Kayne Anderson Real Estate

'Get comfortable being uncomfortable'

Some property sectors offer an outsized buying opportunity today

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.

Last we spoke, we covered the macroeconomic environment, including the Fed's rate increases and the regional banking crisis. Now that we're further into this environment, what are you seeing?

We are seeing the third stage of capitulation on the seller side, for both debt and equity. The first stage is: Something happens, the world changes and people respond as if that had not happened. In stage two, people admit, "Okay, things have changed. Maybe my assets are worth less, but they will be worth more later. Interest rates are going to come down. I just need to wait this out and everything will be back stronger than ever." And then stage three is: "Okay, things have changed. I can't necessarily survive for X period of time. The world may not come back to where it was before, or better, and I have to make hard choices about what I'm going to do." That's where we are today. The stock market reflects a very forward-looking dynamic, where we've had a tiny bit of euphoria, resulting in a slightly overbought market. In contrast, there are a lot of things that are not working in the real world. The Excel spreadsheets that had 3.5 percent interest-rate projections now have interest rates at 8 percent. Tough decisions have to be made. We haven't even seen anywhere near close to the full impact of the Fed rate hikes we've already had. We'll probably see the full brunt of that by the end of the second quarter of 2024. Even if the Fed starts lowering rates at that point in time, it is going to take a long time to work itself through the economy and the "real world." Putting the stock market to the side and focusing on private assets, we're starting to see capitulation.

It's an exhilarating time, prospectively, to be investing in real estate. I think 2024 and 2025 are going to be the two best vintage years on record, going back 10 years and probably forward 10 years. Obviously, there is a lot of trepidation out there. People have been hurt – most notably, in the office sector. There's some pain, but for those with capital to invest, it's an exciting time.

As you think about your alternative sectors of focus, what are the key tailwinds that are driving their success and your bullishness?

Demographics is the differentiator between the sectors we invest in – medical office, senior housing and high-end off-campus student housing – and other real estate asset classes. Demographics is an underpinning for every investment – not just real estate – because it drives everything from spending habits, to where people are spending their time, to basically all valuations over time. The U.S. population is quickly aging, and we will have nearly 11,000 Americans turning 65 every day for the next 20 years. This is the basic dynamic, particularly in healthcare real estate, medical office and senior housing.

In addition to those demand tailwinds, there are huge supply tailwinds today in the form of massively constrained new supply for a myriad of reasons: initially, the pandemic and supply-chain issues, then inflation, then interest rates. The lack of liquidity in the markets today and the inability to get construction loans has dramatically changed new development, and we're back to 2010 levels of new development in off-campus student housing, senior housing, medical office and in many other real estate sectors. But the distinguishing factor in the real estate sectors we're investing in is escalating demand. Combine that with diminishing supply, and now you've got an environment where, not only do you have demand and supply tailwinds, but the confluence of events that has brought us to this point has set up an incredibly outsized buying opportunity.

Do you think recent secular changes to office and retail are here to stay?

Yes, however, it's not a static environment. Where office sits today is not where office will sit five years from now. But we're not going back to pre-pandemic office. In office, people went through several stages of thinking, starting with: "The pandemic is going to pass, and everyone will be back," and eventually resigning to, "Okay, the hybrid model is here to stay." What that means varies dramatically. I'm here in West Palm Beach, where the class A office market is close to $100 per square foot, and it is very hard to find space. It's leased before it's built. But New York and San Francisco have different dynamics, and these things ebb and flow.

The hybrid model is here to stay in some shape or form. People aren't going to be spending five days a week in the office. We see examples of downsizing office space that anticipate the secular shift. A lot of firms have employed this strategy, as well, transitioning to an open office and cubicle floorplan. You just bring your laptop and take whatever space is available. There are people who come in five days a week or even more, and there are other people who come in zero days a week. A lot of companies have found out the hard way that you need to give employees a reason to want to be in the office, rather than an edict. There are benefits to being in the office, and people who are highly driven understand that, if you're providing that environment where people can grow and excel by being in the office, people will be in the office.

How about retail?

There are parts of retail that are flourishing and other parts that are suffering. I don't think retail will be as big a part of institutional portfolios as it has been historically, but there is a bifurcation where you've got some very successful retail – be that high-end malls or grocery-anchored shopping centers – that are working well. The well-known class B mall is dead. In the United States, there's been a gravitation to online marketplaces, but global retail is different. The retail occupancy rate in Australia, for example, is in the mid-90s. If you walk through Sydney, you don't see a vacancy. Instead, you see a large amount of high-end retail. The point is, there are pockets of retail that continue to work. It will be a smaller share of the institutional pocketbook, going

forward, and I think there will be a rotation into demographically driven sectors.

Ten years ago, if I wanted to talk about medical office or senior housing, a typical response from the CIO at a pension plan would be, "We're not quite ready for that yet. We're going to fill out our core sectors first, and then we'll get into the higher-risk investments." I would say, "I understand. But how about investing in higher-return, lower-risk assets?" That's what these sectors are — they aren't higher-risk assets. Rather, they're lower-risk assets because of the demographic demand and other dynamics behind them.

Now, the United States has seen office blow up. It's had retail blow up. And investors are saying, real estate is still a core part of my investment thesis. Some of it goes to industrial, some of it goes to multifamily, and now I'm looking for other property sectors. Now, it's not us pitching these alternative sectors. During the past 20 years, medical office, senior housing and student housing have shown outperformance during both good times and bad. Investors can look at the consistency and the low volatility. And so, today there is strong interest in medical office, senior housing, student housing and data warehouses. These sectors are becoming far more mainstream.

You have noted this has the potential to be one of the great times to be investing. Can you expound on that?

I'm old enough to know that the interest-rate environment right now is not a high interest-rate environment. It's just far higher than where we've been the past 15 years. We have become addicted to essentially zero interest rates. When things change and change quickly — which they have with 525 basis points of rate increases in 16 months — many players are left in unenviable positions, and we've seen this play out. Unfortunately, we've continued to create more and more of a moral-hazard dynamic by throwing funding at our crises. We've been basically running in 10-year recession cycles for the past 50 years, which all follow the same playbook: eight or nine years of incredibly accommodative fiscal policy followed by things getting out of control. There's some catalyst, something happens, and we slam the brakes on, people get hurt, things don't work anymore in a new interest-rate environment, and then we start easing again. That's an oversimplification, but we have not shown the political will to this point to really stomp on the brakes and admit this isn't sustainable. This glorified Ponzi scheme of continued borrowing and voting ourselves entitlements isn't going to work forever. There's going to be a day of reckoning. I'm not predicting gloom and doom. I'm just saying all these events have implications. There is a huge opportunity because this has happened quickly, and it creates opportunity for those who have been better prepared for a downside scenario. I'm not casting any aspersions here because virtually nobody foresaw a pandemic. Senior housing, for instance, is an incredibly strong sector right now, but it suffered about 30 months of lost time because you couldn't allow "nonessential" personnel into your properties. Leasing lagged, revenues lagged and expenses increased. But you have to put that to the side.

I will say, the better prepared you are, the luckier you get. These things aren't all gloom and doom if you are just trying to identify risk where we are at a real moment. It is addressing reality, and the reality is, get comfortable being uncomfortable. It's not a comfortable time. It's a hard time geopolitically and economically. There just aren't a lot of people who feel good. But while things are far from perfect, the United States, on a relative basis, is still the world's largest economy and the best place in the world to invest, where you have rule of law, precedent and a true democracy. We can go down a lot of negative rabbit holes, but there is a lot to be thankful for, and there is huge opportunity.

What is the fundraising environment like out there?

For us, it is very constructive. In general, it is night and day from six to eight months ago. A lot of global allocators, sovereign wealth funds and pension plans, recognize what I've said. If we're not at peak interest rates, we're close to it. It's going to be a more constructive environment, going forward. There is going to be some level of capitulation. This is a buyer's market. Investors want to allocate to both equity and debt. Obviously, debt has been all the rage and delivering, at least on paper, outsized returns. Relative to historical performance, returns will likely be outsized for debt. Three years from now will not be the same fantastic investment environment as you have today. From a fundraising perspective, 18 months ago, investors were saying, "I'm going to do some re-ups but other than that, call me toward the end of 2023." Today, investors are eager to allocate and put money out in 2024.

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CORPORATE OVERVIEW

With assets under management of more than $15 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, Kayne Anderson 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.

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