# Commercial Mortgage Spread Commentary

**November 2012**

## CMLS Financial brings to market the second Canadian CMBS issue of 2012

**The Canadian CMBS market took a step closer to rejuvenation in early October with a $249 million issue by CMLS Financial Ltd. The bonds were backed by debt on a high quality portfolio of retail, office, industrial, and multifamily real estate. Following the $240 million offering by Institutional Mortgage Capital this summer, the deal marks the second Canadian CMBS issue in 2012 and third since 2007. The bonds were rated by DBRS, featuring 15% subordination to the AAA class.**

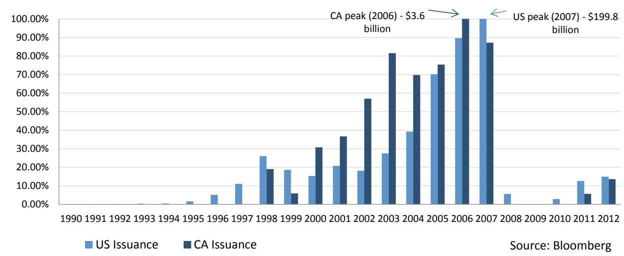
"The CMBS lending product has been a hit amongst investors and borrowers alike," said vice president Glen Malcolm. "CMLS Financial is delighted to be at the forefront of re-establishing this valuable funding source. We continue to develop our CMBS origination platform in anticipation of future demand."

The collateral pool consisted of 26 fixed-rate loans backed by 27 properties spread across major Canadian cities, with the provincial distribution roughly mimicking that of the Canadian population. Limited to the "four main food groups", the pool featured property types which historically exhibit low cash flow volatility. The pool also featured an attractive recourse profile, with two of the top three Canadian REITs by market cap standing behind 35% of the cut-off date principal balance.

Some of the senior tranche was sold via private placement, with Casgrain & Company acting as lead agent, and the remaining senior bonds and all subordinate paper were taken by a Canadian institutional investor and CMLS Financial. Priced at 130 bps over Government of Canada securities, the market's warm reception of the AAA bonds represents continued tightening of spreads in the Canadian market, increasing the attractiveness of issuer economics. It is safe to say that the market is a long way from the $3.6 billion per year industry it once was here in Canada. But with increasing demand on both sides of a CMBS transaction – investors looking for yield and borrowers in search of lending alternatives – the business case for conduit lending operations appears to be strengthening.

Another encouraging sign for the Canadian market is that pricing continues to be strong south of the border, with benchmark ten-year super-senior tranches recently selling for as low as 85 bps over swaps. Bond swaps are used as the standard reference securities for CMBS pricing in the US. American investors starved for yield in a prevailing low interest rate environment – especially following the Fed's September announcement of QE3 – are finding what they are looking for in the MBS market.

**Exhibit 1: Annual CMBS Issuance as % of Peak Volume**




Source: Bloomberg

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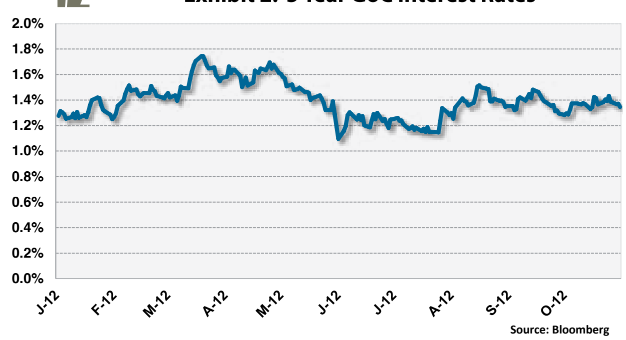
CMLS Financial is building on the momentum of this program with a second issue slated for the first half of 2013. Generally, loans which fit the program are backed by properties with stabilized cash flows, strong occupancy histories and attractive lease maturity profiles.

## Economic Overview

The Bank of Canada's October 2012 "Monetary Policy Report" indicates that Canada's economic activity continues to be constrained by global credit issues. The Bank views consumption levels and business investment as two positives forces on domestic financial conditions, helping lead the economy to reach full capacity by the end of 2013. Canadian exports are expected to gradually increase reaching pre-recession levels by late 2014. The main restraint on exports continues to be the strength of the Canadian dollar. The Bank expects the household debt burden to gradually increase until the end of 2014 at which time it will stabilize. The imbalance in Canada's household debt remains the biggest concern and something to keep an eye on. More recently, Minister of Finance Jim Flaherty noted that Canada is not immune to the global economy and is especially vulnerable to low commodity prices – particularly oil. The Government's November Update of Economic and Fiscal Projections noted that the deficit will jump to $26.2 billion and that the return of federal surpluses would be pushed out another year to 2016-17. So, while Canada continues to outperform the rest of the G7, we cannot escape global challenges.

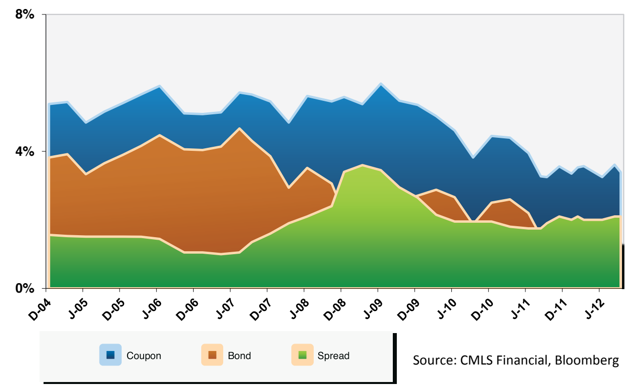
**Exhibit 2: 5 Year GoC Interest Rates**




## Commercial Mortgage Market Update

The commercial mortgage market in Canada continues to be well capitalized with most major lenders being active participants. A few lenders continue to be very selective as annual allocation targets have been met and in many cases exceeded. The commercial real estate sector continues to offer an attractive yield premium to lenders in an environment where yield is a scarce commodity. This return, supported by conservative underwriting and strong real estate fundamentals, provides a solid investment profile.

**Exhibit 3: Commercial Mortgage Loans**
**5 Year Spread, Bond Yields and Mortgage Coupons**

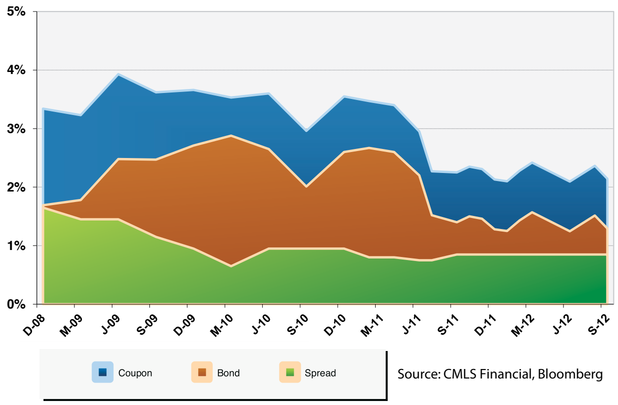



Five year loan terms continue to be the most common product offered by lenders. Myths of ten year funds being in short supply are not supported by lenders who face stiff competition for quality ten year product. The pricing differential between five and ten year terms continues to be around 10 bps which is consistent with the long term average. This provides further support for a reasonable level of capital availability for longer term loans. Borrowers will continue to face difficulty when searching for longer loan terms with stretched underwriting parameters or inferior quality product. We continue to see a stable spread environment with attractive commercial loans being originated at 200 basis points and above. Some newly originated loans will break below the 200 level but must be supported by institutional quality borrowers with top quality product.

## CMHC Update

The Canada Housing Trust (CHT) may find increased demand for its Canada Mortgage Bond (CMB) product now that CMHC no longer provides bulk insurance on Covered Bonds. Investors seeking a bond product backed by CMHC insurance are now limited to CMBs which offer investors some spread over GOC yields. Covered Bonds issued by Canadian financial institutions are full-recourse senior unsecured debt, with additional recourse to a portfolio of specific assets (residential mortgages). The bonds are overcollateralized and historically insured with CMHC bulk insurance.

**Exhibit 4: CMHC Insured Loans 5 Year Spreads, Bond Yields and Mortgage Coupons**




Source: CMLS Financial, Bloomberg

The policy change to remove bulk insurance may be causing the tighter 5 year CMB spreads currently at 34bps over GOC bonds. In comparison 10 year spreads have seen less tightening remaining approximately 52bps over GOC bonds. The recent November 10 year CMB issue priced at 51 bps over the curve. Some participants believe these higher spreads (and larger spread between 5 and 10 year) might be driven by a weakened investor appetite for 10 year CMBs, which could be signalling investor saturation of this market. This is running headlong into tightening 10 year origination spreads as 10 year CMHC insured money is seeing more competition amongst lenders as competition heats up for quality deals. Recent months have shown a balanced supply of 5 year CMHC insured capital and fairly constant spreads with quality assets continuing to price in the range of 90bps – 100bps over GOCs

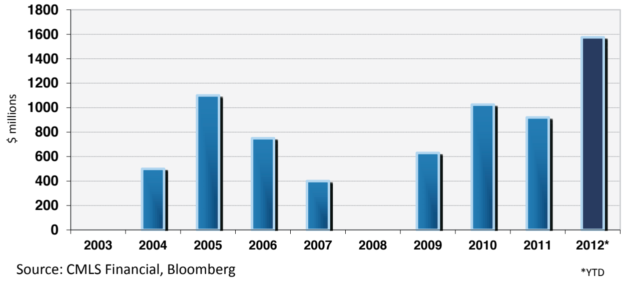
Also on the CMHC front, CMHC has proposed enhancements to the NHA MBS program. The goal is to achieve greater standardization across NHA MBS Issuers, improve industry understanding of the indemnity policy and calculation methodology, and to enhance transparency across the board. It is hoped that these enhancements will increase interest and liquidity in the NHA MBS program which should benefit both issuers and borrowers.

## Senior Unsecured Issuance

Senior unsecured debentures offered by real estate investment trusts and real estate owner/operators reached $1.58 billion in year-to-date issuance and $1.25 billion of this total can be attributed to entities included in Bloomberg's Canadian REIT index. The latest REIT issue was a $125 million five-year float by Cominar REIT which priced at 260 basis points over GoCs. The deal was a re-opening of Cominar REIT's June issue as the company took advantage of favourable spread movement and doubled the total amount outstanding to $250 million. The bonds sold in June had priced at a spread of 295 basis points.

2012 is now a record year for senior unsecured debt issuance by real estate investment trusts, establishing this type of issue as a credible funding source. Pricing relative to secured mortgage funding appears not to be the primary driver; as an illustration, Riocan was issuing unsecured paper in line with or below mortgage rates back in 2005. Possible reasons for the newfound popularity include better access to capital markets, the market's demand for products with stable yields, the ability to diversify the capital stack with unsecured funding, and a low all-in coupon. Look for this industry to continue to develop as still only a handful of well-known REITs have joined the fray and both investors and issuers are becoming comfortable with the structure.

**Exhibit 5: Senior Unsecured Debt Issuance**




Source: CMLS Financial, Bloomberg

## Covered Bond Update

In September Royal Bank of Canada issued U.S. $2.5 billion in covered bonds backed by uninsured residential mortgages on properties throughout Canada. The issue represented the eighth series of the bank's covered bond program, which now totals approximately CAD $11.4 billion in bonds backed by a CAD $14.7 billion collateral pool. The bonds priced at a spread of 51 bps over similar maturity US treasuries. Rather than issue the paper as a private placement, RBC accessed the wider public markets through the first SEC-registered covered bond, thus opening the deal up to a much wider range of investors.

RBC is the first Canadian bank to issue covered bonds since the announcement of new federal regulations prohibiting the use of insured mortgages in the collateral pools. Apart from the stubborn low rate environment causing investors to scramble for yield pick-up, a lack of supply of non-agency mortgage-backed securities and the ability to register the securities with the SEC helped to make the American market an attractive alternative to a domestic issue. Although the SEC approval process was reportedly very strenuous for RBC, there is now a market precedent from which other issuers can draw. It is highly likely that the remainder of the Big Six banks have studied this deal closely and could follow suit with issues of their own.

## High Yield Market: Is 6% The New 8%?

With the overwhelming appetite by Canadian investors for yield paying stocks (see REITS), it is not surprising we have seen a number of new MIC (Mortgage Investment Corporations) and other high yield mortgage funds launched or proposed in the past three months. All of these funds are targeting payouts in excess of 5%. Given the 5 year GOC rate has hovered around 1.30% recently, these funds will need to target spreads well in excess of 500bps in order to fund the required payouts to investors.

These new entrants are joining an already well supplied market. High yield rates have continued to contract as more money chases fewer quality deals. The entrance of these funds will be a boon for borrowers as better deals will command ever lower rates, and deals well up the risk curve will likely get a second look as lenders chase production and yield for their funds.

## 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's Mortgage Valuation Group 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 spreads and valuation in Canada, please do not hesitate to contact our team.

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