Methodology for Rating Credit Tenant Lease Transactions and Other Secured Corporate Obligations

Version V1

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Introduction and Overview

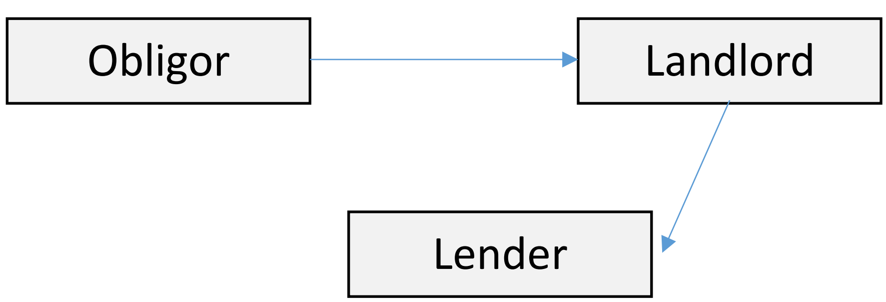
This document describes EJR's approach to rating securities backed by the "credit tenant lease" (CTL). From a credit analysis perspective, Credit Obligor Leases are similar to secured loans or secured debt (collectively Secured Obligations or "SOs"). In assessing CTL's, we first determine the credit quality of the obligor and assess the additional support which can be derived from the collateral. If at the end of the term of the obligation, proceeds are needed from the collateral to fully retire the obligation, EJR will evaluate the amount and reliability of repayment. However, the normal outcome particularly for CTLs is that the obligor releases or purchases the collateral. Therefore, since the primary and normally secondary source of repayment of the obligation is derived from the obligor, CTLs and other SOs analyses are viewed as corporate analyses. Note, CTL-related debt instruments commonly have debt service coverage ratios much lower and loan-to-value ratios much higher than conventional real estate loans.

When applying this methodology, EJR will consider qualitative and quantitative factors that it deems relevant when determining ratings for CTL transactions. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the obligor may be strong in most other areas.

Egan-Jones rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic cycles, Egan-Jones strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.

Rating Factors

The factors we analyze in rating CTLs are: (1) obligor credit quality, (2) the certainty of repayment, (3) the structure of the transaction, and (4) the realizable collateral. The structure of a typical CTL is illustrated below. The Obligor will lease the asset from the Landlord and cash typically flows from the Obligor to the Landlord and to the Lender. The Landlord will finance the acquisition of the collateral with proceeds from the CTL financing and lease the asset to the Obligor. As security for the debt issuance, the Landlord typically assigns the lease and rents to the Lender. Pursuant to the assignment, the Obligor will make all payments directly to the Lender (or agent of the Lender), who will use the lease payments to pay interest and principal payments.



Assessing Probability of Default, Loss Given Default, and Estimated Loss

We use EJR's rating to derive the probability of default (PD) under the Obligor's non-terminable lease, which generally will be the Obligor's senior unsecured debt rating (or equivalent). We may consider the risk of default to be lower than implied by the Obligor's senior unsecured debt rating in certain circumstances, for example, when the leased facility is considered important for the continued business of the Obligor.

Loss given default (LGD) under CTL financings is a function of the loan balance at time of default, and net recovery proceeds from the collateral (plus any potential claims recovered from the Obligor). To the extent that the expected LGD under the CTL is in the neighborhood of 55%, the rating of the credit lease bonds will generally be the same as the reference point for the PD described above. Loss given default (LGD) under CTL financings is a function of the loan balance at time of default, and net recovery proceeds from the collateral (plus any potential claims recovered from the Obligor). To the extent that the expected LGD under the CTL is in the neighborhood of 55%, the rating of the credit lease bonds will generally be the same as the reference point for the PD described above.

Structural Features/ Certainty of Payments

Aside from the credit quality of the Obligor, we will look for or evaluate the following:

A bondable lease, which unconditionally obligates the Obligor to pay rent in an amount sufficient to timely pay the debt service and costs associated with occupying, operating, and maintaining the collateral, without any set-offs;

The realizable collateral value of the asset; that is, the value of the collateral assuming rejection of the lease by the Obligor in bankruptcy. However, we may make adjustments for the possible affirmation of the lease in bankruptcy; and

The stability of the Landlord.

Triple Net/ "Hell or High Water"

To timely pay the principal and interest due to the Lender without interruption, the Obligor is obligated to pay basic rent without any rights of set-off, abatement or counterclaim. This type of lease is known as a "bondable" (or "hell-or-high-water") lease, because it mimics the attributes of a bond: the pure promise of payment of net rent. The Obligor typically pays all the collateral maintenance costs and real estate operating expenses of the Landlord, any other real estate related expenses, and any ongoing transaction costs to insulate the transaction from any reasonably conceivable real estate risk. Maintenance and operating expenses of the Landlord include real collateral taxes, utilities (water, gas, electric), insurance, repairs and capital improvements, liens and special assessments. Ongoing costs, if any, associated with the bond transaction structure may include yearly trustee and other costs.

No Damage/ Destruction Offsets

Lease payments may not be interrupted by damage to or destruction of any part of the leased collateral. In the case of damage or destruction, the Obligor is required to apply all insurance proceeds to repairing or rebuilding the collateral as nearly as practicable to its previous fair market value and utility. In the event the insurance proceeds are insufficient to restore the premises, the Obligor must complete the restoration at its own expense. If restoration is economically impractical following a substantial casualty, the Obligor may terminate the lease by paying a termination amount or purchasing the collateral in an amount at least sufficient to retire the outstanding debt.

Condemnation

The government may take private collateral for public use through condemnation or eminent domain proceedings (also known as "compulsory purchase" proceedings in some non-US jurisdictions) if it pays compensation to the collateral owners. The government may totally, partially or temporarily condemn a collateral. In such cases, the Obligor is obligated to continue to make payments under the lease. However, in the case of a total taking or a partial taking which renders the remaining portion of the collateral unsuitable for its intended use, the Obligor may terminate the lease and pay an amount sufficient to retire the outstanding debt. If the government takes a portion of the collateral which does not render the remaining portion unsuitable for the Obligor to terminate the lease, the Landlord should apply the condemnation award proceeds to partially prepay the debt and thereafter reduce the lease payments due to an amount sufficient to pay all future debt service.

Indemnification

Future lawsuits and claims against the Landlord could increase the risk of the Landlord's bankruptcy. The Obligor generally bears this risk by agreeing to indemnify the Landlord from all losses, liabilities, judgments, costs, and expenses arising out of its acts or omissions, or in any way related to the real estate or the financing transaction. In addition, the Landlord generally has no monetary or material non-monetary obligations under the lease, nor does the Landlord make any material representations or warranties.

Assignment & Subletting

Since the rating of the transaction is based on the credit quality of the lease stream, the Obligor may assign its interest under the lease or sublet only if the Obligor continues to remain liable for all future lease obligations.

Environmental Risks

To shield the Landlord from possible liability for claims or remediation costs caused by environmental problems, the Obligor generally indemnifies the Landlord for any liabilities, damages, costs or expenses arising from the release or presence of hazardous waste occurring before or during the term of the lease, whether or not known, unknown, discovered or discoverable before or during such term. We may review environmental assessments for conditions that may have a material adverse effect on the value or operation of the collateral.

Purchase and Re-Leasing Options

the Obligor may be given the right to purchase the collateral for fair market value from the Landlord, thereby terminating the lease. The lease ensures that the purchase price is always in an amount sufficient to retire the outstanding debt.

Guarantees

If the Obligor is an unrated subsidiary or affiliate of the rated "credit," the rated entity typically guarantees the timely payment of all sums due under the lease. The guarantee should be drafted to include commercially customary waivers of defenses.

Insurance

The Obligor is expected to carry adequate collateral and casualty insurance on the premises. In certain cases, the Obligor may self-insure depending on the strength of the Obligor.

Recoveries and Collateral Value

Like other SOs, lenders in CTLs have two forms of repayment: payments from the Obligor and the value of the collateral. To arrive at a final rating outcome, we assess the value of the leased assets, because the ultimate recovery for holders of the Obligor's long-term unsecured debt and for holders of debt backed by the Obligor's lease may be different due to the treatment of leases under bankruptcy or insolvency rules in various jurisdictions. However, if an asset is needed in the Obligor's operations, leases are often reaffirmed in the case of a bankruptcy so that the Obligor can continue the usage of the asset.

Other Factors

Early amortization/ Defeasance

Depending on the senior unsecured rating of the Obligor, we may give credit for early or accelerated amortization of the debt. The higher the investment grade rating of the Obligor, the more likely that amortization of the debt will be realized, thus decreasing the LGD of the transaction.

Residual Value and Other Specialized Insurance

Some CTL deals have "almost bondable" leases, where rent may be abated, or the lease cancelled, if casualty or condemnation events occur. In addition, some leases by their terms may terminate prior to full amortization of the debt. Specialized insurance policies have been developed to cover such risks: "lease enhancement policies" for the casualty/condemnation risk, and "residual value insurance" policies for the balloon payment risk. We carefully review such policies to determine that the insurer has unconditionally covered such risks. The rating of the insurer typically must be at least equal to the rating of the Obligor. Downgrade or withdrawal of the insurer's rating may adversely affect the rating of the CTL transaction.

Construction Risks

If construction of the premises will not be completed until after the rated debt is issued, the Obligor's obligation to pay rent usually will not have commenced. In these cases, provisions may be documented to ensure that debt service will be fully and timely paid prior to the Obligor's rent commencement date. Typical provisions include the posting of cash reserves or a letter of credit in amounts sufficient to pay debt service until the "date certain" when the Obligor's net rent obligation commences. If there is not a certain rent commencement date, the cash reserves or letter of credit should be in an amount sufficient to completely pay down the outstanding principal and accrued interest by a specified, outside date. Alternatively, the lease may provide that the Obligor will pay a termination payment equal to the outstanding principal and accrued interest by an outside date.

Asset Value

If the value of a collateral is strong, we may assign credit lease bond ratings above the senior unsecured rating of the Obligor. That is, if the LGD is low enough, the EL of the CTL transaction may be reduced so much that the overall rating of the CTL transaction is consistent with a rating above the Obligor's PD reference point.

In other situations, if the value of a collateral is low, the LGD would be higher, and we might assign ratings to the issued debt one or two notches below the senior unsecured rating of the Obligor.

Jurisdictional Law Concerns

In the US, case law from state to state may vary in how rigorously the courts will interpret a "hell-or-high-water" lease, though generally such lease terms are honored in the Landlord's favor. In other jurisdictions, certain factors could also affect how strictly lease provisions may be enforced. We may cap or adjust the rating of a transaction to reflect any state or jurisdictional law weaknesses.

Monitoring

Our approach to monitoring the rating of outstanding transactions is generally similar to the approach we use to assign the initial ratings. Obligor rating is normally the key rating driver in monitoring CTL transactions since the other rating drivers (bondable typically remain unchanged over the life of the transaction. CTL ratings may change based on a change in the Obligor's senior unsecured debt rating or a change in the appropriate metric used to reflect the risk of default.

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