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COMMERCIAL MORTGAGE COMMENTARY

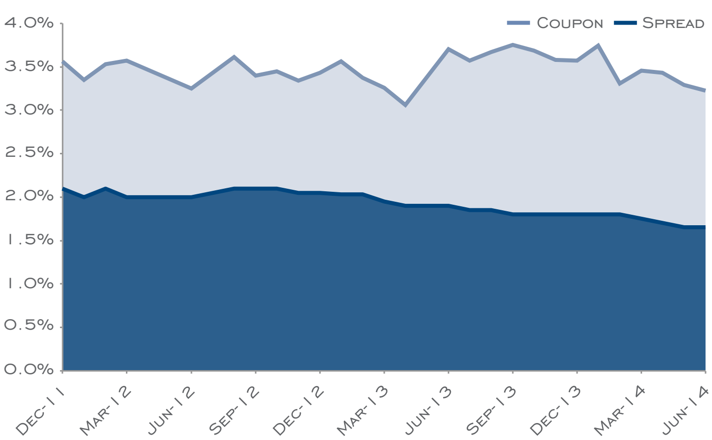
CANADA'S MORTGAGE COMPANY.™

AUGUST 2014

COMMERCIAL SPREADS

Conventional lenders have found year-to-date deal flow slow, in that the current market liquidity has made it difficult for lenders to keep pace with allocation targets. As a result, commercial mortgage spreads have continued their downward trend since the first quarter of 2014. Current spreads on high quality assets range from 160 – 175 bps for 5 year terms and 170 – 185 bps for 10 year terms. We have even seen some pricing in the 150s.

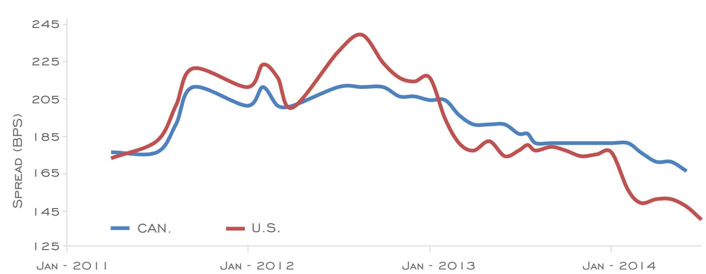
5 YEAR COMMERCIAL MORTGAGE COUPONS & SPREADS



Source: CMLS Financial

Canadian spreads show a tendency to follow spread movement south of the border. In Q2, 10-year US spreads compressed another 10 bps supporting future tightening in Canada.

10 YEAR MORTGAGE SPREAD - US vs CANADA (1-MONTH LAG)



Source: CMLS Financial, Trepp

Activity from non-bank lenders continued as GE Capital acquired Bank of America's $575 million mortgage portfolio. In a press release, GE Capital commented "It's a great reflection of our strategy to grow our debt business in Canada and a strong fit with our existing on-book loan portfolio."

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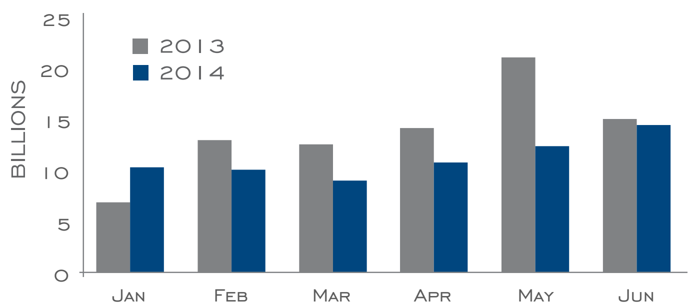
CMHC

Spreads on CMHC products have compressed by 5 bps to 10 bps in the past quarter. This comes despite increasingly restrictive CMHC underwriting and policy guidelines.

NHA MBS and CMB issuance for the first 6 months of 2014 totalled roughly $66 billion, or a little over half of the $120 billion limit imposed by CMHC. This figure is a material decrease from the first 6 months of the previous year, which saw $82 billion of issuance. 965 pools, which were amended this quarter to only allow multi-family and social housing mortgages, had total issuance of $1.8 billion, a reduction of $600 million (25%) year over year.

NHA MBS ISSUANCE (MONTHLY)



Source: CMHC

In the registered covered bonds universe, the last of the big banks, TD, has signed up under the covered bonds registry, making 7 total active issuers. The covered bonds program provides a non-CMHC guaranteed alternative source of funding for residential lenders.

CMHC IN THE NEWS

The Organization for Economic Co-operation and Development (OECD) released a report cautioning against CMHC's role in the financial stability of Canada, noting a market correction could spell trouble given CMHC guarantees 100% of insured loan amounts, where some other countries limit loss protection to 30%. The report recommends imposing a deductible on mortgage insurance to ensure lenders absorb more risk for their loans, and suggests CMHC privatize its insurance activities over time to reduce taxpayer exposure to the real estate market.

In response to the growing criticisms, CMHC has undertaken a review of its mortgage loan insurance business and implemented changes to reduce taxpayers' exposure. These changes include eliminating insurance on second homes effective May 30, 2014, as well as discontinuing insurance on all individual low-ratio homes over $1 million and condominium construction effective July 31, 2014.

CMBS

The CMBS market continues to lag previous forecasts into the second quarter of 2014. The announcement of the first deal of the year came in Q2/14, a $311.8 million deal secured by 41 mortgages originated by Institutional Mortgage Capital (IMC). According to the DBRS Pre-Sale Report, 87% of the pool is rated AAA. The 13% AAA subordination reflects a 75 bps decrease from IMC's last deal in December 2013 and a 100 bps decrease from IMC's deal in February 2013; continuing the downward trend of subordination levels in post-recession Canadian CMBS issuances. DBRS's underwriting assumptions yielded a portfolio weighted average term DSCR of 1.42x and refinance DSCR of 1.22x, with the majority of properties concentrated in retail (42.3%) and Ontario (62.0%). The portfolio is comprised of loans with a weighted average remaining term of approximately 5 years. We understand 35% of the bonds were placed with U.S. domiciled investors and that investor demand both north and south of the border was strong with every class of securities being over-subscribed. We anticipate investor appetite to remain strong through the second half of 2014 encouraging more issuers to market.

FIRST MORTGAGE BONDS

There have been no new first mortgage bonds since the $900 million issuance on West Edmonton Mall in February 2014. The inactivity appears to be caused by a lack of large financing needs rather than the use of alternative financing methods. Of note, the $310 million first mortgage bond on First Canada Place matures this winter.

INVESTMENT ACTIVITY

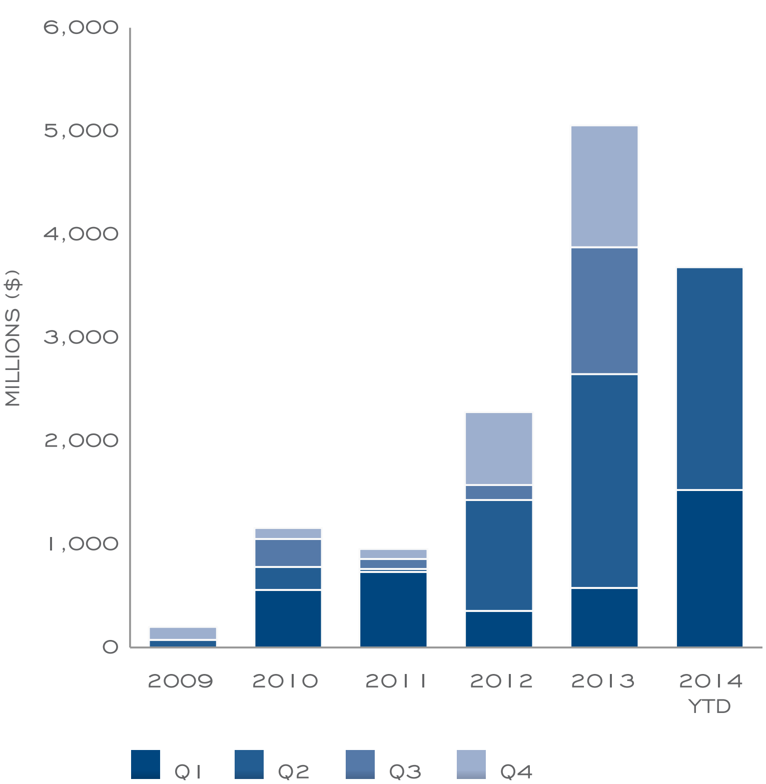
REITs have recovered slowly since the May 2013 US Federal Reserve tapering announcement, with the S&P/TSX REIT Index reporting a 5.34% increase since January. At the start of 2014, it was believed that REITs would focus on tightening up their balance sheets and refrain from making investments, while pension funds would look to increase exposure as they sit on capital earmarked for Real Estate. According to CIBC World Markets, pension funds are currently $60 billion underweight in their real estate holdings targets in Canada. Some analysts suggest that given this relationship the REIT sector is ripe for takeovers by pension funds.

SENIOR UNSECURED

Q2 2014 sets a new high for quarterly senior unsecured issuances with $2.2 billion. Choice Properties was the largest issuer with 6 issuances totalling $1.5 billion. This more than doubles the senior unsecured debt outstanding for Choice Properties, which now totals $2.55 billion. Q2 also included a $300 million issue from the real estate arm of OMERS, which received the DBRS rating of AA (low).

Comparing spread movement of similar issuances between Q1 and Q2 we have seen mixed results. First Capital Realty's 11 year $300 million issuance in Q1 2014 commanded a spread of 184 bps, while a similar 11 year issuance by First Capital this quarter had a spread of 197 bps. Conversely, Choice Properties REIT's 7 year $250 million issuance in Q1 had a spread of 171 bps, while a similar 7 year issuance by Choice Properties this quarter had a spread of 155 bps.

SENIOR UNSECURED DEBT ISSUANCE



	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Spread (bps)
	First Capital Realty	300	BBB (high)	10	184
	Dundee	150	BBB (low)	6	221
	RioCan	150	BBB (high)	6	160
	Choice Properties	200	BBB	10	198
Q1	Choice Properties	250	BBB	7	171
	Calloway	150	BBB	7	187
	Crombie	100	BBB (low)	7	195
	Cominar	100	BBB (low)	6	260
	Artis	125	BBB (low)	5	200
	OMERS Realty Corp.	300	AA (low)	7	95
	Choice Properties	200	BBB	3	100
	Choice Properties	300	BBB	2	94
	Choice Properties	200	BBB	7	155
Q2	Choice Properties	200	BBB	5	128
	Choice Properties	300	BBB	6	140
	Choice Properties	300	BBB	8	167
	RioCan	150	BBB (high)	8	167
	First Capital Realty	210	BBB (high)	11	197
	2014 YTD Issuance	$3,685			

Source: Bloomberg, DBRS, RBC

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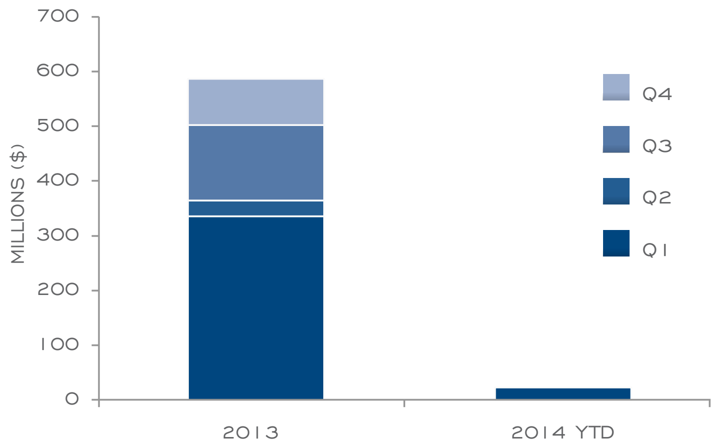
CONVERTIBLE DEBENTURES

In 2013, we identified $586 million of convertible debenture issuance, an amount projected to reoccur in 2014 (RBC REIT Outlook - Q1 2014). The sole issuance in the first half of this year was a $23 million convertible debenture by True North Apartment REIT. The 5 year offering has a 5.75% coupon. Each debenture converts to 107.5 shares of True North Apartment REIT, representing a conversion price of $9.30 per share (ending Q2 share price was $8.23 per share). The convertible debenture came shortly after the announcement of True North's acquisition of a 29 property portfolio located in Ontario and Alberta for a purchase price of approximately $286 million.

InnVest repaid $70 million of its Series C convertible debentures on June 3, 2014, two months prior to their maturity date. Kingsett provided the takeout financing with a $50 million second-mortgage and an option for an additional $50 million. A settlement was as expected as the REIT's shares had been trading at about one-third of the Series C conversion price.

CONVERTIBLE DEBENTURE ISSUANCE



Source: Bloomberg

HIGH YIELD

Public Mortgage Investment Corporations (MICs) capital issuance was slow in Q2, with only one $34.6 million common share offering from Atrium occurring in May. Recently, most of the discussion in the sector has revolved around the impact of proposed regulatory changes on private mortgage investment entities (MIEs).

British Columbia, Ontario, Saskatchewan and New Brunswick are working together with a national agency (Cooperative Capital Market Regulator) to draft a new capital market policy.

The new regulator will enforce common standards among participating provinces and enhance protection for investors. Proposed changes include requiring the use of registered third party dealers, and investment limits for non-accredited investors. These changes will likely increase operating costs and eliminate the more relaxed oversight British Columbia MIEs enjoy when compared with Ontario. The increased costs and compliance will likely hurt smaller MIEs located in BC.

ABOUT CMLS FINANCIAL LTD.

CMLS Financial is a diversified provider of lending products and services to the commercial real estate and real estate finance industry. CMLS Financial has been providing mortgage valuation services to Canada's leading institutional mortgage investors and borrowers for over 10 years.

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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