Q1 2020 SINGLE-FAMILY RENTAL INVESTMENT TRENDS REPORT

ARBOR CHANDAN

COVID-19 CREATES IMMEDIATE CHALLENGES, LONG-TERM OPPORTUNITIES

STATE OF THE MARKET

Unsurprisingly, COVID-19 is the unavoidable and overarching theme across all areas of commercial real estate — the single-family rental (SFR)[1] sector is no exception. Most market watchers peg industrial as the only asset class with downside immunity from the current crisis. Expected outcomes in other sectors range from softness in operating fundamentals to record-setting distress. It may, however, be too soon to say SFRs will not emerge a long-term net-beneficiary of this unprecedented market reshuffling.

By late April, COVID-19 related shutdowns have forced more than 30 million Americans out of work, with millions more seeing reductions in hours worked. Naturally, households are struggling to make ends meet. By extension, the income-producing capacity of rental properties will see some deterioration. As noted by a recent Roofstock report, SFR owners, which tend to be small "mom and pop" operations, are caught in the middle of the turmoil — often facing a lack of rental payments on one side and mortgage payments due on the other.

Where SFRs may come out ahead of the pack is in their ability to attract new sources of demand. The single-family rental investment community has long insisted that the sector is one of the most impervious to recessionary pressures you can find. One of the reasons is because many potential homebuyers will have difficulties qualifying for financing during a recession. The SFR sector is positioned to capture these buyers, allowing households to achieve the lifestyle-change they seek while maintaining the flexibility of renting. Early indications suggest that this exact script is playing out across the country, where SFR leasing and investment brokers are reporting record-levels of new demand.

KEY FINDINGS

1. CAP RATES TICKED UP TO 6.6%
2. SFR RETURN PREMIUMS WIDENED TO 5.2% ABOVE U.S. TREASURYS
3. SFR HOUSING STARTS TOTALED 38,000 UNITS AS OF Q4 2019, ACCOUNTING FOR 3.5% OF ALL SINGLE-FAMILY CONSTRUCTION

PERFORMANCE METRICS

Occupancy

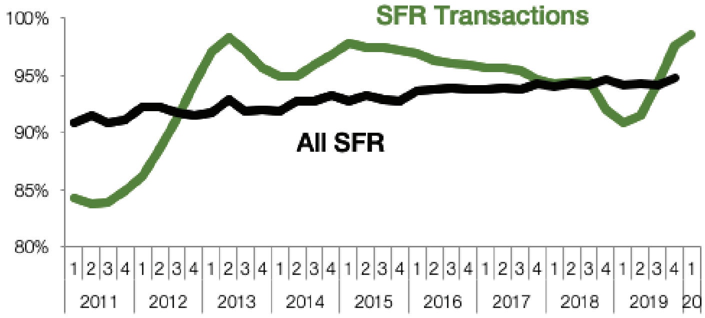
Based on Chandan Economics' model estimates, occupancy rates on transacted SFRs jumped up to 98.5% in the first quarter of 2020, up 1.0% from the fourth quarter (*Chart 1*). Across all single-family rentals, as measured by the U.S. Census Bureau, occupancy rates average 94.8%. While the Census Bureau's measure casts a broader net and is less volatile, it follows a similar trend line of improvement as this cycle has lengthened. From its 2007-low, occupancy rates for all SFRs are up by 4.9%.

The rapid rise in occupancy rates for transacted SFR properties is due to several factors. The first is tenant retention is exceptionally strong. The second factor

[1] Chandan Economics defines SFRs as properties containing less than five units for all performance metrics data and as one-unit properties for all SFR construction starts data.

which can explain the transactional occupancy rise is in the way that the sector has operationally evolved. The presence of institutional investors and the emergence of dedicated SFR exchanges (Renters Warehouse, Roofstock, etc.) have made it easier than ever to transact occupied assets, circumventing the need to sell vacant properties on a traditional multiple listing service (MLS). Lastly, the transactional measure does not capture many of the conversion trades still executed through MLS and build-to-rent assets.

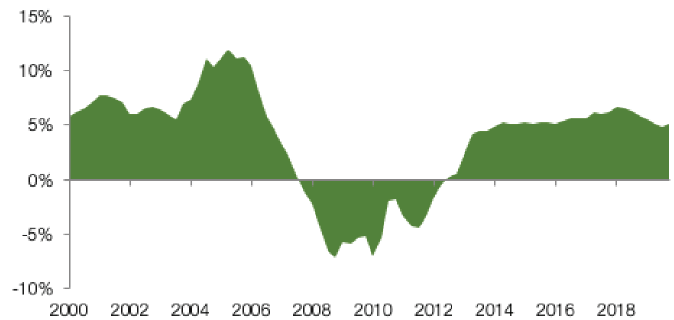
Chart 1
SFR Occupancy Rates
Trading & Market Total



Cap Rates & Prices

Within multifamily, asset prices are often formulaic. As long as there is an understanding of property-level cash flows and expenses, and surrounding cap rates, evaluating a property's fair market value is pretty straightforward. For SFRs, the calculus is a little less clear. Data points on local SFR cap rates can be few and far between, making it difficult to establish a baseline for comparison. While the emergence of purpose-built SFR communities should help the sector achieve some degree of price independence, SFRs still operate within the broader context of the U.S. single-family housing market. According to the FHFA's All Transaction Home Price Index, property prices are continuing to rise, but are doing so at a slowing rate (*Chart 2*).

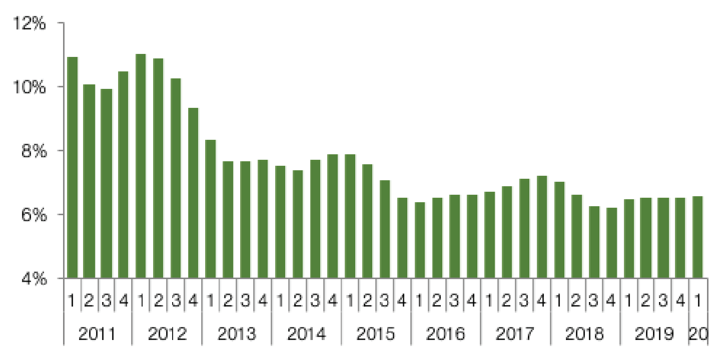
Chart 2
U.S. All-Transaction House Price Index
Year-Over-Year % Change, Through Q4 2019



Source: Federal Housing Finance Agency

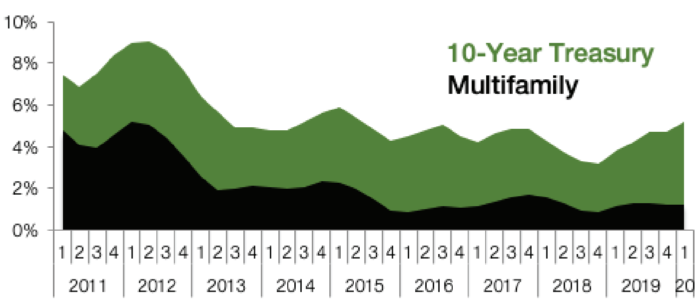
Cap rates on SFR properties peaked at 11.0% as home prices bottomed out in 2012 (*Chart 3*). The formalization of the SFR sector in the intervening few years has meant greater cap rate stability. Generally, national SFR cap rates have hovered between 6.0% and 8.0% for the past six years. SFR cap rates ticked up to 6.6% in the first quarter of 2020, up 6 basis points (bps) from the prior quarter, and up 8 bps from a year earlier.

Chart 3
SFR Cap Rates



The difference between cap rates on SFRs and multifamily properties, as well as Treasury yields, provides a measure of how risky investors view the sector. As a result of COVID-19, global investors are engaging in a "flight to safety," where demand rises for low- to no-risk investment instruments. Naturally, this has caused Treasury yields to crater, reaching new all-time lows. The spread between SFR cap rates and the 10-year Treasury note averaged 5.2% in the first quarter 2020 — the widest risk premium since mid-2015 (*Chart 4*). Spreads between SFR and multifamily cap rates remained unchanged at 1.2% in the first quarter, signaling that all residential sub-sectors are so far absorbing similar effects.

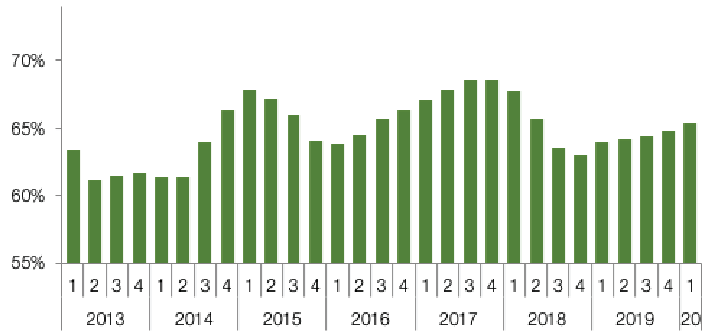
Chart 4
SFR Return Premium
SFR Cap Rate Spread Between
Multifamily Cap Rates & 10-Year Treasury



Loan-to-Value Ratios

Loan-to-value (LTV) ratios on SFR mortgages rose from their 2013 nadir of 61.2% up to a post-recession high of 68.6% in late-2017 (*Chart 5*). Tighter underwriting standards and rising interest rates weighed down LTVs through 2018 before they began to tick up again in 2019. Even before the COVID-19 outbreak and ensuing dislocation of global capital markets, borrowing costs were near historic lows, creating a strong incentive for borrowers to secure as much debt as possible.

Chart 5
SFR LTV Ratios



In the coming months, it is unclear how average LTVs on SFRs might move, as low interest rates and tighter lending standards will have an oppositional effect on one another. Through the first quarter of 2020, LTVs rose for the fifth consecutive quarter, jumping by 55 bps to 65.4% — up 146 bps from last year. Still, levels of leverage are well below recent highs of 68.6% observed at the end of 2017. As the U.S. economy enters a recessionary stretch where both valuations and tenant performance will see downside pressure, healthy levels of investor equity should prevent an overabundance of inter-sector defaults or distressed asset transactions, all else equal.

Debt Yields

Debt yields rose in the first quarter of 2020 to 11.4%, the highest reading since 2015 (*Chart 6*). The initial estimate is up 10 bps from the fourth quarter and up just over one full percentage point from this time last year. The inverse of debt yields, debt encumbrance per dollar of NOI, dropped by 7 cents from the fourth quarter to $8.79 (*Chart 7*). Debt encumbrance has now fallen in five of the last six quarters, dating back to the high watermark of $10.17 set in the third quarter of 2018. These trends reflect that SFR underwriting has tended to be more conservative over the past two years. The relatively low level of indebtedness across the SFR sector should portend greater asset-level resilience despite cashflow disruptions.

Chart 6
SFR Debt Yields

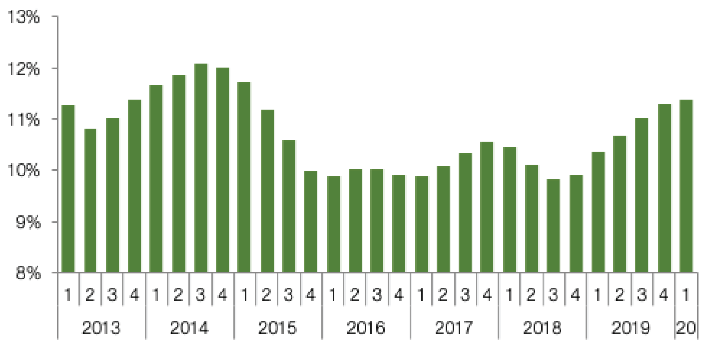
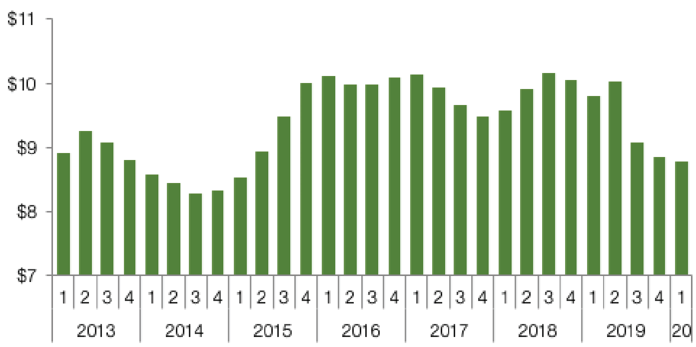


Chart 7
SFR Debt per Dollar of NOI

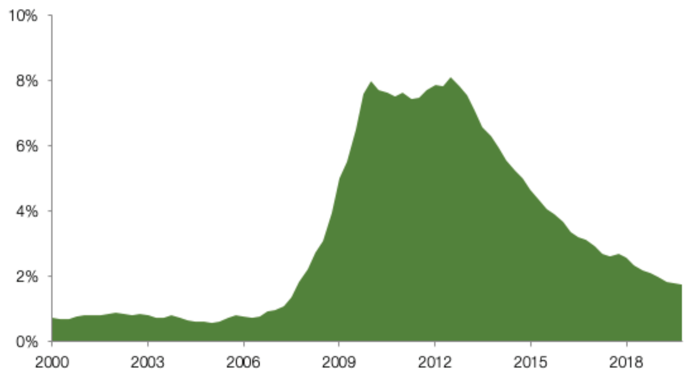


SUPPLY & DEMAND CONDITIONS

Residential Default Rates

During the housing crisis, investors with available financing took advantage of the opportunity, acquiring large portfolios of single-family assets at steep discounts. Mortgage default rates soared to 8.1%, and an abundance of buyers began seeding the SFR sector as we know it today (*Chart 8*).

CHART 8
Default Rate on Real Estate Loans Secured by 1-4 Family Residential Properties
Through Q4 2019

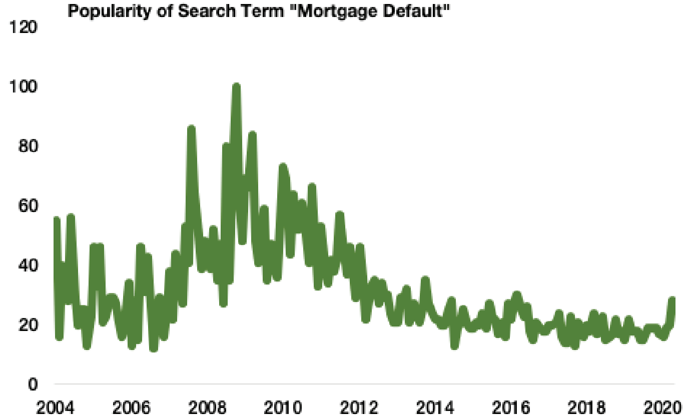


Source: FDIC

Mortgage defaults are expected to rise as a result of the current crisis, though it remains unlikely that they will touch the same stratosphere as in the 2009-2012 period. Homeowners are viewed as blameless victims of the COVID-19 crisis, thus far reflected in the policy response. This contrasts with the global financial crisis, where real estate prices and housing market conditions were considered causal factors of the downturn. Through the fourth quarter of 2019, defaults had declined in 28 of the last 29 quarters and currently sit at 1.8%.

It will be a while until the effects of this crisis begin appearing in public data sets. The Federal Deposit Insurance Corporation does not publish its detailed loan performance data until 55 days after the end of each quarter, meaning the effects of COVID-19 on mortgage performance will not be reviewable until the summer. There are, however, clues we can use to anticipate the severity and directionality of defaults in the coming months. According to Google Trends, popularity for the search term “mortgage default” is rising and is now at its highest point since 2013. Still, the term was far more frequently searched during the Great Recession *(Chart 9)*.

Chart 9
Popularity of Search Term "Mortgage Default"



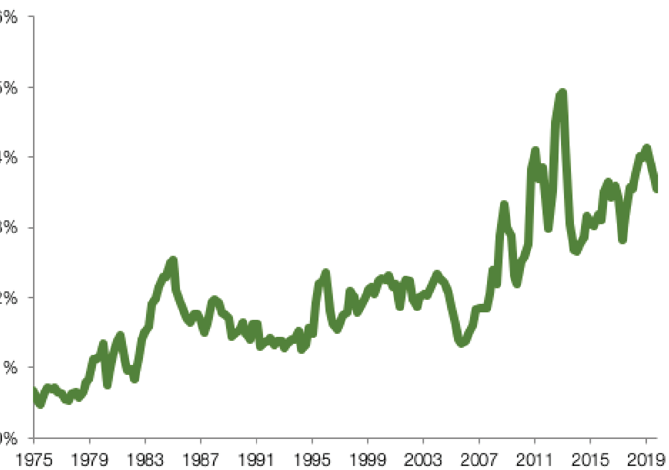
Source: Google Trends

Build to Rent

Build-to-rent strategies continue to become a defining feature of the SFR sector. In addition to better aligning supply with the demand, builders and operators realize the advantages of purpose-built, single-family communities. These developments are often able to replicate similar amenity packages as one might find in a Class A multifamily property, all from the spacious seclusion of the suburbs. As the maturation of the Millennial cohort continues to support household formations, access to quality public schools will become a higher priority in the housing choice equation. For households that are reluctant to give up their urban, amenitized lifestyle, build-to-rent communities provide an attractive balance.

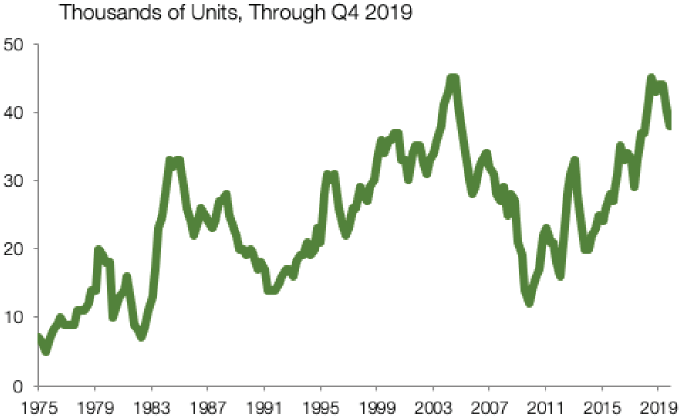
Based on an analysis of Census Bureau data, between 1975 and the start of the recession in 2007, SFRs accounted for a little less than 1.6% of all single-family construction (*Chart 10*). SFRs’ share of single-family starts has since soared. In 2013, SFRs’ construction share approached 5%, and today it remains elevated at 3.5%. SFR construction starts totaled 38,000 units through the 12 months ending in the fourth quarter of 2019, down 7,000 from the post-recession high set in the third quarter of 2018 (*Chart 11*).

CHART 10
SFR % of All Single-Family Housing Starts
Measured on a Rolling 12-Month Basis, Through Q4 2019



Source: Chandan Economics’ Analysis of Census Bureau Data

CHART 11
SFR Housing Unit Starts
Measured on a Rolling 12-Month Basis, Thousands of Units, Through Q4 2019



Source: Chandan Economics’ Analysis of Census Bureau Data

Tracking Future Demand

We again used Google Trends as a proxy to measure existing and future hotspots of SFR demand. Using the search term "homes for rent" as an input, metropolitan areas in the Southeast unsurprisingly dominate the list. The list of top-10 markets where the search term was most popular in recent months only includes five states: Georgia, North Carolina, South Carolina, Tennessee and Alabama (*Table 1*). To track which parts of the country might expect to see new demand in the coming months, we measured the popularity of the search term between the fourth quarter of 2019 and the first quarter of 2020, noting where the biggest jumps occur. Leading the way is Mankato, Minnesota — a small city nestled just outside the Minneapolis-St. Paul metropolitan area (*Table 2*).

Table 1: Popularity of Search Term "Home for Rent" Rank by Metropolitan Area

Rank	Metro Area
1	Augusta, GA
2	Memphis, TN
3	Macon, GA
4	Savannah, GA
5	Dothan, AL
6	Columbia, SC
7	Greenville-New Bern-Washington, NC
8	Tallahassee FL-Thomasville, GA
9	Albany, GA
10	Columbus, GA

Source: Google Trends, Measured over Q1 2020

Table 2: Popularity of Search Term "Home for Rent" Change in Rank from Q4 2019 to Q1 2020

Q4 2019 Rank	Q1 2020 Rank	Change in Rank	Metro Area
202	63	139	Mankato, MN
205	97	108	Ottumwa, IA-Kirksville, MO
150	48	102	Lubbock, TX
147	59	88	Jonesboro, AR
162	74	88	Joplin, MO-Pittsburg, KS
134	48	86	Billings, MT
108	23	85	Zanesville, OH
134	63	71	South Bend-Elkhart, IN
172	104	68	Fairbanks, AK
125	59	66	Rapid City, SD

Source: Google Trends, Measured over Q1 2020

OUTLOOK

Absent an immediate policy response, owners of single-family rental properties can expect to see their share of COVID-19-related economic pain. While the CARES Act and incoming unemployment benefits should provide financial support for households and the residential rental sector indirectly, a more targeted approach remains needed. In a recent policy paper, Urban Institute argues that without a direct, federally led intervention, there is a present and growing risk of a housing market crash.

Still, unlike other commercial real estate property types, the SFR sector maintains a cause for optimism. SFR is the rental niche most likely to capture affected households that would otherwise choose to buy their own home. Assuming that both underwriting standards and household economic security remain tight, the SFR market is likely to see another surge in demand, holding all else constant. ■

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