Deutsche Bank

February 2002

Canadian CMBS

Market Developments and Growth

Table of Contents

- The Canadian CMBS market is small but growing. Sixteen deals totaling C$3.8 billion have been issued to date.
- Potential changes in tax laws will likely have a positive affect on Canadian CMBS by eliminating withholding tax for non-Canadian investors and non-Canadian lenders. We anticipate the proposed repeal of the tax will expand the investor base into the U.S. and Europe and increase the number of non-Canadian lenders originating loans in Canada.
- Collateral performance in Canadian CMBS has been exceptionally good to date, with only one loan currently delinquent.
- Floating rate issuance is expected to be the next area of growth in the market. We take a look at the floating rate market in the U.S. to provide investors with a guideline of the features to consider when analyzing floating rate deals.

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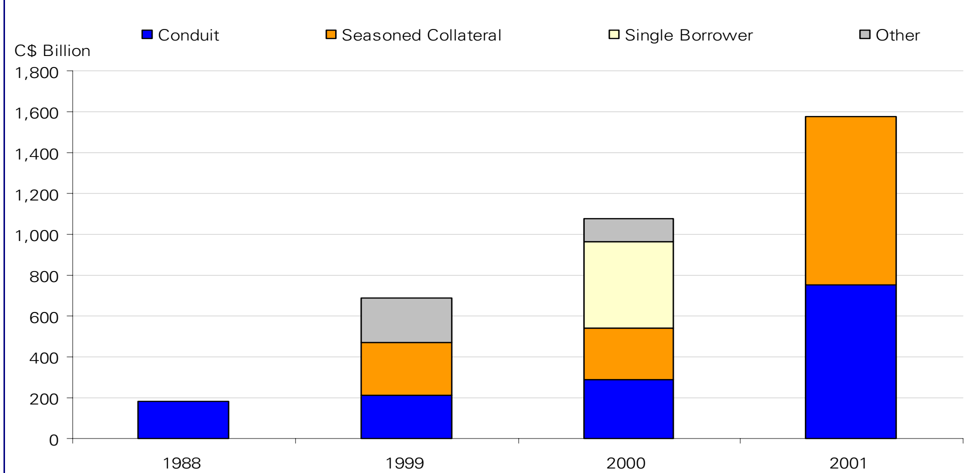
Canadian CMBS Issuance



Source: Deutsche Bank, Commercial Mortgage Alert

Introduction

The Canadian CMBS market has grown steadily since the first issue in late 1998. While the number of market participants is still quite small compared to more established markets such as the U.S. and Europe, we expect continued growth as investor's knowledge of the product type increases.

Additional market growth is expected to result from two developments: the anticipated repeal of the withholding tax on cross-border interest payments and the formation of a floating rate market, a sector which has been untapped thus far.

In the following sections, we give an overview of the brief history of Canadian CMBS and recent developments within the market. We then take a look at where the market is headed, primarily with respect to collateral performance and floating rate issues, utilizing the mature U.S. market as a guide

Canadian CMBS Overview

To date, 16 CMBS deals with a balance of C$3.8 billion have been issued. The deals are generally small in size, averaging only C$237 million, and the number of dealers is limited, with only six banks involved on the new issues.

16 deals with a balance of C$3.8 billion have been issued in Canada

Figure 1: Canadian CMBS Transactions

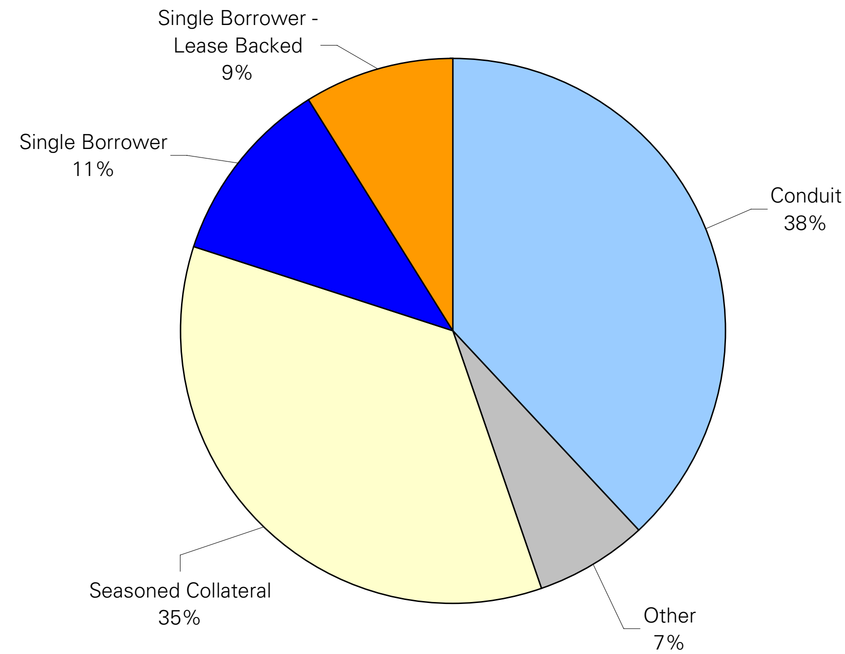
Deal Name	Amount (C$)	Deal Type	Date
Merrill Lynch 1998-Canada 1	182.1	Conduit	Dec-98
N-45 First CMBS 1999-1	254.1	Seasoned Collateral	May-99
Merrill Lynch 1999-Canada 2	214.1	Conduit	Sep-99
Merrill Lynch 1999-1STT	220.0	Single Borrower - Lease Backed	Oct-99
Merrill Lynch 2000-Canada 3	257.6	Other	May-00
N-45 First CMBS 2000-1	235.0	Single Borrower	Jun-00
Merrill Lynch 2000-BMCC	115.0	Single Borrower - Lease Backed	Oct-00
N-45 First CMBS 2000-2	251.0	Seasoned Collateral	Oct-00
Solar Trust 2000-1	189.6	Single Borrower	Oct-00
Merrill Lynch 2000-Canada 4	287.6	Conduit	Nov-00
Merrill Lynch 2001-LBC	200.2	Seasoned Collateral	Jan-01
N-45 First CMBS 2001-1	358.4	Seasoned Collateral	Apr-01
Merrill Lynch 2001-Canada 5	248.7	Conduit	May-01
Mansfield Trust 2001-1	265.2	Seasoned Collateral	Jul-01
Solar Trust 2001-1	241.2	Conduit	Aug-01
Merrill Lynch 2001-Canada 6	265.5	Conduit	Dec-01

Source: Deutsche Bank, Commercial Mortgage Alert, Moody's

The transactions have been predominately conduit (38%) and seasoned collateral (35%). The Canadian CMBS market is still in its infancy, and the large share of seasoned collateral deals is typical of a young market. As occurred in the U.S. and Europe, the first use of the CMBS market is for whole loan holders to remove seasoned loans off their books by pooling them as CMBS. Following the initial pooling of seasoned loans, programs designed to originate loans specifically for securitization develop. Securitization programs, as opposed to the mere pooling of existing loans, are a necessary component for a market to mature and grow.

The establishment of securitization programs, and thus the first signs that the market is increasing its presence, is evident in three of the four most recent deals issued. The average loan age at the time of pricing for Merrill Lynch 2001-Canada 5, Solar Trust 2001-1, and Merrill Lynch 2001-Canada 6 was 1 to 12 months. The composition of these deals signifies market development and the potential for future growth.

Figure 2: Canadian CMBS by deal type



Source: Deutsche Bank, Commercial Mortgage Alert

Canadian CMBS consists predominantly of conduit and seasoned deals

Recent Market Developments

The CMBS market is expected to benefit from the proposed elimination of the Canadian withholding tax statute. The statute currently requires all non-Canadian entities receiving interest payments from a Canadian entity to pay a 25% withholding tax. This tax liability is a two-pronged impediment to market growth: it affects both non-Canadian investors buying Canadian CMBS and non-Canadian lenders originating Canadian loans.

One of the obstacles to expansion is due to the small number of Canadian investors in the market. This is largely a result of the relative newness of the sector. U.S. and European accounts intending to enter the market are faced with an additional tax liability due to the statute. Repealing the tax would quickly expand the investor base and create growth in the market.

The second area of growth following the elimination of the withholding tax is for non-Canadian based lenders. The CMBS deals that have been completed by non-Canadian lenders, have been through Canadian based subsidiaries. If the tax is eliminated, non-Canadian banks will have greater ease in entering the loan origination market. Increasing the number of originators will increase competition, resulting in a lower cost of borrowing and greater visibility in the market.

The proposal to eliminate the tax is currently being reviewed by Canadian lawmakers. As with most law changes, a definitive timeframe is difficult to determine, however, market participants anticipate a decision within the next 12 months.

Canadian CMBS Outlook

While Canadian CMBS deals have been issued since late 1998, the market is extremely young from both a collateral seasoning and deal variety perspective. To develop an estimate for the future of Canadian CMBS we look to the U.S. market as a guide.

Collateral Performance

Collateral in Canadian CMBS has a nearly pristine performance record. Of the 16 total deals, 14 had January trustee remittance reports available. Of the 768 loans in these deals, only one loan was delinquent. The loan, 30 days delinquent in January, represents only 0.4% of Merrill Lynch 2001-LBC.

The insignificant level of delinquencies bodes well for future performance, however, it can not be used as a reliable forecast for Canadian deals. As the CMBS market grows and ages, delinquencies and defaults will certainly occur.

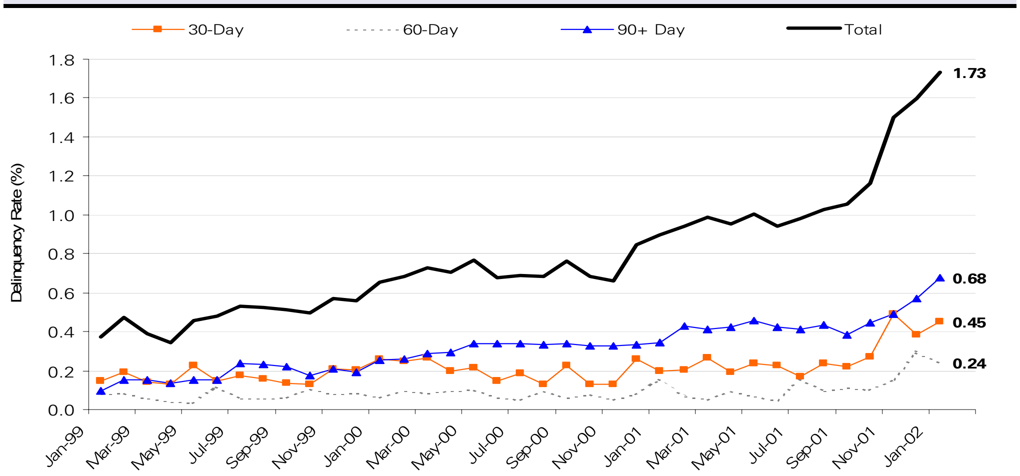
Conservative underwriting and a stable real estate environment are likely contributors to the strong performance. Loan seasoning characteristics of the deals has also played a significant role. Defaults in U.S. commercial mortgages generally begin to appear only after 12-24 months of seasoning. Between 24 and 36 months mortgage defaults experience a significant increase, and begin to stabilize only after 48 to 60 months.

The loan age on N-45 1999-1 and Merrill Lynch 2001-LBC, two seasoned deals, is in the 41 to 64 month range, towards the stabilization area of the seasoning curve. If we look at the five most recent non-seasoned deals, dating back to Solar Trust 2000-1 in October 2000, the weighted average seasoning is currently only 12 months. This is in the area of the seasoning curve that also does not experience many defaults.

Due to the seasoning characteristics of Canadian collateral, we use U.S. conduit CMBS deals as a guide to expected future performance. As seen in Figure 3, total delinquencies in U.S. conduit CMBS have been low.

U.S. conduit CMBS has experienced exceptional performance

Figure 3: U.S. conduit delinquency rates



Source: Deutsche Bank, INTEX

While the shape of the delinquency curve, rising due predominately to seasoning, can be expected to be similar, we believe Canadian collateral is likely to perform as well as, or better than, collateral in U.S. deals.

Canadian loans originated for securitization are based largely on standards already established in the U.S. market. New loans, in addition to securitized seasoned loans, are analyzed by U.S. rating agencies with years of CMBS experience. The Canadian transactions therefore started "further up the learning curve" compared to the U.S. market. Advances both in our understanding of loan risk and structuring techniques are expected to provide stronger loan performance in Canadian deals.

Canadian mortgages are typically recourse to the borrower. This differs from the U.S. commercial market, which is almost exclusively non-recourse. Recourse loans give the lender rights against other assets of the borrower, in addition to the collateral property, in an event of default. Recourse can be full or partial. Partial recourse gives the lender the right to recover losses on a portion of the loan amount.

Recourse loans have a lower default probability and lower loss severity. Borrowers are less likely to default because they have a greater incentive to increase the amount of support provided to a struggling property. Additionally, the assets recovered from the borrower above the real property can help offset losses on the loan.

Canadian loans are typically recourse to the borrower

Figure 4: Recourse provisions in Canadian deals

Deal Name	Full or Partial Recourse (%)
N-45 First CMBS 1999-1	100
Merrill Lynch 1999-Canada 2	25
Merrill Lynch 2000-Canada 3	43
N-45 First CMBS 2000-1	100
N-45 First CMBS 2000-2	74
Solar Trust 2000-1	86
Merrill Lynch 2000-Canada 4	62
Merrill Lynch 2001-LBC	100
N-45 First CMBS 2001-1	14
Merrill Lynch 2001-Canada 5	53
Mansfield Trust 2001-1	96
Solar Trust 2001-1	68
Merrill Lynch 2001-Canada 6	62

Source: Deutsche Bank, Moody's

Floating Rate CMBS

As the Canadian market matures, we expect an increase in the variety of deal types. All 16 Canadian issues to date are on a fixed rate basis and have been largely comprised of conduit and seasoned collateral.

Figure 5 demonstrates that as a market and investor base expands, so do the variety of deals and uses of the market. As occurred in the U.S, a more mature market allowed issuers to utilize the capital markets to offer a greater variety of loan types to borrowers. We expect a typical development pattern in Canada with an increase in the number of floating rate issues in the near to long term.

As the U.S. market matured, floating rate issuance as a percent of total CMBS increased

Figure 5: Percent of U.S. deals by note rate

	Floating Rate	Fixed Rate	Mixed Rate
1994	9.6	62.6	15.7
1995	6.4	71.3	17.0
1996	8.5	82.1	6.6
1997	10.9	78.3	9.8
1998	15.2	82.6	2.2
1999	26.7	71.3	2.0
2000	27.3	67.0	5.7
2001	23.7	58.8	16.7

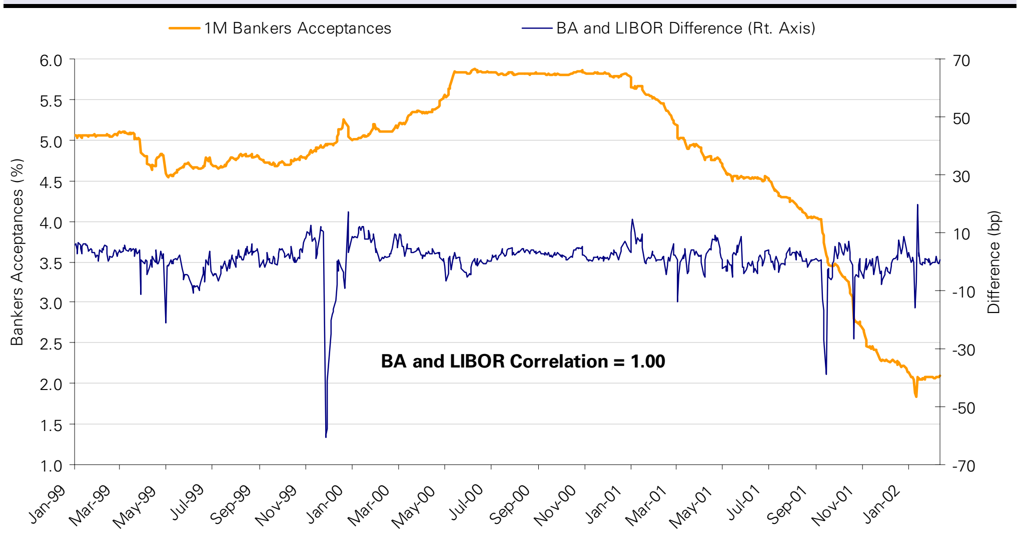
Source: Deutsche Bank, Commercial Mortgage Alert

The structure of floating rate deals in Canada will likely be very similar to those in the U.S. We therefore focus on the U.S. floating rate market to provide investors with a guideline of the features to consider when analyzing floating rate deals.

Floating rate paper reduces interest rate risk. Floating pass-through rates are generally reset on a monthly basis to a benchmark. In the U.S., the benchmark most commonly used is one-month LIBOR. Canadian CMBS will likely utilize the Canadian Bankers Acceptances (BA) rate as the pricing benchmark. The BA rate is the average rate, excluding outliers, quoted by eight Canadian banks. The rate is highly correlated to LIBOR and is the standard short-term interest rate used in Canada.

Canadian Bankers Acceptances are highly correlated to LIBOR

Figure 6: 1 Month Canadian Bankers Acceptances vs. 1 Month LIBOR



Source: Deutsche Bank and Bloomberg

Banks and investment vehicles are generally funded on a short term floating rate basis. Holding floating rate paper provides matched funding, which allows the entity to earn the difference between the bond pass-through rate and interest payments on the funding requirement.

While the ratings performance of conduit deals has been excellent, the performance of floating rate deals has been even better. In 2001, only 20 bond classes in 8 conduit deals were downgraded. By contrast, of the 42 multi-borrower floating-rate deals in our study, 14 were re-rated in 2001. Of the 123 re-rated bond classes in these 14 deals, 65 were upgraded, 58 were affirmed and none were downgraded.

Figure 8 presents the number of upgrades, affirmations and downgrades by ratings class. Even at the BB+, BB and BB- levels, upgrades have significantly outweighed affirmations.

Rating actions on floating-rate deals have been even better than in the conduit sector

Figure 8: 2001 Floating-Rate Rating Actions by Rating Class

		Up	Affirmed	Down	Up	Affirmed	Down
Class	**# Bonds**	**# of Loans**			**%**		
AAA	18	0	18	0	0	100	0
AA+	4	4	0	0	100	0	0
AA	10	7	3	0	70	30	0
AA-	4	4	0	0	100	0	0
A+	5	4	1	0	80	20	0
A	8	7	1	0	88	13	0
A-	2	2	0	0	100	0	0
BBB+	10	5	5	0	50	50	0
BBB	13	7	6	0	54	46	0
BBB-	15	8	7	0	53	47	0
BB+	5	3	2	0	60	40	0
BB	10	7	3	0	70	30	0
BB-	4	3	1	0	75	25	0
B+	2	1	1	0	50	50	0
B	7	2	5	0	29	71	0
B-	5	1	4	0	20	80	0
CCC	1	0	1	0	0	100	0
Total	**123**	**65**	**58**	**0**	**53**	**47**	**0**

Source: Deutsche Bank, Moody's Investor Services, S&P and Fitch IBCA

The key to the extraordinary ratings performance enjoyed by multi-borrower floating-rate deals has been the relatively fast pace of prepayments, which has generally lead to quick de-leveraging of floating-rate bonds. Floating rate loans are generally used to finance properties in the process of being renovated and/or re-positioned. The borrower's intention is usually either to sell or increase the leverage on the property as soon as its revenue increases sufficiently. To allow borrower's this flexibility, loans are typically structured with three year terms and only 12-24 months of lockout.

Figure 9 compares the actual de-leveraging of bond classes in two U.S. CMBS deals, COMM 2000-FL1, a floating-rate deal, and COMM 2000-C1, a conduit deal. Because of prepayment restrictions in conduit deals, de-leveraging comes almost exclusively from amortization and, thus, is very slow.

Floating-rate bonds have historically de-leveraged very quickly as a result of prepayments

Figure 9: Comparison of Bond Class De-Leveraging

COMM 00FL1

Rating	**Pricing Date**	**6 mos**	**12 mos**	**18 mos**	**24 mos**
AAA	30.25	32.26	34.67	56.96	68.96
AA	24.50	26.13	28.08	46.13	55.85
A	17.50	18.66	20.06	32.95	39.90
BBB	10.00	10.67	11.46	18.83	22.80

COMM 00C1

Rating	**Pricing Date**	**6 mos**	**12 mos**	**17 mos**
AAA	23.00	23.13	23.21	23.29
AA	18.75	18.85	18.92	18.98
A	14.38	14.45	14.51	14.55
BBB	10.00	10.06	10.09	10.12

Source: Deutsche Bank, INTEX

Conclusion

The Canadian CMBS market has demonstrated steady issuance growth since the first deal in 1998. As investors become more comfortable understanding and analyzing the collateral, the market is anticipated to expand further.

We expect market expansion to be particularly notable in floating rate CMBS. While multiple-borrower floating rate transactions are an established sector in the U.S, Canada has yet to witness a floating rate deal. As investors discover value in the sector, and demand builds, growth will likely occur.

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