Deloitte.

Chasing higher yields
Buying, renting, and selling single family residences

Private investors are entering the distressed single family home (SFH) market with increasing frequency, buying large numbers of properties with intent to refurbish and then rent and/or sell them. In the process, these investors are spurring creation of a new type of institutional asset class with a unique set of opportunities and challenges.

This article offers perspectives on single-family residential foreclosure sales; among them, the challenges of holding foreclosed single-family residences; asset management issues; lessons learned on liquidation approaches; acquisition strategies; and potential transaction structures, including tax considerations.

Market overview

A number of housing market trends are fueling institutional investors' interest in distressed SFHs:

- Mortgage debt declined 0.5 percent Quarter over Quarter (QoQ), to $8.1 trillion in 2Q12, down 14.1 percent from a peak of $9.3 trillion in 3Q08. In 2Q12, credit card and home equity debt decreased 1.0 and 3.7 percent (QoQ), respectively, while auto loans increased 1.8 percent. The rate of decline increased in 2Q12 with a 3.7 percent Year over Year (YoY) decline compared to a 2.7 percent YoY decline in 2Q11 (Figure 1).[1] These trends reflect increasing numbers of individuals leaving mortgages and moving to rentals, as well as increased activity in foreclosures and short sales.

[1] Federal Reserve Bank of New York: Quarterly Report on Household Debt and Credit, September 2012

- Residential mortgage delinquencies remain high, at around 10 percent[2]. Delinquencies (seasonally adjusted) rose sequentially in 1Q12 for residential real estate loans at commercial banks to 10.2 percent from 9.9 percent in 4Q11 but improved YoY from 10.3 percent in 1Q11. Overall, according to Mortgage Bankers Association, delinquency rate on one-to-four unit residential properties improved to 7.4 percent in 1Q12, down 18 basis points and 92 basis points, sequentially and YoY, respectively. Hence, high residential loan delinquencies at commercial banks continue to pose a risk.
- July 2012 foreclosures were down 0.2 percent Month over Month (MoM), at 4.08 percent, and seriously delinquent (90+) or in foreclosure decreased 50 bps MoM to 7.19 percent from 7.24 percent in June. July foreclosure starts increased 7.1 percent MoM to 185,811, from 173,556 in June; however, they have decreased YoY by 10.5 percent.3 While the decline in delinquencies and serious delinquencies is positive news, the level is still higher than the industry would like to see and the national foreclosure inventory remains stable, continuing near historic highs.
- Home sales news is mixed; however, there are positive indicators. Housing sales increased 5.9 percent YoY and 4.6 percent QoQ in 1Q12,4 with demand driven primarily by first-time owners. In April, available housing inventory declined 3.6 percent MoM to a supply of 5.3 months, 5.3x the stable housing market figure (less than one month).5 Further the shadow inventory (seriously delinquent properties of 180+ days past due) fell to 1.5 million units, its lowest level in three years. The dollar volume of shadow inventory was $246.0 billion as of April 2012, down from $270 billion a year ago, and also a three-year low.

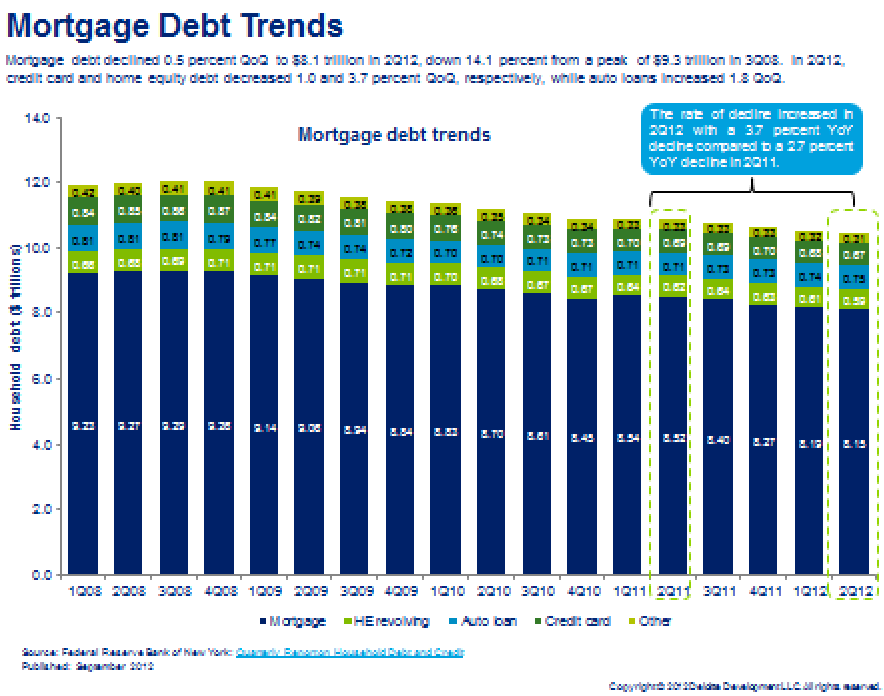
[2] MBA National Delinquency Survey, August 2012; Federal Reserve, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks

[3] Lender Processing Services, LPS Applied Analytics, Published August 2012.

[4] MBA Mortgage Finance Forecast, Published: June 12, 2012

[5] CoreLogic Report, June 2012

Figure 1:



However, fewer SFH distressed assets are entering the Real Estate Owned (REO) pipeline today than a year ago. This downward trend reflects the use of alternate strategies to resolve delinquencies, such as short sales and loan modifications. That said, other alternative REO liquidation strategies are on the rise, such as bulk sales, rental sales (REO to lease), and auctions.

Liquidation strategies

A buildup of distressed assets on lenders' balance sheets is prompting them to think outside the box when identifying strategies to liquidate REO properties. Among the options — each of which has advantages and disadvantages (Figure 2) — are:

- **Traditional retail sales** — An advantage of this one-sale-at-a-time approach is that assets typically sell at a higher percentage of the Broker Price Opinion (BPO) or appraisal value; however retail sales have longer-term disposition timeframes and higher carrying costs. Also, because the retail sales process slows portfolio turn, it is not an effective strategy to move large quantities of assets.

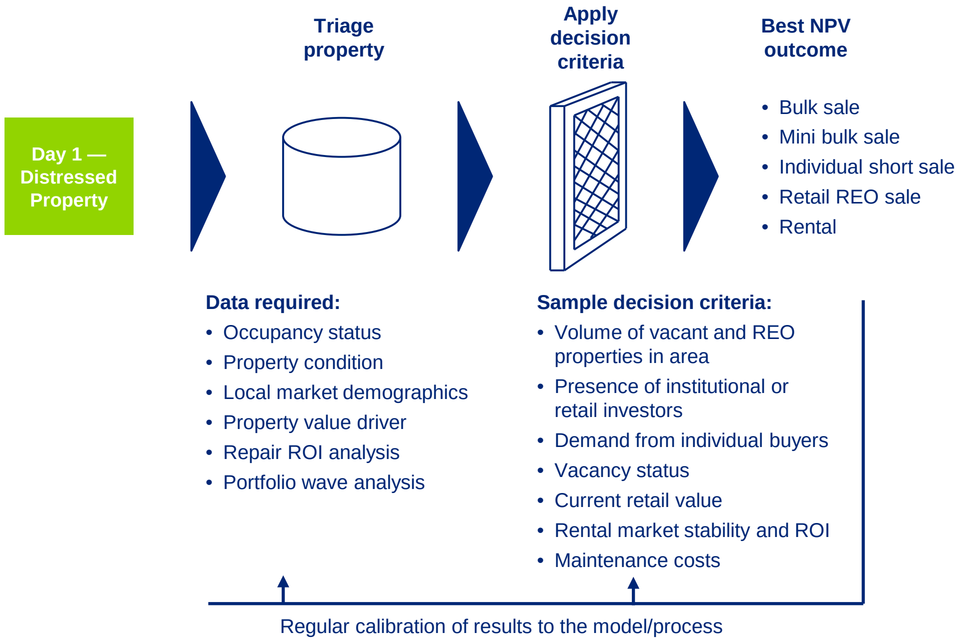
- **Auction REO** — This approach offers a faster turn of ready assets — which are sold as-is — and lower carrying costs. However, a property can bring a lower sales price to BPO and, lacking proper due diligence, the auction investor can be exposed to title issues.
- **Bulk sales** — Bulk sales require large pools of available capital but are an effective way to liquidate large portfolios to investors and to generate quick sales results with lower carrying costs. Like an auction REO, this approach can result in a potentially lower sales price to BPO.
- **REO to lease/rental** — This is an effective strategy to allow existing homeowners to remain in their homes, and to enable unoccupied assets to begin generating a monthly income. The approach is particularly applicable for low-value assets. On the downside, property management and repair costs are typically higher.
- **Donations** — Donating an REO property can generate goodwill; however, the bank sees zero return on the asset.

Figure 2: Advantages and disadvantages of alternative liquidation strategies

	Potential advantages	Potential disadvantages
Traditional retail sales	• Assets typically sell at a higher percentage of the BPO or appraisal value	• Longer term disposition timeframes — higher carrying costs to sale date • Slow portfolio turn — not an effective strategy to move large quantities of assets.
Auction REO	• Faster turn of ready assets • Sold as-is • Lower carrying costs related to quick sale	• Lower sales price to BPO • Auction investor exposed to title issues if not due diligence properly
Bulk sales	• Effective in liquidating large portfolios to investors • Large pools of capital willing to participate in bulk sales • Quick sales result in lower carry costs	• Potentially lower sales price to BPO • Need to measure against other NPV alternatives to realize value
Rental/REO to lease strategy	• Effective strategy for existing homeowners to stay in home • Assets unoccupied begin to generate monthly income • New investor buyer base for these assets • Effective for low value assets	• Residential property managers with national coverage is rare • Operational logistics are complex • Management costs higher • Repair costs higher
Donations	• Generates goodwill in the public eye • Certain assets are liabilities	• Bank sees zero return on the assets • Typically, banks target low value assets

To determine which liquidation strategy will provide the best potential outcome as measured by a net present value (NPV) calculation, banks should employ a rigorous triage and decision-making process on lost sales approaches for their REO portfolio assets (Figure 3):

Figure 3: Triage and decisioning: The process



Because there are a number of market-specific issues of concern to investors interested in buying, refurbishing, then renting or selling SFHs, the triage model used by lenders should incorporate core business rules, metrics and NPV data analytics. Among required inputs are repair ROI; valuation data (e.g., as-is, as-repaired, bulk sale price, HPI trends); property-specific data (taxes, insurance, preservation costs, utilities); assumed days to liquidation metrics by MSA/state; and rental demographic distribution data. Having all required inputs is imperative to an informed decision-making process, especially since operational risk is increased with the property management component of these properties. Results should be constantly calibrated to determine the best NPV outcome, whether that is a bulk sale, mini bulk sale, individual short sale, retail REO sale, or rental. In addition, constant communication with independent valuation sources and the use of institutional, retail, and broker sales data is essential to managing a portfolio of these assets on a long-term basis.

Patience is a virtue

The investment buy side is showing increased interest and is currently well-positioned to acquire banks' distressed REO residential assets. Exemplifying the adage "patience is a virtue," a heretofore sluggish market is opening up: An estimated $20+ billion in immediate and available new capacity has entered the buy-side space, with more dry powder accessible behind that number. Potential buyers include PE firms, hedge funds, specialty servicers, high-net-worth individuals/family office funds, not-for-profit neighborhood groups, and homebuilders and developers. Their investment focus includes REO resale homes, REO rental properties, sub- performing residential loans, late-stage non-performing residential loans, fractured condo projects/entitled and developed land, and mortgage servicing rights (MSRs). Among recent action:

- Investors are trying to spend at least $6.4 billion on single-family rentals, with participation from funds such as Colony Capital LLC, GTIS Partners, KKR & Co., Oaktree Capital Group LLC, Och-Ziff Capital Management Group LLC, and the Alaska Permanent Fund Corp.[6]
- Colony Capital LLC launched its Colony American Homes Division in March 2012. To date, the company has invested about $350 million in REO homes. The company plans to reach 5,000 homes by year-end and double that volume to 10,000 homes by mid-2013.[7]
- Blackstone has spent about $1.5 billion on 10,000 foreclosed properties in the U.S. this year, making it the country's biggest buyer of single-family homes. Activity continues with Blackstone buying $100 million of houses per week.[8]
- Property Access, a unit of FirstService Corp. that manages about 10,000 single-family rentals a year for banks and institutional investors, is starting an "acquisition platform" to help large funds find properties.[9]
- Treehouse Group LLC, a Tempe-Arizona-based real estate company, and London-based property investor Regis Group PLC, formed a partnership to buy and manage $1.5 billion of single-family homes.[10]
- Reven Housing REIT, Inc. (formerly Bureau of Fugitive Recovery, Inc.), a U.S.-based company engaged in the acquisition of portfolios of occupied and rented single-family houses, announced September 5, 2012, that it has agreed to raise up to $25 million shares of its common stock at a price of $1 per share through private placement.[11]
- Norway's $660 billion sovereign wealth fund, the world's largest, plans to invest about $11 billion as it enters the U.S. real estate market.[12]

Of particular interest to institutional investors are single-family residential rental properties. This market accounts for roughly 20 million units — slightly more than 50 percent of the total rental market.13 Four million homes have gone through foreclosure, with an additional four million expected to follow. At the height of the market, U.S. home ownership stood at about 70 percent; however, industry observers anticipate that level will fall to approximately 60 percent, a decline that represents eight to 10 million single family homes.14 These trends could signal a generational shift; people don't see the value of home ownership increasing over time, so they are renting.

---

[6] "Private Equity Funds Target Foreclosed Homes as Rental Play," *National Real Estate Investor*, August 22, 2012; "Private Equity Has Too Much Money to Spend on Home," Bloomberg, June 13, 2012; "Reven Housing REIT to raise up to $25 million private offering of common stock," MarketLine Financial Deals Tracker, September 7, 2012.

[7] Ibid

[8] http://www.bloomberg.com/news/2012-11-14/blackstone-sees-two-year-window-to-buy-houses-mortgages.html

[9] "Private Equity Funds Target Foreclosed Homes as Rental Play," *National Real Estate Investor*, August 22, 2012; "Private Equity Has Too Much Money to Spend on Home," Bloomberg, June 13, 2012; "Reven Housing REIT to raise up to $25 million private offering of common stock," MarketLine Financial Deals Tracker, September 7, 2012.

[10] Ibid

[11] Ibid

[12] http://www.bloomberg.com/news/2012-11-30/norway-wealth-fund-to-invest-11-billion-in-u-s-property.html

[13] "Housing 2.0: The New Rental Paradigm," Morgan Stanley Research, October 27, 2011

[14] "Private Equity Funds Target Foreclosed Homes as Rental Play," *National Real Estate Investor*, August 22, 2012

Tax considerations

Double-digit returns on REO SFH investments can be quickly eroded if the investor and operator do not consider the tax impact on operating entity structure, acquisition and operation, and dispositions and sales. In addition to income taxes, for each property they need to consider transactional taxes (e.g., transfer taxes), real property taxes, other business taxes (e.g., gross receipts tax, franchise tax, capital tax), federal state and local income taxes and income tax withholding. Note that this article's focus is on federal income tax considerations. Other taxes, which may also be significant, typically vary by geographic location.

Structure

The after-tax rate of ROI expected by the investor group is often the driving force behind the initial structure of an operating entity. The entity's tax characterization and/or its investors may significantly impact the income tax burden: of the many types of taxpayers who could be potential investors — individuals, corporations, real estate investment trusts (REITs), trusts, LLCs, limited partnerships, tax-exempt entities, non-U.S. firms, government entities — all have different tax implications.

Also, the nature of the asset's operations — real property investment, real property rental, real property sales to customers ("dealer" sales) versus liquidation of the investment — may generate significantly different tax consequences to investors, as well as impact the selection of an operating entity structure (e.g., "dealer" sales may cause tax problems for a REIT). The type of operating entity may then impact the tax treatment to the investors (e.g., non-U.S. investors may prefer a REIT structure to an LLC operator). Also, pass-through structures (e.g., LLC, LP, REIT) may subject certain investors to a federal or state income tax withholding regime. With these potential consequences in play, understanding investor expectations with respect to the tax structure may be the most critical income tax consideration.

Acquisition and operation

Investors face a number of tax issues during the acquisition and operation process — and these everyday issues can have a significant impact on after-tax returns. For example, when deciding whether to classify certain costs as capitalized versus a current deduction, considerations should include organizational and syndication costs; property due diligence costs; property direct/indirect acquisition costs; eviction and lease-up costs; repairs and maintenance (improvement versus repair); depreciation; real property tax and interest; and whether the property is "held for sale" versus "held for rent." Revenue recognition considerations include rent-to-own programs (current sale versus rental); options to buy; and prepaid rent.

Dispositions and sales

Tax considerations in asset dispositions and sales are important in the context of whether the process is a dealer activity or a rental investment activity (i.e., ordinary business income versus capital or sec. 1231 gain from an investment). In general, avoiding the "dealer" characterization for sales may be one of the most critical considerations upon disposition, depending on the investor group because the designation creates numerous tax issues — it particularly impacts the character of the gain/loss on disposition. For example, "dealer" sales are not eligible for like-kind exchange or installment sale treatment; disqualified "dealer" sales may subject a REIT to a 100 percent penalty tax (consider instead a Taxable REIT Subsidiary or bulk sales); and "dealer" sales may be a disadvantage to tax-exempt and foreign investors.

Developing a disposition strategy requires balancing tax concerns against the overall economic return and investor expectations with respect to the tax profile of what they are investing in. Among potential disposition strategies are functional segregation of acquisition, rental and disposition operations to isolate potential "dealer" sales, and sale of properties before any "dealer taint" occurs. Note that sale of stock in a corporation or REIT is not a "dealer" sale, but the sale of partnership interest or LLC interest is subject to "look-through" ordinary income rules. Also, sale of stock may present a problem for non-U.S. investors, depending on the facts, according to the Foreign Investment in Real Property Tax Act (FIRPTA).

Final thoughts

Institutional investors are actively seeking foreclosed single-family residences from lenders, government-sponsored enterprises (GSE), and municipal courthouses. They believe that markets will recover over time, rental markets will provide strong yields, and ample capital will remain available. A successful approach to this new institutional asset class requires careful strategy, scalable acquisition and operational plans, independent valuation sources, robust management infrastructure, and careful consideration of tax consequences

Contacts

Guy Langford
Principal
Deloitte & Touche LLP
glangford@deloitte.com

Elizabeth Jordan
Director
Deloitte & Touche LLP
ejordan@deloitte.com

Paul Prescott
Principal
Deloitte Tax LLP
pprescott@deloitte.com

Matthew Cooleen
Senior Manager
Deloitte & Touche LLP
mcooleen@deloitte.com