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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

Prime Minister Justin Trudeau and the incumbent Liberals secured a third mandate in Canada's 44th Federal Election. While the seat distribution may look awfully similar to before, the election has spurred tens of billions of dollars in new spending on social programs, the pandemic recovery, and affordability. On housing affordability – a major issue in this year's election – the Liberals pledged a number of new programs on the campaign trail. Among them, the First Home Savings Account will allow Canadians to put aside up to $40,000 tax-free towards their first home, while $1 billion in federal funds has been earmarked for rent-to-own projects. Additionally, the cost of CMHC insurance will be reduced by 25%, the First-Time Home Buyer's Tax Credit will increase to $10,000, and foreign home buyers will be barred from the market for 2 years. The election programs amount to $78 billion in new spending over and above the most recent Liberal budget. Cumulative budget deficits are now projected to add $336 billion to the federal debt over the next 5 years.

Oxford Properties Parting Ways with Three Major Office Properties in Strategic Shift

Oxford Properties, the real estate division of OMERS, engaged in a slate of high-profile office dispositions during Q3. The sale of One Memorial Drive in Cambridge, MA became the largest single office transaction in North America this year when it sold for CA$1.05 billion in August. The 17-storey, 409,422 sf building is fully occupied by Microsoft and InterSystems. The deal was quickly surpassed in September following Google's decision to purchase the St. John's Terminal development in New York City for CA$2.6 billion. Oxford acquired the site in 2017 alongside the Canada Pension Plan Investment Board. With completion expected in 2023, St. John's Terminal will anchor Google's 1.7 million sf Hudson Square Campus and eventually support a workforce of 14,000. Finally, Oxford is also seeking the sale of Royal Bank Plaza, the iconic 1.5 million sf office complex in Toronto's financial district and the headquarters of RBC, in a deal that would likely exceed CA$1 billion. These sales support Oxford's strategic initiative which would see the asset manager pivot to having 45-60% of its global portfolio in life sciences, logistics and multi-family assets by 2025.

H&R REIT Sells Iconic Calgary Skyscraper The Bow for $1.2B

The focal point of Calgary's skyline found new ownership in August after H&R REIT sold The Bow building to Chicago-based Oak Street Capital for CA$1.2 billion. The tower was completed in 2013 at the height of Alberta's oil boom and in many ways represented Calgary's ascension as a major player in the global energy business. Subsequent oil price crashes in 2014, and then again in 2020 as a result of the pandemic, have posed significant challenges for Alberta's energy sector and the wider economy. According to CBRE, the vacancy rate in Calgary's downtown office market reached 32.7% in June. At 33.9%, The Bow has one of the highest vacancy rates of any Class-AAA office in the city.

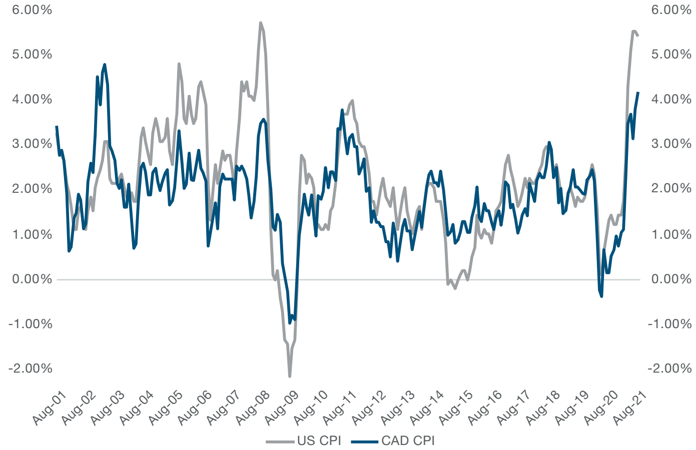
Economic Environment

The Bank of Canada (BoC) elected to maintain current levels of monetary stimulus at its September interest rate announcement and shared an optimistic view on Canada's economic recovery for the remainder of 2021. The decision followed a series of contrasting economic data indicators that highlight the challenges facing the Bank as it navigates the pandemic recovery and future policy decisions. While the labour market has recovered to pre-pandemic levels, official data released by Statistics Canada showed that economic growth stalled in Q2. The economy contracted by an annualized 1.1%, well short of analysts' expectations and the BoC's own forecast in July of 2.0% growth. The Bank will continue purchasing government bonds at a pace of $2 billion/week and the target for the overnight lending rate remains at 0.25%.

Inflation Exceeds 3% for Fifth Consecutive Month

Annual inflation jumped to 4.1% in August, its highest level since March 2003 and the fifth consecutive month it has exceeded the upper bound of the BoC's 1-3% target. Housing costs, gasoline and durable goods were the primary items lifting prices. While concerning, the Bank has been steadfast in its messaging that elevated prices are temporary. So much so that governor Tiff Macklem recently took to writing an op-ed in the Financial Post explaining how the latest inflation figures are a result of pandemic-driven supply chain disruptions and depreciated prices at the onset of the pandemic. In the BoC's July Monetary Policy Report, inflation was forecast to reach 3.9% in Q3 and 3.5% in Q4 before normalizing in 2022.

Canadian vs US Annual Inflation

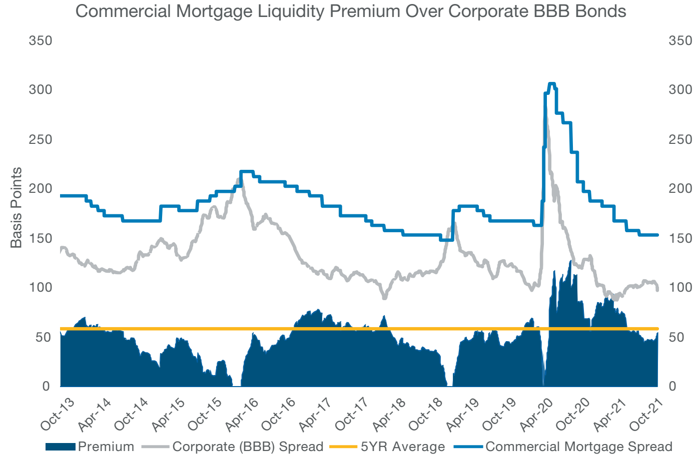


Source: Statistics Canada, U.S. Bureau of Labor Statistics

Conventional Mortgages

The "beds and sheds" phenomenon that arose from the pandemic and defined 2020 is still very much intact thus far through 2021. Multi-family and industrial assets have accounted for nearly 50% of all observed conventional mortgage transactions and consistently drive market-leading pricing. Market intel suggests that 5-year spreads on these assets have closed at less than 125bps over Government of Canada (GOC) bonds, albeit only for a handful of deals. Such favorable pricing is largely a function of strong lender-borrower relationships and remains reserved for top tier assets, typically in primary markets and with institutional quality borrowers. Overall, commercial mortgage spreads have held relatively flat since last quarter. A decline in corporate BBB bond spreads through the final weeks of Q3 brought the liquidity premium on commercial mortgages back in line with the 5-year average.

Commercial Mortgage Liquidity Premium Over Corporate BBB Bonds

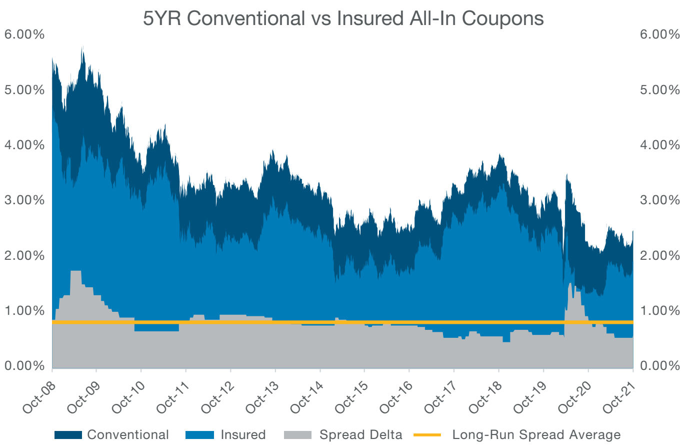


Source: Bloomberg, CMLS

On the equity side, a recent report by CBRE showed that nationwide investment in commercial real estate (CRE) reached $14 billion in Q2, driven largely by multi-family and industrial assets at 60% of total volume. At the current trajectory, Canada is on pace to reach $49.6 billion in annual CRE investment and eclipse the previous record set in 2018.

CMHC

By now it's no secret that insured multi-family has become one of the most desirable asset types in the COVID era. Data from our 2020 Annual Survey found that insured multi-family origination was up 45% YoY and accounted for 36% of total origination volume in Canada last year, a trend that has only continued through 2021. This excess demand for insured financing has driven up CMHC wait times to anywhere from 14-20 weeks, causing many borrowers to consider conventional financing options. However, more timely access to funds may not be the only variable enticing borrowers toward the conventional space. Already high demand for conventional multi-family mortgages has compressed spreads, narrowing the premium for conventional financing. In-house analysis indicates that the difference between all-in coupons for conventional and insured multi-family mortgages continues to be well below the historic norm. Currently, the spread remains about 30bps below its long-run average.



Source: Bloomberg, CMLS

Liquidity for Insured Mortgages Remains at All-Time Highs

Elevated liquidity levels for insured multi-family product shows no signs of dissipating in the months ahead. Market intel suggests that banks in particular remain flush with capital and are pricing aggressively as a result. Unprecedented liquidity means that lenders bidding on 5-year deals have been seen to quote as low as the high 30s/low 40s over CMB, which translates to pricing in the high 50s/low 60s over GOC given the current rate environment.

CMHC Assigns the Canadian Housing Market a 'High' Degree of Vulnerability

The degree of vulnerability in Canada's housing market increased from moderate to high in the CMHC's September Housing Market Assessment. While the sales-to-new-listings ratio (SNLR) dropped to 73.5% in Q2 from a record high of 84.1% in the previous quarter, evidence of price acceleration and overvaluation persisted. The shift was primarily driven by markets in Central and Atlantic Canada, with vulnerability in Toronto, Ottawa, Montreal and Halifax, among others, rated as high. In contrast, most major markets in the Prairies and BC were rated as having moderate to low vulnerability. As per the MLS Home Price Index, the national benchmark price reached $738,100 in August, up from $608,500 in August 2020 (~21%) and $567,100 in January 2020 (~30%).

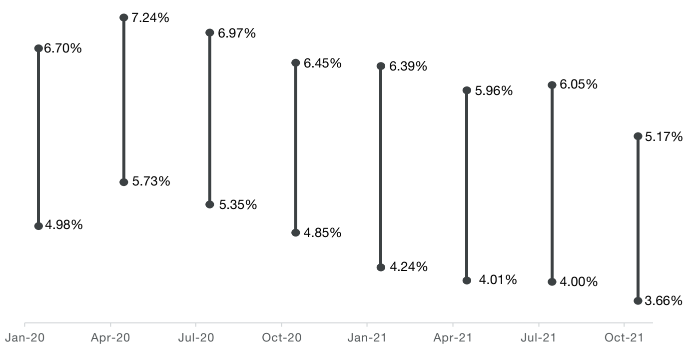
Construction

Similar to the rest of the industry, elevated liquidity for construction financing continued to compress mortgage pricing throughout the summer. All-in coupons for CMHC-insured projects have now dipped below the 2.0% mark for the highest quality borrowers, with intel suggesting sharpest pricing as low as prime minus 50-60bps (1.85-1.95%). However, not all markets are awash with capital. Calgary in particular has been dealing with an excess supply of available units for the past several quarters, driven by an elevated vacancy rate for rental units and a low absorption rate for new condominiums. CMHC's appetite to insure new construction in the city has diminished as a result. That said, in the CMHC's September Housing Market Assessment, Calgary's degree of vulnerability in the 'excess inventories' category declined from high to moderate. The total inventory of unsold units declined substantially through the first half of 2021 after reaching a record high of 1,236 units at the end of 2020. A decline in the inventory of unsold condos from 911 to 556 units (~38%) was a major contributor.

High Yield

Risk-adjusted returns on high yield deals remain below historic norms as lenders continue to pump liquidity into the space. Observed transactions indicate that multi-family deals are garnering the most attention from lenders, while preliminary results from our most recent lender survey show a sustained downward trend in interest rates. Aside from conventional assets, deal flow for land financing has been trending upwards of late. Direct market intel suggests that elevated levels of liquidity for land assets has led to deals being financed with increasingly stretched metrics and relatively relaxed covenants and deal terms.

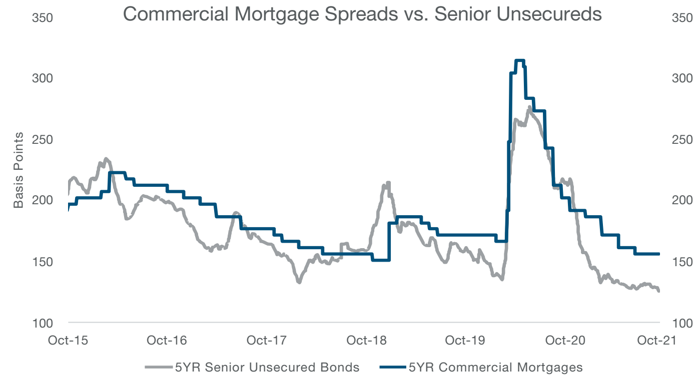
Competitive Coupon Range for Loans With Stretched Metrics - Average Survey Response



Source: CMLS

Senior Unsecured Debt

After two consecutive quarters of decline, issuances of senior unsecured bonds saw an uptick in Q3 to $1.4 billion. Average tenor and average coupon also climbed relative to previous quarters, reaching 8 years and 3.27%, respectively. With one quarter remaining in the calendar year, issuances are on pace to finish well below the $9.0 billion mark set in 2020. That comes despite what appears to be all-time lows in spreads and all-in coupons for senior unsecured bonds. However, it should be mentioned that annual issuances over the three-year period prior to 2020 averaged $6.1 billion, making 2020 a statistical outlier. On another note, the green bonds trend continued in Q3 with over 70% of total issuances destined toward the financing of eligible green projects.



Source: Bloomberg, CMLS

2021	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Coupon	Spread (bps)
Q1	CT REIT	150	BBB	10.0	2.37%	163
	BCI QuadReal Realty	400	AAL	5.0	1.07%	59
	Allied Properties REIT	600	BBB	5.0	1.73%	117
	H&R REIT	300	BBBH	6.0	2.63%	189
	BCI QuadReal Realty	400	AAL	3.0	1.06%	61
	Q1 Averages	370		5.8	1.77%	117.8
	Q1 Total Issue Size	1,850				
Q2	Summit Industrial Income REIT	250	BBBL	5.8	2.25%	118
	Dream Industrial REIT	200	BBB	3.0	3mth CDOR + 0.35%	N/A
	Dream Industrial REIT	200	BBB	4.5	1.66%	95.1
	Dream Industrial REIT	400	BBB	6.0	2.06%	107.6
	Q2 Averages	263		4.8	1.99%	106.9
	Q2 Total Issue Size	1,050				
Q3	Summit Industrial Income REIT	225	BBBL	7.0	2.44%	131.7
	StorageVault Canada Inc	50	N/A	5.2	5.50%	N/A
	Allied Properties REIT	500	BBB	10.5	3.10%	192.4
	Crombie REIT	150	BBBL	10.0	3.13%	184.2
	Granite REIT Holdings LP	500	BBBH	7.0	2.19%	115.4
	Q3 Averages	285		7.9	3.27%	155.9
	Q3 Total Issue Size	1,425				
	Total Issuance YTD	4,325				

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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