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The single family rental industry is getting a lot of attention, but do the opportunity and the fledgling businesses deserve the hype?

- **Distressed single family houses are not one product, but rather an entire asset class of several different product types and classes by physical status, vintage, and location.**

- **Macro housing data – including sales, prices and construction activity – has improved, but local differences are increasing. Phoenix has less than a 3 year supply of delinquent mortgages, while New York has more than 40 years.**

- **For the purposes of single family rental investing, we believe the most important measure of distressed inventory is 4MM – an estimate of seriously delinquent, foreclosed and REO properties – resulting in a large and long-lived investment opportunity.**

- **Different investment strategies from macro housing trades to real estate value investments can result in substantially different risk/return profiles.**

- **Different operating models, from true vertical integration to distributed fee-based networks, can also result in different risk/return profiles – as well as NOI and expense margins.**

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All The Difference In The World

Welcome to the first edition of SRC Housing Perspectives from Sylvan Road Capital, a new periodical investment publication in which we intend to analyze, evaluate and discuss key issues facing the housing market as well as the burgeoning institutional single family rental asset class.

Introduction

The last time I wrote about the single family rental market and the industry emerging as a result of institutional investments in this asset class, I was at a different shop, in a different role, with a different focus in a different market environment. It is appropriate then, that the first issue of SRC Housing Perspectives focuses on the importance of the critical differences in housing data and approaches to single family investing. In this report, we look at the differences in the estimates of supply of distressed single family homes, the differences in investment strategy of the players now in the market, and the importance of understanding these differences when considering investing in, operating in, or otherwise taking part in this investment opportunity.

Hype vs. Substance

It's hard to believe that it has only been nine months since the first true institutional capital to enter this market was announced by Waypoint Homes and GI Partners (for purposes of this report, we will limit institutional capital to names that you've probably heard before). Over the course of these nine months, we have seen the entrants of half a dozen additional large private equity firms, hedge funds, REITs and institutional investors, including Sylvan Road Capital. Despite the surge of activity, it looks like there is currently more hype surrounding this investment than substance. There seems to be more news articles, research reports, conference panels and press announcements than there are actual investments in actual houses.

The highest estimate of institutional capital raised or ring-fenced for this investment that we've seen is $8 billion. While this is a substantial amount of money by most measures, it is a miniscule percentage of the total supply of distressed inventory. We dig into this topic further in this report, but we believe that the $8 billion is *less than 1%* of any reasonable estimate of the size of this actual opportunity. And yet the hype keeps building.

While the attention to the industry is generally positive, one of the issues with hype is that it often glosses over the details, with reporters and analysts alike lumping all participants into the same bucket. We see this playing out in news headlines nearly every day. This has led to some misperceptions about not only this opportunity, but the entire emerging industry being developed to serve institutional investments in single family rentals. And the biggest misperception is this: that all investments in single family rentals are the same. The truth is, this couldn't be farther from the truth.

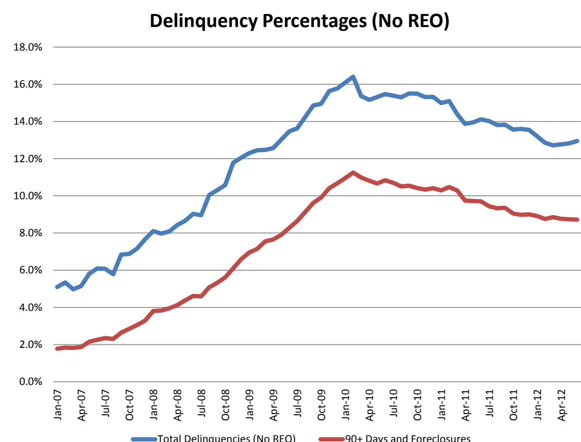
It is unfortunate that most of the important differences in this market are often obscured, including the different types of distressed housing products, the different goals of investors, the different risks involved or the different investment and operating strategies. Especially since not only are these differences stark, but they directly impact every aspect of the investment. Treating all distressed single family investing as one business is the same as lumping leveraged-buyout investing together with long-term value investing just because they both involve buying stocks.

So what exactly are the differences between various investments in single family rentals, and why do they matter? Those are exactly the questions we hope to answer in this report.

The Roof and the Foundation

Before we get into our analysis, we believe it is important to point out that the housing market environment has changed over the past nine months. Top down headline numbers continue to show that the market has turned positive, with increases in sales, prices and construction activity. As Morgan Stanley recently pointed out, even the backlog of distressed inventory has improved as we show in Exhibit 1.

Exhibit 1 – Shadow Inventory Estimates Vary Widely



Source: Morgan Stanley

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While we agree that housing has finally turned the corner, the view from the ground up is not quite as optimistic. From what we have seen, certain areas in the country have experienced improvement, while others have actually worsened. The judicial vs. non-judicial states for foreclosures have certainly had an impact on different markets, but other issues also matter as economic, employment and legal differences continue to hurt certain markets more than others. In Exhibit 2, we provide an example of just how divergent things have become by looking at the "years supply" of distressed inventory. We calculated these numbers by dividing the total delinquencies and foreclosures for each MSA by their respective distressed sale counts in Q2 of 2012 and 2011 and then annualizing the results.

Exhibit 2 –Delinquent Years Supply Varies Considerably by MSA

MSA	Q2 2012	Q2 2011
Atlanta, GA	10.8	12.4
Chicago, IL	17.0	17.1
Detroit, MI	6.5	8.3
Las Vegas, NV	2.7	3.5
Los Angeles, CA	5.6	7.1
New York	41.7	30.7
Phoenix, AZ	2.4	3.4

Source: Morgan Stanley

As the data shows, most of these MSAs have shown some improvement, which should be expected, from 2011 to 2012, however, some have worsened. More importantly, the differences between markets is staggering, with Phoenix at less than a three year supply, and New York and more than 40 years!

A Backlog by Any Other Name…

Given the contrasting supply numbers, we also need to clarify one more data point, and that is the size of the distressed inventory. This number is important not only because it helps to gauge the size of the opportunity, but also because when combined with varying investment and operating strategies, it helps in understanding the longevity and the future of the industry. Sometimes, but not always, this number is referred to as the "shadow inventory". After seeing a lot of different estimates from 1.5MM to 5.6MM, we realized that the disagreements usually stem more from the definition of "shadow inventory" rather than the actual data.

In fact, of the six different estimates that we present in Exhibit 3, all of them use the same two data types: property-level data, and loan-level data – and usually from the same sources.

The various definitions are specified in the footnotes to Exhibit 3, but basically the differences arise from what is or is not included in the estimate (e.g. 90+ delinquencies or REO properties, etc.)

Exhibit 3 – Shadow Inventory Estimates Vary Widely

Source	Estimated Units	Estimated Value (150K average)
CoreLogic[1]	1,500,000	$ 225,000,000,000
Morgan Stanley[2]	5,600,000	$ 840,000,000,000
OCC/OTS Report[3]	2,600,000	$ 390,000,000,000
Scaled OCC/OTS Report[4]	4,193,548	$ 629,032,258,065
Amherst[5]	3,200,000	$ 480,000,000,000
Sylvan Road Capital[6]	4,000,000	$ 600,000,000,000

1. Estimate of distressed inventory not listed on MLS. Peak was only 2.1MM in Jan 2010
2. All delinquent and foreclosures only. Does not include REO on market (listed or not)
3. 90+ delinquencies and foreclosures only. No REO. Based on ~60% of total mortgages
4. Sale OCC/OTS report higher by factor of all mortgages
5. 1+ year delinquencies, foreclosures and REO
6. 90+ delinquencies, foreclosures and REO

Source: CoreLogic, Morgan Stanley, OCC, Amherst Securities

For purposes of this report, and the number that we think is most applicable to the single family rental opportunity, we are going to use our own estimate, which is simply a general definition of what is distressed and likely to result in a distressed sale without the use of a fancy roll-rate model. Our number is 4MM properties.

Distressed Houses and *DISTRESSED* Houses

Now that we've sorted out the total inventory size, we get started by answering the easiest question first: what are the differences in the inventory, and therefore potential opportunities, of distressed houses? Answering this question helps to determine how the opportunity breaks out by product type.

Exhibit 4 – Distressed Houses Can Differ Significantly

House 1

House 2

House 3

House 4

Source: SRC, NPR, Getty Images, Missouri Tribune

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In Exhibit 4, we show a few examples of actual distressed houses in today's housing market. It doesn't take more than a second to notice that one of these things is not like the other – in fact that none of these things is much like any of the others.

The first thing to notice is that house number one looks like it needs a lot of work, and house number two does as well. House number four looks like a house you might move into today (minus the debris in the driveway). Other observations might include that house number three is sitting in a desert while house number one is in a more wooded setting. Further analysis might conclude that house number three is probably easier to maintain – it doesn't even have a lawn to mow! Or that house number one looks like it may have mold issues as it looks like it rains a lot around there. Regardless of what catches the eye, it seems abundantly clear that these are not the same types of houses.

These pictures prove an easy point, but let's look closer at the details and some characteristics of the distressed inventory that is usually treated as one big homogeneous investment product. In Exhibit 5, we take a look at the breakout of the distressed inventory by vintage, or the year in which the house was built.

Exhibit 5 – Vast Majority of Shadow Inventory is Older

By Year Built	Post 2000	Pre 2000
National	20.4%	79.6%

Source: Morgan Stanley

Headlines have mostly focused on investors who only buy houses built since 2000 or maybe 1990. Most large investors do this because building codes changed from era to era, resulting in different internal systems and standards across vintages, making it harder to manage if your goal is to own tens of thousands of them. But it's pretty clear here that houses built before 1990 make up the vast majority of the distressed inventory out there.

If a house is nearly turn-key and move-in ready, but needs some paint and carpet work, pretty much anyone can do that – including prospective home owners. It just so happens that this type of house is what most of the large investors are buying. But what about houses that need to have their walls re-plumbed because someone stole the copper out of them? The point here is clear: these are not the same products.

Beyond Phoenix and Atlanta

Next, we looked at the simple geographical concentrations of the distressed inventory. It has also been pretty clear that the hype has surrounded places like Phoenix, Southern California and Atlanta.

But as Exhibit 6 shows, the vast majority of the distressed inventory is located outside of those areas. Perhaps surprisingly, about half of the distressed inventory is located outside of the major cities in the major regions across the country. Again, geographical differences make for different products.

Exhibit 6 –Half of Shadow Inventory is Outside Major MSAs

Phoenix, Los Angeles, Las Vegas	Atlanta, Miami, Tampa	Chicago, Detroit, Cleveland	New York, Boston, Philadelphia	Washington, Baltimore, Charlotte	Rest of Country
9.6%	13.7%	10.5%	13.1%	5.1%	48.1%

Source: Morgan Stanley

Not the Same Renovations, Operations or Risks

This last point about the differences in the distressed inventory is hard to show in the data, because the data we would need to show generally doesn't exist. But there are some suppositions we can make. Going back to Exhibit 4, we pointed out that distressed houses in some areas of the country may be easier to maintain because they don't have yards, or maybe it's a dry climate, or only experience moderate temperatures. Exhibit 6 below further supports this point by highlighting the climate differences between major investment MSAs.

Exhibit 6 –Different Climates Create Maintenance Issues

MSA	Avg January Temp (°F)	Avg July Temp (°F)	Avg Annual Rainfall (Inches)	Avg Days of Rainfall	Avg Annual Snowfall (Inches)
Atlanta, GA	42.7	80.0	50.2	115	2.1
Chicago, IL	22.0	73.3	36.3	125	38.0
Cleveland, OH	25.7	71.9	38.7	155	57.6
Las Vegas, NV	47.0	91.2	4.5	26	1.2
Los Angeles, CA	57.1	69.3	13.1	35	0.0
Miami, FL	68.1	83.7	58.5	131	0.0
Phoenix, AZ	54.2	92.8	8.3	36	0.0

Source: National Oceanic and Atmospheric Administration

We also pointed out that while some houses look beyond repair, others appear move-in ready. We think it is safe to say that these types of differences directly lead to different costs and types of required renovations, different levels of maintenance and expected repairs, and different risks of property damage such as frozen pipes or termite infestations. All of that is to say that they do not require the same amount, type, or level of effort

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when it comes to renovating, maintaining and repairing the homes.

As a result, operating models that are truly vertically integrated vs. models that are based on a distributed fee-based network will have different abilities to complete the required work as well as different NOI margins and expense ratios.

Distressed Houses are Different. So what?

The importance of these differences depends on who you are and why you're reading this report in the first place. We think these differences are critical when considering an investment in this space, but also because we think it does the whole industry an injustice when everyone involved gets lumped into the same bucket. Not all distressed investors are the same, not all distressed investment strategies are the same and not all distressed investments will succeed. **It pains us to say this, but there are going to be some failures so it's probably important to know exactly what you're investing in.**

Divergent Risk/Return Profiles

Believe it or not, there are different investment strategies in how institutions are approaching this opportunity. While it seems simple enough – buying houses and renting them out – views on housing, the product and operations can cause significant differences in investment strategies, and therefore the risks taken by investors are again, different.

The Macro Housing Traders

The bulk of the larger investors out there are all in the same investment more or less, which explains to us why the media thinks this is all one big homogeneous investment. They buy the same types of houses, they buy in the same locations, they pay the same types of prices, and they run their operations the same way. Most of these investors are in this investment because they see it as a way to get long home prices, or in other words, to play for a home price recovery.

The premise is simple: buy as many distressed houses as you can, as fast as possible. The focus is not on the rental yield, with most of these investors underwriting (though not necessarily delivering) to roughly a 6-7% net rent. The underlying view is that home prices are going to go up strongly as the market recovers, so the more homes you own, the more you will benefit. For the most part, these investors also use a fee-based model for their operations – that is, they pay a fee to someone to buy the homes for them, another fee (or profit margin or both) to someone to renovate the homes for them, another fee to a leasing agent to lease the home for them, and yet another fee to a property manager to run the property for them. Since it's a macro play on housing, the view seems to be that operating infrastructure is not necessary and not realistically possible anyway to keep up with the pace of acquisitions.

In terms of what investors in this strategy are really investing in, they have extensive beta risk to home prices. As the total cost basis (acquisition price plus renovation costs) have approached, and in some cases exceeded, replacement values and/or current market values, an increasingly large part of the total return will need to come from fundamental home price growth. Since most of these investors are promising a 20-25% levered total return, that's a lot of home price appreciation that needs to occur before those returns can be met.

To sum it up, we would call this a buy first, build later (or never) strategy.

The Housing Value Investors

The niche players in this space have taken a more value-oriented real estate approach. For full disclosure, Sylvan Road Capital advocates and follows this strategy. The premise here is that the value in this investment comes from extensive renovations of physically distressed houses and the efficient operations of those houses as rental properties. This strategy is almost the opposite of the prior one – distressed housing investors try to minimize, not maximize, the beta risk to home prices by acquiring these houses at significant discounts to replacement or current market values. Total returns are therefore more dependent on rental yields, and capital appreciation comes not from home price appreciation, but rather from the convergence of the discounted price back to replacement or market values through extensive renovations and time. Of course, beta home price growth will help here as well, but it is the gravy, not the focus.

Since this strategy is dependent on efficient operations, both for the renovation and on-going management phases, most investors who have chosen to take this approach, have also built the infrastructure required to execute those operations. In most cases, this infrastructure is wholly-owned by the investment firm and

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outsourcing is minimized both to better align incentives, but also to enhance quality and cost controls.

Most investors in this strategy also look to provide a 20-25% levered total return, but the biggest difference is that greater than half of the total return is expected to come from cash-on-cash returns from rent.

We would consider this to be a build first, buy later strategy.

We Beg to Differ

Now that we've laid out the differences in distressed inventory and investment strategies, we offer our opinion on these differences and why we decided to take the approach that we do for this investment opportunity.

First, let's start with the inventory. It is clear to us that the vast majority of the distressed inventory is of the more run down and older variety and is spread across the country. Such houses are more difficult to deal with for a variety of reasons, but they represent the bulk of the investment opportunity – if the investor is equipped to handle them. Since this model is so dependent on operating infrastructure, we believe the only way to invest successfully in this strategy is for the investor to also own the operating companies. The more integrated and aligned the operations are with the investors, the higher the chance for success. That's not to say there isn't opportunity in the more turnkey properties too, but it is clear by all of the hype surrounding this investment, that such strategies have already become increasingly competitive, with prices rising, yields compressing, and all of it occurring in just over six months in a few cities.

Second, the investment strategy is a key differentiator. The long beta trade on home prices is interesting and certainly a way to play a macro housing recovery. But it is always important to ask if it's the best way to play it. Is it attractive from a relative value perspective? The bottom line, in our opinion, is that there are several different ways to play a macro housing recovery. You can invest in non-agency mortgages, homebuilder, housing supply or building materials equities, mortgage REITs, property management and residential service equities, options or futures on lumber and other commodities, etc. Each and every one of those investments is more liquid and far less operational than buying distressed single family houses. And if all we wanted to do was to express that limited view, we would probably not be in this business.

Conclusions

The opportunity to invest in single family rental houses continues to move forward. While only time will tell how this new burgeoning industry plays out, we believe that when it comes to success, the differences between distressed housing products, investment strategies, risk/return profiles and operations can make all the difference in the world.

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