RMBS Commentary:

Single-Family Rental Market Update

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Author:

Brian Grow | Managing Director, RMBS | brian.grow@morningstar.com | +1 646 560-4513

Morningstar Perspective

As we mark the two-year anniversary of the initial single-family rental transaction, the fledgling asset class continues to evolve. To date, 27 single-family rental deals have come to market, with issuance totaling $13.81 billion. Morningstar Credit Ratings, LLC believes issuance should continue to grow, notwithstanding the summer slowdown in issuance attributable to issuers' reduced property acquisitions and focus on property management, as well as choppiness in trading across fixed-income markets caused by economic turmoil. Multiborrower securitization, including single-borrower, single-property loans, will drive the long-term growth in single-family rental issuance. The performance of the securitized pools has met Morningstar's forecast; cash flow coverage of debt service remains robust and delinquency rates low; vacancy and retention rates also remain in line with Morningstar's forecast. One area to keep an eye on is elevated capital expenditures, which can affect performance on several fronts, including lower net cash flow, a less effective debt yield trigger, and less protection from an interest-rate cap.

State of the Single-Family Rental Market

Single-family rental housing has existed for decades as a significant part of the U.S. housing stock. Investing in single-family rental properties has been a way for Americans to build and maintain wealth, prepare for retirement, and hold income-producing assets in perpetuity. Unlike paper investments, rental properties allow small investors to apply sweat equity to further increase yield and have direct input into the returns generated by their investments. Single-family houses comprise about 35% of U.S. rental stock, according to the Joint Center for Housing Studies of Harvard University, which relied on data from the 2011 American Housing Survey from the Department of Housing and Urban Development. There are approximately 43.3 million renter households, and 15.2 million, or 35.1%, live in single-family houses, according to the National Multifamily Housing Council.

After the Great Recession, owner-occupied house prices dropped precipitously in many areas. While the decline varied from region to region, the national home price index fell by more than 30%. This plunge accelerated and deepened because of limited credit availability – prospective nonprime homeowners simply could not qualify for mortgages. In some regions, the decline was so extreme that the return on some properties became attractive to institutional investors, and a new business model was born. Institutional capital was put to work buying properties to rent out where the net cash flow generated by a rental implied a house value that exceeded the current market price. The institutional bid became the house price decline floor, and it is possible that without the institutional investment, prices could have fallen further. Houses previously owned by nonprime borrowers were rehabilitated to institutional standards and leased. The target renter is a nonprime income-producing family seeking to live in a single-family house.

It can be argued that a large portion of the nonagency, nonprime homeowner population was converted to renters, which led to greater rental demand and resulting increases in rental house prices. Regardless of the cause, rents have increased and rental house prices have also steadily climbed. According to CoreLogic, Inc., the year-over-year median rent on a three-bedroom house increased 4% nationally as of April 2015, and national house prices increased by 6.4% year-over-year as of September 2015.

When house prices rose to levels that made them less attractive to investors, the institutions turned their attention to property management. During the acquisition phase, these investors focused on buying while the opportunity existed. Beginning in 2013, investors institutionalized property management, building internalized local maintenance and leasing offices and leveraging centralized functions where more efficient. Local, on-the-ground managers are needed to handle day-to-day maintenance and tenant relationships, while centralized staff performs the back-office roles such as finance, legal, contractor relationship, and call centers.

Throughout 2012 and 2013, Morningstar worked with participants to understand the market and potentially finance the institutional investment through securitization. Morningstar visited Green River Capital LLC, a West Valley City, Utah, real estate manager, which was active in the single-family rental market, through its experience with disposition of real estate owned properties, or properties owned by the lender, and obtaining broker price opinions for single-family rental lenders. Morningstar analysts also contacted real estate agents in the most active single-family rental markets to get a first-hand perspective on the state of each housing market. As data started to provide a complete picture of the economics of single-family rental property management, Morningstar built a model and developed a methodology and assumptions that would be used to rate single-family rental securitizations.

Lessons Learned

In November 2013, Invitation Homes L.P., a subsidiary of Blackstone Group, launched the first single-family rental securitization. Since then, as of this article, an additional 26 securitizations have been issued, and all of the public securitizations have been rated by Morningstar. Morningstar expects issuance to pick up after a slowdown this summer due in part to issuers' turning their focus to property management, general economic uncertainty and volatility in fixed income markets.

Each month, Morningstar standardizes data from issuers and publishes its monthly performance summary which compares key performance statistics across all single-family rental transactions rated by Morningstar. Performance of all single-family rental transactions has met or outperformed Morningstar's original forecast. Vacancy levels are well within expectations, and rents have exceeded originally underwritten rents. Interestingly, "other income" which includes charges such as pet fees, parking fees, application fees, and reimbursed maintenance, is much higher than originally underwritten.

Vacancies are generally correlated with lease expirations. When a large percentage of leases expire and a portion of those tenants move out, many of these properties will be vacant for a short period until they can be marketed and re-leased. Therefore, the vacancy level of the pool can temporarily appear to be abnormally high, but as those properties are leased, vacancy rates generally decline. Morningstar also tracks retention rate, which is the percentage of tenants that stay in a house beyond the lease expiration, either on a month-to-month basis or a longer-term lease. Retention rates for Morningstar-rated single-family rental transactions have averaged 76.7%.

Expenses have generally exceeded originally underwritten expenses, especially for the early transactions. Across the board, capital expenditures have been higher than Morningstar's original forecasts, and often more than double issuer underwritten capital expenditures. Actual capital expenditures are important to investors for a few reasons, namely net cash flow, debt yield triggers, and cap strike rates.

- Net cash flow is affected by actual capital expenditures, since if capital expenditures are higher than underwritten, it will affect the total amount of cash that is available to single-family rental bondholders and constrain the debt service coverage ratio.
- Generally, debt yield triggers are calculated using underwritten capital expenditures. Generally, the higher the debt yield the better for investors and a tripped debt yield trigger will trap excess cash to help offset a falling debt yield. It is possible that actual debt yield for a single-family rental transaction is lower when calculated using actual capital expenditures than when calculated using underwritten capital expenditures. In this example, a debt yield trigger based on underwritten capital expenditures may not be tripped even if the actual debt yield is below the trigger threshold.

- Future interest rate cap strike rates in floating-rate single-family rental transactions are set based on a DSCR that is calculated using underwritten capital expenditures. For purposes of illustration, consider a hypothetical securitization where if the borrower chooses to extend the bond maturity at each of the early maturity dates, the borrower needs to obtain a cap contract with a strike rate that results in a 1.2x DSCR. In this example, the DSCR used to calculate the required cap strike rate if calculated using underwritten capital expenditures results in a 1.2x DSCR. However, actual capital expenditures are much higher than underwritten, and the DSCR calculated using actual capital expenditures is 1.1x. In this case, investors would have less than the 20% DSCR cushion that is required by the terms of the transaction.

Although Morningstar generally receives actual capital expenditures as part of its surveillance process, it is not part of the investor reporting package for all outstanding transactions. Morningstar typically considers actual capital expenditures in its surveillance analysis, and to date, actual capital expenditures have been higher than underwritten capital expenditures. However, the actual net cash flows using actual capital expenditures are consistently higher than what Morningstar originally underwrote.

Expected Future Single-Family Rental Securitization Volume

To date, there have been two broad types of single-family rental securitizations: single-borrower and multiborrower. Single-borrower consists of a single loan to a large institutional investor, while multiborrower transactions contain many loans made to smaller investors usually backed by five or more properties. The majority of issuance has consisted of single-borrower securitizations. However, in 2015 Morningstar rated all three multiborrower transactions, from B2R Finance, L.P., FirstKey Lending LLC, and Colony American Finance, LLC, that have launched as of the date of this publication.

The institutional investors own a small percentage, approximately 2%, of the single-family rental housing stock, according to Urban Institute. As institutional acquisition has slowed as housing prices stabilize, Morningstar does not expect single-borrower issuance to be the driver of growth in the single-family rental market in the near term. Most market participants expect the growth of the single-family rental market to come from multiborrower single-family rentals. However, for a variety of reasons, including lack of borrower awareness and administrative challenges of underwriting the loans, multiborrower issuance has been slower than expected. The growth of the single-family rental market ultimately depends on the demand of the smaller investor for financing.

A relatively new product for nonagency originators is the single-borrower, single-property loan. This loan looks similar to agency investor property loans, but is underwritten more like a business loan. Unlike with agency investor loans, the underwriting for SBSP loans is based on DSCR, rather than borrower income and creditworthiness. The theory is that a rental property that can cover the mortgage payment is less likely to default than a rental property for which the mortgage payment is greater than the property net cash flow. If successful, this product may attract a new segment of borrowers and could potentially compete with agency investor loans. There is a small potential for these loans to become occupancy “liar loans” – borrowers may claim they are planning to lease the property and then occupy the property postclosing. Morningstar will look for mitigants to this risk, such as a tenant-in-place at the time of securitization, when analyzing SBSP loans.

Closing Thoughts

The single-family rental market continues to evolve. Issuance has been strong throughout the past two years with 27 deals closing. Morningstar has continued to monitor performance, which has been in line with our forecast. Income and expenses have generally been higher than expected, and Morningstar has adjusted its assumptions accordingly. Looking forward, growth in the single-family rental sector depends on the demand for single-family rental financing by smaller noninstitutional investors, and the ability of lenders to meet this demand.