intellifi

Q4 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.

FEBRUARY 2023

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Making News

2022 Year in Review

The commercial mortgage market of today would hardly recognize itself if it could look back just one year ago. The year 2022 commenced on the heels of a record $76 billion in Canadian origination in 2021 (as per Intellifi's 2021 Annual Survey), and ample liquidity had forged a highly competitive environment that saw mortgage spreads compress to near historic lows. Trophy assets were fetching spreads as low as 130 basis points (bps) over Government of Canada (GoC) bond yields and, given how depressed bond yields were in the wake of the pandemic, the typical conventional deal was securing 5yr financing at all-in rates around 2.80%. For lenders who couldn't win deals on spread alone, competition flooded into other areas of loan underwriting. Lenders got creative with interest-only terms, relaxed recourse requirements, and stretched amortizations, giving borrowers broad flexibility with which to finance deals.

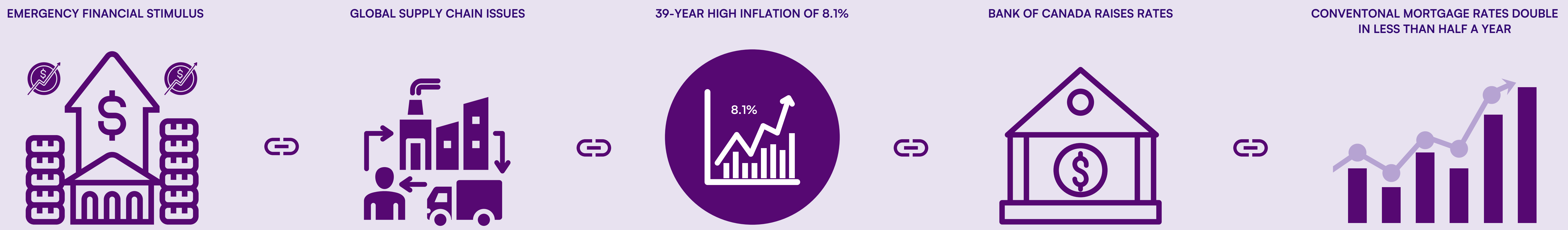
This window of ultra-competitive, ultra-easy financing would not last long though. By March, two years of emergency monetary and fiscal stimulus, global supply chain issues, and pent-up consumer demand had all coincided to severely impact prices. To add to the problem, Russia's invasion of Ukraine brought about a global energy crisis and sent commodity prices soaring. The Canadian Consumer Price Index (CPI) reached 6.7% in March, its 12th consecutive month above the Bank of Canada's (BoC) 1.0-3.0% target, and would continue to rise in the months following. By June, inflation had reached a 39-year high of 8.1%, measures of core inflation — which tend to exclude more volatile goods such as energy and food — all hovered around 5.0%, and 75.0% of CPI categories were accelerating above the BoC's target. The central bank's notion that inflation was "transitory" was officially dead.

In an effort to quell decades-high inflation, the BoC (and central banks globally for that matter) ushered in one of the most aggressive monetary tightening campaigns in its history. By mid-year, the bank had already hiked its key policy rate by 125bps, sending bond yields surging and tightening credit conditions substantially. Yields on the 5yr GoC eclipsed 3.0% for the first time since 2010 and investment-grade corporate bond spreads were up some 60-70bps. Likewise, conventional mortgage spreads rose 30-40bps and, in tandem with the sharp climb in government bond yields, the typical 5yr conventional deal was securing financing above 5.0% - a near doubling in just 6 months.

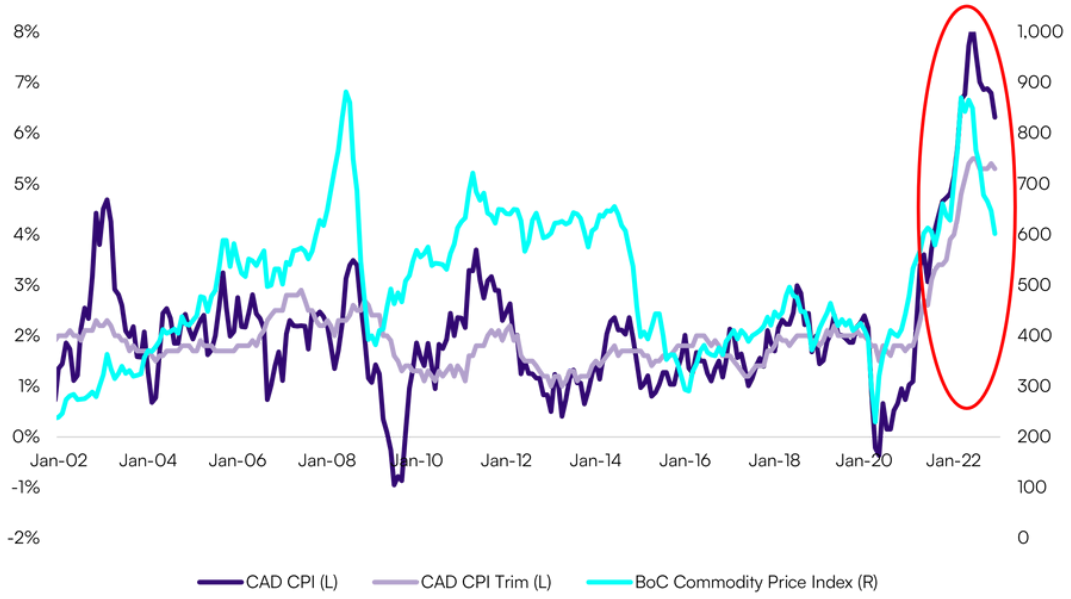
Naturally, such an abrupt rise in financing costs would have sweeping effects on lending activity. Our poll of 30 of the largest institutional lenders in late summer showed that 40.0% had witnessed moderate declines in year-over-year (YoY) origination in the range of 5.0-15.0%, while a further 15.0% of lenders had witnessed significant declines of greater than 15.0% YoY. Observed mortgage transactions were down some 15.0-30.0% YoY, with the sharpest declines witnessed in conventional and high yield lending. Only CMHC-insured deal volumes remained resilient.

Other notable trends emerged as well. A sharply inverted GoC yield curve severely limited lender demand for longer-term mortgages. Over 65.0% of lenders in our most recent survey had a high degree of interest for terms of 5 years or less, whereas the vast majority of lenders reported low or no interest in issuing anything longer-term. For borrowers, the assumption that interest rates would decline in the next several years saw demand for short-term (Continues on next page)

TWO YEARS OF EMERGENCY MONETARY AND FISCAL STIMULUS, GLOBAL SUPPLY CHAIN ISSUES AND PENT-UP CONSUMER DEMAND ALL COINCIDED TO SEVERELY IMPACT MORTGAGE RATES



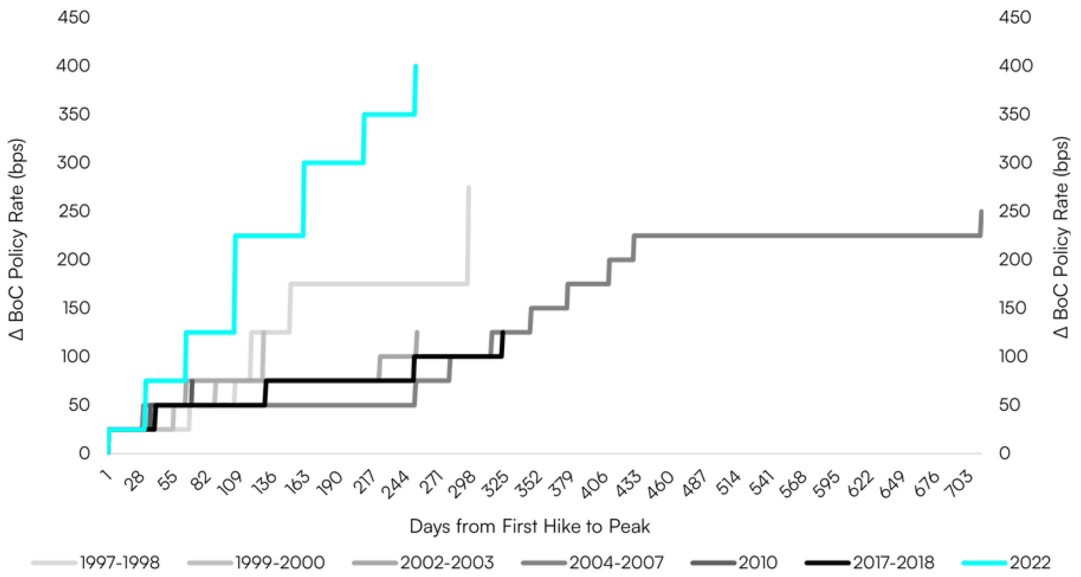
Canadian Inflation Indicators



Source: Bank of Canada, Statistics Canada

"The highest inflation in 4 decades prompts central banks to drop their idea that inflation is "transitory", ushering in one of the most aggressive monetary tightening campaigns in history."

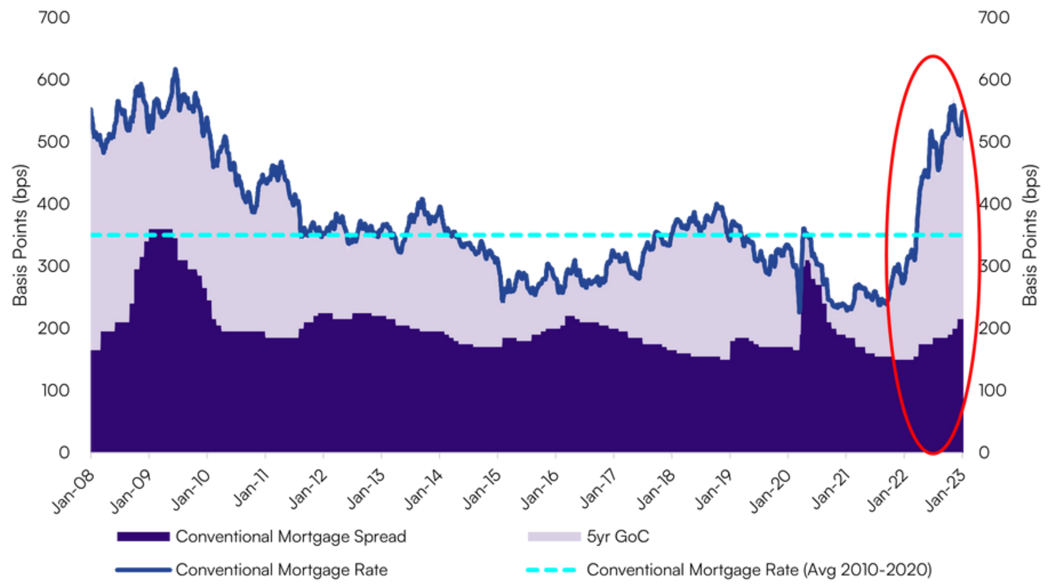
Historical BoC Tightening Cycles



Source: Bloomberg

"The Bank of Canada would hike its key policy rate at 7 of 8 meetings in 2022, implementing 400bps worth of hikes in just 251 days. The trepid pace was quicker and of greater magnitude than any of the previous 6 tightening cycles by a significant margin."

5yr Conventional Mortgage Index



Source: Bloomberg, Intellifi

"The sharp monetary policy pivot by the Bank of Canada sent the 5yr GoC above 3.0% for the first time in over a decade. Credit spreads tightened in tandem with rising base rates causing the typical 5yr conventional mortgage rate to nearly double in half a year — reaching levels unseen since the Global Financial Crisis."

debt spike. As interest rates continued to rise, the proportion of higher risk mortgages originated on a floating rate basis increased significantly, an effort by lenders to capture the additional return brought on by continued rate increases expected by the BoC. Ever-rising financing costs, in tandem with double-digit increases in construction costs, brought about a sharp decline in development activity. Many lenders stepped away entirely from lending on land given the challenged development environment.

Meanwhile, inflation continued to rage on and an historically tight labour market, in tandem with surprisingly positive GDP prints, gave the BoC ample runway to continue hiking interest rates at breakneck pace. Following a historic 100bps hike in July — the first hike of such magnitude since August 1998 — the bank would go on to hike its key policy rate another 175bps through the remainder of the year. Cumulative hikes of 400bps through 2022 brought the BoC policy rate to 4.25% at year-end, a level unseen since before the Global Financial Crisis and well above an average of around 1.0% seen through the decade of 2010-2020.

If elevated mortgage rates weren't enough of a headwind for mortgage activity, firming expectations of an impending recession provided further resistance. A significant portion of lenders responding to our Q4 survey continued to report declining quarter-over-quarter (QoQ) deal flow across the risk spectrum, and observed mortgage transactions, especially in the conventional and high yield space, slowed to a trickle. For deals that were closing, strained debt service coverage resulted in reduced loan proceeds and lower leverage. Lengthy interest-only terms and waived recourse requirements were few and far between. Additionally, liquidity became a growing concern for some lenders. Given the relative tightness in yield between conventional mortgages and more liquid publicly traded fixed income securities, some lenders saw new capital inflows drop and, in a few cases, were forced to deal with sizeable fund redemptions (see Conventional section for more details).

Overall, headwinds on activity throughout 2022 led to large misses in expected origination targets for many lenders. As per our Q4 survey, half of insured and high yield lenders missed their lending targets for the year, while 40.0% of conventional lenders reported the same. For 2023, lenders were relatively split on the direction of their origination targets given current market conditions. Forty percent of respondents reported relatively stable origination budgets but a full 30.0% reported moderate declines in the range of 5.0-20.0% YoY. An additional 7.0% saw significant declines of greater than 20.0% YoY.

However things ultimately unfold in 2023, you can be sure to find all the latest commercial mortgage market information and trends in the Intellifi Commercial Mortgage Report. Stay tuned for our Q1 2023 report where we will summarize results from our 2022 Annual Canadian Commercial Mortgage Survey — our flagship annual report that attempts to measure and breakdown origination and market size in Canada. If you would like to be notified when future issues are published, consider subscribing today!

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Economic Environment

Is the Bank of Canada Done Tightening?

The BoC proceeded with a widely anticipated 25bps hike at its January 25th interest rate decision, bringing its key policy rate to 4.5% and cumulative rate hikes to 425bps since March 2022. In an interesting about turn, the bank used its forward guidance to announce that it will be pausing further interest rate hikes — at least conditionally. As per the BoC's press release: "if economic developments evolve broadly in line with [the bank's] outlook, [the] governing council expects to hold the policy rate at its current level while it assesses the impact of the cumulative interest rate increases."

The BoC acknowledged growing evidence of a decelerating economy — especially in household spending and housing market activity — but pointed to stronger than anticipated economic growth in the second half of 2022 and a historically tight labour market as support for its decision to hike rates once again. The bank continues to be of the view that the Canadian economy will see a "soft landing", with growth stalling through the middle of the year and picking up thereafter. It expects GDP to climb about 1.0% this year and 2.0% in 2024 — in line with its previous forecast from October. Where its views have changed notably, however, are around the trajectory for inflation. The bank now sees inflation dropping significantly in the near term as a result of lower energy prices and improving global supply chains. Headline inflation is expected to reach 3.0% by mid-year and to fall to the 2.0% target in 2024. Previously, the bank was of the mind that inflation wouldn't reach 3.0% until the end of 2023.

Insured

Vacancy in Canada's Rental Market Reaches 21-Year Low

The Canada Mortgage and Housing Corporation (CMHC) published its signature 2022 Rental Market Report in January highlighting the extent of tightness in Canada's multi-family rental market. Despite the supply of rental units growing at the highest rate since 2013 (up 2.6% YoY in 2022), growth in occupied units (up 3.8% YoY) more than offset new supply causing a sharp decline in the national vacancy rate for purpose-built rentals. At 1.9%, national vacancies are at their lowest level since 2001 and stand well below their 30-year average of 3.2%. Vacancy declined in the vast majority of census metropolitan areas (CMA) tracked by the CMHC and were tightest in BC, Ontario and Quebec. Although vacancies in the prairie region were considerably higher, strong interprovincial and international migration buoyed by a strong economy helped to bolster rental demand and pushed vacancy rates down substantially YoY. Notably, Calgary saw the most significant increase in supply of new units of any CMA in Canada (up 8.0% YoY), but a surge in occupied units (up 10.7% YoY) saw the vacancy rate decline 2.4 percentage points to 2.7%. Vacancy rates in other major markets include 0.9% in Vancouver, 1.7% in Toronto and 2.0% in Montreal.

Naturally, strong rental demand and a tight vacancy rate put significant upward pressure on rental rates. The national average rent for a 2-bedroom unit climbed to $1,258, up 5.6% YoY. That marked a new high for annual rental growth and was well above the average growth of 2.8% from 1990-2022. Halifax (9.3%), Gatineau (9.1%), Victoria (6.7%) and Calgary (6.0%) saw the sharpest rise in rents YoY. As one would expect, Vancouver and Toronto continued to see the highest rents nationally at $2,002 and $1,765 for 2-bedroom units. Further highlighting the housing affordability challenges faced by many Canadians, the CMHC provided new data in this year's report showing the sharp divergence in rents paid by new and existing tenants. The average rent for a 2-bedroom unit that turned over in 2022 was up 18.2% YoY nationally, whereas average rent for units that didn't turnover was up just 2.8%. That disparity was widest in Toronto at 29.1% for turnover units versus 2.3% for non-turnover units, followed by Vancouver at 23.9% versus 3.9%. The report noted that the national turnover rate fell from 15.1% in 2021 to 13.6% in 2022, likely a result of reduced willingness by renters to vacate units in the face of higher market rents. In Vancouver, the average asking rent for vacant units is now 43% higher than the average rent of occupied units.

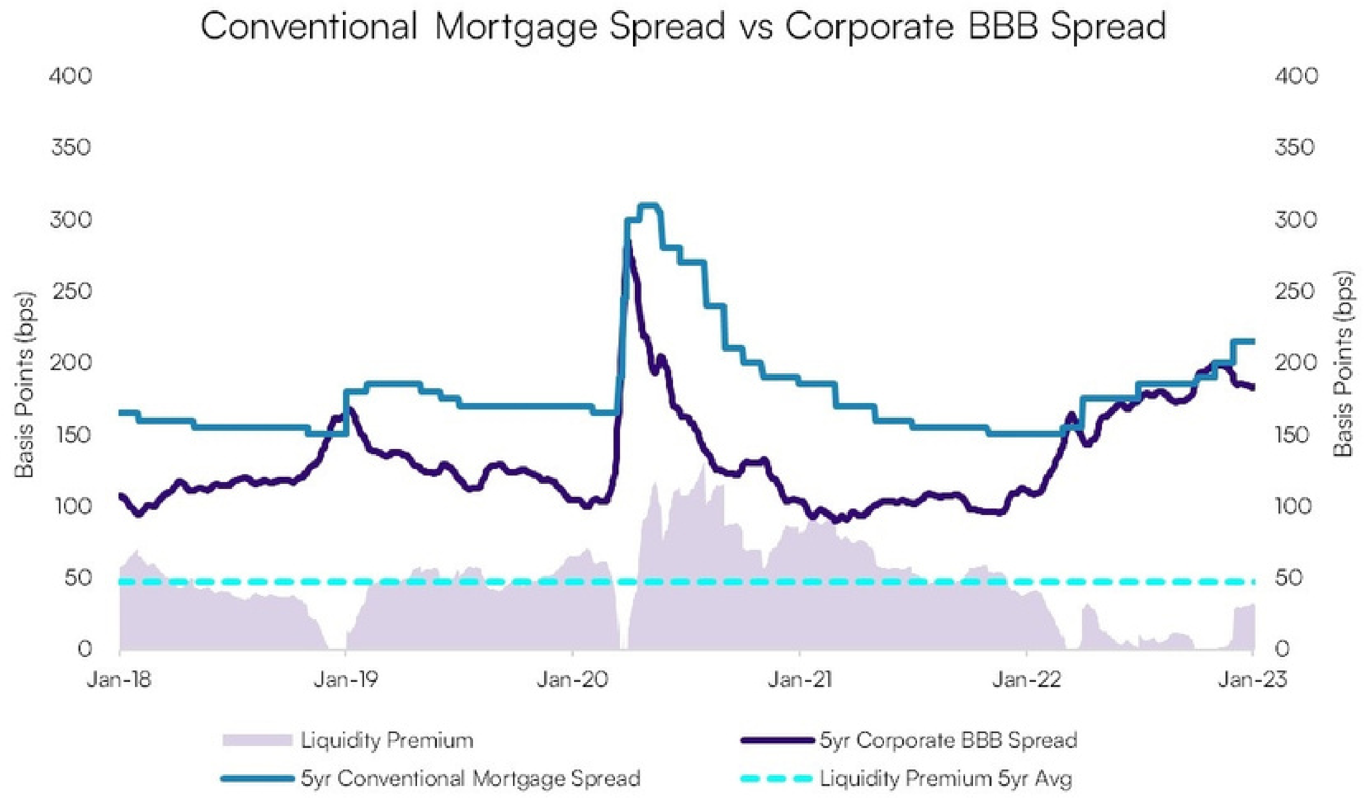
All told, tighter vacancy rates and higher rents should improve multi-family valuations in loan underwriting in 2023, providing some resistance to the impact that higher interest rates have had on debt service coverage and loan proceeds. That said, these improvements could be offset by any increases to cap rates, which are expected to rise further as real interest rates rise. As per CBRE's Q4 Canadian Cap Rates Report, multi-family cap rates have so far only budged slightly. The national average cap rate for all multi-family types was 4.4% in Q4, up about 20bps through 2022.

Conventional

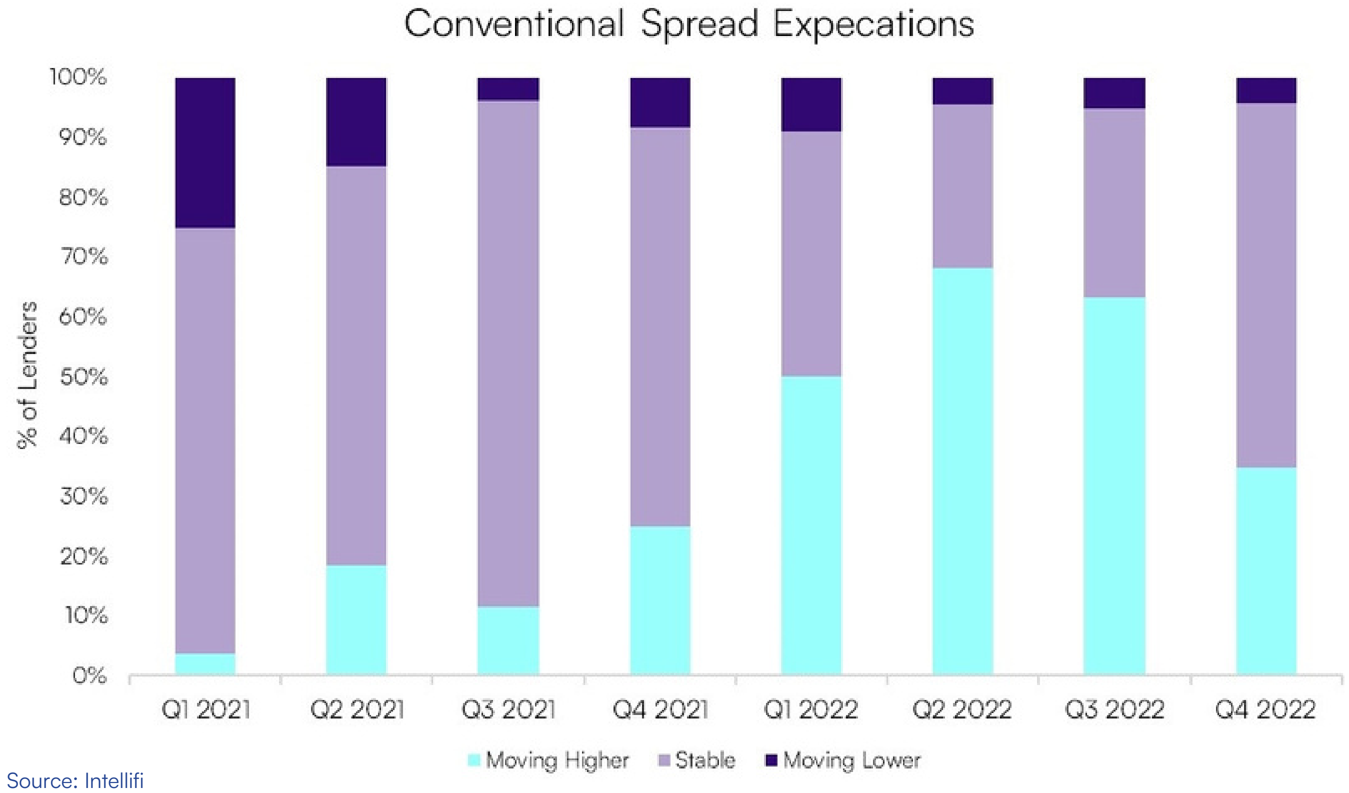
Five-Year Mortgage Spreads Eclipse 200bps, Stabilization Expected in 2023

Conventional mortgage spreads continued their ascent through the final quarter of 2022 resulting in 70-80bps of cumulative tightening over the year. Notably, 5yr conventional mortgage spreads eclipsed the 200bps over GoC threshold to close the year in the 210-250bps range, while spreads on the highest quality top tier assets were seen as low as 190-200bps at year-end. Given significant inversion in the GoC bond yield curve and limited demand for longer-term mortgages, an average term premium of 30-40bps existed for 10yr conventional mortgages. At the beginning of 2022, lenders required a much smaller 10bps premium over a corresponding 5yr deal for the standard conventional mortgage.

The sharp rise in conventional mortgage spreads was just one example of the abrupt tightening in credit conditions that unfolded across financial markets. Corporate bond spreads, whose behaviour has historically been a reliable indicator for the direction of mortgage spreads, were also up considerably in 2022. In fact, investment grade corporate bond spreads actually climbed more quickly than conventional mortgage spreads, as evidenced by the compression in the light pink shaded area of the chart on the next page. The result was near parity between the two through much of the year as high liquidity among commercial mortgage lenders helped to keep mortgage pricing relatively competitive, even amid a deceleration in activity. The conventional mortgage liquidity premium, which has averaged about (Continues on next page)



Source: Bloomberg, Intellifi



Source: Intellifi

50bps over the past 5 years, was eroded to an average of just 15bps in 2022. In the Conventional section of our Q3 2022 Intellifi Commercial Mortgage Report, we posited that near parity in yields between conventional mortgages and investment grade corporate bonds would ultimately incentivize capital to flow toward more liquid corporate bonds, creating some headwinds for mortgage lending liquidity and putting upward pressure on mortgage spreads. To some degree that came to fruition through the final few months of 2022. In late Q3 and Q4, several institutional lenders spoke of less new capital entering the commercial mortgage space as investors took advantage of more attractive relative yields in other fixed-income investments — a trend that hampered liquidity and their ability to bid on deals.

Given some easing and stability in corporate spreads from November through January, which has restored the conventional liquidity premium to around 30bps, it appears that upward pressure on conventional mortgage spreads heading into the new year has subsided — at least for now. As further support, the majority of lenders who responded to our Q4 survey in December also believe that conventional spreads will hold stable in Q1. About two thirds of respondents see spreads staying flat, while about a third think spreads will rise further. That was the smallest proportion of lenders forecasting upward pressure on spreads since before the events of Q1 2022 that led to a significant tightening in credit conditions.

High Yield

High Yield is High Yield Again

Mortgage rates for higher risk deals continued to climb in Q4 in tandem with the increasing BoC policy rate and rising bank prime rates. Our latest high yield coupon guidance generally sees senior ranking deals attracting yields in the high single digits and subordinate debt into the low double digits, with the highest quality second mortgages able to capture coupons as low as 8.00%. This is quite a stark contrast to just a year ago when those same institutional quality deals were receiving coupons in the mid- 4.0% range (which is a rate more attractive than what is being paid on most top tier senior ranking mortgages today). It seems that high yield is, well, high yield again.

While the current rate environment may be providing lenders with attractive yields, feedback from our quarterly surveys and conversations with lenders describe a market where the supply of high yield deals is quite depressed. Most lenders have capital to deploy on these higher risk loans but report relatively few deals available to bid on. From the borrower perspective, it's become difficult to justify financing costs in the high single to low double digits without having significant value-add or rent growth potential in place. As a result, many would-be borrowers are pausing on refinancings and acquisitions where possible until there is more certainty on the trajectory of the economy and interest rates.

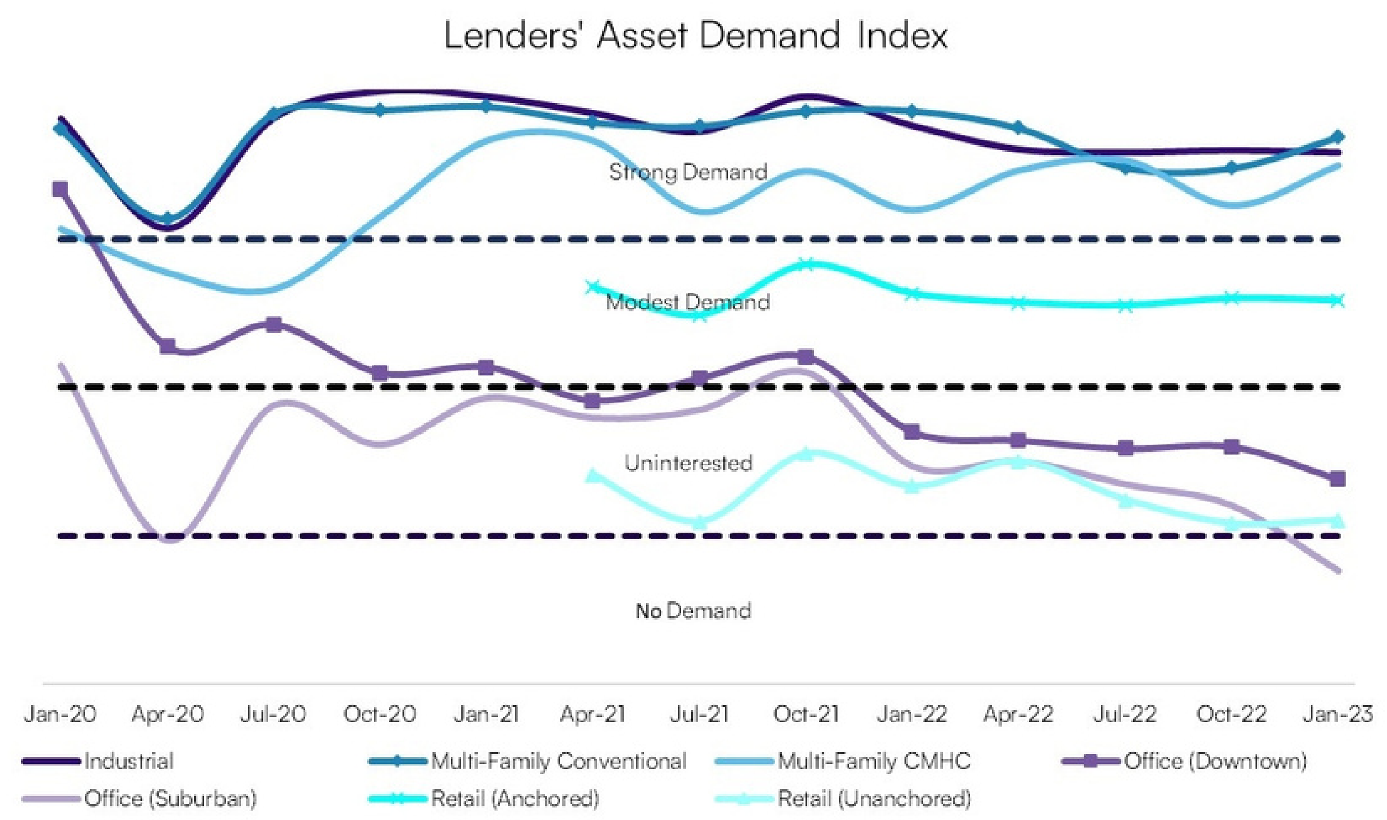
Another trend borne from the high-rate environment is that more borrowers appear be substituting other, cheaper sources of capital in place of debt, which may be another factor contributing to limited deal flow. Several lenders have reported losing bids in recent months to none other than borrowers themselves, who increasingly appear willing to pay out existing debt or finance purchases with cash and equity. Word is that many real estate investors remain quite liquid and, given where borrowing costs are currently, potential borrowers may be better suited to inject cash as opposed to taking on more leverage.

Development

Office Challenges Halt Development

The pandemic challenged many things and, in the world of commercial real estate, one of the clearest examples has been the impact on “out-of-favour” assets like office and unanchored retail. Our Lenders’ Asset Type Demand Index, which aggregates sentiment from roughly 30 of the largest institutional commercial mortgage lenders in Canada, highlights the disproportionally large decline in demand for office assets at the onset of the pandemic (see chart below). Since then, several years of pandemic lockdowns, work-from-home policies and an ever-changing outlook on how and where we work have weighed on office demand. Both downtown and suburban office have been in the “uninterested” section of the index for much of the past three years.

Results from our latest Lender Sentiment Survey pointed to another decisive downward shift in demand for office assets in Q4. While many workers are once again frequenting office towers and downtown cores (at least some of the time), new economic risks and lingering effects from the pandemic are working in unison to suppress demand. Seventy-five percent of lenders we surveyed in Q4 indicated a low interest in downtown office, up 20 percentage points QoQ. Similarly, 55% of lenders reported low interest in suburban office, while an additional 40% indicated no interest, both up by roughly 10 percentage points QoQ.



Source: Intellifi

The sharp decline in lender demand also coincided with some pretty bleak data on vacancy rates and office development in Q4. As per CBRE, the national office vacancy rate reached an all-time high of 17.1%, up from a pre-pandemic rate of about 10.0%. It seems that the true impact of post-pandemic hybrid and remote workplace policies are beginning to be realized as more leases roll over. CBRE also noted that the curbing of growth plans by several major tech companies had a significant impact on vacancy in Toronto. Given the likelihood of an imminent recession, this trend could deepen and perhaps expand to other industries, putting additional pressure on vacancy rates across the country.

Meanwhile, office construction activity fell to a 5-year low as the outlook for office deteriorates with CBRE reporting just 11 million square feet currently under development, versus about 18 million pre-pandemic. Looking at our own data from our quarterly survey, the majority of construction lenders participating over the past 5 quarters have reported declining QoQ deal flow for office developments. Office construction lending has consistently been the softest of all the major asset classes we track.

Commercial Mortgage Backed Securities

CCMOT Issues Only CMBS of 2022

The final month of 2022 saw the Canadian Commercial Mortgage Origination Trust (CCMOT) bring the year’s first and only commercial mortgage-backed security (CMBS) to market. CCMOT 5 had a principal balance at issuance of $494.5 million and consists of 35 loans secured by 52 collateral properties. The pool had a weighted average interest rate of 3.63% and the senior AAA tranche was sold at a spread of 200bps over GoC equivalent. The rating agency DBRS Morningstar determined its weighted average loan-to-value (LTV) at issuance to be 58.3% and its weighted average debt-service-coverage ratio (DSCR) to be 1.48x. The pool largely consists of industrial and multi-family properties, which each constituted 35.3% and 22.5% of the pool’s loan value. There was also notable exposure to hotel assets at 11.1%, while office and unanchored retail assets accounted for approximately 11.0% each. Regionally, Ontario and Quebec assumed the largest share of the pool at 53.1% and 29.4%. The 10 largest loans accounted for 64.4% of total pool balance, with the 887,329 square foot Olymbec Industrial Portfolio in Montreal being the largest loan at $72.5 million, or about 14.7% of the pool.

The CCMOT 5 transaction marks the first Canadian securitization since RBC and BMO delivered REAL-T 2021-1 in Q4 of 2021. That was a $574.3 million issuance secured by 79 loans and 150 commercial properties. DBRS Morningstar noted in its 2023 Canadian CMBS Market Outlook that it expects increasing CMBS activity this year as a result of the negative impact that elevated interest rates and recession risks are having on conventional mortgage lenders. (Chart on next page)

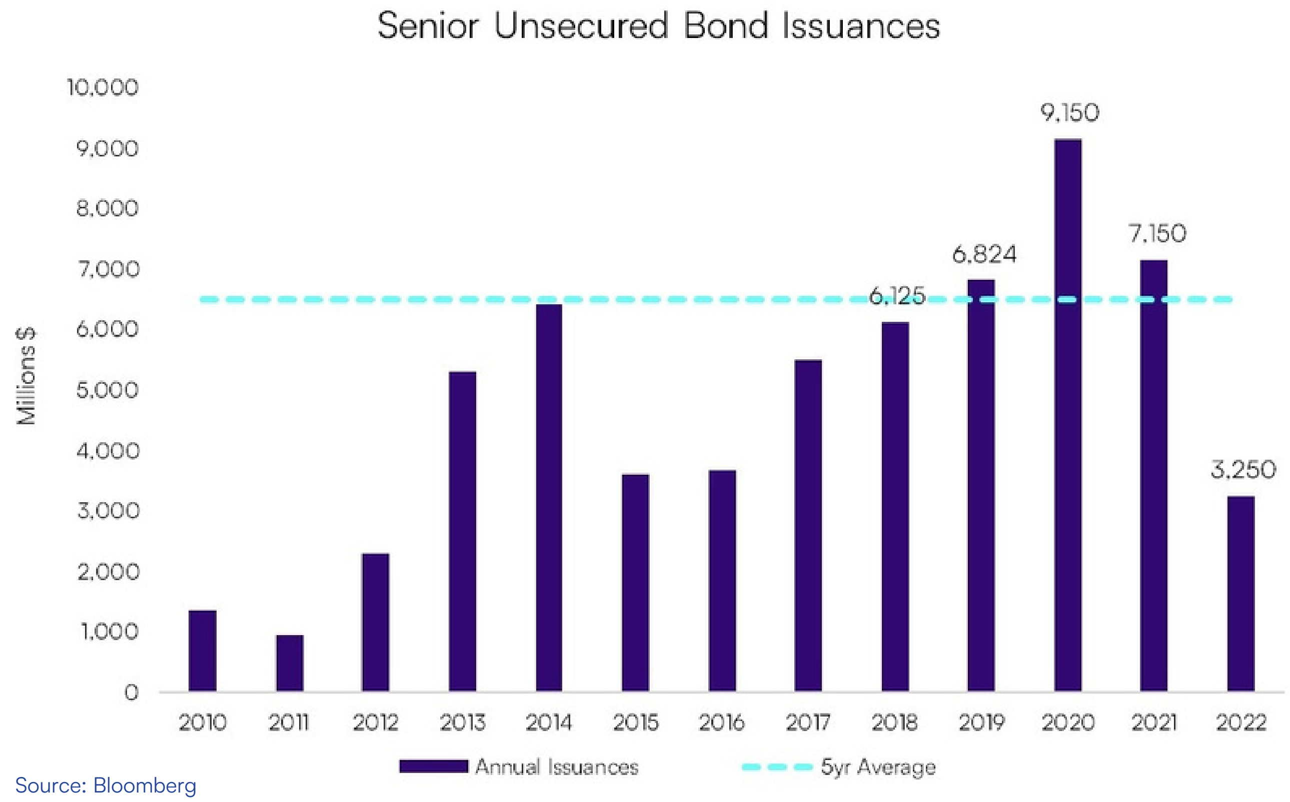
Deal	Issue Size Millions ($)	# of Loans	# of Properties	WAVG Interest Rate	WAVG LTV at Issuance	WAVG DSC at Issuance
CCMOT 5	$494.5	35	52	3.625%	58.8%	1.48x
REAL-T 2021-1	$543.7	79	150	3.868%	65.3%	1.49x

Source: DBRS Morningstar

Senior Unsecured Debt

Annual Bond Issuances Fall to Lowest Level Since 2012

In our Q3 2022 Intellifi Commercial Mortgage Report we highlighted the extraordinary deceleration in issuances of senior unsecured bonds by Canadian real estate investment companies. Over the past decade, investors have increasingly tapped senior unsecured bonds to raise capital for acquisitions, developments, debt consolidation and general operations to the tune of about $1.2 billion per quarter. However, Q3 marked the first time in 51 quarters (or since Q3 of 2009) that investors issued $0 of new bonds in public markets. We chalked this up as additional evidence of a decline in commercial real estate borrowing activity in response to a sharp rise in financing costs and growing economic uncertainty.



Source: Bloomberg

The final quarter of 2022 saw two issuances. The US-based Prologis REIT and OMERS, a Canadian pension fund, issued a combined $1.1 billion in bonds at an average term of 7 years and an average spread of 193bps over GoC equivalent. The bonds brought total annual activity in 2022 to just $3.3 billion, a decrease of 55.0% YoY and a 50.0% decline relative to the 5yr moving average of $6.5 billion. That was the weakest year for issuances since 2012 when real estate investment companies raised $2.3 billion from senior unsecured bonds.

Similar to corporate BBB bond spreads (see Conventional section for context), the Intellifi 5yr Senior Unsecured Bond Spread Index softened through the final few months of 2022 and into 2023. Spreads reached a 52-week high of 220bps over GoC in early November and have since declined about 30bps to around 190bps in January. Easing spreads, in tandem with declining government bond yields, have reduced all-in borrowing costs for real estate investors and should provide some support for issuances into the new year. The index currently sits about 10% above its 10yr moving average

SENIOR UNSECURED BOND ISSUANCES BY QUARTER

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	AAL	4.4	2.55%	91.3
	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	3.34%	143.1
	Q1 Total Issue Size	1,000				
Q2	Dream Industrial REIT	200	BBB	4.0	3.97%	154.1
	Rio Can REIT	250	BBB	7.0	4.63%	212.8
	Artis REIT	200	BBBL	3.0	5.60%	300.4
	Choice Properties REIT	500	BBBH	10.0	6.00%	252.3
	Q2 Averages	288		7.1	5.28%	235.0
	Q2 Total Issue Size	1,150				
Q3		No Issuances This Quarter				
	Q3 Averages	n/a		n/a	n/a	n/a
	Q3 Total Issue Size	n/a				
Q4	Prologis LP	500	AL	8.2	5.25%	205.0
	OMERS Realty Corp	600	AAL	6.0	5.38%	183.4
	Q4 Averages	550		7.0	5.32%	193.2
	Q4 Total Issue Size	1,100				
	Total Issuance YTD	**3,250**		**6.4**	**4.70%**	**192.6**

Indicates Green Bond Issuance

Source: Bloomberg

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
Back up Servicing
Securitization Administration

Software

Crystal Automated UW Engine
LMS360 Servicing Platform
LMS360 Underwriting Platform

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