SYLVAN ROAD

May 11, 2020

SRC Housing Perspectives – COVID Whitepaper 2020

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COVID, US Housing and SFR

The COVID-19 pandemic has already had a profound impact on the US housing market overall and the single family rental sector specifically. In this whitepaper, we cover…

- **Where the housing market stands immediately prior to the pandemic, and the strengths and weaknesses that may benefit or hinder its path ahead**
- **Where the single family rental market stands, as well as how Sylvan Road is positioned within that market relative to the threats from the pandemic, lockdowns and economic impacts**
- **Our views and experiences with regard to the effect of pandemic-related factors on multiple performance measures for single family rentals, including rent collections, vacancy rates, rent levels, stabilization of assets, operating expenses and capital expenditures**
- **Our views and experiences with regard to the effect of pandemic-related factors on macro housing market performance including on home sales, home prices and their trends**

Rentership Revisited

Introduction

The bulk of the impact of the pandemic on the US housing market and SFR market specifically, should be through indirect effects from a corresponding recession such as rising unemployment, and not from direct effects such as hospitalizations and deaths. Even in worst case scenarios being considered by the CDC (210MM infected, 21MM hospitalized, 1.7MM deaths), the loss of direct population, while unimaginable from a loss of human life standpoint, would still represent less than 50 bps of the total US population. Given the disproportionate distribution of deaths by age, we believe that the direct impact of population loss on the overall housing market should be minimal.

That said, the indirect effects of recession on the US housing and SFR markets could be significant. The likeliest drivers of the impact should come as a result of the social distancing measures being implemented across the country. The differences in magnitude and duration of such measures means that their effects (both positive and negative) could vary dramatically from one geographical area to another. Stronger, more enforced measures may slow the outbreak but lead to a longer duration, while weaker, less enforced measures may result in an uncontrolled outbreak of a shorter duration. The resulting economic toll and impact on housing markets could vary widely by geography, product type and ownership status.

The magnitude and duration of impacts on US housing and SFR markets will depend on both how severe and how long social distancing measures remain in place. Immediate impacts would including a sharp drop in housing transactions (but not prices) and delinquencies (but not evictions). Longer term impacts could be more traditional in nature relative to macro-recessions, however, could be harder to predict due to pandemic-specific effects, such as certain industries receding while others prosper.

There are many issues to consider when evaluating the risk to the US housing market and the single family rental (SFR) industry specifically. This paper summarizes our current view of the situation and provides both historical data as well as early current market data from our operations to support these views. To be clear, the situation remains fluid, and as new data becomes available we will reassess and reconsider our views in response.

For now, our views in this paper are based on the underlying assumption that the current market turmoil will persist for 18-24 months until one or more of three endpoints is/are reached: 1) an effective vaccine is widely distributed, 2) an effective treatment reducing fatalities is available, and/or 3) herd immunity is reached. While the path through those 18-24 months may be volatile and disparate across the country, ultimately we believe a lasting recovery will take hold once at least one of those endpoints is reached. Our views would likely become more negative if another externality occurs and/or the cycle of massive unemployment and subsequent recovery is prolonged considerably beyond 18-24 months.

Housing Market Overview

Please note that the following analyses and opinions are based on the conforming-balance portions of the US housing market which are supported primarily by FHA and GSE lending in addition to some non-agency lending. While this includes the vast majority of the market, it does not include the luxury sector or many parts of the higher-cost coastal markets in the West and Northeast.

The US housing market began the COVID pandemic in a very strong position. In particular:

- Vacancy levels, for both owner-occupied and rental housing were at or near record lows.
- A prolonged period of underdevelopment since 2008 had led to a shortage of supply despite continuous household formation during that period.
- Mortgage lending to the conforming market was more disciplined vs. pre-2008 standards, with higher credit and down payment requirements, extensive documentation and the prevalence of traditional fixed-rate 30-year products.
- Price growth remained in a reasonable mid-single-digit percentage range despite a prolonged recovery from 30-50% aggregate price declines from 2006/7 to 2009/10.
- Affordability ratios for both ownership and rentership in non-coastal markets remained at comfortable levels below 30%. *(note this is definitely NOT the case in certain coastal markets)*

In addition, the US housing market has not seen the type of rampant speculation, whether in development or mortgage lending, that it did pre-Great Recession. As a result, we do not anticipate significant foreclosures on owner-occupied nor investor properties. Supporting this hypothesis, the fiscal and monetary responses to the pandemic have included protections to prevent exactly that foreclosure crisis from re-appearing. Highlights include:

- Mortgage forbearance programs up to 12 months for government-backed mortgages
- Eviction moratoria for government-backed mortgage and rental programs (e.g. section 8)
- Record low mortgage rates which have led to spikes in refinancing demand
- Record low mortgage rates which are starting to bring buyers back into the market despite on-going social distancing rules (more on this below).

Finally, while this is still to be proven in the data, we believe there will be a preferential payment positioning for housing payments (whether mortgage or rent) vs. other household obligations such as auto loans and credit cards, as people prioritize their homes in a "safe at home" environment that minimizes auto usage and retail spending. Initial data that the savings rate has increased to levels not seen in almost 40 years seems to partially support this view.

SFR Overview

The SFR market also began the pandemic in a strong position. Demand for SFR housing was high, which led to:

- Mid-single-digit percentage increases in contractual rents.
- Occupancy was averaging in the mid-90% range
- Rent collections were in the upper 90% range.

Despite tremendous growth since its inception in 2012, institutional SFR ownership remained below 2% of the total market. That said, capital inflows far exceeded capital outflows and institutional growth was strong – most recently attracting traditional CRE investors and foreign capital.

SFR is also unique amongst all CRE asset classes in that it operates within the greater single family US housing market, which remains dominated in participants and transactions by retail owner-to-owner sales. The result is a product that can trade on a cap-rate basis *OR* a comp-basis to a differing set of buyers, which can result in price-dislocations and arbitrage opportunities even despite the high friction costs in the retail market. Since the pandemic started, we have also witnessed other strengths of the institutional SFR product, including:

- Preferential positioning vs. multi-family in an environment where social distancing is prioritized, and in some cases, highly desired.
- Advantageous positioning in the middle of the market by price and rent-point. Institutions generally do not play in the high rent/no or negative yield assets, nor the more volatile and risky low rent/super high yield assets.

SRC Positioning

Within the institutional SFR market, Sylvan Road manages assets in the middle of the middle. This has the advantage of allowing for tenant mobility from higher-rent sectors of SFR, including in institutional-grade assets, to the Sylvan Road assets resulting in higher quality tenants, while allowing tenant mobility from current tenants out of the tenant pool. The result is better qualified applicants, which will lead to better qualified tenants. We are already starting to see this in our applicants since the beginning of the pandemic.

Furthermore, due to our tenant underwriting standards and our market positioning, the Sylvan Road tenant base was not over-exposed to the industries that have been initially hit by the economic fallout of the pandemic, such as retail and hospitality. In an analysis of over 1,000 recent applicants, we found that while 30% of all applicants were employed in such industries, only 10-15% of accepted tenants were employed in those industries – the bulk of which were not primary leasees, but rather secondary household members.

Finally, Sylvan Road's asset exposure is limited to Southeastern markets which have been among the less hard-hit areas of the country despite more relaxed safe-at-home regulations. While the longer term implications of such policy decisions remains to be seen, the result has been an environment where we continue to operate as an essential service and our tenants continue to apply for, and move into, SFR assets.

Rent Collections

When the pandemic began and initial job losses started skyrocketing, there was a view that rent collections would drop precipitously – potentially by 30% or more given the media reporting around a 30% unemployment number. There was also some misunderstanding in the early reporting for

April collections that 30% of multi-family households did not pay their rent on time. While this was true, it needed to be noted that even in pre-COVID times, about 20% of households do not pay their rent on time, so the true deficiency vs. historical payment was closer to 10%. For SFR, industry chatter was closer to a 5% initial deficiency vs. historical collections, which is where Sylvan Road collections stood as well – also within the margin of error due to month-to-month volatility in on-time collections.

By the end of the month, however, almost all of that deficiency had been caught up in SFR, and Sylvan Road ended up at a slight surplus across its entire portfolio. Likewise, multi-family rents also recovered and generally ended the month down with a low single digit to no deficiency.

Our view on collections is that it is aided in the short-to-medium term by two factors:

1) $1,200 federal stimulus payments (one-time)
2) $600/week federal bump to unemployment benefits (through July 2020)

While the stimulus payment was only one-time, it included nearly 100% of institutional SFR tenants. A household of two adults and two children would qualify for a total of $3,600 – more than enough to make their April payment. The federal bump to unemployment benefits is even larger. At $600/week, the New York Times reported that qualified individuals in 37 states would make more in unemployment through July 2020 than they did working in their last job. This benefit helps SFR specifically because our tenants must have jobs to qualify as tenants in the first place, which generally makes them eligible for unemployment (especially as it's now been extended to self-employed workers). So long as a worker is entitled to at least $1 of unemployment benefits, they automatically qualify for the extra $600/week. As a result, we see collections remaining strong through July 2020. What happens post-July will depend on the depth of job losses, breadth of industries affected, and future government stimulus plans.

Finally, initial concerns about collection rates were likely also overblown. The steep declines in collections that we heard about were also tied to people's perceptions of subprime default rates post-2008. However, subprime default rates were driven by 2/28 and 3/27 mortgage resets, which were amplified by poor underwriting. Unlike those payments, rents do not reset to that extent – in fact they can decline in recessions – and instead look more like fixed-rate mortgage payments. Not surprisingly, 30-year fixed rate subprime mortgages had much lower default rates of around 10% and ultimate foreclosure rates even lower than that. With better underwriting and rent relief/forbearance/restructuring programs, we do not believe that ultimate collection rates will fall below 90% during the pandemic, although we model as low as 80% to be conservative.

Rental Vacancy

Vacancy rates are usually the result of a few different factors: 1) demand/supply for rental homes, 2) voluntary turnover, and 3) involuntary turnover. The pandemic could have an effect on all three of these factors. In prior economic downturns, vacancy rates overall tend to increase slightly as a result of a drop in demand and potentially an increase in involuntary turnover as a result of defaults and evictions. However, the pattern can vary by sector, price point, housing type, geography, etc. In the Great Recession, vacancy rates did not increase much – primarily because they were already at record highs in 2006 due to excessive development leading to excessive supply – and in some areas did not increase at all. This time around, vacancy rates began the pandemic at record or near record lows due to a prolonged period of underdevelopment that lagged household formation. Normally, we would expect a drop in demand due to rising unemployment and we still do for this cycle. That said, with "shelter-in-place" and "safe-at-home" restrictions in place and the continued demand for shelter simply from fear of the virus even as such restrictions are slowly lifted, we are seeing an increase in demand for our rental assets. Despite such restrictions, we saw our rental applications rise in April to a monthly record, with an increasing number of applicants making their holding deposits to reserve vacant assets. We have heard the same color from across the single family industry. This differs slightly from what we are hearing from multi-family, but that could be explained by a preference for single family units as households look for more space for social distancing and move away from more densely-populated forms of housing.

With regard to turnover, we have seen both voluntary and involuntary turnover decline, but for starkly different reasons. Involuntary turnover, which is due to default and evictions, are down as a result of local moratoria on evictions. While filings can proceed and be used as a payment tool (historically over 50% of initial eviction filings result in payment), physical evictions are difficult to impossible to complete in the current environment. Certain policies, such as cash-for-keys, can be utilized to vacate such assets and given the high level of demand for SFR, should be used to help reduce loss of revenue through non-payment. We expect involuntary turnover to return to normal levels once these moratoria are lifted, and potentially rise if collections become more of an issue than they currently are. Voluntary turnover is also down, as tenants have shown a desire to retain their shelter given the circumstances. We expect this may jump post-lockdown, but over time it should return to normal levels. For now, the combination of higher demand for SFR and lower turnover overall is leading to increased occupancy rates.

Rent Levels

In times of recession, rents typically fall, as would be expected due to a drop in demand from lower employment levels and income. However, the extent to which rents decline does not always follow the extent to which prices decline (if they move in the same direction at all), just as rent growth does not always align with value growth. In the Great Recession, rents fell much less than home prices. Even in the hardest hit markets such as Atlanta and Miami, where home prices fell more than 40%, rents declined less than 10% cumulatively.

This dynamic could be due to the rental market having more flexibility than the homeowner market. Since leases typically only have a 12-month term, and evictions are easier to pursue than foreclosures, turnover can allow the rental market to naturally restructure in a recession. Underwriting standards for rental assets usually require proof of income, so new tenants move in with employment – even in a recession – and must quality to carry the monthly rent. In recessionary times, higher income earners move down in price point when seeking rentals, thereby not only keeping a particular tenant base strong, but in many cases actually improving overall tenant quality and RTI ratios. This is possible so long as the asset base is relatively well insulated in the middle sectors of the market.

We have already seen this dynamic play out in the early part of this pandemic and recession. Our applicants still have jobs and are easily qualifying for the homes for which they are applying. They are also more than able to pay the asking rent, so we have not seen a need to reduce rents despite the sharp economic downturn – in fact, we were able to raise rents by 5-6% for assets completing turn in April, which was consistent with recent historical performance. And if the Great Recession is any indication, even in a prolonged recession, given where vacancy rates were pre-COVID vs. pre-Great Recession, we would not expect rent levels to decline significantly, if at all.

This last point of vacancy rates was made earlier in relation to the overall health of the housing market immediately prior to the pandemic, and is a critical point in our opinion. While unemployment may well exceed the peak reached during the Great Recession by 2-3 times, the housing market is in nowhere near the same position. Vacancy rates are maybe the most critical factor. To put this in perspective, there are roughly 140MM housing units in the US. At the start of the Great Recession, the total vacancy rate was 13.8%, the highest it had been since records were kept in 1965. During the recession, declines in employment and increases in foreclosures caused the vacancy rate to rise to 14.5% by 2009, or an increase of about 2.4MM units. This increase, however, was quite different from owner-occupied vs. rental units, as well as from single family to multi-family assets. Specifically to single vs. multi and renter vs. owner, the chart below shows the differences:

	SFR			Multi		
	GR Start	GR Peak	Pre-COVID	Start	Peak	Pre-COVID
Renter	10.0%	9.8%	5.6%	9.9%	12.3%	8.0%
Owner	2.1%	2.5%	1.3%	8.5%	9.2%	3.5%

Source: US Census

On the contrary, pre-COVID, vacancy rates were much lower across the board, whether single or multi family, and whether renter or owner property type. This positions the housing market, and the SFR market specifically, in a much more defensible position than at the start of the Great Recession. Even if mortgage foreclosures hit the total number of 3-4MM in the four years from 2008-2011, it would only increase the vacancy rate by 2-3% overall. This is highly unlikely to happen given that the vast majority of outstanding mortgages today are backed by GSE or FHA guarantees, and not non-agency securitizations like in 2007 – more on this below.

Asset Stabilization

The pandemic could have specific impacts on rental housing that a typical recession would not. One of these impacts could be the ability to stabilize assets, which requires completion of construction projects and successful lease-up of assets. Indeed, in California, where residential construction was prohibited, the ability of landlords to complete renovations was put on hold (they have recently been allowed to continue). In the Southeast, residential construction remained an essential service and no disruptions took place. As a result, our ability to complete renovation jobs was unaffected. Furthermore, as newly renovated assets are vacant both during the renovation phase as well as the marketing and leasing phase, our ability to stabilize assets overall has not been negatively impacted. This, combined with the increase demand for SFR assets, is allowing us to stabilize vacant assets at an increased, not decreased, rate so far during the pandemic.

While construction teams across SFR have been affected by the pandemic, including in some cases both layoffs and furloughs, this has primarily been the result of a decline in new acquisition activity by investors or shifts in geographical focus (e.g. away from Houston), and not because of an inability to perform construction services.

Asset OpEx / CapEx

Along the same lines as for asset stabilization, the ability to perform required maintenance and turns during the pandemic has not been affected, allowing us to complete turns and work orders in the same amount of time as our pre-pandemic average. We have heard the same color from our competitors, and unlike for construction, where usage levels are heavily influenced by acquisition activity, maintenance and turn resources have been stable.

Protocols, however, have changed as a result of social distancing rules. For example, our techs are now provided PPE and maintain social distancing while performing services inside our houses to protect our residences and employees. And while turnover is down somewhat as discussed above, they are still occurring and require the same crews to perform the work and ready the asset for re-leasing.

We expect R&M may decline in the short term as residents are more wary of having others in their residences out of fear of the virus, and turnover to remain a bit lower as discussed, but we expect both of these issues to even themselves out over time and have a net neutral impact on the economics of SFR assets, despite having an effect on the timing of such expenses.

Home Sales

The initial and universally expected impact of the pandemic was that it would reduce the number of housing transactions, which it has. A number of factors drove the declines, including fewer listings as homeowners sought to limit their exposure to strangers, fewer showings for the same reasons, lower bids from potential buyers weighing the risks of buying a home during a pandemic while sellers hold on to asking levels, and difficulties processing closings due to social distancing regulations. To be clear, the retail market (homeowners) dominates and drives transaction volumes – along with pricing discussed below. Investors remain a minority of the market, and institutional investors an even smaller proportion.

For the first several weeks of the pandemic and lockdowns, transaction volumes did fall. Leading indicators of transactions, such as mortgage applications for purchases and available listings also fell – in same cases dramatically. A bit surprisingly, however, the retail market has shown significant resilience. In the latter part of April, mortgage applications for purchase began to tick up, and have continued to increase for three straight weeks. This is no doubt driven by record low mortgage rates, but also by the fact that the GSEs and FHA continue to provide new credit and the FHFA has taken steps such as allowing mortgages in forbearance to remain and even be purchased into agency securitizations. The combination of credit availability and record low costs seems to be outweighing the difficulties with showings and transaction processes. In fact, the industry has adjusted certain practices to reduce those headwinds, by implementing virtual and online showings and allowing online recordings.

The initial easing of lockdown restrictions has also unleashed some pent up demand (it is the traditional spring selling season), and while we only represent a very small number of retail sales, we have seen our retail activity recover quickly as our number of showings and offers received have grown since mid-April. We continue to monitor transaction volumes, but increased retail activity should lead the way back to a more normalized market and provide significant price support, which we detail below.

On the investor side, while large bulk transactions of SFR have slowed, it appears the driving factor is a lack of competitive bids from potential buyers as they practice caution and move bids back 10-25%. Sellers, particularly investors that were initially believed to quickly end up in distressed situations, including iBuyers, builders and fix and flippers, have realized the strength of the retail buyer and have successfully sold assets at or near asking prices. The result has been a sustained level of transaction volume from such sellers without much compromise on pricing. That said, they have been slow to buy new assets, but even there we are seeing activity begin to pick back up for certain investors who have access to capital.

Home Prices

An entire white paper could be dedicated to the effects of the pandemic and lockdowns on home prices, but we will limit this section to some historical experience, our views, and our current market data.

First, prior to the Great Recession, home prices as measured by major price indices never declined at the national level during or after a recession. Even at the local level, most MSAs showed strong resilience in pricing throughout the early

1980, 1990 and 2000 recessions, with only certain MSAs exposed to the core of the recessions (e.g. Houston in the early 80s or LA in the early 90s) showing any declines at all. Historically, any price declines were driven by major shocks to the system and also took a long time to become an established trend. Research we did in 2008 showed a lag of 1-2 years on average at the MSA level for prices to decline following a drop in housing activity, if they declined at all. In some cases, they simply flattened out before growing again. This behavior has been attributed to the axiom that as a real estate owner in a recession, you simply don't sell if you don't have to. If you can weather the storm, pricing will eventually recover and your asset value can be preserved. As a result, while bid prices may decline in these situations, offered levels hold firm, transactions fall, but prices do not decline much or at all. What we learned in 2008, however, is that if the market is flooded with distressed sellers who are willing to hit the lower bids, then pricing will move and can do so fairly quickly.

Back to the present situation, we do not foresee a spike in distressed selling. When the pandemic first started and the credit markets were roiled, we expected some distressed selling from certain investors like iBuyers, builders and fix and flippers with the rational that their businesses are built on velocity, low margins and high leverage so if they lost access to credit they would need to reduce balance sheet very quickly. In some ways, this did play out as these investors stopped buying or building and started reducing balance sheet. However, with the strength of the retail market noted above, they quickly realized that they did not have to discount their pricing to move assets and have been successfully selling at or near their pre-COVID asking prices. We have been bidding on such assets at 10-25% discounts and not receiving a warm welcome to say the least. While a major distressed selloff from such investors would still not have been enough to drive overall pricing lower (they represent less than 1% of the market even in their most concentrated markets), it was the one source of distressed assets that we thought would hit the market.

As for the retail market, we do not believe we will see a significant foreclosure crisis like we saw in the last cycle, and any foreclosures that do occur would not be enough to drive a strong downward shift in prices. Our view here is based on two critical factors:

1. While the number of mortgages that are in forbearance has risen during the pandemic (now about 7.3% of all mortgages), the pace of increase has slowed since mid-April and the vast majority of such mortgages are backed by the GSEs and FHA. The agencies have shown broad support for these borrowers, including providing forbearance for up to 12 months and changing rules so that mortgages in forbearance are still eligible for securitized pools. While 12 months may not be long enough to save 100% of these homeowners, the fiscal response has been dramatic and we expect future government action will continue to try to prevent a major foreclosure crisis.

2. Outstanding mortgages are overwhelmingly fixed-rate in nature, have much higher credit standards than prior to 2008 and have been well documented. The largest drivers of the 2008 crisis were lax lending standards coupled with innovative products that involved large payment resets (e.g. 2/28 subprime mortgages and option-ARMs). Fixed rate, high credit, agency products did not default at nearly the same rate during the Great Recession. In fact, areas of the country where these types of mortgages were dominant saw the lowest declines in home prices – if they declined at all. The Fed published a great paper looking at these trends in 2016 called *"FHA, Fannie Mae, Freddie Mac and the Great Recession*".

While the retail market may still see some weakness as a result of potential volatility in lockdowns, mortgage rates, some foreclosures, etc. it has so far held up even stronger than we anticipated. Home prices are still rising – which is not too unexpected given the lag in price behavior vs. market activity that we referenced earlier, however, market activity is again picking up. If transactions continue to rise while inventory remains low, pricing could very well grow even faster in the short term than it had immediately pre-COVID. Over time, we expect pricing to flatten out as initial market activity shocks work their way through the system, but we do not believe prices will decline more than by a few percentage points, if at all, through this cycle.

Conclusions

In general, we believe that the housing market is well positioned to withstand an 18-24 month pandemic and resulting economic recession. Clearly, much of this depends on government action or inaction on multiple fronts, including fiscal and monetary stimulus for households and lenders, and the path of economic opening and closing will also have an effect on the various parts of the US housing and

SFR markets. But early indications are that so long as the market can function even to a minimal degree, the existing supply and demand dynamics seem to benefit the housing market and favor SFR specifically. While we expect to see some lower collections, higher evictions, and softness in rents and prices, we do not expect to see the type of drastic declines that we did in home prices during the Great Recession.

Important Disclosures