Real Estate Lending: Seeking Stability Amid a Housing Imbalance

Despite mortgage rates at levels not seen in more than two decades, home prices in the US have remained elevated. Napier Park Global Capital's **Rajesh Agarwal,** head portfolio manager of the US Mortgages & Consumer strategy, and **Tim Ruberti,** loan origination lead, believe this is likely indicative of a structural shift in the housing market that began with the global financial crisis and was exacerbated by the dislocations of Covid-19. Below, they discuss how housing market dynamics are creating what they believe to be durable investment opportunities in residential real estate credit and how Napier Park seeks to take advantage of them on behalf of clients.

Q:

The conventional wisdom held that the US housing market was likely to struggle in the face of Federal Reserve rate hikes and higher mortgage rates. After more than two years of tighter policy, however, home prices remain near record highs. What happened?

Rajesh:

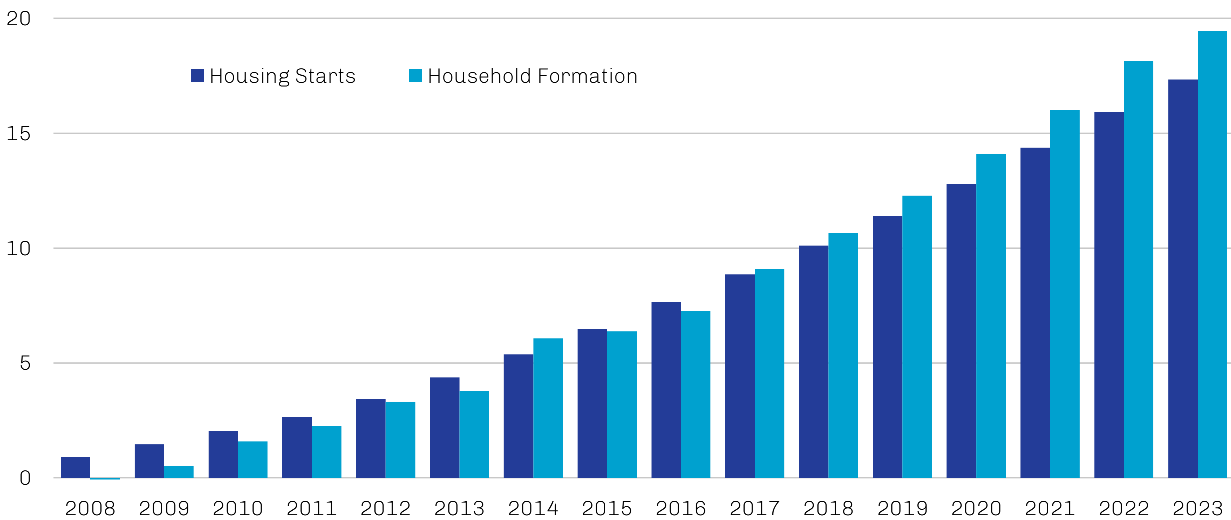
Our view, in short, is that the unprecedented macroeconomic conditions of 2020–22 caused significant structural changes to the housing market. We think these changes are likely to persist.

When analyzing the housing market, we consider a broad range of factors and how they may impact lending opportunities. Affordability—which reflects home prices, incomes and mortgage rates, among other considerations—has long been a key metric for those seeking signs of the housing market's direction. Reduced affordability generally curbs the demand for housing, which in turn weighs on prices and ultimately brings a hot market back into equilibrium. Today, however, US housing prices have continued to appreciate even as affordability has become as challenging as it has ever been.[1] We believe this is due primarily to a significant housing shortage that took root during the global financial crisis and worsened during the Covid era.

After approaching highs not seen since the early 1980s, housing starts fell dramatically beginning in 2006, ultimately contracting about 75% before bottoming in 2009.[2] While household formation also slowed in response to the economic challenges of the global financial crisis, it soon rebounded and ultimately began to grow at a rate that outpaced new construction. In fact, as shown in Exhibit 1, housing starts have consistently lagged household formation since the mid-2010s, turning what had been a surplus of housing as recently as 2016 into a deficit of nearly 2 million homes by the end of 2023. You can see the housing gap accelerate beginning in 2020, as Covid-related restrictions and shortages of building materials and labor constrained construction activity while various economic supports—including stimulus payments and student-loan forbearance—encouraged the formation of new households.[3]

Exhibit 1. The US Housing Gap Has Widened in Recent Years

Cumulative in Millions, 2008 through 2023



Source: Federal Reserve Bank of St. Louis; data as of December 31, 2023.

Tim:

Of course, new construction is only one part of the housing supply equation. In fact, the resale of existing homes represents the vast majority of housing market transactions, and the structural changes in this segment as a result of the pandemic have been even more stark and perhaps may prove more sticky.

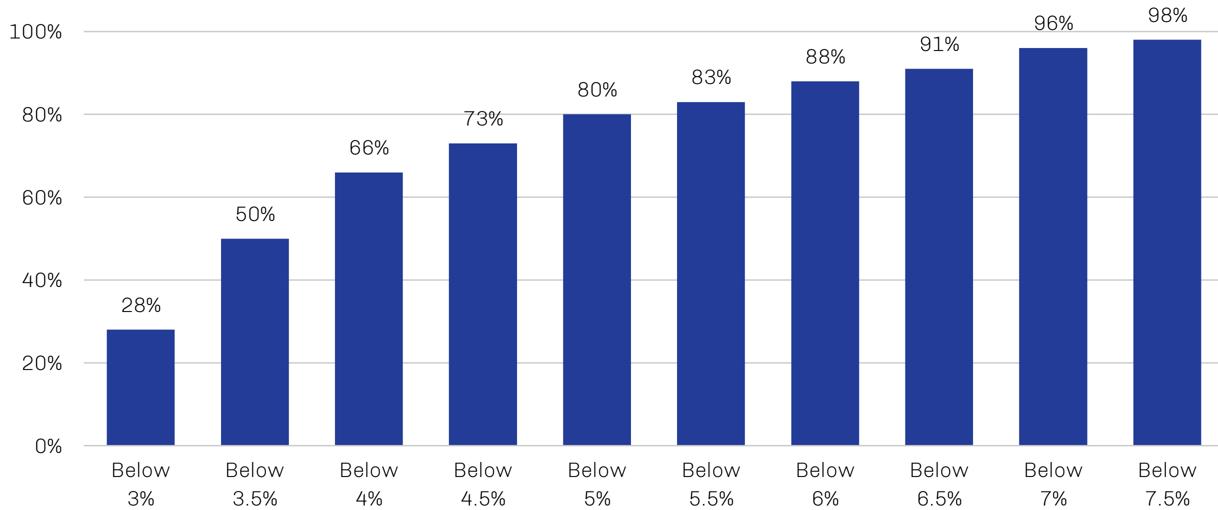
The inventory of existing homes followed a trajectory similar to that of new-home starts with the outbreak of Covid, falling sharply as social-distancing conventions discouraged would-be sellers from allowing potential buyers in their homes.[4] More impactful on the resale market, however, were the rock-bottom mortgage rates that resulted from vigorous central bank intervention. With sub-3% rates readily available throughout 2020–22, homeowners refinanced aggressively; as a result, around 80% of outstanding mortgage debt today carries a rate of 5% or lower, as shown in Exhibit 2. Today's meaningfully higher prevailing rates—30-year mortgage rates have averaged about 7% over the past 12 months—serve as a major disincentive for homeowners to sell, and this "lock-in effect" has weighed on existing-home inventories and sales.[5] Consider the difference in carrying costs between a 7% mortgage rate and a 5% one. If you are buying a $500,000 home with 20% down, your monthly payment on a $400,000 30-year mortgage at a 7% rate is $2,661. At 5%, the monthly outlay would be $2,147—19% less.

1. Source: Federal Housing Finance Agency; data as of February 29, 2024.
2. Source: Federal Reserve Bank of St. Louis; data as of May 31, 2024.
3. Source: Joint Center for Housing Studies of Harvard University; data as of January 17, 2023.
4. Source: Morgan Stanley; data as of February 29, 2024.
5. Source: Freddie Mac, Federal Reserve Board of St. Louis; data as of May 16, 2024.

Unless we have a significant and sustained rally in rates, which seems unlikely at the moment given the path of inflation, it's hard to envision a scenario in which the supply of homes for sale improves materially. We believe this imbalance should continue to support prices.

Exhibit 2. The Mortgage "Lock-In Effect" Has Been a Major Disincentive for Potential Home Sellers

Percentage of Outstanding Mortgages by Rate



Source: eMBS, Freddie Mac, Bureau of Economic Analysis; data as of May 17, 2024.

Q:

In light of these affordability dynamics, the participation of large institutional investors in the single-family home market has come under scrutiny from federal and state lawmakers. Do you think legislation is likely? If so, what impact may that have on housing supply?

Rajesh:

The buying of single-family homes by institutions since the onset of Covid has garnered a lot of headlines, and the rhetoric seems likely to continue throughout this election year. That said, we don't believe institutional buying has had a significant influence on broad housing market dynamics, at least at the national level.

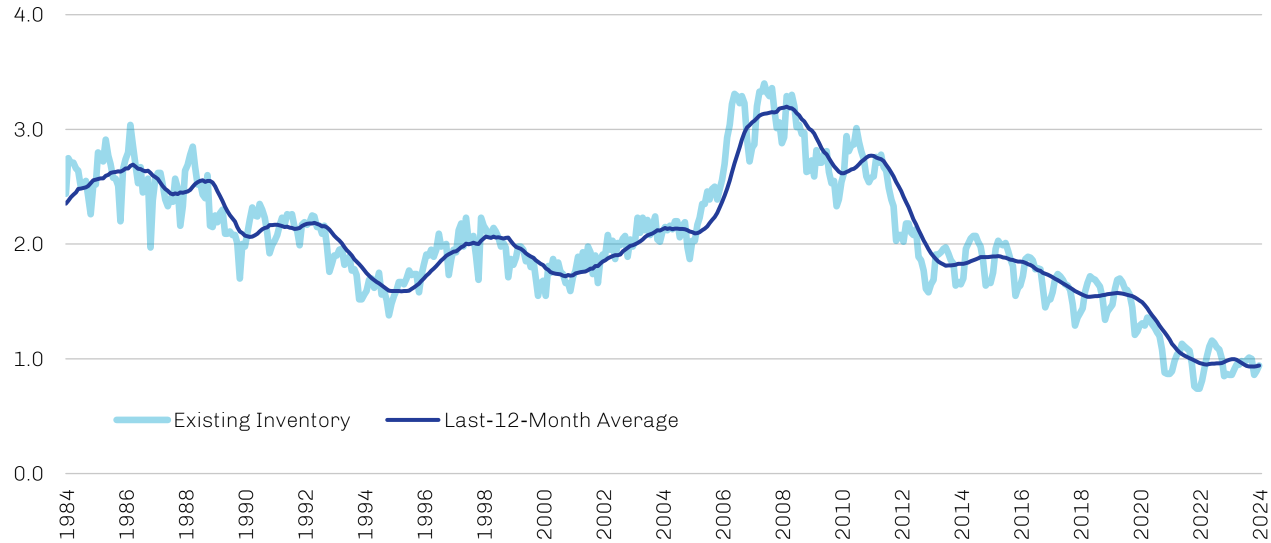
Put simply, the footprint of large, institutional landlords—owners of 100-plus units for the purpose of this discussion—is too small to have a marked impact on national conditions. These investors own and rent out about half a million single-family homes across the country. Compare this with the 105 million units of multifamily and single-family properties nationwide, a metric I consider apt in that it captures the full residential housing stock, both owned and rented. So, institutional buyers are impacting far less than 1% of the total housing market.[6]

But let's suppose certain aspects of these proposals make it into law. For example, the bicameral End Hedge Fund Control of American Homes Act, introduced in December 2023, calls for institutions to phase out their ownership of single-family homes by 10% each year over a 10-year period, after which they would be banned from owning such properties.[7] As shown in Exhibit 3, the current inventory of homes for sale is around 1 million; a 10% annual divestment by institutions would increase supply by 100,000, an amount I believe could be readily absorbed given the current depressed state of inventory relative to its long-term trend and ongoing strong demand. While certain local markets where institutional ownership is more pronounced—including Sun Belt markets like Atlanta, Charlotte, Dallas, Houston and Jacksonville—could feel some impact, the marginal supply would be far less significant on a national level. Of course, it will be interesting to see if lawmaker enthusiasm for regulation persists beyond the current election cycle.

6. John Burns Real Estate Consulting; data as of March 31, 2024.
7. Congress.gov, "S.3402—118th Congress (2023–24): End Hedge Fund Control of American Homes Act," December 5, 2023. Note that the bill defines "hedge fund" as an entity that manages pooled investor assets in excess of $50 million.

Exhibit 3. The Supply of Existing Homes Listed for Sale Remains Very Low

Active Listings in Millions, January 1984 through February 2024



Source: Morgan Stanley; data as of February 29, 2024.

Q:

Given your constructive outlook for the US housing market, where are you finding the most attractive investment opportunities?

Rajesh:

Napier Park has a long history with the ebbs and flows of credit markets, and we believe it's important to remain nimble rather than be dogmatically committed to a particular asset type. This flexibility enables us to rotate our exposures between private and public opportunities as relative value dictates, which in the past has been particularly advantageous during periods of market dislocation. A fear of market slowdown given the rapid increase in interest rates during 2022 and early 2023, for example, pushed spreads wider across public structured credit and provided ample opportunities to buy these securities at what we viewed as a meaningful discount. Now that public spreads have tightened, we believe relative value has shifted in favor of private assets.

Within private assets, we further refine our focus to areas we believe are supported by durable fundamental tailwinds, like constrained supply. In addition, we want investments offering attractive yields and low volatility, as well as short durations and robust cash flows that enable frequent reinvestment of proceeds. Given these parameters, the two segments of the US real estate market that stand out to us are residential transitional loans and land banking. The complexity and liquidity premia offered by these assets currently translate into a yield advantage of 200–300 basis points over more traditional fixed income options like leveraged loans and high yield bonds.[8]

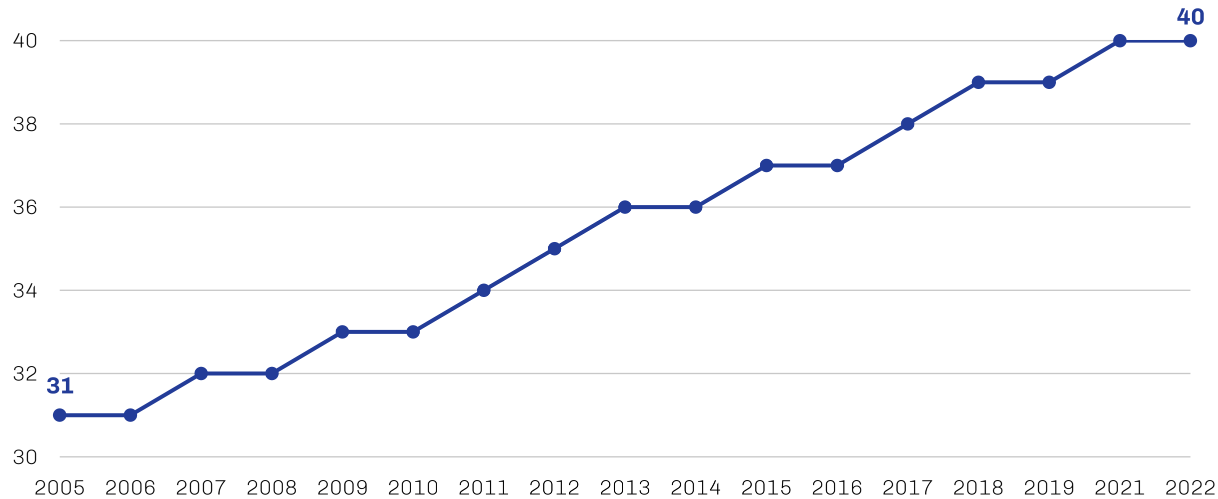
Residential transitional loans, or "fix and flip" loans, fund real estate investors' efforts to purchase residential homes and quickly renovate and resell them at a profit. Commercial banks have pulled back from providing this type of financing in recent years, but a fragmented group of specialty lenders have stepped in to fill the void. The majority of these lenders lack the capital to underwrite and hold these loans at meaningful scale, however, which has created an opportunity for asset managers like Napier Park to construct diversified portfolios of loans selectively purchased from originators.

Providing liquidity to this space enables us to take advantage not only of the supply/demand imbalance in housing that Tim mentioned earlier but also the aging of the US housing stock. As you can see in Exhibit 4, the median age of an owner-occupied home has been climbing steadily and now stands at 40 years, suggesting that renovations are likely required to bring these homes up to modern living standards and maximize their resale or rental values.

8. Source: Citi Research; data as of December 4, 2023.

Exhibit 4. Aging Housing Stock May Drive Demand for Renovation Capital

Estimates of Median Age in Years of US Owner-Occupied Housing, 2005 through 2022



Source: US Census Bureau, American Community Survey; data as of December 31, 2022.

Note: The Census Bureau did not release the standard American Community Survey in 2020 due to data-collection disruptions experienced during the Covid-19 pandemic.

Tim:

Another byproduct of post-crisis US housing market dynamics is a shortage of permitted, build-ready lots for single-family construction. The ownership of these lots can tie up substantial capital on a homebuilder's balance sheet, and many are willing to pay a significant spread over benchmark interest rates for the optionality and off-balance-sheet treatment of a land-banking arrangement.

Here's how a land-banking deal typically works. A lender acquires an entitled, permitted and improved property while simultaneously entering into an agreement with a homebuilder giving them the option to acquire lots on this property over time in exchange for a nonrefundable fee. The two parties also commonly enter into a construction agreement whereby the builder is paid by the land banker to develop the land, and a "takedown schedule" governs the pace at which the homebuilder must acquire lots on the property. Given their financial strength and long operating histories, large public homebuilders have the capacity to furnish significant upfront deposits and completion guarantees, and cover entitlement risk and environmental liabilities.

Q:

How did Napier Park's real estate lending strategy come about?

Tim:

Napier Park has been involved in real estate lending for more than a decade, but for most of that period we concentrated on investing in securitized products like non-agency mortgage-backed securities. Following the post-crisis bottoming of the housing market and its subsequent rebound, however, we felt that much of the potential price appreciation in the public markets had been realized, and we were exploring other ways to leverage our expertise underwriting residential loans. Further, we recognized that the availability of bank financing for certain types of real estate activities had been curtailed even as the demand for housing outstripped supply, creating an opportunity for alternative providers of liquidity.

After several years of researching various ideas, we began to build portfolios featuring the specialty-lending segments we manage today, including residential transitional loans and land banking. We believed these areas had the potential to offer the most attractive combination of consistent yield premia, short durations and robust cash flows, while also being somewhat insulated from the day-to-day volatility we felt was likely in public market securities.

Rajesh:

There are high barriers to entry in real estate lending, and building a capability at scale was an intensive, protracted process. Our intention to purchase and hold mortgages directly, for example, required that we establish a network of counterparties we could transact with consistently. The team evaluated more than 100 mortgage originators—looking closely at such factors as tenure of the business, geographic footprint, lending capacity and balance sheet strength—to narrow the universe down to 10–20 lenders.

In our view, data is king when it comes to underwriting loans in the housing market. With no off-the-shelf, centralized resource available to support our underwriting process, however, we needed to develop our own data solution.

We aggregate information derived from both public and proprietary sources to develop a granular view on the history and current condition of property sales and loan-servicing activity in the US. This includes a database of the more than 20 million mortgage loans currently outstanding in the US and their status, as well as another that looks back at residential transaction history based on decades of MLS (multiple listing service) listings. We also tap into a database that includes almost all private real estate transactions in the US, which enables us to review borrowers' track records in previous private transactions.

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Finally, and perhaps most impactful, is our private database of the 7,000-plus loans Napier Park has transacted across about 5,000 borrowers. In addition to basic underwriting data like location, address, size, property photographs, the borrower's credit report and payment history, etc., it also includes a detailed history of the borrower/lender relationship over the course of each loan. Did the borrower have any problems during the period of the loan, like a lien or a liquidation need that required special considerations? Has the borrower been subject to foreclosure beyond the seven-year period covered by their credit report? How did the borrower react to severe macroeconomic challenges, such as the global financial crisis or Covid-19?

Tim:

While we look at real estate market fundamentals broadly, our investment process is built on underwriting individual loans. At the end of the day, the more information we have about borrowers and properties, the better positioned we will be to make good decisions when deploying our clients' money.

Q:

How does the real estate lending strategy work alongside other strategies in a diversified portfolio?

Tim:

Whenever we develop an investment strategy for clients—predominantly institutions, but we are also introducing retail solutions—we're cognizant of how it may fit within a broadly diversified, multi-asset class portfolio. In many cases, there is no one right answer; it's highly investor-dependent. That said, we believe the diverse asset class exposures of the residential lending strategy —which include private credit, real estate and fixed income —can be a source of flexibility for those with strategic allocation targets.

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- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
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- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below investment grade loans, which may default and adversely affect returns.

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