CMLS Financial Ltd.

Commercial Mortgage Spread Commentary

November 2011

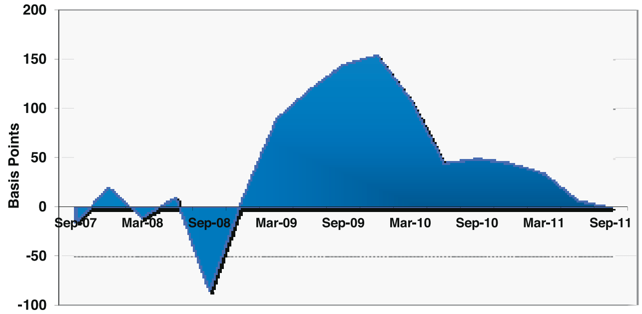
The ongoing uncertainty in the Euro zone continues to provide a significant source of volatility and concern for global credit markets. European leaders continue to search for an appropriate long term solution to assist banks and sovereign states deal with their debt crisis. Leaders from around the world have placed increased pressure on European leaders to act decisively as market turmoil continues to undermine investor confidence and raises the possibility of pushing the global economy into recession.

The Bank of Canada ("BoC") elected to maintain its target for the overnight rate at one percent during their October 25th meeting. This action was widely anticipated by market participants and is consistent with the weakened outlook that has been adopted by the BoC in recent meetings. The BoC stated that "the combination of ongoing deleveraging by banks and households, increased fiscal austerity and declining business and consumer confidence is expected to restrain growth across the advanced economies". The BoC also identified that these issues are most pronounced in the Euro area where they expect a brief recession to be experienced. The outlook for the Canadian economy has weakened since July largely driven by a weaker external environment. This less favourable economic outlook has reduced upward pressure on core inflation which has recently exceeded the Bank's target rate of 2%.

Commercial mortgage rates have not escaped the impact of this global uncertainty and a broad decrease in risk-taking appetite. However, the pace and timing of spread expansion in the commercial mortgage market has not been uniform when compared with other fixed income asset classes. This can be principally attributed to the opaque and over-the-counter nature of the mortgage market where participants do not have the luxury of obtaining current market information from a centralized source. We have seen corporate BBB and unsecured real estate debt spreads increase at a much faster pace than whole loan commercial mortgage spreads. After a frenzied start to the year, REIT & REOC issuance of senior unsecured debentures slowed considerably in the second and third quarters of 2011. This has prompted these borrowers to rely more heavily on the commercial mortgage market where spreads have not widened out nearly as much. We are also entering into a seasonally slower time of the year during which many participants have a limited supply of capital available; this could lead to further expansion in spreads as there are fewer participants.

Exhibit 1: Commercial Mortgage vs. Corp BBB Spread Differential

Dec 2007 to October 2011



Source: Bloomberg, CMLS Valuation

Conventional Mortgage Spreads

Conventional mortgage spreads have widened over the past few months and continue to experience upward pressure. Based upon CMLS' risk rating model, conventional multifamily and commercial mortgages ranging from very good to fair quality would attract spreads between 175 and 265 basis points over GOC Bonds.

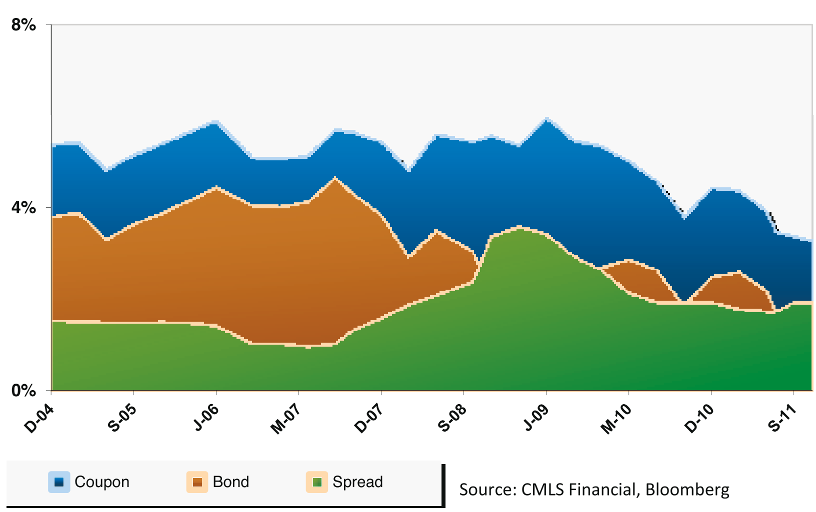
Mortgage deal flow continues to be steady but noticeably slower than volume experienced in the first half of 2011. This is a consistent seasonal affect where deal flow is typically lower in the last quarter of the year as many institutions have reached their full allocations. Economic uncertainty could also be having an impact on real estate transaction volume.

A recent trend that has developed in the past quarter is the re-emergence of interest rate floors imposed by some lending institutions. Many institutions relied on floor rates during the credit crisis as capital was constrained and several of these institutions found it difficult to deal with spread volatility. We do not see a consistent reason for the floors currently being established. However, spread and GoC volatility along with historically low all-in lending rates are all contributing to the trend. This lack of a common driver is also causing a wide array of floor rates which have ranged from 3.25% to 6.0%.

Continued cap rate compression is also beginning to drive property valuation levels that cannot be supported by some lenders. Cap rates have been declining steadily since 2009 and many participants do not believe there is justification for further compression. Fortunately for borrowers, steady cap rate compression has been surpassed by an even stronger reduction in commercial lending rates. The increased rate differential between cap rates and borrowing rates has provided support for borrowers to justify higher property valuations in this low cap rate environment. A larger differential between cap rates and lending rates increases the leveraged return for real estate owners. Some lenders are taking a conservative approach by placing more emphasis on debt service requirements and stressing cap rates upward to ensure debt levels can be managed in an increasing cap rate and interest rate environment. The outlook for value creation provided by NOI growth is also limited given the poor economic growth conditions ahead.

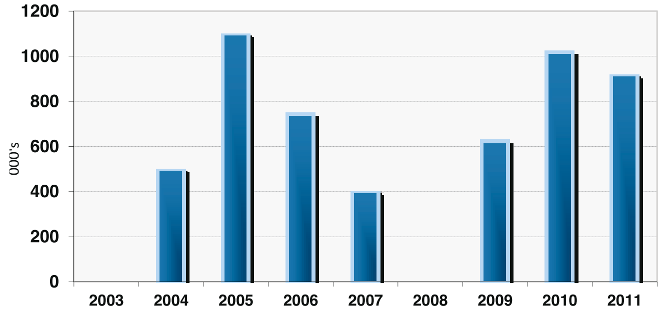
Commercial real estate continues to be supported by very strong operating fundamentals. Commercial mortgage spread expansion has been driven by a globalized retrenchment of risk appetite rather than a deterioration of credit quality in this sector. Although the outlook of slower economic growth will impact certain asset classes more severely, we don't expect fundamentals to suffer drastically.

Exhibit 2: Commercial Mortgage Loans
5 Yr Spreads, Bond Yields and Mortgage Coupons



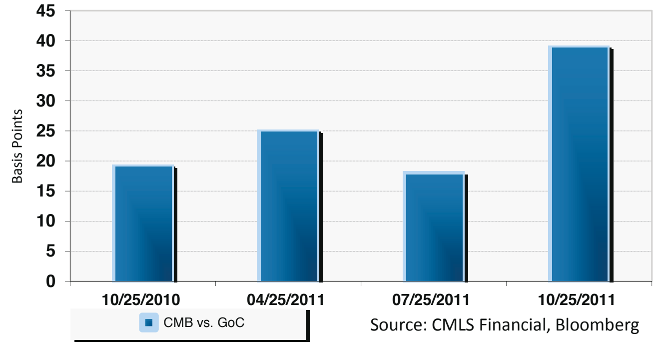
Source: CMLS Financial, Bloomberg

Exhibit 3: Senior Unsecured Debt Issuance



Source: CMLS Financial, Bloomberg

Exhibit 4: CMB 5 Year Spread Premium



Source: CMLS Financial, Bloomberg

Senior unsecured debt issuance by REITs and REOCs has been strong in 2011. Year to date issuance has been $820 Million which represents the third highest volume of issuance in the past decade. Senior unsecured debt issuance was strong during the 2004 –2007 period but was shut down during the credit crisis in 2008. In 2009, this market was resurrected as the credit market recovered and spreads returned to their long-term average range of 200–250 basis points. Issuers have had excellent access to this market over the past several years as depicted in Exhibit 3. However, the period of favorable conditions might be over as we have seen a substantial expansion in spreads on existing senior unsecured debt over the last several months. In many situations, spreads have expanded to well over 300 basis points which represents an increase of approximately 100 bps. This could hinder any near term issuance as this source of funding will be unappealing relative to other sources of capital which have not had the same level of deterioration in pricing.

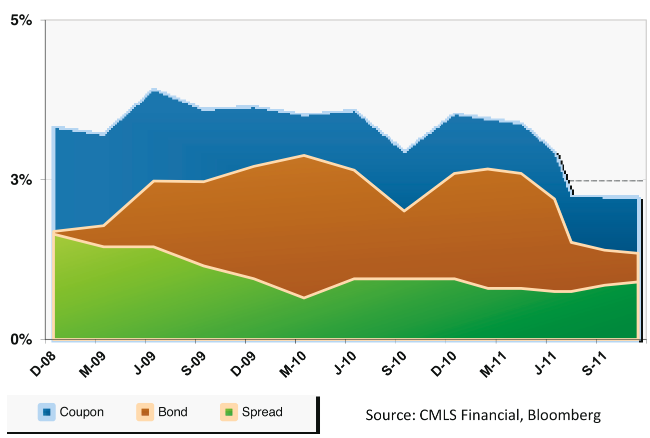
CMHC Insured Mortgage Spreads

CMHC insured mortgages have not been immune to spread expansion despite the inherent guarantee provided by the Government of Canada. The expansion in CMHC Mortgage spreads has been less than non-insured mortgages and the timing has lagged. Recent pricing has been in the range of 90 and 140 basis points over GoC bonds.

In September, Canada Housing Trust issued a $5.0 Billion Canada Mortgage Bond with a coupon of 1.85% that matures December 15, 2016. This bond was initially issued with a spread of 44 Basis points over the GoC Bond which represents a substantial spread increase. Exhibit 4 shows various points at which CMB bonds have traded over the past year.

NHA-MBS issuance has been much lower in 2011 compared to the record levels issued in the 2008-2010 period. The high volume of NHA-MBS issued during the credit crisis was the result of banks having a limited availability of funding sources aside from government backed product. The government funded Insured Mortgage Purchase Program aimed to purchase up to $125 billion of insured mortgage pools which provided a crucial and affordable liquidity source for Canadian lenders during this period. Canada Housing Trust (CHT) has issued 42 series of Canada Mortgage Bonds since its inception which have an outstanding balance of $204.1 billion as of June 30, 2011 (source: DBRS). The NHA-MBS and CMB programs have proved to be a very efficient source of liquidity for mortgage lenders in Canada especially during times of economic distress.

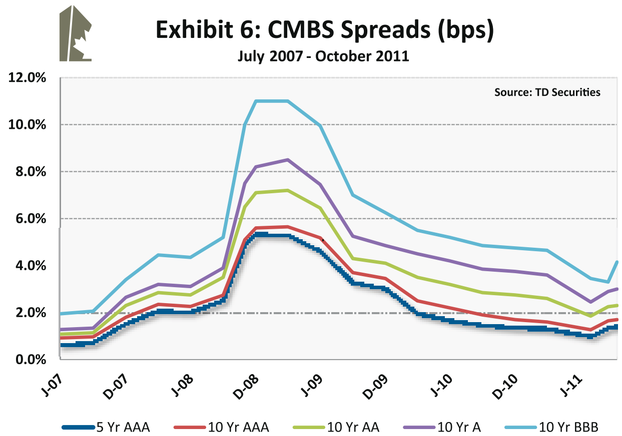
Exhibit 5: CMHC Insured Loans 5 Year Spreads, Bond Yields and Mortgage Coupons



Source: CMLS Financial, Bloomberg

CMBS Market

The CMBS market in Canada has experienced a level of volatility that has been consistent with broad changes in the fixed income universe. The risk profile has not changed fundamentally as underlying collateral continues to perform extremely well. CMBS loan delinquency continues to hold below 0.50% which is in stark contrast to the U.S. where delinquency is hovering around 10%. Secondary market trading continues to see a disproportionate shift in pricing for different Class levels based on overall risk appetite from participants and the level of liquidity for that class. Strong exit debt yields for maturing CMBS loans combined with adequate mortgage financing availability has allowed for a high rate of refinancing for maturing loans.



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. 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.

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