CMLS
Canadian Mortgage Loan Services Limited

COMMERCIAL MORTGAGE SPREAD COMMENTARY

CMBS RETURNS! ***February 2011***

The mortgage industry in Canada is buzzing as the first CMBS pool since 2007 has been recently issued. Institutional Mortgage Securities Canada Inc. issued a $206,000,000 CMBS pool which is comprised of 16 fixed rate loans secured by 16 retail properties. All loans carry a full recourse guarantee by the transactions two sponsors, RioCan REIT (12 Loans) and Calloway REIT (4 Loans). The loans are structured with 10 year terms and 30 year amortization periods. The retail centers have a high average occupancy level of 98.4% and include a strong roster of national tenants including, Wal-Mart, Canada Safeway, Shoppers Drug Mart, Metro, and Loblaw (Source DBRS). The quality of this transaction is spectacular when compared with the 2006/2007 vintage CMBS pools with the lowest “E” Class tranche receiving BBB rating from DBRS.

It will be interesting to see how this transaction revives the CMBS market and the role this source of capital might play moving forward. The Canadian mortgage market is already facing a significant supply of capital this year with increased allocations available for most assets classes across the country (albeit at different pricing levels!). The spread differential between whole loan commercial mortgages and CMBS tranche levels remains a restrictive factor preventing an extensive return of CMBS issuance. Further divergence between commercial whole loan spreads and CMBS spreads will be required to enhance the economics of new issues which should bring additional conduit lenders to the market. We expect to see contrasting strategies for issuers re-entering this sector with the focus being on quality and each transaction having its own unique characteristics.

The demand for CMBS product should be reasonable as net issuance has been negative since 2007. Many previous CMBS investors will be looking for re-investment opportunities in this asset class. CMBS performance continues to remain strong with delinquent loans representing less than 0.50% of outstanding balances. Performance issues in Canada continue to be one-off instances rather than widespread fundamental issues with the commercial real estate sector.

The availability of B piece buyers will also have an important effect on CMBS pool composition. Structuring and selling the B piece tranche is a vital part of a CMBS transaction. Most B piece investors over the past few years have been opportunistic buyers with a unique understanding of this market and the capability to work out loans that have been transferred to special servicing. Traditional B piece buyers are no longer able to securitize these tranches in CDO’s as they have in the past and U.S. investors may prove scarce. As the CMBS market returns, it is probable that high yield investors will emerge, albeit with a lower tolerance for risk. High yield lenders in Canada are currently faced with a very competitive environment with limited opportunities lending on income producing assets. Lenders who can understand the complexities of investing in junior/mezzanine CMBS positions could see attractive opportunities.

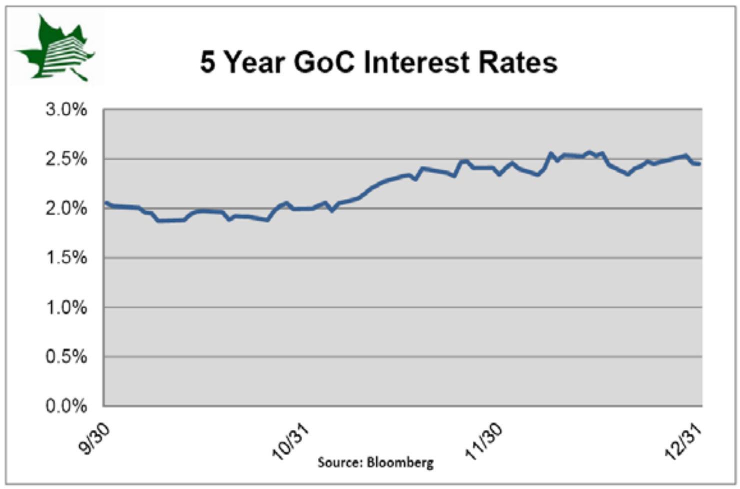
Changing regulations could also have an impact with shaping the dynamics of the Canadian CMBS market. Currently, Canada has not been subject to any sweeping regulatory reforms as we have seen with the Frank-Dodd reform in the U.S. It is unclear whether the conversion to IFRS will impact the CMBS market in Canada to the degree it has impacted the securitization of CMHC insured loans issued though Canada Housing Trust (CHT).

Despite a current delinquency rate of approximately 9.5%, 2011 is shaping up to be a busy year for U.S. CMBS issuance. CMBS began to re-emerge in 2010 with $11.6 Billion of issuance. Various participants estimate that $25 billion to $60 billion of new CMBS will be issued in 2011. This still represents a drastic change from the peak issuance in 2007 where banks issued more than $230 billion of CMBS.

Commercial Mortgage Market

Commercial mortgage rates have reversed their downward trend for the first time in 18 months. This recent trend reversal has been a direct result from an expansion in the underlying Government of Canada (“GoC”) risk free yields. Throughout most of 2010, movement in commercial mortgage coupons could be completely attributed to Government of Canada (“GoC”) bond volatility. Early October marked the end of the GoC rally with yields rising at a steady pace since. Borrowers are paying as much as 70 basis points higher today for a new five year mortgage when compared to September 2010.

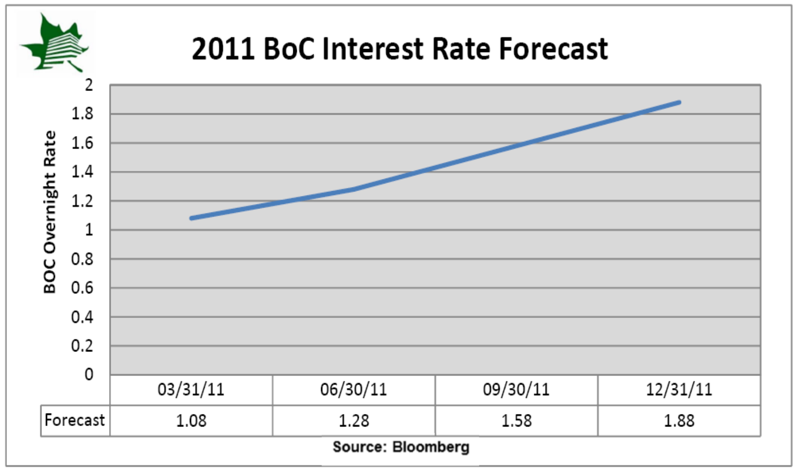
What has changed since Q3 2010 to cause this recent increase in yields? In September, economists were cutting their GOC yield forecasts as they predicted slower inflation and a more gradual pace of central-bank interest rate increases. This was also consistent with cautious comments by the Bank of Canada Governor, Mark Carney, who indicated renewed concerns in the United States and weak economic measures in Canada would potentially limit further growth of the Canadian economy. This sentiment was supported by market participants who questioned the ability of the Bank of Canada to increase rates in the face of renewed weakness in the United States.



The economic outlook has improved significantly in the past four months. Economists now expect the Bank of Canada to increase borrowing costs sooner than previously forecasted. Recent economic data has shown the recovery in the U.S. and Canada may be gathering momentum. Reports have shown better than expected job creation and unemployment numbers in both countries. The U.S. economic recovery remains the most dominant factor affecting growth in Canada as the U.S. accounts for approximately 75% of Canadian exports. Canadian economic growth continues to be inhibited due to a significant trade deficit which will be decreased dramatically if exports to the U.S. recover. The Bank of Canada has also outlined that a combination of poor productivity performance and persistent strength in the Canadian dollar could prevent Canada from realizing the full potential of a U.S. recovery.

Growing consumer debt levels in Canada are becoming a significant concern. The Bank of Canada has repeatedly voiced its concerns over the level of household debt that Canadians are accumulating. There is concern that the persistent low interest rate environment could allow for excessive borrowing and risk taking. Statistics Canada has reported that the ratio of household credit market debt-to-personal disposable income rose to 148.1% in the third quarter. This has now surpassed the U.S. where this figure sits at 147.2% according to the U.S. Federal Reserve. This creates a difficult situation for the Bank of Canada. Further interest rate increases to slow the pace of borrowing will place upward pressure on the Canadian dollar causing additional hardship to

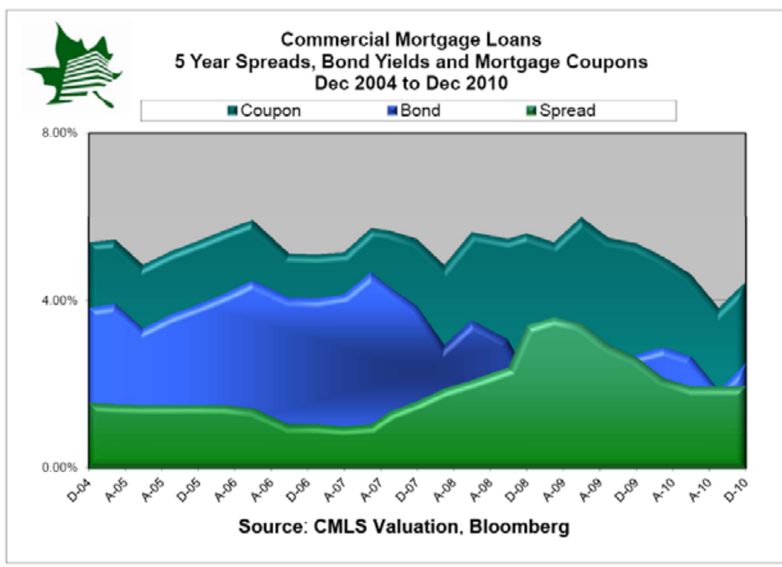
Canadian exporters. This is consistent with Mr. Carney's repeated comments which outline that there are "limits to how much Canada's economy can diverge from the U.S." The chart below outlines the results of the most recent interest rate expectations survey conducted by Bloomberg. The median result indicates that the Bank of Canada will raise interest rates to 1.88% by the fourth quarter of 2011.



There does continue to be risk that sovereign debt concerns in several European countries could generate renewed volatility and stress in the global financial markets. However, on a global scale Canada remains very attractive with solid fundamentals. Canada is holdings less debt than any other G-7 country and has a very sound banking sector which performed strongly during the financial crisis. This attractiveness has been further established when reviewing foreign purchases of Canadian assets in 2010. Statistics Canada has reported that a record level of foreign investment in provincial and federal government bonds has been set in the first 10 months of 2010. Foreign investors could begin to play an important role in the commercial mortgage market. Historically, foreign lenders have not been active investing in commercial whole loans.

Conventional Mortgage Spreads

Commercial mortgage spreads continued to remain steady during the 4th quarter of 2010 but have recently experienced some downward pressure. Based upon CMLS' risk rating model, conventional multifamily and commercial mortgages ranging from very good to fair quality would have attracted a spread of between 150 and 240 basis points over GOC bonds.

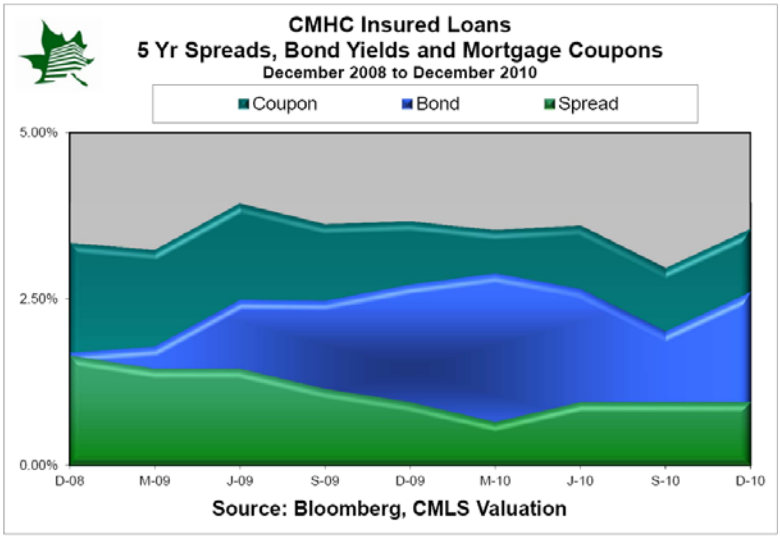


2011 will be an interesting year within the Canadian commercial mortgage universe. Recent surveys have indicated that numerous participants anticipate a generous supply of capital to be available for commercial mortgage investments. Most institutions remain bullish on the commercial real estate sector. A prominent question within the industry continues to be if a significant supply of capital will create an environment where ultra-competitive pricing will be required to win business. We have already started to see downward pressure on pricing in the first few weeks of 2011. Most lenders see some compression in spreads but do not see a drastic decrease occurring. The financial fundaments of real estate need to improve considerably before a considerable decrease in spreads would be warranted. Many lenders continue to place significant weight on actual cash flow in their underwriting decisions rather than relying on a value that has been driven up by recent cap rate compression. A contributing factor to the cap rate compression was the historically low lending rates that we experienced in 2010. Purchasers could rationalize a low cap rate valuation as coupon rates of 4.0% could help justify the purchase from a return on equity basis. If commercial lending rates continue to increase, we could see upward pressure on cap rates which will remove a lot of value that has been created in the past year. A return to 2006-2007 levels of rental income growth and vacancy levels will be required before most lenders are more comfortable materially decreasing pricing or underwriting standards. Most lenders continue to be comfortable with 25 year amortizations and loan to value ratios in the 60-70% range.

Secondary markets and non-traditional asset classes remain an attractive alternative for lenders looking to earn some appropriate risk adjusted yield. Secondary markets have been attractive to a lot of smaller lenders and entrepreneurial capital. These lenders are filling an important void where CMBS lenders were traditionally very active.

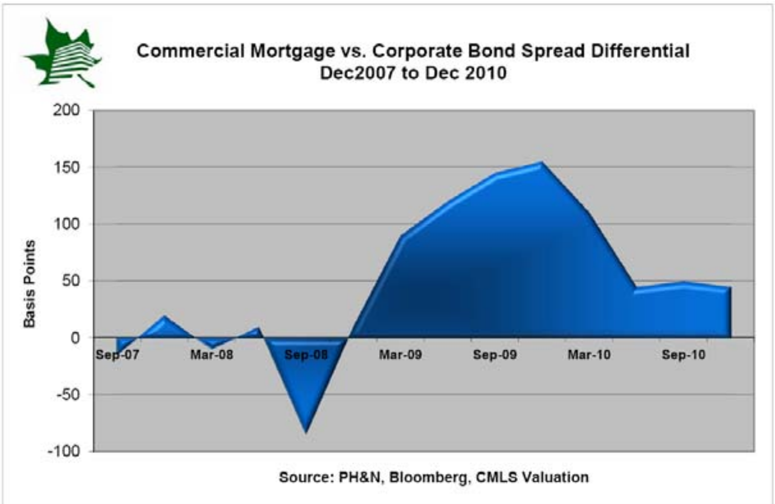
CMHC Insured Mortgage Spreads

CMHC lending activity continues to be largely dominated by lenders who are securitizing loans in the National Housing Act Mortgage Backed Security Program ("NHA-MBS"). This continues to be a very competitive marketplace as multiple lenders have a significant allocation of capital available for these programs. Lenders active in this program quote their spreads over Canada Mortgage Bonds ("CMBs"). Based upon CMLS' risk rating model, CMHC insured mortgages would have attracted a spread between 80 and 130 basis points over GoC bonds. High quality, large transactions in major centers with terms that are eligible for inclusion in the Canada Mortgage Bond program would have commanded spreads at the lower end of the range.



Although issuance is down in 2010, CMB's remain a very sought after investment product by domestic and international investors. Canada Housing Trust ("CHT"), a financing arm of CMHC, issued $39.4 billion of CMB's this year according to Bloomberg. CMB's have been attractive as the instrument has limited sovereign risk and earns a yield above traditional GoC bonds. 2011 will continue to be an active year for the CHT. The CMB program has been designed to benefit homebuyers and the housing industry as a whole by providing a cost-effective funding vehicle to Canadian mortgage lenders. CHT must balance overall credit market performance and mortgage demand from lenders when deciding on the structure and scale of the CMB issues.

Corporate Bond Spreads



There has been minor movement in the spread differential between corporate BBB bonds and commercial mortgages. Commercial mortgages still hold a 50 basis point premium over corporate BBB bonds. This remains consistent with the long term historical average.

Real Estate entities have dominated debt market issuance so far in 2011. RioCan REIT, H&R REIT, First Capital Realty, and Cadillac Fairview have all been active raising a combined total of over $2.5 billion in bonds year to date. Spreads on these issues are trading tight considering the unsecured nature of these issues. The bond sales provide these entities with a significant cash position for acquisitions.

High Yield Market

The high yield market continues have a significant level of capital available for income producing assets. The story remains consistent with many lenders reporting limited opportunities and stiff competition for desirable transactions. Pricing appears to be experiencing some downward pressure as a result. We are now seeing high quality income producing loans being originated in the 7-10% range. High yield lenders remain cautious when dealing with mezzanine, preferred equity or bridge financing loan structures. These loans typically have interest rates that start around 10% and increase from there. There does not appear to be as much competition in this space especially when dealing with larger loan sizes, as there are few national lenders able to participate in this space. As mentioned previously, high yield investors comfortable with the CMBS structure might see opportunities in this area.

About Canadian Mortgage Loan Services Limited

Canadian Mortgage Loan Services has been servicing commercial mortgages for over thirty five years and currently services a portfolio exceeding $4.2 billion. CMLS has also been providing mortgage valuation services to Canada's leading institutional mortgage investors and borrowers for over 10 years. The Valuation division currently values in excess of $7 billion of mortgages per annum. Such services involve an annual review of each mortgage to determine the overall risk profile which drives a mark to market spread which is updated on a monthly basis. CMLS can price mortgages as frequently as required by your financial statement, performance measurement, or portfolio valuation needs, from daily to annually.

Introducing objective, independent, third party mortgage valuation enhances governance by increasing transparency and aids in the objective assessment of fund and fund manager performance.

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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