James Woodson/Getty Images

Student Housing Graduates

A niche sector goes mainstream.

by John Preiss

In the early 1990s off-campus student housing was primarily single-family homes and small apartment buildings around universities. The owners were local mom-and-pop operators who rarely had properties in more than one market. But since then, institutional capital has begun to recognize student housing's potential, and this niche play has evolved into a mainstream investment.

In 2011, U.S. student-housing transaction activity reached $2.2 billion, according to Real Capital Analytics, a 40 percent increase from 2010 and well over triple 2009's total. Institutional buyers accounted for 42 percent of these transactions, up from 29 percent from 2010.

The largest student-housing operators are all growing at a brisk pace due to the flow of debt and equity into the sector, and acquisitions have been heavy. Austin, Texas-based American Campus Communities was by far the most active buyer from February 2010 through February 2012, acquiring 23 properties totaling $603.4 million, according to RCA. Los Angeles-based Kayne Anderson and Memphis, Tenn.-based Education Realty Trust rounded out the top three buyers during that period, with $442.1 million for 16 properties and $260.1 million for 10 acquisitions, respectively. Boston-based Fidelity Investments topped the list of sellers, disposing of 18 properties for $383.3 million.

With all the competition in the acquisition world, development has become very attractive. Even merchant builders, which have been out of the game since 2006, are slowly coming back.

What's the Attraction?

Student housing fared well through the recession, mainly because the tenant base did not change — enrollments do not drop during recessions. Debt from Fannie Mae and Freddie Mac remained constant. Conventional multifamily, which can be a significant shadow market, benefited from the demise of the single-family market. A few properties have gone back to the bank primarily because of overleveraged loans maturing, similar to what has occurred in other real estate sectors.

Construction has blossomed in the past few years with plenty of banks willing to provide loans and plenty of buyers looking for product. The Preiss Co. recently received 25 offers from well-known operators and funds for a student-housing asset in Raleigh, N.C. Two rounds of best and final offers resulted in a higher sales price than expected at a 7.5 percent capitalization rate. If an unattractive loan hadn't had to be assumed, the asset would have traded at a 6.7 percent cap rate.

The increased buyer pool has pushed down cap rates and generated more interest in building new product as opposed to acquiring existing product. Depending on market, proximity to campus, and product age, cap rates generally range from 6.2 percent to 7.5 percent. According to RCA, the average cap rate for 1Q12 (through February) was 7.2 percent. Student-housing cap rates fell by 53 basis points during 2011, compared with a 29 bps decrease in conventional multifamily cap rates.

However, student-housing cap rates are about 75 bps higher than conventional multifamily rates. The cap rate premium is due to the business risk of running student housing. If owners miss lease-up in August they are done until next year, as opposed to conventional multifamily, where owners see constant move-outs and backfill. Likewise, if a new student-housing development is not ready by August, it is dead in the water. Delivery on time is absolutely paramount.

Land close to universities has become scarce, causing developers to venture further from campus or redevelop existing product nearby. Land value, which is backed into by taking construction costs and rents into consideration, varies based on proximity. The Preiss Co. has a project in Raleigh where the high-density land near the school is valued at $2 million per acre. Lower-density locations a few miles from a school might be valued around $150,000 an acre.

Some redevelopments have gone urban with concrete and steel construction, structured parking, and even a mixed-use component such as first-floor retail. The West Campus area in Austin, Texas, has seen several such redevelopments, garnering rents up to $1,000 per bed. On the low end, the average rent is around $350 per bed. The sector has a 45 percent expense ratio to income, which is much higher than

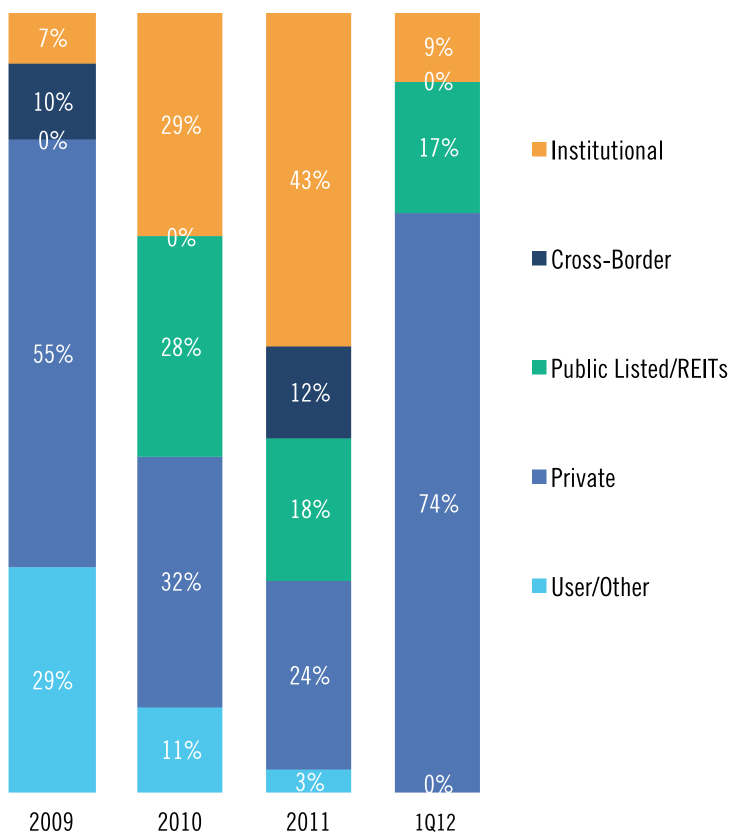
THE FUTURE OF STUDENT HOUSING?

The University of Kentucky became one of the first universities to turn over its entire student-housing operations to a private real estate company, Education Realty Trust, according to the *Wall Street Journal*. EDR will assume management of the university's 6,000-bed dormitories on July 1, and the company signed a 50-year ground lease with the university to build and operate a 600-unit, $25 million on-campus student-housing community.

In addition, EDR will redevelop and expand the school's current on-campus dorms over the next seven years to 10 years, adding about 3,000 additional units on school land, funded through private financing. The project, which will eventually replace the school's 44-year-old inadequate student housing, may be worth as much as $500 million upon completion. EDR is a publicly traded real estate investment trust that owns or manages 60 student-housing developments in 23 states.

— *CIRE* staff

STUDENT HOUSING BUYERS



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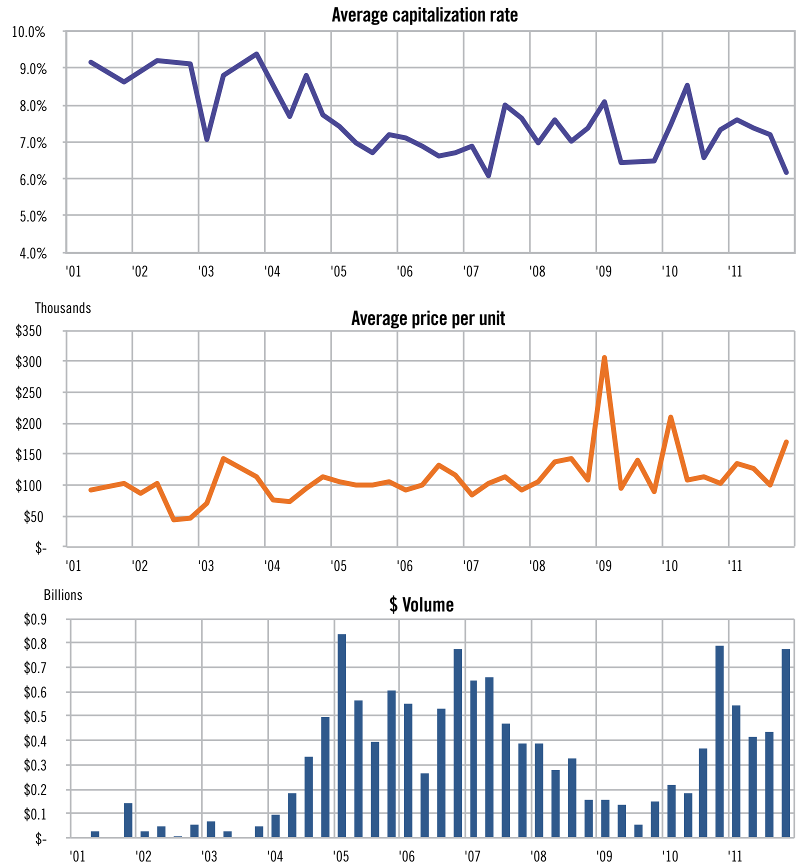
STUDENT HOUSING



Source: Real Capital Analytics

conventional multifamily, due to staff requirements, marketing initiatives, and resident functions.

Financial Aid

Construction loans are available for student housing right now, unlike other real estate classes. The Preiss Co. has recently done construction loans with PNC Bank and Wells Fargo. But smaller regional players are starting to get into the game as well.

Mezzanine financing has become popular with developers because a large amount of equity is needed upfront to do a deal. Typically, the leverage is anywhere from 65 percent to 75 percent. Interest rates are usually based on the London interbank offered rate, or Libor, creating very attractive low interest debt. The mezzanine financing can leverage it up to about 95 percent with a higher cost of capital somewhere around the mid-teens.

As soon as a project is built and stabilized — normally within two years to three years — the biggest permanent lenders are Fannie Mae and Freddie Mac, which offer attractive leverage up to 75 percent with a debt coverage ratio around 1.3. Both Fannie and Freddie require an enrollment of at least 8,000 students before funding a project.

Equity has increased from a few niche players to the largest blue-chip providers such as Carlyle Group, Heitman, and ING Clarion. Life companies have also started to compete, but their share is relatively small.

Looking Ahead

Since the first purpose-built student apartments surfaced in the late 1990s, finishes and amenities have continued to improve. The construction has evolved from basic garden-style product to full-blown clubhouses with gyms, tanning beds, and game rooms, and, of course, ultra high-speed Internet. Finishes now include granite countertops, nine-foot ceilings, and wood laminate floors.

The new product is typically furnished, rented out by the bed, and all utilities are bundled and included. Parental cosigners accompany all leases. Preleasing generally starts in October, when students start planning for the following school year, and runs until move-in.

The Preiss Co. currently has developments totaling $65 million under construction in Raleigh, N.C., for North Carolina State University, Statesboro, Ga., for Georgia Southern University, and Clemson, S.C., for Clemson University.

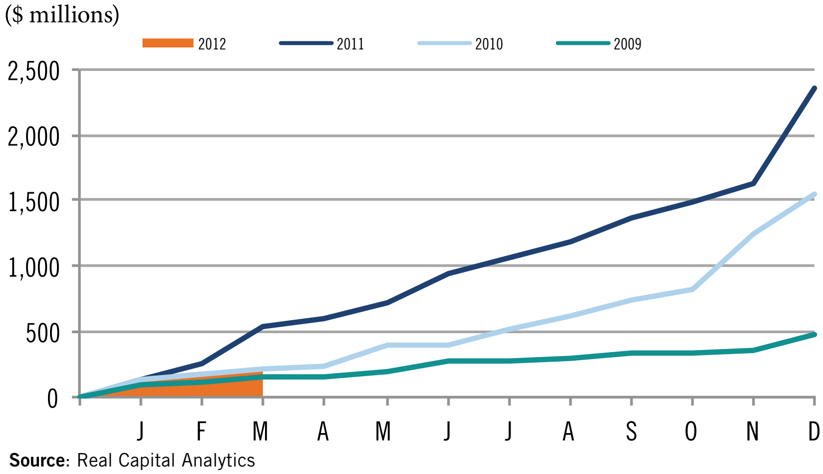
As an investment vehicle, student housing is still in its infancy, with 80 percent of the product still controlled by local mom-and-pop operators. However, it now has the attention of Wall Street and the capital markets, indicating that growth will continue.

Right now, 95 percent of student-housing transactions are handled by a small number of brokers who specialize in the sector, and listings can be difficult to secure. ARA, CBRE, and Marcus & Millichap have been the main contenders over the last few years.

But opportunities exist for brokers who can locate raw land or a potential redevelopment property near a university. If you find it, they will build.

STUDENT HOUSING VOLUME

($ millions)



Source: Real Capital Analytics

John Preiss is executive vice president of The Preiss Co. in Raleigh, N.C. Founded in 1987, the Preiss Co. is now the eighth-largest student-housing company, with projects in eight states. Visit www.tpco.com for more information.