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Home fires burn

Evan Lorenz writes:

"I think industrial will be a winner from e-commerce demand," ventured a knowledgeable real-estate man in a segment-by-segment survey of the post-pandemic prospects for American property markets. "Self-storage will be a winner for the same reasons as we saw in the last crisis: downsizing.

"Apartments will be a winner but have a moral-hazard issue," our friend—his name is John Needell, president and CIO of Kairos Investment Management Co.—went on. "Money is flowing to the right people, but will they use it for the right thing? Retail will get hit with redevelopment expenses. Office is going to get hurt, probably a little less than retail. Hospitality is a yard sale. It is horrendous."

A national policy of mass unemployment was never going to be bullish. How it bears on real estate broadly is the first topic for analysis. The investment merits, or lack thereof, of Invitation Homes, Inc. (INVH on the New York Stock Exchange), owner/landlord of almost 80,000 single-family houses, is the second item on the agenda.

Skipping down to the bottom line, our conclusions are, respectively, "pretty bad with one possible exception" and "bearish."

Embedded in the Coronavirus Aid, Relief and Economic Security Act is a 120-day moratorium on evictions of renters from dwelling places financed by, or through, a U.S. federal agency. Such protection covers no more than 28% of the American rental-housing stock, according to the Urban Institute, but the spirit of the legislation may turn out to be of greater consequence than its statutory power.

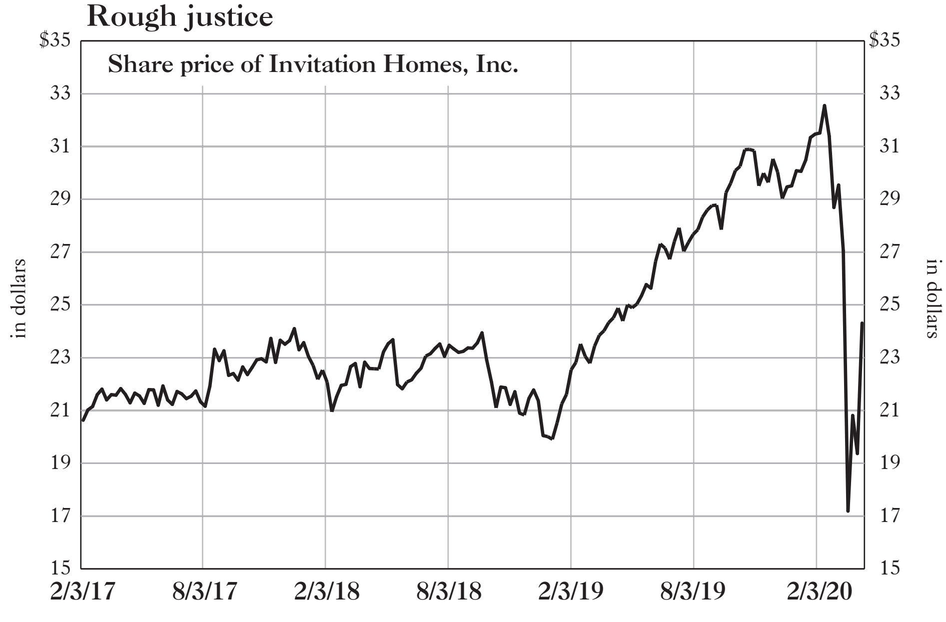
Americans were not so flush as you might imagine they'd be at the end of a 10-year business expansion. As of one year ago, 39% of a survey group could not have produced the cash with which to meet an unexpected $400 expense, according to the Fed's latest "Report on the Economic Well-Being of U.S. Households."

A late-March *Financial Times*/Peter G. Peterson Foundation poll uncovers the unsurprising data that the novel coronavirus has cost 73% of Americans a portion of their income, including 24% who have suffered "very significantly."

Perhaps recipients of the Treasury's $1,200 pandemic checks (and expanded jobless benefits) will turn those windfalls over to the landlord. The National Multifamily Housing Council must certainly hope so. It finds that, as of April 5, 31% of tenants had failed to pay their rent, compared with 18% who had not remitted funds on the same date one year ago.

Landlords will never get the sympathy vote, but the withholding of rent ripples far and wide. "You've got to broaden your thinking," a real-estate investor who owns office, retail and apartment buildings in New York City tells me. "It's not just that if we don't get the rent, we don't pay the mortgage. We can't pay our Con Edison bill. What happens to ConEd? We can't pay our insurance bill. We'll run out of

Rough justice



source: The Bloomberg

money, and we can't pay our employees.... The City of New York looks for most of its income from the commercial real-estate tax."

"If I lose a tenant and have to replace them, that is $50 to $100 per square foot," our nameless source goes on, alluding to the cost of renovating space to attract a successor tenant to the one who won't, or can't, pay. "That's why we don't want to lose any, and why we'll work with someone. The cost of putting someone in is higher than the cost of keeping the slow-pay incumbent."

"If we lose a month," our informant continues in response to a question about the likely timeline of distress, "let's just talk a month—that is one-twelfth. I would argue that any well-founded business can lose one-twelfth of its revenue and make it through. By hook or crook, you have enough cash, you can go to your bank. One month we can handle. We'll argue with our tenants. The second month it becomes geometrically harder. If you get to three months, there is no business I know that can lose a quarter of its revenue and survive."

He leaves us with this thought: "If the government starts saying, 'Don't pay,' then the system falls apart."

Is there not one beam of sunshine? Needell has one: "Everyone I've talked to who is sheltering-in-place who has a vacation home or a second home is in that second home. People in Lake Tahoe or Vermont are telling me that all the driveways are full of cars. The retailers and the grocers are doing great in these resort towns, though they are having trouble with supplies. This might be a weird niche in the market where second homes become more valuable because this is viewed as a likely risk in the future, which is counterintuitive."

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Invitation Homes came into the world in 2012 as The Blackstone Group, Inc.'s vehicle to buy up cheap houses in the wake of the 2008–09 financial crisis. Five years later, the acquisition of Starwood Waypoint Homes almost doubled the Invitation portfolio to 81,979, making INVH the largest single-family lessor in the 50 states. A December liquidation of most of the Tennessee portfolio reduced the grand total to 79,505.

Invitation's M.O. is to own and manage large blocks of houses in prosperous, fast-growing markets that, through one policy or another, discourage new residential construction.

Invitation Homes, Inc. at a glance
all figures in $ millions

	2019	2018	2017	2016	2015
revenue	$1,764.7	$1,723.0	$1,054.5	$922.6	$836.0
total expenses	1,725.5	1,784.6	1,193.2	1,017.9	995.4
other, net	11.6	7.0	-1.0	-1.6	-3.1
gain on sale	96.3	0.1	33.9	18.6	2.3
net income	145.5	-4.9	-105.3	-78.2	-160.2
cash	92.3	144.9	179.9	198.1	274.8
debt	8,467.5	9,249.8	9,651.7	7,570.3	7,726.0
assets	17,392.9	18,063.4	18,683.6	9,732.4	9,797.0

source: company reports

California, Seattle, Phoenix, Las Vegas and Denver produced 39.4% of fourth-quarter revenue; Florida chipped in 31.4%; Atlanta and the Carolinas, 18%; Texas, 5.1%; Chicago and Minneapolis, 5.3%.

The average Invitation Homes tenant, the front office says, is 39 years old, is married with kids, makes $100,000 a year and pays a monthly rent of $1,809. Even so, says John Pawlowski, head of residential research at Green Street Advisors, LLC, the typical INVH renter has a 650 FICO score, below the 706 national average.

Invitation Homes closed 2019 on a high note. Tenants occupied fully 96% of its houses, and a 3.4% rise in rents helped to produce a 3.8% jump in like-for-like net operating income. "In 2020, we expect to grow same-store net operating income by 4.25% at the midpoint of our guidance," CEO Dallas B. Tanner told listeners-in on the Feb. 19 earnings call. "This expectation is supported by strong market fundamentals. Across our unique footprint, household formation rates have been running at over twice the U.S. average, and many of these households have demonstrated a preference to lease."

Hence the bull case for a stock that, at 22.6 times enterprise value to trailing earnings before interest, taxes, depreciation and amortization, nobody would call compellingly cheap (not even with the 2.5% dividend yield attached). Yes, goes the bullish argument, a wave of millennials is reaching peak home-buying age (see the issue of *Grant's* dated April 3), but they need savings enough to swing a down payment. As many don't have the cash, demand for single-family rentals will remain robust. And having wisely built a portfolio in the most desirable markets, Invitation Homes should outgrow its competition.

"Based off of Invitation's going-in yield, you get to a—call it high 6%—unlevered internal rate of return, which screens well compared to other sectors Green Street covers," Pawlowski, who rates INVH a buy, tells me. "It's roughly 75 basis points north of the U.S. average."

Anyway, acquiring a portfolio of almost 80,000 homes over eight years hasn't come cheap. At year-end, Invitation's net debt footed to $8.4 billion, or 8.9 times last year's $940.1 million in Ebitda. Unrated INVH will one day become an investment-grade company, CFO Ernest Freedman indicated on the Feb. 19 earnings call. A spokesman advises that this goal will likely require a leverage ratio close to 6 times Ebitda. In 2019, Ebitda covered interest expense by 2.6 times.

Of the 18 analysts who cover the stock, 14 say buy against one who says sell. Short interest constitutes only 1.8% of the float, though insiders themselves constitute a kind of bears' club. Over the past 12 months, they've dumped a net 2.2 million shares for proceeds of $65.5 million. And that excludes Blackstone, which owned 34.3% of the float as recently as April 2019. It sold its last share in November.

As for the Invitation front office in the coils of the pandemic, it can't be said that here, at least, "we're all in this together." On Feb. 21, a time when Delta Air Lines, Inc. CEO Ed Bastian and Fiat Chrysler Automobiles N.V. CEO Mike Manley, to name two, were taking pay cuts to show solidarity with struggling employees, the board of directors boosted compensation for the C-suite, including a 50% raise for CEO.

Since Florida, California and Seattle together generate some 57% of corporate property income, Invitation is hardly out of the viral line of fire. And, since 2018, the company has positioned itself as a middleman between customers and utilities in new leases. "In many cases, the company pays local water, sewer and waste removal services directly and subsequently bills tenants for reimbursement plus a monthly utility management fee," Capitol Forum, a Washington, D.C.-based research firm notes. So, Invitation is in many cases on the hook for utility bills if tenants don't pay.

Another plank in the bearish platform is Invitation's contentious relationship with those tenants. We here incorporate by reference long-form exposés by *The New York Times* (March 4) and *The Atlantic* (Feb. 13, 2019), numerous complaints on customer-review sites and the content of a Facebook support group called "Tenants of Invitation Waypoint Homes." Broken appliances, pervasive mold, leaking roofs and broken air-conditioning units feature among the critics' particulars. Invitation is slow to fix problems (if at all), the collective refrain goes, and tries to saddle its renters with the cost of repairs—and with the effective-rent-raising gambit of loading on nuisance fees.

(While INVH stopped disclosing fee-based revenue after the Waypoint acquisition, the Feb. 19 call revealed a 10.8% rise in "other property income," far outpacing the overall 3.4% rise in rents.)

Of course, some customers are impossible to please, and happy tenants rarely write reviews on the Better Business Bureau's message boards. However, a comparison of INVH with AvalonBay Communities, Inc., an apartment REIT with 79,636 units, suggests that Invitation has more than an image problem.

Thus, while reviewers rate each company a hair above one star, Avalon has logged 31 complaints to Invitation's 307. For the volume of complaints and for each company's track record in dealing with such problems, the Bureau rates Avalon A-plus and has downgraded Invitation to not-rated from C-plus as *Grant's* went to press.

"When you own 80,000 homes," Greg Van Winkle, Invitation's head of investor relations, tells me in response, "there are always going to be some cases where you don't get it right 100% of the time. But we take every single one of those seriously, and we strive to get it right 100% of the time. And I would say it's the No. 1 principle in our business that guides the way we do things: Putting the residents first....We want to keep homes occupied, keep residents in the home."

In that worthwhile cause, adequate maintenance capital spending is, of course, a must. From which it must follow that if Invitation were underspending, earnings must be overstated. Van Winkle says that normalized capex per house is about $3,000 a year, or 1.5% of the depreciated book value of an Invitation property. Multiply an annual outlay of $3,000 times 79,505 houses, and you get $238.5 million a year in maintenance capex, whereas management, last year, spent $164.2 million, not counting $57.4 million on initial renovations for newly acquired houses.

"What is the maintenance capex on this portfolio?" James Chanos, founder and managing partner of Kynikos Associates, L.P., rhetorically asks, and he answers: "The Realtors Association will tell you that it is 1% of the value of the home every year. Freddie Mac has told people to expect 4% per year. I've spoken with real-estate brokers who specialize in this stuff, and they say that, if it is rental single-family homes, the number is really 4–5% per year because tenants beat these things up.

"At 3%, the figure I use, you are talking about $500 million a year and they are spending less than $200 million," Chanos, who is short INVH, continued. "It does make a difference." Deducting the $500 million in normalized capex from the Ebitda gives $440 million, which, on Invitation's $21.6 billion enterprise value, gives a cap rate of about 2%.

"Whatever you think," said Chanos, "this is not a 2% type of asset. You can dial the capex assumptions up or down, but any way you cut it on how the market is valuing residential real-estate assets once removed, mortgage REITs or otherwise, no one is valuing these assets at a 2% cap rate."

Nor does Invitation have the single-family, home-rental market all to itself. On April 8, Booking Holdings, Inc., the owner of travel sites including Booking.com, Priceline.com and Kayak.com, disclosed that newly booked room reservations, excluding cancellations, fell more than 85% year-over-year "in recent days." Also facing a precipitous decline in demand, Airbnb, Inc. sold $1 billion's worth of bonds at a spread of the three-month London interbank offered rate plus 10% and free warrants at an $18 billion valuation versus a $31 billion value the last time the short-term-rental company raised capital. As a result, many Airbnb hosts, who themselves have mortgages to service, are turning towards long-term renters for revenue according to a March 25 CNBC dispatch.

Following Blackstone out the door, Barry Sternlicht, the chairman and CEO of Starwood Capital Group, and two out of the three directors associated with Blackstone, will be stepping down from the board, it came to light last week.

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"I dreamt I got a haircut."