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Commercial Mortgage Commentary

CMLS Mortgage Analytics Group

The Commercial Mortgage Commentary aims to inform the market on 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.

Commercial Real Estate & COVID-19

CECRA and Borrower Payment Concerns

The federal government's Canada Emergency Commercial Rent Assistance Program (CECRA), has been top-of-mind for many small business owners, property owners, and lenders who have been affected by the pandemic. Eligible property owners can receive a forgivable loan from the government equaling 50% of rental payments for the applicable period; 25% is to be paid by the tenant with the property owner foregoing the remaining 25%. As of July, the federal finance ministry reported that applications from property owners representing approximately 29,000 small businesses had been approved. This amounted to about $221 million in funding, well below analysts' initial expectations. Polling by the Canadian Federation of Independent Business (CFIB) indicates part of the lackluster uptake was due to the initially cumbersome application process as well as the fact that property owners are being asked to forgo a quarter of rents. Additionally, the poll also suggests that 60% of Canada's small businesses do not meet CECRA requirements. Despite the ongoing rent concerns from some tenants and property owners, lenders remain optimistic about the performance of their portfolios in the near-term. Our Q2 Lenders Sentiment Survey found that over 90% of lenders expect less than 3% of their portfolio would require loan payment relief during Q3.

First Mortgage Bonds

At the end of Q2, DBRS Morningstar updated ratings criteria for Canadian First Mortgage Bonds (FMBs) following the finalization of its North American Single-Asset/Single-Borrower Ratings (NA SASB) Methodology in March 2020. Among the changes listed in the new methodology were updates to LTV sizing benchmarks and cap rate ranges employed in DBRS Morningstar's credit risk analysis. The new methodology came about after the consolidation of DBRS's original NA SASB methodology and Morningstar's US CMBS SASB methodology. In general, the changes resulted in lower property valuations, potentially impacting bond ratings.

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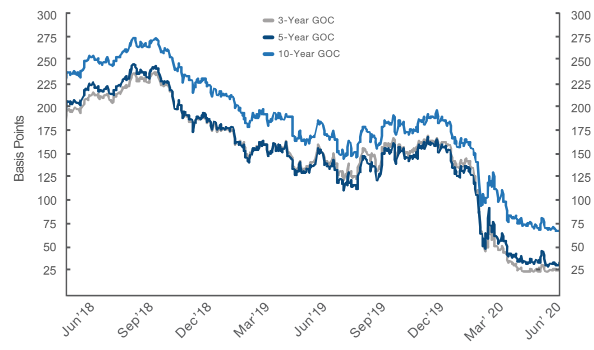
Economic Environment

Government of Canada Bond Rates Fall to Historic Lows

After staging a small rally at the start of the quarter, the benchmark Government of Canada (GoC) rates continued their downward trend to touch historic lows across all tenors of the yield curve. Meanwhile, the bank prime lending rate remained at 2.45%, the lowest its been in over a decade. Banker's Acceptance rates also fell sharply during the course of the quarter to end around 0.30%.

In other news, the Bank of Canada's latest Monetary Policy Report outlined a commitment to hold its overnight interest rate at 0.25% until the 2% inflation target is met. The report also forecasts Canadian GDP to decline 7.8% in 2020, after which growth would resume back to normal levels. In response, the Bank has implemented a quantitative easing program via the ongoing purchase of at least $5 billion per week in GoC bonds.

5YR Mortgage Premium over BBB-Rated Corporate Bonds



Source: Bloomberg

Canada's Credit Rating Takes a Hit

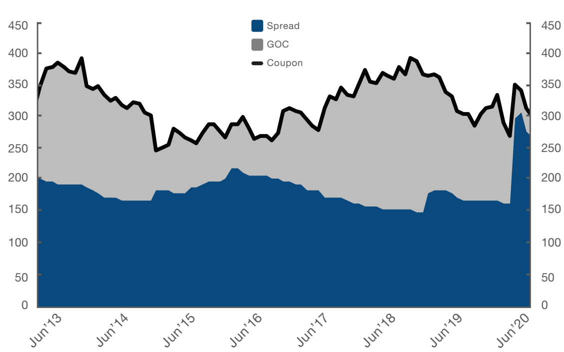
In June, Fitch ratings announced a downgrade of Canada's sovereign credit rating from AAA to AA+. The agency, one of the three largest credit raters in the US, cited the federal government's recent borrowing to support the economy in the wake of the COVID-19 lockdown. However, Canadian risk-free yields remain near historic lows.

Commercial Mortgages

After skyrocketing at the end of Q1, commercial mortgage spreads were fairly quick to reverse course in Q2. While still remaining considerably higher than levels observed at the start of the year, spreads for higher quality assets saw a considerably decline to end the quarter slightly above 200bps. Moreover, even with broader market volatility beginning to subside, many lenders still find themselves competing for higher quality deals, putting sustained downward pressure on spreads.

Lower quality assets have struggled to keep pace for the most part, but the quality gap shows signs of shrinking as markets continue to stabilize. However, cost of debt for borrowers has remained relatively stable compared to the end of last year, as the rise in spreads has been largely offset by the fall in GoC rates. The decline in commercial mortgage spreads has lagged Canadian BBB corporate bonds, which are often a leading indicator for the commercial mortgage sector. The BBB index was more than 100bps below mortgages at the end of Q2, representing a significantly wider gap than the long-run average of ~50bps.

5YR Conventional Spread vs Coupon



Source: CMLS, Bloomberg

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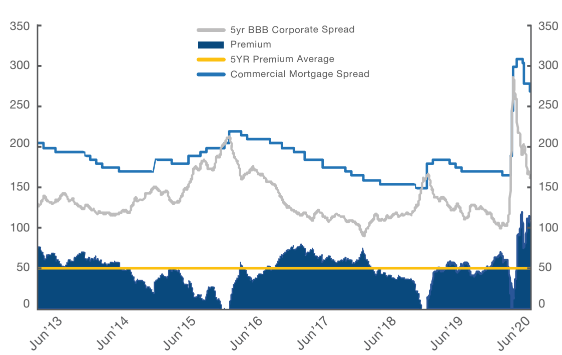

Source: CMLS, Bloomberg

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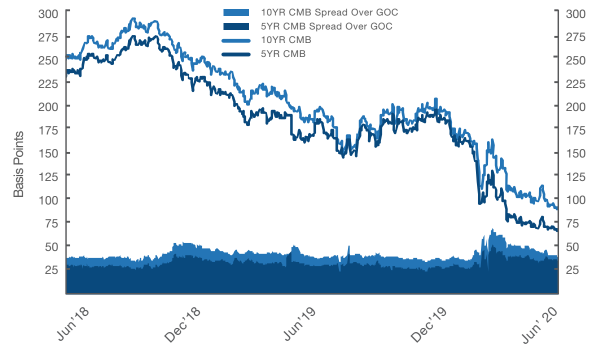
CMHC

As with GoC rates, Canada Mortgage Bond (CMB) rates touched historic lows at the end of Q2, with 5yr rates averaging below 70bps and 10yr rates averaging below 100bps in June. CMB rates are the most common base rates used by lenders of CMHC insured loans.

CMBs Over Time

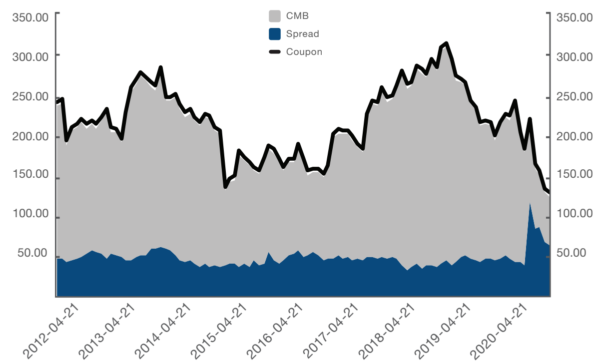


Source: CMLS, Bloomberg

Changes to CMHC Use of Funds Guidelines

In late May, CMHC announced new restrictions on borrower access to insure refinance loans. The aim was to ensure refinance proceeds were only being directed to the purchase, maintenance/improvement, and construction of multi-family properties. However, the ambiguity of the policy led many borrowers and lenders to wonder if the CMHC market was poised to shrink dramatically. That being said, after an initial slowdown in deal flow, lenders report increasing transactions and many expect to hit deal volumes similar to last year. While alternative financing may be necessary for some borrowers in the short-term, there is no expectation of a large shift of long-term capital from the insured market to the conventional or high yield space.

5YR Insured Spread vs Coupon



Source: CMLS, Bloomberg

CMBS

As many expected, no new CMBS issuances took place in Q2. Market uncertainty hampered securitization economics and deal flow. That said, Fitch Ratings held its credit rating of Canadian CMBS stable at the end of Q2. In holding their CMBS rating steady, Fitch cited the fact that there have been few payment relief requests by borrowers as of yet, and that programs like CERB and CECRA have helped to ensure some degree of stability in rent collection. Despite more than one-third of CMBS being secured by retail properties, which are currently viewed with a high degree of uncertainty, Fitch noted that many of these retailers operated in essential industries such as groceries and drug stores. However, statistics recently released by DBRS for May indicate that delinquencies in the Canadian CMBS market increased to 3.7% from 2.3% in April and 0.7% in March.

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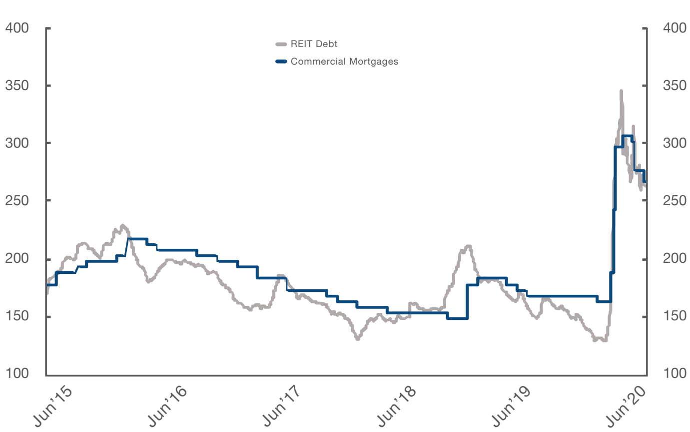
REITs

While a number of institutions issued new debt in Q2, REIT unsecured debt yields remained considerably higher than their long-run average despite reversing course early in the quarter. REIT debt yields are often considered a leading indicator for commercial mortgage spreads and their recent volatility could allude to parallel moves in the commercial mortgage market.

REIT Performance During the Pandemic

Like many sectors of the Canadian economy, REIT market values plummeted at the end of Q1. Analysts since revised their forecasts in Q2 on the basis of stronger than expected rent collection, but still the Q2 TSX REIT index return of 7.22% trailed the overall TSX return of 15.97%.

5YR Mortgage Premium



Source: CMLS, Bloomberg

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	3.25	97
	H&R REIT	400	BBBH	5	366
	SmartCentres REIT	300	BBBH	10.5	296
	SmartCentres REIT	300	BBBH	7	262
	Granite REIT Holdings LP	500	BBB	7	260
	Choice Properties REIT	500	BBB	7	240
	Allied Properties REIT	300	BBB	8	265
	Cominar REIT	150	BBH	5	557
	Total Issue Size/Average Term Q2	1200		7.5	
	Total Issue Size/Average Term 2020	**2,975**		**5.61**	

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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