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Residential Rental Loans: High-Yield Credit That Finances Growing Landlord Portfolios

Faced with surging demand for single-family rental homes and significant limits on Fannie/Freddie loan programs, landlords are using new products to expand their portfolios one home at a time.

A slew of regulatory, economic, and market forces, as well as changing demographics, have pushed rental demand in the United States to record highs since the financial crisis. From 2005 to 2015, the number of renter households increased by 9 million, the largest-ever increase over a 10-year period, according to the Harvard Joint Center for Housing Studies. As a result, vacancy rates have fallen to their lowest levels (7.1% in 2015) in 30 years and annual increases in rents (3.6% in 2015) are significantly outpacing inflation.[1] Meanwhile, homeownership rates have declined to around 63.6%, below the long-term average of 65%, according to the U.S. Census Bureau.[2]

In response to the growing demand for rental housing, an increasing percentage of the U.S. housing stock is being converted to rental properties. While institutional operators have increased their holdings of single-family rental homes since the financial crisis, families who own and rent out a handful of homes and regional landlords with slightly larger portfolios continue to own the clear majority of single-family rental properties. Non-institutional operators own more than 98% of U.S. rental homes, according to analyst estimates published in a December 2016 article by *The Wall Street Journal.*[3]

Many of these small and midsized landlords would like to expand their holdings, but financing options for these non-institutional operators have been extremely limited historically. Over the past several years, however, a robust market for residential rental loans (RRLs or “investor loans”) has begun to take shape. Given the strong

Three things investors need to know about Residential Rental Loans (RRLs):

1. Pullback in mortgage lending and demographic forces have caused demand for single-family rental housing to surge across the United States

2. Specialty finance companies offering RRLs for individual properties are helping landlords expand their holdings, filling a large gap created by property limits and onerous underwriting processes of Fannie/Freddie rental loan programs

3. RRLs, which typically have 3- to 5-year durations and are underwritten based on the home’s rental income, add diversification in terms of duration and default risk to residential real-estate credit portfolios

demand by borrowers for RRLs, we believe that these medium-duration credits currently provide attractive risk and return characteristics for investment funds.

RRLS FILL THE VOID

Landlords for single-family homes are limited in the number of properties for which they can get conventional residential financing. Under Fannie Mae and Freddie Mac guidelines, individuals can get conventional mortgages for up to four residential properties, in addition to the investor's primary residence. Even within this threshold, many borrowers are unable to secure financing for rental properties because these loans are underwritten based on the borrower's credit score, income, and personal balance sheet.

Commercial-type financing is an option for some operators, but these loans have distinct drawbacks. These are blanket loans that cross-collateralize the properties covered by the loan. Because of this cross-collateralization, the borrower can't make borrowing or refinancing decisions for one individual property. For example, if the borrower wanted to access capital represented by one property and use that capital

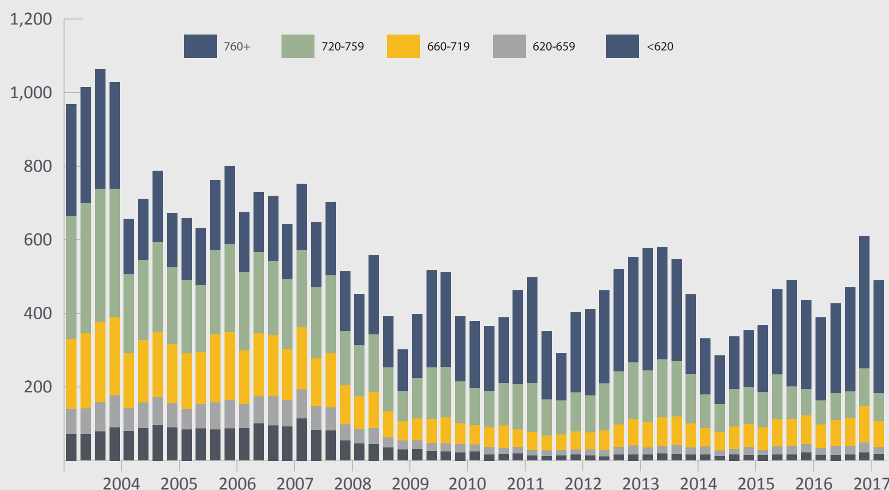
Lending Pullback Spurs Rental Demand

Numerous market-based and demographic forces have contributed to the shift away from homeownership toward renting over the past decade. These trends include a shortage of lower-priced starter homes and a large portion of the Millennial generation that is either delaying household formation and/or opting for the flexibility of renting vs. owning.

One of the biggest drivers of the shift toward renting since the financial crisis has been a widespread pullback in lending activity by banks. The mortgage-lending rules imposed by the Consumer Financial Protection Bureau have been successful in eliminating the irresponsible lending practices that led to the housing bubble. But the onerous nature of these rules and the resulting fines have caused many banks to either exit the mortgage-origination business altogether or drastically tighten their underwriting standards.

As a result, many would-be homebuyers are unable to get financing to purchase a home. Whether it's young adults with high levels of student debt, entrepreneurs with irregular or no W-2 income, or individuals with a one-time blemish on their credit history, many people with less-than-pristine credit profiles are effectively locked out of the housing market. The percentage of originations that involved borrowers with credit scores less than 760 fell from 69% in 1Q 2003 to 39% in 1Q 2017.

Mortgage Originations by Credit Score*
($ Billions)



Source: FRBNY Consumer Credit Panel / Equifax
* Credit Score is Equifax Risk Score 3.0

to acquire an additional rental home, this would be extremely difficult, if not impossible, with a blanket loan.

In response to the limitations of conventional financing options and the drawbacks of commercial-type financing for landlords, a growing number of specialty lenders have launched RRL programs over the past several years. These loans, which charge a higher interest rate than conventional mortgages, are structured on a "one property, one loan" principle that looks at the property's cash flow and value. This allows borrowers to get individual loans for specific properties. While the borrower's credit score and personal financial situation are certainly taken into consideration, the primary criteria used in the underwriting process for investor loans are the property's value and the ability of the rental income to service the debt.

INVESTMENT CHARACTERISTICS AND RISKS OF RRLS

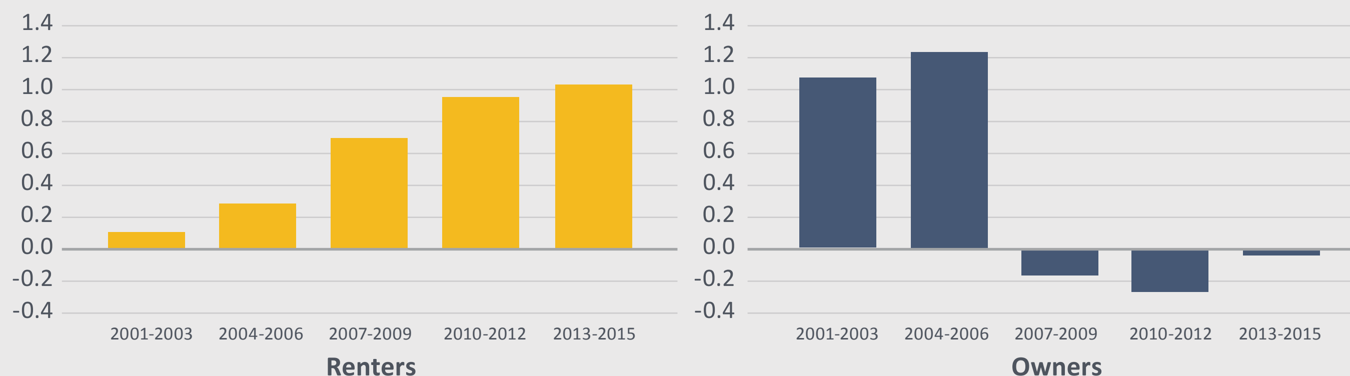
The universe of specialty lenders that originate RRLs has significantly expanded in recent years, but it still hasn't caught up to the demand from borrowers. As a result, lenders are able to charge relatively high interest rates on these loans, and the loans, in our opinion, provide attractive potential returns for funds that invest in real estate credits.

Terms of RRL programs vary by lender, but many have monthly payments based on a 30-year amortization schedule and a fixed rate for the first three to seven years. Based on our observations of recently completed RRL transactions, investors who purchase these loans typically receive a potential net coupon of 6.0% to 7.25%, which we believe is attractive given the approximately three- to five-year expected duration of these credits. Other characteristics that,

Rental Population Surges as Homeownership Falls

A pullback in mortgage lending and rising home prices have pushed more and more U.S. households to become renters. From 2005 to 2015, the number of renter households increased by 9 million, the largest-ever increase over a 10-year period, according to the Harvard Joint Center for Housing Studies.

Average Annual Growth in Households
(Millions)



Source: Harvard Joint Center for Housing Studies tabulations of U.S. Census Bureau, Housing Vacancy Surveys

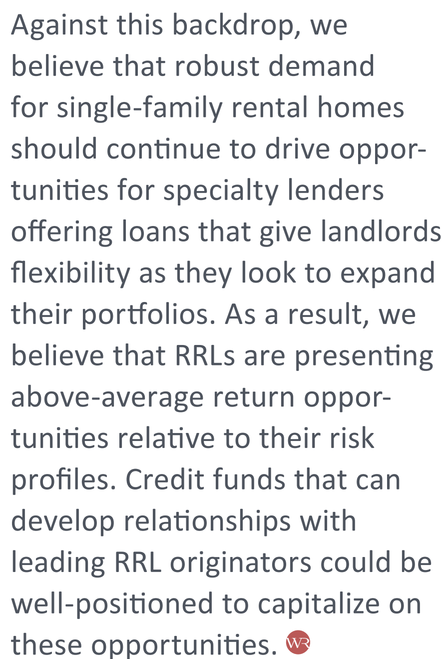
in our opinion, make these loans attractive to investors are LTV ratios that typically range from 65% to 75% and property debt-to-income (DTI) ratios that range up to 100% (on a small subset of loans with additional reserves).

Because these loans have different refinance profiles than consumer mortgages, we believe that RRLs add a valuable offset in terms of prepayment risk and diversification to a residential real-estate credit portfolio. If the borrower were to default on the loan, the legal process to foreclose on a rental home is much faster and more efficient than foreclosing on a primary residence.

From a risk perspective, RRLs in some situations may have a higher default risk than consumer mortgages because borrowers might be more likely to default on an investment property than on a primary residence. The default risk on RRLs would further increase if home values fall or if rental demand eases. Also, increased demand from funds wanting to purchase these loans could drive the net coupon lower. Another potential factor that could lessen the attractiveness of these loans for investors is if originators become more aggressive and begin relaxing their underwriting standards in an attempt to capture more market share.

CAPITALIZING ON TODAY'S RESIDENTIAL CREDIT OPPORTUNITIES

The U.S. housing market continues to strengthen, driven by falling unemployment and pent-up demand from Millennials and other would-be home-owners who have been on the sidelines since the financial crisis. Although rising interest rates and the undersupply of new homes are creating affordability pressures, the housing market should continue to strengthen over the next several years.



Against this backdrop, we believe that robust demand for single-family rental homes should continue to drive opportunities for specialty lenders offering loans that give landlords flexibility as they look to expand their portfolios. As a result, we believe that RRLs are presenting above-average return opportunities relative to their risk profiles. Credit funds that can develop relationships with leading RRL originators could be well-positioned to capitalize on these opportunities.

ABOUT WINDOW ROCK CAPITAL PARTNERS

As an opportunistic strategic credit specialist, Window Rock Capital Partners seeks to generate consistent alpha, high yield, and strong risk-adjusted returns by capitalizing on long-term secular trends in the private credit market. We strive to identify opportunities aligned with our investment thesis early in their cycle, before returns compress, while also having a deep understanding of risk and taking that risk when it is compensated. As an investment firm, we are patient but quick to act when conviction is high. For more information, visit ***www.windowrock.com*** *or email the company at* ***info@windowrock.com****.*

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RESOURCES

[1] Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing 2016."

[2] U.S. Census Bureau, "Current Population Survey/Housing Vacancy Survey."

[3] The Wall Street Journal, "Wall Street as Landlord: Blackstone Going Public with a $10 Billion Bet on Foreclosed Homes." December 6, 2016.