

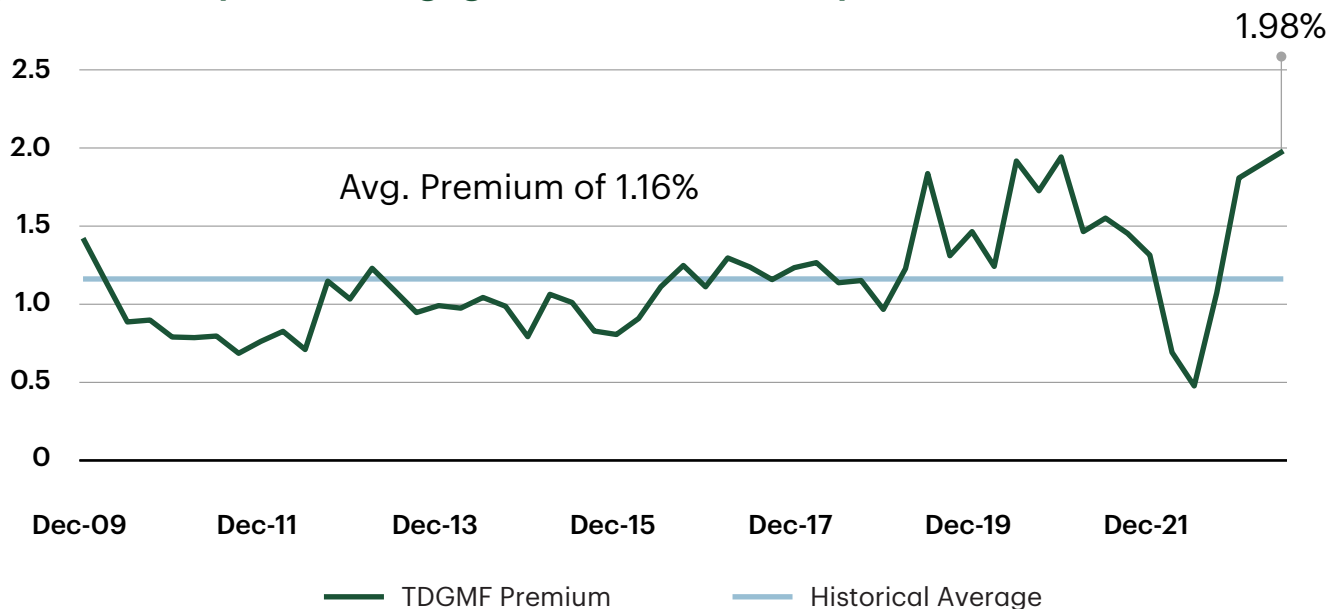


Through the Noise:

Capitalizing on Elevated Commercial Mortgage Yields

Absolute and relative yields of commercial mortgage strategies are near 15-year highs, while the properties securing the commercial mortgage strategies face negative sentiment. Such crosscurrents often present rare investment opportunities, and today's commercial mortgage market is no exception.

Figure 1: TD Greystone Mortgage Fund Yield over Corporate Bonds



Source: TD Greystone Mortgage Fund vs. FTSE Canada All Corporate as at June 30, 2023.



By understanding the different return drivers of commercial mortgages (debt) and commercial real estate (equity), followed by developing clear loan loss probability evaluation criteria, investors can sift through the noise and capitalize on elevated commercial mortgage yields.

Without predicting future returns for the commercial real estate market, we can analyze expected returns for various types of commercial mortgage strategies, even in a potential commercial real estate downdraft. Typically, commercial mortgage and commercial real estate strategies display very low performance correlation. Since its inception, the TD Greystone Mortgage Fund (“TDGMF”) has demonstrated a correlation of -0.44 with the Canadian commercial real estate market.¹ Underlying the fundamental differences between debt (commercial mortgages) and equity (commercial real estate) is the fact that commercial mortgage returns are primarily driven by the cost of capital (i.e. compensation for lending/mortgage coupon), while cost of capital is a detractor for commercial real estate performance (see **Figure 2**).

Figure 2: Return Contributors for Commercial Mortgages and Commercial Real Estate

Commercial Mortgage Return	Commercial Real Estate Return
Cost of Capital – Loan Losses	(Income + Valuation Change) × (Leverage) – Cost of Capital

Source: TD Asset Management Inc. Illustration.

As a result, expected returns for commercial mortgages can increase as the expected returns for commercial real estate decreases. For instance, when sentiment for commercial real estate falls, the availability of capital falls, causing the cost of capital (i.e. compensation for lending) to increase.

This is currently the case, as the TDGMF is facing less competition from other lenders due to negative commercial real estate sentiment and is thus able to secure high-quality commercial real estate with attractive coupons.

¹ Correlation based on quarterly performance of MSCI/REALpac Canada Property Fund Index (PFI) and TDGMF from Sep 30, 2007-Dec 31, 2022.

Case Study: Global Financial Crisis

In 2008, commercial mortgage rates (cost of capital) increased as sentiment around commercial real estate waned. As a result, the yield of commercial mortgages and the forward-looking returns also increased – culminating in a TDGMF 7.4% annualized return through 2008–2010, 2.4% above its long-term average, with zero loan losses.

Figure 3: Historical Mortgage Rates

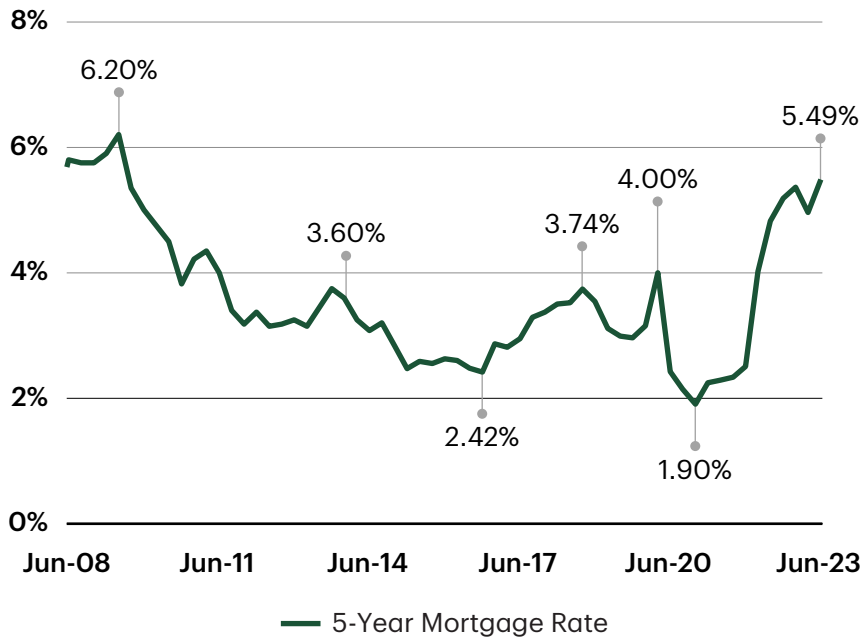
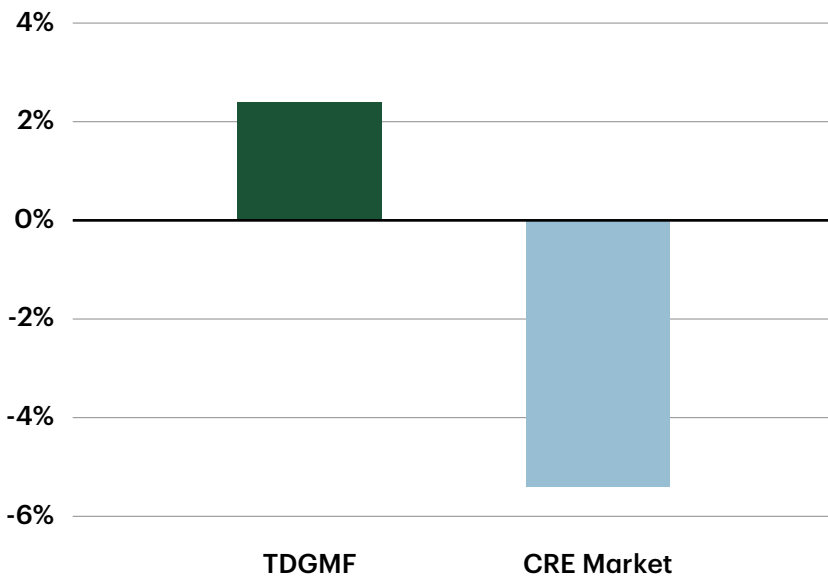


Figure 4: Global Financial Crisis Return vs. Long Term Average Return



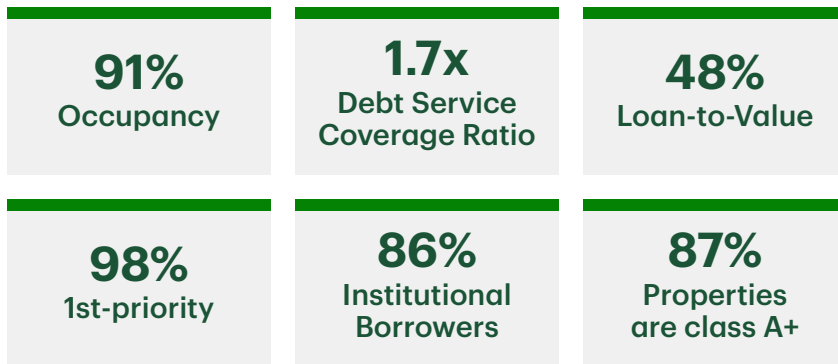
Source: TD Asset Management Inc. MSCI/REALpac Canada Property Fund Index (PFI) and TDGMF performance from Dec. 31, 2007 - Dec.31 2010 less their respective performance from Dec.31, 2007-Dec.31, 2022 (annualized).

Today's mortgage rates have reached levels not witnessed since the Global Financial Crisis; however loan loss probabilities have also moved higher (Commercial Mortgage Return = Cost of Capital – Loan Losses). Allocators must discern what commercial mortgages can participate in elevated costs of capital tailwinds while insulating performance from potential commercial real estate market turbulence and corresponding loan losses.

The probability of loan losses can be determined by evaluating the commercial mortgage's **A debt serviceability**, **B the security backing the mortgage**, and finally **C the manager's ability to enforce security**.

As an example, we will apply the above criteria to the topic du jour, the office market, for the TDGMF.

Figure 5: TDGMF Office Fundamentals (22% of Portfolio)

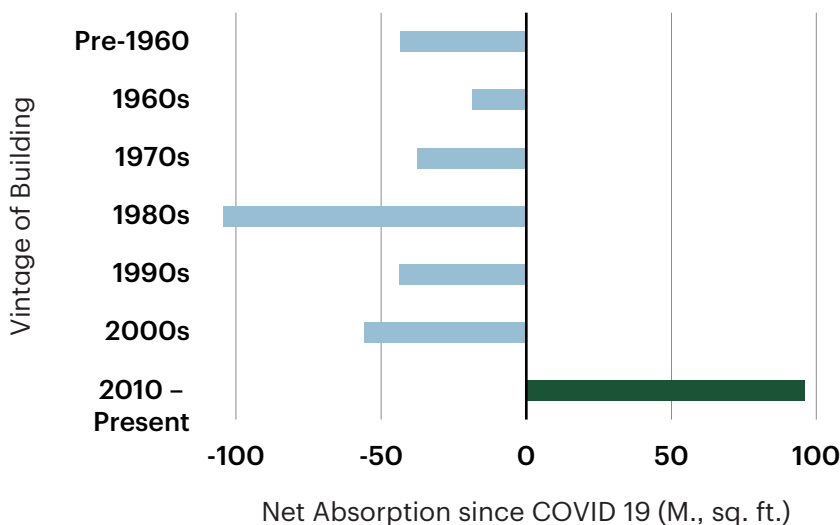


Source: TD Asset Management Inc. Core mortgages only.

A Debt Serviceability

The debt-service cost ratio (DSCR) of the TDGMF's office portfolio, which is 1.7x, indicates the underlying office cash flows must fall ~70% before the average property could no longer service the debt. Additionally, if we stress test interest rates another 200 basis points ("bps") higher from current levels, the average DSCR remains buoyant at 1.67x at the time of maturity.

Figure 6: Net Absorption by Vintage since COVID-19



Source: JLL Office Outlook Q1 2023. As of Mar 31, 2023.

Top-down metrics are informative, however evaluating the sustainability of debt serviceability requires comprehension of the underlying commercial real estate quality. The reason for this is simple: quality lasts. The "flight-to-quality" ongoing in the office market today is a testament to this (see **Figures 5 and 6**) and the TDGMF is attractively positioned with 87% Class A+ exposure.

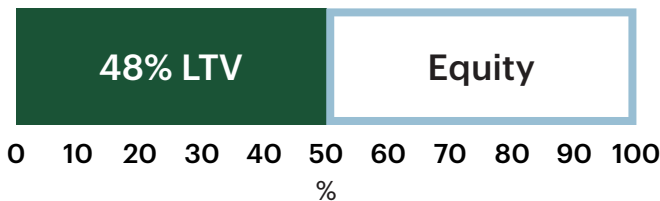
High-quality is also expensive and, for this reason, size matters for commercial mortgage strategies. As the largest open-ended commercial mortgage fund in the country, the TDGMF has access to office assets and borrowers that other commercial mortgage strategies cannot access due to the size of financing required. Highlighted by 86% institutional borrowers and 91% occupancy, the TDGMF's office holdings are serviced by well-established and resourced borrowers that continually invest in the underlying property to drive sustainable leasing demand.



B Security in-Place

High-quality real estate also provides security on the loan in case of default, observed by the average capital stack of TDGMF office positions depicted in **Figure 7**. The average office commercial real estate could decrease 50% from appraised value, and the real estate that TDGMF has first-claim of in case of missed debt payment would still be worth more than TDGMF office mortgages.

Figure 7: TDGMF Office Capital Stack



Source: TD Asset Management Inc. Illustration of TDGMF average office position.

Nevertheless, any lending with a yield above government bonds does entail default risk and commercial mortgage strategies must be able to manage through defaults by enforcing their security.

C Enforcing Security

Enforcing security entails pushing the borrower into default if it is the most prudent decision for the commercial mortgage investors. Private commercial mortgage lenders that own the entire first-priority mortgage are advantageously positioned to do this versus other unsecured debt investments. For comparison, public corporate bond holders typically own a fraction of the unsecured loan, necessitating a special servicer to conduct the work-out for the corporate bond holder amongst a plethora of other holders.

The TDGMF is uniquely positioned to enforce security and protect investor capital in case of default. By being fully integrated with the TD Greystone Real Estate Strategy, which is approximately \$23 billion in size, the TDGMF has in-house commercial real estate expertise available to help reposition properties and optimize value for investors if ever required.

Summary

Commercial mortgage yields are at 15-year highs and are elevating income performance potential. However, high-quality (lower risk) commercial mortgages are likely to outperform lower-quality commercial mortgages if the commercial real estate market were to experience a significant downdraft. Allocators can discern high-quality versus low-quality commercial mortgages by evaluating

debt serviceability, the security in place and the lender's ability to enforce security. Commercial mortgage risk metrics are informative in this regard, however, as the "flight-to-quality" within the real estate market is currently demonstrating, investors must further investigate the quality of borrowers and collateral to capitalize on this rare opportunity. ■

**For more information on the TDGMF please see:
The TD Greystone Mortgage Fund: 15 Years of Income Generation >**



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