Commercial Property Financing Renaissance

Debt Capital Markets Canada Research, July 2014

A Macro Perspective

The commercial mortgage lending pendulum has swung in the borrower's favour and commercial real estate financing has fully recovered from the 2008 crash. The U.S. is leading the rebound with a notable trickle-down effect on the Canadian lending landscape. 2013 was a very robust year in the US where commercial mortgage bankers originated well over $200 billion in loans. **The Commercial Mortgage Backed Securities (CMBS) market in particular saw a huge jump in new originations from $40 billion in 2012 to well over the $80 billion mark in 2013.** Similarly, in Canada, over $30 billion of loans were originated in 2013 and the CMBS volumes more than doubled from 2012 levels to reach almost $1.6 billion in 2013.

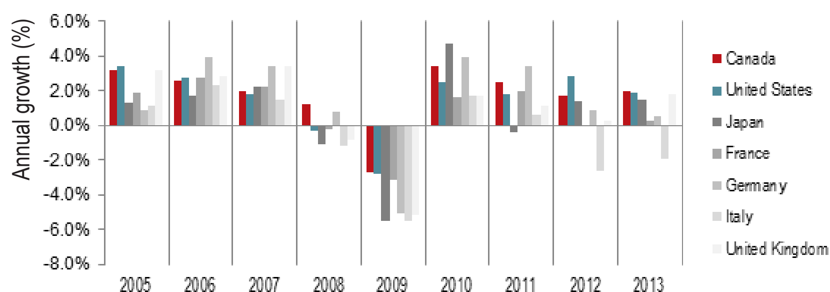
This reflects the on-going improvement in financial markets globally, with more confidence leading to increased liquidity and improved access to commercial property debt. While 2013 saw a concentration of this debt in most core markets, in 2014, this debt pool is expected to widen to include secondary assets and smaller peripheral geographies. While pricing and access to debt has improved, the conditions lenders are putting on borrowers continue to evolve. More warranties are common, with larger penalties for non-compliance of asset level business plans.

Despite the overhanging risks related to new regulations curtailing mortgage affordability in the US, the state of health-care law, complications in the Federal Reserve's (Fed) tapering, and the poor performance of certain loan pools (student loans etc.), it appears that the U.S. economy is reaching escape velocity and will soon be able to overcome the gravitational pull of all these underlying risks. Some of the key variables impacting the debt markets include GDP and housing recovery, delinquencies and foreclosures, Federal Reserve policies, spread history, and Government of Canada yields.

GDP and Housing Recovery

The US economy is growing steadily, second only to Canada in terms of growth, and followed closely by other G7 countries. The housing market has recovered more rapidly than the broader economy to date. Single-family housing starts and permits have increased strongly and are at their highest level since 2008 with home price growth having increased from 4 percent to 11 percent between 2012 and 2013. There are regional variances though; Denver and Dallas have now exceeded their pre-crisis peaks in terms of median home prices while others like Las Vegas and the Inland Empire in California are still well below previous highs.

Figure 1: Canada and the U.S. leading the G7s in GDP Growth



"Single-family housing starts and permits have increased strongly and are at their highest level since 2008"

Source:Oxford Economics, JLL research

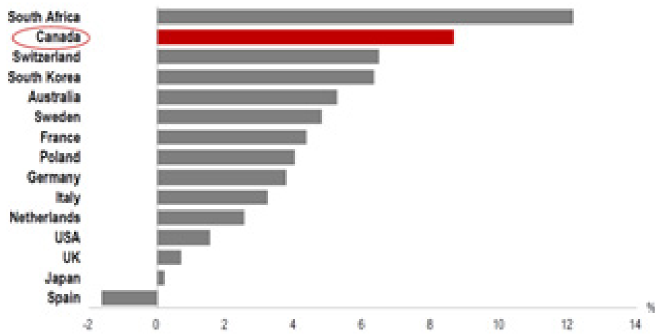
Delinquencies and Foreclosures

Mortgage delinquencies have been declining steadily and the rate of homeowners faced with foreclosures has dropped to less than half of what it was at its peak. According to the Mortgage Bankers Association (MBA) in the U.S., the seriously delinquent loans make up 5.7 percent of all loans outstanding and have reached their lowest level since 2008. The rate of growth of this segment has also almost halved since its peak.

On the commercial side, delinquency rates hit a four year low in 2013, a trend that is expected to continue. Stronger economic fundamentals and business confidence has boosted occupancy levels and rents, reducing the amount of bad real estate left over from the crisis. This has resulted in a stronger confidence in the lending markets for both CMBS and traditional life insurance company/bank financing.

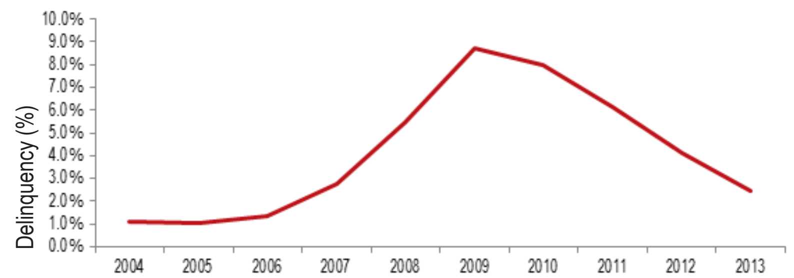
"Stronger economic fundamentals and business confidence has boosted occupancy levels and rents"

Figure 2: Total Real Estate Returns (2007 - 2012)



Source: JLL research

Figure 3: U.S. commercial loan delinquency rates closing in on pre-crisis levels



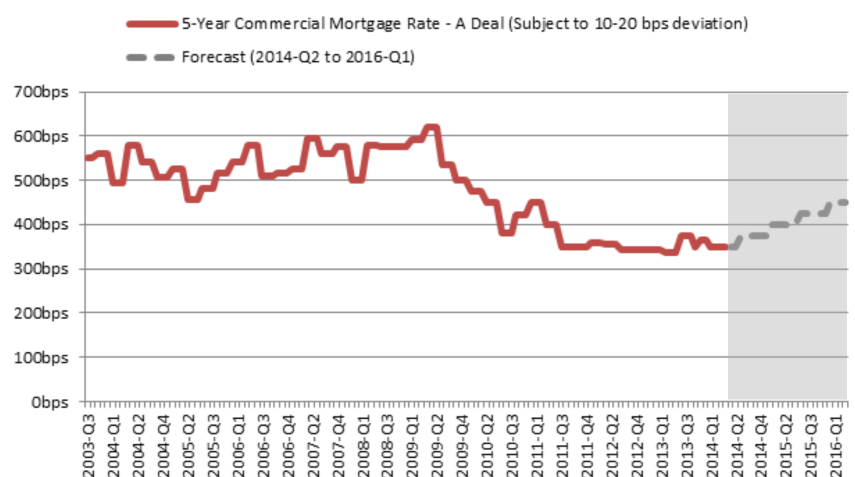
Source: Oxford Economics, JLL research

"Delinquency rates hit a four year low in 2013, a trend that is expected to continue. Stronger economic fundamentals and business confidence"

Federal Reserve (Fed) Policy

In 2008, Fed Chairman Bernanke had to scramble to save the financial system from collapse by, amongst other things, starting off the Quantitative Easing (QE) program which involved unprecedented purchase of Treasuries and Mortgage backed securities to coincide with the massive fiscal stimulus. As a result, the Fed's balance sheet as of today sits at around $3.5 trillion in Government- Sponsored Enterprises (GSE) and Treasury Securities. This brought mortgage rates from 5.6 percent down to 3.5 percent. However, the Fed is and will continue to taper off this program, resulting in an overall increase in the bond yields. **This will have a trickle-down effect on Canadian bond yields which are set to rise over next 12-18 months**. It will also lead to higher cost of debt, as underlying bond yields will most likely rise in the near future.

Figure 4: 5y commercial mortage rate

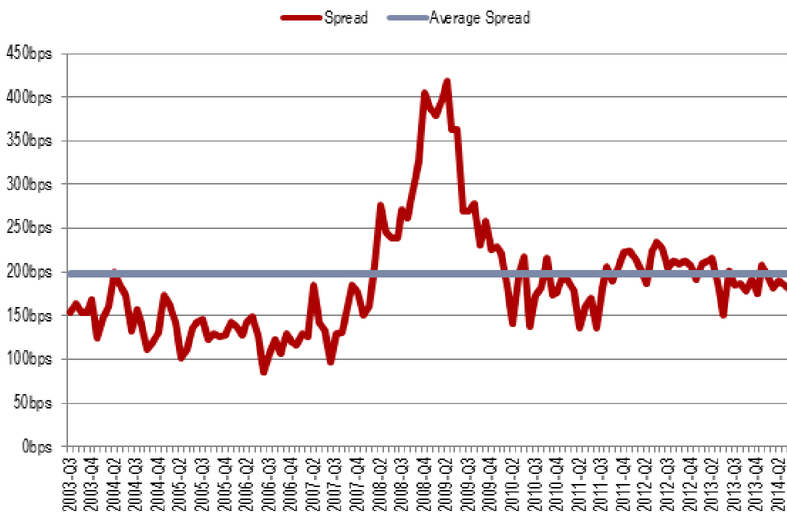


Source: JLL Debt Capital Markets

Spread History

Leading up to 2007, competition for commercial mortgage financing intensified and credit spreads for mortgages had compressed to all-time lows of 90 to 120 basis point range. Compressed credit spreads continued until the summer of 2007 when the U.S. economy began showing signs of weakness. What began with defaulting sub-prime residential loans and other illiquid mortgage-related instruments originated in the U.S. quickly transformed into a worldwide financial and credit crisis. As a result, commercial mortgage credit spreads widened dramatically from the lows experienced in 2007 to the 300 to 375 basis point range by the spring of 2009. However, Canada weathered the economic downturn significantly better than other countries and by the end of 2009, investor confidence returned in moderation. **2009 and 2010 were one of the most profitable years for commercial mortgage lenders as the cost of funds for most financial institutions had dropped significantly in 2008 but the spreads remained at historically high levels.**

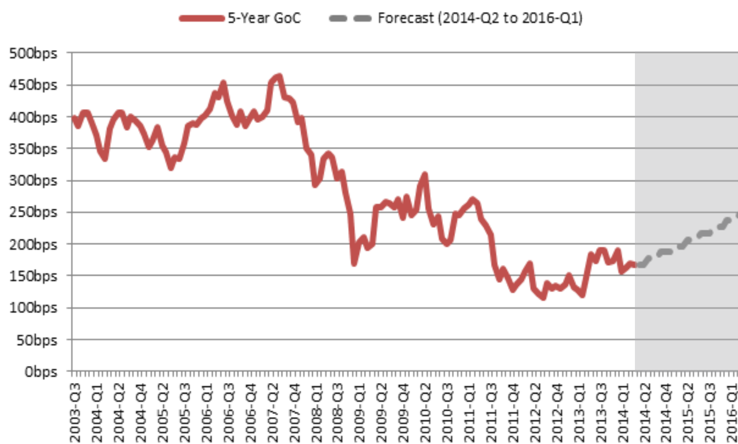
Figure 5: Historical Spread on 5y commercial mortgages



Source – JLL Debt Capital Markets

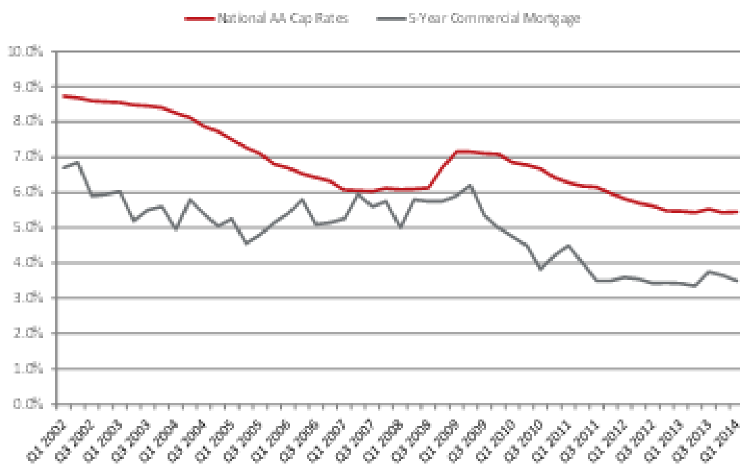
"This strong competition has resulted in credit spreads compressing to as low as 160 bps"

Figure 6: 5y Government of Canada Bond Yield



Source: JLL Debt Capital Markets

Figure 7: National AA Cap Rates



Source: JLL

The fundamentals of the Canadian commercial real estate market remained solid, with conservative borrower leverage, prudent underwriting criteria and relatively balanced supply and demand levels cited as the primary drivers of the industry's resilience. As a result, allocations to commercial real estate financing in 2010, 2011 and 2012 continued to steadily creep up. Over the last 18 months, strong competition amongst the lenders has resulted in credit spreads compressing to as low as 160 bps at present for conservatively underwritten first mortgages on institutional quality real estate with strong borrower and guarantor covenants.

Government of Canada (GOCs) Yields

As much as downward pressure on spreads is good news for the borrowers, there is an equal or even higher pressure on the Government of Canada Bond yields to rise with the easing of QE in the U.S. **The two metrics to keep an eye on are rate of inflation and rate of unemployment. The trigger for a rapid easing and the resulting spike in bond yields will be a three percent inflation rate and a six percent unemployment rate.** Velocity of money is at an all-time low which is usually considered a good sign based on past recoveries – it is often lowest when the economy is set to rebound strongly. The QE exit strategy is not well defined and unwinding it will be a challenge, as the size of the accumulated bond portfolio has pushed the balance sheet holdings of the Fed to $3.6 trillion. By comparison, the Fed had about $800 billion of assets prior to the crisis. Any abrupt exit from these holdings will trigger volatility in bond yields as seen in the summer of 2013, when institutional bond holders started rushing to exit their bond holdings due to the fear of falling prices, which can result in a self-feeding frenzy. We expect this journey to be somewhat tumultuous with an end result of higher bond yields which will more than negate any drop in spreads on the commercial real estate mortgages.

The Outlook

In the commercial real estate finance (CREF) sector, a renaissance is happening with mortgage origination levels, both in the US and Canada, reaching the momentum that was seen in 2004. As US economy is rejuvenating – vacancy rates are steadily coming down, rents are going up and incomes are strengthening.

This has had a positive impact on debt servicing ratios and collateral values; and as a result the commercial lending space has reawakened. Outstanding commercial mortgage debt grew by the largest amount since 2008 with total amount outstanding $2.47 trillion. U.S. commercial banks continue to hold the largest share of commercial loans at $870 billion, 35 percent of the total. In the US, commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDO), and asset-backed securities (ABS) are the second largest holders at $563 billion or 23 percent. Agency/ (government sponsored entity (GSE) portfolios hold about $391 billion or 16 percent. Life insurance Companies are right behind that at $333 billion, 14 percent.

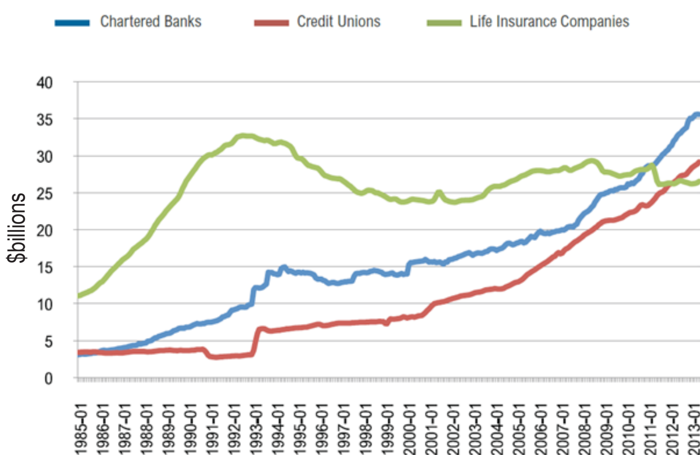
According to Mortgage Bankers Association (MBA) in the US

- The $51 billion in commercial and multi-family mortgages banks added to their balance sheet in 2013 is largest increase since 2007.
- Life insurance Companies' originations in 2013 were 20 percent ahead of 2012 production levels
- After hitting $44 billion of new issuance in 2012, CMBS lenders originated over $80 billion of product in 2013.
- Similarly, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Housing Association had record levels of production in 2012 and as a result set goals for each of the GSEs to limit the 2013 multi-family loan purchases to 90 percent of 2012 levels.

Similarly in Canada:

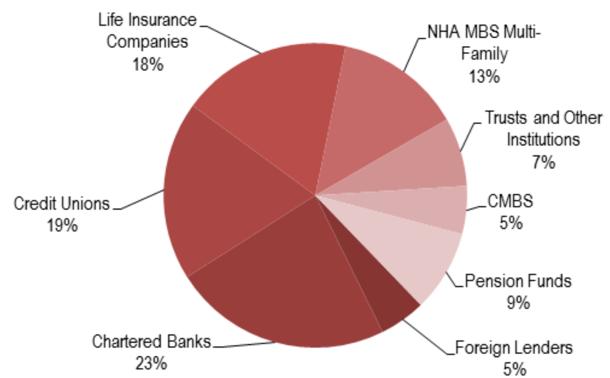
- The Canadian big five banks in 2013 had on average an increase of 13 percent in their production levels, compared to 2012 levels.
- Life insurance Companies' origination levels also demonstrated an overall robust years, however, their production over the last 25 years seems to have dropped vis-à-vis Banks and Credit Unions.
- Given the 100 bps discount of Canada Mortgage and Housing Corporation's (CMHC) insured multi-family financings, there has been a very strong demand for this product. However, CMHC has enacted a cap to limit the amount of new National Housing Act Mortgage-backed Securities (NHA-MBS) per issuer and as a result this is the only sector of CREF that will see a relatively higher pressure on mortgage coupons, we also expect further regulatory changes restricting available capital to this sector.
- CMBS lenders originated around $500 million in 2012 and saw their production levels go up to $1.5 billion in 2013. This is expected to cross $2B in 2014.

Figure 10: Commercial mortgage holdings from 1985 to 2013



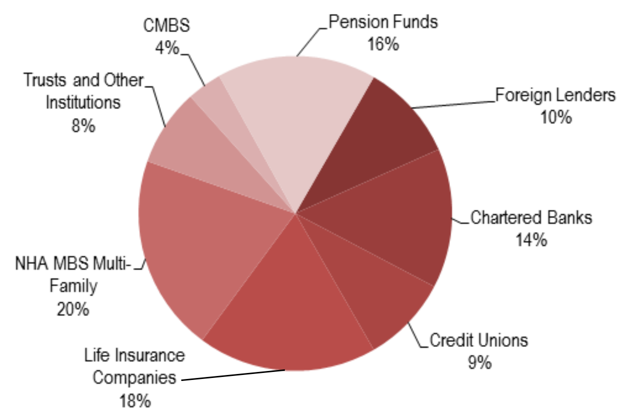
Source: RealPAC

Figure 8: 2013 Commercial Mortgage Balances ($175 Billion)



Source: JLL Debt Capital Markets (Approximation based on 2014 lender survey)

Figure 9: 2013 Origination ($39 Billion)



Source: JLL Debt Capital Markets (Approximation based on 2014 lender survey)

At JLL, Debt Capital Markets (DCM) group, **we track over 110 sources of debt capital available to Canadian borrowers across different lender types**. Almost all of the suppliers of capital have expressed an interest to lend at the same or higher levels than 2013.

The Canadian lending landscape is divided amongst the five biggest banks, tier 2 banks, foreign lenders, life insurance ompanies, pension funds, credit unions, trust companies, MICs, Mezz Funds and other foreign lenders.

New CMBS lenders have entered this space and we expect to see five conduits up and running in 2014, putting further pressure on traditional lenders to compress their spreads. It is to be noted that just before the peak of the credit crisis, there were 11 CMBS lenders operating in Canada, doing around $5 billion of CMBS lending per year. The overall new production levels have steadily climbed over $33 billion in 2013, including approximately $1.6 billion in CMBS issuance. The entry of additional CMBS lenders will certainly swing the pendulum further in the borrower's favour.

JLL had a big representation at the MBA conference in Orlando that was held earlier this year and we noticed an increased level of appetite from all lenders.

We are tracking nine U.S. based lending groups, and several other European and Asian funds, that have expressed a strong desire to lend in Canada often times on a non-recourse basis with loan-to-value (LTV) of up to 75 percent both on five and ten year terms. **These lenders, on a case by case basis, are willing to stretch amortizations to 30 years and also do interest-only loans.**

Given the strength of supply side dynamics, we are seeing downward pressure on the spreads and expect some quality transactions to be done in the 150 bps range in 2014 which is even lower than the 170 bps seen in 2013. We are also seeing top-line underwriting terms being stretched slightly, LTV ratios are hitting 75 percent, Debt Services Coverage Ratios (DSCRs) are getting down to 1.1x on A/B structures, some 30 year amortizations are now available, and we also have access to non-recourse and interest only loan structures.

We expect life insurance companies to lead production levels by way of competitive spreads while we forecast that the Big Banks will struggle with their production levels, given their stringent risk management practices. CMBS and foreign lenders will make a strong come back in 2014.

Some of the key trends that JLL's Canadian DCM team is noticing are:

Lending Industry Trends

- Lending to non-traditional products outside of core sectors of commercial real estate like hotels, long term care, self-storage and specialized assets is becoming more liquid. The JLL DCM team in Canada is tracking 15-20 sources of lending to the hotel and hospitality sector, up from 3-4 sources a few years ago.
- Lenders are increasingly under pressure to fund single asset loans on their own balance sheet without syndication partners. Large Canadian life insurance companies, in this regard, have shown an increased level of confidence to fund loans over $50 million and in some cases over $100 million individually.
- Some of the LifeCo's have also raised mortgage funds by tapping into their network of equity investors. This will further enhance supply of debt to the marketplace.
- The network of various small Credit Unions (CU) across Canada historically was comfortable lending to smaller assets only, under $10 million; however, with increasing origination pressures, we are finding a higher number of CUs showing willingness to form syndications to take down larger loans.
- Foreign lenders are showing an increased appetite to lend on short term transition projects that are typically funded by way of a variable Bankers' Acceptances (BA) or Canadian Dealer Offered Rate (CDOR) pricing. Value add, transition and redevelopment projects all qualify for these programs. Term lenders are pricing some of the higher quality deals at spreads that are as low as 160 bps.
- While the lending to the condo construction sector is getting more cautious, we still find no shortage of debt capital that is pursuing these projects and, depending on the project, funding is also available at a lower level of pre-sales albeit at higher pricing.

Regulatory Trends

We are keeping a close eye on the **new draft proposal to abolish Fannie Mae and Freddie Mac in the U.S.** and create a lender-owned cooperative that would issue government-backed loans. Goals of the plan include 1) protecting taxpayers from the cost of a housing downturn; 2) promoting a stable mortgage market; 3) maintaining the availability of affordable 30-year fixed-rate mortgages; and 4) gives small banks access to the financing for their home loans and ensures they are not shut out by larger corporations. In the U.S., Fannie Mae and Freddie Mac together guarantee about 60 percent of existing mortgages. Since the global financial crisis in 2008 the U.S. government, through Fannie, Freddie and the Federal Housing Administration, has backed about 90 percent of all new mortgages. In addition, in 2008 during the financial crisis, the government seized both Fannie and Freddie and provided them with a $187.5 billion taxpayer bailout. As a result there is an obvious political pressure for financial reform in this sector. If this bill goes through, there is a possibility that the **Ministry of Finance in Canada** will also start to look at reform to ensure that Canada does not face similar challenges should there be a downturn in housing market. We also expect provincial financial regulators, such as the Office of the Superintendent of Financial Institutions (OSFI), to be taking a closer look at certain aspects of the mortgage industry and making further changes to strengthen the system against the shocks. **In particular, the role of "Mortgage Administrators and Servicing Agents" will be further investigated to ensure that prudent underwriting practices are being followed. In this regard, we expect OSFI to take over regulatory reins from the Financial Services Commission of Ontario (FSCO)** with respect to such "Mortgage Administrators and Servicing Agents", which are considered shadow banks. These private companies over the years have outgrown their original mandates and now have a size that mirrors some of the largest financial institutions operating in Canada without much of regulatory oversight.

Beyond this, competition for quality asset lending is fierce and large REIT, pension fund and private developers are not only able to get the cheapest source of financing, but also are getting some aggressive underwriting features like 30 year amortizations, Interest-Only options, higher than 70 percent leverage and non-recourse elements in their deals.

To conclude, while debt availability is abundant and debt spreads have compressed, the end of secularly declining bond yields is on the horizon and overall cost of debt should continue to increase in the coming years. Traditional lenders like the Big Banks and life insurance companies continue to underwrite loans on a conservative basis, but at the same time there is an emergence of non-traditional sources in providing creative financing solutions and filling a void in the market place. The chart below summarizes lending "Sweet Spot" of different financial institutions.

Capital Source	Canadian Banks	Life Co.'s	Pension Funds	Foreign Lenders
Preferred Loan Size	$1 - $25 million	>$10 million	>$2 million	$10-$100 million
Spread (over GoCs)	180-230	150-200	180-250	165-240
LTV	50%-65%	55%-65%	Up to 75%	50%-75%
DSCR (min)	1.35x	1.30x-1.40x	1.25x +	1.25x-1.50x

Capital Source	Credit Unions & Trust Co.'s	CMBS/ Conduits	MIC's / Privates	Mezz / Equity
Preferred Loan Size	$1 - $40 million	$5-$40 million	$1 - $50 million	+$5 million
Spread (over GoCs)	210-275	200-240	600-900	Varies
LTV	50%-75%	Up to 75%	Up to 90%	100%
DSCR (min)	1.25x-1.50x	1.20x +	1.10x +	Varies

Source: JLL Debt Capital Markets

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Amar Nijjar heads up the Debt Capital Markets group at Jones Lang LaSalle (JLL) Canada. His team is responsible for the origination of term, construction, bridge, high yield and mezzanine debt on all types of real estate properties throughout Canada. DCM group at JLL also arranges debt for the properties located in the US. Additionally, he is responsible for sourcing of Institutional Debt partners, establishing syndication strategy on large loans and expanding private placement and correspondent relationships for JLL.

Mr. Nijjar is an expert at finding real estate debt solutions both at the corporate/institutional level and at the SME (small to midsize enterprises) level. Previously, Mr. Nijjar was AVP, Commercial Mortgages at FNF LP and prior to that he was Manager, National Accounts at CIBC where he specialized in real estate financing solutions for REITs, Pension Funds, Public Corporations and other large Private and Institutional entities. Prior to that, he spent three years within the commercial banking divisions of RBC and BMO in Toronto and Vancouver. In the last 13 years, Mr. Nijjar has successfully funded over $3 billion of term and real estate debt throughout Canada and evaluated more than $10 billion of real estate debt investment proposals.

Mr. Nijjar holds an MBA degree from Schulich School of Business (York University) and an undergraduate degree in Chemical Engineering.

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Larbi Moumni is an Analyst on the Debt Capital Markets team at Jones Lang LaSalle (JLL). He is responsible for preparing proposals, asset valuations, and performing due diligence for the Debt Capital markets team. He conducts market research with a focus on market fundamentals, ownership, tenants, and macroeconomic analysis. He addresses borrower and lender inquiries as well as liaises with other real estate professionals. In addition, Larbi makes contributions to the team's publications, whitepapers, and quarterly reports.
Prior to joining Jones Lang LaSalle, Mr. Moumni worked as a Market Analyst with Brookfield Renewable Energy Partners. Having lived on three continents and speaking four languages, Mr. Moumni brings an international experience to the JLL Canadian operations.

Mr. Moumni received an Undergraduate Degree (Highest Honors) in International Business concentrating in International Investments, Finance and Banking with a Minor in Spanish from Carleton University. Larbi is currently a Level II CFA Candidate and aspires to become a CFA Charter holder

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Chad Gemmell is responsible for liaising with borrowers and lenders on deals in process as well as overseeing the underwriting and due diligence through his team of analysts and support staff.

Prior to joining Jones Lang LaSalle, Mr. Gemmell was an investment broker at Petrus Commercial Realty, Inc. in Toronto for 6 years, where he sold office, industrial, and retail properties, as well as residential and mixed used development land. Mr. Gemmell also worked at Sun Life Financial and TELUS Mobility, where he acted as a credit risk analyst in both commercial and consumer facets. Having lived in North America, Europe, and Asia Mr. Gemmell brings an international experience to the JLL Canadian operations.

Mr. Gemmell received an M.B.A. from the NSYSU School of Business and a BCom (Hons) in Finance and Accounting from Lakehead University. Chad is licensed to trade in real estate and a member in good standing with the Canadian Real Estate Association and Real Estate Council of Ontario, and also holds the LEED AP accreditation from Canada Green Building Council.

About JLL:

JLL (NYSE: JLL) is a professional services and investment management firm offering specialized real estate services to clients seeking increased value by owning, occupying and investing in real estate. With annual fee revenue of $4 billion, JLL has more than 200 corporate offices and oper- ates in 75 countries worldwide. On behalf of its clients, the firm provides management and real estate outsourcing services for a property portfolio of 3 billion square feet and completed $99 billion in sales, acquisitions and finance transactions in 2013. Its investment management business, LaSalle Investment Management, has $48.0 billion of real estate assets under management. For further information, visit www.jll.ca.

JLL Capital Markets

From dispositions and financings to note sales, net leases, advisory and transaction structuring, we provide capital solutions that maximize value and returns. Globally, we have completed over $300 billion in transaction volume over the past five years, maximizing value for clients by focusing on their unique investor and occupier needs. By collaborating with us, you can be confident that we'll structure the best deals and negotiate the best terms to maximize returns on your investment. Leveraging our unified platform, we match clients with the right opportunities every time—so you leave nothing to chance.

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