Capital Debt Markets Update

Spring 2022

Quick Stats

GOC 5-Year Bond

1.70

▲ 1.30

01//2021 – 01/2022

GOC 10-Year Bond

1.763

▲ 0.95

01//2021 – 01/2022

TSX

21,270

▲ 3,278

01/2021 – 01/2022

Prime Rate

2.45%

No Change

Back to normal? And what will normal be?

It is almost 2 years since the onset of a world changing dynamic. Lock downs have altered our habits, changed how we work and created unprecedented low interest rates. While there have been short periods where the pandemic was not disrupting the economy and the well being of our society, learning how to live within the bubble has become a fact.

We have all adapted to this in different ways. Though we continue to have personal and governance restrictions impacting us all, on a broader basis this does impact the business environment. Each person or corporation has to make decisions based on perceived comfort levels. At the same time "Covid fatigue" is becoming more normal while other factors are influencing how we see the coming year impacting the availability of debt and the trend in borrowing costs.

So, what will create the biggest impact on the real estate lending market over the coming year. Inflation has set a 30 year high but how much of that is the elastic rebound resulting from emergence out of the pandemic. Supply chain issues continue to impact the delivery of materials for the construction industry creating a host of issues. The ability to control prices for construction materials has all but vanished for most and the labour market remains an out of balance sector of the economy.

Since the 50's the response of the Bank of Canada to battle inflation was to suppress inflationary pressures by increasing interest rates. This model is based on both wages and prices having a direct correlation, with unemployment and inflation traditionally having an inverse relationship or, inflation is low when unemployment is high. The uncharted territory we are about to enter into might require guidance that is not based on historic approaches.

From a period where Quantitative Easing was implemented to support our economy, to the coming Quantitative Tightening approach, interest rates remain attractive based on historic analysis. Statistics indicate that the BoC currently owns

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approximately 42% of the bond market as contrasted to the US which owns 28%. The maturity profile suggests that in the order of 50% of bond holdings mature by the end of 2024. Careful attention to how the BoC deals with this component of the balance sheet may have more direct impact on inflation and change the narrative on where/when interest rates stabilize.

42%

Approx. BoC Bond Market ownership

It gave me pause to remember that in the mid-70's when wages were increasing at double digit numbers annually and inflation was running at between 8% - 12%, the Federal government imposed wage and price controls through both mandatory and voluntary structures. The finger was pointed at wage increases (12% to 14%) as the primary driver, and in the end the programs were deemed to have been failures. One can only hope that this lesson has been learned.

On the bright side, real estate transactions and debt placements through 2021 were occurring at an accelerated pace and are spilling over to 2022. The availability of debt capital remains strong in Alberta, and as usual, most competitive in British Colombia. In Alberta net migration for the 3rd quarter of the year was 16,690 as contrasted to the same period in 2020 which was negative 1,214. Lower cost housing and greater job opportunities are cited as the keys. This should continue throughout 2022 and have a positive influence on the real estate markets.

Looking forward there is a strong sentiment that The Bank of Canada (BoC) will raise rates, the question is when? Although the current health measures in some provinces and Covid impacts on the economy may cause the increase in rates to be delayed there is another major factor that is driving the rate decision, that being consumer price inflation (CPI). In December, CPI hit its highest level since 1991, and in consecutive months has well surpassed the Bank target of 1% - 3%. The Bank of Canada has forecasted that rate increases are certain in 2022 rather than the original forecasts early in the Covid epidemic which suggested 2023. The inflation we are experiencing is a key driver.

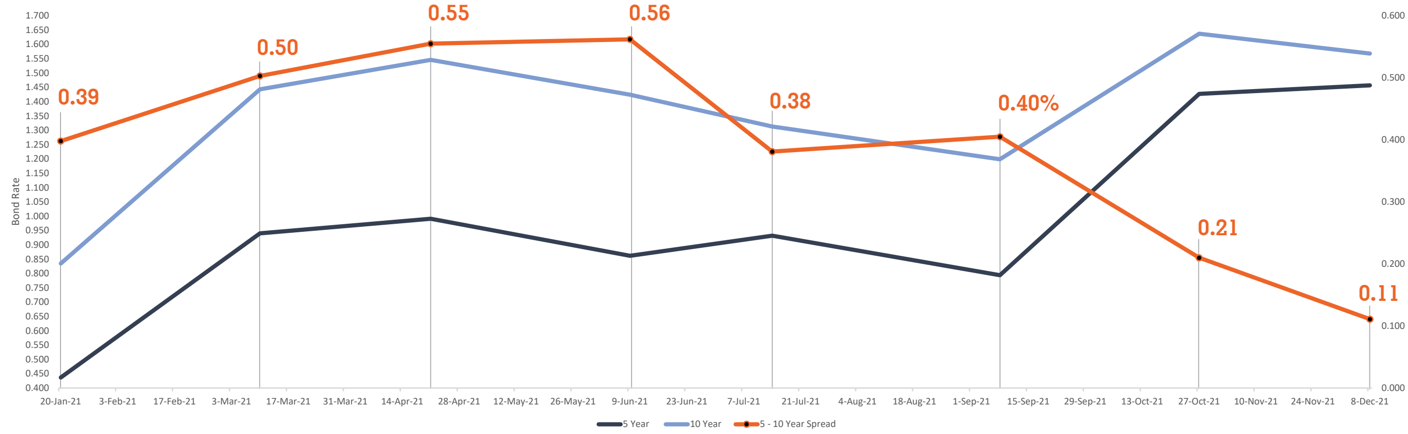
The Bank has a difficult decision to make balancing their "tools" to combat inflation and the fact that a large portion of consumer debt is based on floating rates which would put many Canadians in a position where they do not have the capacity to make debt payments, especially once Government supports are no longer in place. Housing prices are also a concern as fewer individuals will be able to service loans or qualify for new home purchases if their mortgage rates increase. We do know that the Bank will use interest rates as one of their main tools in combating inflation, but it is yet to be seen if the economy is strong enough to handle this increase. Although the decision on the Bank rate has a correlation to bond rates, we are under the assumption that this has at some level been priced into the sharp increase we have seen in the bond market over the past few months. This can be further proven by the fact that bond rates seem to have somewhat stabilized since the first announcement, though they are trending higher. Although, we have become used to an extremely low-interest rate environment the imminent increase in rates is not doom and gloom as we are moving towards a healthy rate environment for the economy.

The cherry on top: Tax hikes. The federal government increased its carbon tax and alcohol taxes twice during the pandemic. Taxes now make up between 31 and 42 per cent of the pump price of gasoline, depending on the province. Taxes also account for about half of the price of beer, 65 per cent of the price of wine and more than three quarters of the price of spirits.

4.8%

CPI December 2021

Bank of Canada Bond Rate



Bond Rate Review

2021 started with a carry over of unprecedented bond yields with 5 years trading at 40bps and 10 years at 134bps. By March 2021 the situation impacting yields creating a once in a decade opportunity for Borrowers to secure debt at the pricing that had been in effect since the Spring of 2020. As mentioned this was a result of the massive buying of bonds under the Quantitative Easing approach. The main difference was that unlike 2020, where there were very minimal differences between the 5 and 10, the variance increased to between 45bps to 60bps by the end of 2021.

While there was slippage in the end of 2021 to the 130bps to 140bps yield range, we are now finding the yields at 170bps for the 5 year and above 185 for the 10. This is contrasted to the bond yields in January of 2020 which were at 160bps for both 5 and 10 year bonds.

The best spreads remain with the trophy assets and can be obtained in the low 120bps to 130bps. More typically the spreads have been consistent in the 175bps to 200bps range where there is tenure with the tenancy, the property is newer, and the Borrower has a strong balance sheet. We have also seen the range creep up into the 200bps to 250bps as properties may reflect some renewal or lease rate sensitivity. These can often retain up to a 25 year amortization. In general there are many strategies to ensure that a client is able to obtain what is required.

The spreads with banks are quite large. We have had quotes at the 100bps to 110bps from some, while others are difficult to find below the 150bps to 175bps range.

Case Study

Case Study 1

The team was successful in securing extremely attractive high leverage financing for a desirable investment asset in NE Calgary. The terms secured included a first mortgage LTV of 85%, non-recourse, at a 5-year fixed interest rate below 5% and 25-year amortization. This debt minimized the equity required to close on the property (purchase price of approximately $26,000,000) and maximize the cash-on-cash return. The 257,793 SF property was fully leased to 7 tenants with a Weighted Average Lease Term remaining of approx. 5+ years.

Case Study 2

Near the end of Q4 in 2021, the team funded a CMHC-insured loan for an 11-unit multifamily property in Vancouver, BC to take out the bridge loan funded for the acquisition the same property in Q1 2021. The CMHC-Insured 5-year interest rate was 2.13% and the bridge loan was fully repaid. This deal exemplifies the team's ability to assist our clients purchase multifamily properties without having to wait for CMHC to approve a Certificate of Insurance. The 9-month window from the bridge acquisition loan to the CMHC loan allowed the client sufficient time to stabilize the property while concurrently we secured the CMHC-insured take out financing.

CMHC Considerations

Due to the volatility in bond rates CMHC underwriting has become an area that needs to be addressed. CMHC insured loans that were set to fund in the last quarter of 2021 faced some difficult decisions as the ceiling rate that was used for underwriting when submitted to CMHC was now well below the prevailing market rates. Borrowers were faced with a choice to go back to CMHC and request a lower loan amount to bring the debt coverage requirements back in line, or to buy down the rate at a cost that varies depending on the spread between the ceiling rate and current market rates.

For much of 2021, timing to receive the Certificate of Insurance from submission to CMHC could take as long as four to six months, making the underwritten ceiling rates nearly impossible to predict. CMHC timelines have decreased to 4 weeks eliminating some of the bond market risk, it will be important to ensure borrowers are prepared for the possibility of exceeding ceiling rates as we move through 2022 and the expected BoC rate hikes.

CMHC is rolling out a new affordable program in March 2022 which will allow Borrowers to achieve loan to values of up to 95%, and amortizations extending up to 50 years. The program will be available for both new construction as well as on existing product in the market. Premiums for this program are reduced in comparison to market CMHC financing depending on the "score" you achieve on the CMHC parameters. As to be anticipated, there will be a flood of applications for the program, though the structure of the program is still being developed.

Since February 2020, the Bank of Canada has created about $375 billion by purchasing financial assets. That 300-per-cent growth in the bank's assets is significantly higher than occurred during the recessions of the 1970s, 1980s and 1990s. It's even higher than the growth from the beginning of 2008 to the end of February 2020. In fact, 300-per-cent growth rivals the growth in assets held by the central bank during the entire six years of World War II .

Last year, the feds ran up a $335-billion deficit, while the bank printed up new dollars to purchase $275 billion in Government of Canada bonds. Just two days after Finance Minister Chrystia Freeland announced her plan to run a deficit of $3 billion per week in 2021, the Bank of Canada announced its plan to purchase $3 billion worth of government debt per week. That sure left the impression the government was using the printing press to finance a chunk of its deficits.

Get more market information

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