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Q2 2022 COMMERCIAL MORTGAGE REPORT

The Commercial Mortgage Report aims to inform the market about commercial real estate finance news. We focus on the following capital sources for commercial real estate: Conventional Mortgages, CMHC-Insured Mortgages, Commercial Mortgage Backed Securities (CMBS), High Yield Mortgages, Construction Financing, First Mortgage Bonds and Senior Unsecured Debt for REITs and REOCs.

AUGUST 2022

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Making News

Lender Sentiment & Activity Improving in Alberta

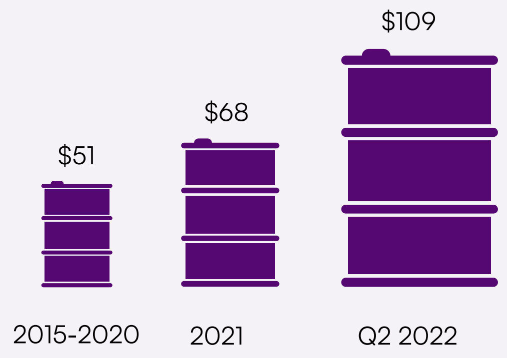
As visitors dawned on Alberta for the 2022 Calgary Stampede this July, it was hard not to feel a renewed sense of optimism permeating the wide-open prairie sky. A lot has been written about the hardships faced by the province in recent years. Once a darling of the Canadian economy, much changed in the latter half of 2014 as global oil markets swelled into surplus and prices cratered. What ensued was the unwinding of decades of effort to stamp the province as a global energy player and a desirable place to call home. Those corporations that didn't go bankrupt cut back on investment and staff. Tenants drained out of downtown offices, unemployment climbed, people emigrated en masse, and a population proud of its strong fiscal standing was forced to get comfortable with billions of dollars of debt and deficits. Five years on, those that endured the adversity to keep the province on its feet were left to deal with the economic fallout born from a global pandemic. The trends that had troubled the province for half a decade were all but accentuated and, while the world collectively faced significant challenges, the prospects for Alberta became particularly bleak.

For commercial mortgage lenders, economic certainty and security of cash flows are key components to their lending decisions. When critical industries are struggling, people are moving and vacancies are soaring, certainty and security are hard to come by. And so, money moves elsewhere. As one might expect then, demand for commercial mortgages in the province dried up starting in 2015. Data from our annual Intellifi Commercial Mortgage Surveys show that origination in Alberta fell 21% year-over-year (YoY) in 2015 from $8.4 billion in the year prior. By 2020, origination was down nearly 40% to $5.1 billion. Meanwhile, origination in Canada climbed 30% to $61.2 billion over the same period. Put differently, Alberta's share of Canadian commercial mortgage origination declined from 18% in 2014 to just 8% in 2020.

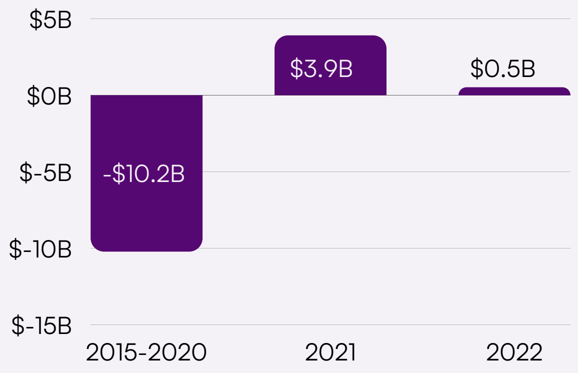
But for anyone who has been to Alberta or knows an Albertan, resiliency is core to the identity of the province and its citizens. Generations of people seeking freedom and opportunity and willing to build a life out of the harsh prairie plains will do that. By 2021, the winds started to change in Alberta and people were again realizing the incredible potential of the province — housing is affordable, its major cities are vibrant and exciting, the quality of life rivals most places, and jobs once again were becoming plentiful. The culture of entrepreneurship was alive and well, this time in places far from the traditional industries that garnered so much of the attention in years past. Five homegrown companies reached "unicorn" status for valuations of $1 billion or more in just 24 months. Major corporations like Amazon Web Services, RBC, EY and IBM, to name a few, were choosing Alberta for new offices, innovation centers and major investments. The buzz in the province was hard to miss, and the numbers speak for themselves. Alberta led all provinces in economic growth in 2021 at 5.1%. In the commercial mortgage lending space, annual origination spiked profoundly to $9.9 billion, up 94% YoY and 18% from the previous high in 2014. Market share of total origination was 13%.

Fast forward to 2022 and things are continuing to look brighter for the province. The prestigious Economist Intelligence Unit recently ranked Calgary the world's third most livable city. Companies in new industries like artificial intelligence, cleantech, fintech and agri-food science are seeing the benefits of setting up shop in Alberta and are helping to diversify the economy. As of July, there were approximately 4,300 tech job openings in Calgary alone. Unemployment is now 4.9% and for the first time since 2015 it isn't higher than the national rate. Most notably, the world has quickly realized the necessity of safe and ethical energy supplies, which has pushed oil prices in excess of $100 per barrel and buoyed an industry essential to the prosperity of Albertans and all Canadians. As a result, the provincial government posted a surplus of $3.9 billion in the 2021-2022 fiscal year ending in March, reversing 7 years of deficits. The consensus among major banks is that Alberta will lead all provinces in economic growth over the next 2 years. (Continues on next page)

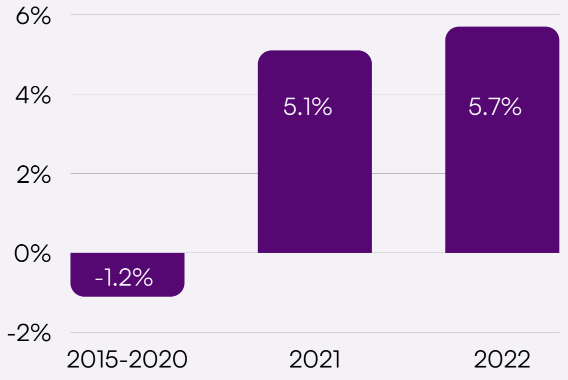
WTI Oil ($/Barrel)



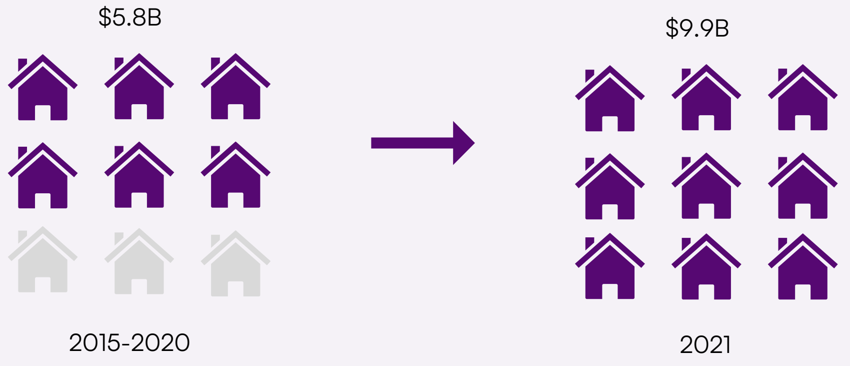
Provincial Deficit/Surplus



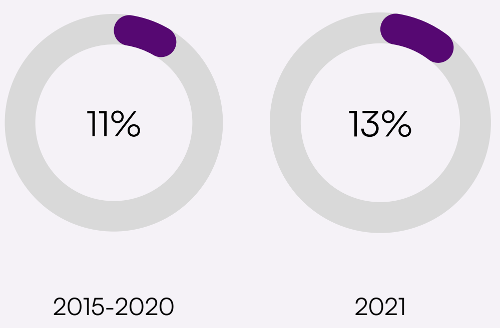
Economic Growth



Annual Commercial Mortgage Origination



Market Share Origination

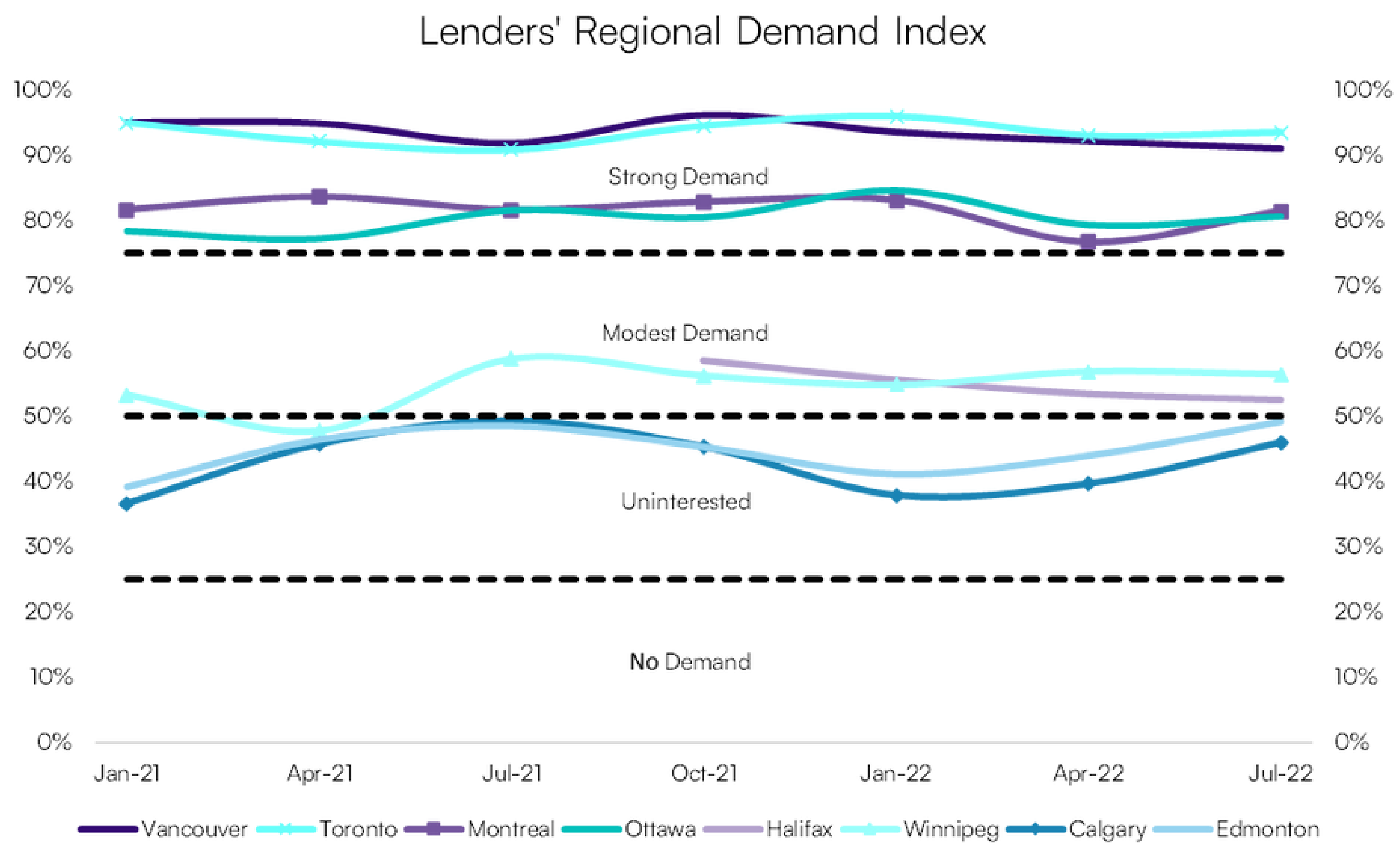


Source: Bloomberg, Intellifi, Government of Alberta, RBC Economics

Notes:
1. All WTI figures are averages for their respective period.
2. Deficit, economic growth & origination figures for 2015-2020 are annual averages over that period.
3. Alberta surplus of $0.5B in 2022 is a government forecast from Budget 2022 (2/24/2022). At this date, the forecast for 2021 was a $3.2B deficit.
4. Origination data is from the 2021 Intellifi Commercial Mortgage Survey.
5. Economic growth of 5.7% in 2022 is an RBC Economics forecast as of 6/7/2022.

Lender Sentiment & Activity Improving in Alberta (Continued)

To be clear, many lenders remain cautious on the province and will continue to in the months and years ahead, especially in today's economic landscape where severe bouts of volatility have become the norm. As per our Lenders' Regional Demand Index, interest to lend in Calgary and Edmonton remains well below that of other major Canadian markets — but it is improving. As of Q2 2022, roughly 50% of lenders surveyed indicated medium-to-high interest to lend in Alberta's two major cities versus just 30% at the end of 2020. As interest has increased, lenders' concerns about their existing mortgages in the province have plummeted. Of the 8 major concerns we track, the health of Alberta's economy was the 3rd greatest worry among commercial mortgage lenders in early 2020, trailing only an economic recession and global events. That metric has since fallen by about 40% to 7th place in Q2 2022. Anecdotally, lenders are increasingly telling us of increasing confidence in the province and opportunities to earn attractive yields. Overall, the business case to invest in Alberta is strong and continues to improve. Adversity builds strength, and Albertans have certainly dealt with their fair share of adversity.



Source: Intellifi

Economic Environment

Combative Monetary Policy Amplifies Recession Risks

The Bank of Canada (BoC) is out to prove that a lot actually can change in a short period of time — 104 days to be precise. That is how long it has taken a rock bottom policy rate of 0.25% to reach 2.50%, resulting in the Bank's most aggressive monetary tightening program since it began fixing its key rate in 1996. At its latest interest rate decision on July 13th, the Bank's 100bps hike came as a major surprise to the market and marks just the second time in 26 years that it has moved with such magnitude. The last such instance was back in August 1998. The forces driving these sharp hikes are clear and pervasive — inflation was 8.1% in June, the 15th consecutive month it has surpassed the Bank's 1-3% target mandate. Less volatile measures of inflation like CPI-trim and CPI-median were also well above the target range at 5.5% and 4.9%, pointing to more widespread price pressures. Nearly 75% of CPI categories are now growing faster than 3% and 50% are growing above 5%. Of greatest concern to the BoC, however, is the fact that consumer and business forward-looking inflation expectations moved higher in Q2, an indication that price expectations are becoming unhinged. Higher expectations for future prices can themselves be inflationary as consumers pull forward purchases, employees demand higher wages and companies raise prices.

Despite the scale of hikes to date, the BoC is only partway through its tightening cycle. Major Canadian banks forecast the policy rate to reach somewhere between 3.00%-3.50% by year end. At present, the policy rate is already well above both its pre-pandemic level of 1.75% and its average through the 2010s of 0.93%. How the Canadian economy responds to such elevated interest rate levels is beginning to garner more attention. Canadian households are among the most heavily indebted of advanced economies, making Canada much more sensitive to rising borrowing costs. As evidence, demand for residential real estate, the largest share of the Canadian economy, has cratered in just 3 months. Home sales activity was down nearly 25% YoY in June and prices fell for the third consecutive month. The MLS national benchmark home price was down 6.7% from March. This data precedes the 100bps move by the BoC, which will further dampen housing demand.

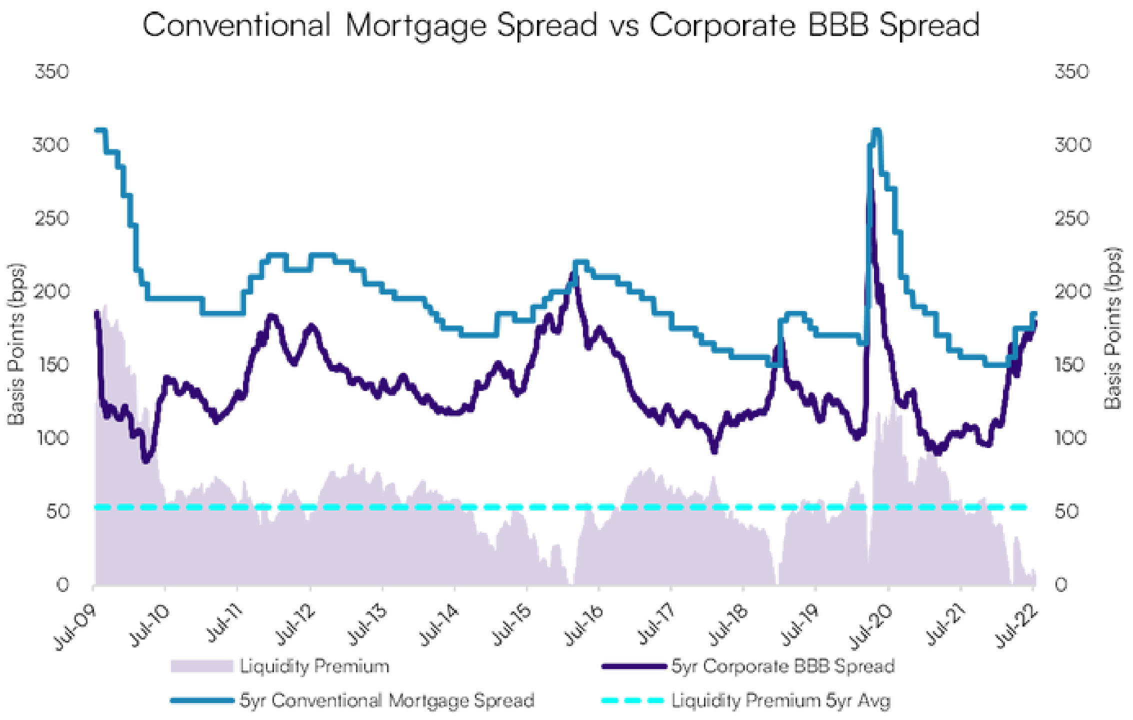
As inflation continues to soar and interest rates follow, the chorus of economists forecasting a recession has grown louder. RBC Economics is now projecting that Canada will fall into a recession, albeit a mild one, in the middle quarters of 2023. The forecast sees GDP falling by 0.5% annualized in both Q2 and Q3 of 2023 before returning to growth of 0.2% in the final quarter of the year. A historically tight labour market will ease pressure on the unemployment rate, rising 1.7 percentage points from the June print to 6.6%. Meanwhile, home prices are expected to drop 10% from their spring peak. Similarly, the BoC also made significant downward adjustments to its GDP forecasts, but it continues to believe that the economy will avoid a recession. The Bank is now projecting growth of 3.5% in 2022 and 1.8% in 2023, down from 4.2% and 3.2% in its April estimate.

Conventional

Corporate BBB Spreads Offer Insight on Direction of Mortgage Spreads

A sharp pivot by central banks to aggressive monetary tightening, increased geopolitical risk and a war in Eastern Europe, concerns of a looming recession after two years of global pandemic — these are but a few of the forces behind major market volatility in recent months that pushed bond yields and corporate credit spreads well above their 10-year averages. For commercial mortgages, the combination of surging base rates and rising mortgage spreads has helped push all-in rates to heights unseen since 2010. For context, our 5-year Conventional Mortgage Index, a general proxy for mortgage rates in the conventional space, eclipsed 5.00% toward the end of Q2. The index averaged 2.59% in 2021 and 3.50% through the 2010s. Clearly, borrowing costs have entered a new realm.

While the majority of the rise in mortgage rates can be attributed to rising Government of Canada (GoC) bond yields, conventional mortgage spreads have also pushed upwards by about 30-40bps year-to-date (YTD). Though noteworthy, it is only a fraction of the YTD climb in a handful of key corporate bond spreads — namely A-rated bonds, BBB-rated bonds, and senior unsecured bonds for Canadian REITs. These spreads are up approximately 55bps, 65bps and 70bps YTD, respectively. Focusing on the relationship between conventional mortgage spreads and BBB-rated corporate spreads, the relatively sharper rise in corporate spreads has nearly erased the liquidity premium on conventional mortgages for the second time in as many quarters. The liquidity premium has averaged about 55bps over the past 5 years and compression of that premium below its historical average has been a fairly reliable indicator of rising conventional mortgage spreads. All that to say the following: the longer that yields on more liquid corporate bonds remain near par with conventional mortgage rates, the more pressure there will be on mortgage lenders to hike pricing in the months ahead.

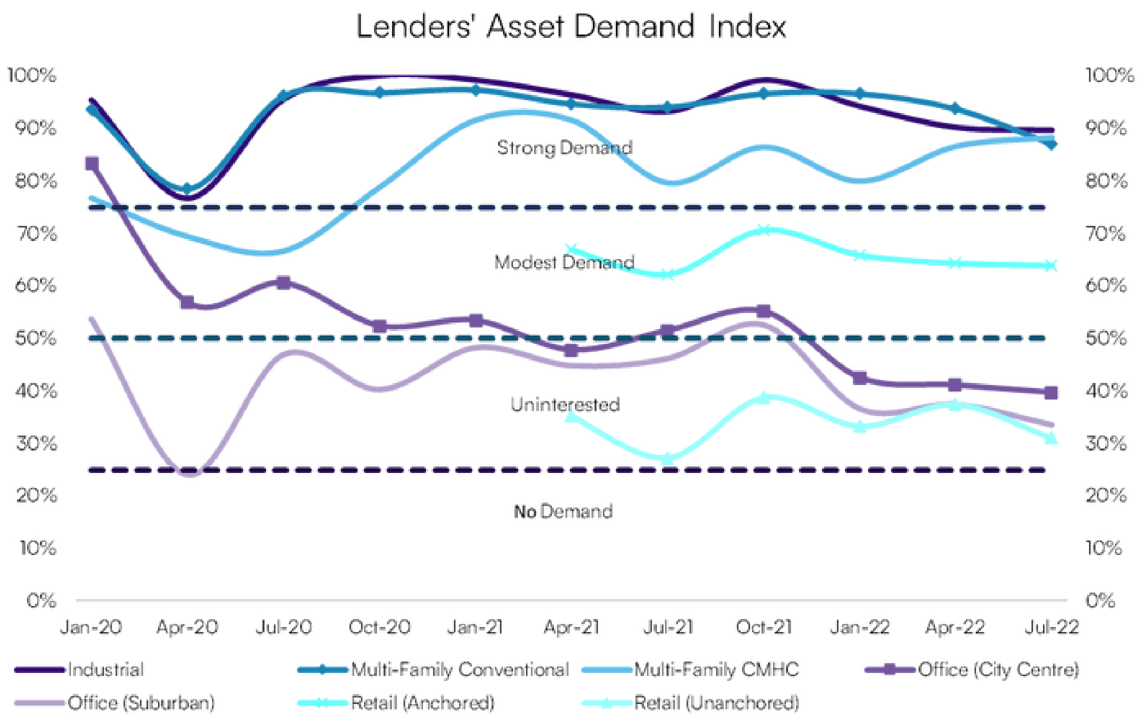


Source: Bloomberg, Intellifi

Out-of-Favour Assets to Face Further Headwinds

It is no secret that certain asset classes have thrived through the pandemic while others have struggled. To add more data to the conversation, consider these figures from our 2021 Intellifi Commercial Mortgage Survey. Origination in 2021 for CMHC insured multi-family, industrial and conventional multi-family assets was up 61%, 54% and 43% versus 2019 — a year when all 3 asset classes reached new highs in annual origination. In contrast, origination for retail and office assets was down 31% and 21%, respectively. In dollar terms, the former "in-favour" assets saw annual origination up a combined $18.6 billion between 2019 and 2021, versus a decline of about $6.0 billion for the latter "out-of-favour" assets. To put it simply, pandemic restrictions and changes in workplace and consumer behavior have hammered lender demand for retail and office assets.

The dichotomy in demand for these in-and-out-of-favour asset classes also led to noticeable risk premiums through the pandemic, with lenders demanding anywhere from an additional 20-40bps on average for retail and office mortgages. Those premiums have certainly come down in recent months as life has become more recognizable to pre-Covid times. However, with new economic risks taking center stage, lenders are telling us that these out-of-favor assets may face further headwinds in the months ahead. As per our Q2 2022 Lender Sentiment Survey, roughly 75% of lenders see a pull-back in liquidity for suburban office and unanchored retail assets as a result of inflation and rising rates, while two thirds see declining liquidity for downtown office. That number was just 25% for multi-family and industrial, and 40% for anchored retail. Our newly developed Lenders' Asset Demand Index highlights this nicely and will be leveraged in future reports to share asset type preferences and interest levels with our readers.

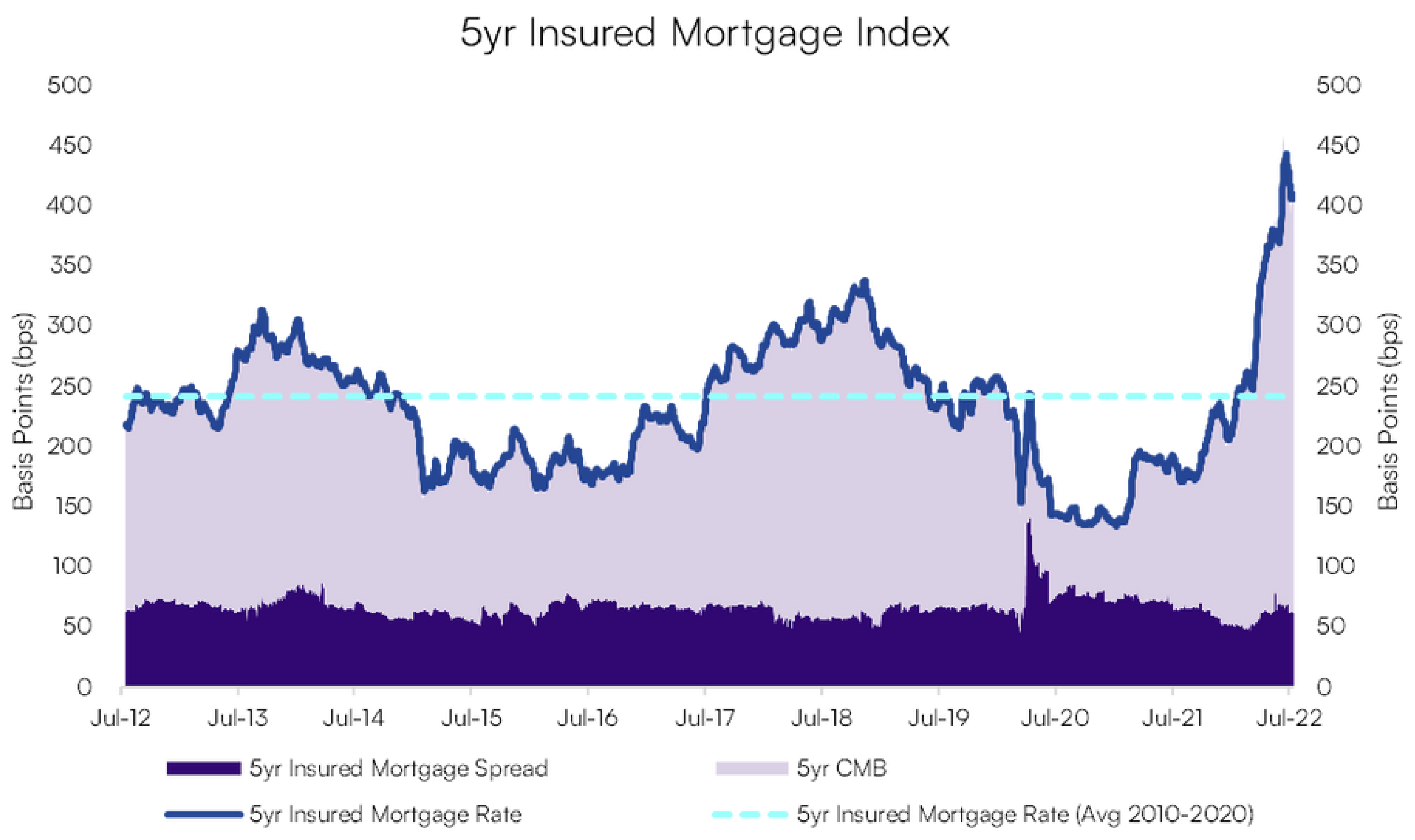


Source: Intellifi

CMHC

Insured Lending Most Resilient Through 2022

The commercial mortgage market has endured a considerable amount of volatility through the first half of 2022. As noted in various articles throughout this report, the result has been a sharp rise in base rates and mortgage spreads, which have pushed all-in commercial mortgage rates to decade highs. The insured segment has by no means been immune to this volatility. Five- and 10-year Canada Mortgage Bond (CMB) yields, the primary base rates for insured commercial mortgages, were up 189bps and 182bps YTD at quarter end. Such drastic shifts in base rates alone have been enough to push insured mortgage rates to decade highs. At around 4.00%, the average insured borrower is now paying a higher rate than the typical conventional borrower was paying as recent as March of this year.



Source: Bloomberg, Intellifi

Where the insured space differs from the conventional space, however, is in deal activity and spreads. Approximately 90% of respondents to our Q2 survey saw stable or increasing deal flow for insured mortgages QoQ. The 10% of lenders who saw declining deal flow was up 7 percentage points from Q1. In contrast, roughly 30% of conventional lenders saw declining deal flow QoQ, up 25 percentage points from Q1. Insured spreads have seen some marginal upward pressure through 2022, but nowhere near the 30-40bps rise seen in the conventional space. The typical insured deal fetched pricing in the 60-65bps over CMB range in Q2, up about 10bps QoQ. The highest quality deals continue to earn spreads in the low-to-mid 40's over CMB. Overall, capital availability continues to be high in the insured space and pricing and deal flow have thus far remained steady, making insured lending one of the more resilient market segments through the first half of 2022.

High Yield & Development

Activity Cools in Response to Higher Rates, Economic Uncertainty

Observed transactions and conversations with lenders suggest a noticeable slowdown in activity for higher risk mortgages in Q2. The sharp rise in interest rates paired with greater economic uncertainty have forced many lenders and borrowers to take pause and await further clarity on the direction of the market. For lenders, the recent surge in GoC bond yields that led to a tightening spread between conventional and high yield mortgage rates caused many to increase their preference for floating rate high yield mortgages. Now that the BoC has followed through with several large policy rate hikes, the corresponding rise in bank prime rates (the typical base rate for floating high yield debt) has restored much of that spread. Borrowers on the other hand have seen borrowing costs climb sharply overnight, causing many to question whether they need higher cost funds or to postpone acquisitions and borrowing entirely. Direct market intel suggests that early-stage pipelines are down significantly YoY, meaning that the number of loans expected to hit underwriting, and eventually funding, is at this point poised to decline further in the second half of the year. That said, some lenders wonder whether tighter underwriting in the conventional space and smaller loan proceeds as a result of higher rates will force more borrowers to seek subordinate debt. This will be something to look for in the months ahead.

On the development front, results from our Q2 lender sentiment survey pointed to sharp declines in deal flow for development financing QoQ, especially for retail and office developments. Deal flow for land was down only marginally QoQ, which at first glance could be interpreted as resiliency for land financing. However, we are hearing from lenders that there are ample land financing opportunities available but few lenders willing to finance them. Anecdotally, we've heard that some lenders have pulled out of the land financing space entirely, while those that remain have hiked pricing and will only lend to those borrowers most capable of carrying a deal through an economic downturn. External data also points to a sharp decline in development activity. Urbanation, a leading research group on condo, rental and land development in the Greater Toronto Area, reported that rental starts in the region fell dramatically to just 87 starts in Q2. Average starts over the previous four quarters was 1,916.

Senior Unsecured Debt

Issuances Down, Spreads Up for Canadian REITs

Issuances of senior unsecured debt by Canadian Real Estate Investment Trusts (REITs) were $1.2B in Q2, bringing total YTD issuances to $2.4B. Compared to the first half of 2021, YTD issuances were down about 17% YoY. Like other credit markets, spreads on these bonds blew out in Q2 with the weighted average spread up 63% QoQ to 235bps. A confluence of factors were likely behind this. For one, weighted average tenor of issuance was more than 2 years longer than in Q1, meaning some of this excess spread may be due to a term premium. Second, the average issuer rating fell marginally QoQ, meaning credit risk from the issuer constituents rose in general.

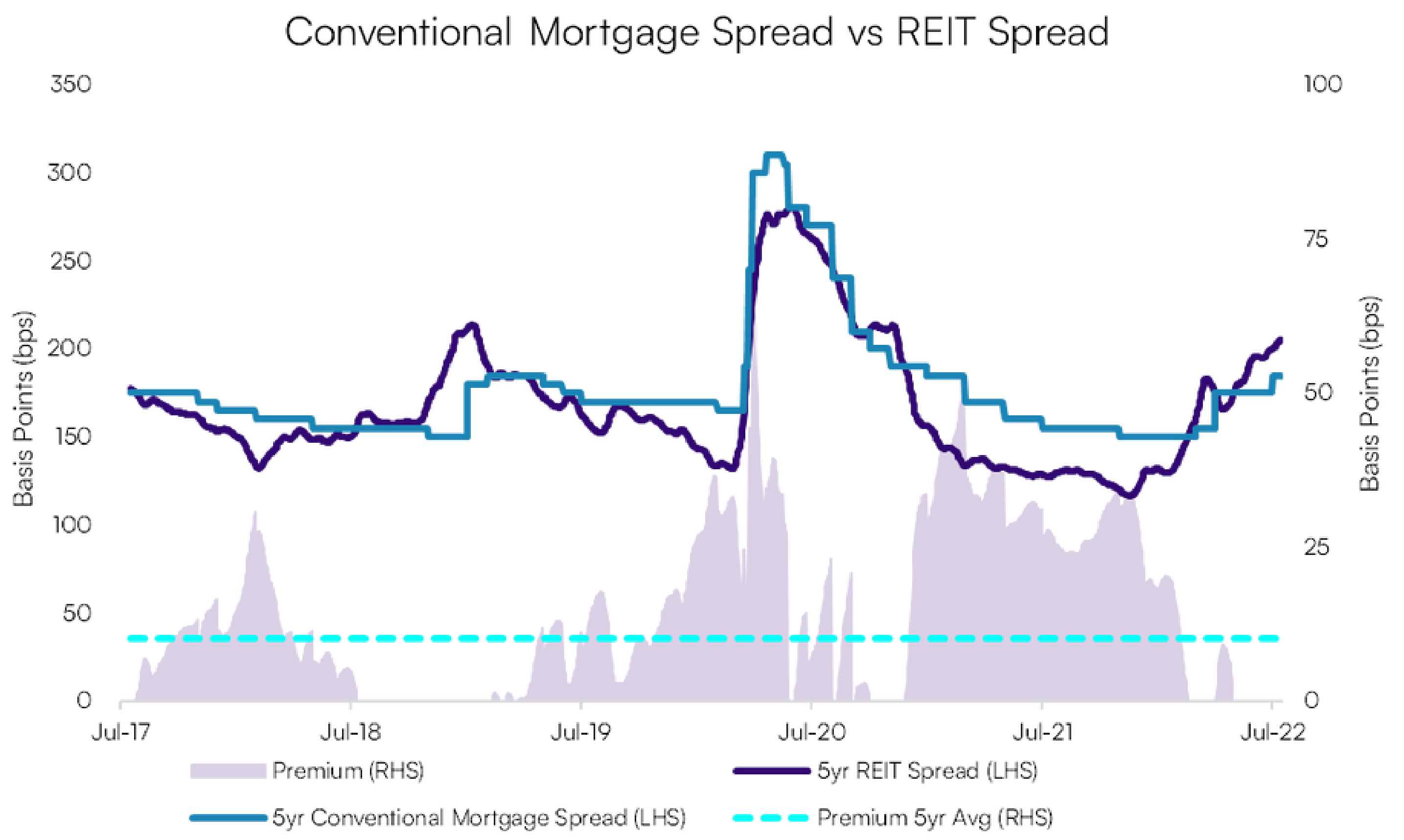
2022	Issuer Name	Issue Size Millions ($)	Issuance Rating	Term (yrs)	Coupon	Spread (bps)
Q1	CT REIT	250	BBB	7.0	3.03%	145.1
	BCI QuadReal Realty	400	AA-	4.4	2.55%	91.3
	Canadian Core Real Estate LP	250	A-	5.0	3.30%	150.4
	Primaris REIT	150	BBB	5.0	4.73%	222.1
	Primaris REIT	200	BBB	3.0	4.27%	185.1
	Q1 Averages	250		4.9	3.33%	144.6
	Q1 Total Issue Size	1,250				
Q2	Choice Properties REIT	500	BBBH	10.0	6.00%	252.3
	Artis REIT	200	BBBL	3.0	5.60%	300.4
	Rio Can REIT	250	BBB	7.0	4.63%	212.8
	Dream Industrial REIT	200	BBB	4.0	3.97%	154.1
	Q2 Averages	288		7.1	5.28%	235.0
	Q2 Total Issue Size	1,150				
	Total Issuance YTD	**2,400**		**5.9**	**4.27%**	**187.9**

Indicates Green Bond Issuance

Source: Bloomberg

Despite the characteristics of bond issuances in Q2 that would warrant higher spreads, the magnitude of overall spread increase appears to point to broader upward pressure in commercial real estate (CRE) borrowing costs. Our REIT spread index, a general proxy of mortgage spreads for major Canadian REITs, was up 30bps QoQ and is up 70bps YTD.

Since February, the spread premium for 5-year conventional mortgages over comparable tenor REIT bonds has been below its long-run average. Since April, that premium has been negative. The rise in conventional mortgage spreads have been unable to keep pace with escalating borrowing costs in public fixed income markets. What might be the reason for this? There are several potential explanations. First, the relative illiquidity of the private lender market means that spreads aren't usually as dynamic as they are for publicly traded debt. Second, many lenders continue to report high levels of capital available to deploy, while also being more selective on deals due to tighter leverage and debt-service requirements brought on by rising interest rates. The result is that lenders appear to have more capital chasing fewer deals and as such spreads for higher quality CRE deals have remained relatively suppressed. Whether or not this trend continues into the latter half of 2022 will depend in part on whether this dynamic holds.



Source: Bloomberg, Intellifi

About Intellifi

Intellifi provides scalable, bespoke, end-to-end solutions for established and emerging lenders. By combining data, people, and technology, we meet the demand for faster, simpler solutions and ensure usability, flexibility, and scalability for your business.

As pioneers in the Canadian mortgage industry, we bring decades of experience to our clients' businesses. We are passionate about spearheading innovative, creative lending solutions that create competitive advantage in the digital age.

Our Solutions

Commercial

Services

Underwriting
Valuations
Risk Reviews
Spread Matrix License
Market Intelligence

Software

Atlas Underwriting Platform
LMS360 Commercial Software
Target Asset Management Software

Residential

Services

Administration
Back up Servicing
Customer Service
Reporting
Underwriting and Fulfillment

Software

LMS360 Servicing Software
LMS360 Underwriting Software

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