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THE SINGLE FAMILY HOME

Rise of an Asset Class

THE NEAR SYSTEMIC COLLAPSE OF THE FINANCIAL SYSTEM IN 2008,

which mostly stemmed from extremely high systemic leverage, irrationality in pricing and over exuberance across asset classes led to institutions taking a first leap into considering single family homes as an asset class. What used to be the domain of mom & pops, and wealthy multi home owners became an attractive investment opportunity for private equity managers, developers and even hedge funds.

THIS INSTITUTIONAL INVOLVEMENT, and the creation of a burgeoning asset class (four of the five fastest growing companies in the real estate industry were in the single family home asset class segment according to Housing Wire in 2014) happened with good reason:

» The aftermath of the 2008 financial crisis left home ownership lower by 6% from its original peaks in 2005 of 70% to 64% in 2015. Every 1% drop represents an increase of 750,000 single family homes that were available for acquisition.[i] Single family homes became arguably a value investment

asset, even deeply undervalued, depending on location.[ii]

The aftermath of the 2008 financial crisis left home ownership lower by 6% from its original peaks in 2005 of 70% to 64% in 2015.

» Coupled with Census data which reflects median rents rising steadily over the past 20 years indicated that owning single

family homes as rentals became a feasible, notwithstanding the higher operating and management costs generally associated with that activity.

» Then there is the demographic shift where our younger generation with their “Digital Nomadic” lifestyles caused shifts in rental vs. ownership patterns. The newer generation is willing to spend a very high proportion of their income on rent rather than own and suffer the lack of geographical and labor mobility that results from home ownership.

» Finally, institutions realized the much greater fragmentation in the single family home space vis a vis that in multifamily and the generally lower levels of sophistication on the end of the mom & pop buyers and sellers tend to lead to higher rental yields (150bps uptick) also making up for higher operating and management costs associated generally with that activity.[iii]

With the rise of single family homes as a true asset class, we decided last year to take advantage of our intimate knowledge of our investment geographies and create a boutique investment vehicle for single family homes, one structured in a manner which would leave the investment vehicle with all the benefits of horizontally stacked (single family homes) investments and without many of the risks of the vertically stacked ones (apartment buildings).

Let me list the challenges we saw in the creation of such a product and discuss the moves we made to address those.



1. HIGH OPERATIONS & MANAGEMENT EXPENSES

GENERALLY, PROPERTY MANAGEMENT FIRMS IN REAL ESTATE ALLOCATE BETWEEN 30-35% OF RENTAL REVENUE TOWARDS EXPENSES FOR MAINTENANCE, repairs and operations of multi-family rental property. Colony Capital, one of the larger institutional single family plans on spending about 50% of rental revenue.

- » We decided for our single family investment vehicle to focus solely on one of our prime focus sub-markets. An area with 48,000 residents and an extremely high concentration of single family residences on smaller and denser lots. - This lowered our operational and management intensity. Now one small team can service the entire portfolio in a very tightly bound geographic location.
- » We focused on a geographic location with an extremely high number of lots with poor land to improvement attribution of value. - This allowed us the optionality of multiple exits by allowing us to take advantage of hot markets by developing / redeveloping the asset to even out the land to improvement ratio or to hold for rental yields.
- » We focused on a sub market with near to 100% occupancy and a large demand vs. supply gap. - This allowed us to rent our assets immediately with ease and at accretive prices. It also allowed us to develop and sell in quick time-frames and at high exit price points.



2. ASSET TO LIABILITY MISMATCH RISK TO RENTS

GENERALLY IN MULTI-FAMILY APARTMENT BUILDINGS, a few vacancies aren't a big problem as the financing costs can generally be carried (at 5% Cap Rate for a property, with 50% Leverage, you should technically be able to run 10% vacancy and still breakeven). In a single family residence, every single vacancy has the ability to put you behind financing costs and in the red.

» We decided to create our single family investment vehicle so that we would not have any property level leverage. - Instead we add only portfolio level leverage, and in a portfolio of multiple single family residences, this form of leverage means that each single family residence acts like an apartment unit and each portfolio acts like an apartment building. Our portfolio now can withstand a 10% portfolio wide vacancy and still break even in the same 5% Cap Rate scenario. But since we expect 100-150bps higher yields from

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single family residences, we can technically bear a higher vacancy rate as well...not that we bank on that!!

» We decided to give our single family investment vehicle a near twelve year life (once you include the

full length of the commitment period, investment period, divestment period and the optional extension periods), which is the length of nearly two full economic cycles. - This allows us to capture nearly 72% of the principal in rental yields before the portfolio wide leverage, nearly 145% total return with the portfolio leverage, while still leaving the optionality of the market prices of the asset rising and the gains from sale of that as just cherry on top.

3. LACK OF EXIT OPPORTUNITIES

GENERALLY, SINGLE FAMILY HOMES HAVE BEEN VIEWED AS “less liquid” than commercial real estate (which should never be considered “liquid”) and something that only transacts as a result of one person’s desire to reside in a particular home; ie. almost a whimsical decision of want vs. need. However, the asset class has matured and come a long way since this belief. Now the options of exiting such a portfolio of income earning single family homes include the possibility of a public REIT exits, the ability to securitize the cash flows from the assets and the ability to sell the homes (in good times like now) as individual sales or as portfolio sales to other institutional buyers looking to enter the particular asset class or particular markets.

- » We expect to be able to take advantage of the relative pricing arbitrage between entry in a pre improved asset to an exit through an improved asset to create liquidity. (Develop & Dispose)
- » We expect to also have the option of holding the improved asset or the pre-improved asset as yielding vehicles in a portfolio and using financing options to create liquidity. (Earn Income & Depreciate)
- » We expect to be able to earn a decent yield while waiting for the improvement arbitrage to increase and possibly sell an entitled and fully permitted project to other developers. (Earn Income & Entitle to Flip)





The argument that we make, is that as times change and circumstances change with regards to financing and structure, what could often be considered a “disadvantaged” asset class can actually become a highly opportunistic one. **AT THE END OF THE DAY, ITS NOT THE ASSET CLASS OR PRODUCT TYPE, AS IT IS THE PRICE, THE LOCATION, THE STRUCTURE AND THE VISION THAT GUIDES LONG TERM RETURNS FOR INVESTORS IN REAL ESTATE. AND AFTER ALL, IF EVERY PROFESSIONAL INVESTOR IS ONLY CHASING COMMERCIAL ASSETS, MAYBE THE REAL OPPORTUNITY LIES AWAY FROM IT???**



SOURCES

^[i] Sultan, Daniel. ***"The Single Family Rental Market - A New Asset Class"***. Wealthfront, February 11, 2015

^[ii] Hasnain, Jafer. ***"Single Family Homes Become An Asset Class"***. Alter NOW; July 31, 2012

^[iii] Whelan, Robbie. ***"Single Family Rentals Keep Pulling in Investors"***. Wall Street Journal, May 16, 2012.