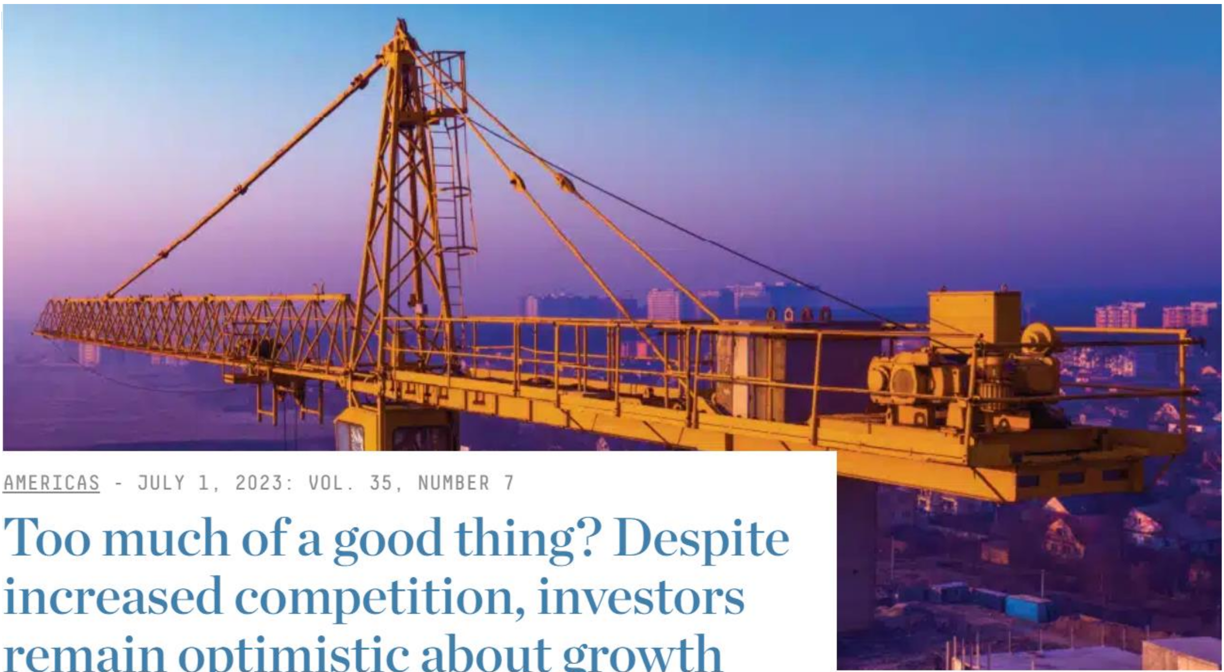

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Too much of a good thing? Despite increased competition, investors remain optimistic about growth opportunities in niche sectors

BY BETH MATTSON-TEIG

When Harrison Street first started investing in so-called "alternative" property sectors 17 years ago, there wasn't a lot of competition. Frankly, a lot of investors were wary of the ability to find institutional-quality assets, not to mention sufficient liquidity for exit strategies. These days, given the historical success of alternative sectors, there is a lot more focus, attention and capital directed at niche assets, such as student housing, storage, senior housing, life sciences and data centers.

"We feel fortunate to be in a strategy that provides stability and resilience, and where the demand profile is less correlated to the general economic conditions," says Joey Lansing, global head of portfolio management and strategy at Harrison Street. "During great economic times, we're not necessarily looking to outperform. But in tough environments like we have been in with scarcity of debt capital, we're still getting projects financed and finding our way to close deals with returns that make sense for investors that have entrusted their capital to us. So, while alternative property sectors are not immune to economic pressures, there are still compelling opportunities for growth ahead, adds Lansing.

Alternatives are no longer the well-kept secret they once were. Bigger portfolio allocations to niche sectors have resulted in more competition for investments and more capital targeting development. Investors are keeping an eye on markets where there are bigger pipelines for new supply and low barriers to entry for new projects. However, increased interest in alternative sectors also means more liquidity, which has a positive impact on exit strategies, particularly for value-creation strategies.

Alternative sectors accounted for 12.9 percent of total transaction volume over the trailing 12 months, through March, a share that is 1.5x higher than it was a decade ago, according to JLL. Putting that growth in the context of current market pressures naturally raises questions for some investors — are alternatives a safe haven for capital, or is there risk of overbuilding? Is there too much supply in sectors such as life sciences, self-storage and student housing, and are investors overestimating the "silver tsunami" in senior housing?

Institutions still like the fundamentals and the risk-adjusted returns in alternative or niche sectors. However, investors also recognize the potential risks ahead, whether it is increased supply and/or weaker demand. So, they are digging into data on a more granular level, and they are being more selective on assets and investment partners.

"We're not hanging out a 'Gone fishing' sign on the door. We all know that it's a challenging environment to do acquisitions with transactions activity back to pandemic-level lows," says Dags Chen, U.S. head of real estate research and strategy at Barings. "That said, we are continuing to look at deals and assess investment opportunities."

No 'silver tsunami' yet

Challenges senior housing faced during the pandemic haven't shaken investors' long-term outlook for the sector. In fact, some of the headwinds created for senior housing during the pandemic that constrained new supply have turned into a tailwind, with demand exceeding supply.

Although occupancies are still not fully back to pre-pandemic levels, slowing inventory growth is helping that recovery, according to Beth Burnham Mace, chief economist and director of outreach at the National Investment Center for Seniors Housing & Care (NIC). Inventory growth as of first quarter was at 1.6 percent, which is its lowest level since 2013. According to NIC, the senior housing occupancy rate notched its seventh consecutive quarter of improvement in first quarter, increasing to 83.2 percent. The occupancy rate has rebounded from a pandemic low of 77.8 percent in second quarter of 2021 but remains below the pre-pandemic high of 87.2 percent.

Slowing supply growth is a positive for continued recovery and a more bullish near-term outlook. In addition, the impact from inflation and staffing shortages that drove operating expenses higher are improving. “Margins are still compressed for operators, but it is definitely on the mend,” says Mace. In addition, active adult housing is becoming more popular and proved to be fairly resilient during COVID. “That’s acting as a feeder into more traditional senior housing. So, I think that’s a favorable development as well,” adds Mace.

Although the “silver tsunami” that many investors have been waiting for is still around the corner, it is nearing ever closer. When looking at the share of 75-plus households, the penetration rate for senior housing on a household basis is 11 percent, according to NIC.

“Even if you maintain the 11 percent penetration rate, with the growing number of baby boomers aging, you’re going to have a lot of new demand coming forward for seniors housing,” says Mace. “So, the demographics are still favorable, and the idea that people could just age at home is not practical because of the expense of in-home care.”

Investors focus on top life sciences markets

The aging population is driving demand across the healthcare spectrum, including life sciences. “The sector is being misunderstood because people are saying that VC funding is drying up or grants are being reduced,” says Lansing. However, there was a huge surge of financing of biotech companies that occurred during the pandemic in 2020 and 2021 that resulted in record real estate demand. Although the big rent increases life sciences saw during that time were unsustainable, the longer-term outlook is still very favorable, he adds.

Yet institutions are navigating the life sciences space carefully, with a focus on the more mature markets such as Boston/Cambridge, the San Francisco Bay Area and San Diego. "As we have been going through this period of dislocation, we have decided to focus strategically on those markets. The drop-off between the scale of the top three ranked markets compared to the fourth through 15th is very steep," says Chen. Other markets have less depth in tenant prospects and less institutional presence. "That is not to say that those markets can't become major life sciences markets, but we want to take some of the risk off the table at this moment when you're looking at a niche sector that has an active supply pipeline," says Chen.

Investors also are watching new supply, including both the purpose-built life sciences development as well as the "shadow supply," including older office buildings that could be converted into lab space.

Barings is digging into fundamentals at an asset level to better understand occupancy and rent trends for a particular building and type of life sciences use. The firm also likes the growth momentum in specific pharma therapy areas, such as oncology and central nervous system.

"It becomes a very bespoke and granular analysis," notes Chen. There are certain life sciences tenants that are incredibly challenged, but others are advancing promising research with sustainable financial backing. "Although there has been a pullback in venture capital funding, it's not a situation where its funding has collapsed. We have seen a deceleration in the rate of investment, but there is certainly investment and investor capital going into life sciences tenants," he says.

Student housing offers resiliency

At the other end of the demographic spectrum is the younger Gen Z cohort that is driving demand for student housing. According to the National Student Clearinghouse Research Center, undergraduate enrollment for the fall 2022 school year remained well below pre-pandemic levels, down by about 1.23 million undergraduates and 1.11 million total enrollment. However, enrollment trends vary widely depending on the institution.

Harrison Street's strategy is to focus its student housing investments around "power five" conference schools (ACC, Big 12, Big Ten, Pac-12 and SEC), where enrollment has remained strong. "Based on our focus area, performance across the student housing sector has been outstanding," notes Lansing. "We're seeing rent increases that far exceed what was originally underwritten."

The increase in new supply has not affected student housing fundamentals; in fact, demand fundamentals have never been stronger, agrees Teddy Leatherman, managing director of the JLL Capital Markets student housing team. According to JLL, the market is averaging 10.4 percent rent growth for academic year 2023–2024, and pre-leasing is 7.4 percent ahead of the same time last year. In addition, the supply pipeline is now slowing.

"Student housing has proven itself to be recession resilient for two reasons. One, every lease has a parental guarantee, and two, people tend to go back to school during times of economic slowdown," says Leatherman. So far in 2023, JLL's conversations with equity sources are indicating continued increases in investor interest. "We've had conversations with six domestic equity sources who are looking to enter or re-enter the student housing sector. Additionally, we have seen new foreign capital entrants, mainly from the Middle East and Singapore," he adds.

Storage fundamentals pull back from highs

Self-storage is another sector that continues to garner attention due to its performance and resiliency in downturns. Although some of the pandemic-related demand for storage is dissipating, institutional investors still see good demand for storage along with the opportunity to leverage technology to create more efficient management.

"Self-storage is an area where we still see very strong growth," says Chen. The growth is driven in part by demographics and people migrating to Sun Belt areas, lower-cost and higher-quality-of-life areas, and that will continue to occur.

Barings is looking for those locations where there are high levels of discretionary income along with barriers to entry. "It does seem that you turn your head and there's a new self-storage facility going up. So, we do try to be wary of markets where there is an oversaturation of existing self-storage properties," says Chen. "Just as we are getting very granular, very location and asset specific when we look at life sciences, the same thing applies with self-storage."

According to JLL, there was an uptick in new supply in 2018 and 2019 that amounted to approximately 5 percent of inventory growth nationally. However, new inventory growth has been moderating to roughly 3 percent of inventory.

“Self-storage fundamentals continue to remain very healthy. The increased demand as a result of COVID-19 has persisted, even with some seasonality returning, and has kept average occupancies in the low-to-mid 90 percent range,” says Brian Somoza, senior managing director and head of the JLL Capital Markets self-storage team. Self-storage fundamentals are pulling back from record-high rental rates and occupancy levels. However, there are not any looming signs of weakness, adds Somoza.

Fears of too many new starts in 2023 are lessened along with higher interest rates and tightening lending. “New supply continues to be the greatest risk at the asset level, but most unfunded, planned developments with limited cushion in underwriting have been halted given increases to construction costs and higher borrowing costs,” says Somoza. Investors are generally underwriting to the same total returns as they were in 2021, and institutional equity sources and the very early innings of foreign capital continue to look for strategic ways to enter the space. According to Somoza, the biggest hurdle is there is not enough opportunity for these groups to deploy the capital they have earmarked for the asset class.

Poised for the future

In a more challenging economic climate, some investors see alternative sectors as segments of their portfolios that have the potential to outperform as growth slows in more traditional property types. In particular, student housing, senior housing and self-storage are attractive because they all have leases that are shorter in duration than 12 months.

“We tend to weight the portfolio a little bit more towards those three ‘S’ sectors right now because we are seeing extraordinary potential in this inflationary environment to grow rents at outsized levels, now and for the foreseeable future,” says Lansing. “Supply will catch up eventually, but over the next three to five years, we feel very bullish about our ability to get above historical year-over-year rental growth.”

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