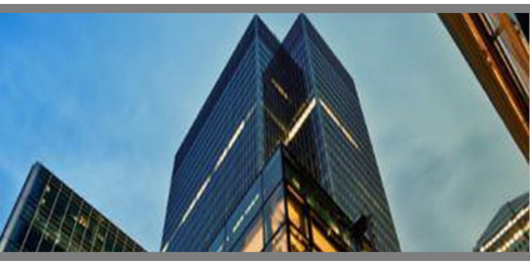
Securitized Products Special Topics

Investor Non-QM: Rental Exposure with Some Structural Twists



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"Investor" Deals Differing Exposures to Rental Markets May Offer Pockets of Value

As non-QM deals get swept up in a rising rate environment, housing softness, and broader market volatility, the investor loans sub-segment may feature divergent performance, driven by rental exposure and unique structural characteristics. Investor non-QM deals are backed by residential mortgages on single-family or two- to four-unit properties that are typically rented out. Property cashflows or rental income are the main underwriting parameters, rather than borrower's income. Negative income shocks have become key delinquency drivers, according to published research.[1] A recessionary environment and potential job market weakening could soon elevate mortgage borrowers' income shocks, leading to performance deterioration across the broader non-QM segment. In contrast, we expect the rental market to remain relatively strong, especially in suburban locations, that are characterized by smaller properties and limited supply. Interestingly, "mom-and pop" landlords are raising rents, leaving renters with "few places to turn", according to a recent Urban Institute study.[2] Small landlords are seeing the rental business as profitable even amid rising costs, the study found. This bodes well for investor deals' pool performance.

On the structural side, investor deals feature provisions that may introduce unique cashflow behavior, distinguishing the segment from other non-QM deals, as well as from CMBS rental exposures. Investor loans typically carry prepayment penalties. These may potentially slow down voluntary prepayment rates, compared to plain-vanilla residential mortgages. To be sure, we expect prepayment rates to slow across the board, as refinancing incentives significantly diminish.[3] Still, penalties can help stabilize bond duration profile, especially as property owners may look to refi on highly appreciated investment properties.[4]

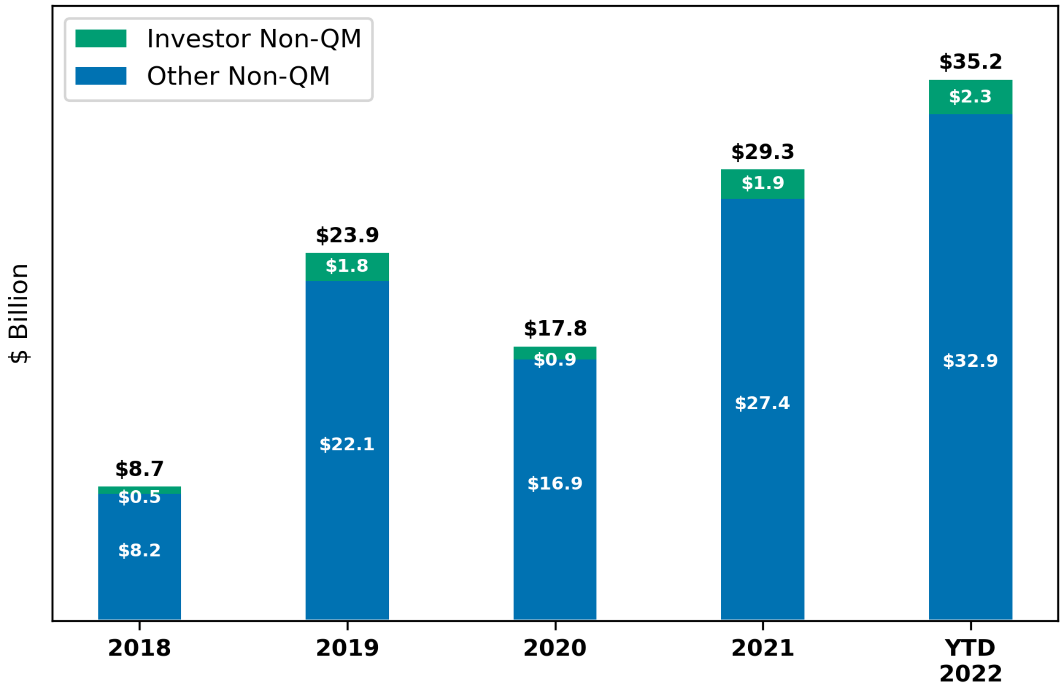
In turn, some investor deals do not include servicer advancing on delinquent loans, a key difference from CMBS transactions. The lack of advancing could lead to elevated interest shortfalls on pools that experience credit issues. On the flip side, investors should expect greater liquidation proceeds compared to advancing deals. Advancing reimbursements regularly drove large loss severities when servicer advancing accumulated over time. With no advancing, we would expect a greater alignment between liquidation values and bond paydowns.

1 See https://www.jpmorganchase.com/institute/research/household-debt/insight-income-shocks-mortgage-default
2 See https://www.urban.org/urban-wire/mom-and-pop-landlords-are-raising-rents-albeit-less-market-rates-leaving-renters-few
3 "Small Balance Multifamily: Value in Concentrated Exposure Ahead of Slower Prepays," Securitized Products Special Topics, Academy Securities, September 13, 2022
4 "Manufactured Housing: Resilient Segment Amid Potential Multifamily Softness," Securitized Products Special Topics, Academy Securities, July 27, 2022

Expect Scarcity Value as Issuance Poised to Dwindle

Overall non-QM issuance increased in 2022 compared to last year, even as the sector faces issuance pressures that are afflicting the broader securitized products market. Issuers priced $35.2 billion non-QM balance across 96 deals YTD (Figure 1). Investor non-QM deals comprised $2.3 billion of this volume (eight deals).

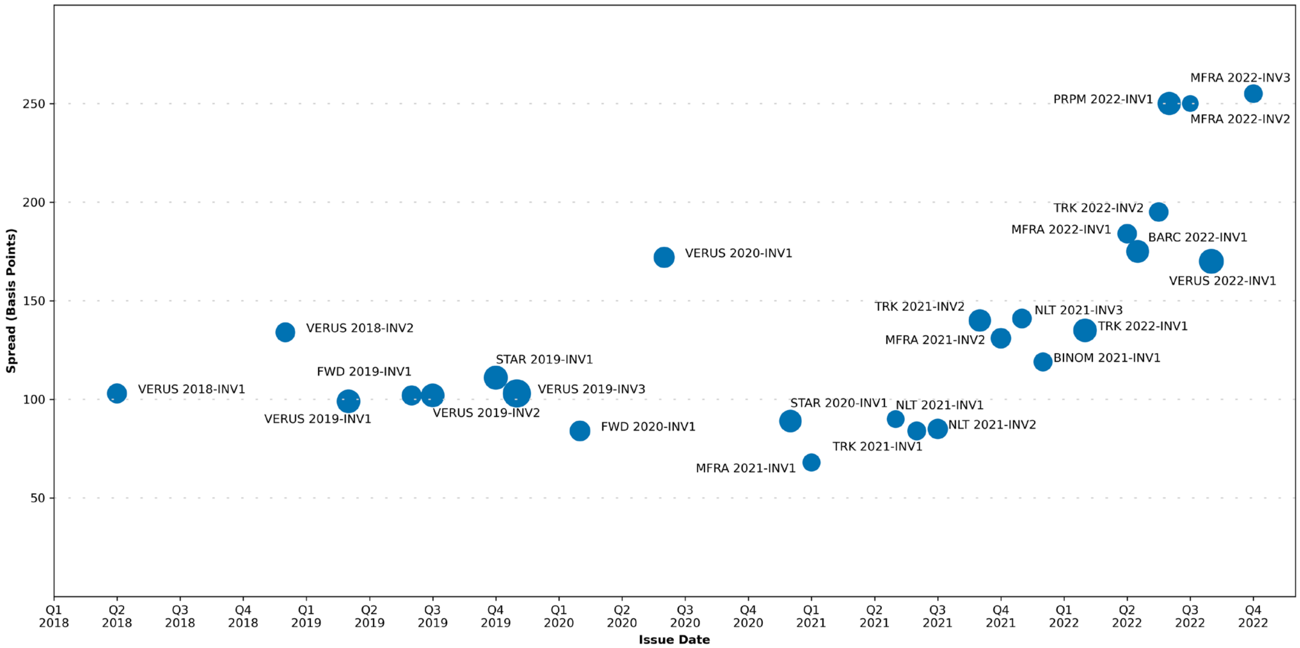
Figure 1. Non-QM Issuance, 2018-2022



Source: Bloomberg and Academy Securities

Investor non-QM spreads significantly widened in 2022. Recently issued MFRA 2022-INV3 priced its triple-A benchmark class at T+255bp (figure 2). This compares to pricing of T+184bp on MFRA 2022-INV1 similar class, issued in April.

Figure 2. Investor Non-QM Issuance Spreads



Note: Spreads are to the Treasury curve for the triple-A benchmark class and dot sizing represents the relative issuance balance of each deal
Source: Bloomberg and Academy Securities

Aspects to Track on Investor Non-QM Deals

We suggest investors track the following aspects on investor non-QM deals:

- **Leases in place.** Deals vary in the percentage of properties that have a lease in place at origination. For example, in MFRA 2022-INV3, 79.2% of the pool properties featured a lease in place (Figure 3). In TRK 2022-INV2, 74% of the properties had in-place leases. In contrast, only 46.8% of the properties had in place leases in Verus 2022-INV1. Some deals also break down the in-place leases to short term (typically <6 months) vs longer term leases. For example, in addition to TRK 2022-INV2's 70%+ in-place long term leases, the deal also featured 6.7% in-place short term leases.

Figure 3. Investor Non-QM Deals Pool Characteristics

Deal	MFRA 2022-INV3	MFRA 2022-INV2	TRK 2022-INV2	BARC 2022-INV1	MFRA 2022-INV1	TRK 2022-INV1
Deal Balance ($MM)	234.8	214.5	244.6	329.4	258	363.3
# of Loans	1,005	888	733	1,049	1,137	1,254
Avg Loan Balance ($)	233,614	241,499	333,636	314,038	226,909	289,752
DSCR WA	1.44	1.47	1.43	1.32	1.56	1.44
Single-family (%)	64.6	63	63.3	63.8	63.8	62.2
Two- to Four-family (%)	32.2	35.3	31.1	28.7	34.6	28.8
Fully Amortizing (%)	82.9	91.4	89.4	84.7	93.1	78.3
Interest-only (%)	17.1	8.6	10.6	15.3	6.9	21.7
Leases in Place (%)	79.2	75.7	74.0	NA	77.7	68.5
Top-3 Markets	Philadelphia (5.9%) Atlanta (4.4%) Baltimore (3.3%)	Atlanta (11.0%) Chicago (4.3%) Philadelphia (3.9%)	New York (12.5%) Tampa (3.6%) New Brunswick (3.4%)	New York (11.7%) Baltimore (7.0%) Los Angeles (6.8%)	Atlanta (5.8%) Tampa (5.4%) Chicago (4.4%)	New York (11.9%) Newark (4.1%) New Brunswick (4.0%)

Source: Rating Agencies, Deal Documents, and Academy Securities

- **Geographic exposure.** Investors may want to focus on deals that feature elevated exposure to tight rental markets. The deals geographical breakdown by state may be too coarse to construct geographical preferences. But drilling down to the metro level, we find fairly diverse exposures. For example, TRK 2022-INV2 features exposure of 12.5% and 3.6% to properties in New York and Tampa, respectively, two relatively strong rental markets. In contrast, in MFRA 2022-INV3 we find that three of the deal's top-five markets are Baltimore, Cleveland, and Chicago, three softer rental markets.
- **DSCR calculations.** The debt service coverage ratio (DSCR) levels for 2022-vintage investor deals ranged from 1.32x to 1.56x, as Figure 3 shows. The DSCR, a key underwriting metric for investor loans, is calculated by dividing a property qualifying monthly rental income and expenses by the monthly mortgage payment. Several underwriting parameters can impact the DSCR calculation. For example, issuers may consider the lesser of in-place lease income or market rent to determine the DSCR's numerator. When there is no in-place lease, issuers may use the market rent. On short-term leases issuers may consider a certain percentage of the most recent rent for the calculation. On lower DSCR deals, rating agencies may look to mitigate the risk by requiring lower original CLTV ratios.

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