COMMERCIAL MORTGAGE SPREAD COMMENTARY

CANADA'S MORTGAGE COMPANY.™

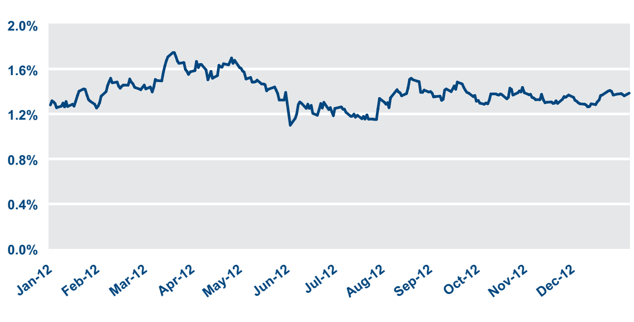
FEBRUARY 2013

BANK OF CANADA OVERNIGHT RATE

In January 2013, the Bank of Canada announced for the nineteenth consecutive time that the overnight rate would remain at 1%. How much longer will the Bank of Canada keep the rate static?

There are 3 major influences that would likely drive a rate increase; 1) a decrease in unemployment; 2) an increase in inflation; and 3) an increase in GDP growth. Recent unemployment figures have beaten expectations but both inflation and GDP growth are below levels that would seem to warrant a rate hike. In their latest Monetary Policy Report, the Bank of Canada cautioned that "core inflation has softened more than the Bank expected" and that "the economy is now forecast to return to full capacity only in the second half of 2014." We believe the Bank of Canada will hold rates until we see more pressure from inflation or GDP growth.

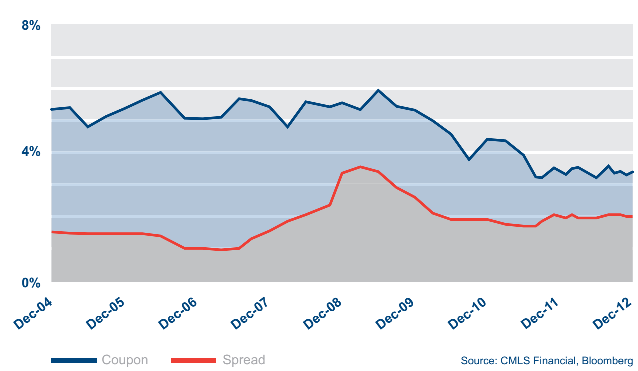
5 Year GoC Interest Rates



COMMERCIAL SPREADS

As we roll into 2013, the commercial mortgage market seems to be well capitalized. There is the usual early year tightening of spreads as certain groups become more active with fresh allocation targets. High quality commercial loans have spreads in the 190bps to 215bps range for 5 year money and 205bps to 225bps for 10 year money. Conventional multifamily spreads are about 10bps lower. All-in coupons remain at, or close to, all-time lows, however spreads are still slightly above the long run average for 5 year money of 175bps. We may also start to see more capital flow to term business as confidence in construction lending diminishes.

Commercial Mortgage Loans – 5 Year Spreads and Coupons

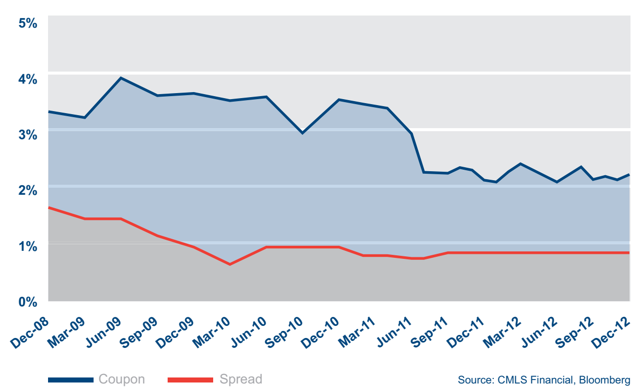


CMHC SPREADS

The Canada Housing Trust (CHT) issued $13 billion of CMB in Q4 2012, $10 billion of which was 5 year currently trading at a yield of ~1.78% – a 26bps premium over GOCs. There were no 10 year issuances in Q4 2012 and none are expected until Q3 2013.

Spreads on CMHC insured mortgages have tightened over the last quarter especially for larger deals with sophisticated borrowers. Similar to what we are seeing in the commercial market, lenders with fresh budgets are boosting competition. Top quality deals are pricing at spreads near 85bps for 5 year and 90bps for 10 year.

CMHC Insured Loans – 5 Year Spreads and Coupons



Source: CMLS Financial, Bloomberg

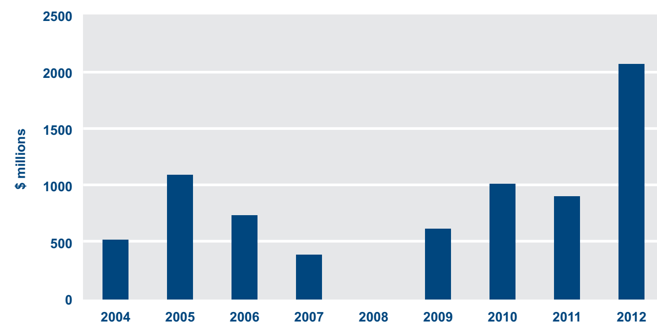
REITS, REITS AND MORE REITS

2012 has been the year of the REIT with approximately $5.1 billion of equity raised in the sector and rumblings that Loblaws and other large retailers are looking to spin assets into REITs.

REITs were originally designed to open up passive real estate investing to the general public but industry growth has also marked a shift in real estate financing. Investment grade REITs have been able to issue unsecured debt to finance properties rather than traditional commercial mortgages, and some see unsecured debt as a more manageable and flexible financing option. Unsecured debt is a popular investment vehicle for insurance companies who like the yield and real estate based security. The debt usually has security covenants similar to those of conventional commercial mortgages, such as:

- A maximum total debt to total assets of 60%
- A maximum secured (mortgage) debt to total assets of 40%
- A minimum coverage ratio of 1.4x

Senior Unsecured Debt Insurance



Source: CMLS Financial, RBC, Bloomberg

REITs and REOCs issued $2.1 billion in senior unsecured debt in 2012, with pricing indicating very strong demand from investors. Fourth quarter issuance was $550 million, including $200 million each from Cominar REIT and Riocan REIT. Riocan's 2012 issuance is especially illustrative of the heat that has engulfed the market for this form of financing. As the largest REIT in Canada, Riocan issued 5-year unsecured paper at the beginning of the year at 239 bps over benchmark bonds according to Bloomberg data; their 9-year December issue attracted a much lower 207 bps spread, reflecting 32 bps tightening irrespective of term premium. This is in contrast to a less pronounced tightening in commercial mortgage spreads, which CMLS estimates came in ~10 bps in 2012.

If REITs continue to gobble up commercial properties at their current rate, the unsecured debt market will continue to grow and may shift volume away from the conventional commercial mortgage market. Are we beginning to see a shift in the way the real estate industry gets financed?

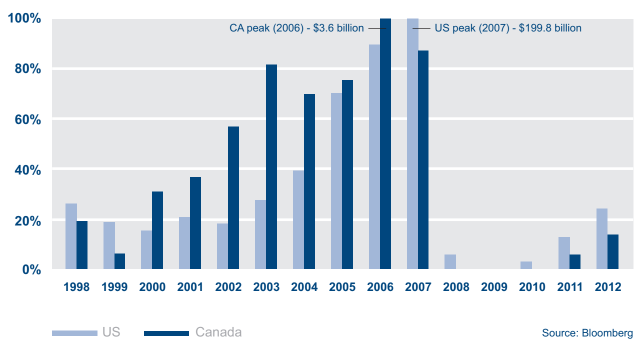
CMBS

Over the past six months, whether it involved hockey-related revenue sharing, compliance buyouts or a revision of the pension system, we have been reminded several times in the media that the economics just weren't there, leaving players on the bench as the two sides worked towards a deal. Although much less publicized and without the intrigues of collective bargaining negotiations, many former players in Canada's CMBS market are well-versed in a similar refrain: "The economics don't work," themselves kept on the bench for almost five years running.

But as we write this commentary, Canada's most beloved sport has returned to the ice. And with increasingly attractive new-issue pricing and two securitizations in 2012 by CMLS Financial and Institutional Mortgage Capital, we wonder who will be next to dust off the skates.

Global CMBS volume in 2012 was pegged at $52.6 billion, including $48.3 billion in US transactions and approximately $500 million housed in the two Canadian securitizations. Although vastly different on a nominal basis, as a percentage of peak volumes achieved in 2006 and 2007, both markets are exhibiting similar acceleration and the trend is expected to continue. The story on the demand side is more of the same with investors gaining comfort in the asset class as they search for yield in the low interest rate environment.

Annual CMBS Issuance as % of Peak Volume

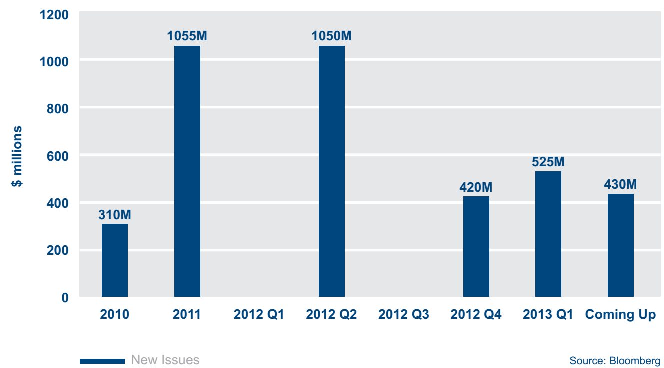


Trades are obviously few and far between north of the border, but there is evidence to suggest spread tightening on both new-issue and legacy transactions. Legacy deals often attract a healthy discount to new issues, especially further down the capital stack, for a host of reasons including general distrust of the underwriting and less information on the current status of properties and loans. However, CMBS spreads still provide considerable yield pick-up against corporates of comparable rating which has coaxed high-yield buyers into the market. These buyers are often not specialized in real estate, executing a pure rating play without much scrutiny into the collateral, and will drive less of a hard bargain on pricing.

FIRST MORTGAGE BONDS

First mortgage bonds found their footing with total new issuance doubling to $2 billion in 2012 and Q1 2013 from $1 billion in 2011.

Major First Mortgage Bond Issuance



Scotia Plaza and The Bow headlined two large issuances in Q2 and Calgary's Centennial Place secured $420 million of bonds in Q4. The Centennial Place bonds are split 50/50 between Series-A (10 year term) and Series-B (5 year term), both with 30 year amortization. Coupons were 3.666% and 3.04% respectively. The bonds were issued by OMERS Realty Corporation (ORC) and secured solely by Centennial Place. The property contains 1.24 million SF divided between the 39-storey East Tower, the 22-storey West Tower and the two storey Retail Podium built in 2010. The complex's main tenants are government agencies and energy companies.

2013 opened with $525 million of mortgage bonds secured by Bay-Wellington Tower (BWT). The bonds issued by Brookfield Office Properties Canada LP have a coupon of 3.244%, a 7-year term, and amortize over 30 years. Bay-Wellington Tower is a 47-storey tower constructed in 1992; it contains 1.3 million SF of office and 43,356 SF of ground floor retail. The property is currently 97.6% occupied and the major tenants are McMillan LLP, Deloitte, Aird & Berlis LLP, Merrill Lynch, Macquarie, and Brookfield. Moody's rated the bonds at A2, given their internal valuation resulting in an LTV of 76.2% and as-is DSCR of 1.82X.

Calgary AAA office buildings were a popular asset type for mortgage bonds in 2012. Activity in 2013 should include deals underway on Coquitlam Centre in BC and Epcor Centre in Edmonton and are likely to include Bankers' Hall in Calgary as the current mortgage, a 10 year loan securitized in a 2003 CMBS deal, expires in November 2013.

HIGH YIELD MIC INVASION

Considering the current low interest rate environment, investors seem more willing to take on risk to boost returns. As a result, the high yield mortgage market has seen an inflow of capital in both public and private mortgage investment corporations (MIC). MIC portfolios can include everything from small second mortgages on residential property to commercial and development mortgages on new projects, although greater than 50% of assets must be invested in residential mortgages. Trez Capital and First National Financial raised funds for public MICs in 2012 along with a host of other players. The demand for this product has increased capital in the high yield space, tightening spreads considerably.

ENDING NOTE

The CMLS Commentary bids a fond farewell and best wishes to David Nygren, one of the founding members of our mortgage valuation team and a key contributor to this commentary over the years. After six years with CMLS, Dave is moving on to join the fixed income group of a western Canadian investment manager. Good luck Dave!

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.

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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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