CMLS Financial®

COMMERCIAL MORTGAGE COMMENTARY

CANADA'S MORTGAGE COMPANY.™

FEBRUARY 2015

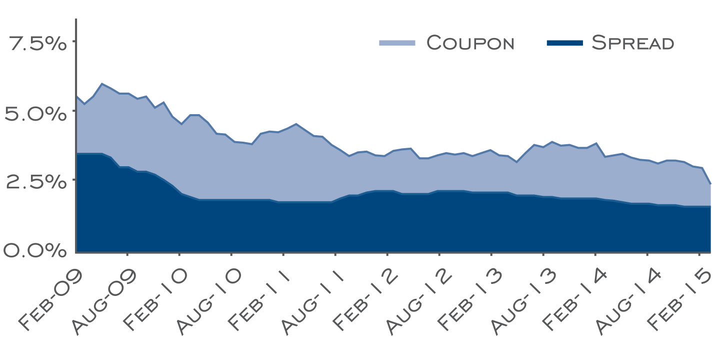
COMMERCIAL SPREADS

The Canadian economy ended 2014 in a state of uncertainty. The TSX composite fluctuated 10% in Q4/14 and oil dropped 43% from $89/barrel to $51/barrel. The volatility precipitated a flight to quality with Government of Canada (GOC) bond rates dropping 28 bps in Q4/14. However, the apprehension in the market did not transfer to commercial mortgage spreads as they remained flat in the final quarter of 2014. High-quality real estate assets in prime locations commanded spreads between 155 – 165 bps for 5-year terms and 165 – 175 bps for 10-year terms at the end of 2014. As we look back at 2014, we saw spreads on commercial mortgages decline approximately 20 bps and 5-year GOC bonds decline another 65 bps from 2.01% to 1.36%. The combination of the two resulted in an 80 bps drop in borrowing costs for property owners.

approximately 65 bps lower in January 2015 than when it opened the year. The retail property sector also appears to be shifting as notable brands are closing Canadian operations. Target is closing 133 stores, Sony is shutting down 14 stores, Mexx is vacating 95 stores, Holt Renfrew is leaving its Ottawa and Quebec locations, Smart Set is leaving 107 locations and Jacob is closing 97 stores.

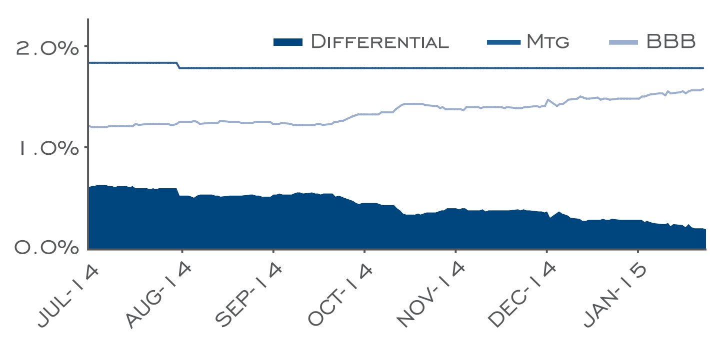
The uncertainty has impacted Canadian corporate bonds as BBB spreads have increased 27 bps since Q2/14, narrowing the yield premium enjoyed by commercial mortgage lenders. US commercial mortgage spreads have also trended up, roughly 10 bps, in Q4/14 after declining nearly 100 bps over the past 2 years.

COMMERCIAL MORTGAGE LOAN COUPONS AND 5-YEAR SPREADS



Source: CMLS Financial, Bloomberg

5-YEAR COMMERCIAL MORTGAGE VS BBB CORPORATES YIELD/SPREADS



Source: CMLS Financial, Bloomberg

The Canadian economic outlook for 2015 is less optimistic than previously expected, as the price of oil and the prospects for continued growth in Canada get digested by the market. The Bank of Canada responded to these weakening prospects in January when it dropped the overnight rate from 1.0% to 0.75%, the first rate reduction since Sept 2010. The cut started a dramatic decline in GOC yields, with the 5-year trading

With the recent decline in GOC yields, market depth has thinned as lenders are bumping into internal floor rates. The ensuing reduction in participants may cause Canadian mortgage spreads to mirror the upward direction of Canadian corporates and the US commercial mortgages.

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THE AMERICANS ARE COMING!

While there have been a few US-based lenders active in Canada in the past few years, most have been absent since the crisis, either too distracted at home or finding it difficult to remain competitive with Canadian lenders on pricing. A big factor for those without Canadian operations was the need to bring US dollars to Canada and the cost of hedging their foreign exchange risk. And while those costs have not changed much, priorities appear to be changing. In the past few months, a number of US-based lenders have re-emerged in Canada – either to do a deal, scope about for one, or in the case of one group, to set up Canadian documents in advance of funding their first deal, something we're sure their first borrower will be very appreciative of. Diversification and new markets are the new rationale with US lenders keen to gain some exposure to the strong real estate markets in Toronto and Vancouver in particular. In fact, many are confining their lending to these two major centres and originating from US cities or through correspondent arrangements. It will be interesting to see what levels of volume the new and returning entrants will be able to achieve given the significant capital available to borrowers from Canadian lenders and financial markets.

CMBS

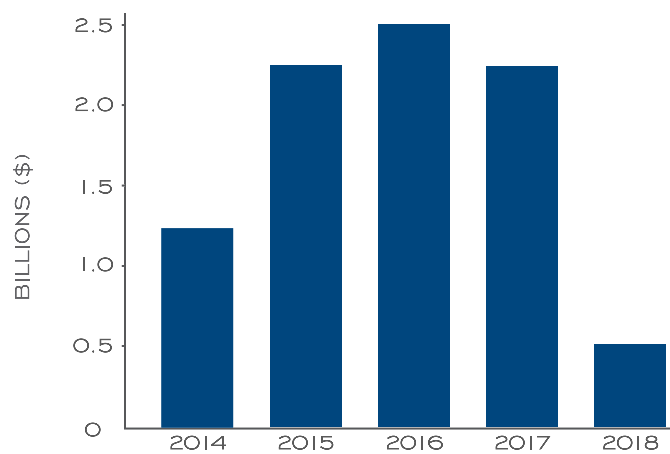
After a slow start to the year, four CMBS deals totalling $1.1B came to market in the second half of 2014, representing a 20% Y/Y decline from 2013 issuance of $1.4B.

Following on the heels of RBC's return to the Canadian CMBS market with REALT 2014-1 in October 2014, CMLS Financial Ltd. launched CMLS Issuer Corp (CMLSI) 2014-1, a $283.7M offering. The CMLSI 2014-1 transaction was the fourth Canadian CMBS deal in the past 12 months to be marketed in the US through the 144A exemption and generated strong interest from US-based investors. In our view, interest south of the border was driven primarily by attractive pricing relative to US CMBS on a risk-adjusted basis.

The $283.7M CMLSI 2014-1 transaction comprised 37 loans secured by 41 properties and provided strong pool metrics with a weighted-average loan to value of 57.75%, and debt service coverage ratio of 1.47x. In addition, CMLSI 2014-1 was the only deal in 2014 offering AAA investors a 10-year weighted average life tranche. MCAP Financial Corporation rounded out the year with MCIC 2014-1, a $224.0M offering marketed only in Canada and offering AAA investors a 3.76-year weighted average life tranche.

Despite the recent volatility in the markets, we are forecasting a strong year for CMBS origination of $2.0B for 2015 across 5-6 deals, underpinned by a significant number of CMBS maturities coming due and moderating competition, including a slowing unsecured debt issuance environment since the end of Q3/14.

CMBS MATURITIES
OUTSTANDING BALANCE MATURING



Source: CMLS Financial, DBRS

2014 DEAL SUMMARY

Cut-off Date	Deal	Size (M)	# of Loans	Cut-off Date LTV	NCF DSCR	AAA Subordination	Weighted-Average Life A1	Weighted-Average Life A2
Dec-14	CMLSI 2014-1	$284	37	57.75%	1.47x	13.375%	5.50	9.78
Dec-14	MCIC 2014-1	$224	32	64.20%	1.36x	15.500%	3.76	n/a
Oct-14	REAL-T 2014-1	$281	34	64.61%	1.59x	13.875%	5.49	n/a
Jul-14	IMSC 2014-5	$312	41	60.18%	1.44x	13.000%	2.85	5.81
		$1,100						

Source: CMLS Financial, DBRS

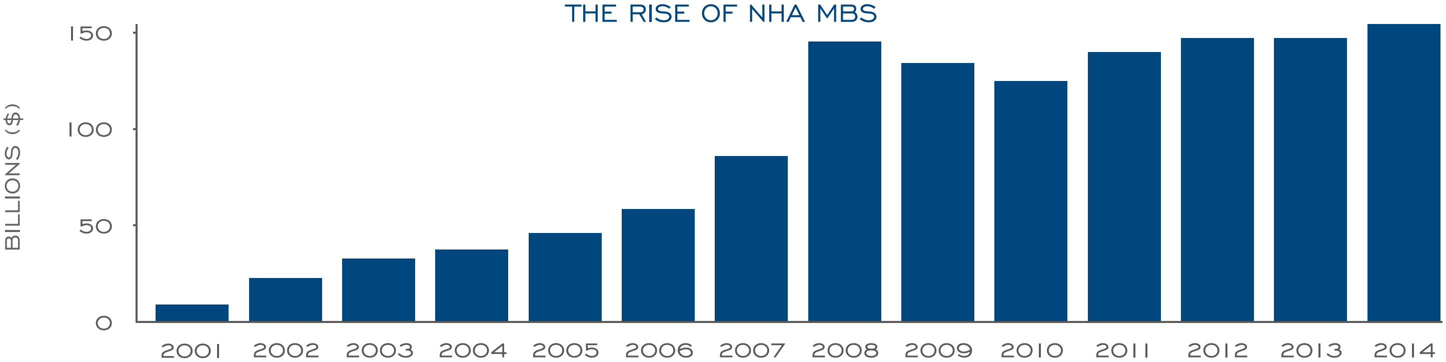
CMHC

Spreads on CMHC-insured commercial mortgages remained flat in Q4/14, with high-quality 5-year and 10-year deals commanding 75 bps and 85 bps, respectively. Over the past year, spreads have fallen close to 10 bps – 15 bps with the majority of the compression occurring mid-year. The compression is amplified by a 5-year Canada Mortgage Bond (CMB) pricing sharper at 30 bps over GOCs and the 10-year CMB pricing below 50 bps over GOCs.

NHA MBS ACTIVITY AND LIMITS

Although NHA MBS is predominately composed of single-family residential, its relatively smaller multi-family pools are a significant source of capital to the commercial mortgage market, making up approximately 16% of annual commercial mortgage origination in 2013. Similar to the previous year, the Minister of Finance has limited CMHC to $80 billion of new guarantees for NHA MBS and $40 billion of new guarantees for CMB in 2015. The limits were introduced in the latter half of 2013 and then again for 2014 in an effort to curb the rapid acceleration of CMHC-insured lending witnessed in early 2013.

THE RISE OF NHA MBS



Source: CMLS Financial, Bloomberg

CMHC IN THE NEWS

Since taking over the reigns as President and CEO of CMHC, Evan Siddall has maintained the organization's focus on decreasing taxpayer exposure to real estate through prudent insurance and lending policies. 2014 saw many changes to CMHC's guidelines and policies designed to accomplish just that:

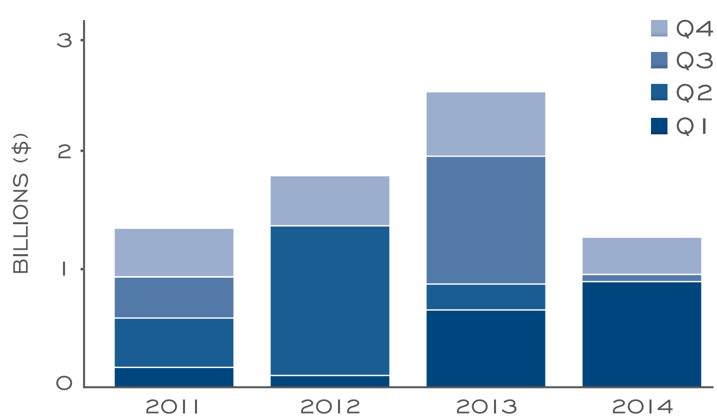
- January 2014: A risk fee on new and existing portfolio insurance
- March 2014: Insurance premiums for new single-family dwellings and 1-4 unit rental properties increased by 10 bps to 45 bps
- May 2014: Discontinuation of insurance on second homes
- July 2014: Discontinuation of insurance on all individual low-ratio homes over $1 million
- July 2014: Discontinuation of insurance on multi-unit condominium construction
- November 2014: Increase in fees charged to issuers of NHA MBS
- January 2015: Fee increase of 3 bps for timely payment guarantee starting March 1st, 2015

FIRST MORTGAGE BONDS

Q4/14 saw a $315M first mortgage series A bonds issue on Canada's tallest tower, First Canadian Place, with an option to issue an additional pari passu bond (series B) of up to $75M. The A series bond has a 3.559% coupon, a 25-year amortization and 9-year term maturing on December 1, 2023. The origination spread was approximately 190 bps over GOCs. The borrowers are Brookfield Canada Office Properties, CPPIB, and AIMCo. Constructed in 1975, First Canadian Place is a Class AAA 2.6 million square foot, 72-storey office and retail complex, situated at the heart of Toronto's financial core.

In Q3/14, Schlegel Villages issued a $60 million 20-year first mortgage bond, with a coupon of 4.841%. The bond is secured by Schlegel Villages' portfolio of high-quality long term care and retirement facilities across Ontario.

FIRST MORTGAGE BOND ISSUANCE



Source: Bloomberg

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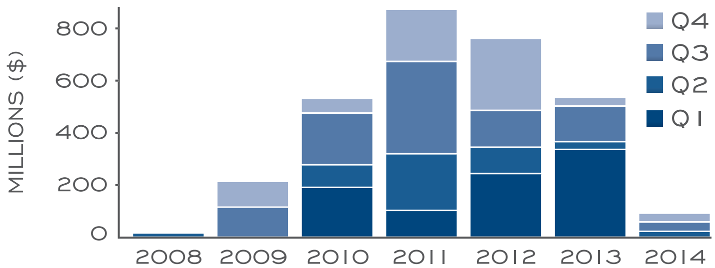
CONVERTIBLE BONDS

Melcor REIT issued the only convertible debenture in Q4/14. The $34.5M 5-year issuance has a 5.5% coupon and converts to 79.0514 shares representing a conversion price of $12.65 per share (ending Q4 2014 share price was $9.46 per share). The convertible debenture was used to partially finance Melcor's acquisition of six commercial properties located in Alberta and Saskatchewan for a purchase price of $138M.

2014's aggregate issuance of $92.5M is far below the $536M issued in 2013 and the lowest volume since 2008. Issuance has declined each year since the high of almost $900 million in 2011. Contributing factors likely include the abundance of senior unsecured debt and conventional mortgage capital.

The only convertible debenture maturing in 2015 is Retrocom REIT's $22.8M offering. It has a coupon of 6.75% and will mature in July 2015. The stock price at the end of Q4/14 was trading at 20% below conversion price of $5.05.

CONVERTIBLE DEBENTURE ISSUANCE



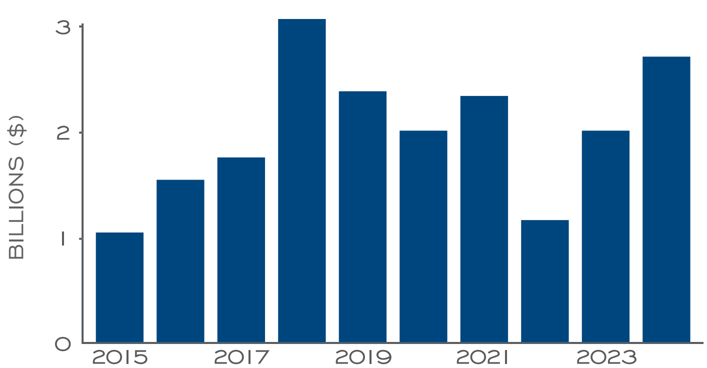
SENIOR UNSECURED DEBT ON REITs, REOCs AND PENSION FUNDS

REITs, REOCs, and Pension funds issued $6.18B of senior unsecured debentures in 2014, an increase of approximately $1B from the $5.36B issued in 2013, and a massive increase from the $2.28B issued in 2012. Q4/14 was the slowest quarter of 2014 with 3 issues totalling $765M. We will be monitoring 2015 volumes to confirm if this is a market shift or temporary slowdown.

Cominar REIT and OMERS Realty Corp were the only issuers in Q4/14. Cominar REIT issued a $200M Series 8 debenture with a 4.25% coupon and a 7-year term maturing December 2021. The issue was rated BBB (low) by DBRS. OMERS Realty Corp issued a $250M series 5 debenture with a 2.473% coupon and a 5-year term maturing November 2019 as well as a $315M series 6 debenture with a 3.328% coupon and a 10-year term maturing November 2024. The OMERS issues were rated AA (low) by DBRS.

The total outstanding senior unsecured debt by REITs, REOCs, and Pension funds is approximately $19.9B. Brookfield Asset Management and Choice Properties LP are currently the largest issuers with 19.4% ($3.9B) and 12.8% ($2.6B), respectively. They are followed by OMERS Realty Corp. and First Capital Realty Inc. with 11.6% ($2.3B) and 11.1% ($2.2B). Looking at the maturity schedule for unsecured debt, we note there is a steady increase over the next few years. In 2015, there will be approximately $1B maturing, but that amount increases to $3B by 2018.

SENIOR UNSECURED MATURITY SCHEDULE
OUTSTANDING BALANCE



	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Spread (bps)
	First Capital	300	BBB (high)	11	184
	Dream Office	150	BBB (low)	6	221
	RioCan	150	BBB (high)	6	160
Q1	Choice Properties	200	BBB	10	198
	Choice Properties	250	BBB	7	171
	Calloway	150	BBB	7	187
	Crombie	100	BBB (low)	7	195
	Artis	125	BBB (low)	5	200
	OMERS	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	250	BBB (high)	8	167
	First Capital	210	BBB (high)	11	197
	Granite	250	BBB	7	187
	Calloway	50	BBB	9	185
	Calloway	150	BBB	8	172
Q3	Cominar*	250	BBB (low)	2	108
	Cominar	300	BBB (low)	5	202
	Artis	75	BBB (low)	5	198
	Ventas	250	BBB+	10	194
	Ventas	400	BBB+	5	138
	OMERS	250	AA (low)	5	94
Q4	OMERS	315	AA (low)	10	127
	Cominar	200	BBB (low)	7	263
	Total	$6,175			

*floating rate issues based on 90 day CDOR

Source: Bloomberg, DBRS, RBC

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.

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

Eric Clark, CFA
Associate Director, Mortgage Valuations
604.488.3897 eric.clark@cmls.ca