Fix & Flip Lending

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Fix & Flip Lending

The Fix & Flip lending industry is a pillar of the $25+ trillion U.S. housing market that continues to rebound post-pandemic. The Fix & Flip lending industry represents approximately 5% to 7% of U.S. home purchases and serves the aging housing stock and end-user demand for refurbished properties. No one wants to live in run-down, moldy, and dated housing. Documentaries such as Bulletproof's Moldy (2017) have raised the awareness of the need for more market participation to update our nation's aging housing supply.

Business purpose lending institutions, aka Fix & Flip lenders, provide capital to investors seeking to buy, improve, and sell properties. There's a real service provided by the investors and their financing sources.

Colonnade is observing significant investor interest in the Fix & Flip lending industry, owing to the short term, high yield, and low loss profile of the large players. Growing access to the capital markets gives lenders with diversification and scale the opportunity to accelerate expansion plans and capitalize on strong market conditions. Banks are increasingly attracted to the sector, as Business Purposes Loans (BPLs) with mid-to-high single digit yields court professional real estate investors and developers, an attractive customer profile with deposit and other cross-sell opportunities. We expect significant investment activity in the sector over the next 24 months.

In this report, we highlight three major themes relevant to M&A activity in Fix & Flip Lending:

1. The industry has strong fundamentals, providing an important value-add to the overall real estate and lending markets
2. Headwinds are creating challenges for industry players, and
3. The outlook is promising for the select participants who will flourish in a "survival of the fittest" scenario

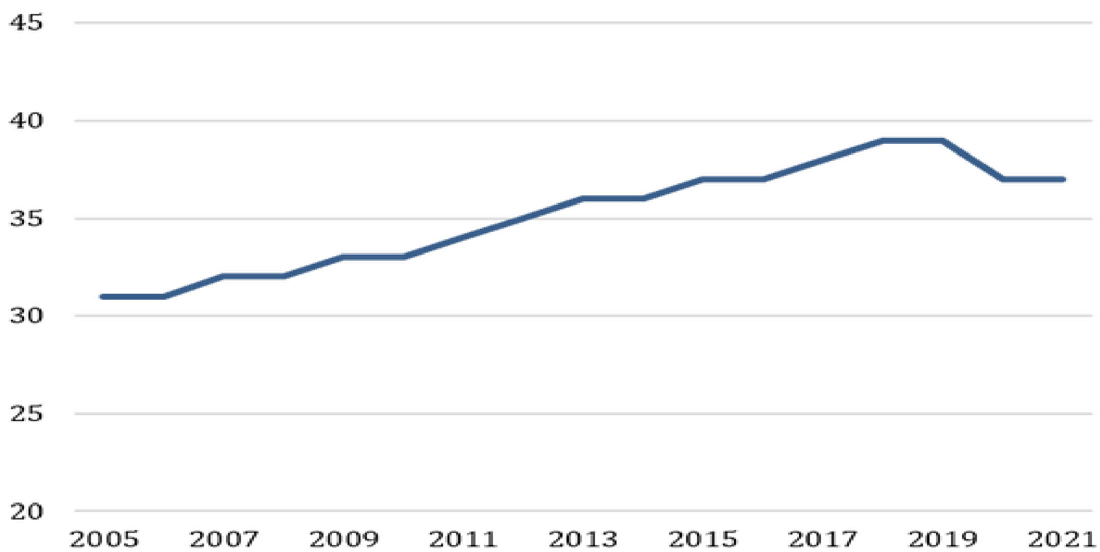
1 The industry has strong fundamentals, providing an important value-add to the overall real estate and lending markets

Business Purposes Loans comprise a $30 billion[1] segment of the U.S. residential mortgage market and provide short-term liquidity primarily to Fix & Flip investors. The Fix & Flip lending segment – also known as hard money lending or private lending – has matured considerably in recent years, as several large players have raised significant capital, expanded operations, increased sophistication, consolidated market share, and leveraged a deep and growing securitization market.

Business purpose lending includes a wide array of borrower and collateral types across three primary segments: Fix & Flip / Construction, Multifamily, and Single Family Rental.

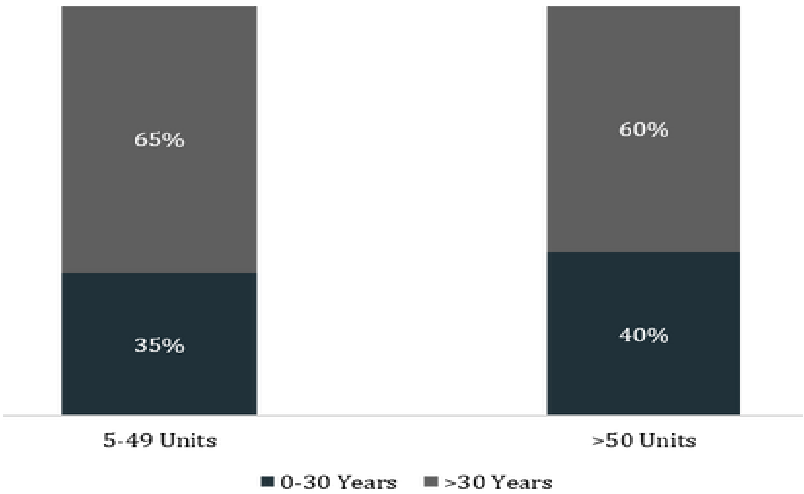
Fix & Flip / Construction is a highly predictable market that consistently represents 5%-7% of total home sales in the US.[2] Long-term tailwinds are driven by an aging housing stock, attractive borrower returns, and demand for renovated or new properties.

AGE OF SINGLE FAMILY HOUSING[3]



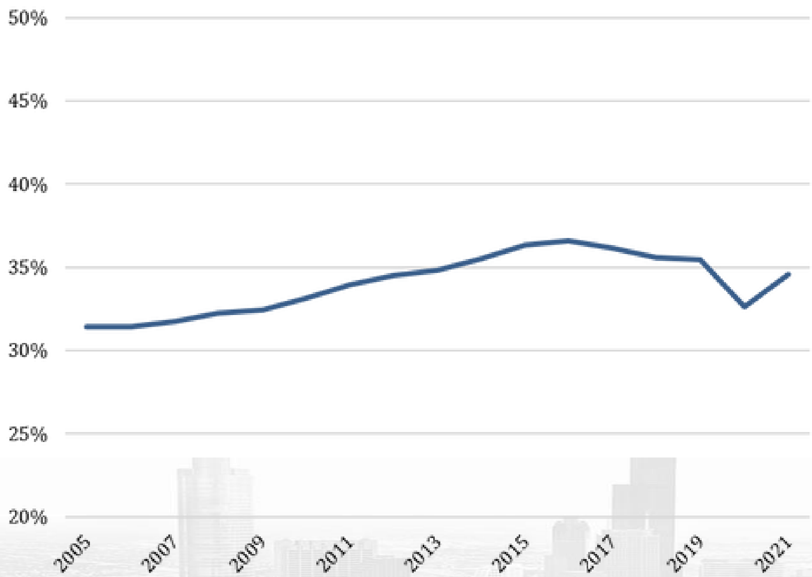
The age of multifamily housing has dramatically increased as well. Over 10 million or 65% of small property units involve structures built more than 30 years ago, many of which are ripe for renovation.[4]

AGE OF MULTIFAMILY HOUSING[5]



Single family rental is another area of opportunity and growth. Since 1965, approximately 35% of the $27+ trillion U.S. housing stock has been rented consistently.[6] Shifting demographics and housing affordability make renting a viable option for consumers and attractive for investors. Many Fix & Flip investors are rehabbing homes specifically for the rental market.

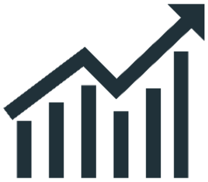
U.S. RENTERSHIP RATE[7]



Aging housing stock and consumer demand for renovated properties - to buy or rent - drives demand. Fix and flip lenders are a much-needed player in the overall real estate market.

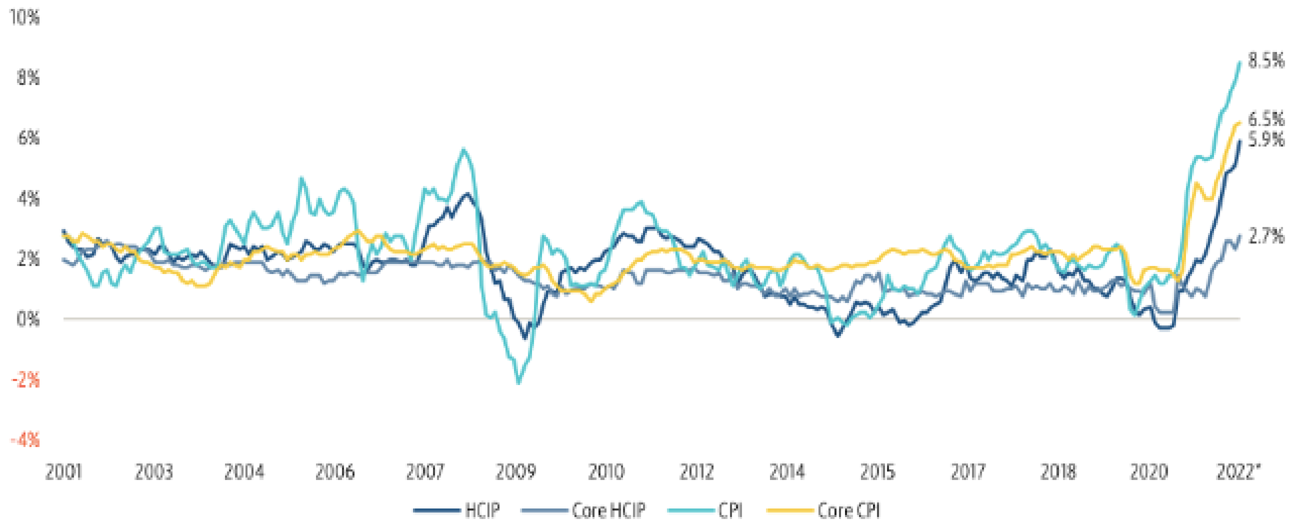
2 Headwinds are creating challenges for industry players

Inflation, supply chain issues, and potential regulatory changes are factors to consider when evaluating the prospects for continued long term growth.



The CPI climbed another 600 bps in March to 8.5%, increasing at its fastest pace in more than 40 years. The Fed is trying to tackle inflation, and interest rates are expected to continue to rise, putting pressure on housing affordability and threatening to cool a red-hot housing market.

RATE OF INFLATION BY SELECT INDEXES



Source: PitchBook | **Geography:** Global
*As of March 31, 2022

Home prices are being driven up by post-pandemic robust consumer demand and disruptions to supply chains.

The pandemic wreaked havoc on supply chains across the globe, as lockdowns created labor shortages at factories and congestion at ports. The construction industry has been feeling the effects acutely as the time to acquire building materials has stretched from weeks to months. The semiconductor shortage has affected the availability of appliances. Time is money, so the uncertainty of when contractors can procure materials means that the Fix & Flip industry suffers as contractors struggle to provide accurate timelines and budgets for projects.

Russia's war against Ukraine has exacerbated issues further, as global energy markets feel the strain from this conflict.

In regards to regulation affecting the fix & flip lending industry, legislators in California are currently proposing AB 1771, also known as the California Housing Speculation Act. This potential change in capital gains tax on home sales would have a significant impact on the Fix & Flip lending industry. The main event of this proposed bill is an additional capital gains tax to the tune of 25% for homes sold within three years of purchase.

The California legislation would have a significant impact on the fix & flip lending industry in California and could drive investors from the state. California's housing stock and construction industry would suffer. While the Act might offer some relief from soaring house prices, the Act would still impact individual homeowners if they seek to sell in a short time frame.

The Act covers residential properties, which is somewhat unique; although, New York attempted such legislation in 2019 with its "New York State small home anti-speculation act" of 2019. Legislators in California proposed the Act based on the concern that many California homes are purchased by investors, driving up prices. Alarmingly, there are no exemptions or carve-outs for equity earned through property improvement.

In summary, inflation, supply chain challenges, and new regulation that threatens the profitability potential for Fix & Flip lending create significant uncertainty throughout the rest of 2022.

3 The outlook is promising for the select players who will flourish in a "survival of the fittest" scenario

The fix & flip lending industry has seen a dramatic shift in recent years as several large players have institutionalized the market, bringing increased liquidity from diversified capital sources. Once a cottage industry of mom and pop players, larger firms have standardized originations and underwriting processes and have capitalized on demand from home buyers for improved properties within the aging U.S. housing stock.

The BPL industry is made up of several key players: independent originators, institutional loan buyers, and securitization lenders. Originators market to and underwrite loans for real estate development professionals to either be held on balance sheet or sold to third parties. Institutional loan buyers develop relationships with a handful of originators to purchase loans at discounted rates in order to achieve the critical mass needed for securitizations.

We estimate the top 10 originators control roughly 60% of the market, after which the industry appears highly fragmented.

Leading market participants

Company	Market Share	Estimated Annual Originations ($mm)
Redwood / Corevest	9.8%	$2,932
Kiavi (*fka* LendingHome)	8.8%	$2,628
Genesis Capital	6.7%	$2,000
Velocity Financial	6.6%	$1,991
Civic Financial	6.4%	$1,920
Anchor Loans	6.0%	$1,800
MFA / Lima One	6.0%	$1,800
RCN Capital	3.7%	$1,100
HouseMax Funding	3.3%	$1,000
LendingOne	3.3%	$1,000
Other Firms	39.4%	$11,829
Total Market	**100%**	**$30,000**

There are many nonbank lenders in the industry, including Anchor Loans, Dominion Financial, Genesis Capital, HouseMax, Lending Home, Lending One, Lima One Capital, Roc Capital, and Velocity.

Aggregators and diversified mortgage lenders in this space include players such as Athas Capital Group, Beach Point Capital Management, MFA Financial, Finance of America, Redwood Trust, Peer Street, 5 Arch, and Toorak Capital Partners.

These firms compete in a fragmented industry, with most firms focused on local markets. Scaling nationally requires significant investments, and different states and municipalities have unique barriers to entry. Expansion across states also requires additional licensing requirements and that foreclosure laws and collateral protection are well understood.

With the industry facing headwinds, we surmise that the survival of the fittest will be based on those companies that can successfully develop reliable and consistent origination networks and consistent funding sources. The fittest will also win on levels of service, experience, leverage, rate, speed/execution, and capital availability.

The Competitive Landscape

REITs

COREVEST A REDWOOD TRUST COMPANY

LIMA ONE CAPITAL

GENESIS CAPITAL

FINANCIAL SPONSORS

RENOVO FINANCIAL

KIAVI

INDEPENDENT / PUBLIC

velocity Financial, Inc.

HOUSEMAX FUNDING

ROC CAPITAL

RCN CAPITAL

BANKS

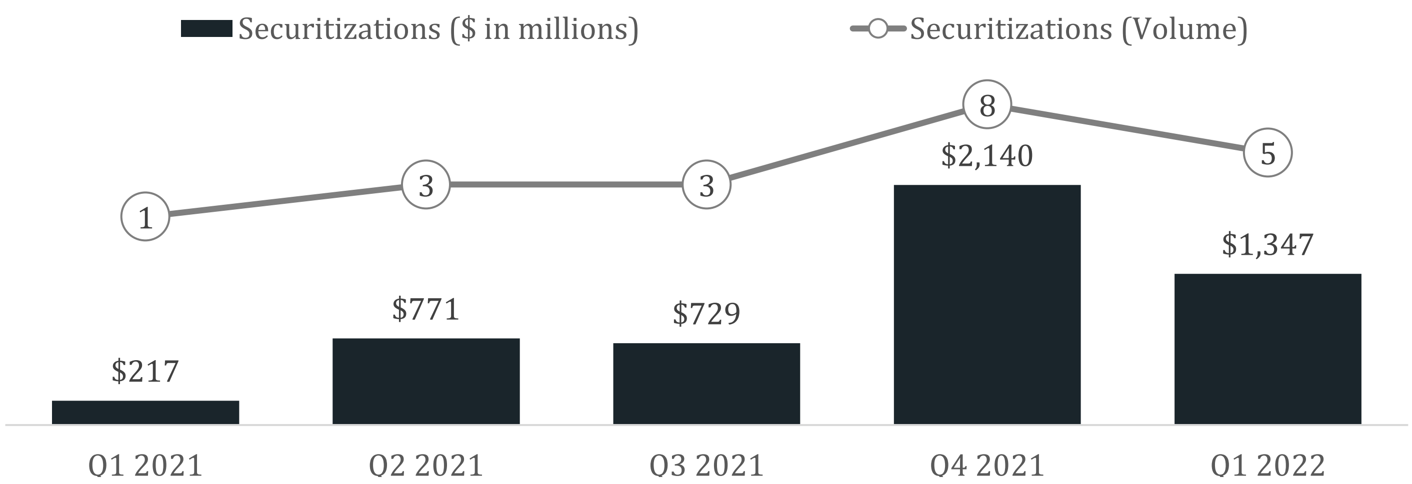
CIVIC

Securitization is the process of taking an illiquid asset or group of assets and packaging them into an asset-backed security that can be sold to investors. Increased securitization activity in the BPL market reflects investor confidence.

As the BPL industry has become more institutionalized, it has paved the way for institutional investors to deploy additional capital, typically through the securitization market. The real estate securitization market is robust, and U.S. mortgage-backed securities issuance reached $4.6 trillion in 2021, 7.3% higher than 2020. Private-label CMBS issuance reached $109 billion in the U.S. in 2021, a 95% increase compared to 2020. The trend extends to significant activity in the BPL securitization market in 2021, with 20 deals totaling $5.2 billion publicly reported by the major players.

Most recently, Q4/21 and Q1/22 each posted over $1 billion in securitization transactions, demonstrating strong momentum and confidence in the space going forward.

BUSINESS PURPOSE LOAN SECURITZATION ACTIVTY



A growing securitization market generally indicates confidence in the underlying asset class and provides additional capital for strong originators. Despite industry headwinds we described, the depth of the securitization market indicates long term confidence in the sector.

Recent Transactions

More than a dozen significant transactions have taken place in recent years, with Redwood Trust being the most acquisitive, acquiring three originators since late 2019. We expect ongoing consolidation in the next 24 months as the big get bigger.

Date	Target	Investor	Comments
Apr-2022	Riverbend Lending	Redwood Trust (NYSE-RWT)	Originated $798 million in 2021
Jan-2022	Merchant's Mortgage & Trust	KKR	Originated $500 million in 2021
Nov-2021	Anchor Loans	Pretium	Originated $1.8 billion in 2021
Oct-2021	Genesis Capital LLC	New Residential Investment Corp (NYSE: NRZ)	Originated $2 billion in 2021
May-2021	Lima One Capital	MFA Financial (NYSE: MFA)	MFA previously acquired a strategic interest in 2018
Apr-2021	Finance of America Mortgage (NYSE: FOA)	Replay Acquisition Corp	Public offering at a $1.9 billion valuation
Feb-2021	CIVIC Financial	PacWest Bancorp (NASDAQ: PACW)	$300 million loan portfolio
Dec-2020	Kiavi	Benefit Street Partners	$75 million Series E funding round
Jan-2020	Velocity Financial	IPO – NYSE: VEL	Originated $1 billion in 2019
Oct-2019	PeerStreet	Colchis	$60 million Series C funding round and $4.25 billion in commitments to purchase loans
Oct-2019	CoreVest American Finance Lender	Redwood Trust (NYSE: RWT)	Originated $1 billion of loans in 2019. $580mm portfolio. CoreVest was previously owned by Fortress
Mar-2019	5 Arch Funding	Redwood Trust (NYSE: RWT)	Originated $850 million in 2018. RWT had an option (acquired in 2018 for $10mm) to buy the 80% it did not previously own
Oct-2017	Genesis Capital LLC	Goldman Sachs (NYSE: GS)	Originated $1 billion in 2016
2016	Toorak Capital Partners	KKR	KKR increased its investment in May 2018 to $250 million from an initial investment of $75 million

Conclusion

While market headwinds sober our outlook to some degree in the coming year, Colonnade believes that the Fix & Flip lending industry is an attractive long term investment opportunity. The industry serves an important need in the value chain, and demand for its services will continue to increase. M&A activity can fortify the "survival of the fittest" – larger, established players will command a competitive advantage and weather the storm. We expect significant investment activity and consolidation in the sector over the next 24 months.

Colonnade Industry Experience

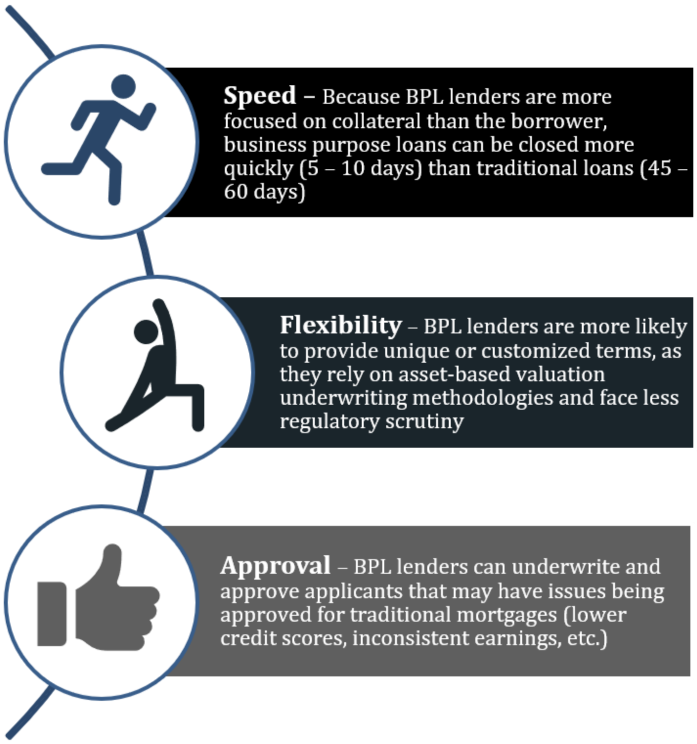
Appendix: Background on the Fix & Flip Lending Industry

- BPLs serve two primary investment strategies: transactional Fix & Flip and buy and hold rental portfolios. Larger investors often migrate from flipping single family homes to a more diversified approach that employs both rehabbing and renting, depending on market conditions. Fix & Flip can range from simple cosmetic improvements, to higher value rehabilitation, to ground-up construction projects. Rental strategies can range from single property investors to sophisticated managers with portfolios that include dozens of properties.

- BPL collateral generally consists of residential properties, such as single family homes and other single family properties (2-4 units) as well as small multifamily properties. The market includes small mixed-use and other commercial properties such as office buildings, strip retail centers and warehouses.

Overview of Business Purpose Loans

- The market for business purpose loans is estimated at $30 billion of annual originations
- Business Purpose Loans provide investors that do not have (or do not want to deploy) all the cash required to fund a purchase and renovation the ability to compete with cash buyers, while utilizing just a fraction of the cash out-of-pocket
  - Generally provided by non-banks with less regulation
  - Typically structured as short- or medium-term bridge loans with higher costs and lower advance rates
  - Loans made to special purpose entities, not individuals
- Demand for business purpose loans is driven primarily by the house flipping industry, ground-up construction, strength of the residential real estate market, and alternative real estate lending markets
- Business purpose loans are often the best option for borrowers who are in a time crunch, because the turnaround time from application to funding is much quicker for business purpose loans than traditional loans



BPL is an Important Part of the Residential Real Estate Lending Market

The U.S. housing market is a $43 trillion asset class supported by $18 trillion in outstanding debt

Conventional Conforming Mortgages

- Annual Originations: ~$1.2 trillion
- Monthly principal and interest payments
- Consumer loans that meet the criteria to be purchased under Fannie Mae and Freddie Mac guidelines
- Traditional mortgages are the most common and cheapest form of residential real estate debt
- Loan Requirements:
  - Credit Score > 620
  - Loan Amount < $822k
  - Debt-to-Income < 43%
  - Down Payment > 3%

Home Equity Lines of Credit

- Annual Originations: $45.6 billion
- Monthly payments of interest only
- Revolving consumer loans that allow homeowners to draw on the equity built in the home above the mortgage balance
- Provides consumers liquidity with flexible payments and without the full cost of refinancing
- Loan Requirements:
  - 15% – 20% equity
  - Good credit, low DTI, sufficient payment history, reliable payment history

Non-Conforming Mortgages

- Annual Originations: ~$250 billion
- Monthly principal and interest payments
- Consumer loans that fall outside the Fannie Mae and Freddie Mac guidelines
- Non-conforming mortgages are typically Jumbo loans where the loan amount if greater than the conventional mortgage limit
- Loan Requirements:
  - Credit Score > 580

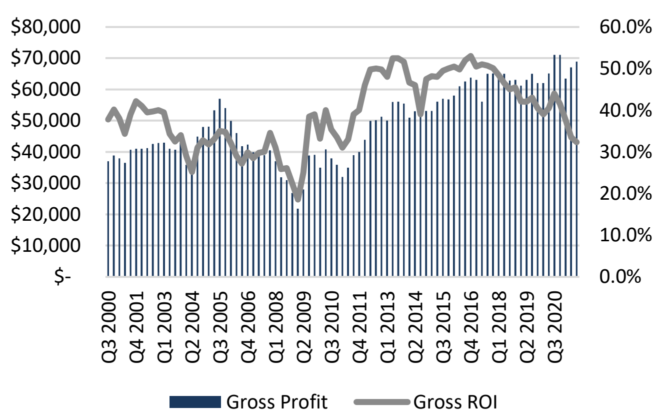
Business Purpose Loans

- Annual Originations: ~$30 billion
- Variable payment schedules depending on structure
- Commercial loan to a real estate entity back by a professional real estate investor/flipper/landlord
- Highly flexible but highly priced solution for the real estate professional
- Loan Requirements: lender specific

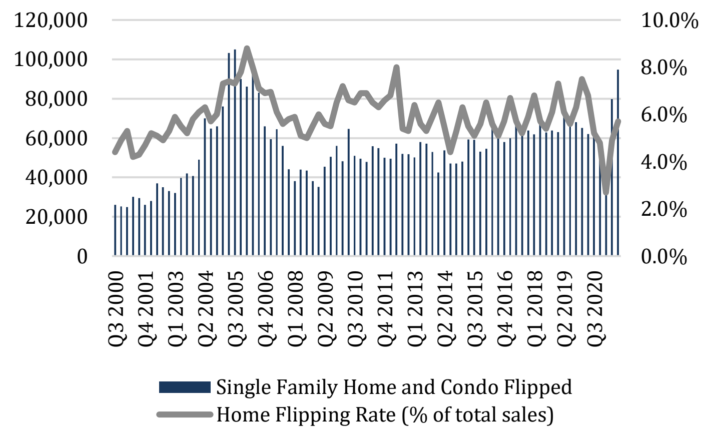
Business Purpose Loan Originations Track Home Flipping Activity

- Demand is outstripping supply, and available housing inventory has declined each year since 2010
  - The number of single family and multifamily future home building permits increased 9.1% in December of 2021
  - Prices remain high; home affordability index has declined from its 2012 high, but remains well above historical averages
- Single family housing has seen a dramatic increase in the median age, resulting in a major need for renovations and creating a robust environment for house flipping
- According to National Association of Realtors, the U.S. median home price rose to $357,500 in the first quarter of 2022, up 14% year-over-year
- Tight inventory, aging housing stock and rising prices create a compelling environment for house flipping activity and business purpose loan originations

HOME FLIPPING PROFIT TRENDS



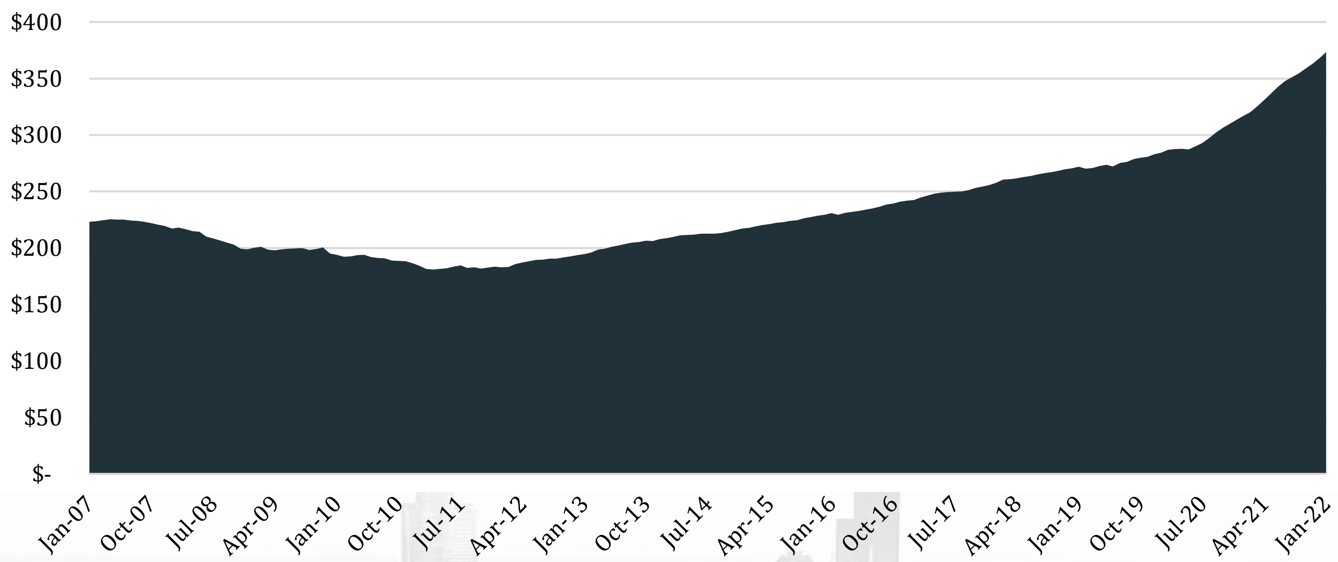
HOME FLIPPING VOLUME TRENDS



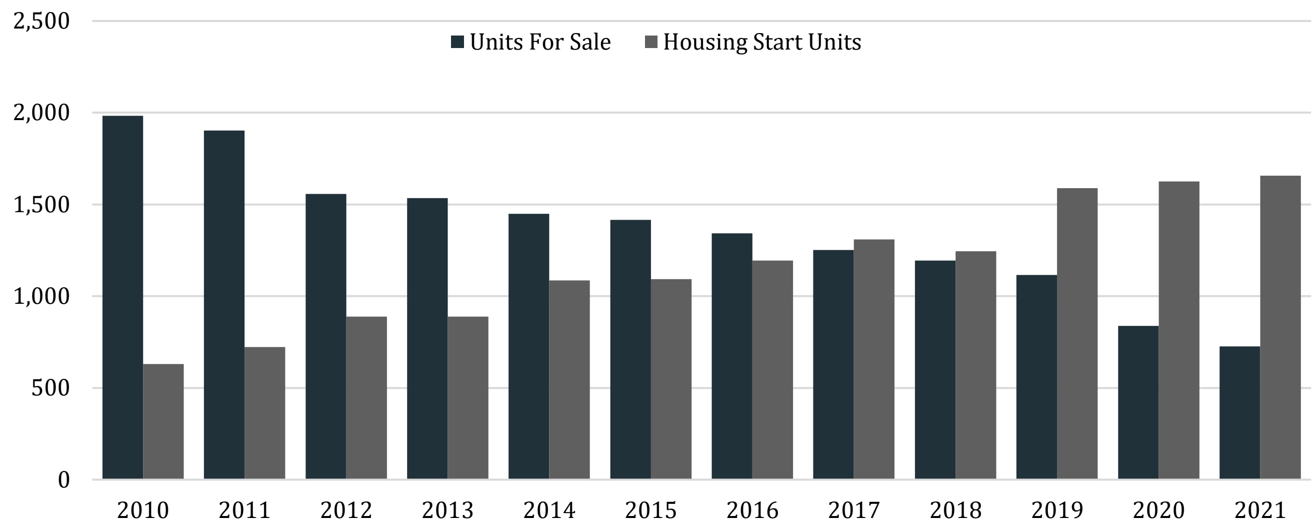
Key Driver: Residential Housing & Rental Markets

- Residential housing is the largest real estate asset class in the United States, with a total value of more than $27 trillion
- The U.S. housing market is in the midst of a massive transitionary period: after years of declining home ownership, the last four years have seen significant increases
  - Demographic shifts as Millennials gain more disposable income and payoff student debt
  - Total single family home sales volume experienced a 7% increase in 2021 compared to 2020 volume
  - Pending home sales, a forward-looking indicator of closed home sales, unexpectedly declined 4.1% in February compared with January, according to the National Association of Realtors. This decline comes at a time when inventory levels are at record low while prices remain elevated
- New housing starts have been steadily increasing for the past several years, but supply continues to lag demand
  - The disparity between supply and demand seems even larger when the age, quality, and condition of some of the homes is taken into consideration; many homes on the market are not move-in ready
  - The Fix & Flip industry is attempting to address the shortfall by modernizing the aging housing stock to meet consumer needs

MEDIAN HOME VALUES ($ IN THOUSANDS)



U.S. HOUSING MARKET (UNITS IN THOUSANDS)



Trends in Single Family Rentals

- Single family homes made up over 84% of housing units in 2020, but only accounted for 42% of rental units
  - There were 40.7 million occupied rental units (including detached and attached units) in the United States, of which 17.1 million (42%) were single family; and an additional seven million units (18%) were two- to four-unit buildings
  - The number of single family rental homes increased 48% to 17.1 million in 2021 from 11.5 million in 2006
- Historically, much of the ownership of one- to four-unit rental properties in the U.S. has been concentrated among smaller, non-institutional investors who own one to two properties. The 2008-2009 global financial crisis reshaped the single family rental housing market
  - Ownership of single family rental homes is now widely distributed with 91% of owners owning 10 or less properties
  - Since 2012, the single family rental segment has been the most active, with larger institutional investors acquiring these homes at scale, helping to grow the overall housing market share of single family rental homes
  - Large institutional owners still own a small percentage of single family rental homes; the four largest publicly traded, single family rental REITs own approximately 1.0% of the total 17.1 million single family rental homes. Investors with 10 or more homes own approximately 9.0% of the total single family rental market

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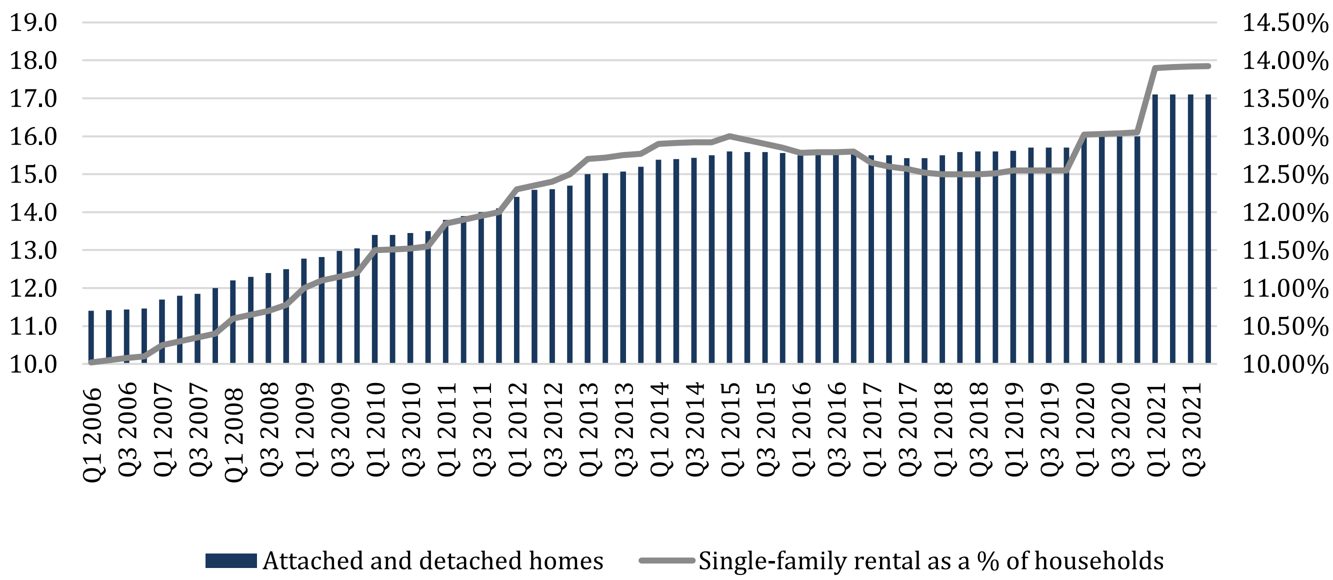
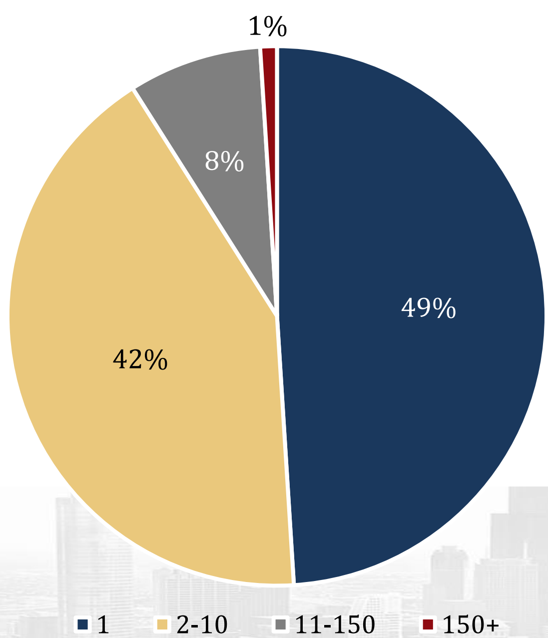
SINGLE FAMILY RENTAL VOLUMES



2021 SINGLE FAMILY RENTAL UNITS



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This advertisement was prepared May 2022. It is not investment advice, and Colonnade undertakes no obligation to update the information contained herein.

Sources:
1. Redwood Trust Q4 2021 Investor Presentation
2. ATTOM Data Solutions
3. American Community Survey
4. U.S. Census Bureau
5. U.S. Census Bureau
6. iProperty Management
7. iProperty Management

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