

CMBS/Japan Servicer Report

Capital Servicing Co., Ltd.

Rating

Special ServicerCSS2 (JPN)*

* Japan

Analysts

Tokyo

Kazuhiko Kaneko

+81 3 3288 2605

kazuhiko.kaneko@fitchratings.com

Yumiko Sugii

+81 3 3288 2701

yumiko.sugii@fitchratings.com

New York

Diane Pendley

+1 212 908 0777

diane.pendley@fitchratings.com

Company Contact

Capital Servicing Co., Ltd.

Carl N. Everett

+81 3 6439 7600

■ Summary

Fitch Ratings recently upgraded the commercial mortgage special servicer rating of Capital Servicing Co., Ltd (“CSC”) to ‘CSS2_(JPN)’ from ‘CSS2-_(JPN)’. The upgrade was primarily based on improvements in the company’s organisational structure following an increase in the number and the diversity of assets in its portfolio. Fitch also noted gains in asset management efficiency resulting from the introduction of a new IT system, as well as improved internal auditing through the use of specialist staff.

CSC’s structure is now based on functional sections, for each of which the company has hired experienced section heads. This arrangement has strengthened middle management, which Fitch views as a positive step. However, given the short tenure of these middle managers at the company, Fitch will continue to monitor how the organisation and structure progress.

Between its inception in December 1999 and end-April 2004, CSC serviced non-performing loans (“NPL”) with a total cumulative unpaid principal balance (“UPB”) of JPY2,259 billion, corresponding to 4,006 borrowers. The company has also acted as a primary servicer for many securitised loan assets, particularly in the past two years.

■ Rating Committee Highlights

Strengths

- Strong commitment and support from Lehman Brothers
- A flexible and well-integrated IT system specifically designed for asset management
- Frequent and thorough internal audits
- Growth and diversity of serviced assets supported by a larger staff base
- Steady increase in profitability

Concerns

- New department heads and many new employees
- Relatively high turnover of asset managers

Mitigating Factors

- Newly employed heads of section have long industry experience, and have held similar positions at other servicers prior to joining CSC
- Most departing asset managers were only in their positions for a short time, and had managed a product line that has since been discontinued by CSC. The company appears to have little or no difficulty in finding additional highly qualified asset managers

■ Company Overview

In September 1999, CSC obtained a licence from Japan's Ministry of Justice ("MoJ") as the country's 23rd servicer, and started servicing operations in December 1999. Hatfield Philips, CSC's parent, was bought out by its own management in 2003 and renamed TriMont Real Estate Advisors, Inc. ("TriMont"). Since the management of TriMont has remained unchanged, there was no specific negative impact on CSC. The parent company, with headquarters in Atlanta, USA, has Fitch servicer ratings of 'CSS2' and 'CPS2', and exclusively handles the real estate operations of Lehman Brothers Holdings rated 'A+/F1' in Europe and the US.

In August 2003, Capital Services Group's Japanese operations were reorganised into three companies: CSC, Capital Realty Inc. ("CRI"), and Global Commercial Real Estate (Japan) Inc. ("GCRE"). CRI is responsible for managing real estate, while GCRE deals with due diligence and underwriting, and the group's administration. CSC mainly services the non-performing and performing loan investments of Lehman Brothers, which currently contribute 85% of its revenue. CSC has, however, indicated that it is trying to diversify its client base.

Between its inception and end-April 2004, CSC has serviced performing and non-performing loans with a cumulative UPB of JPY2,532bn, corresponding to 5,609 borrowers – a substantial increase from the previous rating review.

As of end-April 2004, the company was servicing JPY1,265bn in commercial mortgage loans, and had handled cumulative NPL collections of JPY73.5bn.

■ Financial Overview

In the fiscal year ended November 2003 (FY2003), CSC reported positive retained earnings. Serviced loans grew sharply and servicing fees were also up about 70% from the previous year. In addition, operating income increased almost fivefold from the previous year as the proportion of sales expenses declined from year-earlier levels. Net income amounted to JPY230million, three times as much as for the previous year. Since it broke even in 2001, CSC's profitability level has been steadily improving. The servicer changed its fiscal year-end from November to December in 2003.

In FY2003, CSC's servicing income grew in response to a sharp increase in loans – particularly performing loans – invested in by Lehman Brothers. However, staff costs increased only slightly year on year because the operations of the IT and financial and accounting sections were transferred to a related

company, together with staff members. This more than offset the cost of hiring new employees in the asset management and loan administration areas.

CSC has indicated that it has no need for investment funds, but has set up its own source of short-term working capital.

Portfolio Statistics (for NPL only)

(Since Inception to 30 Apr 2004)

Total Loans Serviced* (JPYm in UPB)	No. of Borrowers* (#)
2,259,000	4,006

Disposal Amount (JPYm)

Since Inception through Apr 2004	Annual figure in 2003
73,472	31,434

Types of Resolution by Disposal Amount (%)

Voluntary Sales	32.0	28.1
Foreclosure	28.0	9.4
DPO	11.0	7.8
Loan-Sold	16.3	51.9
REO	3.2	0.0
Other	9.5	2.8

* "High Yield assets" are not included.

Source: Capital Servicing Co., Ltd.

■ Staffing and Training

CSC is the only one of the three group companies to have obtained a servicer licence from the MoJ. Real estate owned ("REO") property is managed and disposed of by CRI, CSC's sister company. CSC also outsources its human resources, administration, accounting and IT systems to its affiliate, GCRE.

CSC's special servicing operations are handled by its asset management and loan administration departments. In 2003, the small asset group was set up within the asset management area; specialising in servicing small unsecured loans, it was established to speed up collections while maintaining efficiency. Asset management has two other sections, one for legal procedures and the other for managing clients' investments.

In the loan administration area, the performing loan team was separated from the NPL team in 2003 to deal with the rapidly increasing volumes of performing loans.

Following this restructuring of the group companies, CSC's staff as of end-April 2004 consisted of 36 executives and regular employees, including board members and auditors – a decrease from 43 as of end-November 2002.

However, staffing at the group level has expanded sharply: the number of employees in loan

administration, for example, has increased from four to 13 since 30 November 2002. This is mainly because the performing loan team was established separately from the NPL team to deal with an increase in performing loans being serviced. The number of IT employees grew from four at the end of November 2002 to 10, mainly in response to the full upgrade of the asset management system. The department that deals with the management and resolution of hard assets increase staff numbers from four employees at the end of November 2002 to nine. Specifically, the newly established hospitality section, which handles accommodation facilities such as hotels, has three staff members. To improve its structure, the company has hired many department heads with substantial experience in relevant areas, thereby developing middle management.

Senior managers have an average of over 21 years' industry experience and average tenure of about 3.5 years at CSC. The middle managers, a team of six officers, have, on average, over 16 years' industry experience and an average tenure of about 1.3 years at CSC. Four of them joined CSC in 2003 or 2004.

Three asset managers left and two have joined the company since the previous review. The two new joiners have an average of over 15 years' related industry experience and are mainly responsible for servicing small unsecured loans. The asset management team has been bolstered by the hiring of a portfolio manager with 24 years of related industry experience. Current asset managers have an average of 18 years' related industry experience and average tenure of 2.7 years at CSC.

CSC has always focused on improving its training programme. During hard-skill training, staff members receive internal classroom training in particular job areas, as well as external seminars and classroom training in the various IT software packages used in the office. Soft-skill training includes English and PC classes. Additionally, CSC has implemented an on-the-job training programme supervised by middle managers, including portfolio managers and loan administrators.

In view of the rapid staff increase, CSC introduced a "New Hire Orientation" programme in 2003, which provides new recruits with information on internal operation procedures, including various system operation procedures. Training for managers occurs on an ad hoc basis; however, CSC has indicated that it has no near-term plans for developing or conducting specific training for this group on a regular basis. In 2003, the average number of training hours per employee was 42 hours.

■ Procedures and Controls

Although CSC has expanded its organisation, and increased its loan count and product mix – resulting in a rapid increase in employees – the results of internal and external audits indicate that the servicer has maintained appropriate internal controls. The following internal and external audits were conducted at CSC.

Internal Audit

The company's compliance officer carries out an internal audit of all operations, whose scope is determined by the controller on a quarterly basis. Following the internal audits in 2003, each audit raised several procedural issues, most of which were addressed by the next audit. In addition, to enhance its follow-up, CSC has established a rule, whereby the issues to be addressed are circulated to department heads starting from the fourth quarter of 2004.

External Audit

Agreed Upon Procedures Audit

Lehman Brothers' external auditors audit CSC's compliance with servicing agreements every two years. The most recent audit was conducted between July and September 2002.

Statutory Audit

One of Japan's leading auditors performs CSC's annual audits. In FY2003, two audits took place (at the end of November and December 2003) owing to the change in the year-end date. No irregularities were found in either of these audits.

Inspection by the Ministry of Justice

In June 2004, CSC underwent its second MoJ inspection. A few minor departures were mentioned, but no irregularities were pointed out.

CSC adds to or revises policy and procedure manuals at a semi-annual review. Manuals are available online to all staff. In 2003, manuals on loan set-up, management and collection were revised thoroughly and the number of relevant manuals increased to seven from two. In 2003, a specific section relating to travel expenses was added to the staff manual.

■ Technology

CSC developed the SCORE asset management system (Servicing Company Operating and Reporting Engine) in October 2003 to replace the Total Collection System ("TCS") system. The SCORE system handles data on loans, obligors, guarantors, collateral and hard assets for both performing and non-performing loans. It also deals

with various records, including records of negotiations with obligors and lawsuits. Additionally, SCORE prepares reports for the MoJ and investors, can select loans requiring legal procedures and can manage due dates efficiently through the use of a watch list function. Above all, the system has the flexibility to prepare all kinds of reports that meet the requirements of investors, management and regulators. Since the previous review, the functionality of CSC's system has improved considerably.

Taking into account each user's role or the assets that he or she handles, the security of SCORE is protected by limiting access to other information or areas of the system. Management also defines access levels for individual users.

CSC uses SORUN as its base servicing system. SORUN calculates disbursements of principal and interest depending on various payment patterns. It is a software package that has been customised by CSC to deal with irregular payments of loans, such as partial payments, and it is integrated into the SCORE system. The data in SORUN is transferred to SCORE every month. In early 2005, CSC plans to convert its accounting system to that which the other group companies already use or will be using by the end of 2004.

Currently, the system's capacity is considered sufficient since the servers' usage rate is on average 24%. Each server is backed up daily onto tapes, which are both stored in the fireproof safe in the office and are couriered to the store-room in the suburbs of Tokyo twice weekly. In addition, the back-up tapes are sent to the company's Hong Kong office for further security.

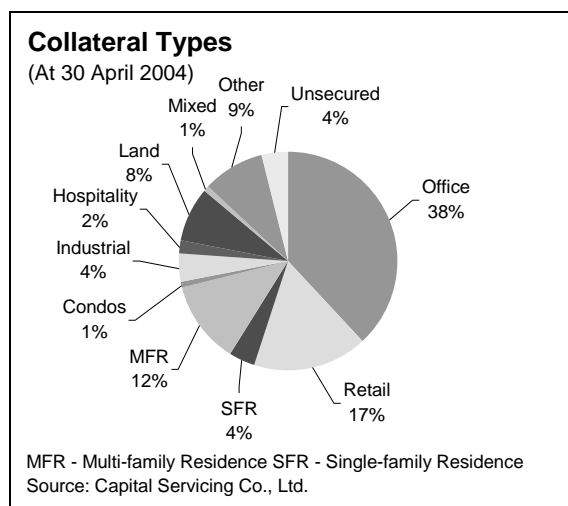
As a contingency plan, CSC has secured temporary office spaces in Tokyo and Sapporo. In July 2004, CSC conducted a catastrophe simulation test at the new office by completely shutting down and resetting up the IT system using off-site back-up tapes. It took less than two days to re-establish the full operational system including hardware. In addition to an annual evacuation drill for all tenant offices in the building, managed by the owner company, CSC conducts its own safety drills. The last drill took place in May 2004. CSC reviews its contingency plan annually, and the latest review was conducted in conjunction with implementing the shutdown test in July 2004.

The IT section of GCRE, CSC's affiliated company, is responsible for the maintenance of the company's systems. The IT section consists of a department head, with 17 years' experience, and nine members

of staff. CSC has a maintenance agreement with an outside systems company.

■ Special Servicing

From its creation up to end-April 2004, CSC had serviced performing and non-performing loans with a cumulative UPB of JPY2,532bn, or 5,609 borrowers, and had collected JPY73.5bn in NPLs. All figures had risen sharply since the previous review.



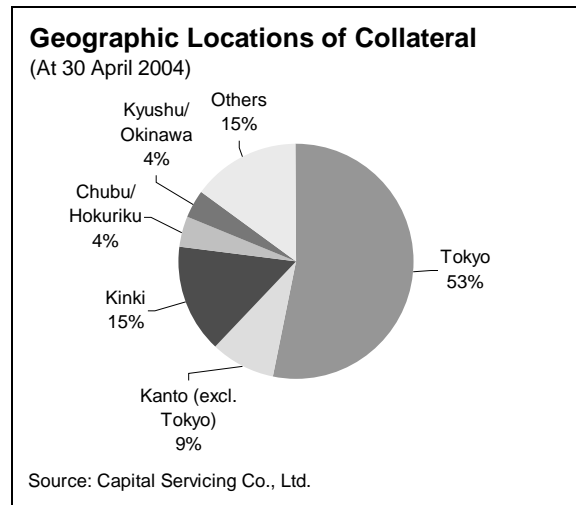
The share of commercial mortgage loans has been increasing as a proportion of the UPB on total loans every year since the company was formed, and at end-April 2004, accounted for 65%. NPLs accounted for almost 100% of the commercial mortgage loans until 2002. However, since 2003, performing loans have gradually increased as a proportion of commercial mortgage loans.

In 2003, Lehman Brothers' investment in Japan rose sharply. The percentage of non-performing commercial mortgage loans was almost 26%, while performing commercial mortgage loans, which accounted for about 70%, have been increasing ever since.

Average resolution days have increased since 2002. This is partly owing to the establishment of a group within asset management that specialises in the collection of small unsecured loans that had previously been left uncollected. However, as a result, the total average resolution period has increased. In general, lump sum collection through the disposal of collateralised properties has decreased, while collection through obligors' repayments has increased as the number of corporate restructurings has grown.

Collection rates (collected amount/invested amount) have tended to decline. However, in light of the general decline in the servicer market, CSC's

collection performance has been maintained at a satisfactory level, both in terms of the collection period and collection rates.



At end-April 2004, each asset manager (excluding portfolio managers and assistant asset managers) had on average 49 active assets. Based on the average number of assets, Fitch believes that the asset managers' workloads are manageable.

From its creation until end-April 2004, most collections were achieved by selling secured property through voluntary sales or auctions, but the use of auctions has been declining sharply in recent years. In contrast, although loan sales have not, on a cumulative basis, accounted for a large proportion of collections in recent years, their use has increased, and in 2003 they accounted for over 50% of collections.

CRI has managed and disposed of REO property since its establishment in April 2002 and CSC has not used REO sales for collection since 2003. Since that date, CRI has completed the disposal of all CSC REO properties.

CSC manages its business plan in the following manner:

Tier 1 Assets: Assets with a Target Amount above JPY10m

Each of these assets requires a resolution plan to be completed within 60 days of receipt of the underwriting package. A business plan is, in principle, reviewed quarterly.

Tier 2 Assets: Assets with a Target Amount below JPY10m

These assets are grouped by portfolio and each group is assigned a business plan within 60 days of receipt of the underwriting package. A business plan is, in principle, reviewed annually.

Business plans for all the loan assets acquired prior to August 2004 are currently being transferred to the new system, with completion by the end of 2004.

As for initial loan set-up procedures, the main stages are largely the same as in previous years. However, with the implementation of the SCORE system and continued enhancements to it, procedure manuals for this area have had to be revised. The manuals concerning cash receipts and expense payments on collections were also revised along with the introduction of the SCORE system. Fitch believes that the introduction of SCORE has resulted in a further improvement in initial set-up procedures and the control of cash inflows and outflows.

The policy manuals also specify outsourcing procedures, which require all outsourcing to be approved by a department head. At the end of each month, the controller checks and verifies outsourcing expenses based on a list that is issued by the company's accounting department.

Copyright © 2005 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.