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Institutional investors are turning to residential foreclosures

Institutional investing in single-family rental market in its infancy

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Institutional investors for the first time are investing in foreclosed single-family housing for the rental market, a tactical strategy that promises a tidy return but could be perilous.

Pension plans, endowments and other institutional investors have mainly stuck to commercial real estate, only venturing into the residential side through multifamily housing and land investments. But a new federal program is tempting them to invest in large portfolios of homes in foreclosure, largely through real estate funds.

“This is really the first time that single-family housing held for rent has been offered as an institutional investment opportunity,” Anthony Frammartino, Cleveland-based partner with The Town-send Group, a real estate consulting firm, said in an e-mailed comment.

Pension funds investing in the strategy through real estate, private equity and hedge fund investments include the California Public Employees' Retirement System, California State Teachers' Retirement System, Teachers' Retirement System of the State of Illinois, Florida Retirement System Trust Fund, University of Missouri System, Texas Permanent School Fund, Oregon Investment Council and the Contra Costa County (Calif.) Employees' Retirement Association.

Pilot program

The Federal Housing Finance Agency, which controls the mortgages of 75% of the nation's single-family homes, announced a pilot program to sell portfolios of foreclosed homes, with the condition that the homes be rented for “a specified number of years.”

But sales of distressed homes might not be limited to the FHFA.

“We might see banks adopt this as a template ... if it is implemented correctly,” said Matthew Bass, vice president of structured assets at AllianceBernstein, New York. He estimated around 6 million homes are either already in foreclosure or very close to it.

Last month, Bank of America announced a pilot program in which troubled homeowners would transfer their homes back to the bank in exchange for leasing their homes for up to three years for at-market or below-market rent. Eventually, the homes will be transferred to investors.

Investors see the potential. CalPERS, for example, already has exposure to the foreclosed home investment through a $500 million commitment to GI Partners III, a $1.9 billion real estate and private equity fund sponsored by GI Partners, Menlo Park, Calif.

Joseph Dear, chief investment officer of the Sacramento-based, $237.3 billion pension fund, said at a March 12 investment committee meeting that renting out single-family homes is an “interesting” tactical investment. “The belief is that if this is done at the right scale and they (money managers) develop efficiencies in processing for the sales — the short sales or the bank-owned sales — and can bring these back to market after they've been rehabbed, this should be a pretty good play,” he said.

In the meantime, before the homes are resold, the portfolio would provide an income stream for investors, Mr. Dear said. “The real returns on rental units, both apartment and houses, are pretty good on a risk-adjusted basis,” he said.

Mr. Dear declined to comment beyond what he said at the meeting

CalSTRS, West Sacramento, also invested in GI Partners III, acknowledged Ricardo Duran, spokesman for the $152.2 billion fund. CalSTRS committed $400 million to the fund in the first quarter of 2008.

So far, CalSTRS does not have any direct investments in the strategy.

“It might be something we will be looking at,” but CalSTRS has not invested in the strategy in a significant way, Mr. Duran said.

An income stream is a big draw for investors these days, said Ted Koenig, CEO of Chicago-based private equity firm Monroe Capital LLC. “The challenge is that investors are looking for yield, and private equity is not a yield business.”

Pension funds, endowments and foundations don't want to wait 10 years to reap returns from private equity funds, he said, adding they need current income now for their actuarial costs.

Driving investors into a foreclosed homes strategy are the assumptions that interest rates will rise and housing prices have hit bottom.

The housing picture has not been pretty. For the 12 months ended Jan. 31, U.S. home prices slipped 0.8%, according to the FHFA. The S&P/Case-Shiller Home Price indexes show a total housing market decline of 34.4%, measured from the June/July 2006 peak through January 2012, according to the latest data released March 27.

For investors, the business model is the same as a multifamily real estate investment trust, said AllianceBernstein's Mr. Bass. “It's an opportunity to earn that rental income. It would be a yield product like a multifamily REIT,” he said.

Some concerns

Townsend Group officials “are initially interested, but have some concerns,” Mr. Frammartino wrote in an e-mail. “We initially think it is a compelling tactical investment opportunity with potentially significant depth to the market.”

Buying distressed homes to rent them out “seems to offer more reliable returns and easily understood execution,” he wrote. “But the next step in the industry is tackling non-performing loans, which portend to be more difficult than simply retaining existing owners or leasing up ... (foreclosed homes). So, we are still evaluating some of the same questions at this point, but the downside risk appears favorable.”

In addition to the return and income possibilities, Mr. Bass noted that with so many distressed homes dragging on the U.S. economy, the problem cannot be solved without institutional capital.

CalPERS' Mr. Dear told the investment committee that investing in foreclosed properties “would help keep people in their homes who can't afford to keep the mortgage up but they could still, on a rental basis, be able to stay in the neighborhood.”

Other investors are not that keen on the investment thesis. Executives at global private markets investment management firm Partners Group AG, for example, are taking a pass, said Nan Leake, partner in the New York office. “There are some general partners who have been trying to tap into the foreclosed housing market as a potential investment opportunity, but it's not particularly scalable nor have we seen institutional investors show interest in the strategy in any meaningful way,” she said.

“There is still a supply/demand imbalance in many housing markets that have experienced high foreclosure rates. So until this ratio improves, we question the exit strategy for those pursuing this investment thesis,” Ms. Leake said.

“Working through the foreclosure process is not for the feint of heart. Plus, taking somebody's home is not how I want to generate returns for our clients,” she said.