intellifi

Q3 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.

OCTOBER 2022

intellifi

TABLE OF CONTENTS

Making News

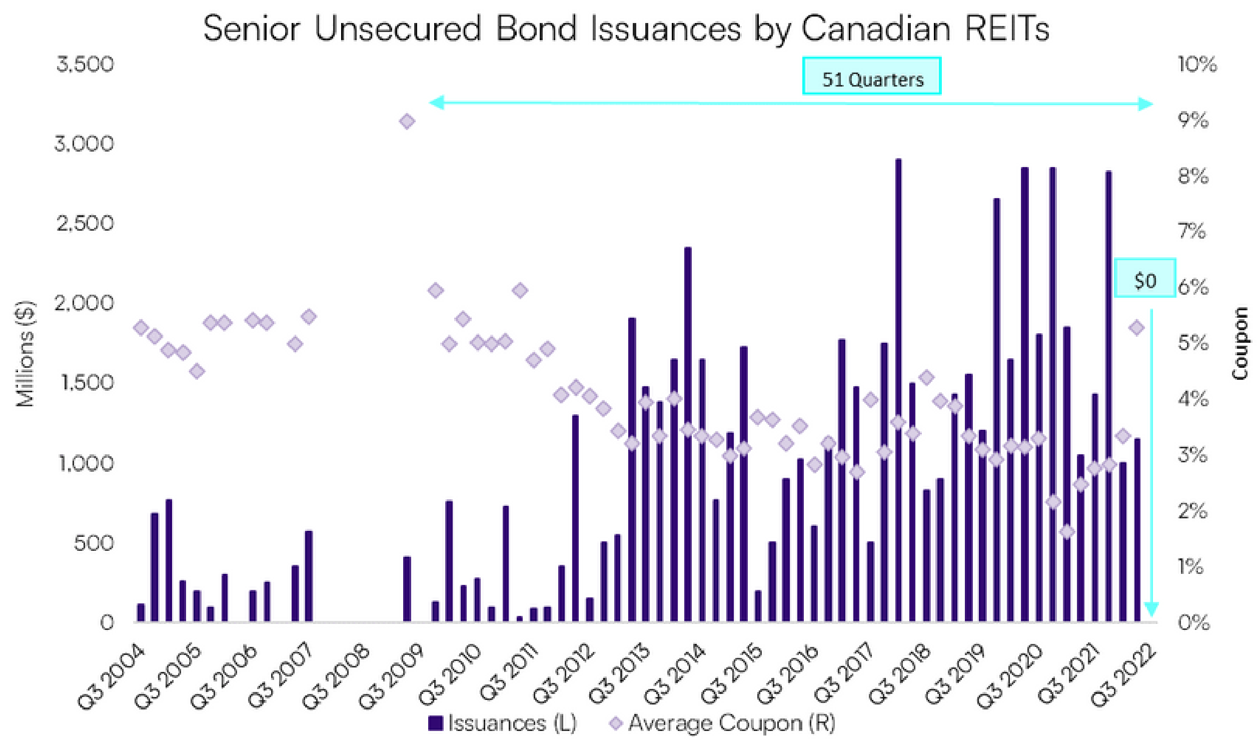
REIT Bond Issuances Stall for First Time Since 2009

Rising borrowing costs, financial market volatility and greater economic uncertainty have taken a toll on commercial mortgage activity over the past two quarters. Trying to gauge in precise terms just how much activity has declined is a challenging task, but several figures provide some evidence of the scale of decline. For example, of the 30 commercial mortgage lenders that responded to our sentiment survey in Q3, more reported that deal flow declined quarter-over-quarter (QoQ) for CMHC-insured, conventional and high yield deals than in any other quarter since the onset of the pandemic. In that same survey, more lenders reported a moderate (5-15%) or significant (>15%) decline in year-over-year (YoY) origination than those who reported an increase. Observed market transactions have ticked down in recent months as well, and conversations with lenders indicate that activity has slowed as the market tries to navigate a sharp rise in interest rates and a basket of economic risks.

For more tangible evidence of market deceleration though, the senior unsecured bond market was a good place to look in Q3. Over the past decade, Canadian real estate investment trusts (REITs) have increasingly tapped senior unsecured bonds to raise capital for acquisitions, developments, debt consolidation and green initiatives, among other things. Since 2010, issuances have averaged about $1.2 billion per quarter, jumping to $1.6 billion over the past 5 years. However, what made the senior unsecured bond market so striking in Q3 is that, for the first time in 51 quarters (or since Q3 of 2009), Canadian REITs issued $0 of new bonds.

The stall in issuances provides a window into the impact that rising borrowing costs and greater economic uncertainty may be having on commercial real estate lending and investment activity. As per the chart to the right, issuances started trending downward in the first two quarters of the year as average coupons rose above 5.00% — the highest level since 2011. Issuances in the first half of the year ($2.2 billion) were down 24% from the first half of 2021 ($2.9 billion). As of the end of Q3, year-to-date issuances were down 49% versus 2021.

While significant, the bond market is far from a perfect reflection of commercial real estate activity. REITs have multiple avenues to raise capital, and acquisitions and developments continue to take place. Furthermore, REITs may still be trying to allocate the large amounts of capital raised through the pandemic, when they moved to lock in long-term financing at historically low interest rates. But for issuances to fall so precipitously is certainly an indicator of how drastically this cycle of credit tightening has affected demand for new funds. How these broader economic headwinds translate into the commercial mortgage space will continue to become clearer in the months ahead.



Source: Bloomberg

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
	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	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				
Q3		No Issuances This Quarter				
	Q3 Averages	n/a		n/a	n/a	n/a
	Q3 Total Issue Size	n/a				
	Total Issuance YTD	**2,150**		**6.1**	**4.38%**	**192.3**

Indicates Green Bond Issuance

Source: Bloomberg

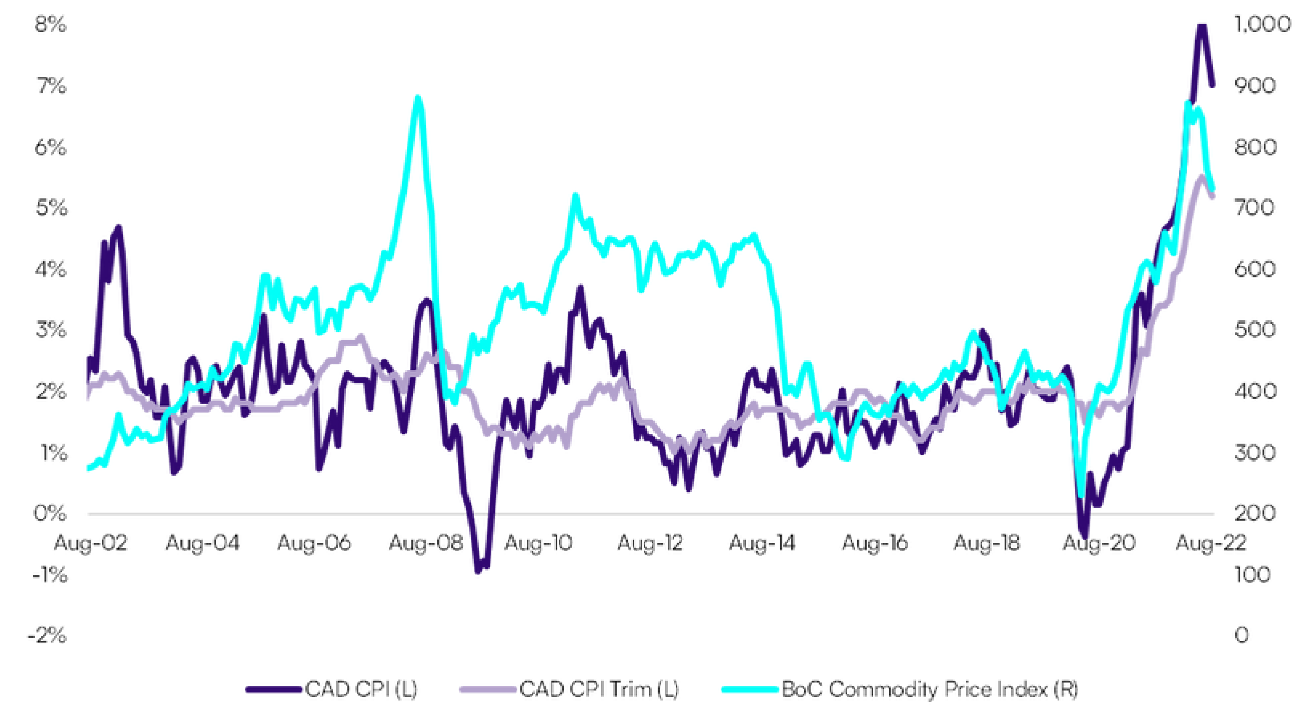
Economic Environment

No Pause in Sight for the Bank of Canada

The Bank of Canada (BoC) followed through with another major rate hike on September 7th, lifting its key policy rate 75bps to 3.25%. With 300bps of rate hikes since March, the Bank has already undertaken one of its most aggressive tightening cycles in history. The latest increase brings the policy rate above what the Bank deems as neutral (2-3%) and is now technically at a level that is restrictive to economic growth. Already though, the Canadian economy has been struggling to absorb the sharp rise in borrowing costs. Canada's labour market has shed about 92,000 jobs since May and economic growth has slowed. Second quarter GDP came in below expectations at an annualized rate of 3.3%, slowing to an annualized rate of 1.2% in July and August. The most noticeable impact of rising interest rates, however, has been on Canada's housing market. Sales activity and prices tumbled for the sixth consecutive month in September. Transactions were down 32% YoY and the national benchmark home price has fallen roughly 14% from its March peak to $746,000. It should be noted though that home prices remain well above their pre-pandemic level, with the benchmark price up about 34% from February 2020.

Where interest rates have not yet had their desired impact is on inflation. At the time of writing, the Canadian Consumer Price Index (CPI) remained stubbornly high, up 7.0% YoY in August. Headline inflation has eased marginally from a 39-year high of 8.1% in June, but nevertheless remains well above the BoC's 1-3% target. The BoC has made it clear that it is seeing through the slight decline in the CPI (primarily driven by a decline in gasoline prices) and keeping focused on measures of core inflation, which continue to point to broadening price pressures. As for the signs that rising rates are already having a negative impact on the economy? The Bank is seeing through that too. It noted that while economic growth appeared to weaken somewhat in Q2, other indicators like consumer spending and business investment point to an economy that continues to operate above capacity. It also stated that housing market activity has declined "as anticipated, following unsustainable growth through the pandemic."

For anyone wondering what all of this means for the trajectory of interest rates, the Bank stated explicitly that it "still judges that the policy interest rate will need to rise further." Following the September interest rate decision, major Canadian banks have all shifted their policy rate forecasts upward and now expect the rate to reach somewhere between 3.50%-4.00% by year end. Other economists see the rate needing to move even higher. While that may indeed be the case, there is growing concern that the BoC's unprecedented moves to date and persistent focus on inflation itself — which is inherently a backward-looking view of prices — may have severe economic repercussions. Especially given that it typically takes anywhere from 12-18 months for interest rate moves to filter through the economy. Forward-looking indicators of inflation, like commodity prices for example — which have had a significant role in driving inflation higher — have already fallen substantially from their peaks. The BoC's Commodity Price Index (BCPI), which tracks spot prices for a basket of 26 globally traded goods, is down 16% from its March high (see chart to the right). Regardless of how things ultimately unfold through the remainder of 2022 and in the years ahead, one thing is for certain — it is an interesting time in the world of monetary policy.



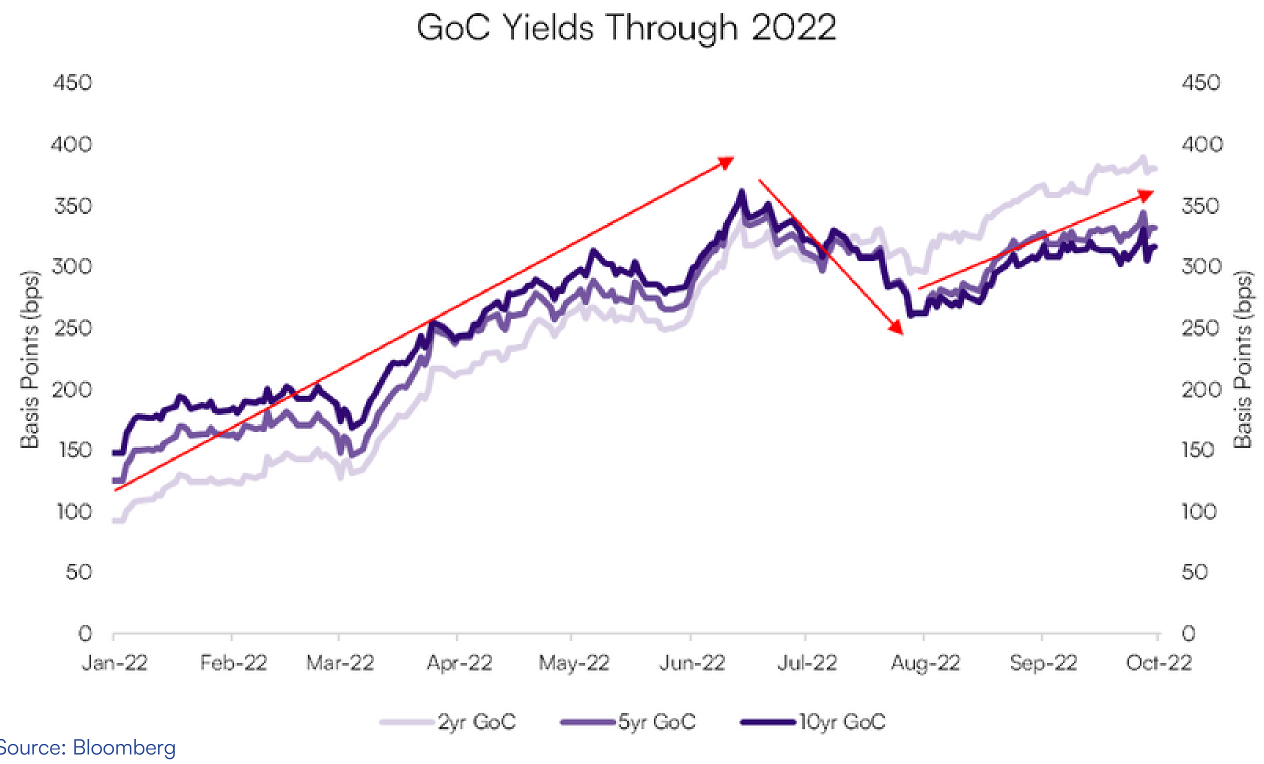
Source: Bank of Canada, Statistics Canada

Bond Yields Surge Again, Yield Curve Deeply Inverted

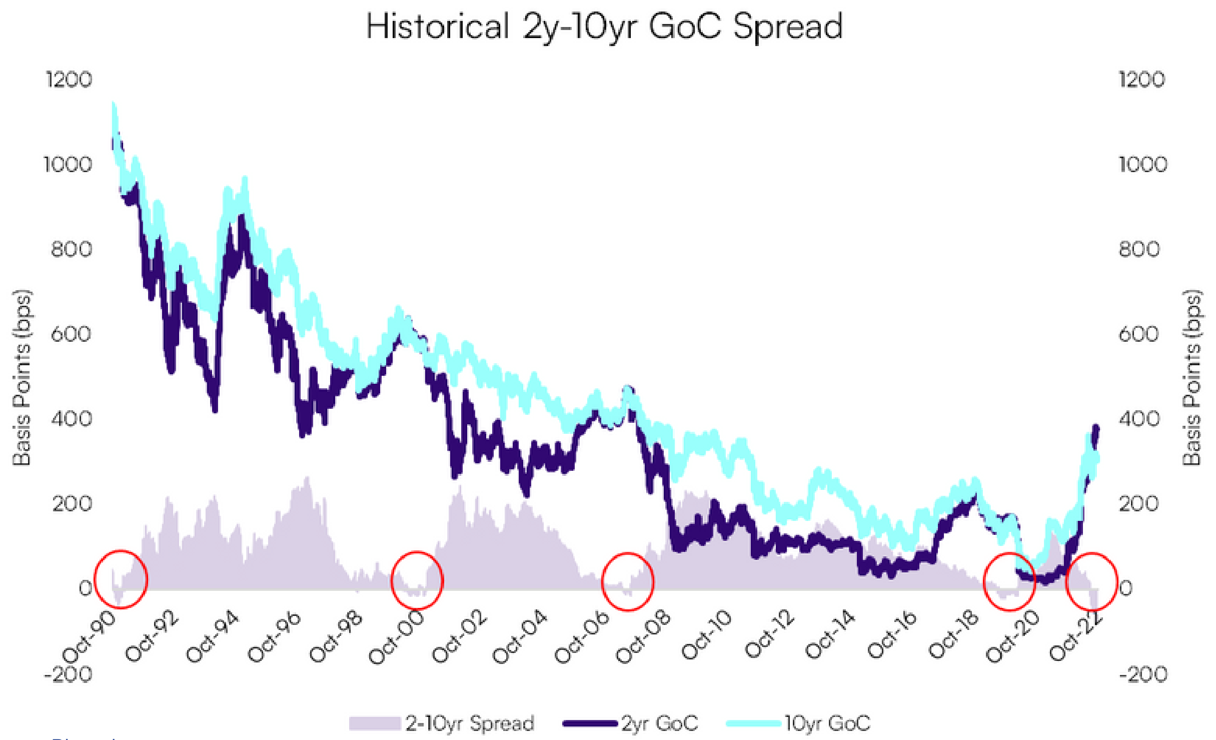
Bond yields surged in a big way through the first half of 2022 as central banks globally pivoted toward the most forceful round of monetary tightening in decades. Five-and-10yr Government of Canada (GoC) bond yields reached levels unseen since the early 2010s when they closed at 3.59% and 3.62%, respectively, in mid-June.

The third quarter commenced with a softening in yields as inflation showed some signs of easing and markets pondered whether the central bank might be nearing the end of the tightening cycle. Five-and-10yr GoCs each fell roughly 100bps through July as a result, providing some much-needed mortgage rate relief to borrowers. Since late July, however, several major rate hikes by the BoC and more hawkish rhetoric by central banks have caused yields to ascend back toward their June highs. The 5yr GoC closed Q3 at 3.32% and the 10yr closed at 3.17%.

Most noteworthy, however, is that the 2yr GoC surged above longer-term rates in Q3 to close at 3.80%. As a result, the yield curve at quarter end was deep in inversion territory, with the spread between 2yr and 10yr GoC yields at negative 63bps. The 2yr-10yr spread is typically used as a barometer for the health of the economy and has been a reliable predictor of economic recession over the past several decades. A historical analysis of GoC rates shows that the 2-10yr spread hasn't been this inverted since the spring of 1990. In the 32 years since then it has averaged positive 89bps. (See charts on next page)



Source: Bloomberg



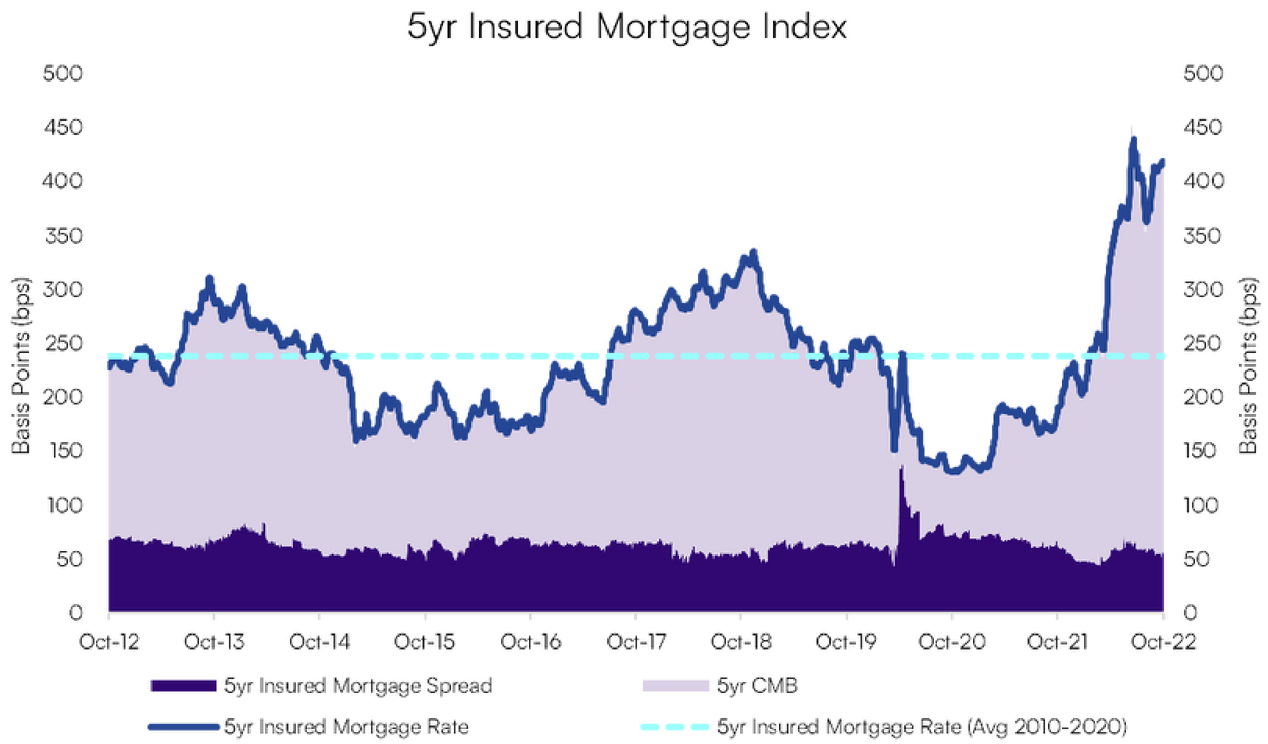
Source: Bloomberg

Insured

Softening Activity Extends to Insured Space

Last quarter we reported that activity in the insured mortgage space had been quite resilient through the first half of 2022 despite market volatility that brought about a cooling in conventional, high yield and development activity. Another quarter on, it appears that these wider market challenges have managed to make a dent in the insured space. A third of insured lenders in our Q3 lender survey reported a decline in insured deal flow QoQ, up 20 percentage points from Q2. Most notably, half of all lenders report that they have funded less volume than expected at this point in the year.

Pressure on Canada Mortgage Bond (CMB) yields, the typical base rate for insured mortgages, are responsible for some of this softness. Barring some easing through July, elevated CMB yields meant that all-in mortgage rates remained near or above 4.00% for much of Q3 — which is in sharp contrast to recent years (see chart below). Such high mortgage rates have challenged the amount of loan proceeds available to borrowers, blown through contractual ceiling rates defined in insurance certificates, and challenged property economics given that borrowers only have so much ability to raise rents to cover higher borrowing costs. As a result, some borrowers are electing to pause on acquisitions. Those who are proceeding are likely to have to put up more equity, or else seek alternative financing, often in the form of bridge loans, until property cash flows can adequately support the borrower's desired proceeds. In any event, the increased difficulty in obtaining financing has also put a damper on CMHC insured lending activity for the time being.



Source: Bloomberg, Intellifi

Conventional

Spreads Relatively Stable Through Q3, But Upward Pressure Remains

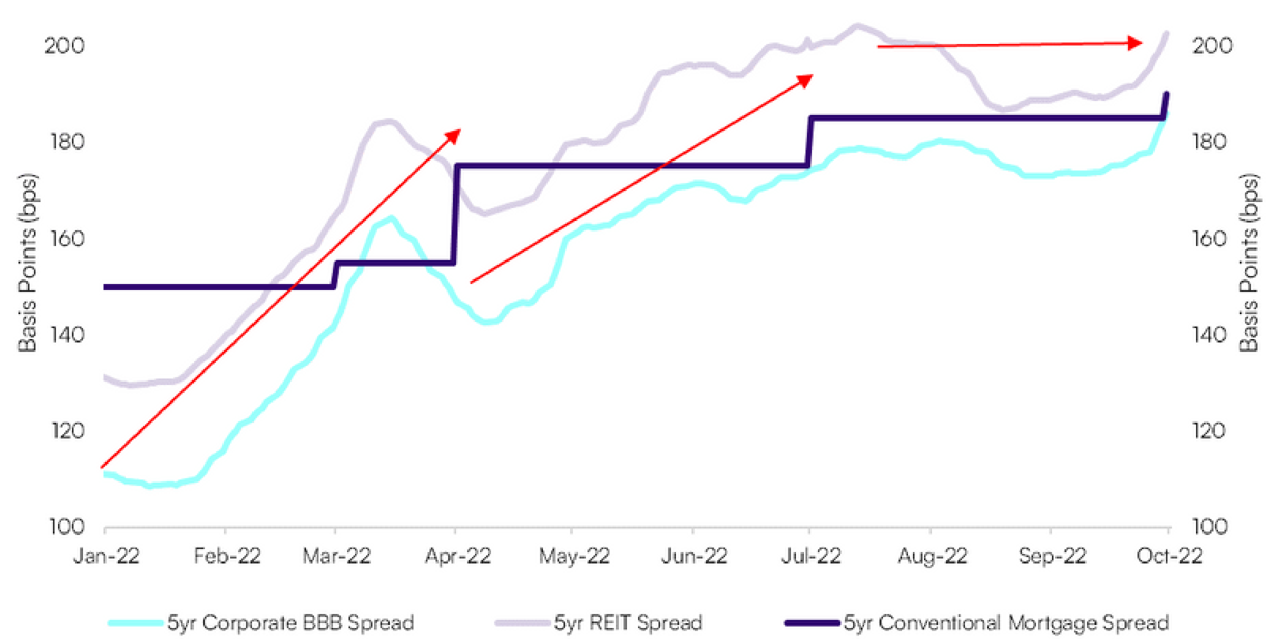
Like bond yields, credit spreads rose sharply through the first half of 2022 in response to significant financial market volatility and tightening credit conditions. Conventional mortgage spreads, in tandem with two closely followed fixed income indicators, moved from near historic lows to well above their long-run averages in a matter of months. Five-year corporate BBB spreads, which track the spread over equivalent GoC of a basket of BBB or equivalent rated Canadian bonds, climbed around 60bps through H1 2022 to 173bps. This was about 40bps above their 10yr average. Similarly, spreads on 5yr senior unsecured bonds for Canadian REITs climbed 70bps to 201bps. Conventional mortgage spreads, as per our Intellifi 5yr conventional mortgage index, didn't quite climb to the same degree but were still up a notable 35bps to 185bps. By the end of June, the combination of elevated mortgage spreads and surging GoC bond yields sent conventional mortgage rates to their highest level since 2010. This abrupt rise in borrowing costs paired with greater economic uncertainty was a major headwind to lending activity in Q3.

Spread volatility in Q3 was in stark contrast to earlier in the year. Five-year corporate BBB spreads remained within a tight band of 171-182bps for most of the quarter before rising steeply in the final week of September to close at 193bps. Similarly, 5yr Canadian REIT spreads stayed between a band of 189-205bps and closed Q3 at 203bps. Our Intellifi 5yr conventional mortgage spread was flat at 185bps through most of Q3, climbing 5bps at the end of the quarter to a close of 190bps.

As we've noted frequently in prior Commercial Mortgage Reports, the sharper relative rise in key fixed income indicators throughout the year (BBB and REIT spreads up 70-80bps YTD versus 40bps for the conventional spread) means that the delta between these indicators and mortgage spreads is quite tight compared to historical levels. For example, over the past 5 years, mortgage spreads have on average maintained about a 50bps liquidity premium over corporate BBB spreads. As evidenced by the upper right graph, this premium has eroded through 2022 to the point where the two were nearly equal at the end of Q3. This tightness raises the incentive for debt capital to move toward more liquid public fixed income markets where it can achieve similar yields with less inherent liquidity risk. While in theory, this parity in corporate bond and conventional mortgage spreads might force some lenders to ease up on mortgage lending activity, so far it appears that many remain ready and able to quote on new deals. That said, observed transaction activity has declined in recent months, and it remains to be seen whether this can be attributed to seasonality or a broader shift in market liquidity.

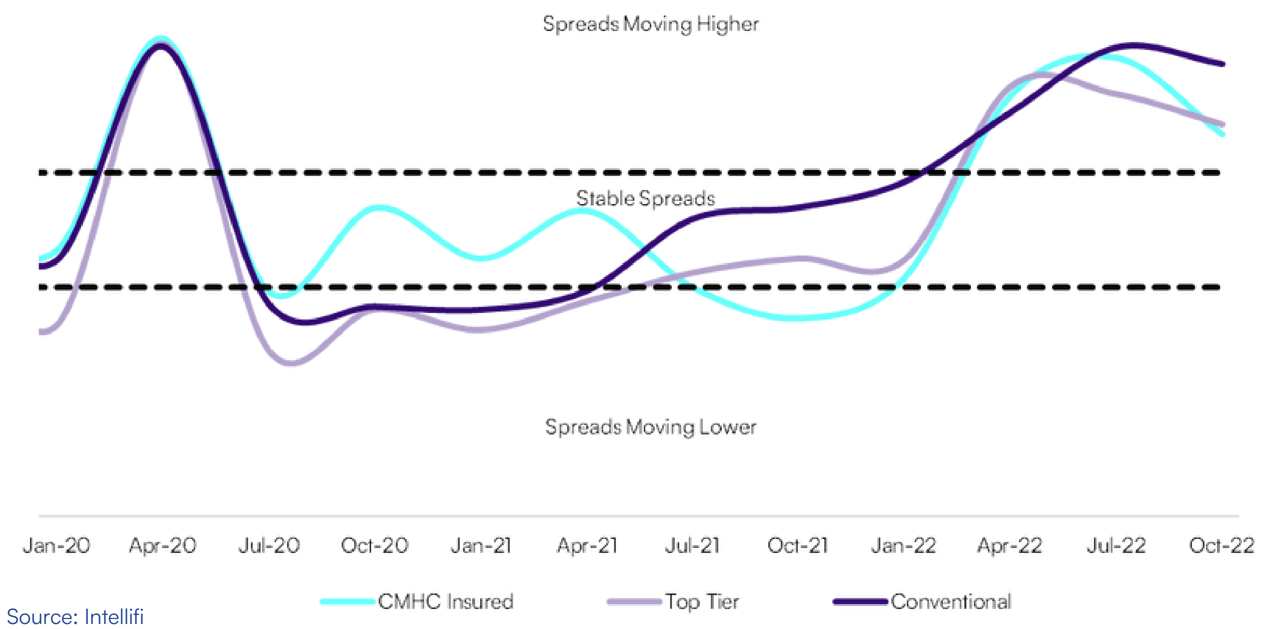
Looking ahead to Q4, many lenders appear to believe that the stability in mortgage spreads seen in recent months may not hold for much longer. Two thirds of conventional lenders surveyed in our Q3 survey expect spreads to move higher in Q4, while roughly half of top tier and CMHC-insured lenders feel the same way. Our Lenders' Pricing Expectations Index has remained firmly in upward territory for 3 consecutive quarters now.

Key Credit Spreads Through 2022



Source: Bloomberg, Intellifi

Lenders' Pricing Expectations Index



Source: Intellifi

Longer-Term Mortgage Activity Nearly Muted

A noticeable trend in the conventional space through 2022 has been a widening term premium (namely, the difference in spread between a 5yr and 10yr mortgage). The year commenced with the average 10yr deal requiring an additional 5-10bps in spread, but since then it has climbed to an average of 20-30bps. Not to harp endlessly on the theme of rising interest rates and greater economic uncertainty, but once again those factors are at play here. Aggressive monetary tightening by the BoC has caused shorter-term bond yields to surge toward the 4% territory, while dampened growth prospects have weighed down longer-term yields. The result? A deeply inverted GoC yield curve as discussed in the Economic Environment section.

With 5yr GoC bond yields averaging around 15bps higher than 10yr yields through September, lenders quoting on 10yr conventional deals require a minimum 15bps term premium just to earn the same all-in coupon that they would on a 5yr term. Why then would lenders take on added duration risk for little to no premium? Market sentiment and deal data confirm this. For the past several months 10yr deals have accounted for less than 10% of all observed mortgage transactions, and results from our Q3 survey show that about 80% of lenders have a medium-to-high demand for 5yr debt while about 65% report low-or-no demand for 10yr deals.

Interestingly, borrowers too appear to have a strong preference toward shorter-term mortgages, but for different reasons. Direct market intel suggests borrowers are frequently opting for mortgages with 2-3yr terms under the assumption that bond yields (and thus mortgage rates) will decline in the next few years when they are up for renewal. In other words, they are willing to eat the costs associated with a higher rate short-term mortgage if it means they can lock-in a lower rate in a few years' time.

High Yield

Fixed or Floating?

Earlier in the spring, as central banks made an abrupt pivot from emergency monetary stimulus to stringent tightening, high yield lenders shifted to almost exclusively issuing floating rate mortgages. With uncertainty surrounding how far, and how quickly, interest rates would rise, lenders were loathe to originate fixed coupon rates only to have the relative yield on those loans eroded as interest rates continued to rise. An analysis of all senior ranked high yield transactions directly observed by Intellifi through 2022 shows that the monthly percentage of deals that were floating ranged between 70-90% from May to July. In contrast, about 30-40% of senior deals were floating in Q1 of 2022. Similarly, the percentage of subordinate ranked floating deals rose to between 65-100% in Q2 from sub-20% in the first three months of the year.

Since then however, the mood in the high yield space has shifted and it appears that more lenders have found comfort in once again issuing fixed coupons on high yield debt. Based on observed transactions, the percentage of floating rate senior and subordinate deals fell to 55% and 30% in August, before sliding further to 25% and 0% in September.

Some lenders have also reported that they are more comfortable issuing fixed coupons now that 300bps worth of rate hikes by the BoC are behind us. And while most economists expect further hikes in the near term, lenders are finding that offering fixed coupon terms can sometimes help to win choice deals from borrowers who are looking to keep a lid on debt servicing costs. Furthermore, lenders are needing to account for the fact that, should rates continue to increase dramatically, some borrowers of floating rate debt may not actually be able to service their debt in full. In our Q3 lender survey, we asked high yield lenders what their preference for floating rate deals was heading into the fourth quarter. A slight majority indicated some degree of preference for floating rate debt; however, 47% indicated that they have no preference. Lenders were also asked whether or not they require a yield premium for issuing fixed rate debt versus floating. Only a quarter of respondents indicated that they do, with the average premium range being 75-150bps over and above a similar floating rate deal.

Development

Some Bright Spots in a Challenging Environment

Rising labour and materials costs, supply chain issues and increased financing costs continued to challenge real estate development economics in Q3. Developers remain cautious and are taking the time to re-evaluate their project pipelines, particularly those that are in the early stages of the development process and have yet to break ground or receive proper zoning and permits. As would be expected, lenders too have grown cautious on the space. The deals that they are closing tend to be those that are either relationship based, well along in the development process, or with borrowers who have strong balance sheets and a greater capability of withstanding an economic downturn. Lenders continued to see softening deal flow QoQ, especially for retail and office developments.

Despite the strong headwinds, however, one bright spot for the sector continues to be industrial development. Sixty percent of lenders in Q3 reported that deal flow for industrial developments was up QoQ, a trend that has persisted for the past several quarters. Intuitively, this is largely a result of the resiliency in demand for industrial properties seen through both the pandemic and more recent bouts of market volatility. As per the latest available reports by CBRE, the industrial sector continued to outpace other asset classes in investment volume in Q2 at $5.3 billion, while industrial construction levels reached 43.9 million square feet, a new record. One segment of the industrial market where developers have told us they have particular interest is in Alberta. And the investment trends support that too. Edmonton and Calgary each saw industrial investment climb significantly in Q2, up 144% and 62% QoQ to $558 million and $527 million, respectively. Nationally, these markets finished third and fifth in industrial investment volume in the quarter, outpacing markets like Ottawa and Montreal where volumes declined 90% and 77% QoQ, respectively. What makes these Alberta markets particularly attractive relative to other major cities is lower land costs, strong net absorption rates and escalating rental rates, among other things.

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

Administration
Back up Servicing
Customer Service
Reporting
Underwriting and Fulfillment

Software

Crystal Auto Adjudication
LMS360 Servicing Platform
LMS360 Underwriting Platform

Get in touch today

Eric Clark, CFA
Vice President and Managing Director, Commercial
E: eric.clark@intellifi.ca

David Maybury, CFA
Analytics Manager
E: david.maybury@intellifi.ca

Roman Melzer
Market Analyst
E: roman.melzer@intellifi.ca

Yumna Urfi
Market Analyst
E: yumna.urfi@intellifi.ca

Brayden Miller
Data Analyst
E: brayden.miller@intellifi.ca

For general inquiries about our business and products, please contact market.intelligence@intellifi.ca for more info.

intellifi.ca

Intellifi Corporation

Copyright © 2022 Intellifi All rights reserved. Any reproduction of any of this report without the express written consent of Intellifi Corporation is strictly prohibited.
The material in this report is provided for information purposes only on an "as is" basis without warranties or conditions of any kind either express or implied. FSRA LICENSE NO. 11749