**Structured Finance**

**International New Issue**

**Harbour City Funding (1) Limited**

**Ratings**
- US$230,000,000 Series A1
  - Floating-Rate Notes due 2005 ....... AAA
- HK$469,000,000 Series A2
  - Floating-Rate Notes due 2005 ....... AAA
- HK$302,000,000 Series A3
  - Fixed-Rate Notes due 2005 ......... AAA
- US$70,000,000 Series B1
  - Floating-Rate Notes due 2005 ....... AA
- HK$319,900,000 Series B2
  - Floating-Rate Notes due 2005 ....... AA
- HK$67,500,000 Series B3
  - Fixed-Rate Notes due 2005 ....... AA
- US$54,050,000 Series C1
  - Floating-Rate Notes due 2005 ....... A
- HK$295,300,000 Series C3
  - Fixed-Rate Notes due 2005 ....... A

**Summary**

Harbour City Funding (1) Limited’s (Harbour City Funding) commercial mortgage-backed floating- and fixed-rate notes (the notes) are rated as listed at left. Within each series, the notes are pari passu regardless of the currency denomination and fixed or floating interest rate. Harbour City Funding is a special purpose company incorporated in the Cayman Islands with limited liability.

The notes are secured primarily by a mortgage loan collateralised by office and retail properties in the Hong Kong Special Administrative Region (Hong Kong) and related tenancy agreements created under such properties. Fitch IBCA’s ratings address full and timely payment of interest and principal. Fitch IBCA’s ratings do not address the likelihood of receipt of prepayment premiums or default interest.

The principal asset of the issuer is a mortgage loan secured by a first fixed charge on the property, consisting of a single complex of seven interconnected commercial buildings in the Tsim Sha Tsui district on the Kowloon peninsula of Hong Kong. The portfolio incorporates more than 1.6 million square feet of office space and more than 880,000 square feet of retail space, making it one of Hong Kong's largest office/retail mixed-use commercial complexes. The mortgage loan is secured primarily by a first-priority fixed legal charge on each of the properties, including Ocean Terminal, Ocean Centre, Ocean Galleries, World Financial Centre, New T&T Centre, World Commerce Centre, and Gateway II (retail podium and car park only). The loan is also secured by an assignment of the mortgagor’s right, title, and interest in, to, and under the relevant tenancy agreements.

The properties are held by Wharf Realty Limited under government leases granted by the Hong Kong government. Wharf Realty is a bankruptcy-remote special purpose vehicle established in Hong Kong and is wholly owned by Wharf Properties Limited. At the closing of this transaction, Harbour City Funding will make a HK$4.457 billion mortgage loan to Wharf Realty.

Fitch IBCA’s ratings reflect the strengths and concerns of the transaction. Among the positives are substantial debt service coverage ratios (DSCRs) using Fitch IBCA’s adjusted net cash flows and mortgage refinance constant for Hong Kong commercial properties of 2.96 times (x) for the ‘AAA’ tranche, 2.17x for the ‘AA’ tranche, and 1.70x for the ‘A’ tranche; the low leverage as indicated by the loan-to-value ratio (LTV) of 36.99%; an excess cash flow trapping mechanism that adds additional funds to a HK$136 million reserve account once the DSCR falls below 2.50x and increases the percentage captured as the DSCR decreases; additional income derived from a ship berthing...
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The Harbour City complex has the only ship berthing facility and one of the largest car parks in Hong Kong. Concerns addressed within the report are the lack of a third-party servicer (although limited oversight is provided by the third-party transaction administrator/security trustee), the lack of servicer advancing (although liquidity is provided through a cash reserve and an excess cash flow trapping mechanism), and the lack of geographic and property-type diversity. The ratings also reflect the integrity of the legal and financial structures.

Fitch IBCA was able to rate the series A notes above Hong Kong’s long-term ‘A+’ foreign currency and ‘AA+’ local currency sovereign ratings because the structure was stressed to withstand up to an ‘AAA’ level, and the swap guarantor rated ‘AA/F1+’ took on convertibility, substitution, and transfer risk. Similarly, the series B notes were stressed to withstand up to an ‘AA’ scenario in addition to the supporting cross-currency swaps absorbing convertibility, substitution, and transfer risk. However, the series C notes, rated ‘A’, do not incorporate such swaps and, as such, this class of notes is fully susceptible to capital controls.

Merrill Lynch Capital Services, Inc. (MLCS) is the swap provider, and Merrill Lynch & Co., Inc. (Merrill Lynch) is the swap guarantor. Furthermore, Fitch IBCA’s rating approach to overcome the foreign currency sovereign ceiling involves the joint probability of two relatively independent and unlikely events occurring simultaneously: an ‘A+’ stress environment resulting in Hong Kong impeding foreign currency debt payments; and a default of the ‘AA/F1+’ rated cross-currency swap guarantor.

Bankers Trust Company, a US commercial bank rated ‘A+/F1’ by Fitch IBCA, through its Hong Kong Branch, will act as transaction administrator. BT Trustees (Hong Kong) Limited, a limited liability company incorporated in Hong Kong and affiliated with Bankers Trust, will act as security trustee. In this role, Bankers Trust Company and BT Trustees (Hong Kong) Limited (together BT) will provide enhanced trustee services, including financial reporting, monitoring of events of default (if any), and, in conjunction with the note trustee (Bankers Trustee Company Limited), payment distribution. Its obligations are more fully described under the deed of charge. BT has had and continues to have extensive experience in this capacity for similar transactions, including commercial mortgage-backed securities (CMBS) and mortgage-backed securities.

### Sovereign Analysis

The ‘AAA’ and ‘AA’ ratings expected to be assigned to Harbour City Funding indicate that its capacity to service foreign debt obligations is higher than that of Hong Kong. Since the series C tranche is expected to be rated ‘A’, which is not above the foreign and local currency ratings of Hong Kong, it is excluded from the following sovereign analysis discussion. Fitch IBCA first looked at the local currency debt-paying capacity of the issuer. Due to the strength of the structure, ‘AAA’ and ‘AA’ local currency ratings were assigned.

Because sovereign local currency ratings do not act as a ceiling, the structure can be rated higher than Hong Kong’s local currency rating. Fitch IBCA believes that it is extremely unlikely that the Hong Kong government would prevent borrowers from making local currency mortgage payments even in the event of default by the Hong Kong government. As opposed to foreign currency, which is a valuable commodity, governments have limited incentive to

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Harbour City Funding (1) Limited

The next step was to look at the foreign currency rating. Country risk affects the ratings in several ways. The general economic and business environment, which can determine underlying creditworthiness, is directly affected by government macroeconomic policies. In addition, changes in relevant legislation may affect the issuer’s debt-paying capacity. However, when rating foreign currency debt above the respective sovereign rating, transfer and convertibility risks are key considerations. In the past, many countries have imposed exchange controls and other similar actions during a foreign debt crisis. Thus, the primary concern for this transaction is how Harbour City Funding would access US dollars and transfer them to bondholders outside Hong Kong if Hong Kong were to default on its debt obligations and impose foreign exchange controls.

To evaluate the scope of this concern, Fitch IBCA analysed the probability of the following two events occurring simultaneously. First, Hong Kong defaults on its obligations and imposes exchange controls. Second, the issuer would have no alternative mechanism for accessing US dollars. The combination of these factors is the basis for the ratings distinction.

If Hong Kong imposed absolute exchange controls, there normally would be no mechanism for debtors to obtain foreign currency to pay creditors. In this transaction, the transfer, substitution, and convertibility risks have been mitigated through the swap counterparty. By modifying and clarifying the International Swap and Derivatives Association master agreement in the swap schedule, the swap provider commits to:

- Making the appropriate foreign currency payments under the swap agreement, even if Hong Kong dollars are deposited into a specific account in Hong Kong for the benefit of the swap provider. Under this situation, the swap provider is obligated to make the appropriate payments, even though it is unable to repatriate the Hong Kong dollars until the exchange controls are lifted.
- Making the appropriate foreign currency payments under the swap agreement, even though the legal tender in Hong Kong is no longer the Hong Kong dollar, as long as the new legal tender is deposited into the specified account.

In this transaction, the cross-currency swap is provided by MLCS, a wholly owned subsidiary of Merrill Lynch. MLCS writes interest rate and cross-currency swaps. Additionally, all swap obligations provided by MLCS are fully guaranteed by Merrill Lynch, which is rated ‘AA/F1+’ by Fitch IBCA. Given the ‘AAA’ and ‘AA’ local currency debt-paying capacity, the deal will default only if Hong Kong imposes exchange controls while simultaneously the highly rated swap provider fails to meet its obligations.

Given the relative independence of these two events, Fitch IBCA considers the likelihood of this happening as ‘AAA’ remote. The “dual default” likelihood is so low that even a one-notch downgrade of either Hong Kong’s or the swap provider’s ratings will not automatically result in a downgrade of the transaction. However, since the series B notes have only been stressed to an ‘AA’ level, the foreign currency rating for that series is limited to ‘AA’.

**Strengths**

- Low LTV of 36.99%.
- Substantial DSCR of 1.70x for the ‘A’ tranche and even higher levels for ‘AAA’ and ‘AA’ tranches (using Fitch IBCA’s adjusted net cash flows and mortgage refinance constant for Hong Kong commercial properties).
- Additional revenues of approximately 13% of total cash flow generated from sources other than office and retail tenancy leases.
- The Wharf Group’s strong sponsorship and depth of management.
- One-year tail after the mortgage loan maturity date, coupled with the relative ease of enforcement of lender remedies in Hong Kong if loan or property performance erodes.

**Concerns**

- Lack of a third-party servicer (although limited oversight is provided by the transaction administrator/security trustee).
- Lack of servicer advancing (although liquidity is provided through a cash reserve and an excess cash flow trapping mechanism).
- Lack of geographic and property-type diversity.

**Credit Issues**

The rating levels are influenced by Fitch IBCA’s DSCRs using Fitch IBCA’s adjusted cash flows and commercial property refinance constant, issues regarding Hong Kong’s recent 1997–1998 period of high interest rates and asset deflation, and the transaction’s financial structure and collateral characteristics.
1997–1998 Global Currency Crisis: As the 1997 currency crisis that started in Thailand with the devaluation of the Thai baht reverberated around the world, Hong Kong was not immune to the capital flight and speculation. As a result of speculation on the Hong Kong dollar and the Hang Seng Index (equities index of the largest companies listed on the Hong Kong Stock Exchange), domestic interest rates rose dramatically, banking liquidity was severely limited, and asset values, especially commercial real estate and residential housing, suffered.

The daily benchmark three-month Hong Kong Interbank Offered Rate (HIBOR) rose to 25%, a level not seen since 1983–1994, when Hong Kong experienced several bank runs and a crisis of confidence due to the rumours regarding the Sino-British Joint Declaration on the Question of Hong Kong (the joint declaration). To restore confidence, the government established the currency board in 1984. Since the 1997–1998 crisis started, Hong Kong has experienced several bouts of extremely high interest rates, as the Hong Kong Monetary Authority successfully defended the currency peg from speculators. As of January 1999, interest rates have come down dramatically. The three-month HIBOR in the first three-quarters of 1998 averaged 8.92%; however, in the fourth quarter, the key interest rate benchmark averaged 6.04%. As a comparison, the average for the three-month HIBOR in 1996 was only 5.47%.

From the height of the real estate market in the first half of 1997, commercial real estate prices and rents have adjusted downward by 40%–60%, depending on whose estimates are followed. Note that this is a generalisation of the market trend, and Fitch IBCA has noted that these trends do not always apply in the case of specific properties. Whereas there was a bounce in residential prices during the fourth quarter of 1998, there has been no such recovery in commercial real estate. As bankruptcies and unemployment continue to climb above their historical averages and additional commercial real estate supply is brought on-line, any sustained rapid recovery in the real estate market will be very difficult.

Although Fitch IBCA has analysed this transaction subsequent to the price and rental declines previously mentioned, it does not believe that the commercial real estate market has reached its trough. However, Fitch IBCA believes that at current levels the trough is much closer. This concern has been translated into Fitch IBCA’s net effective rent analysis.
**Property Type:** The Harbour City complex, which includes all the properties in this transaction, incorporates several interconnected office and retail sections. Additionally, there are restaurants located throughout the structures. Each of the four office buildings has individual main entrances at ground level in addition to elevator stops into the retail complex on the second floor, linking both structures. Core tenants average 50% within each of the office buildings, including many large multinationals such as Eagle Star Life Assurance, Arco Toys, Mattel Toys, Mobil Oil, Hitachi, Marks and Spencer, and AIA. The Wharf Group occupies approximately 7.7% of the complex. Other office tenants tend to be smaller trading companies or service-oriented firms, such as insurance companies.

The retail operations of Ocean Terminal, Ocean Centre, Ocean Galleries, and Gateway II retail have several major entrances into the complex in addition to entrances through street-level shops. The retail complex is anchored by many international brands, such as Marks & Spencer, Hugo Boss, Polo Ralph Lauren, Versus, Toys R Us, Fendi, Louis Vuitton, and Salvatore Ferragamo. Most of the retail space is occupied by local Hong Kong chains such as Lane Crawford, Vivienne Tam, Design 2000, G2000, City Chain, Optical Shop, and The Swank Shop, as well as non-chain shops.

The Gateway II retail area opened in fourth-quarter 1998. As of January 1999, approximately 48% of total square footage is occupied by tenants currently open for business. The anchor tenant is City Super, a supermarket/department store that has been extremely successful elsewhere in Hong Kong; it occupies approximately 47,000 square feet. According to projections, City Super will fully utilise the space by the middle of 1999. Renovation has been completed in the common areas but is still ongoing on the office towers located above the mall and is not expected to be completed until third-quarter 1999. Fitch IBCA expects that the retail and office operations will have synergies once the offices towers are completed and leased out.

The Ocean Terminal complex includes the only ship berthing facility in Hong Kong for international cruise ships. The facility has averaged more than 300 dockings a year, including international naval vessels. Additionally, Ocean Terminal/Ocean Centre incorporates one of the largest two-level parking lots in Hong Kong, with 1,660 spaces. Fitch IBCA has
noted that the car park regularly reaches maximum capacity throughout the year.

Fitch IBCA views the lack of property-type diversity as a credit concern. Office and retail property cash flows are particularly volatile, given the timing of tenant lease expirations and the potential for tenant bankruptcies, as well as the need to attract new tenants through payment of leasing commissions and provision of tenant concessions. Moreover, the performance of an individual office property depends on its market/location, nature of its office tenants (i.e. credit tenants versus non-investment-grade or unrated tenants), ability of its retail tenants to draw shoppers, quality of its construction, and strength of its management. Fitch IBCA adjusted for the lack of property-type diversity in its net effective rent analysis.

**Geographic Concentration:** All the properties are located in the Tsim Sha Tsui district on the Kowloon peninsula. Given the relatively small geographical size of Hong Kong, it is extremely difficult to develop any level of meaningful diversification. Fitch IBCA views such significant geographic concentration as a credit concern. Consequently, any adverse economic conditions in that market could negatively affect the cash flows of all the subject properties. Fitch IBCA adjusted for the lack of geographic diversity in its net effective rent analysis.

**Underwriting/Net Effective Rent Analysis:** Fitch IBCA relies primarily on a cash flow analysis when sizing the appropriate debt amount at a given rating level. To address the cash flow volatility of the office and retail properties and the lack of diversity in this transaction, Fitch IBCA marked rental income to market, as evidenced by the most recent leases signed within the subject buildings. On a lease-by-lease basis, the actual costs incurred by the landlord for tenant improvements, leasing commissions, and free rent were deducted from the face rent paid over the lease term, with allowances for down time between leases.

The resulting average gross revenue contribution per square foot was applied to the entire office space to normalise income. Additional revenues were given credit, including car park income, berthing facility income, and exhibition and signage income. Property management fees were netted against property management expenses, as both items should, over time, negate one another. Additionally, Fitch IBCA’s analysis only gave credit to base rent while the monthly rent of many retailing tenants is based on the greater of a base rent and a percentage of sales.

To the extent that no historical data were available for tenants that calculate rent only as a function of percentage of sales, Fitch IBCA excluded their rental contribution. A vacancy factor also was applied to total revenues for each property based on current average vacancy plus an additional haircut to reflect that in the recent decline in the commercial real estate market, the trough has not been reached.

Fitch IBCA also reviewed historical operating expenses and made adjustments for items such as professional fees, car park management expenses, stamp duties, and average annual capital expenditures to derive the Fitch IBCA underwritable cash flow. Fitch IBCA based future unrecoverable capital expenditures, such as builder’s works and repairs for equipment and machinery, on a Jones Lang Wootton Ltd. (JLW) engineering report. JLW is an independent real estate engineering, property management, appraisal, and consulting firm. Additionally, the JLW engineering report indicated the estimated costs of remedies to be made immediately. Wharf Realty deposited HK$22 million into the capital expenditure fund at the time of closing. On an annual basis, the relevant managers of the property will determine the
appropriate level of capital expenditures, but such amount will be no less than HK$22 million, to be funded on each anniversary of the transaction. To minimise the possibility of cash flow volatility due to the annual funding of capital expenditures and give managers the incentive to ensure adequate capital expenditures are made, the monthly DSCR calculation will deduct one twelfth of the capital expenditure fund whether the funds are used or not. If Wharf Realty does not fully utilise the HK$22 million, the remaining amount will be reserved and will not count toward future additions.

In Fitch IBCA’s analysis of the Gateway II complex, credit was given only to the currently opened tenants that have passed their free rent period by January 1999. Based on these current leases, Fitch IBCA applied an additional vacancy haircut. Although Gateway II is new, it remains intricately connected to the original retail and office complex such that visitors will view the buildings as one complex.

Assumptions used included average lease terms of two and a half years, average vacancies of 8%–21%, average free rent of one to three months, and average leasing commissions of 4% of gross income (one month’s rent on a two-year lease) for new leases (none for renewals). Since most tenancy agreements in Hong Kong provide for “bare shell” office and retail spaces, tenant improvements provided by the landlord are negligible for new leases and virtually non-existent for renewals.

Debt Service Coverage Ratios: Fitch IBCA’s estimate of sustainable annual cash flow available for debt service, derived from the net effective rent analysis, was HK$933 million. Fitch IBCA reviewed several years of comforted financial statements for each property. Actual net operating income at each property is significantly higher than Fitch IBCA’s underwriting of cash flow, given the net effective rent analysis described earlier.

Due to the 1997–1998 speculation on the Hong Kong currency peg, interest rates have been consistently higher than US interest rates, reflecting a Hong Kong risk premium. In the past 18 months of this stress period, the three-month HIBOR has averaged approximately 8%. Using the 8% as a base, Fitch IBCA reviewed pricing on other secured property transactions and noted that a spread of 300 basis points should be adequate to obtain funds for refinancing. As such, Fitch IBCA used a hypothetical mortgage refinance constant for the office properties in Hong Kong of 11.43% based on an 11.0% interest rate and a 30-year monthly amortisation schedule. The actual interest rate on the mortgage loan is 10.193%. Fitch IBCA believes that its mortgage refinance constant is appropriately higher than the actual interest rate to mitigate the risk that refinancing costs will be higher at the balloon maturity date.

The government lease on the Ocean Terminal complex, which includes the retail operations in the structure, in addition to the car park and ship berthing facilities, ends in June 2012. Therefore, to limit the credit given to the cash flow to reflect that the government lease will expire by June 2012, Fitch IBCA adjusted its refinance rate by using a 13-year monthly amortisation schedule in the analysis. Based on Fitch IBCA’s underwritable cash flows and refinance constant, the DSCR is 1.70x. This coverage ratio is consistent with Fitch IBCA ratios for similar office properties at the ‘A’ rating level. To arrive at the ‘AAA’ and ‘AA’ levels, Fitch IBCA used DSCRs of 2.96x and 2.17x, respectively. Additionally, the sizing of the tranches above the foreign currency sovereign rating of Hong Kong was limited by the availability of a Hong Kong dollar/US dollar cross-currency swap with transfer, substitution, and convertibility language as provided by MLCS.

Loan-to-Value Ratio: Although Fitch IBCA’s analysis is primarily cash flow driven, Fitch IBCA views LTVs as important indicators of whether liquidation of the assets would provide adequate proceeds to enable investors to recover all principal and accrued interest through enforcement and sale of the properties. Based on an approximate loan amount of HK$4.457 billion and an assessed value of HK$12.048 billion (dated 1 Feb. 1999) by JLW, the actual LTV for the mortgage loan and a
stressed LTV using double the capitalisation rate would be as shown in the table at the bottom of page 7.

The transaction’s relatively low leverage provides strong comfort that investors ultimately would be able to recover all principal and accrued interest through enforcement and sale of the properties, as well as any third-party costs involved in such sales. The total loan per square foot is HK$1,731.89.

**Balloon Risk:** The mortgage loan is a five-year bullet loan, with payment of interest only at each monthly payment date and no amortisation prior to the scheduled maturity date. Consequently, Wharf Realty, as mortgagor, could encounter difficulty in refinancing at the balloon maturity date, particularly if rates are high or capital is constrained. In addition to using the Fitch IBCA mortgage refinance constant in lieu of the actual mortgage loan interest rate, this risk is mitigated by several other factors.

Although the mortgage loan matures in March 2004, the notes have a final payment date in March 2005. At March 2003, one-year before the maturity of the mortgage loan and two years before the maturity of the notes, Wharf Realty must either present an acceptable letter of credit from a bank with a minimum rating of ‘AA–/F1+’ for the full loan amount on or prior to the scheduled mortgage loan maturity date; or Wharf Realty may also enter into or extend the swap agreement with commercial terms similar to the swap agreement in effect through March 2004, except that the additional period from March 2004–March 2005 is also covered.

If the mortgagor does not refinance its loan by the end of the mortgage loan term in March 2004, the security trustee can immediately draw on the letter of credit and pay the noteholders. Otherwise, if the option of a new swap or swap extension is chosen and the mortgagor fails to refinance its loan, any proceeds from the foreclosure process will be swapped into the proper currency and interest rates by the note maturity date.

Moreover, if Wharf Realty triggers an event of default by not supplying an acceptable letter of credit to the issuer at the required time, not entering into or extending a swap agreement with acceptable terms,
or not paying the outstanding loan amount in full, the security trustee, as lender, can call a default and exercise its remedies. The security trustee can enforce payment through a sale of one or more of the properties. To the extent required, the proceeds from either the letter of credit facility or the exercise of remedies will be swapped into the applicable currency and interest rates using the current swap structure. The current swap structure will mature on the mortgage loan maturity date in March 2004.

Fitch IBCA’s rating addresses full and timely repayment of principal by the note maturity date, one year following the scheduled maturity of the mortgage loan. A one-year tail was deemed to be sufficient by Fitch IBCA. Fitch IBCA’s rating does not address the timing or amount of prepayments, if any.

**Leaseholds:** The Hong Kong government, being the ultimate holder of land in that region, has adopted the practice of granting only leasehold interests to purchasers. Consequently, title to all properties is derived from a “government lease” (originally named “crown lease” during colonial rule) or agreement for leases granted by the Hong Kong government, and all owners of property in Hong Kong are effectively long-term leaseholders.

The terms of the crown leases have varied in the past but were typically granted for periods of 75, 99, or 999 years, with or without renewal rights. Based on the joint declaration, for all crown leases that expired before 30 June 1997 and did not contain a right of renewal, the maturity for those leases will be extended to 30 June 2047, the end of the 50-year period agreed to by the People’s Republic of China and the UK for Hong Kong status as a Special Administrative Region. For the applicable leases, the Hong Kong government, with specific exceptions, has generally applied an additional 3% annual rental fee based on a government-determined rental value. Almost all the properties in this transaction have government leases where the maturity is well beyond the mortgage loan’s scheduled maturity date and the Fitch IBCA 30-year monthly amortisation maturity. The outstanding loan amount is expected to be refinanced at terms that fully liquidate each loan within the remaining lease terms under the ground leases. The government lease maturity dates for the properties are shown in the table at the top of page 8.

For government leases such as the lease that secures Ocean Terminal, Hong Kong law does not explicitly define how the renewal will be handled — only that it will be conducted under the relevant land laws and policies of Hong Kong. Fitch IBCA believes there is convincing rationale why it would be in the best interest of the Hong Kong government to extend the government lease to the existing tenant, and there has been at least one publicly disclosed historical precedent whereby the Hong Kong government extended a government lease to August 2047 for a mixed residential/commercial property that matured in August 1997.

In that example, the government also incorporated an annual rent of 3% of the estimated rental value. There have been numerous other examples, but those negotiations are private and Fitch IBCA was not
privy to the information. Government-directed programs for the reclamation of land and for redevelopment purposes are an unknown political factor that is critical to the extension process for government leases. Since the laws and practices of the government are not explicitly clear in this area, Fitch IBCA determined that the certainty of a renewal of the Ocean Terminal lease was not within the ratings of Harbour City Funding.

**Negative Pledge:** With the exception of certain existing intercompany debt (in accordance with the transaction documents) to Wharf Properties, which will be unsecured and subordinated, no additional debt will be permitted as liens against any of the properties or any of Wharf Realty’s partnership interests. Payments for intercompany debt will be subordinated to reserve fund deposit calculations and requirements pursuant to the cash trapping mechanism. The only exception would be a subordinated claim by the bank providing the letter of credit meant to repay the principal balance at maturity. Fitch IBCA excluded any proceeds or interest from intercompany debt in its analysis. The maximum trade-related indebtedness will be capped to HK$65 million, including any capital expenditures.

**Insurance:** Three types of insurance policies are provided for in the transaction and are shown in the table above.

The property damage and loss of profits insurance is provided by two insurance companies that have a weighted average rating of ‘AA–’. The public liability insurance provider is rated ‘AA’. The property manager will maintain property insurance coverage of at least HK$4 billion unless a reputable third-party consultant and Fitch IBCA agree that the minimum level can be lowered. Insurance coverage for loss of profits will be equivalent to a minimum of two years worth of gross rental income. Minimum required public liability insurance coverage is HK$50 million. All insurance companies are required to have a minimum claims-paying ability rating of ‘A–’.

Following damage or destruction, the property insurance policies will provide insurance coverage on a reinstatement or indemnity basis. Should the property damage be so severe as to exceed 7.5% of the property valuation and subject to several requirements, the proceeds of the insurance will go toward the repayment of the outstanding principal and unpaid interest. However, if insurance proceeds are less than the outstanding loan balance, the funds will automatically be used for reinstatement unless an event of default has been simultaneously triggered. Moreover, the insurance policies will cover loss of rent for the properties that have been destroyed or damaged.

**Financial and Legal Structures**

**Accounts:** Several accounts will be opened to facilitate this transaction, including but not limited to:
- Transaction account.
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**Cash Flow Triggers**

<table>
<thead>
<tr>
<th>DSCR (x)</th>
<th>% of Excess Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.50–2.20</td>
<td>15</td>
</tr>
<tr>
<td>2.20–1.85</td>
<td>30</td>
</tr>
<tr>
<td>1.85–1.50</td>
<td>75</td>
</tr>
<tr>
<td>Below 1.50</td>
<td>100</td>
</tr>
</tbody>
</table>

DSCR – Debt service coverage ratio.

- Property operating account.
- Carpark operating account.
- Berthing operating account.

All payments of rent and management fees from tenants, security deposits from tenants, signage and exhibition fees, and insurance proceeds (only includes 100% of proceeds from business interruption insurance and proceeds greater than HK$2 million for property loss insurance) will be deposited directly into the property operating account. Other sources of revenue, including the car park and ship berthing facilities, will be paid into their respective operating accounts. The property operating account will include subledgers for capital improvements to be made as deemed necessary by the applicable Wharf Group managers. Except for those funds earmarked for capital expenditures, all remaining amounts in the operating accounts will be transferred on a monthly basis into the transaction account.

The transaction account will be used as a source of funds for the corporate manager (Wharf Properties) to make any necessary expenditures related to management fees, profit taxes, insurance premiums, security deposits for departing tenants, and capital improvements, among other things, during the period between payment dates, payments of interest on each payment date, and payments of principal on the note maturity date in accordance with the administration agreement. Between interest periods, funds may be withdrawn from the operating accounts to pay for any amounts due to third parties as a normal course of business, lease renewal costs, government rent or rates, and similar operating expenses.

Although there is neither a third-party servicer nor servicer advancing as a source of liquidity, this is partially mitigated by the fact that there are two liquidity reserves available for payment of interest and property protection expenses in the event there is a shortfall in the transaction account, as well as oversight by BT, the transaction administrator/security trustee.

**Liquidity and the Reserve Fund:** The transaction account will have a designated reserve fund in it that will include the initial balance of the greater of HK$136 million or six months of security deposits. The initial balance represents approximately 40% of total security deposits outstanding on the current tenancy agreements. More important, the balance represents one-quarter’s worth of mortgage loan interest and the equivalent of the largest amount of security deposit liability due in a single month based on the current rent roll. This balance will form the base amount of reserves. Should the balance dip below the required level, cash flow from the transaction account (subordinated only to payments of interest and principal and crediting the expense retention fund) will be deposited into the reserve fund such that the proper level is maintained on a monthly basis.

Moreover, the transaction incorporates a cash trap mechanism whereby if the properties experience declines in income such that the actual debt service coverage ratio of the mortgage falls below 2.50x at any monthly calculation date, excess income would be accumulated in the reserve funds for payment of interest and principal until the relevant mortgage loan

**Payments During Collection Period**

- Refund of Security Deposit to Tenant
- Payment of Amounts to Enable the Making of HK$ Investments
- Expense Retention Fund
- Third-Party Corporate Manager
- Swap Payment to Pay: Agents, Trustee, and Transaction Administrator

**Reserve Fund Release Mechanism**

<table>
<thead>
<tr>
<th>Month</th>
<th>% of Release</th>
</tr>
</thead>
<tbody>
<tr>
<td>One</td>
<td>50</td>
</tr>
<tr>
<td>Two</td>
<td>30</td>
</tr>
<tr>
<td>Three</td>
<td>20</td>
</tr>
</tbody>
</table>

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is repaid in full or the reserve fund release mechanism is activated. The percentage of excess income to be trapped is determined by the relevant DSCR (see table at the top of page 11).

The total amount of reserves that can be trapped through this mechanism, including the base amount, is equivalent to 50% of total security deposits and four quarterly payments of interest.

However, funds in the reserve fund greater than the base amount can be released under certain conditions. Should the DSCR climb back to 2.50x or above for two consecutive months, all the cash flow that was trapped under this mechanism would be released in the following three months (see table at the bottom of page 11).

Fitch IBCA believes that there is sufficient liquidity in the transaction corresponding to the ratings on the notes.

Interest on the notes is payable on a quarterly basis, but calculations related to the actual DSCRs are made monthly. Monthly interest on the mortgage loan is paid into an interest payment account (one-third of the quarterly interest) and released at the end of the quarter for interest payment on the notes. Funds in the form of excess income will be released on a monthly basis, as well as deposits into the reserve account due to the cash flow trapping mechanism (if applicable).

**Expense Retention Fund:** On the closing date and on each anniversary thereafter, the transaction account also will have a designated expense retention fund that will include sufficient proceeds to at least cover the estimated amount of profit taxes, certain capital expenditures, and insurance premiums for the next 12 months as required by the properties. The initial balance of this account is HK$16 million. They will accrue one month of the estimated amount necessary for the subsequent year on each of the following payment dates and will be replenished, as necessary, on each anniversary date. Moreover, these funds can be drawn from a tertiary source for interest shortfalls if there are insufficient funds in the relevant reserve fund.

**Series C-1 Tranche:** Since the US dollar-denominated series C-1 tranche will not have the benefit of a swap absorbing convertibility, substitution, and transfer risk, the ramifications on an imposition of currency controls
have been limited to these notes. Once currency controls are instituted, the swap will be unwound. Hong Kong dollar funds will continue to be paid into a separate account using the terms of the original swap agreement. The DSCR calculations will remain in place, and payments toward the series A and series B tranches will not be impeded. This scenario is not an event of default for the mortgage loan or the notes.

If the currency controls are lifted before the maturity date of the mortgage loan, a new cross-currency interest rate swap may be entered subject to certain restrictions. If the note maturity date is reached prior to lifting of the currency controls, the US dollar-denominated series C noteholders will have recourse toward the remaining assets in Harbour City Funding according to the cash flow waterfall.

**Swap Provider:** MLCS will remain as swap provider for the transaction even in the event of a downgrade of Merrill Lynch or a downgrade of MLCS to ‘A–’ or below. The swap will be marked to market on a weekly basis and should MLCS be out of the money or, basically, losing money on the swap and should the foreign currency long-term rating of Merrill Lynch fall below ‘AA–’, the following mechanism is activated (see table above).

Any loss will be collateralised by cash in US dollars. This mechanism may not forestall a downgrade by Fitch IBCA of the transaction should Merrill Lynch be downgraded. Fitch IBCA will evaluate the situation at that time and proceed accordingly.

**Events of Default:** The mortgage loan events of default include, among other things:
- Default by the mortgagor in making payment of the principal amount on its due date.
- Mortgagor does not present an acceptable letter of credit or an acceptable swap extension/new swap on or before February 2004.
- Default by the mortgagor in making payment of interest.
- Breach of any representation, warranty, or failure to perform any undertaking or obligation by the mortgagor or the indemnifier that is not remedied within 30 days.
- Any material security that becomes no longer valid or enforceable and is not remedied within 60 days.
- Occurrence of a note event of default.
- The actual DSCR of the mortgage loan declines below 1.00x.

Based on discussion with local counsel in Hong Kong, Fitch IBCA understands that as long as certain legal conditions are met as of closing and are supported by required legal opinions (such as borrower solvency), enforcement of the mortgage deed for a given property during a mortgage loan event of default can be realised in one of four ways — mortgagee sale of the property, “voluntary” sale by the mortgagor, sale by a receiver, or application to the courts for foreclosure.

Among these possibilities, mortgagee sale of a property is most likely to happen and the security trustee would only need to consult with a broker or brokers to auction the properties. Local brokers have indicated to Fitch IBCA that such a sale can be consummated within two to nine months, or well within the time frame of the one-year tail.

The note events of default include, among other things:
- Failure to receive payment of the principal amount on its due date.
- Failure to receive payment of interest on any series outstanding for five business days from its due date.

**Representations and Warranties:** As of the closing date, the mortgagor will make representations and warranties pursuant to the mortgage loan agreement regarding the properties, tenancy agreements, and licenses that serve as security interests for their loans. Wharf Properties will indemnify the issuer for any loss incurred as a result of any breach of the representations and warranties.

**Ownership and Management:** As part of its due diligence process, Fitch IBCA met with the Wharf Group senior management, conducted Lexis/Nexis searches, and checked lender references. No unresolved adverse information was reported, except an ongoing legal dispute with a US telecommunications company, United International Holdings, Inc., that is currently in the US Court of Appeals.

The Wharf (Holdings) Limited is one of the largest conglomerates in Hong Kong in terms of assets and market capitalisation. It was originally founded in
1886 as a colonial British trading company, or “hong.” It was one of the first of such companies to be taken over and controlled by the Hong Kong Chinese. It has since diversified its holdings into property (41.6% of 1997 revenues), terminal and warehouses (28.5%), cable television (10.2%), hotels (8.9%), and others (10.8%). Property development and investments remain one of its core strengths, both in terms of revenue and operating profit.

As mentioned, Fitch IBCA is concerned that there is no third-party servicer or backup servicer on this transaction. Many of the entities, except for the security trustee, that will deal with the practical operations of the transaction or management of the properties are wholly owned subsidiaries of The Wharf (Holdings) Limited, including what is listed in the table above.

Fitch IBCA’s concerns on this issue are partially mitigated by the fine reputation of The Wharf Group of companies and the fact that the Harbour City complex has been successfully managed by The Wharf Group since its completion in 1966, encompassing many periods of economic and political uncertainty, including the riots in 1967, the recession in 1983–1984, the Tiananmen Square incident in 1989, and the recession in 1994–1995.

Fitch IBCA has a high regard for the company’s approach to management, its maintenance of its properties, and its leasing strategy. Wharf Properties appears to be managed by an experienced staff of professionals, including on-site property managers, marketing managers, leasing agents, and finance and accounting managers. The Wharf Group owns and manages more than eight million square feet of commercial and residential properties.

**Site Inspections:** Fitch IBCA extensively toured each of the properties on multiple occasions, including the retail tenant spaces, office tenant spaces, and car park facilities. Each property was then attributed a collateral quality ranking based on its physical condition and appearance, layout, location, and positioning within its market. The rankings range from “A+” to “D,” with the following distinctions: properties in the “A–” to “A+” range are regarded as above average to excellent; “B+” properties, very good; “B” or “B–” properties, average; “C+” or “C” properties, below average; and “C–” or “D” properties, poor.

The properties are characterised as follows:
- Ocean Terminal, a three-level retail building containing 635,000 square feet of gross floor area (GFA), two levels of car parking facilities of approximately 1,360 spaces, and a ship berthing facility. The grade is “A–.”
- Ocean Centre, an 18-story office and retail building containing 900,476 square feet of GFA and a 300-space car parking facility. The grade is “B–.”
- Ocean Galleries and Gateway II retail podium, a four-level building containing 782,821 square feet of GFA. The grade is “B–.”
- New T&T Centre, a 15-story office building containing 257,280 square feet of GFA. The grade is “B–.”
- World Commerce Centre, a 15-story office building containing 253,670 square feet of GFA. The grade is “B–.”
- World Financial Centre (North Tower), a 14-story office building containing 271,730 square feet of GFA. The grade is “B–.”
- World Financial Centre (South Tower), a 14-story office building containing 240,715 square feet of GFA. The grade is “B–.”

**Surveillance**
As with all transactions rated by Fitch IBCA, we will maintain ongoing surveillance of this transaction by reviewing property operating statements, rent rolls, and reserve balances and report to investors annually, or as warranted by events.
Harbour City Funding (1) Limited