Commercial Mortgage Spread Commentary

August 2012

Continued Strength and Stability

The Commercial Mortgage Market in Canada continues to be characterized by a balanced supply of capital and continued strength in underlying collateral performance. This most recent quarter also marked the return of the Commercial Mortgage Backed Security ("CMBS") market in Canada.

CMBS

In July of 2012, Institutional Mortgage Capital led a $240.2 million CMBS offering backed by 31 fixed-rate loans secured by 33 commercial properties across Canada. The deal, IMSC 2012-2, put an end to the near 5-year drought on the diversified new issuance front and was generally well received amongst the CMBS community. CMBS investors eager to replace run-off of their existing book and in search of yield relative to similarly rated structured products welcomed the new issuance with open arms. The deal was also brought to market during a period of relative calm in wider capital markets with concerns over Europe less visible than in the weeks leading up to the July 20th pricing. This confluence of events helped contribute to oversubscriptions and tighter pricing, leading most industry veterans to deem the issuance a widespread success for Institutional Mortgage Capital.

The diversified offering featured 15% AAA subordination levels and was rated by both DBRS and Fitch. Although subordination levels landed inside those of the preceding Canadian CMBS offering, IMSC 2011-1, which featured 16.75% AAA subordination when issued in January 2011, the credit support offered by the AAA class was far greater than the 9%-12% levels observed near the peak of the market in 2005 through 2007. The non-investment grade bonds, or B-piece, comprising just 4.5% of total certificates was purchased by Institutional Mortgage Capital, or an investment fund managed by it, and 75% of the loans by pool balance featured full or partial recourse.

The pool was well diversified from both a property type and geographical perspective. The top three loans supporting the offering comprised 25% of the pool and were each secured by multi-family properties with multi-family representing the largest asset class at 32% of the pool. Anchored shopping centres and office represented the second and third largest concentrations at 27% and 14%, respectively, with seasoned self-storage loans, retirement, industrial, mixed-use, unanchored shopping centres and hospitality rounding out the pool. With the exception of PEI and New Brunswick, the pool contained exposure to all Canadian provinces.

Meanwhile, underlying performance of Canadian CMBS continues to be strong with 8 loans totalling 0.32%

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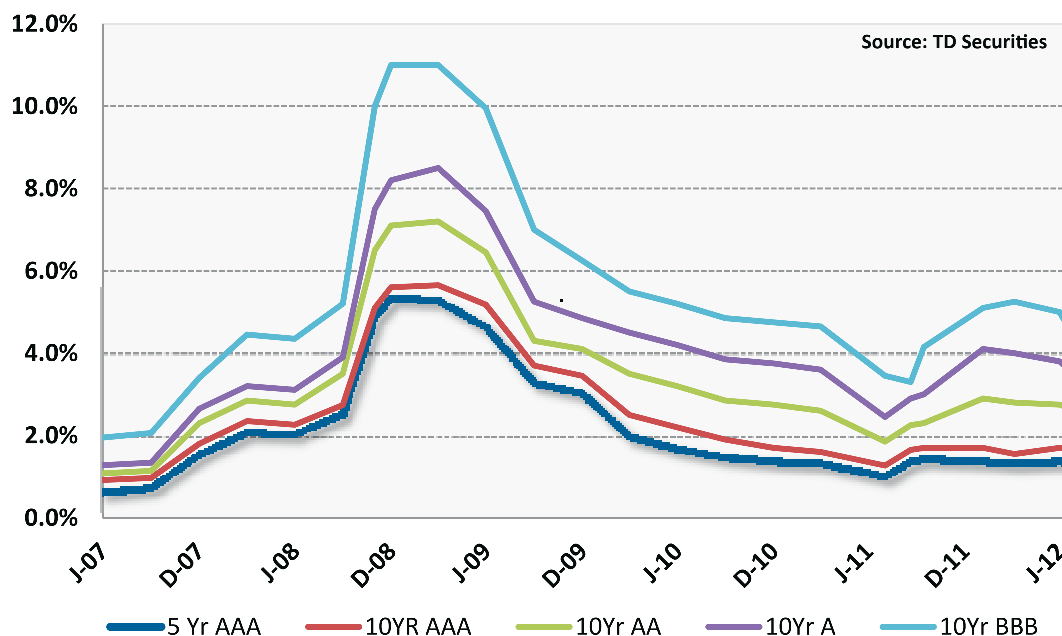
of the outstanding CMBS universe more than 30 days delinquent based on July 2012 remittance reports. Once again, this figure is running at a fraction of the comparable number south of the border. Since 1998 more than $24 billion of Canadian CMBS has been brought to market. Of the more than 3,200 loans backing these offerings just 20 have experienced losses resulting in an aggregate loss of just $21 million, or 0.09% of total issuance. Industry experts have attributed this to a wide variety of factors, including but not limited to borrower recourse, prudent borrower behaviour and generally conservative underwriting practices when compared to the US.

Final pricing levels for the IMSC 2012-2 issuance came inside of those highlighted in our Q1 commentary and reached a level that, in our opinion, may help facilitate a controlled return of CMBS in Canada. It would appear that we`re not alone in predicting a future for Canadian CMBS. According to the Commercial Mortgage Alert, an American publication focusing on the real estate finance and securitization industry, there are also rumblings of a second Canadian deal close on the heels of IMSC 2012-2. This will definitely be a space to watch for the remainder of 2012 and beyond.

IMC Pricing Levels			
Class	Rating	Subordination	Spread
A-1	AAA	15.00%	+136
A-2	AAA	15.00%	+168
B	AA	12.50%	+260
C	A	9.00%	+345
D	BBB	6.00%	+430
E	BBB-	4.50%	+465



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Economic Overview

Economies outside of Canada have produced mixed results since last quarter. China's export growth, factory output and retail sales weakened in July, indicating a slow down of the world's second-largest economy. Concerns are growing that China could post its weakest showing since 1999, with GDP growth of 8% this year, down from 9.2% in 2011 and 10.3% in 2010. Although China's rate of expansion exceeds that of any of the world's developed economies, any decline threatens to hurt the already fragile global economy. Chinese Premier Wen Jiabao has warned that his country faces significant economic problems that are likely to persist for some time.

Europe is edging closer to recession as the 17-country eurozone is wrestling with high debt levels and record unemployment. Statistics from Eurostat indicate that the economy shrank by 0.2% in Q2 after zero growth in Q1. The lone bright spots are the slightly better-than-expected GDP figures from the eurozone's two strongest economies, Germany and France. Europe's debt woes are considered responsible for the sharp deterioration in the global economic outlook over the last few months.

In the U.S. economic activity increased 0.4% in July after falling 0.4% in June, evidence of an economy that may be regaining some momentum. Current bullishness is attributed to a jump in applications for housing permits and declines in applications for unemployment benefits. August saw an unexpected improvement in confidence among U.S. consumers enhancing the likelihood of stronger household spending this quarter. Economists see the results as evidence that the economy has started to stabilize, potentially easing concerns that the U.S. is in danger of slipping into another recession.

The global headwinds have no doubt restrained Canadian economic activity but the Bank of Canada ("BoC") is still expecting growth to be approximately in line with production potential. Consumption and business investment are expected to be the most dominant factors contributing to growth which is consistent with the intent of the Banks stimulative monetary policy. Record high household debt coupled with the volatile and weak global economy continue to be the most prominent risks to domestic growth. The BoC is projecting the economy to be at full capacity in the second half of 2013. As slack is reduced and the economy returns to full capacity, inflationary pressures will expand as wage growth and input prices increase. Interest rate increases will become reality if the economy continues its progression towards capacity, as this will be required to keep inflation within established targets. The BoC has continually relied on the statement that "some modest withdrawal of the present considerable monetary policy stimulus may become appropriate". However, Canada's economic policy remains partially dictated by Europe's debt crisis and the pending US presidential election along with the struggling economic recovery south of the border. Canada's willingness to discuss raising interest rates differs with other leading central banks (Europe, China, US and Japan) which are moving towards further stimulus for their economies.

Exhibit 2: 5 Year GoC Interest Rates

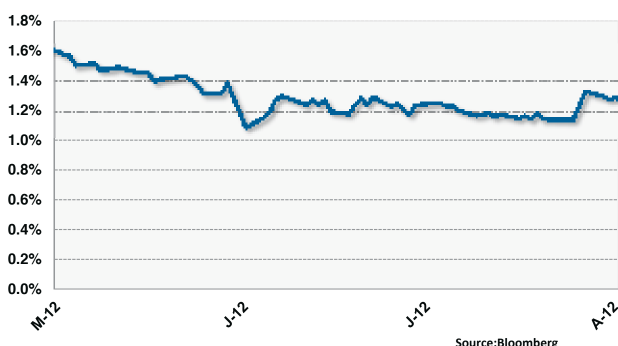
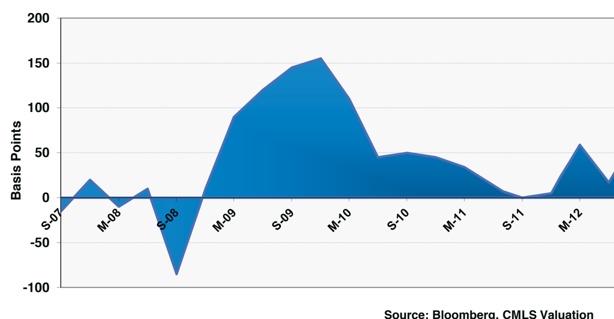


Exhibit 3: Commercial Mortgage vs. Corp BBB Spread Differential



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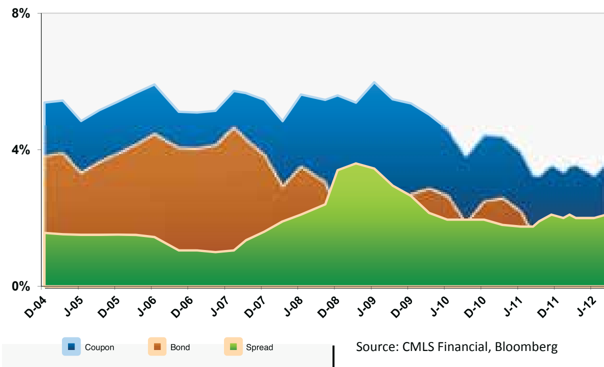
Commercial Mortgage Market

Conventional Mortgage Spreads have faced some expansionary pressure throughout the second quarter of 2012. Based on CMLS' Commercial Mortgage Spread Matrix, conventional multifamily and commercial mortgages ranging from very good to fair quality would attract spreads between 185 and 275 basis points over GOC Bonds.

Exhibit 4: Commmercial Mortgage Loans 5 Year Spreads, Bond Yields and Mortgage Coupons

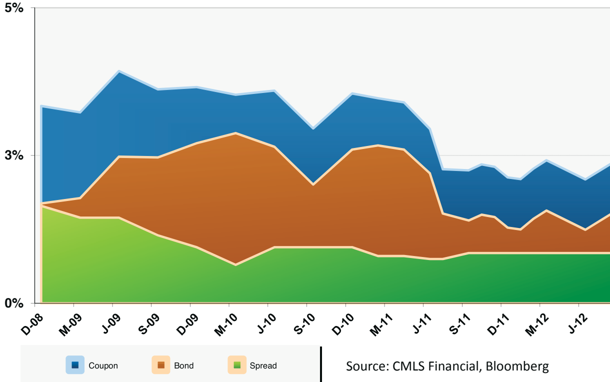


The Commercial mortgage market in Canada continues to see participation from most major lending groups. We are approaching the season when some lenders begin to reach their annual allocation targets due to active origination volumes in the first half of the year. This development has already removed some lenders from the game and would provide justification for the recent expansionary pressure we are seeing on mortgage spreads. Top tier assets and borrowers can still obtain mortgage debt with spreads sub 200bps, but the fundamentals required for this pricing level need to be ideal. Five year funds continue to be the most prevalent financing option provided by lenders. Ten year funds are being offered by fewer lenders but are still available for strong borrowers with high quality assets. Although there are fewer lenders with ten year money, competition remains strong as the active lenders continue to compete strongly for high quality deals.

CMHC Insured Multi Family Market

CMHC spreads continue to be tight as the Canadian Mortgage Bond ("CMB") program continues to be a very active source of financing for lenders in Canada. Institutional quality CMHC insured loans will currently attract pricing in the range of 85 to 115 basis points over GOC Bonds.

Exhibit 5: CMHC Insured Loans 5 Year Spreads, Bond Yields and Mortgage Coupons



Canada Housing Trust ("CHT") issuance continues to provide an active source of capital for mortgage lenders in Canada. Year-to-date issuance has been approximately $24.6 billion which has been achieved through eight CMB issues. The most recent $2.25 billion ten year issue settled in August and was priced at approximately 50bps over the Government of Canada yield curve. This bond carries a 2.40% coupon and matures on December 15, 2022. CMB Bond issuance should be strong for the remainder of the year as Banks can no longer issue covered bonds with CMHC insured mortgages as collateral.

On June 21, 2012, the Department of Finance announced changes that affect Canadian mortgage lending practices. These changes demonstrate that the federal government is concerned about its financial exposure and the exposure of federally regulated financial institutions (FRFIs) to a possible downturn in the Canadian housing market. The changes are not intended to cover existing multifamily practices at CMHC, however are important to note as they mark a fundamental shift in the government's attitude towards risk in the housing market.

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The Department of Finance's announcement is the third in a series of similar announcements it has made (the first two being in February 2010 and March 2011). The June 2012 release states that the department is instituting the following changes to government-backed insured mortgages effective July 9th 2012:

i. Reducing the maximum amortization period for insured mortgages from 30 to 25 years (previously reduced from 35 to 30 years by the March 2011 release);
ii. Lowering the maximum amount that Canadians can withdraw in refinancing an insured mortgage from 85% to 80% of the value of their homes (previously reduced from 95% to 90% by the February 2010 release and to 85% by the March 2011 release);
iii. Setting the maximum gross debt service ratio at 39% and reducing the maximum total debt service ratio from 45% to 44% (as per the February 2010 release, these tests are to be met using the interest rate on a five-year fixed rate mortgage even if the borrower chooses a mortgage with a lower interest rate and shorter term); and
iv. Withdrawing insurance for residential mortgages on homes with a purchase price of $1 million or more.

The timing of these latest changes differ from the previous rounds of regulatory tightening given previous policy adjustments occurred during periods of high asset appreciation and falling mortgage rates. The latest adjustments are being implemented during a period when housing prices are projected to soften, interest rates will likely be flat at best, and consumer debt levels have reached all-time highs. The cumulative effects of these changes and the current economic landscape present considerable downside risk to the Canadian housing market.

In addition to the policy adjustments outlined above, legislation was introduced in April 2012 which, once in force, will serve to prohibit Canadian federally regulated financial institutions ("FRFIs") from backing covered bonds with CMHC-insured mortgage collateral. The response from the market was drastic and immediate, with second quarter issuance grinding to a halt following a record $12.8 billion in first quarter issuance. The elimination of a formerly robust source of funding for the banks' residential mortgage programs will have a marked impact. It will be interesting to see where these institutions turn to fill the void. Some commentators have speculated that residential mortgage-backed securities may eventually provide the answer, although additional regulatory steps would need to be taken to ensure a liquid market.

First Mortgage Bond Issuance

In 2012, first mortgage bonds continue to be an important source of funding for large scale deals. The bonds provide borrowers with financing sums outside the range of traditional mortgage lenders. More importantly for borrowers, bonds provide liquidity and potentially credit ratings, opening up the offering to a more diverse investor base (such as fixed income desks) and allow for numerous investors to take partial positions in the offering.

Last year saw three significant first mortgage bond issuances. The first was a $300 million issuance by Ontrea Inc, owner of the RBC Centre building in Toronto's financial core. The LEED Gold building was completed in 2009 and contains 1.2 million sf of leasable space with RBC Dexia as a lead tenant. The second issuance was a $350 million deal by Brookfield Office Properties Canada LP and 1023803 Alberta Ltd, owner of Fifth Avenue Place in Calgary, Alberta. The complex was completed in 1981 and consists of two 35 storey towers connected by a two level shopping galleria with Imperial Oil as the lead tenant. The third issuance was a $405 million unrated bond issued by Brookfield Office Properties Canada LP on the West Tower of Bay Adelaide Centre, a 1.2 million sf office building in Toronto. A consortium of 8 lenders participated in this unrated bond.

This year, we have already seen two major mortgage bond issues: Scotia Plaza and The Bow. Scotia Plaza was purchased earlier in the year by Dundee Real Estate Investment Trust (66.7%) and H&R REIT (33.3%) in the largest office deal in Canadian history. The $1.266 billion purchase price was partially funded by a $650 million first mortgage bond. The bond has a 7 year

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term, 30 year amortization, a 3.21% interest rate, and priced with a spread of approximately 180 bps over GOC rates. The property contains 2 million sf of office space with Scotiabank occupying over 60% of the building at an average remaining lease term of 13.5 years. Fundamentals were good with an estimated DSC of 1.39X and an exit LTV of 64.4%.

The Bow is a newly constructed office building in Calgary, Alberta. The Class AA office tower has 58 storeys with approximately 2 million sf of office space. The property is owed by H&R REIT who have currently issued two mortgage bonds (Series A and Series B) each with a face value of $250 million. Series A has a 9 year term of interest only payments and a 3.69% interest rate. Series B has a 10 year term, a 30 year amortization and a 3.693% interest rate. Both Series priced with a spread of approximately 195 bps over GOC rates. These two offerings are the first of an aggregate of up to $800 million of mortgage bonds. The main tenant is Encana who has agreed to terms on a 25 year lease. Recourse will be limited to the property and current fundamentals are very strong with a DSC of 2.56X and a loan-to-appraised value of 46%.

Commercial mortgage bonds will continue to be the financing vehicle of choice for large office properties in Canada due to the large dollar volume required and the difficulty of traditional mortgage lenders to 'club' deals of this size.

Unsecured Debt Issuance

After a very strong first quarter of issuance for senior unsecured REIT debt, the market abated somewhat, but a pick-up in June and July has resulted in three new issues – one each from Cominar REIT, RioCan REIT, and Calloway REIT, totalling $450 million. The most recent issue was Calloway's $150 million in 4.05% senior unsecured notes due in 2020. The 8 year bonds priced at 256bps over the applicable benchmark (source: Bloomberg).

This brings total 2012 issuance to $1.4 billion just over half way into the year, surpassing the prior annual high of $1.1 billion achieved in 2005, based on CMLS estimates. Should the market remain at this pace for the latter half of the year, the unprecedented annual volume will prove there is ample investor demand for this type of product, and unsecured debt will continue to be an attractive funding source for Canadian REITs.

About CMLS Financial Ltd.

CMLS Financial is a diversified provider of lending products and services to the commercial real estate and real estate finance industry.

CMLS has been providing mortgage valuation services to Canada's leading institutional mortgage investors and borrowers for over 10 years.

Need More Specific Information?

For additional detail on our spread ranges or any other matter with respect to commercial mortgage valuation in Canada, please do not hesitate to contact our team.

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