CRETE COMMUNICATIONS

DEBT CAPITAL MARKETS INTELLIGENCE - CRE / CORPORATE GROWTH

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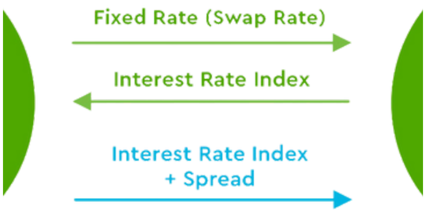


MARKET SENTIMENT UPDATE

CRETE CAPITAL

In this month's issue, our team provides an update on tools and strategies to help manage interest rate risk. With the Bank of Canada raising the overnight rate to 5.00% at their July meeting, we currently have the highest borrowing costs since the year 2000.

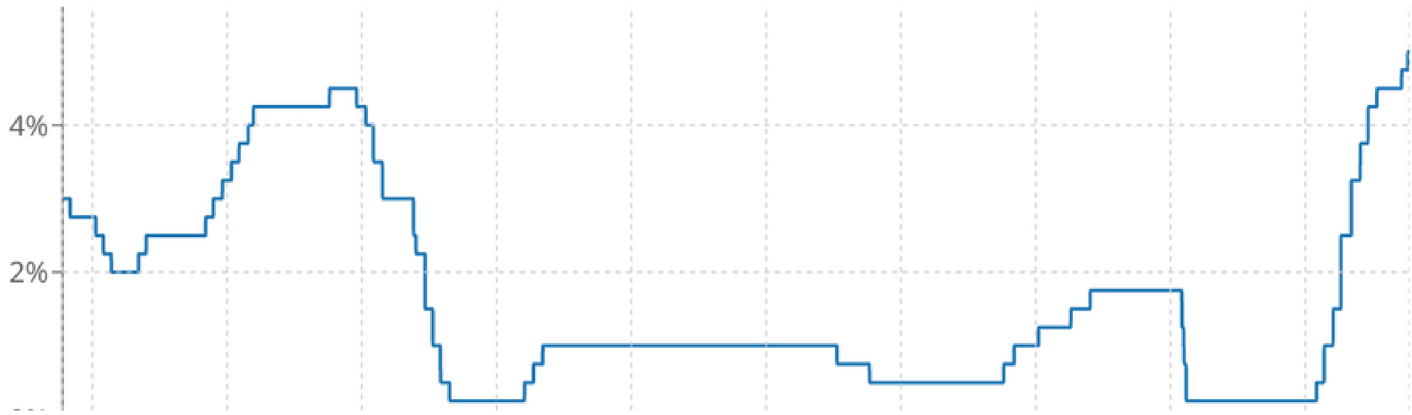
While buyers have enjoyed a historically low interest rate envrionment in recent history, our current interest rate environment requires investors to explore all options when it comes to managing interest rate exposure, especially when considering a larger purchase such as a commercial property.

In commercial lending, the options for interest rate fixing and hedging are much more customizable when compared to the residential lending world. One tool that we feel is underutilized in the commercial mid-market space is the Interest Rate Swap, which is a flexible and customizable alternative to a standard Fixed Rate Term Loan.

Our first section will explore some of the mechanics and benefits of the Interest Rate Swap, including the ability to hedge future exposure. This is particularly useful for buyers who are committed to a future purchase, and want to eliminate the uncertainty of future interest rate movement.

In our final section, we will dive into some analysis around leasing vs. buying a commercial property. In a historically low interest rate environment, the scales have generally been clearly tipped towards a beneficial purchase scenario. However, with a higher cost of borrowing and a larger interest rate expense, the decision to purchase or lease has become more complex.

Finally, we review a recently approved transaction, in which we were able to secure high LTV financing for a company purchase with no tangible security. By emphasizing the strength of the business and management, preferred pricing and terms were ultimately achieved.



WHERE WILL RATES BE WHEN I CLOSE?

MANAGING INTEREST RATES WHEN PURCHASING PRE-SALE COMMERCIAL STRATA

Industrial inventory maintains in tight supply relative to the dynamic and growing demand of operating business users. That said, the purchase of pre-sale properties currently under construction may pose as the best current state option for a portion of the market, as industrial product under construction in the first half of 2023 exceeds that of both 2022 and 2021.

Sean Bagan, Vice President of Colliers, shares that as of Q2 of 2023 there are 24 projects currently under construction compared to 13 and 17 projects respectively for Q1 of 2022 and 2021. The key developing item to follow over the next year will be the status of sites for which projects will proceed for industrial strata sale vs repositioned for income/holding properties, as this trend has been noticed among larger developers over the last 12 months for newly planned projects.

Steve Brooke, Senior Vice President, CBRE adds colour to this transition by giving the example of a significant industrial site in Delta, BC, where the developer repositioned their industrial strata project into a long-term income project for a Fortune 500 company via a build to lease arrangement. This took 250,000 to 300,000 sq. ft. of industrial strata ownership opportunities off the market.

With the preconstruction process consuming 14-18 months prior to start, such as that used for planning, zoning and permits, etc., although construction activity is healthy, this may not follow through to readily available inventory for sale, applying downward pressure on supply. Meanwhile, in our current economic environment, interest rates have proven to not only be volatile but unpredictable, proving many economists and bankers to be myopic when it comes to interest rate predictions.

Whether a business is currently aligning a future lease expiry with the re-location of a future home, looking to take control of occupancy costs to avoid lease rental escalation or there just isn't enough built inventory in a desired area or function – pre-sale projects may be the solution for future requirements.

HOW DO INVESTORS AND OPERATING COMPANIES HEDGE SIGNIFICANT INTEREST COSTS ON A LARGE PURCHASE SET FOR CLOSE IN A FUTURE DATE, I.E. 1-2 YEARS FROM TODAY?

At Crete Capital we advocate management strategies and hedging tools over predicating the factors that drive interest rate announcements. Purchasers contracted for a future close of a commercial property are exposed to significant interest rate risk by the time substantial completion and occupancy is reached.

Fixed Rate Solutions
The conventional way to fix your commercial mortgage interest cost is the standard fixed rate term mortgage. However, these terms can only be entered into on or close to the funding date (i.e. fixed on the day of closing or in some cases 2-4 weeks out via customized arrangements). For closings deeper into the future, the alternative tool for fixing interest rate costs is the **Interest Rate Swap.** Interest rate swaps are financial derivatives offered by Canadian Commercial Banks to hedge interest rate volatility for a future period of time.

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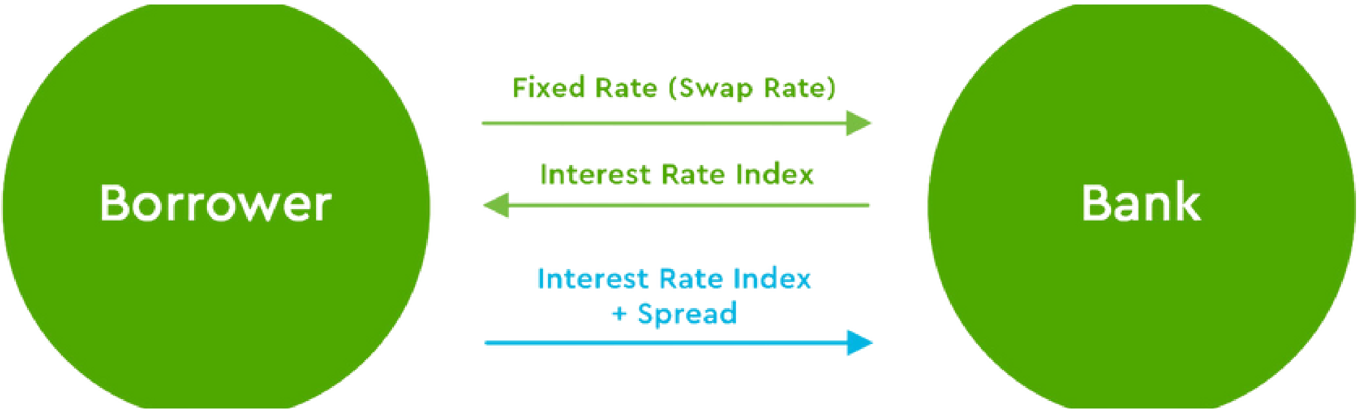

WHERE WILL RATES BE WHEN I CLOSE?

MANAGING INTEREST RATES WHEN PURCHASING PRE-SALE COMMERCIAL STRATA

Here is the formal definition of an interest rate swap:

A contract between two parties to exchange a series of interest rate payments on a specific principal amount for a specified term.

Want the ability to enter into a fixed rate interest rate swap contract but not the obligation? That is possible as well, via a “Swaption”. This instrument is purchased to provide you with the right/option to enter into a defined swap contract on a specified date.

The typical example for fixing an interest rate via a SWAP is a borrower agreeing to pay a fixed interest rate on a notional principal amount in exchange for receiving a floating interest rate from a commercial bank. The cash flows from a swap are effectively netted out resulting in zero exposure to fluctuations in the market and a fixed interest rate obligation.

What does an interest rate swap cost? The cost of the swap is called a stamping fee which is a premium built into the future fixed rate you commit to paying. The stamping fee or interest premium, is derived from various factors, including borrowing company strength, the bank’s economic forecast of interest rates, rate terms and other financial factors. The stamping fees, as with all interest premiums are negotiable and variable among major commercial banks. Depending on where BA rates float during the swap term, you will either receive or have to pay the net difference to the commercial bank.

Most Fortune 500 companies have a majority of their debt portfolio in fixed rate agreements. Managing exposure is key to uncertain economic times, particularly when committed to significant investments in future time. To learn more about how interest rate swaps can help you or your clients gain confidence in a future commercial real estate purchase, reach out to your debt capital advisors at Crete Capital.

LEASE VS. BUY

A COST-BENEFIT ANALYSIS

Our comprehensive 'Lease vs. Buy' evaluation provides a detailed cost-benefit comparison to help your business make an informed decision. The process begins with the analysis of the total interest expense per sq. ft. in a purchase scenario, contrasted against the NNN market lease rate per sq. ft.

In the initial years, leasing might seem to be the more cost-effective solution. However, this cost-benefit changes over time due to two main factors:

1. Annual Increases: Lease expense will continue to rise year after year due to scheduled annual increments. This impact is especially evident at lease renewal times when rates can be significantly adjusted to match current market rates.

2. Interest Costs: In contrast, a purchaser will feel the most economic impact in the earlier years post-purchase, when a larger portion of their monthly payment is applied towards servicing interest costs. As the loan balance decreases (assuming a constant interest rate), the interest costs also continue to decline. This gradually makes owning property a more attractive long-term option, from an occupancy cost perspective. Investors in the BC commercial market have regularly seen their real estate assets appreciate annually.

These gains in value often outstrip the benefits of merely comparing interest costs to lease rates.

We recommend caution in expecting immediate, short-term profits from a purchase, as market volatility can always result in temporary downturns. However, historical trends and our current inflationary environment suggest that purchasers are likely to enjoy a longer-term appreciation across most asset classes.

LEASE VS. BUY

A COST-BENEFIT ANALYSIS

In the following table we took an example of an industrial property purchase and included a Capital Appreciation Calculation (CAC) per sq. ft. This assumes a conservative growth rate at 3% and a purchase price of $715 per sq. ft. The values listed under "Buy" represent the average annual interest expense per sq. ft. for three Loan-To-Value (LTV) scenarios: 70%, 85%, and 100%. Interest rates of 5.75%, 5.95% and 6.25% were used respectively.

Table 1: Comparative Analysis

	Buy (Interest per sq. ft.)			CAC Per sq. ft.	Lease Rate Per sq. ft.
	70% LTV	85% LTV	100% LTV		
Year 1	$28.54	$35.87	$44.34	$21.45	$24.00
Year 2	$27.99	$35.20	$43.55	$22.09	$24.96
Year 3	$27.41	$34.49	$42.71	$22.76	$25.96
Year 4	$26.80	$33.74	$41.82	$23.44	$27.00
Year 5	$26.15	$32.95	$40.87	$24.14	$28.08
Average	**$27.38**	**$34.45**	**$42.66**	**$22.78**	**$26.00**
Less CAC	**($22.78)**	**($22.78)**	**($22.78)**		
Net Average Cost	**$4.60**	**$11.67**	**$19.88**		**$26.00**

This analysis clearly shows how, after accounting for capital appreciation, the average net cost of buying can be significantly lower than the lease rate. This difference amplifies over time, making buying an increasingly more viable option.

Moreover, owning real estate not only acts as a hedge against inflation but also offers substantial non-monetary benefits such as control over the property, the opportunity for expansion or modification, and a potential boost in your company's public image. It is, however, crucial to take into consideration that each business is unique. Various factors such as cash flow stability, future space needs, and market conditions should also influence your decision. We are here to help you navigate these complexities to make the most informed choice.

CRETE CAPITAL DEAL HIGHLIGHT

HIGH LEVERAGE M&A FINANCING

While most lenders are generally taking a more conservative approach to credit underwriting and deal adjudication, our previously published Lender Sentiment Survey confirmed that banks are still facing aggressive lending targets, and are willing to stretch on terms and pricing for strong companies and well structured transactions.

Through a recent financing placement engagement, Crete Capital was able to obtain aggressive terms, structure, and pricing, for an M&A transaction in Metro Vancouver. Our client is purchasing an operating business with consistent EBITDA and strong management in place, which led to a competitive process amongst the competing banks.

The successful lender has approved the transaction, with the following high level structure:

- Acquisition of a very strong company, consistent EBITDA, and over 30 years in the business.
- Nature of the business - marketing and direct mail services
- Financed 100% loan to cost plus closing costs. Deal includes a patient VTB.
- Financing at sub 7% interest rate, 8 year amortization. Provided operating line on top for future business needs.
- No tangible security, thus fully reliant on the strength of operating business cash flows.

In an uncertain economic environment, strategic M&A transactions could present attractive investment opportunities for operating businesses and investors. Your capital advisors at Crete Capital should be involved early in your due diligence process, to gauge the potential financing options, and manage a competitive financing placement process to obtain off-market pricing and structures.