CAPITAL LeaseFunding

The *Source* for Credit Tenant Lease Solutions

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Hot Buttons Earthquake Risk

Developers or buyers of net lease property in an earthquake area should understand how potential damage to the property resulting from an earthquake could impact their lease. High risk areas are designated seismic zones 3 and 4 by the Government and are found in: Alaska, Arkansas, California, Kentucky, Missouri, Oregon, Puerto Rico, South Carolina, Tennessee and Washington. While property owners on the west coast are often familiar with earthquake risk, it maybe overlooked in some eastern states where only a small portion of the state falls within these earthquake zones. Borrowers need to focus on two factors: the probable maximum loss (PML) in the event of an earthquake, and the impact such an event will have on the landlord's and tenant's obligations under the lease.

For properties within an earthquake zone, the lease must provide that the insurance on the property covers all-risk of loss or damage including an endorsement covering damage resulting from an earthquake. If a lease provides abatement or termination rights to the tenant in the event of an earthquake, the lease must specifically require that the tenant carry earthquake insurance at the tenant's expense.

Borrowers will need a PML study, which estimates the probable maximum damage from a maximum magnitude earthquake. The amount of expected damage is expressed as a percentage of replacement value. S&P specifies a PML of less than 20% for securitized loans, although many lenders require that it fall below 15%.

Weak and Uncertain Economic Outlook Undercut Real Estate Fundamentals

CLF briefed over 180 of its correspondents on the economy, real estate and net lease markets, and its plans for '03 at the MBA meeting in San Diego.

Against a backdrop of slow, erratic, economic growth in '02, 6% unemployment, depressed industrial sector, weak consumer confidence and the threat of war and terrorism, the outlook for '03 is uncertain at best.

CLF's '03 forecast is for 2.5%-2.8% GNP growth with a slow first half and stronger growth in the 2nd half. While industrial production and capital spending is expected to increase, unemployment will continue in the 6-6.2% range until the 2nd half. Growth in consumer spending, which benefited from several one time cash infusions (i.e., over $225 billion from home refinancing, $75 billion tax cut and record high debt), is likely to slow to 2.5%-2.7%. Interest rates are expected to rise in the second half with short term rates reaching 2.5-2.75% by year's end. Housing is likely to weaken with new home construction down 3%.

Overall commercial real estate fundamentals are expected to continue to weaken with rising vacancies, increasing costs and declining rents in many segments. Nonetheless, demand for real estate -especially net lease properties- is expected to remain strong as equity markets continue to be volatile and depressed. The net lease market in particular is expected to benefit from the new FASB synthetic lease regulations and the growing attraction of selling real estate as a cost effective means of raising capital. Net lease volume is expected to be in the $7.5 billion range.

"Event risk" is the biggest risk to net lease investors/borrowers. A good example of the consequences of "event risk" is the "fall" of Ahold Koninklijke. In Jan '02 Ahold was rated BBB+, and was every lenders "darling" and their corporate spread was 170 over. By summer earnings weakened and Ahold were put on negative outlook and rumors spread about possible accounting problems. Corp spreads widened to 230-240. In the fourth quarter Moody's downgraded Ahold two notches and S&P dropped them to BBB negative outlook. In February '03 accounting irregularities were announced. S&P downgraded Ahold to BB+ negative watch and Moody's lowered them to B1 from Baa3 negative watch. Ahold is being called Europe's Enron and can no longer be financed as a CTL.

While equity and debt capital will be adequate to support overall demand for net lease properties, full leverage CTL financing will continue to be credit and transaction selective with 20-year self amortizing loans available only for the strongest credits. For weaker credits with lease issues or shorter terms, CLF's proprietary 10 year CTL program will provide maximum leverage.

Credit Update

Ahold Koninklijke N.V. (BB+ negative watch) was downgrade by S&P from **BBB+** after the company announced accounting irregularities. (see adjacent article)

AT&T (BBB+) was put on **negative outlook** due to a steeper than anticipated decline in revenues in the 4th qtr and expected continued weakness in the company's business services segment in '03.

SBC Communications, Inc. (AA-) was put on **negative outlook** due to the loss of several retail lines to competitors and the weak economic outlook for '03.

Chubb Insurance Companies (AA+) was put on **negative watch** following the announcement by Chubb of several unexpected incremental 4th quarter charges for asbestos exposure and D&O liability.

Delhaize America, Inc. (BB+) was downgraded from **BBB-** due to disappointing cash flow protection measures which after the acquisition of Hannaford Bros. Co. deteriorated to pre '01 ratios.

May Dept. Store (A) was put on **negative outlook** following a continued trend of underperforming the already weak department store sector.

Perkin Elmer (BB+) was downgraded from **BBB-** due to weakening financial and operating performance.

"PreConstruction" Financing Program Launched

Press Release Attached

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