Credit Tenant Lease – Private Placement Loan Program

Overview of Private Placement Credit Tenant Lease Financing

Credit Tenant Lease ("CTL") transactions; focus more on the credit of the tenant and the lease structure than on the type, quality, and location of the real estate. The CTL lease structure typically requires the tenant to pay directly any expenses for which they are responsible. If the lease is structured like a real estate deal with the tenant reimbursing the landlord, a funded reserve account is required.

Private Placements: Private placements are fixed income securities that are not registered with the Securities and Exchange Commission (SEC). As such, they are not publicly issued and <u>not</u> required to be rated by a rating agency. The securities do require a rating by the NAIC if they are sold to a life insurance company. A rating of NAIC 1 (AAA through A-) or NAIC 2 (BBB+ through BBB-) are acceptable credits to most private placement purchasers. A rating of NAIC 3 (implied non-investment grade) may be placed depending upon the firm's industry rating and the business outlook.

Pricing: The pricing of loans is based on the credit of the tenant and the investment community's perception of the tenant's credit and business. Investors often perceive a difference in the quality of two tenants with the same credit rating. Thus, two deals with different tenants that have the same rating may be priced differently.

Loan to Value: The maximum loan to value in CTL transactions is 100%.

Loan to Dark: Loan to dark is designed to factor in any rent premiums a credit tenant is willing to pay for a particular location. The appraiser determines the appropriate market rental rate for the space and uses this rental rate to determine the go-dark value. This value determination rarely limits the loan amount in a private placement structure, but is often a limiting factor in a securitized CTL transaction.

Debt Service Coverage Ratio: DSCR on a private placement CTL is 1.05x unless the tenant pays all expenses directly and there are no landlord obligations, then it is 1.00x. If the Lease has a termination right in the event of condemnation, then the DSCR is 1.01x.

Rent Increases: Fixed rent increases can be factored into structuring a CTL and have the impact of supporting greater loan proceeds. The amortization schedule usually changes with each rent increase. Rent increases tied to changes in the CPI cannot be considered unless there is a minimum increase, which can be underwritten.

Residual Value Insurance: Residual value insurance, which typically costs 4-5% of the residual value insured amount, is an option when a borrower desires a longer amortization schedule and/or more loan dollars. There are several insurance companies with credit ratings ranging from A to AAA that offer this insurance. The underwriting, fee structures, and level of residual value insurance provided differ with each company. When the borrower desires residual value insurance, bids for the coverage are taken with each company in order to obtain the best overall product to meet the borrower's objectives. Residual value insurance ranges from 25-45% of the initial loan amount with some as high as 50%+ for offices. The amount depends on the type of real estate, the lease structure and term, and the location.

Lease Enhancement "GAP" Insurance: Gap insurance is required any time the tenant has a termination right in the event of a condemnation or casualty. For private placement transactions, only condemnation insurance is required if the tenant has a termination right for condemnation or casualty and the one-time cost is approximately 40 basis points of the loan amount. With a securitized CTL (conduit), <u>both</u> condemnation and casualty gap insurance is required and the total cost is nearly three times greater than for private placement CTLs. The cost of the gap insurance is a one-time cost paid at closing.

Separate Parcel: The collateral for a CTL transaction must have a separate tax parcel to qualify for CTL treatment. The property may be encumbered by a reciprocal easement agreement; however, if the maintenance expense reimbursements are not paid directly by the tenant; a reserve will be established.

Assignability: The tenant may have the right to assign its lease as long as it remains responsible for the obligations under the lease.

Self Insurance: Tenants often have self-insurance language in their leases. This can be acceptable if, in addition to a $100 million minimum net worth requirement, they have an investment-grade credit rating requirement. Sometimes with self-insurance language, the tenant does not carry all risk coverage. In that case, the landlord needs to obtain difference in coverage (DIC) coverage. This expense amount is a deduction in determining NOI for DSCR calculation.

Underwritten Expenses: With the exception of a marginal Annual Trustee/Servicer fee, no deductions are taken from the lease payments to arrive at cash flow available for debt service.

In the event the landlord has obligations under the lease, a management fee of .5 to 1.0% (depending on the size of the loan) is deducted along with a reserve to cover landlord obligations. If rent abates following a casualty and the tenant is not obligated to carry rent loss insurance, the landlord is required to purchase 12 month's rent loss coverage and the premium is deducted in arriving at net cash flow. The minimum DSCR for leases with landlord obligations is 1.05x.

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