ABOUT

Real Estate Research provided analysis of topical research and current issues in the fields of housing and real estate economics. Authors for the blog included the Atlanta Fed's Jessica Dill, Kristopher Gerardi, Carl Hudson, and analysts, as well as the Boston Fed's Christopher Foote and Paul Willen.

In December 2020, content from *Real Estate Research* became part of *Policy Hub*. Future articles will be released in *Policy Hub: Macroblog*.

Disclaimer

Email Me

Subscribe by E-mail

Subscribe by RSS

Other Fed Websites

May 16, 2014

Are Single-Family Rental Securitizations Here to Stay?

In the fall of 2013, private equity firm Blackstone LP issued the first single-family rental (SFR) securitization: Invitation Homes 2013-SFR 1. In March, Colony Capital released another SFR securitization. The Invitation Homes 2013-SFR 1 was backed by 3,207 single-family rental homes concentrated in Arizona, California, Florida, Georgia, and Illinois. Deutsche Bank arranged the deal. There are a variety of estimates of the size of institutional investors' activity in the SFR market, but with numbers like 90,000 to 150,000 homes and 15 to 20 billion dollars invested, most agree that we can expect more securitizations like these in the future. So what exactly is this new asset class, and how did it obtain its strong credit rating?

In this post, we look at how the structure of the Invitation Homes SFR emerged and compare it to more familiar commercial mortgage-backed security (CMBS) and residential mortgage-backed security (RMBS) classes to better understand the triple-A rating. We also consider some factors that could determine whether the SFR security class will stick around.

(For a nice discussion about the entry of institution investors into the rental market, read this second-quarter 2013 *EconSouth* article.)

Please note that much of the information that follows is based on reports from the rating agencies:

- Kroll Bond Rating Agency. "Kroll Bond Rating Agency Assigns Final Ratings to Invitation Homes 2013-SFR1". (November 11, 2013.)
- Kroll Bond Rating Agency. 17g-7 Disclosure (Invitation Homes 2013 SFR1).
- Moody's Investor Services. "Moody's sees growth for single family rental securitizations; outlines rating approach." (March 6, 2014.)
- Moody's Investor Services: "Moody's identifies key risk factors in securitizations of single-family rental properties." (August 23, 2012.)

Commercial or residential—or both?
This product took a long time to come to market. For nearly two years, the industry discussed how to structure this new security class. Discussions in 2012 and 2013 about the rating and pricing of an SFR security focused on three gray areas. The first was housing market risk. Would housing markets, and the underlying value of investor-owned homes, appreciate on a market-wide basis?

The second was property management risk. Could scattered-site, single-family homes be managed cost-effectively? And with a lack of historical data for scattered-site, single-family rentals, how could credit rating agencies predict vacancy rates, maintenance costs, and income streams with any precision?

Finally, there was confusion about how to structure an SFR securitization and what tensions and risks would exist in that structure. There was also some uncertainty about whether an SFR securitization would be more like CMBS or RMBS. Like RMBSs, the underlying assets of SFRs are single-family homes. And many risks—for example, home price depreciation and household income—are the same as in the homeownership market (Joseph Hu 2011). But like CMBSs, the borrower is a corporation, not a homeowner, and the cash flow comes from rental, not mortgage, payments. That means the payments come from highly variable net operating income, which is sensitive to vacancy rates, market rents, and maintenance costs unlike the fixed-income streams of mortgages, which are sensitive to repayment and default risk but otherwise fairly predictable. Also like CMBSs, the sponsor of the SFR deal would be responsible for maintenance, meaning they might have to keep some cash on hand.

Equity pledges or first-priority mortgages?
These issues influenced the structure of the security. High maintenance costs associated with the rental properties created a nontrivial conflict. Ideally, in a security, assets are owned by a tax-neutral, special-purpose vehicle (SPV), with assets and liabilities perfectly matched. However, retaining cash flows for

REAL ESTATE RESEARCH SEARCH

Search

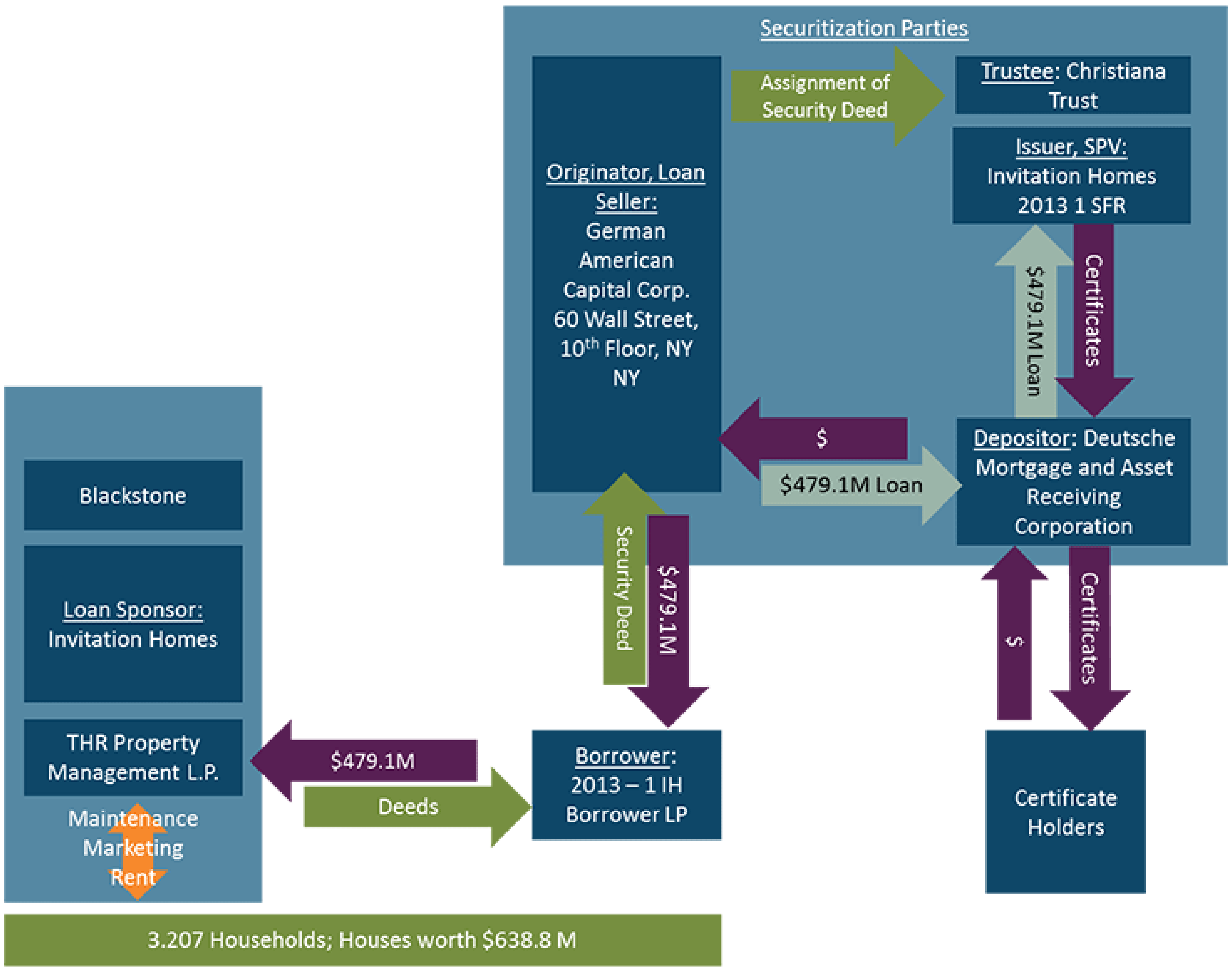
RECENT POSTS

Assessing the Size and Spread of Vulnerable Renter Households in the Southeast
What's Being Done to Help Renters during the Pandemic?
An Update on Forbearance Trends
Examining the Effects of COVID-19 on the Southeast Housing Market
Southeast Housing Market and COVID-19
Update on Lot Availability and Construction Lending
Tax Reform's Effect on Low-Income Housing
Housing Headwinds
Where Is the Housing Sector Headed?
Did Harvey Influence the Housing Market?

CATEGORIES

Affordable housing goals
Credit conditions
Expansion of mortgage credit
Federal Housing Authority
Financial crisis
Foreclosure contagion
Foreclosure laws
Governmentsponsored enterprises
GSE
Homebuyer tax credit
Homeownership
House price indexes
Household formations
Housing boom
Housing crisis
Housing demand
Housing prices
Income segregation
Individual Development Account
Loan modifications
Monetary policy
Mortgage crisis
Mortgage default
Mortgage interest tax deduction
Mortgage supply
Multifamily housing
Negative equity
Positive demand shock
Positive externalities
Rental homes
Securitization
Subprime MBS
Subprime mortgages
Supply elasticity
Uncategorized
Upward mobility
Urban growth

maintenance jeopardizes that tax-neutral status. Early discussions favored a structure in which the borrower, not the SPV, would retain ownership of the properties and instead of mortgages, equity pledges would collateralize the securitization. While these equity pledges might be preferable for maintaining properties and would be less transaction-intensive than issuing individual mortgages, equity pledges would create a weaker claim than first-priority mortgages for investors in the event of default. Further, equity pledges were not deemed to be as bankruptcy-remote as mortgages. All this meant equity pledges could be vulnerable to material consolidation in the event the sponsor were to become bankrupt or if the sponsor were to mismanage the properties, either selling them or borrowing further and creating competing liens on the properties (Matthew Clark 2013). For this reason, Moody's and Kroll stated that they would cap securitizations using equity pledges at Baa or A.



Source: Author

(enlarge)

Ultimately, the Invitation Homes/Blackstone SFR security used first-priority mortgages, not equity pledges, and secured a triple-A rating. In structure, the security is probably more like CMBS than RMBS. Deutsche Bank compared the instrument to CMBS, and the ratings agencies also leaned this way—Kroll and Moody's compared the security to CMBS on the forms where they express their expectations for representations and warranties. Aspects of the transaction itself suggest that it is more like a CMBS deal than an RMBS one. For instance, the special servicer, Situs Holdings LLC, specializes in CMBS (not RMBS) workouts. Still, the security remains a hybrid. Kroll used a CMBS model to determine the probability of default and an RMBS model to determine severity, working on the assumption that the income-based approach typically used in valuating CMBSs would not be appropriate for pricing the sales of single-family homes in a distressed housing market. Similarly, Morningstar used both Cap Ex and HPI stress tests to generate ratings of the various tranches, feeling that both an income/expense approach and a sales approach to valuation were appropriate.

The structure of the securitization reflects a priority for enhancing an investor's ability to take ownership and sell the homes in the event of a default, rather than other structures which might have prioritized management of homes to enhance rental income. Moody's did not base its rating on an evaluation of the income streams from the properties, because the agency did not feel it had the ability to evaluate with certainty vacancy rates, maintenance costs, and other key factors. Instead, it based its rating on the strength of investor claims on the homes in the event of default, and estimated sales prices of the underlying properties assuming a distressed housing market. Another factor in the triple-A credit rating is that the security is overcollateralized. That is, the value of the collateral ($638M) is well above the value of the loans ($479M)—Invitation Homes took a 25 percent advance rate on these homes.

Will they last?
Some negative commentary has surfaced in the five months since the Invitation Homes offering. And S&P has come out strongly against the triple-A rating, arguing that without historical performance data there is too much uncertainty about income streams. Recent appraisals noted that several tranches were trading below par, and that rents had declined 7.6 percent due to increasing vacancy rates. Firms that had hoped to make margin by “pushing rent” or increasing rents every year are now talking about keeping rents stable in order to minimize turnover and the associated vacancy rates. So with all of these issues, how much staying power does the SFR securitization structure really have? To the extent that these transactions are driven primarily by the value of the underlying collateral and not by rental income, they begin to resemble trades that will decline as home prices approach normal levels. Indeed, many SFR investors and managers say they ultimately intend to sell single-family rentals back into the owner-occupied market either 1) when maintenance costs begin to outweigh the potential of the asset’s income stream or 2) it appears that, in the medium term, home prices and mortgage markets have recovered—and thus the opportunity for this market to exist disappears.

Other commentators suggests otherwise: this asset class will grow, possibly driven by fundamental demographic shifts such as increasing labor mobility and shifting preferences for rentals. These attributes, combined with stagnant wages and tight mortgage markets, suggest increased demand for single-family rentals. They may also suggest that SFR securitization represents a new normal.

By Elora Raymond, graduate research assistant, Center for Real Estate Analytics in the Atlanta Fed's research department, and doctoral student, School of City and Regional Planning at Georgia Institute of Technology

May 16, 2014 in Housing demand, Rental homes, Securitization | Permalink