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The Modernization of Student Housing | August 2014

In July, REITs continued their trend of positive performance as they rolled into earnings season. As measured by the MSIC US REIT Index (RMS), REITs produced a total return of +0.1% for the month which compared to -1.4% for the S&P 500. Year to date, REITs have generated a total return of +17.8%, while the S&P 500 has totaled +5.7%.

Since 2005, the student housing sector same store net operating income (NOI) growth has outperformed their apartment peers and even maintained positive growth during the recession, posting a 1.6% gain in 2009 when apartments declined by 4.7%! The current supply and demand trends continue to support a positive thesis toward student housing and should continue to attract a variety of investors including REITs and other institutional investors. Student housing can no longer be viewed as the bare-bones, poorly maintained on-campus dorms of the past. This property type has taken on a life of its own, differentiating itself from other residential property types.

The New Dorm

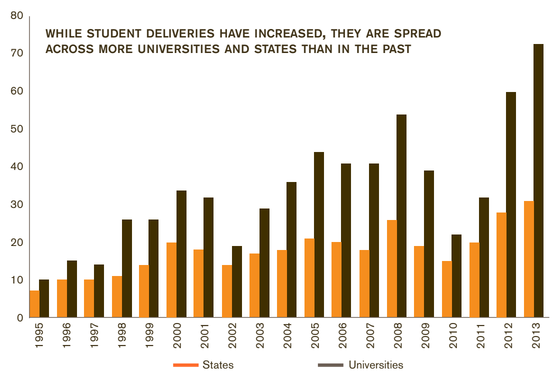
There are several ways that student housing is separate from other residential property types. The unique leasing structure of student housing is one of its idiosyncrasies. Properties are leased "by the bed", instead of "by the unit", and typically have 11.5 month leases, though some dorm-type leases expire at the end of the school year. A student tenant base creates a challenge with leases typically beginning and ending in tandem, creating concentrated turnover and a tight leasing window (especially for a development project). To compensate for the tight window, owners, most notably REITs, have discovered how to efficiently and effectively market to students throughout the school year. Leasing begins in August by targeting the easiest demographic to reach, current on-campus students. The second phase initiates in January with off-campus students. During this phase, leasing velocity (how quickly properties are able to sign leases) begins to affect rental rates as owners try to reach their targeted occupancy of 100%. Better leasing velocity increases the likelihood that current rents will hold or even increase, while disappointing velocity may necessitate lower rates. The final stage targets incoming freshman and transfer students during the waning summer months prior to the school year. As a last ditch effort to reach occupancy goals, owners will increase marketing expenses and even offer rent concessions. Yields on REIT quality properties tend to be around 6.5%.

The modern student housing property can be thought of as a live/work/play environment for students. The units themselves mimic those of an apartment, but typically come fully furnished, which eases the move-in/out process. Properties also tend to have an academic focus with amenities such as study rooms, computer labs, and access to printers. Additional "play" amenities can range from workout rooms to movie theaters, roof-top pools, tanning beds, lazy rivers, golf simulators, and even laundry and maid service. It almost leaves one to wonder how any studying gets done!

New Supply is Modern Supply

Deliveries of student housing are expected to be near 60,000 units in 2014, an increase of approximately 9% from 2013, and a 300% increase from 2010 deliveries. Importantly, new supply is being delivered in more universities (Figure 1) and often is replacing existing supply that has become functionally obsolete. Over the past few years, non-REIT markets have also been accounting for larger portions of new deliveries. The catalyst has been the demand for modernization of student housing. Amenity-rich product is replacing alternate supply (traditional less amenity-rich apartments and rental homes) and traditional dorms. American Campus Communities (NYSE: ACC), one of the leaders in student housing, determined that only 21% of the student housing supply in

Figure 1: States & Universities with New Deliveries by Year Since 1995



Source: Axiometrics Inc. Based on coverage as of October 2013.

their markets was purpose-built for students, with alternate supply (58%) and on-campus housing (21%) making up the remainder. As purpose-built supply enters the market, alternate student housing choices and outdated dorms are increasingly at risk of losing students.

For purpose-built supply, a property's proximity to campus is a good gauge for how it will be affected by new supply entering the market. Properties within 0.5 miles from campus tend to have higher barriers to entry and tend to lease the strongest as students prefer to live near their classes (the snooze button can be hard to resist sometimes).

Cause for Concern?
As of late, headlines of growing student debt burdens, slowing college enrollment, and increasing use of online college courses have caused concern for potential investors. However, most news reports have relied on data that considers the entire college universe, including public, private, for-profit, not-for-profit, 2-year, and 4-year universities.

In 2012, 71% of students that graduated from four-year colleges had almost $30,000 in debt. However, in relation to how the REITs are impacted, the data is skewed. 75% of students from private non-profit universities borrowed an average of $32,300 and 88% of students from for-profit universities borrowed an average of $39,950. Most of the markets that are targeted by the student housing REITs (especially ACC and EDR(NYSE:EDR)) are public, four-year, "Tier-1" (broadly defined as large and research-oriented with diverse programs) universities. For these universities, the average student debt at graduation was closer to $25,000, and 43% actually graduated with no debt! Even with student debt, a college degree still remains valuable because the average annual salary differential between a high school and college graduate is about $24,000, almost a one-year payoff excluding income taxes.

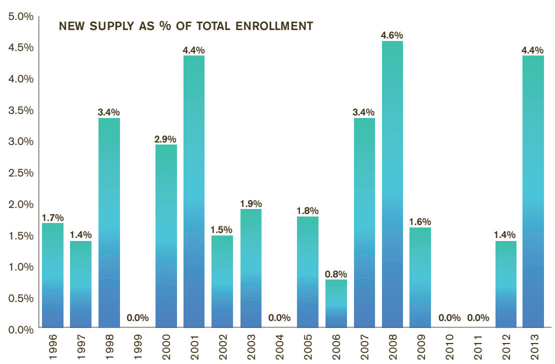
Though there is volatility in enrollment trends, according to the National Center for Education Statistics (NCES), from 2014 to 2021, college enrollment is expected to increase 1.1% per year to nearly 24 million students. Additionally, a historical correlation exists between college size and enrollment trends with "Tier-1" universities experiencing the highest median enrollment growth. These are the markets that REITs are targeting. REITs control risk of fluctuating enrollment by investing in new facilities either on campus or within walking distance. In addition, they target universities with high applicant-to-admitted ratios (the inverse of the acceptance ratio).

We do not believe that online classes and large universities are targeting the same students. Richard Levin, the CEO of Coursera—an organization which offers free online courses from universities around the world—does not believe they will be a replacement for the traditional 4-year residential universities (Richard also happens to be the former president of Yale University). Instead, they are trying to serve those who do not have access to higher education. Additionally, recent studies on online classes by the University of Pennsylvania have shown that course completion rates have averaged only 4%, with participation falling off significantly after only a few weeks! With statistics like that, it is hard to argue for online education being a substitute for physical classes at a Tier-1 university. Though online classes, the potential for declining enrollment, and rising student debt are legitimate issues, REIT-targeted universities should be the most insulated.

Austin, Texas Case Study
New, purpose-built student housing supply is *replacing* alternate housing and therefore, by itself, new construction is not necessarily all bad for landlords. In late 2013, ACC conducted a case study on the student housing market for the University of Texas at Austin (UT). The study looked at data going back to 1996 when the UT market was 7% purpose-built, 13% on-campus, and 80% alternate supply. From 1996 to 2013, the UT market was what many would call a "worst-case scenario" for owners of student housing. Enrollment limits at UT translated into annual student growth of only 0.5%, while the student housing supply skyrocketed. From 1996-2005, Riverside, an area about 4.5 miles from campus with little barriers to entry, added 7,500 purpose-built beds, and from 2005-2013, over 8,800 purpose-built beds

(17 projects) were delivered pedestrian to the university in an area dubbed West Campus. On-campus supply also added 1,300 beds. Figure 2 shows the supply delivered from 1996-2013 as a percent of the total student enrollment.

Figure 2: The University of Texas - Austin



Source: The University of Texas Office of Management and analysis; ACC Market Research.

Despite the "worst-case scenario", the new on-campus housing was 100% occupied and new supply in the West Campus and Riverside submarkets were 97.4% and 94.4% occupied, respectively! Even better, Austin was ACC's top market that year with +8.9% rental growth. The reason? The new modernized supply took share away from alternate supply so that, by 2013, market share had shifted to 37% purpose-built, 14% on-campus, and 49% alternate supply.

What's next?

The student housing REITs are upgrading the quality of their portfolios by reducing the average distance from campus. One of the main drivers of this movement will be public-private partnerships (PPP) with the universities they serve. In a public-private partnership, a university partners with a third party to develop and/or operate on-campus student housing. There are currently two different structures of PPPs. In the first, the university maintains ownership of the land and finances the development, hiring a third party (usually a student housing REIT or private developer) to oversee the development. The fees create short-term earnings for REITs, and the partnership gives them an opportunity to showcase their product. In the other structure, the REIT finances the development and enters into a ground lease with the university typically lasting 70-90 years. In such an agreement, the REIT maintains ownership and operations of the property. It expedites the development process as the REIT is able to act without having to go through the bureaucratic processes a university would. Importantly, the structure creates long term value for the REIT as they receive the full upside potential of operations, and they become owners of an irreplaceable asset—one that should hold its value over the course of time.

PPP properties typically receive more applications than there are beds because universities usually have mandatory requirements for some students to live on-campus. The university is also incentivized to promote leasing, as high occupancy helps secure the ground lease payment from the REIT. Furthermore, being on-campus benefits the REIT from a competitive supply perspective because it would be impossible to duplicate their location. As REITs continue to add successful PPPs to their resume, more universities will begin to come forward with solicitations for partnerships, in our opinion.

PPPs could also become more popular due to budget cuts at most universities, even as tuition has been increasing. Over 25% of university budgets are from state appropriations, and, as of 2013, median state appropriations per student remained 16% below that of 2009. While university budgets are tight, they still need to reinvest in their infrastructure (especially housing!) in order to attract the top students. Universities are finding that a ground lease-type PPP solves this problem. The university avoids taking on development and the capital requirements, while gaining an additional revenue stream from ground lease payments. In many situations, the university also benefits from a long-term partnership with a REIT or other institutional owner that has an infinite life, a solid balance sheet, and proven expertise in student housing development and operations.

"...they still need to reinvest in their infrastructure in order to attract the top students."

The University of Kentucky, featuring EDR

EDR was selected by the University of Kentucky (UK) to develop, own, and manage a multi-phase project with the goal of revitalizing the on-campus housing. The $500 million project began in April 2012 and is expected to continue until 2017/2019. In total, EDR will be replacing 6,000 existing beds (most of which date back to the 1950's) with 9,000 modernized beds. To date, 64% of the beds have been formally approved through 2016 for a total cost of almost $350 million. As of 1Q 2014, the units available for this fall are 181% applied for, highlighting the intense demand for new, purpose-built housing.

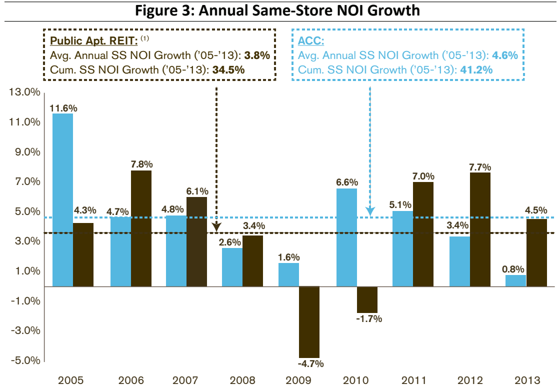
The deal was structured as a ground lease-type PPP (75 year lease), with EDR providing 100% of the capital requirements. This structure allowed the University of Kentucky to preserve their debt capacity for academic uses in addition to receiving a percentage of the dorms' revenues as a lease payment. UK will link the dorms to their housing website to help drive occupancy, while EDR will maintain full control over operations.

Many universities have begun to take note of the outstanding performance of PPPs like that of EDR and the University of Kentucky. At EDR's investor day, it was revealed that tens of other schools have called UK officials about their partnership with EDR, and another dozen or so have visited the assets. Starting from zero dollars in 2008, EDR and ACC will have invested $1.6 billion in on-campus equity developments by the year 2016. With yields that reach up to 8%, it appears that on-campus public-private partnerships will only continue to gain in popularity.

Student Housing Internal Growth

Student housing has a history of solid internal growth as outlined in Figure 3, which compares the historical same store NOI growth for student housing versus apartment REITs. We use ACC as a proxy for the student housing REITs due to its size and having the longest life as a publicly traded REIT. Since ACC became public, they have outperformed apartments in same store NOI growth by 80bps per year on average. The chart also illustrates that student housing REITs maintained positive NOI growth through the years of 2008-2010, suggesting that student housing might provide an advantage over apartments or other property sectors during a recession.

Figure 3: Annual Same-Store NOI Growth



Source: American Campus Communities, Company filings, SNL financial.
1) Includes AEC, HME, UDR, ESS, MAA, AIV, EQR, AVB, CPT, CLP, BRE and PPS

The future looks bright for student housing REITs as the fundamentals and sector trends give them paths for both internal and external growth. With the opportunity to gain market share in new and existing markets through the modernization of supply, look for the student housing REITs to be at the top of the class.

We currently do not own any student housing REITs due to valuation, but we will be reevaluating our target prices after 2Q earnings.

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RMS: 1545 (7.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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