MOODY'S
INVESTORS SERVICE

SPECIAL REPORT

US CMBS: Defeasance Activity Increases As Commercial Real Estate Liquidity Improves

Table of Contents

2011 DEFEASANCE	2
DEFEASANCE BY PROPERTY TYPE	2
DEFEASANCE BY LOAN SIZE	3
DEFEASANCE BY YEARS TO MATURITY	4
DEFEASANCE BY VINTAGE	4
IMPACT OF DEFEASANCE ON CMBS CREDIT	5
MOODY'S RELATED RESEARCH	6

Analyst Contacts

Sandra Ruffin
Vice President–Senior Credit Officer
1.212.553.4074
sandra.ruffin@moodys.com

Tad Philipp
Director–CRE Research
1.212.553.1992
tad.philipp@moodys.com

Michael Gerdes
Managing Director
1.212.553.4776
michael.gerdes@moodys.com

Raymond Flores
Associate Analyst
1.212.553.7978
raymond.flores@ moodys.com

» contacts continued on the last page

MOODY'S CLIENT SERVICES:
New York: 1.212.553.1653
Tokyo: 81.3.5408.4100
London: 44.20.7772.5454
Hong Kong: 852.3551.3077
Sydney: 61.2.9270.8100
Singapore: 65.6398.8308

ADDITIONAL CONTACTS:
Website: www.moodys.com

In 2011, defeasance improved significantly over 2010, rising to its highest level since its peak in 2007.

Among the highlights of 2011 are the following:

» Defeasance of CMBS loans increased 76% to $4.9 billion from $2.8 billion in 2010.

» By balance, the largest shares of defeased loans were for multifamily, 31%, and office properties, 30%. Multifamily benefited from improved real estate fundamentals and additional financing options because of the availability of government-sponsored enterprise (GSE) debt. Most of the defeased office loans were located in major markets, including New York, Houston, Los Angeles and Washington DC, where valuations have improved and investor interest has focused.

» The ten largest defeased loans amounted to $1.6 billion or 33% of defeasance volume. The single largest was a loan on Chelsea Market, an office and retail building in New York City, with a $313 million loan balance, which constituted around 6% of activity.

» Most of the loans that defeased were originated between 2002 and 2005. These loans benefited from amortization and the recovery in valuations to levels comparable to or higher than those at securitization.

» By aggregate loan balance, 78% of the loans that defeased had remaining terms of two years or less. Given the high cost of defeasance, borrowers who only had to purchase replacement government securities for a relatively short period were responsible for the largest proportion of defeasance.

» Defeasance remains a positive credit factor in seasoned pools, but has had a limited impact on the performance of more recent deals, which have low levels of defeasance. Even for earlier vintage deals, classes with full protection from principal loss as a result of defeasance may still be subject to ratings migration because of interest shortfalls.

2011 Defeasance

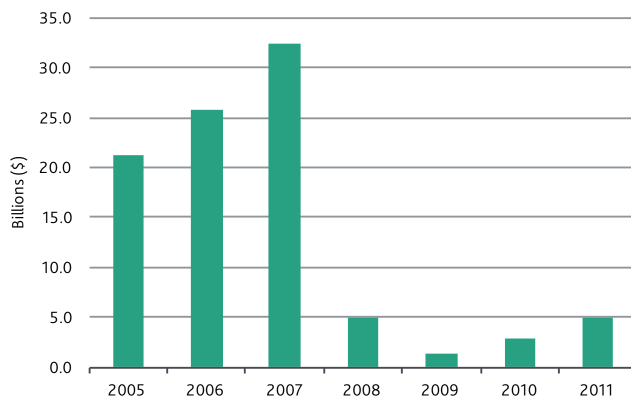
In 2011, defeasance increased 76% to $4.9 billion, from $2.8 billion in 2010. By loan count, defeasance increased 60% to 379 loans, from 237.[1]

Even with the dramatic increase, recent activity is still far below the levels of 2005 through 2007, as Exhibit 1 shows. The increase in 2011 was due to a rise in liquidity, a low interest rate environment, and an improvement in real estate fundamentals. New CMBS issuance and insurance company lending has picked up steam, making more commercial real estate financing available.

Fixed-rate loans originated for CMBS generally limit a borrower's ability to prepay a loan before maturity. Defeasance allows the borrower to refinance prior to maturity or to sell a property unencumbered by debt.[2]

EXHIBIT 1

Annual Defeasance, 2005-2011



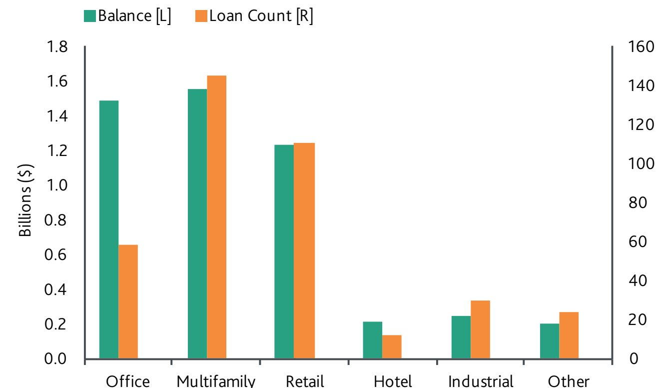
Source: Defeasance consultants

Defeasance by Property Type

By balance, the largest shares of defeased loans were for multifamily, 31%, and office properties, 30%, with retail, 25%, industrial, 5%, hotel, 4%, and other, 4%, following. By number of loans, multifamily still constituted the largest share, 38%, with retail, 29%, and office, 15%, following. Industrial represented 8%, hotel, 3%, and other, 6%, as Exhibit 2 shows.

EXHIBIT 2

2011 Defeasance by Property Type[3]



Source: Defeasance consultants

The distribution of defeasance by property type varies over time because of changes in investor appetite, borrower motivation, liquidity, and financing opportunities. In 2011, multifamily and office constituted the largest shares by balance, reflecting the improved fundamentals in these markets. Significant liquidity in the multifamily lending markets, where myriad lenders exist, including major GSEs Freddie Mac and Fannie Mae, resulted in multifamily constituting the largest share of defeasance by both balance and loan count.

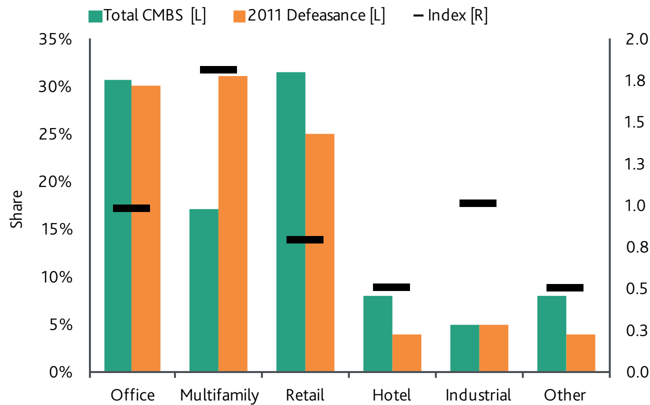
The defeasance of multifamily loans is disproportionate to the segment's share in the CMBS universe. Exhibit 3 indexes defeasance by property type to the share of each in the CMBS universe. Loans on multifamily properties constituted the largest share of defeasance, at 31%, while multifamily loans constituted only 17% of the CMBS universe. In other words, defeasance on multifamily properties was 1.8 times greater than it was for the overall CMBS universe.

Office constituted 30% of defeasance, fairly consistent with its 31% share of the CMBS universe. Retail constituted 25%; its share of the CMBS universe was 32%. Defeasance on retail properties was 0.8 times less than it was for the overall CMBS universe.

EXHIBIT 3

2011 Defeasance Indexed to CMBS Universe, by Property Type

Outstanding CMBS balance as of December 2011



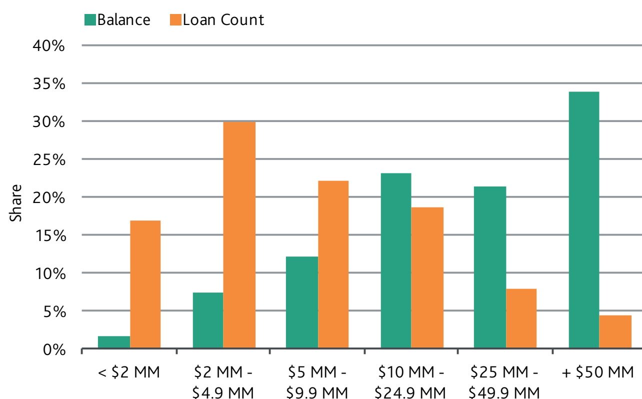
Source: Defeasance consultants and Trepp LLC

Defeasance by Loan Size

By number, approximately 47% of loans that defeased in 2011 had balances of less than \$5 million, but constituted only 9% of aggregate defeasance. Loans of \$50 million or greater constituted 34% of aggregate defeasance but just 4% of the number of defeased loans, as Exhibit 4 shows. The distribution by loan size was consistent with that of previous years, in that most of the loans had an outstanding balance of \$10 million or less at defeasance.

EXHIBIT 4

2011 Defeasance by Loan Size



Source: Defeasance consultants

Exhibit 5 shows that the ten largest defeased loans constituted approximately 33% of overall volume. Borrowers defeased for a variety of reasons; for example, to facilitate refinancing at more favorable rates, sale of a property, or repositioning of a portfolio.

EXHIBIT 5

Top 10 Defeased Loans in 2011

Property Name	Location	Property Type	Vintage	Balance at Defeasance (\$)
Chelsea Market	New York, NY	Office	2003	312,906,274
Hometown America Portfolio[4]	Various	Manufactured Housing	2004	301,465,758
Four Allen Center	Houston, TX	Office	2006	240,000,000
Starrett-Lehigh Building	New York, NY	Office	2004	165,095,457
Baltimore Multifamily	Various	Multifamily	2005	156,000,000
Cars Chauncey Ranch	Phoenix, AZ	Retail - Automotive	2007	120,000,000
205 East 42nd Street	New York, NY	Office	2002	90,174,081
Extendicare Portfolio II	Minerva, OH	Health Care	2007	86,538,391
E Walk on the New 42nd Street	New York, NY	Retail	2005	77,500,000
Summit Hotel Portfolio	Various	Hotel	2005	76,258,570

Source: Defeasance consultants

The largest defeasance was Chelsea Market, an office and retail building in New York City, with a \$313 million balance that accounted for around 6% of 2011 activity. Jamestown Properties bought out its equity partners to obtain full ownership of the property and then recapitalized it with a new \$380 million loan.

The second-largest was Hometown America, which consisted of 35 manufactured housing communities located throughout the US and had a \$301 million balance. This defeasance comprised nine separate loans and accounted for around 6% of activity. Equity LifeStyle Properties Inc. and American Manufactured Communities purchased the portfolios as part of two acquisitions of 92 properties.

The third-largest was Four Allen Center, an office building in Houston, with a \$240 million balance that accounted for around 5% of activity. Chevron Corporation, the sole tenant of the building, purchased the property for around \$380 million.

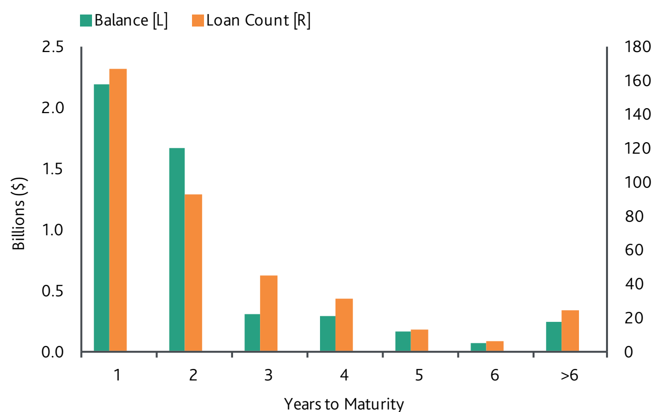
Defeasance by Years to Maturity

By aggregate balance, 78% of the loans that defeased in 2011 had remaining terms of two years or less; only 10% had remaining terms of five years or more, as Exhibit 6 shows. By loan count, 69% had remaining terms of two years or less, while 11% had remaining terms of five years or more.

Given the high cost of defeasance and modest real estate appreciation, borrowers who had to only purchase replacement government securities for a relatively short period of time were responsible for the largest share of defeasance. Several loans defeased even though they matured within a few months because the borrower wanted the assurance of locking in a favorable refinancing rate. Other loans defeased to accommodate a property sale. Because of short remaining loan terms, prospective owners wanted the ability to refinance for a five or ten year term rather than assume the existing short-term debt.

EXHIBIT 6

2011 Defeased Loans by Years to Maturity



Source: Defeasance consultants

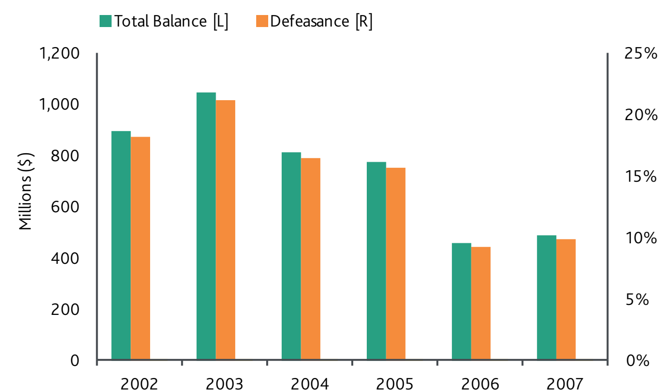
Defeasance by Vintage

Because of REMIC regulations, defeasance cannot take place until after the second anniversary of the start date of a CMBS transaction. Thus, no defeasance took place in any of the deals from 2010 and 2011. Exhibit 7 shows that most of the loans that defeased in 2011 were originated between 2002 and 2005. These loans benefited from collateral appreciation or less value loss than loans from more recent vintages. Furthermore, these loans had shorter periods to maturity, and in many cases lower market interest rates than in-place contract rates, which lowered the cost of defeasance.

Loans originated between 1996 and 2001 constituted only 8% of all 2011 defeasance by balance; those originated between 2006 and 2009, 20%.

EXHIBIT 7

2011 Defeasance by Vintage



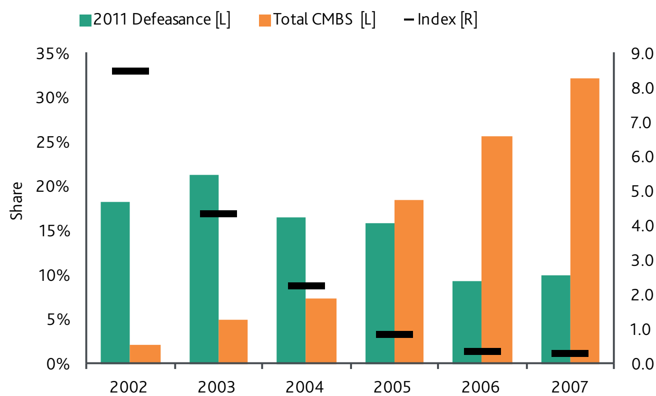
Source: Defeasance consultants

Exhibit 8 indexes 2011 defeasance by vintage to the share of each in the non-defeased CMBS universe. For example, loans originated in 2003 constituted the largest share of 2011 defeasance, 21%, even though the 2003 vintage constituted only 5% of the CMBS universe. Defeasance of 2003 vintage loans in 2011 was 4.4 times greater than its share of the CMBS universe. The 2002 and 2004 vintages had index values well above one; the 2005, 2006 and 2007 vintages had index values of less than one.

EXHIBIT 8

2011 Defeasance Indexed to CMBS Universe, by Vintage

Outstanding Non-Defeased CMBS Balance as of December 2011



Source: Defeasance consultants and Trepp LLC

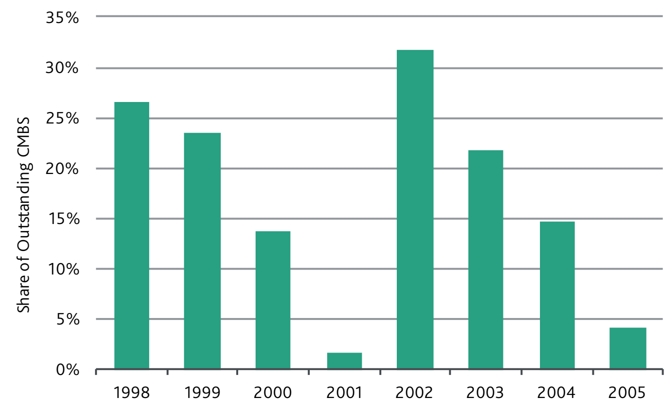
Impact of Defeasance on CMBS Credit

Defeasance remains an important factor in CMBS credit because it dramatically reduces the risk of the loss of principal and interest associated with real estate assets, by substituting Aaa-rated US government securities for real estate collateral of lower credit quality. However, the amount of defeasance, and hence the benefit to CMBS credit, varies significantly by vintage and deal. For example, more than 30% of the 2002 vintage has defeased, which makes for a significant boost to credit, but only 5% of the 2005 through 2008 vintages has, as Exhibit 7 shows. Defeasance in many early vintage deals is high, which protects the most senior outstanding classes against principal loss, but these classes are still subject to interest shortfalls stemming from specially serviced loans.[5] As a result, even classes with full protection from principal loss stemming from defeasance may still be subject to ratings migration, because of interest shortfalls.

EXHIBIT 9

Cumulative Defeasance by Vintage

As of December 2011



Source: Trepp LLC

Moody's Related Research

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions please refer to the following reports:

Special Reports:

» U.S. CMBS: Strong Property Appreciation Fuels Defeasance, March 2007 (SF94356)

» U.S. CMBS 2007 Defeasance Activity Sets New Record Despite Midyear Slowdown, March 2008 (SF125196)

» US CMBS and CRE CDO Surveillance Review: Q2 2010 August 2010 (SF215204)

» U.S. CMBS: Defeasance Activity Picks Up As Commercial Real Estate Liquidity Improves, May 2011 (SF243635)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

[1] Data for this study came from advisory firms involved in the defeasance process, including AST, Bank of America, Chatham Financial, Commercial Defeasance, Trimont Real Estate Advisors, Waterstone Capital Advisors and Wells Fargo.

[2] Defeasance allows a borrower to substitute the real estate collateral securing a mortgage loan with a portfolio of US Government securities sufficient to satisfy all debt service payments, including the balloon payment upon maturity. The mortgage loan remains in the trust, the real estate that originally served as collateral for the loan is released and the certificate holders receive an uninterrupted Aaa payment stream from the defeased mortgage loan.

[3] "Other" category includes Health Care, Mixed-Use and Self-Storage property types.

[4] The Hometown America Portfolios consist of nine separate notes in four CMBS deals. For this report, we treated the notes as one because the entire defeasance facilitated a portfolio sale.

[5] Interest shortfalls occur when the interest available is insufficient to pay 100% of the interest due on all the certificates. Interest shortfalls are due to special servicing fees, including workout and liquidation fees, appraisal subordinate entitlement reductions (ASERs), loan modifications, extraordinary trust expenses and non-advancing by the master servicer based on a determination of non-recoverability.

Report Number: SF280240

© 2012 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Any publication into Australia of this document is by MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657, which holds Australian Financial Services License no. 336969. This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001.

Notwithstanding the foregoing, credit ratings assigned on and after October 1, 2010 by Moody's Japan K.K. ("MJKK") are MJKK's current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. In such a case, "MIS" in the foregoing statements shall be deemed to be replaced with "MJKK". MJKK is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO.

This credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be dangerous for retail investors to make any investment decision based on this credit rating. If in doubt you should contact your financial or other professional adviser.

MOODY'S
INVESTORS SERVICE