The Growing Role of Specialty Sectors in Real Estate Portfolios

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Real estate specialty sectors—those outside the traditional apartment, office, retail, and industrial sectors—have several tailwinds that may increase the institutional adoption of these property segments. Specialty sectors can generally be bracketed into two camps: one focused on a broader definition of residential real estate and the other an expansion of the definition of commercial real estate. Residential specialty property segments beyond traditional apartments include single-family homes for rent, manufactured housing, senior housing, and student housing. Commercial specialty property groupings include self-storage, medical office, life science, data center, and infrastructure.

Invesco Real Estate believes that specialty sectors will have a growing place in investor portfolios in years to come for five key reasons:

- Real estate specialty sectors service important areas in the economy that focus on technology, seniors, health care, and education.
- Many specialty sectors are supported by secular demand drivers, such as aging and technology, which should underpin demand over the medium to long term.
- Specialty sectors may offer cycle durability given the needs-based and less-elastic demand in many segments.
- Specialty sectors are still in the early stages of institutionalization in the private markets segment. This may provide investors with opportunities as early entrants and could benefit from yield compression and economies of scale as these sectors grow and attract institutional attention. Although specialty sectors are still a relatively small exposure in direct institutional benchmarks, non-core sectors have been widely embraced by the listed US REIT universe and represented nearly 50% of the overall real estate market capitalization at the end of 2022, according to the FTSE Nareit All Equity REITs Index.
- Given the differences in cycles and pricing, many listed real estate specialty sectors are trading at large discounts to net asset value and support potentially high internal rates of return, thus emphasizing that specialty sectors are a private market opportunity and are readily available within listed real estate at value prices.

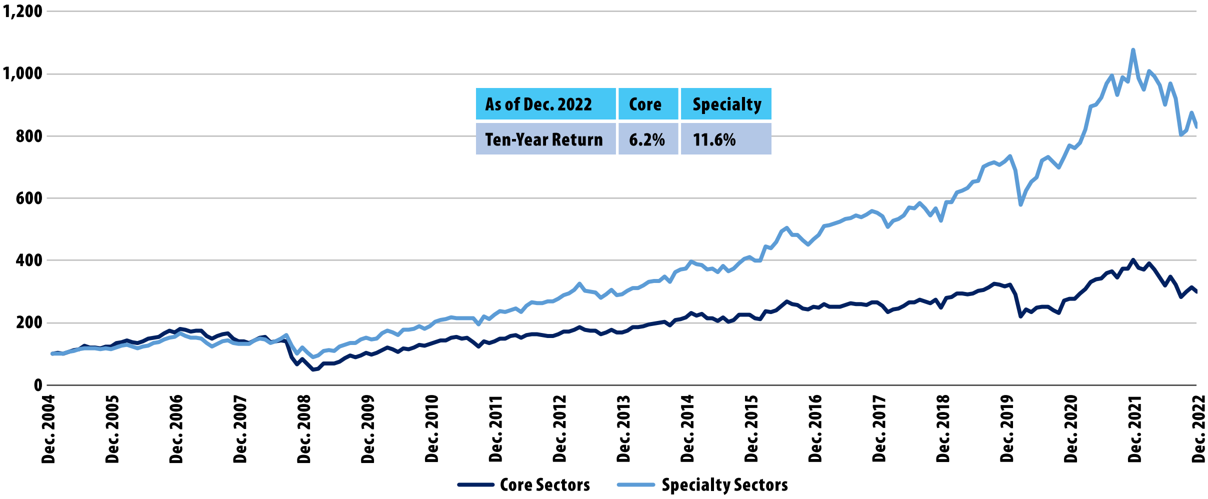
Promising Attributes for Both Private and Listed Portfolios

Specialty sectors can play a role in both private and listed portfolios because of attributes including favorable long-term demand drivers, stable income returns, higher yields, and diversification benefits. The alignment with longer-term demand drivers from demographics, lifestyle, and technology help underpin the growth potential of specialty property sectors. This alignment looks attractive relative to some traditional property sectors that face secular headwinds. Many specialty sectors offer "needs-based" characteristics that are often less cycle sensitive and may offer investors more stable and predictable cash flows. The shorter-term lease structure of some specialty sectors may allow investors to respond more quickly to improving market conditions. Yields for specialty sectors in many cases offer a premium to traditional sectors, although this premium varies depending on sector and geography. As in the listed real estate space, the consolidation of ownership and operations may allow for greater operating economies that drive higher net occupancy income growth.

Specialty sectors also offer diversification benefits. Broadening the number of property sectors in a private market or listed portfolio provides diversification benefits for portfolio construction purposes because many specialty sectors have relatively low correlations or similarity of demand drivers relative to traditional sectors. For example, during the latest period of globally heightened inflation, capital expenditures as a percentage of net occupancy income as of the end of 2022 were almost 40% lower cumulatively for specialty sectors versus traditional, according to Green Street—just one illustration of the diversification of many characteristics that specialty sectors may offer.

As illustrated in Exhibit 1, although specialty sectors are a relatively new element of private market

Exhibit 1: Listed Real Estate Core Versus Specialty Sector Performance



Source: Invesco Real Estate using data from Nareit; as of Dec. 2022
Notes: Core sectors include apartment, industrial, office, retail, and diversified; specialty sectors include health care, self-storage, manufactured home, single-family rental, data center, timber, infrastructure, and specialty. Sector performance is based on equal-weighted methodology.

Exhibit 2: Comparison of Diversification Benefits of US Residential Specialty Sectors

	Apartment	Single-Family Rental	Manufactured Housing	Senior Housing	Student Housing
Categorization	Traditional	Specialty	Specialty	Specialty	Specialty
Demand Drivers	Aging Millennials Affordability	Aging Millennials Affordability	Affordability Aging Population	Aging Population Stock Modernization	Demographics Lifestyle
Cycle Sensitivity	Mixed	Below Average	Below Average	Mixed	Below Average
Lease Length	One Year	One Year	One Year	Monthly	One Year
Current Fundamentals	Slowing	Healthy	Healthy	Mixed	Mixed

Source: Invesco Real Estate

real estate funds, they have been a staple of listed real estate markets for many years and over many cycles. In addition, the cumulative and compounded returns of listed companies that fund under specialty sectors has been demonstrably higher than the returns generated from traditional sectors—11.6% annualized versus 6.2% annualized. The outperformance of specialty sectors is a reflection of much higher cash flow growth, better returns on equity, stronger cap rate compression, and better alignment with structural trends than some traditional sectors. Given the superior growth characteristics of the specialty sector space, what was once a relatively small component of US REIT benchmarks now exceeds 50% of the total capitalization of some benchmark structures.

Diversification Benefits

Exhibit 2 provides a comparison of how adding specialty sectors into the residential space may provide return and diversification benefits, and Exhibit 3 details the characteristics of specialty sectors within the commercial space.

Trends Within Specialty Sectors

Understanding the key trends underpinning the allure of specialty sectors is an important part of the research process when evaluating specialty areas.

Residential

■ **Single-Family Rentals:** When it comes to residential real estate, one of the first specialty sectors on investors'

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DALLAS

COMMERCIAL REAL ESTATE DEBT EXPERTS

Exhibit 3: Comparison of Diversification Benefits of US Commercial Specialty Sectors

	Self-Storage	Medical Office	Data Center	Life Science	Infrastructure
Categorization	Specialty	Specialty	Specialty	Specialty	Specialty
Demand Drivers	Lifestyle Stock Modernization	Aging Population Med-Tech	Technology Data Generation	Aging Population Technology	Technology 5G
Cycle Sensitivity	Average	Below Average	Below Average	Average	Low
Lease Length	Monthly	Average/Long	Average/Long	Average/Long	Average/Long
Current Fundamentals	Slowing	Healthy	Healthy	Healthy	Healthy

Source: Invesco Real Estate

minds is the single-family rental housing space. This sector appears poised to benefit from the aging of the millennial cohort combined with a spike in affordability concerns stemming from increased home prices plus elevated mortgage rates. The strong growth in the 35- to 44-year-old demographic should support single-family rentals as aging millennials with young families seek more space and quality school districts. Many millennials continue to struggle with student debt and challenged balance sheets, which impact their transition to homeownership. Additionally, many millennial households live with impaired credit, locking many into the long-term rental market. Finally, fewer than 2% of rental homes are owned by large owners, and institutionalization of the sector may result in better operating economies, which would drive higher net occupancy income growth.

■ **Manufactured Housing:** Another residential business model increasingly coming into the fold is manufactured housing. The US has about 50,000 manufactured housing communities; approximately 10% of these communities are considered to be of institutional quality, report Green Street and Moody's Analytics. The manufactured housing business model is based on affordable ground leases landlords offer for various types of manufactured homes that residents own. Demographics and affordability are critical drivers of the sector. Retiring baby boomers are a key and expanding demographic, given the growing need for affordable housing for residents on limited retirement incomes. Tenants of manufactured housing tend to be much stickier than those of other residential areas because moving is generally cost prohibitive once a housing unit is placed on a pad. This makes this specialty sector relatively defensive in nature.

■ **Senior Housing and Student Housing:** Senior housing and student housing both focus on areas that have potential structural demand. With the 75-plus age cohort set to grow by 40 million by 2040, according to Moody's Analytics and the National Investment Center for Senior Housing and Care, demand for senior housing looks set to be durable in the coming decades. The upcoming ratio of adult children to seniors is declining significantly, and a reduction in caregivers is likely to drive additional demand for senior housing. Furthermore, as age expectancy increases, so will the need for dementia caregiving, which is very difficult in home settings. Student housing likewise remains an interesting residential specialty sector, even though the demographic growth of college students has flattened. The number of students enrolled in four-year colleges has increased by more than 50% since the mid-1990s, according to Moody's Analytics, which has helped create a backdrop of stable fundamentals and elevated occupancy. Colleges continue to outsource their housing needs and recognize that quality housing stock is a key attraction to students and parents.

Commercial Specialty Sectors

■ **Data Center and Infrastructure:** Both stand out as beneficiaries of technology-driven structural growth. Increased spending on IT, cloud services, content distribution, and social media has made the data center sector a critical component of corporations. With global data storage set to double in the next five years, wholesale (single tenants) and hyperscale (multiple tenants with interconnections) facilities remain in high demand from technology companies, communications firms, and government entities. The infrastructure specialty sector is likewise a beneficiary of changes in technology and data consumption and of increased spending on 5G. Infrastructure real estate companies generally focus on cell towers and fiber networks, allowing for the rapid transmission and distribution of information through communications carrier networks. Demand for this business model remains robust, with occupancy levels at virtually 100% and tenancy per tower reaching all-time highs at nearly two tenants per tower, according to Green Street. This inelastic business model is among the most profitable in all real estate and has several appealing features—very high gross margins, a low-cost operating business model, and very high barriers to entry. Unlike all other specialty sectors covered in this article, the infrastructure specialty sector can generally be accessed only through listed companies because tower site requirements (more than 100,000 for scale) are generally unavailable in private markets.

- **Self-Storage:** Self-storage has long been a fixture of listed real estate companies but is increasingly becoming a part of many NCREIF Fund Index—Open End Diversified Core Equity portfolios. Job growth, household formation, disruption, and lifestyle changes have driven occupancy levels to record highs. Tenants for self-storage tend to be sticky; once they fill their units, they are generally less sensitive to rent increases versus those in other sectors, which contributes to the increased durability of the sector. Modern self-storage stock offers greater appeal with climate-controlled units, 24-hour access, and heightened security. Further institutionalization of the sector, which is still fragmented, may result in future operating economies that can drive higher net occupancy income growth.
- **Medical Office and Life Science:** An aging population, shifts in health-care delivery support, and technology support the commercial specialty sectors in medical office buildings and life science. Medical office buildings support the largest sector in the US economy—health care. Moody's Analytics and the National Investment Center for Senior Housing and Care report that domestic health-care spending has grown by nearly 10% annually for the past 20 years, contributing to the durability of revenue through economic cycles for sectors such as medical office buildings. For more than the past two decades, outpatient services have dramatically increased while inpatient services have decreased, thus supporting the medical office business model. The projected growth of the senior population and its increasing health-care needs are key demand drivers for medical office and foreshadow a predictable future revenue environment. The life science specialty sector, which focuses on the development of medical cures and treatments, also is at the cross section of aging and technology trends. Life science clusters that bring together both academic and health anchors have emerged in a handful of markets, such as Boston, San Francisco, and San Diego. Demand for lab space is expected to remain healthy, providing investors with another opportunity in the specialty camp.

Conclusion

Specialty real estate sectors have a role to play in a portfolio—either in private markets or public securities. Although somewhat smaller in scale than traditional property sectors, specialty sectors service attractive segments of the economy, are often supported by durable long-term trends, and in some cases, provide an attractive yield premium. Invesco Real Estate believes these sectors may have the potential to increase not only diversification but also risk-adjusted returns. Though still a small but growing part of private market real estate portfolios, specialty sectors have an established long-term track record of strong value generation in the listed real estate markets. Specialty sector transaction volume has jumped significantly during the past decade, and liquidity appears to be improving. For these reasons, Invesco Real Estate believes that specialty sectors will continue to demand the attention of institutional investors and gain momentum in the coming decades. ■

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