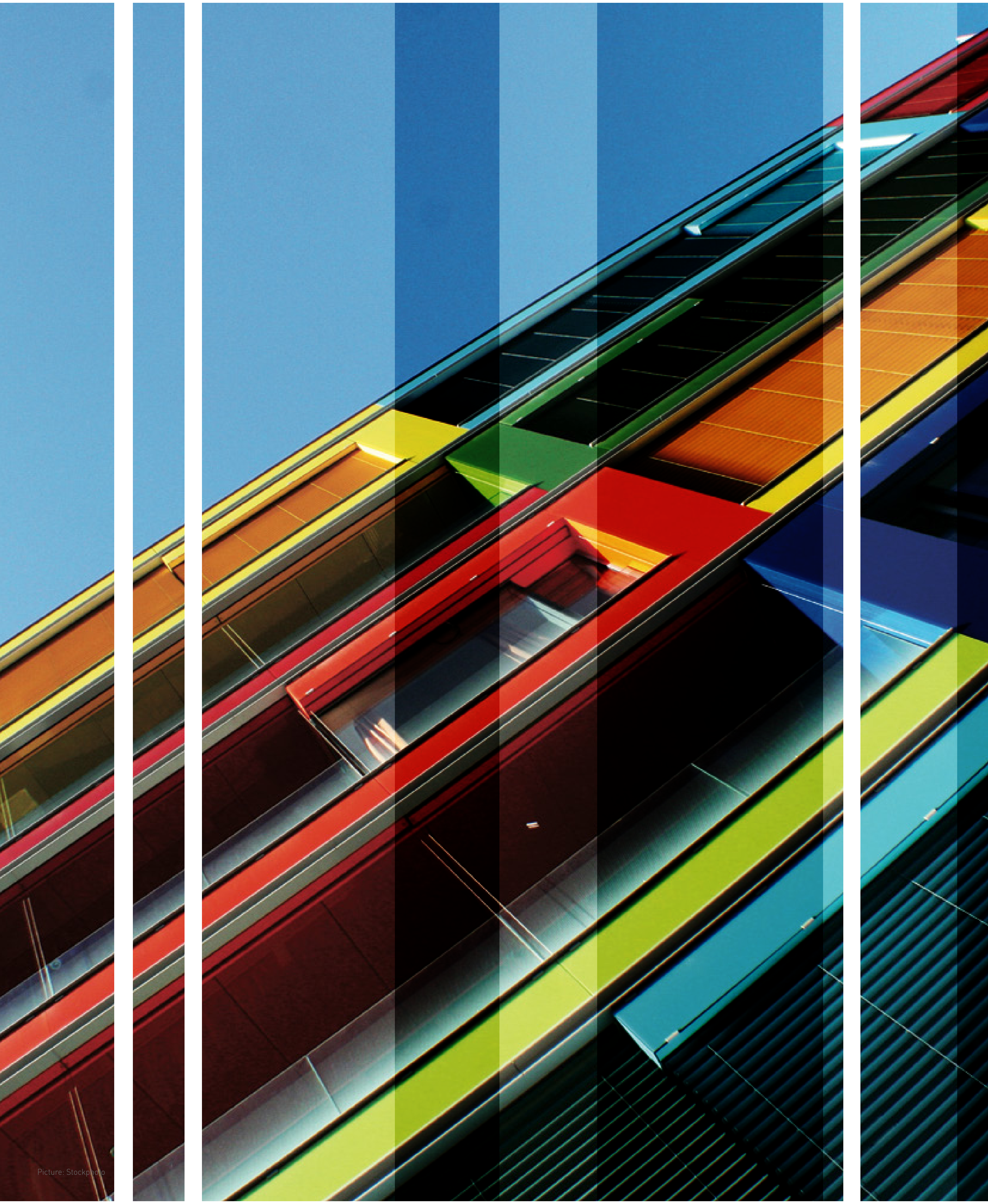

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Escape from Colditz: the transformation of student accommodation

By Shayla Walmsley

Time was when student housing meant either a concrete Colditz or an infested suburban squat overlorded by an Alexei Sayle lookalike. Now it means a low-risk, liability-matching, countercyclical investment with better returns than you can get from gilts.

At least it does to pension funds and insurers. How they get to it depends on a couple of factors. Size is one of them. When Dutch pension fund manager PGGM last autumn closed an agreement to acquire 60% of on-campus housing provider, University Partnerships Programme (UPP), the rationale included the latter's 12-asset operational portfolio and long-term partnerships with universities, a typically 30-year concession-based model, and a platform to acquire new deals.

PGGM, which manages the assets of the €118bn Dutch healthcare pension fund, acknowledges that there are few such platforms around. There aren't that many PGGMs, either. One of the few with comparable capital clout, Singapore sovereign wealth fund GIC, currently participates in two UK joint ventures with UK operator the UNITE Group: the £400m UNITE Capital Cities vehicle and a 10-year vehicle that targets assets in London. For those with neither the size nor the in-house nous to set up a joint venture, in April Gravis Capital Partners launched the UK market's first student accommodation real estate investment trust (REIT), seeded with a single London asset and targeting a 5.5% annual yield. Although partner Tom Ward acknowledges UK pension schemes' habitual reluctance to invest in listed real estate because of equity volatility, he believes they will overcome their aversion because student accommodation tends to be less volatile than most other real estate.

Is it a bond? No, it's a building

If you look at pooled funds – the most obvious route to exposure – relatively few target student accommodation exclusively. The £1.2bn UNITE Student Accommodation Fund (USAF), which includes the Universities Superannuation Scheme (USS) among its investors, is one that does; Cordea Savills's student hall fund, launched in 2006, is another. Since 2008 they have faced increasing competition from funds dedicated to long-lease assets, including student accommodation. Yet institutional investors may be underestimating the risks associated with student accommodation – and, for that matter, with long-lease assets more generally. Richard Tanner, managing director at AEW UK, believes the comparisons with fixed income have in some cases been overplayed. "If you went into the market over seven years ago, it was difficult to persuade investors that real estate had bond-like characteristics. Now they think real estate is only a bond," he says. That can lead investors to underplay risks such as obsolescence and covenant changes. Actuarial assumptions of bond-like yields for super-long leases are not what investors get when they sell the student housing asset 20 years down the line.

"In student accommodation, the problem is that if you know who the counterparty is and what the credit rating is, you're still faced with uncertainty in 20 years' time compared with a bond," says Tanner. AEW has attempted to mitigate these risks by operating on the basis of adverse assumptions and agreeing prices that reflect them.

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Yet pricing for prime assets is keen to the point of aggressive – even if, as Prupim senior research analyst Emma Harding points out, it is still better value than other types of London properties such as West End office.

One way around it is to finance development, rather than acquire assets. Insurers, especially, see debt finance as a means to gain exposure while avoiding potential overpricing. Legal & General last year loaned just over £120m to UNITE to refinance a bank loan. At around the same time, M&G pooled investors' money to fund the £266m acquisition of Blackstone's Nido portfolio. In recent weeks it agreed to provide £32m to Swansea University and its development partner St Modwen's to developing new accommodation on a 45-year post-completion lease.

Either way, investors in student housing will be taking on counterparty and operational risk because in most cases they are acquiring not assets but operators – explicitly in PGGM's case, implicitly when they invest indirectly.

"Returns are intrinsically linked to the quality of the operator — including whether they have a sales and distribution network in China, their links to the university, and whether they can use Facebook effectively to stimulate demand. You have to treat student accommodation as a specific business. You have to know what you're doing," says Dan Bowden, head of alternatives at Axa Real Estate.

"In 13 years working in the sector, there are a handful of operators we can trust. My concern would be with the old-school developer who found himself in the building that he's turned into student accommodation because he couldn't get planning permission for an office."

The arrangement between PGGM and UPP, works in three ways. UPP leverages its partnerships with its own partners (universities) to gain preferred housing provider status. "The overarching risk is that we're taking the risk of the university continuing to attract students, even if we're not letting directly. The universities we work with have to ensure that students go to them and, when they do, that they get them into beds," says UPP director of strategy Jon Wakeford.

Once the deal has been closed, its terms cover the concession's entire duration. Those terms involve restricted covenants – which limits the amount of new supply that can be brought into the university – the rent agreement, the performance mechanism and the upside revenue-sharing.

"The biggest risk is a deterioration of the mid- and long-term attractiveness and position of UPP's partner the universities, the main driver behind demand for student accommodation," says PGGM senior investment manager Vincent Gerritsen.

The undergraduate dilemma

There are related sector-specific risks, too. The government's removal of the cap on university fees paid by domestic students has not had the predicted catastrophic impact on tertiary student numbers – at least not yet. After a drop in applications in the cycle following the announcement, they recovered somewhat in the most recent round. But according to Bowden, which invests in student accommodation as part of its long-lease and residential funds, the new fee structure will

polarise an already maturing market. Students who pay more, the argument goes, will be more discerning.

(In fact, several investors interviewed located student accommodation not within residential real estate but within hospitality. The comparison, especially given that investors are targeting high-end universities targeting middle-class students from India and China, is with hotels.)

Yet unfavourable demographics is one reason for caution cited by student housing sceptics. Robert Houston, partner at investment management firm St Bride's, acknowledges that investing in student accommodation has been largely successful for investors over the past decade. But he points out that projected UK population growth over the next 20 years will be among newborns and the elderly, with almost no growth in the student age bracket. "Combine this with tougher visa conditions and the burden of student loans and the prospects in this arena are much less compelling," he says.

In any case, the prospect of the drop in demand has focused investors' minds. Now they are looking for ways to get out even before they get in.

Exit strategies were uppermost in Luxembourg Fund Partners (LFP) director John Hill's mind when the fund manager launched its Student Accommodation Opportunity Fund earlier this year. In contrast to existing strategies focused on purpose-built blocks, the SICAV targets residential assets LFP can convert into student units – and back again.

"It's easier to sell a portfolio of houses than a purpose-built block," says Hill, pointing out that the only alternative use for a purpose-built asset would be as a hotel conversion. "Managing investors' money is about having a back-up plan."

Even if demand and other risks can be managed, there are limits to the potential for investment in this asset class. Student accommodation is a local – at best national – business with enough market specificities to make it almost uninvestable outside the UK. PGGM, for example, sees little chance of replicating its UK student accommodation investment elsewhere in Europe, though not because it lacks the appetite. In the Netherlands, for example, student housing is typically subsidised. Rent regulation prevents investors from earning market based returns, creating shortages in the market and driving students to the expensive private rental market, "In a subsidised and over-regulated sector, investors struggle to find economic sensible opportunities," says Gerritsen.

Still, there are reasons to be cheerful, at least for the UK. Harding points out that, despite recent cuts, "the government is not looking to affect demand – they want people to go to university". In any case, she says, government funding cuts will mean there is less money to spend on accommodation, so it will be up to external providers to provide it.

Meanwhile, the good news for investors is that operators need their capital. "It's been clear for four or five years that we need pension funds to come into the higher education market. It's a natural fit," says Wakeford. Back in the late 1990s, it wasn't unusual for a single bank to come up with a £100m loan for a project. Now, he says, you would have to line up four banks for the same ticket.