Commentary

European CMBS 2023 Outlook

DBRS Morningstar
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Mirco Iacobucci
Senior Vice President
Head of European CMBS
+44 20 7855 6653
mirco.iacobucci@dbrsmorningstar.com

Mudasar Chaudhry
Senior Vice President
Head of European Structured Finance Research
+44 20 7855 6613
mudasar.chaudhry@dbrsmorningstar.com

Christian Aufsatz, CFA
Managing Director
Head of European Structured Finance
+44 20 7855 6664
christian.aufsatz@dbrsmorningstar.com

In 2023, we expect the European commercial mortgage-backed securities (CMBS) sector to face several challenges. Our outlook for rental markets is negative for two of five property sectors covered, amid expected economic weakness and structural changes. More imminent, inflationary pressures in 2022 forced central banks to increase interest rates, which translated into rising reference rates, such as Sonia and Euribor. Commercial real estate (CRE) markets and CRE debt performance are sensitive to interest rates as long-term interest rates largely determine CRE valuation yields while the prevailing interest rate determines the cost of financing the purchase of properties. As a result, the rising interest rate environment increases refinancing costs and negatively affect property values, with subsequent increase of loans' default risk at maturity. During the loans' term loan-level interest rate cap agreements are used to hedge the risk of rising interest rates on floating-rate loans, mitigating the impact of rising interest rates. However, such hedging agreements typically expire at loan maturity, also for loans with extension options, with the borrower required to arrange a subsequent hedging agreement to extend the loan maturity date. Failure to put new hedging in place triggers a loan event of default. Some recent transactions have emerged wherein the interest rate cap agreement does not expire on the loan maturity date but prior to the loan termination date, requiring the borrower to purchase a new interest rate cap agreement during the loan term, and failure to do so could cause a loan default.

Also, we would expect short-term financing (two- or three-year terms with annual extension options) to remain popular, as borrowers do not want to be locked in to the current high rates for the traditional five-year loan term. However, short-term loans are more exposed to extension risk and potential default at maturity.

Considering the maturity profile in European CMBS considering next maturity of extendable loans and fully extended maturity dates, our credit outlook for the sector is negative and we expect more loans to be transferred into special servicing during 2023. However, the lower leverage compared with before the great financial crisis (GFC) should keep negative rating performance contained.

The market volatility caused by economic and policy factors negatively affected European CMBS issuance last year as only four public transactions were placed in 2022 versus 15 in 2021. We think that the European CMBS new issuance market is likely to remain subdued in 2023, especially in the first quarter. The expected stabilisation of interest rates and spreads during the year may open windows for new issuance and we forecast a maximum of seven transactions in 2023 for a total amount of EUR 2.5 billion to EUR 3.0 billion.

The following table further details our expectations for the year across each of the main European CMBS property types:

Office

2023 Credit Outlook **Negative**

Prime office locations continue to be resilient, with stable vacancy rates at around 7.8% and headline rents pushing higher. In most tier-one cities, prime office rents hit new records in H1 2022, owing to low prime supply and the ongoing rebound in leasing activity since the Coronavirus Disease (COVID-19) pandemic.

The picture is more negative for secondary offices as a two-speed market takes hold. Vacancy rates in poor-quality offices and in weaker locations are increasing as occupiers cut costs and reduce inefficient space. The existence of 'grey space' is sizeable in poorer-quality offices. Tenants will continue to shed excess floorspace in properties that do not meet corporate environmental and social requirements and will therefore as a whole occupy fewer higher-quality offices.

Retail

2023 Credit Outlook **Negative**

Retail markets have come under renewed pressure as consumers are feeling more negative now than at any time on record in most European economies. Higher interest rates, falling real household incomes, and the war in Ukraine are all weighing on consumer confidence. Higher unemployment is anticipated in 2023, meaning that consumers will prioritise essential spending and cut back heavily on discretionary items, such as fashion, consumer electronics, and home furnishings. In this context, tenant defaults will likely rise and retail rents will likely decline further. Supermarkets and convenience-based retailers will be more resilient, but they are not immune to recession.

Industrial

2023 Credit Outlook **Stable**

The logistics market is likely to feel the effects of recession, although the message from asset managers is that there is no sign of reduced demand – yet. While rising interest rates and higher debt costs have pressured yields, continued rental growth or indexation in lease contracts has offset some of the yield impact. As a result, capital values have been more resilient than expected so far. Prime logistics rents increased by an average of 5.0% in H1 2022 and by as much as 10.0% in Belgium, 9.0% in France, 8.0% in Germany, and 6.5% in the Netherlands. So far, most tenants have been able to absorb the full extent of rent indexation to consumer price index (CPI) in their lease terms, with only a few looking to negotiate fresh terms.

We expect logistics rents to remain resilient as structural demand drivers offset some of the macroeconomic weakness. Furthermore, prime rents in Europe are often set during the pre-letting of new schemes, so higher construction costs and development finance rates will need to be passed on to tenants. This will mean higher asking rents if developers are to retain profitability.

Multifamily

2023 Credit Outlook **Stable**

The situation for residential occupier markets is mixed. While vacancy rates remain very low, tenants are facing pressure from higher inflation and the knock-on effect of indexation in their lease terms. Many jurisdictions are introducing rent regulation in response to this trend—most notably in Denmark, France, Scotland, and Spain—with varying effects on rental levels. We believe that the significant rise in mortgage rates and other difficulties in the mortgaged housing market will make renting the increasingly preferred option, which supports the demand side of the residential sector.

On the supply side, there are depressed levels of housing starts across Europe and we expect the housing shortage to continue for the long term. In Germany, the latest data to July 2022 showed a 2.1% decline in housing permits, although permits for multifamily schemes increased. However, with rising construction costs and debt financing becoming increasingly expensive, we do not expect these permits to be fully developed in the next few years. Limited supply should also remain a positive driver of occupancy rates.

Hospitality

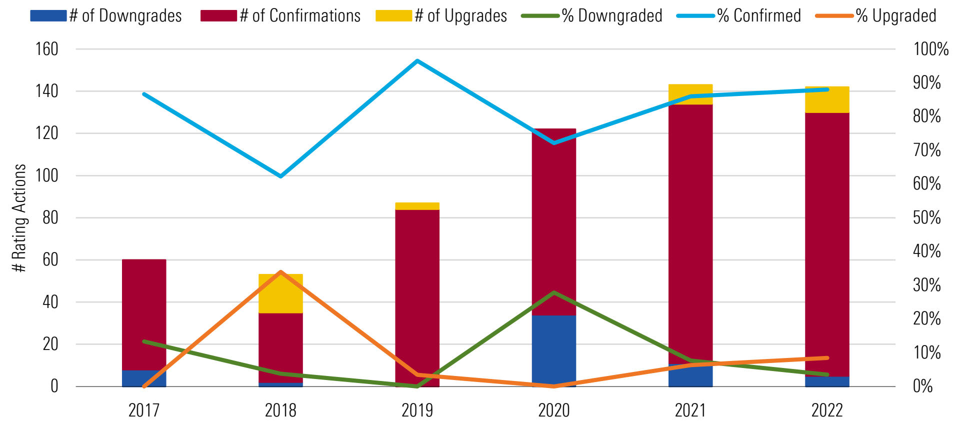
2023 Credit Outlook **Stable**

The lodging industry's recovery continued to accelerate in the first nine months of 2022, despite increasing global economic uncertainty and deep labour shortages across travel and tourism. Year over year (YOY), hotel occupancy and the average daily rate (ADR) across all major European countries grew, supported by strong domestic and emerging international travel demand. Urban markets are experiencing greater momentum in their recovery as more employees return to the office and leisure travellers return to restaurants and live entertainment venues.

CMBS Rating Activity

While during 2020, the number of rating upgrades were limited by the pandemic, on a percentage basis in 2021, rating upgrades have been in line with those in 2018. In 2022, the vast majority of ratings actions were confirmations, but the proportion increased over 2021 as a result of market recovery in the hospitality sector, loan redemptions, and deleveraging. For more details, please refer to table DBRS Morningstar 2022 Surveillance Rating Activity on page 11.

Exhibit 2 European CMBS Rating Activity by Class, 2017–22



Source: DBRS Morningstar

European CMBS Sector Considerations

	Pool Notes		Structural Notes	
	Positive	**Negative**	**Positive**	**Negative**
European Single-Asset Single-Borrower (SASB) CMBS	• Initial loan leverage is still relatively moderate compared with before the great financial crisis (GFC). • Inflationary pressure is expected to push rental income higher, to some extent offsetting the increase of valuation yields. • To hedge against increases in the interest payable under the loan due to fluctuations in Euribor or Sonia, the floating-rate loans are normally hedged with interest rate cap agreements. • The vast majority of loans benefitted from strong sponsorship during the coronavirus pandemic, with sponsors ready to support transactions when required.	• Rising interest rates increase borrowers' debt costs, which translates into lower debt service coverage levels at hedge maturity and/or higher default risk at loan maturity. • Long-term interest rates largely determine CRE valuation yields. As a result, the likely increase of valuation yields in line with interest rates should drive the value of CRE assets downward, translating into higher risk of default at loan maturity. • Mezzanine or subordinated loans increase the overall leverage. • According to DBRS Morningstar's recently published Baseline Macroeconomic Scenarios, we expect negative economic growth in 2023 for some of the largest European economies, including the UK (-1.0%), Germany (-0.6%), and Italy (-0.1%).	• Liquidity reserves can cover potential interest shortfalls. • Principal waterfall typically switches to sequential pay upon adverse loan event. • . • Payments to Class X notes are switched off following the occurrence of certain credit events.	• For interest rate cap agreements expiring before loan maturity or on loan extension date, in a raising interest rate environment, it may become expensive to purchase new agreements. • Cash trap mechanisms in the most recent loans are significantly weaker than standard CRE loans, with the sponsor holding the signing right of the cash trap account until an event of default. • There is a lack of default financial covenants.
	Pool Notes		**Structural Notes**	
	Positive	**Negative**	**Positive**	**Negative**
European Concentrated Multi-borrowers CMBS	• There are more diversified pools with several asset types and different sponsors. • Initial loan leverage is still relatively moderate compared with before the GFC. • Inflationary pressure is expected to increase rental income as well, to some extent offsetting increasing valuation yields. • To hedge against increases in the interest payable under the loan due to fluctuations in Euribor or Sonia, CRE floating-rate loans are normally hedged with interest rate cap agreements.	• Multi-borrower portfolios have generally lower asset quality compared with single-borrower portfolios, with many value-add assets in need of repositioning or full refurbishment. • Rising interest rates increase borrowers' debt costs, which translates into lower debt service coverage levels at hedge maturity and/or higher default risk at loan maturity. • Long-term interest rates largely determine CRE valuation yields. As a result, the likely increase of valuation yields in line with interest rates should drive the value of CRE assets downward.	• Liquidity reserves can cover potential interest shortfalls. • The controlling class is typically the first loss class, which promotes longer liquidations and potential for asset value recovery. • Principal waterfall typically switches to sequential pay upon first adverse loan event. • Substantial principal sequential allocation mitigates negative pooling risk. • Payments to Class X notes are switched off following the occurrence of certain credit events.	• Re- or prepayment principal proceeds of stronger loans allocated (modified) pro-rata to the notes makes senior notes more susceptible to potential credit deterioration of weaker loans. • Relatively weaker sequential triggers in more recent transactions. • Pari passu pieces may be participated in various transactions and/or held by various investors. • For interest rate cap agreements expiring before loan maturity or on loan extension date, in a raising interest rate environment, it may become expensive to

		• Mezzanine or subordinated loans increase the overall leverage. • According to DBRS Morningstar's recently published Baseline Macroeconomic Scenarios, we expect negative economic growth in 2023 for some of the largest European economies, including the UK (-1.0%), Germany (-0.6%), and Italy (-0.1%).		purchase new agreements.
European Granular CMBS	**Pool Notes**		**Structural Notes**	
	Positive	**Negative**	**Positive**	**Negative**
	• Pools have significant diversification in terms of property types and locations. • Some portfolios consist of long term, fully amortising loans. • Some portfolios consist of fixed rate or fully hedged floating rate loans, mitigating the effect of interest rate increases.	• May include shorter-term debt, which is likely to increase the transaction's refinancing risk. • The borrower/lender faces ongoing future funding obligations to complete and meet the business plan. • Rising interest rates increase borrowers' debt costs, which translates into lower debt service coverage levels at hedge maturity and/or higher default risk at loan maturity. • The loans included in these transactions are normally backed by more challenging, transitional types of CRE assets. • Relatively lower sponsor quality than in European SASB and concentrated multi-borrower CMBS. • Long-term interest rates largely determine CRE valuation yields. As a result, the likely increase of valuation yields in line with interest rates should drive the value of CRE assets downward. • According to DBRS Morningstar's recently published Baseline Macroeconomic Scenarios, we expect negative economic growth in 2023 for some of the largest European economies, including the UK (-1.0%), Germany (-0.6%), and Italy (-0.1%).	• The sponsor typically retains a large portion of the first-loss notes, with significant risk retention. • The operating adviser (or collateral manager) from day one is entitled to certain modification rights with respect to the collateral but also to extensive consultation rights for material actions. • Note protection tests exist, which are financial covenants that, if breached, cut off distributions to the equity and set off alarm bells, signifying distress. • Some transactions are sequential from day-one, following the typical European RMBS structure. • Some transactions benefit from considerable excess spread.	• Re- or prepayment principal proceeds of stronger loans allocated (modified) pro-rata to the notes makes senior notes more susceptible to potential credit deterioration of weaker loans. • Pari passu pieces may be participated in various transactions and/or held by various investors. • Deal documents and investor reporting are less standardised.

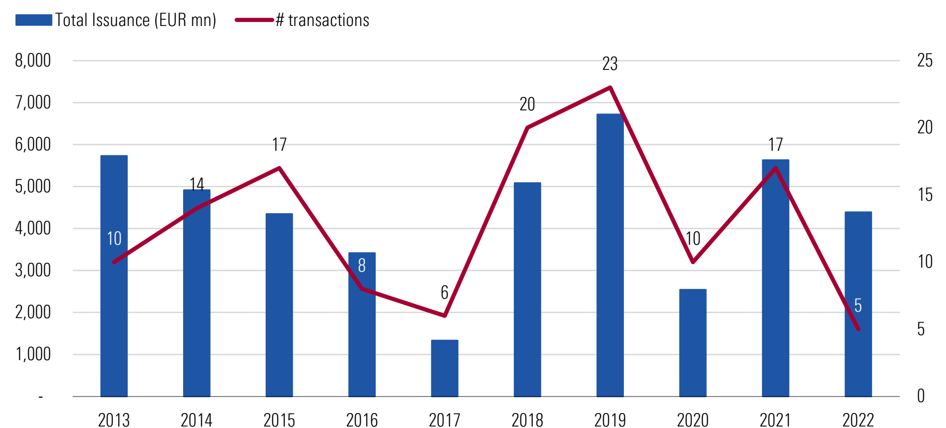
DBRS Morningstar Issuance Perspective

The market volatility caused by economic and policy factors negatively affected European CMBS issuance last year as only four public transactions were placed in 2022 versus 15 in 2021. Also, there was a GBP 3 billion CRE collateralised loan obligation (CLO) retained by the arranger, which is unusual in European CMBS.

DBRS Morningstar thinks that the European CMBS new issuance market is likely to remain subdued in 2023, especially in the first quarter. The expected stabilisation of interest rates and spreads during the year may open windows for new issuance. Generally, DBRS Morningstar expects a maximum of seven transactions in 2023 for a total amount of EUR 2.5 billion to EUR 3.0 billion.

We still anticipate that large single loans will constitute the lion's share of new issuances, but would not be surprised to see one or two pooled European conduit CMBS transactions including eight or more loans, especially in the second half of the year.

Exhibit 1 Aggregate Comment on Rating Activity



Source: Concept ABS, DBRS Morningstar.

European Commercial Real Estate Occupier and Investment Markets

According to CBRE, investment into European CRE reached EUR 229 billion in the first three quarters of 2022. CRE investment volumes reached EUR 68 billion in Q3 2022, a 17% decline compared with Q3 2021. Despite slowing activity during Q3, investment into European real estate achieved a new record for the first nine months of the year, driven by a very strong Q1 wherein total investment volumes reached EUR 87 billion. Rapidly increased borrowing costs will likely continue to negatively affect prices and volumes in the quarters to come.

The rise in interest rates has mechanically pushed up real estate valuation yields. The extent of the rise varies across property types and markets, with an intensifying polarisation between sectors and hyperselectivity by CRE investors. The number of forced transactions remains limited, but could increase as assets have to be refinanced and borrowers struggle to do so. A further slowdown in

economic activity may lead to sharper rises in property yields, namely for assets not considered prime in terms of property type, property characteristics, and/or location.

European CRE Lending

Debt markets remain liquid, but more cautious amid increased scrutiny on underwriting assumptions and more stress-based calculations. Generally, borrowing costs have shot up and some lenders, unsure of where rates and property values will settle, are choosing to cut back or sign off only on the safest loans.

Investors are now warning of a lack of financing in parts of the CRE market, namely with respect to financing costs for development projects that are increasing, according to the *Financial Times*.

Alternative lenders are also retrenching, despite consistently improving their market share of the European real estate lending sector that banks historically dominated before the GFC.

European CMBS Continues to Show Stable Performance, but Deterioration Expected

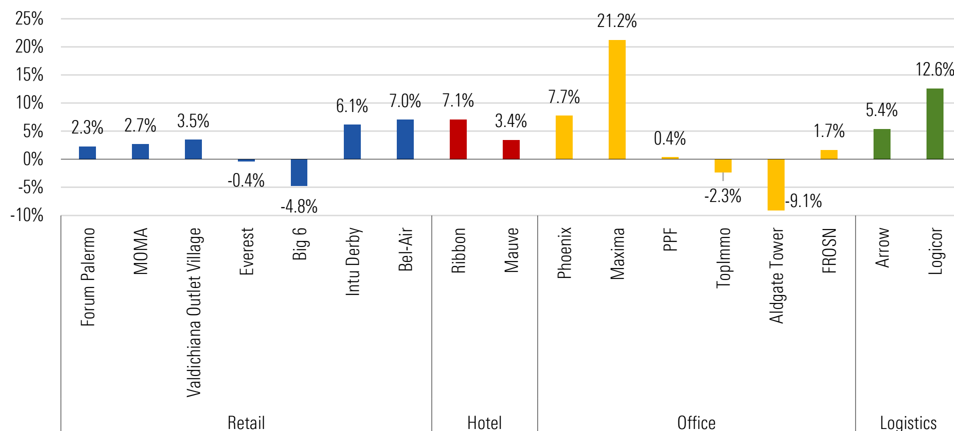
As governments removed travelling restrictions related to the coronavirus pandemic, DBRS Morningstar noticed a general return to normality for most of the loans secured by retail and hospitality assets, which were particularly affected by the pandemic.

The revaluations received in the last 12 months have shown a positive trend for most assets in our surveillance portfolio (see Exhibit 3). With the exception of the Everest Loan (three secondary shopping centres in Italy) and the Big 6 Loan (six secondary shopping centres in the Netherlands) loans, included in Emerald Italy 2019 SRL and Kanaal CMBS Finance 2019 DAC, respectively, DBRS Morningstar noticed a rebound in the value of retail and hospitality properties after the difficulties caused by the pandemic.

Most revaluations of office assets report a market value decline or minimal growth with the exception of the Phoenix and the Maxima loans, secured by 14 and six Dutch office properties and included in Oranje (ELOC 32) DAC and Kanaal CMBS Finance 2019 DAC, respectively

Finally, the logistics sector continues its positive trend with substantial value appreciations during the last 12 months.

Exhibit 3 EU CMBS Portfolio Valuation Changes, December 2021–December 2022 (%)



Sources: DBRS Morningstar, investor reports.

Two out of the three loans that moved to special servicing in 2021 are still in special servicing, with no new loans transferred in 2022.

1. Elizabeth Finance 2018 DAC

   The Maroon loan (the only remaining of the initial two loans in the transaction) is secured by three secondary shopping centres—two in the UK and one in Scotland. The loan has been in special servicing since April 2020 and was accelerated in October 2020, with the appointment of fixed-charge receivers and administrators.

   The portfolio was revalued on 31 January 2020 at GBP 68.9 million, which implies a loan-to-value (LTV) ratio of 92.3% based on the current loan balance of GBP 63.5 million. DBRS Morningstar's distressed value is GBP 50.8 million, which translates in DBRS Morningstar's LTV of 123.4%.

   In June 2022, Waypoint Asset Management (Waypoint) replaced APAM Property Management as the new asset manager of the portfolio. Currently, Waypoint and Mount Street Mortgage Servicing Limited (the special servicer) are discussing the two most viable options to maximise recoveries on the senior loan:

   a. Market the assets for sale in their current state; or
   b. Hold and manage the assets for a period of time and sell on an individual basis at the optimal time.

2. Emerald Italy 2019 SRL

   The EUR 94.8 million senior loan is secured by three secondary shopping centres in northern Italy—two in Milan and one in Brescia.

   Since inception, the portfolio value declined by 18% to EUR 134 million based on the June 2022 revaluation compared with the initial valuation of EUR 164 million, which translates into a current LTV of 70.7% versus 65.5% at origination. DBRS Morningstar’s distressed value is EUR 90.1 million, which translates in DBRS Morningstar’s LTV of 105.2%.

   The loan had an initial maturity on 15 September 2022 and included two one-year extension options. However, the extension option conditions were not met and, as a result, the loan matured on 15 September 2022, triggering the loan's default and transfer into special servicing.

   The special servicer considered that a further standstill on enforcement, subject to certain conditions, would be the best course of action to maximise recovery on the loan on a net present value basis.

   As a condition, subsequent to entry into a new standstill agreement, the borrower appointed a primary standing real estate broker to market and sell the properties. At the borrower’s expense, a surveyor was also appointed to monitor the progression of the marketing and sale of the properties.

   At the latest interest payment date in December 2022, there was interest deferral due on the Class C and Class D notes.

3. Helios (European Loan Conduit No. 37) DAC

   The GBP 310.6 million facility is collateralised by a portfolio of 49 limited-service hotels located across the UK. This transaction, instead, left special servicing in April 2022. A GBP 30.0 million prepayment as well as a GBP 15.5 million deposit into the debt service account to cover potential interest shortfall contributed to the loan's return into primary servicing as a corrected loan.

4. Pietra Nera Uno S.R.L.

   The special servicer extended the final repayment date of the three loans included in this transaction by one year to May 2024. The loans are secured by three retail outlets and one dominant shopping centre in Italy. According to the special servicer, the extension would provide the borrowers time to implement the following strategic asset management initiatives:

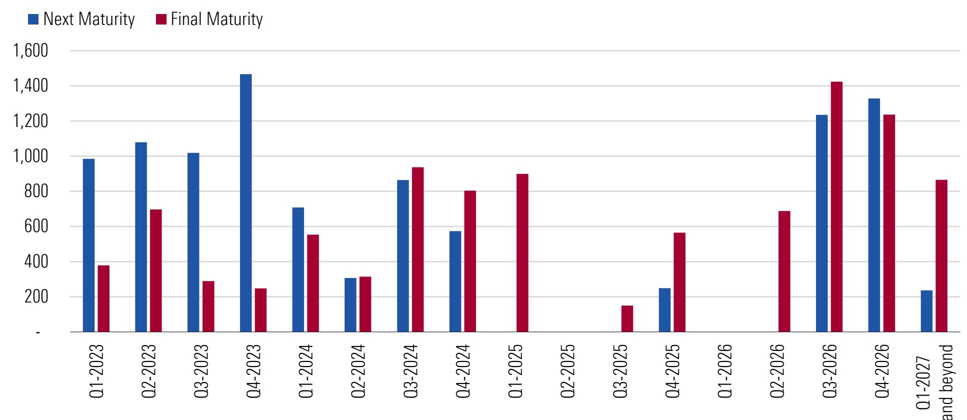
   a. Stabilise occupancy while improving tenant quality and
   b. Continue focusing on footfall and sales growth as well as wait for the recovery of the Italian retail market following the disruption caused by the pandemic and the current macroeconomic instability.

The special servicer concluded that a likely default at the May 2023 loan maturity would lead to a lengthy recovery process and would therefore have negative repercussions on property value.

5. Taurus 2018-1 IT S.R.L.
   The difficulties of the Italian retail market are further underlined by the EUR 78 million Bel Air loan included in this transaction, which is currently secured by five shopping centres located across Italy with a loan maturity scheduled for February 2023. However, the lack of liquidity and investor appetite for retail assets in Italy forced the borrower to propose a restructuring of the transaction, including an extension of the loan and note maturity. A noteholders' meeting will be held in January 2023 and will decide on the borrower's request.

DBRS Morningstar currently rates a total number of 43 loans in 33 European CMBS transactions, with a considerable number approaching maturity in the next few years.

Exhibit 4 European CMBS Maturity Profile by Whole Loan Balance (EUR million)



Sources: DBRS Morningstar, investor reports.

DBRS Morningstar 2022 Surveillance Rating Activity

Deal Name	Collateral	Rating Action	Rationale
Elizabeth Finance 2018 DAC	Three secondary shopping centres (two in the UK and one in Scotland)	In April 2022, we downgraded the Class A Notes to A (high) (sf) from AA (high) (sf), Class B Notes to BBB (low) (sf) from A (low) (sf), Class C Notes to BB (low) (sf) from BBB (low) (sf), Class D Notes to CCC (sf) from B (sf), and Class E Notes to C (sf) from B (low) (sf).	The downgrades follow the portfolio's deteriorating cash flow. The Negative trend reflects the continued slow recovery in the aftermath of the coronavirus and the continuing uncertainty surrounding the UK retail property market.
Deco 2019-RAM DAC	Dominant regional shopping centre located in Derby (UK)	In December 2022, we downgraded the Class A notes to BBB (high) (sf) from A (low) (sf) and confirmed the Class B notes.	The downgrade reflects the collateral's relatively weak performance since issuance and following the deterioration in performance after the onset of the coronavirus pandemic.
Sage AR Funding No.1 Plc	1,609 new purpose-built residential units located across England	In October 2022, we placed all classes Under Review with Negative Implications (UR-Neg.). In November 2022, we confirmed the ratings on all classes with Stable trends and removed them from UR-Neg.	The rating actions resulted from the risk associated with the upcoming expiration of the interest rate cap agreement and the consequent uncertainty about the sponsor's ability to purchase a new, expensive interest rate cap. However, the borrower bought a new hedging agreement and, as a result, we confirmed the ratings on the notes and removed them from UR-Neg.
Helios (European Loan Conduit No. 37) DAC	Portfolio of 49 limited-service hotels located across the UK	In November 2022, we placed the Class E notes UR-Neg. and confirmed the other classes. Later in November 2022, we confirmed the rating on Class E with a Negative trend.	The rating action resulted from the interest shortfall on the Class E notes following the application of the GBP 30 million prepayment of Class A notes in October 2021. The prepayment reduced the excess spread in the deal and, together with the presence of the senior-ranking issuer costs, started to eat into the interest amount payable on the Class E notes since the February 2022 interest payment date (IPD). However, we removed the rating from UR-Neg. once it was confirmed that the trigger of the available funds cap on the Class E notes meant that the interest shortfall was not due and accrued.
Ribbon Finance 2018 Plc	20 hotel properties located across the UK	In November 2022, we upgraded the Class F notes to BB (sf) from BB (low) (sf) and confirmed the other classes. We also changed the trends on Class A through Class F to Stable from Negative.	The upgrade on the Class F note resulted from the reverse principal allocation of GBP 20 million in voluntary prepayment. The trend change to Stable reflects the loan's improved revenue performance and the recovery in the hospitality sector following the lifting of the coronavirus pandemic-induced restrictions.
Oranje (European Loan Conduit No. 32) DAC	14 office properties located across the Netherlands	In February 2022, we upgraded Class B to AA (high) (sf) from AA (low) (sf), Class C to A (sf) from A (low), Class D to BBB (high) (sf) from BBB (low) (sf) and Class E to BBB (sf) from BB (sf).	The upgrades follow the full repayment of the Cheetah loan in February 2022, with the proceeds applied pro rata to the notes at the February 2022 IPD.
Taurus 2019-1 FR DAC	158 predominantly office and mixed-use properties situated throughout France	In April 2022, we confirmed Class A and upgraded Class B to AA (high) (sf) from AA (low) (sf), Class C to A (sf) from A (low) (sf), Class D to BBB (high) (sf) from BBB (low) (sf), and Class E to BBB (low) (sf) from BB (sf). Also, we changed the trend on Class E to Positive from Stable.	The rating upgrades follow the transaction's improved performance due to the deleveraging of the underlying loan and a stable rental cash flow.
Taurus 2019-2 UK DAC	112 urban logistic and multi-let industrial properties throughout the UK	In September 2022, we confirmed Class A and Class D and upgraded Class B to AA (sf) from AA (low) (sf), Class C to A (sf) from A (low) (sf), and Class E to BB (sf) from BB (low) (sf).	The upgrades follow the improved performance of the securitised senior loan in the last 12 months.
Viridis (European Loan Conduit No. 38) DAC	The Aldgate Tower office building located on the	In July 2022, we confirmed that ratings and changed the trend on all classes to Negative from Stable.	The Negative trends reflect the fact that a sizeable tenant, representing 12.9% of annual contracted rent, is in rent arrears and vacated the property in October

Deal Name	Collateral	Rating Action	Rationale
	outskirts of the City of London		2022. Consequently, the loan is expected to be in a debt yield (DY) cash trap at the July 2022 IPD. The Negative trends also reflect the high vacancy level once the sizeable tenant vacates the property and the loan no longer benefitting from a loan-level capital expenditure (capex) reserve or a loan-level interest reserve, as this was released to the borrower following temporary compliance with the relevant thresholds.
HAUS (European Loan Conduit No. 39) DAC	Portfolio of 6,284 multifamily residential units across 92 sites (equivalent to 59 properties) in Germany	In August 2022, we changed the trend on all classes to Negative from Stable and confirmed the ratings.	The Negative trends reflect the delayed execution of the business plan and the consequent misalignment between the target rent and the projected net rental income, which resulted in a breach of the DY cash trap covenant since the April 2022 IPD.

Sources: DBRS Morningstar, investor reports.

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