

Investments in SBA Pools

Vanderbilt Avenue Asset Management
Emad A. Zikry, Chief Executive Officer

In an investment environment characterized by credit market uncertainty, we analyze a lesser known security type: SBA pools. Small Business Administration (“SBA”) is a government agency that works with lenders to provide loans to small business borrowers who comply within its eligibility requirements. The SBA loans are then pooled and sold to investors with a full U.S. Government guarantee. We will specifically analyze the SBA 7(a) loans, which are mostly adjustable rate and tied to the US PRIME index.

The SBA provides a guarantee for 75%-90% of the loans and the lender (usually a bank or credit union) is responsible for the credit performance of the remaining portion. The SBA portion of the loan is the only part that is pooled and sold to investors. The lender retains the balance of the credit risk, an incentive for the lender to fully vet the borrower.

The loans are primarily adjustable rate. The majority reset quarterly and some monthly, to movements in the PRIME rate. When loans are pooled, the assembler bank combines loans with similar characteristics: such as maturity, interest rate, and loan terms. No individual loan may represent more than 25% of the pool.

Maturities for loans typically range from seven to twenty five years. Seven year loans tend to provide businesses with working capital. Ten year loans are primarily for equipment purchases. Fifteen to twenty year loans cover equipment and real estate purchases, and twenty five year loans are solely for real estate purchases. Borrowers agree to pay rates up to PRIME plus 2.75% for access to SBA financing.

Prepayments tend to be faster on the shorter loans and slower for the real estate loans. The shorter loans do not typically have prepayment penalties, but the longer ones (15+ years) do. These penalties usually penalize the borrower from prepaying the loan the first year or two. Given the prepayment penalties, historical prepayments on SBA loans have averaged about 8 CPR (see table below), so pools are analyzed at this prepayment speed. Pools tend to prepay slow in the first year or two, picking up speed in the next several years when prepay penalties roll off, and then slow down again to maturity.

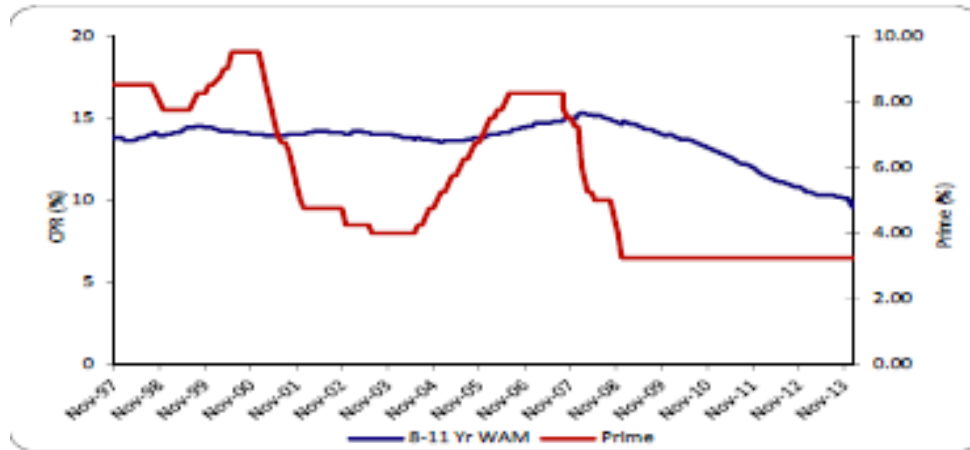
The table below summarizes historical prepayments. Pools are displayed by issuance year in the column on the left with their lifetime CPRs in the corresponding row cells. For example, the 2006 SBA pools pre-paid 7.5 CPR year 1, followed by 14.5, 14.3, 7.7 CPR in the following three years and then slowed down to 6.1 CPR and below in the latter part of their life. The 2015 SBA pool has two years of history, having pre-paid 3.1 in 2015 and 5.5 2016 YTD. The shaded orange section highlights the faster prepay periods for each vintage. But it’s safe to say that all vintages display a relatively similar, stable prepayment profile, ranging, on average, between 3 and 12 CPR.

Iss.	Num	\$Mil			YTD	Calendar Year Historical CPR									
Date	Pool	Cur	Orig	Life	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
2016	126	2,979	3,018	0.5	0.5										
2015	289	5,942	6,476	4.6	5.5	3.1									
2014	258	4,594	5,704	6.6	9.2	5.8	3.6								
2013	222	3,059	4,557	8.8	12.7	10.5	6.6	2.7							
2012	239	2,361	4,265	9.7	10.8	14.1	11	5.4	2.4						
2011	276	2,067	4,270	9.1	7.8	12.2	12.2	10.2	4.6	1.8					
2010	289	1,408	3,382	8.4	6.5	8.4	10.6	11.9	7.7	5	3.8				
2009	258	1,000	2,820	7.9	6.4	6.1	7.7	8.9	8.5	8.4	7.4	4.9			
2008	323	742	3,060	8.2	5.4	6	6	6.3	6.3	7.8	12.1	11.1	6		
2007	336	979	4,162	7.8	3.7	4.9	5	5.6	5.2	6.1	9.5	11.8	10.7	8.6	
2006	392	854	3,968	7.7	4.7	3.8	3.7	5.1	4.3	4.5	6.1	7.7	14.3	14.5	7.5
Total	3,008	25,986	45,680	8.1	7.7	8.2	8.1	7.4	5.7	5.7	8.2	9.8	11.3	12.9	7.5

The table above also tracks SBA pool issuance. Our research indicates that pool issuance ramped up to over \$6 billion in 2015, and is expected to reach the same levels in 2016. Average pool size during this period is approximately \$25 million.

While most investors buy SBA pools to hold, there does exist a relatively active and liquid secondary market which is offered primarily through regional broker/dealers. Expressed in dollar terms, the bid/offer spread for the lower priced securities (priced at 102.00 and below) typically run from 0.125 to 0.25 and the bid/offer spread for the higher price securities (priced above 105.00) ranges from 0.375 to 0.50.

· Historical, Prime Rate vs CPR 8-11 yr WAM



Source: Bloomberg

As discussed earlier regarding the floating rate note coupon, SBA yields vary widely from about 0.85% for pools priced at 100.00 to 2.0% for pools priced at 114.00. Premium priced securities present an obvious prepayment risk that investors should be aware of prior to investment. Premium paper should be viewed in light of possible yield uncertainties associated with loans prepaying faster than expected. This may be a valid concern; however our research indicates that while PRIME varied from 9.5% to 3.5% over the last twenty year period (see chart above), average prepayments on SBA loans remained within a tight and predictable range.

In our assessment, for those investors seeking a stable prepaying, par-centric, floating rate portfolio asset, SBA pools are worth a studied look. While the market for these securities may present investors supply challenges in locating larger tradable blocks, SBAs certainly offer competitive yields, which coupled with the peace of mind of the full faith and credit of the US Government, can be hard to match. SBAs may fit well in portfolios that have a buy and hold horizon but are looking for securities with stable pricing.

Suzanne Saurack