# Global CMBS Newsletter

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**Jack Toliver**
Managing Director
Global CMBS
+1 312 332 0889
jtoliver@dbrs.com

**Mary Jane Potthoff**
Senior Vice President
CMBS
+1 312 332 0837
mjpotthoff@dbrs.com

**Erin Stafford**
Senior Vice President
CMBS Surveillance
+1 312 332 3291
estafford@dbrs.com

**Tim Westlake**
Senior Vice President
CMBS
+1 416 597 7320
twestlake@dbrs.com

**William Dallman**
Senior Vice President
CMBS Marketing
+1 312 332 9445
wdallman@dbrs.com

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

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

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

**Andrea Flynn**
Publisher
+1 312 332 3429
aflynn@dbrs.com

## THE POINT OF POOLING: A SURVEILLANCE PERSPECTIVE

In recent weeks, many market participants have called asking about how we approach monitoring the CMBS transactions we rate. The common goal of the investors' questions were aimed at predicting the ratings volatility within CMBS rated by DBRS and seeking the rationale behind the recent rating actions of other agencies. While we cannot opine on the latter, a July 7, 2008, publication from Bank of America, entitled *Recent Rating Agency Announcements,* summarized CMBS rating actions from the first half of 2008 and stated: "The pattern of downgrades was vexing, given the downgrades of some older bonds on relatively benign performance data; inconsistent with the level of risk on significant numbers of 2006 and 2007 transactions."

In light of these rating actions and the inquiries from investors, DBRS offers our published methodology entitled *DBRS Approach to Monitoring CMBS: Performance Update Reports*. In addition, we thought a newsletter may be a timely way to highlight our process. We do so by examining the performance fundamentals of DBRS-rated U.S. CMBS transactions from recent vintages. DBRS looked at ten CMBS transactions issued between 2004 and 2006. (Transactions rated by DBRS from the 2007 vintage were not included because the first year's reporting cycle in CMBS transactions often consists of partial-year financial performance data and they often have less overall financial collection rates by June than more seasoned transactions.)

As a whole, these ten CMBS transactions continue to maintain stable performance with few delinquent loans, strong weighted-average debt service coverage ratios (WADSCRs) and solid YE2007 financial reporting (88.0% average). From the table below, it is also apparent that defeased loans are most abundant in the 2004 vintage as many borrowers took advantage of property appreciation and favorable refinance terms to justify the substantial cost of defeasing a loan.

**DBRS Rated U.S. CMBS 2004–2006 (As of June 2008)**

| Transaction | Number of Loans | Number of Defeased Loans (%) | Number of Watchlisted Loans (%) | Number of Loans Below 1.0x (%) | Number of Delinquent Loans (%) | WADSCR | % Reporting YE2007 Financials |
|---|---|---|---|---|---|---|---|
| BSCMS 2004-PWR5 | 125 | 10 (18.3%) | 9 (3.6%) | 5 (1.6%) | 1 (0.2%) | 1.74x | 85.2% |
| COMM 2004-LNB2 | 87 | 14 (27.0%) | 17 (15.8% | 8 (4.3%) | 1 (0.2%) | 2.02x | 74.9% |
| COMM 2004-LNB3 | 92 | 12 (20.9%) | 15 (16.7%) | 9 (3.7%) | 1 (1.8%) | 1.87x | 95.0% |
| GECMC 2004-C2 | 117 | 13 (11.1%) | 21 (10.2%) | 8 (2.8%) | n/a | 1.55x | 91.5% |
| WBCMT 2004-C15 | 87 | 5 (8.9%) | 15 (9.8%) | 7 (11.3%) | n/a | 1.36x | 100.0% |
| JPMCC 2005-LDP4 | 183 | 3 (4.1%) | 30 (12.1%) | 20 (14.8%) | 1 (0.5%) | 1.39x | 77.7% |
| GECMC 2005-C1 | 126 | 10 (10.6%) | 18 (12.8%) | 8 (4.0%) | n/a | 1.60x | 84.5% |
| MLMT 2005-CIP1 | 135 | 4 (8.7%) | 23 (11.6%) | 14 (9.3%) | n/a | 1.54x | 96.5% |
| MSC 2005-HQ6 | 168 | 6 (2.0%) | 15 (3.8%) | 11 (3.3%) | n/a | 1.46x | 79.6% |
| MLCFC 2006-1 | 148 | n/a | 26 (14.7%) | 10 (3.4%) | n/a | 1.69x | 94.8% |

Source: Servicer files and DBRS analysis.

For the purpose of this article, an in-depth DSCR analysis was made on four of these transactions (Wachovia Bank Commercial Mortgage Trust, Series 2004-C15, J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2005-LDP4, Morgan Stanley Capital I Trust, Series 2005-HQ6 and Merrill Lynch Mortgage Trust 2005-CIP1), all of which met the following criteria: a minimum of three years of borrower reporting, relatively low defeasance and a higher number of watchlisted loans. We specifically chose the transactions with less defeasance because defeasance often boosts or masks the performance of the remaining loans in the pool. For these transactions, DBRS tracked the DSCR from 2005 to 2007 and

included the issuance DSCR for all non-defeased loans that reported YE2007 financials. As the charts below show, a pattern develops that depicts a gradual widening of the DSCR distribution over the course of the early reporting cycles. The natural flattening of the DSCR distribution over the course of the transaction is anticipated at issuance. As some loans' DSCRs increase, those of others fall as a result of the volatility in commercial real estate cash flow and changes in revenue and expenses over a five- to ten-year loan term. In fact, it is widely accepted that borrower cash flows generally decline in the first few years post-issuance because borrowers have clever ways of maximizing cash flow in order to get the most favorable financing terms. The ongoing DSCR distribution can be explained by a number of contributing factors, including the following:

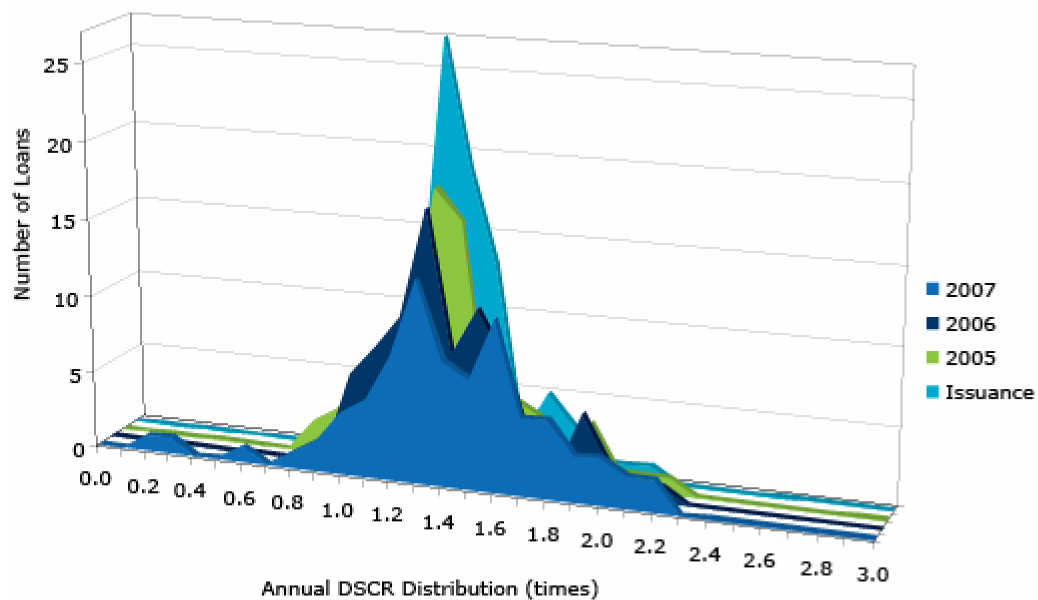
**DSCR Increases**

- Improved occupancy.
- Tenant rent bumps.
- Decreased expenses as a result of new or more efficient management.
- Rollover coinciding with improved market conditions.

**DSCR Declines**

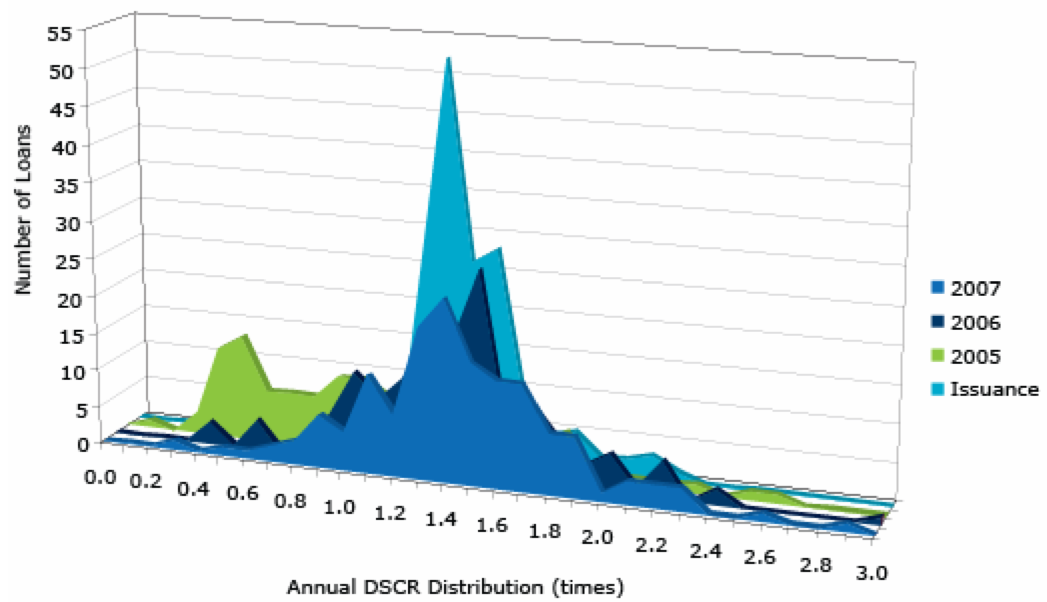
- Tenant lease expiration or bankruptcy.
- Rollover coinciding with a decline in market conditions.
- Increased operating expenses (involuntary).
- Inflated expenses in an effort for the borrower to minimize taxes (voluntary).
- Failure to realize the projected cash flow growth that may be based on events that have yet to occur.
- Expiration of the interest-only (IO) period.

**Annual DSCR Distribution of WBCMT 2004-C15**



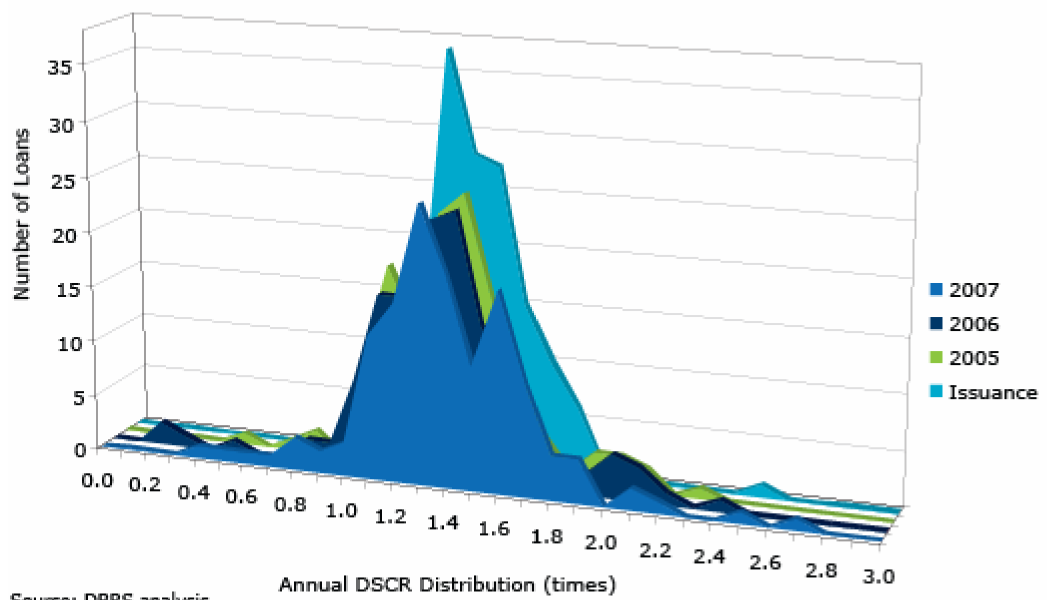

Source: DBRS analysis.

**Annual DSCR Distribution of JPMCC 2005-LDP4**



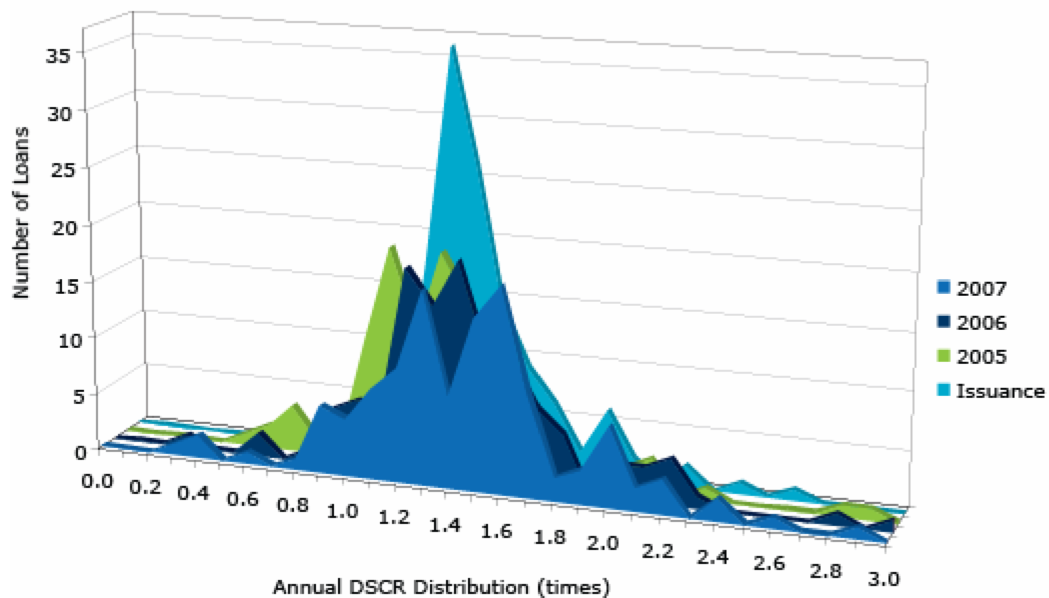

Source: DBRS analysis.

**Annual DSCR Distribution of MSC 2005-HQ6**




Source: DBRS analysis.

**Annual DSCR Distribution of MLMT 2005-CIP1**




Source: DBRS analysis.

A decline in net cash flow (NCF) and, ultimately, DSCR does not necessarily signal a concern. Historically, many loans that exhibited a low DSCR (at or below 1.0 times) for the life of a transaction successfully refinanced. However, this may change for loans from recent vintages that are full-term IO and/or have an interest rate below market rates at maturity.

As the DSCR distribution widens, the servicer's watchlist inevitably grows. In theory, one might expect that a transaction with a larger watchlist would have more defaults, but in the table above, you can see that is not always the case. DBRS has observed little if any correlation between the number of watchlisted loans and the number of loan defaults or losses. The watchlist is meant as a guide and the Commercial Mortgage Securities Association's Investor Reporting Package (CMSA's IRP) refers to the watchlist criteria as Portfolio Review Guidelines.

Loans are pooled to create CMBS transactions to counter fluctuations related to individual loan performance and to minimize potential losses. It is through the diversification of property type, sponsorship, geography and loan size, in addition to structural enhancements, that DBRS is able to tranche conduit CMBS deals based on a stabilized re-underwriting of the loans' credit profiles. Over the life of a transaction, there will undoubtedly be variations in individual loan performance and rating actions will occur. However, DBRS's CMBS ratings take into account the cyclical nature of commercial real estate and downgrades occur when there are substantial performance declines that could not be anticipated at origination. As DBRS underwrites to in-place or contracted cash flows, DBRS ratings are significantly less vulnerable to downgrades when cash flow growth is not achieved.

We know that we cannot expect to get the ratings right if we simply monitor for fluctuations in loan-level DSCRs (or worse, review only a WADSCR) and the size of the servicer's watchlist. Maintaining accurate ratings requires a consistent approach that must incorporate both quantitative and qualitative analysis over the life of the transaction. This includes ongoing analysis of property rent rolls, operating statement analysis reports (OSARs), site inspections and local and/or regional market conditions. In an effort to maximize the transparency of DBRS analysis of collateral performance, we publish annual performance updates for all DBRS-rated CMBS transactions that contain in-depth analysis of the top ten loans and any loans of concern (the DBRS HotList) as well as stratifications of the pool. In addition, DBRS publishes the *Monthly CMBS Surveillance Report*, which covers the entire DBRS CMBS universe and includes updated statistics and detailed commentary for loans of concern as well as any specially serviced and large watchlisted loans.

DBRS applies a number of tools to caution investors of the possibility of future rating actions. If a transaction experiences a decline in property performance, for example, and losses appear imminent (or have recently been realized), rather than an immediate downgrade, other DBRS ratings actions that could be applied to alert investors to possible issues include a Trend Change or placing the debt Under Review with Negative Implications. DBRS is committed to providing this level of transparency of our thought process and analytics.

As a specific example, in September 2006, DBRS placed Class O (B (low)) Under Review with Negative Implications in COMM 2004-LNB2 and changed the trends of Classes M (B (high)) and Class N (B) to Negative from Stable as a result of an unknown loss associated with the Frenchman's Wharf loan (0.8% of the pool at the time), a 60% realized loss on the Village Crossing loan and the large number of loans on the DBRS HotList. Since the liquidated loss for the Frenchman's Wharf loan was lower than projected, DBRS removed the Class O from Under Review with Negative Implications and changed the trend to Negative. Upon the following deal review in July 2007, DBRS changed the trends of Classes M and N back to Stable but maintained the Negative trend on Class O in light of the HotList loans and the delinquency and losses to Class P.

Our CMBS team has not varied in its analytics and in light of low levels of investor confidence and skepticism in ratings, we feel our approach is well reasoned and transparent. By insisting on a DBRS rating, one can be assured the initial risks of the transaction were considered and the ongoing performance will be measured in a consistent and detailed manner.

For more information, please contact Matthew Reid, Senior Financial Analyst, CMBS Surveillance, at +1 312 332 9447 or mreid@dbrs.com.

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