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FEBRUARY 2017

Commercial Mortgage Commentary

CANADA'S MORTGAGE COMPANY™

Economy

2016 marked a strong year for Canada on paper: the TSX Composite posted a 17.5% gain following an 11% drop in 2015; the price of oil climbed to the mid-$50's after bottoming out near $26 per barrel earlier in the year; and both domestic and global economic indicators remained stable if not improved. Despite these encouraging trends, Canadian investors are cautious heading into 2017 and a general sentiment of uncertainty appears to have taken hold. The Bank of Canada echoed these sentiments by maintaining the key policy interest rate at 0.50% for the 12th consecutive meeting in early 2017, citing undiminished global uncertainty.

Uncertainty going forward is largely driven by global headlines that carry unpredictable and consequential effects on the Canadian landscape. Real estate lenders weigh the potential impact of the following headline news on the profitability and success of their portfolios in 2017.

US Policies: Newly elected President of the United States, Donald Trump, made it clear that his administration will follow an "America first" agenda, laid out in various campaign promises and protectionist rhetoric throughout the election cycle. Canadian investors will have a keen eye on which policies the new administration successfully enacts, and their subsequent impact on Canada.

Future of Oil: Recent developments appear encouraging for Canada with the BC approval of Kinder Morgan's pipeline expansion, a revival in Keystone XL pipeline courtesy of Trump, and OPEC production cuts. Countering the positive news is the continued increase in US oil production, which threatens to drive down price and the demand for Canadian oil. A struggling Alberta market is heavily influenced by oil, and real estate investors optimistically look towards a reversal.

Canadian Government: The government continues to undertake measures to dampen Canada's booming real estate market. The brunt of these policies is focused on the residential market, but commercial real estate is not immune to this intervention. Stricter mortgage qualification, lender risk sharing and foreign investment monitoring are some ways the government has exerted its influence thus far.

Brexit: Q4/16 saw British Prime Minister, Theresa May, acknowledge that Britain will leave the European Union. Besides the potential for short-term market or economic disruptions, the execution is being watched closely by Canadians as Britain is Canada's 3rd largest trade partner. A poorly executed "Brexit" may negatively impact the Canadian economy, further hurting real estate and commercial activity.

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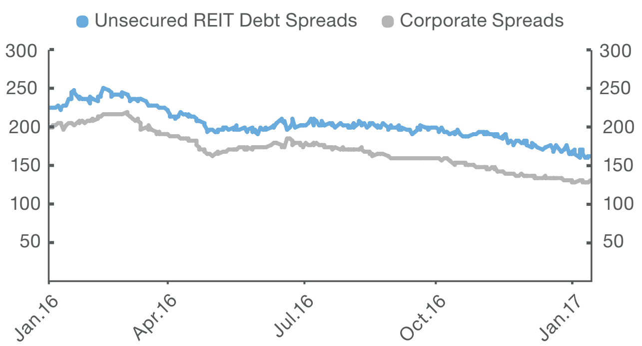
Commercial Spreads

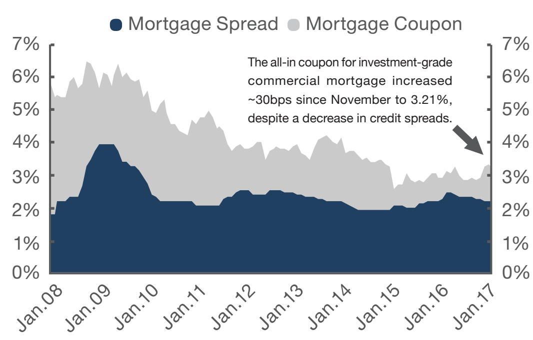
Yields on Government of Canada bonds ("GOC") increased 45 to 60 basis points ("bps") since November, with the 5-year GOC at 1.16% and the 10-year GOC at 1.83% as of February 1st closing. The increase in GOC yields coincided with the US presidential election results and a 65 to 75 bps increase in US Treasuries. As per the Bank of Canada Monetary Report released in early January: "The rapid back-up in global bond yields, partly reflecting market anticipation of US fiscal expansion, has pulled up Canadian yields". Both countries saw the yield curve steepen as well, with yields on longer term bonds increasing by almost 15 bps more than shorter term bonds.

Rapid increases in government yields have a negative correlation with spreads on credit instruments. Spreads on 5-year Canadian corporates and senior unsecured REIT debt decreased by approximately 20 bps since November, and the CDX Investment Grade Index decreased by 15 bps. With fresh budget allocations chasing deals to start the new year, commercial mortgage spreads tightened by 5 to 10 bps since November as well. Indicative spreads on high quality assets are observed at being in the 180 to 200 bps range for 5-year money, and 195 to 215 bps on 10-year money.

5-year credit spreads continue to inch tighter since November



Commercial mortgage spreads compressed 5 to 10 bps



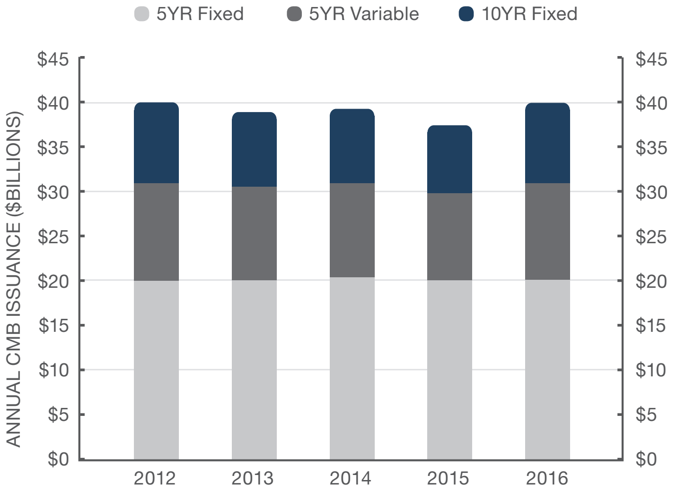
Source: Bloomberg, CMLS

CMHC

Canada Housing Trust issued $9.75 billion of Canada Mortgage Bonds ("CMB") in Q4/16, bringing total issuance to $40 billion for 2016. Issuance included a $2.25 billion re-opening of a 10-year fixed rate note, a $2.5 billion initial opening of a 5-year variable rate note, and a $5 billion re-opening of a 5-year fixed rate note. Annual NHA MBS multi-family pools 965 and 966 issuance reached $7.53 billion, representing an increase of 20% Y/Y and sustained upward momentum since 2014.

The Minister of Finance has authorized CMHC to provide $40 billion of new guarantees under the CMB program and an increase in market NHA MBS from $105 billion to $130 billion for 2017. Effective April 2017, 50% of an issuer's unused NHA MBS guarantee allocation for the prior year will be subject to a 1 bps administration fee. The penalty will likely smooth out allocation of NHA MBS guarantees throughout the year and discourage issuers from overbidding.

From a pricing perspective, spreads on CMHC insured products are unchanged from Q3/16, with 5-year terms in the range of 90-100 bps and 10-year terms in the range of 95-105 bps.



Source: Bloomberg

Senior Unsecured Debt

Real estate senior unsecured debt issuance totaled $1.5 billion in Q4/16, marking Q4 as the highest volume quarter since early 2015. On the back of a strong final quarter, 2016's total annual issuance of $3.9 billion is equal to the total issuance in 2015, but far from the peak issuance of $6.2 billion in 2014. Q4/16 comprised 5 issues, the largest of which were by Brookfield and Granite REIT at $500 million and $400 million, respectively. Q1/17 is off to a quick start, with a total of 3 issuances in January totaling $650 million. The January 2017 issuance total alone represents 90% of the total issuance in Q1/16.

New issues are indicative of spread compression in the space, with H&R REIT's 7-year note spread tightening almost 20 bps against the Q4/16 6.5-year note. Secondary market trading of senior unsecured REIT debt also indicates towards spread compression, with the 5-year benchmark spread down 20 bps from 185 bps to 165 bps since November. We observe that senior unsecured REIT debt is trading at approximately the same spread as conventional mortgages secured by best in class assets with investment grade covenants.

2016	Issuer Name	Issue Size ($Millions)	Issuance Rating	Term (yrs)	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
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
Q3	Riocan	250	BBB	4	160
	Smart REIT	250	BBB	10	244
	Smart REIT	100	BBB	8	217
	First Capital Realty (re-open)	150	BBB (high)	10	217
Q4	Brookfield Asset Management	500	AL	10.5	260
	H&R REIT	200	BBBH	6.5	221
	Omers Realty Corp	230	AAL	6.5	104
	Morguard Corp	200	BBBL	4	315
	Granite Reit Holdings LP	400	BBB	7	256
	Total/Average	**3,880**		**9**	**229**

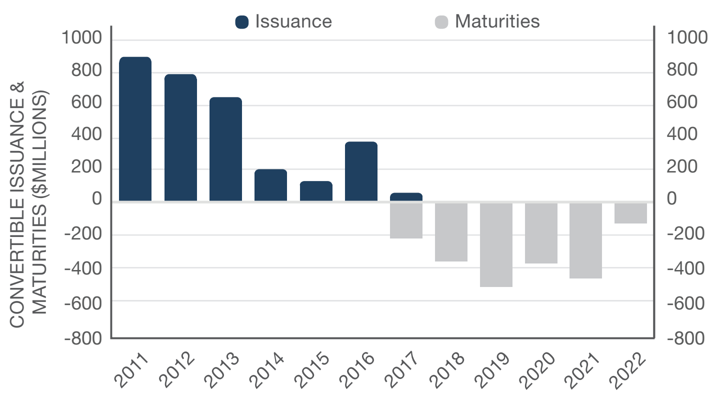
2017	Issuer Name	Issue Size ($Millions)	Issuance Rating	Term (yrs)	Spread (bps)
Q1	H&R REIT	200	BBBH	7	202
	H&R REIT	150	BBBH	2.5	CDOR + 123
	Riocan	300	BBBH	6	160
	Total/Average	650		**5**	**181**

Source: Bloomberg

Convertible Debenture

Annual issuance for 2016 totaled $378 million, breaking from the trend of declining yearly issuance observed over the past few years. Q4/16 brought 3 convertible debentures totaling $267.5 million to market, representing the highest issuance in a single quarter in almost 4 years. The largest issuance over the quarter was a 5-year, $175 million note bearing a 4.5% coupon and conversion premium of 43% by Morguard REIT, with net proceeds used to repay an existing convertible debenture coming due. The second highest issuance for the quarter was by NorthWest Healthcare Properties REIT for a 5-year, $70 million note bearing a 5.25% coupon and a conversion premium of 33%. Net proceeds for this debenture were used to pay off high interest Brazilian term loans, to invest in European assets, and for other general purposes.

Q1/17 has already seen some activity in the convertible space. Timbercreek Financial announced a 5-year, $40 million issuance bearing a 5.45% coupon and conversion premium of 15%. Timbercreek intends to use the net proceeds to repay amounts owed under its secured revolving credit facility and to subsequently draw on the credit facility for future mortgage funding. $200 million of convertible debentures mature in 2017, with $82.5 million scheduled to pay out in Q2/17. Coupons on the maturing issues range from 5.75% to 7.75%.



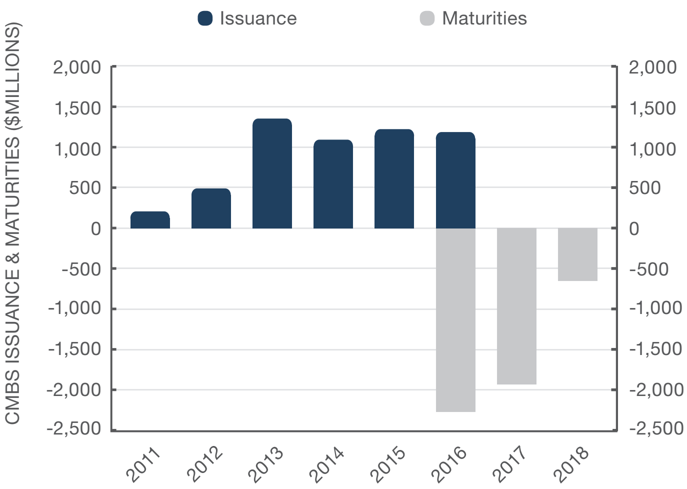
Source: Bloomberg

CMBS

The CMBS market has remained stagnant since IMSC's $352 million deal in October 2016. Issuers continue to originate new loans for CMBS deals in 2017 despite what appear to be slim margins. CMBS issuers profit by selling CMBS bonds at a weighted average price greater than the par value of the mortgages originated. For their part, investors are typically willing to pay more for the bonds as they offer more liquidity than whole loans and the bonds can be structured to appeal to a larger pool of investors.

Given current indicative CMBS bond prices, commercial mortgage spreads in the private market would have to increase significantly from current levels before we see an uptick in CMBS issuance. As a result of the economics noted above and the significant number of CMBS mortgages coming due in 2017, it is likely we will see negative net new issuance again in 2017 (i.e. more runoff than new issuance).

CMBS maturities likely to outstrip issuance in 2017



Source: Bloomberg

Events Calendar

Date	Event
Commercial Real Estate Industry Events	
Feb 16	Quebec Apartment Investment Conference
Feb 28	RealCapital
Mar 28	Montreal Real Estate Forum
Economic Data Releases	
Feb 28	Q4 GDP Second Revision (US)
Mar 1	Bank of Canada Rate Announcement
Mar 2	Q4 GDP (CAN)
Mar 10	Employment Change (CAN & US)
Mar 15	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.

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