Criteria for Rating U.S. Mortgage REITs and Similar Finance Companies

Sector-Specific Criteria

This report updates and replaces the criteria report of the same title dated Feb. 25, 2014.

Criteria Update: This sector-specific criteria report updates Fitch Ratings' methodology on analyzing the credit risk of U.S.-based mortgage real estate investment trusts (REITs) and similar finance companies. Fitch's master criteria for non-bank financial institutions are outlined in Fitch Research on "Global Financial Institutions Rating Criteria," dated January 2014, available on Fitch's website at www.fitchratings.com. Fitch's rating methodology for U.S. mortgage REITs and similar finance companies also takes into consideration various cross-sector criteria reports noted to the left.

Impacted Credit Ratings: This report addresses forward-looking opinions on the creditworthiness of mortgage REITs — companies that own direct or indirect interests in mortgages on real estate or other interests in real property — including long-term issuer default ratings (IDRs) as well as credit ratings for revolving credit facilities, long-term debt obligations and preferred stock of these issuers.

REIT Tax Election: The vast majority of issuers to which Fitch applies these rating criteria have elected REIT status under the U.S. Internal Revenue Service tax code. Additionally, these criteria apply to finance companies that have not elected REIT status but whose asset compositions and financial and operational strategies are similar to those of mortgage REITs.

Qualitative and Quantitative Factors: Fitch's credit ratings for mortgage REITs are based on qualitative factors such as the company's business model, asset quality, funding diversity, financing strategy, servicing platform, management and governance, staffing, track record and competitive position. Quantitative factors include leverage, unencumbered asset coverage, access to capital and liquidity management and operating performance.

Credit Ratings Spectrum: The vast majority of mortgage REITs have IDRs or other forms of credit opinions that are below investment grade. Mortgage REITs typically have a soft cap of the 'BBB' rating category. Funding diversity and financing strategy, liquidity and unencumbered asset quality are typically major obstacles in a company's evolution toward achieving investment-grade ratings. Business model and management discipline may also be differentiating factors in the ability of mortgage REITs to achieve investment-grade ratings.

REIT Rating Constraints: Mortgage REITs would likely be considered less attractive stock investments if they utilized minimal levels of leverage commensurate with higher rating levels, given the dividend yield and return expectations of equity investors. The long-term cash retention limitations placed on REITs, given the tax code requirement for a REIT to distribute at least 90% of its taxable income, may also limit the extent to which mortgage REITs could achieve higher rating levels, as mortgage REITs consistently rely on access to the capital markets.

Relevance of Analytical Factors: Depending on the mortgage REIT, certain analytical factors may carry more significance than others. For instance, Fitch would place less emphasis on asset quality for a mortgage REIT that owns low credit risk assets than for a mortgage REIT that owns high credit risk assets. Fitch would place less emphasis on funding for a mortgage REIT that primarily utilizes long-term unsecured bonds than for a mortgage REIT that primarily utilizes short-term reverse repurchase agreement financing.

Related Criteria

Global Financial Institutions Rating Criteria (January 2014)

Treatment and Notching of Hybrids in Nonfinancial Corporate and REIT Credit Analysis (November 2014)

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Mortgage REIT Industry

There are three types of companies within the mortgage REIT sector to which this criteria report applies: commercial mortgage REITs (CM-REITs), residential mortgage REITs (RM-REITs) and hybrid REITs.

Commercial Mortgage REITs

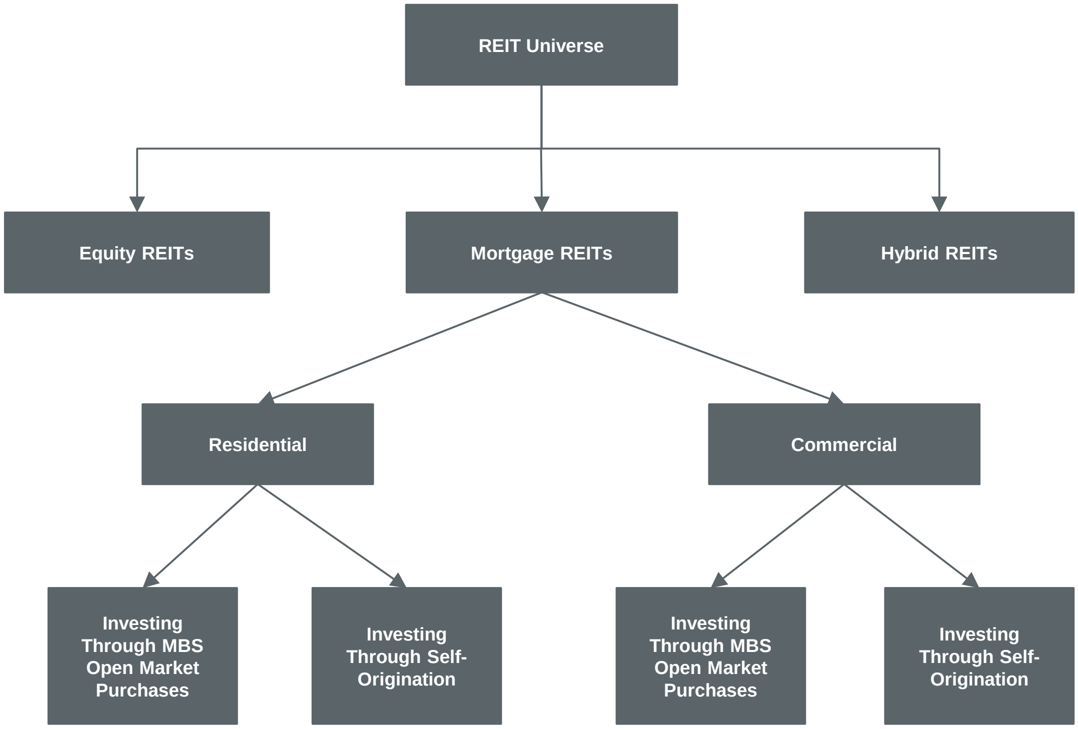
CM-REITs generally invest in first and mezzanine commercial mortgages, commercial mortgage-backed securities (CMBS) and/or other interests in commercial mortgages. Certain CM-REITs originate loans, while others purchase third-party-originated whole loans, CMBS and other real estate-related loans and securities.

Certain CM-REITs have real estate servicing platforms. These servicing platforms enable the generation of fee income and may provide opportunities to expand investments in residual interests. Additionally, servicing often helps CM-REITs identify new business opportunities with existing portfolio borrowers.

Residential Mortgage REITs

RM-REITs generally invest in residential mortgage whole loans and residential mortgage-backed securities (RMBS). Asset quality varies from lower credit risk assets, such as U.S. government-guaranteed securities, to higher credit risk assets, such as subprime mortgages. Like CM-REITs, RM-REITs may either originate and service their owned portfolios or rely on the origination and servicing capabilities of third parties.

Overview of REIT Industry Universe



Hybrid REITs

Hybrid REITs constitute some combination of mortgage real estate and equity real estate assets. Hybrid REITs typically invest in loans and mortgage-backed securities (MBS) and have direct equity ownership interests in real estate properties.

Qualitative Analytical Factors

Business Model

Fitch focuses on the company's value proposition and relative position in its markets. There are various models and combinations of models in the mortgage REIT universe, including whole loan/MBS buyers, servicers and special servicers and originators.

Whole Loan and MBS Buyers

Certain mortgage REITs utilize mathematical modeling in an effort to maximize the efficiency of spread lending. Such companies do not generally service commercial or residential-based assets or provide other asset management services. Nevertheless, pure-play whole loan/MBS buyers may add liquidity to the mortgage markets and, when capital markets are accommodative, may add value by distributing risk as a financial intermediary by utilizing the secured debt markets to finance their portfolios.

Originators

Mortgage REITs with comprehensive origination platforms grow their portfolios from opportunities created by their service-based franchises. Such REITs may be more selective in pursuing investment opportunities than servicers, have the ability to build a base of repeat borrowers and tend to have more control of the assets they own than servicers or whole loan/MBS buyers. However, an origination and surveillance capability can entail substantial costs due to the need for a regional or national sales and marketing platform.

Servicing Capabilities

Mortgage REITs engaged in servicing or special servicing are more transaction-oriented and, therefore, require heavier labor and technology infrastructures. By managing underlying assets such as residential and commercial mortgages, such mortgage REITs generate recurring fee income and may strive to reposition underperforming assets. These companies may also benefit from a hands-on approach to asset management, particularly during weaker points in a real estate cycle.

Fitch views mortgage REITs that make servicing decisions internally more favorably than those that delegate major servicing decisions to third parties. The closer an issuer is to controlling its origination and servicing, the better insights its management will have on asset quality.

Asset Quality

Factors affecting asset quality include the number of properties, property types, tenants, stability of asset cash flow, underlying credit quality of the borrower from the REIT's perspective, tenor, geography and loan origination vintage.

Nonperforming or Delinquent Assets

The level of nonperforming and delinquent assets is central to assessing asset quality. The terms and amount of any modified loans, which would typically not initially be included in nonperforming or delinquent asset categories, also affects asset quality. Fitch generally focuses on nonperforming and delinquent assets as a percentage of total assets for both commercial and residential issuers (see Appendix B, page 14, for additional details).

Underlying Real Estate Quality

Beyond reviewing asset quality of the mortgage REIT's portfolio, Fitch will endeavor to monitor the asset quality of the underlying real estate that collateralizes loans held by the REIT or, in the case of REITs with a focus on MBS, the quality of underlying loans against which securities have been originated.

Asset Quality Disclosure

Mortgage REITs have various ways of disclosing asset quality metrics. Regardless of the mortgage REIT's disclosure, Fitch will not assign or maintain ratings or other forms of opinion in cases where data on both the mortgage REIT's portfolio and the underlying real estate are not sufficiently robust relative to the ratings or credit opinions.

Style Drift

Mortgage REITs may change their investment focus through cycles. Fitch does not necessarily view style drift negatively; however, in such cases, Fitch focuses on the rationale and appropriate staffing and/or experience when migrating into different investments.

Cash Flow Stress

In reviewing asset quality, Fitch may stress cash flows generated by assets in a mortgage REIT's portfolio to determine the ability of the REIT to service corporate obligations.

Management and Governance

In analyzing corporate governance, Fitch applies "Evaluating Corporate Governance," dated December 2012, available on Fitch's website at www.fitchratings.com. Issuer credit ratings will not be negatively affected by country-specific characteristics, given that issuers operate in the U.S. When looking at issuer-specific governance characteristics, Fitch focuses on systemic corporate governance characteristics as well as issuer-specific corporate governance characteristics. Issuer-specific characteristics include:

- Board effectiveness.
- Management effectiveness.
- Transparency of financial information.
- Related-party transactions.

Key Man Risk

Key man risk is the potential overreliance on one or a few individuals within the management team. Key man risk is not unusual for mortgage REITs or similar finance companies. For mortgage REITs or similar finance companies with key man risk, Fitch reviews key management members that could replace top executives for succession-planning purposes.

External Management

Externally managed mortgage REITs are typically managed by affiliated companies that, through a management agreement, provide all managerial and operational services for the REIT. As a result, the mortgage REIT itself is an externally managed company and does not have any employees of its own. Fitch judges the linkage between an externally managed mortgage REIT and its manager on a case-by-case basis. While managers receive fees from externally managed REITs, there have been instances where managers do not support externally managed REITs in distress.

Management Agreements

When reviewing the management agreement, Fitch reviews whether the incentives of the REIT are aligned with the manager; this includes whether the REIT is required to pay manager fees should the board elect to terminate the management contract or should the board decide to internalize management. Fitch generally has a more favorable view toward internal management teams than external management teams because internal management teams are dedicated solely to the REIT, minimizing conflicts of interest. External management may have several investment vehicles under management, with potentially overlapping investment objectives. In reviewing whether management is a shared service, Fitch reviews the mortgage REIT's operations, such as the outsourcing of accounting staff.

Unconsolidated Entities

In analyzing management, Fitch also reviews the exposure of mortgage REITs to unconsolidated entities such as joint ventures. Fitch reviews the extent to which the mortgage REIT's incentives are aligned with those of the unconsolidated entity, including joint-venture terms and conditions for recourse to the REIT.

Track Record and Operating History

Mortgage REITs and similar finance companies with longer operating histories of greater than three years — particularly during periods of market stress — have more operating credibility and experience than mortgage REITs with limited operating histories. Fitch places an IDR or credit opinion ceiling of 'B+' for mortgage REITs and similar finance companies that have less than three years of operating history. More seasoned REITs may also have stronger access to a variety of capital sources.

Many mortgage REITs take a significant amount of time to generate a core portfolio of assets, particularly in periods of limited long-term financing availability. Conversely, rapid growth may place stress on underwriting and surveillance functions. Rapid growth may also create uncertainties regarding the mortgage REIT's targeted or optimal operating leverage and scale, potentially increasing credit risk.

Competitive Position

Servicing functions typically have high barriers to entry given the degree of relationships, track record and industry expertise required. Therefore, certain special servicers and master servicers of both residential and commercial assets possess a stronger competitive position compared with smaller players or those that do not service assets. Conversely, mortgage REITs that do not own any servicing operations, while potentially benefiting the issuer from a cost standpoint, may be forgoing significant market knowledge that could help the issuer manage through cyclical downturns. When reviewing a mortgage REIT's market position, Fitch does not rely on league tables. A mortgage REIT may try to climb league tables by making risky business decisions or seeking business volumes not commensurate with staffing levels.

Impact of REIT Tax Election on Liquidity

All else being equal, Fitch typically views REITs as having weaker liquidity positions than similar finance companies that have not elected REIT status, as these finance companies can have stronger capital retention flexibility than REITs. However, REITs that address required dividend distributions through the issuance of new shares as opposed to cash dividend payments may have stronger liquidity than REITs that issue the majority of taxable income as cash dividends to shareholders.

Quantitative Analytical Factors

Developing Funding Options

Obtaining a diverse funding base is one of the greatest challenges that a mortgage REIT faces. Many mortgage REITs typically begin with a reliance on reverse repurchase agreements and/or secured warehouse funding lines with strict covenant features, provided predominantly by a limited universe of financial institutions. This funding concentration magnifies event risk across the industry, as several lenders exiting the market at once could have a significant negative impact, particularly during times of liquidity reductions similar to the financial crisis of 2008–2009. Additionally, these lending facilities are often short term, not committed and are subject to market valuation requirements, requiring the REIT to maintain unencumbered assets for contingent liquidity to meet margin calls. Margin call risk is elevated during periods of capital market stress.

Funding Diversity

Fitch views positively mortgage REITs with demonstrated access to multiple forms of capital. Prior to the capital markets crisis in 2008–2009, certain mortgage REITs broadened their funding to include commercial paper conduit facilities, collateralized debt obligations (CDOs), secured and unsecured committed credit facilities, unsecured term debt, MBS, loan syndication facilities and unsecured trust preferred securities. These financing options provide liquidity diversity as well as favorable interest rate and term characteristics and open mortgage REITs up to a much wider array of potential investors, including pension funds, insurance companies, hedge funds, mutual funds and even other mortgage and equity REITs. However, even U.S. mortgage REITs and similar finance companies that have diverse funding sources may encounter increased default risk if they hold risky assets, and thus, Fitch places greater emphasis on an issuer's asset quality than its ability to access various funding sources.

Committed Funding

A robust funding profile within a REIT or similar finance company typically includes reliable sources of contingent funding, both for financing new asset originations and refinancing maturing debt obligations. Fitch looks favorably on issuers that have access to committed, unsecured revolving liquidity facilities with terms of one year or more. In addition to the funding ratios in Appendix B, Fitch reviews the financial and qualitative covenants embedded in mortgage REITs' financing agreements to monitor the flexibility to withstand market fluctuations.

Other Funding Risks

Repricing Gap

For highly leveraged mortgage REITs, a rapid change in interest rates on a rapidly resetting liability structure relative to a largely fixed-rate asset base could make such entity vulnerable to refinance risk. To measure this risk, Fitch reviews the average repricing gap.

Pipeline Risk

Fluctuations in a mortgage REIT's new investment pipeline can be significantly influenced by the interest rate environment. Additionally, an unhedged pipeline can lead to challenges in terms of securing long-term financing for new assets in volatile interest rate circumstances and may negatively affect ratings if significant interest volatility results.

Margin Call Risk

In instances where the collateral for a borrowing arrangement is subject to mark-to-market valuation adjustments, Fitch applies a valuation stress scenario to determine portfolio pricing in a more adverse environment. For REITs that utilize short-term funding, such as reverse repurchase agreement facilities with prescribed advance rates, Fitch's more conservative range will gauge the REIT's ability to withstand margin calls that would require the REIT to post additional collateral in the event that portfolio values deteriorate rapidly.

Valuation

Issuers with large concentrations of purchased MBS are vulnerable to market value volatility, as changing credit quality and/or interest rates may have an effect on holdings due to changes in interest income, prepayments or defaults.

Cash Traps

For mortgage REITs with significant on-balance sheet CDO funding, Fitch reviews whether cash traps are imbedded in the CDO structure. In the event of a CDO covenant violation, cash interest income from assets collateralizing the CDO may be trapped in the CDO and would be unavailable to the REIT to fund corporate-level debt, which Fitch would view negatively.

Leverage and Capitalization

Fitch's analysis of a mortgage REIT's leverage and capitalization includes the calculation of leverage ratios shown in Appendix B. Fitch also reviews the leverage utilized across a mortgage REIT's portfolio based on the ability of the REIT's various assets to withstand declines in value. Two mortgage REITs with the same leverage ratios may have different credit ratings if one mortgage REIT owns lower credit risk assets and another owns higher credit risk assets.

Unencumbered Asset Coverage

For REITs issuing unsecured debt, Fitch reviews the extent to which unencumbered assets cover unsecured debt. Unsecured debt is commonly issued by higher rated mortgage REITs. Fitch views unencumbered asset coverage in concert with its review of the mortgage REIT's investment focus. For example, all else being equal, a mezzanine commercial mortgage owner would need stronger unencumbered asset coverage than would a senior commercial mortgage owner for the same rating.

Mortgage REIT Funding Summary

Funding Type	Strengths	Weaknesses
Reverse Repurchase Borrowing	Low cost	Short term and rate duration Limited providers Susceptible to pullback in adverse liquidity environment Margin requirements
Commercial Paper Conduit	Low cost Diverse investors	Short term and rate duration Margin requirements
Mortgage-Backed Securities	Matched rate and duration Diverse investors	Less control of assets Requires shorter term if not sold Leaves higher risk residuals if sold
Collateralized Debt Obligations	Matched rate and duration Diverse investors	Less control of assets Leaves higher risk residuals if sold Limited transparency and/or esoteric structure
Mortgages	Long-term commitment No margin call Moderate cost	Asset-specific structuring sometimes required Can make repositioning property a challenge
Unsecured Notes	Long term Increases financial flexibility Unsecured capital	Higher cost Restrictive covenants
Secured Revolving Credit	Additional source of liquidity Lower cost than unsecured revolving credit	Often have high advance rates Margin call risk Not a source of corporate liquidity
Unsecured Revolving Credit	Increases financial flexibility Unsecured capital	Higher cost than secured revolving credit Entails commitment costs regardless of usage levels
Preferred Stock	Long term Unsecured, subordinated capital	Higher cost

Relative quantity and quality of unencumbered assets is also important. A larger, diversified pool of unencumbered assets may help insulate unsecured bond and preferred stock investors from concentration issues within the unencumbered asset pool. Cash flow coverage also plays a significant role in the assessment of unencumbered assets. Fitch reviews a mortgage REIT's unencumbered asset net operating income relative to unsecured interest expense in measuring the cash flow-generating ability of unencumbered assets.

Access to Capital

Mortgage REITs typically rely on the equity capital markets for capital formation because most of these issuers pay out the vast majority of their taxable income as cash dividends to shareholders. They may seek contingent sources of liquidity, such as reverse repurchase facilities or readily accessible liquidity, including committed revolving credit facilities.

Regular Capital Markets Access

Repeated capital markets offerings can help issuers maintain familiarity with their investor base and add new investors. Such offerings give companies an opportunity to keep the markets informed of their story and can potentially help make issuances in more challenging times slightly easier.

Funds from Operations and Adjusted Funds from Operations

Based on guidelines established by the National Association of Real Estate Investment Trusts, funds from operations (FFO) consist of net income excluding gains (or losses) from property sales, plus depreciation and amortization, plus adjustments for unconsolidated partnerships and joint ventures. Fitch compares dividends paid to stockholders with FFO. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect FFO on the same basis.

Fitch subtracts capital expenditures and excludes noncash items included in FFO to arrive at adjusted funds from operations (AFFO) and compares dividends paid to stockholders with AFFO. Although FFO and AFFO are after-interest expense measures, these measures are relevant to bondholders and preferred stockholders. Namely, if FFO or AFFO payout ratios are close to or exceed 100%, it indicates the REIT is not retaining cash flow for future liquidity to meet its fixed-charge obligations and is accessing other forms of cash flow to pay its dividends, which Fitch views negatively.

Liquidity Management

Crucial areas within which mortgage REITs manage their liquidity are through bank commitments and liquidity coverage.

Bank Commitments

Unsecured committed bank agreements with maturity dates out at least one year represent a liquidity cushion for mortgage REITs. Fitch will consider the facilities that also have a one-year term-out provision as a positive factor. Additionally, REITs with meaningful operating flexibility under any covenants included in the facility will also be viewed as stronger from a credit perspective. Fitch rarely views reverse repurchase facilities as beneficial from a liquidity management standpoint, as they are secured, often not committed, or, in many cases, are only committed when funded. However, reverse repurchase facilities may be one way in which mortgage REITs demonstrate access to capital.

Liquidity Coverage

Fitch compares a mortgage REIT's sources of liquidity (measured as unrestricted cash, availability under unsecured committed revolving lines of credit and projected retained cash flows from operating activities after dividend payments) with uses of liquidity (secured and unsecured debt maturities and other projected expenditures) over an 18- to 24-month horizon. If sources exceed uses, a liquidity surplus is generated. If uses exceed sources, a liquidity shortfall is generated. Additionally, Fitch divides sources by uses in calculating a base case liquidity coverage ratio, which assumes no external access to capital raises or asset sales. If a REIT's liquidity coverage ratio is below 1.0x, Fitch typically scrutinizes the extent to which the issuer's access to capital and contingent sources of liquidity may mitigate such a liquidity shortfall.

Fitch supplements this base case liquidity methodology with calculations assuming various levels of access to the capital markets. For example, Fitch may assume a range of secured debt refinancing activities (e.g. between 80% and 100% of secured debt will be refinanced on maturity). See the table on page 10 for an illustrative example of liquidity sources and uses and liquidity coverage, including a sensitivity analysis assuming 90% of secured debt is refinanced on maturity.

Fitch further supplements the base case liquidity methodology with an asset portfolio stress case that reflects margin call risk limits availability under revolving credit facilities. Such mark-to-market adjustments are applicable to mortgage REITs that hold liquid assets such as so-called agency mortgage REITs (i.e. mortgage REITs that invest in mortgage bonds issued by government-sponsored enterprises such as Ginnie Mae, Freddie Mac and Fannie Mae).

Liquidity Coverage Example

($ Mil)

	Base Case Assuming No Asset Sales or Refinancing Activity in the Capital Markets	Sensitivity Analysis Assuming 90% Refinance Rate on Secured Debt	Stress Case Assuming Margin Call Risk Limits Availability Under Revolving Credit Facilities
Sources of Liquidity			
Cash	20	20	20
Availability Under Revolving Credit Facilities	500	500	300
Projected Retained Cash Flows from Operating Activities	25	25	25
Total Sources of Liquidity	**545**	**545**	**345**
Uses of Liquidity			
Upcoming Secured Debt Maturities (Next 18-24 Months)	150	15	15
Upcoming Unsecured Debt Maturities (Next 18-24 Months)	330	330	330
Other Recurring Capital Uses	160	160	160
Total Uses of Liquidity	**640**	**505**	**505**
Total Sources of Liquidity Less Total Uses of Liquidity	**(95)**	**40**	**(160)**
Liquidity Coverage (Total Sources of Liquidity Divided by Total Uses of Liquidity) (x)	0.9	1.1	0.7

Unencumbered Assets

For mortgage REITs with unencumbered assets, Fitch measures contingent liquidity by stressing the value of unencumbered assets and comparing those values to outstanding unsecured debt.

Asset Sales

Asset sales may be a supplementary source of liquidity. However, mortgage REITs that fail to remain active or at least familiar to investors in the securitization or whole loan markets risk facing additional hurdles if they should need to raise liquidity from these markets quickly. Fitch views mortgage REITs that are less reliant on asset sales to generate liquidity more positively, given the execution risks inherent in disposing of assets during periods of limited capital markets access for potential acquirers.

Operating Performance

Fitch generally looks for mortgage REITs to have a solid component of recurring contractual cash income from their investment portfolio. Fee income may fluctuate during market cycles. Income from gain-on-sale and gain-on-securitization of assets are often noncash based or nonrecurring. Therefore, Fitch excludes gains-on-sale and gains-on-securitization income from operating performance credit ratios.

Given the various qualities of a mortgage REIT’s earnings, Fitch supplements its review of earnings with a cash flow analysis when analyzing a mortgage REIT’s operating performance. See Appendix B for an overview of operating performance metrics.

Rating Outlooks

Base Case Projections

Base case adjustments to a mortgage REIT’s earnings reflect what Fitch believes the most likely case of earnings generated by a REIT over the next 12–24 months to correspond with the typical outlook time frame. In determining the base case, Fitch utilizes a combination of company projections that Fitch reviews, historical data, peer comparisons, volatility relative to peers and Fitch's view on the performance cycle. Base case adjustments may be positive, negative or flat. Fitch compares its base case with third-party perspectives. Fitch places greater emphasis on its base case projections during its rating process than other REIT projections, including the stress case.

Stress Case Projections

Stress case projections incorporate a view of a potential deterioration in earnings tailored to the specific REIT. In determining the stress case, Fitch reviews factors such as the company's worst performance to date and other risks.

Limitations

General Limitations

See Fitch research on "Global Financial Institutions Rating Criteria," dated January 2014, available on Fitch's website at www.fitchratings.com, for limitations to credit ratings, including credit ratings for U.S. mortgage REITs and similar finance companies.

U.S. Tax Legislation

U.S. mortgage REITs benefit from favorable tax treatment, as they do not pay income taxes on the portion of taxable income paid as dividends to shareholders. Credit ratings could change if federal tax legislation affects U.S. REITs changes.

Appendix A: Hypothetical Examples

Attributes of a Mortgage REIT with a ‘BB’ Issuer Default Rating

Company A is a commercial mortgage REIT that primarily originates commercial real estate loans and finances those originations by issuing senior unsecured notes and preferred stock. To a limited extent, Company A packages its loans into on-balance-sheet securitizations.

Qualitative Credit Strengths

- Company A’s management team is solid. Many management team members have numerous years of experience in the commercial real estate mortgage industry, and the company has existed through various cycles, including periods of challenging capital markets conditions.
- Company A’s underwriting process is robust, and the systems that it uses to monitor the loan portfolio are efficient.
- Company A receives explicit financial support from a large, diversified financial institution with which it is affiliated.

Qualitative Credit Weaknesses

- Commercial properties backing Company A’s loan portfolio are geographically diversified throughout the U.S., although certain of these markets have experienced weakening fundamentals. Collateral backing Company A’s portfolio includes office buildings as well as shopping centers that have underperformed relative to their markets.
- A small portion of the commercial real estate landlords that borrow from Company A are not creditworthy.

Quantitative Credit Strengths

- Company A’s leverage levels, measured as debt to tangible equity and net debt to recurring operating EBITDA, are 3.0x and 5.0x, respectively, and Fitch anticipates these leverage ratios will remain at these levels over the near term. These levels are appropriate for the ‘BB’ rating category given the credit risk of Company A’s portfolio.
- Company A’s liquidity position is good, with sources exceeding uses of liquidity. Additionally, Company A’s portfolio consists of a modest pool of unencumbered assets covering unsecured debt by 1.5x, providing further financial flexibility.
- Company A’s recurring operating EBITDA-to-interest incurred ratio is 2.0x, which is appropriate for the rating category. Fitch anticipates coverage will remain between 1.8x and 2.2x over the near term.

Quantitative Credit Weaknesses

- Company A recently paid dividends to stockholders in excess of the company’s core funds from operations and has not signaled an intention to reduce dividend payout ratios over the near term.
- More than 25% of Company A’s debt obligations are short-term, floating-rate obligations, exposing Company A to funding rollover risk and interest rate movement risk.
- Company A’s on-balance-sheet securitizations may be its ability to sell assets, although they provide long-term match funding.

Fitch assigns a ‘BB’ IDR to Company A based on its credit profile. Company A’s senior unsecured debt ratings are also ‘BB’. Company A’s preferred stock ratings are ‘B+’, which is consistent with Fitch Research on “Treatment and Notching of Hybrids in Nonfinancial

Corporate and REIT Credit Analysis," dated November 2014, available on Fitch's website at www.fitchratings.com.

The following factors may have a positive impact on Company A's ratings and/or Rating Outlook:

- Debt to tangible equity maintained below 2.0x.
- Recurring operating EBITDA to interest incurred remaining above 2.5x.
- Improved credit profile of Company A's borrowers.

The following factors may have a negative impact on Company A's ratings and/or Rating Outlook:

- Debt-to-tangible equity maintained above 4.0x.
- Recurring operating EBITDA to interest incurred remaining below 1.5x.
- A liquidity shortfall.

Attributes of a Mortgage REIT with a 'B' Issuer Default Rating

Company B is a mortgage REIT that originates, acquires and retains an interest in fixed-rate, one-to-four-family prime and jumbo residential mortgage assets. Company B principally utilizes reverse repurchase facilities to fund originations and acquisitions. In the long term, Company B packages its loans into on-balance-sheet RMBS transactions and issues senior unsecured notes and trust preferred securities.

Qualitative Credit Strengths

- Company B's loan portfolio is collateralized by assets owned by individuals with strong and well-documented credit histories.
- Company B's management team has worked together through various capital market cycles, including periods of extremely limited liquidity.

Qualitative Credit Weaknesses

- Company B's master servicer platform has been in business for only two years.
- Sustained adverse conditions in the U.S. housing market could significantly impair the value of Company B's portfolio.
- Company B has a small balance sheet of just more than $1 billion.

Quantitative Credit Strengths

- Company B's leverage ratio, measured as debt-to-tangible equity, is 4.0x, which is strong for the rating category, although the majority of Company B's borrowing base consists of short-term reverse repurchase funding.
- Unencumbered assets cover unsecured notes and trust preferred securities by 1.5x, a respectable margin above covenant requirements. Fitch anticipates unencumbered asset coverage will remain consistent over the near term.

Quantitative Credit Weaknesses

- Company B has a liquidity shortfall over the next 24 months, requiring that it has access to the external capital markets for liquidity funding.
- Company B's recurring operating EBITDA-to-interest incurred ratio is 1.2x, which is weak for the rating category.

Fitch assigns a 'B' IDR to Company B based on its credit profile. Company B's senior unsecured debt ratings are rated 'B/RR4', as recoveries are expected to be average. Company B's preferred stock is rated 'CCC/RR6', as recoveries are expected to be weak.

The following factors may have a positive impact on Company B's ratings and/or Rating Outlook:

- A decreased reliance on reverse repurchase agreement funding to below 25% of overall borrowings.
- Recurring operating EBITDA to interest incurred remaining above 1.5x.
- Increased balance sheet size.

The following factors may have a negative impact on Company B's ratings and/or Rating Outlook:

- Unencumbered asset coverage remaining below 1.5x.
- A covenant violation.
- A long-term decline in housing prices throughout the U.S. from current levels.

Appendix B: Selected Financial Ratios

Fitch typically utilizes the ratios noted below in its analysis of mortgage REITs, but disclosures vary by company. Regardless of the mortgage REIT's disclosure, Fitch will not assign or maintain ratings in cases where data on the mortgage REIT's portfolio and the underlying real estate are not sufficiently robust.

Asset Quality

Key Metric	Definition
Delinquent Assets/Period-End Assets	Assets classified as past due at least 30 days relative to period-end gross assets.
Modified Assets/Period-End Assets	Assets that have been modified such as modified loans to period-end gross assets.
Impaired or Nonperforming Assets/Period-End Assets	Assets where income has either stopped accruing to period-end gross assets.
Gross Chargeoffs/Average Assets	Gross chargeoffs to average assets during the period.
Net Chargeoffs/Average Assets	Gross principal losses less recoveries to average assets during the period.
Reserves/Nonperforming Assets	Asset reserves to nonperforming assets.
Impairment Charges/Average Assets	Impairment charges on loans/average assets.

Assets may include residential or commercial whole loans, mortgage-backed securities, securities referencing loans or mortgage-backed securities or other interests in residential or commercial real estate.

Funding

Key Metric	Definition
Short-Term Debt/Total Interest-Bearing Liabilities	Debt with an original maturity of less than one year to total interest-bearing liabilities.
Short-Term Debt plus CPLTD/Total Interest-Bearing Liabilities	Short-term debt plus current portion of long-term debt to total interest-bearing liabilities.
Secured Debt/Total Interest-Bearing Liabilities	Debt secured by corporate assets to total interest-bearing liabilities.
Committed Funding Facilities/Total Funding	Committed and undrawn funding facilities to total interest-bearing liabilities.
Drawn Credit Facilities/Total Credit Facilities	Drawn funding facilities to total credit facilities.
Unencumbered Assets/Unsecured Debt	Amount of assets free and clear of any encumbrance relative to unsecured debt.

Leverage

Key Metric	Definition
Tangible Equity/Managed Assets	Total shareholders' equity less goodwill and intangibles to managed assets.
Core Capital/Tangible Assets	Core capital to period-end assets less goodwill and intangibles.
Debt/Core Capital	Reported interest bearing liabilities plus off-balance-sheet funding to core capital.
Debt/Tangible Equity	Reported interest bearing liabilities to tangible equity.
Combined Payout Ratio	Dividends plus net share repurchases as a percentage of reported funds from operations.
Net Debt/Recurring Operating EBITDA	Debt less cash divided by recurring operating earnings before interest, taxes, depreciation and amortization.

Operating Performance

Key Metric	Definition
Return on Average Assets	Reported net income to average assets.
Return on Average Equity	Reported net income to average common equity.
Net Interest Margin	Net interest income to average interest earning assets.
Efficiency Ratio	Operating expenses to net operating income.
Fixed-Charge Coverage	Pretax income plus interest expense and other fixed charges divided by fixed charges.
Recurring Operating EBITDA/Interest	Earnings before interest, tax, depreciation and amortization to interest expense incurred.

Appendix C: Industry Profile and Operating Environment

Industry Profile

In 1960, the U.S. Congress created the REIT designation to facilitate investment in real estate by a diverse range of investors, hence the requirement that REITs have at least 100 common shareholders. The legislation offered real estate companies the opportunity to adopt a REIT status for tax purposes, allowing the companies to offset taxable income with the payment of dividends. However, the original act did not allow REITs to generate meaningful income from the sales of assets, which is an important characteristic of the business model for many commercial and residential mortgage originators.

The current REIT structure was established under the Internal Revenue Service Code of 1986, whereby, to maintain tax status as a REIT, a company must distribute at least 90% of its taxable income in the form of qualifying distributions to shareholders. The REIT Modernization Act of 1998 built on the 1986 code and expanded REITs' flexibility to sell assets by allowing for the creation of taxable REIT subsidiary entities. These entities may contribute to a portion of REIT earnings and typically derive much of their income from sales of assets owned less than four years and other nonrent, non-interest-income-generating real estate-related activities.

As U.S. REIT legislation has evolved, mortgage REITs have faced various challenges related to their business models and access to the capital markets. Traditionally, mortgage REITs initially fund the acquisition of investments with short-term secured indebtedness, such as reverse repurchase obligations, wherein the REIT sells securities to a counterparty under an agreement to repurchase them after a short time frame of from 30 days–360 days. These investments are then financed via CDO financing or other types of long-term financing. Availability of both short- and long-term financing contracted sharply on certain occasions, including during credit market disruptions in 1998 and during the financial crisis of 2008.

Operating Environment

In the period leading to the current operating environment, mortgage REITs' investment strategies have been tested, and various companies that elected REIT status failed. Several mortgage REITs that had significant exposure to subprime mortgage-related assets filed for bankruptcy protection after the subprime housing market collapsed in 2007 and the years that followed.

Several RM-REITs that were not primarily exposed to subprime loans were adversely affected by the overall decline in housing prices beginning in 2006. These RM-REITs had increased reliance on short-term financing and exposure to margin calls and filed for bankruptcy, as did several CM-REITs that were unable to refinance short-term funding agreements. In contrast, certain mortgage REITs have been tested and have thrived through real estate and capital market cycles due to a focus on low credit risk investments and/or reliance on long-term match-funded on-balance-sheet securitization financing.

Fitch's rating criteria for mortgage REITs and similar finance companies take into consideration the inconsistent performance of companies in this sector during real estate and capital market cycles. Various qualitative and quantitative factors are incorporated into Fitch's forward-looking views regarding the credit risk of these companies through such cycles.