Single-Family Investing in 2024: FFCM Memo

January 30, 2024

In the first 10 months of 2022, 30-year mortgage rates surged 250% and it seemed clear that the U.S. housing market was poised for a bust and home prices would collapse. It wasn't and they didn't. When the wave of free money went out, there were few shipwrecks on the beach and since then confused home buyers and single-family investors have wondered "what is next and what should we do?"

FFCM is in a unique position to offer some insight into the state of the housing market. We are a boutique investment and advisory firm that specializes in US single-family housing. Our clients range from individual investors to some of the largest institutional-backed firms in the world. This allows us to merge an on-the-ground, transaction-level view with a larger macroeconomic one. As we begin 2024 by opening our flagship single-family fund, we want to share how we see the current single-family landscape and how we plan to chart a course forward.

Homeowners and Primary Residences

Housing inventory remains near historical lows[1] and there is very little relief in sight. Anecdotally, we interface with hundreds of homeowners each month and generally all of them have the same reaction when they consider selling their residence: "Yes, I could sell my home for a significant profit, but then I'd have to spend just as much for another one and I'd have to finance it at a much higher interest rate."

Higher interest rates have done more to restrict inventory than they have to lower home prices. The majority (80%+) of homeowners have low interest rate debt fixed over a 30-year term. These homeowners are the counterparty to the banks, who hold extraordinary-but-unrealized (hundreds of billions) losses in their loan books. As a result, the average homeowner who has a low interest rate mortgage (the vast majority) has as much as $150,000 in unrecognized gain from their low-rate mortgage. This gain doesn't appear in their bank account, but it is very much a part of their personal finance calculations. "Staying in place" makes sense for current

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[1] https://www.jchs.harvard.edu/sites/default/files/reports/files/Harvard_JCHS_The_State_of_the_Nations_Housing_2023.pdf

homeowners, this reduces housing supply, and (counterintuitively) higher interest rates bolster home prices as a result.[2]

While supply is at historical lows, demand is extremely robust. The homebuyer constituency is as large as it has been in recent decades (likely since the baby boomers) as the underappreciatedly-large millennial population forms families. Swaths of millennials are in the market for their first home, only to find that current owners are staying in place and that, since 2008, very few new homes have been built.

Our take: Limited inventory and little new construction combined with robust demand will continue to support high home prices. While prices are hard to predict over the short term (12-24 months) we expect home prices to increase at a reasonable (perhaps high single digit) rate over the medium (5-10 year) term.

Institutional Investment – Existing Housing

Large institutional investors are largely paralyzed in the current environment. We have relationships with many of the largest national single-family buyers and are consistently told that they "are ramping up to buy again soon." This promise seems to be ever extending to one or two quarters in the future. For some institutions this may make sense; for most, we think it's an indication of poor investment discipline and reflects little about the current state of the housing market.

For the largest single-family institutions in the country (behemoths like Invitation Homes, Pretium Partners, etc.) it may make sense to pause buying initiatives as they wait for smaller, aggressively financed portfolio aggregators to fall into distress or liquidate their portfolios. Invitation Homes, for example, owns 80,000 homes and portfolio acquisition (as stated by their CEO) is really the only growth strategy that makes sense at their scale. For large, evergreen firms like these, waiting to acquire portfolios as they become available makes sense.

"Smaller" portfolio aggregators (5,000 – 20,000 homes) generally face a different set of circumstances. Many saw the COVID+ZIRP-induced growth of home prices and aggressively jumped into the market. Assuming that "a future buyer will pay more regardless of what we pay" they financed their portfolios aggressively, gave little thought to operations, and threw any conservative approach to investment decision making out the window. We have watched several portfolio aggregators go into receivership or otherwise begin to dispose of their portfolios. Generally, they receive high prices for their homes in their inventories; they are winding down for reasons unrelated to the current fundamentals of the housing market.

[2] https://www.pimco.com/en-us/insights/viewpoints/mind-the-supply-the-counterintuitive-impact-of-higher-rates-on-us-housing/

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Our take: The largest single-family owners look to grow only through portfolio acquisition; these are likely waiting on some smaller portfolios to fall into distress or liquidate. We don't think they will be able to purchase even distressed single-family portfolios at a significant discount, instead they may not need to pay as high of a premium. Some smaller aggregators are in trouble because they underestimated the complexities of the single-family market, not because the market turned against them.

Build-for-Rent

While institutional investors are reluctant to purchase *existing* single-family homes, the appetite for single-family exposure is still very large. We often say, "everybody knows that we have underbuilt housing, but nobody seems to know how to turn this knowledge into profit." Build-for-Rent (BFR) has quickly become the latest craze in single-family investing.

Build-for-Rent is essentially sub-division development with a twist: instead of selling the completed homes to homeowners, they are rented to tenants. As large investors struggle to efficiently purchase and operate scattered-site single-family rentals, they have elected to build neighborhoods instead. There are some benefits to this approach, but there are often significant tradeoffs as well. In general, we think that investing in existing inventory is a much better proposition if you don't have excessively large amounts of capital to put to work and have the necessary operations in place. Regardless, here are some of the pros and cons we see to the new BFR trend.

Build-for-Rent: Pros

- **Streamlined Negotiations** – As part of the development, the end-buyer/landlord negotiates the acquisition terms for all the homes in bulk. The seller and buyer are relatively sophisticated, and the scale of the transaction is large enough for experienced executives to weigh in on the terms of the deal. This is in stark contrast to purchasing properties on a one-off basis from traditional homeowners.
- **Standardized Product –** All the homes use the same finishes, have the same features, use the same appliances. This simplifies marketing and maintenance.
- **No Deferred Maintenance –** By definitions, new build construction has no deferred maintenance. Existing homes can have significant maintenance and end-of-life issues (from the roof to the sewer) which can materially increase the cost of ownership.
- **Management Efficiency –** This depends somewhat on scale, but if the BFR development is over 100-150 units, a centralized manager can provide some economies of scale over scattered-site portfolios.
- **Lower Impact on Market Prices –** Even a relatively small amount of money can significantly move prices in a given submarket. BFR allows larger amounts of money to be put to work ($20 million+) without significantly increasing home prices in an area.

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Anecdotally, we worked on behalf of a large national fund to purchase about $15 million of single-family homes in a Tucson, Arizona submarket. This relatively small amount of capital, deployed over a 3-month period, was enough to increase home prices in the submarket by 40%.

Build-for-Rent: Cons

- **Non-Central Locations –** Land near central business districts and highly desirable areas has already been largely developed. BFR communities (at least ones of moderate scale) are usually built near the outskirts of a city. This results in longer commutes to work and attractions.
- **Buying at Replacement Cost –** New-build construction is sold at roughly its replacement cost. This is significantly better than grossly overpaying for homes, however, there is little investment alpha to be achieved by buying at replacement.
- **Is this really single-family housing?** Product types vary considerably among BFR projects, but many seem more like a new take on apartments than they do a substitute for a single-family home. Some communities aren't separately platted so individual homes cannot be sold off to end consumers. Other communities have pushed density to its limit so a future buyer will have to settle for very close neighbors and little yard space. It seems to us that if these BFR communities prove to be large successes, traditional single-family homes will perform even better.

Our take: If you need to deploy a significant amount of capital ($100+ million) into single-family housing, then build-for-rent may keep you out of trouble. An experienced manager and investor will outperform BFR in any given market provided they don't have to deploy so much capital that they materially bid up prices on themselves.

FFCM: 2023 Recap and 2024 Strategy

In the relatively stalled real estate market of 2023, FFCM continued to find opportunities. We completed over $31 million of transactions and our 2018-2019 conservatively leveraged, private funds realized about a 20% fund-level IRR. Admittedly, this return was significantly bolstered by the run-up in home prices over the last 5 years but given that public REITs only returned a levered 9.5% during this time, we have confidence that we generated material alpha without taking on undue risk.

2023 Highlights

- **Acquisitions**
  - Acquired 51 properties ($13.8 million)
  - Louisville, KY – This was the target MSA for our 2023 fund and our most active market for acquisitions. We hold 58 properties in Louisville at a stabilized CAP rate of about 6.3%.
  - We estimate that our average acquisition was purchased at about a 10% discount to its fair market value.
  - We have purchased a few properties at far steeper discounts including two homes in Tucson, AZ we purchased for ~65% of market value, a home in Louisville we purchased for 70% of market value, a home in Kansas City we purchased for 75% of market value, and a slew of other great discounts we have found.
- **Dispositions**
  - Sold 50 properties ($17.9 million)
  - Most dispositions were homes in our 2018 Tucson-focused real estate fund. We purchased these homes very cheaply (even at the time) and they performed very well over the investment lifecycle.
- **Operations**
  - We currently manage $45 million of assets and 233 units spread across 4 markets.
  - Portfolio occupancy as of January 2024 was at 97%.
- **Other Opportunities**
  - We currently hold $4.5 million of hard money loans at an average yield of 11% at an 80% LTV. This yield was very attractive when interest rates were near zero and we anticipated rates for HMLs to increase more than they have. This business results in recycling capital frequently, but the short-duration loans allow us to earn a reasonable yield while waiting for longer-term opportunities.
  - We purchased and sold a 16-unit apartment complex over a 2-week period in late April. This was a one-off opportunistic deal, but we anticipate (hope) to see more opportunities in the small multi-family space in 2024 and 2025 as loans mature at higher rates.

2024 Strategy and Opportunities

Flagship Single-Family Fund – We will continue to deploy capital into high-quality single-family rentals in select markets across the country and are opening our flagship fund (First Floor US Housing Fund II) for capital commitments at the end of January. We expect there to be more opportunities for astute single-family investors in 2024-2025 than there have been the last few years as the lack of institutional competition should make it easier to purchase homes attractive prices. We think that conservatively purchased and professionally operated single-

family homes will continue to outperform the real estate market at large and we believe that there will be demand for high-quality single-family portfolios from institutional buyers who struggle to compose them on their own.

Investment and Advisory Services – Along with our private investment funds, we offer white glove investment, brokerage, and advisory services to single-family investors. Our clients range from high-net-worth individual investors to institutional-backed funds. We offer our advisory clients the same level of attention and care as our private investors as we help them meet their single-family investment goals. In 2024, we believe clients will need help disposing, repositioning, and optimizing their single-family rental portfolios.

Best Regards,

The FFCM Team

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