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SOP Student Housing Forum Takeaways: Reading, Writing and Core Investing

While Student Housing may only have two public companies, the level of institutional interest continues to grow with return expectations steadily declining as shooting for the stars is replaced with the luxuriousness of consistent mid-upper single digit returns. Earlier this week we hosted ACC, EDR, Harrison Street, Landmark Properties, Peak Campus and Pierce Education Properties at our 7th Annual Student Housing REIT Forum at our New York office. The biggest takeaway from the general panel session was the extent to which the sector has matured both in fewer concession battles during preleasing and that merchant developers are choosing to keep more of their product (allure of NOI) which echoes the sentiment we heard at this year's InterFace conference (see our April 10 note, "InterFace Student Housing Takeaways: For the Growing Love of Cash Flows"). The sector continues to see increased interest from institutional investors, with one panelist noting that 40% of institutional investors planned on allocating money to Student Housing according to a recent industry survey.

Despite the increased interest, investor expectations remain low with larger investors content with mid-single digit returns. One of the panelists noted a leading SWF said that Student Housing provides some of the best risk-adjusted returns at 5%. On the transaction front, it seems as though 2017 will have fewer transactions (estimated to be ~$5b, of which ~ $2.5b has already transacted) than 2016 (~$10b) as merchant builders are holding on to properties longer and fewer large portfolios are expected to come to market. While starts may be coming down for next year, deal sizes are not. Despite the smaller bed count of the newer projects, the cost has essentially doubled ($30m average to $70m+) as these deals are more infill, pedestrian to campus. Cap rates remain low and stable for the sector broadly, particularly for pedestrian assets while off campus cap rates can see variability based on local conditions. The panels noted that while the influx of infill purpose built projects have disrupted the rents of drive properties, once the assets reprice, those same drive assets tend to draft off of the rate increases of the pedestrian. With a $300 - $500/month pricing difference, those assets appeal to a broader student base but for the operator, mean lower margins in that the extra cost of landscaping, shuttle service, more exposed exterior walls all increase the relative operating costs.

In contrast to the prior years, the idea of going public seems to be growing among the private companies; though, they all seem to prize the ability to operate and compensate away from the transparent public market eyes. While all the privates were clear there is sufficient equity capital to stay private, we believe the ability to convert to an infinite life vehicle that has the potential to trade at premiums to private market values and build wealth through public shares seems to be growing. The challenge of course is the track record of the public Student Housing REITs - of the four, ACC is the only one that's been a success from the get-go, while EDR underwent a reboot before they succeeded where as GMH and Campus Crest never translated. Thus, we believe any private looking to go public needs to have a sufficient track record of performance and should be of size so that it is relevant in a sector that is only ~2% of index. With an IPO, however, comes the need for lower leverage, the likelihood of less development versus stabilized assets, and the need for public disclosure. In addition, whereas private companies often have lucrative promotes, these would likely need to be settled up beforehand so that public shareholders are not asked to compensate for the past. Though ACC and EDR have hammered home pedestrian class A, we believe a more diverse portfolio could work, assuming the historic performance is there.

On the public side, ACC is looking to pare back the level of detail in their preleasing stats to more general quarterly commentary as it seems the market often uses the disclosure against them (EDR is undecided). As the private companies on the panel noted, preleasing stats are varying +/-300bps in occupancy with rent growth 2.5% - 3.0% for this coming Fall and yet all expect to achieve their preleasing goals. Both ACC and EDR made it clear that being ahead or behind in pre-leasing has very little to do with where the portfolio ends up. Ultimately, no investor would publicly advocate for less disclosure but many of the attendees understand the frustration among the public REITs. While we like the transparency of the current preleasing disclosure, we agree with ACC that it seems to cause more headache for the company as folks focus on the moment-in-time minutia versus the totality of the trade-off between rent and occupancy to maximize NOI.

While none of the panelists see a growing trend of multi-year stabilizations of new developments, they all seemed to agree that there is more focus at ensuring on-time deliveries in light of a tighter labor and regulatory environment. A seemingly easy fix is to start sooner so the CO date is advanced 30-90 days than previously (traditionally August 1) but this increases the project's cost because of the added carry. That said, it seems a small price to pay top ensure on-time opening. As those developments progress, the question of stable cash flow evokes the question of location. Interestingly, despite the holy grail on developing on-campus, these assets are still very much subject to the pricing of off-campus and thus tend to price below, so as to maintain a steady 2% - 3% rent growth profile versus the volatility that can occur off-campus as landlords maximize price each year but then pullback in face of new supply.

With Harrison Street partnering in an open-ended fund with Capstone to build equity on-campus deals, there is a steady growing pool of players to compete with ACC and EDR's equity on-campus programs though the private companies noted the challenge of measuring up to the brand name and public disclosure of ACC or EDR. While there are 10-12 bidders on college RFP's, it doesn't seem like all have the same debt, equity, or fee capability depending on the school's ultimate decision. The attraction, however, is the lower volatility of on-campus to allow private platforms to invest more core dollars. As one panelist noted, if developing on-campus real estate is the botanical equivalent to planting a single tree, then off-campus development is the equivalent to planting a tree farm. It is for that very reason, therefore, that despite the long gestation period, some of the privates have expressed interest in growing to the on-campus space. Finally, while financing is not an issue for the sector, several of the panelists noted that the implementation of tighter banking regulations (HVCRE) varies tremendously by bank, with some even increasing the leverage on developments (up to 70% versus 65% last year).

APPENDIX

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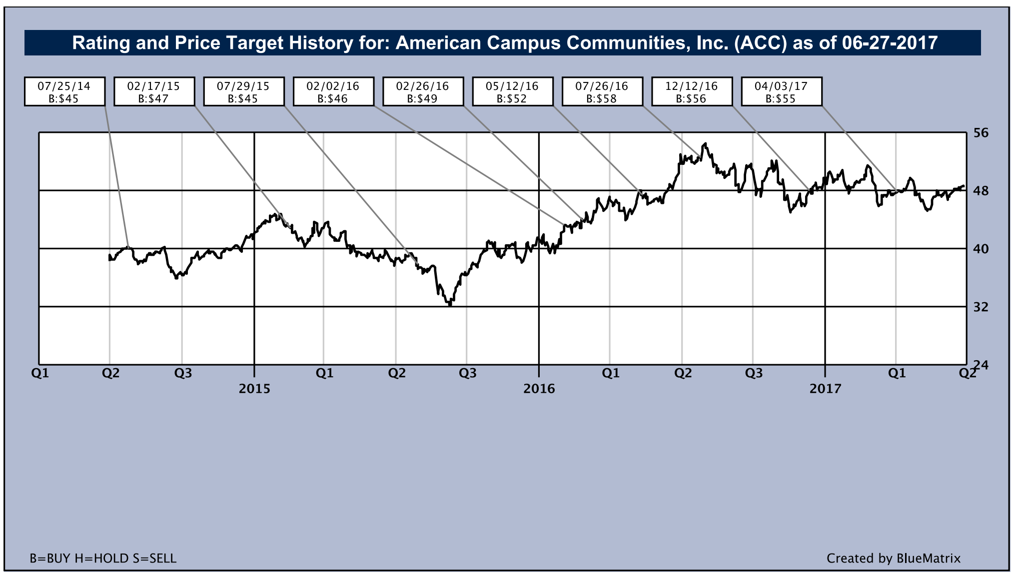

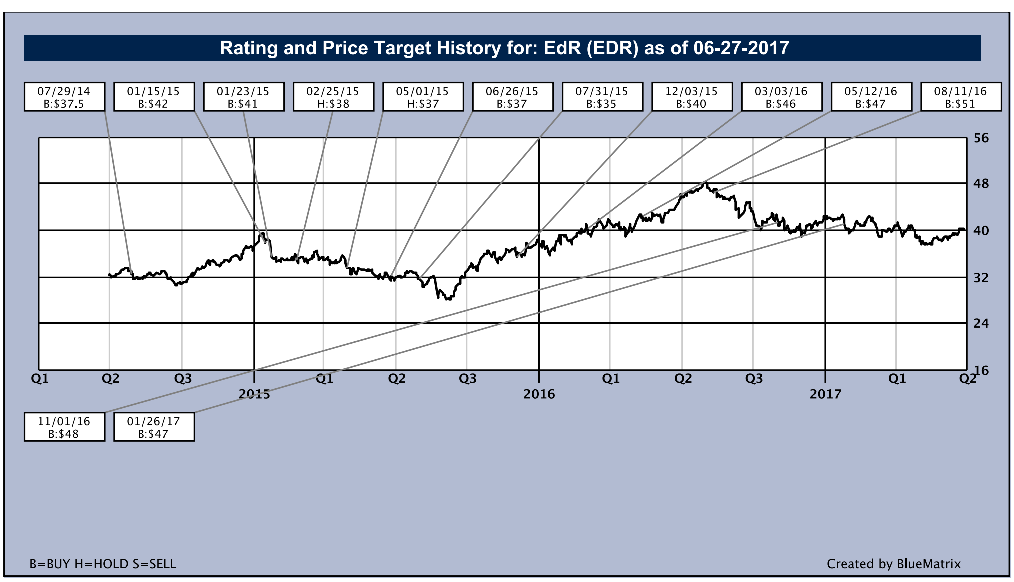

EdR (EDR)

Price Target
Our 12-month price target is $47.

Valuation Methodology
Our $47 price target represents 24.7x our 2017E of FFO, a 2017E dividend yield of 3.3% and a 2017E AFFO yield of 4.1%.

Risk Factors
EDR is subject to a number of risks, including development, leasing and credit. The biggest risk to student housing is new supply.

The company is also reliant on the cooperation and partnership of public universities, particularly for its ONE Plan program. The terms of the projects must be negotiated and any of those deals has the potential to fall apart as they move through the negotiation with and lengthy approval process of the schools.

EDR has to continuously raise common equity to fund acquisitions and development, requiring the company to generate a positive return on that capital sufficient to offset the dilution from those offerings.

Unlike typical apartments, where units can be leased year round, the student housing leasing season is school specific (but can start as early as the first day of school). If EDR fails to successfully complete its leasing and turning programs within these time-frames, its earnings could be negatively impacted.

American Campus Communities (ACC)

Price Target
Our 12-month price target is $55.

Valuation Methodology
Our $55 price target represents 23.3x our 2017E, a 2017E dividend yield of 3.2%, and a 2017E AFFO yield 4.0%.

Risk Factors
ACC is subject to a number of risks, including development, leasing, and credit, but the biggest risk to student housing is new supply.

The company is also reliant on the cooperation and partnership of public universities, particularly for its ACE program. Although ACC has a number of these developments approved, the terms of the projects must be negotiated and any of those deals has the potential to fall apart as they move through the negotiation with and lengthy approval process of the schools.

ACC develops a number of its properties, creating a possibility that the company will not meet its revenue targets while still being exposed to potential cost overruns on projects in pre-development or future developments as they break ground.

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