

Niche sector pros and cons

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Michael C. Hudgins**, senior managing director of research with Hines, about niche sectors and the dynamics that affect their return profile. Following is an excerpt of that conversation.

Niche sectors are getting a lot of attention. It feels as though some investors are playing catch-up as they jump into these sectors. What is Hines' experience with investing in niche sectors?

In 2023, niche sectors passed the 10 percent share mark for the new index for NCREIF¹ that includes niche sectors and subtypes. It was less than 1 percent 20 years ago. But while there is a fair amount of niche-sector product out there, the share that is of institutional quality, in our view, is still relatively low. That's a real opportunity for a company such as ours because we have a long history as a developer. With all this investor interest in niche sectors, more product will likely have to be built.

We are also a buyer, and we have been investing in various niche sectors for years. In the United States, we were investing in medical office as early as 2007. In life sciences, we did a project in 1995. We were involved in self-storage and senior living as early as 2016 – a good three to four years before COVID-19. We have been buying, building and even managing student housing in Europe since 2016, and we made 14 investments in that niche sector, as of the second quarter. We also have a history with U.S. data centers since 2008. We're making a big push now in Europe in the data center sector, and we are looking at a data center opportunity in Asia, as well. In fact, our U.S. core-plus fund is targeting as much as 20 percent in niche sectors. It is invested now in a broad range of property types, including life sciences, industrial R&D space, medical office, single-family rental and self-storage. These were sourced by our local teams. The expertise has been there for a while and is only growing.

How do investors navigate the niche sector space? Do you invest in all of them or just pick a few?

There are a number of things to consider when you're investing in niche sectors. It's not a monolithic block of assets driven by demographics. For instance, medical office can range from a traditional doctor's office space to an acute-care facility. We like to think about niche sectors as complementary to specific traditional sectors. Office complements would be life sciences and medical offices. Apartment complements run across a broad range of senior living, student housing, single-family rentals [SFRs] and self-storage. Data centers and cold storage complement industrial. Now, all of these have great secular tailwinds we investors like to talk about. The silver tsunami, which is the aging of our population, is supporting the fundamentals of medical office, life sciences and senior living. We've also seen younger cohorts aging into what we call the "raising-children" cohort. These are people between 35 and 54. These households need more space, whether bigger homes or storage. That's a tailwind for single-family rental demand and self-storage. The data tsunami and artificial intelligence boom continue to drive demand for data centers. But when we started to build scale in these various sectors, we realized we needed to take our understanding of why to invest in each of these sectors to the next level.

We seek a long-term view on how each sector performs, but also a mid-term view on pricing. We want to know why we would

invest in a particular niche sector in terms of risk/return profile, and when is the right time to lean into a given sector. One of real estate's attractions is the cash flow it generates. You have rental revenue leading to net operating income that supports cash distribution, but also capital appreciation over time. A property portfolio is a collection of different buildings, which is really a blend of cash flows. The quality of those cash flows will drive the quality of that portfolio's performance. We ask ourselves: What do these niche sectors bring to the table on that score? Why would you put them in a portfolio to improve their performance? Right now, the value proposition is quite compelling, but it's also different by sector. You can combine several niche assets – some for yield, others for growth, some for stability, and ideally, some for a combination of these factors. They diversify each other. We have considered each of these niche sectors' revenues and the quality of their cash flow across three dimensions: yield level, or the percentage of return being spun off in a cash distribution; growth levels; and stability, or the volatility of revenues and cash flows. Building a property portfolio is an exercise in optimizing the balance of yield, growth and stability. We like to combine the last two to have a fourth factor: risk-adjusted cash flow, or the most growth, but at lower volatility. All these niche sectors, in our view, are just new material for building out that optimized portfolio.

What looks attractive right now?

Right now, we particularly like SFR, data centers, student housing and self-storage. First, the United States is dealing with a tremendous housing shortage. Estimates differ, but our research indicates we need about 3 million new housing units immediately. Second, traditional multifamily, or apartments, enjoyed a tailwind of growth in the United States during the past decade, given the fact that the renter cohort was growing. That has slowed. There is still opportunity for traditional multifamily, but we have a strong forecast for growth coming in the "raising children" cohort for SFRs. Today, it is more affordable to rent than buy in the United States than it ever has been for the period we have data. We expect to see a continued choice to rent. We've also found SFRs capture a larger share of rent or demand in higher-income households, which makes sense because they can afford a larger space. But these households spend less on rent compared with similar income brackets and apartment communities. SFRs lack amenities like pools and fitness rooms you find in apartment complexes. We think there is an opportunity to improve existing SFR communities with the amenities, tennis courts, fitness centers and community areas you might find in a purpose-built apartment complex. On the cash flow side, historically, SFRs have delivered growth and stability that compare favorably with traditional sectors. Out of 10 niche sectors we looked at, SFR is the only one that has provided very strong growth and stability, resulting in a strong risk-adjusted growth profile. That's rare. It is a growth play, but one with low volatility in its revenue stream. Generally, we think this sector is set up for continued rent growth.

Data centers offers a similar growth profile. The sheer amount of data being created has grown exponentially, which creates demand. The AI phenomenon throws fuel on the fire. Historically, our research pointed to the data center sector as a clear growth story. Years ago, it started off being higher yielding versus the average for traditional sectors. Today, it is definitely growth

U.S. niche sectors: The opportunity

Niche sector	Complements	Secular support	Additional drivers / opportunities	Quality of revenue+			Cash flow margins+
				Yield	Growth rate	Risk-adjusted growth	Capex % of NOI
Medical office	Office	Silver tsunami	Yield level, better pricing, stable occupancy	●		●	●
Life sciences lab	Office	Silver tsunami	Medical research tsunami	●	●		
Senior living	Apartment	Silver tsunami	Very inexpensive, per Hines research	●		●	●
Student housing	Apartment	Stable cohort/ occupancy	School shake-out favors sharpshooters			●	●
Self-storage	Apartment	Secular shift to renting	Older renters likely have more stuff to store		●		●
Single-family rental	Apartment	Rise of older renters	Rise of older renters		●	●	●
Data centers	Industrial	Data tsunami/ AI	Arbitrage: Reposition industrial land to data center land		●		

● = Better than traditional sector average

Sources: Green Street Advisors, CoStar, Hines Research. As of 4Q 2023. Note: All metrics are based on revenue per square foot (SF) average annualized growth rates from 2005 to 4Q 2023. Ranges are taken for the sectors by category. Revenue per SF is calculated by multiplying occupied square feet by market rent and dividing that figure by total square feet inventory. A green bar indicates that the sector delivers performance on either yield level, growth rates, risk-adjusted growth rates and capex as percentage of NOI relative to the average for the traditional sectors by data source, i.e. comparing Green St niche sectors only to Green St data for traditional sectors. The traditional sectors include apartment, industrial, office and retail. The niche sectors include (CoStar) medical office, life sciences, data centers, (Green Street) self-storage, senior living, student housing and single-family rental.

oriented. Buying well-located assets near hard-core users of data, such as government tech firms, makes sense. So does development, if you can find the land. We are considering repositioning industrial land to data center uses.

Student housing is similar to the apartment sector in that the cohort driving college or university demand has been stable. It's not growing significantly. It can be offset by international students filling out enrollment, which is happening in the United States, Europe and Australia. Our European research team looked at about 150 universities there and found rental properties near the universities with the highest number of international students received the highest rent premiums relative to the average within the same metro. We like student housing for its cash flow, but you have to pick the right schools. It has offered solid growth with low volatility, relatively.

Self-storage is also interesting. For years, it was viewed by some as an industrial play, but we found self-storage revenues act more like apartment revenues. It's another way to play the living sector, but it's offering value at the moment. Even though there are some major U.S. REITs in the space, it's still fragmented among many smaller owners, meaning there is an opportunity to aggregate properties over time and then potentially sell portfolios for a premium. We consider this more of a growth play. Another plus is that self-storage requires very little ongoing maintenance in terms of reinvestment of capital, or capex. The reinvestment is taken from the income generated at the property level. For niche sectors, generally, the capital expenditure needed to maintain the property has been roughly two-thirds of what is needed in the traditional sectors. Self-storage historically has had the lowest capex load among the niche sectors we track.

Is it all blue skies from here for these alternative sectors? Can investors acquire these assets and just ride the wave?

Even with the compelling secular trends filling the sails for these niche sectors, investors still can't just go buy whatever's available and ride the wave. This is still real estate. You have to think carefully about the quality and location of the property. One overarching concern is these sectors are small compared with the size of the traditional sectors. As investor interest is growing,

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prices can potentially get frothy because everyone's chasing a smaller pool of institutional-quality properties. On the other hand, this is a great set-up for firms with development capability.

A near-term concern for data center investments is the electricity these properties need. U.S. power generation needs to ramp up to meet the demand, but it's been relatively flat during the past decade. In many countries, there are several-year wait times to get land connected to local electrical grids. But there are some locations where power is more plentiful. Nuclear energy, for example, is plentiful in France. As a result, we're getting active there because it's relatively easy to get your site connected to the network. Artificial intelligence is a secondary point. Conventional wisdom says investors tend to overestimate the impact of new technology in the near to mid-term, but they underestimate the impact over the long term. We may be in the overestimation phase for AI, meaning demand could initially lag what's expected.

For student housing, investors need to be very discerning about where they buy or build student housing. Our research shows online enrollment, where students enroll in a school but never leave home, is having an effect on demand in some locations. We put schools into four buckets: highly selective, selective, not selective and open enrollment. The last two have had declining enrollment since 2010. Selective and highly selective showed significantly positive enrollment in the same period. Investors can still do well in the student housing sector, but they need to be sharpshooters.

In the spring of 2024, our research team found the average size of self-storage properties included in NPI Plus was approximately \$20 million, compared with \$80 million per asset in the traditional sectors. There are opportunity costs to spending the time and money to buy these properties on a one-off or small portfolio basis. Self-storage tends to perform better when people are moving. But with higher mortgage rates right now, people are more likely to stay put. That can be a drag on overall demand. Oversupply, however, is the real problem for self-storage. Focusing on locations where supply constraints are strongest is, we believe, the key to performance.

¹The NCREIF NPI-Plus, short for NCREIF Property Index Plus, is an expanded NPI that incorporates all property types and new nontraditional subtypes. The objective of the NPI-Plus is to provide a quarterly, unleveraged composite total return for private commercial real estate properties held for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors and held in a fiduciary environment. Property types include apartment, hotel, industrial, office and retail, plus nontraditional investment properties including student housing, self-storage and senior living. The composition of the NPI-Plus can change over time. The number of properties changes as data-contributing members buy and sell properties and new data contributing members are added. Properties exit the NPI-Plus when assets are sold or otherwise leave the database. All historical data remains in the database and in the Index. The Index represents investment returns from a single class of investor. As such, the NPI-Plus may not be representative of the market as a whole.

CONTRIBUTOR AND COMPANY OVERVIEW



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