# Methodology for Rating Ground Lease Transactions

Version V1

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## Regulators' Requirements

A general description of the procedures and methodologies used to determine credit ratings. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. Market participants are provided the opportunity to comment on the methodologies through the EJR's website (publicly available) for EJR's consideration.

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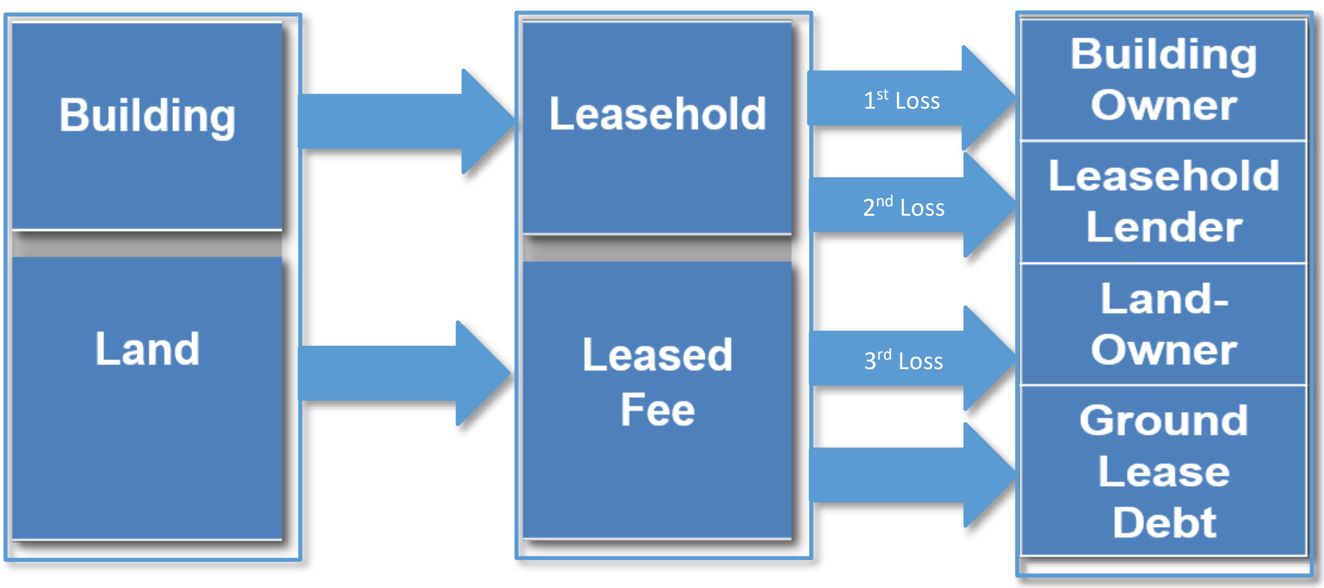
## Introduction and Overview

This document describes EJR's approach to rating debt backed by ground leases ("Ground Lease" or "GL"). This document should be read in conjunction with EJR's "Procedures and Methodologies for Determining Credit Ratings". From a credit analysis perspective, GL debt ("GLD") are secured debt which is normally senior other capital sources for a real estate asset. The GLD is typically secured by the land (the "Land") and is typically leased to the owner of the Improvements (the "Improvements" or "Building") under a triple-net lease whereby the Ground Lessee is responsible for all expenses relating to both the Land and the Improvements including but not limited to taxes, maintenance, insurance, utilities, and compliance with law. The Land and the Improvements, collectively, are referred to as the "Property". Ground Leases are a long-accepted form of financing and have existed since the reign of England's Henry VIII[1]

GL are generally considered to be of high credit quality because of the extensive amount of capital which is subordinated to the typical GL. For example, if the lessor of GL defaults on its ground lease payments, unless made whole, the GL lender typically gains control of the land, and if in some cases the improvements. If the land is worth $100M, the improvements worth $250M, and the Property worth $350M ($100M plus $250M), the Building or Improvement owner is highly incentivized to make sure Ground Lease payments are made to protect the investment in the building.

Below is a diagram of a typical transaction structure. As illustrated, the Ground Lease Lender is in a "Last Loss" position meaning that it has substantial capital which will absorb losses before it is impaired.

Figure I: Typical Ground Lease Transaction

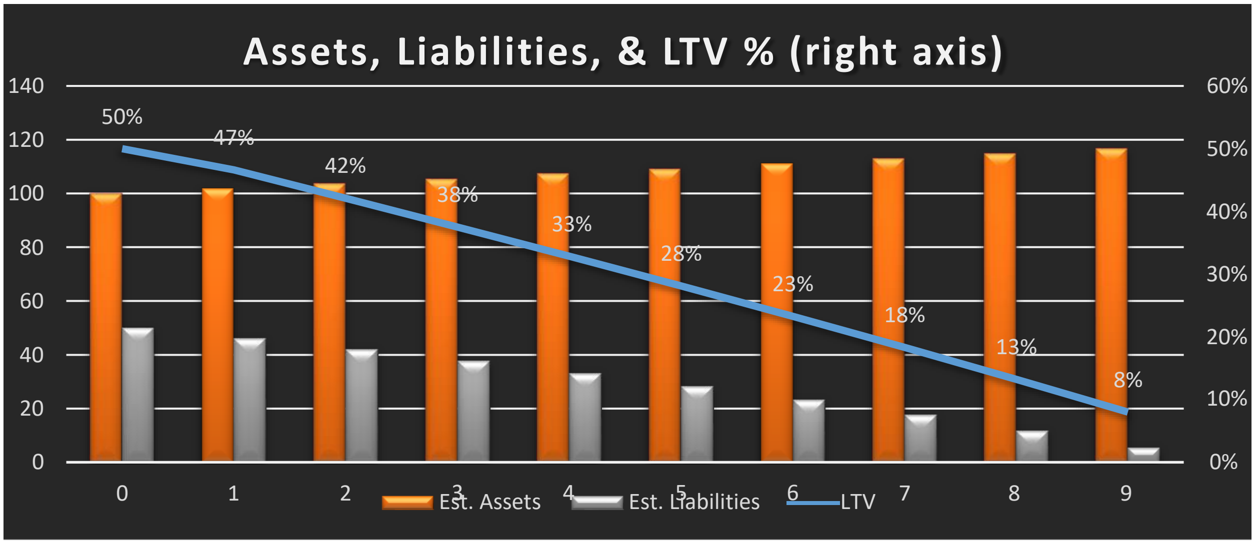



The Building and the Land are treated separately such that the Building Owner (i.e., the Ground Lessee) gains control of the land via a Ground Lease and the Ground Lease Debt or Leased Fee Lender is in the most senior position in the capital structure. Pursuant to the assignment, the Building Owner (i.e., the

[1] http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=4029&context=ylj

Ground Lessee) will make all payments directly to the Leased Fee Lender (the Ground Lease Debt), who will use the ground lease payments to pay interest and principal payments.

The expectation is that over time, the security of the GLD grows as debt is amortized and the value of the property increases. Below is a simple illustration of the LTV for the Ground Lease Debt starting at approximately 50% whereby the illustrative Property value is $100M and the Ground Lease Debt is $50M.  Over time, the LTV declines as a result of the appreciation in the value of the Property (assumed to be 2.0% per annum in this case) and the amortization of the debt.




## Rating Factors

The factors we analyze in rating GLDs are: (1) quality of the Property, (2) current and potential alternative uses, (3) the appeal of the Property location (macro and micro), (4) the level of subordinated capital, (5) the structure of the transaction, (6) the experience and professionalism of the parties involved, (7) tenants creditworthiness, (8) property rental income and cash flow, and (9) any property appraisal.  In assessing GLD, we assess the quality of the Property, including an assessment of the current usage, alternative usage, location, growth factors, local economic climate, tenant profile, and current and prospective subordinated capital. 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 GLDs is that the obligor releases or purchases the collateral. Note, GLD-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 GLD 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.

## Assessing Leverage and Implied Ratings

A major factor in assigning ratings is the adjusted Loan to Value ("LTV"), which is essentially the exposure compared to the value of the collateral. In the case of Ground Lease Debt, since it is typically senior debt, we compare the debt amount (i.e., the "L" in "LTV") to the value of the collateral. Adjustments might be made upwards or downwards on the value, or "V" in the LTV ratio.

Below is a graphic showing an assessment of the LTV. As can be seen, with LTV ratio of merely 50%, the corresponding implied credit rating is high and the [Estimated] Loss low.

| Asset | Cumulative LTV | Implied Rating |
|---|---|---|
| Building Owner | 100% | |
| Leasehold Lender | 80% | |
| Landowner | 70% | |
| Ground Lease Debt | 50% | strong |

## Structural Features/ Certainty of Payments

Aside from the leverage in the transaction, 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 setoffs;

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 adjust for the possible affirmation of the lease in bankruptcy.

### Triple Net/ "Hell or High Water"

To 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 Amendments without Consent: Neither the landlord nor the tenant should have the right to amend, modify, terminate or alter the ground lease in any way without the leasehold lender's consent.

Priority of Ground Lease over Fee Mortgages: The ground lease should include a requirement that any mortgage or deed of trust placed on the lease fee owner's interest in the property is subordinate to the ground lease so that a foreclosure sale by the lease fee lender does not terminate the ground lease.

## 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 enough 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.

## 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.

## 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 GLD of the 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 Loss Given Default (LGD) is low enough, the Estimated Loss (EL)of the GLD transaction may be reduced so much that the overall rating of the GLD transaction is consistent with a rating above the Obligor's Probability of Default (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 GLD transactions since the other rating drivers (bondable typically remain unchanged over the life of the transaction. GLD 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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# DEFINED TERMS

**Ground Lease -** A ground lease is an agreement in which a tenant, the lessee, is permitted to use and develop a piece of land for a specified lease period, after which the land and all improvements are returned to the property owner, the lessor.

**Ground Lease Debt (GLD) -** A form a secured debt, typically in the form of loan or note secured by the ground lease, which is normally structurally senior to other capital sources for a real estate asset.

**Leasehold Improvements -** Modifications made by an owner or a lessee to render a space or property more usable.

**Lease -** A contract between the owner of a specific asset, the lessor, and another party, the lessee, allowing the latter to use/hire the specific asset. The lessor retains the right of ownership, but the lessee typically acquires the exclusive right to use the asset for a specific period of time in return for a specific stream of payments (rent).

**Leased Fee -** an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; usually consists of the right to receive rent and the right to repossession at the termination of lease.

**Leased Fee Lender** – Also known as the Lessor, the Ground Lessor, or the party that receives the monthly lease payments (from a lessee) by extending the financing terms for the use of the asset.

**Lessee -** The party to a lease contract who uses the asset and makes the lease (rent) payments in exchange for such use.

**Lessor -** A party to a lease contract, who has granted permission for a lessee to use that party’s asset.

**Triple Net Lease -** A lease agreement on a property, whereby the lessee promises to pay all the expenses of the property including real estate taxes, building insurance, and maintenance.