Operational Risk Assessments

1st Service Solutions, Inc.

November 2016

Operational Classification: Commercial Vendor: Commercial Debt-Resolution Advisor

Ranking: MOR CV2 (Assigned)

Forecast: Stable

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Rationale

Morningstar Credit Ratings, LLC assigned its second-highest ranking, MOR CV2, to 1st Service Solutions (1st Service) as a commercial vendor serving as a commercial debt-resolution advisor for borrowers with distressed loans contained in commercial mortgage-backed securities. Morningstar based its ranking on the following factors:

- Experience: The company has highly experienced managers and asset managers with servicing and special-servicing backgrounds.
- Track Record: The company enjoys a solid track record of assisting borrowers to work through successful loan resolutions. Since 2011, the company has resolved 397 distressed or defaulted commercial mortgage loans covering a variety of resolution methods, property types, and geographic locations, with a combined balance of $7.3 billion involving 19 CMBS special servicers. As of July 2016, it completed 32 resolutions, compared with 45 in 2015 and 52 in 2014.
- CMBS Expertise: 1st Service has familiarity with CMBS pooling and servicing agreements and special servicers' reporting requirements.
- Technology: The company has a robust proprietary net-present-valuation model which it recently enhanced to provide 10-year income and discounted cash flows projections. It also has a tool to integrate loan and securitized pool data from third-party sources to identify and communicate with potential clients. The company is currently developing a portal for clients to track their casework progress.
- Policies and Procedures: The company has workflow diagrams for each operational function available to employees on a shared drive. These diagrams, which make procedures for each operational function very clear, can be readily amended as the need arises.
- Capital Sourcing: The company has strong relationships with brokers and other real estate-capital providers who are familiar to and work with many CMBS special servicers. These relationships provide borrowers access to capital needed to make their resolution strategies practicable and acceptable to special servicers.

Forecast

The forecast for the ranking is Stable. Morningstar expects 1st Service to serve as an effective debt-resolution advisor for CMBS borrowers and expects the ranking to remain unchanged during the next 12 months.

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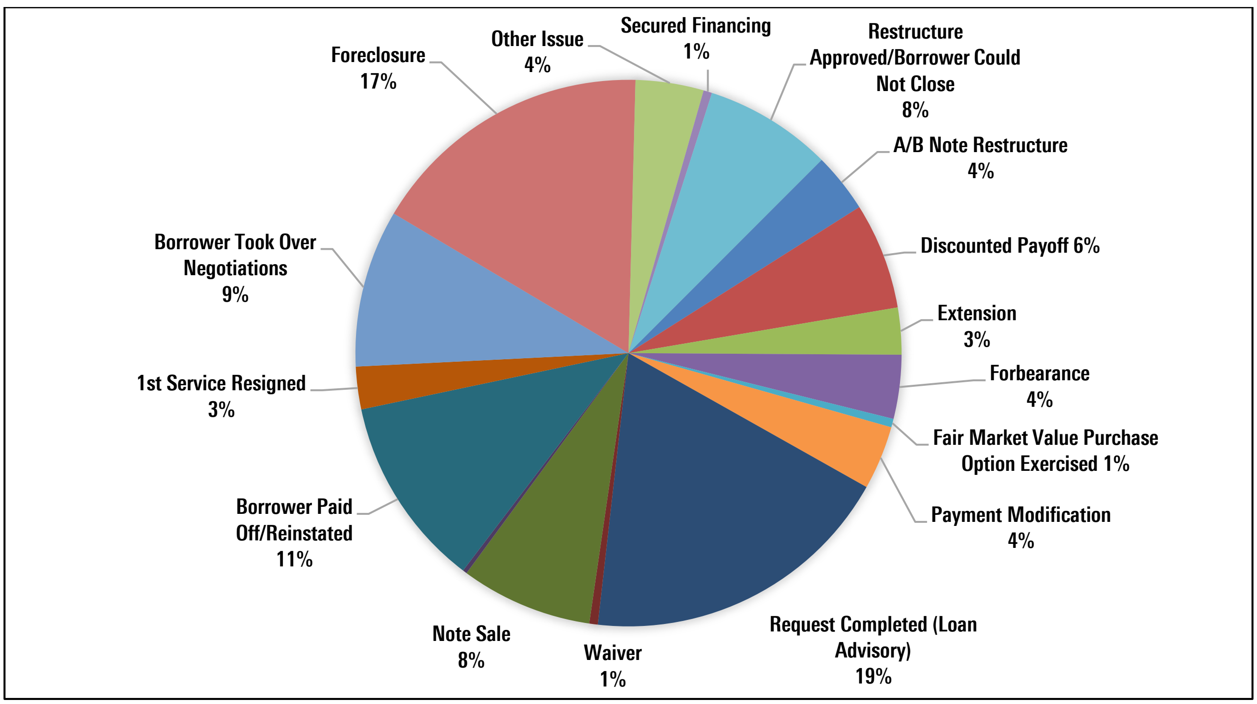
Company Profile and Business Overview

Privately held 1st Service is headquartered in Dallas with offices in San Diego and Boston. CEO Ann Hambly started the company in 2005 to guide borrowers through the myriad of complex and often confusing requirements imposed by the documents governing CMBS transactions. As was the case with defeasance several years ago, some CMBS borrowers have become confused and frustrated by the labyrinth of requirements and conditions imposed for consents such as assumptions, partial releases, and easements. Hambly conceived 1st Service as a boutique company dedicated to supporting borrowers throughout this often arduous process. The company initially focused on the assumption approval process; however, since the financial crisis in 2008, the company has focused primarily on restructuring CMBS debt, providing guidance for borrowers involved in the note auction process, matching borrowers in need of equity injections with sources of capital, and assisting borrowers in need of a 1031 exchange under the Internal Revenue Service code. The company succeeded in gradually expanding its client base beyond borrowers to include attorneys, investment sales brokers, capital market brokers, mezzanine lenders, company turnaround experts, and distressed-property buyers. These entities, which interact with distressed debt borrowers, could benefit from the company's expertise. The company maintains an affiliated entity which connects borrowers to potential sources of capital for equity infusions as part of the resolution process. As of July 30, 2016, the company employed 19 people. A senior management team with extensive backgrounds in banking, real estate asset management, and commercial loan servicing, leads 1st Service. The firm has completed 397 total loan resolutions since 2011 through July 2016 representing a total of $ 7.3 billion in unpaid principal balances (UPBs).

Chart 1 – Total Loan Resolutions (2011-July 2016)*



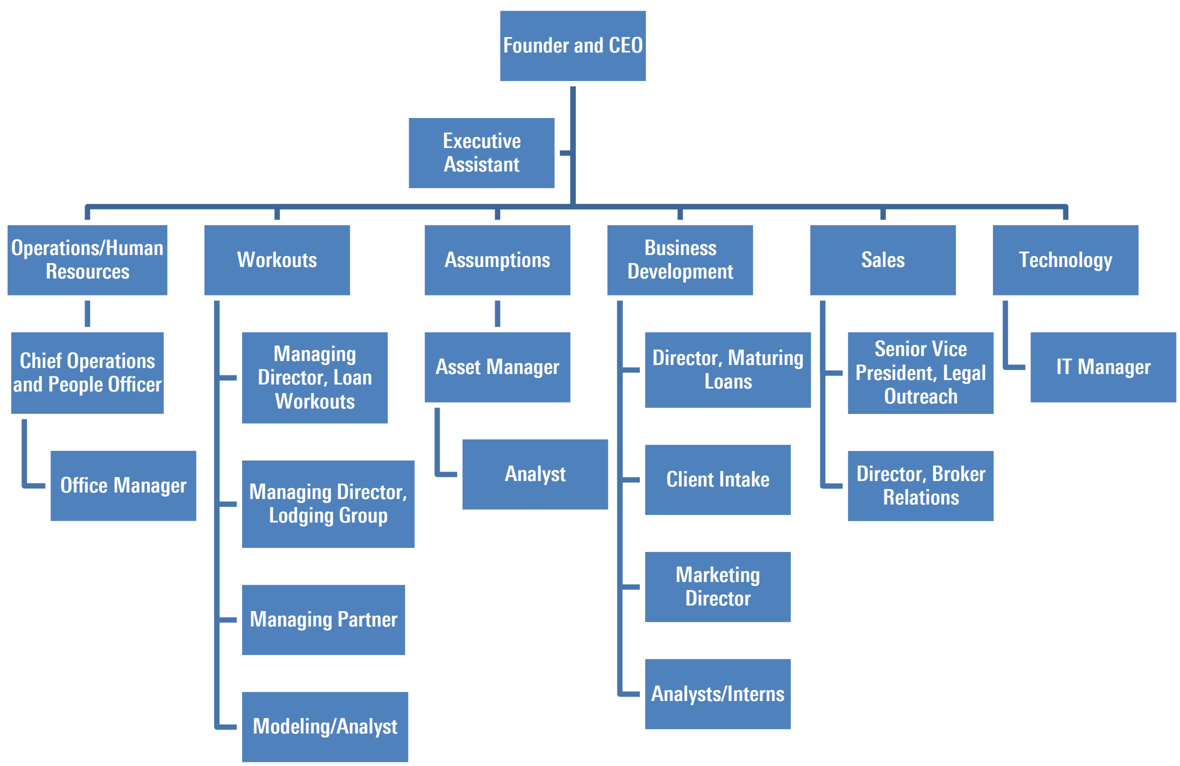
*Total exceeds 100% because of rounding.

Operational Infrastructure

Organizational Structure

1st Service's organizational structure reflects the company's focus on two main goals: borrower advocacy and outreach. The company has six departments: workouts, assumptions, business development, sales, technology, and operations and human resources. The workout department handles all aspects of borrower loan resolutions, including discounted payoffs, capital infusions, note sales, and any other methodology of resolving nonperforming or underperforming loans. The assumptions group works on the firm's original business line of guiding borrowers through the consent process within the context of CMBS pooling-and-servicing-agreement requirements. Business development focuses on the task of identifying and reaching out to troubled borrowers using a variety of data feeds and outreach methods. Sales focuses on negotiating engagements and maintaining relationships with brokers and other intermediaries with borrowers to build a referral business. The technology department maintains and enhances the company's proprietary software for loan resolution modeling and the applications used to track workflow. Operations and human resources handle personnel issues, training, and the day-to-day running of the company.

Chart 2 – Organizational Structure



Management and Staff Experience

As of June 2016, senior management had nearly 30 years of industry experience and middle management averaged nearly 27 years of experience. Staff averaged about 14 years of industry experience and nearly three years with the company. This somewhat large discrepancy in industry experience is intentional, as the company recruits staffers out of college, frequently through internships, and senior managers mentor them. This seems to be an effective approach, as the field of commercial debt advisory is relatively new, and it allows staffers to become acclimated with the company's culture and borrower-oriented business approach. The strong oversight of senior managers, coupled with the frequent quality control and process reviews of each case disposition, allows this employment model to work well and foster staff retention. There has been no employee turnover in the past 18 months.

Table 1 – Management and Staff: Average Years of Experience

	June 2016		December 2015		December 2014	
	Industry	Company Tenure	Industry	Company Tenure	Industry	Company Tenure
Senior Management	29	4	28	4	27	4
Middle Management	27	8	26	7	15	5
Staff	14	2.5	14	1	3	2

Management and Staff Turnover

The high turnover rate in 2015 involved the voluntary departure of seven people coinciding with a temporary downturn in business volume.

Table 2 – Management and Staff Turnover Rates*

	First-Half 2016	2015
Total Staff - Beginning of Period (# of Positions)	15	15
Total Turnover Rates (%)	0	47 (7 Positions)
Involuntary (%)	0	0
Voluntary (%)	0	47
Management Only(%)	0	20
Staff Only (%)	0	27
New Hires (# of Positions)	4	7
Total Staff - End of Period (# of Positions)	19	15

* Staff departures divided by number of staff at beginning of period.

Workload Ratio

1st Service had 10 analysts dedicated to distressed loan resolutions as of June 30, 2016, and the ratio of resolution cases per analyst stood at 20/1. This ratio may fluctuate depending upon the complexity of a particular resolution case.

> **Assessment:** Although the company experienced high employee turnover in 2015, this largely reflected a severe, but temporary downturn in resolution case volume and all were voluntary departures due to this fact. The turnover rate has stabilized to 0 since then. 1st Service's senior and middle management are well-experienced and its organizational structure effectively addresses its debt-advisory business both with regards to loan resolution casework as well as the sourcing of new and maintenance of existing client relationships. The average years of experience for staff involved in loan resolution, while much lower by comparison, reflects the company's practice of hiring young people who can be mentored in the somewhat unique business of borrower advocacy and nurturing their career within the company.

Training

1st Service maintains a robust albeit informal training regimen for its employees as befits a company of its size. It holds formal monthly training sessions, which are taught by senior managers or third-party experts. Each employee receives 18-24 hours of training through these sessions. In addition, the company provides monthly practice sessions where a senior manager will review a specific service offering provided by the company. The purpose is to walk through the function and identify any weaknesses or areas for improvement. Practice sessions have covered topics including assumption, option analysis, restructure planning, and prequalification processes. Finally, the company offers free instructional webinars on a quarterly basis and has done so since 2009. These webinars focus on timely topics within the CMBS industry, such as impending maturities, note auctions, receiverships, tenants-in-common restructures, and modifications, and are open to the public. The company offers 140 hours of training and expects each employee to complete a minimum of 80 hours of training. While this number may seem high, the company believes the nature of borrower-advisory work necessitates even greater training and preparation than traditional loan administration.

> **Assessment:** The company possesses a robust training regimen for a company of its size. While formal classroom training would not be expected, it is generally an industry best practice to have each employee's hours of completed training tracked centrally and incorporated into his or her performance review.

Audit, Compliance, and Procedural Completeness

1st Service uses a thorough and detailed quality-control regimen that regularly reviews functions performed by each department. Rather than reviewing processes on a quarterly or even monthly basis, the company performs quality-control reviews on each active resolution case for each step in the process before the next step is undertaken. The program is extremely detailed and outlines the areas to be reviewed, the review objective, the type of examination performed, the responsible parties, the frequency and the supporting documentation evidencing the review, and results reporting. In addition, the company said that it is committed to engaging a third-party company to perform an independent, agreed upon procedures audit each year beginning in 2017.

> **Assessment:** Based on the small size of the company and the fact that it handles no cash in its loan-resolution activities, Morningstar believes 1st Service has an effective quality-control program. Furthermore, the company's commitment to hire an independent third party to perform agreed upon procedural audits speaks well to 1st Service's attention to risk management. Such an audit protocol will serve the company well as it grows its loan debt advisory business.

Legal Liability and Corporate Insurance

1st Service reported that it was not involved in any pending litigation connected with any of its businesses. Furthermore, it reported that it has directors and officers and errors and omissions insurance coverage in place.

> **Assessment:** Morningstar, which reviewed the company's insurance coverage, determined that its directors and officers and E&O coverage amounts are adequate, because the governing language in its engagement contracts unequivocally limits its liability in any dispute to fees paid by the client, and the business involves no cash management or custody of any kind.

Technology and Disaster Recovery

1st Service uses two proprietary technology systems. One, named client relationship management, or CRM, is a data warehouse fed by three outside data sources which assist the company in identifying new business and following leads to borrowers in potential distress. This system also maintains a running ledger of pipeline activity for all borrower casework and prospective new business. The second application, named Joule, is a net-present-valuation cash flow model that can be used for any type of collateral and can be adjusted to work with any set of variables and assumptions. A third-party technology company reviews the system and issues recommendations for upgrades or other changes as needed, A third-party vendor data stream providing loan-level information also feeds into the Joule application. In addition, the company uses ARGUS for lease analysis. Both CRM and Joule reside on a shared drive. The company is also working on several technology enhancements. It is developing a customer login portal allowing borrower clients to view progress on their cases in real time. It is also working on enhancing Joule to allow for multiple regression analysis for property valuations.

1st Service conducts disaster-recovery testing annually, with the last test performed during the first quarter of 2016, and the results were satisfactory. The company backs up and moves data to an external hard drive mirroring the in-house server. The shared drives are also backed up to cloud sync for off-site back-up as well as external file sharing. All employees have access to a detailed up to date disaster-recovery and business-resumption plan complete with calling tree and scenario instructions. The company contracted with a third-party vendor which provides alternative office locations at 12 different sites within the Dallas-Fort Worth area, and it has another location available in Denton, Texas. In the case of a more widespread event, the company has alternate back-up locations available in Framingham, Massachusetts, San Diego, and Houston. The company identified critical and essential business functions, with critical ones recovered within 48 hours and essential ones within five business days.

> **Assessment:** 1st Service has sound technology well -suited for its business. Its net-present-valuation model allows for the creation of a number of options for distressed borrowers to choose in working out their loans. Developing an outward facing borrower portal will provide the company with a competitive advantage and improve client communication. The company has robust disaster-recovery and business resumption protocols especially for a company of its size.

Debt-Resolution Advisory Administration

1st Service has worked on the resolution of loans involving myriad property types across 41 states and nearly 20 different special servicers, including most of the major ones in the CMBS industry. The company has employed diverse approaches to resolving troubled loans with the dual goal of preserving borrowers' equity while making a case for minimizing loss to the trust so as to make the arrangement mutually acceptable. In most of these cases, a substantial decrease in value of the collateral has occurred since the loan's original underwriting, and the company's first hurdle is to make both the borrower and lender recognize this fact to bring both parties to the negotiating table.

Chart 3 – Total Loan Resolutions Completed (January-July 2016)

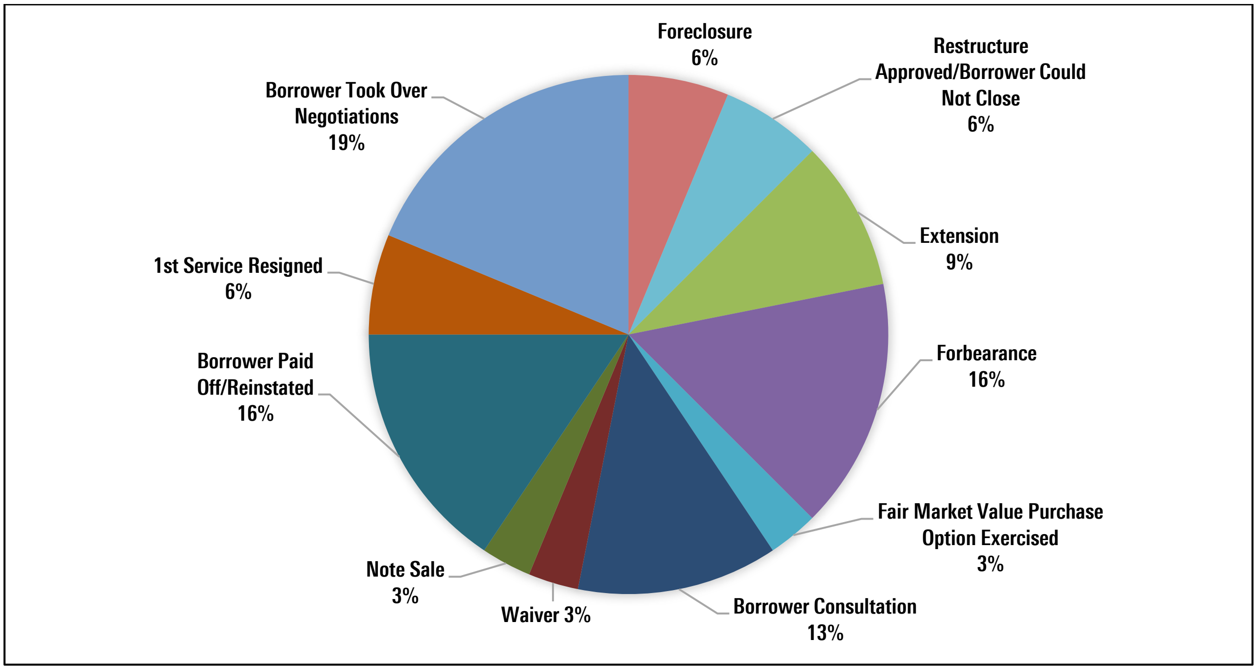


Chart 4 – Deals by Master Servicer (2011-July 2016)

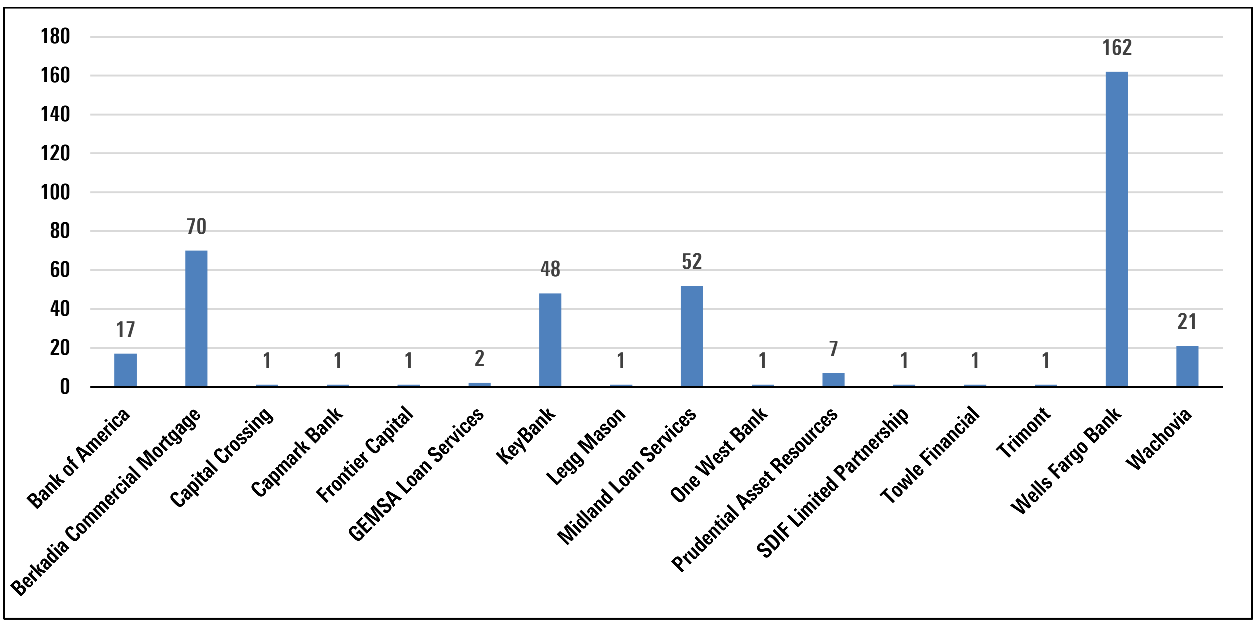


Chart 5 –Deals by Special Servicer (2011-July 2016)

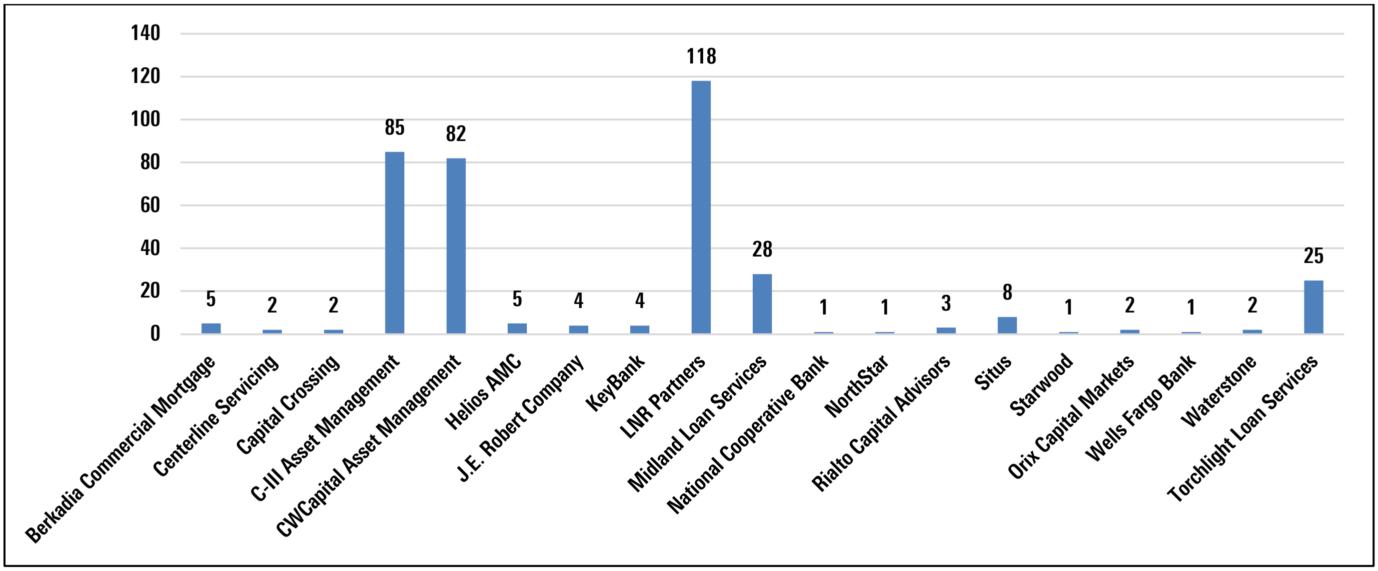


Chart 6 – Deals by State (2011-July 2016)

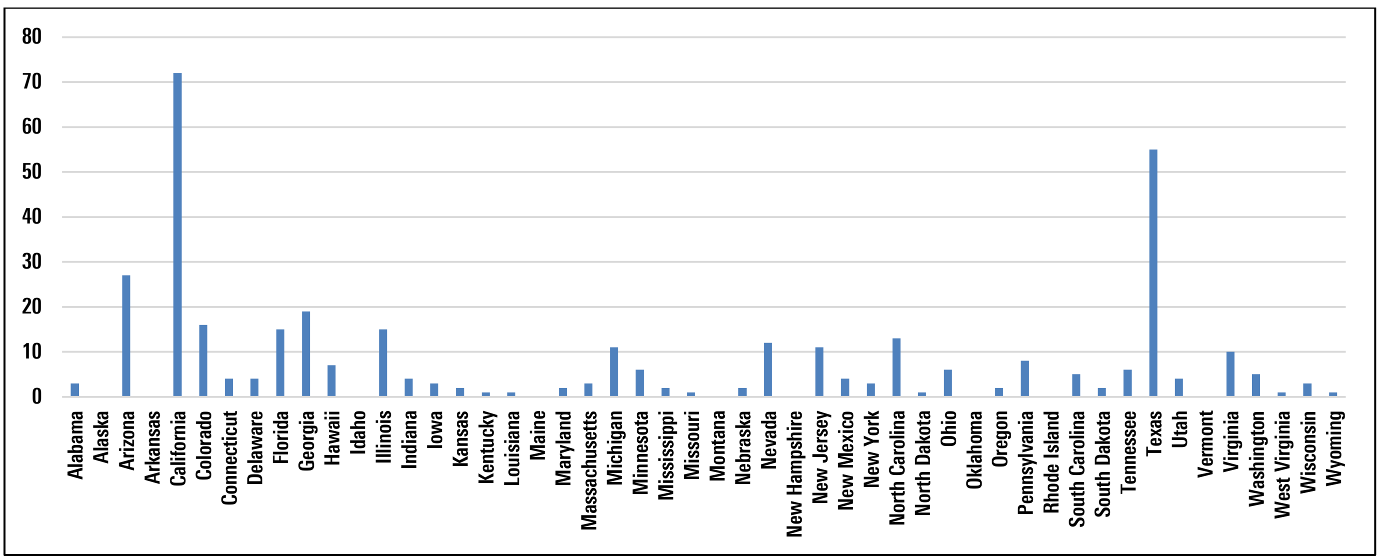
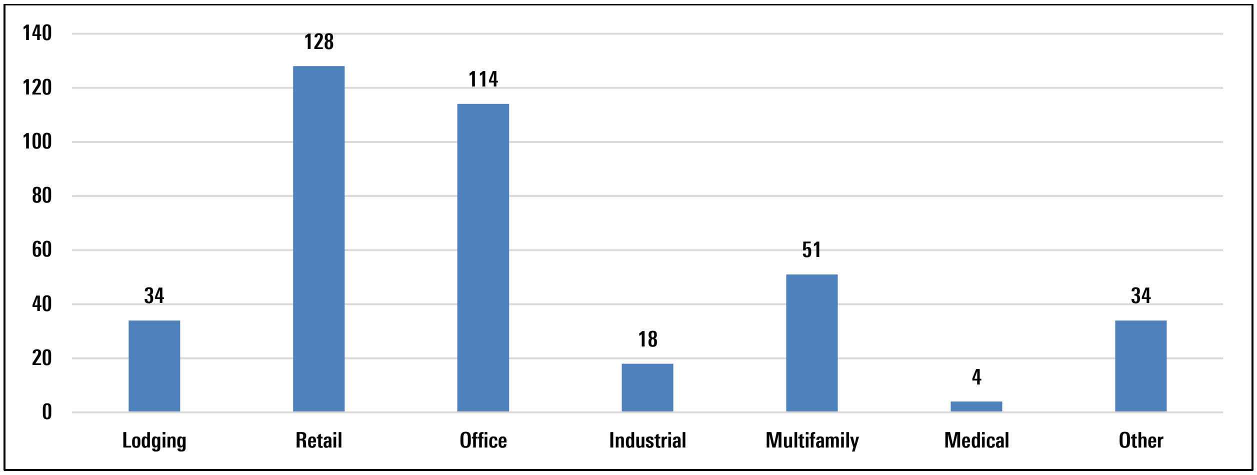


Chart 7 – Deals by Property Type (2011-July 2016)



Screening, Prequalification and Engagement Process for Borrowers

The first step in the company's loan-resolution process is to screen potential clients. The company researches past performance on any CMBS loans the borrower may have had. This helps gauge the level of understanding the borrower may have regarding the myriad requirements of pooling and servicing agreements governing CMBS transactions and the amount of education and counseling the borrower may require. Next the company determines the borrower's willingness to accept advice and follow the instructions of the resolution advisor. If the company senses a lack of such willingness it will refrain from being engaged on the case. This is a key determinant, as the company cannot effectively negotiate with a lender if it cannot guarantee adherence by the borrower to its proposals. In fact, the company reports that it typically rejects over 50% of resolution cases brought to it by distressed borrowers for this reason. Lastly, but equally as important, the company gauges the borrower's capability and willingness to inject fresh capital into the transaction. This will determine what option scenarios can be modeled for the resolution as injections of additional equity is often a requirement by lenders before they agree to consider a proposal. As of July 30, the company had been engaged on 32 loan-resolution cases, compared with 45 cases in 2015 and 52 in 2014.

Once the screening and prequalification process is complete, the company uses an engagement agreement which has been reviewed by counsel and approved by the CEO. The agreement includes an appendix with a standard list of required documentation to be submitted by the client as well as the scope of services the company will provide. As part of its quality-control function, the company each quarter reviews every case to ensure that a fully executed engagement agreement accompanies each case and that actions being undertaken fall within the scope of services defined in the agreement.

The assigned asset manager will then begin a review of the property-level documentation to asses such items as past performance and current metrics such as debt service coverage ratios, occupancy levels, and the like. Income projections are then made, and a broker's opinion of value is obtained. In addition, the asset manager reviews all pertinent documentation associated with the securitized transaction, such as the controlling pooling and servicing agreement and any prospectus supplements issued at the time of transaction sale. The asset manager then uses a third-party data source to ascertain the loan status, its maturity date and any relevant servicer comments derived from its monthly trustee reports. The manager reviews the latest trustee report to check the status of any outstanding bonds in the securitized transaction holding the troubled loan and determine the position and potential motivations of the special servicer in that securitization regarding resolution of the loan. The manager creates an abstract of this information and uses it during the first kick off call with the client.

Assessment: 1st Service's screening and prequalification practices for new clients are very thorough and well -designed to assure effective vetting of new clients and minimize the chances for failure due to a lack of engagement by the client or factual shortcomings of the underlying property. The engagement procedures are also well controlled and provide the asset manager with a solid base of data upon which to build an effective action plan for resolution of the distressed loan associated with the property.

Distressed Debt-Resolution Analysis and Initiation of Negotiations

The company analyzes various debt-resolution scenarios through the its proprietary Joule net present value model. This application allows the asset manager to run multiple scenarios for resolution strategies inputting a wide range of different variables to produce a 10-year income stream for the underlying collateral and then apply a discounted cash flow analysis to arrive at the present value created for the property with each option. Among the variables that can be adjusted in the model is infusion of fresh equity into the property by the borrower. Depending upon the specific characteristics of any given case, typical scenarios run through the model are note sales, extensions, modifications, forbearance, foreclosure, and bifurcation of the note into an A/B structure, where the B note accrues no interest and is paid back only upon final liquidation of the property. Once a specific option has been selected, a committee, composed of senior asset managers and the company's CEO, reviews the action plan. If approved, the asset manager then presents and explains the option to the borrower for approval. At least weekly, asset managers update borrowers on the current status of their resolution cases. The company is developing an outward facing application for borrowers to view resolution activity in real time. It is scheduled for launch by the end of the second quarter of 2017.

Once a resolution proposal approach has been established, the company then seeks to make contact with the special servicer as quickly as possible. The average time it takes to do this depends on whether the loan is still with the master servicer at the time of the company's engagement or has already been transferred to the special. If still with the master servicer, immediately upon engagement the company crafts an imminent default letter for presentation to the master servicer. The consequences of this action are fully discussed with the borrower prior to delivery, and the company responds to any additional information request received from the master servicer. The company reports that the average time elapsed for the loan's transfer to special servicing once the master is notified is usually between 30 to 60 days, at which point direct contact is made with the special servicer in one to two business days. If the loan is already with the special, then the latter time frame applies. The average time frame for submission of the actual resolution proposal to the special servicer however can vary widely, depending on several variables, many tied to the borrower. Some of these include the length of time the borrower takes to execute the prenegotiation letter and provide any required documentation or information to the special servicer as well as the time it takes the borrower to review and approve resolution proposals prior to submission to the special servicer. Delivery of the initial resolution proposal to the special servicer commences the negotiation process, and timelines can vary widely depending on the individual circumstances surrounding the loan as well as the underlying collateral.

Assessment: 1st Service has a thorough and well-established process for developing loan-resolution action plans and explaining them to the borrower. The committee process is a preferred way of reviewing and approving credit decisions involved in developing loan-resolution plans. The company's client portal, now under development, for real-time access to resolution activity reflects the company's focus on delivering a high level of customer service.

Ranking Definitions

The numerical scale of MOR CV1 to MOR CV4 is defined as follows:

1	Exceeds prudent loan servicing standards in key areas of risk
2	Demonstrates proficiency in key areas of risk
3	Demonstrates compliance in key areas of risk
4	Demonstrates lack of compliance in one or more key areas of risk

A company assigned a ranking of at least MOR CV3 is deemed to comply with what we view as the minimum prudent standards and requirements for the company's operational category and role. For access to Morningstar's Operational Risk Assessments of Commercial Servicers: Methodology and Process and other published reports, please visit www.morningstarcreditratings.com

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