GSE Financing of Single-Family Rentals

What Have We Learned from the Invitation Homes Deal?

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May 2017

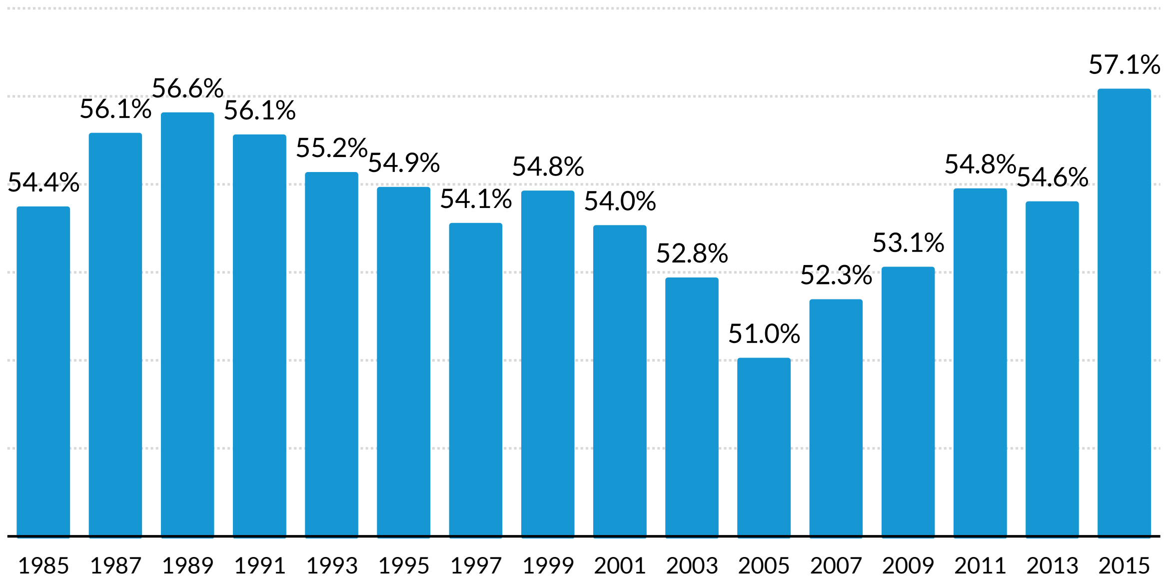
Fannie Mae recently completed the first government-sponsored enterprise (GSE) securitization of single-family rental (SFR) properties owned by an institutional investor. This securitization, Fannie Mae Grantor Trust 2017-T1, was for Invitation Homes, one of the largest institutional players in the SFR business (Fannie Mae 2017). When this transaction was first publicly disclosed in January as part of Invitation Homes' initial public offering, we wrote an article describing the transaction and detailing some questions it raises (Goodman and Kaul 2017). Now that the deal has been completed and more details have been released, we wanted to look closely at some of its structural aspects, examine the need for this type of financing, and discuss SFR affordability.

Single-Family Rental Background

The 2015 American Housing Survey indicates that approximately 40 percent of the US rental housing stock is in one-unit, single-family structures, with another 17 percent in two- to four-unit structures, which are also classified as single-family. Thus, 57 percent of the US rental stock falls under the single-family classification. Although this share increased from 51 percent in 2005 to 57 percent in 2015, this increase was preceded by an almost identical decline from 56.6 percent in 1989 to 51 percent in 2005 (figure 1).

FIGURE 1

Single-Family Rentals as a Share of the Total Rental Housing Stock



Source: 2015 American Housing Survey.
Note: Single-family includes one- to four-unit properties.

Most SFR properties are owned by mom and pop investors. These purchases were typically financed through the GSEs' single-family business. Fannie Mae allowed up to 10 properties in the name of a single borrower, and Freddie Mac allowed up to six properties. Rent Range estimates that 45 percent of all single-family rentals are owned by small investors with only one property and 85 percent are owned by those who own 10 or fewer properties (Rahmani, Tomasello, and Jones 2016). So the GSEs cover 85 percent of the single-family rental market by extending loans to small investors through single-family financing. Of the remaining 15 percent, 5 percent is estimated to be owned by players with over 50 units,and just 1 percent is owned by institutional SFR investors with more than 1,000 properties.

Institutional investors, such as Invitation Homes, entered the SFR market in 2011. Entities raised funds and purchased thousands of foreclosed homes at rock-bottom prices and rented them out to meet the growing demand for rental housing. Then, they built the expertise, platforms, and infrastructure to manage scattered-site rentals. Changes in the business model have required these entities to search for financing alternatives.

Changes in the Institutional Business Model

Although the number of SFR units institutional investors own remains tiny (less than 300,000 units, which is 1.7 percent of the 17.5 million one-unit SFR properties and 0.68 percent of the total rental housing stock), their share has grown from zero over the past six years. Meanwhile, the supply of foreclosed properties has diminished and house prices have increased, causing two changes in the institutional SFR business model:

- **Increased diversity in buying patterns**. In December 2012, only 9 percent of the properties institutional investors purchased were acquired through a multiple listing service. Fifty-two percent were acquired at auctions, and the rest through real-estate-owned/short sales and bulk purchases. By March 2016, however, 33 percent of the properties were acquired through a multiple listing service, and the percentage acquired at auction had dropped to 30 percent (NRHC 2016). Historically, institutional investors have not directly competed with first-time homebuyers, as the institutional comparative advantage is in bulk purchases of properties that require considerable renovation expenditures. Data provided in support of this securitization show that Invitation Homes spent over $20,000 per home on up-front renovation. That said, bulk purchases by institutional investors for renting reduce the inventory of homes available for purchase by homebuyers. Moreover, as purchases through a multiple listing service increase, the amount of competition will increase.
- **Use of leverage.** Early financing for institutional purchases of SFR properties was mostly through cash. Then came leverage through bank lending and securitizations. The first single-family securitization was done in late 2013 (Goodman 2014). Currently, there are close to $19 billion in these notes outstanding. Leverage becomes a more important component of overall return in an environment with rising house prices. Numbers from the current securitization transaction makes this clear (table 1).

TABLE 1

Return on Investment for Properties in This Transaction

Market value of the average property[a]	$231,551
Revenues, expenses, net cash flow[b]	
Total revenue from the average property	$18,364
Less total operating expense	$6,303
Net operating income per property	$12,061
Less capital expenditure	$750
Net cash flow per property	$11,311
Total return[c]	
Net cash flow return	$11,331 / $231,551 = 4.9%
Plus, assume house price appreciation	2.5%
Additional yield because of leverage (assume 50 % financing at 4.23% borrowing cost)	3.1%
Total return	4.9% + 2.5% + 3.1% = 10.5%

Source: Fannie Mae, *Guaranteed Grantor Trust Pass-Through Certificates: Fannie Mae Grantor Trust 2017-T1* (Washington, DC: Fannie Mae, 2017).

[a] Market value measured by broker price opinion on page 105.

[b] Portfolio underwriting, as given on page 13.

[c] Urban Institute calculations from the above information.

At current house prices, the cash flow return is only 4.9 percent. This was higher a few years ago when house prices were lower relative to rents. But as prices have increased faster than rents, the portion of total return generated purely from rental cash income has declined, leading the industry to increase its reliance on leverage. This suggests that demand for SFR financing is likely to grow in the future.

This deal received negative press when it was announced in January and raised several important questions. Why did Fannie Mae do its first deal with a large institutional investor? It is not Fannie Mae's mission to assure that large institutional investors can achieve a high rate of return on capital. Why was the deal not done with a nonprofit? Why did the deal refinance existing properties, rather than support purchase activity? Why did the deal not support those with more limited access to financing (Invitation Homes has both single-family rental securitizations and bank loans in place)?

Why Did This Deal Take More Than Three Months to Complete?

This deal was the first of its kind for Fannie Mae and required above-average due diligence and an abundance of caution. In addition, Fannie had to ensure it had appropriate internal systems, processes, and controls to collect and process data and analyze this transaction's performance. Lastly, Fannie had to ensure it was on solid legal ground.

The due diligence required Fannie not only to assess the value of the properties at origination and reconcile to its automated valuation model, but also to track the collateral properties *on an ongoing basis*. The latter is critical because when Invitation Homes exercises its right of substitution (to put new properties in place of those taken out), the collateral that protects Fannie Mae should remain strong if the deal fails to perform. Fannie Mae also needed to build systems to track and analyze various financial metrics and monthly data on rents. As for the due legal and contractual diligence, the 17-page term sheet is accompanied by a 412-page prospectus and a detailed property level data annex.

Why Transact with a Large Institutional Player?

Doing this pilot allowed Fannie to venture into the SFR space with minimal risk, identify potential issues, and work through them. This is also why this deal could not have been done on a purchase property. Because wait times expose property sellers to holding and maintenance costs and other expenses, they have a strong financial incentive to close the deal quickly. No seller would have waited four months or longer. (We estimate the deal was likely in process for at least a month when it was announced in January.) Thus, using properties that needed to be *refinanced* allowed for more flexible timing. And partnering with Invitation Homes, one of the largest SFR operators, allowed Fannie Mae to gain access to a rich dataset on the underlying properties. These data are important in getting comfortable with this asset class.

How Much Risk Is Fannie Mae Taking Relative to Typical Multifamily Financing?

This transaction consists of a 10-year, interest-only loan for just under $1 billion, originated by Wells Fargo to Invitation Homes. Fannie Mae is guaranteeing the top 95 percent of this transaction, and Invitation Homes has the risk on the first 5 percent. This loan is secured by 7,204 single-family rental properties in 26 metropolitan statistical areas across 10 states. We believe Fannie Mae's risk on this transaction is less compared to a typical multifamily deal because of lower loan-to-value ratio, enhanced risk sharing, and a higher than average debt service coverage ratio (DSCR).

Lower loan-to-value ratio than average. The aggregate value of properties collateralizing this debt is $1.683 billion, as measured by broker price opinion. The notes guaranteed by Fannie Mae represent 56.7 percent of the properties' value. The total loan amount, which includes the 5 percent first-loss piece, is 60 percent of the collateral value. This is considerably lower than a typical Fannie multifamily deal. Fannie Mae's latest 10-K indicates the origination loan-to-value ratio of Fannie's multifamily book of business averages about 67 percent.

Risk sharing with Wells Fargo and first-loss held by Invitation Homes. In addition to the 5 percent first-loss piece, Fannie Mae's guarantee of the top 95 percent is reinsured under a loss-sharing arrangement with Wells Fargo. Although the precise arrangement is not public, Fannie Mae's Delegated Underwriting and Servicing–approved multifamily lenders (of which Wells Fargo is one) are typically required to share one-third of the loss while Fannie absorbs the remaining two-thirds on a pari-passu basis. The requirement that the sponsor also take the 5 percent first-loss piece is not typical.

Conservative debt service coverage. The debt service coverage ratio for this deal is 1.35 on a fully amortizing basis. Even though this is an interest-only loan, the debt service coverage ratio has been underwritten on the basis of a 30-year amortizing loan. This underwriting is conservative. Assume a $100 million loan with a 4 percent interest rate. The annual debt payment for an interest-only loan would be $4 million. But under a 30-year amortization schedule, the debt payment would be $5.72 million. Fannie is using the latter to compute the DSCR even though this loan is interest only. Effectively, Fannie is holding Invitation Homes accountable to a higher financial standard relative to what the underwriting would suggest. And the Invitation Homes 1.35 DSCR compares favorably with the 1.30 underwritten DSCR on Fannie Mae's 2016 book of business.[1]

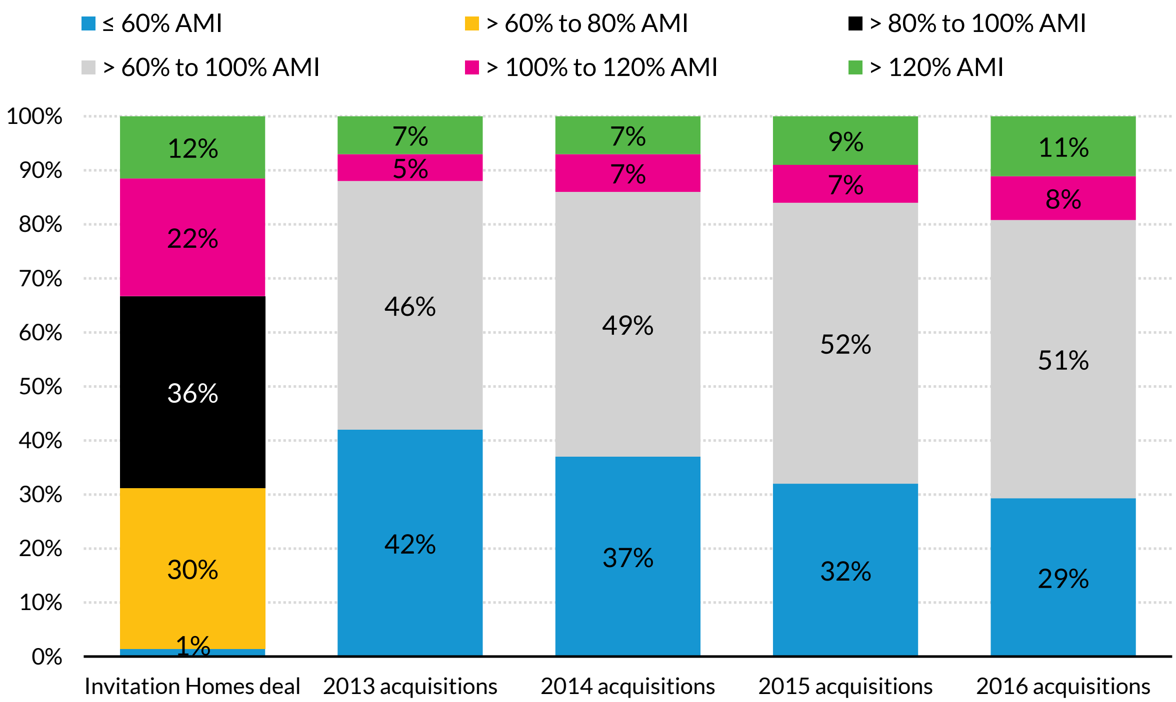
Other terms similar to typical multifamily. The general terms for this deal are nearly identical to Fannie Mae multifamily loans: 10-year term, fixed rate, with yield maintenance for the first 9.5 years. Borrowers who want to pay down the loan before the end of the 9.5 years must compensate Fannie Mae for the lost interest—that is, the net present value of the difference between the interest rate on this loan and the then-current 10-year Treasury rate. This interest is passed on pro rata to the ultimate securities investors.

How Does This Deal's Affordability Compare with Fannie Mae Multifamily?

Perhaps the largest policy issue the GSEs and the Federal Housing Finance Agency (FHFA) will have to grapple with is whether there should be explicit affordability requirements and what they should be. Government-sponsored enterprise multifamily properties have no explicit affordability guidelines, but, for families earning less than the area median income (AMI), this deal is less affordable than Fannie Mae's typical multifamily acquisitions(figure 2).

FIGURE 2

Affordability Comparison: Invitation Homes Transaction versus Fannie Mae Multifamily



Source: Fannie Mae.
Note: AMI = area median income.

- 826 properties (11.5 percent) of the 7,204 in the deal are not affordable to families earning up to 120 percent of the AMI. This is roughly in line with the 11 percent for Fannie Mae's 2016 multifamily acquisitions. But the affordability percentage at lower AMI levels is less compared with Fannie's 2016 multifamily acquisitions.
- The number of properties in this deal affordable to households earning up to 60 percent of the AMI is 100, or 1.4 percent of the 7,204. This compares with 29 percent for Fannie's 2016 acquisitions.

- Households with incomes between 60 and 80 percent of the AMI could afford 2,150 properties, or 29.8 percent of the total. Cumulatively, 31.2 percent of the total would be affordable to households earning up to 80 percent of the AMI.

- Households with incomes between 80 and 100 percent of the AMI could afford 2,559 properties, or 35.5 percent of the total. Cumulatively, 66.7 percent of the total would be affordable to households earning up to 100 percent of the AMI. This compares with 80 percent for Fannie Mae's 2016 multifamily acquisitions.

- For families earning 100 to 120 percent of the AMI, the number of properties affordable is 1,569, or 21.8 percent. Cumulatively, 88.5 percent are affordable to those earning less than 120 of the AMI, versus 89 percent for Fannie's 2016 multifamily book of business.

To reiterate, 66.7 percent of the 7,204 properties in this transaction are affordable to renters earning 100 percent of the area median income or less. This share is far less than the 80 to 90 percent for recent Fannie Mae multifamily acquisitions. This is an area of major concern. A financing arrangement that uses a taxpayer guarantee to subsidize institutional SFR debt should have appropriate measures to ensure the benefit of the guarantee is used to increase the availability of rental housing for those earning up to the AMI.

That said, there are additional factors to consider. Single-family and multifamily rentals are different from each other in several ways:

- One-unit, single-family rentals tend to have more square footage (figure 3) and are more likely to be in suburbs and rural areas compared with multifamily rentals, which are more apt to be near city centers.

- One-unit, single-family structures are also more likely than two-or-more-unit structures to be rented by families: 49 percent of all one-unit, single-family rentals are occupied by three or more people, versus 36 percent for structures with two units or more. Conversely, two-or-more-unit structures are more likely than one-unit structures to be rented by individuals: 24 percent of single-family rentals have only one occupant, versus 36 percent for structures with two units or more.

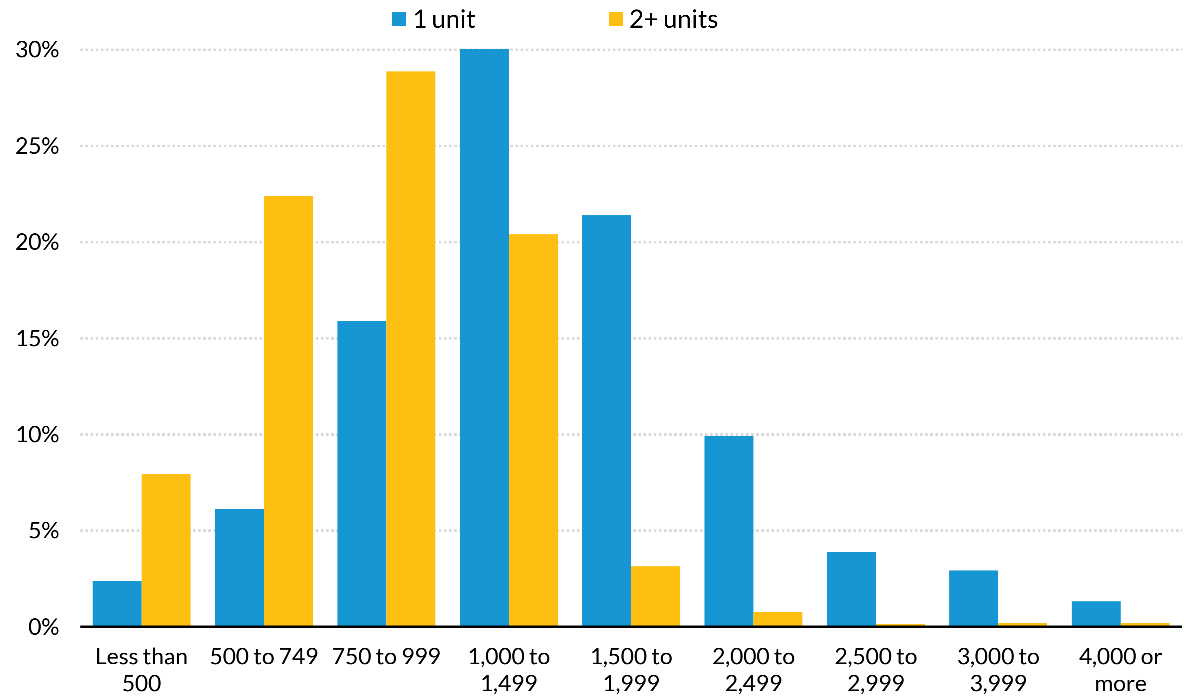
- Single-family rentals are better designed for families: approximately 60 percent of all SFR properties have three bedrooms or more, versus about 15 percent for rentals with two units or more.

An important affordability consideration is that when calculating the percentage of households below 100 percent of the AMI, should this be scaled for the number of residents in the home? For Section 8 vouchers and public housing assistance, the US Department of Housing and Urban Development adjusts for family size. For example, a four-person household can earn 42.8 percent more than a one-person household to qualify for public housing assistance.

Surprisingly, American Housing Survey data indicate that rents for one-unit single-family properties are not significantly higher than rents for structures with two or more units, but utilities for SFRs are significantly higher relative to those for two-or-more-unit structures. Consequently, despite rents not being significantly higher, total housing costs are.[2]

FIGURE 3

Square Footage Distribution of Renter Households with One Unit and Two or More Units



Source: American Housing Survey and Urban Institute calculations.

Another distinction is that properties in the Invitation Homes deal are skewed toward the higher end of the single-family rent distribution and tend to be clustered in areas with higher than average incomes. In 2015, the median rents for one-unit detached and attached single-family homes were $800 and $834, respectively, according to the Census Bureau. In comparison, the median rent for properties in the Invitation Homes deal was $1,470. (We are comparing 2015 census numbers with 2017 rents, but the difference is larger than inflation can explain). Similarly, the 2015 US median income was $56,500, according to the Census Bureau. In comparison, 96 percent of properties included in this deal are in areas with median incomes above the US median. Forty percent of single-family renters have income of $50,000 or more, versus 30 percent for renters in structures with two units or more. This suggests that single-family renters are likely to be more affluent than multifamily renters.

In line with this, a recommendation is to make it mandatory for single-family rental operators who receive government backing to report rent histories on all their properties to credit bureaus. This will make it easier for tenants who live in these properties to qualify for a mortgage when they want to buy. These renters are more likely than other renters to become homeowners as they are more affluent and value the additional space.

What Does This Mean for the GSEs' Role in Financing Institutional SFRs?

Invitation Homes was an important first transaction—it allowed Fannie Mae to learn about the institutional single-family rental market by partnering with an established player. As it thinks about expansion, this transaction opens the door for programs to finance the middle sector—properties with 10 to 1,000 units—which have a dearth of financing opportunities. Some of these participants will be nonprofits. In addition, demand for institutional SFR financing is likely to grow as investors increasingly rely on leverage to maintain an acceptable rate of return.

If the FHFA concludes that the GSEs should participate in this growing and important market, questions surrounding affordability will be front and center. These questions include whether there should be explicit affordability requirements, whether this type of financing should count toward the GSEs' multifamily caps, and whether SFR rentals should count toward meeting either the single-family or the multifamily housing goal requirements.

As we pointed out in the last piece, the FHFA needs to articulate a clear vision for the GSEs' role in the SFR market. This vision should be accompanied by explicit guardrails and provisions that expand the availability of rental housing in a manner consistent with that in the GSE multifamily space—that is, it should mainly benefit households earning up to the area median income. And if there are reasons this alignment cannot be achieved (for example, if the FHFA concludes that the two markets are sufficiently different), those factors should be acknowledged and used as inputs in coming up with distinct affordability guidelines for single-family rentals.

Notes

1. Information provided to us by Fannie Mae.
2. According to 2015 American Housing Survey, the median monthly housing cost for one-unit detached and attached single-family structures was $1,036 and $990, respectively. The median monthly housing cost was $825 for 2- to 4-unit properties, $850 for 5 to 9 units, $889 for 10 to 19 units, $968 for 20 to 49 units, and $1,028 for 50 or more units.

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Acknowledgments

The Housing Finance Policy Center (HFPC) was launched with generous support at the leadership level from the Citi Foundation and John D. and Catherine T. MacArthur Foundation. Additional support was provided by The Ford Foundation and The Open Society Foundations.

Ongoing support for HFPC is also provided by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. Funds raised through the Forum provide flexible resources, allowing HFPC to anticipate and respond to emerging policy issues with timely analysis. This funding supports HFPC's research, outreach and engagement, and general operating activities.

This brief was funded by these combined sources. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at www.urban.org/support.

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