Lending Perspectives in the COVID-19 Era

Key insights and observations

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EY
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Introduction

Commercial real estate values are inherently linked to future cash flow returns and the certainty to which a purchaser believes these projections are achievable. Since most properties are purchased with both equity and debt, the cost and availability of debt has a direct impact on investor returns and, as such, plays a major role in establishing market value.

It is often overlooked that the most common metric for measuring an asset's return – the market capitalization rate – is inextricably linked to prevailing lending rates and the investor's access to debt. Due to this relationship, understanding the current state of the Canadian debt market is integral to determining market values, particularly in a recessionary market with few benchmark transactions.

EY survey

Over the course of April and May 2020, EY Canada's Transaction Real Estate professionals surveyed and tracked the Canadian real estate debt market to gauge changes in lending criteria, availability of new debt, and changes in both commercial mortgage spreads and all-in commercial mortgage rates. The ultimate goal was to provide an informed viewpoint on capitalization rate impacts.

Our survey includes representatives from more than 25 lenders, including chartered banks, institutional lenders, alternative lenders and mortgage brokers.

Key survey results

Asset and market allocations

Most respondents indicated that while their overall lending strategy remains mostly unchanged, they are re-evaluating capital allocation to specific asset classes and geographies.

Respondents are either applying caution or temporarily avoiding retail and hospitality assets, given the temporary mandated closure of these assets and the near-term uncertainty surrounding their financial performance.

In our conversations, we noted that of the respondents that previously provided financing on retail and hospitality assets, 70% indicated a willingness to continue to do so, but are approaching with more caution, while 30% are temporarily not lending on these asset types.

Several respondents indicated that they are narrowing their geographic focus and lending exclusively in major markets such as Toronto, Montréal and Vancouver. While financing is available, participants are being far more selective around assets in Alberta given the fragility of the province's economy caused by uncertainty in the oil and gas sector.

The overarching theme of respondents is a heightened focus on the covenant strength of in-place tenants, asset quality and conviction related to the stability of future cash flows.

Availability of debt

Respondents indicated that they are favoring their existing borrower clients and allocating significant resources and capital to them. However, 90% of respondents expressed a willingness to lend to new borrowers at this time, albeit with a more conservative approach to their lending criteria. Lenders are demonstrating greater scrutiny than usual for new borrowers based on factors such as liquidity and financial strength, reputation, track record and historical performance.

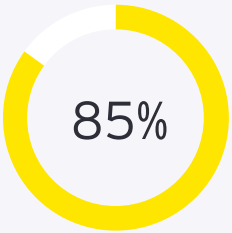
Additionally, most respondents indicated that they are being more conservative in their asset and portfolio underwriting, including more stringent due diligence processes.

Notable changes to debt metrics including loan-to-value (LTV) ratios and credits spreads are having a material impact on the availability of debt for both new and existing borrower clients.

Mortgage relief

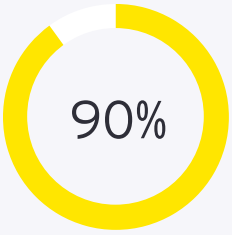
Nearly all participants have seen requests for mortgage relief, which they've handled on a case-by-case, borrower-by-borrower basis. Lenders are reviewing rent rolls, property operating statements and cash flow projections to determine which tenants are most likely to pay rent and which are most likely to default in the near or medium term. Mortgage relief is also dependent on the borrower's business plan and the strength and history of the borrower-lender relationship.

Survey Results



85% of lenders are re-evaluating their capital allocation strategy.

Survey Results



90% of lenders indicated that they are lending to new borrowers at this time.

Changes in debt metrics

Base rates, commercial mortgage spreads and mortgage rates

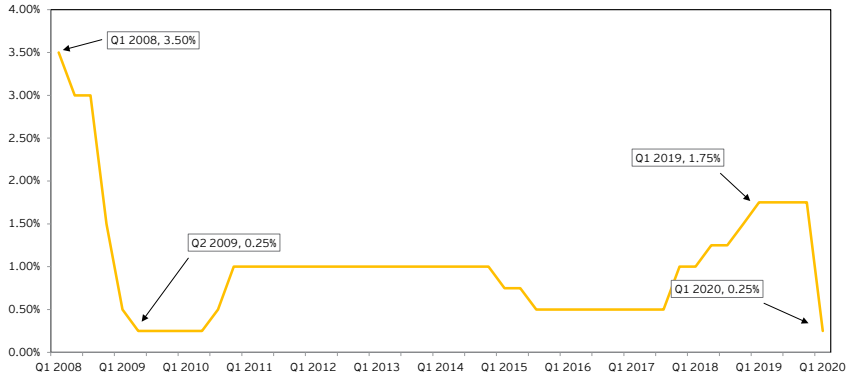
As a result of COVID-19, the Bank of Canada lowered its key overnight interest rate to 0.25% in Q1 2020 (from 1.75% in Q4 2019), the lowest it has been since 2009 during the global financial crisis. This, in turn, has led to the prime rate dropping to 2.45% (from 3.95% pre-COVID). This results in a greater supply of credit which, all other things being equal, should lead to more competitive all-in commercial mortgage rates for borrowers.

However, our survey revealed that the sharp decrease in the overnight and prime rates, and subsequent decrease in the 10-year Government of Canada bond yield, was effectively entirely counterbalanced by an increase in commercial mortgage spreads ranging from 100 to 150 basis points (bps). As of Q4 2019, the 10-year Government of Canada bond yield was trading at 1.70%. Between March 16, 2020 and June 5, 2020, this same yield was posted at an average of 0.66%, a decrease of 104 basis points.

According to survey respondents, this increase in commercial mortgage spreads is primarily to account for the elevated risk lenders are taking on during this period and the uncertainty related to future cash flows. Most respondents highlighted that commercial mortgage rate "floors" have been instituted for most 5- and 10-year deals for both new and existing borrower clients.

Based on the above, we note that high-quality assets and well-capitalized institutional and private borrowers with meaningful track records are able to access commercial mortgage rates at similar levels offered pre-COVID-19, while respondents suggested that the increase in commercial mortgage spreads for the next tier of assets and borrowers would more than offset the decrease in base rates. As such, asset and borrower bifurcation within various Canadian markets is occurring and is likely to become more pronounced over the next 12 months.

Bank of Canada overnight interest rate



Source: Bank of Canada

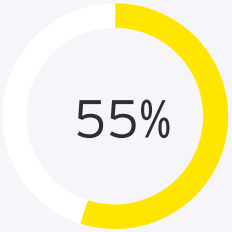
Loan-to-value ratios

Our survey revealed that 55% of respondents indicated that their LTV ratios have changed. Additionally, the 45% of lenders that indicated no change in their LTV ratios did suggest they are being more conservative from a property-level underwriting perspective, which necessarily translates to

Survey Results

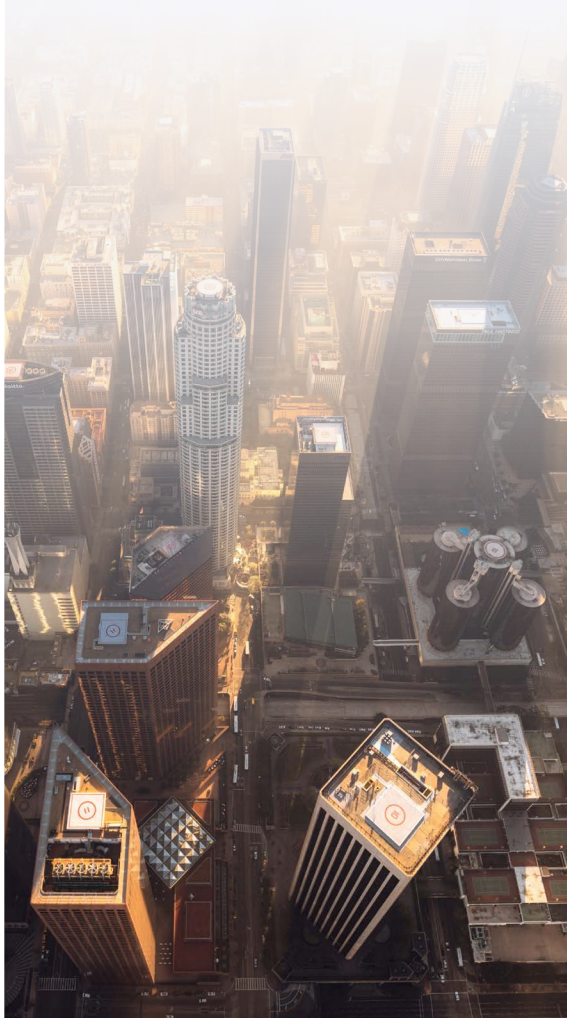
100bps to 150bps

Increase in credit spreads during COVID-19.



Change in LTV: 55%

No change in LTV: 45%



more conservative values and subsequently debt proceeds. Some of these underwriting changes may consist of an increase in bad debt allowance, changes in market leasing assumptions (e.g. market rental rates, rental rate growth and renewal probabilities), an increase in capitalization rates or changes to capital expenditure reserves. According to respondents, conservative underwriting is more likely to lead to lower property valuations and a higher required debt service coverage ratio, which results in less risk for the lender even if their LTV ratios remain largely unchanged.

More than half (55%) of respondents did indicate a decrease in LTV ratios ranging from 5 to 10 basis points. Respondents that provide short-term and/or bridge financing indicated the most significant decrease in LTV ratio.

Default projections

Respondents largely suggested that defaults are not likely to rise in the short term as both borrowers and tenants continue to benefit from government and mortgage relief programs.

Respondents were unanimous in their belief that borrowers on retail and hospitality assets will constitute the large majority of defaults. Respondents expect defaults to begin towards the end of 2020 as government assistance and cash reserves are eventually depleted. Defaults will also increase with more loan expiries, as borrowers will have difficulty refinancing given the more restrictive lending criteria.

Lenders, particularly ones that are focused on higher-risk assets, have begun to increase loan loss provisions in anticipation of potential defaults and impairments. Many lenders expressed concern that reduced market liquidity will result in borrowers being unable to divest of at-risk real estate holdings in a market with slower transaction velocity.

Outlook on mortgage spreads and all-in commercial mortgage rates

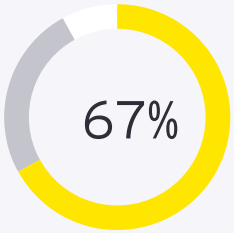
The majority of respondents (67%) expect credit spreads to increase over the next year. Credit spread fluctuations are dependent on a variety of factors, including the status of the benchmark base rate and/or a lender's cost of funds, and will necessarily vary by asset class and geography, asset quality, creditworthiness of the rent roll in place, and the borrower's financial strength.

Most respondents preferred to present a viewpoint on potential fluctuations in all-in commercial mortgage rates rather than credit spreads given the potential near-term volatility in base rates and differing cost of funds across institutions.

Overall, most respondents expect all-in rates to remain relatively consistent with pre-COVID-19 for high-quality assets with strong borrowers. Conversely, assets and/or borrowers outside of this first tier should largely expect an increase in all-in financing rates relative to pre-COVID-19 levels as lenders implement wider spreads and floors to mitigate both some of the property-level cash flow risk and structural economic risk and its corresponding impact on commercial real estate. In addition, non-bank lenders have indicated that their all-in financing rates are likely to be higher one year from today.

Survey Results

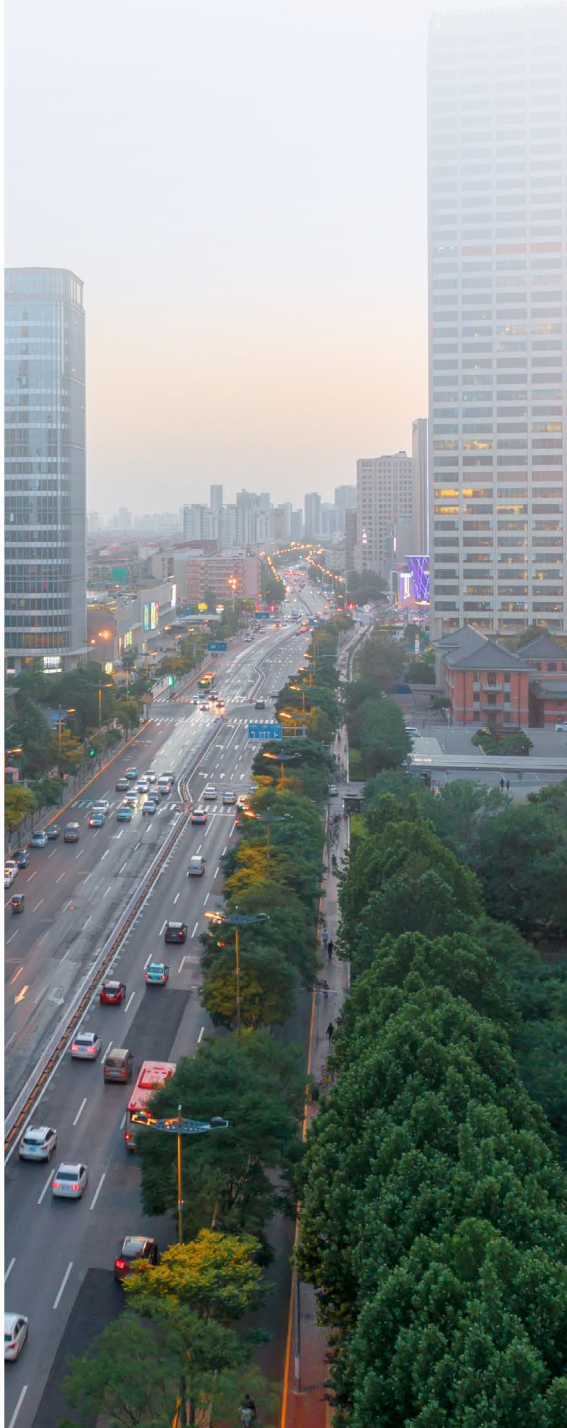
Credit Spread projections in 1 year



Increase: 67%

Decrease: 25%

Flat: 8%



EY outlook and perspectives

As shown by the survey results, lending institutions are pricing in increased risk on debt capital, applying higher scrutiny on borrower clients and largely asking for higher equity contributions on deals.

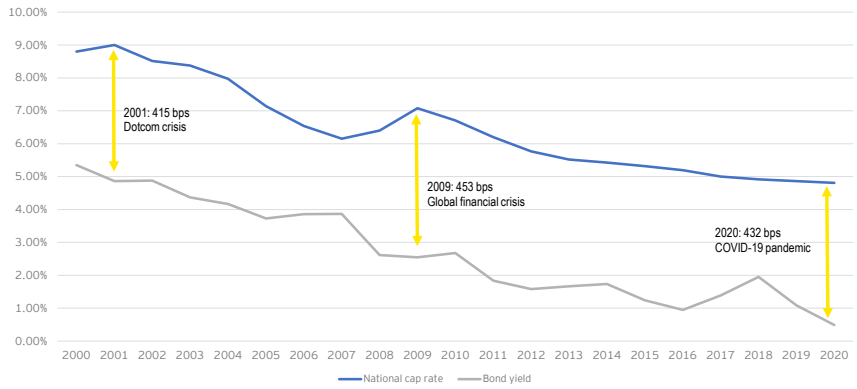
As unemployment figures remain near historic levels and consumer spending is forecasted to remain below normal levels for many months, an expeditious recovery appears less likely. As such, we anticipate that higher yield expectations are likely to set in across most major asset classes and geographies, with Tier 1 trophy assets being the least impacted. Our outlook is supported by the following analyses and historical trends.

Government of Canada bond yields vs. cap rates

One of the key relationships that we typically evaluate is the spread between cap rates and the 10-year Government of Canada bond yield. Generally, bond yields and cap rates move in the same direction – as one decreases or increases, so does the other.

However, we see a divergence from this trend during times of economic distress, as evidenced by the last two major events. In both the 2000-01 dotcom crash and the 2008-09 global financial crisis, bond yields decreased and cap rates increased, which translated to the widest spreads between the two data points.

National cap rates vs 10-Year Government of Canada bond yields



Source: Bank of Canada, Altus

The COVID-19 crisis has led to a sharp drop-off in bond yields, while we have little transaction data to date to earmark cap rate movement. From a historical perspective, we should anticipate an upward movement in cap rates as commercial real estate investors' return expectations will increase to account for elevated property-level and market risk. Between Q2 2007 and Q2 2020, the minimum, maximum and average spread between the 10-year Government of Canada bond yield and the average national cap rate were 1.48%, 4.53% and 3.34%, respectively.

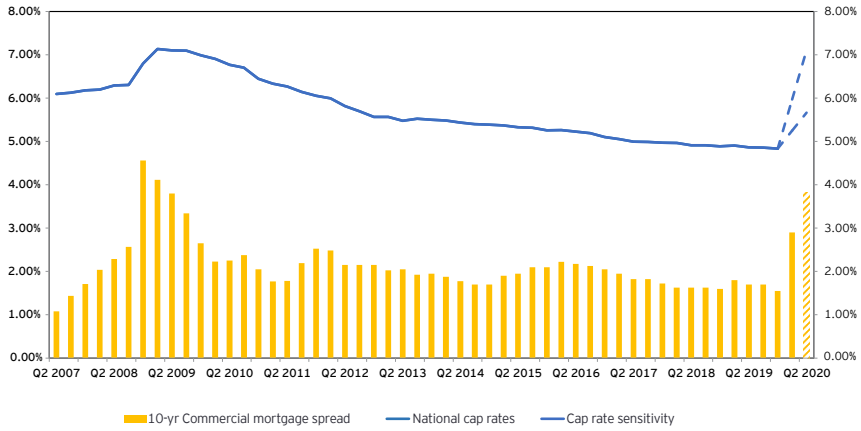
Band of investment theory

Another perspective of viewing the anticipated movement in cap rates is through the band of investment theory, which is based on the premise that most commercial real estate properties are purchased with a combination of debt and equity capital, and the cap rate must satisfy the required return on both investment parameters. The cap rate therefore consists of a debt component and an equity component, and both work together to impact the levered returns of a commercial real estate investment.

This means that if the cost of debt increases and/or the ratio of debt to equity (i.e., loan to value) decreases, investors will need to contribute higher levels of equity, which generally command higher returns. This theory demonstrates that cap rates are directly influenced by the availability and cost of debt, and through analysis of the lending market we can deduce valuable insights applicable to our current market.

The following chart shows the average quarterly surveyed cap rates for the four major asset classes - office, industrial, retail and multi-family - along with 10-year commercial lending spreads.

Commercial mortgage spreads vs. cap rates



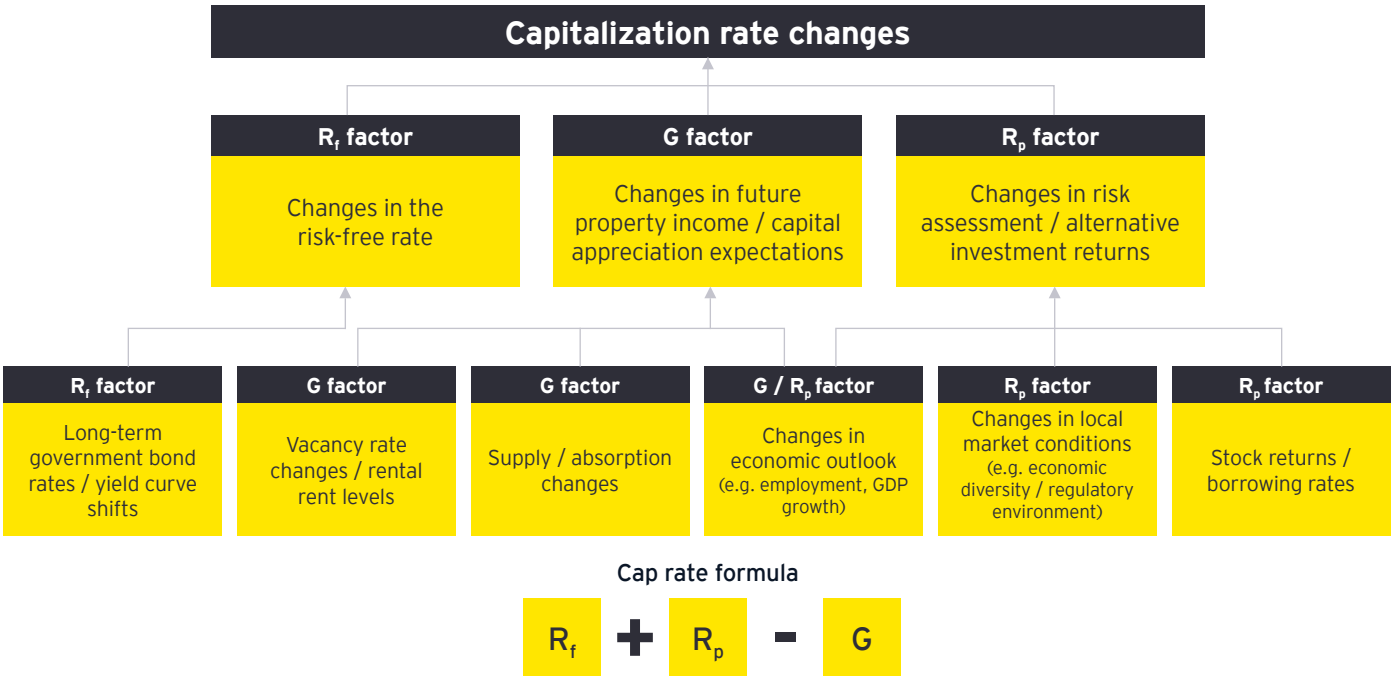
Source: Bank of Canada, CMLS, Altus, CBRE

We note that spreads increased by 225 basis points in late 2008, and as of Q1 2020 lending spreads had increased between 100 and 150 basis points. Based on this historical data point, an additional 100 basis point increase in spreads could potentially be anticipated later this year. If we follow the cap rate trendline of 2008, which shows the national average rate increased by 83 basis points, and assuming bond yields do not decrease further, we could see average cap rates jump from 4.84% as at year-end 2019 to 5.67% in Q2/Q3 2020.

There is a possibility, however, that average cap rates will increase at a rate that is more in-line with the change in commercial lending spreads. In 2008, commercial spreads increased by 227 basis points, reaching a high of 4.57%. If we see LTV ratios drop further and the overall availability of debt become more challenging to obtain, average cap rates could jump even higher than in 2008 and surpass 6.0% across all asset types.

The DNA of a cap rate

A capitalization rate is composed of three main components: the risk-free rate (Rf), a risk premium (or spread over risk-free rate) (Rp) and growth rate (G) assumptions. To understand anticipated movements in a cap rate, we need to examine what is happening to each underlying component of the rate.



Risk-free rate: As previously acknowledged, the risk-free rate has decreased substantially over the past quarter. The drop in the risk-free rate of approximately 100 basis points would initially lead one to believe that further decreases in cap rates could be expected. Instead, the drop in the risk-free rate is being counterbalanced by two other forces - the risk premium and growth assumptions.

Risk premium: The risk premium has a direct correlation to borrowing rates and local market conditions. As previously mentioned, the widening of credit spreads and the overall increase in the cost of borrowing for most assets has led to an increase in the risk premium that more or less offsets the drop in the risk-free rate. The change in the perception of risk and the pricing of risk in the debt markets would lead one to believe that this factor will result in an increase in cap rates.

Growth rate: Cap rates are reduced when market indicators point to periods of significant growth. The growth factor is a combination of economic outlook, changes in supply and absorption, vacancy rates, and rent rate change assumptions. The most recent economic forecasts indicate the foreseeable future will likely be a period of slow to moderate growth. There is limited expectation of rental growth rate and most are anticipating increases in vacancy rates across all asset classes. As such, expectations of growth in the real estate market are reduced from where they were in Q4 2019, which will put further upward pressure on cap rates.

An illustrative example is shown below on how changes in the three factors would impact cap rates:

	Rf +	**Rp -**	**G =**	**Cap rate**
Q4 2019	2.00% +	4.8% -	2.0% =	4.8%
Q2 2020	1.00% +	5.8% -	1.0% =	5.8%

The impact on cap rates is not uniform across assets, asset classes or geographies. The following table details our projections on cap rate movements by real estate sector:

2008/2009 financial crisis	COVID-19	EY perspective
Industrial		
Pre-crisis: 7.00% **Peak-crisis:** 8.00% **Change in cap rate:** 100 bps	**Pre-crisis:** 5.25% **Anticipated increase** 0 bps to 50 bps	Warehouse and fulfillment facilities will experience less of an impact given the increased demand for e-commerce, while manufacturing and other industrial types will continue to see a slowdown from the general decrease in demand for non-essential production. That being said, we anticipate all industrial assets to be impacted as consumer demand weakens from the increased unemployment rate, which was estimated to be 17.8% in April 2020.
Office		
Pre-crisis: 6.25% **Peak-crisis:** 7.25% **Change in cap rate:** 100 bps	**Pre-crisis:** 5.25% **Anticipated increase** 50 bps to 100 bps	We are already seeing a major impact to the office market as many companies are implementing work-from-home policies at an unprecedented rate and scale. While many organizations are already looking to explore ways to reduce their footprint, some organizations have announced a permanent work-from-home model for most employees. We anticipate more significant cap rate increases for office properties in suburban locations and/or with private tenants vs. office properties in downtown locations and/or with institutional tenants.
Multi-Residential		
Pre-crisis: 6.00% **Peak-crisis:** 6.50% **Change in cap rate:** 50 bps	**Pre-crisis:** 4.25% **Anticipated increase** 0 bps to 50 bps	Multi-residential assets have been largely unaffected by COVID-19 to date, with many landlords reporting 90% to 95% rental collection rates in April and May. However, it is important to recognize that many people are still being subsidized by government financial assistance programs, including the Canada Emergency Response Benefit (CERB) and the Canada Emergency Wage Subsidy (CEWS), among others. Once funding from these programs is over, and coupled with unemployment rates likely remaining high for the foreseeable future, we anticipate higher rental collection issues going forward.
Retail		
Pre-crisis: 6.00% **Peak-crisis:** 6.75% **Change in cap rate:** 75 bps	**Pre-crisis:** 4.75% **Anticipated increase** 50 bps to 100 bps	Retail has experienced a severe impact as the mandated shutdown across Canada has forced many businesses to close their doors temporarily. Government assistance programs are only providing temporary relief, and many landlords have reported rental collection rates as low as 25% in April and May. Many believe that the COVID-19 pandemic has only accelerated the consumer transition to e-commerce, which will likely lead to even more retail companies filing for bankruptcy or restructuring in the coming months.
Hospitality		
Pre-crisis: 9.25% **Peak-crisis:** 10.00% **Change in cap rate:** 75 bps	**Pre-crisis:** 7.50% **Anticipated increase** 100+ bps	Similar to retail, the hospitality asset class in Canada has witnessed a significant drop in demand, which has prompted many operators to lay off most of their staff until business and leisure travel resumes. Recent reports from hotel research experts indicate occupancy rates of 10% to 15% across all major cities in Canada. While hotels are seeing signs of improved occupancy in other countries, it will likely be a while before the industry fully recovers from this pandemic.

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