Gimme Shelter: The Case for US Residential Credit

January 2024

Time to read: 5 minutes

Everyone needs a roof over their head. Residential credit offers investors a number of benefits: Attractive yields resulting from increased rates and spreads, healthy underlying market fundamentals and government agency support throughout credit cycles.

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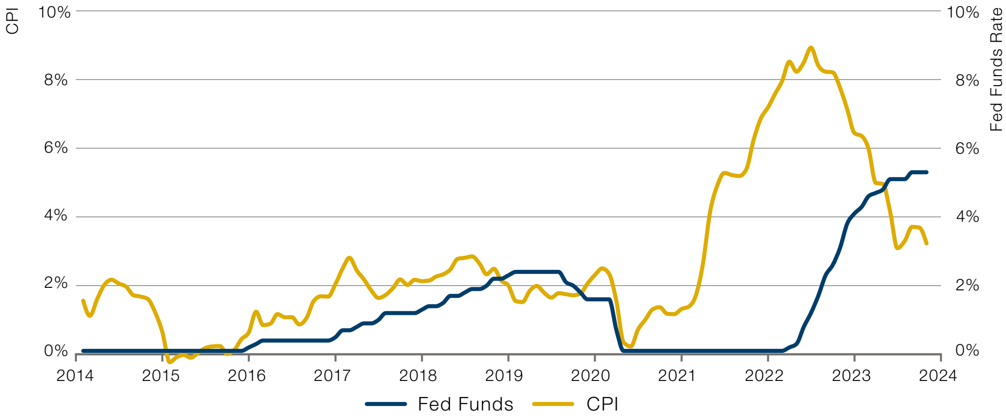
Introduction

The US residential private credit market (both single-family housing and multifamily buildings) offers a differentiated and scalable value proposition for institutional credit or real estate investors. Against a backdrop of increased rates and spreads, underlying residential fundamentals are healthy, providing an opportunity to achieve equity-like returns through credit investing, with a cushion against any future value declines.

The macro environment – Impact of inflation and rates on US residential investors

During periods of economic downturn or macroeconomic challenges, investments tend to respond in order of liquidity: first bonds, then loans, then real estate. With the emergence of inflation and interest rates moving from near-zero to over five percent, we witnessed bonds and then loans repricing while US house prices remained sticky.

Figure 1. While rising interest rates prompted a repricing of liquid assets house prices remained sticky



Source: Federal Reserve Bank of St Louis.

For institutions acquiring and aggregating single-family homes (the equity side of the residential business), rapid home price appreciation and accretive leverage, coupled with attractive capitalization rates (cap rates), led to substantial investment volumes before and during the COVID-19 pandemic.

Today, financing costs have backed up while home prices nationally have continued to rise to the point where the cost of financing may be higher than the cap rate/yield, i.e., we're in a period of negative leverage. Yet, this exact challenge for institutional Single-Family Rental (SFR) investors underscores the opportunity within residential credit today: stability amid volatile rate cycles, with house prices reflecting healthy market fundamentals and strong consumer demand.

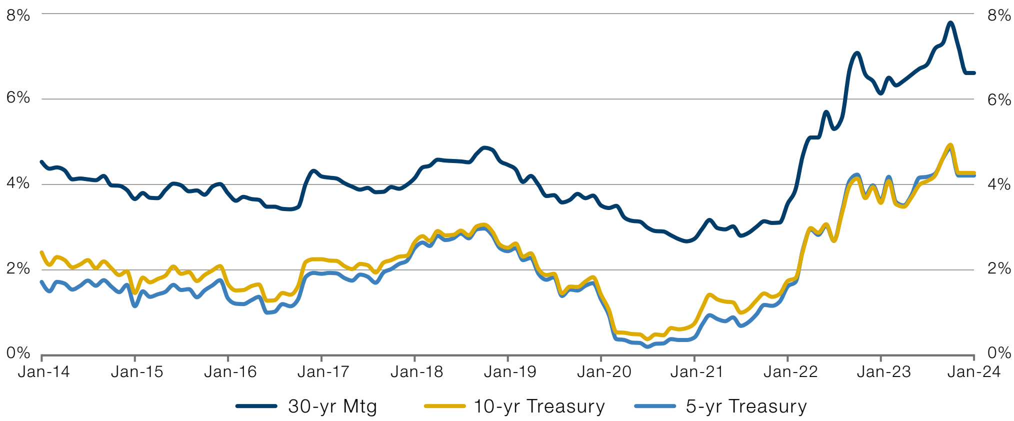
Paradigm shift for financing investment properties

For credit products, banks have historically served as the primary conduit for borrowers to access debt financing and capital markets. However, in the current climate following the regional bank crisis, banks have continued to adopt a risk-off approach to certain types of lending. This has been attributed to a range of factors including: (i) increased capital requirements stemming from Basel III regulations, (ii) higher interest rates, (iii) a flatter yield curve, (iv) deposit outflows, and (v) growing risk in banks' existing portfolios. Private markets investors have increasingly stepped in to fill this void, particularly prominent in areas like commercial real estate (CRE), non-Agency residential, loans to smaller sponsors, and consumer lending. For investors, we believe the shift from public to private markets financing is emerging as an attractive source of income-driven returns at low attachment points to underlying collateral.

Rates are up, yet home prices grind higher due to lack of supply

While yields and spreads have increased in many sectors, we see the residential credit space as particularly compelling given the strong underlying fundamentals and opportunity to diversify other credit exposures. Conforming 30-year mortgage rates reached nearly 8% for consumers after the Federal Reserve (Fed) rate hike campaign, and have since rallied into the mid to high 6%s following US Treasury moves. Despite affordability levels at all-time lows, we've seen home price resilience due to a stark lack of supply – a shortage estimated at around 3.6 million new single- and multifamily homes based on household formations between 2015 and 2022.[1]

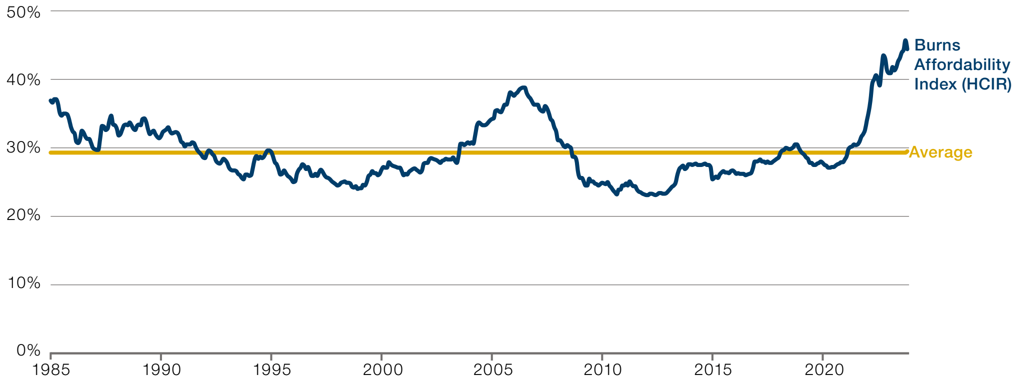
Figure 2. 30-year mortgage rates surged after Fed hikes



Source: Freddie Mac, Pensford, Federal Reserve Bank of St Louis.

This equilibrium between scarcity and affordability has made home price stability for the near-term future feel probable, a sentiment also recognized if macroeconomic conditions continue to improve.

Figure 3. Despite affordability hitting an all-time low (housing cost as proportion of income), house scarcity is keeping prices stable



Source: John Burns Research and Consulting, LLC, as of November 2023.

In this environment, private real estate credit investors are able to target higher yield-driven returns, with limited pick-up in risk.

1. Source: JP Morgan, Census Bureau as of 4Q 2022.

Government agencies provide stability through cycles

Residential real estate provides investors with a unique opportunity to gain the benefits of real estate exposure without some of the traditional limitations of other real estate classes. Unlike assets that rely solely on debt capital markets, residential real estate has support throughout credit cycles from government-sponsored enterprises ("GSE" or "Agency"), such as Fannie Mae, Freddie Mac, and Ginnie Mae. The existence of permanent agency financing for multifamily and single-family, typically 10- and 30-year terms, respectively, makes for an even more stable investment over time.

Role of the consumer in residential real estate

In addition to attractive Agency-financing, which is unique to residential real estate, the residential market has distinct features that support the sector. Unlike other property types, the single-family market is granular and driven by the individual homeowner primary residence purchase bid. Meaning, as long as the job market remains healthy and people have the means to pay their mortgage, there's no margin call putting downward pressure on housing due to 30-year agency mortgages, which are primarily fixed rate. Within CRE, we believe multifamily is poised to outperform relative to non-residential commercial property types due to the strong fundamentals underpinning the residential market.

The nationwide shortage of homes coupled with elevated mortgage rates has resulted in an increase in both the size of the rental pool and the quality of the tenants. Strong tenant demand and granular short-term leases (typically, one year) can act as a natural hedge to evolving macro environments from market rate lease turns. This is in contrast to other segments of CRE, e.g. office, where fundamentals are impaired as the result of the tenant-demand paradigm shift of work-from-home.

Conclusion

The macroeconomic environment has been supportive for private US residential credit investors, as rates have risen, spreads have widened, leverage has decreased, and regional banks have pulled back. Meanwhile underlying residential real estate fundamentals are healthy and anticipated to remain so. Amid this unique market dynamic – rates, spreads, and home prices all rising together – we see a compelling opportunity for investors seeking income-driven returns from low volatility, diversifying credits with protection against downside risks throughout the cycle.

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Eric Atlas is Head of US Residential Debt at Man Global Private Markets ('Man GPM'). He is responsible for overseeing the US residential debt business, including origination, underwriting and execution of real estate loans. Prior to joining Man GPM in December 2019, Eric was a portfolio manager at 1Sharpe Capital, an investment manager focused on the US bridge loan space between 2018 and 2019. Before that, he worked at Cerberus Capital Management in the residential credit group and related portfolio companies for more than 10 years, most recently as portfolio manager of a single family rental portfolio. Eric holds a Bachelors' degree from the University of Pennsylvania.

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