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Riding the Rental Revolution

WINTER 2016



A booming U.S. rental property sector is attracting new interest from a range of commercial and institutional investors but can this growth be sustained? Here, **Amherst Capital Management's Sandeep Bordia** considers the market outlook for 2017.

The U.S. housing market has witnessed a seismic shift since the global financial crisis of 2008, when millions of Americans lost their home in foreclosures¹, following the sub-prime and U.S. banking crises.

According to 2016 research from Harvard University², the national home ownership rate has been on an unprecedented decade-long downward trend, sliding to 63.7% in 2015. The U.S. Housing Vacancy Survey also shows the number of households renting increased by nearly nine million between 2005 and 2015 (see chart on the next page).

This rental demand trend has been exacerbated by demographic shifts which have seen a new generation of young adults and families increasingly unable to afford their own homes.

Tighter rules on mortgage lending, rising house prices for owner occupiers, stagnating real incomes and limited

federal assistance for low earners have also played their part in boosting demand for rented residential property in both the multi-family and single-family rental sectors (SFRs). According to the Harvard analysis, the failure of supply to keep up with rapidly rising demand has led to the longest period of rental market tightening since the late 1960s.

Commenting on other factors behind rental market growth, Bordia adds: “While all of the main drivers that buoyed the rental market in recent years remain intact, another factor is the rise in student debt, which has quadrupled over the past 13 years.³ “While graduation usually allows students to go into better-paying jobs and afford a mortgage, for ex-students who took out loans but did not graduate, it becomes much harder to qualify for a mortgage.”

1. *Bloomberg*: 'Millions of Spenders Are Ready to Come Back From the Mortgage Crisis,' July 7, 2016.

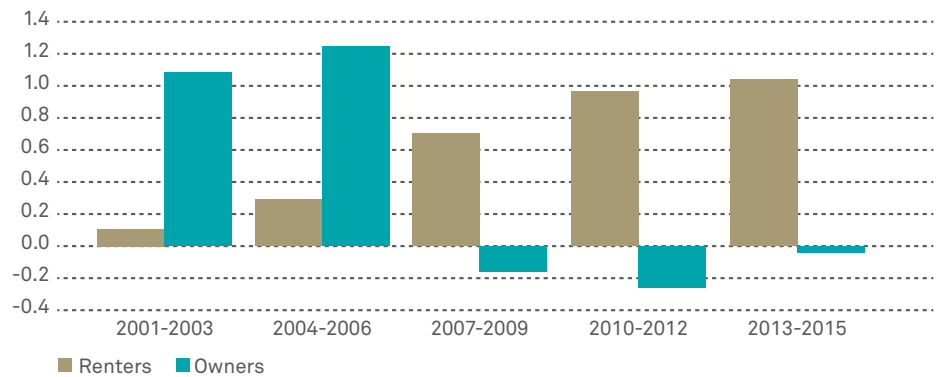
2. *Joint Center for Housing Studies of Harvard University*: 'The State of the Nation's Housing 2016,' June 22, 2016.

3. *FRBNY/Equifax Credit Panel*, as of 2016 Q1.

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RENTING HAS SURGED OVER THE PAST SEVERAL YEARS AS HOME OWNERSHIP HAS STALLED

Average annual growth in households (millions)



Source: JCHS tabulations of U.S. Census Bureau, Housing Vacancy Surveys.

INSTITUTIONAL INTEREST

This rise in demand for rental property, particularly SFRs, and healthy returns have attracted a range of retail and, increasingly, institutional investors. While it's estimated institutions currently account for just 1%-1.5% of the market, demand for SFRs continues to grow and the average number of new rental households has increased by 770,000 a year since 2004.⁴

Institutional investors can access the market via a range of methods, including buying single-family properties outright to rent or invest in securitized debt packages backed by those properties. With institutions able to benefit from ongoing economies of scale, purchasing power and geographic reach, Bordia believes there is room for ongoing growth in their share.

"Institutions certainly enjoy a range of advantages over smaller 'mom and pop' type retail investors, including access

to cheaper and more appropriate finance lines.

"Most of the existing institutional SFR operations have also made a lot of investment in infrastructure and technology, which helps them throughout the lifecycle of the property portfolio from acquisition to ongoing maintenance and repairs.

"Geographical diversification is another benefit. Most retail investors, even if they own more than a couple of properties, tend to have their investments concentrated in areas near where they live. For institutions, it is easier to spread portfolio investments across geographies. They can buy properties in Florida, Georgia or whichever region offers the best risk/reward," he adds.

Within the wider U.S. property market, investment research analyst Morningstar expects multi-borrower securitization, including single-borrower, single-property loans, to

4. *New York Times*: 'More Americans Are Renting and Paying More as Home Ownership Falls,' June 24, 2015.

drive long-term growth in single-family rental issuance.⁵ It adds that cash flow coverage of debt service remains robust and delinquency rates are low with vacancy and retention rates also in line with its latest forecast.

REGIONAL SPREAD

Commenting on institutional investor appetite for rental property across the U.S., Bordia notes investors are looking beyond major U.S. cities to explore the potential of smaller cities and towns where demand is high.

“From a geographical perspective, institutional investors have been more active in certain specific cities and closer to urban areas. They are looking beyond New York and San Francisco to cities like Minneapolis, Denver, Chicago, Cincinnati and Nashville. These are not the biggest metropolitan areas but can offer lower capital risk exposure,” he adds.

With demand steadily rising, Bordia remains optimistic about prospects for the sector for 2017. However, he also remains alert to potential risks. “While we anticipate high-single-digit unlevered returns in the sector in the year ahead, no asset class is entirely immune from risk.

One of the reasons for institutions grabbing a higher market share in the single-family rental market is because many retail investors have not been able to qualify for a mortgage or are not getting rates which are attractive. If that were to change and mortgage availability comes back to the market, it could prove challenging for institutions to ramp up portfolios. However, we are seeing no sign of

widespread improvement in credit availability.

“Looking ahead, the real risk to the market is not political, regulatory or related to mortgage credit availability — it is the threat of a major economic downturn. If the U.S. economy were to seriously underperform, it is likely rental occupancy numbers would fall and rent growth would flatten. That said, we see no major threats on the horizon indicating a downturn is imminent.”

While there has been a handful of recent securitizations in the private label mortgage market, Bordia also thinks it unlikely the market will see a return of the high-risk property investment strategies that damaged both investors and corporate reputations in the late 2000s.

“The few securitizations we have seen in the private label have tended to be of pristine quality and with total annual issuance of less than a few billion dollars — in a market which had \$2.5 trillion outstanding at the peak. Since the financial crisis, a lot of new regulation has been introduced and there is almost zero appetite for some of the more risky investments which were common back then,” he adds.

What to Watch in 2017

- New U.S. government economic strategy.
- U.S. Federal Reserve activity for potential tightening.
- Rental demand.

5. *Morningstar Advisor*: ‘Sizing Up the Single-Family Rental Market,’ February 18, 2016.

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