

CMBS Special Servicer
Japan
Servicer Report

Capital Servicing Co., Ltd.



Rating

Special Servicer CSS1-(JPN)^a

^a Japan

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Summary

Fitch Ratings has affirmed Capital Servicing Co., Ltd.'s (Capital, or the company) CMBS Special Servicer Rating at 'CSS1-(JPN)'. The rating reflects the company's sustained strengths such as its flexible and well integrated system, highly-experienced and stable asset managers with proven performance, comprehensive risk management infrastructure and experienced senior management team.

While Capital has been affected by the failure of Lehman Brothers (Lehman) in September 2008 (Lehman had been its primary source of revenue), its impact on Capital has been limited thus far due to the fact that it continues to service most of the Lehman-related assets. In addition, Capital has successfully expanded its client base as a result of its efforts in the last few years. As Capital continues to diversify its sources of revenue, Fitch will continue to monitor its progress in these efforts.

Strengths

- Flexible and well-integrated asset management system (SCORE).
- Highly-experienced and stable asset managers with proven performance.
- Comprehensive risk management infrastructure supported by active involvement of senior management.
- Experienced senior management team involved in day-to-day decision-making.

Challenges

- To increase revenue from third parties to offset possible loss of revenue from fees derived from servicing the assets originated by Lehman, its affiliates and other Lehman-related business. Such revenue accounted for a substantial amount of total revenue in 2008.
- To maintain the quality of special servicing through this difficult market.

Mitigants

- Capital expects reasonably that Lehman-related servicing revenue will continue to flow in fully for some time and then to a lesser degree throughout this year. The company has a strategic plan laid out and has reinforced its business development efforts. Fitch notes that multiple new business opportunities have already been acquired, and this underpinned the company's financial performance in the first quarter of 2009 in line with its budget.
- So far, Capital has been successful in keeping its staff almost entirely in place. In addition, it reinforced its corporate finance platform function for itself and other Capital Services Group companies (CSG companies) in 2008 by adding new management personnel. Capital continues to improve its systems and internal control functions as well.

Company Overview and Operational Highlights

Capital is a leading servicer in Japan with a top quality servicing system and bi-lingual servicing capability, which it deems to be its main strengths.

Capital was licensed by the Ministry of Justice (MOJ) in September 1999, and commenced servicing operations in December that year. Since then, the company has serviced approximately 8,000 loans, the unpaid principal balance of which amounted to JPY4,332bn as of December 2008.

Capital is the flagship of CSG companies, an independent group of servicers and real estate-related companies owned by Capital Services Holding Corporation (CSHC), a holding company established in the British Virgin Islands.

Capital maintained its strong capitalisation and good liquidity throughout 2008 despite the default of Lehman in September 2008. Capital has been working to diversify its client base since 2007, and non-Lehman business is increasing.

In January 2008, Capital absorbed most of Global Commercial Real Estate (Japan), Inc. (GCRE), which provided Capital with such corporate functions as HR management, IT, accounting and reporting. As a result of this consolidation, Capital's staff more than doubled to 117 in January 2008, from 55 a year earlier. In December 2008, this remained unchanged at 117. Capital's Japanese operations now consist of Capital and Capital Realty Inc. (CRI), a real estate asset manager. Capital offers primary and special servicing for investors and now provides support functions to other CSG companies, and CRI is responsible for managing real estate.

Portfolio Statistics (For NPL Only)

From inception to December 2008		
Total loans serviced (UPB, JPYm)	No. of borrowers	
4,332,352	7,952	
Disposal amount (JPYm)		
From inception to December 2008	Annual figure in 2008	
332,338	49,787	
Types of resolution by disposal amount		
	Inception to December 2008 (%)	Annual figure in 2008 (%)
Voluntary sales	34.5	32.4
Loan sale	19.8	19.9
Discounted pay-off	15.3	26.6
Foreclosure sale	12.4	6.1
Insolvency	3.0	1.0
Other	15.0	14.0
Total	100.0	100.0

Source: Capital Servicing Co., Ltd.

Financial Details

Capital continues to focus on servicing for third-party investors. The September 2008 bankruptcy of Lehman Brothers (Lehman, Capital's largest customer with about a 66% share in Capital's 2008 revenue) was a significant threat to Capital's revenue. However, as the court approved and reaffirmed the existing servicing contracts for the portfolio originally invested in by Lehman or its affiliates (Lehman portfolio), Capital continued to receive servicing fees in full with no significant effect on its operation thus far. The outlook for Capital's revenue depends partially on retaining some of the Lehman portfolio as the appointed servicer, and continuing to service Lehman and other non-Lehman portfolios, and the result of the company's efforts to expand its customer base.

Currently, the Lehman portfolio continues to be serviced by Capital. The portfolio is expected to be on sale in 2009, and if all prospective purchasers were to retain Capital for their servicing needs, its revenue will be protected and at the same time significant revenue diversification will likely be achieved. On the other hand, if no purchaser retains Capital, substantial revenue will be lost. Capital already has laid out a plan to be implemented to control costs to cover such a risk.

Despite a significant reduction of new investments made by Lehman in 2008 due to bankruptcy and the resultant shrinkage of its portfolio, Capital's operating revenue increased by 17% over the previous year. This was mainly due to an increase in non-Lehman business, a result of its efforts in the last few years, as well as some one-time transactions involving existing portfolios. In addition, Capital's internal cash

generation remained at a level similar to 2007. Net income for 2008 decreased 51% from the previous year due mainly to the loss recognised as a one-time bad-debt expense for claims to Lehman.

The company forecasts in its 2009 budget to maintain stable profitability. Fitch notes that the overall assumptions made in the company's 2009 budget are reasonable and somewhat conservative, reflecting serious considerations and analyses made internally. In Fitch's opinion, Capital's financial condition will continue to be stable at least for a while, as it has been successfully expanding its non-Lehman customers/business in recent years and its 1Q-09 financial performance showed relative stability.

Employees

As of December 2008, Capital employed 117 full-time employees. The significant increase from 55 a year ago is the result of consolidation with Global Commercial Real Estate (Japan), Inc. (GCRE), which provided various support functions, including HR, accounting, IT and reporting to CSG companies.

Capital Organisation

Dec 07		Dec 08	
Capital	55	Capital	117
Management	2	Management	10
Asset management	20	Asset management	22
Loan administration	33	Loan administration	30
		IT	16
GCRE	63	CS tech support	5
IT	17	Finance	13
Finance	13	Investor reporting	9
Corporate administration	7	Office mgmt + HR	6
Investor reporting	8	Sales & marketing	4
Others	18	Other	2

Source: Capital Servicing Co., Ltd.

Top executives at Capital, including the group CEO, have, on average, 27 years of relevant industry experience and more than seven years tenure with the group companies. The portfolio manager has been with Capital since 2003 and the servicing director since 2007, and both have extensive experience in the industry.

Changes related to middle management since the last rating review by Fitch in October 2007 include: addition of the group CFO-Asia as a new position (who later became a member of the board) and replacements of the internal audit director and compliance director (both positions were taken over by promoted employees with adequate experience).

Capital encourages employees to have 40 hours/20 hours of training per year for exempt/non-exempt employees. Each department's manager assists the staff in making their own individual training plan, and helping them achieve their goals. The HR department organises training, but each employee has to apply for the programmes individually.

The average training hours in 2008 were 40.3 hours for exempt and 27.8 hours for non-exempt employees. The overall total was 37.7 hours, down 8% from the last rating review, for both exempt and non-exempt employees collectively. 2008 was a turbulent year for Capital, causing the figure to drop. The asset management department had 33.4 hours of training in 2008.

In 2008, Capital started departmental training programmes for asset management and loan administration as a new measure to increase staff knowledge and internal cohesion in these key areas. As part of the cost control programme, Capital intends to reduce training costs. Nevertheless, it will firmly maintain necessary programmes available for employees.

Internal Control

Since the last review, Capital has enhanced its internal control function by formally establishing a compliance committee and by consolidating its legal and compliance functions.

Established in March 2008, the compliance committee (chaired by the representative director) oversees and manages the corporate level risks regarding compliance with related laws and business ethics. It also directs two sub-committees created to cope with two major issues: private information protection and the books and records that servicers are legally required to maintain (MOJ books).

Compliance and legal functions have been consolidated into the legal & compliance department (LCD), established in June 2008. LCD maintains corporate documents and monitors all agreements and MOJ books in addition to coordinating the compliance committee and its two sub-committees (private information protection committee and steering committee). The LCD has four staff, and the newly appointed department head, director of legal & compliance, has two years tenure in the former legal department and has nine years of industry experience.

Capital established the risk management committee (RMC) in September 2005 at CSHC level to enhance the control framework for all CSG companies. The RMC continues to meet on a monthly basis and conducts an annual risk assessment to identify, prioritise, analyse and initiate mitigation strategies for risks that could potentially have a significant adverse impact on the operations of the company. The company-level control framework was developed based on the COSO (Committee of Sponsoring Organizations of the Treadway Commission) model and is used as a basis for undertaking internal audits for all CSG companies.

Capital has a comprehensive set of policies and procedures (P&Ps) based on the foundation of having proper corporate governance throughout the company. The P&Ps are updated and amended when necessary by the respective department manager and inspected by the LCD on an annual basis. Since the last review, Capital implemented 16 policies and procedures and updated 13. The LCD is in charge of keeping management and staff up-to-date with relevant laws and regulations. All employees can readily access the current P & P through the intranet.

Fitch views Capital as having one of the most advanced company-wide risk management infrastructure among servicers with its timely efforts to strengthen its risk management platform to accommodate the various regulatory and market changes.

Internal Audit

The director of internal audit conducts quarterly internal audits on Capital and on an annual basis for other CSG companies, focusing on a company-level control framework, client and corporate operations and fraud risk mitigation (COSO-based approach). Detailed reports are compiled with audit results.

Any control deficiencies identified through internal audits are first communicated to the directors of the company to assess the risk and implement action plans and are remedied by the respective department manager as soon as possible and no later than by the next audit.

Capital's internal audit is based on a focused approach for group risk control enhancement. Fitch believes Capital's risk control framework is well structured and the internal audit is effectively conducted. The agency will monitor the effectiveness of the internal audit coverage.

Statutory Audit

One of the leading auditors continues to perform annual financial audits for Capital. The report for 31 December 2008 showed no irregularities.

Inspection by the Ministry of Justice

Since January 2007, there has been no on-site inspection conducted by the MOJ.

Technology

Since 2003, Capital has utilised a self-developed asset management system, the servicing company operating and reporting engine (SCORE). The SCORE system handles loans, obligors, guarantors, collateral and hard assets, as well as information on obligor negotiation and court records. Additionally, SCORE is useful in selecting loans requiring legal procedures and managing due dates efficiently through the use of a watchlist. Above all, SCORE is valued for its flexibility, which allows access to a combination of data to prepare various reports that meet the requirements of investors, the management and its regulator.

SCORE is also equipped with the capability to function in a multi-lingual, multi-currency environment for use not only in Japan, but in multiple countries. Fitch believes SCORE to be a highly integrated and versatile tool and that it is one of the most advanced IT systems in the market.

Capital's commitment to technology and quality infrastructure is evidenced in its investment in SCORE. The system started as a NPL management system in 2003, and since then Capital has been constantly improving the efficiency and versatility of the system.

Recent improvements to SCORE include an enhanced reporting function and improved module functions such as loan acceleration, default interest accrual and correction module, and an online asset workout module. Capital intends to further improve its service to investors. Capital believes that SCORE is considered by many in the servicing field to be cutting-edge technology.

SCORE has been licensed to third parties since early 2007, including those in Portugal and Turkey as well as to other CSG companies. CSG has indicated that it intends to promote this licensing business further, and CSG companies are marketing the licensing of SCORE to parties in Asian and European countries.

Capital has established a comprehensive set of disaster recovery plans, which includes, among others, a business continuity management plan and disaster recovery plan (DRP). These plans are subject to annual review, and updated as necessary based on the findings of annual testing. Server data at Capital are backed up daily onto tape, which is sent to the offsite data storage facility provided by a vendor. Capital's Osaka office (five staff) also acts as a back-up site, which provides "warm" back-up, which replicates data within 24 hours.

Capital has contracted for a data centre, which is linked via VPN to all CSG companies, including Capital and other overseas offices. The Osaka back-up site, which is located next to the Osaka branch, is equipped with more than 30 work stations with networked PCs.

Capital has conducted DRP tests every year since 2005. The latest test was performed successfully in November 2008.

The IT department has 16 staff and three consultants (including two Infosys consultants), with 11 years of staff industry experience on average. The department added two staff and lost one since the last review.

Special Servicing

Loan Administration

The loan setup process, cash management and reporting at Capital have not significantly changed since the last review. The procedures are explicitly stipulated in the company's manuals, and Fitch continues to regard these processes as mostly efficient and well-supported by SCORE.

The loan setup process is for the most part automated. When the company receives all the necessary data on newly assigned loans, the data is re-formatted using a standard template and uploaded into SCORE. The process has been further enhanced to be more flexible to allow for increasing non-Lehman clients.

The information on borrower repayments is obtained daily from banks and electronically uploaded to SCORE. The asset management department receives the printed repayment record several times a day from the treasury department. The next business day, repayment information is uploaded into SCORE by the treasury department and an asset manager is responsible for confirming the collection amount in SCORE. Unusual or irregular payments, such as payments in cash or by cheque, have to be reported to the treasury section, which investigates the matter. The cash management function has also been enhanced with the reporting capability improved to a larger number of investors with a variety of reporting requirements.

Capital's ability to service securitisations, including investor reporting, is well supported by SCORE. The application is able to generate customised investor reports and entrustors have access to portfolio performance data on a real-time basis.

For the management of a large collateralised property, the asset manager visits the site and completes a property inspection report, which is attached to the original business plan, and an annual update of the property inspection report by the asset manager follows.

NPL/SPL Asset Management

From inception to December 2008, Capital has serviced approximately 8,000 commercial mortgage loans, the unpaid principal balance of which amounted to JPY4,332bn, and has collected approximately JPY325bn. Capital continues to service a large portfolio of NPLs, which includes sub-performing loans (SPLs) that account for about 20% as of December 2008.

Almost the entire servicing portfolio has been entrusted for servicing to Capital by investors and securitisation trustees. Recently, performing loans have gradually increased in its portfolio, reflecting changing characteristics of the loans available for investors. At FYE 2008, the percentage of non-performing commercial mortgage loans to the total mortgage portfolio in terms of the investment amount was approximately 25%. It should be noted that Capital's performance on primary loan servicing is outside the scope of this rating and report.

The volume of so-called SPLs has been on the increase. Approximately 90% of new NPL investment made by investors in 2008 was for SPLs, and 20% of the current outstanding NPL portfolio comprises SPLs.

In servicing NPLs, Capital's asset managers normally maintain collection plans to attain target collection amounts. However, Capital maintains a two-tier approach to its asset management for certain assets described below:

- Tier 1 Assets: Assets with a target collection amount above JPY100m. Each individual asset requires a business plan to be completed with approval from the representative director and the investor within 120 days of receipt of the underwriting package. The business plan is reviewed annually or as necessary.

- Tier 2 Assets: Assets with a collection target amount below JPY10m. These assets are grouped together by portfolio and each group is assigned a business plan within 120 days of receipt of the underwriting package. The business plan is reviewed annually, or as necessary.

As of December 2008, each asset manager is responsible for, on average, 99 cases, almost at the same level as the last review. Since Capital occasionally transfers internally NPLs that have reduced below a certain amount after a substantial collection is made to a special team to maintain collection efficiency with SCORE providing sufficient support, Fitch believes the asset managers' workloads are manageable.

Capital has consistently met the aggregate NPL collection targets imposed by its entrustors and, in Fitch's opinion, the company operates a highly efficient special servicing operation. The agency believes the collection performance of Capital is equal to or better than that of peer players.

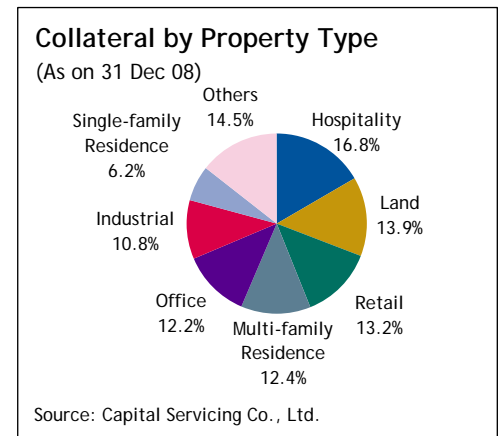
This strong performance is attributed mainly to its stable and highly experienced asset managers (12 staff in total), with more than 25 years of average industry experience, including 13 years in NPL workouts, and no turnover in the past five years. Also,

senior management closely monitors day-to-day administration of servicing processes through SCORE, and often provides instructions. These contribute to the higher-than-average organisational responsiveness and efficiency at Capital.

Capitalising on its various servicing experiences, Capital demonstrates high quality measures of loss mitigation. Through periodic monitoring, the business plans are revised from time to time if necessary, to minimise loss. When an asset resolution is proposed, the asset manager submits a resolution approval memo/action approval memo to the portfolio manager/MD for approval (via SCORE). In case the expected collection in the proposed resolution falls short of the amount in the business plan, the proposal has to be approved by the investor.

Also, Capital takes various measures to control costs for asset management. For example, the company sold loan receivables it managed that it deemed valueless through the secondary market in 2005. Also, in 2006, it wrote off more than 250 loans that had been over the statutory time prescription (statute of limitation).

The resolution methods employed by Capital for resolving NPLs (portfolio statistics table on page 2) show little change since the last review. Fitch notes that there has been a priority for voluntary repayment/voluntary property sale, primarily to ensure maximum collections.



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