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Master/Head Lease Proliferation

Real estate's stable returns and performance in recent years has resulted in it attracting significant capital investment from both debt and equity sources. As these investment opportunities have been more aggressively pursued, real estate investors have realized and benefited from compression of mortgage interest rate spreads and cap rates. At the same time, what some investors consider to be acceptable risk has also shifted and manifested itself in various structural deal components including "Master Leased or Head Leased Space." By recognizing master/head lease income, borrowers are able to maximize loan proceeds. Although maximizing loan proceeds is almost always a good thing for a borrower, when doing so results in a deviation of standard underwriting procedures, it becomes imperative that the rating agencies prudently quantify the risk.

Standard underwriting procedures are to recognize the higher of the current physical vacancy (all unoccupied space) of the property, contractual vacancy (all un-leased space) or market vacancy (direct and indirect) for comparable space within a defined peer group or sub-market. The rental rate for each lease is adjusted to be the lower of contractual rent (plus recoveries if market is for gross or modified gross leases) and rental rates recently achieved for comparable space at the subject property or comparable assets within their peer group or sub-market. This policy is specifically intended to identify all un-leased and all unoccupied space, recognizing that vacant space need not be both.

The underlying theory is that there is inherently greater priority of payment and credit quality when a tenant derives value from occupying a space regardless of property type. This also serves as proxy for the relative ability of that space to meet the needs of the local tenant base. Conversely, obligating the borrower to lease vacant space concentrates reliance on the borrowing entity, fails to confirm the marketability of the space and may overstate the value of the space by applying what seems to be a market rental rate to inferior or potentially unusable space.

As with many rules, it cannot be a rule without an exception. We do recognize comparative benefit when a master/head lease obligates an investment grade entity throughout the term of the loan and additional benefit if this obligation covers the amortization term of the loan. In jurisdictions where recourse is viewed as a meaningful obligation and the obligor is an investment grade rated entity, recourse is a far more effective tool in providing credit support in a transitional situation. Although one may perceive benefit over the term of the loan, it is unlikely that a master/head lease will facilitate refinancing and one can be certain that it will be of no value in the event of default. As such, it is important to recognize the relative value of the master/head lease and the affects that it can have on the credit quality of the income stream, liquidation value in the event of default and refinance risk at the term of the loan.

DBRS views the proliferation of master/head leases as having negative implications to real estate credit. Third-party leases are fundamental to commercial real estate and represent the foundation upon which property income and value is based. The presence of a master/head lease will be reviewed on a loan specific basis and underwritten consistently to ensure that the proper structure is in place before the rent can be recognized.