

REO to Rental: *The Creation of a New Asset Class and the Transformation of the American Single-Family Landscape*

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Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

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ABSTRACT:

The prodigious US single-family housing market consists of roughly 80 million existing homes and of those, more than 14 million are currently being rented. This trillion-dollar rental market has traditionally been operated exclusively by mom and pop organizations, until now. Since the housing collapse began five years ago institutional investors began taking note of falling home prices and rising inventories of bank owned properties. Private equity giants like Blackstone and Colony Capital saw a once-in-a-generation opportunity to invest at pennies on the dollar in a sector long regarded but never before accessible to large institutions.

Reminiscent of California in the late 1840's, there was a massive rush West and South by firms looking to deploy billions of dollars of investment capital through the purchase of thousands of single-family homes. By the middle of 2013 nearly \$20 billion had been raised or spent and more than 150,000 homes were in the hands of institutional investors. A new market was born and fast maturing. In the early days skeptics permeated the space while investors looked to further formalize the hundreds of millions already invested.

By the end of 2013 three Real Estate Investment Trusts existed with a market capitalization exceeding \$4 billion and the Blackstone Group finalized the formation of the world's first bond backed by single-family rental streams.

Today analysts and investors disagree on what stage of maturity the single-family rental (SFR) exists. Specifically, there are those who see SFR as a new asset class advancing toward a double or triple digit billion market capitalization. On the other hand there are those who see these investments as nothing more than a short-term trade, destined to fade within the next few years.

This contemporary thesis topic aims to shed light on the buy-to-rent strategy surrounding single-family home investors including tactics being adopted to garner the greatest rewards. Furthermore, the thesis will assess the recent investment methods

being made by the burgeoning industry's largest players including filing for REIT classification and securitizing single-family rental incomes. Finally, the thesis will answer the question of whether this new national investment will endure as a business model and forever change the single-family landscape or simply remain an opportunistic 'trade' at a time when so many Americans lost their home.

Thesis Supervisor: Walter Torous
Title: Senior Lecturer, Center for Real Estate

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CHAPTER 1 - INTRODUCTION

1.1 The American Dream and the Rise and Fall of Homeownership

The American Dream is at odds with itself in the wake of the Great Recession. Since its incorporation into our vernacular, the idea of the American Dream has been rooted in the notion of property ownership and the ability of all Americans to rise up from any beginning and achieve success through hard work and ingenuity. And yet these two seemingly congruent ideas came into conflict during the recent housing collapse and economic recession when the creation of new financial instruments contributed significantly to the repossession of thousands of American's homes.

In the 1970's an aspiring chef, working part time in the mailroom for Solomon Brothers in New York City, worked his way up to running the mortgage-trading desk. Once there he helped to create a new financial instrument and in 1977 became known as the 'father of securitization'.¹ Lewis Ranieri was the first to recognize that if you package together varying mortgages from across the country you can accomplish three key goals, diversify or spread the risk from any one mortgage, sell slices of these packages and finally, take these mortgages *off* of bank's balance sheets. "This powerful idea, dubbed, 'securitization,' was one of those once-in-a-generation innovations that revolutionized finance."² At the time and throughout the following decades the innovation would prove beneficial to all parties involved including investors, originators, banks and home owners who enjoyed greater mortgage opportunities at lower costs. In 2004 Ranieri was named by Business Week as one of the greatest innovators of the past 75 years.³ However, Ranieri's Mortgage Backed Securities also forever changed the way Americans buy their home.

Whereas once the local banker would determine whether or not a home buyer could pay back the loan and then have to live with that investment on his or her balance sheet, now they could quickly sell off the mortgage, unencumber their balance sheets, and worry less about the reliability of future payments. For years after this financial innovation Americans experienced a time of increased home ownership. However, in 2007 additional innovations as well as other factors lead to a mortgage crisis and the eventual Great Recession in 2008. Hundreds of thousands of Americans lost their homes to default, foreclosure and watched as banks repossessed their property. Now, for the first time in 18 years we are seeing the percent of home ownership decline⁴.

¹ "Lewis S. Ranieri."

² Cohan, "Why Wall Street Loves Houses Again."

³ "Lewis S. Ranieri."

⁴ Gopal and Gittelsohn, "U.S. Homeownership Rate Falls to Lowest Since 1995."

1.2 Thesis Impetuses and Scope

In the past five years the above circumstance created a ‘perfect storm’ for institutional real estate investors: Housing prices dropped dramatically while foreclosure inventories rose, all the while access to capital grew scarcer to average home buyers. The result was a glut of single-family homes sitting on the market, looking for buyers and minor rehabilitation. As these properties languished private equity giants and opportunistic real estate investment firms saw an opening to purchase these homes at well below replacement costs. Firms such as Blackstone Group, Colony American Homes, American Homes 4 Rent and other similar groups spent the last 24 months plowing up more than 200,000 single-family homes and securing more than \$25 billion in institutional investment.

The scope of this thesis will encompass the attributes of the American Dream mentioned previously: capitalism, creativity and innovation and how they pertain to single-family homeownership in 2014. Specifically, the thesis will examine the genesis, and investment rush on single-family Real Estate Owned (REO)-to-rent strategy in the United States over the past four years. The research will shed light on this investment strategy that stands to impact millions of Americans and perhaps change the landscape of single-family homeownership, as we understand it today. Additionally, the thesis will analyze and review the monetizing and exit opportunities of securitizing these new single-family rental (SFR) income cash flows.

Never before have securities been sold that consist entirely of rental incomes from single-family homes and it is at this juncture that this thesis provides an analysis to better understand the potential underpinnings of these securities, the inherent flaws and benefits of their creation and the farther reaching impacts of both the large scale home purchases and potential long term social and market implications to the national level single-family property market. Finally, this thesis will determine whether in the end this strategy will be sustainable, viable and successful.

CHAPTER 2 – THE MODERN DAY LEAD UP

2.1 Housing Market Collapse

In June of 2002 then President George W. Bush, while addressing HUD employees at a ‘National Home Owners Month’ event, said, “I believe when somebody owns their own home, they’re realizing the American Dream... I’ve set this goal for the country. We want 5.5 million more homeowners by 2010.⁵” Although rhetoric regarding home ownership by US Presidents is not new nor partisan, in this instance the progression just a few years later showed sizeable increases. Ownership reached an historic and unprecedented peak of nearly 70% of Americans owning a home by late 2004⁶. At the time housing experts, historians and politicians alike were pronouncing a social shift in the US to an ‘Ownership Society’. Much of this increase in the following years is attributed to subprime mortgages, a general lack of discretion among mortgage issuers and an increase in mortgage backed security issuances.

By early 2007 the housing bubble burst and things began crashing down including resident’s ability to maintain ownership of their homes. In early 2008 a recession was inevitable and foreclosure rates began to rise. These trends continued and by 2010 RealtyTrac®’s Year-end US Foreclosure Market Report™ showed default notices, scheduled auctions and bank repossessions on a record 2,871,891 U.S. properties. This was an increase of nearly 2 percent from 2009 and an increase of 23 percent from 2008. The report also shows that 2.23 percent of all U.S. housing units (one in 45) received at least one foreclosure filing during the year, up from 2.21 percent in 2009, 1.84 percent in 2008, 1.03 percent in 2007 and 0.58 percent in 2006.

“Total properties receiving foreclosure filings would have easily exceeded 3 million in 2010 had it not been for the fourth quarter drop in foreclosure activity — triggered primarily by the continuing controversy surrounding foreclosure documentation and

⁵ HUD Archives. June 18, 2002

⁶ US Census Bureau, July 2013

procedures that prompted many major lenders to temporarily halt some foreclosure proceedings,” said James Saccacio, CEO of RealtyTrac⁷. As families continued to lose their homes another reality was beginning to take shape, one that included: tightening credit markets, increasing rental rates, and exponentially growing stockpile of Real Estate Owned properties.

In the wake of the housing collapse the credit markets tightened quickly and comprehensively⁸. Lenders required much higher down payments and nearly perfect credit, making qualifying for any home loan nearly impossible to the average consumer. Therefore, even those who might otherwise be able to afford a new home purchase were forced to sit on the sideline and instead of own, rent a place to live. These potential buyers, combined with the hundreds of thousands of families losing their homes created an increase in rental demand across the country, as people still need a place to live⁹. In addition to declining home ownership they saw the reflexive increase in the number of Americans renting. Specifically, estimates in 2010 showed that the percentage of US renters would likely rise nearly 36% by 2015, up from their recent low in 2004 of 32.4%¹⁰.

Real Estate Owned or Bank Owned properties are a specific type of distressed or non-performing asset. REOs are traditionally the result of a homeowner failing to pay their mortgage resulting in a foreclosure by the bank. These foreclosed homes are then assessed by the bank, which hires a broker to conduct what is called a Broker’s Price Opinion (BPO). The bank uses the BPOs to determine how much equity and debt remains on the property and thereby what price they should set in a foreclosure auction. If, as often was the case between 2008-2012, no one purchases the home out of foreclosure the property becomes Real Estate Owned and sits on the banks balance sheet as an REO.

⁷ RealtyTrac Press Release January 12, 2011

⁸ “Tight Standards Make Mortgages Tough to Get.”

⁹ “Newly Released Zillow Rent Index Shows Rental Markets Heating Up Nationwide, But Home Values Continue to Decline | Zillow Real Estate Research.”

¹⁰ AUTHOR, “Housing Outlook.”

2.2 Homeownership Trends

Currently there are 14 million single-family homes for rent across the United States worth an estimated \$2.8 trillion. By 2012 demand for rental housing was increasing each year as more Americans could no longer afford to own a home and the next generation of buyers no longer viewed home ownership as self-actualizing. Morgan Stanley analyst Haendel St. Juste, in a recent interview explained, “The US homeownership rate will stabilize in a few years at 63%, down from the current 65% and a 2004 peak of 69.2%. This would add more than 2 million rental households to the current 40.1 million.”¹¹ Another way to view the US homeownership rate impacts is that for every percentage it drops, the renter pool increases by 1 million Americans.

There are a variety of reasons homeownership rates are not expected to go up any time soon including strict mortgage policies, declining fertility rates, access to capital, student debt, interest rates, weak employment figures and market uncertainty. However, a key indicator that is discussed among single-family investors and seen as impactful is the figures surrounding household formation.

In the United States a typical year will see approximately 1.1 million new households created. Much of this is due simply to population growth¹². However between 2008 and 2011, during some of the worst and hardest hit years of the recession, the US saw annual household formations of 450,000 per year (a 60% decline). When compared to other factors in the market such as home prices and foreclosure rates, household formations are still lagging behind. Another way to measure these declines is to count the number of ‘missing households’. Missing households represent adults who would otherwise be renting or owning their own home if household formation had stayed at a normal rate. These numbers have more than doubled during the downturn and today

¹¹ Gittelsohn, Perlberg, and Mulholland, “Deutsche Bank Opening Rental Bond Spigot to Cerberus.”

¹² “Sorry, Mom and Dad.”

show that there are 2.4 million¹³ ‘missing households’ in the US (see Chart below). Put another way, if the average is 1.1 million households created each year than this figure shows more than two years of household formation ‘missing’ from the current market. Young people are deciding to either postpone their families and/or stay at home with their parents instead of moving out and purchasing a new home.

Table 1

Year	# of “missing” households, millions
2008	0.9
2009	1.8
2010	2.6
2011	2.6
2012	2.3
2013	2.4

Note: estimate takes into account changes in the age distribution of the population. See note at end of post. *Source: Trulia.com*

These lower formation numbers directly impact demand for new homes and homeownership. This can be seen clearly within the construction industry ‘starts’ data. According to the US Census Bureau among single-family homes ‘construction starts’ drop from over 1 million in 2007 to 430,000 in 2011 (average over the previous ten years was approximately 1.5 million starts). These figures are starting to climb back up as the economy improves but recent figures in September of 2013 show only 620,000 starts, still well below the long term averages even as the population continues to grow.

This is important to investors buying up homes across the US as each of these people must still find a place to live. Among the younger demographic some will most likely stay at home but a sizeable population will (and are) move out and become renters. The

¹³ “More Americans Living in Others’ Homes.”

resulting increase in renters, in theory, will keep rental prices stable, demand for rental properties high and vacancy rates relatively low. Investors on the ground view these figures as proof of a longer-term sustainability in the single-family rental market investment space.

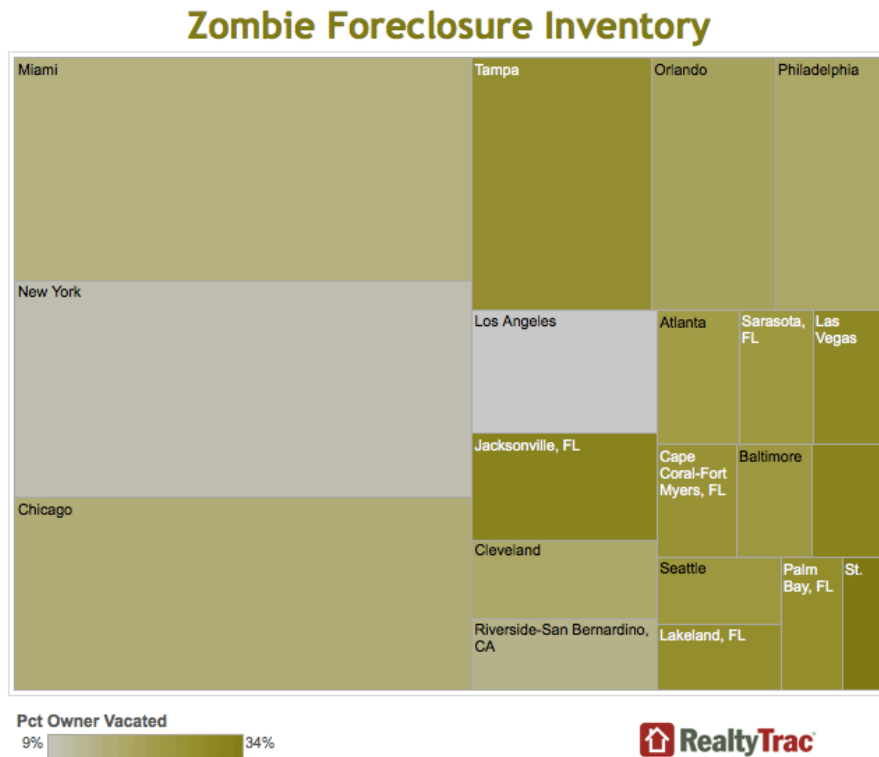
Today, with the housing market improving it is unclear how strong buyer's memories remain, but if in fact there is a shift to 'renters-by-choice' from 'homeowners-in-training' investors like Blackstone will be able to provide a desirable service to people who cannot be bothered by mom and pop absentee landlords of yesteryear.

2.3 Zombie Foreclosures and Vampire REOs

Since the housing collapse, the prolific rise in the number of foreclosed and REO homes gave birth to a ghoulish description for such properties: Zombie Foreclosures and Vampire REOs. Zombie Foreclosures are those homes where the owners handed the keys back to their mortgage lender and vacated the property. These homes sit vacant across the US, depreciating and deteriorating on a daily basis. As illustrated in Figure 2.2 places like St Louis, Las Vegas and parts of Florida currently categorize some 25% of their foreclosed inventory as 'Zombie'.¹⁴

¹⁴ "Monsters of the Housing Market."

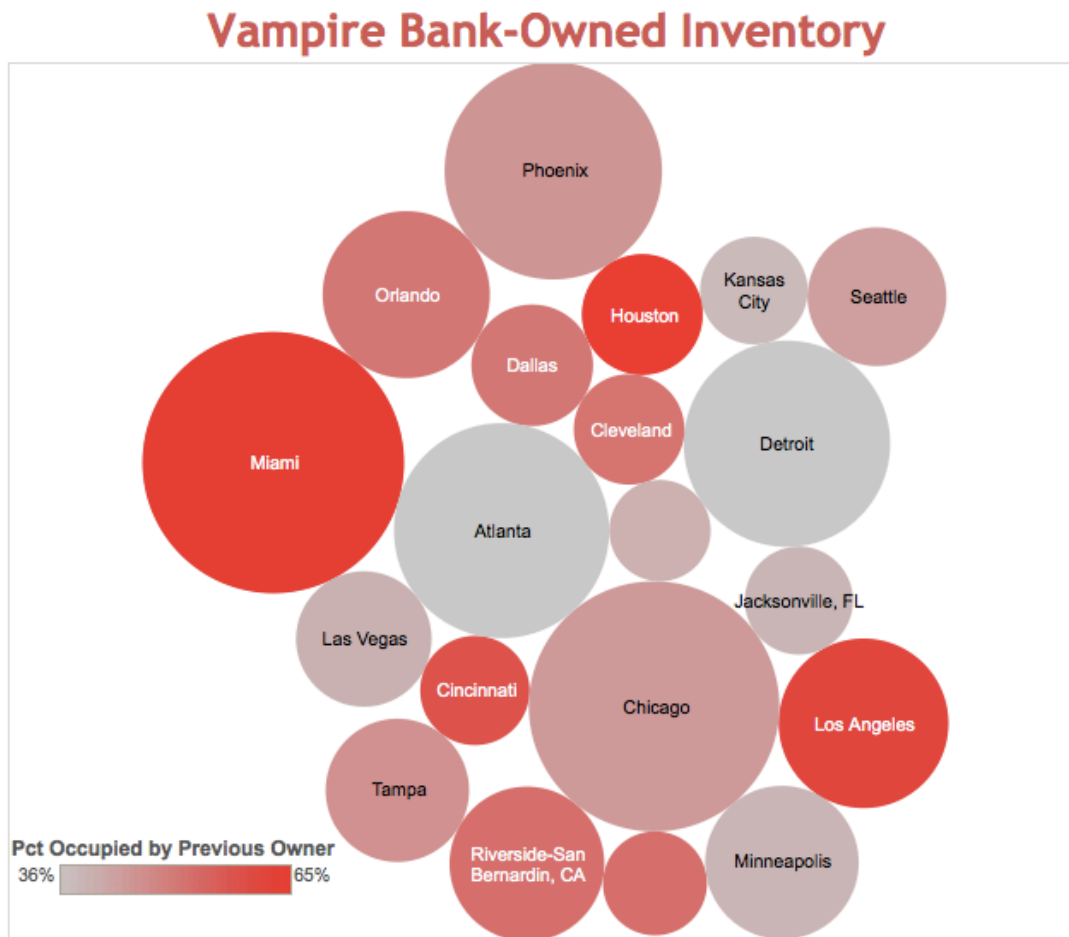
Figure 2



In Houston and Miami banks are seeing a large percentage of Vampire REOs, which are considered those properties currently in default where the residents have not vacated the premises. “These properties often will look like normal, non-distressed homes. But in reality, they represent a shadow inventory that is becoming more imminent as rising home prices motivate banks to sell off these types of homes to try to recoup their losses on soured loans¹⁵.”

¹⁵ “Vampire REOs and Zombie Foreclosures Threatening Housing Recovery.”

Figure 3



Source: RealtyTrac 2013

By late 2011 nearly 19 million homes sat vacant across the United States¹⁶ while single-family rental vacancy rates dropped for two years straight starting in 2009.¹⁷ Housing prices had fallen nearly 33% from their high in 2006 resulting in approximately \$7 trillion in household wealth losses.¹⁸ All public organizations were under constant scrutiny to find a way or ways to mitigate the plummeting housing market and stop the bleeding. In the private sector banks were watching their balance sheets fill up with these vampire REO and zombie foreclosures. It was in this high pressure, economically distressed environment that the seed for the REO-to-Rent investment strategy was sewn.

¹⁶ "Number of Vacant Homes in U.S. Hits 19 Million."

¹⁷ US Census Bureau News Release, July 2013.

¹⁸ US Housing Market: Current Conditions and Policy Considerations, January 2012.

The investment strategy of buying single-family homes to rent has been going on for decades among 'mom and pop' investors. However, it took the housing collapse to make the investment appear viable to institutional investors. Surprisingly, one of the initial instigators behind REO-to-rent was not private banks or Wall Street investors but the Federal Reserve.

2.4 FHFA White Paper Release

By late 2011 Federal Reserve was looking for ways to activate these languishing homes, lower the vacancy figures and relieve the balance sheet of banks. In January they published a white paper suggesting that investors purchase many of these low cost REO properties and rent them out instead of flipping them as an option to help the distressed housing market. At the time estimates by CoreLogic™ were of an REO inventory of nearly half a million properties across the United States and growing greater each quarter.

On February 27th of 2012 the Federal Housing Finance Agency (FHFA) proposed a pilot program that involved selling a large bundle of 2,500 Fannie Mae foreclosed homes from eight of the hardest-hit regions of the country. The new initiative mirrored the Resolution Trust Corp., which in the late 1980's used securitization to unload 2,600 real estate loans through mortgage trusts after the savings and loan crisis¹⁹.

In this new attempt to reduce the surplus of REO inventories the government inserted a bit of caution in making the offer only to experienced investors. These investors' qualifications were not expected to only include the capital to purchase thousands of homes but also the track record and wherewithal to operate and manage such a large portfolio of single-family homes. Finally, as part of the pilot program the FHFA mandated that each investment group hold the properties and rent them for a set number of years before selling.

¹⁹ "REO-to-Rent Securitizations" S&P, 2012.

The initial offer included differing pools of asset types including vacant homes, homes with existing renters and properties with non-performing loans. Still, even as they viewed the offer as a way to alleviate the oversupply of distressed homes while responding to the increased demand for rental properties, the concerns surrounding operations and management remained paramount. In a joint statement with the National Apartment Association (NAA), president of Government Affairs for the National Multi Housing Council, Cindy Chetti said, “Mismanaging these rentals would make an even bigger mess out of our already struggling housing sector [so] we would encourage the government to rely on trained, professional management entities to handle these properties.”²⁰

On that same day, when asked about single-family homes on CNBC, investment guru Warren Buffett quipped, “I’d buy up a couple hundred thousand single-family homes if it were practical to do so²¹.” Buffett’s remark, although off-the-cuff and simplistic, was prescient in bringing to light what quickly became the market’s appeal as well as its shortcomings in the coming years.

The FHFA program was focused on properties located in metropolitan areas hit hardest by the downturn. Specifically, they offered REO homes from Atlanta, Chicago, Las Vegas, Los Angeles, Phoenix and Miami. Within four months the FHFA received more than 4,000 ‘Requests for Information’ regarding the program.²² Clearly, they were on to something.

²⁰ “Fed’s REO-to-Rental Experiment Begins.”

²¹ “Warren Buffett on CNBC.”

²² FHFA REO Pilot Initiative, Press Release, July, 2012.

2.5 Private Sector takeover of REO-to-Rental

Renting single-family homes has been around for a long time and in itself is nothing new. However, in the past such an investment strategy was conducted exclusively by small, local ‘mom and pop’ outfits that knew the market and were within a proximity to provide any needed service and maintenance on their investment. To this day they remain the largest investor group in the single-family marketplace but starting with the Great Recession the market began to see large scale Wall Street level companies investing in earnest. Instead of buying one or two or even a dozen homes they are setting minimums of 300-500 homes per Metropolitan Statistical Area (MSA). Their initial strategy also focused entirely on distressed properties that they could purchase for cash at a low cost basis.

One of the very first to identify the value and potential in the Federal Reserve’s initiative was the Blackstone Group. Blackstone, with a Market Capitalization of more than \$16 billion is one of the largest private equity firms in the country. As the Federal Reserve was marketing their large pool of REO properties Blackstone created “Invitation Homes”. Invitation Homes is a Delaware Limited Liability Partnership officially formed in June of 2012 as a subsidiary of Blackstone Real Estate Partners VII (“BREP VII”)²³. The partnership was created as the managing entity tasked with aggregating single-family homes on a national scale, as well as renovating and then operates them as rental properties. Within less than a year Invitation Homes spent over \$1 billion buying single-family properties to become the largest REO-to-rent investor in the country²⁴. Other investment firms such as Colony Capital, American Homes 4 Rent, Waypoint, and Silver Bay quickly followed suit.

What began as a way for the Federal Reserve to unload a fraction of their distressed property surplus became a multi-billion dollar investment strategy among some of Wall Street’s biggest players. Fannie Mae’s initial pool of 2,500 would represent a small

²³ “Pre-Sale Report”, Moody’s Investors Service 2013.

²⁴ “Rental Market’s Big Buyers.”

fraction of the investments being made as one year later in February of 2013 estimates suggest that \$10 billion had been raised or committed to purchasing REO single-family homes for the purpose of renting them²⁵.

“Single-family rentals have been among the most publicized real estate investment strategies of 2012, but also perhaps one of the least understood²⁶.” This headline put out by Private Equity Investment publications in late 2012 sums up much of the sentiments regarding the newly created investment strategy at that time. A few weeks earlier the former head of US Housing Strategy for Morgan Stanley, Oliver Chang said, “It looks like there is currently more hype surrounding this investment than substance.” These two sentiments appropriately illustrate the REO-to-rental market in late 2012, however, the investment strategies and the public’s understanding of them have since become far more refined as they continue to grow in number of homes, investment regions and capital raised. In fact, shortly after making that statement Oliver Chang resigned from Morgan Stanley and founded his own single-family investment company called Sylvan Road Capital and within five weeks raised nearly half a billion dollars.²⁷

Finally, on a broader scale, estimates showed that approximately 7.5 million homes were either in foreclosure or delinquent in their mortgage, meaning that nearly \$1 trillion worth of assets would be liquidated or foreclosed through distressed sales by 2016.²⁸ As home ownership declined, the number of renters increased and the price for a single-family home plunged. Investors saw great opportunity in purchasing these distressed properties at a low cost basis and offering them up as rentals in an increasing rental market. Suzanne Mistretta, a Senior Director in Fitch’s RMBS group described it more aptly, “the [current] supply and demand imbalance has prompted single family rental investors to step in and take advantage of market dislocation in regional markets at a pace some refer to as a ‘pie eating contest’.²⁹”

²⁵ Dayen, “Your New Landlord Works on Wall Street.”

²⁶ PEI, “Cutting through the hype” November 2012.

²⁷ Perlberg, 24, and Print, “Morgan Stanley Analyst Swaps Research for Home Rehabs.”

²⁸ Gittelsohn, “Foreclosures Draw Private Equity as U.S. Sells Homes.”

²⁹ Mistretta, Chambers, “To buy or not to buy”, Securitization Intelligence, 2013.

CHAPTER 3 – REO-TO-RENTAL INVESTMENT STRATEGY

3.1 The Market Place

There are approximately 80 million single-family detached homes in the United States and of those nearly 14 million are for rent or renter occupied. Out of those 14 million 'institutional investors' represent less than 1%³⁰ of the owners with the majority being owner occupied or 'mom and pop' owned. Between 2007 and 2012 more than 4.3 million distressed REO homes were added to the national housing inventory. The REO inventory peaked in the third quarter of 2010 when bank repossessions reached 288,345 during that quarter alone. Put another way, the market was seeing more than 3,000 bank repossessions a day.

The exponential increase in distressed single-family inventory became the primary driver for many investors to enter the market. Additional market factors that played a role in encouraging institutions was lack of competition from the country's largest buyer of single-family homes, individuals. Homeownership rates were dropping and even as the market collapse began to stabilize the ability by many to get back into home buying was restricted by far tighter mortgage and lending practices. Instead, those individual buyers needed to live somewhere and quickly became single-family renters.

Upon entering the market, institutions strategically focused their initial buying on specific regions. Geographically, preliminary purchasing was concentrated within what investors called "The Sand States". Specifically they are referring to states like Arizona, Nevada, Florida and California aptly named for their deserts and beaches. These states experienced some of the largest housing construction and speculation in the run-up to the housing collapse. Driven by dramatic increases in population and expanding local economies, these markets witnessed an influx of buyers using non-traditional mortgage instruments. Subsequently, the same areas fell victim to the dramatic price reductions and gave birth to some of the largest inventories of distressed and bank owned

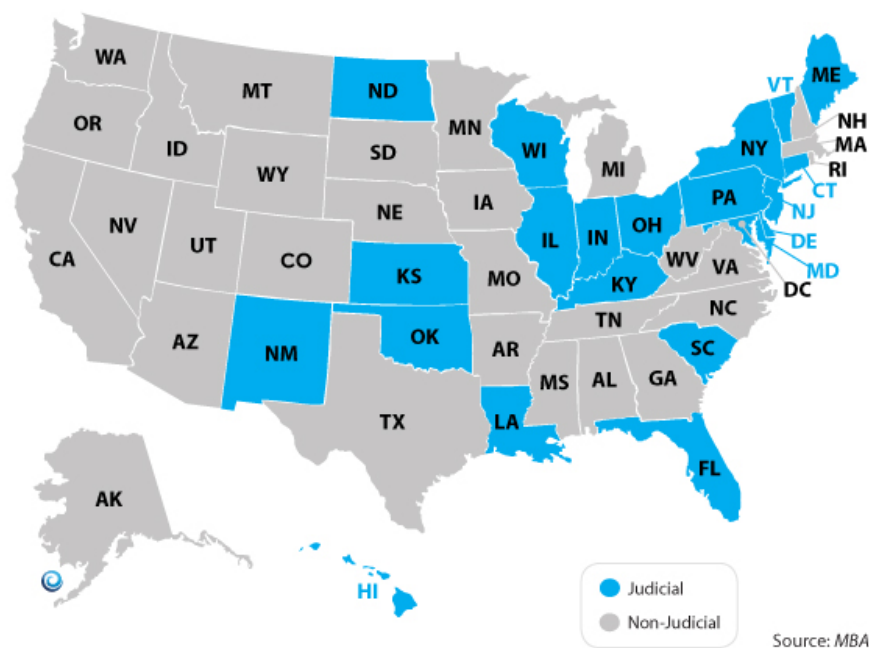
³⁰ AUTHOR, "Single-Family Home REITs."

properties once the recession hit. In 2009 these four states represented more than 42% of the foreclosure starts across the entire United States³¹.

Not coincidentally, Arizona, Nevada and California are all non-judicial states. The foreclosure process is different from state to state and is deemed judicial or non-judicial based on whether a state uses mortgages or deeds (or trusts) for the purchase of real property. Institutional investors in the REO-to-rental market try to avoid judicial states, as the process of foreclosure requires each property to go through the court system before being released making the process more time consuming and labor intensive (see Figure 4).

Figure 4

Judicial & Non-Judicial States



In 2012 Phoenix was the darling of most REO investors. In 2011, institutional investors represented 16% of all buyers of Real Estate Owned properties but by the end of 2012

³¹ Mortgage Bankers Association

that figure had jumped to more than 26%³². That increase was larger than any other major investment area in the country at that time. Coming in second and third were Atlanta and Las Vegas both of which hovered around 15% institutional investors in 2011 and jumping to 24% and 22% respectively. However, toward the end of 2012 as investors chased inventory and became more comfortable with the foreclosure procedures place like Florida saw substantial increases in investor buyers. In December of 2012 Miami was the leader with a full 30% of REO buyers identified as institutional (Phoenix 23, Charlotte, 21 and Las Vegas, 19).

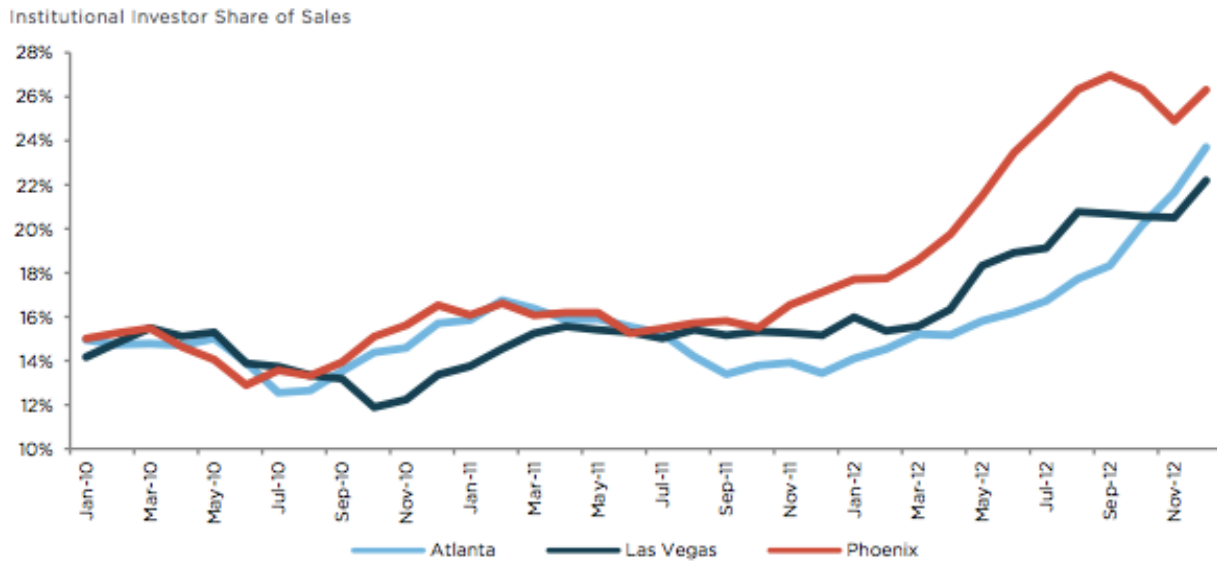
On a national scale RealtyTrac, in their October 2013 Residential and Foreclosure Sales Report estimated that the market was on pace to see 5.67 million homes sold in 2013. That's a 2 percent increase from August 2013 and a 14 percent increase year over year from September 2012. Out of these purchases they also began calculating investor involvement and, "in September [2013] institutional investors accounted for 14% of all sales, a new high since RealtyTrac began tracking this emerging demographic, defined as buyers who have acquired 10 or more properties over the past 12 months, in January 2011³³." September also saw the highest percentage of 'all-cash' home purchases which reached 49 percent.

³² CoreLogic, Inc., The Market Pulse, March 2013.

³³ "Nearly 50% Of All Home Sales Now Cash, As Institutional Investor Activity Hits New High."

Figure 5

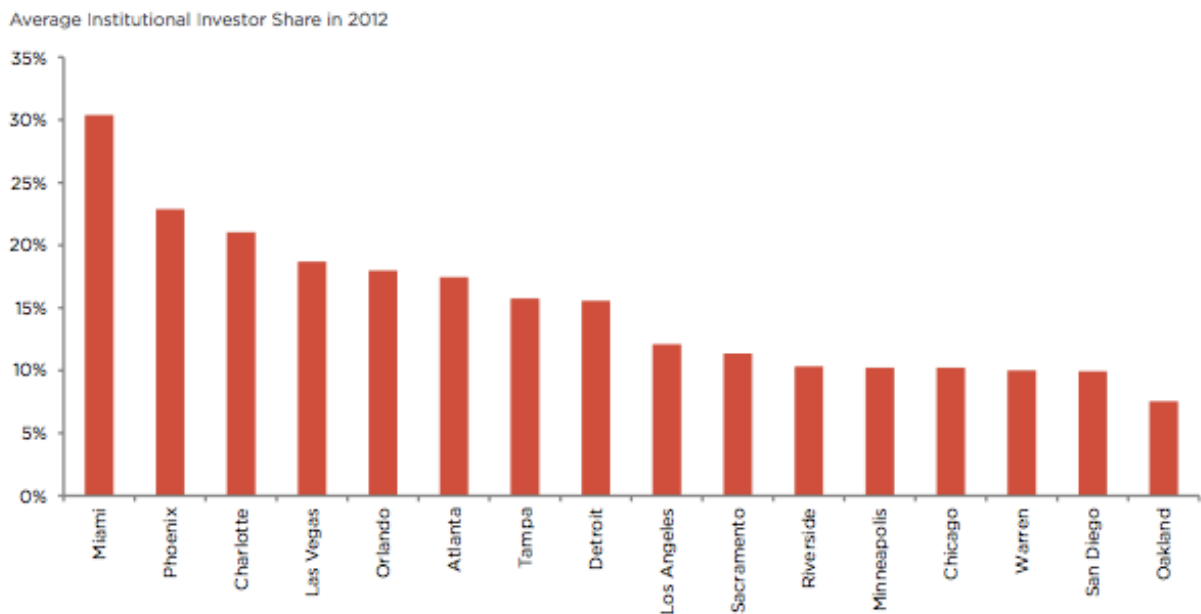
FIGURE 2. RISE IN INSTITUTIONAL INVESTORS DRIVE DOWN REOs



Source: CoreLogic December 2012

Figure 6

FIGURE 3. INSTITUTIONAL INVESTORS MOST ACTIVE IN SOUTH AND SOUTHWEST



Source: CoreLogic December 2012

As more and more investors entered into the market and demand rose, housing prices rapidly increased. In the REO market alone, Phoenix saw prices 37 percent higher year

over year by the fourth quarter of 2012³⁴. Overall home median prices in Phoenix climbed 34 percent in 2012 from \$122,500 to \$164,000³⁵. The home prices would continue to climb and a more recent study shows that between October 2011 to October 2013, Phoenix saw home prices increase by an astounding 71 percent.

The added competition and price increases resulted in a rapid decline in institutional investor interest in the area due to impacts on their yield structures. Among single-family homes in the metro Phoenix area, sales activities dropped by nearly 20 percent between October 2012 and October 2013³⁶. Investors are not willing to pay a premium or even market rate for a single-family home they intend to rent and as certain geographic markets improve many seem willing to move their acquisition operations out of these markets.

Today, in late 2013, investors are pivoting away from the Sand States. At a recent REO-to-rental forum in Scottsdale, Arizona (December 2013) several institutional leaders described buying opportunities shifting to regions like the Rust Belt including Illinois (Chicago), Ohio (Columbus) and Indiana (Indianapolis) as well as southeastern states like, Georgia (Atlanta and Savannah), the Carolinas (Raleigh, Charlotte and Charleston) and northern Florida (Jacksonville). California also remains attractive but in tertiary markets. Their motivations are driven by low cost basis as well as scalable opportunities, however, these strategies are also shifting with the changes in the fast paced market.

³⁴ CoreLogic, Inc., The Market Pulse, March 2013.

³⁵ Year End Housing Report, The W. P. Carey School of Business at ASU, Feb. 2013.

³⁶ December Housing Report, The W. P. Carey School of Business at ASU, Dec. 2013.

3.2 Investment Overview

Research suggests there is not a standard “one size fits all” REO-to-rental strategy among the largest investors, however; in general, the strategy is reasonably straightforward.

Investors enter economically distressed and discounted housing metropolitan areas and strategically buy homes at 25% to 45% below their original market values. In almost all cases their intentions are to scale up as quickly as possible through the purchase of at least several hundred homes in a single area. Upon closing they invest some percentage into repairing or refurbishing each home. It is here where investors stray from traditional large scale housing investment strategies of the past. Instead of flipping the property after seeing modest home price appreciation (HPA) they are leasing up each house and holding onto the property in order to capture a stream of rental incomes as well as appreciation.

Although each market is different in terms of home prices, home appreciation rates and rental yields, institutional investors are generally targeting 12 percent net yields from each single-family home investment. That 12 percent figure is inclusive of both rental returns as well as home price appreciation. Research indicates that investors' fates lie within the nuances of this yield structure.

In more broader terms, companies like Blackstone are buying homes at least 30 percent below replacement but then focusing on generating rent through home improvements and operational strategies that will cover any debt service and operational expense placed on the property.

Investors are betting on a housing market recovery that will bring prices at least part way back up to 2006 levels. Their vision is to not only benefit from positive cash flows but also take advantage of appreciating home values.

3.3 Buying at Low Cost Basis

Fundamental to investors' strategy is their need to acquire homes at highly discounted prices. However, different from buying a car or similar high cost items, the home investors' purchase must be thoroughly inspected, be in line with their particular investment strategy and likely represent one of twenty, fifty or even a hundred homes bought that week. In other words, purchase price and speed are important and often not complimentary to one's investment strategy. Colin Wiel, co-founder of the Waypoint Real Estate Group explained, "We realized that there is a tremendous amount of brain damage around acquiring single-family homes, renovating them and renting them out. We think this is a huge opportunity and we are going to treat it like a factory and create a production line to do this³⁷." His organization is able to have one of their inspectors sweep through a single-family home in less than twenty minutes and provide what they deem is accurate intelligence on what work must be done and generally how 'rental ready' each property is. Other companies are operating similarly.

Specifically, some companies, using residential mortgage backed securities databases are accurately estimating sales prices at the 'zip code level'. The data is showing that in the spring of 2012 home prices remained considerably depressed with levels 20-45% below real, non-inflation adjusted 2000 area prices.³⁸ In California around this same time companies like Arixa Capital Advisors were seeing prices for similar single-family homes at 35% of replacement cost.³⁹ These low basis figures allow investors to increase yields in a primary way through what industry players call HPA or home price appreciation. Whereas in the past the 'buy and flip' model focused on adding value through physical amenity updates and refurbishments, now investors see the added benefit of discounted purchase prices with potential for future appreciation.

³⁷ Rich, "Investors Aim to Buy Thousands of Homes to Rent to Tenants."

³⁸ Doyle, Landmann, Whalen, "Buy, Hold, Lease: Investing in The Housing Turnaround." TCW, April, 2012.

³⁹ Jacobius, "Investing in housing going from tactical investment to strategic?" 2013.

Institutional investors' low basis strategy also provides a realistic 'exit' to investors in case the rental market cools and families again look to owning their own homes. In a supply and demand housing economy as demand increase there is inevitably a delay in 'new' housing stock as home builders try and catch up, however, if such a shift occurs investors can almost immediately convert their rental property to a for-sale opportunity and capture that rising demand and subsequent rising price. The worry, however, is the likelihood of too many investors flooding the same markets at once and creating a regional glut and therefore a depression of pricing.

Another important factor in acquiring homes at a low cost basis is how and who is evaluating and making the purchase. Among the major investment players in the REO to rental market there are two primary strategies. The first involves engaging a third party to assess and acquire each single-family rental property in a region or nationally. The second involves the creation of an in-house acquisition and management company or to a similar end, purchasing an existing brokerage/management firm.

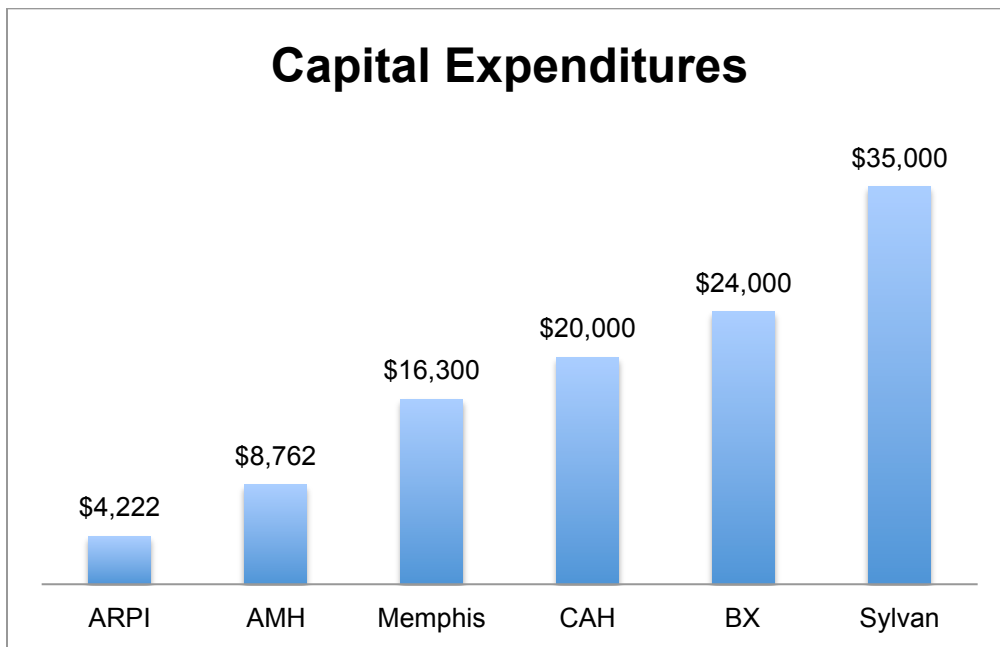
Many institutional investors, eager to get into the market, embraced the first of these strategies by contracting with a third-party broker/manager. Most operators in the multi-family housing market took years to hone their strategy and learn from previous mistakes. However, as this burgeoning investment opportunity seemed to grow and develop in what one investor described as 'dog years', new comers to the market realized that essentially buying experience and local knowledge could be strategically more advantageous.

In most cases where third parties are hired to purchase homes for absentee investment firms, a flat fee will be negotiated instead of a percentage on each property. In exchange the institutional investor gets a stable and easily quantified cash outflow but more importantly they get local knowledge and expertise immediately. The local brokers enjoy guaranteed bulk purchase over a short period of time. However, such an arrangement can also create an imbalance of incentives.

3.4 Capital Expenditures

The two primary capital expenditure strategies among active major institutional investors can be described as cosmetic and comprehensive. There are those who allocate 4 to 5 percent of purchase cost to capital expenditures in the hopes of keeping costs at a minimum while making minor cosmetic improves. Among the biggest investors, American Homes 4 Rent (AMH) spends on average 5 percent or \$8,762 per home while its competitor, American Residential Properties, Inc (ARPI) spends only \$4,222 per property.

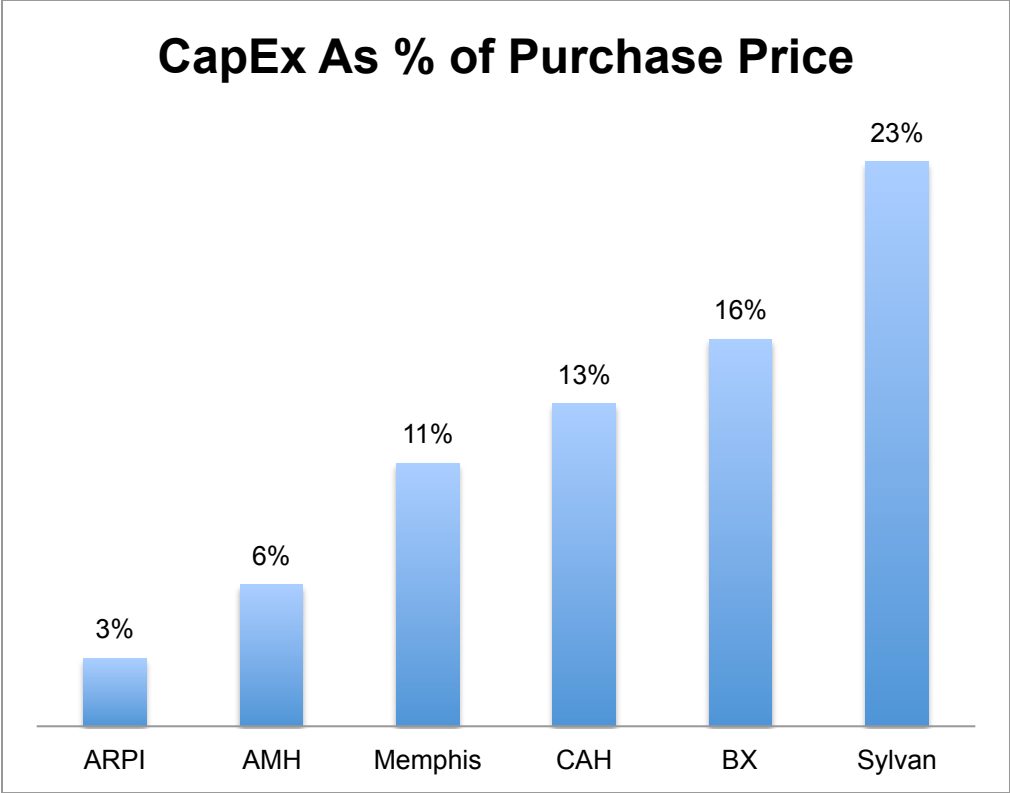
Figure 7



On the other side of the spectrum, companies like Sylvan Road Capital, Blackstone (BX) and Colony American Homes (CAH) spend double or quadruple the amount on comprehensive physical improvements to each home. Oliver Chang, the founder of Sylvan Road Capital and former head of Morgan Stanley’s housing strategy, explained in an interview with CNBC in August of 2012, “We specifically look for homes where we put more renovation work in. Our cost could be as high as 30 to 50 percent.” Sylvan

Road is perhaps more of the exception than the rule as they advertise a unique strategy focused not only on HPA and rental yield but also adding value through comprehensive renovations.

Figure 8



Note: Percentages based on an average home price of \$150,000

Capital expenditures and renovation expenses are a key component within the single-family rental investment market as they define what type of homes investors buy as well as whether or not they realize a profit. Organizations like AMH and ARPI seek homes where little rehabilitation work is required and will likely pass on properties that sat vacant for years and experienced considerable dilapidation. By keeping costs low they may miss out on the opportunity to add value through strategic renovations, however, they also avoid the pitfalls that come with improperly allocating funds at the wrong time in the rental and sales process.

Rental properties by their nature take a harder beating and are treated with less care by their tenants than an owner occupied unit. Moneys spent up front can often be negated after one cycle of a neglectful or destructive tenant and therefore investors must be shrewd in how and when they apply their renovation expenses.

At the second annual REO-to-Rental Forum in December of 2013, contractors and investors spoke to some of their strategies when approaching single-family homes they purchased in order to rent. Ben Walls, director of business development for American Real Estate Investments, LLC explained, “We learned very quickly from experience not to install carpets on the lower levels.” Carpet, while easily replaced and relatively inexpensive, is not durable. Investors found that they had to replace lower level carpets annually in high-traffic areas and links to the outdoors. Spending a little extra for vinyl, Pergo or even wood flooring can avoid future maintenance issues or reoccurring rehabilitation expenses. Other interior tips include using semi-gloss paint, which costs more but has a higher durability or installing tile backsplashes in the kitchen and bathrooms.

Other important areas for investment fall under the category of ‘curb appeal’, or how each home is seen from the road to perspective renters. Most investors anticipate spending funds on landscaping such as trimming trees, and bringing in new mulch. Another investor admitted to repainting the trim across the entire front of a home as well as adding shutters that specifically match the front door color. To investors, employing seemingly minor strategies such as these can not only minimize vacancy durations but also act as a good defense against other expenses. As one operator explained, “[The exterior] is the first thing I address, especially if it’s an REO property. Doing so helps prevent squatters or vandalism and keeps attention away from code enforcement.⁴⁰”

Investing in curb appeal and visually pleasing additions is equally important to institutional investor’s marketing and lease up strategies. Some groups eluded to the creation of a brand for renters in certain markets. Much like some buyers recognize

⁴⁰ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013.

multi-family owners like Avalon Bay or Related Companies, single-family property owners aim to distinguish themselves through quality as well as service/operation superiority. In the financial modeling world of Wall Street, being able to reduce lease-up duration and decrease turnover across properties have dramatic impact on rental yield projections.

Lastly, investors closely analyze and monitor capital expenditures in order to control maintenance expenses and subsequent operational costs. In an early report released by Morgan Stanley's Housing Strategy department they explain, "The importance of getting construction — or specifically, re-construction or rehabilitation — right cannot be overstated. The quality and cost of rehabilitation can continue to benefit or haunt the asset far past the initial completion of work. For example, shoddy plumbing or other infrastructure work can result in significantly higher maintenance costs over time, and can also affect eventual exit pricing⁴¹."

⁴¹ "Housing Market Insights," Morgan Stanley Research, April 2012.

3.5 SFR Operating Strategies

To institutional single-family rental investors, operating efficiencies represent a critical cornerstone in their profitability as well as future exit opportunities. Operators are quickly recognizing the high-cost of operating disparate and geographically scattered properties. To combat such costs and achieve necessary operating expense ratios (OER) operators are investing in technology, preventative rehabilitation, scale and ‘institutionalizing’ or ‘branding’ services.

American Residential Properties’ Laurie Hawkes, ARPI’s president, COO and co-founder explained the importance of operating efficiencies, “Unfortunately, if not operated cost efficiently there could be serious indigestion. Buying right is important but operating right is critical⁴².”

Anyone who has ever renovated their home understands that more often than not the work takes longer and costs more than initially estimated. Frank Terzuoli, Director of KPMG’s Credit and Analytics department reiterated the issue as it pertains to single-family aggregation, “The hidden costs of owning rentals can really bite you. They eat away at profits at the back end. [For example in Florida] home prices are low, but the cost of replacing a roof could exceed the cost of acquiring the property⁴³.”

Unlike more mature contracting markets, single-family home construction is different with every home. Additionally, the majority of these investment properties are spread out across neighborhoods, cities and regions. Whereas a multi-family building might have a superintendent on duty every day or a management company with dedicated staff that can see to multiple units and problems by walking up or down a flight of stairs, the single-family layout cannot.

⁴² Perlberg and Kelly, “Colony Spends \$1.5 Billion on Homes as Next REIT Boom.”

⁴³ “REO to Rental.”

Each reported incident requires a personal and direct interaction with the tenant and property. This means that even in the most minor cases it may cost the investor \$50 to \$150 just to have a contractor drive out to the site, never mind the \$100+ per hour they charge to fix a leaky faucet. Stephen Schmitz, the CEO of the REIT ARPI explained his experience, “In the first month of opening our call center we received more than 600 phone calls from tenants!⁴⁴” Minimizing such calls while also providing sufficient services to tenants is paramount to the success of the single-family rental market.

One solution touted among operators is ‘technology’. Nearly every major investor in the SFR space boasts of the in-house, proprietary technology they use to inspect, acquire, renovate, lease up and operate each of their properties. Many of these systems are mobile and cloud-based with Application Programming Interface (API) capabilities, which allows inspectors to upload data and images into the system onsite. The investor, and contractor can then log into the site and see what needs to be built and how each project is progressing. In cases where investors are hiring third party contractors the required work can be emailed out to bid in almost real-time, allowing contractors to estimate a project rapidly while investors to get competitive pricing.

All of this data is collected, stored and analyzed so that investors can plot typical times from purchase to rehabilitation to lease-up. Once leased up the same system can track maintenance requests and subsequent costs and time factors. Eventually, their data will show what the ‘typical’ maintenance calls will be on homes of a certain ‘vintage’ in a certain geographic region as well as how much and how long it will take to remedy those tenant issues. In some cases they will integrate that information into their acquisition strategies and renovation choices before lease-up.

Preventative rehabilitation, although intuitive, represents a minority strategy among most investors, as existing data does not justify spending a higher percentage on initial construction. Moreover, the fear of ‘over-rehabbing’ each home is strong with investors watching those expenditures evaporate after five years of renting. However, those who

⁴⁴ MN, REO to Rental Forum, Scottsdale, Arizona. December 2013.

swear by it are adamant that if investors take shortcuts in the beginning they will suffer high maintenance costs down the line. They believe that up front investment will in fact pay dividends over the life of the property. Those dividends come in the form of reduced maintenance calls, lower vacancy and a smaller turnover rate, all of which erode yield among SFR properties. One contractor explained that some of his clients purchase a home and immediately, “go in, do a new roof and new mechanicals no matter what...this minimizes calls [in the future] and it works⁴⁵.”

In the quest for achieving the aforementioned operation efficiencies, investors are looking to economies of scale. Used much in the same way multi-family properties do, owning single-family homes in bulk and proximity can be advantageous to operating costs. Still, while investors recognize that reaching the operational efficiencies seen in multi-family housing are for the most part unattainable, they agree that the advantages remain viable, if only on a lesser degree.

A driving motivation behind scaling up is that operators can justify eliminating any third-party management company as well as opening a regional offices run by in-house employees. The typical management company charges between six and eight percent of monthly rents. Often their incentives are not aligned with the investors’ as their monthly income is based income *not* on minimizing expenses.

Pat Whelan, the CEO of Beazer Pre-Owned Homes cautions, “You cannot buy scale for scale’s sake. [Investors] must buy in targeted areas, get rents right, target those rents first and then scale up. At that point we’ve found that 300-500 homes is a minimum to achieve scale and [one should expect a] six to nine month period to get to 500 homes⁴⁶.” Once scaled-up operators are opening regional offices and looking to streamline the process in order take advantage of economies of scale. One example is Waypoint Homes, with approximately 570 employees operating 13 regional offices and almost 5,000 single-family units across the country. Invitation Homes, with 41,000+

⁴⁵ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁴⁶ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

homes is able to accomplish the same management operation with just 14 regional offices and 1,550 employees.

Lastly, SFR operators are looking to ‘institutionalize’ and ‘brand’ the single-family rental asset class through operating services. In fact this strategy is a key component in the success of the REO-to-rental investment plan and in order to succeed companies like Blackstone and American Homes 4 Rent must be responsive to tenants and vigilant with maintenance and property up-keep. Part of their thinking is that many people are currently renting from mom and pop absentee landlords who are unresponsive to renter’s issues and investors have an opportunity to “professionalize” these tenant services through an online or ‘24 hour hotline’ type operation. As Jonathan Gray, Blackstone’s head of Real Estate, explained, “The downturn created an opportunity to create a business, and in doing so we can actually do something for tenants that never existed before ... Wouldn’t somebody pay for that experience?”⁴⁷

Another example can be found with Beazer Homes, a SFR operator looking to draw in tenants and keep them. Beazer does not refer to their properties as rentals but as ‘previously owned homes’. CEO Pat Whelan is not shy about admitting that they borrowed this tag line directly from the luxury automaker, Lexus. SFR aggregators want their tenants to enjoy the experience so much that they never leave or look to move into a similarly run property elsewhere. It is here more than any other strategic avenue that investors show the most confidence in their ability to improve the current ‘informal’ marketplace.

Reigning in operating costs will not only benefit property level gross yield but also strengthen the operating expense ratio (OER). OER is the measure of what it cost to run a property compared to the gross operating income. Understanding OER helps determine the net cash flow available to cover debt service on each property. More importantly, as rental operators begin to look at exit opportunities such as securitization or a public offering their ability to demonstrate viability and profitability becomes crucial.

⁴⁷ Cohan, “Why Wall Street Loves Houses Again.”

Rating agencies like Moody's view the operating expense ratio as an important tool in assessing default probabilities. Additionally, a good OER indicates an efficient and skilled operator, which Moody's believes, will lower volatility and thereby potential downside risk.

3.6 Hold Period

Among investors the hold period on single-family rentals is determined by their investment strategy, what type of capital they operating with, for instance: the cost or the lock-up term of that capital. Additionally, the hold period will in some ways be determined by what other opportunities exist in the market to reduce investors cost of capital as well as what exit opportunities exist to groups with 1,000 to 41,000 homes in their portfolio.

Understanding these parameters, many investors are looking at a five-year hold period. As the market becomes more saturated with buyers and fewer properties are available below replacement costs, investors are looking much closer if not entirely at rental yields and operational efficiencies to generate profits. These investors are resigned to seeing house price appreciation of no more than slightly above inflation. Moreover, they are envisioning longer holding periods as a result.

The co-found of Sylvan Road Capital, Oliver Chang, explained in recent conference, "We didn't enter the space to take a deal on home prices. We're not in this because we think home prices are going to go up 5-10% a year and then cash out that way⁴⁸." He went on to explain that all of Sylvan Road's capital is long-term locked-up money. Another speaker at the same conference, Jordan Kavana, CEO of Transcendent Investment Management, explained how his original fund, created in 2008, had an initial hold period of seven years was just extended and that all new incoming capital is being considered '5-10 year money'.

⁴⁸ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

On a broader scale, ORC International, in the summer of 2013, conducted a national survey of investors in the single-family rental market place on how long they expected to hold their properties. Over half of the investors surveyed said they plan to hold them for at least five years, while one third said they would hold for ten years or more.⁴⁹

In viewing the hold period for these single-family properties there is a fundamental question that persist and that is whether this investment is a 'trade' or a 'business'. Are organization and investors in the market to flip properties and make a quick profit on HPA or are they in it for the long term, investing in rental yields? In response to this question, Steve Schmitz, the CEO of ARPI, a company with nearly \$1 billion invested in the space responded, "I think for people who think it's a 'trade' it will never be more than a 'trade' and for the people who think it's a business and are willing to build the machinery that the business requires it will be a real business⁵⁰." In other words, the answer is 'both' and this sentiment is reflected in the hold period announced by investors.

⁴⁹ 5:28PM, "Investors Backing Out of 'REO-to-Rent' Market -- AOL Real Estate."

⁵⁰ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

CHAPTER 4 – INVESTMENT ANALYSIS

4.1 Home Price Appreciation (HPA) Trappings

The housing debacle in many places caused housing prices to drop in half while at the same time rents and vacancies remained mostly unchanged. Any investor with an eye on the market could see the ‘trade’ opportunities. In other words, buy homes at extreme discounts, knowing their value would have to appreciate and use it like a commodity while at the same time using them as a cash flow vehicle as rental property. The math was simple and the opportunity straightforward. In the spring of 2012 the investment management firm TCW released a report entitled “Buy, Hold, Lease: Investing in the Housing Turnaround”. In the report they make their case plainly, “In Phoenix, we have been able to purchase, close and renovate homes to rent-ready condition for an average cost of \$44.75/per square foot – only \$2.75/PSF over wholesale construction costs (See exhibit below). In other words, we got the land practically for free with a few pools thrown in. Note that this is a huge discount to the \$85/PSF average home resale costs in the area in 2001.”

Table 2

Exhibit A Phoenix Area – Wholesale Construction Costs versus Our Group’s Properties		
New Home Construction Costs	\$42.00	PSF
Land With Improvements and Permits-Ready to build ¹	\$21.00	PSF
Total Wholesale Costs	\$63.00	PSF
Our Group’s Secondary Distressed Acquisition Costs	\$44.75	PSF
Discount to Wholesale Cost	29%	
2001 Home Resale Avg. Cost in Our Group’s Footprint	\$85.00	

Source: TCW, RS Means Construction Data, MLS, ASU W.P. Carey School of Business
¹ Current pricing ranges from \$34,000-\$42,000 in West Phoenix-ex Maryvale.

Investors, who bought homes in 2011 and 2012 expecting high HPA figures, appear vindicated as “single-family homes climbed in 88 percent of U.S. cities in the third quarter (2013) as buyers competed for limited inventories that included fewer discounted foreclosures⁵¹.” Moreover, existing home sale prices (which includes single-family homes, townhomes and condos) of \$199,500 in October 2013 were 12.8 percent higher than those in October of 2012 making it the 11th consecutive month of double digit, year over year sales price increases⁵².

Still, national market indicators do little good to investors if they overpay for properties or operate in markets where home prices have not appreciated. Equally important is the nearly universal opinion among investors and market professionals that 2014 will bring slower gains within housing market’s price appreciation. In a November 2013 Zillow Home Price Expectation Survey 108 respondents (economists, investment researchers and RE experts) predicted an average 4.3 percent home value appreciate in 2014. This figure is down considerably from the same groups estimate of 6 percent appreciation for 2013. These figures and expectations suggests that late entrants into the SFR market are in danger of being trapped by unrealistic HPA estimates in their models.

By late 2012 many firms were already clambering to get a piece of the millions of discounted homes. The market is nuanced and requires experienced and knowledgeable on-the-ground inspectors, brokers, contractors and managers. However, by 2013, in the rush of getting to homes first and buying as many as possible there were firms who sold the investment to potential money partners with HPA being the primary payoff and the rent representing at best a tool to cover holding costs and worst a ‘bonus’. Some of these buyers had their head down, focused on getting to scale before understanding the pitfalls others experienced in the single-family market.

Additionally, from a purely real estate investment perspective, betting on single-family house price appreciation is proven to be an unwise strategy. All economic data

⁵¹ Gopal, “Home Prices Climb in 88% of U.S. Cities.”

⁵² “October Existing-Home Sales Cool but Low Inventory Drives Prices.”

suggests in the long run that house prices appreciation is nominal and therefore investors should be looking to rents to drive their investment, no short-term appreciation. Those rents come from rent ready homes, which requires additional investment and further depletes one's appreciable base. Some investors are seeing their margins diminished as they are forced to pour more and more money into repair and maintenance (R&M).

Finally, the supply of distressed properties for sale in the United States has been declining since 2009⁵³. As supply shrinks and demand remains, prices on these distressed properties rises. The market has become so 'frothy' as one investor put it, that new entrants are looking to MLS and market rate properties to fill their quotas. Rick Sharga, the EVP of Carrington Holdings' mortgage arm said in the summer of 2013, "We believe some institutional investors are overpaying for assets⁵⁴." Carrington is not just vocalizing concern, they've stopped purchasing after investing nearly a half billion dollars into the single-family market.

Companies are buying so rapidly, they are forced to stockpile some of these homes, which now sit vacant as they try to sift through, rehabilitate them and lease them. In other words the assumptions they used to buy many of these homes, some of which they overpaid for, are not yet fully vetted in the marketplace. An example might be a group that paid \$115,000 for a house worth \$160,000 in 2006. They estimated \$10,000 to renovate but it sat vacant while they continued to buy. By the time they get to it they've already been paying real estate taxes, a broker fee, possibly a home owners association fee and then realize the work is closer to \$20,000 due to further damage from vandals or a leaky roof that went unattended. The needed repairs take an additional two months complete, all the while they are suffering vacancy losses. By the time the property is leased the margins are nearly evaporated.

⁵³ 29 et al., "America's Supply Of Cheap, Distressed Homes For Sale Is Shrinking."

⁵⁴ "Wall Street Buying Adds To Housing Boom. Is A New Bubble On The Way?"

These investors are not necessarily the exception within this market. They were trapped by the notion of HPA and dove into the deep end without knowing how to swim in a marketplace that does not forgive inaccurate pricing assumptions. However, those who were able to buy *smart* and *early* and view the investment as driven by rental yields with HPA being the bonus do stand to see real returns.

4.2 Third Party Premiums

Another drawback originating from investors looking to rapidly enter the space is the hiring of third parties to inspect, buy, renovate and lease-up their new investments. This setup creates three potential issues for investors, first, they run the risk of getting bad information, second they pay a premium for such services and third, many of their negotiated arrangements with third party operators represent a conflicting incentive structure.

Third party brokers and contractors make a convincing argument for their utility in bringing market knowledge and valuable experience to an outside operator. As one contractor explained, “We can look at a neighborhood [and understand whether] you take a \$50,000 home and make it a \$150,000 home and is that in keeping with the neighborhood?⁵⁵” The idea is that they eliminate the learning curve. Third party managers and brokers know their market area, are familiar with local trends and idiosyncrasies and bring with them a network of important relationships.

However, despite having their clients’ best interests in mind, these companies are independent operators looking to maximize their returns. They generate money separate from investors and just like when investors flooded markets like Phoenix, Las Vegas and Orlando, so too did contractors and property managers. Their information is imperfect and their fees are unregulated and mostly unchecked due to the nascency of the market. As investors look at other markets these same brokerage companies look to

⁵⁵ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

go with them and continue the strong relationship they created. It is here where they become no more helpful than the investors themselves as they no longer possess the comprehensive market knowledge and the risk of making poor purchasing decisions grows exponentially.

Secondly, investors often pay a premium to quickly gain the aforementioned local knowledge, insight and relationships. However, when third parties gouge investors it can seriously eat into the rent revenues and diminish the operating expense ratio. Some companies like Silver Bay are showing fees and similar operational expenses representing more than 50 percent of their rental income. They are either fully overpaying for third party management or not generating enough rental income or both.

In the worst-case scenarios third party organizations could be overpaying for poorer quality homes in less than ideal locals. When private equity and REITs are buying fifty homes a day such missteps can quickly snowball until an investor's portfolio is poisoned by a series of bad homes. However, some of the bigger players are able to negotiate flat fees from the very beginning. Companies like Colony who are buying thousands of homes in one area are able to get third party brokers to reduce their typical fees.

Lastly, investors are not properly incentivizing their third party managers and brokers. In at least one known example, a company is paying a flat fee of \$3,000 on a per-house purchased basis. In other words, the more homes the third party provider buys, the more they get paid. The incentive structure is flawed. This strategy is not in keeping with an investor's investment demand of buying quality homes at the lowest prices. The same can be said for managers who pay flat fees but don't incentivize these providers to minimize maintenance calls and expenses.

As mentioned there are ways that operators can best utilize third party brokers and managers but the best form of action is to create or buy a management and brokerage company. Operators who are doing this are essentially doubling down on their initial

investment and looking at the market more long-term. Furthermore, instead of allowing that additional income go to a third party, they are recapturing it themselves.

Companies like ARPI and Invitation Homes have such structures already in place. Additionally, Colony Capital announced this summer that it is building an in-house staff to realize its plans to acquire \$1.5 billion of rental homes by April of [2013].⁵⁶

4.3 Poor Capital Expenditure Oversight

Allocating capital expenditures judiciously and strategically are critical factors in the viability of a good investment in the SFR space. Organizations looking to enter the market or invest funds in an existing operator must take a detailed look at this aspect of the investment.

Interviews and research indicate that as new institutional investors began gobbling up properties their strategy or vigilance surrounding physical improvements diminished at best and at worst never existed. Several industry professionals suggest that in order to ‘refinish’ a single family home *for rent* it should cost \$8,000 - \$12,000 *at most*. Typically these expenses go to new paint (inside and out), landscaping, new carpet, some new fixtures and minor repairs. However, some investors are spending more than double that amount on these initial repairs. Companies like Colony and Blackstone report spending \$20,000 to \$25,000 on average per home which depending on initial home price means they are devoting 10 to 25 percent on CapEx.

Due to the ‘newness’ of these investments and the lack of sales and turnover cost data it is too soon to draw definitive conclusions, however, the concern is that these initial ‘investment’ cannot be recouped. The idea is that renters over a certain period will extract all of the value added by most of these initial expenditures. If an investor installs new carpet, in three years it will have to be replaced if the owner wishes to actually sell

⁵⁶ Gittelsohn, “Private Equity Has Too Much Money to Spend on Homes.”

the property. Professionals in the 'flipping' side of housing explain that investors will need to come up with a similar amount when it comes time to sell. Mid-sized players who have been in the industry for longer say that the first tenant will destroy or devalue almost the full amount of that investment.

American Homes 4 Rent (AMH) appears to be an example of people treating the investment as truly a rental property. They are investing minimal amounts at the beginning in the hopes of keeping costs low and not throwing bad money after good. Their average percent of CapEx is between 5 and 8 percent. Ideally, a REIT like AMH tries to strategically purchase homes at a low basis, in good neighborhoods, that do not require extensive renovation work.

However, if one were to look at investing aggressively in renovations, as 'flippers' often do, then Sylvan Road is one of the leaders. They spend 30 to 40 percent of acquisition costs on renovations but do so deliberately. Sylvan Road actively searches for homes that need extra work in the hopes of adding additional value. An example might be purchasing a distressed property for \$60,000 and then investing another \$40,000 of renovations and coming out with a \$150,000 house for rent. However, it should be noted that this strategy is not yet proven in the market as Sylvan Road has yet to sell any properties or release any of its financials.

4.4 All Single-Family Homes Are *Not* Created Equal

One attribute that analyst looking at SFR and securitization comment on is the uniqueness of each home in a portfolio. The single-family housing market in Miami is different than that in Memphis, which is different from Las Vegas, which is different from Chicago or Atlanta. In other words all single-family homes are not created equal. Using a general or national buying strategy and matrix cannot work. Proximity to downtown in one place may not be as valuable in others. You must know which neighborhoods are best and worst, where resale values are highest as well as the entire market on a macro

level. Housing declined rapidly in Las Vegas but not as much in Boston for a reason and investors cannot approach a house in one area the same way they approach it in another.

These locations should also be considered when making capital expenditures, as the weather in Chicago will require different precautions and fixes than Las Angeles or Miami. Rain in Seattle may require more frequent roof repair or even replacement and so on. Homes in these differing regions will perform differently and require different operating procedures from one another. A concern is that institutional investors bought and are operating single-family rentals on a nationally established modeling system expecting a certain level of performance from each property. The reality, according to some professionals in the field, will be far different.

4.5 Keeping Overhead Low

It cannot be overstated how important overhead and cost controls are to the success of each property on a yield basis. One mistake that may have been made early on is too look at the 'Mom and Pop' model and attempt to replicate it on a large scale. Even today individual buyers dominate the single-family rental housing market with purchase of five or ten homes in an area. Part of the reason they survived is based on their ability to put in considerable sweat equity into each of their investments.

Someone owning three or four homes is typically the property manager, plumber and carpenter and they do not charge 'the business' any money for their time. Instead that work is essentially built into their small returns and the investment acts as a long-term retirement vehicle. Depending on the year of the house and condition of the property such owners will spend hours a week operating their few properties and expect no immediate payout.

In contrast large institutional operators entering the space must pay third parties or in-house staff to manage all of the tenants, rent rolls, as well as hire contractors that charge high hourly wages. All of this should be filed as an operating expense and deducted from gross operating income.

A property without debt service can handle high operating costs but with debt service payments, taxes, HOA fees as well as operating expenses the gross yield projections start to look very unrealistic. It is the investment firms that are able to control and minimize their overhead costs that will thrive and survive in the SFR marketplace.

4.6 Impact of Turnover Volatility

Turnover rates among multi-family investors are well documented and based on comprehensive historical data. However, statistics of this nature are highly limited among the nascent single-family rental market and represent an unknown risk to rating agencies as well as capital investors. Their concerns are well founded as high turnover rates and costs can be the death of investor's gross yields.

In general it is reasonable to say that renters are traditionally transient people. They rent not just because they can't afford a home but because their job often forces them to move or they aren't ready to settle or a variety of other personal reasons. Still, SFR investors must attract these tenants and in order to do so must spend \$5,000-\$30,000 to repair and renovate properties (depending on age and purchase condition). Much of the costs go into quickly depreciating work such as paint and carpet. When a tenant leaves investors are required to go back into the home and spend additional funds to once again make it rent-ready. The investment in-between turnovers did not add value to the property but rather brought it back to the level in which investors can get their required rental price.

Worse still for SFR operators is the vacancy loss during the turnover and rehabilitation period as well as the requisite marketing and broker fees to ensure re-leasing.

A real life example provided by an operator in Las Vegas illustrates the problem nicely. The typical renter for their properties stayed 16 to 18 months and the investments were seeing approximately \$250 in net profit per month. After 18 months, with the operator \$4,500 in the black, the tenant moves out and the operator, in order to re-lease needed to repaint, repair and clean at a cost of \$5,000. In the end, they are looking at a \$500 loss on this one property and this isn't considering vacancy loss or broker commissions.

The conclusions, in the broadest sense, are that renters will continue to be transient and owners will always need to spend money on turnover repairs. Owners who are able to extend the lease terms (2-3 years or greater) will be able to show much greater returns and not only minimize turnover expenses but also reduce the labor and brain damage required to lease up an individual single-family home.

4.7 Monetizing the Asset or “Exiting”

Although there are a growing number of investors dedicated to the single-family rental space as a mature business model, there are others who will eventually look to exit. The concern and question for these investors is how do you monetize this new asset?

Unlike stocks or bonds, these individual homes cannot be sold with the click of a button and a small sales commission. In many cases the homes will need to be brought up to salable quality. This means spending additional funds, (estimates are \$20,000 per home) to repair and upgrade what was previously a rental property. Depending on the buyer such action might require delivering a vacant property, which would entail paying a tenant to move out, plus vacancy loss as the deal is completed. Finally, the seller faces 4 to 6 percent sales commissions depending on what type of deal they negotiate with a brokerage firm. In the end an appreciation of twenty percent could quickly look

more like five percent or less and such returns are not acceptable in such a risky investment.

Alternatively, the operator can sell the properties to another single-family aggregator. However, while such buyers are growing in number, so too is their understanding of the market. As the market continues to mature and more data is compiled potential sellers cannot rely on the 'greater fool theory'. Investors are quickly becoming shrewder and will continue to want properties at a discount, especially when buying in bulk. Equally, important in such a sale will be the seller's ability to demonstrate cash-flow performance and a solid management track record. No buyer wants to purchase a ticking time bomb with mismanaged properties and uncertain rental yield capabilities. Once again the seller is looking at considerable work to bring the properties to a salable level as well as the probability of a discount on the appreciation they advertised.

These shortcomings push investors to innovate in order to avoid such a problem. 2013 saw two new innovations that allow operators to monetize this new asset class as they bring more transparency and clarity to the new investment space. In early January the first initial public offering for a Real Estate Investment Trust backed exclusively by single-family rental properties was announced. By July two more publicly traded SFR REITs were created. These REITs allow properties to in fact trade like stocks. Next was the securitization of single-family rental incomes, another first of its kind in the history of fixed-income structures.

The level of investment in single-family homes coupled with the caliber of investors' means any drawback or downside is addressed head-on. Therefore it will be operators' ability to innovate, and strategically pivot when necessary, that will determine the future feasibility and sustainability of the single-family rental business.

CHAPTER 5 – FIXED INCOME STRUCTURES

5.1 Overview

Investors who spent hundreds of millions aggregating single-family homes for rent are starting to see diminishing capital availability. Moreover, some are looking to ‘cash out’ of their initial investments while others, who view the space as a ‘business’ are simply looking to buy more property and further formalize the new market. Whatever their objective, SFR investors began investigating the notion of securitizing the single-family rental incomes almost as soon as the first purchase and sale agreement was signed.

Securitization is the process of combining different assets, in this case single-family homes rental payments, into ‘pools’. Those pools are then divided up by their level of risk and marketed to investors with compatible risk profiles. Each pool or tier or tranche also determines priority of payment to the holder or owner. The top tier or Aaa Bond holder is paid first and then so on down the line. The benefits include providing greater liquidity in a market as well as diversifying and spreading risk. However, detractors say it is these very financial instruments that got the country into the most recent financial crisis and that their creation puts unnecessary divides between owners, renters and investors.

Since its first mention in 2012 the hype, anticipation and most of all skepticism surrounding the idea of creating a never-before-seen security permeated the marketplace. In the early days and even months before the eventual creation of a security, the rating agencies remained some of the most vocal critics of the new bond’s success.

However, in November of 2013 Blackstone, with the help of numerous investment firms on Wall Street, did in fact issue the first single-family rental security in history. Its reception was overwhelmingly positive and those intimately involved in its success as

well as indifferent observers agree that the future appears bright and robust for such fixed income structures.

5.2 Single-Family Rental Securitization

The fundamental key to the success of securitizing single-family rental incomes is investors' ability to obtain high-level ratings from the various ratings agencies. Fixed income buyers such as pension funds and life insurance companies must often adhere to investment and risk constraints including purchasing only Aaa bonds. To discerning operators like Blackstone, achieving such ratings remains vital to the instrument's salability and thereby their ability to successfully securitize the rental streams.

In 2012, rating agencies were reeling from the public relations beating they continued to take over the CMBS and subprime mortgage crisis surrounding the housing collapse. Their new found desire to get everything right is reflected in the year and a half it took them to warm to the possibility of rating pools of SFR cash flows.

The main players in rating these bonds include The Big Three: Moody's, Fitch and S&P as well as Kroll, DBRS and Morningstar. Moody's, Morningstar and S&P released three of the first ratings analysis on securitizing single-family rental homes in the summer of 2012 followed by more updated reports by Moody's and Fitch in January of 2013. In all three reports there are overarching concerns that illustrate the complexity and risks associated with securitizing this new asset as well as a hesitancy to provide any significantly high rating.

The concerns shared by the rating agencies prior to the October Invitation Homes offering include:

1. Lack of historical data
2. Operator and manager performance

3. Variability of cash flows
4. Investors' security interest in the collateral in the case of bankruptcy

Among the list of concerns, the current lack of historical data for single-family rental investments is the one hardest for investors like Blackstone to immediately remedy. Rating agencies and future bond investors require comprehensive market data in order to properly calculate loss severity as well value the assets under varying stress scenarios. Specific to single-family rental properties they are looking for historical data on:

- Rent levels
- Delinquency rates
- Vacancy rates
- Expense ratios
- Rental yields
- Re-leasing periods
- Market performance

All of these figures impact expected cash flow projections, which are used along with operating expense assumptions to stress the investment and assign a proper rating.

In order to achieve those ratings, organizations like Moody's rely on some multi-family historic data as well as single-family property price data including distressed sales. However, the information on the rental market remains sparse. Even as data pours in from new institutions operating in the space since 2011-2012, rating agencies view it as 'finite in duration and geographical breadth'⁵⁷. Analyst at Fitch Ratings admit, "Although some firms have a few years' operating history, most do not have a proven track record managing in a down cycle, outside their footprint, or on a large-scale basis⁵⁸."

⁵⁷ Moody's Investor Service Report, August 23, 2012

⁵⁸ Shen, "Rental-Home Securitizations Unlikely to Get Best Fitch Ratings."

The resulting uncertainty adds volatility to cash flow projections in both expected and stressed scenarios. Rating agencies are therefore asking for more downside ‘protection’ than they might otherwise request if historical data was available.

When securitizing single-family rental streams agencies are taking a very close look at the operations aspect of the investment. They recognize the viability of meeting cash flow projections rests in the skill and quality of the operator. Additionally, as a potentially new asset class, rating agencies are concerned with the untested strategies of managing thousands of diverse properties across equally diverse geographies and markets.

Specifically, rating agencies are concerned about operator’s ability to:

- Set appropriate rent levels
- Navigate local laws and ordinances pertaining to rentals
- Properly collect rents
- Evict tenants in a timely manner
- Quickly re-lease properties
- Maintain properties (effects rent collection, home price appreciation, and turnover durations)
- Appropriately market the properties
- Handle operator bankruptcy (disrupts property management and rent collection)

Many of these concerns by rating agencies are assuaged by financially strong operators who demonstrate extensive experience in both single-family rental operations as well as across varying geographic locations. Ideally, these operators will have a track record of high performing properties as well as examples of disposing of properties at fair market values⁵⁹. Again, we look at the formation of Invitation Homes, currently the largest player in the field. Blackstone partnered with Riverstone Residential Group, one of the

⁵⁹ Moody’s Investor Service Report, August 23, 2012

country's largest multi-family management firms. Riverstone brought with them an abundance of experience and market knowledge that greatly supported Blackstone's case with rating agencies.

The next major concern is the proposed dual cash flow structure. In other words, SFR operators are claiming cash flows from not only rents but also the eventual sale of the home. The concern among detractors is the fact that each piece is vulnerable to market trends and downturns. For example, if rental markets weaken, the income from rents may become insufficient to cover operating expenses and other ongoing liabilities. Rents could decline as a result of the oversupply of rental housing in the market or regional employment declines requiring tenants to migrate out of the area or a switch back to ownership.

Investors explain that as a partial hedge, if or when homeownership becomes more desirable than renting, institutional investors can opt to sell in what will likely be an advantageous market. In other words the market shift will actually benefit their investment strategies. In the case of securitization bond buyers are not exposed to home price appreciation or depreciation unless the security defaults and assets need to be sold to cover the bond repayment.

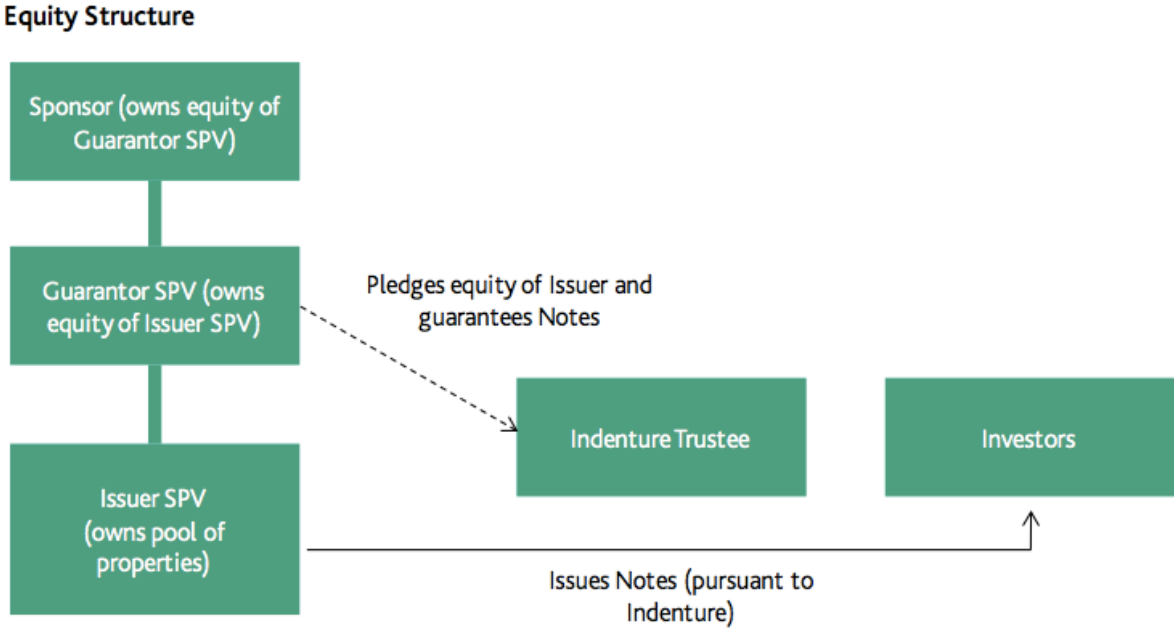
Still, rating agencies note that instead of selling to cover foreclosures or non-performing RMBS, operators in SFR homes will sell them at whatever time will most benefit the transaction. Again, if they are forced to sell the risk remains around poor timing in a down market. Additionally, rating agencies are concerned about high concentrations of properties in certain locales, where a forced sale could potentially flood a regional real estate market and further reduce home prices and thereby hinder repayment of each class of bonds.

However, the most significant sticking point among rating agencies is the notion of what security interest investors' possess in the collateral in the case of bankruptcy. Whereas in CMBS and RMBS investors maintain senior rights on the underlying collateral, initial

structures presented by SFR operators offered only an equity lien or lien on the equity of the entity or entities that own the single-family homes. In other words, investors are entitled to no direct lien on the *key collateral* in the case of a bankruptcy.

In January of 2013, Moody’s released a report specifically addressing their concerns about securitizing single-family rental properties without mortgages, “Equity structures expose investors to low-probability but high-severity risk following a sponsor’s bankruptcy⁶⁰.” Specifically, the concern is that in the case of bankruptcy a court might substantively consolidate the group of properties and thereby negatively impact the entire pool instead of individual properties. In the case of securitizing homes with mortgages the trustees would be able to recover funds for investors based on the underlying mortgages *before* paying any creditors or lien holders (see Figure 9).

Figure 9



Source: Moody’s Investors Service

⁶⁰ Moody’s Investor Service Report, January 17, 2013

Additionally, an equity structure would allow the operator to place additional liens on the property, which would subordinate the securitizations claim. Similarly, the operator would be free to sell individual properties at will without any further authorization. In both instances the concern is for those investors who purchase the highest tranche of bonds and the traditional sense of security provided to those tranches with the lowest risk. The bonds will not be purchased if buyers believe that in the event of a bankruptcy they will *not* enjoy any priority based on the tier they own. The most significant consequence for operators in advocating for an equity structure is the fact that universally, the rating agencies would not provide a rating of higher than Baa1 (S&P/Fitch: BBB+) or just above investment grade. The result would be a diminished market of buyers and a much less attractive view of the total product. They would in a sense be creating junk bonds.

Investment firms like Blackstone originally pushed back on rating agencies claiming the origination fees and registration costs associated with placing a mortgage on every property would not be economical. The rating agencies continued to make their case and by the fall of 2013 Blackstone acquiesced and committed the time, effort and funds to create first lien priority for its first securitization. However, instead of a mortgage on each property as initially suggested, Blackstone created one single loan for the entire portfolio as well as a grant of a security interest in all personal property of the borrower⁶¹. In the end, analysts agree that “the new deal has characteristics of both types of structured finance (CMBS and RMBS), and the rating agencies who rated it used a combination of both residential and commercial rating methodologies to evaluate it⁶².”

In addition to scrutiny applied by the rating agencies, those looking to securitize part of their SFR portfolio must expect and be prepared for a considerable examination of their entire operation. Whereas buying individual properties for cash, yields minimal public inspection, bringing on debt, new investors and market regulations forces operators to

⁶¹ “Kroll Bond Rating Agency Assigns Final Ratings to Invitation Homes 2013-SFR1.”

⁶² Alloway and York, “Blackstone Tests Waters with First Security Backed by Rented Homes.”

bare it all and demonstrate a very high level of proficiency. Stephen Blevit, a partner at Sidley Austin who worked on the Invitation Homes structure explained, “Lots of legal work went into doing the first deal...so many properties, so much title work to do, [we had to] get the right service providers, BPO providers, and title agents involved and it took a lot of work.” Most important among lenders and securitizing firms is an operator’s ability to demonstrate viability in their cash flows as well as their ability to manage and operate each home at the highest level. Specifically, focus is placed on the rental incomes and what is done with it once a tenant makes a payment.

Questions banks and attorneys ask include, do tenants pay online? How is the cash managed? Is there a lockbox or some type of separation of those lease payments? What are the ‘anti-money laundering’ safety nets in place? What is the delinquency policy? Does the operator offer ‘cash for keys’? Do you have title on *all* of your properties? Are properties fully leased and rehabilitated? What level of due diligence is done on each property? Those looking to securitize a pool of their portfolio must be prepared to answer any and all of these questions and concerns.

Lastly, borrowers must have very strong ‘reps and warranties’. Reps and warranties or representations and warranties made by both the buyer and seller are essential on both the loan and transaction level. Professionals believe that such insurances and assurances must be as ‘robust’ as what is currently expected among CMBS deals⁶³.

All of these hurdles faced Blackstone and their subsidiary, Invitation Homes and it was their ability to overcome them and meet the requirements set forth and in some cases newly created by the rating agencies, attorneys and lenders that allowed them to be the first to create this new fixed income structure in late 2013.

⁶³ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

5.3 Case Study – 2013-SFR1

In early November of 2013, after months of adjusting and rearranging, Blackstone's subsidiary Invitation Homes released a first-of-its-kind fixed income security backed by single-family rental incomes. The prospect of such a bond had been talked about for more than a year. However, few thought that it would be received so well and even fewer thought it would garner a Aaa rating from three of the biggest rating agencies on Wall Street. Although the supporters drowned out the naysayers upon its release, it remains to be seen if the security represents a one-time offering or the future of a new asset backed security.

The final transaction, dubbed 2013-SFR1, is collateralized by a \$479.1 million non-recourse, first lien, floating rate mortgage loan secured by 3,207 single-family homes. The term is for two years but allows for three one year extension options and consists of six classes of pass through certificates identified as class A through F. Class A is rated Aaa and in the amount of \$278.7 million or 58% of the overall offering. The option to extend is determined by the bond buyers. If they choose *not* to extend the term of the security, Blackstone must payoff the loan.

Blackstone maintains an equity interest in the underlying single-family homes and after two to five years (depending on extensions) will realize any up or downside if or when they sell each home. Below is a comprehensive overview of the offering and the individual parties involved:

Invitation Homes 2013-SFR1

- Collateralized by \$479,137,000
 - \$278.7m of Class A assigned Aaa
 - \$34.3m of Class B assigned Aa2
 - \$47.1m of Class C assigned A2
 - \$31.5m of Class D assigned Baa2

- \$46.0m of Class E assigned Baa3
- \$41.5m of Class F assigned Ba2 (Non-investment Grade)
- Secured by mortgages on 3,207 income producing single-family homes
 - One to four unit residential homes in AZ, CA, GA, FL, and IL
- 2-year Term
- Three 12 month extension options
- Collateral is non-recourse, first lien, floating rate mortgage loan
- Broker Price Opinion (BPO) - \$639 million
- Debt Service Coverage Ratio: 1.60X to 1.27X at current LIBOR (Avg. 1.50x)
- 2013-SFR1 is structured as a real estate mortgage investment conduit (REMIC).
- Seven classes of certificates will be issued: 6 entitled to principal and interest and the seventh a residual class.

Securitization Parties:

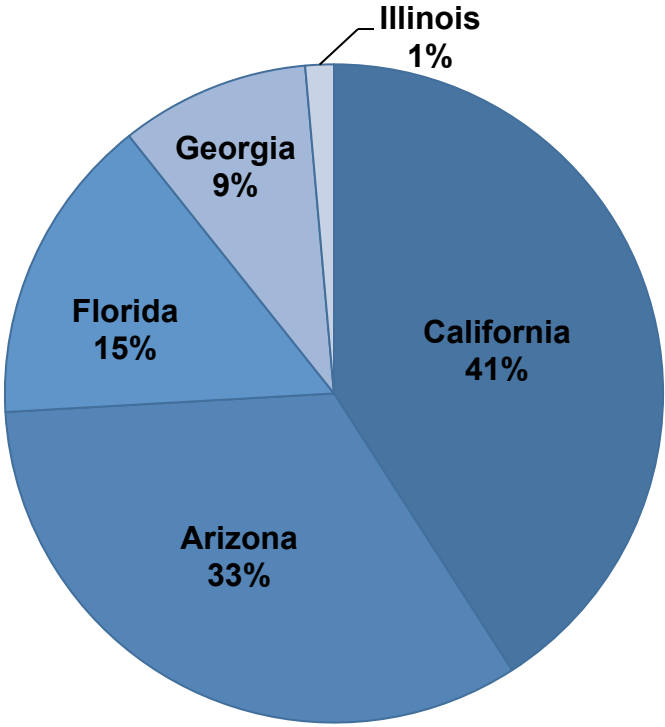
- Issuer: Invitation Homes 2013-SFR1 Trust
- Depositor: Deutsche Mortgage and Asset Receiving Corp.
- Borrower: 2013-1 IH Borrower LP
- Loan Sponsor: Invitation Homes, LP
- Originator and Loan Seller: German American Capital Corp
- Servicer: Midland Loan Services (division of PNC Bank)
- Special Servicer: Situs Holdings, LLC
- Certificate Administrator: Wells Fargo
- Trustee: Christiana Trust (division of Wilmington Savings Fund Society)

Pulling from the more than 40,000 homes that Blackstone owns they chose 3,207 from specific locations among 18 different Metropolitan Statistical Areas (MSAs) in just five US States. Specifically, they picked properties in Arizona, California, Georgia, Florida and Illinois. Choosing to pull geographically diverse single-family homes into their first

structure helped to satisfy rating agencies desire for cross-collateralization and cross-default, although in reality the concentration of properties remains an issue.

Figure 10

Investment Distribution By State



Source: Moody's Investors Services Report 2013

The majority of the homes are three to four bedroom, two bathroom structures and all of them were previously refurbished by Invitation Homes. The average size is 1,700 square feet and as of October 1, 2013 the portfolio was 100% leased with a weighted average remaining lease term of 8 months.

Table 3

Collateral Overview

	Minimum	Maximum	Average
BPO Values	\$74,000	\$650,000	\$199,205
Total Cost Basis (Post-Rehab)	\$71,599	\$483,005	\$169,266
Total Upfront Renovation Costs	\$1,110	\$100,982	\$23,836
Contractual Rent per Month	\$641	\$3,100	\$1,448
Underwritten Net Cash Flows	\$4,295	\$22,763	\$10,459

Source: Moody's Investors Services Report 2013

In terms of the loan, Moody's calculates a 1.30x debt service coverage ratio (DSCR) based on average rents of \$1,312 per month and a range of \$641 to \$3,100 per month⁶⁴. Overall, Invitation Homes is reporting net cash flows (NCF) of \$30.5 million per year including expenses, taxes, vacancies, turnover costs and capital expenditures reserves (see chart below).

⁶⁴ Moody's: "Pre-sale Report" October, 2013.

Table 4

IH 2013-SFR1 UW NCF

	Total	Per Property	Percent of Rent
Rental Income	\$50,493,909	\$15,745	100%
Other income	\$436,942	\$136	0.9%
Vacancy	(\$3,029,635)	(\$945)	-6.0%
Net Revenue	\$47,901,217	\$14,936	95%
Property Management Fee	(2,847,856)	(888)	-5.6%
HOA Expenses	(969,419)	(302)	-1.9%
Insurance	(1,245,421)	(388)	-2.5%
Property Taxes	(5,875,364)	(1,832)	-11.6%
Leasing/Marketing	(1,122,269)	(350)	-2.2%
Repairs and Maintenance	(2,371,835)	(740)	-4.7%
Maintenance Turnover			
Costs	(1,517,762)	(473)	-3.0%
CapEx Reserves	(1,443,150)	(450)	-2.9%
Total Expenses	(17,393,076)	(5,423)	-34.4%
Net Cash Flow	\$30,508,141	\$9,513	60.4%

Blackstone is reporting an overall 75% loan to value ratio. Although the securitization is made up of one mortgage loan each property accounts for an allocated loan amount equal to 75% of the properties broker price opinion (BPO)⁶⁵. The loan is for \$479.1 million while the BPO, is calculated to be more than \$638.8 million (see chart below).

⁶⁵ Ibid.

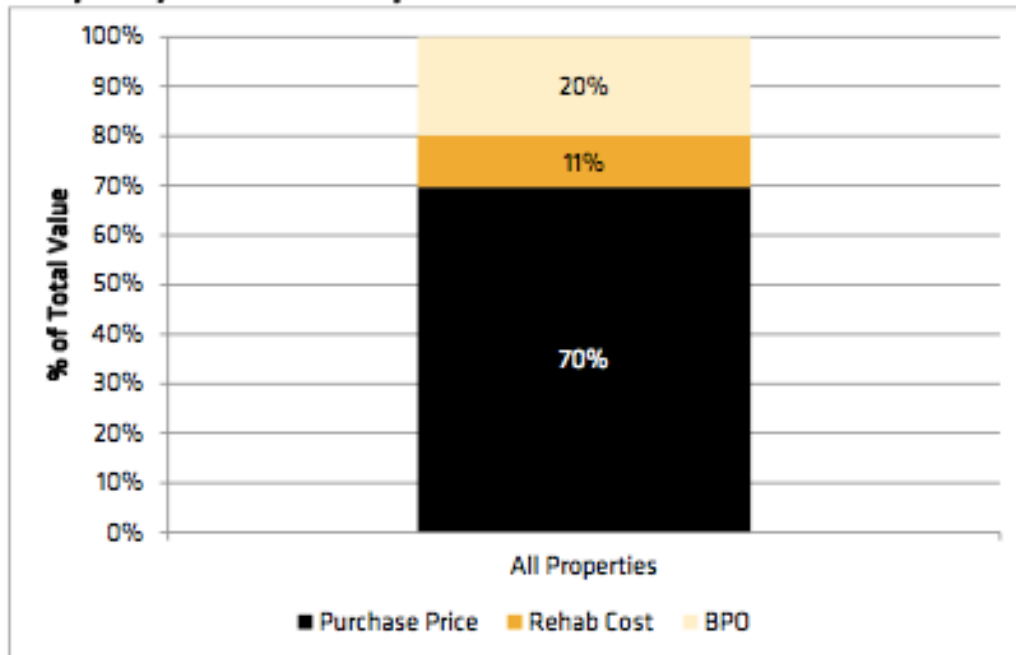
Table 5

Geographic Distribution (MSA)			
MSA	Count	BPO (\$)	BPO % of Total
Phoenix-Mesa-Scottsdale, AZ	1,365	217,349,000	34.02%
Riverside-San Bernardino-Ontario, CA	415	110,168,453	17.24%
Los Angeles-Long Beach-Santa Ana, CA	210	76,614,100	11.99%
Atlanta-Sandy Springs-Marietta, GA	325	60,345,415	9.45%
Sacramento-Arden-Arcade-Roseville, CA	239	48,519,100	7.59%
Tampa-St. Petersburg-Clearwater, FL	257	48,380,990	7.57%
Orlando-Kissimmee, FL	123	21,837,317	3.42%
Vallejo-Fairfield, CA	43	10,986,000	1.72%
Lakeland, FL	66	9,461,600	1.48%
Chicago-Naperville-Joliet, IL-IN-WI	42	9,248,069	1.45%
Miami-Fort Lauderdale-Pompano Beach, FL	31	7,016,000	1.10%
Sarasota-Bradenton-Venice, FL	38	6,078,400	0.95%
Oxnard-Thousand Oaks-Ventura, CA	10	4,059,000	0.64%
San Francisco-Oakland-Fremont, CA	10	2,669,800	0.42%
Yuba City, CA	11	1,992,900	0.31%
Deltona-Daytona Beach-Ormond Beach, FL	11	1,711,500	0.27%
Stockton, CA	5	1,164,200	0.18%
GA, Non-Metropolitan Area	3	649,000	0.10%
Jacksonville, FL	3	599,000	0.09%
Total	3,207	638,849,844	100%

Source: Kroll Bond Ratings

Figure 11

Property Value Composition



Source: Kroll Bond Ratings

Broker price opinions are often regarded as an inexpensive and imprecise version of appraisals and to those agencies looking to rate the bonds, Blackstone's decision to use BPO's added an additional level of uncertainty to the new structured finance product. However, this was far from one of the larger concerns among investors and ratings agencies who took a very long time to look at and find the best way to bring this new ABS product to market. Daniel Rubock of Moody's, who worked on the 2013-SFR1 deal said, "It was actually a year and a half process trying to find out what the best structure for the first maiden deal [would be]⁶⁶. Attorney Stephen Blevit, a partner at Sidley Austin, who also worked on the Blackstone securitization described it further, "The first deal was a little bit of trail and error, and lots of legal work went into doing the first deal.⁶⁷"

Some of the concerns addressed in Blackstone's offering include switching from an equity structure to one that benefits from a direct lien on the properties. Additionally, rating agencies saw reassurances in: cross-collateralization; experienced in-house property managers; the 'strong sponsor' status of Blackstone as the parent company; creation of a lockbox and in-place cash management system; equity pledge; independent BPOs on all properties; and a 100% occupancy rate⁶⁸.

Still, even though 2013-SFR1 was rated highly in its Class A tranche, the ratings agencies continue to have real concerns. Specifically, they worry about the lack of historic data on the SFR market. In an effort to mitigate these concerns Invitation Homes is providing data from across their entire portfolio such as a 72% renewal rate on leases signed or their ability to lease up 95% of their properties available for rent for 60 days or more. Still, it will take many more years and aggregation of renter data before ratings agencies can feel more comfortable.

⁶⁶ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁶⁷ Ibid.

⁶⁸ Moody's: "Pre-sale Report" October, 2013.

Finally, rating agencies like Kroll expressed concern for the choice by Blackstone to pay for broker price opinions (BPOs) instead of providing full appraisals on each property. BPO's are less expensive to Blackstone but are also considered much less precise. These potentially imprecise evaluations have the potential to effect the advance rates provided by borrowers in a securitization deal. Advance rates are the maximum percentage of value of a collateral that a lender is willing to place on a loan and provides a cushion to the lender in the case of default. In order to minimize this risk, banks and lenders greatly scrutinize the brokerage firms performing these BPOs.

David Lefkowitz, managing director of JP Morgan Securities explained, "We went out to Green River (BPO provider) and actually did an operational risk assessment ranking and they were above average on their operations. We spent a lot of time in their office going through how they do BPOs, getting comfortable with the evaluations and getting comfortable with the 'comps', understanding their realtor network and got very comfortable with the BPO values⁶⁹."

All of these efforts and industry education on the new product helped to dampen the negative impression of the SFR space and increase positive anticipation for 2013-SFR1. By November, 2013 it was considered by some to be "the most hotly anticipated [structured finance] deal of 2013"⁷⁰ the new product tantalized people across the financial world including the 2013 Nobel Prize for Economics recipient Robert Shiller who tweeted on November 4th, "Packaging foreclosed homes for investors could mark a revolution."

Upon its release 2013-SFR1 was viewed as "an absolute blowout, attracting scores of investors desperate for access to any aspect of US residential mortgage credit after a five-year drought⁷¹." In fact the hype was so impactful that initial estimates of A-piece

⁶⁹ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁷⁰ Tempkin, "Blackstone Invitation Homes 2013-SFR1", IFR, December 2013.

⁷¹ Tempkin, "Blackstone Invitation Homes 2013-SFR1", IFR, December 2013.

buyers getting 150bps premiums over traditional 'known CMBS' products ended up being only a 115bps premium due to the demand.

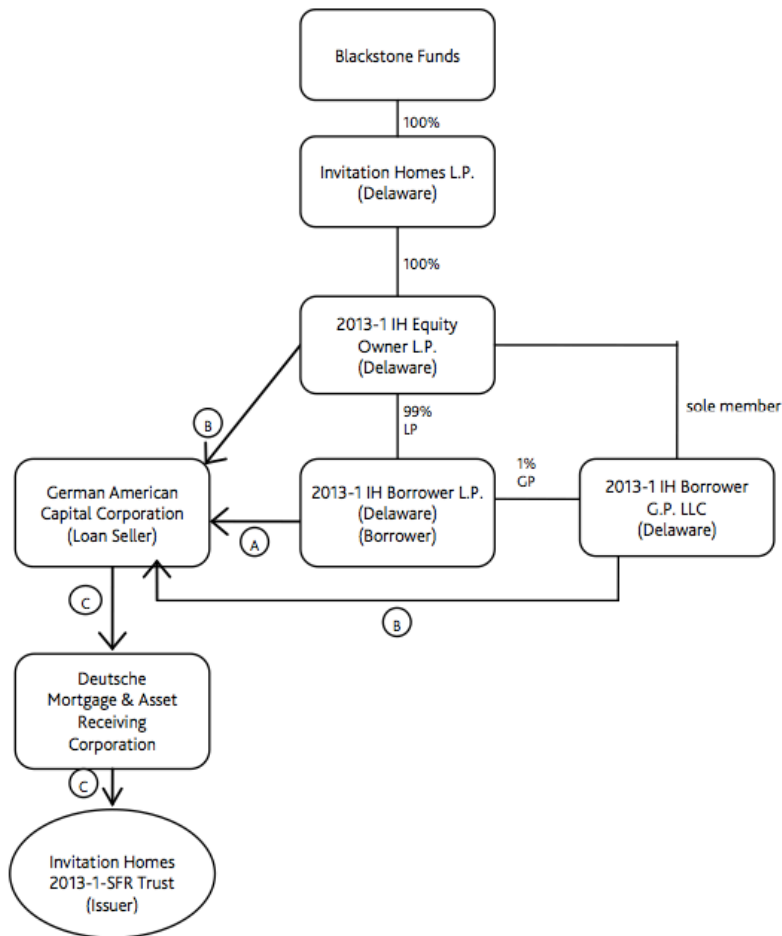
However, there were those who did not buy into the new securitization claiming that the returns were simply too low for the amount of risk demonstrated by this new and unproven asset. Moreover, the demand, they say, is not based on confidence in the product but a high level of liquidity in the market that makes investors chase any and all yields. This high demand coupled with the scarcity of investments squeezes returns to the point where people are overpaying for returns at a higher risk.

In many ways Blackstone and Invitation Homes was the perfect canary in the coalmine for single-family securitization proponents. As Moody's and other rating agencies pointed out, they are a strong sponsor and bring with them expertise and a very large financial backing in the case of future unforeseen volatility. The company also knows and understands Wall Street and what it requires to make a deal successful. Blackstone strategically chose properties based on geography, years purchased, level of rehabilitation and rent stability to fulfill its first pool of homes.

All of this contributed to the impressive and positive reception 2013-SFR1 enjoyed in mid-November and to those in the marketplace, it bodes well for the future of securitization. Now that the template for securitizing single-family properties is built and many of the concerns addressed going forward should be a lot easier, according to Daniel Rubock of Moody's⁷².

⁷² IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

Figure 12



Source: Moody's Pre-Sale Report October 2013

5.4 SFR Securitizations in 2014 and Beyond

If 2013 was the year of buying homes and setting the foundation for securitization, then analysts are predicting 2014 as a year much more focused on securitizing those rental streams. In a recent HousingWire article the future of SFR securitization appears robust, “The purchasing of properties for potentially pooling into securitizations, on the other hand, hit \$15 billion, with Blackstone totals equal to nearly half of that. Of that, up to \$5 billion holds securitization potential⁷³.”

⁷³ 5 and Comments, “Rental Securitization Market Could Hit \$5 Billion next Year.”

Ryan Stark, a Director at Deutsche Bank, and David Lefkowitz of JP Morgan are even more bullish, predicting somewhere between six and eight billion dollars of issuance, additionally they believe the market will see four to five *new* issuers. In referring to 'new issuers' they mean operators other than Blackstone/Invitation Homes who are securitizing a portion of their single-family homes. Colony American Homes and American Homes 4 Rent are the likely front-runners in this area. Stark and Lefkowitz also expect to see the first multi-borrower securitization deal which will be even more complicated but achievable, they think.

Wall Street investors are hungry for this new product and operators of single-family homes have spent the better part of the last two years building what they believe are attractive investment homes. Due in part to the year and a half of work carried out by firms like JP Morgan, Deutsche Bank, Blackstone, Moody's and others, the road map to securitization is no longer ambiguous.

CHAPTER 6 – SFR REAL ESTATE INVESTMENT TRUSTS (REITS)

6.1 SFR REIT Overview

Real Estate Investment Trusts or REITs are ‘pass-through’ investment vehicles that distribute at least 90% of their earnings and capital gains to shareholders. In 1960 the US Congress created REITs through the Real Estate Investment Trust Act. “REITs offer investors a liquid way to invest in a diversified portfolio of commercial property, [while] at the same time, [providing] a way for commercial property to obtain equity capital financing via the public stock market⁷⁴.” However, more important than obtaining equity financing, REITs provide important tax exemptions to owners and operators. Specifically, REITs do not pay income taxes on rents and other income streams.

In order to maintain a REIT designation, REITs must pass an ownership test, an asset test, an income test and as previously stated a distribution test⁷⁵. Among most REITs operating today the concentration in real estate types in order from largest to smallest include regional malls, other retail products, apartments, office and industrial. Single-Family Home REITs, having only come about in late 2012 do not even register on the spectrum. Still, in the past year more companies in the SFR space chose IPO’ing as a way of formalizing their business strategy, obtaining more funding for investment and in some cases pulling already invested money out.

⁷⁴ Geltner-Miller, “Commercial Real Estate”, 3rd Edition, 2014.

⁷⁵ Ibid.

6.2 Size of the REIT Market

The single-family rental REIT market place is relatively small but growing at a pace in keeping with the explosive nature of the SFR investments. In 2011 there were no SFR REITs in existence and it would not be until December 14, 2012, when Silver Bay Realty Trust Corp IPO'd for \$300 million with a market cap of \$709 million that such an operation became public.

Twelve months later there are now three public REITs in the single-family rental space including Silver Bay Realty Trust (SBY), American Residential Properties (ARPI) and American Homes 4 Rent (AMH). Together these REITs make up a combined market capitalization of \$4.16 billion (Note, this figure fluctuates with the market and could be as high as \$5b). Combined these REITs control nearly 33,000 single-family homes across almost half the states in the US. In the third quarter of 2013 they collectively spent two thirds of a billion dollars on additional home purchases throughout states like Texas, Arizona, California, Florida and Georgia. During that same quarter these REITs renovated more than 7,000 homes at a cost of \$5,000 to \$10,000 per home at a total cost potentially reaching \$70 million.

2013 also saw two failed IPO attempts by major players including Waypoint Homes and Colony American Homes. Still, operators in both the private and REIT organizations remain bullish on the future of SFR REITs while investors continue to be cautiously optimistic if not at times bearish on the same. In November of 2013, Baron's investment publication wrote, "Twitter had the splashiest initial public offering of the past year, but three quieter debuts may prove more important. These companies turn single-family rental homes into Wall Street shares to be held by investors in their brokerage accounts. If they thrive they could alter America's housing market. But for now, view them cautiously⁷⁶."

⁷⁶ AUTHOR, "Single-Family Home REITs."

Table 6

REIT Overview

	Homes Owned	Leased	% Leased	Q3 Homes Purchased	Q3 Expenditures	Q3 Homes Renovated
AMH	21,900	15,800	72%	2,900	\$450,000,000	5,300
ARPI	5,440	4,100	75%	1,351	\$204,000,000	834
SBY	5,600	4,550	81%	0	\$0	1,000

6.3 REIT Strategies

In listening to CEO's at the 2nd annual REO-to-Rent Forum as well as investigating REIT earnings call transcripts illustrates the reality that the strategy among REITs is similar to private operators and those looking at securitization. Specifically, REIT operators believe there is enormous potential to bring technology and institutional management to branding, marketing, servicing and operating single-family rental homes, however, while they all remain optimistic on the SFR space, their pace of acquisition dramatically slowed toward the end of 2013.

The early participants in the SFR market viewed the investment, as an economic play in the discount on homes prices, however, more so than low prices was the fragmentation and disorganization of the market. As a mom and pop run enterprise there was no branding, no marketing, no technology and no service offering among single-family home renters. Doug Brien of Waypoint Homes explained, “[We saw a] real opportunity to come out and build a brand and build a platform. The concept of the customer service and quality home [was lacking and we saw an opportunity to] focus on aesthetic and functional quality⁷⁷.” Brien’s competitor, Steven Schmitz, CEO of ARPI, agreed, “If you can build that technology and machinery to keep customers happy, you can reduce turnover⁷⁸.” Streamlining and institutionalizing are viewed as the answer to operational

⁷⁷ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁷⁸ Ibid.

efficiency just like those operating privately in the SFR space. The process causes a tremendous amount of 'brain damage' but CEO's like Schmitz and Brien view them as a necessity and key strategy to success.

Across the few REITs in existence there seems to be a slight shift in strategy from the previous year. Whereas in 2013 REITs focused primarily on the robustness of their acquisitions and the yield from appreciation they are now directing their efforts more to improving operating efficiencies and rental yields.

Again Doug Brien of Waypoint described the 2013 as "constantly flooring the car toward a cliff" where the cliff represents running out of capital. Waypoint, throughout the past year was spending close to \$60 million a month on single-family home purchases and as Brien put it, they began to run out of high net worth individuals and the need for a constant and reliable stream of funding was constantly a challenge. Although Waypoint was not able to complete their IPO in 2013 they announced a joint venture with Starwood Homes that is expected to result in a REIT spinoff to be completed in February 2014. Still, their 2013 strategy is representative of many of their REIT peers.

In March of 2013 AMH raised \$748 million of common equity and again in August where they raised an additional \$887 million⁷⁹. In June of this year they acquired a 7,500 home portfolio followed by bringing all of their management operations in-house. By the end of October 2013 AMH owned 21,900 properties of which 15,800 were leased. More in keeping with the strategic trends described previously, AMH acquired approximately 2,900 during the third quarter of 2013 and is expecting that number to drop further to 2,000 homes purchased in the Q4⁸⁰.

This slow down in purchasing is even more apparent at Silver Bay Realty Trust Corp where they doubled their portfolio in the first two quarters of 2013 but made almost no purchases in Q3. According to SBY CEO David Miller, "In the third quarter we

⁷⁹ "American Homes 4 Rent's CEO Discusses Q3 2013 Results - Earnings Call Transcript."

⁸⁰ Ibid.

dramatically slowed our acquisition pace and focused on stabilizing the portfolio. As a result, the number of homes in the portfolio has remained relatively unchanged since the second quarter⁸¹.”

Part of REIT operator thinking in buying so many properties is the notion of achieving a certain scale level on a regional basis. ARPI co-founder Laurie Hawkes explained on a recent investor call, “We continue to acquire in our core market...we believe we need to own 300 or more homes in the market to begin leveraging the operational efficiencies that comes with critical maths⁸².” Specifically, she goes on to say, “With the purchases we made in the third quarter, we now have achieved or our approaching operational efficiencies in eight states with 1,300 or more homes in Arizona and Texas, 400 or more homes in North Carolina, Indiana and Illinois and nearly 300 homes in California, Georgia and Florida⁸³.”

Still, as SFR REITs continue to buy and tweak their investment strategies, Wall Street looks on with a keen and skeptical eye. Time will tell whether taking SFR investments public as REITs is strategically advantageous or even whether the investment as a whole will prove fruitful but in the meantime perception is reality and time among those watching is limited.

6.4 The Current State of REITs

The current condition of the SFR REIT market is one of proving to investors and Wall Street that their investment strategy is not only viable but profitable. REIT managers are slowing their acquisitions in order to focus on improving their operations and boosting gross yields.

⁸¹ “Silver Bay Realty Trust’s CEO Discusses Q3 2013 Results - Earnings Call Transcript.”

⁸² “American Residential Properties’ CEO Discusses Q3 2013 Results - Earnings Call Transcript.”

⁸³ Ibid.

Pat Whelan, the CEO of Beazer recently explained, “Institutional REIT Buyers are in ‘show me mode’ because they don’t believe in the market...[they’re saying] ‘Show me the metrics, show me the numbers, and lets watch this play itself out’⁸⁴.”

REITs are attractive to investors looking for high dividend payout as the structure demands that all profits are ‘passed through’ to investors in order to justify not paying federal income taxes. However, SFR REITs in 2013 were focused on buying at discounted prices and not focused as much on maximizing rental income as a percentage of the purchase price. As a result the ‘profits’ or ability to distribute substantial dividends were negligible. One market observer wrote in November 2013, “REITs are prized for their dividend payments, but the single-family ones aren’t yet profitable enough to produce much income. Silver Bay pays only a negligible dividend of a penny per share each quarter and the other two pay (AMH & ARPI) nothing⁸⁵.”

Other concerns among potential equity investors include: decentralized business models (or third party property management), crowded market can limit margins, all cash home purchases exposes asset portfolio to inflation, and limited exit strategy⁸⁶. As a first run REIT, Silver Bay has not proven to be a pillar of promise and opportunity. The stock opened at \$18.50 in December of 2012, shot up to \$22 a share over hype but has since dropped and stayed at around \$16 a share and was recently trading below its Net Asset Value (NAV).

The NAV takes all of a REITs’ market value, subtracts its liabilities and divides that by the number of outstanding shares. By reporting NAV, REITs like Silver Bay allow investors a better understanding of a REITs capital appreciation as a component of their total return profile. However, there are investors and industry professionals who are skeptical about how liabilities are calculated and in fact some REITs like American Residential Properties that are not disclosing their NAV estimates.

⁸⁴ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁸⁵ AUTHOR, “Single-Family Home REITs.”

⁸⁶ “Silver Bay Realty Trust - A Business Model Doomed To Fail.”

However, all is not bad for REITs at present and in fact many argue that in the third and fourth quarters of 2013 they have showed only promising numbers. One such REIT is American Homes for Rent (AMH), which saw a \$0.09 FFO per share in the third quarter of 2013 (FFO of \$19.6mm). FFO or Funds From Operations is perhaps the most widely used REIT industry measuring stick of success. FFO, in the most basic sense, illustrates the cash flows generated from operations while also adding depreciation and amortization expenses.

As a result of their cash flow from operations AMH was able to issue a \$0.05 quarterly dividend to start in December 2013. However, “Even more interesting is the operating income of \$31 million. It clearly shows that the leasing process produces solid returns, but the question is whether these rental firms can reduce the expenses of operating vacant properties. In the latest quarter, those expenses equated to \$7 million, or nearly 16% of revenue⁸⁷.” In other words, ‘The Street’ is growing more interested in SFR REITs but will not relinquish its skepticism.

The CEO of Reven Housing REIT, Inc., concluded, “public investors want to see dividends and profitability and we must deliver that to compete against other REITs if we really want to grow this business⁸⁸.”

6.5 The Future of SFR REITs

Over a five to ten year period REIT managers remain optimistic and bullish on the growth potential for SFR REITs while in the short term they expect to see additional IPO’s with a renewed focus on profitability and operating margins and less on acquisitions and scaling up.

⁸⁷ “American Homes 4 Rent Offers Intriguing Value.”

⁸⁸ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

According to NAREIT there are 170 publicly traded REITs currently operating with in the United States that comprise a market capitalization of approximately \$580 billion⁸⁹. CEO Chad Carpenter, of Reven Housing REIT, Inc. explained the size of the market in a recent REO-to-Rental forum in December of 2013, “Out of that market cap apartment REITs are approximately 17% and if you compare how many apartment units there are in the US to single-family housing there’s about 25 million apartment units in the US and there’s currently 14.5 million single-family housing units⁹⁰.” Using these percentage breakdowns and comparisons Carpenter suggests that the potential market capitalization among single-family housing REITs could reach \$35 to \$40 billion as the market matures over the next few years. This figure is supported by Beazer Pre-Owned Rental Homes CEO Patrick Whalen who said, “I think [we’re looking at a] 10x multiple of existing market cap looking forward⁹¹.”

Additionally, Waypoint Homes and Colony American Homes looked to go public in 2013 but were unable to successfully carry out the process and delayed any such move until 2014. If both companies complete an initial public offering in early 2014 (as projected) the market cap among single-family housing REITs could jump to close to \$7 billion. Still, this figure appears far from the \$35 billion mature-market project laid out by Mr. Carpenter who says the SFR REIT market is still in the 2nd or 3rd inning for the core public strategy⁹².

In 2014 SBY, ARPI and AMH will direct the bulk of their efforts boosting earnings. Earnings will come from improvements in renovations, leasing, rent collection, services, mitigating turnovers, minimizing delinquencies, better underwriting tenants and looking for high yield buying opportunities only.

REITs understand improvements in these areas will boost FFO and NAV figures and help prove to the market their viability and profitability. The importance of each REITs

⁸⁹ “Research and Markets.”

⁹⁰ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁹¹ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

⁹² IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

success cannot be understated as CEO Steven Schmitz explained, “At this stage in the industry we want everyone to do well. We don’t want any missteps because the world paints with a broad brush and that will hurt all of us⁹³.”

By demonstrating success both private and public investment firms will be able to attract more capital and take advantage of the growth potential seen throughout the single-family space. Despite skepticism and criticism from potential equity investors, REIT managers are anything but down on the future market potential in this growing market are in which they believe in unequivocally. Chad Carpenter, of Reven puts it into historical perspective, “I tell people we’re out buying houses and people go, ‘there’s no houses to buy...you read in the paper they’re all getting bought up by institutional buyers!’ I tell people, imagine twenty years ago when there was one apartment REIT, now there’s twenty! So you can see there’s a lot of room to grow and when I look at this opportunity and strategy there’s tremendous opportunity to grow. We will be some of the biggest single-family REITs in twenty years.”

⁹³ Ibid.

CHAPTER 7 – CONCLUSIONS AND PREDICTIONS

7.1 Overview

Prognosticators from CNBC to Wall Street to local investors agree that much is ‘unknown’ when speaking about the future of the single-family home rental market in the United States. Is this national investment a ‘trade’ or is it really a ‘business’ with staying power? Will these investors be good landlords to the thousands of families living in these homes or have they merely created another housing bubble? What does the future hold for this market?

7.2 SFR as an Investment ‘Trade’

Current thinking at the end of 2013 among pragmatists, those on the sideline and even some of those in the industry is that REO-to-rental, and single-family rental investments are and have never been anything more than a ‘trade’. Some might go so far as to say a bad trade due to the investment’s inherent complexities. Their thinking, however, is not base solely on skepticism or pessimism but a list of concerns and issues including:

- No market proof of success among existing SFR REITs
- Existence of too many inexperienced players
- The constant amount of ‘brain damage’ required to perform
- The Mom and Pop sweat equity factor
- Hold periods among certain investors and
- The existence of limited exit opportunities

To those looking at the SFR market the biggest red flag comes from the three large SFR REITs operating with the most transparency and measurability. Unfortunately, those REITs have yet to disprove any of the naysayers. Silver Bay, American Homes 4

Rent, and American Residential Properties are all trading below book value.

Traditionally, those companies that are earning good returns on investment trade at a premium to book value. For example, the closest comparable REIT, Apartment REITs that regularly trades at 1.8 times their book value⁹⁴. Additionally, the elder statesman of the group, Silver Bay IPO'd at \$22 a share but soon thereafter started falling and hasn't really looked back. It is currently trading close to its 52 week low of \$15/share. More disconcerting still is SBY's recent announcement in December that its COO Patrick Freyberg resigned 'to pursue other opportunities'. Regardless of speculation, senior personnel shifts for ambiguous reasons do not instill confidence in an already timid market.

A failure of one REIT among a large group does not necessarily imply a bad investment or indicate that a market is not viable. However, in the very small SFR REIT field, such a failure could prove too great to overcome.

Another issue driving the belief that SFR is a 'trade' stems from the notion that too many firms jumped into the market without enough experience or genuine understanding. Hedge fund manager Bruce Rose of Carrington explained, "There's a lot of -- bluntly -- stupid money that jumped into the trade without any infrastructure, without any real capabilities and a kind of build-it-as-you-go mentality that we think is somewhat irresponsible⁹⁵."

In 2012 and early 2013 investors across the US saw the single-family rental market as 'sexy' and a very 'hot space'. In late February 2012 the Case-Shiller Index started to climb and kept going up. These factors combined with considerable capital sitting on the sidelines for so many years anxious to be utilized pushed investors into the space that didn't know turnover rates or required initial capital expenditures or operating efficiency requirements. In other words, millions and eventually billions were potentially spent before people formalized their operating strategies or determined whether a certain

⁹⁴ "Single Family Rental REITs May Have More Potential Than Wall Street Believes -"

⁹⁵ Gittelsohn, "Carrington Stops Buying U.S. Rentals as Blackstone Adding."

house could produce the yields described in their financial models. The ‘trade’ aspect, some believe, will come as these investors and operators realize the infeasibility of a long term investment and that their best move is to capture the home price appreciation and/or cut their losses sooner rather than later.

The notion of feasibility surrounding SFR properties is also a key factor when considering these investments as a trade. As one industry professional described it, ‘there’s simply too much brain damage to make it all work’. Unlike multi-family properties, single-family homes are often built to be unique. To an individual homebuyer or renter this is a positive attribute. However, to institutional investors the reality of addressing each problem from each tenant in regards to each of their separate properties can prove too much for too few returns. Wall Street tends to like ‘easy money’ but also doesn’t mind doing the extra work to get the larger payoffs. Those who support the notion of the SFR market as a trade believe that the ‘work’ or ‘brain damage’ required is simply too great and that the previously described eager investors chasing this ‘new’ and ‘sexy’ investment will soon bail out in search of simpler investments.

It has been said several times that the single-family rental market is only ‘new’ to institutional investors, and that mom and pop operations existed for decades. Their sustained success should not be forgotten as investors rushed into the market. After all, they showed a track record of feasibility and profitability and did not require institutions to reinvent the wheel. Still, a very important component of the mom and pop model cannot be replicated when large investors scale up.

In the common instance of required maintenance on a single-family investment property a mom and pop outfit will typically if not always send over mom or pop to fix the issue. The investors are the managers and the plumbers and the electricians and more importantly they are the unpaid plumbers and electricians. To small individual investors maintenance and management is filed under ‘sweat equity’. They mentally factor in such work to their modest returns instead of adding a line item or labor costs.

Companies like Colony and Blackstone are forced to pay in-house or third party staff to not only fix the physical problem but also manage the tenant's maintenance call. Again, skeptics see this as a negative pressure on profit margins that, over time, will prove insurmountable to investors who will then trade out of the space.

One of the greatest sticking points among those who view SFR as a trade is the continued depletion of distressed properties across the country. In the past year tens of thousands of real estate owned and similarly distressed homes were purchased by institutional investors. Already markets like Phoenix and Las Vegas experienced record levels of home price appreciation and driven the majority of big players out of the market. The question remains whether investors will continue to or even be able to grow their portfolios once the bulk of distressed properties cease to exist? To many investors the large yield play comes from the home price appreciation with the rent being a bonus, however, when that appreciation is taken away when investors are forced to pay at or near market value then so too does the investment as a 'business'.

Finally, the most impactful aspect of single-family rentals as a trade is the lack of proven exit opportunities. In May of 2013 Carrington Holding Co. stopped buying single-family homes and began looking at ways to exit the market⁹⁶. They quickly realized that selling one home might be easy but looking to unload thousands limits the buyer market and typically forces additional pricing discounts. At present they have yet to fully sell all of their properties. To those who view this investment as a trade the inability to easily exit the market suggests that it may not only be a trade but a bad one.

⁹⁶ Ibid.

7.3 SFR as a Business

Supporters of the single-family investment strategies do not deny the pitfalls and strategic changes required in order to demonstrate profitability. However, they view the space like most entrepreneurs, as one with problems that can be fixed; in a market with the flexibility and strength to adapt and reposition itself for long-term viability that has already proven to be a business and a new asset class. Justin Chang of Colony Capital put it simply, "we don't see it as a trade; we see it as a business⁹⁷." Chang is not alone and those who view SFR as a business root their belief in both macro and micro level experiences including:

- The existence of tremendous growth opportunities
- Larger social shift to a renter's society
- Size and scale of the momentum is too great to reverse and
- The flexibility in the investment strategies

Investors and operators see themselves as small fish in a very large pond and while they may wield some influence on a local level, as impactful factors go, they remain inconsequential. To understand this one only has to realize that out of the 14 million single-family homes rented in 2013, institutional buyers and owners represent only 1%. In other words, companies like Sylvan Road or Waypoint or even Blackstone were in fact not the biggest drivers, individual consumers were.

Over the past six years a generation of Americans witnessed a very real and negative aspect of owning their own home as values plummeted and friends and families found themselves evicted from not just their homes but also their investments. Culturally, as well, some argue that the new economy does not necessarily *need* to focus on home ownership. In the Atlantic Monthly, journalist Emily Badger explained how home ownership is, "now a liability, not an ambition. It's an anachronism in an age when nothing remains permanent anymore, when no one stays in the same job—let alone the

⁹⁷ "Investors in Rental Homes."

same city, or even the same career—long enough to dent a 30-year mortgage. Homeownership represents the opposite of all the values that economists say will matter from now on—flexibility, mobility, adaptability—in a country where the Company Man will now work for himself, selling his portable ideas instead of his labor.”⁹⁸ Demographically, at least in recent years, the numbers are supporting such a claim. Nationally homeownership has been declining since a peak in 2009 of 69% to more recent levels near 64%. Institutional single-family homebuyers are quick to point out that with every percentage point decrease in homeownership the number of renters increases by 1 million. Even at their peak of buying, investors could not come close to satisfying all of these new renters.

In addition to the potential social change described above, there is a real documented financial burden in the form of student loan debt. Specifically, student loan debt is shrinking the number of potential new homebuyers and forcing the next generation to look at renting instead⁹⁹. First time home buyers and those looking to start a family are finding it difficult if not impossible to get a home loan with tens of thousands of dollars in college loan debt. These potential buyers are being forced to postpone or forego buying a home but like everyone they must live somewhere and renting becomes their primary option.

Other similarly relevant macro observations include a five-year dearth of housing construction. In fact 2013 saw housing inventories at a fifty year low after construction companies saw a peak of 2.07m new homes in 2005 fall to only 554,000 in 2009¹⁰⁰. All of this occurred as population continued to climb with the adult population in need of housing, growing at approximately three million per year.

⁹⁸ “The Anxiety of the Forever Renter.”

⁹⁹ Ellis, “Student Loan Debt Delays Marriage, Home Buying, Saving.”

¹⁰⁰ York, “US Home Building Drives up Lumber Prices.”

All of these national macro trends work in the favor of institutional investors who have large amounts of capital to spend and the ability to buy homes for cash and offer them to a growing demand of renters.

Although they may have made a large dent in the REO inventory, distressed properties are by no means extinct nor will they ever be. Maryland alone saw foreclosure auctions up 200% year over year in October of 2013¹⁰¹. Moreover, much of the distressed inventory remains in the court systems. Judicial States like Florida, Illinois and Maryland are still processing a backlog of foreclosed properties. Daren Blomquist, a VP at RealtyTrac explains, "Lenders are likely moving these properties more rapidly to the public auction given that there is strong demand from institutional buy-to-rent investors at the auction and that rising home prices mean more of the loan losses can be recouped, either by selling to an investor at the auction or by repossessing the property and reselling as bank owned¹⁰²."

The optimists or those who remain bullish on the SFR investment see these simple economic factors of a large supply and a growing demand as reason to stay in the space. Moreover this underlying foundation suggests a serious viability for single-family rentals as a long-term business.

Another, less tangible notion that buoys the strategy of SFR as a business, is the momentum created by so many serious players in the marketplace. This momentum illustrates a genuine 'buy-in' among industry professionals in not only the greater concept of renting single-family homes but also the opportunities within that space.

In looking at Blackstone's 2013-SFR1 securitization alone one sees organizations like Deutsche Bank, JP Morgan, Sidley Austin, Moody's, and Riverstone Residential Group, not to mention Blackstone itself. Such elite financial pedigree does not guarantee nor

¹⁰¹ "Officials Launch Offensive to Debunk Foreclosure Data That Ranks Maryland Third-Worst in U.S. - Baltimore Business Journal."

¹⁰² "Judicial States Working Through Huge Backlog of Distressed Properties."

does it prove the sustainability of an asset class but it does illustrate the caliber and high level of those invested in the space. Groups of this nature as well as others like Colony Capital do not loosely commit billions in capital to investments they expect to walk away from in a short-term trade.

Furthermore, the momentum in the market place is just that, momentum. It is the growing and building of a business into something more stable and mature with lower returns but returns none-the-less. Skeptics look for immediate proof of viability in such groups as the SFR REITs, however, during much of 2013 these REITs were stock piling properties whereas in recent months they've switched their focus to streamlining operations, boosting occupancy rates, minimizing turnover rates and driving up returns. In other words, they were building momentum and refining their strategies. 2014 will show greater premiums over book value among existing SFR REITs while at the same time more companies go public from this space.

Securitization is another example of momentum working in the favor of single-family homes for rent as a business. It took more than a year and a half to create the first security and industry professionals now estimate that ten times that amount will be created in the next 12 months. These successes provide positive reinforcement to investors and the capital markets.

All of these improvements and escalations work to formalize and improve the single-family market into a sustainable business model. In a purely capitalistic and Darwinian way the best companies with the best practices will thrive while those who cannot survive will be bought up at a discount or fail. Many operators demonstrated this when they chose to focus more on operations and less on acquisitions. Moreover they brought the management in-house to minimize third party premiums. These rapid reactions and adjustments speak to another factor driving the long-term business viability of the market that is the investment strategy flexibility and willingness to constantly innovate.

Although the majority of initial investments focused on HPA yields, the more recent home buying strategies have shifted to a much greater importance on rental yields. This in itself is an indication of a shift in investment approach away from a 'trade' mentality toward a longer more typical real estate focused approach whereby appreciation is viewed as a bonus and the income stream is viewed as the investment feasibility determinant. The shift also illustrates the flexibility among operators who recognized the need for immediate change toward a longer-term platform.

Another attribute that can be assigned to investment strategy flexibility is the ability for operators to buy and sell single-properties at any time (market dependent) when they determine those properties to be incongruous with their investment criteria. An example might be of a large investor buying 500 homes in an MSA and realizing that ten of them maintain a higher vacancy rate which effects the rent yield. They may decide to simply sell those properties out of their portfolio. Understandably this does not work in a securitization format or in a down housing market. Still, the optionality remains there for many and is being utilized of late.

Lastly, is the idea of institutional investors becoming creative in their buying and operating. Although some entered without fully vetting the marketplace most were quick to learn and see additional opportunities. As competition grew investors changed their outlook, for example, some began looking at MLS instead of just distressed sales, others looked to tertiary markets like Savannah, GA, Columbus, OH and parts of Oklahoma. Some investors went up market to places like San Diego while others went down market into the affordability space. These market expansions demonstrate a innovative outlook by investors looking to stay in the space for many years to come not those looking to make a quick trade. Blackstone, not satisfied with the US market alone is looking abroad to places like Spain where distressed housing stock also exists¹⁰³. These are all signs of companies looking to double and triple down on their investments in an area they consider to be a business. More than that they are investing considerable amounts of time, energy and capital in order to expand their buying

¹⁰³ Smyth, 30, and Print, "Blackstone Vies With Goldman in Spain Rental Housing Bet."

opportunities and securitize their existing portfolios. To these investors the single-family rental market will never be a trade.

7.4 Social Impacts

The future social impacts of the buy-to-rental investment strategy combined with securitizing large pools of these rental incomes remains unclear, however, some conclusions can be drawn in both the short and long terms.

In the short term investors and government officials agree that the benefits are real. Where once there were vacant ‘zombie foreclosures’ and ‘vampire REOs’ investors are buying, fixing and filling properties in impacted neighborhoods. In an interview former FDIC chairman Sheila Bair commented, “It breaks my heart what the subprime crisis did to neighborhoods [but] we do need buyers to come into neighborhoods and commit capital to their revitalization.”¹⁰⁴ It is well documented that a vacant and foreclosed home in a suburban neighborhood brings down nearby property values. Often these properties are neglected before the owners leave and vandalized once they’re gone. This blight can spread and negatively impact communities. Therefore to have investors, especially in 2011 and 2012, make commitments to fix and fill these properties can be beneficial on a broader short-term basis. “If you have a lot of foreclosures in one community you will improve everybody’s home values if you take them off the market,” said Diane Swonk, the chief economist at Mesirov Financial. “If those homes are renovated and even rented, it is a lot better than having them stand empty¹⁰⁵.”

On the other hand the large influx of institutional buyers hinders first time homebuyers and individuals looking to purchase with mortgage debt. “The housing market continues to skew in favor of investors, particularly deep-pocketed institutional investors, and other buyers paying with cash,” says Daren Blomquist, vice president at RealtyTrac, a

¹⁰⁴ Dayen, “Your New Landlord Works on Wall Street.”

¹⁰⁵ Rich, “Investors Aim to Buy Thousands of Homes to Rent to Tenants.”

distressed property data aggregator.¹⁰⁶ In September of 2013 RealtyTrac reported that 49% of all home sales were completed as all-cash deals. This figure was up from 40% in August and 30% in September of 2012. Typically, the average buyer of a \$100-200,000 home does not have the equivalent in cash to compete with the institutional buyers and in some areas are being outbid or pushed out of sales. The social and economic impact of such a trend is not beneficial explains Steven Ricchiuto, chief economist with Mizuho Securities USA Inc., "First-time buyers are important to get the housing market to move to a new plateau. Without them, you just get stuck at a marginal recovery environment¹⁰⁷." Still, institutional buyers maintain their impact on such a large market remains negligible.

The long-term tangible benefits remain more elusive to social observers. Concerns include poor property maintenance, zero tolerance delinquencies; and an increase in 'cost-burdened' renters. It can be expected that new landlords, with thousands of properties under management, having just entered a new market, will have maintenance issues. However, thus far tenants are not overly impressed with their Wall Street landlords. In a Huffington Post review they discovered that, "Most who spoke with HuffPost said they moved into their rental homes only to find that renovations they were assured were comprehensive amounted to little more than a fresh coat of paint and new carpeting. Tenants said they immediately discovered major mechanical and plumbing problems¹⁰⁸." Mindy Culpepper, of Atlanta, described her Colony American Homes landlord, "You can not get in touch with them, you can't get them on the phone, you can't get them to respond to an email¹⁰⁹." The concern among many is how removed investors are from tenants and the conflicting incentives for managers to keep expenses low and tenant retainage high. In order to get the most out of every property institutions will have to maximize rents and minimize expenses while at the same time decreasing vacancy and turnover.

¹⁰⁶ "Nearly 50% Of All Home Sales Now Cash, As Institutional Investor Activity Hits New High."

¹⁰⁷ Dougherty, Wotapka, "Housing Recovery Increasingly Prices Out First-Time Buyers"

¹⁰⁸ Hallman and Berman, "Here's What Happens When Wall Street Builds A Rental Empire."

¹⁰⁹ Ibid.

A key driver in maximizing returns for institutional investors is underwriting their tenants in order to avoid delinquencies. One key way SFR operators are accomplishing this is through massive amounts of data collection.

In June of 2012, Riverstone (an Invitation Homes partner) agreed to contribute its rental data to Experian Rent Bureau, the leading provider of rental payment data to the multi-family industry. This seemingly innocuous agreement, however, could impact lower income Americans who tend to make up a larger portion of the rental market. Where before a renter who neglected to pay might have trouble getting approval in the same town now may see their name 'black listed' across the country. Although this has yet to be proven it remains a concern among renters who are used to a more personal tenant-landlord interaction:

“I’ve lived in single-family rentals all my life,” says Shabnam Bashiri, an organizer with Occupy Our Homes Atlanta, one of the hottest markets for REO-to-rental. If I have a problem with getting my rent in some month, I can call my manager and let him know what’s going on. In the case of Wall Street investors, you have an absentee landlord and in the worst-case scenario an absentee slumlord¹¹⁰.”

In such cases of late payments or failure to pay rent there will be little flexibility among investor landlords. Charlotte, NC real estate investor Dan Grosser explained, “If you have large institutional capital behind these businesses, the investors are going to expect a very systematic and streamlined process for owning and operating these assets. It wouldn’t surprise me if the resident collection process is something that’s streamlined¹¹¹.”

¹¹⁰ Dayen, “Your New Landlord Works on Wall Street.”

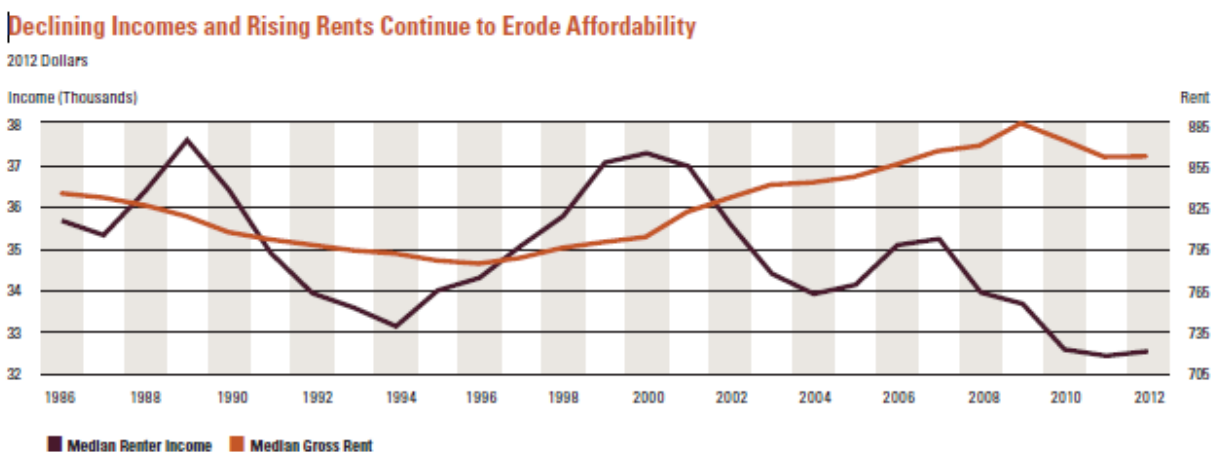
¹¹¹ Sunday, 10, and 2013, “Charlotte’s Wall Street Landlords Move Quickly to Evict Renters.”

Kroll Bond Ratings, in their report on Blackstone’s 2013-SFR1 describes Invitation Homes’ collection strategy:

Delinquent tenants are contacted immediately to determine why the rental payment was not made. Invitation Homes issues 3-day, 5-day and 7-day late notices. Invitation Homes could start the eviction process as early as seven days after a missed rental payment.

Finally, in a time when social activist and more recently the President of the United States make mention of a growing income inequality the concern of ‘cost burden’ and rent-to-income ratios become important social aspects of SFR homes. A recent Harvard study completed by the *Joint Center for Housing Studies* revealed, “In 1960, about one in four renters paid more than 30 percent of income for housing. Today, one in two are cost burdened¹¹².” As more and more buyers are priced out of the homeownership market the demand for rentals increases and prices go up (see Figure 13).

Figure 13



Source: Joint Center for Housing Studies

The social ramifications of institutional investor actions in the growing single-family rental market will determine whether their involvement remains a positive social

¹¹² Coy, “Harvard Study Finds.”

development or negative. If proven successful and beneficial to both parties it will result in considerable changes in the way we as a country and culture view renting vs. owning a home. If, however, Wall Street becomes one big slumlord the short-term positives could disintegrate and leave low-income renters with fewer places to live.

7.5 The Future of SFR near and long term

Due in large part to the fledgling nature of institutionalized single-family rental investments, as well as their fixed-income and REIT derivatives, their future remains undecided. However, based on the findings of this thesis combined with interviews with industry professionals, some projections and future trends can be deduced.

In the near-term there will be a continued shift among existing SFR operators from an ‘opportunity play’ to a ‘yield play’. Investors will be looking less at home price appreciation and more at rental yields. 2014 will see more shrewd acquisition of properties that display a greater ability to deliver the required rental returns. In turn this will result in lower expected secondary investor returns. Whereas before such capital contributors could expect high teens or greater, the more mature market may deliver consistent unlevered returns of ten percent¹¹³.

Tying into these strategy shifts and also likely in the short-term will be a diversification of investment strategies. An example is homebuilders looking at build-to-rent strategies. Last year 5.8% of the 535,000 single-family homes started were being built as rentals, up from 4.8% in 2011 and the highest share since at least 1974, according to an analysis of census data by the National Association of Homebuilders¹¹⁴.

On the finance spectrum Blackstone announced in late 2013 the creation of B2R Finance, which aims to provide buy-to-rent financing for property investors looking to

¹¹³ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

¹¹⁴ Dougherty, “New Homes get built with renters in mind.” WSJ.com 2013

enter the single-family rental market on a much smaller scale (minimum five properties). Blackstone recognizes the craze to buy single family homes for rent goes well beyond institutional investors and is therefore looking to capture returns on lending to local mom and pop level operators.

Lastly, 2014 will likely be a year of consolidation. Firms that considered the SFR space as merely a trade may look to exit with justifiable home appreciations. Others without the desire or acumen to manage a multitude of properties will look to get out with minimal damage. Larger and more established firms will likely buy these portfolios where feasible. Capital for such consolidations will come from an increase in REIT and securitization creation as well as a move toward debt structuring as investors shift from an all-cash purchasing strategy to more financing.

In the longer-term the influx of investors along with the ties to the stock market through IPO's and securitization will result in a more volatile single-family housing market. Mark Fleming, the Chief Economist for CoreLogic at the REO-to-Rental Forum in late 2013 explained, "The single-family housing market today is being treated more as an investible asset class than ever before in history. And what we know from looking at investible asset classes (like the stock market) is that the more they are treated as an asset class, the more volatile they are¹¹⁵." This volatility will come from the liquidity in the space, as global investors will be able to enter and exit the market more quickly.

Finally, on the broadest of terms, as 2014 begins, it appears that single-family rentals as an institutional investment are here to stay. Dozens of industry experts expressed serious doubt that a securitization could be done and yet Blackstone not only proved them wrong but 2013-SFR1 was a runaway success. SFR REITs, after initial losses, are proving resilient and more SFR firms like Waypoint and Starwood are looking to IPO in early 2014.

¹¹⁵ IMN, REO to Rental Forum, Scottsdale, Arizona. December 2013

The future of the American Dream may be one where a flexible and constantly migrating work force is able to *rent* the single-family home of their dreams while also *owning* shares in the very same public company that owns their property. Renters will enjoy a professionally managed home without the hassle of maintenance costs and the flexibility to move under short notice. All the while the new asset class will be driven by market level efficiencies working to change the landscape of single-family housing, as we know it.

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