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Methodology

# *CMBS Rating Methodology*

OCTOBER 2005



*Insight beyond the rating.*

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## CONTACT INFORMATION

**Jack Toliver**

Managing Director  
Global CMBS  
Tel. +1 312 332 0889  
jtoliver@dbrs.com

**Erin Stafford**

Senior Vice President, Surveillance  
CMBS  
Tel. +1 312 332 3291  
estafford@dbrs.com

**Mary Jane Potthoff**

Senior Vice President  
CMBS  
Tel. +1 312 332 0837  
mjpotthoff@dbrs.com

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DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



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# CMBS Rating Methodology

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## Executive Summary

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Real estate assets have traditionally been viewed as a source of stable cash flow and a long-term hedge against inflation. Although future value can be somewhat variable and markets suffer from intermittent periods of illiquidity, for its part, commercial real estate has proven to be a prudent investment for patient investors. In addition, debt on commercial real estate has a relatively low likelihood of default and a high recovery rate should default occur. Although the credit dynamics are relatively strong, losses on commercial mortgages have traditionally been highly cyclical and debt instruments have been longer term assets with minimal liquidity. These factors have historically limited the participants in the commercial mortgage sector. With a limited number of participants, the market had suffered from inefficiencies that caused illiquidity in declining markets and exacerbated losses as many participants chose to exit the market at the sign of rising delinquencies.

Structured finance in general has brought unprecedented liquidity to the commercial mortgage sector. CMBS have created an extensive array of high credit quality products with call protection and exceptional credit support. These CMBS products have enabled fixed-income investors of all shapes and sizes to participate in investments backed by commercial mortgages.

For example, Super Senior AAA classes in US CMBS transactions are specifically designed to provide an investment product that eliminates an investors' need to have specific knowledge of commercial real estate. As Super Senior AAA tranches typically have over 150% of the rating agency prescribed AAA credit support, dealers have joked that investors need not even look at the pictures in the prospectus. While the Super Senior Classes attract more investors to the CMBS product, the down-side of this is that 70% to 80% of the investor base is

being steered away from scrutinizing the issuer's cash flow assumptions, underwriting or the structures of the underlying loans.

Because the CMBS market has evolved to a point where structure and creative exit vehicles reduce the level of investor due diligence, more reliance is placed upon rating agency analysis and transparency thereof. In this publication, DBRS lays out our CMBS rating methodology and the asset-specific analytical procedures to which we adhere and on which investors have for years relied. We welcome the challenge of upholding underwriting standards that are proven winners in the continually changing, challenging arena of commercial real estate finance.

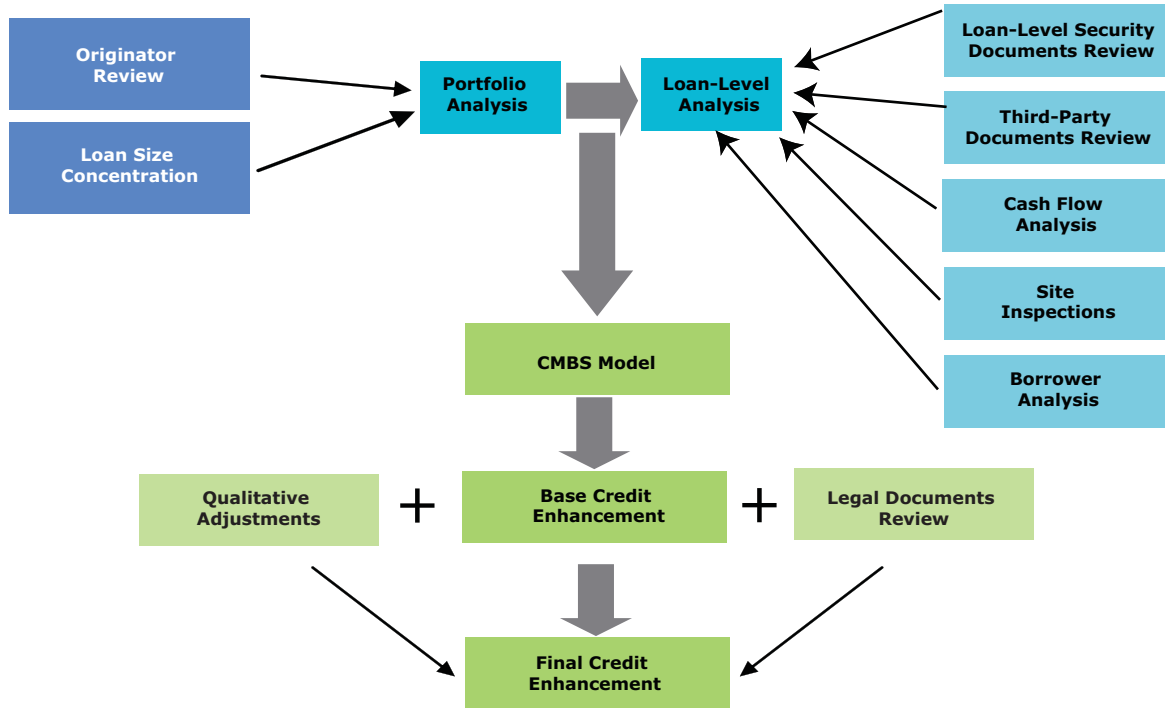
### APPLICATION OF METHODOLOGY

The following diagram describes the overall process to analyze a CMBS transaction:

- (1) DBRS will conduct loan and property level analysis.
- (2) DBRS will use the results from the portfolio and loan level analysis as inputs into the CMBS model. The resulting number will provide the base credit enhancement.
- (3) A review of the legal documents that govern the transaction is undertaken and consideration of any qualitative factors is made. The resulting output represents the final credit enhancement.

The CMBS Model is a substantial component of the DBRS rating process. A material deviation from the rating implied by the CMBS Model would be a three-notch rating difference. The quantitative and qualitative factors that could result in a material deviation are included in this methodology.

## DBRS Rating Process for CMBS Transactions



## Commercial Mortgages as Securizable Assets

Unlike other assets that are securitized, commercial mortgages (CMs) are subject to some deficiencies when compared to the “ideal” securizable asset. Securitization technology is built upon two basic doctrines: (1) that by segregating the risks of the seller from the performance of the assets, and (2) by adequately analyzing and understanding the underlying performance/characteristics of the assets in question, it is possible to structure a transaction that has better credit risk than the seller does.

Under premise one, the “ideal” securizable asset must perform independently of the seller’s exis-

tence or performance. CMBS transactions often lack this complete independence where day-to-day servicing and problem loan resolution are handled by the seller in its capacity as servicer. However, all servicers are bound to the industry servicing standard and as part of that servicing standard are expected to service the CMs for the benefit of all investors in the CMBS transaction. Therefore, this is seen as a non-issue.

The second premise, understanding the performance characteristics of the underlying assets in question, generally relies upon (1) a high level of



transparency of market information, asset reporting, and ongoing performance information; (2) a large statistically diverse pool of assets; (3) a statistical universe of market performance data through cycles; and (4) any obstacles in the market conditions that may increase costs or delay resolutions of defaulted assets.

Having characteristics associated with the “ideal” securitizable asset and methods to identify deviations, allow the use of statistical techniques to quantify the risks associated with a structured finance product. Although CMBS is particularly good at segregating the performance of the loan from the performance of the seller, CMBS transactions often fail one or more of these four characteristics. CMs’ transparency varies widely across jurisdictions, from a highly transparent public market in the U.S. to a highly privileged/protected market in several countries within Europe. Pool size (in terms of numbers of mortgages) can range from single digits to several hundreds. Length of performance history varies widely across markets and even within regions and, even if data is available for a lengthy period, it is not always in the form or detail that is required by DBRS (or investors).

Given these challenges, how does one adequately assess the risks involved? Hard work. Except in the case where we have a very large pool of relatively uniform CMs with a long track record, most CMBS transactions involve an individual review of the underlying CMs or a statistically significant sampling of the underlying CMs. Such reviews attempt to assess individual credit risk. As such, the rating process is labour intensive compared to a statistical analysis of pools of homogeneous assets.

Predicting economic cycles is hazardous at best. DBRS’s rating methodology does not attempt to predict when or if an economic downturn will occur. It is assumed in each stress scenario that such an economic downturn DOES occur and that it occurs immediately. To the extent that the scenario is false (as it almost always is); amortization of mortgage balances with no decline in property values will improve coverage levels. However, even without a recession, property values do move as a result of general economic sentiment, interest rates, lease rates, occupancy levels, etc. Through time, effective protection levels will vary.

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## CMBS Process Overview

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DBRS begins the rating process by picking a statistically relevant sample for diversified pools by property type, loan originator, and geographic location. For single-borrower or large loan transactions, having 20 or fewer assets, DBRS will generally sample the entire pool as the event risk associated with any one asset is higher. DBRS performs site inspections and management meetings (when available) for sampled properties. In addition, DBRS reviews all third-party reports, including engineering and environmental reports, to ensure no significant contingencies exist, such as environmental contamination, structural faults, or deferred maintenance. The appraisal is reviewed for historical usages, market dynamics, and competitive property statistics. Finally, DBRS determines a stabilized net cash flow for each asset.

### CASH FLOW IS KING

The crux of analyzing CMBS transactions is evaluating the underlying credit quality of the individual mortgages that form the pool. Fundamental credit analysis of any real estate related funding is based on an evaluation of cash flow dynamics of each asset as projected by the lease obligations in place and projected roll over, as well as the historical operating expenses. Within a pool of loans, a full analysis consistent with a formal rating for each individual property is achieved through direct analysis or sampling. For specific loan sizing parameters, refer to Appendix A. The fundamentals of a property are reflected in the cash generated. Consistent with our general securitization approach (cash flow) and the general real estate focus on cash flow, it would be inappropriate to rely significantly on other factors in assessing default risk. Ultimately, a property will



pay its obligations only if, on a consistent basis, cash flow exceeds cash obligations.

### **STABILIZED NET CASH FLOW (NCF)**

The starting point for any analysis of cash flow begins with the rent roll. The most current rent roll is indicative of the future and stabilized revenue stream. DBRS gives credit for leases signed with tenants that are in occupancy (tenants must be open for business and paying rent). DBRS adjusts any above-market leases to market rates with the assumption that when the tenant has to renew, it will renegotiate its lease to a rate competitive with the market.

Next, one needs to review historical financial statements (preferably audited). A period of three years' financial performance, including a trailing 12 months, provides a reasonable view of sustainable financial performance. While shorter periods are acceptable, they provide less tangible support for determining stabilized cash flow – as such, more conservative estimates are utilized. By having a historical trail of financial statements, one can reasonably determine the stabilized expense line items. The DBRS stabilized NCF reflects adjustments for the following items: higher of actual or market vacancy levels and credit loss; normalized tenant improvement, leasing commissions and capital expenditure requirements; and market rate management fees. Such adjusted NCF represents a conservative assessment of sustainable performance. More information regarding DBRS asset specific underwriting parameters can be found in Appendices B, C and D.

### **NCF STABILITY FACTORS**

Once the stabilized net cash flow is determined (in which DBRS makes certain market assumptions), one must consider how stable the cash flow is likely to be throughout the loan term. Factors that increase the stability of the NCF during the term are higher tenant quality (often investment-grade rated tenants) longer lease terms, a staggered lease expiration schedule, a low expense ratio, and little reliability upon the going-concern revenue. DBRS also takes into consideration factors that are likely to keep an asset that is currently underperforming the market from ever reaching market rates. Qualities such as an inferior location within a market or poor property amenities may prevent an asset from ever achieving market rental rates.

And vice-versa, a superior location with superior amenities cause the property to outperform the market until such time as new competition levels the playing field.

### **DSCR**

Debt Service Coverage Ratio (DSCR) is generally defined as the annual net cash flow of a property divided by the annual debt service obligation. DSCR is, in our view, the best measure of the default risk of a loan as it incorporates the current operating performance of the property (NCF) and its capacity to service debt (i.e., how much debt can the cash flow support?).

#### ***Term DSCR***

Term DSCR is the stabilized net cash flow divided by the maximum actual annual debt service obligations of the borrower throughout the term of the loan. DBRS uses DSCR tests on stabilized net cash flow to determine the likelihood of default over the term of the loan. This includes analyzing net cash flow projections in periods of concentrated lease expirations to ensure there are adequate reserves in place to cover debt service as well as anticipated costs associated with tenant rollover.

#### ***Refinance Risk and Refinance DSCR***

Fully amortizing commercial mortgages are relatively rare in the CMBS market. As such, for most mortgages, the outstanding balance of the mortgage must be refinanced at balloon/maturity. The timing of loan maturity can have a significant impact upon the borrower's ability to refinance due to increases in interest rates, slowdown in economic activity, depressed real estate values, or a drop in liquidity in the real estate markets.

DBRS addresses refinance risk by evaluating a number of different parameters of the loan. Specifically, DBRS calculates a Refinance Debt Service by applying a constant to the balloon balance of the mortgage. The constants that DBRS uses are consistent with a historical view of interest rates plus appropriate spreads and required amortization schedules per property type. DBRS uses its stabilized NCF against the Refinance Debt Service obligation to determine the Refinance DSCR. The constants may be adjusted based on the term of the mortgage.



## LTV

Loan-to-value (LTV) in and of itself is neither a reliable indicator of default nor recovery. Value (defined as what a willing buyer will pay and a willing seller will agree to on a certain date) becomes a point-in-time analysis and not necessarily indicative of future value or liquidation value in the event of default. That said, many components of a comprehensive appraisal report including replacement cost, market comparisons, and capitalization, provide insights/support into DBRS's loan-level analysis.

Within the context of commercial real estate lending, value is most relevant at maturity/balloon or in the event of default. At maturity the market dynamics that determine capitalization rates are likely to have changed since origination. During the term, a default is likely to be precipitated by a decline in net cash flow. Therefore, DBRS Value determination is indicative of a reversion value similar to that used at the end of a 10-year discounted cash flow projection. DBRS applies a normalized capitalization rate, determined by long-term market performance, to the stabilized net cash flow to calculate DBRS Value.

## Model Overview

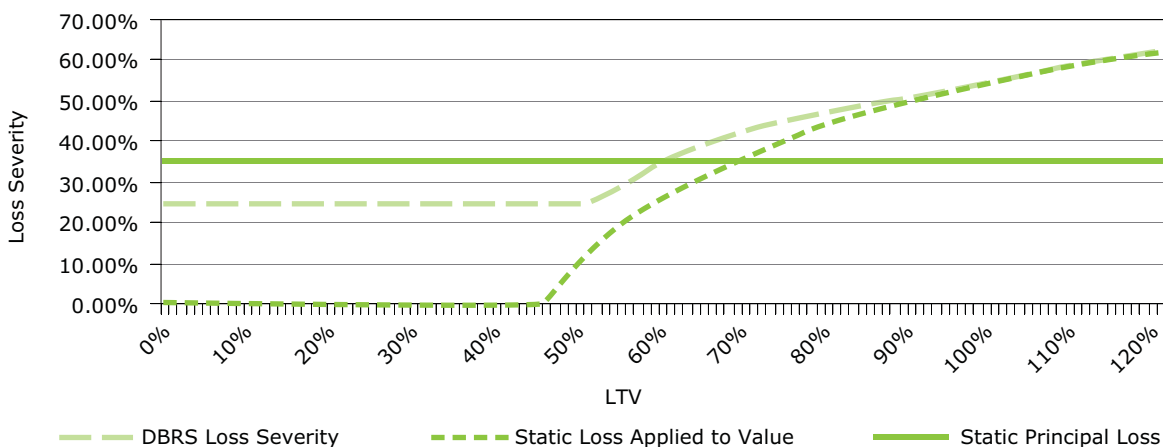
DBRS sizes diversified pooled transactions (defined as those with greater than 20 loans with multiple borrowers) on a probability of default and severity-of-loss model. As mentioned earlier, the primary indicator for determining probability of default is DSCR. DBRS will look at the lower of the Term DSCR or the Refinance DSCR to determine the probability of default for each loan. The probability of default curve used by DBRS is based on a combination of jurisdictional studies of cash flow volatility where available, and local, regional, or at the very least ACLI (American Council of Life Insurers) data for commercial mortgage defaults.

Loss severity, given a default, is primarily based on a percentage of principal loss analysis. DBRS does bring value into play when determining a loan-level loss

severity. Real estate assets have some residual liquidation value even in the event of the most depressed (or negative) cash flow. The model recognizes a minimum percentage of value recovered for each rating category; however, a low LTV will never translate into a loss severity of zero because DBRS assigns a minimum principal loss rate to each rating category. See depiction of loss severity and its relation to DBRS LTV in Table 1. At the other end of the LTV spectrum additional leverage does not translate into additional principal recovery. As leverage approaches 100% LTV, recoveries are capped at a maximum percentage of DBRS Value for each rating category.

The following equation reflects the calculation of credit enhancement for each loan, which is probability of default multiplied by loss severity. A

**Table 1: LTV vs. Loss Severity**





transaction's credit enhancement is the summation of the necessary credit enhancement for each loan based on DBRS's determination of DSCR and LTV.

$$\text{Loan Credit Enhancement} = p(\text{Default}) \times \text{Loss Severity}$$

$$\text{Transaction Credit Enhancement} = \sum \text{of the Weighted Average Loan Credit Enhancement}$$

## QUALITATIVE ADJUSTMENT FACTORS

There are several qualitative factors that can impact the frequency of default or severity of loss. Adjustments are made at the loan level to account for such asset-/loan-specific factors.

### *Property Type*

Certain property types historically have higher operating expense ratios; thus, small revenue swings can result in compounded declines in net cash flow. Given this volatility, these asset types are more susceptible to default. Therefore, DBRS will increase the base probability of default for these assets types. For more information regarding office, retail, multi-family, and industrial underwriting parameters see Appendix B.

### *Recourse*

Loans that have enforceable recourse to a financially capable guarantor are expected to have lower probability of defaults. In the event the recourse is to an investment-grade rated entity, it would imply that the unsecured debt would be rated investment-grade. As such, mortgages carrying a full recourse covenant from an investment-grade rated entity will be floored at the guarantor's rating. While generally viewed as a positive, loans with recourse to non-investment-grade rated guarantors are considered on a case-by-case basis.

### *Property Quality*

The highest quality properties within a market have lower probabilities of default because quality often signals viability and attractiveness to new tenants; therefore indicating cash flow stability. To evaluate property quality, DBRS considers the location; functional utility of the asset; the comparability of the surrounding and competing properties; and the quality of construction, property condition, ingress and egress, and property amenities.

### *Sponsorship Strength*

DBRS defines a strong sponsor as one that is financially capable of doing that which is economically advisable and structured in a way that does not preclude or diminish the likelihood of capital contributions in the event of economic stress. Although financial capability does not suggest that a borrower will cover debt service payment shortfalls unless there is significant equity to protect, neither will they cover refinancing shortfalls in an over-levered asset, DBRS generally recognizes strong sponsors are less likely to default due to a short-term cash flow shortfall and less likely to exacerbate the losses in the event that their equity has eroded.

### *Concentrations*

Concentrations are abundant in CMBS. The following are areas where concentrations tend to appear: obligors, location, loan size, and property type. DBRS default probabilities assume a large, diverse pool of loans. Where concentrations arise, the probabilities must be adjusted accordingly.

### *Market*

DBRS recognizes that in times of economic stress, real estate capital focuses on more highly populated markets with comparatively higher transparency. As such, defaulted loans in tertiary or rural markets will experience significantly higher losses due to a limited investor base and market inefficiencies.

### *Leasehold Interests*

DBRS's CMBS Methodology assumes loans are secured by fee interests in the property. Having a fee interest in a commercial real estate asset assumes you have a valuable asset into perpetuity; one that creates revenue and likely appreciates. A ground lease effectively splits a fee simple asset into two ownership interests: leased fee and leasehold. The leased fee interest maintains ownership in the land and enters into a long-term lease (typically 50 years with multiple extension options). The leasehold estate is specifically intended to enable the lessee to develop an income-producing asset (improvements) on the site, which then enables the lessee to recover construction costs and a return on capital prior to maturity of the initial term of the lease.

The leasehold interest, whose term is finite, is viewed as a wasting asset that becomes totally worthless when occupancy rights revert to the

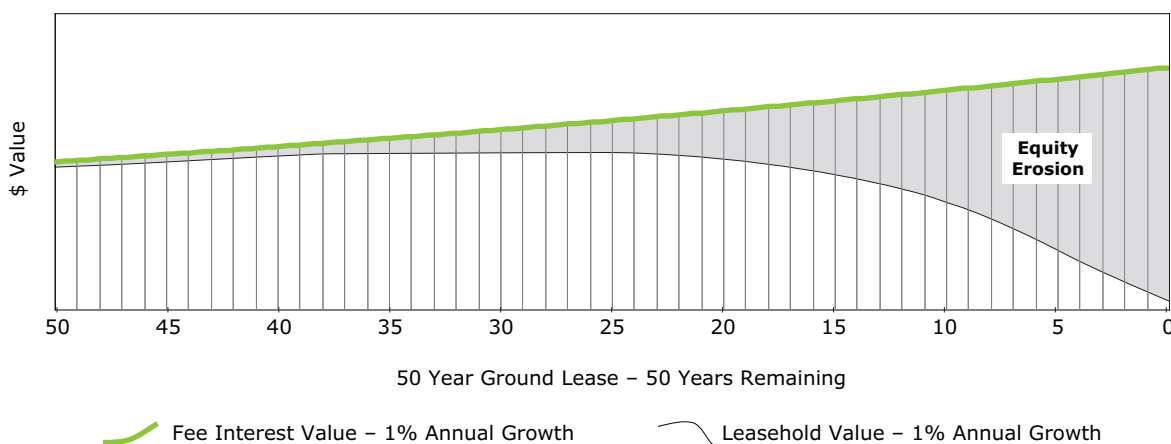


leased fee holder at the termination of the ground lease. As shown in the chart above, there is significant equity erosion in the leasehold interest as compared to a fee interest. While no growth over a 50-year time horizon is an extreme assumption, when calculating value for the graph DBRS assumed a conservative 1% annual growth rate in NCF. By doing so, the leasehold interest value begins to deteriorate with 20 years remaining on the lease. With only 10 years remaining, the value begins to decline much more rapidly. Thus, if a loan on a property subject to a ground lease needs to be refinanced with only 20 years remaining on the ground lease, the expected valuation decline will make it difficult to get the loan refinanced. Further, it may also not be possible to fully amortize the remaining loan amount prior to the ground lease

expiration if interest rates increase or a credit event, such as a major lease expiration, occurs.

Recognizing that unsubordinated ground leases are not readily re-financeable, DBRS insists on an amortization term expiring 10 years prior to the ground lease termination. In addition to the refinance aspect, DBRS considers more factors that may cause a property subject to a ground lease to have lower cash flow stability resulting in a higher probability of default and potentially increased loss severity. Factors DBRS considers include contractual ground rent escalations, leasehold mortgagee's notice of default and right to cure provisions, and the leasehold mortgagee's rights to become the borrower in the event of a foreclosure.

**Table 2: Leasehold vs. Fee Value**



## Legal and Structural Considerations

CMBS transactions share many similarities with the securitization of other asset types, with some twists. Key issues involved in CMBS securitizations include: (1) The overall structuring of the transaction; (2) Separation of asset risk and seller risk through a true sale; (3) Servicing issues where the seller acts as a Master Servicer or Special Servicer; (4) Characteristics of a special-purpose vehicle (“SPV”) used to hold the mortgages; (5) Mortgage origination practices, including the type and nature of security taken by sellers in the mortgages; (6) Representations and warranties made by the seller

in relation to the mortgages and properties; and (7) Servicing (both primary servicing and special servicing) of defaulted mortgages.

### TRANSACTION STRUCTURE

Generally, CMBS transactions are structured as debt issuances by an SPV or as direct, undivided co-ownership interests in the underlying pool of mortgage loans. In most instances, the preferred choice is to use a trust that issues debt securities. The trust and the cash flows are structured to be pass-through entities that are not subject to



double taxation. As discussed below, structuring the SPV as a trust also helps to minimize substantive consolidation risk.

### TRUE SALE

Generally, the key to a CMBS securitization involves isolating the assets from seller risk. This is accomplished by a “true sale” of the mortgages and related security from the seller to an SPV. Following a true sale, the mortgages and related security are not assets of the seller and are not subject to claims by creditors of the seller or a trustee in bankruptcy. The criteria governing a true sale of mortgages is the same as the criteria governing the sale of other securitized assets. In this respect, the key is that, after the sale, the seller retains no beneficial interest or equity of redemption in the sold mortgages and related security. Having said this, sellers may retain subordinate notes or certificates in a CMBS transaction; provide representations and warranties with respect to the mortgages, which may lead to an obligation to repurchase mortgages; and may have purchase options once the pool amortizes down to a specified percentage of the original pool balance. To the extent jurisdictional requirements dictate that mortgagors be notified of the sale of their mortgage into a trust, notification triggers must be clearly outlined in the transaction documents.

### THE SELLER AS A SERVICER

Other legal risks may arise when the seller is also the Master Servicer. If the seller enters into bankruptcy or applies for creditor protection to reorganize under an applicable country’s legislation, the SPV may be stayed from taking steps to protect or remove the seller as Master Servicer. The extent of the stay will depend on the relevant court order authorizing it. Assuming the seller is a Master Servicer, issues that have to be considered in relation to the stay order include: (1) The ability to appoint a replacement Master Servicer; (2) Obtaining cash held under the control of the seller as Master Servicer and any commingling issues; (3) Obtaining any records or mortgage files in the Master Servicer’s control, including the right to use any record-keeping software in transferring the servicing function; (4) The ability to register transfers of mortgages and related security on title to the various properties; and (5) Informing mortgagors of the sale and the redirection of cash

flows to the replacement Master Servicer. A court order will likely be required to vary the stay order to deal with these issues.

### THE SPV

It is important to consider the nature of the SPV in relation to the seller. Complications can arise when the SPV is a related entity of the seller. In this situation, the risk is that, if a seller goes bankrupt or reorganizes, the SPV will be included in the filing. Substantive consolidation case law varies in different jurisdictions. The effect of a substantive consolidation is that the assets of the SPV and the seller are shared among the creditors of both entities. Obviously, this would be extremely problematic for a CMBS transaction. For this reason, DBRS prefers that SPVs be structured as an entity independent of and separate from the seller. This can easily be accomplished by organizing the SPV as a trust with a third-party trustee.

### MORTGAGE ORIGINATION PRACTICES

The rights obtained by the SPV with respect to each individual obligor depend on the security package obtained by the seller when the mortgage was originated. It is important to examine each loan’s security package because substantial differences can exist. In its preliminary analysis, DBRS assumes that the originators have exhibited a best practices approach in underwriting and that the engineering and environmental reports indicate that there are no impairments or latent defects in the subject security.

A standard origination package will include a real property mortgage, standard charge terms for the mortgage, an assignment of leases, an assignment of rents, a general security agreement, and a legal opinion on the enforceability of the mortgage (or a title insurance policy). There will also be real property registrations. In addition, there may be subordination and attornment agreements entered into by the seller (as mortgagee) with the property’s major tenants. There may also be non-disturbance agreements between the seller (as mortgagee) and the major tenants. The documents in the origination package for each obligor will be assigned to the SPV as part of the transaction. If the SPV has to enforce its rights against the obligor, without the benefit of subordination and attornment agreements with tenants, enforcement can become more complex since, in particular



circumstances, tenants may be in a position to terminate the existing leases. Avoiding this result requires informed legal advice at the time enforcement action is taken against an obligor.

As part of the origination package, it is also important to look at the seller's practice with respect to appraisals, environmental reports, and engineering reports. Ideally, these reports will be obtained at the time of mortgage origination or renewal. It is important to note, however, that the SPV may not be able to rely directly on these expert reports if the reports disclaim liability to third parties. This difficulty can be overcome by having the consultants agree to allow the SPV to rely on these reports. Having said this and depending on when the mortgage was originated or last renewed, the reports may not be of great practical value. In addition to environmental reports, DBRS will review the use of environmental insurance for CMBS transactions, provided that the insurance coverage is comprehensive and the individual and global policy limits in the insurance policy are satisfactory given the mortgage pool and types of properties involved.

## REPRESENTATIONS AND WARRANTIES

As part of the sale transaction, the seller generally provides a series of representations and warranties concerning the mortgages and related security. The representations and warranties will cover the status of the properties, the mortgages, the mortgage files, related security, the nature of the sale transaction, and so forth. If a representation and warranty is untrue, and remains uncured, a repurchase obligation may arise if it materially impacts the SPV's security. The repurchase obligation is often the only legal recourse for a breach of representation and warranty, and the remedy is frequently limited by the requirement that the breach have a material impact on investors.

## SERVICING

Servicing is one of the least appreciated aspects of CMBS despite its crucial role in the transaction. There are generally three servicing roles (more than one role can be assumed by one servicer) in a CMBS transaction. The Primary Servicer is responsible for a loan's day-to-day administration and servicing. The Master Servicer is responsible for overseeing the Primary Servicer(s) as well as providing any liquidity for temporary disruptions in cash as required within the transaction. It must be stressed that this liquidity is NOT credit enhancement. The Special Servicer generally becomes involved in the servicing process when the mortgage ceases to perform within expectations (i.e., it may be prior to actual default).

Special servicing arrangements are an important component of CMBS transactions. Most CMBS transactions provide for the transfer of a mortgage loan from the Master Servicer to the Special Servicer in the event of default or if default appears imminent. By transferring a mortgage loan to the Special Servicer before a default occurs, it is possible to eliminate some of the delays in enforcing the mortgage and personal property security. Anything that delays the Special Servicer from taking action may ultimately increase the loss on a loan.

Generally, because different remedies can be pursued on default, either concurrently or alternatively, it is important to have a Special Servicer that is knowledgeable in workouts and also has the resources and connections to obtain advice from legal and real estate specialists. Remedial decisions can make a very tangible difference in the timing and amount of any recoveries.

Although DBRS rates commercial mortgage servicers, we reserve the right to approve a transaction's servicer on a transaction-by-transaction basis due to the complexity of the transactions and associated servicing requirements.



## Appendix A: DBRS Large Loan Sizing Parameters

### DBRS Large Loan Sizing Parameters

Property Type	Rating	DSCR Range		LTV Range	
		Low	High	Low	High
Regional Mall	AAA	1.90	2.10	45.0%	50.0%
Regional Mall	AA	1.70	1.90	50.0%	55.0%
Regional Mall	A	1.50	1.70	55.0%	60.0%
Regional Mall	BBB	1.35	1.55	60.0%	65.0%
Regional Mall	BBB (low)	1.28	1.48	65.0%	70.0%
Multi-family	AAA	1.95	2.15	42.5%	47.5%
Multi-family	AA	1.75	1.95	47.5%	52.5%
Multi-family	A	1.55	1.75	52.5%	57.5%
Multi-family	BBB	1.40	1.60	57.5%	62.5%
Multi-family	BBB (low)	1.33	1.53	62.5%	67.5%
Retail – Anchored	AAA	2.00	2.20	40.0%	45.0%
Retail – Anchored	AA	1.78	2.00	45.0%	50.0%
Retail – Anchored	A	1.58	1.78	50.0%	55.0%
Retail – Anchored	BBB	1.45	1.65	55.0%	60.0%
Retail – Anchored	BBB (low)	1.38	1.58	60.0%	65.0%
Industrial	AAA	2.00	2.20	40.0%	45.0%
Industrial	AA	1.78	2.00	45.0%	50.0%
Industrial	A	1.58	1.78	50.0%	55.0%
Industrial	BBB	1.45	1.65	55.0%	60.0%
Industrial	BBB (low)	1.38	1.58	60.0%	65.0%
Office	AAA	2.20	2.50	37.5%	42.5%
Office	AA	1.90	2.20	42.5%	47.5%
Office	A	1.60	1.90	47.5%	52.5%
Office	BBB	1.50	1.80	55.0%	60.0%
Office	BBB (low)	1.43	1.73	57.5%	62.5%
Retail – Unanchored	AAA	2.25	2.55	35.0%	40.0%
Retail – Unanchored	AA	1.95	2.25	40.0%	45.0%
Retail – Unanchored	A	1.65	1.95	45.0%	50.0%
Retail – Unanchored	BBB	1.55	1.85	52.5%	57.5%
Retail – Unanchored	BBB (low)	1.48	1.78	55.0%	60.0%
Lodging – Full	AAA	2.95	3.35	27.5%	32.5%
Lodging – Full	AA	2.60	3.00	32.5%	37.5%
Lodging – Full	A	2.20	2.60	37.5%	42.5%
Lodging – Full	BBB	1.85	2.25	42.5%	47.5%
Lodging – Full	BBB (low)	1.75	2.15	47.5%	52.5%
Lodging – Limited	AAA	3.00	3.40	25.0%	30.0%
Lodging – Limited	AA	2.65	3.05	30.0%	35.0%
Lodging – Limited	A	2.25	2.65	35.0%	40.0%
Lodging – Limited	BBB	1.90	2.30	40.0%	45.0%
Lodging – Limited	BBB (low)	1.80	2.20	45.0%	50.0%

1. DSCR is determined based off the more constraining of Term DSCR or Refinance DSCR. Term DSCR is calculated using the cut-off balance measured against DBRS's stabilized net cash flow and the maximum actual annual debt service. By applying refinance constants to the balloon amount DBRS calculates Refinance Debt Service. DBRS's stabilized net cash flow is then divided by the Refinance Debt Service to obtain a Refinance DSCR.
2. LTV is calculated based on DBRS's stabilized net cash flow capped at DBRS's capitalization rates.
3. Refinance constants and capitalization rates are determined based on property quality, cash flow stability, market conditions and sponsor strength.



## Appendix B: Property Type Underwriting

### OFFICE

DBRS's analysis begins with a property's cash flow. Cash flow volatility can vary greatly based on a property's location, its condition, market, property type, and respective expense ratio as well as the sponsor's ability to attract tenants and carry the property in distressed times. Therefore, underwriting to a stabilized net cash flow is very property- and market-specific. Following are DBRS's general office cash flow component guidelines. DBRS realizes every piece of real estate is unique and will take a reasonable approach when determining stabilized net cash flow based on the property and the loan structure.

#### Revenue

**Base Rent:** Stabilized net cash flow is calculated based on the lower of current or market rent for tenants in-place, open for business, and paying rent. DBRS distinguishes between income that exists and income that may never be. Upside potential from future events will not be underwritten, though it may mitigate other cash flow events (e.g., an increase in expenses).

DBRS takes a reasonable approach to recognizing income on a case-by-case basis when a signed lease is in-place but the major three rules of accepting revenue are not in effect. Generally, the three events required to recognize income is that the tenant is:

- (1) In occupancy,
- (2) Paying rent, and
- (3) Open for business.

DBRS looks for a signed lease and considers whether the term has commenced; the landlord has satisfied all obligations and has delivered the space to the tenant; the tenant is spending its own money to complete the space; the tenant is an expansion tenant; and whether the loan has been structured with a reserve, letter of credit, or a holdback earn-out equal to the difference between in-place and stabilized sizing. DBRS also considers the sponsor's sophistication and the tenant's underlying credit quality.

An office building's quality is determined by the property's age, condition, design (e.g., floor sizes and layout), access to transportation, market perception, and ability or inability to offer certain amenities to its tenants, including sophisticated building systems (such as fibre-optic cables, satellite communications, or other base building technological features). The higher the property's quality, the easier it is to attract creditworthy tenants and achieve higher rents. When determining achievable rents and stabilized vacancy, DBRS distinguishes between asset classes. DBRS recognizes that higher rents can be achieved at trophy properties and at strategic locations instrumental to the tenant's success.

**Mark-to-Market Analysis:** DBRS recognizes the lower of current, in-place, or market rents. Market rent depends upon current market conditions and types of space.

- **1st Generation Space:** Rents for anchor tenants in recently constructed buildings are based on the cost of construction. If a loan amortizes over the lease term, DBRS recognizes the 1st generation rent. For non-amortizing loans, DBRS reduces the rent to reflect 2nd generation leases in comparable buildings with the same market value.
- **2nd Generation Space:** Market rents are determined based on market data. Additionally, recently signed leases at the subject and comparable buildings for similar-size space are used to measure achievable rent.

**Rent Steps:** Future contractual rent bumps that are within market ranges, and generally occur within four to six months of loan closing, are recognized as there is a high likelihood of occurrence. DBRS underwrites to the average of the contractual rent bumps over the loan term for investment-grade tenants if the tenant's lease extends a minimum of three years beyond the loan term. When calculating Refinance DSCR for properties containing investment-grade tenants with leases extending at least five years beyond the loan term, DBRS recognizes the tenants' contractual rent payment at the loan's maturity.

**Free Rent:** Concessions such as a rent-free period are an obvious sign of a weak market. Attracting



tenants is unlikely without it. If a lease includes a free-rent period that has not been burned off by securitization, DBRS will underwrite to the tenant's net effective rent. If the free-rent period has expired but free rent is still prevalent in the market, DBRS will also underwrite to the tenant's net effective rent rather than in-place rent. If, however, the tenant is investment-grade, the in-place rent will be recognized.

**Amortized TIs:** The high cost of refitting office space for a new tenant can significantly erode a property's net cash flow. In order to attract users, the cost of TIs is often borne by the landlord. In a healthy market, the landlord will likely be able to recoup the investment by amortizing the TIs over the tenant's lease term. Although a tenant is contractually obligated to pay, it is not a component of market rent and will be excluded from DBRS's underwritten income. If, however, the credit quality of the tenant is investment-grade and the lease extends at least three years beyond the loan's maturity, DBRS will recognize the revenue over the loan term.

**Master Leased Income:** Master leased space will generally be treated as vacant as the space is often less desirable or the added leased square footage represents something higher than market occupancy.

**Investment-Grade Tenants:** As mentioned above, DBRS will often treat investment-grade tenants more favourably than non-investment-grade tenants. For high credit tenants with long-term leases (generally three years beyond the loan term), DBRS averages any fixed contractual rent bumps through the loan term (rather than lease term) when arriving at the loan's term DSCR. Averaging rental bumps through the lease term is recognizing revenue that will never be achieved during the loan term. Revenue over the initial lease term has greater certainty based on the credit rating of tenants, but having an investment-grade tenant does not increase the likelihood of renewal or the likelihood that the tenant will pay above market rent at its lease expiration. When calculating the Refinance DSCR, DBRS recognizes the rent at the balloon date for investment-grade tenants with lease terms at least five years beyond the loan term.

In the event, all or a majority of the income is from an investment-grade tenant and its rent alone sufficiently covers annual debt service payments,

and provided its lease does not allow for early termination options or rent abatement, DBRS will floor the loan proceeds at the rating of the tenant.

**Rollover:** A diversified rent roll isolates a landlord from the risk associated with a high concentration of space rolling within any given year. The costs and risk associated with re-signing and re-tenanting a building for comparable terms in a large rollover year can be significant. To calculate releasing costs, DBRS assumes a 60% renewal probability. DBRS considers what TIs should be given the market conditions and the space's functional utility and recognizes that renewal TIs could be considerably less. However, some tenants with old leases may demand more to convert their space into more desirable, functional space. Leasing commissions will also depend upon the market environment.

DBRS will also roll to market above-market leases expiring in the near term. According to REIS, one in five office buildings are currently exposed to rollover risk of above market leases.

**Other Income:** This often includes parking revenue, storage income, antenna rents, and miscellaneous tenant services. DBRS underwrites based on historical collections given a stabilized occupancy. One-time collections are excluded and typically so is income from non-real estate related operations.

**Reimbursements:** DBRS examines actual reimbursement methods and underwritten expenses. Although it is common to utilize the historical percentage of recovered expenses, this method can prove erroneous when there is a near-term concentrated roll of legacy leases. With modified gross leases, a landlord is at risk when a large percentage of the space is rolling and released because recoveries are then reset at zero. It is important to consider recoveries in addition to base rent as compared to current market levels, which assumes a base year and recoveries of zero. DBRS resets expense recoveries for tenants on old modified gross leases with near-term expirations if their base rent plus recoveries is above current market rates.

#### *Expenses*

Office properties are moderate to high expense ratio assets. Many expense increases can be passed through to tenants, but then affordability becomes an issue. DBRS looks at historical expense trends and



will reference IREM for similar expense per square feet comparisons based on asset class and location.

**Taxes:** As a percentage of total revenue, real estate tax burdens represent the greatest expense. As such, significant increases in tax liabilities could cause a sizeable cash flow decline. Taxes could significantly increase as a result of a property sale as the tax is reset to reflect the price (new value) of the asset. As such, for acquisitions, DBRS determines whether the underwritten tax burden reflects the property sale. In other instances, the current real estate tax bill, inflated by 3%, will be underwritten.

In instances where the property is benefiting from a tax abatement, DBRS considers the remaining term of the abatement, the difference between the abated tax and the actual tax, and considers whether any contractual future rent bumps would mitigate the burn-off of the abatement. Taxes may be underwritten to reflect the full tax liability.

**Insurance:** Insurance premiums will generally be underwritten to the current bill inflated by 3%. Because insurance expense represents a small percentage of revenue, an increase would minimally impact cash flow and the potential erosion of coverage. However, the potential cost of terrorism coverage concerns DBRS. Although the TRIA program has reduced the cost of this insurance, the insurance industry has not developed an efficient market to handle this risk, and the TRIA program is up for congressional renewal. If left to the commercial insurance market, the cost of terrorism insurance could increase insurance costs exponentially.

**Management Fee:** DBRS underwrites a management fee based on the higher of the contractual fee or 4%. When DBRS looks at properties with absentee borrowers, it recognizes the need for professional management and the fees associated with that expertise.

**Utilities:** Energy costs may be escalating faster in some markets than others. DBRS focuses on increasing trends and, if necessary, inflates accordingly, or will underwrite to the current bill inflated by 3%.

**Operating Expenses:** Historical trends and budgeted figures are considered when underwriting operating expenses.

**Ground Rent:** DBRS considers a ground lease's structure vs. a loan's structure to determine whether a leasehold interest's value is maintained through the term and can be refinanced at balloon. DBRS averages contractual rental increases throughout the term of the loan if it is not offset by contractual rental increases.

**Capital Expenditures:** Reductions for capital expenditures are based on the higher of the engineer's recommendation, actual collected annual reserves, or DBRS's minimum parameter.

#### *Cash Flow Volatility*

In order to determine an office property's cash flow volatility, DBRS considers, among other things, the:

- (1) Property's location,
- (2) Property's condition,
- (3) Borrower's experience and ability to access capital,
- (4) Market conditions (rent, vacancy, absorption, new construction),
- (5) Lease terms (modified gross vs. NNN, free rent, amortized TIs),
- (6) Tenant mix, and
- (7) Rollover schedule.

#### *Dynamics of Supply and Demand*

Office vacancy and absorption is generally based on employment. The strength and stability of an area as a desirable business location (including labour costs, tax environment, and quality of life) is crucial to the market's office sector. Employment growth creates demand for office space. About one-third of service-sector jobs are candidates for office space, including sectors such as information, financial services, and professional business services. Without job growth, demand for office space will not increase, and even with job growth, there may be a lag in increased demand due to the number of firms with more space leased than in actual use. In certain markets, the most troubling issue going forward is the space that will be coming on the market, either because of lease expiration or new construction.



## RETAIL

DBRS's analysis begins with a property's cash flow. Cash flow volatility can vary greatly based on the property's location, its condition, market, property type and respective expense ratio as well as the sponsor's ability to attract tenants and carry the property in distressed times. Therefore, underwriting to a stabilized net cash flow is very property and market specific. Following are DBRS's general retail cash flow component guidelines. As mentioned previously, DBRS recognizes the uniqueness of each piece of real estate and takes a reasonable approach when determining stabilized net cash flow based on the property and the loan structure.

### *Revenue*

**Base Rent:** Stabilized net cash flow will be calculated based on the lower of current or market rent for tenants in place, open for business and paying rent. DBRS feels compelled to distinguish between that which is and that which may or may not ever be. Upside potential from future events will not be underwritten although they may mitigate other cash flow events (e.g., increase in expenses).

DBRS will take a reasonable approach to recognize income on a case-by-case basis when a signed lease is in-place; however, the big three rules of accepting revenue is not in effect. Generally the three events required to recognize income is that the tenant is

- (1) In occupancy,
- (2) Paying rent, and
- (3) Open for business.

DBRS looks for a signed lease and considers whether the term has commenced; the landlord has satisfied all obligations and has delivered the space to the tenant; whether the tenant is spending its own money to complete the space; the tenant is an expansion tenant; and whether the loan has been structured with a reserve, letter of credit, or a holdback earn-out equal to the difference between in-place and stabilized sizing. DBRS also considers a borrower's sophistication and a tenant's underlying credit quality.

**Mark-to-Market Analysis:** DBRS recognizes the lower of current, in-place, or market rents. Market

rent is a function of current market conditions and types of space. DBRS attempts to determine market rents from a combination of occupancy costs and recently signed leases at the property and in the sub-market. Sales are frequently reported for anchor tenants but less often for in-line tenants (unless located in a regional mall). Grocery store occupancy costs should ideally be below 5%, as profit margins for grocers are very small. Other anchor tenants that can be found at power centers typically have occupancy costs around 10%. DBRS takes special note of any anchor occupancy costs over 20%, and then determines whether or not the tenant can continue to pay its rent and operate profitably, or if it will move to a less costly location.

**Rent Steps:** Future contractual rent bumps that are within market ranges and occur generally within four to six months of loan closing will be recognized as occurrence is highly likely. DBRS underwrites to the average of the contractual rent bumps over the loan term for investment-grade tenants if the tenant's lease extends at a minimum three years beyond the loan term. When calculating Refinance DSCR for investment-grade tenants with leases extending at least five years beyond the loan term, DBRS recognizes the tenants' contractual rent payment at the loan's maturity.

**Free Rent:** Concessions in the form of a rent-free period is an obvious sign of a weak market. Attracting tenants is unlikely without it. If a lease includes a free-rent period that has not burned off by securitization, DBRS underwrites to the tenant's net effective rent. If the free-rent period has expired but free rent is still prevalent in the market, DBRS will also underwrite to the tenant's net effective rent rather than in-place rent given the current market conditions. If, however, the tenant is investment-grade, the in-place rent will be recognized.

**Master Leased Income:** Master leased space will generally be treated as vacant as the space is often less desirable or the added leased square footage represents something higher than market occupancy.

**Investment-Grade Tenants:** As mentioned above, DBRS often treats investment-grade tenants more favourably than non-investment-grade tenants. For high credit tenants on long-term leases (generally three years beyond the loan term), DBRS averages any fixed contractual rent bumps through the loan



term (rather than the lease term) when arriving at the loan's term DSCR. Averaging rental bumps through the lease term, is recognizing revenue that will never be achieved during the loan term. Revenue over the initial lease term has greater certainty based on the credit rating of tenants; however, having an investment-grade tenant does not increase the likelihood of renewal or the likelihood that the tenant will pay above market rent at its lease expiration. When calculating the Refinance DSCR, DBRS recognizes the rent at the balloon date for investment-grade tenants with lease terms at least five years beyond the loan term.

In the event all or the majority of the income is from an investment-grade tenant and its rent alone sufficiently covers annual debt service payments and provided its lease does not allow for early termination options or rent abatement, and in the event the tenant goes dark, it remains obligated for all terms of its lease, DBRS will floor the loan proceeds at the rating of the tenant.

**Vacancy:** DBRS differentiates between anchor and in-line space when deriving an appropriate underwritten vacancy rate. A vacancy rate equal to the greater of in-place, market, or 5% will be applied to anchor space. A vacancy rate the greater of in-place, market, or 10% will be applied to in-line space.

**Rollover:** A diversified rent roll isolates a landlord from the risk associated with a high concentration of space rolling within any given year. The costs and risk associated with re-signing and re-tenanting a building for comparable terms in a large rollover year can be significant. To calculate releasing costs, DBRS assumes a 60% renewal probability. DBRS takes into consideration what TIs should be, given the market conditions and the space's functional utility and recognizing that renewal TIs could be considerably less, although some tenants with old leases may demand more to convert their space into more desirable, functional space. Leasing commissions will also depend upon market environment.

**Co-Tenancy Provisions:** Tenants often have co-tenancy provisions that allow them to terminate their leases without penalty if certain tenants or a certain percentage of NRA goes dark and are not open for business at the property. DBRS determines if any of these provisions could cause future

cash flow volatility by looking to tenants' sales performance to assess the likelihood that they will leave the property.

**Dark Space:** DBRS will generally not give credit to income generated by tenants that still pay on their leases but are no longer open for business because it is highly unlikely that the dark tenant will renew its lease. Therefore, any income from these tenants is not likely to last beyond lease expiration. Also, certain tenants may have go-dark provisions that allow them to stop operating their businesses while still paying on their leases. DBRS views these provisions unfavorably, as a dark anchor tenant can have a significant negative effect on a shopping center. For this reason, in the event that go-dark provisions exist, it is favorable for the borrower to have recapture rights that allow the borrower to re-tenant the space and cancel the dark tenant's lease in order to maintain customer draw to the shopping center.

**Other Income:** Often includes parking revenue, storage income, and miscellaneous tenant services. DBRS underwrites based on historical collections given a stabilized occupancy. One-time collections will be excluded and typically so will income from non-real estate related operations.

**Percentage Rent:** Certain tenants are contractually obligated to pay a specified percentage of their sales over a breakpoint in addition to base rent. DBRS looks to historical percentage rent figures and sales performance to determine how much can be included. Percentage rent should represent a small amount of total income, usually less than 10%.

**Reimbursements:** DBRS examines actual reimbursement methods and underwritten expenses. Most tenants at retail properties sign NNN leases wherein the tenant pays a pro rata share of all expenses at the property. Reimbursements will be underwritten in line with the level of underwritten occupancy.

#### **Expenses**

Retail properties are moderate to high expense ratio assets. Although most expenses are passed through to the tenants since leases are generally NNN, affordability becomes an issue. DBRS looks at historical expense trends and references IREM for comparable expense per square feet comparisons based on asset class and location.



**Taxes:** As a percent of total revenue, real estate tax burdens represent the greatest expense. As such, significant increases in tax liabilities could cause a sizeable cash flow decline. Taxes could significantly increase as a result of a property sale as the tax is reset to reflect the asset's price (new value). As such, for acquisitions, DBRS determines whether the underwritten tax burden reflects the property sale. In other instances, the current real estate tax bill inflated by 3% will be underwritten.

In situations in which the property is benefiting from a tax abatement, DBRS considers the remaining term of the abatement, the difference between the abated tax and the actual tax, and considers whether any contractual future rent bumps would mitigate the burn-off of the abatement. Taxes may be underwritten to reflect the full tax liability.

**Insurance:** Insurance premiums will generally be underwritten to the current bill inflated by 3%. As the insurance expense represents a small percentage of revenue, an increase would have little impact on cash flow and the potential erosion of coverage. However, the potential cost of terrorism coverage concerns DBRS. Although the TRIA program has reduced the cost of this insurance, the insurance industry has not developed an efficient market to handle this risk, and the TRIA program is up for congressional renewal. If left to the commercial insurance market, the cost of terrorism insurance could increase insurance costs exponentially.

**Management Fee:** DBRS will underwrite a management fee based on the higher of contractual obligation or 4%. DBRS looks at properties with absentee borrowers and recognizes the need for professional management and the fees associated with that expertise.

**Utilities:** Energy costs may be escalating faster in some markets than others. DBRS focuses on increasing trends and if in-line with historical will underwrite to the current bill inflated by a representative amount.

**Operating Expenses:** Historical trends and budgeted figures are considered when underwriting operating expenses.

**Ground Rent:** DBRS considers a ground lease's structure vs. a loan's structure to determine

whether the value of the leasehold interest is maintained through the term and can be refinanced at balloon. DBRS averages contractual rental increases throughout the term of the loan if it is not offset by contractual rental increases.

**Capital Expenditures:** Reductions for capital expenditures will be based on the higher of the engineer's recommendation, actual collected annual reserves, or DBRS's minimum parameter.

### *Dynamics of Supply and Demand*

Major factors that can influence shopping centers' performance are demographics, traffic count, and population trends. Although, in general, a high median income in the area closely surrounding a shopping center indicates a high level of buying power, a lower median income is not necessarily disastrous. For instance, a shopping center that focuses on value and discount consumer goods can do quite well in an area with low median income, whereas a higher-end center would not perform as well. Traffic count is a good indication of a desirable location. Although traffic counts vary, typically a count over 10,000 vehicles per day would be considered good. While local populations generally grow slowly, some experience more rapid growth and some experience contraction. It is very difficult to forecast higher than average population growth and assume that said growth will greatly benefit a certain shopping center. However, a declining population is a definite red flag and DBRS will further analyze the area to see why population is declining. For example, population often declines in blue collar areas that have experienced heavy job losses. Ways to mitigate the risk of further population decreases include having anchors on long-term leases and having a loan that amortizes.

### **ANCHORED RETAIL**

Anchored retail can be a regional mall, an open-air lifestyle center, a grocery-anchored center, or a power center. There are typically two or more true draws/anchors at the center. Most important, anchored retail centers are often located on major surface streets with access to the property controlled by traffic signals (signalized access) in densely populated, in-fill locations and managed by large national operators that have established relationships with major tenants. Anchor tenants generally occupy rather large, generic boxes. Because strong anchor tenants generate



traffic flow and are highly coveted by developers, their rental rates are typically significantly less than those of an in-line shop space. As a result, loan amounts, on a per square foot basis, are generally less when the anchor is included in the collateral. Because of the locations, generally utilitarian design, and ample parking, even troubled anchored retail centers often have a greater turnaround story and more interest from outside investors. DBRS assesses the relative health of each anchor by reviewing historical sales volumes, floor plate size, market trends, and barriers to entry to determine the dark anchor risk for each center. The center should additionally have ample parking, signalized access, good visibility, and strong historical sales.

### SHADOW ANCHORED RETAIL

Shadow anchored retail centers benefit from the draw dynamics of the anchor tenants. However, they have limited ability to accurately assess the anchor's relative health and have few if any remedies should an anchor cease operation. Vacant anchor space owner's economic objectives are likely to differ significantly from those of surrounding tenants. For instance, the shop tenants of a grocery-anchored center would desire a replacement grocery if the original tenant failed. But, if that grocer had moved across the street to a larger store that better suited its needs, it would be in the grocery store's best interest to keep the space vacant or possibly lease it to a non-competitive tenant. If the vacant grocery store owner is an unrelated investor, it will find it more valuable to maximize its rental rate than traffic flow. In such a scenario, the owner may find a pet supplies store, hardware store, or health club to be preferable to another grocery store.

### UNANCHORED RETAIL

Unanchored retail centers lack the draw dynamics of an anchor tenant. They frequently offset this, however, with convenient locations in going-home traffic patterns with high visibility and easy access. Unanchored retail centers often consist of smaller strip centers that do not have the draw of national retailers. The tenant mix is typically smaller users and may be a mix of traditional retailers and service providers. When evaluating unanchored retail, DBRS looks at traffic patterns, access, visibility, leverage, and amortization. In addition, DBRS considers the tenancy mix and use of the

center, the parking availability, and the nearby competition. If the center has the closest dry cleaner, nail shop, or convenience store to a large residential neighborhood, it will likely increase the center's success. The local borrower with many retail centers may also have access to tenants an absentee borrower may not.

### MULTI-FAMILY

DBRS's analysis begins with a property's cash flow. Cash flow volatility can vary greatly based on the property's location, condition, market, property type, and respective expense ratio as well as the sponsor's ability to attract tenants and carry the property in distressed times. Therefore, underwriting to a stabilized net cash flow is very property- and market-specific. Following are DBRS's general multi-family cash flow component guidelines. DBRS realizes that every piece of real estate is unique and takes a reasonable approach when determining stabilized net cash flow based on the property and the loan structure.

Multi-family properties' cash flow volatility is considered higher given the short-term leases to non-creditworthy tenants. The volatility in multi-family product varies depending on the market. Economic factors that positively impact multi-family performance include job and population growth. Declines in performance could be caused by a poor manager, new supply, affordable alternative housing (home ownership), or job loss. Typically, properties located in markets relying heavily on one industry (including the military) are at risk if the sector suffers. An equation for a probable well-performing multi-family property is one located in a high demographic-growth market with a limited supply of land and high cost of home ownership.

#### *Revenue*

**Base Rent:** Stabilized net cash flow will be calculated based on trailing 12 month (T-12) collections. DBRS looks for three years of historical operating statements to determine if any increasing trends are sustainable. An additional vacancy allowance and credit loss factor may be necessary subject to market conditions. DBRS underwrites to the lower of actual or market occupancy. If there is new supply coming on-line and competing directly with the subject, occupancy or rents will suffer. The new product will offer a lease-up special that



will attract tenants from the subject. DBRS recognizes the additional stress on the properties' net cash flow and takes an additional vacancy factor.

**Concessions:** It is important to recognize what, if any, concessions are being offered at the subject and in the market. Considering current concessions, DBRS underwrites to a net effective rent. For example if a one-month free move-in special is commonplace in the market, DBRS underwrites to the effectively reduced annual rent. Other move-in incentives such as "Free Washer/Dryer" will be considered when determining revenue stability.

**Other Income:** Often includes laundry and vending revenue, as well as clubhouse rental and business center services. DBRS underwrites based on historical collections given a stabilized occupancy. DBRS carefully assesses the situation when this income exceeds 5% of base rent.

#### *Expenses*

Generally, multi-family assets are high expense ratio assets with short-term leases to non-creditworthy tenants. DBRS looks at historical expense trends and references IREM for comparable expense psf comparisons based on asset class and location.

The greater the common area, the higher the borrower's cost to maintain it, thereby increasing the property's expense ratio. In theory, luxury apartments should have the highest expense ratio; however they should also have the highest asking rents for the expansive common areas and amenities they provide. In addition, it should offset the increase in operating expenses.

**Taxes:** As a percentage of total revenue, real estate tax burdens represent the greatest expense. As such, significant increases in tax liabilities could cause a sizeable cash flow decline. Taxes could significantly increase as a result of a property sale as the tax is reset to reflect the asset's price (new value). For acquisitions, DBRS determines whether the underwritten tax burden reflects the property sale. In other instances, the current real estate tax bill inflated by 3% will be underwritten.

In instances where the property is benefiting from a tax abatement, DBRS considers the abatement's remaining term, the difference between the abated tax and the actual tax, and considers whether any

contractual future rent bumps would mitigate the burn-off of the abatement. Taxes may be underwritten to reflect the full tax liability.

**Insurance:** Insurance premiums will generally be underwritten to the current bill inflated by 3%. As the insurance expense represents a small percentage of revenue, an increase would have little impact on cash flow and the potential erosion of DSCR.

**Management Fee:** DBRS underwrites a management fee based on the higher of contractual obligation or 4%. A higher management fee may be justified for a small complex with less than 100 units.

**Utilities:** Energy costs may be escalating faster in some markets than others. DBRS focuses on increasing trends and if necessary inflates accordingly or underwrites to the current bill inflated by a 3%.

**Operating Expenses:** Historical trends and budgeted figures will be considered when underwriting operating expenses.

**Capital Expenditures:** Reductions for capital expenditures will be based on the higher of the engineer's recommendation, actual collected annual reserves, or DBRS's minimum parameter.

#### *Cash Flow Volatility*

To determine the cash flow volatility of a multi-family property, DBRS will consider among other things:

- The property's condition considering its age, appearance, and construction quality,
- Location near employers and service providers,
- Local economy and local employers, including military bases and colleges, relocating, closing, or going out of business,
- Strength and reputation of management to rent units and provide adequate maintenance,
- Property amenities,
- Mortgage interest rates and affordability of single-family homes, either of which may encourage tenants to purchase rather than lease housing,
- In the case of student housing facilities, reliance on the financial well-being of the college or university to which it relates, as well as physical layout of the housing, which may not be readily convertible to traditional multi-family use,
- Competition and prospective new supply or reduction in supply given condo conversions, and



- Dependence upon governmental programs that provide rent subsidies to tenants pursuant to tenant voucher programs, and which vouchers may be used at other properties and influence tenant mobility.

### *Dynamics of Supply and Demand*

Multi-family performance is based on a number of factors, most notably an affordable housing market and the local employment base. A low interest rate environment and a large housing supply, resulting in lower prices, would negatively affect the performance of a multi-family asset. However, the reverse holds true as well: in a market with a small supply of available homes, which drives up prices, multi-family performance would be markedly better. The strength of the local employment market and the number of major employers is crucial to multi-family stability as well. Markets with a diverse employment base are often able to weather downturns in the economy while markets that rely on one major employer or industry can face volatile periods.

## INDUSTRIAL

DBRS's rating analysis begins with a property's cash flow. Cash flow volatility can vary greatly based on the property's location, functionality, condition, market, property type, and respective expense ratio as well as the sponsor's ability to attract tenants and carry the property in distressed times. Therefore, underwriting to a stabilized net cash flow is very property- and market-specific. Below are DBRS's general industrial cash flow component guidelines. DBRS realizes the uniqueness of every piece of real estate and takes a reasonable approach when determining stabilized net cash flow based on the property and the loan structure.

### *Revenue*

**Base Rent:** Stabilized net cash flow is calculated based on the lower of current or market rent for tenants in-place, open for business, and paying rent. DBRS distinguishes between income that exists and income that may never be. Upside potential from future events will not be underwritten, although they may mitigate other cash flow events (e.g., increase in expenses).

DBRS recognizes income on a case-by-case basis when a signed lease is in-place; however, the big three rules of accepting revenue are not in effect.

Generally, the three events required to recognize income is that the tenant be:

- (1) In occupancy,
- (2) Paying rent,
- (3) Open for business

DBRS looks for a signed lease and considers whether the term has commenced; the landlord has satisfied all obligations and has delivered the space to the tenant, the tenant is spending its own money to complete the space; the tenant is an expansion tenant; and whether the loan has been structured with a reserve, letter of credit, or a holdback earn-out equal to the difference between in-place and stabilized sizing. DBRS also considers the borrower's sophistication and the tenant's underlying credit quality.

DBRS assesses a space's functionality and its overall marketability when determining achievable rent and stabilized vacancy.

**Mezzanine Space:** DBRS looks to the functionality of the mezzanine space and the ability to command rent for it. Generally, second-story and mezzanine space in industrial buildings is difficult to lease up and may be treated as vacant or excluded from a properties NRA. However, on a case-by-case basis, if the space is functional office space and there is a market for it, DBRS will underwrite to the lower of actual or market rent.

**Office Buildout:** For a typical warehouse/distribution facility, the percentage of interior space completed as office typically ranges from 5% to 15% of total space, and a higher rent is not achieved for this common amenity. For larger buildings, the ratio of office space is generally smaller. As the ratio of office space grows, the building is often deemed inefficient and actually may negatively impact the property's value.

For R&D/flex facilities, a larger portion of office space is preferred and often this can range from 20% to 100% of total space. Properties with a higher percentage of office improvements can demand higher rents in a peak market environment as office rents push some office users out to take advantage of a lower rent in flex space.



However, during weak market conditions, the office user will vacate the flex space for higher quality typical office space for a comparable rental rate, leaving the flex space functionally obsolescent to most industrial users. This will, result in high vacancies and stressed cash flows.

**Mark-to-Market Analysis:** DBRS recognizes the lower of current, in-place, or market rents. Market rent will be a function of current market conditions and types of space.

- *Specialized Improvements:* Rents for built-to-suit tenants in recently constructed buildings are based on the cost of construction. If the space has specialized improvements and the loan is structured such that it amortizes over the lease term, DBRS will recognize this 1st generation, built-to-suit rent. For non-amortizing loans, DBRS reduces the rent to reflect the marketability of this specialized use.
- *Plain Vanilla Space:* Market rents will be determined based on market data. Additionally, recently signed leases at the subject and comparable buildings for similar size space are used as a measure of achievable rent.

**Rent Steps:** Future contractual rent bumps that are within market ranges and occur generally within four to six months of loan closing will be recognized as there is a high likelihood of occurrence. DBRS underwrites to the average of the contractual rent bumps over the loan term for investment-grade tenants if the tenant's lease extends at a minimum three years beyond the loan term. For investment-grade tenants with leases extending at least five years beyond the loan term, DBRS recognizes the tenants' contractual rent payment at the loan's maturity when calculating Refinance DSCR.

**Free Rent:** Concessions in the form of a rent-free period is an obvious sign of a weak market. Attracting tenants is unlikely without it. If a lease includes a free-rent period that has not burned off by securitization, DBRS underwrites to the tenant's net effective rent. If the free-rent period has expired, but free rent is still prevalent in the market, DBRS also underwrites to the tenant's net effective rent rather than in-place rent given the current market conditions. If, however, the tenant is investment-grade, the in-place rent will be recognized.

**Master Leased Income:** Master leased space will generally be treated as vacant as the space is often less desirable or the added leased square footage represents something higher than market occupancy.

**Investment-Grade Tenants:** As mentioned above, DBRS often treats investment-grade tenants more favourably than non-investment-grade tenants. For high credit tenants on long-term leases (generally three years beyond the loan term), DBRS averages any fixed contractual rent bumps through the loan term (rather than lease term) when arriving at the loan's term DSCR. Averaging rental bumps through the lease term recognizes revenue that will never be achieved during the loan term. Revenue over the initial lease term has greater certainty of attainment based on the credit rating of tenants; however, having an investment-grade tenant does not increase the likelihood of renewal or the likelihood that the tenant will pay above-market rent at its lease expiration. When calculating the Refinance DSCR, DBRS recognizes the rent at the balloon date for investment-grade tenants with lease terms at least five years beyond the loan term.

In the event, all or the majority of the income is from an investment-grade tenant and its rent alone sufficiently covers annual debt service payments and provided its lease does not allow for early termination options or rent abatement, DBRS will floor the loan proceeds at the rating of the tenant.

**Rollover:** A diversified rent roll isolates a landlord from the risk associated with a high concentration of space rolling within any given year. The costs and risk associated with re-signing and re-tenanting a building for comparable terms in a large rollover year can be significant. To calculate releasing costs, DBRS assumes a 60% renewal probability. DBRS considers what TIs should be given the market conditions and the space's functional utility and recognizes that renewal TIs could be considerably less, although some tenants with old leases may demand more to convert their space into more desirable, functional space. Leasing commissions will also depend upon market environment.

**Other Income:** DBRS underwrites based on historical collections given a stabilized occupancy. One-time collections will be excluded and typically so will income from non-real estate related operations.



**Reimbursements:** DBRS examines actual reimbursement methods and underwritten expenses. Typically, industrial leases are triple net (NNN).

#### *Expenses*

Industrial properties are low- to moderate-expense ratio assets. The majority of industrial leases are NNN, with expenses passed through to tenants. As such, any increase in expenses becomes an affordability issue for the tenant. DBRS looks at historical expense trends and references IREM for comparable expense per square foot comparisons based on asset class and location.

**Taxes:** As a percentage of total revenue, real estate tax burdens represent the greatest expense. As such, significant increases in tax liabilities could cause an increase in the tenant's occupancy costs. Taxes could significantly increase as a result of a property sale as the tax is reset to reflect the asset's price (new value). As such, for acquisitions, DBRS determines whether the underwritten tax burden reflects the property sale. In other instances, the current real estate tax bill, inflated by 3%, will be underwritten.

In instances where the property is benefiting from a tax abatement, DBRS considers the remaining term of the abatement, the difference between the abated tax and the actual tax, and whether any contractual future rent bumps would mitigate the burn-off of the abatement. Taxes may be underwritten to reflect the full tax liability.

**Insurance:** Insurance premiums will generally be underwritten to the current bill inflated by 3%. As the insurance expense represents a small percentage of revenue, an increase would have little impact on cash flow and the potential erosion of coverage. However, the potential cost of terrorism coverage concerns DBRS. Although the TRIA program has reduced the cost of this insurance, the insurance industry has not developed an efficient market to handle this risk, and the TRIA program is up for congressional renewal. If left to the commercial insurance market, the cost of terrorism insurance could increase insurance costs exponentially.

**Management Fee:** For Warehouse/Distribution facilities, DBRS underwrites management fee based on the higher of contractual or 3.5%. For R&D/Flex facilities, DBRS underwrites management fee based on the higher of contractual or 4%.

DBRS looks at properties with absentee borrowers and recognizes the need for professional management and the fees associated with that expertise.

**Utilities:** Energy costs may be escalating faster in some markets than others. DBRS focuses on increasing trends and if in-line with historical will underwrite to the current bill inflated by a representative amount.

**Operating Expenses:** Historical trends and budgeted figures will be considered when underwriting operating expenses.

**Ground Rent:** DBRS considers the ground lease's structure vs. the loan's structure to determine whether the leasehold interest's value is maintained through the term and can be refinanced at balloon. DBRS averages contractual rental increases throughout the term of the loan if it is not offset by contractual rental increases.

**Capital Expenditures:** Reductions for capital expenditures will be based on the higher of the engineer's recommendation, actual collected annual reserves, or DBRS's minimum parameter.

**Tenant Improvements and Leasing Commissions:** Leasing costs associated with industrial space are typically limited to leasing commissions. Generally, industrial buildings have limited tenant improvement costs as space is very generic. However, industrial buildings with a significant amount of office improvement (20% or more), such as R&D/Flex facilities, will have much higher TI costs as the cost to fit out the office space is comparable to a typical office building. For these types of buildings, DBRS segregates the space and applies separate tenant improvement amounts for the industrial and office components.

#### *Dynamics of Supply and Demand*

Functionality is the key to industrial properties. Restrictions imposed by building and site characteristics can adversely affect the value and cash flow of industrial properties. There are a number of important characteristics and qualities to consider that ultimately will keep a building desirable to tenants and valuable to property owners:

*Ceiling Clear Heights* are an important design feature, especially in warehouse/distribution



facilities where cubic storage capacity is a major factor. In general, these properties will have ceiling heights higher than 18 feet and less than 35 feet. In recent years, the trend has been to increase the clear ceiling heights in new industrial buildings, especially in major distribution markets. For R&D/flex facilities, it is important to maintain clear heights that range from 16 to 18 feet for design flexibility to allow for alternative uses, as well as expansion.

*Loading facilities* are also important as they provide easy access for trucks transporting to and from the site. Larger industrial buildings typically will contain a mix of drive-in and truck dock loading facilities with a higher number of docks than drive-in doors. Warehouse/Distribution facilities typically have a higher ratio of loading docks than manufacturing facilities. For new facilities, the average number of loading docks is typically between 10 and 12 per 10,000 sf of total space. As for R&D/flex, the number of docks and loading facilities will determine how flexible the property is and ultimately can add or detract from the value.

Just as important is the *truck drive and turning areas* for large semis. In industrial parks, adequate truck turning areas must be provided as part of the property, so that trucks do not use public streets for turning. Most delivery areas should also be concrete paved to accommodate the heavy truck loads.

*Site access and location*, as with all real estate, is important. However, visibility is not as crucial as access for large trucks and tractor trailers hauling heavy loads. In addition to easy access,

the ability for trucks to get to the site from major road arteries and expressways and the proximity to distribution and manufacturing centers is important. It is preferable for buildings to be in industrial parks and away from residential areas but close to interstate interchanges, major airports, and transportation hubs.

Major U.S. *seaports* are a great demand generator for industrial space. Currently, imports into the U.S. have overwhelmed seaports, increasing demand for industrial space in surrounding markets and causing small seaports to expand to handle the extra capacity. Some of the fastest growing seaports are along the western seaboard as trade with Asia (Japan, China, South Korea, Taiwan, and Malaysia) continues to expand. Markets in L.A. County, San Diego County, and Orange County continue to show some of the strongest market dynamics both in availability and rental rates.

Despite the fact the major corporations have shifted production overseas and downsized many production facilities within the United States, net absorption occurred within the last year. The pace of imports has helped to stabilize the market as well as efficiencies in the manufacturing process and distribution without increased labor costs. Business spending on equipment has been suggested as more of a lead indicator for the health of the industrial market. With continued growth in trade, the demand for warehousing nationwide will continue to grow. However, rising energy costs that cause a large rise in production costs, could hinder future leasing and development.



## Appendix C: DBRS Underwriting and Sizing Guidelines

Property Type	NET CASH FLOW ADJUSTMENTS <sup>1</sup>						SIZING ADJUSTMENTS <sup>1</sup>			
	Revenue	Vacancy	Management Fee	Capital Expenditures	Tenant Improvements	Leasing Commissions	Interest Rate	Refinance Constant	Amortization Term	Capitalization Rate
Multi-family	T-12	5%	4.0%	\$250 per unit	—	—	9.00%	9.66%–10.07%	25–30	8.00–9.50%
Manufactured Housing Community	T-12	5%	5.0%	\$50 per pad	—	—	9.00%	9.66%–10.07%	25–30	8.00–10.00%
Industrial – Warehouse	Leases-in-Place	5%	3.0%	\$0.15 psf	\$0.75 <sup>2</sup>	5.0%	9.00%	9.66%–10.80%	20–30	8.00–10.00%
Flex (Industrial/Office)	Leases-in-Place	5%/10%	4.0%	\$0.15/ \$0.20 psf	\$1/\$10	5%/4%	9.00%	10.07%–10.80%	20–25	8.50–10.50%
Office	Leases-in-Place	10%	4.0%	\$0.20 psf	Based on 75% of Annual Rents PSF	5.0%	9.50%	10.48%	25	8.50–10.50%
Regional Mall	Leases-in-Place	5%	4.0%	\$0.20 psf	\$10 - \$25	5.0%	9.00%	9.66%–10.80%	20–30	7.50–10.00%
Anchored Retail	Leases-in-Place	5%	4.0%	\$0.15 psf	\$3–\$5	5.0%	9.00%	10.07%	25	8.00–10.00%
Power Center	Leases-in-Place	5%	3.5%	\$0.10 psf	\$3–\$5	5.0%	9.50%	10.48%	25	8.50–10.50%
Unanchored Retail	Leases-in-Place	10%	4.0%	\$0.15 psf	\$2–\$4	5.0%	10.00%	11.58%	20	9.00–11.00%
Self Storage	T-12	10%	6.0%	\$0.10 psf	—	—	10.50%	11.33%	20	10.00–12.00%
Hotel – Full Service	T-12	NA	11–14% <sup>3</sup>	5% (EGI)	—	—	10.50%	11.98%	20	10.00–12.00%
Hotel – Limited Service	T-12	NA	11–14% <sup>3</sup>	5% (EGI)	—	—	11.00%	12.39%	20	10.50–12.50%
Assisted Living	T-12	10%	5.0%	\$350 per unit	—	—	10.25%	11.78%	20	10.00–12.00%
Independent Living	T-12	7.5%	5.0%	\$300 per unit	—	—	9.75%	11.38%	20	9.00–11.00%
Skilled Nursing Facility	T-12	5%	5.0%	\$250 per bed	—	—	10.50%	11.98%	20	10.00–12.00%

1. Sizing adjustments are calculated based on balloon balance, see below for sizing constraints. DBRS guidelines are subject to change based on property and market specific attributes.  
2. Assumes 5% office improvements. Office buildout in excess of 5% will be addressed based on size of office buildout.  
3. Combination of Franchise Fee, Management Fee and Sales and Marketing Fees.  
EGI = Effective Gross Income



# Appendix D: Sample DBRS Underwriting

## \$15,000,000 Atrium on the Sea (Toronto, Nunavut): Current Rent Roll

RR Type: Draft RR As Of: 5/30/04 Short Name: DBRS Underwritten Cash Flow

TENANT INFORMATION										UNDERWRITTEN GROSS POTENTIAL RENT										Lease Length (Yrs)			
NET RENTABLE AREA					UNDERWRITTEN BASE RENT					Base Rent					Underwritten Occ. Cost					Lease Dates		Lease Length (Yrs)	
Tenant Name	Lease Type	Tenant Occupancy Status	Tenant Class	SF	% of NRA	Unit	Contractual	Market	Underwritten	\$/Yr	PSF/Yr	PSF/Mo	Percent- age Rent	Reimburse- ments	\$/Yr	PSF/Yr	%GPR	Lease Start	Lease End	Remain	Term		
CIBC - Direct to Consumer/Amicus Financial	Net Office	Leased	Office	22,000	16.6%	\$PSF/Yr	14.00	18.00	14.00	308,000	14.00	1.17	0	280,416	588,416	26.75	14.9%	01/11/2003	31/10/2016	12.4	13.0		
r - MCI Medical Clinic Inc.	Net Retail	Leased	Retail	14,356	10.8%	\$PSF/Yr	15.00	22.00	15.00	215,340	15.00	1.25	0	156,416	371,756	25.90	9.4%	01/11/2003	31/10/2016	12.4	13.0		
Public Trustee	Net Office	Leased	Office	12,345	9.3%	\$PSF/Yr	16.00	18.00	16.00	197,520	16.00	1.33	0	162,210	359,730	29.14	9.1%	01/09/1999	31/08/2009	5.3	10.0		
Registry Office	Net Office	Leased	Office	5,672	4.3%	\$PSF/Yr	17.00	18.00	17.00	96,424	17.00	1.42	0	60,069	156,493	27.59	4.0%	01/07/1999	30/06/2004	0.1	5.0		
r - The Kitchen Table	Net Retail	Leased	Retail	4,567	3.4%	\$PSF/Yr	18.00	22.00	18.00	82,206	18.00	1.50	0	57,263	139,469	30.54	3.5%	01/11/2003	31/10/2013	9.4	10.0		
Provincial Auditor	Net Office	Leased	Office	2,355	1.8%	\$PSF/Yr	18.00	18.00	18.00	42,390	18.00	1.50	0	41,637	84,027	35.68	2.1%	01/11/2003	31/10/2011	7.4	8.0		
Hunter Keilty Muntz Beatty 920	Net Office	Leased	Office	6,434	4.9%	\$PSF/Yr	19.00	18.00	18.00	115,812	18.00	1.50	0	92,452	208,264	32.37	5.3%	01/07/2000	30/06/2014	10.1	14.0		
Land Registry Office	Net Office	Leased	Office	7,453	5.6%	\$PSF/Yr	13.00	18.00	13.00	96,889	13.00	1.08	0	107,651	204,540	27.44	5.2%	01/11/2000	31/10/2005	1.4	5.0		
r - Pharmx	Net Retail	Leased	Retail	8,431	6.4%	\$PSF/Yr	20.00	22.00	20.00	168,620	20.00	1.67	0	144,560	313,180	37.15	7.9%	01/11/2003	31/10/2013	9.4	10.0		
r - Spring Rolls	Net Retail	Leased	Retail	2,354	1.8%	\$PSF/Yr	15.00	22.00	15.00	35,310	15.00	1.25	0	36,630	71,940	30.56	1.8%	01/11/2003	31/10/2016	12.4	13.0		
r - Guess Canada (Ground Floor)	Net Retail	Leased	Retail	7,653	5.8%	\$PSF/Yr	11.75	22.00	11.75	89,923	11.75	0.98	0	119,064	208,986	27.31	5.3%	01/11/2003	31/10/2016	12.4	13.0		
Alcohol & Gaming Commission'	Net Office	Leased	Office	5,243	4.0%	\$PSF/Yr	18.00	18.00	18.00	94,374	18.00	1.50	0	92,039	186,413	35.55	4.7%	02/04/2001	31/03/2006	1.8	5.0		
Hunter Keilty Muntz Beatty 900/901	Net Office	Leased	Office	4,078	3.1%	\$PSF/Yr	19.00	18.00	18.00	73,404	18.00	1.50	0	73,809	147,213	36.10	3.7%	01/07/2003	30/06/2014	10.1	11.0		
Western Town Community College	Net Office	Leased	Office	5,026	3.8%	\$PSF/Yr	13.50	18.00	13.50	67,851	13.50	1.13	0	90,506	158,357	31.51	4.0%	01/04/2000	31/03/2014	9.8	14.0		
Alcohol & Gaming Commission' 834	Net Office	Leased	Office	6,001	4.5%	\$PSF/Yr	14.00	18.00	14.00	84,014	14.00	1.17	0	97,393	181,407	30.23	4.6%	28/02/2003	01/03/2006	1.8	3.0		
r - Indian Flavour	Net Retail	Leased	Retail	3,034	2.3%	\$PSF/Yr	15.00	22.00	15.00	45,510	15.00	1.25	0	48,433	93,943	30.96	2.4%	01/11/2003	31/10/2013	9.4	10.0		
Alcohol & Gaming Commission' 925	Net Office	Leased	Office	4,056	3.1%	\$PSF/Yr	15.00	18.00	15.00	60,840	15.00	1.25	0	63,653	124,493	30.69	3.2%	01/04/2002	31/03/2006	1.8	4.0		
Registry Office 530	Net Office	Leased	Office	4,365	3.3%	\$PSF/Yr	16.00	18.00	16.00	69,840	16.00	1.33	0	65,836	135,676	31.08	3.4%	01/11/2000	31/10/2004	0.4	4.0		
r - Red Lobster	Net Retail	Leased	Retail	1,020	0.8%	\$PSF/Yr	28.00	22.00	22.00	22,440	22.00	1.83	0	22,206	44,646	43.77	1.1%	01/05/2002	30/04/2010	5.9	8.0		
r - LCBO	Net Retail	Leased	Retail	500	0.4%	\$PSF/Yr	25.00	22.00	22.00	11,000	22.00	1.83	0	6,532	17,532	35.06	0.4%	01/02/2000	31/01/2014	9.7	14.0		
Vacant Office	Net Office	Vacant	Office	3,500	2.6%	\$PSF/Yr	0.00	18.00	18.00	63,000	18.00	1.50	0	24,725	87,725	25.06	2.2%	01/01/1901	01/01/1901	0.0	0.0		
Vacant Retail	Net Retail	Vacant	Retail	2,100	1.6%	\$PSF/Yr	0.00	22.00	22.00	46,200	22.00	1.83	0	14,835	61,035	29.06	1.5%	01/01/1901	01/01/1901	0.0	0.0		
<b>TOTALS BY OCCUPANCY STATUS (a)</b>		<b># Spaces</b>		<b>Total</b>	<b>% Total</b>					<b>Total</b>	<b>Wtd Avg (b)</b>		<b>Total</b>		<b>Wtd Av</b>	<b>% Total</b>				<b>Wtd Avg (b)</b>			
Leased		20		126,943	95.8%					1,977,707	14.92	1.24	0	1,818,773	3,796,480	28.64	96.2%			8.0	10.0		
Subleased		0		0	0.0%					0	0.00	0.00	0	0	0	0.00	0.0%			0.0	0.0		
MTM		0		0	0.0%					0	0.00	0.00	0	0	0	0.00	0.0%			0.0	0.0		
Dark		0		0	0.0%					0	0.00	0.00	0	0	0	0.00	0.0%			0.0	0.0		
<b>Total Occupied</b>		<b>20</b>		<b>126,943</b>	<b>95.8%</b>					<b>\$1,977,707</b>	<b>14.92</b>	<b>1.24</b>	<b>\$0</b>	<b>\$1,818,773</b>	<b>\$3,796,480</b>	<b>28.64</b>	<b>96.2%</b>			<b>8.0</b>	<b>10.0</b>		
Vacant		2		5,600	4.2%	< Physical Vacancy				109,200	0.82	0.07	0	39,560	148,760	1.12	3.8%	<Ease Economic Vacancy		0.0	0.0		
<b>Total</b>		<b>22</b>		<b>132,543</b>	<b>100.0%</b>	<b>&lt; Net Rentable Area (NRA)</b>				<b>\$2,086,907</b>	<b>15.75</b>	<b>1.31</b>	<b>\$0</b>	<b>\$1,858,333</b>	<b>\$3,945,240</b>	<b>29.77</b>	<b>100.0%</b>	<b>&lt;Total UW Rent</b>		<b>7.7</b>	<b>9.6</b>		
<b>Total Square Footage Has Changed</b>																							
<b>TOTALS BY TENANT CLASS</b>																							
Office		13		88,528	66.8%					1,370,398	15.48	1.29	0	1,252,395	2,622,753	29.63	66.5%			6.2	8.8		
Retail		9		44,015	33.2%					716,549	16.28	1.36	0	605,938	1,322,487	30.05	33.5%			10.6	11.2		



**\$15,000,000 Atrium on the Sea (Office/Office): Cash Flow Analysis**

# Sq Ft: 132,543

OpStmnt Name Type As-Of Date   Mos   Adjusted Source	Historical 12/31/2002			Historical 12/31/2003			Historical 12/31/2004 3:58 pm			DBRS Concluded		
	12/31/02	12/31/03	12/31/04	12/31/02	12/31/03	12/31/04	12/31/02	12/31/03	12/31/04	No	Underwriting	Notes
	Amount	PSF	%	Amount	PSF	%	Amount	PSF	%	Amount	PSF	%
Physical Occupancy %	90.0%			95.0%			93.0%			0.0%		
<b>INCOME:</b>												
% GPR Base Rent	1,800,000	13.58	49.3%	1,950,000	14.71	50.6%	1,970,000	14.86	50.6%	2,086,907	15.75	52.9%
" CAM Reimbursement	1,850,000	13.96	50.7%	1,900,000	14.33	49.4%	1,920,000	14.49	49.4%	1,858,333	14.02	47.1%
" Tax Reimbursement	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Insurance Reimbursement	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Management Fee Reimbursement	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Other Reimbursement	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Percentage Rent	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" <b>Gross Potential Revenues</b>	<b>3,650,000</b>	<b>27.54</b>	<b>100.0%</b>	<b>3,850,000</b>	<b>29.05</b>	<b>100.0%</b>	<b>3,890,000</b>	<b>29.35</b>	<b>100.0%</b>	<b>3,945,240</b>	<b>29.77</b>	<b>100.0%</b>
" Less: Vacancy Loss	0	0.00	10.0%	0	0.00	10.0%	0	0.00	10.0%	394,524	2.98	10.0%
" Less: Concessions	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Less: Credit Loss	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" <b>Net Rental Income</b>	<b>3,650,000</b>	<b>27.54</b>	<b>100.0%</b>	<b>3,850,000</b>	<b>29.05</b>	<b>100.0%</b>	<b>3,890,000</b>	<b>29.35</b>	<b>100.0%</b>	<b>3,550,716</b>	<b>26.79</b>	<b>90.0%</b>
" Parking Income	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Other Income	56,000	0.42	1.5%	60,000	0.45	1.6%	66,000	0.50	1.7%	60,667	0.46	1.5%
" <b>Effective Gross Income</b>	<b>3,706,000</b>	<b>27.96</b>	<b>101.5%</b>	<b>3,910,000</b>	<b>29.50</b>	<b>101.6%</b>	<b>3,956,000</b>	<b>29.85</b>	<b>101.7%</b>	<b>3,611,383</b>	<b>27.25</b>	<b>91.5%</b>
<b>OPERATING EXPENSES:</b>												
%EGI Real Estate Taxes	300,000	2.26	8.1%	325,000	2.45	8.3%	335,000	2.53	8.5%	335,000	2.53	9.3%
" Property Insurance	250,000	1.89	6.7%	270,000	2.04	6.9%	285,000	2.15	7.2%	295,000	2.23	8.2%
" Ground Rent	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" <b>Total Fixed Expenses</b>	<b>550,000</b>	<b>4.15</b>	<b>14.8%</b>	<b>595,000</b>	<b>4.49</b>	<b>15.2%</b>	<b>620,000</b>	<b>4.68</b>	<b>15.7%</b>	<b>630,000</b>	<b>4.75</b>	<b>17.4%</b>
" Utilities	135,000	1.02	3.6%	137,000	1.03	3.5%	139,000	1.05	3.5%	139,000	1.05	3.8%
" Repairs & Maintenance	200,000	1.51	5.4%	210,000	1.58	5.4%	220,000	1.66	5.6%	220,000	1.66	6.1%
" Janitorial	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Management Fee	155,000	1.17	4.0%	153,000	1.15	4.0%	154,000	1.16	4.0%	142,029	1.07	4.0%
" Payroll Expense	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Advertising & Marketing	0	0.00	0.0%	206,000	1.55	5.3%	216,000	1.63	5.5%	216,000	1.63	6.0%
" Security	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Professional Fees	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" General & Administrative	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" Other Expenses	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" <b>Total Operating Expenses</b>	<b>1,040,000</b>	<b>7.85</b>	<b>28.1%</b>	<b>1,301,000</b>	<b>9.82</b>	<b>33.3%</b>	<b>1,349,000</b>	<b>10.18</b>	<b>34.1%</b>	<b>1,347,029</b>	<b>10.16</b>	<b>37.3%</b>
" Reimbursement Ratio	177.0%			146.0%			142.0%			138.0%		
<b>%EGI NET OPERATING INCOME</b>	<b>2,666,000</b>			<b>2,609,000</b>			<b>2,607,000</b>			<b>2,264,354</b>		
<b>CAPITAL EXPENDITURES:</b>												
%EGI Tenant Improvements	75,000	0.57	2.0%	73,000	0.55	1.9%	70,000	0.53	1.8%	53,776	0.41	1.5%
" Leasing Commissions	65,000	0.49	1.8%	67,000	0.51	1.7%	55,000	0.41	1.4%	48,775	0.37	1.4%
" Replacement Reserves	0	0.20	0.0%	0	0.20	0.0%	0	0.20	0.0%	26,509	0.20	0.7%
" Other Capital Expenditures	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%	0	0.00	0.0%
" <b>Total Capital Expenditures</b>	<b>140,000</b>	<b>1.06</b>	<b>3.8%</b>	<b>140,000</b>	<b>1.06</b>	<b>3.6%</b>	<b>125,000</b>	<b>0.94</b>	<b>3.2%</b>	<b>129,060</b>	<b>0.97</b>	<b>3.6%</b>
<b>%EGI NET CASH FLOW</b>	<b>2,526,000</b>	<b>19.06</b>	<b>68.2%</b>	<b>2,469,000</b>	<b>18.63</b>	<b>63.1%</b>	<b>2,482,000</b>	<b>18.73</b>	<b>62.7%</b>	<b>2,135,294</b>	<b>16.11</b>	<b>59.1%</b>

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**Toronto**

DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
TEL +1 416 593 5577

**London**

1st Floor  
25 Copthall Avenue  
London EC2R 7BP  
TEL +44 (0)20 7562 5600

**New York**

140 Broadway  
35th Floor  
New York, NY 10005  
TEL +1 212 806 3277

**Paris**

27, avenue de l'Opéra  
75001 Paris  
TEL +33 (0)1 7038 5214

**Chicago**

101 North Wacker Drive  
Suite 100  
Chicago, IL 60606  
TEL +1 312 332 3429

**Frankfurt**

Trianon Tower  
Mainzer Landstrasse 16  
60325 Frankfurt  
TEL +49 (0)69 9716 8144