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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, First Mortgage Bonds and Senior Unsecured debt for REITs and REOCs.

Making News

In November, the federal government launched its revamped commercial tenant subsidy program, the Canada Emergency Rent Subsidy (CERS). The new program will be retroactive to September 27th in order to overlap with the winding down of the federal government's previous rent subsidy program, CECRA. Unlike CECRA, the new subsidy program will allow tenants to apply for aid directly to the government rather than rely on their landlords to do so for them. CERS will provide up to 65% of tenant's monthly rent dependent on certain requirements, and up to 90% for businesses forced to close for extended periods due to lockdowns. Many believe that uptake will be much higher than the approximately 140,000 businesses that received rent relief under the CECRA program.

US Pulls Out of Keystone XL Pipeline

Shortly after his inauguration, President Joe Biden signed an executive order rescinding the presidential permit for the USD$8 billion Keystone XL pipeline expansion. The project, which was already under construction by TC Energy, was designed to bring 830,000 barrels per day of diluted bitumen from the Alberta oil sands to heavy refineries in the US Gulf Coast. As a result, Alberta taxpayers could face losses of USD$1.5 billion after the provincial government took an equity stake in the project in 2020. The negative impact of the cancellation on future oil development will also challenge the recovery of Calgary's ailing downtown office sector which saw vacancies reach 29.5% in Q4, according to CBRE. Although there was a material uptick in the national figure to 13.0%, office vacancies in downtown Calgary remain significantly elevated when compared to those in Vancouver (5.8%), Toronto (7.2%) and Montreal (10.2%). As a result, the city assessed value of Calgary's downtown office buildings fell 13% YoY to $9.4 billion. Prior to the oil price downturn of 2015, their value was $24.6 billion

Montreal's West Island to Receive Massive Mixed-Use Development

Cadillac Fairview (CF), the multi-national real estate developer and manager, announced plans in October to develop approximately 50 acres of land on Montreal's West Island. The project will consist of around five million square feet of residential, office, retail, and hotel space in what CF is branding a downtown experience in the suburbs. The development is one of the latest spurred on by the construction of Montreal's Réseau Express Métropolitain (REM) light rail transit project. The West Island project will benefit from both a REM station and bus terminus. Overall, the project highlights continued strong demand for suburban amenities as many look to relocate from dense urban cores.

Economic Environment

In one of the Bank of Canada's (BoC's) last press releases of 2020, the Bank reaffirmed its commitment to keep overnight interest rates stable at 0.25%, as well as continue with its quantitative easing program which pledges to purchase a minimum of $4 billion/week in federal government debt. In its discussion, the BoC highlighted the fact that all measures of core inflation were below their 2% target for the year, and that there was still considerable economic slack in the market. Additionally, the BoC noted that near term economic headwinds due to rising COVID infections and uncertainty regarding the speed of the vaccine roll-out all played a role in the latest policy decision. Earlier in the quarter, the BoC projected that its 2% inflation target would likely not be achieved until 2023. The December press release noted that low overnight rates, in concert with the Bank's quantitative easing program, would be in effect until that inflation target is sustainably achieved.

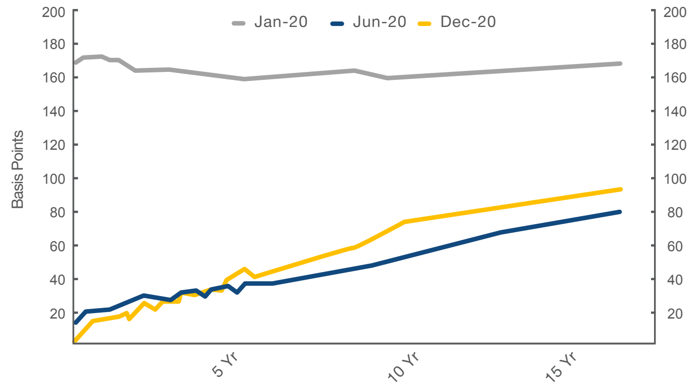
GOC Yields Finally Come Off Record Lows

After spending much of the year near all-time lows, Government of Canada (GOC) bond yields began trending upwards at the end of Q4. The 5yr GOC averaged 43bps and 10yr GOC averaged 72bps during the quarter, an increase of 9bps and 17bps respectively when compared to Q3.

Historical Interpolated GOC Yields

Source: : Bloomberg

The change in yields also altered the slope of the yield curve, shifting it further upwards when compared to the beginning and middle of 2020. An upward sloping yield curve is typically indicative of positive forward-looking economic sentiment.

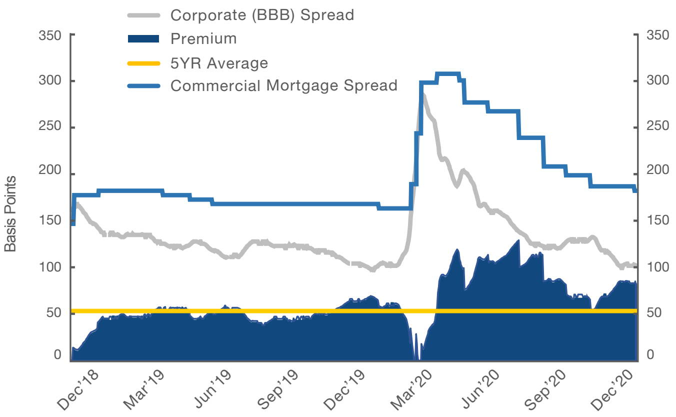


Source: : Bloomberg, CMLS

Commercial Mortgages

The last quarter of 2020 saw the continuation of favorable deal flow and increasing competition in the conventional mortgage space, leading to sustained downward pressure on credit spreads across the risk spectrum. Transaction data for the quarter revealed that for the most sought-after asset types, such as multi-family and industrial, pricing came down to as low as 150-160bps over GOC. Similarly, lender sentiment indicated a relative increase in risk appetite overall. Loans appeared to be priced competitively for most asset types, with the bulk of origination spreads coming in around the 200bps mark. However, pricing for currently less-favored assets such as certain office, lodging, non-essential retail, and student and senior housing continue to require a premium.

Despite their overall downward trajectory, mortgage spreads have lagged the recent drop in benchmark BBB corporate debt. The result is that the liquidity premium offered by commercial mortgages has increased once again after approaching its long-run average at the end of Q3.



Source: : Bloomberg, CMLS

Industrial Assets – The Clear-Cut Winner of 2020

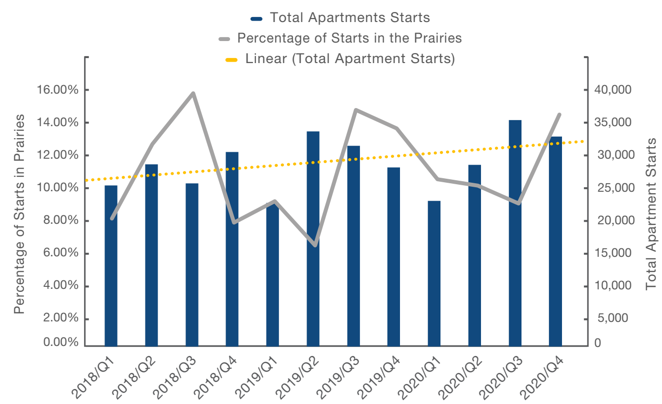
Unsurprisingly, industrial properties topped the lending communities' list of the most sought-after assets in Q4. Results from our quarterly sentiment survey indicate that >95% of respondents reported a high-level of interest in industrial assets for the third quarter in a row. In a similar vein, PwC and Urban Land Institute's annual Emerging Trends in Real Estate report showed that market participants thought fulfillment centers and warehouse spaces -two subsects of the industrial asset class- were the best positioned property types heading into 2021 from an investment and development perspective.

CMHC

Having been one of the first markets to see a healthy return of liquidity in the wake of the pandemic, the CMHC space also appeared to be one of the first to see pricing plateau to some degree. Observed transactions continued to close at a wide variety of spreads, indicating that lenders are finding success at pricing that is well above the sharpest, despite the relatively low risk profile of CMHC loans overall. Along those lines, CMHC lenders reported an impressive year overall. Many institutions reported very strong origination numbers in 2020 despite the various challenges brought on by the pandemic. For some, these challenges included being closed to new business for several months. Overall, a flight to quality by investors, coupled with the apparent durability of the multi-family building as an asset class, helped make 2020 a strong year for the CMHC market. Many lenders expect this trend to carry over into 2021.

Robust Construction Starts in Prairies Prompts Some Concern

Construction of multi-family units nation-wide were quick to rebound from the initial shock of the global pandemic. As the chart below indicates, the proportion of total apartment starts in Alberta, Manitoba, and Saskatchewan in Q4 reached heights comparable to their peaks in 2018 and 2019. However, over the course of the last two years, the total number of apartments starts has continued to trend upwards, meaning the total number of apartments starts in the prairies has followed suit. Initial concerns are that the growing volume of larger projects coming to completion may over-saturate the market, which is characterized by a significant amount of smaller scale apartment stock. Though this has yet to manifest itself, absorption of new stock warrants continued monitoring as 2021 progresses.



Source: : CMHC, CMLS

CMBS

With only one public issuance to its name, most lenders would agree that 2020 was a quiet year for the Canadian CMBS market, even when accounting for its relatively small size. While transaction volumes are not expected to meet or surpass pre-COVID levels, CMBS originators are nevertheless optimistic heading into 2021. Issuers report that there is high investor demand and a strong desire to deploy capital. Issuers also appear willing to approach the sharpest market pricing to secure choice assets and meet demand. Concerns about the ability of newly originated loans to meet credit rating standards and achieve investment grade status have also lessened as of late. Though the body of examples to draw on is still relatively sparse, it appears that credit rating agencies' evaluation methodologies have not become unduly harsh in the wake of the pandemic. While increased scrutiny of office and retail assets is expected, rating agencies such as DBRS made no material changes to their evaluation of CRE assets in 2020.

REITs

Many long-term REIT investors will be glad to see the end of 2020, a year in which overall valuations struggled to keep pace with the larger economy, and many REITs closed the year at steep discounts to NAV. The S&P/TSX Capped REIT Index posted a -13% total return, lagging well behind the TSX composite's 6% return for the year.

The less-than-stellar situation with REIT equity prices contrasts sharply with opportunities in the REIT debt sector. Here, the ultra-low interest rate environment that is expected to persist well into 2021 has created an opportune time for REITs to finance their operations with unsecured debentures. As data on issuances in Q4 shows, REITs were quite active at the end of 2020, issuing larger bonds at longer duration with lower spread over benchmark on average.

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	3.3	97
	H&R REIT	400	BBBH	5.0	366
	SmartCentres REIT	300	BBBH	10.5	296
	SmartCentres REIT	300	BBBH	7.0	262
	Granite REIT Holdings LP	500	BBB	7.0	260
	Choice Properties REIT	500	BBB	7.0	240
	Allied Properties REIT	300	BBB	8.0	265
	Cominar REIT	150	BBH	5.0	557
	Total Issue Size/Average Term Q2	2850		6.6	
Q3	Morguard Corp	175	BBBL	3.0	413
	Artis REIT	250	BBBL	3.0	355
	Summit Industrial Income REIT	250	BBBL	5.0	180
	First Capital REIT	200	BBB	7.5	299
	Brookfield Property Finance ULC	500	BBB	5.0	355
	BCI QuadReal Realty	350	AAL	10.0	123
	StorageVault Canada Inc	75	N/A	5.5	N/A
	Total Issue Size/Average Term Q3	1800		5.6	
Q4	Crombie REIT	150	BBBL	10.0	259
	Crombie REIT	150	BBBL	7.5	219
	H&R REIT	250	BBBH	5.5	245
	RioCan REIT	500	BBBH	5.5	148
	SmartCentres REIT	300	BBBH	8.0	173
	SmartCentres REIT	350	BBBH	5.0	129
	Granite REIT Holdings LP	500	BBB	10.0	161
	Dream Industrial REIT	250	BBB	5.0	121
	Summit Industrial Income REIT	200	BBBL	5.3	136
	Total Issue Size/Average Term Q4	2650		6.9	
	Total Issue Size/Average Term 2020	8950		7.8	

Source: : Bloomberg

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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