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Single-Family Securitized Financing: A Blueprint for the Future?

Abstract

In November 2013, Invitation Homes LP, the Blackstone subsidiary that is the largest of the REO-t--rental operations, completed the first securitized financing of REO-to-rental properties (Invitation Homes 2013-SFR1). The private placement was very well received by the market, producing more favorable terms than many had anticipated. In this short article, we walk through why the deal was done, how it was structured, and what the financing means for the market.

Motivation for the Deal

The first question many people have is why this securitization was done. The answer is straightforward: Invitation Homes owns and manages approximately 39,000 scattered-site single-family rental homes, and property managers can generate a higher return for their equity investors if they use leverage. With home prices up nationwide by 22 percent from their 2011 low, and up even more where REO-to-rental investors are active, moderate leverage is needed to attract new money to the space and to keep returns attractive to current equity investors. Leverage can take the form of securitization, bank loans, or preferred stock offerings. Invitation Homes is the first securitization.

An example will make this clear. Let's assume a home sold for $90,000 and needed $10,000 of repairs, for a total cost of $100,000, and it could be rented out at $1,200 a month, or $14,400 a year. That home would be generating a gross cash-on-cash return (often referred to as a gross capitalization rate) of 14.4 percent ($14,400/$100,000). Out of this, the property owner must pay taxes, insurance, homeowners' association dues, and both routine and emergency maintenance on the property. The property owner must also account for tenant turnover: the property may sit vacant part of the year, an agency may charge fees to rent to another party, and there will be fees to screen potential tenants and repaint the home. Let us assume these fees total $500 a month, or $6, 000 a year. Taking all these expenses into account, the property owner would be left with a net cash-o--cash return (net capitalization rate) of 8.4 percent ($8,400/$100,000), plus any property appreciation.

Now assume that $90,000 home goes up in value and sells for $120,000, plus the same $10,000 in repairs, for a total cost of $130,000. If the rent and expenses stay the same, the gross capitalization rate is 11.1 percent ($14,400/$130,000), and the net capitalization rate is 6.5 percent ($8,400/$130,000), much less attractive than the original 8.4 percent. Moreover, part of the anticipated price appreciation has been achieved, reducing potential future returns. (This example is fairly realistic; on the Invitation Homes deal, the actual net capitalization rate is 6.37 percent.)

Leverage can restore the appeal of the investment. Assume the property owner can borrow 75 percent of the purchase price to finance new properties, these properties also have a net capitalization rate of 6.5 percent and the rate on this borrowing is 4 percent. The investor would be receiving 6.5% + 0.75(6.5%-4%) = 8.4 percent, restoring the cash-on-cash return of 8.4 percent. In addition, because this transaction serves as the financing vehicle for further purchases, the property owner is entitled to any property appreciation on additional purchases. Thus, for each $100 investment, an investor who has borrowed 75 percent of the purchase price can purchase an additional $75 of homes, and will be entitled to the appreciation on $175.

Deal Description

The collateral for the Invitation Homes deal consisted of 3,207 properties with a total value of $638.8 million and an average value of $199,200. The loans in this deal were all acquired in the second and third quarters of 2012, had been repaired, and were currently leased. The properties had been leased for an average of 8 months; the longest lease was 16 months. The top three MSAs (as measured by balance) were Phoenix, AZ, with 34 percent; Riverside, CA, with 17.2 percent; and Los Angeles, CA, with 12.0 percent. The top three total, 63.2 percent, reflects the geographic concentration of REO-to-rental operations.

The security is collateralized by a single loan that is in turn secured by first-priority mortgages on the 3,207 income-producing single-family residences. The three rating agencies that rated this transaction (Moody’s, KBRA [Kroll], and Morningstar) consider the mortgage structure superior to a loan secured solely by an equity pledge, because the trust will have a first-priority lien on the properties. In the event of a default, the trust would be able to acquire the properties, rather than being limited to the sponsor’s equity. This structure also helps protect against the bankruptcy of the guarantor or sponsor.

Structure of Invitation Homes 2013- SFR1

Capital Structure

Class Ratings (Moody’s/ KBRA/Morningstar) Original Balance ($MM) Certificate Principal to BPO Value Ratio (%) Initial Maturity Date WAL (yrs.) Fully Extended Maturity Date WAL (yrs.) Assumed Final Distribution Date Rated Final Maturity Date

A Aaa(sf)/AAA(sf)/AAA 278.7 43.6 [2.0] [4.9] December 2015 December 2025

B Aa2(sf)/AA(sf)/AA 34.3 49.0 [2.1] [5.1] December 2015 December 2025

C A2(sf)/A(sf)/A 47.1 56.4 [2.1] [5.1] December 2015 December 2025

D Baa2(sf)/BBB(sf)/BBB+ 31.5 61.3 [2.1] [5.1] December 2015 December 2025

E -/BBB-(sf)/BBB- 46.0 68.5 [2.1] [5.1] December 2015 December 2025

F -/BB(sf)/- 41.5 75.0 [2.1] [5.1] December 2015 December 2025

Property Loan

Property Count 3,207 Loan Balance 479,137,000

Issuer Purchase Price ($mm) 444.7 Loan Term 2 years initial, three 1-yr extension options

Issuer Cost Basis ($mm) 542.8 Amortization Amt. 1% per year

BPO Value ($mm) 638.8 Libor Cap 2.497%

Source: Moody's, KBRA, and Morningstar.

The deal contains six tranches (A, B, C, D, E, and F), shown in table 1. Class A, the AAA tranche, was \$278.7 million (43.6 percent of the \$638.8 million value of the properties); the six tranches together were \$479.1 million (75 percent of the \$638.9 million value of the properties). The stated maturity of the deal is two years from issuance (December 2015), with three one-year extensions. The principal pay downs are made first to Class A, until that Class reaches a zero balance, then in sequential order to the other tranches. Interest accruals are also distributed sequentially. Realized losses are allocated in reverse sequential order. Just as in commercial mortgage backed securities deals, a Special Servicer, in effect chosen by the most subordinate tranche outstanding, is responsible for the servicing and administration of the loan if there is a default or reasonably foreseeable default.

Protections for the Bondholders

The deal contains a number of protections for the bondholders:

While rents are fixed for a period, the interest payments are based on LIBOR (London Interbank Offer Rate) plus a spread. The sponsor was required to buy an interest-rate cap for the initial period to ensure the trust has sufficient cash to pay the bondholders if LIBOR increases. If the deal is extended, future extensions also require the purchase of an interest-rate cap.

There are modest prepayment penalties during the first year for prepayments arising from casualty or condemnation, or prepayments made in connection with the transfer of disqualified properties that do not meet certain representations and warranties.

When individual properties are released from the securitization, the sponsor must pay the trust 105 percent of the allocated loan amount, if the released properties make up less than 10 percent of the initial balance of the securitization. This increases up to 120 percent of the allocated loan amount if released properties make up more than 20 percent of the initial balance of the securitization.

If the loan's debt yield falls below 90 percent of the closing date debt yield (a low debt yield period), excess cash is directed to the bondholders.

Criticisms of the Deal

Whether investor ownership of single-family rental property is positive or negative for communities continues to be debated; securitization will be another factor in that discussion. Here we focus on the criticisms of the transaction raised by the rating agencies that did not rate the deal and the investor community, namely these four:

- the lack of a long term history of rents for comparison
- the geographic concentration of the homes
- Blackstone's limited equity in the deal (\$63.7 million)1 may reduce the incentive to maintain the properties
- the "release of properties" clause

The first two points are inherent in any securitization of single-family rentals; the industry is new and geographically concentrated. The rating agencies clearly recognized these points, and protection has been built into the securitization, via additional required subordination. For example, the AAA bond is sized to be only 43.6 percent of the overall property value, smaller than in most commercial real estate securitizations. As to the third point, we believe any REO-to-rental operator will do the best it can for its equity investors. This means maximizing rental income and selling at as good a price as possible. Both require the properties to be maintained.

The bigger concern for investors (and also for alignment of interest) is the release-of-properties clause. In some circumstances, the interests of the debt holders and the equity holders are not aligned. In particular, the manager, representing the interest of the equity holders, may want to sell off “winning properties” (those that have appreciated) while retaining in the securitization properties that have fallen in value. As an example, recall that all properties in the Invitation Homes securitization are initially valued at 75 percent of property value. Now assume the value of 50 percent of the properties doubles while the value of the other 50 percent decreases by half. If all the appreciated properties were sold, the trust would receive 1.2 times the loan amount initially allocated to those properties. Thus, the total value of the cash plus the remaining properties in the securitization is calculated as (50% x 75% x 1.2) + (50% x 50%), which equals 70 percent of the initially allocated loan amount, although 75 percent is necessary to repay the investors. This example is very unrealistic, but investors would have been better protected had the manager been required to repay the securitization trust the greater of the allocated loan amount times 1.2 or 75 percent of the sales price. Mitigating this concern is the fact that Invitation Homes has only securitized a small amount of its total portfolio (3,207 of its approximately 39,000 homes). With the longer-run interests of their equity investors in mind, Invitation Homes is incented to keep this channel of financing available, which requires them to do a good job for debt holders.

The Future: More Securitizations, as Well as Other Sources of Leverage

The pricing on this transaction was very favorable, with most of the securities selling at higher-tha--expected levels. As a result, more such transactions are likely. Both American Homes 4 Rent (AMH), an REO-to-rental operation with 21,000 single-family homes for rent, and Colony American Homes, which has 15,000 single-family homes, have announced they are looking at similar transactions. In addition, many REO-to-rental operators have arranged for bank financing, and a number of banks have made substantial investments in the systems to monitor the risk in this lending. And AMH has already concluded two very favorable preferred stock offerings.2

One fact is abundantly clear. With home prices up from the levels at which properties were bought, and continuing to rise, institutional investors need to add moderate leverage to deliver attractive returns to their equity investors. Look for many more institutional investors in single-family properties to add leverage in 2014.

Notes

1The sponsor’s total cost basis in the securities is $542.8 million, consisting of a purchase price of $444.7 million, closing costs of $7.9 million, other related costs of $22.5 million, and rehabilitation costs of $67.7 million. The par amount of the securities is $479.1 million, leaving Invitation Homes with hard equity exposure of $63.7 million.

2The offerings took place in October and December 2013. They carry a lower coupon than debt but have added return potential equal to 50 percent of the home price appreciation in AMHs top 20 markets, using the FHFA’s home price indices. By offering a home price appreciation kicker, AMH was able to lock in a lower rate on the transactions.

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