WINDOWROCK

Residential Transition Loans: Short-Term, High-Yield Credit Driven by Booming Home Renovation Activity

As the market for loans to professional home flippers matures and becomes more institutionalized, these short-term credits provide attractive risk/return profiles for funds and their investors.

Long before HGTV's prime-time lineup became dominated by shows like "Flip or Flop" or "Masters of Flip," real estate investors were seeking to generate attractive returns by acquiring, renovating, and quickly re-selling homes that were physically, and sometimes financially, distressed. These operators could be small, informal family teams or large professional general contractors with projects in multiple states.

Historically, the majority of homes to be flipped have been purchased with cash, but today a sizable percentage of them are financed. According to RealtyTrac, approximately 30% of all homes flipped in 2015 were financed at purchase,[1] and nearly all of these residential transition loans (a.k.a., RTLs, "fix 'n flip loans," or "bridge loans") are made to experienced professional developers. The market for these short-term loans has undergone a major overhaul of its own over the past five years as the single-family housing market has recovered.

In addition to rising home prices, other forces driving surging demand for RTLs are a significant undersupply of new homes and an aging U.S. housing stock. In the first quarter of 2017, the number of U.S. single-family housing starts was just 62% of what is considered normal historically, and the median age of owner-occupied housing in the United States increased from 31 years in 2005 to 37 years in 2015, according to the National Association of Home Builders.

Three things investors need to know about Residential Transition Loans (RTLs):

1. Aging housing stock and other market forces in the United States are driving demand for renovations of existing inventory
2. Market for short-term loans to professional home renovators has become more institutionalized since 2012, but remains quite fragmented
3. Lack of securitization and short-term nature of these loans create challenges for large funds looking to invest in RTLs, which creates more opportunities for midsized, specialized funds

In this housing environment, we at Window Rock believe that RTLs have become particularly attractive for credit funds and their investors over the last several years. Against a backdrop of rising interest rates and strengthening home prices, these short-term loans to professional investors and operators in the residential real estate market present, in our opinion, the opportunity for appealing risk-adjusted returns.

EVOLUTION OF THE RTL MARKET

In the past, virtually all financing for flipping homes came in the form of hard-money loans from family offices, angel investors, or other non-institutional sources. These hard-money loans typically have six- to 12-month terms, very low loan-to-value (LTV) ratios, and mid-teens interest rates. Banks, traditionally, have not been viable sources of financing for these projects because of the rapid turnaround needed by borrowers. When a distressed property comes on the market, an investor typically needs to secure financing and submit an offer in 24 to 72 hours—a timeframe that is much shorter than most banks can accommodate.

Once housing prices stabilized following the financial crisis,

Aging U.S. Housing Stock Drives Increased Renovation Activity

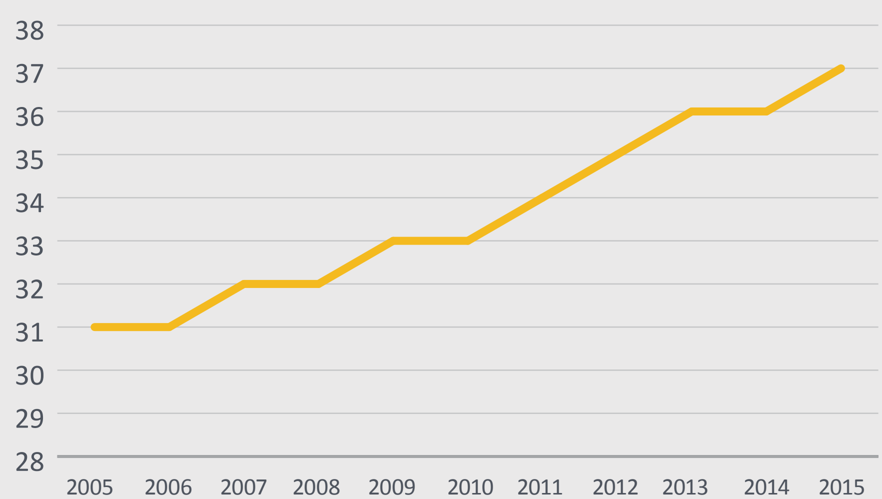
Thanks to the lack of new construction over the past decade, homes across the United States are showing their age. This is driving an increase in flipping by investors and other renovation activity. The median age of owner-occupied housing in the United States increased from 31 years in 2005 to 37 years in 2015, according to the National Association of Home Builders. More than half of the homes were built before 1980, and 38% were built before 1970.[2]

Home builders that survived the recession had to significantly scale back their operations. Their efforts to ramp back up now that the housing market has recovered are being frustrated by a lack of skilled labor. Although new construction activity has been steadily increasing over the past few years, demand for homes continues to far outpace supply.

This supply/demand imbalance is being exacerbated by generational trends. On the heels of the relatively small Generation X and Generation Y, the massive Millennial generation is entering into home-buying age. Despite Millennials' well-documented delays in household formation, these young adults overwhelmingly still plan on buying homes someday. A 2015 Demand Institute Survey found that 83% of Millennials expect to become homeowners someday.[3]

Across the country, the dearth of new homes has led to more flipping and renovation activity. Faced with limited options for acquiring a new home, investors and homeowners are looking to modernize and improve existing homes.

Median Age of Owner-Occupied Housing



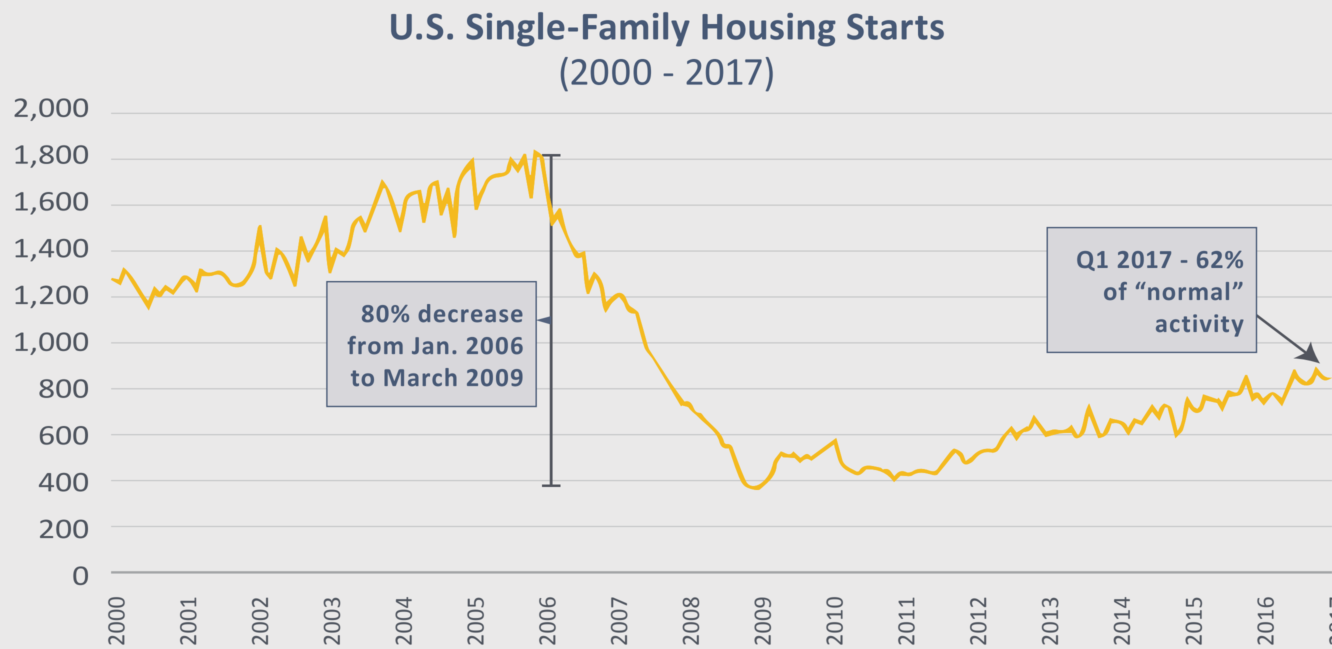
Source: National Association of Home Builders; 2015 one-year ACS estimates flipping activity accelerated starting around 2012. At the time, investors focused on buying homes out of foreclosure, making light renovations, and then selling the homes—earning what we consider to be an attractive profit primarily for rescuing these properties from financial distress. As the housing market continues to recover, flipping activity has shifted from being focused on making minor improvements to financially distressed homes to making more substantial improvements to older, outdated homes

As flipping activity increased, so too did demand for financing from investors looking to acquire more properties and expand their operations. Because of this growing demand, specialty finance companies and other lenders saw the opportunity to build more robust platforms for originating these bridge loans. Since around 2014, the market for these loans has become much more institutionalized—and the terminology used to describe these loans has become more institutionalized as well, taking on the moniker residential transitional loans (RTLs).

Nomura estimates that in 2016 RTL annual origination volume grew to $12 billion - $14 billion. Furthermore, Nomura estimates that the total addressable market for RTLs is $30 billion to $40 billion a year.[4] The gap

Housing Starts Remain Well Below "Normal"

After falling more than 80% from the 2006 peak, single-family housing starts have been slowly recovering since early 2012. According to the National Association of Home Builders, the number of housing starts in the first quarter of 2017 was still only 62% of what is considered normal.



Source: U.S. Census Bureau, National Association of Home Builders between current production and total addressable market is primarily the result of a lack of available financing. This gap, however, should shrink as more and more specialty lenders continue to build out origination platforms to serve this market.

INVESTMENT RATIONALE AND RISK FACTORS FOR RTLS

For funds and their investors that invest in real estate-related credits, RTLs provide what we consider to be an attractive risk-return profile for such short-term instruments. Based on our observations of recent RTL transactions, these loans typically charge 8% to 10% interest to the borrower, which, after subtracting the originator's servicing fees, translates to a potential 7% to 9% net coupon to the investor who purchases the loan. RTL borrowers typically make down payments in the 15%-30% range, resulting in relatively low LTV ratios.

At a time when 30-year mortgages are yielding 4% to 6%, RTLs are, in our opinion, attractive relative to other residential real estate-related credits. With an average duration of about nine to 12 months, we believe that the short-term nature of RTLs makes them a valuable addition to a portfolio by providing high current income in an environment of rising interest rates.

As with any residential mortgage loan, falling home prices pose one of the greatest risks to funds that invest in RTLs, which are underwritten as asset-based loans. This risk, however, is mitigated by the fact that RTLs typically are repaid in 12 months or less when the property is sold, limiting investors' exposure to home-price fluctuations. RTLs also have relatively low LTV ratios, which further protects investors from falling home prices. As competition increases among RTL originators, however, lenders may begin relaxing their underwriting guidelines and using more aggressive LTV ratios. This would reduce the margin of safety that investors have on the collateral if housing prices were to decrease significantly.

STRUCTURAL FACTORS LIMIT CAPITAL INFLOWS

RTLs do not represent an evergreen opportunity for investment funds, and over the past 12 months an influx of capital has driven returns lower for investors. While this dynamic is bound to continue as long as RTLs provide above-market return opportunities, the RTL market has several structural characteristics that should limit the amount of capital that can enter the space.

There are two primary ways for credit funds to invest in residential loans: 1) securitized loans (i.e., groups of loans that have been bundled together and sold to investors) or 2) whole loans (i.e., loans that are not securitized and are sold individually). Because there has been little securitization of RTLs and because the RTL origination market is highly fragmented, most large funds, which mostly invest in securitized loans, are limited in their ability to invest in RTLs. As of mid-2017, there have been only a handful of securitizations involving RTLs, meaning that funds must be adept at acquiring and managing whole loans if they want to participate in the RTL market in a meaningful way.

Even for those funds that are set up to invest in whole loans, the total RTL opportunity set may be too small and too fragmented to make sense for the portfolio. To move the needle in terms of their fund's performance, mega-cap credit funds typically are looking to deploy capital in $1 billion+ positions. Lending Home, which is the largest RTL originator, may generate only $50 million - $75 million of new loans a month, and the average RTL originator may do only $10 million - $20 million a month. Building a sizable RTL portfolio requires a fund to build relationships with numerous originators—a labor- and resource-intensive process that likely does not make economic sense for mega-cap funds.

The short-term nature of RTLs is another challenge to constructing sizable RTL portfolios. Because these loans are usually repaid within a year, fund managers are constantly needing to source new collateral to reinvest the proceeds from payoffs. These challenges mean that midsized, residential credit-focused funds that understand how to acquire whole loans and have established relationships with high-quality originators are in the best position to invest in the opportunities currently presented by the RTL market.

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 homeowners 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.

Renovations to an aging stock of existing homes should, in our opinion, continue to be a very active market, and we believe that professional contractors in this space will continue to seek institutional-quality financing through a growing and maturing RTL industry. We believe that RTLs will present above-average return opportunities for investors relative to their risk profiles. Credit funds that can develop relationships with leading 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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Mr. Parekh has more than 23 years of experience in residential structured products, residential mortgage finance- and real estate-banking. Before joining Window Rock's management team in 2016, he was a managing director at Premium Point Investments and executive vice president of its subsidiary, WinWater Home Mortgage, where he managed the residential whole loan conduit. He has also had senior roles at Bank of America Merrill Lynch and UBS.

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Mr. Pettiford leads Window Rock's investor relations efforts and is responsible for client service, investor communications, product development, financial consultant relations, and fund raising. Mr. Pettiford, who began working in the investment management industry in 1999, is also a member of Window Rock's management team.

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RESOURCES

[1] Nomura, "A Brief Introduction to RTLs." Sept. 16, 2016.

[2] National Association of Homebuilders, "The Aging Housing Stock." January 5, 2017.

[3] The Demand Institute, "2015 Consumer Housing Data Survey."

[4] Nomura.