CMLS Financial®

COMMERCIAL MORTGAGE COMMENTARY

CANADA'S MORTGAGE COMPANY.™

NOVEMBER 2013

CMBS

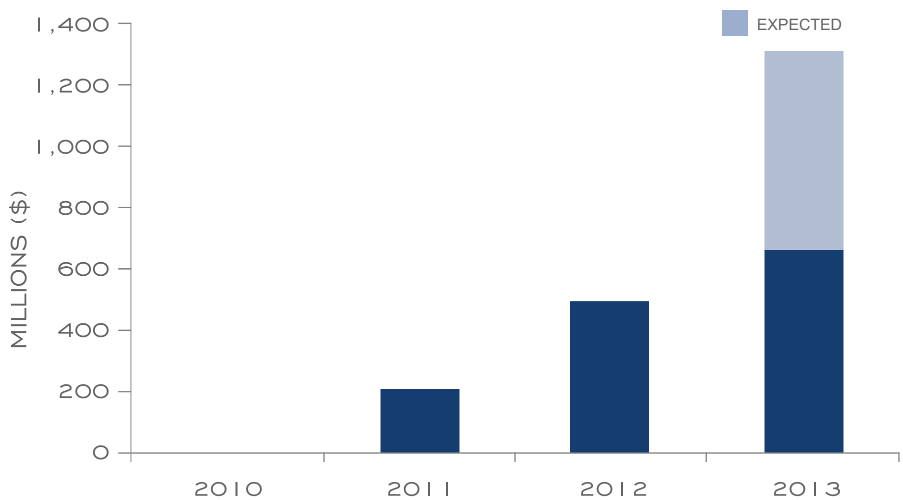
The Canadian commercial mortgage backed securities (CMBS) market took another step toward revival in September with Starwood Capital Group's Series 2013-CWP commercial pass-through certificates, a $400 million CMBS offering backed by five Westin hotels located in key Canadian markets. It was the first single-borrower transaction since West Edmonton Mall was financed by way of CMBS back in 2006 and the largest CMBS issuance since 2007.

"The financing is a testament to the re-emergence of the CMBS market in Canada and we see this as another key milestone," says Glen Malcolm, Senior Vice President at CMLS Financial. CMLS acted as loan advisor on the deal and was retained as master servicer.

Collateral consisted of a single blanket mortgage loan secured by the hotel portfolio and exhibited strong credit metrics with a 51% loan to value ratio and 2.39x debt service coverage ratio. The certificates were rated by DBRS and Fitch and were entirely investment grade, with the most subordinate tranche carrying a BBB- (structured finance) rating. The senior AAA-rated tranche was $170 million, 42.5% of total loan principal, resulting in a debt service coverage of 4.89x.

With additional conduit deals rumored to hit the market by the end of 2013, Canadian CMBS volume is likely to exceed $1.3 billion for the year, a marked increase over 2012 issuance of $490 million and approximately one third of peak volume reached in 2006.

CANADIAN CMBS ISSUANCE



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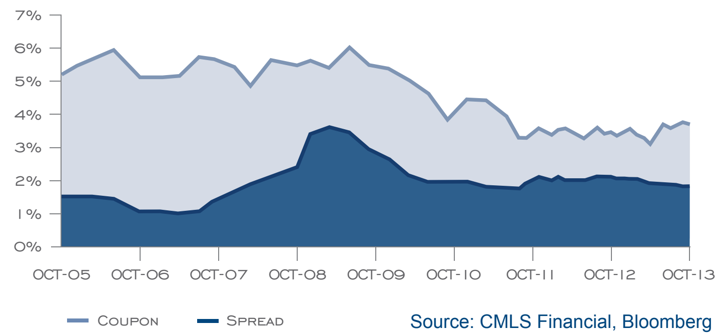
COMMERCIAL SPREADS

The commercial mortgage market in Canada continues to be well capitalized. New supply from the CMBS market and foreign investors paired with REITs and REOCs increased use of senior unsecured debt financing may result in future spread tightening. Loan fundamentals continue to be strong with cap rates and vacancy rates falling in most markets, while coupons are still near historic lows allowing borrowers to cover payments at higher loan volumes. The recent real estate and lending environment has been near ideal for borrowers.

Commercial mortgage spreads moved slightly downward over the last quarter, largely a result of the supply of capital available. Mortgage spreads on high quality assets range between 175 – 190 bps for 5 year terms and 185 – 200bps for 10 year terms. The underlying GOC bonds continue to be the source of coupon volatility this past quarter with a near 50 bps swing.

COMMERCIAL MORTGAGE LOANS 5 YEAR SPREADS AND COUPONS



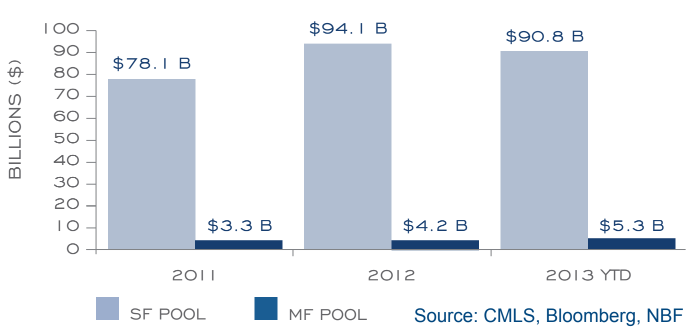
CMHC

Since last quarter, CMHC spreads increased modestly in response to recent legislative changes affecting insured single-family (SF) and multi-family (MF) residential loans. The regulatory changes will limit capital available for CMHC-insured mortgages, which should put upward pressure on CMHC MF mortgage spreads. High quality assets now attract spreads of 90 – 100 bps for both 5 and 10 year terms.

NHA MBS ISSUANCE CAPS

Due to higher-than-expected levels of MBS issuance through August 2013, CMHC enacted a cap to limit the amount of new NHA-MBS securities per lender/issuer for the remainder of the year. The commercial MF component of the NHA-MBS securitization market is a sliver of the market compared to the SF component (depicted below). In an environment where issuance is limited or restricted, issuers may gear allocation towards the larger SF market as it generally has more favorable economics (securitization graph below). This has the potential of leaving little to no allocation space for MF origination. If borrowers turn to mortgages not backed by CMHC they will likely pay a 90 – 110 bps spread premium.

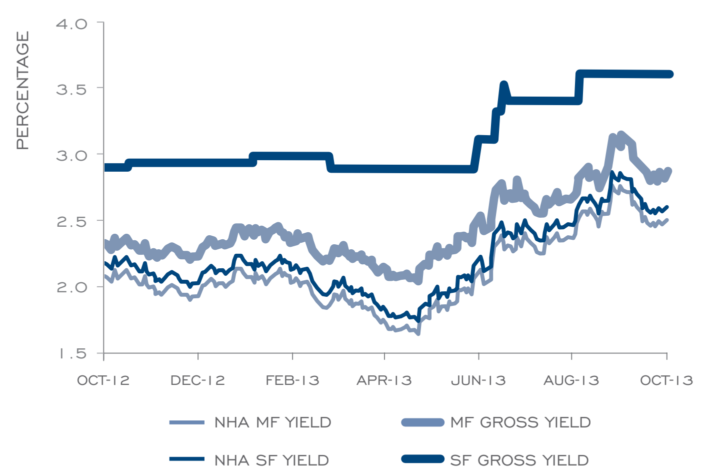
SF vs MF ISSUANCE



MATURITIES TO THE CMB AND IMPP PROGRAMS

As part of the Government of Canada's response to the 2008 financial crisis, the amount of mortgages funded through the CMB program increased significantly. By the end of 2014, $44.2 billion in CMB issues will mature. The Government also introduced the Insured Mortgage Purchase Program (IMPP). Mortgage-backed assets were purchased from financial institutions in 2008 and 2009 under the IMPP, which formed part of the Government of Canada's response to the financial crisis. Approximately $41 billion of these assets will mature in fiscal year 2013–14 (March year-end) with the remaining $11 billion maturing in fiscal year 2014–15. With concerns regarding the amount of insured capital available in the future, the resulting demand once these loans begin to mature may put further pressure on the market, particularly if the government continues to enact legislations designed to restrict the use of CMHC insurance.

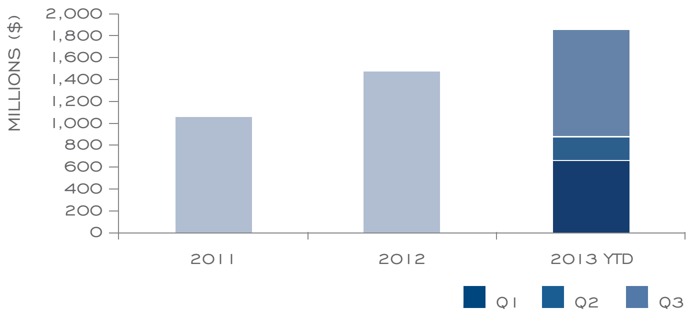
5-YR SF vs MF SECURITIZATION ECONOMICS



FIRST MORTGAGE BONDS

The 2013 year-to-date first mortgage bond issuance of $1.8 billion already exceeds the $1.47 billion issued in 2012.

MAJOR FIRST MORTGAGE BOND ISSUANCE



Source: Bloomberg

In June, H&R arranged the final first mortgage bond series of a three series facility secured by The Bow tower in Calgary, Alberta. The Series C tranche is an interest-only $300 million 10 year bond, bearing an interest rate of 3.797% and matures on June 13, 2023. The Bond was rated A by DBRS and will rank pari-passu to the $250 million 3.690% Series A Bonds due June 14, 2021 and the $250 million 3.693% Series B Bonds due June 14, 2022 (both issued in June 2012). The Bow is a Class AA office tower consisting of 58 storeys and 2 million SF and has EnCana and Cenovus Energy as the main tenants.

In July, a $550 million first mortgage bond was issued on the Suncor Energy Centre in Calgary. The 20 year bond has an initial spread of 220 bps and is secured solely by the property. The property, which was constructed in 1984, contains 1.73 million SF of office space divided between the 32-storey East Tower and 52-storey West Tower, which is connected via a four-storey atrium. Suncor Energy, Crescent Point, PricewaterhouseCoopers, and Cenovus Energy occupy 93.2% of the property's leasable area and have a weighted average lease term of approximately 14 years.

In October, a $125 million first mortgage bond was issued on Dartmouth Crossing, with a 7 year term and a 30 year amortization. Dartmouth Crossing, located in Nova Scotia, represents one of the most prominent power centre concentrations in Atlantic Canada. The property totals approximately 1.4 million SF of retail and office space and includes future development potential of an additional 600,000 SF.

SENIOR UNSECURED DEBT ON REITs AND REOCs

Q3 2013 was an active quarter for new senior unsecured debt issued by REITs and REOCs. The quarter saw 6 issues totalling $910 million and indications from early Q4 are that the remainder of the year will be even more active with 7 issues in October alone. The year-to-date total of new senior unsecured debt is $3.6 billion, already surpassing the $2.1 billion issued in all of 2012.

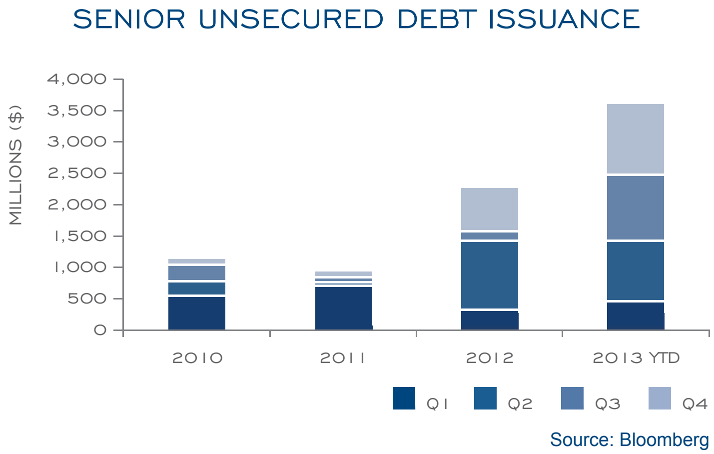
We note a trend towards floating rate issuances with shorter terms of 2 to 4 years – October had $770 million of floating rate unsecured debt. The floating rate issues generally have lower coupons and borrowing costs than their fixed rate counterparts but at the expense of holding the interest rate risk. Given the current low rate environment, it will be interesting to see how long this new trend continues.

We note that similar issuances are being issued at higher spreads compared to earlier in the year. The BBB (High) senior unsecured debentures issued by First Capital Realty in May 2013 with a 10 year term had a spread of 193 bps and its issuances in August 2013 with a 9 year term had a spread of 200 bps. The BBB (Low) senior unsecured debentures issued by Cominar REIT in May 2013 with a 7 year term had a spread of 256 bps, while a similar issuance in July 2013 had a spread of 290 bps.

(continued...)

	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Spread (bps)
Q1	Cominar REIT	100	BBB (low)	7	268
	RioCan REIT	250	BBB (high)	5	140
	First Capital Realty	125	BBB (high)	10	201
Q2	RioCan REIT	200	BBB (high)	10	192
	Cominar REIT	100	BBB (low)	7	256
	First Capital Realty	175	BBB (high)	10	193
	Calloway REIT	150	BBB	10	205
	Dundee REIT	175	BBB (low)	5	191
	H&R REIT	175	BBB	5	180
Q3	Choice Properties REIT	400	BBB	5	167
	Choice Properties REIT	200	BBB	10	200
	CREIT	125	BBB	5	199
	Cominar REIT	100	BBB (low)	7	290
	Calloway REIT	150	BBB	4	167
	First Capital Realty	50	BBB (high)	9	200
Q4	Granite REIT	200	BBB	5	270
	Dundee REIT*	125	BBB (low)	3	170
	H&R*	235	BBB	3	150
	Cominar REIT*	250	BBB (low)	3	205
	Calloway REIT*	100	BBB	2	138
	H&R	60	BBB	4	165
	Crombie	175	BBB (low)	5	225
	2013 YTD Issuance	$3,620	Source: Bloomberg, DBRS, RBC		

*Floating rate issues based on 90 day CDOR



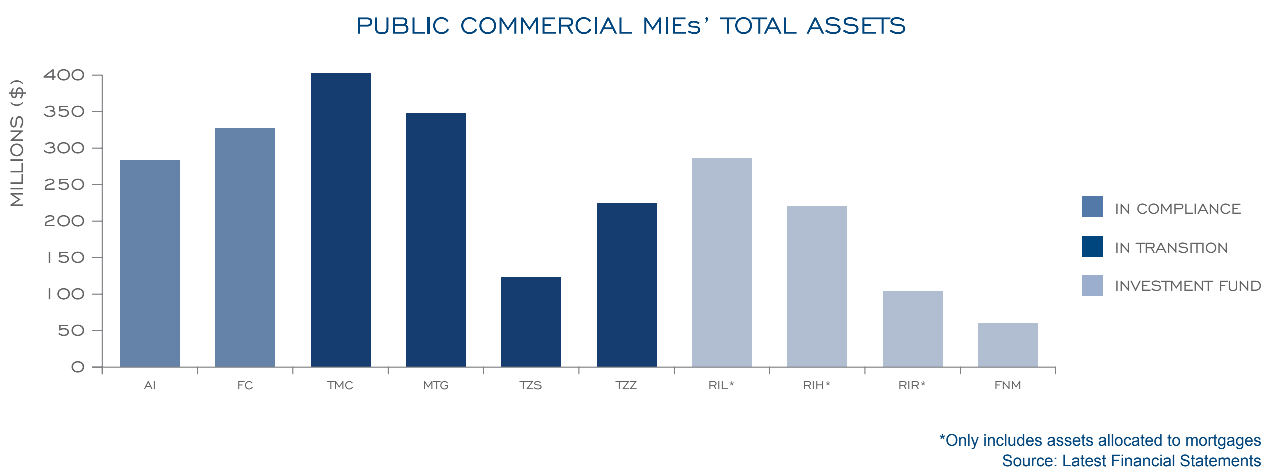
According to the Mortgage Maturity Schedule from the Q2 2013 DBRS Canadian Real Estate Study, approximately $5.6 billion of conventional mortgages for DBRS Rated REITs and REOCs mature in 2014, at which time REITs and REOCs can choose to refinance with either conventional mortgages or senior unsecured debentures. Will the market for unsecured debt hold up and might we see record issuance in 2014?

HIGH YIELD REGULATORY CHANGES

The Canadian Security Administrator (CSA) has proposed new regulations that will impact public Mortgage Investments Entities (MIEs) under the non-redeemable investment fund reporting regime. The proposed regulations will require non-redeemable investment funds that contain mortgages without government insurance to convert to a public company reporting regime. The reason for the proposed regulatory change is that in the regulator's opinion, many MIEs act as extensions of originators' mortgage lending businesses, which is contrary to the definition of a non-redeemable investment fund that must be passively managed.

The public company reporting regime is subject to different regulations than investment funds. The corporate regime has stricter reporting requirements, no trailer fees, voting rights for shareholder and no redemptions. As a public company, investment fund restrictions will cease to exist; instead guidelines can be implemented and amended by the Board.

The proposed regulations will affect 8 commercial mortgage investment funds. Both Timbercreek and Trez have been proactive in transitioning their funds to public corporations. Below we have listed the publicly traded commercial MIEs and their approximate total assets, which we estimate to be $2.3 billion.



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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