Kayne Anderson

Investing in alternatives from the ground up: a subsector approach for stable returns

Chase McWhorter, Institutional Real Estate, Inc.'s Managing Director, Americas, spoke in January with Kayne Anderson's **Kyle Mayes,** Senior Managing Director, Fund Management, Core Real Estate, about the long-term, resilient demand drivers in alternative sectors, how their outperformance has occasioned a rethinking of the role they can play in the core real estate market, and how a subsector approach and operational expertise can generate stable returns from the ground up. Following is an excerpt of that conversation.

How are you defining core real estate today?

A lot of people define core real estate based on the traditional sectors of apartment, industrial, office or retail. But if we're thinking about long-term risk and recession-resistant characteristics, we find those in the alternative sectors of medical office, seniors housing and student housing. It's these sectors that produce reliable income-driven returns. No matter where you are in the cycle, up or down, you have long-term demand drivers less correlated to the broader economy; regardless of the economic conditions, you're going to see your doctor. To me that's what core real estate investing is about – protection during tough times, and durable income that grows over time. And then you can go reach for the home run hit with opportunistic strategies or greater risk-return elsewhere.

What kind of portfolio composition should investors focus on when looking at core real estate?

The key is a strong income return with a focus on net operating income and cash flows. The question to ask is how you can get a balance across portfolio sectors of long-term locked-in leases and leases that can be marked-to-market every year for inflation hedging. It's about mixing these characteristics to construct an optimal steady return through market cycles. Our target sectors have done exactly this, and outperformed the traditional sector portfolio benchmark during up and down markets.

Investors should also focus on managers who are leaders in their sectors with disciplined allocation to build their core portfolio. We are not going to be all things to all people, even in alternatives. You don't need one manager to do everything. But we have a long track record and deep expertise in our few alternative sectors of focus, which together achieve the core risk-return objective. In a world where operational alpha increasingly divides the winners from the losers, picking a large fund with an allocator approach that does a little bit of everything will become less common.

They should also seek managers with the right amount of allocation flexibility. We will never do a deal solely to meet a target allocation. Our number one focus is delivering the strongest risk-adjusted returns possible. We migrate towards the best relative value and expect the long-term sector allocation to match the targets, but only when the deals make sense. That may mean being underallocated to one of our target sectors for a period of time. We stay nimble at the property level, willing to move around and get the right investment that makes the most sense on a risk-adjusted return basis.

When you're talking to investors, how are they thinking about core real estate?

Their thinking has shifted, and their portfolios are starting to head in that direction. There are redemption queues in many core funds, so they may want to be invested in other sectors but have an existing legacy portfolio. If you got everyone in a room and asked them where they would want to be invested today, you would likely get answers very different than the ODCE composition as it stands. Currently, there's still strong conviction long-term in apartment, in industrial warehouse. Those are overallocated in many LP portfolios, though, so there is a desire to rotate into alternatives.

Just this past quarter NCREIF made a significant change to their traditional NPI benchmark for unlevered property returns. The standard "Classic" version of the NPI had historically focused on the main four traditional sectors. The new standard benchmark now focuses on subsectors, many of which are alternative sectors. They've done what a lot of other organizations have done, which is basically to say, "We are living in a new world. Let's measure how we're thinking about this new world." It's more representative of alternative sectors, which is more representative of the way investors are thinking. LPs and consultants, many of whom have long had strong convictions in these alternative sectors due to their long-term demand drivers, now have more returns data to back their convictions. They are able to see how an alternative sector allocation stands on absolute returns, how the lower volatility and lower correlations improve the risk-adjusted return metrics of their broader real estate portfolios, in both up and down markets. As the alternative data set continues to grow, and as NCREIF and other benchmarking organizations set their benchmarks up in the right way, they will increasingly reflect the way we and others invest.

The data will become more granular as well. A big-picture metropolitan statistical area data set isn't what you use to evaluate an alternative sector. It's important to understand that ultimately investing in our sectors is a ground-up game: the key is to outperform managers within and outside of our sectors. In other words, it's not just being in the right sectors at the right time. It's not enough to have a set allocation in alternatives. The future is going to require a subsector approach and experienced managers in those subsectors, who generate operational alpha from the ground up and know when to expand or decrease exposure to each of those subsectors. That is becoming increasingly apparent.

Why is seniors housing getting so much attention?

Overall U.S. population growth is not strong, and everyone already has their full allocation for multifamily and industrial. So where else can you invest right now? You don't want to invest in office – you want to be in a growth sector where you have 4 percent-plus population growth, not 0 percent to ~0.5 percent. There's one clear sector that stands out, and that's seniors housing. In the PwC/ULI Emerging Trend survey that came out late last year, seniors housing was number two out of something like 27 subsectors, so very hot. Welltower is mostly senior housing at this point, trading at 3.3 percent implied cap rate at more than a 100 percent premium to gross asset value. Green Street is projecting rental rate growth of 4 percent or 5 percent-plus per year for the next few years, with further revenue gains from steady occupancy growth. This is not a short-term story; it's a long-term story. It's a story of accelerating demand, especially for higher-end, private-pay seniors housing. This is backed by residents who have five times the average U.S. net worth. It's a dual trend of aging and increasing wealth. As every year goes by, more people "qualify" financially for seniors housing.

Their wealth is compounding as they age, so it's more affordable every year; even after strong rent growth, affordability ratios are at historically strong levels. And medical office, not to be neglected, came in number three out of 27 in that survey. The common denominator here is the acceleration of aging demographics.

The demand is such that it's not going to be solved by a few companies. We'll likely need to nearly double the supply over the next 20-plus years to meet the aging population, so it's not a zero-sum game. It'll take a lot of different sources. New supply right now is at rock bottom, and as a result, you have favorable supply-demand fundamentals that should drive long-term growth.

Another demographically demand-driven sector we like is student housing, which is a more complex story. Many non-flagship public universities and financially challenged private liberal arts colleges are seeing reduced enrollment, and that will continue. At the same time, the large Power Four state universities are seeing steady enrollment gains, and a consolidation of demand. Students are seeking a great education and the all-around college experience that those universities are uniquely positioned to provide. If they don't get into their local flagship, they will go out of state to get that once-in-a-lifetime experience. College is where they will meet their closest friends, it will be part of their identity for the rest of their lives, and they're not going to miss out on it. Even during a tough period like COVID, they still went to campus. They want to be part of a lively campus community, and you only have one shot in your life to do that in a unique way. We don't anticipate that changing.

Since 1978, more than 90 percent of unlevered returns in core funds have been income-driven. How does that affect your investment philosophy?

We focus on two things. We're looking at the cap rate you get on the buy-in, which means consistent discipline. We didn't load up in 2021, when cap rates were rock bottom. We did our buying in 2020, and then again after cap rates increased. Our approach is to buy select properties with strong in-place income and income growth profiles at the right time, often through proprietary sourcing. When core funds and other market players are tied up and have redemption queues, that's when we lean in and buy at higher cap rates. Some alternative sectors have higher cap rates because they are more operationally intensive. They're tougher to get into, and they're more challenging to operate "at scale," which creates a barrier to entry. You need expertise; you need alignment with the right operating partners and vertical integration in-house to work hand-in-hand with them. It can't be a desktop approach. That's why the second thing we focus on is having significant operational advantages in sectors with long-term demographic trends, where we can drive that income growth over time. We will not invest in an alternative sector unless we believe we can be a leader in that sector.

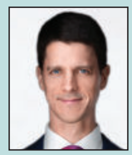
Through the years, we've developed experience, refining our operating practices, and sharpening how we underwrite, buy and sell in our sectors. This is the path to income performance, which has historically led to total return outperformance.

What are you hearing from investors regarding the real estate market? And how are you responding to any concerns they have?

Within the core real estate market, there's been ongoing concern about valuation. In our conversations, we try to be as open as possible with sharing our valuation metrics. And we're seeing significant amounts of capital coming into alternative core strategies. That's still a concern in the core fund space, which continues to have redemption queues.

During the past six quarters, there's been a tremendous pickup of investor interest in our sectors for core fund investment. That's not across the board, but we do think that interest should continue to pick up as the core space thaws and as investment opportunities in our sectors continue to be attractive. As redemptions are paid, increasingly, it'll be deployed into alternative sectors with strong demand drivers — not all alternative sectors will see this flow. Right now, there's still an educational process going on. Many investors aren't ready to enter seniors housing, student housing, or medical office, but they're taking this time to do a lot of research. We love the opportunity to answer questions about our sectors — however long it takes and wherever we need to go for property tours. We understand it's a process. You're not going to get to a NAREIT alternatives allocation overnight. It's going to happen as money comes out of queues, as allocations increase, and as the educational process brings conviction.

CONTRIBUTOR



Kyle Mayes

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Kyle Mayes is a senior managing director of the core portfolio for Kayne Anderson's real estate group, responsible for overseeing fund management, including the impact of property operations, transactions, and financings on risk-adjusted returns.

Prior to joining Kayne Anderson in 2018, Mayes was vice president of portfolio management at ASB Real Estate Investments ("ASB"), focusing on their core fund. During his time at ASB, Mayes led the advancement of institutional portfolio management practices, as the core fund grew from $1 billion to $6 billion in net assets under management. Mayes previously worked at E*TRADE Financial Capital Markets ("E*TRADE"), underwriting and analyzing home equity loan portfolio acquisitions. Prior to E*TRADE, Mayes worked as a financial consultant for IBM Global Business Services, focusing on federal government clients.

Mayes earned a B.S. in Economics from Duke University, where he was a B.N. Duke Scholar. Mayes is a CFA® charterholder and member of the CFA Institute.

COMPANY OVERVIEW

With approximately $22 billion of assets under management, **Kayne Anderson Real Estate's** investment objectives are to create strong risk-adjusted returns by focusing on current cash yield and increasing value through cash-flow growth, while remaining sensitive to capital preservation. Since 2007, Kayne Anderson Real Estate has invested in alternative real estate sectors, including medical office, high-end senior housing, off-campus student housing/multifamily, self-storage, and light industrial. Our vertically integrated team brings expertise in all aspects of real estate investing and management to each of our investments, thereby maximizing operating capabilities.

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