

Silver Bay Realty Trust
(NYSE: SBY)
\$17.30
2/1/17

Trading at only 77% of current estimated NAV, SBY and its nearly 9,000 single-family rental homes represent a compelling investment on a risk/reward basis. Due to the positive effects of leverage, and with just 5% annual appreciation in its portfolio, SBY's NAV should jump to nearly \$30 per share in three years (by the end of 2019) from its current NAV of \$23 per share.

SBY is a prime target to be acquired by either Colony Starwood (NYSE: SFR) or Invitation Homes (NYSE: INVH), which just went public. The geographic overlap is compelling and either company could take significant costs out of SBY's business. Absent an acquisition, the company is under-levered and a private equity firm could take the company private and slowly liquidate the portfolio over time. With SBY still trading below its December 2012 IPO price, it wouldn't take much for shareholders to jump at the chance for change.

There is a shortage of starter homes which is exactly what SBY owns

We are now entering the ninth year of a historic underinvestment in housing. Since 1948, residential investment as a percentage of GDP never fell below 3% and averaged about 4.5% annually, until 2009. Since 2009, we have been below 3%.

The shortfall in residential investment is primarily from single-family homes and more specifically from entry level homes. In 2003, 52% of the market for newly built homes was priced \$150,000 or less. Last year, it was only 7%. The median price of a new home in 2003 was \$152,000; last year it was \$306,000.

Builders have simply abandoned the price point of homes below \$200,000. That market is not economic anymore. Since the financial crisis, cash-strapped states and local municipalities have substantially increased taxes and fees such as water and sewer, causing development fees to soar for single-family land development. Even worse is the labor situation, which has gotten extremely tight. Contractors and other builders are having real problems keeping labor from being poached as the job market is hot. Add in an extremely restrictive immigration policy and the labor situation could get even worse for builders (overall, immigrants account for nearly half of all drywall and ceiling-tile installers, 43% of roofers and nearly 60% of plasterers and stucco workers, per a recent Wall Street Journal article).

These structural changes have caused home builders to move upscale, and to leave the home building industry entirely. Lennar (NYSE: LEN) is building apartment communities now, something that would have been shocking a decade ago. And with builders not keeping up with

demand, market forces continue to press prices higher, especially for entry level homes, which used to be the bread and butter of the housing industry.

Generally, in investing, you want to own what is in short supply. And what is in short supply right now is exactly what SBY owns.

SBY's portfolio is in all the right places

Silver Bay owns homes in the hottest real estate markets with some of the tightest supply of homes: Atlanta, Phoenix, Dallas, Tampa, Orlando and Charlotte. Case Shiller's latest data shows these markets currently increasing in value by an average of 6.7% year over year. And Case Shiller underestimates what is happening on the low end of the housing market due to low supply, prices in SBY's price range are anecdotally growing much faster than the overall local index. These markets are hot not only because the lack of supply but the relentless push of demographics and strong job growth.

Charlotte is just one example. Existing inventory of housing is down 26% year over year and the amount of new homes priced at \$200,000 or less is down 20%, yet existing home sales are up 23%. Add in 109 net new people moving every day to Charlotte and you have the recipe for a housing shortage with only 2.3 months of supply of housing available with no increase in inventory on the horizon.

Limited downside due to its valuation, and low leverage

SBY trades at just 77% of NAV, providing real downside protection for investors. SBY estimates the average value of every house was worth \$167,000 on June 30, 2016. Assuming just 3% price appreciation since then, gets you an average price of \$172,000. With 8,911 homes and \$611 million of debt, this nets you a NAV of \$23 per share with a fully diluted share count of nearly 38 million shares. Due to the company's low-cost debt, for every 1% of price appreciation, the NAV jumps \$0.40 per share. Therefore, with just 5% price appreciation in its portfolio, the NAV jumps \$2 per share every year.

Even more interesting is that SBY's leverage level looks too low at just 43% of market value of the homes it owns. If SBY increased its leverage to 60% debt to market value, the company could extract \$258 million, which could retire nearly 40% of the shares outstanding at current prices. This is the kind of analysis that gets more attractive as NAV keeps marching higher than the share price. Private equity specializes in taking under-levered companies private.

Overlap with Colony and Invitation Homes

Both Colony Starwood and Invitation Homes could easily acquire SBY, integrate the portfolio into their own, achieve economies of scale and take the valued employees they need. SBY is heavily concentrated in Florida and in Atlanta, just like Invitation Homes and Colony Starwood. Scale is

important in single-family rentals and SBY doesn't have it. Also in any acquisition, all the duplicative public company expenses could be eliminated.

SBY needs to act, or investors will demand change

With SBY's stock still selling below its December 2012, IPO, the company has underperformed the market and has kind of been left for dead. With an under-levered balance sheet, no real path for growth and a stock price that has diverged from its NAV, it won't take much for either an acquirer, a private equity fund, or an activist to make a move for change.

The company could easily take on more debt, initiate a large buyback or sell homes and buy back stock. Any of these actions would send NAV and the stock price materially higher.

Summary

With a limited downside, a portfolio full of attractive housing assets in short supply, SBY could easily double in three years, providing investors with a compelling risk/reward.