Opportunities for alpha

Niche investments in real estate

Alternative Investments

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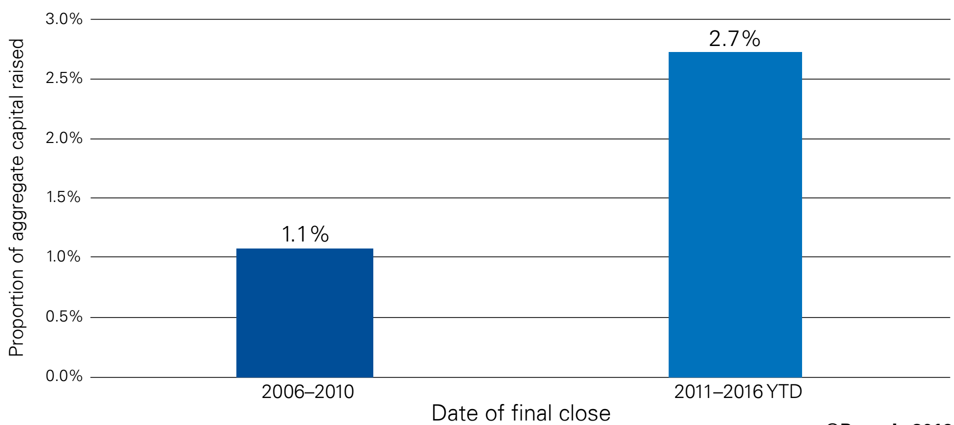
Niche investments in real estate

Alternative investors have always had an allocation of their dollars to real estate, but uncertainties affecting financial, geopolitical, and regulatory directions may create challenges for investors to find deals through 2017 and beyond.

Even with headwinds created by some of the uncertainties, alternative investors may find ways to create alpha. We suggest that, because prices are lofty for some core real estate assets, such as retail, office, industrial, and hospitality in major markets, in order to find alpha, alternative investors may need to look where fewer investors are looking: niche investments in real estate.

Specifically, the niche sectors of student housing, storage facilities, data centers, single-family rental properties, and senior housing may bode well for them, particularly if they are in strong secondary markets that have good job growth. But, finding value in the niche arena is not always easy and requires rigorous due diligence to create alpha in this complex investment environment. Still, we suggest that those willing to look beyond the four major sectors and use new tools to root through rich trend and demographic data sets may be rewarded.

Fig. 1: Capital raised by North America–focused niche private real estate funds as a proportion of capital raised by all North America–focused funds (as at October 2016)



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Niche investing, while still a small portion of the pie of real estate investing, has been growing.

Student housing

As more colleges and universities around the country grapple with mounting enrollment and financial challenges, developers are taking a larger role as partners with institutions of higher education to build and manage on-campus dormitories and off-campus multiunit dormitory-style buildings. Investors should look for campuses that have either an aged housing stock or are growing enrollment at a rapid pace.

Investment in the student housing sector hit an estimated $9 billion in 2016,[1] much of it from offshore investors.

Although there are a number of reasons for new housing in college towns, a key motivation for higher-education institutions to align with investors and developers is the trend toward schools wanting to offer highly styled edifices with roomy academic common areas and other amenities in the buildings.

Such amenities add to the schools' "brand," and the amenities serve as an attraction to students looking for out-of-the-ordinary living arrangements at a school.

It is not uncommon for new student housing to include "luxuries" in order to attract students. One school in the Southwest offers a dorm with a clubhouse, fitness center, tanning beds, common rooms for studying, a media center, swimming pools, an outdoor theater, and barbeque pits. But that school is hardly alone in creating new "learning-and-living environments" through partnerships with investors.

Speedy Internet service also is a must: "Over-the-top Internet is almost like hot water" with respect to student expectations, an operator of several dozen student housing communities said in a recent report about student housing development.[2]

"To satisfy investors clamoring for higher property returns, more purpose-built off-campus student housing is being built within walking distance of schools, despite escalating land and labor costs in core markets. And cash-strapped colleges and universities are turning to developers as partners to renovate, build, and even manage their on-campus housing properties."

"4 factors driving the student housing market," Building Design & Construction: bdcnetwork.com, February 29, 2016

[1] "10 Must Reads for the CRE Industry Today," National Real Estate Investor, March 30, 2017.

[2] "4 factors driving the student housing market," Building Design & Construction: bdcnetwork.com, February 29, 2016.

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Student housing issues to keep in mind before investing

- Evaluate the age and supply of the school's existing student housing stock, seeking answers to whether upgrades or new stock are needed.
- Examine the school's trend in enrollment.
- Understand the school's plan for any increase in tuition.
- Evaluate the housing developer's financial position.
- Investigate the health of the institution's endowment fund.
- Determine if the school's academic rating (often available in well-recognized magazines) has been lowered recently.
- Ascertain if local municipalities are offering incentives, such as real estate tax abatements.
- Come to a decision about whether the location of the school is conducive to growth in student enrollment.

Demand is strong. "It would be pretty hard to overbuild in most markets," was the way a property management software executive described the privately owned student housing market in a National Real Estate Investor article published in November 2016. "In most markets you could double the amount and not overbuild."[3]

Axiometrics, an apartment data services and student housing analytics firm, reported in the same article that developers have plans for 45,700 beds in new student housing starting in the fall of 2017.[4] And, per-bed rents have steadily increased during the past several years.[5]

Approaching this segment with caution is wise, even though it has performed well in the past. During the Great Recession, when prices for overall apartments dropped 20 percent, average prices per bed for student housing properties did not retreat.[6]

Randy Churchey, chief executive of EdR, a student housing real estate investment trust (REIT), said recently that growth through on-campus development is the result of "universities that are running low on funds and have aging housing stock that needs to be upgraded to recruit new students."[7]

[3] "Demand for Student Housing Looks Strong for 2017," National Real Estate Investor, November 21, 2016.

[4] Ibid.

[5] "Student Housing Strong, though Prelease Dips Slightly: Rent Growth Improves," Axiometrics, September 21, 2016.

[6] "New Investors Rush Into Student Housing," National Real Estate Investor, February 2, 2015.

[7] "Student Housing REIT EdR Finds External Growth Opportunities," REIT.com, November 29, 2016.

Self-storage

As more people move into urban areas, they are likely to have smaller living spaces, which will create an increasing need for storage. Some of these storage needs are met on site, but often, on-site storage at apartment communities is limited.

Self-storage units are those unassuming, nondescript structures that have become a vital part of urban, and even suburban, life. These investments have been relentless alpha-producing assets for quite a while. In 2001, according to REIT.com, while the stock market was doing poorly, self-storage was a top-performing REIT sector, with a 35 percent total return. The following year, the sector's total return was just under 20 percent.[8]

In 2015, when equity REITs were up just 2.8 percent and the broader stock market was flat, self-storage REITs returned 40 percent.[9] A Kansas-based financial adviser found that the storage REIT index has performed the best of any REIT index from June 1995 through May 2016.[10] Exchange-traded funds in the storage-unit arena throw off returns similar to storage-unit REITs, and often with lower risk of volatility.

Among the reasons for their attractiveness as an alternative investment is that break-even for a typical self-storage unit is about 45 percent occupancy.[11] Further, public storage often is a low-cost-of-entry project.

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Self-storage is in play

— Many locations are owned by small operators.

— Demographic development now in play may keep the self-storage train chugging. (Downsizing baby boomers and millennials having to rent a place to live will need space for storage.)

— There are opportunities for investors to consolidate local/regional players.

— There are opportunities to develop new facilities near recently constructed condominiums and multifamily complexes in fast-growing cities.

— Because of Millennial and demographic trends, there are few signs that self-storage alternative investments will cool off anytime soon.

[8] "Technology: Boosting REITs' Presence in Self-Storage Sector," National Association of Real Estate Investment Trusts, March 13, 2013.

[9] "How Humdrum Self-Storage Became the Hottest Way to Invest in Real Estate," *Forbes*, April 13, 2016

[10] "3 Things to Know About Investing in Self-Storage Spaces," *U.S. News and World Report*, June 20, 2016.

[11] "How Humdrum Self-Storage Became the Hottest Way to Invest in Real Estate," *Forbes*, April 13, 2016.

Buy or rent?

Single-family rental housing is hot.

If anyone needs convincing, look no further than Blackstone Group LP's decision to invest $10 billion to buy, renovate, and now rent 50,000 foreclosed homes that were casualties of the 2008 financial meltdown and resulting credit crisis.

Blackstone's plan to rent homes at a time when lending by banks is still too tight for many buyers to purchase a home may turn out to be a brilliant move on its part. After all, an entire generation of pent-up apartment renters may soon flow into the home-rental market because they have outgrown apartments but are too weighed down by student debt and flat wages to qualify for a mortgage to buy a house. In mid-January, Blackstone's REIT, Invitation Homes, raised $1.54 billion in an initial public offering. Invitation Homes' houses are predominantly located in western and southeastern states.[12]

So, as an alternative investor, where might you find your best buys? Manhattan? Los Angeles?

Perhaps, but, smart bets actually might be placed in smaller metropolitan areas. Though there are many lists out there, and the locations on the lists sometimes conflict, one fact they have in common is that many of the cities are in secondary and tertiary markets.

Here is just one list (from a March 2017 Altisource.com press release) on top rental investment markets and yields:[13]

Rank	MSA	Average gross yield – Q4
1	Cleveland-Elyria-Mentor, OH	13.7%
2	Detroit-Warren-Livonia, MI	13.5%
3	Dayton, OH	13.1%
4	Memphis, TN-MS-AR	12.8%
5	Toledo, OH	12.5%
6	Milwaukee-Waukesha-West Allis, WI	12.5%
7	Birmingham-Hoover, AL	12.1%
8	Indianapolis-Carmel, IN	11.8%
9	Canton-Massillon, OH	11.7%
10	Tulsa, OK	11.7%

[12] "Blackstone's Invitation Homes Raises $1.54 Billion in IPO: Source," cnbc.com, January 31, 2017.

[13] "RentRange Identifies 25 Markets with the Highest Average Gross Yield," Altisource.com, March 30, 2017.

Alternative investors seeking valuable properties in these and other locations may be most successful by utilizing data mining tools that can offer valuable demographic insight about the scope of potential renters and their needs.

> **"The single-family rental market across the United States continues to offer significant opportunity for investors ... The robust data available today empowers even non-institutional investors to analyze geographies and select the investment locations throughout the U.S. that are most opportune, as opposed to being limited to their own backyard."**
>
> — **RentRange CEO Wally Charnoff,**
> "Top Ten Cities to Buy Rental Housing," Investopedia.com, May 27, 2016

Many of the demographic forces driving other financial services products and services are in play in home rental: baby boomers who no longer want the burden of owning a home may consider renting, and, according to the Zillow January 2016 Housing Confidence Index study, only 9 percent of millennials (generally defined as those born between 1982 and 1999) said they planned to buy a home in the near future. For many of the younger generation, burdensome student debt precludes them from buying—millennials owe an average of about $40,000 in student loan balances.[14]

Investors are also considering that as current renters increase the size of their families, they are likely to outgrow the typical two-bedroom multifamily rental, which leaves the single-family home rental with three and four bedrooms as their only option.

[14] "Majority of Millennials Have 'No Idea' When Student Loans Will Be Paid Off," Bloomberg News, April 7, 2016

KPMG observation

Attributes of population growth

Institutional investors looking for indicators that would attract renters might want to include in their search cities with employers who understand millennials' desires, including a better work-life balance.

Employers increasingly seek to locate in regions where a majority of people are educated. About one-third of the national workforce holds a bachelor's degree, according to the U.S. Census Bureau. Businesses would look for regions that exceed that national average. Many people moving to such areas would want to rent first, before buying a home.

Other factors of attractiveness that could help alternative investors decide on locations for investment in rental property include highway accessibility, proximity to a major airport or waterway/ocean port, railroad service, whether the city is in a right-to-work state, the overall rate of job growth in the past several years, whether the state or city has laws that protect against lifestyle discrimination, and the region's birthrate trend line.

Senior housing

As the population of seniors in the United States (and elsewhere) grows, senior housing and related real estate assets may become an attractive alternative niche opportunity for some investors not already involved, whether they are institutional or individual investors.

The numbers that argue for this case seem compelling:

— America's older population will double by 2030, reaching 70 million.[15]

— By 2030, people over the age of 65 in the United States will account for one-fifth of the total population. Today it is about one-eighth.[16]

— Americans are living longer: The average life expectancy for Americans age 65 in 2000 was for 18 more years—an increase of 50 percent since 1900—and the number of U.S. citizens living in poverty has declined precipitously, from 35 percent in 1959 to 11 percent at the turn of this century.[17]

— In 2014, the number of people living to be 100 years old was 44 percent greater than in 2000, and double the number in 1980.[18]

— Expect that many of these people will sell the houses in which they now live because they are too big for them to care for, and they will either move to smaller homes or to senior-living communities.

[15] "Older Americans Living Longer, Study Says," ABC News, August 10, 2016.

[16] "Aging Demographics Lure Investors into Senior Housing," *Institutional Investor*, April 21, 2015.

[17] "Older Americans Living Longer, Study Says," ABC News, August 10, 2016.

[18] "The 'Platinum Years?' More Americans Are Living Longer," *U.S. News and World Report*, January 21, 2016.

These data points can make a persuasive argument for alternative investors to consider whether to add senior-related properties to their portfolios. Beyond living quarters, seniors' numbers may make other real estate assets attractive investments. These include, among other properties, medical-office buildings and/or assisted-living communities.

As most economists will attest, demographics are destiny. So despite some investors believing that it may be too late to focus on senior housing and medical offices, we believe that the growth trend will continue into the future.

Transaction value in the assisted-living sector totaled about $3.5 billion as of the third quarter of 2016. Though the $3.5 billion reflects a dip in comparison to recent quarters, 2017 is expected to see an increase in deal volume. One national real estate brokerage firm, Senior Global Advisors, recently predicted "an acceleration of transaction volume in 2017" by at least 20 percent.[19]

[19] "Seniors Housing Investors Focus on Assets Offering Continuum of Care," National Real Estate Investor, October 16, 2016.

KPMG observation

Selecting deals in senior housing

The senior citizen housing and medical-care facility sector remains attractive to alternative investment players because yields can be healthy, although the sector is fairly saturated at the moment, but opportunity exists. Redevelopment of older complexes in high-demand locations may be an opportunity.

Nevertheless, while investors will need to rely heavily on their traditional relationship network to uncover potential targets for investment, data analysis to discover underutilized opportunities, or even underserved markets, will be critical.

For example, investors may focus on funds that specialize in private-pay seniors housing instead of those that are dependent on government reimbursement. We already see such investments in the private-pay sector from a variety of institutional and individual alternative investors. Some investors also may be looking at micromarkets in certain geographic locations, although discovering those micromarkets will rely on tapping into local knowledge and analyzing information contained in sophisticated databases.

Investors, therefore, may want to evaluate their talents needed related to database analysis in order to tap into the senior market.

Data centers

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Data center attraction and power usage

In considering investment in data centers, investors may want to look to the sun and the wind. Some data-center providers already have tapped into solar and wind power to reduce their costs and help with their profitability.

We see data centers as a way to invest simultaneously in technology and alternative real estate assets, both of which are key growth areas.

Alternative investors will need to do their homework to find the right assets that have the right technology and that fit their investment profile.

Data center investments are heating up, giving alternative investors a reason to examine this subsector of real estate that they may have overlooked. These centers, where a business houses its information technology operations and equipment, are where real estate and technology meet.

Demand for data centers in 2016 was very strong, and we expect this niche to remain popular through 2017. The use of cloud services by a myriad of businesses continues to escalate, as public-cloud providers such as Google, Amazon, Microsoft, and others are expanding offerings to meet the needs of many businesses.

Even with the possibility of an easing of financial-services regulation by the new Republican-led administration, we see broad usage of data centers by banks, insurers, and others in the financial-services industry.

Since the Urban Land Institute suggests that "ideal data center locations are near large population centers,"[20] and have access to abundant low-cost energy, alternative investment players may want to focus on these regions when considering where to place bets.

Silicon Valley–based analyst firm Constellation Research, which studies data center usage, estimated that although about 7 percent "of the world's workloads are in the cloud today … by 2020, 67 percent of the world's workloads will be processed by cloud data centers."[21]

A bet on data centers essentially is a bet on big data, which may be a safe bet—given how much businesses across industry lines are relying on big data to help with everything from their operational efficiency, to decision making, and the identification and attraction of customers.

[20] "Data Centers Are a Leading REIT Sector in 2016," Urban Land Institute, April 18, 2016.

[21] "Trends: Five Data Center Trends for 2017," Constellation Research Inc., November 12, 2016.

The final thought - Infrastructure

In his inauguration speech, President Donald Trump voiced a firm commitment to improve the U.S. infrastructure, pledging that "we will build new roads and highways, and bridges, and airports and tunnels and railroads all across our wonderful nation." On the campaign trail he promised a $1 trillion infrastructure plan. While many of the details about the plan have yet to be released, infrastructure investment may be another large niche that alternative investors should consider in their upcoming investment plans. Infrastructure comes in many varieties—some of which have very significant real estate components.

Infrastructure can be defined as:
Facilities, structures, equipment, or similar physical assets—and the enterprises that employ them—that are vitally important, if not absolutely essential, to people having the capabilities to thrive as individuals and participate in social, economic, political, civic or communal, household or familial, and other roles in ways critical to their own well-being and that of their society, and the material and other conditions which enable them to exercise those capabilities to the fullest.[22]

In addition to the transportation infrastructure mentioned by President Trump, significant opportunities exist in the social infrastructure arena with transit-oriented housing, master-plan communities, educational facilities, municipal utilities, sports facilities, courthouses, correctional and civic buildings, and telecom infrastructure. The key financial characteristics that interest investors are stable and predictable income streams over long periods of time, high barriers to entry, and good risk-return profiles on existing assets. Those investors looking for higher returns can also invest in greenfield, development assets, or public-private partnerships that have higher risk but can provide investors with private-equity-type returns.

[22] "Infrastructure - Defining Matters," www.law.harvard.edu, 2016, page 15, Larry Beeferman and Allan Wain.

Contact us

For more information please contact our national and/or local Alternative Investments leaders.

Jim Suglia
National Practice Leader –
Alternative Investments
T: 617-988-5607
E: jsuglia@kpmg.com

Philip A. Marra
National Real Estate Funds Leader –
Alternative Investments
T: 212-954-7864
E: pmarra@kpmg.com

Cara Scarpino
Director, Marketing Strategies and
Programs – Alternative Investments
T: 201-505-3474
E: cscarpino@kpmg.com

Boston
Declan Lee
Partner, Audit
T: 617-988-1064
E: declanlee@kpmg.com

Chicago
Patrick Brooks
Partner, Tax
T: 312-665-2871
E: pbrooks@kpmg.com

Dallas
Steve Menna
Partner, Audit
T: 214-840-2884
E: smenna@kpmg.com

Los Angeles
John Donovan
Partner, Audit
T: 213-955-8415
E: jdonovan@kpmg.com

Minneapolis
Lynda Graham
Partner, Audit
T: 612-305-5483
E: lagraham@kpmg.com

Philadelphia
Matthew Tomasicchio
Partner, Audit
T: 267-256-2928
E: mtomasicchio@kpmg.com

San Francisco
Seth Blackman
Partner, Audit
T: 415-490-4506
E: sblackman@kpmg.com

Stamford
Michael Hayes
Partner, Audit
T: 203-406-8272
E: michaelhayes1@kpmg.com

Contributor

Timothy Dougherty
Director, U.S. Financial Services
Thought Leadership and Content
T: 212-872-7620
E: trdougherty@kpmg.com

kpmg.com/socialmedia