Mortgage deal revives stalled securities market

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Canada's moribund commercial mortgage-backed securities market is awakening from a three-year slumber.

Two major real estate companies are tapping the market for $206-million in the first deal of its kind since 2007, signalling that investors are returning to a sector they had abandoned over worries about the health of the country's commercial real estate market.

Prior to the recession, Canadian real estate companies went to the CMBS market for about $4-billion a year in low-cost financing. The market literally vanished as lenders retreated and investors shunned higher-risk securities, forcing real estate companies to obtain mortgages almost exclusively from large banks.

The resurgence could make it cheaper for real estate companies to raise the money they need to expand their portfolios, driving up property values as more bidders vie for buildings. It will also give investors other than banks the chance to add secured mortgages to their portfolios.

A deal put together by Institutional Mortgage Securities Canada will see RioCan Real Estate Investment Trust and Calloway Real Estate Investment Trust take out mortgages on 16 properties, which will then be securitized and sold to investors looking for yield.

"We've been getting a lot of investor calls and there seems to be interest," said Erin Stafford, an analyst at DBRS Ltd. who helped rate the securities. "We met investors last year and there seemed to be some appetite again – people were asking what it would take to bring this market back."

The properties behind the deal – which is still being shopped to investors – are so-called power centres in cities such as Winnipeg, Edmonton and Sherbrooke. Many have a Wal-Mart as an anchor tenant, with other retailers such as Shoppers Drug Mart and Rona also taking space.

The deal has broad implications for the country's real estate investment trusts. Because banks have been the only lenders willing to take on mortgages, the lenders have been able to charge higher rates.

"This makes for a pretty interesting option for borrowers and adds to competition amongst lenders," said Alex Avery, executive director and REIT analyst at CIBC World Markets. "The banks have been achieving very wide spreads on commercial mortgages."

Meanwhile, the companies can take a property out of the mortgage pool at any time, and replace it with another of similar quality. That's key to both RioCan and Calloway, which both hope to attract expansion-minded U.S. retailers to their properties over the next 10 years.

A slew of retailers have expressed an interest in expanding to Canada over the next decade, with Target Corp. already agreeing to spend $1.8-billion to buy most Zellers stores and convert them to Target's banner by 2013. Most of these expansions will require retrofits of existing properties.

Landlords need permission to renovate or sell buildings under traditional mortgages, but would not need to seek approval if they pluck the building out of its CMBS pool and replace it with something else.

"Most mortgage lenders – understandably – want you to come back to them if you are about to do anything," said Simon Nyilassy, chief executive officer of Calloway. "It is not going to be a static market over the next 10 years, and this gives us a lot of flexibility."

CMBS loans have been fingered as one of the main culprits of the U.S. commercial real estate crash, as an abundance of lenders and a voracious appetite among investors led to billions of dollars in risky deals being financed. The flood of money also drove asset prices higher, as more buyers competed for properties.

The U.S. CMBS market has been struggling to recover, with deals expected to climb to $45-billion (U.S.) this year, according to JPMorgan Chase & Co. Banks arranged $11.5-billion of the debt in 2010 compared with a record $234-billion in 2007, according to Bloomberg. In the U.S., delinquency rates ended the year near 8 per cent. In Canada that figure was about 0.3 per cent.

"The demand from investors was so high in 2007 that investors weren't concerned about too much," Mr. Avery said. "That turned out to be a bad thing. In Canada, we've always maintained a more stringent approach and made sure loans were properly structured before securitizing them."