AMERICAS: Trader or operator
PERE
1 September 2012

By Evelyn Lee

As more private equity firms look to take advantage of the single-family rental opportunity, two very different investment strategies are emerging.

As the chief US housing strategist at Morgan Stanley, Oliver Chang was one of the earliest and most vocal proponents of investing in the buy-to-rent single-family housing market. In an October 2011 report, he touted the property type as being in the early stages of becoming "a new institutional-owned asset class."

Indeed, since last fall, some of the biggest names in private equity – including GI Partners, Kohlberg Kravis Roberts & Co and The Blackstone Group – have been ramping up their investments in single-family rental real estate, typically forming partnerships with other firms focused on the buy-to-rent strategy.

Chang, meanwhile, went from covering the single-family rental market to becoming an investor himself, leaving Morgan Stanley in May and announcing last month the formation of Sylvan Road Capital, an Atlanta-based asset management firm focused on acquiring, renovating and managing distressed single-family homes nationwide.

"I quickly realized that the opportunity was something very unique," Chang said in an interview with PERE. "We're in the middle of a housing cycle the likes of which the country hasn't seen since the Great Depression."

With backing from a major private equity firm, Chang and his partners, the former principals of Atlanta-based Delmar Realty Advisors, initially will acquire more than $300 million in single-family homes, and he expects to invest more than $1 billion in the market over the next two years. While he currently estimates the single-family rental market at about $3 trillion, he anticipates the market will grow by an additional $1 trillion over the next few years.

That said, "the market actually has changed quite a bit over the course of the past six to eight months," Chang said. With an influx of capital from private equity firms and hedge funds into the single-family housing market, two distinct investment strategies have emerged: one focused on making trades and the other on building operating platforms.

The majority of the private equity firms and hedge funds have adopted the first approach, where returns are based on appreciation in home prices. Under this strategy, an investor aims to acquire as much property as it can in order to generate the highest possible returns. To quickly build up its portfolio, a firm focuses on buying assets that require only minimal improvements before they can be rented out and often outsources many of its operations.

Chang, however, counts his firm among the operators, which typically handle all acquisition, renovation, leasing and property management functions in-house and target assets that are in need of extensive renovation but can be acquired at a more significant discount to replacement costs. Under this strategy, returns are based on higher rental yields from lower operating expenses, as well as capital appreciation from increased home values post-renovation.

"While we're all in the distressed single-family housing opportunity, it doesn't mean that we're all in the same markets and going after the same products," said Chang. Most of the trade-focused firms have targeted areas such as Arizona, southern California and Nevada, which have a higher concentration of turnkey single-family homes. Operators, meanwhile, generally have sought out areas such as the Southeast and Midwest, where there is a higher percentage of older homes in need of renovation work.

Of course, “a lot of hedge fund and private equity firms that have gone after the same product, because of the same play on home prices, have been competing against each other to buy these houses, so they’ve bid up those prices pretty significantly,” Chang added.

In some markets, investors are now bidding on homes at prices that are nearing or even exceeding replacement costs and buying at 5.5 percent to 6 percent net yields, Chang said. Those returns are considerably lower than those that can be achieved under an operator strategy, with targeted yields that can range from the high single digits to the low double digits, he noted.

Building an operating platform, however, is time- and capital-intensive, said Doug Brien, co-founder and managing director at Waypoint Real Estate Group, which in January announced a partnership with GI Partners to acquire $1 billion of single-family rental homes by 2013. A trade-focused approach is a faster, easier way to invest, but it carries the risk that “you don’t end up buying as well on an asset-by-asset basis, and the returns might not be as good as a result,” he explained. “Some guys would argue that’s fine. They would argue that the economics are compelling enough, and they’re not going to spend the time building out a platform.”

While some private equity firms are investing in single-family rentals on a short-term basis, both Chang and Brien view buy-to-rent as an evergreen opportunity – an assessment supported by Morgan Stanley analysts Vishwanath Tirupattur, James Egan and Jose Cabronero in a June report. The team gave a bullish outlook on rental housing and predicted that US homeownership rates were unlikely to return to their previous highs, given the numbers of Americans who have lost their homes and the large percentage of 18- to 34-year-olds who are not financially ready to buy. “We continue to believe that the current stock of single-family distressed housing – the shadow inventory – offers the best opportunity to meet this demand for rentals,” they wrote.