Methodology

# *European CMBS Surveillance*

MAY 2011

DBRS

*Insight beyond the rating.*

## CONTACT INFORMATION


**Scott Goedken**
CMBS Europe
+1 44 0 20 3137 9365
sgoedken@dbrs.com

**Erin Stafford**
Managing Director
+1 44 0 11 20 3137 9516
estafford@dbrs.com

**Mary Jane Potthoff**
Managing Director
+1 44 0 11 20 3137 9515
mjpotthoff@dbrs.com

# European CMBS Surveillance

## TABLE OF CONTENTS

# Introduction

The property collateral underlying commercial mortgage-backed securities (CMBS) transactions is dynamic. A variety of events can have an impact on the properties of a CMBS pool and on the cash flow necessary to ensure timely and ultimate payment of CMBS bonds. During the life of a transaction, loans go delinquent, take losses or prepay; tenants vacate; markets improve or soften; property values increase or decrease, to name only a few things that can change. When initially establishing a rating, DBRS Ratings Limited (DBRS) assumes that changes in the performance of the underlying loans can and do occur; therefore, it assigns ratings designed to withstand a certain level of volatility within the underlying commercial mortgage loans. Surveillance is critical in measuring and communicating to the investment community whether a change has the potential to affect the ratings assigned to the bonds. The magnitude of the changes that occur with each loan and the loan's relation to the other loans in a transaction can determine whether a rating action is necessary.

This methodology details DBRS's surveillance procedures as they relate to all European CMBS rated by DBRS (inclusive of public ratings, private ratings and commercial real estate collateralized debt obligations (CRE CDOs)) and describes the analysis taken to arrive at any rating action that arises from the surveillance. This methodology provides the reader with greater transparency into the DBRS CMBS rating philosophy. DBRS expects its ratings to hold throughout a cycle; however, DBRS is committed to performing surveillance and releasing quarterly reports corresponding to the receipt of the bondholder report (typically delivered on the interest payment date (IPD)) and/or the servicer collateral report that provide increased transparency to its ratings.

# Rating Actions

A number of steps must occur before DBRS changes the rating of a transaction. Each quarter or at a frequency consistent with the IPD, all DBRS-rated CMBS transactions are reviewed for statistical changes and cumulative credit evolution. Following the review of the portfolio, a full review process is initiated on a transaction when there are significant changes in the collateral performance. If no significant changes in performance have occurred, DBRS conducts an annual in-depth review of all its rated transactions.

The loans belonging to the pool are analyzed by a surveillance analyst. Because of concentrations in European CMBS transactions, DBRS considers the cumulative impact of small loans as well as the changing credit dynamics of large loans. Each of the loans within a pooled transaction is subject to an in-depth review. Troubled loans are identified as those that are delinquent or those assigned to the DBRS HotList (i.e., loans that are perceived by DBRS to have a higher likelihood of default). The pool is then remodeled to account for all changes in its collateral and financial performance.

During the review process, changes to the ratings may be recommended. There are four types of rating actions that may be taken on each class following the review of a transaction: upgrade, downgrade, confirmation and interest in arrears. On occasion, there are classes of CMBS with interest payments in arrears, but the cumulative or ongoing shortfall is expected to be ultimately recoverable or paid. When the interest shortfall is a question of timing in the shorter term and not of ultimate payment, DBRS notes this with the Interest in Arrears rating action for the class(es) affected. In addition, ratings can be placed Under Review with Negative, Positive or Developing Implications or assigned Stable, Negative or Positive trends. Classes are placed Under Review when something occurs that would change the credit makeup of a pool in one direction or another. DBRS typically keeps a class Under Review for only a short period of time as the information needed to help determine the magnitude of the action needed is often waiting to be filed by the servicer. CMBS uses Positive, Negative and Stable trends to indicate a change in the credit dynamics of the pool that is not significant enough to warrant a rating action. For example, there may be a number of loans with poor financial performance yet they remain current. This situation may not be sufficient in and of itself to sway the model, but real estate cash flows can change rapidly. It should be noted that transactions do not need to be placed Under Review or have a trend change prior to a rating action taking place.

# Quarterly Review

Corresponding with each IPD, DBRS performs a review of its entire European CMBS portfolio for changes. There are some changes that occur in European CMBS transactions between IPDs for which DBRS receives advance information, such as a transfer of ownership, special servicing transfers and/or loan modifications. Upon receipt of each remittance report and the subsequent servicer collateral report (typically received by DBRS 30 days following the IPD), DBRS reviews the changes that have occurred at both the bond level and the collateral level. In some instances, these changes prompt additional steps that DBRS takes in monitoring the transaction.

Changes that directly affect the bonds and need to be addressed immediately include losses, classes paid in full and interest shortfalls to a rated class. If the portfolio is monitored quarterly, none of these things should be a surprise to DBRS or its investors; however, each has different consequences as it occurs. The results of the DBRS quarterly review are published in the Quarterly European CMBS Surveillance Report.

## BOND-LEVEL REVIEW

### *Losses*

Losses occur as specially serviced assets are resolved and sold from the pool. Losses erode credit enhancement. As losses occur, DBRS reviews the actual loss and compare it with the DBRS estimated loss for the loan and with the assumptions from the initial rating and/or last rating confirmation. If the actual loss is greater than the anticipated loss, it may spark a detailed review of the transaction.

### *Classes Paid in Full*

As classes are repaid in full, DBRS retires the ratings in its rating database and on the website. The ratings for the class are now Discontinued – Repaid.

### *Interest Shortfalls*

Interest shortfalls occur when fees accumulate from specially serviced loans or when the full quarterly payment has not been advanced. If interest shortfalls occur on a rated class and are anticipated to continue for an extended period, DBRS amends the rating to carry an Interest in Arrears designation. If the class is subject to available funds interest distributions, the class may not accumulate any shortfalls from trust expenses or delinquent loans. If the bonds allow for deferrable interest, DBRS would not assign an Interest in Arrears designation.

## COLLATERAL-LEVEL REVIEW

Changes that affect the collateral and ultimately the bond performance are monitored quarterly.

### *Delinquencies and Specially Serviced Loans*

Changes in delinquencies and specially serviced loans are scrutinized. DBRS remains in close contact with the special servicer to determine any changes in the status of any specially serviced loans. If new delinquencies appear, DBRS wants to know more about these loans, including whether the borrower has been contacted to get an initial understanding of the problem and whether there is a potential resolution strategy in place.

### *Prepayments*

Prepayments in large part are credit positive to a CMBS transaction. For sequential-pay transactions, prepayments cause the credit enhancement to increase for the existing bonds. For pro rata pay transactions, the impact of the prepayment is generally neutral. DBRS reviews each instance of prepayment to see how it was applied and whether any rating action is warranted.

### *Watchlist Changes and Additions*

A loan moves on or off the servicer watchlist when it meets or no longer meets certain criteria identified in the transaction documents or in the Commercial Real Estate Finance Council (CREFC) European Investor Reporting Package (E-IRP). The criteria were established to be a guideline to highlight loans that may have a higher likelihood of default. DBRS reviews each loan and the servicer commentary on the watchlist quarterly. Some loans have concerns that can be mitigated with external research and others are legitimate concerns that may result in an in-depth review.

### *Interest Coverage Ratios, Debt Service Coverage Ratios and Loan-to-Value Ratios*

DBRS looks at the financial reporting of a transaction quarterly. If DBRS is awaiting financials to complete a deal review or if financials reveal large variances (both positive and negative), it may prompt more investigation. Transactions are monitored using weighted-average interest coverage ratios (ICRs) and debt service coverage ratios (DSCRs) as well as both ICR and DSCR stratifications. DBRS reviews the ICR and DSCR levels against the various mortgage ICR or DSCR covenants and, to the extent that there is a breach, DBRS follows up with the servicer to understand the course of action being pursued. It is common in European CMBS transactions for loans to be revalued every one to three years in accordance with the mortgage security documentation. It is also common for the mortgages to contain loan-to-value (LTV) covenants, akin to the monitoring of the ICR or DSCR covenants. Therefore, DBRS also reviews any LTV covenant breaches and follow up with the servicer to understand the course of action being taken. In an environment subject to declining values, as the European commercial real estate markets have experienced in the last few years, many loans are approaching their LTV covenants or are already in breach of them. Sponsors have had little to no equity remaining to rebalance the mortgage to cure the breach. Even though DBRS monitors the LTV covenants, it has not been the experience of DBRS that these covenants have a huge positive impact on the transaction as the servicer is not often able to enforce them. Therefore, DBRS uses the updated LTV more as a gauge of a decline in the performance of the loans and the overall transaction.

DBRS is very focused on the exit strategy of the loans. As such, DBRS closely monitors all loans maturing within a 12-month period and look at metrics that would indicate a problem for the loan to refinance, such as low ICRs or DSCRs, high LTVs or other property-specific issues that may cause a delay or uncertainty in the borrower obtaining refinancing for the loan (e.g., there are a large number tenant lease expiries near the maturity date).

## STRUCTURAL REVIEW

### *Interest Rate Swaps or Hedging Agreements*

Counterparty ratings are monitored at the individual transaction level in accordance with the DBRS's *Legal Criteria for European Structured Finance Transactions*. Any changes to the rating that may trigger additional collateral posting requires DBRS to promptly notify the trustee and/or the servicer of the transaction. Additionally, to the extent the information is available, DBRS considers the position of any loan-level swap agreement when assessing the borrower's obligations during the term and at balloon.

### *Liquidity Facility Draws*

Liquidity facilities are in place to ensure interest paid to bondholders is current. DBRS monitors the liquidity facility provider, the draws and the expiry of the facility. As the draws increase as a result of delinquent or non-performing loans, DBRS considers the priority of repayment of the liquidity facility against the value of the non-performing loan.

### *Transactional Covenant Review*

DBRS monitors a transaction for any pro rata or sequential-pay triggers at the bond level and assess the impact on the repayment of the notes.

After all of the bond and collateral reviews are complete, the portfolio is assessed and a deal review is completed as necessary.

# Detailed Analysis

## BOND-LEVEL SURVEILLANCE

DBRS considers things such as interest shortfalls, class repayment, losses and general credit enhancement at each rating category. Part of the quarterly review is to look for and assess interest shortfalls and losses that occur each quarter. Interest shortfalls and advances on the liquidity facility, if not repaid, are an embedded loss to the lowest outstanding class of bonds. Any type of loss erodes credit support to the rated securities. DBRS looks at current losses and projected losses from the specially serviced loans. The resulting credit enhancement needs to be compared with a model that has the most recent annual financial performance of the remaining collateral. Bond-level surveillance in its truest sense cannot be done without the full review of the collateral.

## COLLATERAL (LOAN-LEVEL) SURVEILLANCE

Collateral surveillance includes loan-level surveillance and modeling. The focus is on property analytics, with a review of the property's rent roll, operating statements, servicer site inspections, hedging agreements, the sevicer's projected ICR and DSCR and the most recent LTV and other loan-level covenant breaches. Property-level cash flow is further analyzed by scrutinizing revenue and expenses and looking at voluntary versus involuntary expenses. Each property is assigned a cash flow, which may be subject to DBRS re-underwriting or a general haircut, depending on how current the reported financials are and the confidence level of the servicer. During the loan-level review process, DBRS develops a HotList (i.e., a list of loans of concern).

### *HotList*

DBRS performance reports identify which loans DBRS considers to be HotList loans. The HotList loans are perceived by DBRS to have a higher likelihood of mid-term and/or balloon default or simply a period of time when tenant bankruptcy or property or occupancy issues may cause uncertainty of cash flow. DBRS explains why the loans are on the list, commenting on the challenges and potential upside of each. Investors can use the DBRS HotList as a supplement to the servicer watchlist to easily identify which loans have potential credit concerns and may affect the overall performance of the transaction. When DBRS identifies a loan that is likely to experience a cash flow stress event, it is added to the HotList. Structural features, such as reserves or cash trap events, could mitigate these risks and keep the loan from appearing on the HotList.

Throughout the life of the transaction, DBRS reviews the loans initially placed on the HotList, monitor their performance and identify additional loans to be added or removed. DBRS adds loans as credit issues arise and remove loans that are no longer a concern or have strong mitigating factors. The criteria that would indicate a higher risk of default within the term or at maturity are identified in Appendix A.

### *Term Risk and Balloon Risk*

Through the HotList, DBRS identifies loans that may have a higher likelihood of default during the term or at maturity. It is important to monitor liquidity near a loan's maturity date because its severity of loss could be greatly affected if it cannot be refinanced. At any given time, the availability of capital differs based on the property type and the property's location. Balloon defaults and extensions may occur more often during times of illiquidity if there is a lack of competing lender bids. Loans that default are likely to have greater losses because there are fewer participants in less-efficient markets. As the loan's maturity date nears, DBRS adjusts refinance constants based on what is available at the time in the market. If current market constants are higher than what the loan is currently paying, the loan could have difficulty refinancing. Loans that may have a higher propensity to default at balloon include loans with a refinance DSCR below 1.0 times (x), loans with a large number of lease expiries prior to the maturity or shortly thereafter, interest-only loans and loans with lower DSCRs secured by properties located in rural or tertiary markets. With respect to DSCR and LTV, DBRS considers the profile of the trust or A-note balance, as well as the whole-loan balance, if there are B-notes or mezzanine financing in place. The presence of additional debt outside the trust debt may make refinancing more challenging for a borrower and could result in delays and extensions in the refinancing of the loan.

### *Extension Risk*

Expanding upon balloon risk, DBRS also assesses the loans that may cause bonds to extend. This differs from balloon risk in that there are certain loans that need to refinance in order for bonds to be repaid. For example, with many interest-only loans in pools from recent vintages, five-year AAA bonds do not receive enough scheduled principal from amortization to pay off at the expected maturity. Therefore, relying on loans with shorter terms to meet the maturity date becomes increasingly important. DBRS identifies these loans at the outset of each transaction. As the bonds season (i.e., get closer to the expected maturity date), DBRS addresses the extension risk in relation to its balloon risk in its performance report. DBRS also considers the tail of the transaction, which traditionally refers to the two to five years beyond the maturity of the longest loan in the transaction, and the market conditions that may hamper the ability of a servicer to resolve the loans or extend the loans prior to the final rated maturity date if it is closely tied to the tail of the transaction.

## PROPERTY TYPES REVIEW

When analyzing the dynamics of each loan, DBRS considers the property that secures the loan and the nuances associated with each property type. Because of the terms of their leases, some properties are viewed as more stable than others. For example, an office building with five- to ten-year leases is going to have more predictable revenue than a hotel that rents rooms daily. Even though a hotel may have a more volatile cash flow, it can adjust more rapidly to market rate increases and decreases. For this reason, we highlight some of the credit concerns that our analysts are reviewing when doing analysis of the loans within a CMBS transaction. Superior locations clearly help a property perform even in soft markets. In addition to the location of the asset and market conditions, there are several unique attributes to each property type that DBRS considers.

### *Office*

- Above-market leases that roll within the term or shortly after loan maturity.
- Tenant improvement and leasing commission (TI/LC) reserves sufficient for re-leasing.
- Master leasing.
- Location.

### *Industrial*

- Functionality and clear height, including specialized improvements, loading facilities and truck turn-around radius.
- Leases rolling within the term and relation to the market.
- Office build-out and flex space.
- Location.

### *Retail*

- Anchor tenants and in-line space performance, if franchise or public companies.
- Co-tenancy clauses.
- Competition in the market from major discounters.
- Location in relation to residential properties and high-traffic nodes.

### *Multi-Family*

- Concessions offered at the property.
- Affordability of housing in the immediate area and replacement costs of the property.
- Employment diversity and trends near the property.
- Location.

Other property types that are often in CMBS transactions include manufactured housing communities (MHCs), hotels, self-storage units and even some health-care and retirement communities. These are all considered individually as performance can fluctuate if the property has seasonality issues or high tenant turnover.

## MODEL AND RECOMMENDATIONS

After all the analysis is complete, we run the model and then compare it with the model at issuance and the current credit enhancement of each of the classes within the transaction.

# Appendix A: Challenges and Mitigating Factors for DBRS HotList Loans

## HOTLIST LOAN EXAMPLE 1

A loan with a term debt service coverage ratio (DSCR) at or below 1.0 times (x) at issuance and/or thereafter.

*Performance Challenges*

- Any change in cash flow could cause a loan with a low DSCR to default.

*Mitigating Factors*

- A stabilized increase in cash flow mitigates a low DSCR. If historical financials are available, DBRS examines revenue growth or contraction and any changes in voluntary and involuntary expenses. If revenue appears to be stable, with a primary increase in voluntary expenses, the loan is less likely to default than an asset operating at similar coverage with declining revenue and increasing involuntary expenses.

## HOTLIST LOAN EXAMPLE 2

A multi-tenant property with concentrated rollover during the term of the loan.

*Performance Challenges*

- Considerable downtime between leases is likely to significantly alter the cash flow of the property and its ability to service the debt when not offset by accumulating reserves. This is a greater concern in office properties where there is lease rollover with limited expense recaptures.

*Mitigating Factors*

- Reserves for lease renewal or lease-up of vacated space at comparable rents allow for concessions and free rent.

## HOTLIST LOAN EXAMPLE 3

A loan with a disproportionate expense ratio.

*Performance Challenges*

- The cash flow volatility is greater in assets with high expense ratios. Therefore, a slight decline in revenue could cause a significant cash flow decline.
- Properties with historically high expense ratios may also be of concern. Hotels may be particularly volatile if they experience a decline of revenue per available room (RevPAR), average daily rate (ADR) and/or occupancy or a substantial increase in involuntary expenses.

*Mitigating Factors*

- The loan has a consistent track record of increasing revenues and expense management.

## HOTLIST LOAN EXAMPLE 4

A property located in a particularly soft or declining market.

*Performance Challenges*

- Incentives and concessions factor into market rental rates. When concessions are prevalent, the borrower's ability to increase rents at lease expiry is limited.
- A market economic change may also have an impact on a property's performance. For example, a low interest rate environment, which can result in increased home ownership, has a direct impact on multi-family properties, causing a decrease in demand for apartments and an increase in the concessions offered.

*Mitigating Factors*

Signs that the market is rebounding include positive absorption and a discontinuation of concessions. The property is outperforming the sub-market.

## HOTLIST LOAN EXAMPLE 5

A property with a single tenant, owner occupied or with shadow-anchor risk.

*Performance Challenges*

- The credit risk of a non-investment-grade single-tenant property may be compounded by the limited marketability of a special-purpose asset. Likewise, the decline in the performance of a non-credit single-tenant owner-occupied business may be difficult to detect.
- The deterioration in the credit quality of a large shadow anchor tenant has an impact on the attractiveness of the property and affects the draw of people to the property.

*Mitigating Factors*

- Lease term extension options exist, but they have been exercised.
- Credit quality of the tenant is high.
- The property is in a strategic or desirable location, critical to the operations of the tenant.

## HOTLIST LOAN EXAMPLE 6

The insolvency of an operator, major tenant or borrower.

*Performance Challenges*

- A tenant has the ability to reject the lease and vacate or renegotiate to market rates.
- Potential for property maintenance neglect is due to the bankruptcy of the operator or the borrower.

*Mitigating Factors*

- Lease rates are below market and the location of the asset is desirable.
- Loan performance is strong.
- Ownership is structured as a bankruptcy-remote special-purpose entity.

## HOTLIST LOAN EXAMPLE 7

A loan in ongoing technical default, with no indication of stable performance, or a loan that is a chronic late payer.

*Performance Challenges*

- Loans in technical default or borrowers chronically making late payments may not only indicate a lack of commitment by the borrower but also the diversion of funds, which can result in deferred maintenance at the property and ultimate value erosion.

*Mitigating Factors*

- Servicer site inspections indicate significant maintenance expenses or improvements are being done on the property through reserve distribution.

## HOTLIST LOAN EXAMPLE 8

A property with dysfunctional or obsolete space.

*Performance Challenges*

- It would be difficult to lease at market rental rates if the current tenants roll.

*Mitigating Factors*

- Properties with significant excess cash flow and/or reserves can allow space to be re-leased at rates below market rents.

## HOTLIST LOAN EXAMPLE 9

An extended period of non-reporting by borrower.

*Performance Challenges*

- Loans that have not provided the servicer with financial statements and/or occupancy information for several years may be viewed as having increased term risk.

*Mitigating Factors*

- Loan payments are on time and current.
- Properties are located in stable markets, with strong DSCRs at issuance.
- Tenants are on long-term leases, beyond loan maturity.

## HOTLIST LOAN EXAMPLE 10

A loan with a loan-to-value (LTV) covenant breach.

*Performance Challenges*

- Loans may not have sufficient equity based on the covenant breach and may be at risk of default.

*Mitigating Factors*

- Loan is current; interest coverage ratio (ICR) is in excess of 1.0x.
- Lease-up has yet to occur, with sufficient term to maturity.

Insight beyond the rating.

www.dbrs.com

**Corporate Headquarters**

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