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Commercial Mortgage Commentary

Making News

Outlook Factors

2017 began with uncertainty from the incoming Trump administration, oil prices, stricter mortgage qualifications, and "Brexit". As we enter 2018, headlines in the market are focused on overall debt levels of Canadians in a rising interest rate environment, possible market impact from new mortgage qualifications and uncertainty around NAFTA negotiations.

Economic Expansion

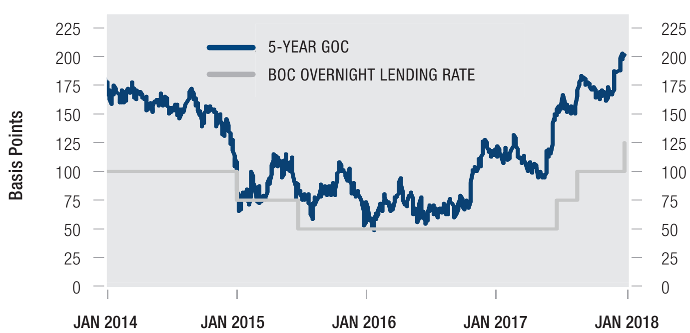
According to Statistics Canada, the Canadian economy expanded for five straight quarters and is expected to show continued expansion. Supporting this expansion are unemployment rates near 40-year lows and oil prices that continue to rebound into 2018, surpassing the $60 per barrel mark. This performance brought about two rate hikes in 2017 for the Bank of Canada ("BOC") overnight target rate, and 2018 started with yet another hike, bringing the policy rate to 1.25%. Global growth is also present, most notably in the US where the Federal Reserve announced three rate hikes in 2017 in light of stronger GDP and inflation.

Yield Curve Flattening

With the overnight rate increases, Government of Canada ("GOC") bond yields also moved upwards in 2017. Between January and December 2017, the 3-year GOC yield increased by 86 bps, the 5-year GOC yield increased by 67 bps and the 10-year GOC yield increased by 27 bps, resulting in a flattening of the GOC yield curve.

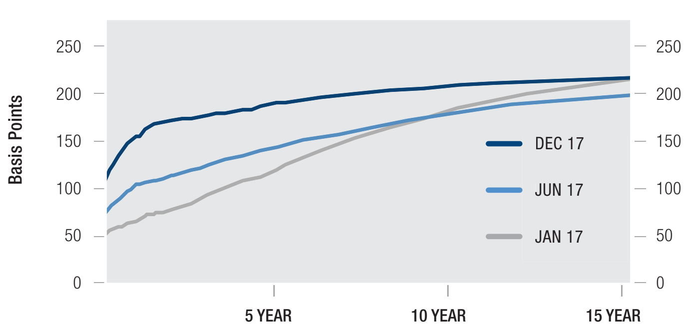
Yields on the 5-yr GOC increased over the past year

Source: Bloomberg, CMLS



Rise and flattening of the GOC yield curve

Source: Bloomberg, CMLS



Making News

Investments

2017 marked another record year for Canadian commercial real estate with transactions exceeding $40 billion, compared to $34.7 billion closing in 2016, according to CBRE. The increase in volume, driven by both domestic and foreign investors seeking to increase their exposure to the growing Canadian market, is expected to continue through 2018. In mid-December of 2017, LaSalle Real Estate Fund acquired a $750 million seed portfolio, providing investors with immediate exposure to core properties in major Canadian markets.

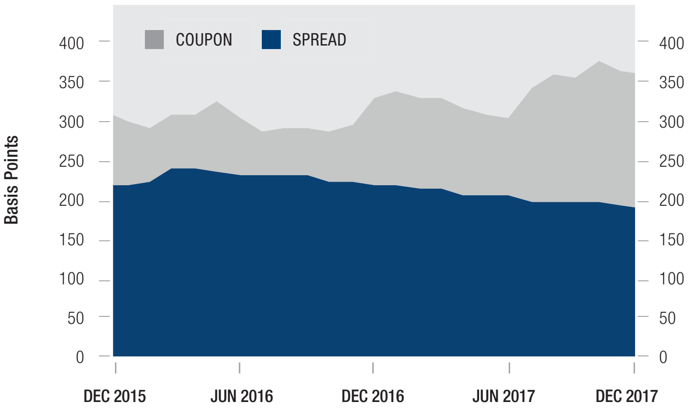
Commercial Mortgages

While total mortgage coupons increased, the competition to deploy capital into the market remained high causing spreads to compress 25 to 30 bps year over year. 2017 ended with high quality assets pricing in the 150 to 170 bps range for 5-year terms and 160 to 185 bps range for 10-year terms.

Comparatively to BBB-rated corporate bond spreads, commercial mortgage spreads were earning a premium of 85 bps at the end of 2017, which is above the long-term average spread premium of 75 bps.

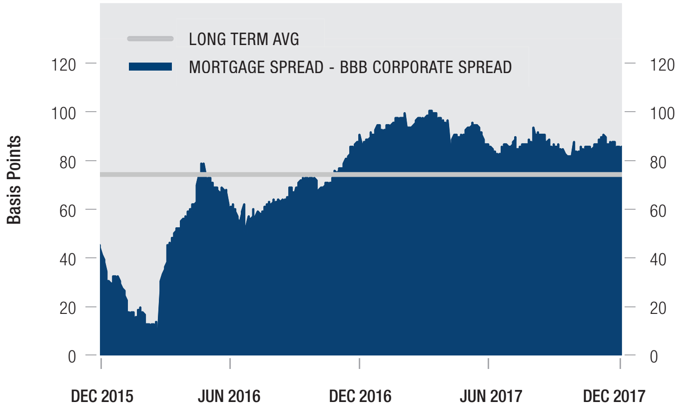
5-year commercial mortgages spreads compressed by 30 bps YOY

Source: Bloomberg, CMLS



5-year commercial mortgages earn 85 bps over BBB rated corporates

Source: Bloomberg, CMLS



CMHC

Canada Housing Trust issued $9.75 billion of new Canada Mortgage Bonds ("CMB") in Q4/17 with three new issues, bringing the total re-opening and issuance in 2017 to $40 billion. The Minister of Finance has authorized CMHC to provide another $40 billion of new guarantees under the CMB program and an increase in market NHA MBS from $130 billion to $135 billion for 2018.

Through 2017, the 5-year CMB spread decreased from 39 bps to 26 bps and the 10-year spread decreased from 44 bps to 33 bps.

From a pricing perspective, spreads on CMHC-insured product tightened by 5 bps since Q4/17, with the 5-year terms in the range of 80 to 100 bps and 10-year terms in the range of 85 to 105 bps.

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Senior Unsecured Debt

2017 was a record year for senior unsecured issuances. Senior unsecured debt issuance increased to $6 billion, compared to $3.9 billion in 2016. 2018 has already seen three issuances totaling $900 million in January, with Choice Properties issuing a $300 million 4-year note and a $350 million 7-year note at spreads of 104 bps and 143 bps, respectively, and H&R REIT issuing a $250 million 5-year note at a spread of 139 bps.

Unsecured debt is an attractive alternative to conventional mortgage financing for REITs, REOCs and pension funds, as it offers flexibility, interest only payments and a large single source of financing. Spreads decreased by 25 bps over 2017, similar to commercial mortgages. Spreads are at 5-year lows for unsecured BBB rated issues, currently at 145 bps to 155 bps, which is indicative of strong investor appetite for the security.

Senior Unsecured REIT debt issuance in 2017

Source: Bloomberg, CMLS

2017	ISSUER NAME	ISSUE SIZE (MILLION CAD)	ISSUANCE RATING	TERM (YEARS)	SPREAD (BPS)
Q1	H&R REIT	$200	BBBH	7	202
	H&R REIT	$150	BBBH	2.5	CDOR + 123
	Riocan	$300	BBBH	6	160
	Smart REIT	$150	BBB	5	156
	Crombie REIT (Reopening)	$75	BBBL	4	245
	bcIMC Realty Corp	$250	AA	5.5	93
	bcIMC Realty Corp	$500	AA	10	122
Q2	Riocan	$300	BBBH	4	121
	CREIT	$125	BBB	6	182
	Allied Properties REIT	$200	BBBL	8	229
	H&R REIT (Reopening)	$150	BBBH	7	202
	AIMCo	$400	AAL	7	97
	CT REIT	$175	BBBH	10	192
	Chartwell Retirement Residences	$200	BBBL	7	275
	Ventas Canada Finance	$275	BBB+	6	146
Q3	First Capital Realty	$300	BBBH	10	196
	Morguard Corp	$200	BBBL	5	255
	H&R REIT (Reopening)	$125	BBBH	5.5	221
Q4	OMERS Realty Corp	$700	AAL	10	113
	Crombie REIT	$150	BBBL	5	241
	AIMCo	$400	AAL	10.5	112
	Smart REIT	$250	BBB	3	CDOR + 66
	Smart REIT	$250	BBB	10	197
	OMERS Realty Corp (Reopening)	$175	AAL	8	86
	TOTAL/AVERAGE	$6,000		6.72	

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CMBS

For the first time in almost a year, the market saw a new CMBS issuance in October 2017. RBC issued REAL-T 2017 at $407 million, through 71 fixed-rate mortgages backed by 111 commercial properties. REAL-T 2017's second largest exposure of underlining assets is in Saskatchewan. This is unlike past REAL-T issues where the secondary market had little presence.

The issue features a weighted average interest rate of 4.091% and weighted average remaining term of 86 months. As reported by RBC, market demand was strong for the issue as it was oversubscribed; however, pricing continues to be unattractive to new CMBS players.

Summary of recent CMBS deals

Source: Bloomberg, DBRS, CMLS

	DEAL	ORIGINAL SIZE (MILLION CAD)	# OF LOANS	# OF PROPERTIES	WEIGHTED AVG. DBRS TERM DSCR
2017	REAL-T 2017	$407	71	111	1.36x
2016	IMSCI 2016-7	$352	38	60	1.47x
	REAL-T 2016-1	$401	55	91	1.30x
	REAL-T 2016-2	$421	47	72	1.38x
2015	CCMO 2015-3	$570	42	59	1.41x
	IMSCI 2015-6	$325	47	64	1.44x
	REAL-T 2015-1	$335	46	46	1.50x

ABOUT CMLS FINANCIAL LTD.

CMLS Financial Ltd. is a diversified provider of lending products and services to the commercial and residential real estate finance industry. We take great pride in continuing our over forty year tradition of exceptional service to borrowers, lenders, mortgage bankers and brokers. CMLS Financial is one of the only independent, dedicated providers of mortgage services for the commercial real estate finance industry in Canada.

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