Single-Family Rental Securitizations: Not 'AAA', Yet

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NEW YORK (Standard & Poor's) Feb. 27, 2014--As securitization continues to evolve in the single-family rental (SFR) sector, with projected issuance in both the single- and multiple-borrower segments, Standard & Poor's Ratings Services has yet to see an SFR transaction with the level of credit enhancement and other risk-mitigating features that warrants the highest investment-grade rating.

Standard & Poor's has been following developments in single-family rental (SFR) securitizations since inception. Our primary reservations regarding the sector, also known as real estate owned (REO)-to-rental, revolve around the industry's operational infancy, historical performance, the current business model's ability to withstand extreme economic conditions, and the ultimate liquidation values of the underlying properties, given the risks associated with short liquidation periods.

Standard & Poor's has extensive cross-sector experience in analyzing asset securitizations, including those with large operational business components. We view SFR securitizations as having credit risk characteristics that are similar to commercial and residential mortgage-backed securities (CMBS and RMBS), as well as some less frequent nontraditional asset securitizations such as those backed by triple-net leases of commercial real estate (CRE) properties. Standard & Poor's believes SFRs are best seen as hybrid assets--a cross between residential and commercial properties. The rental payments, net of property- and trust-level expenses, and the value of the underlying homes are all critical to the analysis of the securitization trust's assets.

A complicating factor in SFR transactions is the degree of operational risk, which is present in CMBS and to a lesser degree in RMBS, but looms much larger in SFR transactions. Indeed, the continuity of net cash flows from the underlying properties depends heavily on the ability of their owners to manage large numbers of single-family homes, which are often geographically dispersed and uniquely constructed. The properties require ongoing maintenance that can't be implemented with a one-size-fits-all approach, and are likely to be leased (or rented) multiple times during the course of a given securitization's term. The management complexities are unique, and shouldn't be underestimated.

The highest investment-grade rating among nontraditional securitizations with associated operational risks isn't the norm for Standard & Poor's. For example, we typically rate many CRE lease-type securitizations below the highest investment-grade rating, even those sponsored by more-established players. In comparison, the SFR asset class has a shorter operating history, shorter lease terms, and higher operating expense burdens.

Furthermore, we continue to have questions about the size and depth of the property manager pool for this asset class. As noted, skilled property management is necessary to avoid disruptions to the cash flows of a given securitization and to avoid or mitigate future losses. The largest institutional owners of SFR properties have demonstrated an initial ability to scale their property management across very large pools, but none have a track record of managing such a large pool through an extreme economic downturn. Should incumbent property management fail, there is no guarantee that an adequate replacement with sufficient experience to oversee a large portfolio of SFR properties could be found. This risk is compounded in geographic areas where SFR operators have limited local staff or affiliates, significantly reducing the transferability of management and servicing.

While comparisons can be drawn between the SFR and multifamily housing sectors, the SFR sector doesn't yet benefit from the same level and depth of standardized and historical data. In some cases, multifamily rental and vacancy rates may be used as reference points in the absence of historical information on SFR properties. However, Standard & Poor's doesn't view these as sufficient proxies to fully gauge the predictability of rental payments for SFR securitizations without further data.

These ongoing questions are the primary challenges we see in rating securitizations of assets in this developing sector. Standard & Poor's believes it is in the SFR market's long-term interest to continue to address these issues to expand investor participation in this emerging securitization asset class. As with other nontraditional asset securitizations, we will continue to monitor the evolution of this sector. If securitization is to become a viable long-term financing tool for SFRs, we believe a longer track record is needed to help assess whether these risks and concerns have been addressed.

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