Cutting through the hype

Single-family rentals have been among the most publicised real estate investment strategies of 2012, but also perhaps one of the least understood.

Posted - 30 Nov 2012 11:42 GMT CET
updated - 30 Nov 2012 11:42 GMT CET

When it comes to new investment opportunities in US private equity real estate, few have captured the attention of the industry the way single-family rentals have in the past year. Indeed, major private equity firms such as GI Partners, The Blackstone Group and Colony Capital – along with hedge funds, REITs and institutional investors – have contributed to raising as much as $8 billion of institutional capital for the strategy so far.

While that's a significant chunk of change, it's nonetheless a drop in the bucket relative to the overall opportunity presented by distressed single-family homes. The size of distressed inventory, after all, is estimated to be as much as 5.6 million properties, with a total value of $840 billion. It's no wonder, then, that Oliver Chang, managing director at Atlanta-based Sylvan Road Capital, said that "it looks like there is currently more hype surrounding this investment than substance" in a report released this week.

The coverage that the strategy has received from the media, analysts and others has proven to be a mixed blessing, however. While the attention has generally helped to positively promote the emerging industry, it also has created increasing competition, rising prices and yield compression in a few cities. As one private equity real estate firm investing in single-family rentals pointed out, investors have already been priced out of many markets, including Los Angeles and Phoenix, Arizona.

Also, the hype has created a number of misconceptions about the industry, the biggest one being that all single-family rental investing is the same. Not only are there different types of distressed single-family homes, based on physical condition, vintage and geographic location, but there is more than one investment approach and risk/return profile in the space.

The best-known strategy is the one being pursued by many of the large private equity firms. Under this approach, the acquisition, renovation and management of the properties are outsourced to third parties, and a large percentage of the total return is expected to come from home price growth. Chang's main motivation for writing the report – which was intended for a wide range of market participants and observers – however, is to point out a lesser-known approach, one that Sylvan Road itself is following.

This strategy involves a firm handling all of the operations in-house and basing total returns on rental yields and capital appreciation through extensive renovations and time. Because of the greater focus on rental yields, players that advocate this approach tend to see single-family homes as a long-term investment play and a new institutional asset class in the making.

Self-interest aside, Chang makes a valid point in noting that single-family rentals are a more complex and nuanced opportunity than many realise. In fact, some firms have told *PERE* that the two investment strategies outlined in Chang's report aren't necessarily mutually exclusive.

To be sure, any real estate investment carries a certain amount of risk. The stakes are much higher, however, for an investment that is still untested on a large scale. In such cases, gaining a deeper understanding of the strategy – indeed, cutting through hype – for investors is paramount.