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Old School, New Analysis

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Consider these factors before investing in student housing.

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Dormitory *B*

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Finance *A*

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Location *A-*

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**Examination**

by | Adam Hird



Grades: A, Excellent; B, Good; C, Satisfactory;



While real estate activity has picked up so far in 2011, investors are still very cautious about their property investments. The areas that have remained relatively strong are those niche-market sectors that allow easy identification of a market's demand generator and its potential for growth.

The student-housing market is an area with strong demand, according to the National Center for Education Statistics. Data indicate that college enrollment will likely increase by 11 percent between 2002 and 2013. This, coupled with the fact that rents for student-housing properties have been rising at a higher rate than they have for conventional apartments, can provide a base level of confidence for investors. However, there are other factors to consider in determining if an investment is viable.

When evaluating properties located close to universities, investors should review the university's historical growth, plans and funding for future growth, educational standards and programs, and special programs, among other factors. Ascertaining the potential for growth and future demand is the common factor: Investors must be confident that demand will outperform the creation of a viable new supply. But beyond that, investors must analyze a market's urban fabric to predict if a real estate market supply shortage is inevitable.

The following examples from university markets indicate the typical and less-common challenges that determine the direction of supply and demand in student housing.

### Leveraging Entry Barriers

Barriers to entry for new real estate include zoning issues, difficult terrain, and high density. Cities with increasing demand grow naturally and government restrictions can impede that growth. But these restrictions are artificial and can easily be removed. For example, in Austin, Texas, zoning regulations were protecting the low density housing around the growing University of Texas. Over time, the city realized that this was pushing student-oriented development away from the university, which siphoned off demand for nearby retail and created additional traffic congestion and campus parking issues.

Eventually the city eased the zoning restrictions and, in just a couple of years, the market near the university went from undersupplied to oversupplied. New buildings were forced to reduce rental rates and were still unable to reach decent occupancy levels. In addition, cleared lots are ready for more complexes to be built. As a result, the supply-demand imbalance will not be in the property owner's favor for some time to come.

In some cases, the zoning regulations may not be the barrier they are perceived to be. For instance, Oxford, Ohio, home of Miami University, has been described as a difficult anti-development environment by several real estate professionals. However, a recent site visit and look at the urban fabric revealed otherwise: The city of Oxford's zoning promotes New Urbanism, which is the use of historic patterns of urban development such as walkable streets, apartments

over retail that front the street, and parking hidden within the urban fabric. Developers have been proposing projects set back from the road with large parking lots facing the street — a more common housing type but not one suited to this particular community. The community isn't anti-development, just misunderstood by developers.

Terrain is another barrier to future supply. For example, a school located on a river presents an obvious barrier to well-located competition: Students make housing choices based on the part of campus where the majority of their classes are held. Terrain problems also might include steep grades that are often not practical for major construction, limiting development as well. Constructed barriers, such as large highways and railroad tracks, especially freight lines, also form obstacles to access and impair growth.

In fact, most large campuses that are in or against mountains tend to have shortages of housing: for example, Appalachian State University in Boone, N.C., and California Polytechnic State University in San Luis Obispo. In

## STUDENT HOUSING INVESTMENT STATS

- Activity: \$41.3 billion properties on the market
- First-year cash on cash yield: 8% to 9%
- Rents: 10% to 20% higher than traditional apartments
- Expense ratio: 45% of revenues, compared with 35% to 38% on traditional apartments
- Occupancy average: 98%
- Rent growth: 3% to 5% since 2006

Source: MarketWatch.com, Sept. 24, 2010

comparison, agricultural fields are not barriers and actually are potential sites of new supply in a market. Several universities are beginning to lease or otherwise use their agricultural fields for new university housing, including California State University at Fresno and the University of California at Davis.

### Competing Uses

Predominant use also may compete with the demand generator in university towns. Property surrounding the University of South Carolina in Columbia is dominated by the state government buildings and downtown offices on two sides. The university and related private housing and retail will not be able to expand into these areas because the property is too valuable and the government use is as enduring as the university.

will continue to use the open land and limit new student-housing supply in the future.

### Exploring Growth Opportunities

An examination of the finer detail and a review of existing structures also are important for determining the future growth opportunities of a market. For example, are there well-maintained homes on small lots? These could be very difficult to buy up at the quantity and price necessary for future development.

Yet as the quality of the property on small lots changes, so does the possibility of development, as shown by student-housing expansion at Texas Tech University in Lubbock. In a fringe neighborhood, homes had lapsed into disrepair and the neighborhood had deteriorated because investing in improving a small home on a small lot in this area would not have been practical, given affordability of land and housing in the area. This allowed a local developer to capitalize on this lower-cost property convenient to the campus and acquire more than 900 acres for development adjacent to Texas Tech.

It also is important to understand the potential for adaptive reuse of the existing buildings within a city. For instance, in any housing, bedrooms and living spaces must have exposure to sunlight. Therefore, the maximum depth of an apartment is generally considered to be 30 feet from the exterior wall. Assuming a configuration of apartments on both sides of a corridor, it is very difficult to efficiently convert a building that is more than 70 feet deep into housing as typically anything more than 65 feet deep is not ideal. For example, an old loft building might look like a potential development for housing, but if it is too deep, it cannot be adapted efficiently and may not be a potential threat for additional supply.

Dense areas that leave few opportunities for redevelopment also reduce the opportunities for parking, making the close proximity of student-housing properties to the university even more important.

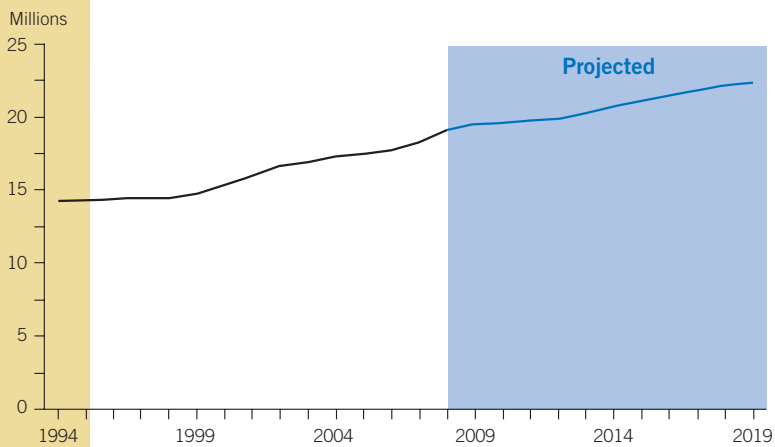
In any setting, the value of the property also is a reflection of the infrastructure in place. A free-standing single-use retail establishment, such as a fast-food restaurant or a gas station surrounded by a parking lot, is a potential target for a developer, particularly if it is close to a demand generator. Within the urban neighborhoods surrounding Virginia Commonwealth University in Richmond, a free-standing Hardees stood directly across the street from the university until a few years ago. The site's proximity to the university and low density made it an optimal location for a tear down and redevelopment into student housing. The property is now a four-story student-housing complex over one story of student-oriented retail and restaurants.

The most important issue for investors to understand is where demand is coming from and if it will grow. With a clear understanding of a market's urban growth patterns and a potential asset's ability to provide favorable returns, investors can not only make wise investments, but can ensure that the value of those investments remains high into the future.

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## U.S. COLLEGE ENROLLMENT



Source: National Center for Education Statistics

What goes on below the ground also can affect growth. When looking at the market of Indiana University in Bloomington, for example, large tracks of land just outside the city limits look like an immediate threat for future oversupply of multifamily housing. But further consideration reveals that this area is not serviced by sewer systems, and large-scale septic systems are not feasible with the large amounts of limestone and karst below grade and a protected aquifer yet farther below. This area also is a shopping and office district for five rural counties, so the current trend of office and retail, which do not have large septic requirements,

In addition to quality of value, density and the residual value of underdeveloped property are factors. In a dense urban market where few opportunities for development exist and growth is pushed away from demand generators, neighborhoods with small buildings on large lots are attractive to investors because they are easy to buy and redevelop. The University of Illinois at Urbana-Champaign is an example of an urban center that is mixed with low-density lots. Many of these lots have recently been redeveloped with high-rise buildings and now this market is in danger of being oversupplied with housing.