February 7, 2024

Investor Memo
BRRRR is Dead. Beware.

"If something cannot go on forever, it will stop."
-Herbert Stein

Around 2012, individual investors began to dip their toes back in the water and buy the inexpensive homes left in the wake of the 2007 housing bubble. At the time, nearly all homes were cheap – but rundown homes were nearly given away, making them even more accessible to smaller investors with limited cash but excess time and energy to spend renovating the distressed properties. Post-renovation, the homes qualified for mortgages and the increase in value, along with high leverage, allowed investors to pull almost all the initial investment out and rent out the property at prices that more than covered the mortgage. When the first project proved successful, another was sure to follow, and before long, there was an acronym for the new home rental investment strategy. The BRRRR strategy: Buy, Rehab, Rent, Refinance, Repeat was born.

The BRRRR model proved to be phenomenally successful. It created multi-millionaires out of people who had no prior experience in real estate nor prior success in investment. Twenty-somethings built rental portfolios that generated more income per year than their parents earned in a decade. The opportunity was accessible, the operations were manageable, and the economics were sound. The strategy was nearly foolproof. As numerous financial gurus selling courses were quick to point out, financial freedom and generational wealth was within reach.

Of course, there was no wizardry at work nor anything unique about the BRRRR strategy that isn't common to all great investment opportunities. A confluence of factors – outside of any individual investor's control – created an opportunity in the single-family market at a specific point in time. Investors who (by luck or skill) participated made fortunes as they were swept along by a river of nearly guaranteed success. However, all investment opportunities, like rivers, eventually end when the factors and time that created the opportunity disappear. The once superb returns reverted to mediocre ones. Such is the case with BRRRR. In 2024, The BRRRR opportunity is *dead*, and no amount of expertise, skill, willpower, or optimism is going to bring back anything even close to the returns or success experienced by enterprising house flippers in the early-to-mid 2010s.

BRRRR (circa 2014): The Drivers of Success

The success of home investors in the early-to-mid 2010s is almost entirely attributable to three factors: cheap home prices, robust rental demand, and the availability of debt financing. First, homes *became very cheap*. The U.S. had overbuilt housing, the housing bubble popped, and no financial institution had remotely prepared for the historic number of foreclosures their loan portfolios faced. Banks held the keys to thousands of homes with no way to efficiently sell them or even manage their sale. Every financial institution wanted out as quickly as possible and there were essentially no buyers. With swaths of new supply and very limited demand, home prices tanked.

Second, rental rates remained robust, despite the collapse in home prices. Rental prices for primary residences in the U.S. have, perhaps surprisingly, *never declined* – even during the height of the GFC, rental rates grew 5.0%. By 2014, these rates were the highest they had ever been. While home prices had not rebounded, their *earnings potential* (through rental income) had increased. Rental yields (CAP Rates) of 8% were easily obtainable and 10% was not uncommon; with any type of optimistic outlook on growth of home prices, rents, or inflation, investors could reasonably expect to earn an *unlevered* 13-15% return on rental home investments.

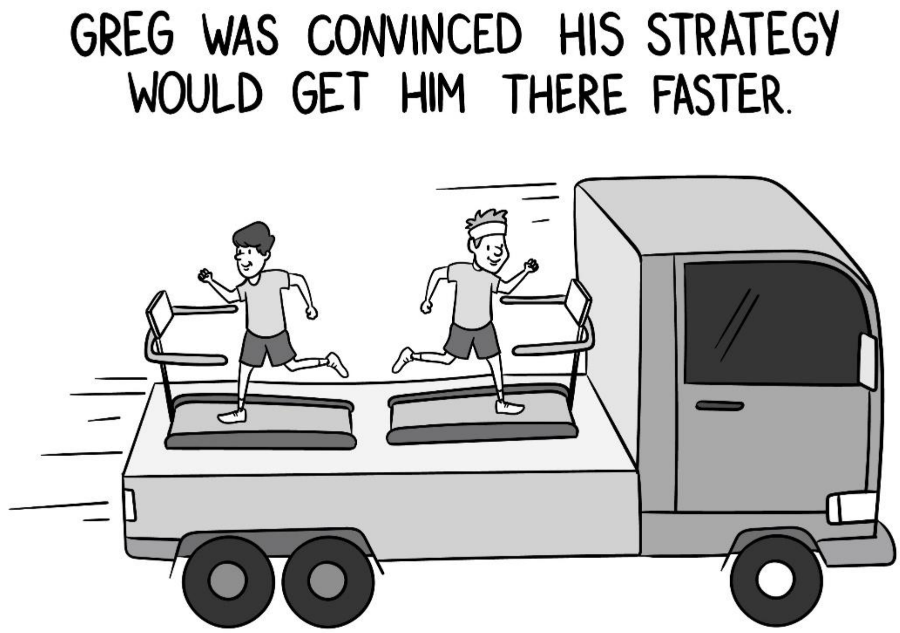
Third, and perhaps most importantly, by 2014 banks had again become willing to lend against single-family homes. While it wasn't as easy to get a mortgage as it was before the housing bust, it stopped being overly onerous. Individual investors, often through local banks and credit unions, were able to refinance their rental properties at *mortgages rates that were significantly lower than their rental yields.* Investors had the ability to take on 80% leverage at 5.0% against assets that yielded 10% resulting in a 30% return-on-equity. The marriage of attractive economics to available financing generated incredible wealth through exceptional returns.

BRRRR (circa 2014): Skill Didn't Matter

In the abstract, if an investor can conservatively borrow a lot of money at 5.0% against assets yielding 10%, they stand to make a lot of money. However, the cohort of housing investors who started their single-family investment journey in the mid-2010s seems to be largely unaware that this basic math was *the primary driver of their success*. Instead, they largely credit their success to their *efforts and expertise*. Having made their money, they are now eager to give advice to newcomers and explain their keys to success which usually comprise some or all of the following:

- "Know how to buy right."
- "Have a good operating team."
- "Manage your renovations carefully."
- "Use creative financing if you can."

While there is some truth in all of this, in the mid-2010s essentially none of it mattered. All you had to do was buy, and unless you *grossly* mismanaged or neglected your investment, you were going to make a lot of money. To be clear, you weren't going to make your money because you bought 10% lower than the next investor or because you collected 10% more rent. You were going to make your money because you were being carried along by the overpoweringly strong current of the market. If the current is strong enough, whether you swim downstream or upstream, you're going to end up in the same place at roughly the same time.



There is one caveat that should probably be mentioned. In the mid-2010s, if you had limited capital, it was better to buy a rundown property than a rent-ready one. Distressed homes were heavily discounted at the time because they were unfinanceable. Banks wouldn't lend against them, and private lending was almost nonexistent. As such, sellers had to almost give distressed homes away. Once renovations of distressed homes were complete, however, they became financeable which significantly increased their value. Investors who bought and renovated distressed properties were able to borrow against this increased value (often called after repair value or ARV), which in turn increased their effective leverage. Because they might have had 90+% loan-to-cost instead of 80% in the case of buying turnkey, they were able to increase their returns. To be clear, it wasn't necessary to buy distressed homes to do very well, but if you could manage the pains of renovation, the extra juice would usually be worth the squeeze.

BRRRR in 2024: The Opportunity is Dead

If the three factors that allowed the BRRR method to produce outstanding results in the mid-2010s were low home prices, attractive rental yields, and low interest rates in relation to those rental yields; in 2024 *none of these factors exist*. Home prices have increased meteorically, and rental prices have not kept pace. Interest rates have increased at historical rates, and mortgage rates are now higher than CAP rates. In short, the BRRRR strategy is dead because its time has passed. Those who continue to implement it are either going to have modest returns or face liquidity issues if they are aggressive with their capital and expect future investments to perform like past ones.

Success Factors	2014	2024
Low Home Prices	Historically low home prices brought about by the largest housing bubble in US history. Median Home Price: $275,000	Historically high home prices brought about by years of under investment. Median Home Price: $417,000
Attractive Rent Prices in Relation to Home Prices (Rental Yield)[1]	Historically high rents and strong rental demand. CAP Rates: 8-10%	Historically high rents and strong rental demand. CAP Rates: 4-6%
Attractive Interest Rates in Relation to Rental Yield	5.0%	7.5%
Return-on-Equity Assuming 80% Leverage	20-30%	(-7.5%) - 0.0%

Considerations for Single-Family Investors in 2024

For small real estate investors, BRRRR-ing in the mid-2010s was the investment opportunity of a lifetime. The economics were sound, the strategy was accessible, and the bets were sizeable. However, investors must face the current reality that the confluence of factors that created the BRRRR opportunity has passed, and the opportunity has passed along with them.

This is not to say that single-family homes are now bad investments. On the contrary, managed appropriately, single-family homes represent some of the best risk-adjusted assets in the real estate market today. There are numerous reasons to be optimistic about investments in this space provided expectations are set appropriately, purchases are made prudently, and operations are managed efficiently. *Unlike the 2010s, skill and expertise now matter* as investors will not be bailed out by a tailwind strong enough to overpower their misjudgments or mistakes.

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[1] CAP rates are market dependent. Depending on the market, you may add 2-3 percent in either direction. The conclusion will be the same.

Given the current housing environment, investors would be well served to consider the following market realities:

- **Downside protection is critical:** This almost always comes down to the price paid and the amount financed. Aggressive leverage and high purchase prices are a recipe for disaster, and investors should focus on preventing loss rather than chase high IRRs.
- **Distressed homes don't trade at attractive discounts:** Homes in disrepair trade at remarkably high prices in comparison with homes that are in good condition. Rarely in the last few years have we seen a distressed home priced low enough to justify the renovation cost. Investors would be well served to buy homes in good condition, as there is generally no alpha to be generated by taking on fixer-uppers.
- **Location matters:** Quality homes in good condition in attractive areas are desired by the best tenants. Better tenants pay rent on time, are concerned about their credit, and treat their rentals more gently. Turnover costs are very high, and all homes (regardless of the tenant base) are expensive. There is no alpha to be generated by taking on a riskier tenant base.
- **Debt doesn't help returns:** When interest rates are above CAP rates, the only reason to take on leverage is to bet on future appreciation and/or the ability to refinance at a lower rate in the future. While both are possible (or even likely) neither is guaranteed. Investors should be *very* cautious with leverage.

Today's housing market is different in nearly every way than the market of the mid-2010s, and the ability for small investors to strike it rich through single-family investments has passed. Investors in the single-family space today should set their expectations accordingly and view single-family investing as a means to protect wealth, not create it.

Best Regards,

The FFCM Team

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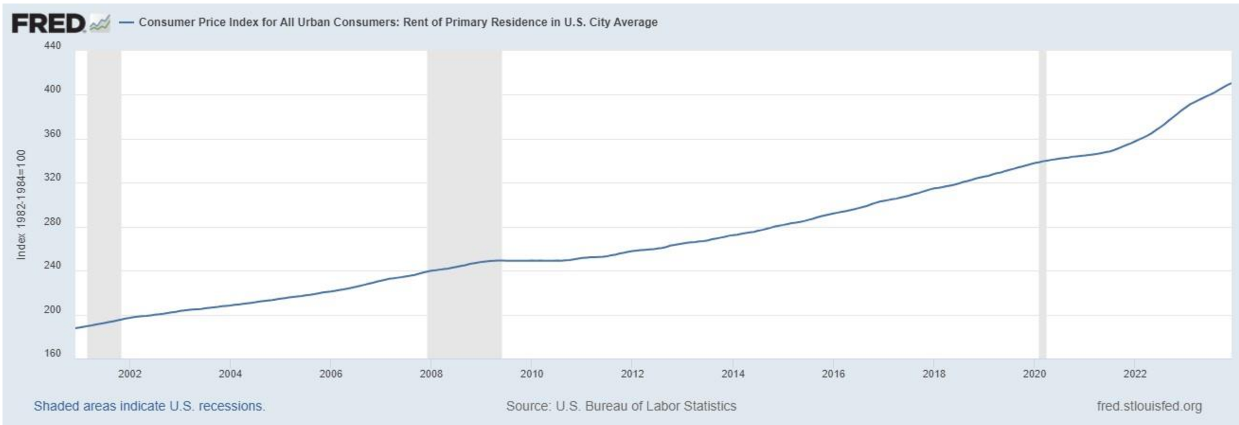

Figure 1- [FRED Economic Data: CPI for All Urban Consumers: Rent of Primary Residence in U.S. City Average (2000 – pres.)]

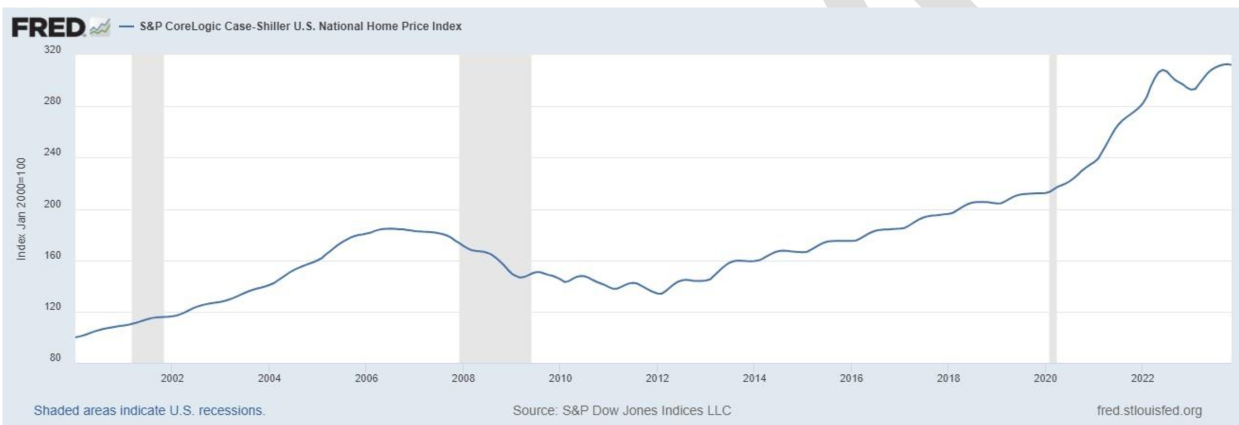

Figure 2 - [Case-Shiller U.S. National Home Price Index (2000 – pres.)]

BRRRR Economics	**2014**	**2024**
Investment Assumptions		
Purchase Price	110,000	215,000
Renovations	30,000	65,000
Total Investment	140,000	280,000
Financing Assumptions		
ARV	170,000	300,000
LTV	80%	80%
Debt	136,000	240,000
Interest Rate	5.0%	7.5%
Operating Assumptions		
Monthly Rent	1,550	2,100
Gross Margin	67%	67%
Annual NOI	12,462	1,407
Interest	6,800	18,000
Income	5,662	(16,593)
Financial Metrics		
CAP Rate		
Yield to Cost	8.90%	0.50%
Yield to ARV	7.33%	0.47%
ROE (Pretax)		
At Cost	**141.6%**	**-41.5%**
At ARV	**16.7%**	**-27.7%**
Distress Discount	17%	3%

Figure 3 - Example economics of a BRRRR investment. Source: FFCM