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A Look at MICs

Mortgage Investment Corporations

What every investor needs to know about Mortgage Investment Corporations

In an investment environment where interest rates remain low by historical standards and home prices continue to inch upward in many parts of the country, Mortgage Investment Corporations (MICs) offer an effective way for retail investors to tap into the potentially lucrative mortgage market.

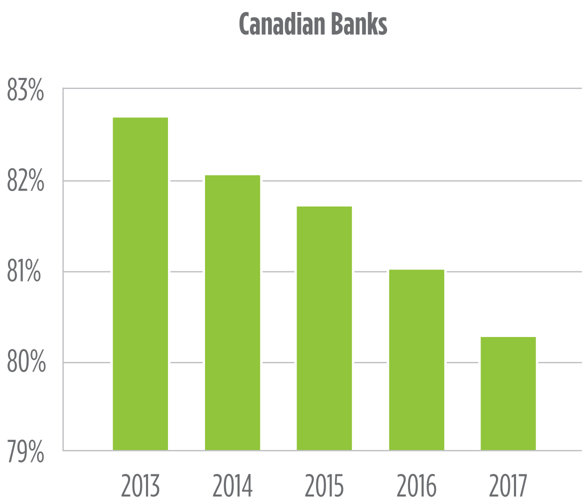
Before including an allocation to a MIC in a portfolio, an investor should have an understanding of how MICs work, the environment in which they operate, and their benefits in a diversified portfolio; including the ability to provide a steady source of income.

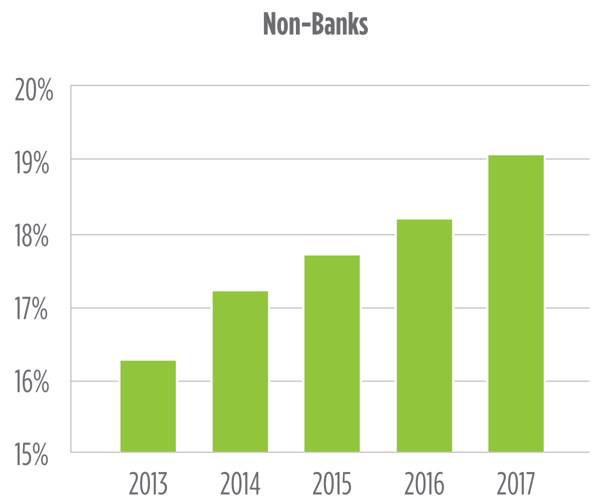
Mortgage lenders in Canada – a changing landscape

Traditionally, homebuyers in Canada go to a bank or trust company to finance their purchase. But that appears to be changing, as the Office of the Superintendent of Financial Institutions (OFSI) tightens the rules around mortgage lending.

Canadians increasingly seek non-bank lenders in wake of tighter mortgage rules

SHARE OF CANADIAN MORTGAGES, BY LENDER TYPE





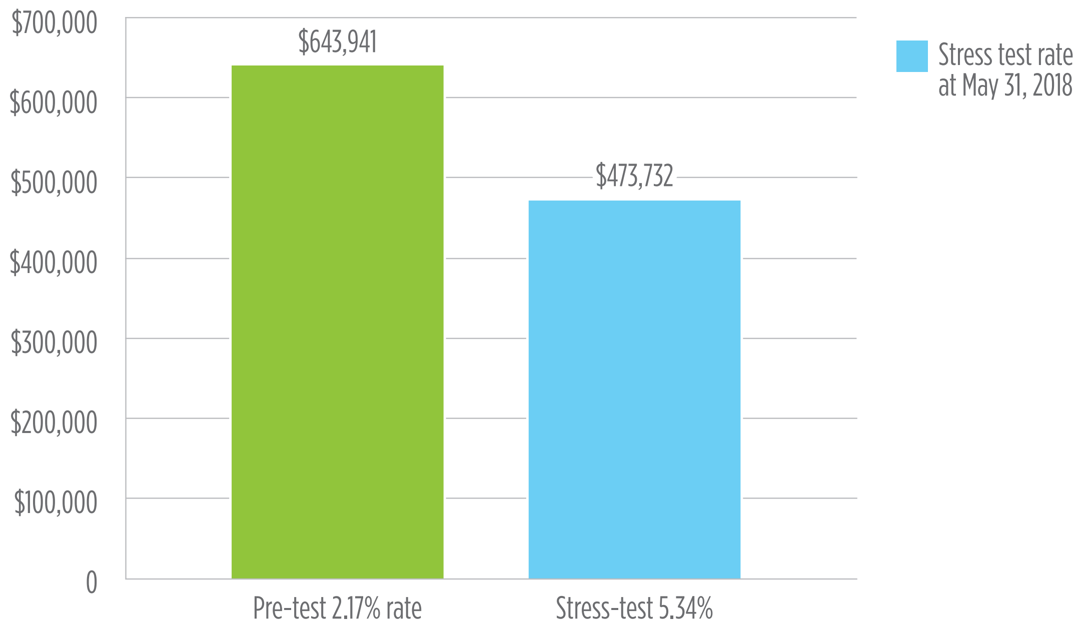
Source: Statistics Canada, Bank of Canada.

New guidelines (known as B-20) came into effect in January 2018, requiring borrowers to pass a "stress test" in order to qualify for funding. Under the stress test, borrowers must prove they can handle payments at a qualifying rate of the greater of the central bank's five-year benchmark rate or two percentage points higher than the contractual mortgage rate. In other words, if the bank's five-year fixed-mortgage rate is 3.34%, the qualifying rate is actually 5.34%. The stress test not only applies to new home buyers, it also affects current homeowners who switch lenders at renewal.

With more stringent lending criteria, many homebuyers may not qualify for the home they wanted or, worse yet, may not qualify at all.

A homebuyer with a household income of $100,000 and $40,000 down payment qualify for a mortgage that is 26% less than a year ago.

MAXIMUM HOME PRICE BUYER CAN AFFORD AT 5 YEAR FIXED RATE

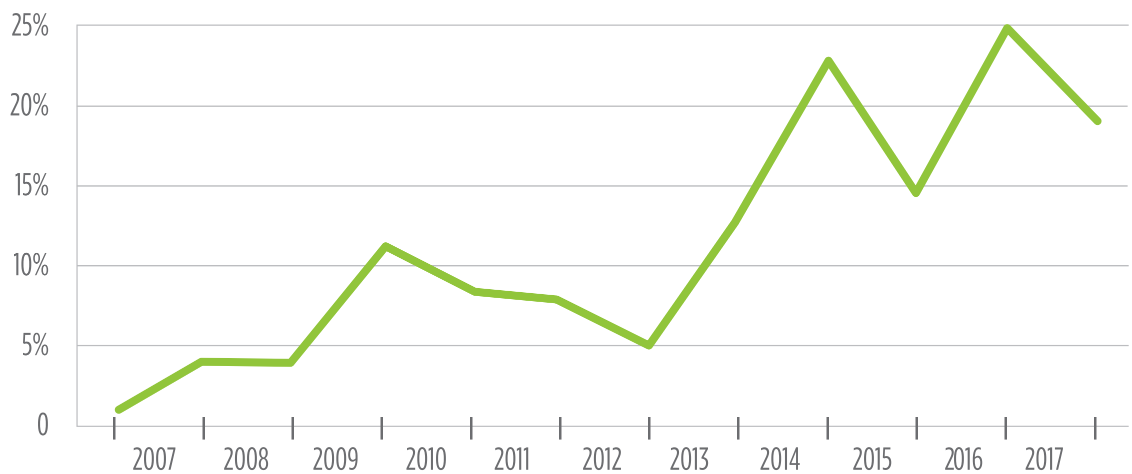


For illustrative purposes only. Source: The Globe and Mail ratehub.ca. Note: RateHub assumes monthly property taxes of $400 and monthly heating costs of $150. Calculations are based on a gross debt service (GDS) ratio limit of 39 per cent, which is the maximum allowed by the federal government. Assumes no other debt or condo fees, both of which would reduce affordability.

However, the new rules apply only to federally regulated lenders. So a secondary effect is the migration of borrowers to lenders who are less regulated, often referred to as "private lenders".

MORTGAGE CREDIT GROWTH AT LESS-REGULATED ENTITIES CONTINUES TO BE STRONG

Estimated share of year-over-year growth in insured residential mortgage loans by less-regulated lenders.



Source: Bank of Canada.

Several of Canada's largest financial institutions are bracing for the impact of B-20

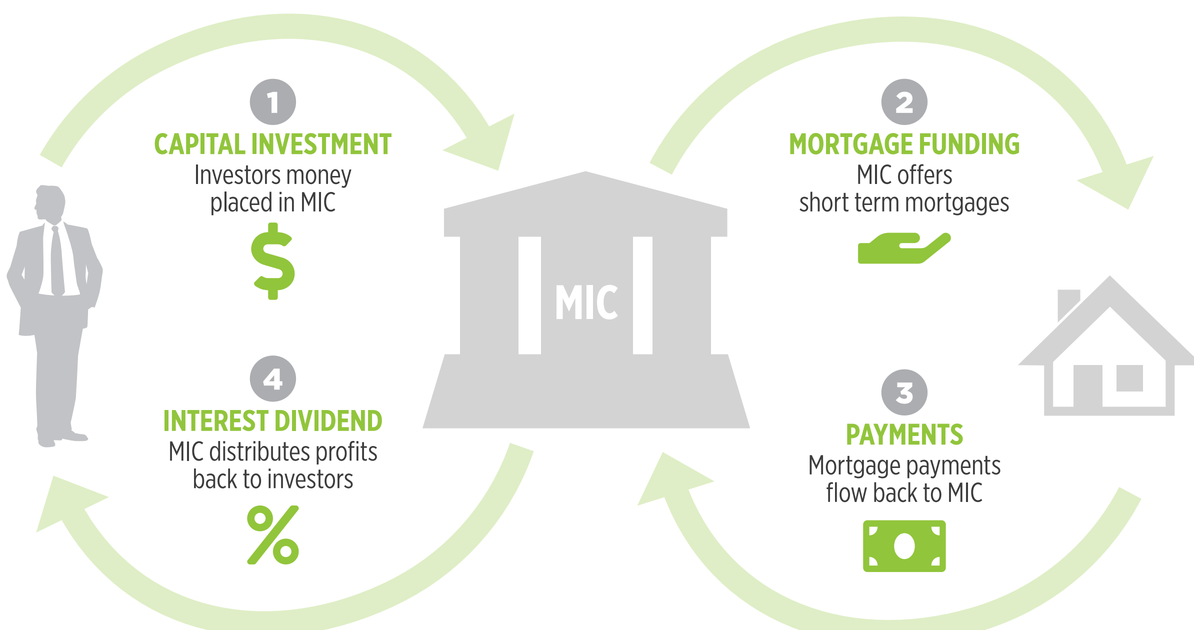
- RBC estimates that approximately 10% of their mortgage originations could be negatively affected.[1]
- CIBC estimates that private lending currently accounts for a record-high 10% of new mortgage transactions in Ontario and expects that number to rise.[2]
- Scotiabank anticipates that some borrowers will turn to credit unions or private lenders who are not subject to the new rules.[3]

For MICs, this represents a significant opportunity to increase their share of the mortgage market and bring better-qualified borrowers on book.

What is a Mortgage Investment Corporation (MIC)?

A MIC is an investment vehicle that pools the capital of private investors and uses that capital to invest in private mortgages in Canada, creating an alternative fixed-income investment. This has two benefits: it increases the flow of money available for the MIC to fund mortgages and provides a way for smaller investors to participate in the residential real estate market.

As less regulated lenders, MICs are not subject to the new, more stringent, lending criteria.



[1] RBC Economics Research, Canada's Housing Market, October 17, 2017. [2] CIBC Economics, In Focus, November 14, 2017. [3] Scotiabank Global Economics, Global Outlook, January 12, 2018.

What are the risks?

Like any investment, MICs are exposed to risks that investors should be aware of.

HOUSING BUBBLES

With lofty housing prices in Canada the underlying collateral (homes) may not be sound. If housing prices decrease and borrowers begin to default on their mortgages a MIC may not be able to recoup all of their money on some homes that need to be sold.

ILLIQUID PROPERTIES

MICs can invest in different types of properties including residential and commercial, each with their own benefits. However, in the event of a mortgage default, some property types can be difficult to sell.

CREDIT QUALITY OF BORROWERS

MICs provide mortgages to people who do not qualify with traditional lenders like banks. If someone is willing to pay upwards of 10% interest on a mortgage from an alternative lender, it could indicate that they are a subprime borrower which increases the risk of a mortgage default.

Does this mean that MICs are always “risky”?

Not necessarily. Here’s a few ways MICs can reduce risk.

PORTFOLIO DURATION: Typically, MICs provide loans of 6 to 24 months. Shorter terms and more rapid borrower turnover reduce exposure to interest-rate risk and fluctuating real estate prices.

LOW LOAN-TO-VALUE (LTV) RATIO: LTV is the amount lent as a percentage of the value of the underlying real estate. The lower the LTV, the lower the risk. If a MIC needs to sell a property, a low LTV makes it easier to recover the outstanding loan value, especially when home values decrease after a housing bubble ‘bursts’.

PROPERTY TYPE: Investing in mortgages of properties that are highly marketable, owner occupied and located in populated geographies helps to reduce the impact of a potential downturn or default.

QUALITY OF SECURITY: MICs can hold first, second or third mortgages. First mortgages carry the least risk as they have priority claim on the underlying real estate security in case of default.

INDEPENDENT BOARDS: Employing independent boards of directors, auditors, and property appraisers. Some MICs make it mandatory for every loan to be approved by an independent board.

LOAN TO VALUE RATIOS EXPLAINED

Loan to Value (LTV) is the size of your mortgage divided by the value of your home. (i.e. what % of your home does the bank own?)

$$\text{LOAN-TO-VALUE} = \frac{\$250{,}000}{\$500{,}000} = 50\%$$

5 Reasons to invest

For investors, MICs offer a number of attractive benefits.

1. **SUPERIOR RETURNS:** Because of their more flexible lending criteria, ability to customize terms, and faster approval process (two to four weeks versus as long as two months with a bank), MICs can charge higher interest rates. Returns may range from 6% to 10%, compared with less than 2% for a five-year Guaranteed Investment Certificate (GIC).[4]

2. **REGULAR INCOME:** MICs pay no corporate tax because they flow 100% of the interest income they earn to investors, typically in the form of monthly dividends.

3. **ELIGIBILITY FOR REGISTERED PLANS:** MICs are qualifying investments for Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), Tax-Free Saving Accounts (TFSAs), providing the opportunity for tax-sheltered growth.

4. **MARKET ACCESS:** When you invest in a MIC, your capital is pooled with the capital of like-minded investors, enabling everyone to participate in a much larger real estate portfolio than you could on your own. In addition, you gain access to professional managers whose sole job it is to manage the portfolio for the benefit of all investors.

5. **PORTFOLIO DIVERSIFICATION:** As a fixed-income asset with no correlation to traditional asset classes, including equity markets, MICs can help to offset the volatility of equities and/or provide consistent income in a persistently low-yield environment.

MIC checklist

When investing in a MIC, these are some of the most important factors to consider.

MANAGEMENT EXPERIENCE
Look for managers with a history in both lending and real estate through all housing market cycles.

TRACK RECORD
Historic defaults or loan loss rate are a key indicator of how well the portfolio is being managed, along with historic returns. Ideally, defaults and losses should be minimal and dividends should be consistent.

PRINCIPALS WHO ARE ALSO INVESTORS
MIC managers who also hold shares have a vested interest in the ongoing success of the operation.

RISK PROFILE
Low LTV ratio, short duration, and a higher proportion of first mortgages are hallmarks of a lower-risk MIC.

PROPERTY TYPE
Highly marketable residential properties in urban and suburban areas tend to be easier to sell in the event of mortgage defaults and housing market downturns.

DRIP OPTION
With a Dividend Reinvestment Plan (DRIP), your monthly dividends are automatically invested in additional shares, compounding returns over time.

[4] Bank of Canada, Canadian Interest Rates and Monetary Policy Variables, as at May 31, 2018.

To learn more about MICs, speak with your investment advisor.

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