Kayne Anderson Real Estate

Alternatives offer strong risk-adjusted returns

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, about the positive prospects and market dynamics in senior housing, medical office and student housing. Following is an excerpt of that conversation.

The U.S. election is finished, and the Federal Reserve has lowered the federal funds rate. What does this mean for the real estate sector?

Going into an easing cycle is positive for real estate. I think the regulatory environment will be a bit more welcoming for real estate, for private equity and for permitting, generally, which I also view as positive. We're going into a period of likely higher unemployment and, to some extent, sticky inflation, which is going to present some challenges for the Federal Reserve, in terms of the easing cycle. The market is pricing in – plus or minus – a Fed fund's neutral rate of 300 basis points by the end of 2025. My personal view is that scenario is highly unlikely. I think we will get to 300 basis points, but it will take six months to 12 months more than where the market has it priced. But still, that's a positive thing. Historically, markets and real estate markets react more positively to a more drawn-out easing cycle than a fast easing or hiking cycle.

We have about a 24-month continued outsized buying opportunity because of where interest rates are today and where they have been historically. On the other side, three to seven years from now, there will probably be an outsized selling opportunity for assets acquired or built during this timeframe because I think we'll be in a lower-interest-rate environment.

I'm extremely bullish on where we sit, from a real estate perspective, with respect to our verticals: medical office, senior housing and student housing. We are in the early innings of a significant rotation of capital into these property sectors, as well as some others that are demographically driven and enjoy long-duration tailwinds, such as data centers. From a pricing and rent-growth perspective, large-scale industrial has cooled off a bit, but I think the long-term trends are favorable.

Can you elaborate on the sectors you focus on? Are there certain sectors or geographies that Kayne Anderson Real Estate is targeting?

Our sectors are medical office, senior housing, off-campus student housing, as well as attainable housing. We've been investing in the first three for more than a decade. We've been investing in attainable housing on the debt side of our platform and on the equity side of our platform for a long time, as well, although we have a separate strategy that is focused on attainable housing.

Geographically, our senior housing team is more focused in the Southeast and Southwest, although not exclusively. We look for demand/supply imbalances that also exist in other states. We do own assets in the Northeast and in New York. Senior housing was very challenging during the pandemic, but unlike traditional office, the underlying demand never diminished in senior housing. Rather, there was an episodic dynamic that caused higher vacancy due to COVID-19 restrictions. But once those were lifted, senior housing has experienced strong growth. There is demand/supply imbalance today that will become more exacerbated because new supply starts are down by more than 60 percent compared with the past 10-year average.

Medical office and student housing starts are also down about 40 percent, so we expect massively escalating demand in all three sectors. For medical office, we primarily invest in major markets in the lower 48 states – we're in 43 of the 48 lower states, and we control more than 32 million square feet in that property sector. We continue to see a very outsized opportunity in that sector and enjoy strategic advantages because we've been operating for the past 15 years with our exclusive partner in medical office, Chicago-based Remedy Medical Properties.

The U.S. population will shift from 40 million to 81 million of Americans 65 years and older, between 2010 and 2040. In the same period, the population will shift from 12 million to 28 million Americans 80 years and older. This massive, escalating demand is being met today by diminished new supply due to higher interest rates, illiquidity and difficulty with sourcing new construction debt. That dynamic will only exacerbate the demand/supply imbalance. We have experienced strong rent growth – more than 8 percent – in our student housing and senior housing investments in each of the past two years. There is a similar dynamic in medical office, although those leases are generally longer term, so the year-over-year rent growth can be a bit misleading because you're not setting rents as frequently. We see a very asymmetric return-risk dynamic from an acquisition perspective today that we think will continue for the next 24 months.

Can you talk with us about the new institutional attractiveness of student housing, or the rising prominence of senior housing in institutional portfolios?

With student housing, from 2013 through 2022 – with a brief respite for COVID-19 – there were very low interest rates and escalating demand for off-campus student housing, where cap rates for high-quality product were generally between 4 percent and 5 percent. That changed dramatically when the Federal Reserve started raising rates, and some of the larger players pulled back significantly. Today there is an opportunity to buy high-quality assets at attractive pricing. Moving forward, there is a limited supply of highly amenitized, pedestrian-to-campus, high-quality assets at the Power 5 conference schools or similar schools with more than 30,000 undergraduate students, a highly desirable undergraduate degree, record application and enrollment growth, and a finite ability to provide incremental supply. When interest rates moderate and liquidity returns, we'll be back to much lower cap rates because this type of student housing is an incredibly attractive property type with more than 97 percent occupancy each of the past two years. That will be a continuing dynamic for the top-quality student-housing assets at high-quality schools. But the most important determinant of your return is your cost basis. We see this as a very opportunistic time.

There may be even a bigger opportunity in senior housing because the sector is a little broader than student housing. Senior housing was hit hard by COVID-19, but that was followed by a rate increase of 525 basis points in 15 months, as senior housing recovered with dramatically improving occupancy, much of which was offset by significantly higher financing costs. But looking forward, there is a very positive outlook. There is a recognition that senior housing is a very operationally intensive property sector. While it is real estate, it is closer to an operating business with real estate attached, than the reverse. There are a significant number of investors who, despite the outlook, remain cautious with respect to investing in senior housing on a going-forward basis. We are aware there is a risk factor there and a tremendous operational intensity to the asset class.

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At the time of this interview, publicly traded healthcare — medical office and senior housing — REITs are trading at large premiums to gross asset value. How do you interpret that?

I interpret it positively. There is a large disparity in pricing between the private and public markets. I won't say one is right and one is wrong — the truth is probably somewhere in the middle. Public markets have taken the dynamics I've discussed here, looked forward five years and priced in the expectation of increased demand in this sector. The public real estate market can be very driven by momentum, which is reflected in these stock prices. Directionally, the public markets understand the future is bright for senior housing, for medical office, for demographically driven property sectors that have long-duration demand tailwinds, particularly in a market where there continues to be significant supply constraints. People do recognize solid management and strong property sectors, but there is perhaps a bit of euphoria built in the pricing. And private-market pricing will likely come up, but it is not likely to match the public market pricing. The gap between where high-quality public market healthcare REITs are trading and where the private market is trading for similarly high-quality assets is very broad right now.

How have the conversations with investors about your sectors changed, when compared with a decade ago?

There has been a massive change compared with a decade ago. In 2013 and 2014, we were just coming out of the global financial crisis and GFC-related dynamics. Basically, no one wanted to hear about alternatives. Investors were just getting back into real estate, so investors would respond they were going to fill up their lower-risk buckets first — multifamily, office, retail — and then they would look at the higher-risk, higher-return property sectors, which is how they categorized medical office, and senior and student housing.

I would say, "I understand you're not going to invest with us today, but are you interested in higher-return, lower-risk assets?" They would ask what I was talking about, to which I would answer, medical office, and senior and student housing. These aren't higher-return, higher-risk sectors, I would explain, but rather higher-return, lower-risk sectors. I did not necessarily meet with a warm reception when I explained these were highly inefficient, fragmented markets where, from an acquisition perspective or even a development perspective, we could generate far higher returns. Medical office nationally has never been below 90.9 percent occupancy in any single year, and it has averaged more than 93.0 percent occupancy. It is a sector with incredibly low volatility and high-quality assets.

Today, however, alternatives are the rage among investors. They are property sectors with long-duration demand tailwinds. Now capital is rotating in, and we welcome that. It's beneficial to us, even though it creates incremental competition. We have a 10- to 20-year head start from an operating perspective. I think we're in the very early innings of a continued significant rotation of capital into these property sectors to the point where, in five to 10 years, senior housing, and probably medical office and student housing, as well, will be considered core real estate. The light switch has gone on, and investors recognize these are large, low-volatility, high-quality sectors that enjoy the dynamics we've been discussing here.

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CORPORATE OVERVIEW

With assets under management of approximately $17 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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