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Commercial Mortgage Commentary

CMLS Mortgage Analytics Group

The Commercial Mortgage Commentary aims to inform the market about commercial real estate finance news. We focus on the following capital sources for commercial real estate: Conventional Mortgages, CMHC-Insured Mortgages, Commercial Mortgage Backed Securities (CMBS), High Yield Mortgages, Construction Financing, First Mortgage Bonds and Senior Unsecured debt for REITs and REOCs.

Making News

The Canada Infrastructure Bank (CIB) has begun accepting applications for its Commercial Buildings Retrofit Initiative, part of the $10B growth plan announced by the federal Liberal government in October 2020. The plan aims to provide affordable financing to commercial building owners and/or project aggregators to implement energy efficient retrofits to existing commercial property. Projects must have a minimum cost of $25MM, and lending can be up to 80% of projected cost. In addition, capital must be fully deployed within 5 years of commitment, and loans can be amortized for up to 25 years. CIB and the federal government hope this initiative will make a meaningful contribution towards the government's green house gas (GHG) emissions reduction target. The government estimates that the heating and cooling of buildings currently accounts for about 12% of annual GHG emissions. The program is also intended to attract private capital to aid in the development of a functioning private debt market for green energy retrofits, which the government believes is currently underserved.

City of Calgary Approves $1B Downtown Revitalization Plan

In late April, the city of Calgary approved its "Greater Downtown Plan" aimed at reimagining Calgary's downtown into a more vibrant space over the coming decade. While measures such as the city's phased tax program have helped control for the fiscal deficit since the 2014 oil price crash, city council has opted for a more lasting solution via revitalizing its downtown core to foster economic growth. Calgary's downtown office properties have collectively lost $16B in value since 2014, and downtown office vacancy rates currently sit at 32.7% according to data from CBRE for Q2.

Along with the overall approval of the plan, city council also approved an initial $200MM in funding which will primarily be directed towards project financing to improve public spaces, financial incentives for office conversions to residential development, and the renovation and expansion of cultural landmarks. The city hopes to raise the additional funding from the provincial and federal government.

Economic Environment

Inflation remained top of mind for investors in Q2 after Canada's Consumer Price Index (CPI) posted the highest YoY increases in over a decade for April (3.4%), May (3.6%), and June (3.1%). Price growth has accelerated in most major product categories with strongest pricing growth in shelter, food, and gasoline. The Bank of Canada (BoC) continued to view this as transitory, arguing that supply chain constraints and faster than initially expected rebounds in demand are temporary factors. Furthermore, the Bank has noted that the high YoY growth is in part due to the especially low CPI figures at this time last year. Commercial real estate investors are typically thought to be relatively insulated from normal levels of inflation given that they can often pass along costs to their tenants; however, this may not be the case if inflation grows out of control.

*If you are a commercial real estate lender and are interested in obtaining a copy of our survey, please email **mortgageanalytics@cmls.ca** for more info.*

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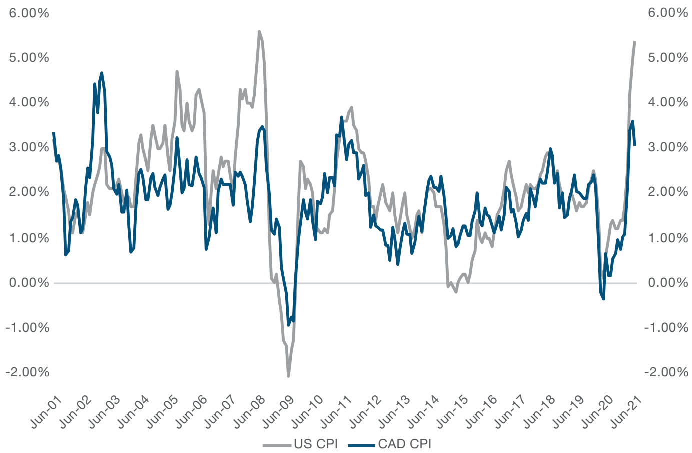
Under such a scenario, property owners are often unlikely to be able to pass along the increase in prices quickly enough. Inflation also affects lenders, especially fixed-rate lenders as they are more at risk of having their real returns eroded. Transitory or not, if the CPI trend in the United States is any indicator, above-average inflation is here to stay for the time being. The US index hit 5.40% in June, the highest it's been since 2008.

Canadian vs US Year-Over-Year Change in CPI



Source: Statistics Canada, U.S. Bureau of Labor Statistics

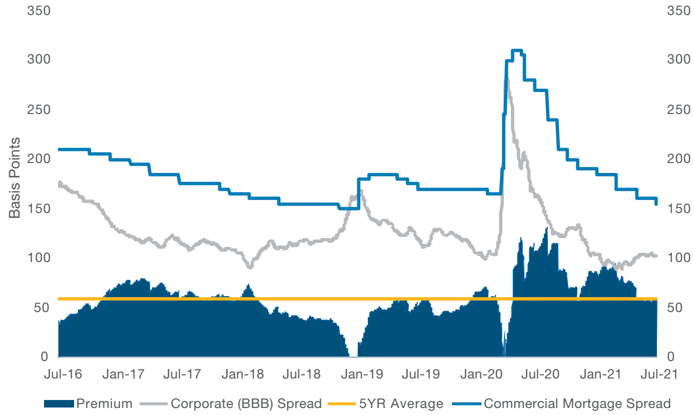
Bank of Canada Further Tapers Weekly Bond Purchases

In July, the BoC announced a further reduction to its quantitative easing program. The Bank will now target weekly bond purchases of $2B/week, down from the $3B/week target it had held since April. The easing of monetary stimulus marks the third such occurrence this year and signals the BoC's continued confidence in the strength of the Canadian economy's recovery. Many analyst's expect further tapering in the latter half of this year, which could allow the BoC to start unwinding its balance sheet as existing bonds mature. The bank currently holds in excess of $400B in Government of Canada (GoC) bonds.

Conventional Mortgages

Spreads on conventional commercial mortgage debt continued to trend downwards, hitting lows not seen since early 2018. The trend comes despite BBB corporate bond spreads flattening out since the last quarter. This resulted in further compression to the liquidity premium offered by conventional commercial debt. The premium now sits roughly in-line with its 5-year average. Lenders report ample liquidity across the risk spectrum, yet as usual competition remained particularly strong for the highest quality deals. Most intel suggests that, over the course of the quarter, sharpest pricing saw spreads in the 130's bps for 5-year term lending. However, some reports indicate pricing dipped below those levels in certain cases. In the latter half of the quarter, the bulk of conventional deals were being done sub-200 bps. There were generally still some notable pricing discrepancies when lending on certain office, retail, and other non-core asset types relative to multi-family and industrial properties. Longer duration deal flow appeared thinner but spreads also seemed to compress in-line with that of 5-year products.

Commercial Mortgage Liquidity Premium Over Corporate BBB



Source: Bloomberg, CMLS

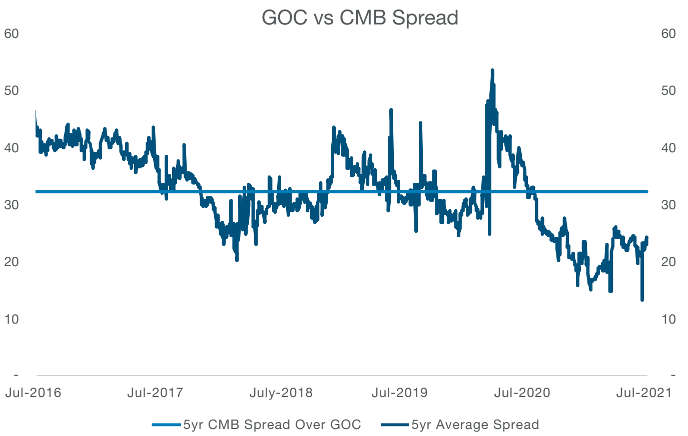
Industrial Demand Remains Red Hot in Q2

Demand for industrial space continues to be extremely high across the country, but an especially noteworthy event took place in Q2 when new data from Colliers revealed that the GTA's industrial vacancy rate had fallen to 0.4%, amongst the lowest in North America for a major city. Nearby, Hamilton also saw its vacancy rate fall to 0.6%. Other major markets also saw vacancy rates squeezed. Vancouver and Victoria's vacancy rates fell to 0.7% and 0.4% respectively, while Ottawa and Montreal's fell to 1.2% and 1.1% respectively, according to their respective Q2 reports from Colliers. In response, developers across the country have been rushing to meet demand. Between 8.8MM and 10.2MM sqft of new supply has already hit the market, and an estimated 26.5MM to 27.1MM sf is under construction according to Q2 data from Colliers and CBRE.

CMHC

Competition in the CMHC space ramped up significantly over the course of Q2 as new liquidity flooded the market. Lenders reported especially sharp pricing from banks, who are recently flush with new capital after reducing the size of loan-loss provisions due to lower-than-expected default rates. This resulted in sharpest pricing on 5-year lending reaching the mid-to-low 40 bps range, and even dipping into the 30 bps range, over Canada Mortgage Bonds (CMBs), with 10-year spreads trending slightly higher. Lenders did report that borrower demand remained strong at higher spread levels for certain smaller loan sizes and lower quality deals.

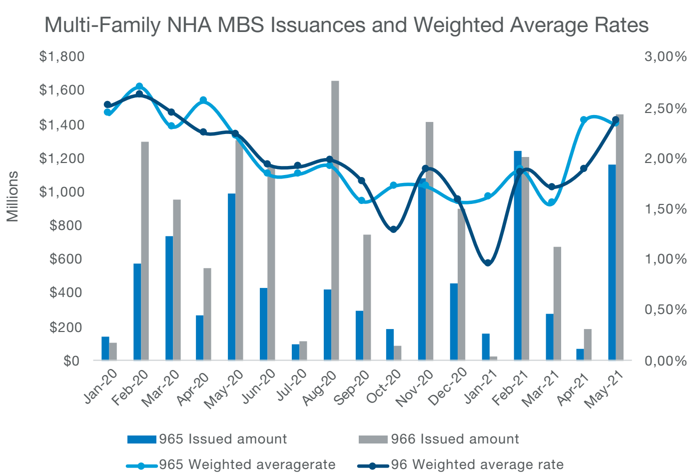
The gap between GoC and CMB rates also remained compressed. Since Q3 of last year, the spread between the two has fallen well below its 5-year average. Which has altered the dynamic between CMHC lenders who bid over GoC relative to their CMB counterparts.



Source: Bloomberg, CMLS

May Securitizations See Strong YoY Growth

May securitizations into CMHC-backed multi-family pools 965 and 966 were up 17% and 12% respectively YoY. The difference in weighted average coupons between the pools has now compressed to just 3bps, with the 965 and 966 pools ending the period at 2.34% and 2.37% respectively.



Source: CMHC, CMLS

CMBS

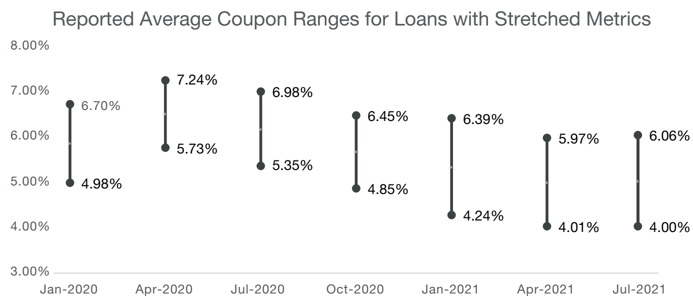
The Canadian market has now been without a CMBS issuance for well-over a year, with the last pool being issued just before the start of the global pandemic. Historically low debt yields are primarily to blame as originators of commercial mortgage debt find it difficult to find deals that provide enough spread for investors, while also meeting risk requirements for pool tranches and for ratings agencies. Nevertheless, with the ample time since last issuance, intel suggests that lenders have likely built up a sizeable pool of warehoused loans by now, leaving the possibility open that the market could still see an issuance in the latter half of 2021.

First Mortgage Bonds

Similar to the CMBS market, First Mortgage Bond (FMB) issuances had been virtually non-existent for the past two years. That changed in June when Schlegel Villages Inc. issued a $120MM refinance bond. The 30-year bond featured an all-in coupon of 3.895% and spread at issuance of 229 bps over GoC. In comparison, Schlegel Villages' last FMB had a spread of 167 bps over GoC. The issuance marks the fourth outstanding FMB issued by Schlegel and brings their total FMB debt outstanding to $333MM at time of writing. Interestingly, one of the last issuances of FMB debt two years ago was also by Schlegel Villages.

High Yield

Lenders report that, for the most part, high yield pricing continued to compress given a favorable trend in liquidity. As per our Q2 Lender Sentiment Survey, over half of respondents indicated increased deal flow relative to the pervious quarter. While institutions remain selective to the credit they lend to, lenders are becoming more receptive to non-primary markets, open to considering more asset classes, and more accommodative in their deal structures. This newfound flexibility for creditworthy deals, coupled with a number of conventional lenders searching for higher yields to achieve their absolute return targets, has led to increased transactional activity for at least certain segments of the market. However, given that most institutions continue to prioritize credit over yield, competition has intensified more-so among assets perceived to be pandemic-resilient, decreasing their return potential relative to previous years and shifting perceived risk/return trade-offs from usual levels.



Source: CMLS

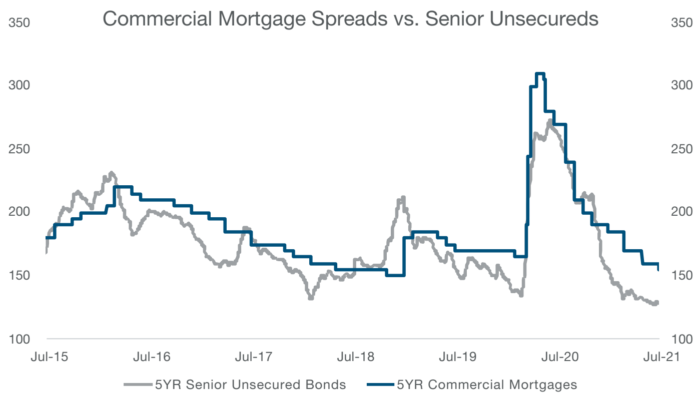
Construction

According to results from our Q2 survey, a majority of lenders reported increasing deal-flow QoQ. A slight uptick in syndicate lending was noted during the quarter, usually for larger deals with various lenders investing in different tranches of risk. As is the case with other types of lenders, construction lenders continue to favor industrial, multi-family, and condo builds, while continuing to be hesitant around most office and retail. Lender's report strong competition in BC especially, where building on spec appears to be more common. Some lenders continue to report concern with the level of multi-family construction in the prairies, particularly in Winnipeg, but that has yet to manifest in a slowdown in absorption rates at this time.

Senior Unsecured Debt

Issuance volume for senior unsecured bonds declined for the second consecutive quarter, ending the period at just over $1B. All Q2 issuances were conducted by industrial-focused REITs, alluding to the sector's strength as most of the net proceeds are destined for further purchases of industrial assets in Canada and across the globe. Furthermore, over 60% of the offerings were related to green bonds, highlighting the industry's push for more ESG-friendly ventures. Both issuers, Dream Industrial REIT and Summit Industrial Income REIT, saw their latest offerings' spreads well below their previous debentures in Q4 2020, yet remained relatively flat from an all-in coupon perspective after factoring in movements in the risk-free rate and differences in tenor. The trend of relatively shorter-term debt issuance continued, with the longest term out of all offerings reaching just 6 years.

2020	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Coupon	Spread (bps)
	Crombie REIT	150	BBBL	10.0	3.21%	259
	Crombie REIT	150	BBBL	7.5	2.69%	219
	H&R REIT	250	BBBe	5.5	2.91%	245
	RioCan REIT	500	BBBH	5.5	1.97%	148
Q4	SmartCentres REIT	350	BBBH	5.0	1.74%	129
	SmartCentres REIT	300	BBBH	8.0	2.31%	173
	Granite REIT Holdings LP	500	BBB	10.0	2.38%	161
	Summit Industrial Income REIT	200	BBBL	5.3	1.82%	136
	Dream Industrial REIT	250	BBB	5.0	1.66%	121
	Total Issue Size	2,650				
	Q4 Averages	294		6.9	2.30%	177
2021	**Issuer Name**	**Issue Size Millions ($)**	**Issuance Rating**	**Term (yrs)**	**Coupon**	**Spread (bps)**
	CT REIT	400	AAL	3.0	2.37%	163
	BCI QuadReal Realty	300	BBBH	6.0	1.07%	59
Q1	Allied Properties REIT	600	BBB	5.0	1.73%	117
	H&R REIT	400	AAL	5.0	2.63%	189
	BCI QuadReal Realty	150	BBB	10.0	1.06%	61
	Q1 Averages	370		5.8	1.77%	117.8
	Q1 Total Issue Size	1,850				
	Dream Industrial REIT	400	BBB	6.0	2.06%	107.6
Q2	Dream Industrial REIT	200	BBB	4.5	1.66%	95.1
	Dream Industrial REIT	200	BBB	3.0	3mth CDOR + 0.35%	N/A
	Summit Industrial Income REIT	250	BBBL	5.8	2.25%	118
	Q2 Averages	263		4.8	1.99%	106.9
	Q1 Total Issue Size	1,050				
	Total Issuance YTD	**2,900**				



Source: Bloomberg, CMLS

ABOUT CMLS MORTGAGE ANALYTICS GROUP

The CMLS Mortgage Analytics Group is a division of CMLS Financial Ltd., and is one of the only independent, dedicated providers of mortgage valuation services and software for the commercial real estate finance industry in Canada. The CMLS Mortgage Analytics Group provides solutions to some of Canada's most prominent financial institutions, investment managers, pension funds and consultants. With investors, regulatory bodies and governing committees requiring increased reporting, independence and third-party advice, the CMLS Mortgage Analytics Group offers a host of risk rating, valuation, and portfolio analysis tools to better manage risk/reward profiles in commercial mortgage portfolios. Clients engage our services to provide independent support for mortgage purchases, fair value accounting, ongoing fund valuation, interest rate appraisals and more.

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