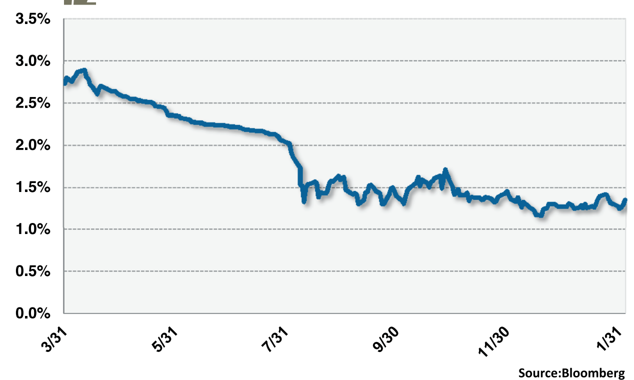
Commercial Mortgage Spread Commentary

February 2012

The supply of mortgage capital appears to be strong as we head into 2012. Most lenders have a similar appetite to last year with targeted origination volumes comparable to 2011 or slightly higher in some cases. Looking back to early 2011, the outlook was positive for the Canadian real estate debt and equity markets. However, a credible concern of disconnect between the abundance of cheap debt available and the required deal flow to deploy this capital echoed amongst mortgage lenders. Fears loomed over an ultracompetitive environment where underwriting standards would be stretched and pricing squeezed in order to deploy capital. Fortunately, this concern did not become reality as REITs, REOCs, and private funds had very active acquisition programs taking full advantage of favourable capital market conditions and cheap debt. According to CBRE, 2011 investment activity is targeted to surpass $22.0 billion which represents a significant increase over the 2010 level of $19.0 billion. Strong demand for assets provided significant upward pressure on prices with many assets surpassing previous highs achieved in 2007. This demand has continued the downward pressure on cap rate levels, which have steadily declined since early 2010 across all asset classes and geographic locations. However, the rate of decrease has started to decelerate and one wonders what fundamentals will support further cap rate compression.

Will historically low mortgage rates and favourable capital market conditions translate into a prosperous Year of the Dragon for Canadian real estate markets?

Exhibit 1: 5 Year GoC Interest Rates



Source:Bloomberg

They certainly should, but there are considerable risks present that could affect credit markets in Canada. The main source of concern for the Canadian commercial mortgage market is the potential effects of continued financial stress in the euro zone. The probability of euro zone discontent spreading to global credit markets is a genuine concern that is on the radar for most developed countries around the globe. The Bank of Canada ("BoC") has continually identified further deterioration of the European debt crisis and a subsequent derailment of global economic recovery as the main risk to Canada and other advanced economies. A global economic slowdown will have an immediate effect on the credit markets; increasing risk premiums and restricting the availability of capital. So in short, the commercial mortgage market in Canada and more broadly, the real estate sector, should perform well unless a major shock or financial incident occurs, likely to be initiated in the euro zone.

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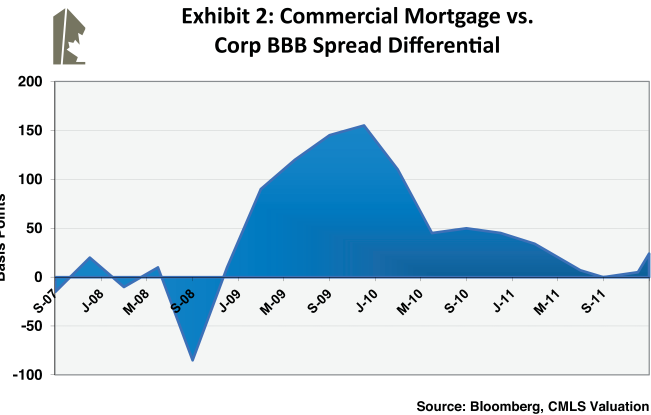
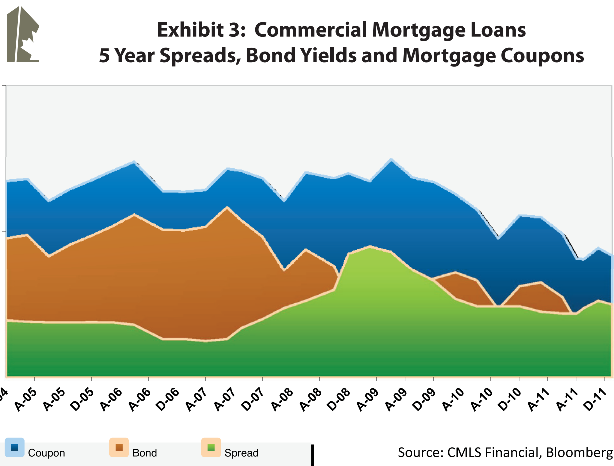
On January 17th the BoC elected to hold the target overnight lending rate at 1.0%, which it has elected to do since September 2010. The Bank's outlook for the economy remains consistent with previous projections. Generally, the pace of growth is expected to be modest and continue to be driven largely by the current external environment. The economy is projected to grow at 2.0% in 2012 and projections now anticipate a return to full capacity in the third quarter of 2013. Several significant upside and downside risks are present in the inflation outlook but the BoC judges these risks to be "roughly balanced over the projection horizon." Inflation is projected to moderate through 2012 and begin to experience upward pressure as excess slack is removed near the end of 2013. Bloomberg's recent interest rate survey of 24 leading economists indicates they don't expect the BoC to increase interest rates until the second quarter of 2013.



Conventional Mortgage Spreads

Conventional mortgage spreads experienced upward movement in the second half of 2011 but have since leveled off. Based upon CMLS' risk rating model, conventional multifamily and commercial mortgages ranging from very good to fair quality would attract spreads between 195 and 285 basis points over GOC Bonds.



The commercial mortgage market in Canada appears to be well capitalized in 2012. Most lenders are active with appetite for origination levels similar to 2011. Interest rate floor rates are becoming more common as nominal lending rates continue to decrease. As depicted in Exhibit 3, 5 year commercial mortgage rates have dropped to around 3.40%. The floor rates being set are institution specific and are driven by numerous factors. Floor rates are generally not being implemented as a risk management tool but rather to ensure a required minimum yield. The current risk spread between 10 year GoC bond yields and commercial cap rates is 450 bps. This risk spread is very high when compared to the 10 year average of 376 bps. At first glance, one might assume that a substantial risk premium is being priced into this asset class. However, we feel this is unlikely to be the case given that credit markets are strong and real estate has performed extraordinarily well across most asset classes and geographic locations. Rather, we believe the inflated risk spread is being predominately driven by historically low GoC yields as opposed to a genuine concern with operating fundamentals. This is further supported by the emergence of floor rates being imposed by some lenders as they are hesitant to pass along a further reduction in pricing in order to preserve minimum yield requirements. This yield requirement also helps to explain the spread expansion that we experienced in the second half of 2011. Spreads expanded from a low of 155 bps in June to approximately 200 bps at the end of the year. Year-end limitations of capital and general credit market spread widening contributed to this expansion, but floor rates and yield requirements were also a major factor as GoC rates continued to decrease during the same period. Moreover, the perceived risk of the commercial mortgage market has not increased as one would expect to accompany an increase in spreads. If it had, we believe we would have seen underwriting standards start to incorpo-

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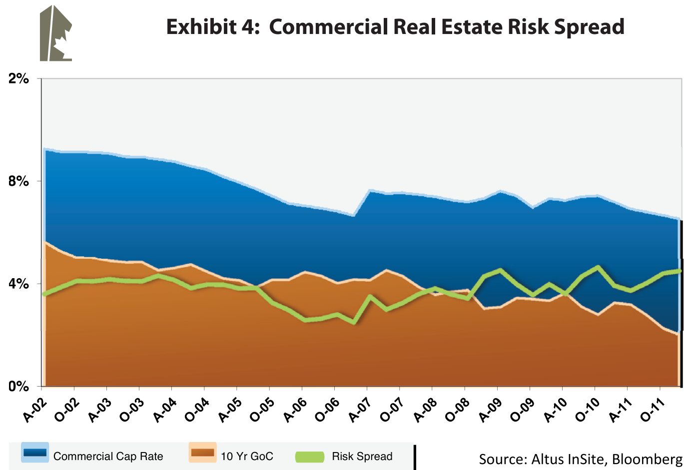

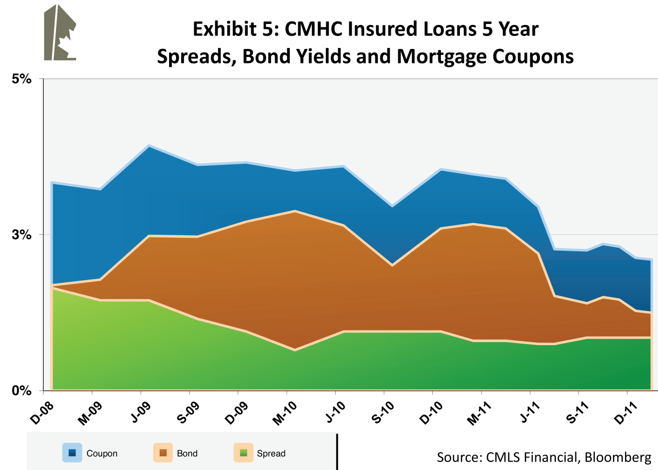

rate a defensive outlook. This has not been the case, as minimum loan to value and debt service requirements have remained steady throughout 2011 and into early 2012. As the New Year marks a reset button for many programs it will be interesting to see what, if any, spread compression occurs as a result of the market being fully capitalized and most participants active. All information indicates a prolonged period of record low interest rates and assuming this will be reality, we believe mortgage spreads will be buoyant and resist substantial compression.

CMHC Insured Loans

CMHC spreads continue to be influenced by lenders who are active in CMHC securitization programs. Institutional quality CMHC insured loans will currently attract pricing in the range of 85 to 115 basis points over GoC Bonds.

Canada Housing Trust ("CHT") closed their most recent ten year Canada Mortgage Bond ("CMB") issuance in February. This ten year bond had a total issue size of $4.5 billion and was issued in two series. The February series was a $2.5 billion issue and was priced at 48 bps above the benchmark GoC bond. The first series was a $2.0 billion issuance in November and was initially priced at 56 bps above the GoC benchmark. CHT was very active throughout 2011, issuing $41.3 billion of CMB's according to Bloomberg. This is an improvement over 2010 where $39.4 billion of CMB's were issued but well behind the record issuance in 2009 of $46.9 billion. 2012 should be a busy year for issuance as this program provides a reliable and cost effective source of funding for Canadian banks. The CMB program could become a more attractive source of capital for Canadian banks if credit conditions tighten due to further euro zone contagion. As noted, 2009 was a record year for issuance as banks were faced with very tight credit markets and had few options at their disposal for issuance. The CMB program also continues to receive strong demand from the investment community as investors have become wary of debt issues from euro zone nations and banks.

In addition to CMB issuance, covered bonds sales are becoming an equally important funding source for Canadian banks. Covered bonds issued by Canadian banks have a very high credit quality as they are almost always backed by mortgages insured by CMHC. In addition to the CMHC guarantee, these bonds have full recourse to the issuing entity, over-collaterization, and the assets are held in a bankruptcy-remote entity. The Canadian covered bond market has grown to approximately $47 billion since 2007 when the first issue was brought to market. 2011 was a record year for this sector with $25.7 billion of issuance. Covered bonds represent one of the cheapest sources of funding for Canadian banks. Bank of Montreal recently issued a $2.0 billion USD covered bond with a 1.95% coupon maturing January 30, 2017. This issuance is currently trading with a spread of approximately 84 bps over treasuries which is extremely attractive for issuers.

CMHC has recently announced that they will be cutting back on bulk insurance activities that CMHC underwrites as they approach the GoC limit of $600 billion of insurance in force ("IIF"). Third quarter results indicate CMHC has reached an IIF value of $541 billion. This number has increased dramatically over the past 5 years as banks have increasingly utilized bulk insurance as a way to reduce risk and allow access to low

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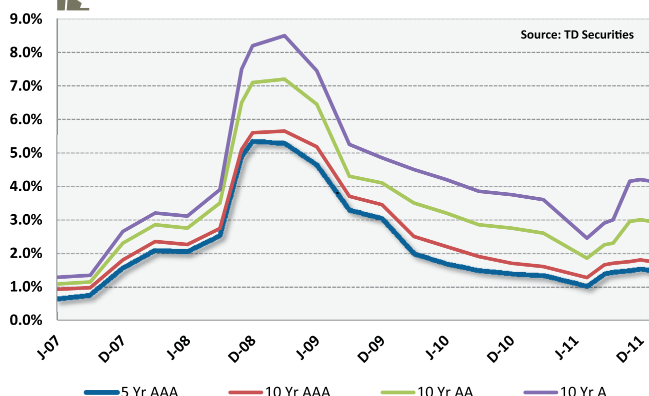
cost CMHC securitization programs. These programs have been a key source of funding for approved CMHC issuers which is supported by the growth in the NHA-MBS universe from approximately $80 billion in 2005 to over $294 billion as of Q2 2011, according to DBRS. Bulk insurance provides lenders the ability to purchase insurance on pools of loans with low LTV ratios that did not require CMHC insurance upon origination. CMHC's cut back on bulk insurance will not affect conventional multifamily lending as policies are traditionally underwritten and granted at loan origination. Private insurance alternatives to CMHC do exist but bulk insurance does not comprise a significant part of their business at this time. Clearly a cut back by CMHC could open more opportunities for private insurers, but costs will likely be higher. This could ultimately lead to an increased cost of capital for lenders and might reduce the long run availability of product for securitization via NHA-MBS and CMB programs. DBRS estimates that NHA-MBS product represents 27.5% of outstanding mortgage credit in Canada.

CMBS Market

The CMBS market in Canada appears to be in a 'holding pattern'; secondary trading is down as investors sense the sector is much more fairly valued. While underlying loan collateral continues to perform well, those pools thought to have problem assets continue to command additional spread. As always, spreads across the tranches depend on pool quality and the level of subordination. Canadian delinquencies continue to hover at 0.50% in contrast to the now almost constant 10% mark in the United States. There were, however, a handful of positive developments south of the border since our last commentary. The US CMBS universe has enjoyed four consecutive monthly declines in the 30+ day delinquency rate and currently stands at 9.55% based on January 2012 remittance reports. Meanwhile, from a pricing perspective, the US market has rallied with the secondary market enjoying spread compression across nearly all components of the capital stack since year-end. Taking account of the current pipeline, the US CMBS market is on pace for approximately $9 billion of first-quarter CMBS issuance and the general consensus amongst US participants is that the market will reach $38 billion in 2012. This compares to $33 billion of issuance in 2011.

Exhibit 6: CMBS Spreads (bps)



Being one of only a handful of active CMBS lenders in Canada, CMLS has a unique perspective on the future outlook of CMBS in Canada. We are, of course delighted to be at the forefront of re-establishing this valuable funding source and strongly believe the Canadian market will see at least one new CMBS deal in 2012. Although we forecast 2012 CMBS origination volumes to fall significantly short of pre-crisis levels, which peaked north of $4 billion, we believe the uptick in CMBS origination compared to more recent years and the resulting increase in the available pool of mortgage capital is sure to benefit Canadian borrowers. There are $1.7 billion of Canadian CMBS loans maturing in 2012. Although 2012 CMBS origination will fall well short of this figure, we believe the market has sufficient capacity to absorb the shortfall.

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 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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