



AUGUST 2016

# Commercial Mortgage Commentary

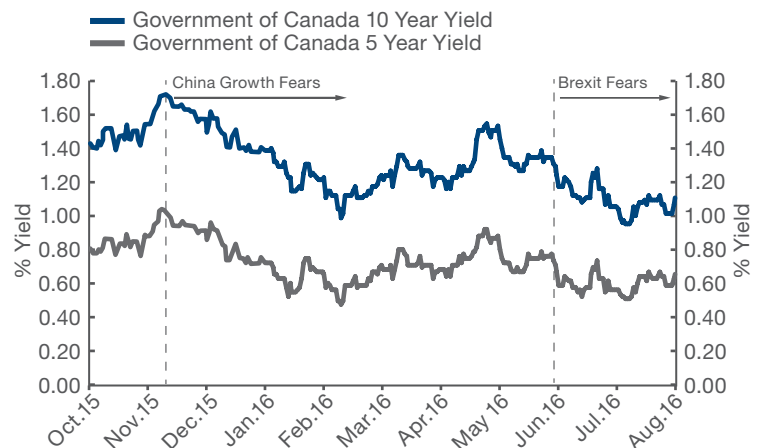
CANADA'S MORTGAGE COMPANY™

## Introduction

H1/16 was one of the more volatile first halves the credit markets have seen in a long time. With the credit markets adopting a risk-off tone to start the year over concern of slower growth coming out of China and the derivative impacts on the resource-heavy Canadian economy, the 5-year Government of Canada (“GoC”) bond traded as low as 49 bps before rebounding to a high of 93 bps on the back of stronger growth out of the US. This reversal was short-lived, however, as the 5-year bond yield subsequently fell following developments in Europe including Britain’s referendum to exit the European Union.

With the markets pricing no chance of a rate hike at the September 7 Bank of Canada meeting and investors generally in summer hibernation mode, it is unlikely we will see any major moves in short-term rates in the near-term, subject to any unforeseen shocks to the economy.

5-year Government of Canada yields traded as low as 49 bps and as high as 93 bps during H1/2016

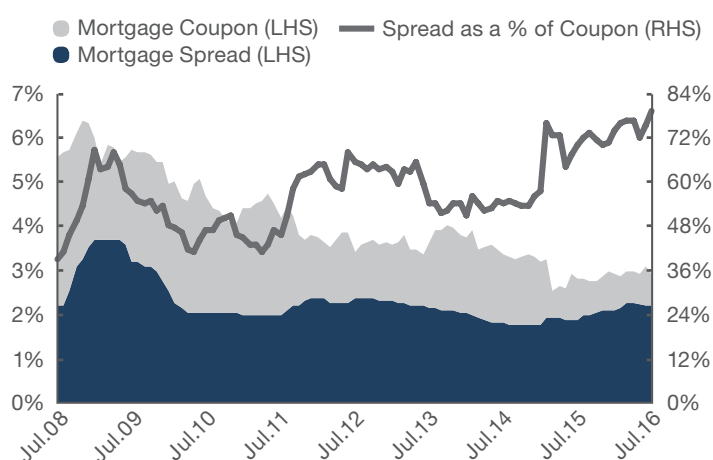


Source: Bloomberg, CMLS Mortgage Analytics

## Commercial Spreads

Commercial spreads on high-quality assets are currently being priced in the 190 to 215 bps range for 5-year deals and 205 to 230 bps for 10-year deals. This represents a decrease of 10 bps over Q1/16, but an increase of approximately 30 bps year-over-year. Credit spreads now make up 79% of 5-year commercial mortgage total return, an all-time high and well above the average of 57% since July 2008.

Commercial mortgage spreads have decreased 10 bps from Q1/16



Source: CMLS Mortgage Analytics

## Senior Unsecured Debt

Real estate senior unsecured debt issuance picked up slightly in Q2/16 over Q1/16 with 5 new issues totaling \$875 million vs. \$725 million over 3 issues in Q1/16. However, the \$875 million issued in Q2/16 is significantly lower year-over-year than the \$1.65 billion issued during the same period in 2015, with the difference largely a result of less refinancing activity and wider credit spreads in Q2/16.

This quarter's largest issuer, CT REIT, had 2 pari-passu issuances totaling \$350 million: a 10-year \$200 million offering (Series D) at 198 bps over the curve and a 5-year \$150 million offering (Series C) at a tight 143 bps, implying a 55 bps term premium between the two issues. The term premium is designed to compensate investors for taking on the risk of holding bonds of longer maturities vs. a series of shorter-term securities.

### Senior unsecured REIT debt issuance in 2016

2016	Issuer Name	Issue Size (Millions \$)	Issuance Rating	Term (Years)	Spread (BPS)
Q1	OMERS Realty Corp	375	AA (low)	8	186
	Choice Properties REIT	100	BBB	30	325
	Choice Properties REIT	250	BBB	7	217
<b>AVG</b>		<b>242</b>		<b>15</b>	<b>243</b>
Q2	First Capital Realty	150	BBB (high)	10	205
	Allied Properties	150	BBB (low)	6	306
	Cominar	225	BBB (low)	7	325
	CT REIT	200	BBB (high)	10	198
	CT REIT	150	BBB (high)	5	143
<b>AVG</b>		<b>175</b>		<b>8</b>	<b>235</b>

Source: Bloomberg, CMLS Mortgage Analytics

## Equity

After a slow Q1, equity issuance for Canada's REITs picked up with \$1.2 billion in total issuances year-to-date reflecting a better tone in the equity markets with the TSX Capped REIT Index up +22.4% YTD vs. the TSX Total Return Index of 13.6%. The outperformance is likely in large part due to the declining 10-year bond yield and potentially to a lesser extent due to incremental demand from investors repositioning portfolios in advance of the creation of an eleventh GICS sector, Real Estate. The new Real Estate Sector will be implemented on September 1, 2016.

### Real Estate Equity Primary Issuance in 2016

2016	Issuer Name	Issue Size (Millions \$)	Issue Date
Q1	City Office	121	3/30/2016
	Plaza Retail	23	3/31/2016
Q2	NorthWest Healthcare Properties	69	4/20/2016
	Crombie	132	5/12/2016
	Mainstreet Health	142	6/2/2016
	Killam Apartment	98	6/2/2016
	Pure Industrial	150	6/15/2016
	Artis	115	6/17/2016
	Summit Industrial Income	30	6/17/2016
Slate Office	51	6/24/2016	
Q3	WPT Industrial (Pending)	79	7/19/2016
	True North Construction (Pending)	9	7/22/2016
	NorthWest Healthcare Properties (Pending)	50	7/25/2016
	Inovalis (Pending)	40	7/25/2016
	American Hotel Income Properties (Pending)	90	7/26/2016
	<b>YTD</b>		<b>1,199</b>

Source: Bloomberg, CMLS Mortgage Analytics

## CMBS

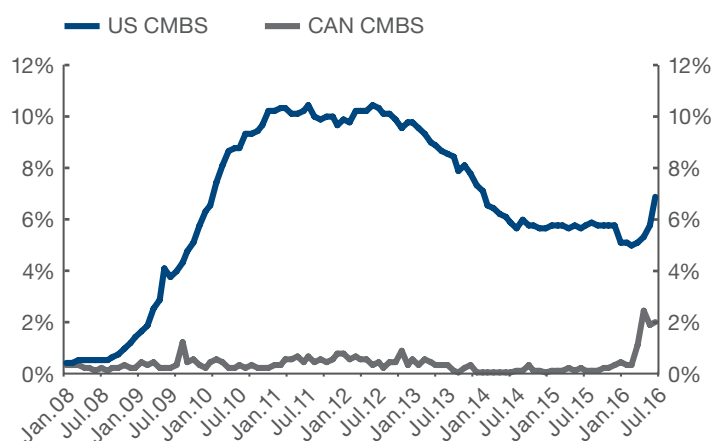
CMBS issuance has been muted thus far in 2016 with only one new deal brought to market in May (REAL-T 2016-1). Despite a general tightening of spreads in the capital markets, CMBS investors continue to demand a premium to hold CMBS bonds, making it challenging for lenders to offer competitive rates to borrowers. With \$1.3 billion in CMBS loans maturing in Q3 and Q4, it is likely that many of these loans will have to be refinanced outside of the CMBS market.

After a protracted period of minimal delinquency rates, Canadian CMBS delinquency rates ticked up in May, reaching a high of 2.4%. The recent spike in Canadian CMBS delinquencies was largely driven by regional economic pressure stemming from the turmoil in the Alberta energy market, with all 7 of the currently delinquent loans secured against properties in Alberta.

Despite the recent spike, the Canadian CMBS delinquency rate still remains considerably lower than the US, with the current spread between US and Canadian delinquencies of 5.90%, slightly below the average of 6.24% since 2008. Over the last 8 years, US delinquency rates averaged 6.58% vs. 0.34% in Canada.

The chart below shows the DBRS DQ1 Index, which measures CMBS loans that are 30+ days delinquent on their debt service obligation. A link to the DBRS CMBS delinquency data can be found [here](#).

### Canadian vs. US CMBS Delinquency Rates 2008 – 2016



Source: DBRS, CMBS.com, CMLS Mortgage Analytics

**Notes:** Includes 30+ days delinquent, foreclosure, specially serviced, deed in lieu of foreclosure, note sale, REO & non-performing balloon loans

## High Yield

In Q2 2016, Timbercreek MIC (TSX: TMC) and Timbercreek Senior MIC (TSX: MTG) merged to form Timbercreek Financial (TSX: TF). The newly formed MIC currently has a book value of approximately \$650 million (more than double the size of any other publicly traded MIC) and total capital of over \$900 million, adding increased diversification and potentially increased liquidity in an otherwise illiquid MIC sector. The new entity's fee structure will also be more aligned with industry standards, with the elimination of TMC's performance fees and the reduction of its management fees from 1.20% to 0.85%.

Timbercreek also announced a \$40 million 5-year convertible unsecured subordinated debenture bought deal in July. The securities were issued to yield 5.40% with a conversion price of \$10.05 (25% premium).

MIC dividend yields may be viewed as a reasonable proxy for high yield mortgage debt pricing given the composition of their portfolio

and the 100% payout ratio. Sector dividend yields are currently trading at 7.7% (post financial crisis range of 6.77% - 8.79%), slightly below their historical average, indicating market expectations for higher growth in the future or alternatively, overpriced shares.

### MIC sector average dividend yields since 2008



**Notes:** Includes average dividend yield of Timbercreek Financial Corporation (formerly Timbercreek Senior MIC and Timbercreek MIC), Trez Capital Senior MIC, Trez Capital MIC, Atrium, Firm Capital, MCAN. Source: Bloomberg, CMLS Mortgage Analytics

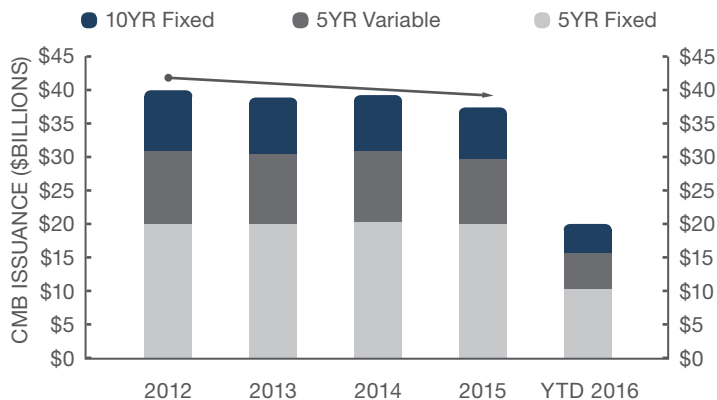
## CMHC

Canada Housing Trust issued \$5.5 billion of Canada Mortgage Bonds in Q2/16, bringing the total to \$20.0 billion for H1 2016, on track to hit the \$40.0 billion cap for calendar 2016. Total annual issuance of CMB has been on a declining trend since 2012, driven primarily by a decline in investor demand for 10-year fixed-rate product and to a lesser extent, 5-year variable rate product. Given the decline in demand for 10-year fixed and 5-year variable product, CMHC is taking steps to allow for greater flexibility to upsize fixed-rate deals in times of strong demand in order to meet their stated goal of \$38 - \$40 billion of annual CMB issuance. As a result, we may see some of the slack in demand of 10-year fixed- and 5-year variable-rate product picked up by larger 5-year fixed-rate issues should demand warrant, as it did in Q2/16.

From a pricing perspective, we are currently seeing spreads on new multi-family CMHC insured mortgages of 95 - 105 bps for

5-year terms and 105 bps - 110 bps on 10-year terms, down approximately 5 bps Q/Q over Q1/16.

Annual CMB issuance trending down due to declining investor demand for 10-year fixed & 5-year variable product



Source: CMHC, Bloomberg, CMLS Financial

## Events Calendar

Date	Event
<b>Commercial Real Estate Industry Events</b>	
September 7	Canadian Apartment Investment Conference (Toronto)
September 8	Canada's REIT Conference (Toronto)
September 19	North American Real Estate Conference (Chicago)
October 6	Real Estate Strategy and Leasing Conference (Toronto)
October 19	Ottawa Real Estate Forum
October 25	Calgary Real Estate Forum
November 1	Vancouver Real Estate Strategy and Leasing Conference
November 29	Global Property Market (Toronto)
November 30	Toronto Real Estate Forum
<b>Economic Data Releases</b>	
August 5	Employment (CAN & USA)
August 17	Federal Open Market Committee Meeting (US)
August 26	GDP First Revision (US)
August 31	Q2 GDP (CAN)
September 7	Bank of Canada Rate Announcement
September 21	FOMC Rate Decision (US)

## About CMLS Financial Ltd.

CMLS Financial Ltd. (CMLS) 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.

## 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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