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EXCLUSIVE REPORT

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The Return-to-Office Rebound

- Work From Home Crushed This Business
- Waiting for a New Surge In Commercial Real Estate

The Return-to-Office Rebound

Work From Home Crushed This Business

Waiting for a New Surge in Commercial Real Estate

> *This issue's interest costs will be*
> *Paid fully, in our estimation,*
> *And holders have additional security*
> *From overcollateralization*
>
> *- Martin Fridson*

Pornography was Sam Zell's gateway drug to investing.

As a teen in the late 1950s, Zell would buy old issues of *Playboy* for 50 cents in downtown Chicago. Then he'd make the trek out of town to sell the tattered girly mags for $3 a pop to kids in the suburbs – where the recently launched *Playboy* wasn't yet on newsstands.

After high school, Zell attended the University of Michigan, where as a freshman he managed 15 apartments in exchange for room and board. At the end of his four years there, he had taken on other properties, earning $150,000 (that's more than a million in today's dollars) during his senior year.

In law school, he went big, managing 4,000 apartments as his side hustle. With a law degree, a pile of cash, and plenty of real-world real estate experience, Zell in the late 1960s started acquiring and managing apartments and apartment buildings in Reno, Nevada, after a friend suggested he could find "hidden gems" there.

He continued buying into the 1970s – in Reno, in Michigan, and in Toledo, Ohio. Low interest rates had created a surge in new construction. He recruited new investors so he could expand his portfolio of properties to include Arlington Towers, at the time the tallest building in Reno, for which he paid $9 million.

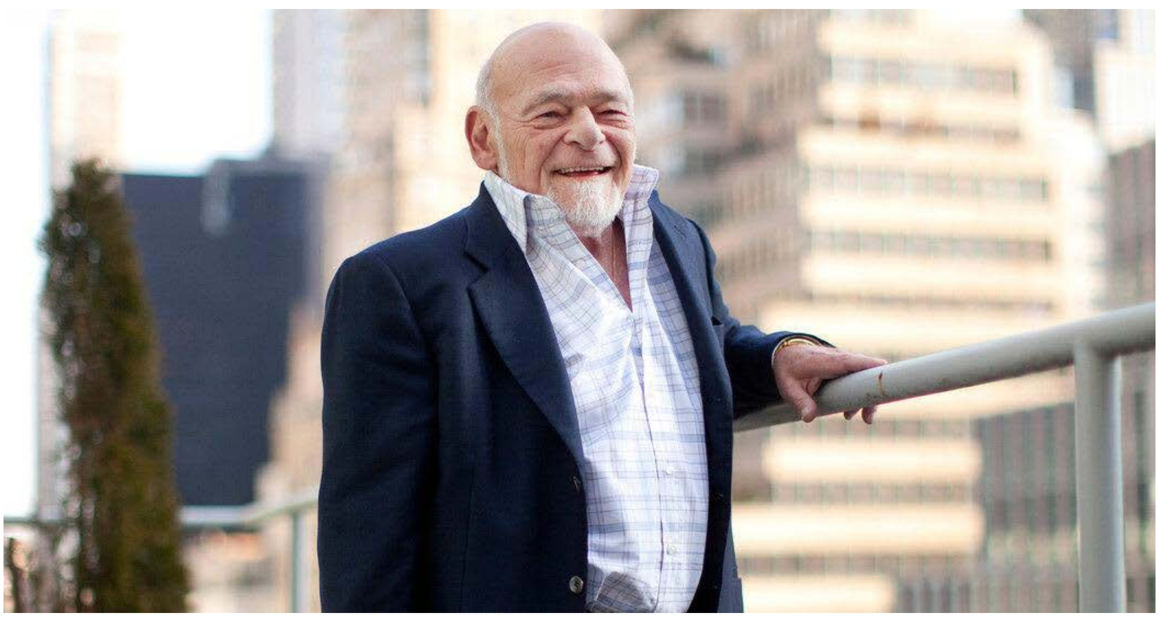
But – as often happens in markets – cheap money led to a bubble. By the mid-1970s, the real estate market was in the midst of a bust. Quality buildings went on sale at bargain prices – as the blind exuberance that fueled the building spree turned to desperate panic as the market collapsed. Not over-leveraged and in good financial shape, Zell gobbled up properties.

It was the kind of bold, take-no-prisoners investing that would make Zell – who titled his autobiography *Am I Being Too Subtle? Straight Talk From a Business Rebel* and headed up a motorcycle gang called Zell's Angels – a billionaire five times over.

Zell grew his business through the late 1970s into the '80s, always looking for good properties at bargain prices. And he found them following the Black Monday stock market collapse in the autumn of 1987, and the subsequent recession. With rents and occupancy rates falling, office landlords were squeezed. Zell raised capital for a fund to buy the distressed properties.

Zell made himself richer – and he also popularized the vehicle that made the investment work. He ushered in the modern version of the real estate investment trust ("REIT"), a – until then – rarely used Eisenhower-era structure to invest in real estate.

Zell refocused REITs to benefit shareholders, himself included – establishing a number of them, including Equity Commonwealth that funded office buildings in the 1980s, then Equity Residential for apartments a decade later, and Equity LifeStyle Properties for prefab houses after that. Each fund was launched at a time when that particular sector of the real estate market was in the doldrums – or on the verge of emerging from the depths.



He gave himself the nickname "grave dancer" for his predilection for swooping in on an asset – an investment – that was on death's doorstep.

By 2007, he had amassed a vast real estate fortune, valued at… well, whatever someone would pay for it, as he liked to say.

That someone, it turned out, was giant money manager Blackstone, who paid Zell and his partners $39 billion for Equity Office Properties, with 500 office buildings and 100 million square feet across the U.S. The purchase was 25% above the REIT's market cap at the time.

A year later, the Great Financial Crisis struck… and Zell was off enjoying life, riding with his Angels, rather than worrying about real estate. Lehman Brothers collapsed, other banks failed, and commercial property values plunged.

Zell died last year, at age 81. But if he were alive, he'd likely be dancing on graves now, because today, commercial real estate is once again in distress. Office vacancy rates across top major U.S. cities are about 20% above what they were in 2020, just before the pandemic.

With legions of employees permanently working from home, companies are giving up their acres of cubicles, and abandoning offices. Companies are shrinking their square footage, consolidating spaces, and driving up vacancy rates.

Conventional wisdom argues for staying away from the office and retail assets that helped make Sam Zell a billionaire. Malls have long been written off for dead, e-commerce is empty out bricks-and-mortar stores, and vacancy rates are rising in cities across the country.

Just last year, Zell ridiculed remote work as "a bunch of bull****" and explained why he doesn't believe it will become a new, permanent norm.

In this issue, we look at the bonds of one REIT that are in deep distress – its vast holdings of offices and mixed-used space has been hurt by the pandemic-driven, work-from-home trend… one that Zell would likely be looking at very closely as well.

What we like about these bonds:

- At market prices, the current income on the bond is roughly 4.8% per year
- They are currently selling at a very distressed price, with an annual yield of 31%
- The market price has declined so far that the upside potential exceeds downside risk
- At book value the company's real estate assets are worth 27% more than all its debt – valued *at full face value*
- The company's properties generate substantial operating income
- Even with operating results in 2024 likely to decline meaningfully, the company should comfortably be able to make all interest payments on time

A Company With No Employees

Office Properties Income Trust (Nasdaq: OPI) owns office buildings and mixed-use properties (for OPI, this means laboratory space and hotels) across the U.S. It will generate revenue – essentially rental income – of roughly $500 million this year. This is down from $534 million in 2023 and $554 million in 2022.

Owing to an oversupply of office space, one of OPI's bonds has declined in price from $970 in 2022 to $490 now. Still declining in value, the bond is currently priced as if a bankruptcy (or a distressed exchange) is likely.

(The stock experienced an even more dramatic decline – it went from $25.93 in 2022 to around $2, where it currently trades.)

That said, we believe the market has driven down the price of OPI's bonds too far. These 2.4% bonds scheduled to mature on February 1, 2027, are selling at half price – $1,000 face value for (roughly) $500. In this issue, we will show you why we think they're worth more than that – possibly much more.

OPI has high-quality assets and a high-grade tenant base. And the company holds $1.2 billion of assets that it could sell or mortgage to raise cash. Alternatively, OPI may attempt to extend the maturity of its bonds to give it time for the real estate markets to stabilize and eventually improve.

OPI is a real estate investment trust ("REIT"). The instrument popularized by Sam Zell, a REIT owns real estate on which it collects rents, which it then distributes as dividends. By buying shares of a REIT, investors can enjoy the benefits of being a landlord without the hassle of buying and managing properties. In the case of a publicly traded REIT like OPI, shareholders own a real estate asset that's far more liquid than an office complex or apartment building.

OPI's REIT structure also enables it to deliver tax benefits to its shareholders. As long as a REIT distributes at least 90% of its income as dividends, it's exempt from taxes at the corporate level. Those profits consequently avoid the double taxation imposed on conventional corporate earnings – that is, when a company's profits are taxed, and then part of the remaining profit is taxed again when shareholders receive them as dividends.

OPI's strategy is to buy and lease high-quality office and mixed-use properties in growing markets around the country. The company aims for geographic balance, owning buildings in central business districts and suburbs. It also strives to have tenants from a wide variety of industries.

Office Properties Income Trust owns 152 properties amounting to 20.5 million rentable square feet – roughly the equivalent of nearly eight Empire State Buildings. Most of the properties are office buildings and a few are multi-purpose office/hotel complexes. The company operates in 30 states and Washington, D.C. And 52.8% of OPI's rentable space – accounting for 68.4% of the $3.42 billion total value of its properties – is located in five markets:

Office Properties' Top Five Markets

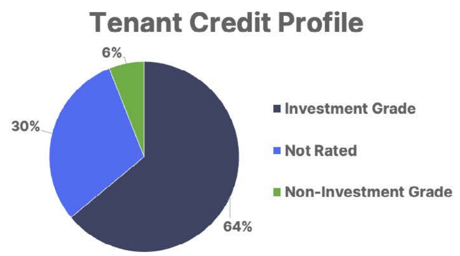
	% of Square Feet	% of Value
Washington, D.C., Virginia, and Maryland	21.6%	33.5%
Illinois (mostly Chicago area)	10.6%	9.8%
Georgia (mostly Atlanta area)	9.4%	9.0%
California (mostly Silicon Valley)	6.0%	9.8%
Texas (mostly Dallas/Fort Worth)	5.2%	6.3%
Total	**52.8%**	**68.4%**

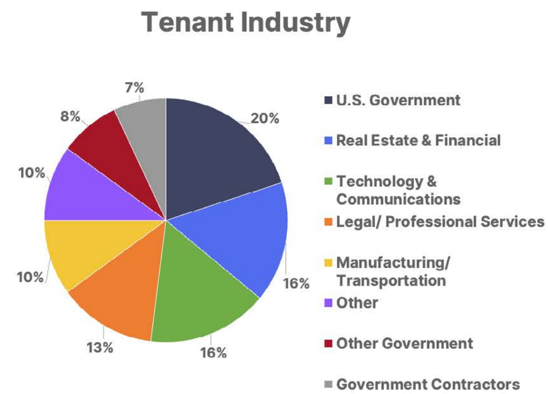
(% of value based on current depreciated book value December 31, 2023)

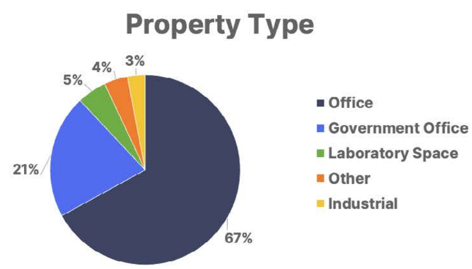
Another 15% of OPI's rentable area is in Kansas City (Missouri), Sacramento, Boston, Provo (Utah), and Indianapolis, with the remaining 32% spread over many smaller markets.

The average rental rate at OPI's properties was $28.51 per square foot in 2022 and rose 1% in 2023 to $28.99 per square foot – slightly below the national average. As of December 31, OPI's properties were 89.5% leased, resulting in a vacancy rate of 10.5%, compared to a vacancy rate of 16.9% nationally. The average lease has six years remaining.

OPI works to maintain a tenant base made up of companies in solid financial condition representing a variety of businesses. About 64% of OPI's tenant revenues come from companies (and subsidiaries of companies) with investment-grade credit ratings. Various agencies of the federal government account for just under $100 million, or 19.5% of total annualized rental revenue.







The company is in the process of completing two significant projects that together will cost an estimated $389 million and begin to create revenue and cash flow in a little over a year. In 2023, the company completed a 427,000-square-foot mixed-use redevelopment named 20 Mass on Massachusetts Avenue in Washington, D.C. The property is 55% leased to Sonesta Hotels, and OPI is marketing the remaining vacancies. According to management, many parties are touring the property, mostly looking for occupancy in 2025.

Also, OPI recently completed its Unison project, a 300,000-square-foot redevelopment of three adjacent properties in Seattle. Two buildings are being converted into life-sciences properties, which provide both office and advanced laboratory suites. The third will be used as office space. This project is 28% leased to Sonoma Biotherapeutics, and OPI is marketing the remaining space.

Office Properties Income Trust itself has no employees. RMR Group – a real estate company that oversees roughly 2,000 properties that generate $5 billion in annual revenue – provides day-to-day property management. It also supervises construction, leases out properties, and provides financial management. (RMR also manages properties for **Diversified Healthcare Trust (Nasdaq: DHC)**, **whose bond we hold in the Distressed Investing portfolio**, and has extensive experience and contacts in the corporate real estate world.)

RMR receives fees for developing, leasing, and managing OPI's office and mixed-use properties. RMR's total compensation is heavily dependent on how the properties and OPI's shares perform. For instance, its management fee is based on the *lower* of the properties' cost or the market valuation of its stock. In addition, using the stock price simply as a compensation metric, RMR earns incentive fees only if OPI stock outperforms similar publicly traded REITs that own office properties.

FEES THAT OPI PAYS TO RMR ARE PRIMARILY PERFORMANCE BASED WHICH ALIGNS INTERESTS WITH SHAREHOLDERS

RMR base management fee tied to OPI share price performance.

- Consists of an annual fee equal to generally 50 bps multiplied by the lower of: (1) OPI's historical cost of real estate, or (2) OPI's total market capitalization.
- There is no incentive for RMR to complete any transaction that could reduce share price.

RMR incentive fees contingent on total shareholder return outperformance.

- Incentive management fee: 12% of the outperformance of our total return per share compared to the MSCI U.S. Office REIT Index over a three year period multiplied by equity market capitalization.
- Outperformance must be positive to be earned.
- Shareholders keep 100% of benchmark returns and at least 88% of returns in excess of the benchmark.

Other fees.

- Property management fee: consists of an annual fee based on 3.0% of rents collected at OPI's managed properties.
- Construction management fee based on 5.0% of project costs.

Alignment of Interests
If OPI's share price goes up and its total market cap exceeds its historical cost of real estate; RMR base management fee is capped at 50 bps of historical cost of real estate.
If OPI's stock price goes down and its historical cost of real estate exceeds its total market cap; RMR gets less base management fees (50 bps on equity market cap plus debt).
Incentive fee structure keeps RMR focused on increasing total shareholder return.
Members of RMR senior management are holders of OPI common shares, some subject to long term lock up agreements.
OPI shareholders have visibility into RMR, a publicly traded company.
OPI benefits from RMR's national footprint and economies of scale of $36 billion platform.

Source: Office Properties Income Trust, April 2024

Why the Merger With DHC Failed

Last year, RMR attempted to merge Diversified Healthcare Trust into OPI. It contended that the combination made sense to both parties:

- OPI would become more diversified. In addition to office and multi-use buildings, the merged company would also have DHC's life-sciences buildings and senior-housing facilities.
- DHC would have more potential collateral it could use to refinance the roughly $750 million of bank debt and bonds that would come due in 2024.

As part of the proposed transaction, DHC shares would be exchanged for OPI stock – and shareholders of both companies would ride the upside (and downside) from the *combined, more diversified* portfolio of real estate assets.

A group of shareholders led by investment funds Flat Footed LLC and D.E. Shaw & Co. convinced shareholders to reject the proposed OPI/DHC merger. DHC's shareholders preferred the potential upside they saw from that company's life-sciences buildings and senior-housing complexes. This shareholder group pointed out that with DHC's asset base, the company could raise the money on its own to pay off the bonds and bank debt scheduled to mature in 2024.

In the near term, the merger with DHC would have been good for OPI, allowing it to diversify its holdings and be less dependent on the office market. Despite its impressive roster of tenants, many in strong financial condition, its bonds trade at distressed prices because there is a nationwide glut of office space. In fact, 19.6% of office space is currently unleased, the highest level since 1979, according to *The Wall Street Journal*.

This excess of unleased office space has come about for a few main reasons:

- Working from home, a trend that started with pandemic lockdowns, remains popular with employees – and some employers as well
- Economic uncertainty triggered by the pandemic left many companies in weak financial shape and looking to reduce fixed expenses
- Rising interest rates have increased borrowing costs over the last couple of years

OPI ended 2023 with 2.69 million square feet – 10.5% of its space – vacant. In addition, 34% of its leases – and annual rental income – come due from 2024 through 2026.

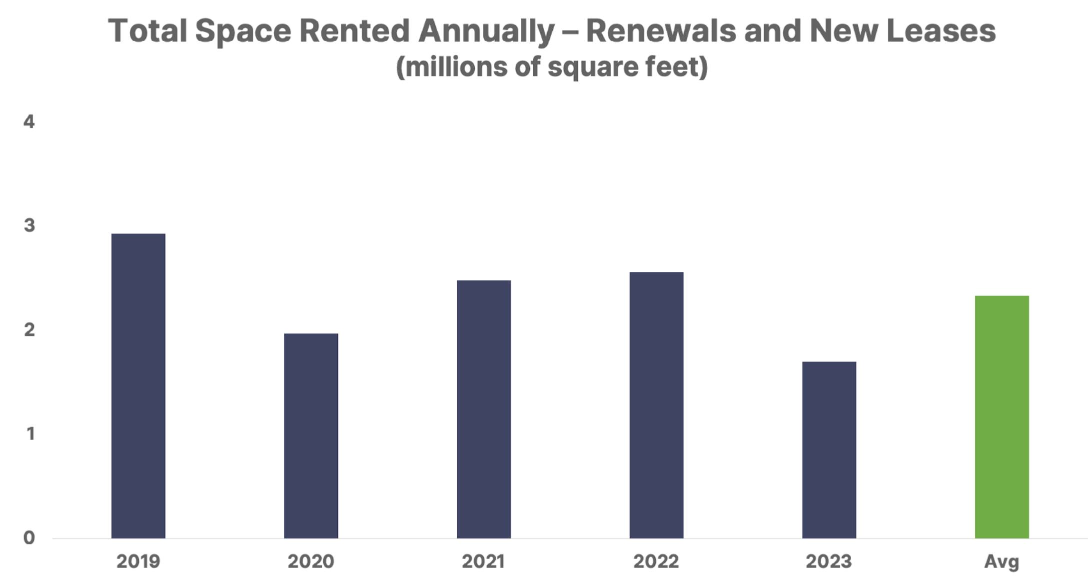
OPI Lease Maturities

	Leased Square Feet Expiring (millions)	% of Total	Annualized Rental Income Expiring ($millions)	% of Total
2024	2.98	16.7%	$79.25	15.5%
2025	2.13	11.9%	$54.21	10.6%
2026	1.45	8.1%	$40.97	8.0%
Three Year Total	6.56	36.7%	$174.43	34.1%

OPI has leases totaling 2.98 million square feet scheduled to expire over the course of 2024. As of February 14, 2024, tenants accounting for at least 1.88 million rentable square feet ($53.8 million in rental income) indicated they will not be renewing their leases. The company has inquiries on 2.8 million square feet of office space (roughly 60% from current lessees and 40% from new tenants). OPI reports that the level of competition for new tenants is intense, and that it's dragging down rental rates. OPI is likely to end 2024 with additional unleased space.

OPI's road gets a little easier after 2024. The company's schedule of expiring leases declines almost 30% in 2025, and by almost half in 2026 – compared with 2024. It is reasonable to believe that after peaking in 2024 or 2025, the amount of OPI's unleased space could begin to decline around 2026.

Without question, this will be a tough year for Office Properties Income Trust with significant lease expirations and intense competition. On a positive note, the company was able to lease or re-lease 1.70 million square feet of space in 2023, despite similarly difficult conditions. In better markets, OPI was able to lease as much as 2.93 million square feet of space. Over the last five years, it has been able to lease or renew 2.33 million square feet of space on average.



There are a few longer-term reasons to be guardedly optimistic about its prospects:

- Companies are increasingly requiring employees to spend more time in the office
- Some office space – particularly in older buildings with smaller floor plates – can be converted into residential housing, which is in short supply in many markets
- Over time, economic growth should cause demand for office space to rise

Looking at OPI's Financials

OPI's office buildings and multi-use properties have traditionally generated more than enough cash to cover its interest expenses. It's a convention in commercial real estate to gauge operating performance by looking at net operating income – rental income minus property expenses – which, as the table below shows, has been in steady decline since 2019.

OPI's Net Operating Income

Year	Net Operating Income	Interest Expense
2019	$449.4 million	$134.9 million
2020	$392.0 million	$108.3 million
2021	$373.4 million	$112.4 million
2022	$359.1 million	$103.5 million
2023	$334.0 million*	$110.6 million

(*Excludes a one-time charge of roughly $30 million related to the attempted merger with Diversified Healthcare Trust.

Turning to 2024, expiring leases account for $53.8 million in annual rent. If the company were unable to rent *any* of the space it knows will be vacated in 2024, its revenues and operating profits would fall by the same amount. It's likely that OPI will be able to rent at least a modest percentage of that space. For this reason, we're assuming that lease vacancies will end up reducing 2024 operating results by $40 million to $50 million – a 15% decline over 2023.

On the positive side, OPI should start receiving revenue from the 20 Mass Ave and Unison projects, which together are expected to generate $35 million to $40 million in operating profits once fully leased. We estimate these redevelopment projects will add $10 million to $15 million to profitability in 2024.

In the chart below, the low profit estimate assumes $50 million negative effect of lease vacancies and $10 million benefit from new properties, and the higher profit estimate assumes $40 million negative effect of lease vacancies and $15 million benefit from new properties.

Estimating 2024 Operating Profit	
Net operating income in 2023	$334 million
Effect of lease vacancies in 2024	($40 million) to ($50 million)
Benefit from 20 Mass Ave and Unison Projects	$10 million to $15 million
Estimate of 2024 operating profit	$294 million to $309 million

Given rising interest rates and increased borrowing, we estimate interest expenses in 2024 will rise to roughly $125 million to $135 million, from $110.6 million.

On its most recent conference call with investors, OPI's management said that it in 2024 it expects to make capital expenditures of **$120 million** for:

- Office improvements for new and renewing tenants **$75 million**
- Investments to improve current properties **$25 million**
- Completing the Seattle Unison Elliott Bay Project **$20 million**

Putting these pieces together, OPI would generate modest free cash flow ("FCF") of $39 million to $63 million after interest payments and capital expenditures, which would likely go toward paying down debt.

2024 Free Cash Flow – Available to Pay Down Debt	
Estimated net operating income	$294 million to $309 million
Minus interest expense	$125 million to $135 million
Capital expenditures	$120 million
Free cash to pay down debt	$39 million to $63 million

Maintaining a Good Level of Liquidity

Since year-end 2023, OPI has taken a number of steps to maintain financial stability. On December 31, OPI had $13.4 million in cash, and it has $193 million available on its bank loans. The company also refinanced its bank agreement, issued new 9% secured bonds, and repaid $350 million in 4.5% bonds that were scheduled to mature on May 15, 2024.

On January 29, 2024, the company signed an amended credit agreement with its banks. The new loan raised the total OPI could borrow to $425 million from $325 million – and it extended the loan's maturity date by roughly three years, to January 29, 2027. These loans are secured by properties with a book value of $942 million.

OPI followed this up on February 12 by issuing $300 million of 9% bonds maturing on March 31, 2029 – secured by assets with a book value of $554 million. On March 9, the company used the proceeds of this bond issue (plus some cash) to redeem in full the $350 million issue of 4.25% unsecured bonds that were scheduled to mature on May 15, 2024.

In these two transactions, OPI raised a total of $725 million. It pledged properties with a book value of $1.5 billion. Because it's currently difficult for real estate companies to raise money, lenders are requiring unusually large amounts of collateral – so that even a forced sale would generate more than the total loan amount. In this case, the borrowed amount of $725 million represents just 48.5% of the $1.5 billion of *collateral* against it – an amount much lower than the 60% to 80% historically required.

OPI also has $529 million in mortgages backed by specific properties we estimate to be valued at $705 million. Since most of these mortgage loans were made when real estate values were higher and markets more robust, we assume that on average the banks applied a 25% discount, so the loans ($529 million) amounted to 75% of the property's value ($705 million).

To summarize, OPI borrowed $725 million against $1.5 billion (book value) in assets – and it has mortgages backed by an estimated $705 million in assets. Putting these together, the total book value of properties mortgaged or pledged as collateral is $2.2 billion. Based on the current $3.4 billion book value of the properties, this leaves $1.2 billion in unpledged assets.

OPI's Unpledged Assets	
Book value of all properties	$3.4 billion
Value of properties securing loans	$2.2 billion
Book value of remaining properties	**$1.2 billion**

Three Valuation Methods

We are going to value OPI in three ways: book value, collateral value in the recent loan transactions, and using an industry-standard method called the capitalization rate.

Book Value

OPI's properties are currently on its books for $3.4 billion. (This value accounts for depreciation – based on the initial cost, the valuation would be close to $4.1 billion.) The company owes its bank lenders and bondholders $2.7 billion, comprised of $982 million in secured debt detailed above and $1.7 billion in unsecured debt, made up of four bonds maturing between 2025 and 2031, that we will detail shortly. Based on today's book values, the properties are worth 27% more than OPI's debt.

OPI Has More Assets Than Debt	
Book value of OPI's properties	$3.4 billion
Total secured and unsecured debt	($2.7 billion)
Value over debt	**$733 million**
Total assets/Total debt	127%

It is entirely possible that OPI will write down the book value of some of the properties – or sell them below book value to pay off bonds coming due – over the next couple of years. This 27% valuation cushion means the properties could decline in value by $733 million and there would still be enough value left to cover OPI's bonds in full.

When we factor in buying OPI's bonds at a discount from their $1,000 face value, the cushion increases:

A Comfortable Cushion
($1.7 billion in unsecured bonds)

Trading Discount	Market Value Cushion	Total Cushion (including $733 million)
10%	$170 million	$903 million
20%	$340 million	$1.07 billion
30%	$510 million	$1.24 billion
40%	$680 million	$1.41 billion
50%	$850 million	$1.58 billion

For example, if an investor buys one of OPI's bonds at a 40% discount from face value – that is, paying $500 for a $1,000 bond – the value of OPI's properties could fall by as much as $1.6 billion (46.2%) from their current book value of $3.4 billion and OPI's assets would be worth what that person paid for them. That's a substantial safety cushion.

Collateral Value

Let's look at the collateral value of assets that OPI has pledged for recent loans...

Because of the current uncertainty in the real estate market, lenders are requiring unusually high collateralization of loans. In practice, lenders apply a "haircut" – shaving off an amount from the actual value – to make sure that even in a forced sale the properties would be worth more than the loan amount. In today's market, that haircut is larger than it has been in the past.

As a reminder, since January 29, OPI pledged properties with a book value of $1.5 billion to borrow $725 million. This means the lenders were valuing these properties *as collateral* at 48.5% of book value – much lower than the 60% to 80% valuation used in a stronger market.

If we apply the 60% to 80% figures to the $3.4 billion book value, we arrive at a range of normal-sale values of $2.05 billion to $2.73 billion. Subtracting the $982 million devoted to secured debt leaves us with a minimum $1.06 billion for unsecured debt – or 63.9%. This would equate to valuing the unsecured bonds at between $639 on the low end and $1,000.

Collateralized Bond Value	
Book value of properties	**$3.42 billion**
Valuation percentage	**60% - 80%**
Equals	**$2.04 billion - $2.73 billion**
Deduct secured debt	**$982 million**
Value left for unsecured bonds	**$1.06 billion – 1.75 billion**
Total unsecured bonds	**$1.7 billion**
Value per $1,000 bond	**$639 - $1,000+**

Valuation Based on Capitalization Rate

The most common method that real estate professionals use to value properties is a capitalization rate – which is a multiple of net operating income that is widely accepted in the industry. To find this value, take the property's net operating income (rental income minus expenses) and divide it by a capitalization rate – an approximate return on capital investors would require. The higher the capitalization rate, the lower the resulting value, and the lower the capitalization rate the higher the resulting value. In a down market, commercial investors require a higher return on investment given the uncertainty of a property's future value.

According to a March 20 Standard & Poor's *Global Market Intelligence* report, the average capitalization rate for REITs that own office properties is 11.6%, compared with 9.5% in 2022.

Earlier in the report, we estimated OPIs net operating income would be between $294 million and $309 million. Let's call it $300 million. If we apply a range of capitalization rates from 10% to 20% to this net operating income, the valuation of OPI's properties would be between $1.5 billion and $3 billion. Again, there is $982 million in mortgages and other secured debt that has first claim on the assets.

After we deduct $982 million, the value left to pay the $1.7 billion in unsecured bondholders is between $0.52 billion and $2.18 billion. So at the low end, dividing the $0.52 billion unsecured debt by the $1.7 billion for unsecured bondholders and you arrive at a value for the unsecured bonds of around $306 – and at the 10% high end, full repayment of the $1,000 face value. A cap rate of 11.6% produces a value of $943.

Valuation Using Capitalization Rate

Cap Rate	Property Value	Less Secured Debt	Value for Unsecured	Per $1,000 Bond
10%	$300 million/10% =$3.00 billion	$982 million	$2.18 billion	$1,000+
12%	$300 million/12% =$2.50 billion	$982 million	$1.52 billion	$894
14%	$300 million/14% =$2.12 billion	$982 million	$1.16 billion	$682
16%	$300 million/16% =$1.87 billion	$982 million	$0.89 billion	$523
18%	$300 million/18% =$1.67 billion	$982 million	$0.69 billion	$406
20%	$300 million/20% =$1.50 billion	$982 million	$0.52 billion	$306

A Shakeup: OPI Looks at Restructuring

During a conference in February, OPI management indicated that it expects to *be able to* pay off bonds maturing in 2025 – through some combination of property sales and bank borrowing. We added the emphasis because just being *able to pay* does not necessarily mean OPI *will pay* those bonds off.

In late 2023 OPI hired Moelis & Company, a leading financial advisor specializing in restructuring companies with high levels of debt, to address the upcoming maturities. Rather than repaying $650 million to the holders of the 4.5% bonds that mature on February 1, 2025, OPI would prefer to have Moelis find ways to push out all its bonds coming due over the next three years.

In fact, OPI would likely want to push out the maturity of the $650 million of 4.5% bonds maturing on February 1, 2025; the $300 million of 2.65% bonds coming due June 15, 2026; and the $350 million in 2.4% bonds maturing on February 1, 2027.

If it could push these three issues to later maturity dates, OPI would not have any debt coming due until the new bank loans of up to $425 million mature on January 29, 2027.

Extending bond maturities would buy OPI three years or more for real estate markets to stabilize and then improve. Since the company *does* generate more than enough cash to make all of its interest payments on these bonds and bank loans, the holders of the 2.65% bonds maturing June 15, 2026, and the 2.40% due February 1, 2027 – which we are recommending in this issue – would likely agree to extend the maturities on all the unsecured debt that will come due over the next three years.

Office Properties Investment Trust Debt

Type of Debt	Maturity	Amount Outstanding ($millions)	Market Price (% of $1,000 face amount)	Market Value of Bond Issue
Secured debt				
Bank loans	1/29/27	$205	100%	$205
Other senior	Various	$477	100%	$477
9% secured Bonds	3/31/29	$300	100%	$300
Total secured debt		**$982**		**$982**
Unsecured debt				
4.50%	2/1/25	$650	84%	$546
2.65%	6/15/26	$300	60%	$179
2.40%	2/1/27	$350	51%	$180
3.45%	10/15/31	$400	42%	$166
Total unsecured debt		**$1,700**	**63%**	**$1,071**

All figures 12/31/23

**Since these bonds aren't due for more than seven years, OPI would have no need to extend the maturity.*

How a Bond Exchange Might Work

Extending bond maturities would buy OPI at least three years for real estate markets to stabilize and then improve. The holders of $300 million in 2.65% bonds maturing June 15, 2026, and $350 million of 2.4% bonds maturing February 1, 2027, should find it in their own best interest to agree to take longer-term debt – ideally with a higher coupon and possibly also secured by OPI's unpledged assets.

The holders of the $650 million in 4.50% bonds scheduled to mature February 1, 2025 – which the company has implied it will honor – will most likely expect to be paid in full. Moelis & Company might suggest giving these bondholders new longer-term bonds secured by OPI's unpledged assets – worth a total of $1.21 billion at book value. However, the holders of these bonds might not want longer-term bonds and may choose to play hardball and hold out for a cash payment at maturity or before – which OPI could probably do if it sold enough assets.

If OPI is able to come to terms on an extension with these 4.50% February 2025 bondholders, the rest of the bondholders should fall in line. Their bonds are all trading at or below 60 – which is $600 per $1,000 face amount. They would likely accept longer-dated unsecured bonds in exchange for a few years of interest payments and a hope that OPI's real estate markets improve – and thus the value of their bonds.

The main point is that Moelis & Company needs to find an alternative to paying off the $650 million in 4.5% bonds maturing February 1, 2025, because paying them off would make paying off the other bonds more difficult and therefore less likely. The $300 million of 2.65% bonds mature just 16 months later, on June 15, 2026, and then $350 million of 2.40% bonds on February 1, 2027.

Unless OPI's markets turn around fairly soon, the company would probably not be able to meet these obligations as well as the 4.5% one expiring in February 2025. A voluntary restructuring *now* looks better to OPI than a possible bankruptcy *in 2026*.

The Best Risk/Reward Profile

There are two basic types of risk to consider when buying distressed bonds:

- The odds that the company makes all payments of interest and principal on time and in full
- How much an investor stands to lose (or, sometimes, gain!) if the company that issued the bonds attempts a distressed-bond exchange or files for bankruptcy

Many companies have more than one bond issue outstanding at any time – as is the case with OPI. When a company has a number of bond issues, we need to figure out *which* one of those bonds offers investors the most favorable combination of upside potential and downside risk.

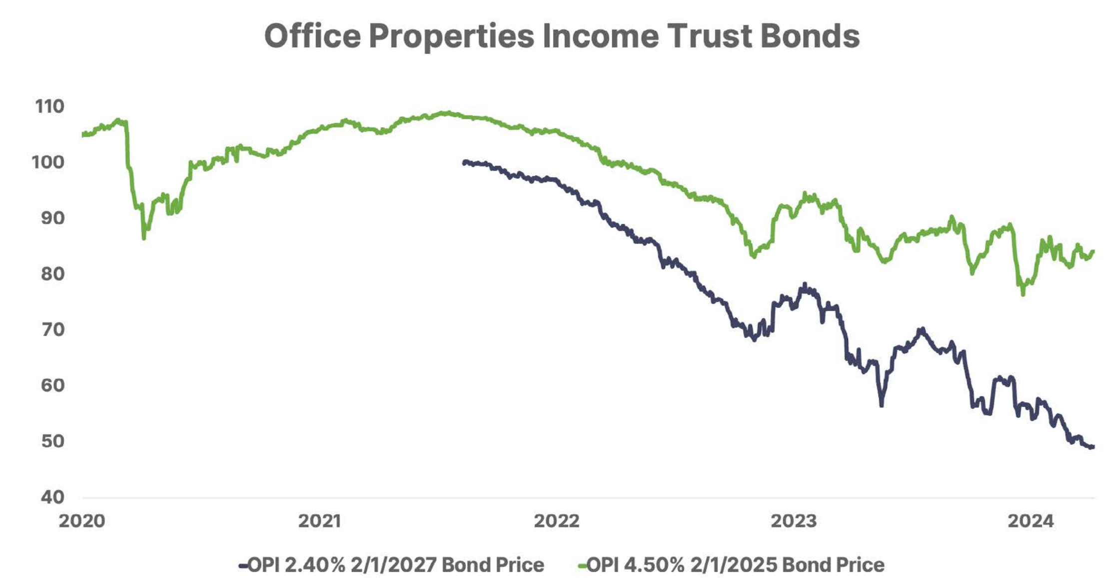
When there is no (or very little) risk that the company might end up filing for bankruptcy, we focus on the bond's price, how long until it matures, and what annual return an investor can expect if they hold the bond until it comes due and gets repaid in full.

That's not the case with OPI – as there is the potential of a bankruptcy filing.

Which bond to buy when there is a risk the borrower will file for bankruptcy – or try a distressed exchange to stave off bankruptcy – is more complicated. A bankruptcy filing means the company stops paying interest while it works out a plan of reorganization with its creditors. (To read in detail about how bankruptcy works, read Porter & Co.'s detailed guide, **Learning to Love Bankruptcy**.)

When a company files for bankruptcy, all of its bonds are accelerated – which means they're all considered to mature the day of the bankruptcy filing. Interest rate and maturity date don't matter anymore. All bonds with the same level of seniority are treated equally.

Let's look at two bonds issued by Office Properties Income Trust – both on the chart and the more detailed table below (bonds are quoted in percent-of-face-value terms, so $490 on face value of $1,000 translates to a price of 49):



Source: Bloomberg

Bond Issue	Maturity	Market Price	Maturity Value	Expected Return/Year
4.50% unsecured	February 1, 2025	$835	$1,000	28.5%
2.40% unsecured	February 1, 2027	$490	$1,000	30.7%

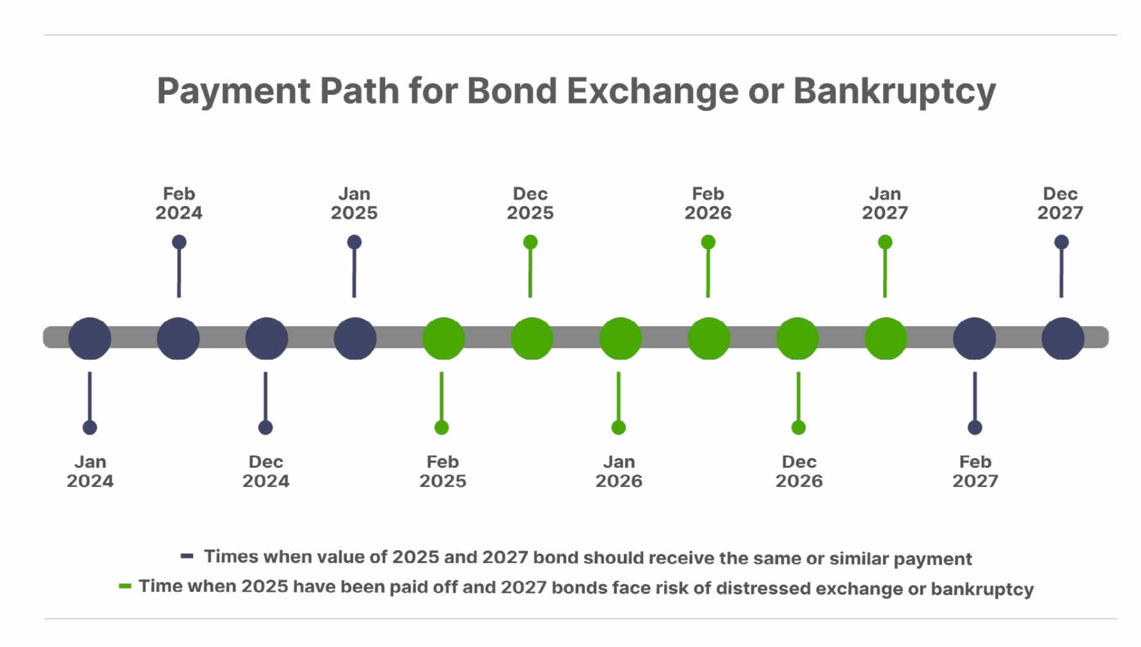
Here are some key points to note:

- The extremely high expected annual returns (or maturity values) of 28.5% and 30.7% show the market is worried that OPI's bondholders will not receive full $1,000 payment per bond – and that the company will need to file for bankruptcy or attempt a bond exchange of some sort.
- The bond maturing in 2025 trades at a higher price than the bond maturing in 2027 because the odds of OPI making all payments of interest and principal through 2025 are higher than making all payments through 2027.
- This lower odds of OPI making all principal and interest payments through February 2027 means the expected return for the bond maturing in 2027 is higher than for the bond maturing in 2025 – because an investor requires a higher return for assuming the higher risk.

Let's look at some possible outcomes:

- If the company never files for bankruptcy or attempts a distressed exchange, both bonds end up being paid in full. The profit is higher on the lower-priced 2027 bond.
- If the company were to file for bankruptcy before February 1, 2025, both bonds would be subject to loss. At the end of a bankruptcy both would likely be lumped into one security and receive the same payment.
- If this happens, the potential loss on a bond (in this case the 2025 one) that costs $843 is greater than on one that costs $490.
- If the company were to file for bankruptcy *after* February 1, 2025, and *before* February 1, 2027, the 2025 bond would have been paid off in full and the 2027 bond would probably receive less than the full value the 2025 bond gets.

We recommend purchasing OPI's 2.40% bonds maturing February 1, 2027. At the lower price of $490 (rather than $843 for the 2025 bond) the upside is greater if the company doesn't go bankrupt or launch a distressed exchange – or if it holds off doing it until after February 1, 2027. Because the bond is already so heavily discounted, the downside risk is lower if it does end up filing for bankruptcy.



Risks

The distressed $490 trading price of OPI's 2.4% bonds maturing on February 1, 2027, indicated that the risk level here is high. The most significant risks for OPI and its bondholders are:

- With a large segment of employees in the U.S. continuing to work from home – at least for part of the week – many businesses are committed to renting more office space than they currently need. Because of that, office vacancy rates have risen in most markets over the last few years and are likely to keep increasing in 2024.
- Rising vacancy rates for office space will likely reduce OPI's operating profit and may require it to write down the book value of its properties.
- OPI has $1.3 billion in bonds maturing between 2025 and 2027. If the company believes it will be unable to repay or refinance all this debt, it will look to exchange the bonds with new longer-dated bonds. If an exchange offer fails, OPI would most likely need to file for bankruptcy.
- The company has pledged almost 80% of its assets to various lenders. In a bankruptcy, the loans secured by these properties are entitled to full repayment before any value would go to pay unsecured bondholders.
- Almost 20% of OPI's operating income comes from leases to various departments of the U.S. government, normally a secure revenue stream. An extended government shutdown, however, would have negative financial consequences.

Discussion of Bond Terms

Office Properties Income Trust's 2.4% bond maturing 2/1/27 is a $350 million bond issue that is senior unsecured – in the event of bankruptcy, bondholders would get paid along with all other unsecured debt but *after* secured bonds and bank loans are satisfied. As of February 14, there is roughly $982 million in debt secured by roughly $2.2 billion in properties and a total $1.7 billion in senior unsecured bonds – so there is more unsecured debt than available assets. Unsecured bondholders get paid ahead of all stockholders.

Action to Take: Buy Office Properties Income Trust 2.40% bonds maturing February 1, 2027 (CUSIP#67623CAE9), up to a price of $520 per bond.

Bond Box

Because of the high likelihood that this bond will be exchanged for one that matures later than February 1, 2027, we are not using our regular Bond Box in this issue. We have included our estimates of the potential outcomes for this bond in the section "Three Valuation Methods" on page 14.

How to Buy This Bond With a Live Broker

If you are putting in a phone call to your broker, here's a quick breakdown of the steps you'll go through.

1. **Tell your broker the number of bonds you'd like to acquire.**
2. **Provide the name of the borrower, the coupon, and date of maturity.**
3. **Provide the CUSIP number.**

CUSIP stands for "Committee on Uniform Securities Identification Procedures" and is a unique series of numbers and letters assigned to every traded security. Providing the CUSIP will ensure that you're buying the right security. The CUSIP of the bond we recommend in this issue is **67623CAE9**.

Specific Instructions for Buying Office Properties Income Trust's 2.4% 2/1/2027 Bond

Now, the bond we are recommending today is generally not tradeable online, except at Schwab, Fidelity, and a few very high-end brokerages, so instead you will need to place your trade by phone. We've confirmed that the Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bond secured bond is available online and over the phone at Schwab, Fidelity, and at full-service brokerage firms.

Recall that the bond market is much less popular (and there's much less trading volume) compared to the stock market, so don't be surprised if you are dealing with a broker who knows little about the bond market. This is part of the reason why, in the bond market, there are fewer market participants and less overall interest, so it's easier to scoop up bargains when opportunities arise.

The instructions for placing an order are usually standard across the brokerage platforms mentioned above.

Here's an example of how the conversation with your broker might go:

Investor: "Hello. I am interested in buying Office Properties Income Trust's 2.4% 2/1/2027 senior unsecured bond. Can you get me the bond quote so I can decide whether or not I want to buy?"

Broker: "Yes, can you confirm with me the CUSIP?"

Investor: "The CUSIP is 67623CAE9."

Broker: "We don't have these bonds in our inventory. However, we can place open market orders which allows for this bond to be traded and sold through an alternative trading system ("ATS"). We can get you a quote. How many of these Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bonds are you looking to purchase?"

Investor: "I'd like to purchase 25 of the Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bond secured bonds."

Broker: "Okay, I will get you a quote and call you back. Bye."

This is where the first conversation with the broker will come to an end… but within the next 24 to 48 hours of the next trading day, the broker should return your call and will give you the quote (the price) of the bond. This call is when you will place and confirm your order.

After your initial call to receive the quote, the broker will call you back in most cases and after he confirms he's speaking to the correct person, he can go ahead and place your order.

Here's how the second call might go:

Broker: "Hello, this is John Doe, the fixed-income specialist you spoke to earlier. I am calling to give you a quote for the 25 Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bond secured bonds you inquired about. The price for the size of your request to buy 25 bonds is $49.00 plus accrued interest. Would you like to go ahead and place the trade?"

Note: The $49 price he quoted is really $490 for the cost of each bond. When quoting bonds, brokers will most likely drop the last zero, so $49 becomes $490. Now, if the investor decides to purchase 25 bonds, his total will be $12,250 ($490 × 25 =$12,250) plus $118.25 for accrued interest ($4.73 × 25 = $118.25) and any commission or service fee.

Investor: "Yes. The total comes out to $12,368.25 plus the service fee. Is that correct?"

Broker: "Yes, it is correct. I will go ahead and make the transaction. You will get an email confirmation over the next 24 hours. Have a great day!"

As always, if you have questions, please call Lance, your personal Porter & Co. Concierge, at his team at (888) 610-8895, or internationally at +1 (443) 815-4447. We do not endorse any specific brokerage and are offering this guide for informational purposes only.

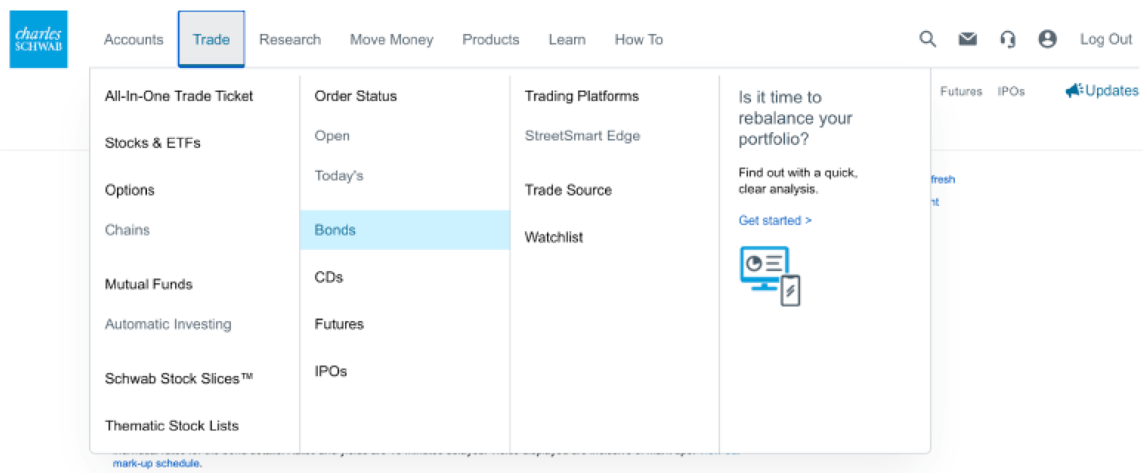
How to Buy This Bond Online

For readers who prefer to purchase bonds online or who have Interactive Brokerage accounts, we've taken screenshots to walk you through what to expect. We do not endorse any specific brokerage and are offering this guide for informational purposes only.

For Schwab Users

1. Log in to your account as you usually would access your equity portfolio.

2. Go to the "**Bonds**" section under the "**Trade**" tab at the top menu.



3. When you land on the bond page, enter the CUSIP in the bar that asks to "**Search by CUSIP**" (as seen below). The Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bond's CUSIP is **67623CAE9**.

Invest in Bonds at Schwab

You're in the right place for bonds

Visit Find Bonds & Fixed Income

Access listings from over 200 dealers, offering over 36,000 daily CUSIPs, including more than 20,000 municipal bonds[1]. The rates shown below are the best available for each maturity range and product based on $25,000 face value amount. Click on the individual rates for the bond details. Rates and yields are 15 minutes delayed. Yields displayed are inclusive of mark-ups. View our mark-up schedule.

Fixed Income Offerings POWERED BY **BondSource**™

	3 Mo	6 Mo	9 Mo	1 Yr	18 Mo	2 Yr	3 Yr	4 Yr	5 Yr	10 Yr	20 Yr	30 Yr+
CDs	5.45	5.36	5.28	5.31	5.10	5.15	5.10	4.40	5.15	4.00	--	--
Bonds												
U.S. Treasuries	5.23	5.21	5.12	5.02	4.81	4.64	4.40	4.31	4.24	4.25	4.53	4.41
U.S. Treasury Zeros	--	--	--	4.86	4.65	4.54	4.37	4.29	4.25	4.33	4.70	--
Government Agencies	--	4.99	5.08	5.01	5.06	4.81	4.93	5.11	5.46	5.76	5.24	4.95
Corporates (AAA)	--	--	--	--	4.67	4.59	4.34	--	--	4.45	4.74	5.13
Corporates (AA)	--	5.05	4.76	4.74	4.72	4.59	4.55	4.49	4.43	4.45	4.84	5.65
Corporates (A)	5.06	5.05	5.15	5.10	4.87	4.71	5.25	4.77	4.87	5.41	5.69	5.93
Municipals (AAA)	3.52	3.25	3.16	3.41	4.11	3.47	4.08	3.32	3.17	3.79	4.12	4.24
Municipals (AA)	3.70	3.42	3.44	3.70	4.11	3.82	4.08	3.57	4.04	4.08	4.60	4.59
Municipals (A)	3.71	3.60	3.44	3.70	4.11	3.82	4.08	3.57	4.04	4.08	4.60	4.59

Select a rate from above for additional information. Ratings by Standard & Poor's

Treasury Auctions | New Issue Municipal Calendar | Retail Notes | Mortgage-Backed Securities

Or Search by CUSIP 67623CAE9 **Face Value $** ,000 Go **Insert CUSIP Here**

This notification is to inform you of certain information which municipal securities dealers must provide their clients per the Municipal Securities Rulemaking Board (MSRB), including the following:

- Charles Schwab & Co., Inc. is registered with the MSRB and the Securities and Exchange Commission (SEC).
- You can learn more about the MSRB online.
- The MSRB offers the MSRB Investor Brochure, which includes information about how to file a complaint.

4. Then select to "**Buy**" the specified bond.

Overview | **Find Bonds & Fixed Income** | CD & Treasury Ladder Builder

Bonds New Issues CDs Bond ETFs

Corporates

If you have any questions, visit our FAQs, Glossary, or call a Schwab Fixed Income Specialist at **800-626-4600**. Bond prices and yields are based on $25,000 Face value, when available. Prices shown are inclusive of mark-up.

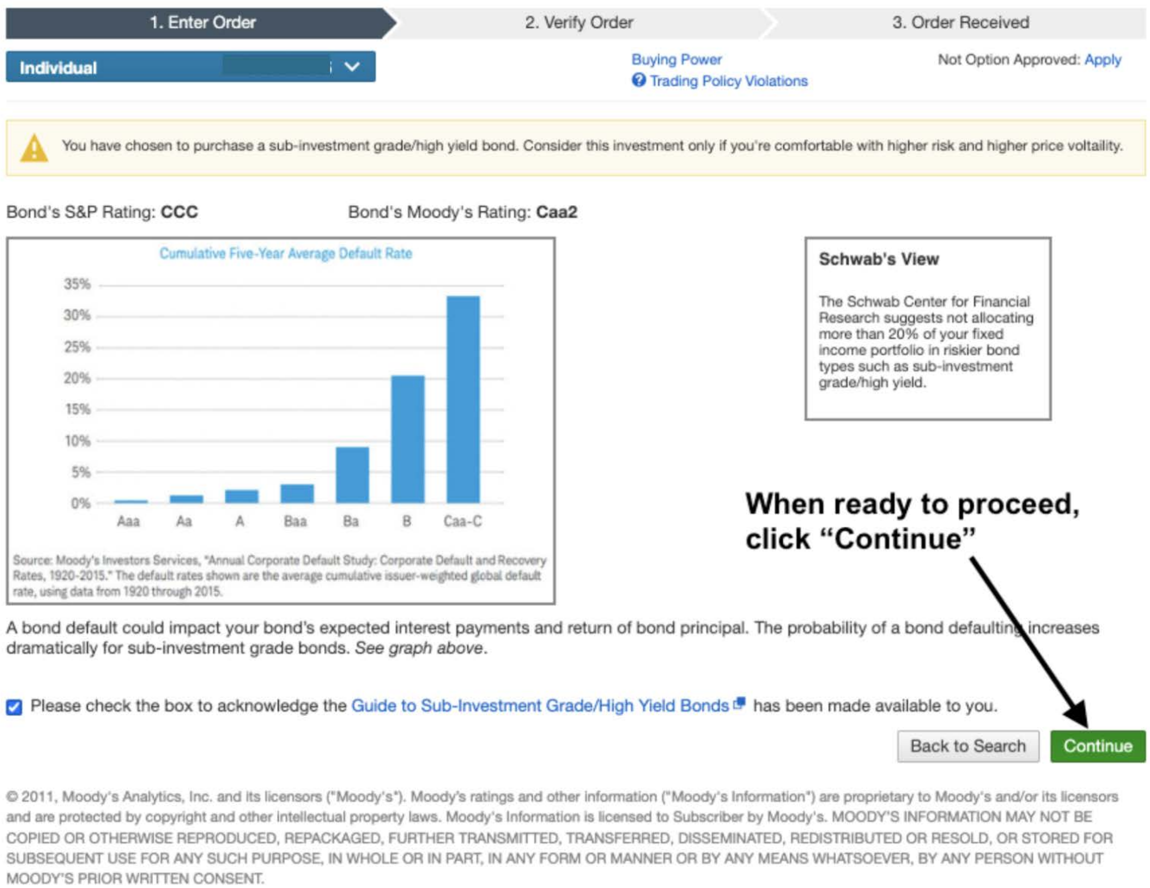
Modify Search | Save Search **Click "Buy" to enter an order**

S&P Credit Watch Symbols **Watch Positive** **Watch Negative** **!Watch Developing** | Moody's Watchlist Symbols **Review - possible upgrade** **Review - possible downgrade** **!On review**

Action	S&P Rating	Moody's Rating	Description	Coupon	Maturity	Callable	Quote	Qty	Price	Min	Max	YTM	YTW [1]	Accrued Interest	Estimated Total	Market Depth
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	49.66500	5	50	29.989	29.989	100.000	12,516.250	View
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	49.72500	5	50	29.938	29.938	100.000	12,531.250	View
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	49.72500	5	50	29.938	29.938	100.000	12,531.250	View
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	49.92700	10	25	29.767	29.767	100.000	12,581.750	View
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	49.97700	2	500	29.724	29.724	100.000	12,594.250	View
Buy	CCC	Caa2	Office Properties In 2.4% 02/01/2027 Callable 67623CAE9 **Make Whole Call**	2.400	02/01/2027	Yes	Ask	25	50.10000	10	25	29.621	29.621	100.000	12,625.000	View

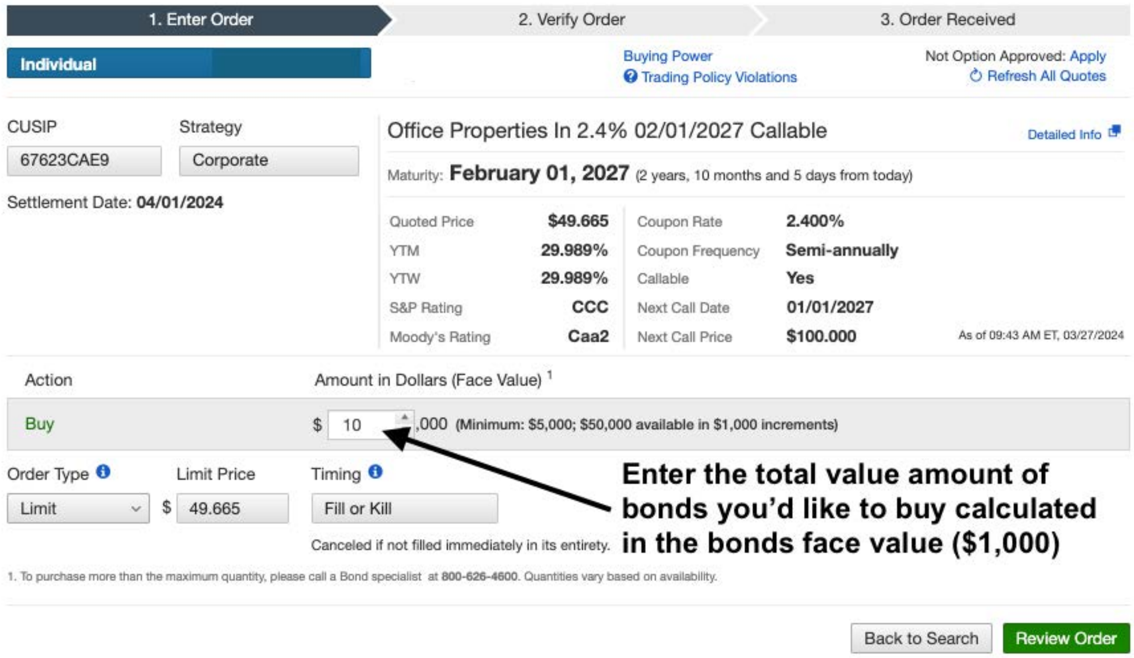
Note: Multiple bonds with slightly different quotes may appear.

5. Next, you will need to confirm the bond's rating before you enter your order. Schwab will display the rating and may ask you to acknowledge the risks of investing in high-yield bonds. (Schwab may not ask for this if you have already purchased a high-yield bond through Schwab in the past). When ready to proceed to enter your order and click "**Continue**".



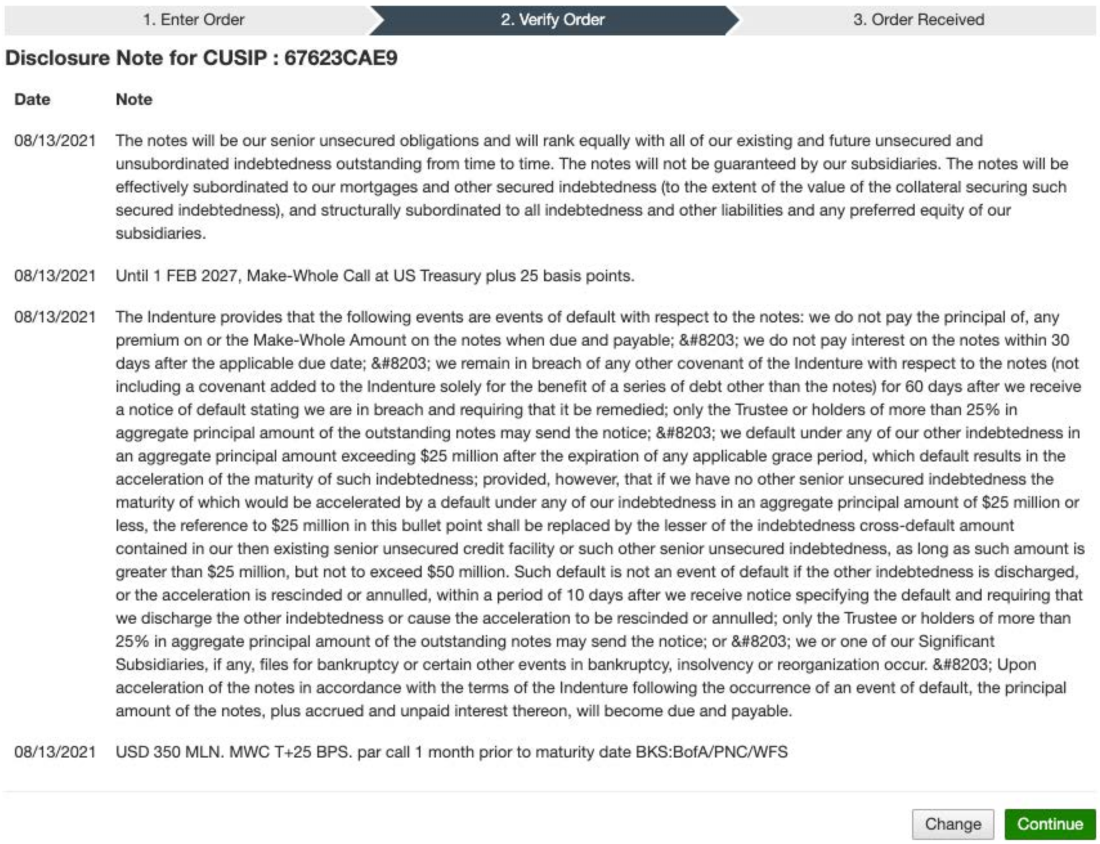
6. Here is where you will enter your order and specify your position size. You will need to specify an amount in dollars, as seen in the image below. Remember, the amount of bonds you enter is based on the face value of the bond. So, if you want to purchase 1 bond, the face value is $1,000 and you'd be purchasing one bond for the price of $496.65. If you'd like to purchase 10 bonds, enter 10, and your order will come out to $4,966.50 based on the quote below.

7. You will also need to specify what type of order to place. Either a Limit order – which is the "limit" price you will pay to place an order – or a market order. A market order will place your trade based on the price of the market at the time of the trade. We recommend placing limit orders.



(Note: the price quoted $$49.665 really means $496.65. It is standard that bonds are quoted out of $100 but the face value is really $1,000.)

8. Click "**Review Order**" on the bottom right-hand corner when ready to proceed. Now, you're almost ready to buy the bond. Read over the disclosure notes for the bond, **confirm the CUSIP (67623CAE9),** and click "**Continue**" to buy the bond.



1. Enter Order | 2. Verify Order | 3. Order Received

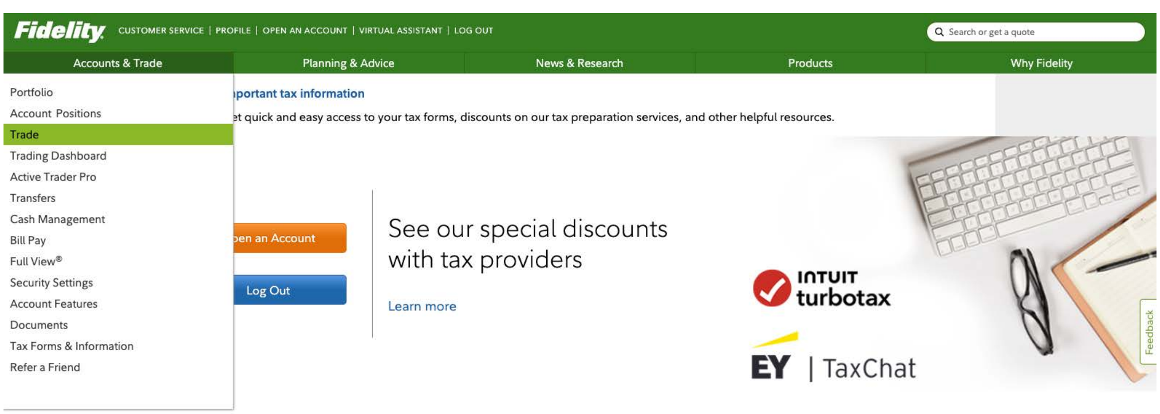
Disclosure Note for CUSIP : 67623CAE9

Date	Note
08/13/2021	The notes will be our senior unsecured obligations and will rank equally with all of our existing and future unsecured and unsubordinated indebtedness outstanding from time to time. The notes will not be guaranteed by our subsidiaries. The notes will be effectively subordinated to our mortgages and other secured indebtedness (to the extent of the value of the collateral securing such secured indebtedness), and structurally subordinated to all indebtedness and other liabilities and any preferred equity of our subsidiaries.
08/13/2021	Until 1 FEB 2027, Make-Whole Call at US Treasury plus 25 basis points.
08/13/2021	The Indenture provides that the following events are events of default with respect to the notes: we do not pay the principal of, any premium on or the Make-Whole Amount on the notes when due and payable; we do not pay interest on the notes within 30 days after the applicable due date; we remain in breach of any other covenant of the Indenture with respect to the notes (not including a covenant added to the Indenture solely for the benefit of a series of debt other than the notes) for 60 days after we receive a notice of default stating we are in breach and requiring that it be remedied; only the Trustee or holders of more than 25% in aggregate principal amount of the outstanding notes may send the notice; we default under any of our other indebtedness in an aggregate principal amount exceeding $25 million after the expiration of any applicable grace period, which default results in the acceleration of the maturity of such indebtedness; provided, however, that if we have no other senior unsecured indebtedness the maturity of which would be accelerated by a default under any of our indebtedness in an aggregate principal amount of $25 million or less, the reference to $25 million in this bullet point shall be replaced by the lesser of the indebtedness cross-default amount contained in our then existing senior unsecured credit facility or such other senior unsecured indebtedness, as long as such amount is greater than $25 million, but not to exceed $50 million. Such default is not an event of default if the other indebtedness is discharged, or the acceleration is rescinded or annulled, within a period of 10 days after we receive notice specifying the default and requiring that we discharge the other indebtedness or cause the acceleration to be rescinded or annulled; only the Trustee or holders of more than 25% in aggregate principal amount of the outstanding notes may send the notice; or we or one of our Significant Subsidiaries, if any, files for bankruptcy or certain other events in bankruptcy, insolvency or reorganization occur. Upon acceleration of the notes in accordance with the terms of the Indenture following the occurrence of an event of default, the principal amount of the notes, plus accrued and unpaid interest thereon, will become due and payable.
08/13/2021	USD 350 MLN. MWC T+25 BPS. par call 1 month prior to maturity date BKS:BofA/PNC/WFS

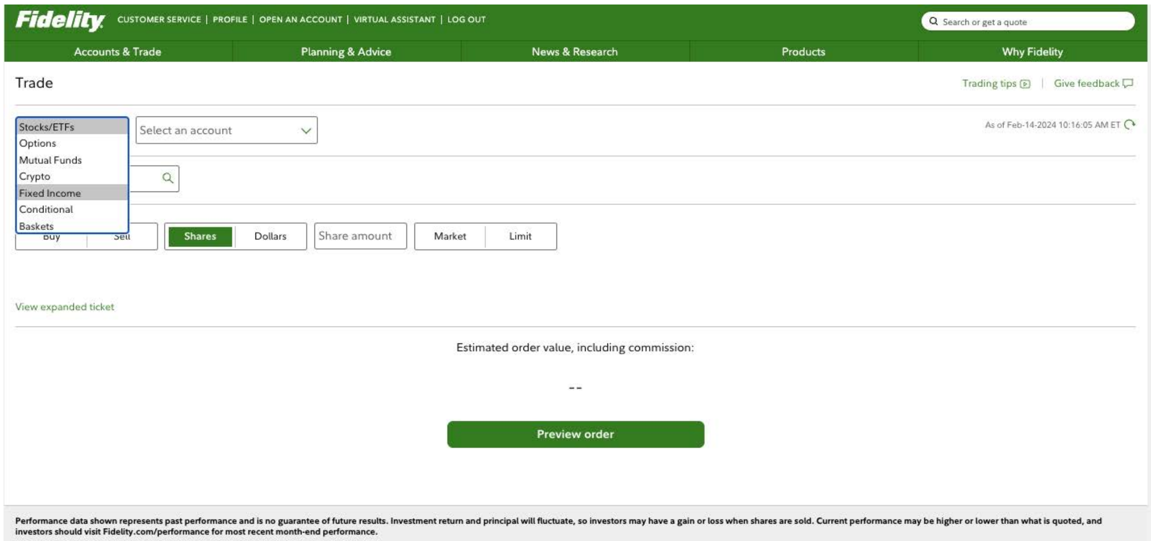
Change Continue

For Fidelity Users

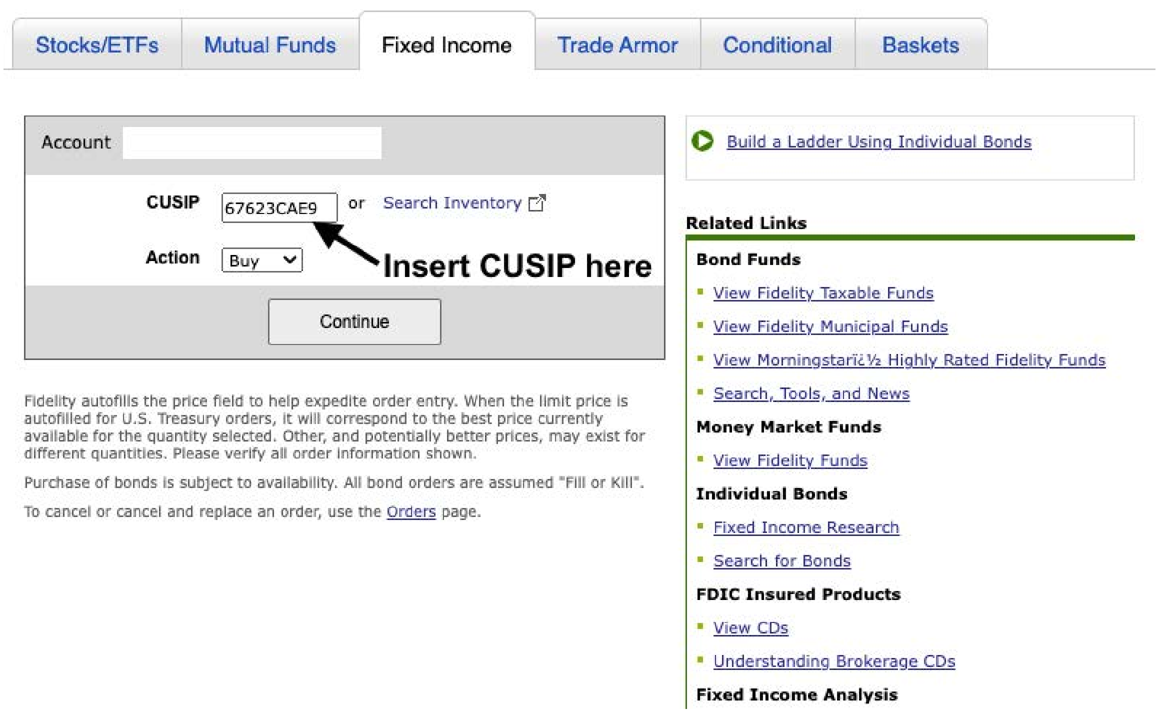
1. Log in to your account as you usually would access your equity portfolio.
2. Go to the "**Trade**" section under the "**Accounts & Trade**" tab at the top menu.



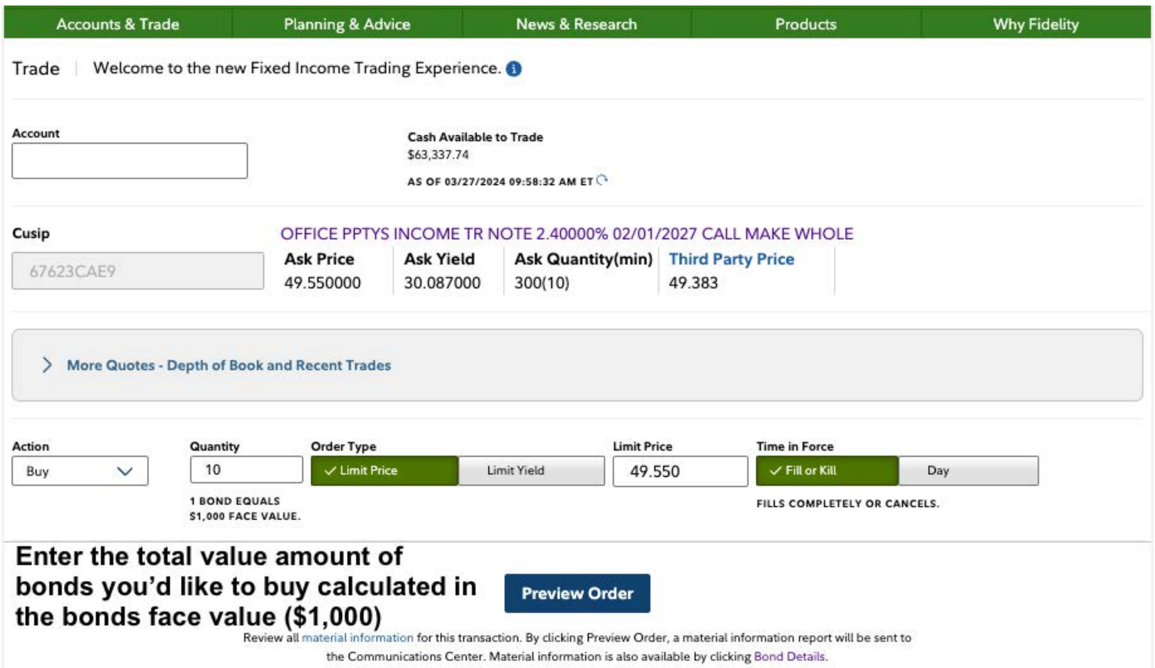
3. On the next page, select “Fixed Income” on the “Trade” dropdown menu as seen below.



4. When you land on the trade page, enter the CUSIP and select “Buy” for the “Action” box. The Office Properties Income Trust 2.4% 2/1/2027 senior unsecured bond’s CUSIP is 67623CAE9. You will also need to select the account you’d like to purchase the bond. When ready to proceed, click “Continue”.



5. Here is where you will enter your order and specify your position size. You will need to specify an amount in dollars, as seen in the image below. Remember, the amount of bonds you enter is based on the face value of the bond. So, if you want to purchase one bond, the face value is $1,000 and you'd be purchasing one bond for the price of $495.50 (not including any fees). If you'd like to purchase 10 bonds, enter 10, and your order will come out to $4,955.0 based on the quote below. Then select "Preview Order".



6. Once you've reviewed and confirmed the details for the order, click "**Place Order**" to purchase the bond.

OFFICE PPTYS INCOME TR NOTE 2.40000% 02/01/2027 CALL MAKE WHOLE

Ask Price	Ask Yield	Ask Quantity(min)	Third Party Price
49.550000	30.087000	300(10)	49.383

- (313063) Quantity is the number of bonds. One (1) bond equals $1000 face value.
- (013001) The limit price that you entered has been adjusted to reflect a mark-up based on the number and type of bonds you are attempting to purchase.

Preview Order

Account		**Action**	Buy
Quantity	10	**CUSIP**	67623CAE9
Order Type	Limit Price	**Price**	49.550
Price w/Mark-up	49.650	**Effective Yield**	30.002102%
Time in Force	Fill or Kill	**Trade Type**	Cash
Trade Date	03/27/2024	**Settlement Date**	04/01/2024

Estimated order value, including **$10.00 (0.202%)** mark-up and **$40.00** accrued interest:

$5,005.00

Please verify your order information before placing order

Cancel Edit Place Order

Visit the Online Message Center for a PDF of important material security information.

Martin Fridson

Porter & Co.

Stevenson, MD

P.S. To read more about bankruptcy and how it plays out in the bond world, check out "**Learning to Love Bankruptcy**."

mailbag@porterandcompanyresearch.com