

# Equal Footing: Financing Single-Family Rentals



## Executive Summary

- While home prices continue to fall, demand for rental housing is strong, translating into rent increases across America.
- The combination of declining home prices and strong rents is creating a situation in which an investment in single-family rental housing can earn a reasonable return.
- Although the economics of the single-family rental strategy have improved significantly and now meet or exceed that from renting multifamily housing, one significant impediment is the lack of financing available in the single-family rental market.
- An appealing solution is to place the rental single-family market on equal footing by providing limited leverage to investment buyers. We believe that such a program is worth developing in more detail.

## Overview

As the echoes of the housing bubble are felt across many cities in America, the volume of distressed inventory continues to weigh on home prices. On the one hand, the economics of owning a home are among the most attractive in a generation. On the other hand, home ownership is poised to continue declining due to a number of factors. Chief among these are very tight lending standards, an increased proportion of Americans with poor credit, a large number of Americans who have lost their homes and who must now rent, and an overall investor psychology which now questions the wisdom of home ownership as a prudent long-term investment after unprecedented price declines. While home prices continue to fall, demand for rental housing is strong, translating into rent increases across America. Apartment rents are now rising at a rate faster than general inflation, and all 20 of the largest metropolitan areas in the US are seeing year-over-year increases in rents. The combination of declining home prices and strong rents is not only making home ownership attractive compared with renting, but is also creating a situation in which an investment in single-family rental housing can earn a reasonable return.

In many of the distressed housing markets in America, the marginal buyer of a foreclosure is now an investor looking to rent the home rather than a buyer looking to occupy the home (owner-occupant). The economics of a home to an investor and to an owner-occupant are very different. The owner-occupant is usually willing to pay a much higher price than the investor is. Now that the marginal demand in many distressed areas is coming from the investor, it is important to understand the economics of buying to rent and why the investor pays a lower price than the owner-occupant. It is also important to study the return threshold necessary to attract sufficient capital to the single-family rental market, where demand can meet the distressed supply. Although the economics of the single-family rental strategy have improved significantly and now meet or exceed that from renting multifamily housing, one significant impediment is the lack of financing available in the single-family rental market.

In the US housing system, there are financing markets that address multifamily properties and owner-occupants of single-family homes. An appealing solution is to place the rental single-family market on equal footing by providing limited leverage to investment buyers. We believe that such a program is worth developing in more detail. A well-structured financing program for single-family rental housing would help to create a floor in home values across distressed markets while at the same time providing attractive returns to the lender.

## Economics of Owning Versus Renting

When deciding whether to buy a home or rent, the prospective homeowner compares the economics of paying rent versus the costs of home ownership. As shown in Exhibit 1, the primary costs of home ownership are the mortgage payments, property taxes, maintenance/repairs, and insurance. A prudent homeowner needs to compare annual market rent to the aggregate annual homeownership cost. In this example, the costs of ownership are subtracted from the equivalent rental cost, with the result being the net saving or cost of owning versus renting. Additionally, there is the opportunity cost of the downpayment, as this money could be invested elsewhere if one chooses to rent. By taking the difference between ownership and rental costs and dividing

by the downpayment, the return on the equity (the downpayment) can be calculated. This return can be calculated on a pre-tax or after-tax basis by incorporating the benefit of mortgage-interest and property-tax deductions from income. While this is a good starting point to compare costs of ownership versus renting, a more thorough analysis would incorporate the expected growth and ownership costs over time.

#### Exhibit 1 Owner-Occupant Economics

Purchase Price	\$160,000
Downpayment (20%)	\$32,000
Value of Housing (by comparison with rentals)	\$1,100
<i>Costs (monthly)</i>	
Maintenance	(\$125)
Insurance (0.3% of value)	(\$47)
Taxes (1.2% of value)	(\$160)
Total Impact of Costs	(\$332)
<i>Financing (monthly)</i>	
Mortgage Payment—Principal	(\$169)
Mortgage Payment—Interest	(\$480)
Adding Back Principal (as added equity)	\$169
Total Impact of Financing	(\$480)
Monthly Pre-Tax Net Benefit to Owner-Occupant	\$288
Annual Pre-Tax benefit to Owner-Occupant	\$3,460
<b>Effective Return on Downpayment</b>	<b>10.80%</b>
<i>Tax Benefits (monthly)</i>	
Interest-Rate Tax Deduction Value (@ 15% marginal tax rate)	\$72
Property-Tax Tax Deduction Value (@ 15% marginal tax rate)	\$24
Total Impact of Tax Benefits	\$96
Monthly Tax-Adjusted Net Benefit to Owner-Occupant	\$384
Annual Tax-Adjusted Benefit to Owner-Occupant	\$4,612
<b>Effective Return on Downpayment Including Tax Benefits</b>	<b>14.40%</b>

Notes: The above assumes a 30-year fixed-rate mortgage at a rate of 4.5%.

Source: Western Asset Management

In many communities across America, the relative costs of owning versus renting are the most favorable in a generation. Exhibit 2 compares the economics of owning a single-family home under three scenarios: the bubble market of 2006, the many stabilizing markets across much of America, and today's distressed housing markets. The homeowner is assumed to provide a downpayment of 20% and to incur annual maintenance expenses of \$1,500, property taxes of 1.2% of property value, and insurance costs of 0.3% of the home value. It is also assumed that the market rent is \$1,100 today and was \$1,000 five years ago. The owner takes out an 80% loan-to-value (LTV) mortgage with an assumed interest rate of 4.5% today versus 6.5% in 2006.

Owning versus renting appears very attractive today, as an owner in today's market buying a \$160,000 home in many parts of America can save over \$3,000 pre-tax and over \$4,000 after tax versus renting. This generates a return on the equity used for the downpayment of over 10% pre-tax and 14% after tax. In distressed markets, home prices are much lower relative to rents. In the distressed example, where the home is purchased for \$110,000, the home ownership savings over renting are more than \$6,000 pre-tax and nearly \$7,000 after tax. This generates percentage returns on equity in the high-teens pre-tax and low-20s after tax.

In contrast, at the peak of the real estate bubble, in many areas the same property would have sold for \$220,000. At that time, owning was more expensive both pre-tax and post-tax, generating negative returns on the equity downpayment.

**Exhibit 2**  
**Owner-Occupant Economics at Different Points in the Real Estate Cycle**

	2011 Today's Market	2011 Distressed Market	2006 Bubble Market
Home Price	\$160,000	\$110,000	\$220,000
Mortgage Interest Rate	4.50%	4.50%	6.50%
Market Rent	\$1,100	\$1,100	\$1,000
Price-to-Rent Ratio	12.1	8.3	18.3
Gross Rental Yield	8.30%	12.00%	5.50%
Net Return on Downpayment—Pre-Tax Benefits	10.80%	18.90%	-13.60%
Net Return on Downpayment—Post-Tax Benefits	14.40%	21.30%	-7.00%
Annual Savings of Owning vs. Renting—Pre-Tax	\$3,460	\$6,035	(\$4,350)
Annual Savings of Owning vs. Renting—Post-Tax	\$4,612	\$6,827	(\$2,238)

*Notes: All of the above assume a 30-year fixed-rate mortgage, 1.2% property tax rate, ~0.3% annual insurance cost, \$1,500 annual property maintenance, and 15% marginal income tax rate.*

*Source: Western Asset Management*

While the financial benefits of owning today are extremely compelling, as shown in the above example, many of those who need housing today either do not have the downpayment needed or lack the quality credit to get financing. Undoubtedly, investor psychology also plays a role. The lure of ever-increasing home prices leading up to the bubble has been replaced with skepticism about whether owning a home is a good investment.

### Economics of Investing in Single-Family Rentals

In the above example, the rental yield<sup>1</sup> ranges from 5.5% in the 2006 scenario to 12.0% in the distressed housing market scenario. Exhibits 3 and 4 show historical rental yields on single-family homes in America by taking median rents and comparing them to the median home prices. As it is difficult to obtain a single rental series which covers an extended period of time, we show two different calculations of rental yields. Rental yields reached their lowest levels during the housing bubble and have now increased to their highest levels in many years.

In many of the distressed housing markets, supply overwhelms demand from owner-occupants, with the resulting marginal bid for homes coming from an investor who intends to rent the property. The value of the home to the investor is almost always lower than to the owner-occupant for a number of reasons. The investor faces a number of additional expenses over the owner-

<sup>1</sup> Rental yield is simply annual gross rents divided by house price. Thus, a home worth \$100,000 renting for \$500 per month has a rental yield of 6%.

occupant, including the cost of vacancy, property management fees, and higher maintenance costs (as rental properties often require more upkeep). In addition, investors generally have a higher return hurdle than an owner-occupant. Finally, investors face limited financing options, making those returns more difficult to achieve.

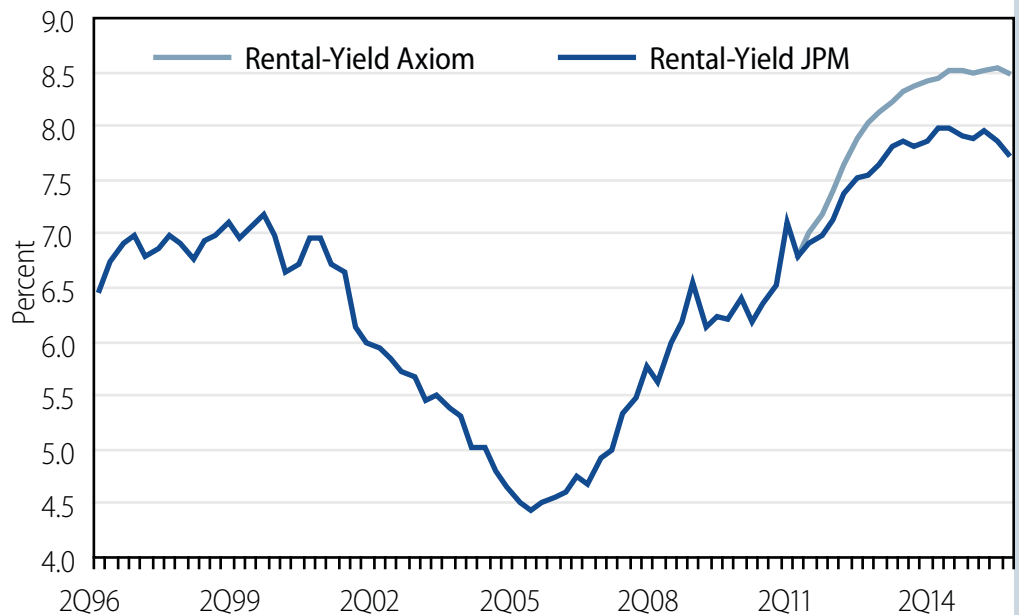
Investor participation in single-family housing has historically been very small relative to the overall single-family housing stock. Those who have bought homes to rent have often relied heavily on long-term price appreciation to generate a significant portion of their returns. Participation by institutional investors has historically been very limited. There are a number of reasons for this low involvement.

1. **Low Historical Rental Yields:** Single-family rents have been relatively low in relation to home prices. A number of companies, such as Trulia and Zillow, compute home price to market rent multiples across cities. While the multiples can vary significantly by city, overall price-to-rent multiples have often been in the mid-teens or higher. The inverse of the price-to-rent multiple is the gross rental yield. By looking at recent rental yields in Exhibit 3 and the longer-term series in Exhibit 4, it is clear that we have been through a period of historically low rental yields. After the recent period of home price declines and rent increases, rental yields are now at one of the highest levels in the past 40 years.
2. **Higher Expenses on Single-Family Rentals:** The expenses of single-family rentals are often greater than those for multifamily rentals due to the lack of economies of scale. When comparing a 20-unit multifamily property to 20 single-family rentals, the costs of repairs and maintenance on the single-family rentals are often higher, as the houses would be located across a broader area. A multifamily property can often have an onsite manager to handle issues, which is not possible with single-family rentals. These differences lead to higher property management expenses. Also, insurance costs on individual rental homes have often been higher than those for multifamily rentals. The higher property management, maintenance, repair, and insurance costs add up to higher overall expenses on single-family rentals versus multifamily rentals. While expenses vary by property and location, a general assumption is that single-family expenses can subtract around 5% from the gross rental yield.
3. **Inadequate Financing:** Historically, financing from the government-sponsored enterprises (GSEs) on single-family rentals has been limited to a maximum of four properties per individual (up to 10 properties at Fannie Mae under limited circumstances). Unlike multifamily loans, financing for single-family rentals has been based primarily on the borrower's income and credit score rather than on the income generated by the investment. The tightening in lending standards has made obtaining this financing even more difficult. This struggle is in contrast to the single-family owner-occupant with strong income and credit and to the multifamily investor, both of whom can obtain financing at reasonable leverage and at attractive rates.
4. **Poor Historical Financing Practices and Performance:** Finally, private and GSE lenders who wrote loans to investors in rental single-family homes in the past often saw poor performance. As mentioned above, the loans were based on the personal finances and credit of the borrowers, rather than how every other form of income-generating real estate is made: based upon the income of the property and its ability to service debt. Many of these investor loans had negative cash flow from the start.

Given these facts, it should be no surprise that the resulting investors in rental single-family homes were often small operators making speculative bets on property appreciation, rather than more sophisticated investors basing their decisions on more prudent cash flow considerations. Exhibit 5 shows the costs of operating single-family rentals. From the gross annual rental yield, the investor needs to subtract estimated loss of rent from vacancies and factor in expenses such as property management fees (rent collection, leasing, and handling tenant issues), maintenance/repairs, property taxes, and insurance. The result is the net cash flow, which can then be divided by the acquisition cost to compute a net cash flow yield or capitalization (cap) rate. If the investor utilizes leverage, the return on equity could also be calculated by taking the above net cash flow, subtracting out mortgage interest costs, and then dividing the resulting cash flow by the equity invested in the property (the property acquisition cost less the mortgage).

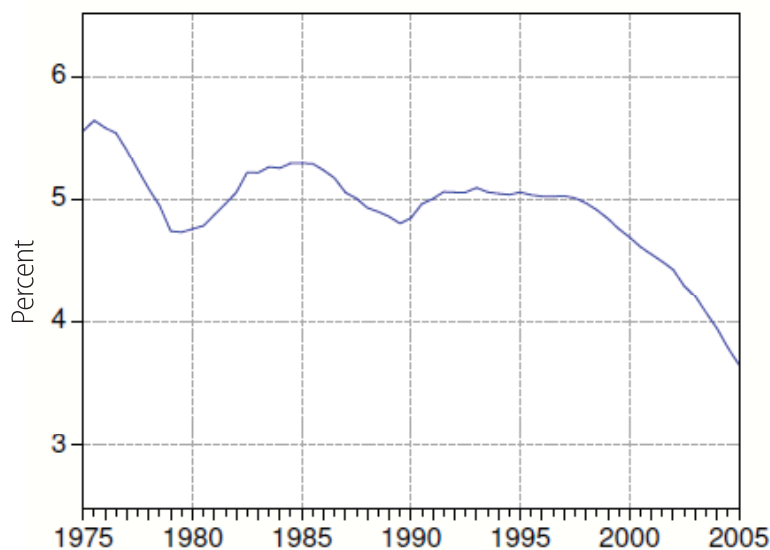
In many distressed real estate markets across the US, gross rental yields are in the double digits, often resulting in net cash flow yields of 7% or greater. This yield compares favorably with the yields from investing in multifamily rentals. In these distressed communities, many of the initial investors employed a strategy of buying real-estate-owned (REO) homes, making repairs to turn the properties into stable condition, and then flipping them to owner-occupants who would then be able to obtain a loan at favorable economics. As the demand from owner-occupants is not sufficient to meet the continued supply of distressed homes, many of these investors are now realizing that the economics of buying to rent are reaching the point of making this strategy attractive. As single-family rentals historically did not provide attractive returns, it is only now that capital is beginning to flow into this strategy.

Exhibit 3  
Rental Yields (Past 15 Years and Forecast)



Source: JP Morgan, Axiometric

Exhibit 4  
Rental Yields (1975–2005)



Source: Campbell, et al.<sup>2</sup> Based on data from the Office of Federal Housing Enterprise Oversight and the Bureau of Labor Statistics.

Exhibit 5  
Cash Investor Economics

Cash Purchase	\$110,000
Monthly Revenue From Rent (@12% rental yield)	\$1,100
<i>Costs (monthly)</i>	
Maintenance	(\$133)
Insurance (0.3% of value)	(\$40)
Taxes (1.2% of value)	(\$160)
Adjustment for 5% Vacancy	(\$55)
Management Fee (7% of collected revenue)	(\$73)
Total Impact of Costs	(\$461)
Monthly Net Income	\$639
Annual Net Income	\$7,662
Capitalization Rate (Net Income / Value)	7.00%

Source: Western Asset Management

<sup>2</sup> Campbell, S., and M. Davis, J. Gallin and R. Martin. 2006. "A Trend and Variance Decomposition of the Rent-Price Ratio in Housing Markets." Published by the Federal Reserve Board. Accessed on Oct. 21, 2011 at <http://www.federalreserve.gov/pubs/feds/2006/200629/200629pap.pdf>

**Exhibit 6**  
**Rental Property Investor Economics Showing the Effects of Leverage**

	Distressed Single-Family Rental		Multifamily (per Unit)	
	No Leverage	With Leverage	No Leverage	With Leverage
Price	\$110,000	\$110,000	\$140,000	\$140,000
Market Rent	\$1,100	\$1,100	\$1,100	\$1,100
Price-to-Rent Ratio	8.3	8.3	10.6	10.6
Gross Rental Yield	12.00%	12.00%	9.50%	9.50%
Capitalization Rate	7.00%	7.00%	6.25%	6.25%
Mortgage Interest Rate	NA	4.50%	NA	4.50%
Loan-to-Value Ratio	NA	65%	NA	75%
Tax Benefits	7.00%	11.50%	6.50%	11.50%

*Notes: All of the above assume a fixed-rate mortgage with a 30-year amortization schedule, 1.2% property tax rate, ~0.3% annual insurance cost, \$1,500 annual property maintenance.*

*Source: Western Asset Management*

Exhibit 6 compares the returns of investing in a single-family rental with those of a multifamily rental. While the unlevered return on single-family rentals now looks attractive relative to multifamily, the reality is that investors in multifamily rentals frequently use leverage and thus evaluate multifamily returns on a levered basis. On a levered basis, the multifamily rental can earn over 11%. One major challenge faced by investors in single-family rentals is the lack of available financing. If financing did exist, even at terms more conservative than those for multifamily, the returns from single-family rentals would be comparable to those on multifamily rentals. This type of return should be sufficient to attract significant capital.

While the leveraged single-family rental strategy provides attractive cash flow yields today, the future upside could be even greater. First, many firms are forecasting strong rent growth over the coming years. Second, the capital appreciation could be significant if the marginal buyer in distressed single-family markets transitions from the investor back to the owner-occupant. The example in Exhibit 6 shows a home value of \$160,000 in a stabilized housing market versus a value of \$110,000 in the distressed market. Over the next five-to-seven years, it is reasonable to expect that many of the distressed housing markets will stabilize as the shadow inventory is liquidated.

### Structuring a Single-Family Rental Finance Program

Unlike previous single-family investor financing, which was based primarily on the borrower's income and credit metrics, a sound financing program should be based on the same income approach that is used to underwrite multifamily properties at the GSEs. While the GSEs and other lenders have suffered losses on their loans for single-family rentals, these investor loans were made at higher loan-to-values, at high initial home prices, and often on properties with poor economics of low rental yields. In contrast, the multifamily lending programs at the GSEs have experienced low default rates and have been very successful, generating net revenue throughout the recent housing crisis. A single-family rental program based on the same sound underwriting principals should be profitable. There are a number of features which should be considered for the new program.



1. **Cross-Collateralization and Cross-Default:** Just as a loan on a 50-unit apartment building is one loan on 50 cash flow-generating units, loans to single-family investors should be made on a cross-collateralized and cross-defaulted basis. This feature would lower the risk to the lender should single properties perform poorly. The loan could also be structured as a single loan backed by multiple properties. Larger loans collateralized by greater number of properties should experience better performance due to the benefits of diversification.
2. **Prudent Leverage:** Loan-to-value targets of 65% and debt service requirements of 1.4× mortgage payments would be conservative enough to generate low defaults while at the same time greatly improving the economics to the single-family investor.
3. **Call Protection:** Fixed-rate single-family investor loans should be structured with call protection similar to the way multifamily and commercial loans are structured. This call protection can take the form of lockout, defeasance, yield maintenance, or prepayment penalties. Loans could also be structured as floating-rate loans, in which case call protection is less of a consideration.
4. **Substitution of Collateral:** Just as many commercial real estate loans allow borrower flexibility, single-family investor loans should provide for the ability to substitute or release properties should the investor want the flexibility to sell individual properties. Substitutions and releases would be done with the approval of the servicer, just as commercial real estate loans operate. If the borrower chooses to sell certain properties before the maturity of the loan, a release price mechanism would be structured into the loan which would allow the borrower flexibility but at the same time prevent adverse credit selection to the loan by requiring that the loan be paid down to maintain or improve the effective LTV.
5. **Escrow Loan Proceeds for Improvements:** When an investor buys a distressed property, there are often deferred maintenance and repairs which need to be performed. The loans could be structured with an initial escrow hold-back whereby the initial loan would be based on the acquisition price, with additional funds to be released to reflect the improved property value once repairs are completed.
6. **Program Administration:** The program could be administered by governmental agencies such as Fannie Mae, Freddie Mac, or the Federal Housing Administration (FHA), all of which have experience underwriting multifamily real estate. The program could also be administered by CMBS conduits. However, given the lack of market familiarity with the product, a CMBS product would require higher yields than one insured by FHA or one of the GSEs. This option would provide for more attractive lending rates.

### Other Considerations

While prudent lending under a financing program would improve the economics of single-family rental housing, other programs could also improve the economics and thus create stronger demand. While the above financing program could likely be implemented at no cost to the government, some additional ideas listed below would involve greater costs.

1. **Tax Incentives:** Direct tax credits or tax benefits, such as accelerated depreciation, could be offered for investments in single-family rental housing in qualifying distressed areas.
2. **Investor Credits for Long-Term Leases:** Longer-term tenant leases provide a benefit to the neighborhood by creating stability. This could be achieved by offering responsible tenants either longer-term leases or rights of annual renewal on shorter-term leases (for a period up to five years).



3. **Credits for Rentals to Existing Borrowers:** Another option to promote neighborhood stability is to offer investor credits for rentals to the existing borrowers facing foreclosure and eviction.
4. **Government Co-investment Similar to the Public-Private Investment Program (PPIP):** The government could create a pool of capital available to invest side-by-side along with private investors. This, along with prudent leverage, would create additional capital and incentives.
5. **Single-Family Rental REITs:** Real estate investment trusts (REITs) seem to be an ideal structure for rental housing. REIT debt covenants often allow for leverage of around 60%. The resulting high-dividend yield could be attractive to income-seeking investors who participate in multifamily, commercial, and mortgage REITs.

### Conclusion

While institutional investment in single-family rental housing has been a rare occurrence in the past, we are already starting to see rapid growth in this space. While creating infrastructure and economies of scale does present challenges, the opportunities for institutional investors are abundant. A program which provides financing at attractive rates, while at the same time providing attractive risk-adjusted returns to the guarantor, could go a long way toward boosting demand and stabilizing prices in distressed communities across America.

*Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset Management. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset Management may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.*

*Western Asset Management Company Distribuidora de Títulos e Valores Limitada is authorized and regulated by Comissão de Valores Mobiliários and Banco Central do Brasil. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered financial instruments dealer whose business is investment advisory or agency business, investment management, and Type II Financial Instruments Dealing business with the registration number KLFB (FID) No. 427, and a member of JSIAA (membership number 011-01319). Western Asset Management Company Limited ("WAMCL") is authorized and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by WAMCL.*