Kayne Anderson Real Estate

Heads up, as markets head into dislocation

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Al Rabil,** CEO of Kayne Anderson and CEO and co-founder of Kayne Anderson Real Estate. Following is an excerpt of that conversation.

What is the current state of the market, and how have conditions changed since the third quarter of 2022?

Let me just hit the highlights. The Fed has continued its tightening and is signaling the potential for continued interest-rate increases. We've seen more than 500 basis points of tightening during the past 13 months, which has had a major impact on all markets, in particular real estate, as this affects cap rates and valuations. There has been huge change in that regard. We are looking forward over the next six months to an environment where we won't be tightening, but I am not predicting easing anytime soon. It is difficult for the real estate markets to work through this state of uncertainty and limbo. Even if it's bad news, certainty is better than uncertainty. We're getting close to the point where we will have a little more certainty, at least in terms of interest rates. We had the SVB collapse, among other banks earlier this year. I believe the worst is behind us, but it continues to be an unsettled time for the regional banking system, and that has a major effect on the real estate market, as regional banks look to shrink their exposure to real estate, reducing liquidity. We have 4,500 banks in the United States. No other country in the world has more than 400 banks. Banking is a confidence game because even well-capitalized banks are levered approximately eight to one, and that doesn't consider derivatives. So, it's been heartening to see deposit bases strengthening and concern dissipating. That said, there is an ongoing liquidity dynamic that will exist for a significant period, as there's a great deal of uncertainty that remains in the regional banking system.

The reduced liquidity in the system at a very challenged time, with higher interest rates and higher cap rates, means owners and developers have fewer options for selling and refinancing. I expect better times ahead, but a rocky road for six to 18 months. Once tightening and the presidential election is behind us, we can leave a lot of uncertainty behind. Things will get better, but slowly. And as the saying goes, while history may not repeat itself, it certainly rhymes.

Which sectors are seeing the impact of shifting demographics and changing behaviors?

Demographics is the tidal wave that just keeps coming and has a huge impact on literally everything, whether we're talking about AI, data centers or office sectors. There is no asset class or investment opportunity that isn't impacted by demographics. And demographics are squarely behind everything we've been doing for 20 years.

The sectors we invest in are medical office, senior housing, student housing and multifamily, all of which continue to benefit from demographic trends. The reasons we invest in these verticals is not by accident; we look for asset classes with inelastic demand characteristics, meaning they are not highly correlated to the macroeconomy. These are sectors where demand stays solid during good times but also in downturns, when people cut spending for discretionary items. They may not buy a TV, a bed, or a new car, but it is unlikely they will put off a healthcare issue for 18 months. On the senior housing side, we deal with the higher end of senior housing, which is the most inelastic demand portion of independent living and assisted living. These are people in their 80s who have more money than years left. The primary consideration for them is, where do I want to live and how do I want to live? And for the next 20 years, we're facing the "silver tsunami" with the aging of the U.S. population. The aging baby boomer cohort is one of the wealthiest, with lifestyle demands that differ from past generations, meaning the future is bright for high-end senior housing.

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In terms of office, we had a global pandemic, and people thought this would last a period of time, and then everyone would go back to the office. Instead, we've entered a new and forever-changed dynamic. Here's an analogy: Say you're a college student. You go to Europe, travel for two months and stay in youth hostels. Then you start working and, at first, you're staying at a Hilton Garden Inn, and then maybe at some point you're staying in a Four Seasons. Once you've stayed in a Four Seasons, are you going back to the youth hostel? Unless that's your only option, you're not. That is similar to where we are in terms of some jobs. We have a hybrid dynamic where people are saying, I don't have to commute an hour and a half every day both ways, five days a week. Maybe it's three days or four days. This is a very mixed situation because it depends where you're located and what the work entails. There are office markets that are essentially 100 percent leased. But in San Francisco or New York, for example, where it shakes out at the end of the day is to some extent demographically driven.

Where does this end up? There are specific demographically driven verticals, such as healthcare and the aging population, where it's very easy to see increased demand, supply constraints and tailwinds. Other sectors are not as clear, such as student housing, where it is a tale of two markets. There are premier properties at powerhouse public universities, where there was no demand diminution even when classes were being held on a remote or hybrid basis. Then there are student housing markets at secondary and tertiary schools, where the dynamic of remote learning is a possibility. We have 5,500 universities in the United States, so there is a variety of demand. We focus on the large state schools where enrollment has increased and there is significant demand for pedestrian-to-campus, highly amenitized assets.

Where are the opportunities in the market?

There are two specific debt opportunities we are pursuing. One is our traditional debt business, which is providing liquidity into a market that has little liquidity. That is much more of a price-maker than a price-taker business today. Whatever real estate arena you're playing in, you have fewer financing options than you had a year or two ago. A lot of players have been spoiled for more than 10 years in a market with $1.5 trillion of debt maturities coming due during the next 12 months. Our traditional debt business, which is bread-and-butter lending to owners, operators and developers in the verticals in which we invest on the equity side, will continue to see outsized opportunities.

There will also be a significant opportunity to acquire real estate debt, whether loan pools or one-off deals, at material discounts to par that have the possibility of becoming workout assets. The acquisitions we are looking for are non-auction scenarios with a relationship dynamic, and where, even in a downside scenario, we're getting to the returns we're looking for. And it's not just identifying the opportunity – you need experienced people to be able to take advantage of that opportunity. Workouts represent a very specific, time-consuming business. I think a lot of people have identified this opportunity. I don't think many of those who have identified it have the teams in place to be able to capitalize on the situation.

On the equity side, we've seen outsized opportunity in high-end, off-campus student housing, where there are supply-and-demand tailwinds. But this is a relatively small asset class that has had some significant institutional ownership, historically. You have a relatively small set of institutional investors looking to play in that sector at a time when we've had dramatically increased interest rates. Even some of the well-capitalized players are looking for certainty-of-close partners or owners. We've seen this market shift dramatically, and we've gone from being a net seller as recently as two years ago to being a significant net buyer.

Looking at the current economy, what is causing stress right now?

It is a challenging fundraising environment. This is a time of outsized opportunity for us, but it's not a feel-good time. We're in good shape, and a hallmark of our business is that we've had very few problems. That said, good times always feel better, even if they don't really present better opportunities. In a time like this, you have to be very careful about your underwriting. There will not be a tremendous amount of growth that will bail you out. There is no room for error. We must be crisp on everything that we do.

What advice would you give to allocators at this time?

My advice to allocators doesn't change over time, in good times or bad. First, allocation dynamics and portfolio makeup are incredibly important. Intelligently choose sectors with inelastic demand characteristics and make sure your investments are allocated so you have exposure to asset classes that perform extremely well in both good times and bad.

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Second, never forget you're betting on people, so you need to choose the right people. There's no magic in saying that. The reality is, that gets done less often than it should. Winners win, and you can have mediocre or even submediocre teams that can do well in certain environments, but the quality will show up over time. It's important to remember that businesses reinvent themselves, particularly with the way technology and AI functions today. What worked five years ago isn't going to work today. The quickest way to become irrelevant is to say, this is what's always worked for us. You had better be looking forward, not backward. It's almost like what used to be seven years is more like seven months now, or seven days. And people who are disciplined investors know not just what they know but know what they don't know, and intelligent investing is more about the deals you don't do than the deals that you do.

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Kayne Anderson Real Estate

CORPORATE OVERVIEW

With assets under management of more than $14 billion, **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, KA Real Estate has invested in alternative real estate sectors, including medical office, high-end senior housing, off-campus student housing/multifamily and self-storage.

Our vertically integrated team brings expertise in all aspects of real estate investing and management to each of our investments, thereby maximizing operating capabilities.