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SINGLE-FAMILY RENTALS:

RENTS AND VALUES ARE HEADING HIGHER

Institutional investors are taking note of the red-hot fundamentals, with capital currently coming into the sector at a rapid pace.

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The single-family rental (SFR) sector offers one of the more favorable demand-versus-supply imbalances in real estate. The confluence of accelerating population growth of key renter cohorts (Exhibit 1), a geographic tilt toward the Sunbelt, and structural impediments to homeownership for median renters in the US will lead to a deep pool of demand for SFR landlords over the coming years. The COVID-19 pandemic pulled some demand forward, but a large share of new demand in 2020 should prove sticky, and there is ample incremental demand coming through the pipeline. New supply is accelerating but off a low base, suggesting a nice runway ahead for SFR fundamentals (Exhibit 2).

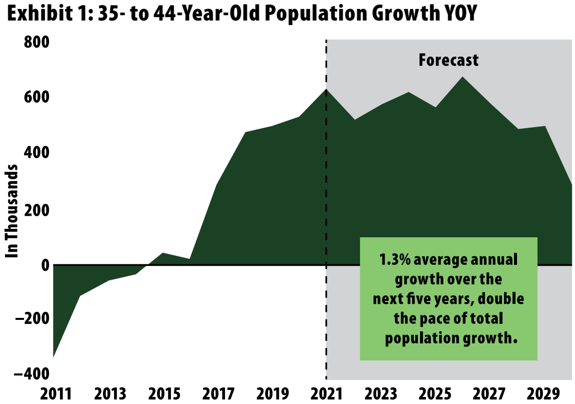
The Global Financial Crisis Spurred SFR Interest

Institutional investors are taking note of the red-hot fundamentals, with capital currently coming into the sector at a rapid pace.

But it wasn't always this way. Green Street shadow covered SFR operators beginning in 2012, when large institutions aggressively bought homes hoping to capitalize on distressed prices following the global financial crisis. Green Street characterized the frenzy at the time as "a pie-eating contest." There was heavy skepticism it would become a viable, long-term operating business.

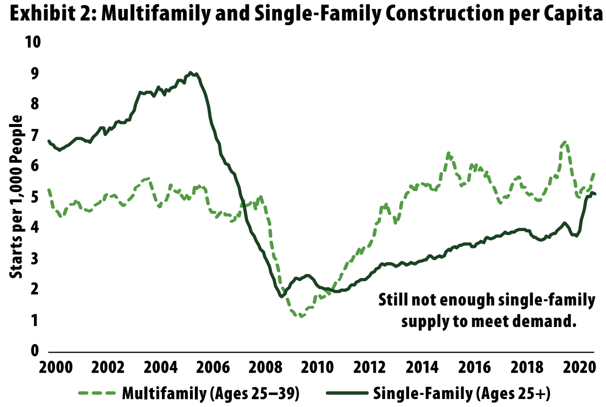
That changed once companies proved they had enough scale, operating execution, disclosure, and communication with the investment community. Still, when Green Street initiated coverage in early 2017, SFR remained a mom-and-pop sector, with institutions holding only about 1% of the US SFR stock. Enter the

Exhibit 1: 35- to 44-Year-Old Population Growth YOY



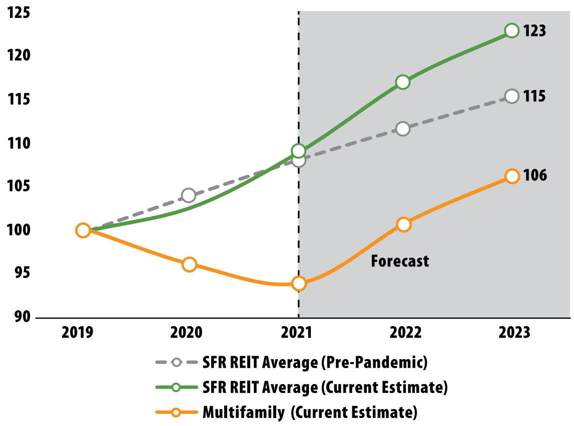
Sources: US Census Bureau, company documents, Green Street

Exhibit 2: Multifamily and Single-Family Construction per Capita



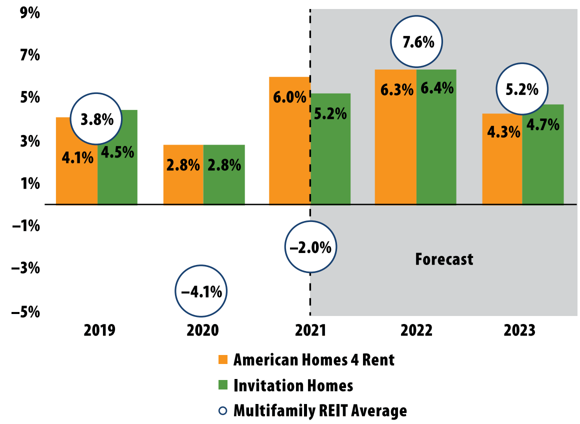
Sources: US Census Bureau, company documents, Green Street

Exhibit 3: Full-Year NOI Forecasts (2019 = 100)



Sources: Company documents, Green Street

Exhibit 4: Same-Store Revenue Growth



Sources: Company documents, Green Street

merger of Invitation Homes and Starwood Waypoint Homes later that year, which dramatically changed the landscape of the institutional SFR industry by creating a $23 billion entity, more than double the size of its nearest competitor.

During the next few years, SFR REITs enjoyed a period of healthy revenue growth, albeit with a few speed bumps on expenses. Unexpected expense growth related to hurricanes, merger integration issues, and previous underspending drove a sharp deceleration in net operating income (NOI) growth and some temporary heartburn for SFR REIT share prices.

Today, operating platforms for the handful of large operators are more sophisticated and enjoy greater economies of scale than during the sector's early days. The financing menu for owners is broader and deeper, and recently, SFR results have comfortably surpassed a high bar of expectations.

As the sector has rebounded, Green Street's net operating income forecasts now sit well above pre-pandemic predictions (Exhibits 3 and 4).

Investors' Growing Interest in SFRs

Large institutional investors continue to ramp up allocations to the sector, as evidenced by two massive deals announced within a three-week period in June. First, Invesco, which manages $1.5 trillion in assets, said it will deploy up to $5 billion in capital to acquire some 20,000 homes over the next few years in partnership with Mynd Management, run by the founders of Waypoint Homes during the SFR sector's infancy. Waypoint's 2014 IPO was one of the first for SFR REITs. The Invesco deal will nearly quadruple Mynd's portfolio of homes for rent.

Blackstone recently made a large splash in the sector, announcing its acquisition of Home Partners of America in a $6 billion all-cash deal. Blackstone reentered the SFR space in 2020 with a modest, passive equity position in Tricon Residential, which owns 31,000 rental homes. The Home Partners acquisition is somewhat tricky to assess because of the company's uncommon rent-to-buy business model and lack of transparency into the structure of Blackstone's joint venture partners. Still, the deal likely signals new benchmarks for valuations in the sector, with an average per-door asset value above $400,000 and a sub-4% nominal cap rate.

Another significant recent development in the SFR sector is the increasing popularity of build-to-rent projects. Over the past few years, several national and regional home builders embraced the strategy but mostly to broaden sales channels and off-load inventory or lots to the large public and private SFR operators. This spring, Lennar announced a new $4 billion SFR joint venture, anchored by about $1.25

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billion in equity from Centerbridge Partners, Allianz Real Estate, and a few other institutional investors. They will partner with Lennar's nascent in-house SFR business to acquire newly constructed single-family homes and townhomes from Lennar and other home builders. Initially, Lennar will deliver about 3,000 homes to the joint venture.

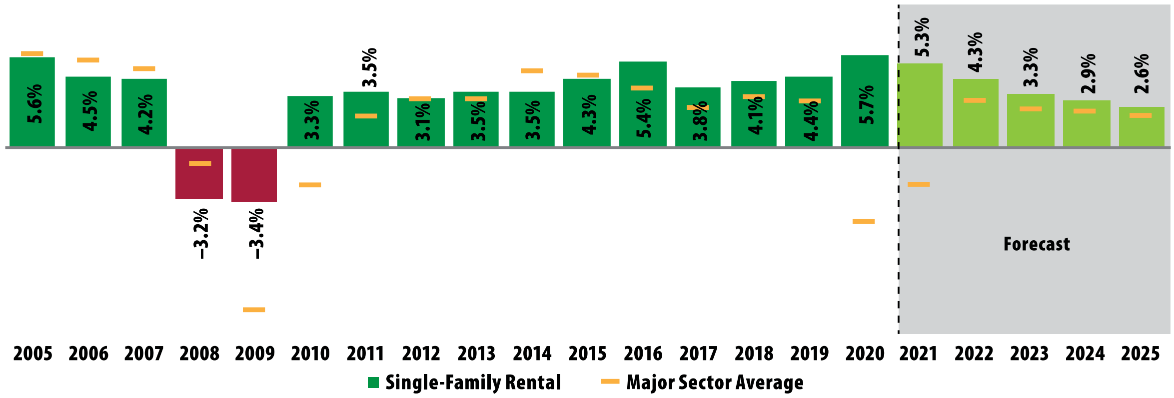
Build-to-rent construction across the country is still a drop in the bucket, representing about 5% to 10% of total single-family construction, but it will likely accelerate as institutional capital pours into the space. The operating outlook for SFR is excellent, debt and equity spigots are wide open, and SFR cap rates have room to compress toward many property types—all suggesting the build-to-rent development cycle is in the early innings.

Although the pandemic is accelerating home buying among wealthier renters, it will make the transition to homeownership much tougher for millions of renters further down the socioeconomic ladder. The personal balance sheet of the median renter was poorly positioned prior to the pandemic, in part because of elevated consumer debt, including student and auto loans. Absent a meaningful loosening of mortgage lending and/or the expansion of federal home buying subsidies, lack of savings for a down payment will continue to be a large anchor on home buying, leading to a stickier SFR tenant base.

Risks of SFR

■ **Capital Expenditures:** The jury is still out on the long-term trajectory of capital expenditures, but the direction is pretty clear—higher. Operators incurred a significant amount of upfront rehab costs at acquisition, and as a greater share of portfolios enter the first and second capital expenditure cycle, reported maintenance costs will rise. REITs are expanding revenue-enhancing capex initiatives, which in some cases simply represent deferred maintenance, despite what label operators use. Green Street's long-term capex reserve of about 15% of NOI is almost double the current level of reported recurring capex.

Exhibit 5: US Single-Family Rental Market Rev-PAF* Growth—Top 25 Markets



Sources: Company documents, US Census Bureau, Green Street
*Market Revenue per Available Foot

■ **Political Risk:** With affordable housing remaining a politically charged issue, SFR landlords will continue to face uphill regulatory and public relations battles, partly stemming from the industry's origins in the global financial crisis. There is no immediate regulation on the radar that would disrupt fundamentals, but rent control proposals, scrutiny of ancillary fees, and regulation that curbs institutional home buying will likely continue to surface periodically. Measures that shorten the path to homeownership will also likely garner support.

■ **Consolidation:** Aggressive acquisition targets from rapidly growing private platforms will pressure REIT external growth over the near term. In its relatively short history, the SFR sector has seen a fair amount of consolidation, particularly as the sector transitioned from a pie-eating contest to an operating story. Economies of scale matter enormously in the sector as a result of the operational intensiveness of the business model. In general, homes are worth more in the hands of larger and more-efficient operators. It is reasonable to expect the current acquisition spree to ultimately lead to another wave of portfolio consolidation several years down the line.

Conclusion

Nevertheless, the merits of the current backdrop seem to outweigh the risks. Green Street expects market rent growth well north of inflation over the next few years—outpacing most property types—with occupancies remaining at or near all-time highs (Exhibit 5).

SFR REIT total returns have outpaced most property sectors in recent years. Green Street has implemented three overweight calls on the sector over various time frames since late 2018, with Invitation Homes and American Homes 4 Rent on average outperforming the RMZ REIT index by approximately 73% and the S&P 500 by about 38% since then. Private-market returns are more difficult to track because of the blurred line between owner-occupied and rental homes, but the combination of robust home price appreciation and outsized NOI growth has likely rewarded most private-market investors as well. Prospective public and private-market returns continue to stack up favorably versus fixed income alternatives and many other real estate sectors, suggesting the sector warrants further attention from investors. ■

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