# Global CMBS Newsletter

Volume 2, Issue 14, June 11, 2007


DBRS


**Jack Toliver**
Managing Director
+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

**London**
1st Floor
25 Copthall Avenue
London EC2R 7BP
+44 (0)20 7562 5600

**Paris**
27, avenue de l'Opéra
75001 Paris
+33 (0)1 70 38 52 14

**Frankfurt**
Trianon Tower
Mainzer Landstrasse 16
60325 Frankfurt
+49 (0)69 97 168 144

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


## 101 "NEW" WAYS TO LEVERAGE A LOAN

It has been just over two years since Darrell Wheeler wrote an article titled "101 Ways to Leverage a Loan and How Investors Can Counter Increasing Leverage." Little did we know at the time that the surface was just being scratched as far as the number of ways lenders can increase leverage on loans. The list could include extra income from re-measuring the building, tenant improvement and leasing commission assumptions that are substantially below market, management fees below 4% (or 3% for single-tenant properties), projecting below-market real estate taxes beyond the term of abatement, and recognizing expense savings due to new ownership. But these techniques are relatively minor compared with the two major offenders: marking rental rates and occupancy up to market when they are substantially below market.

Prior to 2005, if a property had an actual occupancy rate that was substantially below market levels (whether it was a new property that hadn't stabilized or a recent tenant defection), loan proceeds would be held back until cash flow increased to a level that could support the whole loan amount, and the sponsor could have master-leased the vacant space. In 2005 and 2006, a performance holdback would not be required; instead, just a master lease would be in place for several years. In 2007, however, occupancy is simply underwritten to the market level, and often the only structure is a debt service reserve to allow the loan to meet a 1.0x DSCR until occupancy hopefully increases. Failure to lease vacant space at the projected rate leads to debt service shortfalls as soon as the second year of the loan term is reached.

For properties with in-place rental rates below market levels, there has also been a downward progression over the past few years. Prior to 2005, issuers would attempt to give credit for tenants with below-market rent by straight-lining their rent over the loan term. And oftentimes this would only be done for investment-grade or otherwise strong tenants on long-term leases. In 2005 and 2006, instead of a straight-line average rent, the rent at loan maturity would be used. Tenant selection also deteriorated, with lower-quality tenants on leases that expired during the loan term receiving the same treatment as higher-quality tenants on long-term leases. In the past few months, below-market rents have been marked up to market, and sometimes market rent is even grown over the loan term to achieve an even higher rental rate. Compounding the magnitude of this effect is the calculation of market rent. Is market rent considered to be the last few leases signed at the 1970s vintage subject property, or is it the new leases at the just-completed trophy property across the street? Unfortunately, market rent is determined at the discretion of the issuer.

The result of these leveraging tricks has been an increasing number of loans that do not cover debt service during the loan term. DBRS has observed this in as much as 41% of the pool in recent transactions.

Given this current state of the CMBS market and conduit loan underwriting, the question has been asked and will be discussed at the upcoming CMSA, "Who's responsibility is it to be the gatekeeper" guarding against these high leverage tactics? Of all possible parties – investors, issuers and rating agencies – rating agencies are the most natural gatekeepers. Not only do the rating agencies have access to the same detailed loan level information that the B-piece buyers have, they have a responsibility to take into consideration all bondholders' interests. B-piece buyers, on the other hand, only need concern themselves with their own performance metrics, and this can put them at odds with investment-grade bondholders.

It appears the responsibility taken has been to increase market share as opposed to maintaining underwriting standards, as evidenced by the increasing usage of the above-mentioned underwriting techniques without a corresponding increase in subordination levels. As the below-investment-grade portions of conduit transactions are typically 3% or less, that leaves 97% of bondholders with no access to the detailed underwriting of property level cash flows. As both rating agencies and issuers have access to this information, these are the parties that investment-grade purchasers should be interrogating. The following actions will go far in preventing the abuses outlined in the list above:

1) Ask questions of the issuers, especially on large loans (perhaps the top 20). How many were underwritten using income assumptions above and beyond those currently in place? What were the TI/LC assumptions? Were expense savings included?

2) Ask questions of the rating agencies. How did they get comfortable rating the particular transaction considering the pro forma UW, high number of loans with low-term DSCR? How did they differentiate this transaction from others? How are they underwriting loans?

3) Vote with your investment dollars. Use the intelligence gathered from the rating agencies and issuers to find those deals that do not heavily rely on increasing cash flow over the term of the loan in order to refinance. Though super senior AAA buyers are likely well insulated from principal loss in even the most aggressive scenarios, junior AAA classes can be susceptible to downgrade risk as well as principal loss if a few (or even one) very large loans does not increase income as expected. For investors further down the credit curve, the risk is even greater.

Though noise has now finally been made regarding these aggressive underwriting practices and there are rumors that conservatism is on the rise, vigilance is necessary. If lenders find that they are still able to profitably make high-leverage loans by selling bonds at a slightly higher yield or through marginally higher subordination levels, they will continue to write these loans. However, a few basis points of yield or 1% extra credit enhancement is likely to be little comfort when it becomes apparent that many of the largest loans are over-leveraged by more than 20%.

For more information, please contact Noel Cain at +1 312 332 9446 or ncain@dbrs.com, or Kevin Mammoser at +1 312 332 0136 or kmammoser@dbrs.com

---