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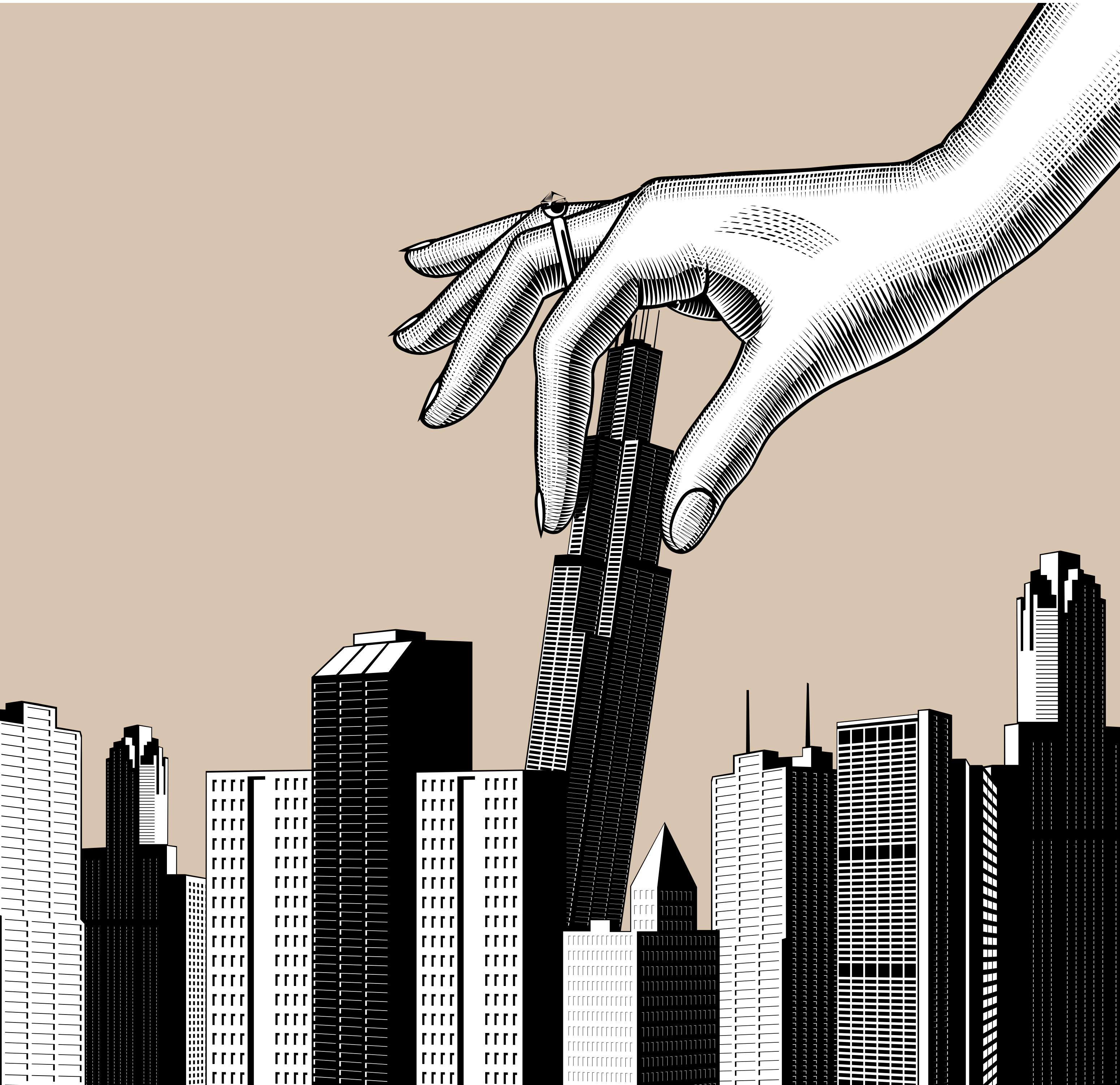

KEYNOTE INTERVIEW

An alternative approach to core

Non-traditional property types are the future of core real estate investing, explains Kayne Anderson's Kyle Mayes

For decades, core real estate investments have been the province of the biggest assets in the biggest markets within the four traditional sectors of office, apartment, industrial and retail. But with the rise in demand for niche assets like senior housing, purpose-built student housing, medical offices and other operationally intensive real estate, the realm of the core real estate investor is once again expanding, notes Kyle Mayes, senior managing director of Kayne Anderson's core real estate portfolio. Alternative real estate sectors are becoming a bigger part of core portfolio allocations.

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Q The traditional definition of core real estate has centered on scale, liquidity and stability. How should investors think about the role of operationally intensive sectors within that framework today?

Traditionally, core real estate has been the main four food groups: office, retail, multifamily and industrial, usually in major markets.

Now there is a greater focus on the subsectors that produce the strongest risk-adjusted returns through up and down markets. It is not necessarily defined by operational intensity, but instead by operational expertise and cashflow-driven total unlevered performance, particularly through challenging times in the cycle.

These sectors tend to have long-term, secular demand drivers, so regardless of what is going on in the general economy, there is still a steady demand underlying returns quarter after quarter.

For example, aging demographics drive both senior housing and medical office. So, while the US population is growing somewhere between 0 and 0.5 percent per year, the 80-plus population is growing at approximately 4 percent each year.

No matter what is happening in the economy, people are aging into senior housing communities.

Q What does the growing acceptance of alternative property sectors within core portfolios say about how the market itself is evolving?

While many institutional consultants and investors have long seen the benefits of alternative sectors, due to the increasing availability of alternative-sector industry data (NCREIF, Altus and others), and due to challenges with traditional sector portfolios in achieving sufficient income and total returns for core return objectives, there is a growing acceptance of alternative sectors in the core sphere.

Many alternative sectors tend to have higher income premiums, as there are higher barriers to entry and fewer firms with deep operational expertise in these subsectors. Nobody knows for sure if that will be there forever, but it is there now. And the consistency of those income streams, now shown in the industry data sets in various market conditions, has been the backbone of our core strategy.

At the end of the day, core real estate investors seek stability, and stability primarily comes from income. Appreciation can be volatile over long periods. Since 1978, more than 90 percent of the total unlevered return of the NCREIF Property Index has come from income, less than 10 percent from appreciation. If you win the income game, there is a good chance that, over the long run, you will outperform on a total return basis and probably with less risk and less volatility as well. A portfolio consisting of alternative sectors with income premiums and long-term demand drivers can be an optimal way of achieving these dual objectives.

Q Operational intensity is often viewed as synonymous with risk. Has that perception kept pace with how these subsectors have evolved?

Traditionally, people have thought of operational intensity being equivalent to risk, but that is not necessarily true across the board. Alternative assets are typically more operationally intensive. However, that does not equate to more risk. Look at traditional office, which today is dealing with massive obsolescence across wide portions of the market.

Across sectors, it is important to do a few things and do them very well. You need deep experience within the sectors in which you are investing and close alignment with operators. We are very hands-on; we are not an allocator throwing capital across 1,000 opportunities and 1,000 operators. We partner deeply with a select few operators, sometimes a single operator in a sector, and work hand in hand with them.

Through understanding our markets, understanding our properties, knowing our submarkets, knowing the subtypes of our alternative sectors, knowing this over long periods of time and knowing how to manage the operations, we found alternatives to minimize risk.

Q How do you expect the competitive landscape for core real estate investing to evolve as alternative sectors become more institutionalized?

We see more groups seeking to enter sectors we operate in. If you look at the sentiment survey from the *Emerging Trends in Real Estate 2026* by PwC and Urban Land Institute, senior housing ranked second out of the 27 property subsectors this past year. Medical office ranked third. More players are looking to do this, even in the core world, but that world has limited capital right now because of redemption queues.

Over the long term, I expect to see more core funds active in alternative sectors. That's likely a slow evolution spanning 10-20 years, but we could end up seeing allocations moving in the direction of public REITs, which are more alternative-heavy. In private capital markets, there has been a bias toward existing managers and their capabilities, but investors understand it is not enough to only invest in the four main food groups.

That is not to say that alternative always equals good and traditional equals bad. We do not view the world that way. We look at it sector by sector, and we are selective about the alternative sectors in which we invest, focusing on sectors with long-term demand drivers through cycles where we have an operational edge.

More managers will see those advantages found in alternative sectors, but they should be careful not to approach it as a top-down/beta allocation to spread out over the whole universe of alternatives. Investors benefit most from investing with managers that focus on doing a few things very well, and likely a majority of the alpha to be earned in alternatives will be from bottom-up returns.

Q As more capital targets these sectors, how do you think about the balance between increased competition and the long-term opportunity set?

We do not worry about increased competition or additional movers in these sectors. These are massive growing opportunities, and we have spent the past 19-plus years building sector expertise and partnerships with seasoned operators.

Based on the trends in our underlying subsectors, there will need to be a lot more capital than what one company is able to provide, so it is not a zero-sum game.

We will likely benefit from selling some of our assets to new entrants who are coming to these sectors. So, we do not see more players in our markets as being a bad thing at all.

Q How is institutional demand for core real estate evolving as investors reassess the traditional definition of the asset class?

Capital raising right now is split, with many of the ODCE core funds having redemption queues and with a few well-positioned firms raising capital as a result of strong performance.

For us, it has been a process of education and taking time with investors to help them understand the growing set of data to make the case for the long-term viability of our sectors. There is always a timeline, and we are not going to rush anything.

When we see capital come in, often this is not the result of a one-quarter decision, it is at the end of a multi-year process.

Now, we are seeing increased momentum into our sectors. I suspect we will see increasing momentum as capital rotates out of the traditional sectors within core funds and into alternative sectors. We have already started to benefit from this, and we expect that trend to continue.

"We will see increasing momentum as capital rotates out of the traditional sectors within core funds and into alternative sectors"

Q From a portfolio construction perspective, are investors primarily reallocating existing core exposure or expanding their allocations to accommodate these sectors?

Some of our capital comes from rotations out of ODCE funds into our alternative core strategy. That is happening and we do anticipate it will increase over time, but redemption queues for many ODCE funds are still fairly long. A common scenario is one in which we are selected to supplement a traditional core allocation.

We can also be a primary real estate allocation, given the foundational income profile of an alternative sector portfolio. It really is all about portfolio construction.

We examine how we fit into how investors are thinking about their existing allocations. It is not a legacy approach to core real estate allocation, relying on convention rather than re-evaluating what core should mean in today's market. Instead, they are thinking about what it should be, how core is truly defined and what subsectors or assets most represent that definition. They can create that optimal core portfolio construction with our sectors included.

Q How have recent challenges in traditional core real estate influenced the way you think about portfolio resilience and long-term risk?

The number one risk I am always thinking about is obsolescence risk. This defines what we are willing to invest in and what areas we are not willing to invest in. We have invested in the high end of each of our sectors to minimize this obsolescence risk, but then within each of our sectors we are only going after a select few of those opportunities within that higher end. Yes, the general sectors matter, but just getting that right is not enough to guarantee strong returns anymore. ■