OnPoint Dechert LLP

November 2012 / Special Alert
A Legal Update From Dechert LLP

REO-to-Rental: An Update

In light of the unprecedented volume of distressed properties currently available in the U.S. housing market, investors are demonstrating considerable interest in single-family rentals as an emerging asset class. Government programs are giving investors the opportunity to purchase pools of foreclosed single-family real estate owned (REO) properties for conversion into rentals. Whether the REO bulk sales transactions are being offered by Fannie Mae, Freddie Mac or the Federal Housing Administration, which control large amounts of REO, or private sector actors, investors must consider a wide range of issues before participating in the REO-to-rental movement. As REO-to-rental strategies develop, market participants must take into account factors such as the form such transactions will take, the availability and terms of financing, the ability to rate the asset, and the potential use of securitization as an exit strategy.

FHFA Pilot REO-to-Rental Program

On February 1, 2012, the Federal Housing Finance Agency (FHFA), the conservator of Freddie Mac and Fannie Mae (together, the GSEs), announced the launch of a pilot Real Estate Owned initiative. The program, which we have previously written about,[1] provides the opportunity for private capital to invest in the distressed U.S. housing market by offering qualified investors the opportunity to bid on pools of GSE-owned single family properties. The winning bidders are then required to convert the REO properties to rentals, which must be rented for a specified number of years. The program focuses on foreclosed properties in struggling markets such as Atlanta, Las Vegas, Phoenix and parts of Florida.

The FHFA has subsequently announced two winning bidders. The first, Pacifica Companies, LLC, was announced in September and was approved to purchase 699 Fannie Mae properties in Florida.[2] The deal was structured as a joint venture with Fannie Mae, in which Fannie Mae transferred the properties to a newly created limited liability company (LLC) and sold Pacifica an interest in the equity cashflows from the LLC. Fannie Mae, which retained a significant amount of equity in the LLC, is entitled to receive 90% of the distributions to LLC equity until the GSE has received approximately $49 million (Shift Threshold), at which point Fannie Mae's share of the distributions to LLC equity drops to 50%.[3] Pacifica is entitled to 10% of the distributions to LLC equity until Fannie Mae has received the Shift Threshold, at which point Pacifica becomes entitled to 50% of the distributions to LLC equity. Pacifica is the Managing Member of the LLC, and will receive an asset management fee of 20% of gross rental income actually collected in addition to the distributions to LLC equity to which it is entitled. The second winning bidder, The Cogsville Group, LLC, purchased 94 Fannie Mae properties in Chicago in a similarly structured transaction.[4] As an equity partner with Fannie Mae, The Cogsville Group is entitled to 10% of equity cashflow until the Shift Threshold of $8.39 million is reached, after which it is entitled to 50% of equity cashflow. Colony Capital, the third winning bidder, purchased 970 properties in California, Arizona and Nevada. The transaction is similarly structured as a modified cashflow joint venture, and has a Shift Threshold of $136.47 million.[5]

The FHFA will continue to auction parts of Fannie Mae's substantial inventory of REO properties to private investors for conversion into rentals. The stated goals of the program include reducing taxpayer losses, stabilizing neighborhoods and home values, encouraging private management of properties, and reducing the supply of REO properties in the marketplace.[6] Interested investors may prequalify for future bulk REO sales by meeting certain criteria specified by the FHFA.

Investor Considerations

Investors interested in participating in REO-to-rental programs must consider a wide variety of issues, including the ways in which purchases can be financed and the potential use of securitization as a viable exit option.

While market participants suggest that there has been a large amount of equity investment in this space, the business model for investing in single family REO-to-rental properties has yet to be determined. REO-to-rentals have a broader assortment of operators than are found in other asset classes, and range from smaller mom-and-pop operators to larger, better capitalized institutional operators. This may influence the structure that the purchase financing ultimately takes, including the ways in which smaller operators may partner with larger equity partners. Key issues that investors will focus on include who the operator is, how they are capitalized and what their history is with regard to managing rental properties.

Potential investors in this asset class should also consider the following issues:

- The size and scope of the REO-to-rental market as the GSEs reduce their REO holdings and cease to offer such properties for bulk sale;
- The operational risks inherent in managing a geographically diverse pool of properties;
- The viability of securitization as a means of financing this emerging asset class; and
- The rights investors will have regarding single-family rental assets in the event of default or the underperformance of the transaction.

In considering potential financing structures for these transactions, the options include a joint venture, discussed above, in which a buyer becomes an equity partner with Fannie Mae in a newly created LLC, thereby helping to defray the upfront cost of investing in REO bulk sale transactions. An additional option involves an all-cash bid, which may also entail third-party financing. Under either option, the structure may involve a mortgage (or mortgages) on the underlying properties or the deeding of the underlying properties to a titling trust and the pledge of the beneficial interest in the titling trust to the lender.

Potential investors must also take into account collateral considerations. It is currently unknown whether a national or regional approach will be followed with regard to this asset class. At this time, there is a regional approach in place that focuses on struggling markets in areas such as California, Florida, Arizona and Nevada. These markets have relatively young housing stocks compared to the Northeast. Future construction plans in particular jurisdictions may also affect the resale value of rental properties in those jurisdictions by creating competition in the housing market when investors are ready to dispose of their portfolios.

Rating Considerations

While several major rating agencies, including Fitch and Moody's, have published initial assessments of the potential risks that securitizations backed by cash flows from single-family rental properties pose, no agency has published official criteria for these transactions. Issues for rating agencies include a lack of data at the operational and market level, and a lack of historical rental-payment data, and will likely result in the imposition of a rating cap for REO-to-rental securitizations.[7]

Fitch has identified four key factors that may play a significant role in their credit view of REO-to-rental securitizations. The factors take into consideration the hybrid nature of the asset, which has characteristics of both commercial and residential mortgage collateral, and the importance of both the value of the underlying property as well as the rental cash flows to service and repay the transaction. The factors are:

- The expertise and stability of management, given the operational nature of the underlying REO;
- The volatility and durability of the cash flows that come from the rentals;

The stability of the collateral's value; and

- The sufficiency of liquidity at the transactional and property level and related structural considerations.

To assess the quality of a property management firm for rating purposes, the firm is expected to have a comprehensive understanding of local markets in which the rental properties are located and well-developed operating procedures and processes for refurbishing and maintaining properties. Additional important operational considerations include the property management firm's experience managing single-family rental properties, their breadth of knowledge related to local rental laws and eviction processes, and their ability to assess local markets and identify viable REO properties for conversion to rentals.

Several unique risks of this emergent asset class must also be taken into consideration in connection with rating any potential securitization. Many renters may be displaced families that have adverse credit issues; therefore, tenant approval may not depend primarily on credit scores. Rather, Fitch expects property management firms to establish underwriting criteria to assess potential tenants' ability to make the monthly rental payments. Factors such as income and employment will likely play a central role in order to assure rental income stability and sustainability.

Conclusion

If successfully managed, transferring REO properties from the GSEs through bulk sale transactions may help stabilize struggling neighborhoods, while simultaneously bringing a considerable amount of private capital into the distressed housing market. Practices and policies concerning REO-to-rental programs will likely continue to develop in the months to come as investors, servicers and other market participants enter this space and seek to benefit from this potential economic opportunity.

Footnotes

1 See our May 2012 *DechertOnPoint*, REO to Rental: A New Paradigm for the U.S. Housing Sector?

2 Federal Housing Finance Agency News Release, *FHFA Announces First Winning Bidder in REO Pilot Initiative* (Sept. 10, 2012)

3 Home Path, *SFR 2012-1 Florida: Transaction Summary*

4 Federal Housing Finance Agency News Release, *FHFA Announces Winning Investor in Chicago REO Pilot Initiative* (Oct. 2, 2012)

5 Federal Housing Finance Agency News Release, *FHFA Statement on REO Pilot Transactions* (Nov. 1, 2012)

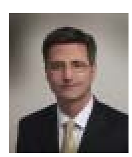
6 Federal Housing Finance Agency News Release, *FHFA Announces Pilot REO Property Sales in Hardest-Hit Areas: Next Step for Investors Interested in Fannie Mae Foreclosed Properties* (Feb. 27, 2012)

7 Fitch Ratings, *REO-To-Rental Securitizations: Considering the Risks (fee required to view)* (Aug. 7, 2012)

This update was authored by:

Patrick Dolan
New York
Send an email
T: +1 212 698 3555

Robert H. Ledig
Washington
Send an email
T: +1 202 261 3454



Ralph R. Mazzeo
Philadelphia
Send an email
T: +1 215 994 2417

Gordon L. Miller
Washington
Send an email
T: +1 202 261 3467

Thomas P. Vartanian
Washington
Send an email
T: +1 202 261 3439

Thank you to Suzanne Sciarra for her assistance with this publication.

For more information on Dechert's Finance and Real Estate Group, click here. For Dechert's Financial Institutions Group, click here.

See our Dodd-Frank reference materials for up to date analysis and regulatory actions.

Unsubscribe | Manage my mailings | Forward to a colleague