

MARC RATING METHODOLOGY

COMMERCIAL REAL ESTATE- BACKED SECURITISATION



SUMMARY

Commercial Real Estate (CRE)-backed securitisation is a structured finance transaction in which an originator raises funding through the direct off-balance-sheet sale of equity interests in a commercial property (collateral property) it owns to a special purpose vehicle (SPV). The funding is typically raised through the issuance of Medium-Term Notes (MTN). The interest or profit component of the notes is paid from the rental income from the collateral property. The principal redemption of the notes is refinanced or redeemed via the sale of the property. This process would be completed prior to the expected maturity date, which is typically 1-2 years before the legal maturity date. During the tail period between the expected maturity and legal maturity dates, the security trustee can commence disposal of the collateral property under the transaction if the process to refinance or redeem the notes has not been put in place.

MARC arrives at the appropriate rating (s) for the structured finance by determining the loan-to-value (LTV) ratios that are mapped against an established rating grid. The funding (loans) limit is capped by the threshold of the rating band

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while the value of the collateral property is determined by the rating agency's income capitalisation approach.

CHARACTERISTICS OF A CRE-BACKED TRANSACTION

In a CRE-backed transaction, the originator places its income generating commercial property asset(s) into a bankruptcy remote SPV. Shares in the SPV are normally held in trust by independent directors as share trustees. Meanwhile, the activities of the SPV are limited to obligations under the transaction to reduce the risk of new liabilities and creditors being created.

The SPV issues bond/sukuk which are collateralised by the property asset(s) while cash flows (rental income) from the asset(s) are captured in designated accounts to meet the interest/profit component of the bond/sukuk. The SPV can issue different classes of securities i.e. senior and subordinated securities for which payments are subject to cash flow waterfalls.

Transaction structure

Exhibit 1: Typical transaction structure

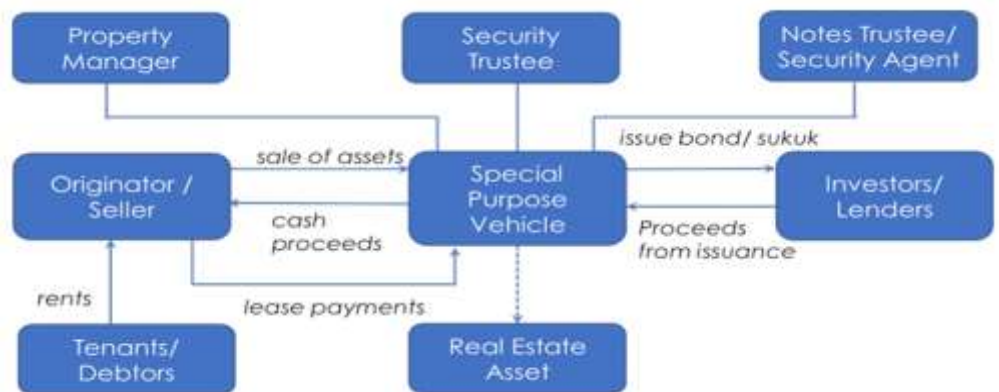


Exhibit 1 shows a common CRE-backed transaction where the originator sells its property asset to the SPV, which in turn leases the asset back to the originator. The SPV pays for the asset via proceeds from the issuance of bond/sukuk.

The property manager undertakes the management of the property including the rental collection in a CRE-backed transaction, although in certain cases the originator undertakes the rental collection in order to maintain its relationship with tenants. The security trustee holds the collateral property on behalf of noteholders and has the power of

attorney to accelerate or early amortise the notes by disposing the property upon occurrence of trigger events. The security agent also monitors compliance with imposed covenants.

Trigger Events

Trigger events are incorporated in the transaction structure to address potential default risk; this is by allowing the security trustee sufficient headroom to undertake remedial measures. Trigger events include underperformance of the collateral property that would be in breach of the financial covenants of the transaction. Another key trigger event is failure to complete the refinancing/redemption of the notes prior to the expected maturity date, following which, the noteholder can instruct the security trustee to dispose of the collateral property during the tail period between the expected maturity and legal maturity dates.

RATING APPROACH TO CRE-BACKED TRANSACTIONS

In its approach, MARC focuses on the following four parameters: (1) evaluating the net operating income (NOI) of the collateral property; (2) establishing the *stabilised* NOI; (3) selecting the appropriate capitalisation rate; and (4) deriving the ascertained value of collateral property under the rating agency's income capitalisation approach.

1. NOI of the collateral property

NOI is derived from the gross rental income of the collateral property after deducting all operating expenses. MARC examines the rental track record of at least three years. The rating agency assesses the following factors to determine the stability and quantum of cash flow generation of the collateral property.

a) Tenancy agreements and profile

For existing tenancy agreements, the analyst reviews the tenancy terms, which among others include tenures, termination options, rental review options, and conditions on the distribution of costs between property owner and tenants. The tenure of the tenancy agreement is a key consideration: long-term tenancies have lower re-leasing risk and cost compared to short-term tenancies. Higher proportion of long-term tenancies mitigates fluctuations in rental

income. Tenancy agreements with punitive exit penalties and high security deposit requirements may mitigate the risk of rental income disputes upon payment default by the tenant.

The rating agency also considers the credit quality of tenants in assessing the stability of rental income. Tenants with an established name and operating track record (such as multinationals) provide comfort in terms of timeliness of rental payments. Tenants with long-term relationships with the property owner, as reflected by historical leases and track record, lower tenancy renewal risk. MARC may consider single customer concentration as an inherent risk to the stability of rental income. However, for a retail commercial property, the existence of a reputable anchor tenant which occupies large floor space, is considered as a positive factor to maintain the competitiveness in attracting new tenants to the property. MARC examines the level of customer concentration based on the share of lease/rental contribution. For an industrial property, the ability to convert the space to meet a tenant's requirement is considered a positive factor for tenant retention. However, a purpose-built or highly specialised building generally poses single tenant concentration risk and may also experience slow tenant replacement in the event of the tenant departure.

b) Occupancy level

MARC examines the occupancy track record of the collateral property and compares it against the overall occupancy level of similar properties in the vicinity and surrounding areas. The analyst determines the prospects of occupancy at the collateral building by taking into consideration data from property market research, National Property Information Centre (NAPIC) report, and the macroeconomic conditions. The analyst considers the location, type and quality of the collateral property in assessing its ability to maintain or improve occupancy level. In terms of analysing renewal risk, considerations are given to the strategic importance of the property to the tenant, and other factors such as the capital investment incurred to convert the premises into a purpose-built property in the case of industrial property which mitigates renewal risk.

For a retail commercial property, apart from the anchor tenant, it has a diversified tenant pool with a large number of tenancies with shorter tenures. These pose higher renewal risk. In this case, the analyst will assess the track record and experience of the property manager in being able to retain tenants, in addition to the competitiveness of the property.

c) Rental rate

The analyst examines the rental rates trend of the collateral property and such similar buildings in the vicinity and surrounding areas. The focus is on the supply-demand dynamics for the property type, which would affect the outlook on rental rates. In arriving at the comparison of rental rates, the analyst uses available data from property market research and NAPIC reports.

2. Stabilised NOI of the collateral property

The *stabilised* NOI is computed as the average NOI over typically a five-year period that includes the current year, the preceding year, and the projected next three years. The NOI for the current and preceding year are obtained from the audited accounts while the projected NOI is derived from sensitising key variables namely occupancy level and rental rate. Assumptions on future occupancy level and rental rate are based on the outlook of the property subsector that relates to the collateral property. For new properties, the analyst estimates market-rate rental based on the quality and competitiveness of the property.

The gross rental revenue includes fixed rental and rental step-up under the tenancy agreements. Depending on the property type, rental reviews and intervals vary subject to negotiations between the tenant and property owner. Therefore, variable or optional rent increase upon renewal is not considered in the projections.

The operating costs borne by the property owner can vary. The *stabilised* NOI may be higher or lower than the actual NOI recorded in any given year.

3. Capitalisation rate

The capitalisation (cap) rate is an estimated required rate of return on any property asset. MARC uses different cap rates based on the type of property assets to reflect the level of risk. A lower cap rate indicates a lower level of risk and therefore a lower return for the property while a higher cap rate reflects the reverse. For example, for commercial buildings with Grade A status in prime locations, a cap rate of 7.5% is applied, industrial properties in good locations the cap rate is 9.0% while for shopping malls in strategic locations the cap rate is 9.0%. Across the property subsector, purpose-built property assets have higher cap rate, such as hospitals of about

12%-14% and hotels of about 11%-13%, given their specific functions that would lead to challenges in disposing such properties on a timely basis. Hence, demand for higher return.

Within the same property subsector, the cap rate can be adjusted to reflect the relative risk of the property asset depending on among other factors: quality, location (accessibility, and the population that the property serves), tenant profile and property manager. The analyst considers the available historic yields from real estate data providers. Over a property cycle, property values can vary with fluctuations in property yields. MARC generally uses a conservative cap rate to value commercial properties to allow for greater stability on the value of the collateral property compared to independent valuers who, under the income approach often apply current market rates.

To arrive at a collateral property's applicable cap rate, the analyst first assesses the quality of property asset to determine the property grade based on the attributes (Exhibit 2).

Exhibit 2: Factors to grade property

Factor	Variables
Location and accessibility	Central business district, fringe city areas, smaller urban areas, newer suburban areas
	Good visibility, multiple access roads, proximity to mass rapid transport, availability of parking space
Property quality	Age, size, functionality, appearance, infrastructure and amenities, customer preference, periodic refurbishment exercise, functional obsolescence
Tenant profile and lease structure	Tenant concentration risk, rental payment track record
	Long-term, fixed step-up rates vs short-term and variable rates
Property management quality	Property manager's track record, experience in facilitating tenant retention and tenant mix, ability to strategise the positioning of the property

The property score for the collateral property asset ranges from 1.0 to 5.0 where a score of 1.0 denotes very strong attributes while 5.0 reflects property assets with very weak characteristics such as unfavourable location, high tenancy turnover, weak rental stability.

Exhibit 3: Property Score

MARC Property Score	Grading
1.0	Excellent
2.0	Strong
3.0	Average
4.0	Below Average
5.0	Weak

Note: Varies on a case-to-case basis

Exhibit 4 reflects the cap rates in MARC's approach to CRE-backed transaction. Within the property types, the range of cap rate reflects the adjustment that can be made based on the rating agency's evaluation of the property grading.

Exhibit 4: MARC Cap rates

Type of property	Cap rates
Office	7.50% - 11.50%
Retail mall	8.50% - 12.50%
Industrial property	9.00% - 13.00%

Note: Varies on a case-to-case basis

4. Ascertained value of collateral property

MARC ascertained value of a collateral property is calculated by dividing the *stabilised* NOI by the cap rate applied to the property under the rating agency's income capitalisation approach. This creates an expected property value, which is typically lower than the current market value. Positive or negative adjustments may also be applied subject to the changes in the *stabilised* NOI.

MARC ascertained value of a collateral property	$\text{Stabilised NOI} / \text{Cap rate applied to the collateral property}$
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Loan-to-value (LTV)

The MARC ascertained value (V) of collateral property is used for loan sizing (L). The LTV reflects the level of stress to the collateral value that is appropriate for the given rating level. For example, for an LTV of 40% at AAA rating level, a property would generally have to lose more than 60% of its market value for there to be a loss on the AAA portion of the loan proceeds.

Exhibit 5: LTV ratio parameters

Rating level	LTV (%)
AAA	<= 43.00
AA	44.00 - 51.00
A	52.00 - 59.00
BBB	60.00 - 66.00
BB	67.00 - 73.00
B	74.00 - 80.00

Note: Varies on a case-to-case basis

The LTV ratio for the respective rating band reflects the allowable limits of maximum amount of debt that can be raised at each rating category. Debt sizing into senior and junior or subordinated tranches with sequential cash flow waterfall redistributes credit risks, prioritising payment for higher rated bonds before the subordinated piece.

Debt service cover ratio (DSCR) covenant

DSCR is the coverage provided by operating cash flow over debt obligations for that year – a measure of cash flow adequacy to support the periodic obligations and loan amortisation. The ratio helps to determine the maximum loan size based on the cash flow generated by the property.

A DSCR of less than 1 indicates insufficient cash flow to cover annual debt service. For example, a DSCR of 0.92 means that there is only enough NOI to cover 92% of annual debt service. A lower DSCR may be acceptable for debt with shorter amortisation periods and/or properties with stable cash flows. Higher ratios may be required for properties with volatile cash flows – for example, hotels, which lack the long-term (and therefore, more predictable) tenant leases common to other types of commercial real estate.

Redemption and/or refinancing risk

The repayment of the principal amount is from the proceeds from the sale of the collateral property or as is often the case in the MARC universe, the outstanding principal amount is refinanced, the process of which commences during the expected maturity date and completes before the legal maturity date. In this regard, analysts would monitor property market conditions and property price trends to ascertain that the refinancing prospects remain intact.

Refinancing ability is based on the ratio of debt-to-market value of the collateral property (loan-to-value ratio), on maturity of the debt. Refinancing risk is driven by factors including the property quality and type, the lease profile, originator's incentive and quality to support the loan, strength of the property manager and management's track record/experience.

Expected maturity date and legal maturity date

CRE-backed securitisation incorporates a tail period which is defined as the period between expected maturity date and legal maturity date. The expected maturity date is the expiration date of the notes where non-redemption leads to a trigger event. The legal maturity date is the expiration date of the notes where non-redemption is an event of default.

In view of the nature of transaction for commercial real estate which requires a sufficient period to conclude a sale, the tail period can stretch from one to two years. The shorter the tail period, the higher the disposal risk. MARC analysts would engage with the issuer before the expected maturity date on the course of action the issuer intends to take in relation to the redemption of the notes. In the rating agency's experience, the collateral property is refinanced prior to the expected maturity date.

Analysts would need to be cognisant of timing risks for the refinancing process to be completed ahead of the expected maturity date. In this regard, factors such as the debt market conditions to be able to facilitate refinancing activities, and the property market conditions that would determine the value of the collateral property would need to be closely monitored. In the event the refinancing/redemption of notes is not completed prior to the expected maturity date, the security trustee can commence disposal of the collateral property under the transaction during the tail period between the expected maturity and legal maturity dates.

Legal and other considerations

MARC reviews legal transaction documents to ensure noteholders' interest are protected. Independent legal counsel may also be appointed to assess the enforceability and completeness of legal documents as well as the consistency of the documents with the transaction structure and issue covenants.

The SPV is subject to tax liabilities throughout the transaction and continue to be exposed to the risk of changes in tax treatment by the tax authorities. Recalibration of tax payable to a higher amount, if any, ultimately heightens the risk of default to the bondholders. As such, opinion from a taxation specialist and a buffer in the cash flow are required to limit the risk.

Valuation report from independent valuers

MARC reviews historical and recent valuation reports from the independent valuer of the property to derive the market rate which reflects the relative asset quality standing between the securitised property and competing assets surrounding the property. The market value of the property also serves as a comparison to MARC ascertained value of the collateral property. In most cases, MARC applies a reasonable amount of discount to the market value given the challenges during asset sale or liquidation.

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