PE Firms Impact Real Estate Prices – Part 2

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What began as a quick read turned into a 30 minute research into what is known as REO to Rental, or rental income securities. I wondered what the PE firms would gain by securitizing and essentially, they are selling their portfolios to the public. If they bought $1 BB of real estate, and it jumps to $2 BB, they can sell to other institutional clients, or they could securitize and sell it to a ton of investors. The PE firms collects $2BB, which would be the face value of the bonds, so it provides an exit for the PE firms.

The investors of the rental income securities are now the owners of the underlying assets, which are the homes. The yield is really the rental income over the purchase price of the houses, which is yielding 7-8%, similar to high yield bonds. The collateral is the property. There are some concerns related to this property as vacancies increase. The funds are underwritten with vacancy assumptions at 6%, or a 94% occupancy rate, but recent market conditions are pointing to a weak rental market, which will affect rental delinquencies and thus, the yield. Also, should the value of the homes decrease, we believe the NAV of the funds will decrease and the prices will reflect that.

The PE firms are well aware of the RE market, and wittingly pulled a blitzkrieg into the market and is now abandoning ship. They preferred RE as it provided an alternative asset class to investors, while the equity market was licking its wounds post-Lehman 2008.