Institutional investment into alternative sectors

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Institutional investors are increasingly allocating capital to non-traditional real estate sectors. Rory Hardick balances the demographics behind the investment rationale with the operating risk investors may have to adopt to get exposure.

As the weight of capital allocated to real estate has grown, office, retail and industrial yields have fallen; creating an investment sourcing and pricing challenge for many investors.

As a result, investors have widened their scope to include new regions and new sectors, ranging from self-storage and senior housing to car parks and marinas. Even public service sectors such as hospitals and schools are being acquired by the more highly structured opportunity fund managers and specialist infrastructure investors. This tracks the growing institutional interest in wider infrastructure assets that share similar investment characteristics to traditional real estate sectors. Indeed several major European institutions have recently made significant allocation shifts away from real estate to pure infrastructure investments. While the range of sectors that investors are considering is broad, certain sectors are emerging as clear favourites: notably, student accommodation, senior housing and increasingly residential.

The attraction of the 'alternative' sectors is driven by two factors. Firstly, there are fewer investors chasing opportunities in these sectors and consequently, until recently, there has been greater availability of product at less competitive pricing. Secondly, many of these sectors offer portfolio diversification benefits since they are often less correlated with economic growth, which is the key driver of commercial real estate performance. Compelling alternative sectors are more likely to be driven by strong demographic or legislative factors which are typically less effectively exploited via traditional real estate sectors.

Student housing

Take, for example, the purpose-built commercial student housing sector in the UK, which, as of the December 2006 launch of the £1bn UNITE UK student accommodation fund, is emerging as a significant institutional asset class in its own right. UNITE's preliminary offering to institutional investors secured in excess of £310m of third party equity investment, largely from UK pension funds. Among other factors, institutions were attracted by the strong occupational demand characteristics and corresponding potential for rental growth in the sector. According to estimates from DTZ, the number of students in the UK is expected to increase by 1.6% pa to 2011, principally driven by the UK government's further education participation rate target of 50% amongst 18-30 year olds and the growing number of international students choosing to study in the UK.

On the supply side, universities are increasingly opting to outsource accommodation provision to the private sector allowing them to focus resources on education provision. Coupled with the poor quality of existing private rental stock and the more stringent landlord licensing requirements enacted by the Housing Act 2006, a significant opportunity for commercial operators has developed. In addition, many commercial student accommodation buildings are based in city-centre locations, where scarcity of land can pose a significant barrier to entry and protect the long term residual value of the investment.

What is more, the availability of data on the higher education population and the certainty provided by the academic year allow sophisticated operators to forecast occupation and rent levels with a high degree of accuracy, providing for a relatively smooth investment profile.

Senior housing

The demographic story is equally compelling in the senior housing sector. DTZ estimates that by 2050, the number of people aged over 65 will increase by 60% in the UK. Coupled with longer life expectancy, the number of aged people in need of care is estimated to increase by 200% to 1.3m by 2050. On the other hand, the supply of care home beds has fallen with the introduction of stricter health and safety regulations, which requires significant capital investment, reducing both the existing qualifying stock and acting as a barrier to new development.

Investment in the care home industry to date has been dominated by traditional private equity funds, and there has been significant consolidation in the sector. For example, over the past few years, Blackstone acquired Southern Cross, NHP and Ashbourne, creating a group with 28,000 beds in 580 properties. Blackstone subsequently floated the operating business in July 2006 after undertaking a sale and leaseback on many of the property assets.

However, institutional investor interest in assets with a lower medical care content is growing as demonstrated by Sunrise Assisted Living's recent £500m UK joint venture with Pramerica Real Estate Investors to assist with its UK development programme.

Market let residential

The stock of residential property in the UK dwarfs the commercial property sector. It seems likely that residential property let on assured short hold tenancies (market let residential) will become of greater interest to institutional investors (especially those who have historically been put off the sector by either regulatory controls or short term pricing concerns) as the longer term demographic and economic drivers are analysed and better understood.

What is clear is that a significant increase in net migration to the UK; a growing trend towards single occupancy households; and affordability issues for first-time buyers are all factors that are driving demand for rented accommodation. At the same time, the supply of new housing stock falls short of providing the necessary accommodation needs of the current professional generation. Research by the Department for Communities and Local Government shows that in the South East alone, there is a shortage of 25,000 new homes per annum.

Given the enormous scale of both primary home ownership and the buy-to-let sector, the short-medium term direction of house prices probably evoke more column inches than any other financial topic in the press. However for investment analysts assessing the supply and demand dynamics of this sector relative to others, many are beginning to feel that both rental and capital values will continue to grow positively over the long term.

From a portfolio perspective, residential property can add both strong performance and diversification. Research shows that total returns from residential property have out-performed all other property sectors and asset classes over the past 30 years, with relatively high risk adjusted returns and low correlation to other asset classes over that period.

Underwriting operating risk

While it is possible to invest in long term leases on certain properties in the alternative sectors, most often through sale and leasebacks, the opportunity to do so can be hard to find. Furthermore, it is unlikely that investment on this basis will yield the higher cash returns that investors are seeking by venturing out of the core allocation based sectors. A student accommodation block in central London which is on a long term lease to a university is as mainstream an investment as any FRI leased office building – and the initial yield will be comparably low. For example, typical net initial yields on student accommodation buildings that are let on a long lease to a university are in the order of 4.75% compared to the IPD all property initial yield of 4.57% at YE 2006.

As a result, many investors are willing to assume greater operational risk in order to attain a higher cash yield. In this case, the income derived from a property is not necessarily contracted on a traditional lease basis and is driven by the ability to extract income by managing an operating business within the properties. It is important, therefore, that investors are mindful of the additional risk that is being borne to extract above market cash returns from investments in alternative real estate sectors. Consider, for example, student accommodation, where rooms in direct-let properties are typically re-let on an annual basis. A thorough analysis of the sustainability of revenues requires an appreciation of the drivers of occupancy and rents year on year. This involves analysing factors such as the location of the building relative to both the university campus and the city's nightlife; the ongoing popularity of the university; supply of new accommodation; quality of the accommodation and the innovation of services offered to students (eg broadband points in each room; on-site launderettes and gym facilities).

Perhaps more important is understanding the operating costs incurred, which tend to be proportionately higher and more complicated than properties in core commercial sectors in the UK, where the UK institutional lease has somewhat uniquely evolved over time to pass such risk through to occupiers. For a portfolio of student accommodation buildings, the effective execution of marketing strategies or the effective management of the large staffing pool that is required to operate the buildings becomes critically important in determining net income to the owner. Figure 1 sets out an approximate example of the gross:net analysis that investors need to understand in making their investment in a direct let student property.

Figure 1: Gross:net analysis

	% of total revenue
Revenue	
Rental revenue	91.0
Other revenue	8.0
Commercial lease income	1.0
Total revenue	**100%**
Operating costs	
Marketing	(1.0)
Repairs and maintenance	(3.0)
Utilities	(10.0)
Variable costs	(1.5)
Property and associated costs	(2.5)
Sinking fund	(5.0)
Staff costs	(8.0)
Total operating costs	**(31.0)%**
Net operating income margin (NOI)	**69.0%**

Partner with specialist operators

Due to their operational nature, alternative real estate assets are often better managed over the long term by specialist operators that possess management infrastructure and a depth of knowledge that cannot be matched by generalist fund managers in their drive to secure funds under management. For example, market leading residential operator Grainger PLC is an integrated operating company employing nearly 250 people in eight offices across the UK. Grainger has developed multi disciplinary expertise in each facet of the effective management of market let residential. This is a sector that is often viewed by gung ho buy-to-let investors as needing minimal management whereas, in reality, careful yield management disciplines are needed to protect investors from the downside of the investment. Grainger assesses that the real NOI margin on residential is in the order of 65%, with its financial appraisal of this being carefully constructed in a similar manner to that set out in Figure 1.

Buy-to-let investors probably believe that margin is closer to 80%-90%. Clearly investors that invest without undertaking careful due diligence of the real NOI yield will be disappointed unless they are fortunate enough to experience significant capital growth.

By partnering with top-tier specialist operators, investors can manage their exposure to the operational risk that comes with what are really real estate backed businesses.

How far should institutional investment interest stretch?

What seems clear is that a number of alternative sectors offer both diversification opportunities and positive current returns relative to core property sectors and as such should definitely be on the radar of savvy institutional investors looking to match their current liabilities with cash yielding investments.

However, the craze for all things asset backed has heated up to such an extent that not just property companies but also institutions have been expressing interest in sectors such as caravan parks. Presumably they have been attracted by NOI yields in the region of 9%-10%. As a non-executive director of a caravan park operating company, I am a huge enthusiast of the sector. However, is it real estate and should institutions be investing in it from their real estate allocation? While there is significant asset backing to the business and that should be reflected in banking terms and to some extent in the methodology adopted by valuers, institutions should tread with care given that the average net operating margin is in the order of 20%-25%. In spite of the continuing need for affordable family holidays, generally stable occupancy since the birth of the sector in the 1960s and with zero new supply being allowed by planners, these assets need to be sweated intensely on an annual basis by their management to make an investment in them pay. Any institution that thinks they can passively sit upon such an investment will rapidly see their NOI yield diminish through their failure to manage the margin.

Institutional investors may not be equipped to underwrite such degrees of operating risk, most certainly should not be doing so on their own (i.e. without an operating partner) and need to carefully assess in each offering whether the returns being offered adequately compensate for the operating risk they might be assuming.