By Sheila Hopkins

REAL ESTATE FORECAST

Debt, student housing and single-family rental properties are all in season for the new year.

Real estate is a cyclical investment class, and after eight years of economic growth — in fact, the United States is currently in its third-longest expansion since World War II — the current upward trend of the cycle is feeling a little long in the tooth. While no one can point to a specific event that will cause it to turn downward, it just feels like it is time for the cycle to start cycling. So how can private investors prepare for a change in the investment climate? One way is to look at what institutional investors are doing.

Following the lead of professional investment managers means looking at the four main sectors — office, retail, multifamily and industrial — and homing in on alternative subsectors that are responding to changing economics and demographics. Institutional investors, for example, are focusing on real estate debt investments instead of equity. Debt is considered more defensive than equity, and they feel this is the time to be defensive.

Multifamily has been a favorite investment for years, but is now becoming overvalued and

oversupplied in some areas. Consequently, institutional investors are looking at variations on the typical multifamily complex, such as student housing, affordable or workforce housing, and single-family for-rent housing. Instead of large logistics facilities, smaller last-mile distribution centers are looking attractive. And instead of central business district office buildings, professional investors are turning their attention to infill office and data centers.

As luck would have it, these niche sectors also happen to be very accessible to private investors.

TAKING A DEFENSIVE STANCE

Investors are finding themselves caught between two competing and equally valid goals. They need to preserve wealth in the face of uncertain economic times when risk is looking risky. Yet they need to grow their wealth in an era of historically low fixed-income interest rates, when taking on more risk is the only way to improve returns. One way to meet both goals is to invest in real estate debt. The advantage of real estate debt is that it sits higher on the capital stack, shielding it from falling valuations. In fact, senior debt investors take the least risk, as they are the first to be repaid when the property is sold.

"In spite of the challenging real estate market conditions — and it is a challenging time to invest — there are still a lot of attractive opportunities, and we think that the best opportunities are debt, where you are moving up the capital stack and in a more defensive position," says Chris Kelly, managing director and head of commercial real estate lending at Amherst Capital Management.

In addition to safety, debt funds provide notably higher returns than typical fixed-income investments. For example, the Fidelity Series Real Estate Income Fund, which invests heavily in real estate–backed mortgages and other real estate debt, returned 5.68 percent over the past year, 6.82 percent over the past three years, and 7.13 percent over the past five years. While we all know that past performance is no guarantee of future returns, this track record compares pretty favorably with the 2 percent return investors are getting on government bonds.

HARNESSING BYTES AND BITS

The explosion of online shopping and digital communications drives two of next year's hottest sectors — last-mile distribution facilities and data centers.

"Industrial/distribution and data center development, infill office in certain metros, as well as multifamily, all seem really strong based on the activity we're seeing," says Holly Neber, CEO of AEI Consultants. "The tech influence and the changing needs of consumers are driving much of this. We love working on infill development sites, and we're working on lots of urban core redevelopment projects, including smaller warehouse distribution closer to population centers."

U.S. online sales have been growing by double-digit numbers for several years, and there is no reason to believe they will slow any time soon. According to Forrester Research, online sales rose 14 percent in 2017, accounting for about $460 billion. This comes out to 12.9 percent of the total retail sales for the year. By 2022, online purchases are expected to reach 17 percent of all retail sales.

It is easy to make sales online, but retailers still need to find a way to deliver the goods — and they need to deliver them quickly. Americans are an impatient group who want to order their cake and eat it, today. Retailers are solving this problem by purchasing and/or developing multiple smaller distribution facilities near population centers rather than relying on huge regional warehouses in the middle of nowhere.

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"Online retailers are expanding their distribution hubs and growing into space that provides that last mile to the customer," says Kelly. "We're seeing meaningful demand for those kind of properties, and I expect that to continue in the near term."

In addition to distribution centers, retailers are setting up fulfillment centers for customers wanting same-day service. According to Amazon, there are more than 60 Amazon Prime Now hubs in high-density urban areas. These warehouses are typically 50,000 square feet to 60,000 square feet and allow customers to order online and receive their purchases in the same day. Where Amazon goes, others are sure to follow, making these smaller hubs a growth opportunity.

The explosion in digital interaction, whether for retail or communications, has spawned a growth in data centers, which are the heart of "the cloud."

"The data center sector continues to grow rapidly to keep up with seemingly insatiable demand from all segments of society and business to store, analyze and stream data," says Darob Malek-Madani, head of research & analysis at National Real Estate Advisors. "Satisfying this demand are credit tenants committed to long-term leases. This combination creates an attractive investment that exposes investors to both tech sector growth and real estate fundamentals."

There are currently six publicly traded data center REITs. This is a relatively new sector, so historical data is short-term in real estate years, but as a group, they have outperformed the S&P 500 for the 3-, 5- and 10-year time periods. A few underperformed the S&P during 2016, but others outperformed for that one-year time period, as well. They all outperformed the NCREIF Property Index and FTSE Nareit All Equity REITs Index for all time periods.

"Investors should view an entity-level data center company investment as a core-plus investment containing a stable core of leased space and significant growth potential," says Malek-Madani. "Therefore, such an investment can offer higher return potential than a strictly core investment."

EVERYONE NEEDS A HOME

The multifamily sector has had quite a run since the crash, when large numbers of families and recent graduates found themselves unable to buy a house and turned to rental housing. Competition and a lack of supply have driven values high — some would say too high — and developers have been working overtime to meet the demand. Now, the sector is beginning to feel overvalued and oversupplied. But all is not lost. For those who like to invest in housing because everyone needs a roof over their head, there are subsectors that are providing very good risk-adjusted returns and are very accessible for the private investor.

Student housing is on everyone's radar. Students no longer want to share a single room with a set of bunk beds and a communal shower down the hall. Today's student housing is modeled on typical apartments with separate bedrooms, private baths and a shared living/kitchen space. These buildings usually have the same amenities found in upscale apartment complexes — laundry facilities, gymnasiums, meeting rooms, and outdoor grills and recreational areas. These assets have become popular among institutional investors, who say they are getting 0.5 percent to 0.75 percent higher returns than on a typical multifamily investment. With demand looking to outstrip supply for the foreseeable future, investors expect these assets to be able to weather whatever the economy throws at them over the next few years.

"We are most bullish about the student housing industry, in both the near-term and long-term," confirms John David Booty, executive vice president at Ventus Group. "Student living has joined the list of institutional real estate asset classes, attracting investment through REITs, private wealth funds and merchant developers."

Two public REITs — EdR and American Campus Communities (ACC) — and several private equity funds enable private investors to take part in the opportunity. EdR's dividend yield currently stands at 4.2 percent while investors in ACC are looking at 4.1 percent, according to Morningstar.

Another subsector getting attention is the single-family rental niche.

"With the advent of institutional ownership of single-family rental properties, this segment appears to be well positioned to capture some of the demand from traditional apartment renters," says Kelly.

This subsector is just beginning to take off. Firms managing single-family rentals view them as the equivalent of individual apartments

— just spread out. It is akin to NNN investments, where instead of owning one building with multiple tenants, the investor owns several buildings, each with one tenant.

Boosted by the thousands of foreclosed and abandoned homes that hit the market in the wake of the financial crisis, the number of homes in institutional portfolios has grown to more than 100,000. Average rents for single-family rental homes have grown just as quickly. Some investors wonder if this growth can continue, but demand remains strong. Many families prefer the space and neighborhood characteristics that come with a single-family home, yet through choice or need, decide to rent rather than buy.

According to Nareit, the single-family rental sector has a YTD total return of 13.79 percent at the end of September 2017. In addition, the top-performing equity REIT property segments on a same store NOI basis in the second quarter of 2017 were single-family homes (6.8 percent) and data centers (5.8 percent), significantly higher than the overall same store NOI of 3.3 percent.

There are five REITs focused on this sector: Altisource Residential, American Homes 4 Rent, Colony Starwood, Invitation Homes and Reven Housing. Invitation Homes is the newest entry, having its IPO on Jan. 31, 2017. The Blackstone-backed REIT, which has about 50,000 rental homes nationwide, raised more than $1.5 billion, making it the largest listed company in the sector.

One final alternative multifamily subsector to look at is affordable or workforce housing. These apartment complexes are built using tax credits to reduce the cost of financing. In return, the developers set aside a certain percentage of apartments to rent at below-market rates to workers making less than the median income for the area. While the general multifamily sector is beginning to feel oversupplied, there is a definite lack of supply — and a definite demand — in the affordable category.

"There has been very little supply delivered for the biggest group of renters in the United States — those making under $50,000," says John Williams, president and CIO at Avanath Capital Partners. "Most new apartments have been aimed at the luxury space and require double that income to qualify."

Investors are waking up to this opportunity, which provides stable income returns along with good growth prospects. Average wages in the United States have remained stubbornly stagnant, making apartments focused on lower-income renters particularly attractive. These apartments tend to have lower turnover rates than standard multifamily units because the tenants simply cannot afford to move as often, and they have higher occupancy rates because demand is so strong.

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"There is a stickiness to the renters that investors like because it gives this investment long-term stability," says Williams. "In addition, a lot of investors are moving toward impact investing, and providing housing in high-rent cities for middle-class workers is a win all around."

ALTERNATIVES BECOME MAINSTREAM

Next year looks to be the year of the alternative as mainstream investments begin to slow or even retreat. For those looking to diversify their portfolios by adding a few nontraditional investments, international REITs might be attractive. International REITs have outperformed U.S. REITs this year — as have foreign equities — although they tend to be more volatile. This risk, however, can be mitigated.

"As quantitative, multifactor investors, we are very much focused on risk management," says Gregg Fisher, founder of Gerstein Fisher. "So, for example, in REITs we hold a globally diversified portfolio that doesn't vary dramatically in country or sector weights from the index, but we tilt toward risks that we believe will benefit investors over the long term [such as momentum and valuation] and away from risks [like leverage] that we think are not worth taking."

The best opportunities next year appear to be out of the mainstream, such as foreign REITs, or driven by demographic trends, such as e-commerce, demand for affordable rental housing and an aging population looking for more security in their investments. But as always, no one sector or one investment is the perfect solution for everyone, or even anyone.

"We think about total portfolios in a holistic way," says Fisher. "We advise against chasing performance in asset classes or sectors, which we believe is a poor strategy. Instead, investors should ensure that they have an appropriately diversified portfolio."

Sounds like good advice for all economic environments — not just next year. ■

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