US landlords will prosper as fewer opt to buy a home

By Stephen Foley September 29, 2015 6:00 PM

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Protest placards and populist politicians may claim "the rent is too damn high", but the market is the market, and the market says that landlords will continue to do very nicely.

The financial return on an apartment block in the US has averaged 13 per cent annually in the five years since the economy emerged from the Great Recession and, in the US as elsewhere, institutional investors are gravitating to residential property in greater numbers.

Multifamily properties, as apartment blocks are known, have been a staple in many pension fund portfolios for decades and the sector's maturity makes it easy for investors to increase their exposure.

The $300bn California Public Employees' Retirement System (Calpers), a bellwether pension fund, raised its allocation to real estate from 9 to 11 per cent last year, with residential property a key plank in that allocation.

Whether the clamour for these assets will mean higher valuations and lower returns in the future remains to be seen, but pension fund consultants are united in the view that US residential real estate is attractive as a means of matching long-term liabilities with a long-term, income-generating asset.

"The demographics support multifamily, residential real estate very strongly and they have been getting stronger over the past five years," says Allison Yager, global head of the real estate boutique at consulting firm Mercer. "We don't believe there is going to be the same level of home ownership as there was before the downturn. Millennials [those born after 1980] are waiting longer to own their own homes and they are waiting longer to get married. Immigration drives demand, too."

Multifamily real estate makes up about a quarter of the benchmark commercial property index run by the National Council of Real Estate Investment Fiduciaries (NCREIF), which is widely used as a guide to constructing an institutional property portfolio.

Investors, who want residential property exposure in particular, can use specialist funds offered by many leading financial institutions, among which the real estate groups at JPMorgan and UBS and AEW Capital Management of Boston, have some of the biggest.

For institutions of size - those with hundreds of millions of dollars to invest - direct investment is also viable, again witl the aid of specialist property managers.

Investors are likely to focus on the leading metropolitan areas and on apartment blocks that are already fully let to tenants. These are the most liquid assets in what is a much less liquid and more difficult asset class than stocks or bonds.

It is an asset class that also has unique market dynamics, including money flows from the global rich affecting prices and changes in government planning policies. However, while real estate is sometimes thought to be unrelated to other assets, it too suffered in the credit crisis: the NCREIF residential property index fell 7.3 per cent in 2008 and 17.5 per cent in 2009.

Since the recession, there has been intense debate about whether single-family homes - houses, rather than apartments - might emerge as a sub-asset class for institutional investors.

Warren Buffett, the investment guru, ultimately demurred. "If I had a way of buying a couple [of] hundred thousand single family homes and had a way of managing them, I would load up on them," he told an interviewer in 2012, but he added: "The management is really the problem, because they are one by one, not like apartments."

Some large financial firms did buy hundreds of thousands of homes in foreclosure auctions. Blackstone, the private equity pioneer, led the movement, along with American Homes 4 Rent and Colony American Homes. They have sought institutional investment to fund their portfolios, by issuing bonds or placing the properties into a real estate investment trust whose shares are available to investors.

Further experimentation is going on in the financing of single-family homes. Home Partners is financing a rent-to-own scheme and BlackRock and KKR have channelled some of their institutional clients' money into the firm.

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>However, these innovations are likely to be too small-scale to attract most institutional investors, at least for now.

For those without a mandate to invest directly in real estate, there is always the securitisation market, where exposure is indirect. Commercial mortgages on apartment complexes are often among the collateral in commercial mortgage-backed securities, while mortgages to individual homebuyers are once again being pooled for private-label residential mortgage-backed securities (RMBS), following a post-credit crisis hiatus: Standard & Poor's, the rating agency, predicts there will be $60bn of private RMBS issuance this year, up from $38bn in 2014.

RMBS issuance is not likely to recapture the heady pre-crisis days, however. Investors learned that house prices in the US do go down. New regulations limit the availability of subprime mortgages and lenders have no intention of returning to a period when mortgage standards were "too damn low".

Many Americans, who might once have been subprime mortgage borrowers, are now renting rather than buying homes. That means more opportunities for institutional investors to add US residential real estate to their portfolios.

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