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Commercial Mortgage Commentary

CMLS Mortgage Analytics Group

Making News

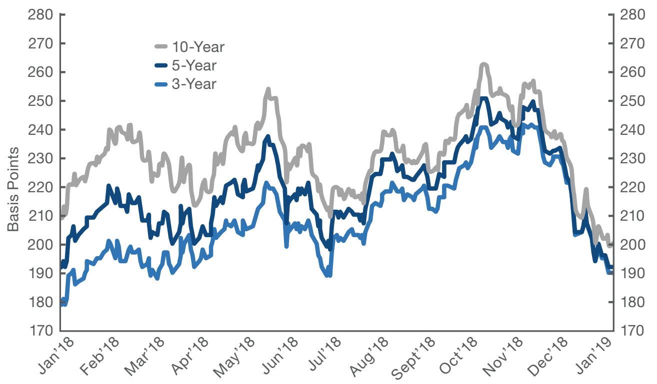
Economy

2018 started with confidence from the Bank of Canada's ("BOC") economic outlook for the year. However, the GDP growth forecast gradually declined as oil prices dropped and as tensions grew in international trade markets. As a result, we saw a reversal in the increasing trend of Government of Canada ("GOC") bond yields at the end of 2018. 2019 begins with some uncertainty around the growth in the Canadian economy, the direction of GOC yields, and whether further increases in the overnight rate will occur in 2019.

GOC Yields

GOC bond yields ended generally flat in 2018 – the 3-year GOC increased by 11 bps, 5-year increased by 1 bps, and the 10-year GOC yield decreased by 9 bps.

Historical GOC Yields

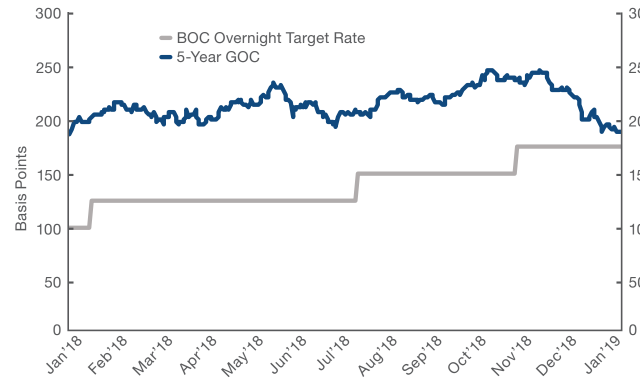


Source: Bloomberg, CMLS

Overnight Rate

There were three rate hikes in 2018 for the Bank of Canada ("BOC") overnight target rate, which brought the rate to 1.75%, the highest since Q4/08, but the Bank of Canada held the overnight rate constant for their last two meetings.

BOC Overnight Target Rate



Source: Bank of Canada, Bloomberg

Commercial Mortgages

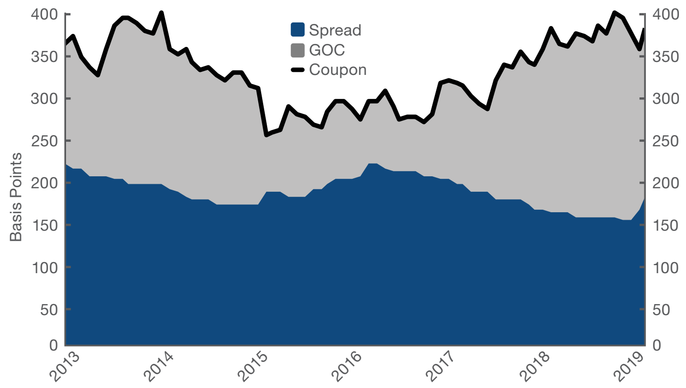
Capital supply and competition for commercial mortgages remained strong throughout 2018 as spreads continued to absorb the increases in the GOC yields, holding commercial mortgage coupons relatively steady. During Q4/18, GOC bond yields fell in response to the deteriorating outlook from the BOC, reversing the upward trend in 2018. Corporate bond markets reacted as investors demanded higher spreads – roughly 50 bps higher for BBB-rated corporate bonds in Q4/18 alone. Commercial mortgage spreads became a hot topic towards the end of Q4, as brokers and investors alike were looking for signs of change in the market. Commercial mortgage spreads eventually reacted with an increase in December by 10-15 bps, ending the year at 150-170 bps for top quality assets. The average 5-year conventional commercial mortgage coupon ended 2018 roughly flat at 3.60%. January 2019 has quickly seen another 15 bps increase in spreads, now in the range of 165-185 bps for top quality assets.

BBB-rated corporate bond investments tend to compete for the same capital as commercial mortgages, since BBB-rated corporate bonds provide a similar return on risk. As firms look to make portfolio investment decisions, the spread premium for commercial mortgages over BBB-rated corporate bonds can be an indication of where capital supply may shift or how commercial mortgage spreads may respond to changes in BBB-rated corporate spreads.

Recent increases in BBB-rated corporate bond spreads improved the relative attractiveness of this investment against commercial mortgages. The spread premium for commercial mortgages dropped from 85 to 25 bps year over year – significantly lower relative to the 67 bps long term average. Consequently, commercial mortgage funds may require higher spreads to compete for capital against their BBB-rated corporate bond counterparts.

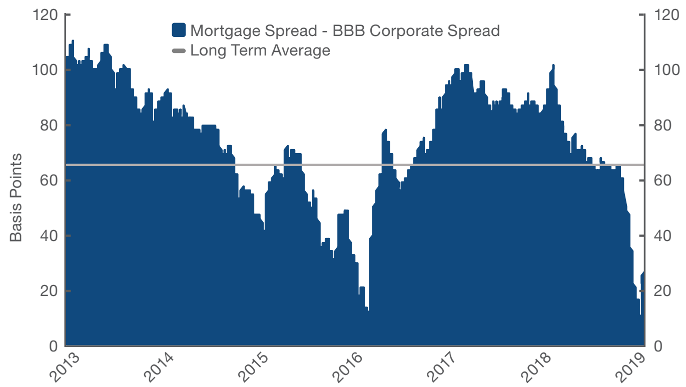
Based on the low spread premium for commercial mortgages compared to the long-term average, a further widening in commercial mortgage spreads is possible.

5-year Commercial Mortgage Spreads



Source: Bloomberg, CMLS

5-year Commercial Mortgage Spread Premium Over BBB-rated Corporate Bonds



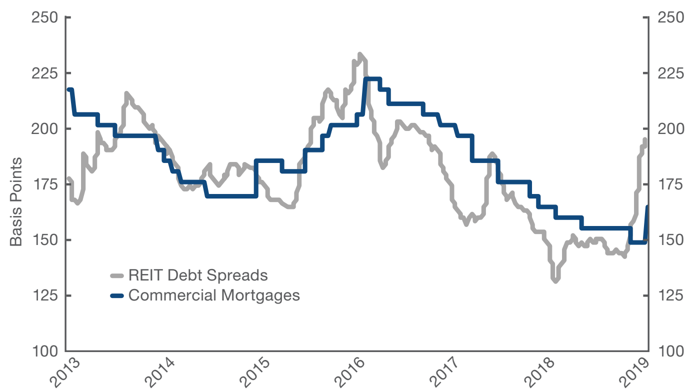
Source: Bloomberg, CMLS

Senior Unsecured Debt

In Q4/18, senior unsecured debt issuance reached $1 billion, up from $375 million in Q3/18. Total issuance for the year was driven largely by the nearly $2 billion raised by Choice Properties REIT in Q1/18.

Overall spreads on BBB-rated senior unsecured debt rose sharply from 145 bps at the end of Q3/18 to 194 bps by the end of Q4/18. With the increase, spreads surpassed those of conventional commercial mortgages. With the current premium for unsecured debt, REITs and REOCs may consider more conventional mortgage financing.

Spread on BBB-rated Unsecured REIT Debt vs. Commercial Mortgages



Source: Bloomberg, CMLS

Senior Unsecured Debt Issuances

2018	Issuer Name	Issue Size ($Millions)	Issuance Rating	Term (yrs)	Spread (bps)
Q1	Choice Properties	350	BBB	7	143.4
	Choice Properties	300	BBB	4	103.5
	Riocan	250	BBBH	5	139.2
	H&R REIT	300	BBBH	5.5	106.9
	CT REIT	200	BBBH	10	159.1
	Artis REIT	200	BBBL	2	CDOR+107
	Choice Properties	750	BBB	10	196.8
	Choice Properties	550	BBB	6.5	146.5
	Total/Average Q1	2,900		6.25	
Q2	Ivanhoe Cambridge II Inc.	500	AAL	5	89.4
	OMERS Realty Group	550	AAL	12	115.9
	OMERS Realty Group	250	AAL	7	93.6
	Morguard Corp	200	BBBL	3	202
	Chartwell Retirement Residences	150	BBBL	7	189.5
	Total/Average Q2	1,650		6.69	
Q3	Brookfield Property Finance ULC	300	BBB	5	230.5
	Crombie REIT	75	BBBL	2.9	170.1
	Total/Average Q3	375		3.95	
Q4	AIMCo Realty Investors LP	325	AAL	8.5	120
	Crombie REIT	175	BBBL	6.25	236.9
	Brookfield Property Finance ULC	400	BBB	3	177.8
	Brookfield Property (Q3/Reopening)	100	BBB	5	230.5
	Total/Average Q4	1000		5.69	
	Total/Average YTD 2018	**5,925**		**6.00**	

Source: Bloomberg

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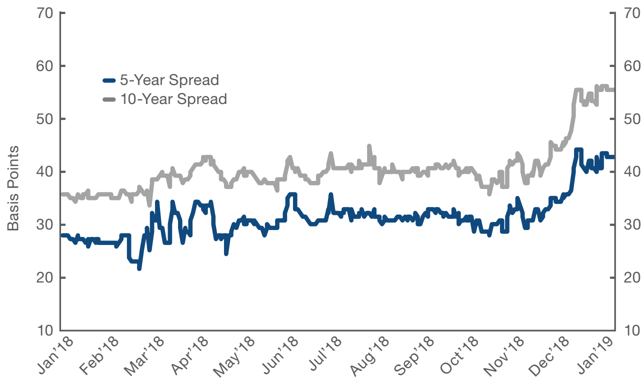
CMHC

CMHC-insured mortgages offer an attractive return for lenders looking to earn additional yield, while maintaining an indirect guarantee from the Government of Canada. As most insured mortgages are originated with the purpose of securitization into the National Housing Act ("NHA") Mortgage-Backed Security program run by CMHC, lenders tend to quote spreads based on Canada Mortgage Bond ("CMB") spreads. Given this, it is no surprise with the increases in CMB spreads seen in Q4/18, that CMHC-insured spreads also increased.

Through Q4/18, the 5-year and 10-year CMB spreads increased from 29 bps to 42 bps and from 38 bps to 55 bps, respectively. Spreads on CMHC-insured mortgages followed suit with a 10 – 15 bps increase to 90 – 115 bps over GOC on 5-year terms and 100 – 125 bps on 10-year terms.

5-Year and 10-Year CMB Spreads



Source: CMHC

Quarterly Lenders Sentiment Survey and Annual Commercial Mortgage Survey

The CMLS Mortgage Analytics Group conducts market surveys to enhance market knowledge and transparency on areas such as size, segment analysis, and trends in the Canadian commercial mortgage market. Since inception in 2010, the surveys have grown to cover over 90% of the commercial mortgage market.

Participant responses and data are kept strictly confidential to preserve the integrity of the process and results are shared only with participants.

If you do not currently participate and would be interested in receiving the quarterly and annual results, please contact one of our team members listed below.

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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