

Global CMBS Newsletter

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LET'S MAKE A DEAL

The talk this week has focused on higher subordination levels as a result of commercial real estate conduit underwriting practices, which have long been on a slippery slope and finally hit a point where they can no longer be ignored. DBRS has been describing issuers' Annex A net cash flows as "terms of art," because the numbers mean whatever they tell you they mean and there is often no way for investors to check the definitions.

Commercial mortgage lending should be based on the premise that the rental income from a stabilized commercial real estate asset is comparatively more resilient than corporate profits throughout economic cycles. In the event that a default occurs, the underlying real estate assets should have sufficient liquidation value to make a substantial recovery even when the asset is completely vacant. As the commercial mortgage-lending environment becomes exceedingly competitive and conduit lenders are economically incentivised to push the envelope wherever possible, nearly every lending principle we know is challenged on a daily basis. Although it is wise to challenge convention, one must not categorically ignore the principles of prudent lending.

In an industry that is full of quips, anachronisms and common-sense rules, my personal favorite is the one attributed to Larry Duggins (of Centerline Capital Group), which goes roughly like this: "When lending on commercial real estate, one must avoid the following three things: real estate that isn't, tenants that don't and borrowers that shouldn't."

When it comes to real estate that isn't, we are seeing more and more instances where the operating profits of an underlying business are being recognized as real estate revenue. Although the differences may be subtle and difficult to separate in high service businesses such as hospitality and health care, one must always remember that when the loan amount exceeds the replacement cost of the real estate assets, one is no longer lending on the real estate. As such, cash flow will be more volatile, increasing the probability of default, and liquidation value will cover a significantly smaller portion of the outstanding balance.

When it comes to tenants that don't, we are seeing more and more instances of lenders including income from master leases (head leases), tenants who have vacated the premises but continue to pay rent, tenants who have signed a letter of intent and tenants who may have signed a lease but are not in occupancy and/or open for business. Within the context of a stabilized operating business, rent on the real estate wherein they conduct their business (with the exception of some continental European jurisdictions) is among the highest priority of all financial obligations of the tenant. By contrast, obligations to pay rent on real estate where tenants no longer do business or have yet to open up shop will ultimately become less important when cash flow is tight.

When it comes to borrowers who shouldn't, well, you can allow your imagination to run freely here; however, character, concentration and track record are all relevant. The current lending environment, in which lenders do not hold the risk associated with their originated loans for more than a few months if not for just a few weeks, can give the lender a rose-colored view of a borrower's character and track record. An important rule instilled early in any lender's career is the "know your borrower rule." Knowing your borrower allows a creditor to identify a borrower's contingent liabilities and asset concentration risks and be able to anticipate how a borrower will honor loan obligations because past borrowing habits are often repeated. A borrower with a litigious past and/or delinquency history can challenge a loan servicer and cost a trust significantly. A lender's absolution of a borrower with a lackluster history is a "pass-the-buck" risk transfer that bondholders have little if any ability to detect let alone price in comparative transactions.

At this point in the real estate cycle, many have chosen to ignore the conventional "isn't, don't and shouldn't" list of commercial lending practices. As a result, the current vintage of commercial real estate loans leaves little room to absorb glitches in property cash flow. Equally as alarming is the extreme leverage, sometimes in excess of replacement costs, that could wear away the liquidity "safety net" that existed previously. As it stands now, the "isn't, don't and shouldn't" list of commercial lending practices has been replaced with the "Let's Make a Deal" philosophy in an effort to make a quick buck. Look behind the doors, so you don't get Zonked by the "Let's Make a Deal" loans that will perform like a live cow dressed in sunglasses and a feather boa. Differentiate, because Monty Hall won't be there to offer you a trade.

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