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Housing 2.0: The New Rental Paradigm

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Housing 2.0: Trade Ideas and Recommendations

What is Housing 2.0?

- Across the country, more Americans are becoming home renters, and fewer Americans are becoming homeowners. The beginning of the rentership society is upon us. But all renters are not equal – of the roughly 40MM rental housing units in the country (representing roughly $6 trillion in asset value), about half are multi-family and half are single-family. In this joint report between our US Fixed Income Housing Strategists and US REIT research teams, with contributions from our Chief US Equity Strategist and Large-Cap Banks Analyst, we take a closer look at what the growth of the rentership society implies for both the single and the multi-family rental markets. What opportunities will be created? How will the two sides of the rental market benefit from this transition? What are the greater implications for those industries closely tied to the development and financing of single and multi-family housing? And most importantly – how can institutional investors participate in these opportunities and position themselves for this change?

Investment Ideas to Best Position for Housing 2.0

- On the public side, Paul favors REITs (ESS, BRE), Betsy favors banking stocks (short-term view: STT, DFS, AXP; long-term view: BAC, JPM, WFC), and Adam Parker favors the Construction Materials and Home Furnishing Retail sectors.
- Opportunity to make private equity investments in distressed single-family real estate funds focused on buy-to-rent strategies
- Opportunity to provide collateralized lending to portfolios of single-family rental real estate

List of Stocks and Other Investment Ideas for Housing 2.0

Trade Ideas Span Public and Private Equity Space

	Multifamily REITs	US Equity Strategy	Banks	Single-family Rentals
Favored	ESS, BRE	Construction Materials, Home Furnishing Retail	Short-term View: STT, DFS, AXP Long-term View: BAC, JPM, WFC	Private Equity Real Estate Investments, Collateralized Lending
Lagging		Homebuilders	Short-term View: BAC, RF Long-term View: DFS, AXP	

Please see page 35 of the report for company names, Morgan Stanley stock ratings and stock prices, as of October 26, 2011

Summary and Conclusions from the Report

Single-family rentals will be an important part of Housing 2.0, and we believe institutional ownership of this asset class is attractive

- Single family rental total returns offer lower volatility and outsized returns vs. other major asset classes even when accounting for the housing bubble and subsequent declines. Returns also have low correlation to other major asset classes and provide an inflation hedge given the large rent component of CPI.

Opportunities to participate in single-family rentals exist for both equity and debt investors

- Private equity investments currently show attractive IRRs when accounting for both current rental yields (from dislocations between rents and distressed home prices), and capital appreciation (from larger than usual discounts for distressed vs. non-distressed properties), while lending opportunities should provide attractive yields given the current collateral characteristics.

Single-family and Multifamily Rentals can co-exist without taking market share from each other

- Single-family and traditional multi-family apartment housing are weak substitutes with segmented demand cohorts that intersect mainly at life-cycle transitions. Demand segmentation means that the supply expansion of one product (e.g., single-family rental homes) is likely to have only a limited effect on equilibrium pricing for the other product (i.e., apartment rents).

Paul favors Apartments REITs as they produce upside to both core growth and development value-creation

- Our favorite REITs are Essex Property Trust (ESS) and BRE Properties (BRE) with attractive West Coast portfolios and attractive development pipelines in key markets that offer strong value-creation potential.

Equity Strategy Views – Adam Parker

- The broad implications of lower homeownership rate and the move towards a rentership society is a negative for homebuilders, but neutral to positive for building materials as multifamily construction begins to assume a larger role in total construction. We view the impact to Home Furnishing (HF) retail sector as positive, as we note that after adjusting for home size, HF purchases are similar between owners and renters.

Banking Analyst Views – Betsy Graseck

- **Near-term**: Negative, if GSEs offer attractive financing (rate, guarantee, leverage), banks would be competing with GSEs for scarce investor dollars in distressed residential mortgage properties. **Medium-term**: Positive, as institutional investor interest in residential mortgages adds liquidity, reduces excess inventory and narrows the gap between distressed and non-distressed housing reducing losses for banks over time. **Longer-term**: Positive, as lower volatility in housing values and credit losses given higher liquidity. Could drive more stable earnings and help boost bank EPS multiples.

US Fixed Income Housing Strategy View

The Asset Class of Single-family Real Estate

Introduction: For the past few months, we have written extensively about our view that America is moving away from a home ownership society and towards a Rentership Society. We have also detailed a proposal, dubbed REBUILD, to help take advantage of the increase in investor demand for distressed residential properties to repurpose them for rentals, to help address the backlog of distressed homes and alleviate a major housing market issue. As institutional ownership of single-family rental properties grows, hopefully with the help of government intervention, but even without it, we believe that the housing market is already beginning to undergo that fundamental change to support a more renter-heavy society. In fact, we believe that we are in the early stages of the development of a new institutional-owned asset class: single-family real estate.

Attractive and Uncorrelated Returns: Single-family real estate in the form of rental properties, is attractive from an asset allocation perspective as its returns have low correlation to other widely invested assets, attractive total returns over time assuming even a conservative average rental yield, as well as a favorable Sharpe ratio.

Inflation Hedge: Single-family real estate is also a better inflation hedge for a landlord position than an owner-occupied position in theory. Unfortunately, reliable rental data does not extend far enough to measure this relationship accurately. However, rents are a large part of the CPI calculation, and total housing-related costs make up of roughly 40% of CPI. In addition, while new home prices may vary with the costs of inputs such as lumber and labor, existing home sale prices do not have the same direct relationship to input costs.

Risks: The biggest risk we associate with this asset class is illiquidity. Single-family real estate assets are not known for their liquidity, although they may be better than other commercial real estate assets in that regard. Historically, about 5-6MM single-family homes trade hands in a year, which at today's market value would represent about $750 - $900 billion in asset value nationwide.

Uncorrelated and Attractive Total Returns[1]

Annualized Comparisons Since 1990

Asset Class	3M T-Bill	10-Y Treasury	IG Corporate	HY Corporate	S&P 500	DJ/UBS Commodity	NCREIF NPI	Single Family Rentals
Average Annualized Return	3.5%	7.3%	7.5%	9.1%	9.5%	7.3%	7.0%	8.1%
Average Annualized Volatility	0.6%	7.9%	5.3%	9.4%	15.1%	14.7%	5.1%	3.2%
Sharpe Ratio		0.48	0.75	0.59	0.40	0.27	0.45	1.42
Correlation to Single Family Rentals	**0%**	**-2%**	**6%**	**3%**	**5%**	**11%**	**45%**	**100%**

1. All series are total returns. To calculate single-family total returns, we used multi-family rents adjusted for home price appreciation to approximate a rental yield which was added to the home price returns

Source: Bloomberg, CBRE, Case-Shiller, NCREIF, Morgan Stanley Research

Investment Returns: A Tale of Two Sources

1. A Historic Dislocation Between Rents and Home Prices: While most overall price to rent ratio analysis focuses on average home prices, we choose to break this out by the distressed nature of the sale. In our Outlook for 2011 (see "2011 SPG Outlook", December 8, 2010), we calculated the price to rent ratios for non-distressed prices across several MSAs. Here, we look at the same ratios, but calculated based on the distressed price, since those are the prices that investors are paying for these target rental properties. Across 20 of the largest MSAs in the country, it is clear that not only do the ratios indicate that distressed property is cheap on this basis, but that they are significantly cheaper than they have been since 2000, which includes the pre-bubble period. At the same time, non-distressed prices remain high on the same basis for most MSAs. The conclusion, therefore, is that gross rents are historically attractive relative to current distressed prices. Adding to this attractiveness is the fact that multifamily data shows rents continuing to rise.

2. Capital Appreciation without Home Price Appreciation?: Usually, we would attach the concept of capital appreciation to that of home price appreciation, and model capital returns based on our home price projections. However, in the current market environment, we believe there are actually two separate sources for capital appreciation. First is the fundamental underlying HPA, which we believe will remain close to 0% over the next five years. Second is the capital appreciation that we believe exists from the convergence of distressed to non-distressed prices as the backlog of inventory is cleared. Historically, there has been about a 5% discount for distressed properties due to quality issues. Currently, this discount ranges from 30-45% depending on the MSA. We believe this greater discount is due to the excessive inventory of distressed properties. If this is the case, then eventually when the distressed inventory returns to a more normal level, distressed prices should also converge toward their non-distressed counterparts. While not all of this convergence will be from the bottom up (indeed, we believe non-distressed prices have more to fall), a good amount of capital appreciation should still occur simply due to the magnitude of the current discount. Furthermore, as the distressed inventory is removed from the market, the overall housing environment should improve and eventually lead to fundamental home price appreciation as well.

Price/Rent Dislocations

MSA	Distressed Price-to-Rent Ratio (100% in 2000)[1]	Non-Distressed Price-to-Rent Ratio (100% in 2000)[2]
Detroit	41.8%	60.3%
Cleveland	50.9%	88.1%
Atlanta	59.2%	109.8%
Columbus	63.6%	98.3%
Chicago	64.6%	104.1%
Miami	71.6%	96.4%
Las Vegas	72.7%	84.1%
Phoenix	73.2%	96.7%
San Francisco	79.5%	127.4%
Minneapolis	80.3%	110.4%
Boston	81.4%	125.9%
Jacksonville	81.7%	111.9%
Sacramento	83.4%	100.2%
Seattle	86.8%	127.1%
Washington DC	87.1%	131.5%
New York	87.7%	129.1%
Philadelphia	88.0%	121.7%
Charlotte	89.2%	126.3%
Denver	89.8%	115.7%
San Diego	90.1%	112.9%
San Jose	92.8%	132.7%
Los Angeles	99.2%	132.3%

Distressed Discounts

MSA	Distressed / Non-Distressed Ratio	Potential Appreciation from Convergence
Atlanta	53.9%	85.5%
Cleveland	57.7%	73.2%
Chicago	62.1%	61.0%
San Francisco	62.4%	60.3%
Boston	64.7%	54.7%
Columbus	64.7%	54.5%
Washington DC	66.2%	51.0%
New York	67.9%	47.2%
Seattle	68.3%	46.4%
Detroit	69.2%	44.4%
San Jose	69.9%	43.0%
Charlotte	70.6%	41.6%
Philadelphia	72.3%	38.4%
Minneapolis	72.7%	37.5%
Jacksonville	73.0%	37.0%
Miami	74.3%	34.6%
Los Angeles	75.0%	33.4%
Phoenix	75.7%	32.0%
Denver	77.6%	28.8%
San Diego	79.8%	25.3%
Sacramento	83.3%	20.1%
Las Vegas	86.4%	15.7%

1. Compares the ratio of distressed home prices to multi-family rent in Q2 2011 to the ratio of non-distressed home prices to multi-family rent in Q1 2000.
2. Compares the ratio of non-distressed home prices to multi-family rent in Q2 2011 to the ratio of non-distressed home prices to multi-family rent in Q1 2000.

Source: CBRE, Case-Shiller, Morgan Stanley Research

Source: DataQuick, Morgan Stanley Research

Modeling Current Yields and IRRs

Introducing Our Single-family Rental Model

In order to better understand the economics behind the buy to rent opportunity in distressed single-family real estate, we built a cashflow model for the acquisition and operations of a portfolio of such homes. This model takes into account costs and timing for asset allocation, property rehab, leasing and maintenance. The chart to the right highlights our model inputs and assumptions for the two real world scenarios described below.

The Return Profile

We used the model to run two scenarios for Phoenix as an example. We chose Phoenix for its distressed inventory and current levels of investor activity. In scenario 1, we made assumptions based on local market data, as well as what current investors have told us they can realize in terms of acquisition price, rent and expenses. In scenario 2, we made more conservative assumptions that we felt would better reflect a higher level of investor activity by increasing expenses, vacancy assumptions and timing. We then ran them across various capital appreciation and leverage environments assuming a 6% flat rate of financing. As we can see in the IRR tables, the opportunity is already attractive on an unlevered current yield basis, and made only more attractive by the addition of leverage and appreciation.

Location, Location, Location

As with all investments in residential real estate, it's all about location. While distressed inventory exists in most MSAs, other factors can vary significantly, with considerable impacts on the opportunity and return profile. In addition to the differences in rents and distressed pricing we already highlighted, in our view some of the more important factors to consider would include: rental laws (favor tenant or landlord?), rent levels and relationship to prices and incomes, employment and income trends, availability and cost of labor, insurance and tax requirements, and property and environmental conditions.

Model Inputs and Scenario Assumptions

Model Inputs	Scenario 1	Scenario 2
Acquisition Price	$97,000	$97,000
Closing Costs	2%	2%
Rehab CapEx	$8,000	$12,000
Gross Rent	15%	15%
Rent Growth	0%	0%
Vacancy Rate	0%	8%
Property Tax	1.80%	1.80%
Insurance	0.85%	0.85%
HOA dues	0.65%	0.65%
Maintenance (of rent)	5%	15%
Rehab Time	1 month	1 month
Marketing Time	1 month	2 months
Exit Type	Portfolio	Portfolio

Illustrative Returns for Scenarios

Scenario 1

		Capital Appreciation				
		0%	**25%**	**50%**	**75%**	**100%**
LTV	**0%**	9.85%	12.11%	15.07%	17.64%	19.91%
	50%	13.48%	17.31%	21.91%	25.61%	28.73%
	65%	16.45%	21.25%	26.71%	30.95%	34.43%
	80%	23.33%	29.57%	36.14%	40.99%	44.85%

Scenario 2

		Capital Appreciation				
		0%	**25%**	**50%**	**75%**	**100%**
LTV	**0%**	7.34%	9.10%	12.21%	14.89%	17.26%
	50%	8.59%	11.78%	16.92%	21.00%	24.38%
	65%	9.60%	13.82%	20.22%	25.03%	28.90%
	80%	11.94%	18.13%	26.55%	32.41%	36.92%

Source: Morgan Stanley Research.

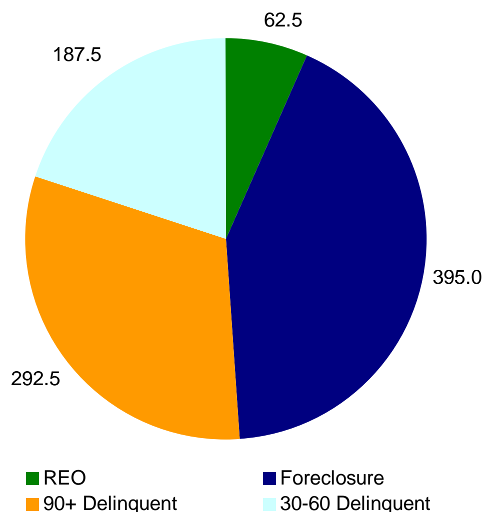
The Equity Opportunity

Sizing the Opportunity: The single-family rental market in the US (defined as properties with up to 4 units, and manufactured housing), accounts for roughly 20MM units – slightly more than 50% of the total rental market. Assuming an average unit value of $150K, we get an existing single-family rental market valued at $3 trillion. This does not include the 7.5MM properties we project will be liquidated over the next 5 years, which represents about an additional $1 trillion in market value. If the homeownership rate declines from the current 66% to our “effective” rate of 60% (see “Housing Market Insights: A Rentership Society”, July 20, 2011), that would result in demand of 7.2MM rental housing units. So even if 50% of the projected single-family liquidations are turned into rentals, it would represent $750 billion in market value and still not be enough to meet our expected rental demand.

Playing the Equity Side: Over the past year, several small funds ($50MM or less) have been established to pursue this opportunity – usually at the local level – typically raising money from private wealth and family offices. Some more recent developments have included a partnership between an operator and a hedge fund, as well as an investment by a university endowment in a separate fund. We would anticipate more investments from private equity capital which could take the form of limited partner (LP) investments in funds established to pursue this opportunity, or additional joint venture structures between operators and capital providers.

Exit Strategies and Economics: Most of the investors we have heard from believe there is an opportunity for the creation of a perpetual institutionally-held single-family rental market, and most of those investors see an eventual exit through REIT IPO. Opinions differ as to the track record that must be established and the assets under management that must be reached to launch a successful public REIT. Smaller investors should have the exit option of selling portfolios to larger investors, and all investors should be able to sell piecemeal to owner-occupiers when that market recovers. In the event that a publically-traded REIT market does not develop, piecemeal sales to owner occupiers should still provide an attractive, though less liquid, exit to investors, particularly if the housing market recovers and mortgage credit becomes more easily attainable.

Size of Projected Liquidations (in $billions)



Source: Morgan Stanley Research

The Debt Opportunity

Collateral Profile

Currently, very little lending is available to institutional buy to rent investors. Some local bank lending has been done, but even lending on individual investor properties has dried up as agency investor loans are harder to qualify for and limited by number per investor. However, when looking at these properties, we believe they represent a good opportunity for high quality collateralized lending. These properties are bought at a distressed price, but are not physically distressed assets as capital improvements are made to turn them into rentals. They generate high rental yields, creating attractive debt coverage ratios and debt yields at reasonable LTVs (50-65%). And finally, those reasonable LTVs are all that current investors seem to be asking for. One possible hurdle to investor lending could be that single-family rental portfolios look like a hybrid asset. While debt investors should look at the cash flows from a commercial real estate perspective (similar to multi-family lending), the ultimate collateral risk is to residential assets and home prices. It is possible that better underwriting will require combined expertise in the evaluation of both commercial and residential real estate.

Loan Characteristics

We believe that portfolio (cross-collateralized, cross-default) lending to investors makes the most sense. Who wants 5000 individual mortgages to manage? Also borrowing from commercial real estate lending, loans could mimic multifamily loans in their terms (5 or 10 years), amortization schedules (30 years), call protection (yield maintenance) and other attributes. This could facilitate institutional trading of whole loans and possibly securitization.

Securitization? Really?

Several hurdles, not the least of which would be getting a deal rated on a new asset class, exist for the securitization of these loans. But as a new (and initially esoteric) asset class, they should also command higher coupons. In that case, given the lower LTVs of the loans, we believe there could be a decent bid for the mezzanine parts of a deal even in an unrated or privately rated deal. In the table, we show potential unlevered returns for a simple senior/sub structure across various coupons and attachment points.

Possible Collateral and Loan Profile

Attribute	Initial Expectation
LTV	50-65%
Debt Coverage Ratio	1.5-3 times
Debt Yield	12-20%
Fixed Coupon	6-8%
Term	5-10 years
Amortization	30 years
Call Protection	Yield maintenance
Loan Size	$5-$50MM
Collateralization	Crossed

Securitization Structure Examples

Net WAC = 5.5%

Credit Enhancement	Senior Coupon[1]	Sub Yield
10.00%	4.25%	16.75%
15.00%	4.25%	12.58%
20.00%	4.25%	10.50%
25.00%	4.25%	9.25%

Net WAC = 6%

Credit Enhancement	Senior Coupon[1]	Sub Yield
10.00%	4.25%	21.75%
15.00%	4.25%	15.92%
20.00%	4.25%	13.00%
25.00%	4.25%	11.25%

Net WAC = 6.5%

Credit Enhancement	Senior Coupon[1]	Sub Yield
10.00%	4.25%	26.75%
15.00%	4.25%	19.25%
20.00%	4.25%	15.50%
25.00%	4.25%	13.25%

1. We believe the senior bond could be placed at a 4.25% yield

Source: Morgan Stanley Research.

Developments to Follow

Government Intervention

As the government evaluates the proposals received from their RFI on the idea of turning distressed properties into rentals by investors, we would keep a close eye on developments for bulk sales programs at the agencies (as well as at banks), and for potential financing of such bulk purchases for investors. Specifically, we would be encouraged by additional discussion around expansion of agency multi-family lending programs to single-family assets for investors

Private Equity Deals

As more private capital is allocated to this opportunity, we would track the number and deal sizes of true institutional capital. This may come from private equity, real estate and hedge funds, and potentially endowments, pensions and other real money sources. We would also expect these deals to accelerate if government intervention is signaled or announced.

Lending Developments

As portfolios of single family rentals grow, we would look out for cross-collateralized, cross-default lending, particularly from banks, insurance companies or money managers. As leverage is made available, even if only at 50 LTV, the acquisition capital increases, and investor activity can increase.

Our Outlook for Housing 2.0

Given the declines in homeownership, availability of single-family housing, projected liquidations and increasing capital investment in single-family real estate, we see the Rentership Society driving the development of an institutionally owned single-family rental market. Taking into account the distressed pricing, strong rent environment, and what we believe will be increased demand for single-family rentals, we believe this as an opportunity to invest in Housing 2.0.

US Multifamily REITs View

Views on Multifamily Rentals: A convergence of positive catalysts

Cyclical & secular demand fundamentals

The multifamily rental sector benefits from strong demographic trends, above-average job growth for the prime-age renter cohort (20-34yr olds or "Gen-Y"), and tailwinds from declining homeownership as renting becomes more compelling for more phases of the consumer's life cycle. These and other factors drove a sharp fundamental snap-back in 2010, accelerating growth this year, and should spur 6%+ same-property revenue growth in 2012.

Single-family vs. apartments: Segmented rental markets

Single-family & traditional multi-family apartment housing are weak substitutes with segmented demand cohorts that overlap mainly at life-cycle transitions (e.g., from newly-married to married with kids; from married to divorced; and from mature families to empty-nesters). Life-cycle progression involves the consumption of increasing and then decreasing quantities of real estate, and is associated with preferences for inversely-correlated neighborhood characteristics (e.g., nightlife at 25yrs vs. kid-friendly at 35yrs). It is for good reason that 70% of MF supply (100+ units/asset) is concentrated in the urban core, while SF housing is largely suburban with twice the average unit size. This demand segmentation implies that a demand or supply shock to one product (e.g., single-family rental supply increasing) has only a limited effect on equilibrium pricing for the other product (i.e., apartment rents).

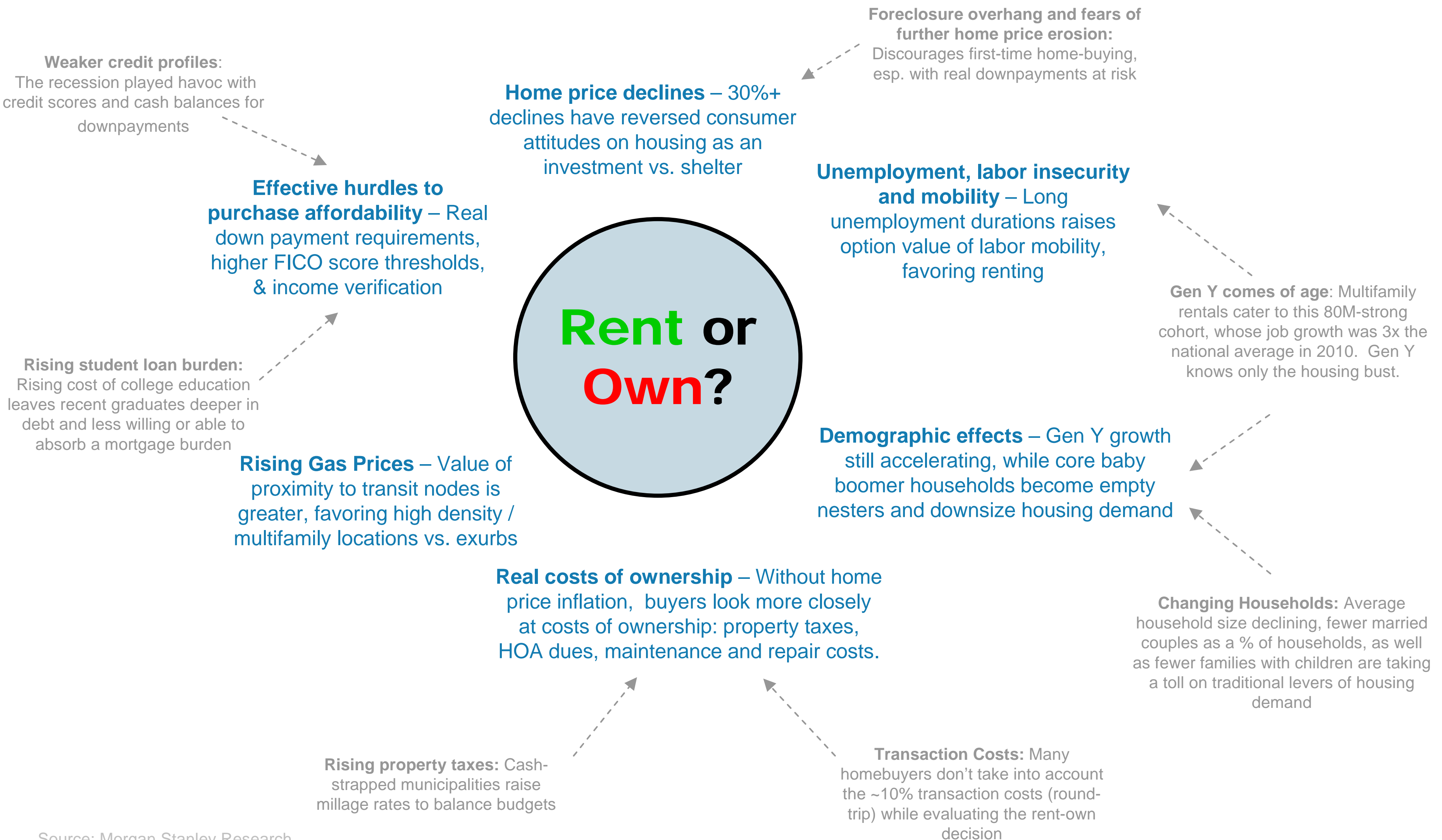
Today's supply gap & the development opportunity

The multifamily share of new construction should trend higher given the weakness in new housing demand, presenting an opportunity for multifamily developers. Due to the evaporation of new construction during the Great Recession and the subsequent cap on construction financing, we estimate that new supply from 2010-12 will fall $30B short of potential demand. This "apartment output gap" represents a compelling investment opportunity for apartment developers, on top of the solid expected growth in potential demand during the 2013-15 period.

REIT Investment Recommendations

We expect apartment REITs to produce sustainable growth that exceeds their REIT sector peers over the next few years, with potential upside surprises stemming from both core growth and development value-creation. As the housing dynamic continues to shift toward renting, our favorite REITs, **Essex Property Trust (ESS)** and **BRE Properties (BRE)** offer a compelling combination of (1) West Coast asset concentrations with better near-term employment trends, and (2) attractive development pipelines in key markets such as the San Francisco Bay Area that provide strong value-creation potential.

From American Dreaming to The New Pragmatism – Renting Offers New Advantages



Source: Morgan Stanley Research.

Multifamily Fundamentals

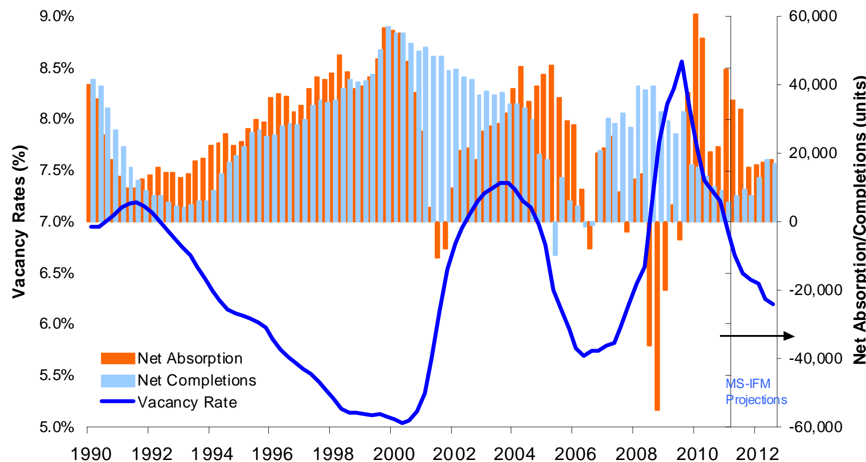
Latest housing crisis has changed consumer attitudes: Burned by the worst housing downturn in history, more households are choosing to rent instead of owning a home. As the US economy transitioned from a manufacturing based economy to a knowledge based economy in recent decades – the old rules of homeownership began to change (*even before the housing crisis*). In a services based economy, workers increasingly value labor mobility and renting provides the frictionless opportunity to shift markets to pursue employment. While traditional drivers like job growth and rent-buy dynamic clearly explain part of the resurgence in demand – the vibrant snap-back in apartment fundamentals in the past year has been augmented by the shifting attitudes in consumers towards renting.

View on multifamily fundamentals: Apartments continue to benefit from population and job growth for prime renter cohort (20-34 year olds), tailwinds from declining homeownership, as well as lack of new supply in the market. Our proprietary (MS-IFM) apartment revenue forecasts predict strong +4.4% same-store revenue growth in 2011, accelerating to +6.4% for apartment REITs in 2012.

GSEs still open for business for multifamily: The GSEs continue to provide the majority of the debt financing for the multifamily sector, helping maintain low cap rates even as shifting credit availability in other property sectors has driven cyclical fluctuations in asset pricing. While potential GSE restructuring could raise the cost of a valuable funding source for the sector, more stringent mortgage financing requirements for single-family housing could keep potential first-time buyers out of the market longer, providing an important offsetting positive.

U.S. Multifamily Fundamentals

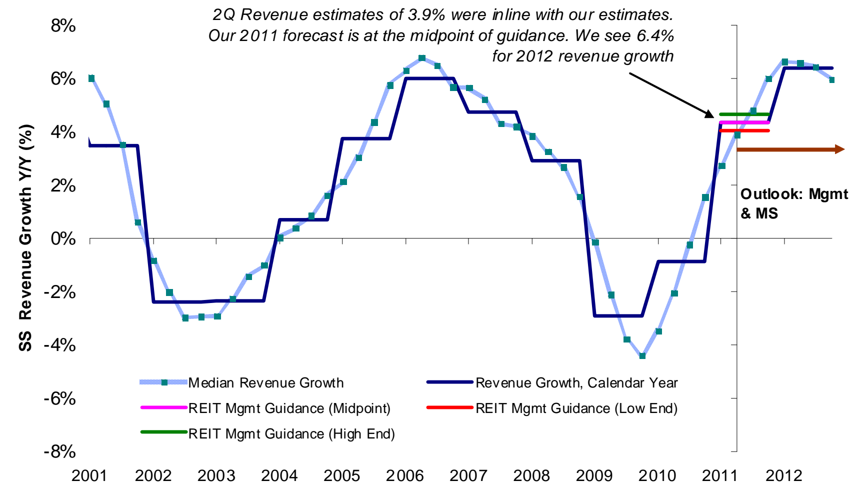
Supply virtually nil at +0.2% in 2011



Source: CBRE, Morgan Stanley Research Estimates

Apartment Revenue Model (MS-IFM)

Forecast same-store revenue growth of 6.4% in 2012



Source: Company Data, Morgan Stanley Research Estimates

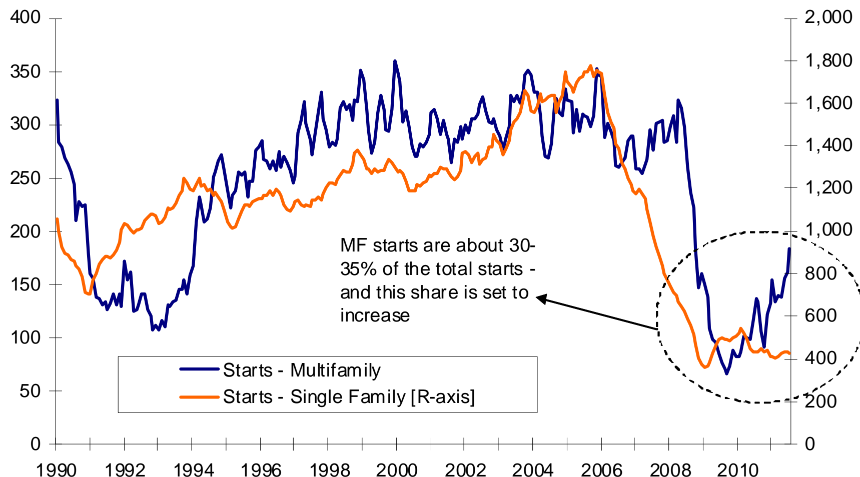
Theme: Low supply in the market is an opportunity for multifamily developers

Muted supply in the coming years is an opportunity for multifamily developers: The silver lining from the Great Recession and the credit crisis is that while fundamentals began to accelerate in late 2009, construction financing remained frozen in all but the best markets for another year. As a result, new multifamily supply will be very low in 2011 & 2012 (+0.2% in 2011 and +0.5% in 2012, vs. a normalized +1.5%).

Building starts are up: Recent data shows starts for 5+ units have more than tripled, while the market's share of MF starts (as a % of overall starts) have increased from a long-run average of 18% to a more recent 30%. We estimate (using long-run average pace of net completions for MF as the equilibrium trend-line) that a supply gap of additional $30Bn of investment (actual deliveries vs. potential demand) for multifamily construction exists for the period 2010-2012, based on current level of supply relative to long-run averages.

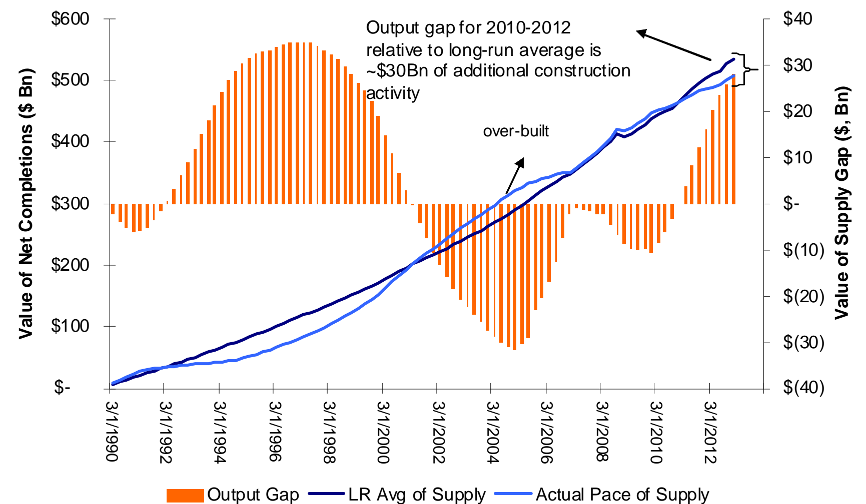
Apartment REITs are best positioned: We see Apartment REITs with strong development platforms and robust balance sheet liquidity responding to the growing demand from the coming wave from Echo-boomers, generating attractive returns for their shareholders beyond core portfolio growth. In our coverage universe, **Essex Property Trust (ESS, MS-OW)** and **BRE Properties (BRE, MS-OW)** are already taking the lead in development and land acquisitions in their core coastal markets.

We see the market share of multifamily construction to increase relative to SF new construction, in the coming years



Source: Census, Morgan Stanley Research.

Opportunity to close a $30Bn supply gap that has emerged since the Great Recession



Source: CBRE, Morgan Stanley Research.

Theme: Do single-family rentals cannibalize apartment demand?

Segmented Markets: A natural question in investors minds is whether an emerging SF rental market would negatively impact the existing multifamily rental market. We believe that the substitution effect between SF and MF rentals is quite limited and view the two rental markets as largely segmented, where demand is a function of life cycle stages: singles, couples w/o kids, students in roommate situations, newly divorced, and empty nesters dominate the apartment rental market, because they have smaller space needs, less demand for associate acreage, and generally prefer denser, transit-centric submarkets. On the other hand, the single-family market – whether to own or to rent – serves larger households that are primarily families with children, whose preferences focus on quality of schools, crime statistics, green spaces, to name a few.

SF and MF rentals can co-exist without taking away demand from each other: As the institutional single-family rental market grows over time, the primary shift that we expect would be a delay in the first-time home buyer decision, providing options for renters to remain renters for longer as they move into stages of their life cycle that traditionally signaled the need for more real estate and a shift in neighborhood priorities (kid-friendly, good schools, etc.). New growth of the middle-age renter population would be spurred while move-outs from apartment units would persist as before, but more would be due to renting single-family houses and fewer would be to first-time home purchase.

Fannie Mae conducted an extensive rent-buy survey in 2010 and the major findings in support of this view include:

1. Controlling for age, income and other factors – married couples are 2.5x more likely to own a home.

2. Almost 75% of respondents said that having children was a major reason to buy a home – this was true for cohorts that did and didn't have children.

3. Older households were more likely to believe that they are better off owning than renting for both financial and lifestyle reasons.

4. Percentage of families with children is shrinking – Single mothers are becoming a more common family type (*24% in 2009 vs. 8% in 1960*) – 60% of this group rents rather than owns.

Source: http://www.fanniemae.com/portal/research-and-analysis/own-rent-analysis.html

Characteristics of Apartment Stock in the U.S.

Approximately 17.5M Apartment Units in the country

Structure/ Units/ Age/ BedRms	All Apartment Units	< 20 years old	All Apartment Units	< 20 years old
Apartment Units in Structure				
5 to 9	5,221	774	30%	4%
10 or more	12,231	2,581	70%	15%
Structure Height				
one story	933	169	5%	1%
two stories	7,033	1,183	40%	7%
three stories	5,153	1,367	30%	8%
4+ Stories	4,334	636	25%	4%
Number of Bedooms				
Studio	721	57	4%	0%
1-bedroom	8,002	1,328	46%	8%
2-bedroom	7,271	1,498	42%	9%
3+ bedrooms	1,458	472	8%	3%
Total	**17,452**	**3,355**	**100%**	**19%**

Source: NMHC, American Housing Survey, Morgan Stanley Research

Apartment stock is older and more garden variety

- 75% of stock is garden type (as opposed to mid/high-rise)
- Only 20% of stock is newer (less than 20 years old)
- 30% of stock is 5-9 units, dominated by "mom-and-pop" operators
- ~90% of stock is 1 or 2 Bedroom Apartments

Investor Debate # 1: What is the extent of overlap in demand?

Our view

The typical household size for SF rentals is 50% larger than MF rentals, which leads to a clear segmentation in demand. A recent Fed paper[1] estimates that ~90% of households that went into distress/foreclosure ended up staying in some form of SF housing – this suggests that overlap in demand is quite marginal.

Multifamily rental units are half the size of single-family

SF and MF homes vary in unit size - the typical size of a MF rental is ~900 sq-ft, with majority of units being one- or two- bedrooms. On the other hand, an interesting dynamic is playing out in the single-family arena – after average size of new homes rose by 50% in the period from 1973-2007, recently trends have reversed with a preference to build smaller size homes (a 5% decline from the peak). Despite the decline, the average size of 1800 sq-ft is roughly double the size of MF units. The lower square footage of MF rentals affects location, design, amenities, operating expenses, and rent/sq-ft for the property - and influence the overall economics of construction and property management.

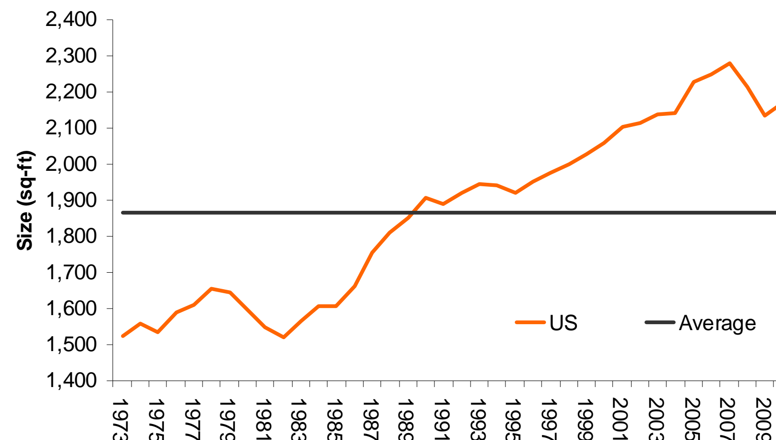
Lifecycle determinants of home size are a key influence

Since married couples and families with children are more likely to live in SF homes, it is not surprising that SF household size is 50% larger than MF households (>5 units). Due to general lack of 3-bedrooms or more in MF stock, larger families tend to gravitate towards SF ownership/rentals.

Household numbers support the segmentation argument: Out of 112M households in the US, 79M are families, of which 36M are 2-member households, while 43M are 3+ member households. The almost 50-50% split in the two buckets of household size keeps the demand segmented.

1. Raven Molloy and Hui Shan, 2011 – The Post-foreclosure experience of U.S. Households, Federal Reserve Board

"Mc Mansion-ization" may have peaked – Size of new homes declining



Source: Census, Morgan Stanley Research.

Household Size is 50% larger for SF rentals vs. MF Rentals

Structure of renter households	Num. of Households	% of HH	Number of Residents	Household Size
SF homes	13,168	*34%*	38,939	**3.0**
Structure 2-4 units	7,443	*19%*	18,450	**2.5**
Structures (>5-units)	16,551	*43%*	34,086	**2.1**
Mobile Homes	1,448	*4%*	3,994	**2.8**
Other	16	*0%*	328	**na**
Total	**38,777**			**2.6**

Source: NMHC, Morgan Stanley Research.

Investor Debate #2: Are the two forms of rentals segmented by sub-markets?

Our view

Yes – multifamily properties (and more so, apartment REIT properties) are concentrated in urban core areas of metros. This product does not compete with Single-family rental product due to its location in different submarkets and transportation networks (Mass Transit hubs vs. Freeway access).

Multifamily & single-family rentals are largely distinct markets – mainly Urban core vs. Suburban/outer exurbs

According to the NMHC, almost 70% of Apartments with 100+ units (the profile of typical institutional and REIT apartment investments) are located in the urban core of metro areas. Almost 50% of the units with 5-9 units in the structure are in the suburbs, and the proportion of SF rentals is almost exclusively suburban.

Apartment REITs own majority of assets in top 20 markets – Apartment REITs own 90% of their assets in the top 25 markets and represent ~4% of the total multifamily apartment stock. Apartment REITs are also substantially underweight single-family housing bust markets like Sacramento, Inland Empire, Las Vegas, Phoenix, and Detroit – with many actively selling out of those markets during the past few years (e.g., BRE has reduced exposure in Inland Empire from 12% of NOI in 2009 to ~7% in 2011).

Favor REITs with portfolios in high density areas. While we see the direct threat of competition from SF rental market as marginal for Apartment REITs, we favor REITs with portfolio concentration in high population density areas. Our OW rated Apartment REITs – **AIV, ESS** and **BRE** remain high on this list.

"We just felt that garden apartment products near the freeway interchange was not where we wanted to be. By adding assets to our portfolio that are higher-density urban assets, those would be in the markets where the jobs would be."

- David Neithercut, CEO, Equity Residential

70% of large multifamily rentals are in urban CBD areas

Location	All Apartment Units	5-9 Units in Structure	10-24 Units in Structure	25-49 Units in Structure	50-99 Units in Structure	100+ Units in Structure
Total	17,452	5,221	6,416	2,011	1,595	2,210
Urban CBD	9,200	2,528	2,956	1,194	1,013	1,509
Suburban	7,223	2,302	2,942	750	569	660
Rural	1,030	391	518	67	13	41
Urban CBD (%)	53%	48%	46%	59%	64%	68%
Suburban (%)	41%	44%	46%	37%	36%	30%
Rural (%)	6%	7%	8%	3%	1%	2%

Source: NMHC, Morgan Stanley Research.

We favor Apartment REITs with portfolios in supply-constrained, high population density areas

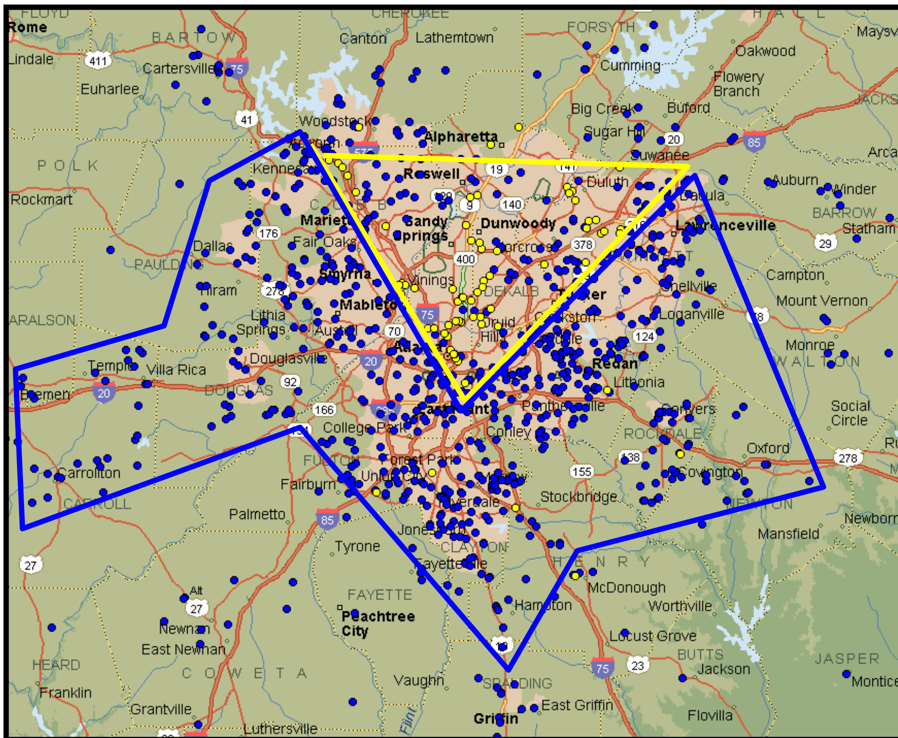
Ticker	Pop. Density (pop./sq-mile)
AIV	6,069
ESS	5,771
PPS	5,769
BRE	5,493
Average	***4,969***
UDR	4,938
CPT	3,876
HME	3,419
AEC	2,322
CLP	2,181
MAA	1,989

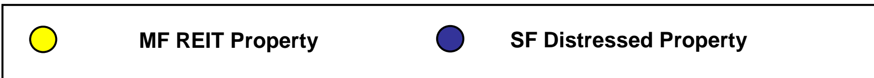
Source: Company Documents, Claritas, SNL Financial, Morgan Stanley Research.

Comparing apartment REITs' in-fill submarkets to single-family distressed assets

REIT Apartments vs. SF Distressed Sales in Atlanta

REITs concentrate in upper- & upper-middle-income in-fill submarkets





Source: MapPoint, Claritas, SNL Financial, Dataquick, Morgan Stanley Research

Comparing single-family & multi-family locational characteristics

- We analyzed 800+ distressed SF transactions that took place in Atlanta during July 2011. The average transaction price for REO/ foreclosure/short-sale was ~$80K
- We compared the locations to the 75 locally-owned REIT properties in Atlanta (including CPT, MAA, EQR, PPS and AIV)
- **REIT apartments are twice as close to core urban nodes** – REIT apartments are on average 10 miles from Buckhead, while the SF distressed homes are 20 miles away on average
- **REIT submarkets have ~70% greater population density.**
- **Average household size is lower (25% lower)**
- **REIT portfolio submarket household income is 22% higher**
- This case study (using Atlanta market as an example) supports our assertion of segmented markets for MF and SF rental markets – both from locational characteristics (**MF closer to urban core centers**), and demographic characteristics (**MF lower household size and higher population density**)

Demographics of MF REIT/ SF Distressed Assets

Demographic and location data show clear segmentation

ATLANTA	MF REIT	SF Distressed
Average Distance to Buckhead (miles)	10	20
Average Household Size	2.17	2.90
Population Density (Pop/sq-miles)	4,511	2,688
Average Household Income ($)	$ 83,045	$ 68,086

Source: Claritas, Dataquick, RCA, Axiometrics, Morgan Stanley Research

US Equity Strategy View

US Equity Strategy: The Equity Market Impact of REBUILD and a Rentership Society

Broad Consumer Impact: There are currently 7.5 million US households that are either in foreclosure or delinquent on their mortgage. These households, who are not paying their mortgage, will presumably be forced to pay rent over the next five years if not sooner. If we assume these households will pay the median monthly rent of $808 from the Census Bureau's American Housing Survey, the incremental annual cost to the consumer would be $72.7 billion (7.5 million * $9,696 annual rent).

This year's revenue for the entire S&P 500 consumer discretionary sector is estimated to be $1.29 trillion, meaning the $72.7 billion haircut to the consumer's income statement represents 5.6% of all large-cap discretionary 2011 revenues. We think the most exposed companies will be middle-end consumer discretionary stocks. Below is a list of consumer discretionary equities rated equal- or underweight or not covered by our analysts and disfavored by both our 3-month (MOST) and 24-month (BEST) quantitative alpha model rankings.

Consumer Discretionary Companies Disfavored by Our Quantitative Alpha Models

Ticker	Name	Sub-Industry	Model Quintile MOST	Model Quintile BEST
AZO	AutoZone Inc.	Automotive Retail	Q4	Q5
ORLY	O'Reilly Automotive Inc.	Automotive Retail	Q5	Q5
HOT	Starwood Hotels & Resorts Worldwide	Hotels Resorts & Cruise Lines	Q4	Q4
GRMN	Garmin Ltd.	Consumer Electronics	Q4	Q4
ULTA	Ulta Salon Cosmetics & Fragrance Inc.	Specialty Stores	Q4	Q5
DECK	Deckers Outdoor Corp.	Footwear	Q5	Q5
LKQX	LKQ Corp.	Distributors	Q5	Q5
TPX	Tempur-Pedic International Inc.	Home Furnishings	Q4	Q4
GNTX	Gentex Corp.	Auto Parts & Equipment	Q5	Q5
UA	Under Armour Inc. (Cl A)	Apparel Accessories & Luxury	Q5	Q5
NVR	NVR Inc.	Homebuilding	Q5	Q5
SIG	Signet Jewelers Ltd.	Specialty Stores	Q4	Q5
DHI	D.R. Horton Inc.	Homebuilding	Q5	Q5
LEN	Lennar Corp. (Cl A)	Homebuilding	Q5	Q5
TOL	Toll Brothers Inc.	Homebuilding	Q5	Q5
CROX	Crocs Inc.	Footwear	Q4	Q5
AAN	Aaron's Inc.	Homefurnishing Retail	Q4	Q4
PHM	PulteGroup Inc.	Homebuilding	Q5	Q5
JOSB	Jos. A. Bank Clothiers Inc.	Apparel Retail	Q4	Q5
BJRI	BJ's Restaurants Inc.	Restaurants	Q4	Q4
MDC	M.D.C. Holdings Inc.	Homebuilding	Q5	Q5
HELE	Helen of Troy Corp.	Household Appliances	Q4	Q4

Source: Factset, Morgan Stanley Research.

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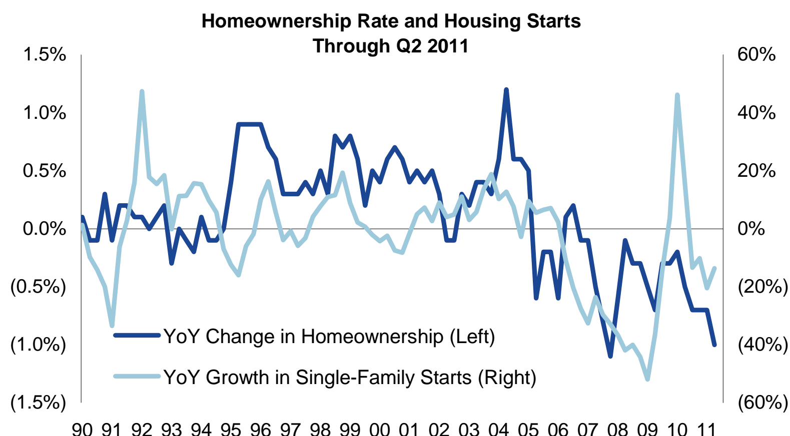
US Equity Strategy: The Equity Market Impact of REBUILD and a Rentership Society

Housing-Related Industries – Homebuilders and Construction Materials

A structural shift away from the peak, 69% homeownership rate to near 60% ownership, has negative implications for homebuilders. Declines in homeownership have historically been associated with weak single-family housing start growth (lower-left), and we would expect this trend to continue if the US shifts towards a rentership society. Additionally, homebuilder equities (not covered by MS) do not screen well in either MOST or BEST alpha model rankings (lower-right).

Less Homeownership Yields Fewer Housing Starts



Source: Factset, Morgan Stanley Research.

Homebuilders Are Ranked Unfavorably in Our Quantitative Alpha Models

		Model Quintile	
Ticker	Name	MOST	BEST
NVR	NVR Inc.	Q5	Q5
DHI	D.R. Horton Inc.	Q5	Q5
LEN	Lennar Corp. (Cl A)	Q5	Q5
TOL	Toll Brothers Inc.	Q5	Q5
PHM	PulteGroup Inc.	Q5	Q5
MDC	M.D.C. Holdings Inc.	Q5	Q5

While construction materials companies are highly exposed to commercial and infrastructure in addition to residential, like homebuilders, these companies' residential real estate revenues are dependent on new construction. A decline in homeownership and new construction due to the additional rental supply provided by REBUILD could be a headwind to segment revenues. However, if multi-family construction were to accelerate, building materials may benefit. Below is a list of construction materials equities and their BEST/MOST ranking.

Construction Materials: VMC Ranks Well in Alpha Models

		Model Quintile	
Ticker	Name	MOST	BEST
VMC	Vulcan Materials Co.	Q1	Q2
MLM	Martin Marietta Materials Inc.	Q4	Q2
TXI	Texas Industries Inc.	Q4	Q3

Source: Factset, Morgan Stanley Research.

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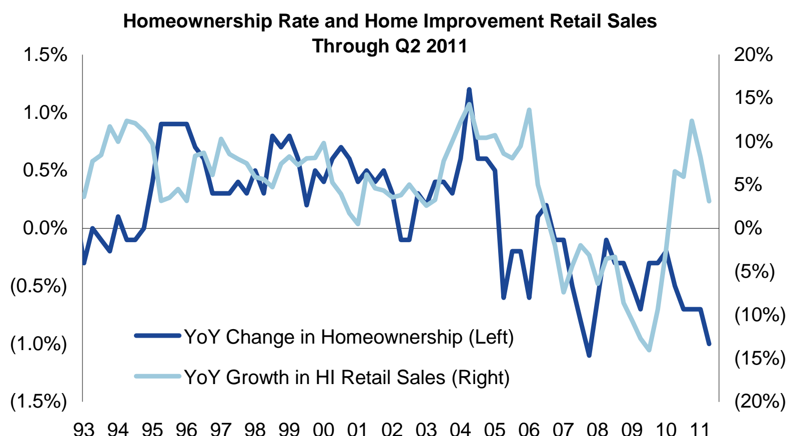
US Equity Strategy: The Equity Market Impact of REBUILD and a Rentership Society

Housing-Related Industries – Home Improvement and Home Furnishing Retailers

A decline in homeownership is also a headwind for home improvement (HI) retailers, as HI consumer spending is historically correlated with the homeownership rate (lower-left). Renters are less likely than homeowners to make meaningful home investments (i.e. remodeling a kitchen). We should note that HD and LOW (not covered by MS) rank relatively well in our quantitative framework (lower-right).

Home Improvement Retail Sales Decline with Homeownership



Source: Factset, Morgan Stanley Research.

Home Improvement Stores Are Highly Ranked in Our Quantitative Alpha Models

Ticker	Name	Model Quintile MOST	Model Quintile BEST
HD	Home Depot Inc.	Q1	Q2
LOW	Lowe's Cos.	Q1	Q1

Home furnishing (HF) sales are related to HI sales, but are less dependent on homeownership and can benefit from mobility. According to Traqline's consumer survey, after adjusting for home size, HF purchases are similar between owners and renters whereas there is a 20-30% discrepancy for HI. Increased mobility caused by delinquent borrowers moving to rental units benefits HF over HI since over 50% of HF purchases occur during the first two years of moving to a new home, while 60% of HI expenditures are spent after the initial two years. The table contains a list of home furnishing retailers along with MOST and BEST rankings.

Home Furnishing Retail Stocks

Ticker	Name	Model Quintile MOST	Model Quintile BEST
BBBY	Bed Bath & Beyond Inc.	Q3	Q5
WSM	Williams-Sonoma Inc.	Q2	Q3
AAN	Aaron's Inc.	Q4	Q4
SCSS	Select Comfort Corp.	Q1	Q3

Source: Factset, Morgan Stanley Research.

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US Banking Industry View

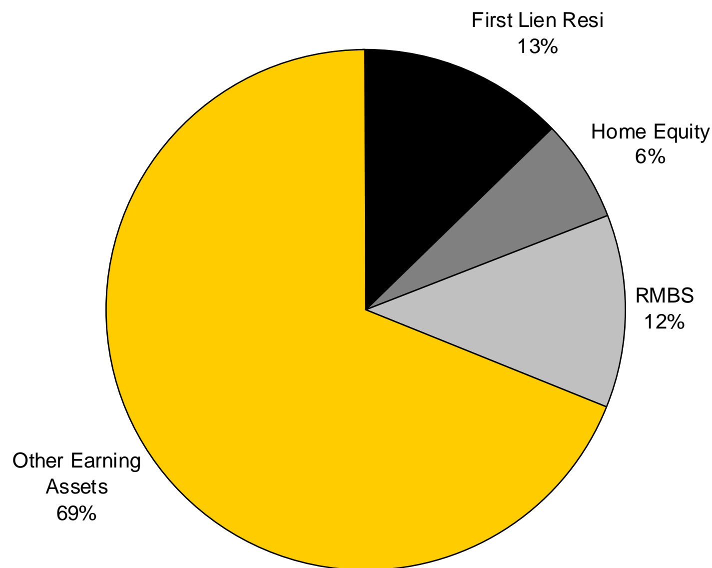
US Banks: REBUILD Impact…Near Term Modest Negative, Long Term Positive

Near-term: If GSEs offer attractive financing (rate, guarantee, leverage), this could be a near-term negative for banks as the banks would be competing with GSEs for scarce investor dollars in distressed residential mortgage properties as they try to sell down distressed assets.

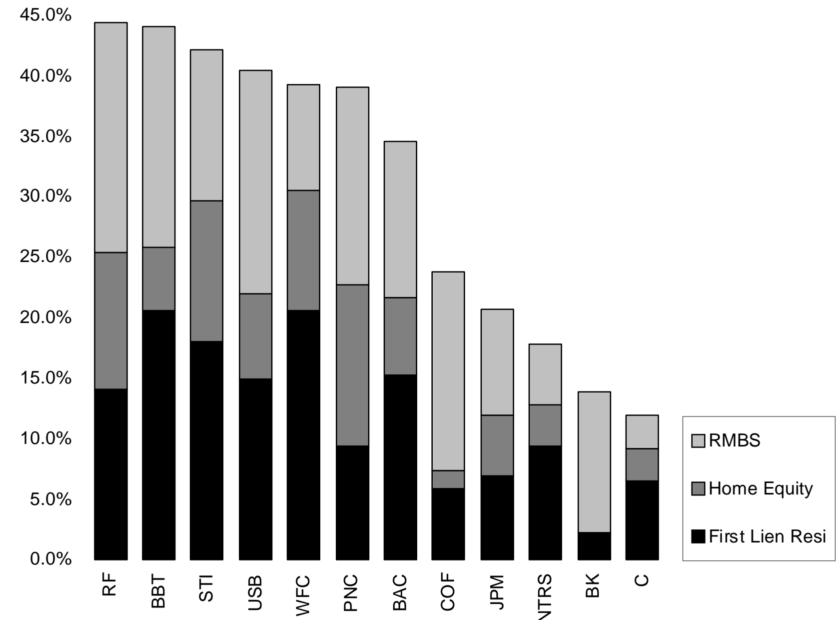
Mid-term: Positive as institutional investor interest in residential mortgages adds liquidity, reduces excess inventory and narrows the gap between distressed and non-distressed housing reducing losses for banks over time.

Longer-term: Lower volatility in housing values and credit losses given higher liquidity. Could drive more stable earnings and help boost bank EPS multiples

US Bank Exposure to Residential Mortgages ~31% of Earning Assets



LC Bank Exposure to Housing Median ~22% of Earning Assets

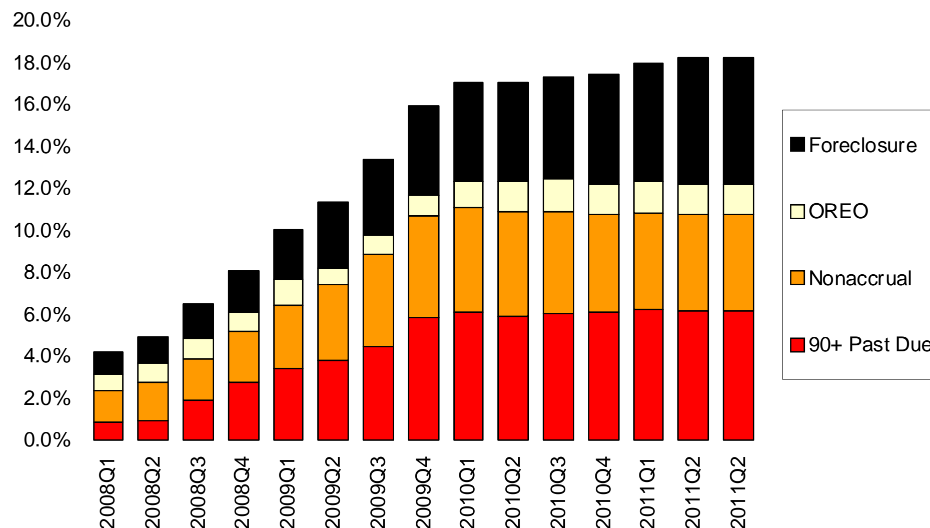


Source: FDIC, Y9C, Morgan Stanley Research.

US Banks: Burning off the Seriously Delinquent Loans Expected to Take 5+ Years

Benefit of this program would take time as there are several years of distressed housing inventory in bank balance sheets.

90 Day Past Due + Nonaccrual + OREO + Foreclosures % of Home Loans (Resi + Home Equity)



We Estimate 5.3 Years' Supply of Distressed Home

(units, in millions)	
Existing Home Sales - Annualized	4.91
% Distressed Sales	30%
Distressed Sales - Annualized	1.47
Distressed Inventory	7.76
Years' Supply of Distressed	5.3

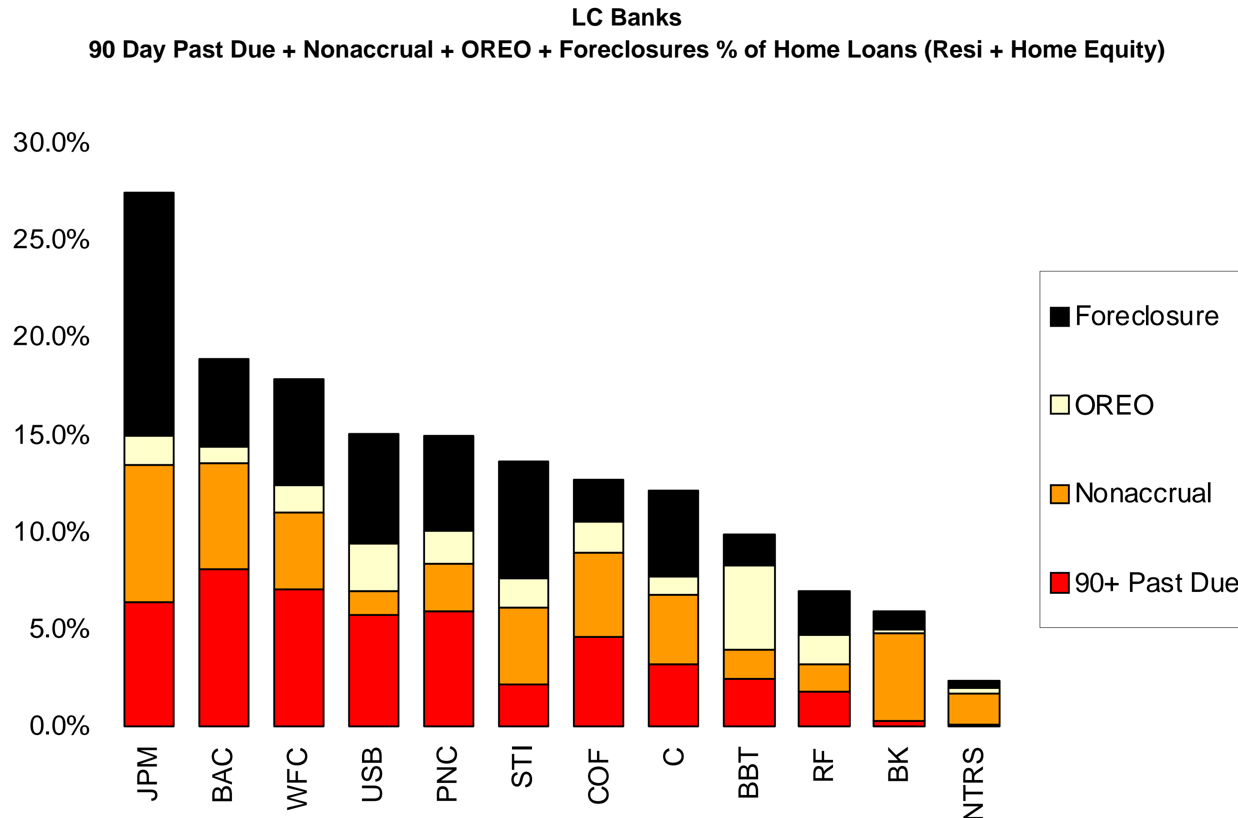
Source: Y9, NAR, Morgan Stanley Research.

US Banks: Near-Term Stay in Lower Risk Banks …
Longer-term Migrate to Riskier Banks as the Market for Distressed Housing Builds

Near-term: As GSEs compete for distressed investor $$$, banks likely to have a harder time selling distressed properties
Argues for exposure to LC Banks with low housing exposures (AXP, DFS)

Longer-term: As new investor class builds, increased demand for Residential Mortgages will add liquidity and raise HPI increasing value of banks with riskiest portfolios the most. (BAC, JPM, WFC)

LC Banks
90 Day Past Due + Nonaccrual + OREO + Foreclosures % of Home Loans (Resi + Home Equity)



Source: Y9, Morgan Stanley Research.

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The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Oliver Chang, Vishwanath Tirupattur, Paul Morgan, Adam Parker, Betsy Graseck.

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Global Stock Ratings Distribution

(as of September 30, 2011)

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Disclosure section (cont.)

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1130**	**40%**	**457**	**46%**	**40%**
Equal-weight/Hold	**1168**	**42%**	**419**	**42%**	**36%**
Not-Rated/Hold	**112**	**4%**	**23**	**2%**	**21%**
Underweight/Sell	**400**	**14%**	**104**	**10%**	**26%**
Total	**2,810**		**1003**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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BAC.N	Bank of America	Overweight	6.59
BRE.N	BRE Properties, Inc.	Overweight	48.36
DFS.N	Discover Financial Services	Equal-Weight	23.3
ESS.N	Essex Property Trust, Inc.	Overweight	140.9
JPM.N	J.P.Morgan Chase & Co.	Overweight	34.18
RF.N	Regions Financial Corp	Underweight	3.84
STT.N	State Street Corporation	Equal-Weight	38.86
WFC.N	Wells Fargo & Co.	Overweight	25.76

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