JANUARY 2023

Commercial Mortgage Commentary

Market Trends

The Cost and Availability of Debt Heading into the New Year

Historic tightening by central banks and a number of threats to global economic stability have tilted market expectations toward a recession. While the full impact of a potential recession on commercial real estate lending remains unclear, lenders have already become more cautious when allocating capital in the current market environment and liquidity has tightened noticeably relative to just a few months ago. As evidence, CBRE's most recent Canadian Real Estate Lenders' Report found that lenders intend to be much more selective when bidding on deals in 2023. Just 48% of lenders expect to be actively or very actively bidding in the new year versus 90% last year. Similarly, a recent survey of Canadian mortgage lenders by Intellifi, a commercial real estate services firm, found that more than a third plan to reduce their origination volumes in 2023 relative to the prior year, while 40% plan to keep them stable. Real estate borrowers are already anticipating more difficulty accessing capital in the new year with about 47% of respondents to PWC's latest Emerging Trends in Real Estate report forecasting an undersupply of debt capital for acquisitions, refinancings and developments in 2023, up 34 percentage points from last year.

Economic uncertainty aside, the relative return of publicly traded fixed income instruments has likely also led to less capital availability for private commercial mortgage debt. For example, the yield on the average 5yr corporate BBB-rated bond and the average conventional mortgage were almost at par from late September until early December. According to research from Intellifi, an index of the two sub-asset classes showed that the average difference between the two through Q4 was just 10bps compared to a historical average of about 50bps. And while the delta did widen through December as corporate bond spreads declined, if bond yields begin to rise again in 2023, capital inflows into private commercial mortgage debt funds could remain muted relative to the past couple of years.

The softening in lenders' bidding intentions and a more challenging outlook for access to mortgage capital comes at the same time that borrowers have seen mortgage costs soar and underwriting standards tighten. Insured and conventional mortgage rates averaged 3.95% and 5.20% in December, a near doubling year-over-year (YoY), driven by a combination of rising government bond yields and mortgage spreads (see Commercial Mortgage Rates section below for more details). Higher interest rates have greatly impacted debt-service-coverage (DSC) ratios, meaning that lenders have scaled back loan-to-value (LTV) on deals in order to meet lending guidelines. The CBRE Canadian Real Estate Lenders' Report found that 71% of lenders have either moderately or significantly changed their underwriting methodologies relative to last year, with uncertainty around appraisal valuations, more stringent sponsorship valuations and modelling for increased vacancy in properties being the most popular changes among a majority of respondents. Nearly half of lenders have increased DSC requirements and lowered maximum allowable LTV ratios.

All told, the commercial mortgage lending environment heading into 2023 is a sharp contrast to this time last year when mortgage rates and spreads were near historic lows, capital was plentiful, competition was high, and lenders were stretching underwriting standards to win business. That said, although the market has tightened considerably and real estate activity has declined, there remains ample capital available for the right deals. Contact your regional representative from CMLS Financial for more information.

Base Rates

The Bank of Canada (BoC) continued to hike its key policy rate in Q4, rounding out a historic year for Canadian monetary policy. Market interest rates climbed significantly through 2022 in accordance with central bank hikes. Government bond yields, Canada mortgage bonds, and the bank prime rate all reached new heights in Q4, driving commercial mortgage rates to levels unseen in over 10 years. That said, some easing in bond yields through the final two months of the year helped drive insured and conventional mortgage rates down relative to levels seen earlier in the quarter.

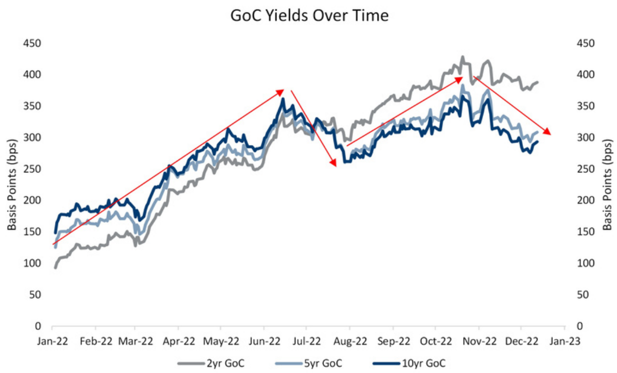
Bank of Canada Rate

The BoC key policy rate closed the year at 4.25%, having increased another 100bps in Q4. Cumulative hikes through 2022 totalled 400bps. A pause on additional rate hikes is now possible after the Bank stated at its December 7th interest rate decision that it will be "considering whether the policy rate needs to rise further to bring supply and demand back into balance and return inflation to target." At every previous meeting through 2022 the BoC stated explicitly that the policy rate would need to rise further. In several speeches since, BoC governors clarified that they remain willing to hike rates further if needed but that all decisions will be dependent on incoming economic data. So far, inflation has shown signs of easing in recent months, but prices continue to climb well above the BoC's comfort level. GDP and labour market data remain strong and were above expectations in Q4, which could put further pressure on prices and drive additional rate increases. The Bank continues to believe undershooting interest rate hikes would be more detrimental to the Canadian economy than the risk of overtightening interest rates and causing a recession. Economists at major Canadian banks are currently torn between a pause and a 25bps hike at the BoC's next decision in late January.

Government Bond Yields

Two-year, 5yr and 10yr Government of Canada (GoC) bond yields reached new decade highs on October 20th at 4.29%, 3.83% and 3.66%, respectively. However, signs of easing inflation and the prospect of less aggressive interest rate hikes by the BoC caused yields to decrease through the remainder of the quarter with declines ranging between 20-40bps from peak to quarter close. Two-year, 5yr and 10yr GoC bond yields finished the year at 4.09%, 3.39% and 3.30%, respectively.

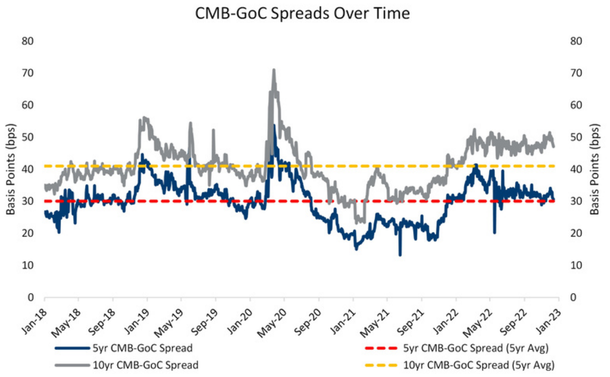
Despite some softening, GoC yields still more than doubled through 2022 and remain well-above their average over the past decade. The most notable trend, however, has been the sharp inversion in the yield curve since July when the 2yr GoC pushed above longer-term bond yields – typically a sign of a looming recession. The 2yr GoC was on average 88bps higher than the 10yr GoC in December, a level unseen since the early 1990s.



Canada Mortgage Bond Yield

Similar to GoC bond yields, Canada Mortgage Bond (CMB) yields fell through the latter part of Q4 after reaching decade highs on October 20th. Two-year, 5yr and 10yr CMB yields closed the year at 4.25%, 3.71% and 3.76%, respectively. The 2yr CMB more than quadrupled through 2022, pushing shorter-term yields above longer-term by a significant margin. The spread between 2yr and 10yr CMBs inverted in July and closed the year at an inversion of 50bps.

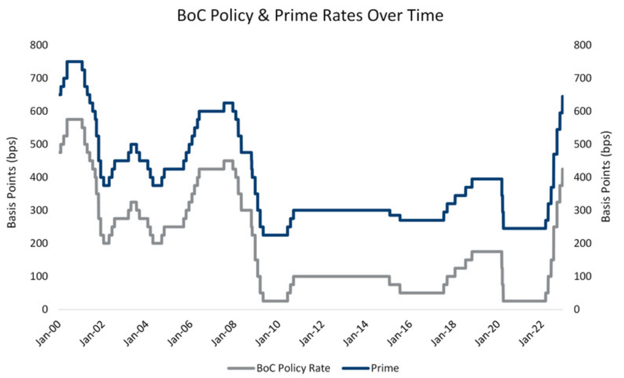
Looking at the relationship between CMB and GoC yields, relevant for those insured lenders bidding over GoC, CMB-GoC spreads remained fairly stable through Q4 and 2022, although somewhat elevated relative to historical averages. The 5yr CMB-GoC spread averaged 31bps in Q4 compared to an average of 30bps over the past 5 years, while the 10yr averaged 48bps compared to an average of 41bps over the past 5 years. There were two new primary market CMB issuances in Q4 – a $5 billion bond with a 5yr term and a fixed coupon of 3.60%, and a $1.25 billion floating rate bond priced at 33bps over the Canadian Overnight Repo Rate Average (CORRA) on a 5yr term.



Base Rate Changes Over Time						
		Delta (bps)				
	2022-12-12	QoQ	YTD	2 Years	5 Years	10 Years
Base Rates						
Bank of Canada Rate	**4.25%**	▲ 100	▲ 400	▲ 400	▲ 325	▲ 325
Canada Government 5yr	**3.09%**	▼ -23	▲ 183	▲ 266	▲ 120	▲ 170
Canada Government 10yr	**2.93%**	▼ -23	▲ 145	▲ 220	▲ 87	▲ 113
Canada Mortgage Bond 5yr	**3.39%**	▼ -25	▲ 183	▲ 277	▲ 124	▲ 169
Canada Mortgage Bond 10yr	**3.40%**	▼ -22	▲ 151	▲ 238	▲ 99	▲ 106
RBC Prime Rate	**6.45%**	▲ 100	▲ 400	▲ 400	▲ 325	▲ 345

Prime Rate

Prime rates continued their steep ascent in Q4 in unison with policy rate hikes at the BoC. Prime closed the year at 6.45%, up from 2.45% at the beginning of 2022. The key lending rate hasn't been this high since Q2 of 2001 and, in the over 2 decades since, has averaged 3.70%. Prime briefly neared its current level ahead of the Global Financial Crisis when it reached 6.25%. The run-up in prime, which is typically used as a base rate for higher risk floating mortgages and construction lending, has pushed up financing costs significantly for said deal types.



Commercial Mortgage Rates

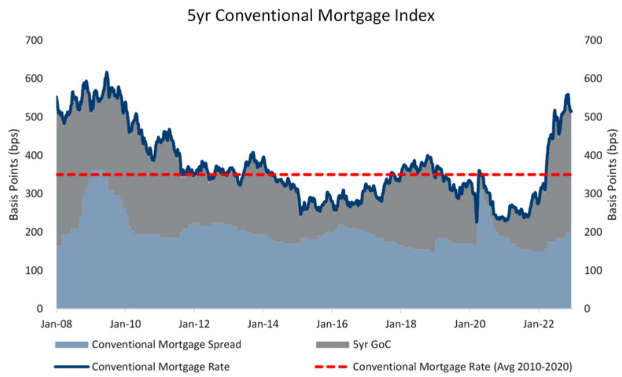
Conventional

Declining GoC bond yields in November and December brought some relief for conventional borrowers, despite rising credit spreads. Intellifi's 5yr Conventional Mortgage Index averaged approximately 5.20% in December, down from an average of 5.40% in October when rates peaked. Despite the decrease, borrowing costs remain significantly elevated.

The index is up about 85% YoY from an average of 2.82% in December 2021, and up about 50% from an average of 3.50% during the decade of 2010-2020.

Rising conventional mortgage spreads offset some of the easing in bond yields in Q4. Declining market liquidity and a lack of competition amongst lenders saw spreads for the typical 5yr mortgage rise to around 215bps over GoC from around 185bps in Q3. Spreads for the highest quality assets have increased substantially as well, with top tier spreads now in and around the low 200bps range. Conventional mortgage spreads began the year around 150bps and top tier assets were fetching spreads as low as 130bps, putting the year-to-date increase at about 50%.

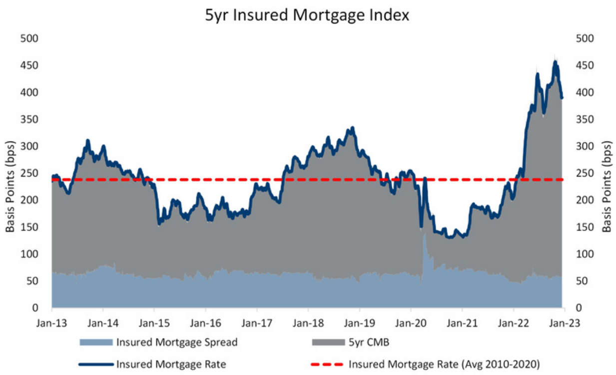
There continued to be very little activity for mortgages beyond 5yr terms, as has been the case through much of 2022. Lenders continue to prefer shorter-term mortgages given inversion in GoC bond yields and borrowers continue to prefer shorter-term mortgages under the assumption that rates will decline in the next few years. Those lenders that are bidding on deals in the 10yr space require significant term premiums with mortgage spreads some 30-40bps above 5yr mortgage spreads. Intellifi's 10yr Conventional Mortgage Index averaged 5.40% in December.



CMHC Insured

Declining CMB yields and stable credit spreads were a holiday boon to borrowers through the final months of 2022. The Intellifi 5yr Insured Mortgage Index averaged 3.95% in December, down from around 4.40% in October when CMB yields peaked. Longer-term rates were only marginally higher, with the 10yr Insured Mortgage Index averaging 4.02% in December, also down from 4.40% in October.

Although rates have softened, they remain significantly elevated when compared to much of the past decade. The 5yr Index was up approximately 90% YoY in December from and average of 2.10% at the end of 2021, and up 65% from an average of 2.40% over the decade of 2010-2020.



High Yield

Data from Intellifi's lender survey, as well as observed transaction volume, point to mortgage rates for senior ranking high yield debt rising some 100bps QoQ to a range of 7.50-10.00%. Market liquidity and deal activity remained depressed relative to earlier in 2022, with most activity skewed toward shorter-term multi-family bridge deals.

As for subordinate high yield debt, activity also remains quite muted. There was some evidence of subordinate multi-family deals with strong borrowers fetching coupons in the low 8.00% range toward the end of Q4, but for the most part, coupons are firmly in the double digits. Generally, subordinate debt was seen to fetch coupons in the 9.50-14.00% range.

Land and Construction

Unlike the past three quarters, lenders see a silver lining for construction projects heading into 2023. Confidence to lend on construction has seen some modest improvement as input costs begin to stabilize and the pace of rate hikes by the BoC eases. However, due to limited liquidity in the market and continued economic uncertainties, lenders generally remain conservative about allocating capital towards development projects. Multi-family continues to be the most resilient asset type when it comes to attracting capital.

As per Intellifi's lender survey, CMHC insured construction saw all-in coupons in the range 6.25-7.00% in Q4 (approximately equivalent to Prime minus 25bps to Prime plus 50bps as of December 2022), while conventional coupons were slightly higher in the range of 8.00-9.50% (approximately equivalent to Prime plus 150-300bps as of December 2022). Coupons for land servicing/acquisition deals generally fell in the range of 8.25-10.75% (approximately equivalent to Prime plus 175-425bps as of December 2022). Intellifi's survey found that CMHC insured construction remains the most desirable development deal type, attracting a high degree of interest from two thirds of respondents. Land was the least desirable development type with half of respondents reporting a low degree of interest and a fifth reporting no interest.

ABOUT CMLS FINANCIAL

CMLS Financial is one of Canada's largest independently owned mortgage services companies. Founded in 1974, we are proud to be Canada's Mortgage Company for over 45 years. With offices across the country, we provide a wide range of commercial lending services, residential real estate mortgages and institutional services.

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