

Methodology

Global Methodology for Rating Credit Tenant Leases

DBRS Morningstar

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Related Research

This methodology has references to related concepts found in the following DBRS Morningstar commercial real estate (CRE) methodologies within Europe and North America:

- *European CMBS Rating and Surveillance Methodology*
- *DBRS Morningstar North American Commercial Real Estate Property Analysis Criteria*
- *North American Single-Asset/Single-Borrower Ratings Methodology*
- *North American CMBS Surveillance Methodology*

The above methodologies are collectively referred to as the CRE Related Methodologies. Defined terms used herein carry the same meaning as in the CRE Related Methodologies.

For a list of principal Structured Finance asset class methodologies that may be used during the rating process, please see the *DBRS Morningstar Global Structured Finance Related Methodologies* document on www.dbbrsmorningstar.com. This list does not limit the applicability of any principal asset class methodology to analyze transactions in an asset class not referenced therein. Not every related methodology listed under a principal Structured Finance asset class methodology may be used to rate or monitor an individual structured finance or debt obligation.

Scope and Limitations

A methodology sets forth the key analytical considerations and applicable analytics used when DBRS Morningstar assigns or monitors credit ratings or other opinions. In accordance with the applicable DBRS Morningstar policies and procedures, DBRS Morningstar applies one methodology or a combination of methodologies, as appropriate, to evaluate a structured finance transaction or debt obligation in a given asset class. DBRS Morningstar exercises analytical judgment, including through the evaluation of quantitative and qualitative factors and analytical considerations and components set forth in the applicable methodology or combination of methodologies, and it considers the regulatory environment, market standards, and customary practices in addition to other factors deemed relevant to the analysis.

As part of the evaluation process, DBRS Morningstar may opine as to (1) whether a sponsor's proposed capital structure supports the assignment of a given rating, (2) the loss levels the capital structure is able to withstand, or (3) the rating levels supported by a sponsor's proposed capital structure. Once completed, this process facilitates the assignment of a DBRS Morningstar rating, at a given rating level.

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In cases where an applicable methodology or combination of methodologies does not address one or more elements of a structured finance transaction or debt obligation, or where one or more such elements differ from the expectations contemplated when each applicable methodology was approved, DBRS Morningstar may apply analytical judgment in the determination of any related analytical factor, assumption, rating, or other opinion. For a methodology that incorporates the use of a predictive model, DBRS Morningstar may also depart from the rating stresses implied by the predictive model. DBRS Morningstar typically expects there to be a substantial likelihood that a reasonable investor or other user of a credit rating would consider a three-notch or more deviation from the rating stress implied by the predictive model to be a significant factor in evaluating the rating. When a rating committee determines a credit rating with a material deviation, DBRS Morningstar discloses the material deviation and its analytical rationale for the material deviation.

Executive Summary

This methodology applies globally to CRE first mortgage loans and outlines DBRS Morningstar's approach to rating CRE transactions in which the property or portfolio of properties is leased to one or several tenant(s) rated by DBRS Morningstar and the rating or internal assessment (if applicable) of the tenant(s) factors into the rating of the transaction. These types of transactions are generally termed credit tenant lease (CTL) deals, and apply to the following:

- Single-asset CRE transactions or loans or single-borrower transactions with one or more CRE assets leased to a single credit tenant (i.e., single-asset/single-borrower (SASB)).
- Single-asset CRE transactions or loans or single-borrower transactions with multiple CRE assets and multiple distinct credit tenants (i.e., single-borrower portfolios).

As the ratings of these transactions are dependent on the creditworthiness of the underlying tenant(s) leasing the property(ies), DBRS Morningstar typically does not rate a CTL security higher than the rating of the tenant(s). Limited exceptions may include structural features that allow for notching above the tenant's rating. DBRS Morningstar expects to use a DBRS Morningstar credit rating in instances where the DBRS Morningstar CTL transaction rating would be based on such rating on a one-to-one basis. For instances where other factors of the transaction in addition to the creditworthiness of the tenant may be considered for purposes of assigning and monitoring the rating, a DBRS Morningstar internal assessment may be used. Please visit www.dbrsmorningstar.com to learn more about DBRS Morningstar's coverage on assigning ratings for tenants in the Corporate Finance, Financial Institutions, and Governments sectors and see the DBRS Morningstar Product Guide for more information on internal assessments.

DBRS Morningstar Approach to CTL Transactions

Evaluating CTL transactions begins with an assessment of the creditworthiness of the tenant(s) and the lease structures for the properties. This generally applies when (1) the borrower is the credit tenant or the borrower owns the real estate leased to a credit tenant occupying the property; (2) the leases are triple net (NNN) (see items 2 and 3 below); and (3) the lease payments are sufficient to service the debt and fully amortize the principal, in which case the rating analysis focuses on the risk profile of the credit tenant versus the credit risk of the underlying real estate.

DBRS Morningstar expects a CTL transaction to be structured such that substantially all financial obligations of the borrower under the mortgage and other economic burdens of ownership are passed through to the tenant and that any residual risks held at the borrower level are not material or are otherwise mitigated commensurate with the assigned rating level.

DBRS Morningstar's assessment of CTL transactions generally considers the following factors:

1. The credit risk profile of the tenant. The credit rating assigned to the CRE debt is primarily based on DBRS Morningstar's tenant rating as an indicator of likelihood of default on its long-term senior unsecured debt. Any changes to the credit tenant's rating during the term of the CTL transaction is expected to have an impact on the rating of the CRE debt. If the tenant is an unrated subsidiary of a rated entity, then the latter is expected to unconditionally guarantee the lease payments of the subsidiary tenant.
2. The structure of the lease, which is expected to be a bondable, NNN lease in which the credit tenant is unconditionally obligated to pay rent through the entire lease term. With a NNN lease, all costs and expenses associated with owning, occupying, operating, insuring, and maintaining the property (collectively, the property expenses) are payable by the tenant without set-off, deduction, or counterclaim. If the landlord retains substantial responsibilities under the lease, DBRS Morningstar looks for additional loan structural features or substantial excess cash flow to mitigate the absence of a NNN lease.
3. The lease is also expected to provide all-risk insurance coverage for the full replacement value of the property. The tenant is expected to carry insurance and name the borrower as an additional insured party. If the landlord retains substantial responsibilities to insure the property against losses during the lease term, DBRS Morningstar looks for the landlord to carry adequate insurance for the entire tenant lease term with an insurer rated at least as high as the subject credit tenant for the full replacement cost of the improvements, and the loan documents are expected to outline replacement provisions for the insurance company.
4. The term of the lease is expected to equal or exceed the maturity of the debt, and the lease payments are expected to fully amortize the mortgage over the term of the transaction. Otherwise, noteholders are exposed to the risk that the lease will not renew and that the mortgage balance cannot refinance and defaults. For cases where the mortgage does not substantially amortize during the lease term, please see the DBRS Morningstar Approach to SASB Quasi-CTL Transactions section of this methodology.
5. The collateral securing the debt is expected to include a priority security interest in the property and the related property lease (as well as other leases with respect to the same property, if any).

Consistent with commercial mortgage-backed securities (CMBS) transactions, DBRS Morningstar also expects the borrower to be isolated from any nonlease or tenant-related risk factors, including risks related to the property owner or the property manager. As such, DBRS Morningstar generally expects the borrower to be structured as a special-purpose vehicle and the related property to be owned by the borrower. The borrower should delegate the related property management obligations to a reputable third party with an appropriate level of expertise and sufficient resources. To further insulate the borrower from risks associated with the property manager, lockboxes or other cash management arrangements may be incorporated in a transaction.

DBRS Morningstar expects to receive typical transaction documents as well as third-party reports (including legal opinions, property condition assessments, environmental site assessments, and engineering reports).

Multi-Credit Tenant Portfolios

In cases where the rental income for several credit tenants enables the borrower to pay debt service (i.e., interest and principal), the credit analysis evolves from considering the creditworthiness of a single tenant toward assessing the creditworthiness of a portfolio of tenants, combined with an assessment of how reliant the borrower is on each independent tenant.

For example, if the expected debt service coverage ratio is just above 1.0 times (x), the borrower relies on each credit tenant and therefore the credit risk of the loan is typically driven by a default of any of the tenants (first-to-default analysis), which may, or may not, be the least creditworthy tenant (weakest-link analysis). The first-to-default risk may be higher than the weakest counterparty risk depending on the default correlation among the entities.

If the expected debt service coverage ratio is considerably above 1.0x, the borrower might be able to service its debt even if the rental income from the weakest credit tenant(s) is zero (e.g., if the tenant goes bankrupt). In this situation, the weakest credit tenant(s) may not be a factor in the rating as the loan can be serviced solely by rent from higher-rated tenants.

Additionally, for multi-credit tenant portfolios where the expected debt service coverage ratio is considerably above 1.0x, it is possible that the loan/transaction rating could be higher than the rating implied by the probability of any single tenant defaulting (first-to-default analysis) or the rating of the least creditworthy tenant (weakest-link analysis) given the granularity of the tenant pool, the initial excess rental cash flow, and the benefit of diversification.

DBRS Morningstar Approach to SASB Quasi-CTL Transactions

DBRS Morningstar generally expects the rated notes in a CTL transaction to fully amortize during the corresponding lease terms for the credit tenants. In cases where full amortization of the debt balance is not achieved prior to or concurrent with the lease expiration or where DBRS Morningstar determines that the underlying leases do not fully qualify for CTL analytical treatment, DBRS Morningstar considers these transactions to be quasi-CTL transactions. Since the sustainable net cash flow (NCF) and the value

of the property could be substantially different if the credit tenant either vacates or renegotiates a lower rent at lease expiration and the debt/certificate balance does not fully amortize during the initial lease term, noteholders are subject to refinance risk and related principal recovery risk from the property itself.

Analysis of SASB Quasi-CTL Transactions

Given that SASB Quasi-CTL transactions expose investors to refinance risk and the related real estate risk of the property, DBRS Morningstar considers the value of the property as it may be necessary to liquidate the CRE asset to pay off the unamortized loan balance should the sponsor fail to refinance the debt. In SASB Quasi-CTL transactions, DBRS Morningstar expects the property value to be more than adequate to cover any remaining unamortized principal balance and the related loan-to-value ratio (LTV) to be commensurate with the tenant's rating or higher. See the LTV, Sizing Benchmarks, and Adjustments section for more details.

DBRS Morningstar Property Value

DBRS Morningstar derives the DBRS Morningstar Property Value for the property by estimating a sustainable NCF for the property(ies). Once a sustainable NCF for the property(ies) is derived, DBRS Morningstar applies a capitalization rate (cap rate) to derive the DBRS Morningstar Property Value. For further details regarding the derivation of the NCF, see the DBRS Morningstar NCF section below. For more details on DBRS Morningstar cap rates, see DBRS Morningstar's *North American Single-Asset/Single-Borrower Ratings Methodology* for transactions based in North America and *European CMBS Rating and Surveillance Methodology* for transactions based in Europe.

When deriving the DBRS Morningstar Property Value, DBRS Morningstar may also consider issuer-provided appraisal reports that include lit/dark value (or vacant possession value) assessments, assuming the credit tenant does not renew its lease, when estimating the DBRS Morningstar Property Value. In certain situations, DBRS Morningstar may assume the land value.

DBRS Morningstar NCF

To arrive at an NCF, DBRS Morningstar estimates the sustainable rent level for the property(ies). DBRS Morningstar may rely on data from third-party sources to estimate historical and projected market rental rates for the property(ies). DBRS Morningstar generally adjusts any above-market leases down to levels close to market rates. Also, market rent estimates for special-use properties may be based on alternative-use proxies. Expenses are also estimated based on historical and expected levels (see *DBRS Morningstar North American Commercial Real Estate Property Analysis Criteria* or *European CMBS Rating and Surveillance Methodology* for more details regarding the derivation of the NCF for the property(ies)).

LTV, Sizing Benchmarks, and Adjustments

DBRS Morningstar calculates the expected LTV based on the DBRS Morningstar Property Value (see the DBRS Morningstar Property Value section) and the unamortized loan balance as of the end of the tenant's lease.¹ The LTV, similar to SASB transactions, is compared with the DBRS Morningstar Sizing

¹ DBRS Morningstar will give credit to loan amortization if the credit rating of the tenant(s) is investment grade.

Benchmarks to ascertain the implied rating for the bond.² DBRS Morningstar may adjust the LTV Sizing Benchmarks or assign a different rating than that implied from the Benchmarks if there are certain structural features present that affect the credit profile of the transaction. Other adjustments to the Sizing Benchmarks are outlined in the *North American Single-Asset/Single-Borrower Ratings Methodology* and *European CMBS Rating and Surveillance Methodology*.³

Should the rating implied by the Sizing Benchmarks be lower than the tenant's rating, the rating for the transaction will typically be constrained by the rating implied by the Sizing Benchmarks (inclusive of any adjustments to the Benchmarks).

Analysis for SASB Quasi-CTL Portfolios

CTL transactions may involve multiple properties leased to the same credit tenant subject to lease terms that may not be co-terminous with each other as well as with the mortgage loan. DBRS Morningstar recognizes that there may be some transactions, such as when there are multiple leases at multiple locations, that may benefit from geographic diversification or more granular cash flows. In these situations, DBRS Morningstar may assume some partial releasing, lease extensions, renewals, and occupancy when deriving the NCF and related DBRS Morningstar Property Value for the portfolio of CRE assets.

In these cases, DBRS Morningstar evaluates the importance that the underlying properties represent to the tenant's business operations. Sites that are critical or essential (e.g., a main distribution center or headquarters) would be more likely to remain occupied and renewed by the tenant. The remaining lease term to lease expiry or break option is also an important consideration. The longer the lease term, the greater the risk of the tenant's business operations changing, therefore changing its real estate needs or increased risk of functional obsolescence. Additionally, special-purpose properties may not be well suited for prospective replacement tenants.

In addition to assessing the relevance of the property(ies) to the tenant's business model, DBRS Morningstar considers the factors below when estimating the portfolio NCF:

- Creditworthiness of the tenant.
- In-place tenant rental rates, adjusted up or down based on each underlying property's attributes and market rents.
- Operating expenses, adjusted for inflation throughout the life of the leases.
- Rental increases at the lease's average annual escalator throughout the average final tenant lease term.
- Tenants vacate at the end of the lease term and the underlying properties must be leased to replacement tenants at market rents following downtime leasing and carrying costs, or tenants renew the leases at market rents with leasing costs.
- Assume special-use properties will be liquidated at lease maturity at a de minimis value.

² See the *North American Single-Asset/Single-Borrower Ratings Methodology* or the *European CMBS Rating and Surveillance Methodology* for the Sizing Benchmarks.

³ For transactions in North America, the relevant SASB methodology is the *North American Single-Asset/Single-Borrower Ratings Methodology*, while transactions in Europe would follow the *European CMBS Rating and Surveillance Methodology*.

Multi-asset portfolios are also typically subject to a rating constraint based on the LTV for the transaction versus the implied rating from the Sizing Benchmarks, inclusive of any adjustments to the Sizing Benchmarks. See the LTV, Sizing Benchmarks, and Adjustments section for more details.

Liquidity

DBRS Morningstar expects SASB Quasi-CTL transactions to include mitigating features similar to SASB transactions, such as servicer advancing, reserves, liquidity facilities, or other relevant transaction features to offset the risk that noteholders do not receive timely payment of interest and recovery of principal from the underlying collateral.

In SASB transactions, liquidity is typically either provided by a liquidity facility or a loan servicer, who advances delinquent interest payments and other amounts related to the collateral such as insurance payments, real estate taxes, and other obligations necessary to maintain and preserve the trust's/issuer's first-priority lien in the collateral. For servicing advances, DBRS Morningstar expects the counterparty responsible for advancing to be rated at least "A" by DBRS Morningstar. Liquidity facilities should be consistent with DBRS Morningstar's legal criteria for the relevant jurisdiction.

Legal Review and Transaction Structural Considerations

DBRS Morningstar expects CTL securitizations to align with structural and legal considerations described in the CRE Related Methodologies. There are also legal and structural considerations common to all structured finance transactions, including CTL securitizations. Consequently, the structural and legal considerations of any transaction should be read in conjunction with DBRS Morningstar's *Legal Criteria for U.S. Structured Finance*, *Legal Criteria for European Structured Finance Transactions*, *Legal Criteria for Canadian Structured Finance*, *Derivative Criteria for European Structured Finance Transactions*, and *Derivatives Criteria for Canadian Structured Finance*.

Servicing

For SASB or large-loan securitizations, there are typically two servicing roles in the transaction: servicer and special servicer. The servicer is responsible for the loan's day-to-day administration, asset management, and ongoing investor reporting. If the loan becomes troubled (i.e., no longer performs within expectations) or defaults, the special servicer will take over the servicing of the loan. The special-servicing role may be performed by the servicer or it may be assigned to another third-party servicer that has expertise with defaulted commercial mortgages and loan workouts. See DBRS Morningstar's *North American Commercial Mortgage Servicer Rankings* methodology or *European CMBS Rating and Surveillance Methodology* for further details.

Surveillance

For CTLs, SASB Quasi-CTLs, or multi-credit tenant portfolios where a counterparty rating is material to the rating assigned to the CMBS transaction, DBRS Morningstar monitors and/or receives notice of the tenant's most recent credit rating and rating trend through various reporting sources. For other aspects of DBRS Morningstar's surveillance, please refer to the surveillance section(s) of the *European CMBS Rating and Surveillance Methodology* and the *North American CMBS Surveillance Methodology*.

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