Methodology

European CMBS Surveillance

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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.
# European CMBS Surveillance

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Scope and Limitations

DBRS evaluates both qualitative and quantitative factors when monitoring structured finance transactions. This methodology represents the current DBRS approach for monitoring European CMBS ratings. It describes the DBRS approach to analysis, which includes (1) analysis of the bonds and (2) evaluation of the collateral providing security for the bonds. It is important to note that the methods described herein may not be applicable in all cases. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.
Introduction

The property collateral underlying commercial mortgage-backed securities (CMBS) transactions is dynamic. A variety of events can have an impact on the properties securing a CMBS transaction and on the cash flow necessary to ensure timely and ultimate payment of CMBS bonds. During the life of a transaction, loans may go delinquent, take losses or prepay; tenants vacate; market rental rates and occupancies improve or soften; and property values increase or decrease, to name only a few things that can change. When initially establishing a rating, 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 properties. 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, commercial real estate collateralized debt obligations (CRE CDOs) and restructurings of CMBS securities) 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 corresponding to the receipt of the bondholder report (typically delivered on the interest payment date (IPD)) and/or the servicer collateral report that follows in order to 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. A full review process is initiated on a transaction when there are significant changes in the collateral performance noted from the IPD. At a minimum, DBRS conducts an annual in-depth review of all its rated transactions.

The loan(s) belonging to the CMBS transaction are analyzed by a surveillance analyst. For transactions that are secured by more than one loan, DBRS considers the cumulative impact of small loans as well as the changing credit dynamics of large loans. Each of the loans within a multi-borrower pooled transaction is subject to an in-depth review. Troubled loans are identified as those that are delinquent or those loans that are perceived by DBRS to have a higher likelihood of default. The CMBS transaction 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 typically three types of rating actions that may be taken on each class, following the review of a transaction: upgrade, downgrade and confirmation. 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 required action is often waiting to be filed by the servicer; however, it can be used for a longer period in the case of a borrower’s insolvency where the outcomes and plans are being developed. CMBS uses Positive, Negative and Stable trends to indicate a change in the credit dynamics of a pool that is not significant enough to warrant a rating action. For example, there may be a period of poor or declining financial performance of a property, yet the loan remains 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. On occasion, there are classes of CMBS with interest
payments in arrears, but the cumulative or ongoing interest 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 designation for the class(es) affected. Further information in relation to rating actions, Interest in Arrears designations, reviews and trends is available at www.drbs.com.

IPD 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 and may trigger an in-depth review prior to its annual schedule.

Changes that directly affect the bonds and need to be addressed immediately include realized 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.

BOND-LEVEL REVIEW

Losses
Losses occur as specially serviced assets are resolved and sold from the pool. Losses erode credit enhancement. As losses occur in a multi-borrower multi-loan transaction or as assets are sold off in a multi-asset transaction, DBRS reviews the actual loss and compares 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 by a liquidity facility. 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 may 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 servicer and/or special servicer to determine any changes in the status of any specially serviced loans. If new delinquencies appear, DBRS will want 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, as they often include a premium. 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 and could even be negative in the event of adverse selection. 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 have legitimate concerns that may result in an in-depth review. DBRS does not view the servicer’s watchlist as an exhaustive list of potential warning signs of deteriorating credit; therefore, DBRS may use some of its own internal tools and knowledge of markets to compare performance of the loans as well.

**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 an in-depth deal review or if financials reveal large variances (both positive and negative), it may prompt more investigation. Multi-loan multi-borrower 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 for individual loans against the various mortgage ICR or DSCR covenants and, to the extent that there is a breach, follows up with the servicer to understand the course of action being pursued. It is common in European CMBS transactions for the properties securing the 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 for purposes akin to the monitoring of the ICR or DSCR covenants. A covenant breach may be an indication of weakening fundamentals and may also be temporary, and, as such, DBRS reviews each covenant breach on a case-by-case basis. 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 and, therefore, closely monitors all loans, and in particular those maturing within a 12-month period, for information 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’s obtaining refinancing for the loan (e.g., there is a large number of 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 DBRS’s *Legal Criteria for European Structured Finance Transactions* and *Swap Criteria for European Transactions*. DBRS monitors changes to the rating that may trigger additional collateral posting. 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 often 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 assesses the impact on the repayment of the notes. After all of the bond and collateral reviews are complete, the portfolio is assessed and an in-depth deal review is completed as necessary.
BOND-LEVEL SURVEILLANCE
DBRS considers things such as interest shortfalls, class repayment, losses and general credit enhancement at each rating category. Part of the review associated with the IPD 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, could be indicative of 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.

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 servicer’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 the DBRS initial underwritten NCF, a DBRS re-underwriting or a general haircut to the servicer’s forecasted net cash flow, depending on how the servicer has determined the net cash flow and the transparency of the figure. During the loan-level review process, DBRS identifies concerns that it may have with the loan(s).

Term Risk and Balloon Risk
DBRS identifies loans that may have a higher likelihood of default during the term or at maturity. It is important to monitor liquidity, in particular near a loan’s maturity date, because the severity of loss associated with the loan 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 a result, as part of its surveillance process DBRS adjusts refinance constants based on what is available at the time in the market, particularly as the maturity date for the loan approaches. 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
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 in relation to employment centers and transportation mediums.

**Industrial**
- Functionality and clear height, including specialized improvements, loading facilities and truck turnaround radius.
- Leases rolling within the term and relation to the market.
- Office build-out and flex space.
- Location in relation to major modes of transportation and customer bases.

**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.

**Multifamily**
- 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 in relation to civil services as well as employment centers and retail developments.

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, DBRS models the loans within the transaction in accordance with the EU CMBS Methodology and then compares the updated results with its expectations at issuance and how the results compare with the current credit enhancement of each of the classes within the transaction.