [https://www.krollbondratings.com/show\\_report/6505](https://www.krollbondratings.com/show_report/6505), p.73
10. Level IV Security (the Pentagon Center) is defined as buildings with 150K SF or more, more than 450 federal employees, and a high level of public access. The Pentagon is Level V Security, defined as a building similar to Level IV but considered critical to national security. <https://fas.org/sgp/crs/homesecc/R43570.pdf>
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12. July 2017, CSMC 2017-MOON Offering Memorandum
13. July 2017, Fitch presale CSMC 2017-MOON; Presale <https://www.fitchratings.com/site/re/900935>, p.6
14. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, summary page and p.24
15. January 2017, United States Government Accountability Office (GAO) Report to Congressional Requesters, "GSA Should Inform Tenant Agencies When Leasing High-Security Space from Foreign Owners"; <http://www.gao.gov/assets/690/681883.pdf>, summary page and p.35

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