Morgan Stanley

MORGAN STANLEY RESEARCH

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Global

Housing Market Insights

Buy-to-Rent

The Year of the Landlord is off to a fast start, with both private investors and government programs targeting the opportunity to turn distressed single-family properties into rentals. For simplicity, we call this overall opportunity Buy-to-Rent, with over $1 billion in capital raises announced in the past month alone.

We believe one of the greatest potential effects of Buy-to-Rent is job creation, with the possibility of creating over 1MM jobs in the hard-hit construction and real estate industries. Best of all, these jobs could be created by private capital without the use of taxpayer dollars, and generally cannot be outsourced.

The government has officially announced the development of a pilot program for bulk disposition of REO properties on agency balance sheets. Initial sales will target Fannie Mae properties and involve sales to pre-approved private investors who agree to turn them into rentals.

As Buy-to-Rent develops, we believe operating efficiency will be the leading driver for investor returns. The difference between internal and external rehabilitation, leasing and property management can result in substantial differences in total returns.

At the same time, valuation and acquisition will remain important, driving total returns through both current yields and capital appreciation. Investors will need to balance their pricing rationale with their need to allocate capital in the face of constrained supply.

Housing Market Insights

Buy-to-Rent

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The Year of the Landlord is off to a fast start, with the government weighing in officially on what is now known as the REO Rental program (very similar to our REBUILD recommendations from last fall), and the institutional investor community is putting its money where its mouth is by announcing several high-profile fund-raising successes aimed at investments in distressed single-family homes with a goal of converting them to rental properties – a strategy we will refer to simply as Buy-to-Rent. With more deals likely in the works, and the idea of institutionally held single-family rentals front and center in the investor community, we are moving away from the theoretical question of whether it is possible, and instead focusing on the question of how best to execute on this opportunity.

We believe that the shift in focus toward determination of an investment strategy means that both private investors and the government now fully realize the potential of this opportunity. Support for the idea has been broad-based, and includes the Fed, the Treasury, FHFA and HUD. The potential is there not only for profit, but also to finally address the biggest problem still standing in the way of a housing – and greater economic – recovery: the backlog of distressed homes.

In this report, we move forward in our analysis of this opportunity. Whereas in the past we have concentrated on the theoretical risks, returns and size of institutionally held single-family rentals, here we dig deeper into the implementation and execution strategies being considered by existing and soon to be existing investors. We attempt to categorize and evaluate those strategies, and in addition, we look at the greater impact of such strategies on the opportunity itself, the housing market as a whole, and the macro economy.

While we strongly believe there are significant opportunities here from all perspectives, the de novo nature of this investment for institutions also means there are a host of pitfalls. Ultimately, the goal is certainly to have a bigger slice of a bigger pie, and avoid dropping the pie on the floor through poor execution.

In performing this analysis, we reach the following conclusions:

- Both private investors and government programs are targeting the opportunity to turn distressed single-family properties into rentals. Buy-to-Rent has seen over $1 billion in capital raises announced in the past month alone.
- We believe one of the greatest potential effects of Buy-to-Rent is job creation, with the possibility of creating over 1MM jobs in the hard-hit construction and real estate industries. Best of all, these jobs could be created by private capital without the use of taxpayer dollars and generally cannot be outsourced.
- The government has officially announced the development of a pilot program for bulk disposition of REO properties on agency balance sheets. Initial sales will target Fannie Mae properties and involve sales to pre-approved private investors who agree to turn them into rentals.
- As Buy-to-Rent develops, we believe that operating efficiency will be the leading driver for investor returns. The difference between internal and external rehabilitation, leasing and property management can result in substantial differences in total returns.
- At the same time, valuation and acquisition will remain important, driving total returns through both current yields and capital appreciation. Investors will need to balance their pricing rationale with their need to allocate capital in the face of constrained supply.

The Government

Before we can fully analyze the various strategies being considered by private investors, we must first try to understand the potential impact of government programs on Buy-to-Rent – some direct, and some indirect. And what a plethora of policies have been announced over the course of the past few weeks.

<u>HAMP Expansion and Underwater Re-Fi</u>

We wrote about the more indirect ones already – the underwater re-fi and HAMP expansion plans – and concluded that they will have only a marginal impact on housing overall (see *Resi Credit Insights – HAMP Expansion and Other Housing Developments*, February 3, 2012). Indeed, we don't believe they will have a material impact on either the returns or the size of Buy-to-Rent. Instead, the two announcements we believe will matter for Buy-to-Rent are the REO Rental program and the settlement between 49 Attorneys General and the 5 largest mortgage servicers around foreclosure issues.

Attorneys General Settlement

Let's start with the settlement. While the settlement includes financial penalties totaling $25 billion to be paid by the banks who own those servicers, some of those funds will go toward programs that we believe will have little effect on Buy-to-Rent. Instead, the two most important components of the settlement in our minds are the $17 billion that will go toward helping delinquent borrowers (mostly through principal reduction modifications, and mostly in CA and FL), and the settlement itself and what that might mean for foreclosures and liquidations.

First, we believe the $17 billion component is still far too small to have much of an effect on the population of delinquent borrowers, even if we assume the total amount of principal reduction could reach the max HUD estimate of $32 billion (based on credit given for certain reductions).

Exhibit 1

Principal Reductions Would Not Move the Needle

Principal Reduction Application	
Total dollars of negative equity	$700 billion
Amount for principal reduction	$32 billion
Potential reduction	4.6%
Total number of underwater borrowers	10MM
Average dollars of negative equity	$70,000
Potential borrowers reduced to 100 MTMLTV	457,142

Source: Morgan Stanley Research, Data Quick, HUD

While those that receive help may end up permanently curing and being removed from the distressed inventory, the potential figure is still miniscule relative to the roughly $700 billion of negative equity in the market. In Exhibit 1, we show how small an impact these reductions could have across two applications: evenly split amongst borrowers, or applied to the average borrower down to 100 mark-to-market LTV.

Furthermore, some of that money can be used to make incentive payments to facilitate short sales, which would result in more, not fewer, liquidations, albeit through a different channel than foreclosure. We believe this is positive news for Buy-to-Rent, as short sales usually result in a higher quality product while still at considerable price discounts.

Second, the fact that the market finally has a settlement should remove some of the uncertainty around future foreclosures, even if new processes and paperwork are more comprehensive. While banks did not get total immunity from future legal action, even this modest reduction in uncertainty should help increase the rate of liquidation of distressed inventory – now in a much more controlled manner. Again, we believe this is positive for Buy-to-Rent by freeing up some of the inventory that investors want to buy, but doing it in such a way that it doesn't simply flood the market.

REO Rental Program

The REO Rental program will clearly have an impact on Buy-to-Rent through the establishment of a bulk sales channel that may also include financing. In fact, it is the driving factor behind some of the institutional interest in the opportunity. The successful implementation of such a program would fundamentally alter the acquisition phase of Buy-to-Rent. Unfortunately, very few details have yet been announced, and the initial phase of this program will be a pilot sale limited in both size and scope. That said, we are pleased that the government is taking careful consideration when designing this program given the importance we believe it holds for the future success of any bulk aspect to the purchase of inventory for Buy-to-Rent. While the ultimate impact of this program may not occur until late 2012 or beyond, it is a huge step forward in our opinion that they have decided to make this program a reality.

The Private Sector

At the same time that the government has been making waves around housing policy and programs directly aimed at Buy-to-Rent, the private sector has also made headlines. Over the past few weeks, we have seen a clear pickup in announcements of private equity fund raises to target the Buy-to-Rent opportunity. Adding up just the four recent deals and firms that have publically discussed their investment targets, we get to nearly $2 billion of capital moving into this space in the first six weeks of the year. Behind these deals are several more, either being negotiated or proposed, most of which involve the tying up of a rental property operator and an investor sponsor, but some taking the traditional fund management route. In fact, since the first report we published discussing the Buy-to-Rent idea in July 2011, we have increasingly received more calls and questions from institutional investors and operators alike about how to get involved in this opportunity. Those questions, which initially revolved around whether Buy-to-Rent was possible or even worth exploring, have more recently become focused on how to do it successfully. Is it better to build out operations or acquire inventory first? Is it best to be focused on select geographies or have a more diversified approach? Where are the best locations? Who are the best operators? Should we buy at auction? Short-sale? REO? Bulk? Is it more important how we buy or how we manage?

While we can't answer all of these questions in this report, we start by concentrating on the most strategic one in our view:

What is more important, acquisition or management?

To best answer this question, we have to consider what it means to focus on acquisition or management because clearly both are important, and we are not suggesting that anyone wants to buy properties without a plan in place of what to do with them. Instead, the question most investors face given the increasing competition and the existing ability to buy properties is whether to buy properties first and externalize the management, or to build out an internal management company before ramping up acquisitions. This question is important because it represents two fundamentally different approaches to Buy-to-Rent: should investors primarily be asset managers? Or operators?

We believe the answer should be both, but with a primary focus on operations. While we would never argue that asset valuation and acquisition are not important – if you really buy wrong, it won't matter how well you manage – we would make the argument that it is easier to buy right than it is to manage right. Here's why.

Buy First, Ask Questions Later

In the world of single-family homes, asset valuation is more a commodity than a unique skill. Unless an investor decides to only make use of cursory broker price opinions (BPO) or some automated valuation model (AVM), which any mortgage investor will tell you is not a reliable single asset valuation method, the combination of on-site appraisals, local expertise and desktop underwriting in markets with large quantities of distressed sales usually makes for a fairly accurate valuation. In this combination, local expertise is critical, so use of appropriate appraisers and underwriters are key, but outside of that, valuing a home is not as difficult as valuing illiquid, opaque securities full of explicit or implicit optionality. The reality is that distressed single-family homes are increasingly liquid, highly transparent (most housing transaction prices are public record and details are generally available in MLS systems), brick-and-mortar assets.

But before we consider the management aspect, we take a closer look at the acquisition and what it might mean to miss on the acquisition component. As we've discussed in the past, the total return on Buy-to-Rent comes from both current cash yield from rental returns and the theoretical annualized yield from capital appreciation. Missing on the acquisition value implies missing on both components, since a higher acquisition cost increases the cost basis of the investment when calculating rental yields, but also squeezes the appreciation by entering at a higher level.

Exhibit 2

Missing on Acquisition: Impact on Returns

	Base Case	5% Miss	10% Miss
Effect on Rental Yield			
Acquisition Cost	$ 90,000	$ 94,500	$ 99,000
Rehabiliation Cost	$ 10,000	$ 10,000	$ 10,000
Total Cost	$ 100,000	$ 104,500	$ 109,000
Annual Rent	$ 14,000	$ 14,000	$ 14,000
Gross Yield	14.0%	13.4%	12.8%
Expense Margin	39.5%	39.5%	39.5%
Property Tax, Insurance, HOA	27.0%	27.0%	27.0%
Property Management	5.0%	5.0%	5.0%
Leasing	2.5%	2.5%	2.5%
Maintenance and Repairs	5.0%	5.0%	5.0%
Net Rent	$ 8,470	$ 8,470	$ 8,470
Net Yield	8.5%	8.1%	7.8%
Effect on Capital Appreciation Yield			
Cumulative HPA	50%	50%	50%
Exit Value	$ 135,000	$ 135,000	$ 135,000
Broker Fee Percentage	3.0%	3.0%	3.0%
Broker Fee	$ 4,050	$ 4,050	$ 4,050
Exit Proceeds	$ 130,950	$ 130,950	$ 130,950
5-Yr Cumulative Return	31.0%	25.3%	20.1%
Annualized Return	5.5%	4.6%	3.7%
Effect on Combined Annual Yield			
Yield from Rent	8.5%	8.1%	7.8%
Yield from Capital Appreication	5.5%	4.6%	3.7%
Total Annual Yield	14.0%	12.7%	11.5%

Source: Morgan Stanley Research

In Exhibit 2, we first analyze the impact on rental yields across acquisition price scenarios. We look at three scenarios, a base case, overpaying 5% for the property, and overpaying 10% for the property – we note that mispricing an asset by 10% is a big miss regardless of asset type. We use some simplifying assumptions for the rents and expense margins based on our past research and continuing conversations with actual investors, with the assumption that operations are handled in-house.

From this, we see that missing by 5% to 10% on the acquisition cost results in a net rental yield loss of 1.3 to 2.5

percentage points annually over an assumed 5-year period, respectively.

We would further argue that it would not be too difficult or take too long for an investor to determine that they were paying too much for product and make adjustments. Since distressed sales occur several times a day in each local market, consistently being the winning bid against local competitors should not be too hard to figure out. Cover bids are also not difficult to determine regardless of whether the sale occurs through foreclosure auction or distressed broker, and should not be difficult to obtain in a bulk process either.

Build It, and They Will Come

But what about management? Some would argue that property management is essentially a commodity as well, to be treated no differently than the use of various mortgage servicers for mortgage investments or building operators for commercial real estate investments. In this area, we make two arguments. The first is purely operational. Nobody in the country has ever managed sizable portfolios of single-family rentals. Period. The development of an operational model is not academic. Indeed, some of the biggest naysayers of Buy-to-Rent are multi-family commercial real estate operators used to managing hundreds of units in one location. How do you effectively manage an operation spread out all over the country?

The second argument we make that property management for single-family rentals is not a commodity is financial. In speaking with dozens of local, regional and super-regional single-family rental managers, we have found that operating models, costs and margins differ substantially. Expense ratios can vary between 30% and 60%, even though they are all in the exact same business. Mostly, the differences occur because of the different levels of outsourcing used.

In Exhibit 3, we highlight the cost differences for outsourced vs. in-house management, from construction and leasing functions to long-term property management and repairs. This data is based on extensive conversations with single-family managers.

Clearly the cost differences can be large. Additionally, the financial impact of external operations can have secondary negative effects. One example would be if construction is externalized without proper alignment of interests, which could result in shoddy work that may lead to higher maintenance and repair costs going forward. Finally, most operators tell us there is always a risk of missing on the estimate for rehabilitation costs due to the nature of a distressed home purchase, which we would point to as another reason to ensure that construction-related costs are minimized as much as possible since the potential for additional work is always there.

Exhibit 3
Outsourced Management Costs Are High

	Internal	External
Cost Differences		
Margin for Contruction (on top of internal)	0.0%	20.0%
Expense Margin	39.5%	51.3%
Property Tax, Insurance, HOA	27.0%	27.0%
Property Management	5.0%	10.0%
Leasing	2.5%	8.3%
Maintenance and Repairs	5.0%	6.0%
Broker Fee on Sale	3.0%	6.0%

Source: Morgan Stanley Research

So in Exhibit 4, we show the impact of an internal vs. external management structure, on expense ratios and returns. As we can see, the reduced yields from externalizing management are greater than those from missing even up to 10% on the acquisition cost.

Exhibit 4
Internal Vs. External Operations: Impact on Returns

	Internal	External
Effect on Rental Yield		
Acquisition Cost	$ 90,000	$ 90,000
Rehabiliation Cost	$ 10,000	$ 12,000
Total Cost	$ 100,000	$ 102,000
Annual Rent	$ 14,000	$ 14,000
Gross Yield	14.0%	13.7%
Expense Margin	39.5%	51.3%
Property Tax, Insurance, HOA	27.0%	27.0%
Property Management	5.0%	10.0%
Leasing	2.5%	8.3%
Maintenance and Repairs	5.0%	6.0%
Net Rent	$ 8,470	$ 6,818
Net Yield	8.5%	6.7%
Effect on Capital Appreciation Yield		
Cumulative HPA	50.0%	50.0%
Exit Value	$ 135,000	$ 135,000
Broker Fee Percentage	3.0%	6.0%
Broker Fee	$ 4,050	$ 8,100
Exit Proceeds	$ 130,950	$ 126,900
5-Yr Cumulative Return	31.0%	24.4%
Annualized Return	5.5%	4.5%
Effect on Combined Annual Yield		
Yield from Rent	8.5%	6.7%
Yield from Capital Appreication	5.5%	4.5%
Total Annual Yield	14.0%	11.1%

Source: Morgan Stanley Research

To be clear, we're not saying that operations are all that matter and acquisition can be done without expertise. Instead, our point is that local expertise is critical for acquisitions, and clearly overpaying for assets will always hurt total returns. But in this case, we believe there is a difference in the required skill set between successful acquisition and successful management of single-family rentals. We believe it is harder to effectively manage these properties than it is to price them.

A Private Market Job-Creation Engine

Finally, given the importance and complexity of operations in Buy-to-Rent, we take some time to look at the immediate impact of an expanding operating model, regardless of whether those operations are built in-house or outsourced.

Part of the reason we believe operations are so vital to Buy-to-Rent is because it is the operations that define this opportunity. To rehabilitate, lease up, and manage millions of single-family rentals is not a simple matter. It is also does not inherently scale well. That is not to say it is not a good opportunity, but more a commentary on the fact that it is, at the end of the day, an intense operating business. As such, it is incredibly labor dependent.

Any operator will tell you that buying and managing a 1000-home portfolio is roughly 10 times as much work as buying and managing a 100-home portfolio. On a macro level, Buy-to-Rent could not have come at a better time. According to the Bureau of Labor Statistics, over the past 5 years, the economy has lost over 2.5MM housing-related jobs. A breakdown of these job losses is shown in Exhibit 5.

Exhibit 5

Housing-Related Job Losses This Cycle (MM)

	Employment at Peak	Employment Now	Net Job Loss
Construction (All)	7.73	5.57	2.16
Real Estate (All)	2.18	1.94	0.24
Furniture & Home Furnishing	0.59	0.45	0.14
Building Material & Garden Supply	1.33	1.14	0.19
Total	**11.83**	**9.10**	**2.73**

Source: BLS

We have discussed the potential positive labor market effects from the REO Rental program and Buy-to-Rent in the past, but here we attempt to quantify those effects, albeit using two very back-of-the-envelope approaches.

To come up with labor-creation opportunities, we went back to our network of single-family rental operators. We talked to them about their experience, current staffing levels, and contractor usage. We took these figures, averaged them, and applied them to this analysis. We note that these are our estimates based on anecdotal evidence, not formal polling data.

Breaking it down simplistically, there are two types of jobs that can be created: one-time construction jobs during rehabilitation, and permanent jobs around management, leasing and maintaining rental properties. These jobs are created regardless of whether investors choose to focus on acquisition or operations since no distressed property can be successfully turned into a long-term rental property without these two functions. In Exhibit 6, we show our full-time job-creation numbers per distressed property turned into rental by each category, and for total jobs. This is a ground-up approach based on the anecdotal labor-usage feedback we received from current single-family operators.

Exhibit 6

Buy-to-Rent Operations Can Create Jobs

One Time Annual Job Creation	
Construction Jobs Per House	4
Construction Time Per House	3/4 months
Equivalent Annual Jobs Per House	0.25
Houses to Rehabilitate	4,000,000
Total One-Time Job Creation	**1,000,000**
Permanent Job Creation	
Full time on-going jobs per house	0.20
Houses to Rehabilitate	4,000,000
Total Permanent Job Creation	**800,000**

Source: Morgan Stanley Research

As we can see, the job-creation potential per property and in total could be substantial. Per our previous estimates, we believe there are roughly 8MM properties that will be sold in some form of distressed sale over the next five years (this estimate comes from our liquidation projection model, which we have discussed in several reports in the past). Even if only half can be turned into rentals, which would represent only a 20% increase in the total number of single-family rental properties available today, that could result in the creation of 1MM one-time construction-oriented jobs plus a possible additional 800K in permanent jobs, mostly in some of the hardest-hit sectors and the hardest-hit economic areas of the country.

Looking at it from a different angle, we can also estimate potential job creation by assessing the total capital available for labor related to Buy-to-Rent, and dividing it by average annual salary for related jobs. In Exhibit 7, we show our estimates. We see that potential job creation using this method is remarkably close to our initial approach.

Exhibit 7

Capital for Buy-to-Rent Can Create Jobs

One Time Annual Job Creation		
Average Rehabilitation Costs	$	10,000
Total Capital for One-Time Jobs	$	40,000,000,000
Average Salary per Worker *	$	40,000
Total One-Time Job Creation		**1,000,000**

Permanent Job Creation		
Total Houses Rehabilitated		4,000,000
Average Cost Per House	$	100,000
Average Gross Rent		14%
Average Share for Employment		50%
Total Capital for Permanent Jobs	$	28,000,000,000
Average Salary per Worker *	$	40,000
Total Permanent Job Creation		**700,000**

* Rough estimate of national average salary from BLS housing-related salaries
Source: Morgan Stanley Research, BLS

Finally, we also mention that the potential job creation engine behind this opportunity essentially comes at no cost to the taxpayer.

In fact, even if the government were to include financing for bulk sales in the REO Rental program (so long as it was only for existing agency-held properties), that would serve to *reduce*, not increase, taxpayer risk to home prices. What's more, these jobs generally cannot be outsourced, as they require local area presence – whether in construction, leasing or property management and maintenance.

Conclusion

Buy-to-Rent is here to stay. Not only are private investors continuing to gear up for what is perceived to be both a massive and long-term investment opportunity, but the government is getting underway with its support as well.

With the added benefit of the potential for significant private sector-led job creation, potentially in the hardest-hit sectors in the hardest-hit regions, we are increasingly confident that Buy-to-Rent can have a positive impact on housing and the macro economy as a whole.

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(as of January 31, 2012)

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