INSIGHTS
FOR INSTITUTIONAL INVESTORS

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The Canadian institutional commercial mortgage market: why is now the time?

HIGHLIGHTS

Why is now the time for investing in the Canadian commercial mortgage market? This paper explores some of the reasons why, including scale, market performance, and investment opportunity.

Scale: The mortgage sector's market capitalization offers ample sector access – with the potential for non-traditional lenders entering the market and gaining market share.

Performance: Institutional investors have earned higher risk-adjusted spreads with minimal volatility. The outlook for continued healthy fundamentals across most property types and geographies – combined with conservative underwriting practices – should prolong sector performance.

Opportunity: Institutional investors should benefit from exposure to the mortgage sector due to short- to medium-term maturities and higher relative yields with the current low and/or rising interest rate environment.

Sun Life
INVESTMENT MANAGEMENT

Canada's institutional commercial mortgage market has almost doubled in the last 15 years, from $50 to $100 billion and climbing as high as $170 billion based on our research. Not surprisingly, this change in market capitalization has kept pace with the expansion of the directly held real estate sector.

The player pool is also growing. Mortgage lending and investing has been dominated by chartered banks, credit unions and life insurance companies – and is used for achieving higher risk-adjusted spreads and matching duration of liabilities. But recently, non-bank mortgage lending companies, pension funds and, to a lesser extent, commercial mortgage-backed securities (CMBS) firms have increased their market share.

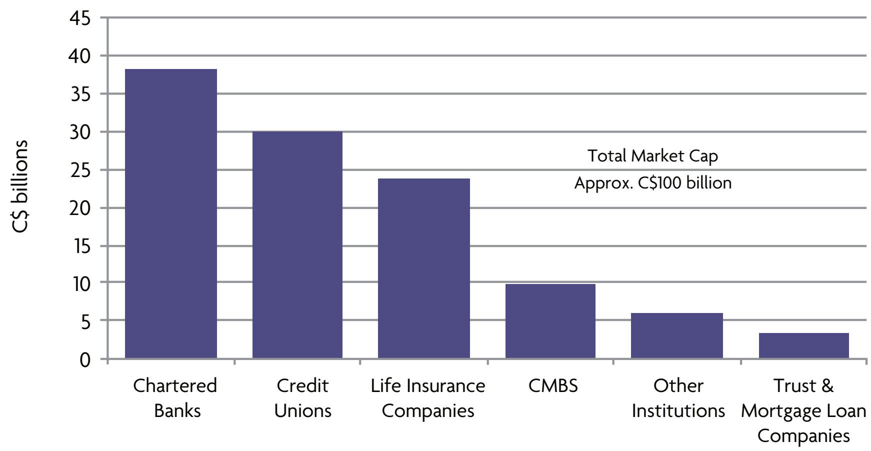
Canadian commercial mortgages performed well through the financial crisis of 2008 to 2010 based on information from the Canadian Life and Health Insurance Association. Default and arrears levels have remained low while yields have provided a consistent premium over risk-free rates – a performance that is in stark contrast to the Canadian experience following the downturn of the early 1990s.

Canada's stable financial system – along with prudent underwriting practices and healthy market fundamentals – have all contributed to this strong performance. In light of stable real estate market conditions, commercial mortgages should continue to serve as an effective alternative investment within Canadian institutional fixed income portfolios.

MARKET TRENDS

Large financial institutions dominate this market. Chartered banks, credit unions and life insurance companies are the top three players.

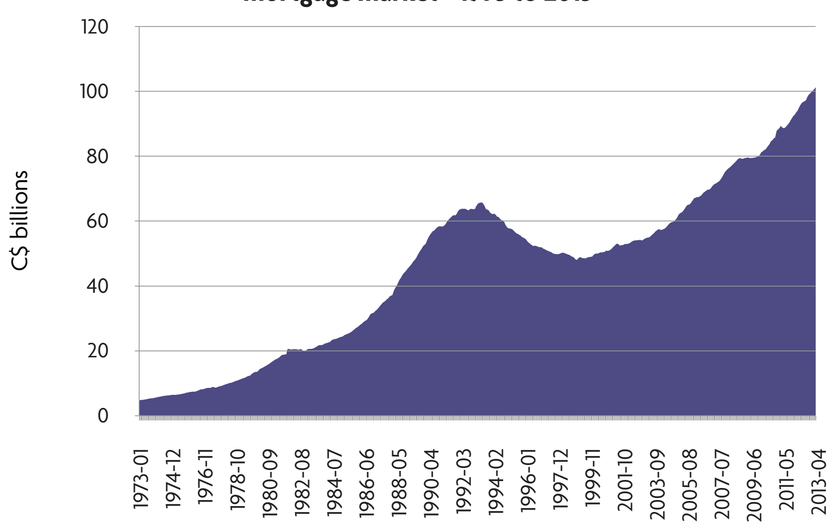
Canadian non-residential mortgage holdings by select institutions H2 2013



Sources: Bank of Canada, DBRS, Statistics Canada

In the last decade, net new mortgage origination has averaged in excess of $4 billion per year – and has exceeded $6 billion annually since 2009. These levels of annual net new investments differ greatly from those during the recession of the early 1990s.

Long-term trend in size of institutional commercial mortgage market - 1973 to 2013



Sources: Bank of Canada and REALpac

The build-up of new real estate supply and new mortgage capital during the mid- to late-1980s was followed by an economic slowdown featuring high government deficits and double-digit interest rates, resulting in negative annual gross domestic product growth. These conditions contributed to high-teen vacancy rates across many real estate property sectors and geographies that led to a decline in the performance and size of the commercial mortgage market.

THIS TIME IT'S DIFFERENT

The evolution of the Canadian banking system, along with industry consolidation over the past 15 years, has led to improved and more stable market conditions. Today, real estate investors are better capitalized – and are afforded greater levels of transparency. Much of this is due to the critical mass achieved by the publicly traded real estate investment trust (REIT) sector and continued investment activity by institutions.

Since the acquisition of some large developers in Canada 10-15 years ago by select pension funds, institutional investment decision-making has become less leveraged and more conservative. This discipline has also contributed to current single-digit vacancy levels and stable (or increasing) rents across most property sectors and geographies.

These conditions, combined with historically low interest rates, have attracted increased investor demand to real estate, contributing to the growth of the commercial mortgage market. Although real estate market fundamentals have softened slightly with the recent macro-economic slowdown, we expect stable commercial real estate market conditions to persist into the foreseeable future.

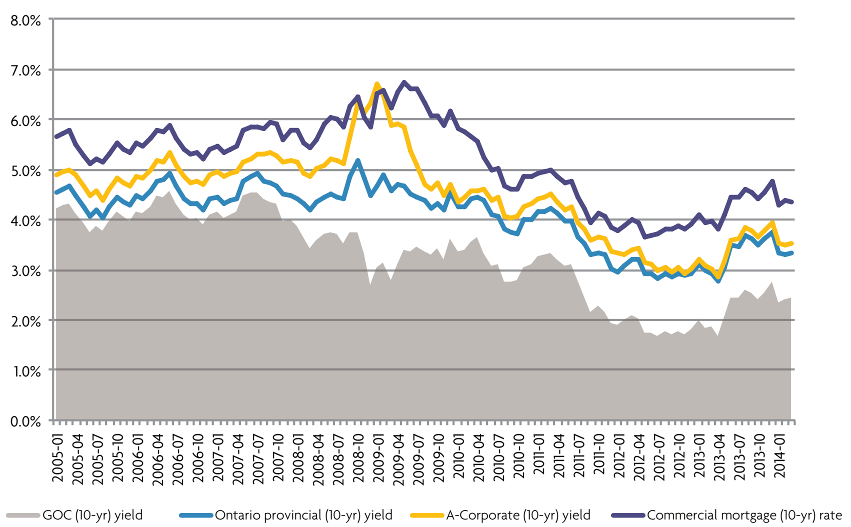
RISING INTEREST RATES

The expected rise in interest rates may drive annual amounts of net new mortgage capital back to long-term averages. And while we expect the 10-year Canadian government rate to increase by year-end, we do not anticipate material corresponding changes to capital values. Capitalization rates, given their relatively wide spread over risk free rates, are expected to absorb initial interest rate uplift helping to preserve capital and loan-to-value ratios. We anticipate further rate increases to correspond with improving economic fundamentals which should translate into higher operating incomes and capital value stability.

There are other factors that limit the risk of default. Canadian commercial mortgages are routinely underwritten for short- to medium-terms of five to 10-years. Upon maturity, loans are then refinanced at new current market rates. Short- to medium-term maturities along with higher relative yields benefit fixed income investors in low and/or rising interest rate environments. The adjacent chart highlights the consistent spread mortgages have delivered investors relative to Government of Canada, Corporate and Provincial bonds.

In addition, a significant portion of Canadian loans are 'recourse to' or the responsibility of the borrower providing additional protection for the lender. When combined with the benefits of amortization, this helps limit the probability and severity of default.

Commercial mortgage rates relative to government and corporate bond yields



Sources: Bank of Canada, Bloomberg, Sun Life Financial

The commercial mortgage spreads in the chart above reflect those derived by Sun Life in order to compute month end market values for the assets held by the company in its general account. The market spreads are estimated internally based on market data collected about where new deals are being priced in the Canadian market. If there are no observable input deals for a given month end, the yields are estimated using interpolated / extrapolated spreads which are added to the interpolated GOC yield in order to arrive at an estimate of the overall market yield.

NEAR-TERM OUTLOOK

The Canadian commercial mortgage market has performed well going into and coming out of the recent downturn, providing spreads over the risk-free rate with minimal volatility. While we expect a slight softening of real estate market fundamentals in the near-term, stable conditions should persist into the foreseeable future, providing ample support for the mortgage sector.

This outlook bodes well for mortgages to serve as compelling liability driven investments, especially during low and/or rising interest rate environments.

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