

CMBS / Japan
Servicer Report

Capital Servicing Co., Ltd.

Rating

Special Servicer CSS2- (JPN)*

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■ Summary

Fitch Ratings (Fitch) recently upgraded the commercial mortgage special rating of Capital Servicing Co., Ltd (CSC) from 'CSS3+(JPN)' to 'CSS2-(JPN)' to reflect the positive developments in the servicer's business and financial standing since the initial rating, and also that CSC has addressed the agency's concerns raised in the initial review. The rating also takes account of the servicer's strengths and Fitch's concerns in terms of its operations, as listed below.

■ Strengths

- Strong commitment from Lehman Brothers (Lehman)
- Comprehensive policies and procedures, as well as favourable internal audit results
- Steady growth and diversification in servicing assets
- Satisfactory recovery results
- Improved IT system

■ Concerns

- Due to significant growth in 2002, nearly half of the servicer's staff were hired in 2002
- In-house training focuses more on soft skills than on hard skills

■ Mitigating Points

- Many of the new staff in key positions worked with CSC staff prior to joining CSC, thus reducing their settling in period or need for adjustment at the servicer. In addition, the solid internal audit result indicates that despite the hiring of new staff, the servicer maintains good internal control.
- While the servicer has not focused on staff training in the past, it is one of their top priority items for 2003.

■ Company Overview

CSC is a Japanese licensed servicer whose primary business is to service Lehman's Japanese NPL and real estate portfolios. Since Fitch's last review, the scope of CSC's collaboration with Lehman has expanded, particularly in the areas of 1) management of Japanese non-performing loan portfolios, 2) REO sales and management, 3) assistance in asset management of Lehman's real estate investment properties, 4) servicing as the master and special servicer for the Lehman sponsored Daito RMBS securitisation and 5) assumption of full responsibility for Lehman's Asian loan servicing platforms in Japan, South Korea, Thailand and Taiwan. However, CSC's primary business continues to be servicing Lehman Brothers' Japanese non-performing loan portfolios.

The corporate organisational structure of Glenfoot Services Ltd (CSC's majority owner) has slightly changed, but this has had only a marginal effect on CSC. For example, Glenfoot now directly owns CSS, rather than through its subsidiary, and it has established Capital Realty (Japan) YK to service hard assets and GCRE (Japan) to handle due diligence. The latter was created by spinning off the due diligence section from CSC.

Portfolio Statistics (For NPL Only)

(JPYm)	Loan Amount (UPB)	No. of Borrowers
Total Loans Serviced (Since Inception to 31 Oct 2002)	1,772,270	5,170
Disposition amount	Since Inception Through Oct 2002	11 Months Through Oct 2002
Types of Resolution by Disposition Amount (%)	43,583	11,691
Voluntary sales	24	32
Foreclosure	41	23
DPO-loan sold	6	4
Loan-sold	5	4
Bankruptcy proceeds	6	10
REO proceeds	4	5
Repayment from borrowers, etc.	10	15
Other	5	7

Source: Capital Servicing Co., Ltd.

The total volume of assets serviced by CSC has expanded considerably and the legal balance of serviced NPL assets has grown to JPY1.41 trillion as of 31 October 2002 from JPY1.06trn as of a year earlier. The servicer added 47 new NPL portfolios with a UPB of JPY493 billion in 2002.

The variety of assets serviced by CSC has changed slightly. In 2002, CSC started servicing performing commercial mortgage loans as well as backup servicing for securitisation. However, non-performing commercial mortgage loans remain by far the most dominant asset category in terms of the target collection amount.

Financials Overview

Glenfoot Services, which is 90% owned by Hatfield Philips, maintains a 75% stake in CSC, while a private company owned by CSC's representative director holds the remaining 25%. Fitch rates Hatfield Philips as CPS2 and CSS2. Lehman Brothers Holding, Inc., to which Hatfield offers an exclusive loan servicing, is rated 'A+/F-1' by Fitch.

CSC has experienced two consecutive years of revenue growth and positive net income. With the

increase of serviced assets, revenue increased to JPY735m in FY2002 ended November 2002 from JPY507m of a year earlier. Net income also rose from JPY21m to JPY75m. During the same period, CSC has managed to maintain personnel expenses at a reasonable level. In view of the nature of the present business, Fitch does not think CSC has any immediate need for capital, and its financial condition appears satisfactory.

Employees

As of November 2002, CSC had 39 employees, nine more than a year earlier. There were three executive/legal staff (unchanged from a year earlier), 13 (up from nine) in asset management, four (up from two) in REO management, five (unchanged) in loan administration, two (up from one) in IT and 12 (up from 10) in finance/accounting/general administration. CSC hired 19 people in 2002, 14 to fill newly created positions, four to replace employees who had left the company, and one to replace a controller who transferred to a sister company in Thailand.

The new additions have strengthened various areas of operations at CSC. Notable improvements include: 1) a new CFO/board member, with 15 years of industry experience; 2) REO management increased by two; 3) the accounting and IT departments added seasoned professionals, and 4) the asset management department hired a legal process manager to assist in the processing of legal matters and a valuation analyst to enhance management and asset level reporting.

In order to assist newly hired staff to easily adjust to the company's systems, CSC established a mentor programme whereby the new employee is assisted by a current employee to integrate into the company. In addition, in an attempt to create a friendly atmosphere, the servicer publishes a monthly company news letter, which provides information, such as anniversaries, details of forthcoming parties and events, names of newly joined employees and other noteworthy matters, such as articles written by employees and/or published in related professional journals.

While the additional staff strengthened various areas of CSC's operations, it inevitably created an increased need for internal control and to assist the effective adjustment of new staff to the CSC environment. However, it would appear that adequate internal control has been maintained, as evidenced by the clean audit results.

The asset management department, whose primary task is to manage non-performing commercial-mortgage loans, consists of seven senior asset

managers, two junior asset managers, two assistants and one valuation associate, and is supervised by a head senior asset manager. Senior managers have an average related-industry experience of 16 years, workout experience of five years and real-estate experience of four years. Their average tenure with CSC is 16 months. Junior managers' experience averages nine years in related industries and five years in workout.

The level of staff training in 2002 was reduced from that of 2001. However, for 2003 CSC has targeted training as an area requiring improvement and the company is scheduling more than 40 hours of training in NPL valuation, workout laws, real estate pricing and IT. During the 12 months to October 2002, asset managers received, on average, less than 15 hours of in-house training (excluding English lessons), primarily on IT skills, investment analysis and business plans/approval memos. CSC also offers a tuition reimbursement programme. Weekly asset manager meetings also serve as training for asset managers, during which the portfolio manager discusses case memos.

■ Policies and Procedures

CSC has enhanced its policies and procedures (P&P) in the areas of corporate approval process and suspense account documentation. P&P manuals were already in place as of the last review: (1) portfolio policy and administration policy (2) accounting (3) human resources (Japanese and English) and (4) general affairs and IT in place. The manuals are on-line and accessible to all employees. The manuals are updated semi-annually with all updates reviewed by middle and senior management with credit committee oversight if applicable. The manuals are systems protected and unauthorised alterations are impossible.

The servicer continues to maintain appropriate internal control. Since the last review, two audits have been carried out: 1) an annual financial audit and agreed upon procedure by Lehman and 2) a quarterly internal audit. Shin Nihon & Co. performed the financial audit for the fiscal year ended November 2001 and reported that the financial statement fairly presented the financial position of the company. Lehman's external auditor, Ernst & Young, conducted a review of CSC's compliance with the 2002 servicing agreement as an agreed upon procedure, and found no material exceptions. The result of the first quarterly internal audit in 2002 noted no material diversions from guidelines.

■ Technology

Last year, for NPL servicing, CSC used an internally-developed, Access-based servicing system called "Japan CMA data base". Since that time, the

servicer has enhanced its capability by introducing ITFOR's Total Collection System (TCS) for non-performing loans and Sorun Loan IV for performing loans. TCS is a well known servicing system, which utilises the Oracle database, to track loans, collateral, borrowers, guarantor's information and collection history. It can also record borrower contact logs and document tracking.

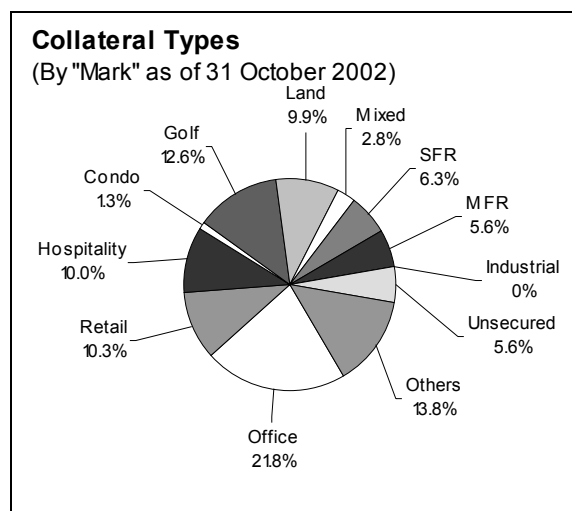
At the current review, system integration is in progress, with CSC utilising both TCS and CMA as asset management systems. As part of their system integration, CSC plans to construct a warehouse where all data from TCS, CMA and other systems can be stored and managed in one database. The target completion date for this project is September 2003.

With the expansion and development of the new system, two new experienced IT staff were recruited. The new Chief Information Officer has 15 years of related experience in the financial service business, including several years with another servicer. The newly hired IT project manager has 10 years of related industry experience.

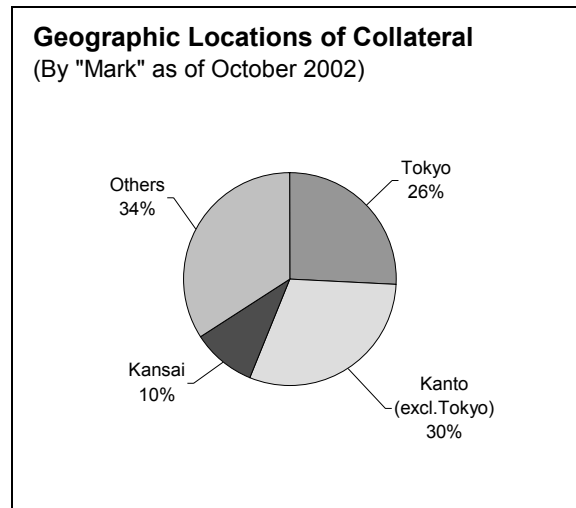
Concerning the system's capacity, backup procedures, disaster recovery and reporting capability, CSC's performance is satisfactory.

■ Special Servicing

Since the last review, CSC has steadily increased its level of servicing assets. Between inception in September 1999 and end-October 2002, CSC serviced NPL loans (both secured and unsecured) that totalled JPY1,772bn in UPB and 5,170 borrowers. This represents a 40% and 53% increase from a year earlier, respectively. Lehman's active involvement in the NPL market accounts for the increase.



CSC's total cumulative collection since inception amounted to JPY43.6bn (compared with JPY31.9bn as of year-end 2001.) Of the total collection, JPY38.5bn (88%) was generated by servicing secured NPLs. CSC has serviced all loan pools purchased by Lehman, with one exception.



CSC sharply decreased the resolution utilising foreclosures, as it acquired an adequate number of AMs. Compared to 43% of collections realised through foreclosures in 2001, the 2002 figure was reduced to 23%, a level close to common industry standards. Fitch views this as an improvement, since the percentage over the target mark attained is higher for voluntary sales than for foreclosures. During the 11 months prior to end-October 2002, CSC's resolution consisted of: 32% by voluntary sale, 23% by foreclosures, 15% by repayment from borrowers/guarantors, 10% by bankruptcy proceeds, and 20% from others, including DPO, loan sales and REO disposition.

CSC appears to have achieved an adequate recovery rate, as suggested by its ability to surpass the target mark set by Lehman for recovery. The information Fitch has received on IRR, as well as the ratio of realised collection to the purchase price of CSC managed portfolios, is consistent with this observation.

CSC has improved the handling of its business plan. This year, the servicer formulates 75% of all assets compared to the top 20 largest assets per AM of last year. AMs review the plan semi-annually, together with relevant Lehman staff.

The number of active assets serviced by each asset manager averages approximately 40. Fitch considers this workload to be a manageable level.

This year, CSC has created a new position designated as a 'legal process coordinator'. Under the supervision of the staff lawyer, the coordinator monitors foreclosure procedures and prepares the documents required. Foreclosure status is tracked by the CMA database. The president, the portfolio manager and the auditor review the weekly foreclosure report produced by the systems.

Since the last review, the REO department's staff has increased to four from two. Two senior members of the department are highly experienced with 28 years of combined real estate development experience. This year the department managed 37 properties/lots, selling or closing 26. According to CSC, the REO disposition proceeds and timing exceeded the expectations of CSC and Lehman. The monthly property status reports for REO include information on rent rolls, cash flows and bank accounts.

CSC's performance has remained satisfactory in respect to initial loan set up, investor reporting document management and expense control.

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