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EXCLUSIVE

The Rise of Private Fund Lenders

By Steve Edwards and Jubin Meraj at law firm Manatt, Phelps & Phillips | Commentary

As the market for traditional home loans made by banks and other customary lenders remains constrained, despite the growth of housing sales generally, the market for non-traditional mortgage lending may be positioned to expand significantly, says Edwards.

ORANGE COUNTY—Many have attributed the financial crisis that started in late 2007 in significant part to fallout from the home mortgage meltdown. Less well-known is the fact that the very industry that arguably set the stage for the downturn has generated important economic opportunities for certain investors and entrepreneurs. Today, as the market for traditional home loans made by banks and other customary lenders remains constrained, despite the growth of housing sales generally, the market for non-traditional mortgage lending may be positioned to expand significantly.

A simple comparison of the pre-recession housing market to the current market provides insight on the changing mortgage industry. Prior to 2008 the landscape of housing looked something like what you might expect in a “normal” economy: 85% of sales were of non-distressed homes with traditional mortgages to individuals, 10% were all-cash sales of non-distressed homes, and approximately 3-5% were distressed sales. The breakdown in 2013 seems radically disparate in comparison: only 40% of sales were to individuals purchasing with mortgages, 40% were all-cash sales, 15% were distressed sales and 5% were flips.[1]

Indeed, the end of 2013 marked a three-year high in distressed sales in the United States at 16.2% of all residential sales.[2] Though it is true that the most recent numbers from RealtyTrac show a slight dip in sales of distressed homes – only 14.3% of all U.S. residential sales in May 2014 – distressed sales are still disproportional when compared to pre-meltdown rates. Rounding out the picture is the recent increase in the volume of home sales and rise in median home prices, despite the high level of activity for distressed properties.

This all begs the question – what do buyers of these distressed assets intend to do with them? And, perhaps more importantly, who is financing (and underwriting) all of these distressed home sales?

As to the first question, the answer of course varies by buyer. But there is a growing sector of buyers who are looking to recapture value in what they believe to be significantly undervalued homes. The median price for distressed homes in May of this year ($120,000) was 37% below the median price for non-distressed units nationwide.[3] Private investors are capitalizing on opportunities to purchase these homes at low values (relative to historic prices), adding value by renovating them, and then holding them out for lease or resale at prices on par with or better than the non-distressed inventory.

As to the second question of where the money is coming from, it is clear that traditional banks are not willing to finance the “fix-and-rent/flip” investors. These loans – characterized by banks as high-risk but low-yield commercial loans – are not the types of credits traditional lenders want to put on their books. Instead, much of the capital is coming from Wall Street equity. Perhaps the most illustrative example of this is the story of Blackstone Group LP. Blackstone, one of the nation’s largest investment firms, has spent the last two years becoming the country’s largest residential landlord by buying 41,000 properties, most of them distressed. Industry wide, institutional funds like Blackstone’s have acquired 1 million homes in the past three years.[4]

But the U.S. housing market is no small pie – based on the most recent numbers from May, sales of residential properties exceed 5 million units, or close to $1 trillion, on an annualized basis.[5] So even taking into account the abundance of Wall Street money, the level of activity in the distressed space indicates a large body of potential borrowers underserved by traditional lenders.

Stepping up to fill that void are entrepreneurial real estate veterans who are forming private funds that originate and acquire home mortgages specifically for the “fix-and-rent/flip” sector. The private fund lenders are making short-term (6-12 months), relatively high yield loans for acquisitions of both distressed and opportunistic residential properties. These lenders are also using warehouse lines of credit (somewhat paradoxically, often from national banking institutions) to further improve returns to their investors by leveraging their lending activity. Perhaps even more ironic, the loans acquired by the private fund lenders are sometimes securitized and resold to the investment arms of big banks – banks that would not have made the underlying loans in the first instance.

One important question is whether the model developed in the changed home mortgage industry can and will be duplicated in other underserved credit markets. Much of the same economics – high volumes of distressed properties selling for markedly discounted values and historically neglected by traditional banking institutions – are at work in other industries as well. Distressed small apartment buildings and small shopping centers may next capture the attention of Wall Street and the private fund entrepreneur.

[1] Housingwire (Trey Garrison), Do investor home sales mask a sick housing market?, February 6, 2014.

2 Ibid.

3 RealtyTrac, U.S. Median Home Prices Increase 13 Percent in May as Higher-end Sales Account for Bigger Share of Market, June 22, 2014.

4 Bloomberg (Heather Perlberg and John Gittelsohn), Wall Street Unlocks Profits from Distress With Rental Revolution, December 20, 2013.

5 RealtyTrac, Ibid.

Steve Edwards, partner, and Jubin Meraj at law firm Manatt, Phelps & Phillips. The views expressed in this column are the author's own.

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