DESIGNER CAPITAL

Q2 2023

COMMERCIAL MORTGAGE UPDATE

The Second Quarter of 2023 was a surprise to many Canadians as interest rates were expected to drop. Instead, we witnessed two interest rate hikes - June 8th and July 13th for 25 basis points each, increasing the Policy Rate to 5.00% from 4.50% and the Prime Rate to 7.20% from 6.70%. The last time we have seen the Prime Rate at this level was in the early 2000s.

How will this affect borrowers? The cost of borrowing for consumers and businesses will become more expensive and this includes mortgage rates, credit card interest rates, and loans. However, it is also important to recognize that interest rate hikes can often indicate a strong economy and help combat high inflation.

The Consumer Price Index (CPI) cooled to 2.8% year-over-year in June, down from 3.4% in May. Moving forward, further easing of inflation is expected to take longer than expected. Tight monetary policy weighs on demand growth, and the economy is expected to enter into mild excess supply in the beginning of 2024. Inflation should then ease, reaching the 2% target in the middle of 2025.

Another headline news occurred in Q2. In the Federal Budget 2023, the government announced that it is considering consolidating Canada Mortgage Bonds (CMBs) into the regular Government of Canada (GoC) borrowing program. As CMBs are a more costly form of borrowing than regular GoC bonds, this proposal to consolidate CMBs is intended to reduce borrowing costs and redirect savings to priority affordable housing programs.

The CMB consolidation would represent a notable change in the Canadian fixed income market. While the pros have been recognized, it is also important to note that the overhaul of CMBs could result in considerable unintended negative consequences. The Canadian Mortgage and Housing Corporation (CMHC) is a Canadian Crown Corporation that serves as the national housing agency of Canada. CMHC provides federal funding for Canadian housing programs which is financed through CMBs.

Many investors purchase CMBs as they typically have a slightly higher interest rate than regular Government of Canada Bonds (GoCs). By replacing CMBs with GOCs, the difference between interest paid on GoC Bonds and the interest received from lenders/Issuers can be retained by the government as revenue, which then can be allocated to housing needs. However, this may drive many foreign investors out of Canada’s mortgage market as the returns are equivalent to government bonds but the risk from real estate holdings remains.

In summary, even though there has been improvement in the economy over the last few months, sentiment has not recovered. Consumers and businesses are still cautious given the high interest rate environment. Quantitative tightening will continue as the Bank of Canada remains resolute in its commitment to restoring price stability for Canadians.

Over the last quarter, we have identified the following trends in the lending sector for commercial real estate:

- Land Financing:

Many lenders have reached their allocation limits for land loans. This product has been increasingly challenging to finance as lenders continue to lend on loan-to-values of 50% or lower. Conventional and private lenders are declining raw land refinances unless borrowers have permits and site approvals in place. It is advised that land refinances must present a clear exit strategy for lenders to consider.

- Construction Financing:

Lenders' appetite for construction loans remains similar to Q1. According to Statistics Canada, residential building construction costs increased 1.9% in Q2. Meanwhile, non-residential building construction costs rose 1.5% in the Q2. Construction costs for residential buildings in the 11-census metropolitan area (CMA) composite rose 7.5% year-over-year in Q2, whereas non-residential building construction costs rose 7.0%.

Skilled labour shortages, cost of materials and labour rate changes were reported by contractors as key factors impacting the construction sector. In the second quarter, prices continued to rise for cement and ferrous metals, while they declined for lumber, plastics, and non-ferrous metals. Spreads are generally between Prime + 50-200bps with Prime at 7.20% as of this report.

- CMHC Financing:

On June 19th, CMHC increased their premiums for applications submitted on or after this date. They have also been employing higher expenses in their underwriting and thus there has been more pressure on return metrics for multi-family developers and operators. In some cases, the increase in these expenses can affect the Debt Service Ratio (DSCR) and make it difficult for some projects to achieve the limit of the 1.10x DSCR.

CMHC is currently overwhelmed with many applications. Corresponding with CMHC's fee increases on their multifamily insurance programs on June 19th, close to 4,500 multifamily deals were recently submitted to CMHC across the Canadian market. However, we expect that as summer comes to an end, more underwriters will return from their vacations and be able to expedite the process. As of today, it may take at least 3-5 months before a file is picked up by a CMHC underwriter to review.

- Term Financing:

Lenders continue to have an appetite for industrial or multi-family properties that are not financed through the CMHC MLI Select Program. Lending values continue to be around 75% LTV. The interest rates are sitting slightly above 6% on this type of product.

COMMERCIAL REAL ESTATE LENDING DEBT TERMS

Financing Type	Benchmark	Lender Spread		Indicative Rate		Max LTV/LTC
Term Financing						
5-Yr Conventional	5-Year GOC	2.00%	2.75%	5.68%	6.43%	75.00%
10-Yr Conventional	10-Year GOC	2.00%	2.75%	5.27%	6.02%	75.00%
5-Yr CMHC MLI Select	5-Year CMB	0.35%	0.60%	4.36%	4.61%	95.00%
10-Yr CMHC MLI Select	10-Year CMB	0.35%	0.60%	4.15%	4.40%	95.00%
Floating Rate Financing						
Conventional Construction	Prime	0.50%	2.25%	7.70%	9.45%	80.00%
High Yield Construction	Prime	3.00%	6.50%	10.20%	13.70%	85.00%
Land Financing	Prime	1.25%	3.25%	8.45%	10.45%	50.00%
Bridge Financing	Prime	1.50%	3.00%	8.70%	10.20%	75.00%

BENCHMARK YIELDS

Jun 30, 2023		Jun 1, 2023	1-Mth Change	Apr 3, 2022	3-Mth Change	Jan 3, 2022	6-Mth Change
5-Year GOC	3.68%	3.41%	0.27%	3.03%	0.65%	3.33%	0.35%
10-Year GOC	3.27%	3.16%	0.11%	2.89%	0.38%	3.19%	0.08%
5-Year CMB	4.01%	3.70%	0.31%	3.34%	0.67%	3.64%	0.37%
10-Year CMB	3.80%	3.61%	0.19%	3.37%	0.43%	3.66%	0.14%
Prime	6.95%	6.70%	0.25%	6.70%	0.25%	6.45%	0.50%

FUNDED DEAL SUMMARY

Designer Capital facilitated Construction Financing for two spec home builds in Sidney, BC. Our clients are experienced home builders and developers of purpose-built rentals. They have successfully rezoned and subdivided the property.

Working with one of the local credit unions, Designer Capital was able to achieve the following Novel Financing Solution:

NOVEL FINANCING SOLUTION

- Mortgage: $1,630,000
- 75% Loan-To-Cost
- 60% Loan-To-Value
- Construction Loan: Priced at Prime + 2.00%
- Built-In Interest Reserve

Designer Capital's *Unbiased Advice* helped secure our clients *Construction Financing* at a *high Loan-To-Cost* to allow for the *minimum amount of capital injection* from the clients to complete the construction of their development.

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ABOUT DESIGNER CAPITAL

Based in Victoria, Designer Capital is a real estate capital advisory firm that provides novel and unbiased solutions for residential and commercial financing.

We support developers and real estate investors in optimizing returns by structuring debt financing in the form of land acquistion, construction, mezzanine, bridge, and term loans.

From multi-tenant investment properties, new construction and development to owner-occupied space, we have facilitated successful funding across all major asset classes.

Designer Capital is licensed and regulated as a Mortgage Broker by the BC Financial Services Authority (BCFSA).

DESIGNER
CAPITAL

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