Non-Core Real Estate

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DelMarche

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Abstract

Commercial real estate has traditionally revolved around four main sectors. However, non-conventional real estate has grown its presence in the market in recent years. These non-core real estate sectors represent a unique opportunity to serve as a natural diversifier within investment portfolios. Among other advantages, non-core assets offer the potential for geographic diversification and protection during downturns given their focus on cash-on-cash. By expanding exposure beyond traditional sectors, an increased allocation to non-core assets can help plan sponsors construct a more representative real estate portfolio.

Commercial real estate has been an important (and growing) component of institutional investment portfolios for over 25 years, providing income, capital appreciation and diversification benefits to institutional investors.

Introduction

Commercial real estate investors typically allocated nearly 11% of their total portfolio(s) to the asset class in 2022 (Pension & Investments). For decades commercial real estate has been dominated by four primary sectors; retail, multi-family, office and industrial. However, in the past 15+ years new types of real estate assets have become increasingly prominent as part of the investable universe for commercial real estate including, but not limited to, senior housing, student housing, medical office and buildings devoted to life sciences. The purpose of our paper is to both explain the nature of these relatively nascent asset types, while also contrasting them to more conventional property sectors.

DeMarche has long been a proponent of understanding the importance of demographics as it relates to (early) identification of investment opportunities. This has led to our early underwriting of real estate funds that were focused on cohort-driven demographic trends like aging baby boomers (requiring both increasing senior living and life science/medical office related assets) and the increasing number of high school aged students intending to attend four-year colleges and universities, the latter of which placed enormous pressure on (often cash strapped) university systems to provide a place to live to interested students as applications and enrollments swelled.

The table below identifies some key differences between demographically driven real estate and more conventional real estate.

Table 1

	Conventional (ODCE)	Demographic (Non-ODCE)
Economic Link	Cyclical	Counter-Cyclical
Return Drivers	Price Appreciation	Income
Demand	Population Driven	Cohort Driven
Location	Typically Gateway Markets	Non-Gateway Markets
Ownership	Concentrated	Fragmented
Leases	Longer	Shorter
Vacancy	Higher	Lower

Note: ODCE is an index of open-ended diversified core equity.

Given the nascent nature of these asset types, it's worth examining the size of the investable universe for these properties, and the NCREIF Property Index (NPI) serves as a good starting point. The NCREIF Property Index (NPI) provides returns for institutional grade real estate held in a

fiduciary environment in the United States. Properties are managed by investment fiduciaries on behalf of tax-exempt pension funds. To understand the size of what we'll refer to going forward as "niche" sectors, we looked at the value of all of the properties that comprise the NCREIF Property Index (NPI) including the newer asset types (the "Plus"), which are the focus of this paper. As of Q2 2022, the total value of the NPI equaled $1,004.2 billion, of which $97.5 billion (or 9.7%) represented non-conventional asset types as reflected below.

Table 2

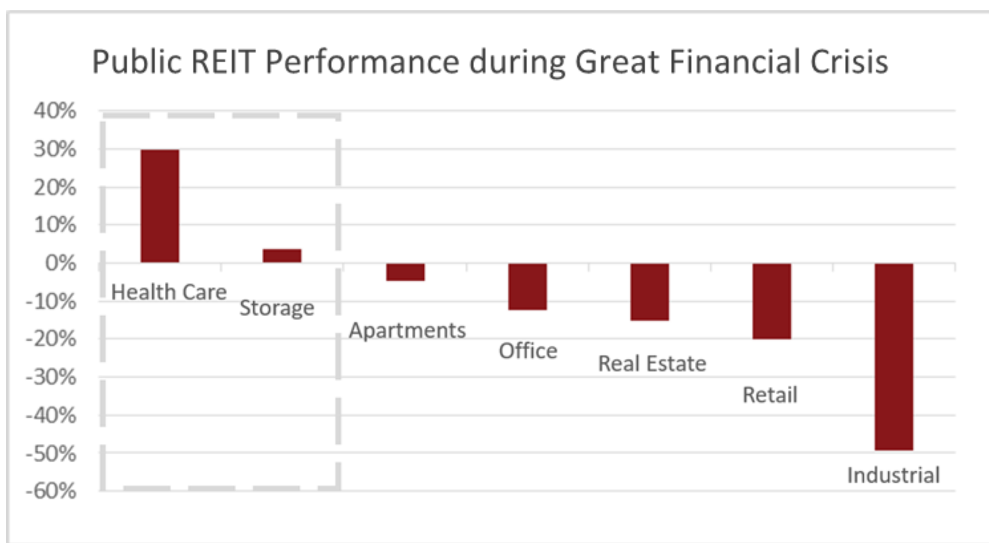
	Market Value ($ in Billions)	% of Total
Life Science	$25.5	2.5%
Medical Office	$20.3	2.0%
Data Centers	$ 3.5	0.3%
Single Family Rental	$ 3.1	0.3%
Student Housing	$11.8	1.2%
Self-Storage	$22.2	2.2%
Senior Housing	$11.1	1.1%
Total Niche	$97.5	9.7%
Total NPI	$1,004.2	100.0%

Source: NCREIF, 2022 Q4

Economic Link

While conventional real estate has always been exposed to the cyclical nature of the economy (recovery; expansion; hyper-supply; and recession), the asset class has been undergoing a sea change of late, with many trends related to how we work, where we live and how we shop pushed forward, some dramatically, by the pandemic. Whether those trends are indeed long-term remains up for debate. However, these changes have led to dramatic decreases in the value of specific asset types, as well as broader sectors. As an example, retail malls have experienced a 44% drop in value on average since 2016. In addition, the office sector is currently under significant pressure, with values of office assets in so-called gateway markets declining by 25% since 2022 (CoStar). Non-traditional real estate is often counter cyclical and feature demographic demand drivers that are not overtly influenced by the economy. An obvious case concerns the need for Senior Housing as we all age. That is a predictable cohort. In addition, consider student housing as an example. Not only is the cohort predictable in terms of size, but historically as the economy contracts, more students head back to the classroom.

Chart 1



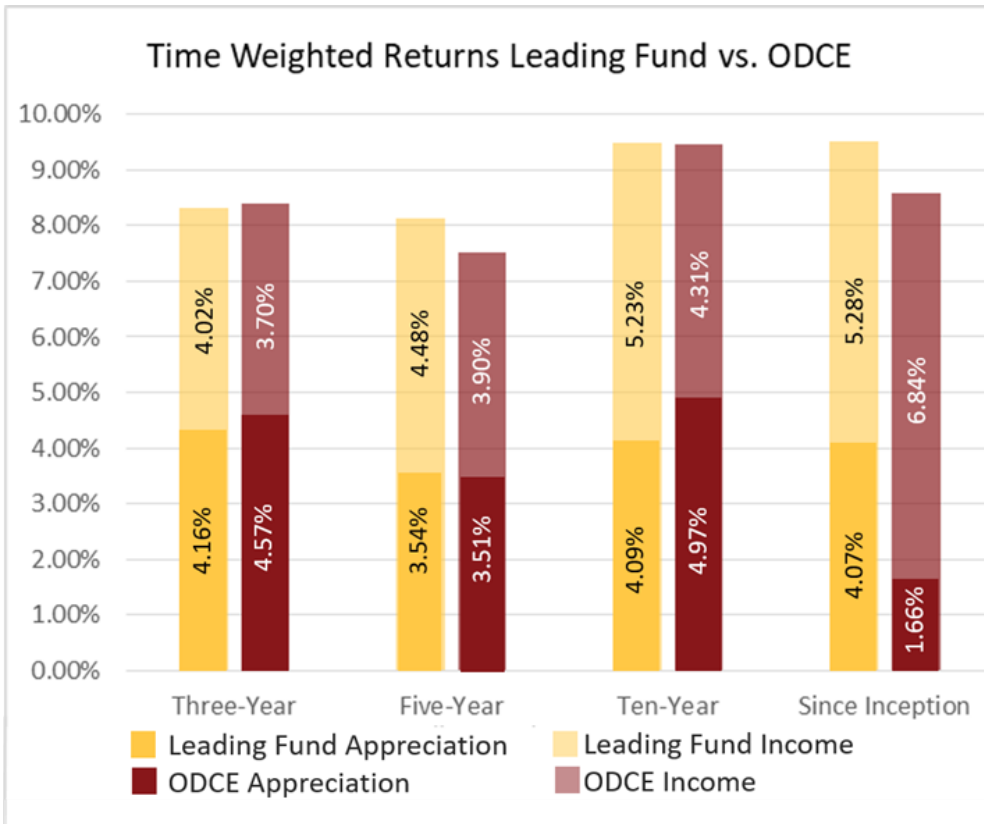
Total Return (not annualized) of FTSE NAREIT Equity Indices from 1/1/2007 through 12/31/2009; sourced from Morningstar.

Return Drivers

The return profiles of commercial real estate share the same basic return drivers, capital appreciation and income. However, non-traditional asset types are more defensive and typically reflect a Beta of .34 (Harrison Street) compared to traditional ODCE sectors. The Chart 1 to the left supports the argument that non-traditional asset types hold up better when the economy is contracting, while also indicating that a higher amount of the total return for non-

traditional asset types is returned to the investor as income. Moreover, this is not a new phenomenon as evidenced by longer-term results.

Chart 2



Source: Harrison Street and Morningstar

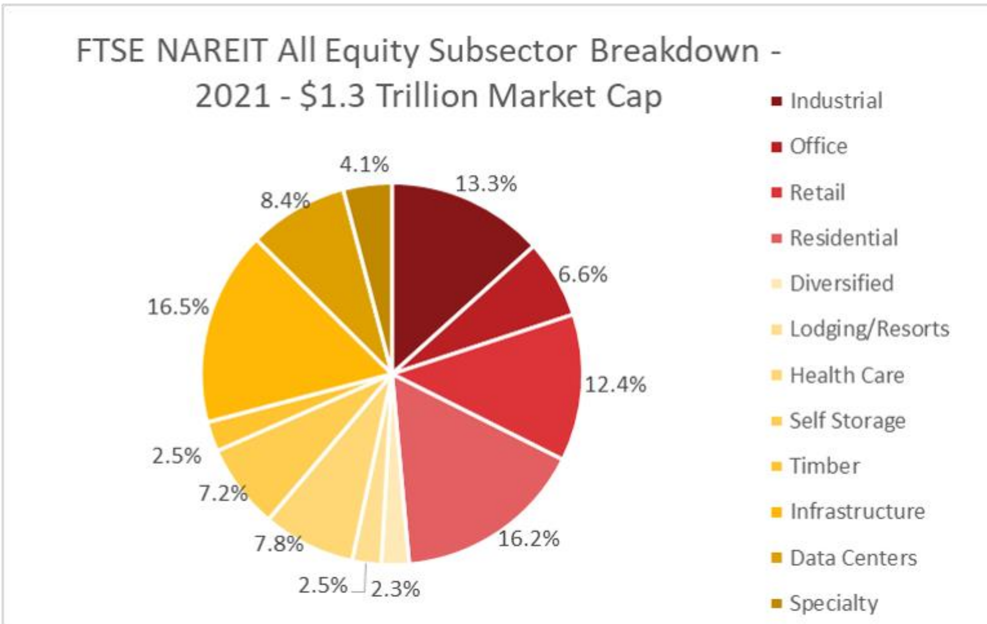
Demand

While all commercial real estate is ultimately demand driven, non-traditional asset types are often considered "needs based" and driven by cohort groups (baby boomers for example) versus larger population trends. In fact, the baby boomer cohort presently drives demand for at least three sub-sectors including medical office, life sciences and of course senior housing. **Location:** Commercial real estate assets that comprise ODCE have traditionally been typically found in so-called "Gateway" markets including San Francisco, New York, Los Angeles, Seattle, Chicago, Washington, Houston and Miami. The conventional thinking was that commercial real estate assets in these locales were the most stable and safe for investors based on population, economic health, economic diversity and desirability for inhabitants. However, times change with several of the aforementioned cities (notably San Francisco as of this writing) experiencing dramatic valuation declines as larger cities undergo dramatic changes related to hybrid work options associated with technology-related industries, as well as general livability. As evidence, consider the Union Bank building which is rumored to be transacting at 20% of its original (2020) asking price of $300 million. Conversely, the footprint of non-traditional asset types is much broader and constitutes over 80 MSA's and over 250 cities (often including Gateway cities), thus providing institutional investors with both asset type and geographic diversification (Harrison Street).

Ownership

The next notable distinction between traditional "core" and "non-core" real estate assets include the concentrated ownership that is typically associated with traditional real estate sectors, whereas non-core is generally more fragmented through a myriad of owners. This is made possible due to the increasing amount of sectors and geographic locations in the non-core asset types. These assets have the capability to attract more diverse investors, including individual owners and smaller investment groups, adding to the assorted ownership of non-core real estate. Over the last decade non-core assets have grown to be a large component of the REITs universe and have recently begun to take on greater ownership of the market. In 2000, out of the $139 billion that was in the US REIT market, the non-traditional sectors only made up about 26% of the market, but flash forward to 2021, 51% of the market is represented by non-traditional sectors (Trading Alpha). The growth in the asset class signifies its rising prominence and increasing representation within REITs.

Chart 3



Leases

Lease lengths are another differentiator between the non-core asset types and traditional real estate in that the lease lengths for non-ODCE assets tend to be shorter allowing for frequent tenant repricing. The shorter lease length is especially a consideration in the student housing sector due to their shortened time horizon for housing. These shorter lease lengths permit for higher turnover in lease renewals allowing for pricing elasticity and rapid price adjustment. Shorter leases allow for the landlord to adjust rental rates to reflect market conditions, volatility, and changes in demand. On the other hand, core real estate assets will typically follow a consistent pricing approach, reflecting inflation expectations, and while the non-core assets arguably benefit from income certainty, longer leases allow less room to adjust for changing market dynamics. For example, the average office building lease typically ranges between 5 to 10 years but in contrast student housing leases will range an academic year, typically 9 to 12 months. So, these shortened leases allow for owners to raise prices and provide additional income for investors due to their pricing flexibility and enhanced ability to adjust prices based on the economic environment, and they act as an inflation hedge.

Vacancy

Non-core asset types tend to suffer less from lower vacancy rates due to the nature of the real estate and higher turnover. For example, Medical Office buildings are less prone to vacancy due to the strong demand in healthcare services and minimal supply of specialized medical features. Life Science buildings enjoy similar effects, while core asset types will have vacancies that fluctuate based on job growth, population trends, and affordability. Furthermore, medical offices and life science buildings hold high switching costs of moving locations, leading to high predictability in lease renewal due to their strategically placed locations (proximity to hospitals and other medical facilities). Another benefit to non-core asset types is the exclusion of tenant improvement (TI) related costs, while real estate associated with traditional core sectors require periodic upgrades and maintenance to attract and retain tenants. According to Maxx Builders, tenant improvement costs for apartments are generally expected to cost from $50 to $200 per square foot, while medical offices and life science buildings' TI costs are a fraction of that price due to the specialized capabilities already in place offering additional resilience to a portfolio.

Conclusion

Non-core real estate assets fit into an institutional portfolio by acting as a natural diversifier in addition to offering potential risk reduction. As discussed, non-core asset types act more defensively than their ODCE counterparts contributing to the asset class maintaining less risk. Leading funds hold significantly less risk as the beta of the leading fund is only .34 compared to ODCE. In addition to maintaining significantly less risk (as measured by standard deviation) than traditional real estate, portfolios will benefit from the diversification among location as returns are not tied to large cities and diversification in monetary returns, as non-core asset uniquely provide investors with income-generating return. By incorporating non-core assets into their real estate

allocations, plan sponsors can achieve a more balanced risk profile and reduce exposure to macroeconomic fluctuations while providing stable and predictable returns over the course of a market cycle.

Sources Utilized:

- *Pension & Investments*
- *Trading Alpha*
- *Maxx Builders*
- *NAREIT*
- *CoStar*
- *Harrison Street*
- *Morningstar*

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