Perspective

Commercial Real Estate in the Time of COVID-19

Issue 1: COVID-19 Q&A
Week of April 13, 2020

CANADA ICI
Leaders in Capital

Seeing Both Sides

These days uncertainty is about the only thing we can be certain about. While inboxes are flooded with circulars from organizations keeping us informed regarding changes to their policies, what's missing is a discussion of the real impact on both borrowers and lenders.

In striving to be Canada's leader in commercial real estate capital, we at Canada ICI want to share our thoughts and insights on this rapidly-changing borrowing and lending environment. Over the coming weeks, we'll discuss how this pandemic will impact the economic ecosystem and how it could affect commercial real estate lending in the future.

We would like for you to engage in the discussion. Please send your real estate investing questions to ***perspectives@canadaici.com***. Our experts will be happy to answer them.

Join the Discussion

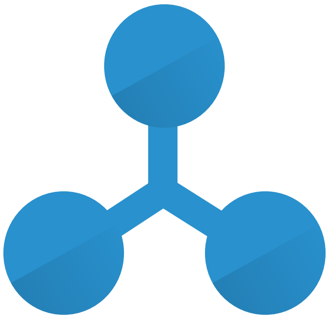
1. Sentiment

In light of the significant disruptions to business around the country due to COVID-19, what is the current sentiment in the Canadian mortgage market?

The sentiment in the business community toward the Canadian mortgage market started shifting quickly during the week of March 9th, 2020. Since that time, we've seen a significant retrenchment of capital as lenders across the spectrum, from institutional capital to private funds, begin to pivot towards a very defensive posture. Ten-year Government of Canada (GOC) yields fluctuated as much as 50 basis points from peak to trough, and Bank of Canada key interest rates were slashed by 100 bps.

Commercial mortgage lenders across the country were reactionary and began shifting their focus to several key priorities including the following:

Managing lending and servicing platforms that can operate in a remote environment



Stress testing portfolio and borrower capacity and liquidity

Working to stabilize volatility in both their pricing models while also managing potential disruptions to internal capital supply.

The Canadian mortgage market remains extremely cautious at the moment and this will continue until the market regains its footing. Lender activity continues by processing pre-existing loan applications, and managing active portfolios. While most Lenders are scaling back traditional Loan-to-Cost or Loan-to-Value Ratio's, we continue to have recent success with new Construction and Term financing requirements.

2. Deferrals

Are lenders offering mortgage deferrals?

The general answer to this widely-posed question is: these requests are being evaluated on a case-by-case basis. A Borrower must appreciate that positions on deferral requests vary widely and are directly related to how a specific mortgage fund is capitalized. Also consider how much support the lenders are receiving from various levels of government.

HOW DOES A DEFERRAL IMPACT MY LOAN?

It is important to understand the difference between a deferral and forgiveness. In these early days, Lenders agreeing to adjust mortgage payments are NOT forgiving principal or interest. In some circumstances they have agreed to defer interest or both principal and interest with the understanding that these amounts will be capitalized and added to the existing loan.

If businesses remain closed, the underlying value of most real estate security will deteriorate, and there is no way to know where cash flows will stabilize until the music stops. One certainty is that stagnant or declining real estate values in combination with impaired asset cash flows, have already increased the Loan-to-Value risk for a Lender, which may just be "flattening the risk curve" by deferring payments without an actual cure.

TO EVALUATE MORTGAGE AMENDMENT REQUESTS, BORROWERS HAVE BEEN ASKED TO PROVIDE THE FOLLOWING INFORMATION:

- **demonstration of hardship at the asset level including negotiated terms with tenants**
- **proof of hardship at the sponsorship level**
- **updated rent roll and operating statements for all properties owned by the borrower and for the guarantor(s)**
- **financial statements of the borrower including year-to-date operating statements**
- **financial statements of the guarantor(s)**
- **bank statements for borrower, shareholders, and guarantors**

How is CMHC viewing mortgage deferrals?

On March 23rd, the CMHC announced they would permit all approved lenders to defer up to six monthly mortgage payments of principal and interest for "borrowers impacted by COVID-19."

NATIONAL HOUSING ACT'S MORTGAGE BACKED SECURITIES

National Housing Act's (NHA) Mortgage Backed Securities are investments that are backed by distinct pools of insured mortgages in which the payment of NHA MBS principal and interest is guaranteed by the Canada Mortgage and Housing Corporation (CMHC).

NHA MBS issued under the program use the modified pass-through approach. That is, when borrowers fail to make timely payments on their loans (that are at least equal to the monthly payments made to investors), the issuer ensures that the necessary funds are available. CMHC guarantees that the monthly payments are made to investors on a timely basis.

THE ISSUER IS RESPONSIBLE

In the event of any failure, delay or default under the terms of the certificate, the issuer is directly responsible and liable for such failure, delay or default. The investor then has the option of recourse to CMHC, as provided in the CMHC Certificate of Insurance.

When a borrower makes a deferral request to their lender (remember CMHC is the insurer), consider that the lender is receiving a deluge of claims, almost simultaneously. Compare this to a standard home ownership insurance policy. Wouldn't the average homeowner experience a severe strain on their finances if they made claims to repair the roof, deal with a kitchen fire, shore-up a sinking foundation, and replace broken windows all at the same time? Is it possible that the homeowner would become insolvent before they receive payment from the insurer?

While we at Canada ICI don't foresee any issuers becoming insolvent because of all the mortgage relief requests during these early days, rest assured it's all hands-on-deck. Lenders are processing each deferral claim with scrutiny and due diligence to triage the ones most in need.

3. Pricing

What impact has COVID-19 had on pricing?

A large portion of the mortgage market is electing to pause underwriting new business at this time because lenders are experiencing difficulties with the following:

1. *assessing the market due to a lack of evolving data points*
2. *managing capital calls and redemptions*
3. *competing for capital internally and externally with alternative investments.*

The few lenders that remain active in this COVID19 environment are price-making and we've seen an uptick in spreads. This has been counterbalanced with index yields like the Chartered Bank Prime or Government of Canada yields that have decreased over the last 30 days.

Effective borrowing rates for the remaining available capital are fairly consistent compared with where the rates were pre-crisis. This is subject to change as capital supply may become more constrained.

FLOATING RATE

Prime Rate (Feb 2020) = 3.95% **+** Spread of 0.75 Bps = **4.70%**

Prime Rate (April 2020) = 2.45% **+** Spread of 2.00 Bps = **4.45%**

FIXED TERM

5 Year GOC (Feb 2020) = 1.35% **+** Spread of 1.85 Bps = **3.20%**

5 Year GOC (April 2020) = 0.57% **+** Spread of 3.00 Bps = **3.57%**

4. Capital

Will capital be available for my real estate financing needs?

In short – the answer is "yes." Many institutions have been provided liquidity from the Federal government which has mandated financial institutions maintain capital outflow. We still have several active investors in both the Term and Construction segments notwithstanding recent developments. While there are many lending groups that are temporarily "pens down" as they watch things unfold, we are encouraged by the amount of cautious capital flowing in the system for new deals.

5. Expectations

What can I expect as a borrower today?

With a national footprint, our experts have been sharing their experiences in weekly internal communication. While we are moving deals through the system, there are some recent changes which borrowers should be prepared for, including:

- More balance sheet scrutiny
- More supporting information requests on a borrower's Net Equity Position – POST COVID
- More lenders passing on deals
- Longer credit approval processes
- Less risk appetite resulting in lower LTV's and LTC's
- Inconsistent pricing models
- Deals requiring higher yielding sub debt that might not previously have been required

We have heard a lot about "the new normal" with COVID-19. We have thought a lot about what that means for our clients in the immediate term, and with the market as the month's progress.

While we don't have a crystal ball, we know two things to be certain:

1.) We WILL stabilize.
2.) We will continue to be at the center of financing transactions from peak to trough

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Our value is NOT to advise and deliver the "new normal"; but to deliver the optimum solutions available in the market. Please don't hesitate to reach out to one of our experts to discuss any and all financing inquiries you may have in this rapidly changing environment.

Join the Discussion

Over the coming weeks, we will be discussing how this pandemic will impact the economic ecosystem and how it could affect commercial real estate lending in the future. We want to hear from you. **Please send your feedback to perspectives@canadaici.com** so we can ensure we're sharing information that is relevant to you.

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