Freddie Mac
MULTIFAMILY

Small Balance Loan-Level Performance for 2016

Executive Summary

Freddie Mac Multifamily launched its Small Balance Loan (SBL) program in late 2014 to provide multifamily loans in the $1 million to $6 million range (up to $7.5 million in certain markets) with highly competitive terms and a streamlined loan process. This report provides an analysis of loan-level financial performance for the second full year of the program using 2016 year-end annual financial statements received on securitized loans.

On average, the key metrics for 2016 are slightly better than the SBL Seller and Freddie Mac Underwriting at origination.

- **Effective Gross Income (EGI):** 3.32 increase (2015: 2.1% increase)
- **Total Operating Expenses:** 0.13% increase (2015: 1.9% increase)
- **Net Operating Income (NOI):** 6.31% increase (2015: 6.9% increase)
- **Occupancy:** 2% decrease (2015: 2% decrease)

Loan reporting data indicates that the overall performance of SBLs during the second year of the offering was consistent with or better than underwritten performance. It is important to note that across approximately 3,000+ loans, the delinquency rate remains at less than one basis point. These metrics are on par or better than expected property performance in the small balance loan space. However, as might be expected from SBL borrowers, there is significant disparity in how they categorized their property's operating performance compared to underwritten performance, which created a wide distribution of performance. This, too, is expected given the broad range of borrower sophistication. It is not necessarily a qualitative issue, but rather a common occurrence for many borrowers during their first post-Underwriting reporting cycle.

The SBL Data Set

As of June, 2017, Freddie Mac securitized 2,894 Small Balance Loans – a total of $7.3 billion in loan volume – across 31 SB-Deal transactions. This includes seasoned pools SB-3, SB-8 and SB-19. There have been a total of 84 payoffs as of June 30, 2017, with a large portion of those coming from seasoned pools. All paid off loans have been excluded from this analysis.

The findings of this report are based on annual financial statements received for loans contained in SB-1 through SB-31. Based on the population of loans required to report, the program achieved a 98 percent collection rate (2016 annual financial statements were submitted for 2,301 loans). We expect that Servicers will continue to work closely with borrowers to collect the few remaining financial statements.

Loan and Property Performance

The year-end 2016 debt coverage ratios (DCRs) remained healthy across most of the loans, with only 4.04 percent (93 loans) under a 1.10x DCR as reported by Servicers (Exhibit 1). It is important to note that 1,102 of the SBLs are still in their Interest Only (IO) period, so many of the DCRs are reported with only IO debt service payments.

Exhibit 1 shows that most SBLs (62.71 percent) have amortizing DCRs between 1.25x and 2.00x, while 11.48 percent of SBLs have amortizing DCRs > 2.00x. This distribution of DCRs is in line with the Freddie Mac SBL Underwriting at origination. However, 299 SBLs (13 percent) have amortizing DCRs < 1.10x.

Exhibit 1: YE-2016 Debt Coverage Ratio (DCRs calculated using Amortizing Debt Service)

	UW		YE-2016		Amortizing YE-2016	
DCR Range	Number of Loans	% Reported (#)	Number of Loans	% Reported (#)	Number of Loans	% Reported (#)
< 0.80	0	0.00%	44	1.91%	69	3.00%
0.80 - 0.99	0	0.00%	20	0.87%	117	5.08%
1.00 - 1.09	3	0.13%	29	1.26%	113	4.91%
1.10 - 1.24	568	24.68%	132	5.74%	295	12.82%
1.25 - 1.49	1143	49.67%	355	15.43%	703	30.55%
1.50 - 2.00	506	21.99%	859	37.33%	740	32.16%
2.00 - 2.49	62	2.69%	563	24.47%	193	8.39%
>2.50	19	0.83%	299	12.99%	71	3.09%
Total	**2,301**		**2,301**		**2,301**	

Same Store Sales Comparison (YE-2016 vs. YE-2015 DCR)

The DCRs of the 554 loans with both YE-2015 and YE-2016 financials submitted appear to be consistent with Underwriting. The average DCRs improved from Underwriting in both 2015 and 2016.

- Average DCR at Underwriting: 1.41x
- Average Amortizing YE-2015 DCR: 1.54x
- Average Amortizing YE-2016 DCR: 1.50x

Exhibit 2: Reported 2015 DCR vs. 2016 DCR

DCR Range	# of loans - UW	# of loans - YE2015	# of loans - YE2016
< 0.80	0	11	9
0.80-0.99	0	18	21
1.00-1.09	3	16	24
1.10-1.24	103	65	57
1.25-1.49	279	192	145
1.50-1.99	141	191	200
2.00-2.49	21	45	68
>2.50	7	16	30
Total	**554**	**554**	**554**

A regional trend of significance is the impact of low oil prices on metro areas with high reliance on oil and gasoline jobs. Although Freddie Mac does not have many loans in these markets, Exhibit 3 shows that Small and Very Small Markets reliant on the oil and gasoline industry have been impacted more by low oil prices than Standard and Top Markets. Low occupancy has been an issue in small markets reliant on oil and gasoline as the demand for housing shrunk after many refineries shut down or slowed production.

Exhibit 3: EGI % change from UW in MSAs with a high concentration of oil and gasoline jobs

Metropolitan Statistical Area	Number of Loans	EGI/unit UW	EGI/unit YE16	Difference
Gillette, WY	1	$ 8,356	$ 6,500	-22%
Odessa, TX	4	$ 10,465	$ 8,301	-21%
Midland, TX	1	$ 11,348	$ 9,773	-14%
Greensboro-High Point, NC	3	$ 5,716	$ 4,994	-13%
Gulfport-Biloxi-Pascagoula, MS	3	$ 6,496	$ 6,230	-4%
Houma-Thibodaux, LA	1	$ 7,406	$ 7,151	-3%
Houston-The Woodlands-Sugar Land, TX	76	$ 9,431	$ 9,536	1%
Oklahoma City, OK	11	$ 6,467	$ 6,565	2%
Tulsa, OK	9	$ 6,495	$ 6,629	2%
Denver-Aurora-Lakewood, CO	31	$ 11,124	$ 11,938	7%
San Antonio-New Braunfels, TX	15	$ 7,918	$ 8,215	4%
Dallas-Fort Worth-Arlington, TX	91	$ 9,011	$ 9,363	4%
Austin-Round Rock, TX	19	$ 10,249	$ 10,812	5%
New Orleans-Metairie, LA	5	$ 9,609	$ 10,178	6%

Wide Distribution of Performance

Beyond the averages, there is a wide distribution of Net Operating Income compared to Underwriting. Much of the variability in NOI is derived from the expense reporting, which can be difficult to predict with SBL borrowers and difficult to normalize. Exhibit 4 shows that only 25.21 percent of borrowers reported EGI with a larger than 10 percent variance from Underwriting, while Exhibit 5 shows that 52.67 percent of borrowers reported Total Operating Expenses (TOE) with a greater than 10 percent variance from Underwriting. The two largest drivers of TOE variance are Repairs & Maintenance and Payroll & Salary. Reported Repairs & Maintenance were an average of 8 percent higher than at Underwriting, with 13.5 percent of SBLs reporting greater than a 100 percent increase from Underwriting. While Payroll & Salary was consistent with Underwriting on average, there was a large variance in the reported amount compared to the Underwriting baseline. Of special note, 21.5 percent of SBLs did not report any Payroll & Salary expense, despite its inclusion at Underwriting.

Exhibit 4: 2016 Effective Gross Income

Change from UW	Number of Loans	% Reported (#)
Declined > 50%	4	0.2%
Declined 30 - 49%	25	1.1%
Declined 10 - 29%	126	5.5%
Unchanged (+/- 9%)	1722	74.8%
Improved 10 - 29%	400	17.4%
Improved 30 - 49%	19	0.8%
Improved > 50%	6	0.3%
Total	**2,302**	

Exhibit 5: 2016 Total Operating Expenses

Change from UW	Number of Loans	% Reported (#)
Decreased > 50%	13	0.6%
Decreased 30 - 49%	77	3.3%
Decreased 10 - 29%	493	21.4%
Unchanged (+/- 9%)	1090	47.4%
Increased 10 - 29%	433	18.8%
Increased 30 - 49%	123	5.3%
Increased > 50%	73	3.2%
Total	**2,302**	

An Observation on Weaker Performing Loans

It is helpful to use the Servicer Watchlist as a representative sample to identify potential trends; there are 109 loans on the Watchlist due to poor financial performance as of June, 2017. While every SBL presents a different situation, much of the weaker performance can be attributed to renovations and repairs, tenant repositioning and routine turnover.

Thirty-nine of the Watchlist loans (36 percent) are either undergoing unit renovations or repairs. This is the most common reason for Watchlist placement for poor financial performance. During the renovation period, NOI and occupancy levels are subject to fluctuation and often the property is underperforming for months at a time. For a typical SBL property with few units, repairs can have a large impact on vacancy rates and financial performance, even if the renovations do not extend throughout the entire property. 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 overall cash flows.

Many SBL properties are smaller and tenant turnover can impact occupancy drastically, but this impact often occurs across a shorter time frame and therefore is less impactful to overall performance than would be seen for a larger property. Across the Watchlist, 14 of the loans (13 percent) are underperforming because routine turnover has led to an occupancy decline that lasted longer than anticipated. This can be due in part to less sophisticated marketing programs by smaller borrowers (many SBL properties are self-managed). An additional 11 of the Watchlist loans (10 percent) are performing poorly due to tenant repositioning. These loans require more monitoring than properties with routine turnover to ensure that property management succeeds, especially if this repositioning plan was not known at Underwriting.

Conclusion

Overall, the SBL portfolio continues to report strong performance consistent with Freddie Mac's Underwriting. The second year of reporting afforded Freddie Mac an opportunity to conduct a deeper review of the SBL market compared to 2015. As expected from SBL borrowers, there continues to be a wide variability in reported performance due to how borrowers categorize their property's operating performance; this variability does not necessarily mean there is a qualitative issue. Freddie Mac will continue to evaluate and measure how borrowers are managing their properties, including extensive monitoring practices around managing forward interest-only risk for those 1,102 SBLs that are still in their IO period.