Securitized Products Special Topics

Small Balance Multifamily: Value in Concentrated Exposure Ahead of Slower Prepays

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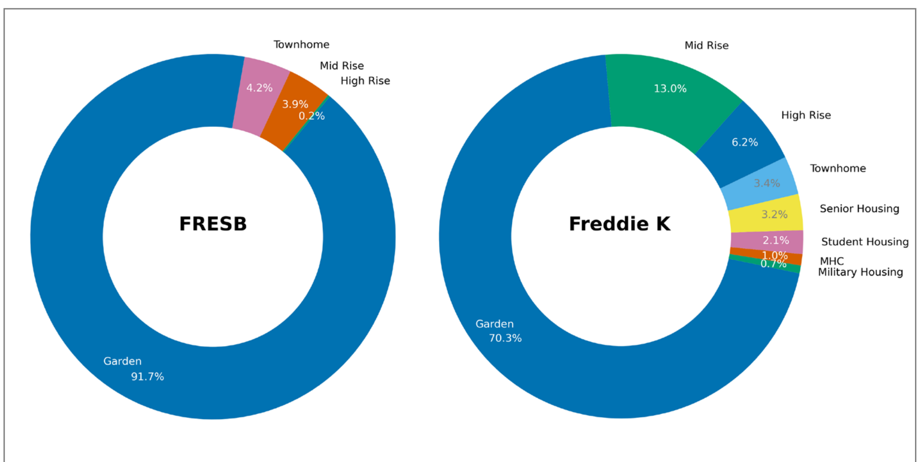
FRESB Collateral Well-Positioned for Evolving Lifestyle Preferences

The prepayment activity of small balance multifamily loans and some of their collateral characteristics suggest value in FRESB deals in a post-pandemic, higher rate environment. Overall prepays on multifamily SBL are set to slow as rates rise, and should concentrate in seasoned deals. In contrast, other multifamily segments, such as Freddie Mac's Multi PC, may feature "surprise" prepays on recently issued deals, driven by property acquisitions.[1] SBL prepays have been mostly tied to loan seasoning and prepayment terms. As loans season and enter lower prepayment premium periods, CPR speeds increase, according to Freddie.

In turn, SBL loans provide exposure to multifamily subtypes that we consider well-positioned for evolving lifestyle preferences. Nearly 92% of 2022-vintage FRESB collateral is garden-style multifamily. Another 8% is townhome and mid-rise properties, leaving very little exposure to high-rise properties that potentially include luxury, urban rentals. For comparison, the garden multifamily exposure in 2022-vintage Freddie K 10-year loan deals is only 70.2%. High rise exposure is 6.2%. Amid the rise of remote work, suburban migration, and the transition of millennials to family age, we are less constructive on the multifamily product that typically caters to young professionals seeking 24/7 urban environments.

Figure 1. 2022-vintage FRESB and K Deals Property Subtype Breakdown



Source: Freddie Mac and Academy Securities

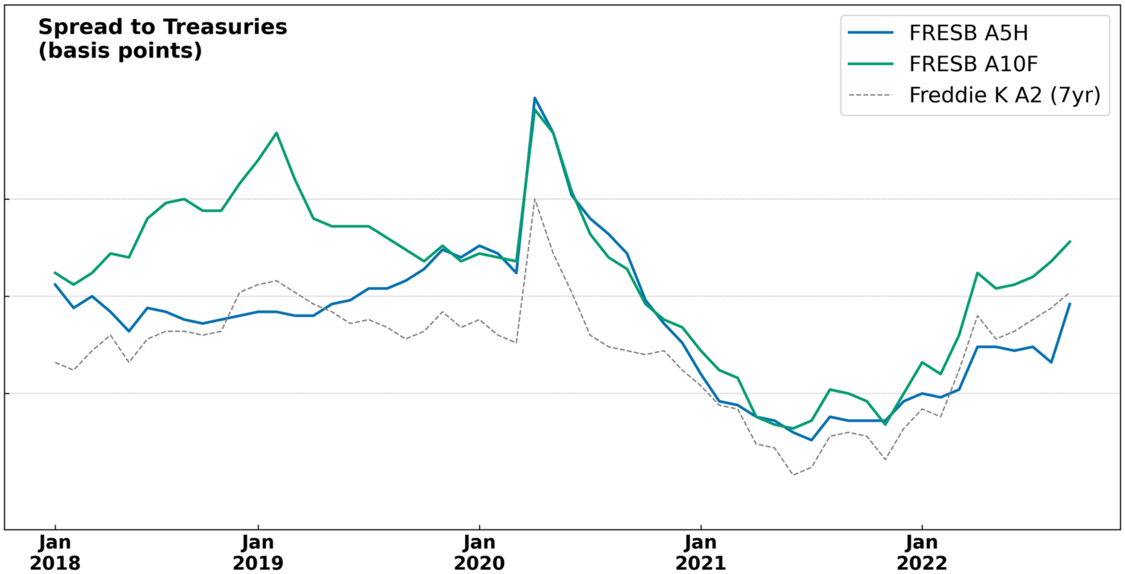
1 See "Multifamily Prepays: Property Sales Trigger Paydowns," Securitized Products Special Topics, Academy Securities, August 10, 2022

FRESB collateral features very few multifamily subtypes, as Figure 1 also shows. Freddie's SBL eligibility criteria exclude properties such as senior, student, or military housing, among other exclusions. While we have a favorable view on some of the ineligible subtypes, such as manufactured housing, the concentrated FRESB collateral alleviates some of the analytical hurdles around smaller, niche subtypes.[2] Student and senior housing account for some of the largest delinquent and specially serviced loans in K deals, as well as some of the largest trust losses, according to the recent K-Deal Performance Data report.

Wider Spreads May Offer Entry Point

The currently wide FRESB spreads can provide compelling entry point for investors trading off some of the favorable collateral and prepay characteristics with potential liquidity and modeling hurdles. FRESB A5H class spread reached T+55bp, widening 18bp over the past month, and 35bp wider YTD (Figure 2). The A10F class spread is T+66bp, 2bp and 34bp wider MoM and YTD, respectively.

Figure 2. FRESB and Freddie K Benchmark Spreads

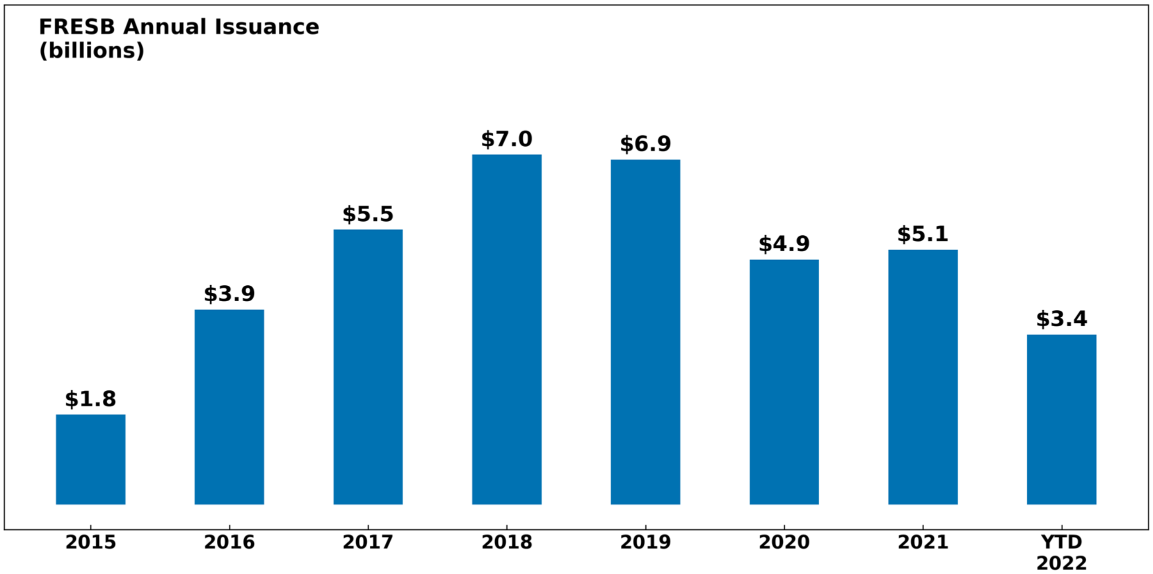


Source: CMA and Academy Securities

2 See "Manufactured Housing: Resilient Segment Amid Potential Multifamily Softness," Securitized Products Special Topics, Academy Securities, July 27, 2022

FRESB issuance picked up since the product's inception in 2015, but the outstanding volume remains relatively small at $24.7 billion as of July 2022 (9,583 outstanding loans).

Figure 3. FRESB Issuance Volume ($ Billion)



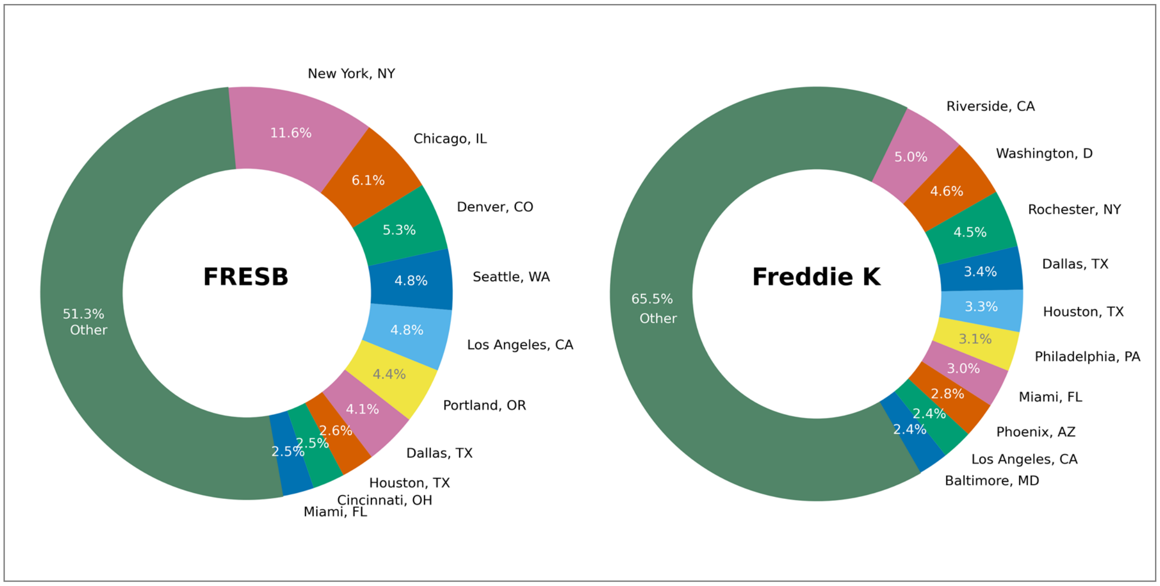
Source: Freddie Mac and Academy Securities

We also identify a few other aspects to note on FRESB deals:

- **Large watchlist exposure.** While SBL feature very strong performance, and FRESB bonds carry a Freddie guarantee, the elevated watchlist balance still raises concerns about involuntary prepayments. 14.4% of the outstanding loan balance is on watchlist (1,409 loans, $3.6 billion), according to the latest SB-Deal performance report. 288 loans ($756 million) fall into the "high risk" bucket. For comparison, the watchlist balance on K and Multi PC deals as of July is 6.84% and 10.7%, respectively. Still, involuntary SBL prepays should pose limited risk for secondary positions as most FRESB bonds currently trade in the low to mid 90s.
- **Large New York market exposure.** 2022-vintage FRESB deals feature 11.6% exposure to the New York area MSA (Figure 4). While we would intuitively expect smaller balance loans to mostly include secondary and tertiary locations, and perhaps lower-income geographies, the large New York exposure underscores the dominance of this market even for FRESB deals. Seven of the 10 largest watch-listed FRESB loans are in Manhattan or Brooklyn (652 Brooklyn Avenue and 411 East 118th Street top the list). As such, unique dynamics of the New York multifamily market, such as rent regulations, may impact performance.[3]

3 See "Approved Increases to Stabilized Rents Are Largest in a Decade," Securitized Products Special Topics, Academy Securities, July 7, 2022

Figure 4. 2022-vintage FRESB and Freddie K MSA Breakdown



Source: Freddie Mac and Academy Securities

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