In Today's Student Housing Market, Doing Your Homework Pays Off

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Student housing is no longer the undiscovered niche asset class with just a handful of quality institutional players. Over the course of 2017, over $7.1 billion of transactions took place in the student housing sector. While 2017 fell short of the $10 billion record year that 2016 was, just five years ago that figure was $2 billion (chart one). And that's mixed news for investors. More capital means more liquidity and a deeper pool of potential buyers. It also means higher valuations, and in the last several years, an abundance of new supply to many markets.

The flood of capital included a number of newcomers as well. More than one third of last year's capital investments came from investors who were new to the student housing space. While most new capital sources have aligned themselves with experienced student housing managers, many don't fully appreciate the nuances of the industry and how that translates to forecasting future cash flows at the property level. That's also mixed news. On the one hand, it creates turnaround opportunities – at least for investors who are knowledgeable and experienced, and who do the required due diligence. On the other hand, it suggests that many student housing markets are in a distressed state. Indeed, 2017 was the year in which supply growth resulted in softer leasing across the entire sector, with significant drops in same-store revenue at properties in some of the more popular low barrier to entry markets.

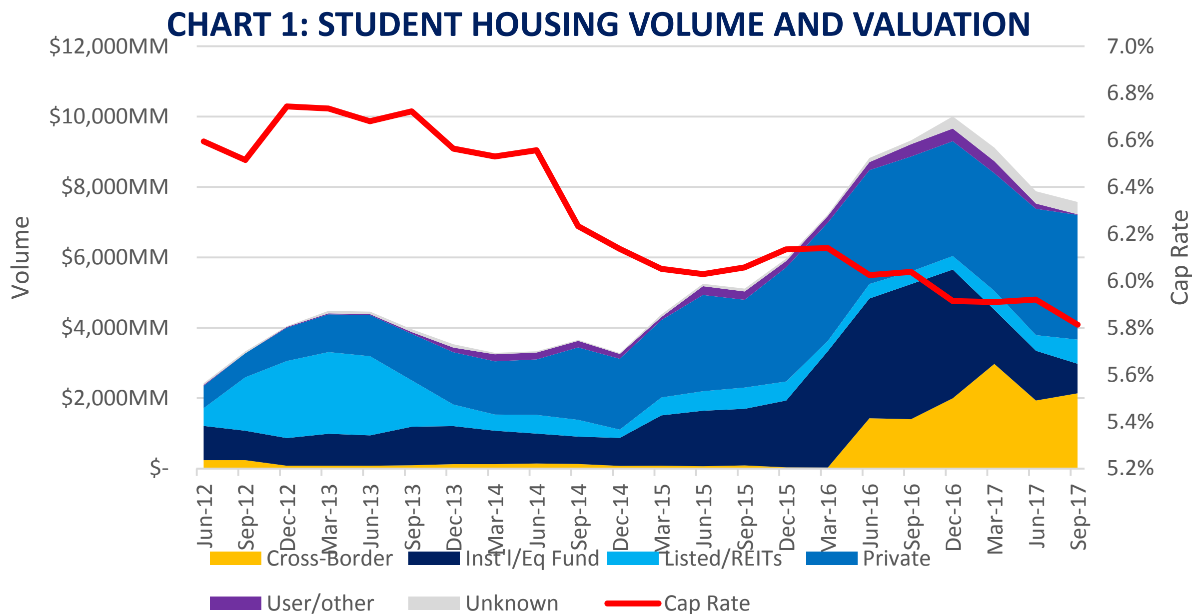


__Chart 1__: Since 2012, both deal volume and valuations have significantly increased. As new players have moved in, cap rates have steadily declined, making attractive deals difficult to source.

Source: Real Capital Analytics

Of course, newcomers have justifiably been attracted by strong tailwinds assisting this market, including:

- **Healthy demographic trends.** Demand for housing has been boosted by the tail-end of the large Millennial generation, a higher percentage of high school graduates attending college, and an influx of foreign students. Demand is expected to peak in 2023.
- **Persistent demand for higher education.** Knowing that college graduates earn more – an average of $24,000 more per year than non-grads – continues to stimulate demand for bachelor's degrees.
- **Universities choosing to outsource housing to the private sector.** Many universities are spending their capital improvement dollars on class rooms, making room for the private sector to supply housing to their students.
- **Modernization of obsolete housing.** A need to modernize student housing has helped drive new supply over the last five years, which until recently has been absorbed.

But there are also a number of headwinds. We see a couple of trends that generally will harm the historically strong fundamentals in the not-too-distant future. The impacts, however, will differ widely, depending on the nature of the particular student housing market:

- **Supply increases and high Valuations**. These are undoubtedly the risks taking center stage in the current cycle. Student housing is no longer a niche industry for a few people in the know, and it has experienced growing pains. In addition to the raw quantity of supply, new supply is too uniformly concentrated at the top of the addressable market due to increases in construction costs. In the very worst cases, this results in over-amenitized projects (think zero edge swimming pools and other frills), which fail to meet target rents. This requires slashing rates to stay full, passing the occupancy risks downstream.

- **Student indebtedness and greater focus on educational ROI.** This is a longer horizon issue, but one that may lead many students and their parents to question the value of a traditional college education. With many recent graduates strapped with large student debts, many have reevaluated the return on a college investment, increasingly opting for online courses or vocational programs targeting specific skills. Because of this, many schools are likely to reallocate resources to a smaller range of "employable" majors to ensure successful enrollment. This is good news for the ROI of a college education, but could have an impact on physical enrollment. This risk is chiefly borne by low quality schools and for-profit colleges, but even a small decrease in physical enrollment can have an impact on real estate values.

- **Barriers to Foreign Enrollment.** Some of the fastest enrollment growth rates have come from international students drawn to the quality of education and networking that American universities offer. The current administration has made it more difficult for foreign students to study—and especially to work after graduation. This will pose multiple challenges for universities, especially those that have put major investment into attracting foreign enrollment. While the highest growth public flagships may not notice the absence in total enrollment figures, they will have difficulty staffing their STEM majors with high quality graduate teaching assistants and research aids, which ultimately impacts the overall quality of their programs.

THE CURRENT MARKET

It is clear that there are risks ahead in the sector. But not all college and university housing markets are equally vulnerable. At one end of the spectrum are the large, flagship state universities with enrollments in the tens of thousands. At Virtus, we view the large flagship schools as relatively immune to negative trends around enrollment. These institutions continue to attract large numbers of students who not only want the traditional college experience (and often the Division I sports team), but also the broad array of professional and technical curricula these schools offer. Their *relative* affordability offers a positive ROI even without accounting for the very real value of the social connections and other experiential factors they give. And indeed, half of students at public universities graduate with no debt or only negligible debt.

Unfortunately, the appeal of these markets is widely understood within the student housing real estate sector and have been hot magnets for development and acquisition, with deal figures soaring even as new properties come online in greater numbers. The risk of new supply is often substantial, because these flagship universities are often located in smaller college towns that do not typically have any significant barriers to entry. In short, attractive deals are scarce, supply is often abundant, and properties are overvalued for the inherent risk of the investment.

On the opposite end of the spectrum, you have smaller private liberal arts schools and low value public schools. Some of these schools look great on paper for their real estate fundamentals, with constrained housing options and lower rates of supply growth. The trouble is we view these markets as ripe for disruption due to their high tuition costs and a lack of STEM-oriented and job-placement resources, which are becoming increasingly central in a world of high student debt. Enrollment declines are a real possibility in these schools, which can be fatal to an investment. If a small college faces even a 5% enrollment decline, it can equate to an effective 16% drop in the addressable private market. Finally, such markets are usually much smaller and less liquid in the eye of the investment community. Therefore, small liberal arts colleges are not where investors want to ride out the growth until the party quiets down a bit.

FINDING AN ATTRACTIVE MIDDLE GROUND

How, then, does Virtus navigate the current moment in student housing? Becoming a net seller of assets is a good option, for one, but it is still possible to find good acquisition opportunities if you have experience in the sector and the discipline to use it.

Consider Texas A&M and Virginia Tech as a case study, two markets which at first glance appear similar from a quality of education and positive enrollment growth story. Virtus operated in the latter (successfully selling in 2017) but we intentionally avoided the former. Both schools have seen strong enrollment numbers, but at Texas A&M the number of new beds grew significantly faster than at Virginia Tech.

Chart 2 shows the oversaturation of beds at Texas A&M. The bed-to-enrollment ratio is a widely used benchmark for supply equilibrium. Total beds are all dorms and private student housing, divided by total enrollment. The higher it is, the less of a safety net the market has in absorbing new supply. Keep in mind, these figures do not account for beds in the shadow market (i.e. unofficial student housing), hence why these figures can be so far below 100% and still be at an equilibrium.

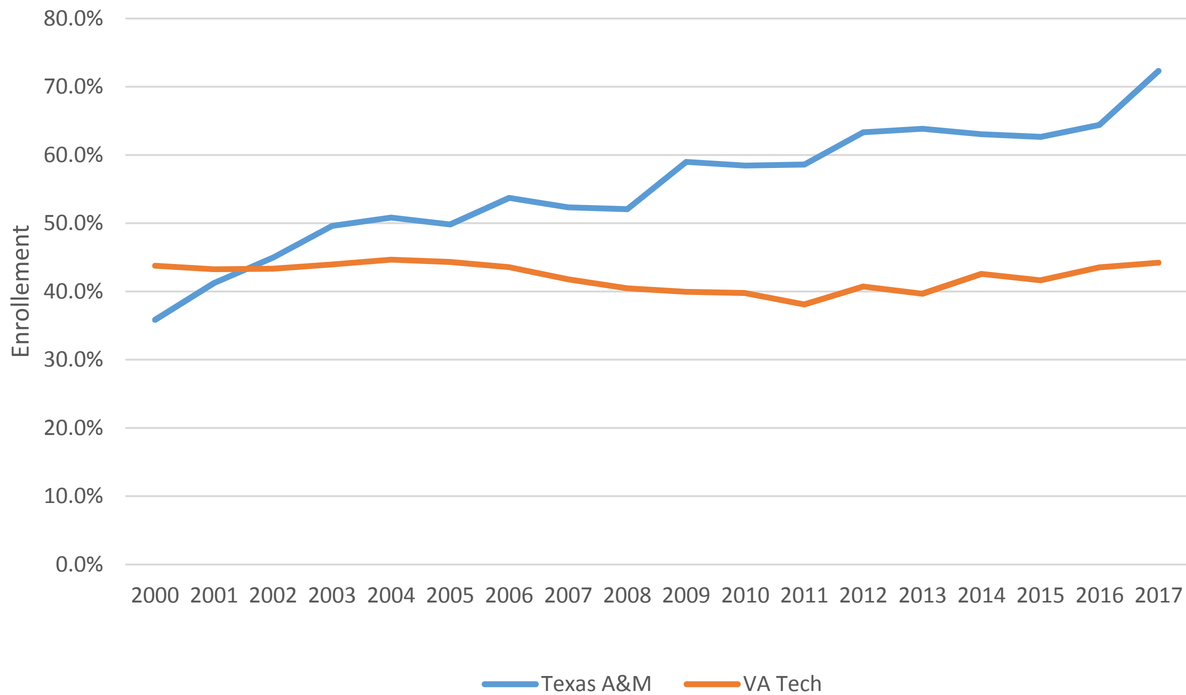
Virtus Real Estate Capital Student Housing Activity
as of December 31, 2017

15
Properties Acquired (2011-2016)

$468.3 MM
Total Acquisition Value

Virginia Tech has retained a consistently low ratio, in part due to the surrounding municipality's distaste for new developments. This means the new projects that *do* happen are more likely to take market share away from conventional

housing in the shadow market, rather than the new purpose-built student housing property for which you just paid an auction-winning price. At Texas A&M, the opposite is true. When new supply comes online, such as the 13,300 new beds added over the past four years, it has had a trickle-down effect throughout the market. New class "A" properties have had to either cut rents to defend occupancy, or hold the line on rental rates and accept lower occupancy. For class "B", the spread in rental rates between them and the class "A" properties narrows, which leads to more students choosing class "A" with their robust amenity package and high quality finish-out as they become more affordable.



Source: Axiometrics

DOING DEEP DUE DILIGENCE

In between these two extremes, however, we see the potential to achieve quality risk adjusted returns. Opportunities still exist in markets that have a positive supply and demand story because of enrollment growth and barriers to entry.

But uncovering these opportunities requires experience and deeper due diligence, which is a key part of how we operate at Virtus. It is easy to get caught up in the exuberance of an asset class that significant investor capital is flowing into, but investors who are experienced in the student housing industry recognize that although this asset class looks like multifamily, it behaves much differently.

Since we focus exclusively on alternative real estate types, such as student housing, we know these markets do not all behave the same. Some markets are able to absorb new supply and other markets feel the acute negative repercussions of even modest new competition. Experienced investors also know that college enrollment growth – and therefore demand for student housing – can be hard to predict. Typically, when colleges make a decision to expand enrollment, they are still heavily dependent on their in-state high school graduation statistics, while a number of other factors also influence demand. Failing to fully understand how these factors will impact a market, can have serious financial consequences for a student housing project.

In addition, some investors perform only cursory assessments of future supply. Deep due diligence requires not only talking with college officials but meeting with city planners to see what projects are underway, planned, and even merely anticipated. Needless to say, understanding the full scope of future supply leads to more realistic projections of market fundamentals.

With more than one third of last year's investments coming from those with little experience in the student housing market and elevated levels of new supply, there will likely be opportunities created by the missteps of these investors. We are also looking at more defensive core capital plays targeting flagship assets with prime locations in high barrier markets. Owning *the* prime property in a market that will ride out the ups and downs of supply absorption can be profitable for investors who are satisfied with return profiles chiefly composed of income and with lower capital appreciation expectations. Going forward, we expect there to be clear winners and losers in this still resilient but heavier trafficked asset class. Well capitalized companies with experience in the industry will be able to take advantage on these opportunities. At Virtus, we are ready and watching.

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