Commercial Mortgage Spread Commentary

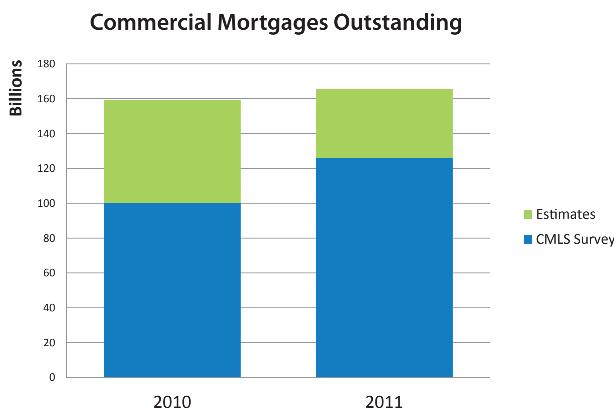
May 2012

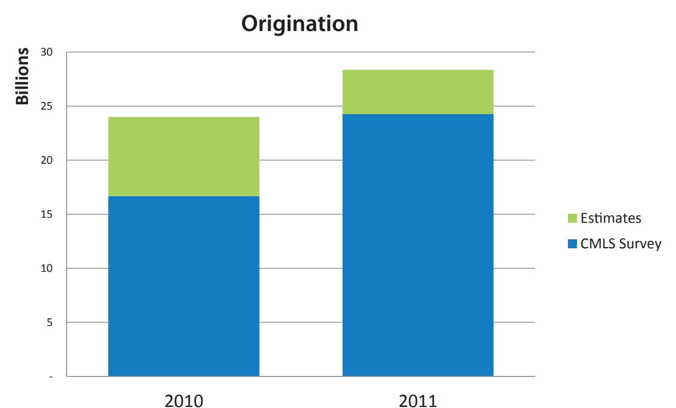
Once again, we presented the highlights from our annual Canadian commercial mortgage market survey at RealCapital 2012. The objective of this annual survey was to accumulate information on the size and composition of the Canadian commercial mortgage market, quantify annual originations, and gauge industry sentiment heading into 2012.

This year, CMLS estimates the size of the Canadian mortgage market to be approximately $166 billion, which represents a $6 billion or 4% increase over 2010. Survey participants identified $98 billion of commercial mortgages outstanding which, combined with $12.8 billion of CMBS outstanding and $15.7 billion of outstanding NHA MBS provided insight into over $126 billion of commercial mortgage lending in Canada. Survey participants identified a further $10.7 billion of current construction lending.

CMLS estimates 2011 originations at approximately $28 billion, a significant $4 billion or 16% increase over 2010. This year's survey participants reported originations in excess of $20.8 billion. Combined with 2011 CMBS issuances of $0.2 billion and NHA MBS issuances of $3.3 billion, total identified origination was more than $24.3 billion, or 86% of our estimate for the year.

As highlighted by the figures above, this year's survey benefitted from even greater industry participation. In particular, we were pleased to receive responses from five of Canada's six largest banks. Last year, only one of these institutions participated. This year, 26 of the 29 participants reported commercial mortgages outstanding in excess of $800 million.





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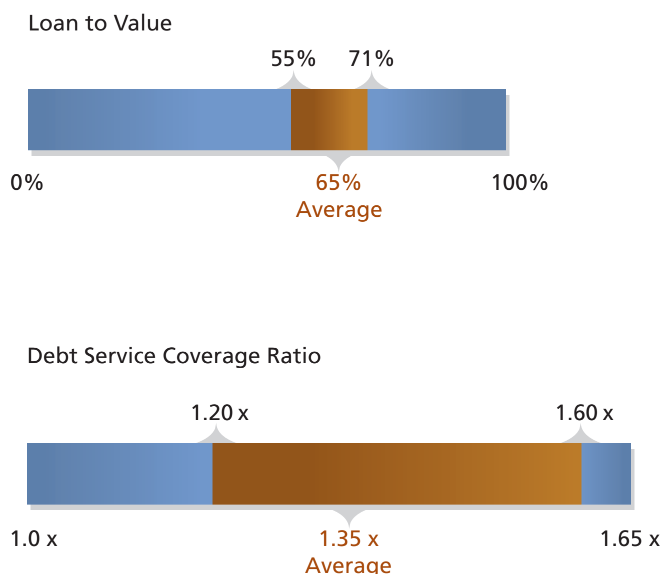
What else did we learn? Over one-half of participants initiated floor rates in 2011, primarily for one of two reasons: either to protect the all-in coupon rate or counter the enhanced volatility in the GOC base rate. We also learned that participants currently feel a BBB commercial mortgage would average 65% LTV and 1.35x DSCR. As for key sentiments heading into 2012? Over 85% of participants indicated their allocation to commercial mortgages for 2012 would either stay the same or increase, and over 80% felt there would be at least as much commercial mortgage credit available in the market as in 2011.



CMLS is committed to continuing this annual survey and providing relevant data to market participants. Full survey results (including composition by lender type, renewal figures, construction loans and seconds) are only made available to participating organizations. If you have any suggestions, questions or thoughts, or would like to participate in 2012, please do not hesitate to contact Mark Achtemichuk directly at (604) 687-0874 or mark.achtemichuk@cmls.ca.

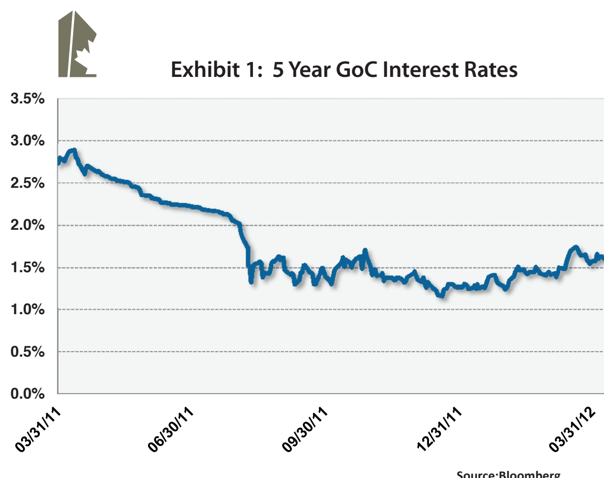
General Market Commentary

With the global economy becoming increasingly interrelated, it is important to first examine the impacts of global economic and credit market issues on mortgage rates and spreads before drilling deeper into domestic and real estate specific factors.

The outlook for the global economy has generally improved since the beginning of the year but continues to be plagued by uncertainty. This is evidenced by a significant level of volatility as the outlook for growth appears to change daily based on the most recent report, election or international event. Mixed domestic signals of economic growth coupled with U.S. uncertainty and an ever changing European landscape provide an incredibly challenging environment for even the brightest economists to predict.

Most agree that the US economy is generally stronger now than it was in 2010/2011 based on a number of key metrics. Small bumps along the way continue to be a reality but most broad based metrics appear to be stronger. Business and consumer confidence continues to improve, labour market statistics are mixed but mostly stronger than in past years, and even some housing data is starting to show progress.

The improving outlook must also be viewed in context with the challenges that the US economy faced in 2011. Political games related to the debt ceiling, supply chain issues resulting from Japan's earthquake, Middle Eastern tensions, energy price shocks, and ongoing fears of European debt contagion all provided credible concerns to the derailment of economic growth. The U.S. is now entering a stage where some of these fears and issues have subsided but the prospects for growth still remain moderate at best. Lingering fears continue to be present but could be contained if consumer confidence remains high and job growth shows signs of improvement.



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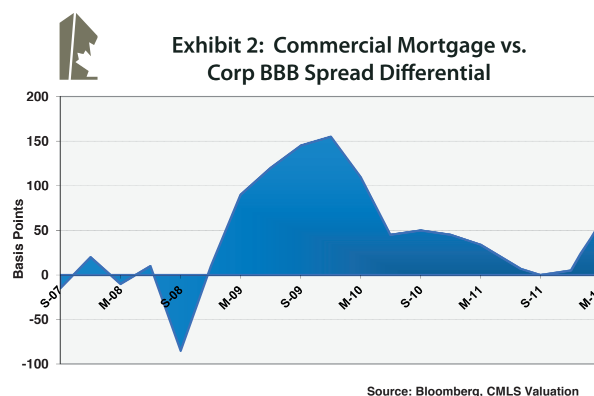
In mid-April, the Bank of Canada raised growth forecasts and suggested that the economy would be returning to full capacity earlier than expected. Many market participants jumped at the more hawkish tone delivered by the BoC and raised forecasts of a September interest rate increase. This interest rate speculation has since subsided as many participants now believe the economy is growing at a slower pace than projected by the BoC and the possibility of an interest rate increase was overstated. According to Bloomberg calculations based on overnight index swaps, the probability that the BoC will raise interest rates in September has fallen to less than 50%, which is down from over 66% at the end of April.

Canadian economic growth prospects show some signs of independence but continue to be largely influenced by U.S. and European events. The Canadian economy is still burdened by record levels of household debt which has become "the biggest domestic risk" according to finance minister Jim Flaherty. Bank of Canada Governor, Mark Carney, has also issued repeated warnings about the ability of households to service record high debt levels in a rising interest rate environment which could also bring negative consequences to housing sector prices. Job growth, income growth and consumer confidence will be key drivers of economic recovery as exports will likely continue to be constrained by a high Canadian dollar. Mark Carney will likely raise interest rates at some point in the near future as he alluded to in his April meeting. As the economy nears full output, inflation concerns will need to be resolved with the removal of economic stimulus. This will likely be done with increases to the overnight lending rate which will in turn increase the Canadian dollar if completed without equivalent interest rate increases by the Federal Reserve in the US.

The Global and domestic landscape discussed above continues to drive a significant level of volatility in Government of Canada ("GoC") yields as we have seen in the past few months. GOC rates have moderately increased as investors switch out of safe havens and into riskier assets on the back of renewed confidence. This trend is expected to continue forcing modest increases to GOC rates. Canada is also set to auction 10-year bonds twice between April and June rather than the typical single auction. The increased supply along with the reversal of the refuge appeal of Canadian Bonds will apply dual upward pressure on GOC yields assuming investor risk appetite continues to increase and shift away from risk free assets. The question is not *if* rates will rise, but *when*.

Commercial Mortgage Market

Conventional Mortgage Spreads have experienced some downward pressure in the first quarter of 2012. Based upon CMLS' risk rating model, conventional multifamily and commercial mortgages ranging from very good to fair quality would attract spreads between 175 and 265 basis points over GOC Bonds.



Commercial mortgage debt markets in Canada continue to be very well capitalized with nearly all major lenders continuing to actively pursue deals. Spreads have compressed during the first quarter of the year, reflecting the typically competitive market early in the calendar year. We are seeing most lenders active in the five year term market, allowing those lenders active in the long term space to be somewhat opportunistic and generally more selective with their lending programs. However, we've found that borrowers with attractive assets and appropriate loan characteristics continue to attract strong interest and multiple offers from most lenders active in both the five and ten year market. This is keeping the spread differential between five and ten year loans within a band consistent with long term averages. Assets in secondary locations or with

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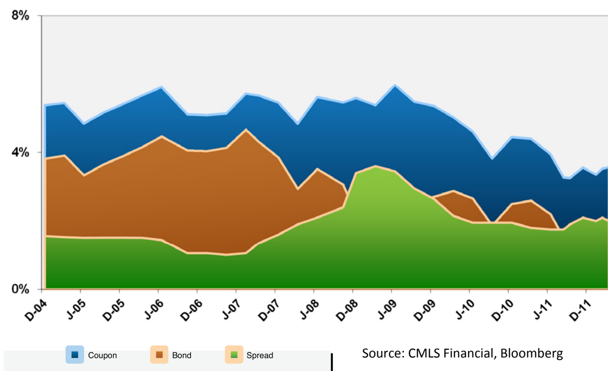
unique situations are unlikely to qualify for long term funds in today's environment. This is understandable given the uncertainty of inflation and interest rates in the long run. Demand for long term money continues to be strong as many borrowers are looking to lock-in at all-time low rates.

Underwriting criteria continues to remain strong with benchmark loan to value levels remaining in the 65% range. Situations exist where this level will be exceeded given asset fundamentals and borrower profile; however, many lenders continue to place increased importance on an asset's ability to support loans with substantially higher interest rates than today's market rates. Exit debt yield is an important metric that some investors rely on, as it removes interest rate uncertainty and cap rates from the equation. Debt yield is a cash flow based metric that is calculated by dividing the asset's net cash flow by the whole loan balance. A lower debt yield lowers the probability of a loan successfully refinancing at maturity. DBRS views a debt yield of 11% as a reasonable long-run benchmark. Of course, this metric cannot be used in isolation and does not always predict an accurate outcome.

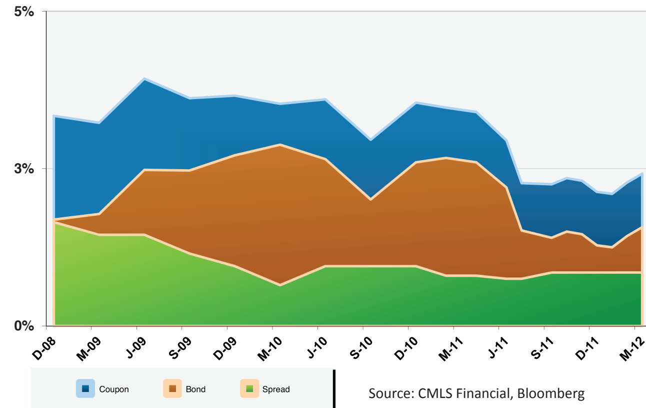
Exhibit 3: Commmercial Mortgage Loans 5 Year Spreads, Bond Yields and Mortgage Coupons



CMHC Insured Loans

CMHC spreads continue to be influenced by lenders who are active in the CMHC securitization programs. Institutional quality CMHC insured loans will currently attract pricing in the range of 85 to 115 basis points over GoC Bonds.

Exhibit 4: CMHC Insured Loans 5 Year Spreads, Bond Yields and Mortgage Coupons



Canada Housing Trust ("CHT") issuance slowed somewhat in the first quarter of 2012 although the market remained active. CHT recently settled $5 billion in CMBs on March 22. The issue matures June 15, 2017 and priced at 39 basis points over the applicable benchmark (GoC's) making for a 2.05% coupon at issuance. This follows a $2.5 billion ten year bond issue in February which priced at 48 bps above the benchmark GoC. The two first quarter issues put CHT on pace for $30 billion in 2012 issuance, well below the $42.5 billion in average annual issuance between 2009 and 2011. This reduced issuance could also be the result of record issuance in the covered bond sector as Banks rushed issues to market before proposed changes affecting this sector were announced.

The covered bond market was extremely active in the first quarter of 2012 as issuers and investors alike feared that the government would restrict the use of insured mortgages as collateral. This lead to both record issuance and favourable pricing in preparation for reduced future supply. Total issuance was $12.8 billion which

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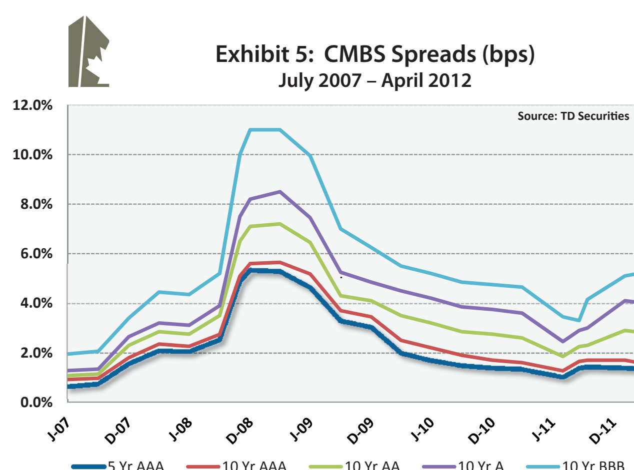
represented a 54% increase over first quarter issuance in 2011. The fears resulted from comments made in a federal consultation paper released last year mentioning the benefits of reducing reliance on government-backed mortgage insurance and as CMHC closes in on its $600 billion limit on principal guarantees. Resulting spread compression led to a strong first quarter for Canadian covered bonds, returning 1.8% as compared with 0.7% for securitized debt overall (Bloomberg, Bank of America Merrill Lynch).

On April 26, legislation was introduced which validated the predictions of market participants. Under the proposed legislation, CMHC will move under the regulatory umbrella of the OSFI, a registry for covered bond issuers will be developed outside of which issuance is prohibited, and insured mortgages will no longer be eligible as covered bond collateral, among other things. The move by the federal government is the latest in a bid to restrict mortgage funding in a residential housing market that many contend is overheating. Most banks exclusively relied upon CMHC insured residential loans as collateral for their covered bond pools which effectively provided a government guarantee for their debt and an extremely cheap source of funds. This legislation will cause banks to re-visit their loan funding strategy in light of these new restrictions. Further issuance in the covered bond sector will be substantially different from pre-legislation characteristics. The end result of this legislation will likely be an increase in lending rates as the banks cost of capital for residential lending has now increased. This will likely cause a re-balancing of the industry as banks no longer have this distinct funding advantage compared to private mortgage lenders. Higher spreads might make alternate capital market funding sources such as RMBS a viable alternative.

CMBS Market Commentary

Underlying performance of Canadian CMBS continues to be strong with only 7 loans totalling 0.30% of the outstanding CMBS universe more than 30 days delinquent based on April 2012 remittance reports. Despite robust loan level performance it's been nearly fifteen months since Canadian CMBS investors have scrutinized freshly originated CMBS product. That deal, a $206m two-borrower transaction brought to market in January 2011, ended a nearly three and a half year dry spell at the time. All told Canadian CMBS issuance has been virtually non-existent for close to 5 years and a market that once accounted for over 25% of all new commercial real estate debt in Canada now represents a modest 7.7% of the wider commercial real estate debt market according to our newly released 2011 survey. This represents a 0.5% decline compared to the 8.2% figure in 2010. Moreover, we expect this downward trend to accelerate in the coming years as conduit loans originated near the peak of the market begin to mature over the next couple of years.



All is not lost though. As highlighted in Exhibit 5, secondary market yields compressed modestly since our last quarterly commentary nudging the economics of new issuance closer to the level we believe necessary to facilitate a market revitalization. The results of our 2011 survey also highlight the degree to which the optimists outweigh the CMBS naysayers. We asked Canadian lenders if they felt the market would see a return of CMBS in 2012, and if so, how much issuance we should expect. Twenty of twenty-three lenders expressed their expectation of at least one CMBS issuance in 2012 with an average volume expectation of $230m.

With the notable exception of size – at its peak the US CMBS market was more than 50 times that of the Canadian CMBS market – the clip of CMBS issuance in Canada has historically displayed a relatively high correlation with that of its US counterpart. Conduits first ventured into Canada in the late nineties, a number of years after their inception in the US. Both markets enjoyed a roughly four-to-fivefold increase in

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issuance volumes between 2000 and their respective peaks in 2006 and 2007, and both have struggled to regain their footing following the recession. There are, however, a number of encouraging developments south of the border. Spread compression since our last report has mirrored that of the Canadian CMBS market and after a slow first quarter, US CMBS volume is now on track to reach $20 billion by midyear, representing a 15% increase over the equivalent 2011 period.

If 2012 US issuance falls in line with current expectations of $38 billion, US CMBS volumes will total roughly 17% of their 2007 peak. Were the Canadian market to reach 17% of its previous peak, 2012 Canadian CMBS volumes would approach $700m. While it's a little early to say we expect the Canadian market to mirror the US in terms of tracking peak volumes, we would be surprised if 2012 Canadian CMBS issuance doesn't exceed the consensus estimate of approximately $230m provided by twenty-three Canadian lenders we surveyed earlier this year.

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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