Commentary

Historical Performance and Recent Trends in Freddie Mac Multifamily Securitizations

Morningstar DBRS
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Contents

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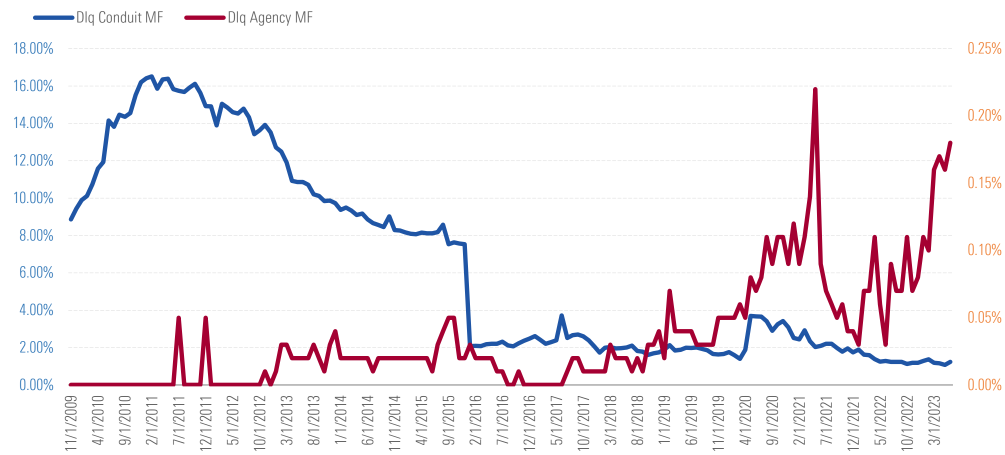
Morningstar DBRS Perspective

As far back as Morningstar DBRS has tracked the data, agency multifamily loans in Freddie Mac K-Deals have experienced significantly lower delinquency rates compared with multifamily loans in conduit securitizations, which is a result of programmatic lending and underwriting standards. Moreover, Freddie Mac uses historical performance to inform many of their assumptions and employs minimal pro forma or speculative underwriting in its analysis. Revenue and income assumptions are generally capped at recent performance and expense assumptions are generally based on the last 12 months of performance. This is relatively more conservative than a pro forma underwriting that may assume growing rents, declining expenses, or lower vacancy in the future. Even as capital markets experienced a significant disruption stemming from the process of Federal Reserve rate hikes, delinquency rates among multifamily Freddie Mac K-Deals have remained a fraction of the delinquency rate for traditional conduit multifamily loans. The delinquency rate for agency multifamily loans in Freddie Mac K-Deals has never breached 0.25%, while the delinquency rate for multifamily loans in conduit securitizations has historically been more than 2.0% and has recently trended to about 1.0% as of Q4 2023 from approximately 3.0% in early 2021. Because of this materially superior performance compared with that of loans backed by multifamily properties in traditional conduit securitizations, Morningstar DBRS has been able to recognize this in its approach to rating Freddie Mac transactions. See the Morningstar DBRS North American CMBS Multi-Borrower Rating Methodology (November 3, 2023, https://www.dbrs.morningstar.com/research/422859).

Recent Performance

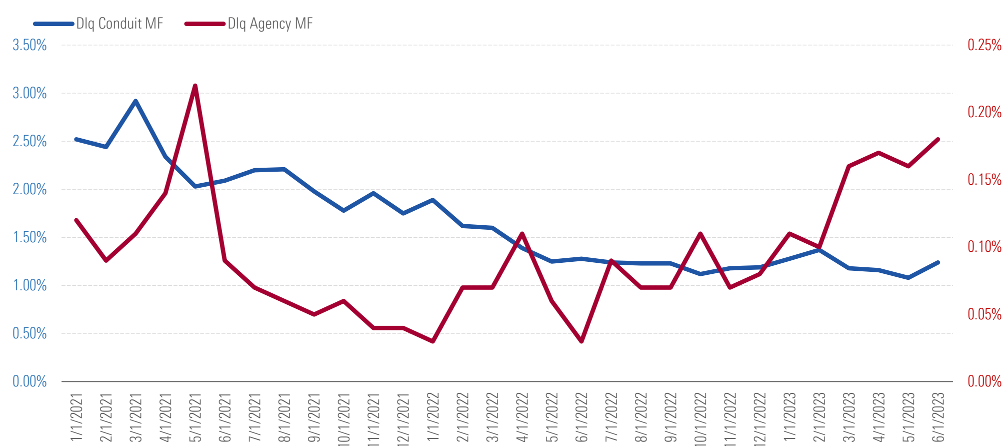
As previously mentioned, delinquency rates for agency multifamily loans in Freddie Mac K-Deals have historically been a fraction of the delinquency rates for traditional multifamily conduit loans. At the same time that credit characteristics have generally declined since early 2021, delinquency rates have also increased among loans that have been securitized in agency transactions; although, the agency delinquency rate remains significantly lower than multifamily loans that were securitized as part of conduit or nonagency transactions. Exhibit 1 shows that, despite deteriorating credit conditions in the agency transactions that were analyzed, the latest delinquency rate for multifamily loans in such transactions is still approximately 0.18%, significantly less than the latest delinquency rate for multifamily loans in conduit transactions, which is approximately 1.24%. Additionally, Freddie Mac K-Deals have only $55.2 million in realized losses, which represents less than 2 basis points of the total issuance volume.

Exhibit 1 Multifamily delinquency: conduit (left) versus agency (right)



Source: Morningstar DBRS.

Exhibit 2 Zooming In: Multifamily Delinquency: Conduit (left) vs. Agency (right)

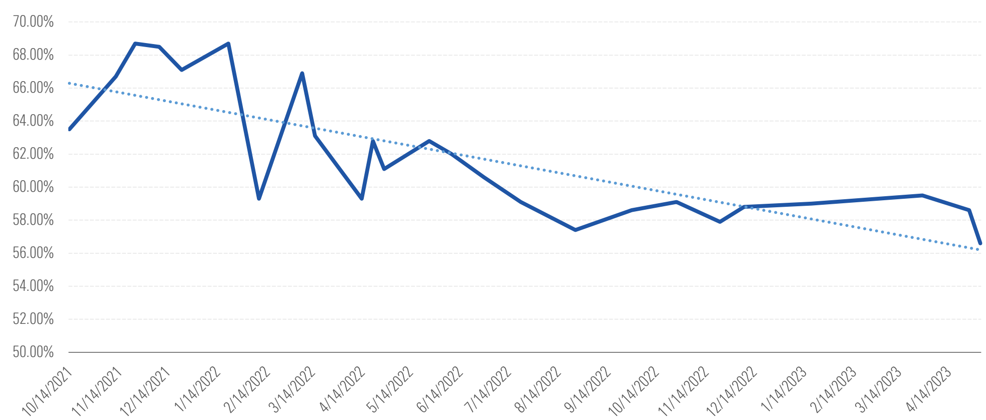


Source: Morningstar DBRS.

Since the start of 2022, when the Federal Reserve began hiking interest rates, higher borrowing costs have led to tighter lending standards. Credit characteristics, such as debt service coverage ratios (DSCR), have become more relevant and restrictive in the amount of proceeds that banks and nonbanks are willing to lend. Further, in Freddie Mac K-Deal securitizations that Morningstar DBRS analyzed, a component of DSCR, the net cash flow (NCF), as measured by the NCF variance, or haircut between the Freddie Mac K-Deal underwritten NCF and the Morningstar DBRS NCF, has increased.

Since early 2021, leverage in Freddie Mac K-Deals based on the issuance loan-to-value ratio (LTV), which is based on the issuance balance and appraised value at issuance, have trended downward, as evidenced by Exhibit 3, while valuations have not increased significantly. In fact, valuations have likely done the opposite as the going-in multifamily cap rates increased to 4.9% at the end of Q3 2023 from 3.4% at the end of Q1 2022, according to CB Richard Ellis (CBRE) research published in October 2023. Despite CBRE reporting increases in cap rates starting in early 2022, implied cap rates in Freddie Mac K-Deals appear relatively unchanged over the same time period. Consequently, the decline in LTVs since early 2021 is likely a result of lenders providing fewer proceeds to borrowers. In fact, the implied cap rates from Freddie Mac K-deals based on appraised values and issuance balance show very little change over the same time period. Despite cap rates not materially climbing until Q2 2022, Issuance LTV based on the appraised value began declining well before then, around Q1 2021. However, once interest rates began climbing in early 2022, decline in leverage can be attributed primarily to a restriction of proceeds from minimum DSCR constraints. When debt service rose in early 2022 with the increase in interest rates, NCF increases did not follow and DSCRs declined.

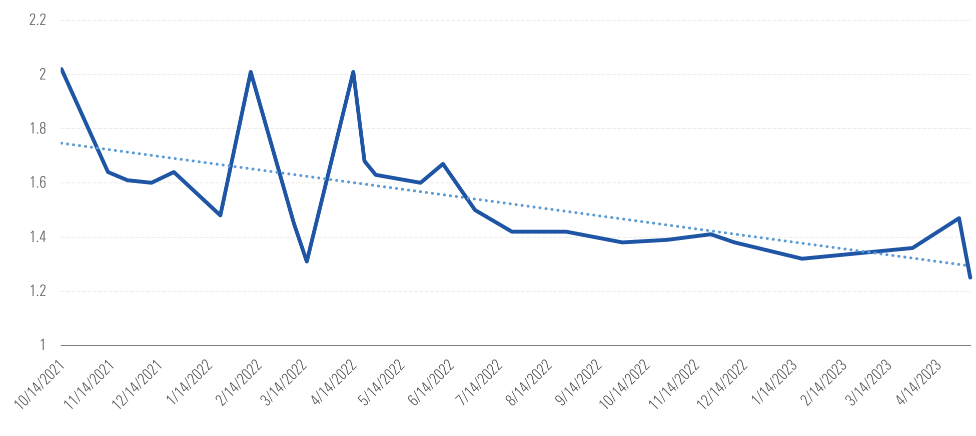
Exhibit 3 Issuance LTV Over Time



Source: Morningstar DBRS.

Partially because of sharply increasing borrowing costs since early 2022, DSCRs have declined as borrowers are forced to make higher debt service payments relative to any increases in revenue or NCF. Interest rates have steadily increased for borrowers, and rental rate increases that operators of multifamily properties were able to achieve in the early days of the coronavirus pandemic have largely leveled off. Freddie Mac K-Deals generally floor DSCR at 1.25 times (x) for loans with any amortizing debt service and 1.35x for interest-only loans. Prior to significant increase in interest rates in 2022, DSCR was usually not constraining borrower proceeds; however, higher rates and stagnant cash flows have caused DSCR to become a strong consideration. The decline in DSCR becomes much more pronounced starting in early 2022, when interest rates started to climb significantly.

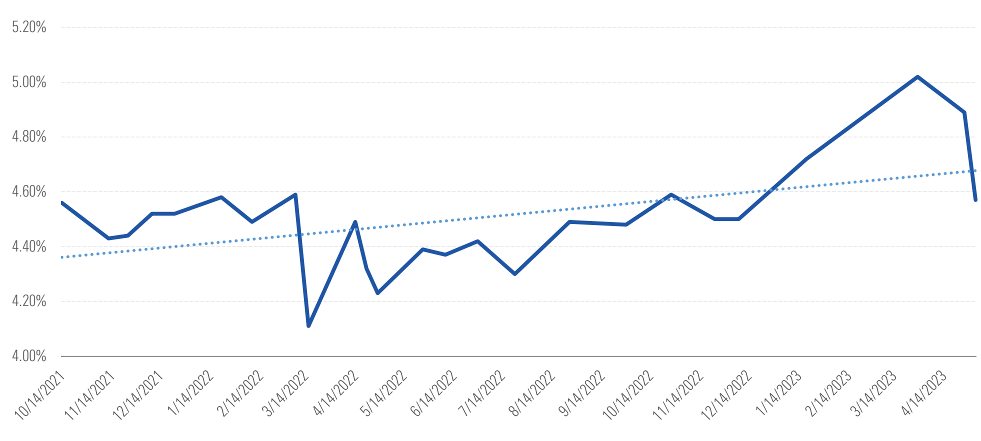
Exhibit 4 Issuance DSCR Over Time



Source: Morningstar DBRS.

There have been two separate trends in implied cap rates since the beginning of 2021. In early 2021, before rates began to increase, implied cap rates in Freddie Mac K-Deal transactions appeared to decline. However, in early 2022, at approximately the same time the federal reserve began raising the federal funds rate, implied cap rates appeared to temporarily plateau before beginning to climb toward the end of 2022 into the early months of 2023. Increases in implied cap rates insinuate that, for a given cash flow, properties are experiencing declining implied values. Generally, an increase in borrowing costs increases cap rates because it becomes more difficult to acquire properties with leverage, resulting in downward pressure on pricing.

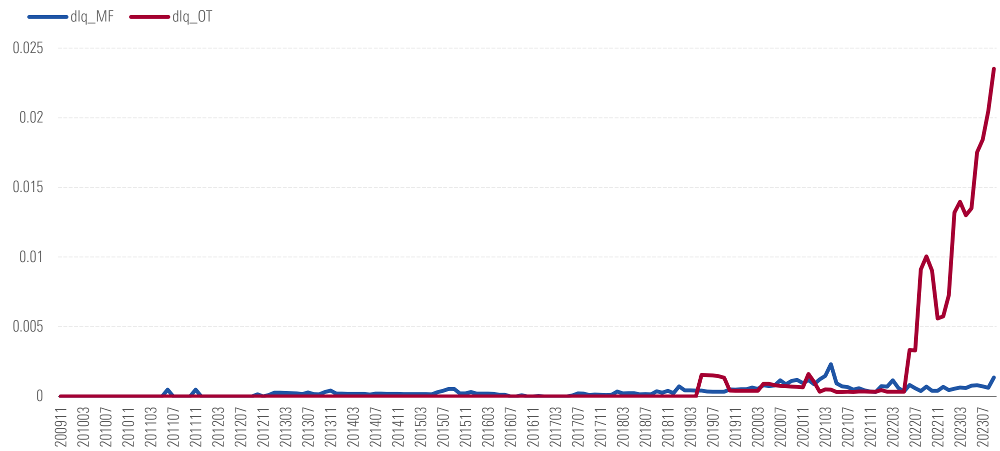
Exhibit 5 Implied Cap Rate Over Time



Source: Morningstar DBRS.

Morningstar DBRS Approach

Exhibit 6 Agency Delinquency Over Time



Source: Morningstar DBRS.

Despite the benefits recognized by Morningstar DBRS in its approach to rating Freddie Mac K-Deal transactions, any declines in credit characteristics are being considered during the modeling process. Like LTV, DSCR is a key driver in the Morningstar DBRS CMBS Insight Model and lower DSCRs elevate the loan-level expected losses. Even though, as discussed earlier, Issuance LTV is declining (or improving) and if the implied cap rates do not fully reflect a shift in values tied to the rapid rise in interest rates, other factors such as DSCR capture a decline in credit.

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