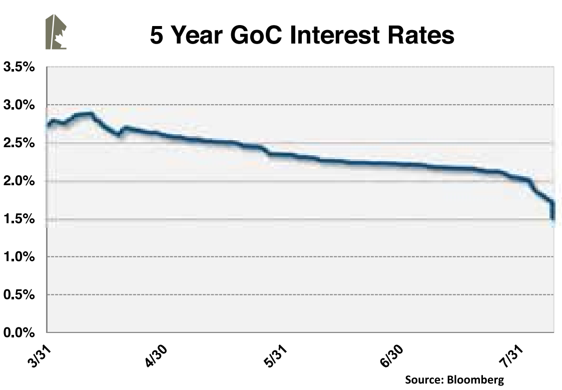
Commercial Mortgage Spread Commentary

Global Credit Markets

August 2011

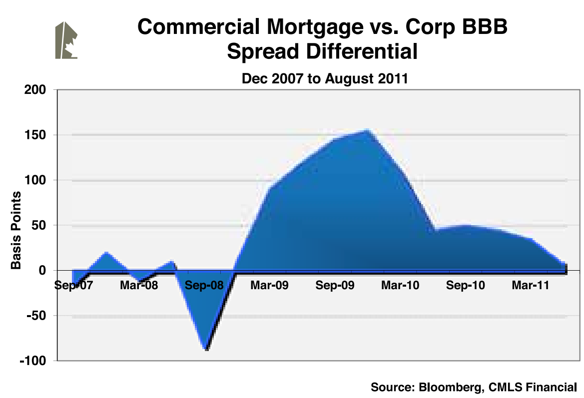
The beginning of the third quarter has brought with it a continuation of the volatility and economic uncertainty that has characterized global markets throughout much of 2011. Sovereign debt concerns became increasingly apparent in both the Euro-zone and the United States, as the former led to a second bailout of Greece and the latter sparked a heated bipartisan debate over how to reduce the American budget deficit. The result has been a convincing flight to quality across the globe; gold, for example, reached record highs and Canadian government bond yields have compressed substantially.

Weak economic conditions in the United States, coupled with necessary fiscal austerity measures to counteract an increasing deficit, have prompted analysts to adjust US GDP forecasts downward. Recent releases of employment, consumer spending, and manufacturing data have failed to indicate a meaningful pick-up in economic activity.



The Bank of Canada reported in July that "financial conditions in Canada remain very stimulative and private credit growth is strong." However, persistent sluggishness to the south continues to adversely impact Canadian net exports which could lead to a restrained economic recovery and increase the likelihood of a low interest-rate environment carrying on into 2012. The BoC considers the domestic outlook for inflation stable, but notes that a withdrawal of monetary stimulus will be necessary should the economy begin to fully absorb excess capacity.

The immediate impact of this latest market upheaval on the commercial mortgage sector is yet to be determined. However, if one thing is clear, it is that the sector will not be immune. The expansion in spreads for competing asset classes will almost certainly affect the supply of capital allocated to commercial mortgages. Fortunately, the commercial real estate sector remains very strong fundamentally. Vacancy rates have continued to decline and operating fundamentals have also improved reflecting general economic conditions. The Canadian real estate market will also benefit from a lack of oversupply. New construction has been limited during the latest recession and developers have remained cautious. Real estate investors have not been constrained by a lack of debt and equity but rather an undersupply of quality investment opportunities. Any commercial real estate weakness spurred by global economic conditions should be subdued in Canada compared to other developed nations around the globe.



First Mortgage Bond Issuance Strong in 2011

The Canadian commercial real estate sector has benefited from strong operating metrics and a healthy credit market environment. Real estate capital market transactions have been very strong in 2011 with REITS and Investment Managers having sufficient access to various credit facilities. Year-to-date issuance of first mortgage bonds has surpassed $1.2 billion with a few notable first mortgage bonds being issued with security against RBC Centre in Toronto and Fifth Avenue Place in Calgary.

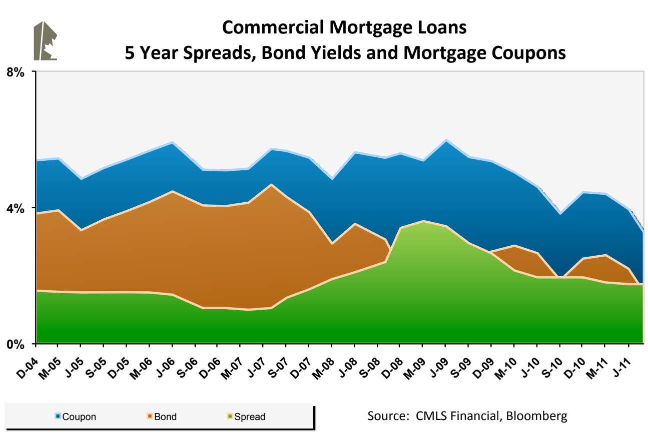
The Fifth Avenue Place $350 million first mortgage bond was recently issued by a wholly owned subsidiary of Brookfield Office Properties Canada and 1023803 Alberta Ltd. which is managed by AIMCo. The mortgage bond has a ten year term/twenty-five year amortization period and was issued with a coupon of 4.71% which equated to a spread of ~185 basis points (bps). Security is limited to the subject property which is a 1.5 million sq. ft. class A office complex situated within the Calgary downtown core. Fifth Avenue Place was constructed in 1981 and is connected to the Plus 15 network, an essential "must have" of any building in the core. The largest tenants in the subject property are Imperial Oil, Enbridge, West Coast Energy, Sherritt International, and Alberta Utilities Commission which account for 86% of the space. The most significant challenge facing the subject property is the pending lease expiry of Imperial Oil in 2016, which occupies 49% of the net leasable area. Risk of departure is mitigated as Imperial Oil is currently paying a below market blended rate of $21 per sq. ft. which is substantially below new class A office space, currently achieving a net effective rental rate of approximately $40 per sq. ft. If Imperial Oil did intend to leave, it would have to be to a new development which would require a minimum of 3 years to complete.

The Calgary office market has experienced a remarkable recovery within a very short period of time. 8th Avenue Place, Jamieson Building and Centennial Place have all been recently completed and are effectively full. Vacancy for class A/AAA space is projected at 9.6% (1.18MM sq. ft.) for Q2, however, a tenant would be challenged to find more than one floor of contiguous space. The Calgary office market is dominated by energy firms which represent 19 of the 20 largest tenants and utilize an average area of 650,000 sq. ft. Large tenants in Calgary have become more savvy learning from past mistakes when they had difficulty obtaining any space in a tight market. Tenants are now looking at their future growth plans and locking up space in anticipation of needing it in the future. Lack of space becomes an operational risk for these companies and rent cost is an insignificant expenditure for most energy companies.

Conventional Mortgage Spreads

Commercial mortgage spreads have remained relatively stable throughout the past quarter. There has been some compression in the AAA space but this has not been consistent across the credit spectrum. Based upon CMLS' risk rating model, conventional multifamily and commercial mortgages ranging from very good to fair quality would have attracted spreads between 150 and 240 basis points over GOC Bonds.

Many commercial mortgage lenders have reported seeing sufficient deal flow during the first half of 2011. Several institutions are now focusing on renewals and foresee only pursuing very selective opportunities for the remainder of 2011. There is still an ample supply of capital available with many lenders reporting a strong desire to find opportunities in the latter half of the year. 10 year money continues to be of limited supply. Lenders with a supply of ten year funds have an upper hand during mortgage term negotiations. Aside from external macro-economic shock factors, spreads should remain fairly steady as the markets appear to be balanced from a supply and demand of capital perspective.

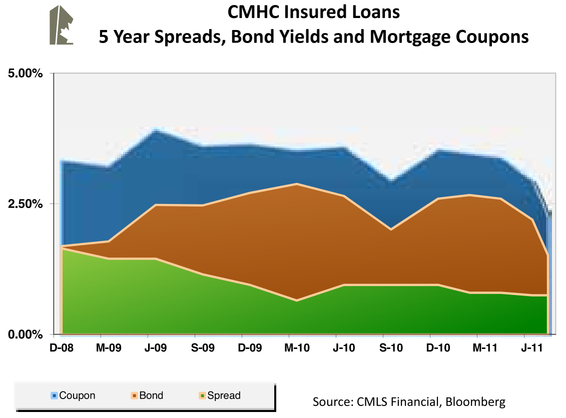


Commercial mortgage lenders continue to be prudent with their underwriting standards and are rationally pricing risk. We continue to see a tranche of pricing being available only for top quality AAA transactions. Deals with any wrinkles or unattractive characteristics have been priced accordingly. This is contrary to past years where we witnessed a race to the lowest spread level. A leading benchmark AAA deal would be completed and all subsequent deals would migrate to that level in short order.

CMHC Insured Mortgage Spreads

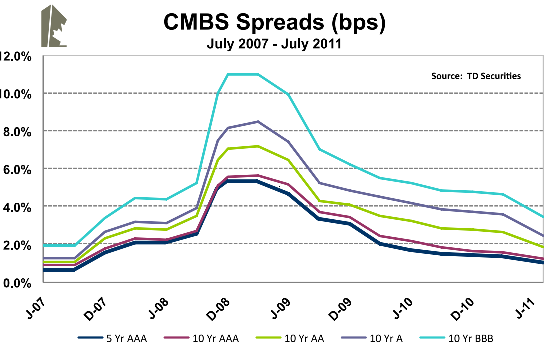
The National Housing Act Mortgage Back Security ("NHA MBS") Program continues to be a dominate securitization and funding source for Canadian multifamily financing. Based upon CMLS' risk rating model, CMHC insured mortgages would have attracted a spread between 80 and 130 basis points over GoC bonds. Top tier assets could achieve a discount from this range.

Canada Housing Trust issued an additional $6.0 B five-year Canada Mortgage Bond (CMB) which matures June 1, 2016. The issue has a 2.75% coupon and was issued at a premium of 25 bps versus the GoC bond. This marks the 10 year anniversary of the CMB program which has proven to be a giant success. The Globe and Mail recently reported that CMB issuance year to date in 2011 has totaled $22 billion and over the past decade, CMB issuance has exceed $250 billion. Over one-third of the June 2.75% five-year was purchased by international participants. Canada is perceived as a low-risk market in times of uncertainty and volatility in the credit markets. Canadian Government debt has been a safe haven as sovereign debt in Europe and the U.S. has deteriorated in credit quality. Foreign investors and central banks are becoming more comfortable with Canadian Federal issuers such as CMB's. These bonds carry the same federal guarantee and credit rating, but offer a slight yield enhancement relative to GoC bonds.



CMBS Market

Underlying performance of Canadian CMBS continues to be very strong with delinquent loans representing only 0.42% of the outstanding CMBS universe. The outstanding balance continues to decrease as new issuance remains non-existent and maturing pools are paid out. Despite a recent widening of spreads, appetite for Canadian CMBS is strong as investors are unable to replace maturing pools with new product.



A considerably different environment is consuming the U.S. market where "much of the positive momentum that had been surrounding the CMBS market recently has now all but vanished in the past few weeks," according to a statement from Trepp LLC. While the first half of 2011 witnessed tightening spreads, falling delinquency levels, and an increased pace of new issuance, the current outlook for CMBS south of the border is now tepid at best.

In July, the delinquency rate for U.S. commercial real estate loans reached a historical high of 9.88% while yields recently jumped to their highest levels in 2011. Against a backdrop of increasing uncertainty with respect to the economic recovery, many are questioning whether there will be sufficient investor demand to pick up the existing CMBS pipeline. Both are contributing factors towards the general sentiment that 2011 U.S. CMBS issuance is going to come in well below forecasts. JP Morgan recently cut its 2011 forecast from $45 B to $30-35 B.

Soaring yields and increased delinquencies weren't the only headwinds faced by the U.S. CMBS industry in the month of July. More recently, it was reported that two banks pared a $2.2 B CMBS transaction back to $1.4 B as they were unable to close all of the planned loans after yields on the transaction rose. Another transaction was recently pulled due to a disagreement between the proponents and ratings agency after investors demanded higher subordination levels to protect top rated tranches.

High-Yield Market

The high-yield market continues to see further yield compression as opportunities are limited given the level of capital available. Lenders have been able to find higher yields by focusing on longer term deals. The historical deals with a 10-12% coupon and a term of 1-3 years for income producing assets are essentially non-existent. High yield lenders may see opportunities return if credit markets begin to experience illiquidity as a result of the latest economic uncertainty and volatility. Less risk appetite from traditional first mortgage lenders could result in stricter underwriting standards. This should provide opportunities for high yield lenders where borrowers are looking for additional leverage. A shift of capital from the high yield universe is also possible as investors flee from riskier asset classes on concerns that sovereign debt issues in the U.S. and Europe could spread. High-yield bond sales have been decreasing in Canada and the U.S. which could trickle down to the mortgage space as investors begin to favor higher grade investments.

About CMLS Financial Ltd.

CMLS Financial has been servicing commercial mortgages for over thirty-five years and currently services a portfolio exceeding $4.5 billion. CMLS has also been providing mortgage valuation services to Canada's leading institutional mortgage investors and borrowers for over 10 years. The Valuation division currently values in excess of $7 billion of mortgages per annum. Such services involve an annual review of each mortgage to determine the overall risk profile which drives a mark to market spread, which is updated on a monthly basis. CMLS can price mortgages as frequently as required by your financial statement, performance measurement, or portfolio valuation needs, from daily to annually. Introducing objective, independent, third party mortgage valuation enhances governance by increasing transparency and aids in the objective assessment of fund and fund manager performance.

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.

Chris Brossard, CA, President
604.488.3858 chris.brossard@cmls.ca

Mark Achtemichuk, CA, CFA, Managing Director
604.637.0874 mark.achtemichuk@cmls.ca

David Nygren, CFA, Associate Director
604.488.3850 david.nygren@cmls.ca