Commercial Mortgage Spread Commentary – 3rd 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

Coupons Continue their Rapid Descent, Reaching New Lows

Since June 2009 we have seen a steady decrease in commercial mortgage coupon rates. Five year loans originated in the June 2009 period would have a coupon rate around the 6.0% level. In today's environment, mortgages with attractive investment fundamentals will currently be originated with a sub-4.0% coupon rate. This 200 basis point decrease combined with a declining cap rate environment has provided real estate owners with a healthy return. Commercial mortgage borrowing rates of 4% for 5 years or 4.75% for 10 years are unprecedented over the careers of anyone active in our industry today. This most recent decrease in lending rates can be entirely attributed to the 50 basis point compression in Government of Canada ("GoC") bond yields over the past three months.

Current Market Spreads

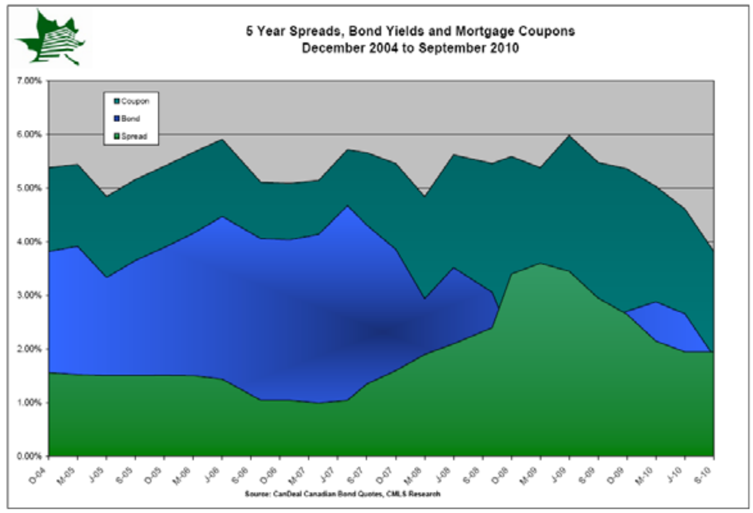
There has been no material change in commercial mortgage spreads during the 3rd quarter. High quality commercial mortgages which attract multiple lenders are currently being placed in the 180 to 210 basis point range over GoC bonds. Conventional multifamily loans are still trading in the 160 to 200 basis point range which is consistent with the previous quarter. Conventional multifamily continues to be a thin market as most borrowers are opting to go with CMHC insured financing.

CMHC insured lending spreads are currently 80 to 110 basis points over GoC bonds. Multifamily apartment owners are benefiting significantly from both an abundance of CMHC insured funds available and historically low GoC bonds. Strong borrowers with attractive assets in desirable areas can obtain a sub-3.0% coupon rate on a five year term.

Conventional Mortgages

Commercial mortgage coupons decreased substantially in the third quarter. As mentioned in our opening vignette, this can be entirely attributed to GoC yield compression. GoC yields continue to decrease to levels not experienced in the modern era. Economists continue to cut their forecast for Canadian bond yields predicting slower inflation and a more gradual pace of central bank lending rate increases. Market participants are assuming that the Bank of Canada will step back and assess if the weakening growth and slower inflation will continue. This is consistent with recent comments by Bank of Canada Governor, Mark Carney, who indicated that further interest rate increases "would be carefully considered" given the renewed concerns of a U.S. slowdown and reduced consumer spending in Canada. Statistics Canada reported on September 30th that Canada's economy shrank for the first time in 11 months in July as retail, manufacturing and building all posted declines. The slope of the GoC yield curve continues to flatten at a rapid pace, more so than any other G7 country in the past year. This adds further evidence that investors expect the slowdown to continue. Investors previously assumed that the Bank of Canada would lift rates at a more rapid pace as they expected Canada's commodity rich exporting economy to lead the G7 nations out of the recession. However, recent information has changed investors' outlook on the pace of recovery. Investors are also questioning the ability of the Bank of Canada to raise interest rates as the Federal Reserve in the United States continues to hold their policy rate steady.

Commercial mortgage borrowers are a substantial beneficiary of this low interest rate environment. Five year coupon rates are well below 4.0% for high quality institutional collateral. Very high quality mortgages with the correct pedigree of location, tenant, borrower, etc are achieving spreads as low as 165 bps over GoCs. This would result in a coupon rate of approximately 3.5%. However, this represents a very small minority of commercial mortgages in Canada. Most institutional quality commercial mortgages are being originated in the 180 to 210 basis point range. This would result in a coupon rate of 3.70-4.0% which is still unheard of in the commercial mortgage market.

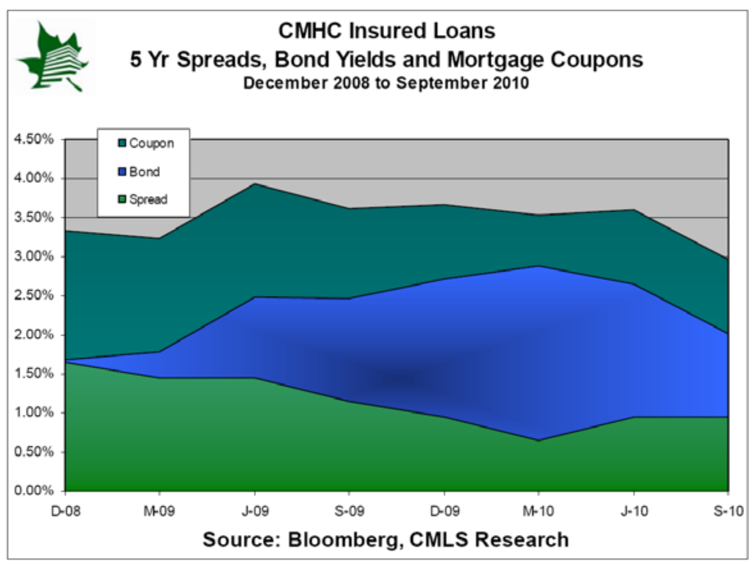


Some lenders in Canada have met their target allocations for 2010. However, there still continues to be a healthy level of capital allocated to commercial mortgages. The inability of borrowers to source capital has not been a prominent issue. Geography is also an important factor determining the availability of funds within organizations as certain regions have had more success meeting their allocations. Real estate investment and transactions levels have not been consistent across the country which has limited opportunities in certain areas.

It will be interesting to see how quickly the commercial mortgage market reacts to this rapid decrease in mortgage coupons. Lending opportunities below 4.0% might be acceptable in the short term but will pose problems in the long term. This is dangerously close to many organizations weighted average cost of capital and provides limited upside for organizations whose mandate is to earn a target return. Some organizations have instituted a floor interest rate which has essentially removed them from the market. Expansion in coupons or a lack of available capital will be required for these organizations to be back in the market. Other lenders have been obliged to think creatively, searching for appropriate risk adjusted yields in non-traditional asset classes.

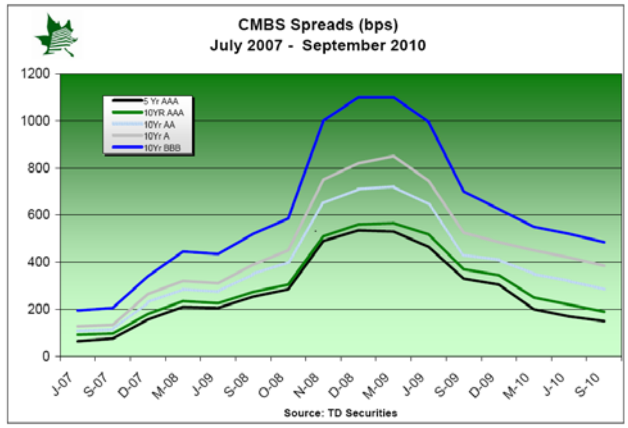
CMHC Insured Mortgages

CMHC spreads, measured relative to Canada bonds, have decreased slightly. There is some volatility when quoting CMHC spreads over GoC bonds as this market continues to be dominated by lenders who are securitizing loans through the National Housing Act Mortgage Backed Security ("NHA-MBS") Program. Lenders active in this program quote their spreads over Canada Mortgage Bonds ("CMBs"). CMHC insured loans are currently being priced in the 45 to 60 basis point range over the CMBs. This equates to a spread over GoC bonds in the 80 to 90 basis point range.



Canada Mortgage Bonds issued by Canada Housing Trust, a financing vehicle utilized by CMHC, continue to be a sought after investment. Foreign investors have increased their appetite for this investment class as non-Canadian buyers purchased 37% of the most recently issued five year pool, according to CMHC. Spreads have also come in substantially for this product with the most recent December 2015 pool being priced at 24 basis points over GoC's relative to the June 2015 pool that was priced at 42 basis points.

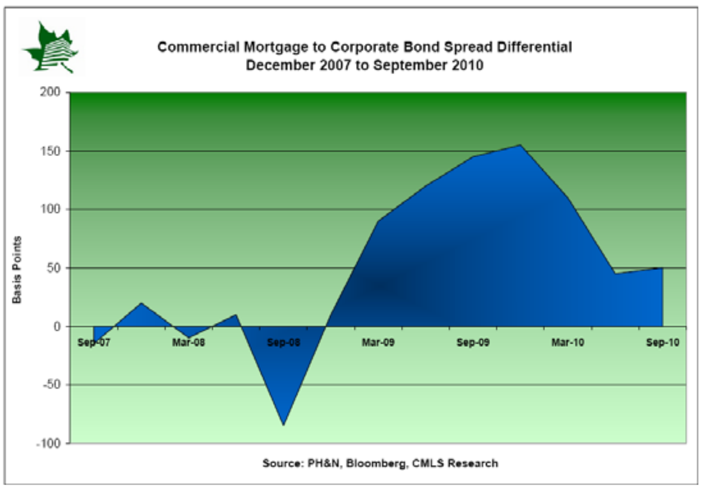
CMBS Spreads



CMBS spreads continued to decrease this quarter. Spreads have decreased approximately 30 basis points across all credit classifications since last quarter. We understand from participants in this industry that they still feel this represents good value relative to other securitized products available. Underlying collateral performance remains strong with DBRS reporting total delinquency to be only 0.38% of outstanding loans. This is negligible when compared to the United States where this figure is currently 8.95%.

Corporate Bond Spreads

The corporate bond market was quiet over the summer months with very little movement in spreads. Canadian corporate spreads have had further compression muted by interest rate increases by the Bank of Canada. Canadian corporate earnings have also dropped substantially from last year providing no justification for further compression. This is not a consistent story in the U.S. where corporate spreads have decreased to match those of their Canadian counterparts. Historically, Canadian corporations have been able to access debt markets at a lower cost. U.S. corporate bonds may also be tightening on the speculation that the Federal Reserve may introduce further monetary stimulus if the economic outlook continues to worsen.



There is not much to report on the spread differential between corporate BBB bonds and commercial mortgages. Commercial mortgages are still maintaining an approximate 50 basis point premium over corporate BBB bonds. This is consistent with the premium that mortgage lenders historically demand to compensate for the illiquid nature of a mortgage investment.

High Yield Market

Many high yield lenders are continuing to report limited transactions and stiff competition for desirable high yield opportunities. Mortgages secured by income producing assets are the most sought after with pricing and loan amounts being tightened to win business. This sector of the mortgage market has become ever more popular as it provides an opportunity to earn a high fixed income return in the current low rate environment. Record repayments over the past two years and an increased allocation to this sector have combined to create a large amount of available capital. This sector has also been at a disadvantage due to a lower level of real estate transactions which decreases the volume of borrowers requiring short term funds. Second mortgages with conservative loan parameters, strong sponsorship and attractive collateral are attracting quotes in the 7.5%-9.0% range.

2011 and 2012 will provide additional opportunities for this sector as 5-year CMBS loans from the 2006 and 2007 vintage approach maturity. CMBS loans of these vintages were originated with more aggressive underwriting standards. This could increase the necessity for high yield funds as first mortgage lenders may be reluctant or unable to lend sufficient funds to facilitate a complete take out upon maturity.

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 $4.0 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 $7 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