Headline risk

Single-family rental is a promising investment opportunity, but too much attention may be problematic

by Carolyn Marshall

Single-family rental (SFR) homes promise to be a hot commodity in 2022. Investors long to finance or buy them. Families and individuals covet them. Developers are scrambling to find land to build them. Never mind the barrage of negative press in all manner of media, where unsettling news stories trumpet financial dead ends for renters and uncertain blowback for investors. Consider a sampling of recent headlines.

- Investors Help Crowd Out Everyday Homebuyers as U.S. Prices Soar (Bloomberg; January 2022)
- Wall Street is Buying Up Family Homes. The Rent Checks are Too Juicy to Ignore (CNN Business; August 2021)
- Selling Out: America's Landlords. Moving in: Big Investors (Reuters; July 2021)
- Single-Family Rents are Surging, and Investors are Flooding the Market (CNBC; October 2021)

The bad press may cause grumbles and prompt stakeholders to collectively cringe, but there has been little or no pushback. To the contrary, the relatively new SFR sector — a product born of the 2008 stock market and housing crash — continues to advance at breakneck speed. Every recent industry report, survey or index tracking the real estate market ranks SFR as the fastest-growing asset class, outpacing all others and generating higher-than-expected investor returns. Industry estimates place the value of today's SFR market at $3.4 trillion — a breathtaking figure when you realize the multifamily market is valued at $3.5 trillion.

Investors have been mesmerized by the prospects and are banking on what some see as a groundbreaking shift away from the urban

ambience of high-rise apartments to suburbia's aura of open space and single-family dwellings. The trend toward building SFRs further evolved beginning about 2017, well before COVID-19 became a household name. That's when the collective biological clock of the millennial generation prompted many to plan for parenthood and a family. That is, until COVID-19 brought reality into focus — high home prices, the burden of debt, cramped apartment life, the need for space and a place to work from home. In other words, the demand for single-family rentals skyrocketed.

Close to 900,000 new households were added to U.S. rental rosters between early 2020 and late 2021, according to a new report from Harvard University's Joint Center for Housing Studies. The report, America's Rental Housing 2022, estimates 15 million to 16 million households are renting single-family homes, and most of the renters are either 25 to 30-something or over age 60. Although some could not afford to buy or remain in a home, a growing number of Americans rent by choice.

SFR and BTR evolve

Single-family rentals — townhomes or detached houses — have always been part of investment portfolios, but typically the owner operators are small firms or mom-and-pop investors, says Sandeep Bordia, managing director and head of research and analytics at The Amherst Group. His research shows SFRs have long been a housing mainstay, accounting for more than 30 percent of all U.S. rentals for more than 30 years.

When the 2008 global financial crisis hit, triggering rampant foreclosures and bargain-basement home prices, a wave of investors swept in to pick up the pieces. A demand for rental housing from former homeowners and cash-strapped tenants surged,

Bella View is a single-family rental community in Atlanta owned by Haven Realty Capital. The firm recently surpassed $1.1 billion in BTR portfolio value. "BTR solves many of the key challenges inherent with the scattered-site SFR business model, which is a reason behind the increased investor interest in the space," says Sudha Reddy, founder and managing principal of Haven Realty Capital. "However, new entrants are finding themselves with a steep learning curve on how to operate in the space. It's a reason a lot of the committed capital has not yet been deployed."

and a lucrative asset class was born — and it has been evolving ever since. So when the supply of fixer-upper houses ran out, investors started buying up leftover units or blocks of unsold homes in new housing developments, trying to replenish profitable portfolios. Then those options started to run out.

"The inventory of available SFR homes had been whittled to nearly nothing," says Bordia.

Building single-family rental homes from the ground up, by all accounts, is the next logical step. Institutional investors and traditional homebuilders are slowly entering the build-to-rent (BTR) business, but a handful of regional developers were among the earliest to pursue the concept of the single-family BTR community. NexMetro Communities, based in Arizona, was founded in 2012 and is widely credited as the first to envision the purpose-built single-family rental community, replete with modern home designs and amenities ranging from swimming pools to fitness centers. Its first community opened in 2015 in Goodyear, Ariz.

Banking on SFRs

More than $50 billion in capital has poured in or been committed to the single-family build-to-rent (SFBTR) market this year, according to a new report from John Burns Real Estate Consulting. In 2021, investors earmarked $45 billion for SFBTR, up from $3 billion in 2020. This capital is being allocated to a combination of the acquisition of existing individual single-family homes, development of new SFBTR communities, as well as the acquisition of newly constructed SFBTR communities from developers.

This is the kind of money and dealmaking that inflame the media. That's why SFBTR stakeholders are quick to point out 95 percent of the 15 million SFR units nationwide are still owned by mom-and-pop firms or by individuals who are renting a second home for additional income. Institutional investors account for only 2 percent of the SFR market share, or 300,000 units. By contrast, institutional investors own 55 percent of the multifamily rental units for lease in the United States. Even if investors doubled their market share in the next five years, they say, it still would only amount to a total of 600,000 units, or a 4 percent share of the SFR market.

SFBTR: It ain't easy

By all accounts, scaling the single-family, build-to-rent community sector in the long term is a done deal, achievable within five to 10 years. But it will require money, so it may be surprising that the more than $50 billion allocated from institutional investors hasn't exactly drawn rave reviews. That's because key players involved in the SFBTR developments understand how difficult it is to get a project approved, let alone completed. It requires a myriad of nuanced skills, political maneuverings and a skill set quite different from all other sectors. BTR is a different animal from traditional SFR, argues Chris Bley, co-president and chief investment officer of IHP Capital Partners.

"There has been an evolution to the business. What started in 2008/2009 was a different business than it is today," says Bley. "It *was* a widget. You'd buy a home for cheap, fix it up and rent it. Now money is coming in trying to build the widget! If there is too much money coming in that doesn't understand the business, we could have problems."

The BTR landscape already comes with its own set of unique challenges. Problems exist in finding land, buying land, getting city approval, adhering to local zoning codes, and that's just for starters, he says.

"A lot of people or organizations are getting into this market and putting money down. They are financial wizards, but they may not have the real estate experience and expertise to understand all of the risks and nuances," says Bley. "If you put too much money in a space, you get a bubble. We are not moving as fast as people say, so it's unlikely we are headed for a bubble. But I wake up at night thinking about it because there is money out there making mistakes."

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Bley views identifying suitable land as one of the toughest challenges for new BTR developers. "There is not enough entitled land, and it is very expensive," he says. Between 2015 and 2017, it was possible to find and buy a 15- to 25-acre plot suitable for a BTR community because there was no demand, but the competitive landscape has changed, and prices have risen significantly. California levies hefty developer fees, says Bley, and the approval process is slow, all of which erode returns. And, he adds, most cities would much prefer developers build homes for sale, rather than for rent, given NIMBY fears that rentals will lure transients.

Steve La Terra, CEO and founder of TerraLane Communities, which is based in Scottsdale, Ariz., is one of the few dedicated developer/builders of what he calls luxury purpose-built, single-story rental communities. The construction group has 1,116 residences, with approximately 500 units completed and approximately 600 units currently under construction, across five communities all located in the west valley of metropolitan Phoenix.

"Five years ago, you could count the number of build-to-rent operators who had successfully executed a project on one hand," says La Terra. "Now there are five times that number, and the segment is still growing."

He believes the dedicated-builder model promises to gain traction, especially when newcomers realize the SFBTR product differs from building a multifamily complex or a freestanding home for sale. The projects carry a different set of operational risks, he says, that can include everything from details associated with utility undergrounding to assessing the cost of building materials and locating supply.

City and county zoning codes, surprisingly, are one of the biggest barriers for developing the SFBTR community. For the most part, they don't exist. "There are very few municipalities that have zoning categories for the product we build," says La Terra. "Some cities struggle with what we are doing. It's confusing for cities because the category doesn't fit neatly into the existing master plan. It's a big challenge."

Most cities are equipped to consider and approve/reject proposals to build a multifamily complex or a single-family home for sale, inside or outside of a development. The SFBTR asset class is a nascent outgrowth of the SFR market and a new concept, in its own right. Most cities, sources say, have no way to evaluate SFBTR projects and often reject proposals outright because the specs of the development don't compute. "We might build 200 homes on a multi-acre lot. In legal terms, it could fit into the apartment-complex category or the condominium model. But it doesn't, and it is not operated the same way," he says.

"The only city that has a zoning designation for the single-family build is Goodyear, Arizona," notes La Terra. Not surprisingly, Goodyear was among the first to welcome a SFBTR community.

David Butler, managing partner of Argosy Real Estate Partners, notes national homebuilders are becoming more active in the development of single-family rental homes. Argosy is an investment firm that provides joint-venture equity to regional developers to construct purpose-built SFR communities. Typically, his group develops communities with 100 to 200 units in the form of cottages, townhouses or small-lot detached homes.

"The public homebuilders are still predominantly focused on building for-sale homes, although we have seen a number of homebuilders enter the space. Toll Brothers, for example, was one of the first homebuilders to enter the BTR market through their partnership with BB Living," Butler says. "We believe, however, that there is plenty of room in the SFBTR space for both national homebuilders and smaller regional developers."

Butler notes rising commodity prices are on everyone's radar right now. "At this time, lumber costs, in particular, are a big issue in the development of single-family rentals since lumber is such a large component of the overall construction cost. Lumber prices rose rapidly in 2020 into early 2021, then fell in mid-2021, but unfortunately have recently increased once again to very high levels."

Butler believes successful investment in the SFBTR sector depends on whether the projects can be managed efficiently and generate strong operating margins. “We have fortunately seen many of the established property management companies make a pivot to manage SFR communities,” he says. “Purpose-built single-family rental communities are in many ways very similar to low-density garden-style multifamily communities, if well managed by a property manager with SFBTR experience.”

He says efficient management has historically been considered to be more of a concern for portfolios of geographically dispersed existing single-family rental homes. “It was thought to be difficult to achieve efficient management because the individual homes are spread out across large geographic areas,” says Butler. “However, the scale and the professional management of the larger public single-family rental REITs, as well as emerging advances in proptech, have helped to greatly alleviate the perceived management problem of the single-family rental business.”

Butler echoes others who believe the SFR segment is vital as a jumping point for many renters bent on eventually buying a home. “If there is a housing-price correction in the future, we may see renters do the math, and if it makes much more financial sense to buy than rent, we may see more renters shift to buying homes,” he says. “However, even though many renters actually can afford to buy a home right now, many still are choosing to rent instead because of the flexibility it provides, as well as the amenities in many purpose-built single-family rental communities.”

Scott Waterstredt is a managing director at MetLife Investment Management (MIM), which provides investment strategies that include residential mortgages, single-family rental financing, and commercial real estate debt and equity. Although familiar with the SFR space, MIM is in the early stages of evaluating purpose-built SFR product. “Our team has started to look at the single-family build, but we have not yet entered the purpose-built developments,” he says.

MIM’s slower approach, however, is not due to concerns or questions about the viability of the asset class. “There are questions floating around, wondering whether this is a long-term asset class. The answer is an undeniable ‘yes’,” he says. “SFR will become an institutional asset, and most investors will have single-family rentals on their balance sheet. It helps diversify a portfolio.” ❖

Carolyn Marshall is a freelance writer based in Florida.