

Something special

Specialty property types are a key element of smart portfolio construction

by Leslie Chua

Specialty property types offer investors a rare combination: yields that exceed those of traditional property types and defensive characteristics in their operations. As a result, these property types tend to perform well across the cycle. An allocation to specialty property types — including data centres, medical facilities, senior housing/care homes, self-storage and student accommodation — is a key component of smart portfolio construction. Over the past 20 years, self-storage and student accommodation have gained acceptance as institutional-quality property sectors in the United States and Europe, and are attracting increasing investor interest in Asia Pacific.



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Leslie Chua
Heitman

Demographic trends support both sectors. Rising household income and expansion of the middle class are changing consumption patterns across the region. Urbanisation continues, accompanied by compression of living space, setting up demand for off-site storage. Similarly, growing demand for higher education has heightened competition for close-to-home university positions. In response, families across Asia are exploring offshore education options for their children. Purpose-built student accommodations can help lessen the perceived risk and complexity of study abroad for parents and students.

Although specialty property types in Asia Pacific represent a great opportunity for investors, they come with risks. The concept of off-site storage, for example, is new. To succeed, operators need to heighten the sector's visibility and establish their brands, while navigating complex bureaucracies to gain project approvals. For both sectors, questions remain about the ability of operators to

achieve scale and the depth of investor demand on sale. For those pioneering in these areas, however, the region's specialty property sectors represent opportunities that can offer great rewards.

High population density and occupancy costs spur self-storage growth

Heitman began investing in the US self-storage sector more than 20 years ago, drawn by its mix of high initial yield and above-average NOI growth. The firm has subsequently made storage investments in Europe, Australia, Singapore and Tokyo. The performance of self-storage during the global financial crisis shows its character. Short lease terms allow tenants to adjust quickly to changing economic conditions, but the sector tends to bounce back faster than other property types as economic growth accelerates. The storage sector's strong performance after the global financial crisis caused a change in investor views, leading to substantial cap rate compression.

High NOI growth stems from:

1. Heightened tenant demand as consumer awareness has broadened
2. The ability of storage operators, given short lease terms and relatively-low rental cost, to pass through rent increases to existing tenants multiple times in a year.

Further, because storage properties require minimal cap-ex to maintain operations, the amount of NOI that becomes net cashflow is the highest among the major property types.

Certain Asian markets offer great potential for self-storage, given favourable demographic trends, high population density, and increasing residential and commercial occupancy costs. We formed a successful self-storage joint venture with National Storage REIT in Australia, followed by another in Singapore with a leading operator in the region. Overcoming high barriers to entry related to government regulation, the joint venture is on its way to a portfolio of five assets, positioning it as one of the leading storage operators in Singapore. Self-storage

inventory is growing in many Asia Pacific markets, as tenant demand rises. As a result, investors have an array of opportunities to enter the market on high current yields, with the potential for self-storage pricing to strengthen in the midterm as the concept matures and tenant/investor demand grows.

We recently formed a joint venture to develop storage in Tokyo. Japan's self-storage business is growing. This isn't surprising given the nation's 128 million people occupy an area smaller than the state of California. Typical houses in Tokyo are small (averaging 60 square metres, or 650 square feet) and expensive, costing 10 times the average annual income in Greater Tokyo, according to the 2015 Demographia International Housing Affordability Survey.

Japanese storage operators are engaging with prospective customers in innovative ways, helping establish self-storage as an option for space-starved households and businesses. Some operators have digitised the concept: A customer can book and pay for space online, and then the customer's mobile phone is used as the key. This cuts staff costs for the operator while lowering start-up costs for the customer. We are not alone in seeing the storage opportunity in Asia Pacific. The Washington State Investment Board acquired Japan's largest indoor self-storage operator in 2013.

As is the case elsewhere in the world, Japanese self-storage yields exceed those for other property types by a wide margin.

International-student population growth contributes to rising student-housing demand

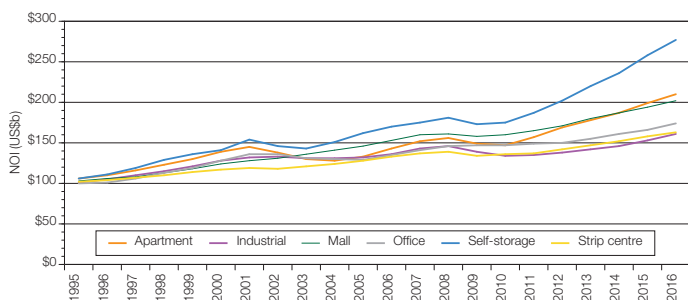
Rapid wealth creation in emerging economies such as China and Malaysia has led to an increasing number of globally-mobile students seeking quality higher education. Growth in the student population persisted during the global financial crisis, as a down economy sparked a surge in student numbers in major higher-education markets within the United States, the United Kingdom and Australia (see graph, page 8). Because many of these students were living far from home, they served to boost demand for student accommodations, even as occupier demand was declining in other sectors. This dynamic caught the attention of investors, who now view student accommodation as showing potential as a portfolio diversifier.

Historically, English-speaking countries such as the United States and the United Kingdom have been the biggest recipients of international students and have the most-developed student-housing markets. Heitman has been an investor in these developed markets for more than 15 years and recently created a joint venture to develop student housing in Australia. In Asia Pacific, Australia is a growing destination for international students, prompting development of student housing in its major university cities of Sydney, Melbourne and Brisbane. The 337,117 full-time international students enrolled in Australian institutions in 2016 represented a 9 percent increase over 2015, following gains of 5 percent to 7 percent in the prior two years. Overseas student enrolment can be volatile. Australia saw a net decline in offshore enrolments in 2011 and 2012 after a crime involving an overseas student.

Improving the quality of its universities is a focus for the Australian government, as is improved overseas recruitment. The latter dynamic is not surprising given the positive economic contribution from international students, who added an estimated A\$28 billion (US\$22 billion) to the Australian economy in 2016–2017. The Australian government views such spending as an export and, as such, educating non-residents represents the nation's third-largest export behind coal and iron ore.

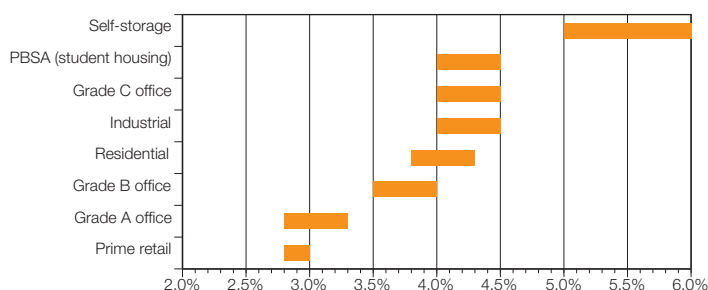
The inventory of purpose-built student accommodation in Australia is expected to increase over the next three years, with as many as 36,150 new beds in the market. If all these beds are added, the inventory would expand by nearly 40 percent. We see this growth in supply as largely warranted, given Melbourne has such a low amount of purpose-built student housing relative to its full-time students. The current inventory can only accommodate 15 percent of full-time university students versus a 37 percent rate in London and 47 percent in the United States. Further, despite the impression created by recent development activity, key barriers to entry for student housing developers remain. The competition for sites against other land uses has limited the extent of student accommodation development.

US REIT same-store NOI trends by property type, 1995–2016



Sources: Company reports, Heitman Research

Relative yields for Tokyo real estate, 2017



Sources: JLL, CBRE, Heitman Research

With student and residential developments often having the same location requirements, student accommodation developers are regularly outbid because of the strength of the residential markets.

Global capital is present in the student accommodation market in Australia, funding development and acquiring existing assets. Singapore-based Centurion Corp is developing a 280-bed asset in Adelaide. In May 2017 GIC, Singapore's sovereign wealth fund, acquired two assets at Central Park Sydney from Frasers Property Australia and Sekisui House in a transaction worth A\$400 million to A\$430 million (US\$314 million to US\$337 million). These prime assets, which comprise 1,041 beds, traded on a sub-6 percent net initial yield. They are now managed by Iglu, a platform GIC acquired for A\$150 million (US\$118 billion) in 2014 through a joint venture with Macquarie Capital.

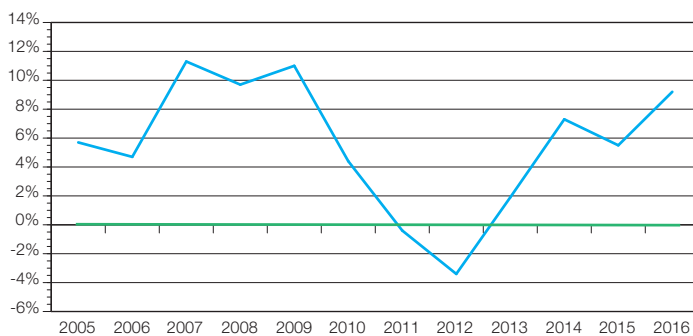
Firms such as Atira, Cedar Pacific Student Accommodation, Centurion, Global Student Accommodation, Iglu, Scape Student Living, Student One, and Wee Hur Holdings have led the initial wave of development. We expect increasing amounts of institutional capital in the sector, including from Australia's superannuation funds as well as other global investment funds. Rising demand for purpose-built student housing may be the impetus for the creation of institutional-quality residential operators, capable of developing and managing student housing as well as for-rent multifamily properties. For-rent

residential is not an institutional-quality property type in Australia today.

Development of student accommodation is occurring in other Asian markets, as well, led by locations such as Japan and China that offer top-quality universities. Japan already has claimed a sizeable share of the mobile student market in Asia Pacific. This reflects its relative affordability, with average tuition of US\$7,800 per year, compared with Australia at US\$15,650 and the United States at US\$30,000. The low cost to study in Japan makes it an attractive destination for mobile students, especially those coming from Japan's neighbours. Further, Japan offers five universities that rank among the world's top 100 universities, according to QS Quacquarelli Symonds, second only to China among Asian nations. China currently has six top-ranked universities.

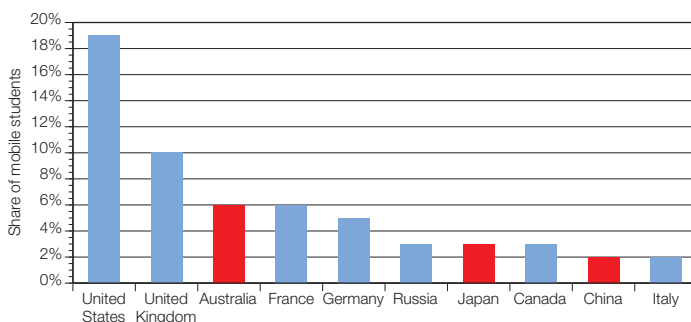
It is reasonable to expect continued growth in demand from non-Japanese students for spaces in Japan's universities. Japan has embarked on an effort to internationalise its higher-education system. Prime Minister Shinzo Abe is seeking to reboot the system so Japanese students can develop the skill set to "walk into positions of global leadership". The goal is to have no less than 10 universities in the world's Top 100 university rankings, double the country's current number. A programme funded by the Japanese government includes the hiring of more English-speaking professors as part of this ambitious plan. The aim is to have 300,000 overseas students by 2020, up 25 percent from current levels, with more courses taught in English in 30 institutions.

Growth in overseas full-time higher-education student enrolment in Australia, 2005–2016



Sources: Department of Education and Training, Knight Frank Research

Top 10 destination countries for mobile students



Source: UNESCO Institute of Statistics

Investment in specialty property types provides portfolio diversification

Self-storage and purpose-built student accommodation are attractive property types for several reasons. First, they provide relatively-high income that tends to be stable through the economic cycle. Based on performance data from NCREIF, specialty property types are negatively correlated with traditional property types, which means adding them to a portfolio should raise its performance. Second, these sectors offer prospects for appreciation as they mature and institutionalise. Demographic changes — population growth, wealth growth, shifts in family patterns/household formation, as well as an increasingly-mobile workforce — have underpinned demand growth for both sectors across many developed Western markets. These drivers are becoming increasingly significant across Asia Pacific. Finally, in an environment where competition for high-yielding real estate assets remains intense, these two property types offer a compelling investment opportunity for investors looking to capitalise on Asia's demographic shifts. ♦

Leslie Chua is senior vice president, director, and head of Asia Pacific Investment Research at **Heitman**.

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