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Houses for the long run

May 18 found David Peligal of this staff in a car headed to the leafy Atlanta suburbs. Aaron Edelheit, general partner of the American Home Real Estate Partnership, was behind the wheel. Three prospective investors of Edelheit's occupied the other seats. The passengers' mission: To see for themselves just how cheap are the houses that fell to earth in Georgia.

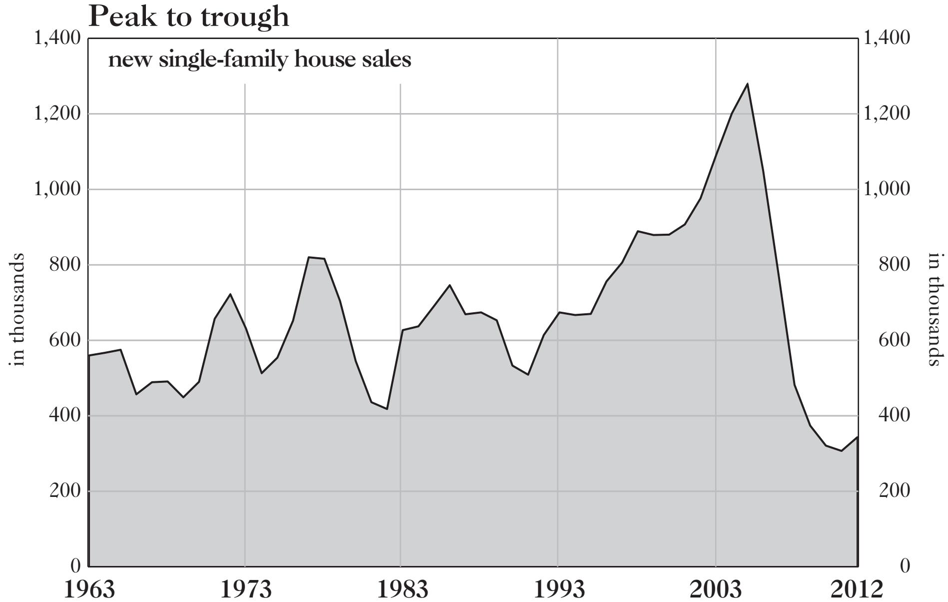
Residential real estate is the subject under discussion, as it has been at close intervals in these pages over the past six months (e.g., "Private island markdowns," Dec. 2; "House of the 16 liens," Feb. 10; "Block trade," Feb. 24; "Value alfresco," April 6). If the topic seems repetitive, it is also momentous. Insofar as houses have been a ball and chain on the leg of the American economy, that leg is—so we believe—in the process of shedding its shackles. Of course, there will be other crises. But whatever becomes of Greece, the euro, iron-ore prices, the Australian dollar or the measured rate of growth of Chinese GDP, it helps to know that hard American assets are available at half the cost of replacing them. In preview, we remain bullish on cast-off residential real estate.

The men in Edelheit's car fell to talking about Facebook—the company was going public, or trying to go public, that very morning. How curious, they mused, that public investors were clamoring for shares valued at 107 times trailing net income and 26 times trailing revenues. The perfectly good houses, sitting only 40 minutes from the point at which Interstate 75 parts company with Interstate 85, presented as striking a contrast in valuation and popular audience appeal as could be imagined. You could buy them—Edelheit has, in fact, been buying them—at gross rental yields in the teens.

To us bulls on houses, the yields seem incongruously high, gross though they are. Certainly, they seem out of sync with current events. Thus, according to the National Association of Realtors, the prices of not-new houses climbed by 10% in the 12 months to April, while the inventory of not-new houses fell by 20.6% over the same 12 months. According to the Commerce Department, sales of new houses rose by 9.9% in the 12 months to April. And then there is this: last week, Oliver Chang, head of U.S. housing strategy at Morgan Stanley, disclosed he was quitting his day job to start an investment partnership dedicated to buying houses in order to rent them. "Having followed this market for the past several years," Chang wrote in his going-away letter, "I believe it represents one of the most compelling investment opportunities across all asset classes today."

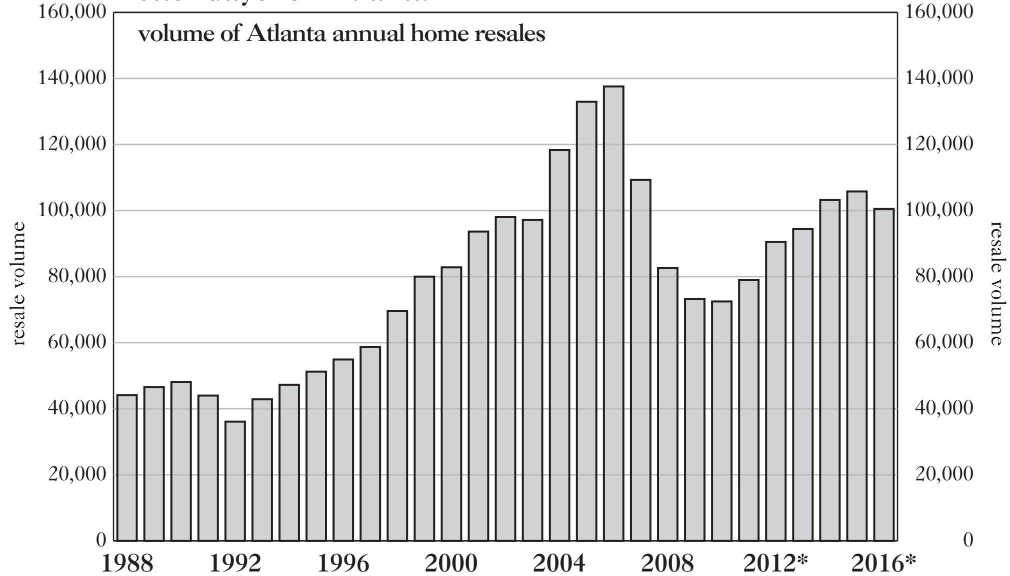
You may have read about Edelheit's American Home Real Estate Partnership in the Feb. 24 issue of *Grant's*. Other funds and partnerships are in the works—Beazer, KKR and Colony Capital are among the names to be reckoned with. Early this month, American Residential Properties LLC, a privately held residential

Peak to trough



sources: U.S. Census Bureau, Gluskin Sheff

Better days for Atlanta



*estimate
sources: Moody's, NAR, John Burns Real Estate Consulting

real estate shop headquartered in Scottsdale, Ariz., raised just over $200 million from institutional investors in a non-public, 144A filing. Like Edelheit, the man from Morgan Stanley and other venturers, American Residential Properties expects to rent the houses it buys—namely, the newer models situated in Phoenix, Las Vegas and the so-called Inland Empire of California. Of 2006 and 2007 vintage, they are the very houses that probably had no business being built in the first place. But here they are in 2012, more affordable than ever.

"American Residential Properties is all about reversion to the mean," a knowledgeable onlooker tells Peligal. "Pricing will revert to the mean. Real estate volume will revert to the mean. Home ownership, at some point, will revert to the mean. Everything reverts to the mean. That's all they need for their business to work."

Understandably, partnerships specializing in single-family houses are something new under the sun. Apartments lend themselves to large-scale investment. Real estate investment trusts like AvalonBay Communities and Equity Residential boast efficiencies that come from managing not a handful of apartments but buildings full of apartments. Single-family detached residences are something else again. "It is simply not proven," Peligal observes, "that the expenses associated with maintaining a few hundred houses are scalable. In consequence, institutional money has left the field to moms and pops. So what's different now? Thanks to the mortgage crisis itself, the volume of houses on offer is huge, and the prices are, as noted, low."

In Atlanta, Edelheit is buying houses for $30 a square foot, half of the prevailing construction cost of $60 per square foot. If "people have to live somewhere"—a basic bullish tenet—that means they must either rent or buy. "Atlanta," Edelheit tells Peligal, "is growing at 1% a year. Businesses and people are moving here. So you have 5.7 million people growing at 1%. That's 57,000 people. And they're building a couple of thousand homes. Those numbers don't work. Eventually, either you have massive rental increases or prices return to incentivize builders to build again. Or you have both. Either way, something has to give. If the economy goes into the tank, there will be even less building. It creates a pressure cooker. That's why, in Atlanta, with 8.5% to 9% unemployment, the apartment companies are raising their rents by 6% year-over-year. You're creating an environment where something has to give. People have to live somewhere."

"I will not mention the name of the neighborhood Edelheit favors—he wants to hand the competition no unnecessary gifts," Peligal relates. "But know there is nothing wrong with it, or with the properties he's buying. Sure, they need sprucing up—new paint, new carpet, etc.—but once that's complete, these houses are what you'd expect to see in most middle-class neighborhoods across the United States. Yet, when you first see the prices he pays, you think, 'This must be a terrible and/or dangerous neighborhood.' Not so. There are lots of trees, enough room in the backyard to throw a football around and well-manicured lawns (especially if the house is under surveillance by a homeowners' association). Edelheit pays an average of about $70,000 per house. He'll put in roughly $15,000 of repairs and renovations and rent the house for $950 a month. His investment partnerships—he expects to close his fourth on May 31—own 450 of these value dream homes.

"Two houses are representative of the others we saw on our tour," Peligal proceeds. "House No. 1 is a two-story colonial with a white exterior and shuttered windows. You can almost imagine it pictured on the cover of one of those happy-talk Fannie Mae annuals during the housing-bubble years. The house was built in 1985 and encompasses 1,912 square feet. It contains three bedrooms, three bathrooms and a two-car garage. It isn't fresh-baked bread you smell when you walk in the front door, but dust or must—plainly, the windows have been sealed for a while. Edelheit says that the place sat vacant for a year before he bought it last month. This would explain the graffiti spray-painted on the exterior back wall.

"The economics of the situation are certainly attractive," Peligal goes on. "In October 1997, the house sold for $111,000. By and by, post-bust, it was acquired by an arm of the federal government, which listed it for sale at $83,000. Edelheit paid just $49,500. Add in closing costs of $2,255 and repairs of $17,930, and you get a total acquisition price of $69,685. Market rent of $950 a month would deliver a gross yield of 16.4%. As the five of us walked out of the house, Edelheit paused to relate a quick story. 'Here's the best part,' he says. 'I was here on a tour a couple of days ago. And the guy next door walks over and he's an investor, too. We're talking, and he's been renting out that house for awhile. I think he's owned the house for around 25 years. He says, "How much did you pay for it?" I say, $49,500. He thinks about it and sheepishly reveals that he

House No. 2—ready for tenants

bought the neighboring property for $90,000 25 years ago. The numbers are silly. It's not going to last. There's nothing wrong with this area. A couple of years from now, this house might very well double in price.'"

"House No. 2," Peligal continues, "had been renovated and was ready for the arrival of a tenant on June 1. Maybe it was the well-groomed landscaping to our left and right, or maybe it's because I've lived in New York City too long, but it's not hard to be impressed by the value proposition of this McBargain. Built 15 years ago and encompassing 2,104 square feet, complete with four bedrooms and three baths, the house sold for $137,500 in December 1997. Edelheit paid not the feds' asking price of $85,000 but $71,800. His all-in cost, after $2,632 in closing costs and $11,827 in repairs: $86,259. Market rent of $1,250 a month produces a gross rental yield of 17.4%." Gross yield, as a thoughtful observer relates to Peligal, "is what the market will provide." Net yield "is what the operator is able to achieve."

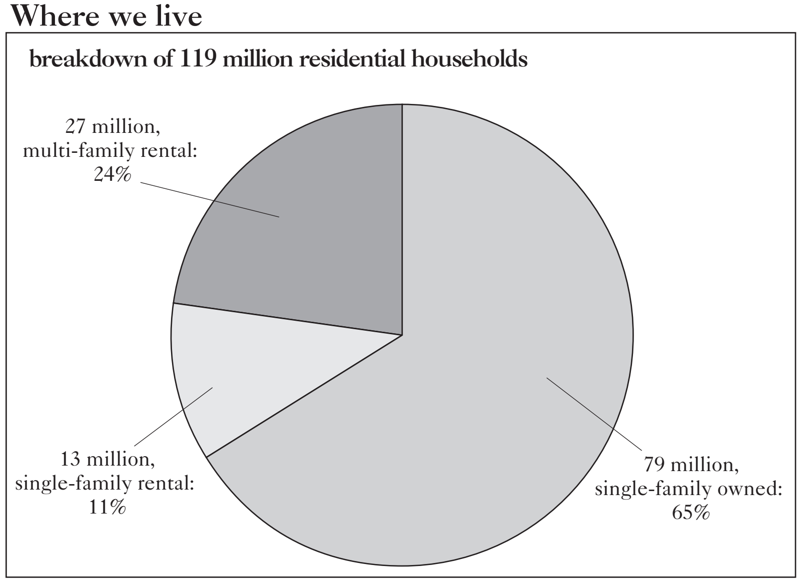
To listen to the house bulls, buying-to-rent is an all-season strategy. If the housing recovery proceeds and the world avoids a euro- or Sino- or American-instigated recession, all well and good; house prices would likely appreciate. If, however, another macro bump in the road lies directly ahead, new-home building would likely stop and mortgage financing would become even harder to come by than it already is. Thus, the argument goes, even the bearish scenario would likely deliver stable or rising rental rates, whether or not house prices resume their fall. For us, we judge that the point survives the bullish exaggeration.

Anyway, the bulls have the wind at their backs. "One of the things that shocks us when we go and talk to investors," says Edelheit, "is that you don't need to convince Wall Street of the macro thesis anymore. It's more the details of how you're structured, how you are operating, etc. You don't need to convince them of the housing thesis—they're all buying the home builders." Certainly, someone is: PulteGroup, Lennar Corp. and Sherwin-Williams (which makes the paint that covers the Pulte and Lennar walls) are three of the top-10 best-performing stocks in the S&P 500 this year. Though home building is a small industry, as market caps go, there can be no such complaint about houses themselves. Here is a market as big as all outdoors.

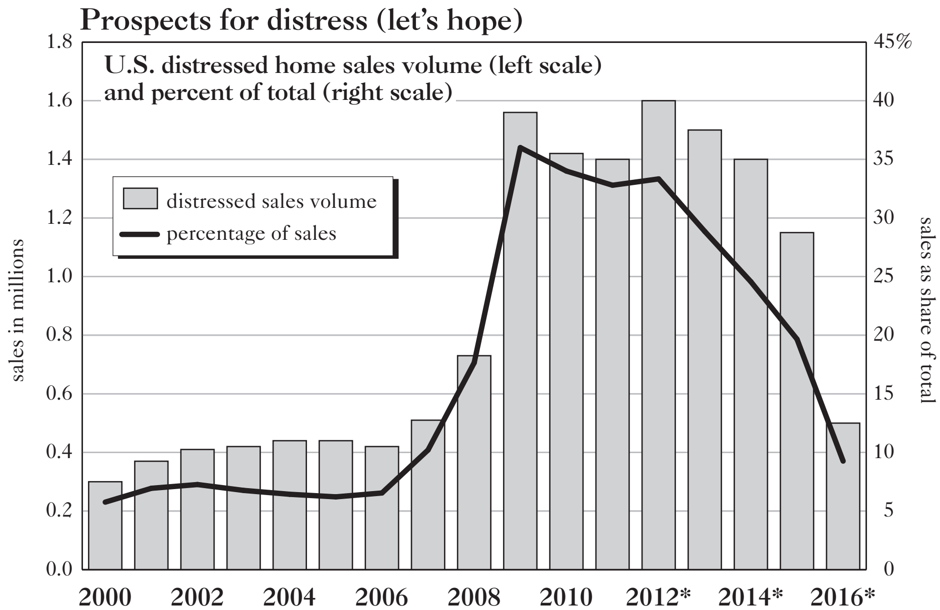
Many hear the quacking of the investment ducks. Thus, on May 3, Beazer Homes USA disclosed plans to contribute its rental-home business, consisting of a couple of hundred single-family houses in Phoenix and Las Vegas, to a newly formed private REIT. Los Angeles-based Colony Capital, which has $30 billion under management, unveiled a single-family residential REIT early this year. Colony American Homes, which says it has raised $750 million, has more than 1,000 formerly distressed houses under its wing, either owned or in escrow. Many of these properties are situated in the former bubble regions of Arizona, Nevada and California.

"We're all trying to help bring capital into an asset class that we think is going to become a real institutional asset class," says Justin Chang, a principal with Colony Capital and acting president of the new REIT. "What has resonated with

Where we live



sources: U.S. Census, John Burns Real Estate Consulting



*forecast
source: John Burns Real Estate Consulting

investors and what has helped us raise a lot of capital very quickly is, one, deal flow. It's easier to raise capital when you can say, 'Here is where I'm investing, here is what I'm buying today, here's what it is'—as opposed to something that is vague. We are buying homes aggressively and quickly, and generating both very attractive total return potential and current yields. . . . We are generally achieving net yields in the high single digits. We are buying significantly below what it costs the home builders to build comparable product."

Altogether, listening to Edelheit, Justin Chang (not to be confused with Oliver Chang, the former Morgan Stanley analyst) and others, you get the sense of a market catching fire. "You ask why I'm moving so fast?" Edelheit says to Peligal. "This won't last. I'd be insane to think that people won't be buying at these prices." Making the reportorial rounds last week, Peligal heard talk that B. Wayne Hughes, founder of Public Storage (PSA on the Big Board) is buying up houses all over the country and generally not permitting himself to be outbid. Calls and e-mails to one of Hughes's investment vehicles, Malibu-based American Homes 4 Rent LLC, went unreturned.

Chang said that Colony was respectful of the competition though not focused on it. "If you take a step back and look at the macro opportunity," he tells Peligal, "there's something on the order of $500 billion to $800 billion worth of single-family rental homes that need private capital in the next three to five years. The sheer scope of the opportunity and the magnitude of the supply are just massive. All the people you mention, plus us, plus 50 of our favorite investment firms, could each go raise a couple of billion dollars and it would still not begin to put a dent into the market. That's not an exaggeration.

"The rush and the opportunity and the time to market, it's not so much driven by a feeling that the window is going to close—because I don't think the window is going to close," Chang goes on. "I think this is a three- to five- to seven-year opportunity. You'll have some markets where prices will bounce up and then they'll bounce back. Of the houses that are out there on the market right now, it's probably less than 10% of the ultimate opportunity. There's a lot of shadow inventory that still needs to be worked through the foreclosure system. That's going to take … several years, and that's playing through. I think the opportunity is hundreds of billions of dollars of investment opportunity. The rush isn't to buy before the window closes at all. I think the rush is because lots of people see the opportunity and anytime you see this opportunity, you want to go after it. As you can move more quickly and acquire more homes, success begets success. What we're seeing in a market is, we start closing in on some homes, we become the preferred call for the brokers. They start calling us first. You prove you can close, you prove you have capital, you prove you can move quickly, you prove you can do what you say you're going to do—in an industry full of people that don't always have all that—you start to get things done and you start getting the best calls first. Pretty soon, you're getting exclusive calls to look at things where other people aren't even getting the opportunity to do it. You start being able to attract better people, all of that. Ultimately, as you get to scale, you lower your cost structure. . . . As you grow, some of the fixed costs get leveraged very quickly. In our opinion, as you get a billion or a billion-and-a-half dollars of capital invested, which is probably 10,000 to 15,000 homes, you start really generating economies of scale that allow you to lower your cost structure and improve your margins and improve, quite frankly, your returns to investors."

Bye-bye, then, to the McMansion phase of the American home investment cycle. Hello to the era of the McBargain.

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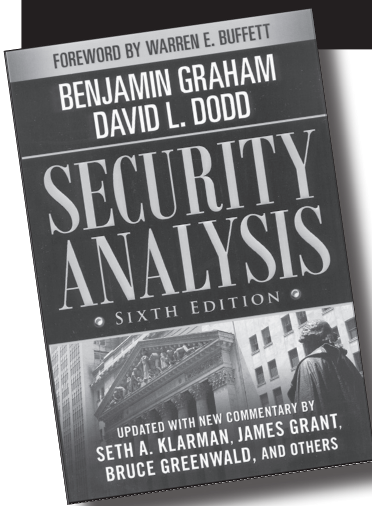

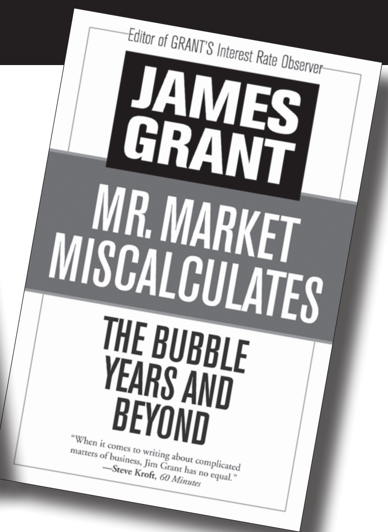

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