KEYNOTE INTERVIEW

Finding the relative value

Pivoting between equity and debt opportunities, Kayne Anderson Real Estate's all-weather relative value approach is helping the firm navigate an uncertain market, says chief investment officer David Selznick

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Targeting an assortment of demographically driven themes and niche opportunities, Kayne Anderson Real Estate utilizes a relative value trading approach in its funds, investing in equity and debt at all levels of the capital structure.

The alternative investment management firm's debt platform specializes in senior, mezzanine, preferred, construction and bridge lending and note acquisitions for assets in student housing, senior housing, medical office, Class B multifamily housing and self-storage.

This multi-faceted focus – spanning a range of niche commercial property types that are low-correlated to the broader economy, and supported by demographic shifts – has enabled the firm to thrive regardless of market environment, says David Selznick, partner and chief investment officer at the Boca Raton-based firm.

Selznick has been closely involved in acquisitions, dispositions and financings completed by Kayne Anderson's real estate equity funds over the past decade. More recently, he co-founded its real estate debt and core businesses.

"When we think about how we position ourselves to be not only relevant in all cycles, but to outperform in all cycles, our objective was to be able to go long and short, to be able to go up and down the capital structure with debt and equity, and to invest in low-correlated assets," he says. "We ebb and flow depending on the different sectors. We can pull different levers; we can trade the relative value between equity and debt."

This approach has allowed Kayne Anderson to rapidly pivot in times of turmoil. It raised $1.8 billion in just a few weeks during the 2020 covid dislocation by purchasing bonds from debt funds, mortgage REITs, hedge funds and other lenders who needed to pay their down their warehouse lines.

"We always use long-term note-on-note facilities, so that we can play offense when there's a dislocated environment," he adds.

Delving deeper, Selznick, who joined Kayne Anderson in 2012, explains how he and CEO and co-founder Al Rabil share the same investment philosophy, which has shaped the firm's

broader perspective on the real estate sector.

"We're value investors; we believe in operating expertise. We want to focus on durable assets where there's a higher likelihood, whether in good times or bad, people are going to want to be in."

Q Since inception, Kayne Anderson has been focused on what were once considered niche asset classes. There has been a rotation of capital toward these sectors over the past 10 years – is this likely to continue?

One hundred percent. The rotation is happening – with each fund, we're getting more calls and more interest than we had in the previous funds that we raised.

While the [NCREIF ODCE] index has underperformed since mid-2022, we've outperformed [the index] by nearly 10 percent. Many investors are in the redemption queue – there's almost $36 billion of fund redemptions – and there's a significant desire to rotate out of traditional sectors like office, retail, industrial, multifamily, etc, into our sectors. Each time we're selling a larger portfolio or selling assets, there's a deeper pool of investors. This deepening of the marketplace is going to continue.

Q What demographic and secular shifts are you seeing in your core sectors?

Everything we do is demographically driven. Every day, 11,000 people are turning 65; the number of 80-year-olds is going to double in the next 15 years. Those are astounding stats that have significant implications on real estate, particularly senior housing and medical office.

In student housing, we focus on the power five universities. There's been a rotation out of liberal arts colleges into those big universities – we're seeing strong enrollment growth at large primary state schools at the expense of smaller, cost-prohibitive private schools. These universities took the distance learning technology refined during the covid pandemic to educate people in a hybrid model, and are now using that to increase enrollment, bringing more people to campuses due to demand, without putting undue stress on their academic buildings.

Student housing annual supply peaked in 2013, close to 64,000 beds. This year and next year, between 24,000 and 30,000 beds have been delivered or are being delivered. When you think about supply-demand fundamentals – rent growth and occupancy – these are performing strongly and near record highs. This should continue as supply constraints, such as lack of available construction financing, cost of construction and available land, remain in place for a considerable amount of time.

Q What have been the key disrupters in the market over the past four to five years?

Given our focus on low-correlated sectors, we aim to take out as many of the uncontrollable black swan-type events as we can. With medical office, during covid we gave some rent deferral, but those tenants paid back the rent deferral by year-end, so we had no increase in delinquency during covid. Same with our student housing – there were parental guarantees, and students wanted to remain on campus. With senior housing, it was really a flock of black swans that hit the sector, which no-one could ever underwrite. During covid, seniors housing was prohibited from moving people in, and then the sector got hit with interest rates and labor supply issues.

You can't control everything, and

Q As a firm that invests in debt and equity, how do the two sides of your business inform each other?

When our equity business may be less active because of less attractive opportunities, our debt business can lean in and scale, which was one of the main reasons for us launching debt – it's highly scalable in times of dislocation. You can move significantly into the bond market, or issue loans quickly, because people need liquidity. In the pandemic, we deployed well over $2 billion of equity in debt investments during 2020.

As an investor, if you don't have these tools, you're stuck on the sidelines. We're an all-weather investor, outperforming in all cycles. We never want to simply become an AUM-driven beta manager.

so with those exogenous events, our investment thesis needs to be durable, and it was.

Q Interest rates are substantially higher than they were five years ago, but still lower than they have been historically. How have you navigated that and what is your strategy going forward around rates?

We think rates will settle somewhere in the 3 percent to 3.5 percent range. Structurally the US can't afford the debt levels where they are, so monetary policy will drive them lower. But we also believe that until you fix labor and supply chain issues, inflation will run higher than 2 percent.

Our investments are not dependent on interest rates, since we match-buy, we buy wide generally and we create value. The biggest opportunity is where people need to mark-to-market their debt to their investment based on whether there's positive leverage or negative leverage. I think those people are missing out on a great buying opportunity.

Q Are you seeing more interest in real estate debt as an investment? How has that shifted in recent years?

The whole lending business has changed with the regulatory pressure on banks. Banks had been a main source of real estate credit, but the private credit market is filling in those gaps. It's a generational opportunity to continue to grow our debt business, which we think will triple or quadruple in size as a result. We have a performing bucket and a non-performing bucket, so no matter what the situation is we can take advantage of well-priced investments, whether they're performing or not, and build on that relative value opportunity and do different things as they arise.

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DAVID SELZNICK

Q What will the impact of Basel III and other regulatory and legislative changes be on the private credit market? Is this the key contributor to the rise of non-bank lending?

Basel III is changing how banks utilize their balance sheets. We have long-standing relationships with many banks, and we've become more like partners on the debt side, not just borrowers on the equity side. Whether it's us getting debt when no one else is, or us co-lending with the bank, the whole ecosystem is predicated on approaching them as partners, rather than treating them simply as a commodity and as a means to an end.

Q What are borrowers asking for right now? What kind of loan requests are you seeing? Are loans more complicated?

People are asking for certainty of execution, and some prepay flexibility, fixed rate alternative pricing, and some floor and cap relief. Borrowers seem to be reasonable, although they're becoming more competitive in certain parts of the business. The more commoditized lending, and the more stabilized lending, is much more competitive than more bridge-like or construction lending.

Q What is your outlook?

I'm optimistic. From a debt perspective, we're seeing our loan pipeline continue to grow. In equity, we're making investments. We see more transactions in the second half of the year than in the first half, given sellers have been waiting for rates to drop, and for cap rates to compress, and maturities are coming up and there are cash needs. Things will continue to move quickly, and potentially in unexpected ways.

Being all-weather relative value investors, you have to be dynamic, and be fluid to market conditions. We're focused on continuing to have the tools to be able to take advantage of those things as they arise. ■