CRISIL
An S&P Global Company

Rating methodology for commercial mortgage-backed securities

August 2021

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Executive summary

Commercial mortgage-backed securitisation (CMBS) is an alternate funding tool for commercial real estate property developers. In a CMBS transaction, lease rentals from property (can be a pool of one or many properties) of an issuer are deposited in a designated escrow account and used for servicing interest payments, while the principal is typically refinanced on maturity.

The CMBS transaction is secured via mortgage on the property, with a debenture trustee empowered to sell it and repay investors if the issuer fails to refinance the debt on maturity. Ratings on CMBS depend on the ability of the underlying property to generate sufficient revenue to meet periodic interest payments, and the ability of the issuer to refinance the principal on maturity.

When rating a CMBS transaction, CRISIL Ratings evaluates the risks of vacancy, pricing and counterparty credit to assess the revenue stability of the underlying property. The profile of the customer, the location of the property and adequacy of liquidity in the form of a debt service reserve account (DSRA) are also considered. The refinancing ability of the issuer is assessed based on the ratio of the debt to market value of the property (loan-to-value) at maturity of the CMBS.

CRISIL Ratings also evaluates the management quality of the property developer/manager, as robust managements typically have better ability to attract and retain tenants, and negotiating power, leading to higher revenue stability and refinancing ability. There is also emphasis on the nuances of the property and management quality, such as the track record of high-quality assets in the issuer's portfolio, the ability of the management to attract and retain marquee clients, and cash flow stability.

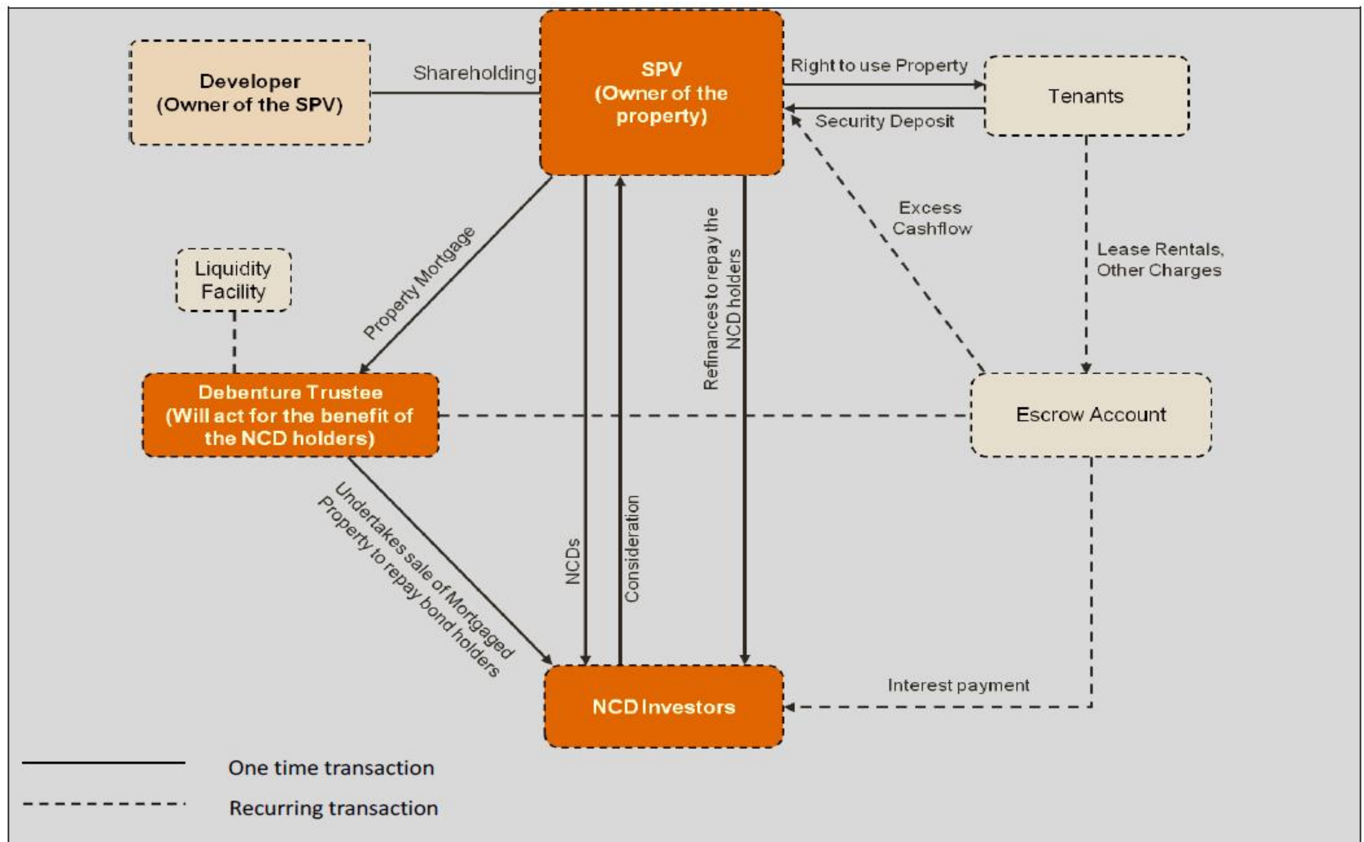
Scope

This document[1] outlines the salient features of CMBS transactions, the key risks involved, and the framework followed by CRISIL Ratings for analysing them.

[1] For accessing previously published document on "CRISIL Ratings' methodology commercial mortgage-backed securities", follow the link: https://www.crisil.com/content/dam/crisil/criteria_methodology/structured-finance/archive/crisil-rating-methodology-for-commercial-mortgage-backed-securitisation-aug2018.pdf

Salient features of CMBS transactions

Chart 1: Steps involved in a typical CMBS transaction



The properties for which lease rentals are to be securitised are housed in a special purpose vehicle (SPV). The SPV houses only the designated properties and does not typically undertake development, capital expenditure or any other business activity.

- Debt, contracted by the SPV by issuing CMBS, is secured by a mortgage on the specified properties
- The cash flow waterfall of the lease rentals is as follows:
  - Net lease rentals (charges such as maintenance costs, tax deducted at source, service tax, income and property tax are deducted from the gross rentals to arrive at the net rentals available to service debt) are paid into a designated escrow account
  - Debt is serviced through the net lease rentals, and the residual cash goes back to the borrower
  - Principal repayment is typically in the form of a bullet payment at the end of the tenure
- A debenture trustee is appointed to act as an agent of CMBS debt holders, with a fiduciary duty to protect the interest of the investors

- The SPV normally acts as the property manager for the securitisation transaction
- The lease rentals are deposited in a specified escrow account. The SPV uses these deposits in accordance with the waterfall mechanism delineated in the agreement. The debenture trustee will intervene only when the terms of the agreement are violated
- The debt instrument has two key dates: the indicative maturity date, and the legal final maturity date. The former is the date by which the principal is expected to be repaid (primarily through refinancing)
- If the issuer is not able to refinance the debt on or before the indicative maturity date, there are features that empower the debenture trustee to ensure repayment by the legal final maturity date
- The debenture trustee has the right to sell the underlying property and ensure repayment of debt. As this process could take time, the terms of the instrument provide a 'tail period' between the indicative maturity date and the legal final maturity date. This period depends on the time it is likely to take for completing the property sale and realising the proceeds. Thus, the legal final maturity date by which investors have to be repaid through the sale of property is set after the indicative maturity date
  - As the sale of property by enforcing the mortgage may not be the most economically efficient mechanism, CMBS transactions typically have additional structural mechanisms that allow the sale of the SPV. For instance, the developer may pledge its entire shareholding in the SPV, which houses the underlying commercial properties, to the debenture trustee. Thus, the debenture trustee can raise funds by selling the SPV and repaying investors on or before the legal final maturity date
- If the CMBS debt holders are not repaid in full by the legal final maturity date, it is considered an event of default on the CMBS debt.

To summarise, in a typical CMBS transaction:

- Lease rentals from the property are used to pay interest on the CMBS debt
- The principal is normally repaid by the end of the indicative maturity date
- Lease rentals alone are normally not sufficient to repay the principal
- Thus, all or almost all of the principal repayment is through refinance
- If the issuer is unable to redeem the principal payment by the indicative maturity date, the debenture trustee is empowered to realise the funds through sale of property or SPV, as the case may be, and repay the debt holders by the legal final maturity date

Rating methodology

The CRISIL Ratings framework for rating CMBS transactions comprises a detailed analysis of the following primary risk factors:

- **Revenue risk:** Lease rentals are the primary source of revenue in a CMBS transaction. Any reduction in the lease rentals lowers the cushion to meet interest obligations, posing a risk to the servicing of the debt instrument. The following factors are considered when analysing revenue risk:

- **Vacancy risk:** Lease contracts with long tenures lead to stable cash flows. The contracts typically contain a lock-in period, on expiry of which the tenant may choose to renew the contract. Vacancy risk arises when tenants decide to vacate the property either mid-way or at the end of the lease tenure. The property's current vacancy level, along with that of the micro-market, as well as the nature of the property (such as retail or office) are considered while assessing the vacancy risk

- **Customer concentration:** A highly diversified customer base would tend to lessen the vacancy risk

- **Pricing risk:** Fluctuations in market rates of lease rentals are taken into consideration when evaluating the revenue risk. Typically, lease rentals rates are negotiated at the time of renewal of the contract. Thus a reduction in lease rental rates during this time poses a revenue risk for the transaction

- **Counterparty credit risk:** This arises when the existing tenant delays lease rental payment. CRISIL Ratings factors in the credit risk profile of the tenants into its evaluation of a CMBS transaction

- **Quality of property and location:** Property-specific characteristics such as size, layout, construction quality, safety features, facilities offered (such as parking spaces, power back-up, recreational facilities, and food and beverage outlets) and location have a bearing on its occupancy level. A well-maintained, high-quality property in a prime location will be able to attract and retain quality tenants and command a premium over other properties

- **Diversity of properties:** The real estate market is significantly impacted by local/regional conditions. Geographical diversification mitigates such risks. Accordingly, CRISIL Ratings takes into account portfolio diversification while evaluating a CMBS transaction

CRISIL Ratings evaluates whether the debt service coverage ratio (DSCR) provided by the expected lease rentals in relation to the debt obligation over the life of the CMBS instrument is commensurate with the rating assigned. In a typical CMBS transaction, revenue from lease rentals is used to service interest on debt contracted by the SPV. Thus, the DSCR in a CMBS transaction primarily represents the interest service coverage ratio.

CRISIL Ratings considers the average DSCR over the life of the instrument for its rating analysis. When estimating the cash flow over the tenure of the debt, CRISIL Ratings considers the vacancy rates, rental rates, and contractual agreements such as rental rate escalations and renewals, and also factors in the presence of a debt service reserve account (DSRA) to tide over any temporary shortfall to meet the interest payments.

- **Refinancing risk:** Property price is the second key risk element in a CMBS transaction. As the principal is to be serviced through refinancing or property sale, property price trends assume importance. The refinancing ability is gauged based on the ratio of debt to the market value of the property (loan-to-value ratio) on maturity of the debt

- **Liquidity risk:** CRISIL Ratings assesses the time gap between the two maturity dates to determine the ability of the trustee to sell the property if the issuer is not able to refinance the debt on or before the indicative maturity date. The gap has to be long enough to enable the sale of the property so that the CMBS is fully redeemed before the legal final maturity. CRISIL Ratings will assess these risk factors primarily from the point of view of the prevalent regulatory and legal systems, and will take into account factors such as the nature of the mortgage, the impact of bankruptcy on the developer (if it continues to be the owner of the property), clear title and any risk of litigation by the developer

- **Parent credit risk:** The financial strength of the developer is a critical factor while refinancing the underlying debt, or even for smooth enforcement of the security and sale of property. If the developer is in financial distress or in bankruptcy, then the developer or the liquidator may create legal impediments, potentially delaying the sale of property to repay the debt holders. Hence, CRISIL Ratings considers the developer credit quality while assigning a CMBS rating

- **Management risk:** The management quality of the property developer/manager influences the ability to attract and retain tenants and negotiate favourable terms, and the refinancing ability of the issuer. CRISIL Ratings analyses the track record of the management in operating commercial properties, the presence of professional teams for managing daily operations, proactivity in management and maintenance of the property, and relationships with tenants and lenders

Conclusion

CMBS ratings primarily depend on the ability of the underlying properties to generate sufficient revenue to service periodic interest payments, and the ability of the issuer to refinance the principal on maturity. The ratings are based on the assessment of factors such as vacancy risk, pricing risk, counterparty credit risk, customer and geographical profile, quality of the property, liquidity adequacy, refinancing ability of the issuer, and its management quality. The ability of the trustee to sell the properties and repay investors if the issuer fails to refinance the debt on maturity is also considered.

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