

# Single-Family Rental Commentary:

## Issuance of SFR Securitizations Tops \$13 Billion

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### Morningstar Perspective

Nearly two years ago, Invitation Homes L.P. brought to market a new type of securitization: a \$479.1 million deal backed by the rental payments of about 3,200 single-family homes in five states. Since then, an additional 24 deals have come to market, including three deals with multiple borrowers, with total issuance for all 25 deals amounting to \$13.08 billion, backed by loans on nearly 100,000 homes. Morningstar Credit Ratings (Morningstar) is the only rating agency that has evaluated the credit risk for all of these transactions.

This article examines the considerations in our ratings and the performance of these securitizations. Since its first new-issue commercial mortgage-backed securities transaction in 2009, Morningstar has rated 208 securitizations, including deals backed by CMBS, residential mortgage-backed securities, and asset-backed securities, with total issuance amounting to \$147.1 billion.

To date, all securitizations backed by single-family rentals have performed in line with our expectations. Key highlights as discussed in Morningstar's monitoring reports include low delinquency levels and robust cash flow coverage of debt service. Stress tests, which are applied during the rating process and detailed below, allow us to be confident that these deals will also withstand more turbulent economic environments. In July and August this year, no single-family rental securitizations came to market, a worrying sign for some market participants. In this article, Morningstar ascribes the recent slowdown to issuers' redirection of focus from property acquisition to property management, and points to two bright spots in the market. The first is the merger of two large institutional landlords announced on Sept. 21, 2015, which signals a commitment to the asset class and represents an effort to increase scale efficiencies through industry consolidation. The second is the promising new variation on the single-borrower single-

family rental deals that have dominated the market: multiborrower securitizations, which create access to the vast majority of single-family rental properties which are owned by smaller investors and have so far been left out of the securitization process.

## Ratings Considerations

Single-family rental securitizations are considered a hybrid of CMBS, specifically those backed by multifamily collateral, and RMBS, backed by mortgage payments on single-family homes. The rental streams from these investment properties support the monthly payments to bondholders, while the eventual sale of the property is expected to be used to pay off the principal balance. The majority of bonds have floating rates with an initial term of two years. After two years, the issuer can typically make 12-month renewals up to three times. However, the bonds in some deals feature fixed rates for 10 years. Some deals contain amortization terms and pay principal and interest, while others pay interest only. The top tranches in the capital structure receive an investment-grade rating, while the lower tranches may not be rated or may receive a non-investment-grade rating. The credit enhancement for each tranche comes from the subordinate tranches. Tranches with a AAA credit rating typically have levels of credit support, or protection against losses in the event of default, near or above 40%. In its analysis, Morningstar considers both a deal's likelihood to cover its debt service, or monthly principal and interest payments, as well as its ability to pay off at maturity.

Morningstar's single-family rental methodology covers both single-borrower and multiborrower transactions. However, additional credit and operational considerations, discussed later in this section, are necessary when assessing multiborrower transactions. The first step of Morningstar's modeling process is to underwrite the base-case net cash flow at the property level. The property-level net cash flow is then aggregated to the pool-level net cash flow, subtracting applicable fees such as servicing fees. Because single-family rental securities may not be fully amortized by the maturity date, the second step in the single-family rental subordination model is to assess the pay-off ratio, which is Morningstar's value of the single-family rental properties divided by the unpaid balance of the securities. After the Morningstar base-case net cash flow and pay-off ratios are determined, they are subjected to a set of stresses at each required rating category. Each set of stresses includes:

1. Net cash flow declines that reflect worsening economic conditions;
2. Capitalization-rate increases that reflect deteriorating demand for single-family rental investment properties;
3. House price index declines to reflect the regional severity of a housing downturn; and
4. Interest-rate stress on the interest due on the securities.

During the term of the securities, the model evaluates whether there is sufficient net cash flow to make the required debt service payments associated with the securitization. The debt service coverage ratio needs to be adequate for each forecast period at each required rating scenario for the related security to "pass" that rating scenario. For example, in a transaction issued by Invitation Homes this year, tranche A passed Morningstar's AAA rating scenario with a DSCR of 2.17 and was therefore rated AAA. The DSCR for tranche F was 0.90, below the desired 1.0 level, and failed to pass Morningstar's B- rating scenario. We therefore could not assign a B- rating to tranche F.

Factors Morningstar considers in its rating analysis include property valuations, income and expenses, and performance of property managers and servicers. Morningstar evaluates property values using two methods. The first uses Morningstar's HPI stress, based on historic data in a particular region, referred to as a metropolitan statistical area. Regional HPI data dating back to the 1970s is available at the MSA level. Morningstar applies a HPI decline to property values. The most severe HPI decline is applied in the AAA rating level, while no decline and no appreciation is applied in the B rating level. In addition, Morningstar uses what is commonly referred to as the income capitalization rate approach, calculated by dividing the Morningstar underwritten net cash flow by a local capitalization rate for multifamily properties. We stress the MSA-level cap rate by 50 basis points, or one-half percent. The lower the cap rate, the higher the value of a property. Transaction documents may allow for collateral substitution or release of properties. The value of the substituted property or, in the instance of property release, the property release price, is typically equal to or higher than the original property value.

Morningstar examines data on rents and vacancies from third-party providers including RentRange and Reis, Inc. In assessing cash flow, Morningstar evaluates rental income, as well as expenses such as taxes, insurance, repairs and maintenance, rent concessions, and homeowners association fees. Local real estate agents provide firsthand knowledge of rental trends. Morningstar evaluates the property managers, responsible for maintaining the properties, and servicers, responsible for collecting rents and passing them along to the trust, especially if they manage or service a significant portion of the properties or loans in a transaction. Given the logistics of managing thousands of properties in various states, the competence of property managers is crucial. In some instances, Morningstar assesses the operational competency of property managers by evaluating management and staff experience, historical performance, technology, auditing and controls, and disaster-recovery procedures. Finally, there are legal reviews of the offering materials, trust and servicing agreement, special-purpose entities acting as borrowers, and other items.

Additional considerations apply for multiborrower deals. In single-family rental securitizations, there exist both bond-level and loan-level DSCRs. The bond-level DSCR is the primary subject of our analysis described above for both single-borrower and

multiborrower transactions, and represents the capacity to use cash flows from the collective underlying properties pledged to the trust to service the debt on the bond. Single-borrower deals involve the bond-level DSCR only, while multiborrower deals necessarily also involve the concept of loan-level DSCRs. Loan-level DSCRs are influenced by issuers' advance rates against the individual loan at origination. Issuers base these advance rates on their underwritten cash flows, which are adjusted downward as appropriate to reflect Morningstar's rating stress. In weighing operational risks for multiborrower deals, Morningstar also evaluates loan originators and their underwriting guidelines and procedures.

The biggest issuer of single-family rental securitizations by far is Dallas-based Invitation Homes, a subsidiary of Blackstone Group L.P., which owns more than 45,000 houses in markets including Atlanta, Las Vegas, Los Angeles, Sacramento, Phoenix, and throughout Florida. American Homes 4 Rent, based in Agoura Hills, California, owns nearly 37,500 single-family properties in 22 states. Colony American Homes, which owns about 19,000 homes in 10 states, and competitor Starwood Waypoint Residential Trust, a publicly traded REIT which owns about 12,500 homes, recently announced that they would merge, estimating their combination will save \$40 million to \$50 million in annual costs. Starwood shareholders must approve the merger, which is expected to close in the first quarter of 2016. When the deal is finalized, the combined company will own more than 30,000 homes and have \$7.7 billion in assets, making it the third-largest landlord by number of homes owned. Shareholders of closely held Colony will own 59% of the new company, which will be based in Colony's headquarters of Scottsdale, Arizona. Colony Capital Inc., which through a subsidiary invested in Colony American Homes, will own 13.4% of the combined company, according to a filing with the SEC. Other single-family rental issuers include Phoenix-based Progress Residential L.P. and Tricon American Homes, which is majority-owned by Toronto asset manager Tricon Capital Group.

Issuer	Number of Deals	Total Issuance (\$ in billions)	Number of Properties Securitized in Deals
Invitation Homes	7	5.17	31,429
American Homes 4 Rent	5	2.54	21,773
Colony American Homes	3	1.71	11,005
Progress Residential	3	1.42	10,487

Critics argue that large, institutional landlords hurt first-time homebuyers, but Morningstar disagrees. Institutional buyers--companies buying at least 10 properties a year--are relatively small players in the housing market, and their activity has been shrinking. Of the all-cash sales for single-family homes and condominiums in May 2015, 2.4% were by institutional buyers, according to RealtyTrac. During May, the top five areas with a population of at least 200,000 with the highest share of purchases by

institutional investors were Rockford, Illinois, northwest of Chicago; Tulsa, Oklahoma; Roanoke, Virginia; Memphis; and San Antonio, according to RealtyTrac. Last year, the number of single-family homes purchased by institutional investors amounted to 105,278, down 31.4% from the previous year, according to RealtyTrac. The real estate data company reports that from 2011 through 2014, institutional investors purchased a total of 528,369 single-family homes, with the most purchases in Florida, followed by California, Georgia, and Arizona. Separately, issuance has begun to ebb, and no single-family rental securitizations came to market in July and August. One reason for this drop is that a number of issuers have started to acquire fewer properties and focus more on property management.

In October 2015, Colony American Finance offered a \$239.1 million single-family rental securitization, with the AAA rated tranche offering 33.3% credit enhancement. Prior to that, three deals from Invitation Homes, Colony American Homes, and Progress Residential came to market in June, followed by an issuance from American Homes 4 Rent in September.

## Performance Monitoring

Morningstar publishes surveillance reports on single-family rental securitizations on an annual basis, and so far has reported on the 10 single-family rental deals that closed more than one year ago. Morningstar found that actual cash flows exceeded what Morningstar had originally underwritten for all 10 deals. The average DSCR for these 10 deals was 2.41, with the lowest at 1.6 for AH4R 2014-SFR2 and the highest at 2.9 for CAH 2014-2. This means that on average, these deals are generating cash flows after expenses that are more than double the amount of cash needed to pay down principal and interest.

The performance of single-family rental securitizations is largely attributable to the popularity of renting rather than purchasing homes. Some people may prefer the flexibility of leasing to incurring mortgage debt. Others may be unable to qualify for a mortgage amid stricter mortgage-underwriting requirements in the wake of the excesses leading up to the financial crisis of 2007-08. The homeownership rate in the U.S. dipped to 63.4% in the second quarter, its lowest rate since 1967, according to the U.S. Census Bureau. Nationwide, the second-quarter 2015 rental vacancy rate amounted to 6.8%, an improvement from 7.1% in the first quarter and 7.5% in the second quarter of last year, according to the Census Bureau. In Morningstar's most recent single-family rental performance update (September 2015), vacancy is trending higher overall, but remains under 6% for most deals. Delinquency rates generally remain low, with 15 of the 21 deals included in the performance update having delinquency rates below 1.0%. In addition to vacancy and delinquency trends, our performance update covers lease expirations, month-to-month leases, and retention rates. Morningstar's performance updates provide an overview of performance benchmarks for all single-family rental transactions, while surveillance reports, mentioned earlier, discuss cash flows for specific deals.

## Room for Growth

In the first two years of this new asset class, there have been 25 deals from 10 issuers, and Morningstar believes there is room for growth. We view the recently announced merger between Starwood and Colony American as positive for the single-family rental market, as it shows that institutional landlords are committed to this asset class. While these deals have yet to be tested in times of economic instability, Morningstar has confidence in its credit ratings given historical rental and housing price data and the credit-enhancement levels in these deals. According to the American Housing Survey, renters occupied more than 14 million single-family homes in the U.S. in 2013. However, according to the Mortgage Bankers Association, the top five single-family rental owners own less than 1% of all single-family rental units. The majority of single-family rental homes are owned and managed by investors with small portfolios, ranging from mom and pop investors who own a handful of properties to regional property managers with hundreds or thousands of homes. Multiborrower securitizations, such as the transactions issued this year by B2R Finance L.P., a division of Blackstone Group, First Key Lending, LLC, backed by Cerberus Capital Management, L.P., and CAF Sub REIT Inc., a subsidiary of CAH Operating Partnership, L.P., offer this pool of smaller investors the opportunity to obtain financing on their portfolios. As such, the market is turning toward this new subclass of securitizations as a likely engine for future growth. Compared with single-borrower single-family rental securitizations, multiborrower deals present an additional set of concerns related to the diversity of the borrowers, their operational procedures, and their properties. Having evaluated the credit risk for the first three deals in the multiborrower area, Morningstar believes that issuers are on track to mitigate these concerns. The continued ability of issuers and credit rating agencies to adequately address these risks is crucial to the success of these multiborrower deals and the near-term vigor of the institutional single-family rental market.

Morningstar editor Diana Rosenberg contributed to this report.

*Note: The figures for total issuance dollar amounts and number of securitized properties for single-family rental transactions are taken from previously published Morningstar presale reports.*

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