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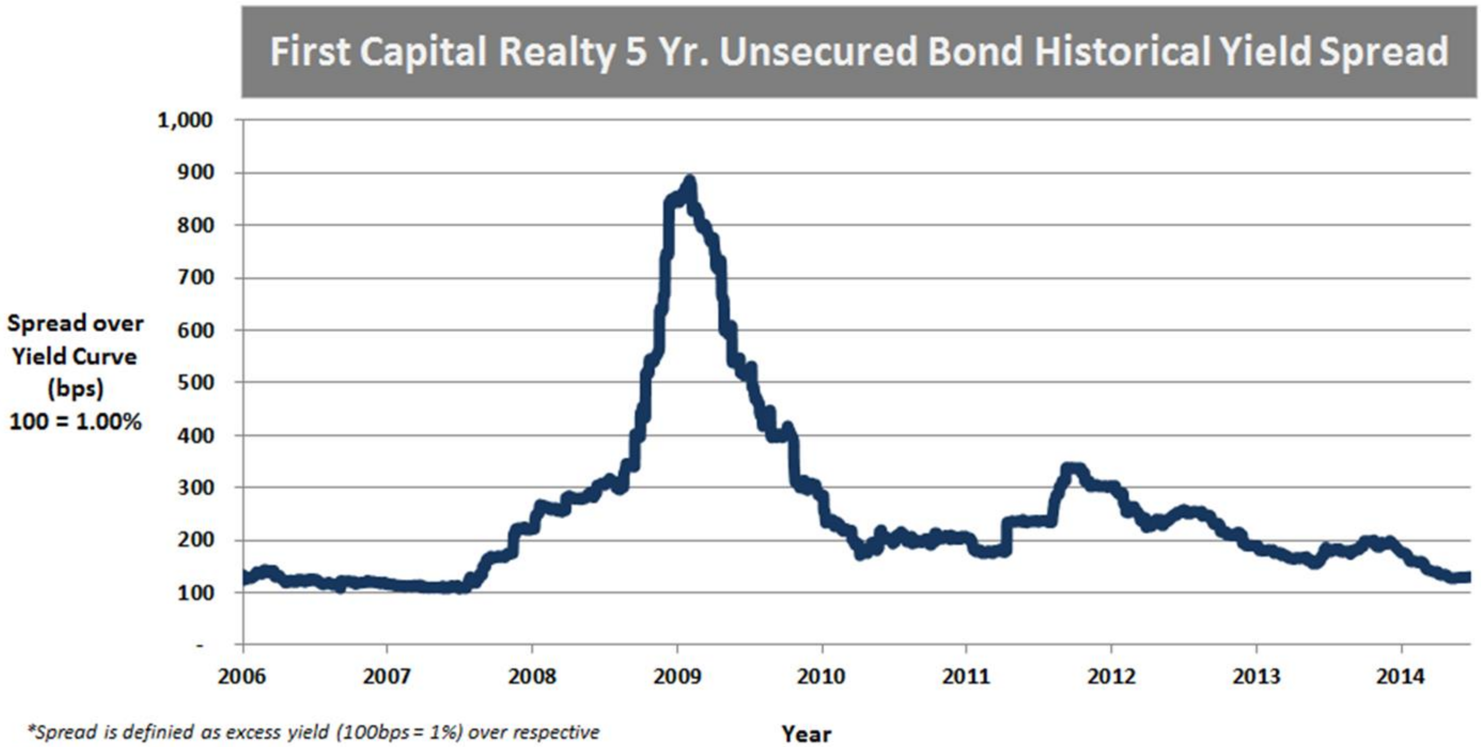
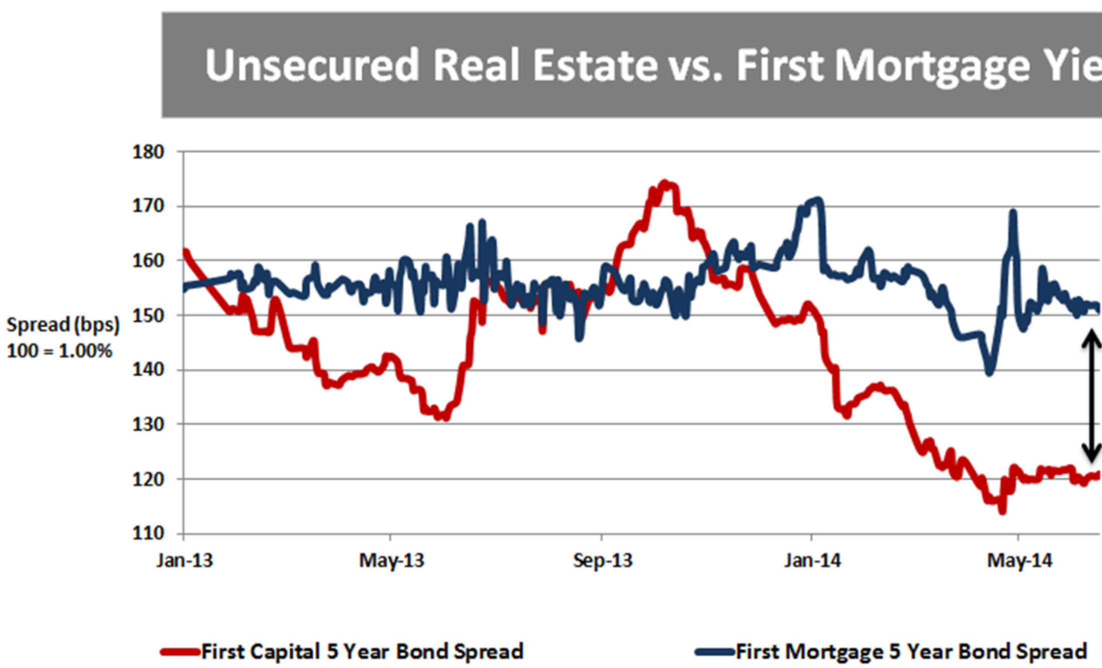
Case Study: The 10 year Real Estate Bond Rally & its Implications



**Spread is definied as excess yield (100bps = 1%) over respective Government of Canada Bond*



So what does it all mean?

Investors in the **unsecured debt** market are accepting lower and lower returns for their capital despite the inherent risk they are taking on

**Spread is definied as excess yield (100bps = 1%) over respective Government of Canada Benchmark Bond*

**Defined as a Bond secured by a mortgage with first call on the Assets. Typically they are backed by either real estate or hard assets.*

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For a considerable amount of time Avenue has publicly and privately pronounced that unsecured real estate bonds were mispriced relative to the risk an investor was taking. We have always seen value and hence our bond portfolio has always been heavily invested in this sector. From 2004 until 2013, 5 year maturity real estate bonds yielded roughly 1.5-2.5% more than Government of Canada bonds (GOCs).

The credit agencies have always rated the sector's debt as BBB or BBB low, which is considered a low quality investment grade bond. The credit agencies had a general feeling that the ratings were appropriate due to Canada's real estate problems in the early 1990s, e.g. the Bramalea Ltd. and Olympia and York bankruptcies.

Avenue has always believed that real estate issuers were being mispriced by the market and the credit agencies. Several factors led to our strong opinion over the past decade.

Real estate issuers benefited from important structural changes that positively affected the sector. Most importantly, the market benefited from low real interest rates. This dynamic was created due to Canada's relatively strong fundamentals on its budget deficits (and surpluses) when compared against the rest of the world. Canada's low debt/GDP, roughly 35%, over this 10 year time period allowed real interest rates to stay very low which directly benefited real estate assets.

Secondly, through this period real estate companies that issue bonds became more conservative. Not only were there stronger bond covenants put in place for the investor since the 1990s but the sector has lived with lower leverage and payout ratios that has helped the balance sheet become more conservative and as a result bond holders have been in a stronger credit quality position.

To put this in perspective, real estate bond yields were priced at 3% over GOCs. Over the past decade, the sector's spreads have narrowed to only 1.2% over GOCs. We believe the sector is now fully valued and it will be hard to justify overexposure to the sector.

A Shift in the Unsecured/Secured Market

An interesting dynamic has occurred recently with the relationship of real estate bonds and 1st mortgage bonds. Historically, 1st mortgage bonds have always traded around 1.5% above GOCs. Real Estate bonds have always traded above 1st mortgage bonds, usually 0.5 – 0.75% over 1st Mortgage bonds. This makes sense since being a holder of a 1st mortgage bond would place the investor higher on the capital structure than unsecured real estate issuers and therefore they would get paid first on any bankruptcy.

As the prior chart shows, an anomaly has occurred. Unsecured bond spreads are now below 1st mortgage bonds. Real Estate bonds are now at 1.2% over GOC and 1st Mortgage bonds are still at 1.5% over GOCs. This gives us an opportunity, because of the yield, to invest in 1st mortgage bonds. The problem is that it is very difficult to find this type of bond due to inconsistent issuing and supply.

As a substitute, mortgage investment corps (MICs) are widely available and trade on the public markets. They are similar to1st mortgage bonds which concentrate on conservative loan to value calculations.

Just to be clear, a MIC is a more risky investment relative to a 1st mortgage bond due to its equity nature; but you are being compensated for that risk. The yield on MICs are roughly 6.5%. On a risk adjusted basis we believe these investments are inexpensive. Both Avenue portfolios own Timbercreek Mortgage. We will be looking for other investments in this sector in order to increase our exposure, instead of buying real estate bonds.

Avenue Investment Management
Getting there together