Customer Forward Thinking.™

Commercial Mortgage Commentary

CMLS Mortgage Analytics Group

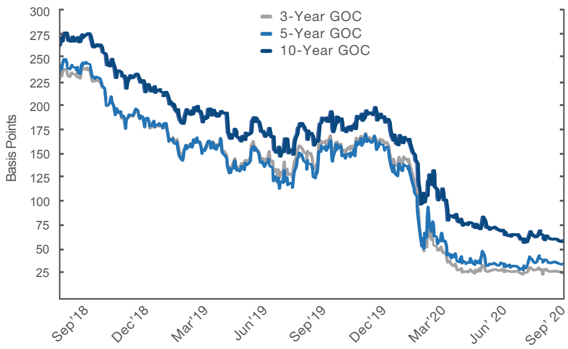
The Commercial Mortgage Commentary aims to inform the market about commercial real estate finance news. We focus on the following capital sources for commercial real estate: Conventional Mortgages, CMHC-Insured Mortgages, Commercial Mortgage Backed Securities (CMBS), High Yield Mortgages, First Mortgage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

The Mortgage Analytics Group is excited to announce that we are in the process of launching a Canadian commercial mortgage performance index slated for release in 2021. The index will serve to help lenders with benchmarking returns. Please email mortgageanalytics@cmls.ca for information on how you can participate.

Economic Environment

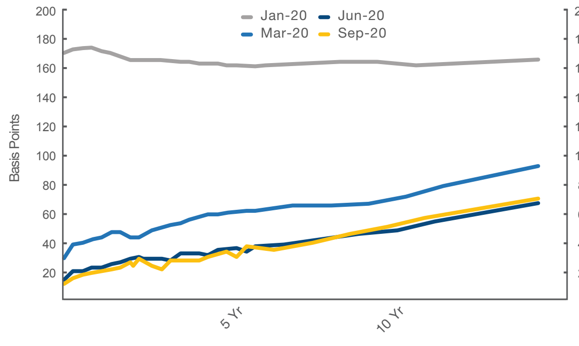
Benchmark interest rates remained near record lows in Q3. Average yields for 5yr and 10yr Government of Canada (GOC) bonds fell slightly (~5bps) compared to their Q2 average. The drop in Canada Mortgage Bonds (CMBs) was more pronounced with the average yield on 5yr CMBs falling by 19bps and 10yr CMBs by 14bps, narrowing their spread over GOC by more than 10bps. After inverting in Q3 2019, the GOC yield curve abruptly steepened at the end of Q1 2020. Since then, the yield curve has maintained its upward sloping shape but has shifted downwards considerably. While credit spreads have generally increased relative to pre-COVID, the offsetting fall in GOC rates has largely kept all-in coupons from rising.

Historical Interpolated GOC Yields



Source: CMLS, Bloomberg

Yield Curve Holds its Shape After Steepening in Q1



Source: CMLS, Bloomberg

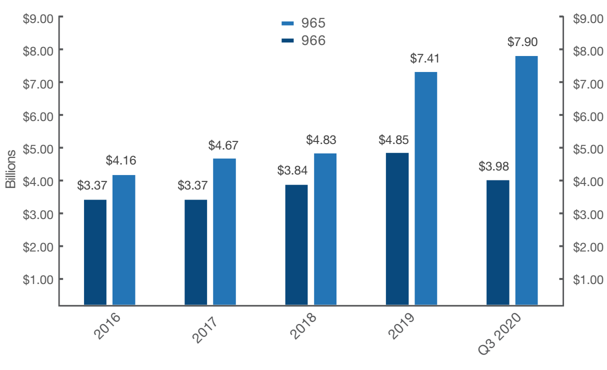
CMHC

August saw the final reopening of 10yr CMBs, the issuance was significantly higher than most participants expected at $4.25 billion, providing welcome capital to the 10yr CMHC insured mortgage space. Despite the increase in liquidity the term premium between 5yr and 10yr CMBs increased by 10% relative to the previous quarter. While not as drastic as previous quarters, this steepening of the yield curve may have affected borrower demand. Observed deal volumes for 5yr terms were notably higher than 10yr terms over the course of Q3. The tightening in CMB spread over GOC, coupled with strong capital supply, has meant that the sharpest CMHC-insured pricing is around 80bps over GOC for high quality deals, roughly in-line with where it was at the start of the year.

Multi-family MBS Issuance on Pace to Beat 2019

Despite the economic headwinds of 2020, issuances into the NHA MBS multi-family pools are on track for another strong year. The 966 pool, consisting of multi-family mortgages that are closed to prepayment, has already surpassed its total issuance in 2019. The 965 pool, which consists of mortgages that are open to prepayment, is on pace to do the same. As of Q3 2020, the combined issuance for the two pools is $11.9 billion — $368 million less than the total issuance in 2019.

965 v 955 Issuances



Source: CMHC

Bank of Canada Discontinues the CMB Purchase Program

In early Q2, the Bank of Canada (BoC) initiated a CMB Purchase program in order to manage its balance sheet and support market functionality. As of the end of Q3, the BoC had purchased $7.5 billion in CMB to support market liquidity and $1.0 billion for balance-sheet management. Cumulatively, this represents 6.0% of the total CMB issuance for the year. As overall financial market conditions continue to improve, the BoC has elected to end the program at the end of October. Given that investor demand to date has remained strong the move appears to be a response to limited need by the market. However, with many wondering if COVID-driven market volatility is likely to resurge, such a move by the BoC may need to be reassessed.

Affordable Housing Given Priority for CMHC Lenders

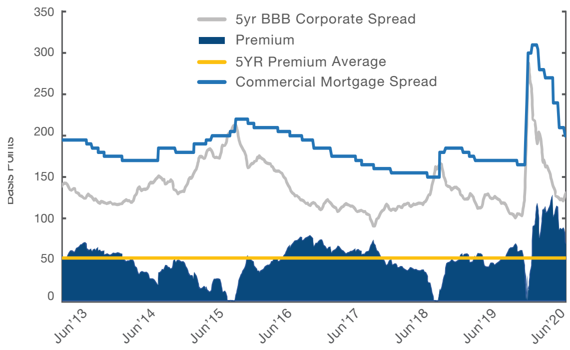
CMHC is planning on introducing preferential allocation in relation to 10-year CMB funding for social housing or multi-family loans insured under the Affordability MLI Flex product (“Affordability-linked pools”). The changes will apply exclusively to 10-year CMB issues and will take effect on January 1, 2021. The policy amendment will result in 10-year CMB issuance proceeds first being distributed to lenders allocating mortgages that meet the affordability criteria. The remaining CMB issuance proceeds will be allocated to all, following the existing allocation methodology.

Commercial Mortgages

Results from our Q3 Lender Sentiment Survey indicate increasing optimism when it comes to the durability of lenders’ commercial mortgage portfolios. On average, lenders reported that less than 5% of their portfolio was granted payment concessions during Q3. On a forward-looking basis, 59% of lenders expect that only 3% or less of their portfolio will have payments in arrears during Q4. Additionally, 94% of lenders fully expect to be quoting on deals in Q4 2020, which marks a 6% increase quarter over quarter.

Competition Among Lenders Continues to Ramp Up

Despite benchmark rates remaining near record lows, the proceeding chart shows that commercial mortgage spreads continue to compress for certain risk profiles, similar to movement in BBB corporate bond spreads. Downward pressure was especially pronounced among higher quality assets, with spreads tightening by over 60bps since the end of Q2. Sharpest pricing at the end of Q3 was quoted at spreads in the low 170s over GOC, while pricing for slightly risker deals was in the low 200’s. This apparent flight to quality has been further supported by a sustained abundance of capital in the commercial mortgage space. However, lenders are requiring stricter underwriting requirements and remain averse to certain property types and regions. Lower deal volume has also been a significant contributor to the buildup of lending capital; less than one fifth of lenders in Q3 reported similar deal volumes to pre-COVID times, and nearly two thirds did not expect deal volumes to rebound until Q2 of next year or beyond.



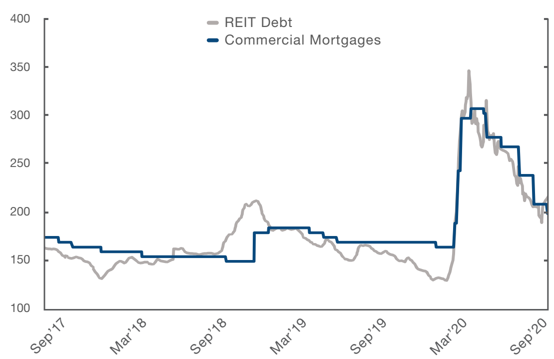
Source: CMLS, Bloomberg

REITs

Average quarterly yields for senior unsecured REIT debt continued to decline in Q3. While yields have mostly mirrored those of of commercial mortgages this year, many REITs continue to have suppressed equity prices relative to the broader Canadian equity market. Analysts note that the industry's lag is partially attributed to significant weightings in retail and office assets.

Issuances of new REIT debt declined relative to last quarter, both in terms of average issuance size and number of issuances. Since March of this year, only one outstanding issuance has been downgraded by DBRS. Interestingly, no REITS with senior unsecured notes currently outstanding have had their long-term issuer rating downgraded since the start of the pandemic

Commercial Mortgages vs. REIT Unsecured Debt Yields



Source: CMLS, Bloomberg

2020	Issuer Name	Issue Size ($Millions)	Issuance Rating	Term (yrs)	Spread (bps)
Q1	Choice Properties REIT	400	BBB	10.0	165
	Choice Properties REIT	100	BBB	30.0	237
	RioCan REIT	350	BBBH	7.0	158
	Allied Properties REIT	400	BBB	10.0	174
	Brookfield Property Finance ULC	400	BBB	7.0	230
	Total Issue Size/Average Term Q1	1650		12.8	
Q2	OMERS Realty Corp	400	AAL	3.25	97
	H&R REIT	400	BBBH	5	366
	SmartCentres REIT	300	BBBH	10.5	296
	SmartCentres REIT	300	BBBH	7	262
	Granite REIT Holdings LP	500	BBB	7	260
	Choice Properties REIT	500	BBB	7	240
	Allied Properties REIT	300	BBB	8	265
	Cominar REIT	150	BBH	5	557
	Total Issue Size/Average Term Q2	2850		6.6	
Q3	Morguard Corp	175	BBBL	3	413
	Artis REIT	250	BBBL	3	355
	Summit Industrial Income REIT	250	BBBL	5	180
	First Capital REIT	200	BBB	7.5	299
	Brookfield Property Finance ULC	500	BBB	5	355
	BCI QuadReal Realty	350	AAL	10	123
	StorageVault Canada Inc	75	N/A	5.5	N/A
	Total Issue Size/Average Term Q3	1800		5.6	
	Total Issue Size/ Average Term 2020	**6300**		**9.0**	

High Yield

Q3 transactional volume in the high yield market improved on a quarterly basis yet remained relatively low when compared to the same time last year. While lenders generally reported ample liquidity and an increased willingness to make a market, tighter underwriting has led to decreased activity overall as lenders shy away from extending too much leverage in the current environment. Institutions have turned their attention to asset types perceived as more resilient to the pandemic, primarily focusing on multi-family, industrial, and some essential retail sectors.

From a pricing perspective, results of our Q3 Lender Sentiment Survey indicate that lenders have been adjusting their rates downward for a variety of deal types, including land deals, bridge loans, and second mortgages. Relative to Q2, all surveyed lenders either decreased or did not change required pricing, while none reported an increase. Institutional focus has been more towards credit quality rather than on return enhancement, with prime locations and strong sponsorship generally being sought.

Making News

Commercial real estate tenants received some welcome news at the end of Q3 when the federal government announced the replacement of the Canada Emergency Commercial Rental Assistance (CECRA) program, which expired at the end of September. The new program, called the Canada Emergency Rent Subsidy, allows tenants to directly apply for financial aid rather than rely on their landlords to apply for them. It will fund up to 65% of rent or mortgage payments for businesses that have had revenues decline by at least 70% due to COVID, and will cover up to 90% for businesses forced to close due to government-imposed lockdowns.

The federal government also announced a new round of financial aid for struggling businesses and communities via its Regional Relief and Recovery Fund (RRRF). Of the $600 million pledged, $456 million is earmarked for small and medium sized businesses facing near-term financial stress. This new funding will augment the $962 million previously pledged to the RRRF by the federal government. The announcement comes in the midst of new lockdown measures announced by a number of jurisdictions as COVID cases trend upwards across the nation.

Special Treatment of Banks' COVID Deferred Loans Set to End

At the start of Q3, the Office of the Superintendent of Financial Institutions (OSFI) reiterated that it would begin phasing out its special treatment for bank loans that experienced COVID-related payment deferrals. The measure allowed banks to continue to classify these loans as 'performing' on their balance sheets, meaning risk-weighted capital requirements remained largely unaffected. The policy was designed to boost banks' available lending capital in an effort to inject further liquidity into the economy, while also incentivizing banks to provide payment relief to struggling businesses and consumers. Since the end of September, any loan granted deferred payments must once again be treated as non-performing. OSFI did note that they were prepared to adjust these guidelines as required but made no indication whether that was likely in the near-term.

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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