CMLS Financial®

COMMERCIAL MORTGAGE SPREAD COMMENTARY

CANADA'S MORTGAGE COMPANY.™

AUGUST 2013

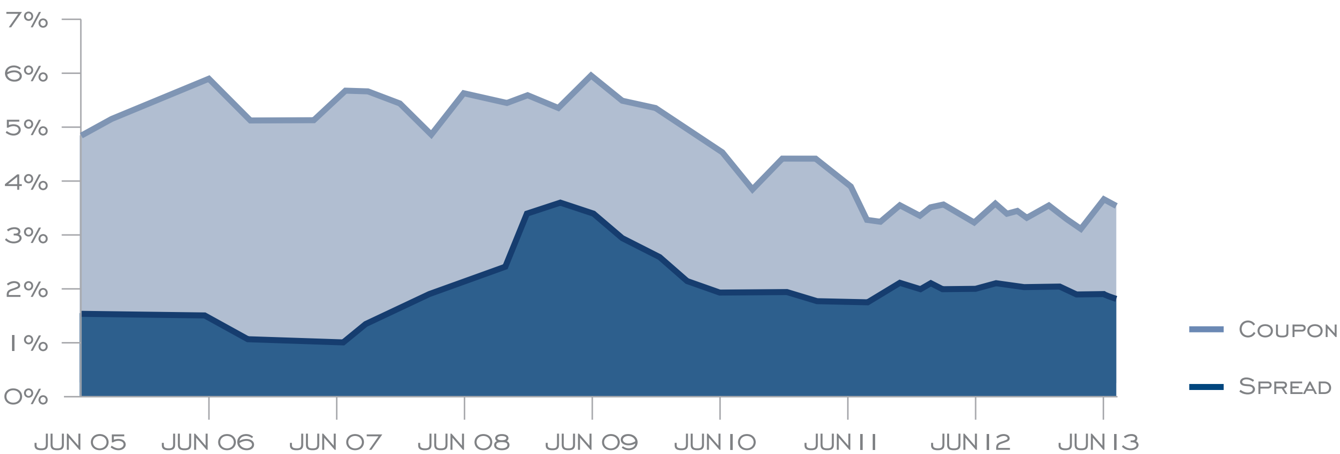
ECONOMY

In late May, Federal Reserve Chairman Ben Bernanke stated that the US central bank could consider scaling back its quantitative easing (QE) program if officials see sustained labour market improvement. The market reacted immediately with a worldwide jump in borrowing costs. Then on June 19, the Fed confirmed its plans to dial back the program that dumps $85 billion of liquidity into the market each month, leading to an even greater increase in borrowing costs. Rates have since come down but remain 60 bps above pre-announcement levels. The increase has led to a near parallel spike in commercial mortgage rates.

COMMERCIAL SPREADS

The upward movement in GOCs has not lead to a corresponding increase in commercial mortgage spreads. In fact we have noticed a slight compression in spreads over the last few months. This may be a result of a higher all-in coupon attracting more money back into the market as institutions with soft floors see an opportunity to earn a more attractive coupon. We are seeing mortgages on high quality commercial assets achieve spreads between 180 - 205 bps on 5 year terms and 190 - 220 bps on 10 year terms.

COMMERCIAL MORTGAGES 5 YEAR SPREADS AND COUPONS



Source: CMLS Financial, Bloomberg

CMHC SPREADS

CMHC mortgage spreads have remained constant over the past quarter. High quality multi-family product is pricing at 90 - 105 bps over both 5 and 10 year GOCs. The lack of spread movement may be a result of spreads reaching a bottom. Lender margins seem to be compressed to a point where any further tightening would diminish profitability to a level not feasible for further origination, especially for lenders securitizing their loans.

Canadian Mortgage Bonds (CMB) continue to be a key destination for insured multi-family product. In Q2, CMHC issued $10 billion worth of the bonds. The most recent issuance was a $5 billion 5 year note on June 28, 2013 yielding 2.005% or 30.2 bps over the GOC curve. In May 2013, a $2 billion 10 year note was issued currently yielding 2.864% or 49.4 bps over the 10 year GOC curve.

NEW COVERED BOND LEGISLATION

Covered bonds are a funding source used by banks to fund their residential mortgage lending. New legislation was introduced on December 17, 2012 that is expected to improve the liquidity and investor base of Canadian covered bonds globally. As of July 2013, CIBC and RBC were the only two registered issuers in the new covered bond registry. The new covered bond program imposes stricter disclosure requirements, extends recourse to the issuers as well as the assets, and restricts the use of CMHC insured mortgages in the collateral pool. With insured mortgages no longer permitted, we expect issuers will turn to low-ratio mortgages to fill these pools. CMHC will govern and maintain the covered bond registry but all administration of the covered bonds will continue to be under the supervision of OSFI. There were no new issuances in 2013, which is a drastic drop from the highly active covered bond market in the first two quarters of 2012.

CHANGES TO NHA-MBS

In early August 2013, there were two significant events on the regulatory front. Firstly, CMHC announced it was limiting the use of insured mortgages for the purpose of creating market NHA-MBS for the remainder of 2013 (although this should not impact insured mortgages funded via the CMB). Secondly, OSFI issued a new Capital Ruling allowing for NHA-MBS to be excluded from the asset-to-capital multiple (ACM) calculation under certain circumstances. The first event appears to have the potential to reduce lender demand for insured multi-family product although initial indications are business as usual while the second could help certain institutions increase their participation in this market. Stay tuned.

CHANGES TO THE BULK INSURANCE PROGRAM

In the March 2013 Federal Budget the Government announced its plans to limit the use of bulk insurance on low ratio mortgage pools outside of CMHC securitization programs. The government appears to be looking to reduce taxpayer exposure and ease competition in the mortgage market. Insured mortgage pools do not attract a capital charge which can lead banks to reduce their capital and put downward pressure on mortgage rates. The change will affect issuers not using the CMHC sponsored NHA MBS and CMB securitization programs. The greatest impact of these changes will be on issuers of asset backed commercial paper backed by pools of mortgages. As of November 2012, residential mortgages and lines of credit made up 50% of the asset backed commercial paper (ABCP) market.

CMBS

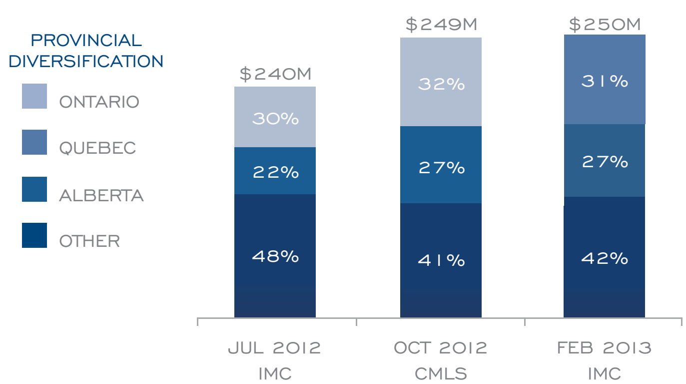
Following IMC's $249M CMBS issuance in February, the second quarter was quiet for Canadian CMBS participants; a stark contrast to the $21 billion of new issuance in the US. The market here remains a long way from its record-setting first half of 2006, when origination exceeded $3 billion.

Experts anticipate approximately $900 million of issuance in 2013, but if CMBS spreads rise relative to commercial mortgage spreads, CMBS lenders will become less competitive in the commercial lending market.

CANADIAN CMBS MARKET OVERVIEW

New issuance since 2012

Issuer	IMC	CMLS	IMC
Loans	31	26	38
Cut-off LTV	63.5%	60.8%	63.5%
Cut-off DSCR	1.44x	1.66x	1.46x
AAA Subordination	15%	15%	14%



REITS AND SENIOR UNSECURED

In June 2013, Loblaw (TSX:L), Canada's largest grocer, spun 75% of its real estate assets into a REIT under the banner Choice Properties (CHP-UN). The REIT holds over $7 billion in assets including 415 retail properties, nine warehouses, and one office complex. The REIT sold 40 million trust units for $10 CAD, with an initial yield of 6.5%, and raised a further $660M through 5 and 10 year senior unsecured debt issuances. This liquidity no doubt facilitated Loblaw's ability to bid on Shoppers Drug Mart, Canada's largest drug store chain, in a $12.4 billion cash and stock purchase. Also this quarter, Canadian Tire (TSX: CTC.A) announced it will create a $3.5 billion REIT to unlock the value of its real estate assets, with an IPO expected later this year. The proposed REIT would contain a geographically diverse portfolio of approximately 250 properties comprised largely of Canadian Tire retail stores, Canadian Tire anchored retail developments and one distribution centre. The total leasable space is anticipated to be approximately 18 million square feet.

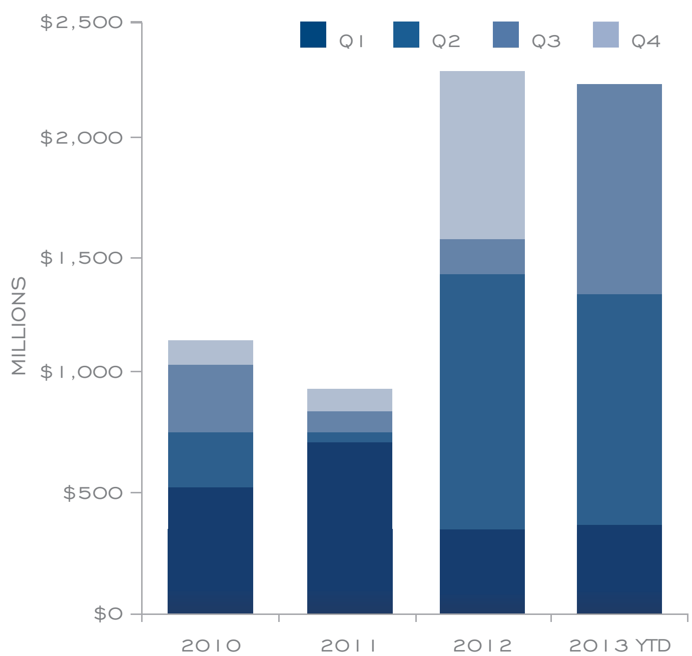
Compared to Q1 2013, we saw a large spike in Q2 as there were more issues and issuers of senior unsecured debt. Issuers raised $975M in Q2 2013 which mirrors the $1 billion raised the same quarter a year earlier. The flood of early Q3 activity puts the year-to-date amount of new senior unsecured debt at $2.24 billion, on pace to exceed last year's total volume of $2.28 billion.

Relative to current conventional mortgage rates, senior unsecured debt can be a cheaper source of financing. Investors have been flocking to the asset class as evidenced by the decline in spreads over the past few years, but a look at early Q3 issues indicates spreads might be on the rise. The 5 year BBB rated issuances by Choice Properties and CREIT at 165 bps and 199 bps respectively indicate a slight increase in spreads when compared to similar issues by RioCan at 140 bps and Dundee REIT at 191 bps earlier this year. Further supporting this view is Cominar's 7 year paper issued at 292 bps over GOCs, versus a near identical issue at 256 bps just two months prior.

2013 NEW SENIOR UNSECURED

	Issuer	Issue Size ($M)	Term (Yrs)	Spread	Issuance Rating	Issuer D/M. Cap
	RioCan REIT	250	5	140	BBB (high)	78%
Q1	First Capital Realty	125	10	201	BBB (high)	95%
		375				
	H&R REIT	175	5	n/a	BBB	100%
	Dundee REIT	175	5	191	BBB (low)	73%
	Cominar REIT	100	7	256	BBB (low)	112%
Q2	Calloway REIT	150	10	n/a	BBB	80%
	RioCan REIT	200	10	192	BBB (high)	78%
	First Capital Realty	175	10	201	BBB (high)	95%
		975				
	CREIT	125	5	199	BBB	107%
	Choice Properties REIT	460	5	165	BBB	n/a
Q3	Cominar REIT	100	7	292	BBB (low)	112%
	Choice Properties REIT	200	10	238	BBB	n/a
		885				
	Total 12 Issues	2,235		Source: Bloomberg, DBRS		

SENIOR UNSECURED DEBT ISSUANCE ($M)



FIRST MORTGAGE BONDS

In Q2 2013, a $220 million first mortgage bond was issued on the TD Canada Trust Tower. The issue has a 7 year term that is secured by PSPIB's 50% interest in the office, 25% interest in the retail, 22% interest in the parking facility, and 31% economic interest in the Hockey Hall of Fame. The bond was rated A2 in Moody's pre-sale report. Now both Brookfield Place Towers (Bay Wellington and TD Canada Trust) are financed using First Mortgage Bonds. The Bay Wellington Tower was financed with a $525MM first mortgage bond issued in late 2012 by Brookfield.

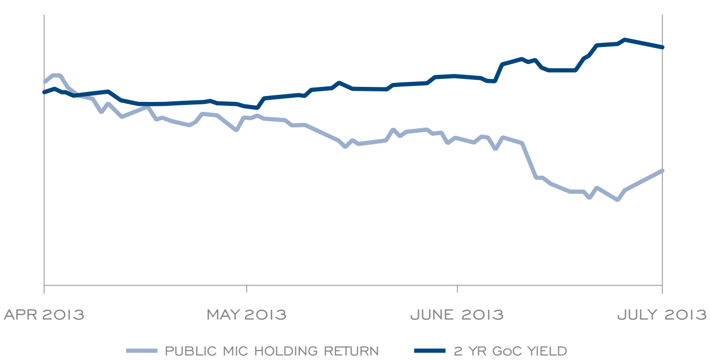
The TD Canada Trust Tower was originally wholly owned by Oxford Properties, a subsidiary of OMERS. In early 2013, OMERS and PSPIB completed a transaction in which OMERS sold 50% of its stake in the tower to PSPIB. Sources pegged the sale at $465 million ($750 PSF), a record for commercial property in Canada. This 51-storey trophy asset was built in 1990 and contains over 1.1 million square feet of rentable space. Occupancy has been above 99% for the past five years.

More first mortgage bonds appear to be on the way with a rumoured issue on a retail power centre in Dartmouth Crossing, Nova Scotia. The bond is expected to have a face value around $150 million.

HIGH YIELD

The high yield space remains competitive as the market is well capitalized. However, the recent uptick in GOC's could have an adverse effect on funding for public Mortgage Investment Corporations (MICs). Whereas private MICs tend to have a fixed unit price, public MICs price per unit tends to be negatively correlated to yield movement, which may result in MICs raising less capital as it becomes more costly to do so. The market caps of most public MICs contracted last quarter and are now trading below their book values. Coupons on high yield mortgages tend to be less reactive to GOC movements. As the spread between high yield mortgages and other fixed income assets decreases it will be interesting to see if the recent flood of capital into the high yield space reverses course. If so, are high yield coupons poised to rise?

PUBLIC MIC INDEX RETURN VS. 2-YEAR GoC



ABOUT CMLS FINANCIAL LTD.

CMLS Financial is a diversified provider of lending products and services to the commercial real estate and real estate finance industry.

CMLS has been providing mortgage valuation services to Canada's leading institutional mortgage investors and borrowers for over 10 years.

NEED MORE SPECIFIC INFORMATION?

For additional detail on our spread ranges or any other matter with respect to commercial mortgage valuation in Canada, please do not hesitate to contact our team.

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