A TILT TO ALTERNATIVES

Ongoing Evolution of Institutional Investment in Alternative Real Estate

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About The Author

Olin recently semi-retired after nearly 40 years in the commercial real estate investment business. His last 27 years were with Heitman, a global real estate investment manager, serving primarily as their Director of North American Investment Research.

Heitman's operational philosophy is rooted in a collaborative interdisciplinary team approach throughout all stages of the investment life cycle. As a result, he therefore worked extensively with:

- Fund Managers in formulating investment strategies and raising capital to execute them,
- Production Officers in identifying and underwriting investment opportunities as well as joint venture operating partners,
- Portfolio & Asset Managers in the formulation of annual business plans, hold/sell analysis and quarterly valuations, and
- Fellow Research Professionals in staying abreast of macro conditions and commercial real estate investment dynamics.

This experience provided him with keen insight into what institutional investors expect in regard to communication, reporting and underwriting before committing capital to a new investment manager or real estate operator.

Heitman was an early entrant into alternative property sector investing and he played a primary role in this initiative from its inception. At retirement such investments totaled approximately $14 billion in gross asset value. During his tenure, he was intimately involved in the production approximately $17.0 billion of real estate investments of which more than 70% were in alternative sector properties.

The author is offering research and advisory services emphasizing:

- rigorous strategic analytical thinking,
- a holistic view of the investment management process,
- promotion of investment management best practices, and
- wisdom and insights gained through four real estate cycles.

Please reach out regarding any top-down and/or bottom-up research needs.

Thank you,

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Interest in alternative real estate continues to escalate as their role in core real estate portfolios expands. At the same time, the structure, character and nature of several alternative sectors are evolving as well. Recognizing this change will be critical to formulating successful investment strategies in the future as the scope and scale of US alternative real estate further develops.

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Introduction

The past three years have been challenging ones for commercial real estate as the industry adjusts to a higher interest rate regime and fading post-pandemic boosts to operating fundamentals that occurred in several sectors. During this time of tumult, one trend that has continued unabatedly is escalating investor interest in alternative real estate ("alternatives").

The National Council of Real Estate Fiduciaries ("NCREIF") has revamped inclusion standards for its Open-End Diversified Core Equity index ("ODCE"), allowing for a higher percentage of investments in alternatives. The Pension Real Estate Association (PREA) now includes a regular feature in its *PREA Quarterly* publication entitled Alternatives. Fund raising has been challenging, but Feguson Partners reports that 45% of committed pension fund capital in 2024 was for funds targeting alternative property sectors.

Historically these sectors were called specialty or in some instances niche real estate. The change in nomenclature is a good development since they are no longer so special. Increasingly they are viewed just like the traditional primary sectors of apartment, industrial, office and retail.

This report outlines the evolution of private market investment in alternative real estate sectors. It discusses how some shared characteristics, previously distinguishing them from the primary sectors, are in some instances becoming somewhat less relevant. Today alternatives are not just targets for value-add and opportunistic strategies. Their role in core portfolios will therefore also be explored.

Evolving Interest

Attitudes about alternative real estate and their role in an institutional investor's portfolio continue to evolve. Thirty years ago, access to specialty real estate was largely limited to indirect investments through the public REIT market. Private investments that did occur were mostly the domain of opportunity funds in search of outsized returns.

The success of these early investments along with the strong performance by alternative sector REITs led several managers around the turn of the century to start incorporating alternatives into their value-add and core+ funds.[1] Alternative investments possess a number of attributes making them strong candidates for value creation through a variety of physical, operational and/or financial strategies. For instance:

- Fragmented ownership results in many underperforming, but well-located assets whose performance can be enhanced through more sophisticated management practices from larger better capitalized operators.
- Small alternative assets can be challenging to efficiently acquire; programmatic portfolio assemblage expands the pool of potential buyers, resulting in pricing premiums.[2]
- Operators often present non- or lightly-marketed investment opportunities to capital partners that can be acquired at better-than-market pricing.
- At various times alternative sectors, like senior housing facilities and data centers today, can be extremely undersupplied, creating attractive development and redevelopment opportunities.

[1] For example: AEW (senior housing), LaSalle (MOBs), Prudential, now PGIM (student housing) and TIAA-CREF, now Nuveen (self-storage)
[2] Portfolio premiums evaporated in late 2022 but are anticipated to return.

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Another noteworthy occurrence in the evolution and awareness of alternative real estate was the 2005 formation of Harrison Street, a fund manager focusing exclusively on them. Today, the firm has more than $55 billion of assets under management. The launch of Heitman's core fund in 2006 with target allocations to self-storage and medical office properties ("MOBs") was also a significant development. It took more than a decade for many investors to appreciate the core-like investment characteristics of these property types, including high cash yields and low volatility.

After the global financial crisis ("GFC"), increased real estate allocations created the need for a more expansive investable universe. Large amounts of capital began seeking direct exposure to alternative sectors for diversification purposes and a return premium to primary property types. Senior housing and MOB investments proved to be defensive during the GFC.[3] Self-storage performance, while far from immune, recovered quickly and strongly.[4] Domestic and overseas investors of all types took note and started targeting these alternative sectors and other emerging ones like student housing, life science assets and single-family rental properties ("SFR").

More recently, operational challenges first in the retail sector and then in office have driven a rotation of capital out of these sectors, benefiting alternative ones as a result. Today, a bit of FOMA (fear of missing out) may also be in play.

Common Characteristics

Investing in alternative real estate requires extensive upfront research to gain an understanding of a sector's operating characteristics, supply and demand fundamentals and risks. While each alternative sector is unique, it has been noted that they frequently share some common characteristics, including:

- return premiums versus traditional property sectors, including strong cash yields,
- demand drivers more dependent on demographic or secular change than economic cycles,
- smaller investable universes with fragmented ownership,
- the need for a partner with specialized knowledge and a well-developed operating platform,
- more limited transparency due to the relative lack of historical operating data, and
- finally, more challenging access to private market investment opportunities.

Today, some of the aforementioned characteristics are somewhat less appropriate in describing the investment environment, particularly for the more mature alternative sectors. Recognizing how these characteristics are or are not changing will be a critical element to implementing successful investment strategies in the future. An exploration of these characteristics follows.

Return Premiums

Many managers and limited partners ("LPs") have had favorable experiences with alternative real estate investments. Some of these positive results likely came from them trading at higher yields and experiencing subsequent cap rate compression as these sectors matured and became more commonly accepted by investors. For example, at the turn of the century on-campus MOBs traded at cap rates in the range of 9.0% to 10.0%. In 2022 before the most recent price correction, they were more typically available in the 5.0% to 5.5%-range. Similarly, self-storage property cap rates were 200+/- basis points ("bps") higher than apartments 20 to 25 years ago. In recent years the difference between the two sectors has been minimal.

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[3] Limited data for that period; based upon author's experience
[4] Best illustrated in REIT same store figures

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ANCIENT WHITE PAPER EXHIBITS

Medical Office Sales Summary *
2000Q4-2002Q3

	No of Sales	Square Feet (mIllions)	Price Per Sq.Ft.	Going-in Cap Rate
2000Q4 to 2001Q3	47	6.01	$112	10.3%
2001Q4 to 2002Q3	70	6.40	$132	9.9%
On Market	43	3.60	$126	9.0%

** Includes mix of both on- and off-campus properties*

Source: Real Capital Analytics

Today investors are more educated about the fundamentals and risks of many alternative sectors and are aware of major owners and operators in them. Non-cyclical demand drivers resulting in defensive cash flows are also more appreciated attributes. These developments are reducing the mispricing of risk, improving transparency and making markets for them more liquid. Further systematic cap rate compression is therefore unlikely to occur in mature alternative sectors. Taking advantage of such in emerging ones (i.e. Build-to-Rent Communities, Cold Storage) is also likely to be quite fleeting given today's intense capital market interest in them.

Outsized returns in alternatives may continue to persist from the execution of a variety of value-add strategies. However, any return premiums for core alternative investments will be more dependent upon relative growth profiles and capex requirements, which vary by alternative sector.

Investable Universes

Estimating the size of a real estate sector's investable universe is as much art as science. Clarion Partners and Rosen Consulting Group recently undertook a detailed analysis of this topic.[5] Their analysis actually distinguishes between a sector's investable universe and its institutional investable universe, with the latter being the appropriate focus for our purposes.

They estimate the overall institutional investable universe ("universe") for commercial real estate to be approximately $11.7 trillion in size. Traditional sectors, including hotels, account for 69.5% ($8.1 trillion) with alternative sectors accounting for the rest (30.5% or $3.6 trillion). SFR at $1.3 trillion accounts for 38% of the alternative institutional investable universe and is the only alternative sector comparable in size to traditional ones. According to their estimates the next largest alternative sector is medical office at $413.1 billion. Data Center's universe is relatively small today but given its projected AI-driven growth trajectory it should rapidly expand in the near future.

[5] Clarion and Rosen Consulting Group: *The US Institutional Investment Universe* (2024)

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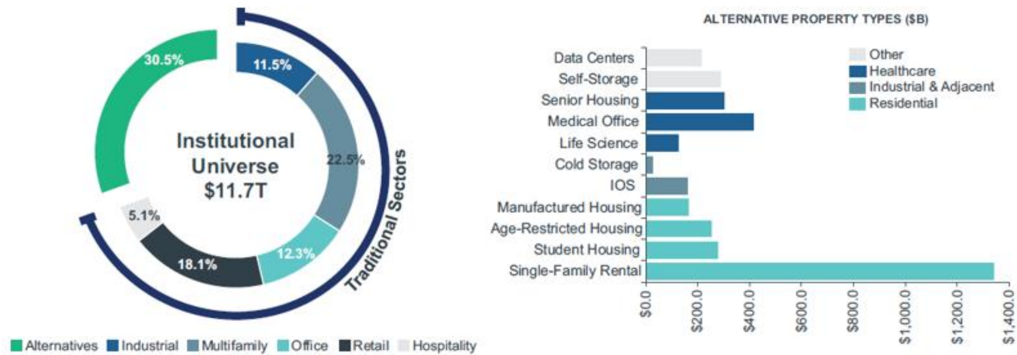
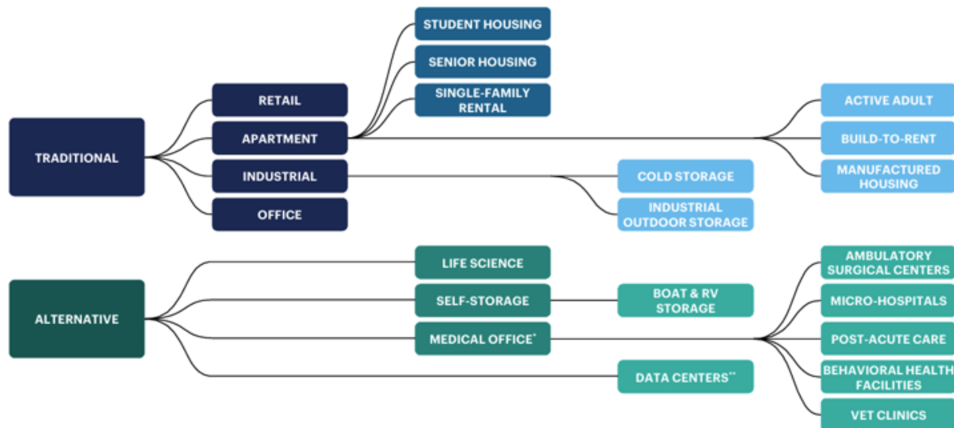
CRE INSTITUTIONAL INVESTABLE UNIVERSE



Source: Clarion & Rosen Consulting Group; *The US Commercial Real Estate Investable Universe*

Some sector universes are expanding by the inclusion of more property subtypes. MOBs are increasingly being recharacterized as medical outpatient buildings to include things like ambulatory surgery centers, dialysis centers and a variety of post-acute property types. The SFR sector is now generally considered to include build-to-rent communities. Similarly, Boat/RV properties are now often classified as part of the self-storage sector. Additionally, Heitman points out in a recently released report that the overall alternative sector universe is expanding by the inclusion of primary property subtypes such as cold storage and industrial outdoor storage ("IOS") that possess their own unique operating characteristics, demand drivers and risks.[6] Even with these expansions, the size of most alternative sector's investible universe remains quite small compared to traditional primary property types.

HEITMAN'S ALTERNATIVE SECTOR TYPOLOGY



Source: Heitman; *Alt+Shift: Expanding Options in Emerging Property Types*

[6] Heitman; *Alt+Shift: Expanding Options in Emerging Property Types* (2025)

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Fragmented Ownership

Not surprisingly, growth in the REIT market as well as institutionalization of private market investments into alternative sectors has made ownership considerably less fragmented than it once was. The degree of consolidation varies by sector. It is highly evident in the purpose-built student housing sector at flagship universities where a handful of groups manage a substantial portion of available beds.[7] MOBs are another sector where REITS, health systems and a small number of institutionally-backed private groups, control an increasingly large portion of the market.[8]

On the other end of the spectrum are senior and manufactured housing sectors, which have experienced some consolidation but are still highly fragmented with numerous small- and medium-sized owner/operators, particularly in tertiary communities.[9] The SFR sector, despite the outcries of the press and some government officials about institutional landlords, is also highly fragmented. Landlords with more than 1,000 homes own only 3.0% of the rental inventory.[10] This is likely a function of the large size of its investable universe and the relatively short-period of time (10-15 years) that it has been targeted by institutional investors.

Consolidation can also vary by geography. The Top 10 self-storage owners account for approximately 35% of the nation's inventory, which is approximately double what it was in 20 years ago.[11] However, in some metro areas their market share is considerably higher. For example, the four public REITs alone own and/or manage approximately 65% of the Washington DC metro area storage inventory.[12]

There are at least two important implications from ownership consolidation in the alternative sectors. First, opportunities for outsized returns simply by buying from small, unsophisticated owners is becoming increasingly less frequent. Second, consolidation has led to greater professionalism and more sophisticated operating platforms enhancing the management of alternative investments, potentially leading to better returns. Some argue that this has also led to improved asset quality.[13]

Operating Orientation

Properties in some alternative real estate sectors are associated with operating businesses. Successful investment execution therefore typically requires an operating partner with specialized expertise and a well-developed platform.

Specialized expertise and knowledge have become more widely distributed beyond just operators in recent years. Third-party property management and leasing services are now available in most alternative sectors. Sometimes these services are from operators themselves. Other times from large real estate service providers such as CBRE and JLL. This is making investing in alternative real estate without an operating party more feasible, if not always desirable. Currently this is more common among private investors than institutional ones.

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[7] Amber; *Dynamics of Purpose-Buit Student Housing* (2023); Groups include ACC, Harrison Street, The Scion Group, Greystar and Landmark Properties
[8] See Revista Med and Grand View Research
[9] Manufactured Housing Institute; *2023 Manufactured Housing Facts* (2023) and Mardar Intelligence; *Assisted Living Market Size and Share Analysis* (2024)
[10] Wolf Street; *Biggest Landlord of Single-Family Homes* (2024): Data from John Burns Consulting
[11] Rent Café analysis of Yardi Matrix Data (2025) and Storage Almanac (2005)
[12] Analysis of Yardi Matrix Data (2024)
[13] See Harrison Street; *Core Real Estate is Out Alternatives* (2023)

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Transparency

Historically, the lack of operational and investment performance data for benchmarking purposes has made investing in alternative real estate less transparent. This is changing with growing capital market interest and the importance of alternatives in investor's portfolios, although it is still more limited than primary sectors.

For many alternative sectors, the best operating data available comes from reported REIT same store figures. This data requires quarterly aggregation, is not granular enough for many purposes and suffers from the lack of a commonly accepted definition of "same store." Green Street Advisors has been a leader in the assemblage and standardization of this data. In recent years, they have also greatly expanded their offerings, incorporating private market data and insights into various alterative sector reports as well.

Private performance return data is now just becoming available through NCREIF's NPI+ index. While a step in the right direction, the data series suffers from small sample size and in some instances, reporting manager concentration. It is important to remember that inferences drawn from small samples can lead to large errors in judgement.

Understanding alternative sector fundamentals has also been enhanced by sector conferences and other industry events that are now widely attended by investment managers. Finally, the availability of far-from-perfect but increasingly creditable data is now available from a variety of third-party vendors.

REPRESENTATIVE THIRD-PARTY ALTERNATIVE SECTOR DATA PROVIDERS

Further development and refinement of operational and investment performance data will be critical for alternative sectors to truly become "main stream."

Access

Access to private market alternative investment opportunities has always been challenging. Fragmented ownership, the need for specialized operating expertise and a smaller set of potential investment opportunities are among the reasons why. Small asset size is also an issue in some sectors. As discussed, some of these constraints are easing but they still remain in place. At the same time, competition for investment opportunities is becoming more intense as alternative sector properties become more prominent parts of portfolio construction.

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Exposure to alternatives through REITs will therefore continue to be a common way of gaining access. On the private side, LPs who invest with managers with a deep base of knowledge, extensive industry contacts and who dedicate significant resources to evaluating alternative opportunities will have the best prospects for deploying capital. Such mangers are not just large established ones, but emerging ones as well who are often alternative sector specialists.

What's Core?

Core funds have historically allocated only a small amount to alternative investments, mostly in their value-add buckets. Investors and mangers are now debating "what is core" and the role of alternative properties in a core portfolio. LaSalle Investment Management's perspective, outlined in the *Spring 2024 PREA Quarterly* and illustrated in the adjoining exhibit, is a good characterization of the dimensions of this debate.[14]

LaSalle's Changing Definition of Core

Traditional Core Mind-Set	"New" Core Mind-Set
Long Leases	Observed Long-Run Income Resilience and Growth Potential
Credit Tenants	Low Cash Flow Sensitivity to Economic Cycle
Lease Clauses that Pass Inflation on to Tenants	Market Conditions Pass Inflation into Market Rents
Minimal Near-Term Capex	Predictable Long-Term Capex
Low Operational Intensity	Established Operating Model
Gateway City Locations	Locations w/Long-Term Liquidity andTenant Demand
Traditional Sectors - Multi-family, Industrial, Office & Retail	Any Sector Offering the Above

Sources: "The Changing Definition of Core," LaSalle Investment Management; PREA Quarterly (Spring 2024)

A couple of years ago NCREIF revamped their property-type inclusion criteria for their ODCE fund index. Primary property sectors were reconstituted and broken down into subtypes with apartments now part of a larger sector called residential. Two new property sectors, self-storage and senior housing, were created. Three existing non-primary sectors, hotels, land and other, were retained.

Primary property sectors, like previously, must account for 75% of a portfolio but up to 25% can be in five primary property subtypes (student housing, manufactured housing, single family rentals, MOBs and life science properties). Effectively, this means an ODCE fund can now have up to 50% in what are generally considered alternative sectors. Twenty-five percent in primary property sector alternative subtypes and twenty-five percent in Other and Newly Created Property sectors. Clearly, ODCE is no longer your father's core property index.

[14] LaSalle Investment Management; *The Changing Definition of Core* (Spring 2024 PREA Quarterly)

REVISED ODCE PROPERTY-TYPE INCLUSION CRITERIA

At Least 75% Must Be Invested in Primary Sectors			
Industrial	Residential	Office	Retail
Warehouse	Apartment	CBD	Strip
Manufacturing	Student Housing	Suburban	Street
Specialized	Manufactured Housing	Secondary CBD	Mall
Flex	Singe-Family Rental	Life Science	
Life Science		Medical Office	
(No More than 25% in these Subtypes)			

Other Existing Property Sectors		Newly Created Property Sectors	
Hotel	Other	Self Storage	Senior Housing
Limited Service	Data Center		Independent
Full Service	Operating Land		Assisted
	Entertainment		Skilled Nursing
	Parking		Continuing Care

Source: MetLife Investment Management; NCREIF (excludes Land)

Core Index Composition

MetLife Investment Management ("MetLife"), is one of a number of managers, who have compared the composition of the ODCE and NAREIT indices over time.[15] As you can see, the inclusion of alternatives in ODCE is lagging this change in NAREIT. As of 2024Q2, alternatives accounted for 11.8% of the ODCE index, up from 0.5% in 2010. For NAREIT, alternatives grew from 18.3% to 47.5% during this time period.

The ODCE allocation to office and retail sectors is down nearly 30% points from 2010 to 2024, with the industrial and alternative sectors being the beneficiaries. Healthcare (4.8%) and self-storage (4.3%) are currently the largest alternative sectors in the ODCE index. MetLife projects the allocation to alternatives in ODCE will grow to 27.0% in the next ten years with the biggest gain in SFR (0.9% to 5.0%). Heitman's core fund, as previously noted an early adopter of alternatives, already has an allocation of approximately 30% to the self-storage, MOBs and student housing sectors.

NAREIT and ODCE Indices Comparison

	NAREIT		ODCE		
	2010	2024	2010	2024	2034
Apartment	14.7%	9.9%	24.0%	25.4%	18.0%
Office	13.5%	5.0%	33.8%	17.2%	9.0%
Industrial	6.1%	12.1%	14.1%	31.7%	30.0%
Strip Center	8.9%	5.1%	11.2%	5.1%	9.0%
Mall	15.8%	4.3%	12.9%	6.2%	2.0%
Freestanding Retail	2.1%	5.4%	0.9%	1.4%	4.0%
Hotel/Lodging	6.5%	2.9%	2.7%	0.2%	1.0%
Primary Sector Subtotal	67.6%	44.7%	99.6%	87.2%	73.0%
Health Care	11.8%	9.9%	0.0%	4.8%	6.0%
Self-Storage	5.8%	7.3%	0.0%	4.3%	5.0%
Student Housing	0.0%	0.0%	0.0%	1.2%	3.0%
Single-Family	0.0%	2.8%	0.0%	0.9%	5.0%
Manufactured Housing	0.7%	2.2%	0.0%	0.3%	2.0%
Specialty Other	0.0%	3.3%	0.5%	0.3%	1.0%
Data Center	0.0%	9.4%	0.0%	0.0%	4.0%
Telecommunication	0.0%	12.6%	0.0%	0.0%	1.0%
Alternative Sector Subtotal	18.3%	47.5%	0.5%	11.8%	27.0%

Notes: NCREIF definitions adjusted for comparison to NAREIT index; Diversified excluded; 2034 is projection
Sources: MetLife Investment Management; NCREIF; NAREIT

[15] MetLife Investment Management; *ODCE Adopts an Alternative Approach* (Summer 2024 PREA Quarterly)

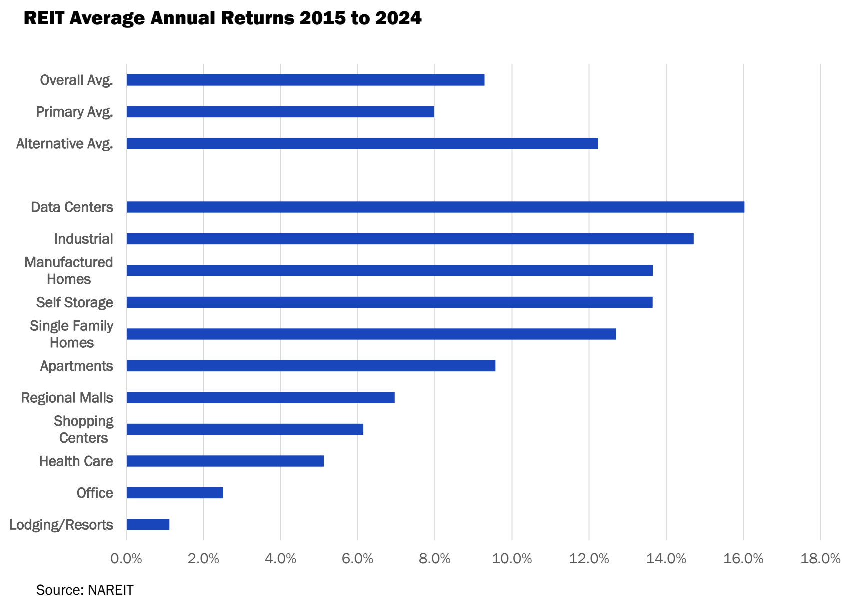
Concluding Thoughts

The focus of core real estate investing in the future will be the same as it is today, namely the construction of a diversified portfolio of high-quality properties with stable income streams. Adding alternatives into the mix for consideration is a positive occurrence in several ways.

Inclusion of alternatives results in a more complete reflection of the 21st Century built environment and it is a significant expansion in the potential scope of core investing, in essence expanding the institutional investable universe by 44% or $3.6 trillion[16]. Expanding the size of the investable universe facilitates capital deployment and increases the probability of making good investments. Further rotation of capital out of retail and office will also be more easily accomplished.

Each alternative sector is unique with different lease terms, capital requirements, growth prospects and demand drivers, some of which are much less cyclically-driven. This should be good for diversification and there is some evidence that the correlation of returns between them and with primary property sectors are low to modest in many circumstances.[17]

If historical REIT performance is a guide, it should also elevate overall core investment returns.[18] During the past ten years, alternative REIT sectors posted four of the five highest average annual returns. Average annual returns were 12.2% for alternative sectors compared to 8.0% for primary sectors. Fewer alternative REIT categories exist over longer periods but two long-standing ones, self-storage and manufactured housing, have exhibited consistent strong relative performance.



Given all the excitement about alternatives, it is important to have realistic expectations about the pace of capital deployment and future core portfolio construction. While transparency will continue to improve, the assessment of risks and underwriting of cash flows will remain challenging, particularly as the sectors themselves evolve. Achieving even modest increases in alternative sector allocations will take time given the many constraints discussed in this report.

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[16] Based upon previously presented Clarion/RCG analysis
[17] Heitman; *Alt+Shift: Expanding Options in Emerging Property Types* (2025)
[18] NPI+ data is also supportive of this observation.