Rendering of the Perennial International Health and Medical Hub in Chengdu, China, that will house the 350-bed ParkwayHealth Chengdu Hospital

The right niche

As competition for core gets crowded, investors eye nontraditional asset classes

by Alex Frew McMillan

Several years into the recovery from the global financial crisis, the good deals in core properties appear to be gone. Too much capital is chasing too few targets in major markets around the world.

"The weight of money is outstripping the supply of institutional-grade properties of most gateway cities globally," says Myles Huang, research director for Asia Pacific Capital Markets at JLL.

This intense competition is pushing yields to fresh lows that increasingly are below the hurdle rates of institutional investors. The situation is likely to push investors up the risk curve in terms of peripheral locations in major cities or secondary cities. Some have expanded the scope of their investments to include noncore assets, such as value-add or development.

It also is likely to push institutions into alternative, niche asset classes. Given the relatively-small stock of investment-grade assets, it is especially true in the Asia Pacific region that demand for core properties exceeds supply when it comes to options for international investors, according to Marc-André Flageole, Asia Pacific specialist and portfolio manager for real estate securities at Presima.

This strong demand has driven capitalisation rates well below 6 percent for prime Australian office space, for example, compared with close to 7 percent at the start of the decade.

That is not to say conservative investors will bypass core property. Despite the perception globally any post-crisis bargains largely have evaporated, an institutional investor typically turns first to "the best properties in the world in the best locations," says Flageole.

The numbers can still work in favour of an institution willing to hold an asset for the very long term. A building that is 99 percent leased to credit tenants with long leases in place, and with 3.5 percent bumps in the rent written into the leases, can generate internal rates of return of 10 percent or so through investors' moderate use of leverage in a low interest-rate environment.

"From their perspective, it can be a fantastic risk-adjusted return," explains Flageole.

Singapore's Perennial Real Estate Holdings' first Chinese joint-venture asset, Modern Hospital Guangzhou

Flageole and others see tremendous opportunity, however, for specialty sectors in Asia. Many niche segments, such as data centres or healthcare properties, are in their relative infancy but should see strong demographic support in high-growth regions.

"Niche or alternative property assets are definitely the next frontier in real estate in the Asia Pacific," asserts Huang.

Healthy demand for healthcare in North Asia

Investors most certainly need to be selective, as it is early days yet. Dr Cuong Nguyen, head of investment research for Asia at M&G Real Estate, sees plenty of obstacles for institutional capital to overcome when it ventures beyond the traditional sectors of office, retail and logistics. Lack of transparency, non-standard leases, and murky or unclear government policies push up the risk premium significantly, he believes. Lack of experience in managing specialised assets also can be a barrier to entry.

The foremost issue, however, is liquidity. "The lack of ready-to-invest assets and the relatively small size of the assets in niche sectors deter major investors from building up their exposure," explains Nguyen.

With the ageing population in Japan, JLL sees increased interest in the healthcare sector and senior housing in that country, which is still among the 10 most populous in the world. Similar trends also are driving increased interest in China. Other countries may be better suited to property targeted at young people, especially student housing.

Domestic investors often have a greater risk tolerance for niche sectors, particularly in China. At the start of this year, Dalian Wanda Group Co — run by Chairman Wang Jianlin, China's richest man — announced it would invest 15 billion yuan (US$2.3 billion) in hospitals in China, its first move into heathcare.

Dalian Wanda got its start as a property developer but now is also the world's largest operator of movie theatres. With its expansion into healthcare, the firm initially plans to build one hospital each in Shanghai, Chengdu and Qingdao. It has struck a 10-year partnership with the British healthcare operator International Hospitals Group, which will manage the hospitals.

While local investors may put up the cash, they often pair with external hospital operators that can bring specialised management expertise. Singapore's Perennial Real Estate Holdings, for example, has ventured into China as an investor, broadening from its traditional focus on residential and commercial properties in its home country.

The company entered the market last July in a joint venture with local hospital operator China Boai Medical Group, with Modern Hospital Guangzhou as its first acquisition. In mid-January, Perennial stated it would expand its presence with two healthcare projects in Chengdu. It is working on a senior-living facility with local operator Shanghai RST Chinese Medicine Co and Chinese builder Shanghai Summit Property Development Co. For a 350-bed hospital development in the same complex, it is pairing with Malaysian hospital operator IHH Healthcare and Shanghai Broad Ocean Investments Co; ParkwayHealth Chengdu Hospital is slated to open in second half 2017. The total combined investment should top 1 billion yuan (US$152 million).

Perennial ultimately aims to invest in some 40 healthcare facilities across China, the bulk of them in partnership with Chinese operators.

Healthcare is obviously one of the most complex specialist sectors to enter, with both operational issues — literally and figuratively — and heavy regulation. But niche investing does not always require specialist knowledge. On the other end of the complexity scale, Hong Kong–based private-equity investor LimeTree Capital

Partners spent US$42 million to acquire an 80 percent stake in Sunsea Parking Management Co, a Chinese firm that manages 100,000 car-park spaces across the country.

The liquid advantage of listed niche plays

Investors can adapt to the shortage of core assets in Asia by partnering with local developers or buying listed real estate securities. Property shares provide instant liquidity and, in a market such as Hong Kong, the vast majority of prime assets are securitised, notes Flageole.

Listed securities are beginning to offer access to niche sectors in Asia, as well. Keppel DC REIT, for instance, became the first dedicated REIT for data centres in the region when it had its IPO in December 2014.

"This highlighted Asian interest in a differentiated real estate exposure offering not only a growing source of recurring income, but also the potential to grow with increased demand for technology," says Flageole.

The Hulic REIT in Japan offers similar niche exposure, investing in data centres and nursing homes. The REIT considers such sectors "next-generation assets", and its success after its February 2014 IPO has spurred other niche listings in Japan over the past two years.

Investing in listed niche-focused firms can mitigate the need for an investor to take on specialist knowledge in areas such as healthcare. A number of early listings are sitting well with both observers and investors, says Flageole. "This would signal that the Asian market is mature enough to handle niche sectors."

The size of the Asian real estate securities market for niche asset classes is small, however, limiting the ability of large institutional investors to make significant investments that would "move the dial". That leads the biggest investors to focus on the United States, which has the deepest stock market and, in many cases, is the largest market for specific niche assets.

Keppel DC REIT, for example, has about S$1.1 billion (US$775 million) in assets under management. Its US counterpart, Digital Realty Trust, is about 19 times that size, at approximately US$15 billion as at 31 December 2015. But the Keppel trust is expanding well beyond the borders of its home markets of Singapore and Malaysia, with investments in Australia, Germany, Ireland and the United Kingdom, suggesting it has the scope to scale up.

On the elder-care side, Nippon Healthcare Investment and Japan Senior Living Investment, with approximately US$154 million and US$231 million in assets under management, respectively, are minnows compared with NYSE-listed Senior Housing Properties Trust in the United States, which weighs in at close to US$7.4 billion. But Japan likely will see more senior housing and nursing-home REIT listings; in 2014, about 25 percent of the country's population was more than 65 years of age, the highest of any nation in the world.

Impressive profit margins

Presima's Flageole says the performance of niche assets within listed vehicles has been similar to traditional properties. The turnover in Japanese senior-living facilities and nursing homes, for example, is similar to traditional residential. That creates similar levels of stability for landlords.

Investors recently have embraced Japanese budget hotels and feel optimistic about that sector. Tourism assets have been buoyed by record-breaking numbers of foreign visitors over each of the past three years. The latest statistics from the Japan National Tourism Organisation showed a new high-water mark of 19.7 million visitors in 2015.

Keppel DC REIT's Basis Bay Green Data Centre in Cyberjaya, Malaysia

Budget and mid-range hotels, therefore, are running at occupancies well north of 90 percent. Those hotels also are able to increase room rates quite substantially, mainly because rates start from a low base, sometimes as low US$40 or US$50 a night.

"We see an opportunity in that segment because growth from such a low base could be long-lasting, given limited new supply and the current composition of the growing demand," explains Flageole.

Self-storage has been a successful niche asset in the United States. But Flageole notes it is unclear whether that it will emerge as an investable asset class in Asia. Many Asian cities are very dense, which may mean storage may not be the most efficient and profitable use of space for landlords.

Huge promise in student housing

Many property professionals see great opportunity for student housing in the Asia Pacific region. JLL's Huang notes Hong Kong, Seoul, Singapore and Tokyo have benefited in competitiveness studies from their status as world-leading higher education centres.

Hulic REIT's Sapporo Network Centre in Sapporo, Japan

Conal Newland, the director of student-accommodation services for Australia at JLL, says Asia is about 10 years behind the United States and Britain in terms of student housing. But global players are moving into multiple markets in the region. They have brought in "significant experience," says Newland, meaning markets such as Australia are catching up fast.

Australia has emerged as a particularly popular investment target over the past five years, driven by a significant shortage in supply as well as increasing student enrolment. That timeframe

Australia has emerged as a particularly popular investment target over the past five years, driven by a significant shortage in supply as well as increasing student enrolment.

may mean the market will begin to mature for institutional investors looking to enter the secondary market, surmounting the issue of liquidity in one niche sector at least.

"At this stage, investment into the Australian market has been development-led," says Newland. "However, in the short to medium term we will see transactions of completed assets increasing."

The strong and steady demand for student housing is one of the attractions, with predictable university enrolments, and increasing numbers of international students. The lack of supply is leading to strong growth in rents and high occupancy levels.

"Understanding the pipeline delivery of new accommodation is a key consideration at this point in time," notes Newland. But with well-chosen projects, the total returns are in line with higher-star hotels. JLL anticipates ungeared IRRs of 10 percent to 13 percent for stabilised properties, depending on location and construction quality.

Major institutional interest moving out of Asia

Asian investors do occasionally move outbound capital from the region into niche sectors. The S$480 billion (US$344 billion) Singapore sovereign wealth fund GIC, for example, teamed up with the C$283 billion (US$203 billion) Canada Pension Plan Investment Board and The Scion Group in a US$1.4 billion deal to buy the University House Communities Group. Scion, headquartered in Chicago, will manage the portfolio of 13,000 beds near US campuses.

Returning to Asia Pacific, it may be only the beginning of increased interest in niche property from institutions as large as GIC or the CPPIB. M&G Real Estate does see a window of opportunity for student housing in Australia and data centres in Hong Kong and Singapore, but asset selection will be crucial.

Even when it comes to residential property, it can be difficult to find deep enough markets. Because people choose to own their homes in Australia, Hong Kong, Singapore and South Korea, only Japan really offers a deep pool of residential rental properties.

Flageole believes niche asset classes will grow gradually and "become front of mind for Asian investors", as they have in Europe and North America. But the emergence will take time and rely on the pace of asset development in those sectors.

Nguyen says most of M&G Real Estate's backers are still seeking core product in the region. So although his company is considering niche sectors, he says it would be "highly specific". Investment managers' hands ultimately are tied by what their investor clients want.

"Understanding the market, its practices and participants will be critical factors for investors to consider," says Nguyen. "That's explaining why until now, most niche markets [were] left for specialist investors whilst mainstream institutional capital continued remaining on the sideline."

The question is likely one of maturity, both in terms of the market and the sophistication of investors. As specialty sectors grow, and as investors become more comfortable the returns produced are solid and predictable, niche may eventually merge with the mainstream. Then it will be niche no more. ❖

Alex Frew McMillan is a freelance writer based in Hong Kong.