Kayne Anderson Real Estate

The new core real estate

New property types, but growth the 'good old-fashioned way'

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **David Selznick,** CIO of Kayne Anderson Real Estate, and **Kyle Mayes,** senior managing director, fund management, core, about the evolving definition of core real estate. Following is an excerpt of that conversation.

How are you defining core real estate today?

David Selznick: Core real estate comprises low-volatility investments with durability of cash flow driven by demand that is perpetual or structural in nature. Core real estate must have predictability in cash flow and growth over time. We've never been traditional office, retail or hotel investors because those assets are too correlated to the broader economy, which is beyond our control. Our thesis is simple. Core real estate for us is healthcare – both medical office and senior housing – and student housing. Over a long period of time, the performance of these property sectors has compared favorably with the traditional real estate portfolio, because of the secular demand drivers throughout the market cycle. Our job is to give investors dividends today, a year from now and five years from now, with growth over time. That's what drives our core investment strategy.

What kind of portfolio composition should investors focus on when looking at core real estate?

Kyle Mayes: Portfolio construction through selecting sectors that can outperform throughout the economic cycle, including through recessions and inflationary environments, is key to building a truly core portfolio. You want part of your portfolio to be composed of stable long-term leases in demographically driven sectors, such as the triple-net leases typically associated with medical office. The other part of your portfolio should be in demographically driven sectors with long-term demand drivers and shorter leases, such as student housing and senior housing. These leases can be marked to market yearly, which is important during inflationary markets. The No. 1 risk factor I consider is obsolescence risk, which has significantly impacted some traditional sectors. We care about whether the sectors we invest in will be relevant 20 to 30 years from now. Ultimately, portfolio construction should be seen from a limited partner's or investor's perspective. An alternative core portfolio should have recession-resistant characteristics that will provide investors with a stable allocation that shows minimal correlation to their other real estate allocations and other asset classes.

What are the demographically demand-driven sectors, and why are you bullish on them?

Mayes: I'll break it down sector by sector, but note we are only focused on the top part of each sector – what we view as the most recession resistant part of each sector that we believe will outperform over time. For example, we focus on class A senior housing due to overwhelming demographic tailwinds. The oldest baby boomers are nearly 80 years old, a milestone age when seniors typically move into senior housing, and they are the wealthiest generation in American history and have been lifted by a recent wave of asset inflation. Due to this "silver tsunami" of baby boomers, the population of 80-plus Americans is expected to almost double by 2040, according to the U.S. Census Bureau.

Another example is medical office, which has been more than 90 percent leased since 2010. Within medical office, we zero in on high-margin specialties. These are tenants who spend a very small part of their steady revenues on rent. We know people older than 65 go to the doctor 2.5 times more than adults younger than 65. In the United States, there is strong growth in the 65-plus population, with more than 10,000 people turning 65 every day and the total number of 65 and older Americans expected to increase by 45 percent by 2040.

In student housing, we focus on large public universities with vibrant cultures and strong academic offerings. The drivers there are a relatively low cost of tuition for public universities, in combination with a strong education that positions students from around the world for employment in the best job market in the world. It's a "tale of two cities" when it comes to student housing. The less-selective private schools and the lower-tier public schools are struggling, but the relatively low-cost, flagship public universities continue to see increasing demand.

Selznick: Within student housing, there is structural demand and there is perpetual demand. The University of Michigan, University of Texas, University of Florida – from now until our children's children graduate and beyond, these universities are going to continue to have more applicants than seats available. These types of investments have the protection of the vibrant university and are in the first concentric circle around those universities. There is a high barrier to entry. Our job as a core investor is to make sure we are deriving income year in and year out, and growing the income faster than inflation. Student housing has those characteristics near these large schools. We've been investing this way for a long time and believe we have an operational advantage – a knowledge advantage based on decades of experience – compared with traditional firms just getting into the sector. That's the case in medical office, as well, where we are the largest nonhospital private operator in the United States, with 32 million square feet under management.

There is also a supply story for each of these sectors. The cost of construction has gone up dramatically since 2019, and rising interest rates, alongside challenged bank balance sheets, have greatly limited financing and new development. These trends support increased pricing power in these sectors during the next few years.

Since 1978, 80 percent of returns in core funds have been income driven. How does that affect your investment philosophy?

Selznick: Portfolio composition is a mix of durability and income plus growth. We lean heavily into medical office because it offers institutional-quality assets in a high-demand business with strong barriers to entry. There is currently much greater demand than available square footage to service the growing population of seniors. With those dynamics, we want that backbone of income, those long-term leases from strong tenants, to be the foundation of this strategy. Then we layer onto that higher-growth annual leases from senior housing and student housing. With that base and those layers, we have a diversified portfolio. We can predict the income from now through the next 10 years because of the strength of the medical office piece, plus the compounding growth of these annual leases with powerful fundamentals of strong demand and little new supply in senior housing and student housing. That is quite powerful for achieving not only predictability, but organic NOI growth over time. Growth the good old-fashioned way. The combination of those two elements drives our portfolio composition.

What are you hearing from investors regarding the real estate market? And how are you responding to any concerns they have?

Mayes: There are several things we've heard from investors about the market generally. One is the entry risk regarding the traditional sectors and how they're valued when you are buying into a fund – office being a focus of that conversation, but certainly not the only one. Public markets have come back. Healthcare alone is a huge outlier at the time of this interview in the public markets. It is trading on the Green Street healthcare benchmark at more than a 50 percent premium to underlying asset value. If investors have questions about values related to our sectors, there are public market indicators of a massive healthcare trend. People are going to look back and say, "How did we not see that?" But the public market is seeing it already.

There will be many investors trying to rotate into our sectors; they will not necessarily be experts in these sectors, and they probably will not go deep. Rather, many will take an allocator approach – drip a little bit here and there. But to be successful in these niche sectors, to create alpha or true outperformance, you need to have operator orientation and be hands on in these operationally intensive sectors.

Selznick: We are not going to buy assets just to buy assets. We must believe in the basis, the thesis, the overall investment period and the risk-adjusted return profile. We're not a generalist – we stick to what we're good at – but we're also not a single-sector investor. You can't be good at everything. We're great at a few things, and we've been doing them a long time. I think more investors will be looking to tactical teams such as ours because we have a track record of discipline in fundamental real estate that has positive demand drivers with supply constraints and barriers to entry.

Given all the buzz around the niche sectors, do you anticipate more competition in your sectors? How will it evolve?

Mayes: There are many different opinions about what is "core," but one thing people can agree on is that it's not going to go back to the four food groups. The alternative bucket has grown over time, and it will continue to grow. There are a number of sectors and subsectors that fit in that bucket. There will be certainly some growth in niche sector allocations within the ODCE funds, but the growth of the allocation of capital into niche sectors will more likely go toward companies that are deep, operationally intensive, large-scale operations.

Selznick: Many of the generalist players are going to overpay. We can source deals because of our reputation, our relationships, our certainty of close. Our differentiator is being known as consistent capital throughout cycles. I believe the next three-plus years will be one of the best investment environments we've had in the past 15 to 20 years. It feels pretty good to have the capital to invest in this very attractive investment environment.

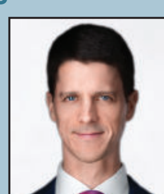
A final word?

Mayes: This rotation out of traditional sectors is just beginning and is going to take some time. There are many people who invested in traditional core and are now stuck in exit queues and not getting paid out quickly. So, this shift will take time, but there has been a building capital momentum in the last half of this year compared with the previous two years. We are engaging in a thorough education process with our potential investors who maybe have never owned medical office, for instance. They may never have toured a high-end senior housing property with amenities. We are leading a lot of property tours, writing white papers and are happy to talk with anyone who wants to get to know our sectors.

Selznick: Five years from now, if you look back, you're going to see the differentiation between the newcomers and the enterprises that have the operational capabilities, specific experience and knowledge, and investment discipline. These firms will continue to outperform.

CONTRIBUTORS

David Selznick
Chief Investment Officer
Kayne Anderson Real Estate



Kyle Mayes, CFA
Senior Managing Director,
Fund Management, Core
Kayne Anderson Real Estate

CORPORATE OVERVIEW

With assets under management of approximately $16.5 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.

CORPORATE CONTACT

Alexander Candia | Senior Managing Director | Kayne Anderson Real Estate | +1 561-300-6237 | publicrelations@kayneanderson.com