Market News

Higher Mortgage Rates Limit Access to Capital for CRE Investors

Over the past two years, higher mortgages rates and their impact on the wider economy have drawn much attention as central banks have moved aggressively to control multi-decade highs in inflation. Much has been written about the speed and extent of these rate increases, including here and in past commentaries. However, more precise details on the direct pressures being faced by commercial mortgage borrowers often gets less attention. To shed light on some of the repercussions of higher rates, we have put together a hypothetical conventional mortgage financing case to measure the degree to which higher mortgage rates are limiting access to capital for commercial real estate investors.

Hypothetical Conventional Mortgage Financing Case	Scenario #1 Q3 2021	Scenario #2 Q3 2023	Scenario #3 Q3 2023	#1 vs #3 ▲
1. Loan Details				
Property Value	$15,000,000	$15,000,000	$15,000,000	Flat
5yr Mortgage Rate	2.50%	6.00%	6.00%	140%
Amortization	25	25	25	Flat
2. Underwriting				
Effective Gross Income	$900,000	$960,000	$960,000	7%
Total Operating Expenses	279,000	317,520	317,520	14%
Net Operating Income	621,000	642,480	642,480	3%
Annual Debt Service Costs	496,812	716,045	513,728	3%
3. Underwriting Metrics				
Min. Debt Service Coverage	1.25x	0.90x	1.25x	Flat
Max Loan Amount	$9,153,456	$9,153,456	$6,567,170	-28%
Max Loan-to-Value	61%	61%	44%	-28%

Consider a borrower looking to acquire a $15.0 million property with a conventional mortgage in Q3 2021 (see Scenario #1 in the adjacent table). At the time, historic lows in government bond yields paired with aggressive mortgage spreads saw all-in mortgage rates fall well below the 3% mark. Intellifi, a mortgage services firm, estimates that the 5-year rate on a typical conventional mortgage was about 2.50% in Q3 2021. Taking this rate as a given and using a standard amortization of 25 years, our hypothetical borrower would have been able to access mortgage proceeds of about $9.2 million for their purchase, or 61% leverage, all while meeting the typical conventional lender's minimum debt service coverage ratio (DSCR) of 1.25.

Fast forward to Q3 2023 and much has changed. The costs to operate a property have soared in tandem with labour shortages, supply chain disruptions, higher energy costs, and general inflation across the economy. Our hypothetical borrower, who opted not to purchase the property in 2021, has noticed that the same property is up for sale and is once again considering a purchase. Reviewing the property's operating statements, the borrower notes that revenue has increased about 7% over the two-year period through a combination of lease turnover and rent step-ups. While this is enough to offset ballooning operating expenses at the property (up 14%), net operating income growth of 3% is insignificant when considering the higher cost of borrowing.

Conventional mortgage rates surged to an average of 6.00% in Q3 2023, an increase of 140% from two years earlier. If our borrower were to seek the exact same loan amount of $9.2 million (61% of purchase price) as they had in 2021, they'd find that higher annual debt service costs (up 44%) would prevent them from qualifying for a conventional mortgage (see Scenario #2). Net operating income would fail to cover annual borrowing costs, and the property would be non-cash flowing from the lender's perspective with a 0.90 DSCR. To qualify for conventional mortgage financing, our hypothetical borrower would have to take a 28% haircut on loan proceeds to attain a 1.25 DSCR, resulting in a maximum loan amount of $6.6 million and 44% leverage (see Scenario #3).

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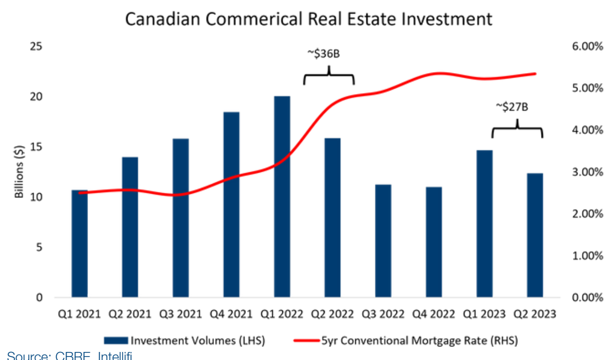
Since the Bank of Canada's (BoC) sharp pivot on monetary policy in March 2022, borrowers across the country have and continue to face similar challenges as our hypothetical borrower. Higher mortgage rates are bumping up against debt service coverage thresholds to limit mortgage proceeds. One of the most obvious effects of this new reality has been a dampening on overall commercial real estate activity. Mortgage proceeds are a key component of the capital stack and, with reduced leverage, many would-be borrowers have had to cancel or postpone purchases as a result of the dynamics presented in our case. The latest available data from CBRE's Q2 2023 Canadian Investment Overview highlights the real impact on commercial real estate investment volumes. National investment in the first half of 2023 was down ~25% from the first half of 2022 to ~$27 billion, and transactions were down ~38%. A longer-term view of investment shows how precipitously volumes have dropped from their highs in late 2021/early 2022 as mortgage rates have accelerated (see chart below).



Source: CBRE, Intellifi

Despite a cooling in investment activity, many borrowers are finding ways to weather the challenging market conditions. Lenders cite a higher prevalence of borrowers filling the proceeds gap with equity, while some borrowers are even opting to pay down or pay out mortgages with cash in lieu of taking on higher cost debt. If and when rates decrease, these borrowers would seek to refinance their mortgages and take out equity. Obviously though, options like this are limited to borrowers with strong balance sheets and the capital on hand to avoid higher mortgages rates.

For borrowers who lack the flexibility, proceeds shortfalls are being filled with higher cost bridge financing and/or subordinate debt. One of the major trends that has emerged over the past year and a half has been a surge in borrower demand for shorter-term mortgages. Despite a severely inverted Government of Canada (GoC) bond yield curve, which has resulted in relatively higher short-term mortgage rates, many borrowers are willing to stomach more costly mortgages with 1-to-3-year terms in the hopes that rates will fall by the time their mortgages mature.

Our hypothetical conventional mortgage case provides but one example of how higher mortgage rates are challenging access to capital for commercial real estate investors. The precise impact will be different for each borrower and each property depending on a multitude of factors including asset type, location, asset quality, lease contracts, and countless others. For financing solutions tailored to your individual situation, don't hesitate to reach out to your mortgage experts at CMLS Financial.

Fixed Income Markets

Since March 2022, bond yields have climbed at a stunning rate in tandem with aggressive policy rate hikes by central banks. In late Q3, bond yields increased even further on news of resurrecting inflation and signals from central banks that policy rates may need to rise further and stay elevated for longer than previously expected. GoC bond yields comfortably eclipsed the 4.00% mark in recent weeks to reach their highest level since November 2007, and mixed messages from the federal government relating to the CMB program continue to cause uncertainty in the insured mortgage market.

Bank of Canada Rate

The BoC held its key policy rate flat at 5.00% in early September on signs of easing excess demand in the economy (code for demand and supply getting closer to balance). Those signs – slowing economic output and easing labour market tightness – are evidence that prior rate hikes are indeed having an impact on the economy. The most recent available data shows that gross domestic product (GDP) declined in Q2 by 0.20% on an annualized basis and was flat in the month of July. This was in sharp contrast to the BoC's July Monetary Policy Report that forecast Q2 GDP to come in around 1.50%. On top of stalling economic output, a recent report by RBC Economics highlighted how economic data is being skewed by record immigration to Canada. As per the report, real per-capita GDP contracted by an annualized rate of 3.50% in Q2, its fourth consecutive quarter of decline.

Muddying the situation further is the fact that inflation has actually taken a turn in the wrong direction in recent months. Since falling to 2.80% in June, the Consumer Price Index (CPI) has come in higher at 3.30% in July and 4.00% in August. Less volatile and more heavily relied upon measures of inflation have also moved higher, pointing to more broad-based price pressures in the economy. The bank's CPI trim measure climbed 30bps MoM to 3.90% in August, while CPI median climbed 40bps MoM to 4.10%. CPI adjusted to exclude volatile changes in food and energy prices climbed 20bps MoM to 3.60%.

Higher gasoline prices were the prominent driver of inflation in August, led by higher crude oil prices that rose in the wake of production cuts by major oil producers Saudi Arabia and Russia. West Texas Intermediate (WTI) benchmark prices averaged $82 in Q3, up 11% from Q2, and reached as high as $95 per barrel in late September. Oil prices fell quite precipitously in the first week of October on economic concerns but have [Continues on Next Page]

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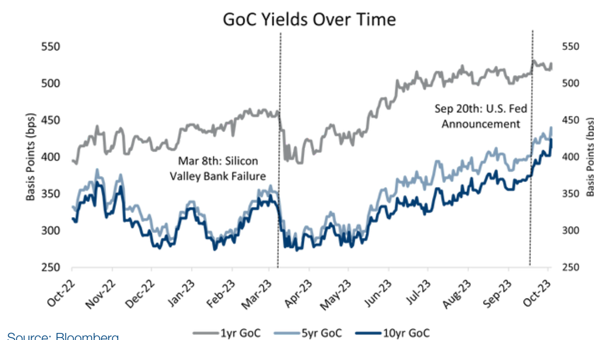
since firmed up somewhat following the terrorist attack by Hamas on Israel. Rising shelter costs, driven by higher rents and higher mortgage interest costs, also put upward pressure on the CPI in August.

Government Bond Yields

Rising inflation in the face of a stalling economy will make the BoC's next policy decision on October 25th that much more challenging. Bets are increasing that the bank will hike its key policy rate again this year with the 1-year GoC yield hovering around 5.25% through the final week of Q3. However, it was sentiment out of the U.S. Federal Reserve at its September 20th interest rate decision that has really moved markets, triggering a global bond selloff that sent yields soaring to levels not seen since late 2007. Both the 5-year and 10-year GoC eclipsed the 4.00% threshold in the final week of September to average ~4.30% and ~4.05%, respectively. They moved higher in the early days of October with increases in 10-year yields outpacing 5-year bonds.



Source: Bloomberg

Bond yields have risen steadily in recent months after having plummeted in the wake of the Silicon Valley Bank failure earlier this year. As of the end of Q3, 5-year and 10-year GoC yields were both up nearly 50% from their levels in mid-March, adding significant costs to commercial mortgage borrowers.

Canada Mortgage Bond Yields

Canada Mortgage Bond (CMB) yields also surged in tandem with the wider bond market. More relevant, however, are questions around the future existence of the CMB program. Our Q2 2023 Commercial Mortgage Commentary detailed how the federal government is considering whether to consolidate the CMB program into its wider government borrowing program. The news came as a part of the 2023 Federal Budget in March and could have wide-ranging impacts on the insured mortgage market if acted upon. At the time, the government announced that it would provide further guidance on a potential consolidation in its fall economic statement, which is expected in November. The $271 billion CMB market is a key source of funding for insured mortgage lenders.

Since March, two additional announcements have been made on the topic. First, the government provided some clarity about a potential consolidation, announcing over the summer that any potential changes to the program would not take effect until April 2024 at the earliest. This has given lenders the confidence to continue originating insured mortgages knowing that they will be able to securitize those mortgages as CMB until at least April.

As part of a slate of housing affordability measures from the federal government in September, it was announced that the annual limit on CMB issuances will be lifted from $40 billion to $60 billion, with the increase designated exclusively for financing of multi-unit residential rental housing. The government estimates that this could help build up to 30,000 additional rental units per year by offering lower-cost financing for multi-unit construction. It is uncertain what this means for potential consolidation of the CMB program.

Commercial Mortgages

Conventional

Building on observations in our Q2 2023 commentary, there was more widespread evidence in Q3 of conventional mortgage spreads falling into the 160-170bps over GoC range for the highest quality assets. Lender demand for industrial assets remained especially high, with market-leading spreads largely limited to institutional quality industrial assets. Multi-family assets also remained desirable to lenders, however, activity here has been more muted with most origination taking place through the CMHC insured program. Interest in anchored retail assets remained high with best available pricing slightly outside of market-leading spreads.

Activity in the 10-year space improved in Q3 with an increase in observed bids and transactions. There was firm evidence of compression in the term premium, especially for top tier assets, with 10-year spreads quoted as tight as 5-10bps over 5-year spreads. Given continued inversion in the GoC bond yield curve and the fact that 10-year GoC yields were on average 25bps lower than 5-year yields in September, top tier assets were able to lock-in 10-year financing at relatively lower rates than 5-year financing. Intellifi estimates that 5-year top tier conventional mortgage rates averaged ~5.80% in September versus ~5.65% for 10-year. Ten-year term premiums for the typical conventional deal were higher in the 10-30bps range. That said, demand from both borrowers and lenders continues to skew toward shorter-term financing.

There was some evidence of spread compression further up the risk curve in Q3 with second tier conventional mortgage spreads falling as low as 180-190bps over GoC. For the most part, however, lenders remain cautious and are most eager to deploy capital on higher quality assets. Mortgage spreads on the typical conventional deal continued to fall in a [Continues on Next Page]

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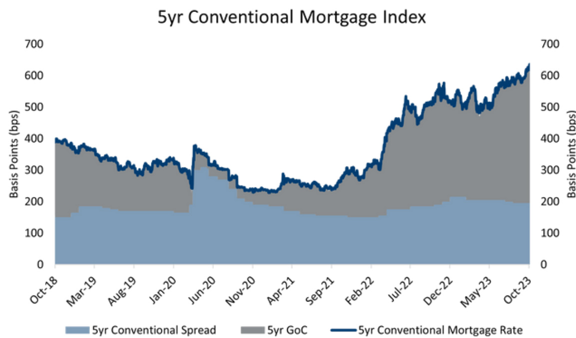
wide range of 190-250bps or higher with notable risk premiums in place for out-of-favour office assets.

Even with some spread compression in the conventional space, these declines pale in comparison to the rise in GoC bond yields in recent months, which has resulted in a significant net increase in all-in mortgage rates. The 5-Year Conventional Mortgage Index, a proxy for the rate on a typical conventional deal, averaged ~6.00% in the final month of Q3 and reached as high as 6.30% in late September following a surge in GoC bond yields. For context, the index averaged ~5.35% in Q2 and ~5.25% in Q1.

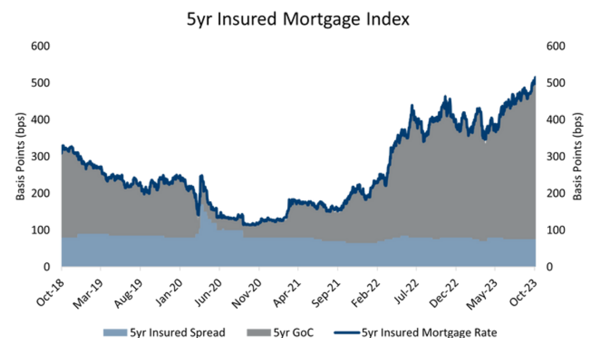


Source: Bloomberg, Intellifi

Insured

There was some evidence of slowing insured mortgage activity in Q3 following a rush of applications to CMHC leading up to the June 19th increase to insurance premiums. Significant delays in processing and underwriting at CMHC remain as the agency works through a backlog of applications. Despite slower activity, insured mortgage spreads appeared to remain stable in Q3. Data from observed transactions and a survey of insured lenders shows that larger loans backed by high quality assets and strong borrowers continued to fetch spreads in the low-to-mid 40s over CMB for both 5-year and 10-year terms. Given that the delta between CMB and GoC yields was relatively stable in Q3 at ~30bps for the 5-year and ~45bps for the 10-year, this translated into GoC equivalent pricing in the low-to-mid 70s for 5-year deals and the mid-to-high 80s for 10-year deals. Outside of market-leading pricing, most lenders indicate that pricing for the typical deal is in the 50-60bps range over CMB, equivalent to 80-90bps over GoC for 5-year deals and 95-105bps over GoC for 10-year deals.

Like the conventional space, soaring GoC and CMB bond yields negated any stability in mortgage spreads to push up all-in insured mortgage rates. For the first time in the history of our 5-Year Insured Mortgage Index (going back to January 2008), rates surpassed the 5.00% mark in the final days of Q3. The index averaged ~4.80% in the final month of Q3 versus an average of 4.05% in Q2 and 3.90% in Q1, highlighting a significant upward shift in multi-family financing costs at a time when housing supply shortfalls are causing serious affordability challenges for Canadians.



Source: Bloomberg, Intellifi

High Yield

Multi-family assets continued to account for the majority of observed mortgage transactions in the high yield space in Q3. Pricing for senior priority deals generally fell in the Prime + 100-300bps range and, given a Prime rate of 7.20% at the time of writing, this equated to all-in coupons in the 8.20-10.20% range. A notable overlap in senior and subordinate coupons was evident in Q3 with ample transaction evidence showing subordinate multi-family assets backed by higher quality borrowers earning coupons in the low 8.00% range. Survey results polling a range of major Canadian lenders pointed to wider coupon ranges for senior and subordinate loans. Lenders generally quoted senior coupons in the 7.00-10.00% range and subordinate coupons in the 9.00-12.00% range.

ABOUT CMLS FINANCIAL

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