CMLS
Canadian Mortgage Loan Services Limited

Commercial Mortgage Spread Commentary – 2nd Quarter 2010

Chris Brossard, CA, President chris.brossard@cmls.ca
Mark Achtemichuk, CA, CFA, Director, Mortgage Valuation mark.achtemichuk@cmls.ca
David Nygren, Senior Credit Analyst david.nygren@cmls.ca

June 2010

Spread Compression Slows but Coupons Reach New Lows

The rapid spread compression that commenced in the middle of 2009 decelerated in the second quarter. Spreads dropped modestly in April but have since been flat in May and June. However coupled with a twenty basis point rally in Canadian government bonds mortgage coupons continued their descent, reaching new lows. This descent occurred against a backdrop of a sovereign debt crisis in Europe and a widening of corporate bond spreads. As a result, the relative value in whole commercial mortgage loans compared to corporate fell sharply and is within striking distance of pre-recession levels.

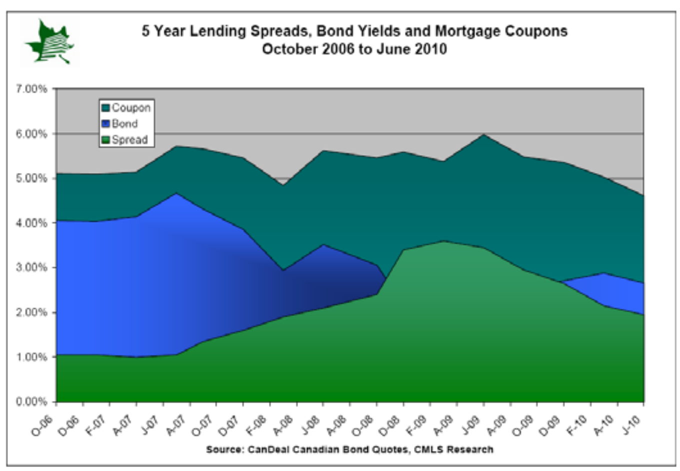
Current Market Spreads

High quality commercial mortgages attracted quotes of 180 to 210 basis points over Government of Canada (GoC) Bonds. This represents a minor reduction of 10 basis points from the March 2010 levels. Solid conventional multifamily loans are attaining spreads of 160 to 200 basis points, also only slightly less than last quarter.

CMHC insured lending spreads for multifamily loans have expanded to 90 to 120 basis points over GoCs. This bucks a two year trend of continuously falling CMHC insured mortgage spreads.

Conventional Mortgages

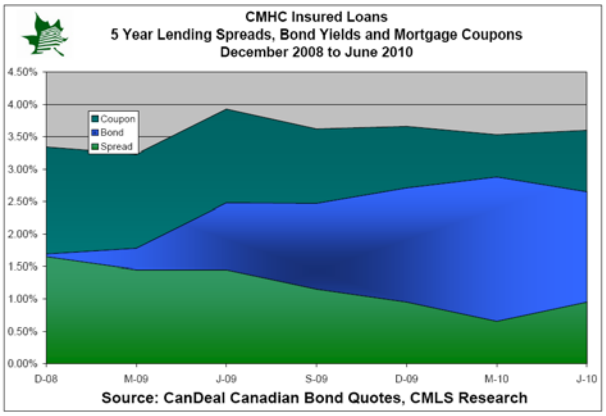
Commercial mortgage coupons continued to fall this quarter. Institutional quality five year mortgages are currently being originated with a sub five percent coupon. Compared with the first quarter of 2010, we have ended this quarter with a modest decrease in spreads and GoC yields. This has resulted in an overall decrease of approximately 40 basis points. It is interesting to compare the coupon levels from June 2009 to June 2010. Coupon Rates have decreased by 140 basis points which can almost entirely attributed to spread compression.



Allocations to commercial mortgages appear to be at reasonable levels, resulting in a relatively balanced market. Some institutions have been very active and have reached or should be nearing their mortgage allocation targets for 2010. Historically this might have created opportunities for patient lenders to take advantage of less competition and achieve more attractive spreads. However, there still appears to be a contingent of lenders who have reported being very quiet for the first half of 2010. Most lenders who are currently out of the market from a pricing perspective are not out by a significant margin. This should prevent any drastic expansion in spreads as less active participants start to make mortgage investments in the second half of the year.

We have heard of a few pending transactions for which proponents will be seeking very large loans by Canadian standards. It will be interesting to see how these transactions are received. Time will tell if any large lenders have the capacity and desire to secure these loans individually or if they will be syndicated or, perish the thought, structured.

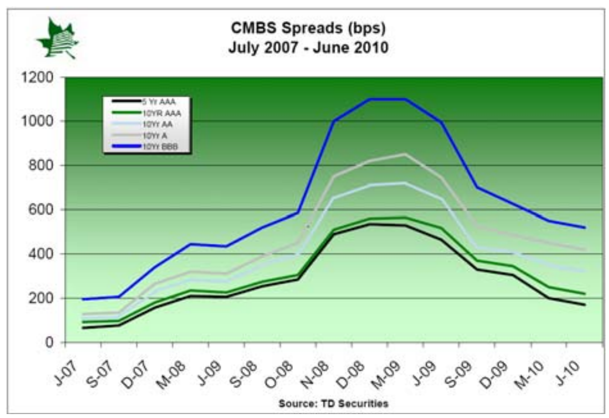
CMHC Insured Mortgages



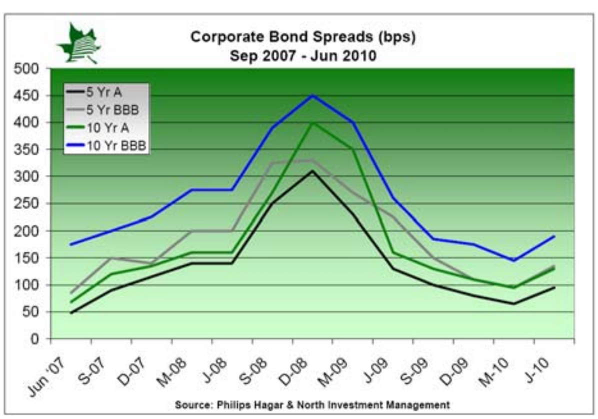
CMHC spreads, measured relative to Canada bonds, have increased by 25 basis points in the second quarter. This still continues to be an active market and the spread expansion has been almost entirely offset by a compression in GoC yields. The net impact to the borrower has been a negligible increase in the coupon rate.

CMHC coupons exhibit very little volatility when compared to traditional mortgage coupons. Many investors see value in this product as it provides a way to earn additional yield while still maintaining the full backing from the Government. International participation continues to be very strong in the Canada Mortgage Bond program although recent issuance has been somewhat lighter than the record sizes of the past few years. Foreign investors continue to be attracted to the strong sovereign rating of Canada.

CMBS Spreads



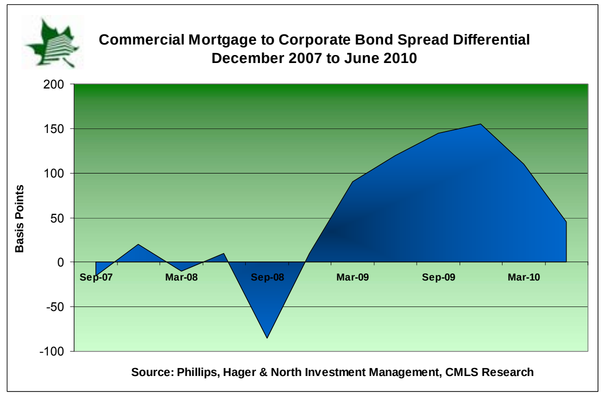
CMBS spreads continued to trend lower after their peak in the second quarter of 2009. Five year AAA spreads were reported to be at the 170 basis points level at the beginning of June. This is consistent with the spreads that we have seen commanded by very high quality conventional mortgages. We are curious to see whether CMBS spreads can maintain this level given the recent expansion in corporate bond spreads. CMBS product in Canada continues to exhibit minimal disruptions in performance with delinquent loans representing only 0.54% of the universe.



Corporate Bond Spreads

Corporate bond spreads reversed their downward trend for the first time since December 2008. Spreads across all terms and ratings increased this quarter. Five year single A rated corporate bonds increased by 30 basis points while ten year triple B rated loans increased by 45 basis points. No doubt the European sovereign debt crisis is causing ripples in bond markets world wide.

The differential between commercial mortgage spreads and triple B rated corporate bond spreads has narrowed substantially. However, the mortgage industry in Canada does not react in a uniform manner to such metrics. Some institutions will continue lending somewhat in a vacuum while others will quickly shift allocations to more liquid fixed income opportunities with comparable risk characteristics. Irrespective of the pace of strategic shifts in capital, eventually corporate spread movements have historically been an accurate indicator of mortgage spreads. This would suggest that we should see a bit of a pullback from mortgage investors as bonds now represent much better relative value than they did last year.



High Yield Market

The high yield mortgage market in Canada is fragmented and for the most part regional. There are very few truly national players. Most investors focus on the $1 to $10 million market with only a few sophisticated participants capable of managing the handful of available transactions in the $10 to $50 million high yield segment in Canada. This segment includes traditional short term second mortgages together with subordinated tranches of single whole loans.

Most participants in our survey report that they are flush with cash and that they are not seeing enough opportunities that match the risk profile desired by their investors. Land loans continue to be difficult to obtain and lenders who previously entertained these loans may only do so on a very cautious basis. Real estate transaction volume continues to be slow which decreases the need for individuals seeking short term secondary funds. We are starting to see some downward pressure on yields as lenders compete to lend their idle cash or commitments. High quality second mortgage opportunities attract significant attention. Second mortgages with conservative loan metrics, strong ownership, and attractive collateral are attracting quotes in the 7.5% to 9.5% range.

About Canadian Mortgage Loan Services Limited

Canadian Mortgage Loan Services and its affiliate Penmor Mortgage Capital Corporation have been originating and servicing commercial mortgages for over thirty five years. CMLS services a portfolio exceeding $3.5 billion. Penmor originates approximately $1 billion in commercial mortgages annually.

In addition, CMLS is a leading CMHC insured mortgage lender, active across Canada specializing in term mortgages secured by multifamily properties. Loan amounts available range from $1 million to $100 million and larger.

CMLS also provides mortgage valuation services to institutional mortgage investors, currently valuing in excess of $5 billion of mortgages per annum. Such services involve a review of each mortgage at origination and then on a periodic basis resulting in a recommendation of the appropriate spread to apply for the purposes of valuation. Introducing objective, third party valuation to a commercial mortgage portfolio enhances governance by increasing transparency and aids in the objective assessment of fund and fund manager performance.

For more information about commercial mortgage spreads, mortgage valuation services, mortgage servicing or any other related matter please do not hesitate to contact us.

Chris Brossard, CA, President 604.488.3858 chris.brossard@cmls.ca
Mark Achtemichuk, CA, CFA, Director, Mortgage Valuation 604.637.0874 mark.achtemichuk@cmls.ca
David Nygren, Senior Credit Analyst 604.488.3850 david.nygren@cmls.ca