

SINGLE-FAMILY RENTAL SECURITIZATIONS

During the largest financial crisis since the Great Depression, many Americans defaulted on their mortgages and the US experienced a massive foreclosure wave. In response, several institutional investors purchased large portfolios of foreclosed homes. This report examines the recent growth in debt financing of these portfolios. These debt securities, known as SFR securitizations, are backed by rent checks from the portfolios of thousands of single-family rentals (SFRs). This report examines these deals focusing on how they work and why they are gaining momentum, their progress to date in the market, associated risks to monitor and future modifications in the pipeline.

HOW THEY WORK

The structure of the various privately offered SFR securitizations are fundamentally similar. Callable and/or non-callable bonds are issued from a single loan, backed by portfolios of fully occupied SFRs. The bonds typically have two to three year terms and a borrower's (obligor) option of multiple one-year extensions for a total of five years.

On September 19th, 2014, American Homes 4 Rent issued the first bond of this kind bearing a 10-year fixed rate interest, with coupon payment tranches amounting to a weighted average coupon rate of 4.418%.¹ The majority of the portfolio is located in Texas, Illinois, Indiana, Ohio, and North Carolina; markets that have experienced less volatility than other markets.² Traditionally, financing of portfolios this size would occur via the capital structure of a REIT and to date, four of the six large landlords that have securitized portfolios are now publicly traded REITs (American Residential Properties, American Homes 4 Rent, and Silver Bay Realty Trust Corp, and Starwood Waypoint Residential Trust). Colony American Homes has continued to postpone its IPO since June of 2013.³ Blackstone has not set plans to execute an IPO for the Invitation Homes unit but they have mentioned the possibility of an offering when the unit/market is mature, stable, and viewed in a positive light by investors.⁴

Exhibit 1 shows the typical SFR financing structure. To illustrate the mechanics of a typical deal, we assume that an Investor/Landlord Co. assembles a portfolio of 100 homes (\$100K each) for \$10 million. Investor/Landlord Co. first forms a REIT and raises \$5 million in debt and \$5

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Dec. 6, 2013, Scottsdale, AZ

“...the brief era of relatively easy money in the space, driven by home price appreciation, is winding down, and a new one is emerging. The new business model will be one of higher leverage, tighter margins and closer attention to detail.”

~ Jake Mooney (SNL Financial)

¹ (American Homes 4 Rent closes \$487.7M Securitization, 2014)

² (Bloomberg Terminal, 2014)

³ (Whelan & Demos, 2013) “Colony says it delayed its IPO because of the bad timing, and indicated that the company will try again when the market improves.” The rise in interest rates put downward pressure on trade single-family rental REITs. Further, investors were wondering if these portfolios were actually being leased due to reports of low occupancy rates.

⁴ (Mooney, 2014) Jonathan Gray, Blackstone Group LP's global head of real estate, said "getting the business to a place where it's ready, where it's mature enough, where it's stabilized enough, where investors can look at it and say, 'This is a really simple, straightforward business...I think that is probably 12 months away'"

Securitization Financing*

*True cost for Landlord/Investor Co. to borrow is weighted-average of coupon payments to bondholders: ~1.9%

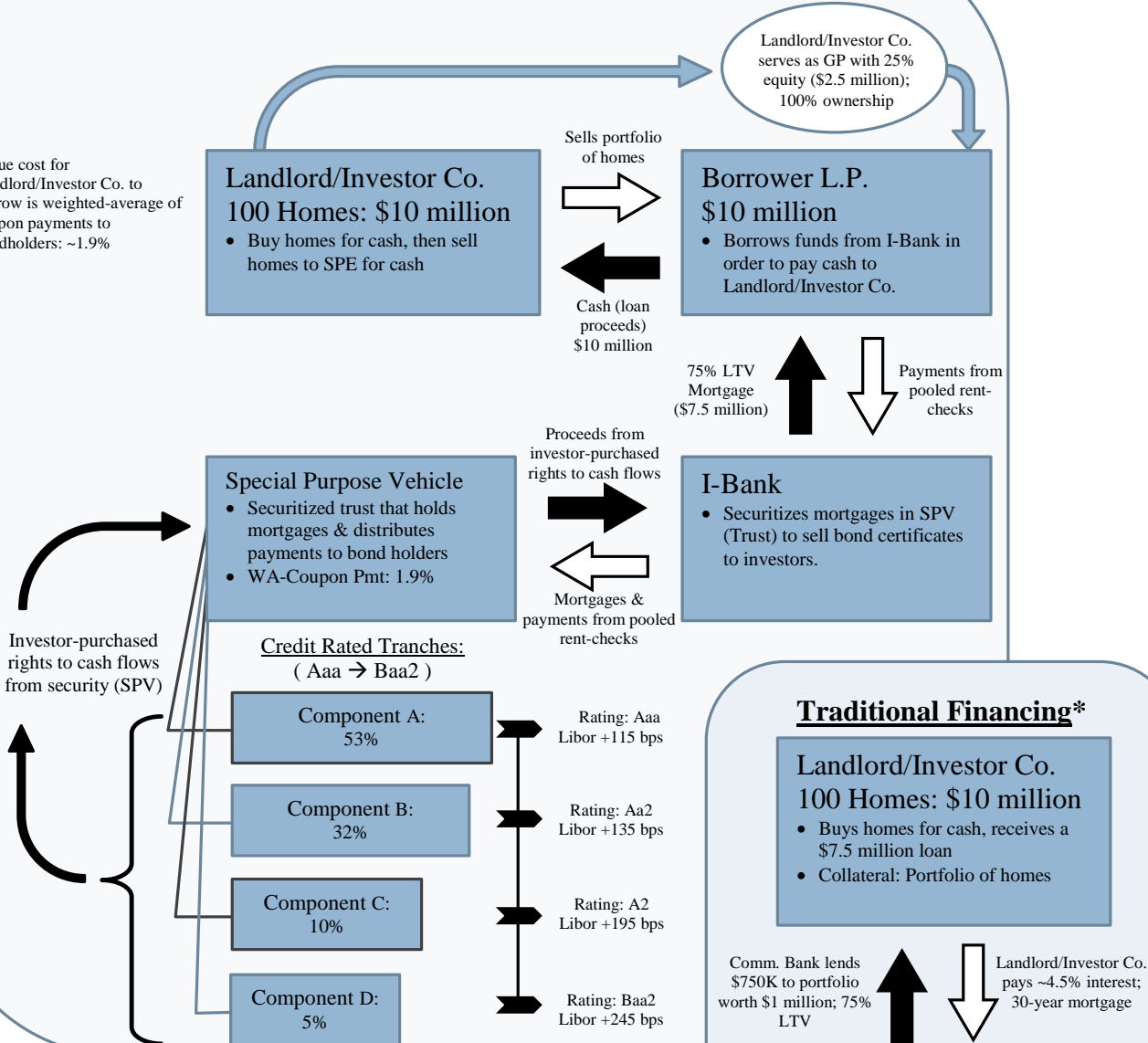


Exhibit 1: Comparison and flow chart between modern financing and traditional financing of single-family rental portfolios

Source: Center for American Progress

* Costs Landlord/Investor Co. 4.5% vs. 1.9% (weighted-average coupon payments to bondholders) in the case of SF-rental securitization

million in equity to purchase 100 rental homes (50/50; Debt/Assets). The REIT transfers the portfolio to Borrower, L.P. in exchange for partnership units in Borrower L.P. The REIT serves as the general partner owning 100% of the equity in Borrower L.P. who then secures a 75% LTV loan from I-Bank and in exchange pays a debt service and fee to I-Bank to perform the following: I-Bank forms a special purpose vehicle (trust) that holds the pledges and mortgage obligations; I-Bank then has credit ratings agencies assign ratings to multiple tranches of the SPV; I-Bank showcases the investment graded SPV and its pooled-rent cash flows to the markets and sells the tranches to investors. The SPV will collect pooled-rent cash flows and distribute coupon payments to the investors of the tranches (i.e. bondholders). Remaining cash flows are used to service the debt payments on the loan of Borrower L.P. In contrast, the traditional REIT return on equity would be 7% in the first year assuming a 6% capitalization rate on the portfolio (\$10 million) and 5% interest only debt payments (\$5 million debt). This modern financing via securitizing method brings in large cash returns in year one to Landlord/Investor Co. and transfers the risk of the portfolio to the bondholders willing to receive rent-backed coupon payments. This is due to the properties of the portfolios being transferred into SPVs (trust), separate entities that, in the case of default, would not incur domino-effect losses to the I-Bank or Borrower L.P.

Fitch Ratings has not agreed to rate the securities. Fitch states reasons being an elevated cash flow leverage, lack of historical data, refinance risk of the loan, maturity risk, and an overall low debt yield (Debt Yield = NOI / Loan Amount; avg. 5% range vs. 9% minimum for Freddie Mac) of to-date securitizations.⁵

The first issue of these securities was pioneered by Blackstone Group LP's (BX) unit Invitation Homes – owning approximately 45,000 SFRs⁶ – on October 31st, 2013 with the Aaa tranche, Component A, priced at 1M-LIBOR plus 115 bp, with a floor of 1.4%.⁷ This is typical among recent offerings, with each subsequent tranche requiring larger rates for the higher risk. *Exhibit 2* shows 14 securitizations listed from left to right according to their offering date, showing each tranche and its respective interest rate spread above the 1-month LIBOR. *Exhibit 2* shows that spreads on these bonds have compressed, expanded, and since compressed again in the past 18 months. It is most likely that these spreads are most attributable to investors' confidence in the products coupled with yield expectations in the capital markets. The senior credit and largest tranche ("A") for each offering has been rated Aaa. In most cases, the first four components (A-D) have received investment grade ratings. The senior class portion of these securities accounts for about 50% of the entire offering. Loan-to-value ratios (LTV) collectively range from 70-75% between the loan and the most recent appraised values of the properties in the portfolio. Kroll gave the third securitization of Invitation Homes a loan-to-value ratio of 79%; the highest ratio of this type of securitization at its issuance.⁸

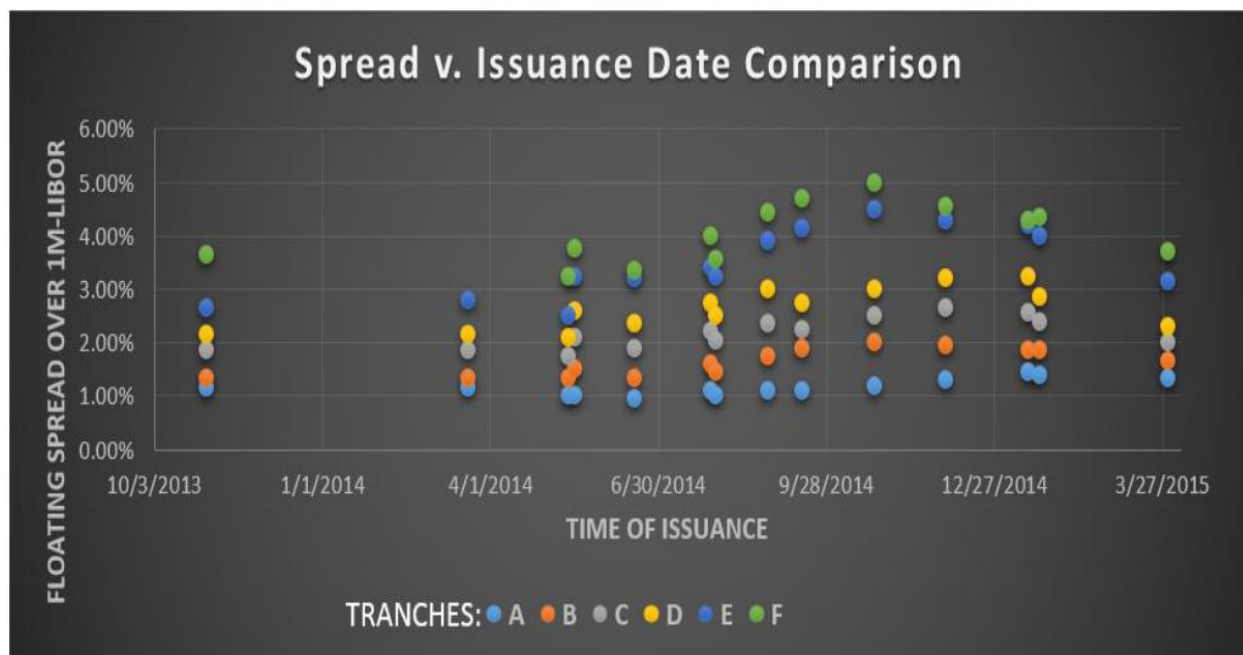
How important are these securitizations? Jake Mooney, at SNL Financial, who has written extensively on the SFR securitization front, states that this new access to funding will be used for normal business practices that come from additional financing. Mooney writes, "Starwood Waypoint Residential Trust is considering using the securitization market to fund the purchase of

⁵ (Chambers & Rowan, 2014)

⁶ (Perlberg & Gittelsohn, 2014)

⁷ (Bloomberg Terminal, 2014)

⁸ (Mooney, Third Invitation Homes securitization receives investment-grade ratings, 2014)



Source: Bloomberg Terminal

Exhibit 2: All 14 floating-rate securitizations classified by their respective tranches (i.e. components A to F). Each tranche is described by its offering date (X) and its corresponding interest rate spread above the 1-Month LIBOR (Y).

nonperforming loans, Silver Bay Realty Trust Corp. might use proceeds from a securitization to fund the repurchasing of stock and Colony American Homes Inc. could use the securitization markets to boost its lending business.”⁹ Securitizing also allows institutions to expand their portfolio, and increase FFO and dividends, in addition to allowing them to begin to create a barrier for other players. Jody Shenn (Bloomberg) writes that according to Keefe Bruyette & Woods Inc., “the rental-home securities may grow as large as \$900 billion, assuming 15% of annual home purchases are conducted by investors and 35% of those and existing rental-home owners turn to the market for financing” (i.e. institutional banks), this sounds quite far on the bright side; however, institutions are off to the races.¹⁰

WHERE WE ARE GOING

Since Blackstone’s unit Invitation Homes paved the way into the uncharted territories of the SFR securitization market, there has been a large volume of transactions by institutions with similar portfolios. *Exhibit 3*, shows the timeline of these securitizations. Blackstone’s Invitation Homes unit has had six offerings totaling \$4.11 billion, this accounts for approximately 43% of the \$9.45 billion market share of these SFR bonds to date. American Homes 4 Rent stands second at \$2.06 billion.¹¹ We have already seen some transformation, the first three deals offered were

⁹ (Mooney & Mantone, Single-family rentals: Yeah, we can securitize that, 2014)

¹⁰ (Shenn, 2013)

¹¹ (Bloomberg Terminal, 2014)

Securizations-To-Market Timeline

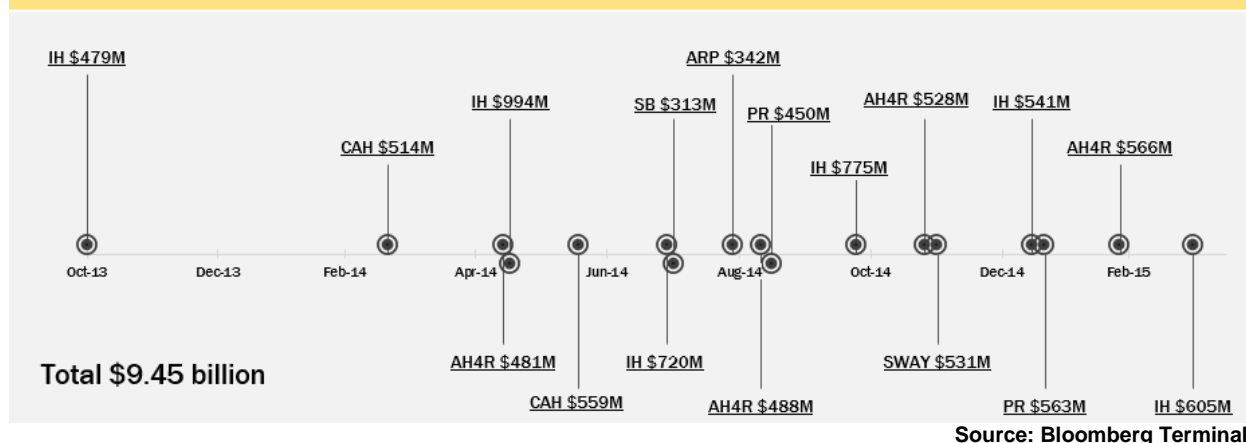


Exhibit 3 : All seventeen (17) single-family rental securitizations representing \$9.45 billion as of April 20th, 2014.

structured to amortize and the following seven deals have been structured as interest-only loans. American Homes 4 Rent priced the first fixed-rate bond with the longest maturity of 10 years and has since offered two more fixed rate bonds.¹² Invitation Homes was the first to introduce a portfolio of properties that had 5% vacancies by the cut-off date of the securitization timeline. In the early stages of offerings, we have only noticed single loans securitized, the day of pooled loans being securitized is finally here.

Looking forward, Jake Mooney noted that “the first multiborrower SFR securitizations, conduit-style deals backed by pools of loans to small and midsize landlords, could hit the market” this year.¹³ These securitizations have in fact already entered the market. Pools of loans from a handful of entities operating SFR portfolios of say, +/- 30 properties are bundled with similar portfolios operating under different financing structures and securitized. The main players that have stepped up to the plate include FirstKey Lending LLC, Blackstone’s B2R Finance and soon to be Colony American Finance (unit of Colony American Homes).¹³ An additional investor protection piece may involve a backup property manager that would gain control in the event of adverse conditions of a multiborrower securitization. The success of such instruments will rely on the underwriting standards of the lenders and the nuances put in place to mitigate the overall risk of these multiborrower portfolios.

RISK & WHAT TO WATCH

As data begins to cumulate, statistical trends will validate investors’ confidence in the SFR securitization market. Will cheaper debt be worth the risk added to the SFR market? Is the SFR industry going to experience standardizations, and will they lead to further regulation by the federal government? Would the sell-off of hundreds of thousands of SFR homes place an over-supply in the housing industry giving way to an economic crisis? Will institutional investors wring out the

¹² (Mustafa, 2014)

¹³ (Mooney, New type of single-family rental securitization is close, lending execs say, 2014)

industry to finance further growth and be left holding the Kool-Aid nobody wants to drink? The answers to these questions will come in due time, and until then, institutions will continue to acquire assets to further the growth of their portfolios.

Discussing risks, a general property appreciation in the market could have a large scale effect on rents in the volatile property markets. Will the desirability of multifamily developments decrease general market rents? Will the expenses of these portfolios remain manageable? If rents experience downward pressure, expenses will experience pressure. This would adversely affect the quality of these rentals as institutional investors work to meet investor and shareholder expectations. Have managers properly communicated their plans for capital improvements on their SFR portfolios? With spreads tight already, how much flexibility is there before terms are negotiated to add further risk? Liquidity risk comes of a concern as more supply enters the secondary markets. The floating-rate bonds will need to be rolled over every 2 to 5 years unless the options are extended for a maximum term length of 5 years ending at the earliest in October of 2018. An increased interest rate environment will put pressure on the performance of these portfolios. Projecting portfolio revenues based on rent growth estimates will give a back of the envelope approach to finding potential default environments if interest rates rise to certain levels by the time these bonds begin to roll over in 2018. According to Jake Mooney, Randy Robertson, head of securitized asset investments at Blackrock said "there's not a lot of data, not a lot of history on the costs associated with turnover for a single-family home on a routine basis." Robertson commented that the costs when someone moves out of an apartment are very different from when someone moves out of a single-family house. Robertson added that "we think that information is not transparent enough. We need a lot more of it. We think it really should be a requirement for entry into the securitization market."¹⁴ In a world of big data, having the transparency of the most basic requirements such as costs and performance of these portfolios with today's technology is obtainable and should be released. For the time being, keep a close watch on the news regarding the performance and vacancies of these portfolios as well as the locations with the highest concentrations of single-family homes. At the end of the day, the competition for cheap financing will prevail as long as investors' appetites accept these structured financial bonds.



John Layton is a senior studying finance with a strong interest in real estate. He will be graduating in December of 2015 and will be interning for PNC Bank this summer in their Philadelphia office for their commercial real estate banking group. You can contact John with specific or general questions and comments at John.Paul.Layton@gmail.com.

¹⁴ (Mooney, Single-family rental bonds are popular, but data is spotty, investors say, 2015)

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