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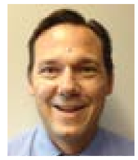
HIGHLIGHTS:

complete contents on page 2

Canadian CMBS: “Low Hanging Fruit” For U.S. Fixed Income Investors



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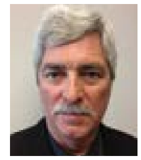

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Canadian CMBS investors are a very happy group. And no wonder — it can’t really get much better. Canadian CMBS has a pristine credit record, with only 0.087% of *cumulative* losses from market inception (1998), and a current delinquency rate (0.27%) that is lost in rounding. It pays on time — 98.1% (by dollar value) of all Canadian CMBS loans have repaid at or within 120 days of scheduled maturity. Furthermore, Canadian CMBS has been “stress tested” — Canadian CMBS investment grade bonds proved to be far more resilient to the 2008–2009 financial crisis, and recovered their value much more quickly than U.S. CMBS bonds and many other credit products. On top of everything else, the new issue Canadian AAA and A CMBS are currently trading at a *discount* to U.S. CMBS bonds (with up to an 18 to 34 bp pickup in spread to investors). For fixed income investors, Canadian CMBS is an attractive risk-adjusted investment.

Unfortunately, in the past most U.S. investors missed this opportunity. The primary culprit was Canadian withholding tax which, for many years, made investment by U.S. investors in Canadian CMBS investment grade bonds highly uneconomic. While many U.S. investors wanted to buy these bonds, this tax was simply too punitive.

However, today things have changed. First, this withholding tax was eliminated as of January 1, 2008 with the passage of the *Budget and Economic Interpretation Act, 2007 (Canada)*. As a result, U.S. investors can now participate in the Canadian CMBS market without any tax disincentive. Second, after three years of hiatus (2008-2010), new Canadian CMBS issues are coming back into the market, with four new deals (including three since July, 2012) and more on the way. Our review of the key CMBS credit metrics of these new Canadian issues indicates that they are as good as, or better than, the legacy Canadian deals that have performed so well. For U.S. investors, or frankly any non-Canadian investor, who wishes to diversify their portfolios, new issue investment grade Canadian CMBS is truly the “low hanging fruit” in this market.

Current Universe of Canadian CMBS

To date, there have been a total of 67 Canadian CMBS issues since market inception in 1998, for a total issuance of $24.87 billion involving 3,706 (Canadian only) commercial mortgage loans. Historically, Canadian CMBS originators and issuers have included Merrill Lynch, TD Bank, RBC, CIBC, Column, GE, GMAC, Laurentian Bank, BNS and First National Financial (as direct participants or sponsors). Of all issuers, Merrill Lynch led the overall market with a 42% market share.

Since the re-opening of the Canadian CMBS market in 2011, Institutional Mortgage Capital Canada (IMC) is the current market leader. IMC has an active CMBS origination platform with over $900 million of new loan originations since 2011, and has sponsored three new CMBS transactions for a total of approximately $700 million. Two other participants have established CMBS origination platforms with one (CMLS Financial) bringing its initial $249 million CMBS issue to market in 2012.

As of August 1, 2013, the current outstanding balance of all Canadian CMBS deals (both legacy and new vintages) is approximately $10.85 billion, with 25 of the legacy CMBS transactions having been repaid and retired.

Exceptional Credit Performance

The overall credit performance of Canadian CMBS has been exceptional:

- *Cumulative* losses for all Canadian CMBS transactions since 1998 have been less than 0.087% ($21.5 million) based on the total issuance of $24.87 billion. *No Canadian CMBS investment grade bond has suffered a loss — ever!* By any measure, this loss experience is truly remarkable. To date, U.S. CMBS has experienced *cumulative* losses of more than $27 billion or 2.87%, *a loss rate more than 30 times the Canadian loss rate*.

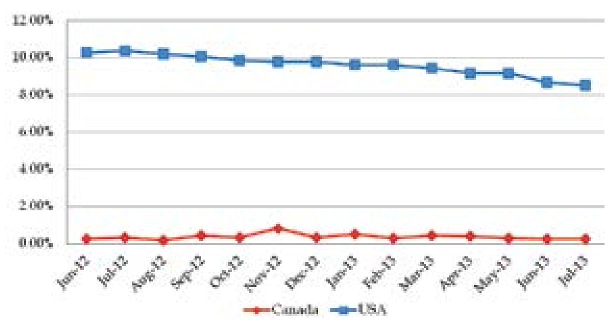
- 2,190 Canadian CMBS loans have matured since market inception and 99.95% of these loans (by dollar value) have been repaid in full; only 2 CMBS loans have matured and not been repaid as of this writing; 98.1% (by dollar value) of all Canadian CMBS loans repaid at loan maturity or within 1–4 months thereafter.

- Of the 386 investment grade principal bond classes in the universe of the 67 Canadian CMBS conduit transactions, only two classes (the BBB and BBB- bonds in the MLFAI 2001-Canada 5 deal) have ever been downgraded by all agencies rating the bonds and both of those classes repaid on time and with no loss to those investors. Of the remainder, there has been only a handful of downgrades and, in each case, by only one of the agencies which rated the transactions; primarily due to a change in rating methodology by one agency.

- As of August 1, 2013, there were only three Canadian CMBS loans in special servicing across all outstanding Canadian CMBS deals. The current delinquency rate for all deals is 0.27% according to the July 2013 DBRS Monthly North American CMBS Market Overview. By comparison, this report reveals the current U.S. CMBS delinquency rate is 8.55% — *again over 30 times the current Canadian delinquency rate*. Table 1, which follows, provides a comparison of Canadian and U.S. CMBS delinquency rates over the past year.

Table 1

Canadian v. U.S. CMBS Delinquency Rates 2012–2013



Source: DBRS

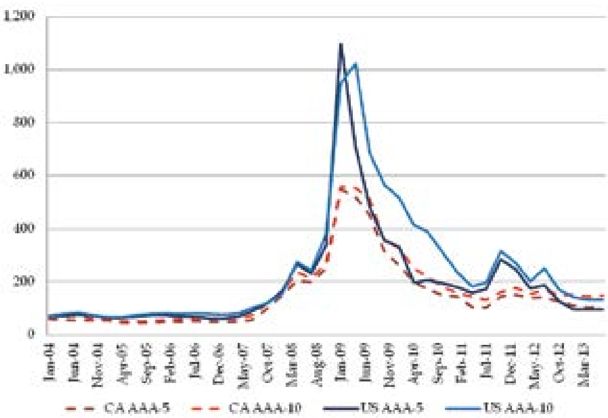
There are multiple reasons for the exceptional credit performance of Canadian CMBS, including strong (non proforma) loan underwriting, a conservative Canadian credit culture, smaller CMBS pools that are more manageable and transparent to investors, a high level of recourse loans in Canadian CMBS pools and lender-favourable Canadian bankruptcy and foreclosure rules. While a review of these factors is beyond the scope of this article, as discussed below the loan pools in the new Canadian CMBS deals compare very favorably to these legacy Canadian CMBS deals.

Strong Relative Value and Lower Pricing Volatility

Given its stellar credit performance, one would expect Canadian CMBS investment grade bonds to trade at spread levels that are very close to or even better than comparable U.S. CMBS spreads. As shown in Tables 2 and 3, this was true prior to the 2008–2009 financial crisis, however, the new recent vintage Canadian CMBS as shown on Table 4 have AAA and A bonds which have traded *at a discount* to U.S., i.e. giving investors not only stronger credit metrics but also a potential yield/spread pick-up.

Table 2

Canadian and U.S. CMBS AAA Spreads for Legacy Bonds



Source: TD Securities; Trepp LLC

As shown in Table 2:

- Before the 2008–2009 financial crisis, Canadian CMBS AAA spreads generally traded at or slightly inside comparable U.S. AAA spreads, on a spread to government bond basis, of up to 15 bps for 5 year AAA's and 19 bps for 10 year AAA's. During the 2008–2009 financial crisis, U.S. CMBS bond spreads widened to levels significantly higher than Canadian CMBS spreads. However, in the past year Canadian AAA spreads have traded on par with or at a slight discount to comparable U.S. spreads.

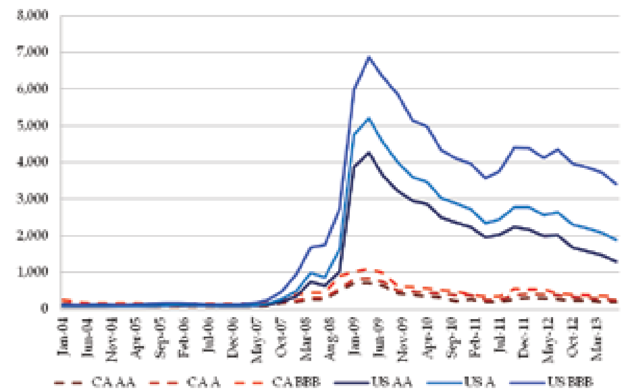
- When "stress tested" by the 2008–2009 financial crisis, Canadian CMBS AAA bond spreads were far less volatile (and held their value better) than U.S. AAA bond spreads — U.S. AAA spreads widened to over 1,000 basis points between January and April, 2009 while the increase in Canadian AAA spreads was only half of U.S. levels.

- Canadian CMBS AAA bond spreads recovered far more quickly from the financial crisis than U.S. AAA spreads, normalizing almost 15 months earlier than U.S. CMBS spreads.

A comparison of Canadian and U.S. AA, A and BBB CMBS bond spreads is even more dramatic:

Table 3

Canadian and U.S. CMBS AA, A and BBB Spreads for Legacy Bonds



Source: TD Securities; Trepp LLC

Not only did U.S. CMBS bond spreads in these investment grade classes increase to unprecedented levels during the financial crisis (U.S. BBB spreads topped out at 6,860 basis points in April 2009), the values of these U.S. investment grade bond classes have not recovered (and likely never will). By comparison, the widening of Canadian CMBS AA, A and BBB spreads was significantly less (on both an absolute and relative basis) and Canadian spreads have now largely recovered to normalized levels.

Compared to U.S. CMBS, Canadian CMBS investment grade bonds have clearly demonstrated that they are significantly less volatile (and hold their value better) in a severe market disruption and recessionary environment. Part of this stronger performance might be attributed to a larger number of "buy and hold" investors due to the positive credit metrics of Canadian CMBS, resulting in fewer day to day traders and lower volatility. The longer term market perspective of Canadian CMBS investors, combined with these positive credit metrics of Canadian CMBS likely helped limit the market dislocation during the 2008-2009 financial crisis.

Table 4

Canadian and U.S. New Issue CMBS Spreads

	AAA		AA	A	BBB
	5yr	10 yr	10 yr	10 yr	10 yr
US "New Deal" Spread to US Treasuries	92	119	204	236	349
Canadian "New Deal" Spread to GOCs	110	145	205	270	350
Canada CMBS Premium (bps)	18	26	1	34	1

Similar to the legacy CMBS bond spread comparison in Tables 2 and 3 (measured as the cost of risk over the government risk free rate), Table 4 shows that recent Canadian AAA new issue CMBS bonds are at a premium to U.S. AAA CMBS spreads of 18-26 bps recently. Furthermore, recent Canadian A rated new issue spreads were a 34 bp premium to the U.S. A rated bond spreads. AA and BBB bond spreads were generally flat with comparable current U.S. levels. Considering that the lion's share of investment grade CMBS buyers invest in AAA CMBS, one would believe the credit metrics and potential of a spread pick up on Canadian AAA CMBS, particularly the 10 year bonds, to be compelling to investors.

Key Credit Metrics of New Canadian CMBS Loan Pools

As shown in Table 5, the new CMBS Canadian loan pools compare favorably to the legacy Canadian pools in key CMBS credit metrics:

Table 5

Comparison of Key Credit Metrics: New Canadian Issues v. Legacy Deals

Canadian Deals	Cut-Off LTV	Maturity Date LTV	DSCR (NCF)	Recourse	Amort.
Older Legacy - CMBS loans to 2005	66.36%	52.25%	1.53	60.53%	282
Newer Legacy - CMBS loans 2006 & 2007	67.99%	55.18%	1.45	62.30%	324
New Canadian multi borrower CMBS[1]	62.50%	52.86%	1.52	85.42%	311

1. Includes IMSCI 2012–2, IMSCI 2013–3 and CCMOT 1 2012–1.

Based on these credit metrics, the underwriting of these new Canadian CMBS loan pools appears across the board to be *more conservative* than the most recent legacy Canadian CMBS loan pools (the 2006-2007 vintage "Newer Legacy" deals) that have performed so well and on par with the "Older Legacy" Canadian CMBS loans (1997-2005 vintage). The new issue Canadian CMBS loan pools have significantly lower Cut-Off and Maturity Date LTVs, higher NCF DSCR and shorter amortization than the Newer Legacy CMBS. When compared with the Older Legacy CMBS, new Canadian CMBS deals fare well with significantly higher recourse, comparable NCF DSCRs and, while amortization is a bit longer, Maturity Date LTVs are comparable to Older Legacy CMBS due to the lower initial Cut-Off Date LTVs in New CMBS.

Finally, we note IO loans *have never been* an established feature of Canadian CMBS and *are not expected* to be going forward. In the new Canadian CMBS deals there were only 2 interest only loans, both in the CCMOT 1 2012-1 pool, and both of which were made to a single investment grade-rated Canadian REIT with

"No Canadian CMBS investment grade bond has suffered a loss – ever!"

recourse. While past performance is never an assurance of future performance, the expectations for the new Canadian CMBS vintage are understandably high.

The Canadian Economy and Real Estate Markets

An in-depth review of the Canadian economy and real estate markets is beyond the scope of this article. However, despite the strong performance of the Canadian economy since the 2008–2009 financial crisis, certain observers have expressed concerns about the current level of Canadian household debt and a possible correction in Canadian residential real estate markets, and particularly the condo markets in Toronto and Vancouver. Based on what we see happening, these concerns appear to be vastly overblown. Here are a few of our own observations:

- Commercial real estate markets are currently performing very well across Canada. Canada's major downtown office markets have a collective vacancy rate of 6.2% (Source: CBRE Canada, Canada Office Occupier Overview, Q1 2013), compared to the U.S. downtown office vacancy rate of 12.5%. For industrial properties, Canada has a 5.8% vacancy rate (Source: CBRE Canada Industrial MarketView, Q2 2013) compared to 12.0% in the U.S. Multifamily vacancy in Canada is 2.3% (Source: CMHC) compared with 5.3% in the U.S. Retail space in the U.S. averages 23.8 sq. ft. per capita, but in Canada (Source: Colliers Canada, The Retail Report, Spring 2013) retail space averages only 14.6 sq. ft. per capita (38.6% less). Potential areas of market concern in Canada are largely limited to residential condominium markets in Toronto and Vancouver, an asset class which is not (and never will be) included in Canadian CMBS transactions.

- The Canadian economy has always performed in a manner that mirrors the U.S. economy — usually with a 6–12 month delay. While Canada generally follows the U.S. economic cycle, it does not experience either the extremes at the top or at the bottom of any cycle. The U.S. is Canada's biggest customer, so good news for the U.S. economy is ultimately good news for Canada. If one believes that the U.S. economy is in the early stages of recovery, it is very difficult to make a compelling argument for any kind of prolonged Canadian economic downturn.

- Some observers point to the current level of Canadian household debt-to-income as a possible indicator of future economic stress. However, in response, many economists and other market commentators have pointed out that, after making appropriate adjustments for items such as health care and other costs, the average Canadian household debt-to-income ratio today appears to be roughly equivalent to current U.S. levels (and significantly lower that U.S. pre-recession levels). Further, at the end of 2012, Canadian households had a higher average net worth than their American counterparts ($400,151 in Canada v. $381,086 in the U.S.).

- The Canadian government has made proactive efforts to avoid a housing bubble introducing changes to mortgage rules in 2012 which (a) reduced maximum amortization to 25 years (March 2011 it reduced this from 35 to 30 years), (b) limited maximum refinancing amount to 80% LTV (March 2011 it reduced this from 90% to 85%), and (c) reduced maximum total debt service (total debt + house related expenses) from 45% to 44% (significant coupled with the amortization reduction in "a").

- As to concerns relating to the flux of new condo units in Toronto in recent years rental demand for such units has been able to keep pace with listings, driving average rents up by 4.1% from last year. The growth in condo rental activity reflects a greater movement of younger households into the downtown Toronto core and a lack of growth in traditional multifamily rental supply. Due to changes in tax structure and the subsequent introduction of residential rent control in Ontario in 1975, development of new multifamily rental construction dwindled to a trickle from the mid-1970's onward. The lack of new purpose-built multifamily rental construction has ultimately led to a net decrease in the traditional supply of this rental stock through the 1990's and 2000's. The development of condo stock and subsequent rental of these units over the past 20 years has served to fill the undersupply due to the dramatic decline in rental housing construction over the past 30 years.

- Canadian and U.S. unemployment rates today are very similar (7.1% in Canada v. 7.3% in the U.S.). Historically, the unemployment rate in Canada has always been higher (by 1% +/-) than in the U.S. Since the financial crisis, these rates have inverted as the Canadian unemployment rate dropped significantly below U.S. levels. These rates appear to be converging again as the U.S. economy improves. However, despite recent fluctuations in the Canadian rate, unemployment in Canada is virtually unchanged from a year ago and total employment is up 1.4%. This addition of 246,000 jobs over the past twelve months is expected to translate into increased demand for all forms of commercial real estate.

- Canadian residential mortgages are not tax deductible and are full recourse to the homeowner. For this reason and others (see Canadian homeowner equity below), Canadian residential mortgage markets are performing very well. *Canadian residential mortgage loan arrears are currently at their lowest level since November 2008* — Canada Mortgage and Housing Corporation (CMHC) reports 0.35% of residential loan arrears across Canada and the Canadian Bankers Association reports 0.31% as of May, 2013. U.S. residential delinquencies at the end of Q2/2013 were 6.96% (its lowest level since mid-2008, *but still over 20 times higher than in Canada*).

    - CMHC is Canada's national housing agency and largest public mortgage insurer. In many respects CMHC is similar to the U.S. GSEs (Fannie Mae and Freddie Mac), however, it is a Crown Corporation whose insurance bears the full faith and credit of the Government of Canada.

- Canada does not have (and never has had) a sizeable sub-prime residential mortgage market. For the most part, Canadian lenders have avoided "no equity" loans, "teaser rates" and other embedded time bombs that have created significant default rates on U.S. residential loans.

- Finally, homeowner's equity currently is (and has always been) significantly higher in Canada than in the U.S. Canadian households average approximately 68% equity in their homes. Not surprisingly, "negative equity" is virtually non-existent in Canada. In the U.S., pre-recession homeowner equity never exceeded 60% and is approximately 47% today.

Conclusion

Canadian CMBS has been around for 15 years. During that time, it has survived three global market disruptions — the 1998 Russian currency crisis, the 2000–2001 "tech bubble" and the 2008–2009 financial crisis, and their related economic downturns, three Canadian Prime Ministers and three U.S. Presidents. It has maintained a pristine credit record and a virtually non-existent delinquency and loss rate. Canadian CMBS credit spreads have been far less volatile, normalized more quickly than the U.S., and new issuance currently provides a discount to comparable U.S. CMBS bonds in the AAA and A tranches. Canadian CMBS has thrived in all markets by providing investors with strong risk-adjusted returns based on exceptional credit performance and its market premium over U.S. CMBS bonds.

Looking forward, we expect that the investment grade tranches of new Canadian CMBS deals will be actively marketed and placed cross border with U.S. and other non-Canadian investors who understand the relative value of this product. For these investors, Canadian CMBS is one of the best opportunities to diversify their portfolios with real "low hanging fruit".

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