

# Commercial Real Estate Single-Asset Single-Borrower Credit Rating Methodology

This methodology provides a description of Transparency Analytics, Inc.'s (TA) criteria for assigning credit ratings to commercial real estate (CRE) transactions for concentrated asset pools. The methodology applies to single-asset CRE transactions or single-borrower transactions with multiple CRE assets (SASB), and transactions collateralized by less than 10 loans.

TA's credit rating process consists of property-level analysis, loan-to-value (LTV) analysis, and review of structural considerations.

**Property-Level Analysis.** TA evaluates property-level net cash flow (NCF) available to service rated debt. The assessment of NCF is performed from the credit perspective to reflect the property's sustainable performance over the term of the debt without reliance on growth assumptions except if contractually supported. Adjustments are made to reflect market rates and sustainable levels of rent and other income, vacancies and expenses.

**Loan-to-Value Analysis.** TA evaluates property value based on derived NCF and assumed cap rate. Stressed cap rates are used to reflect a credit discount to market levels and to account for the refinancing risk present in SASB transactions. Selection of the cap rate is based on CRE asset category and individual asset considerations including market quality, asset quality, lease portfolio quality, profitability and liquidity. The resulting asset value and the contemplated debt amount are used to calculate the Initial LTV.

**Structural Considerations.** TA considers the credit effect of any transaction characteristics that may differ from typical SASB transactions. Key areas include diversification, reserves, additional leverage, amortization, collateral considerations and legal considerations. If warranted, TA makes appropriate adjustments to the Initial LTV to derive the Final LTV.

The Final LTV level is used to determine the credit rating for the debt instrument based on stated LTV threshold ranges applicable for the specific credit rating categories, as outlined in the methodology.

Corporate debt securities issued by companies engaged in ownership and operation of commercial real estate (such as REITs) that are not linked to individual properties are rated under the Corporate Credit Rating Methodology.

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**I. OVERVIEW OF METHODOLOGY**

Table 1 summarizes factors considered by TA to assign credit ratings to CRE single-asset single-borrower transactions.

**Table 1**  
**Commercial Real Estate Single-Asset Single-Borrower Credit Rating Methodology**  
**Credit Rating Assessment Summary**

<b>Property-Level Analysis (Section II)</b>	
Derivation of Net Cash Flow (NCF) Market/Sustainability Adjustments	<b>Sustainable Net Cash Flow (NCF)</b>
<b>LTV Analysis (Section III)</b>	
Determination of applicable stressed cap rate Derivation of TA estimated property value Derivation of Initial Loan-to-Value	<b>Initial Loan-to-Value</b>
<b>Structural Considerations (Section IV)</b>	
Evaluation of structural considerations Adjustments to Loan-to-Value	<b>Final Loan-to-Value</b>
<b>Derivation of Credit Rating Based on Final Loan-to-Value (Table 2)</b>	<b>Assigned Credit Rating</b>

Table 2 summarized Final Loan-to-Value threshold ranges applicable for credit rating categories.

**Table 2**  
**Commercial Real Estate Single-Asset Single-Borrower Credit Rating Methodology**  
**Final Loan-to-Value Credit Rating Threshold Ranges**

Rating Category	Final Loan-to-Value Range
AAA	≥40%
AA	40%-50%
A	50%-60%
BBB	60%-75%
BB	75%-85%
B	85%-95%
CCC	95%-110%
CC	>110%

This methodology document describes TA’s approach to factors used to derive credit ratings for CRE single-asset single-borrower transactions.

**Section II:** Property-Level Analysis

**Section III:** LTV Analysis

**Section IV:** Structural Considerations

**II. PROPERTY-LEVEL ANALYSIS**

Property-level analysis focuses on deriving the long-term sustainable level of net cash flow (NCF) expected to be generated from the commercial real estate property, assessed from the credit perspective. Table 3 summarizes the derivation of NCF.

**Table 3**  
**Sustainable Net Cash Flow (NCF) Derivation**

	Contractual Rent Income
<i>Plus</i>	Other Income
<b>Equals</b>	<b>Potential Gross Income</b>
<i>Minus</i>	Vacancy Factor Adjustment
<i>Minus</i>	Market / Sustainability Adjustment
<b>Equals</b>	<b>Effective Gross Income</b>
<i>Minus</i>	Operating Expenses
<b>Equals</b>	<b>Net Operating Income</b>
<i>Less</i>	Capital Costs
<b>Equals</b>	<b>Property Sustainable Net Cash Flow (NCF)</b>

**Contractual Rent Income:** Contractual rent income generally includes signed leases for which all landlord obligations with respect to delivery of the space are satisfied, tenant is in occupancy of the space, tenant is paying rent and operating its business. In certain cases, signed leases not yet in occupancy can be included if commencing in the near future and no contingencies allow the tenant to cancel the lease. Contractual rent increases within market ranges occurring within 12 months can be included for tenants with strong credit quality. Free rent periods, renewal options tied to market rates, cancellation clauses and co-tenancy clauses are considered. Month-to-month space is treated as vacant. Master leases are included if rents are in line with the market, space is suitable for alternative use, and a business case exists for the owner to operate the business at the property.

**Other Income:** Other income can include parking income, storage income, amenity income, antenna rents, billboard/signage rents, and income from miscellaneous tenant services. Other income is included based on historical collection levels or current budget assuming a normalized level of occupancy. One-time collections or non-real estate related income are excluded.

**Vacancy Factor Adjustment:** Vacancy factor adjustment to reduce gross income is determined based on actual vacancies, submarket vacancy rates, and tenant-specific considerations. Credit quality of the tenants is an important consideration influencing assumed vacancy factor, and individual tenant profitability relative to occupancy costs can be evaluated to ascertain sustainability. Tenants that pay rent but are no longer operating (dark) or are subject to bankruptcy proceedings are considered vacant.

**Market/Sustainability Adjustment:** In-place rent rates are compared to current and anticipated market levels to determine if any leases are at above-market rates. Rent rates above market averages are generally adjusted down to the average at a factor of 110% due to tenant stickiness and market rate variability. For properties deemed to have above-average quality or location commanding a consistent rent premium as evidenced by leasing history, a premium over market averages can be recognized. Leases signed within the last two years are considered market. Long-term leases may not be subject to market adjustment depending on tenant credit quality and lease terms.

**Operating Expenses:** Operating expenses include fixed expenses such as ground rent, insurance and real estate taxes, and variable expenses driven by occupancy such as maintenance, utilities and management fees. Operating expenses are derived based on historical levels or current budgets, assuming a normalized level of occupancy. Real estate taxes can be adjusted to market levels from current assessed levels in certain situations. Management fees are captured at the greater of contractual fee and market rate. Ground rent is captured at average expense payable over the term of the loan, and evaluated to ensure availability through the term of the loan and a refinance at maturity.

**Capital Costs:** Capital costs include maintenance, tenant improvement (TI) allowances, and re-leasing costs. Maintenance costs are based on the greater of engineer report requirements and minimum thresholds. TI allowances are based on historical and market rates. Re-leasing costs are based on market leasing commissions, tenant retention ratio, average lease term and market rents.

**III. LOAN-TO-VALUE ANALYSIS**

Loan-to-Value (LTV) analysis derives the Initial Loan-to-Value ratio based on the NCF derived in the property-level analysis, an assumed stressed cap rate, and the level of debt incurred. Tables 4 and 5 provide a summary of the calculation of Initial LTV.

**Table 4**  
**Metric Derivation: Property Value**

	Net Cash Flow (NCF)
<i>Divided by</i>	Stressed Cap Rate (%)
<b>Equals</b>	<b>Property Value</b>

**Table 5**  
**Metric Derivation: Loan-to-Value Ratio**

	Debt Balance
<i>Divided by</i>	Property Value
<b>Equals</b>	<b>Loan-to-Value Ratio (%)</b>

For property valuation from the credit perspective, stressed cap rates that are higher than observed market cap rates are used. Stressed cap rates reflect a conservative discount to market and account for the refinancing risk present in most SASB transactions. SASB transactions often do not have material amortization requirements during the life of the loan and rely on refinancing for repayment at maturity, and a stressed cap rate accounts for the possibility of higher market cap rates at maturity. Application of stressed cap rates results in valuations below market benchmarks such as property appraisals. Table 6 shows stressed cap rate ranges applied by TA for CRE property categories. For less common property types, cap rate range of most similar category is used.

**Table 6**  
**TA Cap Rate Ranges Applicable for Commercial Real Estate Asset Categories**

CRE Asset Category	Cap Rate Range
Regional Mall	6.0% - 11.0%
Multifamily	5.5% - 9.5%
Retail	6.0% - 10.0%
Industrial	6.5% - 10.5%
Office	6.0% - 10.0%
Lodging	7.0% - 12.0%
Self-Storage	7.0% - 11.0%

Key factors considered by TA in determining the specific stressed cap rate level to be applied for the valuation of a particular property within the range for the asset category are summarized below.

**Market Quality:** Key considerations include market macroeconomic conditions, market demographic and societal trends, demand environment for comparable properties in the market, supply and zoning dynamics for comparable properties in the market, and regulatory and tax considerations in the market.

**Asset Quality:** Key considerations include property location, differentiation of the property in its market, quality of construction, property age, functional characteristics, available amenities, maintenance requirements, efficiency and sustainability characteristics, and quality of management and leasing. Stronger asset quality generally translates into greater ability to command strong rent rates, higher occupancy rates, and higher quality of tenant base. Transitional properties generally receive a valuation discount, with magnitude dependent on the perceived risk of the plan.

**Lease Portfolio Quality:** Key considerations include credit quality of the tenants, concentration of the tenant base and associated renewal risk, average term of the leases, and occupancy and renewal rate trends. A higher quality lease portfolio implies a greater level of stability of NCF generation, therefore commanding a valuation premium.

**Profitability:** Key considerations include the operating leverage rate of the property and variability in operating leverage over time. Properties with lower operating leverage (i.e. higher profitability) are better able to withstand adverse market conditions and revenue declines, which implies greater stability of NCF generation and commands a valuation premium.

**Liquidity:** Key considerations include property prominence among tenants, buyers and financing providers, and efficiency of the property market enabling buying and selling of properties. High-quality properties in attractive markets with significant recognition receive a valuation premium, as do properties with readily available financing alternatives from multiple financing sources.

**IV. STRUCTURAL CONSIDERATIONS**

Property-level and LTV analyses outlined in Sections II and III of this methodology are based on certain base case assumptions regarding the nature and structure of the rated transactions. To the extent a transaction has certain characteristics important to credit analysis that differ meaningfully from the base case assumptions, adjustments must be made to account for the differences. The Initial LTV is adjusted up or down from the level derived in Section III, deriving the Final LTV level used to assign the credit rating based on Table 2. Table 7 provides a summary of potential LTV adjustments.

**Table 7**  
**Potential LTV Adjustment Categories**

Structural Consideration	LTV Adjustment Direction
Diversification	Positive
Reserves	Negative
Additional Leverage	Negative
Amortization	Positive
Collateral Release/Substitution	Negative
Loan-Level Legal Document Review	Negative

**Diversification:** Base case LTV benchmarks assume limited diversification of NCF-generating assets in a SASB structure. If a debt instrument rated under this methodology is collateralized by several assets with uncorrelated financial performance, it can be deemed to benefit from credit-positive diversification. If diversification is deemed to be materially higher than average for credits rated under this methodology, a positive adjustment is applied to LTV. Magnitude of adjustment can range from 1% to 10%.

**Reserves:** Base case LTV benchmarks assume an appropriate level of reserves. In situations that are deemed to have potential for operational disruption or capital needs, upfront reserves may be deemed necessary to cover anticipated expenses for capital investment, tenant improvement, or leasing costs for a certain time period. If available reserves are viewed as insufficient, a negative adjustment can be applied to LTV. Magnitude of adjustment can range from 1% to 10%.

**Additional Leverage:** Base case LTV benchmarks assume no additional debt obligations supported by the properties. If NCF generated by the properties is used to service subordinated or mezzanine debt in addition to the SASB loan, the credit risk of the SASB loan is inherently higher despite the subordination of the additional debt tranches, and a negative adjustment is applied to LTV. The magnitude of the adjustment depends on the quantity of the additional debt, the type of debt (secured or unsecured), and degree of capital structure complexity.

**Amortization:** Base case LTV benchmarks assume limited to no amortization, as prevalent in SASB loans. Presence of amortization requirements is viewed as credit-positive because it results in decreasing property leverage over time, and a positive adjustment is applied to LTV. The magnitude of the adjustment depends on amount of amortization and sufficiency of the resulting DSCR ratio.

**Collateral Release/Substitution:** Base case LTV benchmarks assume that the entire collateral pool at inception continues to support the rated debt instrument through its maturity. If the loan documents allow specific collateral to be released by paying an allocated loan amount, a possibility is created of better-performing properties leaving the structure and weaker-performing properties remaining. Similarly, if a borrower is able to substitute collateral, a possibility of erosion of collateral quality is created. While specifics of transaction terms can have a significant effect on the outcome, a negative adjustment can be made to LTV. Such negative adjustment can offset a positive adjustment for portfolio diversification.

**Loan-Level Legal Document Review:** Base case LTV benchmarks assume a typical SASB legal structure. If transaction legal structure increases perceived risk compared to typical structure, a negative adjustment can be made to LTV. Key considerations include:

- True sale and bankruptcy-remote SPV, limited purpose borrower
- Separateness covenants, non-consolidation
- Lockbox and cash management agreement
- Additional debt considerations, e.g. intercreditor agreement terms
- Collateral considerations, e.g. lender protections in ground lease