MAY 2023 COMMERCIAL MORTGAGE REPORT

The Quarterly 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 real estate investment companies.

TABLE OF CONTENTS

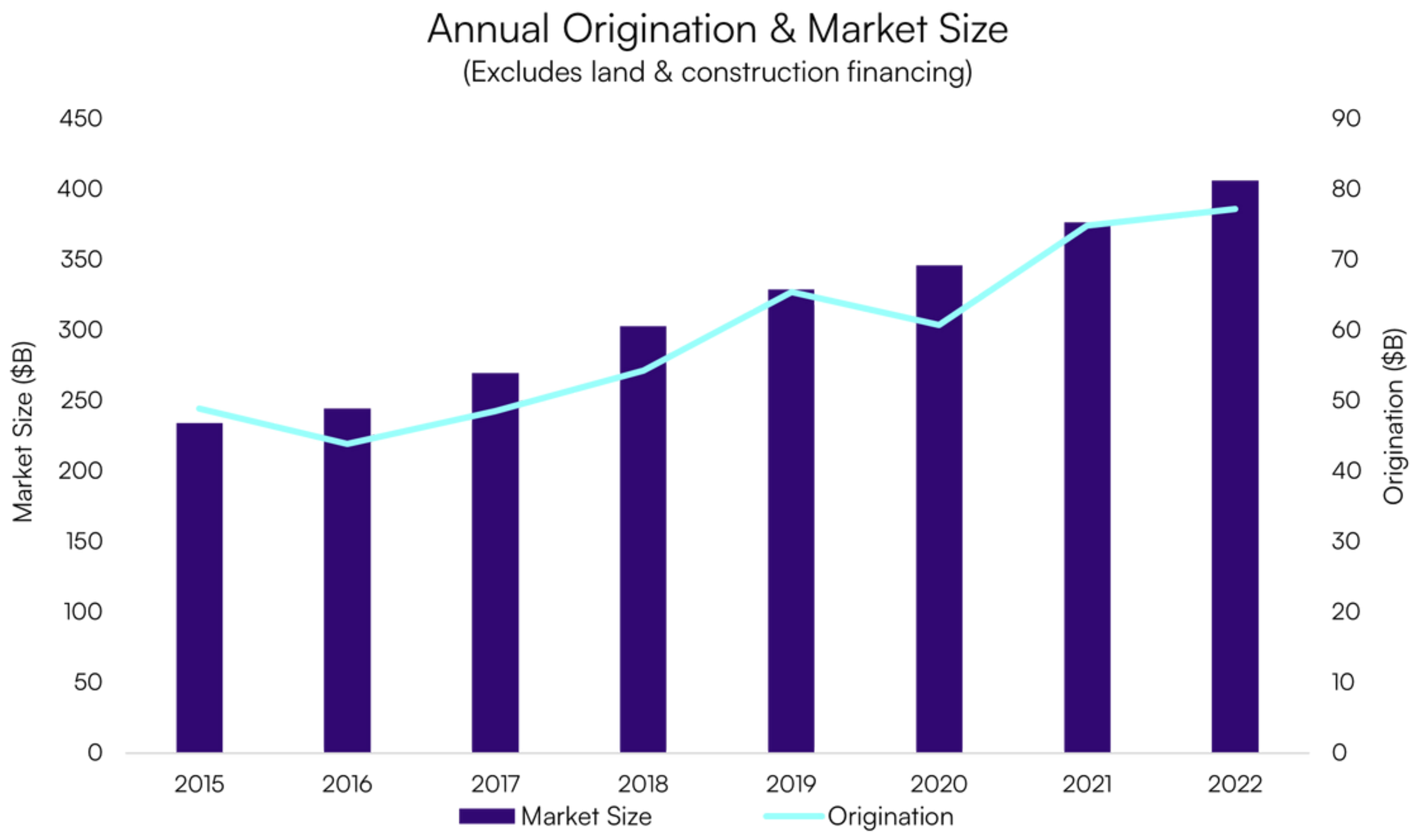
Making News

Origination Resilient in 2022 Despite Economic Challenges

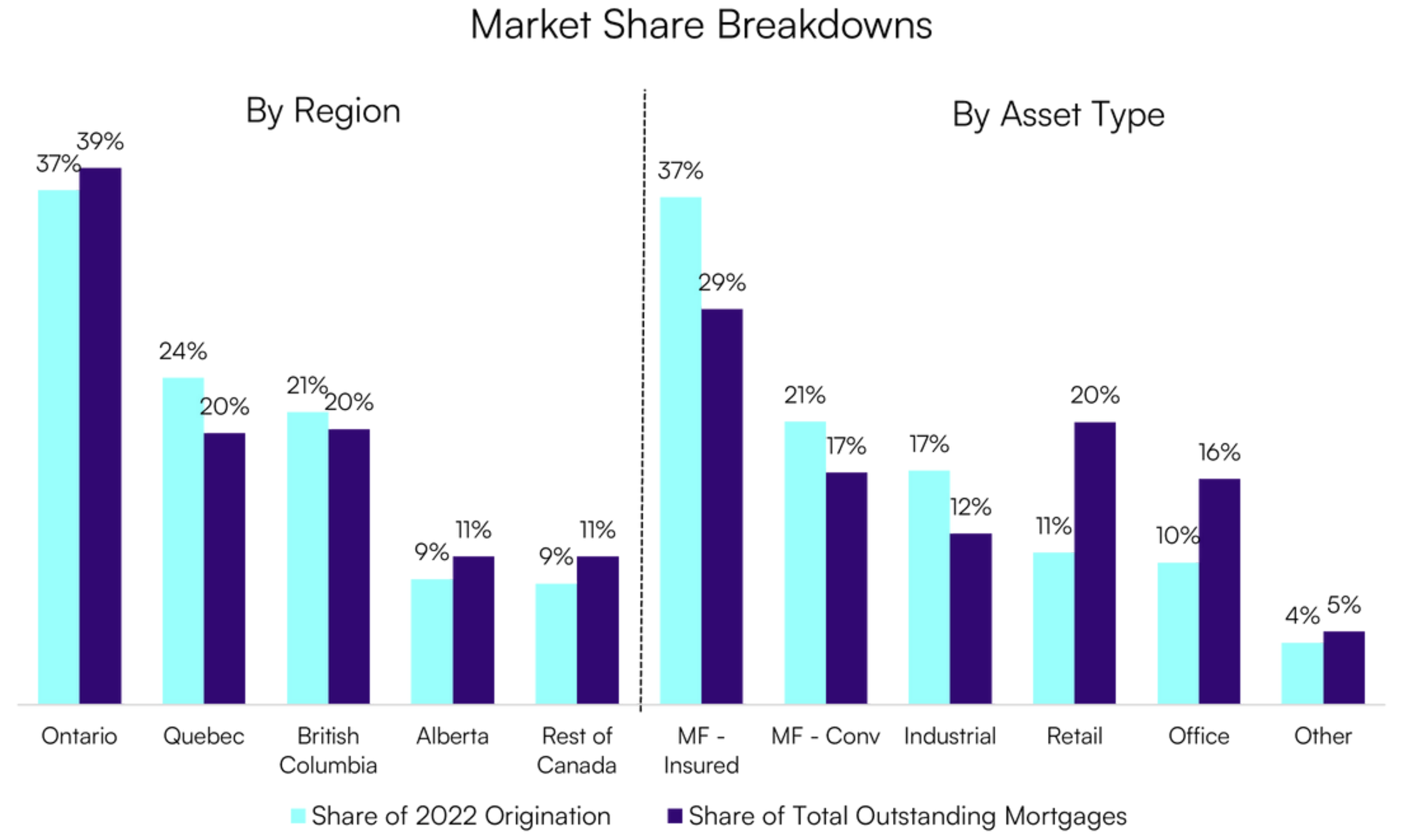
Despite severe macroeconomic headwinds in 2022, commercial mortgage origination in Canada grew modestly year-over-year to reach a new annual record. As per Intellifi's 13th Annual Commercial Mortgage Survey, origination was up 3% ($2.4 billion) YoY to $77.2 billion and total outstanding mortgages climbed 8% ($29.6 billion) YoY to reach $406.4 billion as of year-end. Banks continued to make up a large part of the market with a 33% share of origination volume, however, it was explosive growth in insured multi-family mortgages — particularly through the National Housing Act mortgage-backed security (NHA MBS) program — that pushed origination beyond 2021 levels. Survey results show insured multi-family origination climbing 16% ($4.0 billion) YoY to $28.4 billion, equivalent to about 37% of total origination. Had it not been for double-digit growth in this product, total origination would have declined by about $1.8 billion (2%) YoY (see the Insured section for a more in-depth analysis of insured origination over the years).

Regionally, Quebec, British Columbia and the Maritimes were the only areas to see their dollar volume of origination grow relative to 2021 and accounted for 24%, 21% and 4% of the market, respectively. Insured multi-family origination through the NHA MBS program was a big driver of growth in these regions. As for a breakdown by asset classes, growth was also concentrated. Insured multi-family and industrial were the only property types to see origination grow year-over-year, with industrial up 5% and insured multi-family up 16%. Together with conventional multi-family, these three asset types have seen the strongest demand since the onset of the COVID-19 pandemic and have increased their combined market share of origination from about 55% in 2019 to 75% in 2022. All other asset classes saw dollar volumes flat or down relative to 2021.

Despite the recent trends in annual origination, changes in the $400 billion commercial mortgage market were more subdued. Banks continued to account for the largest share of outstanding mortgages at 30%, and Ontario remained the region with the most mortgage debt outstanding at about 40%. Insured multi-family remained the largest asset type with 29% of outstanding mortgages. Although retail and office assets have seen their shares of origination plummet since 2019, their shares of outstanding debt were down only slightly year-over-year to 20% and 16%, respectively. That said, should current origination trends continue, the commercial mortgage market could look substantially different in a few years.



Source: Intellifi



Source: Intellifi

Economic Environment

Cautious Optimism as Pace of Inflation Decelerates

Headline annual inflation as measured by the Consumer Price Index (CPI) continued to decline in March, dropping to 4.30% from 5.25% in February. At 95bps, March marked the largest month-over-month drop in the CPI since it began declining from its 4-decade high of 8.13% last June. It also marked the lowest CPI reading since August of 2021. This is all very promising in the fight against inflation, which has exacerbated affordability issues in Canada and sent borrowing costs to levels unseen in over a decade.

That said, it's the numbers beyond the CPI which have some economists worried that hitting the target inflation rate remains a distant goal. The Bank of Canada (BoC) sees the CPI reaching 3% in the next few months but doesn't see it reaching its 2% target until the end of 2024. One reason has to do with base-year effects — the downward (or upward) impact that certain items within the CPI basket of goods may have on headline inflation due to elevated (depressed) prices in the prior year. For example, gasoline prices in March 2023 were down considerably from March 2022 when oil prices jumped at the onset of the war in Ukraine. This had a significant downward impact on the CPI in March 2023, which could make the headline figure somewhat misleading.

Meanwhile, prices for things like shelter and food continue to rise at uncomfortable levels, and inflationary pressures in other parts of the economy persist. These pressures can be seen in core measures of inflation — those that exclude more volatile components of the CPI and measure underlying price levels across the economy. The CPI trim and CPI median, for example, peaked in the low-to-mid 5% range in June 2022 and have since fallen to only the mid-4% range. What's more, prices for services continue to remain elevated, largely a function of rising wages and a historically tight labour market. Hourly wages were up 5.3% YoY in March.

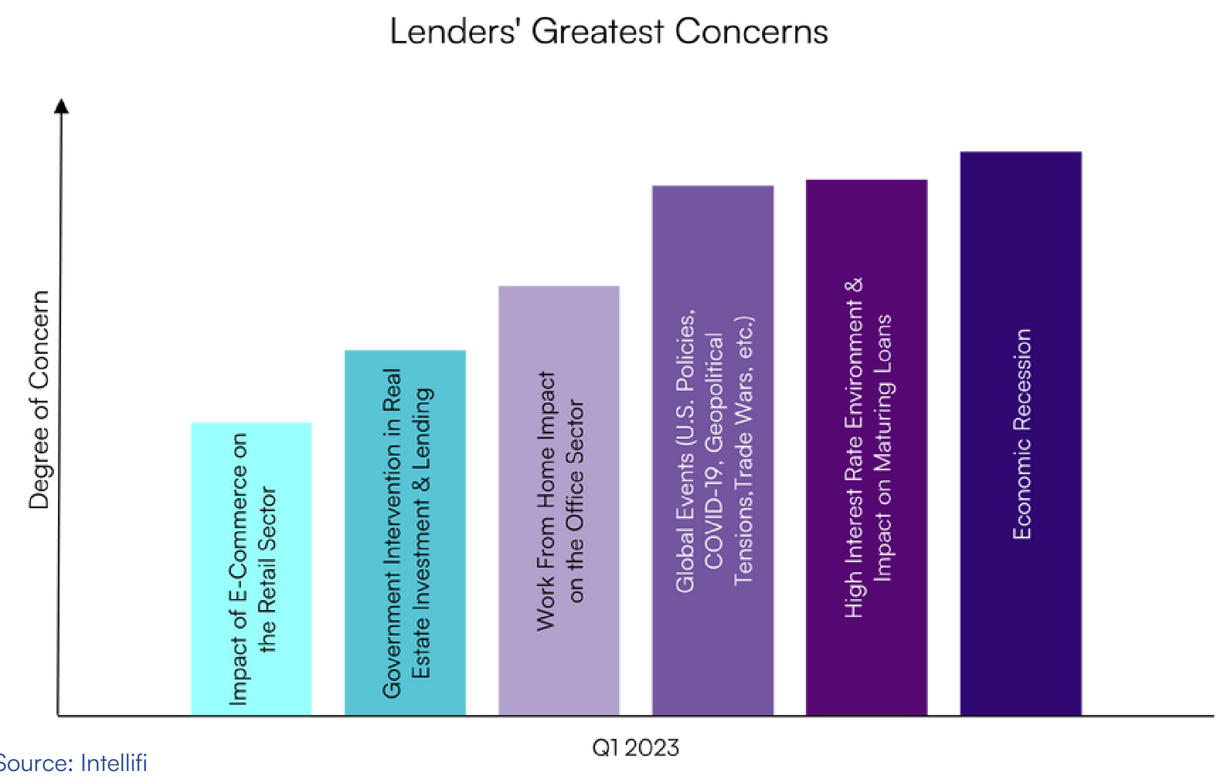
Should underlying inflation remain elevated, this could mean that interest rates, including commercial mortgage rates, may stay elevated for longer than markets currently expect. The BoC has been trying to reinforce that message too, pushing back on the notion that it might cut its policy rate later this year. Nevertheless, most major Canadian banks continue to hold the view that the BoC will begin cutting its policy rate in the next 9-12 months and that government bond yields will decline in tandem. For example, RBC Economics sees the BoC cutting rates 50bps to 4.00% in Q1 2024 and the 5yr Government of Canada (GoC) yield falling to 2.70% — about a 30bps decline from its average in April. By the end of 2024 it forecasts the policy rate to fall another 100bps to 3.00% and 5yr GoC yields to be around 2.50%.

Should these forecasts come to fruition, declining bond yields (in the absence of an offsetting rise in mortgage spreads) would offer some significant debt relief for borrowers. As the next article will highlight, that would temper serious concerns about the impact that sharp increases in mortgage rates are having on mortgages up for renewal.

Conventional

Maturing Mortgages Draw Concern from Lenders

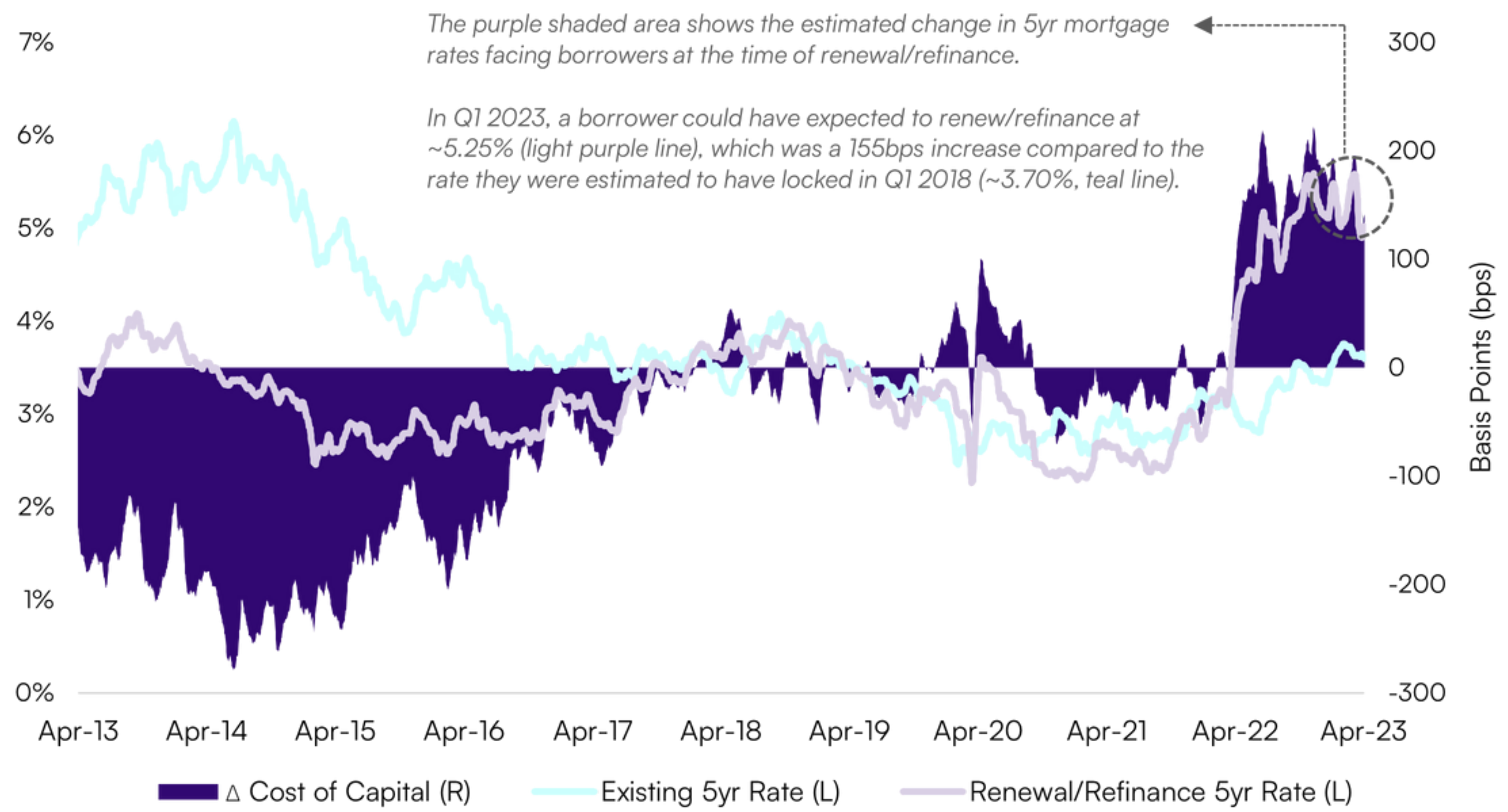
It's a question consuming discussion in the housing market and the wider Canadian economy — what will happen when residential borrowers are forced to renew their fixed-rate mortgages in this higher rate environment? Those same concerns are present in the commercial mortgage space, and the impact this may have on lenders' portfolios is garnering increased attention. As per our Q1 Lender Sentiment Survey, the impact of higher rates on the debt service coverage of loans maturing in the near-term was a leading concern among respondents. This rivalled other top concerns such as an impending recession and negative global events (and there have been plenty of those disrupting financial markets in recent years).



Source: Intellifi

Concerns for higher rates are well founded too. The graph on the following page shows not only the magnitude at which conventional mortgage rates have risen in the past year, but how much higher of a rate a borrower would face when renewing or refinancing a conventional mortgage today relative to their existing rate. The light purple line is Intellifi's 5yr Conventional Mortgage Index, which approximates all-in conventional mortgage rates from 2013 to 2023. The teal line is that same index but from 5 years prior — it is the mortgage rate that a borrower would likely be paying on their existing 5yr conventional mortgage leading up to mortgage maturity. For example, a borrower renewing their 5yr mortgage in Q1 2023 might have secured a new rate of ~5.25% (the average in that quarter), which was a full 155bps higher than the ~3.70% rate they were paying on their existing 5yr mortgage that was secured back in Q1 2018. (Continues on next page)

Impact of Higher Rates on Maturing 5yr Conventional Mortgages



Source: Bloomberg, Intellifi

$10 Million Renewal Scenario			
Item	Existing 5yr Term	Renewal 5yr Term	% Change
Bg. Balance	$10,000,000	$8,663,779	-13%
Mortgage Rate	3.70%	5.25%	42%
Monthly Payment	$51,141	$58,380	14%
Total Interest Costs	$1,732,261	$2,101,388	21%

Source: Intellifi

Building on that example, had a borrower taken out a $10 million mortgage in Q1 2018 with a 5yr fixed rate of 3.70% on a standard 25yr amortization, that borrower would have seen their mortgage rate climb 42% and their monthly payment climb 14% at renewal in Q1 2023. Borrowers looking to maintain debt service coverage at renewal would need to see cashflows rise 14% or more to offset higher payments, while those seeking to refinance would need to demonstrate even higher increases. All of this puts additional pressure on rents and could impact refinance volumes in the quarters ahead.

Back to the chart, the light purple and teal lines together show the change in conventional mortgage rates between origination and maturity on a 5yr loan, which is measured by the dark purple shaded area of the chart. Since April 2022, borrowers have seen 5yr conventional rates rise 150-225bps above their existing mortgage that was originated 5 years before. In Q1 2023, the average was 155bps. The current situation is one that borrowers (and lenders for that matter) have not seen in over a decade. Five-year conventional rates at renewal or refinance were some 100-280bps below existing rates from 2013-2017 and were relatively flat from 2018-2022.

Higher borrowing costs have led to an increase in cash paydowns and even mortgage payouts. However, for borrowers lacking that sort of flexibility, many are opting to renew or refinance their mortgages for shorter durations. The hope is that, should inflation fall back to target soon, central banks may opt to cut their policy rates, resulting in lower mortgage rates in the next 1-3 years. While such a move means that borrowers will have to face even higher borrowing costs over that shorter-term loan (the GoC bond yield curve is steeply inverted and shorter-term “bridge loans” generally have higher interest rates), lender sentiment indicates that borrower demand for short-term deals is strong. The trajectory for inflation and interest rates so far appears positive and, should economists’ forecasts come to fruition, that would provide significant financial relief for borrowers and reduce concerns from lenders about the health of their loan portfolios.

Insured

Insured Multi-Family Driving Commercial Mortgage Growth

As mentioned in the opening article, strong origination growth for insured multi-family product helped drive total origination growth in 2022. Insured multi-family origination of $28.4 billion was the highest volume asset class by a sizable margin. That rivalled the combined origination of industrial, retail and office mortgages, which totaled about $29.5 billion.

Looking at longer-term origination data, the impact that insured multi-family lending has had on the wider commercial mortgage market has been quite remarkable. Based on the last five years of Intellifi’s Annual Commercial Mortgage Survey, total annual origination volumes have grown about $22.9 billion (42%) from $54.3 billion in 2018 to $77.2 billion in 2022. Of that growth, insured multi-family accounted for a resounding $17.0 billion (74%). Clearly, the asset class has become a critical component of the Canadian commercial mortgage market. But why?

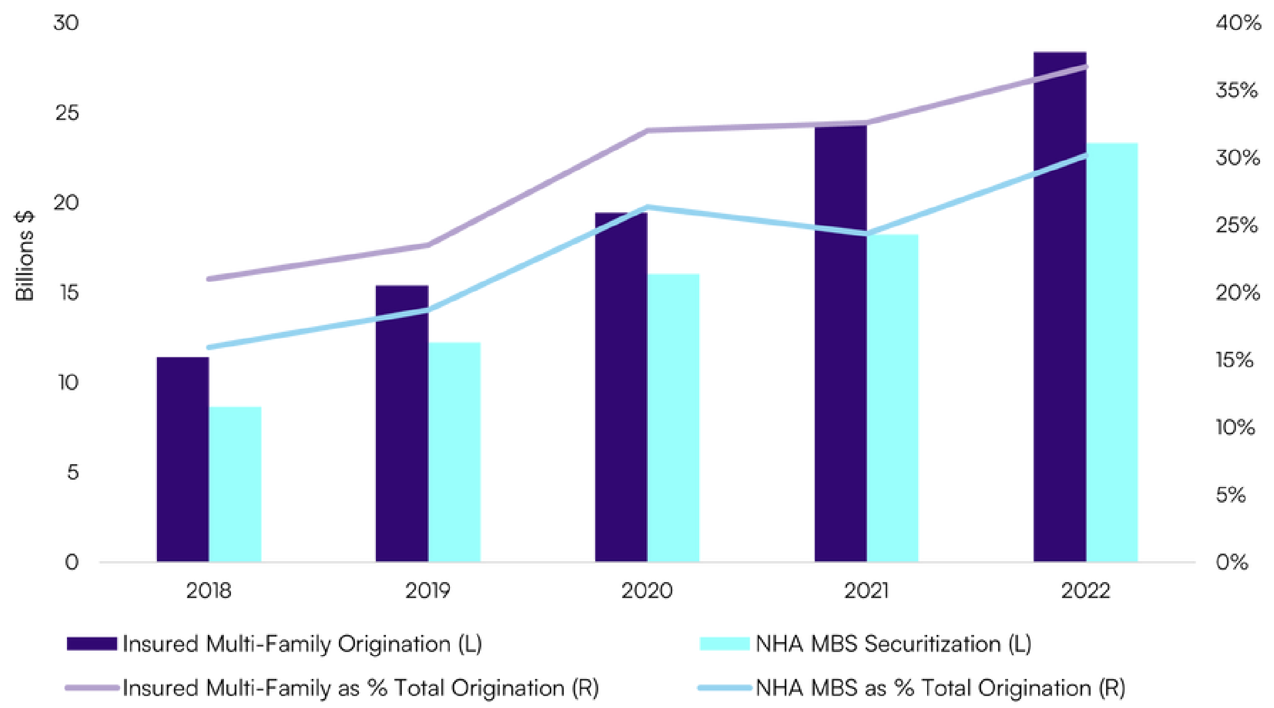
One of the more obvious reasons has been significant growth in the NHA MBS program. The program allows lenders to pool and sell mortgages as investment securities (with payments of interest and principal guaranteed by the federal government) and recycle the proceeds back into new mortgage lending. Annual issuances of NHA MBS backed by pools of multi-family assets reached a record $23.3 billion in 2022, up $5.1 billion (28%) YoY and $14.7 billion (169%) since 2018. Over 80% of all insured mortgages in 2022 were securitized as NHA MBS. (Continues on next page)

The ability for lenders to securitize these mortgages, as well as the fact that all payments are guaranteed by the federal government, allows borrowers to access lower mortgage rates relative to conventional financing. This has become especially important in this era of higher interest rates. Furthermore, the ability to obtain longer amortization periods and higher leverage relative to many conventional lending programs, or to access further financial incentives through programs like the Canada Mortgage and Housing Corporation's (CMHC) MLI Select, have made insured mortgages even more attractive. With development, operating and borrowing costs up significantly in recent years, as well as tighter underwriting in the conventional space, many borrowers see insured mortgages as one of the few viable ways to acquire, refinance or develop multi-family housing.

There are challenges on the horizon though. As the next article shows, mortgage insurance premiums are set to rise in June, and the lending community continues to await clarity from CMHC on Advice No. 18, a modification to CMHC's securitization policy that could disrupt the business models for many of Canada's largest insured lenders. On top of that, certain incidents in the Canada Mortgage Bond (CMB) market have led to disruptions in insured mortgage securitization, which could result in higher insured mortgage spreads in the near-term and challenge insured origination altogether.

Lastly, should interest rates remain higher for longer, this could further dissuade borrowers from using leverage to invest in multi-family product and reduce demand for insured mortgages. Although insured rates may be more favorable than conventional financing, they remain well above their historical average. Despite some risks on the horizon, however, deal flow for insured multi-family has remained strong through the first few months of 2023 and has been one of the few bright spots in the commercial mortgage market to date.

Insured Multi-Family Origination Trends



Source: Intellifi, CMHC

Headwinds on Insured Lending

CMHC announced on April 18th that it will be increasing mortgage insurance premiums for multi-unit residential properties, effective June 19th, 2023. The premium increases span borrowing for standard insured rental housing, retirement housing and student housing, as well as borrowing through the MLI Select program. Standard rental housing premiums will increase 75-85bps across leverage points depending on whether underwritten effective gross income (EGI) has been achieved at the time of funding. Premiums for loans issued through the MLI Select program will increase 155bps across the board. The table below provides a summary of the increases and updated premiums.

Beyond higher insurance premiums, lenders are also awaiting clarity on CMHC's Advice No. 18, an announcement made in July 2022 to modify the allocation methodology for new guarantees of market NHA MBS. As per CMHC, the modification seeks to limit the use of certain business models in order to provide more equitable access to mortgage funding through CMHC securitization programs. The modification was implemented after CMHC realized that certain issuers of NHA MBS were securitizing significant volumes of third-party originated loans, which resulted in some issuers avoiding higher fees and others being able to access NHA MBS allocations beyond what was technically available to them. To address this, CMHC redefined what it means to be an "aggregator" under its NHA MBS allocation policy. An aggregator is now any issuer of NHA MBS who sources 50% or more of the total loans they securitize from third-party originators. (Continues on next page)

Standard Rental Housing						
	Current Premium		New Premium		Increase	
LTV	EGI Met	EGI Not Met	EGI Met	EGI Not Met	EGI Met	EGI Not Met
<=65%	1.75%	2.50%	2.60%	3.25%	0.85%	0.75%
<=70%	2.00%	3.00%	2.85%	3.75%	0.85%	0.75%
<=75%	2.50%	3.50%	3.35%	4.25%	0.85%	0.75%
<=80%	3.50%	4.25%	4.35%	5.00%	0.85%	0.75%
<=85%	4.50%	5.25%	5.35%	6.00%	0.85%	0.75%
Total Points	MLI Select					
Min. 50pts	2.25%	2.50%	3.80%	4.05%	1.55%	1.55%
Min. 70pts	1.75%	2.00%	3.30%	3.55%	1.55%	1.55%
Min. 100pts	1.00%	1.25%	2.55%	2.80%	1.55%	1.55%

Source: CMHC

The challenge facing an entity whose status is changed from "issuer" to "aggregator" is that it would limit their ability to securitize self-originated mortgages. As a result, certain issuers who were previously securitizing large proportions of third-party loans have reduced their purchasing volume to avoid a status change to aggregator. This would especially disrupt the business models of smaller issuers who don't have the infrastructure or expertise to scale origination volumes to a level that is equivalent to their current aggregated securitization volumes. In response to these changes, Intellifi is developing a solution tailored to the needs of issuers that will allow them to maintain their "issuer" status by leveraging Intellifi infrastructure and expertise to increase loan originations, while limiting the increased overhead of processing additional loan volumes.

Additionally, Advice No. 18 also poses significant challenges for entities who originate and sell sizable volumes of insured mortgages to other NHA MBS issuers. With certain issuers now limiting their purchases of insured mortgages to protect their "issuer" status, this has left other entities unable to place their insured mortgages and thus source funding for new origination. Should Advice No. 18 remain as is, lenders indicate that this could cause a decline in insured mortgage lending and liquidity. CMHC is in discussion with the lending community and is currently collecting feedback on the matter. Further updates on the implementation, and any revisions to the current guidance provided, are expected in the near future.

Lastly, the outlook for liquidity has become challenged following CMHC's May 2023 CMB update where they highlighted the possibility of zero funding availability for standard pools in the upcoming 10yr CMB issuance. Affordability-linked pools, which must include a minimum of 20% affordable mortgages, receive priority allocation over standard pools (or non-affordability-linked pools) in CMB issuances. Affordable housing mortgages are defined as loans on multi-family properties where a percentage of units have rents below 30% of median household income in a given region. If CMB allocation demand from affordability-linked pools outweighs CMHC's total CMB issuance size, then standard pools receive no allocation in said issuance. This was the scenario demonstrated in CMHC's May 2023 update. It should be noted though that final figures for the May 2023 CMB have not yet been released by CMHC as of this writing.

In the event that there is in fact no allocation for standard pools in the upcoming CMB issuance, then lenders holding non-affordability linked pools will be forced to keep these relatively low-yielding loans on their balance sheet until they can be securitized, or otherwise sold off, at a later date. Should these challenges spill over into future CMB issuances, this could result in a significant drop in insured lending liquidity and a rise in mortgage spreads. Lenders may be forced to sell their NHA MBS pools to market buyers, but the yield demanded by the market has historically been higher than that of the CMB. Lenders would therefore require a higher spread from borrowers. Price discovery is ongoing in mortgage markets as lenders work to securitize warehoused loans and resolve origination pipeline bottlenecks.

The CMB program is an important source of cheap capital for the healthy functioning of insured markets, meaning the current bottleneck poses a significant headache to market liquidity. Likewise, CMHC securitization programs play an essential role in multi-family financing in Canada and have helped insured multi-family as an asset class become the largest share of commercial mortgage growth in recent years. The risks listed above by no means spell the demise of insured multi-family lending, but will cause headwinds in the near term should they not be addressed.

Fixed Income Markets

Senior Unsecured Issuances Bounce Back After Slow 2022

After one of the quietest issuance years in a decade, Canadian real estate investment companies started the year on a strong note with $2.5 billion in senior unsecured bond issuances in Q1 2023. The large increase in volume means that year-to-date issuances already equate to about 75% of the total in 2022 ($3.3 billion). On a year-over-year basis, issuances were up 150% relative to Q1 2022 — a time when aggressive monetary tightening had yet to send interest rates surging.

Although activity was up significantly, the rise in issuances was not indicative of increased activity in commercial real estate investment. As per company press releases, the majority of funds were destined to refinance existing debts rather than finance new acquisitions or developments. Higher issuances were not a function of more favorable financial conditions either. The weighted average coupon on bonds issued was 5.64% in Q1, well above 5yr and 10yr moving averages, and the weighted average spread at issuance was 252bps over GoC. Without new investment activity or easing financial conditions to justify elevated issuances, it seems that borrowers may instead be finding themselves with no choice but to re-enter debt markets and face the reality of higher borrowing costs.

Senior Unsecured Bond Issuances Q1 2023

Issuer Name	Issue Size ($MM)	Issuance Rating	Term (Yrs)	Coupon	Spread (bps)
StorageVault Canada	150	n/a	5.2	5.00%	n/a
Brookfield Property Finance	500	BBBL	5.0	7.13%	392.0
Choice Properties REIT	550	BBBH	10.0	5.40%	210.0
RioCan REIT	200	BBB	4.6	5.61%	198.0
OMERS Realty Corp	400	AAL	6.1	4.54%	140.3
Dream Industrial REIT	200	BBB	5.0	5.38%	232.0
Crombie REIT	200	BBBL	6.5	5.24%	258.8
Primaris REIT	250	BBBH	5.0	5.93%	297.3
Q1 Averages	306		6.4	5.64%	252.0
Q1 Total Issue Size	2,450				

Source: Bloomberg

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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 Servicing Software
Target Asset Management Software

Residential

Services

Underwriting and Fulfillment
Mortgage Servicing
Back up Underwriting
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Software

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