Investors Fueling Growth in Alternative Property Sectors

By Beth Mattson-Teig
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Commercial real estate investors are hitting refresh on stodgy investment strategies and sending more capital flowing into alternative property sectors.

ULI's *2024 Emerging Trends* report highlights the "portfolio pivot" underway, with shifts in both property and financial markets that are upending long-established norms of how commercial real estate portfolios should be constructed. Portfolio managers that were once laser-focused on traditional property sectors are expanding strategies to include bigger allocations beyond the typical mix of office, retail, industrial, and multifamily assets.

"Every time you listen to an institutional investor share their best ideas for sector strategy, all you hear is data centers, student housing, self-storage, life sciences," says Michael Gordon, a partner and global chief investment officer at Harrison Street. "All of these asset classes have tremendous secular demand drivers and the potential to deliver outside NOI growth, which is paramount in a market with depressed multiples."

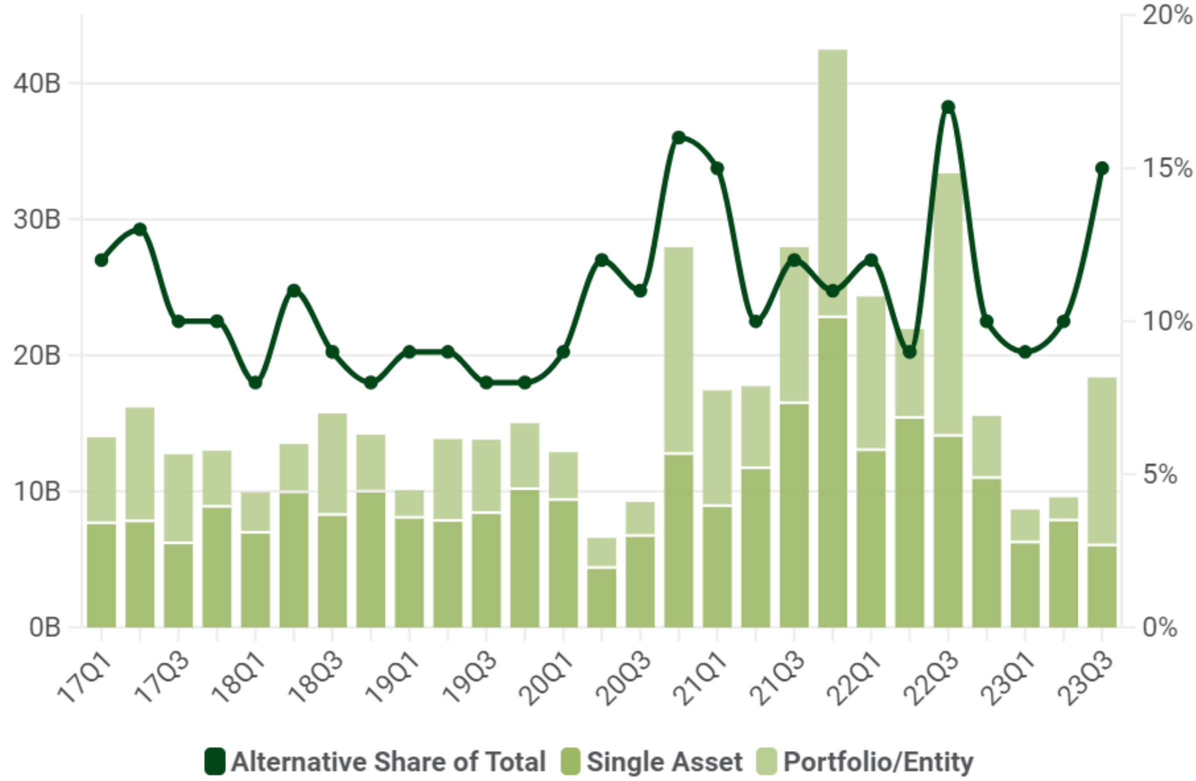
Belmont Village Senior Living in La Jolla, California.

Harrison Street has been investing in alternative property sectors since 2005, focusing primarily on life sciences, medical office, health care, student housing, self-storage, and data centers. "Frankly, when we expanded our strategies into core investments over a dozen years ago, our peers were really dubious, claiming that these sectors didn't possess a core profile and that the strategy wouldn't work," says Gordon. "At that point, we had several years of exclusive experience in alternative real estate investing and the data that really proved otherwise, and that lack of competition gave us a great jump-start."

Industry data reinforces the argument that investors can generate alpha from exposure to alternative sectors for core commercial real estate. According to Harrison Street's analysis of NCREIF data from Q4 2011 through Q1 2023, alternative sectors have undergone a 14.4 percent average annualized total return compared to average returns of 8.3 percent for traditional sector assets.

MSCI Alternative Transaction Volume

As of 12/20/23



Source: MSCI

Search for yield

Alternatives are by no means new to the commercial real estate investment universe. Property types that used to be considered niche sectors have been a major part of the mainstream conversation for the past several years. “It’s clear that alternatives started gaining traction in the mid-2010s, and what we saw was a very big uptick following the pandemic,” says Darin Mellott, vice president of capital markets research at global brokerage firm CBRE.

A big driver behind that shift is investors reaching for yield. Additionally, broader market forces are influencing the expansion into alternative sectors, including the maturing and growth within those sectors, and data and transparency into how those sectors are performing.

“Alternatives have to be part of the conversation,” says Mellott, “just because folks want to expand the pool of investment opportunities. They would be foolish not to be looking at some of these areas, particularly where we’ve seen pretty decent growth and very strong fundamentals over the last several years.”

Industry data on alternative investment sales volume can be difficult to pinpoint, depending on what is or isn’t included in the data set. For example, some firms include such specialties as medical office and cold storage as part of office and industrial sales, respectively.

Data from CBRE shows that annual sales activity for alternative sectors has fluctuated between 11 percent and 17 percent of total commercial real estate transaction volumes over the past decade. Despite increasing attention and a choppy transaction market, alternatives have maintained a relatively stable share of total investment volumes.

In the first three quarters of 2023, alternatives accounted for about 17 percent of all transaction volume in the U.S., with approximately $43.4 billion in sales, according to CBRE. MSCI Real Assets data shows a lower volume for alternatives, with a 12 percent share of total transaction volume for 2023 year sales through Q3 at $36.7 billion.

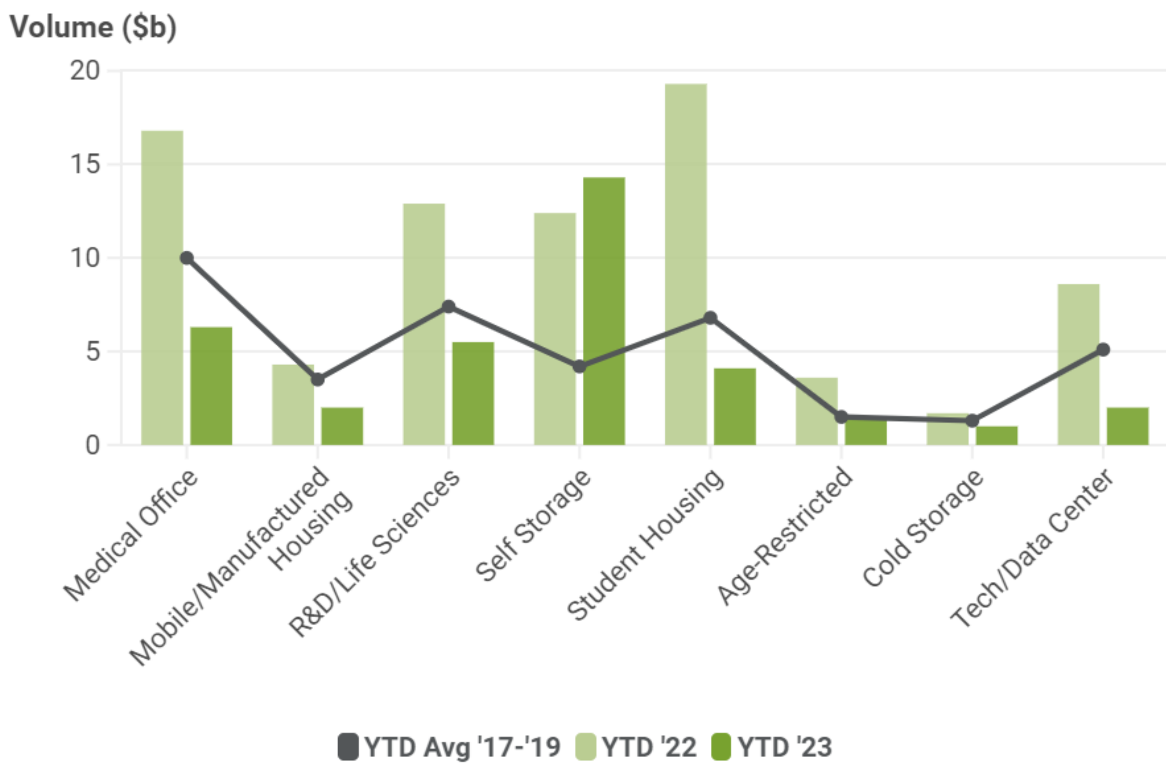
REITs pave the way

Public real estate investment trusts (REITs) have led the charge into nontraditional sectors and helped bring alternatives into the mainstream of commercial real estate investing. According to the National Association of Real Estate Investment Trusts, 55 percent of the market cap in Nareit's All Equity REITs Index is held in assets other than office, industrial, retail, and residential. Office, in particular, has become a small portion of the REIT universe, at roughly 5 percent. In comparison, institutional investors are underinvested, with alternatives representing less than 10 percent of assets held by NCREIF-ODCE Index funds (as of Q3 2023).

Anecdotally, Harrison Street is hearing from investment managers that they're interested in raising allocations to alternatives to represent 25 percent or even 50 percent of real estate portfolios. "Even increasing allocations to 20 percent would represent doubling of historic exposure to these asset classes," says Gordon, "and that increase of capital and liquidity is likely to provide an interesting shock to valuation and the overall institutional profile of these sectors, which is a great thing in our opinion."

MSCI Alternative Sector Sales Volume

As of 12/20/23



Source: MSCI

Urban Land Institute

Evolving commercial real estate marketplace

The push into commercial real estate alternatives is fueled by something more than an appetite for higher returns. According to Tim Bodner, a partner in PwC's real estate practice and a member of PWC's U.S. and global real estate leadership team, "When you take a step back and look at what's really driving trends across the global economy—technology, the energy transition, an acute shortage of housing—these are broad [macrotrends] that are going to be driving the global economy for the foreseeable future. The outcome [is that] you have higher returns, but it's more the trends that are driving this shift, versus just a search for alpha."

One sector that is attracting a lot of capital is data centers and digital infrastructure. For example, Blackstone announced a $7 billion data center development joint venture with data center REIT Digital Realty in December. As part of that partnership, Digital Realty will develop four "hyperscale" data center campuses—in Frankfurt, Paris, and Northern Virginia—over the course of the next several years.

Data centers are top of mind because they tie into the broader story that people are living in their daily lives and the tremendous advancements in technology, notes Mellott. However, in the investment universe of alternatives, data centers are a small portion of total volumes. According to MSCI Real Assets, tech/data center properties accounted for $2 billion in sales in 2023, through third quarter—roughly 1 percent of total commercial real estate sales volume. Self-storage represented the largest share, with $14.3 billion in sales that accounted for 5 percent of total market volume.

The "other" bucket of real estate is a lot more interesting to investors these days, thanks in part to the changing nature of real estate that was amplified during the pandemic. COVID spurred new investment that has benefited such sectors as data centers, life sciences, and cold storage. Traditionally, those alternative sectors have been relatively small, with less opportunity for interested investors. COVID helped to flip that dynamic, and now there is a boom in many niche sectors. As investors look for places to put more dollars to work, it is those "other" sectors that have the secular tailwinds behind them, and investors want exposure to that growth.

Property types such as senior housing, student housing, self-storage, and single-family residential have become highly institutionalized, which raises the question—what qualifies as "alternative" these days?

"What we're getting to is kind of a blurring of the line between real estate and infrastructure, where real estate investing is going to become much broader in its scope," says Bodner. Another sector to watch for more activity is the one around energy transition. "I think that's an area where we haven't even really scratched the surface yet, and our perspective is that we'll certainly see more activity."

Growing momentum ahead

Looking ahead in 2024, all types of real estate are being affected by the same macroeconomic story—higher interest rates and a repricing of assets that have slowed transaction activity. However, the U.S. economy appears to be headed toward a soft landing, with strong optimism for interest rate cuts in the coming months that should create traction for more investment activity.

"I think there will continue to be some very interesting opportunities that pop up," says Mellott. "We sometimes forget that real estate is really a reflection of the broader economy, consumer preferences, and the evolution and change in the way that we do business and shop and live our lives. So, these alternatives are going to reflect a lot of those changes, and that's where a lot of the opportunities in the future are going to be."

Another notable trend is that as alternatives have become more popular, different types of buyers have become more active. It's clear that the buyer pool has broadened, and alternatives are undergoing more inflows from both institutional capital and private buyers, and that is likely to continue, Mellott says.

"That's still a small number when you consider what the need is," Bodner says. "One of the things that we need to be thinking about is how real estate investors broaden their investment strategies to encompass some of these megatrends that are just starting."