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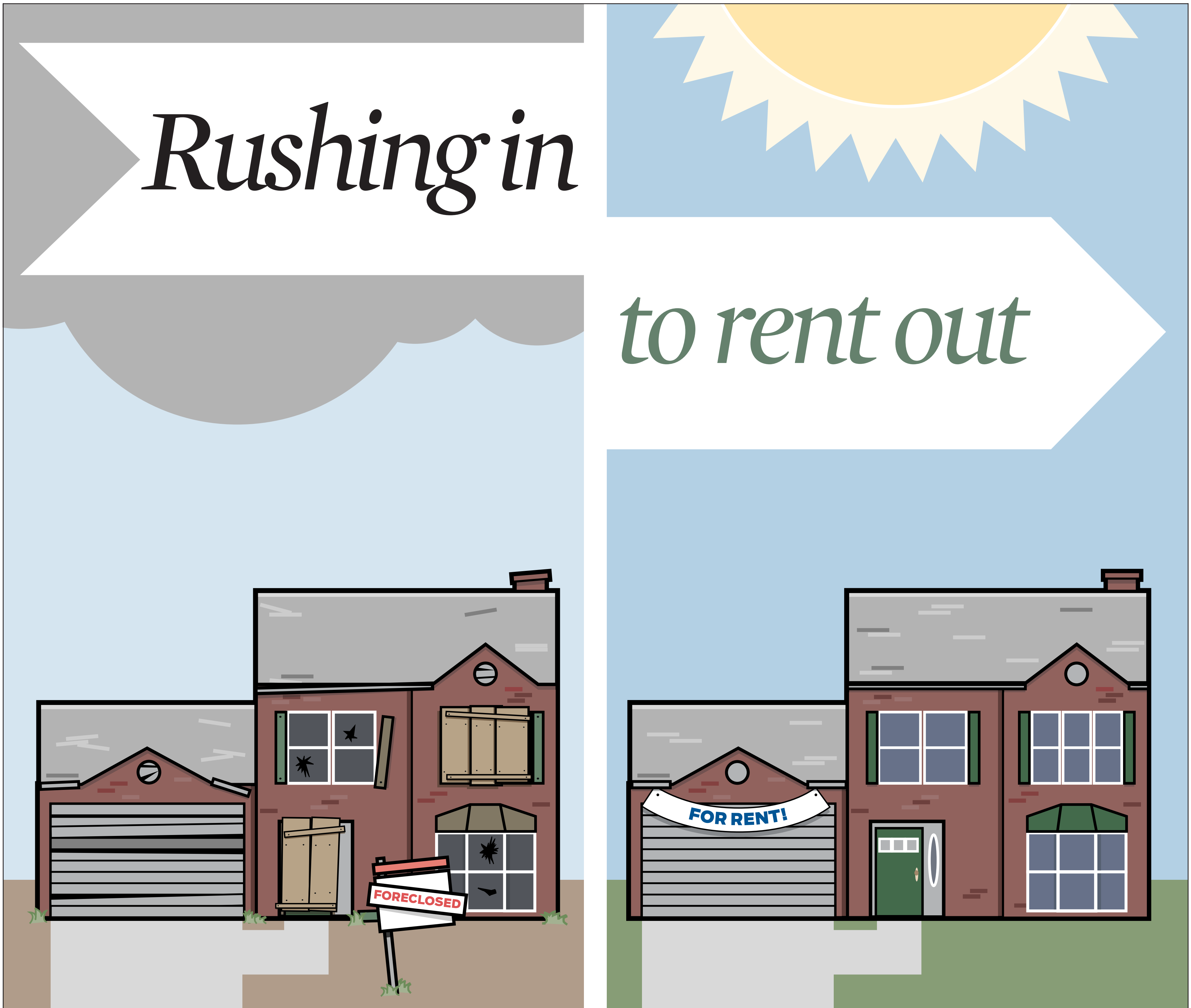
BUSINESS

Rushing in to rent out



ALEXANDER HELBACH/TRIBUNE ILLUSTRATION

Communities wonder if out-of-town private equity funds will be good neighbors

By Mary Ellen Podmolik
Tribune reporter

The foreclosed home on Kenmore Street in Aurora was an outdated, unkempt eyesore until crews arrived this fall, performing thousands of dollars of work to make it attractive and modern, inside and out.

But it wasn't until workers walked across the street to ask for some water that neighbors Mario Cervantes and Oralia Balderas-Cervantes learned that a corporation, not a consumer, had bought the house, intending to turn it into a rental property. Despite being landlords themselves, the couple aren't sure they like the idea.

"If it's going to be a company that is watching out for the community, yes," Cervantes said. "If it's going to be a company that is watching out for themselves, no."

Added Balderas-Cervantes: "I'd rather see a homeowner. A lot of renters don't care. It's like renting a car versus buying a car. It's different."

Similar scenarios and concerns are unfolding across Chicago and in other markets hard-hit by the housing crisis. Well-capitalized, out-of-town private equity funds are scouring neighborhoods, paying cash for distressed single-family homes and renting them out. The opportunities are plentiful, enabling investment groups to profit from low home prices, rising rents and an increase in the number of potential renters.

The transactions are returning vacant properties to active use. But they also are stoking fears among neighbors and municipalities about the long-term effect of large, private investors — including many that are operating under the radar — in their communities.

"This scares the hell out of me," said Ed Jacob, executive director of Neighborhood Housing Services of Chicago Inc. "In this rush to say this is a new asset class, are we creating the next community development problem?

"You talk to them and it's all about

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Investors rushing in to rent out

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SCOTT STRAZZANTE/TRIBUNE PHOTO

Leslie Mendoza, 8, uses a laptop as her father, Felipe Mendoza, right, and his nephew Aaron Carrillo and Carrillo's 9-month-old son, Jayden, gather in the kitchen of the Aurora house rented by the Mendoza family. The residence is a former foreclosure.

neighborhood recovery. They all have the narrative down."

In April, housing research firm CoreLogic named the Chicago area one of the better housing markets for institutional investor funds. It cited the area's large number of foreclosures, which will increase the number of vacant homes, and the estimated rental income relative to the low cost of acquisition.

The general strategy of the companies is the same: buy low, make the necessary upgrades, fill them with tenants and then sell the homes in three to seven years. With companies and analysts anticipating projected returns of at least 8 percent, there also is talk of creating publicly traded real estate investment trusts.

"What this reminds me of is the dot-com boom," said Rick Sharga, executive vice president of Carrington Mortgage Holdings LLC, a California firm whose asset management arm is actively looking in the Chicago market. "That's what this feels like. Every investor in America wants to buy foreclosures and turn them into rentals."

Two statistics increasing that appetite are the homeownership rate and rental rates. Foreclosures, tight lending conditions and wary consumers have pushed down the nation's homeownership rate to 65.5 percent at the end of September, according to census data. Meanwhile, the percentage of vacant rental units has been on a steady decline since 2010 as more people opt for leases rather than mortgages.

Tighter inventories are pushing up rents. As of October, annualized rents in Chicago were up 7.7 percent, more than the national increase of 5.1 percent, online real estate site Trulia found.

But investors aren't flocking to all neighborhoods equally. Most want homes in desirable neighborhoods with strong area employment. They also look at the strength of local rules protecting landlords in disputes with tenants.

After vetting the tenant and securing a lease, property managers say they routinely drive by the homes and sometimes schedule inside inspections to protect their investment.

WARREN SKALSKI/PHOTO FOR THE TRIBUNE

Oralia and Mario Cervantes, of Aurora, stand in front of a house that a corporation has converted to a rental property across the street from their home.

Risk vs. reward

It remains to be seen whether their expectations will be met. One problem with the business model is there's no performance track record to speak of. And as housing prices slowly recover, acquisition costs also will increase and cut into returns.

There also isn't any history on property management firms tasked with overseeing so many scattered-site rental properties. Any well-publicized mistakes involving poorly maintained properties or wronged tenants could taint investors' reputations.

That's one reason why big-name players are likely to avoid buying in neighborhoods where they fear a greater chance of eviction proceedings occurring.

"You make one mistake in those properties and you'll be toast," Sharga said.

While some funds have outlined plans for foreclosure-to-rental conversions, it's impossible to easily quantify the purchases. For one thing, purchasers have formed various corporate entities to do the deals. In other cases, there's uncertainty about whether investors plan to resell the homes immediately or rent them and outsource property management to other firms.

An early leader in the sector, and one of the first of the larger firms to make significant inroads in Chicago, is Waypoint Real Estate Group LLC, which recently secured more than $300 million in financing from Citigroup to expand its national portfolio. Since July, Waypoint has paid cash for almost 90 homes in the far western and southwestern suburbs, 40 in October alone, and it hopes to quicken its pace to as many as 100 homes a month.

Unlike other companies, Oakland, Calif.-based Waypoint is handling the purchase, rehab, renting and management of homes internally. It has established a Chicago office to oversee its local operations and its expansion into other Midwestern cities.

"We're providing an answer to what has been a challenging period of time," said Charles Young, Waypoint's regional director.

By design, its portfolio includes homes of various sizes in different types of neighborhoods, with rents running from $1,250 to $2,600 a month. On average, it invests $20,000 in property improvements; much of that work is done in the kitchens and bathrooms. It likes two-year leases because it finds the occupants act more like owners than renters.

In fact, Waypoint tries not to use the word "renters" because it argues the term has negative connotations. "We call them 'residents,'" Young said. "We find ourselves trying to change that perspective."

Felipe and Mily Mendoza and their family have been renters since losing their home to foreclosure in 1998. Five weeks ago, they moved into a Waypoint home in Aurora close to an elementary school. It's a home with updated bathrooms and a spacious kitchen that easily accommodates the large oval table for their extended family.

Felipe Mendoza doesn't mind the $1,575 monthly rent because the home is in much better shape than their last rental, and he likes the two-year lease. He's also participating in a Waypoint program that rewards him with points for taking care of the property, paying the rent on time and repairing any credit problems.

At the end of the two years, accumulated points are credited toward a purchase of the home, something Mendoza would like to do, now that he's gotten to know the neighbors. "Everybody told me, 'We hope you keep the home,'" he said.

Carla Gregg lives next door to a home Waypoint recently purchased in a different Aurora neighborhood, a 4-bedroom, $2\frac{1}{2}$-bath property that will rent for more than $2,200 a month. Another renovated Waypoint home is for rent a few doors away in the other direction.

She's been on the receiving end of some people's negative perceptions of renters. When she and her husband moved into the subdivision 15 years ago, they rented a home on another street and didn't feel welcomed by neighbors. As a homeowner now, she thinks "renter" is taking on a more positive connotation.

"The majority of people understand that with the economy, this is the way it's going to be," Gregg said. "People would rather have residents than vacant homes, for security reasons."

Cities scramble

That's a sentiment shared by the Chicago Metropolitan Agency for Planning, which has been working with communities grappling with how to address an influx of rental properties. Such oversight is difficult for strapped local governments. In addition to private equity funds and mom and pop investors, individual homeowners are renting their homes because they're unable to sell them.

"It's not a question right now of owner versus renter," said Andrew Williams-Clark, principal planner at the agency. "Right now the economy is going to decide that. Right now the question is occupied versus vacant. The best thing you can do is make sure that whoever is occupying it is keeping (it up)."

Many municipalities put the onus on owners to come forward and identify themselves as landlords and be subject to rental ordinances that have been expanded, some very recently, to include single-family properties.

Southwest suburban Woodridge, for instance, in July adopted a new residential rental program that requires owners of single-family rental homes to register with the village. They or their property management company must attend a seminar on crime-free housing.

After a year of consideration, a new ordinance takes effect Jan. 1 in Buffalo Grove that also will require all rental properties to be registered. Single-family homes, town homes and condos that are turned into rental properties will be inspected annually.

"We have no problem with somebody out of state owning property," said Carol Berman, deputy building commissioner, administration, with the village. "But we do care that they have somebody here that is responsible that we can contact 24 hours a day. The whole idea behind this is to protect the character and stability of the residential neighborhood. We want to make sure nothing happens that adversely impacts that."

There also are concerns that private equity funds are underestimating the costs associated with the business. Unlike other active foreclosure-to-rental markets such as Phoenix, Las Vegas and parts of Florida and California, much of the housing stock in Chicago is older. Seasonal factors like snow also may slow a company's progress.

"There are a thousand steps in between buying it and generating an 8 percent return, said Eric Workman, vice president of sales and marketing at Mack Cos., a Tinley Park firm that has been turning distressed homes into rentals for 15 years.

"The model works so well on paper and then you throw an asset with a million moving parts and people into it and you have the opportunity for things to go well or things to go really bad. For a company to just raise $500 million and say we can make it work is just asinine."

Mack has been approached by several institutional investors seeking to partner with it, and those discussions continue, Workman said.

Meanwhile, Mack remains in litigation with a lender, FirstMerit Bank, which alleges that Mack failed to pay the required Cook County property taxes on 65 homes.

Fannie Mae, which held more than 107,000 foreclosed properties in its portfolio in September, recently completed bulk sales to investors of equity interests in almost 2,000 foreclosures, most of which were occupied by tenants.

The transactions included 94 properties in the Chicago market that were sold to The Cogsville Group LLC, a firm looking for additional residential investment opportunities.

About 60 percent of Fannie's vacant properties are sold to noninvestors. Fannie Mae President and CEO Timothy Mayopoulos said he prefers to sell the agency's homes to owner-occupants, only in part because investors demand greater purchase discounts.

"We think that's better for neighborhoods long term," he said. "We very much want to favor people who live in these communities."

Carrington's Sharga understands the concerns but offers a caveat: "Don't be afraid of the investor. This is a win-win if it's done correctly."

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