The case for alternatives in uncertain markets

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Investor demand for alternative real estate sectors in Europe continues to remain at record levels. Sectors once viewed as niche have established themselves as part of well diversified real estate portfolios, with specialised strategies such as student accommodation, build-to-rent, life sciences and healthcare now regularly featured among the top of investor's sectoral wish-lists. These investors, in turn, have both allocated and deployed more capital to alternative sectors over the past few years. In fact, alternatives' share of total UK real estate investment has grown from just 2% in 2000 to 20% in 2021.[1] Given the current macroeconomic headwinds, protracted inflationary environment and rapidly shifting capital markets, it is likely these sectors will attract greater inflows of capital.

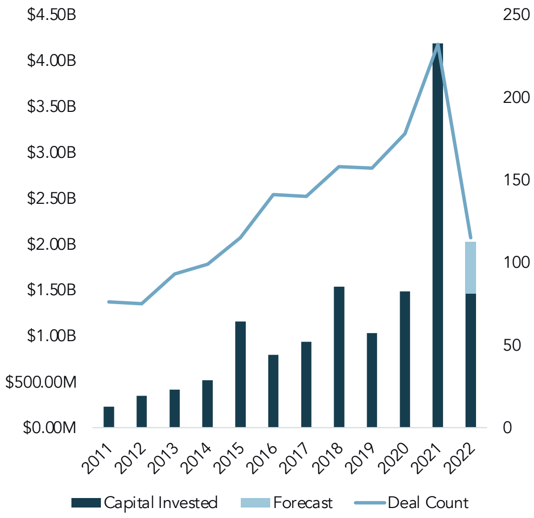
Alternatives in Europe can point to demonstrable resilience and defensive attributes through multiple black-swan events that have acted as a litmus test for investors' investment rationale and recent pivot to alternatives. These black-swan events show that alternatives are driven by positive demographic changes that are well underway and forecast to persist in Europe over the medium to long-term. It is also clear is that these alternative sectors' performance is not linked to wider economic performance, unlike more traditional real estate asset classes. In fact, many of the alternative real estate sectors in which Harrison Street invests have experienced significant expansions in demand during economic downturns and uncertainty due to their needs-based demand characteristics.

Positive indicators for alternative sectors

The resiliency of alternative sectors has been illustrated by the increases in full-time student enrolment during the Global Financial Crisis (GFC) and Covid-19 pandemic, as well as the increasing share of private rental households across Europe over the past two decades, which originated during the GFC. This dynamic looks set to be repeated once again, with tenant demand levels for private rental housing already equal to what was experienced during the GFC.[2] The life science sector is also well positioned to weather the uncertainty brought on by periods of economic slowdown, with mission critical laboratory space playing a vital role in a world with a growing and aging population. Forward looking demand indicators, such as venture capital fundraising and continued onshoring from occupiers, remain resilient for the sector. Venture capital fundraising for UK life sciences remains on track to reach approximately $2 billion by the end of the year, which would represent the second highest annual total achieved.[3]

Alternative real estate sectors are also linked by a key theme of chronic undersupply that began before the pandemic and worsened during it. Though this undersupply has recovered, it is now likely to worsen in the near-term as development financing has become more stringent and costly.

UK Life Science VC Fundraising



Source: Harrison Street Research based on Pitchbook Data. 2022 Capital Invested and Deal Count as of 20.09.2022. Forecast capital data based on annualised trend rate.

While many parallels can be drawn to previous cycles, the current market exhibits a number of unique circumstances than have been born out of the past 18 months. Alternative real estate sectors in Europe have not previously experienced a period of prolonged and high inflation, but there are many reasons to suggest that they provide an effective partial inflation hedge. Leases across most alternative sectors are short in duration, providing asset owners with more flexibility for near-term adjustment of rents, to reflect potential price rises in the wider economy. Historically, private residential rents have tracked inflation trends closely and, over the long term, have outpaced inflation. Between 1981 and 2021, rents in the UK grew by 4% per annum ahead of CPI inflation which averaged 2.5% p.a.[4] Given the relative immaturity of the purpose-built student accommodation (PBSA) market, it is not possible to point to a similar, significant depth of data, but over the past decade a similar outperformance of rents has played out.[5] Longer leases in sectors such as life sciences also include contractual annual rent increases to help mitigate inflationary pressures.

High barriers to entry

While it is easy to understand the fundamentals that underpin the investment rationale for alternatives, gaining access to these sectors is not so easy. High barriers to entry are ubiquitous across many different parts of the alternatives industry, from fragmented institutional ownership and smaller asset sizes, to difficulties in finding experienced developers or operators with the relevant knowhow to develop and manage operationally complex and intensive assets.

The relative nascency, opaqueness of the property data and highly fragmented nature of alternative real estate curbs investors' ability to deploy substantial capital in the space. Each of the alternatives sectors has a highly fragmented ownership structure and while there are leading owners in each segment, they do not hold a dominant market position. However, the fragmented nature of alternatives presents the opportunity to create large, institutionalised portfolios of alternative assets, thereby creating value not only at the asset level through professional management, but also through portfolio composition, as potential portfolio buyers often lack the ability to acquire individual assets. Portfolios that have traded in the alternative segments also tend to generate additional premia given the infrequency that scaled, income-producing portfolios trade.

Alternative sectors are operationally specialised and highly idiosyncratic: life sciences properties are often complicated to operate, creating a necessity for property managers to be willing to work closely with experienced health systems; senior properties must offer intensive, around the clock care, making health care delivery a key differentiator between properties; and student housing properties must service a different type of younger user, reacting to heightened competition in this space. Consequently, choosing a property manager or operator to lease and manage alternative properties is, in some cases, as important to the investment strategy as the property's physical location and amenities.

Though traditional real estate management also requires some operator expertise, it is often transferable across sectors and owners. By contrast, alternatives operators who specialise in a specific sector do not generally manage other asset types, instead choosing to bring deep sector expertise to their segments. The need for operator expertise makes it harder for single firms to amass ownership across most alternative segments. Multi-country strategies across European jurisdictions must also be tailored to reflect local legislative and cultural environments, with many operators, so far at least, focused on one or two markets where they can provide local, specialised expertise.

While operators in traditional real estate sectors are most likely to be affected by the macroeconomic environment, weaker alternative operators are also likely to be hurt. This will provide an opportunity for specialist GPs to target distressed groups who may have weak balance sheets at an entity level despite strong asset level performance. While many investors are now allocated to alternatives due to its attractiveness and structural lack of supply, they remain predominantly focused on commercial sectors, with limited experience in developing and operating alternative assets. Those investors with significant alternatives experience and early-stage advantage can leverage strong relationships with operators and market participants.

FOOTNOTES:
1 Colliers, PropertyData
2 RICS: UK Residential Market Survey October 2022
3 Pitchbook. Data as of October 2022
4 ONS. RPI rents = private rental component of RPI
5 CBRE. Gross PBSA Rents (2012-2021). Data pre-2017 is limited to regional PBSA assets only