NOVEMBER 2017

Debt Market Monitor

National Debt Capital Markets Services

Anticipating higher interest rates and underwriting mortgages

Anticipated further interest-rate hikes in Canada and the U.S. will likely have impacts on real estate financing. Government bond yields have risen considerably over the past 18 months. Although Federal reserve funds rate and lending rates are not directly tied to one another, increases in central banks' short-term interest rates could lead to higher long-term rates if growth, inflation and unemployment continue to act appropriately.

In a rising interest-rate environment, such as the one that we find ourselves in currently, lenders will sense the need to protect themselves against anticipated decreasing property values. Lenders can do that by tightening lending standards further and requiring more equity from borrowers. Although lending has not approached aggressive levels seen prior to the 2008 financial crisis, the underlying basis for qualifying a property's debt load has been based on historically very low interest rates. Inherent equity components have increased during the current cycle; however, in the face of higher rates and tougher lending standards, that equity may start to erode. Higher interest rates typically are tied to higher cap rates and, thus, lower property values.

Lenders have the ability to restrict lending in a number of ways, including by requiring more collateral and or equity, or reducing exposure to property types and markets deemed riskier. This approach from lenders will be magnified in the construction-financing segment – which, by its very nature, has a higher degree of risk attached to it. Suffice it to say that stricter lending standards are already becoming more evident for most types of construction lending. More speculative loans, or those that may not provide the necessary credit worthiness from cash flows, and financially strong tenants with longer-term leases, will also take a hit. Sponsor guarantees are being more closely scrutinized, as they form a meaningful part of a lender security package.

Although we are in the early days of experiencing higher interest rates and the rise in rates is expected to be slow and methodical, in general, lenders will react fairly early on – before it is too late to protect their investments. None of this change will be instantaneous. It will take some time to sink in and work its way through the system; however, you can be sure that lending institutions' senior policymakers are thinking about this impact and, in some cases, have already started to react.

Fiscal Snapshot

Bank of Canada

	Bank Rate	Bank Prime Lending
October 2017	1.25	3.20
One month ago	1.25	3.20
One year ago	0.75	2.70

Government of Canada Benchmark Bond Yields

	5-Year	10-Year	Long
October 2017	1.62	1.95	2.30
One month ago	1.75	2.10	2.47
One year ago	0.69	1.20	1.85

Indicative Commercial Mortgage Spreads* Over Government of Canada Bond Yields

Conventional	5-Year	10-Year
October 2017	1.50 - 2.00	1.65 - 2.35
One year ago	1.85 - 2.00	1.95 - 2.25

Insured	5-Year	10-Year
October 2017	0.90 – 1.10	0.90 – 1.10
One year ago	0.95 - 1.25	0.95 - 1.30

*Spreads are indicative of high quality real estate in major Canadian markets.

Highlighted Transaction

Asset Type	Suburban office
Location	Major Canadian city
Facility Details	A senior charge in the amount of $9,000,000, structured for a 5 year term, 25 year amortization at a competitive rate of interest.

Intelligent Debt Financing Solutions

The Avison Young National Debt Capital Markets dedicated team is focused on providing innovative North American-wide debt and equity solutions to accomplish goals. We originate debt and equity for all types of real estate and all types of clients. Debt origination includes fixed and floating rate structures, permanent and construction financing, structured finance, bridge and mezzanine debt and insured agency financing - CMHC and Fannie Mae / Freddie Mac.

Our years of combined debt/equity capital markets experience has created meaningful relationships that we can put to work for you.

Please contact our National Debt Capital Markets team for more details related to debt financings or real estate transactions.

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