AUGUST 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.

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Making News

Intellifi Valuations Offer Clarity in Volatile Environment

The Covid-19 pandemic and ensuing market volatility have given commercial mortgage lenders plenty to navigate in recent years. As pandemic restrictions eased and life returned to normal, elevated inflation and rising interest rates introduced a fresh slate of economic challenges for lenders and borrowers alike. An analysis in our May 2023 Intellifi Commercial Mortgage Report showed that, over the past year, conventional borrowers have seen interest rates rise some 150-225 basis points (bps) when renewing or refinancing their 5yr mortgages. Should rates remain higher for longer, borrowers who secured financing during the lows of the pandemic would see even larger increases. As per our Annual Commercial Mortgage Survey, Intellifi estimates that some $150 billion in commercial mortgages were originated in 2020-2021. It's no wonder then why lenders responding to our Quarterly Lender Sentiment Surveys indicate that their greatest concern right now is the impact that higher interest rates will have on maturing loans in their portfolios.

While higher interest rates certainly add an element of risk to mortgages as they mature, they also impact the current market value of all mortgages in a lender's portfolio. That is because fixed-rate mortgages are priced like bonds — when interest rates rise, their fair market value falls (and vice versa). The reason for this is relatively straightforward. If a mortgage was originated 2, 5 or 10 years ago in a lower interest rate environment, that same mortgage would likely be paying a higher rate of interest if it was originated today. As such, the price of said mortgage must fall to a discount so that the yield is closer to prevailing mortgage rates. Across a lender's entire portfolio, this can lead to a situation where the fair market value of the portfolio is less than the outstanding balance.

For many lenders, commercial mortgages are held in a fund, sometimes alongside other assets like bonds. A market price is needed for each asset to facilitate investors purchasing or selling shares of the fund, as well as for lenders who may buy or sell mortgages in the fund. However, even for those lenders whose portfolios aren't structured as investment funds, knowing the fair market value of their mortgage portfolio is important for monitoring performance and for providing stakeholders with transparent reporting. From a risk management perspective, it allows lenders to better assess struggling or impaired loans and to make more informed strategic and lending decisions. Unfortunately, not all lenders have the resources internally to regularly assess the credit risk of their loans and fair market value of their portfolios.

Luckily, third-party mortgage valuations firms like Intellifi exist to provide credible and independent assessments of fair value for lenders. Our group of valuations experts rely on an established valuations process that has been developed and refined over a decade and over thousands of loan reviews. The process starts by deriving a credit score through our proprietary risk rating model. Our team does due diligence to collect the latest servicing records and re-underwrites loans based on the current performance of the underlying assets and current market conditions. Loans are then measured on over 20 quantitative and qualitative risk factors across loan structure, borrowing group and collateral to produce an industry-recognized and auditable risk rating score. Many of Canada's largest institutional lenders, whether they be pension funds, investment managers or insurance companies, rely on our valuations system for recurring, objective assessments of mortgage credit risk and for daily pricing of their mortgage portfolios. (Continues on next page)

Intellifi's Mortgage Valuation Process

Our proprietary risk rating model measures loans on over 20 risk factors to derive an industry recognized credit risk score.

Our Market Intelligence team monitors market pricing trends to develop a monthly publication that categorizes current commercial mortgage spreads by risk score and term to maturity.

Our proprietary mortgage pricing software, Target, combines credit scores with current mortgage spreads to calculate the price, market value, yield and duration for all loans in a lender's portfolio.

The second part of the valuations process leverages insights from our Market Intelligence group. Our team of researchers sits at the center of the mortgage market and maintains relationships and regular touchpoints with over 30 of the country's largest commercial mortgage lenders. We also manage an extensive database of commercial mortgage transactions that gives us further insight into mortgage pricing mechanics and other market trends across the country. Using this data, our team develops a monthly spread matrix publication that contains guidance on current commercial mortgage spreads categorized by risk rating score and term to maturity.

The final piece of our comprehensive valuations system is our proprietary mortgage pricing software, Target Asset Management. Our software combines risk rating scores with current mortgage spreads to calculate the price, market value, yield and duration for all loans in a lender's portfolio. Lenders can track the performance of their portfolio, as well as individual loans, through an intuitive web-based platform offering access to dozens of time-series charts, datasets and metrics. Additionally, our software also serves as a repository for lenders to consolidate and archive essential loan documents and information. Most importantly, lenders can have confidence in the insights on our platform knowing that they are underpinned by our industry-leading risk rating scoring system and mortgage spread intelligence.

If you think your firm could benefit from our comprehensive mortgage valuations, please reach out to mortgagevaluations@intellifi.ca for a more detailed account of our product suite and a formal introduction to our risk rating scoring system, spread matrix package, and Target Asset Management software.

Economic Environment

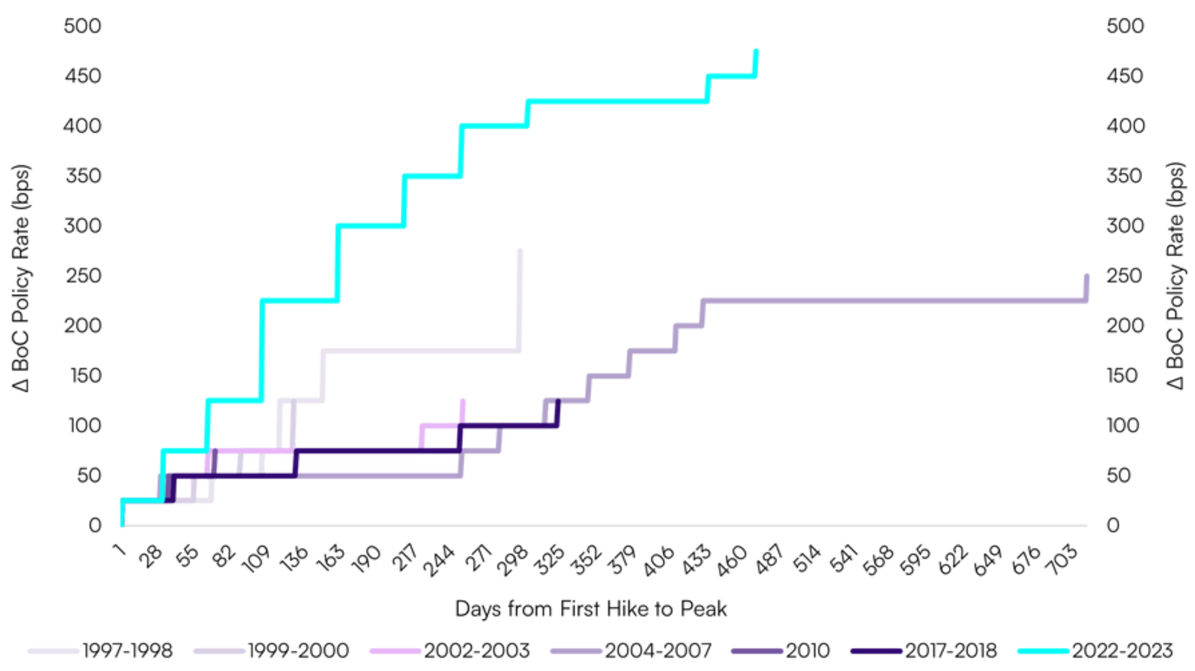
Another Pause for the BoC?

The Bank of Canada (BoC) became one of the first central banks among developed economies to pause its monetary tightening campaign earlier this year, holding its key policy rate at 4.50% through the first five months of 2023. At the time, signs of easing inflation, normalizing global supply chains, and a slowing economy persuaded the bank to hold rates steady. The U.S. banking crisis in March and tightening credit conditions provided further support. Amid the unease, financial markets and economists were expecting the bank to reverse course and begin cutting rates as soon as Q1 2024.

Since then, the BoC has recommenced its rate tightening program with two additional 25bps rate increases in June and July. Stronger than anticipated economic growth, in tandem with still elevated measures of core inflation, gave the bank room to push rates higher, even as the Consumer Price Index (CPI) fell to below 3.00% for the first time since March 2021. Continued labour market tightness, elevated wage growth, and rising housing market activity and prices provided further support.

All told, the bank's actions over the past year and a half have culminated in its most aggressive monetary tightening campaign in recent history. As per the adjacent graph, the key policy rate has risen 475bps over 10 interest rate decisions. That is faster and of greater magnitude than any of the previous 6 tightening cycles going back to 1997. At 5.00% currently, the policy rate is at its highest level since 2001.

Looking ahead, there is early indication that the BoC will pause its tightening campaign once again to assess how the economy and inflation respond to cumulative rate hikes. The bank itself noted in a recent summary of its July interest rate decision that it is more aware of the risk over-tightening interest rates, a sign that it could leave its policy rate unchanged at its next meeting in September. Forecasts by most major Canadian banks see the BoC holding its policy rate steady at 5.00% through the remainder of 2023. Unlike earlier in the year, economists have pushed back their views as to when the BoC might begin cutting rates to later in 2024.



Source: Bloomberg

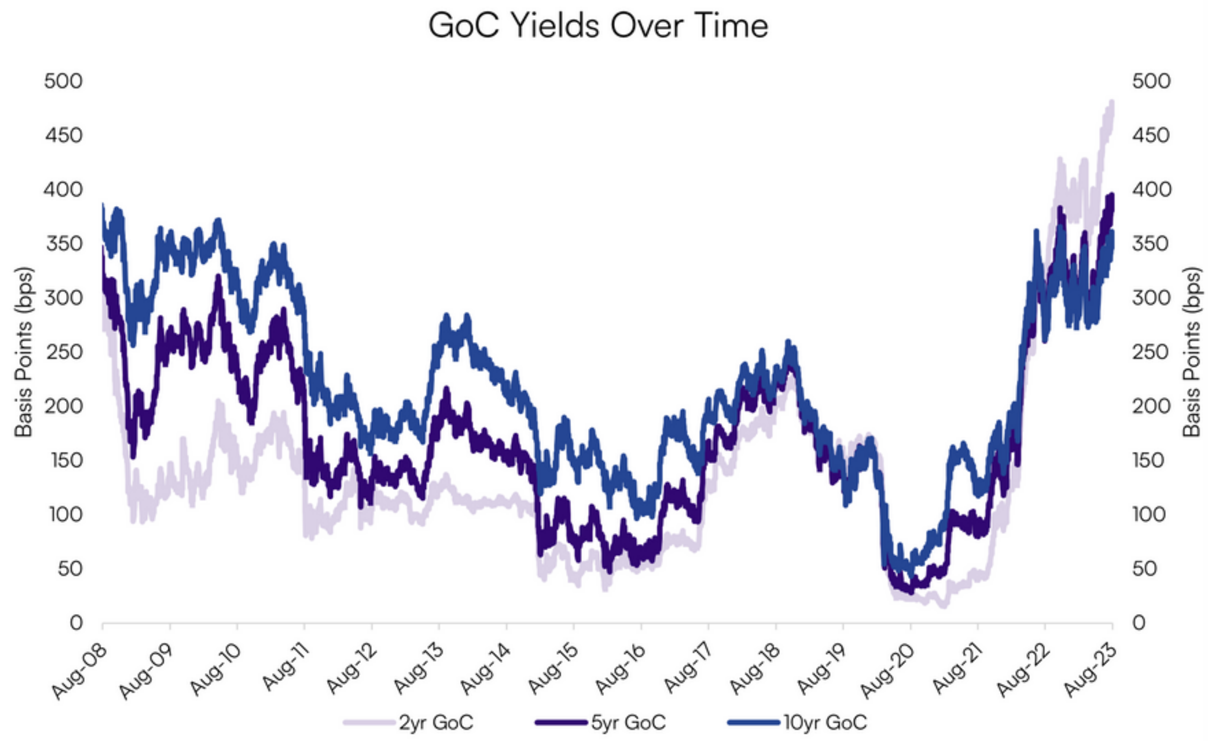
Tightening Cycle	Period	Trough	Peak	Days	Increase (bps)	Hikes
Cycle #1	1997-1998	3.00%	5.75%	295	275	6
Cycle #2	1999-2000	4.50%	5.75%	128	125	4
Cycle #3	2002-2003	2.00%	3.25%	253	125	5
Cycle #4	2004-2007	2.00%	4.50%	713	250	10
Cycle #5	2010	0.25%	1.00%	70	75	3
Cycle #6	2017-2018	0.50%	1.75%	323	125	5
Cycle #7	2022-2023	0.25%	5.00%	469	475	10

Source: Bloomberg

Government Bond Yields Reach New 15-Year Highs

In response to two additional rate hikes by the BoC, Government of Canada (GoC) bond yields have climbed significantly in recent months, first unwinding all of the declines that followed the U.S. banking crisis, and then ascending to new 15-year highs by the end of July. The 5yr GoC, the most common base rate for fixed-rate commercial mortgages, reached as high as 3.95% in the final days of July. That is up about 120bps from its low in March. The last time the 5yr GoC hovered this close to 4.00% was in the final weeks of December 2007. The ascent in shorter-term interest rates has been just as remarkable, pushing the degree of yield curve inversion to levels unseen since 1990. The 2yr GoC yield reached as high as 4.80% in late July and, given that 10yr yields are much lower around the 3.50% mark, the 2-10yr spread averaged minus 120bps in July.

The recent expansion in government bond yields has pushed mortgage rates higher at a time when borrowers are already dealing with the highest borrowing costs in over a decade. Our estimate of the average rate on a 5yr conventional mortgage was 5.75% in July, its highest level since June 2009 when conventional mortgage spreads accelerated into the high 300bps range. For context, conventional mortgage spreads are around the 200bps mark today. The run-up in rates means that, on average, conventional borrowers renewing or refinancing their 5yr conventional mortgages in July saw their mortgage rate increase approximately 215bps (the typical rate on a 5yr conventional mortgage in July 2018 was approximately 3.60%).



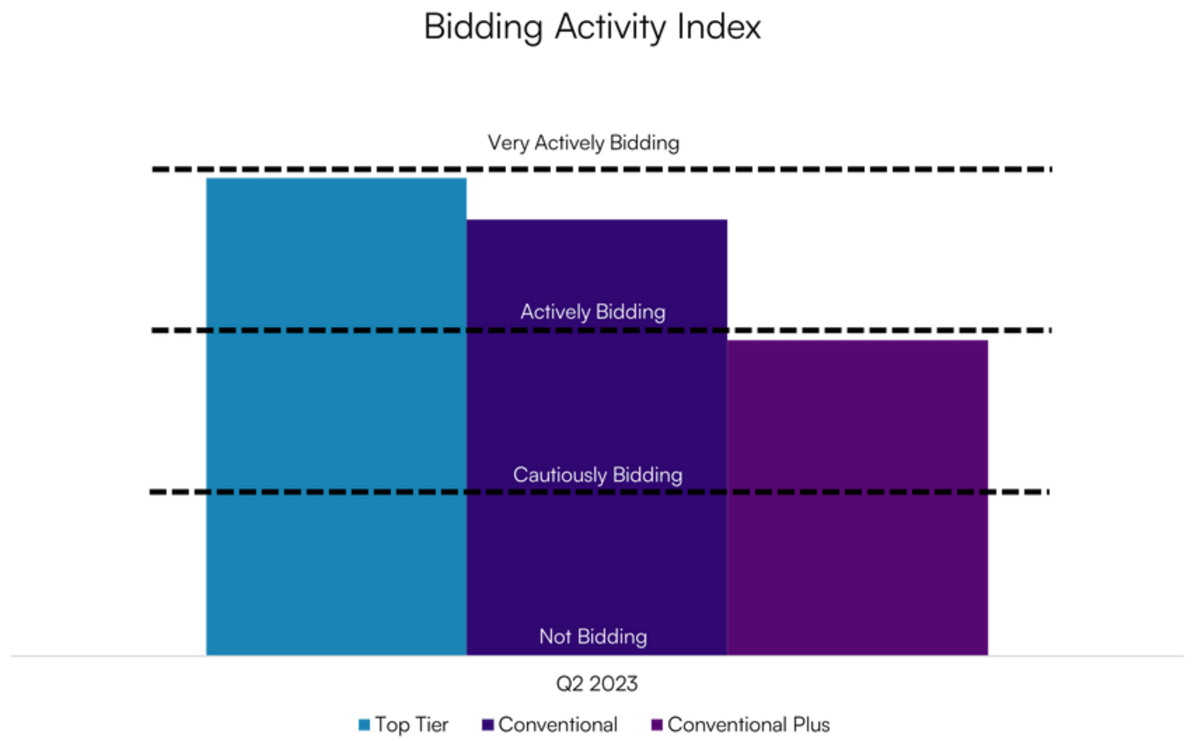
Source: Bloomberg, Intellifi

Conventional

Top Tier and The Rest

Aggressive interest rate hikes by central banks and a banking crisis south of the border were a drag on conventional mortgage activity through much of 2022 and early 2023. While sentiment and activity have shown some signs of improving, general economic uncertainty continues to weigh on overall activity. As per our Q2 Lender Sentiment Survey, about 40% of top tier and conventional lenders reported that they were behind their year-to-date origination targets, with that figure climbing to 60% for higher risk conventional plus deals. To make matters worse, lenders generally reported continued softness in new lending opportunities.

Despite falling short of their origination targets and a limited supply of new opportunities, lenders remain well capitalized and are actively bidding, particularly on higher quality deals. As per our new Bidding Activity Index, about a third of top tier lenders reported that they were very actively bidding in Q2, while a further two thirds indicated that they were actively bidding. Moving up the risk curve, however, lenders were less enthusiastic. A quarter of conventional lenders reported that they were cautiously bidding in Q2, while half of conventional plus lenders reported the same. (Continues on next page)



Source: Intellifi

Pairing survey data with sentiment from lender conversations and analysis of mortgage transactions, there is increasing evidence of market bifurcation between top tier deals and the rest of the conventional market. Well-located, well-tenanted properties backed by strong and well-capitalized borrowers are attracting increased attention from lenders given so much uncertainty on the horizon. Increased competition has pushed down spreads on top tier deals into the 170s and, by account of some lenders, even lower for select deals. We had been hearing rumors of deals falling into the 170bps range for several months, and recently we have seen more firm evidence of this in observed transactions.

Further up the risk curve, deals aren't quite seeing the same spread compression. Second tier conventional deals are generally garnering spreads as low as 190-200bps, but given lower competition and liquidity, pricing can be quite irregular. We are frequently seeing deals fall anywhere in the 200-275bps range depending on the market, asset type, tenant quality and borrower quality.

Insured

Federal Government Updates CMB Consolidation Proposal

CMLS Financial recently provided an in-depth overview of the federal government's announcement that it is considering consolidating the Canada Mortgage Bond (CMB) program into its regular government borrowing program. The announcement has caused much uncertainty among the lending community given that the $271 billion CMB market is a key conduit of capital for insured residential lending in Canada. Following its consultation period, the government recently provided the following update on its website:

"The government recognizes the importance of providing transparency and forward guidance to market participants with respect to the CMB program and ensuring that stable access to mortgage financing is not disrupted. While the government continues to assess the benefits and risks associated with the proposal, should the government decide to announce changes to the CMB program in the fall, changes to the program would be undertaken no earlier than the beginning of fiscal year 2024-25 (April 1, 2024)."

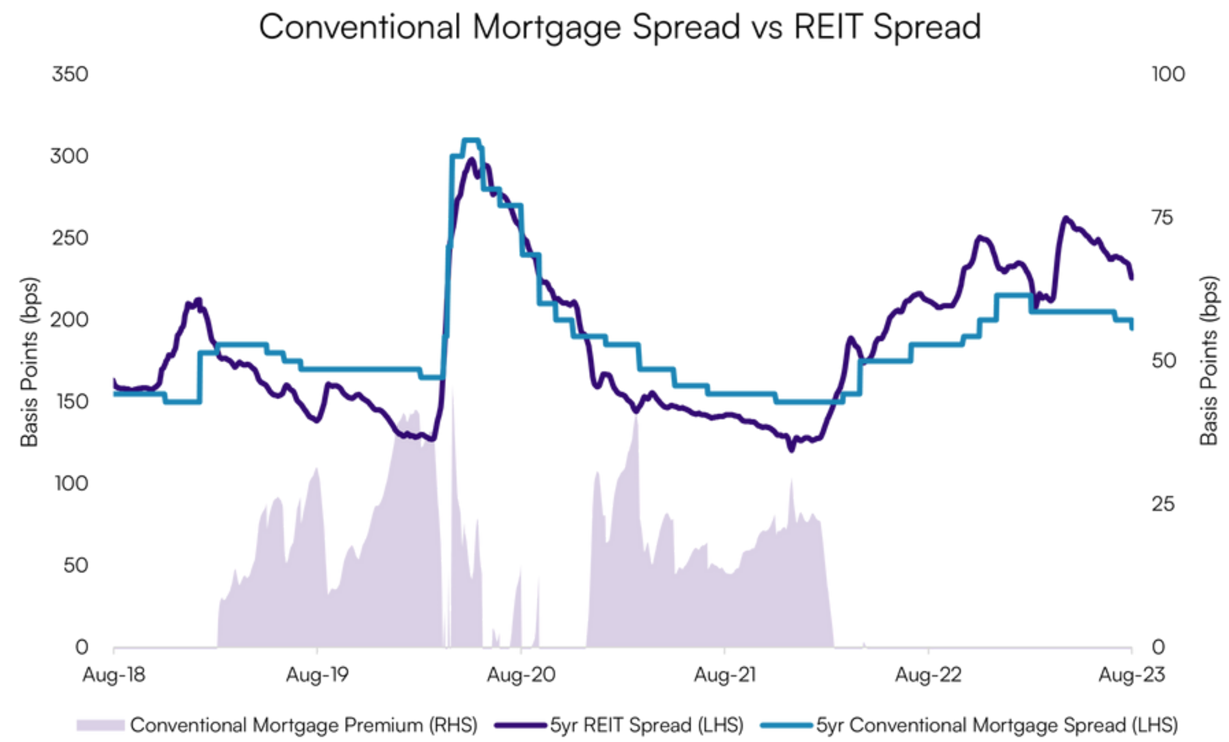
Previously, lenders only had certainty around the August and September issuances for 5yr and 10yr CMB. Given that it takes roughly 3 months (or longer) for lenders to quote, underwrite, obtain a certificate of insurance, and fund an insured mortgage before it can be securitized, lenders were reaching the point where they could no longer confidently quote on insured mortgages. The update provides lenders with certainty that the CMB program will continue to function normally for at least the next 8 months.

Fixed Income Markets

REIT Spreads Ease in Tandem With Mortgage Spreads

Issuances of senior unsecured bonds by Canadian real estate investment companies declined in Q2 after a strong Q1, falling about 40% QoQ to $1.5 billion. The weighted average spread at issuance declined some 30bps QoQ, partly a function of a shorter weighted average term to maturity, and partly a function of a higher average credit rating among issuers.

Nevertheless, our REIT Spread Index, which tracks the spreads of approximately 30 investment grade senior unsecured bonds issued by Canadian REITs, shows that 5yr spreads have declined in recent months alongside a general decline in corporate bond spreads. REIT spreads ascended about 50bps following the failure of Silicon Valley Bank and the U.S. banking crisis in March and, while the index has yet reach pre-crisis levels, spreads have declined approximately 35-40bps from their most recent peak of 260bps. REIT spreads do not equal conventional mortgage spreads, but their movement provides a general indication of directional movements in conventional mortgage spreads. The recent decline in both REIT and corporate bond spreads provides further support for credit spreads easing in the commercial mortgage market.



Source: Bloomberg, Intellifi

Senior Unsecured Bond Issuances Q2 2023					
Issuer Name	**Issue Size ($MM)**	**Issuance Rating**	**Term (Yrs)**	**Coupon**	**Spread (bps)**
Ventas Canada	600	n/a	5.0	5.40%	240.6
SmartCentres REIT	300	BBB	5.0	5.35%	234.9
Ivanhoe Cambridge	300	AAL	5.0	4.99%	147.8
RioCan REIT	300	BBB	6.3	5.96%	249.8
Q2 Total & Averages	1,500		5.3	5.42%	222.7
YTD Total & Averages	3,950		6.0	5.56%	240.5

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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
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Risk Reviews
Spread Matrix License
Market Intelligence

Software

Atlas Underwriting Platform
LMS360 Commercial Servicing Software
Target Asset Management Software

Residential

Services

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Mortgage Servicing
Back up Underwriting
Back up Servicing
Securitization Administration

Software

Crystal Automated UW Engine
LMS360 Servicing Platform
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Loan Reviews as a Service
Debt Valuation

Software

Atlas Underwriting Platform
LMS360 Servicing Software

Analytics

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Spread Matrix License
Market Research Reports

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