Capital Debt Markets Monthly Update

JANUARY 2019

5 - Year GOC		TSX		Prime Rate	
1.82%	▼ 0.06% 01/03/2018-01/03/2019	14389.12	▼ 1920.87 01/03/2018-01/03/2019	3.95%	▲ 0.50% 01/03/2018-01/03/2019

A Year of Uncertainty

Sitting down to write this newsletter has been a bit of a challenge as the year concluded. Every week seemed to bring a new wrinkle to the economy which impacted the potential movement in the BoC Prime rate, the TSX, Bond Rates and mortgage financing structures. While debt availability remains relatively strong, underwriting parameters are changing, and the major banks may be poised to react as they have in the past.

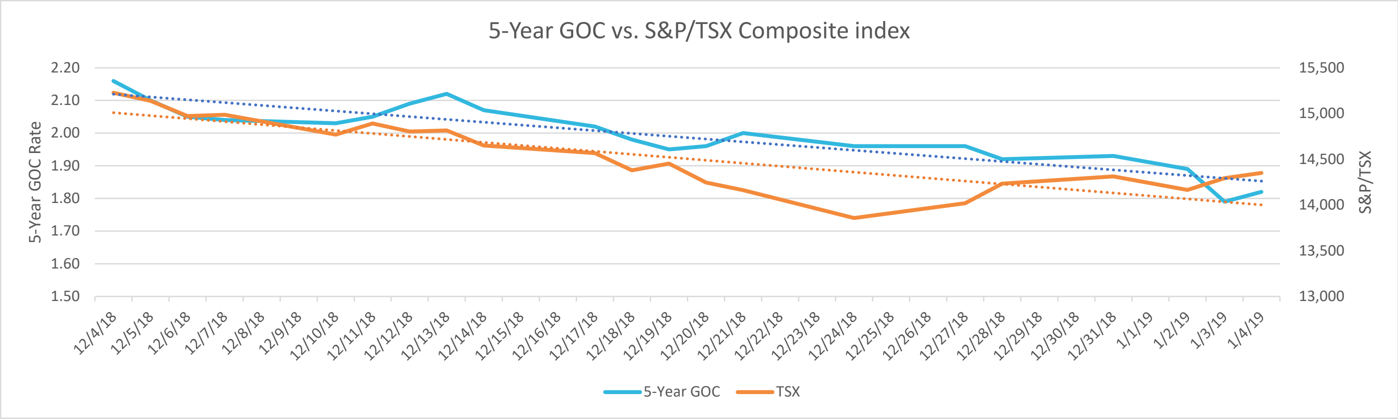
The Avison Young Western Canada Debt Capital Group operates out of Edmonton, Calgary and Vancouver. This creates a unique perspective on how real estate assets are being analyzed and financed as files are worked on conjunctively. Vancouver remains the strongest of these locations for commercial assets with Calgary having challenges ahead until the oil industry can come to grips with a fundamental change towards seeking out ways to move product, rather than secure the resource.

The institutionalization of real estate over the past 25 years has caused challenges for investors from being able to compete on price. The subsequent compression of capitalization rates may have come to an end for many locations in Western Canada thereby providing opportunities to acquire assets that are being culled by the institutional investor.

Market Update

- Bond rates have shown a dramatic decline over the past couple of months. The 5 year bond was trading in the 2.45% in November, 2.20bps range in early December, with the current bond rate being more in the order of 1.85%. The slim variance between 5 year and 10 year bond rates at approximately 7.0bps has held constant through that time frame.
- Lenders are beginning to incorporate "floor rates" into offers to finance. Where a spread of say 200bps over the applicable bond might result in an interest rate of 3.80%, the minimum acceptable rate is being noted at 4.00% or higher.
- Credit availability specific to any investor may show some deceleration as the year unfolds. The typical response is to limit the Loan to Value ratio even though debt coverage ratios can be maintained with lower interest rates than earlier in 2018.
- Spreads over the bond rate or cost of funds are showing some potential for increase. Though not impacting the "trophy assets" in the same way as the general pool of realty investments, uncertainty will create a landscape where any perceived risk in the revenue potential of an asset may default to such an approach.
- While there was some consensus that the BoC would increase the overnight rate in December, it did not materialize. There are predictions suggesting up to 3 increases over the next few quarters, but as the new year begins to provide some direction on the economy, and more importantly how elections in Alberta and Federally gain momentum, a stand still attitude may take hold.

Bond Rate



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Looking Ahead

- Where might the Canadian Prime rate head in 2019? In October of 2014 Prime was noted at 3.0%, which coincided with the change in Alberta's economy. By January 2015 the rate declined to 2.85% and held steady to July 2015 when a drop to 2.70% occurred. There was no movement through to July 2017 when the current upward trend took hold. Over the next 16 months the rate increased 1.25%. With an imminent decline in the TSX for 2019, the potential for major increases are less likely and perhaps we will see softening in the prime rate.
- The anticipated results of Provincial elections in Alberta and the Federal election can dramatically alter how real estate assets are perceived by lenders. By mid 2019 there will be a tendency to rethink how the lending process will be conducted awaiting the impact of certainty in the political landscape.
- Responses to any perceived risks tend to be dealt with by "stressing" interest rates and adjusting revenues. What can occur is loan amounts begin to reflect loan to values that can be lower than might be desired. This can also act to have an impact on the level of guarantees that may be required of borrowers.
- The structure of debt for a real estate acquisition may now require more detail and discussion on the above components.
- The likelihood of the secondary lending market gaining market share through this time frame for re-positioning and development are high.
- With bond rates at a low end of the range and the beginning of a new year, lenders may be aggressive in pricing and underwriting in order to deploy allocated capital before mid-year.

Case Study

Recently the Avison Young Debt team funded the acquisition of a 3-tenant retail centre located in Nisku, Alberta. Financing of $3,850,000 (70% LTV) was funded on a purchase price of $5,475,000 amortized over 25 years with a term of 5 years. An interest rate below prime rate (3.95%) at the time was achieved for the client, maximizing cash flows available from the buildings operations. This interest rate was achieved due to the team's analysis and tracking of the bond rate to capitalize on setting the rate at a point that was of the best value for the client. The team was also able to move quickly within tight time constraints to produce a commitment letter that was optimal for the Borrower. Throughout the process there were minor environmental concerns due to an external property that our team were able to negotiate with the engineers in order to come to a sensible conclusion for presentation to lenders.

Contact Information

Ron Dezman, AACI
Senior Vice President
780.408.6771
ron.dezman@avisonyoung.com

Don Taylor
Senior Vice President
604.607.1333
don.taylor@avisonyoung.com

Jordan Dezman
Associate
780.408.6773
jordan.dezman@avisonyoung.com

Sam Dezman
Associate
780.408.6770
sam.dezman@avisonyoung.com

Garrett Plester
Associate
403.232.4301
garrett.plester@avisonyoung.com

Brennan Yadlowski
Associate
587.882.9753
brennan.yadlowski@avisonyoung.com