Freddie Mac
MULTIFAMILY

Small Balance Loan-Level Performance for 2015

Executive Summary

Freddie Mac Multifamily launched its Small Balance Loan (SBL) program in late 2014 to provide borrowers seeking $1 million to $5 million multifamily financing with highly-competitive terms and a streamlined loan process. This report provides an analysis of loan-level financial performance for the first full year of the SBL offering's availability using 2015 year-end annual financial statements received for securitized loans originated under the program.

Loan reporting data indicates that the overall performance of SBLs during the first year of the offering was consistent with underwritten performance. On average, the key metrics are slightly better than the underwritten numbers. The indicators and their change after underwriting include:

- Effective Gross Income (EGI): 2.1% increase
- Total Operating Expenses: 1.9% decrease
- Net Operating Income (NOI): 6.9% increase

These metrics reflect the expected property performance in the small balance loan space. However, there is disparity in how borrowers reported their property's operating performance compared to underwritten performance, which created a wide distribution of performance.

The SBL Data Set

As of August 2016, Freddie Mac has securitized 1,769 SBLs – a total of $4.47 billion in loan volume – across 20 SB-Deal transactions, which includes seasoned loan pools. A majority of loan payoffs to date – 21 in total – were seasoned pools.

The findings of this report are based on annual financial statements received for loans contained in the SB1 through SB10 securitization transactions, which were completed in 2015. It does not include loans that were part of securitizations settled after December, 2015, or acquisition loans funded in the last half of 2015, which were not yet required to report 2015 year-end financial statements loans because they had less than six months of available data. Seasoned pools are also excluded from these statistics since the loans in those pools were not originally underwritten by Freddie Mac.

Based on the population of loans required to report, the program achieved a 96 percent collection rate; 2015 annual financial statements were submitted for 462 loans. We expect that Servicers will continue to contact and work with borrowers to further increase the reporting collection rate.

Loan and Property Performance

As shown in Exhibit 1, SBL property occupancies held steady, reducing only slightly from an average of 98 percent at origination to 96 percent. The distribution of occupancies shows 8.9 percent of the properties had occupancy levels of less than 90 percent. In reviewing the lower occupancy properties, many appear to be related to property-specific issues and not market driven issues.

Exhibit 1: Occupancy

Rate	# of Loans	% Reported (#)
100	222	48.05%
97 – 99	75	16.23%
90 – 96	124	26.84%
85 – 89	28	6.06%
< 84	13	2.81%
Total	**462**	

In addition, the debt coverage ratio (DCR) remained healthy across most of the loans with only 3.3 percent (15 loans) under a 1.10x DCR (Exhibit 2). The major reason cited by these borrowers for the lower DCR was renovations ongoing at the property, which impacted performance. In other cases, it appears rental income was consistent but expenses had increased over the underwriting benchmark.

Exhibit 2: Debt Coverage Ratio (DCR)

Range	# of Loans	% Reported (#)
< 1.00	10	2.16%
1.00 – 1.09	5	1.08%
1.10 – 1.19	13	2.81%
1.20 – 1.49	65	14.07%
≥ 1.50	369	79.87%
Total	**462**	

Wide Distribution of Performance

Beyond the averages, which are consistent with underwriting, there is a wide distribution on performance compared to underwriting. In Exhibit 3 below, more than 50 percent of the loans reported an NOI that was 10 percent above or below the underwriting benchmark.

Exhibit 3: Net Operating Income (NOI)

Change from Underwriting	# of Loans	% Reported (#)
Declined ≥ 50%	5	1.08%
Declined 30 – 49%	15	3.25%
Declined 10 – 29%	56	12.12%
Unchanged (+/- 9%)	199	43.07%
Improved 10 – 29%	144	31.17%
Improved 30 – 49%	27	5.84%
Improved ≥ 50%	16	3.46%
Total	**462**	

As the report shows, there are differences in borrowers' reporting of operating performance compared to underwriting, especially on the expense side of operations. Much of the variability in the NOI came from expense reporting. Nearly half the loans reported Total Operating Expenses that were 10 percent higher or lower than those at underwriting, as compared to only about 15 percent of the loans having an EGI with those differences.

On the expense line items, reported repairs and maintenance were an average of 10 percent higher than at underwriting, but this was often offset by many loans not reporting any payroll and salary, which is consistent with many smaller self-managed properties where there are no employees. Almost 30 percent of the loans had expenses that were more than 10 percent less than expenses at underwriting.

Specific Market Performance

Because expenses can vary depending on how a borrower represents their operating performance reporting, a much better and more consistent measure of performance is EGI. A representative sample of market observations is shown in Exhibit 4.

Exhibit 4: Effective Gross Income (EGI) % change from UW in select MSAs

Good performance (>3.0%)	Flat performance (0.0% to 3.0%)	Weak performance (<0.0%)
New York	Los Angeles	Houston
Boston	Chicago	Atlanta
Dallas	San Diego	Fort Worth-Arlington
Oakland	Columbus	Philadelphia
Tampa	Seattle	Jacksonville

The loans analyzed for this report represent a small segment of their markets and they may be concentrated in specific neighborhoods. Plus, in many cases, the sample is less than 10 loans in a given market. Nonetheless, the loan performance is consistent with what has been seen generally in their respective markets.

An Observation of Weaker Performing Loans

There was a common theme across loans that made it to the servicer watch list due to a significant decline in performance. Much of the weaker performance was attributed to newly acquired properties undergoing renovation projects.

It is not uncommon for a newly acquired property to undergo early renovations or tenant repositioning as new management is engaged and/or new owners are seeking to improve collateral condition, attract creditworthy tenants, and increase cash flows to strengthen market presence. During the renovation period preceding stabilization, NOI and occupancy levels are subject to fluctuation. For a typical SBL property with few tenants, increased vacancy rates can have a bigger impact on performance.

It is helpful to know the potential renovation plans prior to loan closing so that servicers, investors and borrowers know what to expect. If a borrower is going to undertake a renovation or repositioning of the property and it is significant enough to impact occupancy or operating performance, it could cause the loan to be placed on the servicer watch list. When a loan is placed on the watch list, the borrower must then report quarterly operating statements and rent rolls until the property stabilizes. If the servicer knew about renovation or repositioning plans upon origination, it would not relieve the borrower from quarterly reporting requirements but it would help the servicer to understand and anticipate operating performance changes and be able to share that information with investors.

Conclusion

Following the first year of reporting, data from loans contained in SB1 through SB10 securitization transactions indicate that loan performance is consistent with Freddie Mac's underwriting. EGI, Total Operating Expenses, and NOI are slightly better than the underwritten numbers, on average. Differences in how borrowers reported their property's operating performance compared to underwriting, created a wide distribution of performance.

It is anticipated that the second year of reporting for these loans, reflecting two years of comparable data, will provide a much better indication of how borrowers of small loans are managing their properties. In addition, with over a thousand loans anticipated to report year end 2016, a much deeper view of the SBL market will be available.

The information in this report is presented August 24, 2016, and could become out-of-date and/or inaccurate. We do not undertake any obligation and disclaim any duty to update any of the information in the report. Previously reported data is subject to change due to information updates and data corrections. This report is provided for information purposes only and is not intended to provide any prediction regarding the future performance of loans, securities or other products owned, sold and/or guaranteed by Freddie Mac. Freddie Mac's future performance, including financial performance, is subject to various risks and uncertainties that could cause actual results to differ materially from expectations. The factors that could affect the company's future results are discussed more fully in its reports filed with the SEC.