Looking Under the Bonnet: Residential Real Estate Investment Loans

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An introduction to the US residential investment loan market, and the opportunities available to institutional investors.

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Introduction

Residential investment loans ('RILs') are business purpose loans secured by 'fix and flip' or rental properties owned by professional investors and secured by 1st lien mortgages. Bridge loans are short-term loans (usually six to 24 months in duration, with an average life of less than a year) to property investors who buy, renovate and sell homes for profit (the aforementioned fix and flip investments) or lease, refinance and hold longer term.

Historical Perspective

The RIL market has historically flown under the institutional radar due to a variety of structural factors and investing trends. Historically, originating/processing RILs has been challenging for large banks and other institutional players. Due to the small loan balance, operational intensity, scaling difficulties and shorter loan duration, RILs can be too high touch for some lenders' origination and operational capabilities. The second reason is that RILs are 'commercial' loans with 'residential' collateral. As such, there has not been a natural home for these assets on many trading desks. Lastly, these loans often do not qualify for inclusion in Fannie Mae or Freddie Mac pools. Government-Sponsored Enterprises' ('GSEs') qualifications in the space have historically been focused on a borrower's debt-to-income ('DTI') ratio, which limits the amount they can borrow, rather than the asset-based approach employed by most non-bank lenders in the space.

Therefore, the RIL market was traditionally dominated by local/regional lenders (e.g., hard money and 'mom-and-pop' lenders). Naturally, where there was limited capital, there was limited origination. As a result, the market stayed relatively small, leverage stayed relatively low and rates were high (e.g., low double-digits for bridge loan originations). Despite this, the underlying credits were quite strong as borrowers tended to be experienced property investors.

Since 2015, institutional capital has become increasingly interested. This interest has resulted in the creation of a robust secondary market and originator access to institutional financing (through warehouse lines and securitisations). As more institutional capital entered the space, originators grew and competition increased. Prior to Covid-19 hitting, the RIL market had matured, but was still fragmented, offering outsized yields compared to other residential mortgage asset classes.

However, due to the Covid-19 outbreak, early 2020 presented new challenges to the RIL market, with originators, loan buyers and borrowers all facing new issues. Loan originators faced liquidity concerns as the secondary markets froze; buyers feared stay-in-place orders would reduce demand for real estate assets; and borrowers were unable to get home improvements done quickly and safely without risk of getting or spreading the virus.

Despite the new challenges, as the pandemic spread, the US housing market (and with it, the RIL market) rallied, with demand for homes increasing. With Covid-19 accelerating millennials' move to suburban single-family homes, remote work opportunities arising and growing social distancing, backyards and other home amenities became increasingly desirable. As the real estate market rallied, institutional allocations to real estate assets followed, increasing 10 basis points year on year, from 10.5% to 10.6% of overall allocations.

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Coming out of Covid-19, the RIL market has proven its resiliency. Despite substantial challenges, the market performed well, in our view, with RIL delinquency rates staying below those of comparable residential and mortgage assets (non-qualified mortgages and reperforming loans, in particular) and origination volumes returning to pre-pandemic levels. And while yields in many asset classes have tightened post-Covid-19, rates in the RIL market are comparable to pre-pandemic levels, with yields comparatively stronger in the spread space as risk-free rates have tightened.

Residential investment loans are an attractive investment option for institutional investors today looking for diversification and yield.

Why Residential Investment Loans?

In our opinion, RILs are an attractive investment option for institutional investors today looking for diversification and yield.

First, residential investment loans showed relative resiliency through Covid-19, maintaining lower delinquencies throughout the pandemic than other non-agency mortgage asset classes.

Second, RILs command a premium over many other fixed income and real estate debt investments. Indirect exposure – through commercial mortgage-backed securities, residential mortgage-backed securities and single-family residential asset-backed securities – may no longer yield the same returns it once did.

Third, RILs could offer significant structural mitigated risks. The shorter maturities of bridge loans mean principal is repaid to the lender quickly, providing protection against significant market shifts. Loan-to-value and loan-to-cost ratios provide significant cushion against substantial market declines, which have historically taken several years. For example, the peak-to-trough decline during the Global Financial Crisis took more than five and a half years, with house prices peaking in July 2006 and troughing in February 2012, with the largest single year drop of 12.7%.

Finally, RILs are secured by one of the largest and most liquid real estate assets in the world. As of December 2020, the US housing market consists of about 140 million units, of which approximately 80% are single-family homes. As of June 2021, single-family homes in the US are on market only six days (on average) prior to purchase. While this is due in part to Covid-19-induced tailwinds, the existing housing shortage in the US (a deficit estimated by Fannie Mae to be about 5.5 million and growing) is expected to sustain it.

Conclusion

As investors grapple with how to navigate the post-pandemic investment landscape, we believe that the RIL market has demonstrated its worth and provides institutional investors the opportunity to invest in high-quality, highly resilient assets, with attractive risk-adjusted returns that are collateralised by one of the largest and most liquid real estate assets in the world.

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