Kings of the castle

The student accommodation sector is in the midst of a boom. How long will it last, asks **Daniel Thomas**

To property investors, student accommodation has always seemed Teflon-coated. While much of the real estate market suffered after the 2008 crash, purpose built student accommodation (PBSA) bucked the trend: investment, development and rental yields have risen consistently for 20 years and currently outperform every other property asset class in existence.

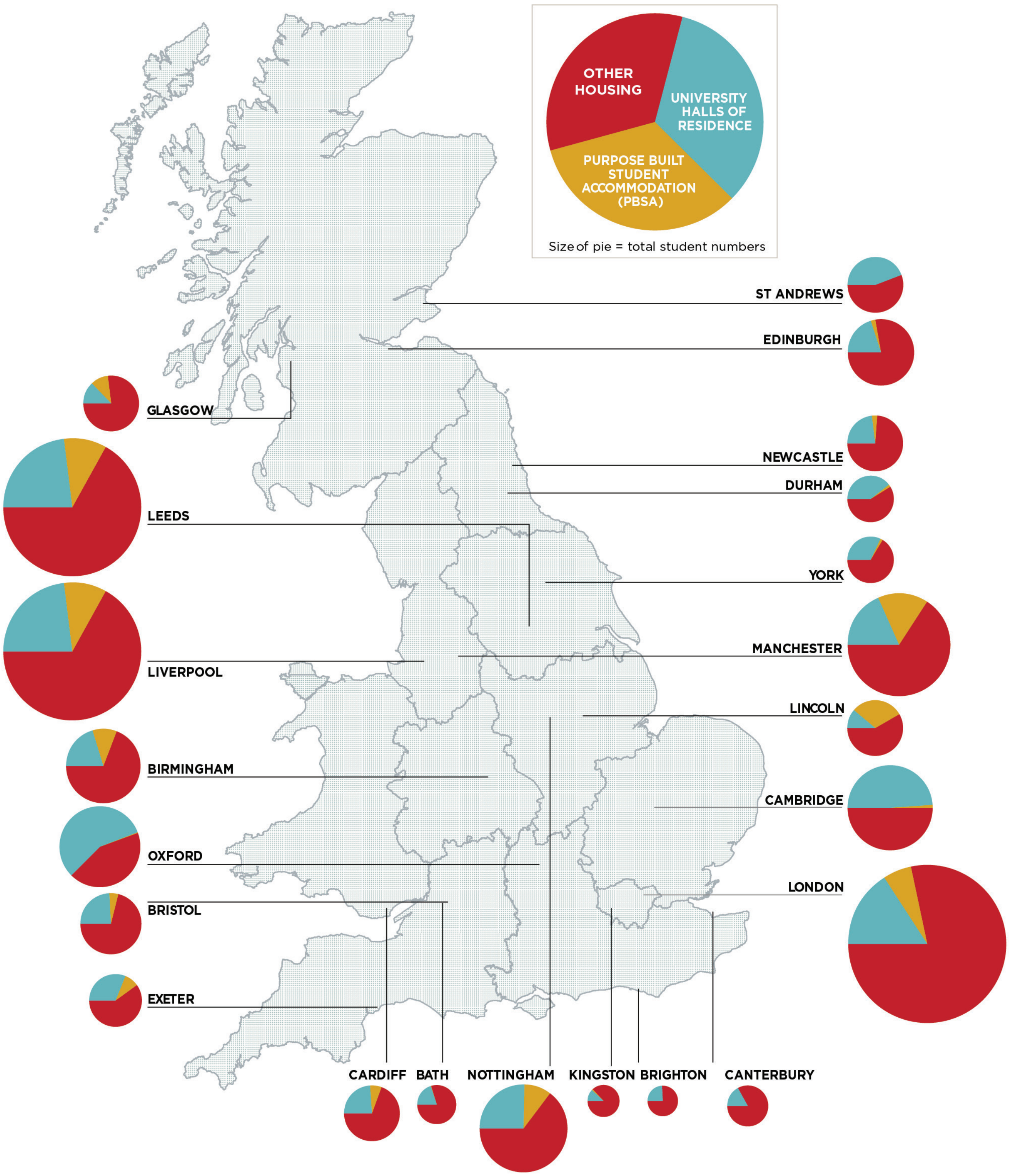
With ever rising demand for better student digs, and increasing institutional investment in the space, the result has been almost weekly announcements of new schemes. There have also been some gargantuan deals: UPP, a leading developer and manager, launched a £5 billion bond programme this time last year (nearly £400 million has been raised in the initial issuance). According to Dealogic, it is one of the biggest programmes of its kind by any property firm ever.

In a market moving this fast, however, it was perhaps inevitable that there would be casualties, too. Last year saw Opal, one the country's biggest operators, collapse under the weight of unsustainable debts. Two large retail investor funds in the space were suspended as well, spurring allegations of overhyped expectations and an 'overhang' of unsold property caused by the Opal disposal.

While it would be hasty to read these occurrences as part of a trend, they have exposed some of the risks in the sector. It all raises a pertinent question: just how long will the good times roll?

This question is all the more relevant as the sector hurtles towards its first significant hurdle. In 2015 the cap on government-funded student places will be removed, flinging the doors of higher education open to market forces. This will likely mean some universities grow, while others shrink, affecting the distribution of demand for student housing. Investors are going to need to be cannier, it seems, if they're to continue getting such bang for their buck.

FIGURE 1
A STRUCTURALLY UNDERSUPPLIED MARKET



Source: Knight Frank/QS

Boom time

What has made PBSA so attractive to investors is a rather serendipitous confluence: demand for higher education has risen consistently for the last 20 years in a sector that's structurally undersupplied. "Students fundamentally don't have enough access to enough purpose built accommodation," says James Pullan, head of student property at Knight Frank. "Every core market needs more of it."

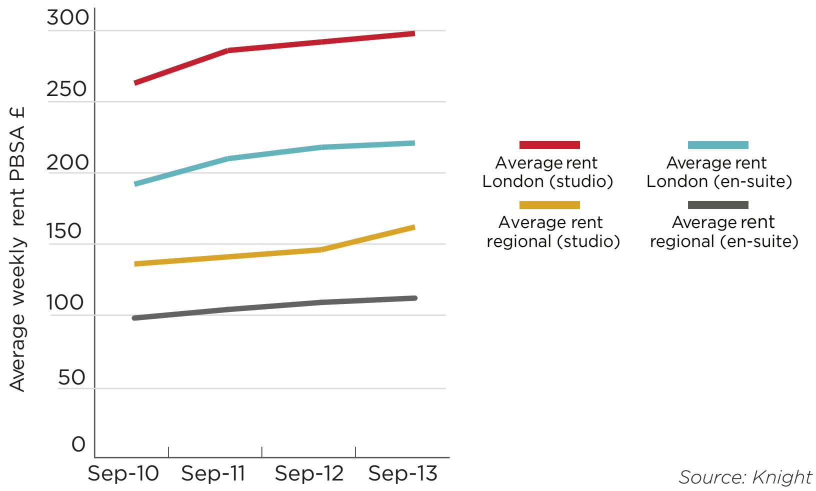
Driving this, a number of reports suggest, is a trend of students moving away from private house-shares – which account for about two thirds of Britain's 1.4 million student beds – to purpose-built digs. They're also willing to spend more money to get better accommodation, it seems, paying premiums of between 20% and 75%, depending on the city. "It's been driven by student choice," explains Pullan. "They are actively choosing to have better specs, and safer, well-located housing."

At present this shift benefits universities most, as they own or have a stake in around 320,000 PBSA beds; the private sector has just 161,000. But this might be changing, as cash-strapped universities cut their capital spending on accommodation, creating a natural opportunity for the private sector to step in – either through joint ventures, or by building their own, off-campus alternatives.

Best of all, the process is self-reinforcing. With the supply of purpose-built rooms increasing, the number of students willing to settle for the shabby halls on campus is falling: universities may need to either up their game, or outsource the job to someone else.

Unite's Woodland Court, London

FIGURE 2
RENTAL GROWTH



Source: Knight Frank

Home and away

There are questions over how long the growth in demand from students can continue, however. For one thing, while domestic students still account for the majority of PBSA beds, a disproportionate share of demand comes from international students. According to Unite Group, the UK's largest developer and manager of student accommodation, some 35% of the 41,000 rooms it manages are occupied by foreigners. "To put that in context, international students account for somewhere in the low 20%'s of all student accommodation nationally," chief executive Mark Allan says. "So purpose built accommodation does over index international students."

International students tend to favour PBSA because of its better facilities, the greater security it is perceived to offer, and its location. They're also willing to pay a significant premium for it, leading to the emergence of a sub market for luxury digs, particularly in London, where renting a self-contained studio flat in Zone 1 can cost as much as £14,000 a year.

The luxury market has handily filled a hole for developers: the capital's sky high land prices have made it untenable to build mid-market PBSA in much of the city, despite it being the country's number one student destination. But the flipside is that domestic students – who still constitute the bulk of demand in absolute terms – have been priced out. Allan says Unite's zones 2 and 3 properties have a fairly even split of domestic and foreign students; but 80%-90% of its central London accommodation is occupied by internationals. And, in the capital at least, new properties are slow to come on stream. "We haven't put anything under offer in London from a development point of view for nine months," Allan notes despondently.

Not surprisingly, talk of overheating is circulating. "At some levels of pricing the market has become very highly competitive, and there is evidence of empty rooms at higher prices [in London]," says Sarah Jones, associate director of education at property consultancy DTZ. The market is characterised by "lots of incredibly high quality but small schemes with not much to differentiate them," she adds.

On top of this, the government still hasn't abandoned its policy to lower net migration to the tens of thousands by 2015, despite repeated assurances from the business department that numbers in higher education will rise. Foreign students have faced tougher border policies over the last few years, and although their number has ticked up, they've grown at a slower pace; the number coming from some markets, like India, have even seen precipitous falls. A further tightening of student immigration policy – say, in reaction to the rise of UKIP – or other market shocks such as fluctuating exchange rates, could see growth stall, and that could leave some developers struggling.

Home on the range

As soon as you get beyond the M25, however, such problems evaporate. Outside London land prices in most areas are at cyclical lows, making building far easier. Tenants are predominantly domestic too, and, as mentioned, are increasingly willing to stump up for better digs.

That is not to say developers don't need to know their onions, though. Picking the right institution, the right city – and the right location within it – is vital, especially in areas where development is starting to get crowded. Stories circulate about schemes struggling to fill rooms in cities like Manchester, Bolton and Leeds. "We hear about schemes where investors have felt they could put a block anywhere and now they're not full," says Jones. "You need a critical eye."

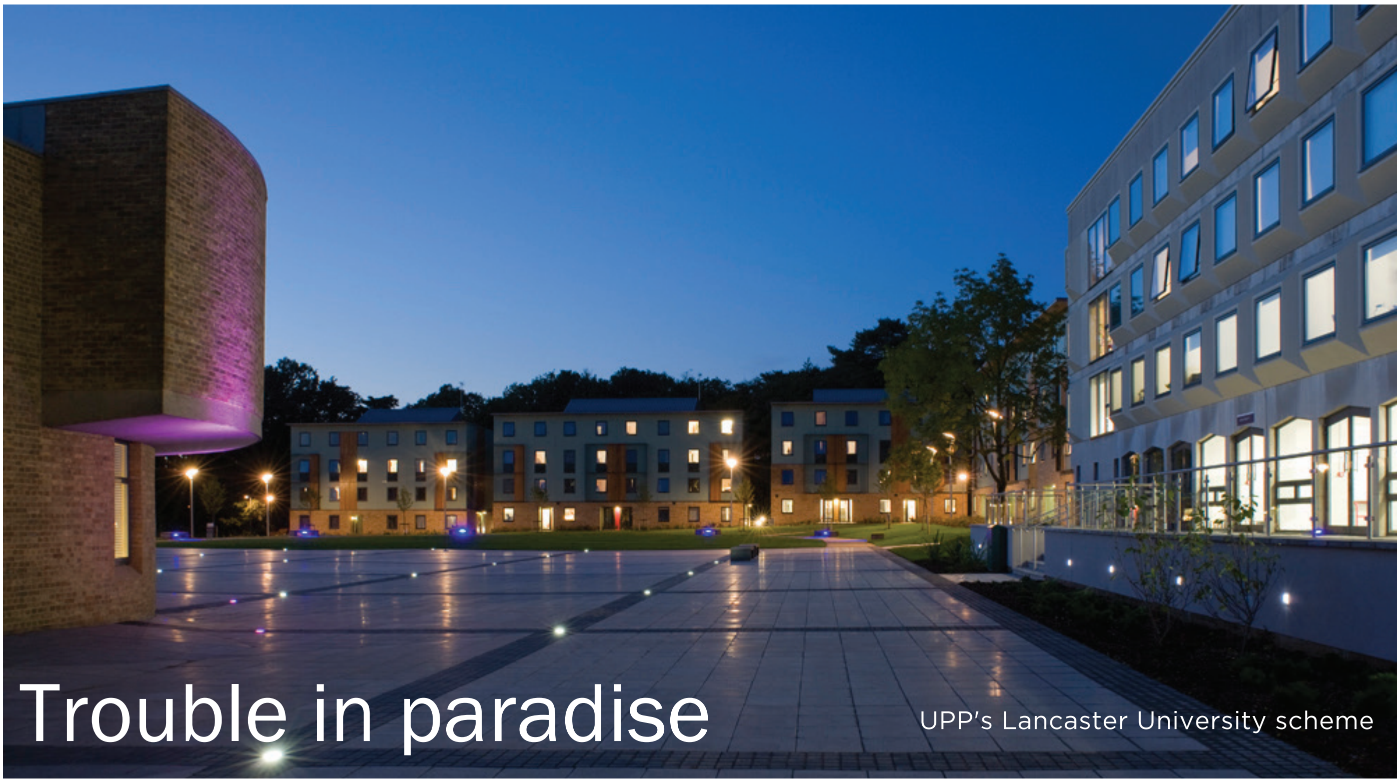
To complicate matters, gauging student demand is about to get harder. Come 2015, the government will remove the cap on student numbers, creating an estimated 60,000 extra university places annually – although this will be offset to some degree by demography, as the total number university age students in the UK declines until early next decade. Regardless, the reform will leave the sector open to market forces in a way never seen before: universities will be freed to compete for as many students as they like, using quality and pricing as bait.

"Not everyone can be a winner," says Unite's Mark Allan. "Some universities are going to struggle to maintain their enrolment levels."

The uncapping of places for ABB students in 2012 has provided a glimpse of what might happen in the 2015-16 academic year. Universities that teach a broad range of subjects but have relatively low entry criteria may struggle and shrink, as those with better brands and reputations – Russell Group institutions, for example – expand. Those at the bottom of the pile may start to close unpopular courses, while they increase their vocational offer and focus on the local community. With a growing number of students living at home, demand for student accommodation could fall.

The biggest developers appear to be well prepared for the change – Unite, for example, has only ever built in high demand locales (although, interestingly, it's expecting domestic demand to remain "broadly static"). Others add that, apart from a few pockets, the effects of the reform are likely to be incremental – although in the long term, patterns of demand could shift dramatically. "There will probably be areas where people thought their model was sustainable but it turns out not to be," warns Jones. "If you go into a one-university town that has a very local student population and you build something that's too big, there's nothing really you can do with it. If you can't fill it with key workers you're stuck."

Unite's Moonraker Point, Kings College London



Trouble in paradise

UPP's Lancaster University scheme

So, there's a growing awareness that the opportunities come with risks attached. Consider the fact that last year saw two open-ended retail investor funds in the sector suspended, after a run of redemption requests which left some investors unable to get their cash out.

The first and biggest, the £1 billion Brandeaux Student Accommodation Fund, stopped issuing new subscriptions or redemptions in June, laying a large portion of the blame on an overheated market. The fund claimed that some £2 billion of student property stood unsold, partly because of the financial collapse of the Opal Group, which had left some 19,000 additional beds on the market. Unable to trade its own properties, the fund said, it just didn't have the cash to satisfy redemptions.

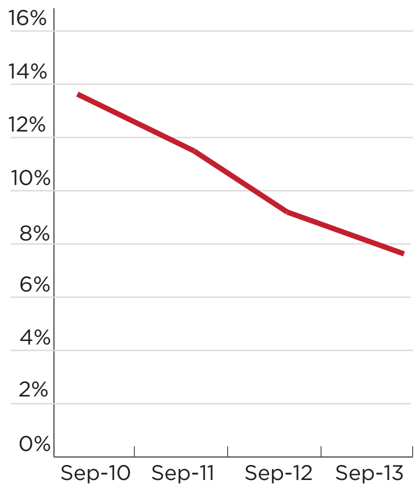
The second, the £282 million Mansion Student Accommodation Fund (MSAF), was suspended in similar circumstances in October. Beyond a brief statement, the Channel Islands-listed fund didn't elaborate on what went wrong – although a former investor was more than happy to give his account of events. John Greenwood, chief executive of fund management group Creechurch Capital, had invested £5 million into MSAF but exited last June, as returns began to tumble. "In many ways MSAF was a victim of its own success," he told *EducationInvestor*. "Early excess returns of the fund became expected rather than appreciated by the market, and [the fund] was unduly punished when the return profile normalised."

The decline was startling. From a phenomenal 30.1% in 2010, returns dropped to 9.8% in 2012 and 4.6% in 2013. A downward trend is apparent right across the sector (see figure 3) in fact, but Greenwood believes that "investment marketing" sometimes skims over such risks. Also underplayed are the threat of competition from new entrants, and the fact that most developments don't come with long term rental leases in place, unless block booked by a university. "In its basic state, it is commercial property investment and carries all the same risks associated" with that, he says.

Others' faith in PBSA as an asset class remains undimmed, though. Both Unite and Coral Portfolio, another big fund, have poured scorn on Brandeaux's claims of overhang, pointing to the speed at which Opal's portfolios were snapped up by the US investors Avenue Capital and Greystar last autumn (another portfolio is now subject to contract; a fourth still on its way to market). Money has also flooded in from institutional investors, including the pensions giant Legal & General, which invested in Unite Group, and M&G, the fund manager arm of Prudential, which backed Round Hill Capital's purchase of the Nido portfolio.

The real problem, say critics, is that retail investor funds just don't work for the sector. They are aimed at private investors who buy shares in much smaller quantities than larger, institutional ones, and promise to be 'open ended', allowing investors to enter and exit when they wish. But their shares aren't tradable and, with their cash tied up in bricks and mortar, they're more at risk of becoming illiquid. They also do not pay dividends, so investors are entirely reliant on redemption mechanisms to get any cash back.

FIGURE 3
TOTTING UP TOTAL RETURNS



Source: Knight Frank

Big deals

2010

Knightsbridge Student Housing, backed by Oaktree Capital, is launched to target £1 billion of student accommodation acquisitions in Britain and mainland Europe.

2012

Round Hill Capital buys the Nido student housing portfolio from Blackstone for £424 million. M&G, the fund management arm of Prudential, and US hedge fund Och-Ziff Capital Management Group help finance the deal.

2012

UPP, one of the sector's leading developer-managers, launches a £5 billion bond programme (nearly £400 million has been raised in the initial issuance). It is thought to be one of the biggest programmes of its kind by any property firm ever.

A sustainable future?

The sector is now looking at ways round this. Its first real estate investment trust (REIT), Gravis Capital Partners Student Living, launched last year; as a listed entity, this offers a much more liquid way of investing in PBSA. More REITs are expected this year, chiming with a broader trend towards for a more sustainable style of operating in the sector. PBSA is, after all, maturing and growth is almost certainly going to cool down eventually.

Some are already preparing for this: Allan says Unite is increasingly reinvesting in both its property and services, rather than just trying to make short term gains. “Ultimately we’re going to get to a point of equilibrium and potentially see some decline. At that point the operators who are going to be successful will be those with really well established brands and strong partnerships with universities, and who are trusted by students and universities.”

Diversification may also be on the cards. This may mean a shift away from the dominance of developer-managers, like Unite and UPP, towards specialisation: dedicated investors, developers and managers may become giants in their own right. And while consolidation may be on the cards after Opal’s implosion, some are already starting to look at new opportunities overseas. “The mainland European market is like the UK was a decade ago in terms of its structure of supply,” notes Pullan. “You can look across and see that the main markets are going to require considerable volumes of purpose-built stock”.

Whatever happens, the market is inevitably going to have to grow up, but there may be some pains along the way. In the short to midterm, at least, the picture is bright. A bullish Knight Frank predicts that in 2014 we’ll see universities extending the leases they offer developers; rental growth at above inflation; and domestic and international student numbers up by 3% and 4% respectively. For the moment, at least, the party looks set to continue – and the canny still have lots of scope to clean up. ■

Unite’s Emily Bowes Court, London

2013

2013: China’s Gingko Tree and the Dutch Pension Fund PGGM acquire UPP for over £1 billion.

2013

After the collapse of Opal, US investors Greystar and Avenue Capital snap up two portfolios understood to be worth £300 million and £95 million respectively. Greystar is understood to be in the process of buying a £190 million development, jointly owned by Unite Group and Bahrain’s Oasis Capital Bank.