Article Title: ARCHIVE | Criteria | Structured Finance | ABS: The Main Legal and Analytical Rating Issues of Pub Securitizations Data: (EDITOR'S NOTE: — This article, originally published on Oct. 11, 2004, is no longer current. It has been superseded by "European Corporate Securitizations," published on Feb. 12, 2016.) The number of actual and potential securitization-type structures within the public house (pub) sector is increasing. This article outlines our rating approach to what has now become a significant asset class in its own right. While the rating approach described below covers many of the same elements of other corporate securitizations, there are several aspects of pub securitizations worth highlighting, particularly with regards to property and potential tax issues. Overview of Analytical Approach When rating securitizations in the pub sector we consider the possibility of moving away from the underlying corporate rating on the operating company by mitigating some of its business and financial risks, including operator insolvency risk (that is, risk due to contingency liabilities), potential cash flow volatility, willingness to pay, tax issues, and refinancing risk. The basic approach to corporate securitizations is to ringfence the securitization assets from the rest of the group and to shield everything within the securitization group from external liabilities. The proposed legal structure needs to be sufficiently robust to ensure noteholders should continue to have sufficient control over the operating assets generating the cash flows following the borrower's insolvency. This control is typically achieved through a U.K. secured loan structure comprising an SPE borrower, an operating company that owns and operates the assets, and an SPE that issues rated notes and grants a loan to the borrower. The operating company retains operational control, but grants security (fixed and floating) over the assets in question, to guarantee undertakings under the loan. In the event of default under the loan, English insolvency law enables the capital markets issuer, as the beneficiary of the floating charge, to nominate an administrative receiver to manage the assets and prevent liquidation. This ensures that noteholders control the assets in the event of the default or insolvency of the operating company. Under the secured loan structure, the receiver has the option to continue the business on a going-concern basis or to realize the underlying assets. The former is the basis for our cash flow analysis. Finally, we check the ability to repay rated debt under stressed scenarios, taking into account the costs arising from the assumed insolvency of the operating company, and any mitigants to inherent business and financial risks, including operating covenants, dividends tests, capex requirements, swaps, liquidity facilities and reserves, an amortizing debt structure, and debt tranching. The rating analysis can be split into four main headings: business risk assessment, cash flow analysis, structural analysis, and legal and tax issues. Business Risk Assessment The first step is an analysis of the portfolio and management strategy to reach a view on the business risk of the estate. The business risk score affects the amount of debt issued and the rating levels achievable. The large pub securitizations are, in general, considered to have a low investment-grade business risk. The pub industry can be split between managed and leased estates. Managed estates usually own and operate the pubs directly through in-house managers. They benefit from a more diversified revenue stream than leased estates as they collect all revenues, but, consequently, also bear all costs. In contrast, leased estates own the pubs but lease them to independent tenants. A leased estate's revenue is usually limited to rent, income from the beer tie, and the pub company's (pubco) cut of machine income. Costs are mostly borne by the tenant. To date, we have tended to view leased estates as being more suitable than managed estates for securitization as their cash flows are considered more predictable. This has been reflected in the debt multiples achieved. When analyzing a portfolio, we expect to receive up to five year's data on the revenues and costs of the pub company, for each pub in the estate. This includes: Beer volumes and margins; Rents and rental growth; Machine income; Food sales; Cost breakdown; EBITDA; Freehold or leasehold and lease length; and Capex spend. The exact information required depends on whether the estate is managed or leased. The analysis of capex spend — both maintenance and development — is critical to the business risk score. We are particularly interested in seeing how the underlying estate has grown on a like-for-like uninvested basis, as EBITDA growth based primarily on significant capex spend has been common in the past. We expect the pubco to spend sufficient capex on its portfolio to ensure the estate at least maintains its competitive position at the time of the securitization. We consider this type of capex spend to be maintenance capex. Further development capex spend is usually only possible at the end of the priority of payments once DSCR tests have been met. Cash Flow Analysis Our assessment of a pub portfolio's cash flow generating potential is based on the projected performance of the cash flows under stress scenarios, corresponding to specific rating levels and reflecting the result of the business risk assessment together with market data. Stresses incorporate business elements, financial stresses, and items resulting from the assumed insolvency of the operator(s). Typically, the stress scenario categories will include: "Business as Usual" Beer volumes and margins; Other drink volumes and margins; Food sales and margins; Rents (for leased pubs); Operating costs, including the effect of changes to wages, rents, and rates; Pensions — ensuring that no unfunded pension liabilities are being securitized; Capex (both maintenance and development); and Smoking ban — future transactions will include a temporary decline in sales to reflect the potential introduction of a smoking ban. Financial Step-up interests (in an event of default and/or if this interest is not subordinated); and Interest rate curve (if not hedged). Insolvency Related Insolvency-related stresses include property risk. That is, as pub properties are split between freehold and long and short leaseholds, leases for leasehold properties have to be checked for matters such as forfeiture risk (loss of lease following the insolvency of the operator), disclaimer risk (the liquidator's ability to disclaim onerous contracts), consent to assignment of lease, and covenants preventing alcohol sales or betting. Cash flows from properties exposed to these risks are excluded. Other insolvency-related stresses are: Commingling risk (the risk of cash from the securitization being mixed with cash from non-securitization companies); Overheads - reflecting the costs of an alternative operator; Taxes; Alcohol and betting licensing; Administrative receiver fees; and Effect on key agreements. Concerning the effect on key agreements, (i) servicing and supply agreements may have clauses that permit their termination, in which case modeled costs need to reflect those in the industry in a stressed environment; (ii) in particular, the beer supply agreement may have minimum throughput obligations and we need to ensure that, where the securitization group meets its commitments, it is not exposed to a contingent liability if a non-securitization group company cannot in turn meet its obligations; and (iii) as we do not assume the beer supply agreement continues post-insolvency, we look to see what an alternative supplier would charge at market rates. It could be argued that insolvency-related stresses should apply when stressed performance goes below the level of the financial covenant, causing an event of default under the loan. However, given that the operating company and the borrower are not bankruptcy remote, we assume that they may default at any time during the transaction for other reasons, such as contingent liabilities. Insolvency is therefore assumed to occur at any time during the life of the transaction, regardless of performance under the stress cases. Modeling of payment priorities reflects the borrower's priority of payments post-enforcement but pre-acceleration, as we assume that the loan is not accelerated and that payments continue to be made to junior noteholders when cash is available and rolled up. We do not model the post-acceleration priority of payment due to the obligation on the security trustee to act in the best interests of all noteholders (see "Trustee Versus Monoline" below). Cash flow stress runs are considered successful when debt at the specific rating level and above is repaid with no or very limited use of the liquidity facility. All notes need to pay timely interest and principal repayments also need to be made in a timely manner for fixed-rated notes. For floating-rate notes, the rating usually reflects the ultimate payment of principal and therefore the timing of payment of principal is not considered in our analysis. One of the most useful comparisons between the various rated pub securitizations is the minimum coverage ratio in a flat-case scenario (see table 1). The differences in levels are due to several factors, including the different stresses applied to managed versus leased estates, the proportion of short and long leaseholds, and the trade-off between debt optimization and operational and dividend flexibility. Table 1 Pub Securitizations/Minimum DSCRs in Flat Case at Last Issuance MANAGED LEASED SPIRIT FUNDING LTD. (SPIRIT) MITCHELLS & BUTLERS FINANCE PLC (M&B;) PUNCH TAVERNS FINANCE PLC (PUNCH) PUBMASTER FINANCE LTD. (PUBMASTER) UNIQUE PUB FINANCE CO. PLC (UNIQUE) AUGUST 2003 NOVEMBER 2003 NOVEMBER 2003 NOVEMBER 2002 SEPTEMBER 2002 EBITDA A 2.33 2.32 1.88 1.67 1.61 BBB+ N/A 2.13 N/A N/A 1.43 BBB 1.76 N/A 1.46 1.37 1.30 BBB- 1.68 N/A N/A N/A N/A FCF A 1.71 1.47 1.75 1.57 1.46 BBB+ N/A 1.30 N/A N/A 1.31 BBB 1.29 N/A 1.35 1.29 1.18 BBB- 1.23 N/A N/A N/A N/A N/A--Not applicable. Another useful comparison, although not cash flow based, is the LTV ratio for each rating level, determined by non-stressed property valuations at closing (see table 2). Table 2 Pub Securitizations/LTV Comparisons at Closing LTV Ratio LTV (%) SPIRIT M&B; PUNCH PUBMASTER UNIQUE AAA 32 27 19 16 14 A 42 45 56 61 65 BBB+ N/A 51 69 N/A 76 BBB 59 N/A 78

77 85 BBB- 62 N/A N/A N/A N/A N/A--Not applicable. The notes rated 'AAA' benefit from a financial guarantee from a 'AAA' rated counterparty, while the underlying rating is 'A'. The fact that no pub securitization to date has achieved an underlying rating above 'A' does not imply the use of a rating cap, but reflects the wide difference between the business risk score and the rating on the debt, which would require stresses delinking the repayment of this highly rated debt from industry drivers. This can be achieved only if the properties have an alternative-use value providing sufficient collateral under our CMBS criteria. In our opinion, it is unlikely that the alternative-use value for a pub estate would be much higher than 25% of its value as a going concern. Structural Analysis The critical features of securitizations are the structural and legal aspects, which enable us to rate the notes higher than equivalent corporate bonds. We analyze whether the inherent business and financial risks are adequately mitigated through a set of structural enhancements, which include operating covenants, dividend tests, interest and currency hedging, liquidity facilities and various reserves, the presence of a sequential amortizing structure, and tranching. Key issues relating to these enhancements are summarized below. Priority of Payments/Events of Default Pub securitizations typically have three priority of payments at the borrower level and two at the issuer level. Borrower level: As long as the trustee has not enforced its security following a borrower event of default, payments continue to be made under the borrower pre-enforcement priority of payment. Following an event of default, the trustee has the choice between two priority of payments: Borrower post-enforcement without acceleration (similar to pre-enforcement but with no dividends); and Borrower post-enforcement with acceleration (the principal on the senior-most notes is paid before the interest on the next most senior notes). In both cases, we check where any excess cash goes. No dividends should be payable in these situations. We expect a broad range of borrower events of default, to ensure that cash is trapped and control given to the noteholders before debt service under the notes is jeopardized. These should include, at the very least, breach of a DSCR covenant set above 1.0x and a minimum net worth covenant. It is usually possible to cure a breach of financial covenants, although our preference is for a lasting cure rather than a one-off cash injection. Enforcement of the loan following an event of default should not be mandatory for the trustee. Issuer level: The issuer pre-enforcement priority of payment is applicable unless the notes are accelerated, in which case principal on the senior notes is fully repaid before any payments (interest and principal) can be made under the subordinated notes (issuer post-enforcement priority of payments). Events under which the notes can be accelerated should be limited to three events: failure to pay, breach of obligation (subject to a materiality test), and bankruptcy of the issuer. Acceleration of the intercompany loan between borrower and issuer is not an event of default for the issuer. Owing to the higher rating on the senior notes, non-payment of the subordinated notes is not an event of default while senior notes remain outstanding. Trustee Versus Monoline As seen above, we do not typically assume acceleration of the debt as this is unlikely to be the chosen option of the trustee who has an obligation to act in the best interests of all noteholders, including the subordinated noteholders. The trustee has regard to the senior-most noteholders' interest only if a conflict of interest arises between the different seniorities of notes. In some pub transactions, the monoline replaces the senior noteholders in the process, which is compatible with our ratings as long as this does not affect the role of the trustee. The situation is, however, different when the senior noteholders, or the monoline on their behalf, control the enforcement process. In this circumstance, senior noteholders clearly have a strong incentive to accelerate in order to benefit from all cash available. We are not comfortable with this situation as it significantly disadvantages subordinated noteholders. Tranching and Amortization Pub securitizations usually amortize fully during the life of the transaction to eliminate any refinancing risk. It is also highly recommended that amortization starts from day one and that it is sequential. Subordination, effectively, includes a no petition clause by the subordinated notes while more senior notes are outstanding. Subordination also requires sequential repayment of each class of notes. Pro rata repayment is possible, but results in lower senior debt levels as a result of our stresses. We have accepted non-sequential amortization in a few cases in which the underlying corporate has similar characteristics to a corporate rating at a level consistent with the highest rated notes outstanding in the securitization by the time non-sequential amortization starts. For example, where the highest rated note is 'A', the underlying corporate should have a similar financial profile to an 'A' rated corporate credit. Liquidity Facility, Reserve Fund, and Swaps The liquidity facility,

swap, and reserve fund all need to be at the bankruptcy-remote issuer level. The reserve fund and liquidity facility have in the past usually been available to any class, including subordinated debt, and so have had the paradoxical effect of continuing payments on the subordinated notes, thereby delaying acceleration. This has been resolved in recent transactions by the introduction of tranched liquidity facilities to avoid all liquidity being used for the subordinated debt. Liquidity facilities are usually sized at between 15 and 18 month's debt service. Prior to default, liquidity facilities are repaid on an annual basis at the top of the priority of payments, except when "tranched", in which case only the portion used for the senior notes should be repaid before the senior notes' debt service. As this best practice can vary, it is important to ensure that the cash flow model mirrors the documented priority of payments. Furthermore, it is key that the liquidity facility be callable in any circumstances where there is a cash shortfall. Pub securitizations typically include interest swaps to mitigate the risk of having flat operating cash flows in a high interest rate environment and, potentially, currency swaps to mitigate adverse currency movements depending on which currency the debt is issued in. Our swap criteria apply for interest and currency swaps, but given that the maximum rating on the notes is usually 'A', no posting of collateral will be required at 'A-1'. Financial Covenants Financial covenants enable noteholders to intervene well in advance of an actual insolvency. The main DSCR test is typically set at 1.10x-1.15x on a free cash flow basis and/or 1.25x–1.35x on an EBITDA basis. A breach can usually be remedied within a certain period; again we prefer lasting remedies. Additional DSCR tests at a slightly higher level may also be set, with a breach resulting in the appointment of an external financial adviser. Other financial covenants include a minimum tangible net worth and/or minimum funding requirements of reserve accounts. The DSCR is calculated on a four-quarter rolling average basis to account for income and cost variations. We prefer to use a free cash flow test to an EBITDA-based test to ensure transparency and comparability between transactions. The cash element excludes non-cash, any exceptional items, and cash balances in reserves, which do not reflect performance. Dividend Restrictions These are set in accordance with the management case to ensure stakeholders are rewarded only if performance is strong. In new transactions, there is often a full dividend lock-up during the first two to five years of the securitization. A breach of the dividend trigger can result in either a replenishment of the cash reserve or a prepayment of the notes. As cash reserve replenishment raises commingling issues with regards to the accounts and is not an optimal solution, we prefer trapped cash to be used to repay the notes. (See also the article entitled "Guidelines to the Release of Excess Cash in European Corporate Securitizations", detailed under "Related Articles" below.) Table 3 Pub Securitizations/Dividend Test Triggers SPIRIT M&B; PUNCH PUBMASTER UNIQUE DIVIDEND TEST EBITDA N/A 1.70 1.50 N/A N/A Cash flow 2.05-1.80 1.30 N/A 2.00-1.50 2.00-1.50 N/A--Not applicable. Operating Covenants Disposal and acquisition restrictions ensure the quality of the assets generating the cash flows is maintained throughout the life of the transaction. In a very diversified pool where no asset has a predominant position, the limit will typically be expressed as a percentage of total EBITDA, and will also be subject to good performance and a sales-to-minimum sale price test (that is, a debt-to-EBITDA multiple). Minimum maintenance capex requirements are in place to ensure the competitive position of the estate remains at least as good as at closing. We check whether enhancement capex has resulted in increased revenues; if not, we are likely to consider it as defensive capex, which needs to be included in the maintenance capex calculation. No additional borrowing is permitted in any pub securitization without rating affirmation, with the exception of Unique, for which a pre-agreed tap of up to £170 million was agreed subject to certain performance tests. This was agreed due to the nature of the securitized assets, which were managed pubs being converted to leased, where the conversion process was not fully complete at closing, and to allow for seasoning. Information Requirements Ongoing surveillance of the performance of a securitization is key to the rating process and requires frequent access to extensive information, which will usually be provided on a quarterly basis. This information needs to be audited at least semiannually and to be sent in a timely fashion. Quarterly reports need to include, at least: A net asset statement; A detailed cash flow statement; A statement of any debt amortization payments made to date, compared with any pre-defined amortization schedule; The calculation of net worth, free cash flow, EBITDA, and relevant DSCRs; Whether the financial covenants and the restricted payment conditions have been met; The amount of expenditure on permitted developments; Details of any permitted acquisitions and disposals and any other material changes to the assets; The return on previous investments; Whether a loan event of default or financial adviser appointment event has occurred and, if so, a description thereof and the action taken or proposed to remedy it; The cumulative amount of capital maintenance expenditure spent in the current calendar year; The balances in the various accounts; and Other, depending on the transaction. Our surveillance process is further detailed in the article "Ratings and Surveillance Process in European Corporate Securitizations". See "Related Articles" below for more information. Risk Capital Requirement and Valuation Our analysis is not only cash flow based, but also takes into account the significant equity contributions from shareholders and management that are required to provide management with the incentive to optimize asset performance. Risk capital is usually calculated as the difference between the property valuation and total debt, rated and unrated. Although we rely on external valuers, we pay close attention to the valuation method used, and usually apply haircuts to such valuations when calculating the level of risk capital. Depending on the business risk of the estate, minimum capital requirements for an 'A' rating usually range between 15% and 20%. We have written an article on risk capital in corporate securitizations, which describe our guidelines in more detail (see "Related Articles" below). Legal and Tax Issues The main issues to be considered are outlined below. SPE's Bankruptcy Remoteness The SPE issuer needs to meet our bankruptcy-remoteness criteria, which include: Restrictions on objects and powers; Debt limitations; The presence of an independent director (for corporate SPEs, or the equivalent in the case of other forms of SPEs) during the whole term of the transaction; Restrictions on merger or reorganizations, etc.; Separateness, covenants, and non-consolidation opinion; and First priority security interests over the assets. The other companies within the securitization net are not bankruptcy remote, but covenants reduce their likelihood of default. The basis of this approach is to ringfence the securitization assets from the rest of the group and to shield everything within the securitization group from external liabilities. Following the implementation of the U.K. Enterprise Act, the issued notes have to meet the criteria for the capital markets exemption, to ensure an administrative receiver can be appointed. Commingling Risk There is a risk that funds in the borrower's accounts or reserves that are in the name of the borrower and which can be used by the borrower or the operating company could be treated as an unsecured debt of the insolvent entity. As in other securitizations, commingling risk is mitigated by security interests over all accounts in favor of the security trustee. The risk of a recharacterization of the fixed charge as a floating charge, in which case preferential creditors would rank ahead of secured creditors and time to recovery extended, is mitigated by restrictions on the borrower's ability to withdraw funds at its own discretion and a declaration of trust or other effective security over the account. It is, however, unlikely that the risk of recharacterization can be fully mitigated, and as a result cash flow stresses usually assume a credit loss up to at least the amount of potential preferential creditors' claims. Security Security requirements are as follows: The properties need to have a fixed charge duly registered prior to closing. If the properties only benefit from a floating charge over the freehold/leasehold interests, there is a risk that preferential creditors might rank ahead of senior noteholders. Following the changes to the Enterprise Act, we take into account up to £600,000 set aside for unsecured creditors for each borrower/operating company. The more borrowers there are in the structure, the more material this amount will be. A share pledge is also required to remove the incentive of a potential liquidator from selling assets and crystallizing tax charges. Preferential Creditors A key risk with respect to insolvency law is the position of preferential creditors relative to rated debt, including wages and accrued pensions. Most of these operating expenses are required to be paid monthly and have already been included in the EBITDA calculation and paid senior to debt service. Any deferrals on payment to preferential creditors would likely occur at or near the point of default and are, therefore, largely a matter of liquidity sizing on a going-concern basis. Finally, we also require a competition law analysis, a Section 151 analysis ("whitewash"/financial assistance), and others depending on the circumstances of the transaction. Tax Issues Pub securitizations are usually tax efficient, as there is no transfer of assets (only shares are transferred), meaning that liabilities such as capital gains tax (CGT) or stamp duty are usually avoided. Tax issues can, however, arise in two ways: (i) securitizations often involve the restructuring of a group, which means that CGT, stamp duty, or secondary liabilities may arise; and (ii) the insolvency of a company may affect the tax position of the issuer — in particular, we look for confirmation that insolvency will not result in the acceleration or crystallization of any tax liability. We check that there are no taxes payable

by the issuing SPE or that any such taxes have been sized for and reflected in the cash flow stresses. The main tax issues are: Group relief. Can losses from non-securitization companies be surrendered in to the securitization group? If so, when and at what price? We usually need confirmation that no group relief is surrendered out of the securitization group company except in appropriate circumstances against prior receipt of payment. Group payment arrangements. If non-securitization companies are included in the group, there may be a contingent liability for taxes for the non-securitized companies on a current basis. Secondary tax liability risk. (i) Embedded CGT: degrouping outside the control of the securitization group can trigger CGT inside the securitization group. (ii) Claw-back of capital allowances: if not enough capex is spent, the pubco could lose the tax shelter of capital allowances. In practice, this is not often an issue for pubs. Stamp duty and claw-back. (i) In principle, we look for a cash reserve pending the granting of stamp duty relief. (ii) Where there is a risk of claw-back, we look for the amount to be reserved in cash unless a legal/tax opinion convinces us that this cannot be involuntarily triggered. VAT grouping. We normally require that the issuer and non-securitization companies do not form part of any VAT group. Related Articles "Guidelines to the Release of Excess Cash in European Corporate Securitizations" (published Sept. 29, 2004). "Ratings and Surveillance Process in European Corporate Securitizations" (published Sept. 29, 2004). All criteria and related articles are available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. The criteria can also be found on Standard & Poor's Web site at www.standardandpoors.com. Group E-Mail Addresses
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