Kayne Anderson Real Estate

Sector divergence and rotation of capital

The advantages of operational expertise as an alternative sector strategy

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, spoke in November with **Al Rabil,** CEO and co-founder of Kayne Anderson Real Estate, about the challenges and opportunities of investing in operationally-intensive alternative sectors. Following is an excerpt of that conversation.

Investment in alternative sectors is growing. What's driving this shift? And why is capital increasingly flowing toward these alternative sectors?

The forces at work are massively escalating demand and diminishing supply. We are at an inflection point where the wealthiest portion of the U.S. population is aging into the years of their highest health care spending and senior housing needs. These demographic traffic trends will force demand not just for one to five years, but for the next 20 years unabated. That demand is here today; it's not a today, tomorrow, the next day thing. None of these tailwinds are going die down. In fact, they're accelerating. This demand is attracting capital to seniors housing and medical office, and similar demand dynamics are at work in student housing and light industrial.

Alongside this increasing demand is diminishing supply. We've had higher interest rates than today's generation is used to alongside sticky inflation and labor cost increases. We have had tariff uncertainty, which has created difficulty for new development from a price assessment perspective. Long story short, there is a contraction in new development in these asset classes accompanied by a massive increase in demand that's here to stay.

Beyond that, COVID was a major turning point for office and retail, which are only going to attract incremental capital on a distressed basis. Traditionally, those two sectors accounted for a very significant portion of wallet share, particularly institutional wallet share. That shift has forced investors to look for other places to invest capital – such as data centers and the asset classes that I just mentioned – that have historically been considered alternative verticals. The ODCE Index is currently 63 percent weighted to industrial and multifamily. Even institutional investors who like those asset classes are already heavily invested in them. The money must go somewhere else, so I think we're entering a 5- to 10-year supercycle for the asset classes in which we invest.

These alternative sectors like healthcare, student and seniors housing, and light industrial are becoming less niche and more "core-like." What makes these property types better positioned for today's market?

If you consider the last 20 years, these alternative verticals have consistently outperformed the traditional real estate asset classes – not only during the global financial crisis, the mini crisis of 2015, and the global pandemic, but during the entire low-interest rate period of 2012 to 2022, when capital and liquidity were readily available. Every single year alternatives outperformed the traditional asset classes.

Not only do they outperform on an absolute basis, but they are dramatically less volatile. In fact, we've seen especially dramatic outperformance during periods of dislocation. In direct contrast to many of the traditional asset classes, alternative asset classes are only lightly correlated to the macroeconomy. They continue to have the same spending dynamics in both good times and bad, or put differently, in times of greater and lesser liquidity. Healthcare outperforms during periods of dislocation because healthcare spending is the last thing to go. People will forego comfort purchases rather than reduce their healthcare spending.

It's been said that investing in seniors housing is investing in a business with real estate attached. How does the operational intensive nature of these sectors provide unique challenges to owners/operators, and how does Kayne Anderson tackle these challenges?

You can call seniors housing a business with real estate attached or real estate with an operating business attached, but it is absolutely an operationally intensive business. It is a 24/7 business and there is a broad spectrum of care and expertise needed. The operational business is a high-employee, low-margin business, so we don't bring operations in-house. It would be too easy to fall into what I call "feed the beast mode" – allocating a significant amount of overhead to one specific asset class. I like to say human nature is a very strong driver. We've set our platform up to give us full operational knowledge and best practices expertise, without having the incumbent overhead in-house.

We tackle operational challenges with a vertically integrated seniors housing team, supported by an array of other in-house teams, including legal, finance, accounting, sustainability, insurance, and design and construction. Then we also have a proprietary relationship with Discovery Senior Living out of Naples, Florida. We work hand in glove with them, talking to them all day, every day on the operational side of the business, and collaborating at quarterly off-sites to make sure we are engaging in best practices for seniors housing.

The starting point has to be working with an experienced operator, which is what we do by proactively aligning ourselves with the best operators in each of these verticals. That's how we address operational intensity and decision making across our platform – by acquiring outsized knowledge and expertise internally and marrying that with established and successful operators.

What sets Kayne Anderson Real Estate apart from other real estate platforms?

We are the premier operating platform for these asset classes within private equity. During the COVID period of dislocation, we achieved significant relative outperformance in seniors housing. That's a case study in how focusing on operational expertise beats the traditional private equity model of raising capital, fielding inbound inquiry, and doling out equity checks. The way we've built this operating platform over the last 20 years has given us an advantage, allowing us to pivot nimbly between asset classes as the opportunity sets shift, and to source on a proprietary basis at prices lower than generic market pricing. Simply being a beta investor in any sector only guarantees you the market return for those asset classes. What we're striving for is alpha in sectors with long-duration demand trends that are not highly correlated with the macro economy.

Another competitive difference is that we don't have myriad joint venture operating partners. Ours are either exclusive or proprietary joint venture partners, so when we're exiting, we almost always do so in a single operator portfolio, without having to negotiate pricing or management internally with each partner. We have full discretion and flexibility in putting portfolios together, so we can offer bespoke portfolios to LP-oriented buyers with the option to leave us in place for property and asset management. That means they get a premier operating platform with no transition costs. So not surprisingly, in virtually every exit we've had, the buyer has opted to leave us in place for property and asset management.

More capital moving into these areas means more competition. What does that mean for the future of alternative sectors?

As I said, we're about to enter a 5- to 10-year supercycle for these asset classes. Those who will benefit most are the very few platforms who have operational expertise as well as unencumbered access to capital. You can raise capital quickly and you can invest it quickly, but you can't quickly acquire 20 years of knowledge and experience. There are very few deeply experienced, scalable operators in existence today. So new platforms need to be created, and they are going to hit a significant number of speed bumps as they try to learn how to manage these operationally intensive asset classes. We're not competing with our check book alone. We're competing with strategic relationships, operational expertise, and a true win-win mentality, with our buyers, sellers, and investors. That will continue to put us in a place to buy assets at a cost basis that garners very outsized returns, even in an environment of escalating capital. Secondarily, we are going to create our own competition by building a broader, deeper buyer base to sell our assets to, because we know how to rapidly turn high-quality transitional assets into fully stabilized core assets. And then we exit the assets at core, core plus returns to the buyer. I think that model is going to continue to work incredibly well.

You said before that human nature is a strong driver. With these sectors in such high demand, how do you stay disciplined and ensure you continue to create value for your investors?

The overlay on everything I've said today is discipline. It's our DNA. For example, we were one of the three largest players in off-campus student housing from 2008 until 2013, when we became a net seller. We continued developing, but for almost eight years we did not acquire a single existing student housing property. Why? Because there was a significant inflow of capital into a relatively small asset class that pushed cap rates below 5 percent. So, we waited. I won't say patiently, but we waited. Then the market dynamic suddenly changed – rates rose 525 basis points in a mere 15 months, opening a very big buying opportunity for those who had not been hurt by the dislocation and had access to capital because they had been disciplined. We were in that group. Since Q4 of 2022, we've invested close to $5 billion in off-campus student housing. The opportunity sets can shift dramatically and swiftly. In early 2013, it became a seller's market. In 2022, it became a buyer's market. We want to remain relevant in all cycles, be able to invest in any portion of the capital stack, but be very disciplined so that when we invest, we have a very high probability of meeting or exceeding our performance expectations.

Everybody claims to have investment discipline; very few actually have it. You're going to continue to see a race towards size and scale in the private equity world, where the focus is on fee-related earnings or management fees rather than performance-related earnings. We've chosen to play private equity by letting the money we make be a result of the money our LPs make. Our platform could be twice as big from an AUM perspective, but we wouldn't have achieved the same return dynamics. We structure our products by the opportunity set, not how much money we can raise. Our objective is to maximize returns for our investors, period. I assure you that is a very rare commodity within the private equity landscape, unfortunately.

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CORPORATE OVERVIEW

With approximately $20 billion of assets under management, **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, self-storage, and light industrial. 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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