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COMMERCIAL MORTGAGE COMMENTARY

CANADA'S MORTGAGE COMPANY.™

FEBRUARY 2014

COMMERCIAL SPREADS

In 2013, borrowers were blessed with ample commercial mortgage capital and signs indicate a similar trend for 2014. The flow of capital to commercial mortgages is partially attributed to the yield premium they provide over Canadian BBB corporates. Even the most aggressively priced commercial mortgages are 60bps to 80bps over the 5 year BBB Corporate Bond Index.

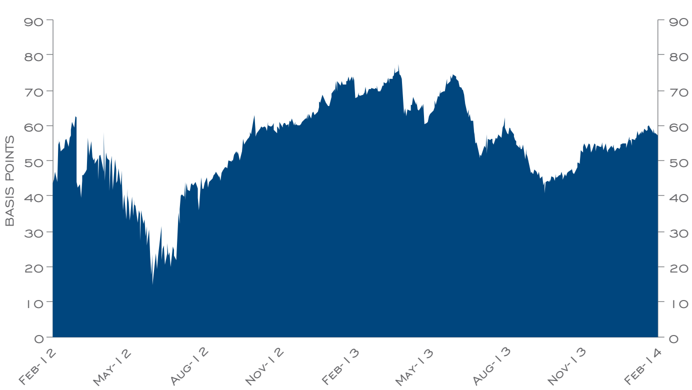
The increasing supply of capital has forced lenders to be more aggressive. Lenders typically use two methods to increase their allocation of the market:

1) Stretch underwriting standards (eg. liquidity ratios, value ratios, tertiary markets, guarantees, etc.), and;

2) Price aggressively.

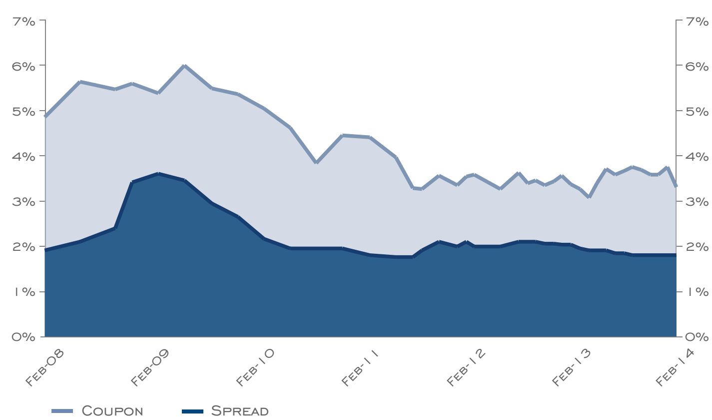
Pricing declined slightly in Q4 2013 with high quality properties attracting spreads of 175bps to 185bps over 5 year GOCs. Over the past year, we saw a cumulative drop of roughly 20bps in commercial mortgage spreads.

5 YEAR MORTGAGE SPREAD PREMIUM OVER BBB CORPORATE INDEX



Source: CMLS Financial, Bloomberg

COMMERCIAL MORTGAGE LOAN COUPONS AND 5 YEAR SPREADS



Source: CMLS Financial, Bloomberg

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CMHC SPREADS

2013 proved to be a year of CMHC legislative and policy changes, aimed at increasing discipline for residential lending and reducing taxpayer exposure to the housing market. Below is a summary of recent changes:

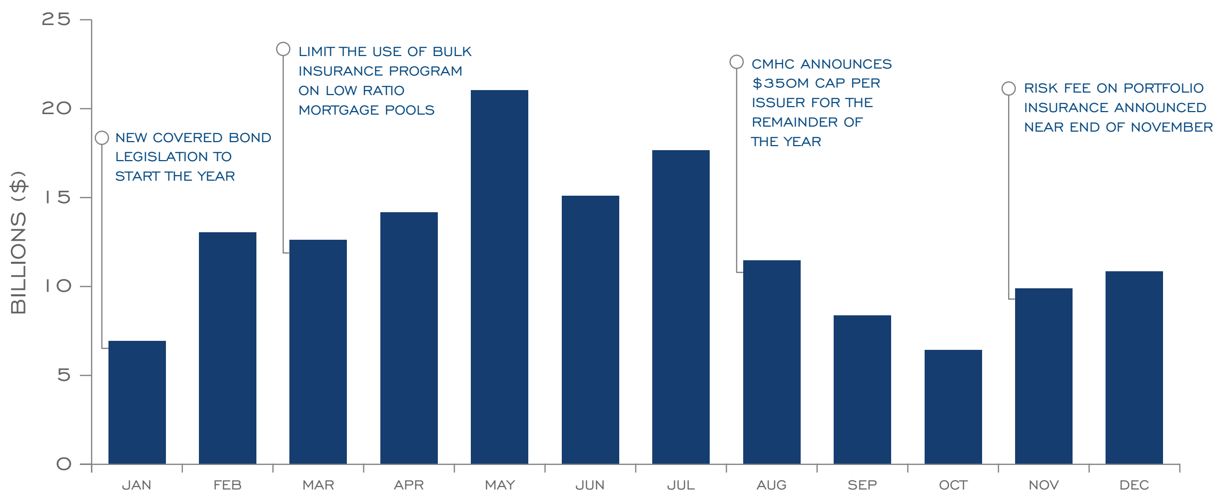
- Caps on NHA MBS issuance;
- New covered bond legislation restricting the use of CMHC insured mortgages;
- Restricted use of bulk insurance on low-ratio mortgages, and;
- Risk fee on new and existing portfolio insurance starting January 1st, 2014.

According to the International Monetary Fund (IMF) economic report released in November 2013, CMHC's measures haven't been effective in slowing the market. The report was critical of CMHC's contribution to Canada's overheated residential property market, and recommended further scaling back of the mortgage lending business.

> *"CMHC exposes the fiscal budget to financial system risks and might distort the allocation of resources in favour of mortgages and away from more productive uses of capital."* – *IMF report*

For 2014, the Minister of Finance has limited CMHC to provide $80 billion of new guarantees on NHA MBS not securitized into Canada Mortgage Bonds (CMB) and up to $40 billion of new guarantees of NHA MBS securitized into CMB, down from the combined $146 billion issued in 2013. We may see this impact the market by reducing lending or making CMHC mortgages more expensive. Observing 2013's NHA issuance, we saw a material downtick in volume following CMHC's cap announcement.

2013 NHA MBS ISSUANCE



CMBS

Momentum continued in the Canadian CMBS market with two new issues closing December 2, 2013, one of which was arranged by CMLS Financial under the Canadian Commercial Mortgage Origination Trust (CCMOT) banner. The $394 million CCMOT 2013-2 transaction was secured by 42 commercial mortgage loans on five year terms and included $336 million in AAA certificates. The second transaction, a $330 million issue from Institutional Mortgage Capital (IMC), was secured by 33 commercial mortgage loans with terms ranging from five to ten years and included $285 million in AAA certificates.

Both CCMOT 2013-2 and IMC 2013-4 demonstrated strong credit metrics with NOI debt service coverage of 1.62x and 1.61x and loan to value ratios of 60.1% and 60.6%, respectively.

CMLS Financial and IMC each brought two transactions to market in 2013 with total annual issuance reaching $1.4 billion, nearly three times the volume achieved in 2012 and approximately one-third of peak CMBS volume in 2006.

CMBS bond spreads compressed throughout 2013 allowing conduit programs to become more competitive with traditional balance sheet lenders. The expectation of a continuing downward trend has enticed additional market participants to open shop and begin aggregating commercial mortgage loans for the purpose of securitization. We should see a few new names in the headlines this year and expect another post-recession high for CMBS issuance.

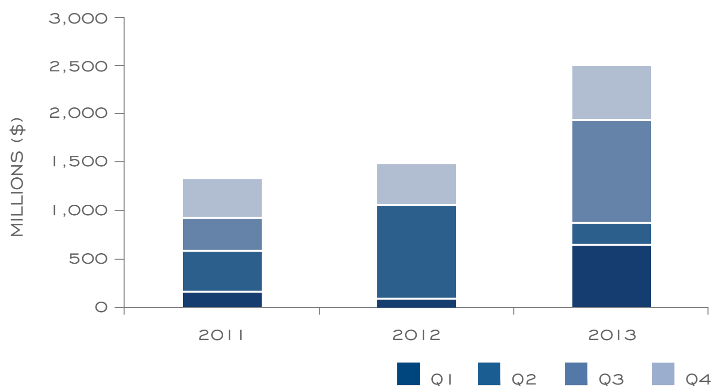
FIRST MORTGAGE BONDS

Q4 2013 had three first mortgage bond issuances occurring in November. Bankers Hall LP refinanced their expiring CMBS deal through a $300M, 4.377% 10-year term private placement first mortgage bond. The bond was rated A (low) by DBRS and priced at 180 bps over the curve. The bond was issued on the 50% of Bankers Hall Complex owned by Brookfield Office Properties Canada. The bond will not have claim over the other 50% interest owned by bcIMC. The Bankers Hall complex is located in Calgary's central business district and is 2.2 million square feet of Class AA office. The complex consists of four buildings – Bankers Hall East, Bankers Hall West, Royal Bank Building and the historic Hollinsworth Building, which are all connected by a four-storey office/retail podium.

Morguard REIT also refinanced their existing debt on St. Laurent Centre in November. The issuer structured the debt using two separate bonds. The shorter term bond is $150 million and bears a 3.59% coupon (179 bps over GOC curve) with a 5 year term. The longer term bond is $100 million and bears a 4.58% coupon (185 bps over GOC curve) with a 10 year term. St. Laurent Centre is Ottawa's third largest shopping centre and spans 971,000 square feet with 170 stores and services. The shopping centre opened its doors in 1967.

Overall, $2.5 billion in first mortgage bonds were issued in 2013 and we expect another $900M to be issued in February 2014 on West Edmonton Mall.

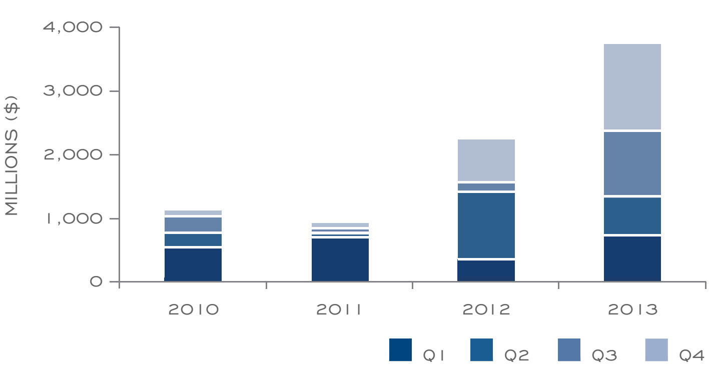
MAJOR FIRST MORTGAGE BOND ISSUANCE



SENIOR UNSECURED

REITs and REOCs issued $3.8 billion of senior unsecured debentures in 2013, a large spike from the $2.2 billion issued in 2012. The increase can be partially attributed to the expanding REIT and REOC market and the desire by these entities for a more flexible debt instrument. Q4 2013 was the most active quarter in 2013 with 9 issues totalling $1.38 billion.

SENIOR UNSECURED DEBT ISSUANCE



The total outstanding senior unsecured debt held by REITs and REOCs is approximately $9 billion, of which First Capital Realty and RioCan are the largest issuers with 21.6% ($1.9 billion) and 18.4% ($1.6 billion), respectively.

	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Spread (bps)
Q1	RioCan REIT	250	BBB (high)	5	140
	First Capital Realty	125	BBB (high)	10	201
Q2	RioCan REIT	200	BBB (high)	10	192
	Cominar REIT	100	BBB (low)	7	256
	First Capital Realty	175	BBB (high)	10	193
	Calloway REIT	150	BBB	10	205
	Dundee REIT	175	BBB (low)	5	191
	H&R REIT	175	BBB	5	180
Q3	Choice Properties REIT	400	BBB	5	167
	Choice Properties REIT	200	BBB	10	200
	CREIT	125	BBB	5	199
	Cominar REIT	100	BBB (low)	7	290
	Calloway REIT	150	BBB	4	167
	First Capital Realty	50	BBB (high)	9	200
Q4	Granite REIT	200	BBB	5	270
	Dundee REIT*	125	BBB (low)	3	170
	H&R*	235	BBB	3	150
	Cominar REIT*	250	BBB (low)	3	205
	Calloway REIT*	100	BBB	2	138
	H&R*	60	BBB	4	165
	Crombie	175	BBB (low)	5	225
	Morguard Corp.	135	BBB (low)	5	230
	CREIT	100	BBB	8	223
	2013 YTD Issuance	$3,755			

*Floating rate issues based on 90 day CDOR

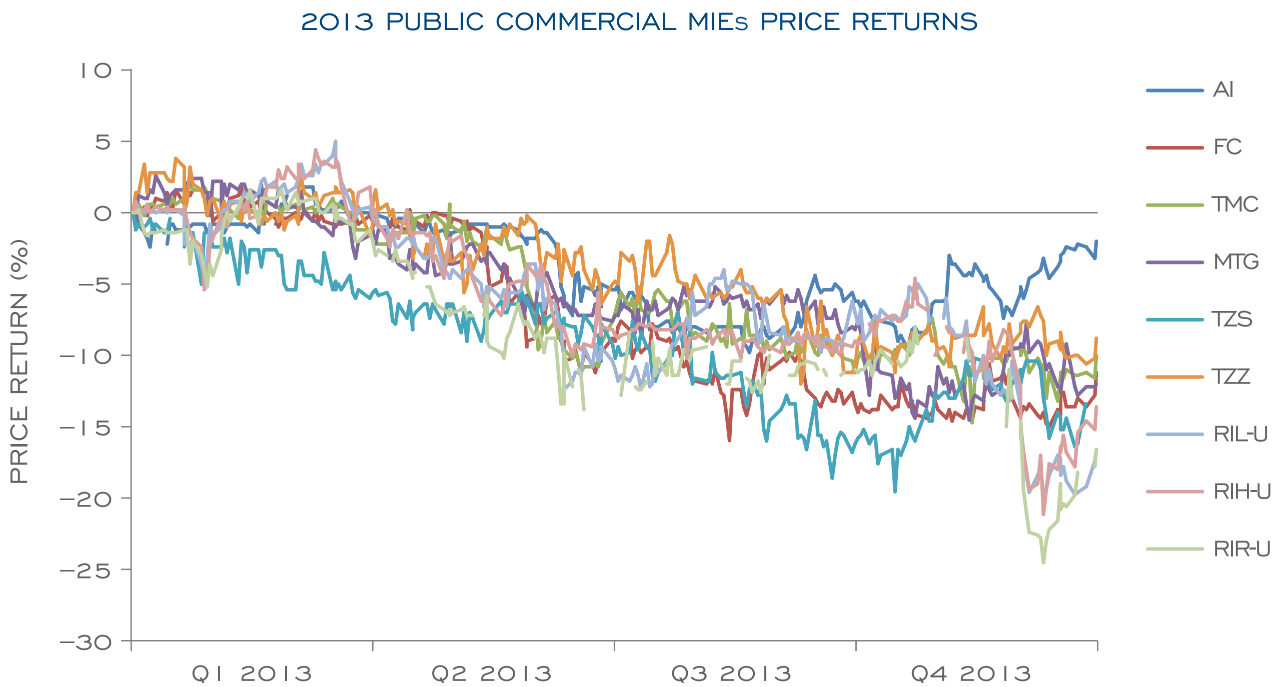
Source: Bloomberg, DBRS, RBC

SENIOR UNSECURED CONT'D

We noticed a trend towards floating rate issuances late 2013. These issuances have shorter terms (2 to 4 years) bearing lower coupons and borrowing costs due to the upward sloping yield curve. However, mid-January 2014 saw the return of fixed rate issuances with RioCan REIT, Dundee REIT and First Capital Realty Inc. each issuing $150M.

HIGH YIELD

The public market for mortgage investment entities ("MIEs") performed poorly in 2013. The upward movement of interest rates was the primary reason for the sector's slip. Advocates of the sector believe the market overreacted to rising rates since most MICs have relatively short duration and floating rate loans. The lower share values have made raising equity capital more costly. We anticipate any new capital in the sector will be raised through debt issuances.



Source: Bloomberg

NEED MORE SPECIFIC INFORMATION?

For additional detail on our spread ranges or any other matter with respect to commercial mortgage valuation in Canada, please do not hesitate to contact our team.

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